Adapting to Survive: The Future of Retail

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The traditional model for retail is rapidly becoming uncompetitive, as the digitization of design, manufacturing, distribution, and demand is exposing its inherent inefficiency. Businesses reliant on large, physical retail footprints, long lead-time design and production, capital-intensive inventory, and storage/distribution assets in order to generate margins now find themselves being outmaneuvered by nimble, agile, and innovative competitors. Individual consumers also expect more – more choice, more convenience, rapid delivery, and a more personalized service. Without adaptation to these new realities, retailers cannot thrive, and in many cases will not survive.

The End of an Era

The traditional retail model, which has been suffering for many years, is now at the point of failure with ever more consumers moving their shopping online. This comes at a time where there is a substantial – and growing – over-capacity of physical retail locations, particularly in America. Across the United States, there is approximately 23.5 square feet of shop space per capita, over five times more than in most Western European and Asian markets. As in-store sales continue to decline, retailers find themselves with a high-cost network of shops that attract fewer and fewer customers and generate ever lower revenues. As a result, average operating margins across the sector have declined by 20-25% in the last five years. As margins have shrunk, businesses have responded by cutting costs across all areas of the business, reducing service levels as expert staff are replaced with automated systems and front-line staff with lower levels of expertise. This cost-based agenda has created a less flexible operating model that is unable to respond to the current period of quickly evolving consumer demand and instead delivers a lower-quality customer experience. And, with more rapid change in consumer preference, aging of inventories has accelerated, leading to discounting for endemic liquidation of excess stock, further depressing margins.

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At the same time, store traffic has been steadily trending down as customers consolidate shopping trips and turn to ecommerce. The online share of global retail has doubled in the last five years. The largest players in the ecommerce space are online retailers who operate almost exclusively through digital channels that go direct to consumer. Digital engagement is becoming increasingly important for all parts of the customer purchase journey, from brand engagement, browsing and product selection, right through to payment.

COVID-19, and the global lockdown response, has only served to accelerate this trend. Digital consumption has not only increased dramatically, but customers are also reporting higher levels of satisfaction, with 45-55% of them expecting to continue their new or increased use of digital services post-COVID.

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Furthermore, as the economy begins to recover from the initial pandemic shock, the high street is likely to look very different. With heightened health-related concerns and suppressed consumer spending, many retailers will struggle to recover. Meanwhile, the stores that remain open will do so with reduced capacity in order to satisfy current social distancing requirements. In many cases, this will erode the social and experiential aspects of these stores, further embedding the digital shift.

To respond to the break-neck pace of changing preferences and the dramatic shift to digitally-mediated demand, retailers must fundamentally reimagine their propositions. They must go beyond just providing goods, and must also figure out how to cultivate deeper relationships with their customers through personalized services, unique experiences, and special offers, all buoyed by a digital-first approach that permeates all aspects of their business strategy.

Leading With a Digital-First Approach

In order to provide the personalized shopping experiences that customers increasingly expect both online and in-store, companies must understand how best to align their ecommerce, sales, and marketing teams. This means moving away from the traditional "split" in the retailers' mindset between brick-and mortar and digital and "bridging" both into a single, combined "brigital" experience. This shift requires much more than merely setting up a website or opening a "digital store." Competing effectively requires a fundamental change in a company's business model, with digital capabilities and data-led decision-making becoming central to all aspects of a retailer's operations.

Alignment of the brick-and-mortar experience in-store, with the digital mobile or on-line experience has the potential to create a seamless process where the customer can interact with the retailer flexibly, choosing the engagement that best suits them, thus combining the convenience and speed of shopping online with the interpersonal and experiential elements of shopping in-store.

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On the flip side, online retailers are also experimenting with physical retail. These digital natives are beginning to pilot stores built on digital rather than physical infrastructure. This approach allows them to add targeted physical locations, based on analysis of both their customers' needs and their supply chain's capabilities. This new thinking of the physical store as a complement of the digital proposition, as opposed to the traditional thinking of the digital capability as a complement of the physical store, is winning in the marketplace.

The physical/digital convergence will have retailer operating model and people implications. It will require frontline retail teams to be retrained and/or restructured, focusing on establishing new priorities that are relevant across multiple types of shopping experiences. Reallocating associates to act as online/video product experts, remote customer support or order fulfillment expeditors are some likely options.

Personalizing the Shopping Experience Using Data

Consumers are increasingly being marketed to by a broad range of organizations (including retailers) via the delivery of personalized experiences in a variety of the digital environments they frequent, including newsfeeds, entertainment and social platforms. Through digital advertising and individualized consumer targeting, retailers have found creative methods of remaining competitive by offering tailored and unique shopping experiences that both drives engagement and builds customer loyalty.

Companies are also beginning to provide personalization through product customization. By leveraging new technologies, retailers can offer a "mass-customization" option to consumers, which enables brands to offer a bespoke product without sacrificing speed or margins. For example, with the adoption of 3-D printing, companies are able to offer customers the option of providing input into the design of the product they want to order. Sporting goods retailers – including New Balance, Reebok, and Adidas – have partnered with tech companies to offer custom shoes which incorporate 3-D-printed components, delivered in a matter of days, not weeks or months.

The demand for personalization goes beyond product choice, as consumers seek unique experiences that fit their preferences and lifestyles. As capabilities evolve, smart retailers will employ advanced analytics in order to gain deeper insights into consumer preferences, allowing more effective customer segmentation while also building feedback loops to ensure design and allocation decisions are aligned with their consumers' needs. Where data was traditionally leveraged solely to drive stock and marketing decisions, increasingly detailed customer profiles and "segments of one" have expanded the personalization opportunities from targeted emails to entirely customized online interfaces and unique assortment building for individual shoppers.

The ability to execute at this more granular level has been accelerated by the explosion of data in the last few years as mobile penetration has increased. Previously, demographic and point-of-sale data were the main drivers of consumer analytics, however, retailers can now combine multiple other data sources, including psychographic and ethnographic data, geo-analytics and device data, wallet and loyalty program data, and service consumption and customer service interaction data. These data sets will increasingly be employed to build the "360-degree view" of individual consumers, which will then be utilized to micro-target potential customers.

Retailers will not only personalize their online business using big data. The "brigital" model also requires use of deep analytic capabilities to re-configure physical stores into "experience centers," allowing the creation of a differentiated, "in-store experience" to drive retention and loyalty. This means converting stores into a curated set of brand experiences. One early example is the way Apple has designed its Apple Stores, which offer a signature brand experience focused around the provision of expert-level customer service through the in-store "Genius Bar." This creates demand for customer support, while simultaneously encouraging customers to more deeply engage with their products. In order to survive, brick-and-mortar retailers will have to quickly grapple with how to reposition their physical offerings, identifying what their customers want, and ultimately reconfiguring store formats and locations to adhere to these new demands.

Prioritizing Socially Conscious Retailing

As retailers seek to create deeper relationships with their customers, they are increasingly being judged in the context of social and ethical priorities of their consumers. With product discovery and brand preference established in a wider context than ever before, retailers must place a greater focus on the implementation of their CSR and ESG agendas. Rising social consciousness, combined with greater product variety, means customers are deliberately choosing to support companies that align with their social values. For a growing number of consumers, supporting specific retailers is becoming a political, ethical, and social statement, not just a simple product choice.

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As a result, companies must position themselves favorably among their target customer base, actively using social media channels to push positive brand narratives. Nike is in the vanguard for this, releasing regular campaigns that address current social issues, including taking a leading role in the Black Lives Matter movement well before other major corporations engaged in the topic.

Beyond social and ethical considerations, consumers are demanding more in terms of environmental sustainability. Many have started voting with their wallets, leading to the rapid growth of secondhand retail. For example, the clothing resale market in the U.S. has grown 21 times faster than new apparel retail in the last three years, as customers have sought alternatives to "fast fashion."

The Digital Demand Chain

For companies trying to reposition their customer propositions for the booming digital economy, traditional retail supply chains are a bottleneck. Their long lead times, high capital investment, and substantial inventory requirements no longer provide the tools to compete. This has only become more apparent during the pandemic as retail traffic has plummeted. Consequently, many retailers who had already placed orders for their summer stock in Q1 2020 (or before) had to alter or cancel releases. This excess inventory created stock gluts, drove greater discounting, and placed under-capitalized firms at the risk of insolvency.

To successfully adapt, retailers must transform their supply chain into a "digital demand chain." This model of ongoing demand sensing will enable retailers to align real-time consumer insights to agile, flexible sourcing that can adapt to the ever-changing retail environment. The demand chain avoids the main problems of the traditional model – inventory and markdown risk – by better understanding customers' preferences and leveraging digital tools to enable shorter planning windows.

At the heart of this understanding sits the improved integration of customer data, collected and analyzed in real-time across all physical and digital engagements. With the wealth of customer information already being captured to drive personalization, retailers can leverage their analytics capabilities to inform their manufacturing, inventory, and logistics operations.

Digital marketing has similarly opened up a plethora of opportunities, both for data collection and location-agnostic customer engagement. Campaigns run on the internet, and social media can be targeted to the appropriate audience and interwoven into their personally curated feeds. Consumers interact with these advertisements immediately, placing orders digitally within minutes. This shortens the time between campaign inception and sale of product, creating a real-time feedback loop regarding customer preferences for both marketing and sales teams - a critical input for a company's flexible back-end operations.

The digital demand chain also rewards businesses for speed. In the old model, it can take more than nine months to deliver products from design to the store. Reliance on demand forecasting, often up to one year in advance, results in inflexible operations, with decisions made with limited visibility into demand, high inventory intensity, and significant warehousing investment to hold the inventory. Unexpected negative shocks to this model of operation have serious implications on the economics of the business, as they can be left with a significant amount of aged inventory.

This inefficiency has led to margin degradation and the rise of self-competing off-price retail that continues to gain share of consumer wallets. Countering this risk requires investment in faster fulfillment capabilities, adjusting design calendars while cutting production lead times by 40-60% to reduce inventory intensity and markdown risk. The growth of the internet, drop in cloud storage costs, and increasing use of API-based integration between systems enables real-time information flow which makes agile adjustments in production and logistics schedules across the supply chain increasingly feasible.

But this alone is not enough. Businesses are also able to further drive down lead times by enhancing sales through their online platforms and shipping directly to the customer rather than waiting for inventory to be sold in-store. This shifts the distribution from a "push" to a "pull" model, allowing demand to drive production, with supply chains shifted to facilitate loose-pair and drop-ship distribution.

However, this cannot be achieved with retailers' existing logistics operations. Instead, companies must review and reconfigure their distribution footprint to cater to specific categories and geographies. In many cases, as the need to hold inventory declines with better demand sensing, this will mean closing large central warehouses and relying instead on multiple, smaller distribution centers closer to the end consumer, including re-designating some stores (or parts of some stores) as local distribution centers, cutting down delivery times and delivering on the consumer's expectation for speed.

Amazon has set the standard for rapid response delivery, but in so doing has raised customer expectations, both on speed and price. This is a challenge for many retailers, for whom low AURs and compressed gross margin cannot cover the costs of a competitive delivery model. Instead, they must seek alternatives. One answer could be recent innovations around collection – e.g. curbside pick-up and in-store collection – which blend the physical and digital shopping experiences, while still providing the convenience of rapid delivery. These can draw customers into redesigned physical stores that provide the experiences and services central to future retail success. We will see the more forward-looking retailers driving digital- and data-led innovation in order to drive further cross/up-sell at the curbside as it becomes an increasingly relevant and salient customer touchpoint.

Smaller organizations will likely continue to struggle to keep up with this decentralized delivery model, as they lack access to the distribution networks of their larger competitors. To address this, niche players can partner with the larger platforms who provide various infrastructure such as payments and distribution architecture.

Additionally, businesses should also look to refine their manufacturing and production centers. By leveraging the recent technological advancements which are cutting down production times, companies can further reduce the design-to-store cycle and create the ability to restock their supply chain based on a real-time view of customer demand.

Lastly, the impact of COVID-19 has highlighted the value of manufacturing diversification. The global pandemic has brought into focus the risks of consolidated supply chains susceptible to localized disruption. As such, spreading risk is becoming an increasing priority in order to protect against future shocks. Indeed, this is becoming a matter of public policy, as well as retailer concern. For example, the Japanese government has decided to financially support diversification by committing $2bn to moving large parts of Japanese multinational corporations' manufacturing operations out of China.

Conclusion

As the digital economy booms, customers are changing the way they shop and interact with retailers. COVID-19 has further exposed the weaknesses of the traditional retail model, which relied on high footfall, high inventory intensity and a multi-tiered warehouse-centric distribution model. Retailers must adapt to remain relevant by re-imagining their physical and digital propositions; adopting a digital-first approach to create a unique customer experience by offering personalized products and services; and re-designing their supply chain into a fast, flexible demand-sensing chain that continually adapts to changing consumer preferences. This is likely to mean a radical overhaul of the existing logistics operations and a comprehensive review of footprint configuration (across store, warehouse, and supplier footprints), accelerated closure of redundant locations, the restructuring of back-end teams, and increased reliance on data and analytical capabilities to enable real-time insights and agile decision-making.