Grant Thornton

Pressure unabated

UK retailers contemplate business model change

Economist Intelligence Unit | The Economist

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Foreword

Do existing business models still deliver the goods?

Most companies need to review, and possibly renew, their business models. This report, written in cooperation with the Economist Intelligence Unit, reviews issues around the resilience and robustness of business models in the retail sector over the past 18 months and how they may fare in the future.

A key finding of the research indicates a lack of urgency, even complacency, among two-thirds of respondents, when faced with the need to change the ways they do business.

Most retailers surveyed turned to cost-cutting at the outset of the recession, and only a small percentage appear to have taken opportunities to better position themselves as the upturn comes. Having taken aggressive measures in the past two years to adjust their cost structure, retailers are now focusing their attention in particular on their target markets.

Retailers need to turn the data that they have on customers into information, so that they are better at selling product that customers want, when they want it.

We believe that this report will stimulate board room discussions about strategic options, and trigger the move from retrenchment to fresh thinking to capture the fleeting opportunities available.

David Bush
Associate Director
Retail Sector
Grant Thornton UK LLP

Defining the business model

For the purposes of this study, we identify five components of the business model:

1. The value proposition:
or the benefits that a company's products or services provide to its customers.

2. Target markets:
the customer segments and product and geographic markets a company aims to serve.

3. Revenue-generation mechanisms:
an organisation's revenue and pricing models – for example, its decisions to earn revenue through direct sales, licensing, franchising, subscription or other mechanisms.

4. Cost structure:
or the balance of fixed, variable and other costs within the organisation.

5. Value chain:
combining a company's supply chain and the sales and distribution channels it uses to deliver its products and services to market.

fresh thinking

About the research
The analysis in this study – one of a series of four reports on business model change in the UK and Ireland – is based on a survey of 53 senior executives of retail firms in the United Kingdom. This was part of a larger cross-industry survey of 465 executives in the UK and the Republic of Ireland conducted by the Economist Intelligence Unit in October-November 2009, commissioned by Grant Thornton.*

All content in the report was written by the Economist Intelligence Unit, with the exception of the foreword and other external perspectives presented elsewhere in the report. Please note that not all survey data shown in the charts add up to 100%, because of rounding or because respondents were able to provide multiple answers to some questions.

*See Retrench or refresh? Do existing business models still deliver the goods? Available at **www.grant-thornton.co.uk/refresh**

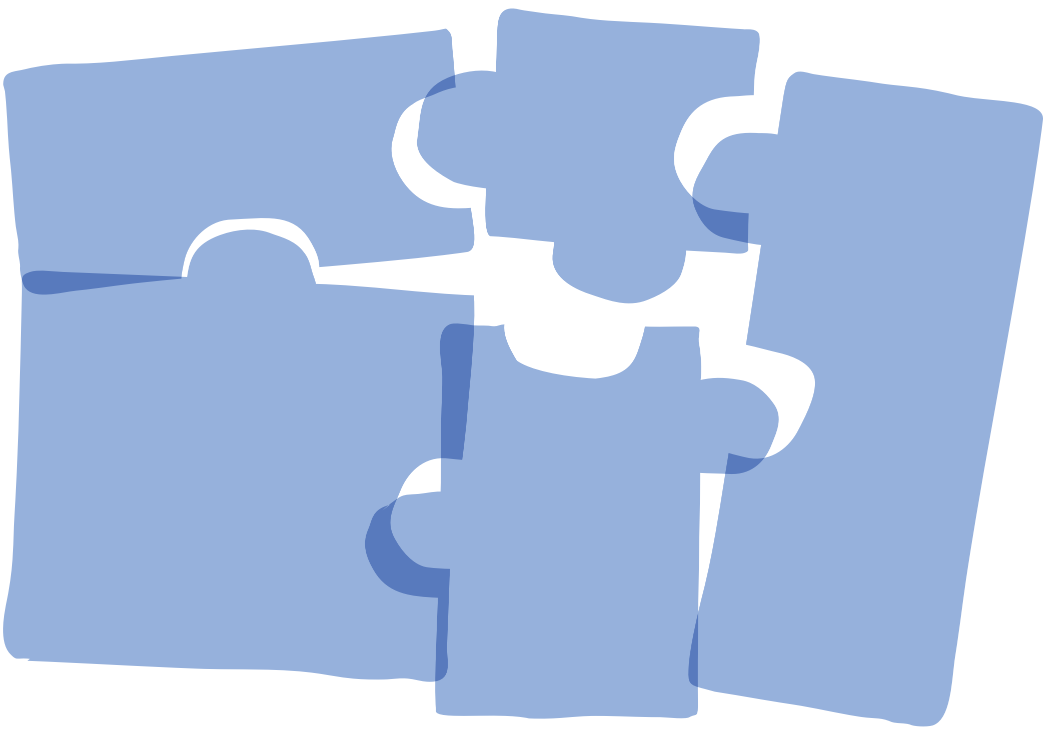
Pressure unabated

UK retailers contemplate business model change

Business model change has been on the agenda of UK retail firms from well before the downturn. Consolidation and the growing power of large nationwide chains, for example, had already been forcing middle market and smaller players to reconsider their product range and distribution channels. Arguably the most profound shifts had resulted from the emergence of the internet, and the ability of some retailers to establish entirely new electronic sales channels with vastly different cost structures.

All of which may help to explain why a clear majority of UK retailers surveyed by the Economist Intelligence Unit believe their business models have weathered the recession well and are sufficiently robust to take them into the post-recovery environment. However, the downturn has clearly had an impact on retail industry structure by, among other things, forcing many small shops to the wall and accelerating consolidation, and catalysing a shift of consumption towards discount retailers and away from niche outlets and brands. Far from all retailers, moreover, have managed to establish a viable presence online.

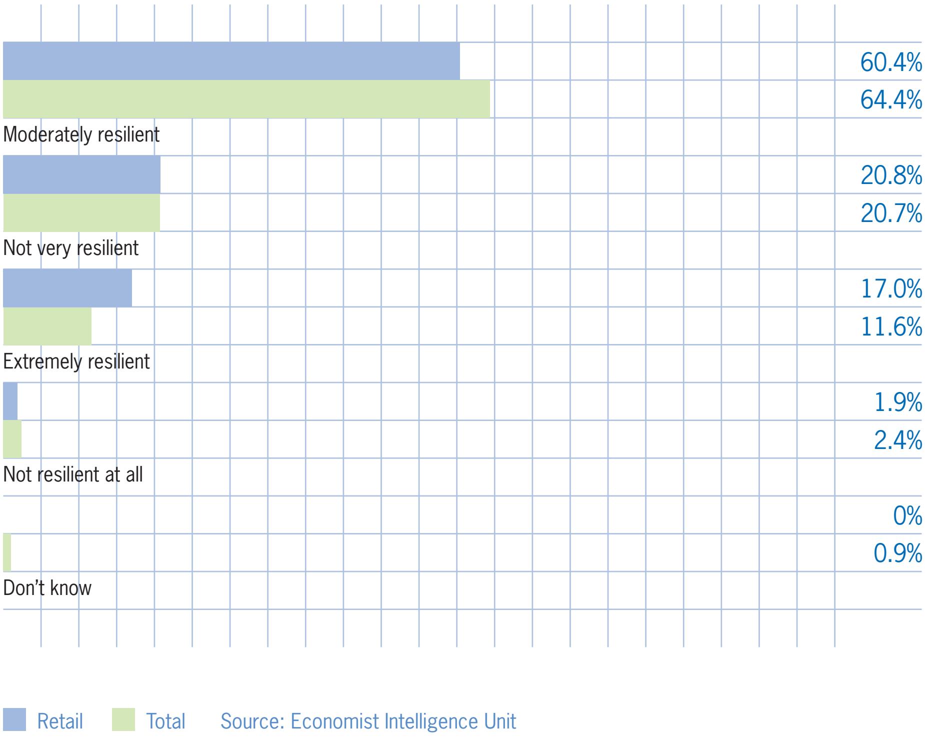
This study suggests that, notwithstanding the confidence that UK retailers harbour in the soundness of their business models – the core objectives they pursue and the ways in which they operate – there remain good reasons to review their key assumptions. Over the next 18 months many will continue to make adjustments to their business models as a result, of varying degrees of magnitude.



Confidence or complacency?

As the British economy climbs out of the toughest downturn in living memory, senior executives in the retail industry seem remarkably relaxed about the state of their business models. Over three-quarters of retail respondents to the survey say their business models have proved resilient during the recession. And the vast majority believe that their existing models will serve their companies well over the next 18 months and will not require major changes. Most respondents, moreover, appear optimistic about the demand outlook in their markets, with 60% expecting 'full economic recovery' within a year, a noticeably more upbeat view than in other industries – no more than 46% of respondents in the wider survey expect recovery in this time frame.

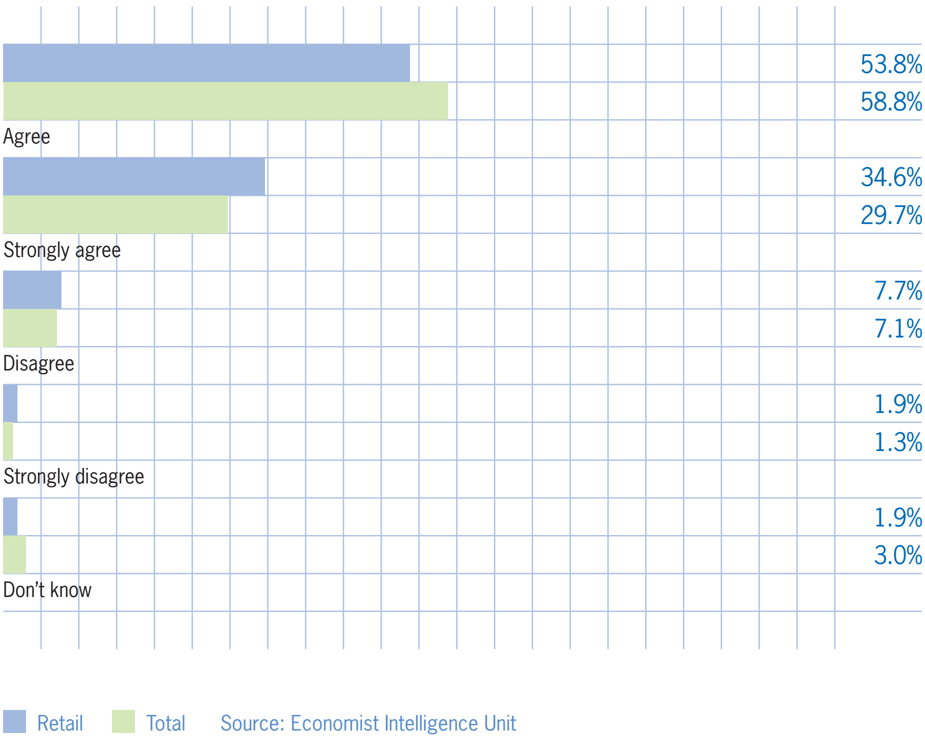
How resilient would you say your company's business model has proven to be during the recent economic downturn? (% responses)



Source: Economist Intelligence Unit

Are the assumptions of UK retailers realistic? The majority expectation of early market recovery may indeed be over-optimistic. In fact, retail sales rose by just 0.7% quarter-on-quarter in the fourth quarter of 2009, which the Economist Intelligence Unit said is disappointing, given that sales usually expand strongly in the Christmas period. The EIU expects that, despite government efforts to stimulate consumer spending, retail activity in the UK is likely to remain sluggish in the near-term future, with sales volumes falling by 1% in 2010 and by 0.5% in 2011, following a 2.5% decline in 2009. Over one-third of survey respondents acknowledge that their assumptions about demand growth are likely to change in the next 18 months – quite possibly in a negative direction.

Do you agree or disagree with the following statement? Our existing business model is set up to enable us to succeed over the next 18 months. (% responses)



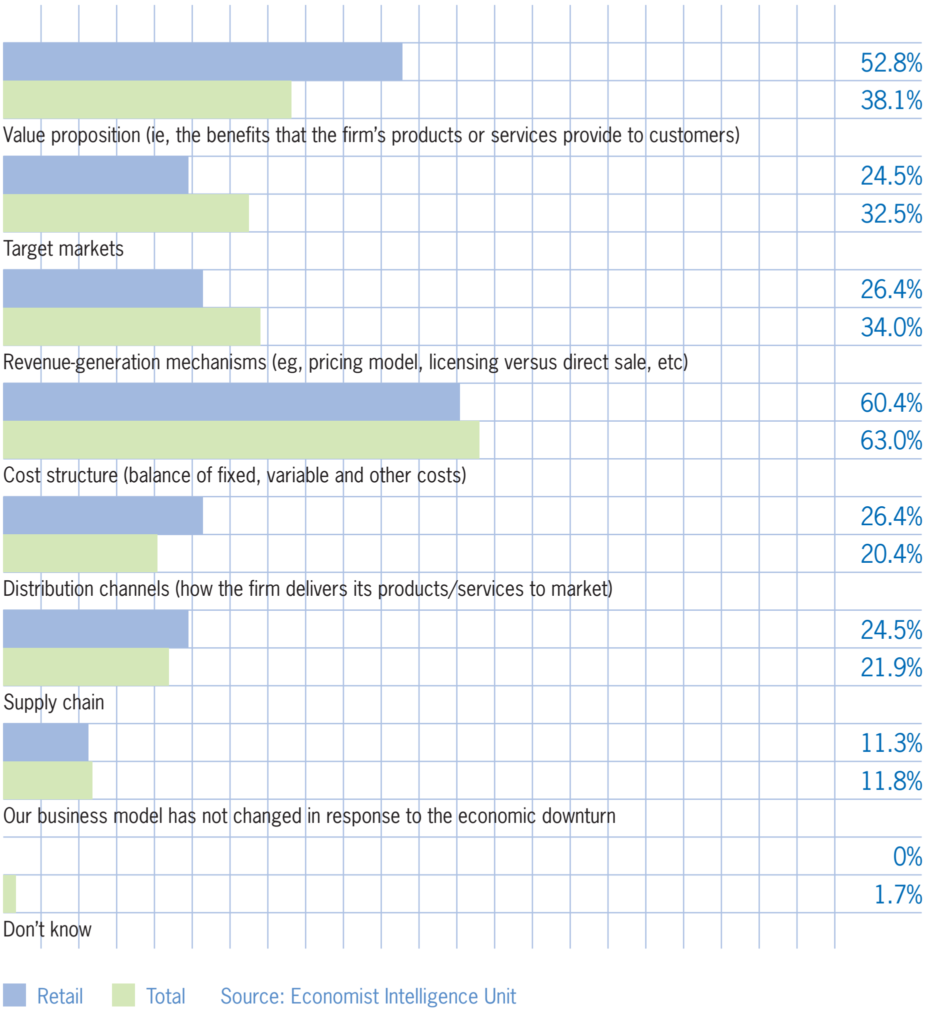
Source: Economist Intelligence Unit

A different-looking industry structure may also emerge after the recovery. The headlines have been grabbed by the collapse of major chains such as Woolworths and the bookseller Borders UK. But the bigger casualties are the small shops that are disappearing fast: the British Retail Consortium, a trade body, says retail employment has fallen by close to 80,000 over the past five years as the market shifts towards fewer, larger shops.

Retailers may be confident about the state of their business models, but most have made some adjustments as a result of the recession. Mainly this has involved necessary changes to the cost structure of their business. But a significantly larger share of executives than in other industries (53% in retail against 38% in the overall sample) say their firms have also changed their value proposition – the products and services they provide.

An example is Republic, a nationwide fashion chain based in the north of England which, through its 96 shops, sells fashion garments to 18-25 year olds, especially designer-labelled jeans. “It is certainly not a recession-proof market,” affirms Finance Director Ed Bennison. He thinks the cash-rich target market (often earning and still living with parents) “will still spend £100… but they will want more for their money.”

In which of the following areas has your company already made significant changes to its business model in response to the economic downturn? Select all that apply. (% responses)

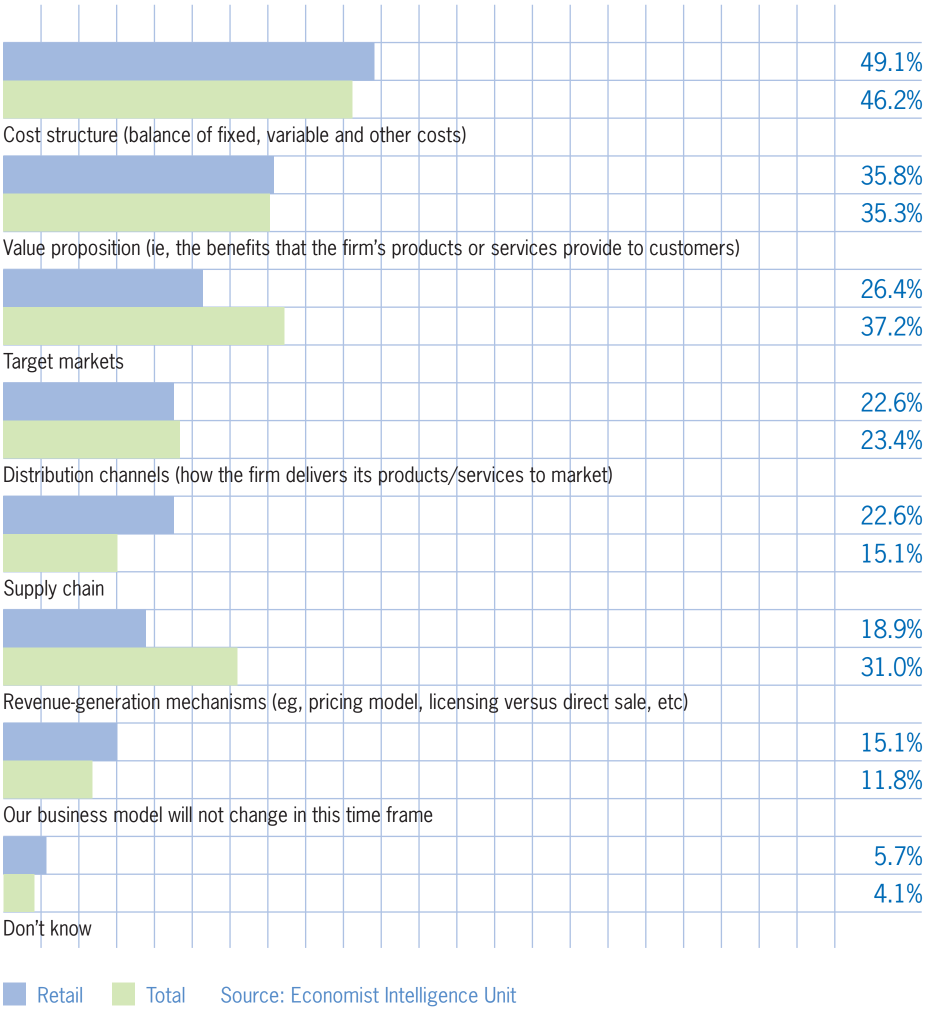


Source: Economist Intelligence Unit

Republic has therefore quietly switched away from its concentration on big-name brands. It still sells them, and it relies on being perceived as an upmarket chain, but well over half of its sales now come from its own brands. "We have doubled our in-house design team to around 40, and we scan the catwalks to make sure our offerings appeal to our ultra-trendy audience," says Mr Bennison. "These internal brands are both cheaper to the customer and higher margin for the company than outside ones," he reports.

Why do so many British and Irish companies exhibit an apparent lack of ambition when it comes to business model innovation? A lucky few, as noted above, may have reason to think there is no pressing need for change. Nobody, however, is completely safe in current conditions. David Bateman, Financial Director of the card and stationery retailer Paperchase, notes that, even though demand in his market typically remains relatively constant during downturns, the collapse of Woolworths and other retailers presented a challenge with large supplies of cards, stationery and wrapping paper coming onto the market at a deep discount.

In which of the following areas does your company plan to make significant changes to its business model in the next 18 months? Select all that apply. (% responses)



Source: Economist Intelligence Unit

Other retailers plan to change their value proposition in different ways. Wiggle, an online seller of bicycle accessories, plans not only to modify its product mix but also to seek new growth overseas. Similar to other business model changes being made by retailers, however, the drivers are not necessarily recession-related. "UK market growth has peaked," says Mark Advani, a director at Wiggle. As a result, he reports, "we will expand internationally and boost our home sales by increasing the number of complete bikes we sell. We will still sell only online but we're changing our markets."
(See case study on page 10.)

Case study

E-tailing works

"Today, high street fashion stores," says Andrew Curran, COO of the fashion e-tailer My-wardrobe.com, "are consciously delaying investment in their websites to husband cash in the downturn, allowing My-wardrobe.com and its competitors to stake out much more of this lucrative growth market than they otherwise might." Andrew reports that online trading is growing, and fashion is the fastest growing segment within that. "We have unexpectedly found ourselves in a sweet spot," he says, "with sales increasing by 168% over the previous year."

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Case study

Wiggle responds to a maturing market

Bicycle sales have held up well during the downturn, as people worry about health and congestion, not to mention the cost of using their cars. And internet selling is a new and still fast-growing part of the £1bn-per-year bicycle business. All of which helps to explain the success of Wiggle Ltd, the UK's biggest bicycle seller online, with 2008 turnover of £33m.

But as the market matures the firm must change its business model to keep growing. Mark Advani, a director at Wiggle and a partner at ISIS, the private equity firm that bought a 42% stake in 2005, reports that UK market growth in Wiggle's niche is at its peak, and the company needs to look to other markets to sustain its growth.

The site started off selling a range of upmarket racing cycle parts and expanded into mountain bikes and triathlon, offering running and swimming gear. Wiggle had considered expanding further, aping the continental sports shop model by selling skiing and tennis gear alongside bikes and running shoes. But, says Mr Advani, along with the decision to sell complete bikes, an expansion into overseas markets is Wiggle's response to the maturing UK market.

Mr Advani maintains that Wiggle's success in establishing reliable delivery systems in the UK can give it an advantage overseas. The firm now sells to 70 countries and has translated its site into several different languages. It started to push overseas sales in mid-2008, and within six months international sales had grown tenfold. "We'll see where the demand comes from," he says. "But sales to Australia have taken off because we can more than compete on delivery times – and costs – with local rivals. International delivery adds surprisingly little to costs."

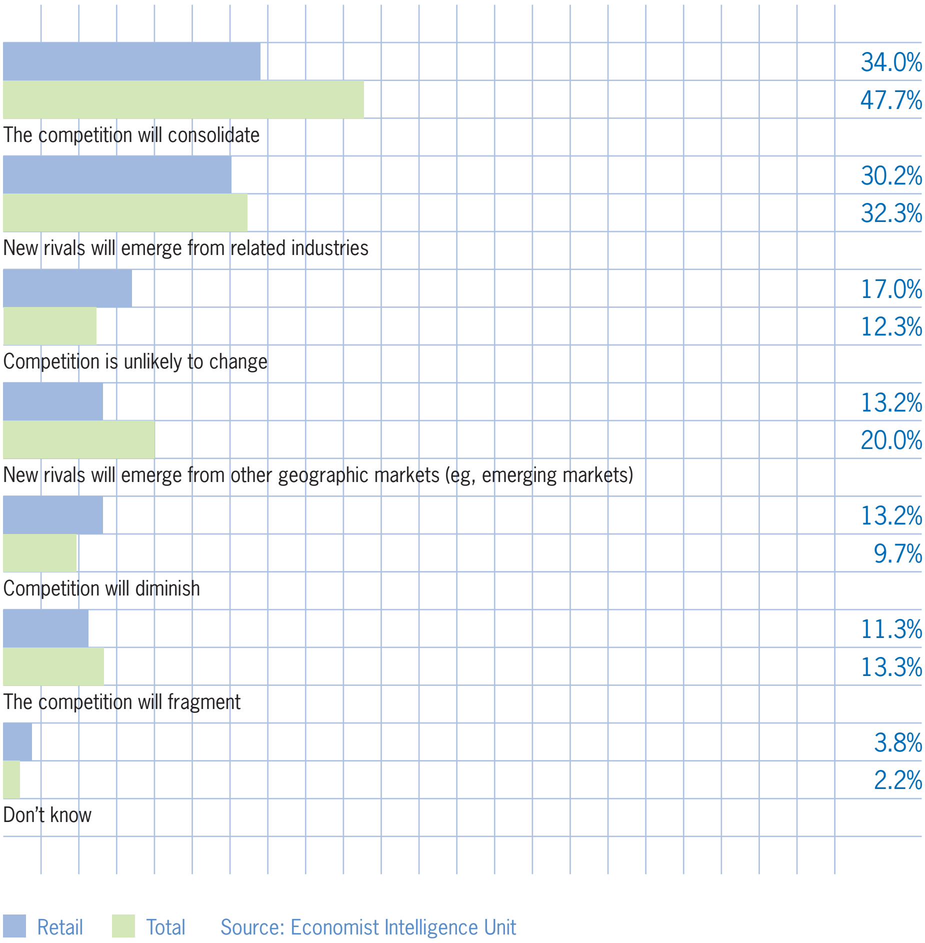
Growing the number of complete bicycles it sells will bring Wiggle into head-on competition with traditional bike retailers which sell both in shop and online. Wiggle already has carved a niche among upmarket bike buyers by striking exclusive deals with manufacturers such as Germany's Focus, meaning it can offer decent bikes cheaply. In order to expand on this, talks are ongoing with other large bike manufacturers, and there are also hints that Wiggle could introduce its own range of bikes. This would lower prices and boost margins, but this will be a tougher nut to crack than components, and it might require a larger change to Wiggle's successful business model than currently contemplated.

The competitive pressures build

They may be sanguine about the robustness of their business models, but UK retailers expect the competitive pressures in their sector to remain intense.

Among the 28% of survey respondents who believe that their future assumptions regarding the competitive environment are likely to change, more expect the changes to result from threats rather than opportunities. The most likely changes to the competitive environment over the next 18 months, judging by the survey, will lead to more consolidation as well as the emergence of new rivals from other industries.

How do you anticipate your competitive environment changing over the next 18 months? (% responses)



Source: Economist Intelligence Unit

Supermarkets will likely encounter greater pressure from discount retailers that have done well in the recession. Germany's Aldi and Lidl discount supermarkets are expanding aggressively, for example, with Aldi growing UK sales by 25% last year. It says it will open a store a week in Britain until its market share has tripled to 10%. Poundland, which as its name suggests sells everything for £1, is expanding quickly as well, acquiring part of the defunct Woolworths chain and opening 50 new stores in 2009 as consumers flocked to its modestly priced offerings.

The discounters' expansion adds to the pressure on supermarkets to sell cheaper ranges on the one hand and to expand into new, higher margin areas on the other. Two of the UK's biggest chains, Tesco and Sainsbury's, are pursuing essentially the same strategy in this regard. They are crunching suppliers on cost and increasing the number of own-label goods they sell, allowing the chains to maximise their margins while squeezing product prices.

The large retailers are also expanding into new areas, including financial services and non-food items such as electronics. And they are segmenting the market by developing different categories of own-label goods and by launching new shop formats ranging from small local convenience stores to, in Tesco's case, non-food outlets selling cheap books and electronics.

Other large retailers, such as the music seller HMV, are also expanding into new areas, including books and electronics, as they try to maintain sales and margins beaten down by recession. "We need to change," affirms HMV's Director of Corporate Communications, Paul Barker. "Our traditional markets are migrating to the internet and so we can't simply carry on using our shops to sell DVDs and CDs. Instead, we need to turn ourselves into an entertainment provider, regardless of medium." In other words, HMV must sell both online and through shops, and it must give people access to music through CDs, downloads and concert tickets. (See case study on page 15).

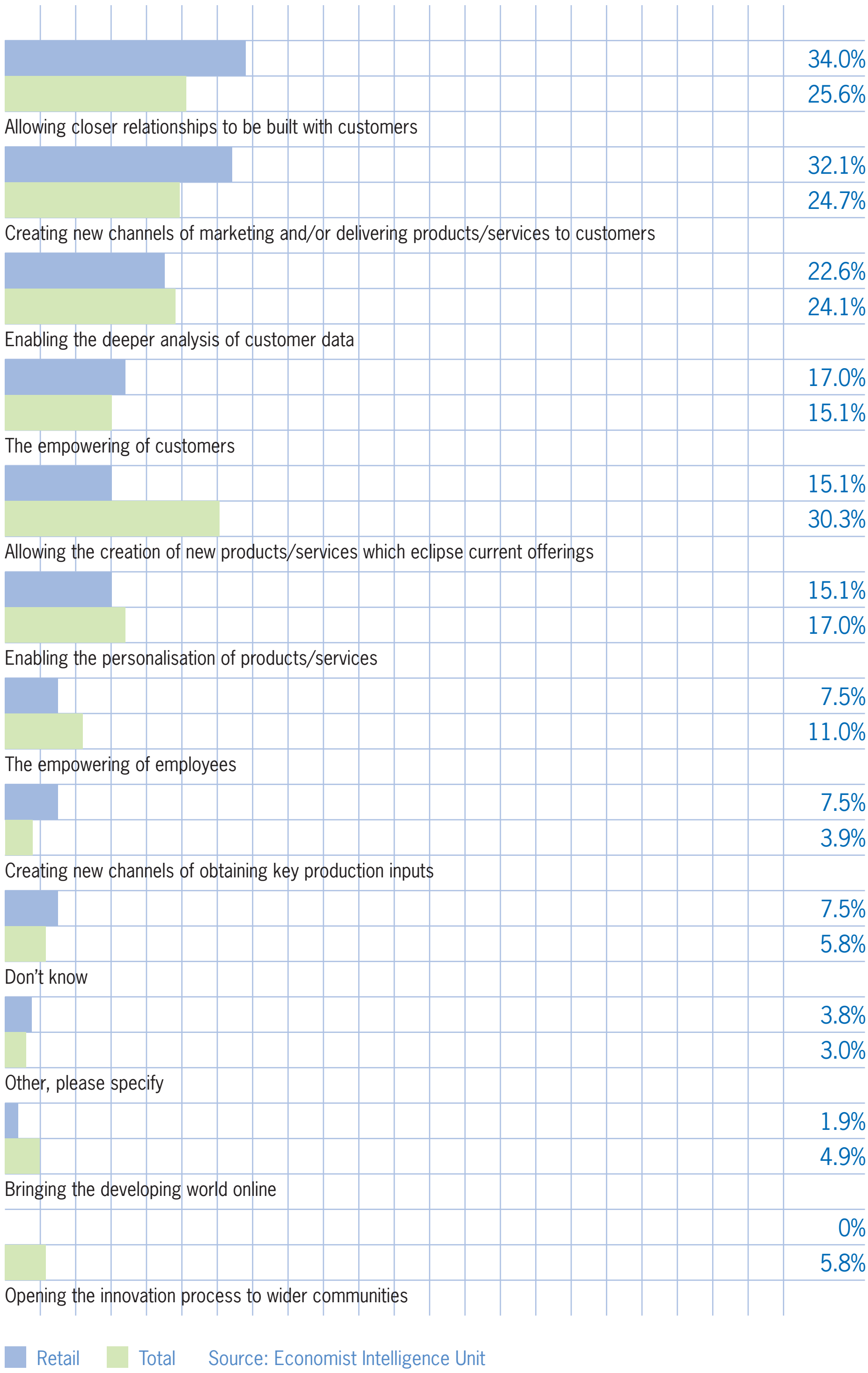
Findings

The internet challenge

Many ‘bricks and mortar’ retailers are indeed increasing their presence on the internet, both to broaden their customer base and to battle competition from cut-price internet sellers. “Customers expect it from us,” says Paperchase’s David Bateman, “although internet sales will never be huge for the company.”

Online sales are already significant for other traditional retailers, however, and the market is coming to be dominated by players that combine physical stores with an internet presence. Online selling (and a successful range of cheaper goods) has helped the department store John Lewis to flourish in the recession, along with its food-selling partner Waitrose. And supermarkets including Tesco and Sainsbury’s have launched successful internet operations, offering people the convenience of home food delivery and the chance to buy everything from books to televisions online.

In which ways will technology impact most heavily on your business model in the next 18 months? Select up to two. (% responses)



Source: Economist Intelligence Unit

Case study

HMV girds for tough change to come

HMV, the UK's largest music and film retailer, has posted remarkably good results given the recession: profits to the end of April 2009 expanded by over 22% to £63m, on turnover up 2% to £1.96bn. HMV's last interim statement showed sales up 12.8% to £471m in the six months to 24 October 2009, with loss reduced to £6.7m from £12.7m. In the five weeks to 2 January 2010 – including the crucial Christmas trading period – sales were up 14.6% year-on-year.

Its market is shifting fundamentally, however, and the company acknowledges that it must change its business model to survive. "We're losing our core markets to the internet," says Paul Barker, HMV's Director of Corporate Communications. "We expect music [CD] sales to fall by 15% a year. And the same thing will happen to film [DVD] and eventually to games."

The company's change initiatives predate the recovery to 2007, after a profit warning the previous year almost led to a private equity takeover. "We couldn't carry on as we were," says Mr Barker. "We've had to play down the importance of music and films in our sales mix and increase our exposure to the computer gaming market, which now accounts for a quarter of sales." The company also cut back on its international exposure (selling out of Japan, for example) to focus on its core UK market.

Now it is battling its online competitors head on, not just by selling DVDs and CDs online but also by launching a music download site at the start of 2010 (although Mr Barker accepts that it will not be easy to break down Apple's dominance in this area). In the short term, this may be a convincing response to a changed market. It may not be a solution for the longer term, however, as the days of the music – and games – shop seem numbered.

HMV's response is to turn itself into an entertainment specialist, regardless of medium. It now sells concert tickets through some of its stores and its website, for example. Customers can try out games in-store, and some stores are even being converted into gaming centres, where people can play against each other or over the internet. Perhaps its most innovative initiative is a joint venture set up with cinema operator Curzon to open movie theatres in its shops.

"We're experimenting with ideas to see which will work," says Mr Barker. "HMV must follow its market. And we accept that could mean our retail stores become redundant."

The importance of internet selling varies between sectors, but a decent web presence has become essential to retailers. Companies such as Republic and Paperchase claim to sell relatively little over the web, for example, but customers do view designs on the site before buying in-store. At the other extreme is multi-channel retailer DSG International, which owns the Currys and PC World electronics stores and Dixons.co.uk. Its tech-savvy customers increasingly buy online. And the revenue model of bicycle accessory retailer Wiggle Ltd is predicated entirely on internet sales.

All of which means that successful retailers have little choice but to establish an online presence, both to add to their own offerings and to battle the competition from pure internet shops with their lower cost-base. It is an essential, but forward-looking, move.

"We couldn't carry on as we were," says Mr Barker, speaking of HMV's efforts to establish sales channels across all mediums. It is clear that it must be able to sell music and entertainment online, but Mr Barker is also certain that the games market will eventually migrate to the web.

At the moment, internet selling remains a surprisingly modest part of the overall retail market. Online retail spending in the UK totalled a little over £4bn in July 2009, according to Interactive Media in Retail Group, an industry body – just 1.5% of the overall annual retail market, which is worth £271bn. However, net selling is growing significantly faster than the overall market, with sales up 17% in July 2009 on a year earlier, and it is more advanced in the UK than in most other markets, especially in Europe. The Economist Intelligence Unit believes that by 2014 Britain will account for over one-third of all European internet sales.

Hence the urgency for retailers to establish an online presence in the UK. Some companies also seek to use the UK's internet retailing know-how to unlock international markets. Wiggle Ltd now sells to 70 countries through its online portal, for example. "UK firms have a distinct advantage over many foreign rivals here," says Mr Advani, "thanks to Britain's highly developed internet shopping culture."

Conclusion

Given the long-standing pressures buffeting their sector, and the upheaval in markets caused by the downturn, it would be harsh to view UK retailers' confidence in their business models as 'head in the sand'. Some of the assumptions expressed by industry executives in the survey, to be sure, ought to be reviewed critically. This pertains especially to the hopes of an early recovery of their markets. And, while this report has pointed to several retailers which have established successful internet businesses, many have yet to tap into the advantages of selling online.

There is little question, though, that under relentless competitive pressure, British retailers will continue making adjustments to many elements of their business model, ranging from changes in the cost structure and product mix to a shift of focus on new customer segments – or on new country markets – to the adoption of new electronic delivery channels. In the unforgiving industry environment in which they operate, they will have to do this to survive.

Expert opinion on what to do next

We asked David Bush, retail expert at Grant Thornton for his views:

David Bush,
retail expert
Grant Thornton

What changes in business models (ways of doing business) are needed if retailers are to survive in today's uncertain economic climate?

Retailers need to adapt more to modern technology. This means creating seamless channels to market; eg Next: mail order, stores, internet. The proposition is still the same. Retailers need to turn the data that they have on customers into information, so that they are better at selling product that customers want, when they want it.

What should retail business leaders focus on to survive?

Ultimately, successful retailers need to be able to sell product that their customer wants to buy, at perceived good value (not necessarily the cheapest) and the stock needs to be available at the right time (ie supply chain needs to be right – no good the product sitting in the warehouse rather than stores). Strong customer flow is key, then all the retailer needs to focus on is ensuring repeat business and up-selling to increase the average transaction value. If the customer base is declining, then the retailer is ultimately doomed.

Where are the weaknesses in today's retail business models?

The major weaknesses are taking the customer for granted and not responding quickly enough to sudden drops in customer footfalls. Once the customers are gone, it is very difficult to regain them.

A view from Tim Ward Chief Executive, Quoted Companies Alliance

There has been a great focus on cost-cutting in the recession, which is a natural reaction to this situation. While 'trimming off the fat' can help a business to survive in the short term, the way in which business leaders go about it needs to be carefully considered.

Cost-cutting across the board is not always beneficial – it can hamper a business's ability to survive, for example, by restricting cash to innovative projects that could deliver a new product or service or by cutting key drivers of the business.

The current economic environment could be the new 'normal' where the economy does not return to previous highs. Businesses need more than ever to focus on revenue growth and how they can adapt their business models to the challenges presented by this market (ie little credit available and a lack of bank finance). The thinking which was used to arrive at the current situation will not be successful in developing a plan to thrive in this environment. This is when non-executive directors and other external influencers can play a key part in developing new thinking and new behaviours.

Businesses which find themselves in difficulty need to apply their business model in new ways, they need to identify strategic opportunities that will allow their businesses to grow, and then develop a clear implementation plan.

The small and mid-cap quoted sector, which the Quoted Companies Alliance represents, has been hit hard by the downturn. The QCA is working hard to ensure that companies continue to be able to access equity and debt capital to finance their business, whilst providing opportunities for quoted businesses to engage with their shareholders across a range of events.

Comment from Jonathan Kestenbaum, CEO, NESTA

Regardless of what sector you are in, survival means gaining an edge on your competitors. And the best way to do this is by investing in innovation – developing new products, services or business models which create value for your customers. NESTA's research shows that those companies which invested in innovation – measured by the percentage of sales from new products – grew twice as fast as non innovative firms and they saw a 10% growth in turnover, in contrast to 5.8% for non-innovators.

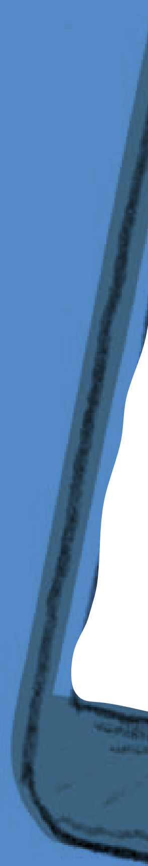
Companies are under enormous pressure to get products brought to market quickly, and this must be reflected in having a nimble approach to idea generation and product or service development.

This means structuring your workforce and resources so that you can respond quickly to challenges, take on board new ideas, and then move to exploit opportunities. Look to take a bite out of markets that were previously not open – the downturn has meant a change for everyone. All companies are now considering new options to save money, provide a better service to customers and to break into new markets. Where there is change there is opportunity for the business leader who is open to innovating. Successful innovation is often less about 'magic bullet' breakthroughs – and much more about core attributes such as adoption, flexibility and agility.

Put business models on the board agenda

Our research shows that most retailers need to review, and possibly renew, their business models.

Here are some suggestions from our own experts on the areas that you might wish to table:



Assumptions

Review those made when the model was last discussed – are they still valid or do you need to revise them?

Focus

Is it too internal or on the right customers?

Customers

Are you satisfying the needs of an ever more value conscious, more demanding market?

What changes do you need to make to ensure competitiveness of your product/service offering?

Can you better involve customers in new services/product development?

Markets

Are you in the right markets, product/service/geographic – are there new growth opportunities to be exploited?

What new technologies might you use to kick-start growth?

What M&A opportunities exist? eg from competitors in distress.

Competitors

How have your competitors responded to the downturn?

Have they focused more on innovation and growth than pure cost-cutting?

Funding structure

Is it still appropriate or are there alternatives available?

Resources

How flexible is your organisation in adapting to the changes brought about by the recession?

Could you source supplies from a lower cost country?

Are outsourcing options available?

Financial performance

How cash generative is your business?

Where could you improve margins?

Have you identified surplus costs?

What opportunities exist to improve your operational efficiency?

Reduce overheads and shut down or mothball unprofitable workstreams.

Talent

Are you acquiring, identifying and nurturing the best people?

Do you have the right leadership and people in place to take your strategy forward?

Relationships

How are you protecting relationships with customers, staff, suppliers, stakeholders?

Are you communicating transparently with them?

Contributors

Grant Thornton wishes to acknowledge the contributions made to the research by the 53 retail sector respondents, and the following who commented on the findings:

Mark Advani	Director, Wiggle
Paul Barker	Director of Corporate Communications, HMV
David Bateman	Financial Director, Paperchase
Ed Bennison	Finance Director, Republic
Jonathan Kestenbaum	CEO, NESTA
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