

Retail and Consumer Packaged Goods

Bending the cost curve in brick-and-mortar retail

Retailers can achieve next-generation store efficiency by breaking down silos and optimizing total cost across the value chain.

by Praveen Adhi, Vishwa Chandra, Karl-Hendrik Magnus, and Aneliya Valkova



Making money in retail—particularly in physical stores—is becoming harder and more complex each year. Many retailers around the globe have addressed many of the possible efficiencies in labor productivity and process automation. It is time to consider the next generation of thinking to make a meaningful difference in brick-and-mortar economics and remain competitive in an ever-changing retail environment.

Our colleagues have discussed how an integrated view on cost can help consumer-goods companies optimize operations costs across the value chain.¹ In this article, we take a closer look at how retailers can benefit from a similar end-to-end perspective. The goal is to help traditionally siloed departments, from store operations to supply chain to merchandising, understand the total cost of each SKU by disaggregating the product's journey from end to end. This understanding can enable retailers to make better decisions about what products to purchase, when to transport them, how to display them, whether to offer a sale—and, all along, how to make best use of their employees' time.

While traditional store efficiency programs focused on in-store labor productivity can save 5 to 10 percent in overall costs, in our experience a more comprehensive cost approach can enable retailers to realize two to three times more savings, bending the cost curve more toward meaningful impact than the traditional incremental approach.

Case for change: External environment

Even retailers with stable balance sheets face mounting cost pressure due to several factors, including decreased foot traffic, increased SKU complexity, higher customer expectations, and rising labor costs.

To start, consumers shop from the comfort of their couches rather than traveling to the nearest shopping center; e-commerce has accounted

for 40 percent of retail growth in the United States since 2016. A recent McKinsey survey found that 82 percent of US consumers reported spending money online over the preceding three months, and 42 percent of millennials report they prefer shopping online to shopping in store.² Still, the in-store experience is far from obsolete. McKinsey projects e-commerce will constitute just 21 percent of total retail sales and 5 percent of grocery sales by 2023.

Second, brick-and-mortar stores are contending with increasing SKU complexity; in a world of ever-shorter product cycles and rapid innovation, SKUs have proliferated rapidly.

Third, stores are facing increased customer service and experience expectations, requiring both more time dedicated to customers and better-trained frontline staff to serve today's highly digital, well-informed customer. In addition, the proliferation of omnichannel experiences is changing the very purpose of a physical store.³ Stores are increasingly expected to offer a variety of omnichannel services, including in-store fulfillment and returns of online orders.

Finally, retailers' traditional labor pool is dwindling due to low unemployment and rising labor costs. For example, the United States is experiencing record-low unemployment.⁴ And to date, states that account for 30 percent of US workers have committed to phasing in a minimum wage increase that will ultimately reach \$15 an hour—more than double the federally mandated wage of \$7.25.⁵

What retailers can do

To remain viable in this environment, retailers must constantly improve their store economics by simplifying, eliminating, or automating routine activities. Most retailers have implemented several rounds of lean cost-improvement programs, such as automating simple activities (reporting and

¹ Philip Christiani, Sebastian Gatzer, Daniel Rexhausen, and Andreas Seyfert, "How to untap the full potential: An integrated—not isolated—view on cost," September 2019, McKinsey.com.

² Praveen Adhi, Tiffany Burns, Andrew Davis, Shruti Lal, and Bill Mutell, "A transformation in store," May 2019, McKinsey.com.

³ Raj Kumar, Tim Lange, and Patrik Silén, "Building omnichannel excellence," April 2017, McKinsey.com.

⁴ "Employment situation summary," Bureau of Labor Statistics, October 4, 2019, bls.gov.

⁵ Chris Marr, "States with \$15 minimum wage laws doubled this year," Bloomberg Law, May 23, 2019, bloomberglaw.com.

scheduling) and streamlining their inventory stocking processes. However, most still take a narrow view of what costs they can optimize, focusing on activities the store can influence and accepting upstream activities and decisions as constraints.

To reach the next level of cost efficiency, retailers must expand their focus outside the four walls of the store. Only the most advanced look for efficiency at the intersection of store operations, merchandising, supply chain, and transportation to adopt a total-cost view—that is, the sum of cost components across the value chain (Exhibit 1). By considering underlying costs, from how products are chosen to how they're stocked, in our experience retailers can expand the scope beyond costs addressed in their brick-and-mortar stores by 50 percent. These underlying costs are also more likely to yield efficiency because they have not been scrutinized as much as in-store costs.

A total cost approach can reveal a host of unrealized efficiencies (Exhibit 2). For example, with input from store operations, merchandising can adjust the store's promotional calendar by category and product to incorporate both the expected incremental margin as well as the store labor required to change price tags and build promotional displays. Given this more comprehensive view of cost, some promotional activities will be seen as unprofitable and thus

discontinued. Further, a deeper understanding of net margin and labor implications in distribution centers and stores can inform decisions about whether to add or remove shelf space from a given SKU. The extra labor cost required to stock the shelf between less frequent deliveries may be offset by transportation cost savings.

A comprehensive view of cost can also inform investments into enhanced capabilities such as automation. For example, if a distribution center can be outfitted to build custom pallets that match a store's layout, frontline staff would spend less time sorting products and moving between aisles.

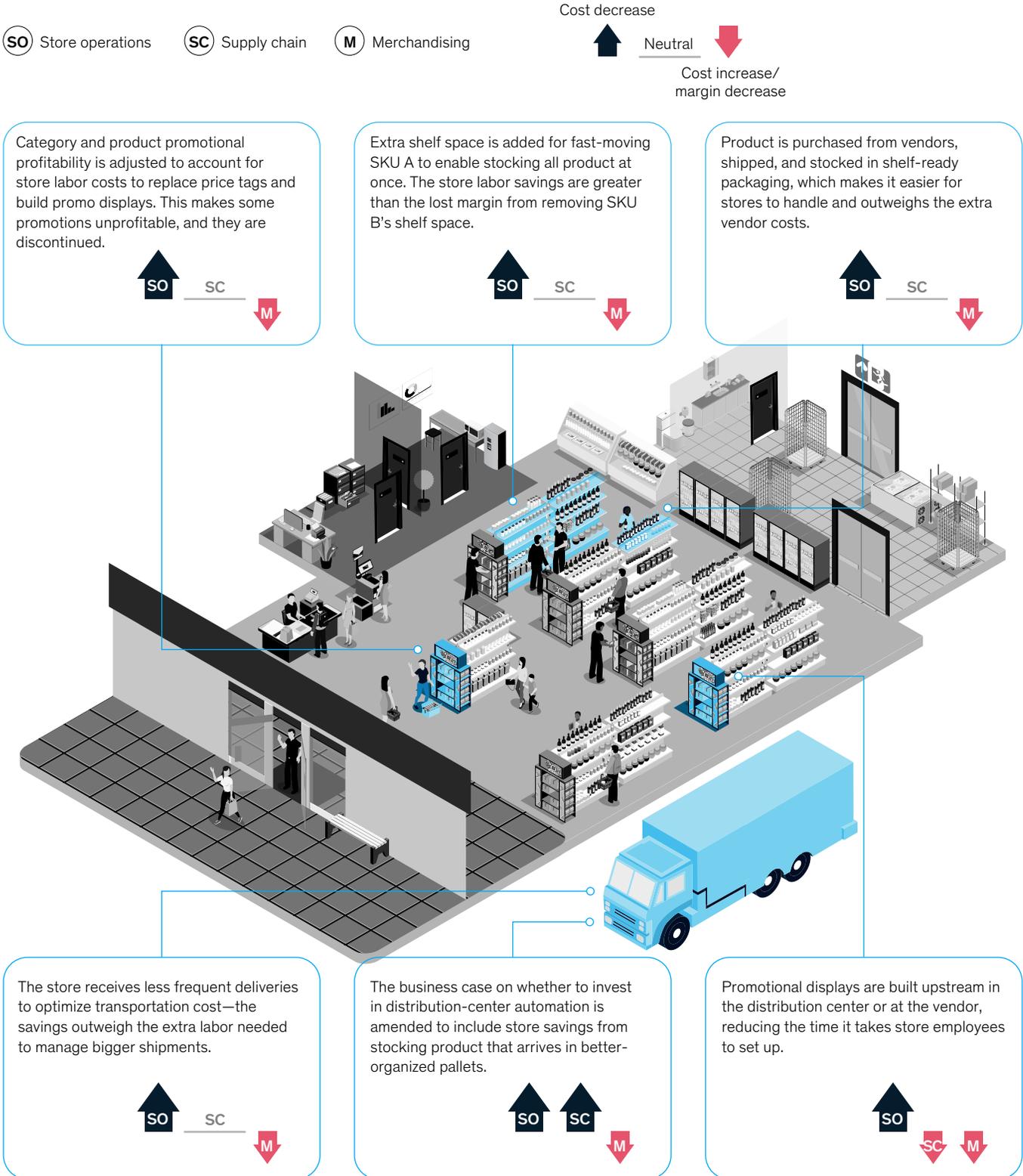
It is important to recognize that these efficiencies will lower costs in some departments but may be cost-neutral or increase costs in others; accounting for these cross-functional effects will be critical to success.

Success factors for bending the cost curve

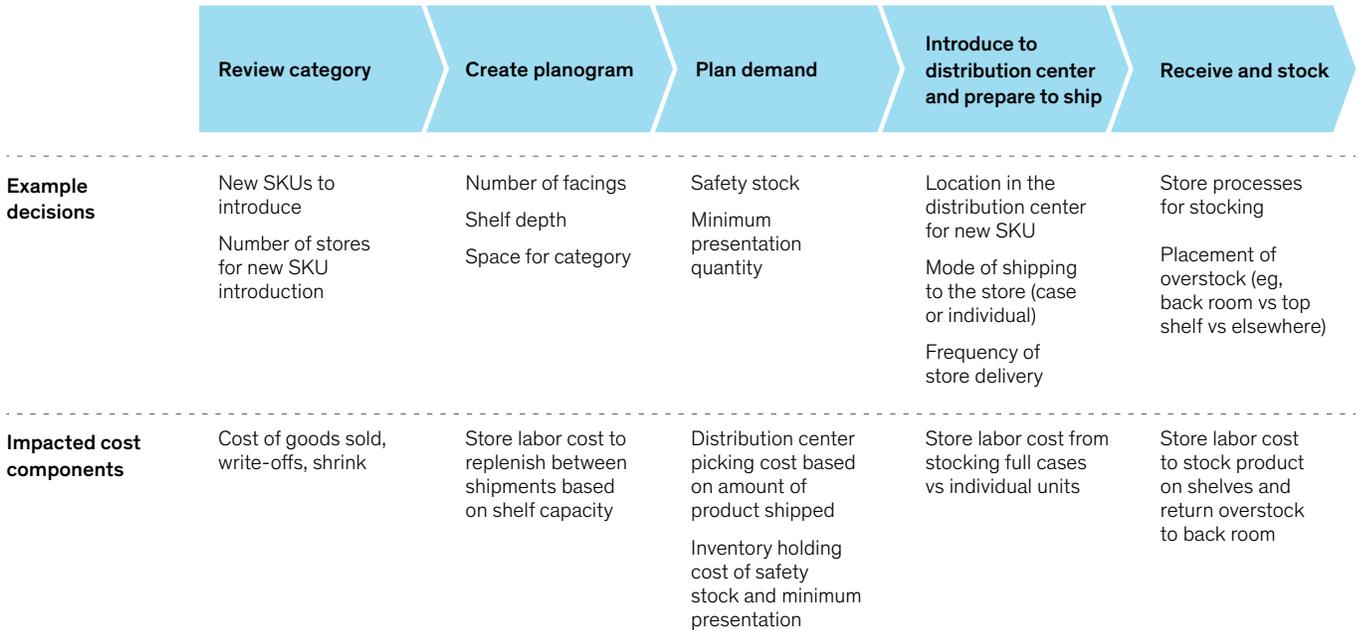
Four primary factors are crucial to bending the cost curve through a total-cost approach: governance and executive alignment, cost transparency, data and analytics capabilities, and key performance indicators (KPIs) and incentive alignment.

To remain viable in this environment, retailers must constantly improve their store economics by simplifying, eliminating, or automating routine activities.

Cross-functional collaboration to understand total cost of handling can lead to a host of unrealized efficiencies.



The total cost of handling a product is determined by considering cost at each step of the value chain.



Governance and executive alignment

It starts from the top. Senior-level, cross-functional alignment and sponsorship are required to communicate change and ensure it sticks. Given the sensitive nature of cross-functional savings—some departments will see a cost increase, while others will see a disproportionate cost decrease—each function needs to be confident that senior leaders support them and that every function adheres to the same new standards.

In addition, the business owner of this new process should be selected with care. Ideally, they should reside outside of functions that own a meaningful number of cost components; finance is often a good option because it lacks a direct stake in where costs are incurred. Store operations is another viable option, as it is furthest downstream in the process.

Cost transparency

Retailers often struggle to calculate their total cost of handling for two simple reasons: they either lack a full understanding of cost components or don't have the data to quantify each. For example, many retailers do not have a clear sense of how much labor is used per unit of product in the store, starting with unloading it from a truck to placing it on the shelf, refilling the shelf between deliveries, checking for out-dates, mounting promotions, and beyond.

Each SKU's journey should be mapped and broken down into cost-component steps. Each step includes multiple iterations based on how it is executed. For example, in-store labor cost is a component with at least two iterations based on how a product is stocked—as a full case or individual units. Identifying where a product goes and stocking

a full case all at once requires much less labor per unit compared with stocking individual units and searching for the correct spot on the shelf after each one. These cost estimates should be periodically refined to reflect changes in cost structure.

Data and analytics capabilities

Establishing cost transparency should result in the creation of a central data repository with access to multiple sources of data at the SKU and store levels, including all cost components across sales, cost, margin, safety stock and presentation requirements, promotional calendar, planogram versions, and shipping quantities. Typically, these data sources are not tied to each other, requiring additional work to build a 360-degree view of each SKU.

Once the data are assembled, sophisticated data and analytics capabilities are needed to simulate the different scenarios based on variable factors—such as how a product is shipped from the distribution center, in what quantity, and how often. An advanced decision-engine algorithm needs to be put in place to determine the lowest-cost path through the system and estimate the cost savings should all SKUs follow the optimal path. Identifying the scenario that matches the current state and comparing it to the optimal state can illuminate the concrete savings gained by moving from the traditional to the proposed approach. Savings can be realized both initially, when the decision engine is put in place, and continuously as the algorithm becomes embedded.

Key performance indicators and incentive alignment

While advanced analytics can enable decisions that optimize total cost across the organization, some areas of the organization may experience relative cost increases that permit bigger decreases in other

areas. However, many parts of the organization have narrow P&Ls that don't account for cross-functional effects. As such, end-to-end costs must be embedded in the reporting and KPIs of each function. For example, a merchandising decision to remove shelf space from the planogram of a fast-moving SKU should consider more than the lost margin and vendor funding. The decision should also consider whether less shelf space may negate the benefit of shipping full cases to the store. In that case, the SKU in that planogram will incur the extra cost from being shipped as individual units from the distribution center and the additional cost of having to be restocked between shipments if its shelf capacity is decreased.

Brick-and-mortar retail will continue being challenged to deliver on multiple fronts at once, including customer experience, omnichannel services, and cost excellence. While initially impactful, traditional lean levers employed by store operations limit the scope of opportunity by ignoring 50 percent of cost controlled by other functions, including merchandising and supply chain. To bend the cost curve and reach performance excellence, retailers should take an end-to-end view of cost. With a data-driven decision engine and senior leadership's support, retailers can realize significant opportunity across the organization and make better long-term operating decisions.

Praveen Adhi is a partner in McKinsey's Chicago office, where **Aneliya Valkova** is an associate partner; **Vishwa Chandra** is a partner in the San Francisco office; **Karl-Hendrik Magnus** is a partner in the Frankfurt office.

Copyright © 2020 McKinsey & Company. All rights reserved.