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How retailers can keep up with consumers

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The retail industry is more dynamic than ever. US retailers must evolve to succeed in the next decade.

The North American retail landscape looks quite different today than it did even ten years ago. The way that consumers make purchasing decisions has dramatically altered: they stand in stores, using their smartphones to compare prices and product reviews; family and friends instantly weigh in on shopping decisions via social media; and when they're ready to buy, an ever-growing list of online retailers deliver products directly to them, sometimes on the same day.

These shifts have led a number of industry observers to forecast the end of retail as we know it. Some predict that retail will change more in the next five years than it has over the past century and that the extinction of brick-and-mortar stores isn't far off. Our view is less dramatic, but we do believe that big changes are inevitable and that retailers must act now to win in the long term.

There is historical precedent for this kind of upheaval, which recasts the industry's winners and losers. Within the past century, local corner stores gave way to department stores and supermarkets, then to suburban shopping malls, then to discount chains and big-box retailers. Each of these shifts unfolded faster than the one that preceded it, and each elevated new companies over incumbents. Indeed, six of the ten largest US retailers in 1990 have since fallen from their positions as new winners, such as Amazon.com, Costco, and Walgreens, emerged in their place (Exhibit 1).

Yet history also offers incumbent retailers some hope: industry shifts have actually tended to unfold slowly—over decades, in most cases—providing time to react. While it is true that powerful forces are at work in retail today, we believe their full impact won't be felt for years. (For instance, despite the e-commerce boom, brick-and-mortar stores should still account for approximately 85 percent of US retail sales in 2025.[1]) That said, incumbent retailers can't expect to stay successful by going about business as usual. In this article, we discuss the major trends reshaping the retail landscape and the actions we believe retailers must take if they are to ride the wave instead of being swept away.

[1] Based on Forrester Research data and McKinsey analysis.

Exhibit 1 Shifts in the retail industry often create new winners, as evidenced by changes in the top ten US retailers.

US revenues, $ billion

New to top 10 in 2012

Dropped out of top 10 by 2012

Rank	1990		2012	
1	Wal-Mart Stores	32.6	Wal-Mart Stores	328.7
2	Kmart	32.1	Kroger	92.2
3	Sears	32.0	Target (formerly Dayton-Hudson)	72.0
4	American Stores	22.2	**Costco**	71.0
5	Kroger	20.3	**Home Depot**	66.0
6	JCPenney	16.4	**Walgreens**	65.0
7	Safeway	14.9	**CVS Caremark**	63.7
8	Dayton-Hudson[1]	14.7	**Lowe's**	49.4
9	A&P	11.4	Safeway	37.5
10	May Department Stores	10.1	**Amazon.com**	34.4

[1]Dayton-Hudson changed its name to Target in 2000.

Source: *Stores*; US Securities and Exchange Commission filings; McKinsey analysis

The trends that will matter most

Drawing on our research and experience working with companies across the North American retail sector, we believe that five trends will have a significant impact on the industry: demographic changes, multichannel and mobile commerce, personalized marketing, the distribution revolution, and emerging retail business models. Each trend is powerful on its own, and collectively they will redefine what it takes to be a successful retailer.

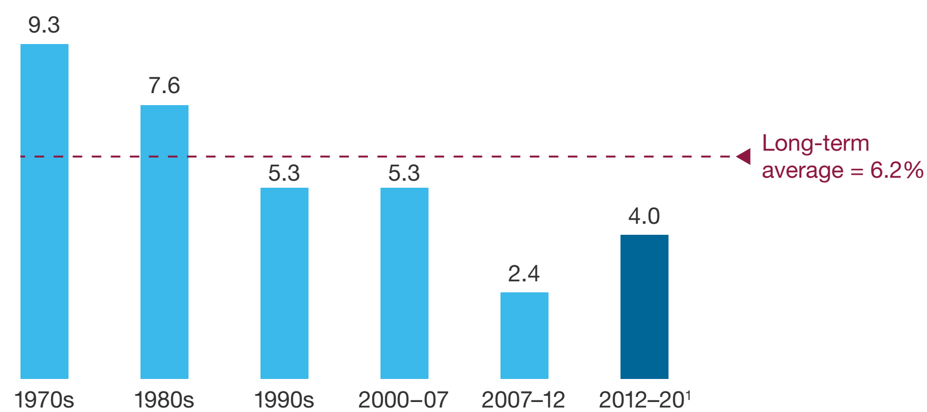
The rise of boomers, Hispanics, and millennials

Economic indicators do not paint a rosy picture for retailers: budget deficits are mounting, unemployment remains high, and the average consumer's balance sheet—while improving—remains shaky, for it has taken more than five years to recover the $16 trillion in net worth US consumers lost from peak to trough in the recent recession. Additionally, rising social costs related to health care, taxes, higher education, and other areas will continue to stress disposable income. Indeed, most industry forecasts suggest that US retail growth over the next five years will average 3 to 4 percent annually, well below the 5 to 7 percent yearly growth seen in the decade prior to the recession.[2]

We believe that these projections are reasonable and that this slower growth rate is likely to extend well beyond the five-year time horizon, becoming the “new normal” (Exhibit 2). Within a

Exhibit 2 Slower US retail growth may extend beyond the next five years, becoming the “new normal.”

US retail-sales growth, compound annual growth rate (CAGR), %



[1]Estimated.

tepid overall market, however, there will be several pockets of strong growth. Three customer segments that will make disproportionate contributions to spending growth, for example, must fit squarely into retailers’ customer-driven strategies. Each is unique and will require retailers to adapt their strategies to target the segments individually.

- **Baby boomers.** Some 47 million households headed by people over the age of 55 will account for the bulk of spending growth in major categories such as food (92 percent), housewares (73 percent), and apparel (56 percent).[3] The segment’s sheer size will drive growth in these categories, but boomers will also disproportionally spend their disposable income on services and experiences instead of off-the-shelf products.

[2] McKinsey analysis based on data from Euromonitor, Forrester Research, Kantar, and Moody’s.
[3] Based on McKinsey Global Institute analysis. See also *2011 American Community Survey*, US Census Bureau, September 2012, census.gov.

- **Hispanic consumers.** The retail spending of Hispanic consumers will nearly double over the next ten years and account for almost one-fifth of total retail spending.[4] Importantly, Hispanics spend money differently from other consumers—for example, they spend at least one and a half times more on children's apparel, footwear, and fresh food than non-Hispanic consumers do—and retailers will have to account for this accordingly.

- **Millennials.** People between the ages of 13 and 30 constitute 15 percent of US consumers. Millennials are the first group that grew up after the Internet, social media, and mobile became the norm—most have never known a world without them. They will account for nearly one-third of total spending by 2020.[5] Even through the economic tumult of the past five years, the spending of millennials has grown by 3 percent a year.

The world's largest store in every pocket

Over the past decade, US e-commerce has grown at an impressive clip of almost 18 percent a year.[6] It now accounts for 8 percent of total retail sales. With the accelerating adoption of mobile—US smartphone penetration exceeds 40 percent today and is projected to reach nearly 60 percent in three years—digital commerce is poised to explode, bringing shopping quite literally into the palms of many consumers' hands.[7] For some retailers, mobile is already a huge factor: at designer-fashion retailer Gilt, for instance, mobile accounts for about 50 percent of daily traffic and more than 30 percent of total sales. Mobile technologies will increasingly influence every stage of the customer's shopping journey—from personalized promotions prompted by geotargeting to in-store research and price checks, as well as to payment capabilities that offer checkout options beyond waiting in line. A recent McKinsey survey of digital shoppers highlights how mobile technology can complement the in-store experience; for example, almost half of the consumers who conduct research on their mobile phones have done so while in stores, and half say they're open to the idea of in-store mobile payments.[8] Indeed, while just two years ago mobile accounted for only 3 percent of e-commerce sales, that figure will probably rise to 15 percent by the end of 2013.[9]

Highly personalized marketing

Habits of consuming content have changed dramatically. US consumers doubled their spending on digital newspapers in the past seven years, for example, while halving their spending on print newspapers.[10] As more consumers abandon print media for digital media, marketers follow: 44 percent of them now allocate at least half of their marketing budgets to digital media, up from only 31 percent in 2009.[11]

We're already seeing that direct mail and newspaper circulars are playing a diminished role in retail marketing. Mass advertising will not disappear overnight, but its influence is certainly waning. Ads are shifting toward not just digitization but also personalization, powered by increasingly sophisticated algorithms and predictive models that analyze transaction data and digital-media trends (for example, what topics are hot on social networks). Already, 35 percent

[4] McKinsey analysis based on data from the US Bureau of Economic Analysis, the US Bureau of Labor Statistics, and the US Census Bureau.
[5] Ibid.
[6] *US Online Retail Forecast, 2012 to 2017*, Forrester Research, March 2013, forrester.com.
[7] "Smartphones continue to gain share as US mobile usage plateaus," *eMarketer*, April 2012, emarketer.com.
[8] Ewan Duncan, Eric Hazan, and Kevin Roche, "Developing a fine-grained look at how digital consumers behave," July 2013, mckinsey.com.
[9] Based on comScore data. See also, Alex Cocotas, "How a new wave of mobile-social commerce has powered online retail," *Business Insider*, February 2013; and "How mobile coupons are driving an explosion in mobile commerce," *Business Insider*, July 2013—both available on businessinsider.com.
[10] *VSS Communications Industry Forecast 2012–2016*, Veronis Suhler Stevenson, September 2012, vss.com.
[11] *The CMO Survey: Highlights and Insights*, a survey supported by Duke University's Fuqua School of Business, the American Marketing Association, and McKinsey, February 2013, cmosurvey.org.

of what consumers purchase on Amazon and 75 percent of what they watch on Netflix come from product recommendations based on such algorithms.

Company-directed marketing is also competing for attention with peer recommendations through social networks, user reviews, and the like. Our research shows that for the average consumer, peer recommendations carry ten times more weight than recommendations from salespeople. Indeed, social media could well make up 22 percent of marketing budgets in five years as retailers increase their spending to facilitate and influence peer connections about brands through paid ads and branded pages on social-media platforms such as Facebook, Ibotta, and Pinterest.

A distribution revolution

Amazon already offers same-day delivery in ten cities and guarantees one- to two-day ground delivery in the continental United States. It is not unreasonable to think that consumers will expect comparable shipping speeds from all retailers—we expect same-day delivery to become available soon in at least the top 150 metropolitan statistical areas, which hold nearly 75 percent of the population.[12] Furthermore, we believe retailers will offer shipping free of charge to their most loyal and profitable customers, as opposed to providing it only for those who make minimum purchases. We also expect to see third-party distribution services evolve and expand. Some companies may make big investments in distribution infrastructure and sell it as a service to other retailers, as Amazon and eBay do now. Others are beginning to invest in infrastructure to provide convenient and secure package-delivery locations: lockers and pickup boxes are appearing in groceries, convenience stores, and drugstores nationwide, and new services are sprouting up to let retailers ship packages for pickup at other retail locations or self-storage facilities.

Consumers have come to expect simple and seamless processes not only for receiving the products they've purchased but also for returning unwanted products. Free and easy returns—including the ability to return or exchange online purchases in stores—are becoming table stakes.

New retail business models

No doubt, retail competition just keeps getting tougher. Consider the ongoing blurring of lines between formats and sectors as retailers try to steal shopping trips and share from one another (for instance, fresh food is no longer the dominion of supermarkets alone but is also increasingly found in warehouse clubs, convenience stores, pharmacies, and even dollar stores). Furthermore, players across the value chain are encroaching on what used to be the exclusive turf of retailers. More manufacturers are selling directly to consumers; examples include Apple, Nike, and—via Vitacost.com—several consumer-product manufacturers. Tech players are also fighting for consumer retail dollars: Google offers more than one billion products for sale on Google Shopping and may soon open retail stores.[13] Additionally, companies such as craigslist,

[12] *2011 American Community Survey*, US Census Bureau, September 2012, census.gov.

[13] Seth Weintraub, "To get products into more hands, Google will open its own stores by the end of the year," *9to5Google* (blog), February 15, 2013, 9to5google.com.

eBay, and Etsy (home to almost a million small businesses) are creating marketplaces where individuals and entrepreneurs can sell their wares to the masses. Finally, rental and aftermarket-circulation models, such as Chegg for textbooks or Rent the Runway for designer fashion, are eating into traditional demand for retail goods.

Competition is coming from near and far as technology makes retailing much more global than it has ever been. UK online retailer ASOS.com, for example, offers free two-day shipping worldwide for a relatively small membership fee, and at times as a promotional offer to all customers. Until recently, retailers didn't have to worry much about global competition until stores started sprouting down the street—nor did they have an opportunity to access global consumers from North America—but that is changing as technology helps break down barriers and generates new retail business models.

What retailers should do

These trends will put considerable strain on the traditional retailers' economic model, with challenges to both the top and bottom lines. On the revenue front, the biggest obstacle will come from a channel shift: in-store purchases will grow by only about 2 or 3 percent a year, and some formats should see in-store sales decline by 5 to 7 percent a year. Gross margins will come under pressure from both price transparency (retailers will need to keep prices low to stay competitive) and a reduced share of trade spending (vendors will allocate fewer trade dollars to secure shelf space in physical stores and more to promote brands in the digital realm, where retailers are but one of many ways to reach consumers). To increase revenues, gain share, remain profitable, and manage capital investment effectively over the next 10 or 15 years, retailers must take aggressive action. Specifically, they should heed the following five imperatives.

Expand revenue and profit pools

Almost all retailers are investing in multichannel capabilities, as they should. Yet a more fundamental reinvention may be needed: Amazon, which most retailers view as a chief competitor, acts as a traditional retailer in only 35 percent of its customer transactions. The majority of the products bought by Amazon's customers flow through its marketplace or its fulfillment services for third-party sellers.

Business-model evolution has been fairly common in other sectors—consider the well-documented shift of both GE and IBM from product- to services-based companies—but retailers have traditionally been slow to reinvent themselves. As pressure mounts on traditional sell-through revenue, incumbent retailers too must find new profit pools. Sears and Wal-Mart Stores, for instance, are earning "rent" on their digital assets by establishing third-party marketplaces similar to Amazon's. Best Buy is using its store space to partner with Samsung in more than 1,000 Samsung Experience Shops, a store-within-a-store format housed within Best Buy locations.

To maximize the chance of sustaining long-term growth and profitability, retail executives should be thinking ahead: to win in the future, how much revenue should come from nonproduct sales? If retail sales of traditional products and services drop by 10 percent in five years' time, do retailers have enough initiatives in place to discover, test, and expand future revenue sources? Beyond physical or digital shelf space, which assets could a retailer exploit?

Create a road map to cut costs

The retail industry's growth over the past decade has masked a lot of inefficiency. With the growth outlook now dimmed considerably, retailers must take a hard look at operating costs. We believe all retailers should address three cost levers: direct product costs, the indirect costs of goods not for resale, and labor costs. Retailers that tackle these levers comprehensively can reduce costs by up to 20 to 30 percent, which is what they'll need to do in an intensely competitive environment.

Managing direct costs through vendor negotiations remains important but is no longer sufficient. Increasingly, leading retailers use techniques such as private-label "design to value," in which they identify the features consumers value most and redesign products accordingly, aiming to strip out anything that increases costs, but not value, to consumers.

Progressive retailers are attacking indirect costs with similar rigor—for instance, by developing "should cost" models to reset the dialogue with vendors from delivering modest year-over-year unit-price reductions to redefining unit costs altogether. One retailer used a detailed cost teardown of its in-store technology hardware to reduce costs by more than 40 percent in several infrastructure-spending categories. We also see retailers removing or redeploying up to 30 percent of costs in store operations and corporate-support functions by applying lean techniques and accelerating offshoring.

Retailers should continue to offshore portions of their support functions, such as finance, HR, and IT, but to remain cost competitive they may also need to offshore elements of core retail functions, such as merchandising and marketing analytics. The most successful retailers are also taking work out—not only shifting it to lower-cost models but also eliminating it altogether. When reflecting on cost structures, retail executives should ask themselves several questions: do we understand the economics of our major vendors well enough to know their true costs and what profit margins they're making from our business? Are we managing the cost of core retail functions and back-office functions by considering a comprehensive set of efficiency levers? A negative response to either of these questions should spur action.

Reduce—and reconfigure—the real-estate portfolio

As purchases migrate to digital channels, most retailers will need less physical selling space in stores. Although some formats (such as groceries) will be relatively unaffected, others (such as consumer electronics and toys) will be hit profoundly and could require square-footage reductions of half or more to deliver a compelling customer experience and economics. Retailers are already seeing this phenomenon, and a real-estate rebalancing is under way as they reassess what should be sold through physical space; in 2012 alone, major chains shuttered approximately 4,500 stores in the United States, and newly opened stores are some 25 percent smaller than the average size of existing ones.

We believe retailers should move quickly and take a hard look at future space needs and mobilize now to right-size their store networks. Given the sensitivity of property values to levels of available inventory, the earlier that retailers shed unneeded real estate the better off they're likely to be—and this is especially true for retailers that own the underlying real estate. Those that rent space should negotiate to create flexibility through leases of shorter duration, in particular for properties with less certain futures.

Real-estate implications also extend to space that will remain in the portfolio in the long term as it will play a different role than it has in the past. To win consumers' loyalty, stores can't simply be places where products happen to be sold. For many retailers, future store layouts will have to foster greater customer learning and experimentation. Technology will need to be fully integrated into how stores and employees engage customers. And the lines between physical and digital must continue to blur—for example, as stores become fulfillment and return centers for online orders.

One indication of how we expect the role of stores to be transformed is evident in the fact that 40 percent of Best Buy's and more than 50 percent of Wal-Mart's online sales already are picked up in stores. To make informed network choices, we believe, retailers must take a long-term view of their real-estate footprint. How will their core formats' size and space allocation evolve in the next ten years? What will be required to enable new multichannel experiences? Beyond building stores, what asset-light expansion models are available when retailers look for growth?

Get serious about using data and analytics for decision making

Forward-thinking retailers are leveraging the vast amounts of data they possess and building analytical muscle to enable targeted marketing, tailored assortments, and effective pricing and promotions. Gathering and analyzing data to understand the needs, preferences, and attitudes of growing consumer segments, such as Hispanics, baby boomers, and millennials, will be especially important, as will understanding *individual* consumers and customizing offers on a one-on-one basis.

Retailers should use advanced analytics to make offers and decisions that are targeted and localized, as well as delivered in real time. These offers and decisions should be informed by product preferences and influences (for example, discounts to consumers who have "liked" a product on Facebook and have a desirable network of Facebook friends). They should also be customized by location (for instance, coupons that are targeted at regular coffee drinkers of a competing coffee shop a block away from where the consumer happens to be) and shopping occasions (say, an ad for a new bathing suit two weeks before a planned vacation).

Advanced analytics isn't just about marketing decisions, however; data-driven insights can create value across the full business. Cutting-edge retailers are using them to tailor assortments at the store level, to anticipate changes in customer traffic patterns, and to determine optimal distribution routes, inventory levels, and allocations, simultaneously enhancing the customer experience and improving unit economics. A leading footwear retailer, for example, implemented a system that links inventory across channels. When a customer orders a pair of shoes online at full price, the system looks across the network for the store that has that pair in its inventory and is least likely to sell it at full price before the end of the season. The system then balances the extra cost of shipping that order from the store against the expected markdown from continuing to hold the shoes in the store. This exercise determines whether the order ought to be fulfilled from a store or from a centralized warehouse. In short, the system helps the retailer to make real-time fulfillment decisions that maximize expected profit.

Retail executives should continually assess their investments in data and analytics to ensure that they are bringing new insights to the biggest business problems: what steps is the company taking to turn data into practical suggestions and actions to increase revenues, reduce costs, or free up capital? What capabilities is it building to become a more customer-centric, analytically driven enterprise?

Rethink assortments and product offerings

As prices and inventory availability become more transparent, retailers will not survive just by being "pass through" sellers of national brands. They will have to give consumers a reason to choose their stores over competitors. No longer will consumers shop at a retailer simply because it happens to be where a product is distributed. Instead, they will seek out retailers that provide value in new and different ways. We believe retailers will need to offer deep product expertise (that is, they must help consumers decide what to buy and explain why it makes sense for them) and a unique product education (that is, they should help consumers learn how to use the product better and do this over time, not just during the moment of purchase). Additionally, retailers must do these things in an environment that is increasingly experiential (for example, fitting a golf club or curating a wardrobe using a "magic mirror," which employs computer technology to show customers how clothes look on them, making the process more efficient and engaging). Retailers must also make it easy for consumers to engage when and how they want—say, from their mobile devices while they are at home or on the move.

Some retailers could position themselves as the champions of style or demand in certain segments, perhaps by developing products and services specifically for population groups that will drive retail spending. Macy's, for example, has embarked on a major effort to court millennials, including the launch of 13 segment-specific brands, new destination zones within physical stores, and a marketing mix that includes social-media programs and a new blog. Others could engage their target segments in new ways to influence products and help curate the assortment. The use of crowdsourcing—instead of traditional focus groups—to advance product development could allow consumers to cocreate products with retailers, providing another point of differentiation and fostering deep loyalty and word-of-mouth benefits.

Winning retailers will proactively shape products and experiences for and with consumers by bringing them directly into key merchandising decisions. How are retailers engaging consumers in the development and curation of new products? How are they tapping into a broad network of marketplace partners to drive innovation, excitement, and experiences? How will they leverage exclusive brands and private labels to become destinations for consumers?

The retail environment is as dynamic today as it has ever been. Competition is intensifying and shifting to new arenas, and consumers are rapidly evolving their approach to purchase decisions. We believe the trends that will most affect the industry's future are evident, and the imperatives are clear. The time to act is now. Retailers that do will be the winners when the next chapter of retailing history is written.

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