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Is your company a value creator or a value destroyer?

By looking at performance through the lens of economic profit, retailers can better understand the effectiveness of their business strategies.

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Among global companies, the rich get richer, while those in the middle tend to get stuck there. These were among the findings from our colleagues' analysis of the economic-profit performance of nearly 3,000 large nonfinancial companies in the 2007–11 period. Using economic profit (EP)—calculated as net operating profit minus the cost of capital—as a measure of value creation and an indicator of market-beating strategy, their research showed that just a handful of companies create most of the value. Companies in the top quintile generated 70 times more EP than all the companies in the middle three quintiles combined. Furthermore, these top companies attracted a disproportionate share of capital. And while it's fairly easy for a company to drop out of the top quintile, breaking

into that top tier from the middle of the pack is no small feat.¹

But what about retailers specifically? Does inequality characterize the retail industry as well? We took a closer look at the 237 publicly owned retail companies included in our colleagues' research and combined that information with more recent data on retailer performance, as well as our own experience working with retail organizations around the world. We discovered that tremendous disparities do exist in retail, and the winners are by no means a homogeneous set. Two outwardly similar companies can have vastly different fates: one can be a value creator, the other a value destroyer. We believe our findings have important implications for how retail

executives and strategists should think about where and how to compete.

Success varies across—and within—retail segments

There are huge differences among retailers when it comes to their ability to create value. Between 2008 and 2012,² top-quintile retailers generated 100 times the EP of retailers in the middle three quintiles. And EP varied widely among retail segments, with apparel companies, food retailers, and pure-play online retailers being the top performers (Exhibit 1).

We estimate that publicly owned apparel companies account for only about one-fifth of global apparel sales, but their success is noteworthy. The 24 apparel companies in our sample together generated \$7.3 billion in EP each year on average. Of that amount, more than half—\$4.8 billion—came from just three retailers (Gap, H&M, and Zara). Vertically integrated apparel players especially have been reliable value creators for several years. In 1997, on average, they generated just \$100 million a year in EP; by 2012, that number had increased more than tenfold, to \$1.1 billion, whereas other apparel retailers did not

Exhibit 1 In retail, the greatest economic profit is made by apparel retailers, while department stores are destroying the most value.

Average profit generated, 2008–12, n = 237 retailers, \$ billion

		Top 3 winners' economic profit	Number of companies
Apparel retail	7.3	4.8	24
Food retail	2.1	2.6	53
Internet retail	1.6	1.7	4
Distributors ¹	1.0	1.2	15
Hypermarkets and supercenters	1.0	5.3	15
Home-furnishing retail	0.8	0.8	3
Home-improvement retail	0.7	1.2	10
Specialty stores	0.3	0.7	17
Computer and electronic retail	0.3	1.0	15
Automotive retail	0.3	0.8	11
General-merchandise stores	0.1	0.7	14
Catalog retail	0	0.0	1
Food distributors	-0.1	0.7	13
Drug retail	-0.3	1.0	11
Department stores	-4.1	1.7	31

¹ Does not include food distributors.

Source: Analysis of data provided by McKinsey Corporate Performance Analysis Tool (a McKinsey Solution)

exceed \$200 million each in EP per year during that period. Not all apparel companies are value creators, however: six of the apparel companies in our sample lost value, although their losses were minor compared with retailers in other segments.

Food retailers represent the second-largest value creators in the retail industry—but here, too, the underlying data tell a more complex story. Among food retailers, including hypermarkets, there were about as many value destroyers as value creators. In general, supermarkets with a traditional business model outperformed other types of food retailers such as discount food stores and convenience-store chains.

The third-richest segment, online retail, has come far in only a few years. From 1998 to 2002, pure-play online retailers destroyed more value than almost every other segment. By the 2008–12 period, they had increased revenues 15 times over, bending margins from negative to positive and becoming one of the industry’s foremost value creators.

As for department stores and drug retailers, neither group created value. Both took an especially hard hit in the health and beauty categories, in part because neither department stores nor drugstores responded effectively to the increased price transparency that the online channel offers consumers. Drugstores also lost business to supermarkets that expanded their nongrocery offerings and undercut drugstores’ prices, while many department stores—saddled with an unclear or outdated value proposition—were challenged by new “category killers” such as cosmetics chain Sephora.

That said, retailers in either segment shouldn’t be resigned to losing value. Some drugstore chains have improved EP by adding pharmacies to their brick-and-mortar outlets, for example. As for department stores, it’s important to note that the top three players in our sample did generate EP—a combined \$1.7 billion per year from 2008 to 2012.

Two of the three are discount department stores.

In our sample of 13 premium department stores, only 1—British retailer Marks and Spencer—created value between 2008 and 2012, most likely as a result of a large-scale, multiyear restructuring effort that began in 2001.

How winners earn a top spot

EP has four components: revenues, margins, asset turns or asset leverage (a measure of the capacity to extract revenue from a given quantity of assets), and the tangible-capital ratio, which is the ratio of physical to total capital, including goodwill.³ In most industries, sizable revenues and high margins are enough to earn a top spot in the EP rankings. In retail, that’s not the case; only companies that outperformed their peers in all four components landed in the top quintile (Exhibit 2).

The need to outperform their peers on margins can be an especially vexing problem for retailers. Although top-quintile retailers generate, on average, 70 percent more revenue and have nearly twice the asset turns as top-quintile players in all other industries, margins in retail are slim (4.6 percent for top retailers, compared with 11.6 percent for top companies across all industries).

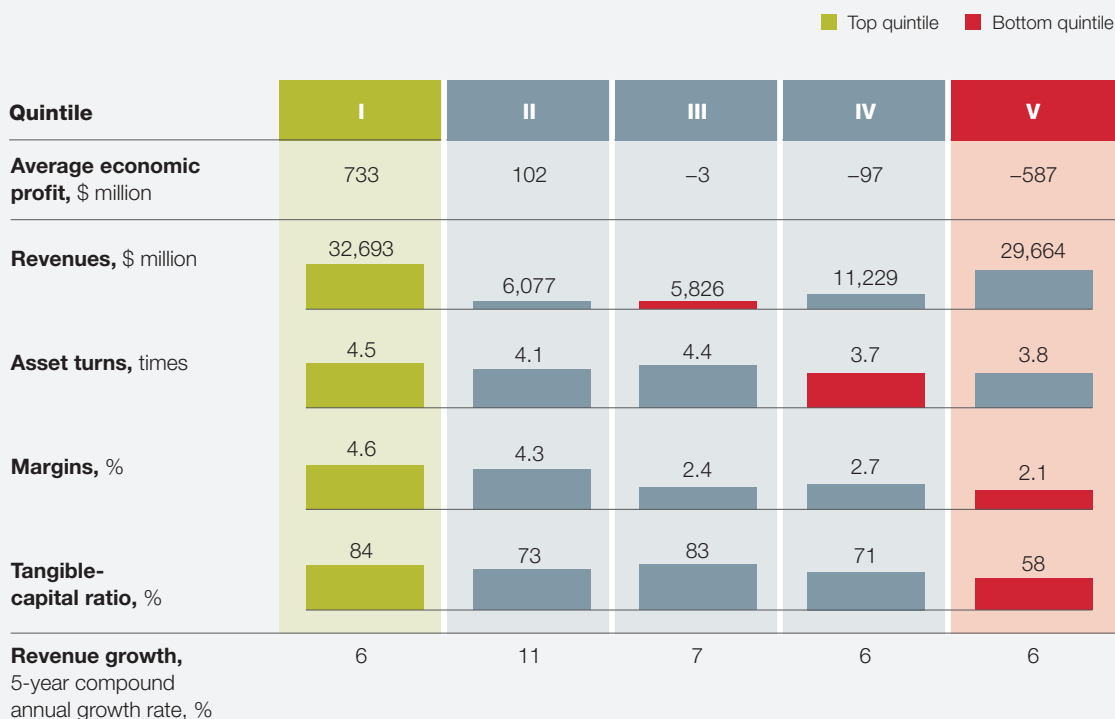
Like their peers in other industries, high-performing retailers shouldn’t get too comfortable. Our research shows that, over a ten-year period, nearly 40 percent of top-quintile retailers dropped into the middle or lower tiers. But losing a top spot doesn’t necessarily take ten years; at least two large retailers dropped from the top to the bottom quintile between 2012 and 2014.

Breaking out of the middle

Even harder than holding on to a top spot is getting there at all. Eighty percent of retailers that were in the middle quintiles in the 1998–2002 period were still in the middle ten years later, meaning they hadn’t significantly improved their ability to create value (Exhibit 3).

Exhibit 2 Only retailers that outperform their peers on all four value drivers can earn a top spot.

Average economic profit generated per year, 2008–12, n = 237 retailers



Source: Analysis of data provided by McKinsey Corporate Performance Analysis Tool (a McKinsey Solution)

Of the 143 retailers that were in the middle quintiles in the 1998–2002 period, only 13 were able to break into the top tier by 2012. Most of them had help from external trends: almost half benefited from emerging-market momentum and four others profited greatly from the massive shift to online retailing. More recent data confirm that mobility remains an issue for middling performers; 85 percent of retailers who were in the middle quartiles in 2012 remained there in 2014.



Our research has several important implications for CEOs and strategists:

Top performers. Maintaining elite status is hard work: even a one percentage-point dip in margins can force a top performer back to the middle of the pack. Retailers that held on to their top spot did so by doubling their revenues while also improving margins, even if only slightly—a 0.6 percentage-point margin improvement sufficed.

Middle of the pack. To earn a top spot, middling performers need to make bold moves and outdo the competition on several fronts: for example, by investing

Exhibit 3 When ranked by economic profit, the majority of retailers are stuck in the middle.

Finish, 2008–12¹

		Top quintile	Middle quintiles	Bottom quintile
Start, 1998–2002²	Top quintile	64%	23%	13%
	Middle quintiles	9%	80%	10%
	Bottom quintile	9%	36%	55%

¹ Based on the largest 3,000 companies by revenues (2011). We excluded companies for which data on normalized operating profit less adjusted taxes and average total invested capital were not available for the full 10-year period.

² Figures may not sum to 100%, because of rounding.

Source: McKinsey analysis

more heavily in revenue-management and pricing capabilities, optimizing marketing and promotional spending, lowering costs through fact-based supplier negotiations, and examining the role of the store network in the organization's multichannel strategy.⁴

Low performers. For companies at the bottom, revenue growth isn't enough. Big ideas certainly have the potential to catapult low-performing organizations into the upper tiers, but restructuring might be the first order of business. There's evidence it can work. Macy's, a bottom-quartile performer for 15 years, launched a massive restructuring program in 2009; by 2014, it was a top performer. ■

³ Bradley, Dawson, and Smit, "The strategic yardstick you can't afford to ignore." There is, mathematically, a fifth dimension of economic value: funding. But the weight of evidence suggests that companies cannot directly influence it. For the purposes of this analysis, we use a global average cost of capital of 9 percent.

⁴ For more on the role of brick-and-mortar stores, see Louise Herring, Tobias Wachinger, and Chris Wigley, "Making stores matter in a multichannel world," *Perspectives on retail and consumer goods*, December 2014, mckinsey.com.

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¹ For more about the research, see Chris Bradley, Angus Dawson, and Sven Smit, "The strategic yardstick you can't afford to ignore," *McKinsey Quarterly*, October 2013, mckinsey.com.

² Our colleagues' research focused on the period from 2007 to 2011; this article is based on retailer performance from 2008 to 2012.