HOW CAN CATEGORY KILLERS COPE WITH AN ONLINE WORLD?
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Much of the story of retail over the last few decades has been about the rise of big box stores, especially those offering an unrivalled level of assortment in a single retail sector – the category killers. The home improvement chains, the office supplies stores, the electronics specialists and others provided the widest choice in large, no-frills boxes in cheaper real estate locations, giving them a decisive advantage over the smaller-footprint stores they superseded. Their low-cost structure and massive leverage of fixed costs allowed them to win with markedly better prices. Coupled with their overwhelming assortment advantage, this meant customers were prepared to drive further to get to their stores. It quickly became clear this was a superior format with a very strong return on capital. The category killers grew rapidly, stamping out store after store. Success was driven by the quality of the real estate department and the ability of operations and supply chain to cope with the rapid rate of store growth. A simple approach to marketing and merchandising was enough when the proposition advantage over the incumbents was so wide. In the US it took twenty or thirty years for most to expand from ‘sea to shining sea’.

Many category killers were approaching the end of this ride: having already built on the vast majority of suitable sites, growth through capacity expansion was slowing dramatically. New stores were cannibalising existing ones, and the margin growth that came from using new volume to further leverage central costs had disappeared. Some were paying more attention to developing their marketing and merchandising capabilities in an attempt to drive more growth from existing stores, but this was always going to be a challenge. For most of the category killers, things were starting to look tough.

THEN THE INTERNET RETAILERS ARRIVED.

At the headquarters of a typical category killer, the lobby is decorated with old flyers or adverts – sometimes with pen-and-ink style product images – emphasising the low prices, wide assortment and warehouse-style shopping environment to which the business owed its success. But now that Amazon and other internet competitors have entered the market, the category killers no longer have the lowest prices, or the widest assortment, or the lowest cost structure. And so they have been losing on the single metric which defines what a category killer is: their consideration rate (Exhibit 1). When your business is built on being the first place consumers would choose to go for the products you sell, losing that lead threatens everything. In effect, any retailer that no longer enjoys a lead in customer consideration is no longer a category killer.
Of course, the category killers have faced serious competitive threats before. The mass merchants have always offered low prices, and have a reputation for value for money. But they don’t have the same breadth of assortment, and they have co-evolved alongside the category killers as they grew. Reliant on bricks and mortar, they face the same trade-offs and the same fundamental economics as the category killers, and are subject to the same constraints on their rate of growth. To a great extent, the threat from the mass merchants is already part of the competitive environment, having shaped the nature of the category killers in terms of their offer and their store densities.

But the online threat is different. Online retailers face fundamentally different economics: they are an alien species introduced into an otherwise stable ecosystem. Category killers have not evolved in the presence of this threat and so, while a new equilibrium will eventually be reached, it may look very different from today. And just as small format stores and mom-and-pop stores were powerless in the face of the category killers’ superior store formats, category killers have limited options for how to react to online competitors.

SO WHAT CAN BRICKS AND MORTAR RETAILERS DO?

There’s no denying that e-commerce presents a serious and sometimes existential threat to the category killers – and in a decade’s time, many retail sectors will be very different from today. But although change is certain, the form it will take is not: established retailers still have the power to shape their destiny. Those who face up to the threat and take their fate into their own hands will fare better than those who persevere with their existing business model and hope for the best.
Bricks and mortar retailers therefore need to ask themselves where the new equilibrium lies and therefore how deep and long their decline could be if left unaddressed: this is a foundational piece of analysis that should underpin their strategy. They can then start adapting their business through a set of defensive and offensive moves.

In our view, the **defensive** options fall into three categories:

**Rush to copy the online business model.** Self-cannibalisation is usually better than waiting for competitors to steal your sales. Building your own online presence is an obvious strategy, but has obvious drawbacks: customers expect the online offer to be aligned with the offer in the stores, especially where prices are concerned. Trying to compete head-to-head with low-priced internet retailers can therefore drag down store prices and hurt profits.

Furthermore, shifting your own emphasis towards online sales accelerates the loss of volume from stores, as well as making it harder to sell the low-ticket, high margin ‘add-on’ items that are key to profitability. With big box operating models relying on volume to cover their high fixed costs, this can rapidly erode profitability. Increasingly, Amazon is benefiting from ‘default’ behaviour where it has achieved such a high degree of trust that consumers don’t check other sites – no category killer’s site will be able to duplicate that advantage for normal consumers.

Finally, it’s important to keep in mind that it’s difficult to make money from online retail. Even for large online retailers, fulfillment costs are very significant, in some cases scarcely lower than the cost of running bricks and mortar stores. For established retailers, it’s a case of adding capital to generate sales at a lower margin – and as such, it’s only likely to be viable as part of a set of other moves.

**Accept and manage your decline.** In many sectors a new equilibrium will be reached that has many fewer stores or much smaller stores. It may be much better to confront this unpalatable truth than to ignore it and continue with business as usual – and the quicker a retailer responds, the less painful the adjustment is likely to be.

Retail is a business characterised by long lags in customer behaviour: in the short term, price elasticity is low, and capital investments generally take years to pay off. This means that some retailers’ instinctive response – cutting prices to match online competitors, while investing in stores to reinvigorate them – may be precisely the wrong one. Instead, the value maximising strategy is more likely to involve managing a decline in the store estate as leases come up, rather than lowering margins and fighting to maintain share. It’s a grim picture to accept, but the implications of refusing to accept it could be grimmer still.

Part of this strategy involves identifying which stores will be viable in the long run – either as part of an integrated multi-channel proposition, or on a stand-alone basis – and which will not. The impact of online competition will be uneven across the estate: two stores that have had similar performance historically can be affected in very different ways, depending on local shopping patterns and competitive intensity. As we discuss shortly, an understanding of what’s likely to happen to your competitors in each location is therefore an essential input into real estate strategy.
Managed decline is never easy, and the consistent falling sales and years of cost cutting that will be needed to keep central costs in check make this type of strategy very difficult for a public company to pull off. It’s worth pointing out, though, that there is room for enormous value creation for specialist buy-out firms.

“Don’t try to outrun the bear.” You simply need to outrun your friend. New competitive pressures can create polarisation amongst incumbents, with the strongest players coping with the pressures better than the weakest. The weakest players will be forced to consolidate their store base fastest, and in many cases stronger rivals can derive more growth from increasing the share they have within their format than they lose to new formats.

This represents an opportunity for certain retailers, and follows a pattern that has played out in the grocery sector in the US over the last 10–15 years as pressure from Walmart Supercenters has grown. In many markets there are only one or two strong conventional grocers left alongside Walmart, but they have thrived at the expense of the players that have left these markets.

So if your sector is likely to end up with half as many stores as it does now, but you currently operate only one-third of all the stores in the sector, being the sole survivor can represent sales growth. If your format still has several different players and you enjoy a productivity advantage, it is worth considering designing your strategy to ratchet up the pressure even further and accelerate the end-game. The challenge is to figure out which retail levers offer the most effective way of pressurising competitors at the lowest possible short-term cost to you – and, of course, to avoid being overly optimistic about the strength of your proposition. A thorough understanding of how favourably customers perceive the different players in your markets is essential to making this strategy work, for example by using a Customer Perception Map (Exhibit 2).

**EXHIBIT 2: MEASURING THE STRENGTH OF A RETAIL PROPOSITION**

**THE CUSTOMER PERCEPTION MAP**

**A TYPICAL PATTERN FOR A RETAIL SECTOR**

**OFFER LEADERS**

Strong assortment, great product quality and/or high levels of service put these retailers in a strong position to defend against the online threat. Typically around 2 in 10 retailers in a sector fall into this category.

**LAGGARDS**

Retailers in this region are poorly regarded by customers, and are in trouble even without online competitors. Only around 1 in 10 retailers is in this position at any given time – in part because they don’t tend to survive long.

**CUSTOMER FAVOURITES**

Very well placed to win share from bricks and mortar rivals – but typically only 1 in 10 retailers in a sector is in this position.

“THE PACK”

Around 4 in 10 retailers in a sector are typically viewed by customers as ‘average’. This is a relatively weak starting point – but it can often be significantly improved by upgrading commercial capabilities.

**VALUE LEADERS**

Price leadership is highly effective against bricks and mortar rivals – whether it can be defended against online competitors often depends on whether basket size tends to be high. Around 2 in 10 retailers fall into this category.

It is vital to understand what customers think of what you’re offering them and the prices they have to pay – and how this compares to competitors.
**GOING BACK ON THE ATTACK**

Depressing as the situation may be, there is hope. Stores exist for a reason. As an environment for presenting a wide variety of product options, for having customers really understand the products that are available, for offering advice and assistance and providing an engaging experience for the consumer, the store is unrivalled. It is also highly efficient to ship product to a store and ask customers to handle the costs of the expensive last mile.

And the art of merchandising has a value – a store is a perfect environment to get customers to buy the products they didn’t even know they wanted. In fact it is common to see multi-channel retailers that typically average four or five items in a basket bought in store, rarely achieve more than one item in a typical online basket. The internet is well designed for fulfilling a single, simple consumer need, but a store is well designed for selling. And customers use the channels differently to start with: they are far more likely to visit a store for a complex multi-item purchase than for a simple single-item one, as Exhibit 3 illustrates.

But the category killers in the bricks and mortar world need to recognise that they are not category killers online, and probably never will be. Amazon’s ability to offer equally wide or wider assortment across many categories, and lead in price perception means that while most category killers still lead in consideration in the real world, they lag far behind online.

Achieving consideration leadership and category killer status online can only be done by leveraging the store portfolio. But not through a typical multi-channel strategy which really only attempts to remove misalignments between the different channels. It requires a shift in thinking about how and why customers buy different products. What are the different purchase types? What are all the steps that consumers go through before, during and after the purchase? How can your different channels support the whole process by working together for the customer seamlessly?

In most category killers the bulk of the organisation is focused on managing the bricks and mortar business while the online business sits off to the side, run separately to free it from the bureaucracy of the legacy business. Under this model the best that can be hoped for is to minimise misalignment and to grow a strong online business out of the ashes of the bricks and mortar business. Instead, category killers should organise around product groups that are defined by the way customers buy them, across channels. This removes the barriers that prevent each channel playing its optimum role in each customer’s individual purchase journey, whether that be initial research, getting advice, actually transacting or receiving after-sales support.

The ultimate goal is a mutually-reinforcing symbiosis between different channels where an online presence increases consideration and conversion in stores and the stores do the same for the online business. The answer for how to achieve this symbiosis will not be the same in different retail sectors and will likely not be the same for different categories within a retailer. The design of the stores and of the website (and other online access routes such as mobile apps) will need to change, as, eventually, will the real estate configuration. But the prizes are a re-established customer proposition advantage that can’t be matched by pure online competitors, and a continued consideration advantage into the future.
### EXHIBIT 3: THE ECONOMICS OF HALO

<table>
<thead>
<tr>
<th></th>
<th>In-store</th>
<th>Online</th>
</tr>
</thead>
<tbody>
<tr>
<td>Items in rest of basket</td>
<td>4.8</td>
<td>1.3</td>
</tr>
<tr>
<td>Sales of rest of average basket</td>
<td>$103</td>
<td>$45</td>
</tr>
<tr>
<td>Margin on rest of basket</td>
<td>$39</td>
<td>$17</td>
</tr>
</tbody>
</table>

In this example, customers buying a particular household item typically bought several other items when shopping in a store, but only one or two when shopping online. This is typical for low-margin big ticket items, and means that stores can often afford to offer lower prices than online competitors.
ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

In the Retail practice, we draw on unrivalled customer and strategic insight and state-of-the-art analytical techniques to deliver better results for our clients. We understand what it takes to win in retail: an obsession with serving the customer, constant dedication to better execution, and a relentless drive to improve capabilities. We believe our hands-on approach to making change happen is truly unique – and over the last 20 years, we’ve built our business by helping retailers build theirs.

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