POINT OF VIEW

The Changing Face of Retail

Adapting to Smaller Formats and Embracing E-commerce

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Food and beverage retailers, as well as other types of retailers, have likely noticed a distinct shift in shopper behaviors in recent years. Customers are increasingly shifting purchases away from larger-format merchandisers toward smaller, more experience-oriented, localized markets. This trend necessitates cutting back assortments to products that will drive the most value. Luckily, the shift to e-commerce has come at the right time. E-commerce both accelerates the trend to small shops and helps managers enable it through moving high-frequency, high-bulk household staples online.

In the face of this change, category managers can efficiently identify where to build or rationalize their product portfolios to adapt to changing in-store space and localized needs, by using more advanced merchandising and analytical strategies.

The Shift Away from Large Brick-and-Mortar Retailers

In the late ’90s and early 2000s, small, local, neighborhood storefronts lived in fear of big-box encroachment. The mom-and-pop shops of the world shut their doors as large-format locations drew customers away with low prices, extensive assortments and the convenience of one-stop shopping. However, following the recent recession, momentum has shifted away from “biggest box” retailing.

Across the majority of retail sub-industries, shoppers are increasingly shifting their purchases to smaller-format locations, with traffic to malls and big-box retailers declining by more than 28 percent since 2011.[1] The reasons range from consumers moving away from valuing one-stop shopping, to the fact that CPG lags other retail sectors in the move to go small. CPG retailers, especially, showcase this shift (see figure 1)[2] as a natural but delayed outgrowth of its occurrence in many other channels, such as home improvement, where smaller, design-focused showrooms are gaining in popularity (see figure 2).[3]

Figure 1

Small Formats Gaining Trips at Large Formats’ Expense

CPG Retailers YOY

Shopper Trips, L52 weeks, % Chg. vs. YA

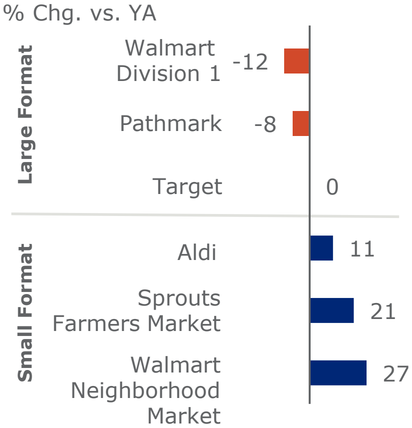
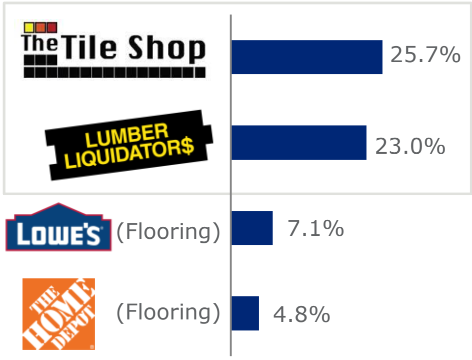


Figure 2

Specialty Stores Outperforming Large Format

Flooring Retailers YOY

$ Sales, % Chg. 2013 vs. 2012



To adapt to this trend of “shopping small,” many larger retailers are opening small-format versions of their traditional larger-format banners. In addition to the oft-mentioned Walmart Neighborhood Market example, Giant Eagle introduced Giant Eagle Express and Tesco has rolled out Fresh & Easy Neighborhood Market.[4] Obviously, retailers cannot simply port over assortments from larger to smaller formats. In addition to space limitations, the move to smaller formats alters the shopping occasion, meaning retailers must take a new look at store layouts and assortments.

Assortment decisions must shift from the traditional supply-chain push approach to assortments, evolving to a pull framework based on a deeper understanding of the shopper to generate same-store growth.

[1] Traffic data collected from 60,000 traffic-tracking devices installed at malls and large retailers in the U.S.
[2] IRI Total Store View ILD Panel data 52 weeks ending 2/22/2015, NBD dollar adjusted.
[3] Source: Annual reports for Lumber Liquidators, The Tile Shop, The Home Depot and Lowe’s.
[4] “For Retail, Is Small the New Beautiful?” *Fitch*, http://www.fitch.com/think-article/for-retail-is-small-the-new-beautiful/

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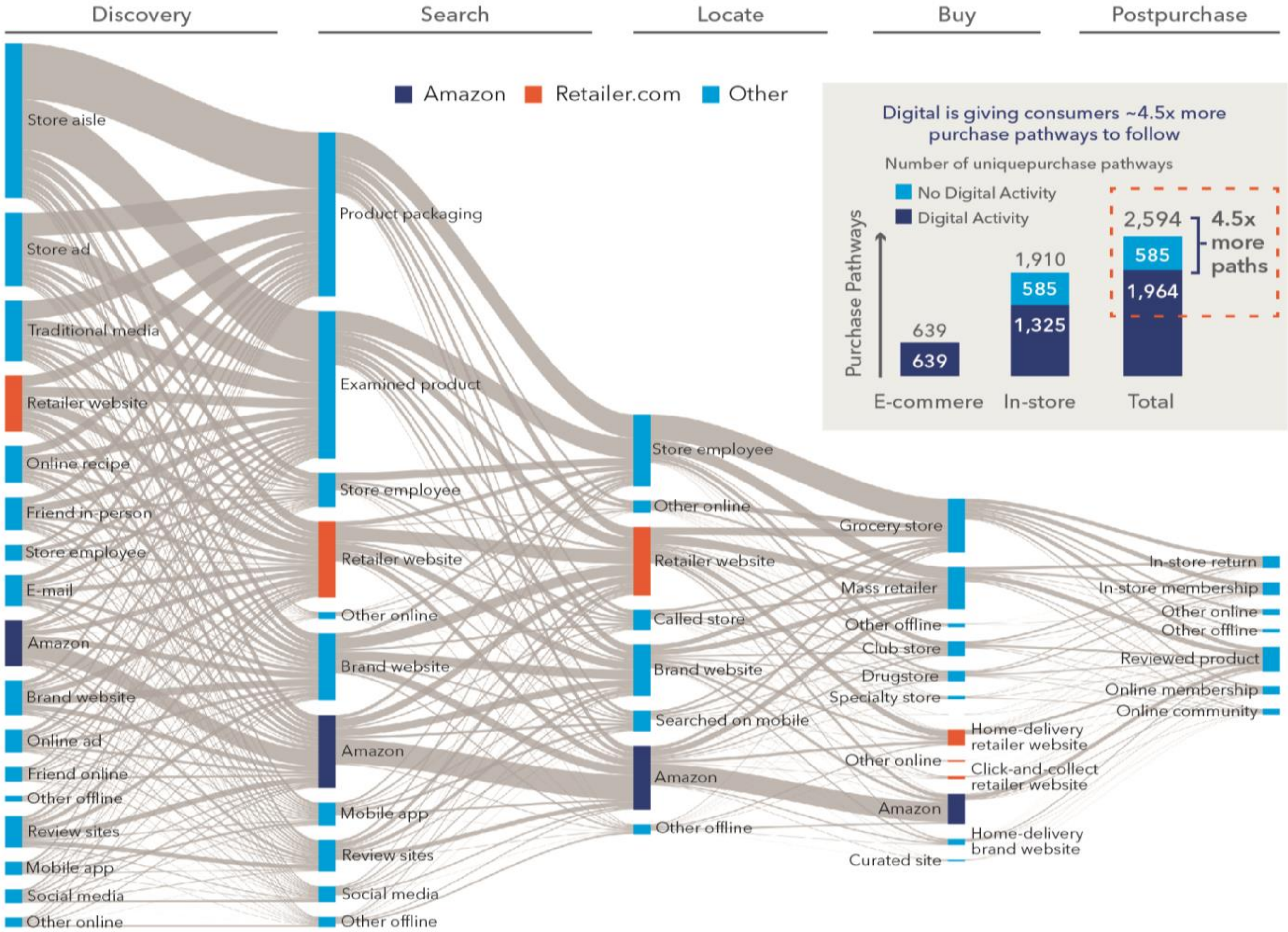
Figure 3

The Shopper Path to Purchase is Becoming More Fragmented and More Digital



Question: Thinking broadly about your last purchase, which of the following activities did you engage in? Please select all that apply. Bar size indicates number of respondents choosing the given path.

The Virtual Bright Spot?

Concurrent with the shift to smaller formats is the increasing impact of e-commerce in the food and beverage marketplace. Solutions such as AmazonFresh will soon cannibalize sales from traditional retailers in significant numbers; however, savvy traditional retailers can turn this e-commerce threat to their advantage by adopting it to give their shoppers a new channel for purchasing, complementing their brick-and-mortar presence.

E-commerce is growing quickly in the CPG space, more than triple the rate of overall CPG sales,[5] and even shoppers who buy products in-store are likely influenced by some digital media (see figure 3).[6] Although only a small percentage of shoppers leverage store websites prior to choosing which CPG products to buy, there is a fairly high chance that potential customers will search for the availability of truly critical items on their chosen retailer's website. This presents the opportunity to lock in sales of items that are most appropriate for e-commerce, or even

[5] Source: comScore data, Q2, 2014
[6] Source: GMA/IRI AttitudeLink online grocery survey, April 2014

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subscription-type replenishment, without devoting as much physical shelf space to them.

Looking ahead, different aisles will have highly varied rates of growth for e-commerce sales (see figure 4).[7] Although Health, Beauty, and General Merchandise are likely to remain in high demand online, Home Care and Beverages have a very high growth potential, likely due to their nature as stock household items bought at a regular frequency. On the other hand, most other edible categories are unlikely to see a great deal of conversion, making them poor candidates to shift items out of physical stores.

E-commerce represents both a challenge and opportunity to retailers. It can help a smart CPG retailer meet the needs of a small, localized store format, but it is only the first step in a journey. To capitalize on changing and fragmenting shopper needs, a merchant or category manager needs to answer several more questions:

- Which categories within aisles will shoppers still want to buy in-store?
- Within each of these categories, which items drive additional sales for the store and which just shift sales among different brands and varieties?
- For the items we remove from the brick-and-mortar assortment, which do we need to still offer online versus which can we eliminate completely?
- How does it all change for each area and shopper segment?

Fail to answer these questions accurately, and pursuing a pull approach can become a train wreck. Cutting items out of stores can lead both to lost sales and lost shoppers. Unfortunately, few CPG retailers are properly equipped to put this pull approach into action, despite its significant competitive advantage and sales growth that comes with it.

Figure 4

Estimated E-commerce Share of Sales by Category in 2018

CPG by IRI Department—2018 Projection—E-commerce Share of Sales

	2014 e-commerce share of sales	2018 estimated e-commerce share range	
Department	**2014**	**2018 Base Case Share Growth[1]**	**2018 Aggressive Share Growth[2]**
Health	**3.5%**	**3.9%**	8.8%
Beauty	**3.1%**	**4.2%**	**15.1%**
General Merchandise	2.3%	**3.3%**	**11.9%**
Home Care	1.8%	2.3%	6.0%
Beverages	1.5%	2.1%	**7.8%**
General Food	1.0%	1.2%	2.4%
Frozen Food	0.7%	0.6%	0.7%
Liquor	0.6%	0.6%	1.3%
Refrigerated Food	0.6%	0.5%	0.7%
Tobacco	0.5%	0.4%	0.3%
Total CPG	**1.4%**	**1.7%**	**5.0%**

Note: 1. Base case assumes growth continues at 2011-2014. Tipping point growth rate assumes e-commerce share growing at 5x the historical department growth rate, based on the total CPG tipping point acceleration rate.
Source: GMA/IRI AttitudeLink online grocery survey, April 2014. IRI ILD Panel Database, NBD Aligned, FY 2011-2014. IRI Consulting Analysis.

The Confidence Gap

Making the right assortment decisions has a significant upside. Beyond supporting smaller formats, having the right assortment can grow sales, traffic, basket sizes, loyalty, turnover and returns on space, while reducing inventory on hand, cost of sales, store size needs and shopper confusion. Sophisticated CPG retailers can even tailor assortments in ways that can direct shoppers to select specific brands, or products that are more profitable or more likely to lead to additional purchases.

The typical, centralized push approach that retailers have used until now (see figure 5) relies

[7] Source: GMA/IRI AttitudeLink online grocery survey, April 2014. IRI ILD Panel Database, NBD Aligned, FY 2011-2014. IRI Consulting Analysis

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Figure 5

The Traditional Push Approach to Assortment (High-Level)

Figure 6

The Recommended Pull Approach to Assortment (High-Level)

heavily on the assumption that store formats will remain large and shopper wants will be consistent across the majority of key movers in major aisles. Essentially, 90 percent of items are assumed to be constant across an entire footprint of larger-format stores to drive supply-chain efficiency.

The influence of granular local needs will be ascendant, expanding well past the 10 percent threshold (see figure 6). The key will be to anticipate demand. Suppliers also will enter the process sooner, the process will incorporate a review of in-store versus online trends, and historical performance is no longer taken at face value but analyzed to more deeply understand the whys behind it.

Bridging the Gap

The critical first activity for decision-makers is to assess their organization's capabilities, identify gaps and prioritize addressing these to begin their localization strategy. Fortunately, getting to a state where the pull approach is possible can be broken down into five simple steps.

Step 1—Look Beyond the Four Walls

The pull approach starts from the outside in. Localized needs will, almost surely, include items never before stocked in a particular banner, and only a full view of performance across the rest of the market will provide the necessary insights. Fortunately, market research firms and data providers are able to supply this full view of the market easily, down to a very granular level.

> It is critical to identify the demands of shoppers and ensure that assortments reflect these needs and drive purchasing.

To be successful without leveraging critical rest-of-market POS data, a retailer would have to sell every single product available in the market at all times. They would have needed to do so within each individual metro area and they would have needed to shift their assortment so many times to try out as many combinations of items as possible. Obviously, no retailer can do all of those three things. Therefore, those that fail to leverage data outside of their own systems are highly likely to find information lacking when making decisions about initiatives, such as new promotions and new pricing strategies. This leads to a tendency to go the safe route rather than try new, possibly much more successful tactics.

The bright spot of e-commerce is a blind spot for many merchants. Retailers will have a basic understanding of categories performing well online or through mobile devices, but those understandings are often colored by their own biases. For example, a number of online storefronts

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refused to sell bottled water online, expecting customers would be unwilling to pay shipping costs. However, this category grew online sales by more than 20 percent in the last 52 weeks,[8] as shoppers happily purchased sparkling and mineral water much more through online vendors like AmazonFresh. The recipe for success consists of drawing inferences from outside demand and outside experience.

Step 2—Reassess Store Clusters

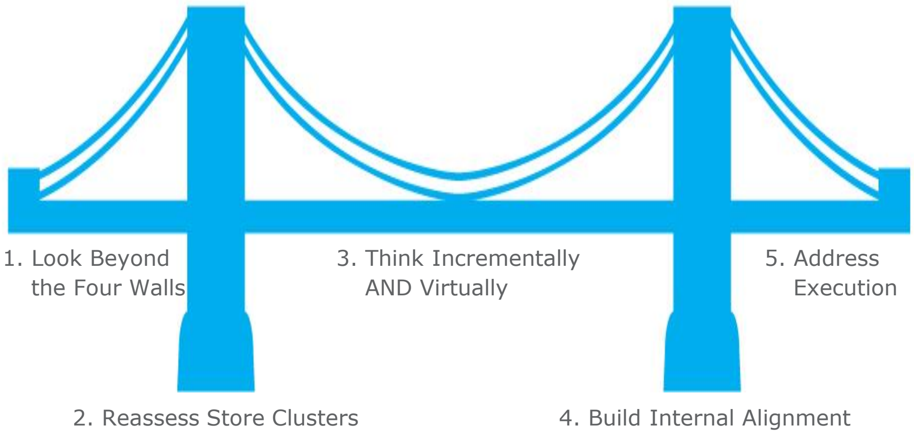
The complexity and cost of managing an individual assortment for each store can be worth it in some cases, but most CPG retailers will find that clustering stores will provide the necessary granularity.

Experience has shown that organizing clusters by shopper profiles first and geography only later is much more successful. This is especially critical for smaller-format locations, as they must stock only well-selling items to be successful.

Organizing store clusters by shopper profiles first and geography later is much more successful.

Several leading grocers and supercenters have learned this lesson well in recent years, clustering their stores to better localize the assortment of key

Five Steps to Bridging the Gap



CPG categories. Effective store clustering by itself can improve sales by as much as 1 percent. This is before the retailer even makes the most advanced assortment planning decisions required to maximize the benefits of localization.

Step 3—Think Incrementally AND Virtually

Assortment optimization has always been based on the time-tested concept of incrementally, a detailed understanding of how much in additional sales a particular product drives that is net new to the retailer, not just cannibalized from other items in the assortment. To survive, the retailer must understand the ability of each item to drive incremental category sales when it is stocked in-store. To excel, the retailer will need to understand the brick-and-mortar impact of the item, its role in e-commerce, and whether the item should be exclusively a virtual offer. This provides the foundation for smarter decisions on how online availability supplements the physical store presence, instead of seeing online in conflict with physical stores.

Moreover, in the drive to provide convenience, some retailers have found their customers are more amenable to the option of a regular, recurring subscription and delivery service. Pet care products are a big area of opportunity, as this regularly purchased category is expected to grow its share of total e-commerce CPG spending upwards of 10 points by 2018.[9] To be ready to take advantage of this, a CPG retailer will need to understand which products in this broad category will best transfer to an online and/or subscription-based channel.

[8] IRI Aisle View ILD Panel data 52 weeks ending 2/22/2015
[9] ComScore and IRI Consulting Analysis

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Step 4—Build Internal Alignment

The retailer should place a premium on information from the field when switching to a pull approach. Internally, the key figures to get on board and in alignment are the local store managers. They can serve as an excellent validation or sanity check on the insights coming from local data. They also will prove invaluable in executing localized assortment decisions in a way that resonates with local shopper needs. At the same time, retailers must beware that without proper engagement, these valuable resources can also have a biased, narrow view that may only reveal a partial picture of local realities. A regular cadence with local managers who are armed with data, as well as their local insights rather than ad-hoc questioning when a problem comes up, has proven successful.

Recently, a regional supermarket noticed its sales mix was substantially shifting from the canned and frozen items in the center store to the fresh categories of the perimeter, except in its largest urban area. There, the center store was similarly shrinking, but perimeter sales were staying flat. Store managers explained that for shoppers in that area, perimeter sales were always the province of small produce markets and family-run delicatessens or butchers. Armed with this knowledge, the retailer was able to shift the assortment to better reflect purchases made at these smaller, alternative competitors, and finally was able to capture some of the growth occurring outside of its walls.

Step 5—Address Execution

Executing a localized assortments strategy effectively requires more and better information, more decision points, and a more strongly aligned decision process. To achieve optimal benefits, retailers must rationally cluster stores, implement a well-defined strategy and align execution.

> An effective localized assortment strategy requires more and better information.

Fortunately, most retailers today have advanced assortment planning solutions that tie into their overall ERPs, and these greatly minimize the chance of errors on the back end. However, there is still the simple chance of misinterpreting the data or making the wrong decision. The safeguards for this last piece are simple: train, monitor and direct. If decision-makers have received support to build their skills, provide them with the right tools and have a process in place to flag decisions for approval when they are outside of specified thresholds.

In recent years, as a national grocer attempted to assort smaller-format stores, it found that these stores were suffering from low sales. Despite basing their assortment decisions on a very sophisticated demand simulation engine, customers were leaving the store, claiming they simply could not find enough of what they wanted to buy. The retailer was trying to use the same assortments for large-format and small-format stores. Once decision-makers created two distinct assortment strategies, one for large stores and the other for small-format stores, results improved.

Conclusion

Moving to small-format stores is inherently risky. Cut out the wrong items and customers will take their dollars elsewhere, but hesitation in reducing the items on the shelf will result in a small format that is cluttered and ineffective. Understanding the products and the channels to which demand migrates, at a very local level, and driving seamless execution will prove the key elements for success. This is only possible with the right data, solutions and processes to make localized assortments a reality, and while building capabilities in each of those areas requires investment, the returns will greatly overshadow the costs.

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