From products to ecosystems: Retail 2010

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"Ecosystems" that cater to interrelated customer requirements may be the next big thing in retailing. They could answer both the consumer's desire for speed and efficiency and the retailer's need for growth—perhaps at the expense of other industries.

Buying a new house involves some of the most complicated and nerve-wracking tasks anyone could possibly undertake. In a short time, the typical buyer must seek out and qualify for a mortgage, find a lawyer to handle the closing, hire a moving firm, and engage a contractor to carry out renovations. There are utilities to be turned on, security systems to be installed, appliances to be bought. And you have to arrange for insurance. What buyer wouldn't prefer to do business with a single vendor that could make or guide every choice and organize the countless details accompanying a change of residence?

Many retailers, building on their core merchandising and customer relations skills, may have the ability to pull all of these things together by offering a broad array of products and services to groups of customers defined by their common situation. In the case of a home purchase—or, for that matter, the entire span of products and services that homeowners want—the retailer might be the do-it-yourself superstore Home Depot, a chain already valued by customers for the home improvement advice its salespeople dispense. Further examples spring to mind. To meet everyday needs, Wal-Mart, the world's largest retailer, could provide a range of goods and services from laundry detergent to utility payments. Walgreens could go beyond selling

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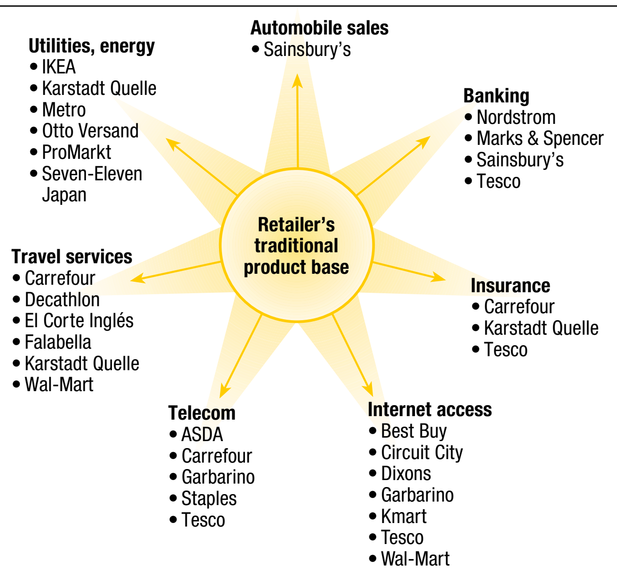
personal and health products to offer referrals to doctors, nutritional counseling, flu shots, and health checkups.

Some retailers are already taking the first steps in this direction (Exhibit 1). Home Depot now offers design and installation services, home improvement financing, and tool rentals. Carrefour, the world's second-largest retailer (based in France), provides insurance, telecom, and travel services. Meanwhile, the US office supply retailer Staples, extending its products and services for small businesses and home offices, provides insurance, telecom services, copying, shipping, and payroll servicing.

In effect, such companies are looking for new sources of profitable growth by shifting away from product lines and toward packages of interrelated products, services, and information. To do so, they are leveraging their inherent product strengths, brand identities, customer relationships, and scale. Ultimately, acting like a biological ecosystem that nourishes and supplies its denizens, retailers could fulfill lall the purchase needs of certain kinds of customers. Retail ecosystems might concentrate on specific purchase occasions such as routine shopping for everyday needs, on lifestyle segments (young urban chic, for example), or on life stages (such as care of the elderly).

EXHIBIT 1

Retailers are branching out



These retail systems would be quite different from those that emerged from past attempts at diversification. In the 1980s, Sears tried to benefit from its large volume of customers by expanding into a series of new businesses, particularly financial services. The company faced a number of challenges, however, in tailoring its broad range of product and service offerings to specific customer segments and in managing a diverse set of new businesses. Kmart too diversified into unrelated specialties such as books, home improvement products, and sporting goods by purchasing, respectively, Borders, Builders Square, and Sports Authority. But these operations were run as discrete portfolio holdings, with no apparent leveraging of common consumer interests or integration of product lines.

This time around, retailers will have to avoid these pitfalls and go beyond simply stretching brand names over unrelated product lines. They will also have to master multichannel dynamics, partnering, and brand leverage while defending themselves against other businesses—inside and outside the retail sector—that seek to "own" the customer. The race will be impeded by obstacles, but if retailers pass the finishing line they will have stronger top-line growth, enhanced margins, and closer customer relationships.

A new race

Retailers won't be alone in their attempts to grow by providing interrelated products, services, and information, and they could find their own customers being poached by others. The sports broadcaster ESPN, for example, has opened its ESPN Zone chain of sports-themed restaurants. The media conglomerate Cablevision has bought Madison Square Garden, Radio City Music Hall, and The Wiz (an electronics retailer). Banks, utilities, media organizations, and health care companies could all become competitors—or partners—of retailers.

Even so, retailers begin with certain advantages. They have unparalleled levels of customer penetration and customer visits. They have extensive national and global networks combining bricks-and-mortar stores with World Wide Web sites and other channels. Many have entrenched themselves in specific consumer segments. In addition, retailers have long experience of taking diverse products from many suppliers and creating a compelling experience for consumers—skills that rivals from other industries would find difficult to replicate quickly. And though players in some industries claim that their products are too complex to be sold by retailers, some of the latter have clearly shown a knack for demystifying the experience of shopping for sophisticated wares, from mobile telephones to custom paint colors.

Benefits for all

Starting with the consumer and working back to the supplier, the kind of consumer ecosystems we envision could yield benefits for every participant in the value chain.

The consumer

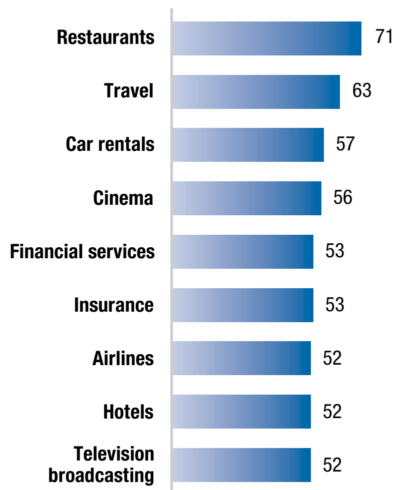
This new retail environment's focus will be consumers and their shopping occasions, life experiences, and lifestyles. To succeed with this approach, a retailer would have to deliver a very tailored range of products and services, increased convenience, a more satisfying overall shopping experience, and, in general, lower costs—whether the customer is a home buyer, a young urban professional, or a sports enthusiast.

Studies suggest that consumers think retailers could branch out into nontraditional product lines. A 1998 McKinsey survey assessing the strength of US brands and the extent to which they could be leveraged found that more than 60 percent of respondents believed that Wal-Mart had the skills to expand successfully into new lines. More than half expected it to be at least as good as traditional providers in areas ranging from insurance to airline travel (Exhibit 2). A similar McKinsey survey carried out in France, Germany, and the United Kingdom this year showed even higher levels of confidence in retailers relative to companies in other industries. Those polled thought that European retailers were quite capable of providing financial services and telephone connections and of selling cars (Exhibit 3).

EXHIBIT 2

Can Wal-Mart enter new businesses?

Percent of respondents who believe that Wal-Mart would be at least as good as traditional providers, by product or service type



Source: McKinsey proprietary branding research, 1998

The new retail environment should also meet the needs of consumers more rapidly and completely—an important value proposition in an age when products and services are becoming increasingly complicated and leisure time increasingly precious. Shopping for home electronics products offers an example. Shoppers used to buy appliances, plug them in, and turn them on. With the arrival of cable television, wireless telephones, personal digital assistants, video players, satellite dishes, fax machines, answering machines, and computers—many capable of communicating with each other—those days have departed forever. To ease the lives of consumers, a home entertainment retailer could not only design and install a unified domestic network in their houses but also help choose its content providers and provide ongoing service for it. Convenience could go hand in hand with lower prices as retailers replicate their cost advantages in areas such as purchasing, customer acquisition, and labor efficiency and pass some of the savings on to consumers.

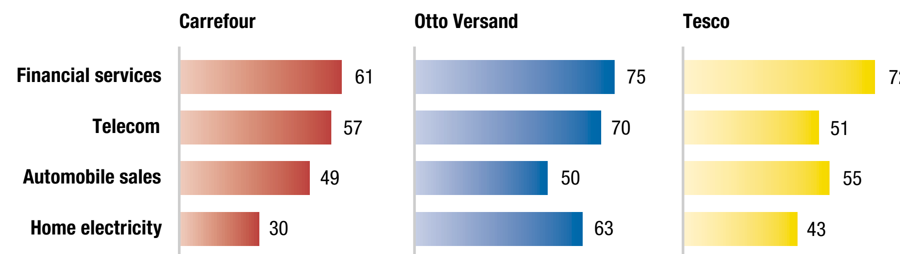
The retailer

In fact, the top-line benefits of providing an expanded range of products, services, and information are obvious in the case of retailers, which must deliver extraordinary growth to meet the expectations of the capital markets. Consumer expenditures are shifting from retail goods to entertainment, culture, and education. Real prices are declining in many markets. Home

EXHIBIT **3**

Confidence runs high

Percent of respondents who believe that each retailer would be at least as good as traditional providers, by product or service type



Source: McKinsey proprietary research, 2000

markets, especially in Europe, are becoming saturated. These changes mean that retailers can generate entirely new revenue streams and capture larger shares of consumer spending. In addition, the increased customer traffic these offerings attract should help boost sales of traditional products.

There are bottom-line benefits as well. Many companies from other industries—companies that lack the benefit of broad physical-distribution networks, strong brand names, or established customer bases—must spend a significant amount of money acquiring new customers (Exhibit 4, on the next page). But strong retailers, which do have these assets, are well placed to entice existing customers to buy new services and products, without incurring high marketing costs. In addition, labor can be more productively employed by strong retailers, since stores generate more traffic than do most other kinds of commercial locations. And overhead costs already incurred can be spread over additional products and services. (Expenses for a bank branch in a supermarket can be about two-thirds those of a traditional bank branch.[1] Profitability can be as much as two and a half times higher.) Finally, the large volumes that national retailers buy help them acquire products and services at very favorable rates. Companies such as Wal-Mart and Home Depot are famous for extracting rock-bottom prices from their vendors.

In short, consumer ecosystems offer a tempting opportunity for companies that are now under pressure to satisfy shareholders' expectations.

The supplier

Participating in retailers' ecosystems will help different kinds of suppliers reap different benefits. Some suppliers—particularly those in newly deregulated industries, with little experience of retail competition—may be happy

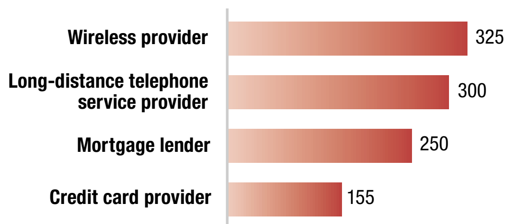
[1] *See* Dorlisa K. Flur, Elizabeth A. Ledet, and Molly McCoy, "Supermarket banks," *The McKinsey Quarterly*, 1996 Number 4, pp. 76–83.

to hand over responsibility for the customer interface to experienced retailers, thus allowing both parties to focus on their core competencies. Such alliances can give a supplier access to new customer segments, help its distribution networks expand rapidly, and give it access to merchandising expertise that is likely to exceed its own (and at lower cost than it could achieve itself).

EXHIBIT 4

Acquisition costs are high for nonretailers

Acquisition cost per customer, $



Source: Forrester Research, 1998; International Data Corporation

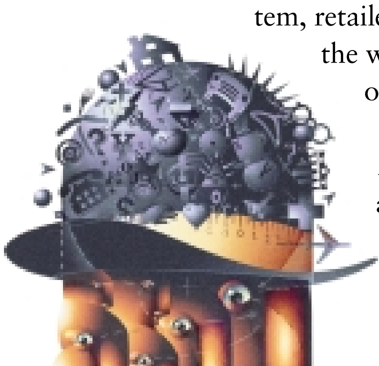
But suppliers that have a strong retail brand are more likely to use retail partnerships to extend their reach. Sprint's deal with Radio Shack, which gave Sprint a chance to build its market share in wireless quickly, is a recent example of such a partnership. The likely outcome of such alliances will be co-branded products that take advantage of the partners' strong reputations.

Retailers will often have to round out their offerings for specific customer segments by turning to private-label and second-tier branded suppliers, which will benefit from access to established customer bases and distribution channels (actual or virtual) and gain the ability to bask in the retail partner's brand credibility. These suppliers will also share in the cost savings that partnerships with retailers generate for the whole value chain. For strong regional suppliers, a retailer's national or international marketing and distribution network might be of interest.

Suppliers that have already built themselves strong brand names, invested in direct consumer marketing, and come to control large distribution networks could stand in the retailers' way and might even decide to develop their own ecosystems.

From tentative experiments to integrated systems

The retail landscape is littered with companies that have tried and failed to implement bold growth strategies. To create a successful consumer ecosystem, retailers must reach beyond their core skills and redefine the way they think about themselves, their customers, and other companies.



A retailer's ability to offer a broader range of products and services and to create a profitable ecosystem rests on the strength of the brand and the ability to leverage it. Despite the success of own-label retailers such as Gap, H&M, and Zara, many retailers emphasize other companies' brands in their overall marketing strategies. Although manufacturers' brands will continue to play a key role in many categories, retailers that succeed in creating integrated systems will shift from promoting other brands to building and leveraging their own across a variety of product and service categories.

Suppliers with strong brand names, direct consumer marketing abilities, and big distribution networks might **develop their own** ecosystems

Today, the authority of a retailer depends largely on the breadth and depth of its product assortment and its ability to get products to the right place at the right time. But to serve the diverse needs of a consumer segment, retailers must move from a product mind-set and embrace a broader emphasis on service and information. For example, Radio Shack, formerly a dealer only in goods, now derives 35 percent of its earnings growth from services. Retailers must also be where consumers expect to find them, which means that they must quickly master at least three distribution channels: bricks and mortar, the Internet, and mobile commerce.

Moreover, if retailers are to perform well in their new businesses, they will have to acquire many a new operational skill. This requirement will inevitably force them to form strong partnerships, for otherwise no retailer will be able to offer a full range of distinctive products, services, and information efficiently. With such partnerships, retailers will be able to concentrate on managing the customer interface.

Finally, the creation of consumer ecosystems will introduce extra complexity into the retailer's organization. Besides developing a number of different channels, retailers will have to build organizational skills to help them control the process.

Consumer ecosystems could change the way consumers shop—indeed, the whole retail landscape—rapidly, though it is far from clear whether traditional retailers or players in other industries will ultimately be the main owners of ecosystems. To forward-looking retailers with strong brands and broad reach, they offer, at the very least, an exciting growth prospect that should be explored. MQ