IF 3310
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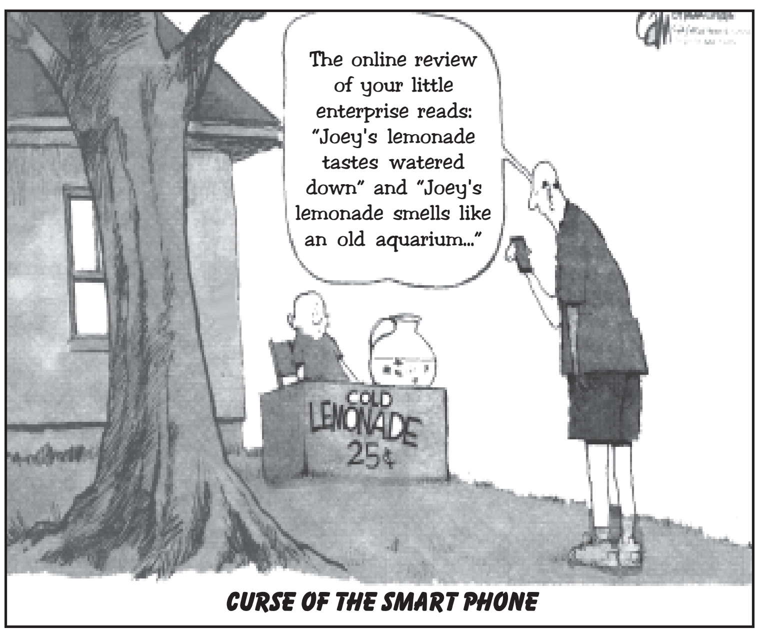
RETAILERS DEAL WITH AN EFFICIENT MARKET: CONSUMERS IN CONTROL AND THE DISRUPTED MARKETPLACE

The customer knows the right price. We can raise the price all we want.
She's only going to pay the right price. And why is that?
Because she's an expert.
– Ron Johnson, CEO, JCPenney

Online retailing has been eating into profits of bricks-and-mortar stores, and even though the percentage of overall sales remains low, the annual percentage increases in online sales have caught retailers' attentions. Large retailers have lately been responding by: (1) buying online retailing; (2) imitating digital retailing; and (3) rethinking physical retailing. Producers have likewise started to rethink how they relate to physical and online retailers. We anticipate more aggressive actions from physical retailers in the near future and infer that market turmoil could be part of the retailing industry for some time.

Market Realities Hurt

So-called efficient markets consider the relative impact of information, with highly efficient markets experiencing well-distributed information across all participants and the opposite being true of inefficient markets. Prices fluctuate, the efficient-market hypothesis suggests, based on the accessibility to relevant information. In the recent past, consumers have gained access to unprecedented amounts of information on products and services in consumer markets, as helpful market resources, most provided by digital devices, have become available to any consumer willing to access them.



Businesses seeking to attract consumers who have so much information at their disposal have had to admit that they can no longer count on tactics that worked in the past, tactics such as coupons, sales and promotions. They do not work because consumers do not accept advertised or stated prices as real – that is, to consumers with comparative-shopping, outlet and couponing sites at their disposal, the lowest price is the price. All others are merely distractions that say: "Wait."

◆ JCP (the retailer formerly known as J.C. Penney), Mango, Supervalu, Urban Outfitters, Stein Mart, Wal-Mart and American Eagle Outfitters have in one way or another announced policies that claim they will be offering the lowest possible price at all times, forgoing the game of starting at one price point and then offering increasingly deeper "sale" prices as time passes. (*New York Times*, 3/27/12)

Part of what has driven these retailers to this tactic is not only that consumers have learned to wait for the deepest-cut sale price but also that consumers have started bargaining with clerks in traditional retail stores, threatening to walk out and buy online if their price demands are not met. Customers report successful in-store haggling at such mainstream retailers as Jos. A. Bank and Brooks Brothers.

The message seems to be that online shopping behavior – that is, accessing reviews about the best price and best service, and using comparative-shopping resources – has been altering consumers' behavior, even when they are in traditional retail stores. Whereas they once favored the comfort of a shopping mall, the imagery of well-known brands, the ease of store credit and the influence of celebrity endorsements, consumers now favor sufficient value, best price, convenience and a friend's endorsement ("friend" includes any personal reviewer they trust).

The proliferation of retail outlets, whether bricks-and-mortar, catalogue or online, has made it possible for informed consumers to play one outlet against another for price advantage, a dynamic we call the Playing Out of the New Industrial Revolution. One of the key effects of this dynamic has been the ability of mostly digital enterprises to insinuate themselves between retailers and consumers, by intercepting would-be shoppers and providing them with lower prices, easier access, consumer reviews and a broader selection. As a result, disintermediation – a third party interrupting existing business relationships and presenting a company's customers with alternatives – has become a constantly evolving reality for the retailing industry, a structural change that has already endangered bookstores, record stores and purveyors of any product that can be delivered digitally (see "Contingent Pricing: Value Propositions and Other Pricing Anachronisms," **IF 2713**, 5/31/06).

"The best things in life are free. The worst are $19.95."

The effects, however, go well beyond industries whose actual products can be digitized. In the apparel industry, to take one example, the list of manufacturers, wholesalers and retailers offering products online seems to expand almost daily. For instance, recent additions to the online apparel-selling market include Ratio Clothing, Moda Operandi and OpenSky, which provide information about and access to high-end clothing. RedLaser assists consumers in comparison shopping for the best deals, and ThreadUp offers direct-to-customer clothes for kids and made-to-order attire for adults. Style Owner and Shop My Label are online retailers with extensive inventory lists. (*Women's Wear Daily*, 10/3/11; *Mobile Commerce*, 4/20/11; *Fast Company*, 3/12; *New York Times*, 11/10/11)

Because of the proliferation of such shopping options – mostly made available by digital technology – and because of the proliferation of consumer-friendly shopping resources – almost totally enabled by digital technology – bricks-and-mortar stores are finally feeling the need to react to this increasingly efficient marketplace, often turning to the same digital technology that has caused them so many problems.

"Something's clicking. I want you to find out what, and click the holy hell out of it."

Taking Action

Last year, online spending in the United States reached $161.5 billion, an increase of 13 percent over 2010. Specifically in the area of apparel and accessories, that increase was 22 percent. While representing less than 5 percent of overall sales, online sales have been making percentage jumps in market share that portend more and more trouble for traditional retailers. (*Crain's New York*, 4/9/12; *Fortune*, 3/31/12)

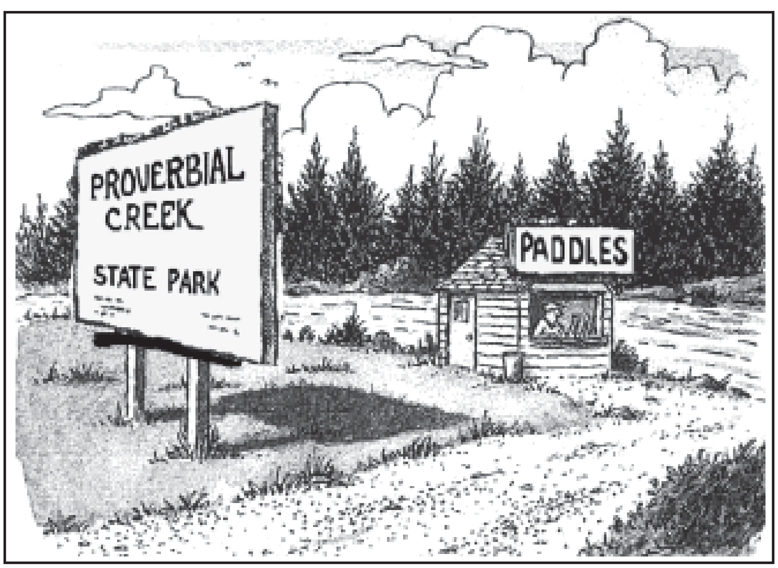
Lately, some bricks-and-mortar retailers have been taking actions to keep pace with the changing marketplace.

Buying online retailing – Last year, Walgreens paid $409 million to purchase an online rival, Drugstore.com, to create an immediate (and successful) online distribution channel. Wal-Mart Stores paid $300 million to buy Kosmix, a social-media startup, which is now called WalmartLabs.com and is testing new Web and mobile applications. Meanwhile, Nordstrom signed a deal with Bonobos, an online-only retailer of men's clothing. Bonobos will sell its wares in 100 Nordstrom's physical stores, while Nordstrom will acquire expertise in online branding and e-mail marketing from Bonobos. Last year, the department store giant also purchased HauteLook, for $180 million, the first time a bricks-and-mortar retailer had purchased a "flash sales" site – that is, a Website that sells deeply discounted merchandise on a limited-time basis. In a different approach, Best Buy hired Stephen Gillett, Starbuck's online specialist, and charged him with "oversight of the critical capabilities necessary to make technology a bigger part of the customer experience." (*New York Times*, 4/12/12; *Information Week*, 4/9/12)

Imitating digital retailing – In 2011, Nordstrom placed more than 6,000 mobile handheld devices in its stores to make checkout and inventory checks easier and faster. The department store's online service, Nordstrom.com, introduced same-day shipping for select markets as well as for iPad and iPhone customers, hoping to sound more like strictly online outlets such as Amazon. Aurora Fashions, a British company, is pushing the envelope considerably, offering delivery of goods purchased online in five days, in three days, on the same day…and in 90 minutes! (*New York Times*, 4/11/12; *Women's Wear Daily*, 4/27/12)

Adidas is moving digital technology into its stores with deployment of the Virtual Footwear Wall, a 46-inch screen that renders three-dimensional images of products and enables shoppers to interact digitally with 24 different shoe models. Not only does a customer watch a specific shoe of his or her interest being put through its paces on the screen, he or she can grab an available "fitting boot" to see how that specific model feels when laced up. Only when satisfied with the style and fit does the customer ask for a sales agent to retrieve the actual shoe. When Adidas first introduced the Wall at an Oxford, England, store, sales of the model F50, which is a featured on a video, increased fivefold. (*Chain Store Age*, 4/12)

Rethinking physical retailing (or, bigger is no longer better) – Best Buy recently announced that it would be closing 50 of its so-called big-box stores, hoping to save $250 million in fiscal 2013. Wal-Mart revealed that it would be focusing its expansion strategy on smaller, in-town stores, and Office Depot and Staples have already started to decrease the size of their new stores. Home Depot has been leasing sections of its parking lots to auto-repair shops and food chains, seeking to make use of the space no longer needed for its customers. Even smaller retailers are downshifting, with, for instance, Third Street Books in McMinnville (OR) subletting space in its store (after having expanded its space in 2006) and Bunch of Grapes, an independent bookseller on Martha's Vineyard (MA) moving from a 5,000-square-foot store to a 3,500-square-foot store. The change from "bigger is better" to "just right is right" is having an effect on commercial real estate. For example, in Phoenix, 10,000 square feet of big-box retail space sit empty, roughly half of all retail space in the metro area. (*CNN*, 3/29/12; *Wall Street Journal*, 3/3/11; *Publishers Weekly*, 4/23/12; *Arizona Republic*, 3/26/12)



Producers Rethink Their Model, Too

We have noted examples of producers controlling supply to manage margins in a stressful market environment. Internationally, cartels seek to control pricing by managing output, whether of energy or commodities. Nationally, manufacturers such as Coach have used something like a "limited edition" model to boost margins on specific new products by placing an implied time limit on when specific products will be available (see "Realigning with the Empowered Consumer," Parts I and II; **IF 3026** and **IF 3027**, 11/30/09).

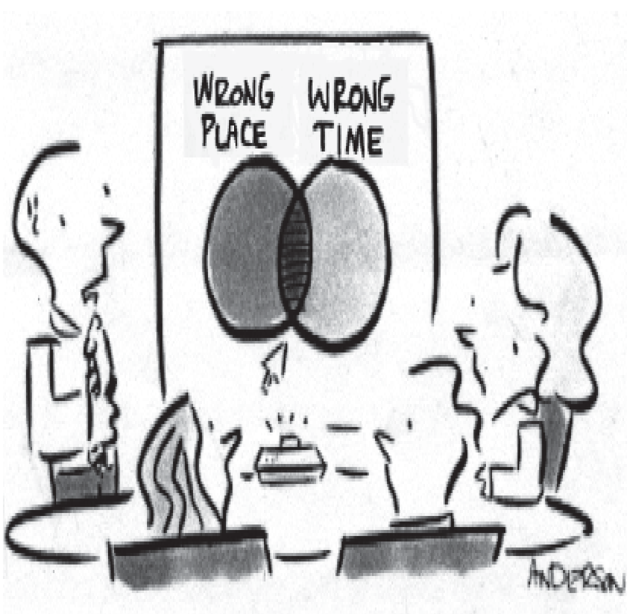
Physical retailers have been competing with online stores by lowering their prices. Recently, some manufacturers have started to react to such pricing schemes when the lower selling prices have threatened their margins.

◆ Panasonic, Samsung, Sony and others have launched a unilateral pricing policy (UPP), which sets the minimum price for their products and calls for the withdrawal of all supplies should a retailer offer one of their products at a price below the set minimum. (*Financial Times*, 4/2/12)

Pricing has become a critical part of many producers' perspectives, and their actions do not spare online retailers.

◆ The Educational Development Corporation (EDC), which typically sells its educational and children's books through a home-party model, recently pulled its entire inventory from Amazon, because the retailer's "wretched $9.99" pricing policy was undermining the company's market. (*New York Times*, 4/15/12)

Because EDC sold books mostly through home parties (its own distribution mechanism), it was feeling the crunch of the Amazon model. According to EDC, sales representatives would hold home parties, display and talk about the books and then watch patrons return to their own homes and order those same books online from Amazon. According to the company's chief executive officer, "[Home parties] were becoming showrooms for Amazon." So EDC decided to sever its relationship with Amazon. (*New York Times*, 4/15/12)



"And, unfortunately, here's us."

The "showroom" problem is one that many physical retailers are experiencing as well. Physical retailers have admitted seeing customers in their stores, looking through merchandise and then pulling out their smartphones, ordering the items online and leaving the store. In fact, one third of smartphone owners have used their phones for product information while in a store. In short order, the whole idea of a "loss leader" to get customers into the stores so they would purchase other items lost its usefulness. The showroom problem was one reason electronics stores, to take one example, lowered their prices so far, hoping to encourage customers to go ahead and buy the product while in the store. Yet such lower and lower prices undermined the market standing of brands such as Sony and Panasonic, and so they instituted a minimum-pricing policy.

The dynamic between manufacturer, retailer and customer is undergoing considerable stress, as each area tries to find some leverage or some mechanism to sustain its market position in the face of an increasingly smart (efficient-market) consumer. Meanwhile, the U.S. Department of Justice intruded into that dynamic in the book publishing industry, alleging that five major publishers (and Apple) have been conspiring to keep book prices artificially high. And Amazon smiled. (*The Week*, 4/27/12)

"On the one hand, eliminating the middleman would result in lower costs, increased sales, and greater consumer satisfaction; on the other hand, we're the middleman."

Where Is This Headed?

"Cash mobs" – groups who organize online to "attack" local stores with $20 bills and spend the money in that store – have popped up in nearly 150 cities across the U.S. Their stated purpose is to draw local citizens' attention to smaller, locally owned stores in hopes of stimulating shoppers to spend money there and not wait for incentive discounts or other retail tactics…just support locally owned physical stores. (*Christian Science Monitor*, 4/16/12)

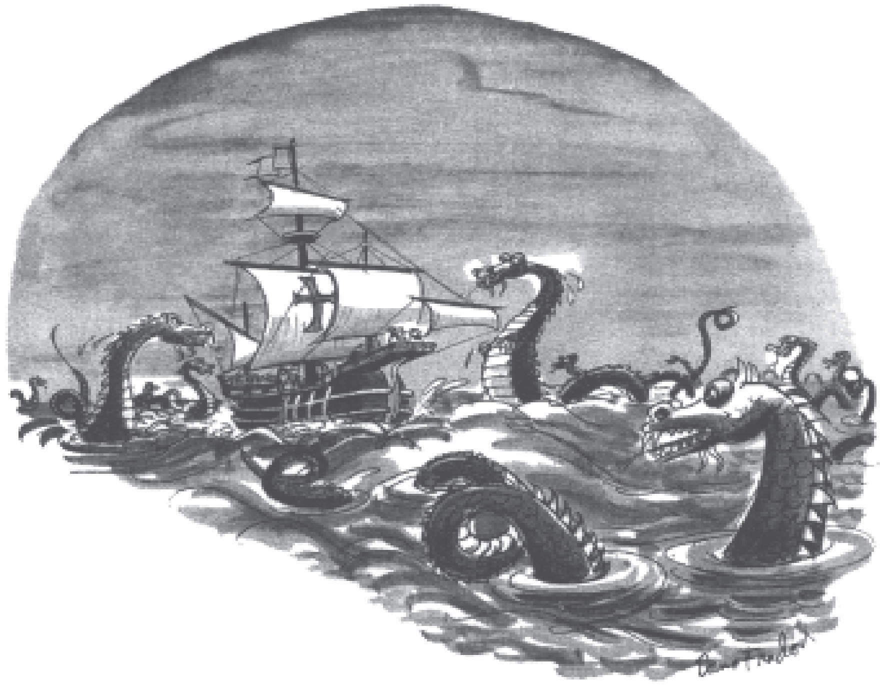
But retailers, whether local or national, should not place their hopes of expansion on cash mobs hitting their stores, mostly because the stores' most critical problems are structural. Physical retailers are getting squeezed from two sides. Customers are playing bricks-and-mortar retailers against online retailers (and online retailers against other online retailers) for best price and service – that is, exploiting the market leverage that digital technology has granted them. Meanwhile, manufacturers are challenging retailers to maintain some minimum level of pricing, and their implied leverage in the deal comes from the digital capability of selling directly to customers, bypassing retailers altogether.

Physical retailers have taken to buying and imitating online competitors and to shrinking themselves down to sizes they hope will make them more effective in this shifting environment. Some stores could easily slide into an iteration of the showroom model themselves – displaying products for customers and offering customers the chance to order online from the store, thereby letting retailers greatly diminish the need for space (no inventory) and lower prices. Meanwhile, the Dollar Store model – cut-rate pricing on mainstream and off-brand products in a moderately sized and easily accessible store – could spread across the industry, negatively affecting retail and commercial real estate. Innovative commercial-real-estate companies will hurry along a process of finding alternative uses for existing large retail spaces…or decide to raze them.

The evolving market dynamic in the retail industry could mark the beginning of a last stand for branding – companies either will be able to sustain their branding margins in an increasingly efficient market of easily accessible information and sustain connections to a more and more mobile consumer or they will join more and more products in a race to the lowest price.

The reset consumer we have been monitoring is satisfied with **sufficient** quality and seems very reluctant to pay up for something whose utility is the same as that of a lesser-priced product. The reprieve for higher-end brands could come from a decision to bypass mass retailing and sell directly to consumers via a high-service online outlet. For instance, Rakuten, China's largest online retailer, is funding Vaniti, which will be an online marketplace for small-to-midsize fashion products seeking to become industry brands. "What we've seen," explains Vaniti's creator, Derek Wall, "is 50 percent of the brands that come on Vaniti…have hundreds of thousands of followers on Facebook" but no Internet sales outlet. What will this constant influx of products with brand aspirations do to existing mainstream brands, especially if consumers perceive the new options as having equal quality and a lower price? (*Women's Wear Daily*, 4/27/12)

Digital shopping has shaken the retail industry, forcing experimentation and change, leading to shifting pricing models as well as lower real-estate values and eventually altering market dynamics between manufacturers and distributors, distributors and customers, and manufacturers and customers. Constant turmoil could well be what truly efficient markets look like, today. If so, such turmoil in retail could last for some time.



"According to the charts, it should be all clear sailing after this."