

Can Department Stores Stage a Comeback?

Traditional department stores are caught in the middle. Once thriving and profitable, many are struggling to compete with hard discounters and high-end specialty shops. So far, these new competitors seem to be winning, with industry analysts ready to sing department stores' swan song. After years of teetering on the brink, are department stores doomed to obscurity? Or are they poised for a surprise comeback?

Back in 1995, a cover story in *BusinessWeek* proclaimed, "An Endangered Species Makes a Comeback." The authors described how U.S. department stores were making an astounding comeback after being battered in the early 1990s. Fast forward 10 years, and *The Boston*

Globe put retailers back on notice with "The Endangered Department Store," pronouncing the "mass-market store as we know it is dead."

Although the news of department stores' demise has been exaggerated, such stories underscore a chronic problem that retailers have yet



FIGURE 1

Department store sales compared to other formats in North America

Comparative sales per square foot for 2003 (in US\$)



Source: Annual reports, Hoover's Online

to successfully address. Once thriving and profitable, department stores have been deeply affected by shifting market dynamics and consumer trends over the past two decades. In the past eight years, department stores lost US\$2.5 billion in sales in the United States mainly to mass discount merchants and specialty stores. Department store sales dropped from 11 percent of all nonautomotive retail sales in 1994 to roughly 7 percent in 2004, and continue to deliver lower sales per square footage of retail space than other formats (see figure 1).

If someone is losing, then someone else must be winning. In the lower end of the market, the biggest beneficiaries are mass discounters. In the United States, Wal-Mart and Target continue to attract value-conscious consumers,

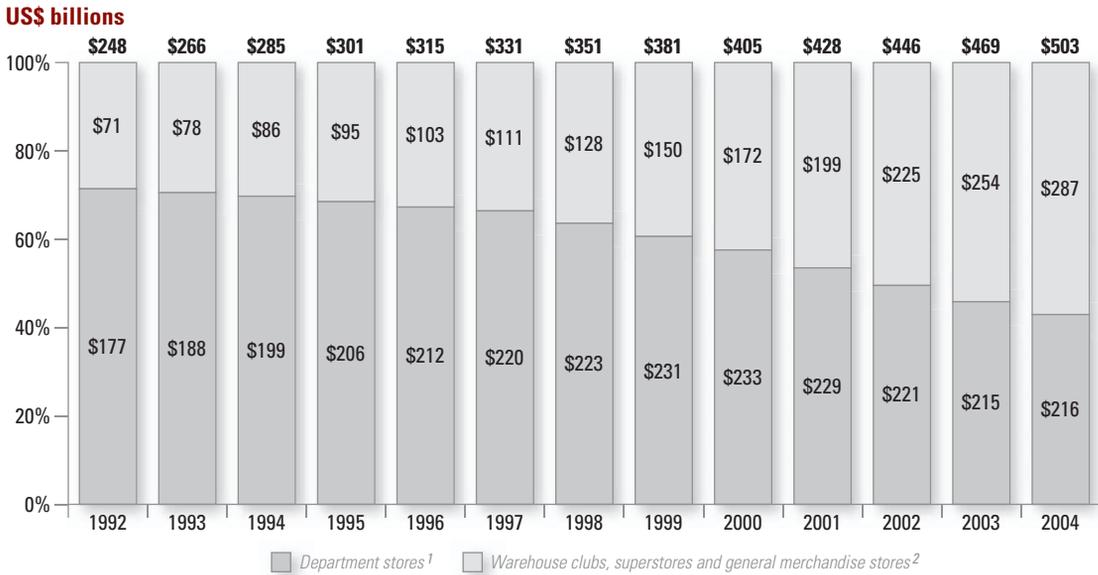
while in Europe this role is largely played by supermarket chains, such as Carrefour. In North America, from 1994 to 2004, sales at warehouses and superstores have increased from 3 to 8 percent.

Specialty stores are also reaping significant rewards. While people routinely shop at the discounters, they simultaneously search out a variety of products and services in specialty stores, such as Bath & Body Works and Williams-Sonoma in the United States, Zara of Spain and Hennes & Mauritz (H&M) of Sweden.

What are the discounters and specialty stores doing that department stores are not? Can they offer ideas to the venerable retail giants? In a word, yes. Department stores are product emporiums filled with too much merchandise.

FIGURE 2

Annual store sales in the United States



¹ 10-year CAGR 0.8%, 5-year CAGR -1.3%; excludes data for leased departments operated within department stores

² 10-year CAGR 12.8%, 5-year CAGR 13.9%

Source: U.S. Census Bureau, Annual Benchmark Report for Retail Trade and Food Services: January 1992 Through February 2005, March 2005

Consumers often see them as having high prices, not being very innovative, and offering mediocre service and product knowledge.

Department stores should be reinventing and reinvigorating their businesses, using many of the same tactics their competitors favor. For example, by targeting and catering to value-conscious consumers, discounters have made significant strides into the US\$166 billion U.S. apparel market, the core of department store business. In 1993, six of the top 10 apparel retailers in the United States were department stores, but by 2003, only two were in the top 10. Price competition will no doubt intensify in the near future as the elimination of textile quotas forces prices down even lower.

Meanwhile, specialty stores have captured a chunk of department stores' market by targeting and tailoring offerings to well-defined customer

segments and then improving operations to increase efficiency. Many specialty stores have honed their skills at procuring the latest styles and using advanced inventory management systems to get product to the floor more quickly.

Survival for department stores will depend on lessons learned from the discounters and the specialty shops, and dramatically improving execution. This includes selling targeted lifestyles and experiences rather than just products, creating a more efficient supply chain, and diversifying and developing new formats.

The Forces of Change

There are various reasons for department stores' latest predicament, with many of the problems due to exogenous forces. For example, demographics are shifting. Aging baby boomers, with

large disposable incomes, are not only increasing their savings rate but also shifting their spend toward goods and services not traditionally offered by department stores, such as health and wellness, home-improvement and entertainment products.

As boomers grow older, younger generations of consumers are not lining up to take their place. There is a growing psychological disconnect among young shoppers who consider department stores to be old and outdated. Today's youth shop at a mix of stores ranging from online to discount to niche specialty shops, such as Abercrombie & Fitch—all are able to turn product more quickly and react faster to the latest trends.

The past decade has also brought significant changes in the way consumers shop. In the United States, warehouse clubs and superstores are replacing traditional department stores as a shopping destination for general merchandise (see figure 2). Also, department stores remain largely anchored to shopping malls at a time when attention is being redirected to “power centers.” In power centers, space is dominated by specialty stores, discounters and category killers—Ikea for home furnishings, Best Buy for consumer electronics and Home Depot for do-it-yourself home improvement. People who shop at power centers believe they get more value for less money *and* time.

Department stores, once the beacon of shopping convenience, have become a cumbersome and sometimes frustrating experience for their traditional customers.

Only the Strong Survive

The laws of evolution have taught us one simple yet powerful concept: Adapt to the environment or become extinct. In a competitive environment where only the strong survive, department store

executives have every reason to be concerned, and every opportunity to regain lost ground.

The following strategies provide a starting point—something for senior executives to consider as they plan ways to adapt to the new world order.

Target well-defined segments. Department stores can no longer be all things to all people. It is time to redefine target markets based on which types of customers they are best positioned to serve. Such segmentation and targeting will require more than cursory knowledge of a customer segment. To effectively compete with new shopping formats, executives must thoroughly review their category strategies and roles, assortments within categories, pricing and promotion tactics, and space allocation to maximize profitability per square foot of selling space. Key questions to answer include: How valuable are different customer segments? What are the different needs and requirements of each segment? Do we have the capabilities to serve those needs and requirements? Who else plays in the same space and how competitive is each customer segment?

Tailor offerings to target segments. Once core customer segments are identified, product categories and assortments must be aligned to meet their needs. In general, this means offering fewer categories, but deeper assortments.

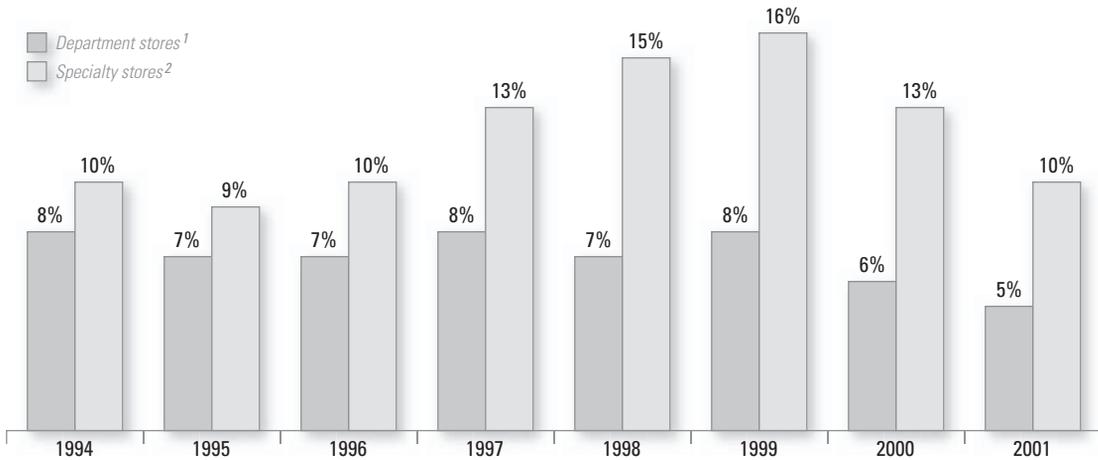
Yet matching products to customer segments is just the first step. It is far more important to determine ways to stand apart from specialty and discounter retailers. Department stores must do what the specialty shops do—consider the types of product categories and assortments that will lure people through their doors. It will require building a better assortment of exclusive and unique brand merchandise that cannot be found anywhere else.

In the United States, Macy's is targeting younger shoppers by turning some of

FIGURE 3

Specialty stores command higher margins than department stores

Average EBIT margins 1994-2001, U.S. department stores vs. specialty stores (percent of sales)



¹ Department stores include: Federated Department Stores, Saks, Dillard's, Nordstrom and Neiman Marcus
² Specialty stores include: The Gap, Ann Taylor, Limited, Abercrombie & Fitch, Pacific Sunwear and Bebe
 Sources: Deutsche Bank, Factset and A.T. Kearney analysis

its locations into more contemporary, hipper stores that offer superior private labels at lower prices. It's currently promoting the "This is It" brand for teenagers and has also launched an interactive website where visitors can download music, view hot fashion trends and get the latest scoop on celebrities. El Cortes Ingles in Madrid is using luxury brands such as Cartier and Bulgari to get older shoppers through its doors and is creating new brands such as Green Coast to capture more teenagers. In 2002, it opened Sfera, a separate chain of stores to compete with specialty retailer Zara.

Figure 3 illustrates the rewards specialty stores in North America have earned by developing stronger ties with their core customer segments.

Sell a lifestyle — improve the store experience. To be competitive, department stores should shift away from simply selling merchandise on racks to selling experiences

and lifestyles that connect to targeted shopper segments at an emotional level. This will help increase the frequency of customer visits and the size of the average purchase.

Through merchandising, department stores can create a unique and differentiating store experience. For example, a more contemporary club-like atmosphere, complete with vending machines, sound systems and contemporary visuals, will attract the young and hip. Want to appeal to professionals? This requires an entirely different strategy. Saks Fifth Avenue uses more displays and mannequins, grouping business apparel with other business-related items, such as cell phones and briefcases, to help customers visualize different, and complete, looks. Drawing inspiration from European boutiques, Neiman Marcus is creating its own small boutiques, nestled throughout the stores using variations in lighting, organization and decor.

Experiences can also be manufactured by offering complementary services designed for a target customer segment. Nordstrom, the model for exclusivity, provides everything from restaurants, espresso bars and free personal wardrobe consultants to differentiate its business from others and get key customers in the door. Staged events are also a good strategy. One year, KaDeWe, a western Berlin landmark, invited shoppers to a Halloween party in its fine-food department. Shoppers could eat, drink, dance and shop well into the night.

A major step for many department stores will be to overhaul store operations to improve “shopability.” This will require centralizing check-out stations, upgrading fitting rooms, making signage more visible so it is easier to navigate around the stores, and designing less cluttered floor plans. It will also require investment in sales training courses for store teams. For too long, sales teams have been offering discount service levels to sell high-priced merchandise. This has to change with sales people learning how to sell an experience.

Find your own way in pricing and branding.

In the apparel segment, department stores have long differentiated their businesses from specialty shops by offering private labels with upscale, more contemporary styling. Private labels command higher margins—at least 20 percent more than their name-brand counterparts—and the exclusivity generates customer loyalty, especially among the more upscale middle class.

Private labels also offer more control over product development and distribution, enabling department stores to get new products out as much as 60 to 90 days ahead of name-brand items. Just 10 years ago, only 25 percent of apparel sales in the United States were private label, according to market research firm NPD

Group. Today, private-label penetration tops 37 percent. Indeed, private labels in Federated Department Stores accounted for 18 percent of sales last year, and are growing faster than any other brand. And they are not limited to department stores. Private labels represent more than 50 percent of all apparel sales for U.S. mass merchants and discounters.

Despite their relative success in department stores, the side effects of private labels are starting to emerge. Many traditional luxury brands have announced plans to reduce their codependence on department stores. Coach, for example, recently outlined its plans to grow to more than 350 stores over the next few years as a way to better control its pricing, improve its product display and enhance its brand image.

Optimize the store footprint. Department stores are largely located in urban centers and often locked into expensive long-term mall leases, and have yet to cope with their costly and inefficient real estate space. Department stores should take a hard look at their existing store footprints, and make tough rationalization decisions based not only on cost-savings opportunities but also on their strategic direction going forward. This means closing unproductive stores, merging operations, and changing or transferring nameplates as necessary. In the aftermath of the May acquisition, Federated plans to close 100 unprofitable or duplicate stores in malls and convert most of the 491 May’s department stores to the Macy’s nameplate. In Germany, the number of department store chains has contracted in 10 years from a half-dozen to two: KarstadtQuelle and Kaufhof, part of the Metro Group of retailers.¹

Diversify and develop new formats. Department stores should find additional opportunities for growth by diversifying and

¹ “In Europe, a Shopping Tradition Updated,” New York Times, 17 December 2003.

Department stores should **SHIFT AWAY FROM SIMPLY SELLING MERCHANDISE ON RACKS** to selling experiences and lifestyles. KaDeWe, a western Berlin landmark, **INVITED SHOPPERS TO A HALLOWEEN PARTY IN ITS FINE-FOOD DEPARTMENT.** Shoppers could eat, drink, dance and shop well into the night.

developing new formats to tap into unmet consumer needs. These formats can be launched under the same banner or under an all-new banner. Additionally, department stores should consider diversifying away from mall locations, and find alternative store formats that better fit consumers' new shopping behaviors.

In 1999, Hudson's Bay first opened Home Outfitters, a chain of kitchen, bed and bath specialty superstores, using its understanding of the home goods market and taking advantage of an open niche to create the off-mall store concept. With no competition from category killers (Bed, Bath & Beyond and others were not in Canada at the time), the chain became Canada's leading housewares specialty store and its fastest growing retail specialty chain.

In the United States, retailers are experimenting with new formats as well. Best Buy launched its eq-life store, a retail concept that incorporates health, wellness and, of course, technology. The store is geared toward women ages 35 and older and also builds off Best Buy's consumer electronics expertise by offering MP3 and DVD players.

However, when diversifying, it is important to never lose sight of the bigger picture.

Although there is significant shareholder value in satisfying unmet consumer needs, it should not come at the expense of the core business. For example, while Limited was busy creating value from spin-offs such as Lerner, Lane Bryant and Abercrombie & Fitch, its namesake store floundered. In the aftermath, Limited is reinventing its business again, focusing on personal care (Bath & Body Works) and lingerie (Victoria's Secret). Last year, personal-care products generated 30 percent of sales and lingerie 41 percent, while apparel (non-intimate) accounted for just 29 percent.²

Size matters. Department stores need to build scale for competitive advantage. Intensifying competition has triggered waves of consolidation and asset rationalization, as illustrated by Federated Department Store's US\$11 billion acquisition of May Department Stores. The May acquisition, the biggest in U.S. retailing history, creates a retail behemoth of more than 900 stores in 49 states. Although consolidation will continue, it has slowed as fewer opportunities to buy exist. Companies are also consolidating from within by combining banners, further limiting the number of players.

As companies get bigger, they achieve the

² "The Nation's Biggest Specialty Chains," special report by Alliance Data Systems, August 2005.

scale economies necessary to become more efficient and increase margins by improving clout with their suppliers. Size also provides a better platform for fostering innovation, particularly in relation to apparel. The larger you are, the more you can form strategic partnerships with suppliers, encouraging them to provide innovative, exclusive concepts relevant to today's consumer. This partnership will help put department stores at the forefront of dictating fashions and styles.

In the supply chain, speed matters.

Department stores must also improve their sales and operations planning process to shorten the cycle time between development and consumption. In this way, they allow for postponement strategies that help guarantee the relevance of merchandise selection, which is particularly important in the apparel segment where fashion trends are difficult to forecast, often resulting in markdowns (due to overstock) or lost sales (due to understock).

Shorter, more efficient supply chains provide a huge competitive advantage, a lesson department stores could learn from Spanish clothing retailer Zara. By creating a design process that eclipses those of its nearest rivals—including H&M and The Gap—Zara has more than doubled the number of shops in the past five years, and plans to double again by 2010. In its

ability to instantly cater to fashion whims, Zara has been able to satisfy increasingly demanding customers while staying ahead of its competition. Small production runs also assures shoppers that they won't be seeing mirror images of their outfits around every street corner.

Moreover, technology has made complex and hard to manage supply chains more efficient—adding speed, flexibility and visibility to key processes. Automated merchandise planning systems help with demand planning and forecasting, and in allocating merchandise across stores. Inventory management systems are helping to reduce inventory levels, optimize replenishment and shorten lead times.

Time Is Running Out

From one direction, department stores have been challenged on price and convenience by mass merchants and discounters such as Walmart, Target and others, which are able to offer a wider variety of goods at lower prices. From the other direction, upscale specialty stores are carving out well-defined and defensible niches, and vying for shoppers' wallets as never before. Consumers will stick around, but only to a point. Department stores have a last-ditch opportunity to sustain and then recapture their fair share of the market—before it is too late. 

Consulting Authors

DEAN HILLIER is a vice president in A.T. Kearney's consumer industry and retail practice. Based in the firm's Toronto office, he can be reached at dean.hillier@atkearney.com.

RAMAN MANGALORKAR is a principal in A.T. Kearney's consumer industry and retail practice. Based in Chicago, he can be reached at raman.mangalorkar@atkearney.com.

BERNARDO SILVA is a consultant in A.T. Kearney's Chicago office and can be reached at bernardo.silva@atkearney.com.