

After the storm
Planning for a retail recovery



In early 2008, with all signs pointing toward an economic meltdown, Deloitte's Global Consumer Business & Transportation group presented the article, "Preparing for an Economic Storm." The mission was to get in front of developing events and position retailers not only to weather the challenging economic conditions ahead but use them to their greatest advantage. By the fall of 2008, the storm had made landfall and, as one crisis followed another, a second article, "Dissecting the Economic Crisis," took a new look at the retailing environment in the context of the intensifying economic downturn.

But even as the storm hit, Deloitte research and client service teams were thinking ahead to economic recovery, recognizing that the timing and elements of an upturn will vary significantly across global economies. The following article examines the shape this economic revival is likely to take and how retailers can prepare themselves to thrive.

The look of a recovery

With surging stock markets and an uptick in corporate profits, a rebound from the economic turmoil of 2008 and 2009 appears to be on the horizon. Good news for retailers, yes—especially if this recovery follows previous patterns and is led by the consumer. But evidence suggests that this recovery will be different, led instead by government spending and by the manufacturing necessary to rebuild inventories. With continued unemployment and uncertainty, consumers most likely will remain restrained even as companies start to place bets on the future—indicating a longer, harder recovery for retailers as consumers regain confidence more slowly than in years past.

Of course, over time, fear will be replaced by caution, caution by optimism, and, eventually, optimism by opportunism. Asset values will reset, debt leverage will normalize, and credit will become available to businesses and consumers. But as the impact of the collective actions and reactions to the global economic crisis emerge, retailers will find themselves operating in a new, more competitive landscape with real changes in marketplace dynamics. There will be fewer players in key segments to compete for market share; there will be pent-up consumer demand; there will be more talent available; and companies will have leaner operating models to leverage against growth. Most importantly, though retailers will find a revived consumer, this will be a consumer with significantly changed values and priorities.

Add to these challenges the usual difficulty of adapting to shifting economic conditions overall and it is clear that managing through an upturn can be as challenging as managing through a downturn. Most businesses just perform better when there is a consistent, stable trend to plan and manage against. Historically, consumer-driven businesses are particularly challenged when planning and managing through an inflection point in the economy, with retailers especially relying on past trends to plan purchases and margins.

As such, coming out of this recession, some businesses may find that their thinking has been too short-term and that they have neglected to focus on investments, innovation, and longer-term strategic issues. In contrast, some businesses have been fairly adept at seizing the opportunities presented by recent market changes. To assess where they stand, retailers would do well to revisit the strategies outlined in “Preparing for an Economic Storm” (see table) even as they move forward and address the challenges and opportunities of the economic recovery. To face these challenges and maximize the opportunities, retailers will need to expand their thinking on a number of fronts. Not only will the playing field look far different in this recovery, but these differences will make taking a wider view of the economy—as well as the retailer’s place within it—increasingly urgent.

Turning the corner

In order to position themselves for the recovery, retailers should continue to address the challenges and opportunities outlined in “Preparing for an Economic Storm.” The strategies will continue to be important as the economy rebounds and grows.

	Relevance pre- and post-recovery	
	“Preparing for an Economic Storm”	“After the Storm”
Create strategic flexibility	Yes	Yes
Reevaluate your plan frequently	Yes	Yes
Improve your forecasting ability	Yes	Yes
Adapt strategies to manage volatility	Yes	Yes
Cash is key		Not as much
Don’t waste a good crisis		Yes

A new playing field

Post-recession, retailers are likely to find that many of the chess pieces have moved and that the strategic and competitive landscape has been reset. In order to navigate this new playing field, retailers must adapt their strategies to several new realities.

Pragmatic, cautious customers: Customer values are going through both a cyclical change and a longer-term permanent shift. The unrealistic optimism of the recent period of growth most likely will be replaced by a new pragmatism and caution about the future. Just as the generation that lived through the Great Depression carried the values established during those years throughout their entire lifetime, consumers' reactions to the effects of this recession will likely yield new patterns of behavior and relationships.

Retailers need to work at understanding the emerging customer and the new set of values and priorities driving his or her decision-making. Customers are demonstrating a taste for longer-term value and are integrating considerations such as sustainability into their purchasing decisions. As such, it is essential that retailers have in place a strategic capability to listen and respond to customers. Listening to non-purchasers and defectors can be particularly enlightening as they represent lost sales and market share and provide learning opportunities to retain existing customers and acquire new ones.

The slow thaw of credit: Business finance is under new stresses on several fronts. With the risk assumptions of asset-based financing vehicles fundamentally changed by the recession, the criteria for access to reasonable credit and financing will likely continue to be more restricted in the future. And as most retailers require significant financing to support the working capital requirements of their business model, there will be a need to think through the strategy, timing, and positioning of financing

their business growth in the future. It is a critical time for retailers to examine the financing cycle and refinancing requirements in the context of future business plans.

The cost of financing growth and investment overall is also likely to change post-recession due to a major shift in the distribution of debt between public and commercial entities. Commercial businesses have aggressively moved to reduce their debt leverage while central governments have dramatically accelerated levels of deficit spending to stimulate the recovery. As the economy recovers, the U.S. Federal Reserve and other central banks will eventually raise interest rates to control inflationary pressure as demand returns. As such, it is likely that businesses and governments will compete for a limited pool of funds available for financing at a higher cost. Much of this depends on the degree to which governments can reduce their structural deficits following the recession. However, it is essential for businesses to consider both financing and investment strategies in light of these developing market constraints and forces.

With global trade severely affected by the current economic downturn, trade finance is an additional challenge, and this condition may persist. Export countries are particularly impacted by the significant decline in trade. The good news is that, at least for the time being, most countries have resisted the strong political temptation to protect their own markets at the expense of the global economy. But in this environment, companies should monitor and diversify their international sources of goods and focus on maintaining trade financing capabilities.

Volatility—the new “normal”: During the recession, volatility and uncertainty played a part in day-to-day decision-making. Post-recession, retailers will need to continue to manage in an environment that has increased potential for game-changing uncertainty. Major shifts in relative currency values, interest rates, and energy costs will affect operating incomes and cash flow. And though financial hedging strategies can reduce short-term risk, contrary to some previously held perceptions, they do not reduce the risk of long-term movements in asset prices. The economic downturn has demonstrated that a more comprehensive understanding of risk is needed. Although there was no defense, haven, or strategy that would have saved retailers entirely from the pain and losses inflicted by this economic downturn, there is a need to improve the adaptability and reflexes of business models. By conducting a profit sensitivity analysis of operating models relative to variability in key commodities, currencies, and the cost of capital, retailers may be able to develop risk mitigation strategies for the most likely scenarios. The backlash to recent events will also inevitably produce new rules, compliance requirements, and corporate responsibilities. And as these may yield unintended consequences where everyone is held accountable for unanticipated events after the fact, risk management strategies need to be more comprehensive, thoughtful, and forward-thinking.

Energy: In recent times energy prices have responded almost instantly to market perceptions of global demand and the value of the U.S. dollar. There are several scenarios that could play out here, but it seems inevitable that the cost of oil and other geologically-based sources of energy will continue to rise with extraordinary short-term volatility. Observe how unusually price- and supply-sensitive these markets are to even perceived changes in supply and demand in recent years. Because transportation is an increasing component of product costs, it is important for retailers to understand the effect of energy on their supply chain strategies and sourcing decisions. They should also examine the landed cost of goods from competing global suppliers under different transportation cost scenarios. This is true even despite any aggressive commitments to alternative energy sources, which will have a limited effect on the enormous supply and demand forces driving energy prices and volatility.

However, consensus is building that the long-term shift from a petroleum-based economy to an economy that harvests ambient energy sources has begun in earnest—part of business’ larger movement toward sustainability. Despite the recession, sustainability and social responsibility have stayed front of mind underneath the media noise of the recession. Leading retailers around the world like Wal-Mart and Marks & Spencer have openly developed longer-term strategies with sustainability as a critical factor.

Emerging economies: The recession has demonstrated in very real terms the interdependent nature of the global economy—and it is clear that emerging economies will play an increasingly important role in the economic future of the planet. With retail in developed economies a relatively mature economic segment, the most successful businesses will position themselves for expansion in such emerging economies as China, India, and Brazil, which are poised to experience rapid growth in their retail sectors. Companies with a global footprint who can demonstrate their ability to succeed across borders and cultures will have distinct advantages as they make investments.

Seizing the moment

The economic turmoil has starkly revealed the deficiencies of a political and economic perspective that is too near-sighted. But both countries and companies tend to become even more short-sighted during a recessionary period, taking a heads-down stance to survive—just when a good dose of strategic thinking could yield significant long-term benefits. To make the most of the coming recovery, retailers have a number of areas they should consider right now if they seek long-term success.

Think strategy, not survival: It is perhaps hardest to recognize opportunities in the midst of a recession when people are surrounded by uncertainty and fear. But this can also be the time for retailers to reset their thinking and plan and develop strategy without being driven purely by financial reporting requirements or an annual cycle. Executive teams need to move forward by lifting their heads and considering longer-term issues and opportunities. Instead of eschewing the annual executive retreat due to cost-cutting, businesses may want to consider a less expensive alternative that brings together management teams with an emphasis on thinking about the future.

With asset values at cyclical lows, for example, it can be a good time to obtain better locations and facilities to support future growth; it may also be the right moment to add strategic business units or buy a regional competitor. The recession is also an opportunity to create a more competitive business model that can be leveraged during the recovery and drive future profitability. Retailers may also consider addressing structural or organizational issues that have been put off or avoided because of internal resistance to change. The operating model improvements developed and implemented in the crucible of the recession can become competitive advantages as the business emerges into a period of growth.

Understanding customers. Retailers' success post-recession will be hugely influenced by how well they really do understand consumers—and how well they are able to leverage that understanding in proposition development. Now more than ever retailers need to understand and monitor the leading economic indicators that are aligned with their target customer, merchandise demand, and business model—such as employment levels, real incomes, aggregate credit scores, default rates, and other predictors of customer spending. By conducting an exercise to discover which economic factors correlate most closely with sales by price point and category, retailers can potentially develop their own set of leading indicators that strongly predict their customer spending behaviors.

Adding value will also be a major challenge in the recovery. The downturn produced excess inventory levels that led to irrational pricing behaviors and harsh cost-cutting measures. While necessary, these measures have left many retail businesses in relatively poor merchandising condition and functioning at very low service levels. Many stores and their teams need to be refreshed and revitalized, giving customers a reason to shop. From the customer's viewpoint, shopping is much less about product procurement than often believed and is much more of an experience, which may or may not result in a purchase. Whether it does indeed result in a purchase will

often depend on how good the retailer is at inspiring and persuading the shopper to buy. And the ante will only be raised in the future by ever-growing online competition.

Deflation and inflation: Economists are still divided on whether inflation or deflation will be a factor in the near term, but each has important implications for how retailers manage their business going forward. The drying up of credit and finance effectively contracted the money that consumers had available to spend, with less available cash and financing causing collapsing asset prices. Some of these economic forces are still playing out in the marketplace. Temporary price reductions are helpful because this raises real incomes, stimulates spending, improves cash flow, and reduces inventories. However, deflation starts if asset values, then product prices, then wage rates continue to reset at lower levels—demand then collapses from deferred purchases.

On the other hand, recovery can cause inflation. One of the most significant effects of a long, deep recession is the structural reduction in production capacity through bankruptcies, layoffs, and plant closures driven by a persistent reduction in demand. With the recovery and the resurgence of demand, inflationary pressure is likely to reassert itself in many commodities because of both pent-up demand and the reduced availability from lost supply sources. This could have a profound effect on retailers' sourcing and inventory management strategies.

Deflation and obsolescence imply managing inventories on a "just-in-time" basis, but more inflation may encourage advance purchasing strategies to reduce cost and benefit from the appreciation of assets. Retailers do have a window of opportunity, however, to look at longer-term purchasing arrangements and forward-purchasing strategies. Most retailers are still being very cautious about inventory levels given the uncertainty over the shape and speed of the recovery and the lingering effects on the consumer; it is important for them to think about how to respond through their supply chains to the scenario of increased customer demand and accelerating growth.

Sustainability: Despite the recession, sustainability and social responsibility have stayed front of mind underneath the media noise of the economic crises. By definition, sustainability issues will return with an increasing sense of urgency and importance. Businesses are integrating sustainability considerations into their business functions and into their longer-term strategies, while customers are increasingly considering social and environmental benefits right alongside personal value criteria when they make product and service decisions. In the long run, retailers' business models may need to operate within the constraints of sustainability—such as disposing and recycling products and achieving zero environmental impact standards in operations and facilities. In light of this, it may be time for a retailer to become a leader and not a laggard in this area. Retailers should consider the strategies and incentives available to them to mitigate future energy needs, explore the emerging alternatives, and aggressively and visibly pursue green alternatives that also reduce operating costs. The tax incentives for these strategies, while complex, are better and more available now than at any time.

Shrink and loss: Recessionary periods often increase the level of desperation. Layoffs, reduced hours, and eliminated bonuses create internal financial stresses and moral challenges—often prompting an upswing in fraud and corruption. Accordingly, the retail industry should be prepared to see accelerating trends in fraud and theft that impact their business and legitimate customers. Many retailers may be caught off guard by these problems, with internal and external theft likely to increase significantly and the methods used growing increasingly sophisticated. In the most recent University of Florida National Retail Security Survey, shrink reversed direction from its long-term downward trend, increasing by seven basis points to 1.51 percent of sales for fiscal 2008. Retailers will need to defend both their physical assets and information assets vigorously as well as seek new strategies and tools to combat cyber-crime. Key strategies include using statistical detection and exception management techniques, engaging the broader organization beyond loss prevention, and developing a higher level of workforce integrity through effective employee screening and training.

Innovation: During a recessionary period, budgets are cut and discretionary spending is typically forbidden—often causing a retreat from innovation when it is actually most needed. Retailers instead should use this moment to take advantage of a startling array of new technologies available that can improve the customer experience, service delivery, seller-supplier collaboration, and procurement as well as reduce transaction costs. For example, many companies still have not completely removed the cost and wasted time of paper and manual processes from their operations. And with online retailing continuing to grow much faster than traditional store retailing, some retailers have started to successfully integrate their online and store capabilities to deliver a compelling experience to the customer. Mobile retailing is also on the verge of changing the way many consumers shop. Even more important than technology is breakthrough business model transformation and reinvention, which represents the largest opportunity to create business value during a recession and recovery.

Supply chain strategy: In the past, retailers and consumer businesses have managed demand and supply chains independently or reactively. Traditional thinking was to forecast demand and then use this to drive supply-chain decisions. But inventory management in the near-term and the future is going to present some of the greatest business challenges for retailers. Retailers and their vendor partners will need to place big bets on inventory position and timing through the transition back to growth. Reliance on imports and a global supply chain will also require retailers to make risky demand forecasts that could be subject to significant variation, while overall inventory management will be complicated by both inflationary and deflationary trends, depending on the merchandise category. This may be a good time, therefore, for retailers to rethink sourcing, inventory, and distribution strategies. Retailers may also want to consider integrating strategies for managing supply and demand together to improve inventory turns and the retained margin, allowing them to manage their sell-through rates and optimize the mix of cash flow and profit contribution.

Tax incentives: There are an unprecedented number of tax incentives, rebates, and credits available these days to stimulate spending and investment in the private sector and to save and create jobs. In many cases, a reduced tax effect can dramatically change the ROI (return on investment) and shorten the payback period of significant investments that lower operating costs. Equipment replacement, building upgrades, energy conservation, recycling programs, and asset management systems almost all qualify for significant tax rebates and credits. But the window of opportunity to capture some of these tax benefits may expire within the next few years. Deficit spending cannot last for a long period without damaging the economy in other ways. And while tax-improved investments that reduce variable operating costs make a lot of sense in the short term, in the future there will probably be fewer tax-benefitted investments and a likely increase in direct and indirect taxes, putting further pressure on businesses when the tax bill comes due.

With the changing realities of the marketplace, it is clear that recovery may be just as challenging as the recession. However, if retailers take the time to shift their short-term focus to critical thinking and take into account the new playing field—as well as larger economic issues—they should be able to spot opportunities that will help them not only ride out the storm, but build a stronger future overall. Courage, supported by a thorough understanding of the risks and benefits of a particular action, will allow a retailer to boldly capture the opportunities afforded by the emergence from the current economic turmoil.

Conclusion

Recovery at-a-glance

- Take care of the hard stuff; make your operating model fit.
- Understand the shifts in your customer's value criteria and decision-making.
- Don't miss the upstream supply side and sourcing opportunities presented by the recession.
- Put longer-term finance strategies in place to position for growth.
- Recognize and mitigate emerging risks and threats to business.
- Recognize opportunities to strategically grow and improve market share.
- Refocus on business model innovation.
- Accept uncertainty and volatility as part of the new reality and make the business adaptable and nimble.



For more information:

Scott Bearse

Deloitte Consulting LLP
sbearse@deloitte.com

Deloitte Research

Ira Kalish

Deloitte Services LP
ikalish@deloitte.com

Chair, Consumer Business Global Editorial Board

Stacy Janiak

Deloitte & Touche LLP
sjaniak@deloitte.com

Retail Leaders

Americas

Vicky Eng

Deloitte Consulting LLP
veng@deloitte.com

Europe, Middle East and Africa

Richard Lloyd-Owen

Deloitte United Kingdom
rlloydowen@deloitte.com

Global Consumer Business Leader

Lawrence Hutter

Deloitte United Kingdom
lhutter@deloitte.co.uk

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