

# Driving Profitability in Retail Networks:

How Location Intelligence Makes a Difference

WHITE PAPER:  
RETAIL SERVICES



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## ABSTRACT

CHOOSING NEW STORE LOCATIONS IS A SIGNIFICANT INVESTMENT DECISION FOR RETAILERS. YET THERE IS AN INHERENT RISK ASSOCIATED WITH THE PROCESS OF SELECTING AND DEVELOPING STORE NETWORKS. THIS PAPER EXAMINES WAYS TO HELP MINIMISE THE RISK AND MAXIMISE INVESTMENT RETURNS BY IMPROVING RETAIL LOCATION STRATEGY THROUGH THE USE OF PREDICTIVE ANALYTICS TO MAKE MORE INFORMED LOCATION DECISIONS.

RETAILERS MAKE FEW DECISIONS THAT ARE AS PERMANENT (AND POTENTIALLY UNFORGIVING) AS SELECTING STORE LOCATIONS.

*Arthur Blank - Former President Home Depot*

# 'SELECTING THE LOCATION FOR YOUR STORE IS THE MOST IMPORTANT DECISION YOU WILL MAKE IN YOUR EFFORTS TO ACHIEVE SUCCESS IN RETAILING.'

*Luigi Salvaneschi, President of Blockbuster Video, VP of McDonald's Corp and Senior, VP of Kentucky Fried Chicken*

## Executive summary

The process of finding new sites and managing a network of stores provides significant challenge and poses many questions to a retail business. Will our concept succeed in this market? How many stores will we need to satisfy demand? Where should we open first? How much revenue will this site generate? How will this new site impact our existing locations? Where should we invest refurbishment budgets?

Finding the answers to these questions is critical to a retailer and getting it wrong can have significant and in some cases catastrophic consequences for the success of their business. Correctly locating a new store or network of stores is a long-term business issue with lifetime investment in some cases of twenty to twenty five years. You cannot easily move a poorly located store, as a result over time they will adversely impact bottom line profitability and jeopardise the business!

Location Intelligence can be applied to make these decisions more transparent and, where successful, repeatable. Predictive models can be created and deployed to plan network strategy, prioritise rollout and manage the site selection process. As Robert W Buckner states, 'The functionality of these tools is impressive. They enable real estate executives to focus on what they do best – thinking strategically about the marketplace rather than dwelling on the minutiae associated with reviewing demographics and deal submittals. The result is the execution of real estate deployment strategies that are better targeted to serve the market's short and long-term needs' ii.

## Introduction

Ask retailers what are the three most important things to their business and many will respond 'location, location, location'. Despite the rise of home shopping via the internet, the location of stores is still critical to retailers. They invest heavily in the physical 'bricks & mortar' stores as this is still the main representation of the brand to the consumer.

Operating a store is a long-term commitment: often retailers are tied into a long lease which means that they have to be in the right place or else risk reducing profitability over a period of many years.

In today's competitive marketplace there are numerous location issues that the retailers must address:

- How many stores can the market support?
- Which are the best locations for their concept?
- Should the stores be on the high street, in a shopping centre or part of an out-of-town complex?
- Is current and future demand in the area enough to support the store?
- Will it get planning permission?
- Will it breach Competition regulations

With significant site acquisition, development, fit-out, maintenance, lease and legal costs, chosen sites will be expensive to establish.

Knowing all the risks, retailers continually need to open stores, manage their existing locations, adapt to new market conditions and react to new consumer demand. A poorly located store can impact dramatically on the retailer's bottom-line profitability. So how do retailers decide where to locate stores?

Often, in the early stages of a concept, the founder will have an in-depth knowledge of the area surrounding the first store. This store may be located in an area in which they have intimate knowledge, perhaps having grown-up in the area. The next few stores may be located using 'gut-feel', perhaps in areas nearby that look the same as the original concept store. These stores will hopefully prove successful and the concept starts to mature. As the concept grows and starts to mature or 'trade-up' attracting the attention of external investors, the need to expand into new markets drives the management into areas of the country of which they have limited knowledge.

There are different approaches to site location strategy. Some retailers that we have spoken to have taken the approach of 'piggy-backing' on to other leading retailers' strategies (i.e. locating wherever there is a Marks & Spencer used to be a favourite): an approach which is fine whilst the strategy of the copied retailer is working! Another common location strategy is called 'hierarchical diffusion' which means opening new stores in the largest cities and working down the retail

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hierarchy. An alternative approach to network development is sequential expansion, (also known as 'contagious diffusion'), that is, opening a 'hub' in a major city and then use this to serve rollout into other nearby markets. In the sequential approach, the aim is to saturate a market before moving onto the next. Starbucks is a classic example of the sequential approach. There were over 100 Starbucks outlets in the Seattle area before the company moved into new markets. Jim Rubin, Starbucks Senior VP of Real Estate, has described their desire to be in highly visible locations; in the path of people's weekly shopping trips, on their way to work and on their way back home from the movies.

As described above, initially the process of store location planning may be an art-form, where the retailer's intuition and experience is at the fore. However to successfully grow the business this intuition needs to be channelled into a scientific, measurable process. As the business grows the process of store location planning must become transparent, enabling the management to compare locations and decide where to locate to get the best return on investment. Which town should we open in first – A or B? Which of these three locations will generate the best revenues? How much revenue will 'switch' to the new store from sister locations? What is likely to happen if a competitor opens in the same area? Store forecasting models can help to make the process of selecting locations and predicting store revenues quicker, more accurate and measurable.

Leading research organisation Mintel found that a convenient location was identified by consumers as one of the most significant reason for their choice of store. Neal Mason of Mintel stated 'Although price is of some importance – location is crucial in the battle to win 'shoppers' trade. The high emphasis placed on the store being close to home shows that it is actually quite hard for grocers to break established shopping patterns. There is so much that can be done with the price, products and overall shopping experience, but it is significantly harder to change the location of a shop. Retailers need to be aware of the importance of accessibility, by considering a variety of store formats, such as local convenience stores, high street shops or out of town supermarkets, to make shopping increasingly convenient for consumers'.

For many retailers the decision to adopt a more scientific approach to store location planning is based on fear: the fear of making a mistake that will leave the organisation with an underperforming store that will be a drain on the bottom line for many years. Retailers want to be able to open, relocate or refurbish stores with confidence that the sales forecasts used in evaluating the investment decision are robust. They want to be able to know that the store will be profitable and that they are maximising their investment. Every decision has to be defensible and repeatable.

Whilst detailed market analysis and store forecasting techniques are of critical importance in identifying new store locations, and contribute to the development of network planning strategies, they are NOT a substitute for retail intuition, but they do add real value in support of the investment decision making process.

### Challenges and Opportunities

There are many challenges and opportunities which concern retailers today as they fight to establish themselves, in highly competitive and often cross border markets, whilst at the same time driving revenues and streamlining costs to increase shareholder value.

These challenges and opportunities can be summarised as:

- **Diversity and Concentration:** a growing diversity of retail formats, distribution channels and concentration of retail 'power'. The biggest retailers are getting bigger and at the same time are branching out into new geographical and 'virtual' markets, and new product and service areas. For example Grocery retailers now provide significant comparable goods product ranges that have been extended to also include financial services products to create a 'one stop shop' and tempt customers to spend more with them.
- **Globalisation:** retailers are increasingly looking to foreign markets to expand their business. High growth markets such as India, China, Russia and the oil rich Gulf States present massive opportunity and significant challenges including store development, product offer, supply chain management, investment, cultural and legislative barriers to overcome.

## 'THE GRAVITY MODEL IS BASED ON THE IDEA THAT THE SHOPPER IS ATTRACTED TO A CLUSTER OF SHOPS BY THEIR MASS AND DETERRED FROM VISITING THEM BY THEIR DISTANCE.'

*Russell Schiller, 'The Dynamics of Property Location'*

- **Multi-Channel Customer Experience:** retailers are having to embrace new technologies, and to offer a consistent customer experience and service quality across all traditional and 'virtual' sales channels. Customers who shop in store and experience high levels of customer service expect the same or better from an online shopping experience, from purchase to delivery, and even when third party service providers fulfil some of the activity on behalf of the retailer e.g. home delivery companies.
- **Regulatory Control:** controls concerning retail development are forcing retailers to modify their growth strategies by creating new formats, choosing alternative trading environments and to develop complementary but more niche offers to ensure compliance with legislative and planning constraints.
- **Changing Customer Needs:** understanding what drives the customer to purchase goods and services has never been so important for retailers, though it is easier now than ever before to gather data it is at the same time increasingly difficult to effectively use this information to measure and understand customer behaviour in order to drive retail strategy.

### Diversity and Concentration

There is growing diversity in retail formats available to the consumer whilst at the same time there is an increasing concentration in the marketplace. For example Tesco, in the UK, have rolled-out a number of different formats (Metro, Express, Extra, HomePlus etc.) focussing on different consumer requirements. The larger retailers are also diversifying the range of products and services that they offer – Tesco again is a good example – offering not only its core grocery products but also electrical, homeware, books, CD/DVD, cars (via the internet), insurance and telecommunications.

### Globalisation

Retailing is increasingly global, with major retailers expanding internationally to escape the pressure in their domestic markets. Major brands now have a trading presence, in some cases adapted to meet local

market/cultural needs, all over the world.

Market share is being concentrated into a smaller number of retailers and there are fewer competitors in each format. This is highlighted by the fact that the four largest food retailers account for 62% of the sales in the UK; 78% in Germany and 83% in France.

However, expanding outside the domestic market presents retailers with significant challenges: how to retain the global brand whilst also offering what the local consumer requires? The global retailer has to be able to maximise the benefits of scale (i.e. product procurement and distribution), whilst recognising and being sympathetic to local and cultural diversity. For example, clothing, colour, size and cut differ from country to country. In China, white is the colour of mourning and brides wear red! Food tastes and expectations vary tremendously – Marks & Spencer found that pre-packaged fruit and vegetables a core part of their offering in the UK did not work in France! Even furniture manufacturers are not immune from the risks associated with globalisation. IKEA found that Scandinavian beds did not fit US linen. Store design and merchandising has to be tailored to the locale. In some countries it is socially unacceptable to display male and female clothing next to each other. Selling seasons also vary from country to country (i.e. Gap's major season in the US is in August but in Europe this is one of the slowest seasons as it is the peak holiday period) presenting buyers with unique challenges. Everything from government regulations, (i.e. German recycling laws) to social values, impact upon store operation and need to be considered by the global retailer. Ahold, one of the most successful global retailers (with over 20 brands globally), work on the principle that 'Everything the customer sees, we localise. Everything they don't see, we globalise'.

### Multi-Channel Customer Experience

Today's retailers are making use of all channels to the customer – 'bricks and mortar', catalogues, the internet, mobile phones, advertising and interactive TV. The challenge is to ensure that the message is consistent across all channels. The truly successful retailers have harnessed and

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integrated all these channels creating 'personalised' shopping experiences.

Shoppers now expect retailers to provide exemplary customer service. They expect to be entertained as they shop, and retailers who are looking to show the value that they provide are looking to provide what The Future Laboratory refer to as 'masstige': the requirement to mass prestige. In an attempt to create value for shareholders high-end brands (i.e. Mercedes) are reaching lower, whilst lower-end brands (i.e. Gap) are reaching upwards. Brands such as Saks 5th Avenue are going to great lengths to create a unique experience; Tchibo change their product offering theme every week as part of their experience.

### Regulatory Control

Regulations around retail development are generally becoming more restrictive, slowing the rapid growth that has taken place in the last 20 years. Retailers now have to prove not only that there is demand for their concept but also that the proposal is not going to impact upon the nearby towns. Indeed the emphasis is now focused on urban regeneration: the pendulum has swung away from the large out-of-town development and is favouring the town centre mixed development. The large supermarkets (especially in the UK) have seen the writing on the wall and are all (with the exception of Morrison) moving aggressively into 'C store' formats: the convenience sector. To a certain extent, this helps them to offset the impact of planning regulations. But more importantly it helps them to target a significant market, the under £10 shopping basket (which in the UK is worth a staggering £75bn).

### Changing Consumers

Consumers' buying patterns and patronage of certain brands are much more complex than in the past. There are now many more niche markets, the shopper faces many more choices and consequently their behaviour is almost constantly evolving.

The very nature of the consumer is changing. In developed markets, families are breaking down, there are high levels of single person households and one-parent families; there is a

growing schism between the rich and the poor; the population is aging and some of the elderly population have more disposable income. Many retail purchases are now based on an "I want..." rather than an "I need..." decision process meaning a growth in new luxury purchases: fashion apparel and travel or experience related purchases, replacing the "old" luxury goods category of fridge freezers, dishwashers and colour televisions etc.

There are also many more ways to communicate with the consumer. In 1950s Britain, one TV advert would reach a significant audience (i.e. early Procter and Gamble adverts for washing powder reached nearly 50% of the adult audience). Now there are many more channels and many more brands. We are literally bombarded by marketing messages! There are now numerous special interest magazines and newspaper supplements for the advertiser to choose. The use of direct mail has increased, with many British households receiving up to 17 pieces of DM each week, while the internet is empowering the consumer to research and shop around for the best deal.

Retailers have vast amounts of consumer information available to them, but often still fail to recognise what drives shopping behaviour. Paco Underhill (the pioneer of shopping behaviour analysis and founder of Envirosell) states examples where retailers have failed to design stores appropriately (by putting products higher than the target audience can reach); he also highlights examples of retailers trying to sell the wrong products and illustrates examples of restaurant operators who fail to provide appropriate seating because they fail to understand the customer.

Sir Terry Leahy, Tesco CEO, confirms that understanding the customer has been vital to the success of his organisation. But he also emphasises that the key to success is to listen to what the customer tells you and then to act upon that information.

As a result of all these influences, it is increasingly vital for retailers to understand their consumers in order to survive and prosper. As a result it is no longer possible to do so based solely on 'gut feel' or intuition.

## 'THE STARTING POINT FOR A STORE'S LOCATION MUST BE THE DEFINITION OF ITS TARGET SEGMENT'.

Henry Assael, 'Marketing Principles and Strategies'

### How can Location Intelligence help?

#### UNDERSTANDING THE CUSTOMER

Location Intelligence exploits the location based information hidden in your business to identify relationships between different data and use this to drive new decisions. For example understanding the relationship between your customers and your stores is a fundamental need of a retail business. Location Intelligence can help create that understanding. Customers have choices. They have choices around which retail brand, which shopping destination, and convenience versus quality of retail offer. These choices are influenced by many other factors including the purchase need, is the purchase discretionary or a necessity, and the cost of the product. Using Location Intelligence retailers can create simulation decision support models which reflect the real world choices consumers have, and to use these models to test future scenarios with a high level of confidence of what may happen if the scenario became a reality.

#### A LOCATION INTELLIGENCE FRAMEWORK

At a simple level Location Intelligence can be used to calculate how far customers on average travel to a store to shop for grocery, clothing, white goods etc. Each shopping trip for a specific type of goods will generate a different cost or travel time. The trip may be carried out from home, place of work or on a linked home/work/leisure outing e.g. post a parcel or visit the bank. Using Location Intelligence software a retailer can build this basic understanding from good quality customer data. If individual transaction sales are known by customer, then further intelligence can be gained as to what the effect of location and trip cost (travel time) has on the average customer spend and which goods they are buying. Combining this information with customer insight which shows how different customer groups spend differently at different stores further augments the understanding of the fundamental relationship between customer and store. We now have a basic understanding of the complex relationship of how far customers travel, how much they spend, what they buy and how that varies for different customer groups or segments. This Location

Intelligence framework can now be further enhanced to help drive decision making.

#### PREDICTIVE MODELS

One aspect of Location Intelligence that is well proven in the support of retail network decisions is the use of predictive models. These models build on the understanding created by the Location Intelligence Framework to simulate future outcomes by testing a number of possible scenarios with regards the store network and suggesting the best or optimal solution to the problem. These scenarios can be single store openings or closures or complex solutions for a market or territory. The scenario will rate the individual solution based on a set of assumptions and a target or desired outcome i.e. highest level of new sales, lowest cost network, least number of stores, maximised customer access, etc This will guide the decision as which is the best or optimal solution.

The methodologies behind these predictive models come from a family of models called spatial interaction models (SIMs). These SIMs are constructed around the premise of a fixed level of product demand, discrete customer choices, satisfied at retail stores (or other indirect channels) thus allowing a model of the real world to be created inside a database or software system. This model can then be asked the questions described above (scenarios) and generate answers which support the retail network decision making processes. Construction of a SIM will use a variety of other techniques such as decision trees, multiple regression, generalised additive models, scorecard models and spatial data relationships to create a complete model.

Of course these models are data hungry beasts and the best quality data coupled with the experience and knowledge of the modeller will create the best quality models. These models are now mature in their methodology, construction and application and truly can improve decision making, reducing risk (lower incidence of poor location decisions) and driving investment return (higher numbers of better location decisions).

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## Summary

### LOCATION IS A VITAL ELEMENT OF RETAIL STRATEGY

Despite the rise and penetration of internet shopping, the 'bricks & mortar' stores are still an important part of the retailing experience. The physical store helps to define the brand. Convenience is critical for the consumer and distance to store is still a significant factor in the shopper's choice of retail destination. Customers are a moving target and so retailers must understand their customers and their changing shopping habits in order to survive. Yet consumer behaviour, buying patterns and perception of brands are more complex now than ever before.

### RISKS ASSOCIATED WITH STORE NETWORKS

The costs associated with developing new stores and shopping centres are extremely high, all hitting the bottom line if the store or mix of shops does not perform as expected. Poor marketing, merchandising and management can all be improved but there is nothing you can do with a store that is poorly located except watch as it impacts upon the bottom line. Leases are long and rents and operating costs only tend to go up. Construction and refurbishment costs are also increasing as consumers expect higher standards and expect the retailer to provide an 'experience'.

### LOCATION INTELLIGENCE AND PREDICTIVE MODELS HELP REDUCE CAPITAL INVESTMENT RISK

A Location Intelligence based predictive model, built and calibrated for a retail concept, will reduce the risks associated with developing and maintaining a network of stores.

A model will help:

- Plan an optimum retail network strategy
- Find the best locations and markets for your concept
- Help to prioritise rollout potential
- Optimise existing store networks
- Minimise sales transfer (cannibalisation) between your stores
- Help to speed up the location decision making process
- Forecast individual store revenues
- Establish realistic performance targets

# 'THE SECRET OF SITE SELECTION IS TO COMPARE, COMPARE, COMPARE.'

*Sam Walton, Founder Wal-Mart*

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EUROPE/UNITED KINGDOM

Minton Place  
Victoria Street, Windsor  
Berkshire SL4 1EG UK  
main: +44 (0)1753 848200  
fax: +44 (0)1753 621140  
europe@mapinfo.com  
www.mapinfo.co.uk

GERMANY

Kelsterbacher Str. 23  
65479, Raunheim, Germany  
main: +49 (0) 6142 203 400  
fax: +49 (0) 6142 203 444  
germany@mapinfo.com  
www.mapinfo.de

SPAIN

C/Ribera del Loira, 42  
Campo de las Naciones  
28042 Madrid, Spain  
main: +34 91 418 5083  
fax: +34 91 555 9957  
spain@mapinfo.com  
www.mapinfo.es

ITALY

Via di Vigna Murata,  
40 00143, Roma, Italy  
main: +39 (0) 65 483 2224  
fax: +39 (0) 65 483 4035  
italy@mapinfo.com  
www.mapinfo.it