Expanding your retail business

Beware of pitfalls when attempting to replicate a successful retail business in new locations.

Despite some heart-stopping moments over the last few years, your retail business is humming. You have decided it's now time to open 10, 20, eventually as many as 30 or more stores around the country. But, simply building more capacity by adding units doesn't ensure you can replicate a well-performing retail store without careful consideration of the foundation of retailing—most importantly, location, location, location. Would you open a $12 haircut shop in a fashionable part of town where hair styling begins at $150?

Executive summary

Successful retailers may consider expanding their model to new locations, in search of economies of scale.

Challenges and potential risks of expansion are discussed, along with tips for planning and performance monitoring.

"Often we find retailers attempting to expand their model to new locations, believing they can achieve economies of scale," says John Berg ☎, a retail industry business assurance partner with PricewaterhouseCoopers in Minneapolis. "In retail, location and offering—how the business is presented and how it is interpreted—have much more variability than in many other industries."

Which brings us to a primary challenge retailers face when expanding:

Stretched owner/manager span of control. In most cases the core business has been under the oversight of an owner/operator team that has achieved success by delivering a consistent customer experience. But now, expansion poses important challenges:

- Ensuring the quality of new store level managers.
- Establishing clear, standardized operating procedures. "Simplification is the key here," says Berg. "These procedures address the basics of what you expect employees to do in the store. Is there an expectation for high customer service? The personal touch? How will you make the customer's expectation happen? One fast food franchise found it best to have just five items on the menu. The company's customers didn't want to deal with a large menu, nor could employees in its locations handle complex preparation protocol."
- Tracking performance. Daily, or at minimum, weekly oversight of individual store performance indicators by non-resident management is essential for identifying warning signs or signals. "This is most critical when moving into unproven territories," observes Berg. Key store-level metrics can follow a "Three P" template, and include:

  -Productivity—sales per employee and per square foot;

  -Profitability—daily gross margins on sales by key product categories; and

  -Promotion—response to advertising, correlation of daily customer counts, and sales per customer. "Measuring response to advertising or excitement by observing who's coming into the store and how that varies, contributes to understanding the effectiveness of different types of promotion," says Berg. "We have clients who are as conscientious about counting people coming over the threshold as they are about counting dollars in the register. To drive sales dollars, a retailer must first attract customers to the store, often by effective promotion."

Other risks encountered in expansion may include:

Overlooking why existing sites are successful. "Securing the right new store location that will perform as well as the owner's base store is always a challenge," says Berg. "When the business model is purring, it's easy to forget that the company may have gone through one to three locations before landing on the successful one." He suggests the following steps:

Manage expectations about replicating ideal locations. Not all will meet objectives.

Learn from the past which key attributes are required for a location to perform. "Understanding neighborhood demographics and logistics is critical," says Berg. "Was the model location successful because it was adjacent to, or on a large mall footprint? Is the business volume-dependent? Does it require high accessibility? Does it require the convenience of a destination strip center? What kind of money flow is in the area?"

Cut initial base terms of leases as short as possible in the beginning to limit economic exposure if a new location fails to meet expectations. "The supplemental cash flows required to service the lease of one failed site could take down, dilute, or sap the contribution of ten," says Berg.

Becoming less "hands-on." In addition to metric indicators, it is critical to maintain frequent management visits to the new locations, both to monitor progress first-hand and to instill accountability in local employees. "Sam Walton called himself 'The Windshield CEO,' because of all the time he spent on the road, visiting locations," observes Berg.

Permitting infrastructure costs to outpace store growth. Keep infrastructure investments to a minimum until the new stores' true contribution can be reasonably determined. "Be sure investments in systems, offices, and people are not made at a rate that outpaces the new-store-level profitability," says Berg. "Establish simple procedures at first, to monitor the key metrics—measures of store-level performance delivered via phone and e-mail, following the 'Three P' template—in advance of major investments in new systems. Evaluate drop shipments of merchandise to stores in lieu of incremental new warehousing in new territories, until the need for a new distribution center is justified."

"One of the most common issues retailers have, when expanding, is moving too fast," adds Don Scotto ☎, a tax partner with PricewaterhouseCoopers' Private Company Services group in Florham Park, NJ. "They often open too many stores, in too many jurisdictions, too quickly, and not all will be as successful as planned."

Failing to do proper financial and tax planning. "We see many businesses reach economies of scale, but they have done no tax planning—and consequently, what they have invested and turned into profits, they are now paying into taxes—and to a large extent, unnecessarily," Scotto observes. "For example, there is a significant state and local tax saving opportunity for retailers with multiple channels—such as stores, catalog, and online sales—to separate stores and the direct sales part of the business into different legal entities. This can limit the tax on direct sales profits to jurisdictions where that part of the business is physically present."

Scotto has found that as businesses expand into numerous locations, they can benefit greatly from looking into how they are capitalizing their cost of inventory, and examining how they account for their fixed assets, and might accelerate deductions. "We have conducted fixed asset reviews and found that a very large percentage of fixed assets qualify to be depreciated over five years, instead of 39 years. When you have 50 stores or more, that may represent significant savings."

Retailers looking to expand beyond U.S. borders, such as north to Canada, should keep in mind that other countries have different tax laws and opportunities than the U.S., and that the structure of foreign operations has a direct impact on U.S. taxes. In any case, retailers are more likely to need in-house tax support at an earlier stage than manufacturers, distributors, or service companies.

"Compliance requirements can get out of hand quickly for retailers," says Scotto. "They may need in-house tax support at an earlier stage than manufacturers because of the compliance needs necessitated by all of their store locations. In contrast, a manufacturer could have $500 million in sales all being generated out of one production facility."

Losing touch with the customer. Not all new store locations are going to be home runs, and it's critical to determine which factors affect the number of customers coming in and spending at a site. A plan is needed to determine how you are going to read the customer pulse in the new stores.

"You want to figure out what's causing home runs, triples, doubles, singles, or strike outs as quickly as possible," says Berg. "Determine a mechanism for gauging customer satisfaction. Consider conducting surveys or focus groups, or simply talking to customers and observing them. The 'Three P' template of metric measurement will tell you what's happening; communicating with your customers will tell you why."

Berg recalls the best adjustment he's seen in customer sensitivity, accomplished by one CEO expanding his retail business from 50 to 250 stores.

"This CEO spent half his time in all of his stores," says Berg. "It didn't take him long to figure out that over half of his customers were women, and he made changes to help them feel welcome and comfortable."

The CEO had cappuccino machines installed in every store, and stocked the waiting area with toys for children. Customer service employees are dressed in white shirts and ties, and address customers as guests. In addition, the CEO makes it a practice to give note cards to employees outlining the simple procedures expected to help guests feel safe and comfortable: Handshake, Eye Contact, Name, Smile.

Not addressing customer privacy requirements. Retailers, already used to having to watch their margins carefully, may have a new expense to factor in. "Some credit card companies are expected to follow Visa's lead in requiring IT security procedures—and their documentation—to protect customer credit card privacy in-store or online," says Scotto. "While the major chain stores have a team of people in place to ensure their store systems have the appropriate firewalls to meet privacy requirements for credit card numbers and personal information, a $300 million retailer may not. Unfortunately," he notes, "they still have to address the same security issues, which are likely to intensify."

Despite its challenges, retail has rewards that some just don't find anywhere else. For those thinking about expansion, proper planning can contribute to continued success.

By Janice K. Mandel

Directory

Want to learn more about expanding your retail business? Please call:

☎ John Berg
612-596-4420
john.c.berg@us.pwc.com

☎ Don Scotto
973-236-5530
don.scotto@us.pwc.com

Or contact the PricewaterhouseCoopers office nearest you, listed on the back cover.

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