Retail Apocalypse

Four Ways Physical Stores Can Survive

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Four Ways Physical Stores Can Survive

With skyrocketing rates of digital adoption and collapsing traffic in physical stores, retailers face an existential question: Are their in-person locations relevant anymore? Over the past ten years, e-commerce has built overwhelming advantage. But there are four retail functions where physical stores still have a chance at shaping superior experiences: ultraconvenience, product touch and feel, immersive exploration, and personal, trusted advice.

Deployed effectively across these four functions, emerging technologies such as augmented and virtual reality could allow physical commerce to flourish. But stores must employ these tools within a specific strategic context—or the advantages will be short-lived.

To determine whether maintaining a physical presence still makes sense, retailers must go back to first principles. If it does, they must prioritize one or two of the four functions that can allow their stores to create unique and defensible value.

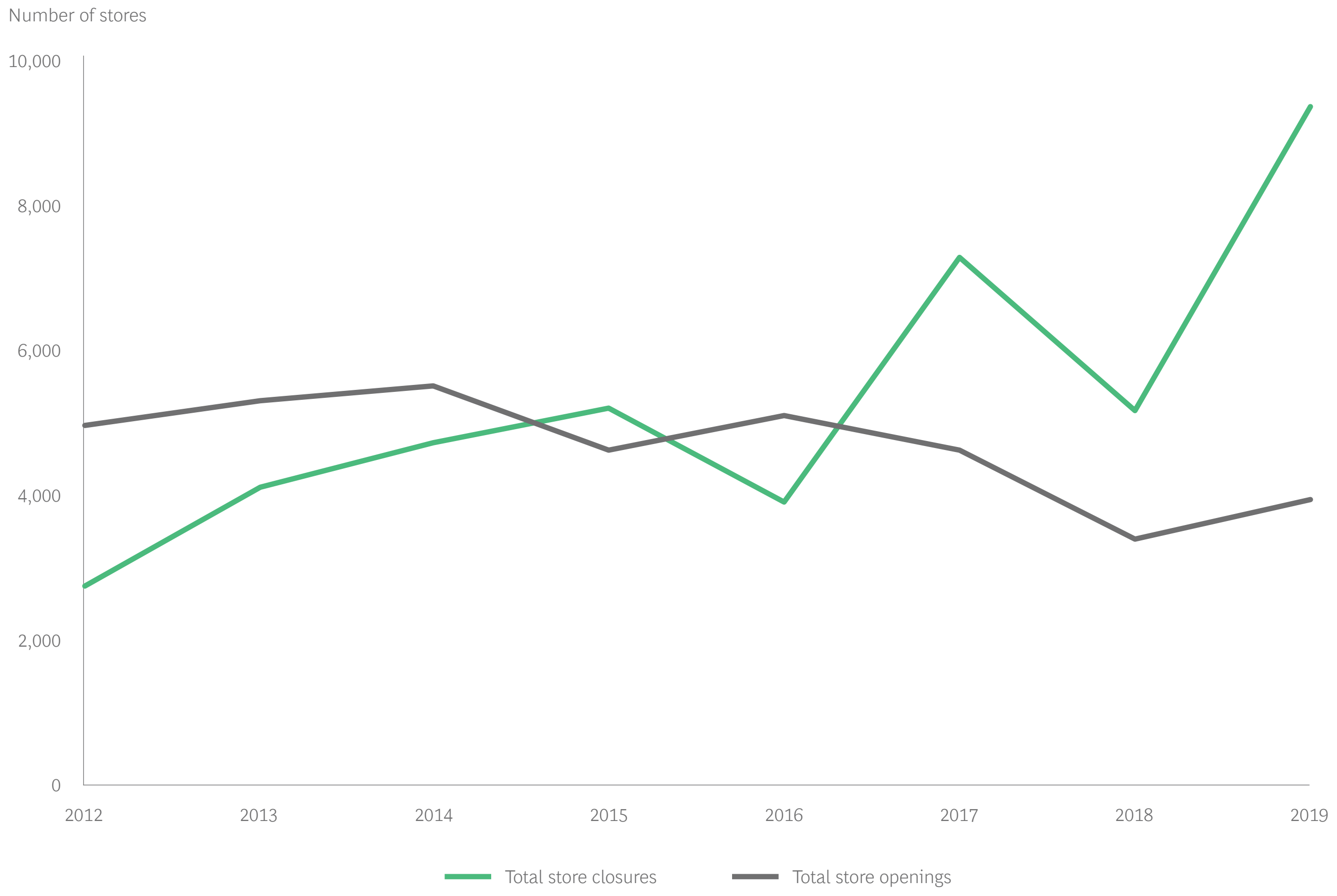
The Retail Apocalypse

The long decline of physical retail is painfully evident. While the pandemic exacerbated matters, store closures were mounting even before the outbreak, with a record 10,000 stores shuttering in in the US alone in 2019. (See Exhibit 1.) When all the tallying is done, the 2020 numbers are likely to be more dire. European retailers are also struggling. The German cosmetics company Douglas announced it would shut down 20% of its physical stores in Europe by 2022. Inditex SA will close 16% of its outlets and shift toward selling online. And Gap is considering departing Europe altogether over the next 12 months.

The "retail apocalypse," as many have dubbed the precipitous decline of brick-and-mortar stores over the past decade, has primarily been driven by one colossal, disruptive event: the rise of e-commerce. Over the past 26 years, one category after another succumbed to digital retail, in an order predestined by their underlying economics. First it was books, audio, and video media—where inventory complexity is overwhelming for the consumer and costly for the retailer. Then it was branded and commodity electronics, household items, and everyday apparel—where the convenience of comprehensive choice, online search, comparison, and user ratings outweighs the lack of touch and feel. Now it is increasingly convenience goods, such as health and beauty items, and staples such as groceries. The extraordinary success of e-commerce pioneers such as Amazon showcases the model's disruptive power. In the 23 years between 1997 and 2020, Amazon created $640 billion more in shareholder value than the rest of the US retail industry put together.

In the face of the retail apocalypse, are there safe harbors? What are the competitively defensible functions of physical retail, the ones where the consumer experience offered in the physical store is sustainably superior? Attending to that question can help retailers regain strategic momentum.

Exhibit 1 - US Store Closings Reached Record Highs in 2019



Sources: Quartz website; Coresight Research; BCG Henderson Institute.

Note: 2019 figures are YTD as of December 13, 2020.

The Central Strategy Question

At its most elemental, retail delivers seven basic functions, though the relative importance of each one varies enormously. (See Exhibit 2.) E-commerce has established fundamental advantage in three of the seven:

Payments. In the mid-nineties, there was widespread consumer concern that online transactions were insecure. But that fear was quickly allayed through HTTPS encryption and bank credit-card guarantees. Since then, contactless and digital payment use has soared.

Navigation. From the outset, HTML linked to online databases presented an array of choices that were more comprehensive, up to date, and searchable than any paper catalog or merchandise layout. As screen resolution, bandwidth, browser technology, and search algorithms improved, the online experience became steadily richer, more interactive, and better customized. And the proliferation of smartphones and apps made the online experience more omnipresent and instantaneous. As a result, the online catalog today is orders of magnitude more efficient and navigable than the in-store experience.

Inventory. With some important exceptions, online retailers enjoy greater economies of scale and improved turnover relative to their physical equivalents because they can centralize inventory in distribution centers. The larger these retailers become, the greater the economies, especially with the introduction of automated warehouse technologies and robotics.

Exhibit 2 - The Seven Basic Functions of Retail

Source: BCG Henderson Institute.

But there are four other functions that e-commerce does not dominate, at least not yet. These are the areas where physical stores can still build and sustain competitive advantage (see Exhibit 3):

Ultraconvenience. This is the reason we want to grab a bottle of wine on the way to a dinner or snacks on the way home: to minimize the end-to-end time between craving a product and getting it.

Product touch and feel. Touch and feel is why we want to sniff perfumes, try on tailored fashions, or test-drive cars before we buy them: because for these products sensory qualities matter, and we want to physically experience them before buying.

Immersive exploration. Entertainment and social appeal are reason enough to visit some stores, independent of any products we purchase: we enjoy the feeling of losing ourselves in an Apple or Disney store.

Personal and trusted advice. The guidance and validation we receive from a knowledgeable salesperson can help us feel that we are making the right purchase decision: we like to feel known and understood.

These functions can harness new, enabling technologies such as artificial intelligence, augmented reality (AR) and virtual reality (VR), 5G communications, and 3D printing to breathe new life into brick-and-mortar experiences. But the same technologies may also be implemented within e-commerce, perhaps giving the physical domain yet another advantage. It is in these four functions, as arbitrated by new technologies, that the fate of physical retail will be decided. For some, they may be four "horsemen" riding to the rescue; for others, they are the final four horsemen of the retail apocalypse.

Exhibit 3 - Physical Stores Can Compete in Four Functions

Ultraconvenience

Source that can fulfill basic needs and supply immediate gratification

Examples include:
Grocery stores, coffee shops, hardware stores that sell frequently purchased commodity items

Product touch and feel

Direct sensory encounter with products before buying

Examples include:
Cosmetics, fashion, luxury, automotive that sells goods with high emotional appeal

Immersive exploration

Brand ecosystem that nurtures a community of afficionados

Examples include:
Strong brands, such as Nike, Apple, and Lego, that shape experiences beyond the transactional

Personal and trusted advice

Guidance and validation from a knowledgeable source

Examples include:
Insurance, banking, telco, and innovative retailers that sell complex products and create "intelligent" experiences

Source: BCG Henderson Institute.

To survive and prosper, retailers need to focus their brick-and-mortar establishments on one or two of these four functions, choosing those where—with the aid of technology—they can deliver a uniquely differentiating customer experience.

Here, we consider how physical stores might use these four functions to their advantage.

Ultraconvenience

Traditionally, if you wanted something right away, you'd go out to a store and buy it. But digital alternatives are steadily encroaching. In some cases, products—books, music, movies, and software, most obviously—have themselves gone digital and the fastest mode of delivery is a download. In other cases, the product can be manufactured in near real time, without the need for a store visit. Today, a high-end Jura espresso machine delivers barista-quality beverages faster than a trip to the coffee shop. Tomorrow, 3D printers installed in delivery trucks could manufacture goods on demand. In 2019, Amazon filed a patent for such technology. The idea may seem fanciful, perhaps, but however advanced technologies manifest it's clear that they will reduce the scale threshold for manufacturing and enable radically decentralized, modular production closer to the point of consumption.

Delivery for most other goods is also getting faster. Amazon's delivery speed has doubled since 2012. Across the retail spectrum, orders that took days a decade ago are now fulfilled in hours. And the options are proliferating: ship-to-home, curbside pickup with geofenced triggers, keyless drop-off lockers, and even drones are all available to home consumers. If an accelerated one-hour delivery costs $5 (a little more than half the US minimum wage), and it would take something like a one-hour round trip to fetch the item in person, it's clear that for many customers the convenience is worth the cost.

Therefore, retailers for whom instant gratification is a key consumer draw must devise different ways for their physical stores to deliver advantage along this dimension. There are four approaches:

- **Match the speed and process efficiency found online.** Kroger and Target, for example, have in-app shopping lists that guide consumers efficiently from aisle to aisle in the physical store. Lowe's NAVii robot leads customers through the store to the products they need. And the new Amazon Go technology bypasses the checkout altogether by allowing customers to pay for their items online and then "grab and go." These time-saving measures do nothing, however, to shrink the time it takes for a consumer to physically travel to and from the store.

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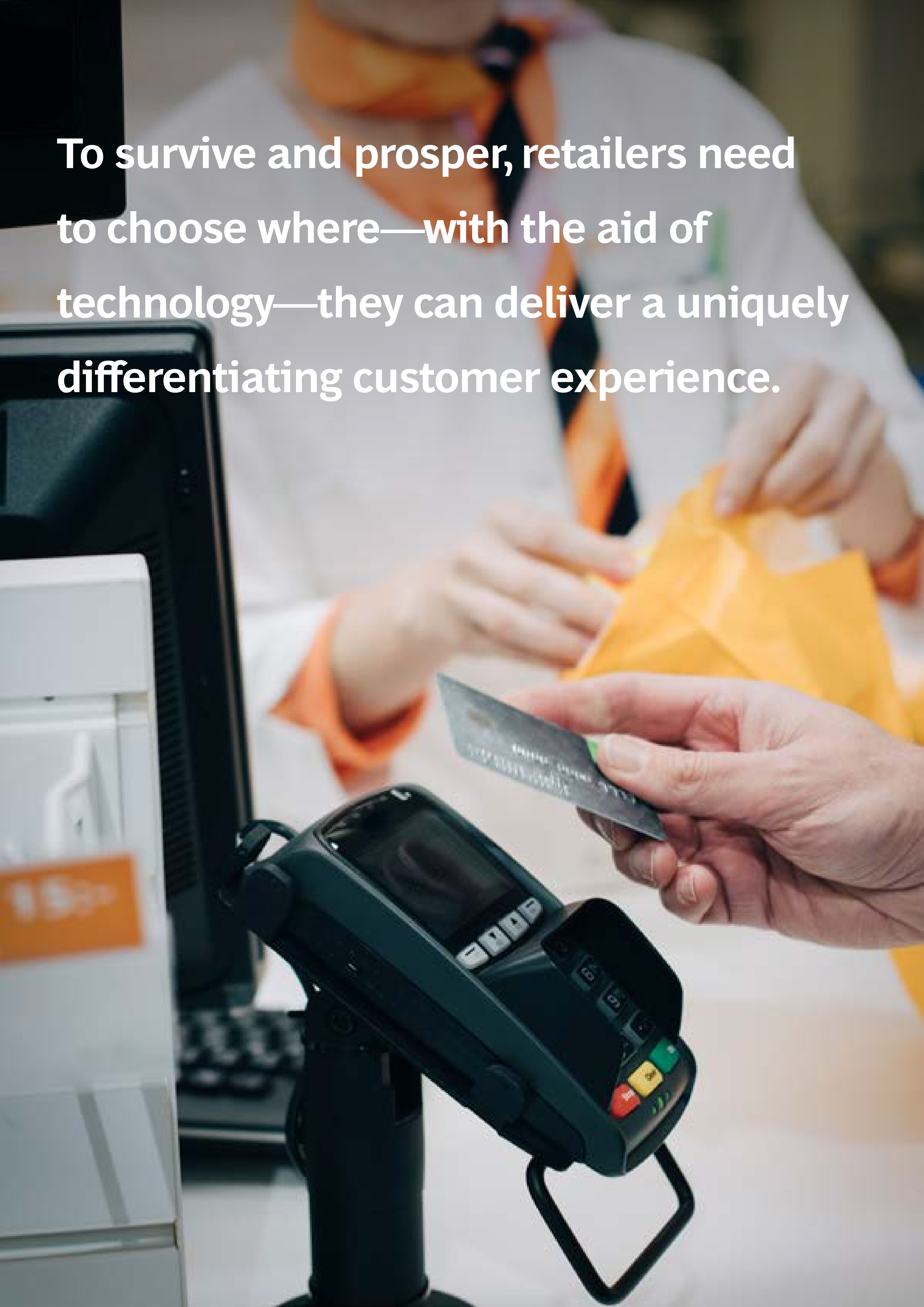

- **Relocate stores closer to the customer.** Retailers are prioritizing convenience stores and mini-marts over supermarkets or hypermarkets. Monoprix, for example, announced a new "city center" strategy with small, fully automated stores that are open 24/7. Nordstrom, Macy's, Bloomingdale's, and Nike have all announced smaller-format stores that are located away from the mall.

- **Provision online delivery from the store.** Retailers can amortize their fixed infrastructure costs over two parallel distribution channels. Walmart uses a warehouse network originally optimized for supplying stores for their online fulfillment. Whether that model is competitive against Amazon's dedicated online distribution centers is unclear, but this type of strategy is already a pivotal battleground for groceries.

- **Carry a wider assortment of products.** Retailers can increase sales and amortize the higher overhead of a smaller store by broadening their product selection and stocking items from other consumer companies. Franprix, for example, has opened "sports corners" inside their mini-marts in collaboration with sports retailer Decathlon.

Fundamentally, meeting the need for ultraconvenience depends on logistical optimization: minimizing the end-to-end time from desire to consumption. Downloads, on-the-spot manufacturing, online order plus delivery, and the various formats of physical shops are simply alternative solutions to the same underlying problem. As technology and customer mobility patterns evolve, so too will the best solutions. The need for ultraconvenience will hasten the convergence of physical retail formats, enabling one-stop shopping for an increasingly diverse set of products, such as banking, postal, and grocery services.

Product Touch and Feel

Some products, of course, have qualities that can't be reduced to specs on a web page. Sometimes people really want to squeeze, sniff, try out, or try on a product before buying, whether it's jewelry, golf clubs, perfume, dress shoes, cars, tailored fashions, or furniture. With advances in bandwidth and browser technology, digital presentation is steadily improving. Web sites and apps dedicated to a product's brand can best exploit these technologies. Luggage maker Tumi, for example, invites the digital visitor to inspect the fit and finish of every zipper and bag handle in intimate, loving detail.

Stores can get in on this game, too. One method is to overlay digital features on a view of the physical item for sale using an AR app on a smartphone or tablet. Car buyers, for example, would still want to get behind the wheel and test drive a vehicle, but AR could help them see what the car looks like with different colors and trims, enhancing the value of visiting the dealership and reducing the volume of inventory that must be carried. Hyundai and Audi both offer this capability today. Others will probably follow.

The same capability also allows retailers to do the reverse and overlay a digital image on the physical reality where the item will be used. IKEA's Place AR app, for example, allows customers to see how a piece of furniture would fit into their home space. Warby Parker's Virtual Try-On feature shows how a pair of glasses would look on a person's face. And L'Oréal's ModiFace and Style My Hair AR features use a "smart mirror" that allows consumers to experiment with different makeup and hairstyle options.

Physical stores could face a challenge from advances in 3D printing, since AR-enabled CAD and CAM can spec a product with unprecedented precision. The latest iPhone, for example, has light detection and ranging (LiDAR) technology. An AR app employing this technology could let a shopper create an exact model of their feet and have custom shoes fashioned. No need to go to the store and try them on, and no need for retail inventories.

Retailers interested in driving traffic to their brick-and-mortar locations will need to create a digitally enhanced touch and feel so elaborate that only their physical store can provide it. In Canada Goose's Toronto store, for example, customers can try on down coats, gloves, and boots and trek into the "cold room" with Alpine dioramas, simulated snowstorms, simulated ice cracking under one's feet, and temperatures dropping to 10°F. The experience brings alive the company's Thermal Experience Index more vividly than any web page. Interestingly, the store does not actually sell the product then and there: customers order the item, and it is delivered that evening. The store is only about touch and feel.

Clearly, we are far from any comprehensive substitution of digital for physical touch and feel. Digital is the domain of sight and sound, and it is advancing rapidly from 2D to 3D. But it is not yet able to reproduce the haptic or the olfactory. Where that matters, stores are robust and can indeed use digital technologies to enhance the in-store experience. The key question is whether consumers care enough about those qualities to offset the other functional advantages of digital retail, and this will vary by category.

Immersive Exploration

Shopping trips can also be fun. Every morning, foodies flock to Tokyo's Tsukiji fish market for the sights, sounds, and pungent smells of the overnight catch being landed. Enthusiasts of fashion, athletic wear, art, gadgets, antiques, and even power tools enjoy visiting their favorite haunts as well. Part of the pleasure is the eye candy. The other part is the joy of stepping into an experience, an aspiration, a way of life, an *identity*. Whether enjoyed with friends or in the company of like-minded strangers, in-store experiences are not only about brand immersion but also about forging a brand community, one that allows consumers to discover and affiliate with others who share similar preferences. Such bonding burnishes brand value.

Indeed, by far the most successful physical retail formats of the past decade have been those that have focused on this kind of consistent, total, shared brand experience. Apple Stores, for example, are iconic spaces, elegantly and expensively laid out and staffed with eager young "geniuses." In 2019, Apple Stores grossed over $5,500 per square foot, by far the highest sales of any retailer in the world. But it is not just Apple. Among the most successful physical retailers are Nike, Chanel, Lululemon, Tiffany's, and Lush. All offer experiences that make the destination as alluring as the product.

In almost every case the store is vertically integrated, selling its own brand of products. A compelling consumer experience requires tight coordination of spatial design and product presentation—and absolute consistency between the product and retail brands. The exceptions to the need for vertical integration are in categories where product suppliers are differentiated but fragmented: Bucherer selling luxury watches or New York's ABC Carpet and Home selling unique and exotic furnishings.

Could digital retailing match this? The out-of-store, purely digital exploratory experience is currently weak, except in VR-gaming environments. But it is precisely the world of online gaming that points to a future for this particular kind of retail. Games are rapidly evolving, as VR immerses the subject in a 3D, stereoscopic, ambient universe. Soon, for a few hundred dollars, VR (delivered by Facebook's Oculus models, Samsung Gear, or a new product expected in 2022 from Apple), will deliver an experience comparable to that of an IMAX cinema.

Nor has the social dimension been missed. Facebook's new social platform Horizon, a massively multiplayer online role-playing game (MMORPG) that uses Oculus headsets, is now in beta testing. If the community network effect is as powerful for Horizon as it has been for Facebook itself—and if Facebook monetizes its service through contextual advertising—then product placement within the game could be a huge retail phenomenon. Some industry participants feel that retail experiences will necessarily evolve to include real-time, 3D elements in partnership with game companies in the years to come.

A number of retailers have already begun using AR and VR technologies to create in-store exploratory experiences. Burberry, for instance, recently partnered with Snapchat on a gamified AR social experience that allows shoppers to step into the fashion brand's Animal Kingdom and see décor around the store come to life. In Lowe's Holoroom How To, customers wearing HTC Vive goggles mix virtual paint and apply plaster to virtual walls. Lowe's claims that user recall is 36% better from the VR experience than from watching a YouTube video.

The snag, of course, is that the Lowe's experience would be identical at home. In fact, by definition, VR is disconnected from the viewer's physical environment. So the only reason to go to the store is that the consumer does not yet own the equipment. As the technology gets cheaper and the goggles become more ubiquitous, the home experience will become a substitute. In-store VR is likely to be a transitional technology, much as PCs in cyber cafés and video games in arcades were in the 1980s.

To be sustainably competitive against an at-home VR experience, the store needs to blend real and virtual exploration in unique ways. Chanel created Coco Flash Club, a branded pop-up store modeled as a nightclub. It offered customers the chance to try and buy cosmetics amid the sensory overload of video projections, strobe lighting, thundering bass, and scents served in cocktail glasses. The installation was staged as a one-hour happening for invited guests in a half-dozen non-store locations around Asia.

Similarly, Nike's SNKRS Days are digitally enabled scavenger hunts. A smartphone app using AR navigates shoe enthusiasts to random citywide locations where they can unlock exclusive rights to a pair of $400 PSNY Air Jordan 12s. These experiences quite literally bring consumers into a journey, using the thrill of the chase to build enthusiasm for the product.

As is implicit in these examples, when physical retail becomes social theater, freshness matters. The retail space becomes a stage, furnished with physical and virtual elements like a theme park or a rock concert. This kind of retailing is neither cheap nor efficient. But for certain kinds of products, where surprise, excitement, and edginess are integral to the brand, it may be the future. Retail becomes entertainment and follows the same principles of entertainment management.

Trusted Advice

Online comparisons, user ratings, and social media can help consumers make informed purchasing decisions, but when it comes to matters of judgment, there are few substitutes for one-on-one engagement, especially when the source of advice is known and trusted.

But that engagement does not have to happen in the store. Nor does it have to happen with a human. Automated advice through chatbots and virtual agents is increasingly pervasive and intelligent, powered by natural language processing (NLP) and "empathetic" AI. Within banking and financial services, the use of robo-advisors is already widespread. Some of these advisors, such as Bank of America's Erica, even have personalities and converse by voice as well as text. And on the theory that eye contact really matters, some NatWest bank branches in the UK have booths staffed by Cora, a winsome on-screen avatar (developed by Soul Machines in collaboration with IBM) with whom customers can engage in simple problem-solving conversations. More-ambitious forms of virtual engagement, such as "holoportation" (already running in several Microsoft labs) allow remote advisors to appear in one's living room through AR technologies.

There are cases where the advisor really must be in the store, because, for example, the customer wants advice on how a fashion garment looks and fits. But this is because the garment is located in the store. If the garment were available to try on virtually, then the advisor could be virtual as well, with the customer and sales associate both looking at the same digital image. Knowing this, retailers can still find ways to make trusted advice part of the allure of the in-store experience, but they will have to be more creative and strategic in doing so. For instance Uniqlo, the Japanese fashion retailer, is experimenting with UMood kiosks, in which customers don a headset that measures neural activity and emotional responses to different video clips. UMood then recommends T-shirts that match the customer's mood. Whether that is a breakthrough or a gimmick remains an open question, but the kiosk initiative is an example of the type of experiential innovation that cannot easily be replicated at home. More-sophisticated experiments may be where physical stores can continue to hold their own.

After a decade-long "apocalypse," most physical retailers cannot seriously expect to continue along their current path.

Revisiting First Principles

After a decade-long "apocalypse" and one or two years of the COVID-19 pandemic, most physical retailers cannot seriously expect to continue along their current path. Leaders must go back to first principles and ask what functions a physical store will fulfill. While every segment is unique, all retailers need to cast a cold eye on their physical business model and form a view on how technology will reshape it for better or worse. They must also consider what digital competitors can do with precisely those same technologies. That is the groundwork for reframing the strategy. Retailers must start the process now. Here's how.

Identify the key vector for customer value. The primary strategic challenge for retailers as they redesign their physical location strategy is homing in on the one thing that their family of stores can do really well. Delivering on that point of unique advantage is where the seven functions form both a checklist and an agenda. No organization can excel at everything—especially during a period of massive dislocation—and so retailers must place their bets selectively. The acid test of strategy is what the organization chooses *not* to do. To make that determination, assess the following:

- Where selection, navigation, and competitive pricing really matter to customers, retailers must go aggressively digital. With continued consolidation of the physical channel likely, retailers should not compromise the competitiveness of their digital offering to prop up legacy physical stores. Better to disrupt yourself before someone else does it to you.

- Where consumers value ultraconvenience, retailers must evolve their physical footprint from large stores spread over wide areas to a dense network of smaller stores hyperclose to the point of consumption. They should re-stage inventory along the supply chain to ensure fast and efficient delivery and form partnerships with retailers in complementary sectors.

- Where product touch and feel is paramount, retailers should fast-track AR and VR technology deployment, using rapid test-and-learn cycles to explore promising applications, solicit customer feedback, and then scale. Focus is crucial. Choose products or moments in the buying journey where these technologies can bring exceptional (and measurable) value.

- Where immersive exploration can deliver advantage, retailers that have the products, selling environment, and brand power should bet—perhaps heavily—on experiential capabilities that transcend the transactional. This option only works for retailers that have a strong brand. Retailers that prioritize immersive experiences are effectively entering the entertainment industry. They need to keep in mind that their chief digital competition is VR in the home and manage accordingly. For these retailers and their customers, surprise, delight, and social context matter more than efficiency or inventory turns.

- When personal, trusted advice matters, retailers must present the advice—and, if required, the advisor—where customers choose to shop. Retailers need to sharpen their customer recognition capabilities across channels. It's the quality of the advice, the depth of expertise offered, and the richness and personalization provided that will set the best retailers apart.

Understand the interplay between physical and digital channels. Determining the value of any one channel requires understanding how different channels work together to shape the overall customer experience. It's not just about tallying what's in the register at the end of the day, but also about calculating the value of softer points such as brand impressions, the fostering of long-term loyalty through community building and exciting in-person experiences, and the interplay among channels. The analysis is both quantitative—understanding the role physical stores play in driving total sales—and qualitative, since physical stores can serve as a critical bridge for marketing and other engagement activities.

Making that determination requires metrics such as footfall, conversion rate, average basket, and revenue per square foot that go beyond classic measures of physical store performance, since those track only a narrow slice of a store's contribution. Instead, retailers should think about stores the same way they do their media expenses—as a sales and marketing lever—and tailor metrics accordingly. The deepest insights come from examining second-order effects: How do in-store interactions shape other types of engagements? A study by Wharton and Harvard, for example, found that positive in-store experiences create "supercharged" consumers who are more loyal and spend up to 60% more on average. It's these second-order dimensions that help reconstitute the role a store can play in the retailer's wider omnichannel strategy. But without understanding and tracking the right signals, retailers may overlook critical relationships and underinvest in the very activities that can help them generate strong customer and business value.

In an industry notorious for its focus on current performance, it can be tempting to put off long-term planning. Tomorrow, we assure ourselves, is bound to look very much like today and can be managed accordingly. But physical retail has high operating and financial leverage, so even small changes in revenue or margin have huge implications for profitability. And with the sustained pace of the retail apocalypse and ten years' worth of change compressed into just a few months of COVID-19 lockdown, too much is changing too fast. For every retailer in the world, the role of the physical store needs to be rethought from first principles—now.

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