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The Secrets of the Great Discount Store Success in America, and their Transferability

In the last decade in the United States, two discount-store chains – Wal-Mart and Kmart – have emerged as the largest retailers of all. They unseated Sears (which had been the largest retailer for well over half a century), Penneys (which is another old-timer), and all the major department store corporations. Kmart had assumed the mantle of retailing's biggest in the 1980s. In 1990, Wal-Mart took over first place from Kmart, and in the process became the world's largest retailer, with sales exceeding USD 65 billion by 1994. What have been the ingredients of the notable successes of these two discount chains, and indeed of the whole discount movement? Are these ingredients transferable to other firms in other economies? The answer as to the transferability is yes. The objective of this article is to reveal the secrets of the discount-store success mode and to consider how they may be adopted in other economies.

Cost Containment

From their beginnings in the late 1950s and early 1960s, the basic differential advantage that discount stores had over traditional retailers was in their being able to operate profitably with a much lower overhead than their competitors. These stores had self-service, lean and flat organizations, austere fixtures and decor, little or no customer services such as delivery and credit, and a minimum use of advertising compared to traditional retailers. With such, they were able to keep their costs often

one-half those of department and specialty stores of the day. They were able to charge such lower prices that customers were willing to drive long distances and stand in lines to get into these stores.

For those merchants having the same brand and item as a discount competitor, the situation was intolerable since they could not match the prices, and still make a profit. And customers were quick to realize the price advantage in doing business with a discount store.

Regular retailers were forced to seek suppliers who did not do business with discounters. A manufacturer then was forced to choose: do business with discounters, or regular retailers, but not both. Because of the great growth of discounters, many vendors opted to do business with them, and not with their long-standing customers.

Eventually, manufacturers came to realize that they could do business with both groups, if they offered similar merchandise under different brands: i.e., one brand for the department store, and another brand for the discounters.

The price differential of discount stores compared to other retailers was rather phenomenal. Discounters in their early days had markups of 20% to 23%, and this compared with a department store's typical markup of 40% to 50%.

These markups are calculated using this formula where R = retail or selling price, and C = the retailer's cost price

$(R-C)/R = \text{Markup Percentage}$
Thus, if an item cost a retailer \$4 and he sold it at \$8, the markup was then $(\$8-\$4)/\$8 = 50\%$.

Such very low markups created problems, however. While the price advantage over other retailers was large, the low markup and the severe cost containment brought profitability problems, as well as housekeeping and stock management problems. A store simply could not keep adequate and orderly merchandise, and be profitable at a 23% markup. Consequently, markups were to rise significantly over the next several decades, though they would still remain substantially lower than those of conventional retailers.

The Secrets of Merchandise Turnover

Merchandise turnover (sometimes called stockturns) is the number of times the average stock is sold during a given period, usually a year.

$\text{Turnover} = \text{Retail sales (for the period)} / \text{Average retail stock (for the period)}$

If, for example, a store had sales of \$320,000 during 1994, and the average inventory at selling price was \$100,000, then the turnover was $\$320,000/\$100,000 = 3.3$

The key to obtaining a higher turnover is to reduce the average stock. Such a smaller stock plays a substantial role in increasing profits. How does it

to this? First, we have to define what profits we are talking about. Net profit dollars as a percent of sales is the common measure of profitability – and it is not directly affected by turnover. A more sophisticated indicator of profitability is *return on investment* (ROI). This figure is what financial analysts and investors are looking for, the 15% and up that they can get on their investment. See Exhibit 1 for specific examples of how increasing stock turnover directly affects return on investment.

In these examples, increasing the rate of turnover from 4 to 5 resulted in increasing the return on investment from 25% to almost 30%. However, we assumed that sales remained the same, while the stock necessary to produce them was cut one fifth. How realistic is this?

It is not unusual for sales to increase with a lower stock because the stock may be fresher and more attractive. Even the enthusiasm of salespeople may be spurred because of the continual arrival of new and interesting merchandise. There may also be more opportunity to pick up special purchases when money is available.

A high turnover may improve not only sales, but also net profits (in addition to improving return investment). Markdowns are usually minimized, since heavy markdowns usually come from heavy stocks. Also, there tends to be a correlation between heavy stock and heavy stock shortages or shrinkage. Furthermore, the lower average stock that goes with a higher turnover means less insurance on inventory and lower property taxes. Less storage space and lower stockroom handling expenses also contribute to lower operating costs and increased net profits.

How Do Discounters Achieve their High Turnovers?

A typical discounter will achieve turnovers of 7 to 8, versus a typical department-store turnover rate of 4 or less. How do they achieve this, and can other stores learn from their experience and do likewise? The major goal of

discounters is to keep the product mix basic and desired. There is no room for fringe sizes and colors; nor is there room for items that are likely to have only limited demand. The result is that full-line discount stores will have many different departments and classifications of goods – a wide breadth of merchandise – but provide only limited choice within each product category – a limited depth.

Such full-line discount stores afford customers one-stop shopping, i.e., customers can take care of practically all their shopping needs under the one roof. (Such one-stop shopping does not require mega-stores. The average discounter achieves this wide assortment often with 100,000 square feet and less.) On the other hand, the Wal-Marts and the Kmart do not give customers much assortment to choose from, whether of men's shirts or women's sweaters or books or sporting goods.

Today, the most powerful discounters place severe demands on their suppliers. They are in positions of great power in their channels of distribution. Wal-Mart, for example, is Procter & Gamble's largest single customer. Even giant Procter & Gamble, a giant detergent manufacturer can not afford to offend Wal-Mart.

Discounters want the delivery time of their orders to be almost immediate; deliveries taking weeks or months are simply not acceptable. Just the Japanese automakers insisted on "just-in-time-deliveries" from their suppliers, so the giant discount chains expect their suppliers to ship instantly, no matter the cost or the efficiency demands placed on these suppliers. With the assurance of quick replenishment, discounters need less backup stock in order to avoid stockout and lost sales.

The Strategy Regarding Seasonal Goods

Goods whose sales peak for only a few months, and then face practically no demand until the season comes up another year, require special care if the discounter is to avoid most of the risks of guessing wrong about the seasonal

demand. These strategies are most prominent in holding down investment in seasonal goods:

1. Not bringing in seasonal goods far in advance of the peak selling season. Instead of putting out vast displays and stocks of Christmas goods in October when most other retailers fall into this trap, the astute discounter will bring in smaller shipments early, but refuse to accept big shipments until approaching the peak selling season. Manufacturers often attempt to motivate early deliveries by attractive seasonal discounts, such as 30 or 60 extra days before payment is due. Such incentives should be approached with caution.
2. Not accepting delayed deliveries even though the goods may be salable for a short time. Often the bulk of such late deliveries hit the downturn in demand.
3. Meeting late season demand with manufacturers' closeouts and other special deals at attractive prices. This minimizes the late season markdowns that confront most retailers.

The Power of Being Guided by Gross Margin Dollars Rather than Gross Margin Percentage

Discounters discovered another secret of effective merchandising that had eluded most conventional retailers. They found that lower unit profit margins, that is, lower markups, could often produce a greater total gross margin, because such lower prices attracted more customers and higher unit sales. This resulted primarily from these two consequences of such lower prices:

1. If there is elasticity of demand, then lower prices create more demand.
2. Lower prices give a competitive advantage over conventional retailers with their higher per unit profit margins.

The mathematics of this strategy of being governed by gross margin dollars rather than gross margin percen-

tage can be rather compelling. See Exhibit 2 for a specific example.

Of course, not every item will produce more gross margin dollars at a reduced markup percentage. Luxury items, the top of the line, often face a relatively inelastic demand, be this for cars, appliances, designer clothing or jewelry. Many pharmaceuticals also have inelastic demand curves because there are few if any substitutes.

But many lower priced products have very elastic demand, such as cheaper appliances, clothing, and the like. If prices can be reduced, demand may increase substantially. Furthermore, if a policy of lower storewide markups is instituted, the store may find that the increased customer traffic and higher unit sales will be promising indeed, especially if competitors persist in their traditional higher markups.

How Can Retailers in Other Economies Adopt the Discount Mode of Operation?

Better Merchandise Turnover

The ability of US discount stores to increase their turnover rates in the quest for greater return on investment is applicable to all firms in all countries. It takes a commitment, of course, to improve reordering efficiency, ordering more frequently and in smaller quantities, not bringing seasonal goods in too early, and taking markdowns promptly. It also takes a firm resolution to use care in expanding the product line to only those items likely to have good demand; in other words, avoiding the fringe sizes and colors, and the otherwise marginal items.

In most Eastern European economies, variety of merchandise has not been a major problem negatively affecting turnover; the assortment of goods and the selection for customers has been far less than in Western economies. Still, any retailer can find goods that are slow sellers and not worth carrying. These should be marked down, sold out, and not replenished.

Exhibit 1 Impact Of Increasing Turnover On Profitability

Example 1

The relevant statistics for a small department store were as follows:

Sales	\$5,000,000
Net-profit percent	.5
Net-profit dollars	\$250,000
Stock turnover	.4
Average stock at retail price (5,000,000:4)	\$1,250,000
Average stock at cost, if gross margin is 40% (1,250,000 X 60%)	\$750,000
Investment in furniture and fixtures	\$250,000
Return on investment	
250,000 (net profit)/[750,000 + 250,000 (investment)] = 25%	

Example 2

For the same store a year later, the stock turnover was increased to 5, with sales and profits the same:

Sales	\$5,000,000
Net-profit percent	.5
Net-profit dollars	\$250,000
Stock turnover	.5
Average stock at retail price (5,000,000:5)	\$1,000,000
Average stock at cost, with gross margin of 40 % (1,000,000 X 60%)	\$600,000
Investment in furniture and fixtures	\$250,000
Return on investment	
250,000 (net profit)/[600,000 + 250,000 (investment)] = 29.4%	

Exhibit 2 Impact of Gross Margin Dollars Rather Than Gross Margin Percentage on Total Profits

Item X: Regular selling price	\$50
Cost	25
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Gross margin per unit at 50% markup	\$25
Units sold	100
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Total gross margin	\$2,500

But with some elasticity of demand for Item X., a lower markup will increase total units sold and may result in more total gross margin dollars, as follows:

New selling price	\$40
Cost	25
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Gross margin per unit at 37% markup	\$15
Units sold	200
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Total gross margin	\$3,000

Reducing Operating Expenses

Discount stores have been industry leaders in finding ways to prune operating expenses. But their tactics can certainly be imitated by other firms. Sometimes they have been able to find greater efficiency in the handling of merchandise from the receiving room to the sales floor. They have been able to reduce expenses through less elaborate displays and less customer services.

In particular, payroll costs have been the easiest to reduce, since they typically are the biggest expense. Any retailer can focus attention on:

- Better scheduling of employees, especially over lunch and dinner breaks. The goal is not to have so many employees working at any one time that their productivity is reduced: for example, having so many salespeople standing around that they outnumber customers is futile. On the other

hand, enough salespeople are needed so that customers can be reasonably taken care of without some leaving in disgust. It helps to have some part-time employees who can work flexible schedules. And some employees may have to have earlier or later meal times in order that adequate coverage can be maintained. Careful attention to scheduling can enable any retailer often to significantly reduce payroll costs without jeopardizing customer service.

- Self-service. Self-service can enable any retailer to operate with far less people than under full customer service. This can be done either by having checkout counters near the entrance, or having decentralized checkout stations scattered throughout the store. Self-service does require utilitarian fixtures that permit the merchandise to be visible and identifiable. Without the presence of a

salesperson, packages, displays, and signs have to assume the selling function. And the fixtures must permit an orderly arrangement of stock that at least resists being misplaced and shopworn.

Testing the Impact on Sales of Reduced Prices

Lower markups may, as we have seen, mean greater sales volume and higher total profit. But this should be tested for individual items and classifications of items by comparing the increase in units sold at the lower prices over those previously sold at higher prices.

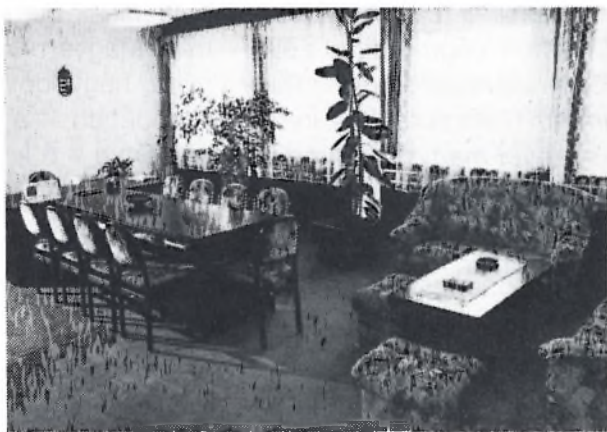
If lower prices of many items being tested result in increased total profit margins, then some businesses may want to consider promoting this discount concept storewide. It helps to advertise the idea of "new lower prices", and "all prices discounted".



*Vállaljuk szállodák, panziók, irodák
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