Building the Consumer Connection: Or How to Succeed in High-Tech Retail

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Executive Summary

Selling components, platforms, products and solutions each require different skills and capabilities. High-tech firms transitioning their strategy from selling components to platforms or products to solutions need to plan for the development of new capabilities and organize themselves differently to ensure that their old biases don't impede the development of the new required skills.

High-tech firms selling through retail channels are likely to experience margin pressures from the dominant electronics retailers unless (1) they attempt to partner and proactively manage their retail relationships, (2) they pursue innovation that differentiates their products both for end users and the retailer, and (3) they build a close and loyal connection with end users. The benefits of the described approaches have raised sales volume and margins significantly for vendors who have pursued best practices in retail partnering, innovation and developing customer connection.

Introduction

Talk to most CEOs in high tech, and their biggest concern is often pricing and declining margins. It's the nature of high-tech companies to have to deal with the challenge of constantly producing better products and receiving less per sale in each generation. For Intel, the curve is called Moore's Law, but the same phenomenon can be observed in many high-tech markets: storage, imaging, printing, bandwidth, cell phones, PDAs, MP3 players, sensors, RFID — the list goes on.

A predictable consequence of increasing volume and declining prices is reduced margins per unit sold.

Just as predictably, organizations can invest in three potential directions:

1. Increase the performance of their products, which often requires expanding the breadth of capabilities or services offered.
2. Drive down manufacturing costs, often through off-shoring or outsourcing.
3. Alter the selling process to reduce the cost of sales or adapt to new buying patterns.

For many high-tech companies, the problems of innovation and product breadth are challenging. Engineering-oriented innovation is often perceived as the primary source of differentiation. But the risk is that companies often over-invest in developing features that are invisible or unusable by customers. They overshoot what the majority of customers are willing to pay for leaving opportunities in the market for new entrants with lower priced and disruptive products.

Driving down manufacturing costs has its own set of strategic issues if loss of knowledge and ability to innovate occurs. But it is in the area of the selling approach that high-tech companies seem to have the most difficulty. Many companies that decide to move from being component vendors to selling through retail channels often discover that the retail environment can be a harsh and difficult place in which to succeed. Take, for example, hard drives. Hard drives, when they first were developed in the late 1950s, were once large devices the size of a refrigerator. Today they are often small, attached externally to PCs or inserted into cameras and other devices. They can be as small as a square inch. Hard drives are now becoming an impulse purchase in a retail outlet with little difference in cost than buying a video game or floppies in the past.

Additionally, the shift from selling to original equipment manufacturers to selling to consumers is a large one for any component vendor. OEMs tend to buy in bulk. Price is critical. Quality is assumed. Only a few technically knowledgeable decision makers are involved.

In contrast, retail is far messier. There is more choice of outlets — specialty stores and chains such as RadioShack, specialty megastore chains such as Fry's and Best Buy, and discount retailers such as Wal-Mart, Target, Costco and Sam's Warehouse. There is also the option of direct sales through a web site or a flagship store approach similar to strategies taken by Dell, Apple or Gateway. Increasingly service vendors, such as cable and telephone companies, are also emerging as a channel to consumers for some categories of products.

Figure 1: The top five retailers constitute 56 percent of sales in the sector

Company	2004 Sales (USD Mil)	2004 # of Stores	Headquarters
1. Best Buy, Co.	27,433	688	Richfield, MN
2. Wal-Mart	12,114	3,066	Bentonville,AK
3. Circuit City	9,611	617	Richmond, VA
4. Dell	7,615	–	Round Rock, TX
5. Radio Shack	4,311	7,433	Fort Worth, TX
6. Target	3,953	1,308	Minneapolis, MN
7. Sears	3,131	2,009	Hoffman Estates,IL
8. CompUSA	2,481	229	Dallas, TX
9. Costco Wholesale	2,224	327	Issaquah, WA
10. Sam's Club	2,070	551	Bentonville, AK
11. Electronic Boutique	1,989	1,977	Richfield, MN
12. GameStop, Corp.	1,843	1,746	Grapevine, TX
13. Fry's Electronics	1,822	31	San Jose. CA
14. Gateway Computers	1,765	–	Irvine, CA
15. Office Depot	1,616	936	Delray Beach, FL
16. Staples	1,566	1,188	Framingham, MA
17. Apple Computers	1,473	86	Cupertino, CA
18. Army-AirForce Exchange	1,233	160	Dallas, TX
19. OfficeMax	946	886	Itaska, IL
20. Amazon.com	828	–	Seattle, WA

Excellence in Execution

Best Buy:
- Launched customer "centricity" marketing intiative in 2005

Wal-Mart:
- Not major CE player 10 years ago, now #2 player and rapidly expanding into private label and off-brand categories (e.g. $30 DVD player)

Radio Shack:
- Plans to operate 500 Kiosks at Sam's Clubs throughout the U.S.

Sears:
- Selling exclusive CE products by Samsung and other leading manufacturers.

Gateway:
- Closed all retail outlets and now sells through the web, phone, and national retailers.

Apple Computer:
- Rapidly risen to a top CE retailer after opening first store in 2001.

Amazon.com:
- Entered CE market through strong partnerships with brick & mortar companies.

As Figure 1 shows, retailing is in fact highly concentrated in consumer electronics. The top five retailers have enormous buying power. With such power, suppliers are likely to experience a margin squeeze from these enormous players.

Moreover, a big risk for many manufacturers is that the retailers will use their buying power and their data about customers to by-pass suppliers and move directly to purchasing from the same off-shore suppliers that are being used to keep costs down. In a comparable strategy to Dell's, retailers like eliminating layers in distribution in order to be competitive and maintain their margins. Additionally, in retailing, many of the great success stories in the past 30 years have come from developing strong house brands.

So, what is a manufacturer to do? If it pursues off-shoring, it runs the risk of setting up long term competition. If it fails to pursue off-shoring, it runs the risk of not being price competitive. If it contracts out design services, it reduces its bargaining power with retailers.

Succeeding in Retailing

Succeeding in retailing requires manufacturers to develop new expertise. Many companies who have spent years driving down costs, systematizing processes and outsourcing activities will now be faced with developing a different mind-set — hiring different types of employees and investing in the development of skills and capabilities that initially will feel unnatural to the organization.

Our work with retailers suggests that there are at least four areas of expertise that manufacturers need to develop:

1. Meaningful consumer-oriented innovation capabilities.
2. Retail partnering and/or execution skills.
3. Building a close connection with the end user.
4. Services-based innovation.

With focused attention on retail execution and account planning, significant increases can be made in overall sales. Even with established brands and products, 5–10 percent increases in revenue are not uncommon. More importantly, effective planning and management of the retail business can result in margin increases at over twice the pace of revenue increases.

Innovation

Apple's recent growth demonstrates some of these capabilities and represents the value of using innovation to create power in the retail channel.

It has used its design skills to create a category-leading appliance family, the iPod, supported by software and hardware on the Macintosh and the Mac Mini, with an ongoing revenue stream from music purchases via iTunes. While iTunes' revenues are low, they do create a barrier to entry as it is inconvenient to maintain multiple music services. Its innovation is based upon exploitation and aggressive purchase of small form factor hard drives, and in the case the iPod Nano, flash memory, high user friendliness and first entry into the legal music downloading market with an integrated hardware/software/services solution.

Unlike many followers into the MP3 space, Apple has created innovations that work together to create synergy between the products and services it has created. It has pursued meaningful and hard-to-imitate differentiation based upon a value chain of integrated user-friendly products, services and suppliers.

Retail Partnering/Execution Skills

As a relatively small player in the personal computer business (with under two percent of installed base), Apple has in recent years had to fight the battle of selling against commodity and modular hardware with a lower price point. Its unique selling proposition has typically revolved around the "appliance" or closed architecture of its products, which makes user friendliness, design coherence and product integration easier to deliver.

However, the move to digital entertainment raised the bar for Apple. Tying together even the limited products that Apple hardware primarily addresses — video, digital cameras, music and networking — raised potential retail support issues. Integration, even of products designed for integration, is no small task in the world of retailing. Best Buy has, for example, been forced to develop a consulting arm, the Geek Squad, to help customers install increasingly complex and networked digital devices. Apple's solution, in contrast, has been a narrow range of highly integrated products with lower-than-average support costs due to control over the integration design. In-store support is provided at the Genius Bar and creates traffic to its stores.

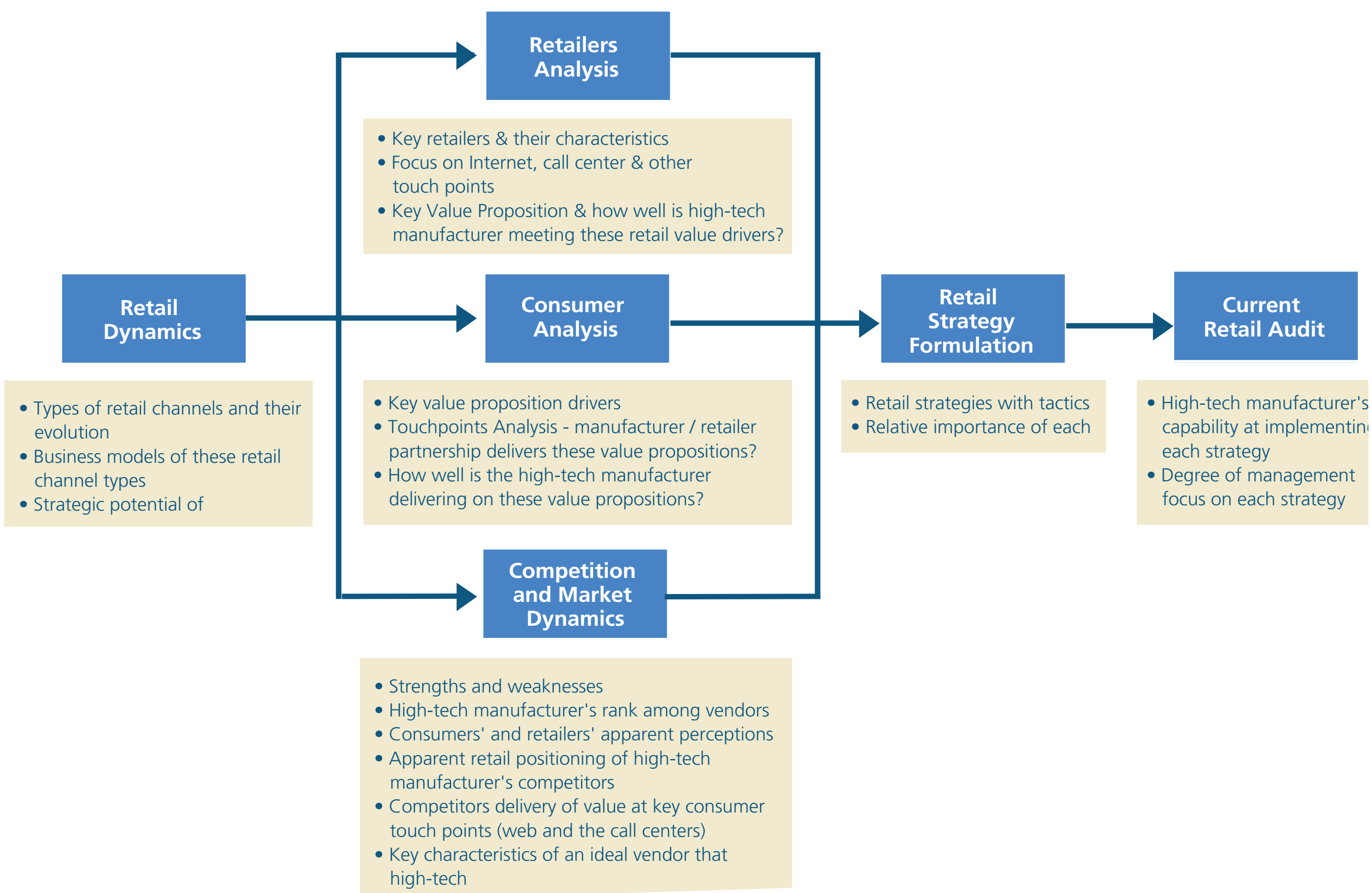
Apple's situation and its use of flagship stores is only one option in retailing. For many manufacturers, their market positions will force them to sell through existing retail channels. For these companies, the challenge is to become important to the retailer. Two skills are required: a high rate of innovation, difficult for the retailer to match; and a proactive teaming approach to working with the retailer. A high rate of innovation makes backward integration by the retailer more difficult. A proactive approach to inventory management with the retailer increases the value of the relationship to the retailer.

Without an explicit attempt to manage inventory with the retailer, the tendency will be for the retailer to over-order and force the supplier to take discounts to move unsold inventory. Neither party will be happy. A more proactive approach might involve inventory planning or even category management.

Building the Consumer Connection

Even with the best of partnering relationships with a retailer, a manufacturer accustomed to dealing with OEMs needs to build a relationship with its end users. The motivation is simple. Without a strong consumer connection, the risk of retailers developing a private label brand remains high. Just as importantly, brand loyalty provides negotiating power with the retailer and increases profitability. A loyal customer generally requires less marketing to and has a higher repeat sales rate. Lower marketing and sales costs can be as important of an advantage as lower manufacturing costs. Additionally, a loyal purchaser is harder to create than a private label product.

Figure 2: Retail partner relationship strategy development is a four stage process



It's also important to remember that brand loyalty is as much emotional as it is rationale — i.e., it is *right brain.* So *left brain*-oriented manufacturers may experience some difficulty in creating touch points with customers, product designs and business models that focus on creating emotionally satisfying product and service experiences.

Consumer connections can vary quite widely. One might think about the following areas for consumer connection:

1. The operational aspects of tracking customer purchases, interactions and warranties
2. Purchase and attitude influence
3. Post-purchase reinforcement
4. Peripheral, service, support and warranty sales, cross-selling, up-selling and generational replacement
5. Owning the relationship with frequent or "heavy" users

Building the Service Connection

High-tech consumer products are different than other products. They are often more complicated to learn and use. They tend to break or malfunction. Different buyers have different degrees of interest in mastering or even using them. And, the rate of obsolescence is high. The moment you buy a product, a new and better one comes out.

As a result, the service component of consumer high-tech products is extremely important. The consumer service connection covers a number of areas:

1. Learning how to evaluate the product category including evaluating whether the product is going to work with current and future products and services
2. Learning how to use the product purchased
3. Making the product work with other products
4. Solving problems
5. Getting support
6. Warranty service
7. Passing along the product to another person, perhaps a member of the family
8. Upgrading or replacing the product
9. Signing up for services that make the product more useful

Each of these areas represent an opportunity to connect with the user for creating demand for additional products and services, generating positive word of mouth and emotional commitment to the product. Loyal customers provide strong word of mouth, often participate on web sites (leaving a written trail for others to follow), and can provide a cost advantage to manufacturers by eliminating costly sales and marketing activities.

Purchase, Registration and Warranty Tracking

Adobe is an example of a company with a focus on operational excellence in tracking customer usage. They sell both directly and indirectly to consumers and offer a single customer view of products and services bought, simplifying the life of customers whose machines have crashed or who have lost serial numbers. It is perhaps no coincidence that Adobe is also a heavy user of user-interaction testing and design and frequently surveys customer usage patterns. Its detailed knowledge of its customers has led it to segment its market for different levels of product interest and knowledge.

Purchase Attitude Influence

Marketing has always involved advertising and an attempt to influence reviewers of products. However, a major shift in retailing today is the importance of mavens and web-based influencers. Traditional media such as the *New York Times*, the *Wall Street Journal, USA Today*, local newspapers, and specialty interest publications are clearly very important. But with the widespread use of Google, specialized hobbyists sites, and other Internet-based forums, alternate mechanisms have become a significant source of "push" for many high-tech products that manufactures ignore at their peril.

In the digital camera space, many will not have heard of sites such as www.stevesdigicams.com which rate digital cameras. It claims that it has received almost 500 million visits since its founding. Those who have not investigated the detailed analysis available will be astounded at the amount of work that hobbyists and enthusiasts will go to compare products (e.g., www.wlcastleman.com or www.fredmiranda.com). They will also be surprised at the amount and quality of information available on rating sites and on discussion boards. Clearly, customers vary in their investigative approach, but some purchasers will do extensive investigation of products, often gaining knowledge that they spread to their personal network of contacts.

Post Purchase Reinforcement

In the same way that movie viewers will often read movie reviews after seeing a movie, buyers will often research their own purchases on the web and in specialty magazines. In some cases, the information about products in specialty third party sites is so useful that it can transform the perception of the purchase and perhaps, more surprisingly, substitute for manuals and training.

Cross-Selling and Upgrades

Most manufacturers offer upgrades and accessories from their sites. In many cases, the rationale is to ensure that their products are supported even when retailers don't carry a full range of product accessories.

Owning the Relationship With Frequent or "Heavy" Users

In an ideal environment, manufacturers would like to have such innovative products that retailers are forced to let the manufacturer siphon off the heavy users. In the world of publishing, this approach was a strategy pursued by Harlequin Romances in the 1970s and 1980s. They innovated in retailing by offering books in supermarkets and signed up the most addicted customers for a book club that generated monthly revenue. There are parallels with this strategy in what Apple is doing today. The iPod hardware is sold in numerous outlets, but Apple retains the service relationship of iTunes.

Summary

Making a commitment to selling products direct to consumers or through retail channels requires careful development of new skills and capabilities. Product development design, integration of products, fostering of review and rating sites, and partnering with retailers will all require improved capabilities. The challenge is to be successful in retailing and not create a market that can be attacked by retailer house brands. The key task is to develop products that create emotional loyalty and programs that create a customer connection with individual consumers.