Point of View

Accelerate Retail Business Results with Technology-Enabled Private Label Capabilities

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Overview

Under pressure to improve business results, retailers are accelerating their focus on private label products to meet local tastes, deliver lifestyle choices, differentiate their brands, and increase consumer loyalty. This is especially true in the United States, where private label products typically account for just 15 percent to 20 percent of items on retailers' shelves (by comparison, private label products represent more than half of European retailers' offerings).[1]

In the last six months of 2009, store-brand unit sales increased by 2.5 percent in the United States, while national brands grew by only 0.4 percent.[2] Private label now represents 19 percent of U.S. retailers' market value, up from 15 percent in 2003.[3] This increase was accelerated by the economic recession, which fundamentally shifted consumer buying behavior toward gaining the most value for every dollar spent.

The rapid growth of store brands has resulted in private label capabilities that may lack the approach, structure, and processes needed to achieve the healthy profit margins retailers expect. Fortunately, new technologies are making it easier to gain consumer insights, develop new products, and market to consumers. This is allowing retailers to mimic the capabilities of consumer packaged goods (CPG) companies at lower cost, and with faster time to market.

To help retailers employ these technologies to improve their private label initiatives, the Cisco Internet Business Solutions Group (IBSG) developed a two-phase maturity model that allows retailers to assess their private label capabilities. With this information, they can develop plans for progressing from today's typical Private Label 1.0 level to the advanced and emerging capabilities of Private Label 2.0. While retailers may take different approaches, it is possible to achieve substantial improvements in shareholder value by embracing all of the technology-enabled capabilities described in this paper.

Key Trends Driving Growth of Private Label Products

Three trends are increasing the need for retailers to improve business results by developing, placing, and marketing private label products:

1. Changing consumer behaviors due to the global economic crisis
2. Growing pressure to improve margins and combat increased competition
3. Shifting consumer attitudes toward private label products

Trend 1: Changing Consumer Behaviors Due to Global Economic Crisis

Due to the economic downturn, consumers redefined their spending patterns and changed the way they shopped. Consumers are smarter: They are buying what they need, rather than what they want, to extend their purchasing power. In fact, a recent Ogilvy survey indicated that 69 percent of consumers have rethought their buying perspective, and 79 percent have changed

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their behavior for the better. People are paying more attention to product value and are being more selective about where they spend their money.[4]

These newly adopted buying behaviors are expected to continue. A recent study of 800 households by GfK Custom Research for the Private Label Manufacturers Association (PLMA) showed that as the economy recovers, the overwhelming majority—91 percent of U.S. shoppers—will continue purchasing private label products.[5]

Trend 2: Growing Pressure To Improve Margins and Combat Increased Competition

Retailers are being "squeezed" between CPG companies passing on increased costs and consumers wanting lower prices. Adding to this challenge is a perception that CPG companies are quick to pass along rising commodity costs, but often are slow to reduce prices when costs fall. Retailers, wanting to differentiate their offerings, also feel frustrated by the lack of control over new product development and innovative offerings from their CPG partners.

These factors and the lure of greater margins have caused a steady rise in private label products from retailers. More and more, retailers are "flexing their muscles" by replacing national brands and using private label strategies as leverage in negotiations with CPG suppliers. As examples, CVS recently replaced Energizer batteries with its own store brand, while Costco temporarily removed Coca-Cola products from its stores.[6] Because retailers currently have greater control over product selection, tensions with their CPG partners are expected to intensify.

Trend 3: Shifting Consumer Attitudes Toward Private Label Products

In addition to new attitudes about shopping due to the recession, consumers are gravitating toward private label products for other reasons. According to Nielsen, 63 percent of U.S. consumers consider private label brands to be of comparable quality to national brands, and 72 percent feel they are "good alternatives" to name brands (both increases are relative to prior years).[7]

These findings are reinforced by recent analysis from KPMG, which states: "It used to be that private labels served as low-cost and generally low-quality substitutes for national brands. Today, nearly 75 percent of all U.S. consumers rate private label offerings as excellent in overall quality. About 40 percent of consumers earning over $50,000 per year are in the 'switch to private label' group. What was once the purview of discount shoppers is now attracting middle and up-market buyers."[8]

Private Label Development Is Flourishing

These trends are causing private label sales to flourish. In the United States, for example, private label sales jumped 10 percent in 2008, to $83 billion.[9] Additionally, a recent study by RSR Research showed 70 percent of large retailers have increased their private label assortment in the last two years.[10]

Even more important for retailers, gross margins from private label products are an average of 25 to 30 percent higher than from national brands. Some products, such as those in the beauty category, can be store-branded at a 63 percent discount.[11]

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Using Technology To Improve Private Label Business Results

Private label products give retailers a way to satisfy consumers' needs, increase margins, and differentiate themselves to increase loyalty and gain a competitive advantage. Today, many retailers are developing a variety of innovative strategies that include co-branding, regional customization, creative packaging, and new product innovations.

In pursuing these strategies, retailers have demonstrated varied levels of private label capabilities that have directly impacted the results of their efforts. For example, a new entrant in creative packaging generally is not as successful as an experienced retailer that has been doing the same thing for several years.

To improve business results, Cisco IBSG developed a maturity model that allows retailers to assess their private label capabilities (see Figure 1). The table also provides innovative ideas and future capabilities to guide retailers as they progress from today's Private Label 1.0 level to the advanced and emerging capabilities of Private Label 2.0. By using this model, retailers can develop roadmaps, experiment to gain experience, accelerate private label offerings, and increase profit margins.

Figure 1. The Maturity Model Allows Retailers to Assess and Enhance Their Private Label Capabilities

		Private Label 1.0	Private Label 2.0	
Capabilities	**Trends**	**Today**	**Advanced**	**Emerging**
1. Consumer Insights / Brand Strategy Identify unmet needs	▪ New data sources provide added insight ▪ Micro-segmentation	▪ Store sales, customer loyalty, and market data for insights ▪ Store clusters based on customer demographics	▪ Listening to social networks for additional insights ▪ Brands target lifestyle needs	▪ In-store and in-home video analytics ▪ Unique persona and profiles for each store
2. Product Innovation Unique design, formulations, and features to delight consumers	▪ Extensive and open sources of ideas ▪ Specialized and nimble partner ecosystem	▪ Employee suggestions and consumer panels to solicit ideas ▪ Manufacturers pitch ideas to win new business	▪ Online employee communities suggest, discuss, and build on ideas ▪ Network of partners collaborate to develop ideas and designs	▪ Online extended communities, driven by competitions and shared IP ▪ Extensive network of universities, freelance designers, and entrepreneurs
3. Concept Development and Testing Speed development, test, and response cycles	▪ Virtual prototypes ▪ Virtual communities to test products	▪ Drawings / graphics to demonstrate products ▪ Employee / consumer panels for feedback	▪ Computers create 3-D interactive models ▪ Virtual panels / video for rich interactions	▪ Interactive virtual reality simulations let consumers interact / assess ▪ Online- / mobile-based augmented reality to test products
4. Value Chain Integration Tighter integration from design to delivery	▪ Tighter integration with partners ▪ Extensive use of specialized resources	▪ Outsourcing for low-cost manufacturing ▪ In-house capabilities augmented with few partners	▪ Virtual vertical integration ▪ Core in-house capabilities	▪ Ecosystem of specialized partners connected through collaboration / communication technologies
5. Marketing and Promotions Awareness and loyalty at minimal cost	▪ Use of digital media / channels ▪ Engaging in social networks	▪ Printed flyers / in-store advertising ▪ Discounts and in-store samples / demos to generate trials	▪ In-store digital advertising ▪ Viral marketing in social media	▪ Innovative use of web, mobile, and gaming / TV placements ▪ Target / create loyal communities

Source: Cisco IBSG, 2010

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The maturity model is divided into five capabilities: 1) customer insights and brand strategy, 2) product innovation, 3) concept development and testing, 4) value chain integration, and 5) marketing and promotions.

1. Customer Insights and Brand Strategy

Traditionally, retailers have analyzed point of sale (POS) and loyalty program information, as well as market data from companies such as Nielsen, to understand what their customers are buying. Many retailers also gain additional customer insights by collecting and analyzing information from their websites.

Most recently, the growth of digital video, proliferation of smartphone applications, and rapid growth of social networking and video platforms have created many rich, new repositories of information. Retailers can now use data from these sources to “micro-segment” consumers along various profiles, such as lifestyle preferences, to develop and target new brands. Linking micro-segments to customers that frequent each store has also enabled retailers to localize store-level assortments.

For example, Cabela’s is using in-store surveillance video to gather new information about customers, such as ethnicity and gender, as well as behavioral data, including dwell times and shopping patterns. This information helps the company segment its customers and understand traffic patterns in stores. In addition, Hilton Hotels is using a conversation “listening” platform to collect additional insights about its customers as they communicate openly on social networking platforms such as Facebook and Twitter.

Although these emerging Private Label 2.0 opportunities increase the challenge of data collection, integration, and analysis, retailers can tap the value of these new information sources while reducing costs, lowering complexity, and mitigating risks. This can be done by creating a customer insight platform using software as a service (SaaS) instead of buying and installing software; by adopting cloud services for infrastructure; and by taking an open innovation approach that provides an agile source of expertise beyond the four walls of an enterprise.

2. Product Innovation

Many of today’s Private Label 1.0 practices focus on sourcing “me-too” products from numerous suppliers to increase margins and give consumers lower-priced alternatives to brand-name products. To do this, retailers negotiate development of the same product with multiple suppliers in an “arm’s-length” relationship. For retailers wanting to improve product innovation, Cisco IBSG recommends creating a more collaborative, open-innovation environment by employing new Private Label 2.0 capabilities that allow ideas to be suggested and built upon by communities of employees, business partners, and customers.

Build fewer, more strategic partnerships for product development. Retailers can accomplish this by pre-selecting strategic partners, entering into longer-term contracts, and using collaboration technologies to create an open environment for idea sharing that produces a continuous pipeline of new products. Open-innovation networks should include anchor members (strategic suppliers), intermediaries, and relevant university resources.

This approach has several benefits. First, retailers save costs since they do not have to develop the same internal R&D organizations that are currently burdening CPG companies. Second, resources can be brought together as needed. This also reduces costs while adding a certain level of business agility. Finally, retailers can gain a competitive advantage over CPG companies,

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which have had difficulties establishing open-innovation networks due to entrenched business cultures and large investments in their R&D organizations.

Solicit ideas directly from consumers and employees. For example, retailers can create programs that encourage active participation through competitions and recognition. Cisco recently created a contest called I-Prize that offered a $250,000 reward to the person who came up with the best idea for the company's next billion-dollar market opportunity. The challenge resulted in approximately 2,000 new suggestions. The winning idea was for an energy-management product that became a key component of Cisco's smart grid solution.[12]

In addition to the significant prize offering, Cisco took a flexible approach to intellectual property rights, which could either be shared or negotiated with the winner. This provided an extra incentive for individuals to participate since they could benefit from the success of their idea in the marketplace.

Outside of Cisco, a large manufacturer is deploying technology-enabled collaboration centers. These centers allow dispersed teams to co-create and innovate in real time using virtual whiteboards and Cisco® TelePresence™ technology. These collaboration centers will allow the company to find experts on-demand, bring them into virtual collaboration rooms to solve problems, and develop new products faster and at lower costs.

Build an enabling-technology architecture. A technology architecture is required to support the advanced and emerging capabilities described in the maturity model. This architecture should include presence technology for intercompany collaboration and the ability to schedule meetings on-demand; telepresence for rich video interactions; virtual whiteboarding to brainstorm new ideas; shared spaces for staying organized; and community tools to provide participants with relevant content.

3. Concept Development and Testing

Determining the design requirements for a successful product starts with a clear understanding of consumer needs and wants. In most instances, observing how consumers use products reveals more than evaluating data gleaned from surveys. This is because consumers' actual needs may be dramatically different from what they articulate. Unfortunately, the time and cost of creating prototypes make testing products with consumers difficult.

Recently, however, advances in Internet technologies have created the ability to rapidly develop and deliver virtual prototypes of physical products that can be used for testing with consumers. These Private Label 2.0 virtual prototyping platforms allow retailers to reduce the time it takes to test new concepts, improve results by involving more consumers in the testing process, and cut the cost of product design.

Lego's interactive community site (www.legoclick.com) is an example of this approach. The site allows customers to build virtual prototypes and have their creations evaluated by the company. This approach generates thousands of new product ideas each year and allows Lego to evaluate new concepts easily and cost-effectively.

4. Value Chain Integration

Bringing new products to market requires five steps: 1) research and development, 2) design, 3) manufacturing, 4) delivery, and 5) support. Today's Private Label 1.0 approach is to have separate groups within a company manage these steps serially. In addition, outside entities

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are not usually involved until late in the process. Bringing partners, suppliers, and other outside parties into the product development process earlier can reduce total development costs by up to 35 percent and speed time to market.[13]

As an example, a major beverage company involved in a product extension effort used Internet-enabled technologies to "virtually co-locate" consumer research, design, manufacturing, sales, marketing, and geographical teams. The company also implemented a rigorous program management effort that incorporated input from suppliers and partners during the concept stage, while maintaining and protecting every participant's intellectual property. Due to this approach, product formulations were reduced from 180 to just five, unit costs to develop an initial product version dropped from $1.4 million to just $50,000, and design time was compressed from seven man-years to less than one man-year.[14]

Across all retail industries, sources of innovation are multiplying while product and service lifecycles are shrinking. These trends necessitate faster product development cycles. Fast Fashion, a Private Label 2.0 apparel manufacturing approach where product assortment is frequently changed to meet rapidly shifting customer tastes, is at the leading edge of this movement.

These trends are also being addressed by a move toward virtual integration. With this approach, each participant focuses on core competencies (design, marketing, manufacturing, sales, etc.). These competencies are then "virtually integrated" through the use of collaboration technologies. The result is that retailers can achieve previously unattainable levels of business performance.

5. Marketing and Promotions

The biggest difference between the cost of product delivery for retailers and that of CPG companies is the amount of money spent on advertising: Retailers apply approximately 2 percent to 3 percent of revenues to promoting their products, while CPG companies spend 10 times that amount.[15] This difference is the main reason retailers can maintain high margins on private label products, even while selling them at lower prices.

In addition to the advantage of lower advertising costs, retailers control the space where advertising is most effective—their stores. A recent study of six Western countries showed that 50 percent of consumers indicated in-store advertising was more effective at getting them to purchase products, as compared to 36 percent who said television was the most effective.[16] Post-recession consumer behavior is also causing consumers to spend more time in store aisles looking for the best values. Because of these trends, CPG companies are paying a lot more attention to what retailers are doing, and have allocated $542 billion to in-store advertising.[17] Cisco IBSG believes that to maintain their competitive advantage, retailers should continue to innovate with in-store advertising and employ the Private Label 2.0 advanced and emerging capabilities recommended in the maturity model.

Another significant trend related to marketing and promotions is the increased usage of mobile devices. In just two years, two-thirds of consumers will carry mobile devices, with nearly half of these being smartphones. In addition, almost 70 percent of customers currently bring their phones with them when they shop.[18] Retailers can take advantage of these trends by using context-aware mobile applications to increase sales and build customer loyalty.

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Walmart, for example, has deployed an opt-in mobile application that sends SMS text alerts to customers and provides links to the company's mobile webpage. Ralph Lauren is using 2-D barcodes in print ads to allow customers to take photos of the code and go to Ralph Lauren's mobile site to buy the product. This helps increase sales by making it more convenient to buy the company's products when the desire to purchase is strongest. These are just a couple of examples from the thousands of applications being deployed for product promotion.

Today's social media channels also offer a lower-cost, higher-return alternative to traditional print and TV advertising. With Facebook now at 500 million users, and Twitter boasting more than 120 million users, it is clear that consumers can be reached, engaged, and measured in ways that weren't possible just a couple of years ago.[19]

By taking advantage of social media, retailers can measure and optimize brand awareness, perception, product affinity, and purchasing intent. They also have the ability to influence consumer behavior to produce sales, co-create new business ideas, and generate leads. For example, celebrities used a new voice-based social media service called "Bubbly" to create demand for the hit film "Three Idiots" with nearly zero marketing dollars.[20]

Other examples include:

- Dell—attributed $2 million in sales to promotions targeting the company's more than 600,000 Twitter followers.
- Charles Schwab—grew its Gen X customer base (consumers born approximately between 1960 and 1979) 55 percent by tailoring targeted offerings via social media sites.
- Marriott—booked $5 million in revenue from customers clicking through to the company's reservations page from a Marriott Blog.

These are just a few of the fast-growing list of companies that have increased revenues through use of social media. In the future, Private Label. 2.0 technologies such as interactive packaging and electronic shelf labels will be available at price points that will allow retailers to develop new ways to differentiate their brands and increase sales of their own private label products.

The Business Value of Private Label Innovation

By moving from today's Private Label 1.0 environment to advanced and emerging Private Label 2.0 capabilities, retailers can improve business results in three ways (see Figure 2):

1) Greater Operational Efficiencies from Tighter Value Chain Integration

The integration of functions and partners—from design to delivery—is foundational, regardless of a retailer's private label strategy. Tighter integration is essential to deploy the advanced and emerging capabilities that help bring retailers closer to faster and flawless execution. From these efficiencies, the representative retailer in Figure 2, with annual revenues of $10 billion and gross margins of 35 percent, can increase shareholder value by $1.4 billion, with an incremental gross margin improvement of 1 percent.

2) Differentiation Through Increased Private Label Offerings Within Product Mix

Replacing national brands with private label equivalents to yield greater gross margins is a logical place for most retailers to begin. By building a better product mix that more closely meets customers' diverse needs, retailers can drive greater wallet share and attract additional

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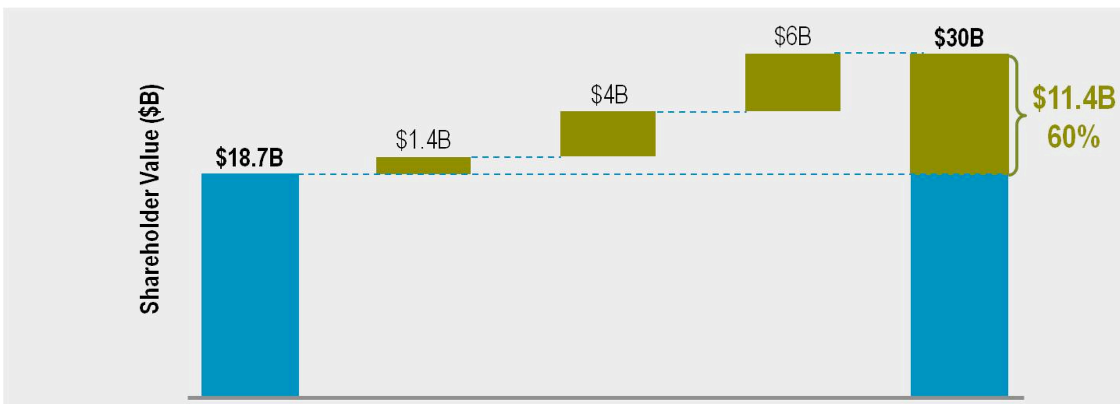
customers. Assuming incremental revenues of $1 billion (10 percent of $10 billion in current sales) and gross margin improvements of 36 percent to 50 percent, the representative retailer in Figure 2 can increase shareholder value by $4 billion.

3) Increased New Business from Identifying and Satisfying Unique and Often Undiscovered Customer Needs

Retailers can increase shareholder value from new business in two ways: 1) offering products—and sometimes, related services—that are typically not offered at earlier stages of maturity, and 2) sensing and responding to opportunities before other retailers and CPG companies. Assuming incremental revenues of $1 billion at the higher gross margin of 50 percent (from number 2 above), the representative retailer in Figure 2 can increase shareholder value by $6 billion.

(Note: This illustrative model is based on previous Cisco IBSG work with retailers and CPG companies. Additional assumptions are listed in the "Endnotes" section.)[22]

Figure 2. Based on a Representative U.S. Retailer, Shareholder Value Can Be Increased by 60 Percent



	Current	Efficiency	Product Differentiation	New Business	Current + Potential Upside
Revenue ($B)	$10B	N / A	+$1B	+$1B	
Gross Margin (%)	35%	36%	50%	50%	
Earnings ($B)	$0.94B	$0.07B	$0.20B	$0.20B	
P / E Ratio	20	20	20	30	

Source: Cisco IBSG, 2010

Next Steps

Multiple business drivers are causing retailers to aggressively pursue a higher percentage of private label products. By moving to advanced and emerging private label 2.0 capabilities, retailers can accelerate store brand offerings and improve shareholder value. To achieve these goals, retailers should take three steps:

Step 1

Identify their current level of private label capabilities (today, advanced, emerging) from the Maturity Model. Some retailers may be "advanced" in one capability and "emerging" in another area. This is normal since retailers are at different stages of maturity depending on their experience with—and commitment to—private label programs.

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Step 2

Assess their private label programs and intent moving forward. Cisco IBSG believes private label programs that employ more sophisticated strategies by using enabling technologies to achieve "advanced" and "emerging" capabilities will increase efficiencies, product differentiation, and new business opportunities.

Step 3

Form a team, establish executive sponsorship, and solicit ideas from other industries that develop products targeted at consumers to assist with the development of a business architecture, technology enablement, and business case to advance private label capabilities.

Endnotes

1. Source: Cisco IBSG, 2010.
2. Source: Nielsen, 2010.
3. Source: just-food.com, July 15, 2009.
4. Source: "How Consumers Rewrote the Old Recessionary Rules," *Fortune,* May 4, 2010.
5. Source: "Private Label Programs Take Off," *Brandweek,* July 2009.
6. Source: "From CVS to Costco, Retailers Put the Screws to Brands," *Advertising Age,* July 14, 2010.
7. Source: "Private Label Brands Gain Favor in the U.S.," Nielsen Wire, November 17, 2008.
8. Source: "Store Brands and the Recession," Private Label Manufacturers Association, 2009.
9. Source: "Private Label Brands Gain Favor in the U.S.," Nielsen Wire, November 17, 2008.
10. Source: "Designing and Delivering Merchandising that Sells," RSR Research, April 2010.
11. Source: "Designing and Delivering Merchandising that Sells," RSR Research, April 2010.
12. Source: Cisco, 2009.
13. Source: Cisco IBSG, 2010.
14. Source: Cisco IBSG, 2009.
15. Source: *Advertising Age,* April 25, 2010.
16. Source: *Advertising Age,* April 25, 2010.
17. Source: *Advertising Age,* April 25, 2010.
18. Sources: Cisco IBSG Economics and Research, 2009; Cisco IBSG Global Mobility Study, 2009; Cisco IBSG E-Commerce Survey, 2009; Gartner, 2009; Jupiter Research, 2009.
19. Source: *The Economist,* July 24, 2010.
20. Source: "Is Voice-Based Bubbly the New Twitter?," *Advertising Age,* March 11, 2010.
21. Source: Cisco IBSG, 2010.

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22. Calculations were based on a U.S. retailer with a starting shareholder value of $18.7 billion. Key assumptions for the impact on shareholder value include:

- Products: 118 in 30 categories. Of these, 50 products were selected as representative
- A weight was assigned to each product category based on a percentage of total sales, category sales, and product margins.
- Gross margin spread: 1 to 40 percent
- Sales, general, and administration (SGA): 22 percent
- Tax rate: 28 percent
- New products have higher growth rates and deserve a higher price to earnings multiple

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More Information

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