

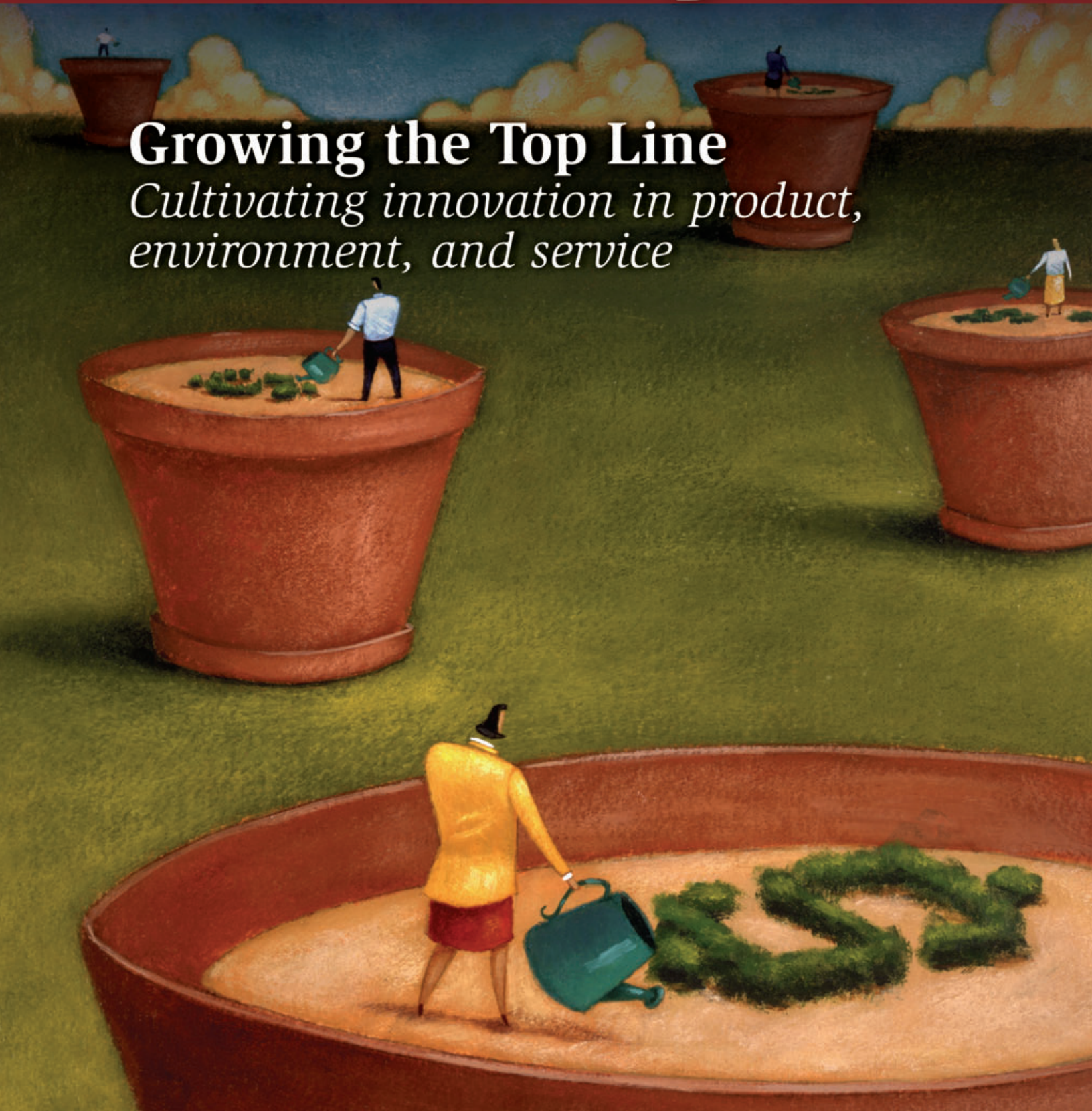
Catalyst

KURT SALMON ASSOCIATES

SPRING 2005

Growing the Top Line

*Cultivating innovation in product,
environment, and service*



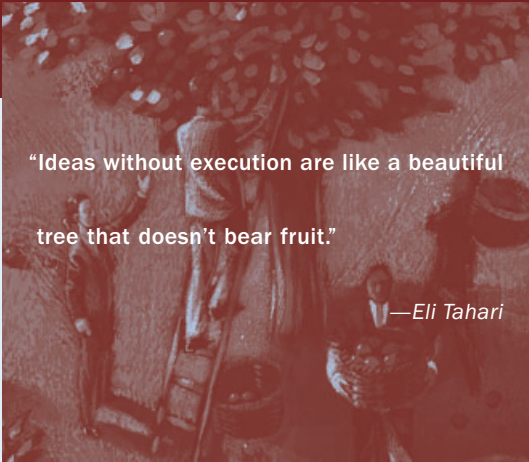
Kurt Salmon Associates (KSA) is the premier global solutions provider focused exclusively on the retail, consumer products, and health care industries. Celebrating 70 years of excellence, KSA helps clients achieve significant gains through strategic growth initiatives, superior product performance, and comprehensive enabling technologies. From concept to consumer, KSA's portfolio of services helps clients in the Americas, Europe, and Asia-Pacific achieve lasting, meaningful improvements that create true distinction in the marketplace.

Introduction

FASHION, WHETHER FOR ONESELF OR THE HOME, IS DEFINING FOR PEOPLE; IT HAS INFINITE POTENTIAL TO ENABLE THEM TO EXPRESS THEMSELVES, AND IT MAKES LIFE MORE ENJOYABLE. Consumers, therefore, expect creativity and innovation in their choices.

It is the retailer’s job to create a stimulating environment in which unique products are presented by sales agents who are happy to be serving customers. Innovation is at the heart of this mandate.

Consumers are doing their fair share to support the economy by outspending disposable income levels (six-year CAGR of 4.9%, vs. spending of 5.7%). Unfortunately, this “over” spending has not been aimed at apparel and footwear,



“Ideas without execution are like a beautiful tree that doesn’t bear fruit.”

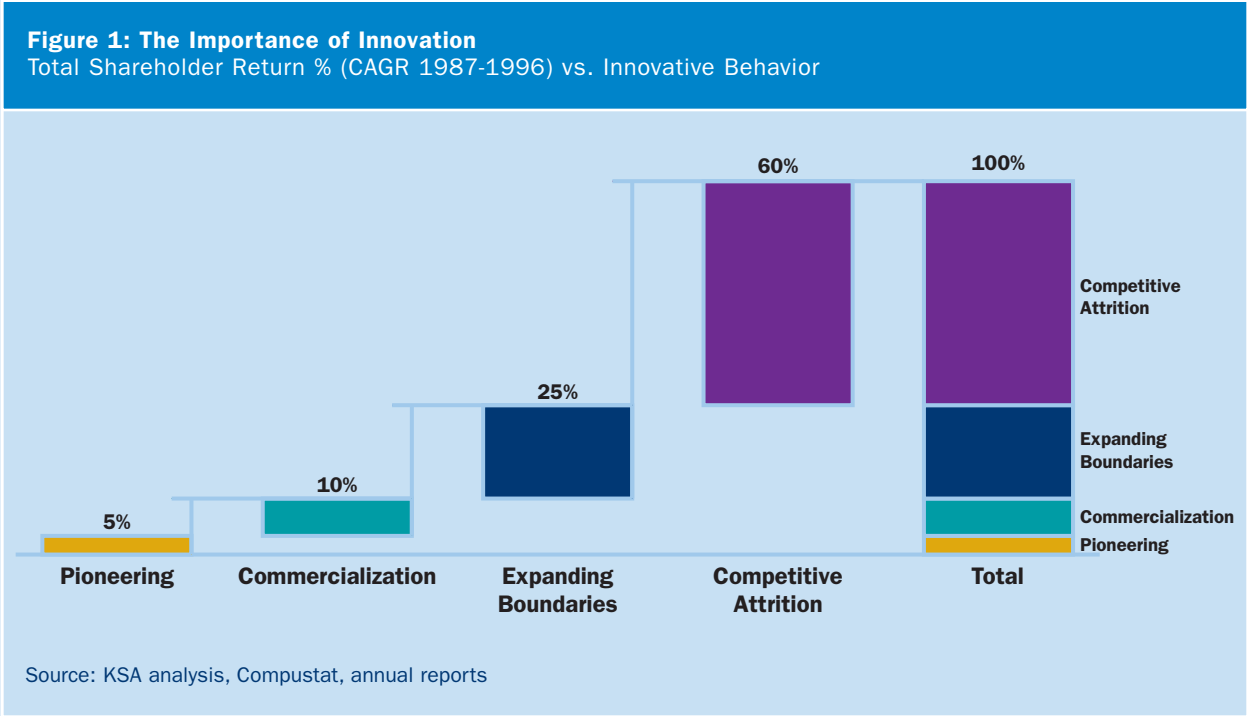
—Eli Tahari

with only a modest 2.8% growth in spending for these categories.

During the economic downturn in the early years of this decade, companies cut costs dramatically. This paid

off as the economy began to turn around. On average, companies are driving eight cents on the dollar as net income, which is the highest in years. But consumers are still hesitating to spend money on apparel and footwear and Wall Street is still insisting on top-line growth. The No. 1 question on every CEO’s mind is how to grow the top line in today’s uncertain environment.

Some are meeting the challenge and others are not. Looking beyond short-term performance metrics and day-to-day imperatives to invest in future business



growth can be difficult. But, like a beautiful garden, a business will only grow if someone takes the time to nurture it. Cultivating innovation in your business is the key to sustainable top-line growth and, in today's uncertain environment, survival (see Figure 1).

The first step in cultivating innovation is to have an insightful framework for thinking about it — an innovation portfolio. A key aspect of this framework is to understand the various types of innovation strategies and how each can be maximized for a particular business model.

Using this portfolio approach will help determine how best to invest product development dollars and focus efforts.

A combination of four themes makes up the growth framework: pioneering, expanding boundaries, competitive attrition, and commercialization (see Figure 2). There are several areas in which retailers and suppliers can innovate using strategies from this framework. Product is the most obvious example, but there are actually four potential innovation levers: **product, environment, service, and employees.**

Figure 2: Growth Framework

Pioneering

Creating or pioneering an entirely new category of products provides strong growth and margins and highly differentiated products. While only a sliver of the innovation portfolio, pioneering helps sow many great ideas.

Expanding the Boundaries

Expanding the boundaries of an existing category provides the opportunity to change multiple elements of a product proposition to reach new users or create new usage occasions. Branded manufacturers have been doing this for several years; Liz Claiborne's derivative brands like Crazy Horse, Dana Buchman, Juicy Couture, Kenneth Cole New York/Reaction Kenneth Cole, and Villager, offered in multiple retail channels, are good examples.

Competitive Attrition

Using competitive attrition to gain share in mature categories and out-executing the competition at every turn results in key players doing battle, usually with one-dimensional changes and little or no category or product growth — the classic Coke vs. Pepsi war.

Commercialization

Commercializing an emerging product, bringing it into the mainstream, typically involves a larger, well-established business buying smaller businesses that are successful in given segments of the market. The segments can be defined geographically, by channel, or by consumer. Commercialization expands them across a larger market by leveraging the infrastructure and market presence of the larger, acquiring business.

Source: KSA methodology

Section One: Planting Innovative Product

PRODUCT INNOVATION REQUIRES OUT-OF-THE-BOX THINKING ALIGNED WITH THE VISION AND MISSION OF THE COMPANY. Since the true test of an innovative product comes when it meets the consumer, successful innovators know what their consumers want even before they want it. Innovative products enhance consumers' lifestyles and provide solutions for challenges they face in their everyday lives. According to KSA's Consumer Outlook Survey, 47% of consumers will spend more for innovative, unique products, and more than half (55%) will buy on impulse if they see something truly different.

One way to innovate product is to **solve a consumer problem**. A second way is to invest in product development to **create a compelling product offering that never existed**. Here are some products across industries that break the mold.

Procter & Gamble's Mr. Clean Magic Eraser



This miraculous piece of foam, which retails for about \$3.99 for four pads, is used like an eraser to remove dirt and grime, such as crayon marks on walls. The product solves a host of problems for the customer and is quick, effective, and not messy or dangerous to use.

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Procter & Gamble discovered the original product in Japan, which, according to them, is the “best place” to find excellent new products. In fact, 50% of new technologies and product ideas exist outside the company. P&G bid farewell to its policy of developing products independently of other firms, a policy with which other long-established companies are often obsessed. This is a great example of a large, established company allowing a more nimble company to do the “pioneering” for it, and then applying the commercialization strategy to really “push it out” with its distribution and financial muscle.

P&G targets the most appropriate end users with this product — moms trying to remove Crayola rainbows from their ecru walls — with advertisements in *Parents Magazine* and other relevant publications.

Geox's Breathable Shoe



An Italian footwear company, Geox aims to solve the problem of smelly feet by introducing ventilated footwear into the marketplace. Geox has more than doubled its sales in the past four years with CAGR increasing 31.2% from 2001 to 2003, and is steadily — and comfortably — marching up market. Geox's founder, chairman, and sole stockholder (no pun intended), Mario Moretti Polegato, thinks the company's “shoes that breathe” formula will prove a winner even in luxury footwear.

The design is based on patented air holes and a plastic membrane that lets air in but keeps water out. Features also keep shoes from suffocating feet. The shoes retail for \$110 to \$120 and are sold in 68 countries in both owned retail and wholesale distribution. Geox has pioneered functionality and core benefits within the luxury footwear segment.

The company has experienced a 42% increase in profits since 2002 and its research and development arm consumes 4% of its revenues. Engineers take prototypes on 200-kilometer walks and inject heated jogging shoes with water to simulate perspiration. They are now using the same technology for clothing, which represented 4% of its total sales in 2003.

GapKids' Expandable Waistband



GapKids has put a simple concept to work to solve two of the great apparel problems kids and their parents face: 1) Kids outgrow their clothes too fast, and 2) Getting kids to try clothes on in a store is a nightmare.

Gap developed a two-button elastic tab on the inside waistband of its kids' pants and shorts. The company actually initiated this product innovation in its maternity wear to allow expectant moms to "expand as you grow." Now moms can buy it for their kids. This is an example of a minor product adjustment that has had a major impact on sales.

Procter & Gamble's Mr. Clean AutoDry



Another approach to developing completely unique products is to use in-house resources and expand the boundaries of existing products into new end-use segments.

This strategy requires a creative culture and the organizational flexibility to support collaboration. P&G has used this tactic as well, urging product development groups to "connect and develop" by recruiting experts from unrelated brands to assist with new product creation.

When it came to the home car care business, P&G looked around the organization for related experience and struck gold. The company's PUR unit's water filter experts knew how to de-ionize water to eliminate minerals, and its Cascade unit already had a compound in its dishwasher detergent that reduced water spots. The company used both technologies in its Mr. Clean AutoDry, a handheld sprayer system that soaps down and rinses cars. The \$24.99 system is so popular it has helped double Mr. Clean brand sales in a year. More importantly, it showed P&G a new way to innovate.

Section Two: Establishing Fertile Shopping Ground

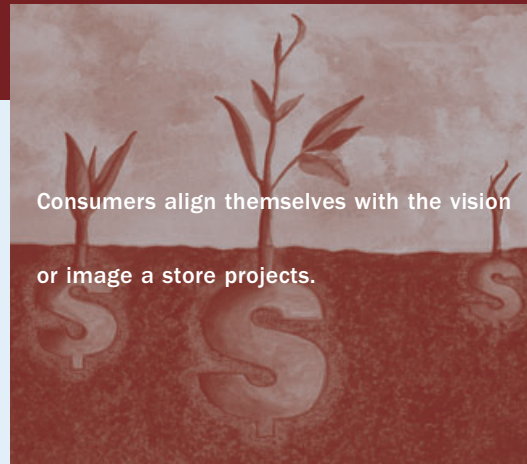
INNOVATION IMPERATIVES EXTEND BEYOND PRODUCTS.

Another way to innovate is to create a truly compelling environment for consumers to shop. Retailers are discovering that fertile shopping ground can distinctly raise the top line.

Consumers are looking for more than just a “pleasant” shopping experience. According to KSA’s Consumer Outlook Survey, 71% of consumers agreed “department stores all look the same today.” More than two-thirds of respondents (74% men and 70% women) said they favor shopping at stores that “have a clear point of view in the style and products they sell.” Sixty-eight percent (66% men, 70% women) said they buy the majority of their clothes from a few stores that “reflect their image/point of view.”

Consumers align themselves with the vision or image a store projects. The clearer the message from the store, the easier it is for consumers to make decisions. Consumers either want to find something that is relevant or meaningful to them, or something that peaks their interest and engages them with possibility.

Therefore, there are two primary concepts for creating a more innovative environment: **1) A holistic experience** in which the retailer meets all the needs of a particular customer segment, and **2) A treasure hunt** in which the retailer creates an environment filled with pleasant surprises and delights.



Holistic Experience

Several retailers innovate and differentiate themselves by creating a holistic experience. Here are a few examples of those who do it well.

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Whole Foods



Whole Foods became the first grocer in the United States to sell “certified organic” foods. The certification is simply the culmination of the company’s persistent drive to deliver the best food to its customers in the best way possible. According to Whole Foods President John Mackey, customers don’t convert to organic foods; they shop at Whole Foods because the food quality, service, store ambiance, and experience are better. He must be on to something: third-quarter 2004 comparable store sales growth was 14.1%.

Williams Sonoma



One of the clear winners in this category is the master of segmentation — Williams Sonoma Inc. Williams Sonoma epitomizes “taste” for each of its target customer segments. It understands the boundaries of each group and has created retail brands that cater to each.

The company's rustic Pottery Barn format is diametrically opposed to its contemporary West Elm format, and now the traditional Williams Sonoma format is expanding from the kitchen to the living and bedroom with Williams Sonoma Home. The company has further segmented its Pottery Barn format to include Pottery Barn Kids and Pottery Barn Teen, enabling it to grow with its target consumer. Its Hold Everything format addresses specific consumer issues, such as organization and storage, and has now expanded to furniture.

This strategy is paying off: For 15 consecutive quarters, Williams Sonoma has met or exceeded earnings per share expectations. Its retail business has year-to-date comp store sales of almost 5% — more than twice the specialty home sector average (1.7%). (Source: KSA analysis, annual reports, Nov 2004 YTD.)

Best Cellars



Wine retailer Best Cellars also epitomizes “taste” in how it pioneers a new way to demystify the wine buying process. With retail stores in several U.S. cities, and online sales through a partnership with Fresh Direct, Best

Cellars promotes a stress-free wine shopping environment by organizing its selling space very intuitively. When it opened its first store in New York, NY in November 1996, its goal was simple: “To make buying wine every bit as enjoyable as drinking it.”

The Best Cellars shopping experience begins by addressing the most obvious decision: red or white? The red/white wine bottles (displayed on recessed shelving with back lighting) are affixed with labels and signage that delineate them as smooth, crisp, fruity, juicy, etc. There are also plenty of well-versed sales associates on hand if further assistance is needed, and a consistently designed website to help consumers quickly find what they need.

With this innovative approach, Best Cellars provides a welcoming, hip environment in which to buy wine, and creates the extra cachet that puts its \$10 bottle of wine on par with or above a \$25 bottle from the local liquor store.

Treasure Hunt

The second way to innovate the shopping environment is to map out a treasure hunt — create curiosity about what's new in the store. Too many consumers walk past stores today for the simple reason, “I already know what's in there.”

This strategy is not just about a hunt for the ultimate discount; it's also about discovering special, unexpected surprises, such as vintage-style jewelry at Banana Republic, design-your-own beaded jewelry at Henri Bendel, or the latest lipstick shade or “flavor” at Sephora.

Costco



A great example of the treasure hunt approach is Costco's “spice items” —

items that are not there by chance, but as an inherent component of the retailer's overall assortment strategy. The chain surprises its customers by constantly shifting selections — one day offering \$20,000 diamond rings and the next, a stack of high-end chandeliers. One Costco consumer tells the story of her discovery of Ashworth Golf shirts — certainly a bargain at \$29.99 or \$19.99 — for \$7.99! She bought seven shirts. It's not the bargain that is important; it is the expectation that something great is going to be found. Consumers expect to find the unexpected; that's what gets them into the store on a continual basis — and drives top-line sales.

Costco has expanded the boundaries beyond the “bulk” items that helped build the business model, and it's working: Comps for the year increased 7% (Nov 2004 YTD). Total annual sales were up almost 10% in 2004.

Section Three: Sowing the Seeds of Service

THE PREVIOUS SECTIONS OFFER SEVERAL EXAMPLES OF COMPANIES USING INNOVATION PORTFOLIOS TO HELP GROW THE TOP LINE IN AN UNCERTAIN ENVIRONMENT.

An important type of innovation, regardless of the innovation strategy (e.g., pioneering, expanding boundaries, etc.) is innovative service.

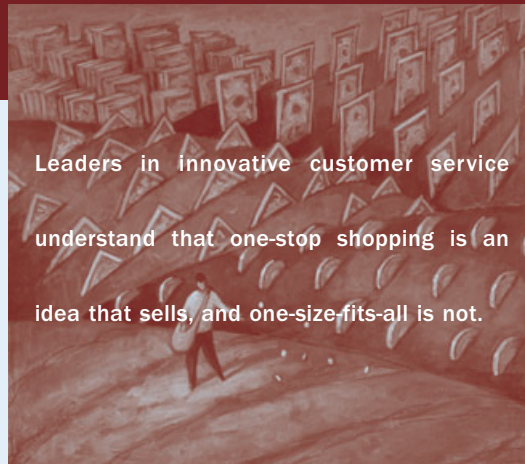
Innovative customer service may be the greatest method of true differentiation in the retail world. Despite common misconceptions, innovative service is not about having a good return policy or easy check-out; customers expect that from every retailer. Innovative service is about exceeding the target consumer's service requirements in a consistent and attention-getting fashion. It is about creating an intense experience for the consumer; one that fosters appreciation and loyalty.

Leaders in innovative customer service understand that one-stop shopping is an idea that sells, and one-size-fits-all is not. Take Neiman Marcus' clientelling, for example. Sure, we've heard it a hundred times, but there are very few department stores that boast 10.6% year-to-date comp store sales — more than five times the department store average of 2.5%! (Nov 2004 YTD).

The three major themes for service innovation are:
1) Intensifying customer service, 2) Bundling services to leverage resources, and 3) Investing in employees.

Intensifying Customer Service

Extraordinary and unexpected levels of service get customers very excited. Here is an example of a company with a hot product and innovative service.



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Mini



Mini has taken a glitch in its demand forecasting abilities and made it fun for the consumer. Since demand has far outweighed supply, Mini realizes the eight-week wait for one of its cars can be frustrating. To make it less wearisome, the company has developed a "Where's My Baby?" tracking tool that allows buyers to follow their car from the factory in Britain to its delivery into the hands of its new "parent." This tool engages consumers in the buying process and gets them excited about their purchase by acknowledging and soothing their anxieties — much like a Lamaze class for new parents. It even uses birthing/parenting analogies!

Bundling Services

There is great opportunity in bundling service components with products. We have seen this trend in the home improvement sector, where retailers have experienced more top-line growth from the same asset base by offering installation services and how-to classes along with their merchandise. Here are some innovative examples from other sectors.

American Girl



This company sells so much more than dolls and accessories. The real deal is the event and adventure that is created in the American Girl store. Little girls (with pay-

ing adults in tow) can take their dolls (or buy a new one) to the doll hair salon or to tea in the American Girl Café. No trip to the American Girl store in New York City would be complete without tickets to the American Girl Revue, a stage production based on stories from the American Girl storybook collection. And of course little girls will want to dress in matching American Girl outfits to attend the show. It's no wonder the company experienced a third-quarter sales increase of 18%, bringing sales to \$49 million.

WeddingChannel.com



There is no denying the force that is WeddingChannel.com. This website's shrewd creators knew that to succeed, their site had to satisfy the most demanding of all of earth's creatures: the bride-to-be. To succeed in this lucrative market is to succeed indeed: two million unique visitors 2.3 times per week browsing 17 minutes per visit spent nearly \$100 million on gifts in 2003 via WeddingChannel.com's registry system. The system searches 1.5 million registries from its multiple retail partners. The website also offers comprehensive wedding planning content and tools (e.g., showcasing honeymoon packages from partner Starwood Hotels) to provide a seamless, multi-channel customer experience.

Investing in Employees

Another powerful and often overlooked source of service innovation is a company's employees. Some innovative retailers are discovering that rather than viewing front-line employees as a "cost to be cut," investing in them is actually fundamental to their success, and pays financial dividends. KSA advises retailers to look at what they are doing to motivate, reward, and foster employee creativity, including financial rewards, training, and activities that inspire innovation and success.

The Container Store

The Container Store®

The Original Storage and Organization Store®

The Container Store, for example, puts the highest level of attention on its employees. One of its core business philosophies is that three *good* people equal one *great* person in terms of business productivity. So, why not hire only *great* people? The Container Store's philosophy about employee development sets it apart from other retailers. It places so much importance on service that *every* first-year, full-time salesperson receives about 240 hours of training in an industry where the average is about eight hours, and training continues throughout an employee's career. Salespeople do not work on commission; instead, they're either salaried or paid by the hour with wages far above the retail industry norm. According to Container Store President and Chief Executive Officer, Kip Tindell, the justification for this expense is loyalty. He says, "A funny thing happens when you train your employees and treat them well: They become fiercely loyal and that allegiance is reflected in how they work with the shoppers."

Liz Claiborne

LIZ CLAIBORNE

Liz Claiborne invests in activities that help keep employees' creative juices flowing. Designer Round Table events provide a great forum for the company's designers to learn from and be inspired by one another. The company also hosts design competitions, inviting outside speakers from a variety of industries to spark new ideas. Its biannual "white space" events, in which people from many business functions participate, are also designed to foster innovation and creativity.

Petsmart



Not all investment in employees must involve spending money. Petsmart for example, discovered it would learn more about candidates if it moved interviews from the back offices to the sales floor, where they could be observed relating to "pet parents." Petsmart executives also spend a week working in the stores in an effort to remain focused on the consumer.

How Does Your Garden Grow?

Looking beyond short-term performance metrics and day-to-day imperatives to invest in the future growth of your business can be a real challenge, but like a beautiful garden, a business will only grow if someone takes the time to nurture it. Retailers and suppliers can innovate product, environment, service, and employees, using a growth framework comprised of the four different themes outlined in this *Catalyst* to help determine how best to invest product development dollars and focus efforts.

KSA recommends the following seven action steps to help cultivate innovation in your business to survive and thrive in today's uncertain environment.

- 1. Preach and live the innovation message.** Convey a clear, concise, and consistent message that product innovation is the most important thing the company does. Build awareness/be perceived as the retailer or brand to go to first for new and existing products.
- 2. Outline an innovation portfolio.** Evaluate how much effort is focused on the different innovation strategies. How are your current brands/businesses contributing to your company's innovation portfolio? Where are the gaps? How is your innovation "risk" allocated across the different types of innovation?
- 3. Set and measure innovation goals.** What metrics fit with your organizational needs (e.g., number of new products to market, percent of repeat styles vs. new styles, number of new vendors, time-to-market, hit rates)? What is the return on your product development investment?
- 4. Understand the target customer by conducting relevant research.** What are her problems? How can you anticipate and meet the needs she can't articulate? Where else are your current and non-customers shopping for new and existing products? What do you know about your customers that your competition doesn't? How can that translate to innovative product, environment, and service strategies?
- 5. Challenge your store environment.** What do you offer that's different? How can you provide a more holistic experience? What is your treasure? Do you make it a fun and enjoyable experience for the customer to find it?
- 6. Intensify your service.** What can you add before, during, and after the sale in terms of product, environment, and services?
- 7. Attract, develop, and retain innovative people.** Build a talent pipeline and keep it full and flowing. Develop and market a reputation as a place of innovation.

For more information about how KSA can help you grow your top line, or to request additional copies of this Catalyst, e-mail publications@kurtsalmon.com.

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