Wilson Perumal & Company's

Vantage Point

Volume 2011 | Issue: 1

Localization with Scale: A winning strategy for sustainable profitable growth

Six lessons from retailer Macy's in how to attain scale economies while building customer intimacy

It is a common corporate cycle: migration to centralization—in the pursuit of scale—followed by a period of decentralization—in the name of customer intimacy and market responsiveness. Each wave can cause upheaval and customer confusion, and neither, as it turns out, is usually satisfactory. The fact that companies yo-yo back and forth between the two reflects how rarely they find a stable, satisfactory solution.

In fact, we would argue, centralization vs. decentralization is not only a false choice but a dangerous one, as it can lead companies to neglect customer needs and insights in the pursuit of scale economies, or conversely, become awash in complexity in the name of customer responsiveness. Both paths lead to poor outcomes. Instead, we suggest a different route: **understand where scale truly matters in your business, create mechanisms for capturing and leveraging customer insight (without creating complexity), combining both to create a profitable business with good economics and competitive differentiation.**

As simple as that sounds, it is hard to do. That is why *My Macy's*, the initiative launched in 2008 by retailer Macy's, is so notable. Under the leadership of CEO Terry Lundgren, the $25 billion retailer has undertaken a complex organizational change, recognizing that the needs and preferences of customers are significantly different from place to place. The goal of the change is simple: that any customer in any part of the country will walk into his or her local Macy's and say, "This is my store. *This is my Macy's.*"

macy's inc

Macy's Snapshot

- Founded in 1858
- CEO: Terry Lundgren, since 2003
- Operates 850+ department stores under the Macy's and Bloomingdales brands
- Fiscal 2010 sales of $25 billion
- Headquartered in Cincinnati and New York City
- 166,000 employees

> "If you look around, the retail landscape has deteriorated, not strengthened. But our outlook is going the other way, and I believe it is because of timing and execution. We're getting better at our job."
>
> –Terry Lundgren

This act of localization has already reaped significant benefits for Macy's (see Figure 1). As Terry Lundgren puts it, "If you look around, the retail landscape has deteriorated, not strengthened. But our outlook is going the other way, and I believe it is because of timing and execution. We're getting better at our job."

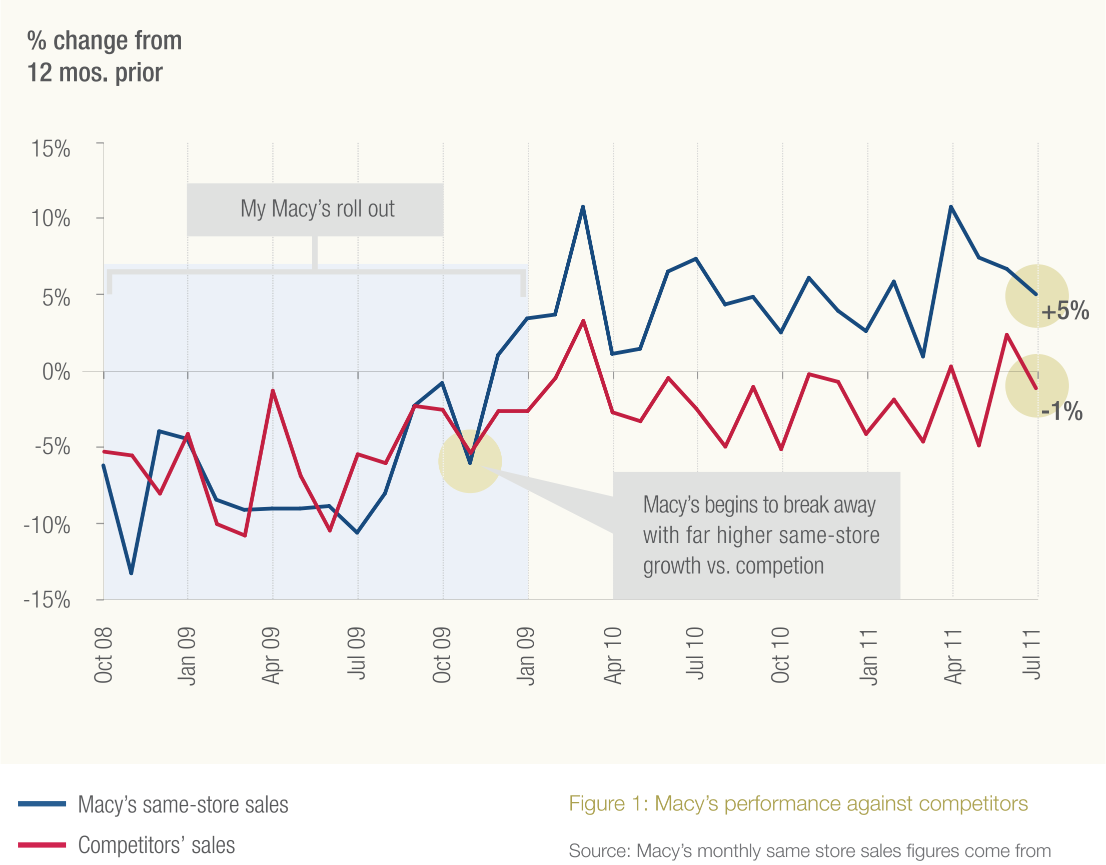


Figure 1: Macy's performance against competitors

Source: Macy's monthly same store sales figures come from macysinc.com; Data for competitors come from the US Census tracking of all department store revenues (NAICS 4521; less Macy's revenues)

In fact, the path that Macy's has taken is rich with lessons for all companies in retail, and beyond, as they seek to battle global competitive cost pressures yet stay relevant to customers. Here are six key takeaways:

Lesson Number 1:

New competitive realities have made many organizational structures obsolete

Today, companies are dealing with the new realities of a global marketplace: 1) tremendous cost pressure as customers refuse to pay for a company's wastefulness, and 2) the need for customer intimacy; a company's product or service has to meet customer needs, not approximately, but exactly.

> "The timing, during a recession, was such that it opened the door for us to take risk."
>
> – Terry Lundgren

The implication here is that companies are increasingly faced with a new polarity: *how to create sources of scale and at the same time build stronger intimacy with customers.* For many companies, this task is complicated by organizational structures that do neither, and have simply "evolved" over time. But what worked 10 years ago won't fly today.

Macy's, prior to the restructuring, is a case in point. Its regional structure, consisting of seven divisions, was both "complicated and cumbersome" according to Jim Sluzewski, Senior Vice President. Each division was its own organization. Each had a Chairman, a President, a Chief Financial Officer, a buying group, a planning group, and a marketing organization, and those divisions operated the stores in their geographic regions. "Which meant that there were really seven different Macy's."

As a result, buying decisions were fragmented and the company missed scale opportunities. At the same time, decision-making was slow. New programs required approval from all seven regions before they could be rolled out nationally. As Sluzewski puts it, "We were challenged if one of [our vendors] had a great idea for us, because very seldom could we implement it nationally with this decision making structure, especially if time was of the essence."

This all changed in 2008, when Macy's consolidated its seven semi-autonomous regional divisions into four, and in 2009, combined the four into one truly national organization. The company unified core functions such as finance, human resources, marketing and buying in New York and Cincinnati. In total, the restructuring eliminated about $500 million in annual operating expenses.

According to Lundgren, "It was something that was necessary. And the timing, during a recession, was such that it opened the door for us to take risk."

Lesson Number 2:

Create scale where scale matters, but customer insights remain local in nature

The restructuring enabled Macy's ambitious, customer-centric localization initiative. The company preserved a team of 1,600 mostly former buyers and planners (professional merchants) who were redeployed to 69 local markets, where they now work in teams of 2 to manage merchandising and planning decisions for specific merchandise categories in clusters of 10-12 stores. Previously, the buyers were responsible for as many as 100 stores.

The new structure means Macy's can identify local variations in taste and customer behavior and better respond to customer needs. These insights are pooled into the head office where buying decisions are now made, driving better leverage from national relationships with vendors. (See Figure 2.)

As an example of local variation, consider the Macy's in Bellevue Square, up the street from Microsoft headquarters. According to Sluzewski,"That store gets an awful lot of traffic: people coming in for business meetings at Microsoft… coming in to buy things that they forgot to pack. That store does an extraordinary business in socks—I think it may sell more socks than any store in America!" Macy's is now able to better sense this local demand and to respond with a large sock inventory positioned visibly in the Bellevue Square store.

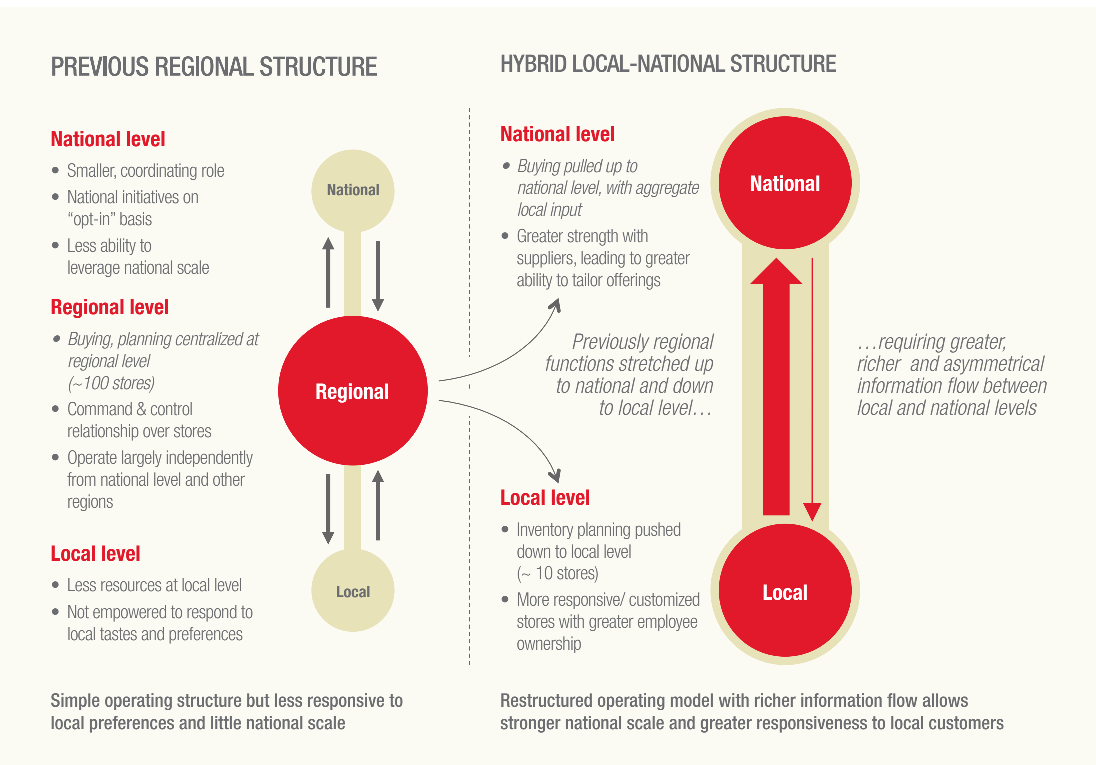


Figure 2: Macy's structure before and after

> "The person in Sarasota is guiding the planning executive in New York about what the assortments for men's apparel should be: the timing, the sizes, the colorations that are selling best, and what the competition is doing around the store."
>
> – Terry Lundgren

The notion that customer insights are local is what gave Terry Lundgren the confidence to pursue the localization strategy. As a buyer for Bullocks Department Stores in the 1970s, Lundgren was so familiar with his 20 assigned stores and their customers that if a store was low on stock, he knew immediately which other store carried the missing item, and could execute a hand-written transfer and move the inventory himself in the back of his Volkswagen. "It sounds so ridiculously archaic," Lundgren says, "but it worked." As a buyer, he recalls knowing "every store manager, department manager, the top sales associate and their kids' names" in every store. Such deep knowledge of the local market is what inspired Lundgren to radically reorganize Macy's.

As CEO Lundgren argues, "How can [a buyer] possibly know what [customers] want in Dallas, Texas, while [she] is sitting here in New York City?"

Today, if a store-level merchandiser in Sarasota believes she can sell a specific line of menswear, she creates a business plan and requests the inventory—the company gives the local merchandiser the benefit of the doubt. The insight is local, but the information flows to a central point in New York, allowing for national visibility and coordinated buying decisions.

"The person in Sarasota is no longer buying," Lundgren says. "The person in Sarasota is guiding the planning executive in New York about what the assortments for men's apparel should be: the timing, the sizes, the colorations that are selling best, and what the competition is doing around the store."

The further implication is that when a Macy's buyer turns up to Ralph Lauren, or Coach, or Estee Lauder, she has their attention.

"We have the scale of the biggest customer working with local knowledge from 69 cities around the country about how to separate the buy."

Lesson Number 3:

Understand your degree of operational readiness, and close the gaps in order to execute on your localization plan

Lundgren reports being interested in the localization concept for many years, but the company's "earnings were good enough. There was never really a sense that [management] needed to rock the boat."

While *organizationally* Macy's had work to do prior to launching its initiative, *operationally* at least the company believed it was sufficiently robust to handle the changes.

In the five years prior to the reorganization, Macy's had focused a lot of time and resource honing its processes and supporting structures. As Jim Sluzewski explains, "Logistics is something that we are really good at. In fact, on a percentage basis we move goods as cost efficiently as any retailer."

The key takeaway here is that for a less operationally and logistically robust organization, My Macy's may have led to increasing complexity, chaos and cost.

Lesson Number 4:

Localization can actually reduce complexity in aggregate

While it may seem like a recipe for increased complexity, localization for Macy's has actually led to a net decrease in the number of SKUs it offers.

The benefits of less complexity are clear. "If, for example, we have nine brands of white shirts, it's hard to keep them in stock in all the sizes all the time because we cannot buy in sufficient depth," says Sluzewski. "By having three or four brands, we can buy in much greater depth, have more in stock, and serve the customer better." Less complexity for Macy's means: less missed sales, less discounting, and better purchasing power.

But how has Macy's managed to reduce the net number of SKUs it carries? There are two levers: the first is that Macy's is now better at targeting its inventory. It knows better what customers want. Therefore a scatter-shot approach is no longer required, which in itself trims the portfolio down; Macy's is selling fewer items that customers don't want. The second lever is the greater visibility to demand due to the pooling and sharing of information between local stores and the head office. This allows Macy's to respond to demand in a coordinated fashion. What matters, for instance, is a good range of white shirts in different sizes. If local buyers were to respond to this demand in isolation, the result would be a hundred slightly different portfolios of white shirts. That is no longer the case, which means a more tailored portfolio at the aggregate level and better availability at the stores.

Lesson Number 5:

Pilot the concept, learn, and then expand aggressively

Macy's began its reorganization in 2008, at a difficult economic time when CEO Terry Lundgren says "no one would have blamed us if things didn't work out." Given the uncertainty, Macy's started the changes cautiously in 20 markets.

"Everybody's job changed, including my own," Lundgren recalls.

When those markets outperformed the rest of the company, Macy's expedited the national rollout.

> "Logistics is something that we are really good at. In fact, on a percentage basis we move goods as cost efficiently as any retailer."
>
> – Jim Sluzewski

Natural Orders of Command

The major navies of the 19th century struggled with the question of group formation: whether it was best to subdivide a fleet into smaller groups of two, three, or four ships meant to specially act together, each group having "all the means of attack and defense."

In 1890, the brilliant and eloquent Alfred Thayer Mahan, the foremost naval strategist of the time, framed the question around natural orders of command:

> "In a well-organized fleet there are two degrees of command which are in themselves both natural and necessary, that can neither be done away with or ignored; these are the command of the whole fleet as one unit, and the command of each ship as a unit in itself… Shall there be introduced between the natural commands of the admiral and of the captains of individual ships a third artificial contrivance, *which on the one hand will in effect partly supersede the supreme authority, and on the other hand will partly fetter the discretion of commanders of ships?"*[1] [Emphasis ours]

Macy's previous regional structure had just such an effect, at the same time diluting national management and eroding the discretion of the individual stores. By removing the regional level—an artificial contrivance of command—Macy's restored its natural orders of command.

It is worth pointing out that the prevailing industry wisdom had been that a true national department store would be too large to manage. Mahan acknowledges that "when a fleet becomes too large to be handled by one man, [then] it must be subdivided." What Macy's did was create the processes, systems, and operating disciplines that effectively allowed it to greatly increase the size of the "fleet" that can be "handled by one man," and then relegated its regional structure to history.

1 The Influence of Seapower Upon History: 1660-1783; A.T Mahan; Little, Brown, & Company; Boston; 1890

> "How can [a buyer] possibly know what [customers] want in Dallas, Texas, while [she] is sitting here in New York City?"
>
> – Terry Lundgren

> "Within two quarters, the roughly 200 stores in the 20 pilot markets, which as a group had been the worst performing part of the company, were outperforming the rest of the company. That got people's attention."
>
> – Jim Sluzewski

"In 2008 we really thought it was going to take a year to determine whether the new system had any effect," Sluzewski says. "However, we found that within two quarters, the roughly 200 stores in the 20 pilot markets, which as a group had been the worst performing part of the company, were outperforming the rest of the company. That got people's attention."

The program expanded into new markets, but also took on a life of its own within the stores. As the stores played a more active role in shaping what was stocked at the local level, the ownership on selling the inventory increased too.

"That was the big bonus in this whole process," Lundgren says. "Of course it makes all the sense in the world today, but when it unfolded and we started seeing it in action, it was amazing…. That is transformational for us, and is a big part of what My Macy's is all about."

▶ Lesson Number 6:

Smashing the false trade-off creates a virtuous cycle of cost-competitiveness and insight

Terry Lundgren is clear on the role that My Macy's can play: "I think we have a very unique competitive advantage in our team of 1600 experienced people living in 69 cities. I think it is a sustainable advantage."

It also challenges the notion of the trade-off between scale and customer relevance. In fact, My Macy's has the power to become just the opposite: a virtuous cycle, as localization (through better meeting customer needs) drives scale, and scale (through better economics) increases the opportunities for further localization. (See Sidebar: Best of Both Worlds)

For example, before its localization strategy Macy's regional buyers did not have the bargaining power with vendors to customize size packs, leading to a mismatch between sizes offered and sizes needed. After centralizing its buying function, Macy's used its scale to influence vendors to customize size packs at the local level—to better match customer needs. Customers, vendors, and Macy's all benefited.

Companies intimidated by the trade-off between scale and customization need to acknowledge that such a virtuous cycle can exist. Why compromise, when centralization and decentralization, combined effectively, can fuel each other for sustainable and profitable company growth? Increased localization does not have to result in higher operational costs.

Summary of Key Lessons

Lesson Number 1:

New competitive realities have made many organizational structures obsolete. What worked yesterday may well be inadequate for tomorrow's consumer. Assess to what degree your organizational structure is supporting or inhibiting your strategy.

Lesson Number 2:

Create scale where scale matters, but customer insights remain local in nature. Understanding what creates true scale in your business is critical to good economics, but don't lose sight of the customer. Extrapolate from local insights to find scalable solutions.

Lesson Number 3:

Understand your degree of operational readiness, and close the gaps in order to execute on your localization plan. Assess whether you are operationally robust enough to successfully manage a migration to a localization model.

Lesson Number 4:

Localization can actually reduce complexity in aggregate. Understand the drivers of complexity in your business. Don't confuse product proliferation with customer variety.

Lesson Number 5:

Pilot the concept, learn, and then expand aggressively. There's no substitute for piloting the concept and tailoring this for your business. Expect surprises.

Lesson Number 6:

Smashing the false trade-off creates a virtuous cycle of cost-competitiveness and insight. Don't settle for the traditional trade-off; it's inadequate for today's competitive realities.

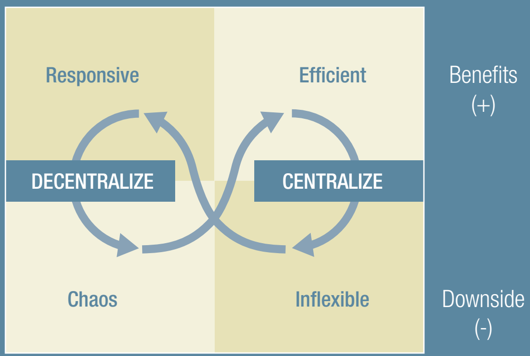
The Best of Both Worlds

Barry Johnson, in his book *Polarity Management,* defines polarities as "sets of opposites which can't function well independently" and shows how "many of the current trends in business and industry are polarities to manage, not problems to solve."

The centralization-decentralization issue is such a polarity to manage, not simply a choice between opposites. Johnson's polarity chart shows the benefits and downsides of each pole, and illustrates how organizations tend to oscillate over time between these poles.

People naturally tend to align around the benefits of one pole and the drawbacks of the other, and vice versa. Organizations with a monolithic approach tend to focus on one pole, at first realizing the benefits of that pole, then the drawbacks, and after some time reverse direction to capture the benefits of the other pole, followed by the drawbacks—and the cycle repeats. At its worst, as Johnson shows, a relentless focus on just one pole of the polarity actually results in realizing the negatives of both poles, and none of the benefit.

Instead, by properly managing the polarity itself, by seeing it not as a choice between poles, it is possible to realize the benefits of both poles, and little or none of the negatives. Macy's did just that, taking a much more insightful and nuanced approach to the centralization-decentralization issue to capture the best of both worlds.



Simplified Polarity Chart*

* Polarity Management; Barry Johnson, Ph.D.; HRD Press, Inc.; Amherst, Massachusetts; 1992

NOTE: To learn more about how Macy's executed their localization program, download the transcript of our interviews with Terry Lundgren and Jim Sluzewski at www.wilsonperumal.com/publications/vantagepoint.

This article was authored by:

Stephen Wilson, Managing Partner with Wilson Perumal & Company, Inc. Contact Stephen at swilson@wilsonperumal.com.

Andrei Perumal, Managing Partner with Wilson Perumal & Company, Inc. Contact Andrei at aperumal@wilsonperumal.com.

Elliott Parker, Manager with Wilson Perumal & Company, Inc. Contact Elliott at eparker@wilsonperumal.com.

Reff Cheng, Case Team Leader with Wilson Perumal & Company, Inc. Contact Reff at rcheng@wilsonperumal.com.

About Wilson Perumal & Company:

Wilson Perumal & Company is a premier management consulting firm and the leading advisor on how to manage and capitalize upon the complexity of today's world. To learn more, visit www.wilsonperumal.com.

Wilson Perumal & Company, Inc.

Two Galleria Tower
13455 Noel Road, Suite 1000
Dallas, TX 75240

contact@wilsonperumal.com

www.wilsonperumal.com

Wilson Perumal & Company, Ltd.

100 Pall Mall
London SW1Y 5NQ
United Kingdom