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# *Retail Winners: Real Estate Performance Management*



## *Retail Winners Study 2007*

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## **EXECUTIVE SUMMARY**

Retail Real Estate is often considered a “fixed expense,” and although management of this critical asset has received C-level attention in the enterprise, it still has not been viewed as an opportunity for revenue and profit improvement. In fact, improved management of real estate, from market analysis through lease administration can yield dramatic results - freeing up working capital for other customer-facing initiatives, speeding up the store opening process, and dramatically altering retailer chain economics. RSAG (Retail Systems Alert Group) conducted this report to highlight the challenges of real estate performance management, and illustrate how retail winners overcome these challenges to achieve value.

### **THE BUSINESS CHALLENGE**

Retail winners agree that the biggest challenge a growing business creates for construction and real estate managers is finding and opening new store locations on time and within budget constraints. Wall Street demands rapid expansion, but without coordination, this expansion can be costly and self-destructive. Since the opening of new stores requires intricate coordination between many parties, it is critical to have an enterprise-wide systematic process in place. On the accounting and auditing front, the new FASB (Financial Accounting Standards Board) regulations have created additional procedural challenges surrounding lease administration, since they change the rate at which a retailer may amortize leasehold improvements. Retailer winners advise that an efficient process facilitates good communication among all parties involved and that technology must be used to facilitate that process.

### **OPPORTUNITIES**

Retail winners feel that better communication and more systematic processes among vendors and in-house staff can help reduce the cost and time wasted on new store openings and remodels. An enterprise-wide process can also accelerate Return on Invested Capital (ROIC). Retailers want faster ROI on new stores, improved site selection, and better predictability of store opening dates. They seek more informed decision-making processes as the “go, no-go” question to remodel a store is raised.

### **ORGANIZATIONAL BARRIERS**

Processes to improve existing sites are being slowed down mainly by the levels of approval involved. “Lone Rangers” who are unable to work efficiently with a team or unwilling to record the status of their activities within the bounds of a system are circumventing these processes. Today’s large retail organizations tend to be siloed, and effective inter-departmental communication does not come easily.

### **TECHNOLOGY ENABLERS AND BOOTSTRAP RECOMMENDATIONS**

Retailers are in the process of upgrading their technologies. In fact, retail winners are already jumping on the bandwagon to implement enterprise-wide solutions. Several solutions from the vendor community are available to assist in the acquisition and management of new stores. Retail winners feel that a mature end-to-end solution allowing all systems and departments (both internal and external) to work together systematically would work best. An enterprise-wide solution that brings disparate departments together would be most desirable.

Retail winners advise a step-wise approach that addresses primary pain points first. The real estate lifecycle can be idiosyncratic across different retail organizations. Any installed system should be configurable enough to support those idiosyncrasies.

# SECTION I: OVERVIEW

## WHY THE STUDY WAS CONDUCTED

Most typically, real estate sits just behind payroll as the second largest expense on a retailer's profit and loss statement. In some instances, it outpaces payroll to become a retailer's number one expense. Opening and re-modeling stores also represents the number one use of a chain's capital. Because real estate is most typically considered a fixed expense, management of this critical asset has not received on-going C-Level attention in the enterprise. These executives recognize the value that Wall Street places on chain expansion, and so they drive to open new stores as fast as possible, but they don't always track critical performance metrics. Questions that should be asked include:

- Has the new store met its pro forma profit and loss?
- Was an effective Return on Invested Capital (ROIC) achieved?
- How long did it take to ramp up to full revenue and profitability?
- How did actual opening costs compare to pro forma costs?
- What was the opportunity cost associated with having people and product in the right place, but at the wrong time?

Certainly retailers establish a real estate strategy (strip center, streets or mall, average occupancy costs, radius restrictions, and general geographic and demographic profiles of surrounding areas) as part of defining their initial pro forma store economics, and most retailers spend a lot of time choosing locations that fit those profiles. But it is also undeniable that retailers waste time and money by ineffectively managing the entire store real estate lifecycle process.

In fact, improved management of the real estate lifecycle, (from initial market analysis through lease administration) can yield dramatic results - freeing up working capital for other customer-facing initiatives, speeding up the store opening process, reducing costs, and dramatically altering retailer chain economics. For fast growing retailers, most importantly, management of the real estate lifecycle process can make store openings and re-models more predictable, meeting pro forma time and budget estimates more effectively.

RSAG produced this report to highlight the challenges in effective real estate performance management, and illustrate how retail winners overcome these challenges to achieve value. We believe that with effective, enterprise-wide management, the entire real estate lifecycle can move from the category of "fixed expense" to a profit and sales enabler.

## METHODOLOGY

RSAG uses its own model, called the "BOOT," to analyze issues in the Extended Retail Industry. This model is built with our proprietary survey instruments. Specifically, the "BOOT" methodology is designed to reveal and prioritize the following:

- **Business Challenges** – RSAG queries enterprises to help them self-identify the biggest external challenges they face. These issues provide a business context for the subject being discussed.
- **Opportunities** – Every challenge brings with it a set of opportunities, or ways to change and overcome that challenge. RSAG’s surveys ask respondents how they’re choosing to meet their challenges.
- **Organizational Inhibitors** – Even as enterprises find opportunities to overcome their external challenges, they may find internal organizational inhibitors that keep them from executing on their vision. Opportunities can be found to overcome these inhibitors as well. RSAG’s surveys help respondents determine what their organizational inhibitors are and how to conquer internal challenges.
- **Technology Enablers** – The Extended Retail Industry can no longer function without a strong technology foundation. RSAG surveys question retailers about the technologies they employ to solve their business challenges.

For this report, RSAG interviewed three leading retailers to understand how they manage the internal and external challenges they face, and how they take advantage of the opportunities in front of them with effective technology enablers. They will be known as “Retailer 1, Retailer 2, and Retailer 3.”

Retailer 1 is one of the largest discount retailers of men's apparel in the U.S. The company now operates more than 700 stores in 44 US states and Canada, and has annual revenues of more than \$1.5 billion.

Retailer 2 operates approximately 2,300 specialty stores in 48 states in the US under three specialty apparel banners. The company has more than \$2 billion in sales per year.

Retailer 3 is a \$16 billion company operating four separate apparel divisions and more than 3,100 stores worldwide.

## DEFINING RETAIL WINNERS

Our definition of retail winners is straightforward. We follow Wall Street. Wall Street judges retailers by their year-over-year comparable store sales improvements, and RSAG does the same. Assuming an industry average comparable store sales growth of three percent, we define retailers with sales above this hurdle as “winners,” those at the sales growth rate as “average” and those below this sales growth rate as “laggards” or “also-rans.”

Wall Street has an additional criterion for retailing success: square footage growth. This report focuses on one way retail winners drive profitable and sustainable growth. Specifically, without effective real estate management, sustained profitable growth cannot be achieved.

## **SECTION II: THE BUSINESS CHALLENGE**

### **RAPID GROWTH STRESSES RETAIL ENTERPRISES**

Retail winners agree that a rapidly growing business creates unique challenges for real estate managers. The biggest challenge associated with growth is finding and opening the best new store locations, and opening those stores on time and within a planned budget. Along with considering whether or not their establishment would be a better fit inside a mall, strip center, or as a stand-alone store, retailers must take into account any specific rules, radius restrictions, or liabilities that may be involved in a specific site of interest.

Speed can be a critical factor in retail real estate decision-making. Desirable sites are only available for a limited period of time. Retailers must be able to move fast enough to make deals work.

The bottom line? It is vital to have a systematic process in place to facilitate efficient real estate growth. Communication is one of the key drivers of an efficient process. Effective communication can mitigate the challenge involved in transferring knowledge in a time efficient manner. Tools are required to facilitate this communication and knowledge transfer.

Retailer 1 considers lack of process consistency as its most significant concern. For instance, opening or re-modeling 60 stores without a clearly documented, enforceable process is going to slow project execution. Having a systematic process in place reduces confusion.

Retailer 2 describes the process of finding new store locations as a scientific process. This retailer works with an analytics group and relies on local knowledge as two critical factors in finding a suitable piece of real estate. However, despite this in-depth research, it has difficulty ascertaining pro forma revenues for new locations.

Retailer 3 looks at real estate growth as a market-driven strategy or a “how large is the pie?” approach. It considers growing and adding more stores without negatively impacting revenue to be the company’s most significant challenge. Therefore, during our source’s tenure as the Senior VP of Real Estate, he based all of his decisions surrounding real estate growth on a market-driven strategy, one that is meant to increase profit, revenue and market share.

This is clearly a Wall Street-driven approach. Square footage growth is expected to lift the three elements our third interviewee described. But too often, retailers open their new stores on “naked bets,” without adequate data and control systems behind them.

### **EVEN “STEADY STATE” RETAILERS ARE PRESSURED TO RE-MODEL AND UPDATE**

As the retail enterprise matures and growth plateaus, the challenge of finding new locations may unwind, but a new challenge arises: the need to re-model tired-looking stores. Re-

models can constitute the biggest capital expenditure for a mature retailer. In some instances, it may be more efficient to close a store and re-open another nearby than it is to remodel the existing location. This “go, no-go” decision point begins to take on similar characteristics to a new store opening – another market analysis, another site selection, another round of lease negotiations with potential landlords – and as such, the re-model process becomes complex.

## **MERGERS AND ACQUISITIONS CREATE SIMILAR CHALLENGES**

We live in an age when retailers are consolidating at a rapid pace. Some years ago, it would have been hard to imagine all regional department stores becoming “Macy’s,” or Eckerd Drug Stores becoming “CVS,” seemingly overnight. The efficient execution of changing a store brand is more than a marketing exercise. It involves changing signage, planograms, merchandise, and pricing without disrupting sales or alienating customers.

## **FASB REGULATIONS CREATE ADDITIONAL CHALLENGES**

Recent FASB (Financial Accounting Standards Board) regulations have created new obstacles for real estate retailers specifically with the accounting departments. Leasehold improvements must be amortized far more aggressively than in the past. Retailer 1 says the new regulations have created many challenges for the accounting department. However it recognized that the regulations do enforce a process that helps create better rollouts and more likelihood to stay on budget. Retailer 2 describes the new set of rules as a complete nightmare that is significantly more complicated than it was five years ago. It is described as the most watched item and has left auditors with additional work. Retailer 3 agrees that the FASB regulations are very frustrating, as they have changed the way retailers treat assets and have impacted decision making.

## **SECTION III: OPPORTUNITIES**

### **MANAGING THE LIFECYCLE PROCESS TO SAVE TIME AND MONEY**

Opportunities exist across the entire store lifecycle process to conserve resources and speed up processes. A description of each of these steps and associated opportunities follows. It is, however, important to view these steps as parts of a cohesive whole, requiring interdepartmental support and communication to be successful.

#### **A. MARKET PLANNING**

Retailers are constantly trying to increase their sales and their profits. The first step to successful new store openings and remodels is to have strategic market plans in place. Retailers look at the demographics and psychographic characteristics of the market to help make these plans. Using more intelligent tools can simplify and improve the market planning process, saving time and money on the front end of the process, and improving sales and earnings for years to come.

#### **B. SITE SELECTION**

Once the market development plans are finalized, retailers begin selecting sites. The old adage is true: the three steps to successful retailing are location, location, and location. Choosing the right location is one of the most significant parts of opening up a new store. The retailer may want to take a look at the competition in a specific area. Some retailers may want to be in close vicinity of their competitors, while others may want to stay as far away as possible. The information gathered in site selection comes from a variety of sources, both internal and external. Using the right tools, and working with the right information can make the difference between a successful or unsuccessful new store. Subtleties like divided roadways, ease of entry, and number of available parking spaces can be as important as the obvious – the demographics and psychographics of the available customer base.

#### **C. CONSTRUCTION/PROJECT MANAGEMENT**

During the construction phase, decisions are made that retailers must live with for the life of the store. In some municipalities, for example, wiring must be buried behind walls or under floors in conduit. The only acceptable time to adjust wiring locations is during construction. Once construction is complete, it becomes cost prohibitive to change. A central repository of information provides the opportunity for all parties to review plans, changes, and updates, thus reducing costs.

Because of the critical decision-making that happens during store construction, it is often seen as the make-or-break tactical part of the project. This phase requires the most coordination between outside companies used to physically build out the store and various departments within the retail organization. Coordination and communication among all parties is a necessary key to efficiency.

## **D. STORE SET-UP**

Cost reduction opportunities abound during store set-up. Without coordination and communication, equipment, people, and merchandise can be delivered to the store too early. Premature delivery drives costs up as storage locations may be needed for equipment and merchandise. Opportunity costs from having the wrong people in the wrong place at the wrong time are high. In addition, the ability to have a store set up on time is the key to a successful soft opening, and ultimately grand opening.

## **E. FACILITIES MANAGEMENT**

Certain retail segments have a bigger need for asset management than others. Restaurants and fast food establishments tend to have higher priced fixed assets, requiring more preventive maintenance and warranty management than traditional hard or soft goods retailers, who are mostly concerned with computer equipment. The opportunity is, of course, improved compliance with both regulatory and warranty issues and heading off problems before they happen.

## **F. LEASE MANAGEMENT**

Lease management has historically been the responsibility of a small number of individuals, even in the largest organizations. Complex escalation clauses, common area maintenance requirements, and other complicated leasing arrangements can be missed when tracked by individuals with spreadsheets. Management solutions from the vendor community can be extremely supportive in helping understand more complex clauses in a lease and alert the retailer when an opportunity for cost reduction arises.

## **G. RE-MODELS – GO, NO-GO DECISIONS**

Two of the many important decisions that retailers face are if and when to re-model their stores. Retailer 1 says stores are typically re-modeled after a four to seven year period. The decision to remodel a store is made on a case-by-case basis due to budgetary constraints and other internal setbacks.

Retailer 3's remodels are market-driven and are part of a multi-year corporate-wide executable real estate strategy to increase profitability. The company looks at the market to see what opportunities are there, and then looks at existing logistics capabilities to confirm that the chain can adequately serve the selected site.

Often, retailers forget to review their options: it may be more efficient to close an existing location and re-open nearby than to re-model. Perhaps the location is not quite right; new construction has made the store more difficult to enter or exit, or physical constraints are reducing revenue opportunities. All these variables should be subject to analysis along with the straightforward question of budgetary constraints. As with any other business decision, an ROI case must be developed. Using an efficient automated solution to model these pro-forma decisions can result in more capital being allocated to re-models and consequential improved revenue.

## SECTION IV: ORGANIZATIONAL BARRIERS

### “LONE RANGERS” SOMETIMES CIRCUMVENT PROCESSES

There are always inhibitors within an organization that prevent it from improving internal processes. All organizations have levels of approval they need to go through to improve and open a new store site. Therefore, the people involved can sometimes slow things down. Retailer 2 strongly feels that people are slowing down these processes. Our source says that you can have the best technology, but if you have people who are circumventing it, then you can never move forward. These “Lone Rangers” may feel heroic in their abilities to get their individual jobs done, but their inability to work within a team oriented environment, or unwillingness to record the status of their activities within the bounds of a system, can work to a retailer’s detriment.

In addition, a lack of resources and tools within the organization are cited as inhibitors to improved real estate management performance.

Retailer 3 feels that tools have come a long way in allowing retailers to make better decisions. Yet these tools are expected to be the magic bullet, ignoring the organizational silos that keep departments from working together. The retailer explains that oftentimes people within the organization want the tool to make the decision, when in reality the tool should simply bring together all required information needed for better decision-making.

### NOT MUCH INTEREST IN HOSTED SOLUTIONS

While retailers are beginning to embrace hosted solutions to support many facets of their business, this interest does not seem to extend to real estate management. We expected to find hosted solutions as a way retailers could overcome the lack of resources available for real estate management. In fact, when asked about hosted solutions, the retailers RSAG spoke with emphasized the benefits of having a solution behind their firewall. They stressed a perceived lack of control with hosted solutions. These retailers feel that information maintained within their facility is better because it is always available and is more flexible and customizable. It should be noted that we did not explore the subject with a wide range of retailers: these findings are based on a small respondent base. Nonetheless, the unanimity of their response is worth noting.

### SMALL GROUPS MAKE TECHNOLOGY DECISIONS

While some retailers have IT executive steering committees, the retailers we spoke with generally have one or two people acting as the driving forces behind technology solution selections. This makes them more efficient, albeit a bit dictatorial.

Retailer 1 speaks about technology decisions being made on a case-by-case basis, rather than as part of an overarching strategy. The organization takes a bottom-up approach where a

team of people makes a case for a solution to the responsible Vice President, who then takes the idea to the CEO, and the two collectively make the decision.

Retailer 2 says that he and his manager drive all technology decisions. He considers his boss to be a real estate deal maker who has also embraced the concept of technology as a facilitator for his work.

Retailer 3 takes a slightly different approach. In this organization, a real estate strategy group of 30 people report to a VP of strategy. This team of people is broken into three different groups: area research, planning and analysis, and asset management. At the end of the day, these three groups report back to the VP of strategy with a “yea or nay” decision.

The bottom line is two-fold: organizational silos inhibit decision-making, and fragmented systems inhibit collaboration. Regardless of the organizational model chosen, it is imperative for organizations to work together. Comprehensive technology can facilitate this collaboration, but the responsible parties must be willing to cooperate for a successful collaborative effort.

## **SECTION V: TECHNOLOGY ENABLERS**

### **VENDOR SOLUTIONS MOSTLY IMMATURE**

Until recently, technology has had little to offer retailers that could mitigate the expense and process of managing real estate. The notion that a “black box solution” could provide a geographically distributed enterprise with a centralized method of locating sites, constructing new buildings, organizing remodels, or even keeping track of leases seemed far fetched.

Like so many aspects of the retail enterprise, retail estate acquisition and management was viewed as an art, and those who excelled at it were seen as artisans. These deal-makers were intuitive and experienced veterans whose decisions were based on technology-mined data, but virtually unaided by management technology solutions.

However, several new technologies have emerged that may help streamline this process. Just as the “merchant prince” has benefited from merchandise optimization solutions, the retail executive responsible for real estate management can also benefit from role-specific solutions. The retail winners we spoke with in this study agree that an end-to-end, enterprise-wide solution would be an invaluable addition to their growing arsenal of tools, which already includes best-of-breed components. And while most retailers have already pieced together systems that may incorporate one or two disparate components with proprietary processes that rely on home-grown, spreadsheet-based analysis, few have ventured to supplement the artisan’s experience with the type of technologies that have begun to hit the market.

### **TECHNOLOGY UPGRADES ALREADY SHOW VALUE**

Retail winners see the value of technology in controlling real estate acquisition, store build-outs, re-models and leases. Several retail winners have already jumped on the bandwagon in implementing technologies to assist their internal and external processes. Retailer 1 reports it is in the process of migrating to more advanced software. The company is moving everyone to a single web-based system to manage the real estate lifecycle. It believes that with the new solution, communication will improve, and therefore processes will be more efficient. The retailer also hopes this solution will help provide one version of truth to the people who need it most across the entire company and its vendors.

Retailer 2 has found success using three key technologies: a desktop mapping/analytics program, a site selection application, and a facilities management application. With technology at every touch point, it considers this to be a successful approach. It believes all available real estate systems have different degrees of potential value for an organization. For now, the retailer prioritizes best-of-breed functionality ahead of an integrated solution.

Retailer 3 believes that tools are available from the vendor community to help retailers make better, collective decisions. It is critical, though, for vendors to allow for extensive

configuration and parameterization to suit the variety of internal operating models used by different retailers.

## **LEASE MANAGEMENT PROGRAMS GUARANTEED TO HELP**

While the applications are still evolving, there is clear evidence that using lease management software saves time and money. The ability to store and retrieve information such as rental and occupancy costs on demand is likely to help make processes more efficient across the retail enterprise.

Retailer 1 stresses the issue of time saved by having applications that capture key points, such as allowances and options that will typically benefit the tenants. According to this retailer, “Only good things will happen when you have that technology present, and that nothing good will ever come from not having that information.” Retailer 3 believes that cross-enterprise visibility into lease management systems can help retailers make faster decisions.

## **SECTION VI: “BOOTSTRAP” RECOMMENDATIONS**

### **A STEP-WISE APPROACH WITH CROSS-FUNCTIONAL TEAMS**

A step-wise approach is always the best approach to solving challenges as large as real estate management. Begin by addressing critical pain points.

Retailer 1 recommends creating a cross-functional team and determining acceptable levels of risk and desired rewards from a new application. Although no system is perfect, this retailer believes that if you rank your needs, it will become easier to discover the one that best suits your operation. Retailer 2 recommends starting at the front end by laying out all of the pieces and making an assessment of which application is the worst. If all applications are equal, the retailer suggests starting with the leasing application first. Retailer 3 suggests keeping it simple. Our interview source stresses the fact that like merchandising, real estate management is an art form that can be informed by science. Systems must be flexible to support retail decision-making, and clarity in internal process is critical for any system implementation to be successful.

### **BUY VS. BUILD**

Retailers are always pre-disposed to “roll their own” when it comes to application software, and enterprises of all kinds tend to rely on spreadsheets for applications far beyond their native capabilities.

RSAG is consistent in its recommendations: packaged software always has advantages over in-house developed applications. A retailer’s core competency and uniqueness does not lie in real estate management. Rather, there are standard, best practices that can be employed to manage this critical asset as efficiently as possible. Find the best application in the marketplace and go with it. Avoid customization as much as possible. It is better to partner with your vendor of choice in co-development efforts than to make it up as you go along.

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Accruent is the leading provider of real estate performance management solutions. Since 1995, these applications have optimized the impact that stores have on retailers' performance – driving revenue growth, reducing costs and achieving financial compliance.

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Retail Systems Alert Group is the leading provider of objective, high-quality information resources for the Extended Retail Industry (ERI). We have followed the advancements of technology and business process innovation in this industry for almost two decades, and we deliver our insights and analysis through high-value conferences and tradeshows, publications, research, training, and Web-based services. For more information, visit [www.retailsystems.com](http://www.retailsystems.com)

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