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# Retailers Need Dynamic Capabilities To Survive And Thrive

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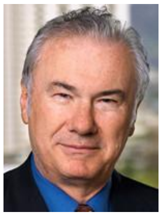

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The U.S. retail sector is experiencing unprecedented opportunities and threats. Threats come from online shopping and demographic change. Opportunities come from the development and adaptation of digital transformation strategies that integrate physical and virtual shopping in a useful way.

This article uses the Dynamic Capabilities framework and its conceptual toolkit to propose strategies for incumbents and newcomers alike. A capability involves activities that enable an organization to produce particular outcomes. The Dynamic Capabilities framework includes, for analytic and expositional purposes, a distinction between ordinary and dynamic capabilities.

Ordinary capabilities are generally oriented toward the execution and administration of an organization's current production plan, while dynamic capabilities are generally forward-looking. The two categories have never been seen as hermetically sealed, and a number of capabilities, such as new product development, have been given both labels by different authors.

The key point is that a company's capabilities must be part of a coherent whole. There is no point in being good at doing something for which there is no market; nor will a brilliant business model succeed if a firm is unable to execute its plans. This means retailers must both rationalize their existing infrastructure and develop new omnichannel business models.

A company's ordinary capabilities must be strengthened to improve efficiency in the use of assets and capital. At the same time, dynamic capabilities must be enhanced and exercised to develop a strategic vision and begin leading the company into the future.

**The Radar Screen: What Do We See?**

The shift of consumer shopping from in-store to online has become a threat to incumbents that is impossible to ignore. Digital transformation dictates that retailers must connect with customers through the web, mobile and physical stores, ideally providing a unified experience across all three.

As Erik Nordstrom, co-president of Nordstrom Inc., put it, “There aren’t store customers or online customers — there are just customers who are more empowered than ever to shop on their terms.”[1]

One driver is a major demographic shift. Baby boomers are on the wane, being replaced by millennials with different habits and tastes. These online “natives” are accustomed to searching online for product and price information. They’re accustomed to deep discounts and are often unmoved by promotional sales. On the plus side, they are often willing to pay a premium when they believe in the value of a product or service.

Another source of pressure is the growth and expansion of Amazon, fueled initially by the willingness of its investors to tolerate years of net losses and now aided by profits from its leading cloud services business. Amazon’s very competitive strategies have allowed it to claim nearly half of all online consumer sales.

Most retailers are no match for Amazon’s scale, yet they increasingly feel pressure to match its offers, such as free shipping. Survivors in US retail, apart from small niche players, have competed with strategies such as developing their online offering, increasing efficiency and leveraging their physical presence.

**Preparing for Renewal: The “Dirty Work”**

Traditional retail is thus facing a weighty challenge. When the base business still has life in it, incumbents more than likely will need to shore up their existing positions before tackling issues of grand strategy, although to some extent they can and should proceed concurrently. Retailers that entered the recession in a strong position, like Starbucks and Home Depot, had the financial slack and dynamic capabilities to invest in new activities while they optimized the old.[2]

Survival strategy is likely to involve an evolution of today’s somewhat uneasy blend of online and physical presence into new business models. The challenge involved in updating and integrating online and in-store business models should not be underestimated.

It is not that retailers are unaware of the importance of balancing their brick-and-mortar and e-commerce businesses. But more and more of them try to perform this juggling act in the midst of a strong downdraft for physical store sales, as evidenced by the unprecedented recent numbers of store closures and retail bankruptcies.[3]

The downdraft for incumbent retailers comes in large part from Amazon’s willingness and ability to compete on price. All aspects of operational capabilities need to be looked at for potential improvement. This “dirty work” entails optimizing the existing asset base.[4] In dynamic capabilities terms, this means strengthening ordinary capabilities.

Retail executives must engage in fact-driven data analysis to adjust operations for new realities and optimize portfolios of products and store locations. This, in turn, requires individual store and product analysis that animates decisions across products, real estate, operations and merchandising.

Capital will be distributed in favor of the better stores, the most promising products and digital agility. When done well, this process yields better financial performance from the company’s existing assets and improves financials so that bold new initiatives can be undertaken. As Jelinek et al. noted, “An aggressive, analytical approach to store portfolio management drives value creation by using the right analytics, ongoing monitoring and decisive action to keep stores competitive and profitable."[5]

Optimization must become an ongoing goal. Processes must initially undergo self-evaluation and then upgrading to match industry best practices. As technical efficiency is achieved, a culture of continuous improvement must take hold. As Coulombe et al. note, this "does not happen in the last weeks of the year or during the first thirty days of the new fiscal year. It is ongoing."[6]

Operations cannot improve without support from improved systems. One of the most critical areas for investment is IT, especially data analytics, but also secure, unified companywide systems that gather and generate pools of data. The ability to collect and analyze data is vital for understanding which customers are most worth pursuing and how they want to be reached.

Logistics, for both the supply chain and distribution, is another "ordinary" capability where great improvement can be achieved. Strong logistical capabilities, in addition to saving money day to day, make it easier to take advantage of short-term opportunities and address sudden problems. They undergird strong dynamic capabilities.

Capital structure is a key vulnerability for many retailers, which often hold high levels of debt as the result of past financial deals. High leverage means fragility in the face of financial and business volatility. Many companies fail to engage in scenario planning or even liquidity planning to get them beyond the next crisis. As Coulombe et al. note, "The key takeaway for any CFO is to value financial flexibility for the enterprise above all else."[7]

Coulombe et al. explain that getting started involves a "willingness to dive into the weeds and ask the tough questions," such as:[8]

- When did the financial planning process last start with a zero-based budget?
- Is the business planning process a result of merely providing high-level targets for sales, margin, conversion and inventory turns, or has management stood back, scrapped that imprecise approach, and started with a clean slate?
- Has management reviewed individual store four-wall profitability and analyzed product performance with hits and misses?
- Does management understand the cost to serve in distribution and e-commerce, and can it identify the opportunities and areas that need improvement?
- What type of field team is required to optimize store support?
- What activities can be simplified or eliminated, both in-store and in support operations?
- Is the corporate cost (SG&A) structure appropriate and balanced to support the business model and financial plan?
- Are products being sourced and manufactured at the best cost?
- Are indirect cost items such as service agreements, corrugated costs, transportation, maintenance, etc. centralized and continuously reviewed for cost-reduction opportunities?

**Dynamic Capabilities and Long-Term Strategic Vision**

As financial flexibility is restored, incumbent firms need to exercise and upgrade their dynamic capabilities. Dynamic capabilities are the firm's ability to astutely integrate, build and align internal and external resources to address and even shape the changing business environment.[9]

They reside in a combination of managerial cognition and organizational routines rooted in the company's culture and history.[10] The higher-order dynamic capabilities essential to strategy formation and maintenance of competitive advantage can be summarized as sensing, seizing and transforming.[11]

Dynamic capabilities help the enterprise make sense of what has been observed in the market, in technology and in public policy. While retail incumbents have "sensed" the changes in their industry, they haven't always been able to make sense of them. Sensing is recognizing that physical stores and online presence will coexist. "Sensemaking" involves identifying the range of business model possibilities that this creates. It involves devising and testing hypotheses about viable approaches for generating an advantage.

Management must then "seize" the opportunities that have been identified as the most promising and transform the company to take advantage of them. Seizing activities include devising and fine-tuning business models, committing to strategic investments, lining up the necessary suppliers and partners and engaging staff with the new strategic vision. External complementarities need to be constantly managed: learning from partners, spreading risk and limiting loss of value in the event that demand shifts in a way that favors an external complement.[12]

Transforming capabilities draw on management's leadership skills. This is most apparent when a major change is undertaken, but more modest changes are needed periodically to soften the rigidities that develop over time from standard operating procedures. This requires a proactive and pro-change cultural shift and must begin at the top.

Focus areas for the transformation of retail incumbents include:

- **Prioritize Digital Transformational Initiatives:** Invest in IT for advanced analytics to capture online and in-store sales complementarity; integrate logistics and inventory across the supply chain and distribution network; invest in marketing and social media to reinvigorate loyalty programs, bolster communications and improve consumer segmentation.
- **Create the Right Customer Experience:** Understand how shoppers integrate online with in-store; figure out how to create the "experience" that younger shoppers crave; actively manage the portfolio of stores (better to trim branches now than risk the whole tree); enhance store-level labor planning to improve customer interaction.
- **Analyze and Track the Evolving Consumer Demographic:** Harness available sources of data to understand changing customer dynamics; invest in IT infrastructure that allows you to understand how your challenges differ by consumer type, geography, online versus in-store, etc.
- **Transform the Business Model Where Needed:** Perform the analyses required to strengthen your business before it is forced upon you by the market; identify and prioritize strategic initiatives; identify the biggest bang for the buck.
- **Manage Capital Structure:** Develop a capital plan that recognizes business trends; align capital structure with strategic plan.

Bold initiatives can succeed, but there is risk, and the challenge of maintaining internal and external coherence is demanding. Whatever approaches are tested and ultimately adopted, the key is to gather, analyze and use information about consumers.

It has become commonplace to say that "data is the new oil" (generally believed to have been coined in

2006 by Clive Humby, a U.K. data scientist). Data, like oil, is of limited use until it has been refined for a specific purpose. Data analysis is the critical capability that must drive long-term strategy.

**Conclusion**

The retail industry is undergoing a wave of disruption, and survivors remain in a precarious state. While the business cycle has turned more favorable, millennials' shopping habits and competition from deep-pocketed e-commerce rivals are as deleterious as ever to the traditional retail business model. Retail is not going away; it is just in a state of revolution.

Dynamic capabilities can help executives organize and prioritize the application of effort, attention and financial resources as they address the existential challenge. While the online component is growing rapidly, good "sensemaking" indicates that some variant of physical stores will remain as a complement to the virtual storefront. But the best method of integration is not evident.

There is a good survival opportunity for incumbents whose leaders can solve the puzzle. Stronger operating capabilities can support the company as it exercises dynamic capabilities that allow it to create the new business model(s) and channels needed for long-term evolutionary fitness.

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