The Evolution of Retailing in the United States

Retailing has evolved in response to suburbanization, cost-cutting, and price competition.

PETER LINNEMAN
DEBORAH C. MOY

SPURRED BY POP culture, suburbanization, and increased competition, retailing in the United States has gone through a major evolution over the past 50 years, changing from a largely urban to a primarily suburban experience. Retailers today confront the traditional challenges of providing convenience, desirable products, selection, and attractive pricing, but they also must contend with the effects of increased purchasing power of children, shortened retail cycles, increased female workforce participation, and increased competitive pressures.

Children now control more purchasing power, directly as well as through their parents and grandparents, than any previous generation. The cash in their hip pockets (which are often at their knees), combined with increased car ownership, has created a new category of consumers. Clothing fads have always been fleeting, but the popularity period of stores has been made much shorter by these young consumers. Historically, a chain of stores would generally enjoy a run of popularity of seven to ten years, but that reign has now shrunk to three to five years, since what is cool for 12- and 13- year-olds is passé by the time they turn 16.

Today, brands are cross-sold by multiple retailers, allowing greater synchronization of product reaction cycles. In the 1980s, when a fashion trend was started by Valley Girls in California or break-dancers in Brooklyn, it spread geographically at a slow pace. Today, fed by MTV and other youth-oriented stations, a new fad is practically instantaneous, meaning that retailers need a much faster response time.

As more women of all ages participate in the workforce and have more disposable income, they have less time for shopping. At the same time, many women have delegated much of the shopping to their teenage children. In the 1980s, going to the mall was a family outing in which Mom, Dad, and the kids went their separate ways and met for lunch at the food court, each shopping at an average of seven stores. Today, between work and shuttling their children to activities, adults are increasingly destination shoppers. They visit an average of only 1.3 stores per trip to the mall, and are back in their cars in 76 minutes. Leisurely mall browsing has become a luxury for all except teenagers, making the retail format of choice for adult shoppers the category killer.

Another factor in the evolution of retailing is the perceived increase in consumer opportunities. Middle-class consumers are bombarded with ways to spend their disposable income—resort travel, fine dining, specialty camps for kids, and so on. With so many luxury items now available, discounts on everyday shopping generate valued savings, driving consumers to value-oriented stores such as Wal-Mart. This is particularly true when budgets are tight and people still strive to maintain the lifestyles to which they have become accustomed.

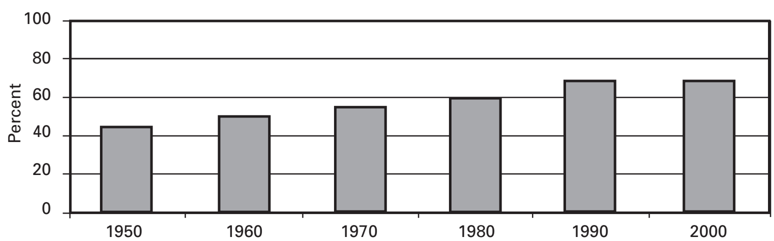
PARALLEL EVOLUTIONS

American suburban retailing has evolved on two related levels: The expansion of product offerings, that is, what is available to the consumer; and the creation of new retail formats, that is, how those products are offered to consumers. Over the last century, people increasingly moved their families to the suburbs. In the Northeast, suburbanization spread along the train lines, while in areas such as Dallas and Los Angeles, the suburbs followed the freeways.

Although by 1950 roughly 45 percent of the population lived in the suburbs, little retail existed “out there” to service them, since few retailers had joined the exodus to the suburbs. Aside from notable exceptions like Sears Roebuck, Montgomery Ward, Kroger, and A&P, all of which had freestanding suburban stores, retailing remained primarily in downtowns or in secondary neighborhood downtowns. In the 1950s and 1960s retailers realized that the most efficient way to meet suburban demand was to be located where their customers lived (and eventually worked). They were slow to get started—in the 1950s, the rate of suburban retail expansion was still slower than the rate of purchasing power suburbanization.

Suburban retail offerings expanded in three phases. In the first, retailers met existing demand by providing necessities, such as groceries and everyday items, through small stores. In the second phase, retailers opened scaled-down versions of their downtown stores in this previously fallow territory. In many ways, their decision to open suburban stores was comparable to companies that ventured into global markets in the 1990s. Only belatedly did retailers offer a full-scale shopping experience via the creation of shopping centers.

Figure 1 Population of the U.S. Living in Suburban Areas



Sources: Property and Portfolio Research; PREI

Figure 2 Number of U.S. Shopping Centers

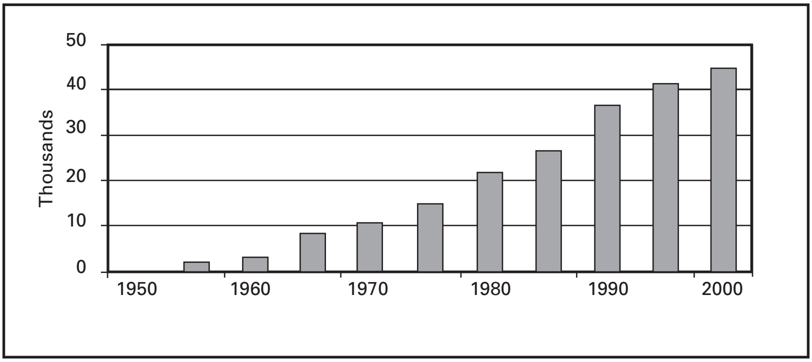
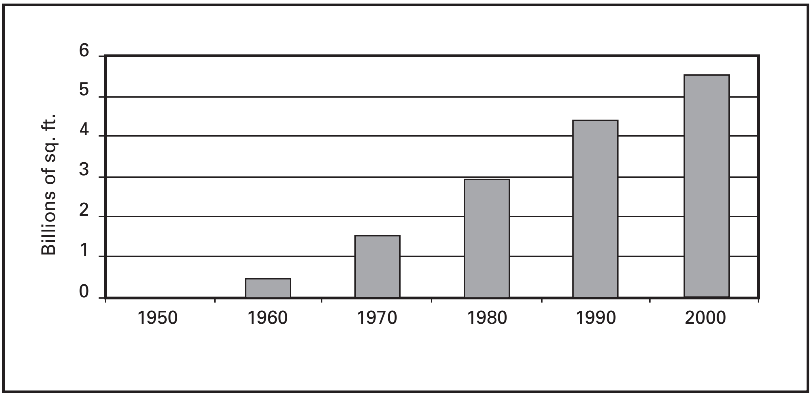


Figure 3 Total Leasable Retail Area in U.S. Shopping Centers



Because the suburbanization of retail shopping massively lagged the suburbanization of purchasing power during the first half of the twentieth century, suburban retail supply was much less than demand. In the 1960s, this condition persisted even as retailers began to move to the suburbs en masse in response to the success achieved by pioneering efforts. In the 1970s and early 1980s, suburban retail continued to play catch-up through the development of regional malls, super-regional malls, power centers, and countless strip centers. Not until roughly 1990 did suburban retailing achieve supply-demand market balance, and did U.S. retailing become firmly entrenched as a suburban—rather than urban—phenomenon.

We estimate that there were roughly 650,000 suburbanites per center in 1950, 22,000 per center in 1960, and approximately 10,000 suburban residents per center in 1970. In 1970, there were only 11,000 shopping centers in the United States, even though about 55 percent of the U.S. population (and a much higher share of the purchasing power) was in the suburbs. By 1990, there were about 36,500 shopping centers, or one center per 4,600 suburban residents. Clearly, the last half of the twentieth century was a period of tremendous catch-up for suburban retail supply. This is reflected in the decline of the growth rate for the development of new centers, from roughly 6 percent per annum through 1990 to about 2 percent over the last decade.

This equilibrium of suburban retail supply and demand has created a new set of competitive pressures on the retail sector. In the 1980s, mispriced money flowed to developers, many of whom did not understand that the high rates of suburban product expansion were unsustainable. It has been only over the last 10 to 12 years that the Darwinian evolutionary process of eliminating the weakest retailers, locations, and center designs has begun. And it is a long way from over.

During the 40-year catch-up period, availability, not quality, was the main concern facing suburban retailers. However, as suburban retail balance was achieved, providing the best quality retail experience became critical for success; and just "being there" no longer assured success. While there is no single correct retail model, markets are rapidly sorting out the wrong models.

Retailers, in concert with developers, have exhibited significant creativity in providing a variety of retail formats. Until supply and demand balance was achieved, identifying the right retail format was very much an experimental process. The result of this experimentation was the proliferation of center locations, store and center designs, and retailing formats. Neighborhood and community centers, often anchored by supermarkets, focused on local thoroughfares, seeking to provide convenient access and everyday items at low-overhead costs. In contrast, malls anchored by department stores, stand-alone department stores, and stand-alone discount stores targeted major interchanges, in order to draw households from an extended radius to an all-encompassing shopping experience.

THREE RETAIL MODELS

Three general models of suburban retailing have emerged: the traditional merchant; the discounter; and the big box. Traditional merchants include supermarkets and department stores. Their traditional model is simple: sell quality goods at a substantial mark-up to wholesale prices (that is, at traditional pricing margins). Prior to 1990, when supply-demand balance was achieved, traditional merchants dominated suburban retailing. Neighborhood centers and regional malls were developed to meet the expansion plans of these retailers. The basic concept behind these shopping centers was to draw traffic to the center with the brand recognition of the traditional anchors, and to cluster complementary stores to maximize sales. In fact, center developers placed so much value on the traditional anchor's ability to draw traffic that they treated anchor tenants as loss-leaders, often giving away space to anchors. These developers counted on the center making money from the complementary in-line stores. Of course, these in-line stores could cannibalize the anchor tenant's sales, but never to the extent of putting an anchor out of business.

Discount stores, including brand-name outlet centers, adopted a different approach. They sold inferior goods, irregulars, out-of-season items, and discontinued items at mark-ups roughly comparable to traditional merchant margins. Since their goods were of lesser quality and their mark-ups were the same, these stores offered lower prices than traditional retailers could. The discounters frequently anchored community centers and smaller malls, and, like traditional anchors, they too were generally loss leaders (though to a lesser extent) for developers.

Big-box retailers, housed in large warehouse-like structures, emerged in the mid-1980s, just as suburban supply and demand were coming into balance. They provided goods of comparable quality to traditional retailers, but at notably lower prices. This was, and continues to be, a particularly attractive proposition to the price-conscious consumers who had previously shopped at lower-end department stores and at discounters, as they could purchase either the same quality goods at lower prices, or better-quality goods at the same prices.

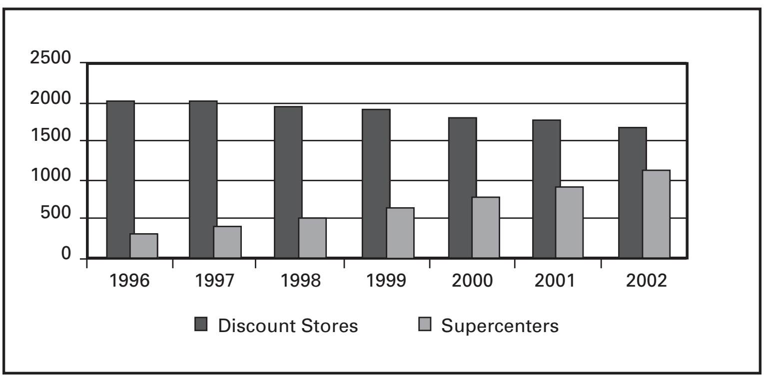
A simple numerical example shows the competitive power of the discounter model when it is well executed. Assume that a department store's wholesale price for a product is $100, and the item sells at a 50-percent mark-up, for a price of $150, while the discounter sells an inferior product with an $80 wholesale price at a 50-percent mark-up, for a retail price of $120. Enter the big-box retailer, who offers the same quality item as the department store, but, by vigorously squeezing the wholesaler, is able to purchase the department store item at $90 wholesale. In addition, by keeping the overhead low, the big-box retailer can be profitable at a 30-percent mark-up, for a retail price of $117. Now ask yourself: Where would you shop?

Within the big-box model, there were two distinct strategies: Wal-Mart's general store strategy and the category killer approach. When well executed, these retailing formats have proven to be formidable competitors in a world of balanced suburban retail supply and demand.

The general store approach is championed by retailers such as Wal-Mart, Target, and Kmart. Some of these retailers have been more successful than others, with Wal-Mart being the poster child of this format. The Wal-Mart model is to squeeze costs from every link of the supply chain (including landlords) and pass the savings on to the customer. The Wal-Mart model seeks to exploit economies of scale in purchasing, while striving to minimize overhead. In some ways, the Wal-Mart approach is more like that of a manufacturer than a traditional retailer. Specifically, Wal-Mart treats merchandise as an input in their production process, rather than as something to sell at a mark-up to cost. In a virtuous circle, their success has allowed them to buy goods at even lower wholesale prices, giving them the opportunity to further reduce their retail prices.

In response to its success, Wal-Mart has expanded the size of its stores. The company opened its first Sam's Club warehouse in 1983 and its first Wal-Mart Supercenter in 1988. Big-box general store retailers have attacked operating costs on several levels. First, they are not concerned about being located at what was traditionally considered to be the best location, because their retail model

Figure 4 Number of Wal-Mart Stores

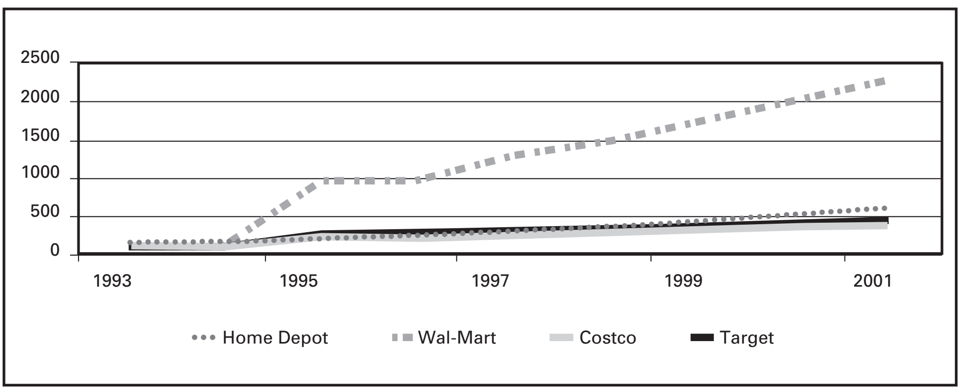


makes *them* the best destination. By being farther away from the major interchanges, they have lowered their overhead via cheaper land costs, rent, and property taxes. Their no-frills presentation and reduced common-area space squeeze costs further. While stores are neat and organized, Wal-Mart avoids expensive improvements, effectively eliminating build-out other than checkout aisles, restrooms, and signage.

Specialty stores have existed since colonial times. For the goods and services of the butcher, the baker, and the candlestick maker, we now look to Hickory Farms, Au Bon Pain, and Pottery Barn. The category killer greatly expands the specialty store. Category killers are big-box retailers that focus on a deep, but narrow, range of products. Their model is to specialize on a massive scale to wipe out competitors (and entire categories within department stores) that sell goods at higher prices and offer less product depth.

It is difficult to pinpoint when the first category killer came into existence, though many claim credit. Home Depot opened its first store in Atlanta in 1979, but did not build big boxes until 1986. Office Depot and Staples both opened their doors in 1986, while Sports Authority entered the market in 1987. Barnes & Noble claims to have pioneered the superstore concept in 1991, but Toys 'R Us may, in fact, be the first modern-day category killer. Toys 'R Us, founded in 1948 as a baby furniture store, opened its first "toy supermarket" in 1957. Not far behind, Tower Records opened for business in 1960, moving into a large, vacant San Francisco super-

Figure 5 Total Sales Index (1993 = 100)



market in 1967. IKEA, founded in Sweden in 1943, opened its first store in the United States in 1985.

Category killers combine the pricing strategy and massive square footage of a superstore with a deep assortment of items within a narrow product line. Thus, they pursue Wal-Mart's approach to quality, overhead, location, store build-out, and margins.

ONE BY ONE, THEY FELL

Since the big-box format appeared during the period of suburban retail supply-and-demand balance, its success has come largely at the expense of existing formats. As Darwin would have predicted, the weakest retail format—the discounter—fell first. Bargain-hunting consumers who had shopped at the early discounters shifted in droves to big-box retailers, leaving many centers once-anchored by these discounters largely vacant. In short, consumers decided there was no reason to settle for inferior products when they could get quality products for the same price.

In the face of the new big-box competition, many large traditional merchants survive, although seriously wounded. Traditional mall anchors find it increasingly difficult to compete with the everyday low prices of category killers, particularly in view of their overhead and operating costs being higher than those of big-box retailers.

Over the last decade, we estimate that at least 90 percent of the growth in retail sales has gone to the big-box retailers. Stated differently, less than 10 percent of new demand has occurred at traditional retailers. Category killers have literally wiped out whole product categories that once made department stores popular, rendering the term "department store" a misnomer. As department stores lost department after department (music to Tower Records and Virgin Megastore; furniture to IKEA and Crate and Barrel; housewares to Pottery Barn and Bed Bath & Beyond; electronics to The Wiz and CompUSA; and tools and gardening to Home Depot and Lowe's), shoppers no longer viewed them as essential shopping destinations.

As departments have disappeared, department stores are left with large amounts of underutilized space. In fact, suburban department stores today offer little more than three departments: clothing, jewelry, and cosmetics. As witnessed by sales results over the past decade, department stores no longer draw shoppers, leaving many landlords holding the bag—with anchors that neither pay rent nor generate traffic for in-line stores.

Unfortunately, even as the big-box

format gained momentum over the past decade, shopping-center developers responded to traditional anchors' desires to expand, and built or renovated space for traditional merchants, further exacerbating the problem. Many of these properties, especially those at less-desirable locations, are suffering severe shortfalls in performance. The resulting retail environment is a tangle of well located or designed centers populated by weak anchors, poorly located or designed centers populated by strong anchors, and poorly located or designed centers with weak or shuttered anchors.

Many of the worst centers have closed, as owners search for alternative uses for those properties. Other center owners are struggling to figure out how to deal with shuttered or non-productive anchors. For the best-located centers, a Chapter 7 filing by a weak anchor is a blessing, as they can put a more productive retailer in the space. Some landlords are adapting their model for leasing centers, choosing to lease empty anchor space to a category killer. Not only do big box-retailers pay more rent than the previous anchor, they also draw more traffic. But will these stores be complementary to the in-line stores? The jury is still out on this question. In particular, one wonders how a center will perform if the big-box store replaces an anchor. While the big-box retailers will pay rent and draw traffic, will they be too productive for the in-line stores that are paying higher rent? And will landlords be able to pass through their high CAM costs to the cost-obsessed big-box retailers? Only time will tell.

No retailer is immune from competitive pressures, not even big-box retailers. Some big-box general store operators (Kmart, Caldor, and Bradlees) have not successfully executed the model. Many category killers (Toys 'R Us, Sports Authority, Circuit City, and Service Merchandise) have also either been forced out of business or experienced restructurings and closures. It is interesting to note that when Wal-Mart entered the toy sector, they left little room for less efficient competitors, and killed Toys 'R Us, the original category killer. Once suburban retail markets achieved supply and demand balance, when big-box retailers failed, it was for two reasons: their competitions' ultra-efficient cost controls, and their own lack of the same. For example, while Wal-Mart maintains an expense ratio between 15 percent and 20 percent, Kmart has been at the higher end of that range even after recent reductions. Similarly, Bradlees and Caldor died with expense ratios in the 25-percent to 30-percent range. The lesson is that if low costs (rather than service or merchandising) are the essence of the business model, only those with the lowest costs survive. This is particularly true in light of the virtuous circle of scale purchasing.

Supermarkets are the latest to face the challenge of the big-box retailers. With lower rent, minimal CAM costs, low vendor costs, and reduced mark-ups, big-box retailers are putting extreme pressure on centers anchored by traditional supermarkets. Conquering one more category, Wal-Mart, Target, Costco, and Sam's Club have entered the grocery business with lower prices than the traditional supermarket. In 1997, the first year Wal-Mart reported grocery sales as a separate line item, grocery sales were only $11.8 billion. By 2001, Wal-Mart was the country's largest grocer, with sales of $52 billion, surpassing Kroger's $50 billion and Safeway's $34 billion. Traditional supermarkets are being forced to cut prices to survive. Many look to bankruptcy in order to shed unproductive stores and reduce overhead, namely rent. It is interesting that to date, Wal-Mart's greatest impact as a grocer has been in small towns. On a national basis, Wal-Mart has a 5 percent to 6 percent market share of the grocery business, but only 3 percent in the 100 largest metropolitan areas. In contrast, Wal-Mart controls over 11 percent of grocery sales in smaller markets.

We now know that the big-box strategy works when properly executed. The success stories of Wal-Mart, Target, Home Depot, Barnes & Noble, and Costco prove that it is a viable retailing format. But execution—not the model itself—is the critical factor in a world where there is no longer a shortage of suburban retail product.

The question of whether customers will go to less-desirable locations has also been answered. But as traditional stores close, big-box retailers are gaining access to the best locations, using the vacant stores of bankrupt retailers to upgrade their current locations, or to enter markets (for example, New England) with high barriers to new development. As in the game of Monopoly, once the owner of Boardwalk or Park Place goes bankrupt, other players suddenly have a chance to grab prime real estate.

Retail landlords face a dilemma regarding Wal-Mart as a tenant. Wal-Mart is the ultimate retail draw and an excellent credit. Plus, if you do not have it, it will locate two miles down the road at your competitor's center. On the other hand, Wal-Mart's strong negotiating position means that it, not the landlord, controls the deal. In particular, Wal-Mart will generally not sign a lease prohibiting them from "going dark." What happens if Wal-Mart decides to close their store in your center, something they have done repeatedly? Although the landlord still receives rent, center traffic disappears, as will your in-line tenants. You are damned if you take them, and damned if you don't. To Wal-Mart, the landlord is just another vendor to squeeze.

New retail formats will continue to emerge—in most cases, through reinventions of older formats. The latest twist in the evolution of suburban retailing is the largely anchorless town center. Such centers offer a niche product with higher-end service and more amenities than big-box retailers. Town centers generally contain upscale specialty stores such as Williams-Sonoma, Anne Taylor Loft, Starbucks, and The Gap, as well as casual to slightly upscale dining. This format is an attempt to create a quaint downtown in upscale suburban settings. In most cases, these developments incorporate limited amounts of multifamily housing and office space, often above the retail space. The town center's open-air format provides better street visibility and access for retailers, and reduces CAM charges by reducing HVAC requirements. Town-center tenants generally provide depth of product within a particular brand name. Developers of these centers hope that by eliminating the anchor tenant, they can enhance revenues while reducing operating costs. The simpler construction design provides CAM expenses more comparable to neighborhood and community centers than to malls.

While the jury is still out on how town centers will perform, they are indicative of the ongoing competition in suburban retailing, which will require greater attention to cost controls and design detail. Now that suburban retail supply has caught up with demand, simply being there is not enough.

The authors would like to acknowledge the invaluable comments provided by Albert Ratner of Forest City Enterprises.