Understanding U.S. Consumer Electronics Retailing

Executive Summary
The U.S. consumer electronics (CE) retail industry has endured severely fluctuating fortunes in the last decade. A swiftly changing CE market landscape, continually reshaped by the forces of continuous product innovation and change, is forcing the entire CE retail industry to confront challenges across multiple fronts. These issues include the following:

- The advent of the frugal and sophisticated U.S. consumer, thanks to the “Great Recession.”
- Debilitating price wars fought by three distinct retail trade formats – discount vs. pure-play vs. online retail.
- Significant competitive advantage enjoyed by online retailers due in part to lower overhead and tax laws that have not caught up with the new rules of the retail game.
- Ever-changing and demanding “millennial” consumer preferences.

These forces have left CE retailers scrambling for cover under their onslaught. In the recent past, we have witnessed the bankruptcy of a large player, Circuit City, as well as the less-than-stellar growth of other key players. It is clear that CE retailers or CE retail divisions of organizations such as Best Buy, Target, Walmart, RadioShack, etc. will need to re-evaluate and re-align their strategies to face the new realities of the marketplace.

In our view, winning CE retailers must:

- Create integrated channels – a “store without boundaries” – that offer all capabilities to the consumer regardless of shopper location to deliver the complete shopping experience.
- Optimize retail floor space through increased “store inside of a store” concepts and reduction of future store size footprints.
- Use in-store space for increased demonstration of “connected shopper solutions,” showing how all elements of a complete basket can work together prior to a shopper exiting the premises.
- Save precious capital and reduce operational costs by embracing emerging service delivery models to transition select commoditized business processes to cloud computing-enabled business process as a service (BPaaS).

U.S. CE Industry Growth vs. GDP Growth

Source: CEA 2011; U.S. Bureau of Economic Analysis; Goldman Sachs Estimates 2011
Figure 1
The Market Landscape

The U.S. retail electronics market tallied revenues of $180 billion in 2010 across five key categories: consumer electronics (video and audio products); home office (PCs, notebooks, netbooks, tablets, mobile phones, etc.); appliances; entertainment hardware and software (DVDs, Blu-rays, CDs, digital downloads and computer software); and services.

Total sales of the Top 10 electronics retailers are expected to grow by 6% in 2011 to reach $110 billion (see Figure 3). Absent Apple’s stellar performance, the previous two business cycles (2008-2010) have been characterized by anemic revenue growth, the demise of Circuit City and flattening in the key category of TVs. After experiencing market share gains following Circuit City’s demise, the major players have essentially seen flat growth a year after the fact, indicating that revenue increases in 2009 for some major players were purely a result of the redistribution of Circuit City sales rather than incremental business gains (see Figure 4, next page).

Reality struck in 2010 and continued in 2011, with revenues of major players growing only by 4.5%; marginal revenue growth was driven primarily by new product introductions, such as tablets and netbooks, and not from existing product lines, as well as from an increase in store fronts and retail floor space. It is clear that shifting consumption patterns and product distribution models,
especially from physical to online sales, have had a major, across-the-board impact on the electronics retailing space.

**Market Forces**

We see four distinct forces that will cause further upheaval in the industry landscape over the next few years. The ability of current players to respond nimbly to these challenges and seize opportunities arising from rapid change will be the key to long-term competitive advantage. These forces include: Consumer sophistication and frugality, increased regulatory scrutiny, cut-throat competition and millennial consumer behavior (see Figure 5).

**Consumer Sophistication and Frugality**

The shift of retailer-oriented product categories from "highly considered" to near commodity status (the result of increasing shopper sophistication) reduces the advantage of sales staff in providing differentiated customer advice. Furthermore, consumer reliance on third-party intermediaries for offers and pricing information threatens to convert retail stores into little more than physical showrooms for online merchants.

Additionally, U.S. consumers continue to reel from a depressed job market and rising prices, especially in key consumption items such as fuel. Conspicuous consumption is on the decline; premium brand substitution with cheaper variants and even postponement of consumption are the order of the day. According to the Consumer Electronics Association, spending on CE products by the average U.S. consumer household fell 14.5% between 2009 and 2010, or $1,380 per household in 2009 vs. $1,179 in 2010.\(^1\) Falling consumer demand is also indicated by the recent uptick in the U.S. savings rate, which has traditionally trended downward during the last few years (see Figure 6, page 5).

Key operational challenges for CE retailers include:

- **Margins:** Prices of key product categories like TVs and PCs (notebook, netbook and desktop) have consistently declined or remained at bargain basement levels over the last few years, creating pressure on margins for retailers.\(^2\) Sales of these products are essentially replacement or extension sales, as these are mature and near-ubiquitous categories. These product categories typically have the highest rate of high-margin warranty and services attachments, which are also declining due to flat sales, creating additional challenges for retailers.

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**Top 10 Players: Store-Based CE Retailing by Domestic Revenues**

<table>
<thead>
<tr>
<th>Retailer</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Best Buy</td>
<td>$40</td>
<td>$30</td>
<td>$20</td>
</tr>
<tr>
<td>Walmart</td>
<td>$30</td>
<td>$20</td>
<td>$10</td>
</tr>
<tr>
<td>Apple</td>
<td>$20</td>
<td>$10</td>
<td>$0</td>
</tr>
<tr>
<td>Staples</td>
<td>$10</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Game Stop</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Target</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Costco</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Sam’s Club</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>RadioShack</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>OfficeMax</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>

*Source: Dealerscope’s Top 101 CE Retailers, March 2011*  
*Figure 3*

**Market Share Gains: The Circuit City Impact**

<table>
<thead>
<tr>
<th>Retailer Dollar Share Increases by Category (March – December 2009)</th>
<th>Best Buy</th>
<th>Walmart</th>
</tr>
</thead>
<tbody>
<tr>
<td>Flat-Panel TVs</td>
<td>5.2%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Notebook PCs</td>
<td>5.5%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Desktop PCs</td>
<td>4.7%</td>
<td>0.3%</td>
</tr>
<tr>
<td>Digital Cameras</td>
<td>5.5%</td>
<td>2.7%</td>
</tr>
</tbody>
</table>

*Source: NPD Estimates*  
*Figure 4*
Large CE retailers are, therefore, moving their revenue mix from lower-margin items such as notebook PCs and TVs, to higher-margin products like smartphones and tablets. They are also selling these devices from small-format stores, which reduces selling costs and paves the way for greater attachment of services to the sale, leading to higher margins.

- **Distribution:** Consumer electronics retailers face rising expenses primarily due to expansion into different retail formats (stand-alone store and store-within-a-store), increased promotional spend and the need to hire knowledgeable workers who can engage customers in a sales and advisory relationship rather than a strict sales interaction.

Additionally, customers are increasingly using a mix of offline and digital channels for transactions, which requires retailers to offer more options, increasing the importance of an effective online channel for brick-and-mortar-based retailers.
Global Unit Shipments of Desktop PCs and Notebooks vs. Smartphone and Tablets

Essentially, the quest for consistently improving financial performance compels single-channel retailers to move to a multi-channel strategy. In spite of real-world concerns – such as negative spill-over and cannibalization, the advantage of low-cost access to new consumer segments and potential increases in customer retention and loyalty – a multichannel strategy makes sense from the vantage point of a retail CFO.

Competing for Hearts and Pocketbooks

CE retailing has always been fraught with difficult issues, but the challenges are even greater today. For example, CE retailers face increasing competition from discounters (e.g., Walmart) that can leverage massive economies of scale, both on the purchase side (by striking deals on bulk purchases) and on the consumer side, by realigning floor space dedicated to electronics according to demand (typically during the holiday shopping season).

A new and interesting dynamic is also at play: The increasing inability to distinguish competitor from supplier. Apple is a case in point; it designs and manufactures some of the most in-demand consumer electronics products in the U.S. and sells them through its chain of specialty stores and online. Apple’s policy of limited distribution, especially in the new and highly lucrative tablet market, effectively penalizes other retailers outside the Apple ecosystem.

Since their introduction in 2010, tablets have proved to be a disruptive force in the computing segment; market researchers predict that tablet shipments will outstrip PC shipments by 2011 and result in the reduction of notebook PC sales by 30% to 35% in 2011 and 2012, successively (see Figure 7). Retailers with significant PC revenue streams will be negatively impacted by this momentum switch (see Figure 8).³
Online retailers have been in play for some time now. However, it is only in the last few years that they have emerged as viable challengers to brick-and-mortar behemoths. Online retailers have been able to take advantage of the consumer frugality phenomenon in a significant manner by competing primarily on price (see Figure 9, page 7). Sales of CE products online grew by 17% in 2010, to $13.6 billion (see Figure 10). This represents only 14% of the total market for CE products, suggesting significant room for growth.

Impending Regulatory Changes

Online sellers enjoy the twin advantages of lower overhead and tax laws that have not caught up with the new rules of the retail game. Most states in the U.S. do not have a sales tax regime in place to extract revenue from online sales. This has created an unequal playing field between offline and online players.

As Best Buy CEO Brian J. Dunn said in a recent investor presentation, "Taxing all online sites equally would be a major, but not complete, closure in the pricing difference. It will also significantly hurt small, online retailers that compete completely on price."

Moves are afoot to address this gap, with five states passing “E-Fairness” laws in recent years, four states doing the same in 2011 and another 20 states holding discussions on similar legislation (see Figure 11, page 8).

Millennial Consumer Behavior

The always-on, always-connected lifestyle of millennial consumers is driving frenetic change in product lifecycles, with time-to-market for product releases compressed to levels unforeseen just a few years ago. This has also created demand for a slew of allied services, ranging from connectivity solutions and service plans, to accessories. The millennial pattern of media consumption — on multiple connected devices — has also required pure-play retailers to get into the content delivery business. Millennials are now armed with instant access to pricing information across channels and also rely on online reviews much more than traditional consumers for their purchase decisions. This leads to a lower reliance on store employees as a preferred source of product information. The “social purchasing” experience, with the ability to engage in instant feedback and rapid price-comparison, will be a significant factor in the market dynamic for CE products, especially among millennials.
Winning Strategies

To succeed, CE retailers must consider the following plans of attack:

- **Engage profitably with millennial consumers:**
  The defining characteristic of millennials is that as digital natives, they adapt to computer and Internet technologies very swiftly. They are demanding and technologically savvy, craving instant access to product information and reviews from third-party sources, especially from their social networks. They extensively use shopping technology, whether PCs for detailed research or smartphones for rapid, on-the-go comparison (see Figure 12). Price, convenience and selection are the most important factors for millennials to arrive at an optimal purchase decision. This demographic does not distinguish between channels but expects an interactive, consistent and seamless experience across channels.

  CE retailers will need to embrace unified strategies across processes – such as supply

Online Commerce Gaining Share vs. Offline

Note: Adjusted for eBay by adding back eBay U.S. gross merchandise volume.

* Assumes no sales tax on Amazon purchases and free shipping.

chain, merchandising, pricing, inventory management and customer service – to ensure a “boundary-less store” experience across channels. The mobile store is one way of interacting with consumers to keep them engaged. It will play a significant part in the future of CE retail, by ensuring uniformity of product information across all channels, be it in-store, online or mobile.

CE retailers will need to invest significantly in equipping their sales forces with the latest and greatest sales tools and technologies, as traditional hard sales pitches do not cut it with millennials, who in many cases have access to as much information as sales staff do. Enabling sales staff with technology will deliver an even more meaningful in-store interaction, as evidenced by recent research:

- 57% of shoppers want improved interactions with store associates.
- 58% of shoppers want engagement with store associates in the aisle, with mobile check-out capabilities.
- 64% of shoppers want store associates with mobile technology to provide improved in-store customer service.

Adapt to emerging distribution formats: Research indicates that U.S. online retail sales will directly account for 8% of total retail sales and, more importantly, will influence 53% of all retail sales by 2014 (see Figure 13). Mobile commerce is likely to deliver $17 billion in sales by that time (see Figure 14).
It is, therefore, imperative for CE retailers to not only embrace but also get full leverage from emerging mobile and maturing e-commerce channels. Online and mobile channels will allow retailers that rely primarily on their physical presence to remain visible across the spectrum, push promotions, provide detailed product information and be visible to consumers when they engage in price comparison. Online channels also enable retailers to play the price game with pure-play e-tailers by stocking online-only product assortments and one-upping them with “buy online and pick up in-store” options, an advantage that appeals to impulse buyers who crave instant gratification.

The introduction and rapid growth of innovative products such as tablets, e-readers and next-generation smart devices needs to be addressed by retailers. They can accomplish this by appearing omnipresent across multiple sales channels, such as offering consumers allied content, accessories and services in the most convenient manner possible. Persistent connectedness to the customer is the cornerstone of this strategy – a CE retailer can conceivably even be agnostic about store format, as long as the customer is engaged across all fronts. Best Buy, for example, is attempting to create traction for its smaller store formats, most notably by expanding its Best

Best Buy Store Strategy:
The Move to Small Box

Buy Mobile stand-alone stores, which is expected to increase the retail giant’s presence and allow it to reduce its large-format store footprint (see Figure 15).

Technology and Global Sourcing

The rapid growth of smartphone connections (overall) and the high-percentage of influential millennials already riding the always-connected wave make it imperative for CE retailers to prepare for a time when a large proportion of their customers will be digitally enabled. They will
need to create services that allow such connected customers to get a view of hitherto unseen store processes, such as inventory status, deeper and richer product information and, ultimately, even self-checkout.

Today, the top two categories of external sourcing of technology for CE retailers are IT consulting and Web site development/maintenance/hosting (see Figure 16). Mobility services and social media integration, meanwhile, are rapidly gaining ground. Deployment of these relatively new and quickly evolving technology domains requires expertise that is not available in-house. Other best-practice technology areas that CE retailers will need to implement to stay viable are:

- Next-generation customer analytics that incorporate data gathered from social media.
- Predictive supply chain management solutions.
- Customer management suites that enable consistent customer recognition, tracking and rewards across channels.
- Multi-channel fulfilment technologies.

The Future of Shopping

In the future, CE retail establishments will eliminate all boundaries between the retailer and the shopper. All capabilities, (pricing, order management, fulfillment, customer service, returns, etc.) will be available to consumers regardless of location (aisle three, checkout, in the home, jogging in Central Park).

Consumer behavior purchase patterns and offers will be integrated across channels. Mobile offers will be distributed to shoppers in real-time based on time, location, customer segment and category position. To get there, CE retailers must consider the following:

- **Cloud-enabled shopper interaction:** Retailers must integrate third-party offers and services in order to reduce shopper decision models and re-establish their authority as a credible source of information. These services can be delivered through the cloud and linked to a shopper’s mobile device to deliver a contextual shopping experience.

- **Linking content across channels:** Products and promotions must be consistent, leveraging emerging capabilities in content and digital asset management.

- **Adoption of mobile devices for store associates to enable a richer shopper interaction:** Equip store-based employees with mobile devices to improve in-aisle customer service and check-out capabilities.

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**Key Third-Party Services for U.S. Retailers**

<table>
<thead>
<tr>
<th>Service</th>
<th>Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>IT consulting</td>
<td>58.2%</td>
</tr>
<tr>
<td>Web site development, maintenance or hosting</td>
<td>54.5%</td>
</tr>
<tr>
<td>Custom application development</td>
<td>45.5%</td>
</tr>
<tr>
<td>Packaged app implementation or integration</td>
<td>37.3%</td>
</tr>
<tr>
<td>Mobility initiatives</td>
<td>36.4%</td>
</tr>
<tr>
<td>Social media initiatives</td>
<td>35.5%</td>
</tr>
<tr>
<td>Telecommunications or networking</td>
<td>30.0%</td>
</tr>
<tr>
<td>Training</td>
<td>29.1%</td>
</tr>
<tr>
<td>Application maintenance</td>
<td>29.1%</td>
</tr>
<tr>
<td>Data center operations</td>
<td>23.6%</td>
</tr>
<tr>
<td>Business process outsourcing</td>
<td>12.7%</td>
</tr>
<tr>
<td>Entire IS organization</td>
<td>5.5%</td>
</tr>
<tr>
<td>Energy reduction and/or sustainability</td>
<td>4.6%</td>
</tr>
<tr>
<td>Currently not outsourcing</td>
<td>3.6%</td>
</tr>
</tbody>
</table>

Percent of respondents

Source: RIS Retail Tech Study, April 2011

**Figure 16**

**Key Retail Software Architectures**

<table>
<thead>
<tr>
<th>Architecture</th>
<th>Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Best-of-breed software</td>
<td>57.7%</td>
</tr>
<tr>
<td>Integrated solutions suites</td>
<td>52.3%</td>
</tr>
<tr>
<td>In-house IT resources to develop software</td>
<td>50.4%</td>
</tr>
<tr>
<td>Third-party services to help develop software</td>
<td>44.1%</td>
</tr>
<tr>
<td>On-demand or SaaS models</td>
<td>33.3%</td>
</tr>
<tr>
<td>Cloud computing solutions</td>
<td>15.3%</td>
</tr>
</tbody>
</table>

Percent of respondents

Source: RIS Retail Tech Study, April 2011

**Figure 17**
CE retailers must also find ways to manage costs, a difficult challenge given persistent low margins across key categories and the heavy investment needed in new technologies to keep pace with their always-connected consumers. A key to the cost management conundrum would be the conversion of Cap-Ex to Op-Ex by using cloud services for SaaS (software as a service) and BPaaS (business process as a service). Significant cost reductions could also be gained by transitioning some commoditized business processes to a BPaaS model (see Figure 17).

We believe CE retailers will find these services attractive, even indispensible, due to factors such as on-demand delivery, compression of implementation time, withdrawal of supporting infrastructure, negation of application testing, reduced training, reduction in ongoing business process change management and greater accounting transparency for such costs.

Another important element of cloud-based services is the scalability factor, allowing retailers to quickly extend solutions in new stores or channels, as well as rapidly withdraw from stores or channels that are not performing at desired levels. Another attraction is the utility concept of pay-as-you-use, which enables adopters to “variabilize” their cost base.

The Road Ahead

CE retailers are uniquely positioned to capitalize on emerging opportunities across the technology and business spectrum to fortify their operating models, as well as profitably engage and stay connected with consumers.

Winning players will do the following:

1. Become “retail format agnostic” and use multiple channels to stay connected with their customers, profitably.
2. Focus on and fortify their unique strengths (e.g., superior customer service, lowest price).
3. Partner and source talent and services globally in a virtualized environment and rein in their expenses.
4. Save precious capital and variabilize their cost base by actively adopting new cloud-enabled service delivery models such as BPaaS.

In short, CE retailers need to reinvent their corporate operating models and dig deeper competitive moats to profitably tap into the fast emerging future of the CE retail market.

Footnotes

2 In fact, gross margins for TVs have dropped from 27% in 2007 to 22% in 2009, while PC margins have remained stagnant at around the 13% mark, according to Goldman Sachs Equity Research, April 2011.
3 According to Goldman Sachs research, RadioShack is expected to be the net winner among other sellers from the proliferation of tablet technology, as the company derives significantly lower sales from PCs and notebooks, which are being cannibalized by tablet sales. Analysts feel there will be a net neutral effect for Best Buy in 2011, as its core PC business continues to suffer from tablet cannibalization, but its competency in wireless and close relationship with Apple could help it absorb this disruption.
Resources


“Best Buy: Framing the Issues: Newer Stores Smaller than the Average Box, Suggesting Need for Downsizing,” GS Equity Research, April 2011.


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