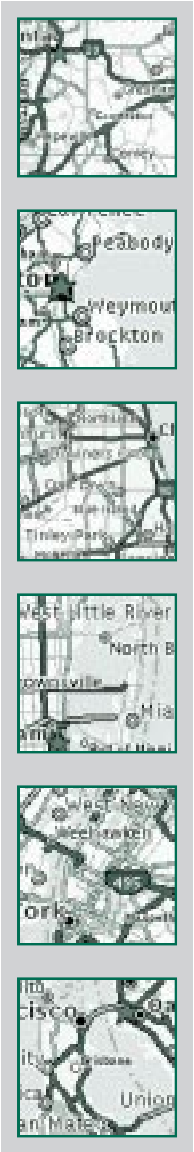
The Boston Consulting Group
in partnership with
The Initiative for a Competitive Inner City

The Business Case for Pursuing Retail Opportunities in the Inner City



THE BOSTON CONSULTING GROUP

in partnership with

The Initiative for a Competitive Inner City

The Business Case for Pursuing Retail Opportunities in the Inner City

June 1998

Contents

The Overlooked Market

Communities with enormous buying power are going unserved. Stores with high-quality merchandise and good service are scarce in their neighborhoods. Are these markets in scattered, inaccessible locations? In emerging countries plagued by political and economic risk?

These overlooked markets are both real and close at hand. To find them, retailers need only look in their back yards—in America's inner cities.

Conservatively, inner-city consumers constitute $85 billion in annual retail buying power—far more than the entire country of Mexico. They live in densely populated areas with concentrated buying power. Nevertheless, unmet demand tops 25 percent in many inner-city markets, and reaches 60 percent in others.

Often, inner-city residents end up having to take a long bus ride simply to buy a bag of groceries at competitive prices. What inner-city consumers often do have available locally are poor quality products and high prices. One African-American resident of Harlem captured the frustration of many inner-city residents about the difficulties of getting value for their hard-earned wages: "Is my money a different color, too?"

What has led to this dearth of retail supply? Retailers, chains and independents alike, have overlooked the promise of the inner-city market. Some might consider it discrimination. We call it bad strategy.

In today's hyper-competitive retail environment, the cost of bad strategy is rising. Retailing is flooded with innovative players experimenting intensively with new formats—witness the rise of power retailers. Shareholder pressures are driving aggressive growth strategies as these innovative formats rapidly roll out. Growth strategies, in turn, are increasing saturation in already highly competitive suburbs and accelerating the push into foreign markets.

Penetrating the largely untapped American inner city is often much more promising. The infrastructure required for doing business is already in place, given the proximity to local suppliers and the city's core. And, there is no need to struggle with a new language, culture, and currency.

Retail development in inner cities gives residents access to quality goods and services at competitive prices, allowing them to share in shopping experiences most Americans take for granted. They are ready, willing, and able to spend their considerable aggregate income. For growth-oriented retailers seeking revenues and new opportunities in today's global marketplace, the inner city is perhaps the last large domestic frontier.

Study Overview

During the past year, The Boston Consulting Group (BCG) has conducted on a pro bono basis a national study on retail opportunities in the inner city, in partnership with the Initiative for a Competitive Inner City (ICIC). The objective of our analysis was to develop the market intelligence to bridge the information gap and assess the attractiveness of opportunities for inner-city retail investment.

Our research focused principally on six inner-city markets—Atlanta, Boston, Chicago, Harlem, Miami, and Oakland. These "new" and "old" cities are diverse in size, region, demographics, population density, and degree of economic and social isolation. Collectively, these markets provide a critical mass of information that is applicable to inner cities nationwide. Within each city, the study examined the following sectors: grocery, apparel, mass merchant, pharmacy, fast food, and other. This work was complemented by additional research conducted by ICIC in twelve inner cities across the country.

The research included rigorous analysis of multiple data sources, interviews with 63 retail managers nationwide, and focus-group sessions with 40 Harlem residents; the focus groups were conducted on a pro bono basis by Marketing Development, Inc., and Marketing Insights of California.

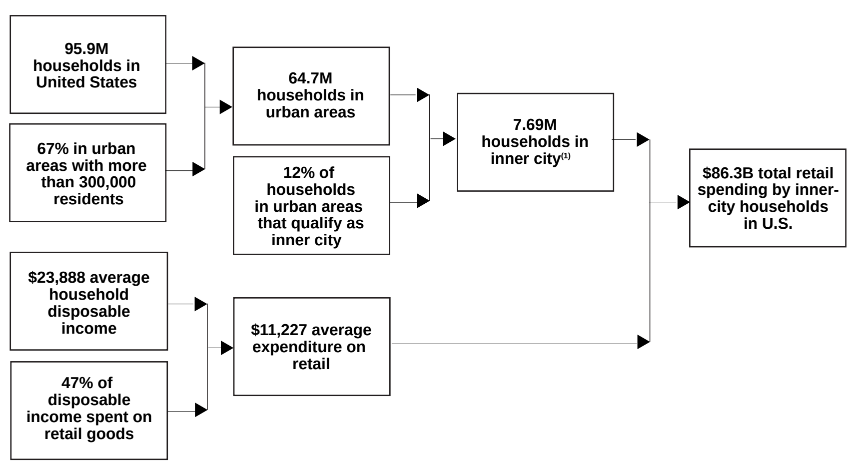
Our research addressed four fundamental questions:

- Is there a retail market in the inner city, and if so, what are the most attractive opportunities?
- What are consumers' unmet needs?
- What is the business potential?
- What are the critical success factors and challenges to success?

The Market Opportunity

The retail market in inner cities[1]—defined as economically distressed urban communities—is large, concentrated by consumers with significant aggregate spending power, yet lacking in competitive offerings, and underpenetrated by retailers of all kinds.

The revenue and profit potential in the inner city is enormous. The estimated 7.7 million households in America's inner cities possess over $85 billion per year in retail spending power,[2] (excluding unrecorded income from legal activities, which could add another $15 billion).[3] This amounts to nearly 7 percent of total retail spending in the U.S.



(1) Inner city = urban zip codes that are economically disadvantaged in relation to surrounding areas (MSAs) identified by income (median household income and percent below poverty used to reflect median and dispersion of income) and unemployment

NOTE: Does not include unrecorded economy

Figure 1, Large Inner-City Market
$85B in Retail Buying Power

The lack of competitive offerings in the inner city is severe. The retailers that do serve this market are not necessarily world-class players. The supply/demand imbalance and insufficient or low-quality product offerings leave this large, concentrated market both less adequately served and with fewer competitive offerings than other retail markets. In many inner-city areas, more than 25 percent of retail demand is unmet[4], amounting to billions of dollars of potential sales and hundreds of millions of dollars of profits. Unmet demand approaches 30 percent in Boston, 40 percent in many areas of Chicago's inner city, and 60 percent in Harlem. The supply deficit appears most acute in the high-demand basic retail categories such as food and apparel. (See Figure 2)

Figure 2, Many Inner-City Markets Appear Underpenetrated
Average of One Quarter of Demand Unmet

	Atlanta	Boston	Chicago	Harlem	Miami[1]	Oakland	Total
Retail demand ($M)	1,627	1,151	4,470	1,387	912	1,132	10,679
Retail supply ($M)	1,301	753	3,839	522	1,027	825	8,268
Market opportunity (demand-supply) ($M)	**325**	**398**	**630**	**865**	**(115)**	**307**	**2,411**
Opportunity as a % of demand (%)	20	35	14	62	(13)	27	**23**

Unmet demand in excess of 50% common in specific zip codes

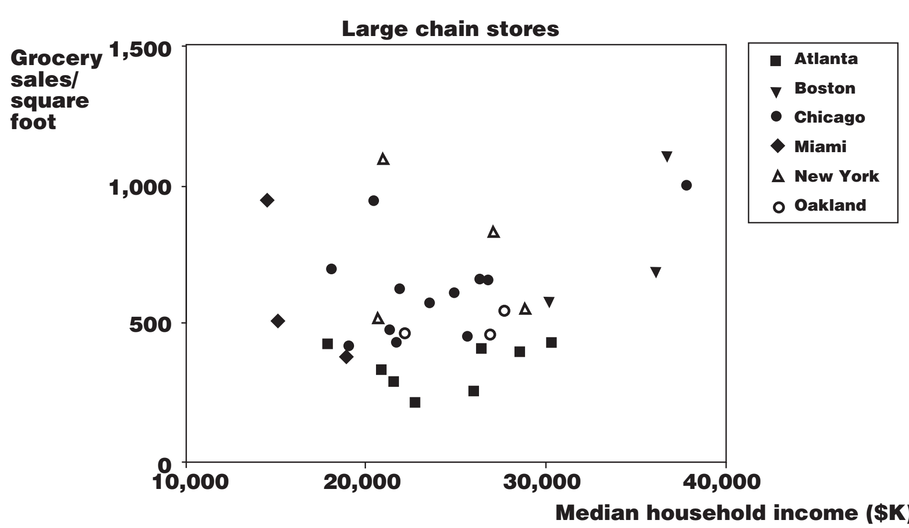
(1) Excludes two beach zip codes strongly affected by tourism

NOTE: Does not include unrecorded economy
SOURCE: Retail census data; BCG analysis; Pro DC Select Phone database of phone books, 1995-1996

A concentrated consumer base of shoppers is cited as *the* primary competitive advantage in the inner city, , according to a survey of retail store managers around the country. As Figures 3 and 4 show, inner-city sales volume is a function of income density, not household income.

Because the market is highly concentrated, there is enormous buying power per square mile in these communities despite the lower household incomes. As

Figure 3, Inner-City Grocery Performance Not Driven by Income Level



SOURCE: IRI Infoscan Data; W.E.R. zip code data; BCG analysis

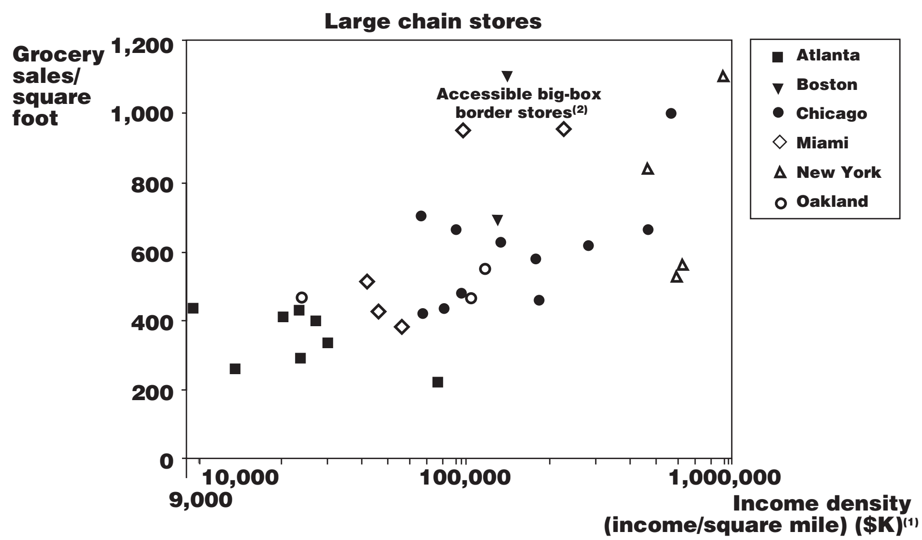


Figure 4, Inner-City Grocery Performance Linked to Income Density

(1) (Number of households x average household disposable income)   zip code square mileage
(2) Boston zip code appears to include a destination superstore that draws shoppers from wide area; Miami zip codes include significant beach community, where tourist spending in supermarkets is not reflected in income/square mile figures

NOTE: Atlanta has much larger zip codes than other cities, causing lower density
SOURCE: IRI Infoscan Data; W.E.R. zip code data; BCG analysis

illustrated in Figure 5, inner-city areas can possess up to *six* times as much buying power per square mile as surrounding areas.[5] Impressively, inner-city demand per square mile for basics such as groceries and apparel can exceed retail demand across all categories in surrounding locations. In Harlem, for example, retail demand per square mile for food and apparel is an estimated $116 million, compared with $53 million across all categories in the rest of the New York metropolitan area. Our estimate of spending potential may be conservative, given that African-American and Hispanic households can spend disproportionately on food products and apparel.

Figure 5, Power of Concentrated Retail Demand

Average retail demand per square mile ($M)

	Chicago	Atlanta	Oakland	Miami	Boston	Harlem
Metro:	27	4	11	14	12	53
Inner City:	57	10	35	40	71	297
	2X	**2X**	**3X**	**3X**	**6X**	**6X**

SOURCE: ICIC/BCG analysis

A majority of inner-city residents are members of minority groups. This should be of particular interest to retailers, since minority populations are growing much faster than the Caucasian population, with minorities expected to account for 80 percent of work-force growth over the next decade.[6] The inner city fits within retailers' overall strategy to capture this proliferating market.

The retail opportunity in America's inner cities is not limited to satisfying unmet demand at competitive prices and capturing the retail spending dollars fleeing the market. Pioneering retailers have an opportunity to win market share from local high-price stores that survive simply because they lack competition.

In most neighborhoods the lack of competitive retail offerings adversely affects pricing. Our analysis of Boston's grocery store market reveals that inner-city shoppers sometimes pay as much as 40 percent more for basic grocery items than their suburban counterparts. This pricing difference is attributable mainly to the low supply of medium and large supermarkets in relation to small convenience stores.

The Customers' Unmet Needs

The unsatisfactory shopping experience in their neighborhoods has left many inner-city consumers feeling poorly treated. To better understand the needs, wants, and dissatisfactions of inner-city consumers, we conducted four focus groups with Harlem residents, one each of Hispanic males, Hispanic females, African-American males, and African-American females.[7]

To understand the preferences of inner-city consumers, we asked focus-group participants to describe their ideal shopping environment. Just how diverse and distinctive are the tastes of inner city consumers? In general, participants sought an experience on a par with shopping in the suburbs. Most of the preferences they expressed were common to any market:

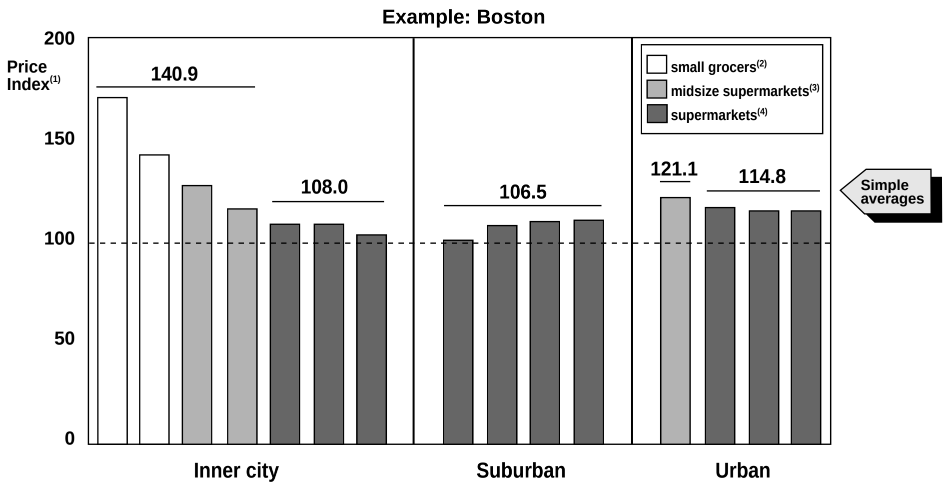
- Basic, quality goods and services
- Branded offerings
- Competitive prices
- Clean and stress-free shopping environments
- Courteous and helpful salespeople
- Clear return policies

Results from the focus groups and surveys of retailers indicate that inner-city demand is largely driven by standard preferences for competitive offerings. However, a fundamental characteristic of inner cities is the heterogeneity of its population. This heterogeneity results in a number of submarkets, each with specific preferences. These preferences include:

- In grocery: wide product selection—special meat cuts and specialty vegetables
- In apparel: unique apparel, and tailored sizes, colors, and styles
- In pharmacy: tailored hair care and cosmetic products

Tailoring products to these preferences usually translates into premium pricing and presents real opportunities for chains and independents to fill a large and growing market gap.

Figure 6, Potential to Offer More Competitive Prices
Save 35–40% With World-Class Supermarket Offering



(1) Weighted average price index relative to Quincy Stop & Shop, which is in a highly competitive grocery market
(2) > = ~ $5M sales/year
(3) = ~ $5M -$15M sales/year
(4) $15M+ sales/year

NOTE: Stores needed at least 75 percent of basket items to quality; the three stores that were not included had comparable pricing on the items they did carry
SOURCE: BCG survey of grocery stores, 1997

Harlem Focus-Group Members Voice Concerns

Consumers often travel to shop:

> "Sometimes six or eight of us share a van to New Jersey to go to BJs," said one participant.

Residents often consider merchandise selection in the inner city inadequate:

> "We do not buy big sizes in our neighborhood—[heck], they do not even have big."

Residents feel poorly served in comparison with other markets:

> "We do not want old, dated, second-rate stores, products, and service."

These consumers are not confident products are priced fairly:

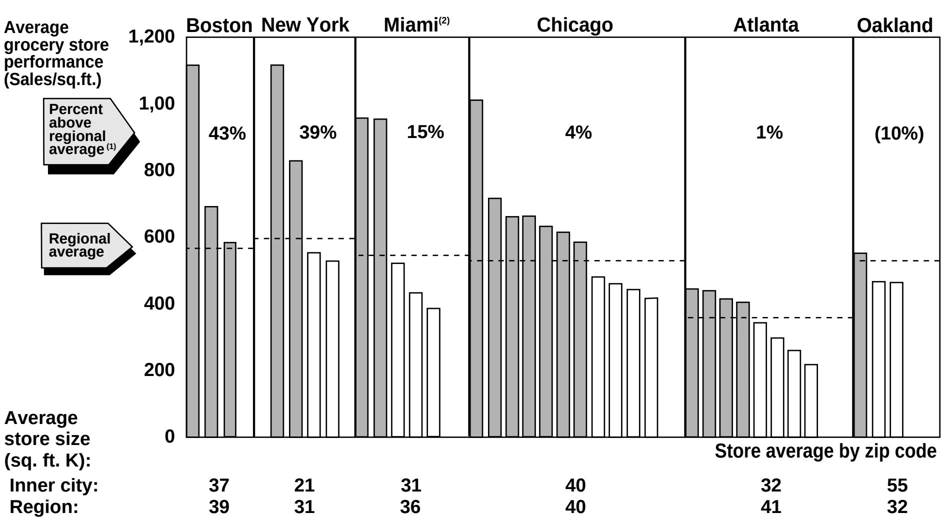
> "I think [the stores] raise the prices during the first two weeks of every month" to coincide with the cycle of public assistance payments.

The Business Potential

Tapping the growing inner-city retail market with competitively priced merchandise tailored to the needs of multiple micromarkets can yield strong returns on investment. In fact, many retailers in our survey privately acknowledged that their inner-city stores can be more profitable than their suburban locations offering comparable prices.

An analysis of inner-city supermarkets in the six major markets we examined revealed that inner-city markets can generate average grocery sales per square foot of up to 40 percent higher than the regional average, and in some markets grocers average twice the regional average. Pathmark's stores in Bedford-Stuyvesant (Brooklyn) and Newark's Central Ward are two of the highest sales generators in the 144-store chain. The Super Stop & Shop located at the South Bay Center in Boston's inner city is the highest grossing store in the 186-store chain. Figure 7 below illustrates sales-per-square-foot performance, with each bar representing an inner-city zip code.

Figure 7, Inner-City Grocery Stores Outperform Regional Average



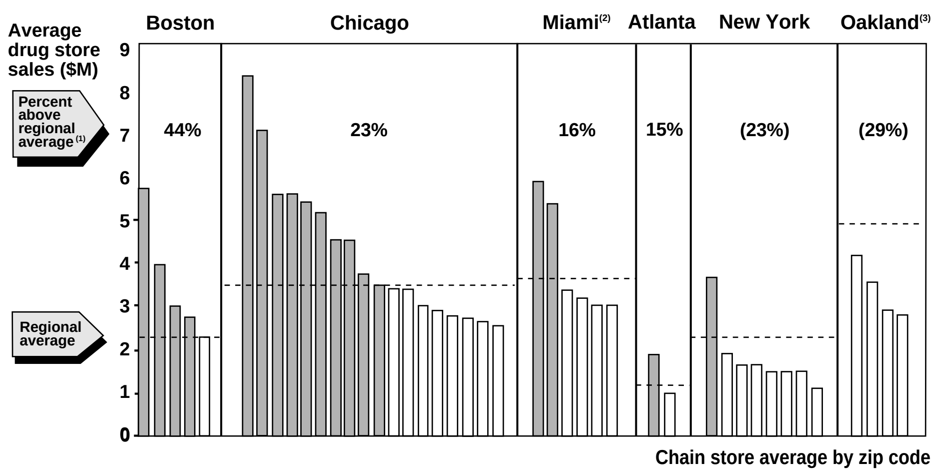
(1) (Weighted average sales /selling square feet for inner-city zips – weighted average sales/selling square feet for non-inner city) ÷ weighted average sales/selling square feet for non-inner city

(2) Miami grocery stores with higher sales/square foot appear to be located in beach communities and therefore are augmented by tourist spending

SOURCE: IRI Infoscan Data 1/1/96 – 2/1/97 annualized

An analysis of drug stores in our sample indicates that inner cities can generate average store sales of up to 45 percent higher than the regional average, and in some areas pharmacies average more than twice the regional average. Consider the Rite Aid and Duane Reade drugstore outlets in Harlem. In May 1994, Duane Reade opened a 7,000 square foot drugstore in Harlem that is one of the fastest-growing outlets in the 60-store chain. Four months later, Rite Aid opened a store a block away. More prescriptions are filled at Rite Aid's Harlem store than in any of the 110 other Rite Aid stores in New York City.[8]

Figure 8, Inner-City Drugstores Can Outperform Stores in Other Markets



(1) (Weighted average sales for inner-city zips-weighted average sales for non inner-city) ÷ weighted average sales for non inner-city
(2) Miami drugstores with higher sales volumes appear to be located in beach communities, so sales are augmented by tourist spending
(3) Oakland has at least one drugstore that did not qualify but that borders an inner-city zip code

SOURCE: IRI Infoscan Data 1/1/96 - 2/1/97 annualized for 73 stores

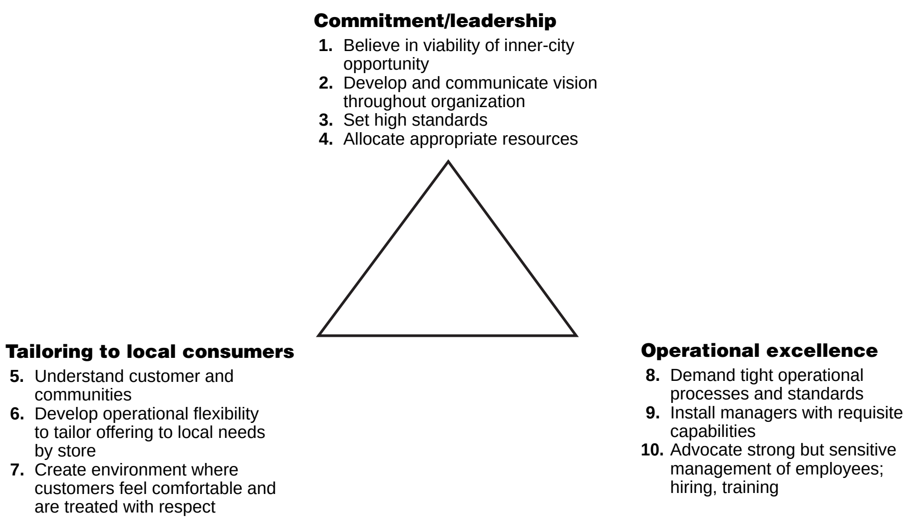
Solid returns from inner-city stores have also been witnessed in other retail categories such as apparel and department stores. Kmart's inner-city SuperK store in Oakland, California, generates 50 percent higher sales volume than comparable stores throughout the chain, and its South Bay Center store in Boston is the highest grossing store in Massachusetts.

Foot Locker's store in Harlem is among the company's top stores, recording sales in excess of $1,000 per square foot.[9] Another leading U.S. apparel retailer reports that its inner-city stores generate twice the sales volume of the typical store within the division and higher profits.

Critical Success Factors

As with any market, profit in the inner city is not guaranteed. As one inner-city retailer noted, strategy and execution, not poor market opportunities, are to blame when subpar results occur in inner cities.

Figure 9, Three Success Factors for Inner-City Retailing



Our analysis identified three factors critical to the success of an inner-city retailing strategy: being firmly committed to the inner city, operational excellence, and tailoring products and services to local market needs.

1. Commitment and Leadership

Commitment to the inner city, combined with strong leadership, is critical. A belief in the viability of the inner-city opportunity must be firmly held and enforced by top management—inner-city stores are profit centers, not cost centers. Top-down communication of a clear mission and vision throughout the entire organization is helpful for success. Not only must leadership commit to the inner-city opportunity; it must demand commitment and performance from its management team and employees further down in the ranks.

Without management's unfaltering commitment to being profitable, inner-city stores are destined for failure, furthering the misconception that retailers cannot make money in the inner city. Top management must allocate the necessary resources, set high operational standards, and institute practices that capitalize on the market opportunity and position inner-city stores to succeed. Qualified, profit-focused in-store managers must be hired and held to the same performance expectations as managers in other store locations.

Sears is one company firmly committed to implementing good retail practice in the inner city. This commitment is one part of Sears' overall strategy to gain share in this competitive environment. As part of its success strategy, the company has repositioned and remodeled existing inner-city stores, has opened new inner-city stores in Oakland and Brooklyn, and is exploring opportunities in other locations, including Harlem.

Sears has been successful in the inner city because it delivers what the customer wants, at the right price, in an inviting shopping environment, and with attentive service. Attesting to the chain's success is its Boyle Heights store in East Los Angeles, which is among the most profitable Sears stores in the region. In 1996, the store generated sales of $50 million, double its 1992 sales, and increased profits by 30 percent.[10] Sears' store in the Ravenswood district of Chicago, one of its top stores in the Chicago area, increased sales and earnings by 10 percent per year from 1994 through 1996.[11]

Walgreen's is another retailer whose success in the inner city can be credited in part to a guiding vision, and a commitment to implementing solid retail practices. The chain long ago recognized the potential of the inner city and aggressively pursued the market. Walgreen's stand-alone stores have thrived in the inner city, serving as convenience retailing outlets with wide product offerings, such as prescription drugs and convenience foods. As a sign of its commitment to the market, the company is dedicating up to 20 percent of its bold expansion plan to inner cities, which will add as many as 100 new inner-city stores over the next two years.

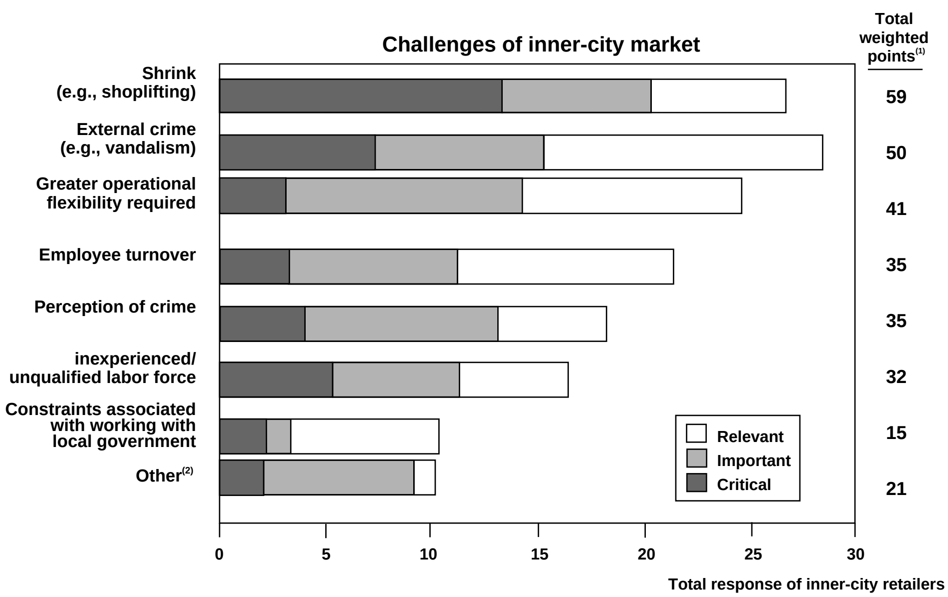
2. Operational Excellence

In the inner city, as in any other market, operational excellence is a prerequisite for success. Store managers must execute best practices—inventory management, effective staffing levels, strict accounting controls and financial management, continual upkeep of stores, and attentive customer service.

By practicing operational excellence, retailers are aggressively addressing the real risks and challenges of conducting business in the inner city. Our survey of retailers revealed a number of challenges to conducting business, all of which exist to some degree in suburban and international markets as well . The most common challenges are:

- Shrink (e.g., shoplifting, pilferage)
- External crime/perception of crime
- Greater operational flexibility required
- Employee turnover/inexperienced and unqualified work force

Figure 10, Shrink and Crime Are Biggest Challenges



(1)Total points based on weighted total of retailer's responses: Critical = 3 points, Important = 2 points. Relevant = 1 point, Unimportant = 0 points
(2)Other includes price sensitivity, difficult/misbehaving customers, diversity of customers, sales/margins pressure, and parking

NOTE: Both unimportant and no response counted as 0 in total responses
SOURCE: BCG and ICIC interviews with 36 inner-city businesses

In achieving operational excellence, retailers have developed systems proven to control shrink, built the infrastructure necessary to limit external crime and reduce the perception of crime, and incorporated policies and procedures required to manage human resource challenges.

Shrink

Just as in suburban markets, controlling shrink in the inner city begins with the installation of competent in-store managers, tight inventory and accounting controls, effective hiring, and proper staff training and incentives. Security technology, store layout, and packaging strategies are all part of an effective shrink-control system.

Many retailers indicate that building ties within the community and hiring locally are essential to shrink-control efforts. As one human resources director of an emerging grocery chain put it, “It is all about managers and employees stopping theft.”

The integration of these practices positions a retailer to quickly identify, immediately respond to, and limit theft. Among the many retailers in our analysis are those with shrink levels ranging from 0.3 percent to 1 percent of sales, compared with industry averages of 2 percent. In the tight-margin retail business, these differences have a critical impact on potential profitability.

Crime

Operational excellence in the inner city includes effective management of actual crime and the perception of crime, and the maintenance of a safe shopping environment. The perceived magnitude of crime in inner cities may be exaggerated, partly because of excessive and perhaps myopic coverage by the media of criminal activity in these areas.

Recent trends provide reason for cautious optimism about a decline in crime. As a result of new crime prevention tactics such as community policing, crime rates are falling dramatically across major U.S. cities, including New York, Chicago, Boston, Atlanta, and Miami. Between 1989 and 1996, the total crime rate fell by 46 percent in New York, by 33 percent in Boston, and by 25 percent in Miami. (See Figure 11)

Successful retailers are bolstering safety efforts with in-store managers who work effectively with law enforcement officials, community groups, and property owners. These retailers equip stores with adequate lighting, install proper surveil-

Figure 11, Significant Progress in Reducing Crime
Especially in Larger Cities

	Total crime rate		Violent crime rate		Property crime rate	
	CAGR* 89-96	% change 89-96	CAGR 89-96	% change 89-96	CAGR 89-96	% change 89-96
Atlanta	-3%	-17%	-2%	-16%	-3%	-18%
Boston	-6%	-33%	-4%	-26%	-6%	-35%
Miami	-4%	-25%	-2%	-16%	-5%	-28%
New York	-8%	-46%	-7%	-42%	-9%	-47%
Oakland	-2%	-15%	5%	45%	-4%	-24%
Total U.S. (1)	-1%	-8%	1%	3%	-2%	-10%

(1) Total U.S. data are from 1986-1995; 1996 total U.S. data had not been released as of July 25, 1997, although data for individual cities have been published
* Compound annual growth rate

NOTE: Rates are for metro/urban areas for each city and therefore include only the city proper
SOURCE: FBI annual crime rate reports

lance systems, and station sufficient staff and security personnel outside of stores. By investing in these necessary crime control measures, Fiesta Mart, a 36-store supermarket chain operating in the inner cities of Houston and Dallas, has avoided any armed robbery in its 25-year history.

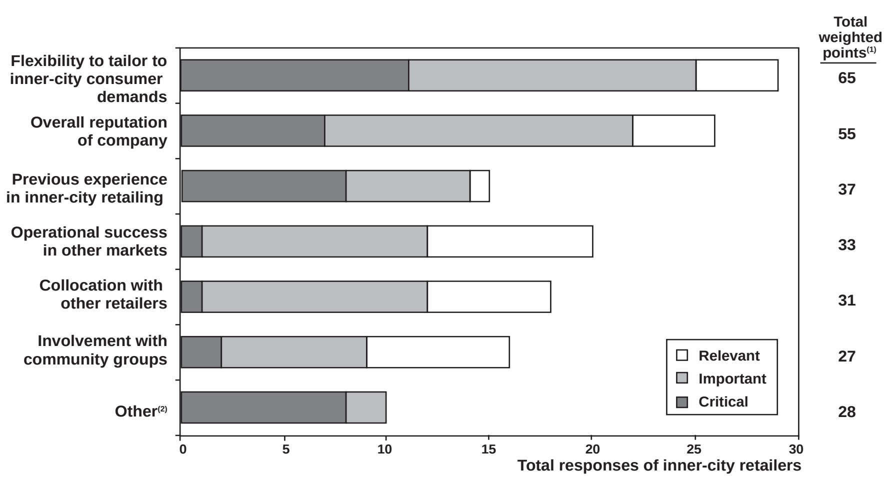
Human Resource Challenges

Operational excellence also encompasses human resource management. Although a large labor pool is available in inner cities, there is a set of challenges faced by retailers in all markets related to hiring, training, and retention, as well as the perception of a less skilled labor force. One operator of a successful inner-city supermarket told us, "The employer makes the employee. Any inner-city operator that wants a quality labor force must dedicate the resources to train its employees and provide the proper incentives to retain them." Fairway, a 35,000 square foot supermarket in Harlem that currently employs 241 local residents, pairs each new employee with a manager for two weeks of training on the floor.

3. Tailoring

Winning strategies in the inner city meet the requirement for a high level of operating flexibility and tailored products and services. Many retailers have indicated that a key operating hurdle is tailoring their merchandise mix to the inner city's different ethnic populations. Dealing with such complexity is becoming a reality in suburban markets as well, requiring a sophisticated approach to meeting the diverse needs of a broad consumer base in all markets. (See Figure 12)

Figure 12, Critical to Tailor to Inner-City Markets



(1) Total points based on weighted total of retailers' responses: Critical = 3 points, Important = 2 points, Relevant = 1 point, Unimportant = 0 points

(2) Other includes price point, sales, and patience & flexibility

NOTE: Both unimportant and no response counted as 0 in total responses

SOURCE: BCG and ICIC interviews with 36 inner-city businesses

Successful inner-city retailers in our study have developed an understanding of inner-city dynamics and the varied preferences of many distinctive micromarkets. These retailers have given local store managers the decision-making authority necessary to tailor merchandise offerings to local consumers' needs, or have provided for the creation of a centralized decision-making group that understands local market needs and tailors the merchandise on a store-by-store basis as warranted.

The standardized approach of some of the large retail chains often lacks the flexibility necessary to operate successfully in the inner city. Today's state-of-the-art information technology infrastructure permits many retailers to manage and modify their merchandise mix to serve the wide-ranging needs of inner-city consumers. Some leading retailers, for example, are capable of using information to pinpoint the merchandise mix that will sell well in a given micromarket and to match that market with sister stores in similar markets, making modifications as necessary. Retailers we surveyed noted that, in most cases, there is a need to modify no more than 20 percent of their mix, and sometimes less than 10 percent, but that a moderate amount of tailoring is crucial. One large merchant we spoke with historically had tailored just 1 to 2 percent of its merchandise chainwide and had experienced subpar results.

Fiesta Mart of Houston centralizes purchasing, yet the store managers are still able to tailor merchandise to meet the unique tastes of Fiesta's primarily Hispanic and African-American consumer base. The company's centralized purchasing system allows for stores to be merchandised store-by-store, facilitating the flow of sales information on a weekly basis between headquarters staff and individual store managers. The effectiveness of this system was evident when we visited Fiesta stores in Houston and Dallas, where we found a distinct difference in the merchandise offerings of stores catering to African-American and Hispanic communities.

Merchandise Mix

Standard merchandise offerings, typically designed for higher-income or more homogenous suburban consumers, do not always sell well in the cities. Merchandise offerings must be tailored to fit the budget and consumption patterns of inner-city customers, many of whom are quite brand-conscious and equate major brands with quality. While these consumers do look for common brands, they also have specific preferences.

Within the apparel sector in some markets, retailers must stock high inventories of very large sizes, as oversized clothing is highly popular with many teenage

African-American customers. Many Latin women show a preference for brightly colored apparel.

Within the food sector, specialty cuts of meat—skirt steak, hamhocks, neck bones—and unique produce are in high demand, along with certain lines of ethnic foods, such as Goya, Glory, and Sylvia's. Fairway in Harlem sells everything from "pigs' feet to caviar." America's Food Basket, a grocer in Boston, offers more than 25 varieties of rice to meet the varied tastes of its customers. In many cases, local businesses are built around different cuisines in order to cater to the tastes of diverse ethnic groups, many representing immigrant populations. Within each of these groups, consumer behavior, to which retailers need to respond, is based on a number of variables, including country of origin, stage of life, and family status and size.

Merchandise display is also critically important: eye level is buy level. Store managers must have the flexibility to rearrange merchandise displays so that the most popular products (with attention paid to size, color, choice, and brands) are attractively and prominently displayed.

Tailoring the retail offering is not limited to merchandise. The winning retail strategy also incorporates modifications to customer service and the shopping environment. In focus groups and consumer surveys we conducted, the desire for multilingual personnel and signage and store managers who work well within the local community were consistently emphasized.

The Lark: Serving the Inner-City Customer with a Winning Strategy

The Lark is a seven-store apparel chain based in Gary, Indiana. The company operates two stores within the inner city and five other locations in shopping malls on the edge of the inner city. Since its opening 25 years ago by Len Rothschild, a local entrepreneur, The Lark has built its franchise on serving the inner-city consumer, particularly members of the African-American community. The company has been consistently profitable, has shown strong profit margins, and is among the highest performers in apparel on a sales-per-square-foot basis. One property manager we interviewed called The Lark "the best urban ethnic retailer in the U.S."

The Lark markets high-end outerwear ($750 plus), apparel ($300 plus), and shoes ($100 plus). Upscale brands—Polo, Nautica, Versace, Coogi, Hilfiger—are in high demand by the retailer's image-conscious customers. Len Rothschild says The Lark is not in the apparel business but in the "ego-substitution business."

Strengthening its operating model and its understanding of inner-city neighborhood dynamics have been hallmarks of The Lark's operations. Salespeople and managers are hired from the community and keep the retailer informed about trends and customer preferences. Company staff frequent entertainment venues to track fashion trends as they emerge. The Lark then leverages this market intelligence in selecting merchandise.

Bringing popular brands and fashions to the inner city is just one factor in The Lark's success. The retailer has effectively tailored its merchandise mix to provide the colors (wide offering of black, red, orange, and pastels) and sizes (large selection of big sizes) that its primarily African-American customers demand.

The Lark also provides a shopping experience with ambience: meticulously clean stores, bright lighting, alluring merchandise presentation, and attentive customer service. Salespeople, who are trained to greet every customer, are both knowledgeable about the stores' merchandise and have the fashion sense to help customers coordinate and select outfits.

Beyond its strengths in marketing and merchandising, The Lark maintains tight inventory management systems, boasts low employee turnover as a result of clear and effective human resource policies, and keeps shrink levels very low with the implementation of appropriate systems and practices.

The Benefits

Here are some of the benefits that would accrue to all of the nation's stakeholders if American retailers took a fresh look at the inner city:

- For large retail corporations, which may face slower growth and overcapacity in traditional suburban markets, the prospect of growing in a large, underserved consumer market
- For inner-city entrepreneurs, the ability to be highly responsive to the needs of the community and create niche markets catering to the tastes of ethnically diverse populations
- For urban developers, the opportunity to increase rental income streams through retail revitalization. Developing and leasing the square footage needed to satisfy unmet inner-city retail demand could generate substantial rental revenue. The Harlem market alone can support over one million square feet of additional retail space

Figure 13, Filling Unmet Demand Provides a Significant Retail Development Opportunity

	Atlanta	Boston	Chicago	Harlem	Oakland
Retail demand ($M)	1,627	1,151	4,470	1,387	1,132
Retail supply ($M)	1,301	753	3,839	522	825
Market opportunity (demand-supply) ($M)	325	398	630	865	307
Capture Rate: 50% ($M)	163	199	315	433	154
Potential Retail Sq. Footage (000)(1)	408	498	788	1,081	385

(1) Assumes sales of $400. per square foot
NOTE: Demand does not include unrecorded economy
SOURCE: Retail census data; ICIC/BCG analysis

- For cities, a chance to increase employment and entrepreneurial opportunities for local residents, reduce urban blight, return abandoned and underused land to economic use, increase the area's foot traffic and desirability, and gain additional sales tax revenue. Filling the unmet inner-city retail demand could create up to 250,000 new direct retail jobs and more than 50,000 new indirect jobs in these communities. To cite a specific example, unmet demand in Harlem could create up to 8,000 jobs

Figure 14, Large Job Potential in Specific Cities

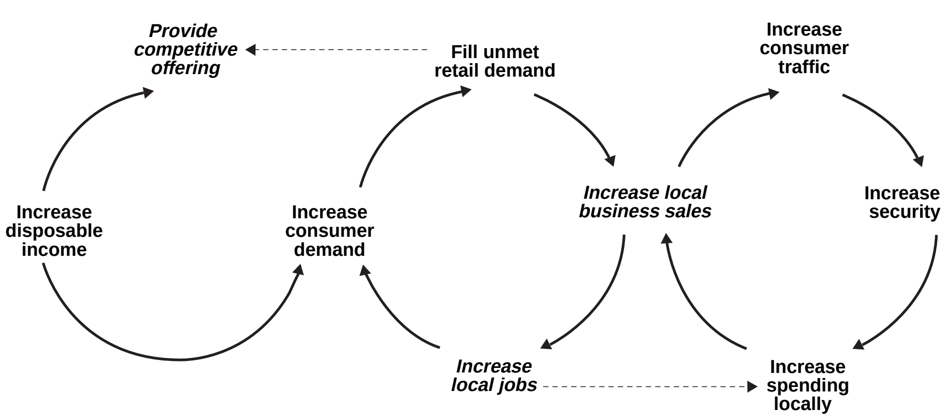
	Unmet demand ($1M)[1]	9.6 employees / $1M sales retail	Potential new retail jobs
Atlanta	325		3,120
Boston	398		3,820
Chicago	630		6,048
Harlem	865		8,305
Miami	(115)		0
Oakland	307		2,947
Total	2,411		24,240

[1] Oversupply in border zip codes eliminated
SOURCE: ICIC/BCG analysis

- For inner-city residents, the benefits of lower prices, less travel time, greater merchandise selections, a better service experience, and more accessible jobs.

Providing a competitive offering and filling unmet retail demand in the inner city creates a virtuous cycle that leads to increased disposable income, consumer demand, local jobs, business sales, consumer traffic, security, and local spending.

Figure 15, Retailers Can Offer Tremendous Benefits to Inner City



The Benefits of Inner-City Retailing Are Real

Some critics say that retail provides dead-end jobs and results in the transfer of wealth out of the community by businesses that are not locally owned. We disagree, and, for many reasons, support the expansion of new, high-quality retailing in inner cities by independents and national chains.

First, profit as a percentage of sales for retail businesses is typically low, averaging 2 to 3 percent in grocery, even for the best performers. Any profits "taken out" of the community are dwarfed by the wages paid to employees, which account for approximately 20 percent of sales. By far the greatest export of money from the inner city is in the form of retail demand that is not met locally. New and high-quality inner-city retailing would result in more local spending and thus more local jobs. Additionally, increased market competition would generate lower prices and better selection, thereby increasing the spending power of inner-city consumers.

Second, although many retail jobs are not high paying, they do provide an entry into the job market, an opportunity to learn basic work skills, and access to training programs. Further, not all retail and service jobs are "dead end," as many retailers promote heavily from within. For example, at McDonald's, which employs 12 percent of all teenagers working in formal jobs, 67 percent of its restaurant managers, 60 percent of its senior management, and 33 percent of its franchise owners began as crew workers. Also, consider that 40 percent of American citizens who enter the work force find their first jobs in retailing.

The Role of Government and Community Groups

City government can do much more to provide support for retail activity and build on existing momentum. The most important steps: eliminating the zoning and permitting morass, assisting in land assembly and reclamation, upgrading streets, improving parking and appearance, reducing crime, and improving public transportation and access to retail areas.

Community groups are well positioned to serve as catalysts for change: disseminating market information to encourage private-sector investment; locating and promoting areas suitable for business development; assisting with community relations; screening job applicants; and training new employees. These groups' efforts in community building and stabilization have been essential to positioning inner cities for economic development and ever-increasing private-sector-led investment.

The Action Agenda

Despite this large and growing market of customers, many retailers overlook the inner city because they underestimate its spending potential and overestimate the risk. The answers to four fundamental questions make a compelling business case for inner-city retailing.

First, is there a market in the inner city, and if so, what are the most attractive opportunities? Yes, America's inner cities represent approximately $85 billion in annual purchasing power, or approximately 7 percent of total retail spending in the U.S. In many markets, more than 25 percent of retail demand is unmet locally. The supply deficit appears most acute within basic categories such as food and apparel.

Second, what are consumers' unmet needs? Results from surveys of consumers and retailers indicate that inner-city demand is largely driven by standard preferences for competitive offerings. Yet, inner-city consumers seek some degree of tailoring to meet distinct preferences.

Third, is retailing in this market attractive? Success is not guaranteed. However, many retailers are benefiting from high foot traffic and concentrated spending power, and are generating sales per square foot comparable to regional averages or higher. While some operating costs may be more burdensome than in other locations, high volume and preferences for certain high-margin goods translate into attractive bottom-line results.

Fourth, what are the critical success factors and the challenges to success? Success in the inner city requires: (1) leadership that believes in the inner-city opportunity and manages with the firm expectation of profitability, (2) operational excellence commensurate with that in non-inner-city operations, including the adoption of proven strategies to deal with shrink, crime, and human resources challenges, and (3) sophisticated and flexible strategies to tailor products and services to meet the diverse and, in many cases, growing needs of this market.

The nature of the inner-city retail opportunity varies by sector. In grocery, there is a tremendous need to increase storing—big box, small box, and convenience formats—to fill unmet demand. Additionally, there is an opportunity in the grocery superstore format, particularly in high-traffic locations that serve both inner-city and adjacent urban markets. In the last few years, a few grocery superstores have established such "edge" market locations.

In apparel, there is a dearth of world-class formats—specialty shops, big-box stores, and outlets. Some markets, such as Boston and Harlem, are vastly underpenetrated in apparel. In pharmacy, increased storing and tailored hair care and cosmetic products are in demand. In fast food, many markets appear well penetrated in select food categories but totally lacking in others. There is an opportunity for restaurants to fill in across categories and cater to distinctive tastes and ethnic markets.

The mass merchant or discount department store sector is also significantly underpenetrated in the inner city. Retailers in this segment clearly have the ability to offer the price point and merchandise mix necessary to capture a share of the inner-city market. Opening stores in "edge" market locations that can draw from a wider urban population is an approach these retailers should pursue.

A significant opportunity is available to large retail chains and to savvy inner-city entrepreneurs. Many have argued that the reentry of large chain stores in inner cities could threaten the viability of independents. However, our research indicates that inner-city retailing is not a "zero-sum" game, in which large retailers automatically displace smaller independents.

One respected chain retail executive told us, "Independent entrepreneurs are capable of running circles around larger chains." By being closer to the marketplace, independent entrepreneurs can better understand neighborhood dynamics; therefore, they can more effectively tailor their offering to the specific needs of shoppers in the inner city. In a niche market, an independent entrepreneur's size can be an advantage, allowing a quicker response to changing tastes and preferences in the marketplace. Independent entrepreneurs are also positioned to form strong relationships with each of their customers and provide a high level of service.

To capture a share of the inner-city market, independent entrepreneurs can develop opportunistic retailing strategies and execute best retail practices. To maintain share in the face of competition from chains, independents also can define a niche position that complements rather than competes with chain offerings. The presence of larger retailers has meant increased foot traffic and profits for inner-city-based entrepreneurs who have created niche businesses with tailored product configurations.

Seizing the Opportunity

Competitive advantage will flow to the early movers in the game—retailers, the local business community, developers, city government, and community leaders. For American retailers, the message should be clear. Begin today to invest in and profit from one of the largest and closest emerging markets in the world—U.S. inner cities. Create the capability to select sites, merchandise, and employees in inner cities. This is the last big underserved market in the U.S.

Endnotes

[1] There are several definitions of "inner city." This study uses the term to refer to economically distressed urban communities that we have defined as zip codes where the median household income is no more than 75 percent of the median for the metropolitan statistical area and where the unemployment rate is at least 30 percent above and its poverty rate at least 50 percent above the metropolitan average. These data are drawn from the 1990 U.S. Census. We have relied on zip codes instead of census tracts for these calculations because business data is collected by zip code, allowing us to compare retail demand and supply for the same geographic area.

[2] The 47 percent of disposable income spent on retail goods is a national ratio that does not adjust for the ethnic and income distribution in inner cities.

[3] In calculating total inner-city retail demand and the unmet market gap, this study does not include the potential retail spending effects of the unrecorded economy. The unrecorded economy includes illegal activities such as the drug and gambling economy but largely comprises legal but unrecorded activities such as income transfers, household improvements, housekeeping, gardening, child care, and street vendors. Although no statistically reliable method has been developed to measure the cash economy, the unrecorded economy nationwide is generally acknowledged to exceed $1 trillion, which means that 17 percent of America's GDP is unreported [Source: M. Leanne Lachman, "Hidden Income = Hidden Potential," International Council of Shopping Centers, Inc., *Research Quarterly* (Volume 2, No. 2)]. A $1 trillion national unrecorded economy averages $10,400 in off-the-books revenue for every household in the U.S. The unrecorded or cash economy is thought to be most active in low- and moderate-income neighborhoods such as inner cities. We have very conservatively estimated it to be $15 billion, which is an additional 17 percent of inner-city

retail demand or 8 percent of inner-city household income ($182.2 billion).

4 Retail supply was estimated from the 1992 Census of Retail Trade. Retail sales were calculated by zip code and aggregated for the entire inner-city area. Certain zip code sales estimates were adjusted to account for the excess sales of centers at inner-city edge locations that cater to inner-city and non-inner-city shoppers. In those zip codes, inner-city demand was assumed to be fully met, and thus excess supply was eliminated. To arrive at basic consumer retail sales, the zip-code sales for the following categories were deducted from the total: auto, building materials, nonstore retail, reimbursed pharmacy, and home heating fuel. Potential purchases of these items were excluded from our estimates for inner-city retail demand.

5 Surrounding areas include all non-inner-city zip codes within the metropolitan statistical area.

6 U.S Census, Employment Outlook: 1994-2005, *Monthly Labor Report*, 1995.

7 Focus groups were conducted on April 7 and 8, 1997. Each session was two hours long. Participants ranged in age from 20 to 55.

8 Source: "Retailers Have Harlem on Their Mind," David Dunlap, *New York Times*, November 10, 1996.

9 Source: Upper Manhattan Empowerment Zone Development Corporation.

10 Source: "Hispanic Dollars Flow as Stores Redo Merchandise Mix," Jennifer Steinhauer, *New York Times*, July 2, 1997.

11 Source: "Just Spiffy," Johnathan R. Laing, *Barron's*, March 24, 1997.

Acknowledgements

Underwriting for ICIC's work was generously provided by The Alfred P. Sloan Foundation.

This report was made possible primarily through the efforts of The Boston Consulting Group, The Initiative for a Competitive Inner City, and ICIC's retail advisory board.

Advisory Board Members:

Michael E. Porter, C. Roland Christensen Professor of Business Administration, Harvard Business School (Chairman)

Peter Borges, President, The Retail Initiative, Local Initiatives Support Corporation

Anthony Downs, Senior Research Fellow, Brookings Institution and the Urban Land Institute

Joe Ellis, Limited Partner and retired Vice President & Senior Research Analyst, Goldman Sachs

Ronald Homer, Partner, Access Capital Strategies LLC

Charles Kendrick, Jr., Managing Director, Clarion Ventures, LLC and Trustee of the Urban Land Institute

Jack Kramer, Senior Vice President of Advertising and Corporate Communications, CVS Corporation

Craig Kurlander, Divisional Vice President of Geo-Demographic Merchandising, Kmart Corporation

Jeffrey Levitan, Senior Vice President of Strategic Management, Staples Inc.

Kenneth Lombard, President, Magic Johnson Theaters Development Corp.

Michael McCarty, Senior Vice President, Simon DeBartolo Group

William Pickard, Chairman, Regal Plastics Company and owner/operator of McDonald's restaurants in Detroit

Lynne Sagalyn, Professor and Program Coordinator, Columbia University Graduate School of Business

Walter Salmon, Professor Emeritus, Harvard Business School

Steven Samuels, President, Samuels & Associates

Malcolm Sherman, Chairman and Chief Executive Officer of Ekco Group and former Chief Executive Officer of Zayre Stores

Deborah Wright, President and Chief Executive Officer, Upper Manhattan Empowerment Zone Development Corporation

The Boston Consulting Group team was led by Mark Blaxill, Vice President, and Jean Mixer, Manager, and included Rick Corcoran, Consultant, and Kasey Craig, Associate.

The Initiative for a Competitive Inner City team was led by Michael E. Porter, Chairman and Chief Executive Officer, and included Anne Habiby, Director of Research and Communications; Lorn Davis, Assistant Vice President of Research; Elisabeth Reynolds, Assistant Vice President; Amelia Alberghini, Senior Analyst; and Rob Devaney, Research and Development Analyst.

Marketing Development, Inc., and Marketing Insights of California conducted focus groups on a pro bono basis.

About the Sponsors

The Initiative for a Competitive Inner City (ICIC) is a national, not-for-profit organization founded in 1994 by Harvard Business School professor Michael E. Porter. ICIC's mission is to transform thinking, reinvigorate market forces, and engage the private sector in fostering healthy economies in America's inner cities that create jobs, income, wealth, and economic opportunities for local residents. ICIC has offices in Baltimore, Boston, Kansas City, and Oakland, California.

The Boston Consulting Group (BCG) is a leading international management consulting firm with locations in major business centers around the globe. The firm's mission is to help its clients create and sustain competitive advantage and thereby achieve superior shareholder returns. BCG also undertakes selected pro bono assignments such as this one on important public and broad private-sector issues.

This report is part of ICIC's national retail study entitled Catalyzing Private Sector Inner-City Retail Investment & Services. Upcoming parts of the study include *The Inner-City Shopper Survey, Opportunities and Strategies for Independent Retailers, Best Practices for Profitable Retail Execution, and Measuring Inner-City Purchasing Power.*

For additional information on this research, contact Deirdre Coyle, Director of Communications, the Initiative for a Competitive Inner City, 617 292-2363 (phone); 617-292-2380 (fax); dcoyle@icic.org (e-mail), or Joan Wheeler, Marketing Communications, The Boston Consulting Group, 617 973-1347 (phone); 617 973-1397 (fax); wheeler.joan@bcg.com (e-mail).

For general information about the Initiative as well as the text of this report, please visit ICIC's web site at: http://www.icic.org.

THE BOSTON CONSULTING GROUP

BCG

in partnership with

The Initiative for a Competitive Inner City