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Minding the Store: Analyzing Customers, Best Buy Decides Not All Are Welcome; Retailer Aims to Outsmart Dogged Bargain-Hunters, And Coddle Big Spenders; Looking for 'Barrys' and 'Jills'

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Abstract (Document Summary)

Mr. Anderson worries that his two rivals "are larger than us, have a lower [overhead], and are more profitable." In five years, he fears, Best Buy could wind up like Toys 'R' Us Inc., trapped in what consultants call the "unprofitable middle," unable to match Wal-Mart's sheer buying power, while low-cost online sellers like Dell pick off its most affluent customers. Toys 'R' Us recently announced it was considering exiting the toy business.

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Full Text (2135 words)

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Brad Anderson, chief executive officer of Best Buy Co., is embracing a heretical notion for a retailer. He wants to separate the "angels" among his 1.5 million daily customers from the "devils."

Best Buy's angels are customers who boost profits at the consumer-electronics giant by snapping up high-definition televisions, portable electronics, and newly released DVDs without waiting for markdowns or rebates.

The devils are its worst customers. They buy products, apply for rebates, return the purchases, then buy them back at returned-merchandise discounts. They load up on "loss leaders," severely discounted merchandise designed to boost store traffic, then flip the goods at a profit on eBay. They slap down rock-bottom price quotes from Web sites and demand that Best Buy make good on its lowest-price pledge. "They can wreak enormous economic havoc," says Mr. Anderson.

Best Buy estimates that as many as 100 million of its 500 million customer visits each year are undesirable. And the 54-year-old chief executive wants to be rid of these customers.

Mr. Anderson's new approach upends what has long been standard practice for mass merchants. Most chains use their marketing budgets chiefly to maximize customer traffic, in the belief that more visitors will lift revenue and profit. Shunning customers -- unprofitable or not -- is rare and risky.

Mr. Anderson says the new tack is based on a business-school theory that advocates rating customers according to profitability, then dumping the up to 20% that are unprofitable. The financial-services industry has used a variation of that approach for years, lavishing attention on its best customers and

penalizing its unprofitable customers with fees for using ATMs or tellers or for obtaining bank records.

Best Buy seems an unlikely candidate for a radical makeover. With \$24.5 billion in sales last year, the Richfield, Minn., company is the nation's top seller of consumer electronics. Its big, airy stores and wide inventory have helped it increase market share, even as rivals such as Circuit City Stores Inc. and Sears, Roebuck & Co., have struggled. In the 2004 fiscal year that ended in February, Best Buy reported net income of \$570 million, up from \$99 million during the year-earlier period marred by an unsuccessful acquisition, but still below the \$705 million it earned in fiscal 2002.

But Mr. Anderson spies a hurricane on the horizon. Wal-Mart Stores Inc., the world's largest retailer, and Dell Inc., the largest personal-computer maker, have moved rapidly into high-definition televisions and portable electronics, two of Best Buy's most profitable areas. Today, they rank respectively as the nation's second- and fourth-largest consumer-electronics sellers.

Mr. Anderson worries that his two rivals "are larger than us, have a lower [overhead], and are more profitable." In five years, he fears, Best Buy could wind up like Toys 'R' Us Inc., trapped in what consultants call the "unprofitable middle," unable to match Wal-Mart's sheer buying power, while low-cost online sellers like Dell pick off its most affluent customers. Toys 'R' Us recently announced it was considering exiting the toy business.

This year, Best Buy has rolled out its new angel-devil strategy in about 100 of its 670 stores. It is examining sales records and demographic data and sleuthing through computer databases to identify good and bad customers. To lure the high-spenders, it is stocking more merchandise and providing more appealing service. To deter the undesirables, it is cutting back on promotions and sales tactics that tend to draw them, and culling them from marketing lists.

As he prepares to roll out the unconventional strategy throughout the chain, Mr. Anderson faces significant risks. The pilot stores have proven more costly to operate. Because different pilot stores target different types of customers, they threaten to scramble the chain's historic economies of scale. The trickiest challenge may be to deter bad customers without turning off good ones.

"Culturally I want to be very careful," says Mr. Anderson. "The most dangerous image I can think of is a retailer that wants to fire customers."

Mr. Anderson's campaign against devil customers pits Best Buy against an underground of bargain-hungry shoppers intent on wringing every nickel of savings out of big retailers. At dozens of Web sites like FatWallet.com, SlickDeals.net and TechBargains.com, they trade electronic coupons and tips from former clerks and insiders, hoping to gain extra advantages against the stores.

At SlickDeals.net, whose subscribers boast about techniques for gaining hefty discounts, a visitor recently bragged about his practice of shopping at Best Buy only when he thinks he can buy at below the retailer's cost. He claimed to purchase only steeply discounted loss leaders, except when forcing Best Buy to match rock-bottom prices advertised elsewhere. "I started only shopping there if I can [price match] to where they take a loss," he wrote, claiming he was motivated by an unspecified bad experience with the chain. In an e-mail exchange, he declined to identify himself or discuss his tactics, lest his targets be forewarned.

Mr. Anderson's makeover plan began taking shape two years ago when the company retained as a consultant Larry Selden, a professor at Columbia University's Graduate School of Business. Mr. Selden has produced research tying a company's stock-market value to its ability to identify and cater to profitable customers better than its rivals do. At many companies, Mr. Selden argues, losses produced by devil customers wipe out profits generated by angels.

Best Buy's troubled acquisitions of MusicLand Stores Corp. and two other retailers had caused its share price and price-to-earnings ratio to tumble. Mr. Selden recalls advising Mr. Anderson: "The best

time to fix something is when you're still making great money but your [price- to-earnings ratio] is going down."

Mr. Selden had never applied his angel-devil theories to a retailer as large as Best Buy, whose executives were skeptical that 20% of customers could be unprofitable. In mid-2002, Mr. Selden outlined his theories during several weekend meetings in Mr. Anderson's Trump Tower apartment. Mr. Anderson was intrigued by Mr. Selden's insistence that a company should view itself as a portfolio of customers, not product lines.

Mr. Anderson put his chief operating officer in charge of a task force to analyze the purchasing histories of several groups of customers, with an eye toward identifying bad customers who purchase loss-leading merchandise and return purchases. The group discovered it could distinguish the angels from the devils, and that 20% of Best Buy's customers accounted for the bulk of profits.

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Mr. Anderson was furious, and Mr. Keskey says he wondered whether it was time to leave the company. But after meeting with the chief operating officer and with Mr. Selden, Mr. Keskey realized there was no turning back, he says.

Best Buy concluded that its most desirable customers fell into five distinct groups: upper-income men, suburban mothers, small-business owners, young family men, and technology enthusiasts. Mr. Anderson decided that each store should analyze the demographics of its local market, then focus on two of these groups and stock merchandise accordingly.

Best Buy began working on ways to deter the customers who drove profits down. It couldn't bar them from its stores. But this summer it began taking steps to put a stop to their most damaging practices. It began enforcing a restocking fee of 15% of the purchase price on returned merchandise. To discourage customers who return items with the intention of repurchasing them at an "open-box" discount, it is experimenting with reselling them over the Internet, so the goods don't reappear in the store where they were originally purchased.

"In some cases, we can solve the problem by tightening up procedures so people can't take advantage of the system," explains Mr. Anderson.

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Timothy C. Storm, president of Roscoe, Ill.-based FatWallet, said the information may have leaked from someone who had an early look at advertisements scheduled to run the day after Thanksgiving.

In a letter to Mr. Storm, Best Buy explained it was cutting the online link between FatWallet and BestBuy.com because the referrals were unprofitable. The letter said it was terminating all sites that "consistently and historically have put us in a negative business position."

Mr. Storm defends FatWallet.com's posters as savvy shoppers. "Consumers don't set the prices. The merchants have complete control over what their prices and policies are," he says.

Shunning customers can be a delicate business. Two years ago, retailer Filene's Basement was

vilified on television and in newspaper columns for asking two Massachusetts customers not to shop at its stores because of what it said were frequent returns and complaints. Earlier this year, Mr. Anderson apologized in writing to students at a Washington, D.C., school after employees at one store barred a group of black students while admitting a group of white students.

Mr. Anderson says the incident in Washington was inappropriate and not a part of any customer culling. He maintains that Best Buy will first try to turn its bad customers into profitable ones by inducing them to buy warranties or more profitable services. "In most cases, customers wouldn't recognize the options we've tried so far," he says.

Store clerks receive hours of training in identifying desirable customers according to their shopping preferences and behavior. High-income men, referred to internally as Barrys, tend to be enthusiasts of action movies and cameras. Suburban moms, called Jills, are busy but usually willing to talk about helping their families. Male technology enthusiasts, nicknamed Buzzes, are early adopters, interested in buying and showing off the latest gadgets.

Staffers use quick interviews to pigeonhole shoppers. A customer who says his family has a regular "movie night," for example, is pegged a prime candidate for home-theater equipment. Shoppers with large families are steered toward larger appliances and time-saving products.

The company hopes to lure the Barrys and Jills by helping them save time with services like a "personal shopper" to help them hunt for unusual items, alert them to sales on preferred items, and coordinate service calls.

Best Buy's decade-old Westminster, Calif., store is one of 100 now using the new approach. It targets upper-income men with an array of pricey home-theater systems, and small-business owners with network servers, which connect office PCs, and technical help unavailable to other customers.

On Tuesdays, when new movie releases hit the shelves, blue-shirted sales clerks prowl the DVD aisles looking for promising candidates. The goal is to steer them into a back room that showcases \$12,000 high-definition home-theater systems. Unlike the television sections at most Best Buy stores, the room has easy chairs, a leather couch, and a basket of popcorn to mimic the media rooms popular with home-theater fans.

At stores popular with young Buzzes, Best Buy is setting up videogame areas with leather chairs and game players hooked to mammoth, plasma-screen televisions. The games are conveniently stacked outside the playing area, the glitzy new TVs a short stroll away.

Mr. Anderson says early results indicate that the pilot stores "are clobbering" the conventional stores. Through the quarter ended Aug. 28, sales gains posted by pilot stores were double those of traditional stores. In October, the company began converting another 70 stores.

Best Buy intends to customize the remainder of its stores over the next three years. As it does, it will lose the economies and efficiencies of look-alike stores. With each variation, it could become more difficult to keep the right items in stock, a critical issue in a business where a shortage of a hot-selling big-screen TV can wreak havoc on sales and customer goodwill.

Overhead costs at the pilot stores have run one to two percentage points higher than traditional stores. Sales specialists cost more, as do periodic design changes. Mr. Anderson says the average cost per store should fall as stores share winning ideas for targeting customers.

Holding Steady

Best Buy still ranks first in terms of consumer-electronics revenue, but emerging rivals are climbing fast.

Estimated 1997 consumer-electronics sales

Best Buy \$7.6 billion
Circuit City \$6.8
CompUSA \$5.1
RadioShack \$3.2
Sears Roebuck \$3.2

Estimated 2003 consumer-electronics sales

Best Buy \$19.5 billion
Wal-Mart \$15.7
Circuit City \$9.8
Dell \$6.3
Target Stores \$5.0

Source: Retail Forward