

# Carnegie Consulting

*Strategic Solutions for Business*

Profitability through a Refocusing on  
an Older and More Affluent Demographic

Prepared for:

**NORDSTROM**

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## Executive Summary

Nordstrom has a long established history of providing quality products and excellent customer service. Like many of the upscale retail department stores catering to an older and more affluent consumer base, Nordstrom relies on its reputation to provide higher profit margins and a loyal customer base. The threat of entry into the market is significantly reduced due to the requisite branding for an entering company and the loyalty of existing customers. The buyer power in the retail department store industry is limited because individual buyers rather than firms or conglomerations are the purchasers. Supplier power tends to be more significant since department stores rely on a supplier's brand to provide incentives for the consumer to shop at its store.

Initially, Nordstrom's focus and attention on the needs of its customers allowed it to expand and profit in the retail industry. Recently, its lack of customer attention has resulted in reduced profitability. In an effort to attract a younger consumer, Nordstrom altered its buying strategy and the overall ambiance of its stores. The fashions that attracted an older and more affluent consumer were replaced by styles targeted towards a younger and more "hip" demographic. Although this is not always a bad strategy, Nordstrom has failed to attract the targeted demographic, resulting in large expenses associated with their inability to turn over inventory.

Carnegie Consulting's analysis of Nordstrom's current market position and potential for future profitability leads us to the recommendation that Nordstrom refocus on the client base that made the firm successful. There are several reasons why for Nordstrom an older and more affluent demographic is superior to a younger and less affluent one. First, disposable income substantially increases, which directly translates into an ability to purchase more expensive items. Second, older consumers tend to be more company loyal and more willing to invest in relationships with a firm. Third, because consumers are more willing to invest in a relationship, customer service levels will increase because there is a larger financial incentive for the sales team. Finally, this demographic already believes that Nordstrom was created for them. They will eagerly return when Nordstrom turns its attention back to them.

Refocusing on the traditional Nordstrom demographic will not be accomplished quickly, just as the movement away was not immediate. Carnegie Consulting outlines a few initial steps that should be taken by Nordstrom to accomplish this task including (1) a marketing campaign focused on attracting an older and wealthier demographic and (2) increased Nordstrom buyer awareness of the target demographic's fashion requirements. Carnegie Consulting believes that this refocus will allow Nordstrom to prosper in the future.

## Company History

In 1901, John Nordstrom and Carl Wallin created Wallin & Nordstrom, a small shoe store in downtown Seattle. The philosophy of the company was to provide a large selection of quality

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products with high levels of customer service. The success of the store led to the opening of a second store in 1923.

The retirement of John Nordstrom in 1928 brought the second generation of the Nordstrom family into the business. A year later, Carl Wallin also retired and sold his shares to the Nordstrom family. By 1960, Wallin & Nordstrom was the largest independent shoe chain in the United States with eight stores in Washington and Oregon. The 1960's also marked the firm's first foray into clothing apparel with the purchase of Best Apparel. A name change followed and customers began shopping at Nordstrom Best. The late 1960s also saw the appearance of both men's and children's clothing in the stores.

The third generation of Nordstroms took charge of the company in 1968. The company went public on July 29<sup>th</sup> 1971 at \$24.50. Adjusted for stock splits the value was \$0.5104. Two years after going public, Nordstrom Best passed \$100 million dollars in sales and formally changed its name to Nordstrom, Inc.

In 1975, the first Nordstrom Rack opened in Seattle. The Rack opened as a clearance center for full-line store items, allowing for continual change in merchandise. Three years later, Nordstrom entered the California retail market, followed by store openings on the East Coast in 1988.

Along with large scale expansion, the third generation of Nordstrom owners ushered in an ill conceived new management philosophy. Nordstrom moved away from focusing on an older and wealthier demographic towards a younger and less affluent one. The attention to store level details such as independent buyers was removed in favor of mass purchasing on a national level. Removing buying decisions from the local level reduced the ability of Nordstrom stores to efficiently cater to the unique needs of its clientele. In turn, this resulted in inventory that could not be sold increasing costs and reducing profit margins.

In 2001, celebrating its 100<sup>th</sup> birthday, Nordstrom had 120 stores throughout the United States of which 77 were full-line, 38 were clearance, 2 were free-standing shoe stores and 3 were Facconable boutiques purchased in 2000. Despite its strong growth, Nordstrom faces serious financial problems. While revenues have grown by 91.2% over the past 11 years, expenses have grown 97.5% equating to a 5.9% drop in earnings. Also the growth in revenues was fueled by store expansion and not increases in same store sales, which were stagnant at an average of .94% growth.<sup>1</sup>

## Internal Rivalry

Nordstrom is an upscale retail department store which competes with Neimen Marcus, Bloomingdales and Saks 5<sup>th</sup> Avenue, among others. Retail department stores sell men's, women's and children's<sup>2</sup> apparel along with shoes and accessories. The standard industrial classification is 5651.

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<sup>1</sup> Nordstrom. 10 Year Statistical Summary. 2 April 2002  
<[http://about.nordstrom.com/aboutus/investor/10yr\\_stats.asp](http://about.nordstrom.com/aboutus/investor/10yr_stats.asp)>

<sup>2</sup> Many Nordstrom stores do not offer children's clothing.

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The retail industry can be understood by examining two criteria: breadth of product line and value added. Nordstrom carries a large variety of products and has a high level of customer service, ambiance and brand image. Because of its positioning, Nordstrom does not compete on prices but rather on factors like service and quality (i.e. higher value added). The high level of “extras” provided by such department stores results in higher margins and lower volumes. Department stores like Bloomingdales and Saks 5<sup>th</sup> Avenue also have similar positioning in the market.

The other side of the department store spectrum stands stores like Macy’s and JC Penney. They offer a wide variety of products but compete largely on price. The value added to the shopping experience (e.g. piano player in the lobby, uncluttered clothing selection and overall store appearance) is low, relying more on higher volume sales to offset lower margins.

## Substitutes and Complements

Substitutes can constitute a threat to the industry, decreasing its customer base and providing some price competition. The main substitutes are niche retail stores, online retail sites, discount stores and mail order retailers. Niche retail stores, such as Banana Republic and Armani Exchange, provide similar apparel to that offered in a department store, though they commonly offer a narrower range of choice. Sometimes the products are identical, such as many products in Ralph Lauren stores, so competition is largely focused on convenience and selection. Other niche stores, such as Banana Republic, provide different brands that compete directly with the products carried by department stores. These niche competitors do not compete directly with retail department stores. They instead pose a flanking threat by offering a more limited and specialized set of goods. By specializing in a specific category of customers or goods, they can provide a focused experience and lower prices than upscale retail department stores that attempt to focus on a wide range of goods and customers.

The recent proliferation of online retail sites, such as Bluefly.com, has placed additional price pressure on the department store industry. Online retail sites offer discount prices on goods that are often identical to those in a department store. They cater to customers who are concerned about brand and quality, but prefer price over service. Customers sometimes use the retail department stores and their services to experiment with goods they intend to purchase online. This increases the costs for department stores while depriving them of revenue. As high-end customers become more accustomed to the Internet, particularly to purchasing goods online, the threat of online retail to upscale retail department stores will grow.

Mail order retailers like Lands’ End share many of the characteristics of online retailers. Because they lack a significant “brick and mortar” presence, they too have the ability to be more price competitive than department stores. They also realize efficiency gains in inventory management since the number of distribution points tends to be limited. As mail order retailers have become more accepted and have established brand images, they have encroached upon the traditional consumer base of high end retail department stores.

The financial success of department stores is often related to the health of complementary industries, such as malls. Upscale department stores serve as “anchors” because they can attract consumers. Nordstrom has been particularly successful playing this role. Anchors

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receive rent reductions as an inducement for them to locate at specific malls. The profitability of such stores is correlated with the financial health of their mall, with popular malls generating additional foot traffic due to shopping externalities and correspondingly higher sales at their anchor stores.

Upscale department stores are also affected by the strength of upscale job markets, with many of their customers buying clothes for work in industries such as law and banking. Strong growth in high-income employment fuels demand for the goods and services in which upscale department stores specialize. This growth in demand is focused on work attire, but also spills into other departments because customers often decide to buy additional apparel once they are in the stores. A societal move toward casual dress in the workplace has not been good for Nordstrom.

## Entry

The major threat of entry into the upscale retail department store market comes from established niche firms expanding their selection and stealing a portion of the consumer base. There are significant advantages to this approach over a direct entry into the department store industry through opening a completely new department store. The supply chain is already established along with a brand name and customer base. Also, the entry can be accomplished gradually with incremental expansion of the product line.

## Buyer and Supplier Power

### *Buyer Power*

Buyer power in the industry is limited due to the size of individual purchases. The overwhelming customer base of the retail department store is the end consumer and not large volume buyers. This results in the inability of the buyer to extract profits from the seller.

There are certain factors that increase buyer power. The geographic proximity of many department stores and publishing of prices online allows consumers to shop efficiently. Also, proximity of competitors reduces the switching cost for consumers while aggregating shoppers into a single location.

### *Supplier Power*

Suppliers in the retail department store industry tend to have substantial power. Land and buildings are a major component of retail cost and their scarcity in places of high population density allows the supplier to extract a significant portion of the retailer surplus. Developers of retail sites are also able to capture most of the site rents that come from the externalities of agglomeration previously discussed. Nordstrom, as an anchor store, however, is also able to capture a part of these site rents as well.

The ability of clothing suppliers to extract profits from the buyer is based on their brand's ability to attract consumers. Designers who create successful branding can charge higher

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prices than companies whose products are essentially commodities. This is especially significant for a store like Nordstrom that caters to a high end, brand conscious clientele.

## **Strengths, Weaknesses, Opportunities and Threats**

### *Strengths*

#### Customer Loyalty and Satisfaction

Customer loyalty and satisfaction are closely intertwined. The most recent figures released in the American Customer Satisfaction Index (ACSI) show that Nordstrom is highly competitive with other department stores in customer satisfaction, receiving a rating of 76. Nordstrom's rating is higher than competitors such as May Company and Federated Department Stores.

Employees of Nordstrom interviewed by Carnegie Consulting believe that customer satisfaction is one of the company's most important attributes. Indeed, they largely credit Nordstrom's care and attentiveness as the reason for customers choosing it over less costly alternatives. Specifically, Nordstrom employs personnel and establishes company policies that are very customer-friendly. For example, Nordstrom allows customers to return products regardless of the purchase date. During many visits employees were extraordinarily helpful, for example offering to teach one shopper how to tie a bow tie (a timely process).

Customer loyalty is the payoff for such amenable customer service and company policies. Although no specific data were available to confirm their assertion, employees and managers told Carnegie Consulting that the vast majority of Nordstrom's customers are repeat customers. They are loyal to Nordstrom because no other store satisfies their needs as well as Nordstrom. It bears emphasizing that customer loyalty is generated because no stores meet customer needs "as well," not "as cheaply." Nordstrom customer loyalty is not the result of low prices, but of better service.

#### Serving an Important Niche

Nordstrom is not merely another department store whose wide product offerings make it a "store for everyone." Rather, it is differentiated from its competitors as an upscale shopping place for upper-middle to upper-class and late twenties to mid-sixties consumers. Its product selection, employee training, and overall focus position Nordstrom to serve this section of the marketplace better than others. Nordstrom caters to customers who shop at Nordstrom for the product and service quality, rather than price.

Although most of Nordstrom's client base consists of people from the aforementioned demographic strata, Nordstrom also has departments that appeal to a younger clientele, such as The Rail and Brass Plum, and this expands Nordstrom's customer base. In addition to creating sales, these departments help diversify Nordstrom economically, groom new customers and ensure that all customers' needs are being met.

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## *Weaknesses*

### Inventory Management

Nordstrom's managers and floor associates are well aware of its serious deficiency in inventory management, which the company has only recently taken steps to remedy. Inventory management issues are perilous for two reasons: First, they create higher costs and lower margins. The operating margin for Nordstrom over the last five years is 5.59%, which is over four percentage points below the industry average.

Second, and more important for Nordstrom, poor inventory management prevents goods from reaching customers in a timely manner. Anecdotal evidence is abundant. One men's department manager explained that the jeans were counted by hand and reordered every Monday. If one size of jeans sold out on Tuesday the sold-out size would not be re-ordered until the following Monday, and so would not arrive and be placed on the shelves for another week after that. Thus, customers who want a specific item that is not in-store cannot expect the item to be replenished into the Nordstrom inventory in a timely fashion.

New inventory control measures are being instituted across most Nordstrom stores. According to one store manager, preliminary results show that the new system is much more efficient, lowering costs and allowing Nordstrom to serve its customers better. The success of the new inventory control system, however, will depend on how well management and associates are trained to use the system.

### Fashion Mistakes

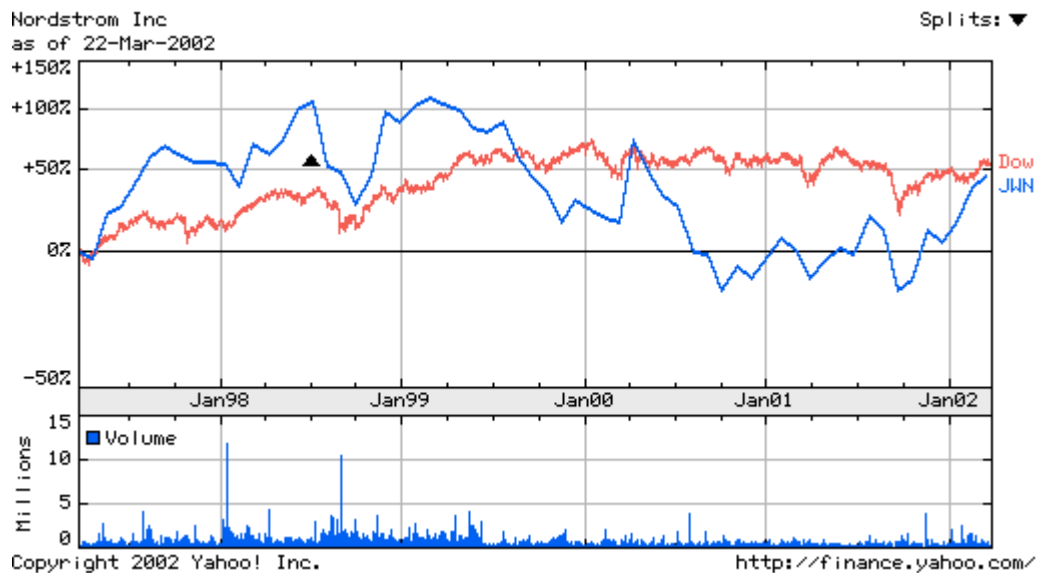
Nordstrom's inability to purchase items attractive to either its traditional or its newly targeted young clientele is a significant failure resulting in decreases to its profit margins and the alienation its consumers. The inventory turnover rate is 3.55 for Nordstrom compared to an industry average of 4.78. The ratio implies that Nordstrom is not providing a product selection attractive to its customers. This results in additional cost of managing and storing the unwanted inventory, along with further decreasing margins due to the necessity of reducing prices in an effort to sell the goods. In addition, consumers, unable to find the desired products, will patronize other department stores eroding Nordstrom's market share.

### Exposure to Business Cycle

Because of Nordstrom's specific clientele base and its competition on service rather than on price, Nordstrom is especially vulnerable to fluctuations in the business cycle. In the following graph, note how Nordstrom (ticker symbol: JWN) follows the trend of the Dow, but greatly amplified.



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Investors are aware that Nordstrom sales are sensitive to economic fluctuations, which in turn adversely affects its stock price.

## *Opportunities*

### Increase Market Share through Expansion

Nordstrom is currently increasing its base of store locations under its three most popular brands. Nordstrom's capital expenditure has grown an average of 4.92% over the last five years while its counterparts in the industry have decreased theirs by 9.10%. The Northeast, Southeast and parts of the Midwest are still largely untapped markets available for Nordstrom. There are also expansion possibilities overseas through the Faconable boutiques. There are dangers associated with expansion and are discussed in the following section.

## *Threats*

### Loss of Focus

Recent managerial decisions to fire local buyers and to centralize fashion decisions and purchasing are contributing to a diminution in the company's effectiveness and to deterioration in Nordstrom's market share. Customers historically preferred Nordstrom, not only because of its outstanding customer service, but also because each store carried items particularly suited to its market. Centralizing buying decisions undoubtedly reduced ordering costs, but this has come at the expense of ordering the wrong items. Individual stores cannot offer the brands and fashions that store managers know their customers want.

### Unfortunate Retailing Trend

The popularity of department stores is decreasing. Much of this trend is due to the increased popularity of smaller, non-department stores such as Banana Republic and J. Crew. These

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stores can serve most, but not all, of the needs of a given Nordstrom shopper, offering dress and casual wear, as well as accessories.

## Financial Outlook

The equity markets have treated Nordstrom's stock positively in the past year (that is, in the trailing twelve months or TTM), although it fell with the rest of the market after the events of September 11th. Over a longer time horizon, however, Nordstrom has suffered significant declines in its stock value from a high close of \$44.188 in February of 1999. Chart 1, below, shows the stock's partial recovery over the past year. However, the chart's value in exposing company trends is minimal because company specific changes are often dominated by overall market conditions.

**Chart 1: Nordstrom Stock Price  
March 2001 – March 2002**

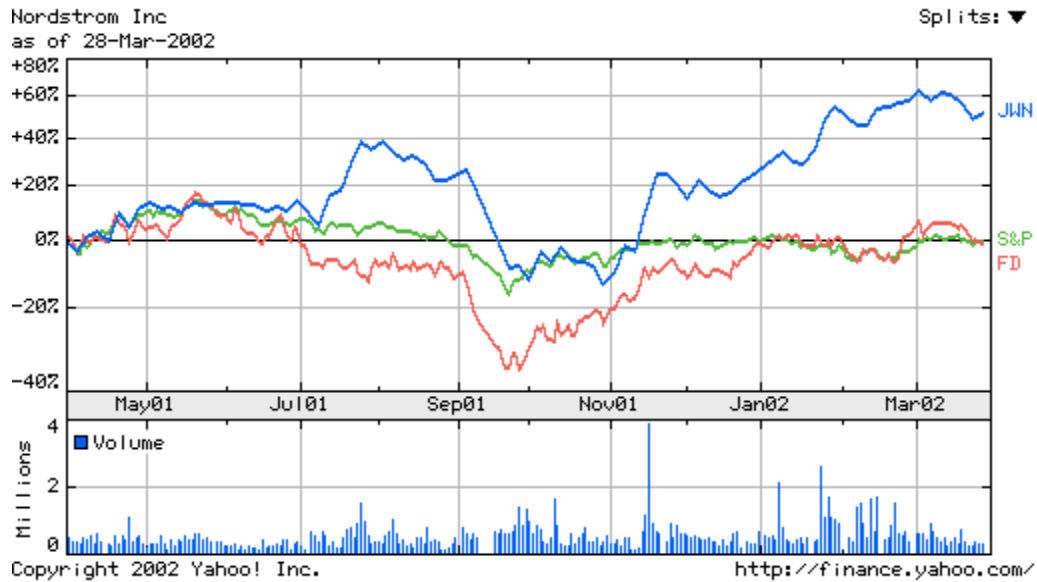


Source: [finance.yahoo.com](http://finance.yahoo.com)

To better examine Nordstrom's stock performance Chart 2 shows the company's stock price changes relative to the S&P 500 index and that of Federated Department Stores' (FD) stock. Federated is one of Nordstrom's biggest competitors operating many of the United States' major department stores, including Bloomingdale's and Macy's. Comparing Nordstrom to a similar company allows one to see company specific trends, which are often otherwise dominated by market and industry factors. Nordstrom has generally outperformed the S&P 500 index and consistently appreciated above Federated. This demonstrates reasonable investor confidence that Nordstrom will improve its financial situation. The sizable appreciation in the stock this year is probably also due to the previous years' decline in the stock relative to the industry, with many investors believing that the stock was brought too low.

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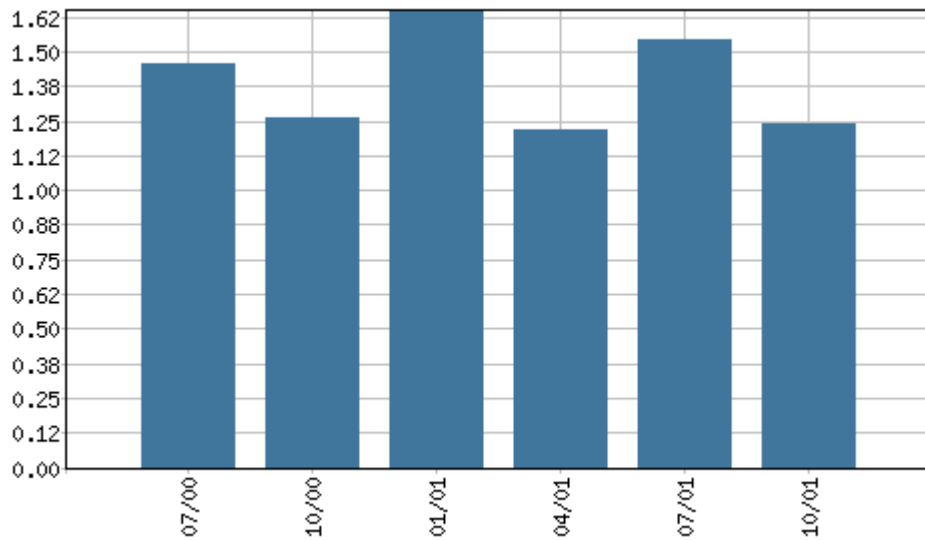
**Chart 2: Nordstrom vs. Federated Department Stores vs. S&P 500 Stock Price  
March 2001 – March 2002**



Source: [finance.yahoo.com](http://finance.yahoo.com)

Revenue growth can be seen on a quarterly basis in Chart 3, with Nordstrom's revenue declining slightly in the past quarter on a year-to-year basis. Overall, revenue growth has been moderate, with reasonable increases relating to company expansion.

**Chart 3 Nordstrom Quarterly Revenue (MM)  
July 2000 – October 2001**



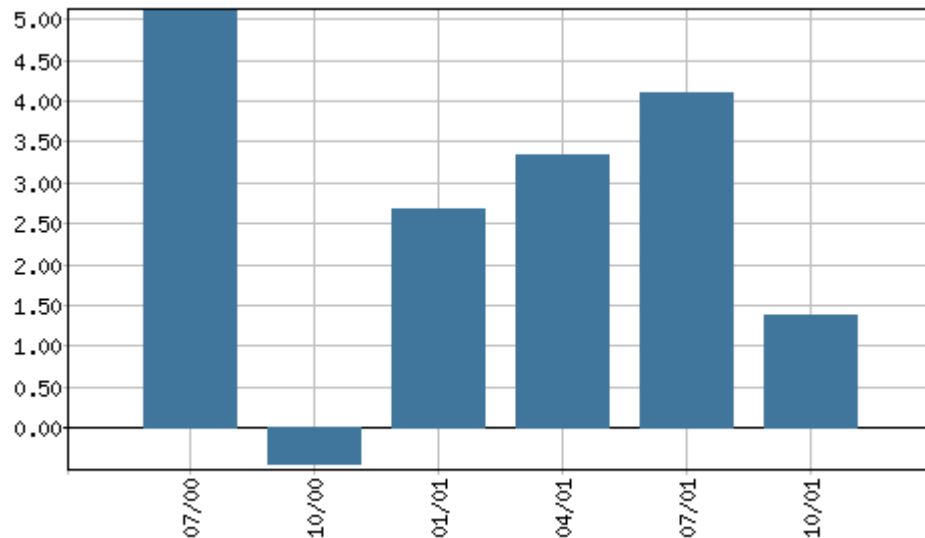
Source: [wsrn.com](http://wsrn.com)

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Despite the reasonable revenue growth Nordstrom has not been able to carry the growth to its earnings before interest and taxes (EBIT). Chart 4 graphically shows the state of the company's operating margins over several quarters. The operating margins for Nordstrom give a more direct picture of ongoing operations than profit margins because it does not reflect interest payments or taxes. However, Nordstrom's profit margins have taken an even larger, although not substantially different, hit because of increasing levels of interest expenses. This is due to Nordstrom's increasing levels of debt, both long term and short term. The chart causes concern about the company's ability to translate revenue growth into growth in its EBIT and, more importantly, its earnings. Improving and maintaining its operating margins is essential to Nordstrom's long-term prosperity, sales growth must be maximized by simultaneous focusing on controlling costs.

**Chart 4: Nordstrom Quarterly Operating Margin (%)**  
July 2000 – October

200



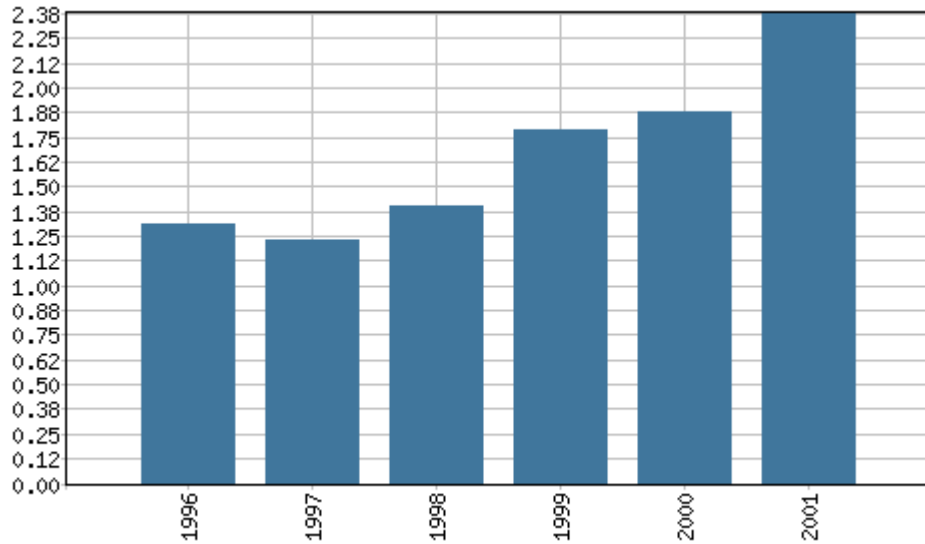
1

Source: [wsrn.com](http://wsrn.com)

Nordstrom has used debt financing to fund almost all of its expansion, even buying back stock since 1996. The company has decreased its shares outstanding from 162.2 MM, in 1996, to 133.8 MM, in 2001, while increasing its total liabilities from \$1.3 B to \$2.4 B. This has led to increasing interest costs, further hurting the company's earnings. The company's long-term debt is rated A- (outlook negative) by S&P and Baa1 (outlook negative) by Moody's. Its commercial paper is rated A-2 and P-2 respectively. These ratings are still relatively strong and do not pose a huge problem for the company, in and of themselves. However, Nordstrom needs to focus on improving its profit margins and controlling its reliance on debt financing, especially if its financial situation continues to darken.

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**Chart 5: Nordstrom Annual Total Liabilities (B)  
1996 – 2001**



Source: [wsrn.com](http://wsrn.com)

## Strategic Analysis:

The future success of Nordstrom is dependent upon a two-pronged approach to the market. The first part is focus. Nordstrom has largely moved away from its demographic focus of pre-1970, which generated healthy returns. Refocusing will allow Nordstrom to reestablish its differentiation from other retail department stores, which is the second part of a strategy to regain profit growth. Although this strategy may eventually restrict the size of the market available to Nordstrom, the alternative is the increasing dependence upon a commoditized market and the stagnant returns that have characterized it.

### Focus

There are certain key characteristics that make an older demographic attractive. Simply put, the older a person becomes the greater their income, wealth, and purchasing power. Households under the age of 35 have an average net worth of \$7,428, while households between 45 and 54 have an average net worth of \$61,248.<sup>3</sup> In addition, older age groups have fewer alternatives for shopping. Unlike younger demographics that have many niche stores competing for their business, older age groups tend to have relatively few. This lack of available competition increases Nordstrom's ability to charge higher prices. Anecdotal evidence also suggests that older age groups are less willing to switch between companies. The saying "tried and true" characterizes their buying habits well.

An older demographic, due to its wealth, tends to have a greater demand for high quality goods than their younger counterparts. The quality issue is important for two reasons. The

<sup>3</sup> United States. Bureau of the Census. Asset Ownership of Households: 1995. Washington: GPO, 1995.

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first is branding and will be discussed in the next section on differentiation. The second is profit margins. Although it is hard to separate the two effects, improved quality brings larger margins due to the socialized mindset that quality equals higher prices.

Another benefit of an older demographic is a natural increase in customer service. Nordstrom's pays its sales force on commission. The idea of commission is to create an incentive for the sales staff to provide a high level of service because of the resulting increase in earnings. The problem with the younger and less affluent consumer groups is that the commission a sales person can earn from each customer is small. When compared to an older demographic, there is less financial incentive for the sales force to provide good service.

## Differentiation

Differentiation creates profits and branding will create differentiation. The Nordstrom name, or brand, has been known for quality and customer service, two qualities that can be restored by refocusing. Branding, the word Nordstrom itself, certifies quality and reduces buyer uncertainty. Purchasing a good from Nordstrom, which is known for quality, removes any lingering doubt of whether the shopper purchased a high quality good or just an expensive one. This certification of quality translates into higher margins justified by the decrease in uncertainty.

Customer service works in a slightly different manner than product quality, and its effects are twofold. The first is that consumers enter the store expecting a certain level of attention. Many consumers value the belief that they are more than a dollar sign to their attendants. They want a sales person that will try to build a relationship and where there is a certain level of trust. Because of this belief, the consumer will invest more in the relationship increasing store loyalty. The acceptance of higher prices in return for quality and service is the second benefit of customer service branding.

## The First Step

When entering a Nordstrom store, customers see televisions hanging from the ceiling playing music videos and groups of teenagers browsing through the aisles. This is largely the result of a conscious management decision to attract younger buyers through The Rail and Brass Plum. It is not necessary to remove these sections, but their prominence should be reduced. An easy first step is to remove the televisions and music that characterize these departments. Also, a shift in the product collection of these sections to attract a more conservative younger consumer will help generate the desired overall ambiance of the store without sacrificing a "feeder" department.

Nordstrom's buyers should refocus on the needs of the core demographic. In the end, customers shop at a store because it carries the product lines that are suited to them at prices they feel are reasonable. Increased attention to the needs of a more mature demographic will draw them back to Nordstrom.

In the past, Nordstrom has not marketed heavily, relying on direct mail pieces along with word of mouth and company reputation to draw consumers. In order to re-establish itself with its traditional clientele, Nordstrom should consider running a brief marketing campaign targeted at more mature demographics. This campaign should subtly send the message that the

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traditional Nordstrom is back. This should not be done until the present fashion and inventory problems have been corrected. Although this will increase expenses in the short-run, the long-term gain in customers will offset the costs.

## A Defensible Market Position

Focus and differentiation on its traditional clientele will once again lead Nordstrom to higher profit margins. A firm trying to enter the market for older and wealthier demographics would have significant barriers to overcome. The company would have to brand itself as catering to this consumer niche. This would be a time consuming and expensive process.

## Conclusion

Focusing on an older and wealthier demographic may ultimately limit the size of the potential market, but it will increase the company's profit potential. There are a large number of firms competing to attract young buyers. Because of this, clothing is largely a commoditized item competing on the basis of price. By focusing on older, up-scale age groups, Nordstrom will target a market that is less price conscious. Nordstrom will also secure a market that has substantial entry barriers and higher profit margins that it needs to support its upscale retail environment. In the long run, Nordstrom will be more stable and financially sound.