

Military Exchange Unification: The Strategic Case for Change

FIRST IN A SERIES

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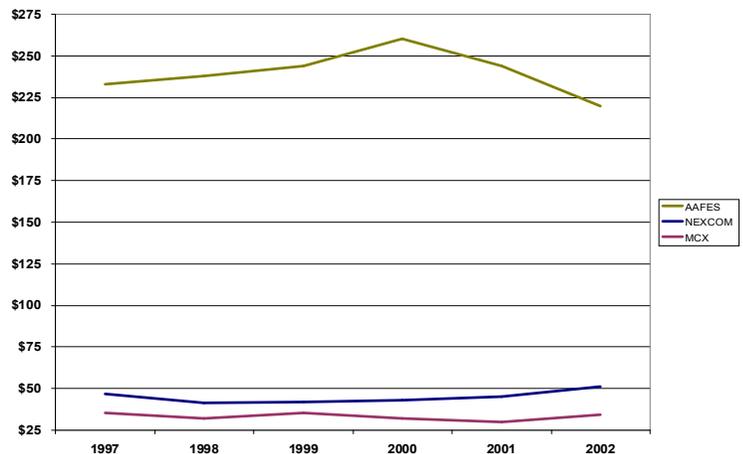
The military exchange system has a long history of serving our armed forces. The Navy Exchange (NEXCOM), the Marine Corps Exchange (MCX), and the Army and Air Force Exchange (AAFES) all offer quality goods and services at uniformly low prices while simultaneously funding critical Morale, Welfare and Recreation (MWR) programs for their respective branches of service. Despite a long-term trend of force reductions dating back to the end of World War II, the exchanges have shown relatively stable revenues and contribution by expanding service offerings and implementing operating improvements (see Exhibit 1a, b, and c). Although it is laudable to hold steady in the face of a declining customer base, the exchange systems' leadership must ask, "Is stable revenue enough in the dynamic retail environment of today? Looking forward, is maintaining the status quo even possible given the further downsizing and redeployment of our forces?"

As has happened before, the rationale for independent exchanges has been challenged and a new task force launched to drive the unification of NEXCOM, MCX, and AAFES. Despite similar recommendations to consolidate and/or privatize dating back more than 30 years, the three exchanges have always managed to avoid or postpone consolidation. Fear of loss of control over MWR contributions,

and fear of the potential pain of losing staff made redundant by consolidation, generates a natural, visceral resistance to unification. Privatization appears impractical because no outside retail organization offers experience in the full breadth of goods and services the exchange system offers. And most important, there is never a good time for consolidating because of pending changes or ongoing efforts. One exchange will be facing major footprint changes while another is in the middle of a comprehensive system implementation and the third has just completed staff reorganization and wants to avoid further confusion.

Unlike past attempts at unification, however, this effort has not required the task force to analyze potential synergies to justify consolidation. Instead, the team has a mandate to develop an

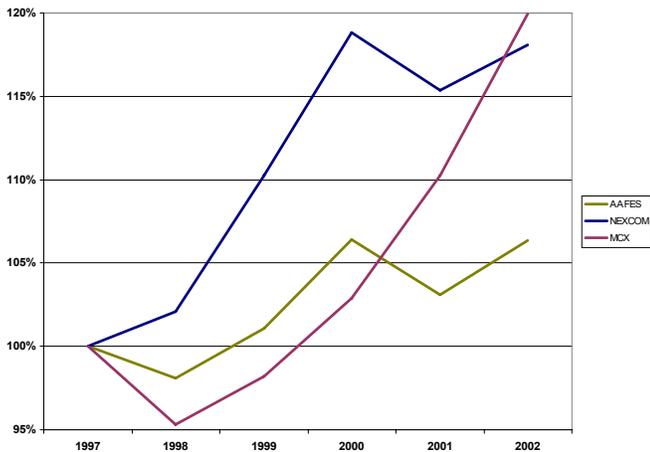
Exhibit 1a—Contribution/dividend Trend



Source: NEXCOM, MCX and AAFES Historical Financials

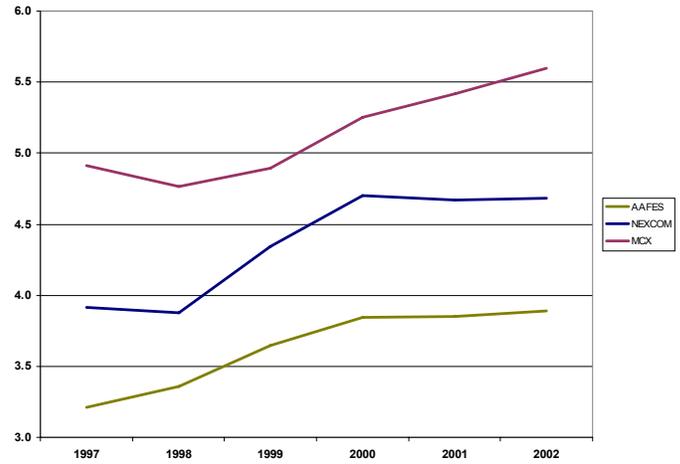
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**Exhibit 1b—Revenue Growth Trend
(Indexed to 1997)**



Source: NEXCOM, MCX and AAFES Historical Financials

Exhibit 1c—Inventory Turns Trend



Source: NEXCOM, MCX and AAFES Historical Financials

implementation plan. After 30 years and multiple studies that have all reached the same conclusion, the Department of Defense no longer sees the need to argue over the numbers. The Principal Deputy Undersecretary of Defense (Personnel and Readiness) and his team are clearly committed to providing the sponsorship necessary to seeing this through. Whether the potential opportunity is in the tens of millions or hundreds of millions of dollars, the strategic rationale is clear: A unified exchange service will better serve the United States Armed Services in the years ahead for a variety of reasons:

- ◆ Impending structural change will stress the existing business economics.
- ◆ Exchange customer loyalty has waned in the face of increasing desire for low prices.
- ◆ Multiple competitors are chipping away at the exchange business on every front.
- ◆ To survive, the system must leverage economies of scale to lower costs.
- ◆ Jointly, the exchange system can achieve a world-class standard—as befits America’s fighting forces.

Accommodating Structural Change

The size of the U.S. military force has been shrinking over a 50-year period. From a high of 2.9 million in 1955, the United States dropped to 1.4 million active-duty personnel by 2000. More insidious has been the increasing fragmentation of America’s foreign deployed troops in recent years. In 1980, about 490,000 troops were deployed in 114 countries around the world. By 2000, foreign deployed troops had dropped to less than 260,000...but the number of countries had increased to 140 (see Exhibit 2a, and b, on the following page).

The current strategic vision for troop deployment recognizes the new realities of threats to our national defense. Plans no longer assume that troops will fight from their forward-deployed base positions. Instead, military strategy will rely upon rapidly deployable capabilities with a decreased emphasis on numbers. This new strategy will inevitably lead to further reductions in traditional troop concentrations in host countries such as Germany. Despite a reduction in forward-deployed troops, the new plan will maintain a scalable presence in a variety of

countries; flexibility will allow the military to contend with uncertain sources of future threats.

Such changes put further pressure on the Exchange System economics. Currently, operations outside of the continental United States (OCOUS) generate 53 percent of profits even though they account for only 30 percent of sales. The unique ability to provide “products from home” for foreign-based troops provides a pricing advantage not possible in the domestic market operations. Furthermore, unlike independent retailers, the exchanges have a mission to serve the troops wherever they are deployed. Subscale exchanges in smaller communities cannot simply be eliminated because of a “weak business case.” Accordingly, the larger, more profitable sites must cover the losses from the smaller ones.

Unfortunately, the evolution of America’s defense strategy will inevitably lead to fewer large, profitable troop concentrations and more small-scale, less-profitable deployments. Collaborative efforts, like the AAFES agreement to provide tactical field exchange support to Marines in Kuwait and Iraq, help to address this fragmentation.

Exhibit 2a—Active Duty Force Size Trend

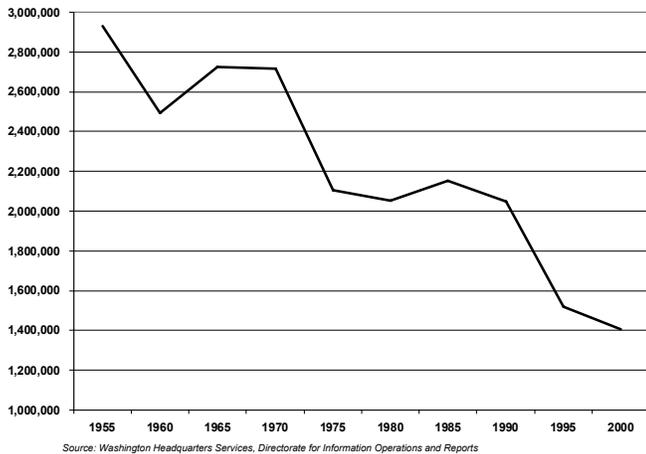
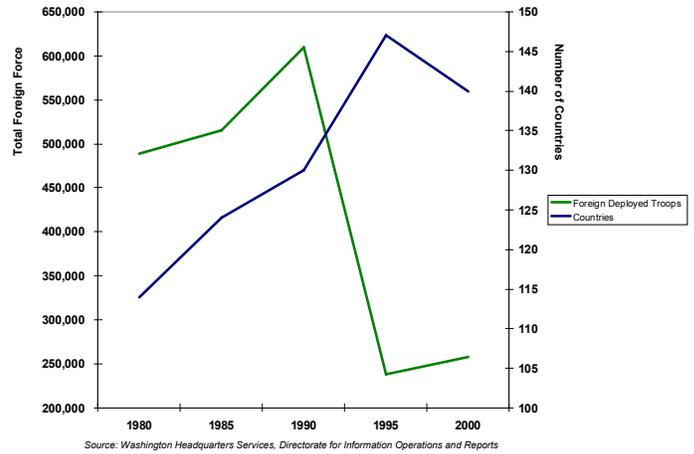


Exhibit 2b—Foreign Deployed Forces Trend



Responding to Customer Needs

One factor that has helped the exchange system cope with decreasing force levels has been the growth in retirees. Active troop numbers decreased by 35 percent between 1985 and 2000—from nearly 2.2 million to approximately 1.4 million. Over the same period, the population of retirees grew 40 percent—from 1.4 million to nearly 2.0 million—while the base of reservists experienced a more moderate decline of only 20 percent. The net effect has been a mere 9 percent

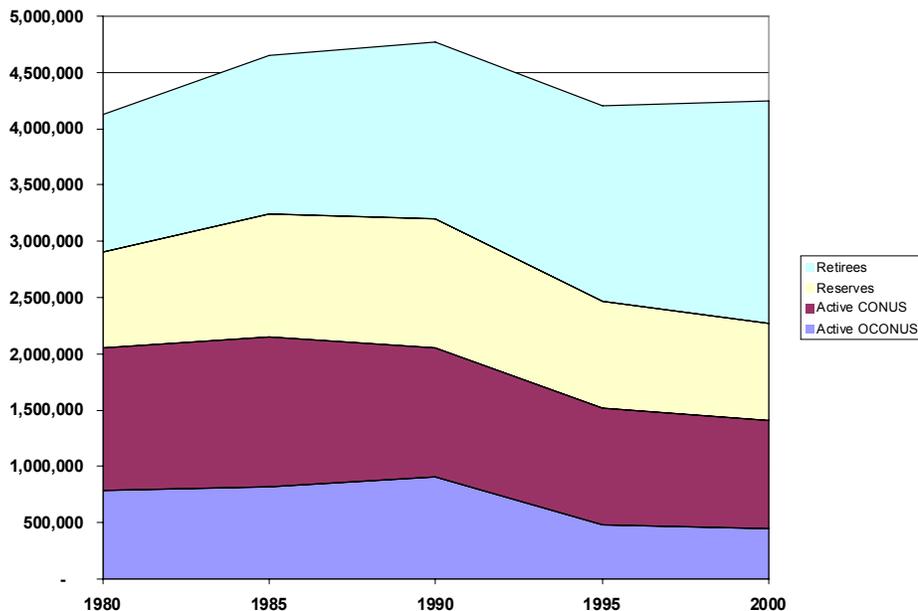
decline in the total population in the exchange customer base of active, reserve, and retired military personnel (see Exhibit 3).

Unfortunately, retirees and reservists are more widely dispersed throughout the nation and not always close to an exchange store. Even when an exchange is conveniently located, retirees choose to shop there primarily to get the lowest prices. Retirees certainly remain loyal to their branch of the service, but today’s longer life spans mean that retirees must stretch their limited pension benefits over more years. If a more convenient

alternative—like the increasingly dominant Wal-Mart Stores Inc.—offers equally low prices, retirees are less likely to shop at an exchange.

The issue of brand loyalty and limited funding affects the shopping habits of the active-duty customers as well. Younger people show far less brand loyalty than older consumers—and with the financial demands of starting a family, many active-duty personnel have to weigh prices more heavily than loyalty to their military exchange. Although they certainly recognize that the exchange helps fund their MWR programs, they also realize that only 3 to 9 cents out of each dollar spent goes to MWR programs...many of which may be of limited interest to any individual serviceman/woman. Practically speaking, for these customers, making purchase decisions based upon anything other than price would not be in their own or their family’s best interest.

Exhibit 3—Military Population Trend



Facing the Competition

Unfortunately, low price has become the standard base of competition throughout the retail world. Discounters such as Wal-Mart and Target lead the pack in both revenues and revenue growth. Traditional department stores, such as Federated, Mays, and Dillard’s—which offer branded products and greater

variety—continue to lose share to the low-cost discounters. Now the world’s largest company, the \$250+ billion Wal-Mart, dwarfs its competitors by being the global price leader (see Exhibit 4).

The Super Wal-Mart format continues to expand into new categories...and quickly dominate them. For example, Wal-Mart has grown from having an 11 percent share of the toy market in 1993 to having a 21 percent share today. Over the same time period, the “category killer,” Toys “R” Us, watched its share drop from 21 percent to 17 percent, thereby ceding the lead to Wal-Mart.¹ Although the company originally was a relatively narrow discounter, Wal-Mart’s expansion into grocery took it to the number-one position in sales over \$50 billion Kroger. It has also achieved the number-one position in jewelry over \$2 billion Zales and number three (so far) in prescription drugs closing in on the number one drug store chain \$22 billion Walgreens. The addition of self-service gas pumps, again with lower prices than competitors can offer, threatens yet another retail category. Furthermore, of particular threat to global retailers such as the military exchanges, Wal-Mart continues to expand its international presence; 17 percent of its revenues now come from outside the United States. It currently operates stores in areas of key OCONUS troop concentration: 258 stores in the United Kingdom and another 94 in Germany.

Gross margin trends suggest that each of the military exchanges feels the pricing pressure of the retail industry (see Exhibit 5). Of course, the threat of competition varies by category. For example, the exchanges have little to no competition in the sale of military uniforms and accoutrement. Unfortunately, that category represents less than 3 percent of exchange sales. The tax advantages for alcohol, tobacco, and

gasoline also provide a relatively unassailable position for the exchange system. Also, the advantage of convenient location for most exchange offerings like food services, vending and barber/beauty shops make them relatively safe from competition. But all of these “safe” categories together make up only 39 percent of exchange sales (see Exhibit 6 on the following page).

The general retail and grocery categories represent 18 percent of exchange sales...and they are already under heavy assault from the discounter competition. The remaining 43 percent of sales come from major household goods, entertainment and electronics, and clothing. Though traditionally in competition with the higher-priced department stores, each of these

Exhibit 4—Retailer Revenues Trend

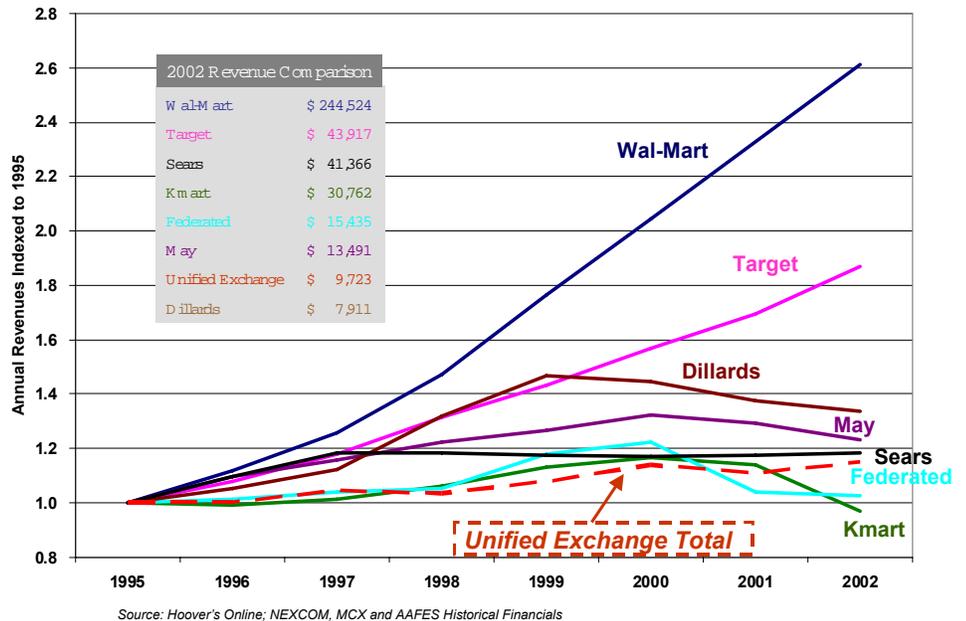
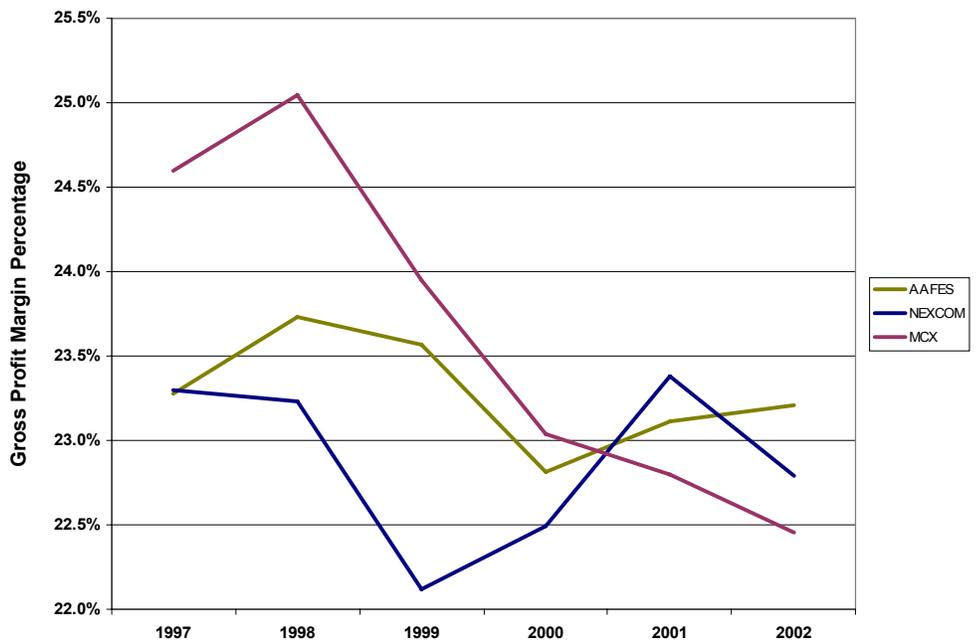


Exhibit 5—Gross Profit Margin Trend



Source: Hoover's Online; NEXCOM, MCX and AAFES Historical Financials

categories is beginning to feel the pinch of the low-cost discounters. Beyond the threat of the discounters, Internet retailing challenges the traditional location and sales tax advantages of the exchange system. Can the independent exchanges avoid further margin erosion and fend off competition from discounters that are 30 to 100 times larger as well as electronic retailers focused on growth over profitability?

Leveraging Economies of Scale

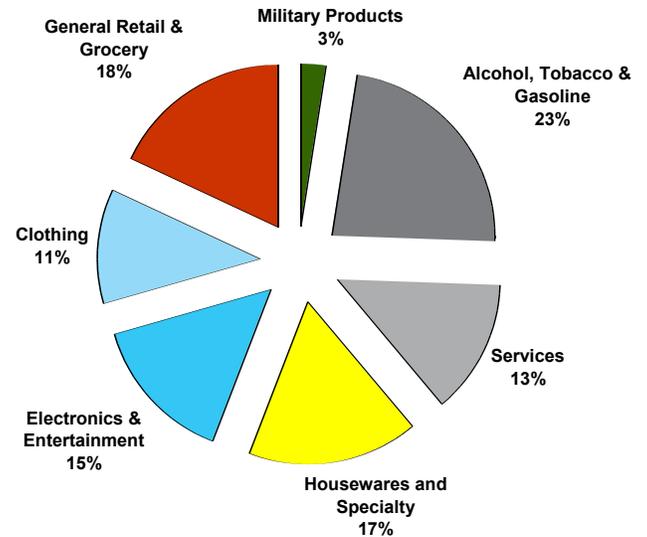
To win in this increasingly competitive retail environment, the exchange system must leverage scale. Economies of scale occur because large facilities and organizations can operate at a lower unit cost by spreading fixed costs over larger volume. For example, a store with twice the sales volume of a smaller store does not need twice as many managers. This scale advantage translates into lower overhead cost per dollar of sales. Exhibit 7 plots location sales and profit percentage for AAFES locations. The curved line models the relationship between size (as measured by revenues) and profit percentage and clearly indicates the decreased profitability of smaller

locations. (The chart also supports the observation that OCONUS locations often produce higher margins than locations in the continental United States.)

Although store-level scale provides some advantage, the greater benefit in the retail industry comes from scale economies in buying and distribution. Central negotiations provide more leverage and can also lower the cost for the supplier, which ultimately translates to lower purchase prices. The MCX transition to centralized buying from decentralized buying reflects recognition of the value of scale. Distribution scale economies also play a critical role. In fact, Wal-Mart gains 1 to 2 percentage points of cost advantage from the scale and sophistication of its distribution network alone.²

Despite the relatively pallid growth rate of less than half of 1 percent per year over the past decade, the military

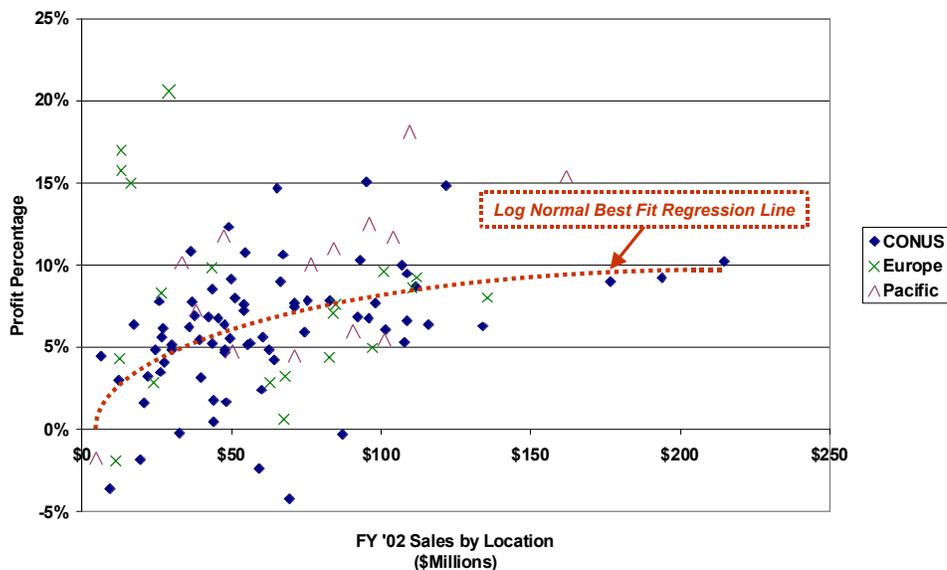
Exhibit 6—Exchange System Sales Mix



Source: Analysis of Exchange & Commissary News, October 15, 2003

exchange system in total ranks among the largest retailers in the United States. In addition to the obvious advantages of centralized buying noted above, a unified operation offers scale advantages in a variety of other areas. Combined distribution networks would lower the operating cost and also allow more volume to run through the average facility. Shared distribution would increase inventory turns and lower transportation costs as common suppliers could ship full trucks more frequently. The ongoing, extensive technology investments required in retail could also be amortized across the broader base of stores in the entire network without the separate fixed costs required for each exchange to invest individually. Back-office operations, too, could benefit from scale economies. Although a unified exchange will require about the same number of front-line employees in customer-facing positions, it will require fewer back-office managers in staff functions such as human resources, finance and accounting. No exchange wants to eliminate the jobs of dedicated, long-term employees, but avoiding the pain harms our most important stakeholders: the servicemen/women and families who depend on MWR funding to maintain a stable and balanced life.

Exhibit 7—Scale Effect On Profit Margins



Source: Analysis of AAFES Financial Reports

Achieving World Class

Although lost independence may be perceived as painful, the customer benefits of consolidation can heal those wounds. Our own military provides many examples. The Secretary of Defense created the Defense Finance and Accounting Services (DFAS) in 1991 to reduce support costs and enhance capabilities. Since that time, DFAS has consolidated operations and improved procedures to reduce the workforce from 27,000 to 16,000 personnel and now has the mission to be the employer of choice for those who remain.³ The roots of another functional support group, the consolidated Defense Information Systems Agency, can be traced back to the 1960s.

Core military operations are now pursuing a unified model as well. For example, the individual branches of the military, as well as key allies, agreed upon a common set of specifications for the Joint Strike Fighter to produce the most advanced fighter jet ever built, without paying for unnecessary redundancy. Rather than spreading the volume across separate programs, five different military units will purchase more than 3,000 planes to this common specification over the coming decade. The effectiveness of the joint command in the Iraqi war proves the feasibility of collaboration without loss of effectiveness. In fact, our fighting forces, working collaboratively, have achieved recognition for world-class supply logistics from the business world. For the military exchange system to follow their example seems only natural.

Although a unified exchange will certainly result in fewer jobs as it did at DFAS, it also offers the opportunity for more rewarding jobs for those who remain. Pooled resources will allow the combined exchange system to create “expertise scale.” A buyer would no longer

be forced to spend her time on day-to-day firefighting because she is stretched too thinly across too many suppliers. Instead, she could become a true expert in a more narrowly defined category with the time to step back and think strategically about how to offer better products at lower costs and generate more value for all stakeholders. A financial analyst would be able to draw upon leading-edge systems to keep a real-time pulse on the business...rather than conducting ad hoc analyses trying to determine what went wrong a month ago. And the human resources staff would enjoy hiring and developing the very best: a group of employees excited about their jobs because they work for a world-class retail organization.

Capturing scale economies and becoming a world-class organization will not happen overnight. In fact, without the dedication and commitment of the leadership teams of the individual exchanges, it may never happen. The opportunity for scale economies can be lost quickly through poor, uninspired execution. A widespread world-class culture will never blossom if individuals remain aligned to their traditional branch of service and resist change. Insiders trying to defend “the way we always did it” can stop progress toward becoming the absolute best.

The Choice Is Clear

Although the Department of Defense has issued an unequivocal mandate to unify the military exchanges, the output remains open to debate. Even if postponing the inevitable proves impossible, the effectiveness of the consolidation remains in the hands of the current independent leadership teams. They can continue to fight for the status quo and only grudgingly accept unification. Such an attitude will likely produce only limited synergies and create

a larger but marginal player treading water in the dynamic ocean of retail competition.

By embracing the change, the current leadership can pursue new opportunities to leverage scale and become truly world class. Whether savings prove to be in the tens of millions or hundreds of millions of dollars, simply combining the full energy from the best and brightest of all three exchange networks will undoubtedly unleash huge synergies. The unified exchange can become a more exciting place for its employees and deliver even more value to its key stakeholders, the men and women of our armed forces.

The individual military commissaries faced a similar challenge when the Deputy Secretary of Defense created the Defense Commissary Agency in 1990. Eighteen months after the mandate, the organization was operational...ultimately producing greater operational savings faster than was predicted by the Jones Commission that triggered its creation. And the customer benefits have also proven significant: price comparison studies show that customers who shop at the commissary instead of independent alternatives save more than 30 percent today versus 23 percent in 1991.⁴

The familiar road of status quo or the uncertain, challenging route to combined excellence. Which path will make your customers, your employees, your country—and you—most proud?

Endnotes

1 Fonda, D. (2003). *Will Wal-Mart Steal Christmas?* *Time*: 54-56.

2 Laseter, T., M. Turner, et al. (2003). “The Big, the Bad, and the Beautiful.” *strategy+business* (33): 20-24.

3 DFAS History, August 21, 2003, http://www.dfas.mil/about/ad_history.htm.

4 History of U.S. Military Commissaries. Fort Lee, Virginia, Defense Commissary Agency. 2003: 2.