

Victoria's Secret

Amid some of the toughest retail conditions in years, Victoria's Secret announced a 9% gain in first half-year 2002 sales and a 30% gain in operating income. With huge brand recognition, Victoria's Secret had well established itself as the leading retailer in women's lingerie. However, market growth was slowing down and profit margins for the company's Direct division, which focused on catalogues and Internet sales, had been declining over the past several years. Catalogue production and other mailing costs jumped significantly, and while Internet sales had experienced tremendous growth since the company's web site launch in 1998, the web also added costs to the business.

Company History

Leslie Wexner founded the Limited, Inc. in 1963 in Columbus, Ohio with two women's apparel stores. The Limited grew organically and through acquisition to include 4,600 specialty stores by the end of 2001, with brands such as Bath & Body Works, Express, Lerner New York, Limited Stores, White Barn Candle Co., and Henri Bendel.

In 1982, Wexner purchased a small San Francisco-based women's lingerie chain, named Victoria's Secret, with four stores and a catalogue.

Victoria's Secret, with its boudoir-style stores, took sexy underwear out of girlie magazines and imbued it with a romantic nostalgia. The merchandise showed good taste, and the company made the products easy to buy in environments that were comfortable and inviting. Over time, the number of stores grew to over 900—by the late 1990s, nearly every major mall in America had a Victoria's Secret store. Catalogue sales grew apace, and total store, catalogue, and web sales topped \$3.2 billion in 2001 (see Exhibit 1, for financials).

The business consisted of three segments: Victoria's Secret Stores, Victoria's Secret Direct (catalogue and the Internet), and Victoria's Secret Beauty (makeup and bath products).

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Intimate Apparel Market

In the past, intimate apparel rarely generated much enthusiasm in the business community. The sameness of the product in style, fit, and price made it difficult for consumers to discern the difference between national brands and generic labels.

In recent years, intimate apparel had grown faster than other women's apparel. Brassieres and other underwear played a more visible role in current fashion. The industry expanded into new techno-fabrics and stretch laces with better overall comfort, better fit, and added flexibility in designing new silhouettes to accommodate a wider range of customers. With innovations such as the water bra, the air bra, and seamless products, the industry made lingerie more varied and customizable. In 2000, intimate apparel represented about 10% of the total \$95.5 billion women's apparel business.

Intimate apparel sold via the same retail channels as typical apparel: department stores, mass merchandisers, specialty stores, national chains, outlets, discount and off-price stores, mail-order companies, and online stores. Simple, functional polyester bras and panties could be found at stores like Sears, Wal-Mart, and JC Penney, while boutiques like La Perla offered stylish products in silk and other fine materials (see Exhibit 2, for top bra brands). According to NPD Fashionworld Consumer Panel, 27.3% of bra purchases were made at specialty stores, such as Nordstrom or Saks Fifth Avenue, 24.5% were made at mass merchandisers like Wal-Mart, and 14.7% were made at specialty stores like Victoria's Secret (see Exhibit 3, for distribution table of purchases by retail type).

Brand and Positioning

While women were spending more than ever on bras, price was still driving the category with brand loyalty flagging, according to the NDP Group. Most consumers had a favorite brand, but aggressively sought out deals (38%). Other influences included comfort, fit, style, reputation, and quality. While Playtex had the most brand loyalty among consumers influenced by fit, and Bestform among consumers who are influenced by price, Victoria's Secret had the greatest brand loyalty among consumers who purchased for style.

Victoria's Secret was an aspirational brand. With sexy supermodels, top-notch photographers, and bold advertising, it combined mass-market access with prestige products. An average Victoria's Secret bra priced in the \$20-\$30 range, which was significantly higher than the high single digit range for bras sold at other retailers. By far the most recognized intimate apparel brand, it held 15% of a \$12 billion lingerie market, and 20% of the \$4.5 billion retail bra market. In the 1980s, Victoria's Secret Direct extended its brand into new categories such as swimwear and clothing, although its core beginnings in bras and panties still accounted for close to 50% of Direct sales and were emblematic of Victoria's Secret brand image.

Victoria's Secret engaged in multiple brand-building activities, including its annual fashion show launched in 1995. It employed the same photography and promotions between its sales channels to ensure a consistent brand image. As a result, brand loyalty grew from 18% in

1996 to 35% in 2000.¹ Advertising and targeted marketing expenses were 4-5% of divisional sales, at approximately \$120 million. Sub-brands—like Miracle Bra, Second Skin Satin, and Body By Victoria—were also an important part of the company's brand strategy. As Sharen Turney, President of Victoria's Secret Direct, said, "Other companies are proud if their entire portfolio has \$100 million in sales. That would represent a sub-brand to us."

The Limited, Inc. viewed Victoria's Secret as a "360-degree" brand, using a comprehensive marketing strategy to connect its retail, catalogue, and web sales. When Leslie Wexner bought Victoria's Secret, he sought to make it "stand [out] as an integrated world-class brand. Across all channels—catalogue, stores, Internet—the same products are launched at the same time, in exactly the same way, with the same quality, and same positioning."

Web Launch

In 1998, management launched www.victoriasecret.com with little fanfare. The new media department was headed by Ken Weil, VP, a former department store buyer and veteran of an Internet professional services firm startup (Proxicom). The new media group of four rolled out the web site, whose stated goals were twofold: 1) to strengthen and support the Victoria's Secret brand and 2) to exceed sales goals. Moving as aggressively online as they did in initially building the brand, Victoria's Secret soon became a leader in online innovation. The web site launched on December 4, 1998 at 6 p.m. Its first order was from Littleton, Colorado at 6:20 p.m. for \$39. This initial site cost less than \$5 million to build and launch.

The web site made a splash with the first large-scale real-time streaming video presentation of the company's annual fashion show on February 3, 1999. Tickets to the fashion show, held annually in New York City, had historically been extremely hard to obtain, and that enthusiasm translated into incredible interest in the web cast. The company's public relations blitz leading up to the show included TV spots, Internet banner ads, and print ads in major newspapers. A teaser advertisement during the first quarter of the Superbowl in January 1999 generated 1 million web site hits in 30 minutes. It was also the first "dot-com" commercial ever in a Superbowl. However, the company's web site and the overall Internet infrastructure were unable to meet demand during the web cast, crashing networks throughout the United States. Nonetheless, the event's huge press coverage earned it Brandweek's Interactive Marketing Awards Best Marketing Event.²

The company invested heavily in back-end infrastructure and technology over the next year so that the next web cast from Cannes, France in May 2000 was able to handle 2 million viewers, up from 1.5 million the year before. That year the web site earned top honors in e-retailing performance, beating other well-known brands such as Amazon and PayPal.³ Then in 2001, the company introduced a combination of streaming video with interactive content and e-commerce, with a video image of supermodel Heidi Klum talking to customers about different swimsuit designs as they surfed through the web site and made purchases.

¹ Intimate Brands, Inc. 2000 Annual Report, p. 24.

² "Victoria's Secret: Best Marketing Event," Brandweek, June 28, 1999.

³ "A rough start for e-retail," Informationweek, December 4, 2000

Today the new media group is staffed with forty people, with an annual budget of over \$10 million. Weil explained his build strategy as follows: “While we do partner as appropriate to build our web site infrastructure, we do a lot internally. For example, rather than licensing content management software from a company like Vignette, and having to spend a lot of time and money customizing it, we built one ourselves in-house. We call it ‘WENDI’ for ‘web enabled database for the Internet.’ We wrote the code ourselves for a couple hundred thousand. And we got 100% of what we wanted. On the other hand, when it came to putting dozens of servers online to support the live web cast, we partnered with Yahoo! Broadcast to do it—that saved us enormous effort and cost.”

Victoria's Secret web store and catalogue were managed as a single unit. From the beginning, the company tried to leverage its existing infrastructure like a distribution or call center to operate its web store. Both catalogue and online orders were filled out of its warehouse in Columbus, Ohio. “From the distribution standpoint, it's the same model,” said Weil. The company also tried to link its different sales channels, adding the “order from catalogue” feature on its web site—shoppers entered an item's catalogue number to find that item on the site. In addition, Victoria's Secret segmented its audience demographically, and delivers specific messages while refining strategy throughout the campaign. The retailer timed its catalogue distribution with its e-mails. “Our goal is to provide the same message to the same customer at the same time,” said Weil. For instance, a customer whose purchase history indicated a preference for swimwear would receive an e-mail promoting a swimsuit sale and would get the most recent swimwear catalogue.

This high-impact web presence translated into strong growth for the online division, whose sales grew from practically zero in 1998 to over \$200 million in 2001. Performance metrics for the web included sales growth, the number of “new to file” customers (i.e., newly acquired customers), average order size, and purchase rates.

The Internet—A Freight Train to Heaven, or Hell?

By 1999, countless retail, catalogue, and start-up companies had attempted to sell online, with mixed results. “Big box” companies like Staples were creating separate companies and tracking stocks or IPOs for their online businesses, hoping to capitalize on the premium Wall Street was placing on all things Internet. Established catalogue companies like Lands' End were moving aggressively online, even attempting to drastically cutback their catalogue mailings in an attempt to migrate customers to the web, where costs would theoretically be lower and profits higher. And “dot-com” start-ups were raising hundreds of millions in venture and public market capital to take advantage of the “promise of the Internet.” Weil remembered thinking, “Next time, I'd like to work for one of these companies where you don't have to make money. It sounds like a lot of fun.”

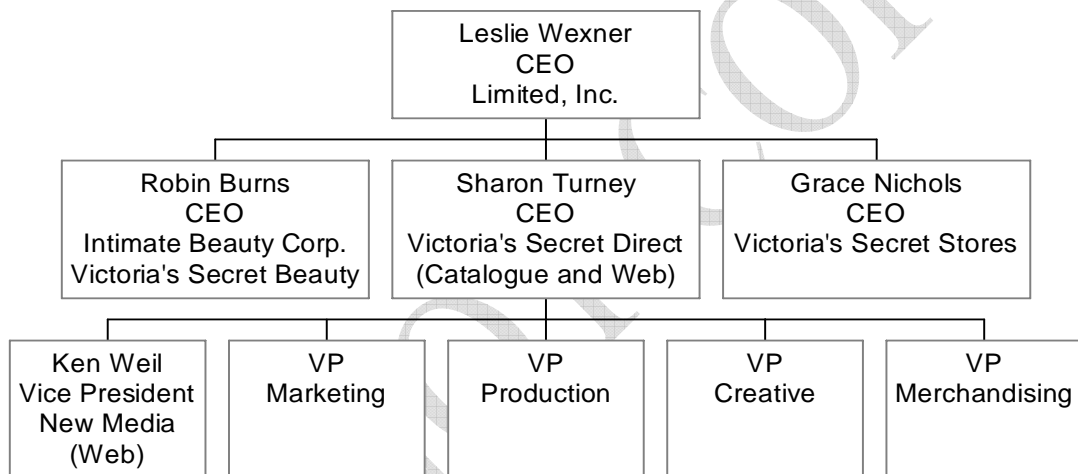
The Lands' End case was one that many catalogue companies studied in depth. Faced with excess inventory after a period of low demand, the company attempted to cut costs by mailing approximately one-third fewer catalogues during the 1999 holiday season and instead mailing only postcards and small brochures designed to drive customers to the web. Although online sales did pick up significantly, it was not enough to make up for the lost catalogue

sales. Overall sales dropped 18%, and Wall Street punished the stock, which fell from a high of \$84 to a low of \$34. Lands' End CEO David Dyer said the company learned that sales by phone and Internet spike after every catalogue mailing; and although profitability was higher with sales over the Internet, catalogue sales still provided a large portion of Lands' End's earnings.

Victoria's Secret Direct Division

Organizationally, Victoria's Secret web group reported to Sharen Turney, President of Victoria's Secret Direct, which included both web and catalogue sales.

Table 1: Victoria's Secret Organization chart



Note: Intimate Beauty Corporation was 98% owned by the Limited, Inc.

Sharen Turney was named Chief Executive Officer and President of Victoria's Secret Direct, the brand's catalogue and e-commerce arm, in May 2000. Ms. Turney brought broad experience and expertise across the retail spectrum including stores, catalogue, and e-commerce. She joined Victoria's Secret Direct from Neiman Marcus where she held numerous management positions since 1989. Her roles since 1997 included Executive Vice President for merchandising, creative production, advertising and public relations; and Senior Vice President and General Merchandise Manager for Neiman Marcus stores. In 1999, Ms. Turney was named President and Chief Executive Officer of NM Direct, the company's \$322 million direct marketing business, which included the catalogue and e-commerce arms of Neiman Marcus, Horchow, and Chef's Catalog.

Despite the overall environment of dot-com hysteria and dreams of instant wealth, Turney and her colleagues on The Limited executive team resisted the temptation to create a separate

Victoria's Secret company for the online business. Instead they chose to keep the channel within the Direct family, believing that an integrated, multi-channel approach would support the brand better than a separate dot-com entity. "We just knew it was right to keep the catalogue and online business together," said Turney. "It was never even really a discussion to do otherwise. Our direction from Les was clear." Turney matched product styles and promotions to the catalogue to ensure a consistent customer experience.

Even with integrated goals, "minor fights" still broke out over allocation of costs. Some catalogue managers argued that the web was not adding incremental profits, but merely shifting sales from one channel to another. To counter this, Turney was careful to align management incentives—bonuses were based on Divisional performance rather than channel performance. Also, she deliberately did not try to calculate the profitability of the web channel: "The entire Direct Division has a shared vision, shared goals, shared incentives. We succeed or fail based on Divisional performance. And right now, we're succeeding."

Turney also had her hands full within her own Direct division. Integrating web purchases with catalogue and store sales was not without challenges. Indeed the growth in web sales did not come without a cost, as customer migration caused cannibalization of sales for the catalogue and store channels. Victoria's Secret estimated cannibalization rates as high as 50-70%, although tracking the actual rate was a difficult task. On the other hand, the web was proving to be an important vehicle for customer acquisition: although web sales accounted for 30% of the Direct division's business, a disproportionate number of "new to file" customers came from the web. However, similar to the cannibalization problem, it was difficult to separate channel effects with respect to customer acquisition, for half of web-generated new customers also received a "prospect" catalogue. As a result, while the first order for these "new to file" customers was through the web, it was impossible to know if they would have ordered online without the offline stimulus of the prospect catalogue.

One thing was clear: web fulfillment costs were cheaper than catalogue orders. Weil estimated that order fulfillment costs were \$3-4 more for catalogue sales than web sales. However, the ease of ordering meant web sales typically had a slightly lower order size, on the order of \$8 to \$10 less, for a net profit gain of approximately \$1 to \$2 for web transactions. Although the web had 10% fewer returns than the catalogue.

The task of calculating the impact of the web became urgent as the relatively mature catalogue business, a longtime source of strong profitability, faced significant challenges. Mailing costs have increased to approximately \$0.60 per catalogue. As a result there was a premium placed on optimally leveraging mailings to improve business results.

A primary tool was a sophisticated algorithm called "Recency, Frequency, and Monetary Value" (RFM), which was based on the idea that recent shoppers were more responsive to catalogue mailings, as were more frequent shoppers and those with higher recent order sizes. The RFM algorithm used each customer's transaction history to determine which customers should receive the largest number of mailings based on their calculated propensity to buy as evidenced by their scores across each of those variables.

In addition to RFM, sophisticated modeling was used to segment prospects and current customers. There were models for customer acquisition, retention, and extension. Each segment had different profiles and costs, and it was a difficult balancing act to set priorities by segment. For example, although it cost \$20 to acquire a new customer and only \$10 to reactivate a previous customer, attracting “new to file” customers was important for the long-term health of the business, despite the increased costs, as customers in any direct business were always “rolling off the file.” In addition, 10% of the customer file generated 50% of the business, so it was also important to cultivate heavy buyers.

Merchandise variables added to the complexity of the business—for example, should a recent swimwear buyer receive a catalogue all about swimwear, or should she receive another catalogue instead to expose her to a broader set of merchandise? The type and form of mailings were other variables: prospect catalogues, “full book” catalogues, mini catalogues, or printing on cheaper paper or in smaller trim sizes. The possibilities and variations were indeed endless, all designed to sort the database and merchandise to predict catalogue response and drive different types of mailings to the most responsive portions of the customer base.

Victoria's Secret was as expert in the use of these techniques as any cataloguer in the business. Still, even with the use of these sophisticated tools, costs continued to escalate. As a result of cost escalation, there was continued pressure to reduce catalogue mailing expense. Consequently, while catalogue mailings had increased steadily from 1978 to 1998 to a peak of over 400 million annually, mailings were actually cut from 1998 to 2002, dropping to 350 million.

Multi-Channel Synergy

While the Direct division was extremely important, the stores remained the flagship for the brand, accounting for 75% of sales. For many customers, the experience of seeing and trying on the product was an important part of the shopping experience. A fair portion of catalogue and web purchases tended to be for “replacement” purposes, when a customer was already familiar with a product.

Victoria's Secret also recognized that there were synergies to a multi-channel strategy. One study estimated that the average multi-channel customer spent 2 to 3 times more than a single channel customer.⁴ However, multi-channel synergy was complicated by the fact that the merchandise mix was not the same across all channels: the stores primarily sold lingerie, sleepwear, and beauty products, while the catalogue and web channels also carried women's apparel. In addition, the company operated Victoria's Secret Beauty stand-alone stores, which only sold beauty products. “The merchandise variations make it harder to achieve true multi-channel synergy with the stores on certain products” said Turney.

Over time, Victoria's Secret hoped to leverage its customer database to improve synergy. This customer database consisted of approximately 10 million twelve-month buyers, with

⁴ “The State of Online Retailing,” shop.org

around 5 million registered to receive special offers on www.victoriasecret.com. Customers' e-mail addresses were merged with the catalogue database to create one cross-channel database. The result was not a complete merge, as Internet customers were sometimes difficult to cross-reference to catalogue customers. In January 2001, the company reorganized the Direct division database by customer, instead of by brand or channel. The database also included retail store customer activity, although it lacked the richness and detail of the catalogue database with respect to historical purchase activity. In addition, the database did not include cash purchase activity in the stores.

At a Crossroads

As CEO of VS Direct, Turney had control over P&L goals and organizational imperatives for the catalogue and online businesses, and therefore could set policy to encourage catalogue and web synergy. However, Victoria's Secret had historically separated the retail store business from the Direct division. Although Turney worked closely with the CEO of Victoria's Secret Stores, their P&Ls were not integrated, and she did not have the authority to implement full-scale changes in the Victoria's Secret brand or merchandizing strategy without VS Stores' support. As a result, Turney was not certain that the overall organization had fully optimized its business across all channels: "Regardless of our structure, I sometimes wonder what we might do differently. Should we try to get better merchandise alignment across all three channels, should we change our promotion allocation and strategy by channel, what should we do?"

The situation Turney faced was difficult. Victoria's Secret sales had grown over 20% since 1998, boosted by higher Internet sales and a greater share of the mall market, in a market growing at only 6%. However, the total market was forecasted to grow at only 4-6% for the next four years.

Turney knew there was potential to further cut costs on catalogue mailings, but the question was how to do it without negatively impacting overall business performance: "As painful as it is, sometimes it's simply easier to fix a troubled company than to optimize one that has done a lot of things right. Victoria's Secret is a really successful place. The obvious fixes have been addressed. Now anything we do gets at the core of our strategy as a business. How do we cut costs when we've come off a year where we've already taken 15% of costs out of the Direct division? Are there revenue opportunities that we're just missing? We're already a major success story on the web, but have we gone far enough? Should we migrate more of our customers to the web and cut catalogue mailings, or is that too risky? We're direct marketers, so it's as much about tactics as it is strategy. What specific tactics should we employ? What should we do and how should we do it?"

Exhibit 1: Victoria's Secret Financial and Operating Results

	2001	2000	1999	1998
Total Victoria's Secret	\$3,272	\$3,301	\$3,078	\$2,710
Victoria's Secret Stores	\$2,403	\$2,339	\$2,122	\$1,816
Victoria's Secret Direct	\$869	\$962	\$956	\$894
Bath & Body Works	\$1,747	\$1,785	\$1,530	\$1,254
Other	\$2	\$31	\$24	\$25
Net Sales	\$5,021	\$5,117	\$4,632	\$3,989
Operating Income	\$667	\$744	\$794	\$671

Source: Intimate Brands Annual Reports

Exhibit 2: Top U.S. Bra Brands

Bra Brand	Total Sales (\$ millions)
Victoria's Secret	\$900
Playtex	457
Bali (Sara Lee)	271
Hanes (Sara Lee)	221
Vassarette	193

Source: Bear, Stearns Equity Research, 3/25/02 (citing The NPD Group)

Exhibit 3: Distribution of Underwear Purchases by Retail Type

Retail Type	Bra Purchases	Panty Purchases
Specialty stores (Nordstrom, Saks, etc.)	27.3%	31.5%
Mass merchandisers (Wal-Mart, Target, etc.)	24.5%	31.7%
Department stores (Sears, JC Penney)	18.4%	13.9%
Specialty chains (Victoria's Secret, etc.)	14.7%	10.3%
Others (drugstores, outlets, online, etc.)	15.1%	12.6%

Source: NPD Fashionworld Consumer Panel, 2000