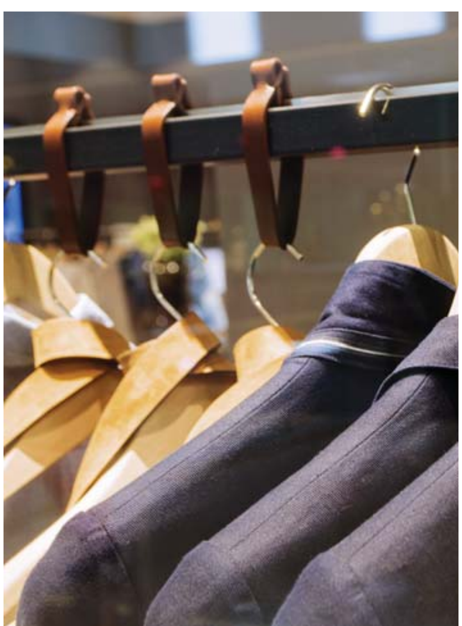
Adapting the Traditional Retail Economic Model to Profitably Compete

Building on HRC Retail Advisory's May 2016 Research Study regarding the erosion of Retailer Profitability as a result of the growth of e-commerce, HRC completed a further research study in October 2016 on 20 major US-headquartered Specialty Apparel, Footwear, Home and Beauty retail chains to determine the impact on Sales and Profitability resulting from retail chains' decisions to continue to open additional brick and mortar stores between 2011 and 2015, a period when the shift of sales from physical stores to the online channel escalated substantially.

Study Demographics

- 20 Apparel, Footwear, Home and Beauty chains headquartered in the USA
- 17 are public and 3 are private
- Annual Sales ranged from $400mm to $16 Billion, with a median of $2.5 Billion
- All 20 chains are mature businesses with established store networks

Note: HRC excluded from the study all retail chains that are in the early to mid phase of their expansion and are still building out their store network. While the findings of this study do not apply directly to their businesses, the study recommendations should be very helpful to them as these chains proactively plan the profitable growth of their businesses in an increasingly complex omni-channel retail environment.



Top Four HRC Study Findings

- Amazon.com is continuing to increase its market share and expand into new categories in the North American retail sector, having recently announced a 32% sales growth rate in Merchandise Sales (following a 31% sales growth rate in the comparable period in the preceding year).
- Online Channel Sales increased 9% for specialty chains and 19% for department store chains in 2015. These represent a significant decline in CAGR growth in these sectors versus the past 5 years of 12% and 29% respectively. It is notable that Amazon's North American Merchandise sales growth rate is about 3X that of the brick and mortar chain's online growth rate, indicating a significant and continued loss of market share to Amazon.com.
- Sixty Percent of the specialty chains in the study continued to open additional stores between 2011-2015, even as their online penetration rate of total sales reached a high median rate of 19% in 2015 (online penetration for these stores ranged from 9 to 39% of total sales) versus 9.1% in 2011. These chains opened a median rate of 14% more stores between 2011 and 2015. The combination of so many physical store additions plus the shift to online resulted in these chains experiencing a median 6% decline in sales per store between 2011 and 2015, with 2015 itself reflecting a 4% decline in sales per store.

- Forty Percent of the specialty chains in the study fine-tuned the size of their store fleets over the 2011-2015 period to better cope with the sales shift from physical stores to the online channel. These chains' online median penetration rate of total sales reached 15% in 2014 (online penetration for these stores ranged from 8 to 25% of total sales) versus 7.8% in 2011. These chains closed a median rate of 13% of their stores over this period, probably reflecting their lowest performing stores, upon lease expiry or landlord negotiation to exit the locations. The closure of so many under-performing stores resulted in these chains experiencing a median 8% increase in sales per remaining store between 2011 and 2015, with 2015 itself reflecting a decline of 3% in sales per store.

The sharp increase in e-commerce penetration rates for brick and mortar retailers is coming at a very high cost, especially as most e-commerce sales are coming as a result of a channel shift. HRC's analysis of almost 40 retail chains sales by channel indicates that e-commerce sales only represent true incremental sales when additional market share is won from competitors and when e-commerce customers are in geographical areas where the particular retailer does not have a physical presence.

While retailers must continue to invest in e-commerce as the customer is demanding it, the transformation of retailer costs from a largely fixed cost structure for traditional physical stores to the new paradigm where sales need to support the legacy fixed cost structure plus a costly variable cost infrastructure to enable e-commerce. In Karabus's experience in working with numerous retail chains, he believes that, in addition to the high handling and fulfillment costs of free returns and the challenging issues of refurbishing and getting returned product into a re-saleable state and to the location that it can be most profitably re-sold at, e-commerce related costs can add more than 2 percentage points to retailers' cost structures!

Karabus recommends that retailers consider the following five factors to ensure they have the right Economic Model to profitably operate in this rapidly-evolving environment:

1. Decide which omni-channel capabilities will be most valued by their specific customer, rather than investing in all capabilities
2. Design and prioritize important decisions such as Price-Matching, Free Shipping, Free Returns, Dedicated Fulfillment Centers and Inventory Visibility
3. Establish a methodology to better exploit data insights to drive customer-focused decisions
4. Determine how to re-think and enhance their real estate decisions in the light of the channel sales productivity issues
5. Ensure Store, Supply Chain and Home Office Infrastructure Cost is properly sized and structured to profitably serve customers and drive shareholder returns

The answers to these issues should serve as an input to strategic growth planning and more effectively making the right capital and operating investments.

HRC Retail Advisory has assisted numerous retail chains to help them adapt their Economic Models to more profitably compete in this complex retail environment.

For more information about how HRC can assist your company to more profitably adapt to this omni-channel environment, please contact:

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