PRESENTED BY:
WWD Studios

Re-thinking Retail Profitability

HRC Retail Advisory's CEO Antony Karabus offers insights and actionable steps to succeed in a retail landscape overshadowed by Amazon, resale, rental and changing consumer demands.

Retail's transformation over the past decade has accelerated in recent years, and has presented "new and significant challenges" to retailers, according to Antony Karabus, chief executive officer of HRC Retail Advisory, a leading retail consulting firm based in Northbrook, IL.

For Karabus and Farla Efros, president of the firm, these changes offer opportunities for success. But these seasoned consultants have also seen – firsthand – the downside of "the new age of retail" for numerous retailers that fail to adapt to change and deploy the necessary tactics to succeed. From HRC Retail Advisory's perspective, the first step in the right direction is to recognize that the old business models simply don't work anymore.

"If you think slashing store and headquarters labor, IT and marketing costs will save a retail business – think again," Karabus said. "Today's winners and losers are determined: in how well they know their customers and their needs; how well they manage their physical stores; and how well they manage inventory and margins."

Here, Karabus offers an overview of what's driving change today, how retailers should respond and where the industry is headed as Amazon – and other macroeconomic forces – continues to cast a large and looming shadow over all of retail. Karabus also shares his firm's "bespoke approach" to help c-level executives right their retail ships. It's a tailored, custom consultancy approach that differs from the "cookie-cutter" options offered by many other firms.

WWD Studios: How would you describe the current market? What's driving change?

Antony Karabus: It's a retail market that is experiencing the impact of digital convergence, where consumers want to shop when, how and where is best for them.

For numerous traditional retailers, there's also mounting pressure from value stores such as TJX Cos., Ross Stores, Five Below and chains such as Dollar General. There's no "retail apocalypse" occurring. What's different is where the consumer dollars are going. It's an evolution in how and where consumer shop and spend. As a result, massive market share is being transferred from traditional retailers to these new competitive forces from both the digital and value players.

Numerous traditional retailers are also burdened by leveraged buyout debt, thus resulting in many of them not having the ability to adequately invest in their stores and other IT investments to effectively compete with the newer competitors, even without managing debt service obligations.

As a result, many chains have restructured or liquidated. Some other retailers face a real risk to their survival, while many others are experiencing significant declines in their operating earnings and working capital. And the digital phenomenon is not about to slow down anytime soon – in fact it is accelerating in its share of total consumer spending. The traditional retailer economic model has been severely disrupted and will not return to the historic model.

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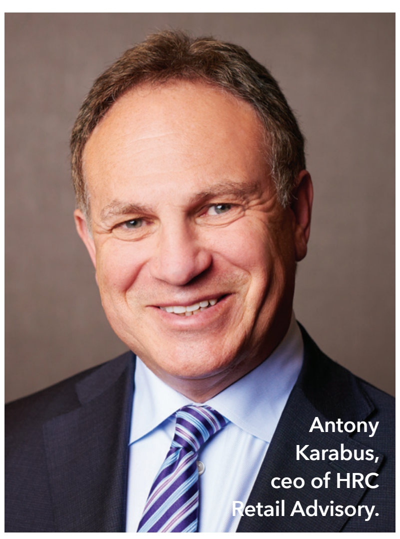

Antony Karabus, ceo of HRC Retail Advisory.

WWD Studios: What role does Amazon play? How formidable is it?

AK: Amazon grows by more than 20 percent annually while most traditional retailers feel fortunate if they realize flat to slightly positive comparable sales (with many others experiencing significant negative comparable sales and profitability trends).

The digital behemoth is adding incremental $20 billion in sales each year – on top of the $20 billion each previous year. That cumulative impact is substantial, and can't be understated. And it is coming straight out of retailer market share, leaving little growth for the remaining traditional retailers in their cross-hairs.

Amazon is also continuously innovating and raising the bar. Determined to protect existing sales, traditional retailers are pressured to follow suit. But often they're simply increasing their costs and complexity without bringing additional top-line sales.

For example, when Amazon introduced Prime membership and its two-day free shipping guarantee (recently evolved to one-day), traditional retailers felt compelled to match that offering. Though profitability is compromised by shipping costs, Amazon makes the economics work thanks to their 100-million-plus Prime membership base generating more than $10 billion in fees annually. Amazon is now raising the bar to same day and in many markets 3-hour delivery promises. This is continuing to put pressure on retailers.

Amazon is also bolstered by the profits generated from its enormously profitable Amazon Web Services ("AWS"), which has over a 48 percent share of the e-commerce cloud market – followed by Microsoft's 15 percent. Subsequently, traditional retailers simply don't have the same heft to offset digital costs and fund the investments needed to make e-commerce profitable and to transform their store experience.

So, while Amazon continues to expand its market share (representing almost 42 percent of total retail industry online revenue this year and anticipated to be increasing to 50 percent over the next few years due to its rapid growth rate), numerous traditional retailers struggle to maintain relevance and profitability on a less-than-equal playing field.

WWD Studios: What other factors are impacting the bottom line?

AK: To remain competitive and play to their strengths of offering a physical experience that allows customers to "touch and feel" the merchandise, many brick-and-mortar retailers have adopted omni-channel offerings. The approach helps bridge the gap between their offline and online channels and provides both an offensive and defensive weapon against Amazon and other e-commerce-only retailers.

But after surveying senior executives

BY THE NUMBERS

$869B
Amazon's market capitalization

$790B
The combined market capitalization of Amazon's 15 closest competitors, which includes Walmart, Target and all department stores

$26B
2019 estimated resale sales

$51B
2023 projected resale sales

64%
Percent of women willing to buy secondhand goods

7.5K
Stores closures YTD, which is 65% more than 2018

3K
Store openings in 2018 – 80% of which were dollar and value chain stores

900
Store openings of Dollar General, 2018

SOURCE: GLOBALDATA, EUROMONITOR AND S&P CAPITAL IQ

Farla Efros, President of HRC Retail Advisory.

at more than 30 North American large retail chains found that, HRC found that while omni-channel is vital, if not implemented properly, the move can lead to customer-service related issues, thus undermining its benefits. Additionally, the cost of "In-Store Fulfillment/Ship from Store" and the associated digital returns is eating up much of the related contribution dollars.

WWD Studios: Is there cannibalization of sales as well?

AK: Yes, for the majority of retailers, e-commerce mostly represents a cannibalization of sales that were made previously through physical stores. The cannibalization means retailers have to add significant capital and operating expenses to achieve the same total sales level – or in many instances lower sales and profitability levels.

HRC Retail Advisory's primary research with more than 40 large retail chains showed that the retailers are often simply increasing their costs and complexity without bringing overall company-wide additional top-line sales. More than 90 percent of the increase in their digital sales represent shifts from their physical store sales, versus net new sales.

But there are other issues as well.

Retailers, for example, often claim they are agnostic as to whether a customer shops online or in-store – so long as they shop with them – but the reality is not so simple and the impact on profitability doesn't support that claim.

Revenue from multiple channels may equal prior total company sales but this is only made possible by the addition of massive capital and operating costs, with minimal overall incremental sales bump.

The retail landscape has been transformed from a largely fixed-cost environment to an increasingly variable-cost one to serve digital and omni-channel sales. HRC's primary research with dozens of large retail chains found that digital sales now accounts for up to 15 percent – and as much as 40 percent or more for those with a digitally-connected customer demographic – of total sales.

And, for most retailers, as much as 95 percent of those digital sales represent a channel shift from their brick and mortar stores, rather than incremental sales.

WWD Studios: Why is inventory management and investment in the related data analytics so important?

AK: As omni-channel-focused retailers try to determine the right inventory investment at a location level while ensuring ROI on the significant accompanying expense, unproductive inventory often gets "trapped" in the wrong store or distribution center, whether at a style or size level. They are then faced with the high costs of addressing that issue – whether through transfers, deep markdowns, liquidation or write-offs. In addition, out-of-stocks at a location level results in lost sales as well as customer dissatisfaction.

Add to those challenges the additional costs of free shipping and very high digitally-influenced returns. In fact, studies conducted by our firm found that e-commerce returns is a serious issue for retailers and is severely undermining their profitability. Serial returns can be offset by firmer corporate policies. But many traditional retailers are resistant to firmly addressing the returns problem.

WWD Studios: So what is the solution? What should Retail CEOs and CFOs be thinking about and executing?

AK: First, executives should avoid the rush to cookie-cutter solutions (that are commonly recommended by many other consulting firms) to help overcome difficulties, whether imposing heavy store labor or marketing and headquarters cost reductions so they can announce big cost cuts in a short-term effort to satisfy private equity owners or investment analysts.

Without completely discounting the value of that approach, the reality is that quick cost reduction wins almost always cause greater problems, resulting in the need to reverse many of those savings in the long run. Further, these quick cost cuts often prevent the retailers from enabling the investments to transform their businesses.

For our part, we understand that each retailer's situation is unique, requiring a tailored approach to its performance turnaround and improvement efforts.

That is why our firm always recommends a bespoke solution, starting with a solid diagnosis of the underlying performance inhibitors and obstacles to the turnaround.

We then develop and partner with the retailer to implement a realistic and innovative plan that not only drives significant performance improvements but better positions the retailer for long-term sustainability – and even to thrive.

It's an approach that could prove especially important with the anticipated consumer slow-down, as the margin of error for retailers will then tighten due to a combination of fixed cost inflation and declining sales.

WWD Studios: Should retailers re-consider their e-commerce strategies?

AK: In these circumstances, a retailer would be advised to raise the bar. By creating a compelling customer service experience and a seamless omni-channel offering, they can mitigate the loss of customers to Amazon or other competitors. Omni-channel is one of the strongest weapons retailers have in their arsenal, as it allows them to create new opportunities for customers to engage with their brand and increase sales.

When successful, omni-channel increases traffic and customer loyalty. But it's not easy to get it right. Retailers must also make sure that their inventory is accurate and that it's integrated across channels. And considering the complexity of omni-channel and the need to maintain profitability, retailers should define success before implementing or expanding their omni-channel.

Our firm has helped numerous retailers improve the precision of execution by optimizing its margin and inventory management practices over the entire product lifecycle, from concept to exit. In this way, they can ensure that product is available where and when it's needed to meet customer demand locally, while minimizing markdown and inventory liability.

Finally, it's vital that brick and mortar retailers develop and put in place the right organization, tools, processes and infrastructure to best and most profitably enable their success in this new digital environment.

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A FIVE-STEP PLAN TO THRIVE

As traditional retailers navigate a market in the throes of a deep transformation, they're incurring high costs trying to meet and hopefully exceed customers' needs across all channels as well as addressing the e-commerce demands born from the ongoing and increasing market pressure caused by Amazon, Wayfair and others. On the P&L, for many retailers, earnings are stagnant and often declining. And old models of addressing costs and operating losses is simply not enough.

HRC Retail Advisory offers retailers a bespoke approach with solutions tailored directly to their individual businesses to help retailers rise above and survive these difficult market dynamics. It's no longer a question of whether to take the next steps, but how soon they can begin. Once they do, positive outcomes are sure to follow.

Here is HRC Retail Advisory's five-step plan for retailers to thrive in today's market:

1. Understand how the changes to the digital retail environment have impacted your chain's economic model and what the implications are.

2. Determine the implications on inventory performance and margin erosion of the shift to digital, digital returns and of omni-channel fulfillment.

3. Determine the new or additional talent and other capabilities to be enabled to operate in the digitally-connected retail environment.

4. Determine the best use of your store fleet to create the right combination of stores to service customers and sales across all channels.

5. Understand the wants and needs of your customers to best determine where and how to invest into store environment and other customer-facing capabilities and tools.