As Market Moves to 50% Online Sales, Retailers Need to Respond – With Compelling Service and Experiences

Antony Karabus
CEO of HRC Retail Advisory

While the demise of traditional retailing and shopping malls has been fodder for headlines and research reports for some time now, the reality is that of a market going through massive changes, which will result in a landscape that might so be unrecognizable.

"Retail is not dead – far from it," said Antony Karabus, chief executive officer of HRC Retail Advisory. "But the overall shopping experience needs to be better. And there are companies out there now who are doing just that."

In his latest "deep dive" analysis of the retail industry, Karabus revealed a market that is seeing the negative effects of Amazon Inc. on specialty and department store retailers. Karabus found that over the past five years, the e-commerce penetration of department stores and specialty retailers has climbed drastically as they've stepped up efforts to compete with one another as well as with Amazon. But the rate of overall ecommerce growth has slowed as Amazon has experienced steady growth.

Moreover, the overall sales volume of department and specialty stores has declined in that time period, while there's also been a drop in the number of physical stores. Karabus said this points to a transformation of the industry, which he aptly incorporated into the title of his report: "Trending Toward a 50/50 World of Ecommerce and Retail Stores."

Karabus concluded that retailers "must develop a new economic operating model" that is based on this reality. And he asserted that there are many brands already executing in this manner,

As a result, market share is being transferred to Amazon, discount retailers and to "extreme value" players such as Dollar General, which is on track to open 1,000 stores this year. The so-called "experiential economy" is also taking a big bite out of the consumer's wallet. The response by traditional retailers (department stores and specialty players) has been to boost investments into e-commerce. But there have been consequences.

"Hardly any of traditional retailers' e-commerce sales are incremental – more than 95 percent of these sales are cannibalizing physical store sales for the sectors analyzed," Karabus explained. "This has led to a significant de-leveraging of store operating infrastructure costs (store occupancy, labor and other costs) and a decline of as much as 40 percent in retailer EBITDA-to-sales performance."

Karabus' research showed that the rate of penetration of ecommerce as a percent of total sales for department store retailers has jumped from about 6.5 percent in 2011 to nearly 19 percent today. For specialty stores, it went from 9.8 to 15.9 percent.

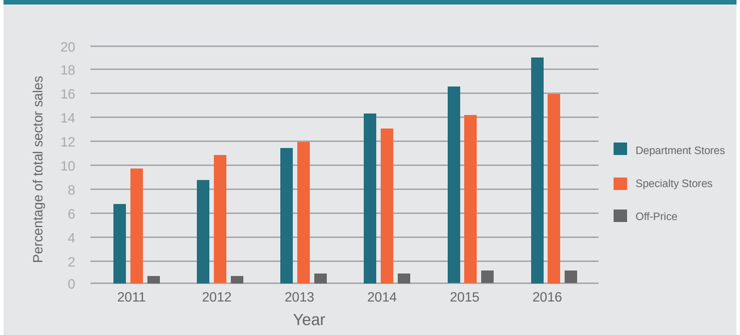
Karabus said for both sectors, "more than 60 percent of the total top-line growth over this five-year period was generated between 2011 and 2012, resulting in virtually no top-line growth since 2012."

Study Methodology

HRC Retail Advisory interviewed and conducted extensive primary research with C-suite executives at more than 30 leading retail clients of HRC in the apparel, home, discount and department store sectors, more than 90% of whom are public and with annual sales of $240mm to $15 billion.

HRC Retail Advisory's primary research with more than 8 department store chains and 18 large specialty chains indicates a decline in sales per physical store of 5 to 9% since 2011.

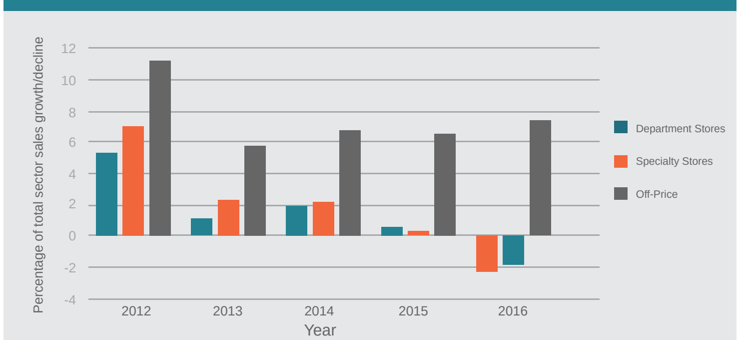
E-commerce penetration rates continue to increase as a percentage of total sector sales, other than off-price



Top-line sales have decelerated

The report also pointed out that "despite e-commerce being the primary growth engine for traditional retailers, it is rapidly maturing, with a significant decline being registered in the rate of e-commerce growth." With department stores, e-commerce sales growth went from a rate of about 39 percent in 2011 to about 12 percent in 2016. For specialty stores, the rate eased back from about 17.5 percent in 2011 to 11.2 percent in 2016.

Retail top-line growth rates are anemic and declining, other than off-price



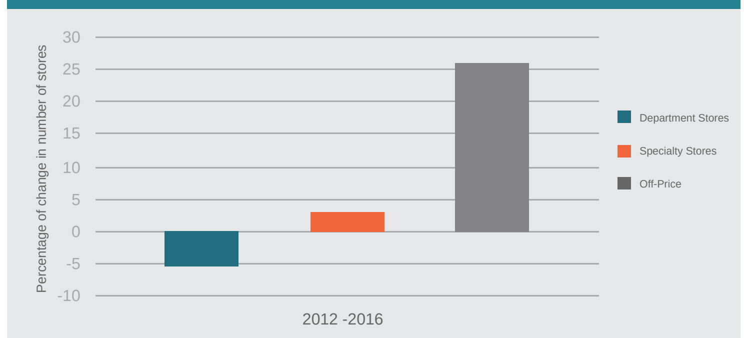
And total store counts have shrunk. "The traditional retail market for numerous retailers is shrinking, despite the disappearance of dozens of retailers, including The Limited, Wet Seal, Cache, Dots, Body Central, Deb Shops, Sports Authority, Sport Chalet, Borders, Circuit City, Bombay Company, Vanity Shoppes, Coldwater Creek and others," Karabus said in the report. "The closure of thousands of store locations from existing retailers is contributing to the shrinkage, including from Sears, Macy's, J.C. Penney, Payless Shoes, Rue 21, A&F, Aeropostale, PacSun, Eddie Bauer, Gander Mountain, Ascena, Gymboree, Guess, Gap, BCBG and others."

Karabus said total U.S. retail merchandise sales, which exclude grocery, motor vehicle and auto parts as well as consumer electronics and building material sales, have grown at a compound rate of 2.9 percent since 2011. "This, together with significant market share becoming available as a result of bankruptcies and store closures, should have produced sales growth for traditional retailers – but sadly this hasn't occurred," he said.

Instead, Amazon, the experience economy, discounters, offprice apparel retailers and value chains are taking share. So how do traditional retailers respond? "They need to create experiences that are compelling," Karabus said. "Consumers will always want the experience of shopping in physical stores."

And lastly, he suggested building a new operating economic profit and loss and working capital model "that incorporates the above assumptions, while providing a roadmap towards acceptable profit

Other than off-price, physical store count continues to decline



performance. Incremental changes will not achieve this goal, at a time when the rate of disruption is escalating."

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