FTI JOURNAL February 2016

Omnichannel for Retailers: It's a Rocky Road to ROI

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When Amazon.com, the online retailing pioneer, celebrated its 20th anniversary in July of 2015 with its Prime Day sales, we were reminded that despite its youthful glow, the online channel for retail goods has reached middle age — not in the sense of longevity (20 years is not that long) but with regard to the medium's potential to capture greater sales and market share at the pace to which it has grown accustomed.

This may be hard to believe as U.S. online sales continue to grow at mid-teen rates, while overall retail sales just plod along. According to the U.S. Census Bureau, e-commerce retail in the third quarter of 2015 increased 15 percent over the third quarter in 2014, while store-based retail sales increased only 1.6 percent during that period. At the same time, mobile commerce just now is hitting its stride, which has added to the ease and appeal of buying goods online. Internet Retailer estimates that 2015 U.S. mobile commerce sales will total $104 billion, up approximately 39 percent from 2014's $75 billion. Moreover, same-day delivery windows are becoming available in a greater number of cities than last year, making online shopping even more attractive, and retailers continue to invest significant sums in their online business — in distribution capabilities and in information technology infrastructure.

So it may not feel like the bloom is off the online rose, but the fact is that online sales growth is decelerating, and annual market share gains are slowing as well — both early signs of maturity. FTI Consulting's forecast model expects U.S. online sales growth to slow to a 10 percent compound annual growth rate between now and 2020. Online market share of total retail sales, currently at 10.5 percent, will approach 17 percent by 2020, ultimately plateauing around 20 percent. To be sure, these projections suggest there still is plenty of growth ahead for the online channel, but it will not resemble what we've seen in recent years.

Given this trend, which FTI Consulting expects to continue for the foreseeable future, the question arises as to how retailers ought to calibrate their investments in the online channel — especially when it comes to building out omnichannel capabilities. This is where retailers attempt to provide customers with what they increasingly expect and demand: a seamless experience whether they are shopping online from a desktop computer or mobile device or whether they are physically visiting a brick-and-mortar store. As is more and more the case, shoppers are using all available channels and devices at various times — or even simultaneously — in the purchase cycle. Providing this omnichannel experience is neither easy nor inexpensive. Retailers must take a long, hard look at how omnichannel is affecting overall sales and profitability and what slower aggregate growth for online sales portends for large retailers that continue to invest heavily in their online business.

It's a Jungle Out There

Amazon.com wasn't the first web-based consumer business, but one can credit it with bringing online shopping to the masses. When Amazon opened its virtual doors in July of 1995, Internet usage among U.S. adults was 14 percent (compared with 84 percent in 2014),

according to the Pew Research Center. Back then, Amazon billed itself as the "Earth's Biggest Bookstore." These days, Amazon's $51 billion of domestic product sales ($89 billion worldwide in 2014) make it the ninth largest U.S. retailer. Forget books. Now Amazon, aspiring to be the "Earth's Most Consumer-Centric Company," competes in dozens of product categories and countries.

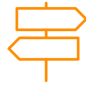
The company has been exploiting its scale and early-mover advantages for 20 years and continues to push the boundaries of what is possible for a retail business, mostly due to its willingness to make huge, ongoing investments in technology and infrastructure, forgoing near-term profits for sales and market share gains. In a recent survey of 2,000 shoppers, 44 percent said Amazon was their first stop for online purchasing. This past Black Friday, the company accounted for 37.5 percent of all online spending despite the best efforts of large store-based retailers to ramp up their online and omnichannel games to compete. Moreover, a Macquarie Research report estimates that Amazon (including third-party sellers) will claim approximately 25 percent of all U.S. online retail sales for 2015 compared with a 16 percent share in 2011, after having captured nearly one-half of all e-commerce retail sales growth last year.

When Amazon makes a move, its largest competitors have little choice but to respond, whether or not those actions ultimately are profitable decisions. For example, when in conjunction with its 20th anniversary Amazon featured a Prime Day "Black Friday in July" promotion, Best Buy, Target and Wal-Mart all offered variations on the same theme, with Wal-Mart rolling back prices on thousands of items, both in-store and online.

But how beneficial is this for the retail ecosystem? All those July deals were great for shoppers but probably not so good for the retailers' bottom line. And some analysts question whether the July deals risked desensitizing shoppers to those all-important holiday season sales and, perhaps, inducing shopping fatigue.

But what choice did these retailers have?

E-commerce is mostly about scale. When many capable competitors are vying to scale in a retail ecosystem that is growing modestly, a select few may benefit — but many more probably will struggle. Indeed, while the online channel has been hugely successful in generating sales, its larger impact on overall margins and profitability is less clear.



The Catch-22 of Omnichannel Retailing

For some large retail chains, an omnichannel strategy is less a panacea than an albatross. On the one hand, no serious retail chain can afford not to have a fully developed omnichannel business. According to a 2014 study by Retail Info Systems News, almost 30 percent of surveyed retailers said they currently were upgrading their e-commerce platform, and another 22 percent said they had plans to do so in the next 12 months. That's more than half of all retailers investing in e-commerce. However, it is difficult to place a dollar figure on these improvements or even apply a cost template to omnichannel initiatives, as every retailer's customer segments, technology stacks, organizational structure and resources are different. But everyone knows the cost in time and money is considerable. By some recent estimates, approximately 25 percent to 30 percent of the capital expenditure budget for large retail chains are earmarked for online/omnichannel initiatives.

But, again, does anyone really have a choice?

Consumer expectations have evolved. Consumers want not just a commerce-enabled website but an integrated platform that will allow them to look at reviews without leaving the site, to search online for items they can pick up and to return purchases either online or in the physical store. And they expect everything to work on their smartphones, too — and to work well. The tolerance for technology disconnects, bugs and glitches is low and is getting lower every day.

On the other hand, developing such capabilities is costly, takes time to design and implement, and does not guarantee new customers, market share gains or higher profitability. J.C. Penney, for instance, generates less in online sales dollars today than it did in 2010, though its online share of total sales remains roughly the same. Traditional Penney shoppers rejected its massive store makeover program several years ago, and store traffic and same-store sales plummeted. Nor was its online business spared, falling by $400 million, or 27 percent, between 2010 and 2013 before Penney began to turn the business around in 2014.

For most retailers, omnichannel may be a Catch-22. Although they have no choice but to commit to online, the return on investment ("ROI") is not only problematic, but it may be negative. The online channel cannibalizes store sales, sometimes at lower gross margins. In a recent survey by HRC Advisory, 75 percent of retailers said a portion of their e-commerce sales steals from more profitable in-store sales, challenging their basic business model. Tesco, the giant multinational UK grocer and merchandiser, for example, has found that its successful online Black Friday and Cyber Monday sales had a net negative impact on the business due to heavily discounted products — some below cost — that damaged bottom-line profit.

For other retailers, online investments arguably are just an added cost of doing business and do not represent the ROI driver they once were expected to be. Wal-Mart unnerved some analysts in October 2015 when it announced its intention to spend $2 billion over the next two years on improving its online business, questioning the payoff on the investment.

Every large retailer must decide exactly how online fits into the organization's

overall business strategy and determine how much financial support it can afford to put behind the effort while preserving margin and profitability. Those coordinates can vary widely among similar businesses and, accordingly, drive very different strategic decisions.

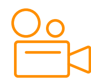
For instance, Williams-Sonoma, a trailblazer in direct selling in the home goods category, reaped nearly one-half of its sales from the online channel in 2015 and is widely regarded as an omnichannel paradigm. Crate and Barrel generated one-third of its sales online, while Bed Bath & Beyond derived less than 10 percent of its sales online but intends to ramp up its online business over the next few years.

Bed Bath & Beyond, a perennial leader in the home goods sector and one of the great retail success stories in recent decades, never made online a priority until the last couple of years. Another home goods chain shut down its e-commerce business in 2007 and didn't relaunch it until 2012. Since then, the organization has nearly doubled its annual capital expenditure (most of it dedicated to the e-commerce platform) and aims to gain twice as much online sales share by the end of 2017 — an aggressive target that's presenting some transitional issues. Although the online sales share is exceeding plan, the company's store traffic is down sharply, gross margins are sliding, profitability is down and inventories are swelling. Many of these woes are attributable to challenges in executing ambitious online initiatives. But what choice did the company have? The success of online-only home goods retailer Wayfair (which has scaled up to $1.5 billion of sales in three years) and Restoration Hardware's popular online site has largely forced the hand of both companies.

And no one can forget what happens if one simply refuses to play the online game. Bookstore chain Borders Group didn't have an e-commerce component until 2008, continuing to rely on its network of brick-and-mortar stores until the company ran itself into bankruptcy, filing for Chapter 11 in 2011 and subsequently liquidating.

The Catch-22: Large-scale retailers cannot opt out of online nor can they opt out of an integrated omnichannel offering, yet embracing and implementing these initiatives provide little assurance of greater customer visits, loyalty or improved bottom-line results.

The online channel has become a battleground, and, as overall retail sales growth remains tepid, some of the combatants assuredly will come out losers whose demise is hastened by the attendant cash drain of such undertakings.



We've Seen This Movie Before

The omnichannel buildout in retail is reminiscent in certain respects of the ill-fated theater renovation craze of 15 or so years ago. Back in the late '90s, some theater chains began modernizing their circuits, installing stadium seating, wide screens and surround sound systems. These upgrades required a significant financial outlay, much of it borrowed. Once the popularity of these new theaters was recognized, it set off a national arms race among exhibitors. The financial results were disastrous, as the advantage of these improvements was lost once every player had them. There was no differentiation, hence no competitive advantage. Exhibitors were left with highly leveraged, state-of-the-art theaters, but movie attendance as a whole increased only marginally while ticket price increases were fairly modest. (There is a limit to how much a moviegoer will pay for a ticket.) A wave of bankruptcies ensued. We're not suggesting that this is in the cards for retailers, but there are several lessons to be learned.

Movie exhibitors were compelled to make these costly upgrades to maintain market share. Again, it was a Catch-22. Not modernizing a theater circuit would likely have been ruinous, but, ultimately, the renovations failed to produce an acceptable ROI because, in the end, no one gained market share. The refurbishments effectively canceled out each other. Large retailers caught up in their omnichannel rollouts should be mindful of this pitfall as they make their investments and must aggressively exploit the store-side economic opportunities that an omnichannel strategy presents.

Rationalizing the Store to Drive ROI in an Omnichannel World

The maturing of the online shopping channel has not deterred large retail chains from continuing to invest many millions of dollars to build out and upgrade their omnichannel capabilities — nor should it. But retailers have to be under no illusions as to what this strategy can do for them. Most omnichannel retailers realize that sales generated from their online channel are only slightly incremental to the top line. For product categories such as apparel and sporting goods, where online is popular and has captured a healthy share of category sales, the online business of a large store-based retailer may post impressive sales figures. But the fact remains that a large portion of sales from its own stores will be siphoned off. Consequently, large store-based retailers must make appropriate store-level adjustments in order for their omnichannel investments to drive meaningful economic returns.

This recognizes the hard realities of a world of shrinking margins in which controlling operating costs — expensive rents, workforce expenditures and so on — must be a paramount concern.

Store rationalization is a critical and too-often overlooked component of an omnichannel strategy. Rationalization can manifest itself in several ways. The first is obvious: The store that gets closed. Unprofitable or marginal stores that are candidates for shuttering should be evaluated with the assumption that some estimable portion of these lost

sales can be retained. In 2015, major chains — from Target to Walgreens and from Office Depot to Barnes & Noble — shuttered almost 10,000 stores in North America.

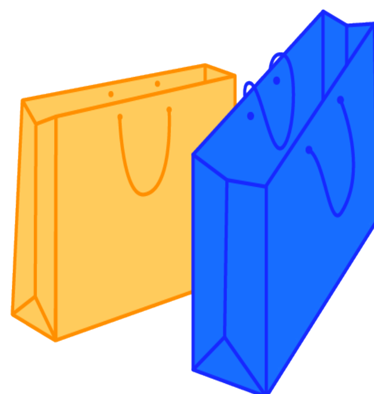
The second is far less obvious: The store that doesn't get opened. The online channel reduces the imperative to be in some secondary markets and locales. Many of those markets can be served without a physical store. The threshold internal rate of return target for opening a store in a non-essential market should be more stringent for an omnichannel retailer. This accounts for the appreciably slower growth rate of new store openings and also the shrinking square footage of those stores. Since 2012, compared with the pre-recession period, new stores are approximately 25 percent smaller than the average size of existing ones.

Rent reductions and other favorable lease terms are another aspect of store rationalization. As leases expire on middling performers or stores in marginal locations, large omnichannel retailers can be more aggressive in negotiating new lease terms, especially with landlords of class B shopping venues that are especially wary of vacancies in this uninspired retail environment.

Macy's, which continues to do well online, recently announced planned layoffs of 4,800 workers (3 percent), the closing of 40 department stores (5 percent) and adjustments to staffing levels at most of its stores — moves no doubt motivated by the soft retail environment and the changing habits of shoppers. These cuts are intended to save Macy's $400 million annually. Measures like these often are part of an omnichannel strategy that will drive return on investment.

Gap, for example, announced in June of 2015 that it would be closing 175 of its 675 North American Gap stores (nearly one-quarter) over the next couple of years. Gap indicated that these were not, in fact, money-losing stores; they were mostly marginally profitable. But the dollars they earned could not justify the cost of needed upgrades. Gap's aggressive decision likely was influenced by its understanding that a fair portion of these lost in-store sales ($300 million, according to Gap) could be recaptured online.

Generating economic returns from sizable omnichannel investments must include both a more deliberate and an increasingly aggressive approach to store rationalization decisions. If efficiencies are not wrung from the store side of the business, an omnichannel strategy is far less likely to be a legitimate moneymaker for large retailers and probably will turn out to be just another cost of doing business (and an expensive one, too). While we recognize that many large retailers have had good success in driving customers and sales to their online sites, it is online's all-in contribution to enterprise ROI that ultimately matters most. ■



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