How Retail CEOs and CFOs are Allocating Capital to Fund Transformation

As the pace of the digital transformation escalates, there is new competition emerging from pure play e-tailers, new international entrants and expanding discount chains. These factors are driving the need for retailers to rapidly transform their businesses as a means to protect and increase their market share. HRC Advisory recently conducted a study to understand how Retail CEOs and CFOs are investing capital to fund the necessary transformation.

The study surveyed CEOs and CFOs of 20 chain retailers. This included 70% in the Specialty Sector (apparel, accessories, home and footwear), 15% in the Department Store Sector and 15% in the Discount Sector. The study was conducted by Antony Karabus, CEO, HRC Advisory during Spring 2015 and follows earlier studies done by Karabus between 2008 and 2011 with retail CEOs and CFOs on key related issues such as growth strategy.

- 60% of participating retailers are private
- 40% of participating retailers are public
- 70% of retailers surveyed are domestic U.S. companies
- 30% of retailers surveyed are Canadian
- Annual Sales from $300M to $15B, with a median of $800 million

Surveyed Retailers' Financial-Related Data

- Earnings varied significantly among the surveyed retailers, with EBITDA as a percent of Sales ranging from break-even to 15%, with a median of 8%.
- Similarly with e-commerce performance, which ranged from 0-24% as a percent of total sales, with a median of 10% of total sales.
- Retailers expected e-commerce sales to continue to outpace physical store sales growth to 11% of sales in 2015, with e-commerce expected to grow to range of 0-30% of total sales.
- The top performing retailers expect to grow their e-commerce sales at 15-20%, while others expect to grow e-commerce at only 5-10% this year.
- 25% of the surveyed retailers have no e-commerce sales, most of which are discounters/value retailers.
- Of this 25% of retailers who have no e-commerce sales, 80% are now investing in online for the first time.

Key Highlights

The HRC study found that the retail industry is divided on the growth and operating strategies as well as the capital spend required to transform their business models in today's retail environment.

1. **Surprisingly, only 20% of retailers surveyed are investing in the right combination of growth strategies while connecting their stores, e-commerce and fulfillment centers, with new capital to fund their growth.**
   - This 20% is comprised of publicly traded companies that have over $1 billion in sales.
   - These retailers are spending on the right combination of growth strategies, including new stores, e-commerce, m-commerce, omnichannel and remodeling.
   - This same group of retailers are increasing capital spend by up to 50% in 2015/2016 to fund their growth and operating strategies, enabled by greater access to external capital.
   - This 20% is most effectively connecting their brick and mortar stores, e-commerce and fulfillment centers.
2. **There is a significant disconnect in retail growth, operational strategies and capital spend.**
   - In fact, 80% of the retailers surveyed are spending approximately the same total amount of capital as in prior years, using internally-generated cash flow. Given their limitations on capital, 75% of them are increasingly working to make capital more efficient through value-engineering (i.e. reducing store capital per square foot).
3. **Of the 80% of retailers that are spending approximately the same capital as in prior years, the vast majority of their total sales and profits are generated from brick and mortar stores, yet 40% are prioritizing e-commerce and omnichannel investments as their top capital spend.**
   - These surveyed retailers frequently expressed concern that the digital transformation and emergence of new technology applications were moving so fast that they were not sure which digital investments would bring the most effective ROI, and which would resonate most with their target customers.

- While 40% of these surveyed retailers are prioritizing e-commerce and omnichannel investments as their top capital spend category, another 40% are prioritizing it as their #2 capital spend category, and 20% are prioritizing it as their #3 category.

Karabus commented, “The distortion of capital allocated to the channel that almost always contributes much less than 15% of total sales and a much smaller percentage of total profits is likely to have a meaningful impact in the mid to longer term on profitability and competitiveness. This is particularly the case as retailers defer maintenance of their profit-generating store fleet, which we expect will result in the physical store shopping experience to start falling behind the e-commerce experience.”

4. Of this same group (80%), the majority of retailers are investing in new stores rather than store remodels.

- 40% are prioritizing new stores as their top total capital spend (representing the largest single focus for the group), while 20% are only somewhat likely to add new stores, and a final 20% will not be adding new stores.
- Only 10% are prioritizing remodeling and refreshing existing stores as a key growth strategy to increase store sales productivity, with the remaining 90% treating remodels as “maintenance” only or spending remodel capital only when required by lease contractual obligations. These retailers have very modest expectations of sales increases, simply trying to avoid store sales deterioration.
- Further, of all the retailers surveyed, 85% do not plan to close stores other than in the ordinary course upon lease expiry or relocation.
- Overall, 35% of the retailers surveyed are increasing capital spend on outlet channels.

Karabus noted, "Surprisingly, the majority of retailers surveyed are adding significantly to their brick and mortar store count, despite the ongoing flow of news reports and articles listing retailers that are restructuring, struggling, going out of business or simply closing stores. 100% of the CEOs interviewed have well-articulated organic growth strategies with increased investments in new stores and e-commerce technology to create a customer experience more relevant to their target customer. This contrasts with the strong flow of M&A activity involving financial sponsors acquiring retail chains prior to 2009."

Karabus continued, “These findings evidence that only the 20% of surveyed retailers with strong balance sheets and access to capital are comprehensively investing in all of e-commerce and omnichannel capabilities, new stores and remodeling the top stores in the existing store fleet – all of which are necessary to transform businesses to reflect today’s shopping environment. As a result, these retailers are positioned for an even stronger future as they are investing to provide the consumer with a more consistent, upgraded experience across all interactions in all channels.”

5. International expansion is no longer a priority for the majority of retailers surveyed.

- Only 20% of the retailers surveyed are even considering international expansion as one of many growth strategies, yet it was one of the most important areas of focus identified in the 2011 growth strategy survey conducted by Karabus. The remaining 80% of the retailers surveyed had no international expansion plans at all, and believe they need to stay focused on their North American business.

Karabus continued, "Many surveyed retailers were increasingly focused on growth strategies that are separating them from the ‘pack’ and allowing them to drive the top line without the need for continual and aggressive price discounting. This was particularly true for the surveyed retailers that have created a uniquely differentiated proposition and thus are able to add numerous new store locations with little competitive risk."

Karabus continued, “Retailers recognize the need to provide seamless, cross-channel information visibility on product availability, price consistency, fulfillment for customers and maintaining consistency of brand experience. They know it is a crucial focus to differentiate their brand at a time where pure-play e-commerce competitors like Amazon are working increasingly hard to commoditize category after category, now including apparel, beauty and food. The key will be in understanding how to effectively invest in the necessary transformations to not only maintain, but also increase market share in today’s retail environment.”

Notes on Survey Methodology and Analysis

HRC Advisory conducted detailed survey interviews with executives. The survey included 35 retail respondents including Specialty Apparel, Specialty Non-Apparel, Department Store, Discount, Dollar/Variety, Health & Beauty/Rx, Big Box, Grocery and Convenience stores. Participating criteria included annual revenues that range from innovative multi-channel smaller retailers to multi-billion $$ retail chains. At least 50% of the companies surveyed are publicly traded.

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