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How E-commerce is eroding retail earnings

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A new report from HRC Advisory finds that retailers' online sales are eroding in-store sales and taking a big bite out of retail profitability. Chain Store Age editor Marianne Wilson spoke with Antony Karabus, CEO, HRC Advisory, about the study and its implications for retailers.

What did you find most surprising in the study findings?

The pace of the transition to the online channel from brick-and-mortar was surprising, as well as the reality that a significant percent of the online sales are coming at the expense of what would otherwise have been growth of the brick-and-mortar channel. The resultant implications on retailers' economic models are more significant than was anticipated previously.

How exactly is this shift impacting retailers' operating earnings?

We found that operating earnings as a percent of sales has declined by up to 25%, due to the shift from in-store to online sales, combined with e-commerce and omnichannel investments and the high cost of fulfilling e-commerce transactions.

The substantial capital and operating costs of creating online and omnichannel capabilities – which includes supply chain upgrades, digital marketing and IT – along with managing online orders and a high level of online returns, are generating incremental SG&A costs of two to three percentage points of sales. And when you combine this with real estate and store wage inflation and declining in-store sales productivity, numerous retailers have realized a meaningful one to two percentage point reduction in physical store profit contribution performance.

There are a number of ways retailers can strategically mitigate and ultimately offset the negative impact of e-commerce on their operating earnings and return to their historically higher brick-and-mortar performance. For one, there is an opportunity to improve inventory productivity by fulfilling online sales from stores where the inventory would otherwise have been stranded and eventually marked down.

How are online returns affecting profitability?

Physical in-store returns are more easily handled with much lower cost implications, as they are simply put back into stock after being steamed or cleaned. With online returns, costs are much higher.

In addition to the significant cost of servicing and fulfilling the online order, unwanted e-commerce orders are often returned to stores late or in unsalable condition, and often need to be returned to a fulfillment center for assessment, remediation and steaming. There are then additional costs incurred to find the best place for the item to be re-sold, which will potentially then be at a markdown.

How can retailers with both brick-and-mortar and online operations grow profitability and compete with players like Amazon in today's digital environment?

First and foremost, traditional retailers need to play their own game, focusing on their own strengths with their unique and local assets, rather than trying to chase Amazon. Brick-and-mortar retailers have a huge often-unexploited local asset advantage, which is the ability to provide customers what they love most – the opportunity to touch and feel the product and truly experience the brand in a physical store.

Retailers need to re-examine the cost structures of their physical stores and infrastructure and become more efficient omnichannel operators to staunch the losses from extremely high online fulfillment costs.

Those who can effectively engage customers and meet their heightened expectations wherever, whenever and however they shop, while offering complete visibility of inventory availability, can be lucrative in reducing markdowns and improving inventory productivity.

The study cites "today's new variable cost-oriented online model." What does that mean?

All retailers need to recalibrate and fine-tune their economic business models to reflect today's new variable cost-oriented online model. In the pure brick-and-mortar era, retail cost infrastructure was largely fixed.

All retail sales took place in the physical stores, so once the fixed costs were covered, the gross margin on additional sales were all profit. Now that an increasing percentage of those sales are being transferred to the online channel, where the cost structure is almost entirely variable (meaning individual online order picking/packaging and shipping to the customer and back, in case of a return), the gross profit from an online order is minimal after all the incremental variable costs are covered.

Furthermore, this minimal profit needs to cover the additional technology and fulfillment center fixed costs, which is no small feat. At the same time, there is less gross margin from store sales to cover the physical store cost infrastructure now.

Are retailers acting too hastily with regards to store closings?

No. On the contrary, I would argue that retailers may have started dealing with the issue to late.

When the stores were originally committed to being opened, the e-commerce era had barely begun, and the impact of the sales transfer to online and pure play e-commerce retailers like Amazon had not yet been conceived.

I believe retailers today should be fine-tuning their store fleets and re-purposing weaker locations and outlets to provide additional fulfillment assets, thereby increasing their productivity and lowering fixed costs. Real estate strategies have become much more complex. They require leadership and direction from the CEO/CFO level.

The survey notes that a lot of retailers have engaged in price matching. What impact does that have on earnings?

Pure play online retailers, which are not judged by the same profit standards as traditional ones, have been offering all kinds of inducements to acquire customers. This has not created a level playing field as pure players don't have the same fixed cost infrastructure that traditional retailers have, and they don't offer customers the same advantage of local assets (physical stores).

Unfortunately, too many retailers offered "blanket price matching" in order to avoid losing the sale, which created loss of margin. I believe much of this price matching was not necessary and was the result of hastily implemented policies. In order to protect earnings, retailers should fine-tune their individual price matching strategies to reduce the negative impact on margins without losing the sale.

What are the biggest takeaways for retailers from this study?

It's important to recognize that the "Amazon effect" is not cyclical but rather structural and is here to stay. Therefore, the size of the overall "retail pie" available to the traditional retailers is not going to grow at the same rate as in past years.

Accordingly, the most important take-away is for retailers to do more conservative financial forecasts bottom up for each channel. They will have to make tough choices in evaluating their cost infrastructure, store fleet and capital plans and find the most cost-effective omnichannel capabilities that are right for their customers. This is imperative if they want to protect, and maybe even enhance, their profitability.

Wal-Mart's latest response to counteract Amazon is the "Shipping Pass" that takes aim directly at Amazon Prime and offers free three day shipping for half the cost of Amazon Prime. While this will help, Amazon Prime offers benefits beyond just free two day shipping.

Last but not least, all retailers need to recognize that they have unique advantages versus Amazon and they need to leverage these advantages to stay competitive in today's retail environment.