Think Tank

Controlling Costs In a Shifting Landscape

By Antony Karabus

Shifts in consumer behavior and expectations have permanently changed the American retail landscape, and as a result, physical store traffic and sales are clearly being impacted. ¶ The bottom line is also under attack, which is going to require retailers to rethink prior assumptions about the role of physical stores as well as ongoing investments in e-commerce, and more specifically omnichannel strategies.

How Did We Get Here?

Over the past five years, these changes in shopping behavior have forced retailers to establish duplicate infrastructures to enable consumers to interact with the retailers when, where, how and in whatever channel they desire.

In addition, numerous brick-and-mortar retailers are experiencing a loss of market share to Amazon.com, which is growing North American merchandise sales at almost 30 percent annually, versus a low- to midsingle-digit increases in top-line sales for most traditional brick-and-mortar retailers with online operations.

Moreover, Amazon continues to add distribution centers and categories (while going deeper into its existing ones), while promising shorter shipping lead times, coupled with additional benefits for Amazon Prime members.

Added Infrastructure Costs

In response, retailers have tried to battle against the "Amazon effect" while also meeting the needs of a consumer-centric environment. In a number of instances, retailers have made substantial investments in omnichannel while neglecting their most important physical stores, which still provide most of their operating profits.

But what has played out on the income statement is what's troubling. The historic, largely fixed-cost infrastructure of the physical store channel has now been joined by a variable-cost-driven infrastructure to enable online sales.

Start by Asking Some Key Questions

So, the need to meet consumer demands for online shopping while protecting profits has created a conundrum for retailers. But there are tactics that can be deployed to address these issues.

First, retailers should conduct a self-assessment as a way to create a sustainable and profitable model in this complex retail environment. Some considerations:

1. Decide which omnichannel capabilities will be most valued by each chain's particular customer, rather than investing in all capabilities.

2. Prioritize important decisions such as price-matching, free shipping, free returns, direct-to-customer dedicated fulfillment centers and full inventory visibility.

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3. Establish the right methodology to better exploit data and related insights to drive customer-focused decisions.

4. Determine how to rethink and enhance real estate decisions in the light of the channel sales productivity issues.

5. Ensure store, supply-chain and home-office infrastructure cost is properly sized and structured to profitably serve store and omnichannel customers to enhance shareholder returns.

The answers to these issues should serve to assist retailers to address their competitive position relative to competitors and pure-play e-tailers, and to making the right capital and operating investments to protect and even enhance earnings in the face of this new operating paradigm.

Understanding This New Operating Paradigm

Numerous retailers are incurring at least an additional 300 basis-point increase in the cost of enabling and fulfilling online orders and related returns, relative to the cost of physical store orders. These numbers are without allocating the cost of shared services infrastructure (such as IT, finance, human resources, payroll, executive management and other areas) to the online channel's P&L. This additional cost burden is not sustainable in the long term if one considers the historically low earnings margin experienced by retailers.

Meanwhile, for public companies, there's been a bit of bias on Wall Street. Shareholders and analysts have not been patient in expecting earnings from traditional retailers who are hard at work transforming their businesses to better compete and remain relevant, while they've been extremely patient in waiting for acceptable profits from Amazon and other pure-play retailers. And in the current climate, traditional brick-and-mortar retailers face extreme pressure from financial analysts, shareholders and activists not only to maintain, but deliver higher earnings.

The result is an increasing de-leveraging of physical store cost infrastructure as sales per square foot decline with the shift to the online channel. The exception to this de-leveraging reality is when major competitors exit the market or experience restructuring and significant store closures, allowing the remaining retailers to increase their market share in the sector, albeit in the short term. And the de-leveraging of store-cost infrastructure increases as the e-commerce penetration rate of total sales in the market increases.

Going on the Offensive

The best response to this new cost of doing business is for retailers to "take command of the game" and really go deep into leveraging their strengths and inherent advantages relative to Amazon.com and other pure-play e-tailers rather than trying to compete directly with these emerging competitors.

This is the Wal-Mart effect of the Eighties and Nineties, but is being repeated at a more rapid pace. So while it would be a mistake to take on Amazon head-to-head, retailers can deploy some offensive strategies. And the absolute best offensive tool that a traditional brick-and-mortar retailer has is its ability to introduce an online customer to a tactile experience in its stores, which means rethinking the role of the physical store so that it becomes an omnichannel service center and a holistic introduction to the brand, rather than just being a place to transact. Retailers need to take a more omnichannel view of their P&L rather than trying to attribute sales and overhead costs by channel.

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Illustration by Andrea Manzati