The Retail Profitability Challenge
A brave new world
September 2017
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Executive summary

The retail industry is going through a period of unprecedented change. You need to act quickly and decisively to remain relevant in today’s market.

Following a period of unprecedented change the retail industry is facing an environment where margins are increasingly under pressure from rising costs, lower pricing power due to increased transparency, and the need to invest in the digital transformation of their businesses. In this new environment traditional assets are potential liabilities and the value of product and service innovation has increased.

After a difficult 2016 for Belgian retailers and a tough start in 2017 there are early signs of improving conditions: confidence indicators are pointing higher and the level of unemployment is decreasing. It must be noted that in 2016, the pain was not evenly shared across the retail market, with online sales in Belgium growing to new record highs. The online channel continues to grow market share in 2017, driven by changing consumer behaviour, with consumers choosing to shop more often via their smartphones. The costs of transforming a traditional bricks and mortar business into an omnichannel organisation have impacted profitability. The required investment in technology combined with the variable costs of marketing and order fulfilment are eroding margins with costs growing faster than sales.

Margins have remained under pressure as prices have fallen for most of the last five years. Deloitte analysis has shown for the UK that profitability is declining with three year average margins declining by two percentage points between 2010-11 and 2014-15. In Belgium, the profit margins during the period of 2011-2016, dropped with 10%.

In 2017, the retail industry continues to face rising cost pressures including: higher property costs, increased staff costs, rising fuel and commodity prices and an increased cost in digitization to stay relevant in a competitive landscape. These pressures are combining to create a perfect storm for retailers that is forcing them to radically rethink what they need to do to remain profitable.

In summary, retailers need to focus on: customer engagement, greater differentiation and focus on innovation that can reduce costs and generate greater returns.
Troubling times ahead

The Belgian retail market remains challenged.

Retail market performance

Following a weak performance in 2016 and in the first quarter of this year, retail sales data in recent months have pointed to a modest strengthening in high-street and online spending. This is in line with an improvement in consumer confidence indicators since the start of 2017, steady employment growth and signs of firming activity across the Belgian economy. The fall in retail sales volumes in July does not negate this firming trend, as this indicator tends to be volatile, but it is a reminder that the Belgium consumer spending recovery under way remains fragile.

Growing sales will not necessarily lead to a commensurate increase in profitability. Take for instance the UK where margins have remained under pressure as prices have fallen for most of the last five years (see Figure 2). In fact Deloitte analysis has shown that in the run-up to Christmas 2016 discounting across the retail market reached 43 per cent – a record level.

The relentless rise of e-commerce

While the majority of purchases still take place in a store, the online channel represents a growing proportion of sales. Over the last decade, the share of total UK retail sales accounted for by online has grown from just 2.8 per cent in November 2006 to 18.3 per cent in November 2016 (see Figure 3). Such growth is forecast to continue over the next four years, with the online channel’s share of total retail predicted to reach 22.6 per cent by 2020. Some forecasters predict that by 2030 it will account for between 30 and 40 per cent of all retail sales.

The shift to online shopping has been driven by changing consumer behaviour, with consumers choosing to shop more and more online, increasingly via their smartphones. In a recent UK Deloitte survey we found that in the previous three months more people had shopped online than in-store across a range of non-food categories.

Figure 1 Belgium retail trade turnover and confidence indicators

Figure 2 Deflation in retail
In Belgium, online sales account for 16% of all expenditures. This is currently lower than the UK, but Belgium is expected to seriously catch up. Main drivers are on the one hand a change in consumer behaviour such as more online purchases per year per person and a higher average amount spent and on the other hand a more favourable environment for online retailers e.g. the possibility for night work.

The perfect storm of cost pressures

Added to the shift in consumer behaviour retailers are also having to contend with rising cost pressures (see Figure 4).

These include:

- **Rising property costs** – rising rental costs
- **Increased staff costs** – national salary indexation based on inflation in Belgium
- **Rising fuel and commodity prices** – due to the increase in the price of oil
- **Digitization** – ongoing investments and operational focus needed to stay relevant with customers

Deloitte analysis suggests the potential for a 300 to 500 basis point fall in operating margins in a number of retail sectors.

Figure 4. Rising cost pressures

Potential impact of cost pressures in 2017

Source: Deloitte and www.statbel.fgov.be

These cost pressures are combining to create a perfect storm for retailers that is forcing them to rethink radically what they need to do to remain profitable.
Shifting sands

Will what generated profit in the past, generate profit in the future?

How retail is changing

Retailers have responded to the challenge of online by adapting their businesses, first by introducing an e-commerce site and then an m-commerce platform to accommodate changing consumer preferences. In fact many have signalled their intent to become an omnichannel organisation – where the focus is on delivering a seamless consumer experience regardless of which shopping channel they choose.11

However, the reality is that for most retailers, omnichannel remains an aspiration as they struggle to implement the required changes to systems and infrastructure to allow, for example, a single view of their customers, a single view of their stock or make greater use of digital technology in store.

The rapid development of e-commerce has been in response to the emergence of a new digital consumer. Empowered by digital technology and access to information in real time and on the go, consumers have become more demanding as their expectations have risen.12

The costs of transforming a traditional bricks and mortar retailer into an omnichannel organisation have impacted profitability. The required investment in technology combined with the variable costs of marketing and order fulfilment are eroding margins with costs growing faster than sales.

The desire for generic products and services associated with mass distribution throughout much of the 20th century has given way to a desire for more personalised experiences. Retailers have grappled with how to offer their consumers a more individual and engaging experience along with the opportunity to customise products and services at scale and at an acceptable cost.

The introduction of new platforms and a plethora of fulfilment options has added complexity to supply chains. Decreasing footfall and store sales resulting from the growth of online have also impacted store valuations and profitability.

At the same time the growth of online shopping has pushed down prices by increasing transparency and competition.

New competitors

The evolving retail landscape is being shaped by new forms of competition such as subscription-based businesses and manufacturers that want to sell direct to consumers. In addition, a resurgent independent sector is emerging in response to the desire of consumers to shop closer to home.

Meal-kit subscription services are using mainstream package delivery services rather than investing in their own fleet of delivery vans, utilising innovative packaging which keeps the food chilled and fresh. Therefore they have avoided the costs of purpose built delivery vans with cold storage facilities that have impacted the profitability of supermarket home deliveries.

These new competitors have different operating models and cost bases. Many are either predominantly online businesses or businesses that have only a small number of stores. They do not need to adapt to the changing retail landscape because they have been set up to fill the gaps in demand that traditional retailers are struggling to meet. As predominantly online businesses they are not exposed to the same cost pressures – for example rising property costs or even the same tax levies.

Case study: The growth of meal subscription services and Amazon Pantry

Hello Fresh is one of a number of meal-kit subscription services that offer consumers recipes and all the ingredients they need, delivered to their home. Consumers sign-up to receive either three, four or five meals a week for between two and four people, choosing from Classic, Veggie or Family options. In the first nine months of 2016 Hello Fresh turnover was €440 million - more than double the previous year’s total.13 In the second quarter of 2016 Hello fresh delivered 22.7 million meals to more than 800,000 regular customers across nine markets. Other providers in Belgium are Smartmat, Foodbag and Marley Spoon.

Local traditional Belgian supermarkets are responding with similar services: Carrefour started with the “Simply You Box” and is experimenting with the Bringr-app from Bpost, Delhaize launched “Click & Cook” and Colruyt wants to provide a similar meal box service next to their “Collect & Go”. However, other established, non-retailers such as Amazon want to get in as well. They recently launched “Pantry”; their home grocery delivery service in Belgium. We expect the competition for this segment to grow fiercer as the number of people buying food online increases each year.14
When is a store not a store?

The role of the store has changed. It is no longer just a place where consumers go to buy a product. Increasingly it is becoming a fulfilment centre or mini-warehouse where consumers can go to collect or return online purchases.

As the role of the store evolves, retailers and landlords struggle to understand the true value of retail space in an omnichannel world (see figure 5). How can they measure the contribution of an individual store when it may be supporting online sales in addition to those that go through the till? How do you incentivise and reward staff who may spend most of their time assisting consumers with issues such as returns and click-and-collect orders? As the role of the store changes, staff working in those stores need different skills and capabilities. For example for fulfilment of online orders in store pick accuracy and productivity become more important.

An improved understanding of the true value of retail space will inevitably lead to a greater focus on productivity. The migration of sales online means that many retailers have more space than they require. However, they have also found it difficult to exit unwanted space either due to long-term leases or issues with competition. For instance, if you close your store what is to stop you customers from wandering across the street to your nearest competitor?

The productivity and profitability of space are becoming bigger priorities. Retailers are being forced to think like landlords renting space to third parties and pop-up shops. They will inevitably look to incorporate more leisure and services into their offering accelerating the transition of the typical high street from a place centred on shopping to one more focused on leisure.

Retailers’ access to more and more data which will enable more frequent reviews of portfolios could lead to higher rates of churn – which in turn will lead to a constant re-evaluation of space requirements and values.
Old metrics do not work any more

Many of the traditional metrics that retailers have used to measure business performance are no longer relevant (see Figure 6). Given the migration of a significant proportion of sales online, how useful is a measure like footfall, particularly when many of the people visiting the store may be returning rather than buying products. In an omnichannel business the role of the store is much wider than just a point of transaction, raising issues such as how to attribute sales and profits, and how to handle store impairment. The role of the store is becoming less clear due to the rapidly evolving model.

A brave new world

In the last five years the focus for many retailers has been on adding new shopping channels and investing in technology, such as automation, to increase the efficiency of their existing operations. However, this has become more difficult each year. Following a period of unprecedented change the retail industry is facing an environment where margins are under increasing pressure from rising costs, lower pricing power due to increased transparency, and the need to invest in the digital transformation of their businesses. In this new environment traditional assets are potential liabilities and the value of product and service innovation has increased.
Responding to the profitability challenge

There are three ways retail businesses need to respond to the challenges they face. We believe they will require revolution and evolution in equal measure.

Survival of the fittest

The traditional model of retail needs to evolve. Retailers are already responding to the structural changes in the market but are they moving fast enough?

There are many challenges to consider and they will differ depending on the sector and nature of each individual business. However, there are also some critical issues to address: the need to remain customer focused, the need to be differentiated and the need to be innovative. Each of these needs to be considered in the context of continuing to deliver value to shareholders. We argue that how businesses respond to the challenges highlighted above will have the greatest impact on profitability in the long term.

1) Real customer engagement

The relationship with the customer is at the heart of the retail experience. Or at least it once was. In an increasingly complex omnichannel market – do retailers still really know who their customers are and what their connection to them is?

Real customer engagement involves both knowing and understanding your customers. Retailers first need to understand what their brand stands for in the eyes of its customer. Then the focus should be on insuring that every interaction the customer has with the retailer – across all touchpoints and stages of the customer journey – reinforces this relationship.

While this may sound simple, in reality it is very difficult due to the structure of many retail businesses which have remained focused around the traditional functional silos such as marketing, commercial and operations. The metrics used to manage the business have reinforced the status quo and it will require both a different structure and different metrics to encourage a more integrated approach and more engaging and more consistent customer experience.

We believe that retailers need to focus more on customer metrics such as customer acquisition cost and customer lifetime value, i.e. the cost of getting a new customer and the total amount of profit you will make from them over the lifecycle of your relationship with them. Another measure would be to look at total share of each customer’s spend.

Brands are also taking more innovative approaches to customer acquisition. Some such as Under Armour are investing in creating ecosystems that build loyalty and collect data that can then be used to personalise products and services for customers (see the following case study). Others, such as Amazon, are investing in content. The Amazon Prime subscription service was originally focused around free or lower cost delivery. Then it added free content streaming services such as Amazon Prime Music and Amazon Prime Video and in recent years has started producing content, receiving its first Academy Award nomination in January 2017. CEO Jeff Bezos has a simple vision for the Prime service: “We want Prime to be such good value, it would be irresponsible not to be a member.”

Case study: Under Armour

Sportswear brand Under Armour acquired fitness app MayMyFitness in 2013 for $150 million and with it acquired 20 million regular users of products such as MapMyRun and MapMyRide. This was followed by the purchase of rival fitness app Endomondo in 2015, adding another 20 million users – the majority of which in Europe – extending the company’s reach. The Under Armour Connected Fitness platform now has over 200 million users and has allowed the brand to appeal to a higher proportion of women. Customers that are part of its Connected Fitness ecosystem are also 26 per cent more likely to make a purchase after receiving personalised recommendations.
2) Differentiation - the speciation of retail

Many retailers feel that they need to be the best at product design, sourcing and merchandising, as well as digital marketing, CRM, customer experience, logistics, distribution and fulfilment. However, this means that they need to invest in all of the above areas and this is impacting profitability and eroding margins. Retailers will struggle to continue competing with different rivals offering the most flexible delivery options, the lowest prices, the widest range and the best customer experience. Given increasing cost pressures, fighting a battle on all fronts appears unsustainable. Therefore, we believe in the future there will be greater speciation in retail. Successful businesses will be those that focus on excelling in just one or two of areas rather than trying to be the best at everything.

Speciation involves clear differentiation between species and a single-minded focus on what an individual retailers wants to be known for. Using the same analogy Deloitte analysis has shown that the most clearly differentiated retailers are often the most profitable.

Deloitte UK analysed the performance of FTSE 350 retailers, ranking their levels of product and experience differentiation from high to low. Four distinct groups emerged with those that were the most differentiated recording the strongest revenue and profit growth (see Figure 7).17

So what might the future speciation of retail mean for the industry? We believe that five main species of retailer will emerge:

**The Entertainer** – has a total focus on the customer experience. Stores are often, but not always, large flagships or destination stores (e.g. Mediamarkt Wilrijk, Rituals). The Entertainer understands that shopping can be a leisure activity.

**The Curator** – seeks to ensure that they offer their customers a carefully edited range of products with strong merchandising. The focus is on making it easy for the customer to find what they are looking for (e.g. The Cloakroom).

**The Deliverer** – offers the most comprehensive range of fast and flexible fulfilment options based on a highly efficient supply chain that employs the latest digital technology. (e.g. Coolblue, Bol.com).

**The Innovator** – is totally focused on the continuous innovation of its products and services. The brand is everything – a marker of quality and design (e.g. Apple, Tesla).

**The Discounter** – focuses on delivering the greatest value which does not necessarily mean offering the lowest price. The Discounter typically operates a simple, streamlined business, with clear marketing messages that support its focus on value. (e.g. Aldi, Colruyt)

Greater ‘speciation’ would require retailers to focus on only making investments that align to their strategy, enabling them to spend less to create more competitive differentiation.

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**Figure 7. Greater differentiation leads to growth**

<table>
<thead>
<tr>
<th>Product Differentiation</th>
<th>Experience Differentiation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highly Differentiated Offering</td>
<td>Highly Differentiated Offering and Experience</td>
</tr>
<tr>
<td>5-year CAGR Revenue</td>
<td>5-year CAGR Revenue</td>
</tr>
<tr>
<td>+8.5%</td>
<td>+18.4%</td>
</tr>
<tr>
<td>5-year CAGR EBITDA</td>
<td>5-year CAGR EBITDA</td>
</tr>
<tr>
<td>+3.5%</td>
<td>+14.3%</td>
</tr>
</tbody>
</table>

Source: Deloitte
3) Innovation – focus on driving greater returns

Traditional retailers are being disrupted by new competitors and new business models. Retail is an established and mature industry, and one that prides itself on product innovation. However, as a mature industry it has shown a lack of business model or service innovation which has allowed new competitors to target specific gaps in the market or growth niches. Technology companies, and under this heading we include e-commerce specialists, understand that they have to innovate to survive. For example in 2015, Amazon spent more than 14 per cent of revenue on R&D (see Amazon case study). Traditional retailers find themselves increasingly in competition with technology companies and other competitors that invest heavily in innovation and research and development.

There are more cost effective ways to increase efficiency and productivity through innovation in areas such as automation, robotics and artificial intelligence. This can both drive cost reduction and enable investment in areas of the business that will create differentiation and build competitive advantage. For example by focusing on the customer experience.

Profitability priorities – A to do list

The retail industry is going through a period of unprecedented change, with the rate of change showing little sign of slowing. Retailers are competing with each other – as they always have – but they are also facing new competitors with very different business models such as e-commerce specialists, subscription services and even the large consumer product companies looking to sell directly to consumers and disintermediate retailers entirely.

In summary, retailers need to focus on: customer engagement, greater differentiation and focus on innovation that can reduce costs and generate greater returns. Below are our recommendations for overcoming the profitability challenge:

1) Be genuinely customer centric – Retail is essentially a customer focused industry, but increasing complexity and rising cost pressures mean that some have failed to keep up with their customers changing behaviours. A greater focus on customer management is required i.e. understanding the value of your customer base and managing them through the customer journey.

2) Greater speciation – There is a clear need for greater speciation, specialisation and differentiation as retailers will struggle to generate adequate margins if they are not focused and try to be all things to all people.

3) Focus innovation on reducing costs and driving greater returns – If retailers are to remain relevant in the fast moving world of modern retail innovation needs to be focused on the current pain points: reducing store costs and overheads, automating processes and augmenting the workforce, and creating a more immersive and differentiated experience.

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Case study: Amazon

Leading e-commerce specialist Amazon is an example of a business that is constantly innovating, first by introducing the e-commerce concept to mass market retail, then developing its Prime subscription service, investing billions of dollars in developing content services, trialling drone delivery and most recently launching a store without a checkout as it looks to expand into grocery retailing. With sales of more than $100bn in 2015, Amazon has also managed to grow margins in each of the last 10 quarters.\(^1\)

The structural changes the retail market has undergone in recent years has led many traditional retailers to prioritise incremental improvements in efficiency above innovation. There have been some successes where companies have invested in ‘labs’ or ‘ventures’ to help fund start-ups so that they can acquire technology or capability at an early stage.\(^2\) However, much of this activity is small scale and taking place at the periphery of the business not the core. It is unlikely to help them meet the profitability challenge and better compete with their e-commerce rivals and other new competitors.
Endnotes

1) The Economist, Intelligence Unit: “Real retail trade turnover picks up”; August 4th 2017
   http://www.eiu.com/industry/article/1085757292/real-retail-trade-turnover-picks-up/2017-08-04
   & The Economist, Intelligence Unit: “Belgium economy: Quick View - Retail sales decline in July”
   & “Consumentenvertrouwen” https://www.tijd.be/rt/1/id/9934226

2) Deloitte analysis of the levels of discounting offered by a sample of UK retailers conducted in the run-up to Christmas 2016. See:

3) “Smartphone shopping driving UK e-commerce sales”, e-marketer, June 2016. See also:
   https://www.emarketer.com/Article/Smartphone-Shopping-Driving-UK-Retail-Ecommerce-Sales/1014137

4) “2030 – The year the high street reaches a dead-end”, ParcelHero, 2016. See also:
   http://edelivery.net/2017/01/opinion-2030-year-high-street-reaches-dead-end/

5) “CX Marks the spot: Rethinking customer experience”, Deloitte UK, November 2016. See also:

6) “Nieuw record: Belgen kopen voor meer dan 9 miljard euro online in 2016”

7) “Belgen geven meer geld uit online”

8) “Nachtarbeid moet online winkelen in ons land boost geven”

9) “Belgische B2C e-commerce is sterkste Europese groeier in 2016”

10) The Deloitte Restructuring team analysed the operating profits of over 600 retailers in the UK spanning all retail subsectors over the
    last three financial years to establish a baseline of the current profitability of UK retailers. As part of this analysis we created dummy
    P&Ls based on the performance of the retailers in each subsector over the last three years and applied the estimated impact of the
    national living wage, business rates, the fall in sterling and rising commodity prices to the relevant cost lines within the cost base to
    estimate the overall impact on operating margins. Our estimates of the impact of the anticipated retail challenges are based on public
    announcements by UK retailers supplemented by proprietary analysis using publicly available information.

11) “Omnichannel Shoppers: An Emerging Retail Reality”, Google, 2015. See also:
    https://www.thinkwithgoogle.com/articles/omni-channel-shoppers-an-emerging-retail-reality.html

12) “Meal kit market heats up”, Handelsblatt Global, January 2017. See also:
    https://global.handelsblatt.com/companies-markets/meal-kit-market-heats-up-689716

13) The growing power of consumers”, Deloitte Consumer Review, July 2014. See also:
    https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/consumer-business/consumer-review-8-the-growing-power-of-
    consumers.pdf

14) Flanderstoday, 13 September 2017: “Amazon food delivery service arrives in Belgium”


18) “Amazon once a big spender is now a profit making machine”, The Verge, July 2016. See also: http://www.theverge.com/2016/7/28/12313526/amazon-q2-2016-earnings-report-aws-cloud-profit

19) “Are retail labs really the path to innovation?”, campaign, February 2016. See also: http://www.campaignlive.co.uk/article/1381099/retail-labs-really-path-innovation
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