Six ways for retailers to drive rapid e-commerce growth

Building a better working world

Developing strategies to accelerate online penetration

Over the past decade, e-commerce has become a vital part of the retail industry, experiencing between 14% to 17% annual growth. In recent months, with the global upheaval resulting from COVID-19, e-commerce has become an even bigger part of the retail business, rising from 16.4% of all sales at the end of 2019 to nearly 35% in March 2020. The online groundswell is likely to remain even after the pandemic.[1]

Traditional retailers, which started as brick and mortar (B&M) retailers in sectors such as apparel, office supplies and consumer electronics, have evolved their business models to keep up with changing shopping trends. However, other sectors, such as retail pharmacy, sporting goods and outdoors, and hardware and home improvement, still have lower e-commerce penetration. Retailers in these sectors continue to bring in more than 90% of their revenue through in-store channels. In a post-COVID-19 world, these retailers will need to rapidly address their e-commerce strategies.

In a Future Consumer Index study conducted by EY, we found that:

- The "anxious consumer" will be the norm, even in the long term, impacting decisions on what consumers choose to buy and how.
- Nearly 50% of respondents believe the way they live will significantly change in the long term; 44% express a willingness to shift daily shopping habits, such as groceries, to online channels.
- Companies will need to significantly accelerate digital investment in operations and experiences that help make consumers feel safe.

Under these conditions, retailers may fall further behind without a focused plan to take their e-commerce to the next level.

We have identified six fundamental levers that retailers can use to improve online penetration and drive growth.

Recommendations to help drive profitable online growth for retailers

How should retailers think about their online product assortment?

1. Develop a distinct online merchandising strategy, instead of re-creating the physical store on the web
2. Be nimble; quickly pivot to match shifts in customer demand

How can retailers grow their e-commerce business without compromising margin?

3. Apply the rule of 40% gross margin to drive price and product assortment
4. Develop a cost focus and find innovative ways to address structural costs

What steps must retailers take to generate online growth?

5. Focus on core capabilities first before moving to omnichannel
6. Use what others built to enhance capabilities and drive scale

1. 14-17% annual growth comes from US Census Bureau numbers on eCommerce sales.

How should retailers think about their online product assortment?

1. Develop a distinct online merchandising strategy, instead of re-creating the physical store on the web

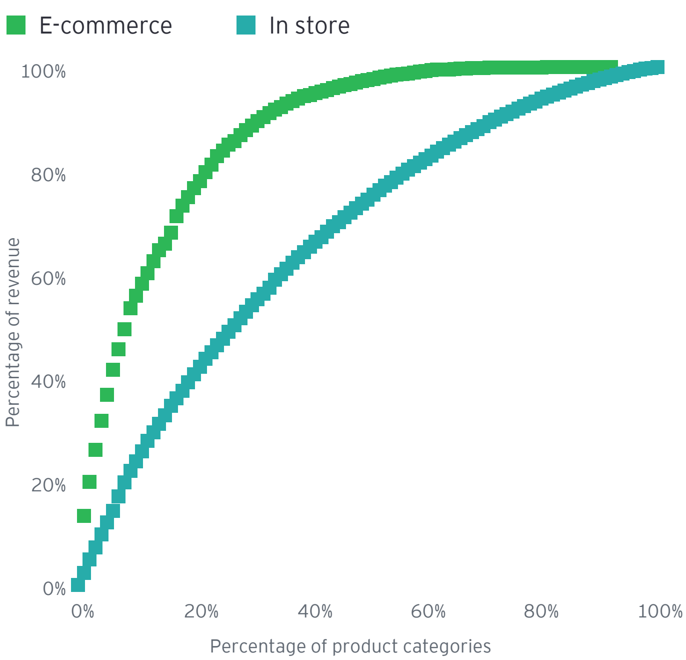
What customers buy and how they buy online differ significantly from their in-store shopping behaviors. The key to rapid online growth may be to develop merchandising strategies tailored to online shopping preferences and experiences rather than simply re-creating stores on a webpage.

An online category and SKU selection replicating the in-store merchandise mix creates unique challenges for retailers and impedes growth:

- Cluttered websites featuring products that do not interest customers can result in shopping fatigue and abandoned carts.
- Unfocused marketing spend can result in lower return on investment (ROI).
- Replenishment bottlenecking and holding inventory of unnecessary items can hinder storage of necessary items.

At one retailer, we found that 80% of online revenue resulted from 25% of product categories versus 60% in store, even with a significantly smaller online assortment (Figure 1).

Figure 1: Revenue as a percentage of product categories



Source: EY internal data

2. Be nimble; quickly pivot to match shifts in customer demand

Product assortments that generate high online sales change quickly, driven by seasonality; innovative, online native products; and macroeconomic changes and disruptions.

Recent trends in pharmacy and sporting goods have shown that certain products can bring significant online growth; however, traditional retailers have captured very little of this growth:

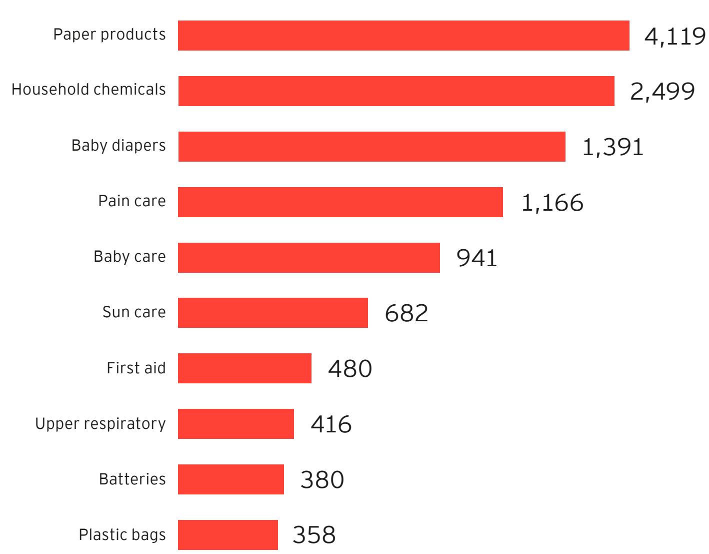
- E-bikes have experienced 72% growth, with digitally native e-bike retailers capturing large growth.
- Eye care wearables have seen 36% annual growth, with one online brand now valued at $1.75b as a result.

Meanwhile, COVID-19 has increased online demand for paper products, household chemicals, baby diapers and other products at one national retailer by more than a thousand percentage points in a very short period (Figure 2).

Pivoting assortments quickly to meet immediate customer needs can provide an opportunity for retailers to gain market share and accelerate conversion.

E-commerce sales for several products normally sold through B&M channels have recently spiked significantly due to COVID-19. For most retailers, nimbly responding to demand shifts in sector-specific product categories can yield large dividends.

Figure 2: Product online sales spikes due to COVID-19



Source: EY internal data

Change in average daily sales from February 2020 to March 2020

How can retailers grow their e-commerce business without compromising margin?

3. Apply the rule of 40% gross margin to drive price and product assortment

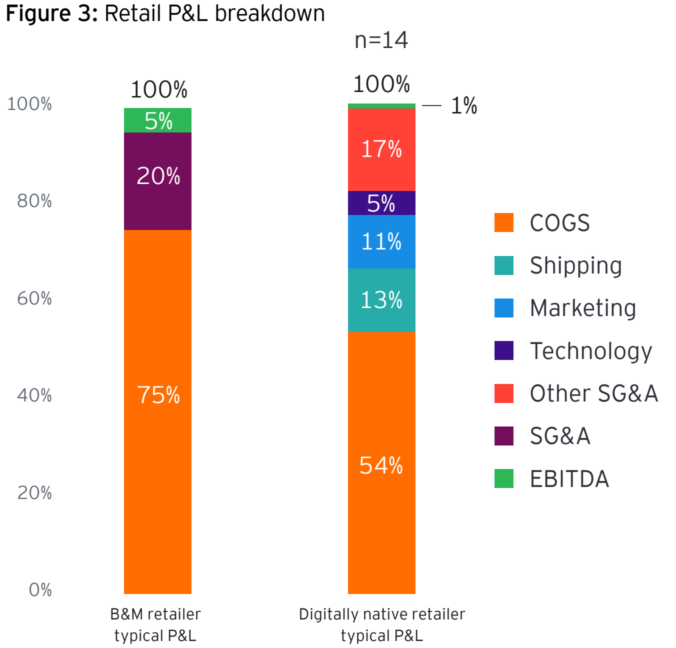
Most retailers cannot go to market online with their in-store cost structure. When closely examined, most online retailers have a fully burdened profit and loss (P&L) with low to negative earnings before interest, taxes, depreciation and amortization (EBITDA), even with gross margins approximately 20 percentage points higher than B&M retailers. Our research indicates that a minimum gross margin of 40% can be the critical threshold to support e-commerce cost burdens.

Pricing and product assortment strategies can be key levers to improve profit margin and achieve online growth. Retailers may need a deliberate pricing plan to protect margin. Strategies that can be utilized include:

- **Promoting own brands:** Private-label brands command higher profit margins than third-party brands do. Private-label substitution in low-margin, low-brand differentiated products could improve overall EBITDA by as much as 5%.
- **Offering product bundles:** Popular low-margin products can be sold alongside complementary higher-margin products to minimize downward price pressure.

A comparison of a typical B&M retailer's P&L to a blended P&L of 14 publicly traded digitally native retailers shows that, despite a lack of a store and personnel overhead, e-commerce carries its own significant costs (Figure 3).

Figure 3: Retail P&L breakdown



Source: 1. B&M Retailer Typical P&L from "Aswath Damodaran, NYU http://pages.stern.nyu.edu/~adamodar/"
2. Digitally Native Retailer Typical P&L from EY analysis of 14 publicly traded digitally native eCommerce retail companies

4. Develop a cost focus and find innovative ways to address structural costs

While the cost structure for online differs from B&M, most retailers largely commingle their online and in-store P&L. Profitable and rapid online growth often requires visibility into the stand-alone online P&L and a focus on achieving positive EBITDA. A good starting point is to address the unique online cost drivers:

- **Shipping and fulfillment:** Retailers carry a shipping burden of 10% to 18% on their P&L. While customers expect free and rapid shipping, reliance on the legacy distribution and logistics network may not only fails to meet customer expectations but also may result in higher cost for rewiring processes and technology. It also can commingle P&L beyond the point of natural synergies. Emerging options include dedicated micro-fulfillment centers and dark stores, which can reduce last-mile delivery times and can reduce costs for high-volume items in certain markets.
- **Marketing:** Marketing creates a cost burden of 7% to 14% for digitally native retailers. Retailers may need to closely monitor the allocation of marketing dollars across product categories and facilitate higher ROI. Tightly controlled and distributed marketing spend can yield up to 400% to 500% returns.2
- **Technology:** The cost of standing up an omnichannel e-commerce solution and maintaining the underlying technologies can be significant. Retailers can leverage IT shared services effectively to lower technology cost burdens. The use of corporate back-office functions and shared services can also reduce selling, general and administrative expenses.

2 EY internal data

What steps must retailers take to generate online growth?

5. Focus on core capabilities first before moving to omnichannel

Our research indicates that most retailers associate online penetration with better technology and features that allow shoppers to have the same experience online as they do in store. While omnichannel is important to attract shoppers and sustain long-term growth, the initial focus can be on eight core capabilities (Figure 4), including:

- **Data integration and analytics:** Many retailers have data that exists in disparate systems. Retailers can use data to generate insights that inform every aspect of their operations, service levels and customer preferences. At one apparel retailer, integrating historical data into existing pricing workflows led to a 9% sales increase and a 12% margin increase.
- **Navigation and customer experience:** Creating a streamlined, more personalized web navigation experience can help direct customers to their precise needs and shorten the sales funnel. One online retailer saw sales increase by 40% after introducing a chat box with three specific options for the customer.

Retailers may invest in e-commerce-specific solutions for the core capabilities below to enhance operational effectiveness and foster higher traffic, better conversion and, ultimately, retention of shoppers.

Figure 4: Capability areas to improve e-commerce

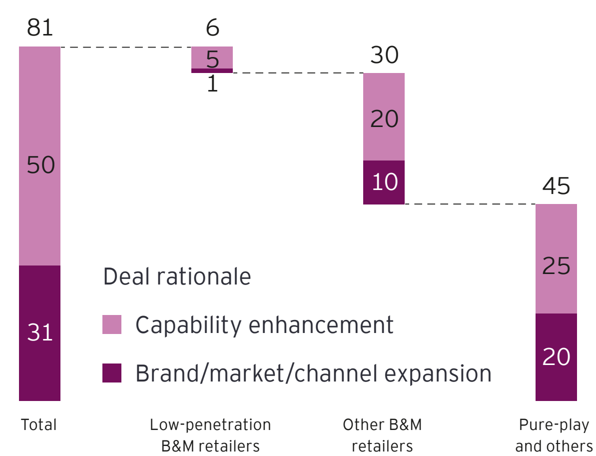
Source: EY internal data

6. Use what others built to enhance capabilities and drive scale

Retailers may make targeted investments to build online capabilities to most effectively realize value. Two key investment strategies retailers with low e-commerce penetration are not fully leveraging are:

- **Acquisitions:** Our research shows that low-penetration retailers have invested significantly less in inorganic growth options. Most retailers lack in-house expertise in areas key to online success, such as online marketing and personalization, yet they are not using acquisitions of digital native and pure-play online companies to address these capability gaps. We tracked 81 retail e-commerce deals since 2017 (Figure 5).

  Figure 5: Tracked e-commerce acquisitions from 2017–20



  Source: EY Global M&A Database

  - Only 6 out of 81 deals involving retail e-commerce were made by retailers with low online penetration.
  - Retailers generally lagged in e-commerce-specific acquisitions.
  - Consumer packaged goods companies joined digitally native retailers and tech giants in strategic acquisitions to add capabilities.
- **Distributed commerce:** Distributed commerce is another way to augment a retailer's online presence. It can enable retailers to shorten the sales funnel by allowing transactions to be completed on third-party platforms. Distributed commerce can be achieved through several different types of customer experience enhancements, such as one-click purchasing, voice ordering through smart speakers, and augmented reality and virtual reality experiences. One study shows that each additional step that is removed from a checkout process results in a 10% increase in transactions. By enabling quicker transactions on multiple high-traffic points-of-sale, retailers may see increased revenue and a decrease in abandoned carts.

Create deliberate online growth strategies to achieve long-term success

Improving online penetration may require an integrated approach that combines leading practices across products, capabilities and profitability dimensions. The online channel will become a growing part of the retail business, considering that the recent crisis has moved customers out of stores and onto the internet and is forcing most retailers to pivot to a new way of reaching consumers.

Retailers that made ad hoc pivots without specific and deliberate e-commerce strategies, anchored by the right capabilities, likely did so at the expense of profitability while also not fully capturing market share potential. Retailers can immediately begin to address these six identified areas to improve their chances of long-term success.

In a post-COVID-19 world, the retail industry is poised for market consolidation, which can present opportunities for retailers with low e-commerce penetration with liquidity and cash flow to invest in opportunistic acquisitions.

Authors

Lead contributor

Hakan Civi
EY US Strategy and Transactions, Partner
hakan.civi@parthenon.ey.com

Jim Doucette
EY Americas Strategy and Transactions, Partner
jim.doucette@parthenon.ey.com

Yemi Alade
EY US Strategy and Transactions, Senior Director
yemi.e.alade@parthenon.ey.com

Taher Lokhandwala
EY US Strategy and Transactions, Senior
taher.lokhandwala@parthenon.ey.com

EY | Assurance | Tax | Strategy and Transactions | Consulting

SCORE no. 10186-201US
2006-3524384
ED None

ey.com