THE SHAPE OF RETAIL:
THE TRUE COST OF ONLINE

ALVAREZ & MARSAL
LEADERSHIP. ACTION. RESULTS.℠

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Introduction

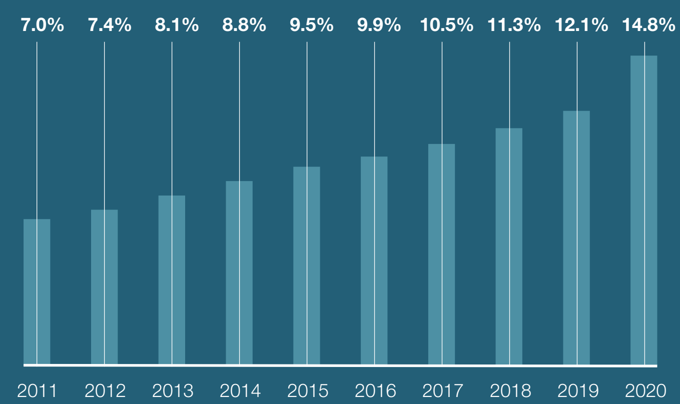
COVID-19 has profoundly impacted retail industries across Europe. The enforcement of store closures, social distancing measures and heightened anxieties over viral transmission has elevated 'digital' to new heights across the entire customer journey.

The initial stages of the pandemic saw a seismic shift towards ecommerce throughout major European retail markets, as consumers embraced new paths to purchase goods and services.

Online sales growth rose rapidly, with markets such as the U.K. seeing online penetration rates peak at almost 40% during 2020. Across key European markets (the U.K., Germany, France, Italy, Spain and Switzerland) the proportion of online sales rose markedly, from 12.1% in 2019 to 14.8% in 2020 (Figure 1).

FIGURE 1:
Step change in online sales across key European markets

Online as proportion of retail (%)



SOURCE:
Euromonitor, Retail Economics and Alvarez & Marsal analysis (includes the U.K., Germany, France, Italy, Spain, Switzerland)

Europe's ecommerce landscape is undergoing significant structural change. The pandemic has caused a seismic shift in the proportion of online shopping, with prolonged restrictions on socialising and the opening of physical outlets cementing these trends.

For many businesses striving to remain relevant and survive the disruption, their transition will likely mean a challenging readjustment as business models are aligned with the 'new normal'. Profitability will come under intense pressure as operating models that are disproportionately weighted towards physical channels struggle to rebalance costs as online accounts for a growing proportion of sales.

Against a backdrop of falling margins and rising competition, the true cost of the online shift will be revealed.

COVID-19 has accelerated many of these underlying trends; it has sparked a sense of urgency across European retail boardrooms in addressing these challenges head-on.

This report focuses on the impact of COVID-19 and the true cost of online. The research contains insights drawn from a consumer panel of over 3,000 households across six European countries and analysis of over 250 European retailers, accounting for over €2 trillion worth of spending in 2019/20. Specifically, it highlights:

1

The **impact of consumer behaviour** on European retail sectors as shoppers experience more digital customer journeys, particularly since the pandemic.

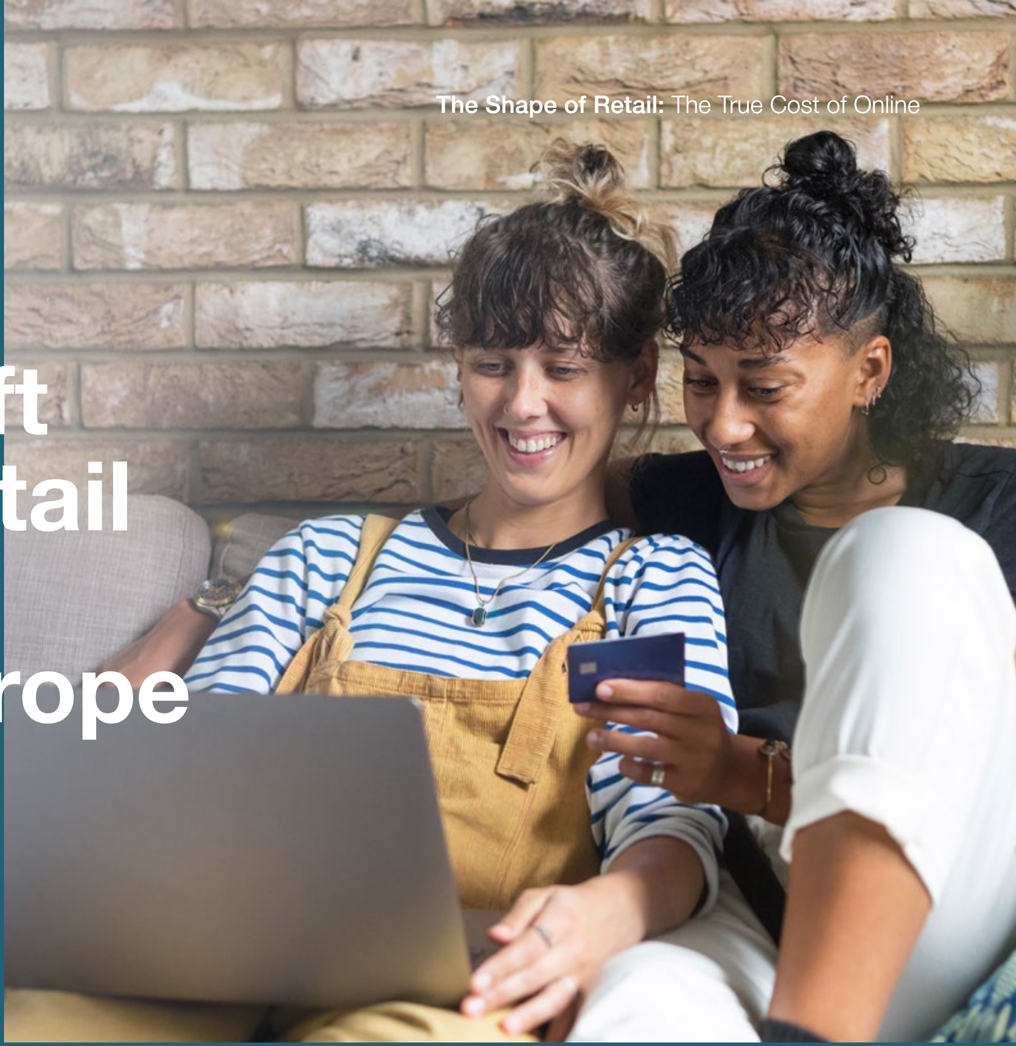
2

An **analysis of profitability** across key European retail markets since 2011, including a forecast for the evolution of profitability across the European retail market through to 2025 revealing the true cost of online.

3

The **most pressing themes** facing the European retail industry and most suited strategies to survive and thrive in this new digital-first environment.

For retailers and brands seeking valuable insight into the impact of the crisis across Europe, this research provides data-driven insights and guidance for action.



Section 1:

Online shift impacts retail dynamics across Europe

COVID-19 has clearly been a catalyst for structural change. Online sales in Europe hit record highs during lockdowns as consumers embraced ecommerce options for the first time across many categories, while online dependency grew for others.

Inevitably, many consumers will revert to previous shopping habits once the impact of the pandemic recedes, but a significant proportion of consumers have spent more time browsing, researching and purchasing online, with these new online behaviours cemented, after having broken through the initial barriers of setting up online accounts, entering payment details and overcoming issues of trust and convenience.

Our research shows that just under a third of European consumers[1] think their shopping habits will change permanently because of COVID-19, with a significant and permanent shift towards online shopping particularly for Apparel, Homewares and Electricals. In some countries such as the U.K., a permanent change in shopping habits rises to almost four in ten shoppers. The majority of consumers intend to continue to do more online shopping post-pandemic, but the extent will vary significantly between category, demographics and country.

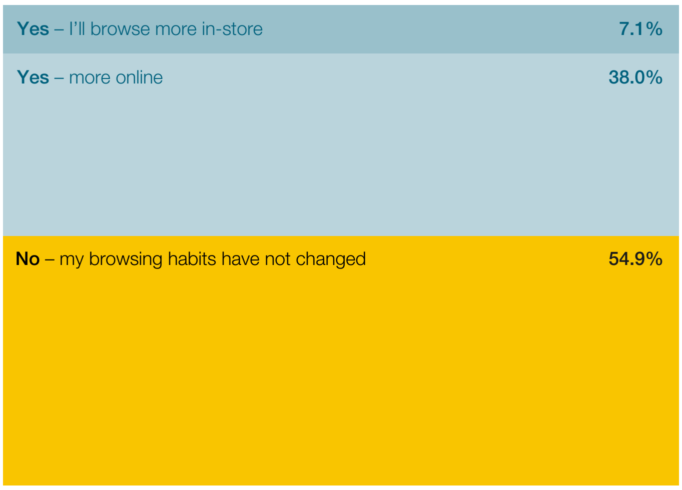
[1] Includes U.K., Germany, France, Italy, Spain and Switzerland

Temporary and permanent changes

The impact of the pandemic has affected all parts of the customer journey, from the discovery and research of products through to service and returns.

Digital has played a much more central role in consumers' lives, whether for social media, communicating with friends and family, or shopping. Our research shows that almost two in five (38%) consumers agreed that there had been a shift towards online when they are browsing and discovering new products (Figure 2). This is significant from a brand perspective because consumer attention is being increasingly fought for online with Facebook, Google, Instagram, TikTok, Snapchat and others becoming the 'landlords' of the digital environment.

FIGURE 2:
Thinking about the way you browse for retail products, do you think this has changed since the outbreak of COVID-19?



SOURCE:
Retail Economics and Alvarez & Marsal

For online-first retailers, digital marketing forms a significant proportion of their operating costs and as the battle to win consumer attentions online has become more competitive, the cost per acquisition of customers has risen putting further pressure on margins.

Across the six European countries analysed[2], around half of consumers have changed their browsing behaviour due to COVID-19. While some changes are temporary (e.g. from safety concerns or capacity constraints), retailers and brands are trying to assess *what proportion of behavioural shifts are permanent* as European economies start to reopen.

Unsurprisingly, due to lockdowns across Europe, the greatest change in consumer behaviour involves shifting attention away from physical stores towards online. Since COVID-19, a net balance of just under a third of shoppers (31.0%) have increased online browsing, but this shift was disproportionately higher for the U.K., Italy and Spain, suggesting that behavioural change might be 'stickiest' for these countries. However, increased online engagement has affected sectors unevenly as explored in the following section.

[2] Countries analysed: U.K., Germany, France, Italy, Spain and Switzerland

Uneven impact across categories

The seismic shift to online has been felt unevenly across categories, with our research showing that Apparel and Homewares experienced the greatest change.

Increased online engagement reflects an acceleration of the changing role of physical stores, together with new preferences for heightened convenience at home.

For retailers seeking to better understand the necessary level of online investment, it is critical to distinguish consumers 'discovering online shopping for the first time' (for certain categories), from 'longer-term intentions to continue shopping online'.

Our research identifies three distinct consumer-driven shifts that differ by category:

Step-change in behaviour: high levels of online discovery that is likely to persist after the pandemic recedes.

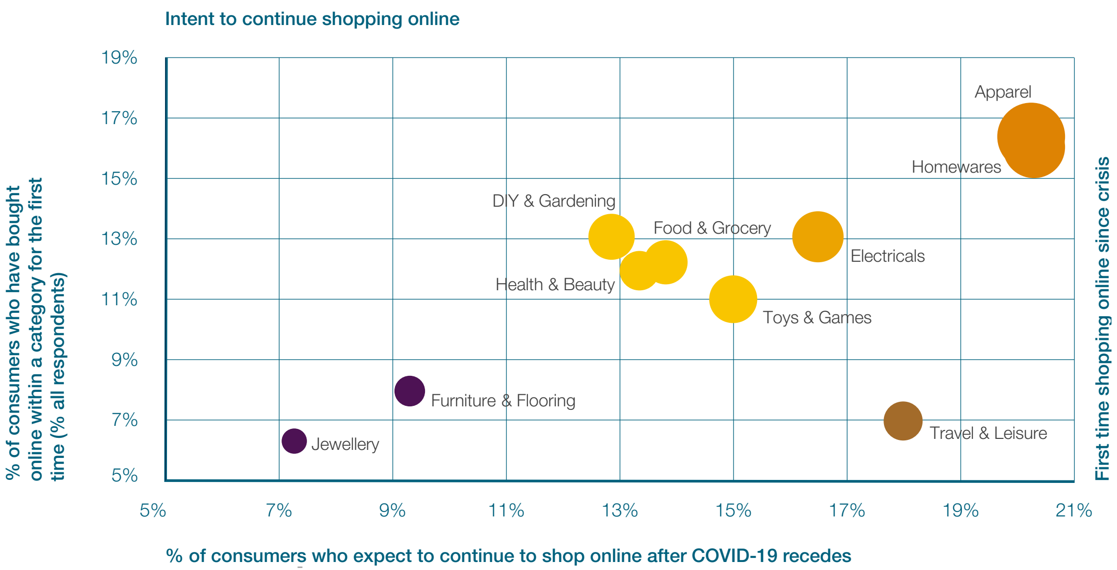
Sticky potential: some momentum in new online experiences showing potential to stick after the pandemic recedes.

Revert to old ways: online experiences have been less convenient compared to traditional shopping, or online had already taken hold before the pandemic.

FIGURE 3:
Consumers discovering new categories online since COVID-19 are most likely to continue home shopping even after the pandemic recedes

KEY:
Step-change in behaviour
Sticky potential
Return to old ways

SOURCE:
Retail Economics and Alvarez & Marsal



Across the six European countries researched, a strong relationship emerged between consumers shopping online for the first time within a category, and their intention to continue this behaviour after the pandemic recedes.

Consumer intentions for a permanent shift towards online were strongest across Homewares, Apparel and Electricals (Figure 3). These categories are likely to have been affected disproportionately by lockdown measures, as products have been much more in demand during this period.

Our research also shows that prolonged periods of lockdowns across Europe between 2020 and 2021 have embedded the shift towards online. The proportion of consumers who now expect to conduct more of their spending online permanently has risen markedly compared with the early stages of the pandemic in Europe.

Between May 2021 and a year earlier, categories such as Homewares, Apparel and Electricals have seen at least a four-fold increase in the proportion of consumers who expect to permanently increase their spending online, but levels have risen significantly across every category (Figure 4).

For Apparel, the magnitude of the online shift varies with consumer age group. Younger and middle-aged shoppers are more likely to permanently shift Apparel spending online compared to senior shoppers. Just 17.0% of 65+-year-olds expect to shift fashion spending online after the virus subsides, compared with 27.3% for 35 to 44-year-olds across the countries analysed.

Health & Beauty occupied the middle ground, seeing a significant uplift in online sales and firm consumer intentions to continue to shop online after the pandemic recedes. While overall demand has been significantly dampened by the lack of social interaction, lockdown has been a catalyst for beauty ecommerce growth. Given the nature of high value, non-perishable products, brands have the potential to drive profitable growth even after shops have reopened.

Although direct-to-consumer subscription models remain a very small part of the channel mix, it appears an area that consumers may be willing to embrace nonetheless.

Home-related products were in high demand as households increased home comfort, improved home entertainment, and adapted to remote working. Likewise, the need to refresh wardrobes during mandated store closures necessitated a shift online for parts of the Apparel sector (e.g. loungewear).

Conversely, Furniture & Flooring, and Jewellery did not experience the same uptick in online spend. Higher priced items typically involve more considered paths to purchase, commonly relying on a 'touch and feel' experience in-store and face more complicated delivery (e.g. two/three-man delivery for furniture items). Consumers in these categories are more likely to revert to previous behaviours of shopping when permissible.

PARTS OF SPENDING CONSUMERS EXPECT TO PERMANENTLY SHIFT ONLINE

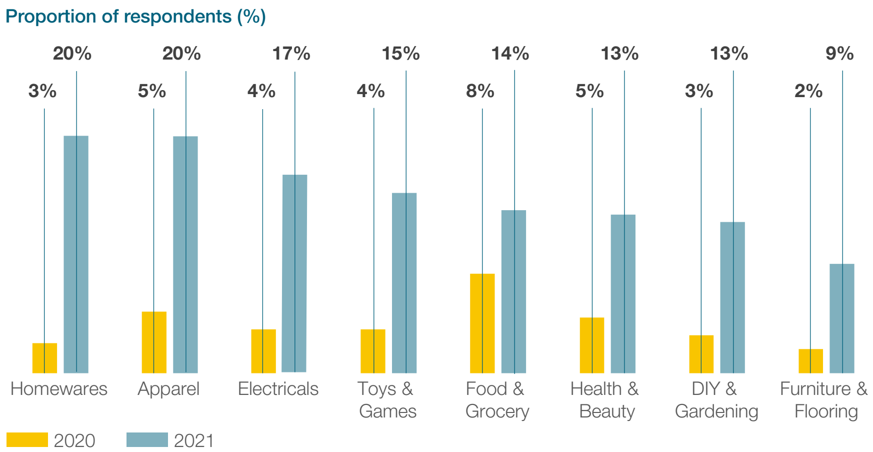


FIGURE 4:
Consumer expectations to permanently spend online have ramped up following more than a year of restrictions

SOURCE:
Retail Economics and Alvarez & Marsal nationally representative consumer panels across U.K., Germany, France, Italy, Spain and Switzerland in May 2020 and May 2021

Online maturity differs across Europe

Across the six European countries, just under a third (30.1%) of household expenditure is expected to permanently shift online as a result of COVID-19 (Figure 5), a considerable uplift from 14.8% in 2020.

EXPECTED PERMANENT SHIFT TOWARDS ONLINE BY COUNTRY

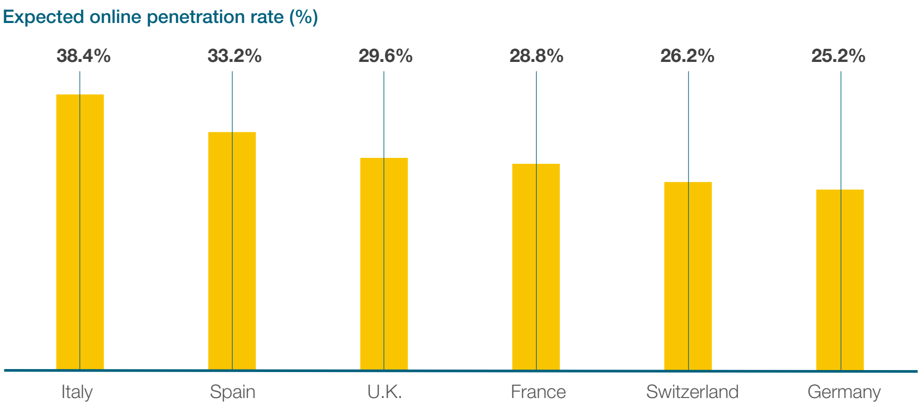


FIGURE 5:
Expected permanent shift towards online by country

SOURCE:
Retail Economics and Alvarez & Marsal

The migration towards online will not be uniform across each country due to differing market conditions such as online maturity, market competition, regulation, infrastructure, and many other factors.

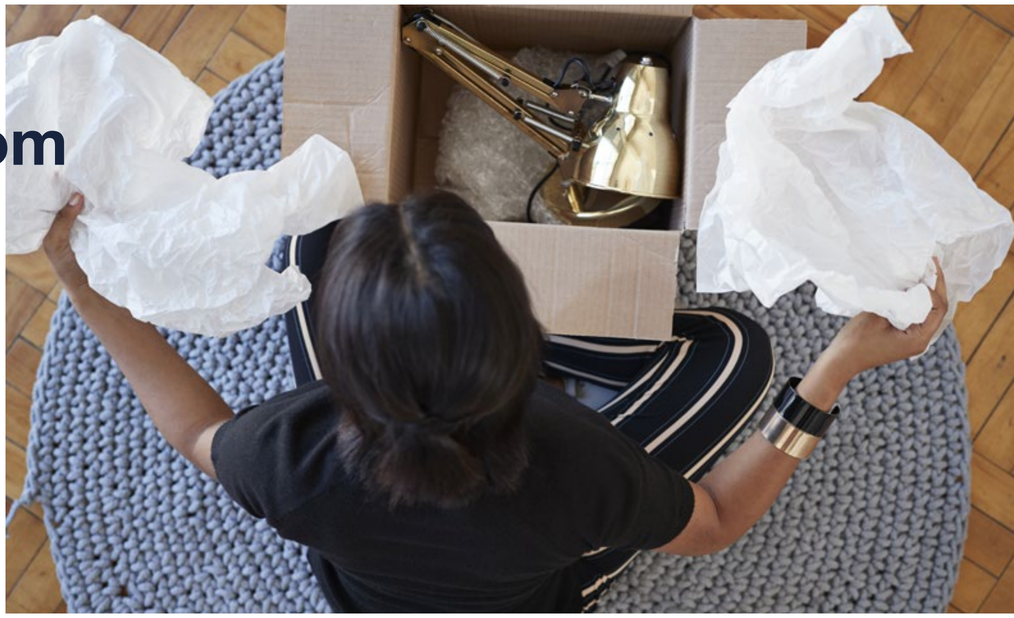
Our research showed that in markets such as Italy and Spain, where online penetration rates are relatively low and the online proposition less mature, consumers expect to see a greater permanent shift in their online spending. In part, this is likely to reflect consumers in these markets shopping online in some product categories for the first time. For example, our research showed that the proportion of consumers shopping online for the first time for Apparel, Homewares and Toys was highest in Spain compared with the other European markets we analysed.

In less mature online markets, the impact of COVID-19 has had a dramatic impact on shopping habits with the closure of shops necessitating a shift towards online. Exposed to new online customer journeys for a prolonged period of time has cemented many of these behaviours, presenting significant opportunities for those retailers that are well-positioned to capitalise on these trends. However, many retailers will need to pivot their proposition to align with these new realities, investing heavily to effectively service a growing online channel. This period of transition will challenge many business models as cost structures change, new skills are required, and investment is needed, all of which will threaten profitability. Strategies will vary across markets with the maturity of the online channel being a key determinant.

However, many factors will influence the future trajectory of online consumer adoption across different markets. Breadth of selection, competitive pricing, loyalty schemes and financing options are all important ingredients, but none are more important than delivery and returns.

Consumers want cheap, fast and easy returns when shopping online. Dynamics within final mile delivery vary widely across markets, and the pace of growth will largely hinge on capacity, cost and reliability of courier services. Consumers have proved to be extremely price sensitive to delivery costs which could hinder growth in some markets.

Shying away from physical stores



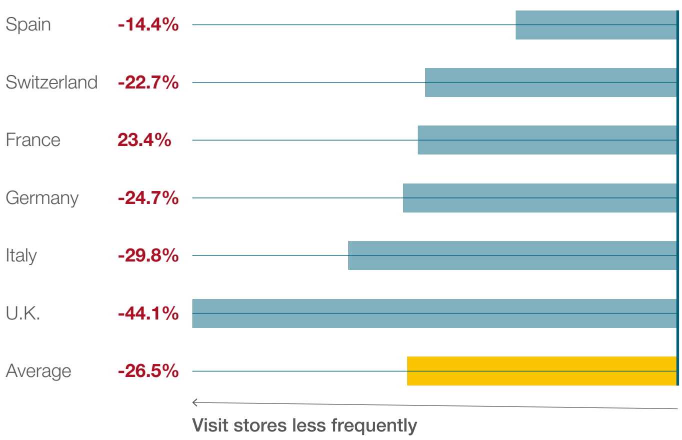
Rising online sales has also led to operational challenges across the customer journey – particularly for fulfilment and after-sales.

Essentially, fulfilment options for online orders have now become critical for conversion. This has led to innovative solutions (e.g. delivery time-slots, curb side pick-up, and click-and-collect) and investment in technology and infrastructure.

FIGURE 6:
Footfall to stores is least likely to return to pre-pandemic levels in the U.K.

After the impact of the pandemic recedes, do you think you will visit retail shops as frequently as you did before?

Net balance, more frequently vs. less frequently



SOURCE:
Retail Economics and Alvarez & Marsal

Multichannel retailers looking to repurpose stores have leveraged their store estates to provide consumers with a convenient channel to acquire goods.

However, the shift towards online will raise serious questions concerning the number, purpose and location of stores.

This is particularly pertinent given consumers across all European markets we researched suggested that they will visit stores less frequently than before the pandemic.

The greatest declines are expected across the U.K., followed by Italy, Germany, France, Switzerland and Spain (Figure 6). While it is unclear how this will translate to actual footfall, the net balance of consumers looking to reduce store visits is concerning for retailers who have expansive store footprints.

City centre locations are likely to face greatest pressures with flexible, remote working expected to remain in place permanently to some extent for many businesses. With fewer store visits and spending shifting online, retailers, landlords and other stakeholders (e.g. local government) must consider how to repurpose shopping destinations to drive sustainable levels of footfall.

Pressure of online returns

As online momentum builds, online return volumes will inevitably rise – putting intense pressure on profit margins.

Our research shows that young adults are the most prolific returners online (Figure 7). In countries such as France, Switzerland and the U.K., those aged 18-24 years return approximately twice the number of items as their senior counterparts (65+ years).

Young adults have grown up experiencing fierce rivalry between retailers and changing consumer rights. They have witnessed the balance of power shift away from retailers towards consumers, to a point where return volumes are now problematic for many retailers.

Within Apparel for instance, ordering multiple items online (with the intention of returning unwanted items, or ordering multiple sizes to ensure a good fit) has become normalised for younger shoppers. This poses long term risks as such behaviours are likely to be sustained into adulthood as online develops.

Beyond returns eroding profitability for retailers, they are also inconvenient for consumers. With the likelihood of fewer store visits in the future, returns could intensify pressure on courier services as goods effectively funnel down fragmented channels.

Successful reverse logistics for returned items introduces a host of additional infrastructure costs too. The merging of physical and digital channels has increased the complexity of supply chains as retailers battle to cater to rising customer expectations and the fragmented nature of store and home delivery networks. The balance between providing convenient returns for online orders with the cost of doing so efficiently becoming a major priority.

Retailers can ease the burden by increasing minimum order values or using subscription models to offer free deliveries, while enhancing the lifetime value and loyalty of online customers. But potential returns still leave multichannel retailers the difficult task of handling combined stock pools for online and store channels, which requires a single-inventory view and advanced capabilities to integrate returns back into the supply chain efficiently.

Consequently, many retailers choose to form strategic partnerships with third-party suppliers to handle returns at scale to ease costs through technology and automation – further disrupting the cost dynamics of online retailing. It is often less capital intensive, faster and less risky to develop sophisticated cross-channel logistics by securing strategic partnerships. However, the speed, cost and convenience of deliveries are all critical components of scaling a successful online business which become vulnerable if third party logistics companies provide a sub-optimal service.

AVERAGE RETURN RATES ONLINE (%)

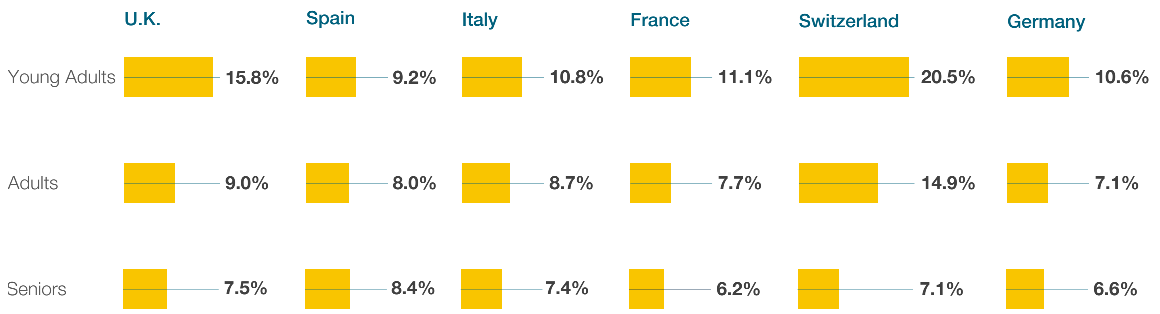


FIGURE 7:
Young online shoppers return the highest proportion of products

SOURCE:
Retail Economics and Alvarez & Marsal

The digital shift will create many challenges

The most significant challenge will be felt by retailers with an expansive store estate.

“Many retailers will be left with more physical outlets than they can commercially justify...”

The shift towards online will leave many retailers exposed with cost structures disproportionately weighted towards their physical channel, while facing rising variable costs as online accounts for a growing proportion of sales. Many retailers will be left with more physical outlets than they can commercially justify, often tied to inflexible lease structures which will inhibit their ability to pivot business models as quickly as they need.

Meanwhile, heavy investment will be needed to make online operations more efficient, from automating dispatch processes to hiring data scientists to integrate more sophisticated marketing campaigns. The digital shift will create new challenges throughout the entire value chain, adding additional cost at each stage.

This transition period will prove challenging and will ultimately put profitability under intense pressure which will reveal the true cost of online.

Section 2:

The evolution of profitability across the European retail industry

The impact of COVID-19 will accelerate the migration towards online well beyond the step-change European markets have already experienced.

The following section outlines six phases that will lead to an accelerated erosion of profitability as a direct consequence of the pandemic, revealing the true cost of online.

1. Profit margins already under pressure

Even before COVID-19, European retail market profitability was already under pressure, particularly within the last five years (Figure 8).

Across the sample of European countries that account for over €2 trillion of retail sales, pre-tax profit margins fell from 6.4% in 2015/16 to 4.5% in 2019/20 – a reduction of 1.9 percentage points.

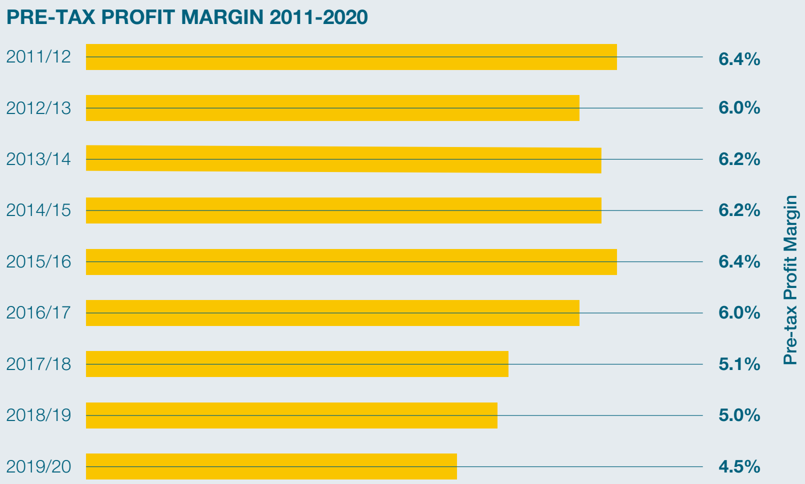


FIGURE 8:
Pre-tax profits have fallen markedly over the last five years across European retail

SOURCE:
Company accounts, Retail Economics and Alvarez & Marsal analysis

2. A consistent picture of falling margins across Europe

Although differences in the size of margins emerge across markets, there has been a consistent narrowing of profit margins throughout Europe. The U.K. has experienced the sharpest fall in margins since 2011 from 9.2% to 5.5% over the period (Figure 9). The German retail market displays anomalous characteristics in that it operates on considerably thinner margins than its European neighbours, reflecting a large discounter presence across food and non-food with cultural price sensitivities.

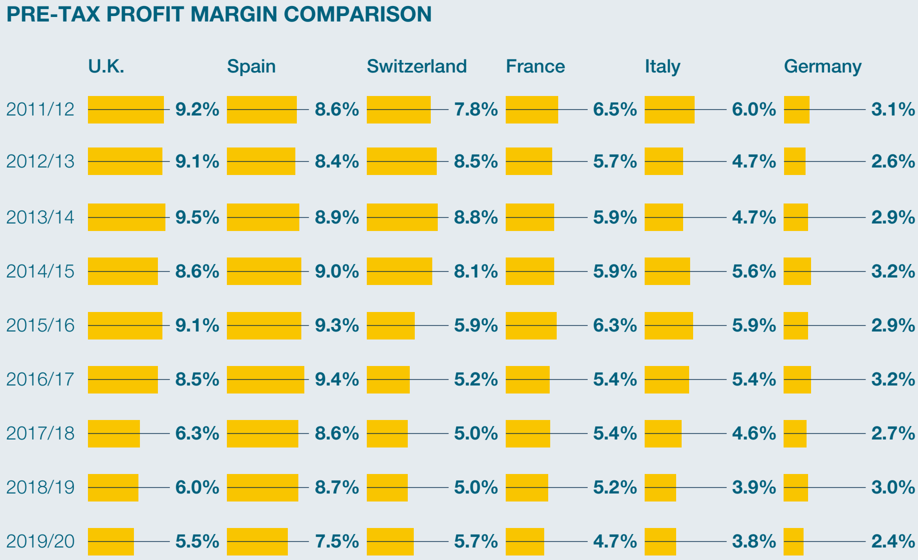


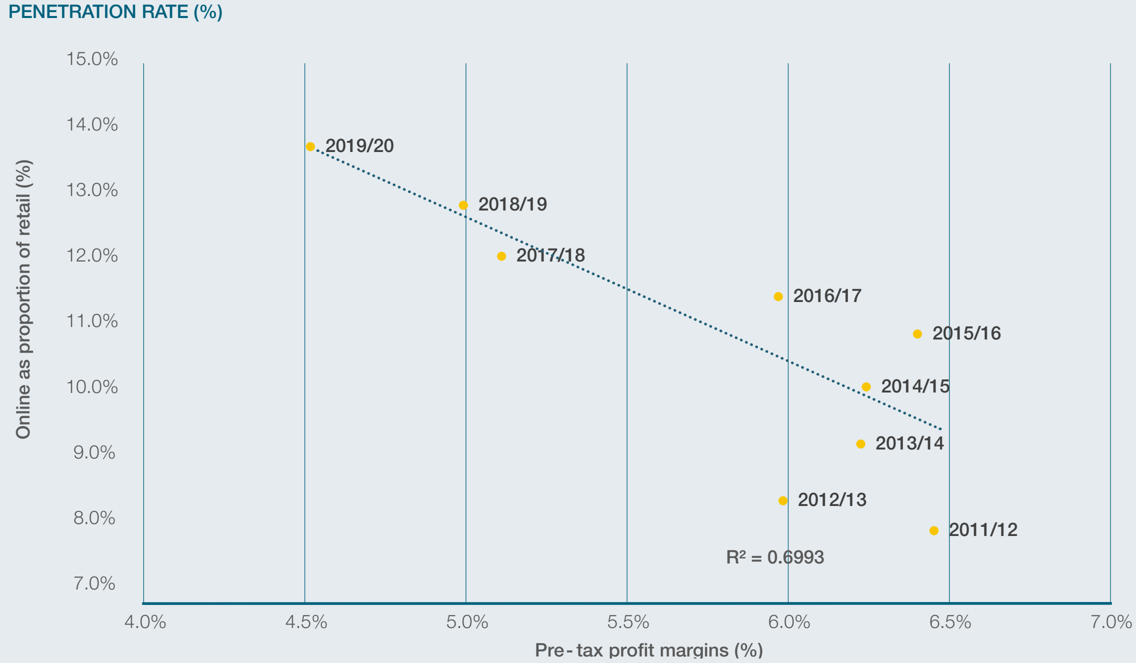
FIGURE 9:
Pre-tax profit margin comparison across major European retail markets

SOURCE:
Company reports, Retail Economics and Alvarez & Marsal analysis

3. Profit margins fall as penetration rates rise

The shift towards online is a significant contributing factor to dwindling profit margins. Our research shows an inverse correlation between a rise in the proportion of online sales and a fall in pre-tax profit margins over the last decade (Figure 10).

FIGURE 10:
Pre-tax profit margins have fallen as penetration rates rise throughout key European markets



SOURCE:
Company reports, Retail Economics and Alvarez & Marsal analysis (includes the U.K., Spain, Italy, France, Germany and Switzerland)

4. The online model is run on thinner margins

Indeed, pure online retailers typically operate on considerably lower margins than multi-channel and brick-and-mortar business models. Our analysis shows average pre-tax profit margins for pure online retailers across the key European markets analysed resided at 1.4%, compared with 5.4% for the total industry (Figure 11). This reflects the difference in cost structures, business models and the price sensitivity of consumers, where transparency in price, service and quality places further downward pressure on margins.

As penetration rates rise across Europe, many retailers will undergo a period of transition where profit margins come under intense pressure as operating models and cost structures are put to the test.

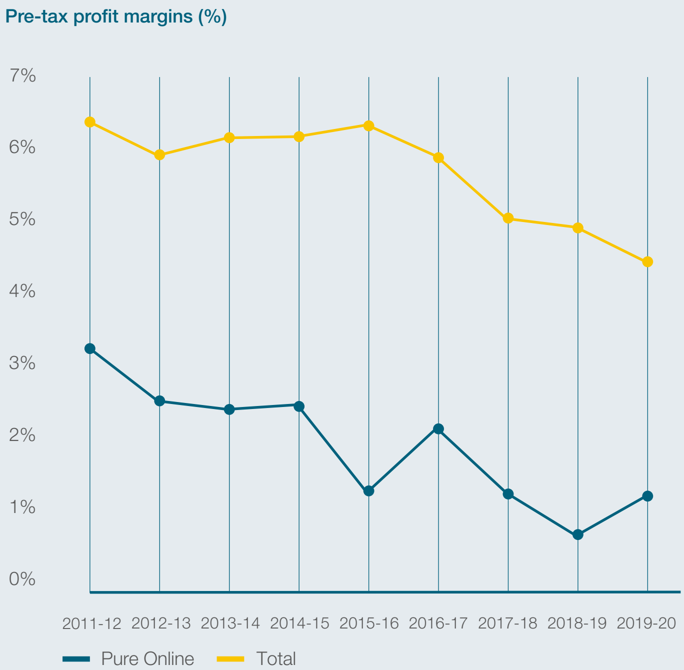


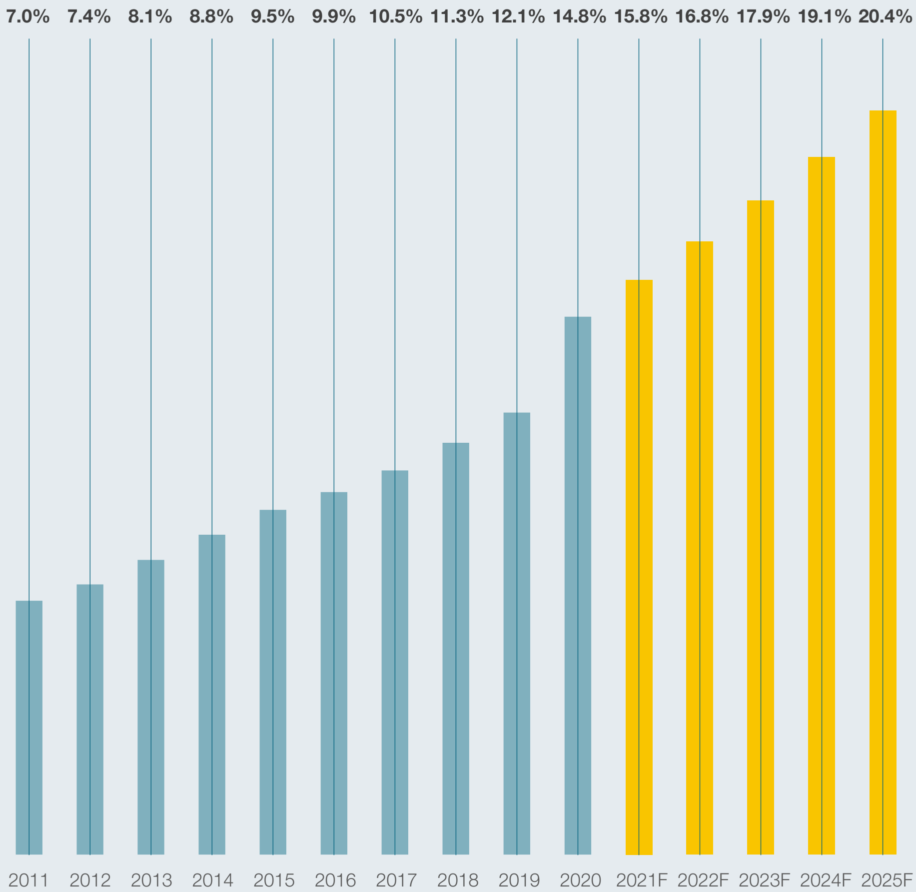
FIGURE 11:
Comparison of pure online retailers pre-tax profit margins across key European retail markets

SOURCE:
Company reports, Retail Economics and Alvarez & Marsal analysis (total retail includes sample of over 250 retailers, accounting for over €2 trillion of revenue. Pure online includes a sample of 32 pure online retailers across the six European countries in our analysis, accounting for over €28 billion of revenue.)

5. There has been a step-change in the proportion of online sales with further growth to come

FIGURE 12:
Online penetration across Europe expected to accelerate to 20% by 2025

Online as proportion of retail (%)



KEY:
To date
Forecast

SOURCE:
Euromonitor, Retail Economics and Alvarez & Marsal analysis

Across Europe, the impact of COVID-19 has caused step-changes in the proportion of online sales. By 2025, more than 20% of retail sales across key European markets are forecast to shift online (Figure 12).

The U.K. is expected to be the most deeply penetrated market, with more than a third (33.5%) of sales expected to occur online by 2025. This will contribute to a reduction in pre-tax profit margins from 5.5% in 2019/20 to just 3.2% by 2024/25. Throughout the five-year forecast period, the U.K. retail industry is expected to lose c.€9.3 billion of profits compared with a scenario where COVID-19 had no impact on the rate of growth for online retailing.

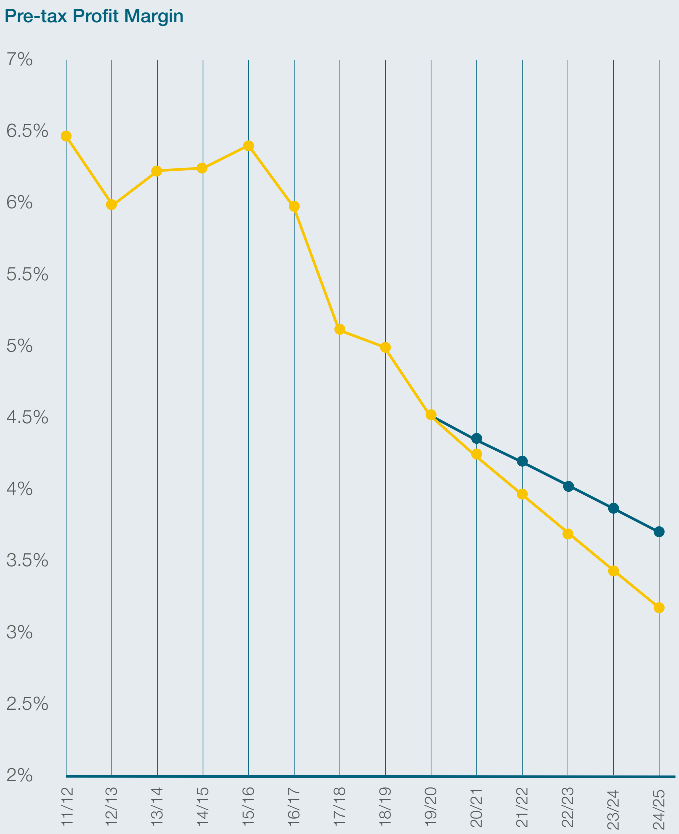
A similar picture emerges across the key European markets analysed. In particular, the proportion of retail spending online in Spain is expected to rise from 10.4% in 2020 to 14.9% in 2025, with the online market accelerating on average by 9.8% each year. The migration towards online will contribute to the erosion of profit margins, falling from 7.5% to 5.7% - leading to a loss of €7.8 billion of profits over the forecast period compared with a scenario where COVID-19 had no impact on underlying consumer behaviour.

However, all European markets are poised to see a significant rise in the penetration of online over the forecast period with Italy expecting to see the fastest growth – rising on average 13.5% each year. Conversely, Germany is forecast to see the slowest online growth across the six European countries analysed, reflecting weaker consumer online adoption.

6. COVID-19 has accelerated the online shift and profit margin erosion

FIGURE 13:
Profits are expected to fall at a faster rate than before the pandemic, driven by a more aggressive consumer migration towards online

PRE-TAX PROFIT MARGINS - SCENARIO COMPARISON



	11/12	12/13	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21	21/22	22/23	23/24	24/25
Pre-Covid-19 (%)	6.4	6.0	6.2	6.2	6.4	6.0	5.1	5.0	4.5	4.4	4.2	4.0	3.9	3.7
Post-Covid-19 (%)	6.4	6.0	6.2	6.2	6.4	6.0	5.1	5.0	4.5	4.2	4.0	3.7	3.5	3.2

SOURCE:
Retail Economics and Alvarez & Marsal analysis

As the growth of online retail spending accelerates in a post-COVID-19 era, the true cost of online will be revealed (Figure 13). Our research compares the future trajectory of pre-tax profit margins based on two scenarios:

1. The impact of COVID-19 accelerating the rate of migration towards online **yellow line**.
2. COVID-19 having no impact on the rate of migration towards online **teal line.**

Our model forecasts a reduction of pre-tax profit margins across both scenarios over the forecast period, until 2025. However, an acceleration in the online penetration rate erodes profit margins at a faster pace.

Indeed, our model forecasts that an acceleration in online growth will lead to profit margins falling to 3.2% by 2025 for the six European countries analysed, compared with 3.7% for a 'no COVID-19 impact' scenario.

As the difference between profit margins widen over the forecast period, **total profits will be €11 billion less by 2024/25,** compared with the scenario where COVID-19 does not impact consumer behaviour for the six European countries analysed.

Aggregated across the five-year forecast period, this amounts to **c.€35 billion in reduced profits** across the key European countries analysed.

The impact of the pandemic has accelerated the erosion of profit margins by around two years compared with the pre-COVID-19 rate of online growth. Even before the pandemic, profit margins were on an unsustainable trajectory with many retailers focused on restructuring their business to remain fit-for-purpose in an increasingly digital age.

The acceleration of these underlying trends has placed an intense urgency on businesses to meet these challenges head-on if they are to thrive, or survive, in this new normal.

Section 3:
Thriving in a digital-first environment

As the European retail industry undergoes a period of transformation, businesses need to adopt a more detailed and data-driven approach to profitability. The shift towards online will exert greatest pressure on store-dependent operating models, requiring businesses to align with more digital-centric customer journeys.

For retailers, the priority of protecting margins and improving operational performance will mean utilising data to gain improved visibility on ecommerce profit and loss. Here, data-driven decisions will be critical in executing more informed investment trade-offs.

Retail strategies will vary widely depending on many factors such as category, customer demographics and the maturity of online propositions. While external influences such as regional market dynamics, regulation and infrastructure ensures that transformation plans are dependent on individual company and market characteristics, such as existing online penetration rates, concentration and competitor activity.

Nevertheless, irrespective of the nuances across operations, successful companies will be those that quickly deploy effective margin-improvement strategies targeted at the largest cost drivers underpinning the digital switch. For most retailers, these centre around digital marketing, supply chain optimisation and channel-mix management.

Our research has identified four megatrends that can help inform their plans:

1. Scale through consolidation and partnerships

Scale is a critical determinant of profitability for ecommerce operations as it allows significant economies of scale. However, retail markets across Europe are significantly more fragmented in some countries than others. For example, the largest 20 retailers in the U.K. accounted for 58% of the total retail market in 2020, compared with just 36% in Italy (Figure 14).

Country-specific market characteristics play an important role in determining the most appropriate strategies for companies to adopt a greater digital focus.

However, markets have become more concentrated throughout Europe in recent years, mainly driven by a more competitive environment striving for efficiency gains.

These individual market dynamics will shape consolidation and partnership opportunities across countries.

As retailers look to build scale across online operations, four strategies are likely to emerge:

Acquisitions: Strategic acquisitions which bolt on expertise and open new routes to market will accelerate as retailers that have performed well during the pandemic search for attractive opportunities.

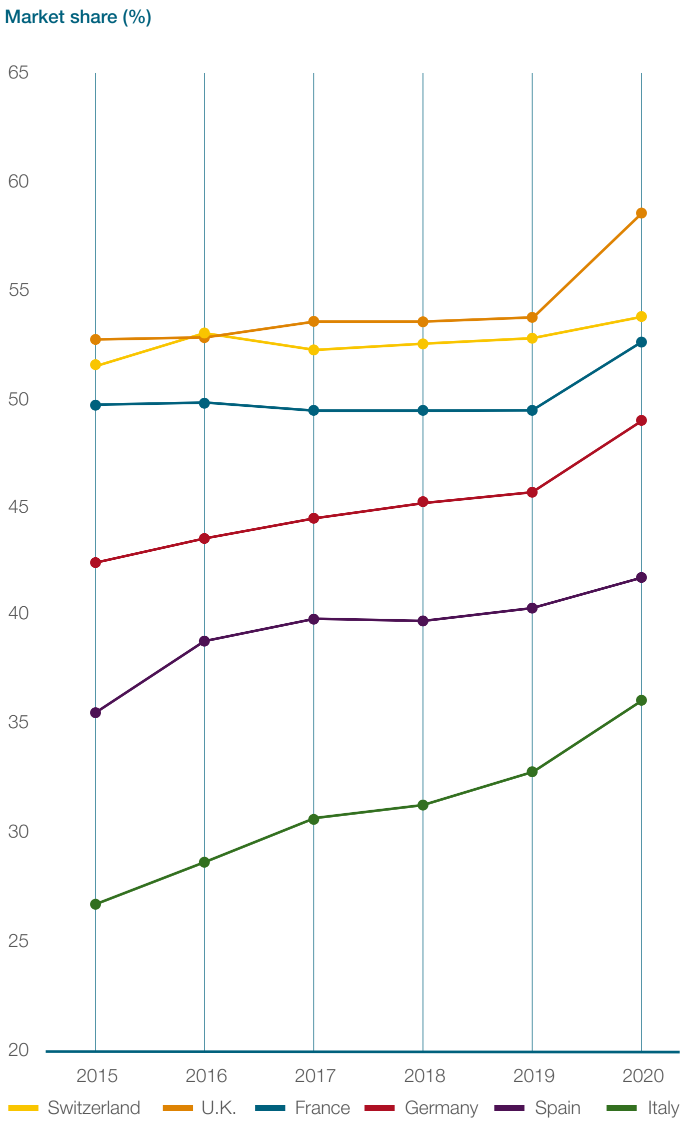
Strategic alliances: Strategic alliances here must leverage a mutually beneficial arrangement. For example, this could involve retail partnerships between pure online and store-based retailers.

Partnerships: Many retailers who struggle to grow profitability by themselves are likely to accelerate the migration towards online aggregators and platforms. This allows retail brands to ‘piggyback' on existing infrastructure and expertise to utilise the benefits of scaled operations.

Digital investment: Retail brands will need to carefully deploy capital investment to ensure they have the right digital infrastructure (e.g. cloud computing, data mining capabilities, high-performance computing) to drive operational efficiencies, improve customer insights and support the digital transition.

FIGURE 14:
Market share for top 20 retailers by country

MARKET SHARE OF TOP 20 RETAILERS BY COUNTRY



SOURCE:
Euromonitor

Specialist online players across Europe have a strong presence particularly across Food and Apparel. These include pure-plays (e.g. Zalando, ASOS, and Zooplus) and multi-channel retailers (e.g. Next, Inditex, H&M).

Many retailers with established online operations have shifted towards creating partnerships with third-party brands, using their digital platforms more as marketplaces to extend ranges, drive website traffic and increase market share.

However, many are taking this one step further, offering third party brands the benefit of 'piggybacking' off their existing infrastructure, leveraging this investment to offer additional services such as web systems, fulfilment and marketing.

This partnership is particularly attractive for retailers who find it too costly to grow their online operation efficiently. Migrating towards this model will be a key strategy that enables less established players to accelerate their online operations by leveraging the benefits of existing infrastructure, technology and logistics. It also provides an effective opportunity for multi-category retailers to expand their proposition in a meaningful way while reducing cannibalisation of store sales.

It also provides operators (e.g. Zalando's Partner Programme, Next's Total Platform) the chance to pursue margin-accretive opportunities by permitting them to monetise their existing infrastructure while growing market share.

For instance, Reiss recently entered Next's Total Platform partnership where it will benefit from the retailer's extensive ecommerce and logistics capabilities to rapidly build its presence online. Reiss CEO, Christos Angelides, said the arrangement would be "quicker, cheaper and less risky" than trying to build infrastructure itself.

Partnerships with agile third-party suppliers (e.g. Amazon) will become essential for businesses to enhance capabilities in a rapidly evolving market while carefully managing profitability. The shift toward digital often requires specialist skillsets that often surpass the confines of a retailers' head office.

2. Repurposing stores and social spaces

As the impact of COVID-19 accelerates the shift towards online, many retailers will be left with a channel-mix bias leaning towards physical stores.

Before the pandemic, there was already excess capacity of retail floor space in most countries from increased online shopping and shifting consumer behaviours. For example, it is estimated that in the U.K. there is around 20%[3] over capacity of retail space that businesses cannot commercially justify. In a post-COVID-19 world, this figure will be higher. Also, the market will correct over a shorter time frame.

These underlying impacts already present telling signs of a forthcoming readjustment period for the retail property market, characterised by falling rental values and higher vacancy rates. For many retailers, COVID-19 has kickstarted the self-correcting process of attaining the right balance between their physical and online presence, aided by power shifting away from landlords into the hands of occupiers. In many cases, proactive negotiations on more flexible lease terms and reduced rents will help protect long term profitability.

[3] A&M/Retail Economics – The Shape or Retail report

The pandemic has forcibly shifted the mindsets of many retailers, as they reimagine the purpose and function of stores amidst more digitally focussed customers, travelling along more digital-centric customer journeys.

Under these conditions, emerging customer journeys will be more frictionless and will continue to merge physical and digital realms. Simultaneously, the purpose of stores will move beyond mere distribution, to one where they buttress existing media channels, facilitating customer discovery, interaction and brand-bonding. In addition, stores will begin to penetrate the consumer lifestyle arena where hyper-personalised marketing will target customers and entice them into stores for lifestyle consultation services, providing value beyond a company's core product offering.

Some stores might be more geared towards click-and-collect (akin to a walk-in fulfilment hub for collection and returns), improving the profitability of the online channel. For example, c.80% of Next's online returns go back into its own stores, making handling returns significantly less costly.

In this new normal, a store's measure of success will demand new performance metrics that recognise its role as a 'customer contact' asset and powerful customer acquisition tool which forces retailers to start thinking more holistically about their ecommerce investments. After all, it's a well-established fact that a physical store presence creates a 'halo effect' of online activity.

Gaining clarity over cost-attribution and revenue allocation models, and accurately calculating omnichannel return on investment (ROI) of digital ad spend and a high street presence, will be critical in protecting and building profitability. Advanced customer insight, data analytics and artificial intelligence will also play an increasingly important role in ROI modelling to improve cross-channel attribution that informs intelligent data-led investment decisions.

Retailers must also recognise the value of stores as social spaces. Retail has always been a social experience, but its meaning has changed as technology yields new opportunities to interact with consumers. Fashion retailer Mango, which now generates around two-fifths of its sales online, opened a two-month pop-up store in April 2021. The so-called Upside Down Teen Pop-Up in Barcelona featured a TikTok stage at the back of the store where shoppers could create choreographies and take selfies to share their experiences online.

Department store Selfridges has gone a step further by offering in-store wedding ceremonies at its London Oxford Street store. The newly created wedding suite on the fourth floor of its historic building allows couples to use existing store services such as hair and makeup, catering, and a private cinema, as well as to curate a luxury gift list.

3. Supply chains and logistics

As a greater proportion of sales migrate online, supply chain optimisation becomes increasingly important for maximising profitability. Retailers will have to carefully consider the implications of the channel shift for end-to-end supply infrastructure and planning.

The step-change in online volumes is likely to introduce inefficiencies across operating models that will need to be quickly resolved to stem the erosion of profits. Some of the key themes will include:

Data and technology: Part of the solution involves intelligent use of data and technology. Whether developed internally, or through third-party suppliers, technology can drive improvements in demand forecasting and inventory management processes which can drive efficiency, reduce waste and improve stock availability. It will also help improve planning to lower order fulfilment costs and reduce dispatch times.

Packaging: Re-engineering packaging for ecommerce (e.g. reducing weight, compacting package shapes to boost delivery success) can also lead to incremental improvements in profitability. Also, being able to reuse packaging for simple returns can boost loyalty while reducing costs.

Final mile delivery: Partnering with final mile delivery specialists has become commonplace as it involves high infrastructure costs to service online efficiently at scale. It also incurs the highest single cost regarding fulfilment.

Returns: Dealing with elevated levels of online returns will also force retailers to explore partnerships in reverse logistics. For example, Clipper Logistics integrate returns across the U.K., Germany and Poland for a number of brands including ASOS, Boohoo, Pull & Bear, Zara and Bershka.

Important strategic decisions must be made concerning the number and location of distribution centres.

→ **Which locations should be used for which channels and to what extent?**

→ **How much investment should be placed on automation versus lean practices?**

→ **How to track and integrate returns into the supply chain efficiently?**

4. Direct-to-Consumer (DTC)

As retail progressively shifts online, brands have more opportunities to sell direct to customers, facing fewer barriers to entry than physical stores.

Brands have traditionally relied on retailers to act as intermediaries to distribute products, but this approach can create inconsistent shopping experiences, often leaving brands unable to harvest data to glean deeper insights into their final customers.

Today, extracting insights has become critical to gain a competitive advantage. Brands with significant following are discovering they can foster existing relationships through social media channels to conduct more meaningful interactions with their customers. Social platforms such as Instagram and Facebook have also made it easier for brands to convert browsing on social feeds into sales by integrating checkout functionality on their social networks.

But established brands are going further to capitalise on extended online browsing times by boosting marketing budgets on service dedicated websites and apps as a route to market to sell directly to shoppers.

DTC models have flourished during the pandemic as ecommerce penetration reached new heights. Within a few months of lockdown, Nike was selling 30% of its goods through its own online channels – meeting its 2023 target. Nike connects to its 250m+ loyal customers directly via an app, which offers everything from free-running guidance to access to vending machines where customers can redeem free products. The company harvests reams of real-time data, so when it noticed that traffic on its app was showing more customers doing yoga, it swiftly produced new yoga clothing ranges.

Other brands turned to direct channels to boost revenue during the pandemic. Heinz to Home offered ‘bundles’ of its food lines during the first U.K. lockdown, including baby food and an essentials collection of beans and soups. Bundles ensured orders were large enough to offset fulfilment costs, avoided conflict with existing retail channels, and provided a level of convenience to customers wanting to stock up.

Brands looking to truly drive unique experiences have relied on a physical presence too, typically through flagship experiential stores and concessions. These stores are partially treated as a marketing exercise, where store turnover is not necessarily the primary objective.

Developing a direct-to-consumer strategy will not be without its challenges. Building new capability in customer relationship management, customer contact and database management, and direct to consumer marketing are all significant skills and capabilities to develop in order to handle one-to-one customer relationships, as opposed to third-party ones. An essential part of this new journey will be considering the right logistics framework to support growth ambitions and to ensure quality and speed of final mile delivery. While integrating returns back into supply chains will also present new challenges.

Armed with more customer information, a different range of skills will be required within the business too. Data analytics requires a whole new range of technical abilities to build, consolidate and provide operational models that automate data mining to derive clearly defined actions.

Consumers and retailers have been adapting to the migration to online for many years now, but the recent shift in behaviour as a result of the global pandemic means that we are entering a new phase across Europe of truly omnichannel customer expectations. Critical to survival is ensuring customer relevance, satisfying changing customer needs, offering outstanding and competitive service, all while managing the impacts of increased online penetration on profit margins.

Methodology

Consumer panel:

A nationally representative consumer panel was undertaken across six European countries including the U.K., Germany, Italy, Spain, France and Switzerland. The sample comprised more than 3,000 consumers with survey data collected between 19 April and 1 May 2021.

Pre-tax profit:

Estimates for pre-tax profits are based on a sample of over 250 private and public European retailers that have operations in either the U.K., Germany, Italy, Spain, France or Switzerland. The sample of retailers have a combined turnover of over €2 trillion in 2019/20, accounting for c.40% of total retail sales across the six European countries.

Pre-tax profit forecasts:

Pre-tax profit margin forecasts are based on a sample of over 250 private and public European retailers that have operations in either the U.K., Germany, Italy, Spain, France or Switzerland. Data was collected on their pre-tax profit from 2010/11 to 2019/20. Collectively, they accounted for over €2 trillion of retail sales in 2019/20.

The aim was to examine the relationship between online market penetration levels and sector weighted pre-tax profits, adjusting for underlying temporal trends. The penetration figures were taken from Euromonitor estimates. The benchmark scenario of ‘no COVID impact’ was based on penetration rate forecasts made before the outbreak of the pandemic.

To create forecasts for pre-tax profits for each market and category (e.g. food, apparel, non-food excluding apparel) under different penetration scenarios, we leverage an Ordinary Least Squares (OLS) regression weighted for the relative market share by category. To meet our assumption that market-level pre-tax profits would remain positive over the forecast period, we applied a logistic transformation to pre-tax profits, and modelled this for time and online penetration.

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- **Store operations assessment** across both store performance (sales and margin) and store productivity (costs) to deliver a better customer experience and operational efficiency.
- **Store locations, formats, sizes and rents assessment** to eliminate loss-making stores, renegotiate rental agreements to deliver improvements to EBITDA and geographic network optimisation.
- **Marketing effectiveness** to analyse and improve marketing effectiveness and efficiency to save costs and optimise budget spend to provide the best return.

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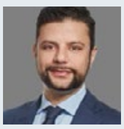

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