FTI CONSULTING

2018 U.S. online retail forecast

AN AUSTRALIAN COMPARATIVE VIEW

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FTI Consulting has produced our annual U.S. Online Retail Forecast since 2010. This research initiative draws data from consumer product categories including music and videos, books and magazines, toy and hobby, consumer electronics, sporting goods, and apparel.

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Our Report has historically provided valuable insights about the state of online retail in the U.S., and the direction in which the market is headed. And, because Australia generally follows U.S. online retail trends, typically with some lag, it provides reliable predictions for Australian pure-play and multi-channel retailers.

This year, our report also highlights a number of nuances between Australia and the United States.

A gangbuster year

In the U.S., retail is a US$3.5 trillion market. While store-based sales currently account for approximately 85% of total retail, online sales are booming. According to the U.S. Census Bureau, in 2017, U.S. online sales were US$450 billion, with 16% year on year growth, up from 15% in 2016 and 14% or so in the preceding two years. U.S. online sales accounted for nearly one-half (46%) of the total increase in retail sales over the past year.

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Australia is well and truly following the U.S. trend. Here, online retail sales are also soaring.

In the last 12 months, online retail contributed $16 billion or 5% to Australian retail sales. IBIS World predicts online retail will reach $22.6 billion in 2018-19 and Australia Post says by 2020, one in 10 items will be bought online.

According to data released by the Australian Bureau of Statistics, Australia's total retail sales (AU$317 billion) grew by just 2.6% in the 12 months to August 2018. A mammoth 54% of that growth came from online retail.

Category surprises

We predict online retail's share of U.S. retail sales will reach 25% by 2040, compared to 13% today. In other words, we predict online has the potential to nearly double its market share from current levels.

Our 2018 U.S. Online Retail Forecast reveals a couple of product category surprises.

Groceries

In the U.S., the online grocery category has been a disappointment. Two decades since it was launched, online grocery represents only 2% of the US$750 billion grocery category.

Why has penetration remained so low? Firstly, delivery is expensive. Many grocery items are bulky and/or heavy so "last mile" delivery is expensive. Online retailers have charged accordingly, and shoppers have resisted paying.

Secondly, Americans prefer to select their own fresh or perishable food products. That, or they don't trust someone else to do it for them.

Still, the online grocery category is now accelerating, in part spurred by Amazon's purchase of Whole Foods, which has made Whole Foods products available to Amazon Prime members (even in areas that might not be served by a Whole Foods store).

The introduction of curb-side and kiosk pickup options is also playing to online's advantage as they allow shoppers to enjoy the convenience of shopping online and avoid the delivery costs.

We predict that as the key impediments continue to wear away, the online growth in the category will improve further, though in the U.S. it is unlikely to achieve more than 10% of total grocery spend.

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Currently, Australia's online grocery sales are proportionately on par with the U.S. Neilson data reveals Australia's grocery e-commerce accounts for 3% of total grocery sales.

Australians have resisted buying groceries online for much the same reasons as Americans. Like Americans, Australians prefer to see and select their groceries. After all, the selection of fresh produce is a matter of personal preference.

Customer experience and cost are also sizeable barriers to online grocery shopping in Australia. Hence, Australian grocery retailers, like their U.S. counterparts, are seeking to reduce or eliminate delivery costs by offering time-saving and convenient alternatives, using 'Click & Collect' services offering networks of drive-thru, locker and parking bay collection points.

Where Australia differs from the U.S. may be in the potential for, and rate of growth, within the online grocery category. In Australia it is racing ahead with 24% growth compared to 2% growth for total grocery sales.

Roy Morgan research shows around 3% of Australian shoppers currently buy groceries online but that 30% of shoppers would consider doing so in the next 12 months.

Retail management software provider Vend refers to online grocery shopping as 'chore' shopping (as distinct from 'cherish' retail). Technology is making 'chore' shopping – that which we have to do – less of an effort and more streamlined through auto-renewals, one-tap purchases, same-day delivery and the ability to predict behaviour and preferences.

Where Australia differs from the U.S. may be in the potential for, and rate of growth, within the e-grocery category. While the category is growing slowly in the U.S., here it is racing ahead faster than the total grocery market.

Homewares

The U.S. homewares category initially was not expected to be significantly affected by online shopping. However, manufacturers and retailers have been much more sophisticated about delivery methods, product design and packaging. Subsequently, in the U.S., online homewares have skyrocketed from zero to a 26% growth rate in just 16 years.

The category is expected to experience continuing double-digit sales growth for at least several more years.

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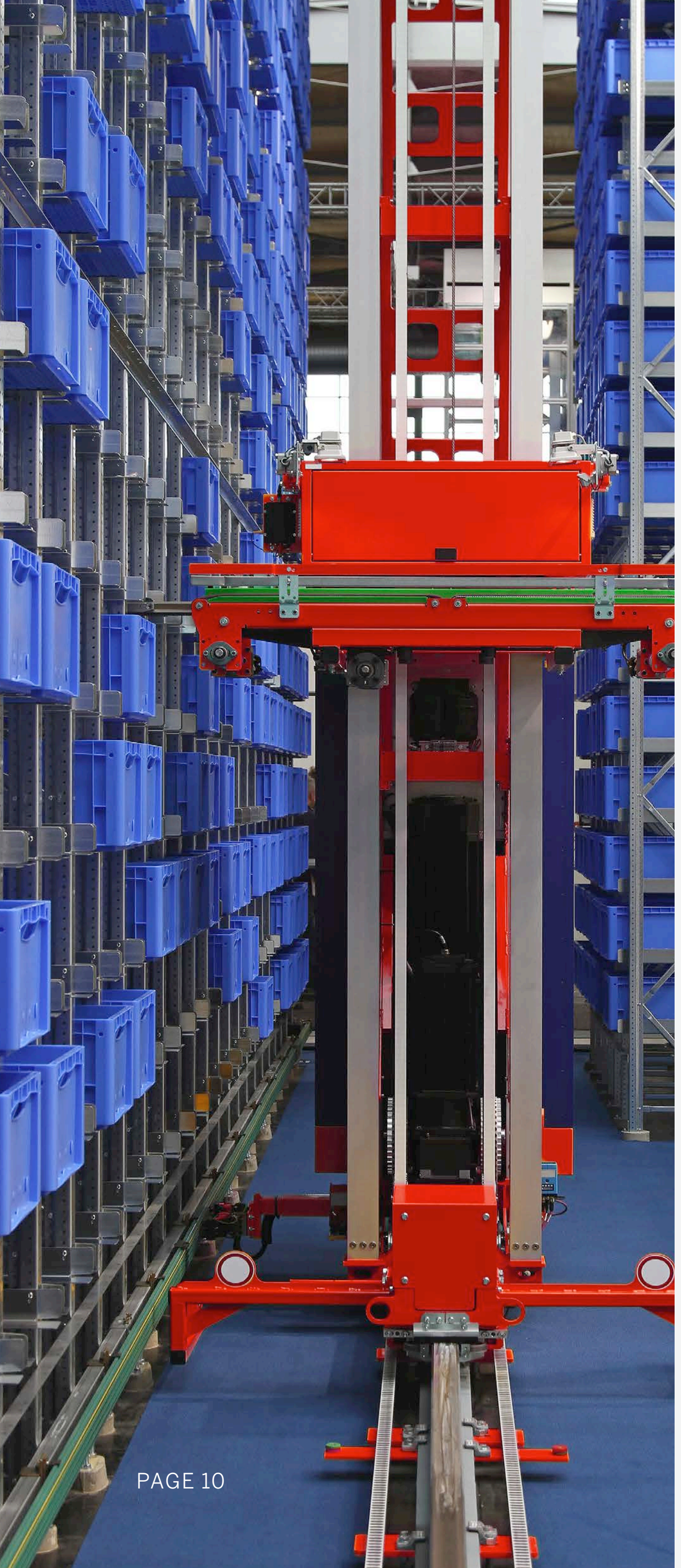
In Australia, the homewares market is heavily fragmented, with established e-tailers, and multi-channel retailers making plays to capture market share. Online homewares represent almost 15% of total homewares sales, with a growth rate of 7%.

Given the Australian fascination with home improvement and renovating, fostered in part by reality television programs, the advancements in product design and packaging and improvements in logistics, this category may well experience significant growth rates.



Amazon’s impact

Amazon already has a highly disproportionate share of U.S. online sales. Based on Amazon’s own financial disclosure, FTI Consulting estimates Amazon captured 30% of the total growth in US retail sales last year while its market share of total online sales now exceeds 35%.

Our forecast model has Amazon’s share of online sales increasing from 35.7% in 2017 to nearly 60% after 2030.

In the U.S., 16 July was 2018 Prime Day - Amazon’s fourth – and by all accounts Amazon set new sales records. Importantly, this was to the detriment of other retailers, not because of robust consumer spending.

Prime Day was also the single best day for new Amazon Prime subscribers. Bear in mind, Amazon’s Prime membership base is already enormous at 100 million, two-thirds of which are U.S. households. Now consider this: Prime members spend on average three times more than non-members.

Amazon’s retail business is comprised of first-party (Amazon-own) and third-party (retailers on the Amazon platform) sales. FTI Consulting estimates that in 2017, nearly 60% of Amazon’s gross merchandise value came from third-party retailers, up from 46% in 2014. Retailers large and small, and manufacturers of consumer products, are choosing to be part of the Amazon ecosystem. Why? Because Amazon is synonymous with traffic. Survey data consistently show that around 50% of consumer shopping searches begin on Amazon rather than search engines or retailer web sites.

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In Australia, the test is yet to come. For now, the Amazon impact has been relatively contained. That said, this is not the time for Australian retailers to be glib. Amazon is a triple threat: it has the audience, the infrastructure, and the finance to keep extending its reach and taking market share.

As Amazon adjusts its offering to the Australian market through initiatives such as the recent addition of dry groceries to the retail offer, it will narrow the expectation gap in relation to price, range and delivery. And with Starcom's research aligning with the U.S. experience showing that for those Australians who have joined Prime, the change in shopping behaviour is immediate (remember, Prime members spend three times more than non-members), Amazon represents a clear and present danger.

Interestingly, Morgan Stanley predicts Amazon Prime will seize market share from existing multi-channel retailers in addition to its obvious competitor eBay. It further estimates Amazon will own 24% of Australian online retail by 2027 (at which point we predict Amazon will own more than 50% of online retail in the U.S.).

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Compressed margins

Many large American retailers are having considerable success selling merchandise online, with a online contributing a significant portion of total sales - Macy's (21%), JC Penney (18%), Urban Outfitters (33%+), Abercrombie & Fitch (28%), Pier 1 Imports (25%) to name a few.

However, look closer and it becomes clear that some of these retailers may be cannibalising their in-store sales with little to no top-line revenue growth. Consequently, some large retailers are consistently profitable companies; others are struggling, while some are barely hanging on.

Across the board, while online sales are booming (for large retailers, in particular), margins are being squeezed. The incentives that were intended to lure consumers online - lower prices, bigger selection, free shipping, generous return policies — have instead become permanent features and there's little sign that shoppers will ever have to bear any of these costs. These accommodations, coupled with the cost of competing, have rendered the multi-channel/omni-channel strategy far less lucrative than was once envisioned.

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In Australia, bricks and mortar and multi-channel are also experiencing the squeeze. Both sales and margins are under relentless pressure, owing in part to growing online competition and their higher cost base. In Australia, as in the U.S., for many retailer's online sales are at the expense of in-store transactions and the add-ons – free shipping, returns and the like – that were intended to be interim incentives are now a standard cost of doing business. This means multi-channel business has become more complex and the cost of providing a seamless customer experience has skyrocketed.

Transformation comes at a cost

Our report recognises that Return on Invested Capital (“ROIC”) is a reliable indicator of a retailer’s overall performance. We examined a high-performing omni-channel group of retailers (Macy’s, Nordstrom, The Gap, Urban Outfitters, Best Buy, Williams-Sonoma, Kohl’s and Dick’s Sporting Goods) and compared their ROIC performance against 75 peers.

In a highly disrupted market, ROIC for the omni-channel group was impacted far less (-13%) than their multi-channel peers (-27%).

In contrast to the U.S., many Australian retailers are in the relatively early stages of transforming their bricks and mortar businesses into what they hope will become highly profitable, multi-channel – or, better yet, omni-channel wonders.

To remain competitive, Australian retailers must address multiple aspects of their business simultaneously.

To succeed in this market, pure-play and multi-channel retailers must:

- ✓ **Bring the right on-trend product to their customer, at the right cost, faster than the competition;**
- ✓ **Deliver their products and services to stores and online at the right cost; and**
- ✓ **Ensure healthy returns on invested capital.**

In short, retailers must continue to refine their value proposition and focus on driving efficiencies across every aspect of their business to remain relevant and competitive.

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