

# 2018 U.S. Online Retail Forecast



# Online Shopping and Large Retailers: BFFs or Frenemies?

As we reflect on yet another stellar year for U.S. online retail sales, we again must ponder whether the dream of digital riches for large retail chains has finally begun to materialize after more than a decade of high expectations and general disappointment despite great efforts.

Back in the early 2000s, some prescient Internet analysts saw where online consumer shopping eventually would go. They saw the strong likelihood of double-digit online sales growth annually for many years ahead — coming mostly at the expense of stores. They envisioned online shopping moving from desktop computers to mobile devices, even if the technology wasn't yet there. Such foresight recognized how enthusiastically consumers were embracing online shopping, and how quickly the technology underlying digital commerce was changing.

Following the tech stock crash of 2000-2002, it was widely assumed that the big winners of online migration by shoppers would be large chain stores that adapted an omni-channel strategy and, of course, the first-mover online retail king, Amazon. The tech stock crash put an end to the notion that upstart pure-plays were going to vanquish entrenched retail chains in the battle for online consumer spending. The infamous tech stock crash claimed 300 casualties that were Internet pure-plays and wiped out \$820 billion of shareholder wealth in the process, according to a 2002 report from then-Morgan Stanley Internet guru Mary Meeker. Famous flameouts, such as Webvan and Pets.com, were reminders that being an early mover back then wasn't necessarily an enduring advantage, while second movers could learn from those fatal mistakes and then do it better.

That dot-com wipeout had little bearing on whether the online channel would thrive as a medium of retail commerce; even amid the carnage, few doubted that ultimate outcome. However, it did alter the perception of who the winners would be. Post-crash, it was expected that the implementation of an omni-channel strategy by large retailers would emerge dominant from this shake-out and transform their staid businesses into highly profitable, multi-channel wonders. More than 15 years later, it has not exactly turned out that way from a profitability and return on investment ("ROI") perspective, even though omni-channel retailers collectively claim a majority of online sales, as we have written about in years past.

What the experts did not anticipate were how few true winners there would be among omni-channel retailers as this transformation played out. However, consumers have been winning in spades. Costly incentives that were once intended to lure shoppers to the online channel — such as lower online prices, expanded product assortments, free shipping, generous return

policies, and online marketing expenses — have instead become permanent features of the landscape with little sign that shoppers will ever have to bear any of these costs. These accommodations have caused margin compression, which combined with the cost of building out, integrating and maintaining an omni-channel backbone, and the cancellation effect of competing retailers all doing the same, have rendered the omni-channel strategy far less lucrative for retailers than it was once envisioned. The online transformation has not been a financial boon even for those large retailers who are doing it exceedingly well, only to see ROI drift lower as the consumer economy recovers, as we demonstrate in **Appendix A**.

In large part, the sprawling presence of Amazon, which many expected, but few anticipated being as vast as it has become in so many product categories, has thwarted efforts by omni-channel retailers to retain or take market share without compromising margins and profitability.

On the heels of three consecutive years of impressive mid-teen growth rates for aggregate U.S. online retail sales, which will surpass \$520 billion this year, it's time again to consider when the big payoff from an omni-channel strategy will come for large retailers. When will these frenemies finally become BFFs?

“ Online transformation has not been a financial boon even for those large retailers who are doing it exceedingly well... ”

Read [Appendix A](#) for more insights.

### HERE'S SOME GOOD NEWS...AND SOME BAD NEWS

First, the good news: Online retail sales are booming. U.S. online sales growth accelerated slightly last year to nearly 16% (YOY) from 15% in 2016 and the 14% range in the two preceding years — and topped \$450 billion in 2017, according to U.S. Census Bureau figures. E-commerce's market share of U.S. retail sales is now 13.2% (excluding auto and gas sales) and 15.7% if the supermarket category is also excluded (see **Exhibit 1**). Currently, e-commerce is gaining about 125 basis points of market share annually, representing peak annual share

gains per our forecast model, which expects online share gains to moderate beginning in 2019. So, we would characterize the current period for U.S. online retail sales as one of peak growth. With annual online sales poised to top \$500 billion before Christmas, we expect that a mid-teen growth rate for sales will begin to moderate next year, as it will become increasingly difficult to continue increasing at such a clip given how large online sales will have become.

Moreover, we estimate that U.S. online sales, which by any measure account for less than one-sixth of total retail sales, have accounted for nearly one-

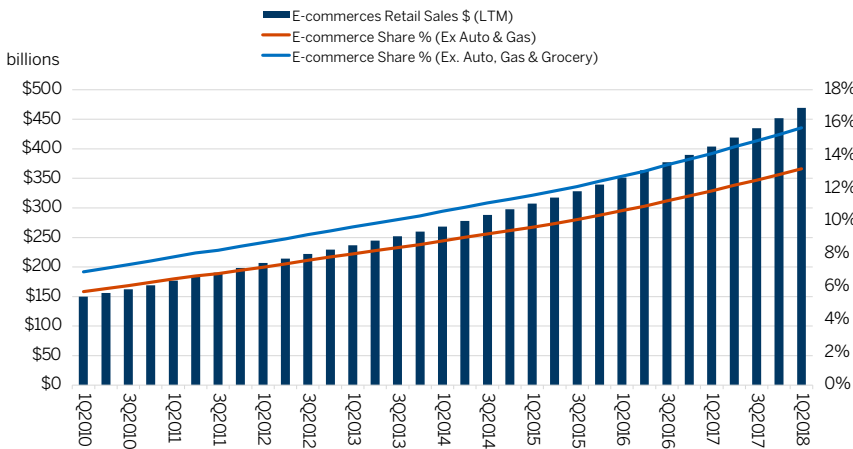
half (46%) of the total increase in retail sales over the past year (see **Exhibit 2**). **In a \$3.5 trillion market for U.S. retail sales, nominal growth remains moderate at about 4.0% (YOY), but the online channel is claiming almost one-half the total dollar value of this growth — an increase of more than 15 percentage points since late 2014.** Store-based sales, which currently account for approximately 85% of total retail sales, collectively are taking just a bit more than one-half of total sales growth, which translates into a growth rate (YOY) approaching 2.0% — hardly impressive, but an improvement from negligible growth for store-based sales prior to the second half of 2017.

The bad news is old news: Amazon is taking a highly disproportionate share of U.S. online sales — and that market share continues to increase. It's little wonder why. Survey data consistently show that approximately 50% of consumer shopping searches begin on Amazon rather than search engines or retailer web sites. That's a powerful and arguably impregnable advantage that some call "the Amazon moat". What we've learned in recent years is that playing catch-up online against Amazon can be a daunting and nearly futile undertaking. Just ask Bed Bath & Beyond, a one-time category killer that's valiantly trying to stay relevant with a long overdue omni-channel push that is killing margins and profitability.

After years of keeping Wall Street guessing, Amazon finally disclosed its Prime membership base, which tops 100 million users worldwide, considerably higher than most analysts' estimates. We estimate approximately two-thirds of Prime members are U.S. households. Now that is a captive audience. Amazon hiked the annual cost of its Prime membership by 20% earlier this year to \$120. We doubt Prime members will bristle much at that; they know what a good deal they're still getting with Prime. In fact, they might even toss a few extra orders Amazon's way to offset that increase with some extra free shipping. Amazon would be fine with that.

#### Exhibit 1

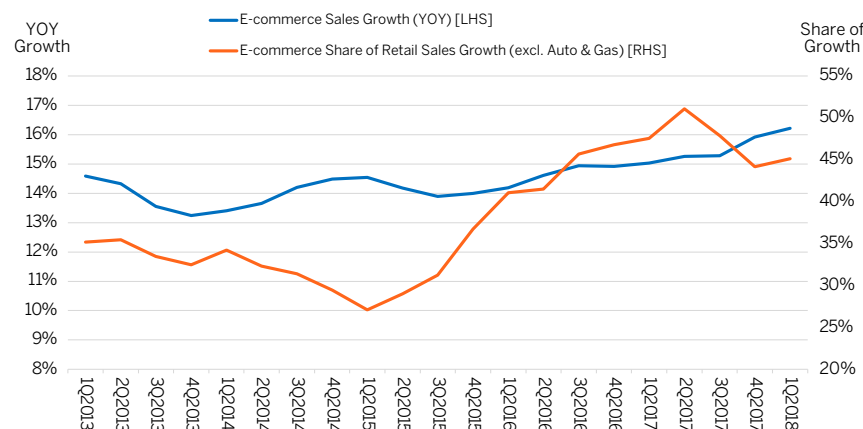
##### U.S. E-commerce Retail Sales



Source: U.S. Census Bureau

#### Exhibit 2

##### U.S. E-Commerce Retail Sales



Source: U.S. Census Bureau

Amazon recently announced an agreement to purchase PillPack, an online pharmacy company, for a reported \$1 billion, its first foray into the retail drug business, which it undoubtedly views as another opportunity to get further embedded in the lives of its shoppers — perhaps with a Prime tie-in eventually.

July 16th was Prime Day, Amazon's fourth, and it was another resounding success even without disclosure of final sales figures. Whether Prime Day sales increased 30% or 40% or 50% is hardly the point, which is that the increase was huge by every credible estimate, and mostly represents sales taken by Amazon from other retailers rather than evidence of robust consumer spending. Most impressive though, Amazon said that this past Prime Day was its single best day ever for signing up new Prime members. That is kind of mind-boggling considering how large the Prime membership base already is — and it's the real long-term win of Prime Day considering how much more folks spend annually with Amazon once they become Prime members.

### IF YOU CAN'T BEAT THEM, JOIN THEM

The “them” we refer to here is Amazon, whose growth in retail sales and market share has far outpaced the rest of the online channel in the last few years. We know this with greater certainty and clarity today thanks to additional financial disclosures by Amazon since 2016 that have shed more light on its retail business, namely the distinction between its first party (“1P”) and third party (“3P”) sales. Amazon's retail reach is best measured by its total Gross Merchandise Value (“GMV” or 1P+3P). Our analysis of Amazon's Seller Services revenue indicates that its 3P business and total GMV is considerably larger than previously believed (see **Appendix B**). Retailers, both small and large, increasingly are choosing to be part of the Amazon ecosystem, as are manufacturers of consumer products that see the opportunity to sell directly to shoppers via Amazon marketplace. The reason is simple: It's where the traffic is.

Our analysis of Amazon's retail sales in 2014-2017, including our estimated breakouts of 1P and 3P sales, indicates that:

- **While 1P sales have been growing at approximately 20% per annum (YOY), 3P sales have been growing at nearly 45% per annum, producing an overall annual growth rate in excess of 30% for Amazon's estimated GMV (1P+3P) over this three-year period. This compares to an annual growth rate of 14%-16% for total U.S. online sales, implying that U.S. online sales growth excluding Amazon is only in the high single-digits.**
- Such strong 3P growth would indicate that Amazon is winning over huge numbers of third-party sellers (which include its Marketplace service as well as Fulfillment by Amazon) whose sales are not reflected on Amazon's income statement as revenue.
- Consequently, we estimate that nearly 60% of Amazon's GMV came from 3P sellers in 2017 compared to 46% in 2014.
- We estimate that Amazon captured nearly two-thirds of the total growth in U.S. online retail sales last year, compared to 58% in 2016 and 52% in 2015. In other words, online sellers (omni-channel and web-only) excluding Amazon's GMV collectively claimed just one-third of the total increase in U.S. online sales in 2017. **Stated another way, Amazon captured approximately 30% of the total growth in U.S. retail sales last year.**
- **We estimate that Amazon (1P+3P) had a 35.7% market share of total U.S. online retail sales in 2017, compared to 30.7% in 2016 and 26.7% in 2015.** These estimates are slightly lower than we reported last year due to changes in our method of calculating market share. Amazon is gaining market share at an accelerating pace (see **Appendix B**).

### WHERE DOES THAT LEAVE OMNI-CHANNEL?

There is a tendency to view the challenges and outcomes of large omni-channel retailers as if they were a homogenous group, but this characterization would be wildly inaccurate. The online fortunes (or misfortunes) of large retailers vary considerably, even among those who are close competitors. These differences in online strategy, investment intensity and results are evidenced to some degree by the percentage of a retailer's total sales derived from its online business — though that metric alone doesn't reflect the totality of the effort or results.

In fact, a retailer's online share of its total sales can be a misleading metric. A list of the top 25 retailers with respect to their online shares of sales would include a motley mix of names comprising both leaders and laggards in retailing. For some of them, “success” by this metric has meant little more than a siphoning of sales from stores to online with little to no top-line revenue growth to show for these huge efforts.

Many large retailers are having considerable success selling merchandise online today — deriving at least 15% or more of total sales from the online channel. Some are consistently profitable companies; others are struggling, while some are barely hanging on. Macy's derives about 21% of its total sales online — but JC Penney is not far behind at 18%. Urban Outfitters gets more than one-third of its sales online, while Abercrombie & Fitch is close behind at 28%. Pier 1 Imports now derives one-quarter of its total sales online, more than doubling this share in just three years — during which time its market value has plunged by 80%. What is manifestly clear in these examples (and many others) is that for large retailers, having a respectable share of sales coming from online is hardly an elixir and, more likely, is a survival requirement.

We mentioned previously that if Amazon were excluded from the analysis of online sales, the mid-teen growth rate of online sales so often cited would be closer to a high single-digit rate. Let's generously

call it 10%. This is, on balance, what store-based chains are achieving. It's not very impressive and, in most instances, is not sufficient to offset persistent declines in store-based sales. Consider a hypothetical retailer today with 10% of its sales coming online, 15% annual growth in online sales, and a 2% annual decline in same-store-based sales. Ten years hence, this retailer would have 35% of its total sales coming online. However, total sales growth over that decade would be a modest 1.3%, excluding inflation. It's an uphill battle for those choosing to fight.

Worse yet, many large retailers aren't yet meeting this threshold of respectability — they're failing to achieve double-digit positions in online share or annual online sale growth. For them, the future is likely to be one of slow retreat or retrenchment, essentially accepting the inevitability that total sales growth will be negligible at best or, more likely, negative for the foreseeable future, and managing the business around that scenario. Such a fate limits the options available to beleaguered retailers to choices that ultimately resemble survival-like tactics. For these unfortunate retailers, it's hard to imagine any event or development that will reverse this dynamic.

### FTI CONSULTING'S 2018 ONLINE RETAIL FORECAST

If online sales growth were best described by an exponential curve (i.e., one that exhibits a steady or constant growth rate over time), then it would be an easier task to accurately forecast where this transformation was heading in the next few years. Alas, it is more complicated than that, with growth rates accelerating then decelerating over time as the base of online sales gets larger, until the point where there is nearly no growth at all. As we like to say, trees don't grow up to the clouds, and the same general growth curve that describes many such natural phenomena also underlies the lifecycle of online sales — the logistic growth curve or S-curve, which is at the heart of our forecast model.

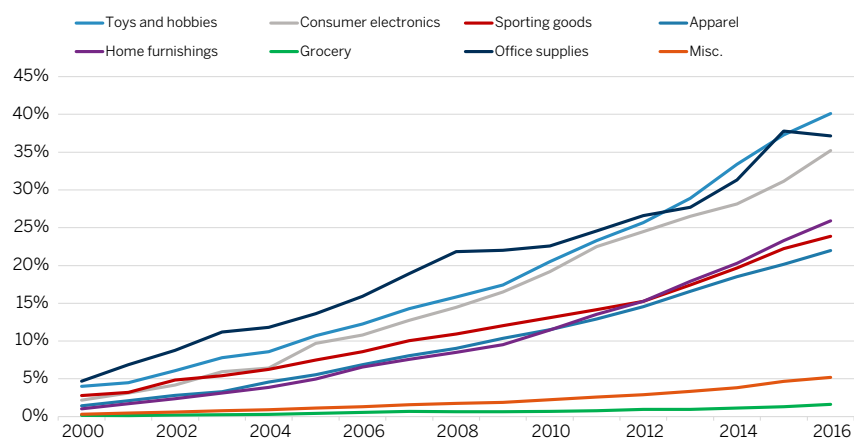
Moreover, various product categories have their own distinct S-curves that best capture their historical growth patterns and trajectories. The best-fitting S-curve for apparel would be distinctly different than the one for grocery, and these distinct S-curves must be quantified and then rolled up into an overall forecast. Each year we reevaluate and revise these S-curves based on the totality of historical online sales data we've accumulated (see **Exhibit 3**). U.S. online retail sales were \$452 billion in 2017 versus our prior-year forecast of \$445 billion — a stronger than expected result that caused us to tweak our forecast model, as we do each year.

share has the potential to nearly double its market share from current levels. Stronger online growth since 2016, in the context of our S-curve math, implies that ultimate ceilings are reached sooner in time rather than an upward shift in the curve.

As we've mentioned, this ceiling reflects the totality of the online ecosystem, but various product categories have their own unique ceilings associated with their S-curves, which can vary significantly. In fact, several products categories have already approached or surpassed a 25% market share (see **Exhibit 3**) and will top out considerably above our overall 25% ceiling — anywhere from 33% to 45%

### Exhibit 3

Estimated Online Market Share of Select Retail Categories



Source: U.S. Census Bureau, FTI Consulting, Inc.

**We expect U.S. online sales will approach \$525 billion in 2018, a 15.9% increase over 2017, and then top \$660 billion by 2020 (vs. \$614 billion in last year's forecast, a 7% revision) and surpass \$1 trillion in 2025 (see Exhibit 4) — a full year sooner than our forecast of a year ago. Our current forecast represents a CAGR of nearly 10.0% over the next decade, compared to a 9.0% CAGR in our 2017 forecast.**

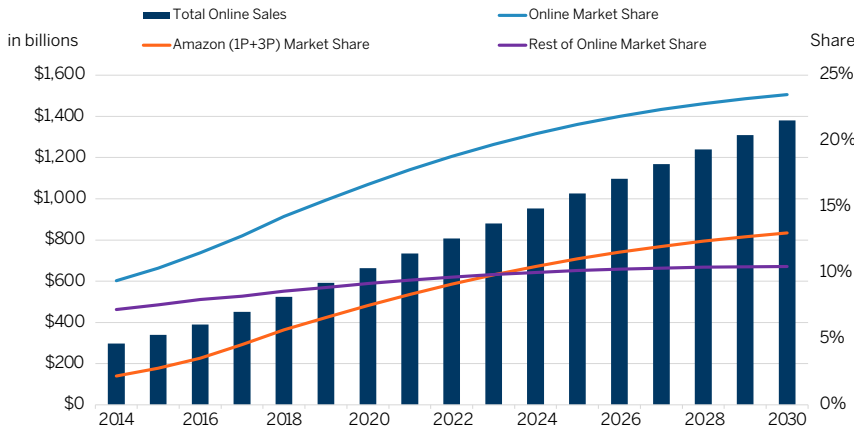
These upward revisions didn't alter our forecast model's ultimate ceiling for online retail's share of U.S. retail sales, which remains at 25% compared to 13% today, meaning that online market

(excluding books, music and computers, which have ceilings closer to 75%). However, several other very large retail categories, such as home improvement, mass merchandisers and discount stores, and grocery, have considerably lower online potential given their historical trajectories to date, which also influences our overall ceiling forecast.

The liquidation of Toys“R”Us will further raise online market share for the toy and hobby category, which already has done exceedingly well online, as Amazon stands to be a primary beneficiary of their closing. Mass merchants such as Wal-Mart and Target are also likely to

Exhibit 4

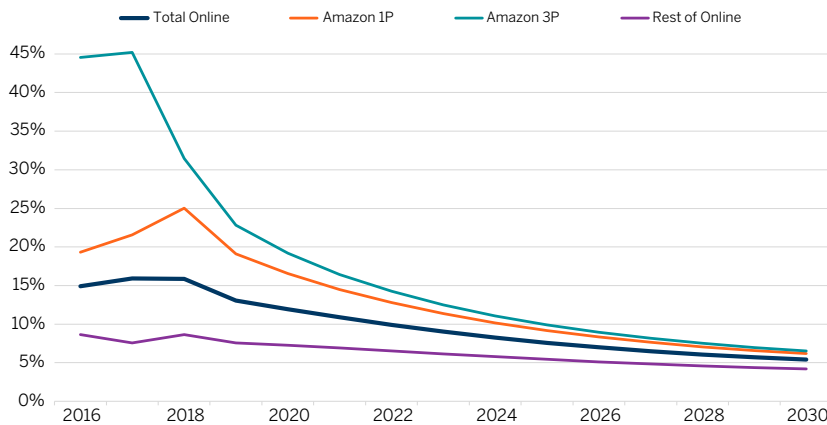
U.S. Online Retail Sales and Market Share



Source: U.S. Census Bureau, FTI Consulting, Inc.

Exhibit 5

U.S. Online Retail Sales Growth (YOY)



Source: S&P Capital IQ, FTI Consulting Analysis

benefit, but the depth of their selection in the category, especially in-store, doesn't come close to Amazon's toy offerings. And let's face it, toy shopping in a store that's not a dedicated toy store is a rather uninspiring experience for parents and kids alike. Better to just click and ship.

As for Amazon, we expect them to continue taking online market share. Our forecast model has Amazon's share (1P+3P) of online sales increasing to 39.7% in 2018 from 35.7% last year, reaching 45.0% by 2020 and hitting

50% in 2023 — at which point a majority of online sales will go through Amazon before finally leveling off near 60% after 2030. So, let's be clear about this: if online growth trajectories stay in place (see **Exhibit 5**), Amazon will touch a majority of U.S. online sales within five years.

There is a certain sense of inevitability about this outcome — as if it is already embedded in current online trends. There is nothing faddish about online shopping, and there's little chance that today's Prime-age consumers ever will rediscover their love of frequent store-based

shopping as a fulfilling use of their time. Moreover, Amazon has the audience and the infrastructure in place to keep extending its reach and taking market share. If omni-channel retailers intend to be BFFs with online shopping, they'll have to do better than they have been.

## APPENDIX A: OMNI-CHANNEL AT ITS BEST IS STILL NOT GOOD ENOUGH

Return on Invested Capital (“ROIC”) is widely considered an excellent summary metric of a retailer’s overall performance, and we will use it to indirectly measure the impact of digital transformation on the U.S. retail sector. We computed ROIC as Pre-tax EBIT (LTM) / Average Invested Capital (LTM), which we defined as Total Assets – Current Liabilities + Debt Due in Current Year.

We selected eight exemplary omni-channel retailers in the non-staples category: those whose online sales are at least \$1 billion, account for more than a 10% share of total sales, and consistently have achieved annual online sales growth exceeding 10%. Those retailers selected were Macy’s, Nordstrom, The Gap, Urban Outfitters, Best Buy, Williams-Sonoma, Kohl’s and Dick’s Sporting Goods. All made the cut with ease.

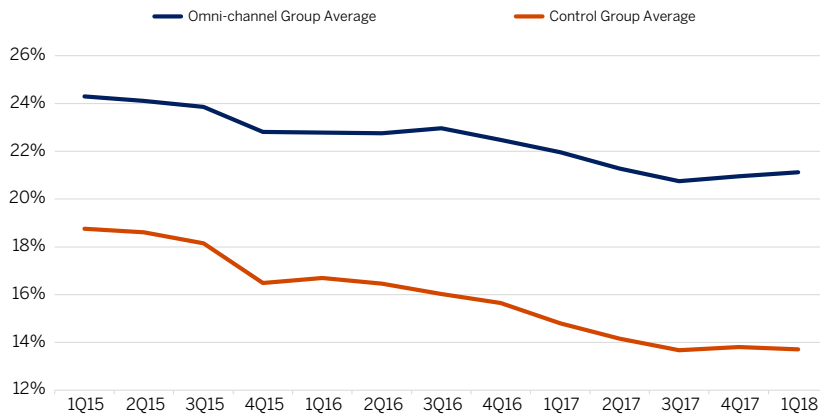
We computed ROIC for these select companies (**the Omni-channel Group**) over the last 13 quarters and compared it to their respective category counterparts that are, to some degree, a control group and will be referred to as such (**the Control Group**). The Control Group consisted of 75 peer companies of our Omni-channel Group. Unweighted arithmetic averages were used for both groups as shown below. There were some notable takeaways:

The Omni-channel Group consistently generated higher ROIC than the Control Group over the entire three-year period, meaning that they were generally stronger companies to begin with.

- **ROIC steadily declined from 2015 through mid-2017 for both groups, but declined more for the Control Group.** On average, ROIC declined by 320 basis points (or 13%) for the Omni-channel Group and 510 basis points (or 27%) for the Control Group over the three-year period. ROIC has stabilized for both groups over the last three quarters.
- The differential in ROIC between the two groups has widened from 550 basis points in 1Q15 to 740 basis points in 1Q18.
- The shorthand conclusion we draw from this comparison is that an omni-channel strategy that is well executed and achieves respectable scale, rather than being a driver of ROIC, has allowed the best of the bunch to flounder less than their less online-savvy peers. That’s discouraging, but it’s not the final word. As the retail shakeout continues, market share gains and improved ROIC eventually should come to those best prepared to take them. For retailers heavily committed to omni-channel, it can’t happen soon enough.

### Exhibit 6

#### Return on Invested Capital



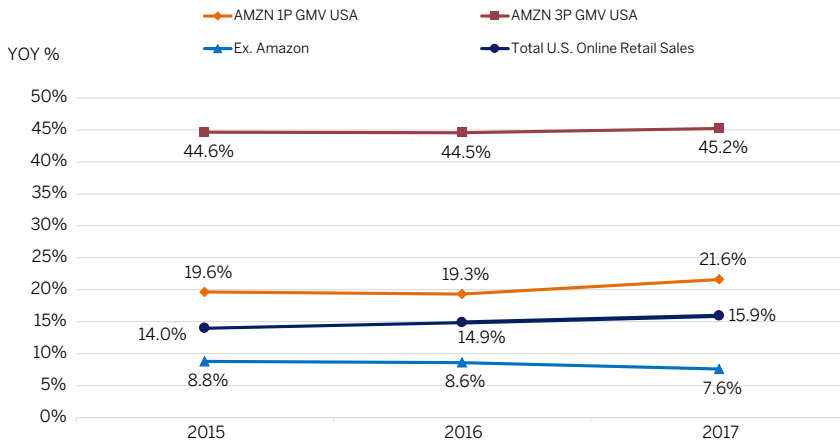
Source: S&P Capital IQ, FTI Consulting Analysis

## APPENDIX B: AMAZON'S RETAIL FOOTPRINT CONTINUES TO GROW LARGER

Amazon's footnote disclosures of its revenue derived from Third Party Seller Services allows for a reasonable estimation of its 3P Sales, which it does not book as product revenue, as well as Amazon's total Gross Merchandise Value (GMV, or 1P+3P). We estimate that Amazon's GMV continues to grow in excess of 30% annually while its market share of online sales now exceeds 35%.

### Exhibit 7

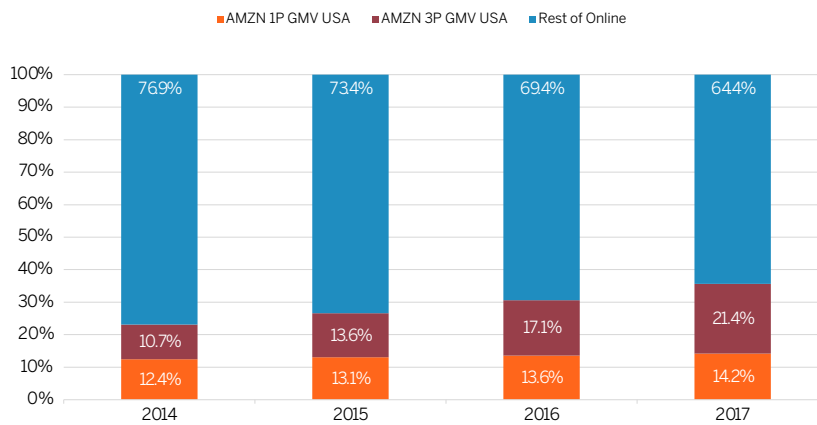
#### U.S. Online Retail Sales Growth (YOY)



Source: Amazon's SEC Filings, FTI Consulting Analysis

### Exhibit 8

#### Market Share of U.S. Online Retail Sales



Source: Amazon's SEC Filings, FTI Consulting Analysis



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