Navigating Disruptive Change

For Retailers, *The Times They Are A-Changin'*

Come gather 'round people
Wherever you roam
And admit that the waters
Around you have grown
And accept it that soon
You'll be drenched to the bone.
If your time to you is worth savin'
Then you better start swimmin'
or you'll sink like a stone
For the times they are a-changin'

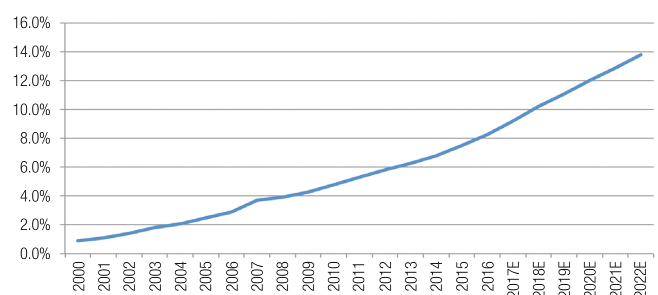
Bob Dylan –
The Times They Are A-Changin'

For retailers, the only constant is change. Technology has structurally changed the way consumers and retailers engage with each other. Meanwhile, consumers are constantly changing the way they shop, what they buy, where they buy, and who influences what to buy. In addition, retailers today face the structural challenges of rapidly rising e-commerce penetration, evolving consumer spending habits, and an oversupply of retail square footage. A retailer's ability to navigate these industry changes will determine its long-term success or failure.

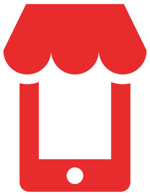
E-commerce is changing the retail landscape

For some, the digital disruption of retailers began in 1994 when tech-savvy shoppers purchased books online from an unknown start-up called Amazon.com. Others would probably point to August 1998, when Amazon.com announced that it would expand its services beyond selling books. No matter the start date, we can all agree that over the last 15–20 years e-commerce has been relentlessly taking market share from traditional brick-and-mortar retailers. As shown in Figure 1, e-commerce penetration as a percentage of U.S. retail sales has steadily increased since 2000 (as far back as available government data), climbing from 0.9% in 2000 to 8.3% in 2016.

Figure 1. **E-Commerce as a % of Retail Sales**



Source: St. Louis Federal Reserve, KPB.



Changes in consumer preferences will continue to drive the shift toward digital shopping, which offers more convenience, greater selection, simpler price comparisons, and significantly improved delivery speeds, reliability, and return policies. As such, we believe e-commerce will continue to take share for the next several years and forecast that e-commerce sales will account for nearly 14% of domestic retail sales by the end of 2022.

To compete in this increasingly online world, traditional retailers are actively investing in digital strategies to better align with changes in consumer shopping behavior. Most retailers are still in the early stages of digital growth and are still expanding online product offerings, improving website navigation, and building supply chain networks. At the same time, these retailers are leveraging loyalty programs and data-analytics to maintain current customers, attract new ones, and grow their digital businesses. However, expanding into e-commerce requires substantial upfront investments in technology, inventory management systems, and distribution. Typically, these investments do not immediately help boost sales, leading to profit margin contraction and lower profits. This is the cost of doing business in the online world.

Consumer spending patterns are changing

In addition to shifting to online purchases, consumer spending patterns have evolved in additional ways over the last decade. Many consumers have become more value conscious. This is especially true for millennials (those born between 1982-2000), who seemingly look for value above all else when shopping. Millennials want newness and innovation, the latest fashions, the same styles they see on social media, but they don't want to pay full price. This dynamic is forcing retailers to shorten the time it takes to offer newer, more innovative merchandise in stores, while selling product at price points targeted at the value-conscious.

Of course, there are areas where millennials are willing to spend money. When they decide to open their wallets, millennials prefer experiences, travel, or entertainment over shopping for apparel, cars, or a home. Retailers that are able to tap into these categories can attract the discerning millennial shopper. For example, "retail-tainment" concepts like Legoland, Discovery Center, American Girl, or Dave and Busters attract consumers looking for an experience.

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While there will be many ways for retailers to try to reach millennial shoppers, one thing is clear; retailers who do not change and evolve to cater to this generation of consumers will struggle to remain relevant.

Shopping malls and the ever-changing retail environment

Given the shift to e-commerce and the spending habits of young consumers, the reality for traditional retailers is that there is simply too much retail square footage and too many shopping malls. As shown in Figure 2, the U.S. is over-stored compared to our global peers. The U.S. has almost 24 square feet of shopping center floor space per capita, which is 44% higher than second place Canada.

The roughly 1,200 U.S. shopping malls account for 15% of the shopping center square footage and are the real estate industry's most at-risk segment. Malls continue to struggle with traffic declines, increased competitive pressures from discounters, off-price retailers, outlet malls, and e-commerce. Indeed, global real estate firm Cushman & Wakefield estimates shopping mall square footage will decline by 25% over the next decade as e-commerce continues to take share.

Figure 2. **U.S. Shopping Centers vs. Select Peers**

Country	Shopping Center GLA* (in millions of square feet)	Population	GLA Per Capita
USA	7,567	321	23.6
Canada	589	36	16.4
UK	299	65	4.6
France	254	66	3.8
Spain	157	46	3.4
Italy	169	61	2.8
Germany	191	81	2.4

Source: ICSC, Cushman & Wakefield, Cowen
*Gross Leasable Area: The amount of floor space available to be rented in a commercial property.

To remain relevant, shopping malls need to give consumers a reason to visit the mall again. These efforts include reconfiguring mall common areas, utilizing technology to connect with the consumer, and working with retailers to create interesting events at the mall. In many locations, this means improving the mall experience through better and expanded food offerings or adding entertainment venues. In others, it means transforming empty stores into healthcare providers (doctors, dentists, optometrists, etc.) to provide patrons with a one-stop shop for their healthcare needs. Both of these examples will help drive traffic into the malls and benefit the retail stores that can survive the shopping mall makeover.

Where do retailers go from here?

The Internet and smartphones have transformed many aspects of consumer awareness and blurred the lines of marketing, sales, and distribution for retailers. That said consumers really don't care what retailers call their digital and mobile strategies. Consumers only want what they want, where they want it, and when they want it. The ultimate survivors will be those retailers that can meet those consumer wants, while making the shopping process easier, more efficient, and more enjoyable. The retailers that do not shift their focus to the what, where, and when of consumer wants will "sink like a stone, for the times are a-changin'."

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