Deloitte.

# A new formula for retail recovery and growth

## The five paths to profitability

# Executive summary

Even before the early onset of coronavirus (COVID-19) pandemic, US apparel and discretionary retailers struggled with stagnating profits due to challenges on multiple fronts: increasing discrete expenses such as rent and wages, declining foot traffic and overall spend on apparel, heightened competition, and consistently declining earnings. The impacts of COVID-19 accelerated cost increases and changes in consumer shopping preferences already underway—demand shifted dramatically from stores to online sales—compressing profits further and tipping over 40 retailers into bankruptcy during the year's first eight months.[1]

Trying to sidestep a similar fate, many discretionary retailers have focused on reducing operating costs; some have sought support (and taken on debt) from private equity investors. These actions may help in the short term, but if retailers want to make it (profitably) to the other side of the pandemic, investing in change may be a better way forward.

Shoppers with new expectations around convenience and value are unlikely to be willing to return to purchasing patterns of the past. Retailers, therefore, should prioritize staying ahead of competitors and proactively exceeding consumer demands. Our analysis has identified five archetypes that can help retailers chart a path to sustained profitability. As the retail industry enters an unprecedented and uncertain planning season, CEOs and their leadership teams need to pick the right model—quickly—and move forward with confidence.

# Retail through the looking glass

*"'Well, in OUR country,' [said Alice, still panting a little,] 'you'd generally get to somewhere else—if you ran very fast for a long time, as we've been doing.' ['A slow sort of country!' said the Queen.] 'Now, HERE, you see, it takes all the running YOU can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that!"*

– Lewis Carroll, Alice Through the Looking Glass

Like Alice, many of today's apparel and discretionary retailers find themselves running to maintain profit levels—or, once recapitalized and facing a heavy debt load—running twice as fast and perhaps never reaching their destination.

Apparel retailers—even successful ones—can only remain stationary for so long. As the market matures and consumer preferences change, sales begin to dip and profits plateau or decline if their offerings don't continue to evolve (see table 1). Over the past 10 years, the apparel industry has seen this play out time and time again—those who fail to adopt usually pay the price in profits.

**Table 1. Anonymized set of retailers who failed to transform from "traditional" (brick-and-mortar) models[2]**

| Retailer | 2009 | 2014 | 2019 |
|---|---|---|---|
| "Women's Casual" | 12% | 9% | 4% |
| "Women's Specialty" | 8% | (8%) | Bankrupt |
| "Discount Fashion" | 5% | 6% | 3% |
| "Family Big Box" | 4% | (3%) | Bankrupt* |
| "Everyday Kids" | 8% | 6% | 5% |

** Filed Chapter 11 in 2018*

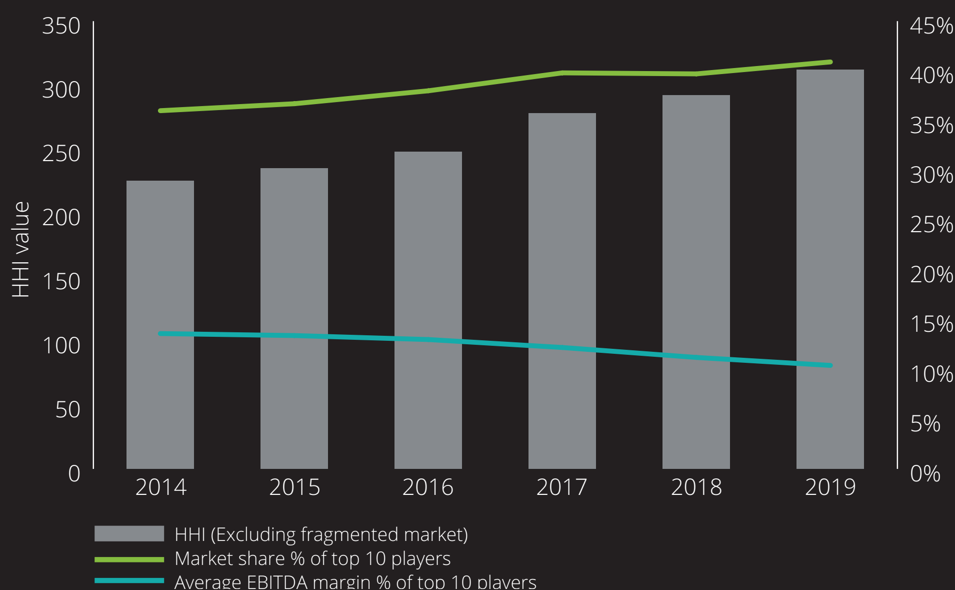
Entering 2020, US discretionary retailers—mirroring a broader retail industry trend—were facing profitability challenges on multiple fronts: increasing discrete expenses such as rent and wages; declining foot traffic and overall spend on apparel; heightened competition due to strong incumbents and a relative lack of diversification; and consistently declining EBITDA—in 2005, the industry average was 11%; by 2015, it had fallen to 9%; and in 2019, pre–COVID-19, 7%[3]—as their offerings stagnate in the marketplace. The ongoing coronavirus (COVID-19) pandemic is exacerbating these challenges and creating new ones that further squeeze retailers' profits (see sidebar).

# Factors squeezing apparel retailers' profits

Despite increased market share over the past six years, top apparel, footwear, and other discretionary retail competitors are continuing to see a decline in EBITDA margin (figure 1); inferring that over time, significant increases in market share are required just to maintain EBITDA levels. While some retailers may find profitability growth through volume, not all players can succeed using this strategy alone—or worse, in the pursuit of scale and share, retailers may make trade-offs favoring volume versus innovation, triggering an inevitable decline in profitability.

The Department of Justice considers an HHI score of 2,500 or above to be a highly concentrated market. US industries with duopolies, such as carbonated soft drinks or salty snacks, where two to three top players have >60% market share, would have HHI scores in the range of 3,000 to 3,100. These players have pricing power and profits to reflect their significant market share—top Consumer Packaged Goods (CPG) company margins are often double retailers', with consistent EBITDAs ranging from 20–30%.[4] Figure 1 infers the opposite to be true of retail: The top 10 players combined held <45 percent market share as of 2019—and each needed to continue to gain incrementally more market share in order to simply maintain EBITDA levels of years past.

**Figure 1. Apparel and soft goods retail competitiveness**




Calculated using Deloitte Analysis of Euromonitor data for market share in apparel and footwear specialized retailers in the United States. HHI score <500 across 2014–19 indicates that the market has remained highly competitive and saturated for the top 10 players.

Numerous factors have been creating cost pressures and squeezing apparel and discretionary retailers' profits:

**Increasing rent and labor expenses.** Retail rents in the United States have increased by 2.6% annually over the past three years and currently average $21.80 per square foot (although the COVID-19 crisis is estimated to decrease retail rents from 8% to 13% in 2020). In addition, average hourly earnings of employees for clothing and clothing accessories stores (not seasonally adjusted) have risen 140% from 2010 to 2019.

**Declining in-store foot traffic.** The shift in consumer purchasing from brick-and-mortar stores to digital platforms is fueling the continued trend of declining retail foot traffic. In-store visits fell 3.8% in calendar 2018 (for apparel, cosmetics, jewelry, toys, and hardware); fell 12.2% year on year (YoY) in December 2019; and took a nosedive between March and April 2020, driven in large measure by consumers' COVID-19-related health and safety concerns.

**Reduced overall category spend.** Retail store sales are down across the board (16.4% change from March to April 2020), but compared with other categories, the pandemic has hit clothing and accessories the hardest, by far, at 78.8% (figure 4). Spending at clothing retailers declined by 51.3% YoY in March 2020. In April, clothing retailers saw their sales plummet by 89.3%. Total sales of apparel and accessories is forecasted to drop by 22% in 2020—equating to a YoY loss of $100 billion.

**Intensified competition.** Even before COVID-19, Deloitte research estimated that apparel incumbents in the United States could lose as much as 25% of their market share to new rivals, as well as new commerce models. Nontraditional competition includes marketplaces that are using transactional data to launch competitive products; alternative commerce models like subscription services, apparel rentals, and "recommerce" (used clothing sales); wholesalers going directly to consumers; overseas retailers; and pure internet players.

# COVID-19 has accelerated changes to consumer buying habits

### Going online for specialty apparel

"The last time I went into a department store was to look for a pair of maternity leggings. I went up to the hosiery department, and they did not carry any maternity items in-store (only online). I should have known better, but was still frustrated. I then proceeded to sign up for a monthly subscription to maternity clothes from an online shop since I'd had so much trouble finding places to buy maternity."

–Meg, New York

Many consumers have been conditioned over the years to buy apparel and other discretionary items on sale, in stores, and with high-touch customer service. The COVID-19 pandemic has accelerated changes to consumer buying habits by as much as five years[5] and increased the collective power of their demands for convenience and value in every aspect of the retail shopping experience[6]—although today's consumer expectations are quite different than those of six months ago. COVID-19–related health and safety concerns have changed the definition of what constitutes a frictionless purchase, whether it's in-person or online.

Only 53% of respondents in a July 25 Deloitte consumer survey say they feel safe going to a brick-and-mortar store. However, when they do shop in-store, consumers expect to see visible cleaning protocols. For an online purchase, consumers' convenience and value measures include robust and user-friendly digital platforms, free and immediate shipping, quality of follow-on or ancillary services, and hassle-free return processes.

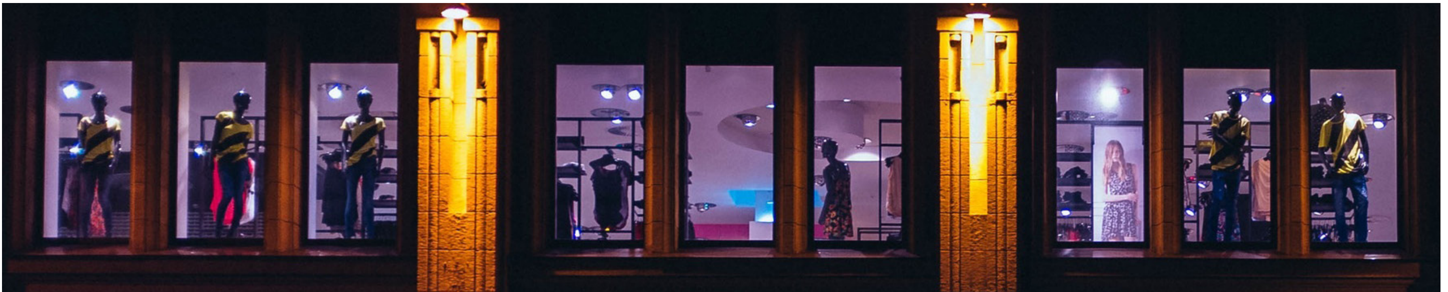
Retailers that have already invested in the technology required to quickly expand buy online/pick up in-store (BOPIS) or curbside have benefited from their foresight: BOPIS saw YoY growth of 130% in June 2020 (although the pace is beginning to slow slightly as stores reopen).[7] And, with many consumers staying at home during the pandemic switching from mobile phone to computer as their primary online shopping channel,[8] retailers that have created an excellent mobile shopping app, which is equally laptop-friendly, should be well-positioned to support a cross-channel shopping journey. Providing expanded online offerings, such as fit and sizing recommendations and curated outfits, can "up" the convenience factor even more.

### In-store shopping losing its value

"Last time I went to the mall was a week ago to do some in-store returns that were not possible via mail carrier. Passed through a major department store; it felt gloomy, disorganized, and even the nicest display didn't tempt me to look further. Store lines took forever, people were everywhere—I will not be going back to the mall or the store. Why would I? I can try things at home and easily return or exchange them if need be. I wasn't going to malls or department stores often even pre–COVID-19; now it's yet another factor to keep me from going."

–Jessica, Atlanta

Having redefined expectations for convenience and value, today's consumers are unlikely to be willing to return to their purchasing habits of the past and lower expectations to previous levels. Apparel and discretionary retailers should seek to keep current with consumers and, importantly, understand which aspects of convenience their customers are willing to pay for so they can target their investments accordingly. According to research by the National Retail Federation, 61% of consumers are willing to pay more for convenience while buying clothes (second to grocery).[9] Retailers who fail to meet—and stay ahead of—changing consumer demands may have greater potential to fall behind competitors, potentially entering the spiral of margin decline, store closures, restructuring, and eventual bankruptcy.



# Tomorrow's survival requires action today

While retailers work through the short-term challenges of mitigating consumers' COVID-19–related shopping concerns, they should also focus on long-term demands and opportunities. Leading companies—those with comparable store and channel sales growth above the industry average of 4.5%[10]—are more likely than their average or underperforming peers to view as "very important" taking remedial actions such as offering more contactless buying options (80% versus 60%), changing store design to facilitate social distancing (65% versus 55%), and assessing supply chain flexibility to improve responsiveness (73% versus 45%).[11] However, making incremental changes to existing business models will not assure long-term viability. Retailers need to efficiently manage costs, strategically invest in product and service innovations, and adopt an agile business model that will enable them to quickly pivot with evolving market and consumer demands.

Some retailers investing in product and service innovation choose to focus their attention and capital on building out their existing R&D function. Others—especially those interested in accelerating time to market—decide to acquire new capabilities; for example, a major retailer recently acquired a logistics company to expand and improve its e-commerce sales. As consumer needs continue to rapidly evolve, growing capabilities via acquisition is likely to increase. Reaction time to emerging trends has become a strategic differentiator, and M&A is a way to leapfrog competition.[12]

In addition, companies can enhance the consumer experience and strengthen customer engagement by investing in a mix of strategies based upon the retailer's starting point, offerings, and customer demographics. Among options to consider are:

- Enhanced digital presence
- Omnichannel offerings and expansion of contactless commerce
- Alternative uses of traditional footprint (such as store-in-store)
- Rationalized footprint
- Showroom format stores
- Frictionless returns (and reverse logistics)
- Private labels
- Augmented and virtual reality in stores
- Apparel rental, resale, and circular economy
- Sustainability-focused offerings

A comparison of two athletic apparel brands' retail strategies reveals that pursuing scale and volume growth without reinvesting in innovation and consumer demands leads to diminishing returns over time. And retailers who fail to proactively innovate to adapt to consumer changes in demand will fare far worse than their peers who do (see table 2).

**Table 2. Comparison of specialty apparel brands' retail strategies**

| | Retailer No. 1 | Retailer No. 2 |
|---|---|---|
| **EBITDA margins** | Consistent | Declining |
| 2005 | 14% | 13% |
| 2015 | 13% | 10% |
| 2019 | 13% | 5% |
| **YoY store expansion** | | |
| Average | 5% | 12% |
| Growth range | 0–14% | 0–59% |
| **Digital innovation approach** | Integration into core offerings | Bolt-on businesses |
| **COVID-19 market cap impact** | –3.6% | –54.2% |

# Five archetypes to put retailers on the path to profitability

There is an opportunity on the back end of the current health and economic crisis for apparel and discretionary retailers to emerge as leaders in a transformed marketplace—if they take steps now to rethink and restructure how they do business to stay ahead of changing consumer needs and demands. Our analysis has identified five archetypes that can put them on the path to sustained profitability (figure 2). CEOs and their leadership teams need to pick the right archetype—quickly—and move forward with confidence.

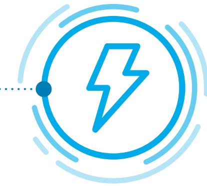
**Figure 2. Five retail archetypes for sustained profitability**

### Technology trend-setter: Established brand, omnichannel mass retailer, with value-driven customers and a traditional buy-and-stock model

- **Profit model:** High-volume, targeted algorithmic advertising with white label products and a diverse, efficient supply chain
- **Strategies for success:**
  - Emphasize multichannel digital shopping
  - Offer one-click order and subscription services
  - Redefine returns processing (for example, one-click, prepaid, and labeled)
  - Expand complementary services for "one-stop shopping" experience
  - Establish store-in-store model for adjacent brands

| | Archetype average | Third quartile | Leading peer |
|---|---|---|---|
| COGS | 65% | 61% | 57% |
| SG&A | 29% | 26% | 20% |
| EBITDA | 8% | 11% | 16% |

| Profit drivers | Impact |
|---|---|
| Revenue | ↑ |
| Marketing | ↓ |
| COGS/logistics | ↓ |
| Real estate | ↓ |
| Digital/technology | ↑ |
| Other | — |
| EBITDA | ↑ |



### Emerging threat: Market-disrupting brand, direct to consumer (DTC), with price-sensitive customers and minimal warehouse model

- **Profit model:** Scaled volume with minimal infrastructure, vertically integrated supply chain, low cost to consumer, direct to consumer, highly targeted advertising
- **Strategies for success:**
  - Establish alliances for omnichannel opportunities or store-in-store models
  - Implement frictionless returns processes (such as home pickup)
  - Utilize minimal showroom-style locations
  - Promote brand awareness through pop-up shops in select target markets
  - Use artificial intelligence (AI) to drive bundled pricing and loyalty programs

| | Archetype average | Third quartile | Leading peer |
|---|---|---|---|
| COGS | 57% | 48% | 44% |
| SG&A | 38% | 34% | 25% |
| EBITDA | 6% | 11% | 17% |

| Profit drivers | Impact |
|---|---|
| Revenue | ↑ |
| Marketing | ↓ |
| COGS/logistics | ↑ |
| Real estate | ↓ |
| Digital/technology | ↑ |
| Other | — |
| EBITDA | ↑ |

### Brand loyalist: Established brand, omnichannel with flagship stores, loyal consumers, minimized distributors, and inventory hubs

- **Profit model:** High brand loyalty, high-quality mid-priced apparel, outsourced manufacturing, revenue growth through innovation
- **Strategies for success:**
  - Rationalize footprint and minimize locations focused on foot traffic
  - Redirect real estate investment to experiential stores in key markets
  - Identify alliances for dedicated in-store space at mass retailers
  - Prioritize direct-to-consumer online sales
  - Upgrade the digital platform and implement AI-driven loyalty programs

| | Archetype average | Third quartile | Leading peer |
|---|---|---|---|
| COGS | 55% | 50% | 45% |
| SG&A | 36% | 33% | 24% |
| EBITDA | 10% | 12% | 15% |

| Profit drivers | Impact |
|---|---|
| Revenue | ↑ |
| Marketing | ↑ |
| COGS/logistics | ↓ |
| Real estate | ↓ |
| Digital/technology | ↑ |
| Other | — |
| EBITDA | ↑ |

### Fast fashionista: Established brand, omnichannel with high foot traffic, trend-focused consumers, and fast fashion model

- **Profit model:** High volume, in-house expeditious supply chain, fast-fashion and cost-efficient production
- **Strategies for success:**
  - Rationalize underperforming stores
  - Expand online platform with "in-store" services (such as virtual dressing rooms)
  - Provided curated content upon login or purchase (for example, buy hiking gear, receive email with best trails within a 50-mile radius of shipping ZIP code)
  - Incorporate white label basics to drive margin expansion

| | Archetype average | Third quartile | Leading peer |
|---|---|---|---|
| COGS | 57% | 49% | 38% |
| SG&A | 35% | 26% | 24% |
| EBITDA | 8% | 12% | 16% |

| Profit drivers | Impact |
|---|---|
| Revenue | ↑ |
| Marketing | — |
| COGS/logistics | ↓ |
| Real estate | ↓ |
| Digital/technology | ↑ |
| Other | — |
| EBITDA | ↑ |

### Social-savvy: Nonestablished brand specialty retailer, high-end price point, loyal and social media–based consumers, boutique store footprint

- **Profit model:** High price point, service experience, fragmented players steal market share from established brands
- **Strategies for success:**
  - Expand through adjacent businesses (such as athletic apparel and digital workout platforms)
  - Provide a personalized consumer experience through online and in-store shopping
  - Produce high-quality goods at an aspirational, yet achievable price point
  - Drive a social media- and influencer-focused marketing strategy
  - Rationalize footprint to highly targeted locations with a boutique footprint

| | Archetype average | Third quartile | Leading peer |
|---|---|---|---|
| COGS | 52% | 44% | 32% |
| SG&A | 37% | 30% | 25% |
| EBITDA | 14% | 18% | 26% |

| Profit drivers | Impact |
|---|---|
| Revenue | ↑ |
| Marketing | ↓ |
| COGS/logistics | ↓ |
| Real estate | ↓ |
| Digital/technology | ↑ |
| Other | — |
| EBITDA | ↑ |

# Reflecting on future profitability

Retailers that are currently thriving in the apparel and discretionary spend market—even during the throes of a pandemic—are doing so because they are delivering goods and services in ways that are meeting consumers' redefined expectations for convenience and value. These companies are migrating to agile, efficient delivery models that can quickly adapt to changing market conditions, using cost savings to fuel innovation, and investing in strategies to enhance the consumer experience. Retailers cannot afford to wait until market volatility subsides to plan their path to future profitability. If company leaders are not already assessing, analyzing, and strategizing, they should begin immediately. The following questions may help guide their way forward:

- Has our brand lost profits by historically responding to changes in consumer preferences reactively? How can we foster a culture of proactivity to avoid the industry's declining margins and stay ahead of competitors on continually evolving consumer preferences?
- How can we most efficiently optimize our cost structure and identify opportunities to reinvest savings in innovative consumer technologies and experiences?
- What unique services or capabilities are core to driving our costs and profitability today? Which require immediate action to avoid commoditization and deliver sustained profits in the future?

Retailers that take steps now to rethink and restructure how they do business have an opportunity to outpace competitors, exceed consumer expectations, and emerge as leaders in the apparel market of the future.

# Endnotes


1 Melissa Repko and Lauren Thomas, "As pandemic stretches on, retail bankruptcies approach highest number in a decade," CNBC, August 3, 2020, https://www.cnbc.com/2020/08/03/with-pandemic-retail-bankruptcies-approach-highest-number-in-a-decade.html.

2 CapIQ, Deloitte Analysis.

3 CapIQ, Deloitte Analysis.

4 Ibid.

5 Ibid.

6 National Retail Federation, "Convenience and the consumer," Consumer View Winter 2020, January 14, 2020, https://nrf.com/research/consumer-view-winter-2020.

7 "As pandemic pushes on, online sales grow 76% in June," Digital Commerce 360, citing research from Adobe Analytics, July 13, 2020, https://www.digitalcommerce360.com/2020/08/11/as-pandemic-pushes-on-online-sales-grow-76-in-june.

8 DI BTS data.

9 National Retail Federation, "Convenience and the consumer."

10 Dan Berthiaume, "Study: Retail 'winners' recognize need to respond to pandemic," Chain Store Age, August 6, 2020, https://chainstoreage.com/study-retail-winners-recognize-need-respond-pandemic.

11 Ibid.

12 Kasey Lobaugh et al., "The future is coming … but still one day at a time," Deloitte Insights, June 17, 2020, https://www2.deloitte.com/us/en/insights/industry/retail-distribution/retail-and-consumer-products-predictions.html.


# Authors

**Larry Hitchcock**
Deloitte Consulting LLP
lhitchcock@deloitte.com

**Steve Maddox**
Deloitte Consulting LLP
smaddox@deloitte.com

**Adam Whiting**
Deloitte Consulting LLP
adwhiting@deloitte.com

**About Deloitte**
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee (“DTTL”), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as “Deloitte Global”) does not provide services to clients. In the United States, Deloitte refers to one or more of the US member firms of DTTL, their related entities that operate using the “Deloitte” name in the United States, and their respective affiliates. Certain services may not be available to attest clients under the rules and regulations of public accounting. Please see www.deloitte.com/about to learn more about our global network of member firms.

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

Copyright © 2020 Deloitte Development LLC. All rights reserved.