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Solving the paradox of growth and profitability in e-commerce

Global omnichannel players that crack the code will be well positioned for the years ahead. Four imperatives can support their journey.

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During the early stages of the COVID-19 pandemic, e-commerce was one of the biggest stories in retail. Lockdowns and public-health concerns for retail workers and consumers alike resulted in a mass migration to online sales. The pandemic essentially squeezed ten years of digital sales penetration into three months. In response, retailers scrambled, innovated, and adapted their distribution and brick-and-mortar operations to keep pace.

Eighteen months later, online sales show few signs of reverting to prepandemic levels. Retailers that may have initially viewed e-commerce as a lifeline now take a slightly more negative view. For the majority, skyrocketing online sales have been accompanied by costs that have risen just as fast. Fulfillment costs, for example, can account for 12 to 20 percent of e-commerce revenues, squeezing margins and making profitability a mirage.

Retailers must now recognize a few truths: all growth is not the same; unprofitable growth destroys value; and healthy, sustainable growth should be the goal. Success will require a concerted, organization-wide effort. The good news: our analysis identified some common trends among leading retailers and highlighted four imperatives that can point organizations down the path to profitability.

The e-commerce catch-22

Even before the COVID-19 pandemic, consumers had begun to embrace the selection and convenience of e-commerce. In 2019, e-commerce represented approximately 25 percent of total retail sales.[1] Since the onset of the pandemic, consumer intent to purchase goods through e-commerce channels has increased by 40 to 60 percent compared with prepandemic levels across categories from everyday essentials to clothing and accessories.

McKinsey research suggests these shifts in consumer behavior will stick over the long term as individuals become more accustomed to purchasing online.[2] More than 50 percent of consumers expect to continue their online shopping habits after the pandemic abates. This pattern will fuel the growth of online sales, which are expected to contribute to 100 percent of the increase in sales of soft goods over the next three years.[3] Forecasts suggest online sales could account for nearly half of all retail revenues by 2024.

Retailers must now recognize a few truths: all growth is not the same; unprofitable growth destroys value; and healthy, sustainable growth should be the goal.

[1] Michelle Evans, “The outlook for retailing in 2021,” Euromonitor International, February 2, 2021, euromonitor.com; McKinsey COVID-19 Consumer Pulse Survey, September 2020.
[2] Tamara Charm, Becca Coggins, Kelsey Robinson, and Jamie Wilke, “The great consumer shift: Ten charts that show how US shopping behavior is changing,” August 2020, McKinsey.com.
[3] Euromonitor 2020 retail data; Forrester 2020 online US retail forecast.

However, the results are not all positive. Our analysis of total shareholder returns (TSR) for 100 large retailers found digital growth alone does not necessarily lead to positive outcomes (exhibit). In fact, the retailers with the most growth in online sales saw the biggest decline in margin (and thus TSR). In comparison, top performers increased shareholder value more than ten times for every percentage point of digital growth compared with companies in the bottom quartile.

Retailers that overemphasize e-commerce revenues could actually be damaging their prospects. Indeed, digital growth is not enough; only profitable digital growth will create value. Since e-commerce is a significant contributor to growth for most retailers, they must not only have a strategy for how to generate more growth from this channel but also ensure that the strategy creates value for the organization.

What separates the winners

Depending on a company's product categories and business model, it may have inherent advantages when competing in e-commerce. Consider a few examples:

— *Higher item value and basket size in categories such as home, sporting goods, and electronics incur lower shipping costs as a percentage of sales.* In comparison, a fast-fashion retailer with a low free-shipping threshold may need to absorb a large number of negative-margin sales.

— *Retailers that offer a unique or custom product or service are more likely to protect margin.* By contrast, a consumer-electronics retailer may need to aggressively price match to generate sales.

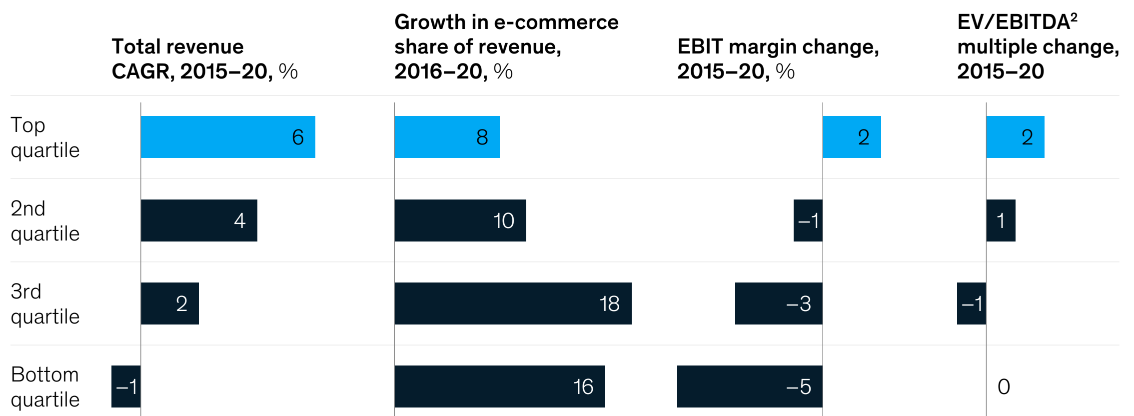
— *Categories with lower return rates, such as furniture, have lower costs related to returns logistics and markdowns.* But a women's apparel player may face a return rate of up to 40 percent on items such as dresses and jeans.

While built-in advantages can increase the odds of achieving profitability, companies can still take actions to improve their performance and reduce costs. Our analysis found that three markers separate top-quartile performers from the pack regardless of their starting point.

Exhibit

Digital growth alone does not necessarily lead to greater earnings.

Retailer performance by TSR[1] quartile



[1]Total shareholder returns.
[2]Enterprise value to earnings before interest, taxes, depreciation, and amortization.
Source: Digital Commerce 360; McKinsey analysis

Category diversification

Retailers in categories with lower price points, higher ability to cross-shop, or high return rates have mitigated these disadvantages by entering into new categories with more favorable intrinsic economics for e-commerce or by launching private-label brands to gain more control over margins. For example, Target has launched 30 private-label brands in the past five years, and more than ten of these brands generate at least $1 billion in annual revenues each. Similarly, Amazon has established more than 100 private-label brands across categories, with penetration as high as about 10 percent in apparel.

Effective EBIT management

Retailers are increasingly faced with a paradox: brick-and-mortar revenues are in decline while a host of fixed costs remain, but the growth of online sales fuels a rise in variable costs (such as fulfillment, delivery, and digital marketing), thus eroding margin. What is the winners' secret? They start with transparency on total cost to serve by identifying key cost drivers and implementing coordinated strategies across end-to-end commercial levers, from pricing and promotion to merchandising and fulfillment. When done well, this approach enables leaders to pinpoint shifts from brick and mortar to e-commerce and determine how those shifts affect markdowns, return processing costs, marketing, and credit-card fees, among other costs.

Levi's "premiumization" strategy demonstrates the effectiveness of this approach. By initiating impactful collaborations and launching hot-spot pop-ups, the company elevated its brand and drove consumer demand, enabling it to strategically reduce its markdowns and increase pricing by about 5 percent in the second quarter of this year across all geographies and channels. These efforts raised gross margins by about one percentage point.[4]

Curate a brand experience to drive loyalty beyond reason

Leading retailers invest in consistent and friction-free experiences, a strategy with a clear link to value across omnichannel. Sephora is a leading example of how to implement consumer-centric strategies that seamlessly blend digital and physical shopping experiences. Ranked number one in Sailthru's third-annual Personalization Index, the retailer creates a personalized consumer experience through the combination of its Sephora app and digitally enabled frontline staff who can access a customer's purchase history to offer real-time recommendations. In addition, Sephora uses augmented-reality tools such as facial scanning so customers can conduct virtual product testing via mobile or in store.

Some of the savviest retailers subtly nudge customers to take certain actions, such as returning products to the store, obtaining a discount rebate, and paying with a debit card to reduce processing fees. The total impact of these efforts can strengthen customer loyalty, increase customers' lifetime value, and improve margins.

Four imperatives to boost e-commerce profitability

Getting to breakeven in e-commerce has proved elusive for most companies because of its tremendous complexity: retailers must connect the dots between growth and cost levers and align incentives across the organization. While a retailer must tailor its strategy to its particular starting point, a successful approach should include four imperatives.

1. Align on the 'North Star' and set clear objectives for the whole organization, enabled by data visibility

Achieving profitability in e-commerce requires a move from functional thinking to system thinking, with different parts of the organization working closely together and making conscious, informed trade-offs. Establishing quantifiable objectives and key performance indicators (KPIs), informed by the "North Star," can support the decision-making process required to achieve desired outcomes. This process starts with a clear understanding of total cost to serve. Accounting for previously "hidden" costs of serving customers—for example, the allocation of upstream personnel such as designers and salespeople—can quantify the true cost of doing business by channel as well as customer profitability.

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[4] Arthur Friedman, "Levi's wants to 'premiumize' the US market—here's what that means," *Rivet*, February 3, 2020, sourcingjournal.com.

A case in point: promoting two-day shipping may help the commercial team achieve its revenue targets, but this decision will likely have a negative impact on the logistics team's cost-management goals. In many cases, commercial teams lack visibility into operations costs at an item level, which means that they might make unprofitable decisions unknowingly. Retailers may need to invest to build this granular cost visibility to enable aligned incentives and shared KPIs.

2. Generate more value from fixed assets

Retailers can deploy several strategies to improve the margin of each transaction and maximize the value creation from fixed assets.

First, performing profitability analysis at the SKU level can allow retailers to be strategic about which products to offer online and promote on the digital shelf. Targeted communications and offers can result in bigger baskets. For example, retailers can identify opportunities in the purchase journey to engage customers—such as outfit recommendations or in-cart add-ons—to reduce the per-item cost of fulfillment and shipping. In addition, since customers likely won't be thinking about a retailer's expense in delivering their goods, companies have an opportunity to nudge them toward lower-cost options, such as no-rush shipping or ship to store.

Another way in which a retailer can improve transaction profitability is to expand offerings into higher-margin categories where the retailer has the right to play. For example, an apparel retailer may consider entering skin care and cosmetics or soft home, categories that not only have better economics but also are complementary to core apparel offerings, which enables basket building. Alternatively, retailers can consider launching private-label brands, which offer more control over margins through decreased price comparability and promotional intensity.

3. Reduce operating costs while providing an excellent consumer experience

Not all cost-reduction measures have a negative impact on consumer experience and revenue potential. In fact, some tactics, when wielded artfully, can improve margins while boosting sales. Using stores as microfulfillment centers can help retailers meet increasing customer expectations for fast delivery while avoiding skyrocketing costs. With more than 90 percent of consumers believing two- to three-day delivery is standard, retailers with an existing physical footprint have a unique advantage to meet customer demands while controlling costs.[5] Omnichannel services, such as buy online, pick up in store (BOPIS) and ship to store, can help decrease the cost of fulfillment and logistics and bring additional foot traffic to stores, resulting in incremental sales.

To take a step further, retailers such as Amazon are leveraging self-serve lockers to further reduce operating cost while increasing efficiency in simple in-store transactions such as pickup and returns. Taking a multicarrier approach can also present an opportunity. Although the approach is complex, when retailers invest in the right tools and supplier development, a larger stable of carriers can enable retailers to actively manage fulfillment costs and maintain customer service-level agreements (SLAs).

Returns have remained a vexing challenge—and one that can eat away at margins. Simple tactics such as encouraging consumers to return merchandise to stores can cut processing time by up to 18 days and improve the chances an item can be resold at full price. Since e-commerce return rates can reach 25 percent, even small improvements can have a significant impact on the bottom line.

4. Accelerate the speed at which the company organizes and operates

The increasingly complex matrix of omnichannel engagement creates friction points that can cloud decision making. Long-standing questions such as "What should be integrated versus stand-alone?" and "What should be owned by the digital versus functional areas?" continue to challenge leaders. One thing is certain: the pace of change and operating rhythm is only accelerating. Retailers are no longer in the world of weekly review. The cadence has shrunk to by-the-minute sales operations.

[5] John Barbee, Jai Jayakumar, Sarah Touse, and Kumar Venkataraman, "Retail's need for speed: Unlocking value in omnichannel delivery," September 8, 2021, McKinsey.com.

Two priorities can help organizations increase their pace. The first order of business for retailers should be to establish an agile operating model that can enable a rapid test-and-learn culture and streamline decision making. Since e-commerce functions such as merchandising are commonly shared with stores, retailers must establish clear ownership and metrics to ensure accountability.

Forming agile squads with a cross-functional team can enable retailers to run rapid A/B tests to evaluate different profitability strategies and use the results to shape large-scale rollouts. This approach helps reduce the risk of new strategies or practices while allowing teams to be innovative.

Second, retailers that have traditionally focused on brick-and-mortar operations likely have workers who lack the necessary digital knowledge. As e-commerce and digital technologies become larger parts of the business, developing this knowledge will be critical to foster effective collaboration—not only in digital and e-commerce teams but also across the organization. A baseline of digital fluency will enable retailers to achieve true cross-channel coordination.

The spike in e-commerce over the past 18 months has led retailers to focus on capturing growth, with mixed results on profitability. To win in the years ahead, retailers must scale their digital channels while maintaining a relentless focus on costs. Addressing several questions can help guide the way:

— How well aligned is the organization on digital growth and profitability objectives?

— Does the organization currently have clear visibility into the full set of cost drivers on the digital and omnichannel business?

— Which types of initiatives and services can nudge consumers toward low-cost channels and help the organization notch quick wins?

Prioritizing transparency, selecting and measuring the right KPIs, promoting cross-functional collaboration, and accelerating the operational speed of an organization represent important first steps.

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