A paradigm shift in retail

Introduction

Few industries have been so affected by the Covid-19 global pandemic as retail. As lockdowns spread across the globe, consumers came to realize how essential this industry is, and the sector itself was forced into a period of rapid change as it adapted to meet their needs.

Even before the pandemic, uncertainty was high. In both the EU and the UK, retailers were adapting their supply chains to Brexit, while changes in customer behavior, driven by an unstoppable move to digital channels, were well underway.

The global crisis, however, has accelerated these trends. Retailers have had to adapt to new customer norms, flex global supply chains, balance volatile levels of inventory, and repurpose unused stores, all while managing their response to the pandemic for their own staff and customers.

All this change has required investment - another call for cash from companies that were already shoring up balance sheets to weather short-term liquidity fluctuations and ensure their survival.

To understand the trends impacting the retail industry, Taulia asked more than 50 retailers worldwide for their views and conducted in-depth interviews with the leadership of some of the largest retailers in the US, UK, and Europe.

The results are significant. More than half of those we surveyed expect the impacts of the pandemic to last longer than two years, and almost a third say the changes will be permanent.

> Almost one-third of retailers say the impact of the pandemic will be permanent.

In this research, we have tried to differentiate between trends that are unique to the pandemic and those that were already in play but have now been accelerated.

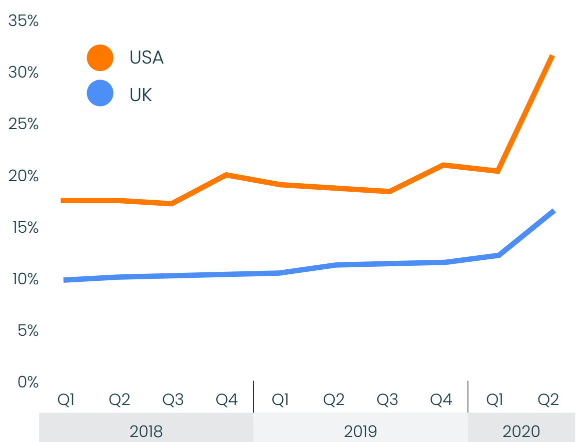
Our main finding is that the biggest challenge for the retail industry in the coming years is the consumers' move online and the digital transformation needed to compete in online channels.

Consumer behavior has permanently shifted online

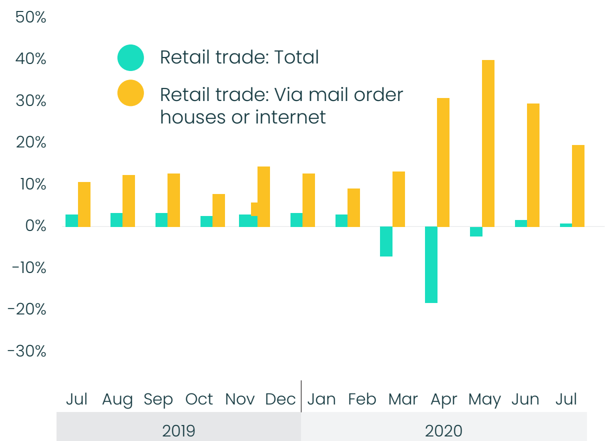
There is significant data pointing to the increase in online sales since the beginning of the pandemic.

The OECD's report in October 2020, 'E-commerce in the time of Covid-19' captured this trend well. The UK saw online sales as a proportion of total retail sales nearly double from 17.3% in Q1 2018 to over 31% in Q12 2020. The EU 27 also saw retail and mail-order sales increase by 30% year-on-year in April 2020, while the US saw slightly slower growth, with their total proportion of online sales rising from 11.8% to 16.1% over the year to April 2020.[1] This trend has continued into 2021 with the UK reporting over 36% of all retail sales through online channels in February 2021.[2]

Share of e-commerce in total retail sales, UK and USA (2018-2020)



Retail turnover,YoY change, EU-27 (July 2019-2020)



Each country has been impacted differently based on its culture and its approach to physical restrictions during the pandemic, but the trend is clear. The OECD report points to the SARS crisis in 2002 and 2003 as one of the catalysts for a permanent change to online sales in China. The current pandemic is also expected to create permanent change among consumers, who are now comfortable buying different products online and in the increased willingness of governments to restrict physical retail in future emergencies.

Almost 90% of the retailers we surveyed expected online sales to continue at their current levels, or increase. One of the largest UK retailers said, "All of our marketing spend has now been taken from stores and allocated to online channels. We've seen online sales go from 20% of our offering to over half and, while I expect some will revert back to store sales, I think we will continue to see between 30% and 40% of our future sales remain online".

> Nearly 90% of those we surveyed have already, or are planning to develop new online sales channels.

In this context, online retail channels are no longer a channel for marginal growth - they are critical to survival. Highlighting this, one retailer in the Middle East mentioned that the e-commerce team now reported directly to the General Manager in response to the pandemic.

The majority of retailers and retail manufacturers are focused on developing their direct-to-customer online channels. Nearly 90% of those we surveyed have already created, or are planning to create, new online sales channels, while 40% have already launched a new channel in response to the challenge. To support this trend, branded consumer manufacturers are investing in the last mile of the supply chain, with the CapGemini Research Institute reporting that 97% of branded consumer firms are joining forces with other consumer product firms to create shared warehouses and logistics for the last mile delivery.[3]

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Procurement head

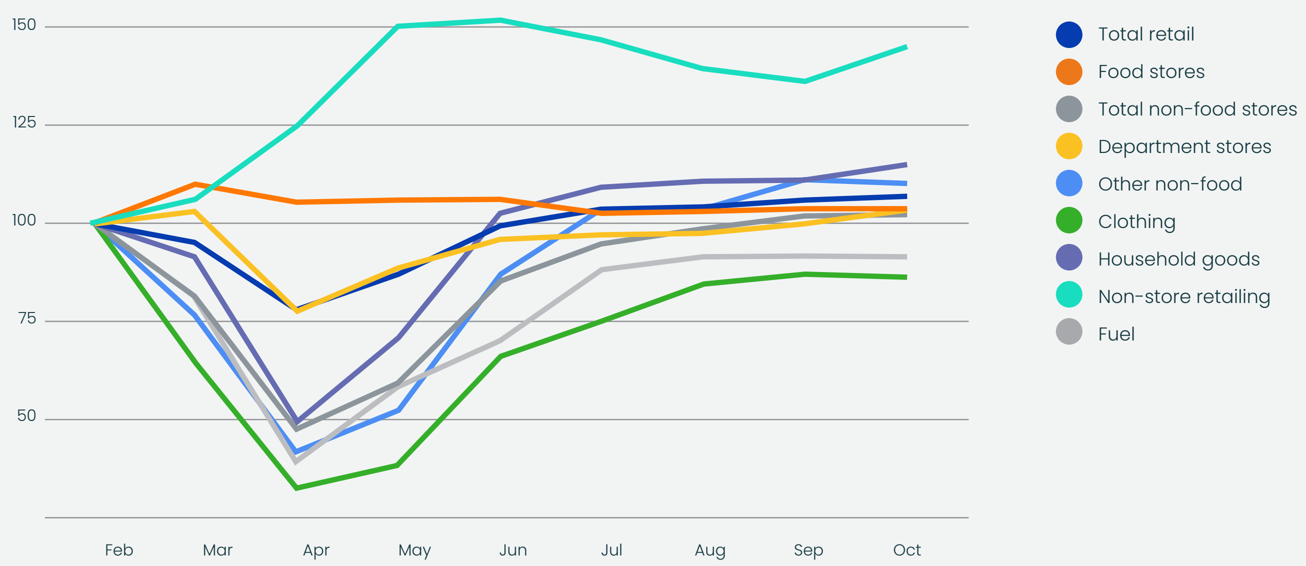
Major UK retailer

A case of the haves and the have-nots

The growth in online sales and retail sales, in general, has not been uniform across different products or company sizes. As one retailer put it – "as far as profits go, this is about the haves and have nots". Many markets have seen a shift from 'non-essential' to 'essential goods', but this varies by country. A global drinks manufacturer mentioned that beer sales have been incredibly country-specific. Some countries with 'pub cultures' have seen sales crash while others have seen a boom.

Household goods have seen a boom in sales, on top of the spike in health and protective gear sales. One large UK home-goods retailer said that although they were experiencing growth in click-and-collect sales before the pandemic, they were surprised by the increase in online sales, but expected sales to reduce as the pandemic comes under control. Data from the UK's Office for National Statistics (ONS) shows a significant increase in online sales for household goods. However, our retailer said that while click-and-collect will likely continue to be necessary, when it comes to home improvement for larger, more expensive purchases, people still want to touch and feel them and see them in the light of day.[4] The behavior change then, as life returns to a new normal, is also likely to be very nuanced and product specific.

Seasonally adjusted UK retail sales by sector in 2020



One Scandinavian retailer mentioned increasing competition from Amazon as a reason for investing more heavily in online channels. The competitive landscape of online retail was a concern for many of our survey respondents as the rapid move to online sales has played to the strengths of a few dominant internet retailers.

This highlights another case of the haves and the have-nots. In our survey, fewer than 20% of smaller firms reported having launched online channels, a much lower proportion than larger retailers. Smaller firms have traditionally been the target users for Amazon's platform, as many of these firms haven't had the IT capability to compete online effectively.

> Although some larger brands were initially reluctant to use a partner site, they eventually saw the need.

But this isn't just the case for smaller firms. Many larger firms simply don't have the IT culture or capability to compete online successfully, so they will need to either buy the capability or find a technology partner. One European online fashion retailer we spoke with saw rapid growth in the second half of 2020 in their partner platform business. They mentioned that, although some more prominent brands were initially reluctant to use a partner site, they eventually saw the need. Industry-specific platforms like this increasingly compete with and offer an alternative to Amazon and often provide more flexible contract terms to win business.

All of this highlights an ongoing shift in retail business models that the Covid-19 pandemic has simply accelerated. Successful approaches to online sales will vary by country, industry, and product line, but all will take years to get right, making healthy cash flow even more critical.

The pandemic was a liquidity shock for everyone

The move to online sales has meant a reduction in the use of cash, as fewer payments are taken at cash registers and more payments are made with debit and credit cards online. The cash flow impact of this behavior change, however, has not been material, although firms did mention that some card acquirers 'can be a bit late in paying' generally. On the other hand the rapid increase in supply and demand uncertainty did create a liquidity shock for everyone in the industry, even those who have since seen a sales boom.

> One UK high street retailer said that banks had been reluctant to provide longer-term facilities.

During the initial uncertainty at the start of the pandemic, the vast majority of retailers we spoke to accessed either the bond markets or additional bank funding early to ensure sufficient liquidity. UK businesses alone borrowed an additional £77 billion since the beginning of the pandemic, according to the Bank of England's December 2020 Financial Stability Report.[5] One UK high street retailer said that banks had been reluctant to provide longer-term facilities, so where they would traditionally have received a five-year revolving credit facility (RCF), in 2020 they were only offered a three-year facility. This retailer brought forward plans to issue bonds. Another home-goods retailer said they immediately drew down on their existing RCF and negotiated another RCF to double their liquidity reserves. Even the large US retailer we spoke to mentioned drawing down on their credit facilities despite a cash surplus.

The Bank of England data showed that larger corporates had repaid some of the additional debt by the end of 2020 and those we spoke to confirmed this. One said that because of the government support, they did not need the additional facilities. In contrast, another said that as sales picked up, they realized that their cash position was better than expected, so they repaid some of their facilities early.

However, as we look to the current year, the Bank of England predicts that a significant funding need still remains. Aside from short-term bank reluctance to offer the longer-tenure funding mentioned earlier, another challenge to funding raised by those we spoke to is the longer-term risk aversion that may be a hangover of the pandemic. One large retailer mentioned their auditors taking a vastly more conservative approach to stress testing and the levels of liquidity required as a going concern. Including scenarios of stores closing for nine months and significantly reduced sales may mean many retailers will need higher levels of cash and credit facilities for the foreseeable future. This adds an extra challenge for a sector investing so heavily in digital transformation.

Capex has been brought forward, and working capital is in focus

Effective cash flow forecasting has been critical in managing the liquidity and funding decisions required by the pandemic. One retailer said, "The early process was just about understanding headroom for the stress". Another mentioned increasing the frequency of financial forecasts weekly for more material areas of the business. "Normal three-month forecasts were out of date in a week", they said. It is no wonder then that nearly 40% of the retailers we surveyed intend to upgrade their cashflow forecasting systems and processes.

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UK retailer

While most retailers said the pandemic had not increased capital expenditure (capex), many commented that it had brought forward investments, which added short-term pressure on funding plans and cash flow forecasting. For a large Scandinavian retailer, these expenses were focused primarily on the digital capabilities of online channels as well as automation of warehousing and logistics. Another retailer, however, mentioned expanding distribution capacity. That meant literally adding a mezzanine floor to their distribution center. While this was in the plan, it had to be accelerated because of the inventory challenges created by the pandemic.

> Where previously the economics for invoice financing had not made sense, the business case was now getting executive attention.

Much of this accelerated expense has been covered by the reallocation of store capex. However, every retailer we spoke to said they had increased their focus on working capital optimization to strengthen the balance sheet. Those that already had working capital programs and systems in place felt their funding strategy was less impacted by the pandemic. Almost all of those we spoke to directly had supplier finance programs in place and many increased these facilities. One drinks manufacturer also said that where previously the economics for invoice financing had not been attractive, the business case was now getting executive attention.

> Supply chains have just gone a bit crazy.

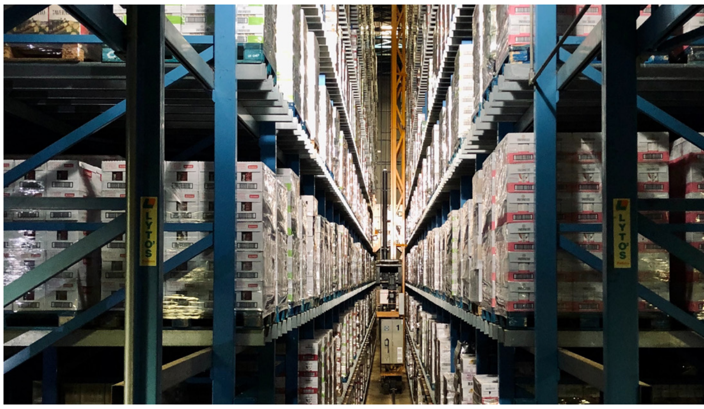
Within this focus on working capital, the most critical element is the stress on supply chains and the impact on inventory levels. A global pharmaceutical retailer said that while customer service is still the top priority, they are looking at all opportunities to improve the management of inventory. “Supply chains have just gone a bit crazy. First, we experienced difficulty getting the products we wanted, and now we have inventory we need to get rid of and are thinking about what we need for some kind of normal”. Minimum order quantities and safety stock is one of their main focuses right now. Product stock can be in store, in the retailer’s warehouse, and down the supply chain in supplier and distributor warehouses and the manufacturer’s work in progress. This represents a significant cost and use of capital with a negative impact on revenues.

Supply chains are under historic stress

Almost

60%

of retailers plan to change their procurement strategy.

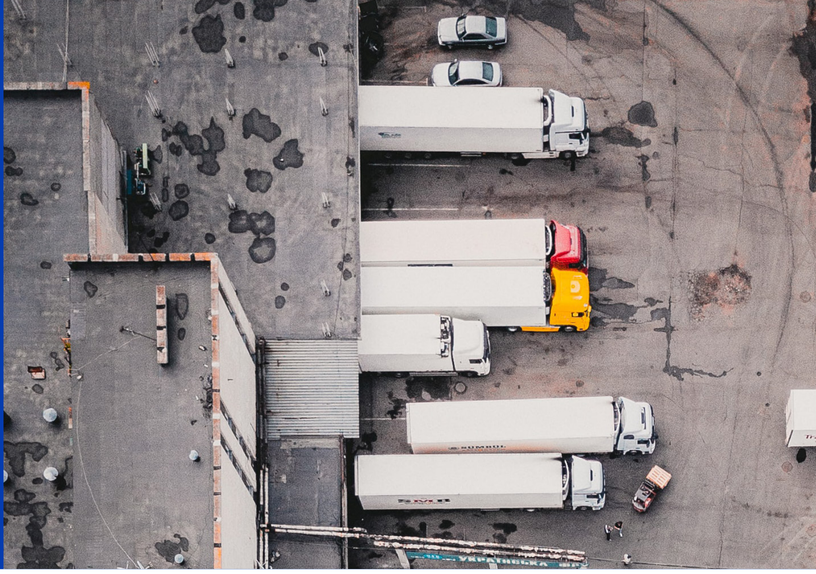


In light of the current environment, nearly 60% of the retailers we surveyed said they already have or plan to change their procurement strategy. This is a unique and challenging time for global supply chains as a combination of factors, from Brexit to geopolitical tensions between China and the US, as well as the drive for sustainability, combined with a once-in-a-generation pandemic.

For some UK and EU retailers Brexit remains the primary driver of supply chain instability. A large specialist retailer from the UK said their supply chains were still focused on Brexit because many suppliers were simply not achieving their service standards. There were also reports of continued disruption for food businesses due to Brexit and new border processes not being as smooth as promised. The challenges are varied. A large Scandinavian retailer who has already worked to source the majority of products domestically said the current environment is not driving any changes. The geopolitical climate was the most pressing procurement issue for less than a quarter of those surveyed.

Shipping delays and supply shortages from the pandemic have been widely reported and were the biggest procurement concern for three-quarters of the retailers surveyed. "Up to six months after March last year, we struggled with shipping delays", said a European fashion retailer. "It seems to have stabilized, but now even if deliveries come earlier, we just accept everything, whereas, in the past, we would have said wait, hold on."

Another homeware retailer with sourcing from Asia said they were reviewing the concentration risk in their supply chains. Since the pandemic, they have seen shortages in stock from Asia and increasing shipping costs. The costs and capacity of shipping are now driving them to use cargo trains from China. This has accelerated a review that was already being driven by the appreciation of the Chinese Renminbi and increasing labor costs.



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European fashion retailer

One of the most immediate challenges reported from this supply chain volatility has been the impact on foreign exchange (FX) hedging. For retailers who hedge transaction exchange risk, the rapid changes to order levels or delayed shipping have resulted in additional FX swap costs. In the longer term, however, the combination of supply chain pressures and this pandemic have the potential to permanently change inventory management practices with more fragile supply chains requiring higher levels of stock at multiple points along the supply chain. This historic pressure is not just on the cash tied up in inventory, but more importantly, on the systems and processes needed to adapt procurement and inventory management to rapidly changing events.

Another driver of change for supply chains in retail has been ethical procurement and environmental sustainability goals (ESG). More than 80% of the retailers we surveyed said that their plans for the next year included ESG initiatives. One of the UK's largest retailers summarized the general approach well, saying that while rating agencies were currently driving some of these changes, they intend to actively include ESG metrics into their bonds and credit facilities in the coming year. ESG initiatives were generally seen as 'business as usual', while one supply chain trend that the pandemic has brought sharply into focus is the health of smaller suppliers.

Larger firms have acted to protect their suppliers

Over 90% of the retailers we surveyed said that supplier retention was important to their business model, with over half saying it was very important. This is not surprising given the pressures on global supply chains we have so far mentioned and the long-term cost implications of supply disruption. One PWC study showed that supply disruptions cause lower returns on revenue and return on assets for up to two years[6]

In light of this, many firms have acted to protect the financial health of their suppliers through the pandemic. Nearly 70% of those we surveyed directly support their suppliers' cash flow through supplier finance, dynamic discounting, or simply paying earlier. The approach, however, is culture-specific.

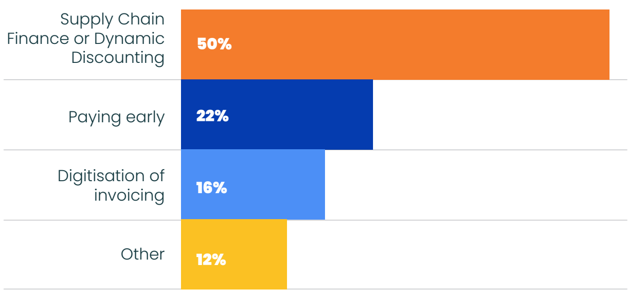
Many retailers in the UK and Europe reported increasing their supplier finance facilities to accommodate the increased demand from suppliers. All of those we interviewed said that they had not increased payment terms; rather, as one homeware retailer put it, "we knew that our suppliers were affected as well, and we are in the same boat". They used a new short-term supplier financing facility to support some of their larger suppliers on top of their existing SCF program. They also mentioned that uptake from their suppliers in Hong Kong was lower than expected, as economies in that region appeared to bounce back relatively quickly.

One of the UK's largest retailers saw higher use of their SCF facilities, saying: "A lot of our suppliers were going through financial difficulties, so we offered them our supplier finance. It meant we didn't need to pay them earlier, but they were in a better situation". Those most affected by limited finance options through the pandemic have been smaller businesses, so another retailer mentioned opening up their SCF program in Italy to much smaller firms than they had previously.

Other firms have gone one step further in their support, with one clothing retailer saying that they had made early payments to any suppliers who asked. Another Swedish retailer, with predominantly domestic suppliers, recognized that many of their suppliers were exposed to the hospitality industry. So they not only extended their SCF solution to these smaller suppliers, but also reduced terms for those with cash flow challenges.

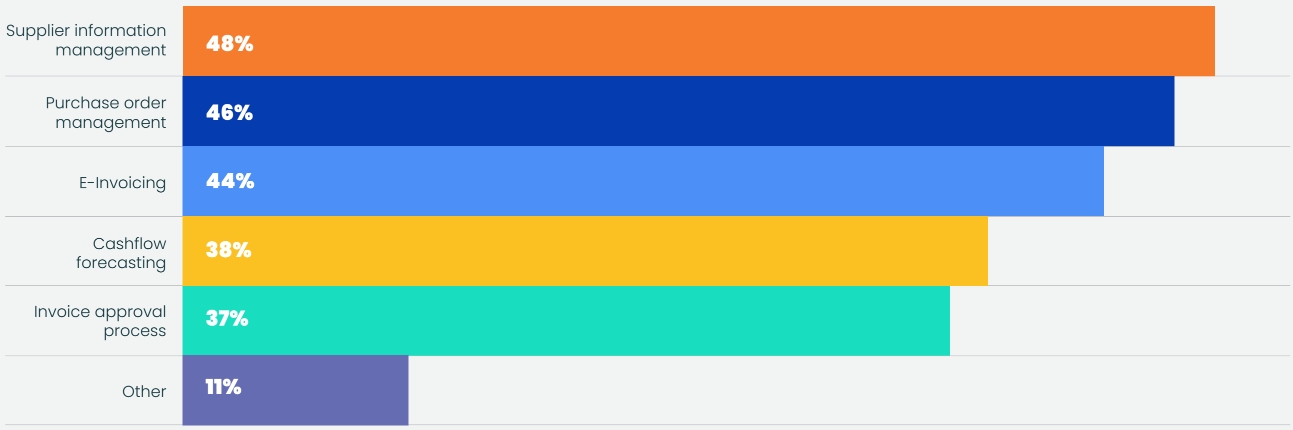
Supplier finance has played a crucial role in the process of retailers balancing their own liquidity needs with the health of their suppliers. The most important enabler for firms who have managed these rapid changes well has been comprehensive and integrated supply chain systems and data transparency.

Which of these tools have you used or do you plan to use to support your suppliers?



Data and digital adoption are critical for success

Plans to introduce/upgrade your digital capabilities in any of the following?



The pandemic has focused retail industry investment on digital transformation. This ranked as the top priority for the industry. Over a quarter of those we surveyed said this is the biggest challenge for the next five years, above changing consumer behavior and the global economic environment. This alludes to the fact that aside from the obvious need for competitive online channels, the entire approach to the retail business model needs to be technology-focused.

Supplier information management was the area that required the most investment, with nearly half of our surveyed retailers saying they intend to upgrade their systems. This was followed by purchase order management and e-invoicing. Supply chain volatility has highlighted the critical need for systems and data that facilitate automation and rapid decision-making.

The advantages of fit-for-purpose supply chain systems were a common theme for those we spoke to, and yet almost everyone we interviewed felt there was an opportunity to improve. One retailer spoke of supply forecasts being essentially copied from year to year and having to call offices worldwide to get accurate shipping data during the pandemic. Some spoke of recently upgrading ERP systems and yet not having the basic data accuracy to split inventory by business unit. Others mentioned having plenty of data but not having the "lenses" for the insights they would like. Interestingly one of the smaller retailers we spoke to mentioned executive focus to build an integrated inventory and supplier system to automate the management of higher value stock items to improve working capital efficiency.

But even where systems are fit for purpose, the ongoing challenge for treasury and finance professionals is often communicating the cash value of supply chain and working capital efficiency. As one of the larger retailers we spoke to said, "Our systems are fit for purpose. We have scrubbed all our data, removed multiple vendor accounts, and we now have a clean and simple set of payment terms. The issue is more behavioral about people sticking to the systems and processes. It's hard to change behavior. Buyers working long hours may not see the importance of inputting the correct data".

Whatever the new normal is, we can help

As we all look forward to a post-pandemic world, most of us understand there will be permanent changes and a new normal. For the retail industry, the biggest question is existential: what is the future of brick-and-mortar stores? Every retailer we interviewed said this consumed much of their thoughts for the future.

A large US retailer didn't see a future in physical storefronts. They felt that US malls could easily change use, with the majority of essential goods retailing through the internet. In the UK and Europe, however, the high streets are ingrained in the culture. Although the pandemic has shifted behavior, even for older generations, our European retailers expect stores to remain. This will take government intervention through business rates or tax, and is likely to be more experience-based, with a shift in product lines.

> The pandemic has shown that the right set of funding options as well as integrated systems and data-led insights are critical.

Regardless, the profitability and business models in retail are changing. As one retailer put it, "There will be boom times, but will it be for everyone?" Changing consumer behavior will require digital agility. It will take time and insights to understand and compete with new challenges fully. It will also need strong cash flow and robust funding. The pandemic has shown that the right set of funding options and integrated systems and data-led insights are critical to managing the cash flow implications of a shock. Unlike traditional banking options, Taulia's supplier finance solution automates expansive programs that reach even the smallest suppliers. This win-win scenario combines improved working capital with cost-effective finance and cash flow support for the health of the ecosystem.

Already, in early 2021 there are reports of shipping backlogs at US ports and further shipping delays in the UK.[7][8] The supply chain implications of the pandemic, specifically uncertainty and fragility, look likely to last for some time. As retailers look to improve their supply chain data and insights, Taulia's technology platform is an enabler. Information exchange between supplier and buyer is automated, improving transparency and supply chain insights. It improves invoice approval processes and times as well as reducing errors and fraud. Most importantly, it strengthens supplier relationships, creates ESG incentives, and offers insights to adapt and ensure your organization's supply chain is a competitive advantage.

Get in touch today to learn how Taulia can support retailers of the future.

5 key takeaways

1. **Change is the new normal** – whether it is sales channels or supply chains, it's clear that as we emerge from the pandemic, all areas of the retail ecosystem need to adapt.

2. **There is no single approach to succeeding online** – while some will try to replicate Amazon, the reality for most will be a balance of partnerships and in-house sales channels.

3. **Digitization of more than just sales channels is needed** – longer-term competitive advantage will require integrated systems to more effectively automate supply chain and inventory management.

4. **Uncertainty is the new normal** – agile and healthy supply chains are critical to managing shocks. Supplier finance has proved effective in supporting buyers and suppliers through this pandemic.

5. **Communication is the key** – as objectives and KPIs shift, communicating the operational and financial value drivers across business functions will support the right business cases and allocation of capital.

1. https://www.oecd.org/coronavirus/policy-responses/e-commerce-in-the-time-of-covid-19-3a2b78e8/
2. https://www.ons.gov.uk/businessindustryandtrade/retailindustry/bulletins/retailsales/february2021
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