Global Retail Disruption: Pressure and Potential in the Digital Age

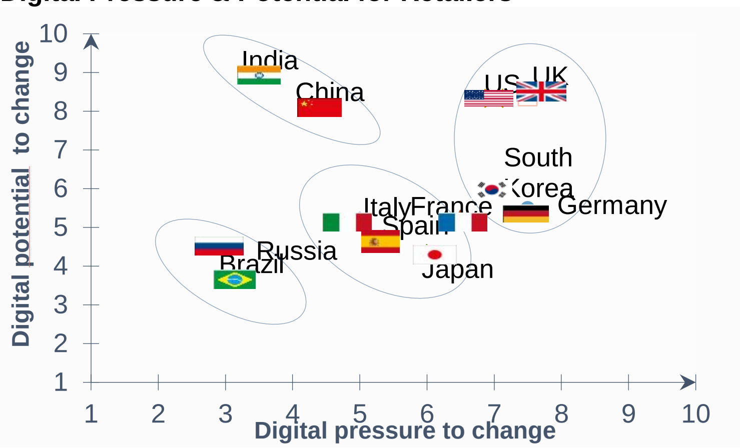
Major retail bankruptcies soared by two-thirds globally in 2016

- Fierce price wars have financially drained traditional retailers; urgent rethink of out-dated business models needed
- Online sales set to climb to 15% of all purchases by 2020
- Omni-channeling, cost of online presence and mobility are top retailer challenges
- US, UK, Germany and South Korea under greatest retail sector pressure

PARIS – 7 JUNE 2017 – Euler Hermes, the world's leading trade credit insurer, has issued its first major Digital Retail Survey examining the significant global impact of digitalization and changing consumer demand within a sector that saw bankruptcies soar by two-thirds last year.

Measuring risks, challenges and opportunities related to the rapid digitalization of the retail sector, the survey draws on expert judgment from 1,500 Euler Hermes credit analysts and underwriters in 12 countries: Brazil, China, France, Germany, India, Italy, Japan, Russia, South Korea, Spain, the UK and the US.

Digital Pressure & Potential for Retailers



Measuring the pressure on retailers to digitalize - and their potential to achieve it - the study found:

- The U.S., UK, South Korea, Germany stand to gain (or lose) the most by digitalization
- France, Japan, Italy, Spain face intense pressure but have limited digital potential
- China & India have kept external pressure at bay
- Russia & Brazil have low digital potential and pressure

Under pressure: The rising value of the customer and the hefty price

Nominal global retail sales have expanded at +4.8% per year over the last decade. While online activity represented 9% of sales in 2016, it should grow significantly to 15% by 2020. Fueled by both supply and demand forces, this acceleration is underpinned by the actions of digital 'natives' and platform businesses that are disrupting and reshaping the industry.

Fierce price wars have drained the financial resources of many traditional players. Many established retailers have failed to adapt to supply chain digitalization and address the ever-growing "consumer experience" challenge. As a result, profitability declined globally to 5.7% in 2016, down from 8% in 2011. Large retailers - with a turnover of USD10mn and more - paid a hefty price: the number of major bankruptcies globally soared by +66% in 2016. To pre-empt financial distress, many companies went on a shopping spree. In 2016 retailers spent a staggering USD2tn to acquire tech companies - a sharp rise from USD148bn in 2014.

Maxime Lemerle, Euler Hermes group head of Sector and Insolvency Research, said: "Retail is at a pivotal moment. Many traditional retailers face the urgent need to rethink their entire business model. While there is a great deal of regional and local divergence, we identified three main challenges facing retailers in the 5 years ahead:

- 'Omni-channeling' or providing customers with a seamless shopping experience whether online, phone or in a physical store;
- The cost of an online presence - a major investment, and difficult for transitioning retailers without growth levers to offset a price war environment;
- 'Mobility' - creating a mobile customer journey by digitalizing the offer and harnessing the Internet of Things.

"The stark choice facing many retailers in the years ahead, however, is quite simply adapt or close."

Top challenges faced by retailers worldwide

Ranked by Euler Hermes retail risk experts, from 1 (least important) to 10 (most important)

	US	UK	France	Germany	Spain	Italy	Japan	Brazil	Russia	India	China	South Korea	Global
Master omni-channeling	10	8	10	3	5	6	9	7	9	10	9	6	7.7
Cost of online presence	7	9	9	9	9	4	8	10	8	7	8	3	7.6
Mobile customer journey	9	10	1	8	10	7	2	6	5	9	10	8	7.1
Tap into big data	8	7	7	4	4	10	3	9	10	6	5	4	6.4
Redefine market positioning	6	6	8	7	6	5	7	4	7	2	6	7	5.9
Mitigate reputational risk	3	3	6	10	8	9	1	2	3	4	3	9	5.1
Leverage marketplaces	4	5	4	6	7	3	6	5	6	3	7	5	5.1
Integrate new payment methods	5	2	4	5	2	2	4	8	4	5	4	10	4.6
Sustainable sourcing	2	1	3	2	3	8	5	3	2	1	2	2	2.8
Other	1	4 Cash generation	5 Marketing innovation	1	1	1	10 Ageing population	1	1	8 Branding	1	1	2.9

Detailed reports produced for each of the 12 countries identify 4 key emerging groups:

1. **Under intense pressure to change: the U.S., the UK, Germany and South Korea**

While most retailers in these four countries are well positioned to adapt to changing demand, traditional retailers have seen the most intense pressure to transform their business models. Some retailers have already missed out on the accelerating digitalization trend and, in some cases, been crushed under the stampede.

The United States: **To thrive you must first survive**
Nominal U.S. retail sales bounced +3% y/y at the end of 2016 and should accelerate in 2017-18 due to increased household consumption and recovering retail pricing power. However, a rise in import costs could see retailers pay a hefty price. Differentiation strategies are needed to increase margins and survive in an uncertain environment where stores are closing and failing at a record pace. The groceries segment has thus far been spared most of the disruptive impact - unlike apparel and electronics, the main victims of restructuring and failures. U.S. retailers should focus on providing quality and innovative customer experiences, and disruptive delivery formats in a market where 70% of customers are e-shoppers.

The UK: No room for complacency
Given the Brexit context, the 2017 and 2018 macroeconomic outlook is uncertain as UK consumer spending is expected to slow, weighing on retail sales. Nominal retail sales have picked up since the end of 2016 (+3.0% y/y) after stagnating at about +1% since Q3 2015. Severe price pressures and low inflation (+0.7% in 2016), both contributed to fierce price wars. Intense competition from online activities is putting businesses under stress; the de-compartmentalization of digital and in-store will be supported by leveraging IT and cutting-edge payment methods. This should limit Brexit's expected negative impact on the retail sector.

Germany: The march of the discount giants
In 2017 and beyond, the return of inflation and the slowing growth of real consumer spending suggests modest nominal retail sales growth in Germany. Retailers have suffered a dramatic decline in profitability: from 7% in 2011 to 2.9% in 2016. Discounters and pure online players are well placed to maintain growth momentum, while the fashion and electronics sub-sectors face pressure.

South Korea: Missing out on data strategy
Modest growth in nominal 2017-2018 retail sales is expected in South Korea, a trend linked to stabilized real consumer spending (+1.3% in 2017, +1.2% in 2018). Retailers' sound financial standing in 2016 was backed by declining debt and strong solvency (57%). General retail needs the right format and offers to protect the segment from major risks. Food and drug sectors are victims of overcapacity while experiencing rising indebtedness.

2. **Limited customer change readiness: France and Japan followed by Italy and Spain**

Major consumer pressures for change in France, Japan and, to a lesser extent, Italy and Spain, parallel limited retailer readiness to undertake the necessary transformation. These markets face a high risk of a messy and costly restructuring.

France: In search of lost innovation
The slight up-tick of inflation (+1.1% expected in 2017) and France's accelerated consumer spending (+2%) may offer retailers a one-time opportunity to boost pricing power eroded by three years of intense price wars. Grocery, pure online players and organic segments are expected to fare better, but the apparel segment may come under further strain.

Japan: The upside-down pyramid
Though still in negative territory, Japanese retail sales have trended upward since October 2016. Yet the upside-down demographic and a rapidly aging population do not bode well for consumer spending growth. Retail sector profits were down from 6% in 2013 to 5% in 2016. Convenience stores and online pure players are the least sensitive sub-sectors. General retail and home & office suffer from unattractive positioning.

Italy: Push and pull
Retail sales in Italy returned to negative territory in 2017, due to declining consumer confidence and slowing private expenditure. Luxury and niche retailers focused on sustainability enjoy a sound outlook, but the home & office and electronics segments employ discounting strategies and put profitability at risk.

Spain: Aging in the age of digital
Spain's retail sales stabilized at +2% in 2016, after struggling to exit negative territory. A deterioration in consumer confidence and an expected slowdown in expenditures shadow the outlook. Apparel should be the leading segment; food & drug is challenged by population decline.

3. Held back by external pressures: China and India

Chinese and Indian retailers are keenly aware of digitalization benefits but market barriers to entry are high and well-guarded by major retailers. Astute market players with a heightened awareness of digitalization have the potential to gain significant market shares.

China: An O2O breath of life
In 2017 and beyond, Chinese real retail sales should stabilize at around +9% growth, slightly below the double-digit long-term average. Retailers are betting on an online-to-offline (O2O) strategy to leverage opportunities offered by the rise of a new middle class. Electronics and online retailers should sustain the momentum, while the luxury segment is set to restructure – impacted by the anti-ostentatious policy.

India: **All bets are off**
Indian retail sales will stabilize at a +3/+4% growth in 2016 and beyond, supported by strong demand and accommodating government policies. The food segment will benefit from a volume effect as consumer spending rises. Fashion profits reached 7.9% in 2016, while general retail enjoyed a more modest 2%.

4. **Struggling and Outdated: Brazil and Russia**

The retail sector is outdated in Brazil and Russia as major retailers struggle with structurally and financially. New market entrant or consumer pressure is limited. This may be a blessing in disguise -- retailers have limited capacity to embrace change due to structural constraints.

Russia: The capabilities and expectations mismatch
After declining -4.5% in 2016, growth resurgence and inflation cooling will support the progressive recovery of retail sales in Russia in 2017-18. They may eventually return to positive territory. 2016 witnessed a lingering struggle of Russian retailers: food grocers and discounters benefitted from essential consumer needs, while electronics and Independent food retailers were the first victims of the 2015-16 recession.

Brazil: No more beginners' luck
Retail sales are slipping into negative territory as Brazil exits recession due to soaring unemployment. Given the poor consumption prospects, the situation is not set to improve in 2017. Apparel, food & drugs showed resilience. Electronics is most at risk, starting 2017 with a staggering 300% indebtedness and low 2.9% profits.

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