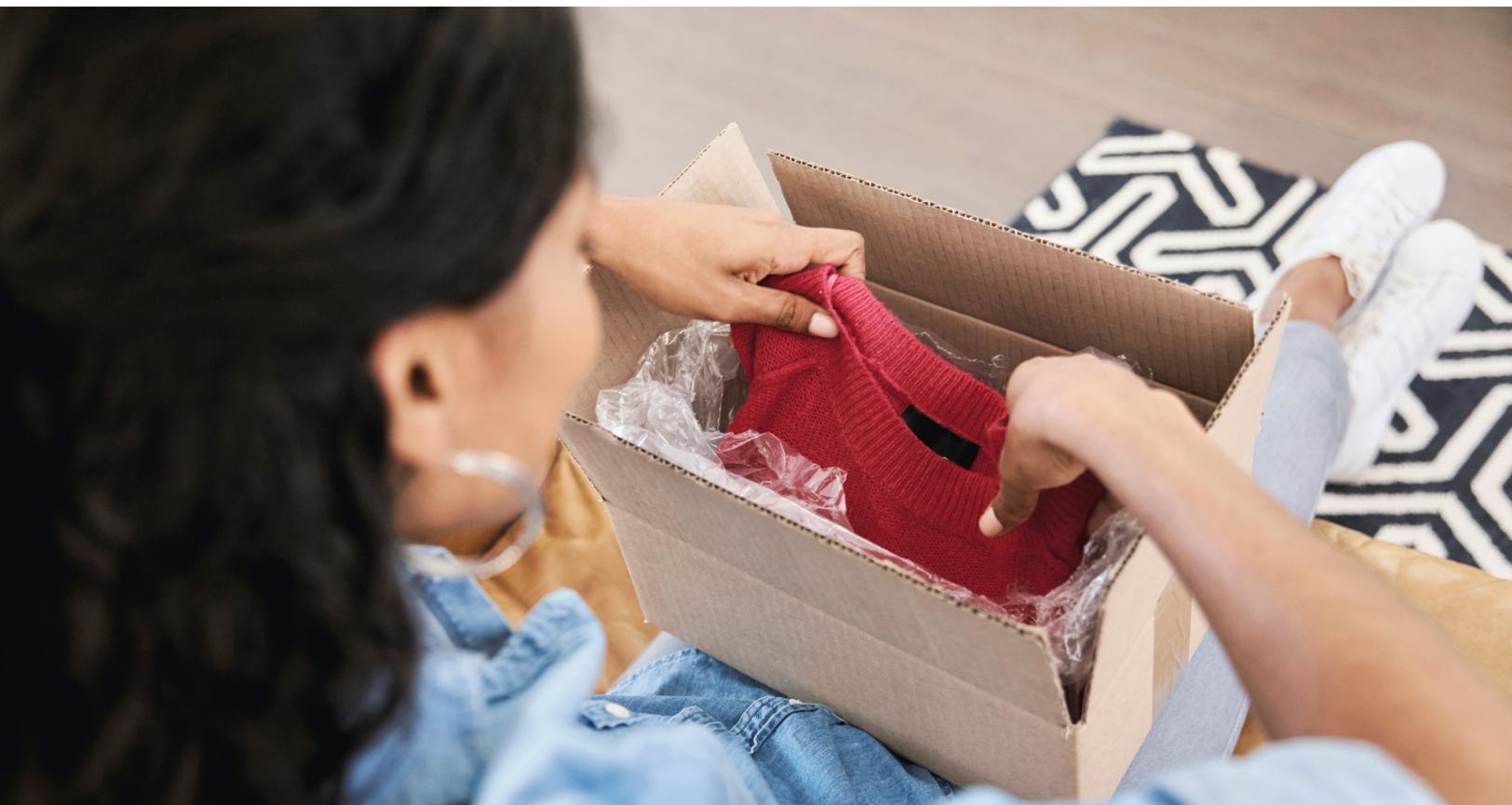


Retail Practice

Perspectives for North America's fashion industry in a time of crisis

Apparel retailers, department-store chains, and cosmetics stores employ millions of people. Industry leaders must take quick action while also planning for postcrisis realities.

by Colleen Baum, Pamela Brown, Emily Gerstell, and Althea Peng



As business leaders worldwide grapple with the COVID-19 pandemic, the health and well-being of their employees and customers must be the top priority. Already, apparel and fashion companies have put their assets to good use in the crisis, be it by turning over their factories to make face masks or hand sanitizer, donating products and services to healthcare workers, or helping employees find temporary roles with companies that are hiring. Ensuring that the business can survive and thrive after this unprecedented shock is crucial as well, as our colleagues emphasize in a recently published article, “Safeguarding our lives and our livelihoods: The imperative of our time,” on McKinsey.com. (For the latest insights on the pandemic, see McKinsey.com/coronavirus.)

In North America, the apparel, fashion, and beauty industry generates approximately \$600 billion in annual revenue and employs more than four million people. Apparel and fashion companies must act quickly to secure business continuity, minimize downside for the latter half of 2020, and get ahead of business-model changes that may be necessary coming out of this disruption.

This article has four objectives. First, we examine COVID-19’s impact on North America’s apparel and fashion sector—and the near-term outlook in light of consumer sentiment and lessons from other regions. Second, we recommend a set of urgent actions to secure business continuity. Then, we look at medium-term actions to take during the recovery to minimize the downside for the latter half of 2020. Finally, we explore longer-term actions to position companies to succeed in the postvirus business environment.

COVID-19’s impact: A fundamental reset or a painful but short blip?

While the apparel and fashion industry, particularly in the US market, has faced challenges in the past decade (because of a combination of recession aftershocks, increased promotional intensity, channel shifts, and an excess of real estate), it has been on a path of steady if slow growth over the past three years, with value and off-price formats being rare bright spots.

Today, the situation is dire. Based on current positions for earnings before interest, taxes, depreciation, and amortization (EBITDA), 75 percent of publicly listed apparel and fashion companies in North America could find themselves with negative EBITDA or untenable net debt-to-EBITDA ratios after three-month store closures. Depending on their cash positions, these companies will be in deep financial distress unless they take urgent action (Exhibit 1).

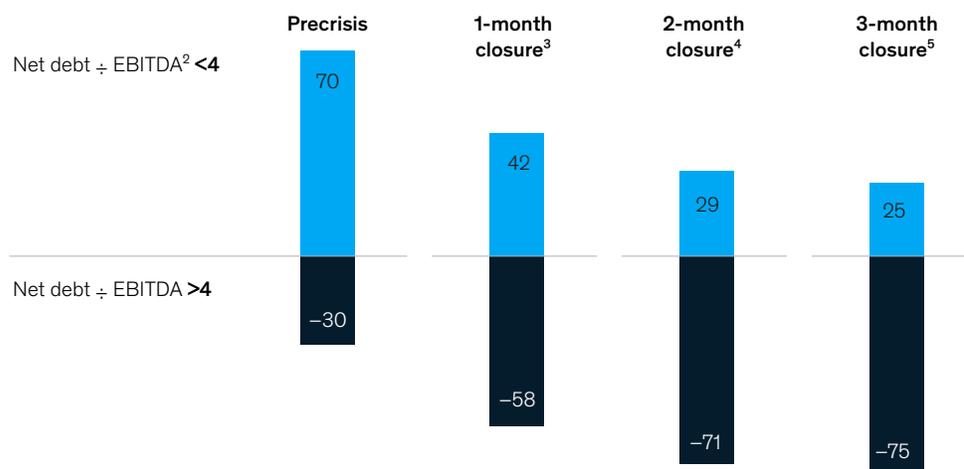
While it’s too early to quantify COVID-19’s toll on the fashion sector, the pandemic has certainly shaken some of the industry’s foundations:

- *Offline retail had already seen massive declines in sales and traffic at the start of the crisis—and now both have gone to zero.* Across North America, retailers are shuttering their doors for consumer and worker safety or in compliance with government orders. Recent announcements suggest no assumptions of normalcy until the end of April 2020 at the earliest. For many brands, the store closures are coming on the heels of disappointing sales in the fourth quarter of 2019 as well as traffic declines in February 2020. Compounding the problem is the fact that North America is “overstored”: the United States has almost 24 retail square feet per person, whereas Germany, for instance, has just slightly more than two. Most concerning of all is the plight of retail workers, many of whom (as of this writing) have been promised at least two weeks’ compensation for scheduled shifts—but stores are unlikely to reopen within that time frame. Some retailers are exploring furloughs rather than layoffs; we are also seeing retailers furlough or reduce pay for corporate employees, as a way of showing solidarity with field workers and as a cash-saving measure. In the meantime, the number of Americans seeking unemployment benefits is expected to increase precipitously in the coming weeks.
- *Online retail is not keeping pace.* While consumer engagement with apparel and fashion brands may be up at this time—as more consumers find themselves at home, idly scrolling through social media—that traffic is

Exhibit 1

Depending on the duration of store closures, 75 percent of apparel and fashion companies could face challenges managing debt levels.

Share of companies with high debt burdens, by duration of lockdown, %¹



¹Analysis of 77 listed apparel and fashion companies in North America. Net debt defined as total debt minus cash and cash equivalents.

²Earnings before interest, taxes, depreciation, and amortization.

³1-month store closure and 1-month lost sales in ramp down and ramp up: equivalent to 17% FY-revenue and cost-of-goods-sold (COGS) decline.

⁴2-month store closure and 2-month lost sales in ramp down and ramp up: equivalent to 33% FY-revenue and COGS decline.

⁵3-month store closure and 3-month lost sales in ramp down and ramp up: equivalent to 42% FY-revenue and COGS decline.

not translating to conversion. Even retailers with higher online penetration, such as direct-to-consumer specialty-apparel players, face challenges as consumers pull back on discretionary spending. Many retailers report that e-commerce sales two weeks ago were flat compared with the same period last year and down 20 percent last week. They anticipate further declines of 30 percent or more this week. These numbers track with what apparel retailers elsewhere in the world have experienced. Retailers with a heavier concentration of in-store sales (such as fast-fashion retailers and midtier department stores) face even greater pressure to drive consumers online and rapidly scale e-commerce operations. Furthermore, the fulfillment of online orders risks disruption,

whether through reduced staffing because of illness, physical distancing, site cleaning, or even distribution-center closures under state decree.

- *Promotion is a potential 'needle mover,' but it is nearing its limits.* Unsurprisingly, retailers are heavily discounting spring and summer 2020 inventory. The specialty-apparel and department-store channels have already reached peak promotional frequency online, so it will be difficult for brands to break through with clear, differentiated offers that stand out to consumers. Messages about flash sales, savings of 50 percent off, and buy-one-get-one deals will be lost among a sea of similar emails and digital ads, which can drive conversion but will become unmanageably expensive for retailers,

given the surge in online traffic. In such an environment, brands must continually evaluate the effectiveness of different promotional offers, as there is risk of giving away margin, resetting customers' value expectations, and adversely affecting brand perception.

- **Consumer spending will continue to decline and may take time to recover.** Sales data from Amazon show that growth in apparel sales fell by an average of 40 percentage points between mid-February and mid-March (Exhibit 2). “Indoor” fashion categories, such as pajamas and activewear, fared a little better—but they are highly fragmented and lower margin, with limited differentiation across brands. In a March 20–22 survey of US consumers, 63 percent of respondents said that they expect to spend less on apparel than they usually do. If the shape of the recovery in

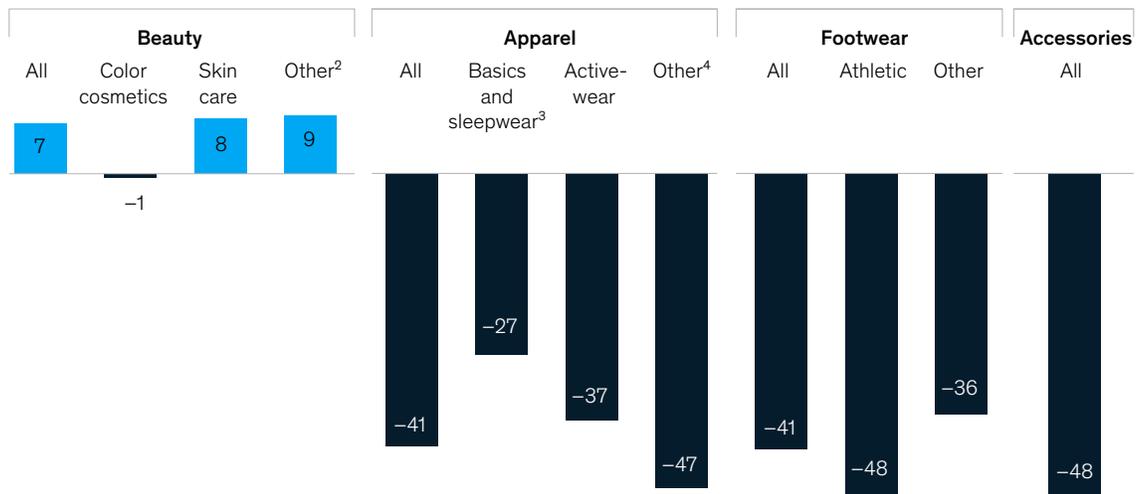
North America mirrors that of China, it could be midsummer before spending and shopping behaviors begin to return to “normal.”

The apparel industry has repeatedly proven its ability to reinvent itself and adjust to where, what, and how consumers buy. We believe in the North American fashion sector’s long-term potential. That said, sector averages cannot predict the destiny of an individual company. In the remainder of this article, we recommend actions for apparel and fashion companies to take. Some of these actions will mitigate risks across the industry, particularly for those retailers and brands that entered this crisis with lower levels of cash on hand. Other actions will help leaders pull further ahead. A company’s ability to execute both types of actions, in a bold and timely manner, will determine whether it will emerge stronger from the crisis.

Exhibit 2

Sales data from Amazon reflect changes in buying behavior, with slower declines in ‘indoor’ categories focused on comfort and self-care.

Change in year-over-year sales growth, percentage-point change between Feb 15 and Mar 14¹



¹ Change between 4 weeks ending Feb 15, 2020, and 4 weeks ending Mar 14, 2020.

² Includes soap, other body-care products, and hair-care products.

³ Includes lingerie.

⁴ Includes tops, bottoms, outerwear, dresses, suits, swim wear, and bridal wear.

Source: Stackline

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Navigate the now: Immediate priorities

While CEOs should stay abreast of how the situation evolves, there is a clear set of actions—ideally, coordinated by a COVID-19 nerve center¹—that companies should implement now, without hesitation.

Lead with compassion and protect your people

Communicate frequently and clearly with employees. Set expectations about the new working norms, safety precautions being taken, and cadence of communication; build morale by creating informal opportunities for connectivity and by being open about challenges (including personal ones); and, when possible, make empathetic offers of assistance or time off to support employees' well-being. The health and safety of employees—at headquarters and in the field—is the absolute priority, requiring solutions that can be technological (such as remote working) or practical (such as staggered shifts). Protecting customers, another top priority, involves introducing new processes and policies, such as strict hygiene practices in stores and new safety procedures for handling and delivering online orders.

Manage for cash

Set up a “cash control tower,” with representation from both the procurement and sales teams, to examine spend and identify potential reductions in cash outflow. Work closely with authorities to find ways to alleviate cash strains via public measures, potentially on a state-by-state basis.

Review your in-year inventory position and assess the supply chain

Quickly review your full-year 2020 buys, category by category, making decisions based on “fashionability” (basics or evergreen products versus on-trend products), depth of buy, and confidence in style. Beginning with the spring and summer inventories, determine which products could be delayed for late summer and fall or 2021, even if in an outlet channel. Some products might also be sold in flash sales during the holiday period, depending on availability of storage space. Clear all other spring and summer products as quickly as possible to improve cash position (Exhibit 3). Managers will need to adjust buy quantities for the fall and holiday seasons, accounting for first-half carry-over and any expected category shifts.

As your company and other retailers reset inventory positions, you should be cognizant of the knock-on effects on brands and upstream manufacturers that are already under pressure because of decreasing unit volume in some channels and categories. Be transparent in your communications about payment terms. Support your long-term partners by consolidating volume and engaging in joint planning.

Amplify digital

Accelerate investments to enhance your digital presence and shift media spending to the online channel. These efforts should primarily apply to your own websites but may also pertain to partnerships

¹ Mihir Mysore and Ophelia Usher, “Responding to coronavirus: The minimum viable nerve center,” March 2020, McKinsey.com.

with e-retailers or with wholesale partners that have stronger e-commerce businesses. Revisit the logic of your marketing investment: shift from brand building to customer activation, focusing on conversion, basket building, and repurchase triggers. Digital marketing will play a fundamental role in not only maintaining engagement and boosting online sales, but also enticing customers to visit stores in those geographic markets when stores reopen.

Maintain connections with consumers

Just as consumers continue to seek connections with one another during this crisis, apparel and fashion companies must continue to engage consumers as well, even if those consumers are not spending. This must happen in a way that is authentic to the brand and resonates with its consumer base. For some companies, that may mean communicating to consumers why it is

still safe to shop online and how the company is ensuring that warehouse workers stay healthy. For others, it may mean sparking candid conversations about how something as seemingly frivolous as a new pair of shoes or a new tube of lipstick can bring comfort and joy in a time of chaos. This is a time to use your brand voice to speak to consumers and forge community around your brand.

Plan the comeback: Medium-term actions for 2020

Beyond the immediate “must-dos,” certain actions can help companies minimize the downside and maximize opportunities in the latter half of the year. The following steps apply to most enterprises, with variance dictated largely by the size of the store network.

Exhibit 3

By reassessing inventory and segmenting stock in each category, a retailer can maximize gross margin and free up working capital.

Illustrative spring 2020 inventory segmentation



Prepare to reopen stores and drive traffic

Make thoughtful, store-by-store decisions as you reopen the store network, not only to safeguard the health and trust of employees and consumers, but also because most enterprises will be operationally constrained. You might decide that certain stores should reopen in a very different capacity—for example, serving a more value-oriented consumer segment and helping to clear excess product—or shouldn't reopen at all.

We expect that most retailers will pursue a region-by-region approach to reopening stores: a gradual ramp up in staff (particularly if rehiring is necessary after an extended closure), digital engagement with loyal customers to invite them back to stores, testing of localized promotions, and compliance with local requirements (with regard to cleaning practices and store density, for example). Consumer behavior and preferences may have changed during the crisis, so forward-thinking retailers will reopen with a new operating model centered around customer engagement and styling (for example, floor-space resets to facilitate seamless in-store pickup of online orders, and scannable products that connect shoppers to online product reviews).

Reassess merchandising plans for fall 2020 and spring 2021

Weeks of shutdowns will almost certainly alter the shape of the recovery for the apparel industry. We expect continued telecommuting, reduced travel, and cancellation or postponement of special events (such as weddings and music festivals). We also expect upstream impact, with significant changes in sourcing and production. Garment manufacturers in Bangladesh, for instance, have already seen \$1.5 billion in canceled orders from Europe and North America.

Brands should monitor sales data and exchange insights with their vendors and suppliers, then review their merchandising plans for the fall and holiday 2020 and spring 2021 seasons. Consumers have been trying new brands and new categories during

this crisis, so—for brands and retailers with resources to invest and the willingness to take risks—there could be opportunity to acquire new consumers.

Connect with brand loyalists

Look to your most loyal consumers first to jump-start growth. It's not uncommon for 10 percent of a brand's consumer base to drive 60 percent of its sales, making activating these VIPs a must-do. These consumers will likely be inundated with other brands' offers, so you will need to set the bar high to stand out; personalization will be the best way to do that. Tailored promotions, early access to new-product drops or limited editions, and invitations to VIP-only experiences can be effective levers. At the same time, many consumers might be in a different financial position than they were before the crisis. Detailed consumer segmentation and personalized promotions (not just discounts, but offers that deliver meaningful value) will be crucial for retaining your loyalists.

Shape the 'next normal': Longer-term strategic actions

CEOs should look beyond epidemiology and sales data to formulate a view on how the COVID-19 pandemic will reshape their ecosystems and how their companies might capture new opportunities. The following longer-term actions deserve management consideration.

Map a strategic journey to financial resilience

Crises can create new avenues for growth. Companies will have entered the crisis from various positions of strength, so go-forward opportunities will be, to some extent, bound by starting positions. But all companies would do well to take a hard look at the portfolio: Are you playing in the most attractive spaces and channels? Are you set up to execute effectively to capture demand? Is there an opportunity to consolidate or acquire brands, assets, or capabilities at attractive multiples that would allow you to better serve your core customer? There will be important choices about what brands, partnerships,

and organizational changes to pursue—but also about what *not* to pursue. The crisis is poised to precipitate a massive shakeout, and the players that ask and answer the tough questions will be better positioned to revive their business.

Build your operating model around digital and become truly omnichannel

While, in the short term, a demand shock has driven a decline in online conversion and sales, we believe that in the longer run there could be permanent shifts in consumer shopping behavior that push more traffic and categories online. For example, in China, new customer segments and markets have gravitated toward e-commerce; the same could happen in North America. Retailers could see a broader adoption of e-commerce among previously underpenetrated categories (such as lingerie) and consumer segments (such as baby boomers and even Generation Zers who, according to recent McKinsey research, are more likely than millennials to go to malls).²

Take this opportunity to leapfrog into the digital arena by making it the center of your operating model. Start by revising channel-mix targets and investment allocation to give a greater share to online channels. Accelerate personalization in digital marketing so that you can deliver the same quality of interactions online that consumers are accustomed to in stores. Explore new ways of partnering with e-retailers to gain growth momentum through their channels while protecting your brand equity.

Anticipate shifts in consumer sentiment and behavior

While no one can predict what the next normal will be like, we expect a strong desire on the part of

consumers to resume their precrisis habits once conditions allow. Some themes that have begun to surface in our consumer research and in discussions with CEOs include the following:

- *All casual, all the time.* Many people will return to a fundamentally different work environment—one in which telecommuting, flexible hours, and an emphasis on work–life balance are new norms. Comfort could become a top consideration in apparel purchases. The trend toward “casualization,” which was already strong prior to the crisis, could further accelerate.
- *A focus on flexible supply chains, centered on ‘made in America.’* Many apparel and fashion companies will look to onshoring or nearshoring, as they begin to value a flexible supply chain over a low-cost one.
- *An evolution in clean beauty.* There could be a shift in what “clean” means in beauty and personal-care products, as consumers increasingly emphasize product safety and quality over organic or all-natural ingredients.

It will be critical to keep a close eye on how your consumer base is changing and determine what that means for your brand.

There’s no denying that the COVID-19 pandemic will make for a difficult 2020. For some companies, even survival will be a struggle. If, however, apparel and fashion companies lead with compassion and undertake bold actions, they can position themselves not only to weather the crisis but to emerge from it even stronger.

² Shruti Bhargava, Bo Finneman, Jennifer Schmidt, and Emma Spagnuolo, “The young and the restless: Generation Z in America,” March 2020, McKinsey.com.

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The authors wish to thank Antonio Achille, Ellie Baker, Achim Berg, Antonio Gonzalo, Aimee Kim, Karl-Hendrik Magnus, Susan Nolen Foushee, Tom Skiles, Emma Spagnuolo, Hannah Yankelevich, and Daniel Zipser for their contributions to this article.