Growth trends in retail consumer financing for 2017

Innovations in consumer financing and multi-lender platform technology are creating an emerging growth opportunity in the retail industry

Written by:
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Retailers have long worked with consumer financing providers to extend credit to their customers. However, when the industry is examined by retail sector, it is clear that primary lending incumbents serve some parts of today's retail market more effectively than others. Although some variability is to be expected, when combined with generally low credit approval rates, the outcome is that many retailers miss out on the benefits that a more robust credit program can bring in terms of increased sales, loyalty and improved customer experience.

Recent innovations in consumer financing have created an opportunity to extend credit to a wider range of customers. Seeing an opportunity, some forward-thinking retailers have moved quickly to expand financing beyond primary lenders with second look programs and other non-traditional solutions. This approach has been gaining in popularity as the retail industry looks for revenue and market share that might otherwise be missed or captured by rivals.

Early adopters looking to expand their credit availability were initially forced to identify and develop relationships with lenders, facing challenges of adapting their systems to handle multiple providers. Now, with rapid improvements in technology, retailers contemplating a similar program have the option of using a multi-lender platform, which enables retailers to offer multiple credit products without increasing their administrative burden or risking a clunky or poor purchasing experience.

A new paradigm appears to be emerging. Streamlined access to a wider range of lenders means retailers of all sizes are now empowered to serve a wider range of customers with credit products that better suit their needs. Early movers will stand the best chance of capturing market share, greater revenue, and increased customer loyalty.
Report note

This report focuses on the following retail sectors: Multi-line (department stores, discounters, warehouse), Big Ticket (furniture, electronics, home improvement, jewelry) and Specialty (big-box, internet). Other sectors where financing is less prevalent, such as convenience stores and apparel, are excluded from the data.

Key facts

- Most retailers work with a small group of large banks that collectively dominate retail consumer financing.
- Consumers spending in big-ticket and high-velocity retail verticals, such as home furnishings and electronics, totals $1.8 trillion annually. However, today less than 15 percent of these sales are financed ($226B).
- Across all in-focus sectors almost half of primary credit applications for credit are declined.
- Alternative financing products have created an opportunity to extend the availability of credit to a wider range of customers. Large retailers have been among the first to take notice.
- Given that many of the alternative lenders are small and less established, there are some inherit challenges.
- Multi-lender platform technology is making it easier to extend credit across sales channels and deliver an optimal customer experience.
Retailing and credit have a long history

Offering customers the facility to buy on account or in installments has oiled the wheels of retailing for decades. Since the 1950s, much of the growth in retail has been fueled by the increased access consumers have to credit. And in recent years, retail credit has grown in sophistication as retailers have partnered with banks and other consumer financing providers to offer a broader range of products.

Today’s customers are well accustomed to accessing credit through a retailer and the range of credit products offered in-store or online has developed in response to a range of demands: convenience, flexibility, increased spending power and brand loyalty. These programs vary from co-branded credit cards that can be accepted anywhere, such as the Amazon Chase Card, to private label cards that can be used only at the providing retailer, such as the Home Depot, Home Improvement Card (see Figure 1).

The use of credit varies among retail sectors, but for the industry as a whole it is accepted that credit is a vital enabler of growth in a competitive market.

**Retail Financing Industry Structure**

<table>
<thead>
<tr>
<th>Co-Brand Card</th>
<th>Private Label (PLCC)</th>
<th>Core Sales Finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Card issued in partnership with a retailer (or other brand)</td>
<td>▪ Card that can only be used at a specific retailer</td>
<td>▪ Product can only be used at specific retailer</td>
</tr>
<tr>
<td>▪ Can be used both at the specific retailer and anywhere the network is accepted (inside and outside the store)</td>
<td>▪ Primarily used to promote rewards/loyalty for the retail partner</td>
<td>▪ Offered to customers as a means to finance a transaction</td>
</tr>
<tr>
<td>▪ Primarily used to promote rewards/loyalty for the retail partner</td>
<td>▪ Can be a significant driver of in-store sales</td>
<td>▪ Mainly used by big-ticket retail sectors such as jewelry, furniture, motorsports, etc.</td>
</tr>
<tr>
<td>▪ Can have promotional financing offers</td>
<td>▪ Sometimes used as a “down-sell” product if applicant doesn’t qualify for co-brand</td>
<td>▪ Limited rewards (if any) on the card, mainly promo financing</td>
</tr>
</tbody>
</table>

![Amazon Chase Credit Card](image1)

![Home Depot, Home Improvement Card](image2)

![Rooms To Go Card](image3)

**Figure 1**
There are 7 primary consumer finance providers that partner with retailers and these firms command the majority of market share (see Figure 2). Primary lenders have become more sophisticated in recent years, with enhanced consumer data analysis and full life-cycle support, continuing to add value to retailers.

*Ranking of Retail Financing Purchase Volume by Issuer*

*(Includes in-store purchase volume on co-brand, PLCC and sales finance programs for big and small-ticket sales)*

![Figure 2](image-url)
A snapshot of today’s retail market

Many segments of the retail market are highly consolidated. It might appear that the top 5 merchants are squeezing out midsized retailers with revenues below $1 billion. However, a closer look at how sales are divided between different sectors of the retail industry tells a different story (see Figure 3).

**Market Segmentation Estimates by Retailer Size**

<table>
<thead>
<tr>
<th>Industry Sales US ($B)</th>
<th>Multi-Line</th>
<th>Big Ticket</th>
<th>Specialty Big-Box</th>
<th>Internet Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mid-size &amp; Small Retailers (≤$B in sales)</td>
<td>5%</td>
<td>17%</td>
<td>41%</td>
<td>70%</td>
</tr>
<tr>
<td>Large Retailers ($B+)</td>
<td>78%</td>
<td>20%</td>
<td>51%</td>
<td>4%</td>
</tr>
<tr>
<td>Top 5 Merchants</td>
<td>38%</td>
<td>46%</td>
<td>4%</td>
<td>26%</td>
</tr>
</tbody>
</table>

1 Includes discounter and general merchandise retailers (i.e. Walmart and Target).
2 Based on Top 500 catalog and web only merchants.
3 Large retailers excluding top 5.


**Figure 3**

The multi-line sector, which is made up of department stores, discounters and warehouse clubs, is dominated by just a few large players. Beyond these large store formats, midsized and small retailers are notably stronger and together account for a larger share of big ticket and internet retail sectors. Nevertheless, the dominance of the biggest players – both credit providers and retailers – had tended to focus the availability of credit toward the end of the market that offers the greatest scale.
Although there is virtually no part of retail where financing does not have some impact, when the industry is viewed as a whole, the vast majority of retail sales are exposed to a credit program. Retail sales within the high velocity, big-ticket sector make up $1.8 trillion in sales, and $1.3 trillion of that are exposed to credit programs. Despite this, an estimated 11 percent of sales are financed by credit within in-focus sectors. (see Figure 4).

**Est. Retail Market by Total & Financing Sales**

($B)

Total Retail Sales: $2,936
Total In-Scope Retail Sales: $1,802
No Credit Program: $449
Sales Exposed to Credit Programs: $1,353
Financing Volume: $226
Big-Ticket Financing Volume: $80

Source: First Annapolis Consulting 2016 benchmarks and analysis.
A closer look at the numbers reveals an inconsistent picture (see Figure 5). Levels of penetration and sophistication vary, but in most sectors financing accounts for less than a quarter of total sales. For certain types of purchase, such as jewelry and furniture, financing can account for the majority of sales. While some sectors are clearly more successful in making credit available to their customers, there is significant room for growth even within the existing confines of the consumer financing market.

Typical Ranges of Retail Financing Sales Penetration as a % of Total Sales
(Ranges represent multiple program benchmarks per sector, data is percentage of sales on all branded cards)

Source: Retailer public filings, First Annapolis Consulting research and analysis.

Figure 5
Where the opportunity lies

Across the retail industry, 47 percent of primary credit applications are declined (see Figure 6). The consequence of this is that at retailers that only partner with a single primary lender, almost half of consumers have to use another form of payment to complete their purchase. As one can imagine, this may have a negative impact on brand perception and loyalty.

**Figure 6**

The data on primary credit application approvals aligns with the average FICO distributions of the US population, where 56 percent of consumers have what is considered a prime FICO score, scores ranging from 700 – 850 (see Figure 7).

**FICO Score Distribution In the US**

(April 2016)

Similar to credit utilization, there are wide variances in approvals across retail sectors and by sales channel - i.e. in-store vs. online. On the lower end, with only 40 percent declined for financing in department stores and on the upper end with 70 percent declined at internet retailers (see Figure 8).

Here lies the opportunity. If credit can become more available to consumers while shopping, there is great potential to increase both the overall penetration of credit programs as well as increase approval rates across the board.

*Note: Numbers may not add up perfectly due to rounding.
Source: First Annapolis Consulting benchmarks and analysis.

**Figure 8**
Why is this the case?

The primary consumer finance providers (Figure 2) operate lending models where investors favor high predictability and low loss rates. Their approach has been shaped in the context of a regulatory environment that dissuades primary lenders’ from having a high proportion of receivables linked to subprime borrowers.

Avoidance of volatility has created a market of lenders with similar risk models, offering retailers little in the way of options to match credit products with the mix of customers who visit their stores. With the majority of retailers that offer financing with a single lender, the scope for serving a broader mix of consumers has been limited.

The effect described above is evident in a scaling back of credit and loans made by all primary lenders to consumers with FICO scores of less than 660 from 2014 to 2016. Approval rates are higher among customers of the largest retailers, but overall the low level of credit approvals is a drag across the whole retail industry.

Secondary lenders and their investors have much more variation in their lending models. With a higher appetite for risk and volatility, the range of credit products available from this part of the market is substantially broader and suitable for many more profiles of consumer borrowers. Higher loss rates (see Figure 9) are countered by higher discount rates that make it possible for credit to be extended to the subprime market.
What can be done?

Innovation is on the rise within the secondary consumer financing market. Specialist lenders are offering credit and loans to those with lower FICO scores, addressing the void left by primary lenders and providing retailers with an opportunity to offer credit to a wider range of customers.

The greater volatility of the secondary financing market might have been a concern to retailers in the past, but technology has enabled them to handle multiple lenders which means that two, three or more providers can be added for second-look applications beyond the primary lender. This means that should one of them tighten its lending criteria or exit the market, the retailer is still in a position to explore credit options with a customer without affecting the purchasing experience.

This approach is being systematized through the development of multi-lender platforms. These offer retailers a route into multi-lender financing that has a lower barrier to entry, while ensuring that customers receive a seamless and standardized experience, regardless of their credit profile (see Figure 10).

<table>
<thead>
<tr>
<th>Primary</th>
<th>LENDERS</th>
<th>Tertiary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Typically approves customers with excellent &amp; very good credit.</td>
<td>Typically approves customers with good &amp; fair credit.</td>
<td>Typically approves customers with poor, limited, or no credit history.</td>
</tr>
</tbody>
</table>

**Figure 10**

Source: Vyze Analysis 2016

Growth trends in retail consumer financing for 2017
Large retailers have seen results

Consumer confidence and the difficulty or ease of borrowing money are two key factors that determine the size of the retail market. Spending increases as confidence increases, as it has recently, and when borrowing is easier. The availability of credit tends to result in larger ticket sizes. Data from PayPal shows that online sales that used credit showed a 15 percent increase in average order size.

Many large retailers have sought to benefit from this significant growth in spending by adding secondary lenders to their credit strategy. These firms report not only increases in sales, but also the advantages to their competitive position and ability to win market share (see Figure 11). This potent combination of increased sales, expanded share, and enhanced opportunities to differentiate is raising interest in working with secondary lenders throughout the retail industry.

“The impact on sales has been extremely positive. We are approving customers that we wouldn’t have otherwise been able to get.”

Group Manager, National Furniture Retailer

“Associates complete just one application for all our financing offers, more customers are approved, and most of all, we say “no” less often.”

EVP, National Appliances Retailer

“For our private label credit card, the approval rates for our pro customers are 71.2% - that’s actually higher than the approval rates for our consumer customers, because we’re coming back with a second look.”

CFO, National Hardware Retailer


Figure 11
Ahead of the curve

In the highly competitive retail industry, opportunities to win sales or share are soon seized upon. The shift toward alternative financing is causing an increasing number of retailers to re-evaluate their credit programs.

There are some key implications that retailers wishing to increase the number of credit providers must consider:

1. The cost of implementation
   
   I. Point of sale systems will generally require a significant level of adaptation to support a multi-lender model. In most cases, those wishing to extend credit programs will have to invest in IT consultancy, new systems or both. In addition to requiring dedicated IT services, there will be costs to train and re-train sales associates with each new lender added.
   
   II. For online shopping carts, there is similar technical work that needs to be done in addition to adapting other areas of the website to promote credit offers.

2. The customer experience
   
   I. Using legacy systems, should a first application for finance be declined the process must be entirely repeated for a second lender. The prospect of a clunky customer experience, with the risk that a customer could be declined twice, has caused many retailers to be cautious about secondary lending.
   
   II. Even where the value of making a secondary offer is compelling, retailers have been concerned about the time needed to fill out a second application. This can result in a delay, extra effort and abandonment of sale not only for the customer applying for financing, but also for other customers waiting at an in-store checkout.

3. Internal processes
   
   I. Changes to IT systems and variations in the details sought by lenders for finance applications result in a need for additional training for shop floor staff.
   
   II. Working with multiple lenders creates additional work for the back office. Loan processing, settlements and management reporting are all increased with each additional lender.

4. Security
   
   Multiple credit applications have an impact on data security, with the potential for a broader range of customer data that must be securely stored and managed.
Technology innovators offer some relief

These barriers to change had, until recently, served to keep secondary financing to the margins of the retail industry. However, the development of technology platforms that manage multiple applications following a single input of customer details are helping to resolve many of the challenges that have dissuaded retailers in the past.

The best solutions on the market fully take over the management of relationships with credit providers, allowing retailers to offer their customers a single application process that presents the best option from a range of lenders. This process can be seamless for both the customer and the retailer, with no duplication of effort or additional administrative burden. It can also be achieved through a cloud-based service that minimizes the time and cost of IT adaptation or renewal, as well as staff training.
Conclusion

Retailers understand the role of consumer financing in winning sales and increasing ticket sizes. However, the difficulty of working with multiple providers, and conservative lending practices of primary providers, has prevented many sectors of the industry from taking full advantage of the potential opportunity.

Some large retailers, with the security of scale in their customer base and internal resources, have been first to benefit from leveraging technology to expand alternative financing options. This advantage is now being challenged as multi-lender technology platforms enable any retailer to offer multiple sources of lending to their customers. Implementing technology that removes concerns about an impaired customer experience has injected a new level of flexibility into the market that makes it easier to match credit with customer needs and circumstances.

As the retail industry adapts the opportunities of a wider range of financing sources and easier access to them, a variety of approaches can be expected. Large retailers that haven’t yet innovated will seek to meet or exceed the competitive position of their rivals. Midsize and small retailers may find they have an agility advantage over large rivals as they can more rapidly shift to a new wave of easier to implement and cost effective cloud-based solutions.

While most will see the potential to expand their customer base by securing more credit approvals, some will seek to differentiate by raising the quality of their customer experience or expanding their brand to different areas of the market. What is clear is that consumer financing is only likely to become more important and prevalent in an increasingly competitive and sophisticated retail market in years to come.

About First Annapolis

First Annapolis advises credit and debit card issuers, transaction processors, payment networks, retailers, and other industry stakeholders in payment-based sectors of the financial services industry.

www.firstannapolis.com

About Vyze

Vyze is a leading cloud-based financial technology company for retail. By combining technology, a comprehensive lending supply, and support under one roof, Vyze is able to deliver businesses more satisfying financing experiences for their customers, wherever and whenever they shop.

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