UST

Striking a balance between returns avoidance and efficiency

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Managing retail returns is an overlooked problem, written off as a necessary evil to retain customers. Poorly managed returns have a significant impact not only on an organization's financial performance but also on the global environment. Done right, it can transform the way consumers experience your brand.

Executive summary

Online shopping is leading to increased volumes of returns to the seller. The growth of eCommerce and lenient return policies have significantly increased the volume of returns retailers are receiving today.

Retailers must take an aggressive approach to understand and manage the specific factors that influence returns, such as:

- **Avoidance** – design the shopping experience to help the consumer make the right decision the first time
- **Efficiency** – consider the reverse supply chain when making product design, distribution, and return decisions
- **Ownership** – consolidate ownership for managing returns to align goals
- **Technology** – adopt innovative technologies to improve the shopping experience and streamline returns processing

Background and overview

Merchandise returns in retail, while unavoidable, can be an untapped opportunity for retailers to improve margins while retaining a loyal customer base. UST's research looks at the 'efficient frontier' that addresses the trade-off between returns avoidance and the expected volume of returns. UST has also developed a framework to minimize returns and optimize the returns operation.

While investment in returns avoidance technologies (e.g., sizing guides, color tools, virtual dressing rooms) is becoming more commonplace, many retailers are not achieving optimal benefits. Based on UST's research, the keys to success are:

1. Understanding a retailer's proficiency in applying returns avoidance tools
2. Understanding the relationship between avoidance practices and returns policies
3. Leveraging best practices and digital technologies for optimizing the returns process

We suggest that retailers can substantially improve returns performance by replacing one-size-fits-all return policies with purpose-built processes. UST's position is that the rate of returns and corresponding challenges will increase manifold and planning for returns will become a fiscal need and an environmental responsibility.

New buyer behaviors

Consumer behavior has changed dramatically over the past few years. For example, a consumer shopping for shoes would traditionally visit the retail store, try several styles or sizes and purchase one pair. Today, the shopper is equally likely to buy several styles and sizes online and return all but one. Online shopping is leading to increased volumes of returns to the seller. The growth of eCommerce (or the online channel) and lenient return policies have significantly increased the volume of returns retailers receive today.

According to the National Retail Federation (NRF), US consumers returned $761 billion of merchandise in 2021[1]. This represents 16.6% of all retail sales, an increase of almost 78% from the previous year[2]. The cost of holiday returns itself amounted to $158 billion in 2021. Automotive parts and apparel had the highest return rates by category at 19.4% and 12.2%. Fraudulent returns are especially problematic as they constitute 10.3% of the overall returns and are rising at a much higher rate.

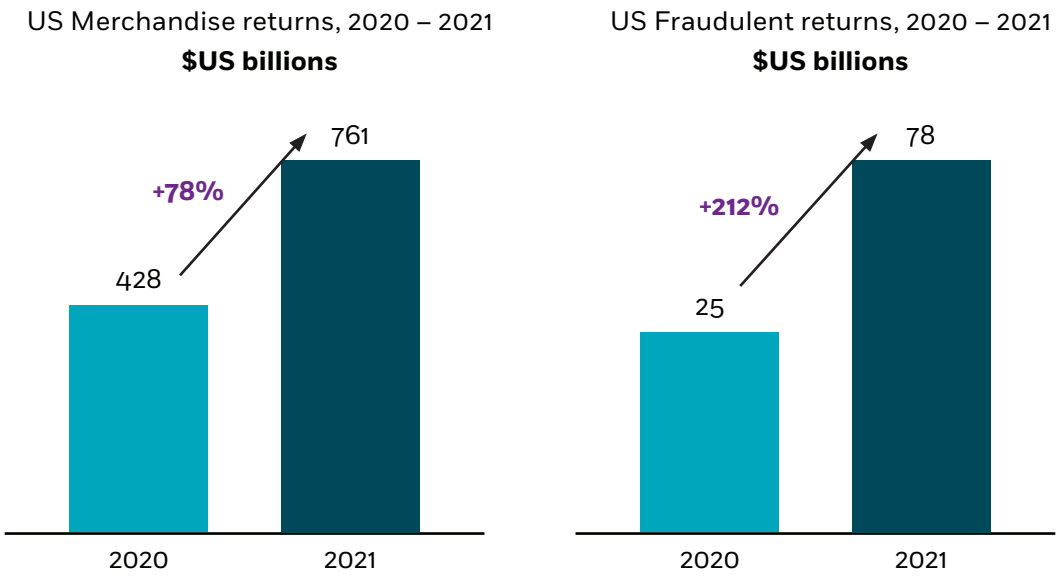


Figure 1

While there are multiple reasons for the high rate of returns, they can be broadly classified into three key categories:

1. Mismatch to the customer needs
2. Issues during ordering or delivery
3. Fraud.

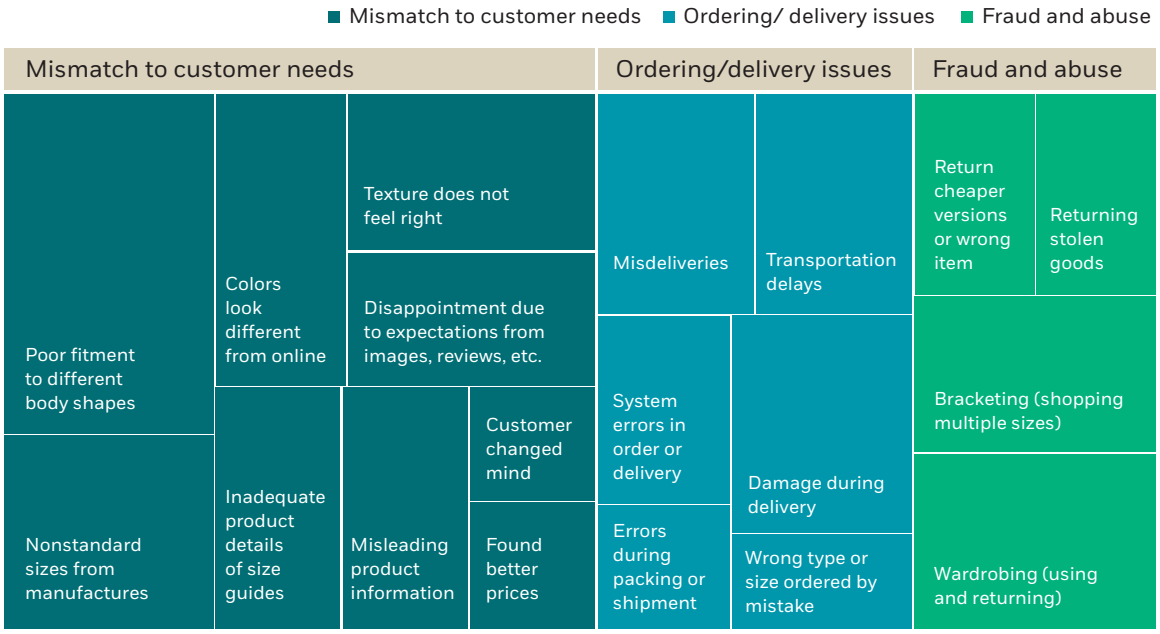
The next figure shows some of the top reasons within these broad categories

In the subsequent sections, we have detailed our playbook for returns avoidance and optimization based on understanding customer behavior and the critical reasons for returns.

[1] https://nrf.com/media-center/press-releases/retail-returns-increased-761-billion-2021-result-overall-sales- growth

[2] https://nrf.com/media-center/press-releases/428-billion-merchandise-returned-2020

Key reasons for online returns



Source: UST Research

Not to scale

Figure 2

Managing returns is a complex process and is still largely ignored. Many retailers look at returns as a necessary evil, as a lenient returns policy is known to lead to increased sales. According to McKinsey & Co., returns are not among the top five priorities for one-third of retailers surveyed[3]. One-quarter of the retailers in the survey also admit that they do not manage returns effectively or efficiently.

Today, however, returns are recognized as a growing problem that retailers must address. While high return rates can significantly impact a retailer's cost and margins, retailers overlook its impact on top-line revenue. Returned merchandise often sits in a complex reverse supply chain with long lag times, resulting in damage, shrinkage, and significant markdowns. The overall environmental impact of returns is also substantial as approximately 5.8 billion pounds of returns ended in landfill, and the transportation of returns released 16 million metric tons of CO_2 of returns in 2020[4] (the average automobile releases seven tons per year)

UST has developed a model (Figure 3) to assess the impact of increased or decreased returns and fraud on a retailer's cost of goods sold, gross profit, and sustainability measures like CO_2 emissions. The scenarios illustrate that even small changes in returns significantly impact financial performance. It can be expected that the increase in online sales and changes in customer behavior will lead to other returns and pressure on retailers from stakeholders to improve their returns processes.

[3] https://www.mckinsey.com/industries/retail/our-insights/returning-to-order-improving-returns- management-for-apparel-companies

[4] https://info.optoro.com/hubfs/The%20Optoro%202020%20Impact%20Report.pdf

Impact of returns on a mid-sized retailer

A Mid Size Retailer • $20 B revenue • 16% returns • 10% fraud (of overall returns)	Cost of Goods Sold • $14 B (70% of Revenue)	Gross Profit • $6 B (30% of Revenue)	Sustainability • 0.12MM metric tonnes CO_2 emitted • 13.6 million lbs end in landfill
Scenario 1 ↑ returns increased to 19%and fraudulent returns to 11%	↑ **3%** increase in COGS	↓ **8%** decrease in gross profit	↑ **18%** increase in CO2 emission and landfill
Scenario 2 ↑ returns increased to 22% and fraudulent returns to 12%	↑ **6%** increase in COGS	↓ **14%** decrease in gross profit	↑ **38%** increase in CO2 emission and landfill
Scenario 3 ↓ returns decreased to 13% and fraudulent returns to 9%	↓ **2%** decrease in COGS	↑ **4%** increase in gross profit	↓ **18%** decrease in CO2 emission and landfill

Source: UST's internal research

Figure 3

Simplifying returns process complexity

UST's retail clients confirm that the explosion in return volumes is inevitable. Based on our research, returns are a must to keep customers happy. Therefore, we suggest retailers implement tools, policies, and practices to limit returns first and foremost. And, when returns occur, adopt robust reverse logistics processes to handle these returns in a manner that controls costs, dispositions products faster, and improves customer loyalty.

UST recently surveyed 30 leading global retailers concerning returns management, allowing us to develop a database of retail returns policies across apparel and electronics retailers to understand returns practices, processes, and costs. Based on this research, we have created a set of frameworks to guide retailers in limiting returns and understanding the best practices for managing returns when they happen. We believe these frameworks will make the overall process more efficient and effective.

Our research also found that most retailers have a limited understanding of the upcoming returns volume and are doing their best to build a forecast "just to get close". Leading retailers are planning an approximate 10-25% increase in returns[5]. It is clear, however, that the retailers are attempting to provide fair and reasonable policies to "take care" of their customers and drive customer loyalty simultaneously.

[5] Latest annual reports from leading retailers like Nordstrom and Macy's

The returns 'efficient frontier'

UST's position is that there is an 'efficient frontier' (Figure 4) representing the amount invested in returns avoidance (e.g., sizing guides, color tools, virtual dressing rooms) and the expected returns volume. Given that investment, we have observed two challenges: 1) Many retailers are not evaluating their return avoidance investments versus the volume of returns expected, and 2) They are operating behind the efficiency curve and are taking in more returns than planned (Figure 5). We also suggest that retailers operate along multiple curves (Figure 6), depending on specific merchandise characteristics and market conditions.

We believe that it is vital to understand the curves specific to the retailers' customers and their product portfolios. Specifically, retailers must analyze:

- How likely consumers are to use advanced returns avoidance tools
- How effective the tools drive expected returns performance. We are suggesting that most retailers can adjust their returns avoidance and operations to create their own specific 'efficient frontier'

The 'efficient frontier' for retail returns

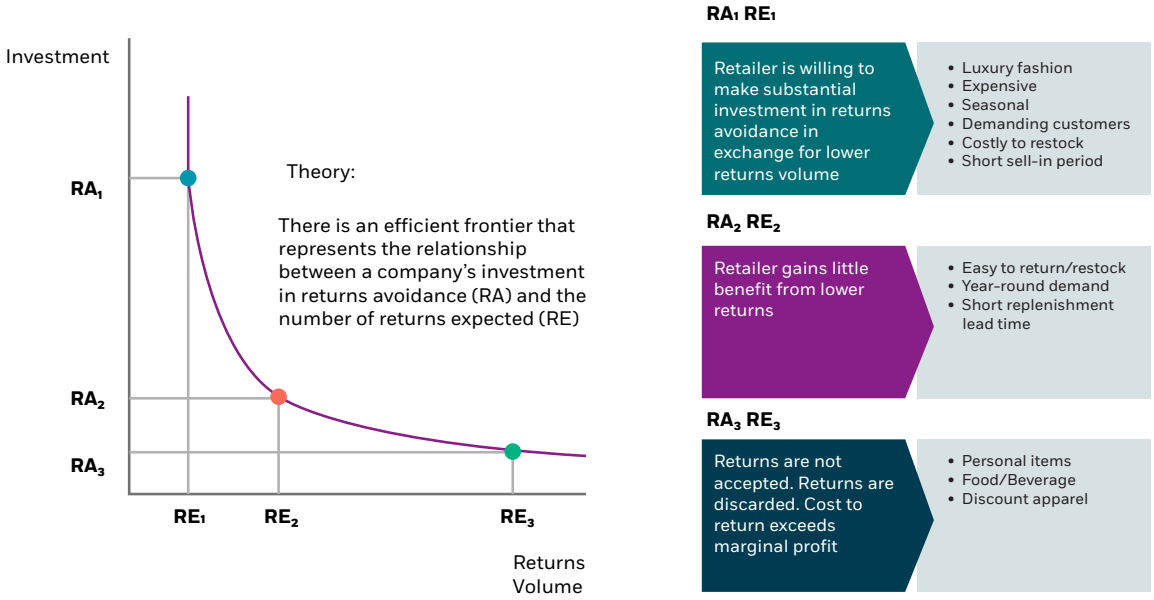


Figure 4

Retailers are operating behind the curve

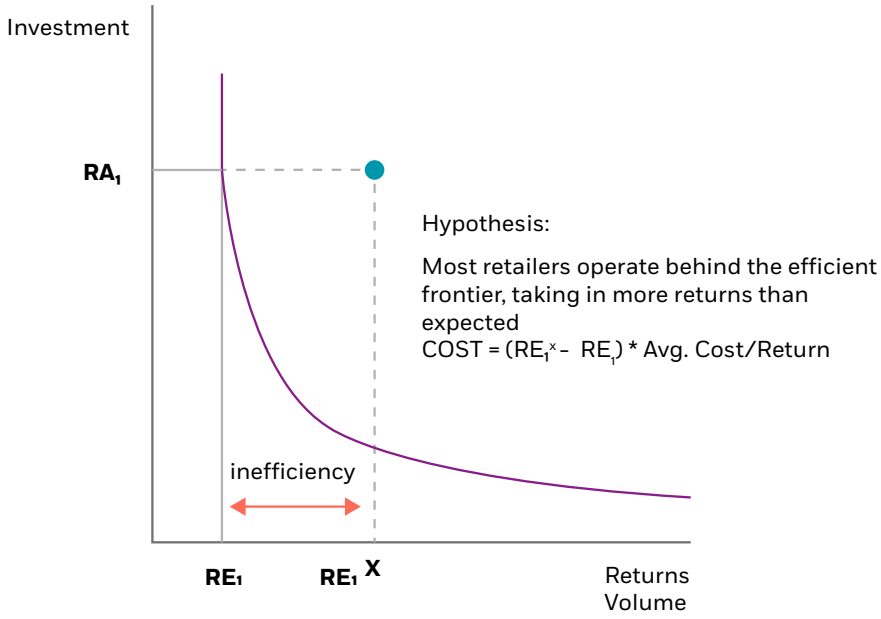


Figure 5

Multiple curves are required based on merchandise and market

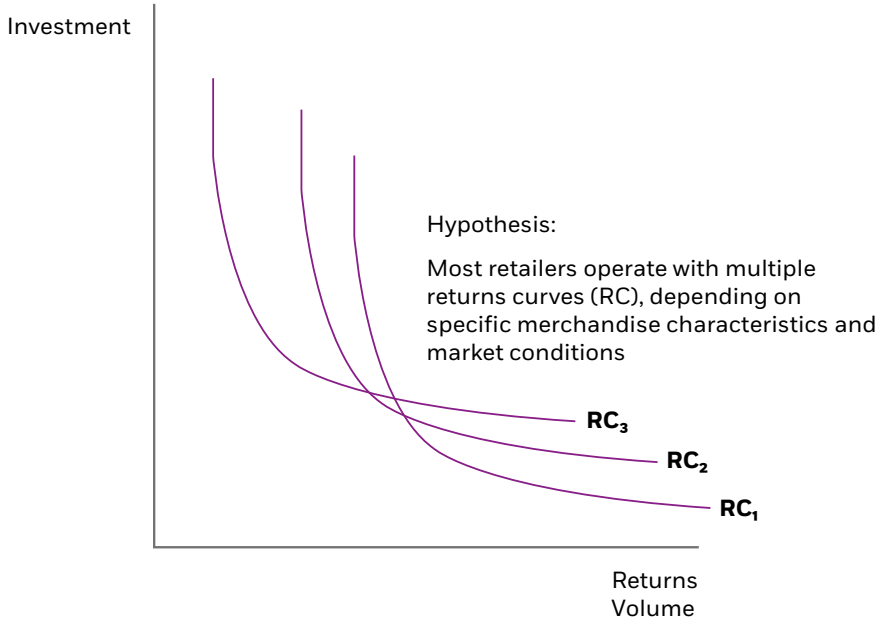


Figure 6

To support this thinking, it will be necessary for retailers to have the analytical capability to understand and evaluate returns avoidance investment trade-offs.

Returns management framework

UST has developed a 'Returns Management Framework' to support retailers in creating a returns management strategy. The framework below (Figure 7) represents UST's view of the return dilemma and how to approach the issue. In the remainder of the document, we will describe how to utilize this framework to maximize customer loyalty and provide operational controls to manage costs.

Overall, UST's Returns Management Framework is guided by two objectives: 1) 'First Time Right (i.e., eliminating the need to return); and 2) 'Optimizing Returns Operation' (when returns are inevitable). The 'retailer's brand philosophy' must guide the ownership of the end-to-end returns process. As it requires tight coordination with multiple teams across the enterprise.

UST's returns management framework

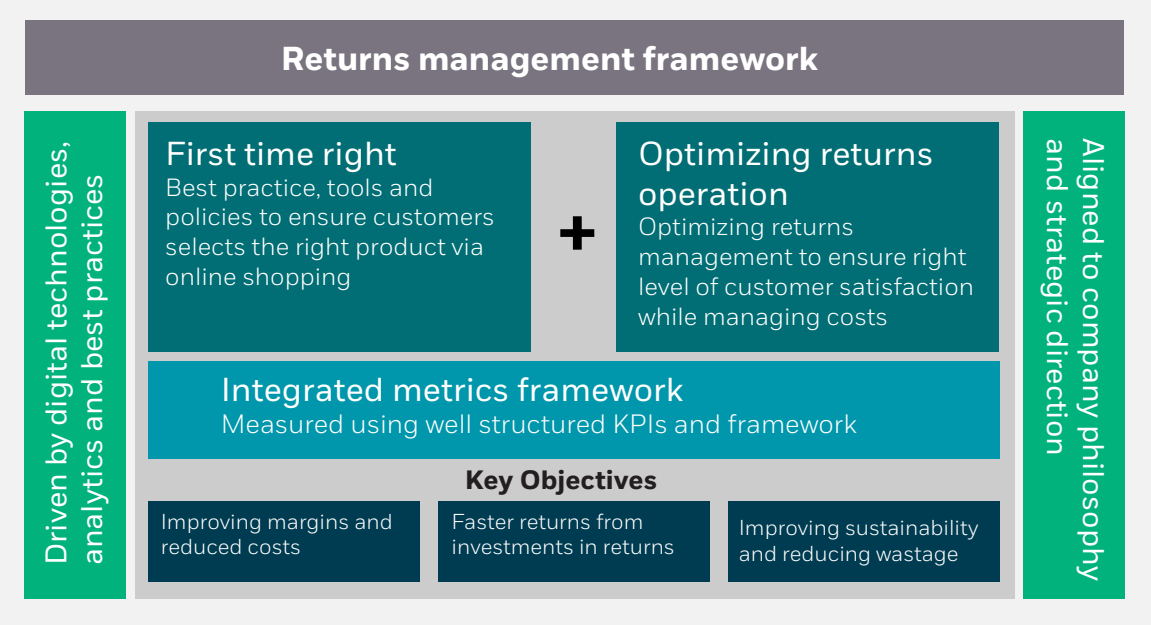


Figure 7

The returns management framework provides a 360-degree playbook for retailers to prevent and manage returns at every customer touchpoint. It considers the reality that the ownership of the returns process is spread across multiple teams and brings them together using an integrated metrics framework.

Key elements of the returns management framework

FIRST TIME RIGHT

Preventing returns requires a disciplined, intra- company approach led with strategic direction by top management. We propose three key levers that retailers can adopt.

1. Create policies that optimize returns
   - Select the suitable returns period while keeping customers loyal
   - Ensure you have the appropriate policies for your product categories
   - Adjust policies to manage post holidays returns
2. Guide customers through their purchase lifecycle
   - Adopt tools that can help improve purchase decisions
   - Avoid misinformation and wrong expectations
   - Ensure the products reach the customers on time
3. Implement measures to reduce fraud and abuse
   - Detect stolen or fake goods
   - Reduce return of used goods
   - Identify serial returners and customer misusing policies

OPTIMIZING RETURNS OPERATION

Managing returns is challenging due to storage space issues, rising logistics costs, and labor shortages. We propose that retailers should consider these strategies.

1. Create alternatives to returning
   - Promoting exchanges instead of returning for cash
   - Refund without returning merchandise for specific product categories
   - Integrate 3rd parties like resellers and returns platforms
2. Leverage cost-effective options for receiving the product back
   - Promote in-store returns
   - Outsource to return specialists
   - Automate fraudulent return detection
3. Optimize the management of returned goods through
   - Automation in handling and logistics (where cost-effective)
   - Sustainable disposition of returned items
   - Eliminate customer hassles in the returns process

First time right-preventing retail returns

Getting the customer's shopping experience 'first time right' is essential to minimize returns. Today's customer is well informed, price conscious, and aware of the more significant impact of returns. By creating the appropriate policies, implementing digital tools, and closing loopholes for fraud and misuse, retailers can minimize the burden of returns and improve customer satisfaction. Outlined below are three best practices for retailers to consider concerning managing returns

1 **Create retail policies and practices with returns in mind**

Retailers are increasingly adopting simple, transparent, and generous return policies that inspire confidence and trust. But companies shouldn't avoid adjusting their return policies to ensure returns do not negatively impact their finances and operations.

- **Select the suitable returns period while retaining customers' loyalty**: According to IMRG, approximately 35% of returns happen between one- and two weeks post-purchase, and almost 65% of customers expect to be able to exchange or refund within a window of 30 days[6]. A study by UT-Dallas found that a more extended return period does not necessarily mean more returns. After a certain period, the probability of returning an item decreases due to the endowment effect[7]. The implications for retailers are to identify the optimum return period for their mix of products and consumers.
- **Ensure you have the appropriate policies for your product categories**: A one-size-fits-all approach does not work well as far as returns are concerned. Most retailers have kept a shorter return window for specific product categories like electronics. For retailers having a mixed portfolio of products, it is essential to maintain different strategies for each segment.
- **Adjust policies to manage post-holidays returns**: A recent NRF study states that 18% of holiday sales were expected to be returned in 2021. Retailers should consider altering return policies for the holiday season, especially for popular items. Customers are more accepting when reasonable changes are made for 'high value' and 'in demand' items. Moreover, inventory and merchandise planning will also improve when it is needed the most.

2 **Guide customers through their purchase lifecycle**

One of the primary drawbacks of online shopping is that users cannot touch or feel the product and are often disappointed when it arrives, leading to high returns. By guiding the users through their shopping and ensuring they have all the information for their purchase, retailers can ensure returns are minimized while improving sales simultaneously.

- **Adopt tools that can help improve purchase decisions:** Poor fit is a primary reason consumers return purchases in apparel. However, innovative technologies are bringing digital dressing rooms directly to consumers.
  1. **Metaverse Fashion**: As the metaverse concept grows, augmented reality (AR) solutions such as those from 3DLOOK are helping shoppers visualize how the clothes will look on them. For home goods, the tool can help users visualize the placement at home. According to Shopify[8], investment in 3D and AR technology can help reduce return rates by as much as 5%.
  2. **Easy to use size guides**: Size guides are essential for apparel but can also often confuse users as sizes are not consistent across different manufacturers. Here, third-party tools like Truefit pave the way for a more accessible and consistent shopping experience by saving user data and utilizing data across retailers.
  3. **Leveraging user's history**: Many retailers keep fit history in their order management systems. This practice supports easier purchases and the right fit.
  4. **Custom Models**: Retailers are experimenting with technology that helps you choose a model best suited for your body profile and helps visualize how merchandise would look on you.

[6] https://www.imrg.org/insight/the-returning-conundrum/

[7] https://news.utdallas.edu/business-management/researchers-examine-effect-of-return-policies-on-c/

[8] https://www.shopify.com/blog/ar-shopping

- **Avoid misinformation and wrong expectations**: Sharp, high-resolution images with accessible zoom features reduces the gap in expectations. Many Shopify retailers utilize image enhancement products such as Picx (Picx.com) to support customer online purchase decisions.
- **Ensure products reach buyers on time and without damage**: It is estimated that an average package is dropped around 17 times[9]. It is essential to minimize the potential for returns due to damage. This can be accomplished by inspecting every item before it is dispatched and ensuring the use of proper packaging.

3 **Implement measures to reduce fraud and abuse**: Fraudulent returns include returning stolen or counterfeit merchandise, purchases made with fraudulent means like stolen credit cards, and returning items customers never intended to keep (but may have used). The losses due to fraudulent returns have forced some retailers to tighten their return policies at the cost of customer satisfaction. Approximately 25% of retailers said they would be getting stricter with retail policies as per the NRF survey[10].

- **Detect stolen or fake goods**: Companies use agencies like The Retail Equation (formerly The Return Exchange) to assist with return fraud detection and prevention by using their database. If your rate of fraud and abuse is above 10%, it is a good idea to evaluate the current policies and procedures.
- **Reduce return of used goods**: Ecommerce has also led to a spike in abuse of return policies by 'wardrobing', where customers return apparel goods after using them. While it is hard to eliminate this practice, innovative new practices and technologies like tamper-evident tags are helping by preventing the usage of high-end apparel while still allowing consumers to try it on. The 360 ID tag is one such product manufactured by BrandWatch Technologies. The tag works by simply looping a durable security tag through the merchandise and sealing both ends with a tamper-evident security seal with a unique ID number. Applying a restocking fee is another acceptable way to reduce serial returners like those returning the big screens immediately after the Super Bowl.
- **Identify serial returners and customer misusing policies**: Advanced analytics can significantly reduce fraud. Retailers should review, understand, and create appropriate analytics from their order management (OM) systems to identify offenders. Patterns in customer, product, and mode of return (for example, through the same store or salesperson) can be identified to reduce these issues.

[9] https://www.marketplace.org/2018/03/06/sustainability/online-retailers-packaging-all-about-economics/

[10] https://www.incharge.org/military-money/military-life/return-fraud-are-you-part/

Optimizing retail returns-strategies to manage returns cost-effectively and efficiently.

Managing returns comes with unique challenges, including rising logistics and handling costs, disposing of items efficiently and sustainably, potential markdowns due to seasonality, and ensuring customer satisfaction.

Storage space has become a major challenge. By 2024, retailers will be facing a 140-million-square-foot storage shortage[11].

The increase in transportation and logistics costs has also compounded the issues. According to an IMF report, the cost of shipping a container has increased by seven times in the 18 months since March 2020[12].

To overcome these challenges, retailers should understand the levers that can optimize their return operations as outlined below:

1 Create alternatives to returning

- **Promoting exchanges instead of returning for cash**: When a return is unavoidable, retailers can still use the opportunity to guide customers for the best outcome for both parties. These options include making it easier (and incentivizing) to exchange instead of returning.
- **Refund without returning merchandise for specific product categories:** Returns may not even be practical for some categories (based on contribution margin). Managers should leverage analytics to evaluate if an item is worth returning or can be refunded directly. This practice, however, needs adequate guardrails to avoid being misused.
- **Integrate 3rd parties like resellers and returns platforms**: Finally, guiding customers towards resellers and the second-hand sales market is a new practice that is helping retailers retain the next generation of customers by reducing the impact on the environment and providing a rich shopping experience.

2 Leverage cost-effective options for receiving the product back

- **Promote in-store returns**: Once a return process starts, the next step is repositioning the product where it is sellable. When possible, encouraging customers to return at a storefront minimizes logistics costs and provides an opportunity to retain customers and increase foot traffic in the store. Additionally, it provides an opportunity to restock items quickly.
- **Outsource to return specialist**: Retailers should evaluate if they want to manage returns operations in-house or outsource it to a third party. As returns specialists mature, retailers should expect improved capabilities, such as AI-powered technologies, to automate the receiving, sorting, and restocking processes. Some specialists, such as Optoro, even provide an option to list merchandise on their eCommerce site specializing in used items[13].

[11] https://www.prologis.com/news-research/global-insights/automation-and-logistics-real-estate-2-how- automation-can-help

[12] https://blogs.imf.org/2022/03/28/how-soaring-shipping-costs-raise-prices-around-the-world/

[13] https:// www.cnbc.com/2016/12/16/a-260-billion-ticking-time-bomb-the-costly-business-of-retail- returns.html

- **Automate fraudulent return detection**: 'Fraudsters' are using more sophisticated ways to cheat by 'stripping' products of value before returning to retailers. This practice is hard to detect and is most prevalent in high-value categories like electronics. Automating the returns inspection process through scanning and weighing can help reduce the incidents of defective items returning to shelves.

3 Optimize the management of returned goods

- **Automation in handling and logistics (where cost effective)**: Although best-in-class retailers use checklists to check returned items, detailed inspections are expensive during the returns process. As a result, many products with issues get restocked, resulting in more dissatisfied customers and other returns. Digital technologies like Machine Vision and analytics can pinpoint issues with much more precision than the human eye. Managers should identify the root causes to avoid future problems, such as a manufacturing defect or an incorrect product description.
- **Sustainable disposition of returned items**: The final stage of the process is about disposition. Returning products need to be planned with the same detail as new products to optimize logistics and operational costs. At the same time, retailers must develop disposal strategies, keeping sustainability and ESG goals in mind. Retailers can leverage analytics to identify the most profitable disposition method for a return by optimizing the best path. Additionally, this may lead to category-specific approaches to the returns process based on feasibility and margins.
- **Eliminate customer hassles in the returns process**: The returns experience and communication are significant for customer satisfaction. Customers expect to be kept apprised about their returns and refund. 76% of first-time buyers with easy returns experience said they would shop with that retailer again[14]. Before COVID-19, returns processing lead times were 4.53 days. Returns processing time has now increased to 8.17 days, almost double the time[15]. To minimize this issue, retailers should use shipping partners that supply tracking information. Once a return arrives at the warehouse, retailers should send the customer an automated message to confirm receipt and provide the expected lead time to process the refund.

[14] https://corp.narvar.com/resources/state-of-returns-consumer-report-2020

[15] https://www.imrg.org/insight/the-returning-conundrum/

Organizational ownership and key performance indicators

Responsibility for returns management can cross multiple teams within an organization. Buyers, merchandise managers, eCommerce, inventory control, and loss prevention teams must work together to ensure an efficient and consumer-friendly process. This requires leveraging the best practices, tools, and techniques. In addition, retailers should modify their key performance indicators (KPIs) and metrics to align their operations with appropriate returns management processes. The success of returns management largely depends on the proper ownership at the executive level to lead a cross-functional team.

Returns management KPIs and metrics should be viewed and measured from a strategic, tactical, and operational perspective. The key performance metrics are the overall return rates, the level of fraudulent returns, and the number of inventory write-offs caused by returns. These performance metrics should be supplemented with detailed drill-downs to measure individual teams related to returns management.

Key Performance Indicators (KPIs) for retail returns

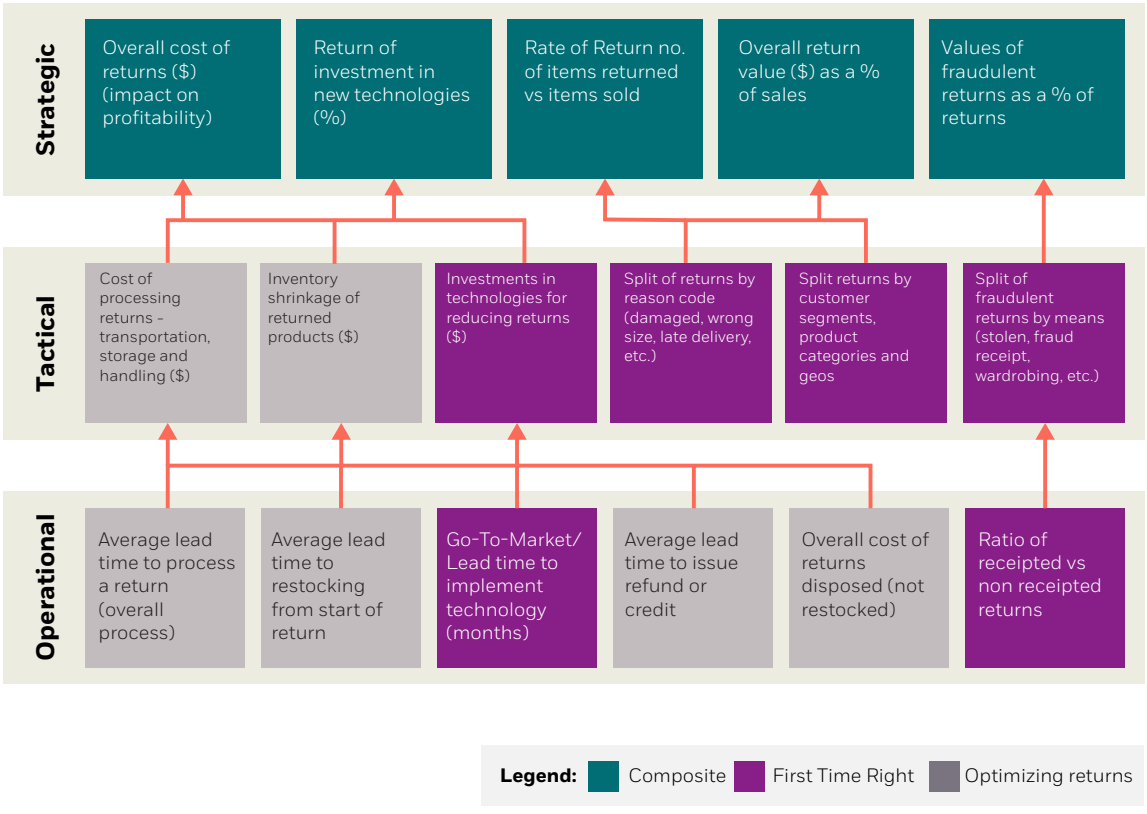


Figure 8

Summary

Returns in the retail industry are unavoidable, and the volume is growing primarily due to the expansion of the online (eCommerce) sales channel. While return volumes will continue to grow, appropriate practices, procedures, and policies supported by intelligent analytics can transform the challenge into an opportunity. The 'efficient frontier' can serve as a framework to manage the returns process systematically and cost-effectively. Companies that utilize a suitable, data-driven, analytical approach to limit and optimize their returns operations will see improved performance.

Retailers must define the ownership of the end-to-end returns process. A 'returns team' that represents all functional groups (e.g., merchandising, marketing, operations, finance, IT, etc.) can consistently measure and analyze KPIs and identify opportunities for improvement.

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Together, we build for boundless impact

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