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Bricks and Clicks: The Changing Nature of Retail

Informational commentary from Rothschild Asset Management Inc., the subadvisor to Pacific Funds℠ U.S. Equity Funds.

In recent years, the retail industry has experienced major shake-ups in regard to shifting business models, including the increasing popularity of e-commerce. Businesses that rely on revenue exclusively from physical stores—once the all-important showrooms for goods and services—have not only become less relevant, but also less efficient from a cost perspective.

That said, the rise in e-commerce has not impacted all retail subsectors equally. To better understand the changing industry dynamics, we sat down with Portfolio Managers Luis Ferreira (covers large-cap retail stocks) and Doug Levine (covers small-cap retail and technology stocks), and Analyst Tiffany Li (covers large-cap technology stocks) at Rothschild Asset Management Inc. ("Rothschild").

Q. What are the driving factors behind the rise of e-commerce?

Doug: It's really a mix of demand-driven and supply-side factors. In terms of demand, cost is one factor; typically speaking, consumers are looking to pay the lowest price for most items—but it is not the only factor at work. Consumers are also looking for ways to save time and compare price and other features across multiple suppliers. Online shopping offers a way to do this without getting dressed, getting into your car, and driving around to multiple stores.

Q. Some of those demand drivers are not new; what has changed on the supply side?

Tiffany: Through improved logistics and innovative business models, "e-tailers" (electronic retailers) have greatly improved delivery times and made it easier to process returned items. In the past, a one-week delivery period might be enough to discourage impulse buying, but e-tailers such as Amazon.com, Inc. ("Amazon") have offered one-day and even same-day delivery of some items. Moreover, trying on clothing in the store to ensure appropriate fit has become less critical given more flexible return policies initially pioneered by firms such as Zappos.com, Inc.

Q: Most observers are generally aware of the rising influence of e-commerce in the retail space. Can you quantify this impact for us?

Luis: Using data from 2016 as a point of reference, although e-commerce remained less than 20% of transactions in the larger U.S. retail categories, it accounted for sizable portions of sales within certain categories. Specifically, e-commerce has thoroughly penetrated the Music, Software, and Computer segments and maintains sizable footholds in the Houseware and Consumer Electronic channels.

Q: Does that mean there are other areas in which e-commerce doesn't have such a strong foothold?

Luis: There are certainly areas in which e-commerce hasn't gained a large share of sales. Referring to the same 2016 data, less than 5% of purchases in the Grocery and Home Improvement categories were made online. Practically speaking, these figures make sense, using the Home Improvement segment as an example, businesses such as The Home Depot and Lowe's receive the bulk of their sales through in-person purchases. Individual consumers are not necessarily interested in shipping two-by-four pieces of lumber to their homes via standard carriers.

Doug: Customers are still largely opting to purchase major appliances through brick-and-mortar locations most of the time. Car buying is another area that has been resistant to e-commerce up to this point. While you have TrueCar, Inc. and other services that help compare pricing, consumers still want to test drive the car and discuss financing options at the dealership.

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Q: Are there areas that were seemingly cornered by brick-and-mortar retailers in which e-tailers have become a threat?

Doug: Furniture retailers are becoming even more competitive in the e-commerce space. For example, Wayfair LLC has emerged as a serious player as an online, discount furniture retailer. The company has targeted the large $300 billion U.S. home renovation, furniture, and design industry, and, with online penetration just below 10% in North America, there is an attractive opportunity for growth. Although it has become somewhat of a volatile “battleground stock” among investors, Wayfair rose more than 120% in 2017. Additionally, smaller private companies, such as Houzz, have raised investor capital and are looking to expand their presence in the market. While the shift to e-commerce in furniture and home-design sales won’t happen overnight, there seems to be an appetite in the market for the discount-business-model approach.

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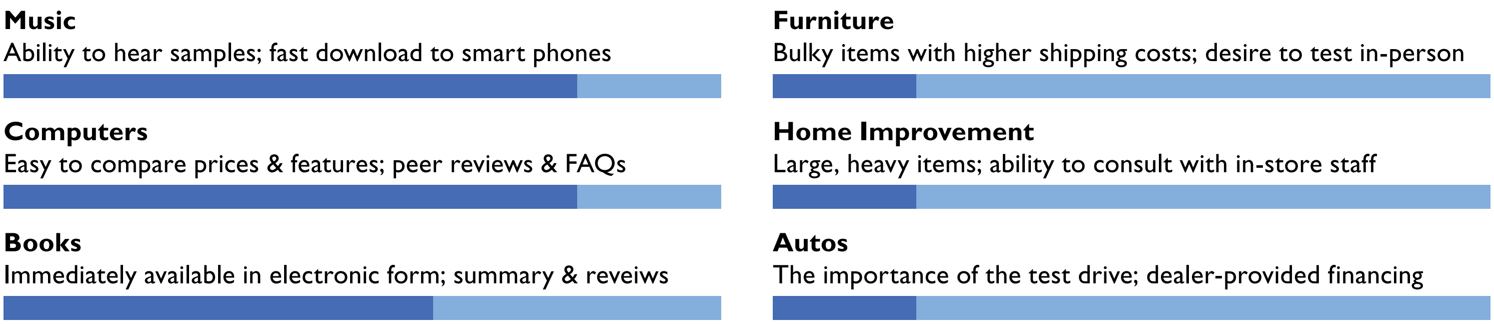
Online retail penetration has not been uniform across industries and products.



Source: Rothschild analysis, January 2018. Analysis is relative approximations based on current market conditions. Not to scale.

Q: Are there any brick-and-mortar retailers that are well-equipped to handle the storm?

Luis: Business models driven around off-price and discounted goods as well as in-store bargain-hunting experiences, such as T.J. Maxx and Marshalls, are among the companies that may present attractive investment opportunities. Another example is Walmart, which acquired Jet.com and invested heavily in its technological infrastructure; coupled with the company’s existing size, scale, and consumer base, the business has maintained a strong presence in the retail world. Additionally, Best Buy, recently considered by many to be a casualty in the shift to e-commerce, has shifted its business model to become more service based and now provides a competitive online presence as well as offering competitive price-matching initiatives. The endeavors have allowed Best Buy to not only survive the advances by the online retailers, but also remain a large player in the consumer-electronics market.

Doug: I’d also add that companies that have strong brand recognition and are not married to brick-and-mortar location sales may be other areas for potential investment ideas. Michael Kors, Steve Madden, Ltd., PVH Corp., and The Children’s Place all maintain retail locations, but are just as happy to sell their goods online or in department stores. Their brand recognition grants them the flexibility to be sold in either channel while adapting to shifts within the retail market segments from a pricing standpoint.

Q: What types of bricks-and-mortar retailers might be particularly vulnerable to e-commerce?

Doug: Department stores that carry products at full price and do not have a strong proprietary offering, such as Sears or Macy’s, are especially susceptible to the shift to e-commerce as they do not have the robust proprietary brand products to pull consumers into their physical locations.

Luis: I would just stress that the rise of e-commerce is a dynamic, rather than static, phenomenon. It’s important to note that several major department stores have made changes to their business models and aren’t simply accepting their fates. Macy’s has had a rough go recently due to the company closing multiple locations and trimming its workforce. That said, Macy’s is taking the proceeds from reducing its footprint and reinvesting in technology with the hope of eventually driving a sizable amount of its business through online sales. Other major retailers have implemented certain omni-channel initiatives—such as “buy online/pick up in store” and “order in store/ship home”—that incentivize consumers to come to the physical locations and pick up their orders; this strategy essentially pairs the advantages of online shopping with the immediate gratification of an in-store purchase.

> “The rise of e-commerce is a dynamic, rather than static, phenomenon.”
>
> | *Luis Ferreira*

Q: It’s impossible to talk about retail without addressing Amazon. What has helped Amazon grow to its current market share, and what are some key drivers to its continued growth?

Tiffany: Clearly the company has diversified itself from its early days of online book sales. By reinvesting in its business over time, Amazon has built a loyal consumer base—largely via its Prime Membership program—which has enabled the company to take risks by branching out into other market segments. In recent years, industry-wide retail sales in the U.S. have grown in the low single digits, while e-commerce sales have grown at roughly 15%. Amazon, however, has posted roughly 30% growth in gross merchandise value (GMV) despite being estimated at roughly $170 billion in North America GMV, so the “law of large numbers” doesn’t appear to hinder its growth rate. To summarize, in the rapidly growing pond of e-commerce, Amazon is not only the biggest fish, but also one of the fastest growing.

Luis: Generally speaking, Amazon has distinguished itself as an innovator in individual segments while also proving to be an expert in supply-chain management. In 2016, a sizable portion of all returns among the top 100 retailers were related to receiving damaged/incorrect goods. By owning most of its supply chain, Amazon has a distinct advantage in both order-fulfillment and return-processing time, which is currently about one day. Such efficiency translates into increased consumer satisfaction, which further strengthens Amazon’s already robust consumer base and allows the company to further expand into other business segments without risking its core business.

Tiffany: The concept of “foes with benefits” comes to mind; Amazon Marketplace offers a tremendous number of clicks for smaller retailers that are not at the scale to handle online fulfillment. Marketing through the Marketplace is a large driver of sales; however, doing so means that Amazon knows all the relevant sales data and profiles, which Amazon then monetizes by forming private-label brands of its own.

Q: We’ve seen some high-profile deals among retailers in recent history, with the most prominent being Amazon’s acquisition of Whole Foods Market. Doesn’t the acquisition of physical stores seem at odds with the trends in retail we’ve discussed?

Tiffany: Rather than subscribing to a strictly e-commerce model, Amazon appears to have recognized that the grocery market may be better accessed via the physical locations of an existing retailer. Acquiring Whole Foods Market grants Amazon access to a grocery chain with strong brand recognition, attractive physical locations, and a robust private-label business. The latter is an important factor as it aligns with Amazon’s recent endeavors to increase margins and product differentiation through vertical integration. Additionally, the acquisition provides Amazon access to a trove of consumer data, as Whole Foods Market maintains a fairly affluent customer base, which provides Amazon with additional high-margin opportunities.

Q. Obviously Amazon is a large-cap stock; has the “Amazon effect” caused any ripples among small-cap stocks that Rothschild holds?

Doug: We do own an aircraft-leasing stock—called Air Transport Services Group (ATSG)—in some of our small-cap strategies. ATSG is a leading provider of air-cargo transportation services that is benefiting from fleet expansion driven by growth in e-commerce. While ATSG’s agreements with Amazon Fulfillment Services, Inc., an affiliate of Amazon, wasn’t necessarily a core tenet of our investment thesis, it does show that some small-cap firms can benefit from Amazon’s growth.

Q. Let’s end on this. Is Amazon the only game in town, and if so, does a company’s competitive positioning relative to Amazon influence your investment decisions?

Luis: As investors, it is certainly important to understand market trends and not to be caught playing catch-up. Amazon may not be a key driver in why we buy or sell a security, but understanding Amazon’s impact is part of our fundamental work because it helps gauge the potential strengths and vulnerabilities within a company’s business model. However, rather than focus on segment trends, or the potential impact of one or two major players, our approach remains grounded in bottom-up fundamental analysis: identifying stocks with positive fundamentals, such as favorable relative valuations versus their peers, and the ability to beat investors’ expectations.

Definitions

A **battleground stock** is one that has polarizing opinions on both sides of the argument that investors tend to no longer see reason and act irrationally when buying and selling the stock.

The **law of large numbers** refers to a statistics and probability theory that states each additional data point gathered increases the likelihood that the outcome is a true measure of the average. As it relates to financials, it refers to the idea that a company that is growing rapidly cannot maintain that pace of growth indefinitely.

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