Where Will Retail's Secular Shift Lead? Follow the Yellow Brick Road

By Paula Reiters, CFA, VP, Senior Credit Analyst

KEY TAKEAWAYS

- While the retail shopper remains in the catbird seat, actually more powerful than ever, the relationship between buyer and seller has become far more complicated, especially for long-established retailers.
- Retailers—traditional and online upstarts—are adopting so called omni-channel retailing. They're attempting to integrate physical and digital environments to create a better, seamless shopping experience for the customer.
- With shopping habits changing so rapidly, no one knows (not even the retailers) how far this shift will go.
- Eventually a balance between "bricks and clicks"—the right amount of physical stores and e-commerce—will be found, but it may take some years to get there and there will be many casualties along the way.

"Toto, I've a feeling we're not in Kansas anymore"

L. Frank Baum
The Wizard of Oz (1900)

"Right or wrong, the customer is always right," is how master bricks-and-mortar retailer Marshall Field described a customer's powerful rights over a century ago. In his view, the relationship between buyer and seller couldn't have been clearer when a customer walked into his downtown Chicago store.

Today, however, while the retail shopper remains in the catbird seat, actually more powerful than ever, the relationship between buyer and seller has become far more complicated, especially for long-established retailers.

As digital shopping trends accelerate and become more dynamic, traditional bricks-and-mortar retailers are finding themselves in uncharted territory. With customers dramatically changing the way they shop—buying just about anything 24/7, comparing prices on their smartphones and tablets with ease and demanding services like shipping for free—the industry is under siege. It's not Kansas anymore.

Welcome to the Omni-Channel World of Retailing

Retailers—traditional and online upstarts—are adopting so called omni-channel retailing. They're attempting to integrate physical and digital environments to create a better, seamless shopping experience for the customer, who spends more money shopping multi-channels than either just trolling online or shopping in a store.

On the traditional side, retailers, such as Macy's and Nordstrom, have been on the forefront of the omni-channel experience, but implementing change is not always easy. There is a cost to increasing online operations, as digital sales are less profitable because the expenses are variable with each additional order—employees must locate, pack, and ship, then deal with returns and restock. Free shipping also eats into margins.

IMPLEMENTING CHANGE

> "With e-commerce putting the pressure on, retail chains are finally beginning to read the tea leaves and many have started closing stores and downsizing store footprints."

And now, with e-commerce putting the pressure on, retail chains are finally beginning to read the tea leaves and many have started closing stores and downsizing store footprints. The total retail square footage—about 46 square feet of retail space per capita in the US—has been a perennial problem. Macy's and Walmart's recently announced store closings are but two examples.

On the other side of the coin, pure online retailers are experimenting with opening physical stores, one indication that bricks-and-mortar stores are not going to disappear.

It's no accident that online firms Warby Parker, Indochino and Bonobos have opened retail shops. There, customers can shop for and try on Warby Parker eyewear, Indochino custom suits and Bonobos khakis before ordering online. Even giant Amazon, the leader of the online revolution, has opened up a couple of bookstores, with more expected in the future; and more recently it's been reported but not yet confirmed that Amazon wants to open 20 bricks-and-mortar grocery stores over the next two years, with the potential of 2,000 stores over the next decade.

With shopping habits changing so rapidly, no one knows (not even the retailers) how far this shift will go. All retailers, traditional and pure online alike, have to remain relevant to the consumer, and not moving fast enough or investing enough could be costly.

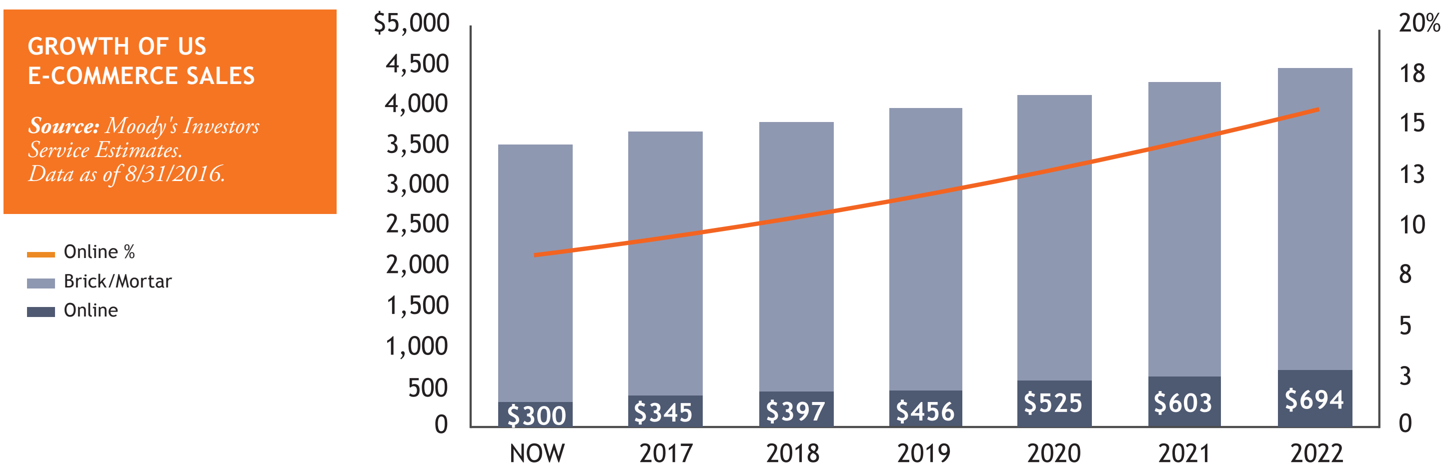
Eventually a balance between "bricks and clicks"—the right amount of physical stores and e-commerce—will be found, but it may take some years to get there and there will be many casualties along the way. Borders, Circuit City, and Tower Records, to name a few, have already fallen by the wayside.

"Lions and Tigers and Bears—Oh My!"

There's no denying e-commerce is on a roll. In 2015, US e-commerce sales grew 14.6% and accounted for about 7% of total retail sales. Looking out, Moody's expects online retail sales to be over 15% of total retail sales by 2022.

GROWTH OF US E-COMMERCE SALES

Source: *Moody's Investors Service Estimates. Data as of 8/31/2016.*



Amazon, the gorilla in the room, is the biggest driver of increased e-commerce penetration in the US and continues to take e-commerce share globally. Amazon's low prices, broad selection, and Prime membership program, which provides a number of benefits including free two-day shipping, help contribute to its share gains. Various estimates from the Street indicate that the Prime penetration rate among all American households could be approaching 50%. Prime members purchase goods on Amazon about three and a half times a month versus two times a month for non-Prime members.

DISRUPTIVE ONSLAUGHT

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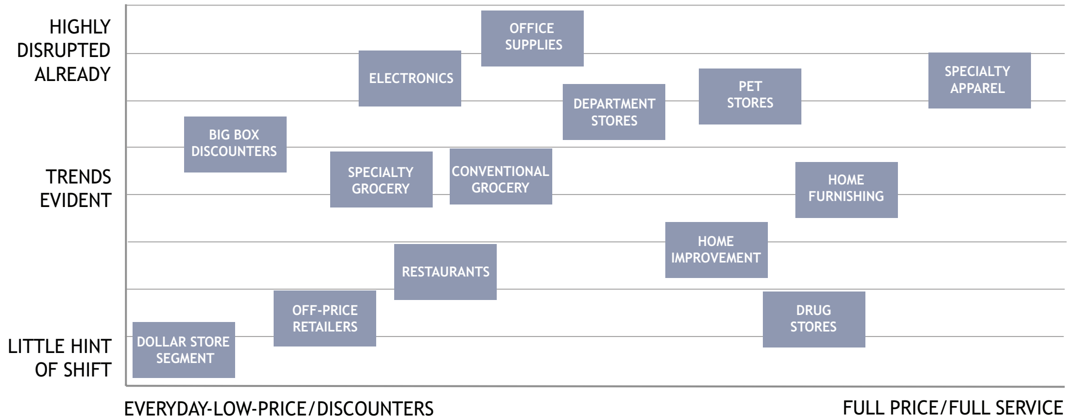
Not resting on its laurels, Amazon continues to be very aggressive with new services for its Prime members such as Prime Now, AmazonFresh, Amazon Dash, and Prime Pantry. Having control over and getting the merchandise faster to its customers is a focus, as the company leases its own Boeing 767s and looks into drone deliveries. Additionally, Amazon is poised to be the number one apparel retailer in the US by 2017, according to Cowen and Company. Hence, as Amazon's market share grows, retailers are fighting for a smaller share of online sales.

Interestingly enough, not all traditional retail sectors are equally vulnerable to e-commerce's disruptive onslaught. Price transparency is the key reason that particular sectors are more impacted than others. The following Standard & Poor's graph shows which retail sectors are being most disrupted. The electronics sector, office supply stores and specialty apparel stores are most impacted, while sectors that offer more value are somewhat protected from the likes of Amazon.

These include dollar stores, which offer value along with quick in-and-out convenience, and off-price retailers, which operate a bargain-hunting model. Value retailers themselves generally are not as focused on e-commerce because it is not cost efficient for these chains to warehouse and distribute low-priced items.

MOST AND LEAST DISTRUPTED RETAIL SECTORS

Source: *Standard & Poor's. Data as of 12/31/2015.*



How Millennials, Smartphones and New Brands Spur E-Commerce Growth

E-commerce's growth is also being spurred by US consumers' changing demographics, increased shopping using smartphones and tablets and brand building via digital channels.

Millennials, the largest generation since the baby boomers, will be entering their prime purchasing years and are expected to make up about 30% of all retail sales in the US alone by 2020, according to Shopify Inc. This group is the most technologically sophisticated generation in history and social media is second nature to them, as millennials are comfortable building relationships online.

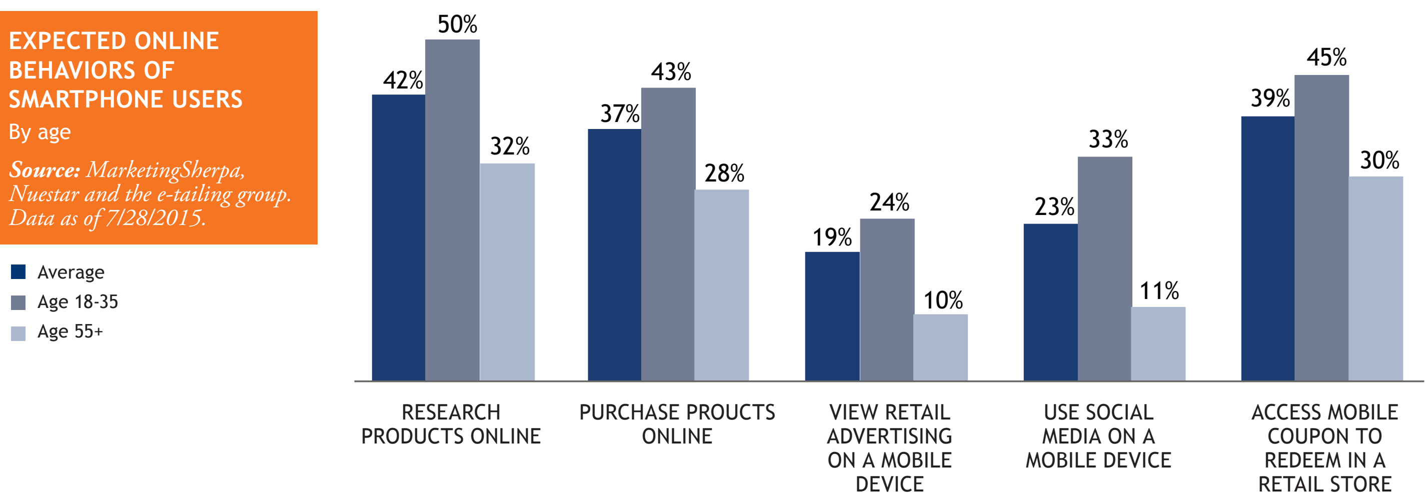
Traditional advertising is becoming less effective as millennials share experiences about retailers and products over social media. Millennials trust user-generated content 50% more than any other type of media. Thus, strategies for marketing to millennials change every day as retailers have to adapt quickly to cater to this mercurial group.

However, let's not downplay the fact that the baby boomers, who still account for most of America's disposable income, also embrace shopping online.

EXPECTED ONLINE BEHAVIORS OF SMARTPHONE USERS

By age

Source: *MarketingSherpa, Nuestar and the e-tailing group. Data as of 7/28/2015.*



No matter their demographic group, when US consumers decide to go shopping, they're probably using their smartphone or tablet more and more. Mobile commerce (shopping from smartphones and tablets) is growing even more rapidly than the US e-commerce overall.

Mobile devices, like websites, are the "front doors" for retailers and link the online experience with the physical stores. Larger screen sizes and better wireless networks make browsing and shopping easier than ever before. Research by eMarketer, a market research firm focusing on digital marketing, the media and commerce, projects that mobile commerce should make up over 40% of e-commerce sales by 2020, up from less than 20% in 2014.

US RETAIL MOBILE COMMERCE SALES: 2014-2020

	2014	2015	2016	2017	2018	2019	2020
RETAIL MOBILE COMMERCE SALES ($B)	$56.67	$88.53	$123.13	$151.11	$178.27	$208.58	$242.08
% CHANGE	35.9%	56.2%	39.1%	22.7%	18.0%	17.0%	16.1%
% OF RETAIL E-COMMERCE SALES	19.0%	26.0%	32.0%	35.0%	37.0%	39.0%	41.0%
% OF TOTAL RETAIL SALES	1.2%	1.9%	2.6%	3.0%	3.5%	4.0%	4.5%

Note: Includes products or services ordered using the internet via mobile devices, regardless of the method of payment or fulfillment; includes sales on tablets; excludes travel and event ticket sales.

Data source: eMarketer, as of February 2016.

Brand building is also helping e-commerce grow. Brand building through digital reduces barriers to entry because it is a much more efficient and faster way to present the brand definition and aesthetics on a website than it is showcasing in physical stores. Marketing time can be cut down from several months to several weeks.

Retailers, traditional and online, are competing for the rights to sell key apparel brands, where the bargaining power of the global vendors is increasing. Further, major brands, such as Nike, Coach and VF Corp. (Vans, the North Face and Timberland), have gone direct-to-consumer with their own websites and, in some cases, their own stores, competing with the retailers that carry their brands.

"True Courage Is Facing Danger When You Are Afraid."

So, how are traditional retailers faring in this new, topsy-turvy world? They've reacted to the changing environment by spending money on IT and e-commerce and doing whatever they can think of to please the customer. But it is expensive as retailers invest in technology, infrastructure, distribution centers, cyber security and shipping. These new costs eat into margins well beyond the fixed expenses for physical stores.

One major advantage that a traditional retailer has over online operators is that it can utilize its store base in a variety of ways. A retail chain can capture traffic if a customer enters the store to pick up a purchase bought online (BOPIS or buy online, pick-up in store) or when a customer enters the store to return an item purchased online (BORIS or buy online, return in store). Also, a chain-store retailer can send merchandise from one store to another or ship to a customer's home as long as the necessary systems are in place.

Still, even retailers that have been on the cutting edge of omni-channel retailing, such as Macy's and Nordstrom, are under pressure as the shift to digital accelerates. Macy's posted negative sales comparisons throughout 2015 and recently announced that it would close 100 stores in early 2017, or 14% of its store base. Nordstrom is closing some stores and cutting costs in its corporate office, while it grows the off-price, value format, Nordstrom Rack.

RETAIL 101

> "Retail 101 is not enough anymore. The retail business is far more complex now. There is much more data-driven technology behind a typical purchase."

Walmart, for its part, announced in late 2015 that it would close 154 stores in the US, or about 2% of its US store base, and invest in its employees, e-commerce, and lower prices, sacrificing some profit margin. Walmart is one of the least online-penetrated retailers in the US at 2%-3%. However, that represents a huge $15 billion for its global online business, which provides a big opportunity for the retailer. In fact, Walmart plans to accelerate its digital business with the $3.3 billion acquisition of Jet.com, an e-commerce startup with an already-existing platform. The acquisition will help Walmart avoid the expenses and time amping up its own online growth.

Best Buy rose to the challenge of "show-rooming" by offering technological knowledge, partnering with key brands such as Apple, Microsoft and Samsung, and by using price match when necessary. There is a reason to go to a Best Buy store, and once a customer is in the store, Best Buy has initiated strategies to try to close the purchase on the spot.

After mall closings, store rationalization, and large investments in improved infrastructure and efficiencies, online profit margins for store chains should finally eclipse store margins starting in 2023, according to Credit Suisse.

"Somewhere Over the Rainbow"

Retail 101 is not enough anymore. The retail business is far more complex now. There is much more data-driven technology behind a typical purchase that includes product sourcing, inventory management, trend forecasting, consumer analysis, customer data management, and marketing. This is on top of the general e-commerce fulfillment functions. Retailers say they will provide what the customer wants and go wherever the customer wants to go, but a study by Forbes Insights and Synchrony Financial, a consumer financial services company, shows only about a third of retailers are past the beginning stages of providing an omni-channel experience.[i]

According to the study, the top five challenges with creating a positive online experience are: cyber-security; understanding customer online habits; privacy issues; variety of product offering; and analytics of online data to understand customer needs. This is where talented people and data analysis will come into play.

Creating ways to keep the interest of the customer (e.g., loyalty programs) and ways to drive traffic are crucial. In our view, all of this requires a CEO to be versatile in many disciplines and/or to hire the right people who have the appropriate talent. Retailers should:

- **Focus on the customer.** The customer is the centerpiece. Retailers have to personalize a shopper's experience at every touchpoint. The process should be very user-friendly (frictionless).
- **Invest in talent.** Leaders need to be more than just a good merchant. Tech savvy and creativity are required characteristics.
- **Utilize customer data more aggressively** by using loyalty programs and private label credit, for example. It is important that retailers know who their potential customers are in order to market to them effectively.

ROLE PLAYING

> "To survive, retailers need to know who they are and the role they would like to fill for customers... Higher-priced retailers that don't offer much differentiation face a tough road ahead."

To survive, retailers need to know who they are and the role they would like to fill for customers. We like retailers that have a key point of differentiation and are less disrupted by digital shopping, such as dollar stores, off-pricers, value chains and home improvement centers. Higher-priced retailers that don't offer much differentiation face a tough road ahead.

Traditional retailers that are investing in talent, data and e-commerce should be able to survive in the long run. Obviously, having the right merchandise is key, but it has to be priced correctly too, given the ease and transparency of the Internet. Having a strong balance sheet is important so that a retailer has the flexibility to withstand competition and the money to invest in whatever is needed to gain or maintain market share. To wit, investment grade rated retailers on average should fair better than the more financially strapped high-yield retailers, especially if an economic downturn occurs in the throes of trying to address secular changes. As for pure on-line retailers, they will also have to adapt to survive over the long run as the traditional players offer more choices in shopping options and faster delivery.

Even though digital sales currently comprise only about 7% of total retail sales, there is still too much retail square footage in the US that needs to disappear, in our view. It will take some time, but we believe that a balance between the right amount of physical stores and e-commerce can eventually be found.

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Endnotes

i Forbes Insights in Association with Synchrony Financial, May 2016.

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