Bricks and Clicks
THE E-COMMERCE REVOLUTION IS JUST GETTING STARTED

By John Rubino

For venerable electronics retailer Radio Shack, 2013's fourth quarter was—unfortunately—one for the record books. Same-store sales plunged by a stomach-churning 19%, producing a net loss 10 times as high as analysts had expected and leading management to announce the imminent closure of one-fifth of the chain's 5,000 stores.

The truly remarkable thing about Radio Shack's plight is that it's not unique. American icons Sears, Best Buy, Barnes & Noble, and Kmart could be on the same path to oblivion, and Circuit City, Borders, UK electronics retailer Comet, and a long list of other formerly widespread chains are dead and gone.

The cause of this brick-and-mortar bloodbath is a lethal combination of hard economic times and the rise of e-commerce, according to R.J. Hottovy, equity strategist with Chicago-based Morningstar Research. "The Great Recession put a lot of pressure on consumers, who flocked to online channels where Amazon and other e-tailers offer lower prices," says Hottovy.

For a sense of the speed with which Amazon and other leading online retailers (e-tailers?) are eating the lunch of the weaker brick-and-mortar chains, consider that a decade ago Amazon and RadioShack each generated annual sales of about US$5 billion but that in 2013 Amazon had sales of US$74 billion compared with RadioShack's US$3.4 billion.

At 8%, e-commerce's share of 2014 US retail sales will be twice what it was in 2001. London-based consultancy IMRG-Capgemini expects online sales in the UK to rise by 18% this year and notes that twice as much was spent via mobile devices in December 2013 as in the year-earlier period.

While Amazon leads the e-commerce onslaught, it is just one part of a vast and growing online ecosystem. In effect, eBay is a huge virtual department store selling everything from gold coins to high-fashion clothing to luxury cars. ASOS, the UK's largest online "style and beauty retail store," is growing by 30% annually and nearing US$2 billion in sales. New York-based Etsy, which offers individual artists and craftspeople a global outlet for their creations,

US E-Commerce Sales
(% of total retail sales)
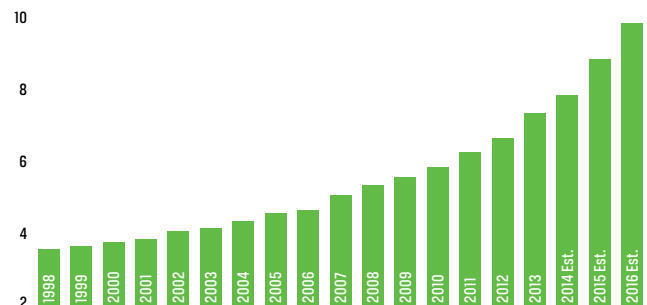
Source: Based on US Census Bureau and Morningstar data.

surpassed US$1 billion in sales in 2013. Today, consumers with an internet connection and credit card can buy exactly what they want and have it delivered to their door, without the hassle of going to a store.

And the next generation of shoppers will turbo-charge this trend, says Sahir Anand, vice president with New Jersey retailing consultancy EKN Research. He recently surveyed 1,700 millennials (born between 1982 and 2004) and found that their willingness to buy most things online far exceeds that of their elders. "For consumer electronics, fully 60% prefer online to in-store," he notes. "That's huge compared to, say, 2006. Millennials already control 20% of GDP spending behavior, and as they replace retiring Baby Boomers, the industry will have to adapt."

OMNI-PLATFORM FUTURE

So is the brick-and-mortar store destined to go the way of newspapers and record labels, doomed by the high cost and destabilizing leverage of physical assets? And by implication, will tomorrow's winning retail stock portfolio consist solely of the best online stores?

No on both counts, says EKN's Anand. Tomorrow's retail universe will include many pure-play online stores but also a fair number of "bricks-and-clicks" chains that seamlessly integrate the physical and the virtual. These "omni-platform" retailers will have an effective online presence. They also will track their in-store shoppers' locations (and perhaps even their eye movements) and will beam targeted coupons to customers' phones while the latter are near the product in question. Store associates armed with company-supplied tablets will help shoppers find the right item, have it delivered automatically to a changing room if appropriate, and then accept payment electronically on the spot. If something is not available on the floor in the preferred color or style, the store will ship it free of charge to the customer's home.

Various parts of the omni-platform vision are already here. For example, Home Depot has equipped store associates with tablets that give instant access to inventory and product details. Britain's Tesco and France's Auchan allow customers to pay with their smartphones. Several chains now use Apple's iBeacon technology to track and communicate with shoppers in-store. Office supply chain Staples has quietly become the world's second-largest online retailer and now enables businesses to order supplies online and either pick them up or have them delivered from the nearest store.

In this scenario, physical stores will double as warehouse/fulfillment centers, turning their ubiquity into an advantage over websites that ship from distant warehouses. If done right, the store-as-fulfillment-center model "improves both the customer experience and the store's inventory management," says Leslie Hand, research director for International Data Corporation's IDC Retail Insights.

Then there's social media. The younger the shopper, the more time they spend on sites such as Facebook (where they share likes and dislikes with friends) and Pinterest (where they post images of their favorite things, creating, in effect, personalized shopping lists). Successful retailers will mine this information and use it to connect with customers. For example, Macy's Facebook page has 14 million "likes," and J.Crew sends its style guide to Pinterest followers before sending it to catalog subscribers.

Amazon's hyper-automated warehouses are well known, but similar things are also happening at the store level. Shoppers at Seattle's Hointer clothing stores use their phones to research and choose outfits and then click "dressing room" to have the items automatically delivered for trying on. Another click sends the final purchase to a pickup area, and one last click transmits payment.

There are tablet apps that enable furniture shoppers to snap pictures of showroom items and drop them into images of their living room to see how they'll look. Other apps analyze the dimensions of shoppers' favorite articles of clothing to create a "fashion fingerprint" for assessing future purchases.

These are only samples of technology available today. In the pipeline is a tsunami of new technologies that will reshape retailing in ways that are both fascinating and harder to analyze. Artificial intelligence systems, such as IBM's Watson and Google's recently acquired Deep Mind, will imbue stores with an eerie combination of personality and omniscience. Google is developing a "take me there" service that offers a ride to the store (eventually in a self-driving car) for certain purchases. 3D printing—in which everything from toys to guns to clothing can be created on-site from digital designs—portends a merger of manufacturing and retailing and a series of ever-more-complicated decisions for retailing executives.

WINNING TRAITS

To sum up, all a physical retailer has to do to survive and thrive in 2020 is seamlessly merge the in-store, online, and social media shopping experience while integrating a torrent of disruptive new technologies as (but not before) each new technology becomes poised to change the world—and do it in all major languages and on all relevant payment platforms. What could go wrong?

Actually, the path is fairly clear. The devil is in the execution. For example, JC Penney tried in 2012 to replace its clerks with self-checkout machines and failed miserably. At the other end of the spectrum is Nordstrom, which seems to be getting it right so far. "Using hand-held devices, associates can now take customers through the whole process from finding products to checkout," says IDC's Hand. In the UK, says Morningstar's Hottovy, fashion retailer John Lewis "was one of the first to create a website for mobile transactions. It offers free Wi-Fi in stores to encourage customers to compare prices, free delivery on orders over £50, and 'click-and-collect' services that allow customers to order online and pick up at the store."

Beyond the generally good execution required for survival in any part of the retailing universe, the characteristics

Picks, Shovels, and Malls

Like any other sector, the retailing universe attracts firms that supply crucial technologies or services. These "pick and shovel" makers frequently thrive even when (or especially when) many of their customers are failing and being replaced by upstarts. eBay, for example, runs e-commerce websites and offers fulfillment and processing services for third-party retailers. Banks, credit card companies, and tech firms such as Google, Apple, and eBay (with its PayPal subsidiary) are developing mobile payment services that are vying to become the standard for retail smartphone transactions. Oracle, meanwhile, offers a "commerce anywhere" software suite that "supports processes that help customers buy, pick-up, or return items via any retail channel and help retailers meet demand without constraints across those channels." The best of the above will see strong demand no matter which retailers win and lose in the coming decade.

On the real estate side of the business are the thousands of shopping malls that house all the bricks and mortar and that feel traditional retailers' pain keenly. As more people shop from home and anchor stores like JC Penney and Sears close, malls and the real estate companies that own and operate them are going through an identity crisis of their own.

Those that survive will look very different a decade hence, with non-traditional tenants playing a much bigger role, says Hottovy. "Fast-casual restaurants, furniture stores and other manufacturers wanting to show off their products" will move into the space that failing retailers are vacating. One especially interesting case is electric car maker Tesla, which is setting up showrooms in malls.

Some malls will themselves become fulfillment centers, aggregating customer purchases for pick up or delivery. It might be more efficient, says Anand, to centralize the packing and shipping at the mall rather than the individual store level.

These new ideas will not, however, be enough to prevent an upheaval. "The traditional mall is an outdated concept, and the coming decade is going to be very difficult," says Hottovy.

that will separate tomorrow's winners and losers include three other critical factors: the "stickiness" of customer relationships, susceptibility to online competition, and continuous improvement.

In a world where brand loyalty is fading and choice is expanding, retailing's holy grail is the enduring customer relationship. This is where Amazon rules, says Hottovy: "Its Prime membership comes with low prices and expedited shipping but also video streaming and [an e-book] lending library that fosters loyalty to that ecosystem." The best online retailers, such as Amazon and eBay, are protected by "wide economic moats" because of "network effects, cost advantages and intangible assets," says Hottovy. Other online stores must contend with the fact that building a website is easier than building a moat.

Where on the spectrum that runs from digital media (fatally vulnerable to downloading) to fresh produce (virtually immune to e-commerce) do a retailer's products fall? Threatened categories include office supplies and consumer electronics (because such things are easily researched and tend to be much cheaper online) and apparel (because of the emergence of ever-more-sophisticated and fun online fashion stores).

Among the less vulnerable retail businesses are home-improvement retailers, "thanks to the high weight/value proposition of their products (shipping items like lumber would be prohibitively expensive) and the specialized customer service that industry leaders like Home Depot and Lowe's offer," says Hottovy. Auto parts suppliers are another business with less vulnerability. Auto parts tend to be needed immediately and often require expert advice.

Websites age much more quickly than stores, so the e-commerce upgrade cycle has to operate on internet time. And brick-and-mortar chains must run their marketing and data processing on the same clock. "One reason online companies have done well is that they quickly integrate customer data into the value system of their online buyers," says Anand. "The store chains had the data but didn't do much with it. Retail marketing is evolving very fast, and the successful retailers will have to continuously differentiate their products and co-ordinate marketing across all channels."

KEY METRICS

Every major retailer claims to be marching boldly into the brave new world of data-driven marketing, mobile transactions, seamless platform integration, and high-touch customer engagement. The result is a torrent of optimistic verbiage and upward sloping graphs, some useful, some deceptive. So how does an analyst separate signal from noise to determine who is building real capital? Obviously, there is no preset formula, but five criteria in particular are helpful.

1. ONLINE SALES GROWTH. "The most obvious metric for measuring success across the retailing landscape is market-share gain. But this is famously difficult to measure," says Jean Roche, CFA, fund manager at London investment firm Hargreave Hale. "So it is exciting when, for example, a retailer upgrades its website and sees its proportion of internet sales double. I can think of two who have done this over the past year."

2. HOME-DELIVERY SPEED. "A true omni-platform retailer should be able to offer next-day delivery [in compact markets], and I would estimate that only 40% of UK retailers can currently do this," says Roche. "A failure to shorten home-delivery speed beyond the five-day standard (which is very slow here in the UK) is often a result of insufficient investment in logistics."

3. TRANSACTION QUALITY AND FREQUENCY. "Increases in the number of items and profitability per sale imply an improving customer experience," says Hand. A related statistic is the number of visits per customer. A friendlier environment, whether online or physical, should lead the average customer to return more often.

4. E-COMMERCE EFFICIENCY. A web store can be analyzed for conversion rates (the percentage of visitors who buy something), page load times (faster is better), engagement per page (the time a typical visitor spends on a page), and speed to purchase, Anand points out. "Especially in mobile, you need an environment that is agile in bringing the customer to conversion," he says.

5. TURNOVER AND MARGINS. For physical stores, the traditional metrics still apply. "Sell-through of merchandise is an indicator of the ability to increase sales and minimize cost of goods sold. This in turn helps determine operating margin, which is the crucial profitability metric," says Anand. For online stores, he adds, "The fulfillment cost per unit is critical for each product."

Combine these points about turnover and margin, and some general profiles emerge. A probable loser has a stagnant top line, falling operating margins, and online sales in the bottom 20% of peers. "These retailers are too dependent on store sales. Inventory is turning over too slowly and debt-to-equity is probably unfavorable," says Anand. "Their value will decline over time."

Winners will display the opposite trends, with rising same-store sales and widening margins implying that customers are satisfied and that, under the surface, the various new technologies and strategies are integrating smoothly.

All of the trends mentioned in this article are global. The same forces that make e-commerce and bricks-and-clicks such compelling ideas in the US and Europe create opportunities across the developing world. "Most of the top 100 retailers are looking overseas," says Anand. "It's a trend that has become extremely strong in the last 24 months."

John Rubino, a former financial analyst, is author of *The Money Bubble*.