T. Rowe Price®
INVEST WITH CONFIDENCE

PRICE POINT
May 2018

Timely intelligence and analysis for our clients.

Sector Outlook

THE "RETAIL APOCALYPSE": HOW DEVASTATING FOR BRICK-AND-MORTAR STORES?

KEY POINTS

- By 2020, e-commerce could account for virtually all of the incremental growth in adjusted retail sales, and Amazon's sales alone may account for more than half of that incremental growth.
- Some T. Rowe Price managers and analysts believe certain stores may stand better chances of surviving the "retail apocalypse" as they offer value, convenience, professional services, or luxury goods.
- Meanwhile, retailers are embracing the "omnichannel" model, with brick-and-mortar chains expanding online and e-commerce retailers opening physical stores.
- Still, Amazon is considered an "operational beast," with few markets seeming out of reach of its long tentacles—despite recent political criticism.

The U.S. "retail apocalypse," with thousands of stores closing in recent years due to e-commerce competition, begs the question: Is any brick-and-mortar store safe?

Indeed, the growth of e-commerce—particularly that of the singularly dominant player, Amazon—has been strong and steady.

At the end of 2017, e-commerce accounted for 18% of adjusted retail sales, according to the U.S. Census Bureau (Figure 1). By 2020, e-commerce could account for virtually all of the incremental growth in adjusted retail sales, J.P. Morgan estimates, and Amazon's sales alone may account for nearly half of that incremental growth. (Figure 2).

The disruption is all around. The list of large chains declaring bankruptcy and closing stores last year—among them, Toys "R" Us, RadioShack, and hhgregg—is long. That's in addition to other big-name chains closing many outlets, including Macy's, Sears, and J.C. Penney.

The U.S. "retail apocalypse," with thousands of stores closing in recent years due to e-commerce competition, begs the question: Is any brick-and-mortar store safe?

"We were in a very high-touch world that had very low price transparency," says Joe Fath, manager of the U.S. Growth Stock Strategy. "With Amazon and other e-commerce merchants, we've evolved into a lower-touch world with high price transparency."

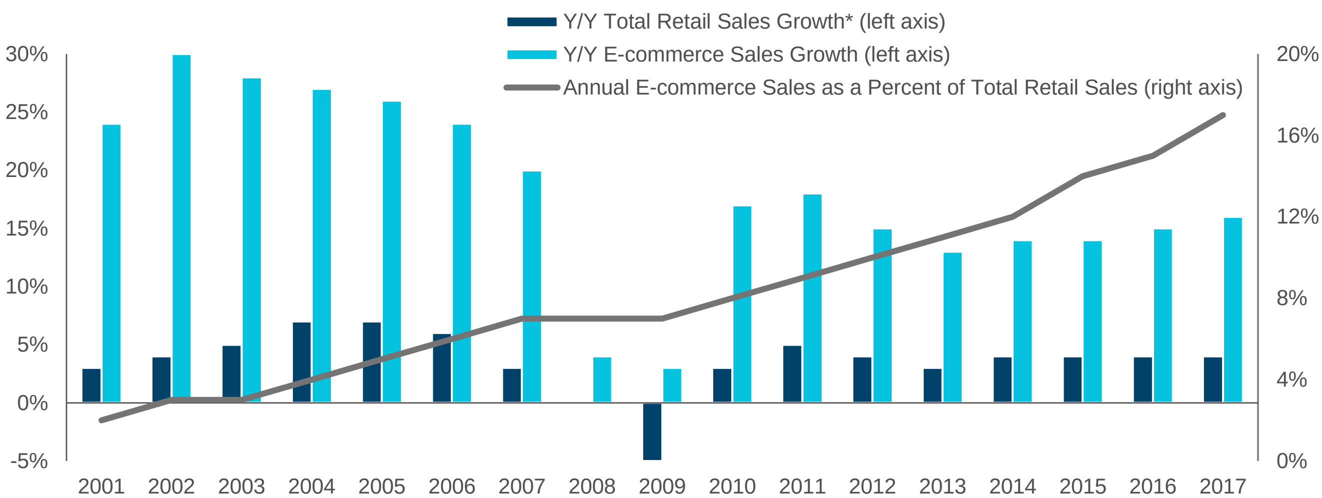
Adds Frank Alonso, manager of the U.S. Small-Cap Core Equity Strategy: "Not all retail is dead, but there's going to be a lot more destruction. Retail stores are largely a fixed-cost business, so there's a lot of stress when they lose sales volume and a disproportionate decrease in their profitability. Many haven't been able to right-size their cost structures fast enough."

Still, there recently have been encouraging signs for retail.

Holiday sales were the best in years, including at some of the more troubled chains. Wages and consumer confidence measures have risen, even before the tailwind from the recent tax cuts. Early in the first quarter of this year, some big retail chains reported surprisingly good earnings.

Figure 1: **E-commerce Contribution to Retail Sales—Retail Sales Rising, but E-commerce Growing Faster**

As of December 31, 2017



*Total retail sales exclude autos, food, and beverages. All data based in U.S. dollars.
Source: U.S. Census Bureau.

INSULATED?

T. Rowe Price managers and analysts often vary in their views. Some say certain kinds of brick-and-mortar stores may stand better chances of surviving the e-commerce onslaught. That's because they may offer value, convenience, professional services, or certain luxury goods.

"The retail narrative that many people have is very binary, that Amazon is going to destroy everything," says Jay Nogueira, manager of the Global Consumer Strategy. "The reality is a lot more complicated."

Figure 2: **Amazon (AMZN) Driving Retail Growth*—AMZN Growth as Percentage of Incremental Growth**

As of December 31, 2017

*Adjusted retail sales growth excludes autos and gas. Data for 2018–2020 are estimated.
Source: J.P. Morgan.

Among the brick-and-mortar outlets that may be relatively insulated for now, some managers and analysts say:

- **Off-price:** Discount chains—Ross Stores, T.J. Maxx, Burlington Coat Factory, Ollie's Bargain Outlet, and Five Below—sell apparel and other goods often acquired from other stores' overstocks.
- **Convenience:** Dollar General has built more than 14,000 small stores in 44 states, often in areas underserved by Walmart, offering low prices on food, housewares, cleaning supplies, health and beauty products, and other items.
- **Service:** Home improvement stores such as Home Depot and auto parts stores such as O'Reilly rely heavily on sales to contractors and repair shops, respectively, that often need a wide range of bulky or specialized items quickly on demand.
- **Luxury:** High-end retailers, such as Coach and Louis Vuitton, tend to control their pricing through their own stores, serving high-touch customers who perhaps are concerned with goods' authenticity.
- **Food:** Given the mammoth size of the U.S. grocery market—and the frequency with which shoppers buy food and other items at the same time—taking share in this category appears to be one of Amazon's ultimate goals. But so far food is the retail sales category least penetrated by e-commerce.

However, Amazon's purchase last year of Whole Foods (and its recent start of two-hour delivery from that grocer in certain markets) has accelerated e-commerce efforts at Walmart and other large grocers. There's also increased buzz about potential tie-ins, such as between Kroger, the nation's largest grocer, and Alibaba, the Chinese e-commerce giant.

"Whether companies can win versus Amazon or not is something you have to examine company by company," Mr. Nogueira says. "You really have to think about each company and their competitive position as to how exposed they are to digitization."

"AMAZON PROOF"

One chain that, so far, has stood its ground against Amazon is Best Buy. As a slew of other electronics retailers went extinct, Best Buy started to take drastic steps in 2013—cutting more than USD $1.4 billion in costs, closing stores, setting up vendor-run "stores within stores," focusing on selling various services, building its online channel, and matching any lower prices offered by Amazon.

In the process, Best Buy gained share from closed competitors, improved its fundamentals, and saw its stock price almost double from the beginning of last year to the end of January of this year—even outperforming Amazon's stock for some periods since then. All of this made Best Buy the poster child for countering Amazon.

"They emerged from the denial stage and reinvented themselves to survive," Mr. Fath says. "Whether they will thrive in the long term is an open question."

Jacob Kann, a T. Rowe Price retail analyst, is skeptical. He notes that Best Buy's share of the electronics market may have been overtaken by Amazon last year, continued cost-cutting will be hard to come by, and its margins will be pressured as its sales shift to online. He says growing online sales can cannibalize retailers' own store sales and lower their sales margins, making it harder to grow earnings.

That also may be a challenge for Amazon's most formidable competitor, Walmart, some managers and analysts say. Walmart is rapidly turning itself into an omnichannel retailer—by buying Internet vendor Jet.com in 2016 and significantly expanding its online sales since then.

However, in February, Walmart reported that its online sales growth for the fourth quarter of last year had slowed—though it still forecast 40% e-commerce growth this year. Meanwhile, Amazon is becoming an omnichannel retailer as well, not only with Whole Foods stores, but by opening book stores, testing convenience stores, and establishing a presence in Kohl's stores.

Across the retail landscape, many other stores also are moving to omnichannel strategies. However, Mr. Kann says that "this may be a necessary step but perhaps not sufficient for long-term earnings stability."

"We're not in denial about the disruption, but we think there will be companies in favor and at risk, and there will be a need for prime retail real estate. Ultimately, there're too many malls, too many stores, but there's a point at which retailers still need a certain physical presence."
—DAVID LEE, PORTFOLIO MANAGER

MALLS, BIFURCATED

Not surprisingly, the "retail apocalypse" has reverberated through large regional shopping malls, which some managers and analysts say were over-built even before e-commerce's acceleration.

As a result of the closing of large department stores that served as malls' anchors and of the name-brand apparel stores that proliferated, the number of U.S. shopping malls has fallen from almost 1,200 in 2009 to less than 1,050, according to Green Street Advisors. More closings are expected by T. Rowe Price analysts.

But David Lee—manager of the U.S. Real Estate Equity Strategy, which invests in real estate investment trusts (REITs) that often own malls—believes they are hardly doomed, particularly high-end malls.

"There will be a rationalization of the amount of physical space that's out there," he says, "because a lot of sales have moved online. But you're also seeing movement to having a physical presence as part of an omnichannel strategy, as well as a big bifurcation between primary retail destinations and others."

Primary malls, he says, may have an Apple store, a Tesla showroom, a high-end retailer, and perhaps a unique retailer with just a handful of stores nationwide, such as those that began exclusively online that now are experimenting with physical locations.

"These primary malls could be the beneficiaries of the consolidation in retail," Mr. Lee says. "These really good malls are running high occupancy rates and are still experiencing rising rents."

At the end of March of this year, the U.S. Real Estate Equity Strategy was overweight REITs that tend to invest in the top regional malls. While stocks of these REITs suffered last year, Mr. Lee says, "Investors have thrown the baby out with the bath water. Investment returns have been much more negative than earnings and growth would indicate.

“We’re not in denial about the disruption,” he says, “but we think there will be companies in favor and at risk, and there will be a need for prime retail real estate. Ultimately, there’re too many malls, too many stores, but there’s a point at which retailers still need a certain physical presence.”

AMAZON’S FUTURE

Amazon, which began as an online bookstore in the mid-1990s, is well down the path of becoming what’s been dubbed “the everything store.” Few markets seem out of the reach of its long tentacles, despite some recent political criticism.

Beyond its estimated more than USD $250 billion in retail sales volume, its dominant and highly profitable Web services business, and its growing advertising business, Amazon announced just this year that it would form a health care consortium, launch a delivery service to compete with the top national shippers, sell medical supplies to hospitals and clinics, offer discounted memberships to Medicaid recipients, and purchase Ring, the smart doorbell company.

Amazon’s fundamental strength in retail sales is its aggressive investments over the long term to build a platform that delivers price and product transparency that no one likely will be able to match, says Paul Greene, manager of the Media & Telecommunications Equity Strategy and the firm’s Amazon analyst since 2009.

“Amazon’s cost of delivering an item to your house is way below everyone else’s, and the gap keeps growing,” he says. “They’re two decades ahead of everyone else. Walmart talks about it, but they don’t even have the right infrastructure.”

Amazon currently has scores of U.S. distribution centers of various kinds. As it further builds out that network, Mr. Greene says, it likely will expand its free two-hour shipping to millions of items from just 100,000 now—potentially opening inroads into such categories as servicing professionals who rely on home improvement and auto parts stores.

With greater warehouse density, he adds, Amazon’s grocery business also could take off, triggering something of a self-reinforcing cycle: The greater frequency of food deliveries could lower Amazon’s marginal costs to deliver more profitable items, in turn driving more business and warehouses.

Adds Larry Puglia, manager of the U.S. Large-Cap Core Growth Equity Strategy: “The key is that Amazon is not a product. It is a continuously improving logistical and operational process.”

That said, both Mr. Greene and Mr. Puglia foresee more brick-and-mortar stores in Amazon’s future—based on the direction taken by two of China’s top e-commerce companies, Alibaba and Tencent, which recently have invested heavily in physical stores in order to expand their payment systems, logistics networks, and breadth of customer data.

In the very long run, Mr. Greene says, Amazon—with its vast logistics capabilities—could end up running the warehousing, inventory, and shipping for many brick-and-mortar retailers, including even some that might not even offer their products through Amazon.

“Amazon,” he says, “is an operational beast.”

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.