Why category leading brick and mortar retailers are likely the biggest long term Covid beneficiaries.

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19-24 minutes

I believe the biggest long term beneficiaries of Covid will prove to be category leading brick and mortar retailers. By this I simply mean brick and mortar retailers who have dominant share in a category — whether it be home improvement, general merchandise, electronics or any other retail category. Their destiny has likely changed forever. Many of the perceived Covid winners such as e-commerce, videogame and streaming media companies have simply been pulled a few years forward into a future that was inevitable. Their destiny did not change. The future for those businesses simply accelerated whereas the future for category leading "brick and mortar" retailers has changed dramatically as a result of Covid, more so than for any other business of which I can think. It is likely that food delivery and videoconferencing companies are also permanently advantaged due to Covid, but the change in ultimate outcome is not as extreme as I think it will be for category leading brick and mortar retailers.

Said another way, long term steady state FCF will likely be the at the same level for many e-commerce, videogame and streaming media companies as it would have been before Covid. This is not to say that Covid did not increase their value; it did but primarily by pulling their financials forward a few years which obviously matters in a DCF. Whereas long term steady state FCF will likely be significantly higher for category leading brick and mortar retailers who had reasonably strong e-commerce businesses coming into Covid. Especially so for those category leading retailers who operate in inflationary categories where inventory turns are less important than they are in deflationary categories where e-commerce only companies have structural cost advantages due to faster inventory turns.

The future was always going to be omnichannel. Pundits have been prematurely predicting this for many years, but it is finally happening. There is a strange belief in certain circles that the future will be e-commerce only and that brick and mortar stores have no value. This is strange because the worlds largest, most sophisticated e-commerce companies are all opening stores. Lots of stores. Amazon opened dozens of "Amazon Go" stores in 2019 and is reportedly planning on opening up to 3000 of these stores by 2021 in the United States alone. Amazon already has multiple store formats in the United States: Go, Whole Foods, Book Stores and others. In his 2017 letter to shareholders, Jack Ma wrote that "Commerce as we know it is changing in front of our eyes. 'E-commerce' is rapidly evolving into 'New Retail.' The boundary between offline and online commerce disappears as we focus on fulfilling the personalized needs of each customer." Alibaba is rapidly opening several different store formats throughout China. JD is also rapidly opening stores. Wayfair has stores. Led by Warby Parker, most DTC branded startups have stores.

The value of a physical retail infrastructure has been clear since Amazon made their largest acquisition ever, Whole Foods (* see addendum below for more on this). Brick and mortar stores have tremendous online value in addition to enabling true omnichannel commerce. Nothing matters more for an e-commerce company than marketing efficiency expressed either as gross margin $ payback period or the ratio of CAC to LTV. Brick and mortar stores significantly lower online CAC by improving marketing efficiency (higher click through rates, higher quality scores for ads). Consumers are more likely to trust a brand they have seen in the real world. Ironic in a world where “CAC is the new rent” that one of the best ways to lower your online rent, i.e. CAC, is to pay rent offline for physical stores. Brick and mortar stores also enable BOPIS (buy online pickup in store) and the in-store return of items purchased online, which consumers value. Economically, BOPIS will always be cheaper than same day delivery and large numbers of consumers are highly cost sensitive.

Despite all of these advantages conferred by owning a physical retail infrastructure, most brick and mortar retailers were painfully slow to embrace e-commerce and omnichannel. An entire generation of management teams effectively ceded the future to Amazon because of objectively incorrect beliefs about e-commerce profitability and internal cultural issues. In some ways, the bursting of the bubble in 2000 was the best thing that ever happened to Amazon. The bursting of the bubble, the collapse in Amazon’s stock price and the aggressive way Amazon ran their business convinced most retail executives that e-commerce was unprofitable. In reality, Amazon’s US e-commerce business likely became significantly profitable more than 15 years ago, but they invested aggressively in new categories and new geographies which masked this fact for people doing superficial analysis.

Amazon actually did periodic “check-ins,” to ensure that their investments were actually profitable — i.e. they were always a super financially disciplined organization driven by FCF and ROIC, but Bezos liked to “check-in” every so often to make sure that their investments were rational investments with a high ROIC that drove FCF. They did these check-ins regularly, most notably in 2004 and 2009, and showed that they could generate significant FCF margins while still growing rapidly. Yet long after these “check-ins,” retail executives continued to believe Amazon was unprofitable. I vividly remember a well regarded retail CEO explaining in 2012 that e-commerce was unprofitable based on Amazon’s headline profitability numbers. At that point, it should have been obvious to even casual observers that Amazon’s US e-commerce business was consistently running between mid single digit to low double digit EBIT margins and funding their international expansion.

It was not until Wal-Mart bought Jet.com in 2016 that retail executives began to broadly wake up and embrace e-commerce. Marc Lore was the CEO and founder of Jet.com and an excellent e-commerce executive who had founded diapers.com and soap.com (urban legend is that he and Tony Hsieh both sold to Amazon because of Sequoia’s RIP Good Times memo from 2008). Marc Lore told everyone who would listen that Amazon was consistently running 8 to 10% FCF margins in North American retail, that no one was competing with them and that there was an opportunity to build a large, profitable competitor in America. I was a board observer for Jet.com and believe acquiring it was profoundly important for Walmart and woke up many other retailers to the importance of aggressively investing in e-commerce.

Beyond an erroneous belief that e-commerce was unprofitable which kept them from investing in e-commerce, brick and mortar retailers struggled online for cultural reasons. The most important functions at a brick and mortar retailer were generally real estate and merchandising. i.e. Getting the right store locations at the right cost and then filling those stores with the right products at the right prices. Unfortunately, both of those functions were largely irrelevant online — a URL was your store and you had endless shelf space. Data and analytics mattered much more online than having a great team of human merchants. There was a great story in the “Everything Store” about how the algorithms outperformed the human editors that Amazon employed in their book section. A culture of relentless A/B testing and data driven decision making was essential to online success.

Retail was still detail online, but it was a different kind of detail that mattered. Obviously a lot more goes into brick and mortar success than just store locations and merchandising, but those are the two necessary conditions. It doesn’t matter how clean and well lit your stores are and how friendly and knowledgeable the employees are if the stores are in the wrong place at the wrong cost or they don't have the right products at the right prices. All of these are important, hard to master skills essential to retail success, but real estate and merchandising were the strategic power centers at most retailers. And almost none of these critical functions mattered online. As an example, all brick and mortar companies had marketing budgets. E-commerce companies often do not have a strict, annually allotted marketing budget — they simply spend to a gross margin $ payback or LTV calc (I prefer the former) subject to a FCF constraint. The path to success was simply very different online vs. offline both culturally and functionally.

Covid has changed all of these dynamics for category leading brick and mortar retailers. If most e-commerce companies have been pulled 1–3 years into the future in terms of their revenue, then the e-commerce businesses of most category leading brick and mortar retailers have been pulled 5–10 years into the future. Covid has permanently changed their destiny and driven significantly higher long term steady state FCF outcomes for them. I sometimes think that investors do not appreciate how large and rapidly growing the e-commerce businesses at some of these category leading retailers are. Wal-Mart's digital revenue in Q2 was an annualized $42 billion, growing 94% — faster than Amazon. Best Buy's digital revenue in Q2 was an annualized $19.4 billion, growing 242% — faster than Amazon. Some will quibble about the inclusion of BOPIS revenue, but I think this is fair as it is a very different experience than actually going into a store.

Perhaps the simplest way to express what has happened during Covid is to note that Amazon has actually lost share in e-commerce during Covid. The largest e-commerce share gainers in most categories have been category leading physical retailers as well as the DTC businesses of most brands. Amazon is still growing really fast, but this is due to growth in the market for e-commerce. They are factually losing share of e-commerce which is a significant change, albeit one that had been in process for several years. There were years pre 2016 when Amazon was taking roughly 100% incremental share of e-commerce and well over 100% incremental share of total retail sales. While Amazon is gaining share of retail spending, they are losing e-commerce share and this is manifested in the fact that they are growing slower than the overall market for e-commerce.

Amazon's retail business may actually be disadvantaged long term by Covid due to more intense long term competition as thousands of SMBs have taken advantage of services from Wix, Shopify, etc. to go online, category leading retailers are investing online like never before and brands are investing in their DTC strategies — all at the same time that Amazon may have begun to erode consumer trust with advertising. The "buy box" used to be sacred at Amazon — the best reviewed product at the best price drove placement in search results — not advertising. Consumer trust is difficult to gain and even harder to regain. While allowing advertising to dictate the buy box was immensely effective at increasing their take rate (anyone who believes this is actually advertising is confused — Amazon is just increasing their take rate and calling this dynamic advertising), this may end up being a very profitable short term decision that creates significant long term pain. Amazon is a phenomenal company and I am sure they will adapt, but Covid may have led to a significantly more competitive environment for them. Regardless, these e-commerce share gains for brick and mortar retailers are not going to be transitory.

The first long term benefit of Covid for category leading retailers who are taking significant e-commerce share during Covid is that for the first time *ever* at many of these companies, e-commerce is being resourced and managed appropriately while taking advantage of all the online advantages conferred by their store networks. I suspect this is the first time that the online analytics team is as important to the CEO as the merchant. This is a profound cultural shift at many of these companies that is likely to be enduring. **Nothing accelerates change like success.**

These retailers also all now understand the playbook they need to run online — they can simply copy what worked for Amazon. Every category leading physical retailer will have a

3p marketplace. These 3p marketplaces will benefit from integration with the stores in the sense that many new DTC brands will not sell on Amazon, but will happily sell through other 3p marketplaces especially if they are attached to a fleet of thousands of stores and the owner of the 3p marketplace and those stores commits to showcasing their brand in-store on a temporary basis a few times per year. Software is also making it easier and easier for sellers to sell into multiple marketplaces.

Beyond cultural realignment and a clear path to follow, the raw numbers in terms of new customers and incremental revenue are going to really matter. Skipping 5–10 years ahead of plan in e-commerce and taking e-commerce share will permanently matter to these businesses. Scale matters more online than offline. Online scale drives significant advertising efficiencies which are one of the most important inputs to e-commerce success. Massive growth in new customers, especially those who repeated quickly, will matter. This customer growth is manifest in the significant growth in app downloads, traffic and commentary on quarterly calls. Credit card data clearly shows an improvement in customer retention and cohort dynamics over the last few years for category leading retailers as their e-commerce % of revenue improved. These retailers will benefit for years from the customers they acquired during Covid.

Beyond scale based advertising efficiencies, physical costs also scale online — even more variable costs like shipping benefit from scale based on the UPS and Fedex rate cards. One of the more interesting observations from attending Jet.com board meetings was that almost any small e-commerce acquisition was accretive as Jet could immediately lower shipping costs for the acquired company by at least 10%. All this manifests in the fact that the revenue increases from e-commerce for category leading retailers have not been at the expense of profits — margins at BBY were flattish YoY and margins at WMT were up despite their mix shifting to more digital.

There is a lot of concern from retail analysts about "comping the comp" in 2021 and for some retailers, consensus estimates embed a belief that July 2020 will be a 3–4 year high for quarterly EPS. While growth is obviously likely to slow in 2021 and might even be modestly negative in July 2021, the idea that July 2020 will be a 3–4 year high for quarterly EPS is at odds with the last 20 years of e-commerce history. I have looked at cohort curves for dozens of e-commerce companies across multiple categories and geographies and I can make one authoritative observation. Once you have a customers name, email address, mailing address and credit card data saved in an account they created and that customer has made two or more purchases, the odds that they continue to repeat are high. Even more so today with the ease of saving your password in Safari, Chrome and IOS or logging into an app with FaceID.

Beyond the convenience of shopping where you have saved your information, habits matter. And BOPIS has become a new habit for many consumers. Evidence from a 2009 study suggests that it takes 18 to 254 days to form a new habit with an average of 66 days. Covid has gone on long enough for consumers to form new habits in terms of both where they shop and how they shop. BOPIS will always be the cheapest same day delivery service because the consumer is effectively paying for the cost of the delivery by driving themselves to the store. Definitionally, category leading retailers have fairly optimal store locations for BOPIS and in-store returns. It would not surprise me to eventually see BOPIS hubs emerge at malls and shopping centers — "dark stores" — a reverse retail analog of dark kitchens. Shop many stores and pickup once. Will be interesting to see which companies can aggregate this experience.

All of these dynamics advantage category leading brick and mortar retailers for the simple reason that it requires a significant amount of technology infrastructure to manage an omnichannel experience — i.e. in store returns have complex impacts on the tax nexus. New customers who have formed new habits and repeated multiple times combined with structural semi-permanent advantages from increased online scale and BOPIS are why I am reasonably confident that these e-commerce gains will not be transitory.

Beyond acquiring millions of new customers, seeing their e-commerce business reach levels in 2020 that most brick and mortar retailers likely did not expect until 2025–2030, experiencing profoundly positive cultural shifts and aggressively resourcing e-commerce for the first time, these brick and mortar retailers will face a significantly less intense competitive environment when consumers do begin shopping online again. Generally speaking, their weakest, most leveraged, most discounting prone competitors have gone bankrupt during Covid. So in addition to a structurally improved e-commerce business that should persist post Covid they will have a stronger offline competitive position post Covid.

The in-store experience will also continue to evolve and likely be more informed by online learnings. We will all eventually pay by face in stores, there will be personalized marketing while we are in stores, technology should significantly reduce shrink, knowing what customers near stores are shopping for online for should eventually help optimize instore inventory and distribution systems will be optimized for e-commerce, BOPIS and in store return in addition to simply shopping in the store. The more data driven cultures that are emerging at these retailers will be helpful to all of this. Frequency also really matters online and omni-channel drives more frequency, which creates more data, which will drive a better customer experience both online and offline.

Time will tell, but I am reasonably confident that category leading brick and mortar retailers are going to be the biggest long term beneficiaries of Covid. These retailers used to be called “category killers,” but that terminology has fallen into disuse as it seemed silly in the face of Amazon. I suspect we will begin to call them “category killers” once again.

The end

*As a sidenote, Amazon’s acquisition of Whole Foods led to the largest day of portfolio turnover of my investing career. At that point, I had been massively underweight brick and mortar retail and significantly overweight e-commerce companies throughout my tenure on the fund. A simple projection of the end state for e-commerce based on it’s incremental share of retail spending (total share asymptotes to incremental share in any growing market) suggested that e-commerce would ultimately be close to 50% of US retail spend which meant that a massive number of stores needed to close over time. But I was beginning to be open minded about the idea that physical retail infrastructure had value circa 2014. Niraj Shah, the CEO of Wayfair, who I regard as one of the ten best CEOs in the world today, was beginning to speak openly about the value of physical stores. Seeing Amazon make it’s largest acquisition ever was an enormous validation of the value of physical retail infrastructure, yet most retailers were down 5 to 15% that day on the absurd idea that owning Whole Foods would make Amazon more competitive with them. It was not as if Amazon was planning on stocking Whole Foods stores with consumer electronics, apparel, furniture or home improvement items yet all of these companies were down significantly. That let to me turning over almost $2 billion of my fund in a single day as I bought the weakness in physical retailers aggressively.

The real end