Which retailers could survive digital disruption?

by Roger Montgomery

To better understand retailing's future, it is important to examine its development to date and to look at countries where its future is already being embraced, such as South Korea and China.

The rate of growth of online retail is well above that of off-line retailing and the result is a loss of market share for those brick-and-mortar retailers not online. The end result is a loss of revenue and profit that has caused many retailers to collapse in 2017.

Of course, the growth is not being entirely driven by retailers themselves. One example of the changes being faced by retailers is the ability of mobile technology to remove borders for consumers. Another is the growth of large online retailers, which has improved the economics for logistics companies and this has translated into efficiencies for small retailers, enabling them to compete more effectively and proliferate. Improvements in living standards, a burgeoning number of brands and rapid changes and uptake in technology have driven changes in consumer preferences. The convenience of online shopping has also allowed, or seen consumers dedicate more time to, entertainment, travel, eating out and even working.

Another obvious development is the change in the value and perception of advertising. Consumers trust what a brand says about themselves less than what other shoppers have to say. Social media has therefore usurped the traditional channels for retailers to articulate their messages.

According to various outlets, e-commerce penetration is highest in the Asia Pacific. But this does not include the more mature markets of Japan, Hong Kong, Singapore and Australia. To date, however, these countries haven't had the benefit of legislation that supports the growth of digital payment methods, nor have they welcomed Amazon, until recently in the case of Australia.

It is likely that continuing advances in e-commerce technology will bring further cost advantages, and with that, the future of e-commerce retailing will see the simultaneous development of mega online retailers, such as Amazon, and millions of smaller competitors.

The next stage will be the rise of the premium online retailer and the e-selling of perishables and bulkier items. This will occur once e-commerce is able to establish trust and is likely to coincide with a slowing of online volume growth – retailers will be forced to increase their average selling prices to combat flat volumes and increasing churn. Any remaining compelling reason to shop at a department store will then disappear.

Let's take a look at three retail stocks.

1. **JB Hi-Fi (ASX: JBH)**

The arrival of Amazon was well flagged and JBH had plenty of time to prepare. The company has made some changes to its supply network and to its online offering. The RBA has said that consumer confidence is improving and that wage growth will remain muted, ensuring margins should be maintained for better quality retailers.

In the short term, lacklustre iPhone 8 sales were due to the delayed release of the iPhoneX, which did have had an impact on traffic initially, but gaming hardware releases such as Nintendo Switch and Microsoft's Xbox One X console, should help to support like-for-like or same-store sales growth.

The longer-term threats, however, remain and some categories (small electronics and music) could be at significant risk of being hollowed-out by the changing

e-commerce landscape and bulky goods (Good Guys) are likely to come under pressure from the slowdown in residential developments applications and commencements.

2. Afterpay Touch (APT)

For those looking for a growth company with exposure to the retail sector, it may be worth your while investigating Afterpay Touch. Afterpay is a digital payments system that provides consumers with short-dated, interest-free, unsecured credit at the point-of-sale, but without the manual credit checks required by banks for products like credit cards.

Afterpay has grown rapidly over the last two years. From a standing start, it annualised over $1.5 billion of purchases in the quarter of September 2017, which is around 7% of all online transaction value, excluding groceries, in Australia.

Afterpay is using its first mover advantage to build strong brand awareness with consumers and retailers, evidenced by its name being increasingly used as a verb – Afterpay it! While its current share price is factoring in a substantial increase in earnings, the product has significant growth potential, which in the current retail landscape is certainly a rarity.

3. Myer (ASX: MYR)

Myer suffers from a compelling offering that is now knocking on the door of irrelevancy. To prove the point, the loss of a Myer lease at a Westfield shopping centre in Hurstville saw the space reformatted and relet to mini-majors and specialty food stores, and resulted in revenue almost tripling. And Myer's strategy involves reducing space or closing more of its department stores.

Whether it is imposed by management or consumers, whose habits are changing, Myer appears destined to be a smaller business.

The 'New Myer' strategy appears not to be working to stave off declines, as indicated by the recent press and upheaval in leadership. In the most important month of the year for department stores (a month where sales should be up), December sales declined after a slight increase in November. As a result, the company has reported that 1HFY18 NPAT will be 'materially below the previous corresponding period.

And investors should keep in mind that the first half results have a much larger impact on the full year results. Many retailers often lose money in the second half, which doesn't include Christmas.

Many analysts are now forecasting the company will suspend its dividends. Myer is a classic and real-life example of the aphorism Warren Buffett has shared; "When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact."

A significant and hitherto unseen turnaround is required to prevent Myer shrinking into retailing history.

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