NEUBERGER | BERMAN

The Reality of Retail: Apocalpse or Renaissance?

Disruptive Forces in Investing

January 28, 2019

Anu Rajakumar: Over the last few years, the retail sector has been hit hard by changing consumer habits. Indeed, in 2017, the term "retail apocalypse" was coined to describe the effect of multiple major retailers announcing their bankruptcy, restructuring or indefinite closure. But despite what seems to be a challenged sector, our guests today argue that retail is growing, and there are in fact unique opportunities for savvy investors in this space. My name is Anu Rajakumar, and on today's Episode of *Disruptive Forces*, I'm joined by Sam Porat and Zack Sigel. Sam and Zack are part of the Marquee Brands team on the Neuberger Berman private equity platform, making high-quality brand investments in the consumer and retail sectors. Sam and Zack, thank you for being here.

Zachary Sigel: Thank you for having us.

Samuel Porat: Nice to be here.

Anu: Now, this is obviously a topic that almost everyone can relate to. Why don't we take a step back and talk about the disruption in retail over the last decade or so?

Sam: Sure. Well, retail is really undergoing significant changes and I think we can all see that, every day when we pick up the newspaper and see bankruptcies and store closures. We actually use that figure at Marquee to give a leading indicator of where the industry is heading. And you can see that, in an average year, there may be about 2,500 or so stores that are closing just through, typical economic turmoil. In a year like 2008, that was about 6,000 stores. Well, in the last three years, 2017, '18, and '19, on average each year was about 7,300 stores. So there's a lot of change.

Anu: Really high, yes.

Sam: Yeah, tremendous. And I think, that's being driven by changes in the marketplace that are quite fundamental. First of all, consumers are shifting more and more online; so, online sales at, sites like Amazon; but others have grown as a percentage of total retail, from about five percent, a little bit more than a decade ago, to about 15 percent now. And that's quite a significant change across all of retail. In addition, there is a generational shift happening in America, and the Gen-X and baby boomer generation is giving way to the millennial and even the Gen-Z, who are starting to get more and more wallet share and becoming a bigger part of the consumption pie. And they have different values and are looking for different things. At the same time, we see big discounters like a TJ Maxx or a Ross becoming a bigger part of the retail marketplace and creating a lot of change as well.

Anu: Thank you. And so Zack, as the consumer has increasingly shifted to ecommerce in recent years—and I know I personally can relate to that—what does that mean for traditional brick and mortar stores? Sam just told us about the number of store closures in recent years. Will they eventually completely disappear?

Zack: Sure. Well, the short answer is no. We do not believe that, that stores will completely disappear. But we do believe that you will continue to see store rationalization and stores really utilized for different purposes that historically they have not been. At the end of the day, we still think that there's a need to meet the consumer where he or she is shopping. You're seeing something very interesting happening with the convergence of digitally native brands and brick and mortar retail business models. Just to give a few examples, Warby Parker, a company that a lot of people know, originally an ecomm only business selling eyewear. Warby Parker has a hundred stores today. Why do they have a hundred stores? Because they're providing the customer with an experience and also I think that the company probably realized it is important to go to a store and and try on glasses. Bonobos is another digitally native company. They have more of a fitting room model, I guess I would call it whereby if you go to that store and especially in men's tailored clothing, it's important to go in and try on a shirt or a suit or pants. But what you'll notice is that they don't have a lot of inventory. So oftentimes they may have only a few pieces in the store. The customer can go try it on but ultimately will place their order online. And then there's examples like Peloton, a company that I'm sure everybody knows now. And Peloton has more of a showroom model where, again, it's important before somebody goes and makes that purchase, they can go to the showroom and test the product. You're also seeing two other concepts which I'll highlight quickly in retail. One is pop-ups, which are short-term stores, whereby the leases are not long-term in nature. There's not a large obligation to a landlord. There's not a lot of inventory risk, and brands can have pop-ups really for more of a marketing angle. And then what we call concessions, which are a store-in-store model. So if you go into a department store, you may see sort of a store-in-store concept, and those have been fairly successful. And then at the same time, traditional retailers are rationalizing stores. There's a lot of examples where a retailer that had 500 stores, might now have 40; and even if those 40 stores aren't hugely profitable, they're in key markets, and they're very important just to market the overall brand. And then finally, there's still value in the ability to collect and monetize, customer data, and a lot of companies are thinking about new and innovative ways, really to use this technology at the store level to monetize this data and create revenue.

Anu: Yes. So on that last point about collecting, monetizing, customer data, I'm wondering if you have any examples you could share.

Sam: Sure. I think, better retailers are finding ways, to use technology, really, to drive sales. And you know, we've all probably experienced different examples of this. If you've ever been surfing the internet, and you see digital ads of products that maybe you've been searching for, companies are using, tools, and software to personalize advertising and to provide product recommendations that are tailored to you. If you are physically walking around in a mall or in a store, retailers are using technologies related to the cell phone like geofencing, which can identify physically where you are. And if you're near a store, they can serve an ad or a promotion. So maybe you get a coupon for 10 or 15 percent off a product and you're right there, and that stimulates a purchase decision. We've all seen platforms like Instagram, in the last couple years in particular, really accelerate their ability to deliver shopping experiences direct from the site. So maybe there's a post that you like with a handbag, and you can click right on the picture and go to a third-party site to transact and get that product specifically. As a marketer, you can test different promotions in real time and make changes from week to week really through data analytics tools. And as analytic tools and rich data expands, the capabilities will expand as well. And as we look to the future things like, AI, virtual reality, facial recognition software, all have a lot of implications in the new future of retail and shopping.

Anu: And maybe just sticking on the theme of technology—one aspect that is really important in retail today is, you know, supply chain and logistics. How has that impacted retailers today, and what are you seeing in terms of that evolution?

Sam: So I think one of the, aspects of the Amazon, growth is what we sometimes call the Amazonification of the supply chain. So as a customer having an online shopping experience, it's quite typical that you might, buy three things online, and then over the next two to three days, you get two or three different packages and you probably don't think much of it as a consumer. But what's happening in the background is really quite sophisticated and in some cases you might be buying that product from an Amazon warehouse. In other cases, a retailer is taking customer data delivered to them from Amazon, and what we call drop shipping that product directly to you through a different logistics and supply chain. And that, infrastructure which has really been built up in the last few years on the backs of company like Amazon and others, allows smaller retailers and some of the folks that we're involved with to piggyback off of that infrastructure and to really deliver products to customers in different ways. And retailers themselves also don't need to invest heavily in the infrastructure and distribution centers that they once did. They're able to use technology and third-party logistics companies to deliver product directly to consumers one by one instead of bulk to store through distribution centers. And, many of these logistic companies in and of themselves have gotten to be very big and sophisticated organizations.

Anu: Yeah, that's great. Thank you very much. And so now, Zack, how and where do you find these opportunities in this kind of environment, kind of leveraging off of what Sam just told us?

Zack: We're seeing brands, with a great identity, a DNA, a reason to exist with the consumer; broad product categories, broad geographies, and broad distribution. However, they are trapped inside of this, challenged or old retail model. Now why are these companies challenged? Those reasons include they may have too many stores, they may have too much debt, there could be just a lack of investment in and around marketing and ecommerce; but a host of reasons whereby these companies may be challenged or unprofitable. And just to give some examples of that, whether it's a BCBG, which, at one point had 300 plus stores and now has 40 but is still a highly, desired brand across the globe; whether it's Martha Stewart; whether it's Ben Sherman, Joseph Abboud actually today it was just announced that that was sold or even a brand like Sports Illustrated. In all of those situations what you've seen is that the brands themselves the intellectual property has traded separate and apart, if you will, from the traditional company.

Anu: So now how do folks obtain only that brand that they have familiarity with if they're sort of stuck inside a company?

Zack: Yeah. It's a good question, and it's complicated. Bbut what I would say is, when you think about a traditional company, vertically run company, there are several pieces of that business. But those pieces will include oftentimes, retail stores. They'll include, inventory, liabilities, corporate headquarters, warehouses, supply chain. And then they'll include a different part of the business, which is more of the intangible assets, which is the intellectual property, the trademarks. They may have existing licensing agreements and contracts. And there are certain situations whereby you can bifurcate the business and that the core, what we call sort of operations—which, again, is the inventory and the leases and the supply chain and the manufacturing—that can effectively be sold to a best-in-class manufacturing partner. Again, these are, you know, companies that do that for a living. And then the brand can be sold to another partner. And the reason it works is because ultimately you have two experts and each part of the business sort of falls within those companies. And then you have somebody owning the brand that's really pouring the marketing back into it, handling the content creation, the social media aspect of it, and then you have the, manufacturer who's figuring out sort of a better, more efficient way to market.

Anu: Right, for, for the operations, essentially.

Zack: Exactly.

Anu: So now, going back to some of the, the trends that you've been seeing, you know, interestingly the off-price and discount retailers like TJ Maxx have actually seen pretty good growth over the last few years with the new store openings, in contrast to a lot of other traditional stores, which have been closing, as you mentioned, Sam, earlier on. Can you explain that phenomenon a little bit?

Sam: Sure. And it's actually interesting you bring up TJ Maxx. Many people that we talk to are surprised to learn that TJ Maxx's market capitalization, for example, very recently about $85 billion, is more than six times the size of Macy's, which is the largest, U.S. mainline department store. And it's not just TJ Maxx. There's Ross, Burlington. There's the clubs and others as well. And at the same time that they've grown, they've grown margin and the traditional department stores have gone the other way. So the growth has been quite significant and they've grown in number of stores as you mentioned, but also profitability. I think we talk a lot about ecommerce for good reason. But the consumer has struggled over the past decade since the financial crisis. And in some of those years, discretionary income growth has been small to negligible. And so, the discounters in general, and TJ Maxx is certainly the biggest example, they all deliver great brands at a great price to the consumer by the way, they're actually, good businesses, for wholesalers to sell to and you can make just as much money, if not more, as a kind of dirty little secret in our industry. But they deliver a good, value proposition overall to the customer. And I think that's really the reason for their growth. And look, not everyone in America can afford, an Amazon Prime membership and it's cost every year. So there needs to be a place for those folks, too and these discounters serve that role.

Anu: Another interesting trend, particularly in 2019, has been, climate change and sustainability, which were key areas of interest for investors and consumers alike. How did these trends relate to the retail sector? And when I ask this question, I'm thinking about recycled clothing, rental fashion services, eco-conscious brands, et cetera.

Sam: Well, I think as consumption is being taken up more and more by millennials and Gen-Z, you can see, as we said earlier, that their values are changing as well. And having a low environmental footprint is important to those customers, and you've seen that in how companies market their products. You've seen that in how packaging for example, has changed. A lot of companies are using, less and less plastic. Also new business models have arisen to meet those demands. And so you get a company like a Rent the Runway, where you can essentially recycle, higher-end dresses and apparel from customer to customer or a company like The RealReal, where you can essentially sell clothing that you're not interested on a kind of a consignment basis. These are new business models that are arising to meet some of these changing consumer values. And I think that is in early innings of playing itself out.

Anu: Excellent, and finally, maybe to you, Zack, as we wrap up this episode, what's your outlook for the retail sector going forward? Should we fear this retail apocalypse, or should we embrace it?

Zack: Well, apocalypse is a very scary-sounding word.

Anu: It is, yeah. Maybe a little extreme.

Zack: What I would say is that we think we're going to see, frankly, more of the same. That may sound like a boring answer, but what I mean by that is certainly increased store closures, especially in mall-based retail. We think that the availability of some of these great heritage brands, will continue to rise because of the retail dislocation, which I, which I spoke about. And we continue to think that digitally native brands or largely ecommerce companies will see value, in retail stores. I think that where we sit today, it's really about, playing the consumer to where the strengths are. At the same time, we think that—and we're already seeing it—that companies will put a lot of effort and investment into some of the more creative ways to play retail, which include concession models, pop-ups, more of the experiential store, if you will. At the end of the day, you know, while ecommerce is, is very powerful and will continue to grow, there is still something to be said about going to that store, trying on the product, seeing it, touching it; and if the retailer is successful, creating a unique, experience for the consumer.

Anu: Great. Thank you very much, and that'll do it for this episode. Sam, Zack, thanks to you both for being here today. Very interesting to hear your perspective on the landscape and opportunities within the retail sector.

Sam: Thank you.

Zack: Thank you.

Anu: If you enjoyed listening to today's podcast, please subscribe via Apple Podcasts or Google Podcasts. You can visit www.nb.com/disruptiveforces for more information about our firm and offerings.