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Investment Insights

Secular Change in the U.S. Retail Sector

June 2015

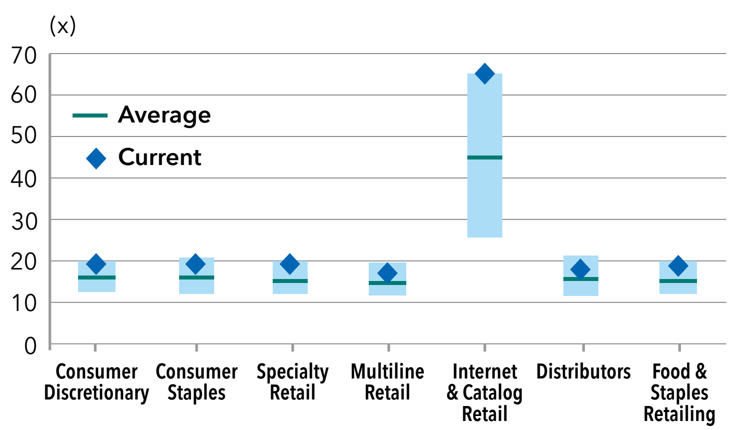
Retail's Shake-Up Creates a Secular Investment Opportunity.

Summary

- Consumer spending is likely to accelerate, supported by a healthy job market, improvements in U.S. housing and upward pressure on wages. This should benefit consumer stocks.
- Valuations on consumer stocks are not cheap and rising rates could be a headwind. But there are many supporting factors as well.
- The secular trend toward online shopping is disrupting many areas and is likely to generate new winners and losers – creating opportunities for stock pickers.
- Restaurants, home improvement and grocery stores are some new areas where the disruptive impact of e-commerce is contributing to upheaval.

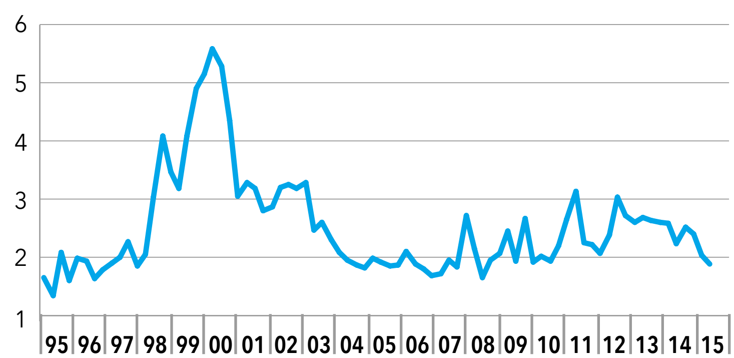
Many Consumer Areas Appear Expensive …

Forward P/E Ratios for Select Consumer Industries Over the Prior 10 Years



And the Market Is Not Distinguishing Among Companies

Valuation Spreads for Retail Stocks



Valuation spread measures the difference in average P/E ratios between the top and bottom quintiles of retail stocks in the Standard & Poor's 500 Composite Index. Retail stocks include distributors, internet & catalog retail, multiline retail, specialty retail and food & staples retailing.

Sources: Capital Group, FactSet. As of March 31, 2015.

Multiple Perspectives. One Approach.®

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Darrell Spence
Economist

Consumer Spending May Be Set To Rebound

After lagging in 2014, consumer stocks have come roaring back. The consumer discretionary sector was up more than 4.5% year to date through April 30, significantly outpacing all other areas of the market. In some industries, the market has been fueled by optimism that the "tax cut" American consumers received from the nearly 50% decline in oil prices over the past year will translate directly into consumption growth.

So why then, despite fairly positive consumer sentiment, has a substantial rise in consumer spending proved elusive? There are several possible reasons. Some people appear to be adding to savings and paying down debt rather than shopping. Research by Goldman Sachs suggests that the steady decline in monthly spending on gasoline that began in late 2014 was accompanied by a similar increase in personal savings. It is also possible that harsh winter weather played a significant role in curtailing shopping trips. Meanwhile, consumers may be figuring that low prices at the gas pump could be short-lived and are reluctant to spend the extra dollars in their pockets.

Nevertheless, we think there's good reason to have a positive outlook on consumer spending. A healthy job market is one of the primary reasons for this optimistic view. Initial claims for unemployment insurance are near a record low as a share of the labor force and the job openings rate is approaching a level not seen in nearly 15 years, when the unemployment rate dipped below 4%. Importantly, there is upward pressure on labor costs, with the Employment Cost Index (ECI) for wages and salaries accelerating in the first quarter.

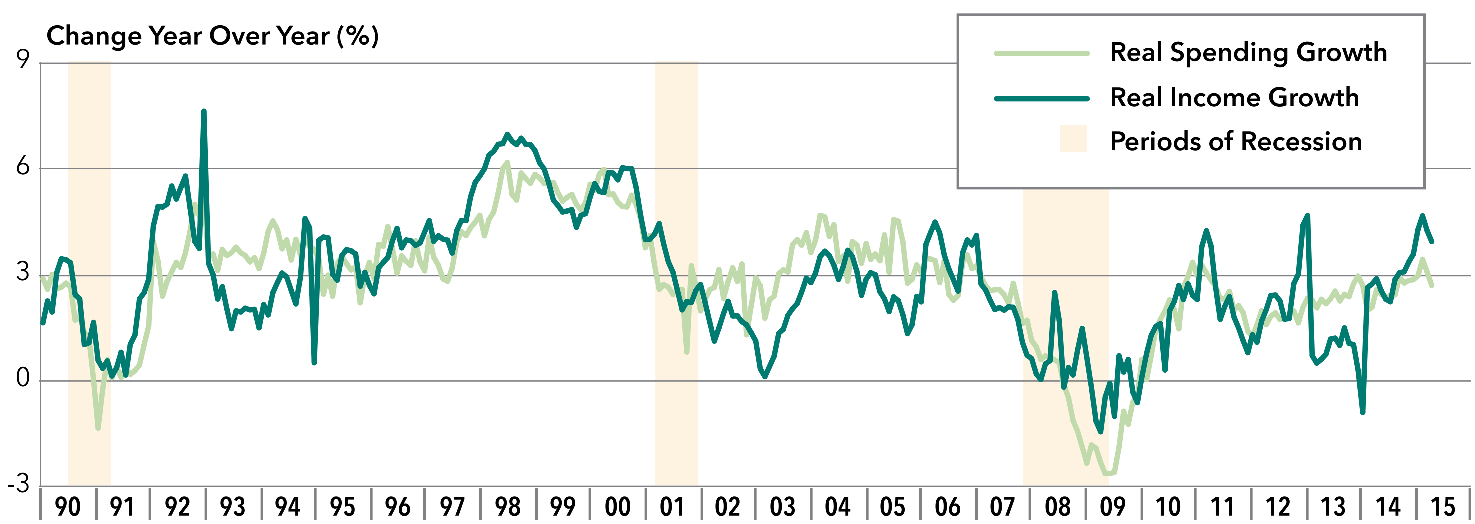
"Assuming that the economy accelerates through the remainder of 2015, the U.S. unemployment rate will likely continue falling," says Capital economist Darrell Spence. "If the Federal Reserve remains on the sidelines, or tightens monetary policy very gradually, the unemployment rate could keep falling for perhaps another year or two. This should have positive implications for consumer spending and provide a boost to the global economy."

Higher Consumer Spending Equals Higher Returns? Not So Much.

Given that personal consumption accounts for nearly 70% of U.S. GDP, a boost to consumer spending would clearly be positive for the U.S. economy. Nevertheless, higher spending has not always been as beneficial for consumer-related stocks as it has been for other sectors of the market. This is because consumer spending tends to accelerate during periods of robust economic

Is Income Growth Setting the Scene for a Spending Boom?

Growth in Real Income and Consumer Spending



Source: U.S. Bureau of Economic Analysis.

> "We continue to like stocks in the consumer staples areas, including beverages and tobacco. These companies know how to manage modest to declining top-line growth, increase cost savings, raise operating leverage and still produce dependable earnings growth."
>
> **Hilda Applbaum**
> Portfolio Manager

growth, which tends to coincide with the Federal Reserve raising interest rates. Because their valuations are more sensitive to rising rates, consumer-related stocks have tended to do less well in this environment.

Of course, history can serve as a useful guide, but the future could look quite different. "There's broad consensus that the Fed will likely not raise rates until the second half of 2015," adds Darrell. "It's also possible that the Fed tightens policy so gradually that any increase in bond yields could still be several quarters away. Even in the face of rate hikes, no matter how gradual, discerning investors can still find good value in consumer stocks. "We continue to like stocks in the consumer staples area, including beverages and tobacco," says portfolio manager Hilda Applbaum. "These companies know how to manage modest to declining top-line growth, increase cost savings, raise operating leverage and still produce dependable earnings growth. On top of that, they tend to have very strong and growing dividends, which should be beneficial – even if rates rise."

Given already-high valuations and the prospect of rising interest rates, at first glance consumer stocks may not appear especially attractive – especially in the aggregate. Cyclical factors are of course a significant driver of near-term prospects for retailers, just as they are in other disparate areas that consumers spend their money on, such as transportation and housing. However, as longer term investors, we're also very mindful of the shifting nature of consumption, particularly in regard to the rise of e-commerce. The longer term repercussions of this structural change should be most apparent in U.S. retail.

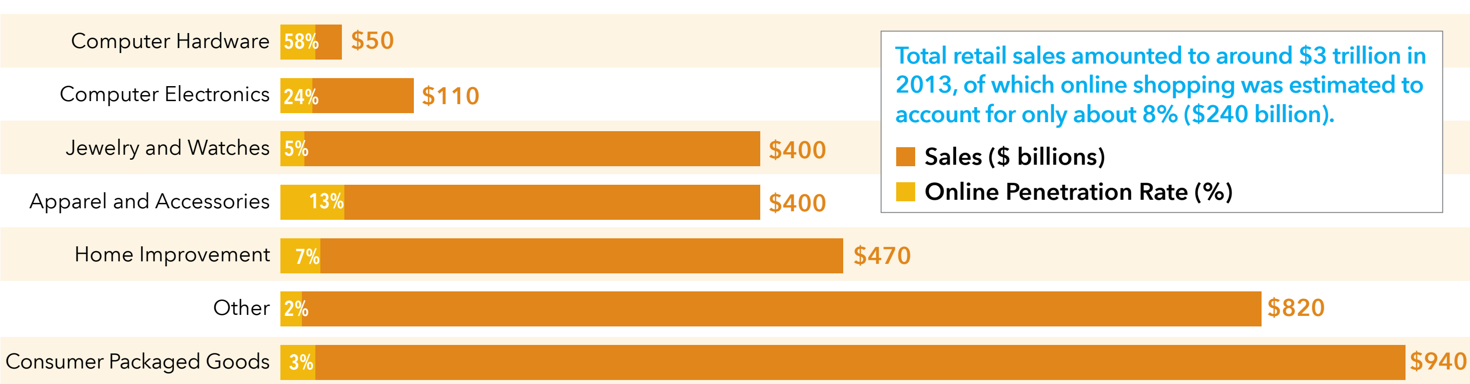
Structural Upheaval Creates Opportunities in U.S. Retail

The U.S. retail industry is in a period of great upheaval. The rise of Internet-based Amazon over the past decade has already had a profound impact on retailing. The Seattle-based firm's disruptive effect should, in the view of some of our analysts, dramatically reshape the competitive landscape in coming years. Most brick-and-mortar retailers are embracing e-commerce as a way to meet changing consumer expectations. However, adapting and truly prospering are likely to prove difficult for many companies. Fundamental research and a long-term perspective are, in our view, crucial elements for investors seeking to discern which firms will ultimately thrive.

"E-commerce is fundamentally challenging the business models of many traditional retailers. The shift to online is driving up costs and lowering profit margins," explains equity investment analyst Anne-Marie Peterson. "Though online purchasing has become a commonplace

E-Commerce Has Tremendous Room for Growth in Some Larger U.S. Retail Segments

Total Sales ($ billions) and Online Penetration Rates (% of Total Sales) in Select Retail Segments



Total includes categories listed in chart, as well as sports and fitness; toys and hobbies; office supplies; video games and consoles; books and magazines; music, movies and videos; and software (excluding PC games). Online penetration rates are as of 2013, which is the most recent period for which extensive data is available. "Other" category includes wine; wireless phone service (non-contract); luggage; baby gear; party supplies; arts and crafts; cigarettes; gifts, cards, costumes and masks; umbrellas; photos; and bulbs, among others.

Sources: Capital Group, Forrester, ITG.

Key Takeaways

- We expect consumer spending to pick up in the second half of 2015. But accelerating consumer spending is sometimes accompanied by higher interest rates, which can act as a headwind for consumer stocks.
- Beyond near-term influences, the rise of e-commerce is having a profound effect on U.S. retail. In our view, the disruptive impact of e-commerce could spark some consolidation as structurally disadvantaged firms cede market share to dominant businesses.
- Currently, the market appears to be pricing companies for similar earnings and sales growth rates. But we believe e-commerce will create divergence within many retail segments, presenting opportunities for discerning investors.

activity for many of us, e-commerce penetration rates still have plenty of room to grow. We're in the early stages of what I anticipate will be a major shake-up."

Costs are rising because e-commerce creates logistical complexity. In the past, a retailer would simply buy goods from vendors, ship them to their distribution center and then on to their store, where consumers would buy them in person. But now, increasing numbers of people are buying goods online and having them shipped to them directly, or requesting in-store pick-up. Consumers are demanding flexibility, and that's requiring retailers to spend capital on technology, distribution centers and other infrastructure to overhaul their logistics, technology and approach to pricing. For example, as Amazon has expanded its reach in terms of products and geography, consumers have come to expect access to real-time inventory. Furthermore, the ease with which consumers can comparison-shop online is driving greater convergence in pricing.

Bricks Are Being Replaced by Clicks

The future landscape of U.S. retail could, therefore, look very different to the present. Specifically, it seems likely that a divergence will develop. In the future, there are likely to be fewer brick-and-mortar retailers with strong businesses. In the U.S. grocery segment, for example, our analysts are working hard to identify firms with the right combination of scale, effective management and vision to thrive in a world where online purchasing, mobile coupons and multiple delivery options have become much more prevalent. In addition to familiar approaches to growing a business such as improving product quality and lowering prices, the use of technology to bolster customer loyalty and shopping frequency is likely to become a key determinant of success in the industry.

We expect independent retailers to continue to lose market share despite their best efforts to compete for the U.S. consumer's online dollars. Pizza lovers may already be a part of this story. In many regions, a fragmented marketplace that was once dominated by smaller operators is being shaken up. Independent pizzerias are ceding their customer bases to large national chains such as Domino's. Mobile ordering technology is proving a game-changer by encouraging repeat orders from consumers who crave convenience.

Another example of this dynamic is occurring in the home improvement segment. Two chains, Lowe's and Home Depot, already account for about 40% of the total market. And yet, there could be further consolidation. Historically, independent businesses that cater to home improvement professionals have benefited from service- and location-related advantages. However, just like other consumers, builders, decorators and architects expect to be able to view real-time inventory and have access to mobile ordering and competitive pricing. Technology is the new service requirement, and smaller firms serving the specialty professional consumer may be less able to afford the investments or negotiate the complexity that e-commerce entails.

Given the shakeout that e-commerce is likely to prompt, it's striking that current valuations are not differentiating more among various areas of retail. "Market pricing seems to suggest that many retailers will experience very similar growth. And yet our research suggests that different firms are likely to see quite distinct growth rates in both sales and earnings," says Anne-Marie. "The next decade will present many challenges for traditional U.S. retail companies. It's also a period in which I expect our long-term perspective and deep company-by-company analysis could prove advantageous."

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