

MFS INSIGHTS: SELECTIVITY IN RETAIL MORE CRITICAL THAN EVER – U.S CONSUMER MARKET

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In brief:

- U.S. consumers want diverse product offerings, convenience and low prices. It's hard for retailers to accomplish all three.
- Discount retailers are a needed merchandizing niche, making them less vulnerable to online competitors.
- Not all retailers will survive the pandemic, but those that endure could gain share and grow margins in the coming years

Brick-and-mortar retailers for years faced structural headwinds from the threat of online shopping platforms. Despite one of the strongest-ever holiday spending seasons, same-store sales for many department stores were negative in 2019.

For at least the past five years, many department stores and retailers have been working toward an omnichannel model, selling product both physically and digitally through their own e-commerce efforts or online marketplaces. Online is hard, however, as it doesn't directly lead to synergy when it's combined with a brick-and-mortar operation. And many stores continue to suffer from falling profits despite success in online traffic because the fixed costs associated with brick-and-mortar locations become a greater drag on total profit as sales shift online. With these realities becoming increasingly apparent at the same time as we experience the demand shock brought on by the coronavirus pandemic, we believe the rate of store closures and retail bankruptcies may jump in the United States..

We don't pretend to know when the economy should or will reopen. While this recession may be the deepest in nearly a hundred years, its longevity remains a question mark. But regardless of the pace of the economic recovery, how should investors think about their exposure to retailers in equity and credit portfolios?

What do consumers want?

Like most everything in investing, it is important to get back to fundamentals. What do consumers value when shopping? In our view, they prize the following:

1. Diverse offerings
2. Convenience
3. Low prices

We think e-commerce has a greater value proposition on product diversity and customer experience. Infinite shelf space accessible from the comfort of your home is hard to beat, especially when your personal health is at risk. However, cost is a

battleground in which online retailers face challenges, and we expect that to remain the case postcrisis. Therefore, we believe it's critical to understand the consumer's sensitivity to low prices compared with his or her sensitivity to choice and experience when weighing the sustainability of each company's business model.

Low prices matter. The importance of cost as a value proposition may increase during the recession. We believe consumers may become more price-conscious as they prioritize precautionary savings when the threat from the pandemic fades. Recession and postpandemic behaviour notwithstanding, there could potentially be two ways to make money in brick-and-mortar in an online world. The first is through big box concepts with a large "basket size" and quick turnover in inventory, such as supercenters and warehouse clubs. The second way is through small box concepts with smaller basket sizes and quick inventory turns, such as designer labels and the like. The way we see it, it could be difficult to make anything in between work.

Discount retailers may potentially be less threatened

There are segments of the large retailing universe, however, that don't easily lend themselves to online, such as discount retailers. Discount stores generally sell high-quality goods at lower than normal prices. Their access to merchandise varies, ranging from out-of-season to overstocked channels. A world without discount stores could potentially mean that consumers may face higher prices for in-demand items. In other words, the economics of discount retailers are outside of the Internet's sweet spot.

Equally important in all of this is that makers of branded goods appreciate the value proposition that discount stores offer. For example, apparel brands have near-constant excess inventory and require a means to sell discounted stock without degrading brand equity, or their ability to sell full-priced items through their primary channels. Offering discounted merchandise on a website is the quickest path to price comparison. So in order to maintain their brands, apparel makers spread excess inventory across many discount outlets. At the same time, this gives customers a sort of treasure hunt experience. We believe the discount retailer segment may potentially have room to grow and could take market share over time, having already grown its share over the past decade from percentages in the high single digits to percentages in the low teens of soft-line retail and home furnishings spending in the United States.

Beefed-up survivors

Ten years ago, retail was an oversupplied industry, and it still is, with many participants offering only a commodity. It was ripe for disintermediation. At the same time, there was a false narrative that we would become a society without stores. We don't believe we will, but we do believe there could potentially be fewer stores and that their offerings will be distinctive.

Looking ahead, we think surviving retailers may possess a defensible value proposition, whether it's cost or a "form factor" such as an unique experience or service. We believe declining industry fragmentation, consolidation, market share growth and — in the out years — margin expansion for those with staying power.

For years, we've been writing and talking about how the easy access to capital and low financing costs have distorted the market's natural selection process. We believe that that era has come to an end. As some merchants fail and profit pools shift, we anticipate appreciable asset price dispersion among retailers — in both equities and credits — creating opportunities.

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