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The 2015 Consumer Value Creators Series

RETAIL

DEFENDING AGAINST THE THREAT FROM E-COMMERCE

By Ketil Gjerstad and Greg Papp

Over the past five years, the retail sector has delivered extremely strong value creation, thanks to a steady recovery in the global economy.

In 2015, The Boston Consulting Group conducted its annual study of the total shareholder return (TSR) of nearly 2,000 publicly traded companies in 27 industry sectors, of which 99 were in the retail sector.[1] (See *Value Creation for the Rest of Us,* the 2015 BCG Value Creators report, July 2015.)

During the five-year period from 2010 through 2014, a time of broad-based strength for consumer companies overall, the retail companies in our sample returned an annualized TSR of 21%. Retail tied with durables for second place among the five consumer sectors we analyzed—fashion and luxury (which ranked first), travel and tourism, and consumer nondurables were the others—and third overall among the 27 industry sectors. Three of the top four sectors were in the consumer space, and all five sectors finished in the top 11. (For an overview of the entire group of consumer sectors, see "The Return of Growth," the BCG 2015 Consumer Value Creators Series, November 2015.)

The top ten companies are far more geographically balanced this year than they have been in the past: only half are based in the US. By contrast, eight of the top ten in last year's retail rankings were US companies. The top retail performer overall was Domino's Pizza, which has more than 11,000 company-owned and franchised locations in 75 countries. Domino's generated an average annual TSR of 65.6%, primarily as a result of paying down debt (26 percentage points) and an increase in the valuation multiple (23 percentage points).

As in past years, volatility was a key theme of the retail sector. Only three companies among last year's top ten managed to stay on the list again this year: Chipotle Mexican Grill (which finished third); ULTA Salon, Cosmetics, and Fragrance (sixth); and Tractor Supply (eighth). Several companies in emerging markets also appeared in the top ten, including two from Thailand: Siam

Makro, a wholesale chain that serves businesses (second), and Big C Supercenter, a large-format grocery store (ninth).

The Drivers of TSR

The retail subsegments represented in this year's rankings are quite diverse: do-it-yourself (DIY) stores, dollar stores, restaurants, pharmacies, convenience stores, department stores, grocery stores, and hypermarkets. Nevertheless, the value-creation path to make the top ten was consistent across all of them. The largest contributor to TSR was an increase in valuation multiples, and all of the companies in the top ten generated double-digit value through improved multiples. (See Exhibit 1.) Of the 27 sectors that BCG analyzed, none had as consistently strong a performance in multiples as the retail sector.

The second-largest contributor to TSR was growth: eight of the top ten companies generated a double-digit contribution through stronger sales. This is consistent with BCG research, which has found that, over the long term, more than half of all value creation for top performers typically comes from growth.

Several companies in the top ten succeeded by applying a balanced approach to value creation. For example, Chipotle Mexican Grill returned an average annual TSR of 50.7%, driven by a contribution from sales growth (22 percentage points) combined with a boost from an expansion in the company's valuation multiple (27 percentage points). Similarly, Dillard's, a department-store chain that finished fifth, generated an average annual TSR that was nearly as high as Chipotle's—48.9%—despite a contribution of just 1 percentage point from sales growth. The bulk of Dillard's value creation came from increases in margin (13 percentage points) and valuation multiples (14 percentage points), and a change in net shares outstanding (12 percentage points).

What Separates Winners from Losers

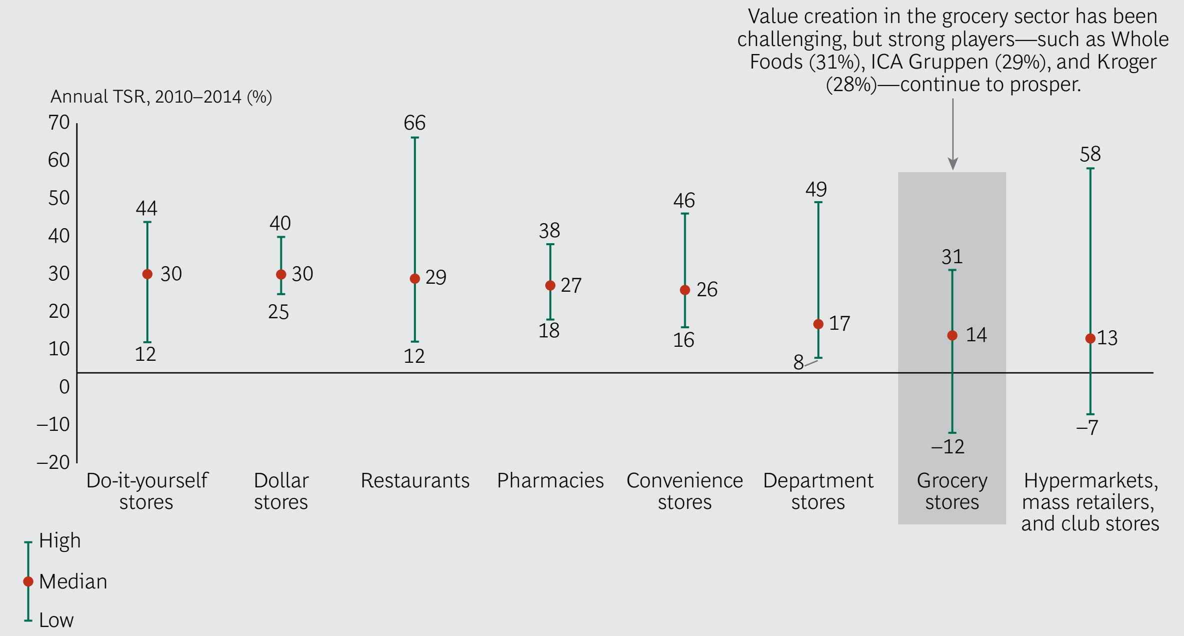
As was true for the 27 sectors in the overall analysis, the TSR performance for the eight subsegments within the retail sector varied widely. (See Exhibit 2.) While the aggregate median TSR for retail was 21%, five of the eight subsegments posted a higher median return. The highest performers were companies in subsegments that have inherent

Exhibit 1 | The Retail Top Ten, 2010–2014

					TSR Disaggregation[1]						
	Company	Location[2]	Average annual TSR (%)	Market value[3] ($billions)	Sales growth (p.p.)	Margin change (p.p.)	Multiple change[4] (p.p.)	Dividend yield (p.p.)	Share change[5] (p.p.)	Net debt change (p.p.)	2015 TSR[6] (%)
1	Domino's Pizza	United States	65.6	5.2	7	4	23	3	1	26	16
2	Siam Makro	Thailand	58.3	5.3	13	6	36	6	0	–2	9
3	Chipotle Mexican Grill	United States	50.7	21.2	22	3	27	0	0	–1	5
4	Hotai Motor	Taiwan	49.8	8.2	10	5	25	6	0	4	–19
5	Dillard's	United States	48.9	5.2	1	13	14	2	12	6	–26
6	ULTA Salon, Cosmetics & Fragrance	United States	48.1	8.2	21	11	16	0	–2	1	28
7	Alimentation Couche-Tard	Canada	45.7	23.8	18	7	19	1	–1	1	8
8	Tractor Supply	United States	44.0	10.7	12	11	21	1	1	–2	10
9	Big C Supercenter	Thailand	43.9	5.9	11	4	29	3	–1	–3	–15
10	Woolworths	South Africa	40.6	6.2	21	8	14	7	–4	–5	26

Sources: S&P Capital IQ; annual reports; BCG analysis.
Note: n = 99 global companies with a market valuation greater than $4.5 billion as of December 31, 2014.
[1]Contribution of each factor shown in percentage points of five-year average annual TSR. Any apparent differences to TSR totals are due to rounding.
[2]Location refers to the location of the company's corporate headquarters.
[3]As of December 31, 2014.
[4]Change in EBITDA multiple.
[5]Share change refers to the change in the number of shares outstanding, not to the change in share price.
[6]As of September 9, 2015.

Exhibit 2 | High, Median, and Low TSR for Retail Subsegments



Sources: S&P Capital IQ; company disclosures; BCG analysis.
Note: Includes 59 global retailers across eight subsegments, excluding outliers such as conglomerates, auto dealers, and drug wholesalers.

barriers to online competition, or "defensible moats."

For example, DIY chains and dollar stores had the highest median TSR (30%), and both subsegments have natural defenses to e-commerce: DIY retailers sell large, bulky items that are costly to ship, while, at the other end of the spectrum, dollar stores offer low-priced items that often sell for less than the cost of shipping. Similarly, restaurants (29%) and pharmacies (27%) also finished above the median TSR for the retail sector as a whole; both require a service element that is difficult to replicate online.

Notably, in most subsegments, the worst performers fell below the median for retail as a whole while the best performers exceeded the median. In other words, though the subsegment of retail occupied by any given company is certainly important, the business decisions that the retailer makes about how and where to compete matter even more.

For example, consider the grocery store subsegment, which, historically, has been a difficult business with thin margins. Of the 99 companies that we analyzed in the retail sector, 16 are grocery stores, and this year—as in most years—several finished near the bottom. Nevertheless, some finished in the top third, including Whole Foods Market (a US company that ranked twenty-second), ICA Gruppen (Swedish, twenty-eighth), and Kroger (US, thirtieth). Each of these three companies made very deliberate choices about how to compete and how to create value for their shareholders.

Whole Foods Market has a clear, differentiated concept—high-quality fresh products complemented by a strong prepared-foods offering—and great retail execution. Store managers have significant latitude in building community relationships and sourcing goods from local suppliers, which gives stores a strong foothold in their local markets. ICA Gruppen, by contrast, continues to reshape its portfolio through strategic M&A and divestitures. In 2013, the holding company that owned part of ICA acquired the remaining shares from majority-owned Ahold and formed ICA Gruppen. During

2014, ICA Gruppen sold off its Norwegian business, divested several smaller companies in the group, and bought a large pharmacy in Sweden.

Kroger continues to grow through multiple avenues. Its sales of organic and natural products—including private-label brands for value-conscious shoppers—generate $11 billion a year, and the company is on track to become the top seller of such goods in the country within two years. Kroger has also invested to improve prices and service, delivering a better overall value to consumers. As a result, the company has posted same-store sales growth ahead of a slew of rivals.

The performance of these grocery stores offers lessons for all retail companies. Strategy and execution are paramount. By determining the right approach to meet the needs of customers—and to differentiate themselves from the competition—even companies in challenging subsegments can deliver superlative TSR.

Note

1. TSR is a metric that encompasses all sources of value that accrue to shareholders. It includes changes in sales, margins, and valuation multiples, along with all sources of free cash flow to investors and debt holders, such as changes in dividends, net debt, and the number of shares outstanding.Hent latem excero

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