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CAN TRADITIONAL RETAILERS COUNTER THE ONLINE THREAT?

By Ketil Gjerstad and Greg Papp

FOR RETAIL COMPANIES, THE competition to create value just keeps getting tougher. In 2017, The Boston Consulting Group conducted its annual study of the total shareholder return of more than 2,300 publicly traded companies in 33 industry sectors, of which 92 were in the retail sector.[1] (See "How Top Value Creators Outpace the Market—for Decades," BCG article, July 2017.) From 2012 through 2016, the global retail sector delivered an average annual return of 16%, ranking 19th among the sectors analyzed and 4th among the five consumer sectors. (The others are durables, travel and tourism, fashion and luxury, and fast-moving consumer goods.)

While the retail sector's recent performance in absolute terms matched its five-year performance through 2015 (average annual TSR of 16%), its relative performance declined compared with other sectors. Retail has not finished in the bottom half of the overall group of industries—or even below the top ten—in more than a decade. So given the sector's lackluster performance in this year's analysis, the message for retail leadership teams is clear: they will need to up their game if they are to continue attracting capital. This is particularly true for retailers in segments facing renewed attack from Amazon: grocers, drugstores, and office products, to name a few. To compete against the online giant, they will need to improve their value proposition, the customer experience, and their internal operations.

The Top Ten

For this year's top ten retail performers, growth was the biggest contributor to value creation. Eight of these companies generated a double-digit contribution to TSR through revenue growth, more than the contribution from any other factor. Changes in the valuation multiple were the second-biggest value lever (with double-digit contributions among seven of the top ten), followed by margin improvements. (See the exhibit.)

There were some familiar names in the top ten. Six companies also appeared on last year's list: Ryohin Keikaku (which finished first overall), Rite Aid (second), Domino's

Retail Top Ten, 2012–2016

					TSR Disaggregation[1] (percentage-point contributions)						
					Profit growth		Valuation	Cash flow contribution			
	Company	Location[2]	Market value ($billions)[3]	Average annual TSR (%) =	Sales growth +	Margin change +	Multiple change[4] +	Dividend yield +	Share change[5] +	Net debt change	2017 TSR[6] (%)
1	Ryohin Keikaku	Japan	5.2	46.0	13	7	26	2	0	–3	46.4
2	Rite Aid	United States	8.6	45.6	5	4	10	0	–3	29	–76.2
3	Tsuruha Holdings	Japan	4.6	40.7	13	3	27	2	0	–4	22.1
4	Domino's Pizza	United States	7.7	39.7	8	3	16	3	4	6	25.6
5	Raia Drogasil	Brazil	6.2	37.7	33	11	–6	1	0	–1	23.4
6	Dollarama	Canada	8.6	35.5	13	6	11	1	5	–1	39.2
7	Alimentation Couche-Tard	Canada	25.9	34.9	10	17	11	1	–1	–2	0.9
8	Amazon	United States	356.3	34.1	23	24	–10	0	–1	–2	28.2
9	ASOS	United Kingdom	5.1	32.1	30	–14	17	0	–2	1	20.0
10	Ulta Beauty	United States	15.9	31.8	22	4	5	0	0	0	–11.3

Sources: S&P Global Market Intelligence; Thomson Reuters Eikon; Bloomberg; company disclosures; BCG Value Creators report 2017; BCG analysis.
Note: n = 92 global companies with a market valuation greater than $4.5 billion as of December 31, 2016.
[1]The contribution of each factor to the average annual TSR is shown in percentage points. Because of rounding, the numbers may not add up to the TSR figure shown.
[2]Location of corporate headquarters.
[3]As of December 31, 2016.
[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 30, 2017.

Pizza (fourth), Dollarama (sixth), Alimentation Couche-Tard (seventh), and Ulta Beauty (tenth).

Ryohin Keikaku delivered average annual TSR of 46%. The company operates nearly 900 Muji retail stores that sell private-label products in a range of categories. About half of its locations are in Japan, another 200 are in China, and the rest are scattered across Asia and Europe. The company's strong TSR performance was driven by revenue growth (13 percentage points), improved margins (7 percentage points), and an expansion in the valuation multiple (26 percentage points).

Rite Aid was a different story. The company finished second this year, with the biggest contribution from changes to net debt. However, Rite Aid has been on an extremely bumpy path for the past several years. Its stock was hovering at nearly $1 in early 2012, at the beginning of our five-year analysis period, and shares experienced a big runup in 2013 and 2014, culminating in a buyout offer from Walgreens. That deal was called off in mid-2017 because of concerns from regulators, which led to a sharp drop in Rite Aid's stock. Shares have fallen more than 75% since the beginning of 2017. The company illustrates the principle that a company can show great shareholder performance during a specific period without necessarily having strong operational performance—a good reminder that there can be a difference between great stocks and great companies.

Another notable feature of this year's rankings was the emergence of three companies among the top ten that joined our list of value creators for the first time. Two are drugstore chains: Tsuruha Holdings (based in Japan) and Raia Drogasil (Brazil). The third is ASOS, a UK-based online apparel retailer.

Finally, this year's list marked the return of another online player (and the top performer in previous years' rankings): Amazon. Even though Amazon dwarfs all other companies among the top ten—its market cap is over four times as large as the rest of the top ten combined—it still generated much of its TSR through sales growth (23 percentage points) and margin change (24 percentage points). Notably, a separate BCG analysis looked only at large-cap companies to identify the best value creators across all sectors, and Amazon was the only retailer on that list.

The Latest Chapter on Amazon

The resurgence of Amazon comes as most retail subsectors have seen diminished value creation over the past two years. From dollar stores to restaurants to convenience stores, department stores, and club stores, the average TSR has declined notably (pharmacies are the only exception). One of the challenges facing all of these sectors is how to respond to the threats and opportunities posed by e-commerce. Amazon and other large online retailers continue to press their advantage in areas where they have a rapidly expanding share of the market. For example, Amazon extended Prime to its Amazon Business customers, increasing the threat to office product retailers. Amazon has also shown a willingness to continue attacking sectors it has been slow to penetrate, grocery being a prime example. The acquisition of Whole Foods gives Amazon an immediate presence in physical grocery and shows the company's willingness to shift tactics. Previously, its largest acquisition had been Zappos, for $1.2 billion in 2009. At $13.7 billion, the acquisition of Whole Foods is more than ten times larger, raising questions about whether Amazon will increase its inorganic moves in sectors that it has been slow to penetrate organically.

The Whole Foods deal generated intense scrutiny, and it generated value for Amazon months before it even closed, thanks to a strong positive reaction from investors. Within two trading days of the deal's announcement, Amazon's market cap had increased by $14.7 billion, significantly more than the Whole Foods purchase price.

Imperatives for Retailers

There are three priorities for retailers wishing to counter the threat from e-commerce players such as Amazon and Alibaba.

Improve the value proposition. First, retailers need to realign their value proposition to incorporate digital. Increasingly, both the B2C and B2B customer journey starts online. Reaching these customers with personalized offers and shopping experiences will be critical. Retailers must also improve their category management to give customers a unique assortment of products, including—for packaged goods—distinct and differentiated private-label products, rather than a set of me-too products with no brand value.

Improve the customer experience. A good customer experience means that products are in stock, stores are clean and bright, and perishables are extremely fresh. Ideally, the store experience is a point of differentiation; at a minimum, it shouldn't be a negative. Regarding fulfillment, convenience is key: customers should have the option of ordering online and either picking up their bagged items at the store or having them delivered. (To build an efficient delivery service at scale, some retailers may need to partner with third-party providers.)

Improve internal operations. Last, retailers need to reduce operational costs, not only to preserve margins but also to fund new initiatives in digital, pricing, and other areas where they can gain an edge over e-commerce competitors. In some cases, they may need to consolidate to generate scale, at both the store and the SKU level. And speed and innovation will become paramount. Some well-established retailers need to dramatically accelerate their pace of operations in order to become more agile—disrupting themselves before they are disrupted by others.

THIS IS BOTH an exciting time for retail companies, because of the pace of change and innovation, and a challenging time, given intense pressure from e-commerce. The sector's value creation performance may be down compared with previous periods—and compared with other consumer sectors—but the fundamentals of retail have not changed. The companies that create a clear value proposition, improve the customer experience, and improve operational performance will win.

NOTE

1. TSR is a product of 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.

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