Specialty Retail

Investing in a Post-COVID-19 World: 5 Major Trends Poised to Accelerate

We believe that despite the inevitable end of this period of uncertainty and suppressed demand, the deep-set shock it has caused is likely to alter consumer behavior and reshape the competitive landscape. Some things will follow uninterrupted from already well-documented shifts. Coming into the last recession, online migration had already begun to accelerate in certain categories regardless of broader financial duress, in large part following from the growing reach of Amazon in the early 2000s and the introduction of the iPhone in 2007. Over the next decade, we identify newer online categories we believe will face similar migration patterns. In turn, this migration, turbo charged by a likely recession, will accelerate closures, which have only just begun. A more lasting impact of the last recession in our view was simply that consumers felt less secure in their finances, accelerating growth in the off-price, dollar, and ultimately fast-fashion industries. Meanwhile, lower interest rates gave rise to inflation in industries such as education and housing, which in turn crowded out spending in more discretionary categories. We believe the importance of the value segment has only increased, though a new breed of companies involved in rental and resale are more likely to take share from legacy value players. In sum, we see an increasingly online world, eventually void of many of the staid brands that defined the retail landscape, with more creative paths to ownership to meet ever-stretched consumer attention.

As they look for value among the rubble, we believe investors will be best served focusing on existing trends now set to accelerate. These include the following broader themes, including companies we believe are already relatively well positioned:

- **Online migration for basics and groceries**: Chewy, Amazon
- **Incremental importance of value**: National Vision, Designer Brands
- **Greater utilization of inventory – rental, resale**: Urban Outfitters, thredUP, Trove (formerly Yerdle)
- **Supply rationalization**: Aritzia, Abercrombie & Fitch, Urban Outfitters
- **Importance of community and customer engagement**: Chewy, Revolve

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Online Migration for Basics and Groceries

Whereas online migration accelerated for many categories in the last decade, we believe it was more a result of newer technology platforms and aging of digitally savvy generations, rather than a lasting impact of the recession. This period of disruption is clearly different, however, and we believe we are poised to see a near-term acceleration of online adoption in categories that have still lagged the broader shift online. This is not simply predicated on a one-time bump in the first and second quarter as consumers have been forced to stay home, where we do acknowledge the likelihood of pent-up demand on the other side to support physical retail recovery. Instead, we believe the current backdrop provides for incremental comfort and awareness of purchasing basic goods at home, which will have lasting impact. On the company end, online providers of basic goods currently seeing a surge in demand are more likely to take away key learnings around efficiency at greater scale. We believe this next wave of online migration will be most impactful for less-disccretionary items such as groceries and basic household goods. These categories are still relatively underpenetrated online (see graph below). Meanwhile, companies including Amazon, Walmart (WMT $109.04), and Chewy have been increasingly providing channels to allow consumers to purchase these types of goods from home. We believe awareness of these services has now been supercharged, and while there might be some near-term frustration in longer lead times, all three of these companies have proven track records in fostering customer engagement and satisfaction to suggest this could drive a broader change in customer behavior.

More broadly, as the following chart illustrates, we expect investors should focus on categories that still remain relatively underpenetrated online, including not only basics, but also furniture and apparel and accessories, categories where we see no structural impediment to getting close to 50% penetration rates if not well above. This, along with broader near-term financial strain, will drive the next round of store closures in our view, noting the near 1:1 tradeoff between retail sales declines and online migration, as evidenced more recently in the apparel space once it crossed what has been in other categories a key midteens inflection point at about 2016-2017 (see graph page 3).

**Online Penetration in 2019 and 5-Year Online Sales CAGR by Market Segment**

![Online Penetration in 2019 and 5-Year Online Sales CAGR by Market Segment](image-url)

Sources: ComScore, U.S. Census Bureau, Euromonitor, American Pet Products Association, William Blair Equity Research
Winners: Across our coverage, Chewy and Amazon are clear winners of CPG spending migration online. While some believe that Amazon will take majority share in the pet space, we are hesitant to believe it will be a zero-sum game given that the industry is still in the very early days of online migration (at close to 13%). We further note that Chewy had been capturing some 60% of every incremental dollar moving online, which in our view does not suggest Amazon is muscling out the company, which is further supported by the recent spike in online demand trends for Chewy. Meanwhile, Amazon has a clear advantage through Prime and ancillary services in capturing continued outside share in the grocery space as online delivery becomes more of a reality. We believe this is the next great growth driver for the company and biggest looming threat for the traditional brick-and-mortar grocery industry, which, for now, we believe is less understood as evidenced by the outsized growth in grocery anchored strip centers in recent years (a trend we covered [here](#)).
Incremental Online Sales for Total Pet Industry & Chewy ($B)

Sources: American Pet Products Association, Euromonitor, FactSet, William Blair Equity Research

Other Online Pet Sales
Incremental Chewy Sales

Note: Current quarter estimate based on regression analysis
Source: Google trends, company reports, William Blair Equity Research
Honorable mention: Wayfair should also benefit in the still early days for furniture online migration (we estimate close to 18%), which we believe Wayfair has been largely responsible for. However, we have near-term concerns over lack of profitability and larger debt balance (albeit low-cost convertibles with the nearest maturity in 2022). Ultimately, the value of Wayfair will come down to utilization of its distribution network, which is a key structural advantage in facilitating the sale of furniture online. While hard to value on a stand-alone basis, we believe there is an ultimate buyer of the company for this asset alone, in that Wayfair has built from scratch the only large-parcel purpose-built fulfillment network in the United States and Europe. In the next wave of online migration for newer categories set to come, we believe this will prove to be an invaluable tool to industries where online growth was previously stunted by fulfillment constraints (including not only furniture, but appliances, automobiles, and even potentially prefab housing).

Incremental Online Sales for Total Furniture & Appliance Industry & Wayfair ($B)

Sources: ComScore, company reports
Incremental Importance of Value

Clearly there is always a greater consumer consideration for value in the midst of and immediately following a recession. However, what was seen coming out of the last recession was a lasting power of this behavior. Indeed, since 2010, the areas of fastest growth were in the everyday low-price categories, namely off-price, fast fashion, and dollar stores, which coincidentally have been the only areas of physical retail expansion more recently. As we have laid out on numerous occasions, the biggest influence in this trend in our view has been the rise in inflation in less discretionary categories, namely housing, education, and healthcare. These industries in turn, with the exception of healthcare, have been fueled in part by the availability of cheap financing. With the current Fed actions to confront the looming recession, we believe interest rates are likely to remain suppressed for the near-term future. Risks to housing price inflation would include rising property taxes to offset the growing threat of municipal pension shortfalls, while education and healthcare costs have both been in the crosshairs of politicians in recent years. We would expect any relief on the costs of these items to be a significant boon to the U.S. consumer.

Winners: Across our coverage, the real winner in the further shift to value consideration among the consumer is National Vision, which is unmatched in its value proposition in the retail eyewear space (see chart below). We also favor National Vision in that it is further levered to the aging U.S. population, with those aged 55 and above set to be the fastest-growing demographic in the United States, while more broadly cases of myopia are set to increase as younger generations age.
Population Growth by Age Bracket

1980 - 2060 55+ Population Growth
1.4% CAGR
91bps higher than population 54 and younger

Sources: US Census Bureau, William Blair Equity Research

Myopia Prevalence Projections

Myopia prevalence to more than double over 50 years

Sources: American Academy of Ophthalmology
Honorable mention: Designer Brands is the only other retailer in our coverage that we would classify as everyday low value, with average pricing that seeks to be some 25% below comparable manufacturer’s suggested retail price. We believe the company's real advantage in a value framework is its loyalty program, with some 30 million active rewards members, driving over 90% of sales. If the company can keep this customer base engaged with strong merchandise at good value, and increasingly at a better value for many private label product, it will play well into this next wave of a value-conscientious consumer. We have two caveats here, the first being the challenges we foresee in the coming quarters as the company looks to execute a challenging integration of the Camuto business, and the other being that while the company plays to the value segment of the market, it still underperformed the post-recession period, giving us less confidence in execution.
While hard to envision in the midst of a pandemic, where people are wary of their surroundings let alone sharing, we do believe the next decade will prove out the concept of rental and resale online platforms. This plays squarely into the next wave of value that we believe will carry on from the last post-recession era, in that these types of platforms allow for not only deeper value, but also greater overall closet utility. While the apparel industry in particular has been able to keep overall prices down by continuing to move production around the globe to the lowest-cost producer, we believe it will become increasingly harder in a post-tariff, increasingly nationalistic, and increasingly more ESG-focused environment to continue to drive down production costs. This would suggest a key advantage to resale and rental, which offer brand name, luxury, and everyday product at a fraction of the cost to the consumer. Further, resale in particular allows for consumers to see an opportunity to further unlock value from their closets, which we believe could become of increasing importance over the coming years as discretionary purchasing continues to get crowded out. We also highlight the ESG component of these businesses, of increasing importance to investors, and a trend that apparel, one of the most wasteful industries, will have trouble finding relevance. Rental and resale both allow for better utilization of inventory, cutting down on waste in a notoriously wasteful, if still necessary, industry.

**Evolution of the Closet Composition Expected BPS Shift 2008 to 2028**

**Winners:** For now, there are few public companies levered to this trend. Meanwhile, for those companies that are public, namely The RealReal (REAL $7.40), we believe the unit economics and broader model will find difficulty reaching profitability, if ever. For now, we see the most promise in private companies such as thredUP and Trove (formerly Yerdle) in the resale industry and Caastle in the rental space. Online resale has proved difficult in that take rates are often low (about 20%), a product margin that makes it difficult to build a direct-to-consumer platform around. The RealReal’s take rate of about 30%-40% does not account for authentication, a higher-cost labor initiative, before you even get to customer acquisition and additional labor costs that are likely to eat into the balance of margin for the company. ThredUP meanwhile has a materially higher take rate, anywhere from 80%-90% depending on the quality of the brand. The company is able to sustain higher take
rates given that the main motivation for the supplier is cleaning out an overstuffed closet not monetizing closet inventory as it is in the luxury space. This gives the company a higher margin threshold around which to build a business. It also allows the company to offer brand name goods at notably lower prices than could be found even in the off-price channel, and more aligned with the fast fashion channel, though with the advantage of actually offering brand name goods (rather than designer knock-offs).

Trove and Caastle are both B2B platforms offering brands turn-key platforms to control their own resale and rental operations, respectively. Increasingly we see both as an opportunity to control what will become increasingly important channels. On the resale side, Trove works with often higher-tier, more durable brands such as Patagonia and Arc'teryx, allowing people to return goods, which the brands then sell often at half off the original or comparable price. Trove notes that resale engages a younger, new customer that would otherwise not have access to the brand, fostering an early loyalty. Similarly, rental platforms are another way consumers can wear brands they would otherwise not have access to, such as a higher-price-point Vince (run by Caastle), or better engage consumers already familiar with a brand, such as an Ann Taylor or Banana Republic (both run by Caastle), where brands have been able to better retain customers by engaging them in rental services.

**Honorable mentions:** Across our coverage, Urban Outfitters has begun its own rental platform, one of the only brands to develop this capability in-house. Already, in the first six months the company has seen some 27,000 subscribers sign up for the program, driving $8 million in sales. While the program is not yet a profitable operation, we believe it can ultimately be as or more profitable than the company's core retail operations with greater leverage on higher logistics costs at scale, while also being a key tool for long-term brand engagement. In the resale space, only Nordstrom is trialing this service, using Trove. While we are encouraged to see the company focus on what we believe will be an increasingly important channel, we note broader fundamental issues across the business that are likely to outweigh any near-term benefits.

Note: See our deep dive report into the resale industry [here](#), with management interviews for thredUP [here](#) and Trove (formerly Yerdle) [here](#).
Accelerated Supply Rationalization

Perhaps a less controversial view, but no less important, we believe store closures are set to accelerate over the next year. The apparel and accessories retail segment has been in a net closing position since 2017, shedding roughly 1%-3% of square footage per year since this time. Backing out off-price, the annual rate of decline has been closer to 3%-5%, driven unsurprisingly by the department store channel, which has been losing supply at an annualized rate of 8%. Going forward, with the ongoing migration online, which we acknowledge could accelerate in the near term but is more than likely to remain relatively stable, we believe the United States is still vastly oversupplied from a physical retail standpoint. In the more immediate term, we see potential for an acceleration of bankruptcies driving mall closures. We believe the most vulnerable brands remain those with larger fleets, including L Brands, Macy’s, Gap, Foot Locker, and American Eagle, all of which we believe will experience outsized closings in the years to come.

![Year-Over-Year Change in Store Count by Segment](image)

Sources: Company reports, William Blair Equity Research

**Winners:** The one company under our coverage we would call out in an accelerated net closing environment is Aritzia, which is in the enviable position to be growing its fleet in the United States, currently with only 31 stores (versus a long-term opportunity likely closer to 150-200). While the company has always taken a measured approach to expansion, opening no more stores in any given year than it believes it can based on the quality of the real estate available, we see some opportunity for a relative acceleration in openings in the United States as more real estate becomes available. Meanwhile, given the company’s track record, we do not believe it will sacrifice quality for numbers.

**Honorable mentions:** Across the balance of our coverage we believe that both Abercrombie and Urban Outfitters have the most rational, productive fleets in the apparel and accessories space, with likely little need to close stores in the coming years, and stronger-than-most liquidity positions (see our liquidity analysis here).

Abercrombie has the “benefit” of having not truly recovered coming out of the last recession, and, as a result, is much further along in supply rationalization and brand development than peers (namely in our view American Eagle). The company decreased the size of its domestic fleet by a net 171 stores over the last decade, leaving it with 256 A&F stores and 391 Hollister stores, both of which we believe are more or less rightsized per brand. Going forward, the company is likely a standout for landlords in that it is actually investing in the existing fleet, revamping Hollister stores, and rolling out a new,
smaller A&F prototype. While the A&F prototype is a much more efficient, brand-enhancing concept, given the need to materially shrink the box, the rollout has been stunted to roughly 10 per year. In any accelerated closing environment, we see an opportunity to potentially accelerate that process.

Urban Outfitters never overdeveloped its retail fleet to begin with, now with 177 UO, 196 Anthropologie, and 130 Free People domestic stores. On its last earnings call, the company actually noted the opportunity to ramp up domestic store growth for the first time in some while, noting the availability of retail locations at more favorable economics, particularly in tertiary cities. We see this dynamic only accelerating in the current environment.
Note: JWN does not report comp beginning 1Q19. YoY sales growth is used as a suitable proxy given limited square footage variances.

Source: Company reports, William Blair Equity Research.
Importance of Community and Customer Engagement

This is perhaps the less obvious trend, and the one where it will be harder to draw facts from numbers. One thing that is clearly emerging from the current lockdown across the globe is the importance of community, as people search for online connections via virtual cocktail hours (link) and even virtual dance parties (link). To be sure, the need for human connection is not something borne out of the last decade. However, it is increasingly a concept that appears to be making its way back into consumer behavior pre-COVID-19. We cite evidence here as the stronger connection consumers seem to have with smaller brands touting transparency and more honest approach to marketing, flying in the face of past conventional marketing techniques promoting unobtainable lifestyles. Brands, including Huckberry, Warby Parker, Everlane, Christy Dawn, have all attempted to create more sustainable, manageable businesses through transparency and more personal customer engagement. We also note the redevelopment of the traditional mall to reflect a town-center model, something that particularly the higher-tier malls have been working on for several years as we have covered in various Retail REIT Recap notes (including here, and here). We believe that consumers will continue to seek out brands and platforms where they have a stronger connection, which by their nature will also be more limited in scale. As such, our view is that it will be increasingly harder to create an apparel brand at the same scale achieved by a GAP (GPS $9.01) or Victoria’s Secret (LB $13.95). Meanwhile, the market share that we see these brands inevitably giving up over the next decade is likely to benefit a broader group of smaller brands and retailers more focused on localized trends and consumption. Lastly, while the current environment creates broad uncertainty, it also provides what could prove an opportunity to speak to an anxious consumer in a more thoughtful manner and beyond trying to sell them something, which in turn can form long-lasting loyalty.

Winners: In our coverage we call out Revolve as being a platform that has gone to greater length to engaging a customer base, largely through its close relationship with influencers. While there is a risk that its primary platform in growing this customer base, Instagram, is losing some of its influence, at the very least it provides the best example among larger brands of the new era of marketing and customer engagement. Chewy is another great example of a brand that has reaped the benefits of focusing more on customer service and engagement than its competitors, namely Amazon. By recognizing the fanatical nature of pet owners, we believe attributes such as customer representative availability and more nuanced actions such as sending impromptu pet portraits, drives long-term loyalty, as evidenced by the platforms cohort growth statistics.

On the private company side, we again draw attention to platforms such as Huckberry, which goes to great length to engage its end-user base via sponsored trips and content that reflects the company’s own interests and connects to consumers on a level beyond the inventory it carries (see our founder interview here).
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