THE VIEW

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RETAIL IN THE U.S.:

TOWARDS DESTRUCTIVE DESTRUCTION

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EXECUTIVE SUMMARY

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- At first glance, the U.S. retail industry is the typical case of what the Austrian economist Joseph Schumpeter called "creative destruction", in which new entrants capture growth or create new markets altogether at the expense of established companies. In the long run, creative destruction is supposed to have a net positive impact on the economy; however, judging from figures pointing to shrinking company count, employment and profitability, e-commerce isn't compensating for the destruction of physical retail.
- **The U.S. has lost more than 56,000 stores, or 10.7%, of its discretionary retail footprint since 2008, despite healthy spending on discretionary consumer goods.** Employment data depict a similarly gloomy picture, with 670,000 net job destructions since 2008 (-9.6%). For one job created in e-commerce, four and half jobs are lost in traditional discretionary retail. The segment breakdown shows a broad-based decline largely consistent with e-commerce penetration, which is the highest for hobby goods (toys, books, music and video content, etc.). Shoppers' growing taste for online orders has also hurt shopping mall footfall and department stores, which reported the sharpest decline in employment (-24.5%).
- **We observe a clear surge in large retail insolvencies since 2015, involving more than USD45bn in liabilities.** High-profile insolvencies are also telling of a broad erosion of profitability. Drawing on a panel of 127 U.S. corporates, we find that one in 10 listed retailers has gone bankrupt since 2008, and that another 41% have seen a decrease in profit margins, especially in the department store, discount store and clothing store sub-segments.
- **As a "winner-take-most" business, e-commerce revolves around a limited number of companies. Leaders have a commanding share of sales, and more importantly, of profits.** The shift from offline to online has had a net negative impact on company count, retail employment and profit distribution. For all its top-line growth, e-commerce displays the lowest median profit margin of all segments. The adoption of new business models also carries inherent transition risks. Moreover, e-commerce has seen few successful new entrants: Between 2008 and 2019, e-commerce accounted for only eight out of 47 newly listed retailers. New entrants display the lowest profit margins and only three of them were cash-flow positive in fiscal year 2018.
- **What does this negative sum game mean for companies?** We expect further e-commerce penetration and heightened competition to eliminate over 500,000 jobs and 30,000 establishments by 2025. All segments, except beauty and cosmetics, will see substantial cuts in physical retail capacities with apparel, electronics & appliances, as well as department stores, facing the biggest challenges. This would represent a significant acceleration from the pace of destruction observed over the past few years. Additional bankruptcies of large retail chains are inevitable and will be instrumental in reducing the U.S. retail footprint: We anticipate the highest default risks for large corporates in clothing, footwear & accessories stores, as well as department stores. Furniture and home furnishings stores are also likely to see a deterioration of credit metrics as competition heats up.
- **For consumer goods companies supplying discretionary retailers, growing e-commerce penetration will not only translate into heightened non-payment risks, but also a further concentration of their retail mix.** Retail consolidation could in turn have an adverse impact on their bargaining power and profitability. Incumbent retailers also face the threat of growing competition from their own suppliers.

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30,000

Expected U.S. retail establishment closures by 2025

WHERE DOES U.S RETAIL STAND IN THE CREATIVE DESTRUCTION PROCESS?

At first glance, the U.S. retail industry is the typical case of what the Austrian economist Joseph Schumpeter called "creative destruction", in which new entrants capture growth or create new markets altogether at the expense of established companies. In the long run, creative destruction is supposed to have a net positive impact on the economy; however, judging from figures pointing to shrinking company count, employment and profitability, e-commerce isn't compensating for the destruction of physical retail.

More than one in ten U.S. discretionary retail stores have closed since 2008

Since 2008, U.S. consumer spending on discretionary items has generally outpaced spending on food and beverages, growing at about +3.2% per annum (vs. +2.9% for food and beverages). In 2019, discretionary consumer goods[1] generated an estimated USD1,960bn in retail sales, accounting for more than a third of the total U.S. retail market.

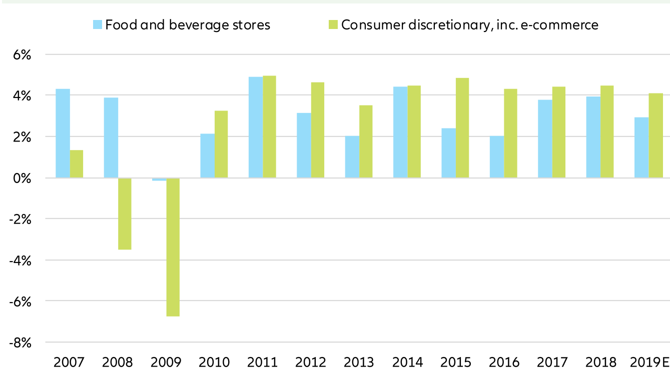
However, the structure of spending has seen tremendous changes, with e-commerce dwarfing all other segments, growing at more than 10% p.a., and showing no sign of slowing down. As a result, healthy consumer spending has not translated into net store openings: the U.S. has lost more than 56,000 stores, or 10.7%, of its discretionary retail footprint, since 2008. And company creation data are worrisome: In 2018, they were standing at a 25-year low[2].

For one job created in e-commerce, four and half jobs lost in traditional discretionary retail

Employment data depict a similarly gloomy picture, with 670,000 net job destructions since 2008 (-9.6%). The segment breakdown shows a broad-based decline largely consistent with e-commerce penetration, which is the highest for hobby goods (toys, books, music and video content, etc. - up to 50% market share in some segments) and comparatively lower for furniture and home furnishings (21%) or cosmetics (10%)[3]. Shoppers' growing taste for online orders has also hurt shopping mall footfall and department stores, which reported the sharpest decline in employment (-24.5%).

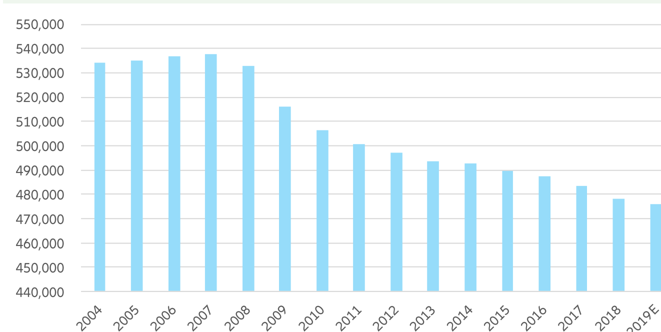
Online retailers employed about 400,000 people in 2019, adding more than 150,000 positions since 2008. In other words, for one net job added among online retailers, there has been four and half net job destructions at a traditional discretionary good retailer.

Figure 1: U.S. retail sales growth



Sources: BLS, Euler Hermes, Allianz Research calculations and estimates

Figure 2: Discretionary retail establishments in the U.S.



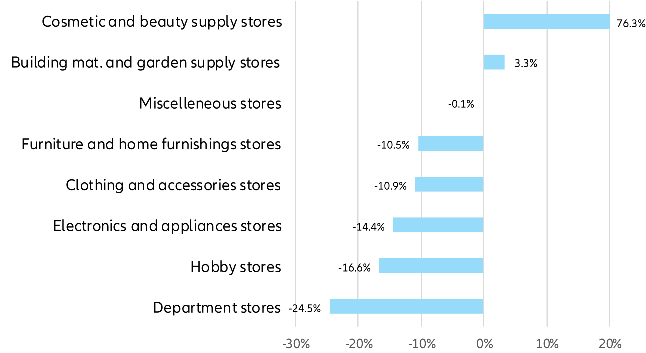
Sources: BLS, Euler Hermes, Allianz Research calculations and estimates

[1] Discretionary spending is as all retail sales but food, beverages, tobacco, gasoline, pharmaceuticals, medical supplies and vehicles. See the appendix for a precise definition of the scope used in the report.

[2] Source: Bureau of Labour Statistics. About 53,200 retail establishments were created for the year ended March 2019.

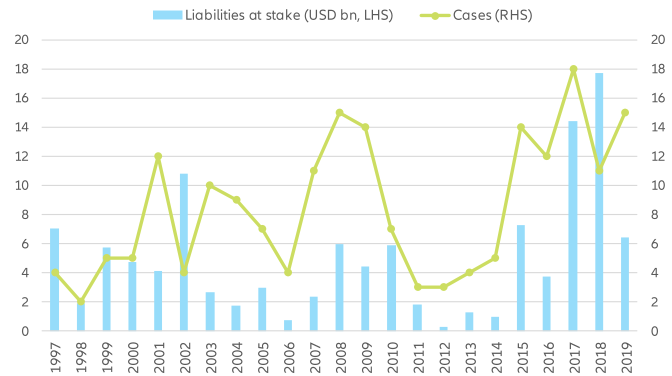
[3] Source: eMarketer, 2019 estimates

Figure 3: Changes in discretionary retail employment by segment, 2007-2019



Sources: Bloomberg, Euler Hermes, Allianz Research

Figure 4: Large retail bankruptcies in the US



Sources: Bloomberg, Euler Hermes, Allianz Research. Figures for companies with liabilities exceeding USD 100m. 2019 liabilities data are still provisional.

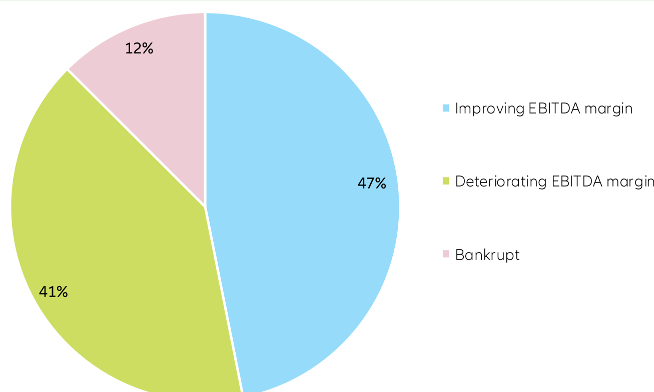
This is not to say that e-commerce alone is responsible for all of the difficulties in traditional retail, which also stem from changes in business models in related industries (preference for digital copies or streaming services vs physical copies) and/or consumer preferences (declining book readership), for instance. Still, the negative impact of e-commerce on employment is undisputable and consistent with available productivity metrics, such as the sales per employee ratio, which are significantly higher among e-commerce companies on average.

High-profile bankruptcies are telling of a broad erosion of profitability

Retail disruption is increasingly taking a toll on well-established retail chains, and not just independent store owners. Focusing on large retail bankruptcies, we observe a clear surge since 2015, involving more than USD45bn in liabilities. While the 2001-2003 and 2008-2010 peaks were triggered by lower demand and tighter credit conditions, the current wave is mostly driven by increased competition in the retail space, with household names including Sears (department stores), Toys"R"Us (toys), H.H. Gregg (electronics), Claire's (jewellery) and Forever21 (clothing) going bankrupt. Looking at credit rating agency data[4], we find about 30 large discretionary retailers with a speculative grade rating, totaling more than USD66bn in liabilities.

The deterioration of profitability due to intensifying competition (see box 1) is also visible in the financials of the largest listed discretionary retailers. Drawing on a panel of 127 corporates in the U.S. and checking for profitability since 2008, we find that one in ten listed retailers has gone bankrupt, and that another 41% have seen a decrease in profit margins. Breaking down figures by segment, we observe that furniture and DIY companies have comparatively fared better, starting from a low in 2008 amid a crash of the U.S. real estate market and being less exposed to e-commerce penetration; conversely, profit margin erosion is the broadest in the department store, discount store and clothing store sub-segments.

Figure 5: Change in EBITDA margins, 2008 vs 2018 (% of total number of companies)



Sources: Bloomberg, Euler Hermes, Allianz Research calculations based on panel of listed discretionary retailers.

[4] Source: Standard and Poor's, January 2020

Box 1: How e-commerce impacts incumbent discretionary retailers

For incumbent retailers, the adverse impact of e-commerce on industry profitability is threefold:

- E-commerce weighs on the volumes sold in stores as consumers make less frequent visits to shops and overwhelmingly opt for delivery rather than store pick-up. This translates into lower sales per square meter of retail space and, all else unchanged, calls for a reduction of retail space. In most segments, e-commerce capabilities have become a prerequisite and companies with no internet presence are the most at risk of losing customers to competitors.
- E-commerce also stimulates price-based competition. The internet has greatly reduced so-called "information asymmetry" by improving buyer information. Price comparison services, search engines, online marketplaces, customer reviews etc. allow buyers to easily identify the products that best suit their needs at the lowest possible price.

The development of e-commerce capabilities entail increased investment, with IT and logistics concentrating the bulk of the additional spending. Anecdotal evidence from bankrupt retailers show that online presence alone may not be enough and that transition and execution risks must not be underestimated.

This increase in investment and operating expenses, combined with strong pressure on volumes and prices, are the main drivers behind the deterioration of profitability margins and the increase in large retail bankruptcies.

Box 2: How e-commerce has transformed retail business models

E-commerce has made the retail competitive game far more complex, with companies trying to strike the right balance between physical and online presence, customer acquisition and profitability. The list below sets forth the dominant business models in the retail industry, bearing in mind that they may not be mutually exclusive:

- Brick-and-mortar refers to retail companies without proprietary e-commerce capabilities. They still make up for the vast majority of independent retailers and remain dominant in many sub-segments of the retail industry (car dealerships or drugstores, for instance).
- Click-and-mortar refers to companies operating both physical stores and online stores. Customers generally place their orders online and decide whether they opt for delivery or product pick-up in a store. Click-and-mortar has become the dominant business model for incumbent discretionary retailers.
- Much like former mail order companies, online stores have no physical presence but replicate the traditional retail business model, that is the retail of various items bought in large quantities at a profit. Founded in 1994, Amazon began as an online store selling books.
- Unlike online stores, a marketplace does not own the products available on its platform. Rather, it serves as an online meeting place for buyers and sellers ("merchants") and generates revenues by collecting fees and commissions on transactions. Founded in 1995 as an auction website, eBay has been a pioneer marketplace.
- Online merchants are companies selling on online marketplaces. They may or may not have proper physical stores.
- Direct-to-consumer refers to born-digital product companies with an end-to-end control over product design, marketing and distribution, generally selling a limited range of up-market items on a proprietary online store.
- "Super-apps" refer to mobile applications revolving around one strong central application and a set of related services which can include e-commerce, messaging, food delivery, mobile payment or ride-hailing. Chinese super-apps Alipay (Alibaba) and WeChat (Tencent) have, so far, no equivalent in Europe or in the U.S.

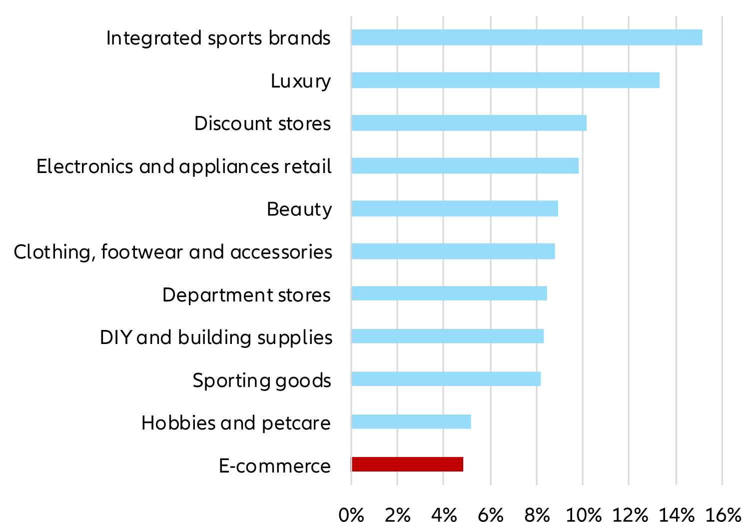
STEADY PROFITABILITY REMAINS ELUSIVE FOR A MAJORITY OF E-COMMERCE COMPANIES

For all its dynamic top-line growth, e-commerce displays the lowest median profit margin of all segments. Anecdotal evidence from click-and-mortar retailers (i.e. those that operate both physical stores and a proprietary e-commerce website) also point to lower profitability of online sales due to generally lower realized prices and the high cost of competitive logistics (product delivery and returns are overwhelmingly free of charge). In other words, the shift from offline to online is not neutral when it comes to profitability; it has so far been a net negative. The transformation of retail business models (see box 2) is far from achieved and steady profitability remains the exception, not the rule, in e-commerce. The adoption of new business models also carries inherent transition risks.

While growing at a double-digit rate, e-commerce sees few successful new entrants

We find further confirmation of the difficult quest for profitability in e-commerce looking at the retail initial public offerings (IPOs) that have taken place in the U.S. since 2008. Despite sales growing at about 10.5% per annum between 2008 and 2019, e-commerce has seen only eight IPOs out of 47 newly listed retailers. E-commerce new entrants display the lowest profit margins and only three of them were cash-flow positive in fiscal year 2018. Founded in 1994 and 1995, respectively, Amazon and eBay remain the only two discretionary e-commerce companies with both a strong track record of profitability and significant clout. Competitors are either far smaller and focusing on niche segments, or still struggling to break even: e-commerce is largely a "winner-take-most" business (see Box 3) where leaders have a commanding share of sales, and more importantly, of profits. Looking at U.S. e-commerce unicorns[5] to identify possible candidates for future IPOs, we find that e-commerce is again underrepresented with only nine e-commerce specialists out of 214 unicorns[6]. Interestingly, investors and new entrants show a clear preference for asset-light (marketplaces) and direct-to-consumer business models.

Figure 6: Median EBITDA margins by segment (EBITDA as % of sales, 2018)

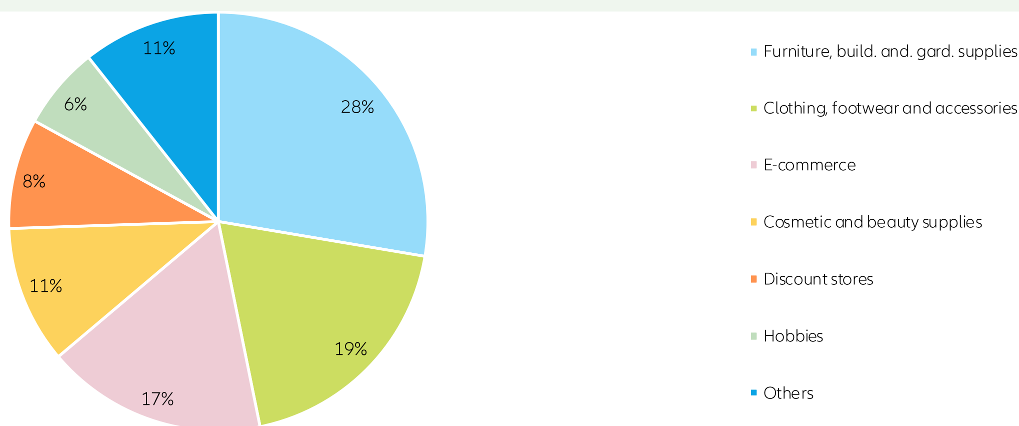


Sources: Bloomberg, Euler Hermes, Allianz Research calculations

[5] A unicorn is a privately held company with an estimated valuation exceeding USD 1bn

[6] Source: CB Insights as of January 2020

Figure 7: U.S. retail IPOs by segment, 2008-2019 (% of all IPO)



Sources: Bloomberg, Euler Hermes, Allianz Research

Figure 8: U.S. discretionary retail unicorns

Company	Estimated valuation (USD bn)	Core business
Wish	$11.2	Marketplace for discounted items
Fanatics	$4.5	Online retail of licensed sportswear and sports gear
Allbirds	$1.4	Direct-to-consumer sale of footwear
Away	$1.4	Direct-to-consumer sale of travel accessories
Warby Parker	$1.2	Direct-to-consumer sale of eyewear
letgo	$1.0	Marketplace for second-hand goods
Rent the Runway	$1.0	Rental of designer clothes and accessories
Casper	$1.1	Direct-to-consumer sale of sleep products
StockX	$1.0	Marketplace for footwear

Source: CB Insights, January 2020

Box 3: Why e-commerce is a 'winner-take-most' business

E-commerce is often referred to as a "winner-take-all" or (more appropriately) "winner-take-most" business revolving around a limited number of companies. Two main factors explain the oligopolistic structure of e-commerce:

- The first factor is typical of traditional retail, where economies of scale are crucial to profitability. The largest retail company has the greatest bargaining power over its suppliers, the lowest unit costs and is generally the most price competitive. Also, companies with the widest range of products available benefit from a "one-stop shop" convenience bonus by which customers can buy a variety of goods while placing a single order and saving on delivery costs. Much like in traditional retail, it still is possible for niche players to thrive but at the price of a distinctive feature (exclusive products, strong focus on a small but untapped segment, innovative interface etc.) hard to replicate;

- The second factor is typical of digital platforms, where network effects give the largest players a strong edge over smaller players. The more merchants on a marketplace, the more customers are likely to find what they are looking for; the more customers on a digital marketplace, the more likely merchants will find buyers. In other terms, the value of the service increases as the service gets more popular, creating a positive feedback loop.

WHAT DOES THIS NEGATIVE-SUM GAME DISRUPTION MEAN FOR COMPANIES?

We anticipate further e-commerce penetration and heightened competition to translate into 30,000 net discretionary retail establishment closures by 2025 (6.2% of estimated 2019 establishment count) for a total of about 510,000 net job destructions (8.2% of 2019 total) by 2025. For 2020 alone, we believe that the economy's slowdown from +2.3% to +1.6% growth will translate into about 32,000 additional job eliminations. This would represent a significant acceleration from the pace of destruction observed over the past few years. Clothing, footwear & accessory stores and department stores, as well as electronics & appliances stores, will be the largest contributors to the reduction of the discretionary retail footprint, while beauty & cosmetics will be the only segment to expand over the period.

We believe additional large-scale bankruptcies will play a major role in physical retail capacity cuts. Taking into account further e-commerce penetration and the dismal credit metrics of many large corporates, we believe default risks for large corporates are again the highest for clothing and footwear & accessory stores, as well department stores. Furniture and home furnishings stores, which had comparatively weathered the rise of e-commerce so far, are also likely to see a deterioration of their credit metrics as competition in the segment is heating up.

Growing e-commerce penetration has deep implications for consumer goods companies too

Looking beyond the risk of non-payment from insolvent companies, we believe e-commerce's continuous rise has other deep and lasting implications for consumer goods companies:

- E-commerce being far more concentrated than traditional retail, consumer goods companies will see the concentration of their retail mix increase as well, meaning their cash flows will be more at risk in the event of payment delays or the insolvency of an important e-commerce customer. As evidenced earlier, short of a few big names, recurring profits remain elusive for many e-commerce specialists.
- The concentration of the retail mix also means that consumer goods companies will be increasingly likely to suffer from the market power of their biggest e-commerce customers, against which they will have less and less bargaining power.
- Circumventing physical and online retailers, direct-to-consumer new entrants have attracted the attention of customers and investors alike with the promise of exclusive products available on websites boasting a superior shopping experience. While they generally focus on a limited range of products, they are already taking market shares away and therefore threatening well-established consumer goods companies. Much like other e-commerce start-ups, they will still have to stand the test of profitability.

Photo by Jose Fontano on Unsplash

Incumbent retailers face the threat of growing competition from their own suppliers

The transformation of the retail industry has prompted many superstar consumer goods companies to ramp up their own physical and digital retail presence, thereby becoming both suppliers to and competitors of established retailers. The trend is noticeable across most segments of discretionary retail – to name a few[7]:

- Household equipment specialist Dyson runs over 800 stores, primarily in China, as well as showrooms and an e-commerce store in more mature Western markets;
- Danish toymaker Lego boasts a network of about 600 stores across the world;
- Sportswear leader Nike has been opening hundreds of company-owned stores in past years. It already derives 31% of its revenues from 1,150 locations and its own e-commerce websites around the world. Competitors Adidas, Puma and Under Armour are engaged in a similar strategy;
- Consumer electronics giant Apple is also seeking to grow its direct-to-consumer business further (31% of 2019 sales). Apple operates more than 500 retail stores around the world.

We believe such strategic moves are not viable for every consumer good company – profitable retail expansion demands substantial financial clout, strong brand equity and a differentiated retail experience to lure shoppers away from multi-brand retailers. Still, the risk is real for incumbent retailers that, as consumer goods companies move further down the value chain to capture retail revenues, the size of the addressable retail market shrinks even further.

Could e-commerce's irresistible rise stall? Possible, but very unlikely

We believe the odds are low but not nil that changes in regulation and investor confidence could significantly hurt e-commerce and tip the scale back to physical retail:

- As of January 2020, competition authorities were investigating the possibility of harmful practices among dominant e-commerce firms both in the U.S. and in Europe. We believe it would take nearly unprecedented measures for antitrust authorities to put an end to the expansion of dominant firms, as well as a very broad and strong political consensus. In the U.S., the last event of a similar magnitude took place in the 1980s with the break-up of the former telecom monopoly.
- The introduction of additional bold environment regulation (carbon pricing in particular) could alter the competitive equilibrium between physical and digital retail. If e-commerce companies were found more carbon intensive than their traditional retail counterparts are, they would incur extra costs that could put their profitability under additional strain. Academic research has so far proven inconclusive because results are found too dependent on assumptions concerning shoppers' purchasing behaviors. Additional carbon footprint disclosure from retail leaders will provide evidence that is more conclusive in the coming years.
- A confidence shock among investors arising, for instance, from a string of e-commerce insolvencies could shift funding away from cash-hungry start-ups, but the eviction of weak players would only contribute to reinforce dominant, profitable players. A wider shock of liquidity in financial markets would have a similar outcome.

European retailers, too, should brace for further disruption

Discrepancies and breaks in historical series prevent direct comparisons between the fortunes of the U.S. and European retail industries in past years. However, quality data, when available, suggest some sub-segments are already experiencing a shock similar in nature and magnitude in Germany, France and the UK. In these countries, employment at household appliance retailers, for instance, has shrunk by 18%, 26%, and 30% respectively since 2009[8]. We believe top European markets, where e-commerce penetration is generally lower[9], will also experience further store and job eliminations albeit at a slower pace than in the U.S. Anecdotal evidence shows that European retail chains have generally proven more adaptive and resilient, and dominant U.S. platforms have comparatively lower market shares than in their home market.

[7] Source: company filings and management statements

[8] Source: Destatis, Acoss, ONS

[9] The market share of e-commerce is lower in Germany (8.8%) and France (9.1%) compared to the US (10.9%). Second only to China in terms of e-commerce penetration, the UK (22.3%) has been the country where retail disruption has been the deepest. Source: Fevad for France, eMarketer for other countries. Using smartphone ownership and Internet penetration as proxies, we believe Italy and Spain have lower e-commerce uptake.

APPENDIX—Scope of the report

The report focuses on those segments of the retail industry where we find significant competition between physical and online retail and disruption is the most at play.
This excludes food retail which has different economics, drivers, e-commerce penetration (growing fast but still below 2%) and, consequently, business dynamics (the segment has added more than 250,000 jobs since 2008). For the same reasons, we exclude regulated activities, such as pharmaceuticals as well as medical supplies and devices, and the retail of fuel and vehicles.

Establishment and employment data were compiled using the North American Industry Classification System (NAICS) with the following activity codes:

- 442 - Furniture and home furnishings stores
- 443 - Electronics and appliance stores
- 444 - Building material and garden supply stores
- 44612 - Cosmetics, beauty supplies, and perfume stores
- 448 - Clothing and clothing accessories stores
- 451 - Sporting goods, hobby, book, and music stores
- 4521 - Department stores
- 453 - Miscellaneous store retailers
- 4541 - Electronic shopping and mail-order houses

Our panel of listed discretionary retailers was built crossing different classification systems to be as exhaustive and as close to the scope described above as possible. To avoid survivor bias in an industry which has seen many bankruptcies, we conducted financial analysis over a panel which has changed over time.

Estimates of future establishment and job eliminations

We estimate future job and establishment eliminations taking account a mix of past data (retail sales, establishment and employment data, corporate credit metrics, announced capacity cuts) at a segment level as well as assumptions on US economic growth, e-commerce penetration and industry competition.

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