SUMZERO

MARKET COMMENTARY

RETAIL 2.0: *HOW IN-STORE EXPERIENCES WILL SHAPE BUYING HABITS IN THE 2020S*

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INTRODUCTION

The American consumer landscape was once dominated by big box retail offerings, department stores, and malls containing scores of shops, some of which served as satellite locations for luxury brands that, just a few decades before, were destination locations. For most Americans, shopping was a planned outing, usually event-centered, that required a trip to a brick and mortar (B&M) location that often inspired visits outside of one's intended destination. As internet-based retail led by **Amazon (AMZN)** began to take hold offering deep discounts and fast shipping, Americans began turning away from B&M stores and towards online shopping.

Department stores were the first to go with some disappearing completely (e.g., Montgomery Wards, which later reappeared as an online retailer) and others, like **Macy's (M)** and **J.C. Penney (JCP)** closing hundreds of stores, with the latter under threat of being delisted from the NYSE since August 2018.

The big box stores and small chains were next, with Toys 'R Us, Payless ShoeSource, American Apparel, and others filing for bankruptcy while leaving huge spaces open in shopping centers and malls. What looked like a sudden shift in consumer spending habits was framed in cataclysmic hyperbole – "the death of retail," "the retail apocalypse" etc – that suggested the end of B&M stores altogether.

Although there have been many casualties in the last two decades, B&M retail is far from dead. At the recent International Council of Shopping Centers conference, Retail & Entertainment panelists were quick to point out that despite dire prophecies, **more than 80 percent of retail sales still take place in brick and mortar stores.** What few people are talking about is how web-based retail catalyzed innovation is forcing retailers to rethink strategies around customer growth and retention.

Successful brands were quick to recognize the importance of omni-channel retailing, creating smart, user-friendly online experiences that utilized simple algorithms to suggest add-on buys, while providing easy checkouts, fast, trackable shipping, and easy return/exchange options, while still maintaining traditional stores. Still others, however, recognized the ability of in-store shopping to provide something that online retail can't: an experience.

Rather than attempting to keep up with the faceless selection, speed, and efficiency of Amazon, some stores recognize the power of retail as an experience, taking their cues from luxury brands and **opting to slow down certain aspects of shopping, making it personal, exploratory, and immersive.**

This has extended to malls and shopping centers. Developed by the privately held conglomerate Triple 5 Group, New Jersey's American Dream – the most expensive American mall ever built at $5.7B USD so far – has taken Mall of America's (Twin Cities, MN) vision and amplified it: in addition to luxury retail outlets like Hermes, Saint Laurent, and Tiffany & Co. alongside H&M and Ulta, American Dream boasts North America's largest indoor water park, an ice skating rink, and a 16-story indoor ski run.

While not all retailers are trying to compete at the intersection of theme parks and shopping centers, SumZero's contributors have an eye on a few that understand the importance of novelty and customer experience.

RE-IMAGINING IN-STORE EXPERIENCES

RH (RH:US, formerly Restoration Hardware)

Citing “promising growth outlook (through) its expansion and transformation plans,” in his long position on the luxury home furnishing brand, FK Capital’s **Eduardo Finkler** notes that:

“RH is optimizing operations and becoming more cost-efficient, (through) its new galleries and relocating or closing selected stores in these or adjacent markets. This strategy enables the company to consolidate fixed costs, close underperforming outlets or those that are no longer consistent with the brand positioning. The aim is to create iconic locations adapting to the customer´s needs and improving the in-store experience, they have also integrated hospitality experiences into the new galleries including restaurants inside them which have been very well accepted by the customers.”

These restaurants will likely be a far cry from the cafeteria-style Swedish meatballs offered by Ikea. RH’s rooftop New York Cafe in Manhattan’s West Village has a solid 4-star rating on Yelp and a 4.8-star rating on OpenTable: comparable to New York’s most exclusive eateries.

Even more appetizing are its returns: RH has exceeded expectations over the last four quarters and, according to Finkler, “**expected to have a net revenue growth of 8% to 12% in the next few years with the goal to reach $4 to $5 billion in North America revenues** with mid-to-high teens operating margins and ROIC of over 50% (it was 21.22% in FY2019).”

Equally bullish on RH’s potential is Warren Buffett: Berkshire Hathaway holds 1.2M shares – worth $264.9M as of latest close – in the company, making it the fourth-largest stakeholder.

EXPERIENCING THE BRAND

Canada Goose (GOOS:US)

If you walk into Canada Goose Holding’s newest concept store, The Journey, in Toronto, you will not find a single piece of inventory. You will, however, find a chance to experience one of the luxury performance company’s parkas in a subfreezing (10ºF, -12ºC) adventure simulation inside the store.

The Journey is part of GOOS CEO Dani Reiss’ innovation initiative that aims for deep customer engagement as the company began to see a steady drop in stock price last November. “We are pushing the boundaries of traditional retail and experimenting to see how an inventory-free format, where experience comes first, works,” Reiss told Bloomberg earlier this month. “Brand awareness and customer engagement are key goals for the store.”

In the new light of this retail reimagining, the stock may well be making a recovery: analyst consensus rates GOOS a buy, with a median target of $44.18 (opened at $35.42 on 01/06/20). Among those that see a strength in GOOS’ innovation is SumZero contributor **Zvika Finkelstein** of HASAQUE Wealth Management, who believes that the storm has passed for the retailer.

Acknowledging The Journey as the "first-of-its-kind concept that redefines luxury shopping with a guided and fully interactive and experiential environment," Finkelstein's bullish take embraces the spirit of change embodied in Reiss' vision.

"We believe that in today's reality," Finkelstein writes, "GOOS perfectly represents the next generation of retailers, by emphasizing customers' shopping experience through its innovative approach and inspiring moves." Like other luxury brands, GOOS enjoys the competitive advantage of pricing power, which Finkelstein notes, allow it to "realize materially higher margins (61% in gross margin and 24% in EBITDA margin during the period of trailing twelve months ending on September 29th, 2019)."

"RETAILTAINMENT" AND MIXED REALITY

Sony (SNE:US)

As a gaming, tech, and entertainment conglomerate dominating the gaming console and music publishing markets (it is currently #1 worldwide in both), it's not surprising that Sony Corp was one of the pioneers of "retailtainment," opening the Sony Metreon – originally intended to be the first of many urban entertainment centers built around the Sony brand – in San Francisco in 1999, long before ecommerce or the dot-com boom.

Although Metreon's execution was ahead of its time (it was sold in 2006 to the Westfield Group, an Australian mall developer), Sony's vision for an immersive, entertaining brand experience has re-emerged in **NYC's Sony Square**, which showcases mixed (virtual and augmented) reality demos, movie tie-in experiences, and other innovations traversing its diverse offerings. The atmosphere at Sony Square is decidedly curated: it has the look and feel of a showroom or interactive museum and, like Canada Goose, doesn't maintain any inventory. **Sony's confidence in its brand kindles desire, relieving visitors of purchase pressure, and inviting them to experience the products for themselves.**

This chance to "try before you buy" is critical for Sony, particularly in its key gaming segment. Noting that although Sony often sells the PS3 and PS4 systems at a loss, Eight Capital analyst **David Gan** interprets the popular consoles as an entry point:

"...the hardware forms the ecosystem for the key profit generators like software sales and subscription services," Gan writes in his recently updated long position published on SumZero. He continues:

"Sony is shifting more towards a service-based subscription model instead of hardware sales, allowing it to reduce earnings cyclicality and this business model appears to be the de-facto moving forward (e.g. Spotify, Netflix). Console exclusive titles give Playstation its moat and this moat comes from its large user base, which incentivizes game developers to release their killer titles with Sony, then keeping Playstation users loyal to its platform and at the same time, possibly converting users from other platforms to Sony. This creates a feedback loop which will only continually widen the moat, as long as the good titles keep flowing to Playstation."

With a median price target of $79.15, SNE may show slight upside, but bullish investors will note the company's solid earnings beats over the last four quarters and its record-breaking 7% income growth in Q2 2019, which earned them an upgrade to “buy” with a target of ¥8000 ($73 USD at time of upgrade) from UBS. Gan is equally confident in his position with a price target of $76.00.

The close of the 21st century’s second decade will see these trends molded and catalyzed by the rush of holiday spending as the spectre of an all-out trade war continues to cast its shadow over the market. No brand is too big or too old to fail, especially in retail (RIP Barney’s). Those who ply their trade in the sale of goods and merchandise – whether online or in B&M stores – cannot afford to lose sight of ever-shifting consumer attention spans and expectations. As these and other retailers have proven, however, the best way to prepare for the future is to invent it.

FEATURED SUMZERO MEMBERS

- **Eduardo Finkler**, Portfolio Manager at FK Capital Management Ltd., long RH
- **Zvika Finkelstein**, Founder/CIO at HASAQUE Wealth Management, long GOOS
- **David Gan**, Analyst at Eight Capital Advisors, long SNE

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