
Why Amazon Can't Kill These Three Retailers

Few companies are as feared as **Amazon** (Nasdaq:AMZN). And for good reason. Amazon has grown revenue at an average rate of 28% per year over the past ten years. Earnings have grown even faster, at 32% per year over the same period. Most of this growth has come at the expense of traditional retailers. This [Euler Hermes report](#) released last week sums it up nicely:

“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.”

There are bricks and mortar retailers that are thriving, though. We own two of them in the Forager International Shares Fund.

There are significant, sustainable advantages to having a large physical store network. Sometimes the economics are just better. Sometimes consumers want to touch, feel and see the product before purchasing it. And sometimes they just enjoy being there. Businesses focused on being the best in one or more of these three areas will keep on thriving.

Bricks and mortar economics just work in some industries

Grocery stores are a prime example. First, they're low margin businesses. **Woolworths** (ASX:WOW) earned an average of only 3% on revenue over the last decade. So keeping costs down is important. Rent and distribution are key here. Rent costs Woolworths less than 4% of sales. Stores like **Myer** (ASX:MYR) spend close to double that on rent, at around 7% of sales.

Then consider distribution costs. Consumers do the picking, packing and delivering for themselves when shopping in (physical) grocery stores. For free. The labour required in-store is declining even further with the roll-out of self-service kiosks. I can't remember the last time I had to interact with a staff member when buying my groceries.

In comparison, distribution costs (including rent) set UK-listed online grocery retailer **Ocado Group** (LSE:OCDO) back roughly 30% of total sales. Granted, this is on a much smaller base. A good benchmark nonetheless.

This means retailers like Woolworths can afford to sell products at lower prices than their online competitors. And keep making profits while doing so.

Consumers like to touch and feel some products

Grocery retailers like Woolworths benefit from this as well. I don't want to tally up the amount of time I've spent in-store trying to pick the best Granny Smith apples. It's a lot. But the idea of someone (or something) haphazardly selecting my produce for me just doesn't fly.

It's even more relevant for beauty retailers. **Ulta Beauty** (Nasdaq:ULTA) is a great example*. Something like 85% of Ulta's more than 33 million (and growing) loyalty program members shop in-store only. The remaining members shop both in-store and online, and are even more valuable to Ulta. When CEO [Mary Dillon](#) is questioned about the threat of Amazon (and she is, often) she always goes back to the tactile nature of beauty products. It makes sense. Often when consumers finish a product, they want to try something new. So they're not just replenishing the same product, which would be an easy online purchase. For example, if a consumer is looking to buy a new foundation, they'll need to find the right shade for their skin. This is a task best accomplished in person.

Ulta's operational performance over the last decade speaks for itself. The addition of almost 900 new stores and a successful eCommerce platform has resulted in revenue increasing 20% per year over the period, and earnings growing at almost double that. And it doesn't look like the business will be slowing down anytime soon. Ulta has more than 200 new store openings planned in the United States alone over the next few years, and management announced a planned expansion into Canada in May 2019. There are many other international markets where the Ulta concept makes sense.

Consumers like some stores for the experience

Without wanting to be accused of sexism, this one is going to resonate with some readers more than others. Some consumers visit stores simply for the experience. Whether it's the store layout, new stock or excellent customer service. Or all three.

Knowledgeable sales staff are another plus of the Ulta model. The cosmetics category is huge and constantly evolving. I could stock a pharmacy with the beauty products in my bathroom, but the sales staff at Ulta know exponentially more than I do about different ingredients and new releases. I could do my own research but it would take hours of internet browsing. And humans are social creatures. I'd rather deal with a friendly expert than an algorithm any day.

Not that algorithms aren't great. They're constantly improving. But they're not very creative. They continue to serve you things that are closely related to what you've bought before. But what if you want something different? Many consumers go in-store to be surprised. To buy things they wouldn't have thought about if they hadn't seen it in-store.

Zara is one retailer that gets it (mostly) right here. I've written about [the pioneer of fast fashion](#) before. The business is owned by Spanish-listed **Inditex** (BME:ITX) and its inventory strategy is central to what makes it different to most other retailers. They've managed to bring most of the benefits of eCommerce into their physical stores. An efficient design process means that new concepts take only three weeks to arrive in-store, compared to traditional retailers that plan their ranges up to six months in advance. And stores receive new stock twice weekly, in small quantities. This is enough to keep consumers coming back often to see what's new, and the small allocation of each design creates the illusion of scarcity.

But you can do all that online as well. What sets the stores apart is a great layout and constant movement of inventory. Every time you walk into your local Zara, you feel like you're walking into a new store. Contrast that with the eCommerce site, where you're left scrolling through hundreds of dresses waiting to feel inspired. There is definitely a place for online shopping.

When you know exactly what you want, the convenience is great. I do it frequently. But I don't think the desire for an offline experience is going anywhere.

Zara's strategy has translated into excellent results for investors over time. Inditex has grown revenue at 10% per year over the past ten years, while adding more than 4,000 physical stores. Yes, online sales are growing too. But they still only represent around 12% of total sales.

Bricks and mortar is here to stay

Online retailers like Amazon are clearly taking share. But it's largely from traditional incumbents that aren't doing a great job. There's no doubt that online retail will continue to grow. But I think bricks and mortar retail will also be bigger in ten years than it is today. Amazon [bought Whole Foods](#) in 2017 and has opened [a number of physical stores](#). Maybe they agree with me. If I'm right, there's still plenty of opportunity for the right retailers to grow their physical presence.

**Ulta is discussed further in our [December quarterly report](#)*