Retail Realities (Part I)

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"We expect the paradigm shift taking place to dramatically alter the retail landscape."
-COHEN & STEERS, global investment manager

INTRODUCTION

The reality facing the retail industry is that it has and will continue to evolve. The emergence of e-commerce players, such as Amazon.com, have pressured traditional brick-and-mortar stores to reimagine how they do business. One of the companies that has been in the crosshairs of this evolution is Nordstrom, an iconic retailer that has stood the test of time and successfully navigated the complexities of changing business conditions since 1901.

This week's EVA brings a special opportunity for Evergreen to sit down with Nordstrom's Co-President, Erik Nordstrom, and ask ten questions on the future of retail. This will run as Part I of a two-part EVA series on the topic. Next week's edition will examine what retail might look like in ten years and give a high-level overview of potential winners and losers in the space.

Please enjoy this unique (and rare) chance to spend time with a retail industry titan.

The opinions expressed by Erik Nordstrom are his own and do not necessarily reflect those of Evergreen GaveKal.

INTERVIEW

Evergreen: *The line between physical and digital retail is blurrier than ever. Traditional retailers are attempting to make an e-commerce push, while e-commerce players are opening (or buying) brick-and-mortar stores. What does this say about the future of retail?*

Erik: One thing is there's a lot of uncertainty. The market has been volatile on retail stocks – and for good reason. The business models of traditional brick-and-mortar retailers are changing and need to change, and levels of fixed costs versus variable costs change as more business becomes digital.

Higher-level, it's like any other industry that's going through significant change with significant speed – there's going to be winners and losers and there's stages you go through. It's not like we woke up yesterday saying, "e-commerce is growing real fast, we need to invest in it." It's been obvious for a while, but the speed has been surprising.

There's been a spectrum – some retailers have just been delayed in coming to the realization that there are fewer people going to stores and [realizing that] you have to have some other plays to run. But, coming up with other plays takes time – there has to be a willingness to try different things and experiment and have a portion of a company's investments be on more aggressive experimentation.

Evergreen: *Warren Buffett recently stated that "the department store is online now" and that he has "no illusion that ten years from now will look the same as today." What do you envision retail looking like in ten years?*

Erik: Ten years is so far out – even five years is tough. But, the implication is companies need to be agile, fast-moving, and nimble. One emerging trend that we believe in is that we're in a platform world. Customers and people spend time on platforms.

[Another] implication is that you're going to see more strategic partnerships. This could come in the form of acquisitions, investments, or commercial arrangements, but there are very few companies out there that have the ecosystem where they can go it alone. For example, brands and retailers are going to have to make some decisions [like where they're going to sell their products].

Part of this is that there's retail and then there's fashion retail. An element of fashion that I don't think is going to go away is that newness is important – there's always the hot, new brand that resonates with customers at a specific moment. [Brands] are unlikely to be great at technology, customer data, supply chain and some e-commerce capabilities that they're going to have to have, so they are going to have to look for partners. We do believe that retail will require more partnerships, and consolidation could be a part of that.

Working with mall developers [is another area of focus]. Traditionally, we've been pretty inwardly focused; we do a deal with a mall owner and that's it, we're done with them. But, they've got the same issues, even more so [than traditionally physical retailers], because they don't have an e-commerce mall to turn to. Synergies [need to be found] between things like gathering customer data and gaining some capabilities that would address customer pain points in coming to a mall.

Evergreen: *The retail trade has lost an average of 9,000 jobs per month so far in 2017. Do you expect retrenchment to continue?*

Erik: I'm not much of a macroeconomist as far as jobs go. But, I certainly don't see signs of the current trend changing, which is that we're in the third year of high single-digit declines in mall traffic. [A likely scenario] is the change of labor from retail stores to fulfillment and warehouse jobs.

Evergreen: *What role has technology played in the evolution of retail?*

Erik: It's impacted customer expectations. For retail, it's not about technology for technology's sake, it's about how technology changes customers' expectations and it has absolutely played a big part. What customers like about online shopping is the information they get. It's easy to use Uber as an example. [It's amazing] how quickly they've built the expectation of "I have a car coming. I want to know exactly where it is. Is it two blocks away? Is it one block away? Where is it coming from?" It's that way with packages. It's not only the speed of delivery, it's also about control, and technology has played a big role in controlling experience.

Customers are less willing to compromise on their experience. [That experience could be anything from] “I want to touch and feel it before I buy it” to “I want to buy it online but I want to return it in a store” to “when I’m in a store, I want to control what type of service I get. I don’twant anyone talking to me when I look around, but when I want someone I want themimmediately.”

More specific to technology, it’s the phone – having a computer in everyone’s pocket – that allows people to bring technology into the physical environment which is massively game-changing. I don’t think that’s such big news, but what that means and what customers want because of that, is. It’s easy to come up with technology solutions that are looking for a problem, as opposed to identifying a point of friction and applying technology as a solution to something very specific.

With any of these questions, it’s important to remember that it all has to come back to the customer. The customer must be the center of it all. Technology has empowered the customer more and forces [businesses] to be much more customer-centric. Taking Nordstrom as an example, we have a long history of customer service. But, really, our history is being salesperson-centric not customer-centric, because that’s how we got to customers, through salespeople. That’s not the case anymore.

If you think about rental cars, when Hertz went to hand-held devices where you didn’t have to check in at the counter anymore, interacting with less people actually was a better customer experience. There’s certainly elements in retail where a person helps, but there’s also elements where a customer doesn’t want to go through a salesperson. [Nordstrom] has had to challenge ourselves on going from being salesperson-centric to customer-centric.

Technology is certainly one of the influencers where the balance of power shifts so much to the customer that you have to put the customer at the center of everything you do.

Evergreen: *Do you foresee any cutting-edge technology that will be particularly disruptive in the space?*

Erik: Certainly, what “experts” point to today is virtual reality (VR), augmented reality (AR), and artificial intelligence (AI). Those are the buzz words of the moment. A year ago it was all about mobile. These categories [are relevant], but more specifically what’s the application of them?

I was demoing [something in the VR space] a couple of months ago, and thought “wow, that could really be part of a shopping journey and help with ensuring that when you’re buying something online it fits.” You can think of applications but it’s out there.

There is a tipping point where customers become accustomed to something and then it can turn commercial pretty quickly. Retail doesn’t have to be on the bleeding edge of that stuff, but what ends up resonating and what doesn’t?

Evergreen: *What role does Big Data play in the retail space?*

Erik: Data is an enabler to almost anything that retailers want to do. Certainly, you have to be more personalized these days in marketing, in service, in how to move product around – and it takes data. Having data as a key part in someone’s business model and their competitive capabilities is hugely important.

Evergreen: *What will separate the "winners" from "losers" over the next 10 years?*

Erik: Agility, speed, and being able to change in a very customer-centric way. Retailers will certainly have to have digital and physical capabilities. It's hard to think of any pure-play e-commerce people that don't have physical stores now, so I think that's a given.

Back to the partnership thing, I don't think people will survive going it alone. Picking partners will be very important. As an example, it's super interesting to me what Wal-Mart is doing, specifically with their big bet on Jet.com. They're being aggressive – and they're probably the only one with the scale to take on Amazon head-to-head. It's interesting, but it's not just making big bets, it's making the right bets.

Evergreen: *Where do you see the most opportunity in retail?*

Erik: I think there will be a separation as things become increasingly digital between transactional commerce and experiential retail. Not all retail is going to move to being transactional.

[For example], what are the shopping errands where if you completely removed the errand, customers would prefer that? I don't think fashion lends itself to that. There is a separation between when you know what you want to get and making it as easy as possible, and the discovery of new things.

I was looking at QVC and Home Shopping Network merging, and I never really understood TV shopping, but it's massively successful and it's pretty defensible against [online retailers] because it's a discovery thing. Those channels lend themselves to someone saying, "Gosh, that is the most incredible mop I've ever seen. Getting a new mop wasn't on my shopping list, but I have to have that."

It's going to be hard for [physical] retailers to compete against [online retailers] on pure transaction stuff. So, that moves the battlefield to the experiential and who can bring that to life.

Evergreen: *What are the biggest challenges facing both physical and e-commerce retailers?*

Erik: Certainly, within physical, it's the drop of traffic and that's not going to change anytime soon. For e-commerce, the biggest challenge is getting traffic. Over half of product searches start on Amazon now, so if you're not on Amazon you don't have a chance of getting noticed. Getting traffic through Google and Facebook is also getting more expensive.

Fewer people are going to malls and [some retailers] aren't getting enough traffic on their website. Some people simply need a bigger platform. The way traffic happens online, it's really hard to get eyeballs on a product.

Evergreen: *In television, owning quality content has proven to be key for companies in the changing cable landscape. Is the ultimate protection for retailers owning established, trusted brands?*

Erik: I don't think you have to own them. There has to be some differentiated product.

There's this guy named Scott Galloway – he's a professor at NYU – who spoke a few months ago on the Amazon effect on brands. His comment core to Amazon's model is that they take any margin, anywhere, and look to pass it onto the customer.

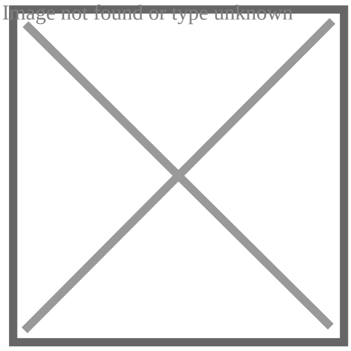
But brands have margin because they're trusted – [customers are] willing to pay 10% more verses a no-name brand. The example [Scott] gave during his talk, was using an Echo on stage.

> **Scott**: Alexa, I want to buy some batteries.
> **Alexa**: Yes, we have the Amazon-brand D-sized battery in a twelve pack.
> **Scott**: No, I don't want that.
> **Alexa**: OK, well, we have the Amazon-brand D-sized battery in a twenty-four pack.
> **Scott**: No, I don't want that either.
> **Alexa**: We have no other batteries.

Then, Scott pulled up Amazon.com and, of course, there's Duracell and other branded batteries online.

Now, do customers care about a brand in batteries? Maybe not, but in fashion I believe they do because of the cool factor.

Getting back to partnerships, owning is one way of doing it, but retailers' track record on owning stuff tends to lose its credibility and authenticity. [It could be that, or it could be saying], "Whatever hot brand is out there, let's partner and combine forces and make our supply chain much more efficient. We'll fill your web orders and our web orders from the same warehouse. And when it goes to off-price, this is how we're going to solve it." Having that type of synergy is essential.



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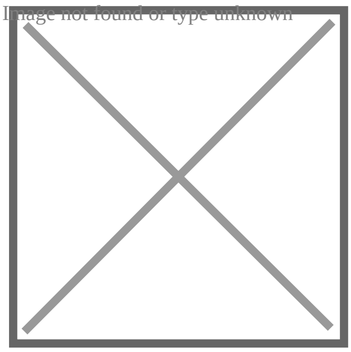

Erik Nordstrom
Co-President, Nordstrom, Inc.

OUR CURRENT LIKES AND DISLIKES

Changes highlighted in bold.

LIKE

- Large-cap growth (during a correction)
- International developed markets (during a correction)
- Canadian REITs (on a pull-back after a healthy recent run-up)
- Cash
- Publicly-traded pipeline partnerships (MLPs) yielding 7%-12%
- Intermediate-term investment-grade corporate bonds, yielding approximately 4%
- Gold-mining stocks
- Gold
- Intermediate municipal bonds with strong credit ratings
- Select blue chip oil stocks
- Emerging bond markets (dollar-based or hedged); local currency in a few select cases
- Mexican stocks **(at lower prices after this year's strong rally)**
- Solar Yield Cos on a pull-back
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)
- **Short euro ETF**

NEUTRAL

- Most cyclical resource-based stocks
- Short-term investment grade corporate bonds
- High-quality preferred stocks yielding 6%
- Emerging market bonds (local currency)
- Mid-cap growth
- Emerging stock markets, however a number of Asian developing markets, ex-India, appear undervalued
- Floating-rate bank debt (junk)
- Select European banks
- BB-rated corporate bonds (i.e., high-quality, high yield)
- Investment-grade floating rate corporate bonds
- Long-term Treasury bonds
- Long-term investment grade corporate bonds
- Intermediate-term Treasury bonds
- Long-term municipal bonds

DISLIKE

- US-based Real Estate Investment Trusts (REITs) (once again, some small-and mid-cap issues appear attractive)
- Small-cap value
- Mid-cap value
- Small-cap growth
- Lower-rated junk bonds
- Large-cap value

- Canadian dollar-denominated bonds
- Short yen ETF (in fact, the yen looks poised to rally)