TILLS TIP TOWARD ONLINE RETAILERS

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Transformation of the retail industry

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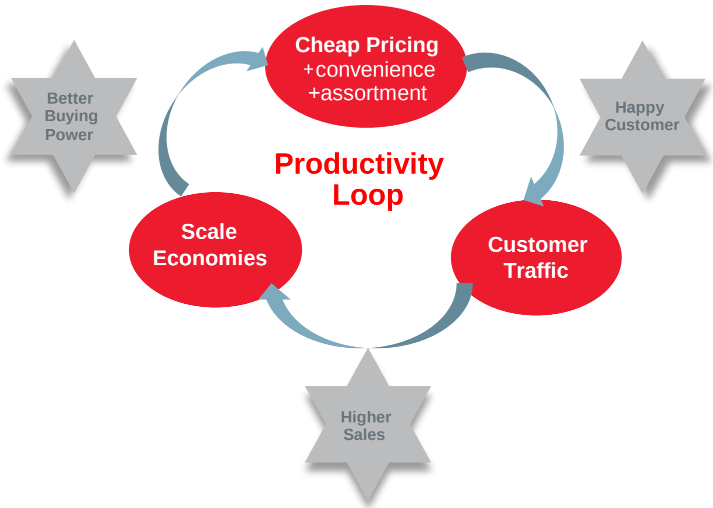
The mass proliferation of hypermarkets and department stores over the last 30 years was driven by price, convenience and assortment. These attributes attracted customer traffic, helped build sales volumes and the resulting scale efficiencies led to cheaper pricing, further attracting customer traffic. This virtuous cycle came to be referred as the ***productivity loop***, and made the big players even bigger and pushed smaller retailers out of business.

Chart 1 : Productivity Loop Enjoyed by Retailers



Source ; Eastspring Investments (Singapore) Limited

The growth of e-commerce over recent years opens up a wider question. Can e-commerce reverse this ***productivity loop*** by weaning away customers from these modern-day retailers; and in the process severely damage profits and stock market valuations for all retailers?

Today, an e-commerce website (Amazon in US / Europe and Taobao in China) offers all the 3 attributes essential for the productivity loop - price, convenience and assortment. Online shoppers can compare prices for similar products across online marts as well as behold a wider assortment with a mere click of a button. Furthermore, the convenience of shopping 24/7 from home without any traffic, pollution or queues is appealing.

Chart 2 : Customer survey on E-shopping

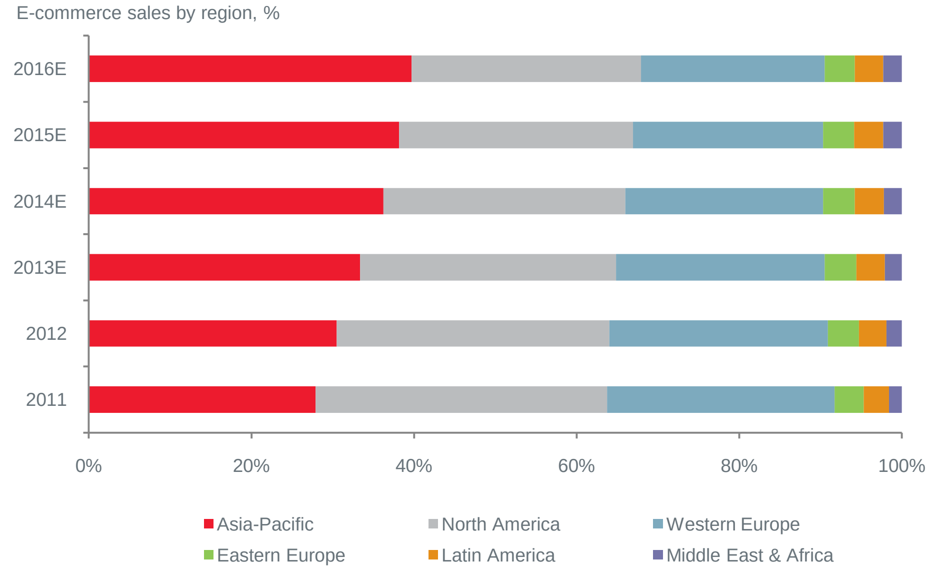
Source ; iResearch, Macquarie Research from Alizila.com website, 2011 data

Online retail is growing fast

The threat from e-commerce to modern-day retailers is real and unraveling at an amazing pace right now. E-commerce sales reached USD 600 billion in 2011 or 6% of global retail sales.[1] While the USA is currently the largest, the Alibaba group estimates China to cross USD400 billion in online retail sales by 2015. High internet penetration and cheap smart phones have made e-commerce thrive in Asia, even in India where modern-day brick-and-mortar retailers are yet to build meaningful presence.

[1] Source : Credit Agricole Securities, USA,

Chart 3 : Asia Pacific set to be a leader in e-commerce sales in 2013



Source ; Citi Research, eMarketer, Jan 2013. The data includes travel, digital downloads and event tickets purchased via any digital channel (including online, mobile, and tablet): excludes gambling

E-commerce retailing in Asia = Faster with bigger risks and rewards

Online retailers are harnessing the productivity loop to gain market share

Unlike their Western counterparts, most Asian consumers' shopping habits at hypermarkets and department stores are still in their formative stage; and thus more flexible to adopt new trends involving the internet. The ongoing global slowdown means every new dollar of sales earned is mostly at the expense of the shopping mall or hypermarket. As e-commerce grows, these online retailers start enjoying the productivity loop with the scale benefit working for them. As modern retailers start losing volumes to online retailing, their scale benefits stop or reverse, cutting off the **productivity loop** for them. This in our view has significant implications for retailers and their eco-system. Already it has caused some of the biggest electronics and books store chains globally to shut down.

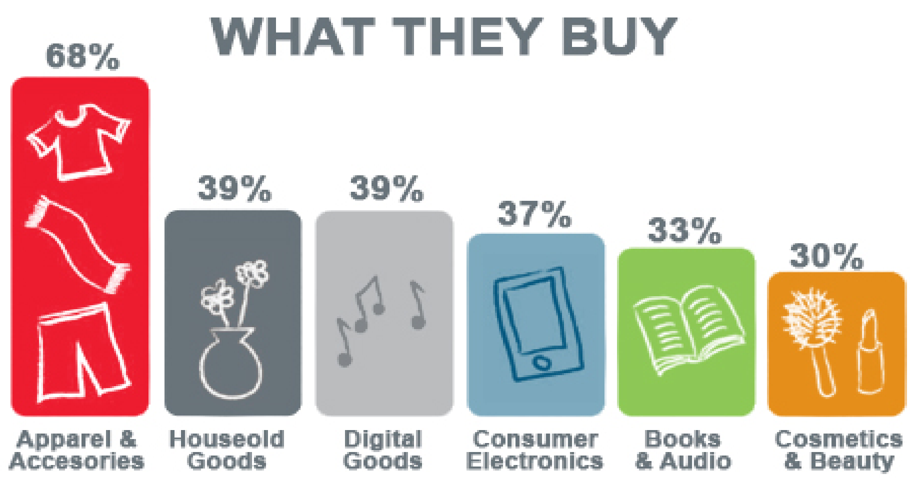
Furthermore, the scale gap and the starting point in Asia is quite narrow compared to when e-commerce platforms were pioneered in the developed markets. For example, Chinese retailers, Sun Art Retail Group and Golden Eagle Retail Group, need to devise their internet platforms almost at the same time as the ones in Singapore, Korea or Australia, which are far more developed and penetrated retail markets.

Implications for the retailing industry

Retailers selling standard products are likely to face a challenging future

Retailers at the mid-end of the market selling a standard product with little customization or shopper experience face the biggest risk of customer loss to online platforms. This loss of customers and hence scale can quickly become a vicious cycle, leading to large decline in profits. Electronics retailers, books, children goods, handbags fall in this category. For instance, in China (refer to Chart 4), apparels, household and digital goods are items most bought online.

Chart 4 : Online buying preferences in China



Source ; China Internet Network Information Centre, 2011 data

Brand owners may regain some bargaining power

For the brand owners, however, it is déjà vu time. Retailing fragmentation and the reversal of the productivity loop would enable many to regain some of the pricing power lost to the hypermarts and department stores over the last few decades. Further online shopping would make the brand more critical than store shopping (lack of touch and feel). Apple for instance, sells its devices directly to consumers; and Procter & Gamble has trialed direct selling in the USA. We expect the ones focusing on brand development to emerge as winners.

The shifting preference towards online retailing will affect not only department stores, hypermarkets and brand owners, but other industries ranging from property landlords, logistics companies, to smartphone / tablet makers and payment companies. Some will be adversely affected while others stand to benefit.

Smart phones are fuelling "show rooming" behaviour

The winners among smartphone and tablet makers will be those who can shift from "improving the hardware" to "improving the shopping experience.'' Smart phone applications need to become more intuitive and better designed to make it easy for people to buy products and encourage "show rooming''[2] behaviour. Similarly, payment processors need to ensure a smooth payment experience. PayPal appears to have a head start over their traditional counterparts like Visa, and stand to gain immensely from this surge in online shopping at the cost of credit card companies.

For an online retailer, his biggest cost is delivery logistics and his largest saving is prime space rentals. In contrast, rentals are one of the biggest cost for department stores and hypermarts. Property landlords will need to readjust to lower rentals, to help shopping malls fight the online tide and keep their malls competitive.

Supply chain companies are clear winners in the rising e-commerce penetration

Supply chain companies stand to gain with most online retailers choosing to outsource distribution centres and deliveries. **Li & Fung**, a Hong Kong based global trading group, manages several product lines for Amazon in the US. **Singapore Post** has built an entirely new business satisfying the Singaporeans' global shopping appetite. **Blue dart** is an Indian logistics company with rising exposure to online shopping in India.

How are offline retailers fighting back?

Offline retailers are fighting back with the experience creation concept not replicable by internet

The area which is expected to see the most work by this 'offline' camp against the new 'online' camp is the experience creation – the thrill, emotion and sense of belongingness to the shopping venue. Shopping malls and department stores need to evolve into niche, differentiated, experience centres; something not replicable by the internet. The Korean retailers have introduced networking clubs, kid clubs and top-notch customer service to attract and keep the family within the shopping precincts. To us, they are emerging as lifestyle destinations for the family to get together, eat and spend their leisure time.

Another area crucial in fending off online competition is product differentiation, customisation and exclusivity. High end luxury brands should continue to do well due to their strong brand and social statement. Besides, the pampering and personalised sales advice at such stores can be quite irresistible. Shopping malls like Paragon in Singapore are able to stand out with their focus on premium luxury, but several others on Orchard Road may need to reposition themselves.

[2] A consumer visits a department store to evaluate a product, and then purchases the product online for a lower price

Big box retailers are moving closer to the customer

Eventually, the consumer may split his essential shopping into two – buying the general merchandise online and the daily grocery at the neighborhood store, while shopping malls become family leisure destinations. This allows him to get the best of all worlds. We believe the convenience chains and mom-and-pop stores are very well positioned to benefit from such a change in consumer buying patterns. They benefit from being the first port of call for the consumer and also become the pick-up point for online deliveries. Their ability to extend small credit in the neighborhood also gives them a big advantage over the internet. The above trend is likely to push the big box retailers closer to the customer homes in the form of big supermarkets. Meanwhile the online retailer has also started tying up with neighborhood stores and opening local warehouses to enable faster and low-cost delivery. Several of them have started offering same-day delivery services.

Our View

Now is the time to identify and position investments in the evolving retail landscape

We expect several retailers to see their productivity loops severely tested over the next few years as e-commerce gains in prominence across Asia. The key to pick winners is to look at their market positioning and customer moat versus the expectations on returns and growth built in their share prices. We do extensive research through meetings, on-the-ground checks, and proprietary valuation to identify the winners and losers. The recent market preference for stability and defensive companies provides an attractive opportunity to exit some of these otherwise old business models, which are unlikely to stand this onslaught from e-commerce. Companies which cannot adapt to the new reality can see their returns and share prices decline sharply in our view.

Meanwhile the eco-system around the mainstream e-commerce companies, namely the technology companies, supply chain players, convenience stores would be an attractive area to identify future winners from this paradigm shift, at the right valuation.

Undoubtedly, these shifts and the loss of the productivity loop will take a few years to be fully visible and mainstream. But we think it is appropriate to analyze the growth and return fade rates for several of these companies right now. Markets and investors will not take that long to discount these possibilities in stock prices.

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