



The New Normal: Retail Going All-In Online

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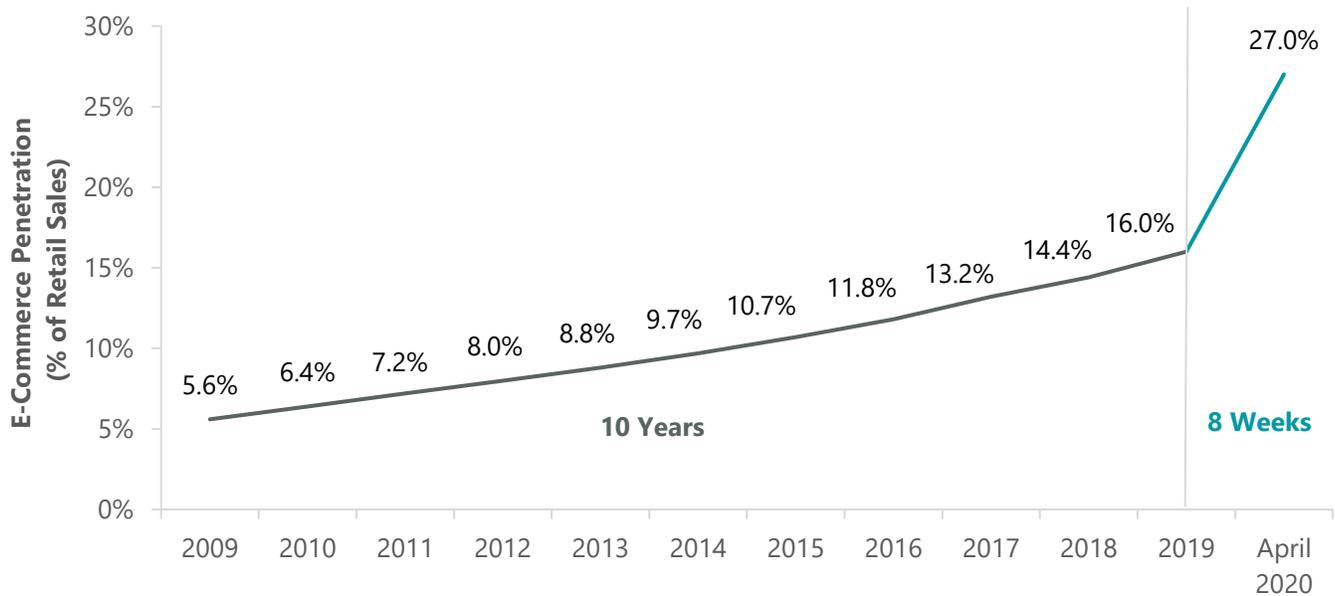
Key Takeaways

- ▶ With most stores and restaurants closed during the height of the COVID-19 pandemic lockdown, consumers shifted their purchasing online, with e-commerce sales soaring across multiple categories and formats.
- ▶ Retailers large and small are leveraging investments in in-house or third-party e-commerce technology to handle surging demand, with the buying experience for groceries and restaurant meals seeing the greatest transformation.
- ▶ While we expect the share of online sales to decline off current peaks as the economy begins to reopen and physical stores and restaurants welcome back customers, the inroads made by e-commerce in certain areas of retail are likely permanent.

E-Commerce Sales During COVID-19 Lockdown Near Holiday Levels

To the multiple benefits of online shopping – price, convenience, wider inventory and easy product comparisons – the COVID-19 pandemic has highlighted another: safety. As shelter-at-home and social distancing policies have kept a majority of U.S. brick and mortar retailers shuttered since March, e-commerce sales have soared (Exhibit 1), with both online merchants and traditional retailers with a digital presence seeing above-average volumes. Online enablement provider Shopify released data in April indicating that its e-commerce platform was handling global commerce traffic in line with 2019 holiday season levels. Restaurants have also been forced online to keep their businesses open, with the food delivery market growing by multiples during the crisis.

Exhibit 1: U.S. E-Commerce Penetration



Source: ShawSpring Research, Bank of America, U.S. Department of Commerce.

While we expect the share of online sales to decline off current peaks as the economy begins to reopen and physical stores and restaurants welcome back customers, the inroads made by e-commerce in certain retail categories are likely permanent. The department store and specialty retail channels were already deeply challenged ahead of the pandemic and things are expected to get worse for the weakest players. JCPenney, Neiman Marcus and J.Crew have filed for bankruptcy protection since the onset of the pandemic, which should accelerate a cycle of permanent store closures.

Having an online or omnichannel sales presence should be a differentiator in terms of who survives, but even those retailers that continue operating may do so with a reduced physical store base. This environment gives retailers an opportunity to look at their store fleet and optimize in a world where some mix shift to online is permanent. Many physical stores are being repurposed as local distribution points or hubs and for buy online pick up in store (BOPIS) formats. While there are challenges in doing this, these stores can help lower fulfillment costs (last mile cost is cheaper if local) and improve shipping speeds to same-day or within a few hours using third party delivery services or their own in-house solutions.

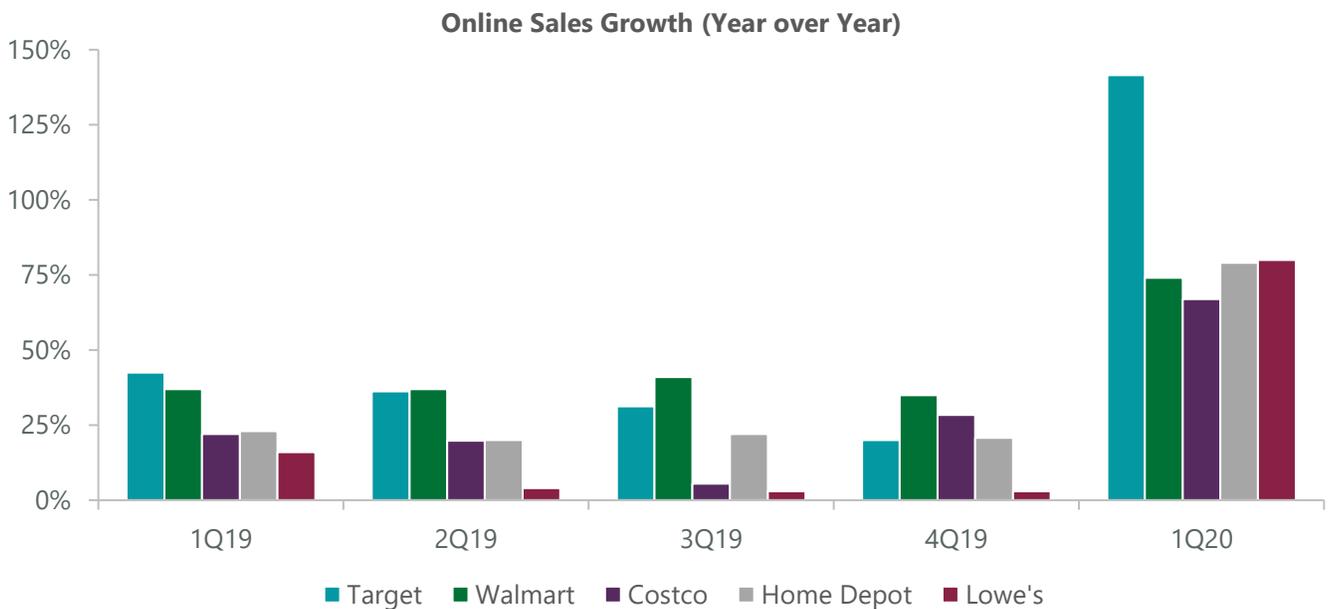
The experience of the last several months illustrates the importance of having robust e-commerce capabilities. The goal is to give customers many options to increase share of wallet and often times omnichannel customers will use multiple solutions depending on their need at the time. We see general merchandise, e-commerce enablement and food delivery as categories likely to benefit from the shift online.

Online Sales Surge at Large Retailers

Digitally native e-commerce companies have seen sales accelerate as COVID-19 lockdowns occurred. Amazon.com remains the dominant player in e-commerce and has benefited from consumers stocking up, particularly on essential items. Accelerating retail revenue growth in the first quarter was accompanied by higher spending on hiring, fulfillment and safety precautions related to COVID-19. The crisis is also allowing Amazon to accelerate progress around strategic ambitions in grocery, where delivery capacity expanded 60% in 1Q.

After an initial period of stocking up in physical supermarkets, many consumers relied on online purchases of groceries as the stay-at-home period wore on – a trend that benefited retailers offering grocery assortments and likely has staying power. As shown in Exhibit 2, first-quarter online revenue gains were substantial at Target (+141%), Walmart (+74%) and Costco (+50% in March and +88% in April). Most of Walmart’s online grocery sales, for example, are for curbside pickup while Costco offers two-day delivery of non-perishable products. We believe both retailers are well positioned for changing purchase habits – Walmart for its ongoing investment in online pickup and now delivery and Costco for its attractive pricing relative to e-commerce pure plays that make it a formidable online competitor when value is the focus. For the grocery category overall, we expect to see an accelerated shift to online shopping in its various formats – BOPIS, direct delivery from supermarkets and third-party delivery services such as Instacart – from the COVID-19 experience.

Exhibit 2: Online Sales Growth Accelerated During the Lockdown



Source: Company Reports, ClearBridge Investments.

Home improvement chains have also seen spikes in e-commerce activity. 1Q online sales were up 80% year-over-year at Lowe’s compared to growth of just 3% in the second half of 2019 while Home Depot saw online growth spike to 79% in 1Q from 21% in the second quarter of 2019. Lowe’s, which has struggled with online sales compared to Home Depot, benefited from its recent migration of e-commerce operations to the cloud which provided the needed capacity and functionality to handle increased traffic during the lockdown. Online sales for both companies are mostly BOPIS. We see a permanent shift to digital in many categories across big box retailers, whose previous investment in sales and fulfillment infrastructure should continue to increase going forward.

Technology Keeps Smaller Merchants Competitive

Online enablement providers like Shopify and Wix.com are helping many small businesses establish and expand e-commerce presence during the COVID-19 crisis. Shopify provides back-end technologies that allow merchants to establish online stores, market their products, and manage their burgeoning customer bases. The company also helps merchants convert those new customers into regular buyers by enabling such services as free shipping and easy returns. Shopify unveiled an expanded tool set for merchants and customers last month including a local delivery option at checkout and an application for customers to manage their orders. Wix has also seen an influx of new demand from customers creating websites utilizing its tools, including adding payment capabilities to facilitate e-commerce. Wix has discussed seeing traditional businesses like fitness establishments begin training clients online, leveraging the company's technology.

Etsy.com, a diversified e-commerce marketplace driven by single proprietor or small business sellers, has also seen sales growth accelerate in recent months, including over 100% growth in April. Etsy pivoted quickly as lockdowns expanded, updating search algorithms and calling on sellers to produce more in-demand goods, highlighting astute management execution and the nimble nature of its marketplace. The company is focused on continuing to engage new buyers which could yield lasting results. Etsy's experience highlights the success that can be achieved online through investment in digital technologies and continuously delivering improved experiences for buyers and sellers.

Lastly, Facebook provides another example of a company expanding tools to help small businesses sell online. Facebook Shops was announced in May and will enable businesses to easily set up a shop for free, have it run across all Facebook apps and allow users to check-out natively without leaving the website. Given Facebook's scale both in users (2 billion daily active users to one of Facebook's family of apps globally) and small businesses (160 million small businesses already use free Facebook tools to reach customers), Shops has the potential to further accelerate e-commerce penetration.

Food Delivery Becoming Essential for Restaurants

Just as brick and mortar retailers have relied on e-commerce through the COVID-19 crisis, restaurants have kept their doors open by offering food delivery. With new social distancing polices that will limit sit down traffic when dining establishments do reopen their tables, we expect delivery/takeout to become a core part of the business model for many restaurants. Chipotle Mexican Grill noted in its 1Q earnings report that delivery and contactless pickup channels are helping mitigate a significant decline in walk-in traffic. Digital was already a higher percentage of its business compared to peers and penetration has accelerated to close to 70% of its sales mix. Overall, reduced dining room seating should end up being a positive for the food delivery market.

Uber, which operates the No. 2 food delivery service Uber Eats, believes the total addressable market for food delivery has expanded significantly as a result of the COVID-19 crisis. Higher food delivery volumes have been driven by an influx of both new restaurant sign-ups and new consumer demand. Average check sizes for delivery have also increased in the stay-at-home environment as customers buy for their families instead of just themselves.

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