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TRADITIONAL RETAIL AND ITS SUB-SECTORS

ARE YOU BEING SERVED? UNDERSTANDING THE INVESTMENT FUNDAMENTALS OF TRADITIONAL RETAIL

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In 107 AD, Emperor Trajan had an idea that would not only improve the life of Rome's citizens but eventually transform the way we spend our money today. What the city needed, he decided, was a shopping mall.

And that's exactly what he got. Three years later, Trajan's Market, featuring more than 150 stores and offices spread over several levels, opened to the public and, it could be argued, modern retailing was born.

Indeed, using ancient Rome as an example helps us realize that traditional retail is probably the most fundamental of the sector fundamentals we will study. After all, we all need to shop, most of us are quite good at it, and, as you can see, humans have been doing it for rather a long time.

NEVER KNOWINGLY UNDERSOLD

Of course, the sector is wider ranging in scope than just megamalls. Traditional retail begins with the convenience stores located on the ground floor of your apartment block and encompasses everything in between. So, before we get down to the business end of this discussion, let's take a high-level look at the sector.

Traditional retail shares many similarities with the food-and-beverages industry — location is crucial because it drives traffic flow and therefore revenue turnover. Emperor Trajan knew this, and that is why he built his mall a slingshot away from the Colosseum.

Another crucial factor underpinning this business model is operational efficiency. How shopkeepers undertake product sourcing and organize their stores, as well as a host of value-chain-related engagements, eventually add up to the dollars and cents on the expenses category of their profit-and-loss statement.

Managing operational costs is definitely an important aspect, but it should never be achieved by compromising the shopping experience. We have all been in a store where it's impossible to find a sales assistant or where the lighting is so dim we can barely read the product labels. This may save staff and power costs, but it doesn't improve our mood.

EVERY LITTLE BIT HELPS

Retail is a scale business — the bigger the operation, the lower the cost per square foot of retail space. As noted, operators have relatively mature operational procedures given the centuries of experience on which they draw. This is reflected in the depth, breadth, and accuracy of their merchandise and how it is displayed. Consider the placement of fruit and vegetables at the beginning of your supermarket journey — its looks fresh, colorful, and inviting. Retailers have become good at promotional pricing strategies: $9.99 is more appealing than $10. Buy one, get one free may give us a thrill, but do we really need two of the same item, especially if the additional product just adds to the general clutter at home?

Store operators know that after a long day at work, consumers may not be in the mood to test their hunter-gatherer instincts any further by traipsing around a busy shop; hence, the rise of value-added services, such as door-to-door delivery. This point leads us to the future — this industry is not being spared from the impact of technological advancement. The internet has become a massive shopping mall that we can explore from our living rooms.

I LIKED IT SO MUCH I BOUGHT THE COMPANY

A logical framework of analysis commences with an understanding of the nature of a company's offerings. Examine the extent of nondiscretionary demand — in other words, does the firm sell essential items, nice-to-have products, or a mix of the two? This will alert you to the company's sensitivity to changes in the economic climate. Simultaneously, explore the elasticity of its products and services and determine whether a change in unit price will affect customer demand. This may be more applicable to food retailing, in which numerous firms are selling the same item. Establish which of the company's product categories are more sensitive to price changes. It is worth understanding whether the company is purely into third-party retailing or maintains its own labels, as the latter tends to offer higher margins if value has been established.

It makes sense to find out whether the company fully understands its customer base. Does it undertake segmentation to classify different spending groups? If so, which dimensions does it use and does it have specific product lines, brands, or strategies that target these segments?

To build a more in-depth knowledge of the company, consider the bigger picture and look at the longer-term demographic, macroeconomic, and geographic factors that affect its operations. Are its stores in city-center locations, but the population is moving elsewhere? This occurred in the United States, with downtown districts becoming ghost towns, while the suburbs boomed. Does the company face tough competition — for example, how easy is it for new players to emerge and compete, and are there any barriers to entry?

IT DOES EXACTLY WHAT IT SAYS IT DOES

It is sensible to delve into the company's books with a study of its operational efficiency. Lines of enquiry to follow include a review of how it has performed organically and on a like-for-like basis. Can the business provide a detailed breakdown of its sales performance?

Appraise the cost structure of the firm's products and services. What are the key elements that drive cost and how does it manage each aspect? Importantly, survey its cash position and the way in which it is controlled.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE FACTORS

The study of environmental, social, and governance (ESG) factors goes hand in hand with operational efficiency. The retail sector stands out as being more exposed to ESG risks than other areas of the market. Among the many avenues of inquiry, we suggest concentrating on people and process. Has the company implemented policies that protect workers' rights? Many jobs in retail are low paid, and firms rely heavily on cheap goods manufactured in the developing world. From a process perspective, how much money does the company spend to ensure that its packaging is recyclable and viably sourced?

THE FUTURE IS BRIGHT

Following that examination, analyze the future growth potential of the business. This screening should occur in two steps: First, look at the company's principal store formats. Are these department stores, hypermarkets, discount warehouses, or convenience outlets? If it has a mix of formats, does the company have a strategy to manage this? Second, probe space expansion and store openings, which can be a double-edged sword. It helps to have some knowledge of how much the firm's plans will cost financially and how they will affect brand appeal. A quick expansion can go horribly wrong — doughnut seller Krispy Kreme suddenly appeared everywhere, but its profits, unfortunately, failed to maintain the pace of its growth.

VORSPRUNG DURCH TECHNIK

Retailing and the internet were made for each other — shopping pleasure combined with sofa-based convenience, particularly on a rainy Sunday in January. No study of the sector would be complete without touching on the effectiveness of a company's online presence. Moreover, if a company lacks one, what threats does it face? Businesses that sell nonessential items are at risk, because people won't go out of their way to find a store if they can source the product online. The proof of this is reflected in Amazon's profits.

The other side of the technology coin pertains to distribution, and how quickly a retailer can get its products to market. Investigate how much money a company is spending (or has spent) on ensuring that its operations run efficiently.

As always, these guidelines are designed to provide a short but solid foundation to kick-start any future analysis. As we end, let's raise a glass to Emperor Trajan . . . because you're worth it!

About the Authors

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TRADITIONAL RETAIL

Infographic showing the step-by-step process of analyzing the traditional retail industry

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1. **How elastic are the company's products and services?**
   a. Does a change in unit price impact customer demand for the company's products?
   b. Do price decreases and increases have the same elasticity? Does it vary across price levels?
   c. Which of the company's product categories are more sensitive to price changes?
   d. When prices change, how does the company manage its purchases? How much of price impact is passed on to its customers?
   e. What price investment strategy does the company follow in the sector? How competitive or different is this from other firms?

2. **What is the extent of non-discretionary demand for the company's products and services?**
   a. What is the company's product profile?
   b. What proportion of the company's product range is categorized as enjoying non-discretionary demand?
   c. For those products where demand is discretionary, which factors drive consumption?
   d. How does the company forecast demand for its products?
   e. Does the company observe seasonality in demand or supply across the products it manages? If so, which products are these and what is the company's strategy when managing them?

3. **What are the long-term demographic, macroeconomic and geographic factors impacting demand?**
   a. What is the average person's age in the company's key markets? Is this expected to change?
   b. How significant a role does consumption play in the company's key markets? Is there space for structural growth in these economies?
   c. How urbanized are the company's key markets?
   d. Is the company flexible enough to quickly leverage or exploit changes in customer trends?

4. **Does the company undertake segmentation of its customer base? If so, what dimensions does it use?**
   a. Under which segments does the company classify its customer base?
   b. Are there significant differences in spending behavior across these categories? How does the company track these?
   c. Does the company have specific product lines/brands/strategies that target the different segments?

5. **How easy is it for new players to enter and compete? What are the entry barriers?**

6. **How has the company performed in terms of constant currency growth and organic volume growth rates?**
   a. Does the company provide a detailed breakdown of its sales performance in terms of volume and price? Similarly, can it produce growth by same-store sales, net additions, inorganic growth and FX impact?
   b. What are the key qualitative factors driving these numbers?

7. **What is the cost structure of the company's products and services?**
   a. What are the key elements that drive the company's cost profile? How does it manage each cost aspect?
   b. What are the company's gross, operating and net margins?
   c. How has this trend evolved over the past few years and how does the company see it developing in the coming years?
   d. How is the company placed in terms of profitability and cash position against its competitors?

8. **How is the company's cash position managed?**
   a. What is the company's inventory and working capital management strategy? How successful has it been in implementing this and what have been the key challenges? How does it plan to address future challenges?
   b. What is the company's average debtor turnover, creditor turnover and inventory turnover days? Combining these, what is the average cash-conversion cycle, in terms of days?
   c. What is the company's free cash flow level as a percentage of sales? How has this trend evolved over the years?
   d. How do the company's turnover and cash flow trends compare to its competition?

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9. Space expansion and store opening – what are the associated expenses?

a. What is the company's strategy for managing space through the addition and removal of stores?
b. How many stores have been added and how many closed in the last few years? What were the reasons for this?
c. How do sales from new stores compare with sales from existing stores?
d. If new stores typically contribute more, how long does this usually last? If they contribute less, how long it takes for them to catch up with the older stores?

10. What are the company's leading store formats – department stores, hypermarkets, discount stores or convenience stores? If it is a mix of formats, does the company have a strategy to manage this?

a. What is the revenue mix from different store formats and how is this evolving?
b. How does the company differentiate between store formats and tackle cannibalization among them?
c. Do profitability and margin trends differ among store formats?
d. Has the company identified any preference among its customers for a store format?
e. Does the company have a long-term management plan for its store format mix?
f. What percentage of sales comes from online channels and how does the company see this evolving?
g. Do per-unit economics differ between the online channels and the brick-and-mortar channels?
h. What are the company's average delivery and technology costs for its online channels? Does it have a strategy to reduce these?
i. Which store formats are most likely to be affected by a rise in online sales? Does the company have a strategy to manage this change?
j. Does the company have pick-up points or pick-at store options that work in tandem with its online channels? Will these impact its costs and margins?

11. Demographics and urbanization levels in the company's key markets – how is the company placed to manage changes and challenges?

a. Where are most of the company's stores located – cities or suburbs? Are these stores concentrated in a specific region or state?
b. Does the company profile its customers by age group and position its products accordingly?
c. Which categories and age groups offer the most potential for future growth?
d. Are the company's capex and expansion plans aligned with urbanization rates of the markets in which it operates?

12. Does the company have a sales strategy for private label and specialised products, such as organic and fresh foods?

a. What percentage of the company's sales comes from private label and specialized products?
b. What are the company's medium and long-term revenue targets for these categories? How does it expect to achieve these?
c. What are the company's price investment and marketing strategies for these products?
d. What is the margin attractiveness in private label and specialized products?
e. Is the growth in private label products affecting the company's relationships with its existing vendors? How does it manage these relationships?

13. What is the impact of channel churn on the retail sector? How is the company managing this?

a. How is the company adapting its business from multi-channel retailing to omnichannel retailing?
b. How does the company enable seamless connectivity for its customers among the different channels?
c. Does the 'pick-up at store' strategy help in reducing churn rate?

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14. How much customer and shopping-preference data does the company capture?

a. How does the company analyze the data it captures?
b. How does the company categorize different customers? Does it develop individual marketing strategies for each customer group?
c. What is the company's definition of a 'loyal customer'? How does it nurture loyalty?
d. Which strategies are employed to retain loyal customers?
e. Does the company have loyalty programs? Is so, how do these improve sales efficiency?
f. What percentage of the company's total sales comes from loyal customers?

15. What are the common economies and diseconomies of scale in the company's business model?

a. How do economies of scale operate between different store formats and customer categories?
b. Being a general retailer, how does the company attract customers who are focused on specialised products?
c. What is the company's broad marketing philosophy? How is it tailored to different customer and product segments?

16. How well does the company manage its costs?

a. How does the company manage currency risk for imported products and ingredients?
b. How often does the company renegotiate its contracts with partners and vendors?
c. How does the company manage operating costs and wage increases, including pensions?

17. What is the impact of technology on sales, distribution and other functions? How is the company managing this?

a. Which technologies are deployed across the company's various functions?
b. How does the company measure the benefits of technological change? What have been the outcomes?
c. How robust is technology that runs the company's online channel?
d. How much does the company plan to invest in technology over the coming years?