



INVESTMENT THOUGHTS

AUGUST 2017

RETAIL IN THERAPY

It has been popular in the past for a shopper to quip that they were in need of some retail therapy and then bustle off to the mall or their favorite department store or boutique. Shopping took place with an element of entertainment and a sense of the place itself as a shopping environment. Holding the item or feeling the fabric was part of the process. E-commerce has changed the way Americans carry on this important piece of our economic activity; particularly personal consumption expenditure. This trend is not new, but it is also no longer a small affair and it is increasingly disrupting the culture of the US consumer and the business models of retailers. If this topic was just about price competition and the so called creative destruction of capitalism, it would mostly interest retail investment analysts. What makes it more interesting is that one huge player, Amazon.com, has evolved into a market dominating force across broad sections of retailing, bringing an ice age to bricks and mortar retail sales and profit margins. It brings to mind the effects of a Wal-Mart coming into a community where their low prices undercut local firms who had traditionally served the people. Family run businesses, some that offered service and product knowledge, withered and died as shoppers traded it all for the low price. I will editorialize and say I don't believe all of our buying choices should be based solely on the low price when that means we lose community businesses and our retail transactions might as well be with a robot. A scorched earth practice for Amazon is to enter a market and run the prices down at a loss until the competition folds.

In past commercial sequencing, the manufacturer of a good or provider of a service might squeeze their vendors to lower their costs as a way to protect or increase profit margins. The unique thing about Amazon is that it has come to dominate the sales channel in a way that they, as middleman, are dictating price to the manufacturer as they take their slice out of the transaction. Someone else has to give up part of the profit too, namely labor, as pressure is put on wages by the manufacturer

2 Maple St., Hanover, NH 03755 603.643.0044 | 178 County Rd., New London, NH 03257 603.526.9251
1 Pillsbury St., Suite 303, Concord NH 03301 603.513.4100 ledyardbank.com

This communication is intended to be strictly informational. Exclusive of our client relationships, it is not intended to be, nor does it constitute an offer to sell or a solicitation of an offer to buy any securities referenced. Information contained herein has been obtained from sources that are believed to be reliable, but its accuracy and completeness cannot be warranted or guaranteed.

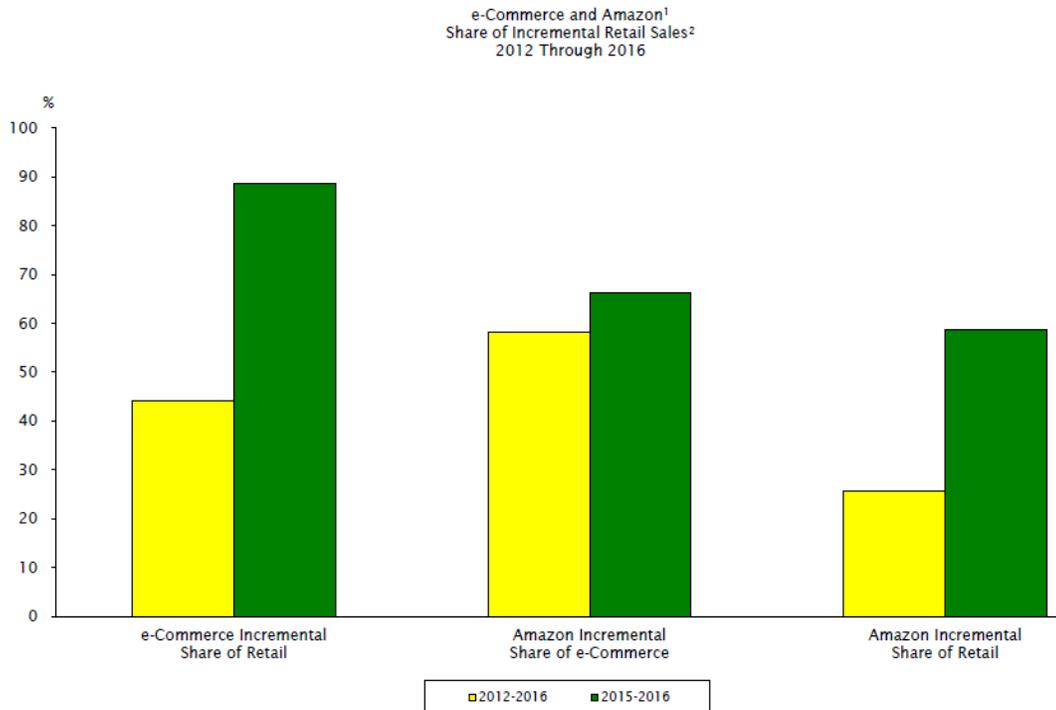
Non-deposit investment products are not insured by the FDIC, are not deposit or other obligations of, or guaranteed by the bank or any affiliate, and are subject to investment risk including the possible loss of principal amount invested.

INVESTMENT THOUGHTS

or service provider. For the consumer to get their low price and free shipping, everyone, besides Amazon, takes a pay cut. Labor is already in over supply for low end jobs and if globalization continues, there is a large exogenous supply of low cost labor outside the US to continue the wage pressure on US workers.

Where does this leave the American retailer? For instance, **Finish Line**, a mall based shoe store retailer, may not reach the finish line as online sales away from them have crushed sales. Their shares traded at \$32 in September 2014. Today they change hands at \$8.50. **Chart #1** indicates e-Commerce and Amazon's share of incremental retail sales from 2012-2016. They clearly dominate e-commerce retail, but also have close to 60% of overall retail. This is enormous in merchandising terms, but it is also approaching a size that could bring anti-trust scrutiny and social consequences. The anti-trust laws are largely to protect the consumer by supporting a competitive marketplace. Can we say the consumer is harmed by Amazon's size and low prices? Not in the usual sense. Those "harmed" by Amazon's pricing power seem to be the manufacturers and service providers in the first place and then, indirectly, worker's wages as the workers have the least bargaining power in the new equation.

Chart #1



Source: U.S. Census Bureau, Empirical Research Partners Analysis.

¹ Revenue adjusted to U.S. gross merchandise value.

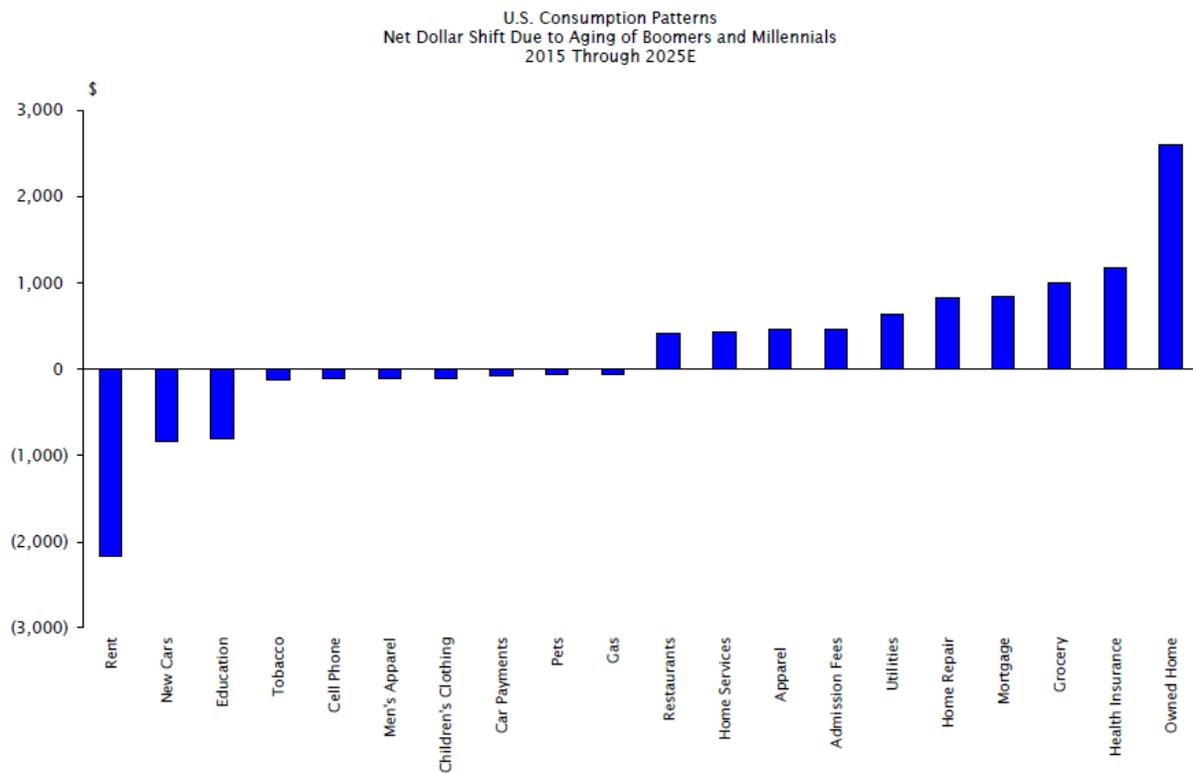
² Retail sales ex-auto.

INVESTMENT THOUGHTS

US retailers are facing off against a rapidly evolving scene from e-commerce, but also face demographic challenges as older baby boomers spend less. Younger consumers struggle with the \$1.2 trillion student loan burden after their magical years in college. Wider access to higher education has not meant colleges have provided equal education in critical thinking or technical skills. Many schools provide degrees as a consumer-oriented experience, not a college education preparing the young for the best jobs. In effect, retailers face a shrinking pie of which their share is also shrinking. The parts of retail where there exists the most price-inelasticity are shifting. The millennial's cohort now have a similar income as boomers, but will spend differently. Spending on travel experiences, food and entertainment may take more importance than acquiring "stuff". **Chart #2** below projects some of these category changes retailers must confront.

Chart #2

Age: The tail of the whip



Source: Bureau of Labor Statistics Consumer Expenditure Survey, Empirical Research Partners Analysis.

INVESTMENT THOUGHTS

The retailers who can use both channels, e-commerce and the value of in store service, stand the best chance in an Amazon.com world. We are told by the visionaries that the future of retail will be artificial intelligence and robots. I'm not sure if we are not finding questionable applications for technology where a problem doesn't exist. Will we be happier if Domino's pizza works out a way with Ford to produce an expensive self-driving car to deliver pizza? Won't we now have to leave our house and go to this car to retrieve our pizza versus have it handed to us at our door? Do I come down from my 7th floor apartment for this? Amazon.com is set to acquire Whole Foods Market. If avocado prices are cut by 50%, what happens to your local grocery and the farmer who grows the avocado? US retailers have to survive a surplus of supply and weak pricing power. Perhaps Americans will come to realize getting the lowest prices has consequences that raise the cost to society in human terms. How many times a week does UPS/Fed-Ex come to your house?



J.T. Underwood
Chief Investment Strategist