

Economics Group

Special Commentary

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E-Commerce Going Brick and Mortar

Executive Summary

For a long time, analysts have made the case that brick and mortar retail outlets, in order to survive, should learn how to build their own e-commerce capabilities. However, even as e-commerce volume within the electronic shopping and mail-order houses sector has grown by leaps and bounds over the past decade and a half, “traditional,” or brick and mortar, retailers’ e-commerce penetration, in aggregate, has been dismal. In fact, the traditional retail sector that has the largest percentage of sales in the e-commerce distribution channel is the sector that comprises dealers of motor vehicles and parts.

Traditional retailers’ e-commerce penetration has been dismal.

Now that the e-commerce retail sector is coming to the fore, representing almost 7.4 percent of total retail trade, it seems that the tables are turning and it is the e-commerce sector that is starting to penetrate the traditional brick and mortar retail trade sector. Still, it is difficult to know if this move is going to be successful, but the fact that some of the better known e-commerce retailers like Amazon, Google, eBay, Apple and Microsoft are making the brick and mortar push suggests this is more than just a passing fad.

Furthermore, other smaller e-commerce players are trying different approaches to the brick and mortar distribution channel by opening pop-up shops, which are small retail spaces that give them enhanced visibility. These are often cheaper than larger retail operations and tend to be temporary rather than permanent brick and mortar operations. Thus, the retail trade space continues to be in flux, but the direction of this flux seems to be different than what many had originally predicted, with e-commerce outlets trying to penetrate the brick and mortar distribution channel rather than the other way around.

E-Commerce: More Difficult for Brick and Mortar than Thought

Since the early days of the internet revolution and the emergence of online commerce, or e-commerce, traditional brick and mortar retailers have been trying to capture a portion of the up-and-coming e-commerce distribution channel. However, more than a decade after the e-commerce sector emerged as an alternative to traditional brick and mortar retailers, these traditional retailers have very little to show in terms of e-commerce penetration.¹

Young consumers are shifting consumption patterns to the e-commerce environment.

Furthermore, according to reports, many brick and mortar retailers are facing “extinction” as American consumers, particularly young consumers, shift consumption patterns to the e-commerce environment. E-commerce represented only 0.2 percent of total retail trade in 1998, but has since risen to 7.5 percent as of Q4 2015. Traditional brick and mortar retailers’ penetration into the e-commerce market in 2013 was just 15.5 percent, while the difference is accounted for by the non-store retailers sector.

¹ Some of our equity analysts have pointed out that the data on e-commerce hide the success that some large retailers have had penetrating this distribution channel, mentioning that many large retailers’ e-commerce sales are above 20 percent of total sales. The low penetration shown for aggregate data probably has to do with the difficulty that mom and pop retail stores have had with this distribution channel. Furthermore, data issues and definition of the term “e-commerce” might make aggregate data understate levels of penetration.



An example of how difficult it has been for traditional brick and mortar retailers to penetrate this new segment of consumers is these sectors' inability to adapt in order to capture this up-and-coming new distribution channel. For example, for brick and mortar clothing and clothing accessories stores, the share of total sales attributable to e-commerce rose from 0.6 of total sales back in 2004 to just 1.4 percent of total sales in 2013, the latest data available. On a level basis, clothing and clothing accessories stores e-commerce sales were \$1.1 billion in 2004 and \$3.4 billion in 2013. However, if we look at clothing and clothing accessories e-commerce sales from electronic shopping and mail order houses, e-commerce sales for that segment were \$7.0 billion in 2004 and a whopping \$40.0 billion in 2013.

Figure 1

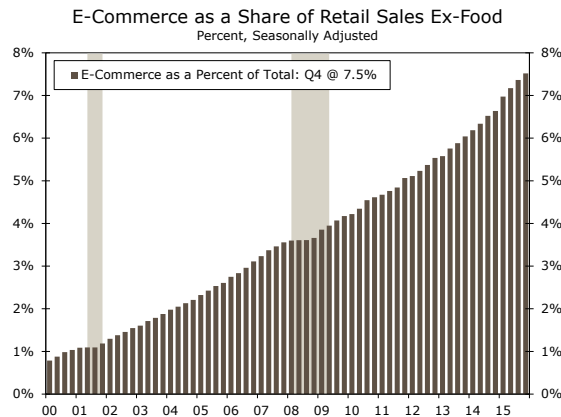
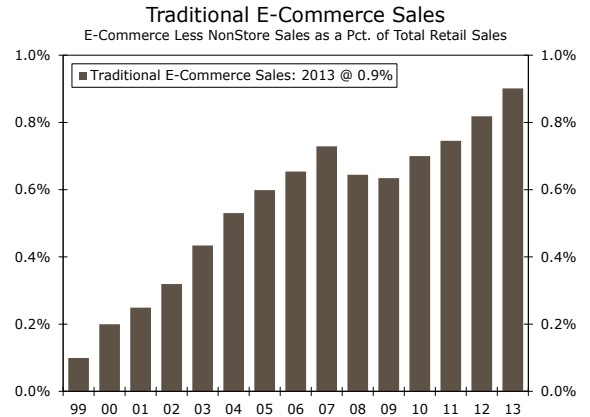


Figure 2



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

The furniture and home furnishings stores sector's e-commerce sales in 2004 represented 0.3 percent of total sector's sales (\$337 million) while it represented only 0.6 percent in 2013 (\$574 million). However, the furniture and home furnishings e-commerce sector within the electronic shopping sector went from \$4.0 billion in 2004 to an impressive \$20.0 billion in 2013. One could argue that traditional brick and mortar sales in the clothing and clothing accessories stores and in the furniture and home furnishings stores could have been up to \$20 billion and \$40 billion higher in 2013 than what they were had they been able to adapt and capture those sales!

The brick and mortar sector that has taken the "lead" in e-commerce sales has been motor vehicles and parts dealers sector, where e-commerce sales have grown from 1.5 percent of total sales in 2003 to 2.9 percent of total sales in 2013, perhaps because there is no comparable motor vehicles and parts dealers sector within the electronic shopping sector. Coming second in terms of growth is the sporting goods, hobby, book and music stores sector whose e-commerce sales contribution rose from 1.0 percent in 2003 to 2.6 percent in 2013.² On the other hand, electronics and appliance store retailers, a sector that should, in principle, be primed for e-commerce, went from representing 1.0 percent in 2003 (\$664 million) to just 1.2 percent in 2013 (\$1.3 billion).³ Comparatively, sales among electronics and appliance stores within the electronic shopping and mail-order houses sector grew from \$11.9 billion in 2003 to \$42.9 billion in 2013.

This means that the business of e-commerce has not been easy for traditional brick and mortar retailers as they have had trouble competing and adapting to this new way of doing business. Although the contribution from e-commerce to the growth in retail sales has varied over the years, it has been punching above its fighting weight. In 2013, growth in e-commerce represented

² We summed the books & magazines, music & videos, sporting goods and toys, hobby goods & games sectors within the electronic shopping and mail-order houses sector, which should be comparable to the traditional brick and mortar sector 451, which includes sporting goods, hobby, book and music stores.

³ In this instance, we summed up computer hardware, computer software and electronics & appliances sectors within the electronic shopping and mail-order houses sector to compare it to the traditional brick and mortar electronics and appliance stores sector.

The brick and mortar sector that has taken the "lead" in e-commerce sales has been motor vehicles and parts dealers.

almost one-fifth (20 percent) of total growth in retail trade. That is, a sector that was only 5.8 percent of total retail trade sales in 2013 was contributing almost 20 percent of growth in the whole sector, an impressive performance for this up-and-coming retail sector.

E-Commerce Is Smelling Blood, but It Will Not Be Easy

Although the e-commerce sector's performance within the electronic shopping and mail-order houses sector during the past decade and a half has been spectacular, growing from 0.2 percent of total retail sales in 1998 to 7.4 percent in 2015, the sector seems to have started to take aim at traditional brick and mortar retailers on their own turf. Thus, now it is not that brick and mortar retailers should adapt and penetrate the e-commerce distribution channel, at which they have been very unsuccessful; now the game is turning around and it is the e-commerce sector that is trying to penetrate the traditional brick and mortar sector.

Apart from the well-publicized move by Amazon when it opened its first brick and mortar store in Seattle last year, there have been other e-commerce businesses like Google and BubbleBar which have also gone "rogue" and have decided to make their first inroads into the brick and mortar retail distribution world. Even Apple and Microsoft have ventured into brick and mortar with a major presence in the computer hardware space even as they continue to use the e-commerce distribution channel as well as other secondary retail distribution channels.

Furthermore, some of these e-commerce firms are opening traditional brick and mortar shops or pop-up shops. Some of these are auction and shopping site eBay, jewelry e-commerce retailer Blue Nile, Frank & Oak, Warby Parker, Bonobos, Birchbox and Casper, just to mention a few. Many of these on-line retailers are in the apparel industry and are probably trying to broaden their brand's reach as the on-line retailer environment remains highly competitive.

The prize for these e-commerce retailers is significant at a time when many traditional brick and mortar retailers are facing competitive pressures and are having trouble growing. Some of these retailers are closing down or shredding a large number of stores in order to rein in the cost of doing business. Although the new generations of shoppers seem to be more inclined to purchase goods online, the challenge for e-commerce retailers is to try to take more of the market from the traditional retail sector. However, the fight will not be easy, especially for those e-commerce retailers that do not have brand and name presence in the brick and mortar retail space.

E-Commerce Sales More Stable than Sales at Brick and Mortar

Although e-commerce sales are small compared to total sales for the retail trade sector, the behavior of the e-commerce sector follows a different path than what the traditional brick and mortar sector has followed over the years, especially during downturns in economic activity. That is, an interesting characteristic regarding e-commerce retailers, both in traditional sectors as well as for the electronic shopping and mail-order houses, is that e-commerce sales seem to follow a more stable path over the years and some segments seem to behave somewhat "recession-proof."

As an example, Figures 3 and 4 show brick and mortar sales as well as e-commerce sales for the clothing & clothing accessories and furniture sectors. While e-commerce sales in the clothing sector were very slow to take off during the initial emergence of the e-commerce industry, they have never looked back again, growing at an impressive rate. However, sales through the traditional brick and mortar channel took a big hit during the Great Recession compared to a mere slowdown in growth for the e-commerce distribution channel sector.

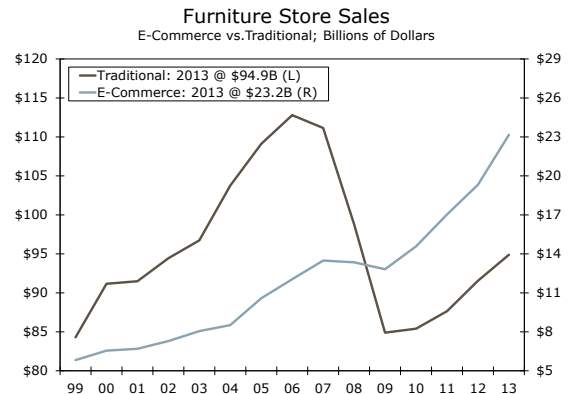
E-commerce represented 0.2 percent of total retail sales in 1998 while today it represents to 7.4 percent.

The behavior of the e-commerce sector follows a different path than what the traditional brick and mortar sector has followed over the years.

Figure 3



Figure 4



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

A very similar pattern can be seen for the traditional brick and mortar furniture and home furnishings sector compared to e-commerce sales for this sector. In this case, both sectors dropped during the Great Recession but the drop in the traditional sector was much larger. In 2009, sales of furniture and home furnishings were down 2.6 percent compared to 2008 but were down 14.1 percent for the traditional furniture and home furnishings sector. Furthermore, 2009 was the only year in which e-commerce furniture and home furnishings sales dropped while sales at traditional retailers in this sector declined for three consecutive years (2007-2009). In fact, sales in 2007 were down 1.5 percent while in 2008 they fell an additional 11.1 percent.

Of course, an argument could be made that this e-commerce sector is so small compared to the overall traditional brick and mortar sector that it is possible that this small base of comparison could explain why the e-commerce sector was so resilient during the Great Recession. However, the severity of the Great Recession was such that we should have seen a similar pattern for both distribution channels and we have not seen that. Furthermore, a very similar pattern is found between other sectors of traditional versus e-commerce retail trade sales, which could indicate that the e-commerce sector is less responsive to periods of slow economic activity or even recessions, at least for now.

Conclusion

About two decades after the internet revolution and the prediction that e-commerce was going to be the new distribution channel that traditional brick and mortar retail shops would have to conquer to succeed, this traditional sector has very little to almost nothing to show. However, what has started to happen is that the now large e-commerce retail sector is starting to penetrate the traditional brick and mortar retail distribution channel sector. Although it is still very early to tell if this move is going to be successful, the move has started with the better known brands creating their own brick and mortar shops and other, less known e-commerce retailers choosing to open pop-up retail shops.

However, it will not be easy, especially for smaller e-commerce retailers, to succeed in this environment, which is very different than they are accustomed. Nevertheless, the retail industry is in flux, with many brick and mortar retailers losing the fight and closing down and other e-commerce retailers taking up shop where the former failed. Having said this, even if e-commerce retailers are not completely successful in penetrating this brick and mortar space, growth for this e-commerce sector should remain strong over the next several years and outpace growth in the rest of the retail trade sector.

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