Letter to Clients
January, 2016

Shop't

"Two out of three ain't bad."

Meatloaf

In recognition of opening a position in **Ross Stores,** an off-price apparel and home products retailer, we are revisiting a topic we first wrote about close to a decade ago: retailing. In reviewing our thesis recently, we found ourselves agreeing with much of our original analysis (which we will reprise for you here), even as the intervening years have seen seismic shifts in the retail landscape. What has changed since our June 2006 letter to clients is subtle but interesting. We have long thought that to be successful, merchants typically needed to pursue either a "low price" or a "strong editorial content" strategy and that retail concepts in the murky middle (so-so prices, acceptable array of non-exclusive merchandise) were at a long-term competitive disadvantage. We still believe that, but with a twist. Recent innovations born of advances in technology and logistics have both changed the expectations of customers and enabled merchants to trade convenience off against price, on the one hand, and exclusivity and the "experience" on the other. Instead of an essentially binary distribution of who wins in retail, we now think of it as more of a three-dimensional system with convenience forming a third axis for strategic positioning along the price-editorial content continuum. While different consumers place differential emphasis on each of these three values, woe betide the retailer that fails to lay strong and definitive claim to at least one—and perhaps two—of these. But like the old management adage of "good, fast, cheap: pick two", competition in retail produces a system where these three values cannot all coexist at the highest levels simultaneously. The importance of this is clear: if a retailer cannot claim either the absolute lowest price or the best, most exclusive or finest curatorial content, then it better strongly embrace convenience.

Retailing has bedeviled us over the years, not because it poses an insuperable conceptual problem—in fact it is quite susceptible to analytical dissection—but because so much of success in retailing has to do with the "gut" of the CEO and his or her team of merchandisers. Data-driven decision-making aside (and the best retailers are in fact avid consumers of data and analytics), a "feel" for one's customers and what they value turns out to be just as critical today as it was a decade ago—and a decade before that. Picking a CEO with a sustainably golden gut is harder than it appears; one year's success can easily be succeeded by next year's failure (just look at Mickey Drexler's ups and downs as CEO, first of Gap and then of J. Crew). Our response to that is to seek out companies that have demonstrated a strong track record of good decisions and that have figured out how to institutionalize their "gut" and build a culture that is sufficiently in tune with the customer that the "gut" becomes effectively ingrained in the company's approach to the business. We think we have found such a company in Ross Stores.

The Customer is Always Right

To have any success at all, a retailer must be able to identify who its customer is and what he or she wants.[1] In particular, in knowing its customer, the retailer must have a clear understanding of the tradeoffs the customer is implicitly making by shopping at that store or on that site. While proliferation and differentiation of retail concepts is the order of the day, the brutal logic of survival of the fittest in retail ensures that only those stores that best serve the needs of their customers will remain in existence over the long term. Marshall Field's admonition in the late nineteenth century to "give the lady what she wants" thus remains evergreen.

When it comes to shopping—for pretty much anything—there are a series of "values" that could be important to the consumer: price; convenience; breadth and depth of selection; quality; exclusivity; great service; the "experience"… the list goes on. Each of these values carries greater or lesser weight with different segments of the consumer population and each of them exists to the exclusion of certain others. Want rock-bottom price? You will have to be satisfied with imperfect selection—and so on. Historically (and all other things such as competent management and good execution being equal), when we've sought to distill these values to their essence, we've seen a binary "barbell" distribution where, when all is said and done, it has come down to price versus quality, as reflected in editorial selection. Think Walmart versus Tiffany or Saks. When well executed, and with an eye toward earning customer loyalty and a high return on invested capital, either strategy can prove successful. As the name implies, the first strategy offers consumers an array of product, usually a combination of name brand items interspersed with house brand products, all at very low prices. The critical factors for survival here are execution-related ones such as logistics and distribution. The second strategy relies on editorial selection, service and shopping experience, taste/fashion, and strong merchandising to deliver value to the customer. The critical factors here are top flight and consistent service and knowing what it is that the customer wants before the customer may even know that him- or herself.

[1] We are limiting this discussion to consumers who are people, not business customers of distributors like **Fastenal**. While many of the same factors of cost, quality, and convenience are relevant to decision-making in the context of a company like Fastenal, the analysis is somewhat different.

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But now, a new front in the competitive skirmish has been opened: convenience. While convenience has always been a value important to certain customers, evidencing itself in proximity of location, depth and breadth of assortment and other characteristics, in our "just in time" culture, it has been elevated to a key metric in the consumer's decision-making matrix. Consumers today expect that what they buy will come with a side order of easy. Just as with price and quality, convenience runs the gamut from limited to none (think stripped down warehouse stores in the back of beyond) to immediate home delivery with liberal (and "free") exchange policies. The addition of convenience as a critical branch in the customer decision tree both liberates and complicates. It gives retailers the freedom to have a more nuanced formula as to how they serve their customers but it also makes it tougher to arrive at the precise balance of the three critical values that will win over the consumer more reliably than the competition. But unlike price and quality, convenience is not a standalone strategy; high convenience coupled with lousy prices and weak selection is unlikely to win the day. Convenience needs to cohabit with one of the other two in order for it to produce a successful retailing formula.

Marriages of Convenience

Convenience can be married with price as well as with editorial selection, but typically at some kind of cost. At the low end, convenience typically comes in exchange for a higher price. Bare bones retailers continue to have the pricing advantage over even most online-only purveyors of goods once delivery costs and returns are added in (though Amazon is trying to put that concept to the test). At the very high end, the cost of convenience tends to be more ephemeral; online availability of a luxury good, for example, increases accessibility but decreases exclusivity and the kind of high touch shopping experience (e.g., champagne and espresso while you cruise the racks) that consumers of those products have historically valued. Indeed, convenience of this sort can actually tarnish a high end brand. This is why a number of luxury brands such as those in the Kering family (e.g., Gucci) and Chanel have only a nominal online presence. Even Tiffany, which has a relatively well developed online profile, declines to sell diamonds of high carat weight on the internet.

Further complicating things, one person's convenience is another person's hassle. The internet has the ability to flatten the globe by bringing together a seller and consumer from far-flung geographies to consummate a deal. On the other hand, internet purchases can be difficult to manage unless you have a doorman to keep away "porch pirates". It may actually be more convenient for certain shoppers to make the drive out to the warehouse today than to wait for a delivery to arrive in two days. And of course, not every purchase is easily translated to a completely distant transaction. Food, healthcare, and beverages are among the categories of products and services where convenience mostly means something other than online, such as geographic proximity. A more granular understanding of one's customer and the way he or she prefers to shop

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thus becomes critically important when considerations of convenience enter into the value equation.

Hotells and Umbrellas

While competitive Darwinism is not peculiar to the retail sector, the intensity of competition in retail is particularly fierce and the resulting carnage impossible to ignore, even if the wounded, like Sears, continue to hobble along far past the point of relevance. For example, there is little doubt that Walmart's original success was at the expense of legions of smaller stores that were simply incapable of competing against Walmart's superior scale, logistics, and global sourcing capabilities. And the class of its victims extended well beyond the mom-and-pop stores that were the mainstay of American commercial life for decades, to include traditional supermarkets, department stores and pharmacies. For some time, Walmart didn't really have to pay a price for its relatively inconvenient location. Because it opened huge stores in less populated areas that people needed to drive to, it was able to keep real estate costs down and deliver shoppers what they wanted at the time and that no one else was in a position to replicate: the cheapest prices for a broad array of pretty good merchandise anywhere in the area.

But now, the category killer of category killers is itself under threat. Based on economic theory, this is not surprising. In the ongoing effort to establish a differentiated value proposition, intelligent competitors often "locate" their concept adjacent to a successful existing one. In economics, the concept of "hotelling"[2], named after the twentieth century American economist Harold Hotelling, describes how businesses will often differentiate themselves as little as possible from successful competitors so that they can effectively share in the competitors' spoils. Just as political candidates often position themselves slightly to the right or left of one another on various issues in order to capture the voters up- or downstream from their opponents' base, so companies attempt to outflank one another by positioning themselves strategically close to but on one side of a competitor with regard to price, convenience, or editorial assortment or quality. In particular, if there is a dominant competitor in an industry, a classic "divide and conquer" strategy is to price just beneath that competitor, in effect using that competitor's pricing as an "umbrella" to protect one's own.

When we wrote our earlier retail letter back in 2006, it was difficult to imagine a merchant competing successfully against Walmart on price, at least in the U.S. Yet since that time, we've seen Walmart take its eye off the ball, not understanding that its success itself bred competition and that to focus narrowly on Target as its opponent-in-chief was short-sighted. As often happens when a niche proves hospitable, and as predicted by Hotelling, others position themselves in the spaces immediately adjacent to it in order to exploit the compromises implicit in the strategy of the original occupant of that niche. And

[2] Apologies to the economists reading this for the use of the lower case.

so Walmart, which bet heavily on large format stores in relatively inconvenient locations and which stocked a mixture of branded and house products, provided a rich target for those willing to push hard on either price or ease.[3] And Walmart's very strengths have proved its greatest weaknesses: encumbered by its inexpensive real estate and in possession of a once state-of-the-art logistical system specifically designed to service that footprint, it has appeared to lack the flexibility to continue to evolve, thereby enabling alternative strategies to arise in order to exploit its vulnerabilities. The result has been the jujitsu we've witnessed of late: both the lowly dollar stores (which are conveniently located along bus routes and are smaller format) and foreign bargain basement imports willing to dispense with branded products altogether (like the German warehouse store Aldi) have been able to effectively sandwich Walmart and siphon off enough of its customers to make a difference. And because Walmart's strategy has to a great extent locked it in, it has found itself with a model that is hard to tweak, notwithstanding its plans for smaller format urban stores and a stronger online presence.

Merchant in the Middle

In retailing, stupid competitors drive down your returns and smart ones do that plus, eventually, drive you out of business. With that in mind, we are at an interesting inflection point right now in retailing. The battle over who can couple convenience with low price has been joined—and it's decimating margins and challenging incumbents who not too long ago were in the catbird seat. Long the exclusive privilege of the economic elite, home delivery has been revolutionized—and democratized—by the internet and the advent of shipping companies like UPS with networks and logistics geared toward speedy home delivery. Free shipping and free returns have become the order of the day, forcing less efficient competitors to provide those benefits regardless of how big a bite they take out of their bottom line. This behavior, in turn, is training consumers to expect such treatment even outside the holiday gift-buying season.

Amazon has specialized in this form of competitive warfare. With the help of algorithms and warehouse robots, to say nothing of its vast scale, Amazon has staked out hitherto uncharted territory by offering convenience in two ways: a broad and deep assortment of branded products (many available through its sub-vendors) and cheap shipping with speedy turnaround (by yearend 2015 it is estimated that there will be up to 60 million subscribers to Amazon Prime), all at competitive (though not necessarily rock-bottom) prices. Amazon's fulfillment nimbleness has forced others to adopt comparable practices, though Amazon's near-seamless execution is hard to match. Even brick and mortar retailers have been forced to ante up on convenience, partly in response to Amazon: this past Christmas, Kohl's kept its stores open for 170 straight hours in advance of the

[3] Target had already pushed on quality to a certain extent, by introducing a hip, fashion element into its designs for clothing and housewares until it, too, fell prey to those like H & M or Zara that did it better and with more conviction.

holiday. And because convenience in the form of broad and deep inventory is costly to maintain, Amazon has figured out how to have ready access to such inventory without having to keep all of it on its own books through the liberal use of sub-vendors who sell on its site. So far, however, though it has succeeded in compelling competitors to try to match its shipping policies, Amazon has not succeeded in doing so while reliably earning profits (outside its cloud computing business) for its shareholders. But given its patience and resolve, it's a company well worth watching.

In the far corner of the retail ecosystem, at the other end of the "taste" continuum, online offerings like Net-a-Porter (an online clothing retailer) have been proliferating, making all but the most exclusive vendors cast about for new strategies to bring people into their physical stores. Such concepts seem at least partly to have cracked the code of how to offer convenience while maintaining a firm editorial hand and without undue dilution of the "experience". Apart from the increasing challenge posed by the internet, the biggest risk with the editorial retailer is not stupid competition or a "hotelling" strategy with copycat designs but rather the risk of misjudgment in editorial selection and a misunderstanding of the core customer. Fashion tastes are inherently fickle, and the more the customer defines value as a function of current style, the greater the risk of misconstruing the preferences of that customer.

It is those merchants in the middle that have allowed competitors to occupy the tails on the price-quality continuum that should worry most. Unless best in class convenience is also part of their strategy, the landlocked retailer is likely to witness declining margins, contracting returns on capital, and a shrinking customer base over time. Many of today's middle of the road retailers like Sears, JCPenny and even Macy's once laid claim to either the bargain or elite selection position on the consumer value spectrum. These national stores elbowed out regional department stores that had made it their business to cater to local tastes by promising better prices or more cosmopolitan selection. But, in turn, lack of flexibility due to strategies that have proved difficult (if not impossible) to modify have prevented each of these from replicating their upstart rivals' more successful strategies. Instead, they have been left to adopt tactics that seek to mimic the strategy of their competitors (through, for example, creating online capabilities) but both without the strategic foundation of their rivals and while continuing to be burdened by archaic investments in an aging brand, suboptimal physical locations, and less robust logistical systems. As consumer preferences change—and history shows that preferences do evolve over time—it is extremely difficult for a merchant, however smart, to have the capacity to change with them if a new entrant, unburdened by the trappings of incumbency, is able to satisfy the new crop of consumers.

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Ross Stores

All of which brings us to Ross Stores. Ross is in the enviable position of – for the most part – being able to exploit whatever consumer preferences happen to be at a given moment in time. While Ross's strategy is simple in theory, it is extremely tricky to execute well. Retail history is littered with the wreckage of rivals like Filene's Basement and Loehmann's that were unable to navigate the treacherous shoals of off-price retailing. Even blazingly successful TJX faltered several years back when it launched a poorly thought out ultra-bargain concept, A.J. Wright, which failed to get much traction. And department store offshoots like Macy's Backstage and Nordstrom Rack have not so far posed any real competitive threat to Ross. While Nordstrom Rack has been moderately successful after much experimentation, the conflict inherent in sourcing and pricing clothing and accessories for both a first- and second-run concept is not easily resolved.

As an off-price apparel and home goods merchant, Ross clearly embraces the "low price" strategy. While even lower priced clothing clearly exists, in its "lane" of good quality clothing and accessories (as well as home goods), it is clearly among the lowest priced out there. But because of high inventory turns and good logistics that allow its buyers to tap into thousands of vendors to purchase overstock in season, its selection is better than that of a typical low price merchant. While certainly not a classic "editorial" approach because its low price commitment militates against that, it nonetheless makes the most of its opportunistic buying position and creates a kind of "poor man's" first run store. It may not have every item in every size, but it doesn't aspire to and it even turns that apparent disadvantage into an advantage. Its strategy is to foster a "treasure hunt" mentality among its customers, who shop the stores frequently, understanding that the merchandise turns over constantly.

But where Ross distinguishes itself in this new world where convenience reigns is in how it is positioned vis-a-vis its internet competition. Ross typically locates in easily accessed suburban or urban strip or indoor malls, often adjacent to similar merchants like T.J. Maxx and Marshalls. This strategy is less one of hotelling than it is of symbiosis; in combination, they represent a compelling value proposition to the woman (its typical customer) who enjoys the "hunt" and is happy for the convenience of being able to pursue it across the thresholds of a handful of nearby stores. And because Ross's "basket" averages $30 (comprised of three items at $10 each), it is virtually impossible for an internet competitor to out-convenience Ross, as the cost of shipping and returns (which are critical in apparel) would be prohibitive for purchases of that size.

While Ross is in the fashion business, it is more pilot fish than shark, living off the items first run stores may have over-ordered or whose vendors may have overproduced. Because the world is teeming with overstock, its merchant team is critically important in selecting merchandise. Ross has assembled a team, a training system, and a compensation plan that, taken together, enable it to capitalize on the mistakes made by front-line retailers who, by necessity because of their business model, need to order product well in advance of the selling season. But most important, Ross has learned how to recruit and train people to be part of an ongoing network of relationships with vendors that helps them get the freshest and hottest product they can in their stores (of which there are currently about 1200) on a continuous basis, thereby effectively institutionalizing that "gut" that is so deeply important to the selection their customer craves.

Angry Birds

The ability to deliver ever greater convenience to the consumer, whether at the lower or higher end of the price/quality spectrum, presents opportunities to the enterprising retailer. But it poses challenges as well. Since what's good for the goose is good for the gander, more opportunities mean a greater likelihood that others will poach on one's turf. It is therefore all the more urgent for retailers to understand their customers at as granular a level as possible in order to provide the optimal value mix he or she wants and to prevent being "hotelled" out of an attractive niche. The retail landscape is inherently unstable, as consumer choices fluctuate over time and as merchant capabilities evolve. While we don't think flocks of delivery drones will be dive-bombing neighborhoods any time soon, it nevertheless behooves those who rule the retail roost today to keep an eye on the horizon.

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