Retail Therapy

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The way we shop is changing. The advent of the internet has had an undeniable impact on global retail, with digital and community spaces increasingly interacting with traditional and new shopping channels. We have been keeping a close eye on how these developments affect some of our portfolio companies and those we monitor in our wider universe, and below we offer what we view as some of our more interesting findings.

The penetration of internet shopping in the UK is substantially ahead of most other countries: 18.6% of total non-food sales are online (compare this to the US's 11.9%) and 4.9% of food sales (just 0.4% in the US). The closest comparison for online non-food sales is Denmark (18.5%) and for online food sales it is France (3.8%). Unsurprisingly this has changed the landscape of the retail sector: take Marks and Spencer, which had operating profits of £1bn in 1998 but 15 years later in FY2013, just £778m[1]. On the other hand, some retailers with long-standing expertise in mail order sales have been able to transition into effective online retailers with an already developed logistics system. Next, for example, has sold via its print Directory since 1988 and has in recent years done incredibly well with its combined store, catalogue and online strategy, resulting in the share price going from 7p in 1990 to just under £69 today!

Despite the increasing importance of digital, this transition is nevertheless at a very early stage and questions remain about how much room there is for online shopping spaces. eBay CEO John Donahoe has argued that while there is room for lots of online and bricks and mortar retail competition, online shoppers will be unlikely to accept more than two or so payment methods – a view which echoes ASOS's opinion that young people will happily go to 15 stores in one shopping session, but will only type their card details into a maximum of four online shops (although it could be of course that a payment platform like PayPal will solve this problem). We like brand driven, strongly differentiated businesses, and we believe that amongst these, the companies really taking advantage of the swing towards online retailing are not those who simply have a sales channel online, but instead those who blur the line between physical and digital, using their websites not only to sell products but also to act as entertainment destinations which reinforce the brand.

Burberry is a key portfolio holding, one which we feel gives us access to a uniquely digitally aware luxury brand which takes advantage of the fact that people are increasingly choosing to spend their leisure time in online spaces. Previous CEO Angela Ahrendts contended that Burberry.com, not Regent Street, was the brand's flagship store and current CEO Christopher Bailey thinks of Burberry as being "as much a media-content company as we are a design company". Unsurprisingly Burberry.com is rich in content, from videos of catwalk shows and current advertisements to "Acoustic", a collection of music videos featuring up-and-coming young musicians dressed head to toe in Burberry. The website is a fully developed sales channel which attracts 100m unique visitors per month and through which visitors can purchase just about any piece they care to, but we also share Bailey and Ahrendts's view of the site as an engaging, content-rich and entertaining brand extension.

Social media and user interaction is also a big part of Burberry's digital strategy – the brand has 17m Facebook friends (more than any of their European luxury peers) and the Body fragrance, launched in 2011, was launched with a video campaign premiering on Burberry.com and the brand's YouTube channel rather than on broadcast TV. "The Art of the Trench" is an opportunity for individuals to submit pictures of themselves wearing a classic Burberry trench coat, and with the free "Burberry Kiss" app, users can physically kiss their smartphone screens and send their lip prints to friends. Offline, digital is used to enhance the shopping experience – in stores many products contain a radio-frequency identification tag which 'talks' to screens and launches a video about the manufacturing process or the provenance of the garment, and some changing

[1]As M&S does not have longstanding expertise in order fulfilment, we think that shifting its business to a more 'multi-channel' model is incurring costs as expenses change from running stores to driving website traffic and fulfilling orders: in FY2014 M&S's online revenues were up 23%, but the company also had to invest in a new website and a large centralised fulfilment centre.

rooms contain video screens which are also triggered by these tags to launch videos of the item of clothing on the catwalk.

Online sales at Burberry are only 5% of total revenues, with pure online (sales placed through burberry.com from personal computers, rather than on iPads in store) a negligible proportion of that. However, Burberry is agnostic as to where sales come from and anticipates the two channels increasingly blending together. This is a view echoed by US retailer Macy's, which thinks that "using the word 'omnichannel'" is no longer relevant, because this is simply an expression of what a retailer must become (for example, Macy's logs online and store sales together to solve the problem of people purchasing 10 swimsuits online and returning 8 to the store, which is then inaccurately logged as 10 online sales and 8 store returns). The icing on the cake for us is that the creativity and effectiveness of the Burberry's digital strategy is evident not just to us but to other fashion companies – our most recent visit to New York included a meeting with a fellow luxury fashion retailer, Coach, who acknowledged Burberry's digital strategy as "best in class".

Continuing the theme of luxury, high-end Japanese cosmetics brand Shiseido is another important holding for Lindsell Train. For most prestige cosmetics retailers, "counselling" (i.e. customers visiting a counter in a department store, specialist shop or spa location to test the products and receive advice from a salesperson) remains the most important sales method. According to their latest annual reports, fellow Japanese brands Fancl and Pola Orbis have 50% and 79% respectively of sales originating from counselling channels, and for Shiseido and US cosmetics company Estee Lauder the figure is 52%. Undoubtedly Shiseido's combination of a unique brand and a certain degree of technicality in the products means that it is well suited to being sold in this way, so we don't anticipate that this sales channel will lessen too much in importance, but we are also very interested in what the company is doing in terms of digital.

As yet a mere 2% of Shiseido's sales come from the internet, which appears to put it behind most other Japanese cosmetics companies. However, a closer look reveals that many of these rivals have historical expertise in mail order sales – Dr Ci:Labo has 26% of sales coming from the web but also generates an additional 35% of sales from catalogue orders, while Fancl's online orders account for 30% of total sales and catalogue orders 20%. For these companies, internet sales are replacing printed catalogue and telephone orders rather than eating into department store counselling sales, so Estee Lauder is probably a better comparative for Shiseido, having little history of mail order and just 5% of total sales coming from online channels in 2013 (both its own websites and distributors' websites).

We believe that the experience of purchasing any luxury product is part of the appeal, so on our latest trip to Japan we put the question to a number of cosmetics retailers: do you feel that it is necessary, and possible, to replicate the counselling experience online? Many seemed sceptical of a website's ability to take the place of a physical sales interaction – direct sales-focused Pola Orbis highlighted that Pola is a prestige brand whose appeal is the consultation and follow-up experience provided by its highly trained sales force. Sensitive skin expert Fancl was more enthusiastic about the potential for web sales and thought that in ten years' time the website could generate the bulk of new orders. The company's enthusiasm for the web is understandable, given that the average additional spend per online order compared to a store order is ¥1300 (around £7 at today's rates), but even their website doesn't try to offer anything approaching interactive real-time counselling and instead uses a questionnaire which goes into a central database. Despite the current tiny percentage of sales from its website, Shiseido recognises the importance of technology and has launched Watashi Plus, a fully functional website which does attempt a counselling-type experience. Interactive pages lead the user through a counselling-style decision making process, and personalised account numbers link up with information from department store sales to build a fuller picture of each customer's needs. So far Watashi Plus has 1.6m members signed up and the site is being developed further.

Our understanding of these shifts in shopping habits also has an impact on our research universe. We have never invested in supermarkets, but for many years we monitored J Sainsbury, Tesco and Walmart as we acknowledged that the strength of their brands and their buying power were excellent competitive advantages. We also thought of M&S in these terms, despite its not being a supermarket. However, as the landscape of shopping continues to change we are increasingly dubious about the durability of this model and the ability of those brands to endure, especially since the investment in property with questionable alternative use makes the current business model highly capital intensive. While there's plenty of scope for online food shopping to become even more popular in the UK in the future, we take the view that ironing out the problems inherent in the model could make the sector suffer.

Delivery is often expensive and inconvenient and it takes time for the goods to arrive, but the most difficult problem is that delivery of food is more expensive than, say, clothing because of the need to pick out a basket of items and then transport it in a climate controlled van. We note that Ocado has never made any material operating profit since operations began in 2007. We came to the conclusion that supermarkets are probably too structurally challenged for us to maintain interest in the sector, so in 2011 J Sainsbury, Tesco, Walmart and M&S were removed from our universe.

Although not a luxury fashion offering like Burberry, the online “fast fashion” retailer ASOS is the newest addition to our universe. Like Burberry.com, the ASOS website is both a sales channel and an advertising medium, featuring a great deal of glossy magazine-style content such as blogs, personal stylists, user uploaded photographs and fashion tips and advice which keep users coming back on average four times per day, mostly to browse the content and put items into their basket for later. Consistently profitable since its inception, ASOS has no bricks and mortar stores and no plans to open any, but we think that its 8.6m active customers (i.e. users who purchased something in the last month) and 2.3m ‘likes’ on Facebook highlight the potential of the terrifically exciting intersection between online content and retail. The jury is out on whether ASOS will ever enter our portfolio, but there is much to interest us and we will continue to monitor the stock closely.

Clearly online shopping has already been very disruptive but we think it is important to make a distinction between essential and “fun” shopping. The recent events in the supermarket sector have demonstrated the real impact that the shift to online retailing has had on shopping which is necessary but not enjoyable and can easily be replaced with a few clicks on a website from the comfort of the sofa; on the other hand, we think that luxury or fashion shopping falls much more into the category of entertainment, and is therefore better positioned to combine traditional and new channels to its advantage.

Madeline Wright, Deputy Portfolio Manager

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Sources: Morgan Stanley, Bloomberg, eBay, Burberry, ASOS, Shiseido, Dr Ci:Labo, Pola Orbis, Estee Lauder, Fancl, Macy’s, Coach.

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