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Don't Blame Amazon for the Retail Apocalypse

By Vitaliy Katsenelson Jan. 20, 2019 8:00 a.m. ET

Photograph by Alfred Grupstra

Retail stocks have been annihilated recently, even though retail sales finished 2018 strong. The fundamentals of the retail business look horrible: Sales are stagnating, and profitability is getting worse with every passing quarter.

Jeff Bezos and Amazon.com get most of the blame, but this is only part of the story. Today, online sales represent only 8.5% of total retail sales. Amazon, at about $100 billion in sales, accounts only for 1.6% of total U.S. retail sales, which at the end of 2018 were around $6 trillion. In truth, the confluence of a half-dozen unrelated developments is responsible for weak retail sales.

Our consumption needs and preferences have changed significantly. Ten years ago, before the introduction of the iPhone, we spent a pittance on cellphones. Nokia was the king of dumb phones, with sales in the U.S. in 2006 of $4 billion. The total dumb-phone handset market in the U.S. in 2006 was probably closer to $10 billion. Today, Apple alone sells roughly $110 billion worth of i-goods in the U.S., and about 60% of those sales are iPhones. By my estimate, the total U.S. smartphone market, including other hardware makers and accessories, is probably about $200 billion. Consumer income has not changed much since 2006, thus over the last 11 years, $200 billion in consumer spending was diverted toward mobile phones.

It gets more interesting. In 2006, a year before the iPhone was introduced, a cellphone was a luxury reserved for adults, but today 7-year-olds have

iPhones. Our phone bill per household more than doubled over the past decade. Not to bore you with too many data points, but Verizon Wireless's revenue in 2006 was $38 billion. Fast-forward 12 years, and it is pushing $125 billion—a $87 billion increase. Verizon's market share is about 30%, thus the total spending increase on wireless services is close to $300 billion.

Between phones and their services, this is $500 billion that will not be spent on T-shirts and shoes.

But we are not done. The combination of mid-single-digit health-care inflation and the proliferation of high-deductible plans has increased consumer direct health-care costs and further chipped away at our discretionary dollars. Health-care spending in the U.S. is $3.5 trillion, and just 3% of that figure is almost $100 billion. Then there are soft, hard-to-quantify factors. We may not care about clothes as much as we may have 10 or 20 years ago. After all, our high-tech billionaires wear hoodies and flip-flops to work. Lack of fashion sense did not hinder their success, so why should the rest of us care about the dress code?

In the '90s, casual Fridays were a big deal—yippee, we could wear jeans to work! Fast-forward 20 years, and every day is casual. Suits? They are worn to job interviews or to impress old-fashioned clients. Consumer habits have slowly changed, including the advent of rental clothes from companies like Rent the Runway and LeTote.

We now put less value on buying and owning clothes and more value on having the latest technology or most memorable experiences—spending on travel and restaurants has grown at nearly four times the rate of spending on objects, most millennials would rather have an experience than buy a product, and most would rather dine out than eat at home. That eats into sales of groceries, not to mention pots, pans, and fancy knife sets.

All this brings us to a hard and sad reality: The U.S. is over-retailed. We simply have too many stores. Americans have four or five times more square footage per capita than other developed countries. This bloated square footage was created for a different consumer, the one who in the '90s and '00s was borrowing money against her house and spending it at her local shopping mall.

Today's post-Great Recession consumer is spending money on new necessities such as mobile phones and paying more for the old ones such as health care, and focused on paying off her student loan debt—which is likely to be higher than previous generations'.

Yes, Amazon and online sales do matter. Ten years ago, only 2.5% of retail sales took place online, and today that number is 10% percent—about a $400 billion change. Some of these online sales were captured by bricks-and-mortar online sales, some by e-commerce giants like Amazon, and some by brands selling directly to consumers.

But as you can see, online sales are just one piece of a very complex retail puzzle. All the aforementioned factors combined explain why, when gasoline prices declined by almost 25% from 2012 (gifting consumers hundreds of dollars of discretionary spending a month), retailers' profitability and did not increase—those savings were more than absorbed by other expenses.

For investors, estimating retailers' future cash flows (and thus fair value) is becoming increasingly difficult. Warren Buffett has said that you want to own a business that can be run by an idiot, because one day it will be. A successful retail business in today's world cannot be run by an idiot. It requires Bezos-like qualities: being totally consumer-focused, taking risks, and thinking long term.

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