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The Secrets of Retail Revenue Winners in 2019

Retailers that delivered 5% or more revenue growth outperformed the market by nearly 60% over the past five years. Morgan Stanley's Consumer Retail team identifies four factors that could be key to success.

Midway through 2019, U.S. consumer retail finds itself in a tight squeeze. Margin pressures are intensifying from higher costs, tariffs and necessary investments. At the same time, revenue growth threatens to slow. And equities markets are paying attention.

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To be rewarded by investors, retail outfits are expected to do more than simply cut costs; they need to deliver sustainable revenue growth. A look at recent sector performance shows that companies that delivered top-line growth of at least 5%—while also maintaining margins—outperformed the overall equities market by nearly 60% over the last five years, while laggards underperformed by nearly 40% over the same period.

To examine what separates outperforming retailers from those that fall short, a cross-section of equity analysts on the consumer retail team at Morgan Stanley Research conducted a deep dive into more than 90 U.S. consumer retail companies. Their findings revealed that only a third of them were able to grow revenues by 5% annually and at least hold margins flat over the past five years.

In their report, the team identified four key factors driving profitable companies: pricing power, freight costs, ecommerce, and labor costs. The report also found that, while some subsectors have natural growth and margin advantages over others, each offers clear opportunities for profitable growth.

Broadly speaking, dollar stores and food distributors have natural growth and margin opportunities, followed by lodging brand companies, gaming, DIY auto, home improvement, franchised restaurants and off-price and branded apparel & footwear. However, home furnishings, department stores and specialty retail could continue to struggle.

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Factor #1: Pricing Power

In the race for profitable growth, pricing power is key. Consumer price index data shows that, on a macro level, over the past 10 years, the food-away-from-home (+3%) and lodging categories (+2%) led in annual growth. However, despite the higher growth for lodging, increased online price transparency and sharing-economy platforms have muted the subsector's pricing power.

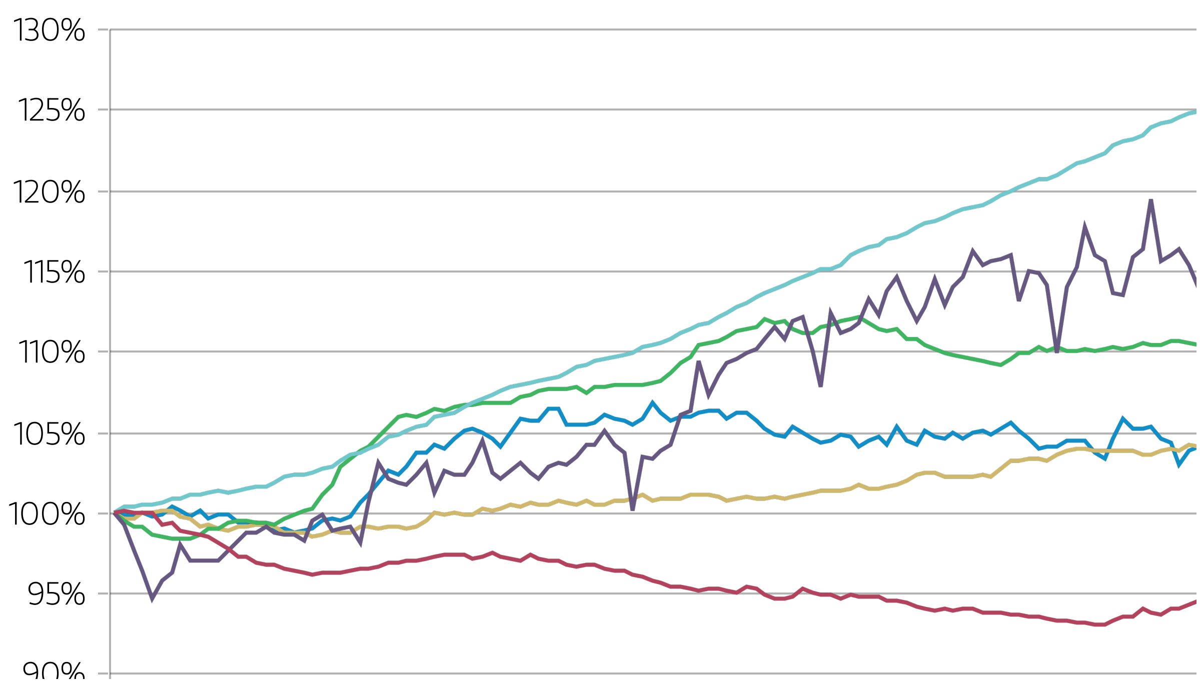
The food-away-from-home category has also gained pricing power. “Our research found that casual dining operators will seek to add roughly 2%-3% of price in 2019, while those in the fast-food space will aim for about 1%-2% of price," says John Glass, who covers the U.S. restaurant industry.

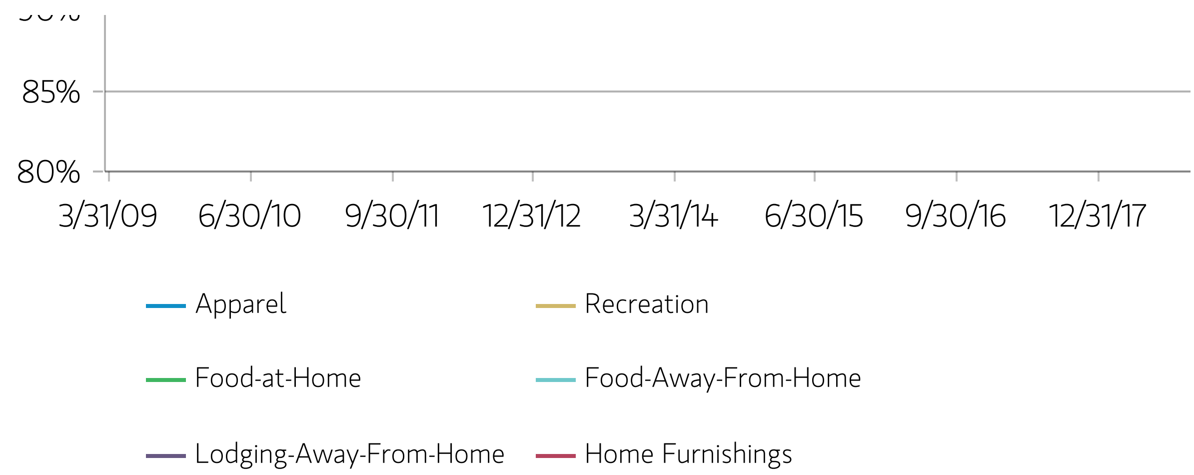
While companies are aware of consumers’ price sensitivity in the current deal-focused economy, “pricing has been necessary to prevent significant margin erosion in a rising cost environment," Glass adds.

At the opposite end of the spectrum, pricing for home furnishings and apparel has been deflationary for a decade. Food-at-home pricing has also slowed, as food retailers cut costs to attract shoppers in an increasingly competitive environment and gains by hard discounters.

Seasonally Adjusted Consumer Price Index by Category

(Indexed to March 2009)





Source: U.S. Bureau of Labor Statistics, Haver

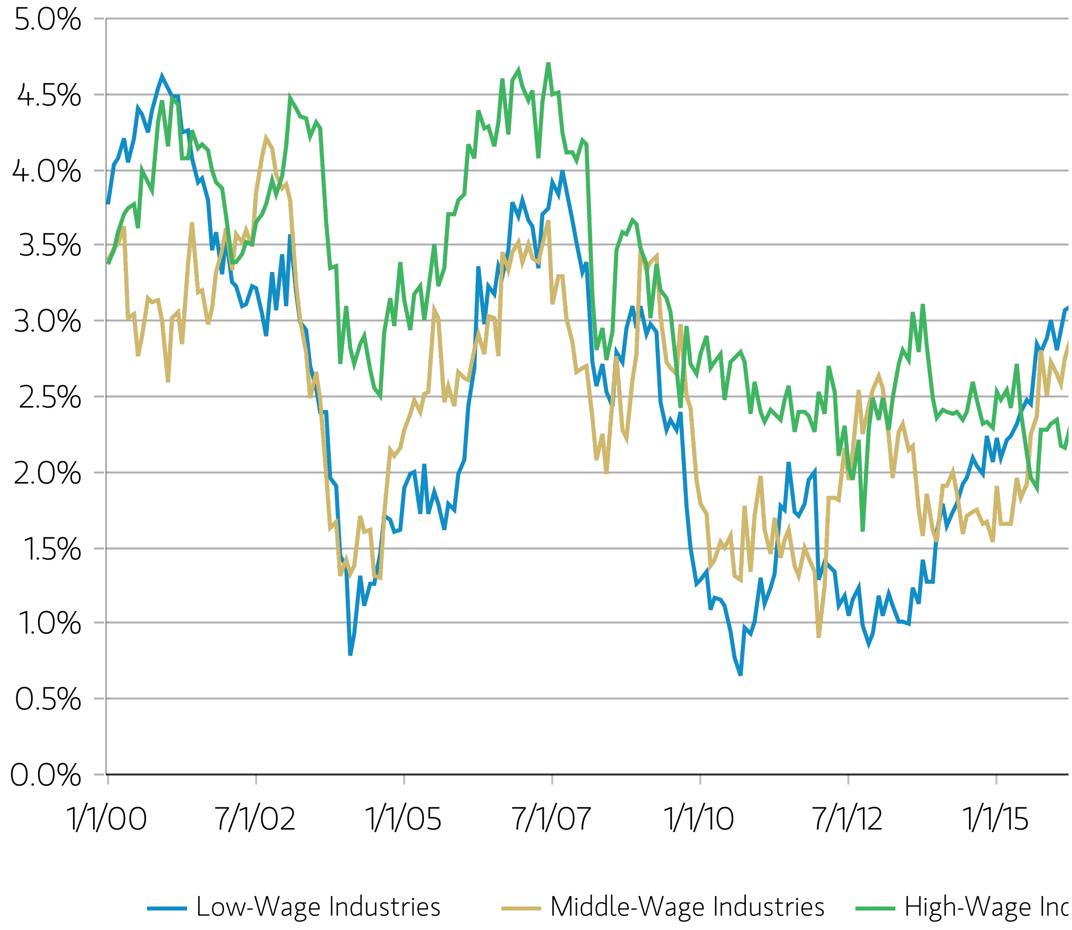
Factor #2: Labor Costs

Rising wages driven by tightening labor markets and government-mandated state and local minimum wage increases will continue to pressure margins across retail. Given the national conversation on wage growth, wage rate pressure is unlikely to subside in the near-to-medium term. The report estimates that population-weighted state minimum wages will continue to rise by about 4% on average over the next two years, before moderating slightly to roughly 3% from 2021-22.

Even so, not all subsectors will feel the same impact. At the top end, labor costs consume about 40% of revenue for lodging real-estate-investment trusts, followed by restaurants, where labor can cost as much as 35% of sales in company-operated models. For the rest of retail, labor costs can run 10%-20% of sales.

Restaurants estimate 2019 wage inflation in the mid-single-digit range, while consumer retailers broadly project about 4%. Gaming and lodging companies expect low-single-digit wage growth.

Wage Growth is Rising in Low- and Middle-Wage Industries



Source: Bureau of Labor Statistics, Morgan Stanley Research. Note: Average hourly earnings for production and non-supervisory workers shown before 2007, average hourly earnings for all employees shown after 2007.

Factor #3: E-Commerce

Ongoing investments in e-commerce and an increase in lower margin sales, as a result of growing e-commerce, have caused structural margin erosion in most consumer product categories. Overall e-commerce retail sales continue to grow at a healthy rate, 14% in 2018, as e-commerce penetration reached 11% of total retail sales at the end of 2018. E-commerce penetration in the GAFO segment—general merchandise, clothing and footwear, home furnishings, electronics and appliances, sporting goods, book and music stores, and office supply stores—have now risen to more than 45%, as brick-and-mortar store sales decline.

In particular, the shift to e-commerce has hit the home-furnishings segment the hardest, given difficulties with logistics and shipment costs. Meanwhile, softline retailers—think clothing, linens and other "soft" goods—have experienced a steady decline in flow-through amid e-commerce disintermediation.

"We estimate about 22% softline e-commerce penetration in 2019—well below the 45% GAFO penetration, but well above overall U.S. retail sales penetration of 11%," says equity analyst Simeon Gutman who covers the Retail Hardlines and Broadlines industries. While food retailers have experienced less e-commerce margin dilution to date (approx. 3%), Gutman predicts that penetration could double in the next four to five years.

In general, e-commerce has had a neutral impact on restaurants, but commissions on third-party delivery poses a key threat to restaurants' margins longer term.

Factor #4: Freight Costs

Finally, freight costs have been escalating on wage increases, driver shortages, increasing demand and the ELD mandate, which requires the shipping industry to migrate to fully digital recording-keeping from paper.

Freight costs are expected to remain elevated in 2019, though with less of a headwind, compared to 2018. Negotiated contract rates usually last one year, so pressure from freight costs of approximately 10%-15% above first-half 2018 levels may begin to level off in the second half of 2019.

Morgan Stanley predicts that these freight costs will stabilize at a new "higher normal." Still, elevated freight costs could weigh on profit growth. Hardline subsectors, such as furnishings and electronics, are more exposed and could see lingering pressure through 2019. Food distributors also have greater exposure to freight costs (about 7% of sales), given their significant trucking and transportation needs.

For more Morgan Stanley Research on consumer retail trends, ask your Morgan Stanley representative or Financial Advisor for the full report, "What Drives Outperformance as Profitable Growth Becomes More Elusive?" (May 3, 2019). Plus, more Ideas from Morgan Stanley's thought leaders.