Peaking E-Commerce?

Avery Sheffield
VantageRock Co-Founder & Chief Investment Officer, Senior Portfolio Manager

In our Long-Short Equity portfolio, we have a skeptical view of numerous highly valued COVID beneficiaries, particularly in e-commerce, that the market continues to believe are secular share gainers. We think this belief is often misguided and that the still sky-high valuations of many e-commerce companies will increasingly reflect their slowing to declining growth following the significant pull-forward in demand due to COVID, as well as from increasing competition from omni-channel retailers and the average consumers' continued interest for shopping in store for much of their needs.

Over the past 20+ years, e-commerce (as defined here by products shipped to home) companies have continuously taken share from brick-and-mortar retail, as their superior marketing and merchandising strategies as well as the convenience of home delivery and low pricing (at least historically) have led consumers to flock to them. Many have even called for the end of stores, regardless of the outsized success of off-price retailers over the same period which have minuscule to no e-commerce presence, as well as the still quite limited traction of grocery delivery outside of the most-dense urban areas. In addition, over the past several years, many brick-and-mortar retailers have significantly upped their game, becoming omnichannel retailers with their own compelling e-commerce presence and importantly, buy-online-pickup-in-store capabilities.

Fast forward to the massive store closures that occurred during peak-COVID, and e-commerce demand surged to new highs, driving revenues and valuations of these companies to unprecedented levels. Given the significant growth in new e-commerce customers as well as expanded use cases even for e-commerce converts, if e-commerce is a never-ending share gainer, volumes should continue to grow in a post-COVID era. However, there is evidence that in many cases the opposite is occurring.

For the first time in over 10 years, e-commerce sales at several traditional and e-commerce only companies have declined. Target, which continued to benefit from a 10% increase in sales placed digitally via mobile or web in 2Q21, stated that their packages shipped to home declined in 2Q21 vs 2Q20 due to customers shifting their preference towards buy-online, pick-up in store and same-day capabilities. Further, Kohl's, Skechers, and Footlocker all said that their digital sales declined y/y in 2Q21 as customers came back to stores. And regarding e-commerce only players, Wayfair's sales declined over 10% y/y in 2Q21 while Overstock grew only 3.6%; yet brick-and-mortar-only HomeGoods sales rose over 60% y/y and 40% from 2019 levels. Declines in e-commerce of this magnitude – or any declines at all – have been highly unusual prior to this past quarter and are especially stark in contrast to the very significant in-store sales growth during 2Q21 at many brick-and-mortar retailers.

This is not to say that some companies aren't still experiencing growth in e-commerce – Amazon's first party business still grew e-commerce 13% y/y in 2Q21 and its 3rd party business still grew over 30%. Many apparel, accessories, and shoe brands are still growing e-commerce given their preference to invest in this direct channel vs send more inventory to wholesalers where they earn a lower gross margin.

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And there are other commerce companies which are still growing sales, but often at a significantly increasing cost and lower overall profitability, raising questions about the quality of that incremental growth. Likely as a result of these changes, total UPS SurePost volume was down 2.9% in 2Q21 and UPS' own business to consumer shipments were down nearly 16% y/y – an alarming decline for one of the largest e-commerce shippers in the country.

Overall, the fact that so many customers tried e-commerce and/or expanded their e-commerce purchases during COVID and have voluntarily switched back to in-store and/or buy-online-pickup-in-store shopping post-COVID, suggests that the natural use cases for unsubsidized and/or "non-crisis" ship-to-home e-commerce could be lower than originally anticipated, and we might not see the never-ending secular growth ahead that many investors anticipate. Further, we believe that the profitability of e-commerce sales will become increasingly important to investors. As a case in point, Amazon.com recently announced that they will be charging a $9.95 service fee for Whole Foods deliveries in several major markets. Beyond delivery costs, we believe profitability will become increasingly challenged for some e-commerce companies due to climbing digital marketing costs, increased privacy restrictions, as well as higher fulfillment costs and increased competition for attention on mobile phones and over the web. This could create incrementally higher cost of customer acquisition, deleverage on fixed costs or potentially both.

We believe certain e-commerce companies are well positioned to enjoy healthy and profitable growth in the years ahead, but also believe that numerous other e-commerce companies are poised to disappoint on revenue and earnings growth and see the potential for a stark multiple re-rating and meaningful downside in stock prices as a result. We will continue to monitor these dynamics carefully as new risks and opportunities arise.

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