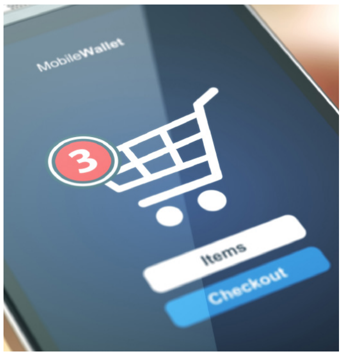
Bricks and clicks

How M&A is accelerating the convergence of the high street and online

The last two to three years have seen a number of significant M&A transactions between traditional bricks and mortar retailers and online retailers. In part, these transactions may be seen to be a result of the maturing of the online retail space. Traditional retailers are now more comfortable with online operating models and the valuations applied to these businesses, not least because nearly all retailers of note will have some online presence themselves. The nature of the recent transactions also provides some indication as to the future development of retail and, in particular, the growing convergence of the online and bricks and mortar business models.



In previous articles in our Future of Consumer series we have examined how artificial intelligence, augmented reality and virtual reality are being used by retailers to offer an enhanced retail experience to consumers. This briefing focuses on the fundamental changes to retailers' models of operation that have occurred since the emergence of the internet as a retail platform. We look at how these changes have influenced recent M&A activity in the retail space and how this activity indicates a growing convergence of the operating models of online retails and traditional bricks and mortar retailers.

Driven by the realisation that bricks and mortar retailers will never be able to overcome the advantages that an online model offers in terms of convenience, costs, flexibility and access to markets (discussed below), bricks and mortar retailers have been looking to leverage those aspects of their operating model with which online retailers have previously been unable to compete. Innovations being implemented by the bricks and mortar retailers have in turn driven online retailers to look at their own operating models and to adapt them to respond to these new offerings. This strategy has led online retailers to take a step that appeared highly improbable in the early days of e-commerce, namely establishing or acquiring a bricks and mortar retail presence.

To understand why this is such a significant development for retailers and what it indicates about the future of retail, it will first be useful to remind ourselves of the historical advantages of online retail compared to bricks and mortar.

The advantages of online

Since the early days e-commerce there has been a sustained narrative, questioning whether online will "kill" the traditional high street. When internet retailers first arrived on the scene it looked as though the high street would be unable to compete with online shopping due to the advantages of the online operating model, including:

- **Convenience** - E-commerce offered consumers the ability to purchase the goods they need at any time and from any location as long as they have access to the internet. This convenience factor has been magnified further by the rise of smartphones allowing consumers to access the internet wherever they are.
- **Overheads** – The largest fixed costs for any high street retailer will usually be the rents charged for high street locations and staff costs. Internet retailers are able to greatly reduce these overheads by operating from large out of town warehouses with additional savings due to the need for fewer employees and ability to use automation to a greater extent;
- **Price** – Internet retailers have been willing to pass on the cost savings from their reduced overheads to consumers to better compete with bricks and mortar retailers. In addition, certain internet retailers have established operations in tax beneficial jurisdictions and satisfy orders from those jurisdictions, again passing on the consequent cost savings to consumers through reduced prices.
- **Choice** – Without being constrained by physical location and needing to have all stock available in the same physical location, internet retailers have been able to offer a much wider range of products to consumers.

An early reluctance to engage in M&A

Despite the apparent advantages offered by online retail, until relatively recently there have been very few significant acquisitions of online retailers by bricks and mortar retailers. The main reasons for this are twofold. First, in the early days of e-commerce bricks and mortar retailers were still assessing the benefits and risks of online sales. Real world retailers were reluctant to spend money on acquiring an unproven business model, particularly when they may have felt they could have better invested the money in developing their own online operations. It was not clear what, if any, advantages online had that could not be easily replicated by real world retailers with the benefit of established trade names. Second, the internet bubble was driving up valuations of online businesses to an extent that was not necessarily supported by the underlying business fundamentals. The valuations that were being set and achieved through IPO's were applying trading multiples that no potential trade purchaser appeared willing to match.

Given that the advantages of online retail are largely driven by not having bricks and mortar presence with the attendant costs, until recently there did not seem to be any advantage to e-commerce establishing a real world presence. Equally, it is only in the last five years that the largest online retailers have reached a size and scale whereby they have the funds readily available for a significant acquisition of a traditional bricks and mortar retailer.

A changing bricks and mortar operating model

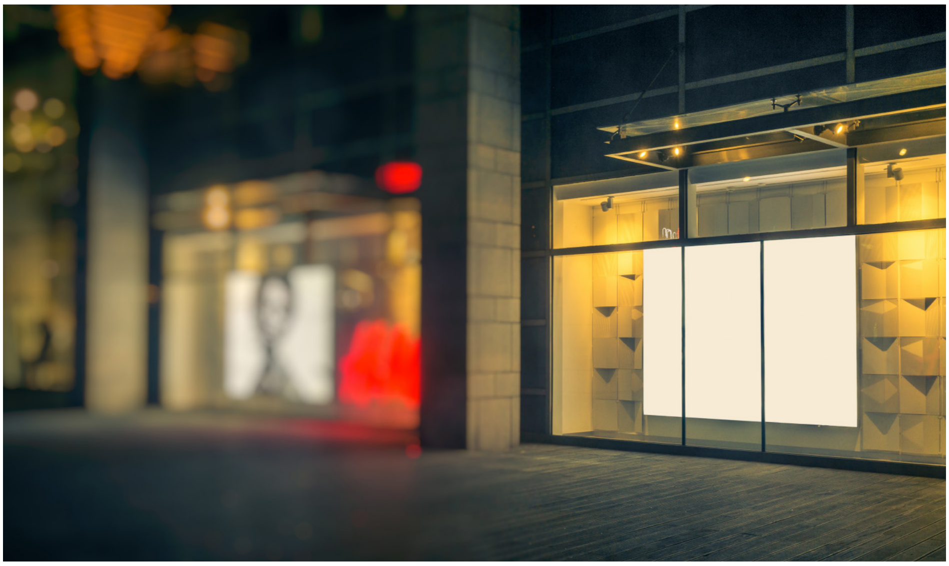
In seeking to compete with internet retail, bricks and mortar retailers have been evolving their operating model over the past 25 years in a number of ways. It is the outcomes of this evolution, in particular the development of "experience" retail and of "click and collect" services, that has triggered the recent emergence of "cross-platform" M&A between bricks and mortar retailers and online retailers.

To compete with the reduced overheads of online, bricks and mortar retailers have increasingly moved away from prime high street positions, with the high rents that such locations command, to out-of-town retail parks and malls. The move to the retail centre model has resulted in a further development of the bricks and mortar operating model, namely the growth of "experience" as a driver of footfall. In seeking to encourage consumers to make a visit to a retailer, mall or out-of-town retail centre, the operators of these businesses have increasingly sought to make such visits an "experience". Mall operators have encouraged not just retailers and the usual food stalls and convenience food options but higher end restaurants, and other entertainment offerings such as cinemas and interactive experiences. Such "experience" models encourage visitors to spend more time in a retail centre, encouraging them to spend more and make discretionary purchases they may not have otherwise made.

The "last-mile" problem

The other significant change to the bricks and mortar operating model introduced to compete with the convenience and choice offered by internet retailers, was the introduction of home delivery and "click and collect" services. The home delivery model was a simple replication of the internet retailers operating model, allowing customers to choose goods on a website that would then be delivered to the consumers' homes.

One disadvantage of the home delivery model that is more keenly felt by bricks and mortar retailers, is the associated delivery costs, in particular "last mile" delivery (ie, the incremental costs of delivering multiple packages to multiple locations from a single distribution centre). Given the reduced overheads of the online model, many online only retailers had been happy to absorb delivery costs in the price of the goods, which could still



be lower than those offered by bricks and mortar. However, bricks and mortar retailers maintained the higher overheads of operating real world locations but also having to deal with additional delivery costs. Traditional retailers tended to deal with these costs by charging a separate, additional delivery charge to consumers or to offer a "click and collect" service whereby customers could collect goods instore that have been delivered online.

The "click and collect" model brought with it some unexpected benefits for bricks and mortar retailers that online retailers are now seeking to replicate.

First, the costs of delivery were greatly reduced by using the retailers existing delivery infrastructure to deliver goods ordered online by multiple customers to a single physical location, ie a high street store. Online retailers have also consistently sought to reduce with "last mile" costs. In attempting to reduce or avoid last mile costs, online retailers have driven the rise of specialised services such as Collect+ or Amazon lockers whereby goods are delivered to a location near to the consumers home and the consumer makes a special visit to collect those goods; or innovative, and cheaper last mile delivery solutions such as drone delivery, currently being trialled by Amazon.

The second advantage that "click and collect" offered to bricks and mortar retailers is the increased incidental purchases made by consumers when collecting their purchases. When going to pick up a "click and collect" item, consumers will very often make an additional unplanned purchase from the same store, thus generating additional revenue that home delivery services do not achieve.

Online retailers establishing a real world presence

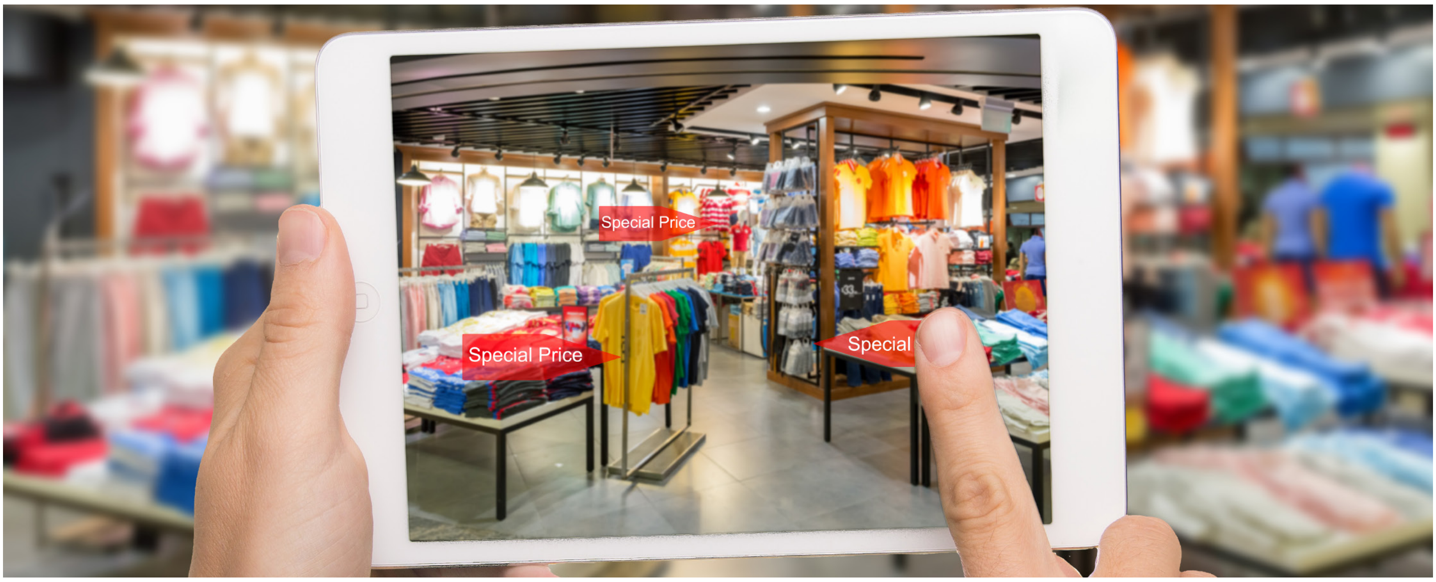
It is the desire to obtain the benefits offered by "click and collect" services that has been a driver online retailers seeking to acquire bricks and mortar retailers and also to move to develop their own real world locations.

Amazon's acquisition of **Whole Foods** for $13.7 billion, announced in June 2017, is the highest profile move by an online retailer into a bricks and mortar operating model. There has been much commentary since the acquisition regarding **Amazon's** motivations and their ability to utilise the enormous quantities of data they hold on consumer habits to disrupt the grocery industry. Another key reason for the acquisition was a desire of **Amazon** to establish real world locations to which it could offer a "click and collect" service to minimise last mile costs and to encourage unplanned discretionary purchases. This is also one of the drivers behind **Amazon** developing its chain of "**Amazon Go**" convenience stores. Though such purchases individually may be small in value, given **Amazon's** customer base is in the hundreds of millions, encouraging just a small percentage to make the discretionary purchases on a regular basis, combined with encouraging the consumer to act as their own delivery person by collecting the goods they ordered online, could rapidly equate to significant additional revenue and reduced cost.

Alibaba, the e-commerce giant, has also taken steps to develop its own bricks and mortar retail locations. Like **Amazon** it has been acquiring stakes in supermarket chains, spending up to $8 billion over the past two years by some reports, and developing its own convenience store. Unlike **Amazon** (for the time being) **Alibaba** has also spent $2.6 billion acquiring the Chinese luxury mall Intime. **Alibaba** is seeking to leverage its knowledge of consumers based on the billions of data points it collects from transactions to help develop a model super-mall to compete with the traditional bricks and mortar super-malls and incorporating the "experience" model.

This super-mall will offer the tech based advantages of an online retailer, with hi-tech fitting rooms allowing customers to virtually try on new clothes and test make up though connected smart mirrors and also visit consumer electronics stores and grocery stores. The concept behind **Alibaba's** move to bricks and mortar malls is that consumers will visit the mall for the experience, including, for example, a meal and trip to the cinema, and while there they will use the hi-tech facilities to buy new clothes and order groceries. The consumer would then have the option of taking the goods home with them or having them delivered to their home at a later date.

Bricks and mortar retailers are not standing still as online retailers move into the traditional bricks and mortar operational model. Recent years have also seen a number of significant acquisitions by traditional bricks and mortar business of business that are intend to help them better compete in the online world. For example, the last two years have seen the two biggest acquisitions of online only business by bricks and mortar retailers, with **Walmart** acquiring **Jet.com** and **Petsmart** acquiring **Chewy Inc**. **Walmart** has been particularly active in acquiring online retailers, adding **Bonobos**, **Modcloth**, **Moose Jaw** and **Shoebuy** to its growing list of online acquisitions. The bricks and mortar retailers are now acquiring online business to offer more choice to customers than they currently offer without needing to necessarily hold an increasingly diverse amount of stock. By acquiring an established online business, traditional retailers can offer the choice of the online retailer without necessarily needing to hold the goods in store. Consumers purchasing through the online store can be offered the chance to "click and collect" from the bricks and mortar store (and encouraged to make unplanned purchases when doing so). In the UK **Sainsbury's** acquisition of **Home Retail Group**, though both traditional bricks and mortar retailers, was driven largely by **Sainsbury's** desire to obtain the online order fulfilment capabilities of the **Home Retail Group**, in particular that of **Argos**.



Conclusion

While significant M&A activity between online and bricks and mortar retailers has only occurred in the past few years, the types of transactions that have been occurring are indicative of a convergence of the online and bricks and mortar operating models, as online retailers seek to take advantage of the operating models that bricks and mortar retailers had developed in response to the threat of online.

The consumer of the future may choose to order goods online during their lunch break and to pick them up from their local convenience store on the way home, whilst purchasing food for their evening meal. At the weekend they will likely travel to an out-of-town mega-mall to peruse the latest fashions and consumer electronics, which they order in-store for home delivery the next day, before heading for a meal and a trip to the cinema, or sample the latest interactive experience, all in the same bricks and mortar shopping mall.

Having spent the best part of two decades assessing the relative strengths and weaknesses of the apparently opposing, online operating model, it appears that traditional retailers are now ready to embrace an operating model than spans both online and bricks and mortar, and they are using M&A to accelerate such a move.

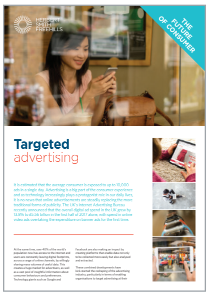
Previous issues

Issue 1

The future of retail: AI, AR and VR

Issue 2

Targeted advertising



Issue 3

The supply chain and brand value

Issue 4

Targeting online risk

Key contacts

Susan Black
Partner, London
T +44 20 7466 2055
M +44 7785 255 009
susan.black@hsf.com

Kristin Stammer
Partner, Sydney
T +61 2 9225 5572
M +61 414 957 572
kristin.stammer@hsf.com

Alex Kay
Partner, London
T +44 20 7466 2447
M +44 7785 775 051
alex.kay@hsf.com

Author

Marc Perkins
Senior Associate, London
T +44 20 7466 2125
M +44 7809 200 881
marc.perkins@hsf.com

This article is part of a **Future of Consumer series** on issues facing the Consumer sector. Click on the thumbnails opposite to access these direct or visit the Future of Consumer pages of our website or contact Rachel Montagnon

Rachel Montagnon
Consumer and IP Professional Support Consulta nt, London
T +44 20 7466 2217
M +44 7809 200 590
rachel.montagnon@hsf.com