BARRON'S COVER

Who's Afraid of Amazon? 9 Surprising Retail Winners

Traditional retailing is far from dead, to judge by the success of Best Buy, Home Depot, Wal-Mart, and others.

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Gphotography

Creative destruction has defined the retailing business since the moment after its birth. Today it bears the face of Jeffrey Bezos and the name Amazon.com, the internet-based retailer Bezos founded in 1994 that changed the way America shops, and even lives. As Amazon has grown into a behemoth, traditional retailers have been forced to adapt in radical ways. Many have failed, and the casualties are mounting by the day.

But don't mourn yet for a sector still beloved by consumers—and one that still could offer potentially rich rewards for investors. You wouldn't know it from last week's cavalcade of dismal earnings reports from companies as varied as J.C. Penney (ticker: JCP), Office Depot (ODP), and Macy's (M), or the widespread selloff in retail stocks, some of which have fallen as much as 50% in the past year. Yet nimble retailers such as Best Buy (BBY), Nordstrom (JWN), and Home Depot (HD), which have developed differentiated products and services, stand a good chance of prospering in coming years—and rewarding shareholders nicely.

Barron's has identified nine retail plays that could thrive in a marketplace growing more competitive by the hour. Also on our shopping list: Costco Wholesale (COST) and Wal-Mart Stores (WMT) in the big-box category; Lowe's (LOW) in home improvement; art-auction expert Sotheby's (BID); GGP (GGP), a mall real-estate investment trust; and Party City (PRTY), a party-goods supplier. (For more retail picks, see the Q&A with Dana Telsey.)

Any bullish call on retail stocks is contrarian these days. More than a dozen retailing companies have filed for bankruptcy protection so far this year, continuing 2016's mournful trend, and thousands of stores have been shuttered nationwide. Short interest in retail stocks, reflecting a bearish bet by investors, is at the highest level since December 2008, according to a recent report from Bespoke Investment Group. Many of our favored names, including Best Buy and Nordstrom, have high short interest, expressed as the percentage of shares outstanding held by short sellers. Many also have deeply depressed share prices.

At the same time, online retail sales are growing by 15% a year as savvier store operators follow the lead of Amazon (AMZN). In April, online sales accounted for 22% of general merchandise sales (excluding food, gasoline, automobiles, and restaurants), up from 15% seven years ago, according to the U.S. Census Bureau. Amazon’s share of the business reportedly exceeds 40%.

THE CASE FOR TRADITIONAL RETAILERS rests on several assumptions. While buying online is easy and saves time, many people still like to shop. Moreover, history suggests that no single company, not even Amazon, can turn its industry into a private playground on a long-term basis. Veteran retail investors might remember predictions made in the late 1990s that Wal-Mart and other big-box chains would sweep away the rest of the industry. That didn’t happen, either.

Our retail picks are distinguished by several characteristics. All have been quick to react to customers’ needs, both online and in-store. Some provide specialized products and services, while others sell things that are difficult to ship. Among traditional retailers, “the ones that will win are those that embrace the experiential element, melding both physical stores and an online strategy,” says Brian McGough, an analyst at Hedgeye, an investment-research firm.

SURVIVORS’ GUIDE

These nine retail plays have upped their game online and off, and are poised to flourish in Amazon’s world.

Company/Ticker	Recent Price	12-Month Change	Earnings per share[1] 2017E	2018E	P/E 2017E	Dividend Yield	Short Interest As % of Float
Best Buy / BBY	$50.61	58.7%	$3.69	$3.91	13.7	2.7%	13.4%
Costco Wholesale /COST[2]	169.15	22.6	5.64	6.39	30.0	1.2	1.7
GGP / GGP[3,4]	21.95	–18.2	1.57	1.65	14.0	4.0	7.2
Home Depot / HD	156.09	18.3	7.24	8.19	21.6	2.3	0.9
Lowe's / LOW	83.75	10.1	4.64	5.29	18.1	1.7	0.9
Nordstrom / JWN	40.81	8.4	2.95	3.05	13.8	3.6	24.3
Party City / PRTY[4]	15.30	24.6	1.27	1.42	12.0	None	24.0
Sotheby's / BID[4]	49.30	77.7	2.07	2.47	23.9	None	17.0
Wal-Mart Stores / WMT	75.12	15.4	4.33	4.55	17.4	2.7	2.5

E=Estimate. 1. Estimates are for the fiscal years ending January 2018 and January 2019. 2. Fiscal year ends August. 3. Earnings are represented by funds from operations. 4. Fiscal year ends December.

Sources: Thomson Reuters; Bloomberg

Click here to view larger table

Department stores have been considered dinosaurs for decades, but don’t tell that to Nordstrom, the Seattle-based apparel specialist that seems determined to flourish in an Amazon-dominated world. Brad Liff, an analyst at Bespoke, considers Nordstrom, which operates about 350 stores, the best-situated among its peers, and the most likely to succeed. The company is renowned for its service culture, in-store experience, and exclusive products aimed at a fashion-focused clientele. Nordstrom also is further along than peers in its digital transformation, and does a particularly good job of helping in-store customers order online when items aren’t in stock.

Nordstrom beat analysts’ earnings estimates in the first quarter, but the shares tumbled on weaker-than-expected same-store sales. Online sales, about a fourth of the total, rose sharply, however, at Nordstrom.com and NordstromRack/HauteLook.com. The company bought HauteLook, which runs “flash” internet sales of designer apparel, in 2011. Nordstrom’s shares have fallen by almost 50% since March 2015 and recently fetched $40.62. They yield 3.6%. The stock trades for 13.7 times fiscal 2018 estimated earnings of $2.97 a share, one of the cheaper valuations in the group.

BEST BUY, THE CONSUMER-ELECTRONICS RETAILER, nearly suffered death by Amazon. But CEO Hubert Joly, who joined the company in 2012, implemented policies that have resuscitated the business and the shares. Critically, he decided to match Amazon’s prices and those of big-box retailers, which helped Best Buy avoid the fate of bankruptcy victims Circuit City, Radio Shack, and hhgregg (HGGGQ).

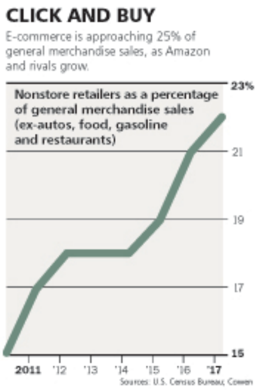
In addition to price, Best Buy competes on service, chiefly through its Geek Squad of tech-support personnel. The company has maintained gross profit margins in the low- to mid-20% range, and is expected to earn $3.69 a share in fiscal 2018 and $3.91 the following year.

Even better, its stock has roared back to $51 from around $10 in 2012, and now trades within a dollar of its 2007 high. Nor is it expensive at 14 times expected earnings.

Home Depot and Lowe’s make our list of retail winners for two reasons. Both sell products that are tough to ship and are benefiting from a strong housing market.

Although housing starts fell modestly in April, the National Association of Realtors said Thursday that sales of existing homes are likely to hit a decade high this year.

Chris Grisanti of Grisanti Capital Management notes that building products like 2-by-4 planks are relatively Amazon-proof. The same goes for white goods. “If your dryer breaks down, you don’t want to wait” for a new one to be shipped, he says. Instead, “you go to Lowe’s” and buy a new one.



[Click here for larger version of chart]

Wall Street recognizes the staying power of both retailers, whose shares have rallied sharply in recent years and trade near all-time highs. Grisanti prefers Lowe’s to Home Depot because it is somewhat cheaper at 18 times expected earnings for fiscal 2018.

Like the home-improvement chains, Party City looks to be beating Amazon because shoppers need its goods on short notice, and some products, like helium balloons, are impossible to ship. But the company isn’t taking chances. It announced this month that it plans to launch a digital marketplace for “party-related services,” connecting buyers with suppliers of decorations, entertainment, and such.

Party City came public in April 2015, and its private-equity owners still control more than half the stock. The company, which has a market capitalization of $1.8 billion, beat first-quarter earnings estimates and is on track to earn $1.13 a share this year, up 14% from 2016. The shares are up 8% year to date and trade for 12 times expected earnings.

ANALYSTS AT COWEN recently developed a list of what it calls un-Amazon-able businesses that could be winners in today’s disrupted market. Oliver Chen, lead author of the report unveiling the list, advises investors to “go high or go low, and avoid the middle.”

On the high end, he favors Sotheby’s, best viewed as a premium retailer that builds relationships on trust between customers and its 200 art professionals. The company, which owns the Sotheby’s auction house, is also aided by a capital-light business model and minimal online expenditures.

An exciting art market helps, too. Last week Sotheby’s facilitated the sale of Jean-Michel Basquiat’s monumental 1982 painting of a skull for a dazzling $110.5 million, the sixth-highest price ever paid for a work sold at auction. The news sent the shares up more than 1% on the week, to $50.01, helping Sotheby’s to a 12-month gain of 78%.

At Walmart.com, you can buy a book on Basquiat for $33.77 or a poster for $60. At Costco.com, a query on the late artist begets another: “Did you mean ‘biscuit’?” Perhaps that’s why Wal-Mart’s digital sales soared 63% in the latest quarter, aided by its recent purchase of Jet.com, an Amazon Mini-Me, while Costco’s rose only 12%.

Nonetheless, both companies are “low” picks, in Chen’s vernacular, as they are figuring out how to flourish in an Amazon-dominated world, where Wal-Mart’s value pricing and Costco’s focus on bulk-buying help. At Wal-Mart, which doesn’t break out online sales, in-store traffic has also been rising. Costco has taken a more deliberate approach to the internet, but the warehouse retailer could come under pressure to ramp up its online store. Meanwhile, shares of both companies are beating the Standard & Poor’s 500 this year: Wal-Mart is up 14% and Costco, 7.2%, against the index’s 6.4%.

MUCH OF THE RECENT CARNAGE in retailing has taken place at the mall, where fashion retailers such as Bebe Stores and The Limited are closing all their stores. Even mall anchors such as Macy’s are struggling. That has hurt the shares of mall REITs, but it need not be fatal to the business. Department-store sales have been declining for a decade, notes Daniel Busch, a managing director at Green Street Advisors, a real-estate research firm, and some REIT-owned malls are already reacting.

The biggest risk to the business is a

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possible acceleration in the pace of department-store closings. It has been modest so far, and redevelopment initiatives could be manageable and value-accretive, Busch says. In some cases, he adds, malls have been able to replace ailing department stores with healthy new tenants, including the rapidly growing Irish fast-fashion chain Primark Stores, which is owned by the United Kingdom's Associated British Foods (ABF.UK).

The death of American retailing isn't a story every company believes. Primark is moving to expand its footprint in the U.S., where it now operates fewer than 10 stores, and large, privately held German grocers such as Lidl Stiftung and ALDI Einkauf are looking to make inroads here. Even Amazon seems to have missed the memo. It reportedly is contemplating its own bricks-and-mortar stores, which are likely to be staffed mainly by robots.

Still, Jeffrey Bezos can't sell everything to everyone, much as he might try. The market hasn't yet made clear distinctions between the predators and the prey in the Amazon jungle. That spells opportunity for investors.

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