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Consumer & Retail Practice

Why retail outperformers are pulling ahead

Retailers' relative performance in capital markets starkly demonstrates a pandemic-driven acceleration of ongoing industry shifts. This means those that wish to keep up need to speed up.

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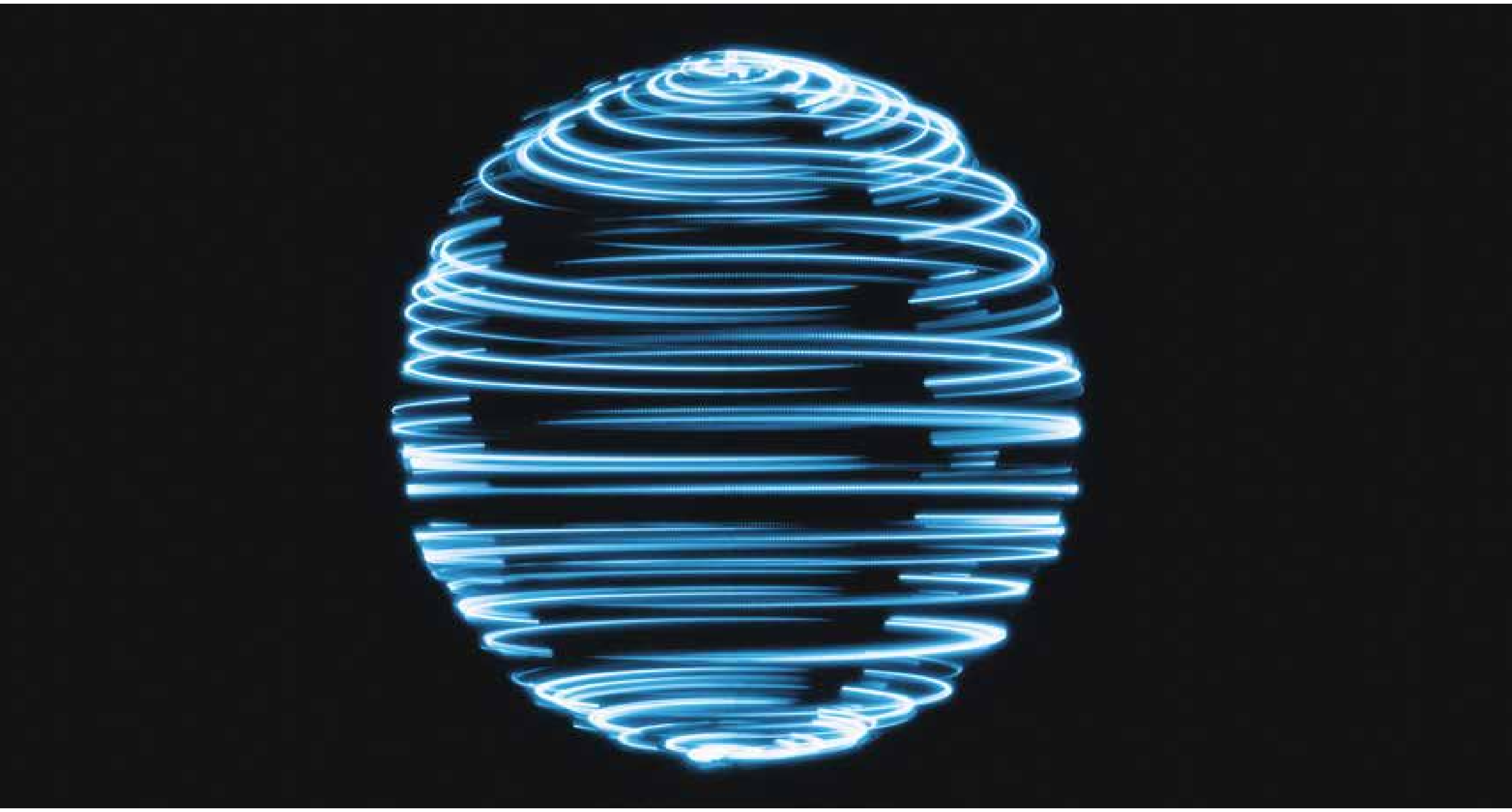

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The seismic impact of the COVID-19 crisis on the retail industry continues to reverberate more than a year after the pandemic struck the globe. Forced to shutter stores overnight and rapidly escalate their shift to e-commerce, retailers have watched temporary effects, such as grocery hoarding and apparel overstock, gradually give way to new consumer behaviors and business practices that may permanently reshape the industry. As the dust from the coronavirus earthquake starts to clear, the retail landscape looks transformed, with the disruption giving some companies a massive performance jolt as others have been devastated.

A look at the industry's performance through the lens of the capital markets is instructive. The first year of the COVID-19 crisis marked a dramatic acceleration of many trends already under way, propelling some industries to record heights of performance as others dropped even further behind.[1] This growing divergence was highlighted in our recent research on capital market patterns through the pandemic's first 12 months.[2] While stock markets overall recovered quickly, the spread between the best- and worst-performing sectors grew, from 27 percentage points in mid-March to 80 percentage points a year later—the widest margin in recent history.

The retail industry outperformed many other sectors, with the average company delivering positive total returns to shareholders (TRS), but the trends that the pandemic amplified are accelerating an industry realignment that had started several years earlier. As in most other sectors, the gap between industry leaders and laggards has widened, with some companies dramatically increasing their market values (Exhibit 1).

The industry's stock market performance demonstrates the powerful tailwinds that the pandemic provided to retailers with already strong omnichannel presence. The companies with tech-forward business models that were seemingly inches ahead before the crisis gained miles on the competition. The past year suggests the recipe for success in retail is changing, and those that wait too long to adapt may never catch up.

The COVID-19 year in retail

Confined indoors, consumers did not remain idle. Despite incomes shrinking significantly for many—especially in Asia, where government stimulus was limited—global shopping volumes overall increased, leading the retail sector to gain 35 percent[3] in market capitalization from late February 2020

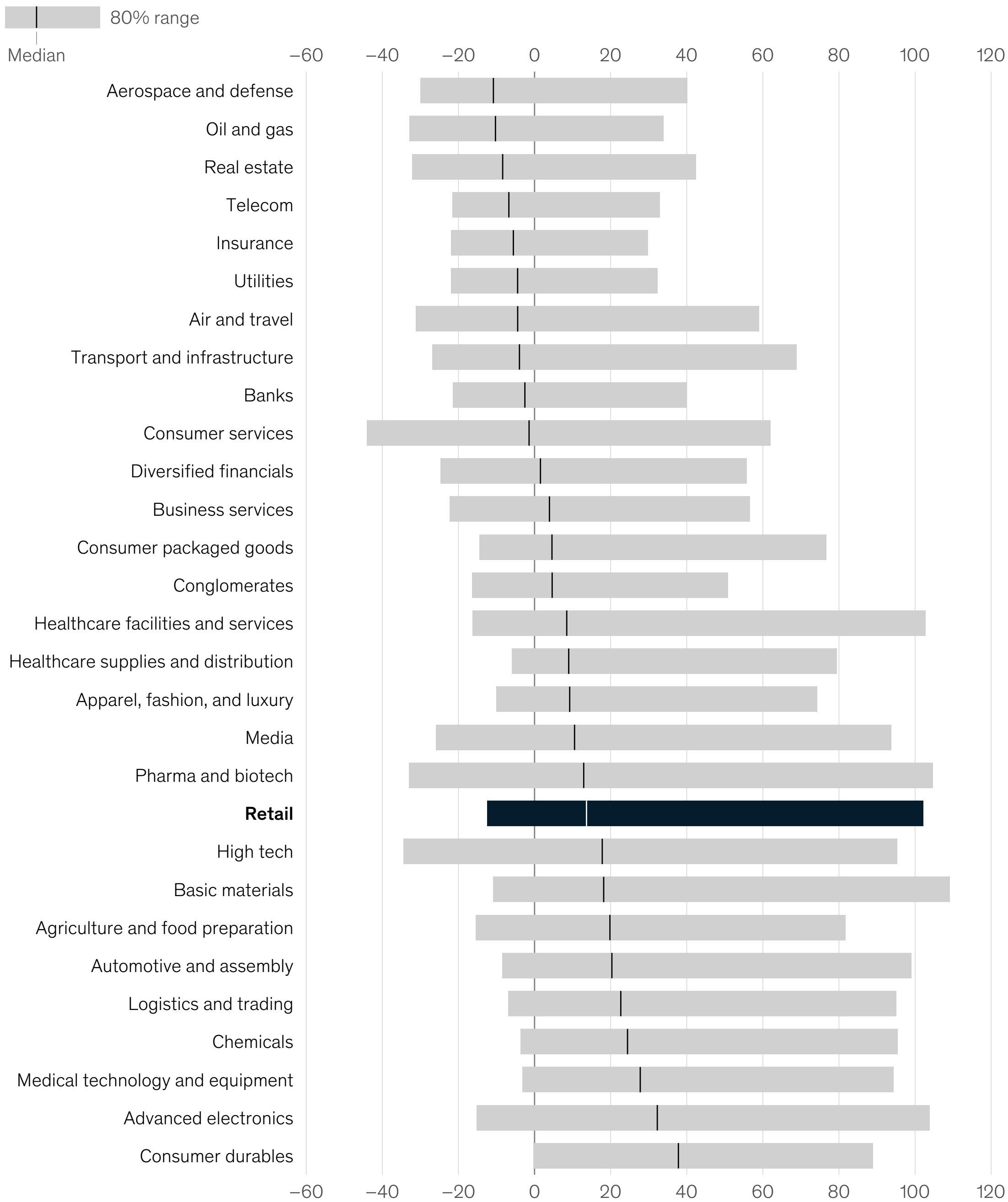
As in most other sectors, the gap between retail-industry leaders and laggards has widened, with some companies dramatically increasing their market values.

[1] Chris Bradley, Martin Hirt, Sara Hudson, Nicholas Northcote, and Sven Smit, "The great acceleration," July 14, 2020, McKinsey.com.
[2] Chris Bradley and Peter Stumpner, "The impact of COVID-19 on capital markets, one year in," March 10, 2021, McKinsey.com.
[3] This includes platforms such as Amazon and Alibaba despite their broad scope of both B2C and B2B offerings such as media and web services.

Exhibit 1

The retail sector outperformed many other industries, but the gap between sector leaders and laggards has grown.

Distribution of total shareholder returns by industry from Feb 21, 2020, to Apr 29, 2021, %



Source: Corporate Performance Analytics; S&P Global

through April 2021. Many used the time to renovate and redecorate homes; embrace new hobbies, clothing styles, and beauty routines; and care for families and pets, all the while splurging on products, services, and experiences delivered online.

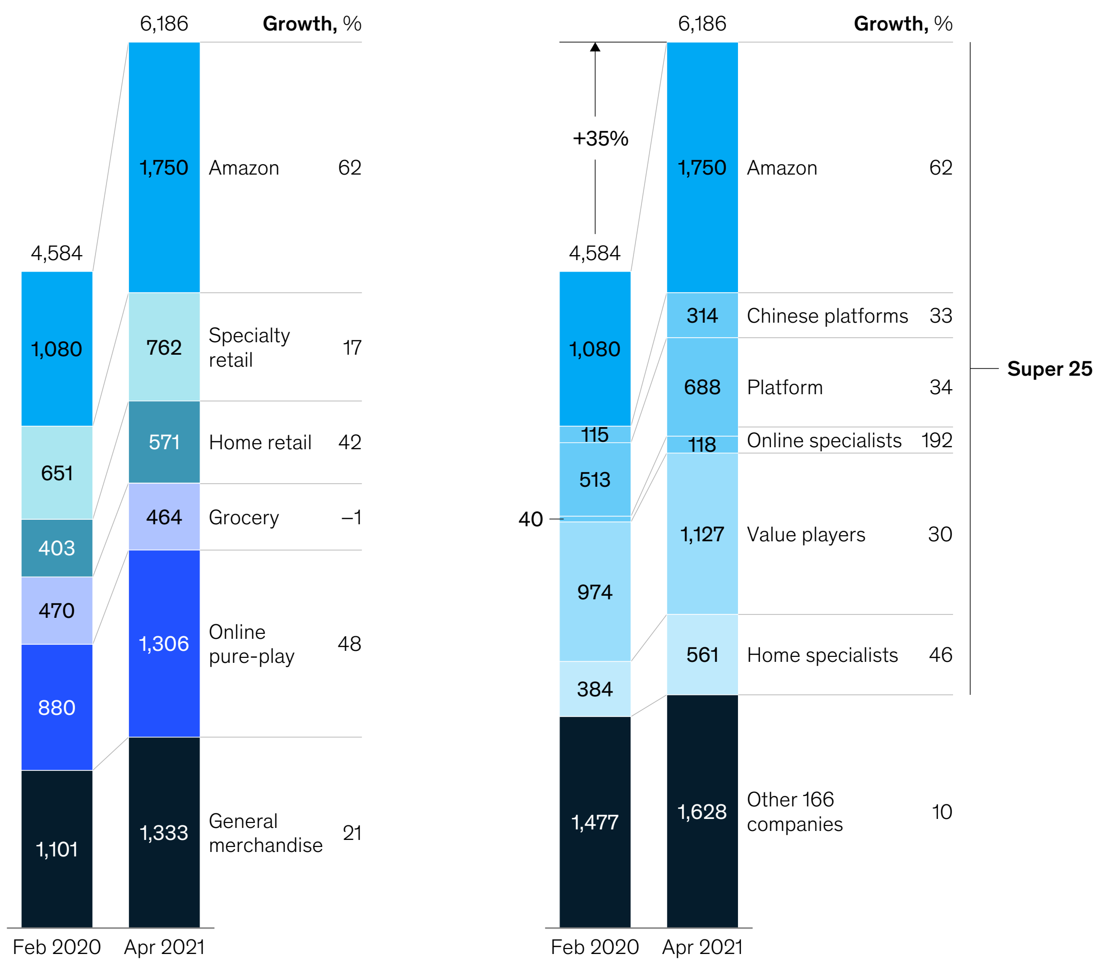
Retailers that catered to those needs thrived—particularly those with strong digital footprints (Exhibit 2). However, the gains were far from uniform. Retailers reliant on office workers struggled more than neighborhood stores, and categories such as business apparel and cosmetics were hit hard. Additionally, there were significant regional differences. American and Chinese companies captured three-quarters of the retail sector's market-cap growth, an exceptional performance that reflects the size of markets and more advanced digital business models of retailers in those countries.

In many cases, the strengths enabling some companies to surpass their industry peers—tech-forward and asset-light business models propelled by the tailwinds of growing demand—

Exhibit 2

The retail industry has seen a huge shift of value to online.

Market capitalization, $ billion
As of Apr 29, 2021



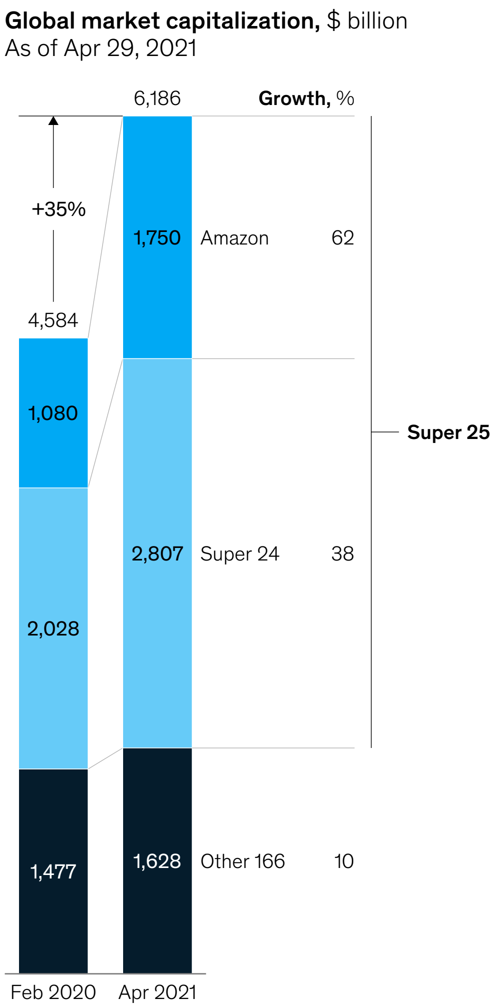
Source: Corporate Performance Analytics; S&P Global

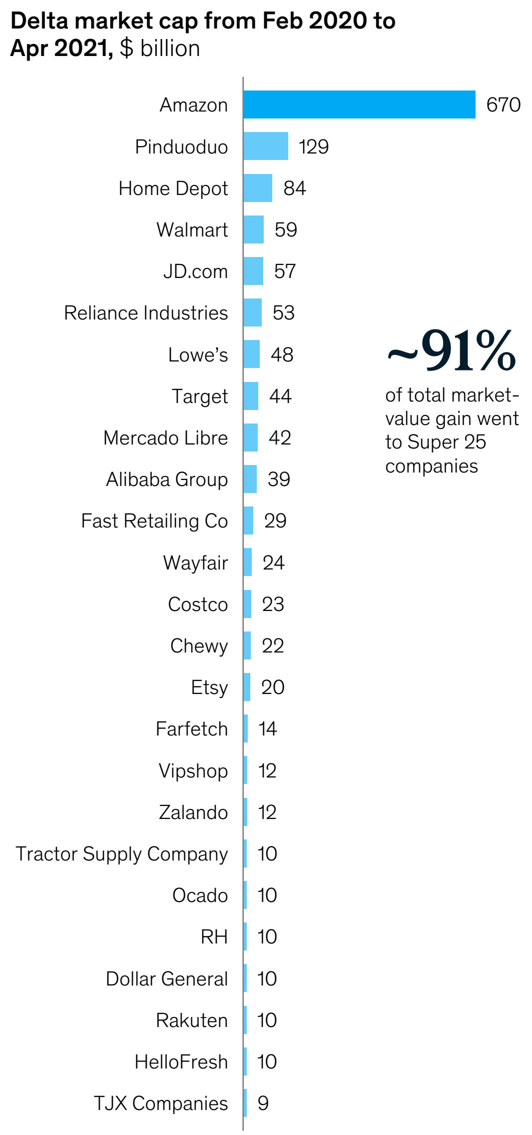
became even more important during the crisis. In our cross-industry analysis, we found a group of companies that rode those tailwinds to such massive valuation gains that they represent their own sector; we dubbed them the Mega 25.

A similar elite category emerged in the retail industry (Exhibit 3). The extreme outperformers included in our Super 25, most of which epitomize the powerful shift to digital, represent more than 90 percent of the sector's increase in global market capitalization.

Exhibit 3

The Super 25 companies accounted for 90 percent of market-cap gains in retail.





Source: Corporate Performance Analytics; S&P Global

Five American companies in our retail index[4] generated more than 80 percent of all value created in US retail, with Amazon alone accounting for almost 60 percent of those gains. In China, meanwhile, four players drove a staggering 98 percent of gains in retail market capitalization.

The rise of the Super 25

Which companies constitute these outperformers, and what do they tell us about the foundations of retail success during the pandemic? The first common element worth noting is their size: the Super 25 as a whole (excluding Amazon, whose magnitude puts it in a category of its own) had an average market cap of $84 billion in February 2020—9.5 times the average size of the remaining 166 companies in our index. Today, members of this top group are on average 12 times the size of the rest of the index, with an average market cap of $122 billion. This represents an average growth of 38 percent since the pandemic's start, compared with 10 percent for the other 166 companies. When we include Amazon in the Super 25 calculations, the divergence is even more stark: before the pandemic, the top 25 retailers had an average market cap that was 14.5 times greater than the average company in the rest of the index, and by the end of April that multiple had grown to 19 times. (For more on the divergence of two categories not included in the Super 25, see sidebar, "The contrasting fortunes of grocery and luxury.")

The Super 25 companies largely fall into four categories: home-economy players, value retailers, online specialists, and platform players. Their growth points to several trends that drove consumer spending over the past 16 months and are likely to persist.

The draw of nesting. Locked-down consumers with time on their hands have been investing in their homes. Home-improvement champions Home Depot and Lowe's and furnishings provider RH (formerly Restoration Hardware) are leading beneficiaries of the trend. These companies represented 11 percent of the market-cap gains for the global retail index. In fact, Home Depot, which increased its market cap by $84 billion, is the 22nd-largest gainer among all companies (not only retail) since the start of the pandemic.

An emerging focus on value. The pandemic has been a tale of two consumer groups, with some seeing their means significantly constrained as others amassed large savings. Whatever their circumstances, many households became more mindful and fiscally prudent consumers, prioritizing

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[4] McKinsey's capital market index is based on the top 5,000 public companies globally, based on market capitalization at the end of 2019. The retail index contains 190 retailers on this list. It excludes Amazon, luxury conglomerates, and consumer-packaged-goods companies with limited direct retail presence. Companies that went public in 2020 or 2021 are not included.

spending on the things that matter most. As a result, leading value-oriented retailers such as Costco, Dollar General, and the TJX Companies have been able to deliver top-tier capital-market performance. The seven companies in this group accounted for 10 percent of the gain in retail market capitalization.

The year of online shopping. Not surprisingly, the global lockdowns launched online players, many of which were already soaring, into orbit. The leading e-commerce specialists in the Super 25 grew their combined market cap by 192 percent and contributed 5 percent of the industry's market-cap growth. They include regional online retailer Zalando and niche companies such as pet products supplier Chewy and crafts marketplace Etsy.

Beyond companies that profited from consumers' shifts in focus, a group of outperformers reflects an increase in the blurring of retail-industry boundaries. These companies are benefiting from platform economics, using scale and the expandability of their business models to generate increasing returns. Through their inherent diversification and adaptability, combined with a focus on capturing a "share of life" beyond their traditional products and services, retailers in these categories are proving to be much less susceptible to economic shocks than their sector peers. (Companies that serve such e-commerce ecosystems have also seen huge gains, with Shopify and Square emerging as two of the greatest value creators, adding a combined $165 billion in market cap since February 2020.)

The continued surge of Chinese e-commerce and ecosystem companies. Understanding the full impact of China's ecosystem companies requires going back to October 2020, before new regulatory measurement released. Through the peak months of the pandemic, three Chinese companies—Alibaba, JD.com, and Pinduoduo—delivered 29 percent of the global retail industry's market-cap growth.[5] The lockdowns accelerated their growth, which was already extraordinary, as strong supply-chain capabilities and business-model resilience enabled these companies to respond quickly to consumers' shift to online purchasing.

China's ecosystem giants were also quick to embrace online content such as short videos and live streaming to fuel sales. Their efforts in recent years to build omnichannel relationships with offline retailers became another advantage as traditional retailers sought to capture the accelerated shift online. Each of these platform companies had been investing in new business models, such as community group buying to attract high-frequency grocery shoppers, particularly in smaller cities. Although the recent pullback in regional capital markets has reduced these companies' share of global market-cap growth to 15 percent, the longer-term trends favor their continued growth.

The expansion of global ecosystems and platform players. Of course, e-commerce ecosystems and platforms are also thriving outside China, including giants such as Reliance Industries and Mercado Libre. The latter's shopping and payments platform is now the largest retail ecosystem in Latin America, having staged expansions into fintech (a business that now represents more than a third of its revenues) as well as advertising and shipping. Walmart is also extending its e-commerce platform with the Walmart+ subscription service, fulfillment, and media assets. Along with a number of other regional platforms, the companies in this category delivered 11 percent of the gain in market capitalization.

One platform company has had an impact larger than any other. Amazon, which boasted the second-largest valuation increase among the pan-industry Mega 25, also leads—by a big margin—the retail sector's gains. To understand the sheer scale of the e-commerce behemoth, consider that Amazon added more market cap than the remaining top 13 of the Super 25 combined, and it is responsible for 42 percent of the industry's increase in total market capitalization. While Alibaba, another large online ecosystem, grew its market cap by 6 percent during the COVID-19 pandemic, Amazon added 62 percent to its valuation.

[5] From February 19 to October 23, 2020.

Like other platform and ecosystem winners, Amazon is much more than a retailer. With its web services and media businesses, the company transcends the boundaries of a traditional industry structure, and its valuation multiples are more analogous to those of tech companies than those of traditional retailers. Consider that in 2020 Amazon Web Services generated 12 percent of the company's global sales yet represented 60 percent of its profits.

If there is one message in the retail sector's stock market performance since the pandemic's start, it is that investors flocked to companies with strong technology capabilities. However, what propelled the Super 25 to surge so far ahead of the rest is more complicated, and the lessons embodied in their steep upward trajectory touch on the fundamentals of future retail strategy.

Implications for the retail sector's future

The capital markets suggest a strong expectation of an ongoing shift in purchasing and consumption patterns—changes very much in line with what we saw before the pandemic. As we explain in a recent report, the extent and permanence of these shifts will depend on how much value consumers gained from adopting the new channels or behaviors, how much they enjoyed the experiences, and whether they have had to make material investments in adopting new ways of consuming.[6] However, the

[6] For more information, see "The consumer demand recovery and lasting effects of COVID-19," McKinsey Global Institute, March 17, 2021, McKinsey.com.

The contrasting fortunes of grocery and luxury

In our analysis of the global retail industry's performance, the fates of two categories not captured by the Super 25 merit special notice. Grocery's stagnation and luxury's soaring gains highlight the continuing bifurcation of demand around the price extremes.

Underperformance of food retailers. The Super 25 tells the story of demand and digital-capability tailwinds, but grocers have not managed to capitalize on these trends. Despite initial hoarding of essential grocery goods and many consumers embracing cooking during lengthy lockdowns, grocery chains on average grew their market valuations by a meager 3 percent. Some pure-play online grocers and platforms did thrive—Ocado and HelloFresh doubled and tripled their market caps, respectively—but when they are removed from the grocery category, the remaining companies lost 1 percent of market value. Why? The shift from in-store shopping to grocery delivery—combined with consumers' increased price-consciousness, substantially higher store-operating costs due to COVID-19 protocols, and investments to support online fulfillment—created significant pressure on margins. Uncertain longer-term growth prospects, due to meal-delivery companies eating into grocers' revenues and platform players using food as a source of consumer engagement rather than profit, have also likely played a role in the sector's mediocre performance.

Big luxury splurge. While consumers tightened their belts at the supermarket, some indulged themselves in other aspects of their lives, leading luxury companies to outperform and reinforcing the barbell pattern in consumer demand we observed before the COVID-19 crisis. Unable to spend on travel, experiences, and dining out, consumers splurged on themselves. Leading vertically integrated luxury groups—LVMH, Kering, Richemont, Hermès, and Prada—collectively grew their market value by 42 percent, and upscale fashion platform Farfetch (one of the Super 25) increased its market cap from $3.8 billion to $17.4 billion. If included in our retail index, the luxury conglomerates would have contributed 11 percent of the global industry's market-cap growth, and four of them would be part of the Super 25, with LVMH and Hermès in the top 10. LVMH would also comfortably make the pan-industry Mega 25 list, with market-cap growth of $126 billion since prepandemic peaks.

retail formula is changing. For those wishing to move into the lead—or stay there—the choices seem clear.

— *Rise to the challenge of the great acceleration.* Over the past 16 months, the capital markets have rewarded companies that, by and large, were already ahead of their peers. The world of retail has undergone a massive acceleration, and the shifts are unlikely to slow down. Those that have fallen behind will need to significantly raise their metabolic rate and adopt bolder ways of thinking and acting—as many showed they were amply capable of doing during 2020. Retailers that can adopt agile ways of working and fast decision making will have better odds of thriving in the future.

— *Prepare to compete with abundantly capitalized megaplatforms*. From Walmart and Home Depot to Alibaba and JD.com, platform players are changing retail's competitive landscape by expanding their offerings and deepening relationships with consumers—and, increasingly, with businesses. Given their sheer size, they will continue to outspend competitors, so how can these companies compete in a differentiated, targeted way? Most retailers will have to adopt an attacker's mindset by deciding which specific customer needs and occasions can provide an arena in which they can outcompete. Super 25 member Chewy offers some inspiration: while its prime offering is the convenience of delivered pet food, the online retailer brings a personal touch to its interactions with pet parents, fostering strong loyalty.

— *Get the channels working.* Most traditional retailers come from a world in which store networks deliver profits superior to that of e-commerce. The accelerating shift online is challenging that margin equation. Increasing the profitability of online sales requires retailers to pull all available levers, from increasing customer-basket value and size to optimizing warehousing and delivery efficiency and introducing smart offers that drive customer loyalty. Over time, standard delivery offerings should reach the same profitability as in-store sales, but retailers need to continue investing in newer models, such as instant delivery, to remain competitive. At the same time, traditional retailers have an opportunity to use their legacy investments. Despite the surge in e-commerce, almost 80 percent of US retailers' revenue is still generated offline.[7] Identifying new opportunities for maximizing the value stores generate—likely with less foot traffic than before the pandemic—will be critical to ensuring margin expansion.

— *Rethink portfolios for a world that increasingly rewards scale.* Many of the past year's biggest winners are beneficiaries of platform economics, able to generate increasing returns on scale and expand their business models to tap into multiple value pools. As retailers make digital investments a top priority, some are looking to build their own ecosystems. However, any ecosystem requires partners. The key is to identify the part of the ecosystem in which companies can beat the competition and double down on it while relying on partners to fulfill the part where they cannot win. In some geographies, the lack of current companies with a dominant winning platform leaves opportunities for retailers to take the ecosystem lead.

— *Consider making a big pivot if a tailwind is lacking.* Trend and market momentum matters; since the start of the pandemic, hot categories such as home, value, and luxury, along with high-growth geographies in Latin America and Asia, have been critical factors in the performance of the Super 25. Those without the benefit of such tailwinds may need to reposition their businesses by exiting lagging categories or dramatically boosting resources allocated to those benefiting from strong trends.

[7] "Quarterly retail e-commerce sales: 1st quarter 2021," US Department of Commerce, May 18, 2021, census.gov.

— *Seize the moment—the disequilibrium won't last.* While the long-term consequences of the COVID-19 pandemic are still far from clear, our past research shows that crises can reshape market dynamics.[8] Those that act boldly to stage a strong exit from this economic crisis can maintain their edge for a decade or more.

Investor expectations embodied in stock-market valuations provide crystal-clear directions for where retailers should head—and they need to get there fast if they hope to remain competitive. Most of the shifts in retail over the past year were evident to keen industry observers before the pandemic hit; the COVID-19 crisis has merely accelerated and deepened them, putting the sector's gradual transition into overdrive. As such, the formula for success in retail has not been rewritten so much as reinforced, creating greater urgency around the strategic pivots companies need to make.

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[8] Martin Hirt, Kevin Laczkowski, and Mihir Mysore, "Bubbles pop, downturns stop," *McKinsey Quarterly*, May 21, 2019, McKinsey.com.