HOW COVID IS CHANGING THE WAY WE SHOP

INTERVIEW WITH MORITZ SITTE

MB – Malcolm Borthwick

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MB Hello and thanks for joining us. I'm Malcolm Borthwick, editor of Intellectual Capital at Baillie Gifford.

Hopes of a V-shaped recovery in Europe have shifted to fears of a double-dip recession due the second wave of Covid-19. This is bad news for most retailers.

Luxury goods stores in Milan and Madrid depend on wealthy shoppers from China and the Middle East. And a second wave of lockdowns in France and Ireland has led to the closure of all non-essential shops. Consumer habits have changed. Some say irreversibly. So how have retailers responded? I'm joined by Moritz Sitte, who is an investment manager in Baillie Gifford's European equity team and a member of the International All Cap portfolio construction group.

But before we start the podcast, some important information. Please remember, as with all investments, your capital is at risk and your income is not guaranteed. And this podcast is being recorded during Covid-19, so Moritz and I are both at home as opposed to in the usual Edinburgh studio.

Moritz, how has consumer behaviour changed with Covid-19?

MS It's been a massive shock to the system in many ways, and a lot of people had to adjust their habits in many areas of life. And one of them is certainly how people shop, how people consume things.

We own a number of retail companies: Inditex, for instance, which is a Spanish company that owns the Zara brand and the Massimo Dutti brand; Zalando, which is the leading online fashion retailer in Europe, and Adidas, which is a global sports brand. It's interesting to see how these companies have reacted very differently to this external shock of massive proportions.

MB And how have they responded?

MS Of course. I think it's worth separating them into various different categories. On the one hand, you have businesses like Inditex who have these stores, let's say Zara and Massimo Dutti, all throughout the world. They have a very strong retail footprint, and that had to be shut down. At the very peak of the first lockdown in April, I think their sales were down something like 70 per cent year-on-year. That was a huge shock to their system because a lot of their retail stores had to be closed. That was by government decree. And those businesses or Inditex specifically has reacted quite well to this, because they have always pursued an omnichannel approach.

Meaning that they didn't just rely on their retail stores to make sales, but they also have built over the years a really strong ecommerce business, which pre-pandemic was about, let's say, 10-15 per cent of sales. That should now be substantially higher. I think how they have managed it is really quite admirable and how quickly they were able to adjust to this new reality. That's one category we can look at.

The second category that we can look at are businesses like Zalando, the leading online fashion retailer in Europe. They have been in a perfect spot to benefit from the closure of brick-and-mortar and from the shift of the consumer habits towards ecommerce shopping. Therefore, they have seen their sales and their gross merchandise volumes on their platform expand quite dramatically and actually accelerate in growth to upwards of 30 per cent.

I think it's important, however, to remember that just because a business is in a good position doesn't mean it necessarily takes advantage of that. And I think, with Zalando, what has really stood out is just how well they have executed on that and how much they have been able to grasp the opportunity that they have been given.

An interesting example there is that they had shifted before the pandemic already towards a model where they turn from an online department store that takes inventory and takes control of a lot of the steps in the supply chain towards more of a platform model where it offers services like warehousing, distribution, marketing to suppliers. And that was a good starting point.

But they have really accelerated that shift towards that platform business model by signing up a lot of brick-and-mortar retailers and traditional suppliers, so to speak, of clothes, of fashion on to their platform and therefore have enhanced the value that they create for their customers by enhancing selection.

And at the same time, they have been able to really help a lot of these businesses stay afloat, stay alive by offering a marketplace which attracts millions and millions of customers and where people can or where businesses can sell their goods to this huge group of customers.

MB And what about the luxury end? I'm thinking here maybe of Kering and L'Oréal. Have consumers remained loyal to the high-fashion brands?

MS What we're seeing there is it's actually a similar shift to the mass market in that if you take a business like Kering, which is the French holding company which controls brands or owns brands like Gucci, like Alexander McQueen, like Bottega Veneta, these are again businesses that pre-pandemic relied a lot on their retail footprint. When you go in and you buy a Gucci suit, for instance, you go there for the experience. You go there for the way you're being treated. You go there for browsing. You go for the full package. You don't just buy. You don't just want to enter something into a search and buy it online necessarily.

But what is interesting is that these businesses have managed quite well the transition towards online, as they have seen their retail footprint close down for an extended period of time really. And what's interesting there is that these businesses have really embraced online in many cases.

And Kering specifically has embraced it not just simply as a distribution channel, as a sales channel but much more as an opportunity really to engage with potential customers and existing customers through channels, be it Instagram, be it their own websites and so on, and offering interesting experiences, offering perhaps special editions and so on.

I think there's a lot been going on. The amount of innovation that is taking place though, the amount of experimentation perhaps that is taking place, is really quite staggering.

Another company is Burberry, which of course many people know as the UK luxury business. They've actually held their fashion show on Twitch, which is a video streaming platform for video gamers. If you told me that was something that would come out of this pandemic, I would've not believed you. But there's really a lot of experimentation going on where people really have to embrace online not just as a sales channel but as a channel to really engage with consumers. And it's that old adage of "necessity is the mother of invention".

MB That point about innovation is really interesting A lot of brands are moving further and further away from traditional advertising. Actually, I just want to play a short clip by way of example of that.

[Audio of Adidas advert]: *Look, sport might not be the answer right now, but it teaches us this: that impossible challenges must be faced and overcome. And the reward is joy.*

MB Top marks if you recognised the voiceover artist, there. That was Siya Kolisi, who made history to be the first black player to be appointed test captain of the South African rugby team. This clip was taken from a one-minute YouTube film. What's interesting about this is that it's a campaign by Adidas, *READY FOR SPORT*, that includes a whole series of other adverts. This one alone has had over 45 million views.

Moritz, we're seeing more and more brands move away from traditional marketing towards YouTube, Instagram, Twitch and other platforms.

MS Absolutely, that's exactly the case.

Again, it's not just about selling. It's about engaging consumers. It's about engaging the populations of the markets that they're in, on YouTube, on Instagram, and on many other platforms. TikTok has been one social media platform that has really seen a massive ascent during this pandemic in the west. I wouldn't be surprised if this became another really important platform to engage consumers and to create that connection with consumers directly.

What's also quite interesting is that the likes of Adidas have not just grown together with fashion retailer platforms like Zalando online, but they've also grown by going directly to consumers.

And that's really quite fascinating because that unlocks quite a lot of opportunities for them. Simply on the customer engagement side, it means that you build a direct relationship with the consumer. And in many ways, I think the opportunity there is that they could build much deeper relationship with the consumer online directly than they could with their own brick-and-mortar stores, because you're on consumers' smartphones. You're an app. You can engage through notifications. You can come up with special deals and so on. And we've seen that already happening with Adidas. They have a close relationship with the consumer. They get more information. They learn more about the consumer. What they like. What they don't like.

Certainly, some of the data that we've seen come out of this direct and consumer online business of Adidas, of Nike, and so on is that the consumers that they engage with they are really even more brand conscious. They're willing to spend more. They're not interested in discounts. They're not interested in special cheap deals. They're really interested in special editions of products and so on. It's a fascinating way to engage with consumers and to create a sales channel that is really quite valuable for these businesses.

MB I imagine it's hugely valuable because it's a younger demographic as well, and these are potentially consumers for decades to come.

MS Absolutely. I think it's a big opportunity if you use the framework of the lifetime value of a customer. When you can acquire them at an early age and then you can keep them for a long period of time by really creating a strong relationship with them. That could be enormously valuable.

I think, let's say, from a merely financial point of view, even in the medium term, it's quite attractive to have a direct-to-consumer business because you cut out the middleman. And therefore, this should lead to higher margins. The model is, in many ways, quite straightforward. You really only need your own warehouses, and that's about it. If you have your app, your warehouses, and your production aligned, then you're pretty much off to the races.

I think that's something that we'll see these companies, be it an Adidas or a Nike, pursue much more aggressively because it is such a big opportunity.

MB We hear a lot about accelerated change and the acceleration of existing changes. Whether or not they're digital or in other areas in the market, they're already occurring. If we look at online retailing, for example, back in 2014, it accounted for about 7 per cent of retailing in Europe. In 2019, it was about 12 per cent, and it's estimated this year to be round about 16 per cent. So quite a big uptick there. But do you think that accelerated change is going to continue to accelerate? Or do you think it'll fall back a little bit and normalise?

MS I wouldn't think that the growth rates that we've seen this year so far or, let's say, since March are necessarily the ones that will persist.

I could see it plateauing perhaps for a little bit, let's say, once the lockdowns are over for good and if the vaccine works, which we all hope it will. Then perhaps people will spend summer shopping in the traditional way in brick-and-mortar stores. But I do think this is a tailwind that is here to stay, and if anything, it picks up speed.

I think eventually what will happen is people will stop referring to it as 'ecommerce penetration'. This will just be the new way of how people shop, and I think that doesn't necessarily mean that brick-and-mortar stores disappear. I think they have a really interesting role to play, but I think the way they have worked in the past is not the way they will work in the future.

And again, there's a lot of interesting things happening. Amazon, for instance, have released or are about release a palm reader, where you can go into a store, you can pick up the things you want to buy, and then you simply present your palm. It's relatively fool proof in terms of fraud. The idea being that you want to reduce friction. You want to avoid the tedious queueing at the checkouts and so on, and you have to get out your credit card and pay and so on.

I think what will happen, if we look ahead 10, 20, 30 years, is that the commerce will be completely linked. The idea of having a separate brick-and-mortar and separate ecommerce will be a thing of the past.

Another example is Shopify, which is an online ecommerce enabler in many ways. But, they are also pushing into brick-and-mortar stores. They have come up with a handheld device that allows people to pay very quickly.

They also have allowed their merchants that have signed on to Shopify to link up their systems between ecommerce and brick-and-mortar because their view is similar. These are just different sales channels, but they really should come with a unified strategy. And I think that's quite exciting. It will be very exciting to see how this will pan out.

And I think the businesses that are willing to experiment, the business that are willing to also innovate and look critically at how they have done things in the past and how they can improve will be the ones that will survive and, in many ways, thrive.

MB And since the start of Covid-19, you've spent a matter of months in Edinburgh and also a matter of months in Munich. Has that changed your perception? Are you seeing different things from both locations?

MS That's a good question. I think, in many ways, it's actually remarkably similar. What's interesting in Germany is that my impression is that online penetration is still lagging compared to, let's say, the UK, and I think that's changing now. I think, because of this lockdown, which was also quite strict in Germany with a lot of shops closed for a very long time, that has really changed.

And what's interesting is that it hasn't just affected, let's say, the younger demographic, but it's also affected the generation of my parents who are now much more comfortable shopping online and, for Germans, it's a big thing, sharing their credit card information because you're always distrustful of giving away too much information. I think that's something that has been changing and again will continue to persist. I don't think that will go away necessarily.

Because I think, once these habits are formed, people are realising that it is really quite convenient to have things delivered to your house, even if you're allowed to go outside. And I think what's exciting is that there's still a longer way to run, in many ways, in a market like Germany than in other markets.

MB And what about your consumer behaviour? How has that changed during the crisis?

MS I have to admit I had been fairly convinced of ecommerce already on a private level before the pandemic. The one big change has not been that I, all of a sudden, discovered this thing called Amazon. If anything, I notice I spend more on it every year and have been for years.

But it's actually what I noticed, or what we've been doing as a household more, is the idea of shopping online locally more. And it's been fascinating to see, for instance, the local fishmonger here, they've gone online. They offer deliveries and so on, and we've been enthusiastic supporters. And I've been loving my salmon fishcakes. I really can't complain. It's been a great outcome.

I think that's been very encouraging to see. These local businesses are able to really adapt very quickly and embrace this really tough situation for them, extremely tough situation and, in many cases, again thrive or at least mitigate some of the effects of the lockdowns.

MB It's all about innovation.

MS Exactly. That's exactly it.

MB Let's end the podcast there, Moritz. Thank you so much for joining us, and I hope you'll join us in the podcast again soon.

MS Thank you so much, Malcolm. It was a pleasure to talk to you.

MB And many thanks to Lord of the Isles for the music. The track we've used is *Horizon Effect*, which was released on Permanent Vacation. And if you're listening at home, stay well, and we look forward to bringing you more insights in our next podcast.

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