Private Bank

OUTLOOK 2015 TRANSFORMING COMMERCE

# Victims and Victors of Transforming Commerce

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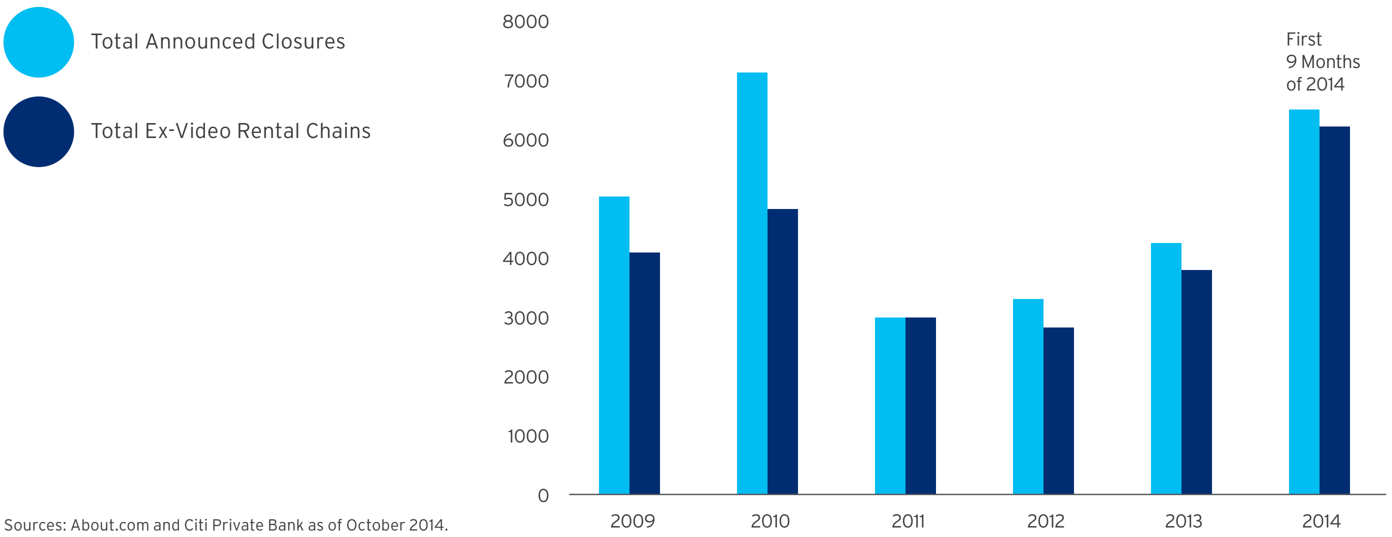
## Technology is revolutionizing the commercial world, creating both opportunities and threats for investors

Dramatic change is afoot in retailing. In 2014, the volume of goods sold in the US grew for much of the year at an annualized rate of more than 4%. Despite this fairly brisk level of activity, however, some 6,484 chain-stores have hung out "closing down" signs – figure 1. Before long, the rate of closures could even outstrip that seen during the Great Recession of 2008-2009, a time when the US was suffering from high and rising joblessness and collapsing retail sales.

Figure 1. Everything must go!




Sources: About.com and Citi Private Bank as of October 2014.

## The changing face of retail

The US data highlights a dramatic shift in how goods are bought. Nearly 15% of US spending on items other than cars, gasoline and building materials now happens over the internet. This figure has doubled in the space of a decade and is rising rapidly. By contrast, the number of shoppers visiting traditional stores these days is shrinking, while the number of packages delivered is growing, as people make ever more purchases from the comfort of their own home – figure 2. Foot traffic at shopping malls is falling at an annualized rate of roughly 5%, the sort of pace usually associated with a severe retail recession. And yet, total retailer sales are actually growing.

This ongoing e-commerce revolution looks set to keep transforming the retail, services and banking landscape, both in the US and elsewhere. In China, a single e-commerce site is now responsible for a flow of goods amounting to 7% of total Chinese retail sales. Just as the rise of the chain-stores over the last few decades crushed many "mom 'n' pop" type outlets, the internet is doing

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the same now for many chain-stores. But whereas the demise of single-store retailers finished off many small family businesses, the demise of chain-stores impacts much larger enterprises – and their investors.

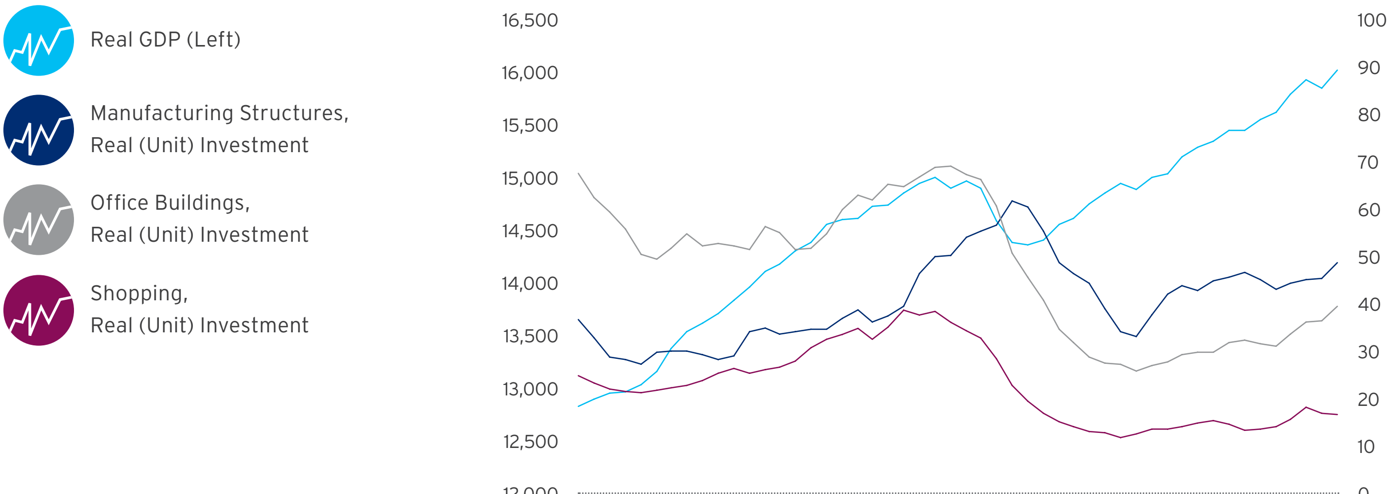
Not all traditional retailers will be equally affected by this transformation. 'Destination' stores in high-quality properties in gateway cities should buck the trend. For others, though, the outlook may be bleak. Chains with large networks of stores in sub-prime locations could find themselves sitting on redundant buildings, which they may have borrowed to develop, or to which they are tied through costly long leases. For owners, converting such property to other uses may not be an easy option, especially in remote or less desirable locations. For clients who hold such properties, generally healthy global property markets and easy financing suggest it might be a good time to explore selling up.

For the shareholders and lenders of traditional retailers, the implications could be enormous. The US stock market currently plays host to "pure" e-commerce retailers valued at $450bn and traditional retailers valued at $750bn, with varying degrees of exposure to e-commerce globally. Who the winners and losers within this mix will be remains to be seen, but there may not be enough room for them all. Oddly, retailers' stock-price returns have been increasingly similar, despite the disruptive forces at work. Looking ahead, though, they are likely to experience very different fortunes. It may be a bad time to be a pure value investor in consumer-related equities given disruptive change and obsolescence of business models.

Figure 2. Goodbye shopping bags, hello home-delivery


Sources: Census, Factset, company reports.

Figure 3. Why there's been no commercial property oversupply – yet




Source: Bureau of Economic Analysis as of 2Q 2014.
Note: Charts shows real US GDP and structures investment.

Looking at the commercial property situation today, though, the threat isn't immediately obvious. In the US, new construction of commercial property has lagged a long way behind the economic recovery of recent years – see figure 3. This is especially true for retail premises. As a result, any over-supply problem has so far been limited, despite the switch away from bricks-and-mortar retailers. However, retail commercial property values have risen faster than industrial ones since 2009, suggesting risk for those in the wrong places with the wrong tenants.

Over this period, of course, risky asset prices – including stocks, corporate bonds and commercial real estate – have generally risen strongly together, a result of economic recovery and ample liquidity in the markets. Going forward, though, there are likely to be much bigger differences in returns between these various asset classes and within them. As e-commerce's grip extends, the weaker traditional retailers and owners of certain retail real-estate could be vulnerable to poor stock-price performance and to downgrades and defaults on debts.

The increasing role of e-commerce is also likely to contribute to even faster growth of cities around the world – and their attractiveness as places to live.

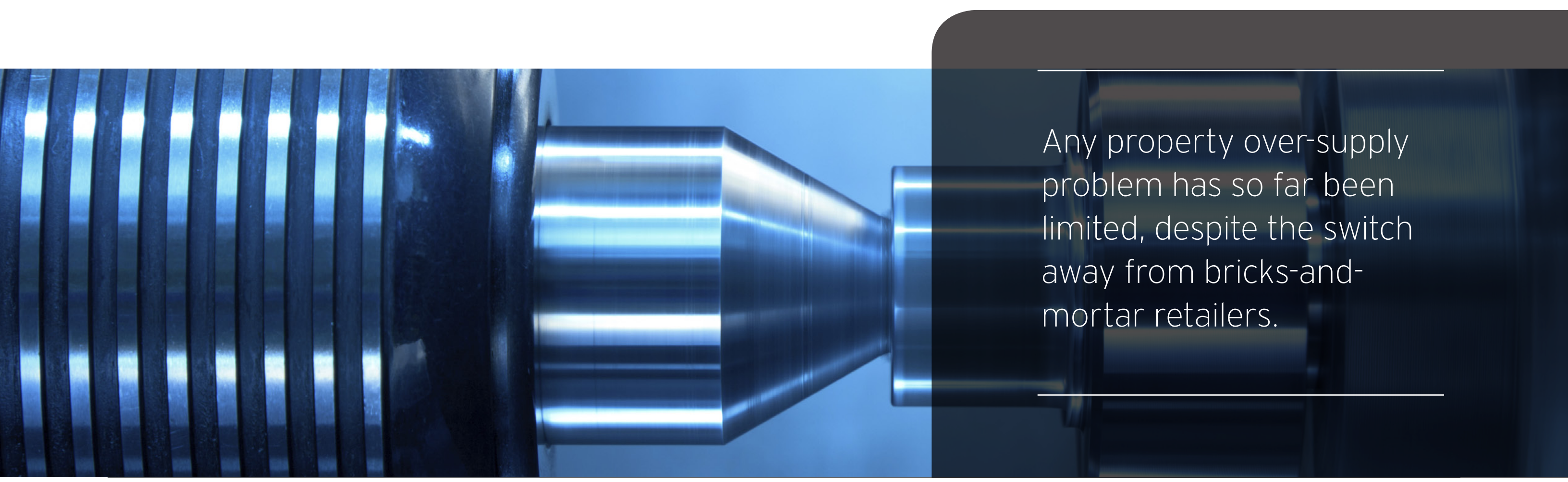


Figure 4. Oil Sensitivity of Select Industries (US Data) and Key Asian Economies

| US Industry | Energy Inputs (% of Total Inputs) | Country | Net Imports (% of GDP) |
|---|---|---|---|
| Utilities | 57.6 | Thailand | 11.7 |
| Air transportation | 47.0 | Taiwan | 6.7 |
| Truck transportation | 42.7 | India | 6.0 |
| Rail transportation | 36.1 | Hong Kong | 5.8 |
| Water transportation | 36.0 | Korea | 5.7 |
| Mining, except oil and gas | 15.9 | Singapore | 5.3 |
| Nonmetallic mineral products | 10.8 | Indonesia | 3.3 |
| Real estate and rental and leasing | 9.3 | Japan | 3.3 |
| Paper products | 9.1 | China | 2.5 |
| Agriculture, forestry, fishing, and hunting | 8.6 | Phillipines | 2.3 |
| Warehousing and storage | 8.6 | Turkey | 1.5 |
| Support activities for mining | 7.3 | United States | 1.2 |
| Amusements, gambling, and recreation industries | 6.9 | Malaysia | -0.1 |

Sources: Bureau of Economic Analysis and Citi Research and Analysis. Note: based on 2012 annual data from GDP-by-industry accounts; Haver Analytics as of August 2014. Note: exports and imports are 12-month trailing sums. GDP is 4-quarter trailing sum.

It will also determine differences in success of traditional retailers between cities. The most desirable e-commerce services along with the best traditional retail and banking offerings will likely gravitate towards the urban centers with the highest populations and wealth. Those living in such places will therefore be best served, while those in other locations will suffer.

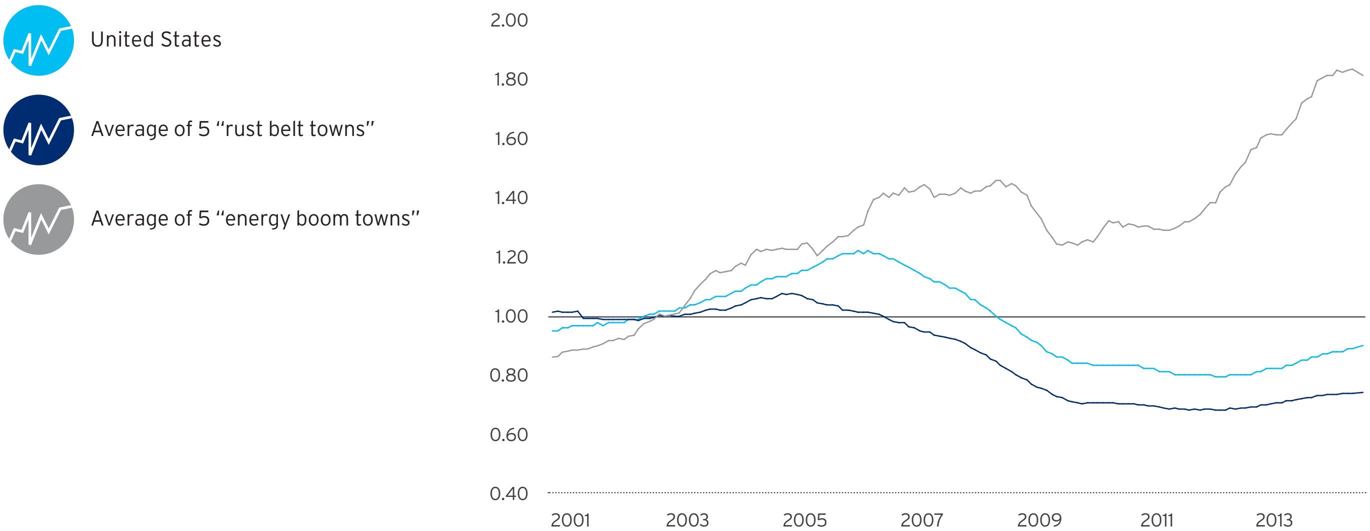
## Energy Revolution Revisited

The revolutionary transformation of the North American energy industry continues apace. US crude-oil production has just risen at a double-digit rate for a third straight year. Depending on price developments, the US could pump out more crude oil than either Saudi Arabia or Russia in two years. This was an unthinkable prospect just a short time ago. What is much less widely acknowledged, however, is how the effects of the rebirth of US energy could spill over into other areas of the economy.

The surge in oil production at home is feeding through into lower costs for US industry. Energy is a major input for certain categories of US manufacturing and commerce. This is true in parts of the transportation sector like airlines, as well as trucking, some areas within which have also benefited from the e-commerce revolution. The gains can also be felt well beyond the borders of the US, such as in Asian countries that heavily import crude oil, and indeed for consumers across the world – figure 4.

Despite the local environmental concerns that fracking for energy arouses, real estate markets near to production areas in the US have been booming – figure 5. Like all booms, this trend bears watching, particularly after the 30% oil-price correction within 2014. We also think that housing and broader real-estate markets that are most tied to the US manufacturing renaissance may soon get a boost, albeit from a relatively more depressed starting point. US goods-makers are winning back share in domestic consumer markets. At the same time, we are optimistic about transportation infrastructure projects in the US energy sector despite the recent oil-price drop.

Figure 5. Location, location, location




Sources: NAHB, First American, and Citi Private Bank as of August 2014. Note: The Leading Market Index (LMI) compares the current levels of three components-- employment (BLS - Bureau of Labor Statistics), house prices (Freddie Mac) and single-family building permits (Census)-- to their normal, sustainable levels. For each component, the current level as a share of the normal level is calculated. The LMI is the average of these three shares. An index value above one indicates the market has advanced beyond the previous sustainable level of economic activity. An index value above the national index level indicates the market is doing better than the country as a whole. Energy boom towns: Bismarck, ND; Grand Forks, ND; Midland, TX; Odessa, TX, Casper, WY; Rust belt towns: Decatur, IL; South Bend, IN; Flint, MI; Akron, OH; Greenville, SC; Columbia, SC

The cases of retail and energy are far from isolated examples of where technology is revolutionizing the landscape and creating both victors and victims. Online media is steadily squeezing out print media, causing a switch in advertising revenues towards cyberspace. The rapid growth of e-payments and mobile payments may well render a vast amount of the world's bank branches redundant in due course.

As risky asset prices of almost every kind have risen over the last few years, we think it is time to look hard for the likely victims and victors of transformational technologies. High-cost oil-producing nations, the makers of obsolete technologies, and retailers with outmoded business models are just some of these victims. Having narrowed in recent times, the difference in the returns from investing in victors and victims is likely to widen in the coming years.

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