Magellan – In The Know: Episode 34

Beyond the sheets: Dissecting the downfall of a US retail giant

Announcement (00:00):

Host (00:14):

This is In The Know, a monthly investment podcast brought to you by Magellan Asset Management.

Hannah Dickinson (00:20):

I think there are some really relevant takeaways about the pace of change in consumer purchasing patterns, the importance of management decisions in adapting to those changes, and also the challenges in finding retail businesses with really strong and sustainable competitive advantages.

Host (00:39):

That's Hannah Dickinson, Magellan sector head of franchises, describing the rise and fall of Bed Bath & Beyond, a US homewares retailer that went from market juggernaut to bankruptcy.

(00:51):

Welcome to Magellan- In The Know. In this episode, Hannah Dickinson joins Magellan Portfolio Manager Jowell Amores, to dissect the downfall of a company that was once a go-to retailer in the United States. It's a salutary story of what not to do in the consumer space, which has important lessons for any investor, and it illustrates just why it's important to team with seasoned market experts when investing your hard-earned funds. But first, here's a warm welcome from Portfolio Manager Jowell Amores.

Jowell Amores (01:23):

Welcome to our podcast, Magellan - In The Know. I'm Jowell Amores, and I'm joined today by our brilliant Hannah Dickinson who heads up our franchises sector team. In our last podcast, we had Hannah sit down with two of our other colleagues doing a deep dive on the consumer sector, talking through some critical characteristics of our consumer portfolio. It was a fascinating discussion, and I highly encourage you to listen to it if you haven't already done so. After a lot of positive feedback, we thought we'd extend that line of discussion. But this time around, we thought we'd do something a little bit different and talk about some consumer plays that are on the wrong side of that quality fence. Those that then have the differentiated product don't have much pricing power and have little to no protection when it comes to inflation.

(02:07):

The one that comes to mind is Bed Bath & Beyond. This is a fascinating one because we get some insight on why retailing is hard, what we can learn from business values as investors, and how Magellan thinks about investing in these businesses. Let's get started. Hannah, Bed Bath & Beyond, this is or was a US-based retailer that most of our listeners might not be familiar with. Unfamiliar with the name having spent a couple of decades in the States, but perhaps, Hannah, you can provide our listeners with some background on Bed Bath & Beyond.

Hannah Dickinson (02:38):

Sure. Bed Bath & Beyond, it's not a company that's been part of our investible universe, but as you might have guessed from the name, it's a specialty Home goods retailer that sells things like towels, sheets, plates, and kitchenware. It's a place where people would go to dec out their dorm room or their first house, as you could really find a large selection of branded and unbranded product at a reasonable price point. You could probably compare it to Australian retailers, like Bed Bath N' Table or Adairs in terms of the category focus. But really, the scale of Bed Bath & Beyond in the US was just on another level.

(03:15):

It did enjoy huge success for many years, but it really started to lose market share about a decade ago, and it's been progressively closing a large number of unproductive stores. If we are looking at its share price today, it's trading at under a dollar, 1 US dollar, after peaking at about US $80 back in 2013. The company did make a few last ditch efforts to keep itself alive and there was a brief moment of mean stock glory in 2021, but unfortunately it filed for Chapter 11 Bankruptcy protection a few weeks ago at the end of April.

Jowell Amores (03:51):

Quite a few interesting things to unpack there. A lot of drama, more drama than an episode of Succession, except cheaper and less luxurious I guess. Let's maybe dive into the company's history first and understand why and how it became successful, then maybe we'd talk a bit about why it's operational wheels started falling off. I remember a management shakeup at some point, which preceded a turnaround that looked sensible on paper, but turns out otherwise. Hannah, would love to get your insights here on what went wrong as well as some of the lessons for investors. We often talk about lessons that we can learn from some of the best companies in the world, but I reckon there's just as many important lessons investors can take away from this bankruptcy.

Hannah Dickinson (04:35):

Yeah, look, I think you're right, but there's a lot of drama in this story and it's a bit more polyester than cashmere, but I think there are some really relevant takeaways about the pace of change in consumer purchasing patterns, the importance of management decisions in adapting to those changes, and also the challenges in finding retail businesses with really strong and sustainable competitive advantages.

Jowell Amores (05:00):

Let's go back to the beginning. Bed Bath & Beyond got its start back in 1971 by two executives with a long history in retail, started from one small store before it eventually grew into this successful retail concept. What did they get right?

Hannah Dickinson (05:15):

They did get a lot of things right in the early days. I think there were a few factors, but I think it really boils down to having a differentiated value proposition that resonated with consumers. Bed Bath & Beyond was founded at a time, back in the '70s, when department stores really dominated the retail landscape, and the department store model is to offer breadth rather than depth. Consumers often couldn't find the product they were after or get the advice that they needed, so the founders of Bed

Bath & Beyond, they were visionaries. They identified a gap in the market for a specialty homewares provider that could really be a one-stop shop for homewares.

(05:55):

They offered lots of high quality merchandise at competitive prices, and they really focused on providing friendly, knowledgeable customer service. They also had a unique store layout that made shopping more convenient for customers. Their philosophy was pilot high let it fly, which meant often stacking goods to the ceiling, leaving stores cluttered. They gave it a treasure hunt feel that apparently consumers loved. So yeah, it quickly became an important player in the retail landscape in the '80s and '90s.

Jowell Amores (06:28):

That actually brings back some memories. I remember walking to the stores and it was pretty much a one-stop shop for buying everything you needed for your dorm room at uni. It had everything and a lot of it. Seeing merchandise stacked that high was impressive because of no doubt, it led to some spectacular injuries. At the time, I never actually really understood why they needed to stack merchandise as high as they did. Actually, over the weekend, I spoke to an old uni classmate of mine in the US who get this as a consumer psychologist or a consumer whisperer. He explained to me that it was used to crater an attractive positive shopping atmosphere and an experience, and it gave the impression that the retailer was flush with cash and doing really well, which subliminally, I'm not sure how, but it encouraged shoppers to buy stuff.

(07:23):

This psychology is still actually quite popular, especially with the likes of Costco or Home Depot, when you think about their store layouts and how they organise their merchandise. Of course, it wasn't just for psychology purposes, but it also is used to make more floor space for other items. Apparently, if you take the other side of that, shoppers, when they see less merchandise, they get the impression of poor planning, limited funding in terms of being able to keep items in stock, and other shortcomings. None of these are really a good look in the world of retail. How can I forget about the coupon programme? Bed Bath & Beyond would send you these coupons for 20% off any single item in the store, which obviously was a big draw for customers. It worked well at first. It drove foot traffic in stores and subsequently helped sales, but then it went nuts.

(08:17):

Mind you, this was at the height of the coupon frenzy in the US. Customers started using different names, but the same address to get more coupons mailed to them. As you might imagine, it didn't take too long before customers got 20% off their entire shopping basket. In response, Bed Bath & Beyond ended up increasing the number of exceptions you could use the coupons. And then in the end, while customers still ended up using those coupons, they ended up buying fewer items and items that were lower margin. For Bed Bath & Beyond, in this case, this made it more challenging to sell the higher margin branded items and basically made nothing on the lower margin unbranded merchandise.

Hannah Dickinson (09:01):

Yeah, the coupon programme was something that consumers really loved. It was an important demand driver and definitely was an effective strategy in the short term. But as you said, it eventually became a contributor to the company's downfall.

Jowell Amores (09:15):

Interesting. Let's talk a little bit about that. Company financials can tell us a lot about a company. What did it tell us about Bed Bath & Beyond?

Hannah Dickinson (09:25):

Well, in the '90s and early 2000s, the company's financials looked really strong. Bed Bath & Beyond and its revenue over that period compounded a rate of about 23%. That's massive, and it reached nearly 9 billion US dollars of revenue in 2010. When we are analysing a retail concept, the important top line metrics that we are thinking about are store growth and same store sales growth, which can also be called comparable store sales growth. From the early '90s to 2010, Bed Bath & Beyond opened nearly 1000 stores across the US, and it ended up totaling about 35 million square feet of retail space. It was a massive scale player in that category.

Jowell Amores (10:08):

Maybe to put that into context, that that's about 540 footy fields and each store was about half a footy field, so a lot of pillows and blankets

Hannah Dickinson (10:16):

Yeah. The store rollout was really a big driver of overall sales growth when you think about that 23% compound rate over that period. But on top of that, comparable store sales growth was averaging about 6% per year. That's a really important metric to consider, because revenue growth, if it's solely driven by new stores, it's not sustainable. It has to be backed up by improving or at least stable store level performance.

Jowell Amores (10:44):

What about profitability?

Hannah Dickinson (10:46):

Yeah, profitability looked good as well. Operating profit margins improved from about 12% to 15% over that period as the business scaled up, and return on invested capital reach about 16%.

Jowell Amores (11:04):

By that point, Bed Bath & Beyond dominant, player in the homeware space, loved by customers, could do no wrong when it came to its investor base, but things went a little pear shaped from about 2011. Same store sales started to decelerate, operating margins started to get squeezed, and free cash flow per share was declining. What was going on in the business at that point?

Hannah Dickinson (11:22):

That was the point when competitive pressures from Amazon really started to take a toll on the business. Up until that point, the company had been a really successful brick and mortar retailer with a loyal customer base, but it really struggled to keep up with changing consumer preferences. Its response to Amazon specifically, and really the e-commerce challenge more broadly was, I think you could describe it as slow and reactive. The company only launched its first online store in 2004, which was many years after Amazon began its ascent. After launching its e-commerce platform, its digital strategy was pretty lacklustre. They had limited investment in website optimization, online marketing, mobile capabilities, that sort of thing.

(12:12):

E-commerce response did eventually pick up steam in the mid 2010s as it started to realise this need to invest more heavily in its digital presence to remain competitive, but by that point, it was a bit too late. Its website and mobile app lagged behind those of its competitors, and at the kind of backend, its supply chain and logistics capabilities were struggling to keep up with the demands of e-commerce. Another issue that came about at this point, as we kind of touched on before, was the company's coupon strategy. As online shopping grew, coupons became less effective because customers could compare prices across different sites to find the lowest one. By that point, customers had begun to perceive Bed Bath & Beyond's product as overpriced unless they had a coupon.

Jowell Amores (13:02):

I guess now you can see how detrimental coupons were when it was really originally planned as a tool for bringing in foot traffic.

Hannah Dickinson (13:11):

The net result of all of this was a loss of market share, not only to Amazon, but to other e-commerce players and even other retailers. As all this was going on, it's unit economics were deteriorating, but the company kept rolling out stores.

Jowell Amores (13:27):

Okay. Bed Bath & Beyond, a case of too little too late it seems, which I'm guessing led to a reactive response as opposed to a proactive one by management. I remember reading an article not too long ago about the two founders. They actually admitted that they were too slow on their digital strategy, which I'm guessing may have been out of caution at the time, not long after the .com bubble had popped.

Hannah Dickinson (13:51):

Yeah, look, I think talking about management, there certainly was some category specific issues, operational issues that the company ran into. Some of it was outside of their control, but a lot of it wasn't. I think it's worth exploring their capital allocation strategy in a bit more detail. Before 2010, the company's performance had mostly been driven by organic growth, but it was interesting to see that as it started to have some of these competitive challenges, the company became more acquisitive. It added new retail concepts like Buy Buy Baby, World Market, and a chain called Christmas Tree Shops, which is like the reject shop with a focus on holidays. This was presumably an attempt to diversify the company's revenue streams and expand its reach.

Jowell Amores (14:46):

Now, I don't necessarily want to move away from our discussion on their strategic failures or mismanagement, but I did also want to talk about their governance. I'd argue that this was really a common thread in all their failings. I'm not actually sure where to start. If we think down the line, we had issues of nepotism, so they acquired that Buy Buy Baby, which was founded by one of the co-founder's children. And then to match that, they purchased a business called Chef Central, which was created by the other co-founder's son even after it had closed its last doors. They bought it after they closed their last doors, and they bought that for a million bucks. But subsequent to that, that resulted in five of the independent directors resigning.

(15:34):

They also had the worst share buyback ever, I would argue anyway. Back in 2014, the board started a buyback programme and in response to pressure from activist investors. They actually took out about $2 billion of debt to pay for the buybacks instead of, as you might imagine, instead of investing in its e-commerce platform. Then in 2020, not to be outdone, they announced another $675 million buyback as part of its turnaround plan. They didn't want to stop there. It looked like they raised that amount to 825 million before finally raising it to a billion dollars in 2021. This was at a time when the business was tenuous at best during the height of COVID, and it was burning through cash like [inaudible 00:16:24] at a Black Friday sale.

(16:25):

And then, let's not forget about their equity raisings on top of all that. They had two separate raisings in a five-month span, one to pay down debt and the other to take advantage of the mean stock phenomenon. That might have been the only thing they did right at the time. If we think about that, they're both buying back cash and then raising equity as well really within that three-year period. But maybe that wasn't the craziest part. Remuneration was insane. In 2021, when all this was happening, the management team collectively took home nearly $36 million. What do you think about all of this, Hannah?

Hannah Dickinson (17:04):

Lots to unpack there. Well, with the benefits of hindsight, all of these things were red flags. The first thing I would say about acquisitions, going back to the M&A piece of the puzzle, acquisitions in the retail space generally lead to poor returns. Sometimes, it's an attempt from management to disguise a weakening underlying business, and in this case, I think it ended up being a distraction that diverted management attention away from the bigger issues facing the business. And then, there's the decision to take on more debt to repurchase shares that was also clearly shortsighted. Buybacks are great for companies that have a lot of excess cash flow, but there's always an opportunity cost in returning that cash to shareholders rather than making other investments. As a long-term shareholder, we are always cautious of the company that chooses to buy back shares to boost EPS in the short term rather than making sensible investments to future-proof the business.

Jowell Amores (18:04):

That was really the beginning of the end. Company fundamentals started to deteriorate at that point, and the activist pushed for more changes, then eventually ended up in a management and strategy shakeup. Sounded great on paper, as we mentioned before. Founders left the business at the time and the board ends up hiring Mark Tritton as CEO, a fellow Aussie, and previously chief merchandising officer at Target. That's where he helped transform the company. Tritton comes in and not surprisingly, sells non-core assets, fixes the supply chain, and then refreshes the company's private label brands. Sounded great, even convinced quite a few investors. Why didn't it work?

Hannah Dickinson (18:47):

The private label piece of Tritton's strategy, that had been a really successful element of Target's turnaround plan when he was there. Private label, by that we mean kind of unbranded product that the retailer manufacturers. The idea behind the strategy is to create exclusive and differentiated products that drive customer loyalty and foot traffic, and private label products can also be more profitable for the retailer than branded products because they're cutting out the wholesaler.

(19:16):

Unfortunately, it was really in the execution of the strategy that things fell apart for Bed Bath & Beyond. One issue was that the company introduced too many private label products at once, which led to cannibalization of existing products and just general confusion amongst customers. It had the effect of alienating the company's core loyal customers who were used to shopping there for branded merchandise.

Jowell Amores (19:43):

I'm guessing it also annoyed a lot of the branded manufacturers. To have Bed Bath & Beyond push hard on their private label offerings over the brand products probably explains why they ended up with limited deliveries to the stores. Well, that and their concerns about Bed Bath's ability to pay their own bills.

Hannah Dickinson (20:04):

Yeah, that's right. The quality of the private label products also wasn't up to scratch in many instances, which damaged the company's reputation. Other companies, like Target, they had spent years and years perfecting their private label offerings, but Bed Bath & Beyond moved really quickly. They also lacked the supply chain infrastructure to support the new private label offerings. This became a big issue really during the pandemic. As you said, the company suffered a lot out of stocks.

Jowell Amores (20:34):

Of course, the other problem during COVID was that the company had under invested in its digital platform for many years. Its website was terrible, and it didn't offer services like buy online, pick up in store, that many retailers had rolled out years earlier. Actually, I was back in New York during the pandemic and remembered that Bed Bath & Beyond, being one of the stores on the news consistently with pictures of empty shelves.

Hannah Dickinson (21:02):

Yeah, I think it's a good reminder that investing in a turnaround story can be incredibly risky, because that's what this was at this point in the company's life cycle. It was a turnaround story. Often, companies like this will look cheap on a price to earnings basis, but the denominator in that equation, the earnings, can be incredibly difficult to predict. We've found that turnarounds often take longer to play out than the market anticipates. They can come with a lot of unexpected costs, and this can be a big problem for a company that has a weak balance sheet to begin with.

Jowell Amores (21:38):

Yeah, cash was an issue clearly. I mean, I think that's the common thing for all bankruptcies. They're all out of cash. Okay. What happens now with Bed Bath & Beyond? Besides the bankruptcy lawyers, are there any winners in all of this?

Hannah Dickinson (21:51):

Yeah, well, the company has 360 Bed Bath & Beyond stores, and 120 Buy Buy Baby locations. Those stores will all start to close, and they'll liquidate their assets. In terms of winners, you need to think about things like category mix, catchment areas and store locations. Target and company called TJX are probably Bed Bath & Beyond's closest competitors. Amazon also, but remember that only 20% of Bed Bath & Beyond sales were online today, so there's just less market share up for grabs for Amazon.

(22:27):

But both TJX and Target, they attract a similar mainstream or value-oriented customer. They offer a mix of home decor, furnishings, and small appliances. They're located in similar, what we would call off-mall plaza or strip mall type sites. We'd expect them to be the primary beneficiaries of a demand share shift. They'll probably gain a bit of market share, and maybe they'll even move into some of the vacant retail space that Bed Bath & Beyond just left behind.

(22:58):

But just worth remembering that the numbers aren't huge because Bed Bath & Beyond has been losing share for many years. But generally, what we see in these times is that it won't be the only one that goes out of business, and the stronger players in the industry will end up being net beneficiaries of a really volatile and disruptive retail environment.

Jowell Amores (23:20):

Hannah, can we switch gears and talk about some of the lessons that investors can take away from the Bed Bath & Beyond story? Why is it that some retail businesses survive, and in rare instances thrive, while the likes of Bed Bath & Beyond fail?

Hannah Dickinson (23:36):

Investing in retailers can be really challenging, and unfortunately, Bed Bath & Beyond's story is a relatively common one when you consider the fact that the US has the highest retail space per capita in the world by a long shot. It is a country that is overstored, it's over-retailed. The trend is going to be for more retailers to go out of business there. When you're thinking about investing in a retailer, and it always depends on your timeframe that you're looking at, but if you're a long-term investor, you really have to think about the quality of the business and the sustainability of a company's competitive advantages. When we are looking at retailers, we are thinking about things like the company's category exposure, so how competitive is the category it's playing in, is this a consolidated or a fragmented market, and is the company a player of scale in that market?

(24:31):

Then, we'd be thinking about structural trends. How are consumer preferences and behaviours changing and is it benefiting the retailer you're looking at, or is it doing the opposite? Then, you'd want to think about the company's differentiation within the category it's playing in. Are they offering some sort of exceptional customer service or exclusive brands? Do they have a location advantage, perhaps a loyalty programme, like Amazon Prime, that really keeps consumers coming back? And then, the final two points would be the quality of the management team or strategy, and that's super important for a retailer. And then also, susceptibility to online disruption. That's really a category-focused question, but we're thinking about things like the importance of touch and feel or trial or customer service because those factors can really influence how susceptible a company is to competition from e-commerce.

(25:28):

Generally, what we find is that there are retailers out there that have strong sustainable competitive advantages, but they are rare. It's hard to be truly differentiated as a retailer. Customer preferences change quickly and bad management teams or a poor strategic focus can be really destructive. We tend to be very selective at our retail investments, and retailers typically own the account for a small percentage of our portfolio, but we do invest in Lowe's and Amazon at the moment.

Jowell Amores (26:05):

Home Depot and Lowe's are good examples of retail business that have really done well, really thrived much in the same way as our Australian equivalent, Bunnings. What makes these businesses work, these particular retailers?

Hannah Dickinson (26:18):

Well, if you go back to some of the factors I mentioned before, I think one important factor is that the home improvement market is really consolidated. The category in the US is a duopoly pretty much between Home Depot and Lowe's. And then, there's this long tail of small players, but Home Depot and Lowe's have immense scale in procurement and distribution. The local players really can't compete with them on price. The other factor that's been really important, particularly over the past 10 to 15 years, is the fact that this is a category that tends to be less vulnerable to e-commerce disruption. It's been insulated from the Amazon effect. One reason is that you need breadth of product offering, if you're looking for home improvement supplies. Generally, if you're coming into the store, it's a product that you need immediately. You can't necessarily afford to wait for shipping time.

(27:16):

But then the other factor is that the sales expertise is hugely valuable to customers. It's much more important to have expert sales advice when you're thinking about home improvement items than when you're thinking about what decor you're going to have for your house. That's kind of helped Home Depot and Lowe's build up a really loyal customer base, particularly with professional customers or tradesmen. They get great service, they know what they're going to get, and they will keep coming back to that same retailer over many years.

Jowell Amores (27:48):

Now, Hannah, you touched on a lot of excellent points in terms of what makes a great retailer. Is there anything else that investors should be conscious of when they think about investing in this retail space?

Hannah Dickinson (28:01):

I did touch on this before, but I think one thing that's super important to understand is the management team, the quality of the management team, and whether you agree with the strategy. We are constantly asking ourselves, "How does this company allocate capital? Do they have a history of making sensible strategic decisions?" We tend to find that management is much more important for a retailer than a brand. It's much easier to stuff up a retailer than it is to stuff up a brand.

(28:30):

The other thing that investors need to be conscious of is where a retailer is in its life cycle, because retail investing can be a game of timing. When the music stops playing for a retailer, the fallout can be quick and painful for investors. If a retailer's rolling out stores, they're posting same store sales growth every year, it'll be pressed as a growth stock. It can make a great investment for many years. But the minute the market sees signs of maturity or signs that its stall rollout and penetration power has started to deteriorate, the price to earnings ratio of that company will derate and earnings estimates will have to come down as well.

Jowell Amores (29:13):

Okay, fantastic. Maybe let's end with a fun one. What does the future of retailing look like? In my mind, I think stores will end up becoming more like showrooms where you go into a store and there's a size for each colour, if we're talking about a clothing store, and you can try it on for size, touch it, feel it, smell it. But in the end, you don't walk out with any merchandise, but instead, it comes out and it's delivered to you same day, next day from one particular distribution site. In that sense, the retailer ends up saving all this real estate and they can ensure the customer that they will have the merchandise on hand. Am I off there? Where do you think retailing goes?

Hannah Dickinson (30:02):

I think you are right in the sense that physical retailing is not dead. I think people wondered whether COVID would be the nail in the coffin for physical retail, but it actually came back with a vengeance. What we've discovered, particularly in 2022, was that people still want physical retail experiences. They want to touch and feel product. They want perhaps a social experience or just something to do. I think physical retail is going to become much more experiential and interactive, and you can already see it with some of the luxury goods players. They're really leading the charge here. They're creating these elaborate flagship stores with fine dining restaurants, private showrooms for high spending clientele. That's the sort of thing that I would say is kind of the future of retailer. Of course, not for every kind of retailer, but it'll be more exciting and immersive.

(30:58):

E-commerce should change as well. One day, we will see digital shopping experiences that are much more seamlessly connected to physical shopping experiences. It will know you across the digital realm or across the physical. You'll have kind of one customer experience. There'll be more interactive tools for people to try on products virtually. And the other thing we are hearing about, particularly from tech companies, is that virtual shopping assistance with the help of AI could be there to help you discover products or find the right size and fit. I think it's an exciting future for retailing.

Jowell Amores (31:40):

Well, that really wraps it up for us today. Thanks again, Hannah, for your brilliant insights, and thanks for listening.

Host (31:47):

That was Magellan Portfolio Manager Jowell Amores, in discussion with Sector Head of Franchises, Hannah Dickinson. We trust you've enjoyed this episode of Magellan - In The Know. Join us in a month's time for the next episode. For more information on upcoming episodes, visit www.magellangroup.com.au/podcast, where you can also sign up to receive our regular investment insights programme. Thanks for listening.