Quest Investment Management

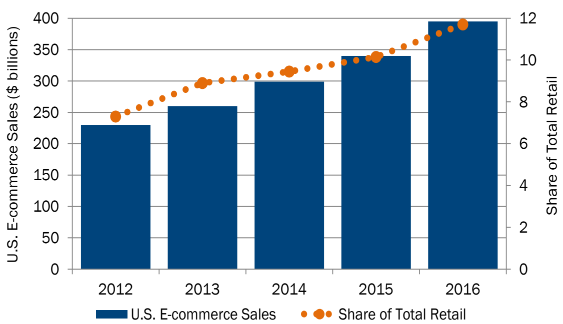
SECOND QUARTER 2017

In Depth…

E-commerce — At a Tipping Point?

E-commerce — commercial transactions that take place on the internet — is responsible for one of the largest secular shifts in consumer behavior in history. The changing market represents a vast opportunity for businesses to improve their relevance and expand their markets in the online world. In 2016, worldwide e-commerce sales reached nearly $2 trillion and U.S. e-commerce sales reached $395 billion, according to the U.S. Department of Commerce. More than 40% of global internet users — 1 billion in total — have purchased goods online. These numbers will continue to grow as internet use becomes more prevalent around the world.

U.S. E-commerce Sales and Share of Total Retail



Source: Internet Retailer

Déjà Vu?

The closest comparison to the seismic shift in the way consumers are now able to purchase their goods was in the late 1800s when the convergence of the newly built railroad systems connected rural America with the most massively disruptive mail-order (old school e-commerce) retailer of the era: Sears, Roebuck & Co.

Sears, Roebuck & Co. was founded in 1886 and went public in 1906. At that time, Americans' disposable incomes were growing, as was their awareness of the higher prices being charged in rural areas. The Sears catalog — the "consumer's bible" — made everything from sewing machines to ready-to-assemble houses available via the railroads, and at clearly-stated, lower prices. It was the dawn of the "middle class" and its desire to have access to more

things at lower prices. Sears was its era's version of a hot technology company. It wasn't just a corporation — it was a revolutionary disruptor in how goods were sold and delivered. The 750-page Sears catalog was advertised as the "Cheapest Warehouse on Earth." It was truly the internet of its day and revolutionized the way business was done for the next 100 years.

Richard Warren Sears retired in 1908 with a fortune estimated at $25 million. He died in 1914, more than a decade before the company opened its first brick-and-mortar store in 1925, as rural customers were moving to the cities.

E-commerce Winners

vs.

Fast forward 100 years. Today, like in the early 1900s, the combination of lower prices and the ease of procurement is a boon to consumers, which is fueling the e-commerce phenomenon. Price discovery, i.e., finding the highest quality at the lowest price, has never been easier and is driving down costs for all consumers. The logistical challenges of delivering goods has given opportunity to today's transportation companies and efforts are being made to make the last mile to the doorstep even easier via drones and other technologies. Solving logistical, warehousing, procurement, and delivery challenges led to successs for Sears in the first half of the last century and is again benefitting many companies today.

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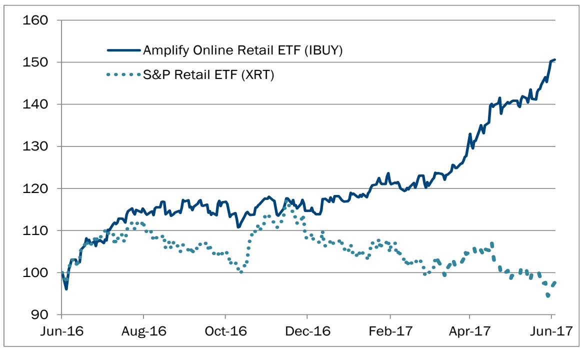
Commercial real estate, especially industrial storage facilities, is a beneficiary of the e-commerce evolution as it increases demand for the "Best Warehouse on Earth." The need for more warehouses is likely to increase as online companies have the growing need to get ever closer to customers.

Another beneficiary of e-commerce is "virtual" stores. IBUY is an exchange-traded fund (ETF) representing 40 companies that generate at least 70% of their revenues online. The following chart compares IBUY with XRT, an ETF representing the old line brick-and-mortar stores struggling to defend their turf.

IBUY vs. XRT



E-commerce Losers

Retail-oriented real estate has and will continue to be challenged. While a combination of favorable demographics and adoption means some malls are well placed, consolidation and closings/repurposing of assets are inevitable, especially for secondary and poorly located assets.

Traditional brick-and-mortar retailers and those that earn most of their sales through physical retail outlets continue to struggle. Year to date, there have been 11 retail bankruptcies and 3,864 retail store closures announced. Additionally, there are over 15 million retail jobs that are likely to be negatively affected by this trend.

Trends

Technology is revolutionizing consumer behavior and profoundly impacting traditional retail by reshaping consumer expectations. According to a recent report from the U.S. Department of Commerce, U.S. e-commerce retail sales have grown steadily over the last ten years. E-commerce sales were up 15% in 2016, far outpacing the 2–4% overall retail sales growth in that same year. This trend is expected to continue.

Today, 89% of retail sales are still in-store, but an increasing proportion of purchasing decisions are influenced by digital. Some traditional retail managers are using mobile signal footprints to optimize retail space and drive greater productivity.

Here are additional e-commerce trends (according to BigCommerce.com):

- 67% of millennials and 56% of Gen Xers prefer to shop online rather than in-store followed by 41% of baby boomers and 28% of seniors.
- Millennials and Gen Xers spend nearly 50% more time shopping online each week than their older counterparts.
- 51% of Americans prefer to shop online.
- 96% of Americans have made an online purchase in their life, 80% in the past month alone.
- E-commerce is experiencing double-digit growth each year, yet 46% of American small businesses do not have websites.

Where and what are we buying?

- 55% of all e-commerce sales are done through branded webstores vs. 45% via marketplaces.
- Webstore shoppers are buying books, movies, and music (15%), clothing, shoes, and accessories (27%), flowers and gifts (15%), and health and beauty products (19%).
- Marketplace shoppers are buying: books, movies, and music (21%), clothing, shoes, and accessories (30%), flowers and gifts (19%), and health and beauty products (19%).

Product shopping trends are similar whether via webstore or traditional marketplace. The biggest difference of course is price and convenience. Retailers who figure these factors out, and sooner rather than later, will be the ones who survive and thrive.

Bottom Line

As always, Quest will remain vigilant and look for opportunities in this changing environment.

MUSINGS

According to the Bureau of Economic Analysis, Oregon and Washington led the nation in GDP growth in 2016.