Signal From Noise

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The Shrinkage Problem: Retail Theft Could Lead to Investment Opportunities

As of publication, we are in the most important month of the year for retailers. And while many have been cautious in their public-facing expectations, the resilience of the economy and of consumers suggests some reason for hope. Yet one headwind that has troubled the sector for several years is not expected to lessen.

In its most recent earnings call, Target CFO Michael Fidedelke warned that "Growth in shrink remains a significant financial headwind." Shrink is defined as the difference between the amount of inventory a retailer has and the amount its records indicate it should have, and Fiddelke told analysts following the company's third quarter earnings results that inventory shrink continued to grow YoY.

Fiddelke's warnings mesh with those of executives at other major retail chains, many of whom have also reported an increase in shoplifting and theft – particularly violent theft and profit-driven shoplifting committed by organized groups (as opposed to the shoplifting of goods for personal use, committed by those of limited financial means).

Words like "shoplifting," "theft," and "shrink" have come to be mentioned increasingly frequently in earnings calls and reports, and the retail industry as a whole has called on government officials and law enforcement for help. "Retail crime, violence and theft continue to impact the retail industry at unprecedented levels," wrote the National Retail Federation in its 2023 Retail Security Survey, asserting that the problem is worsening across all retail segments and in locations around the United States.

The latest figures from the NRF show that the retail shrink rate increased to 1.6% (roughly $112.1 billion) in 2022, up from 1.4% in 2021. Current shrink levels are reportedly almost double pre-pandemic levels, and many retail chains blame this on an increase in organized retail theft.

The NRF attributed part of this to the expanding opportunities presented by platforms that make it easy to set up an online storefront and resell stolen goods, and it successfully lobbied for the passage of the Inform Act in June 2023. The legislation requires such marketplaces to verify the identities, addresses, and contact information of high-volume sellers and to disclose such information to potential customers. The NRF also continues to lobby Congress to pass the Combating Organized Retail Crime Act (H.R. 895/S. 140), which would establish a dedicated group within the Department of Homeland Security to combat the problem of organized retail theft.

Yet despite these legislative efforts, a survey of 97,000 U.S. retail locations representing 177 retail brands showed how shrink stemming from organized retail crime is still a growing concern for retailers.

Response	**2023** (more of a priority vs. one year ago)	**2022** (more of a priority vs. five years ago)
Organized retail crime	78.1%	70.7%
Violence during a criminal act	72.3%	n/a
Homelessness concerns	72.3%	n/a
External theft (non-ORC related)	68.8%	74.1%
Mass violence / active assailant event	65.6%	57.9%
Guest-on-associate violence	65.2%	77.6%
Ecommerce fraud / loss	57.8%	n/a
Internal (employee) theft	48.5%	56.9%
Loyalty program fraud	48.3%	49.1%

Credit: National Retail Federation

Nor is this problem limited to the U.S. Zebra Technologies ($ZBRA), a manufacturer of barcode scanners and inventory management systems, found that 82% of retailers in the EU cite shrink and theft as significant challenges.

Many experts argue that the increase in retail theft has to do with self-checkout registers and a reduction in store staffing. John Eck, a criminologist at the University of Cincinnati, argues that "The more retailers go toward reducing their labor costs and putting more of the energy on shoppers, the higher the shoplifting." He explained that for customers, "if you're being watched, you're generally more careful. Not too many things in criminology are better understood than that."

Yet, many retailers are committed to finding an alternative approach or supplemental solution. It is therefore unsurprising that one report (by Maximize Market Research) estimated the average annual growth rate for the retail loss-prevention market from 2022-2029 at 13.7%. Some companies positioned to benefit from increased demand in such options include:

Sensormatic Solutions (subsidiary of Johnson Controls ($JCI)

Sensormatic, formerly known as Tyco Retail Solutions, provides a comprehensive range of products and solutions to help retailers prevent theft and manage inventory. This includes merchandise security tags, high-definition security cameras, data analytics, and loss-prevention training for retail employees.

Checkpoint Systems (subsidiary of CCL Industries $CCDBF)

Checkpoint is a leading manufacturer and provider of electronic article-surveillance tags, RFID inventory-tracking tags, and associated hardware. It also makes security devices to help retailers secure high-theft merchandise while keeping it on display.

Napco Security ($NSSC)

Napco designs, manufactures and sells security systems geared toward both small businesses and large retailers. Its products include access control systems, intrusion alarms, locking devices, and video surveillance. The company is also leading provider of home security systems.

Axis Communications (subsidiary of Canon Inc. ($CAJPY))

This Swedish company is a subsidiary of Canon, the Japanese multinational conglomerate. Axis is a top provider of high-definition networked cameras, along with surveillance and video-analytic software and solutions. Its surveillance systems are used by major companies like Nike and Fedex, as well as by public-sector entities the Los Angeles Metro System and Singapore's Changi Airport.

The Caveat

This piece has focused on the problem of theft, as many retailers have begun to use “shrink” and “theft” almost interchangeably, thus indirectly equating rising shrink rates with an increase in organized retail theft. Yet after examining local crime statistics, some retail analysts and researchers suggest that this implication might be inaccurate, and that retailers might be trying to divert attention from operational issues which also contribute to shrink, or using theft as an excuse for unflattering business decisions such as the closure of retail locations.

For instance, after closing some locations in New York City, Target cited the increasing prevalence of theft in the city as the reason for the closures. However, independent journalist Judd Legum and his colleagues pointed out that NYPD data shows that the New York locations selected for closure reported fewer shoplifting-related incidents than other locations that remained open.

Inventory mismanagement has long accounted for a significant portion of shrink. This has become increasingly likely due to a shift toward omnichannel sales models. Customers once exclusively bought merchandise directly from brick-and-mortar locations, but they can now also choose from buying via online app or website, and having goods delivered to their homes or picking them up at a nearby store location. Similarly, while brick-and-mortar locations once only had to deal with returns of merchandise purchased there, they now sometimes handle returns from online purchases as well. While this enhances the customer experience, tracking inventory as it shifts between the various channels becomes more difficult and prone to error.

If in fact retailers are knowingly overemphasizing the contribution of external retail theft to shrink to avoid discussing other factors, then they might focus more on improved inventory management to reduce it. Companies that can help with this include:

IBM ($IBM)

IBM’s offerings include its Sterling Order Management, which facilitates omnichannel order fulfillment with real-time inventory and warehouse management. The solution incorporates AI-based optimization and automation into its offering.

Microsoft ($MSFT)

The Redmond software giant offers Dynamics 365, a supply-chain management solution designed to help companies plan, forecast demand, and manage inventory at every level, with support for omnichannel sales models. This offering can be integrated with data from RFID tags and other sensors to identify potential theft problems in real time.

Manhattan Associates ($MANH)

Manhattan Associates has a client base that spans apparel, electronics, and grocery stores, along with distributors and manufacturers. Its solutions support omnichannel and multichannel sales models, with a particular emphasis on reverse logistics – handling returns to accurately track inventory and quickly return it to saleable condition.

Most of the companies mentioned above offer a diverse array of products and services that transcend retail loss-prevention. Thus, although the problem of increasing retail shrinkage could result in a potential investment opportunity, this piece – as always – should not be viewed as an investment recommendation but rather as a starting point for further research.

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