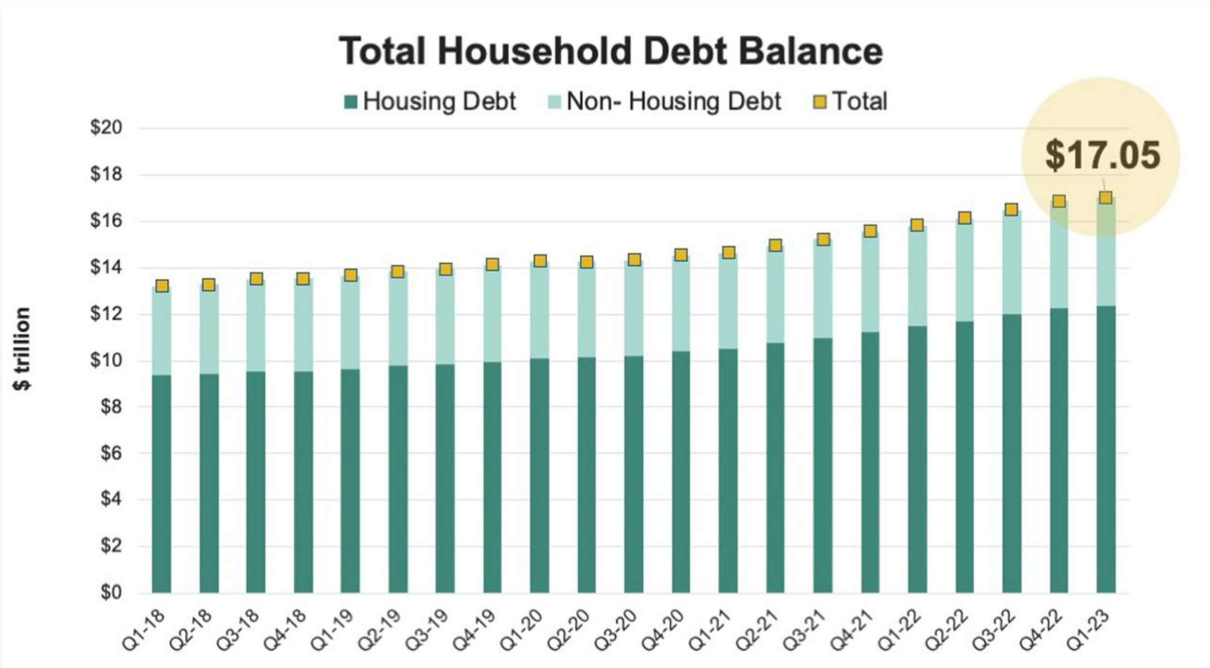
Retail 2023 – Headwinds Continue to Gather Strength

Looking Forward in a Period of High Inflation, Increasing Interest Rates, and Cautious Consumers

As we approach the busy spring and summer retail seasons, there is ample cause for concern given recent sales trends and historically low consumer sentiment. Headwinds are gathering despite robust employment numbers and an improving inflation trend.

Household debt reached a new high in Q1 – passing $17 trillion for the first time ever.[1]



Consumer sentiment took a nosedive in May, dropping over 9% from April[2], hitting its worst level since the historic low last June. Consumers are worried about the economy amid a rash of negative news, especially concerning the debt crisis standoff.

April retail sales increased just 4.3%[3] (well below the core inflation rate of 5.5%), and most key retail segments experienced year-over-year sales declines. Other than non-discretionary categories and e-commerce, most key retail segments experienced YOY sales declines in April.

Companies are just starting to report first quarter financial results, but recent sales trends and the financial results seen in Q4-2022 do not inspire optimism. Key financial metrics for Q4-2022 were mixed, with declining metrics in key performance indicators

[1] https://www.newyorkfed.org/microeconomics/hhdc.html

[2] The Surveys of Consumers, The Survey Research Center at the University of Michigan. (https://data.sca.isr.umich.edu/survey-info.php)

[3] US Census Bureau

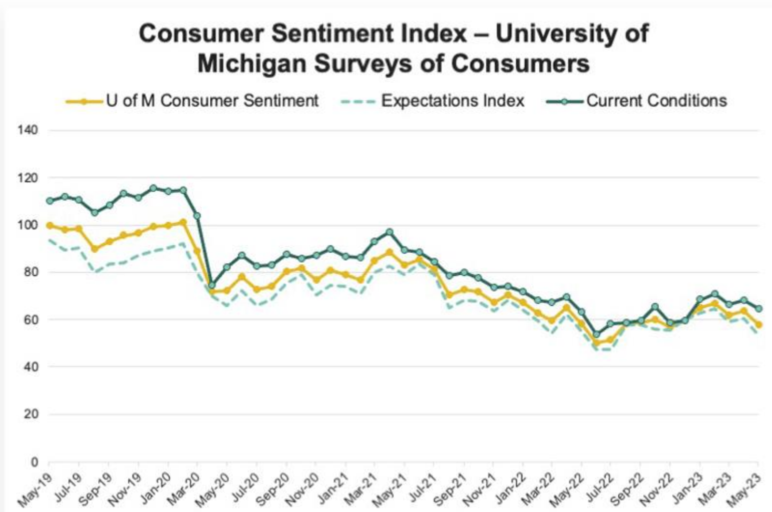
for many retail segments. Given recently reported April sales and the downward slide in consumers' economic outlook, Q1-2023 results may not show improvement.

CAUTIOUS CONSUMERS

The post-pandemic environment of persistently high inflation and increasing interest rates has hammered consumer sentiment and caused shoppers to focus primarily on non-discretionary categories like groceries, basic apparel, and home needs. This leaves a smaller share of wallet remaining for savings and discretionary spending, allowing for fewer dollars to be spent across the full breadth of retailers that achieved significant success in the pandemic era.

	Consumer Sentiment	Expectations Index	Current Conditions
2-Year High	85.5	83.5	89.4
2-Year Avg.	65.0	62.1	69.6
2- Year Low	50.0	47.3	53.8
Current	57.7	53.4	64.5
LY	58.4	55.2	63.3
YOY % Change	-1.2%	-3.3%	1.9%
Previous Month	63.5	60.5	68.2
MTM % Change	-9.1%	-11.7%	-5.4%

Source: The Surveys of Consumers are conducted by the Survey Research Center at the University of Michigan. (https://data.sca.isr.umich.edu/survey-info.php)



In a recent Yahoo Finance article[4], Restoration Hardware CEO Gary Freidman noted that consumers are "spending less on expensive home furnishings because of weakness in the luxury housing market, inflation, the banking crisis, and higher interest rates." Chewy CEO Sumit Singh told Yahoo Finance that the company "absolutely [is seeing a more cautious shopper] when it comes to categories that are discretionary in nature."

Further, Bank of America released data that sends a cautionary note for spending going forward and shows the concern felt by consumers about the economy and their reluctancy to spend as they have in the past.[5] Specifically:

[4] Brain Sozzi, "3 charts from Bank of America that reveal growing consumer caution", Yahoo Finance, March 30, 2023, https://finance.yahoo.com/news/3-charts-from-bank-of-america-that-reveal-growing-consumer-caution-192021027.html
[5] Ibid

1. **Q1 Demand Weakness**
   Bank of America analyzed recent earnings calls, and executive mentions of “weak demand” have risen to highs not seen since the days of the COVID-19 pandemic.

2. **Promotions Increasing**
   Retailers are increasing promotional activity to attract consumers. B of A found that promotions at select fashion retailers so far in 2023 are still elevated and foretell a highly promotional spring selling season.

3. **Excess Inventory**
   For many companies, excess inventory remains a concern. Mentions of “excess inventory” by executives in early 2023 earnings calls are at a five-year high.

MOVING FORWARD IN 2023

Ongoing economic trends and concerns caused by inflation, low consumer sentiment, the recent banking crises, and continued global unrest create a need for retailers to manage costs, margin rates, and inventory levels to meet strategic and financial targets. A guarded approach may be necessary if the long-anticipated recession that many analysts have been predicting comes to fruition in the back-half of 2023.

As we wait for the complete picture of Q1 earnings numbers to unfold, a review of the latest round of financial reports (Q4-2022)[6] includes the following key findings and highlights some significant and concerning trends:

[6] Ankura tracks quarterly financial results and key financial metrics for 104 publicly reporting retail companies.

- **YOY sales** continue to soften, with especially significant declines in department stores, consumer electronics, and home furnishings. The April Census showed sales declines across most non-discretionary retail categories.
- **Margins** declined significantly across most segments in Q4.

	YOY Sales	Margin Trend
Apparel	2.7%	-536.5 BPS
Discount Apparel	4.6%	-468.5 BPS
Footwear	3.3%	-365.9 BPS
Department Stores	-4.7%	-503.5 BPS
Mass & Discount	6.8%	-107.9 BPS
Club Stores	8.5%	-41.9 BPS
Grocery	10.0%	-18.8 BPS
Grocery Wholesale	14.5%	-16.2 BPS
Drug Stores	5.7%	-147.2 BPS
Personal Care	6.2%	-945.1 BPS
Home Improvement	3.3%	-11.1 BPS
Home Furnishings	-8.4%	-179.4 BPS
Auto Parts	8.0%	-168.7 BPS
Sporting Goods	7.1%	-301.0 BPS
Consumer Electronics	-8.9%	45.5 BPS
Jewelry	22.3%	764.0 BPS

	SG&A % Revenue	Op Income %
Apparel	-272.0 BPS	-268.0 BPS
Discount Apparel	-495.5 BPS	25.7 BPS
Footwear	-47.3 BPS	-341.9 BPS
Department Stores	+55.4 BPS	-554.9 BPS
Mass & Discount	-18.5 BPS	-84.0 BPS
Club Stores	-5.9 BPS	-36.1 BPS
Grocery	-24.1 BPS	5.3 BPS
Grocery Wholesale	-41.1 BPS	24.4 BPS
Drug Stores	-121.3 BPS	-25.9 BPS
Personal Care	-746.2 BPS	-198.9 BPS
Home Improvement	98.1 BPS	-107.2 BPS
Home Furnishings	217.9 BPS	-293.9 BPS
Auto Parts	-4.1 BPS	-135.1 BPS
Sporting Goods	65.7 BPS	-367.5 BPS
Consumer Electronics	-61.5 BPS	78.8 BPS
Jewelry	610.1 BPS	287.6 BPS

- **SG&A costs** (percent of total revenue) worsened in several segments – notably apparel and personal care stores. Expense reduction/control will be crucial to retailer success going forward in 2023.
- **Operating income** was a generally bad story; most segments saw serious declines in operating income percentages in Q4.
- **Inventory** levels have generally been building throughout 2022. YOY inventory turns were down in 11 of 16 segments. Compared to Q3-2022, results in the fourth quarter were better as average turns improved in 11 of 16 segments.

Consumer debt rose to $17.05 trillion in Q1-2023, the first-time household debt has passed $17 trillion.

YOY sales in non-discretionary spending categories begin to show signs of decline.

Q4 operating income suffered – current sales trends point to continued challenges.

	Inventory $	Inventory Turns (YOY)	Inventory Turns (Prev Qtr)
Apparel	$9,392	-0.35	0.29
Discount Apparel	($220)	0.04	1.58
Footwear	$1,482	-0.91	0.24
Department Stores	($302)	-0.09	1.73
Mass & Discount	$1,873	-0.04	0.87
Club Stores	$1,765	-0.77	-3.52
Grocery	$1,168	-0.42	0.18
Grocery Wholesale	$764	0.55	-0.42
Drug Stores	$1,208	0.48	-0.22
Personal Care	$104	0.74	2.07
Home Improvement	$4,648	-0.45	-0.07
Home Furnishings	($89)	-0.78	0.42
Auto Parts	$1,768	-0.03	-0.24
Sporting Goods	$756	-0.53	0.55
Consumer Electronics	($1,057)	0.39	2.78
Jewelry	$1,012	-0.58	0.72

"Slowing sales could create challenges for retailers in managing inventories as we head into spring and summer seasonal merchandise."

STRATEGIC CONSIDERATIONS TO WEATHER THE CURRENT ENVIRONMENT

1. **Price/Promotions Optimization**
   Given the current economic environment, focusing on the right product, the right price, the right place, and the right time is more important than ever. As we enter key selling seasons in 2023, it will be vital to make certain promotional calendars that align with early buying, providing attractive offers to capture what could be more limited spending for cautious consumers.

2. **Inventory Management**
   The continued shift to a virtual world presents an interesting challenge. Retailers must have inventory in stores while still supporting online sales through the key selling seasons in 2023. Lighter pushes of inventory to stores and more frequent targeted replenishments will help maintain the placement of inventory based on purchase patterns. With the recent economic turbulence, many

retailers have been actively managing purchases to avoid excess inventory, but some may wind up overbought - presenting challenges in shedding excess inventory.

3. Customer Acquisition and Retention

Now more than ever, it is critical to understand what drives an audience. Young generations focus on “look and lifestyle,” going out, and experience-based activity. Older generations center on family, renewing relationships, and weathering the storm. Using direct marketing messages to appeal to consumers’ focused needs and concerns through the various seasonal events in 2023 is critical.

4. Renewed Focus on Stores

We expect consumers to rely on a satisfying omni-channel experience, one where physical stores play a key role in the total shopping experience. After enduring the COVID shutdowns, consumers returned to stores and are expected to continue to do so. E-commerce presence is still largely significant, but retailers must understand the differences among shoppers. Older generations look to visit stores to make the best use of limited funds. The in-store experience - touching the product, finding the right item, and getting “live support” - are critical in driving conversion on what should be healthy traffic this year. It is best to align staffing schedules to peak selling periods, while still ensuring good sales coverage at off times. Appropriate staffing levels can also help mitigate inventory loss stemming from shoplifting and increasing shrinkage.

5. Shipping

Consumer expectations show two-day delivery as the “norm.” From a shipping perspective, this is costly to retailers, as parcel carrier rates for two-day shipping are much higher than three-day or standard ground. Free shipping is an attractive consumer offer and sales lever for retailers, but they must factor these costs into the equation to net a favorable margin. Make sure this offer is aligned to service level (three-day or more). If two-day shipping is key to a business, alternatives to “free,” such as percent off or money off shipping to minimize the margin impact, should be considered.

SUMMARY

Retail executives are under increasing pressure to mitigate the impact of increased caution among consumers, driven by inflation, continued increases in interest rates, and the potential for a recession in the U.S. economy. The current environment presents new patterns of consumer spending, and companies must react. It is critical for retailers to respond strategically to the ever-changing economic environment and shifting consumer behavior. Retailers need to sharpen their promotional focus, optimize inventory allocation, and closely manage expenses to avoid the pitfalls that have recently created serious financial challenges for some very notable companies.

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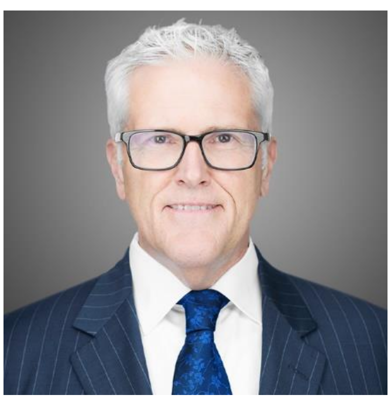

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