A Second-Half Look at Retail Sales – Consumer Resilience is Being Tested

What is in store for retail in the 2nd half of 2023? We are about to enter the relatively dull and uneventful days of summer for retailers. Other than the seasonal rush to garden centers, outdoor furniture, and BBQ retailers – and perhaps purveyors of warm weather sporting equipment - retail in general lazily meanders along until the back-to-school pick-up.

Consumers are feeling the squeeze, hammered by rising costs to service credit card debt, escalating mortgage rates, inflation, and the upcoming end to the student debt payment moratorium. One must question whether shoppers will flock to stores in the 2nd half of 2023, even with back-to-school and the holidays looming.

This is certainly in contrast to the consumer spending boom of the past few years. In the three-year period between 2020–2022, over $5 trillion of pandemic stimulus was injected into the U.S. economy[1], like the inflation adjusted cost of World War II (including the cost of the Manhattan Project). A large portion of this stimulus went directly to individuals and families ($1.8 trillion)[2], which helped contribute to an unprecedented level of consumer resilience during a period of great economic and health uncertainty, the COVID-19 pandemic.

Multiple factors – some experienced in economic cycles before, some unique to a pandemic and post-pandemic world – contributed to the uptick in sales and pricing during this period. To understand and analyze this, and to give insight into what might be next, we aligned these factors into three groups: (1) Accelerated Demand, (2) Demographic and Shopping Shifts, and (3) Consumer Evolution.

Accelerated/Decelerated Demand	Demographic/Consumer Shifts	Consumer/Market Evolution
• Extend period of low (to negative) interest rates	• Rise of remote work and resulting "refusal" to return to the office	• Digital economy growth (in summary, everyone needs a smart phone and computer)
• Historically low inflation (thru 2020)	• Remote schooling, and the return to in-person schooling	• Sustainability bias (primarily Millennials and Gen-Z)
• Inflation spike 2021-2023	• Diminished brand loyalty due to market scarcity	• Circular economy (e.g., second-hand market) acceptance
• Government policies (CARES Acts, unemployment enhancement, student debt forbearance)	• Skyrocketing labor costs	• Peer-to-peer selling tools proliferation, and ease of use
• Panic and comfort buying	• Pandemic cities	• Fluctuating food prices caused by bird flu outbreaks and wheat supply issues in the Ukraine
• Supply chain disruptions	• Health and safety (e.g.,cleaning/hygiene products, home gyms, dining in versus dining out)	

Early in the pandemic, panic and comfort buying became prevalent consumer behaviors, driven by uncertainty and concerns surrounding the global economy.

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[1] [1]Where $5 Trillion in Pandemic Stimulus Money Went. The New York Times, March 11, 2022.

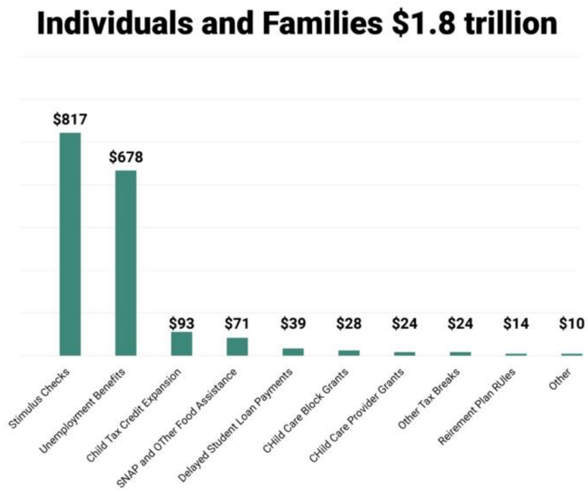
[2] [2] What Were the 13 Most Expensive Wars in U.S. History? USA TODAY, June 13, 2019.

Consumers rushed to secure essential items and sought comfort in purchasing products that provided familiarity and reassurance. Brand loyalty took a backseat during this period – toilet paper was toilet paper. If the store brand was in-stock, you grabbed it even if historically you purchased the brand name. And forget about getting your hands on hand sanitizer. A plethora of substitute products hit the market, with consumers buying in droves. Even the Food and Drug Administration (FDA) issuing recalls and warnings on multiple hand sanitizers did not stop the purchasing frenzy.

Household dynamics drastically shifted. Entire families working and/or studying from home demanded digital and personal electronic devices, and internet speed upgrades with increased monthly fees. Additionally, some households moved entirely, spurring “Pandemic City” terminology leading to growth in cities like San Antonio, Phoenix, Austin, Bend, Boise, Myrtle Beach, and Salt Lake City to name a few.

Low-interest rates facilitated by the Federal Reserve further encouraged spending and borrowing, stimulating sales. Supply chain disruptions, beginning with the 2019 China “trade war” and including an extended COVID shutdown in China, played a significant role in increasing product prices due to reduced availability and increased production costs. These factors collectively contributed to the growth in sales and pricing across various sectors.

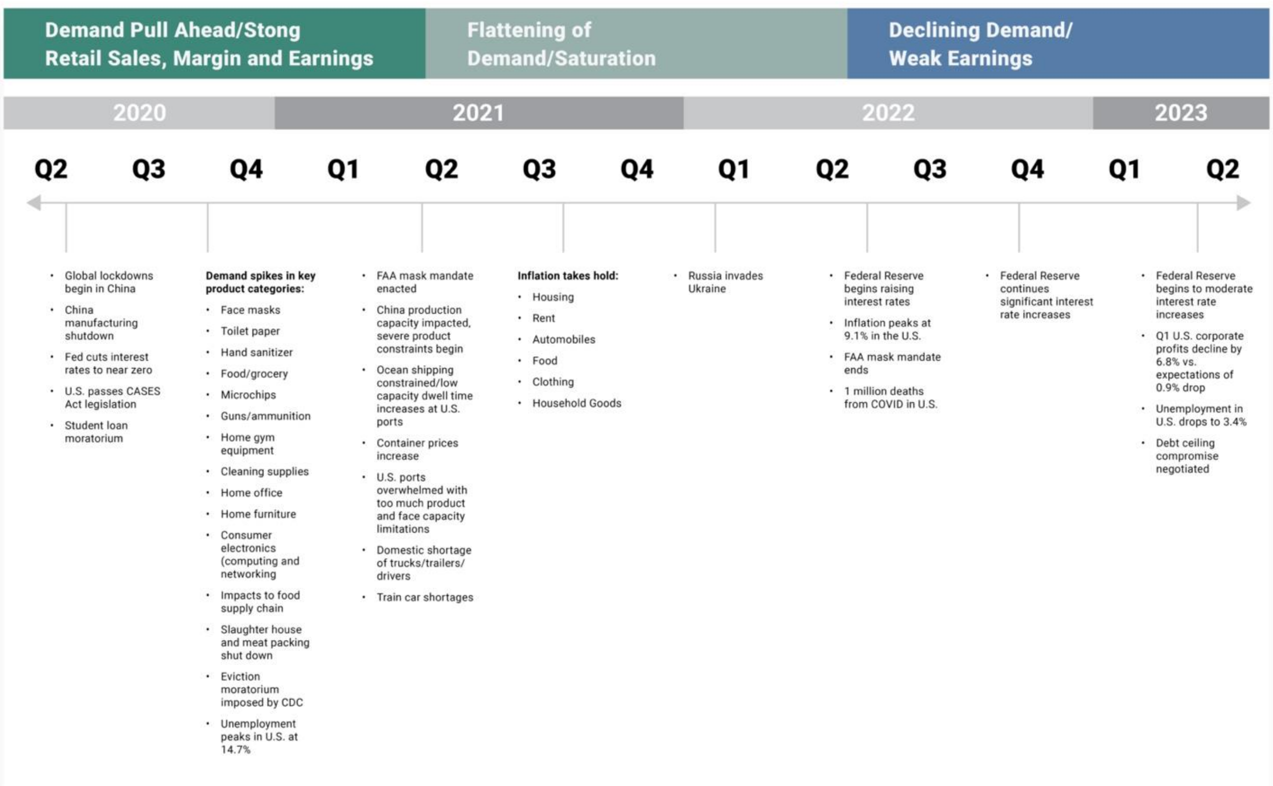
In sum, many retailers generally prospered, especially if they could get inventory into their stores and distribution centers. Interestingly, total retail sales in the United States



rose from $5.4 trillion in 2020 to $7.1 trillion in 2022[3], an increase of $1.7 trillion, in line with the federal stimulus spending "lifeline" sent to households.

WHERE ARE WE TODAY?

Fast-forward to 2023. As demand and supply return to a sustainable state of equilibrium, the production chain reaching from the consumer back to global brands/vendors and component manufacturers is being impacted. This includes the web of services that surround consumer-focused production, from international and domestic multimodal freight providers to ports, pilots, drivers, installers, technicians, mechanics, and of course retail stores.



Recently reported quarterly earnings (and forward-looking guidance) are beginning to light up red, potentially confirming that the American consumer may be less resilient this go-around. Q1-2023 results show that twelve of the eighteen retail sectors we track are

[3] [3] Total Retail Sales in the United States from 1992 to 2022, Statista 2023.

generating revenue growth versus last year. However, twelve of eighteen are also exhibiting a contraction in profit and operational measures.

These results underscore the growing vulnerability of the retailers in these sectors. In order to be set up for long-term success in retail, a blend of increasing sales, profit growth, and operational strength must be achieved.

Q1 2023 - YOY Trends

	Revenue		Gross Profit		Operating Inc.		EBITDA		SG&A		Inventory		Q1-2023 RESULTS
Retail Sector	$	%	$	%	$	%	$	%	$	%	$	Turn	
Grocery Wholesale	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🔴	🟢	🔴	🟢	Positive Results
Club Stores	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🔴	🔴	🟢	🟢	Positive Results
Discount Apparel	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🔴	🔴	🟢	🟢	Positive Results
Jewelry	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🟢	🔴	🔴	🔴	🔴	Mixed Results
Mass & Discount	🟢	🟢	🟢	🔴	🟢	🔴	🟢	🔴	🔴	🟢	🟢	🟢	Mixed Results
Office	🔴	🔴	🔴	🟢	🟢	🟢	🟢	🟢	🟢	🔴	🟢	🟢	Mixed Results
Drug Stores	🟢	🟢	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🟢	🟢	🟢	Mixed Results
Grocery Stores	🟢	🟢	🟢	🟢	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	Mixed Results
Personal Care	🟢	🟢	🟢	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🟢	Mixed Results
Apparel (excl. Discount)	🟢	🟢	🟢	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	Mixed Results
Athletic Apparel	🟢	🟢	🟢	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	Mixed Results
Auto Parts	🟢	🟢	🟢	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	Mixed Results
Sporting Goods	🟢	🟢	🟢	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	Mixed Results
Home Improvement	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🟢	🟢	🟢	🟢	🔴	Negative Results
Department Stores	🔴	🔴	🔴	🟢	🔴	🔴	🔴	🔴	🟢	🔴	🟢	🔴	Negative Results
Consumer Electronics	🔴	🔴	🔴	🟢	🔴	🔴	🔴	🔴	🔴	🔴	🟢	🟢	Negative Results
Home Furnishings	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🟢	🔴	🟢	🔴	Negative Results
Footwear	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	🔴	Negative Results

Some Areas of the Economy Came Through the Pandemic Relatively Unscathed

The U.S. economy went through tremendous upheaval in the past several years and there were some sectors that experienced enduringly positive results post-pandemic. These include:

- Computer Systems Design
- Electrical Equipment, Appliances, and Components
- Housing and Real Estate
- Nursing and Residential Care Facilities
- Healthcare (Human and Pet) and Assistance
- Waste Management
- Performing Arts, Spectator Sports, and Museums
- Warehousing and Storage
- Truck Transportation
- National Defense

While each of these sectors may have its own unique challenges going forward, they have all been buoyant (so far) and driven positive economic momentum.

As the Federal Reserve continues to raise interest rates in an effort to curb inflation, the follow-on effects may present issues even to some of these areas of ardent strength. For example, the truck transportation and warehousing sectors could be hampered by the general cooling of the economy and the overcapacity that was built up to deal with the immediate demand spikes from the early phases of the pandemic.

Retail trade has several sectors that experienced positive results through the pandemic era and have suffered no substantial post-COVID declines, yet. For example:

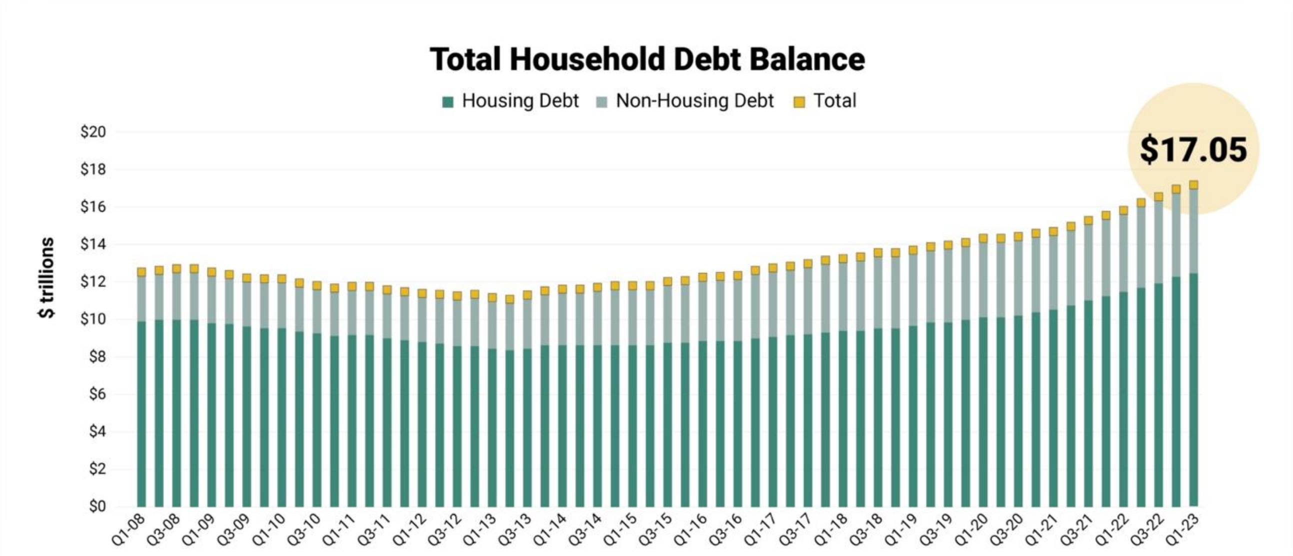
- Mass and Discount
- Athletic Apparel
- Grocery and Grocery Wholesale
- Drug Stores
- Personal Care
- Club Stores
- Auto Parts

However, some retail categories that saw significant growth during the pandemic are now experiencing declines. These include:

- Consumer Electronics
- Household Furnishings
- Home Improvement
- Home Office

Consumers Are Not So Resilient – The Retail Gravy Train May Have Ended

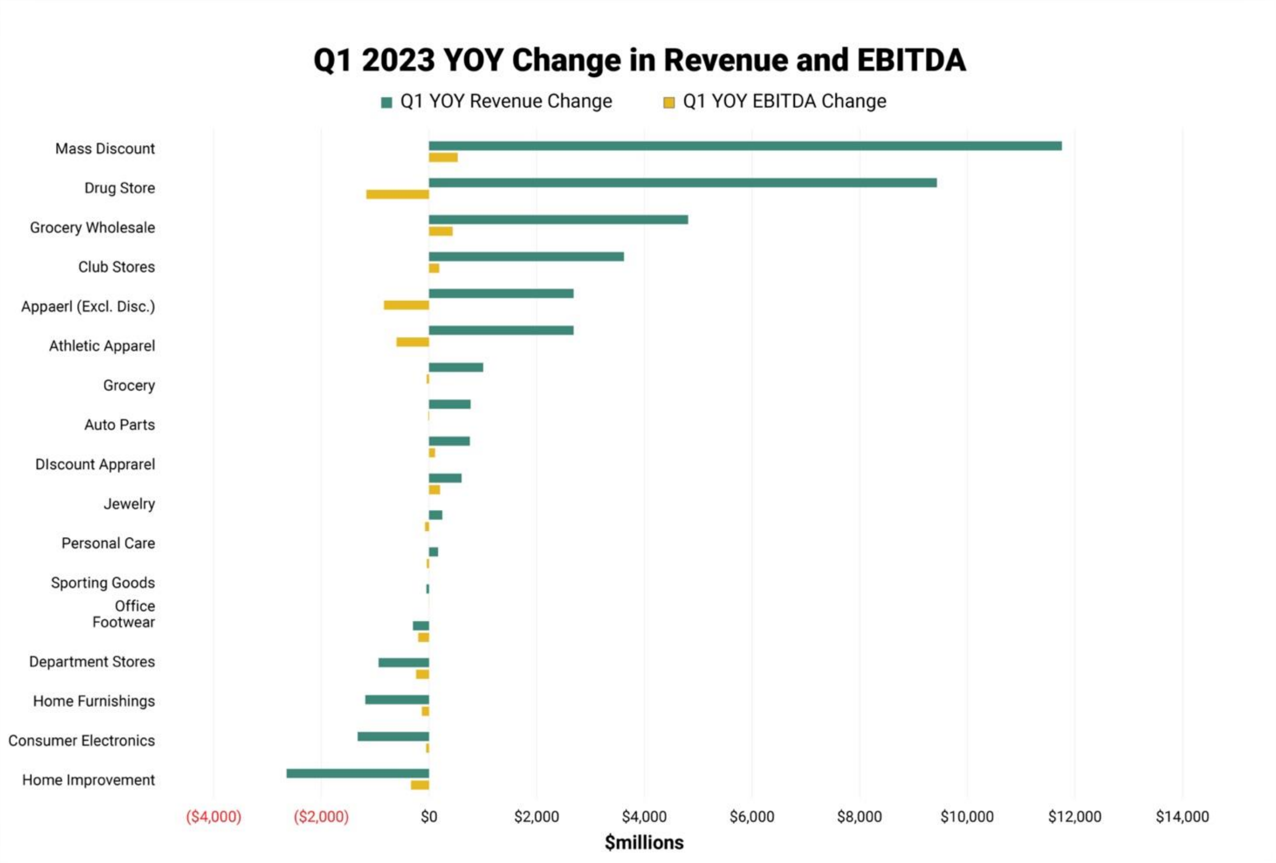
As pandemic-era lockdowns and restrictions eased or went away, several factors impacted consumer spending and created challenges for retailers. Consumer discretionary spending is stagnant at best and high inflationary pressures could squeeze consumer budgets further. Consumer sentiment is at historical lows. Total household debt has reached record levels. Higher mortgage rates and stock market losses from equity-heavy retirement savings are beginning to negatively influence not



https://www.newyorkfed.org/microeconomics/hhdc.html

just consumer confidence but a willingness to spend. These and other economic factors will continue to reverberate throughout the economy.

The economic stress on consumers and their adjusted spending behavior is being felt by retailers. As in other recessionary-like environments, consumers are trading down to store label brands, to the clearance racks, and to less expensive product substitutes (e.g., pork from steak). This behavior, coupled with new strategies around opportunities in the sustainable second-hand economy (pre-loved, circular, or pre-owned), is pushing prices lower on key items.



Financial results from the first quarter of 2023 have shown clear evidence of a more cautious consumer and the evolving retail landscape. Discretionary spending appears to be declining across the economic spectrum, with more spending focused on consumables. As we expect in more difficult economic times, consumers are clearly shifting from higher-end stores to Mass Merchandisers as they seek more value. This is evidenced by the strength of retailers in that segment, which saw healthy comp store sales increase in Q1 2023, coming mainly from the grocery category.

Even the trade-down platform, aka “the dollar store,” is showing signs of weakness. There was a spending shift out of higher margin discretionary categories into lower-priced and lower-margin consumable purchases in Q1 2023 within Dollar stores. This caused downward revisions to forecasted comps and EPS, which resulted in recent significant declines in share prices.

Given the current evolving economic environment and the potential for continued interest rate increases by the Federal Reserve, we expect these trends to continue through the back half of 2023 and into early 2024. Considering this, we have worked with our clients to execute strategies to help them not only ride out the upcoming storm, but to take market share, drive customer satisfaction, and improve shareholder returns.

Key Strategies for Achieving Stronger Results

LABOR OPTIMIZATION AND OPERATING EFFICIENCIES

- Embrace automation, process improvements, and efficient staffing to shift more activities to customer-facing and away from off-the-floor.
- Rationalize store, manufacturing and supply chain footprints as demand patterns have changed.

DRIVING IMPROVED INVENTORY EFFECTIVENESS

- Balance just-in-time with just-in-case inventory strategies focusing on higher full price sell through.
- Reduce excess inventory positions to shift investment to growth areas, consider eliminating poor performing categories.

ADJUSTING TO RAPIDLY CHANGING CONSUMER DYNAMICS

- Improve marketing performance to focus on channels that can maximize return on advertising spend, place best bets and don't spread too thin.
- Enhance your knowledge of the customer and use of CRM to engage at the point of purchase.
- Understand target customers (e.g., higher margin customers, customers with multiple purchase frequencies, etc.) and craft/offer compelling customer value propositions (CVP).
- Pivot toward private brands where customers want value.
- Incorporate resell channel opportunities as more consumers desire sustainability.
- Embrace the trend of trading-down in the marketplace.

CONCLUSION

Thus far, 2023 has been a mixed bag of results for retailers. For the remainder of the year, consumers are likely to exhibit certain trends and behaviors based on the evolving economic environment and their personal shopping preferences. While no one can predict what lies ahead in the next 6-12 months, there are some key strategic steps all retailers should focus on to drive a successful 2nd half of 2023.

- **IN-STORE SHOPPING**: Bricks and mortar traffic will continue to be strong. Consumers still value the social interaction with in-store sales staff. Be prepared to shift labor to areas that drive conversion and support the omni-channel experience.

- **ONLINE SHOPPING**: Digital traffic will be steady, but don't expect significant spikes. Ensure performance marketing dollars are invested in channels that are proven winners – retailers should not spread their bets too thin.

- **SHIFTING ECONOMIC ENVIRONMENT**: Be prepared for difficult sledding ahead. Government relief and stimulus will fade. The student loan grace period will end later in the summer, consumer debt continues to balloon, mortgage delinquencies are increasing – all of which will cause many shoppers to focus on value channels and cut back on non-discretionary spending. Any discretionary spending for holiday will likely be driven by products screaming value. Retailers must be certain they are ready to take advantage of the opportunities.

- **INVENTORY PLANNING**: Retailers must take steps to avoid being saddled with excess inventory and heavy markdowns. If sell through targets are not being achieved, don't waste time "pushing the peanut forward". Take your medicine and take the markdown early. The best markdown is always the first one.

- **PEOPLE (LABOR):** People are a retailer's biggest asset. Pay attention to the front-line workers. Clearly communicate expectations, share company and store performance, and take the time to reinforce good behaviors when an associate shows initiative and goes the extra mile with a customer.

The retail outlook for the remainder of 2023 will be driven by a combination of factors. E-commerce will continue to play a critical role for retailer success, but consumers increasingly show how much value the in-store experience. Retailers must drive an omni-channel experience that meets the needs of various consumer segments. Personalization and customization will be crucial. The current retail landscape demands retailers to adapt quickly, embrace digital transformation, and provide a seamless omnichannel experience that meets consumer expectations.

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