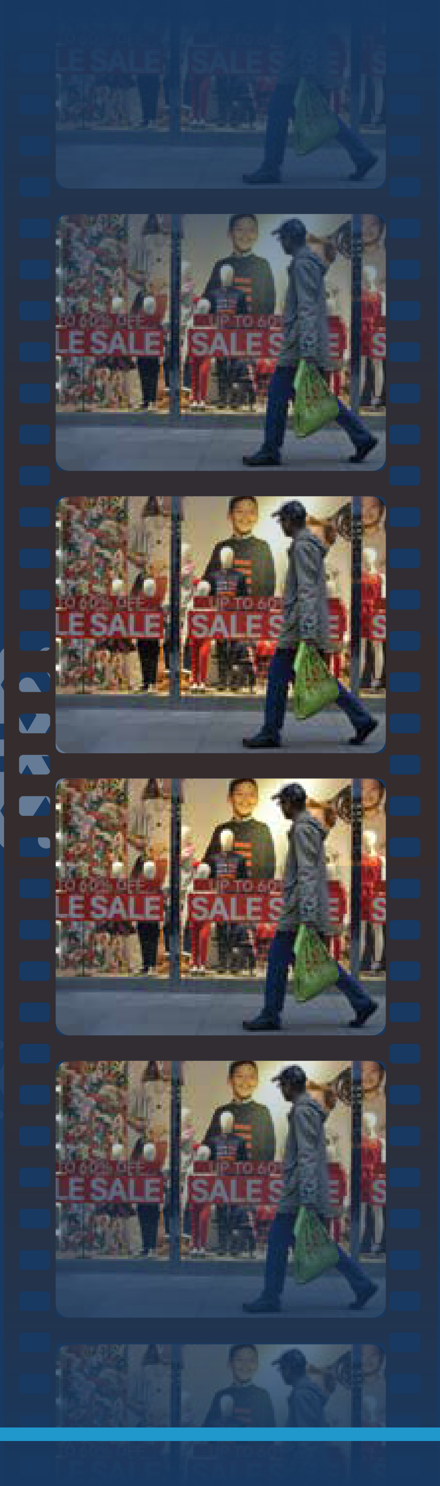
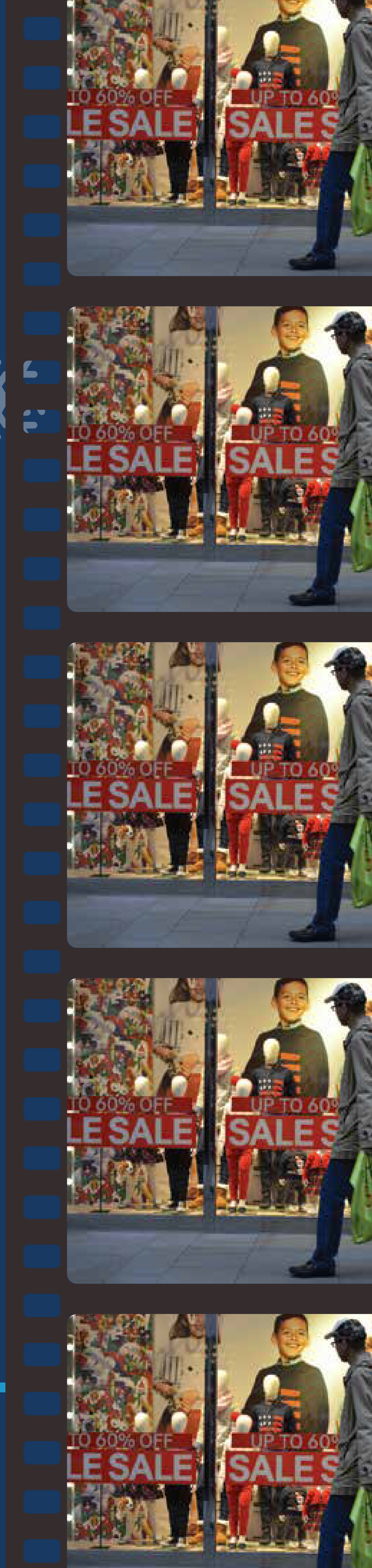
The 2016 Holiday Retail Report

GROUNDHOG DAY FOR U.S. RETAILERS





FTI CONSULTING

EXPERTS WITH IMPACT

THE 2016 HOLIDAY RETAIL REPORT

It’s Groundhog Day for U.S. Retailers

First there was Brexit, followed by the Chicago Cubs, then president-elect Trump. Sadly, in this year of upsets and unexpected outcomes, the U.S. retail sector has given us more of the same mediocrity and few surprises.

During 2016, the long-awaited revival of vibrant consumer spending has failed again to materialize, and in this sixth year of a sluggish retail recovery, it’s fair to ask whether this anticipated moment will ever arrive — or at least before the next recession is on our doorstep. Retail sales growth remains stubbornly substandard despite the best efforts of merchants to win over shoppers.

The condition of the U.S. economy has been trending favorably since 2014, and the personal finances of most Americans are considerably better than our president-elect would have us believe. But you wouldn’t necessarily infer that from consumer spending levels of the past year or so, which remain uninspired at best.

For those who are wary of attributing significance or validity to headline economic readings, consumers themselves continue to say they are fairly upbeat on the economy, as well as their personal finances.

What Has Changed in 2016 and How It Might Impact Holiday Sales

- **U.S. Automobile Sales Likely Have Peaked:** New vehicle sales have been a cornerstone of this economic recovery, with consumers replacing aged vehicles after several years of deferred auto purchases. It now appears this replacement cycle may have peaked based on reported 2016 unit sales for light vehicles and slowing growth of auto-related debt. This could be an encouraging development for the retail sector as consumers redirect some of their spending.
- **Consumer Credit Card Debt Has Begun to Accelerate:** After declining nearly 20% from peak to trough, revolving credit outstanding (primarily credit card debt) began to creep higher in 2013 and now has accelerated to 6% year over year (“YOY”) growth in 2016 — outpacing gains in wages and wealth. More shoppers are using their plastic again, and, believe it or not, this is good news.
- **The Energy Windfall Recedes in Consumers’ Minds:** Most Americans got an unexpected gift in 2015 in the form of lower energy prices. This windfall was not insubstantial; retail sales at gasoline stations decreased by nearly 20% last year, saving Americans about $650 per vehicle in fuel costs, as well as lower home heating bills. Unfortunately for retailers, this windfall didn’t exactly ignite a spending spree; Americans ate out more frequently last year, but that was about it in terms of self-indulgence. Unlike the spending bonanza on Hummers and gas-guzzling SUVs spurred on by $1.00+ per gallon gasoline in the ’90s, this energy boon hasn’t energized shoppers in any noteworthy way. In 2016, consumers seem even less inclined to spend this bounty.
- **Labor Trends Remain Favorable but Have Lost Some Momentum:** Wages and other personal income gains continue to trend favorably, but have decelerated in the most recent two quarters as labor market hiring and new job creation have slowed in 2016. Several measurements of unemployment leveled off in the last six months, and there has been talk among some economists that the U.S. labor market could be soon approaching full employment — surely a laughable premise to millions of struggling Americans.
- **Savings Rate Ticks Higher:** Americans have decided to become better savers, particularly younger baby boomers and older Gen-Xers who under-saved during their working lifetime and now see retirement on the distant horizon. The nation’s personal savings rate hit 6% in 2016 — more than double the 2%-3% savings rate in 2005-2007. This represents approximately $200 billion-$400 billion that Americans are diverting from consumption to investment each year. It’s commendable, and it’s needed, but it’s a bummer for retailers and anyone else reliant on spendthrift consumers.
- **Cost of Being Connected to Our Devices Is Affecting Spending Choices:** The ongoing cost of staying connected to our TVs, smartphones and PCs continues to climb and is consuming a sizable share of disposable income for many Americans — about $2,500 a year for the average U.S. household, or nearly 4.5% of annual expenditures, according to the most recent Consumer Expenditure Survey from the Bureau of Labor Statistics. Americans are trading off other discretionary spending as they wrestle with high monthly communication bills, especially younger adults.

The two foremost indexes of consumer confidence are sending that message, with the Conference Board's Consumer Confidence Index recently at its best level since 2007 and the University of Michigan's Index of Consumer Sentiment slightly below its post-recession high. Both indexes currently are at levels above their 20-year average. Respondents are reasonably sanguine in their outlook for the broad economy, as well as their personal financial prospects. However, they do continue to exercise uncharacteristic restraint compared with their free-spending ways of the past.

So contrary to the impression we've heard repeatedly in some circles during this political season, most Americans are not feeling downcast or gloomy on economic matters (nor are they giddy).

This is not to ignore or minimize the grievances of a sizable portion of Americans who have failed to regain their pre-recession economic standing or financial security. Their anxiety over the economy, which was highlighted during the presidential campaign, is legitimate. There are still too many dispossessed Americans at this late stage of an economic expansion that is widely regarded as disappointing and exclusive. Nonetheless, a majority of us do perceive that economic conditions are improving, though they remain far from ideal.

The Future of Stores: The Conversation Heats Up

If you stroll along the area near the Ponte Vecchio in Florence, Italy, you can shop in some jewelry stores that have been family-owned businesses for hundreds of years. Multiple generations of family members have pulled the gates up and down each day dating back to the Renaissance or earlier. It's a reminder that the fundamental business of retailing hasn't changed much over the centuries … until recently.

It might be only a slight exaggeration to say that the business of large-scale retailing has undergone more change in the last decade or so than it did in the century before that. The transformational impact of the online channel as a virtual storefront and a transacting medium cannot be overstated; online has fundamentally altered the very nature of the retail business and, in the process, upended the established order. The impact of online commerce on retailing far exceeds the $400 billion of online sales it will generate this year. Foremost, it has diminished the importance of the physical store as the nexus of shopping activity and, in doing so, has radically altered the economics of retailing.

This is hardly a novel observation, but after several years of merely tacit acknowledgment that America was quite overstored, 2016 is the first year we can recall when serious business conversations, media coverage and corporate actions have been devoted to the topics of declining mall traffic, store closings and the changing role of the store in the retail mix. This was punctuated by Macy's mid-year decision to close 15% of its full-line department stores. In short, the ball got rolling in 2016 and will pick up speed going forward. Many large omni-channel retail executives are finally focusing attention on their diminishing need for so many stores now that their online business has scaled up nicely.

To appreciate the profound online impact, consider **Exhibit 1**, which shows growth of in-store discretionary spending (we use the GAFO[1] category as our proxy) and of non-store sales since 2011 as reported to the U.S. Bureau of the Census ("BOC"). The BOC requires that reporting retailers strictly separate their store sales from online sales, which are then reported by BOC in a separate category (NAICS Code 454; Non-Store Retailers, which includes online and catalog sales). So GAFO sales, as reported by the BOC, are stripped of their online component and reflect what we consider to be a best approximation of "pure" store-based performance for discretionary product categories.

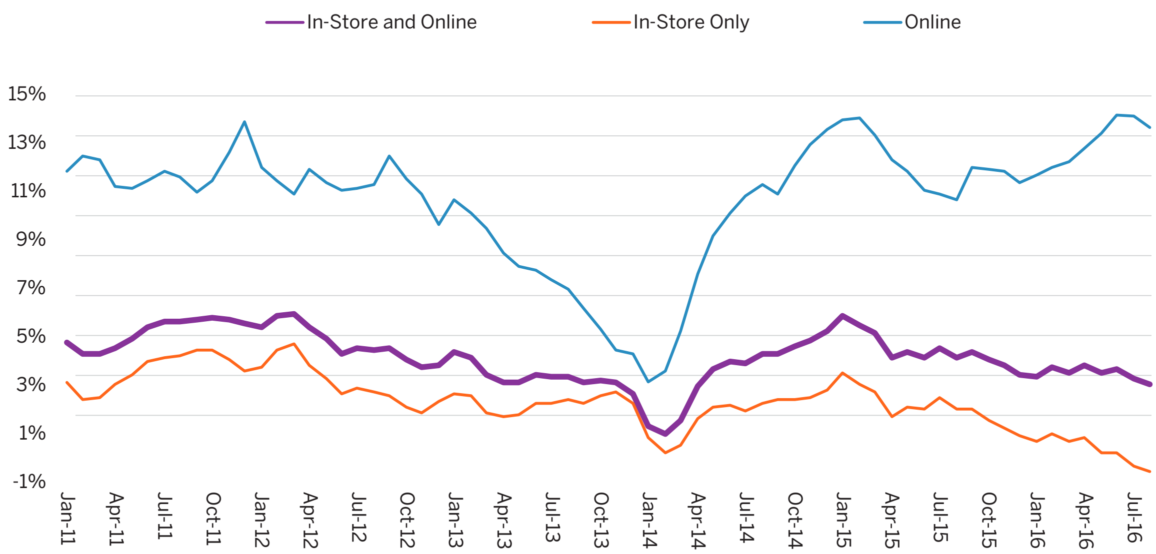
It is not a pretty picture, with in-store sales growth (YOY) gradually trending lower since 2012 and recently turning negative. In contrast, non-store sales have consistently grown by a low double-digit rate and have accelerated since 2015.

[1] GAFO represents firms that specialize in merchandise consisting of furniture & home furnishings; electronics & appliances; clothing & accessories; sporting goods; hobby, books and music; general merchandise; office supplies and stationery; and gift stores.

EXHIBIT 1

U.S. Discretionary Retail Sales

(Nominal, YOY % Change)



Source: U.S. Census Bureau

The sum of in-store sales for the GAFO categories plus online sales is our best estimate of total discretionary spending, and it depicts a fairly discouraging story for sales growth, which has slowed to approximately 3.0% (YOY) in 2016 from 4.0+% in 2015. That's hardly anything to celebrate as we approach the holiday season. Spending continues to migrate away from stores, while overall top-line sales growth, which includes online, is anemic.

Let's be clear about what this is telling us: In the aggregate, in-store sales growth for discretionary spending in 2016 is just about nil, largely as a result of sales being siphoned by the online channel. If these trends persist, it will likely accelerate the closing of marginal stores in 2017 and beyond.

Our 2016 Holiday Forecast

Most large retailers continue to engage in highly promotional activities that ultimately are harming their underlying business. What choice do they really have? With a few exceptions for standout brands, holding the line on higher price points will not get the sale made. Smart shoppers have come to expect large retailers to be at least price competitive with Amazon — or else they will move on quickly. But winning the sale under these conditions is not nearly as easy or profitable as it used to be.

What is demonstrably true in such an environment is that the enterprise of retailing has become less lucrative by most measures. Operating margins and return on investment have been trending lower during the last three years across nearly all retail segments (see Appendix), and there is little indication that a reversal is at hand. In a sense, it is a race to the bottom against a retailing giant that has a distinct cost advantage over all of its store-based competitors. As Amazon extends its reach into a greater number of product categories, more retailers are confronting this conundrum. There is no reason to believe that any of this will change during the upcoming holiday season.

Bargains will abound, but shoppers are still balking. This is a recipe for another bland fruitcake of a season.

The comeback of denim and the arrival of virtual reality headsets and gaming are among the few noteworthy lineup changes this season. Early indications from retailers that have already reported third-quarter results reinforce our belief that top-line growth remains challenged — even for those that met or beat sales and earnings expectations.

As we've seen in recent years, the holiday season will begin earlier than it traditionally has, with big promotions kicking in well before Thanksgiving week or Black Friday. Some shoppers did some really early holiday shopping during Amazon Prime Day back in July. In any case, the time boundaries that once defined the holiday shopping season have faded, as has the cadence of promotions. The dilution of holiday spending into October (or earlier) is another challenge for those trying to forecast the prospects for the season. This holiday season includes two extra shopping days between Thanksgiving and Christmas compared with 2015, which can't hurt sales but doesn't likely matter much. A few retailers already have said the Hanjin Shipping bankruptcy will have some impact on their holiday sales, but it's hard to ascertain how extensive this is or whether it simply is a ready-made excuse for a soft season.

Our forecast model expects a 3.3% increase this season for adjusted GAFO category sales – which include non-store sales – roughly in line with last year's results.

Our 2016 holiday forecast is below last year's forecast of 3.9%. The slight moderation of income growth and household wealth gains going into this season is the primary reason for our lower expectation. Other than a momentous presidential election and the digestion of its results, the holiday backdrop will be quite similar to the 2015 season and should also produce middling top-line growth (**Exhibit 2**).

Curiously, there were a few retailers that mentioned the uncertainty and high drama surrounding the recent election as a contributing factor to soft sales in early autumn but it's unlikely that its resolution will have any noticeable impact on the holiday season, as it is far too soon for Americans to have any real sense or expectation of how they will fare financially under a Trump presidency.

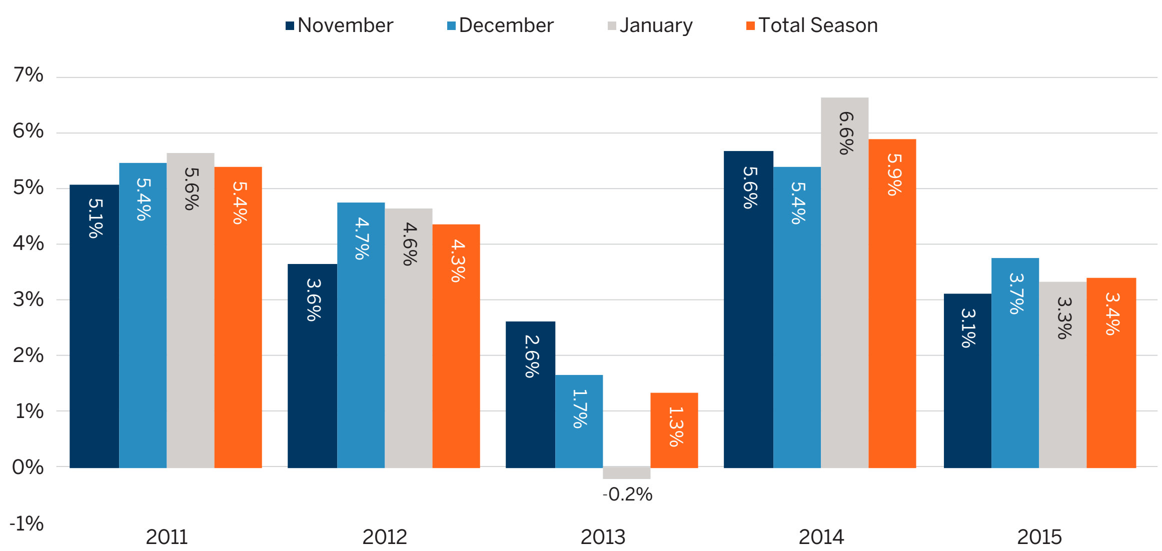
Whether the 2016 holiday season comes in a bit above or below our forecast, it is not likely to be very consequential in the big picture. Large retailers must contend with the more daunting challenge of defending **market share** and **profitability** in an environment that continues to dilute the former and squeeze the latter. What we can say with certainty is that the path many retailers are on cannot persist indefinitely.

Wishing you and yours an exciting holiday season!

EXHIBIT 2

Holiday Season Retail Sales

(YOY % Change)



Source: U.S. Census Bureau

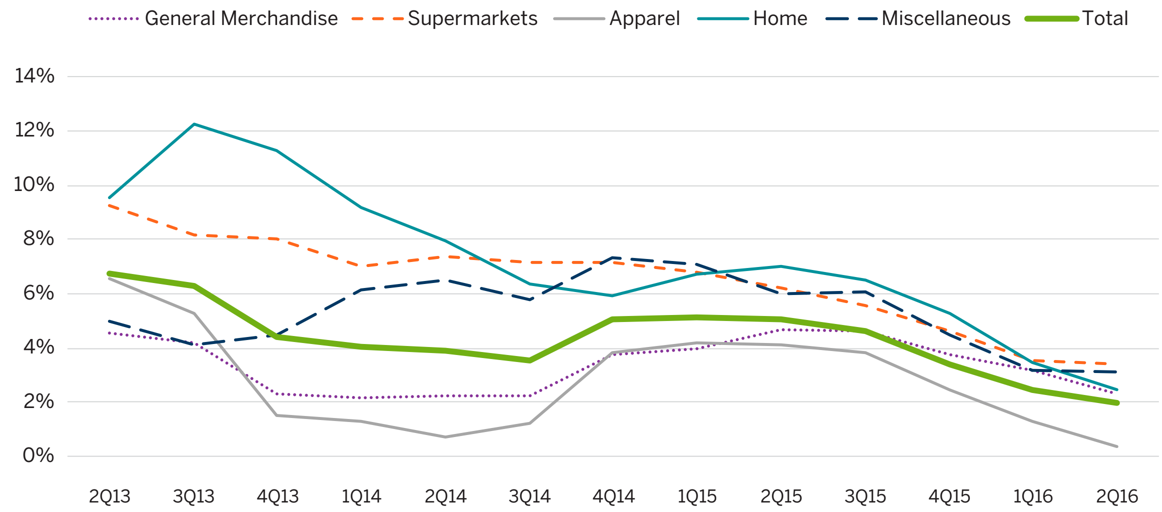
Appendix

Averages are based on 120 public and large private U.S. retailers with annual sales of at least $100 million since 2013. All companies are equally weighted.

EXHIBIT 3

Total Sales Growth

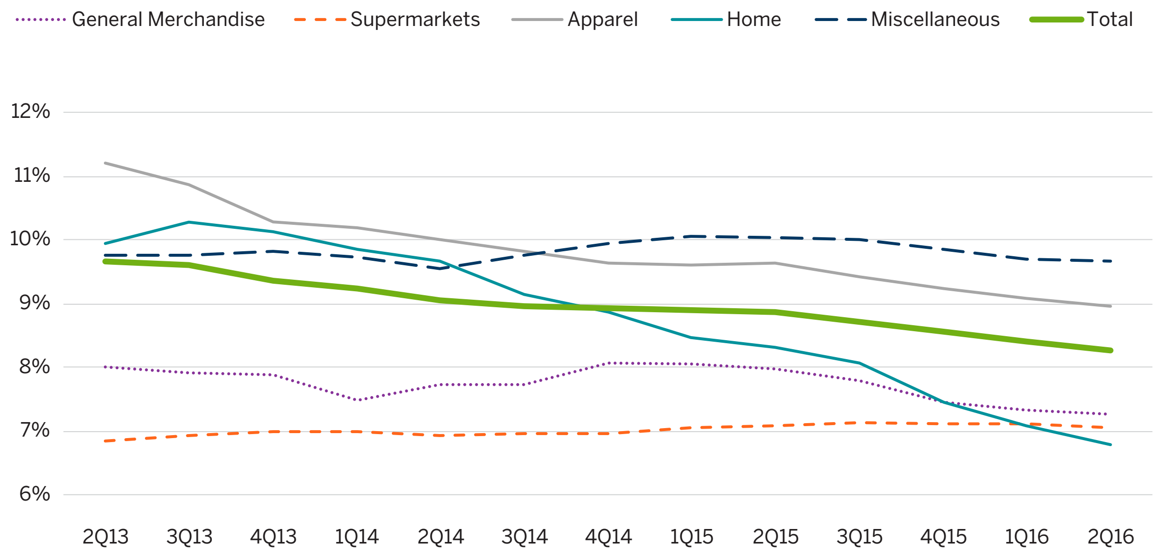
(YOY % Change)



Source: Standard & Poor's Capital IQ

EXHIBIT 4

EBITDA Margin



Source: Standard & Poor's Capital IQ

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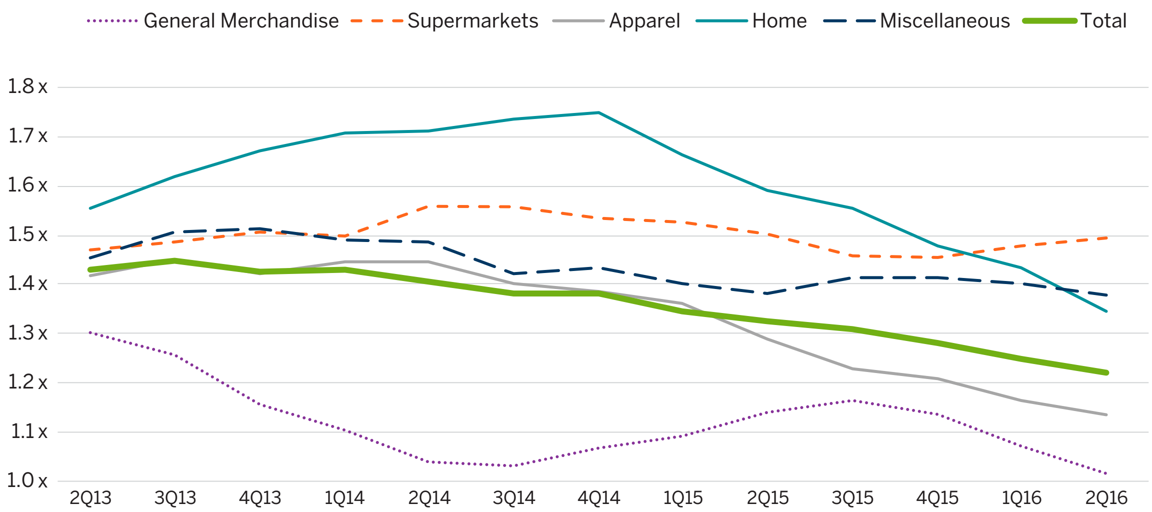
EXHIBIT 5

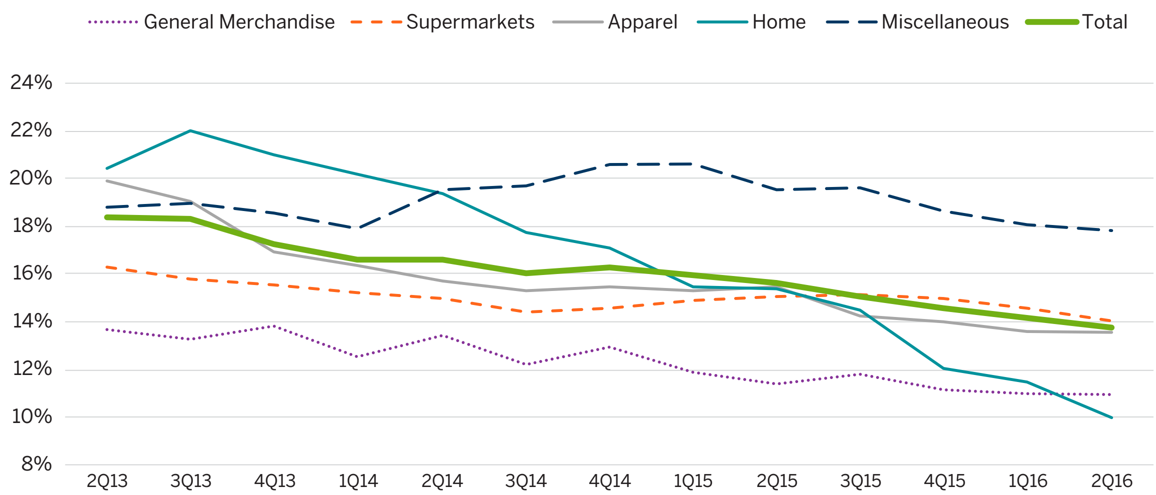
CAPX to Depreciation Expense



Source: Standard & Poor's Capital IQ

EXHIBIT 6

Return on Invested Capital



Source: Standard & Poor's Capital IQ

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