FTI CONSULTING

2019 U.S. HOLIDAY RETAIL FORECAST:

HOLIDAY MAGIC IS JUST AN ILLUSION FOR MANY U.S. RETAILERS

AN FTI CONSULTING REPORT

EXPERTS WITH IMPACT™

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For those of us who can remember a time when broadcast coverage of the Rockefeller Center tree lighting *wasn't* followed by a Victoria's Secret lingerie show, it's obvious that the holiday season isn't what it used to be. The season starts earlier and ends later than it used to in decades past. The lament of middle-aged folks complaining about Christmas commercials or music in October has become a familiar refrain. Holiday shopping has become less intense and frenzied. Nobody seems like they are shopping in panic mode anymore. Gift cards often have replaced thoughtful gift-giving, and their usage has extended the holiday season well into January. Malls and stores generally are less crowded on Black Friday weekend, with store traffic down by mid-single digits last season. Checkout lines move more quickly. Christmas shopping also has become a more solitary and personalized experience rather than a socializing activity or get-together. Online shopping has made holiday spending less weekend-concentrated. Last minute shoppers can buy online with less concern of disappointment. Returns are less of a hassle. Some fair share of shoppers will brag to friends that they hardly stepped foot in a mall this holiday season. These myriad conveniences are made possible only by the enormous efforts and investment of primarily store-based retailers over the last decade to accommodate the many whims of shoppers, who have done little to return the favor in any meaningfully pecuniary way. Instead, they have turned their shopping loyalties elsewhere. Consequently, retailing is a far more complex and less profitable enterprise than it used to be. The only unambiguous winners are shoppers—and Amazon.

The two months comprising the holiday season have traditionally been the make-or-break period for retailers. We don't mean to downplay its importance, but as we consider the profound challenges and tortuous transition still confronting the retail sector today, the import of a holiday season that's a bit better or worse than expected seems almost inconsequential in the bigger picture. It's unlikely to alter the trajectories of those chains on their way to irrelevance. Moreover, the bucks we spend to please our loved ones are increasingly directed towards fewer retailers, meaning that the aggregate success of the season has less bearing on the outcomes of its many constituents. Retail prosperity has become more selective and less shared among its participants. More than ever it seems, the retail sector is segmented hard between leaders and laggards. The technologies that were expected to propel traditional retailers in the 21st century have also created new impediments to greater prosperity for the enterprise. Recently, The Gap's sharp takedown of earnings guidance for FY19 and the resignation of its longtime CEO are another harsh reminder that it requires more than online success to make the cut.

Forecasting holiday sales has always been something of an abstract exercise, and against the sobering backdrop we've described it seems less connected to the health of the retail sector without some additional insight. So, let's provide that.

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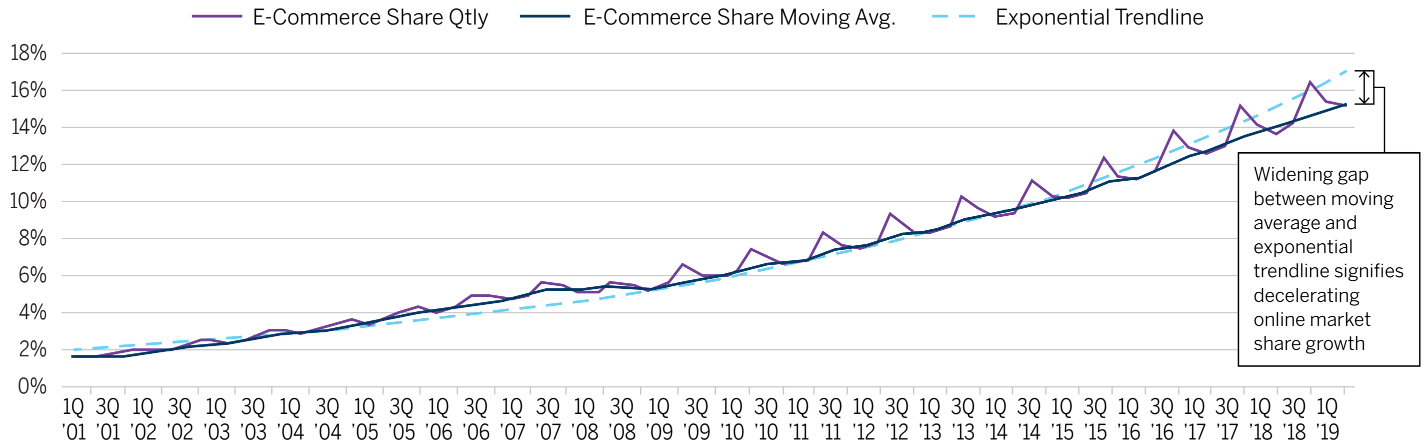
EXHIBIT 1

E-Commerce Market Share (Not Seasonally Adjusted)



Source: U.S. Census Bureau and FTI Analysis

WE SHOP ONLINE MORE DURING THE HOLIDAY SEASON

However much we shop online, we do it more during the holiday season. The seasonal impact on online shopping has become more pronounced since 2010, as we see in **Exhibit 1**. The online channel now claims a market share of 15.3% of total retail sales (excluding auto and gas) on a trailing four-quarter (or LTM) basis. But expressed on a quarterly basis, online market share pops higher every fourth quarter of the year, which is evidence of a seasonal effect. In fact, online share is nearly 15% higher in the fourth quarter than it is on an LTM basis, meaning that if online share currently is trending towards 16%, it would be approximately 18.2% this holiday season. ***This would translate to $185 billion of online retail sales in 4Q19, an increase of 15% year-over-year.*** Online sales growth (YOY) had slowed notably for several quarters since mid-2018 but has picked up again since 1Q19 to a low-teen rate from a mid-to-high teen rate at its previous best earlier this decade.

Another noteworthy takeaway from **Exhibit 1** is the widening gap between trending online market share (i.e., its moving average) and the best-fitting exponential curve we have imposed on the data. This gap represents the decelerating (or slowing) growth of online market share in recent years compared to its exponential growth trajectory. This phenomenon is to be expected and will widen further, as the online channel cannot continue to take market share at such a prodigious rate. To that point, if the online channel's market share growth continued intact along this exponential trajectory, it would account for 100% of total retail sales in 2039! Before you ponder those implications (no more stores!), realize the absurdity of such a projection and recognize that high growth must inevitably slow. We all know this to be true but quantifying exactly how this slowing phenomenon unfolds over time will be a primary challenge for industry pundits in the next few years.

THE ONLINE CHANNEL IS EFFECTIVELY CAPTURING MOST RETAIL SALES GROWTH

The greatest contributor to the widening disparity in the fortunes of large retailers in recent years is the swelling size of the online pie and the disproportionate size of its slices. We mentioned that the online channel now commands nearly a 16% share of total retail sales and continues to gain just over one percentage point of market share annually. That is a lot of merch — about $69 billion of additional retail sales moving from store-based purchases to the online channel (which includes both online-only sellers and omnichannel retailers) in 2019. **With total retail sales growing at about 4.0% annually, this movement of sales from physical stores to online is the equivalent of approximately 50% of the industry's total annual sales growth.** This metric has edged higher in 2019 (**Exhibit 2**) and, depending on the precise measurement, generally has vacillated within the range of 40%-60% since 2015. For primarily store-based retailers, this leakage of sales to the online channel blunts the effect of stronger consumer spending.

Think of this dynamic as murky lake water flowing through a giant sieve at a near constant rate. Initially there is little sediment (online sales) trapped in the sieve, but over time more and more sediment is caught and less liquid flows through. But, unlike lake sediment, this gunk is valuable, and retailers are fighting fiercely for it.

The second blow of this one-two punch is Amazon's incumbent advantage in the online channel, a topic we have discussed in the past. Previously we estimated that Amazon's share (1P+3P) of U.S. online retail sales hit 40% in 2018, and there has since been a new development on that front. Amazon began free one-day shipping for Prime members in the second quarter, and it has moved the needle. Our analysis of third-quarter results indicates that Amazon's estimated market share jumped to 43.5% in 3Q19 from 41% in 1H19 (**Exhibit 3**), which is most likely attributable to free one-day shipping. This perk has been very costly for Amazon — shipping

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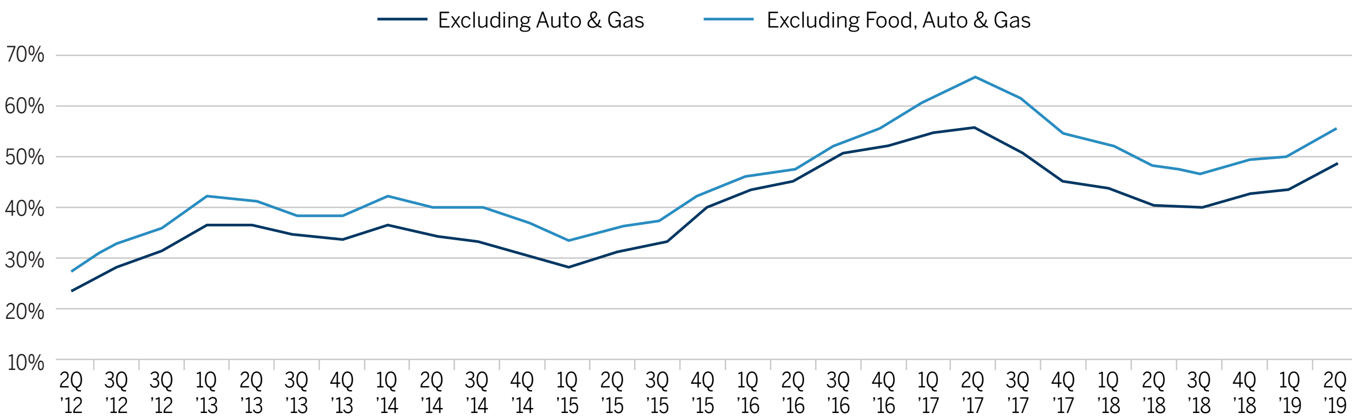
EXHIBIT 2

E-Commerce Sales Growth as % of Total Retail Sales Growth



Source: U.S. Census Bureau and FTI Analysis

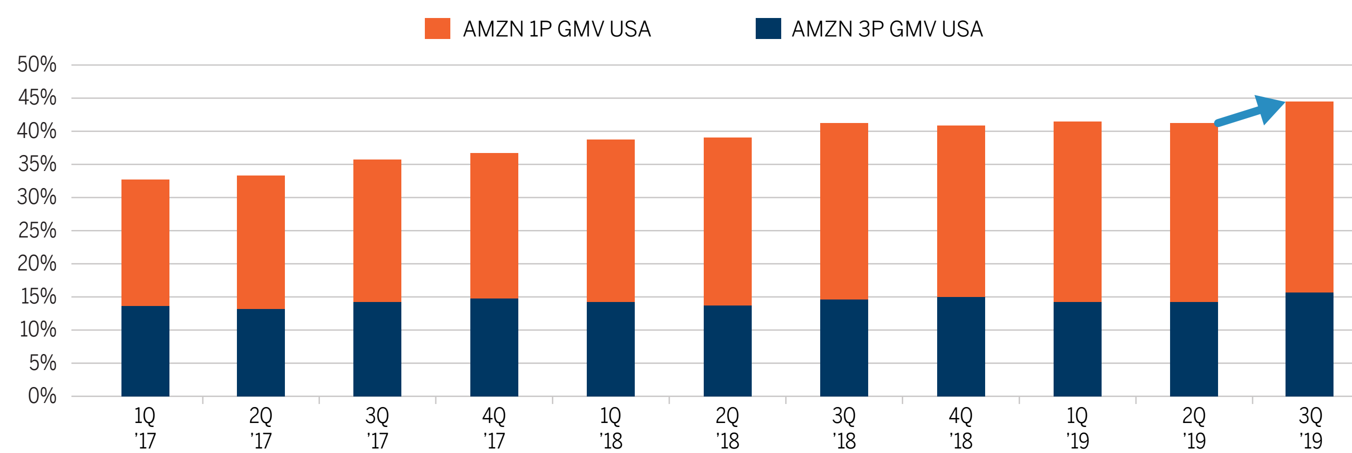
costs are expected to increase by $1.5 billion in 4Q19 due to one-day shipping — but the company is confident that this investment will prove to be a hit with customers and build deeper loyalty. Early indications are that this expectation is accurate. Amazon's retail sales growth (1P + 3P) had been slowing over the previous year, but that growth suddenly picked up last quarter. Some of the growth is attributable to stronger consumer spending since 1Q19, but Amazon almost certainly increased its market share as well in the third quarter, implying that Amazon's domestic reach has yet to plateau. At current growth rates and market shares, Amazon's Gross Merchandise Value (GMV) this holiday season would amount to 8.0% of total retail sales. Moreover, Amazon's domestic GMV is on track to surpass Wal-Mart's within five years. Amazon's mission is to get Prime members to spend more and more, even as new Prime member growth slows.

WHAT THE HECK HAPPENED LAST HOLIDAY SEASON?

Nearly a year later, we remain perplexed by last year's flameout holiday season. We are also surprised it received so little attention. The 2018 holiday season was set up to be a good one, with consumer spending remaining strong (5%-6% YOY) through mid-2018 before weakening a bit in the third quarter (**Exhibit 4**). The broader economy was performing reasonably well, and consumers were upbeat going into the holidays. But it turned out to be the weakest holiday showing since 2013, due entirely to the worst December for retail sales since 2008. By several measures, YOY retail sales growth in December 2018 was negligible — close to zero — and that includes e-commerce sales. Consumer spending growth slowed to a crawl that month and began to

EXHIBIT 3

Amazon's Estimated U.S. Online Market Share



Source: SEC Filings and FTI Analysis

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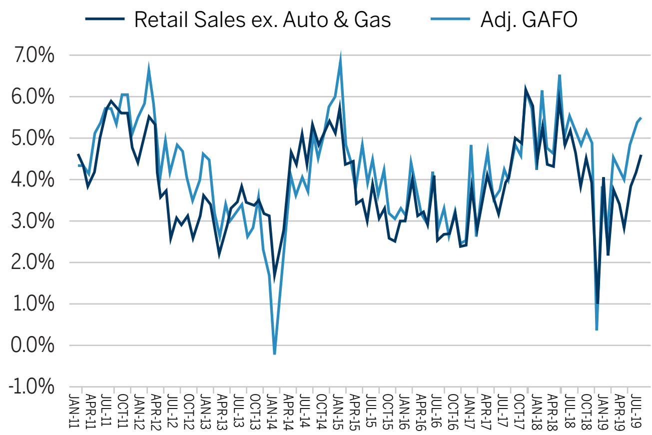
EXHIBIT 4

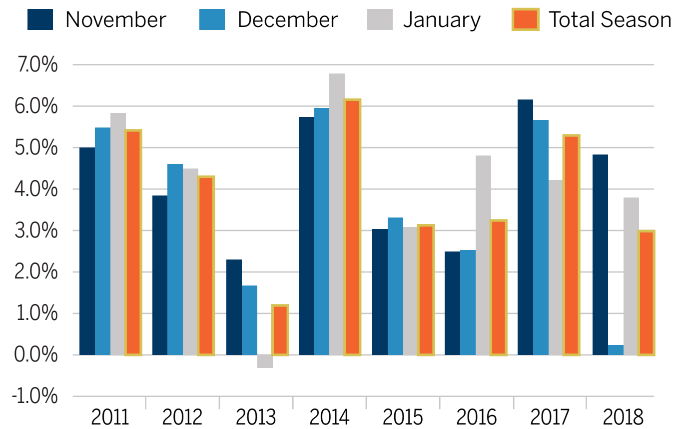
U.S. Retail Sales Growth



Source: U.S. Census Bureau and FTI Analysis

EXHIBIT 5

Holiday Season Retail Sales (YOY % Change)



Source: U.S. Census Bureau and FTI Analysis

recover in early 2019, too late to save the holiday season, which finished with meager YOY increases of 2.6% (Nov.-Dec.) and 3.0% (Nov.-Jan.) [**Exhibit 5**].

To emphasize this surprise factor, consider that the difference between retail sales growth for the back-to-school season and the holiday season — which is usually negligible or small given their close time proximity — was wider in 2018 than any year in nearly three decades except for 2008 (**Exhibit 6**).

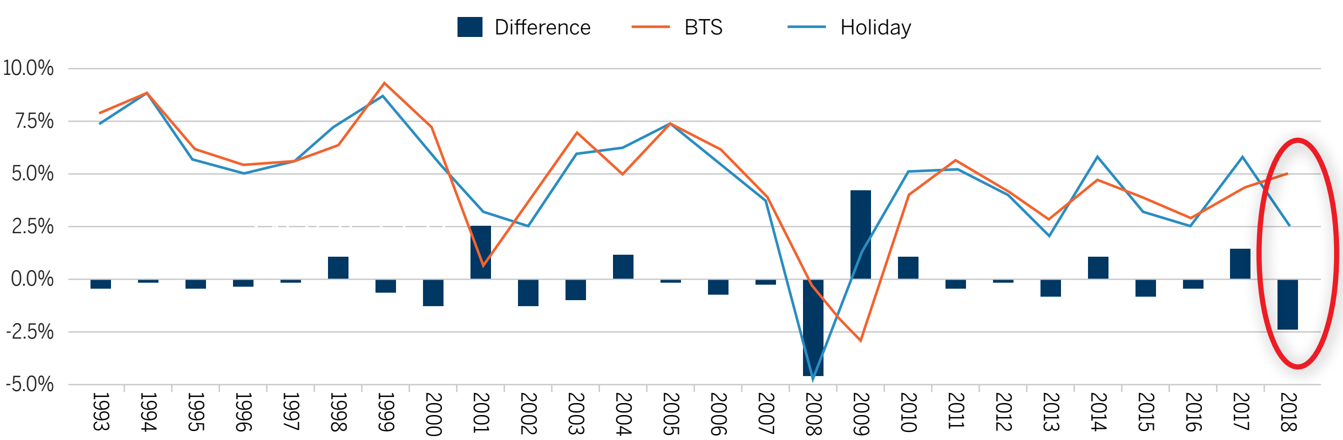
Such a disparity would suggest a sudden, unanticipated shock event of some sort, like the onset of the financial crisis following the collapse of Lehman Brothers in September 2008. Of course, we recall vividly that the stock market fell sharply in December 2018, with the S&P 500 cratering 15% that month before bottoming on Christmas Eve. But could that have caused shoppers to stop in their tracks?

Given the relatively modest sums of stock wealth owned by most Americans and the high concentration of market wealth owned by a tiny minority of affluent households, it would seem unlikely that a stock market correction could tank consumer spending. (A recent Bloomberg article stated that the top 1% of Americans controlled just over 50% of the equity in all U.S. private and public companies while the bottom 50% owned just 6% of all financial assets.) Moreover, consumer sentiment levels remained strong and steady throughout the final three months of 2018 across all income cohorts, signifying that Americans were at least saying they remained confident in the economy as markets sold off.

Furthermore, the impending government shutdown, which began on December 22nd and furloughed nearly one million federal employees for 35 days, might have spooked shoppers as the Congressional impasse persisted and inevitability of a shutdown became clear. These two events are the only plausible explanations for last year's lousy December.

EXHIBIT 6

Back-to-School (BTS) vs. Holiday Retail Sales (YOY % Change)



Source: U.S. Census Bureau and FTI Analysis

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If indeed a sudden stock market correction caused many Americans to retrench, then economists might want to recalibrate their models for the impact of the wealth effect on consumer spending. It may not have been a wealth effect per se that brought pause for so many, but rather the specter of another financial crisis and the awful memories it conjured. In other words, the fear of another crisis and its aftermath still might resonate acutely with many Americans who don't necessarily have much market exposure. However, we remain skeptical of a market-driven cause to explain last year's holiday spending swoon, though there is no other obvious explanation. It is an unsettling thought that a fleeting stock market correction could wreak such damage on the consumer economy — and what that would suggest about the fragility of this recovery. The mystery of the disappointing 2018 holiday season may go unsolved.

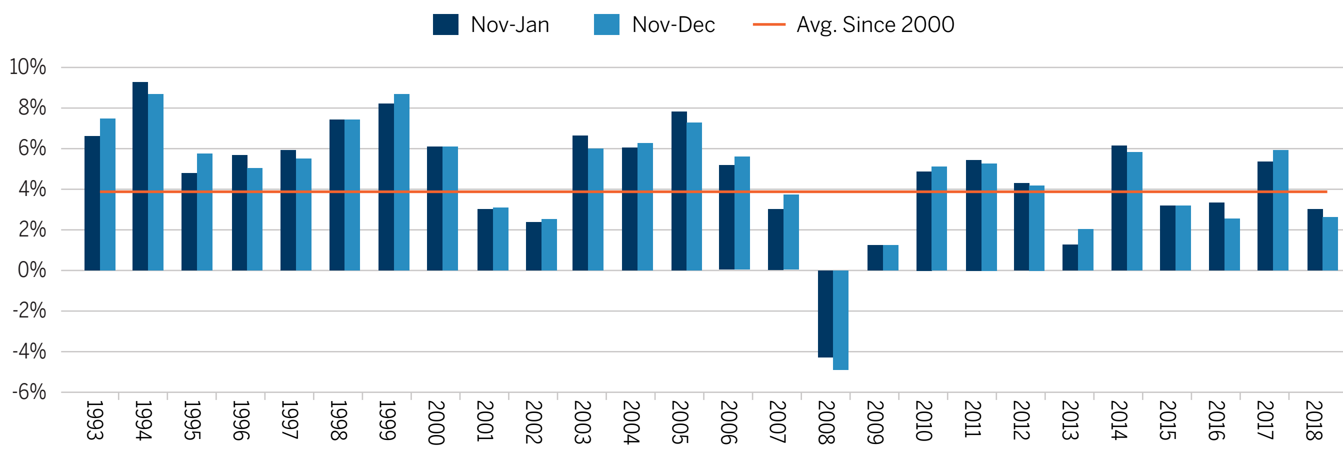
OUR 2019 HOLIDAY FORECAST

The economic backdrop entering this holiday season is much the same as it was a year ago, and generally that's a good thing. Macroeconomic indicators continue to trend mostly favorably except for some tariff-impacted industries. The job market remains resilient, and wage growth has leveled off near 3.0%, a decent if uninspiring rate. Inflation at the consumer level remains tame, edging slightly lower from a year earlier. Consumer confidence is slightly weaker than a year ago but remains at healthy levels. Consumers remain upbeat but tempered in their optimism. And the stock market isn't cratering — quite the opposite. Apparently, the only ones worried about a recession are economists. This all makes us a bit nervous, since our 2018 forecast turned out to be much too optimistic given many of these same economic readings.

The best thing this season has going for it is that it's competing against a weak 2018 holiday season. A stronger December is all but guaranteed. The "shorter" holiday season given the late Thanksgiving this year should be of little or no consequence with respect to this season's performance. We have long believed that shoppers have relatively fixed lists of gift recipients and those lists get tackled regardless of when the season officially begins. Having six fewer shopping days this season might dent November's sales, but that should be offset in December. The topic is much ado about practically nothing.

EXHIBIT 7

Holiday Sales Since 1993 (YOY % Change in Nominal Retail Sales)



Note: Holiday sales consist of GAFO category sales plus online and other non-store sales.

Source: U.S. Census Bureau and FTI Analysis

Our forecast model projects a 5.2% increase in discretionary holiday sales this season, which we measure from November through January. That would constitute a solid season in any historical context (**Exhibit 7**), but not quite a standout. What we know with greater certainty is that the outcome of this season — even if it's an exceedingly good one — won't much alter the fortunes or long-term prospects of struggling retailers that have lost their place in this landscape. We expect store closures and bankruptcies to remain at abnormally high levels in 2020, and Santa Claus can't do much to change that.

Happy Holidays!

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