SMARTER PERSPECTIVE: RETAIL INDUSTRY

Supply Chain Disruptions and Labor Shortages Further Intensify Pressure for Retailers as Holidays Approach

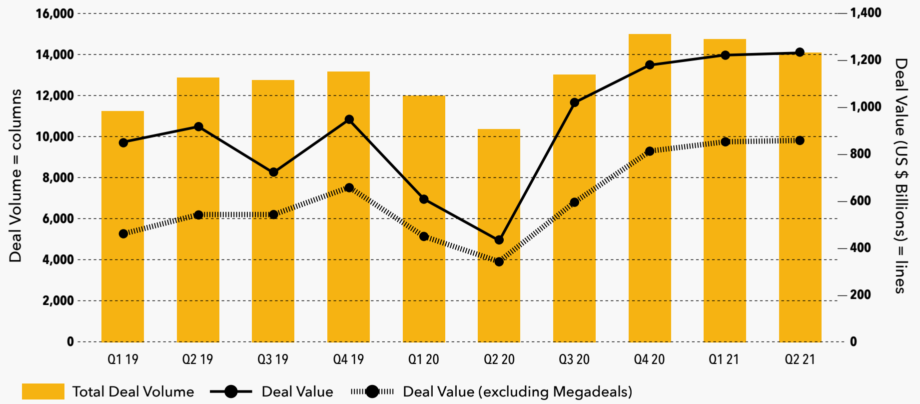
By Dominick Keefe and Tim Anderson

In this article, we take a look at the current state of the supply chain and the challenges it is causing for retailers as the lingering effects of COVID-19 are amplified ahead of the 2021 holiday shopping season.

COVID-19 has ravaged the global supply chain, magnifying its greatest inefficiencies. The problem first began when consumer demand recovered before factory workers could return to work. As factories and countries across the world were shut down, consumer spending shifted away from experiential purchases, like concerts, dinners, and vacations, and toward tangible products, like appliances, home goods, and vehicles. As a result, production could not keep up with demand. And, while many thought the spending shift would normalize during summer and fall, the widespread emergence of the Delta variant has caused the shift to persist, worsening the supply chain problem ahead of the 2021 holiday shopping season.

In a world where companies fiercely compete for access to the same factories, raw materials, and shipping slots, and as inflationary pressures increase costs rapidly, large players are better positioned than their smaller counterparts. This has created a situation where many companies are scrambling to find a way to improve their status in the eyes of vendors, including prepaying for orders, placing larger orders, and, in some cases, accelerating payments. While this strategy comes with some risks, like procurement cash flow issues or getting stuck with a significant amount of unproductive, aging inventory, most companies have implemented it to their benefit. Inherently, larger companies with grander scale, purchasing power, and positive vendor relationships have an advantage when it comes to maintaining their elevated priority status. As a result, we have seen a significant increase in M&A activity as companies and private equity firms have recognized the benefit of purchasing other players to increase their scale and improve their position. However, even if a company manages to find its way to the front of the line, manufacturing is only one part of the complex supply chain problem. Once

Global Deal Volumes and Values



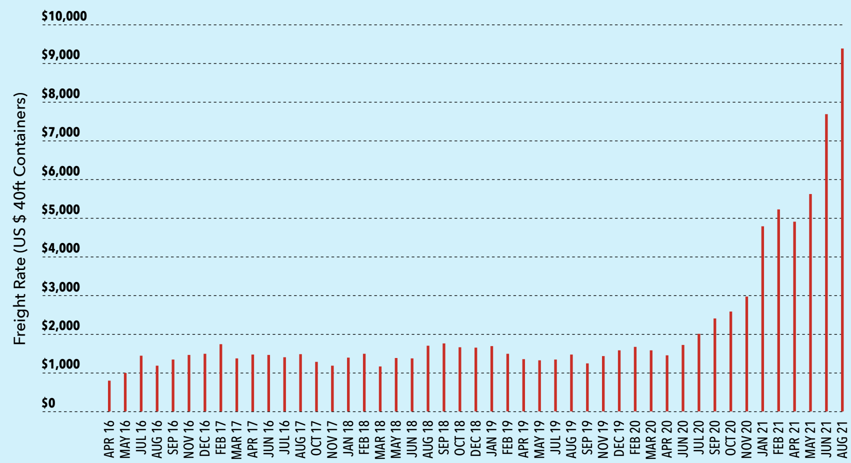
Source: Refinitiv, Dealogic and PwC analysis

Retail acquisition activity, aimed at generating scale and advantage, has notably increased over the past 12-month period.

products are made, retailers still need to get them to customers.

Before the pandemic began, it was rare to see a single ship anchored outside of a port. Now, there are dozens of fully laden cargo ships scattered across the world, sitting idly outside nearly every major port. As this article is being written, speculation continues to brew as to whether an anchor from one or more of those vessels damaged a critical oil pipeline that then leaked hundreds of thousands of gallons of oil near Huntington Beach. With hundreds of ships like these sitting idly around the world, the effective utilization level of fleets has been significantly diminished. As a result, these anchored ships are providing no value to the system that could desperately use them.

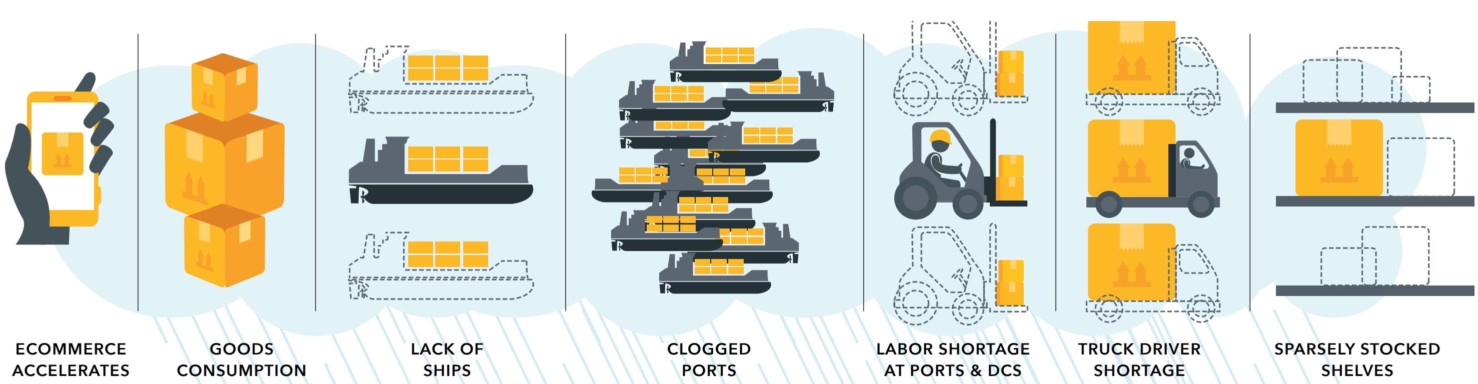
A Weighted Freight Rate Assessment of Eight Major East-West Trades



Sources: Drewry Supply Chain Advisors

When containers do finally land at ports, the unloading process has been taking far longer than usual. As a consequence of the spending shift, the sheer volume of imports alone would strain the system, but the problem is further amplified due to ongoing labor shortages. In the beginning, the staffing shortage was caused by COVID-19 driven closures and ensuing layoffs. Now, the situation is worse and further complicated by the difficulties these facilities are experiencing in luring employees back to work or hiring replacements for those who took jobs elsewhere. The result is higher overall costs from wage inflation and slower processing rates. This scenario is playing out at ports across the globe with widespread implications, including a shortage of pallets, which further complicates the logistics of transporting and warehousing retail inventory. To make matters worse, similar factors are also impacting the domestic trucking industry.

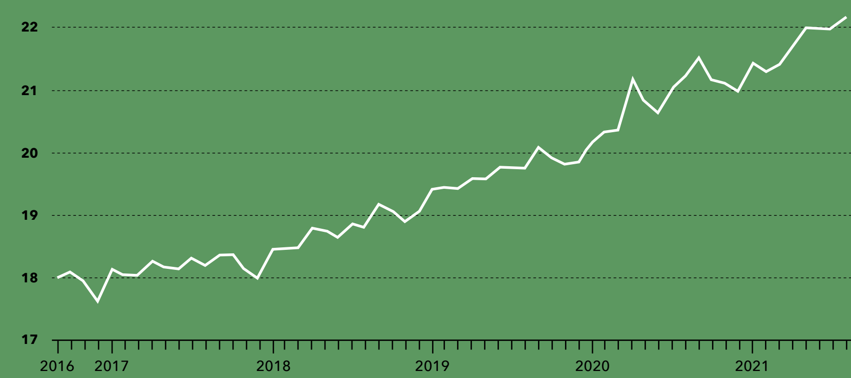
While the shipping industry's troubles primarily stem from a shortage of available ships, containers slots, and port capacity to handle the unprecedented volume, the trucking industry's issues center mostly around a shortage of qualified drivers, even though an ample supply of trucks, themselves, exists. This is particularly problematic considering that some 70% of all freight delivered in the U.S. is carried by truck at some point during its journey. As a result, trucking costs and transit times have increased by 3 to 5 times since the pandemic began.
With factories overseas still behind on production, more and more retailers continue to miss their allocated shipping slots. This results in more delays in ports and domestic distribution centers, making it nearly impossible for retailers to absorb their inventory when it arrives, both because there is not enough space and, as referenced earlier, manpower to process it all. As a result, containers transported by both ships and trucks are sitting idle for a week or more, rather than just a few days, as was the case prior to the pandemic.
According to the Bureau of Labor Statistics and Financial Times, the number of unfilled retail jobs in the U.S. spiked from about 750,000 before COVID-19 to 1.1M this July, leaving employers racing to staff up for the holiday season; the critical few months during which most chains achieve a disproportionate share of their annual sales. Not only is labor in short supply, but it is also more expensive than ever. Entry level jobs are being offered at $15+/hour and many retailers are also



Shortages down the various links of the supply chain continue to amplify the extended timeframes associated with the delivery of retail goods during the pandemic.

US Retail Wages Have Climbed Through the Pandemic

Average hourly earnings ($)



Source: US Bureau of Labor Statistics

offering incentives like signing bonuses, referral bonuses, immediate hiring, gym memberships, mental health benefits, tuition reimbursement and more. While costly, most large companies have big enough margins to absorb these costs without an issue. Smaller companies, on the other hand, often cannot afford to compete.

In addition to the labor shortage, many companies have also experienced material fill rate challenges, resulting in lost sales. More nimble organizations with the ability to pivot and quickly adapt their supply chain have demonstrated resiliency in getting the right product mix into their stores. Specifically, companies that quickly diversified their vendor base across different countries in anticipation of increased taxes/tariffs on goods sourced from China have been able to mitigate against localized lockdowns, allowing them to continue production when others could not.

Similarly, organizations with deep pockets have been able to pay extra to air freight goods in, or secure other priority transport services that deliver the supply they require in a timelier manner. For example, Walmart, The Home Depot, Costco and Dollar Tree, among others, have chosen to charter their own, smaller cargo ships. While almost double the price of standard ocean cargo, this strategy has not only provided these companies with dedicated space to transport their goods at a moment's notice, but has also enabled their entry to smaller ports, thereby bypassing significant congestion and delays. The increase in cost is justifiable for these companies because it is essential to have the right mix and depth of product on hand for the appropriate selling season. Those that don't have the leverage with their suppliers and/or ability to navigate the global supply chain issues, will surely lose business and share to competitors that do.

While margins were significantly challenged with the forced sell-off of goods earlier in the pandemic, the opposite is now true. Margins have generally increased as a result of higher prices and a shift in the demand curve. There is no guarantee, however, that these beefier margins will last in perpetuity, especially as costs continue to increase. For this reason, lenders should have a close eye on margins and inventory levels, in addition to the percentage of aged inventory on hand, as they all have a notable impact on recoveries.

This year's holiday seasons should be frothy as consumers are expected to continue their discretionary spending spree, even though the Personal Saving Rate is much lower today than earlier in the pandemic. As a result, companies with advanced analytics delivering more targeted and tailored digital advertising strategies should be better positioned to take advantage of current market conditions, ultimately capturing more sales. However, it is worth noting that consumer willingness to pay may not hold beyond the holiday season, as the cost of goods and pressure to maintain margin continue to increase prices.

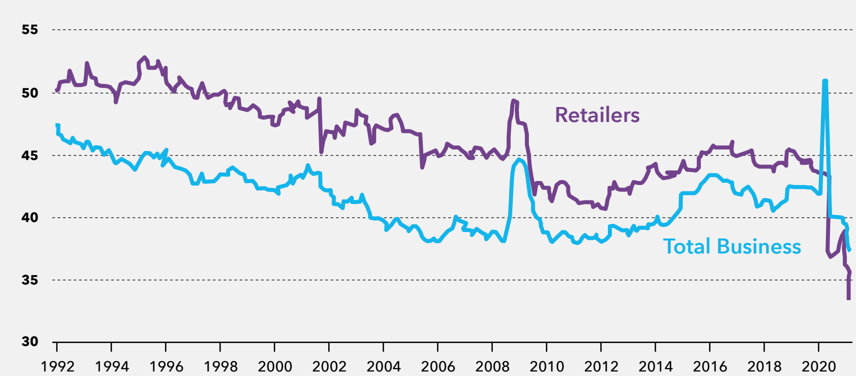
Conclusions

As the future remains uncertain, both the buying and supply chain optimization decisions that retailers are making today are perhaps more critical than ever before. Maintaining the appropriate inventory mix at the right time and delivering a quality customer experience are among the top challenges all retailers face. The ones that meet demand and bring the right products to market alongside a targeted advertising spend can succeed during most economic conditions.

With this in mind, Hilco often procures inventory on behalf of retailers,

Businesses Have Little Inventory to Sell

Inventor-to-sales ration (days of sales in inventory)



Sources: U.S. Census Bureau, CEA Calculations assuming all risk of ownership and eliminating any impact to the existing capital structure or the ABL borrowing base. Furthermore, Hilco's relationships and ability to buy in bulk enable us to negotiate with vendors and obtain discounts that most retailers simply cannot achieve. We can also greatly assist in overcoming labor shortage-driven issues at the retail level. Our team of highly capable and experienced retail experts can be deployed to help unload and unbox shipments or supervise entire internal teams. No task is too trivial or arduous.

Optimizing the buying process is an essential but complex undertaking, particularly during periods of uncertainty. Beyond advertising, advanced, algorithmic predictive analytics are also used widely across the industry to inform buying decisions based on trends. The trouble with the current environment is that there is no "like" period in modern history upon which to base a trend. Therefore, it is critical to find the right balance of what and how much to buy in the absence of that information. In our experience, we have seen that most retailers' buying teams have difficulty balancing the right inventory mix and amount during unprecedented periods. With this in mind, if retailers struggle to get the right holiday goods stocked or restocked on time, Hilco can quickly assist to monetize any unwanted inventory via strategies designed to deliver maximum value without conflict.

Given these and other factors, Hilco urges retailers and lenders to anticipate the need for inventory appraisals three times throughout 2022, and likely beyond. With inflationary impacts and numerous other pandemic-driven factors likely to be with us for the foreseeable future, it is essential to closely monitor inventory levels, mix and associated buying behavior. We encourage you to reach out to us to discuss any of the topics covered in this article and how they may pertain to your business or a business in your portfolio during this complex period for the retail industry. We are here to help.

Over the last 30 years, Hilco Global has built one of the most successful and comprehensive retail practices in the global marketplace, focused on servicing the needs of retailers from strategy to execution. Hilco's reputation for excellence is driven by the delivery of unique and customized solutions, including (i) the most accurate valuation analysis and expertise (ii) the most extensive toolbox of monetization strategies to help retailers maximize asset values and (iii) a highly experienced and proven retail advisory/consultative practice that covers consumer and wholesale inventory, store operations, real estate, management services and profit performance enhancement strategies.

DOMINICK KEEFE IS VICE PRESIDENT AT HILCO MERCHANT RESOURCES

Dominick originally joined Hilco in 2016 as part of Hilco Real Estate's lease restructuring advisory team. From 2016 to 2020, Dominick and the team negotiated thousands of leases resulting in hundreds of millions of dollars in cost savings for Hilco's clients and their constituents. Thereafter, Dominick moved within the organization to Hilco Merchant Resources to primarily focus on business development and certain strategic growth initiatives across the company's global retail platform, including Hilco's hedge fund, ReStore Capital.

Since joining Hilco Merchant Resources, Dominick has played an integral role in originating new business opportunities and structuring numerous transactions that have maximized asset recovery values for Hilco's clients. Additionally, as the result of a recent strategic initiative, Dominick helped co-found, launch and develop CareerFlex, a technology-enabled platform connecting displaced retail employees with new job opportunities.

Dominick holds a BBA from the University of San Diego and is an active member of the Turnaround Management Association (TMA), Secured Finance Network (SFNet), and Association for Corporate Growth (ACG).

TIM ANDERSON IS EXECUTIVE VICE PRESIDENT AT HILCO VALUATION SERVICES

Tim joined Hilco Valuation Services in 2001. He has conducted and managed thousands of appraisals on behalf of lending institutions worldwide. These valuations are comprised of retail, wholesale and industrial operations in most key markets. Tim's tenure at Hilco provides a diversified background to assist these institutions in recognizing collateral value and potential exit strategies for their portfolio companies.

Tim currently oversees consumer and retail appraisal operations. He is responsible for the overall vertical growth while ensuring the delivery of high quality, dependable services to clients. Tim also specializes in developing and enhancing client relationships for the New England region.

Prior to joining Hilco, Tim worked with GE Plastics, where he was a graduate of the GE Financial Management Program. Tim holds a bachelor's degree in finance and Accounting from the University of Massachusetts, Amherst, MA.