SMARTER PERSPECTIVE: RETAIL INDUSTRY

Consumer Demand and Supply Chain Promise Tempered by Rates, Banking Collapses and Debt Ceiling Gridlock

By Ian Fredericks

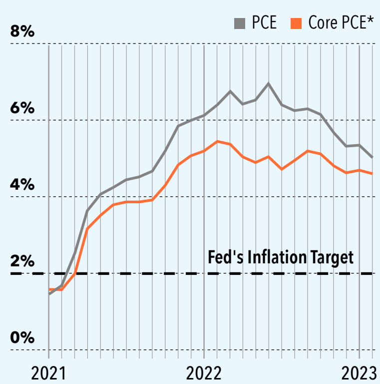
This article discusses developments in the retail market during Q1 2023 and toplines expectations for the months ahead.

CONSUMER DEMAND

Consumer demand appears to be on the upswing. While Q1 data is not available as of this report's issuance, U.S. consumer spending posted its biggest gain in nearly two years in January 2023, increasing by 2%. This was the largest increase seen since March of 2021. Strong gains were seen across manufactured goods such as cars and motorcycles, household furnishings and equipment, recreational goods and vehicles, and clothing. Goods outlays rebounded by 2.8% and services by 1.3%. This was accompanied by new home sales increases of 7.2%. A 0.9% wages and salaries jump and an 8.7% cost of living adjustment for more than 65 million Social Security recipients were among factors that, no doubt, contributed to this growth. In February, spending rose more modestly at a seasonally adjusted rate of 0.2%. When end of quarter figures become available, we can expect to see some impact from the banking crisis that emerged in early March.

Personal-consumption Expenditures Price Index

Change from year earlier



** Excluding food and energy.*
Note: Seasonally adjusted.

Source: Commerce Department via St. Louis Fed

SUPPLY CHAIN

Supply chain constraints have eased. Container costs have retreated to levels much closer to – but still above – historical norms and ports have resumed a more typical level of activity, alleviating the rows of highly stacked containers and congested harbors filled with container ships that we all saw on the evening news for quite a while.

There is still, however, some remaining headwind. Last-mile delivery costs remain high. While some of that is a factor of inflation and input costs, some reflects steps by carriers such as UPS and FedEx to raise their rates and layer on various surcharges that many have argued are unwarranted now that the impacts of COVID have eased.

Additionally, while the government settled the labor dispute with the railroads, port worker labor disputes remain largely unresolved. Without a resolution, and given that the Teamsters will be advocating on behalf of UPS workers, whose contract is up this coming summer, a broader supply chain recovery could remain hindered for some time to come.

Next, we need to consider the impact of the war in Ukraine and the potential challenges that a prolonged conflict there will have on the supply chain. There is a possibility of naval blockades occurring, as the EU and the U.S. seek to restrict the transport of Russian oil where possible. And we have already seen production and export of Ukrainian crops, including corn and wheat, to nations dependent on those staples, disrupted by the war.

On a more positive note, we are seeing more manufacturing coming back to the United States, especially in the southeast and some other areas. Much like Toyota and BMW which have moved manufacturing for some key segments to the United States over time, in part due to demographic shifts in Japan and Germany, the goal now is to bring production closer to the end-user/ consumer. This is indicative of a broader overall shift taking place toward more near-shoring and onshoring, fueled in large part by the short- and long-term impacts of the COVID pandemic.

Lenders that will likely be in the best position to pull the right levers and assist their retail borrowers in achieving greater liquidity during this period are those that 1) thoroughly understand the innerworkings of their portfolio businesses; 2) discern between inventory in transit on the water and inventory in transit within North America or domestically, and 3) surgically establish a borrowing base accordingly.

INFLATION AND THE BANKING CRISIS

The Federal Reserve is engaged in an interesting and somewhat unexpected balancing act. To combat inflation, the Fed has one meaningful tool at its disposal – increasing interest rates, which it did once again by 25 basis points at its most recent meeting on March 22 of this year and I expect will occur again at its next meeting.

At the same time, rising interest rates are unexpected contributors to some of the problems in banking. Because of those rising rates, Silicon Valley Bank, Signature Bank, First Republic Bank and others have found themselves with treasuries that have a below par value. This has resulted in depositors getting worried and withdrawing funds, which means selling more assets/treasuries at losses, etc. And so the vicious cycle begins.

Curiously, as the Fed raises rates to combat inflation, it also makes more treasuries worth less, which in turn makes depositors pull more money. With all of this in mind, it will be interesting to see which takes priority, inflation or bank stability. The likelihood, as I see it, is that the Fed will choose the latter. As a result, inflation will likely persist longer.

DEBT CEILING GRIDLOCK

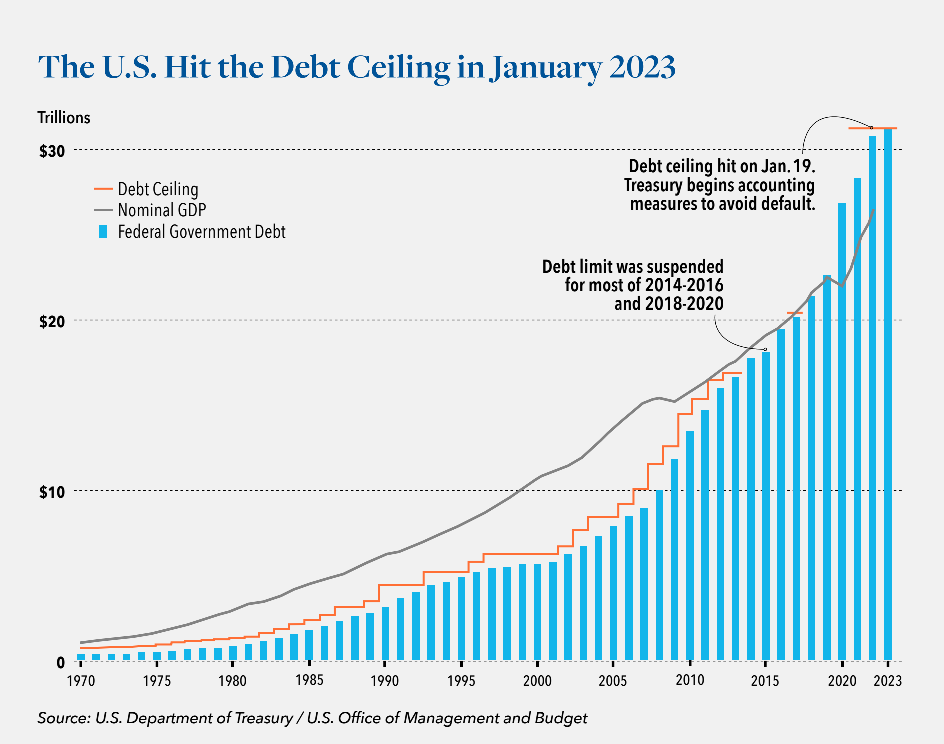
Although the U.S. hit its debt limit of $31.4 trillion back in January, the Treasury enacted "extraordinary measures" to ensure that its bills would continue to be paid. Those measures are expected to reach exhaustion sometime early or mid-summer of this year. Yet, as of March 28, House Speaker McCarthy reported that no progress had been made in debt ceiling negotiations, with House Republicans holding firm and refusing to take steps to lift the ceiling in the absence of reassurances on spending cuts.

As a result, the U.S. continues to risk default, which could result in a range of unpleasant and detrimental outcomes ranging from frozen Federal benefits to a true recession with substantial job cuts and continued high (or even higher) borrowing costs. Individually and collectively, these occurrences can be expected to dramatically impact retail operators and suppliers as well as a host of other industries and sectors.

PERSPECTIVE

As we consider the challenges that face those across the retail industry in the current environment, it is worth pointing to actions taken by home goods retailer Tuesday Morning since the start of this year. After announcing its filing for Chapter 11 bankruptcy in mid-February, in mid-March the company revealed that it had initiated steps to close some 263 stores across 38 states during 2023.

Company officials explained that the filing would enable it to reduce its



When the U.S. reached the debt ceiling on Jan. 19th of this year, Treasury Secretary Janet Yellen instituted "Special Measures," indicating that the government would only be able to pay its bills through early June without increasing the limit.

outstanding liabilities, obtain significant and necessary capital, and ultimately transform into a more nimble retailer. They also indicated that the store closures would enable them to focus all of their energy on higher-traffic locations and ultimately emerge as profitable after the 263 locations are auctioned off.

In our 2022 year-end report, we suggested a series of tough decisions and associated steps that retailers should undertake given our outlook for the coming year. These fell into five categories:

- Refocusing on your customer
- Treating e-commerce as "just one more store"
- Shoring up liquidity
- Conducting SKU rationalizations
- Putting tech in the hands of store team leaders

The predicament Tuesday Morning finds itself in is not a new one. And I say that not simply because we have seen others before them. Rather, I say that because Tuesday Morning, itself, has previously filed for bankruptcy as recently as Q1 of 2021 and subsequently closed hundreds of stores.

The hope of course is that after auctioning off its ~200 locations under bankruptcy protection, it will emerge as a profitable and cash generating entity once again. But I can't help but wonder whether things would have been different if the company had acted sooner.

No one has a crystal ball, but one isn't needed to know that the balance of 2023 is going to be challenging for many across retail. At the risk of sounding somewhat like a broken record, we continue to urge those across retail and their lenders to remain closely engaged and proactively make tough decisions and strategic investments now, rather than reactively in a disadvantaged state at a later date.

We'll build on the thoughts presented here and provide more details on tackling these and other tough challenges currently facing operators in our next Perspectives article. In the meantime, if your operation or retailers in your portfolio of companies are facing tough challenges and decisions as we enter the second quarter, we encourage you to reach out to our team at Hilco for a discussion. We are here to help.

The Hilco Retail Group offers broad and deep expertise in all retail sectors. Our seasoned professionals deliver a wide range of analytical, advisory, asset monetization, and capital investment solutions to help define and execute client strategic initiatives.

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