

2018

U.S. Holiday Retail Forecast

This Holiday Cheer Could Be A Last Hurrah



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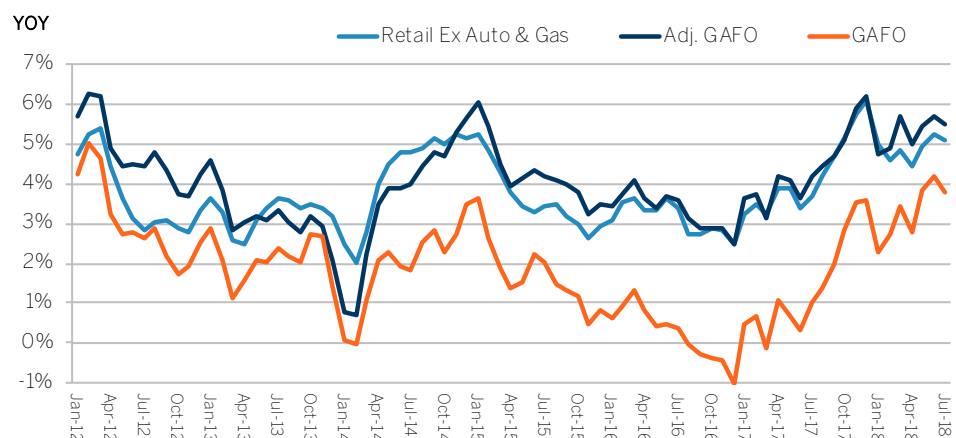
After 60 years as a familiar fixture in the retail landscape, Toys “R” Us will be conspicuously absent from the scene this holiday season. Commentators and shoppers may lament its demise but the void it leaves won’t cause any children to awaken to disappointment come Christmas morning.

Those many billions in sales will not leave the retail ecosystem: others will divide that haul. Such is the fluid, mutable and disrupted state of retailing in 2018. If we’ve learned anything about retailing in the last decade or so, it’s that nobody is too big to be threatened by the digital transformation that is still rippling across the sector. In fact, several notable retail chains that have failed and disappeared altogether over the last decade were not also-rans; some were once big kahunas themselves, with Toys “R” Us perhaps the most prominent example of a once dominant retailer that has bitten the dust. In contrast, Sears and Kmart haven’t been dominant in decades and their parent company, Sears Holding, finally ran out of time and money, putting an end to a painfully slow death spectacle. Other casualties are coming in 2019, and we all know the names on that short list.

As we enter the 2018 holiday season, there are 21 publicly owned retailers with market valuations-to-sales of less than 20%, an exceedingly low relative market value. Furthermore, 9 of these 21 had a market cap-to-sales of less than 10%, an indication of deep distress coming from investors. There are also several private equity-owned retailers on the ropes as well. Some of these names will file for bankruptcy in 2019—and a few of them may disappear entirely. No degree of over-performance this holiday season will alter that trajectory.

EXHIBIT 1

U.S. Retail Sales Growth



Note: GAFO is a proxy for store-based discretionary retail sales. Adjusted GAFO includes online sales as well.

Source: U.S. Census Bureau

Nonetheless there is a distinct whiff of optimism in the air coming from the retail sector recently, even as this harsh dynamic continues to play out. Consumer spending has picked up nicely this year, but for the severely disrupted it is too little and too late.

There has been a reprieve for retailers in 2018 that has breathed life back into market valuations for the sector and caused depressed expectations to be upwardly revised. Major retail executives are speaking publicly with a degree of optimism for the first time in quite a while as consumers are spending again with some vigor. Retail sales growth has accelerated since mid- to late-2017 and now resembles what was once considered a normal spending rebound during periods of economic expansion. We’re now

seeing nominal retail sales growth (YOY) of 5%-6% compared to 3%-4% for much of 2015-2017 (**Exhibit 1**). Most encouraging, much of this improvement is occurring in-store as online sales continue to grow at a steady mid-teen rate, as they have for several years. Yes, store-based sales have staged a comeback of sorts this year, with total in-store sales gains moving to a range of 2%-4% compared to negligible growth prior to 2017. It’s reasonable to surmise that continued job gains and the personal tax cut provisions of the Tax Cuts and Jobs Act of 2017 have put some extra money back in the hands of most Americans, which likely has contributed to the uptick in spending across much of the retail sector. Heck, a bump in consumer spending is the least we should get from a tax

reform bill that's helping to blow up the federal budget deficit.

Let's give this spending rebound some context. It's a \$75 billion boost in a \$4 trillion U.S. retail sector, certainly a nice uptick in discretionary consumption but it doesn't represent a new paradigm or a "turn the page" moment for a challenged retail sector, nor will it be sufficient to rescue those chains on deathwatch. It's also a reminder that the challenges confronting the U.S. retail sector prior to 2018 were manifold: persistently weak top-line sales growth, a notable redistribution of sales and market shares due to digital disruption, and sector-wide margin compression caused by fierce competition to retain or take market share. The relief experienced to date only represents an improvement in sales growth, but it has been sufficient to redirect some of the conversation around retail away from the dreadful "apocalypse" narrative. Some retail executives are downright upbeat, with Target CEO Brian Cornell recently calling the consumer spending environment, "... perhaps the strongest I've seen in my career." (Not many have shared that sentiment.) Unfortunately, this rising tide won't lift all boats. However, it will very likely make for a prosperous holiday season from a top-line perspective.

CONSUMER CONFIDENCE IS SKY-HIGH BUT IS IT WARRANTED?

Consumer confidence is a sentiment reading that's informed by a mosaic of perceptions, anecdotal evidence and personal experiences of respondents. We pay close attention to consumer sentiment because over long stretches of time it is highly correlated with discretionary consumer spending. (**Exhibit 2**)

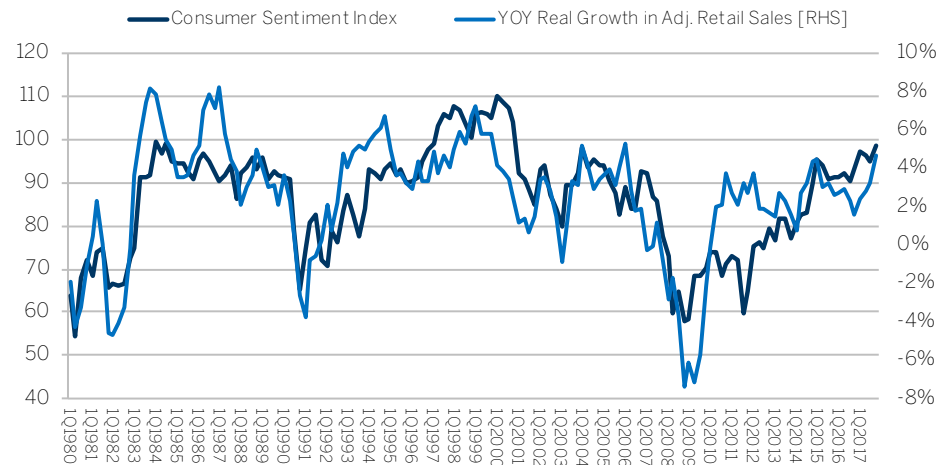
One cannot say that consumer confidence is too high or too low. It's a collective opinion, after all. However, the last time consumers were feeling this good was back in the late 1990s, when their personal financial conditions were, on balance, considerably stronger than today.

It's no secret that consumers are feeling decidedly upbeat these days. The two preeminent gauges

of consumer confidence, The Conference Board's Consumer Confidence Index and the University of Michigan's Index of Consumer Sentiment (**Exhibit 3**), are near their best levels in nearly two decades. In fact, consumers are feeling quite positive about their current finances and the economy generally (Current Conditions Index) as well as in the next 6-12 months (Consumer Expectations Index).

EXHIBIT 2

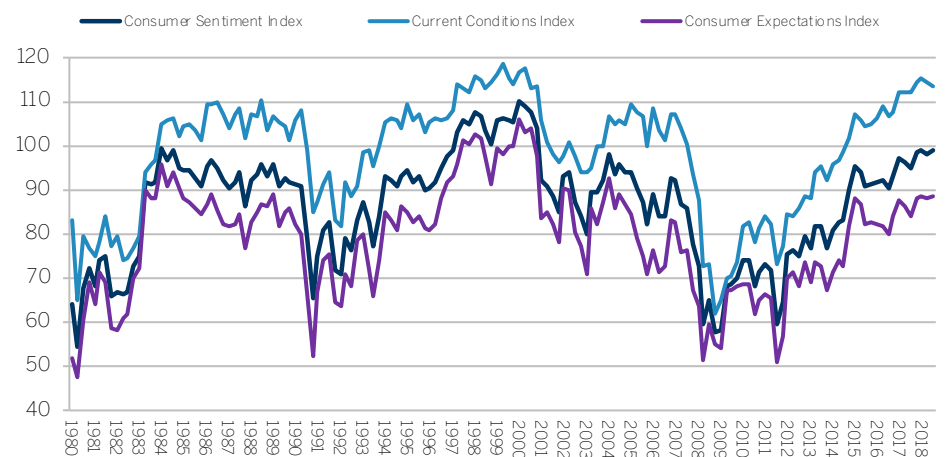
Consumer Sentiment Index vs. Retail Sales Growth



Source: University of Michigan's Survey of Consumers

EXHIBIT 3

Index of Consumer Sentiment



Source: University of Michigan's Survey of Consumers

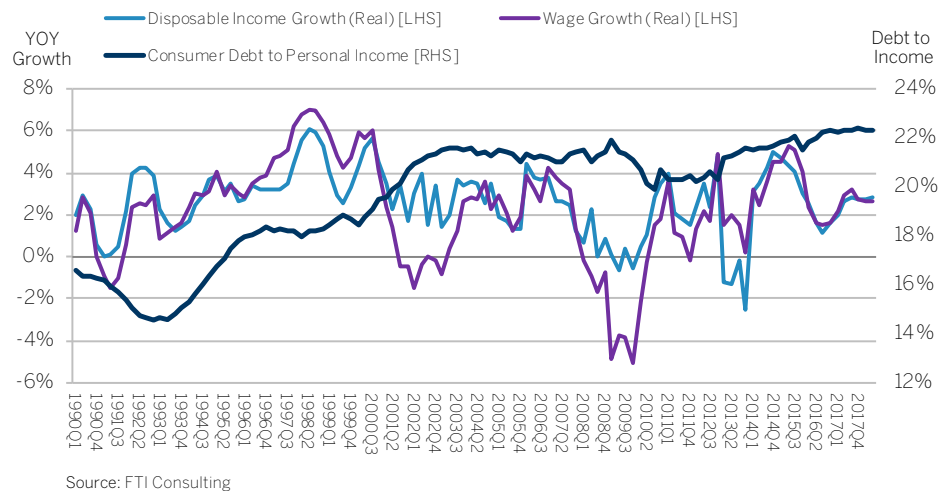
Certainly the backdrop for consumers' finances and economic prospects has improved in the last couple of years, but is such strong optimism misplaced? Comparisons of the current financial condition of U.S. consumers to the late 1990s **(Exhibit 4)**, when confidence was last at these levels, reveals the degree to which the finances of Americans are worse off today compared to 20 years ago. So why are they feeling so good? Many adults under the age of 35 have only experienced challenging economic conditions in their working lifetimes, so the recent upturn must seem nearly euphoric to them. Moreover, respondents expect this economic momentum will continue—though the history of consumer confidence indicates otherwise.

As for consumers' financial condition, personal income and wage growth are considerably weaker and relative levels of consumer debt are much higher today than in 1998-1999. Real growth in total wages during the late nineties was nearly double the current rate of 2.6%. Corporate productivity soared in the late nineties—much of it technology-driven—and workers initially shared in that prosperity in the form of healthy wage gains. That is not the case today and meager wage growth remains an oft mentioned impediment to stronger personal consumption. It is too soon to know if a fair share of the profit boost resulting from corporate tax cuts in the Tax Cuts and Jobs Act of 2017 will make its way into workers' regular salaries, though early indications are not encouraging.

Consumer installment debt (which mostly consists of credit card debt, auto loans and student loans but excludes home mortgage debt) has been increasing at a rapid clip of

EXHIBIT 4

Income Growth & Consumer Debt-to-Income



approximately 5.5% annually since 2013—well in excess of income gains—and is poised to top \$4 trillion by mid-2019. Just for context, that works out to an average of nearly \$33,000 per household excluding mortgage debt. Relative levels of consumer debt are trending higher after having contracted for the first time during the 2009 recession **(Exhibit 4)**. This could be viewed favorably as an indication that consumers are feeling confident enough to step up their borrowing. However, our preferred metric, Consumer Installment Debt / Total Personal Income, has now surpassed its levels of the mid-2000s and has blown past its readings of the late 1990s—representing an additional \$6,000 of debt per average household compared to 1998. Let's hope consumers' optimism is not misguided, because they have left themselves financially vulnerable in the event of an economic downturn.

From a historical economic perspective, it would be hard to characterize these days as the best of times for most Americans. However, respondents to both these index surveys would indicate this is nearly so, with both confidence gauges near

their all-time highs. History says it won't last—both these indexes of consumer confidence previously have topped out near current levels. The Index of Consumer Sentiment has been above a reading of 100 in just 10% of all months since 1978. The three other times that consumer sentiment reached these lofty levels, particularly the current conditions component of the index, it preceded a recession. Just saying...

WE'RE STILL NOT "SPENDING ON STUFF" LIKE WE USED TO

The U.S. retail economy was also in better shape in the late nineties, as evidenced by persistently strong total annual spending growth of 6%-7% in that period—nearly all of which accrued to store-based chains. Amazon was still a puppy back then. In fact, those were the glory days of traditional retailing.

It's often said that consumers today aren't spending as much on "stuff" as they used to, and there is persuasive support for that claim. Discretionary retail sales relative to total personal income—a convenient metric to measure relative spending on discretionary goods—has been declining since 2006 (**Exhibit 5**).

This decline occurred in two distinct phases: from 2006 to 2008 when energy prices spiked and the housing bubble began to pop, and from 2009 to 2012 during the recession and its aftermath. Inexplicably, this metric has not improved since the current recovery took hold and has languished by nearly two percentage points below its pre-2005 levels. This may not sound like a lot, but it represents some \$250 billion of reduced spending on discretionary goods, or 6.5% of retail sales, which is sizeable. Stated alternatively, discretionary retail sales in the aggregate would be nearly 7% higher today if consumers had continued to spend on goods at the levels they did back in the late nineties. It's no wonder why for most retailers, nobody seems to be partying like it's 1999.

OUR 2018 HOLIDAY FORECAST

Discretionary retail sales growth to date in 2018 has been a pleasant surprise, and we must emphasize that much of this increment appears to be occurring in-store. We hesitate to trumpet this news too loudly. Let's just say that, generally speaking, store-based shopping isn't dead or on life support, a theme that has dominated the retail narrative

since 2015. While foot-traffic figures for stores and shopping centers remain uninspiring, that trend doesn't preclude more robust spending per shopping trip. It's also likely that stepped up spending by less affluent consumers, who shop online less frequently than high income households, has contributed to stronger in-store sales since mid-2017.

It has been largely forgotten that last holiday season was a good one that exceeded most expectations

(**Exhibit 6**), so many retailers will be comping against some fairly strong prior year numbers this holiday season. Nonetheless we believe the ingredients are in place for another solid holiday season coming on the heels of a healthy back-to-school season. The mid-term elections are the only event on the near-term horizon that could alter Americans' perceptions of the economy and their prospects. Yes, there is even a politicized view about that: Bloomberg's Consumer Comfort Index is at an 18-year high

EXHIBIT 5

Retail Sales as a % of Total Personal Income



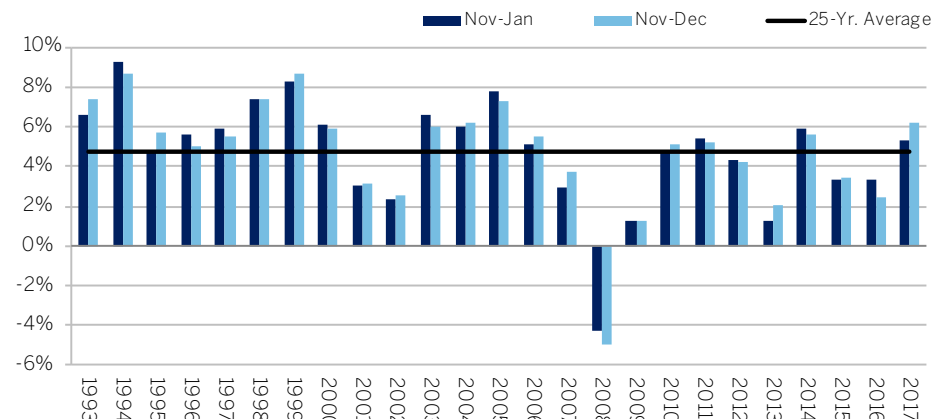
Note: Retail sales above exclude food, auto and gasoline

Source: FTI Consulting

EXHIBIT 6

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

We expect that discretionary retail sales—consisting of the GAFO store categories plus online—will increase by 5.8% this holiday season.

Approximately 60% of this increase will be store-driven while 40% will come from the online channel. Breaking out this growth forecast by channel, we expect total in-store sales will increase by 4% (YOY) while online sales will increase by 15.5% (YOY)—consistent with our 2018 U.S. Online Retail Forecast (*Online Shopping and Large Retailers: BFFs or Frenemies?*).

yet diverges sharply by political party affiliation. However, it's highly doubtful this would impact holiday spending intentions in 2018 regardless of the mid-term election's outcome.

The Amazon factor is a big asterisk next to these favorable prospects. We believe that the Amazon ecosystem (1P + 3P) is capturing nearly two-thirds of online retail sales growth. If that holds true this season, then Amazon alone would garner about 25% of the total increase in retail sales, which certainly mitigates the season's upside potential for traditional and omni-channel retailers.

There was a time when a strong holiday season could save the year for most large retailers and help to gloss over deficiencies in strategy or execution for the laggards. Indeed the rising tide of a strong season could lift all boats. Those days are gone. Today's retail environment is a more unforgiving place where most shoppers are highly price-conscious and convenience-driven, and the bulk of their spending is increasingly directed towards retailers that consistently meet those two priorities. It's just crumbs for the others.

Thanks to more robust consumer spending, the prospects for U.S. retailing as a whole are more encouraging this holiday season than they have been in several years—but these top-line gains will continue to disproportionately accrue to those who have already transformed their businesses to accommodate the myriad demands and high expectations of today's coddled shoppers.

Happy Holidays!

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