Special Analysis: 4Q Retail Update

March 22, 2023

KEY TAKEAWAYS:

- ***4Q sales mixed, but margins largely lower on increased input costs & promotions***
- ***High inflation continues to stress non-essential purchases***
- ***Inventory levels more balanced heading into 2023***
- ***Retailers being more conservative with inventory and capital***

	Comps	Sales Change	Δ Gross Margin (bps)	Inventory Change	Quarter-End Date
U.S.					
Walmart	8.8%	7.3%	-80	0.1%	1/31/23
Target	0.7%	1.3%	-200	-2.9%	1/28/23
BJ's Wholesale	8.7%	13.1%	10	10.9%	1/28/23
Costco	6.8%	6.5%	10	-2.5%	2/12/23
Dollar General	5.7%	17.9%	-40	20.4%	2/3/23
Best Buy	-9.3%	-10.0%	-20	-13.8%	1/28/23
Kohls	-6.6%	-7.2%	-1015	4.0%	1/28/23
Macy's	-2.7%	-4.6%	-240	-2.6%	1/28/23
Nordstrom	N/A	-4.1%	-530	-15.2%	1/28/23
Gap	-5.0%	-6.2%	-10	-20.8%	1/28/23
Urban Outfitters	3.0%	3.9%	-30	3.1%	1/31/23
Abercrombie	N/A	-0.4%	-260	-3.8%	1/28/23
Victoria Secret	-6.0%	-7.1%	-240	N.A.	1/28/23
TJX	4.0%	4.8%	-105	-2.4%	1/28/23
Ross	1.0%	3.9%	-14	-10.6%	1/28/23
Foot Locker	4.2%	-0.3%	-290	29.8%	1/28/23
Academy	-5.1%	-3.4%	50	9.5%	1/28/23
Dick's Sporing Goods	5.3%	7.3%	-515	23.2%	1/28/23
Home Depot	-0.3%	0.3%	10	12.8%	1/29/23
Lowes	-1.5%	5.2%	-60	5.3%	2/3/23
Kroger	6.2%	5.4%	-40	11.5%	1/28/23
Albertsons	7.9%	8.5%	-40	8.2%	12/3/22
Amazon	N/A	8.6%	280	5.4%	12/31/22
Wayfair	N/A	-4.6%	170	30.4%	12/31/22

Overview

Fourth quarter retail sales were largely mixed, while margins and profits were mostly lower. Inflation remained the key issue; driving top-line sales for some, with transactions broadly down, while higher input costs and retail prices curbed consumer demand, especially for more discretionary goods. Consumers shifting their spending back to travel and other services is also putting pressure on the sale of retail goods. Higher input costs and increased markdowns to clear out excess inventory, combined with higher shipping and shrink costs broadly pressured retail margins in 4Q. The risk of a recession has been with us for over a year now, but with labor markets still tight and consumer spending relatively resilient, it has yet to officially arrive. But with inflation still above 5% and real wages negative, it's arguable that half the population is already in a recession.

In this environment, mass merchants, dollar stores and other discount players benefitted, including **Walmart**, **Costco** and **Dollar General**, with comps up about 6% to 9%. On the other hand, department store and apparel retail sales were largely lower, except for the discount operators; **TJX** and **Ross** comps were up 4% and 1%, respectively. Even the more resilient luxury brands are starting to see sales stall; **Macy's** comps fell nearly 3% with the Bloomingdales banner essentially flat. Electronics has been one of the biggest underperformers in recent months, highlighted by **Best Buy's** 9.3% drop in 4Q comps. Pandemic's winners such as home goods and home improvement are seeing their sales fall, and are likely to remain stressed, especially for big-ticket items that saw a pull forward in demand and don't need to be replaced.

Online spending trends have normalized, after correcting from the steep growth in 2020 and 2021 and are expected to continue to outpace growth for the rest of retail. However, we are seeing the effects of the larger economic headwinds. The online cost to acquire new customers and fulfillment has made profitability more elusive. Now with demand falling, these companies could be at more risk, especially as many have realized the importance of investing in a brick-and-mortar presence. **Amazon's** retail profits were challenged in 2022, and the Company is reacting by slashing labor and distribution centers, as well as closing a number of ineffective retail concepts, while still trying to figure out how to crack the grocery business.

After a surprise increase in January U.S. retail sales, February saw consumers pullback spending across most categories except essentials, with apparel and department stores seeing outsized losses. As companies focus on rightsizing inventory positions entering 2023, there is less demand from retailers for goods in 1H23. To preserve capital, many retailers are also slashing budgets for labor, marketing and growth. While we believe this will alleviate short-term cash flow problems for a quarter or two, it is not a long-term strategy and could be particularly detrimental to many online retailers who require the strong top-line growth to build scale and leverage their higher marketing and fulfillment costs.

As consumers become increasingly value focused, mass merchants, dollar stores and other discount players should continue to outperform. Many consumers are also turning to private labels and searching out cheaper alternatives. As a result, it's not surprising to see increased interest in the resale market, with companies from **Dick's Sporting Goods** to **Saks OFF Fifth** expanding partnerships. Assuming inflation trends improve, but still remain somewhat elevated, grocery too should continue see top-line growth, and if inflation trends ultimately moderate (2% to 4% range), margins could also benefit.

Sector Discussion

Mass Merchandisers posted broad gains in comps and sales but were not immune to margin erosion. Walmart comps improved 8.8%, with sales exceeding guidance during 4Q and FY22. Domestic sales gains reflected both increased traffic and ticket, as well as a higher mix of lower margin grocery sales, which contributed to gross margin falling 80 bps. Walmart said inflation in food categories was up mid-teens and anticipates higher inflation to linger through 2023. The Company ended the year with inventory levels flat, and indicated normalization of inventory was ahead of schedule. Competitor Target, which has a higher mix of discretionary goods, saw comps grow just 0.7%, while gross margin fell 300 bps as management aggressively marked down inventory to clear out overstocks; inventory was down 3% YOY. Target's management also called out higher shipping and shrink costs, which has increased broadly across retail. The Company said it will increase its value offering, including more private label brands.

Costco was one of the few retailers to report positive sales and margin growth in its most recent quarter (2Q). U.S. sales were driven by both stronger traffic and higher tickets, while the Company was able to right-size its inventory, which fell 2.5% YOY. As expected, the dollar stores continued to show solid growth. Dollar General's sales were up nearly 18%, reflecting 5.7% comps and store growth. However, store traffic saw a slight decline during 4Q, while management said all discretionary categories posted negative comps. The mix shift to lower margin consumables also hurt gross margin, down 40 bps.

The **Department Store** sector continued to see mixed or worse results as sales and margins eroded during 4Q. Macy's comps and gross margin were both lower, although it noted not as bad as expected as its efforts to clear inventory saw strong demand. Meanwhile, Nordstrom had less luck with sales down 4.1%, including a sharp 8.1% drop at the struggling Rack business. Kohl's continues to slip as its new management team attempts to find its footing going forward. Kohl's management is looking to rebalance its merchandising mix including more casual and work wear, while also tweaking its pricing and promotions. Sephora roll-outs continue, while Kohl's also looks to build its marketplace (Lands' End called out Kohl's as a key driver for growth of its 4Q third-party revenue in 4Q). While inventory levels were cleaner heading into 2023, we continue to think the economic headwinds will challenge the sector, and we are now even seeing cracks in the more resilient high-end players, including Saks and Neiman Marcus.

The **Apparel** sector saw mostly negative sales and lower margins from aggressive discounting taken to reduce inventory levels. Negative operating trends continue at The Gap with in-store and online sales down 3% and 10%, respectively. Sales fell 6% with comps down across all four banners (Old Navy, The Gap, Banana Republic and Athleta, were down 7%, 4%, 3% and 5%, respectively). Operating losses reached $30 million, but on a bright note, inventory was cut 20%. Weak sales are expected to continue in 1Q23.Urban Outfitters had mixed 4Q results with sales up 4% to a record $1.40 billion, but operating income down 30% due to aggressive markdowns at both the Urban Outfitters and Free People banners. Urban Outfitters comps were negative 10%, following a 9% decline in 3Q. Entering 2023, management expects better merchandise margin from "an improved inventory position". For Abercrombie & Fitch, the Abercrombie brand had positive momentum with sales up 14%, following a 10% increase in 3Q, while Hollister, which caters to a lower income group, reported a 4% sales decline. For 1Q23, consolidated sales are expected to be flat.

Discount Apparel companies performed well during the quarter as consumer preferences shifted towards value. TJX and Ross reported sales growth of 5% and 4%, respectively. Burlington lagged its peers for most of 2022, but its sales trend improved in 4Q with sales up 5.2%. Across all three off-price retailers (including Burlington), EBITDA margins remained stable. Given the plentiful inventory in the marketplace and a more value-oriented consumer, off-price retailers stand to reap the benefits in 2023.

Following a two-year reprieve from significant competition, the selling environment for **Electronics** has become increasingly promotional, to the point that it has normalized to pre-pandemic 2019 levels. Sales are down due to consumers curbing discretionary spending coupled with the pandemic's pull-forward of demand. Additionally, the natural upgrade and replacement cycle has now run its course, leading to a further hiatus in demand. This lack of control over sales and margins will make cost cutting a crucial tool in limiting downward pressure on profitability. Reflecting these trends, Best Buy's comps dropped 10%. However, it has effectively brought down its inventory levels.

Home Improvement retailers are feeling the pinch from a cash strapped consumer as Home Depot and Lowe's both reported slightly negative comps in 4Q, but more notable declines in traffic (both down around 6%); comps, at best, are expected to be roughly flat in FY23, as we expect a continued slowdown in new housing activity and pullback in residential remodel spending. Currently, over 90% of U.S. homeowners, either own their homes outright or have fixed rate mortgages under 5% and have little incentive to sell and take on a higher rate mortgage or home equity loan, curbing the appetite for remodels. Further, spending on home improvement continues to moderate following the extraordinary levels experienced during the pandemic. On a positive note, both retailers reported relative strength in professional sales, most likely fueled by a higher income consumer less impacted by inflation.

After the pandemic boosted sales perhaps more than any other sector, the **Sporting Goods** segment continues to normalize, as spending slows across the board. The questions is: how much of the gains can the retailers retain as pre-pandemic issues come back to roost including growth in manufacturers selling direct-to-consumers, and online competition? Sector leader Dick's continued to outperform in 4Q, and provided a fairly optimistic outlook for 2023, as it believes it will be able to retain much of its sales and margin gains. At the same time, it is ramping up store growth, including the more experimental House of Sports and the recently acquired Moosejaw outdoor concepts. Other retailers, including Academy and Sportsman's Warehouse, have ramped up growth. However, their outlook is more challenging than the sector leader Dick's, which has more effectively carved out a compelling niche. As a result, the rest of the sector is seeing sales and margins fall back to earth, including Academy, whose 4Q comps fell 5.1%. As we have been covering, more cyclical categories, like firearms, and soft goods are expected to see the most pressure going forward.

The **Grocery** sector remains a bright spot among retailers. Given the inflationary environment, we expect results to remain consistent, since consumers will cut down on discretionary spending in order to continue to put food on their tables. Albertsons' latest quarter saw comps up 7.9%. Meanwhile, Kroger continues to see growth in its private brand business, although its gross margin was also lower. Kroger's latest quarterly comp was up 6.2%, driven by the higher prices. Kroger management commented that the gap between food at home and food away from home spending grew during quarter, as more customers gravitated toward affordable meal solutions that restaurants are not able to provide. Looking ahead, we believe the sector will continue to benefit even as inflation falls, since price reductions for the consumer tend to lag declines in company procurement costs. A growing mix of private brand sales will also benefit margins.

Online retailers are also facing a challenged outlook. Most recently, Amazon reported mixed 4Q results as strong holiday sales were overshadowed by low operating profits and management pointing to a change of direction ahead as it focuses on cost controls in 2023. In addition to layoffs over recent months, the Company has closed a handful of Whole Foods stores, reduced service offerings like Amazon care, suspended development and even sublet a fair amount of distribution capacity and closed all 68 of its physical bookstores, pop up shops, and '4-star' stores. On these latter closures, management noted, "I think there were just some areas where we didn't have conviction that they were going to be big needle movers for Amazon."