

Commentary

Global 2024 Retailer Outlook: Pullback in Consumer Spending to Escalate Volume and Margin Pressure

Morningstar DBRS

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Key Highlights

- Our negative outlook acknowledges earnings pressure in the near term as lower consumer spending and value-focused buying exerts margin and volume pressure on retailers.
- Retailers that cater to basic consumer needs or offer value are generally in a better position to navigate this period of dwindling consumer confidence.
- Possibility of some rating changes, particularly for discretionary/smaller retailers with larger variable debt stack.

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2024 Outlook: Negative

Acknowledging considerable uncertainty around the macroeconomic setting, our negative 2024 outlook for the global retail sector reflects our view that consumer confidence and spending will continue to be constrained in the near term. We believe that compounded effects of inflation and aggressive interest rate hikes, which have not yet been fully felt, and depleted excess savings are likely to weigh on consumer confidence and spending, and negatively impact operating margins and volumes for retailers, even more so for discretionary retailers.

While consumer spending demonstrated some resiliency in 2023, benefitting from accumulated savings, relatively stronger consumer balance sheets, and a tight labour market during the year, we believe the aforementioned challenges could cause these mitigants to erode, posing a considerable challenge for the retail sector in 2024. That said, we note that we expect retailers to feel these effects to varying degrees, depending on where they are on the discretionary to nondiscretionary spectrum. Please note that we have published a separate outlook for our global portfolio of food retailers, [Global 2024 Food Retailer Outlook: Grocers Are Set to Weather Macroeconomic Challenges](#), on January 4, 2024.

Earnings Pressures Could Result in Credit Rating Changes

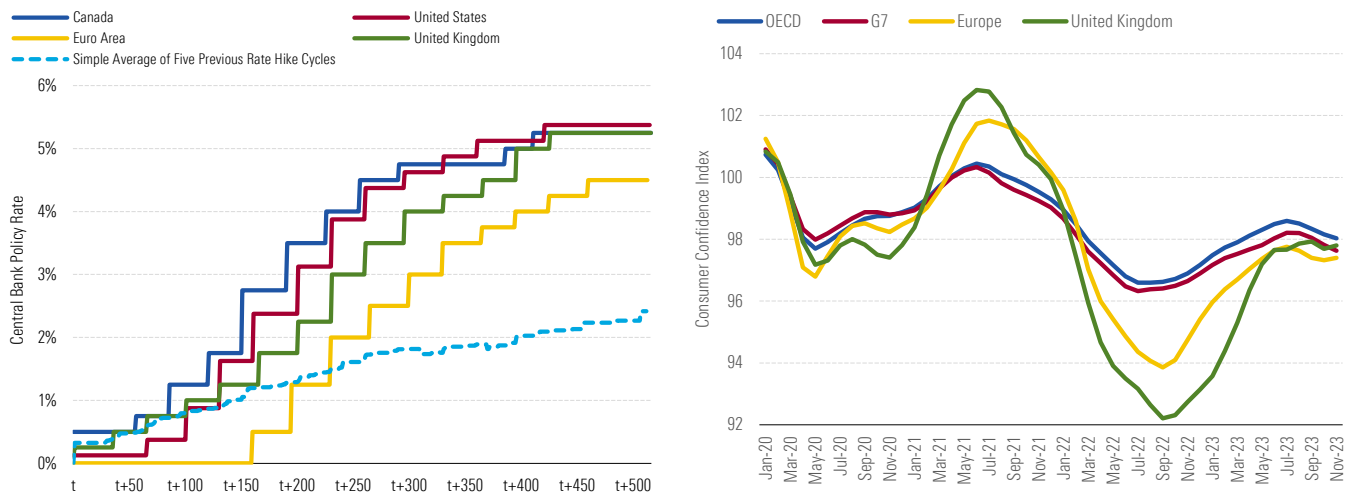
We believe aforementioned challenges around consumer spending are likely to pressure credit risk profile of some retailers in our portfolio, albeit to varying degrees, depending on an individual retailer's value proposition to customers and discretionary/nondiscretionary nature of the merchandise offering. At the same time, with shifts in spending patterns towards need-based and discounted merchandise, we believe that retailers further along the consumer staples end of the spectrum, or those such as dollar stores or large, big-box retailers, that offer value-based products and a wider range of merchandise, should continue to benefit from higher demand and an increased number of visits from price-sensitive customers.

While we expect the higher interest rate environment to weigh on consumer spending, as it relates to issuer's direct financing costs, it should not have a considerable effect on weighted-average interest expenses and coverage levels of most of the investment-grade issuers in our portfolio, given largely fixed rate debt maturity profiles that are relatively well spread out. General sector trends aside, weaker-than-expected operating performance on a case by case basis, because of relatively poor operational execution, loss in market share against the backdrop of an intensely competitive operating environment, and/or more aggressive financial management because of debt funded acquisitions or notably higher returns to shareholders, could continue to result in negative credit rating actions.

Uncertainty Around Consumer Spending Trends Remain Elevated

Despite stubbornly high inflationary pressures and aggressive interest rate increases (see Exhibit 1), consumer spending demonstrated some resiliency in 2023, benefitting from excess savings, relatively stronger consumer balance sheets and a tight labour market. However, with consumers' wages lagging inflation, depleted excess savings rates, and higher interest costs on car loans, mortgages, and credit card debts, consumer confidence remained subdued across geographies (see Exhibit 1) and we believe consumers will maintain a cautious approach with regards to their spending habits.

Exhibit 1 Central Bank Policy and Consumer Confidence Index



Source: Bank of Canada, Federal Reserve Bank of New York, Bank for International Settlements, Bundesbank, OECD, Morningstar DBRS.
 Note: For current cycle, t = December 15, 2021 (first Bank of England rate hike). Date count ends at t+516 and excludes weekends. Previous rate hike cycles for Bank of Canada: 1999, 2002, 2004, 2010, 2017; Federal Reserve: 1988, 1994, 1999, 2004, 2015; Bundesbank/ECB: 1979, 1988, 1999, 2005, 2011; Bank of England: 1994, 1996, 1999, 2003, 2006. Data as of Dec 7, 2023 for Canada; as of 6-Dec-2023 for US; as of Dec 4, 2023 for Euro Area; as of Dec 1, 2023 for UK.

As such, in light of a soft economic outlook (see our commentaries *2024 Sovereign Outlook: Higher Rates and Slowing Economies, but Stable Credit Ratings* and *Baseline Macroeconomic Scenarios for Rated Sovereigns: December 2023 Update*), we expect many of the trends related to strained consumer purchasing power observed in 2023 to persist, and likely escalate, in 2024. We believe consumers are likely to particularly reduce spending on high-ticket purchases, which are often purchased using credit, as well as nonessential categories, such as fashion, electronics, and home decor and continue to seek affordability and value. As inflationary pressure eases and possibly results in interest rate cuts later in the year, consumer sentiment is likely to improve and help mitigate some of the volume and margin pressures referred above.

Margin Pressures to Intensify

We forecast profitability for most to likely remain pressured as they continue to experience cost inflation, particularly on wages and transportation costs, amplified by operating against the backdrop of an intensely competitive operating environment. We believe margin pressures could be more severe for discretionary retail given their inability to fully pass on cost increases to consumers without material volume declines. Even if the nominal retail sales may be higher, in some of these cases, benefitting from

inflation-driven price increase, real sales growth could still be negative given a likely decline in volumes. At the same time we believe discount or value stores, which generally experience higher demand during weaker economic environments, could be more successful in offsetting inflation-driven cost increases through product refreshes and markups while also benefitting from operating leverage. Please refer to our commentary on discount stores for more details ([Price Check: Discount Grocery Stores Set to Largely Outperform Their Conventional Peers Worldwide in 2023](#))

Despite Cash Flow Pressures, Increased Focus on Technological Advancements

We forecast that the free cash flow generation for many retailers will be pressured amid declining profitability and higher interest costs. This is especially relevant for the smaller, non-investment-grade retailers in our global portfolio with large variable-rate debt burdens and already-strained credit metrics. Higher interest rates and inflated project costs could force these retailers to suspend capital projects, and overall be more diligent about their capital allocation priorities. That said, we expect larger retailers, with stronger balance sheets and liquidity positions, to continue to invest in technology and supply-chain capabilities to be in a position to maintain or grow their market share when economic conditions start to improve. In general, we expect retailers' investments to focus on technological advancements, including Artificial Intelligence to analyze customer data and spending behaviours, allowing them to create more tailored marketing strategies to retain and acquire new customers. Furthermore, we expect retailers to continue ongoing investments into rewards programs as they aim to differentiate themselves, increase customer loyalty, and ultimately preserve or even grow market share.

Shift to Omnichannel To Continue

In 2024, we expect retailers to continue to invest in augmenting their omnichannel capabilities, integrating multiple digital and physical touchpoints, to address consumers' increasing demand for e-commerce offerings. During the last two years, a number of geographies witnessed substantial store closures. For context, in Europe over 17,000¹ retail stores were closed in 2022, followed by more than 4,000 store closures in 2023. Similarly, in the U.S. alone, around 2,800 stores have been closed in 2023 (as of September, 2023). Consequently, we expect a larger share of investments to focus away from conventional brick and mortar stores. While e-commerce growth rates have slowed in the post-coronavirus pandemic environment from elevated levels experienced during the pandemic, that aberrational period has brought about a structural shift in consumer behaviour and online penetration. Looking ahead, as cash-strapped consumers search for the best deals and discounts across various platforms, online presence, and marketing strategies have become even more relevant.

Outlook Largely Consistent Across Geographies

Our negative outlook for 2024 is largely consistent across geographies, with our ratings portfolio primarily spread across the U.S., Canada, and Europe. We note that the competitive environment across these markets remains intense and a further heightening in any one market, especially in the context of a challenging macroeconomic backdrop, could meaningfully amplify the pressures on retailers' operating performance. Nevertheless, we expect to see the effects of some differences. Relatively shorter

¹ Source: Center for Retail Research.

mortgage terms are likely to force households in Canada to allocate a higher portion of their disposable income towards mortgage payments and away from discretionary spending, while some countries in Europe could see a slower easing of the inflationary environment. As such, the pace of disinflation and ultimately interest rate cuts in any specific geography could act as the main catalyst for a revival of consumer confidence and drive a recovery in consumer spending later in 2024.

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