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Black Friday for consumers, Bleak Friday for retailers?

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EXECUTIVE SUMMARY

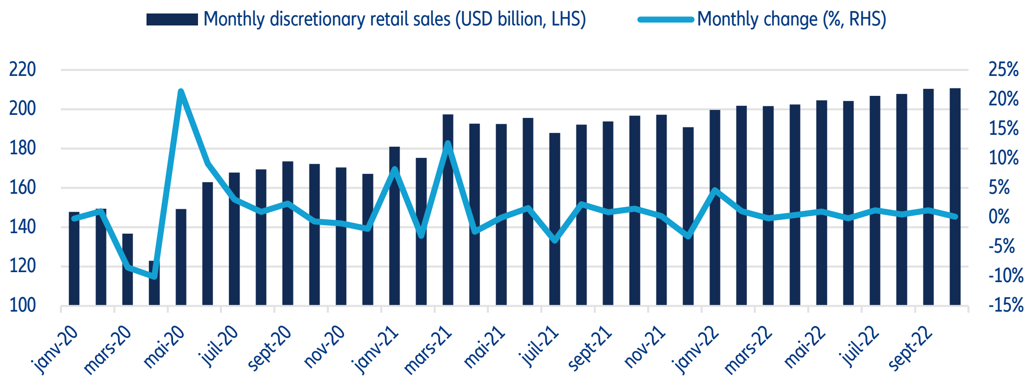
- **US discretionary retail[1] sales (durable goods, apparel, entertainment and leisure goods) peaked in Q3 2022, mostly driven by prices. In the same period, retailers had an estimated USD54bn in additional inventories vs 2021.** With the US economy anticipated to slip into a recession in 2023, retailers are expected to make the most out of Black Friday and the holiday season to avoid a possible inventory glut.
- **For the holiday season, retailers will have to strike the best possible balance between volumes and prices, on the one hand, and profitability and liquidity on the other**. Retailers expecting high demand and keeping prices relatively high may preserve their profit margins, but face the risk of disappointing sales volumes translating into rising inventories and deteriorating liquidity. On the other hand, retailers expecting low demand and granting generous discounts may see satisfactory sales volumes and inventories going down, but at a substantial cost: an average -20% price cut dilutes gross margins by -13pps (furniture retailers) to -17pps (electronics retailers) depending on product segments.
- **In contrast, the prospect of stalling sales, and high inventory, could mean consumers are in for great deals.** Discounts are expected across all product categories, with computers and televisions featuring prominently. Factoring in both the increase in retail prices caused by inflation and expected rebates on discounted items, we find that consumers are likely to save an extra USD30 for a discounted computer and USD130 for a discounted TV set compared with last year. The average discounted price for toys, appliances and sporting goods would be marginally lower, while apparel and furniture would still be more expensive.

[1] *Includes appliances, electronics, furniture, clothing, sporting goods, toys etc. See the appendix for the associated activity codes.*

Discretionary retail sales peaked in Q3 2022, driven mostly by price increases.

In the US, the great retail binge is coming to an end just ahead of the critical holiday season. Monthly discretionary sales peaked at USD211bn in October 2022, up from USD148bn in January 2020 prior to the Covid-19 pandemic (Figure 1), driven by a mix of spending moving from services to goods (2020), generous government support to households (2021) and a surge in inflation (2022). However, growth is now essentially driven by prices rather than volumes: We estimate that they rose by an average +4.2% y/y, explaining most of the +7.1% increase in retail sales over the period. In other words, the same basket of electronic goods, apparel, furniture, toys and recreational products cost US households USD8.5bn more in October 2022 vs 2021.

Figure 1: US discretionary retail sales

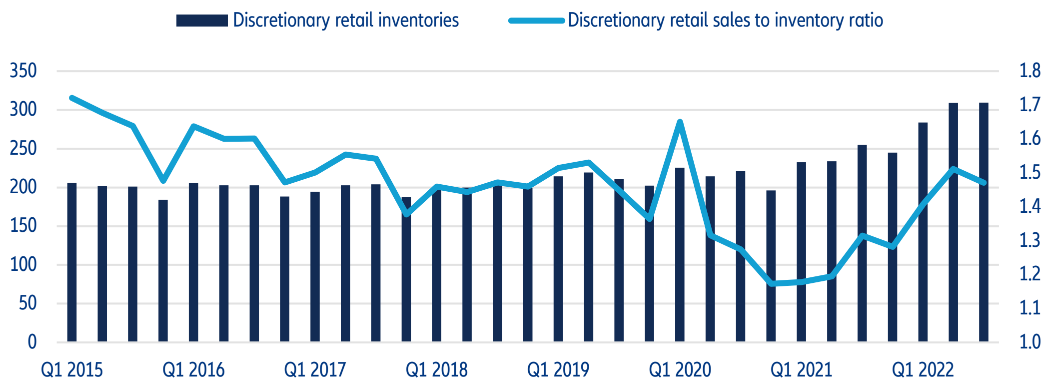


Sources: US Census Bureau, Allianz Research calculations

Retailers have accumulated more than USD50bn in extra inventories compared to last year.

The decline in sales volumes is all the more worrying since many prominent retailers have warned about rising inventory levels, indicating that they already had to lower prices in Q3 to clear inventories. Since the beginning of the pandemic, inventory management has been particularly challenging for retailers faced with booming demand, manufacturing disruptions in China, bottlenecks in US ports, a shortage of truck drivers and rising transport costs. Combining inventory data from the US Census Bureau with the balance sheet financials of leading US retailers, we estimate US discretionary retail inventories stood at USD309bn at the end of Q3 2022, a +USD54bn increase from Q3 2021. Measured against sales, inventories were standing at the equivalent of 1.5 months of sales, above their 2015-2021 average (Figure 2).

Figure 2: US discretionary inventories

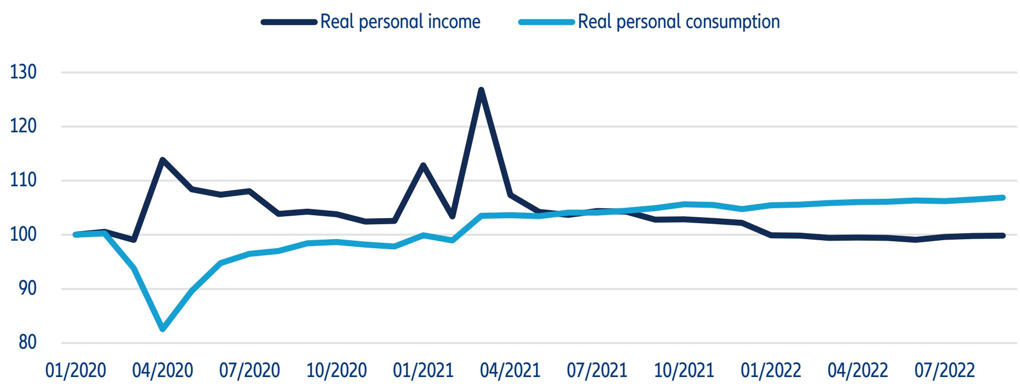


Sources: US Census Bureau, Bloomberg, Allianz Research calculations

A slowing US economy does not bode well for future household consumption.

Flat sales and rising inventories are occurring against the backdrop of a looming recession in the US, induced by tightening monetary and financial conditions. In this context, consumption expenditure — already hurt by high inflation squeezing real personal income (Figure 3) — will remain depressed.

Figure 3: Real personal income and personal consumption (January 2020=100)



Sources: Refinitiv, Allianz Research calculations

In this context, retailers face a profitability vs liquidity dilemma.

This gloomy outlook for household consumption could not have come at a worse time: The holiday season accounts for more than 20% of annual sales among most segments (Appendix), while the first calendar quarter is generally the weakest of the year. In other words, retailers failing to clear excess inventories before year-end may be stuck with inventories for quite some time and face the risk of even deeper price cuts next year if demand worsens further. In this context, Black Friday discounts will play a decisive role in inventory management and retailers will have to strike the right balance between prices and volumes, profitability and liquidity:

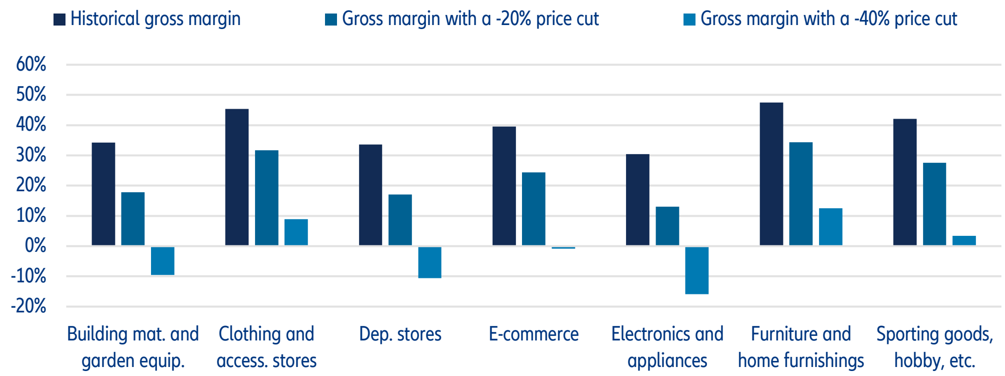
- Retailers overestimating consumer demand and keeping a conservative pricing strategy may preserve their profit margins, but face the risk of disappointing sales volumes translating into rising inventories.
- On the other hand, retailers underestimating consumer demand and granting generous discounts may see satisfactory sales volumes and inventories going down, but at a substantial cost for profit margins.

While reporting their results for Q3 2022, many prominent retailers said they were already taking pricing actions to stimulate demand, with a noticeable and adverse impact on profitability. A few big names have also lowered or scrapped their Q4 guidance amid a fast-changing and unpredictable trading environment.

Discounts have a strong dilutive impact on profits.

To assess the average impact of discounts on retail profits, we look at historical gross margins across segments and simulate the impact of blanket -20% and -40% price cuts. We observe they have a strong dilutive impact on gross margins: a -20% cut reduces gross margins by 13-17pps, while a -40% cut already sends profitability in the red for many segments. Bearing in mind the other major cost items further down the income statement (corporate costs, taxes, interest expenses, rents etc.), we can assume that a -20% price cut is often enough to mean a sale made at a loss. Building material retailers, department stores and electronics & appliances retailers are more sensitive to price cuts due to their lower gross margins.

Figure 4: Historical gross margins and gross margins simulating price cuts

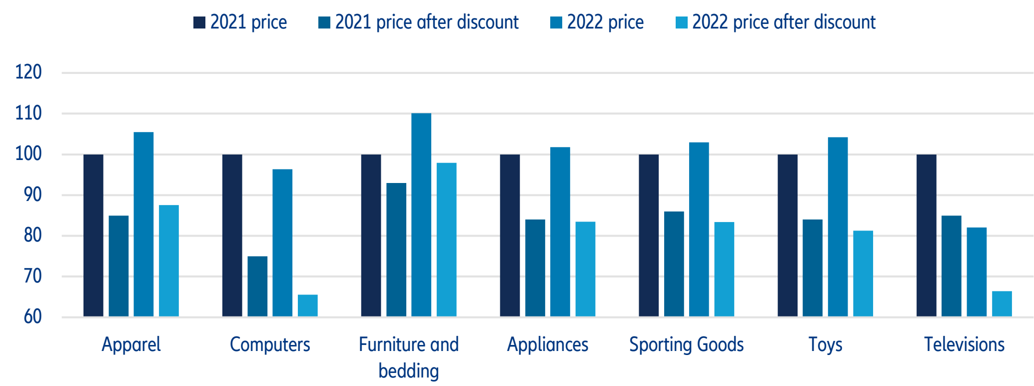


Sources: US Census Bureau, Allianz Research calculations

Consumers will find bargains on Black Friday – especially for computers and TV sets.

The combination of stalling sales, high inventory levels and a challenging economic outlook paves the way for an interesting Black Friday – for consumers, at least. But will discounts be enough to compensate for the surge in retail prices observed over the past 18 months? To find out, we factor in both the increase in average prices using inflation data at product level and expected rebates on discounted items for the holiday season compared with last year. We find that consumers are likely to find the best bargains when hunting for computers and televisions (Figure 5). Conversely, because of inflation and despite higher discounts, deals should be less interesting for apparel, furniture and appliances compared with last year.

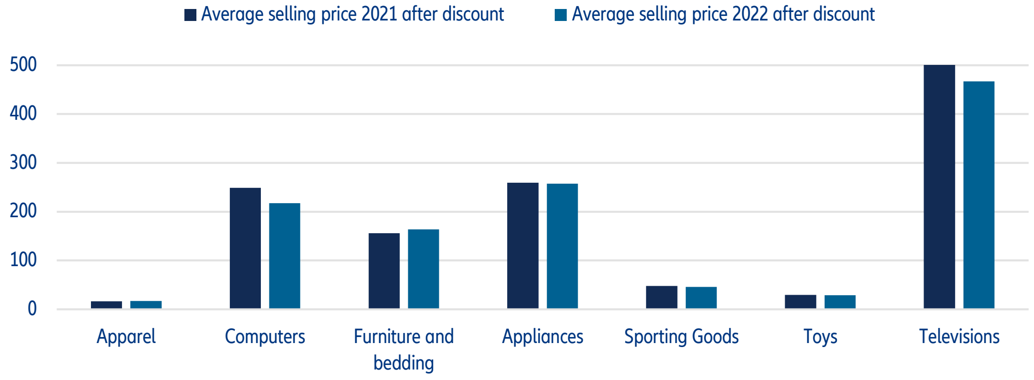
Figure 5 – 2021 and 2022 prices for selected items, adjusted for inflation and discounts (full price item in 2021 = 100)



Sources: US Bureau of Labor, Adobe Digital Insights, Allianz Research calculations

To provide an idea of how much consumers could save in dollar terms, we again apply inflation and discounts but this time on average selling prices. We compute consumers could on average pay USD130 less for a discounted TV and USD31 less for a discounted computer compared with last year. Savings on toys, appliances and sporting goods would be negligible (between USD1 and USD2).

Figure 6 – discounted average selling prices for selected goods (current USD)



Sources: US Bureau of Labor, Adobe Digital Insights, Amazon Most Wished For Allianz Research calculations

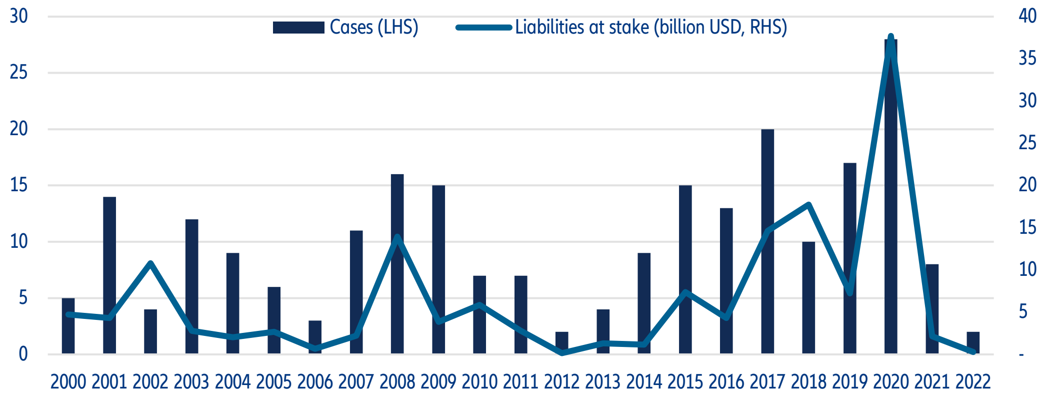
Looking ahead, downtrading, interest expenses and wages will add further pressure on retailers' profitability.

Price pressures will not be the only force squeezing profitability going forward:

- As inflation eats into the purchasing power of households, consumers will be more keen on downtrading i.e. satisfying similar needs by choosing cheaper alternatives that are less profitable for retailers.
- Retailers are also seeing their wage bills swell: wages are the second-largest cost item in retail and have grown by an average +7.3% in Q3 2022 y/y in the retail sector.
- Financing conditions are tightening, with another +200bps increase in interest rates likely in H1 2023. This will leave indebted retailers with higher interest expenses when rolling debt.

Overall, we expect the risk environment to worsen in Q4 2022 and 2023, with higher insolvency risks. This marks a noticeable change from 2021-2022 (Figure 7) when, after the initial retail collapse of the first half of 2020, retailers enjoyed record sales and profits. Because payables account for the bulk of retail liabilities, suppliers are traditionally the most at risk in the event of a default. As of Q2 2022, US discretionary retailers were sitting on more than USD320bn in payables.

Figure 7: large retail insolvencies



Source: Bloomberg

Appendix

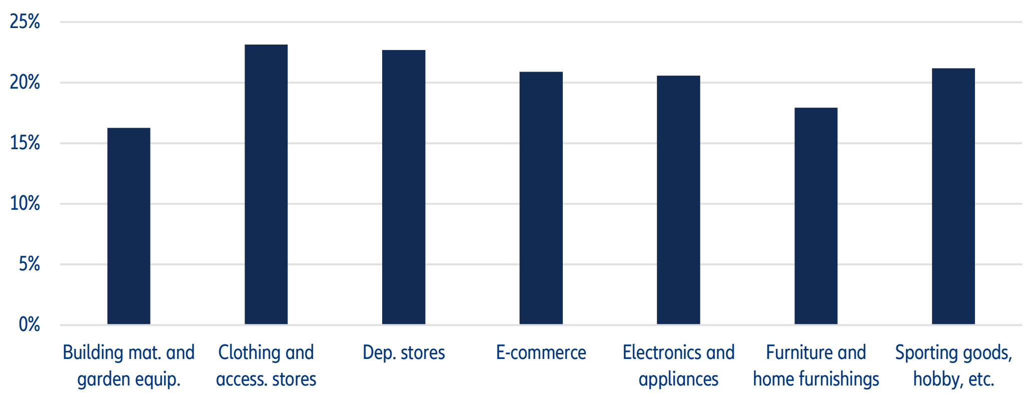
Scope of the report and data sources

To better reflect the different dynamics within the wider retail industry, we exclude consumer staples (food, fuel, drugs) as well as car and car parts dealers from our samples and calculations. Our definition of discretionary retailers includes the following activity codes:

442	Furniture & home furnishing stores
443	Electronics & appliance stores
444	Building material & garden equipment and supplies dealers
448	Clothing & clothing accessories stores
451	Sporting goods, hobby, musical, instrument, & book stores
4521	Department stores
4541	Electronic shopping & mail order houses

To compare 2022 Black Friday deals with those of 2021, we combine inflation data at product level provided by the US Bureau of Labor with estimated discount rates provided by Adobe Digital Insight and average selling prices based on the ten most wished for items on America's leading e-commerce platform (data retrieved 18 November).

Share of year-end sales in annual sales, 2015-2021 average (%)



Sources: US Census Bureau, Allianz Research calculations

These assessments are, as always, subject to the disclaimer provided below.