CONSUMER & RETAIL

WALKING A TIGHTROPE: RETAILERS GRAPPLE WITH INFLATION, DEBT AND DWINDLING DEMAND

Introduction

The UK economy has been severely impacted in recent months by a combination of factors, piling misery on the retail sector. With sales volumes down, disposable incomes dropping for a fourth straight quarter and retail companies saddled with debt, we look at how the sector is affected and how it can survive the storm.

Rising interest rates, spikes in energy prices and falling consumer demand have all taken a toll. The UK retail sector has suffered shortages in the labour market across logistics, frontline and suppliers, all against the backdrop of Russia's invasion of Ukraine. With Europe particularly affected, consumers are tightening their belts and business-to-consumer (B2C) businesses are feeling the pinch.

On top of this, exchange rates have been extremely volatile with the only shred of consistency being the US dollar strengthening against most of its peers – the British pound notably plunged to a 37-year low in September. Recent research shows that some 610,000 companies in the UK are in significant financial distress, representing an 8% increase year-on-year[1].

The risk of recession is a dark cloud hanging over the UK economy, which contracted by 0.3% in August. It came as factories and consumer-facing businesses encountered increased hardship, with prices rising at the fastest rate in 40 years, affecting people's budgets and outpacing wage growth. The Bank of England has warned that some UK households may face difficulty with debt repayment akin to the 2008 financial crisis if the economic situation persists.

While many of the drivers of the current situation will be resolved, many of the solutions could take years to deliver. Any company banking on a swift return to the pre-Covid environment soon risks exposing their organisation to an unpredictable and potentially costly future.

One thing remains clear, the struggle is being felt across the board in the retail sector:

Retailers

Demand rose with the easing of lockdowns but this confidence fell significantly during Q2 of 2022. Those fortunate to save during lockdowns have spent much of their savings and there is a large part of the economy with little disposable income.

According to the Office for National Statistics (ONS), the household saving ratio peaked in Q2 2020 at a record 23.9% and remained elevated during the pandemic period before falling close to the pre-Covid ratio at 6.8% in Q4 2021[2]. The ONS also reported that retail sales volumes in Q2 this year were down by 1.2%, and then by 1.6% in monthly terms in August – its biggest fall since December last year. Disposable incomes also dropped 0.2% in Q1 – the fourth straight quarter of decline marking the longest run since records began in 1955[3].

Suppliers

After a torrid two years during the pandemic, where ONS estimates say almost one third of businesses in retail trade experienced global supply chain disruption, many suppliers are now back to full capacity. Despite this, recurrent lockdowns in China are still impacting many businesses which European retailers are reliant upon.

Logistics

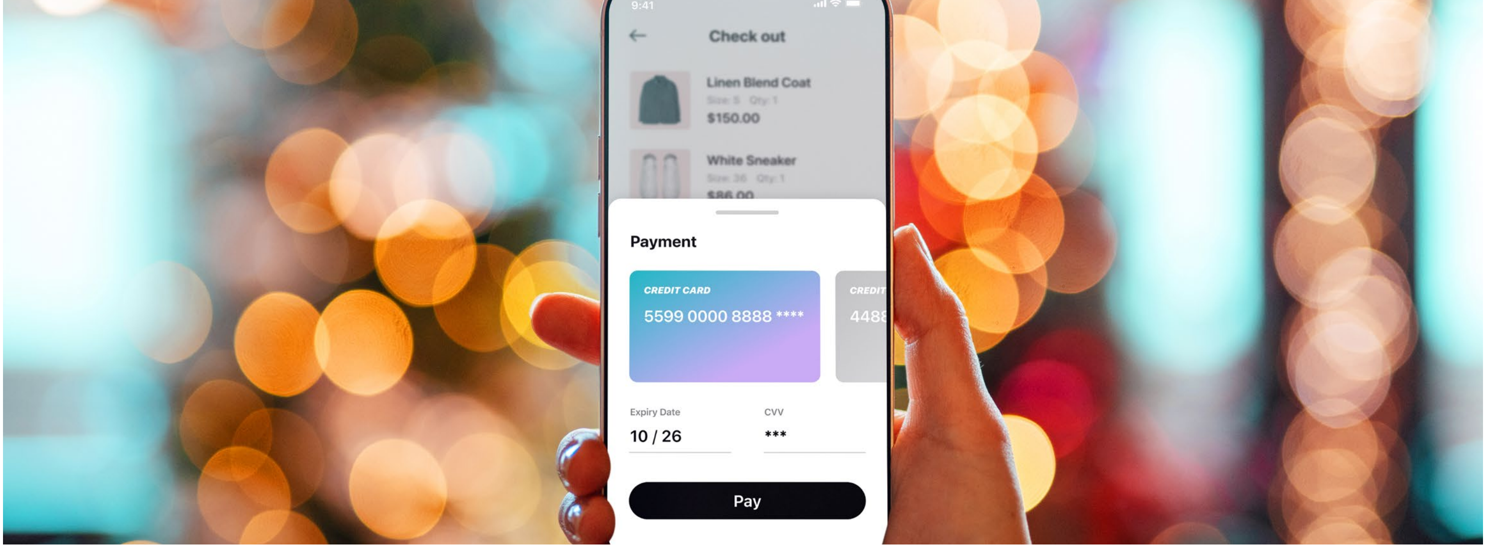
Severe disruption has eased and freight rates have dropped from their all-time highs, but the rapidly changing landscape has led to new challenges where demand has become more unpredictable and subject to short term changes.

Container volume imported into Europe in the first four months of 2022 fell 4% on a year-on-year basis, according to data from Container Trades Statistics[4]. On top of this, when goods arrive in Europe, moving containers from ports has been beset by delays, due to issues such as a shortage of warehouse delivery drivers and port strikes across the region.

Wholesalers

Many have not sold seasonal inventory during Q2 and Q3 2022, resulting in significant roll-over inventory during the winter months.

While there is an expectation this will correct itself during 2023, many retailers are overstocked and desire to clear their inventory before accepting more. An estimate by the US Commerce Department found that business inventories increased by as much as 18.5% on a year-on-year basis in June 2022[5]. There has also been an uptick in returns that is challenging businesses; shoppers returned an average of 16.6% of their purchases – over double the rate in 2019, according to the National Retail Federation[6].



The debt conundrum

Retail is a challenging sector currently characterised by limited new-to-bank appetite and a focus on underlying costs and impact of inflation, as well as waning staffing levels and consumer confidence.

After many businesses across Europe received relief loans and government support to weather the Covid pandemic, those loans are maturing and companies will now be refinancing in a considerably altered environment. Debt issuance has plummeted this year, and those borrowers able to access the market are having to offer investors significantly higher yields. Similarly, lenders are being more cautious in rolling over loans, requiring more diligence and only backing those they believe will succeed.

Without the fall in demand, corporates exposed to the rise in base rates will have seen more of their cash flow allocated to servicing debt. But combined with the fall in demand, for many, this may become a significant issue in the months ahead. When refinancing is required, will the lenders be more stringent on their covenants and service requirements?

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The sector is braced for further challenges as Black Friday and Christmas lay ahead, posing a great risk to companies' management of debt loads. Retailers could potentially undergo a bleak period of heavy discounting and sales, an even higher rate of returns, and consumer credit defaulting. It will be high stakes balancing the risk with the debt for many retailers.

[1] Rising inflation puts stressed companies on brink of failure | Business | The Times ("Significant distress" is defined as when businesses have minor county court judgments (CCJs) totalling over £5,000 filed against them)

[2] Economic modelling of forced saving during the coronavirus (COVID-19) pandemic - Office for National Statistics (ons.gov.uk)

[3] https://www.bloomberg.com/news/articles/2022-06-30/uk-real-household-incomes-fall-for-an-unprecedented-4th-quarter

[4] ShipcoWeekly, No. 21 – Shipco World

[5] U.S. business inventories increase solidly in June | Reuters

[6] Retailers' average return rate jumps to 16.6% as online sales grow (cnbc.com)

Key steps for survival:

1 Working capital management will be key

Retailers need to drive down inventory levels and be agile in responding to where demand is strong. With funding costs reaching 15-year highs, excess inventory will prove to be a heavy drain on cash flow.

2 Cost control

Companies must operate on a cost base that reflects the new environment. Those with a bloated cost base may have survived with strong demand, but as low demand persists, an efficient cost base will be key and those without one will struggle against competitors.

3 Cash visibility

With visibility, companies can plan to mitigate pinch points and address more prolonged issues. There is a mutual benefit for all companies involved in the chain to assist each other and be clear on what support is needed and when. A robust cash forecast, including scenario analysis, allows corporates to take action in good time and preserve solvency.

4 Proactive debt refinancing

Debt will likely be more expensive when refinancing occurs, with more questions asked by lenders before committing, so a proactive approach allocating sufficient time to examine the market will ensure accessing the best deal available, and help borrowers have the liquidity and headroom suitable for the outlook ahead.

Our team is currently working with clients, implementing plans to deal with this volatility. If you would like to talk to us about your business, then please contact a member of the team.

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