FOR MEMBERS ONLY

RETAIL CONDITIONS REPORT

Outlook 2018

HOLIDAY MOMENTUM TO CONTINUE

BUT DRAMATIC LABOUR COST INCREASES CHALLENGE RETAILERS

The following results are from an RCC survey of large and mid-size members concerning their expectations for 2018 and their experience in the holiday season. The survey was conducted during the period February 12 - 16, 2018. It includes results from a total of 53 retailers operating more than 9,600 stores.

OVERVIEW

Retailers experienced a solid 2017 holiday season. Good sales were achieved along with planned margins. Merchants finished the year with clean sellable inventories. Store traffic continues to drop as customers shift to online. 2018 should be another year of growth, although at a slower pace. In anticipation, merchants are buying more merchandise. Apart from labour, cost increases should be moderate and manageable. Many hope to improve margins and some are hopeful they can firm up their prices.

2018 Outlook

- 98 percent forecast total sales, including new stores and online, to grow by an average of 5 percent.
- 66 percent plan to increase their merchandise buy.
- 58 percent expect merchandise costs to rise by 1-5 percent.
- 90 percent expect other costs to rise by 1-5 percent.
- 46 percent plan to raise prices, 52 percent will hold them flat.
- 50 percent expect to increase margins.
- 57 percent will increase capital expenditures, focused on stores and online.
- 57 percent will increase total selling space.

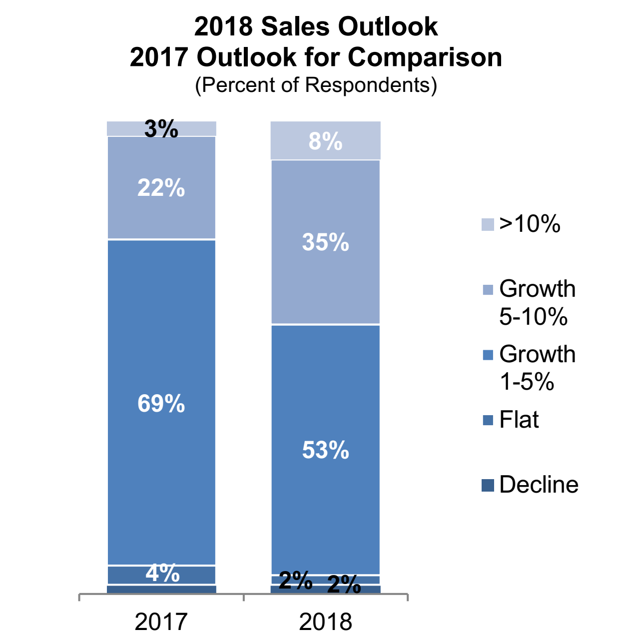
2017 Holiday Season

- Average sales growth (same stores plus online) over 2016 for all respondents was 5.4 percent.
- 49 percent report higher margin rates, and 75 percent say margin dollars rose.
- 42 percent report higher inventory levels, 69 percent report higher turns.
- Online sales grew strongly.

RCC is already looking ahead to the next report. It will review spring performance and report on how well retailers are managing to adjust to the increase in labour costs.

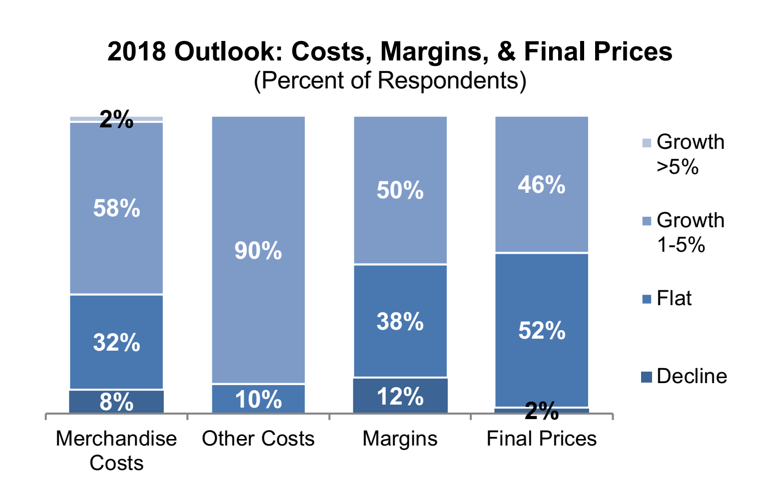
OUTLOOK 2018 – SALES, COSTS, MARGINS, PRICES, INVESTMENT

Retailers anticipate the momentum of last year will continue in 2018. With the economy still growing steadily and employment prospects encouraging, retailers expect demand will stay solid. While total **sales** growth including new stores and online is not expected to be as healthy as it was in 2017, the average forecast increase is five percent, and 66 percent will buy more merchandise. The online channel is increasingly the driver of growth in many retail companies. The range of growth estimates for **online sales** is so wide, an average would be meaningless, but practically all forecasts of online sales growth are a multiple of that for bricks and mortar. This is the case even for companies where online already counts for ten percent or more of total sales, so the momentum is not decreasing as the channel grows in importance. The other side of this is retailers expect **store traffic** will continue to diminish.



Retailers anticipate they will be able to hold or improve **margins** modestly. Some are counting on this improvement to cover part of the increase in the payroll budget. Members note their margin forecasts are based on a stable exchange rate for the Canadian dollar. Currently it is in a relatively good position and hedging provides some short term protection, but a significant drop could still sideswipe margins for the important last part of the year. Respondents are hopeful they can firm up **prices**. Merchants are still very reluctant to confront customers with a direct increase in prices, but there may be opportunities to change promotional cadencing or the size of discounts. Shifting more to private label may allow for compelling value at a different price point. In the same breath, they say they will retreat if there is resistance.

Respondents do not see any major **merchandise cost** pressures emerging in 2018. Some are experiencing cost increases from Chinese suppliers and have shifted to other locations in response. Retailers that source from domestic suppliers anticipate these vendors will try to pass on some of their minimum wage-induced cost increases. There are no inflationary pressures on most **other operational costs**. The main exception is the minimum wage increases in several provinces which will hit **labour costs** both in stores and in the DC and head office. Every retailer is struggling to deal with the impact. This is particularly severe in Ontario where a huge jump is exacerbated by employment law changes that add further to the cost burden. Members note the pressure is also on vendors and suppliers of services such as cleaning and transportation. **Transportation and distribution costs**, particularly for the delivery of online orders are growing at the upper end of the 1-5 percent range.



Capital expenditures will be stronger in 2018. Stores and online are the main areas for investment. Many retailers say their plans in these two areas have been developed to be mutually complementary and supportive. The projects are intended to improve how the stores support the web and *vice versa*. The focus is on store renovations, store systems, and website changes to facilitate the pick-up of online orders, in-store ordering from the website, and other initiatives to achieve the omnichannel experience.

The forecasts for specific categories should be read with great caution. The base of respondents is very small. Some categories were not covered because forecasts were too diverse or the number of respondents too few.

2018 PRODUCT CATEGORY SALES FORECASTS (% Growth in Total Company Sales)					
Product Category	**% Growth**	**# Respondents**	**Product Category**	**% Growth**	**# Respondents**
Apparel	5.3	21	Appliances & Electronics	3.7	7
Furniture, Home Furnishings	5.5	10	Housewares & Supplies	5.3	8
Sports & Leisure	5.1	13			

RCC COMMENT

It is a measure of the confidence of retailers that they are considering buying more merchandise and even firming up prices. In previous years, plans almost always called for the merchandise buy to be held flat, so inventories could be worked harder and more efficiently. Retailers preferred to chase inventory rather than feel pressure to chase sales in order to move their stocks. Similarly, even when confronted with exchange rate driven cost increases in the past, respondents expressed doubt at their ability to pass these on in prices. Retail has not suddenly broken through into a sunshiny world of easy growth. The level of competition will continue to be fierce, Canadian customers remain value-obsessed, and pressure from pure play and foreign online retailers will only grow.

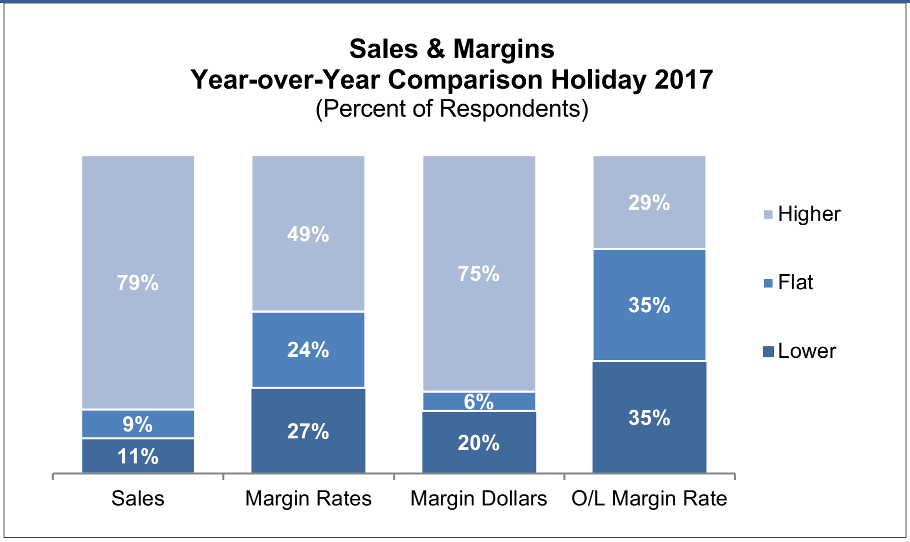
The pressure to grow margin dollars, partly through sales growth and firmer prices, and partly through a range of productivity-enhancing initiatives, is intense. Retailers simply must do this to accommodate the sharp jump in labour costs. The only alternative is lower profits or a red bottom line. Even after retailers have worked all the magic they can on costs, they will still face a wage bill that has not been fully accommodated and margins will either suffer or will be raised to cover the extra hit.

While the outlook for 2018 is positive, there are two risk factors that could change the prospects. The first is our old friend, volatility in the Canadian dollar. While most retailers hedge their merchandise buys, a drop in the dollar could quickly unravel margins, which in turn would make it much more difficult to accommodate the labour cost increases. The planned way forward would be blocked, and it is hard to see what a Plan "B" would look like. The second risk is an increase in interest rates that materially affects household cashflow. As the Bank of Canada has pointed out repeatedly, Canadian households are highly leveraged and if they must budget for a higher payment on the mortgage, home equity or car loan, retail purchases is where the money will come from.

HOLIDAY 2017

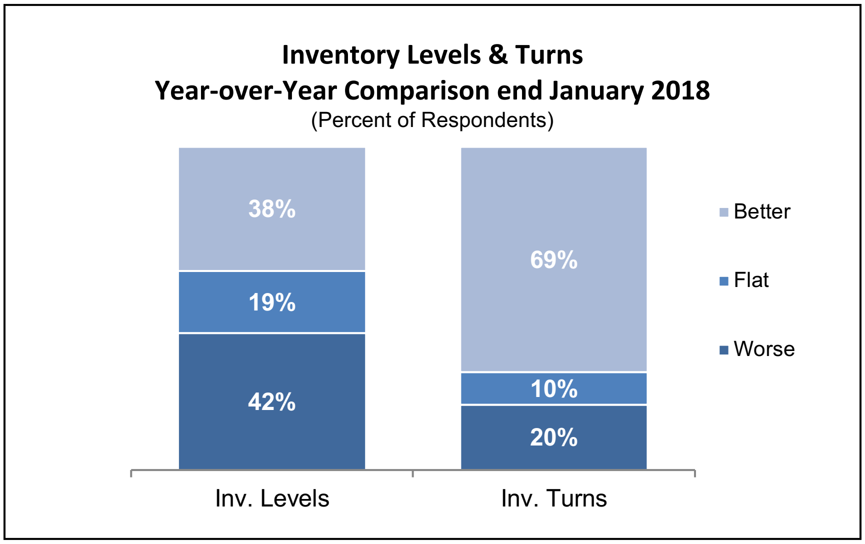
RCC asked respondents to compare holiday **same store plus online sales** to results in the previous year. They defined the season in a way that was most relevant for their concept.

- Average sales increase, sales stronger than holiday 2016: **5.4%**
- Average sales decline, sales weaker than holiday 2016 **excluding one outlier**: -4.0%
- Average sales change for all respondents **excluding one outlier: 3.9%**



Retailers enjoyed a solid holiday sales season. A healthy economy and strong employment growth gave customers confidence to shop more freely than they have in many years. Black Friday continues to expand and pull sales forward from December into November. Boxing Week is losing some of its momentum as customers take advantage of aggressive promotions before the holiday when stocks are fresh and complete.

RCC does not expressly ask about conditions in January and the first part of February, but member comments indicate the healthy conditions have continued.



One consequence of the demand conditions is differences across the regions have diminished. Some note Western Canada produced slightly stronger results than Central and Eastern Canada. **British Columbia** sales firmed up over previous reports. Many report better results in **Alberta**, although they note this is on top of soft 2016 comps. **Saskatchewan** is one region that is still struggling. The results for **Manitoba** are again at the national average. **Ontario** continues to be a good performer for most retailers although for some it is no longer their strongest region. The reports from **Quebec** are more positive and more consistent than previous reports although there are several who say sales are soft. Many say their **Atlantic Canada** results are trending more positive. But again, in this region the results are mixed, with some retailers experiencing soft conditions. **Newfoundland and Labrador** is the weakest province, **Nova Scotia** the strongest.

Margin rates performed better than they have in recent reports. When combined with the strong sales, this produced the healthy **margin dollar** results. Merchants finished their retail year with clean **inventories**. Many of those who report **inventory levels** are up note their **turns** are still steady or positive, proof the merchandise is needed to meet demand. Most say their merchandise is fresh and sellable at planned margins. Very few say they have any overhang; they admit this is a problem of their own making.

Traffic continues to be soft, even with the healthy demand conditions, as customers continue to shift their research and buying to the website. 64 percent say **traffic** is down, while 29 percent say it has increased. **Conversion** remains strong, with 82 percent reporting a higher rate. **Transactions** are solidly positive.

The shift to **online shopping** gained even stronger momentum this holiday. Numerous retailers note their store sales grew modestly, while the sales from the website boomed. In many cases the website accounted for all or almost all the sales growth.

Holiday 2017 Online Sales as a Percentage of Total Company Sales (% of Respondents)							
	Alcohol Retailers	No Online	< 3 %	3 - 5 %	5 - 10 %	10 - 20 %	>20 %
% of Respondents	8%	13%	21%	11%	28%	13%	6%

RCC COMMENT

There is no question Canadian retail enjoyed a solid holiday. Even though sales were pulled forward into the intensely promotional Black Friday frenzy, margins do not appear to have suffered. This would suggest retailers have learned how to manage their bottom line through the new promotional and sales pattern of the holiday season. Of course, the strength of the season helped. The real test will come when retailers face a soft season.

Traffic continues to be a clear measure of the customer's shift away from stores to the online channel both for research and purchasing. While some members believe the pace of the decline in traffic is easing, a review of the results from the past five *Retail Conditions Reports* does not show any pattern of change either up or down. The averages have been generally negative but have moved around from one report to the next.

The online sales results suggest the trade is entering a period where the core elements of a company's business model will change in a major way. Yes, stores will continue to be the channel through which the great majority of sales will take place, and will continue to be a focus of the business. But for an increasing number of retailers, the website is now a large part of their business and one that is in a much more dynamic growth and development phase. This has at least two implications. When the website is growing rapidly but represents three or four percent, it requires one level of executive attention. When it is ten percent of sales and still growing at a multiple of the rest of the business, it becomes the strategic priority for the company. The learning curve about online for retail executives has always been steep. Moving up that curve rapidly is now critical to the future of the company. The second implication relates to the first. The online channel is a different business. The website draws a slightly different customer, visitors behave and buy differently than store visitors. Many of the tools retailers have historically used to drive sales don't work or work differently, and new tools are needed. Cost structures are different, and as some note, without the overhead infrastructure provided and paid for by the store network, the site would run at a loss. What does this mean? The future will be driven by a dynamic new channel whose business model is very different, and which currently produces lower margins and profits. This is not sustainable. Unless retailers are willing to accept a future with permanently lower profits, they will have to make some dramatic strategic and operational changes.

RCC always tests the *Retail Conditions* results against the authoritative data that come from Statistics Canada. There are some relevant differences that cause the two to differ. RCC tracks same store sales rather than total sales, uses a different, smaller sample and different time periods. RCC's results are usually close, a bit on the low side. This time, it looks like the gap will be wider. RCC's holiday edition reported sales results significantly lower than Stats Can. The average holiday growth reported in this edition, likely will also be well below the agency's results to be released February 22, 2018. It is not clear why. RCC will continue to compare and highlight significant discrepancies.

SPECIAL FOCUS: MANAGING LABOUR COSTS

The increases in minimum wage costs especially in B.C., Alberta, and Ontario are having a dramatic impact on the cost structures and business models through which retailers operate. In Ontario, the wage pressure is extended and exacerbated by changes to employment standards. As always when confronted with changes that undercut the operational model for the company, retailers are deploying every tool available to manage the impact on employees and the business. Respondents stress how hard it is to balance fair treatment of employees with maintaining competitiveness.

A strong focus is on store operations, because that is where many employees work, but adjustments are also being made in the DC and at headquarters. On the cost side, every retailer is on a hunt for any savings that can be used to compensate for the increase in the salary budget. This hunt extends well beyond HR costs, to wherever there is a cost that can be removed or reduced without impact on the customer experience: re-lamping to reduce electricity costs, reducing or changing packaging. Many say they simply have no choice but to reduce hours and employment, but this is a last resort. Retailers who operate a high service model or small footprint stores have less opportunity to use these tools because there is an irreducible minimum staffing level for the store to operate. Many other HR measures have been implemented. Some have the ability to move toward a draw / commission compensation model. Some are reassessing the sharing ratio for employment benefits, adjusting automatic cost-of-living allowances, or reassessing bonus structures. Some are altering the balance between full and part time staff. Because of the impact on employees, these tools are very much secondary options. There is intense attention to improving store productivity – employee sales training, new incentive and selling programs, merchandise mix changes, store redesign, software tools to matching staffing levels more accurately with customer flows, store technology such as automated checkouts and automated shelf labels. Despite all this work, the wage cost increase will push some stores into a loss position, and these will be closed.

Retailers have recognized that improvements in costs and efficiencies will not be enough and changes are required on the margins / sales revenue sides as well. Some of the store productivity measures should also help to boost sales. As noted above, retailers are shifting more of their merchandise mix to private label items in order to offer customers good value, but at a different price point. An important reason retailers plan to be firmer in pricing is the need to grow the top line in order to pay the higher costs. Some say they are using margin improvements arising from the higher value of the dollar to cover their higher compensation budget, although they acknowledge this risks being upset if the dollar drops. It helps that 2018 promises to be a year of sales growth. Higher sales mean more dollars for employee compensation.

For all this activity, retailers are still deeply worried about how they will navigate their way through. Many note the increase is not a one-time change. In some provinces further substantial jumps are now programmed in for future years.

RCC COMMENT

Normally RCC asks members what keeps them awake. This time, it was immediately apparent there is one overwhelming issue – labour costs. It is hard to overstate the degree of stress the changes in minimum wages and employment standards have placed on retail business models. This is particularly the case for store operations. The business model each retailer has developed has at its heart a relationship between sales and the payroll budget. The store and the retailer are successful when this relationship is maintained; when it is broken, the business model breaks down. As a result, retailers can only work to improve the denominator (sales) or the numerator (labour costs) of the ratio. The ratio itself can’t be changed permanently unless the retailer can dream up a whole new model for operating the business.

Governments are probably right when they claim that “the land is strong” and employment will not drop as a result of their policies. The economy is growing and generating new jobs at a healthy rate. But retailers and other employers are also right that an inevitable consequence of the sharp increase in the price of labour is that some workers will get fewer hours or will lose their jobs. Let’s be very clear. This is not because retailers will “punish” their employees for public policy changes. It is because they will have exhausted every other option and have no choice.

In the last ten years retailers have faced some fierce challenges and survived. They will ultimately get through this one, but it will be very painful – both for retailers and those who work in the trade.

On Wednesday March 28, RCC is offering a minimum wage forum where retailers can learn about what others are doing and discuss best practices. In May, RCC will be asking members how their initiatives are working. The spring *Retail Conditions Report* will ask about changes in:

- hourly store labour costs;
- labour costs as a percent of store sales; and
- store sales per payroll hour.

By looking at results in different regions it may be possible to see how successful retailers are at accommodating the changes.

RCC thanks our members who generously contribute time, information and insight!

RCC produces the *Retail Conditions Report* four times a year. The next *Retail Conditions Report* will be conducted in May 2018. If you would like to participate, please contact Peter Woolford (see contact information below) or reply to this e-mail with your contact information. We value your input. All information is kept strictly confidential and we do not reveal the names of the companies surveyed.

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