FOR MEMBERS ONLY

RETAIL CONDITIONS REPORT

Fall 2018

BACK TO "CAUTIOUSLY OPTIMISTIC"

SALES SOLID BUT NOT UP TO PLAN; MARGINS, INVENTORIES OK

The following results are from an RCC survey of large and mid-size members concerning their experience in the summer. The survey was conducted during the period September 10-14, 2018. A total of 38 retailers operating approximately 7,100 stores participated.

OVERVIEW

The results of this report should be read with a degree of caution, as the number of respondents is considerably lower for this particular edition. The summer months have seen sales continue to grow solidly, although not quite at the pace in company plans. Margins and inventories remain stable, except for an overhang of seasonal apparel. Traffic counts continue to decline, but all other measures of consumer confidence remain steady. Retailers have not yet felt the impact of tariff changes but anticipate it will arrive soon.

Summer, August, & September 2018

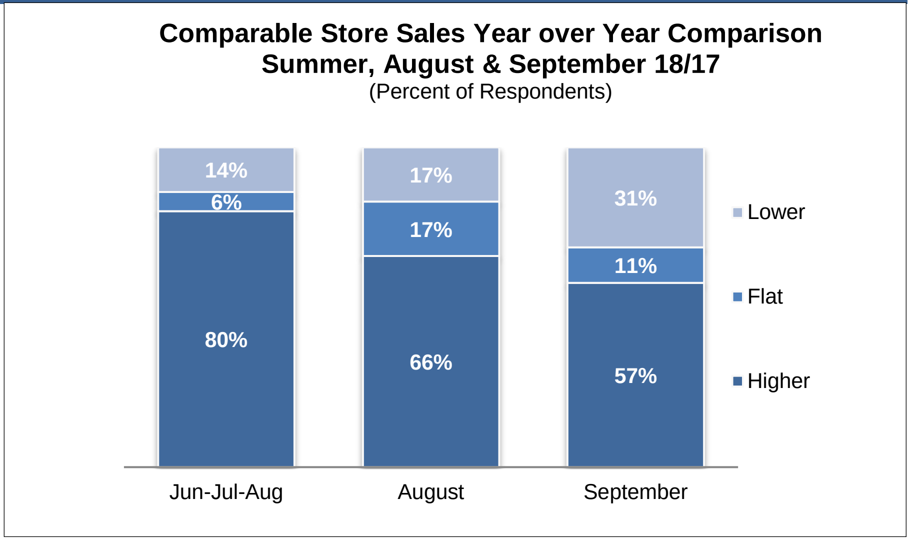
- 80 percent of respondents say **summer** sales were higher. The average three month increase for all respondents is 2.4 percent.
- 66 percent of respondents say **August** sales were higher. The average increase for all respondents is 2.1 percent.
- 74 percent say **August** margin rates were higher and 86 percent had an increase in margin dollars.
- 50 percent report higher inventory levels in **August.** 44 percent had faster turns.
- 74 percent say **August** traffic counts are lower. 83 percent say conversion is higher.
- 78 percent say **August** transactions are higher.
- Average ticket, basket, and unit retail are steady.

The next edition of this report will look at the start of the holiday season, including Black Friday weekend and Cyber Monday. It will cover sales, margins, inventories, and customer behaviour, with a special focus on mobile.

SALES

RCC asked respondents to compare summer, August, and September 2018 total company sales to 2017.

- Average sales increase, sales **stronger than summer 2017**: **3.5%**
- Average sales decline, sales **weaker than summer 2017: -3.3%**
- Average **total company summer** sales change: **2.4%**
- Average sales increase, sales **stronger than August 2017**: **4.1%**
- Average sales decline, sales **weaker than August 2017**: **-4.4%**
- Average **total company August** sales change: **2.1%**



- Average sales increase, sales **stronger than September 2017**, excluding one outlier: **4.0%**
- Average sales decline, sales **weaker than September 2017,** excluding two outliers: **-2.9%**
- Average **total company September** sales change, excluding three outliers: **1.6%**

The **sales** results paint a picture of a stable consumer shopping as expected, but the comments of respondents suggest a slightly more nuanced scenario. Members acknowledge sales are growing at a decent pace, but many also note the growth is below their 2018 plan. This is not yet a cause for concern, but it is certainly a development they are watching carefully, as the fall season gives a preview of how the holiday season is likely to perform. At the time of writing, we only have the Statistics Canada data for June, but they are consistent with this picture, showing unadjusted growth in sales excluding autos and gas of 2.7 percent. RCC will report on the agency's July data during the September 26 webinar. The long, very hot summer across much of Canada did affect the sales of some seasonal goods. At times, it was too hot to do work around the home, and the weather encouraged families to play in the sunshine rather than hit stores. No one was interested in cool weather apparel. Several of the retailers reporting sales declines acknowledge it has more to do with internal company factors than the market. The data for the three periods – summer, August and the first days of September - do not indicate any trend over the course of the summer. This is consistent with the diversity in member experience. Some saw stronger sales at the start of the summer, for some it was the reverse, and others saw no trend.

A number of retailers report their sales are consistent across the country, something that has not happened recently. For most, the regional differences remain largely the same. **British Columbia**, once again, is the strongest sales region. For some retailers, it significantly outstrips the rest of Canada. The **Alberta** market is showing growth, but the picture is not consistent, and some say it is still soft. **Saskatchewan** and **Manitoba** are reported to be soft. **Ontario** is a solid market for the majority of respondents, but there are some who see weakness they attribute to consumer apprehension about the outcome of the trade talks. **Quebec** again presents a diverse and confusing picture. Some are enjoying solid growth, while others say it is a soft region. Some also report significant differences in conditions within the region. The **Atlantic Provinces** present a mixed picture.

Online sales are playing an ever-increasing role in determining the sales performance of retail companies. The impact of the much faster rates of growth in the online channel on overall company performance appears to show up when online sales exceed five percent of the total. At this level, the base combined with rapid growth is enough to add a percentage point or more onto total sales growth. The lower number of members participating in this report may mean the results in the table below are skewed and not fully reflective of how large and midsized retailers are growing their online channel.

Fall 2018 Online Sales as a Percentage of Total Company Sales (% of Respondents)							
	No Online	Alcohol Retailers	< 3 %	3 - 5 %	5 - 10 %	10 - 20 %	>20 %
% of Respondents	11%	18%	21%	18%	13%	13%	5%

RCC COMMENT

Canadian customers are among the best economists we have. Via the sales results they are sending some tentative, subtle signals about their confidence in the future. The positive cast to the numbers confirms customers remain confident and willing to increase their spend despite threats to the Canadian economy from tariff tussles and threats to NAFTA from our biggest trading partner. But the fact that many retailers are slightly behind their plan suggests consumers too, are watching the economic scene carefully. Past experience suggests bad news in the form of interest rate increases, the arrival of the long-awaited downturn, no trade deal, or other threats to Canada’s economy will cause customers to react quickly. Fingers haven`t moved to close the wallet yet, but… Just as inventory control is critical for retailers, so is expenditure management top-of-mind for consumers.

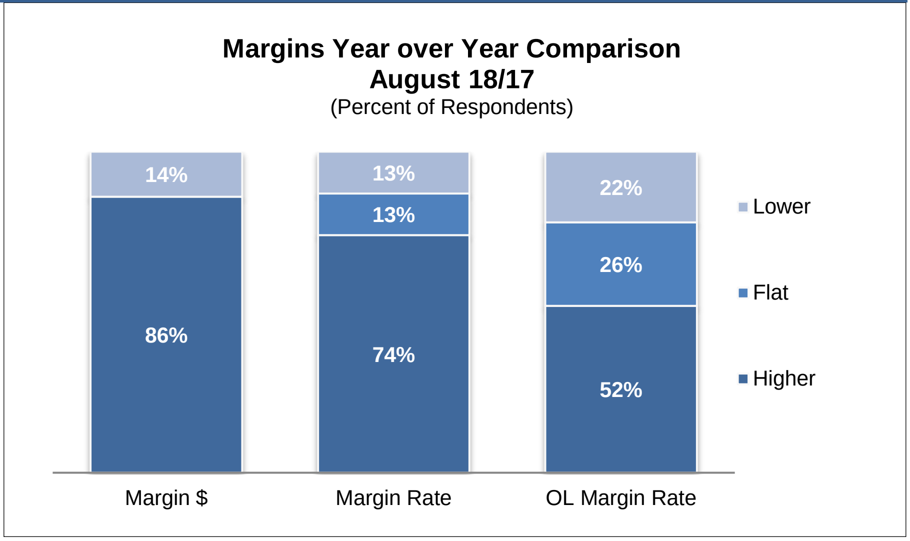
The state of employment in Canada is also a reason for the softer than planned sales. After strong growth in 2017, employment has changed relatively little so far this year, and total seasonally-adjusted employment in August of this year was actually lower than the peak reached last November. A less dynamic employment market directly lowers the energy in the retail market. That said, it must also be recognized full-time employment has shown stronger growth than part-time. Having a full-time job must do more for a customer’s confidence and spending power than a part-time position.

The world’s “climatologist-in-chief” in Washington has declared global warming a hoax, but a number of members have noticed in recent years spring has been arriving later, summers are longer and hotter, and fall is later and drier. If this is truly a long-term trend, retailers that have a seasonal component to sales may need to revisit their

MARGINS AND INVENTORIES

As the data show, margins are in good shape. This suggests retailers have been able to execute their promotional plans successfully. However, a number of respondents see a very aggressive level of promotional activity in their markets which they believe was not in competitor’s plans. Few mentioned the Canadian dollar, likely because it has been less volatile recently. The solid sales results ensure margin dollars are strongly positive.

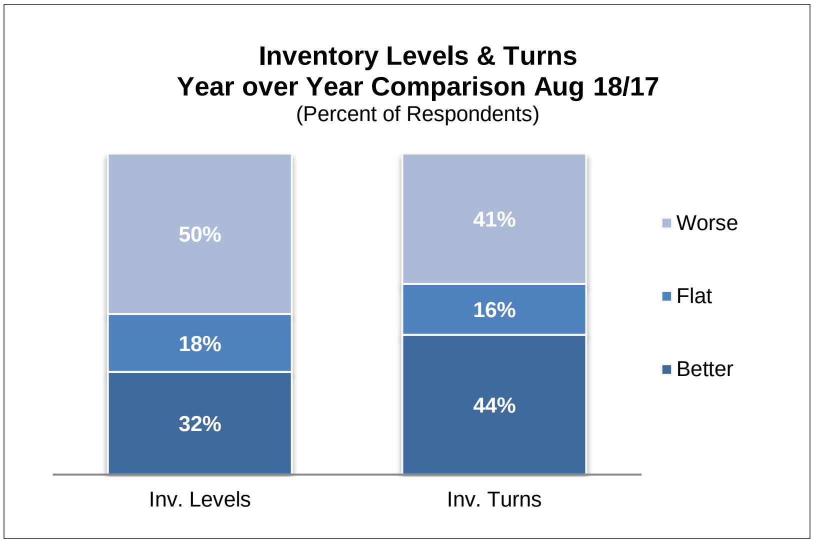
Online margins are not performing as well. This channel is all about price, so the need to promote aggressively has pushed margins down. As well, pressure to meet rising customer



delivery expectations can weigh heavily on the P&L.

Many report inventory levels are higher, but only a few are expressing concern or planning to take further promotional action. There is a measure of inflation in the dollar amount stemming from cost increases due to previous changes in the exchange rate. As well, higher sales require larger inventories. The results for inventory turns are soft, but there is not any concern about the metric at this point.

There is some overhanging inventory in seasonal goods - fall apparel, and certain items of home and garden related merchandise.

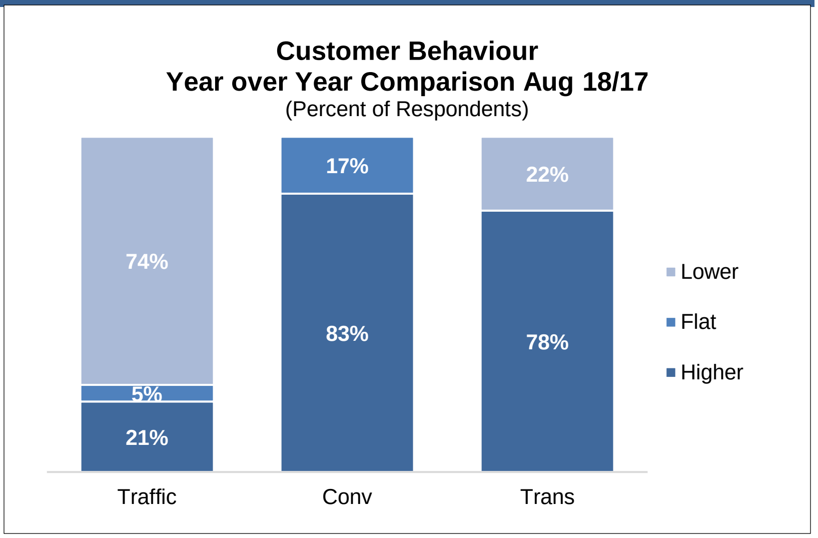


RCC COMMENT

RCC is very respectful of members who are the folks actually making their living in the retail marketplace. We are reluctant to second guess their assessment of promotional activity. The programs in effect today may well be more aggressive, but the work done for this report suggests that retailers have held firm to their plans. Admittedly, if the weather continues to stay summery in large parts of Canada, merchants will be marking fall seasonal goods down faster and lower than planned. But so far, the margin data suggest retailers have not done so and the inventory results do not show any pressure building for it.

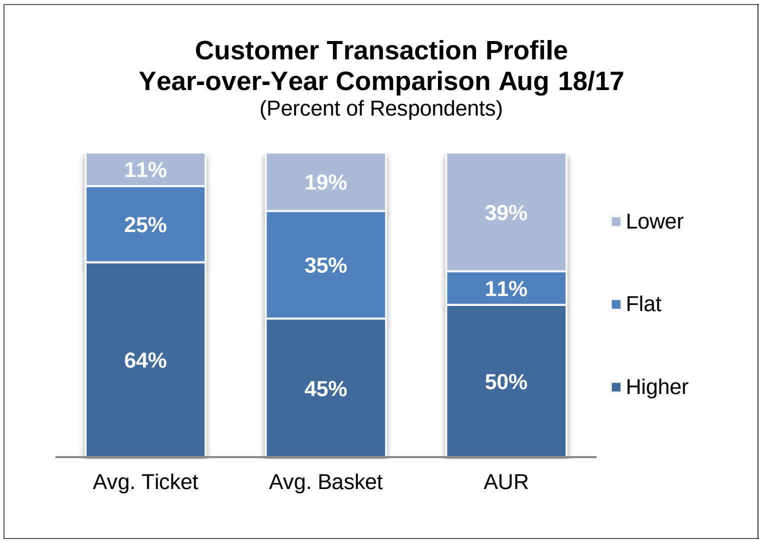
CUSTOMER BEHAVIOUR

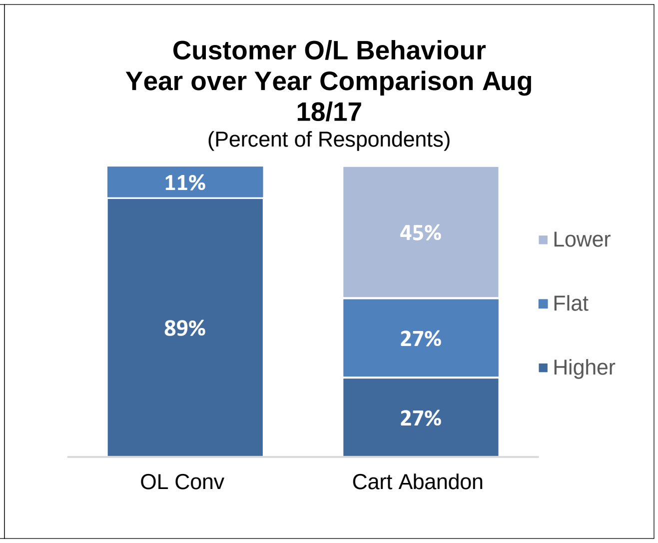
The data in this section are affected by the drop in overall participation. Only 18 members report traffic, conversion, and online conversion. Cart abandonment is reported by 11, so these data are meaningless. The graph for online behaviour has been included in recognition of the emerging importance of these metrics.



Traffic continues its long slide, although members report the pace of decline has eased. Two years ago, year-over-year declines of more than five percent were common; the drop now is more likely to be in the low single digits. Improvements in conversion are helping most retailers to limit the loss of sales in stores. For an increasing number of retailers, the growth of the online channel has reached the point where these sales are a meaningful replacement for sales lost due to fewer store visits. The solid market environment means the transactions results are positive and do not provide any insight into any changes in customer behaviour.

The metrics for customer transaction behaviour show little change, confirming confidence is still steady.





RCC COMMENT

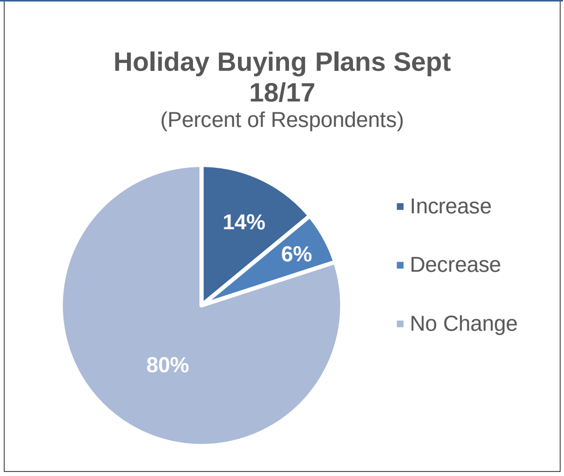
The slower decline of foot traffic into stores is cold comfort at best. It helps that conversion is improving, although that is what should happen. But sooner or later retailers will reach a point where there is diminishing potential to increase conversion. They can work on growing the average value of each transaction, but that too has its limits. When retailers have extracted the maximum from these two options, what happens to the economics of the store? The outlines of the future are starting to emerge. There may well be fewer, smaller stores. They may function more as a pick-up point for online orders – and be restructured to facilitate that and encourage impulse add-ons. Amping up the experience/entertainment/service side may pull people in and partly turn the store into a marketing venue. What is not clear is how much these new format stores will continue to contribute to the bottom line. And to add an extra dash of fun, maybe the customer will have something completely different in mind and retailers will have to pursue entirely new directions in their quest to serve. We should never forget the customer's potential to surprise. Ten or twelve years ago, no one thought the customer would ever consider buying online and then driving to the store to pick up the purchase. It seemed completely contrary to what ecommerce was about. Today retailers are enlarging their back areas to make them mini DCs.

RCC will continue to talk with members about customer behaviour metrics for online commerce. Currently many members do not track the two metrics RCC has identified – conversion and cart abandonment – or the results are not readily available to the Finance Department. RCC will continue the dialogue with members about these two data sets, and what their results tell us.

Customers and retailers find themselves in the same situation. Current conditions are decent and seem to be moving along smoothly. There are no hard facts that threaten the future, and yet the level of uncertainty about economic prospects has risen. Both customers and the retailers who serve them are aware of this and assessing it carefully, but neither group has yet acted.

OUTLOOK

Retailers are back to being cautiously optimistic. Most still expect to see sales growth over 2017, although perhaps not quite at the level in their plans. It was always going to be a challenge to surpass the strong comps of last year. Several openly state they will get close to but not achieve plan. As always, the great majority of holiday merchandise is already ordered and in DCs or on tidewater, explaining the high percentage saying they will not change their plans.



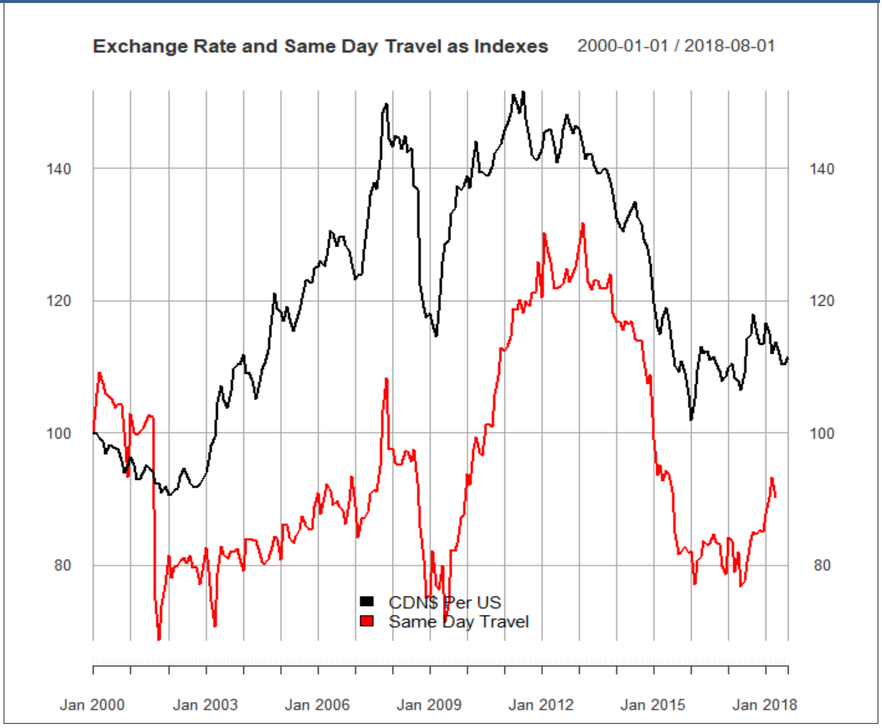
RCC COMMENT

There are definitely some straws in the wind in this outlook. The odds are still heavily in favour of sales growth over holiday 2017, and jumping over those comps will be an accomplishment. We may be seeing the very first faint signs of a slower momentum to sales. Several members caught this sense, saying they had been fully confident about the holiday at the start of the summer, but now are not so sure. As noted earlier, Canadian consumers are among the best of economic forecasters, and they are starting to send early warning signals to retailers.

SPECIAL FOCUS – BORDER ISSUES

All retailers are aware cross border shopping either in U.S. stores or websites is a continuing phenomenon. The great majority of respondents have not seen any recent change in the situation. Several find their stores in communities close to the border are doing well. With the dollar in the mid-70's, there is little economic incentive to go south. Few believe different merchandise selection is enough to overcome the exchange rate. Some say the emergence of aggressive pure-play online U.S. retailers is costing them market share.

This situation is confirmed by the best statistical indicator we have of cross border shopping, the number of single-day cross border trips by Canadians. RCC's consulting economist, Paul Jacobson of JCI Consulting, prepared the graph in this section. It shows the number of trips dropped precipitously when the dollar fell from its high point in the early teens.



Graph Source: Statistics Canada Data, prepared by JCI Consulting

To facilitate comparison, both data series are shown as an index based at January 2000. This actually overstates the relative size of cross border travel in later years because of the growth in the Canadian population. The 2001 Census reported there were just over 30 million Canadians. Stats Can estimates there were more than 37 million of us in April, but the number of trips in 2018 is actually down from 2001.

Business from foreign tourists is negligible except for one or two retailers, and a few others say it is a modest part of sales in a few stores located in popular tourist areas.

RCC also asked members about impacts from the tariff changes implemented by Canada and the U.S. earlier this year. Most respondents have not seen much impact, and only a few have changed their supply chain arrangements – yet, but they know it is coming. 76 percent of respondents source partially from the U.S., 18 percent do not source from the U.S., and six percent source exclusively from the U.S.

Retailers that will be most affected are those who source their merchandise from the U.S., typically from the parent company or an affiliate, and those carrying national brands. In these circumstances goods from China are sourced for the North American market as a whole and tend to be imported through the U.S. Retailers whose products contain significant steel or aluminum content expect their merchandise costs will rise in the near future because of the tariffs on these commodities. Retailers say they must pass the costs through to the customer in prices, but recognize customers are still highly resistant to paying more for their purchases. The uncertainty, harm to the Canadian economy, and higher prices will all damage consumer confidence and spending power.

RCC COMMENT

Retailers are facing a deeply worrisome set of border issues. As noted in their comments on tariffs, members foresee independent hits on both costs and sales, and the combination of both should further increase the damage. Then, it could get worse. Even with the Canadian dollar sitting in the mid-seventies, customers still have that old cross border shopping itch. If Canada must concede an increase in the *de minimis* rule that allows customers to import goods free of duties and taxes, retailers will be facing competitors with a permanent built-in price advantage between five and fifteen percent for the HST portion alone. Given the average ticket ($ per transaction) at most retailers is less than $100, even a moderate increase in the duty-free limits would put a lot of transactions in play.

RCC ASKED RETAILERS: "WHAT KEEPS YOU AWAKE AT NIGHT?"

Facing the prospect of a second year of decent sales growth, one would expect retailers to be sleeping soundly, but there are still things to fret about. As they look into the future, many are worried about the volatility and economic risks confronting the Canadian economy. These are the same challenges at the top of the news headlines: tariff threats, NAFTA negotiations, and especially changes to the *de minimis* rule. They note this mix of challenges would hit the trade from two sides, increasing their merchandise costs while also threatening a sharp economic downturn that would slam sales. That is enough to keep Rip Van Winkle awake! In the more immediate future, retail execs are contemplating the implications of a holiday season that now looks softer and tougher than planned.

The robust state of the economy and employment is making it more challenging to find staff at many levels in the company. At the same time retailers are still struggling to accommodate the impacts of recent increases in minimum wages and other employment standards changes. So HR headaches are again plaguing retailers' nights.

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 December 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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