Strangers Come To Town

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Most Canadian food and general merchandise retailers have experienced six or seven consecutive years of strong earnings performance despite somewhat muted overall sales growth. The source of the earnings growth has been a relatively calm competitive market due to limited net square footage growth; a strong Canadian dollar (particularly in the last three years), which lowered the cost of a large number of products procured in U.S. dollars; and the use of clout and market share leverage by the largest merchants to negotiate ever-larger rebate packages (and lower net costs) from suppliers.

However, there are numerous industry trends and activities that cause us to be more cautious on the domestic Canadian consumer sector for the next couple of years. The most notable challenge is the arrival of a number of "strangers" to the Canadian retail scene. Target is the obvious entrant, but included in our list of "strangers" are the numerous ethnic (largely Asian) large-format grocery stores being built across the country; Walmart's pick-up of 39 ex-Zellers stores and the company's recent commitment to smaller formats; Nordstrom's plan to open six stores by the end of 2016; plenty of international specialty apparel retailers flooding into the country; the development of outlet-style power centers that seem to attract both brand-focused stores and clearance-style additions to merchants portfolios; and the upcoming exponential growth of e-commerce driven both by Amazon and bricks-and-mortar players.

Enabling these strangers are real estate developers, funded by high REIT valuations. Commercial square footage in Canada is growing rapidly with the expectation that sites will be easily filled. This ignores the fact that a large number of Canadian retailers (i.e., Loblaw, HBC, Sears, Canadian Tire, RONA) probably have too much space and would happily re-purpose millions of square feet. This certainly opens the door, and gives plenty of options, for multinational merchants or brands looking for an inexpensive foothold in Canada.

Most observers point to the fact that Canada is "under-stored" relative to the U.S. Indeed, we do have about 40% less retail space per capita. But we suspect that there are fundamental reasons for this, most likely embedded in the reticent and deal-driven shopping habits of Canadians. In other words, driving up the amount of available retail space in Canada might not be a good idea for anybody.

Looking ahead to the next few years, we would identify the key market trends as follows:

- <u>Cautious Canadian consumers</u> are heavily dependent on foreign demand to create jobs; and are focused on the pay-down of non-mortgage debt. This reduces funds available for consumption. Larger-ticket goods have seen the brunt of the cutbacks, but consumers are pretty sticky about spending even on necessities.

- The rising power of <u>Asian and South Asian</u> consumers. Probably 70% of all the growth in Canadian consumer spending over the next 10 years will come from these groups, which will likely foster the growth of large format ethnic grocery stores.

- An increasing tendency by consumers to purchase on promotion. Partly, this trend has been fueled by a cautious consumer. But over the past three years, a material amount of the windfall from a stronger Canadian dollar was passed through as increased deals. This caused merchants to increase promotional weights and breadths without having to overly invest their own margins. As a result, Canadian consumers have become increasingly addicted to deals and are more skeptical than ever about regular prices.

- A rapid and sudden rise in retail industry square footage. This is especially apparent in food, where the footage is now growing above and beyond the “sustainable” 1.5% rate. This began in late 2012 and will continue through 2013 and 2014. This sudden burst, caused by former Zellers stores converted partially to food square footage by Target and Walmart, will hurt store-level sales productivity almost nationally, and across numerous categories.

- Rising square footage is exacerbated by very little “dead” square footage dropping out the bottom. Invariably, instead of going “dark”, old stores are now sold or leased to ethnic merchants (largely grocers), who run low-priced, high-volume operations. We have observed this re-purposing activity in everything from redundant grocery stores, to old building supply stores, to small department stores.

- Lower sales productivity is usually addressed by competitive price responses and accompanying lower margins. We are already seeing this in early earnings results from several merchants, and this problem will continue.

- Retailers experiencing margin erosion will increasingly look upstream to their suppliers for relief. Look for that pressure to build over the next 12-18 months.

- Large merchants such as Canadian Tire and Loblaw will soon be launching points-based loyalty programs. These types of programs are usually funded by suppliers. Unfortunately, dollars allocated to support these new programs are generally shifted from more focused promotional and pricing programs.

- The Canadian dollar is beginning to slide below previous year’s levels. This increases purchasing costs on the wide array of goods that are bought in U.S. dollars. The most immediate impact is on grocers (within days), the next impact (although much smaller) is on drugstores, then dollar stores (within six months), general merchants (eight months) and apparel retailers (12 months). It is much more difficult to turn cost increases into price increases in a highly-competitive market, so there is a high probability that gross margins will begin to come under increasing pressure.

- Suppliers will be racing to support the new primary growth channels such as Target, Walmart, dollar stores, drugstores, Costco and ethnic grocers. The core traditional merchants will increasingly struggle for supplier support, and will be leveraging only large market share.

- Ongoing provincial pressure to lower generic drug prices is squeezing drugstore profitability and no end is in sight. Our guess is that governments will continue down this path until the drugstore industry cracks under the pressure, although we are not sure what form that takes. Regulatory pressure trims sales and profits from a wide array of merchants (drugstores, grocers, department stores) who use prescription drug counters to drive traffic growth.

- Eroding margins will cause traditional domestic retailers to consider consolidation. Although Canada is already a heavily consolidated market, there are possibilities for more. Primary targets for acquisition will be Safeway Canada, Overwaitea and the ethnic grocers; drugstore operators suffering under the drug reform headwind; chains of domestic apparel retailers; and retailers sitting on below-market leases.

- E-commerce is nowhere in Canada – by our estimates only about $4 billion of "relevant" merchandise is being transacted remotely in a $270 billion merchandise market. But investments by Amazon and Walmart; improvement in logistics and delivery systems; and the development of true "omni-channel" strategies could see the sales in e-commerce grow to $50 billion in 10 years. And then what happens to all that square footage?

It has been a largely peaceful and prosperous decade for Canadian retailers. But that type of environment inevitably invites disruption. Disruption has certainly arrived, and will test the resolve and resiliency of Canadian retailers, large and small.

It will, however, make it a good time to be a consumer as choices will continue to expand and prices will begin to come down.

Wanted: Real Income Growth

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Canadians have heard the message from Ottawa: be careful what you borrow for. But turning more prudent on debt accumulation has meant leaner times for retail spending growth over the past year. With a particularly weak finish to the holiday season, retail sales grew at a lean 2½% rate for 2012 as a whole, the second year of deceleration from a heady 5.6% pace back in 2010, when households were much more eager to borrow at low rates to finance their shopping spree.

The global economy kicked off 2013 advancing at a similarly modest pace to what we saw in the outgoing year. Overseas, somewhat better news out of China and hopes for policy stimulus to boost Japan were balanced by renewed recession in the Eurozone.

The U.S. economy looks headed for a decent first quarter, but tax hikes should gradually drain consumption momentum, and government spending restraint will take a further bite. So while we expect only a roughly 2% real GDP growth rate for 2013 in the wake of those fiscal headwinds, the outlook looks much sturdier for 2014, in which no similarly scaled new tax hike is coming. The underlying improvements in U.S. housing and credit conditions should drive growth above 3% that year, a plus for those Canadian retailers operating south of the border, and lending Canada support for both exports and related capital spending.

Until then, however, the Canadian economy faces a disappointing 2013, lacking sufficient momentum in domestic demand to do better than last year's 1.8% growth rate. A deceleration in home building is expected to subtract about a half percentage point from real GDP growth, offsetting a planned pick-up in oil output after production disruptions dented the prior year. Capital spending plans also look muted, awaiting better visibility on global growth and resource demand. Non-energy exports should get some lift from better U.S. auto sales and home building, but aren't likely to be sufficient to drive the economy much until global growth improves in 2014.

In that climate, we expect the Bank of Canada to continue to hold short-term interest rates at current levels for 2013. Longer-term borrowing costs could drift higher later this year, as the bond market anticipates better global growth, and the end of U.S. quantitative easing.

For consumers, with caution on debt growth likely to continue, real income growth remains the key to spark any acceleration in retail activity. Job growth has on the surface been brisk, but the surprisingly sharp gains in employment headcounts have not been matched by total hours worked. Wage rates have also remained tame. The result is that total wage and salary growth has been lackluster, and tax hikes in some provinces are cutting into that on an after-tax basis. Only a very tame run of inflation, one unlikely to persist, has created much in the way of real disposable income gains.

Job growth is expected to decelerate in 2013, to come into closer line with real output gains. And wages should remain fairly tame, particularly in the public sector given fiscal restraint plans. In that climate, discount stores will continue to grab market share, particularly given the entry of a major U.S.-based player this year.

For retailers, the good news is that we've already seen the big pullback in the use of consumer credit. But with margins held in check by the competitive pressures from new entrants, sales are unlikely to do much better than 3% this year. Margins will also be slightly squeezed by the Canadian dollar, which we see averaging a few cents weaker than parity this year. A stronger year, with nominal sales topping 4% in a less harsh pricing environment, awaits firmer job and income gains associated with a revitalized export sector in 2014, which should also enable the Canadian dollar to rebound to levels stronger than parity.

A deceleration in both new and existing home sales should show up in continued soft sales performance for related furniture, appliance and home renovation retailing in 2013, with more to come in 2014 as housing completions further slide. Margin compression will keep a lid on nominal clothing sales, but the hype from new entrants could create some real volume gains.

Regionally, Central Canada and the Maritimes lagged the rest of Canada last year, but we expect that gap to be somewhat narrower for 2013 due to a slower pace for resource capital spending and related impacts on employment. Longer term, demographics and resource development prospects still favor the west in terms of retail growth.