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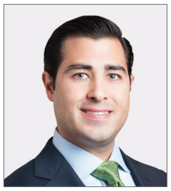
Insights Series | Retail, Restaurants, and U.S. Consumer Resilience

Podcast Transcript



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Welcome to Boston Partners Insights! Going beyond the headlines with our investment team to provide a deeper perspective on the capital markets. I'm Chris Villalba from Boston Partners Investor Relations Team and on this episode, we revisit everyday spending and the impact of consumers on equity investing. It may be too soon to talk about holiday shopping, although it does seem to get earlier and earlier every year, but there may be no better way to introduce the topic of consumer spending than the familiar sounds of the mall at Christmas time. Post-Pandemic the world is going shopping, people are dining out, the crowds are back, back to the movie theaters this summer, vacationers are back to setting sail on cruise ships, or going on that European vacation they've been putting off.

C.V. | It's clear that consumers are spending. At a time of high employment, high prices and high interest rates amid a climate of inflation and even forecasts of a potential recession, consumers are making a wholesale impact on the economy. To deepen our understanding of consumer behaviors, trends and companies worth watching in this sector, we are joined by two Boston Partners' equity analysts whose work can give us a 360 degree view on consumer spending. Jackie Hall covers a variety of businesses, including insurance, REITs and two key areas we're about to focus on retail and e-commerce. And Jennifer Mace specializes in a variety of lifestyle and consumer product companies, in particular, her expertise in restaurants and stable products rounds out the perspective we bring to you now. Jackie, Jennifer and I sat down at the Boston Partners Home Office to share their perspective and insights. Jackie Hall, welcome to the show.

Jackie Hall | Hi, Chris. Thanks for having me on.

C.V. | And Jennifer Mace, glad to have you as well.

Jennifer Maze | Hi, Chris. Great to be here.

C.V. | Well, it's the end of September, Autumn's barely started, but tis the season to talk about consumer spending. Let's start off by going back in time for context. Jackie, walk us through the state of consumer spending from the pandemic to where we are today.

J.H. | Sure. So just rewinding the clock to the early parts of the pandemic, we saw a huge shift in consumer behavior just driven by a wide variety of factors. Essentially, you had efforts to stay at home, you had migration out of urban areas and dedensification combined with an ultra low rate environment, add on top of that several rounds of stimulus payments. All of that combined shaped the retail landscape in a different way relative to the pre-pandemic backdrop and really helped amplify the sales and margin trends in a number of categories within retail. We saw categories such as consumer electronics, home furnishings and home improvement related areas really benefit from just the overall propensity to spend more time in the home. Grocery and food-at-home-demand also spiked meaningfully at the onset of the pandemic, and there has been some reversion in normalization in demand within that channel, but that space continued to see ongoing top line benefits beyond the reopening of the economy just from elevated, double-digit type food inflation. Auto parts, that was another category that benefited from the pandemic backdrop just driven by the auto shortage, as well as an aging vehicle fleet and normalization in miles driven coming out of the pandemic. Athletic and the sporting and outdoor goods segments, that was another category that saw tremendous benefit and earnings tailwind from the backdrop. More time was spent outdoors, you had a hyperfocus on fitness, and then you had the return to activities such as team sports and that really helped extend the runway in that particular segment. And then as we moved into the reopening phase of the economy, you started to see a normalization in consumer behavior driving a pickup in categories such as cosmetics, as people went out of their homes more and became more comfortable not wearing masks. That category saw benefit and just bigger picture, you started to see the incremental reversion back to pre-pandemic trends whereby you had the consumption of services and experiences really taking wallet share away from goods. Generally speaking, I would say at a high level, the elevated levels of consumer spend has been really quite resilient to date and that's really been funded, if you will, by consumers utilizing and drawing down on trillions of dollars in excess savings that have really helped fuel inflation and nominal retail sales growth.

C.V. | Jen, same question to you. What's your perspective?

J.M. | So in my area, similar to Jackie's, some areas saw huge benefit from the pandemic while others struggled. Some of the beneficiaries were companies that sold packaged food, household products, cleaning supplies. Names like Kimberly-Clark, Clorox and General Mills as people stayed home and weren't going out or eating out and were focusing on cleanliness and eating at home. You also saw video game publishers and toymakers benefit as consumers were stuck at home and looking for a way to fill time that otherwise might have been spent out of the house. They turned to video gaming, which could also fill a social gap in their life. And then parents were willing to buy an extra toy to keep their child entertained while at home. On the flip side, you saw restaurants and food distributors suffer, particularly early on in the lockdown phase. Sales for some companies dropped by more than 50% virtually overnight as consumers sheltered in place and social distanced. Restaurants ultimately adapted to an extent increasing their off premise sales through delivery and pickup, which helped to offset some of the challenges and keep their business alive. When the world reopened, you saw a pretty significant surge in consumers dining out. And while there were some fits and starts to the reopening, fast forward to today, and restaurants have largely, if not more than recovered, the traffic lost in COVID, depending on the company. And on the flip side, while restaurants and food distributors were recovering, you did see some video games and toy companies and staples companies start to give back some of their gains as consumer behavior normalized.

C.V. | Two topics that have been in the headlines all year, inflation and the potential of a recession. Let's focus on the former, because inflation impacts consumers on a day to day basis. The U.S. has fared better than other developed economies, and U.S. consumers have been resilient, even though there's no doubt that prices are up. Jackie, how is this showing up for retailers?

J.H. | I would say that inflation has been a tailwind to top line growth and it really has helped nominal sales growth. But, if you peel back the layer of the onion, what you'd see is that real consumer spending trends would suggest a somewhat less robust story. Really within retail, there's been a variation in inflation levels across categories, which somewhat complicates the reversion narrative in some regard, but I would say that by-and-large we've increasingly seen that volume or unit growth is under pressure, while ticket gains, which has basically been much of the driver of sales through call it 2022, is also now starting to show more broad based signs of moderation. That includes categories where you've seen fairly robust levels of inflation. So you essentially have categories like grocery inflation that's decelerating off of a prior double-digit levels to call it low single-digits now. Auto parts, that's been a segment which has benefited from strong pricing power and the ability to pass through inflation of input materials, and in that category is also starting to see more moderate levels of inflation at this point in time. So the inflationary and pricing tailwinds, I would say are certainly starting to wane across many categories. If I take a different lens and think about it from the consumer level, I would say that elevated levels of inflation has been squeezing real purchasing power of the consumer and to date, that pressure has primarily been concentrated at the lower income consumer cohort. And you're seeing that inflation is forcing consumers to really make choices and make tradeoffs, and that inflationary pressure has had ramifications on retailers that have above average exposure to that specific income cohort.

J.M. | Most of the companies within my coverage and restaurants and staples companies took significant amounts of pricing in the past one to two years to help offset inflation. In face of that, most companies have cited that consumers continue to hold on better than they expected, with more benign elasticities relative to pre-pandemic and original expectations. That said, elasticities this year have begun to creep higher in light of the continued elevated pricing that companies are taking to combat inflation. So you're starting to see this show up and some of the volume and traffic trends. Many companies, as Jackie mentioned, are also calling out pressure on the low income consumer and are seeing some signs of value seeking behavior. Whether this is buying a 12 can pack of Coca-Cola instead of the six pack of mini cans or changing their trash bags less frequently to save costs. And then you've also seen some shift from branded products to private label, which is typically cheaper, as well as shift within channels into club stores or mass markets, where the value proposition can be better through prices or pack sizes. So that's all sort of examples within staples. Shifting to restaurants and food distributors, the consumer is still buying food out of the house, but you're seeing some check management at casual and fine dining and then also some trade down into something like quick service restaurants from the slightly more expensive, fast casual.

C.V. | Let's briefly talk about what's happening on the costs and expenses side of the equation. Jackie.

J.H. | A year or so into the pandemic, we saw a period of record margin expansion really on the back of excess demand for goods that was amplified by a supply constrained backdrop, which essentially resulted in low promotional and discounting activity, which helped to basically provide an offset to some of the cost pressures that were brewing out there. As the economy continued to reopen and that initial benefit of the stimulus bump started to wane, in 2022 you essentially had the impact of demand falling short of this big inventory rebuild on the back of that strength in consumer demand in the prior year, and that hit a number of retailers from a gross margin standpoint. Beyond that rate, that has been a pressure point and has been as much as a several hundred basis point headwind for some retail players. The cost pressures have generally been easing on that front and companies have started to recoup some of that margin headwind at this point, but there are some other pressure points that are out there as well. Commodity prices, those have been a headwind for certain categories that don't benefit from as much relative pricing power. So, for example, cotton, that has been a headwind for some players in the apparel space, you've had elevated e-commerce mix that was a headwind during the pandemic just due to the cost of fulfillment, and that has somewhat normalized a bit. You've had unfavorable mix with skewed towards consumables and away from high margin general merchandise or more discretionary type products. That's also played a role in the margin pressures out there. And then shrink, shrink has become a meaningful and surprisingly persistent headwind to margins as well for a number of quarters now and I think organized crime has been a much discussed factor, but I don't believe that the issue is just limited to this. And then, of course, on the labor front, we've seen upward wage pressure that's likely more a structural headwind to margins and expense structures. By-and-large, I'd say that there's been a varying ability for companies to pass through these cost headwinds onto the consumer, and there are still a number of incremental unknowns on the horizon that reduce just the overall visibility around the margin outlook. So you have, still, the potential for promotions to continue to normalize, slowing demand could drive inventory imbalances leading to markdown risk and just drive greater SG&A deleverage on sales. So still, I would say a number of considerations on the expense and margin side of the equation.

J.M. | Thinking about the cost of goods for companies that's in my coverage, commodities, including food, are one of the biggest buckets. It's been a headwind to margins for both restaurants and consumer staples companies, which has resulted in some cases pretty meaningful price increases in an attempt to offset some of the headwind and pass cost inflation onto consumers. One thing I specifically look at is the CPI of food-away-from-home versus food-at-home. When the CPI of food-away-from-home is lower than at-home, which it was for essentially all of 2022, with food-away-from-home, up 6 to 9% versus food-at-home up 8 to 13%, it's supportive of consumers going out and buying food out of the home at restaurants, given the rate of price increases for food purchased at the grocery store is higher than food at restaurants. This year, we've seen that flip with food-away-from-home now above food-at-home as restaurants were a bit slower to react to inflation and so we'll see what happens with consumer spending and share of wallet as this dynamic continues to progress.

C.V. | Are these price increases sustainable?

J.M. | At this point, most of the companies across my coverage have no intent to cut prices. You're seeing some increases in promotion, but primarily at the frequency level over depth. This is where pricing power comes into play, a concept that's very important within staples coverage. Ultimately, if companies take too much price, you'll see the consumer react and start to buy less, resulting in weaker volume trends, potentially more than offsetting the price increase. So it's a fine line and the companies in more commoditized categories are the most at risk here of pricing rollbacks. At this point, as I've said, elasticities remain better than expected but are increasing. However, at the same time, cost inflation hasn't eased enough to warrant price decreases for most companies. So most are planning for a more normal level of pricing at this point in 2024 something like low single digits given what we know today, which is a significant deceleration from 22 and 23 as level of price increases.

C.V. | Shifting gears to the labor issue, the labor issue is really interesting because it factors into both the supply side of the consumer sector and into the buying power of consumers themselves. Unemployment is down, but wages may or may not be, depending on who you ask. Jackie, can you weigh in on that?

J.H. | Most are likely aware the labor market has remained incredibly tight and given that consumption trends have remained elevated, the demand for Labor has essentially remained quite strong and that's partly due to the fact that it was very difficult to find labor coming out of the pandemic and just generally churn and turnover of the employee base can have ramifications on a business. But ultimately that dynamic has put a fair amount of upward pressure on wages, which supports consumer incomes, which in turn supports pricing. Earlier this year we were seeing still solid, nominal income gains supported by a decent employment backdrop in wage growth, combined with slowing headline inflation, which incrementally helps support real consumer spending. Look, ultimately the elevated level inflation has been squeezing real purchasing power of the consumer and putting volumes under pressure. But at this point, job creation is slowing and this is somewhat anecdotal in nature, but within retail, I've had mixed trends as far as holiday hiring plans, some up, some down, some flat. Just the other week, there were some headlines around a major retailer cutting wages for some new hires, so potentially some early signs of relief on the wage front, yet there are also ongoing union negotiations that are looking for greater wages and higher pay and then at the same time, gas prices, those have been steadily moving higher. We're still off the highs that we saw in 2022, but still moving higher of late and that's an incremental pressure point and acts as a tax on the consumer. So all of that I mentioned just to highlight how many crosscurrents exist in how incredibly dynamic the unemployment and the consumer backdrop has been and still remains.

J.M. | What I'm seeing in my coverage area is labor has also definitely been a challenge across companies, both coming out of the pandemic when companies literally couldn't hire enough people, creating a challenge of labor availability and then accelerating wage inflation of as much as 15% plus for some restaurants, which has certainly been a challenge to the headwinds of the P&Ls of consumer staples companies, as well as restaurants and food service distributors. For restaurants specifically, labor has been a frequent issue for really the past decade. There's been legislation pushing for higher wages, a recent example being the modified California Fast Act, which targets raising the minimum wage for fast food workers at chain restaurants to $20 an hour. So restaurants with a geographic footprint skewing toward California will likely have to take more price or take labor costs out of the business to offset. In addition to geographic footprint, another factor affecting a restaurant's exposure to wage and overall inflation is whether the company's franchised or not. So to take a step back, a company like McDonald's at a high level is mostly franchised, and so they ultimately collect a royalty on sales that their franchisees generate at each unit. So the franchisee essentially pays for the wage or labor inflation. It does impact the brand from sort of a box economic or franchisee strength perspective. And they want the franchisee to have strong margins and profit and good returns, in part to incentivize unit growth, but it doesn't have as direct of an impact on the P&L as something like a Cheesecake Factory that owns its units and operates its day-to-day operations, where a 7% wage inflation number would directly flow through their P&L. So given this headwind, you've seen a lot of restaurants both franchised and un-franchised shift toward digital as a way to reduce the labor requirements at each location.

C.V. | Sticking with that point on digital, I think it's fair to say that the pandemic accelerated all things digital, virtual connections, remote work, e-commerce. Jen, can you talk a little bit about that within the restaurant industry?

J.M. | Restaurants have definitely increased their digital capabilities, in part accelerated from pandemic behavior to save on labor costs, given the inflation and just due to changing consumer preferences. So you're seeing some restaurants renovate their units or new builds that include more digital capabilities to drive customer traffic, higher average check and take labor costs out of the box. And more restaurants are also partnering with third party aggregators like Uber Eats and DoorDash® to support delivery sales as consumers increasingly prefer the convenience.

J.H. | To your point, Chris, on just the pandemic accelerating all things digital, I think that is certainly true within the retail space. Essentially, when the economy shut down, there was a huge surge in consumption within the e-commerce channel and you did see the e-commerce penetration take a step back in 2021 just with the reopening of the economy, but the e-commerce penetration levels have remained above pre-pandemic levels at this point. That said, I don't think that the backdrop has been entirely bad for brick and mortar retail. Retailers still have a need to continue to optimize and fine tune their supply chains, particularly around last mile logistics and I would argue that the pandemic actually served as a nice reminder to how physical real estate can actually play a critical role in helping solve for some of these profitability challenges around supply chain and last mile logistics. During the pandemic, there was an uptake in services such as curbside pickup, buy online, pickup in-store, you had retailers shipping from store, and all of that has helped enhance and support traction for just broader multichannel efforts. And then another piece of the puzzle, if you will, is that with the higher rate and cost of capital backdrop, there is certainly more of a focus today on profitability and in some ways I would say it's been a race to the bottom on aspects such as speed of delivery within e-commerce, and that's really been led by the 800lb e-commerce gorilla in the room. But what you're seeing now is that many companies have been becoming much more disciplined and more focused around margin and are seemingly more reflective or at least are being forced to be more reflective around just the underlying returns on the investments that they're making in their businesses.

C.V. | So a lot of the retailers have used their brick and mortar stores and turn them into essentially mini distribution centers.

J.H. | Correct.

C.V. | Jen, What are some other structural trends or ongoing dynamics that you're seeing in your industries.

J.M. | Starting within restaurants and food distributors, pre-pandemic, you saw a fairly steady trend of spending more on food-away-from-home versus food-at-home — consumers essentially eating out more. Food-away-from-home increased from 40% of food expenditures in 2000 to 55% in 2019 and within that, you saw a structural shift toward independent restaurants from chain restaurants. Both of these have ultimately resumed post-pandemic, and you're seeing some of the food distributors prioritize the growth of their independent restaurant business as a result, because it's both growing faster and it's actually also higher margin for them. Another trend within restaurants would be driving growth in breakfast and p.m. snacks two less well penetrated areas that have been a particular focus for quick service names like McDonald's and Wendy's, since it's a way to drive additional sales that are high margin. Shifting gears to consumer staples within food, you've seen faster growth of the snacking category relative to the rest of packaged food as consumers pre- and post-pandemic are increasingly on the go and enjoying smaller meals but more snacks. And in alcohol, specifically beer, you've seen a shift away from economy and premium economy beer over the past one or two decades toward import beer and premium beer.

C.V. | What's the takeaway for investors? We like to end each show with a look through Boston Partners unique three-circle lens. So let's look ahead to the rest of 2023 and into 2024. Jackie, do certain segments within retail lend themselves to the three-circle process more than others?

J.H. | I would say that much of our current exposure within the retail space has been to names where we think there are relatively defensive or countercyclical attributes, names that have opportunities for relative growth through market share gains or for more cyclically enhanced exposures. Basically names where there are some form of earning support through P&L offsets and just lower operating leverage, which all should kind of allow for relatively better momentum. Generally we've been avoiding names that are still relatively early in the sales and margin reversion phase, particularly those categories that have experienced meaningful pull forward and tend to have longer replacement cycles. And from a fundamental standpoint, just given the uncertainties in the backdrop, we're invested and positioned in names that have strong management teams with good historical track records around execution, at companies that have strong competitive moats and strong balance sheets. Specifically, I would call out one of my top ideas for the year has been Walmart. We see this as a two plus circle stock with strong fundamentals and momentum at reasonable valuation. So fundamentally, Walmart benefits from the fact that it has dominant positioning in the grocery industry and it offers Walmart tremendous scale advantages. The company sees benefits from strong free cash flow generation and they have a rock solid balance sheet. And on the momentum front, Walmart has benefited from its less discretionary and value oriented offering. And in the context of the inflationary backdrop, Walmart has been a beneficiary of trade down and just market share gains. On top of this, they are coming off the back of multiyear investments in a number of initiatives, including its multi-channel capabilities, which have essentially been a headwind to bottom line flow through over recent years, but they've, at this point, reached a tipping point where they should begin to see more leverage and really begin to scale some of their prior year investments. And that should help support the overall profit trajectory for the company on their investments. And valuation still appears reasonable in the context of what we see as strength in the fundamental and momentum circles.

J.M. | From a fundamental standpoint, a company like Procter & Gamble would fit this description right now, but then it ultimately comes down to the momentum of the business and the price that you pay for it. And given it's a bellwether industry name, it's typically a bit rich. I'll also highlight one of my best ideas this year so far would be U.S. Foods, a food distributor. This is a company that has strengthening fundamentals under a new CEO with internal initiatives to drive an improvement to the business, while also having favorable exposure to the structural tailwind I mentioned of growing food-away-from-home and a shift toward independent restaurants. They generate cash, leverage has come down, they're expanding margins and they're starting to repurchase stock. And valuations, attractive on an absolute basis and relative to peers, and momentum as good as they're successfully executing on the things that they can control.

C.V. | Are there any other headlines going on in the restaurants or staple space?

J.M. | Yeah. So within my coverage, both in restaurants and consumer staples, you're starting to see an uptick in both M&A and IPO. We saw Darden acquire Ruth's Chris Steak House, Campbell Soup acquired Sovos Brands and J.M. Smucker is acquire Hostess Brands. So we're starting to see companies look for attractive assets to help them drive growth and or operating efficiencies as pricing power wanes and volumes remain a bit uncertainty to drive growth, which I expect will continue looking into '24. And then you're also seeing an uptick in IPOs with Kava Restaurant Group, Aditi, Can View etc. and I think this will likely also continue if the markets remain favorable.

C.V. | Jackie, Jen, thank you both for the insights and joining the show.

J.H. | Thanks for having us, Chris.

J.M. | Yeah, thanks, Chris. It was great to be here.

C.V. | That was Jennifer Mace and Jackie Hall, equity analyst who cover the consumer sectors here at Boston Partners. Stay tuned for future episodes of the show. Meanwhile look for deeper investment related content from Boston Partners on our Entry Points video series featuring the expertise and analysis of other top minds at the firm. That and more can be found on our website at www.boston-partners.com or give us a follow on our LinkedIn page. I'm Chris Villalba. We'll see you next time with more Boston Partners Insights.

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Mr. Villalba is a member of the Investor Relations team at Boston Partners and joined the firm in July 2010. In this capacity, his responsibilities include sales and relationship management of Boston Partners products within financial intermediary channels. Prior to joining the firm, Mr. Villalba was a regional private banker with Wells Fargo Bank, N.A. Before that, Mr. Villalba held the role of investment associate at Morgan Stanley in the firm's Global Wealth Management division. He holds a B.B.A. degree in finance from Pace University and FINRA licenses series 7, 66, and 3. Mr. Villalba began his career in the industry in 2007.

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Disclosure

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