

The Week That Was: How Will Market Turmoil Change the CPG/Retail Marketplace?

30 Sep 2008

By: Bryan Gildenberg & the MVI Research Team

We at MVI have been just as riveted by the economic drama being enacted in our nation's capital this week as many of you have been. In an attempt to frame up some of the potential implications of this, our content experts put some thought into what everyone should be thinking about as this week turns into the rest of 2008 and 2009.

In particular I would like to extend many thanks to David Marcotte, John Rand, Leon Nicholas, Lindsey Olssen, and Sara Korn for their contributions, with an additional thanks to Ray Gaul (who is on holiday this week) for his contributions to my thinking on this topic.

Quick Thoughts on Finance/Economy

If we could forecast precisely what was going to happen to the global equity and debt markets we'd be hanging out with Warren Buffet more often than we do; and as of 1:59 am EDT on September 30, 2008, there was no asset purchase plan in place from the US Government to solidify global credit markets. Obviously, if this condition continues for the next three to five days, the performance of the equity markets may radically reshape consumer sentiment.

For the Short Term

In the short term (assuming credit and asset markets do something like stabilize), the most obvious implication seems to be that the cost of credit will go up markedly as its availability will shrink; then as demand for credit and the supply of quality credit risks goes down the cost should fall markedly.

This relatively immediate shock to the system heavily impacts retailers whose strategy or operating stability is most dependent on capital inflows in the short term (we'll explore this idea more closely in the Retailer Behavior section). One retail entity that may be impacted by this in the very near term is McDonalds, as reports indicate that its McCafe rollout may be coming under pressure due to franchisees being unable to get access to bank capital.

There are also some predictable implications in the medium-long term:

- The dollar is headed for a period of revaluation versus other currencies. Just last week, the head of Bundesbank was talking about how the dollar will no longer be the global currency of record and that the world financial system will become more "multipolar."
- A US whose government cannot balance its books will continue to struggle to post above historic average growth unless the dollar significantly declines in value.

The Sourcing/Manufacturing Impact

This should have significant impact for anyone responsible for sourcing/manufacturing capacity decisions, and it will be interesting to continue to watch what types of manufacturing continues to relocate back to the USA. We would expect this to be products where manufacturing cost is a relatively small part of the total product cost and products where inventory carrying costs are high. The

opportunity to manage down pipeline inventory for a US business by NOT having significant chunks of production coming from 10,000 miles away makes more economic sense with a weaker dollar. This may be a real economy of scale for global manufacturers versus multinational ones—the multinationals may find themselves not diversified enough in their sourcing/outsourcing process and may find that the process “clots” (i.e., too much capacity in markets that are the wrong cost point for the US marketplace).

Dollar-Based Economies

In addition, there is the “dollar-based” economies of Central America to consider, which have seen a major rise in orders from the US. Target and Wal-Mart both recently started shifting more volume from sourcing product in Southeast Asia to these markets, and again Wal-Mart has an advantage here because it runs the largest retail business in Central America. Being dollar based has become an advantage, but not necessarily one limited to US manufacturers!

In the very long term, it will be interesting to watch US consumer morale if the dollar loses its place as the currency of record/index.

Consumer Behavior

1. Our expectation is that this uncertainty should lead to unprecedentedly low levels of consumer confidence, which should translate to slower retail sales momentum. The news this week appears to be more impactful for the “balance sheet” consumer in the USA than the “income statement” consumer, and that balance sheet-type purchases (e.g., major durables, holidays, high-ring services) are probably going to be impacted more than the movement of everyday consumables (see the article [Finding Routes in Tougher Times: Multivalued Consumer Decision Making](#)).
 - This is particularly significant because many people literally can't buy a major consumer durable if they can't get credit. *Couple a lack of credit with shrinking earnings and there's nowhere to hide if your items cost more than what the average person has in his pocket/the bank.* Many products that require financial planning to purchase will probably be deferred in the short-medium term.
 - For everyday purchases it will be interesting to see how public perception of the “bailout” plan shapes the perception of everyday reality. It seems likely that unless there is a direct and specific impact, the intensity of the media coverage surrounding this plan will fade and that income statement consumers will be left with essentially the same reality they faced three weeks ago.
 - “Informal high interest credit,” which includes pay day loan and pawn shops, is already reporting increases in business this past year. Most of the larger companies have now branched out into all forms of consumer credit and can be accessed online. They are also moving from being informal businesses to more formal ones.
2. Volatility or uncertainty (about the present AND the future) translates into very cautious, even hoarding consumer behavior, where “stability” is the goal.
 - Immediate consumption needs tend to do well in this environment.
 - Advertising that reassures and offers a haven should be well-received. Wal-Mart's low-key, family-centric campaigns are well-positioned here and the same can be said for traditional food companies.
 - At MVI we have been discussing attributes of “new premium” brands (transparency, preservation, purpose). A key question raised here is: *if there is a new premium, is there a new everyday as well?* If there is, one of the attributes we would have to consider for it in this environment is “stability” (MVI will provide additional forthcoming insight into the new premium).
 - This volatility also drives the broader question of consumers trading out of categories altogether or moving those purchases to used products. For example, thrift stores are reporting significant growth over the prior year.
3. A key question on the front burner is: how can suppliers and retailers enable shoppers to have a respectable and enjoyable holiday this year given the economic situation? If no one feels like celebrating, how can retail help lift spirits? If shoppers are worried about having money to spend, is starting Christmas in October the best way to make shoppers happy? *We expect that suppliers in seasonal categories are/will be in intense conversations with retailers about how to appropriately position seasonal good cheer in this unique environment!*
4. Finally, it is probably a mistake to over focus on the economic situation, particularly when

thinking about medium/long-term planning. For instance, many suppliers have become intensely concerned with retailer's private label shares in this landscape—especially around the brand derivative low price point private label. However, it is important to remember that the broader threat to suppliers from private label still comes from retailers that use private label in an “incandescent” way to develop their own brands (see the presentation [Brands on the Run? The Future of Private Label](#)). Suppliers that take their eye off of these broader consumer trends (e.g., media fragmentation, new premium, sophisticated retailer brands) will regret that decision in 2010.

Retailer Behavior

As we previously mentioned, the specifics of a tight B2B financing environment is that retailers whose strategy or operational stability rely on access to capital will suffer most severely.

- **Strategy.** One retailer we follow closely that most reflects this is probably Walgreens. Walgreens has been engaged in a variety of financial strategies in the past 6 to 12 months (including reducing capital expenditures on new stores and taking on significant balance sheet debt for the first time) to fuel strategic acquisitions. An increasingly challenging capital environment makes this more difficult. It may, for instance, put more intense pressure on Walgreens' attempted takeover of Longs (though that proposal looks to be under significant pressure even without a banking crisis; see the article [Longs Acquisition Update: Declines to Entertain the Walgreens Offer](#)). Any retailer that has an aggressive store expansion or acquisition strategy is going to need to revisit that strategy, as it will cost more than it did a month ago!
- **Operational stability.** This reflects those companies that are poorly performing and highly leveraged more severely than any other enterprises. We would caution suppliers to expect “cash-optimizing” behavior, which includes:
 - Conservative buying,
 - Slow payment, and
 - Excessive deductions

from their slowest growing, most highly leveraged customers!

Suppliers Should Watch for the Five Additional Behaviors

There are five additional key behaviors that suppliers should be watching carefully:

1. Retailers that rely on perception of wealth as part of their purchase appeal (rather than actual wealth, such as Tiffany Company) for growth are going to struggle in a global economy where asset values appear uncertain. *Expect these retailers to try to aggressively reposition themselves around any need/high purchase frequency categories they sell.*
2. If US growth is slowing and retailers have to deliver growth to shareholders, overseas may be the best place to go. *This may make international expansion a more attractive strategy for US retailers that have historically resisted it, and may cause retailers that are already expanding internationally to accelerate (though a weaker dollar may make this less attractive in some cases).*
3. If the move toward premium has left a category with gaps in its “merchandising ladder,” the white space left behind will probably end up being non-brand or retailer brand. *Suppliers must continue to ask the question: should we be more diversified here and provide offerings up and down the ladder rather than simply focusing on our premium solutions?*
4. As previously mentioned, M&A activity is going to slow considerably from lack of third-party backing. *Retailers that close are going to remain dark. Expect overall selling space capacity to decline in sudden drops.*
5. As long as there continues to be significant variances in economic uncertainty by geography (e.g., housing prices, employment), *there is an increasing need to tailor strategy by trading area. For very centralized retailers (like Safeway and Target), this may be difficult to accomplish. Retailers that are equipped to do this well, or that only operate in one trading area, should benefit from this marketplace complexity.*

Knock-On Effect: A Global View

Outside of North America the downturn in the housing market and the financial services industry has caused an economic slowdown in markets where growth was strongly dependent on one or both of those—Ireland, UK, Spain, and Australia, for instance.

Canada

As far as the rest of North America, Canada seems to be weathering the initial storm reasonably well. Its financial services industries were much more conservative in extensions of credit (industry estimates suggest that only 4% of Canadian mortgages issued are subprime), but it did fully participate in the derivative and shared risk markets. With economic uncertainty setting in, weaker players, such as Metro and Hudson, are very exposed at the moment because they are undergoing major transitions. There has been a lot of conversation in Canada over the past 24 months about how “decoupled” Canada’s economy has become from the USA—a weaker dollar in the long term versus the Canadian dollar and a slowdown in Canada’s #1 export market may put that assumption firmly to the test.

Mexico

Mexico is a more complex story—there are a host of things going on in the country that are uniquely Mexican (see the article [UBS Downgrades Walmax to Sell Status](#)). From a credit perspective, there is a glut of bank consumer credit (the market was flooded last year) and defaults on consumer credit cards are up. Walmax was benefiting from that glut, as its own card does not have the same historic brand loyalty as some of the other retailer cards. The other variable in Mexico is that the foreign remittance part of its economy is directly linked to the USA (almost USD10 billion this is the second-largest driver of external income for the country). Due to the crackdown on border security, even though the jobs have dried up in the States, Mexican citizens in the US are reticent to come back because they are very unsure of getting back into the States once things improve. This creates a double-edged impact, particularly on the poorer areas of Mexico’s cities and low-income rural areas that rely on foreign remittances as a primary source of income—there’s no money coming in and no workers to fuel economic growth at home.

Top 10 Key Conclusions

1. Credit will be more expensive and less available for consumers and businesses in the short-medium term; major credit-related purchases appear significantly at risk.
2. The dollar’s long-term revaluation versus other currencies in the world should create opportunities for supply chain realignment, especially with increased manufacturing in dollar-based economies (e.g., the US and Central America).
3. Consumer confidence is the lever to gauge how credit uncertainty impacts shopper behavior on non-credit-related purchases.
4. Uncertainty may place greater value on brands, retailers, and suppliers that can communicate stability to shoppers.
5. Retailers and suppliers may need to work hard to reposition holiday seasonal messaging in a more appropriate way.
6. Over-focusing on short-term economic conditions and ignoring longer-term issues on media/consumer fragmentation, the evolution of brands, and the repositioning of premium for consumers is a mistake, even though these times are emphasizing short-term, price-sensitive responses.
7. Retailers that rely on capital for key strategic initiatives or operational stability are most at risk in this environment. Across the board, any retailer pursuing an aggressive expansion strategy will find that strategy more expensive in the short-medium term.
8. We expect retailers to focus on positioning themselves as needs, not wants. The retailers whose brands and merchandise do not effectively stretch this way are most exposed in this environment.
9. Retailers will push suppliers for greater understanding up and down their “merchandise ladder,” as well as for regional insights as the economic situation drives very different trading behavior by region.
10. The global impact of this is already being felt. Markets that were experiencing explosive growth in property values or rely heavily on financial services are feeling the pain first. Closer to home, Canada is expecting some volatility and Mexico is undergoing a host of economic challenges.