INTUITION

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A festive slowdown for retail apparel

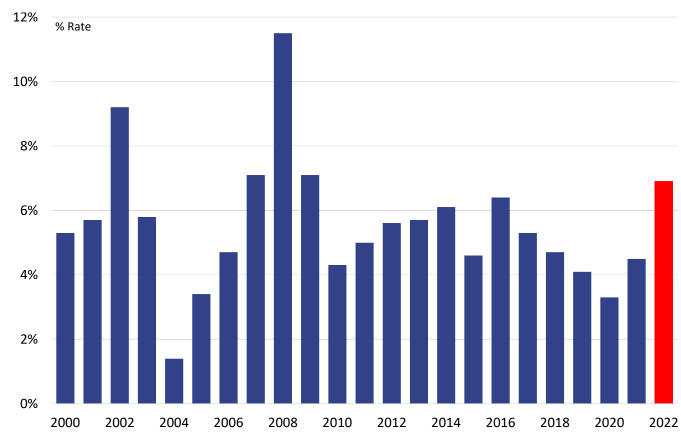
For most retail stores the festive period is where seasonal peaks occur as customers flock to malls to splurge on Christmas gifts. For the recent festive period, it certainly wasn't a case of "one size fits all." The apparel retailers had either relatively good updates or muted growth, and those that granted customers credit fared better than their peers. In this article I will highlight the festive trading updates from the apparel retailers, focusing on what contributed to their performance (or lack thereof) and what could be expected for the first quarter in the new year.

Jana
van Rooyen

I am really bad at buying gifts and unfortunately for the economy I was one of the consumers that spent very little over this past Christmas period. Why? The 2022 year proved exceptionally challenging for the everyday consumer with the average annual inflation rate reaching a 13-year high of 6.9% in 2022. (The previous high was in 2009 at an average inflation rate of 7.1%). Consequently, the South African Reserve Bank (SARB) increased interest rates aggressively - by 3.75% in just thirteen months. On top of it all, we also had the worst year of loadshedding ever. Loadshedding affects a company's growth either by reduced sales or through higher costs to run back up power, which cascades through the economy, resulting in subdued overall growth. These headwinds mean that companies cannot increase other operating costs such as salaries. Despite BankservAfrica's data reflecting an increase in salaries paid into bank accounts in December (204,075 more salaries), the December BankservAfrica Take-Home Pay Index (BTPI) noted a drop of almost 5% in take-home pay. It is likely that any new job opportunities that were created were in the lower income categories.

All the 2022 headwinds make for a depressing outlook for GDP in the year ahead. The World Bank projects that our

AVERAGE ANNUAL CONSUMER PRICE INFLATION



South Africa's average consumer inflation for 2022 was 6.9%. The previous high was 13 years ago in 2009 at 7.1%.

SPEED READ

- **2022 was a year of headwinds for the consumer with average annual inflation reaching a 13-year high. Consequently, interest rates rose sharply, putting pressure on disposable income.**
- **December's trading updates reflected an increase in household credit. Of the major listed apparel retailers, Truworths' and Woolworths' credit approval rate was less conservative than peers. Both attracted more customers as consumers increasingly turned to credit for their clothing needs.**
- **Encouragingly, consumers are returning to malls and shopping centers. There was a noticeable increase in footfall over the Black Friday period in November and this continued into December, albeit at a slightly slower pace.**
- **With headwinds still expected for the first quarter of 2023 at least, we question whether granting more credit to drive sales is the right strategy?**

GDP growth for 2023 will be only 1.4%. This was lowered from 1.5% previously as the World Bank stated that “weak activity in major trading partners account for over 40% of exports, tight global financial conditions, political and policy uncertainty will constrain growth and widen external vulnerabilities”. Closer to home the SARB is even more bearish. It has also materially lowered its outlook for GDP growth this year to just 0.3%. Furthermore, it estimates that loadshedding will shave around 2% off our growth rate this year. Scathing indeed and a timely reminder of the opportunity cost of government failure. Retail apparel is mostly discretionary spend and therefore relies on a conducive economic environment with growth in net employment. With muted GDP growth, discretionary spend will remain constrained or consumers will turn increasingly to more credit.

Over the past few weeks, the apparel retailers released their festive season updates and there were a couple of themes that came through:

1. **Deceleration during the festive period:** We noticed that although some companies had a better trading update for Q4 2022 compared to the 3rd quarter, there was a deceleration noted in the sales growth for some. Stats SA’s Retail Sales data for November reflected an improvement with growth of 0.4% year on year (and after falling by 0.7% in October.) The uptick was largely driven by the household furniture and appliances sector which was up by 6% and the clothing and footwear sector which was up by 5.9%. Black Friday, which typically now lasts for the full month of November in SA, certainly boosted trading.

2. **Loadshedding:** Those retailers that had sufficient back up power were able to trade better during the festive season. Mr Price (MRP) did not quite get on board the “back up power boat” as quickly as their peers, with less than 50% of stores covered. The impact on sales between stores with backup power and those without was noticeable. They are now accelerating the process of putting back up power in 70% of their stores before the 2023 financial year end (March 2023.) Fortunately, they have sufficient free cash flow to enable them to do this. We expect that when the annual accounts are reported for all retailers later this year that the cost of running backup power will be substantial. Shoprite has already reported a R560 million bill for diesel in their interim results while Pick and Pay’s 10-month trading result reported spending R350 million on diesel. Given weak consumer spending, retailers are struggling to pass these costs on, which implies that the sector will experience significant margin pressure.

As an aside, if the cost of loadshedding was passed onto consumers, we would be facing higher food (and other) costs, which in turn would drive inflation higher and consequently interest rates as well. It’s a vicious circle, but one that can so easily be avoided if government is proactive!

MISSING THE BACKUP POWER BOAT

The Foschini Group: stores comprising 70% of turnover have energy backups.
Truworths: stores comprising 77% of turnover have energy backups.
Pepkor: stores comprising 100% of turnover have energy backups.

Mr Price: *You guys have backups?*

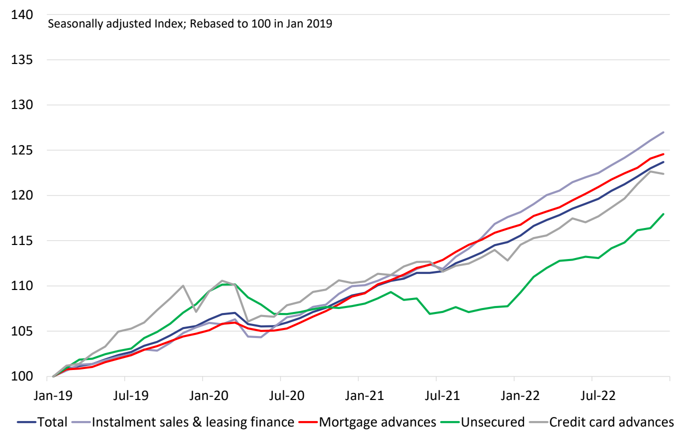
MRP did not quite get onboard the “back up power boat” as quick as their peers, and the impact on sales between stores with backup power and those without was noticeable.

3. **Acquisitive growth:** After years of little activity, acquisitions across the sector have gained momentum over the past 2 years. MRP, Pepkor (whose stores include Pep and Ackermans) and The Foschini Group (TFG) reported good growth, however all three of these companies have recently acquired smaller competitors. If you exclude the recently acquired businesses, like-for-like sales were softer.

4. **Credit:** One of the most notable features of this reporting season was the difference between cash and credit sales. Those who provided credit had a better festive season. Truworths’ and Woolworths’ credit approval rate was not as conservative as their peers. Consequently, they attracted more customers as the consumer turned to credit for their clothing needs.

Looking forward, those companies who implement strict credit granting controls are likely to see their rate of sales growth slow further. According to the NielsenIQ household survey that was conducted in December on 2000 households spread across South Africa, to determine consumer shopping preferences, 50% of the LSM 1 – 6 segments said that they are more likely to access credit facilities to purchase clothing over the next 12 months. Of all the categories such as food, health, electronics and beauty products, clothing had the highest preference to credit for both poorer and wealthier households. It would appear that credit retailers have the upper hand.

SA HOUSEHOLD CREDIT GROWTH

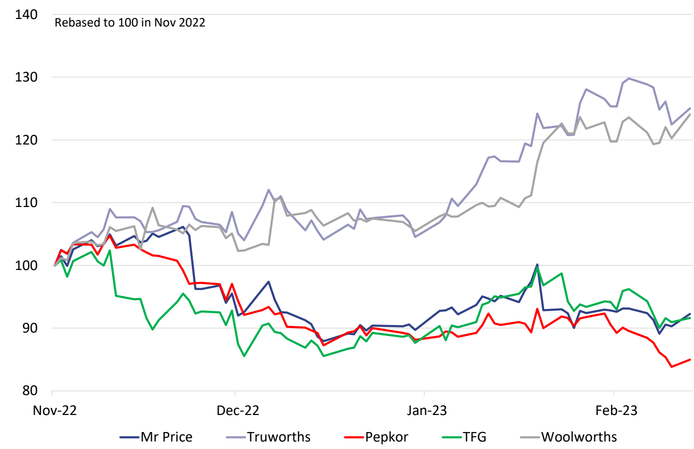


South African Reserve Bank data reflects that household credit grew by 7.4% year-on-year in December, compared to the average of 6.7% in 2022. Unsecured credit, which would include retail accounts, was lagging but has accelerated sharply over the past 12 months.

But the downside is with mounting pressure on the consumer and weaker disposable income, the likelihood of consumers defaulting on their retail accounts are high. SARB data also reflects a 7.4% year-on-year increase in household credit for the month of December compared with the average of 6.7% for the 2022 year. Therefore, despite weaker sales near term, we believe that cash-based retailers are a safer bet in the current environment
.

5. **Footfall returning:** Most retailers reported a drop in their online sales demand and a corresponding increase back to the physical store as we return to some pre-Covid normality. Vukile Property Fund, which owns malls in South Africa and Spain, reported that December footfall was higher than last year, especially in the township and community malls, which outperformed regional malls. The footfall for Black Friday weekend in South Africa was up by 15% year on year with rural centres up by 13% over the same period. This translated to sales growth of 6.7% and 6.0% year on year respectively from November and December 2021. Whilst Vukile did experience growth in clothing sales across its malls over the festive period, that growth was only 4.8%, well below other categories.

SHARE PRICE REACTION OVER FESTIVE PERIOD



Truworths and Woolworths have outperformed their peers in recent months as credit sales boosted revenues.

In conclusion, the trading updates reflected companies that remain resilient and are strong businesses. Yet the consumer remains under pressure and the outlook for the next 6 months remains tough. There could be good news in the Budget due in 2 weeks' time – tax incentives for solar and further details about a Basic Income Grant, and inflation is moderating. These could ease consumer pressure and continue to play into our theme of "The Supported Consumer" which favours companies like MRP and Pepkor over more affluent retailers like Woolies and Truworths. Furthermore, coming from a commercial credit background, I would be reluctant to increase my credit exposure in this difficult environment. Higher bad debts might easily be the prevalent theme in 12 months' time!

Truworths is focused on a more affluent segment and therefore faces a more challenging environment.

Our next Insight seminar will be held in March on the dates shown. Please save the date.

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Topic: **Mechanics of Volatility**

Natal Midlands	
Date:	Thursday, 16th of March
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	Tuesday, 14th of March
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

CONTACT DETAILS:

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HARVARD HOUSE GROUP

3 Harvard Street, Howick, 3290, South Africa

P.O. Box 235, Howick, 3290, South Africa

+27 (0) 33 330 2164

+27 (0) 33 330 2617

@ admin@hhgroup.co.za

W www.hhgroup.co.za