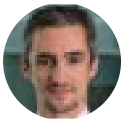
12 July 2023

Allianz Research

European retail: a cocktail of lower spending and tighter funding

Executive Summary

Aurélien Duthoit
Senior Sector Advisor
aurelien.duthoit@allianz-trade.com



Maxime Darmet
Senior Economist US & France
maxime.darmet@allianz-trade.com

- **One year on since Russia's invasion of Ukraine, retail sales in Europe have proven more resilient than expected despite record-high inflation and poor consumer confidence.** Income growth has (partially) cushioned the inflation shock. In particular, strong gains in labor income, mostly from strong job creation in France and higher wages in Germany, Italy and Spain, have supported household purchasing power. Overall, accumulated pandemic savings have had a secondary effect to support consumption spending, and credit contributed significantly in France and Italy. However, consumption is only likely to pick up steam after the second half of 2024.

- **The purchase paradox: Unlike in past economic downturns, spending on non-durable goods (predominantly food, but also electricity and car fuel) has fallen the most (from -2% in Italy up to -7% in Germany).** Conversely, bigger ticket items such as durables (cars, consumer electronics, furniture, appliances) or semi-durables (clothing, toys, cultural goods) have generally continued to grow by a low single digit despite the surge in the cost of living, and services including air transport (+42% y/y), food service (+13% y/y) and accommodation (+30% y/y) are thriving.

- **One possible explanation is the asymmetric nature of the inflation shock on households.** Because they are most exposed to items seeing the fastest increase in costs such as food and shelter, the lowest-earning households have no choice but to cut back on essentials, while more well off households can maintain discretionary spending. Our calculations show that in H1 2023 the average household spent an extra +EUR132 for the same basket of goods and services in Spain, +EUR244 in France, +EUR301 in Italy and +EUR290 in Germany, compared to H1 2022. .

- **Lower growth, higher interest rates and tighter funding put fashion, department stores and e-commerce specialists most at risk**. As the positive impact of legacy Covid-19 support schemes fades away, consumption slows down and credit becomes more scarce, large insolvencies are making a comeback with 16 cases in 2022 for a total turnover at stake superior to EUR5bn. Already in Q1 2023, the pace of the deterioration accelerated further, with 11 cases totalling EUR2.4bn at play, paving the way for a return to levels last seen in 2019 should the trend continue through the year.

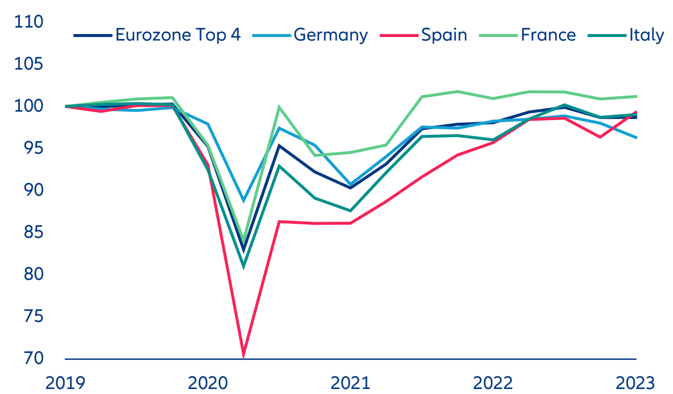

Photo by Thomas Le on Unsplash

Income growth shields consumption

European household consumption expenditure resilient in the face of historically high inflation. Russia's invasion of Ukraine in February 2022 ushered in an era of higher inflation and lower consumer confidence in European countries. Over the past year however, household consumption expenditure has been more resilient than initially feared with Q1 2023 data showing quarter-on-quarter and year-on-year growth across all major Eurozone economies short of Germany (Figure 1).

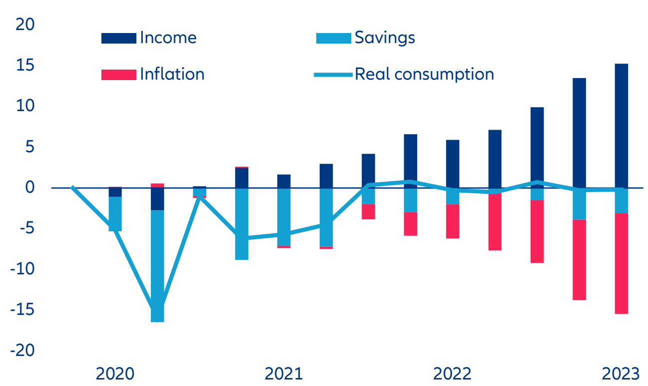
Strong income growth has (partially) cushioned the inflation shock on European households' consumption. As Figure 2 illustrates in the case of France, the strong pickup in nominal income has supported consumption in the face of high inflation. In Germany and France, household income growth has outpaced inflation, by 1.7pt in Germany and 2.9pts in France between end 2019 and end 2022. However, in Spain and, more particularly in Italy, inflation outpaced household income: by -2pts in Spain and a large -4.3pts in Italy. Savings have generally remained elevated in large European countries, adding headwinds to consumption growth, except in Italy where households have been saving less since end 2022 to help fund their spending in the face of elevated inflation.

Figure 1: Final household consumption in volumes (Q1 2019=100)



Sources: Eurostat, Allianz Research

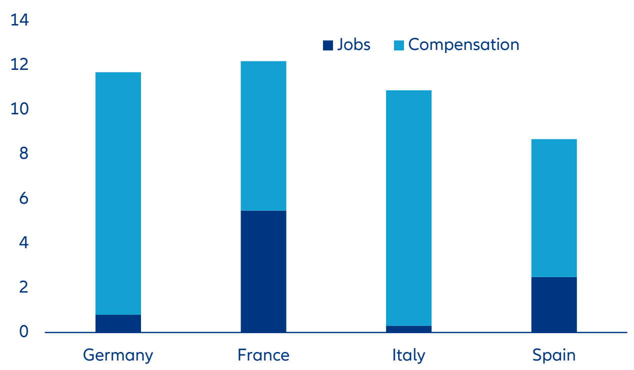
Figure 2: Final consumption (in volumes) growth drivers in France (cumulative growth rate since Q4 2019, %)



Sources: Eurostat, Insee, Allianz Research. Note: a negative 'Savings' bar means that household are increasing savings, which decreases consumption ceteris paribus.

Households' income growth has been primarily fuelled by strong gains in labor income (the larger share of total income by far). The composition of labor income growth reveals large differences between countries. In Germany and Italy, elevated compensation per working person (which comprises wages and other variable earnings such as bonuses) has supported labor income, whilst job creations have been subdued (see figure 3). Conversely, in Spain and more particularly in France, labor income has grown out of strong job creations rather than large gains in compensations. The upshot is that in Germany and Italy, real consumption per working person has probably decreased less than in France and Spain[1].

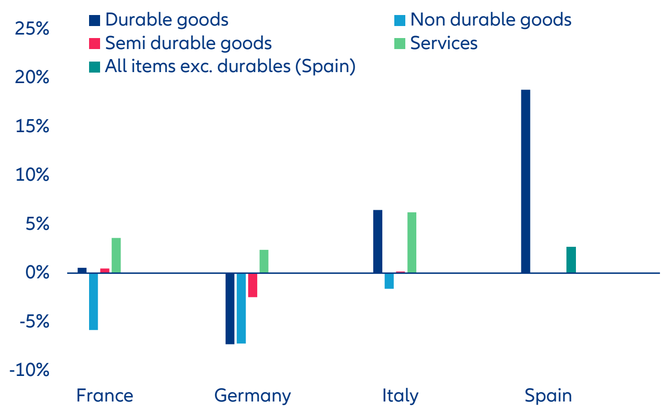
Figure 3: Growth in labor income (growth rate between Q4 2019 and Q4 2022, %))



Sources: Eurostat, Insee, Allianz Research

Overall consumption resilience masks opposite dynamics between categories. Looking at the individual components of household consumption, and contrary to past periods of economic downturn, we observe that, of all categories, non-durable goods (predominantly food, but also electricity and car fuel) saw the biggest decline in consumer spending over the past year across all major eurozone economies. Conversely, bigger ticket items such as durables (cars, consumer electronics, furniture, appliances) or semi-durables (clothing, toys, cultural goods) have continued to grow despite the surge in cost of living (Figure 4).

Figure 4: Final household consumption expenditure by category (volume, % change Y/Y, Q1 2023)



Sources: Eurostat, Allianz Research

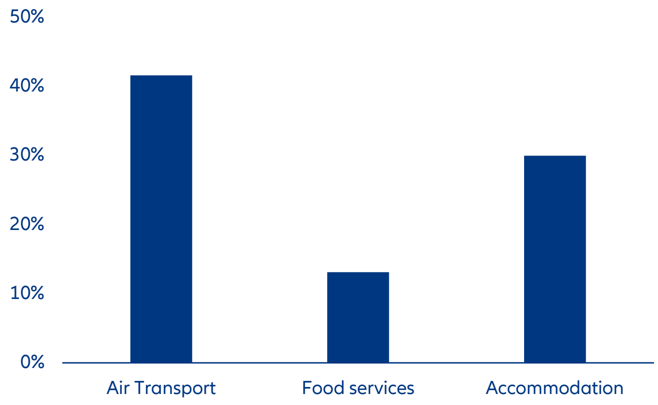
What about other sources used to fund consumption? It is hard to assess the precise contribution of consumer credit to consumer spending, but it is likely to be quite small. In France, the outstanding stock of consumer credit has increased by EUR 85bn between Q4 2019 and Q1 2023, versus a cumulated flow of total consumer spending of EUR 4200bn, ie consumer credit has made up around 2% of cumulated consumption. In Italy, the contribution is also around 2%, but in Germany and Spain, the stock of consumer credit has actually decreased. As regards pandemic savings, the evidence suggests that households have barely used them to fund consumption. Households' deposits holdings – ie, liquid assets which can been drawn upon easily – have flatlined in Spain and are continuing to grow in Germany and France. In Italy they are decreasing since August 2022, but part of these liquid savings may be shifted to less liquid, but higher-yielding forms of assets.

Of note, we observe that services have generally been more resilient and benefited from spending rotation, in part because spending on actual rents, imputed rents, or insurance (about half of the "services" aggregate) is not discretionary, in part because foodservice, accommodation and transport services have seen strong demand. Adjusting turnover data for inflation, we observe that activity in the three segments grew by +13%, +30% and +42% in the first fourth months of 2023 vs 2022, respectively (Figure 5).

2023 growth forecasts across an even wider range of goods and services confirm the antagonistic trends in goods and services consumption, with leisure services outperforming and a few categories of durables and semi-durables such as automotive and luxury personal goods still enjoying robust growth (Figure 6)

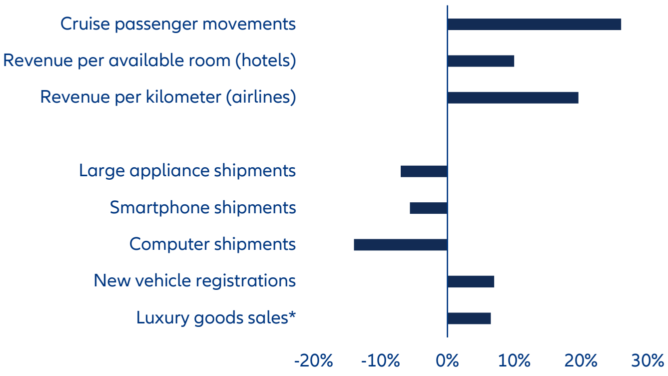
[1] Non-working persons also consume; therefore, it is possible that these people cut back on their spending more than working persons (dragging down aggregate consumer spending) and thus that working persons have not cut back as much.

Figure 5: Deflated turnover growth in selected services, EU27 (% change year-to-date, Y/Y)



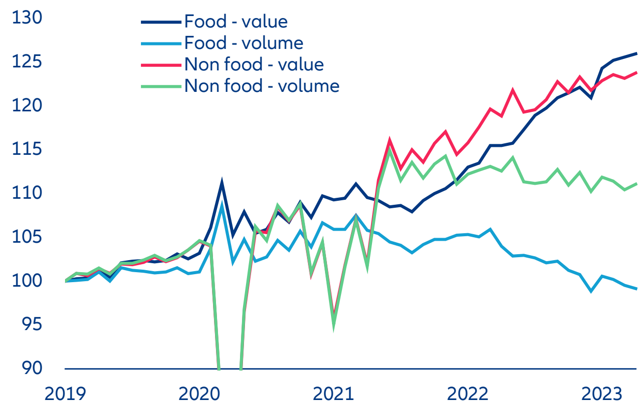
Sources: Eurostat, Allianz Research

Figure 6: 2023 growth forecasts, Europe (% change Y/Y)



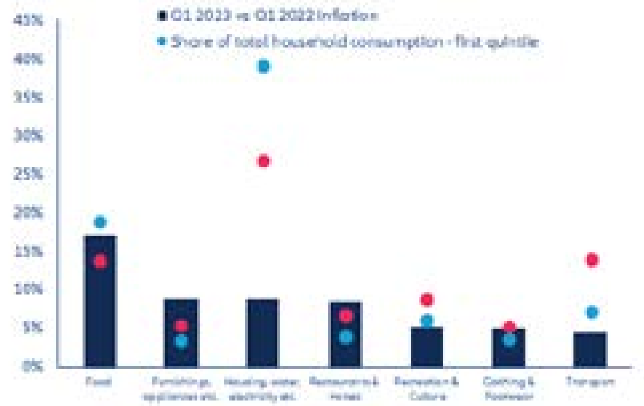
Sources: IATA, Risposte Turismo, IDC, Bain, Altagamma, company information, Allianz Research

Figure 7: EU27 retail sales (Jan 2019=100)



Sources: Eurostat, Allianz Research

Figure 8: Inflation rates and share in household consumption of selected items (EU27, %)



Sources: Eurostat, Allianz Research

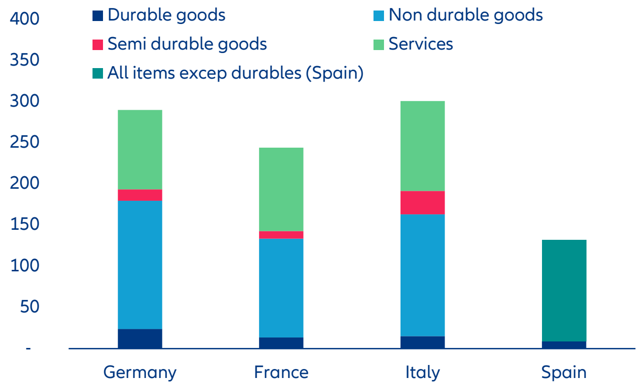
Looking at retail sales for validation of the divide between non-durables goods and other goods, we find confirmation of the paradox, with consumer staples (food) falling further (-5% y/y in Q1 2023) than non-food items (-1% y/y), which are supposed to be cyclical (Figure 7).

What explains this puzzling pattern? We believe it is the asymmetric nature of the current inflation shock. Plotting inflation across products and services against their relative weight in the consumption expenditure of the 20% poorest households by income (first quintile) and the 20% richest households by income (fifth quintile), we find that the poorest households are disproportionally exposed to high-inflation items. In particular, food (prices up +17% y/y) and the “shelter” aggregate (rents, water, electricity etc. prices up +9% y/y) combined account for over 57% of their total spending vs only 41% for the fifth quintile (Figure 8). Conversely, restaurants, recreational goods, clothing and transport, which have a bigger weight in the consumption of wealthier households, have seen comparatively lower increases in prices. In other words, the current inflation shock is leaving the poorest households with no choice but to cut back on everything, including essentials, while the more well off continue to indulge on discretionary spending.

Inflation is costing European households +EUR130 to +EUR300 per month. To help quantify the exceptional inflation shock on households, we analyze nominal household consumption by product category over the past year in the Eurozone’s top economies, with a view to distinguish the contribution of volumes and prices. Once the contribution of price i.e. inflation is computed at a macro level for H1 2023, we convert it to express it on a per month and per household basis.

Our calculations show that the average household spends an extra +EUR132 for the same basket of goods and services in Spain, +EUR244 in France, +EUR290 in Germany and +EUR301 in Italy (Figure 9). Across all countries, and despite accounting for less than 30% of total household consumption, non-durable goods are either the largest or second-largest contributor to the increase in the cost of living, together with services (50-55% of total household consumption).

Figure 9: Monthly cost of inflation per household (Q1 2023 vs Q1 2022, EUR)



Sources: Eurostat, Allianz Research

A pick-up in mid 2024

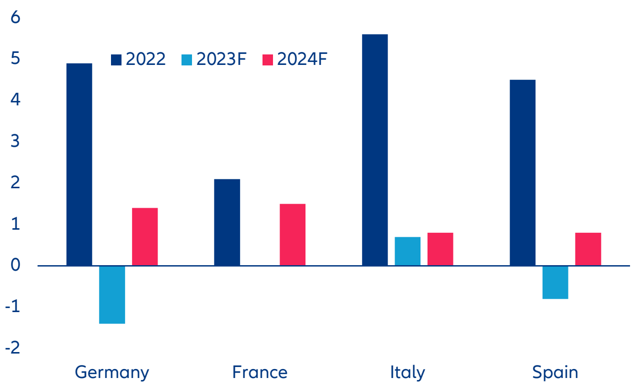
Consumption is expected to remain depressed through mid-2024, before picking up modestly as households' real wages and confidence improve. We expect household consumption to remain lackluster until mid-2024 in the large Eurozone economies. Consumer spending intentions for large durable goods purchases are low amid tight credit conditions and elevated interest rates. Besides, higher interest rates are likely to increasingly incentivize households to shift accumulated savings to higher but less liquid accounts, and/or to keep their savings rate elevated. According to surveys, savings intentions for the next 12 months remain at historically elevated levels. We expect household consumption to dip by -1.4% this year in Germany and -0.8% in Spain (Figure 10), with downside risks to our forecasts owing to weak May retail sales.

However, the medium-term consumption outlook for consumption should improve amid brighter prospects for real household income growth. Firming wage growth, resilient labor markets and normalizing inflation should boost household income growth and support an acceleration in consumption. Real (inflation-adjusted) wage growth already started to turn positive in Q2 2023 in Germany and Spain, and it is expected to turn positive in France and Italy in Q3 2023. All else equal, gains in real wages in 2024 are expected to boost households' real disposable income (purchasing power) by +EUR16.8bn (+1%) in France over the whole of 2024, +EUR36.5bn (+1.5%) in Germany and +EUR13.4bn (+1.1%) in Italy – the equivalent, per household of EUR545, EUR877 and EUR522, respectively.

However, we expect the consumption recovery to be relatively lackluster and to pick up steam only from the second half of 2024. Gains in real wages will only gradually feed through to higher spending as tight financing conditions will keep a lid on household confidence and keep savings intentions high.

Muted consumer spending until mid-2024 will weigh on the retail environment. Our expectations for softer consumer spending will continue to weigh on sales volumes in the coming quarters, while the easing of inflation will progressively see turnover growth moving into negative territory.

Figure 10: Real consumer-spending growth outlook (% y/y)

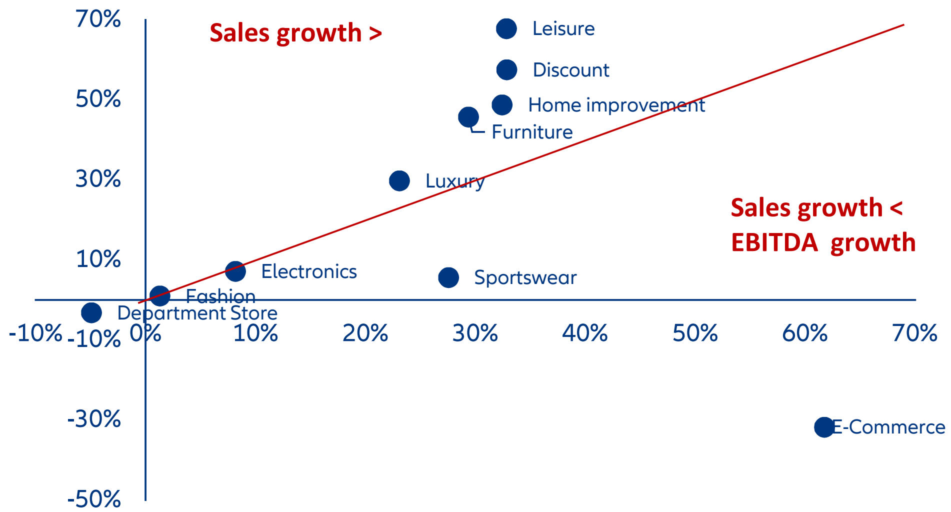


Sources: Eurostat, Allianz Research

This marks a trend reversal from the post-pandemic period. Looking at the median sales and profit growth for a panel of European retailers, we find that profits and sales have returned above their 2019 levels across all segments short of e-commerce and department stores, and that profits grew faster than sales among leisure, discount, home improvement, furniture and luxury retailers (Figure 11). On top of strong underlying demand and high inflation, sales and profits of leading companies have also benefited from market share gains from defunct retail chains and independent stores that never reopened post-pandemic.

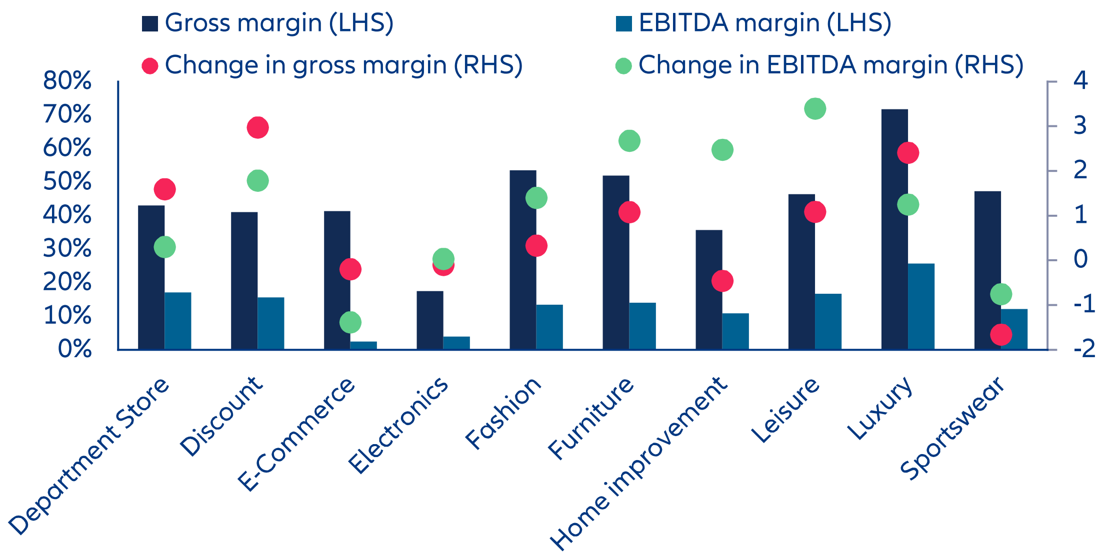
Looking at profitability not in EUR but as a percentage of sales, we find that gross margins grew by a median +0.7pp and were a key contributor to the +1.8pps increase in median EBITDA margins. Here again improvement is widespread among sub-segments. Higher profitability among retailers compared to pre-pandemic levels is consistent with the wider trend that corporate profits explain, in part, the magnitude of the inflation surge in Europe. However, extra profits from 2021-2022 did not always compensate for the losses of 2020

Figure 11: 2023 vs 2019 turnover and EBITDA (% change, median value))



Sources: Eikon, Allianz Research

Figure 12: Median 2022 gross and EBITDA margins (%) and change from 2019 (pps)



Sources: Eikon, Allianz Research

Focusing on credit metrics, we find that the median net debt to EBITDA ratio across all categories fell by -0.3 to 1.9 between 2019 and 2022, while the interest-coverage ratio gained 1.5 to reach 9.7 times the net interest expense. In other words, after a very challenging 2020 and first half of 2021 marked with unprecedented business disruption, the increase in profitability has been enough to significantly improve the risk profile of the median company.

Lower growth, higher interest rates and tighter funding put fashion, department stores and e-commerce specialists most at risk. Together with lower growth ahead, we believe the tightening of financing conditions in Europe will further add to the risk environment and lay bare the vulnerabilities of companies that so far were able to stay afloat. While interest expense is a minor cost item for most retailers (less than in 1% of sales in our sample), a few big names that ventured into acquisitions or breakneck expansion display greater sensitivity to higher financing costs. More worryingly, the tightening of financing conditions could hamper the capacity of retailers to finance their operations. Unlike food retail where working capital requirements are negative, discretionary retailers generally have the equivalent of two to three months' worth of sales locked in receivables and inventories.
To identify the segments the most at risk, we create a simple risk scorecard by assigning a score from 1 (best) to 10 (worst) based on how sectors rank on turnover growth since 2019, net debt to EBITDA and the interest coverage ratio. We find that department stores, e-commerce and fashion specialists stand out as the top three risk pockets, with scores superior to 20. Conversely, luxury and sportswear stand out as the safest segments**.**

Our scorecard finds confirmation in recent high-profile cases of retail insolvencies involving companies from the three mentioned segments. While the restructuring of the fashion and department store segments has arguably been going on for more than a decade, the situation is new in the e-commerce segment where abundant and cheap funding have long allowed a preference for growth over profitability. The equation is now different and the patience of investors will be tested at a time when online sales volumes have been declining on a year-on-year basis in the last three quarters.

We also find confirmation of the deterioration of the risk environment in large insolvency data. Our monitoring shows that after the initial shock of the pandemic in 2020, insolvencies of retail companies with a turnover of more than EUR50mn fell dramatically amid strong government support to SMEs, including guaranteed loans, partial unemployment schemes and the postponement of social security contributions, among others. As the positive impact of those support schemes began to wane and the economic environment began to sour, large insolvencies bounced back, with 16 cases in 2022 for a total turnover at stake superior to EUR5bn (Figure 15). The pace of the deterioration accelerated further, with 11 cases totaling EUR2.4bn at play in Q1 2023 alone, paving the way for a return to levels last seen in 2019 should the trend continue through 2023.

Figure 13: Median credit metrics for listed European discretionary retailers

Segment	Net debt to EBITDA (2022)	Change in net debt to EBITDA (2022 vs 2019)	Interest coverage ratio (2022)	Change in interest coverage ratio (2022 vs 2019)
Department store	2.1	-2.1	6.0	0.9
Discount	2.4	-0.7	14.5	2.2
E-commerce	4.2	-0.8	4.4	0.2
Electronics	1.8	-0.7	17.8	10.9
Fashion	1.8	-0.0	8.6	1.4
Furniture	3.0	0.2	13.1	2.5
Home improvement	2.2	-0.8	10.9	2.2
Leisure	1.9	-0.5	9.8	3.8
Luxury	1.0	-0.3	25.0	8.8
Sportswear	0.8	-0.1	22.9	7.1

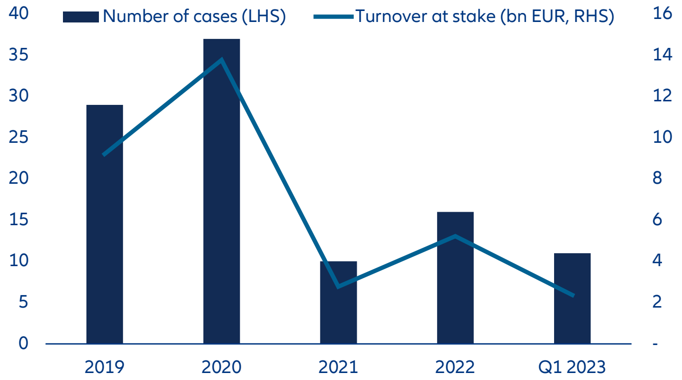
Sources: Eikon, Allianz Research

Figure 14: Risk scorecard: ranking of retail segments across indicators

Segment	2022 / 2019 sales growth	Interest coverage ratio	Net debt to EBITDA	Total risk score
Department stores	10	9	6	25
Discount	2	4	8	14
E-commerce	1	10	10	21
Electronics	8	3	3	14
Fashion	9	8	4	21
Furniture	5	5	9	19
Home improvement	4	6	7	17
Leisure	3	7	5	15
Luxury	7	1	2	10
Sportswear	6	2	1	9

Sources: Eikon, Allianz Research

Figure 15: Large discretionary retail insolvencies (turnover > EUR50m)



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Our team

Chief Economist
Allianz SE

Ludovic Subran
ludovic.subran@allianz.com

Head of
Economic Research
Allianz Trade

Ana Boata
ana.boata@allianz-trade.com

Head of Macroeconomic &
Capital Markets Research
Allianz SE

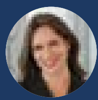
Andreas Jobst
andreas.jobst@allianz.com

Head of Insurance, Wealth
& Trend Research
Allianz SE

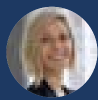
Arne Holzhausen
arne.holzhausen@allianz.com

Macroeconomic Research

Maxime Darmet Cucchiarini
Senior Economist for US & France
maxime.darmet@allianz-trade.com

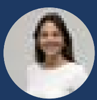


Roberta Fortes
Senior Economist for Ibero-Latam
roberta.fortes@allianz-trade.com

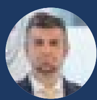


Jasmin Gröschl
Senior Economist for Europe
jasmin.groeschl@allianz.com

Françoise Huang
Senior Economist for Asia Pacific
francoise.huang@allianz-trade.com



Maddalena Martini
Senior Economist for Italy & Greece
maddalena.martini@allianz.com



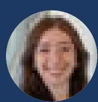
Luca Moneta
Senior Economist for Africa & Middle East
luca.moneta@allianz-trade.com

Manfred Stamer
Senior Economist for Middle East &
Emerging Europe
manfred.stamer@allianz-trade.com

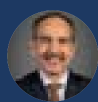
Corporate Research

Ano Kuhanathan
Head of Corporate Research
ano.kuhanathan@allianz-trade.com

Aurélien Duthoit
Senior Sector Advisor, B2C
aurelien.duthoit@allianz-trade.com

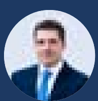


Maria Latorre
Sector Advisor, B2B
maria.latorre@allianz-trade.com



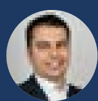
Maxime Lemerle
Lead Advisor, Insolvency Research
maxime.lemerle@allianz-trade.com

Capital Markets Research



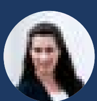
Jordi Basco Carrera
Lead Investment Strategist
jordi.basco_carrera@allianz.com

Bjoern Griesbach
Senior Investment Strategist
bjoern.griesbach@allianz.com

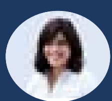


Pablo Espinosa Uriel
Investment Strategist, Emerging
Markets & Alternative Assets
pablo.espinosa-uriel@allianz.com

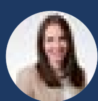
Insurance, Wealth and Trends Research



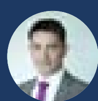
Michaela Grimm
Senior Economist,
Demography & Social Protection
michaela.grimm@allianz.com



Patricia Pelayo-Romero
Economist, Insurance & ESG
patricia.pelayo-romero@allianz.com



Kathrin Stoffel
Economist, Insurance & Wealth
kathrin.stoffel@allianz.com



Markus Zimmer
Senior Economist, ESG
markus.zimmer@allianz.com

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Director of Publication
Ludovic Subran, Chief Economist
Allianz SE
Phone +49 89 3800 7859

Allianz Group Economic Research
https://www.allianz.com/en/economic_research
Königinstraße 28 | 80802 Munich | Germany
allianz.research@allianz.com

@allianz
allianz

Allianz Trade Economic Research
http://www.allianz-trade.com/economic-research
1 Place des Saisons | 92048 Paris-La-Défense Cedex | France
research@allianz-trade.com

@allianz-trade
allianz-trade

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