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Low oil prices continue to fuel discretionary spending among all demographics in the U.S., but especially in the middle class, and analysts are optimistic about retail sales as the holiday shopping season fast approaches. Joe Brusuelas, chief economist at RSM, and Bain Capital's Tricia Patrick discuss macro trends in consumer spending.

**Privcap:** We're talking consumer spending. Heading into the holiday season, what are some macro trends that you're seeing right now, Joe?

**Joe Brusuelas, RSM:** What you're seeing is a very strong tailwind in the U.S. household sector, driven by a long period of strong job gains, job gains that are tilted towards higher-paying jobs, modest wage gains—and the biggest thing is the fall in gasoline prices. We were here last year, and I said that we would see roughly the equivalent of \$150B tax cut. That's exactly what's happened, and the consumer spent roughly three quarters of it and saved the other quarter, so we're setting up for probably the strongest holiday season since before the recession.

**Tricia Patrick, Bain Capital:** It's interesting, heading into the

holiday season, because if you look at the fundamentals, it's pretty easy to feel that the season will be good. And many of the retailers we're involved with think that is probably right. But there's a sense of angst as any individual retailer worries about the weather, the changing days in the holiday season, and everything else. It certainly feels like it will be a good holiday season, but every single company is going to be at war out there, because every year it gets increasingly promotional.

**Cyber Monday was a big story a couple of years ago, and now it seems like people want to have something tangible, don't they?**

**Brusuelas:** Cyber Monday and Black Friday are purely promotional. They don't mean anything with respect to the

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direction, the nature, or the dynamics of the overall holiday season. We've seen the discount started already, and because the U.S. consumer's been conditioned to accept price cuts, what we really get is that game of chicken between retailers and the consumer that will go all the way until just before the holiday season, and then even after December 25th.

**Patrick:** I agree with Joe. Black Friday, Cyber Monday, Green Monday, the day after Thanksgiving, the opening times—it's all just one big reason to get in front of consumers and have them hear your voice.

**We hear a lot about millennials, how to reach them, how to get their loyalty. Joe, are you seeing big brands diversifying a bit to try to reach those millennials?**

**Brusuelas:** From a bigger point of view, the millennials are disrupting the traditional retail industry when we think big box or malls. Their spending habits, their preferences, are so vastly different from, say, Generation X or the baby boomers that it challenges the way in which we can track what the real holiday season is.

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So, having said that, [retailers] are trying to diversify. You can see what Macy's is doing, right? That's probably the best example. But what's more important is millennials aren't content to just buy things for themselves. They want to go out and they want to experience things. So when I'm looking at the holiday season, I include accommodation and recreation in my estimate of what I expect holiday sales to be. It gives a much more robust and accurate picture of the underlying dynamics of holiday spending.

**Patrick:** This is a long-term trend that retailers and consumer products companies have to be focused on right now. This isn't just about the holiday season. Millennials are the largest consumer base in the U.S. as of now. They're beginning to actually increase their household formation rates and start spending on the things that they haven't been spending on for a long time, like home decor, like groceries.

And they consume differently. They're experiential; they're digital; they've grown up in an environment where they tend to value safety. They also value uniqueness, something that's more craft-oriented or personal. So this is going to change the way a lot of retailers need to refocus their own brands. And a retailer who doesn't think about their offering and how they're reaching this consumer base is basically giving up. For the long term, it's going to be a real issue to keep those brands from aging.

**Brusuelas:** One thing many retailers are missing is, if they do alter what they're doing to accommodate this new population, they'll actually regain some measure of pricing because that millennial population will pay a premium for handcrafted beer, for smart digital tech.

**Patrick:** We've been talking about bifurcation of spend for over a decade now— people want to spend and splurge on quality items, but they want to get value for the items they consider more a commodity. This consumer base is taking that high-low [split] to another level, and by keeping an eye on that and getting ahead of it, you can actually create more spending power.

**Is there still a middle class in this country?**

**Brusuelas:** There is, but because of the sluggish recovery and the slow rise in wages, the middle class remains somewhat beleaguered.

**Patrick:** The middle class is certainly present in this country. They've been struggling, but it's one of the biggest spending groups in the country, when you think about discretionary spend. We have a number of investments that target that middle class. TOMS Shoes is absolutely in the square-spending pattern of the middle-class consumers. [So is] Bob's Discount Furniture.

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**Brusuelas:** The windfall from falling gasoline prices and the appreciation of the dollar has actually increased the purchasing power of the middle class. For many middle-class individuals, this year is the first year they’ve seen real increases in disposable income, and maybe some of those imported goods they like from France or Italy or Germany or Japan or South Korea are actually relatively cheaper. I’m expecting the middle class to be the major driver of holiday spending this year, as opposed to the upper two quintile of income earners, who are going to pull back just a little bit because of the volatility we’ve seen in equity markets since the middle of summer, which has been somewhat stomach-churning.

**Do energy prices trending down affect the way that retailers are shipping things?**

**Brusuelas:** The cost of transportation is an enormous variable in terms of setting the overall price. What you’re seeing are some lower prices coming on the production

side also, because the cost of production has declined so noticeably over the past 18 months. My sense is there’s a bit of apprehension, because at one point that game of chicken between consumer and retailers has to end. And the key is not to cut the prices. Set the price, try to stay with it—at least from a retailer point of view—to the extent you can.

**Patrick:** There’s been a huge change in input costs. So it’s not just energy and freight, it’s a lot of the actual commodity costs—and labor wage rates have slowed their growth. And when there are dollars on the table, people fight pretty hard for it. We’ll see what happens to the consumer, but certainly retailers, as they look at their product costs, are looking to negotiate pretty hard.

**Technology is supposed to make things easier, but does it also make things way more expensive?**

**Patrick:** It has to. Retailers are spending huge amounts of money to make this a seamless consumer experience, [especially] from mobile devices, which are actually where the predominance of pre-shopping is happening for online purchases. All of these different initiatives cost a lot of money. And the reality is retail as a whole is still growing in the low single digits—3, 4 percent year-over-year. So if you’re spending all of this extra capital and you’re not getting all that much full growth for the business, it is affecting profit margins, and it will continue to.

**Brusuelas:** I’m not such a big fan of multiple channels describing what’s going on. It’s a digital future, right? We need to have bricks and mortars, we have to be online, and the way in which we do it is important. One of our clients, Rebecca Minkoff, does a great job of integrating technology into stores to create a holistic consumption experience where you’re in the store but you also can go online and buy some very cutting-edge, interesting, and stylish products.

**Tricia, as an investor, where do you see the retail opportunity right now? Is it ancillary transaction businesses?**

**Patrick:** Almost every subsector in retail has an interesting strategy you can get behind. A lot of the investments we’ve made over the last three or four years have been in smaller companies. In part, that’s because with the amount of disruption going on in retail, those smaller businesses are primed and able to compete in a very different way, and it’s been exciting. But within each sector there are interesting sub-trends to play behind, especially with everything going on demographically in this country. The question is what you have to pay for it. Prices have been pretty high for several years now, both in the public markets and in the private markets where we spend most of our time. ■