CANADIAN CONSUMER: TOO BIG TO FAIL

The role of the Canadian Consumer in the post COVID-19 pandemic economy

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COVID-19 is a crisis of historic proportions: a supply and demand shock, amidst a global pandemic.

Even in Canada where we have managed to contain the spread and mostly re-open our economy, many fear, the worst is yet to come. At BCG, we have been pulsing global consumer sentiment and analyzing macro-economic data since the start of the pandemic. We share the concerns about the future, with a potential second wave and impending financial recession, but we also know the reality is highly nuanced. One thing is for certain: The path out of this crisis requires the Canadian consumer to keep on spending.

Canada's economic prospects amid the COVID-19 pandemic largely lie with the Canadian consumer. Consumer spending drives nearly 60% of Canadian GDP and will play a major role in shaping the length and depth of the post-COVID recession (see Exhibit 1). During the global financial crisis that started in 2008, it was the Canadian consumer (together with global energy and commodity prices) that spurred Canada's economic recovery and ensured the recession was fairly moderate, compared with most other countries. However, this time will be different: Canadians came into this crisis in far worse shape than in 2008, over-levered and insecure (see Exhibit 2).

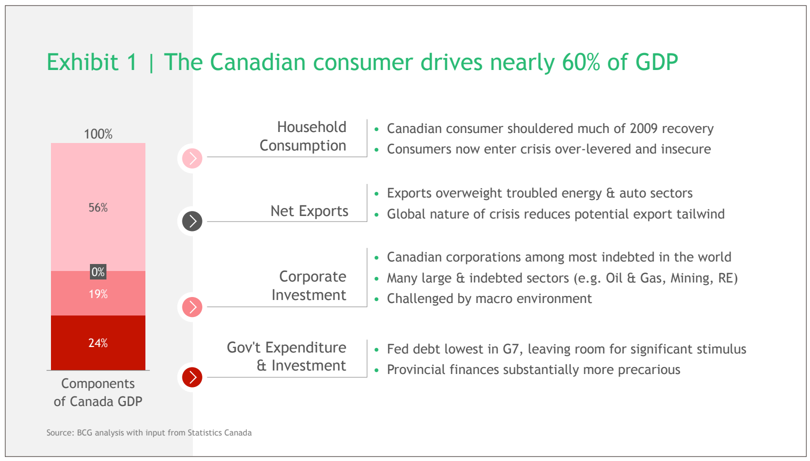


Exhibit 1 | The Canadian consumer drives nearly 60% of GDP

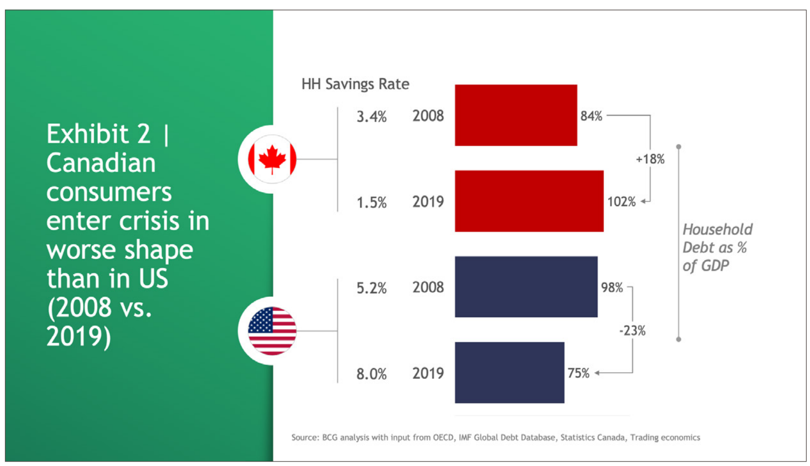
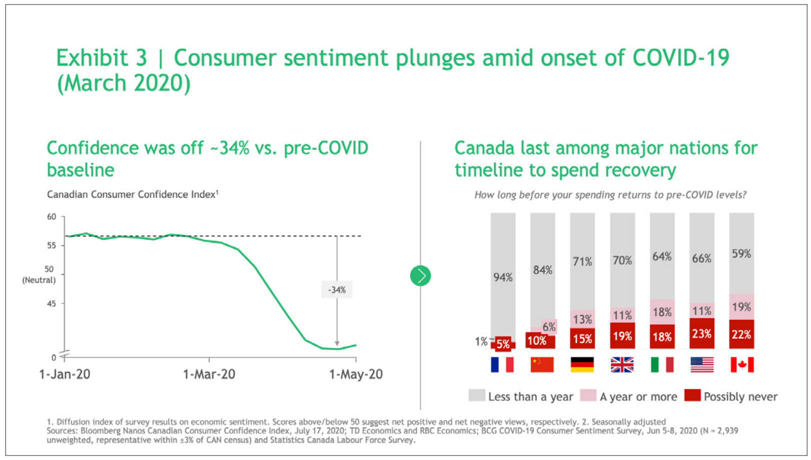
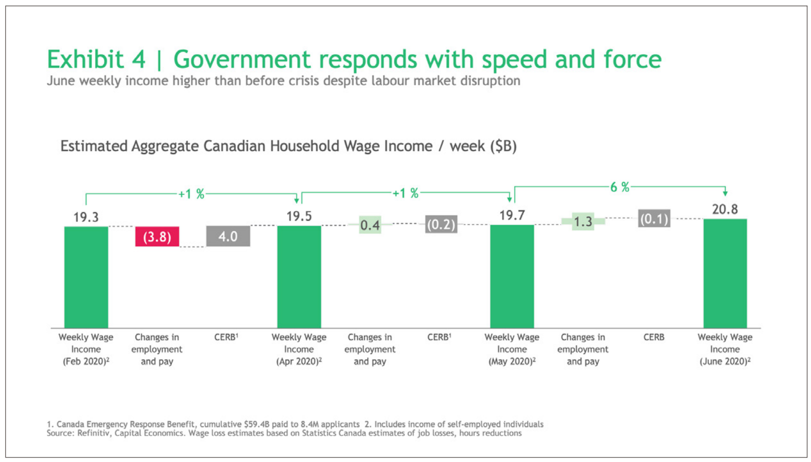


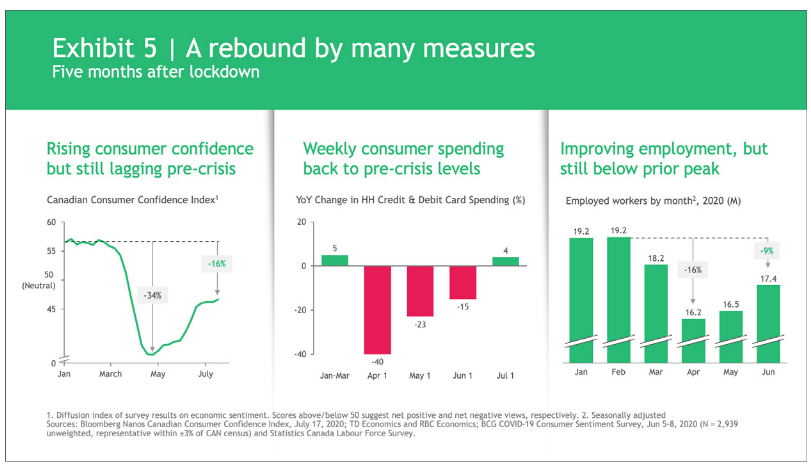
Exhibit 2 | Canadian consumers enter crisis in worse shape than in US (2008 vs. 2019)

At the start of the crisis, Canadian consumer sentiment tracked the desperation felt across the country and hit historic lows in April. In fact, throughout the crisis, Canadian consumers have been among the most pessimistic among all the nations we surveyed (see Exhibit 3). As a result, the federal government moved with speed and force to make the consumer whole, e.g., by launching wage support (CERB) and working with financial institutions to delay mortgage payments. By all accounts, it was a success with household income and savings rising (see Exhibit 4) even as unemployment spiked from 5% to 13% and nearly 40% of the workforce felt the ill effects of the pandemic on their jobs.





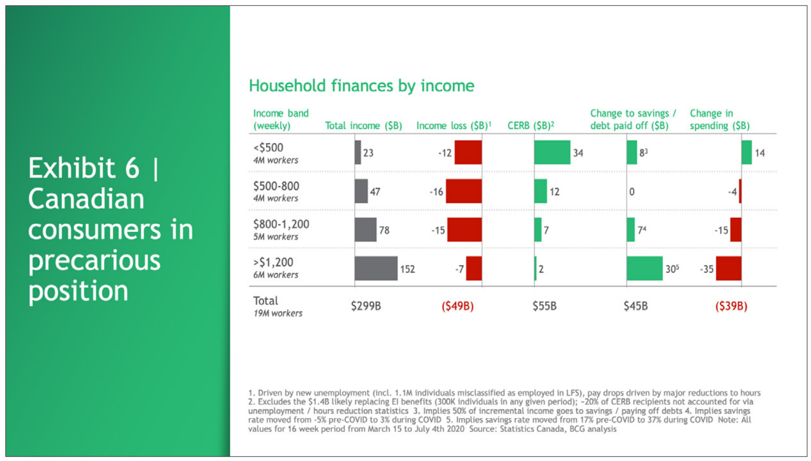
In the months that followed and during the summer, consumer sentiment recovered nicely, with Canada leading most major economies when comparing to pre-COVID levels. By early July weekly spending in Canada on credit and debit cards showed a return to pre-crisis growth rates of around 5% compared to last year. We have also seen the number of employed workers starting to rise again, but not yet at pre-COVID levels (see Exhibit 5). The metrics might even have prompted some to think we were on a path to a V-shaped recovery. After the exhaustion of more than 100 days of lockdown and the arrival of better weather, it was no wonder there was some optimism left in the market driven by pent-up demand, retail re-opening, virus suppression, and the additional savings accumulated during lockdown.



Unfortunately, the reality on the ground today is much less rosy.

The most important lesson we can draw from the last few months (or the ongoing challenges in the U.S.) is not to extrapolate based on short-term trends. The consumer economy, while in far better shape than in the throes of lockdown in April, remains on life support. Programs like the CERB, CEWS, and rent subsidies from the government have pushed the day of reckoning out from the spring to the fall. Households and businesses deferred tougher decisions through the summer, hoping a return to normal post Labour Day – which looks less and less likely. And with 15% of mortgages deferred, twice that of the U.S., there is clear stress on the household balance sheet that has yet to play out.

For the fall, we see a 'tale of two tapes' with downside risk across the income spectrum. For lower income band workers, the challenges will be the tapering-off of CERB, the uncertainty of what childcare and education options will look like and the slow, organic recovery of the labour market. For higher income band workers, we see around CA$50B of unused spending power sitting on the sidelines with limited outlets for expenditure (see Exhibit 6). The bottom line: consumer spending may get weaker before it gets stronger - even before considering the risks from a second wave of the virus.

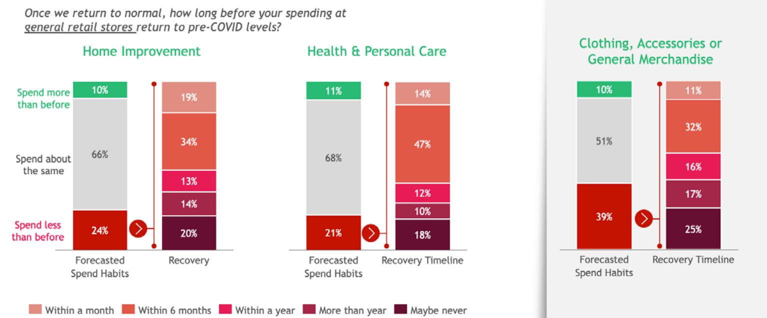


There's no question COVID-19 will reshape the retail landscape.

One of the obvious shifts is how health and safety concerns will change the bricks and mortar store experience. Our latest research shows consumers say safety measures are their number one priority when deciding where to shop, rating these measures 10 points higher than their usual top priority, price (see Exhibit 7). Soft goods, given the health exposure from fitting, and how the demand for

these items is closely tied to work, school, and travel, will continue to face huge challenges (see Exhibit 8). We also see retailers across the sector shifting focus and resources to on-shelf availability and assortment rationalization. Maintaining trip assurance, while continuing to inspire customers, will be critical as retailers adapt to this new environment.

Exhibit 8 | 20%+ of spend in Soft Goods may never return to pre-COVID levels

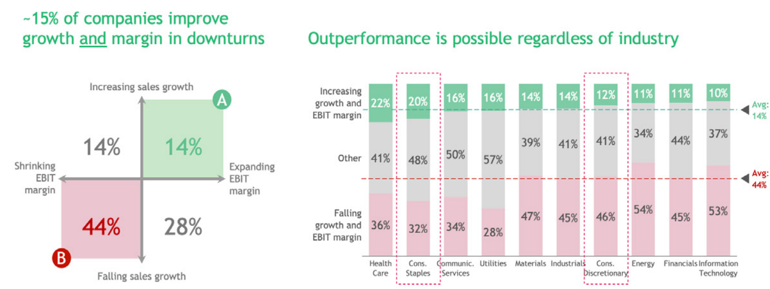


Source: BCG COVID-19 Consumer Sentiment Survey, Jun 5-8, 2020, (N = 2,939 unweighted, representative within ±3% of CAN census)

But all is not lost. In fact, crises are great accelerators for innovation and trends.

Our research shows 15% of companies flourish during downturns by seeing around the bend and turning crisis into an advantage (see Exhibit 9). We see the COVID-19 crisis fast-forwarding many trends already underway in the retail sector. For example, COVID-19 has prompted the growth of digital and e-commerce. It has also boosted the growth of aggregators, both online and offline, making winners of those with great assortment density. Aggregators are picking up market share as shoppers consolidate trips and the middle tier hollows out. Categories and retailers that are able to capitalize on bright spots created by COVID-19 trends (such as work-from home and entertain-at-home) will continue to see a tailwind for the foreseeable future as spend is re-prioritized from those most negatively impacted from COVID-19 (e.g. travel and tourism), presuming current consumer sentiment is maintained.

Exhibit 9 | About 15% of private firms flourish in downturns



1. Average across last four U.S. downturns since 1986; based on performance compared to three-year pre-downturn baseline for U.S. companies with at least $50M sales 2. Annualized revenue growth during the downturn period 3. Compared to three-year average pre-downturn EBIT margin | Source: S&P Compustat and Capital IQ, BCG Henderson Institute

Despite these silver linings, all these changes will result in increased costs and complexity for the retail sector that ultimately will be passed along to the consumer. Canada needs consumers to keep spending for our economy to survive this crisis. Millions of jobs and small businesses depend on it. Governments and the private sector must urgently work together on the dual-mandate of ensuring the health and safety of society, while ensuring the return and vitality of the consumer and retail sector. There will be many pressures on our government as they continue to navigate us through these unprecedented times, but one thing is certain: Consumers are simply too big to fail.