How Excess Inventories are Impacting Furnishings Businesses

The macro-level supply challenges initially spurred by the COVID-19 crisis have largely subsided while their lingering effects have continued to weigh on many consumer products companies. The pandemic period saw ocean shipping costs skyrocket and grossly overwhelmed ports and manufacturing facilities unable to keep up with extraordinary consumer demand. Supply chain operations became a prominent focus of diligence in M&A processes as their profitability impact and a "shortage of everything" environment effect took hold.

More recently, the clearing of supply chain bottlenecks and dampening of consumer goods demand amid macroeconomic headwinds has led to a reverse bullwhip effect with many businesses now contending with excess, high-cost inventory. This is particularly challenging if a company is holding old inventory at a cost that is above the current replacement cost, leaving companies to make the difficult choice between maintaining market share and profitability. While nearly every industry participant has been impacted, they have not all been affected equally. Companies that managed these challenges well have reaped significant benefits. A strong go-forward inventory strategy is a necessity of any business that imports large consumer products from overseas.

WHAT IS THE CURRENT STATE OF INVENTORY?

U.S. retail inventory levels have surged by over 20% since the end of 2021[1]. Overstocked retailers carrying excess inventory from last year are finding themselves struggling with a weaker-than-expected 2022. The rapid reversal caught many companies off guard after they already preordered into long lead times and chased scarce inventory. In some cases, because of supply chain delays, inventory came in too late for their respective seasons, leaving companies with too much of the wrong product. The median consumer goods producer is now seeing inventory grow 19% faster than sales which is the highest level since 1990[2]. There are two primary drivers of this situation:

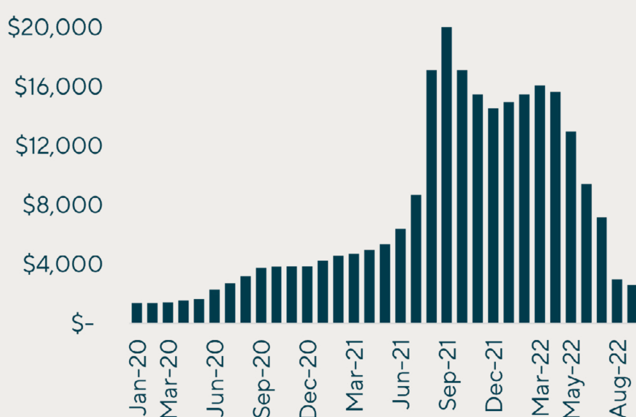
Consumer Slowdown

Consumers overspent on goods during the pandemic primarily because of lockdowns and stimulus payments. While many assumed the high level of growth would remain, it instead flattened throughout 2022 due to inflation, negative consumer sentiment, rising interest rates and an otherwise deteriorating macroeconomic backdrop. The U.S. Consumer Confidence Index dropped from a pandemic high of 127.3 in June 2021 to 102.5 in October 2022 largely due to this confluence of factors[3]. The decline is sharp enough that shipping lanes canceled 26% to 31% of their sailing across the Pacific in October as large retailers slashed projections and canceled orders[4].

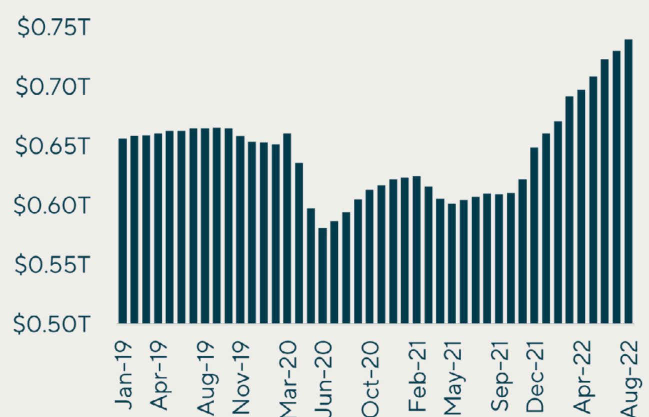
Decongested Supply Chain

Supply chain stress has significantly improved throughout 2022 and mostly normalized to pre-pandemic levels. At the height of the supply chain crisis, many companies were forced to order twice as much as needed to receive one-third as much as wanted. However, ocean transit times from China to the U.S. West Coast have improved by approximately 50% since January 2022 despite ongoing COVID-19 lockdowns in China[5]. Similarly, there are currently fewer than five container ships waiting off the ports of Los Angeles and Long Beach which is a sharp decline from the over 100 ships waiting in Q1 2022. This led to massive increases in inventory at wholesalers and retailers.

China to U.S. Ocean Freight Costs[5]



Retailers Inventory Level in the U.S.[1]



Inventory levels had not yet peaked as of October 2022 after shipping lanes cleared up but much of the growing inventory glut was acquired when container costs were at extreme levels.

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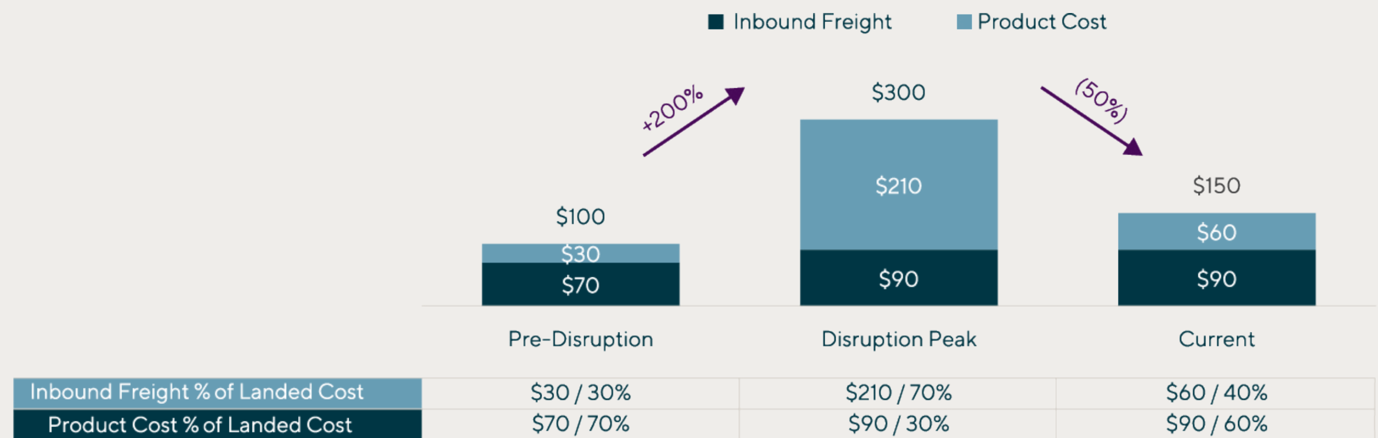
HOW DOES IT IMPACT FURNISHINGS COMPANIES?

The furnishings sector has been more impacted than most other sectors by the excess inventory buildup. Prior to the supply chain disruption, some of the bulkier segments of home furnishings expected 30% of the total landed cost of imported furniture inventory to be in-bound freight cost. During the supply chain disruption, that number ballooned for many to over 60% of landed cost at its peak. When the shipping costs came back down, many companies were left with extensive supply of inventory held at costs well above replacement cost. Many furnishing companies passed along the higher freight costs to customers in the form of a freight surcharge of typically 10% to 30% over the original customer price. However, an increasing number of those same companies are being forced by the markets to remove the charge in order to keep generating sales and remain competitive. For many companies, this means a significant narrowing of margins for the near to mid-term as these expensive inventories are worked down.

Total Landed Product Cost (Illustrative)



	Pre-Disruption	Disruption Peak	Current
Inbound Freight % of Landed Cost	$30 / 30%	$210 / 70%	$60 / 40%
Product Cost % of Landed Cost	$70 / 70%	$90 / 30%	$90 / 60%

The chart depicts the significant impact some furnishings businesses experienced when inbound freight went from less than one third to more than two thirds of the cost of goods sold.

DRIVING FACTORS AND SITUATIONAL CHALLENGES FOR FURNISHINGS PARTICIPANTS

Magnified Impact from Shipping Bulky Goods

Shipping big and bulky items is resource intensive which means furniture shipping is more prone to severe dislocation during supply chain disruptions. These large, heavy items require more container space, and shipping therefore represents a large portion of landed product cost. It can be more challenging for companies to find carriers for furniture during periods of extraordinary shipping demand as these items become increasingly less desirable freight on board. As a result, furniture can literally "miss the boat" due to these dynamics.

Stronger Backlog Running Low

The home furnishings category outperformed during the pandemic and benefited from stronger-than-average backlog heading into the slowdown. This is because bulky products often stretched out lead times even further due to sourcing delays and slower order fulfillment as noted above. However, that backlog has mainly subsided for many furnishings businesses that have now found themselves overstocked with expensive inventory purchased at the peak of container cost increases. Net inventory orders have declined approximately 40% year-over-year in Q3 2022[2].

Adverse Credit Impact

Both the public and private debt markets have experienced significant tightening. It will be challenging for home furnishings companies to access debt capital at reasonable rates until there is more consumer purchase behavior visibility into 2023. Lenders are currently more discerning with the discretionary segment of the home furnishings market, placing higher scrutiny on businesses that ramped significantly during the COVID-19 pandemic.

Many consumer companies use asset-based loan (ABL) revolvers to finance their inventories; however, many banks have started requiring updated appraisals in light of the economic cycle and excess inventory levels. This may result in much tighter liquidity for companies as borrowing bases are re-appraised downward, in some cases materially.

Additionally, the rising interest environment is substantially increasing the ongoing cash interest burden for floating rate leveraged loans, which is another drag to liquidity and may pressure companies' ability to service debt obligations. For reference, three-month SOFR, which is the basis of many leveraged loans, has risen 436 bps since November 30 2021, from 0.05% to 4.41% as of November 30, 2022. In addition, since November 2021, the weighted-average price of the Home Furnishings Leveraged Loan Index decreased from 92 to 84, while the weighted average price of the S&P / LSTA Leveraged Loan Price Index decreased from 98 to 92. Similarly, the average Issuer Credit Rating for the companies composing the Home Furnishings Leveraged Loan Index decreased from B rated to B- rated per S&P. This reflects the higher level of credit risk in the home furnishings category relative to the overall loan market.

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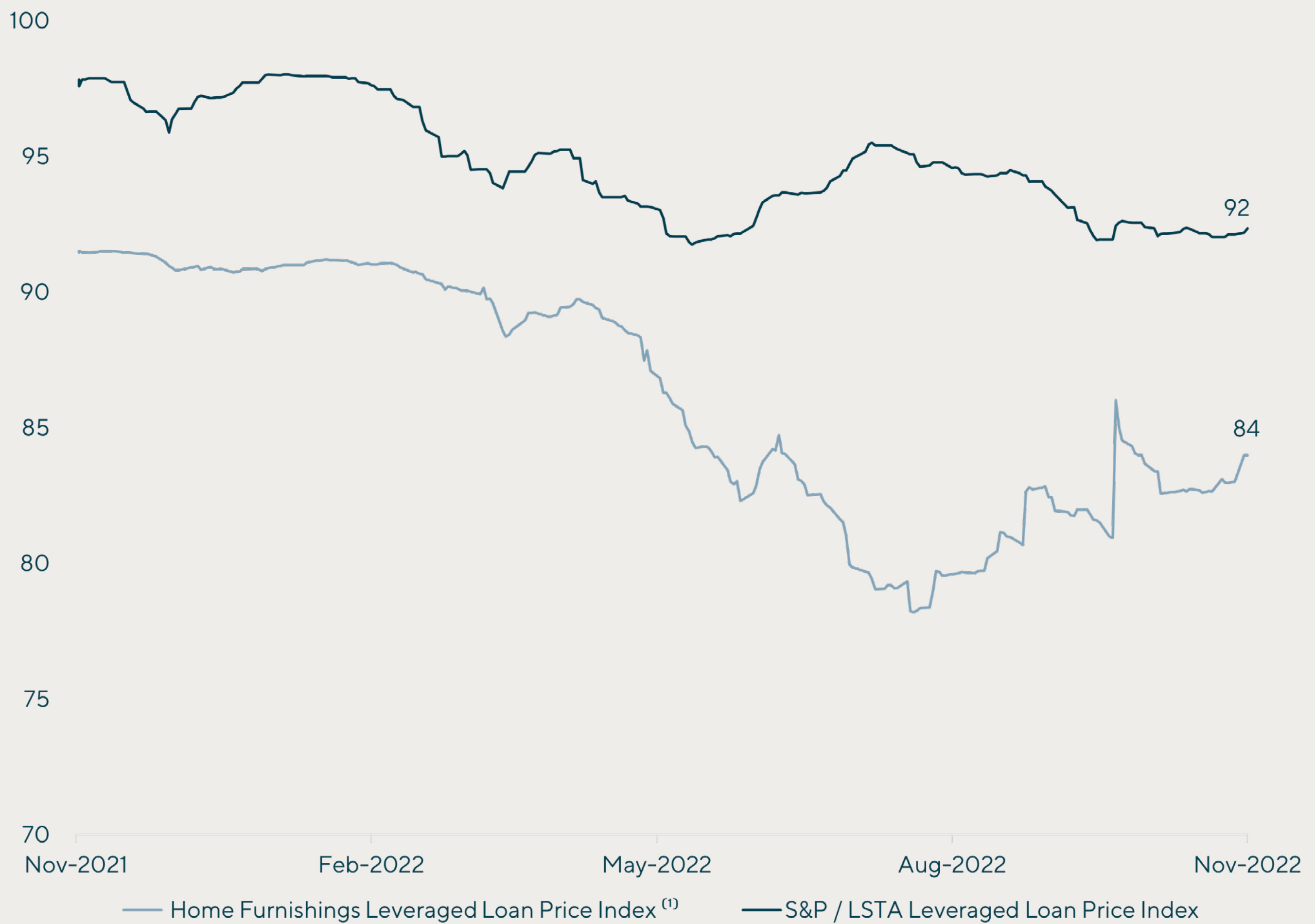

Proprietary screen performed by Lincoln. N=12. Criteria as follows: Security Type: Term Loan (active); Lien: First Lien; Amt. Outstanding: >$100M, Country: United States; Industry: Home Furnishings

Source: Bloomberg

SPOTLIGHT

De-Stocking Challenges in Home Furnishings vs. Other Sectors

Industry executives are trying to manage a difficult balance of sales volume and profitability as they grapple with inventory recently acquired at extraordinary cost levels. Many are understandably hesitant to engage in an unprofitable price slashing exercise to avoid losing precious market share which means maintaining inventory for longer periods of time while incurring high carrying costs. However, this challenge is unevenly distributed across different sectors, and the impact within each sector is far from uniform. Depending on strategies used during the peak shipping shortage, there is a wide range of inventory and cost positions for durable, bulky consumer products. Generally, bulky "hardline" products that use up more pricy container space absorbed far more of the container costs challenges than did smaller "softline" décor items.

There are a number of market participants with premium and value brands that have outperformed despite recent macro supply chain challenges and are not expecting meaningful margin impacts in the future. For instance, global sales of luxury goods are expected to grow over 20% in 2022, and over 95% of luxury market brands have generated positive growth this year[6]. Additionally, some companies in the value segment navigated the supply chain crisis more adeptly, leaving them in the enviable position of being able to offer an excellent value to consumers while still maintaining attractive margins. These companies are currently experiencing strong growth as they take market share.

Meanwhile, other industry sectors such as machinery, electronics and automotive are still catching up from semi-conductor shortages while sales are sustaining on that pent up demand.

LINCOLN PERSPECTIVE

We believe the home furnishings inventory de-stocking challenges will normalize by mid 2023. The sector was overconsumed as a result of the pandemic, but demand has held up somewhat better than other consumer discretionary categories, and long-term demand drivers for the category are still favorable.

Lincoln's view is that price has and will come down as industry participants further align their pricing to better reflect replacement cost. In what has been a broadly softening environment, this will be reflected in increased promotional activity of old inventory and management of supplier orders in a manner that reflects normal demand levels.

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Hence, companies with high volumes of expensive inventory may face significant margin pressure through Q1 2023 while those with better inventory positions are expected to capture market share. A strong liquidity position will be critical as we enter the new year. There will be some businesses already facing significant capital structure and cash flow challenges out of that gate.

In the long-term, we are bullish on the home furnishings sector outlook, which will benefit from underlying tailwinds. These include a shortage of over five million homes in the U.S. which will likely take a decade to correct in combination with Millennials and Generation Y increasingly moving into their first homes[7]. While there was a surge in spending for home furnishings in 2021, current U.S. monthly retail spending levels of $12.6 billion on the sector remain above pre-pandemic levels of approximately $10 billion[8]. For existing participants and prospective investors in the furnishings space, Lincoln recommends noting the following near-term market opportunities and considerations:

Effective inventory management has become a more prominent value driver
Middle-market companies with effective inventory management and disciplined sourcing systems have recently demonstrated they can better navigate supply chain disruptions and come out ahead. The resiliency and competitive advantage afforded by such has enabled those participants to outperform and gain customers which makes for a more attractive asset in the market.

Nearshoring or reshoring supply chains can be easier done through acquisitions in many cases
Vertical integration or incorporation of a domestic supply chain through an acquisition is a good means by which a furnishings company can diversify and make more resilient an existing sourcing network. Reshoring a supply chain can be a logical decision but doing so organically is often expensive and complex to execute.

Liability management will come into focus
A combination of deteriorating credit conditions and sector-specific challenges have made it more difficult to access capital markets. Companies with upcoming maturities or liquidity concerns on the even distant horizon should proactively address those now rather than later when solutions available to them may become more limited.

Unique buying opportunities for add-ons at attractive valuations
There will be some very interesting opportunities for consolidators in the sector with strong balance sheets and excellent operational platforms to acquire good companies with troubled balance sheets. There is a strong pipeline of pent-up furnishings assets that may be available in 2023.

Private equity will continue to pursue high-quality platforms
Financial sponsors have tremendous dry powder they still need to deploy for their investors and will seek out top-tier platforms to do so. Strategic buyers have generally been less active as they focus on internal priorities in this environment. Those publicly traded in this space have recently seen their market values significantly decline.

The best investment opportunities will be at the high and low end of the value scale
Premium furnishings brands represent an area of strength and potential M&A opportunity. The resilience afforded by their affluent customers has enabled them to outperform in 2022 despite macro supply chain challenges that have meaningfully impacted the broader sector. Expect to continue to pay a more premium multiple for these businesses that are more insulated from turbulence and can help strengthen an acquirer's platform especially in challenging times.

With many newly formed households at average income levels, moderate to low-income consumers are seeking good value. Companies that offer this perceived good value are still benefiting from significant growth as they capture market share.

Inventory audits and increased inventory diligence are a necessity prior to an acquisition
Potential acquirers will need to understand inventory positions, replacement costs and any related adverse margin impact from that existing inventory. The details and timing of such will also be necessary to substantiate normalization adjustments.

Inventory-related addbacks will be more validated in 2023 if shipping costs remain low
Sellers now have a stronger argument to propose adjustments that normalize earnings for the unusual inbound freight peak. It will be important to provide detailed analysis to support income statement adjustments and to quantify the amount of excess freight in inventory balances.

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Interested in learning more? Get to know Lincoln's Consumer Group at www.lincolninternational.com/consumer.

(1) Source: Louis Fed
(2) Source: "Taking Stock of the Inventory Problem." Morgan Stanley Research, October 10, 2022
(3) Source: Conference Board
(4) Source: WSJ
(5) Source: Freightos
(6) Source: Bain
(7) Source: CNBC
(8) Source: Louis Fed