PACIFIC FUNDS insights
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HOW A PORT IN A STORM AFFECTS RETAIL

The retail sector has been hit by several headwinds, including challenges in the ports. What's the deal?

We recently sat down with Pacific Asset Management Senior Analyst Ron Rangel to get his insights on his tour of the Port of Long Beach (the second largest port in the U.S.), supply-chain weaknesses, and the state of the retail sector.

Given you cover retail, and supply chains are so vital to this sector, you recently went on an interesting due diligence trip to the Port of Long Beach. Can you give us some quick background on the port?

Sure. Combined, the Port of Long Beach and the adjacent Port of Los Angeles touch over 40% of Far East imports to the U.S. The Port of Long Beach is the second busiest port in the U.S. and aids in about $200 billion of trade annually. It's just huge, covering nearly 12 square miles. The Port of Long Beach also has one of the deepest harbors in the United States at about 72 feet, allowing them to handle the largest container ships.

What stood out to you at first glance on your tour?

The biggest surprise was the sheer number of containers sitting at the port. It was quite astounding.

What were your biggest takeaways?

The significant headwinds across the supply chain, and a notable backlog of containers and products. The bottlenecks in the supply chain range from lack of warehouse space to truck and rail staffing shortages. There's even a lack of truck chassis. All of this creates a negative feedback loop in the supply chain and reinforces concerns for retail margins.

Can you talk a bit more about the issues facing trucking and rail in moving freight?

Both trucking and rail are used at the port, and I would say that each of them has their own set of issues right now. From a high level, I'll just say that rail is now viewed as more efficient than trucking. In addition to the chassis shortage, the trucking industry may also have a secular issue when it comes to attracting drivers. Some of that is related to trucking regulations, including California's Gig Worker Law passed in 2019 that makes it difficult to operate as an independent trucker in the state.

Moving to the rail, it has declined as a share of the port's transportation since the pandemic began, and idle times remain near their peak. The rail industry has been also experiencing issues around labor and equipment shortages.

I think when you take this all together, it demonstrates the complexity and the fragility of global supply chains and just how quickly things can go wrong. These issues remain something to watch in both the near and the long term for the retail sector.

Shifting gears slightly, how has the retail sector been impacted from the beginning of the pandemic until now?

The retail sector has been on a pretty interesting rollercoaster ride. Initially, in March 2020 when the pandemic first hit the U.S., sales fell off a cliff. But then the Fed and U.S. government came in with huge amounts of monetary and fiscal stimulus to support the consumer, and this led to a rapid recovery—a V-shaped recovery—in retail sales that continued pretty much through 2020 and 2021.

When you look at the back half of 2021, you really started to see the first signs of inflation creeping into the system. That was mostly caused by rising freight costs, which started impacting retailers' margins. Supply-chain bottlenecks caused inventory delays, which then prompted retailers to begin ordering large amounts of inventory ahead of what was strictly necessary.

This year, consumers have shifted their spending toward services, while simultaneously tightening their purse strings, which ended up being a terrible combination for the retail sector at a time when it had ordered massive amounts of inventory. Overall, this has led to significant clearance events across the sector, and I think may threaten future profitability as we look toward the holiday season.

How are these retailers adjusting to that new shift in consumer spending?

In theory, the older inventory gets, the more its value declines. This has resulted in retailers having canceled orders and increased promotions to clear excess inventories, particularly in categories such as discretionary goods, where demand has been more impacted. And we've also heard of more extreme examples such as companies allowing you to keep the items when you request a return or refund, which could potentially make sense economically in certain cases for a retailer in this environment.

So, will we see some pretty good discounts during this holiday season?

It'll definitely be better than last year, which may have been a record low promotion year for retail. Promotions this year are certainly picking up. The deals have already been out there, and hopefully we get some pretty good Black Friday deals as well.

It sounds like we still have a long way to go here before we fix these supply chain issues, which are having an immense impact on the retail sector. Where are you seeing investment opportunities currently?

First and foremost, I think when it comes to opportunities in retail, you really need to be particularly picky. I think it's a sector that's best considered when sentiment is bearish and levels are more favorable for the buyer. But I would say overall look for companies that have differentiated offerings and strong brand names, ideally in more niche areas where there's less commoditized product and lower competition.

I also think there should be a certain level of comfort around the ability of the company to grow same-store sales consistently over the medium to longer term, both on secular and cyclical trends. And lastly, I would make sure the capital structure is appropriate for the business, and it can handle its debt load even in a severe downturn. I definitely think there are some specialty retailers that I think have pretty unique and interesting business models.

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