Retail Practice

Tackling inflation and margin pressure in the sporting goods industry

The sporting goods industry faces new challenges from inflation and an emerging economic downturn, adding to existing pressure on input costs and supply chains. Now is the time to act.

by Sabine Becker, Kevin Bright, Jessica Genta, and Alexander Thiel
Following our second annual sporting goods industry report, *Sporting goods 2022: The new normal is here*, we have once again teamed up with the World Federation of the Sporting Goods Industry (WFSGI) to provide the sporting goods industry with an update.

Sporting goods companies have exhibited strong performance over the past two years. Growth has been driven by resilient demand and secular shifts in consumer attitudes to health, wellness, and sports. However, recent economic and geopolitical developments are becoming a serious concern for players across the industry. The concern facing many executives is whether inflation and weakening demand, alongside pressure on supply, represent the eve of a perfect storm and what can be done about it.

To provide a perspective, we have analyzed three main factors characterizing current industry dynamics: inflation’s impact on demand, supply chain issues, and rising input costs. We have also outlined concrete levers to overcome the challenges and help sporting goods companies make the right decisions quickly.

1. **Inflation and economic downturn**

   **Rising consumer pessimism and sharply declining household savings.** For the first time since the global pandemic has started to weaken, we see consumers becoming more pessimistic rather than optimistic. Our consumer surveys in the United States and Europe show that concern over prospects for an economic recovery has increased significantly and is now higher than during the COVID-19 crisis. The convergence of the geopolitical situation in Europe, continued supply chain challenges, rising interest rates, and inflation is changing consumers’ outlook.

   Despite these dynamics, for now, spending remains strong, supported by a substantial increase in household savings in 2020 and 2021 (which more than doubled in the United States and Europe). The pattern was echoed worldwide, due in part to stimulus measures rolled out during the pandemic. In 2022, this pattern might start to change as we see personal savings declining, falling to near-zero percent of disposable income in the United States for the first time in more than a decade, while central banks around the world are raising interest rates and thus reducing disposable income further.

   **Rising inflation, and inflation expectations, are likely to reduce spending on sporting goods.** During the pandemic, the sporting goods industry proved to be resilient (Exhibit 1). It recovered fast in early summer 2020 and maintained solid growth up until now. However, recent economic developments suggest a change may be imminent. Over the past few months, inflation has accelerated, with growth in the consumer price index (CPI) exceeding 8 percent year on year in the eurozone, United States, and elsewhere. Inflation has moved beyond natural resources, and steeply rising core inflation rates suggest it is unlikely to be transitory in the short to medium term.

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The good news for the sporting-apparel industry is that it is one of few categories in which there is still real growth, driven by increased consumption (Exhibit 2). However, as inflation picks up, real consumption starts to decline in some categories, and where spending is rising in absolute terms, inflation is often the key driver. In fact, consumers are starting to cut back on discretionary expenditures, reflecting the fact that prices (and mandatory household expenditures) are rising faster than incomes.

Our European consumer study shows that spending intent on apparel, footwear, and sports and outdoors equipment is declining (Exhibit 3). Given this reality, how are sporting goods categories bucking the trend? One reason is a common behavior that occurs at the beginning of inflationary periods called “intent to action delay.” In this state, consumers expedite planned purchases because they expect prices to rise.
Consumers are starting to cut back on discretionary expenditure, reflecting the fact that prices (and mandatory household expenditure) are rising faster than incomes.... Spending intent on apparel, footwear, and sports and outdoors equipment is declining.
Further polarization of demand occurs because inflation does not affect everyone equally. Inflation has a varying impact on different income and age groups. This leads to polarization of demand that will impact a company’s approach when it comes to pricing strategies, as outlined in the next section. For high-income households, increased mandatory-household spending has a relatively low weight in their overall budgets. In addition, before reducing discretionary spending, many high-income consumers have the option to tap into their savings. There is also a reduced inflationary impact on younger generations, who can change jobs more easily and thereby see salaries adjusted for inflation. Demand from these groups is more likely to remain steady. Conversely, lower-income households and older generations are likely to consume less. This correlates with our recent consumer survey data that shows low-income and elder consumers are more pessimistic.

The polarization of demand puts pressure on companies’ ability to sustain growth and risks increasing inequality. In the latter case, it could widen the physical-activity gap across income groups—a topic discussed in both our 2021 and 2022 reports.

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1 Net change is calculated by subtracting the % of respondents stating they decreased spend from the % of respondents stating they increased spend in the category.

2 Low income = <25,000; middle income = 25,000–50,000; high income = >50,000. Income brackets use euros for France, Germany, Italy, Spain; for UK, the same brackets were used with pounds.

3 Includes silent generation.

Source: McKinsey Europe Consumer Pulse Survey, Apr 12–18, 2022, n = 5,075 (France, Germany, Italy, Spain, UK), sampled to match European general population aged 18+ years.

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2. Persisting supply chain issues

Disruptions in global supply chains have persisted since the beginning of the COVID-19 crisis, and were exacerbated by rising demand for physical goods and unpredictable lockdowns, which are still impacting Asia. We have seen delivery lead times increase significantly, with bottlenecks and port congestion reducing daily container capacity actively sailing by around 14 percent from the end of 2020 to the end of 2021. We have seen further declines in the first half of 2022. Congestion can also be seen at terminals, with yard dwell time for imported containers more than tripling in the United States since the start of the pandemic. Rail transportation has also been affected, with intermodal car congestion peaking in 2021 and the first months of 2022.

Delays have caused out-of-stock situations for many sporting goods players. This has limited growth and impacted customer services already hurt by limited product availability.

Looking forward, a significant risk is excess inventory, as past blocked orders get unlocked and large flows of goods hit companies’ warehouses. Excess inventory could be especially problematic for in-season products, which would most likely need to be sold at discounted prices once the season ends. The situation could get even worse if inflation accelerates further. This would exert cash-flow pressure on many players—especially retailers, but also brands and manufacturers.

Another element contributing to increasing complexity of supply chain networks is the recent increase in regulatory requirements that restrict imports from certain regions in Asia. These mean sporting goods players have less flexibility in setting up supply chains and may prompt some companies to review their supplier networks. In addition, the restrictions add administrative burdens and, in some cases, increase costs.

3. Input cost pressures

Since early 2020, input costs have risen, especially in transportation and raw materials. The result is that companies have struggled to maintain their margins. Container freight rates have risen by as much as sevenfold from prepandemic levels. In response, many players have switched to air freight, despite a fivefold cost increase compared with ocean freight.

Meanwhile, from the start of the pandemic in early 2020 to the first quarter of 2022, we saw a significant increase in raw-materials prices. The price of metals rose 88 percent, and there were increases in the price of cotton by 84 percent, fibers by 40 percent, and rubber by 32 percent.

An additional element contributing to extra costs is new official verifications introduced by some governments, for example relating to chemicals.

What can sporting goods companies do to protect their growth and margins?

To successfully navigate the current economic environment characterized by volatility and uncertainty, companies need urgently to get ahead of the curve. Reacting fast is relevant, but this should not mean a consistent price increase across the board (neither in absolute nor in percentage terms). Instead, successful impact requires a nuanced strategy leveraging different levers outlined below in a differentiated way by channel, customer target segment, and product type.

The levers we identified can be classified in three key areas, all of which have the goal to increase a company’s resilience in the current economic environment: assortment and commercial strategy, smart pricing, and proactive cost management. Dependent on individual situations, a variety of these levers can be applied.
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**Assortment and commercial strategy**
A review of assortment strategy can be effective in lifting profitability. There are several typical levers we see:

— Discontinue low-margin products across all price points.

— Make down-trading less attractive by emphasizing the value of mid-market and premium products, and reducing especially low-margin products in the entry segment.

— Focus on communication by emphasizing product aspects beyond price that may justify higher prices, for example, superior quality, sustainability, innovation, and exclusivity.

— Make part of the assortment premium by collaborating with luxury brands and earning higher margins.

— Increase direct-to-consumer (DTC) offering, cutting out underperforming intermediaries. This will increase pressure on retailers to differentiate themselves and their value proposition, and ensure they are properly embedded in a brand’s omnichannel strategy.

**Smart pricing**
When it comes to pricing, a prerequisite to any action is to understand your consumer and identify which products are key value items (KVIs). This will vary based on customer group—for example, because inflation impacts different income and age segments in different ways. Potential actions include the following:

— Increase prices quickly on products with low-demand elasticity, non-KVIs, and no next-best alternative or a much higher-priced one.

— Consider reductions in promotions or, where possible, price increases for products with limited availability.

— Review gross-to-net ratios, especially in promotion strategy. Also, consider actions such as reducing breadth or depth of promotion activities to improve average profitability.

— Adjust prices regionally based on market dynamics and/or selectively move prices in certain channels while avoiding gray-market cannibalization inside harmonized trade zones.

— Rebalance between entry price points and midmarket prices based on margin structures, and emphasize the perceived value gap to make downtrading less likely.
Proactive cost management
To protect margins, companies need to manage rising raw-materials costs, transportation costs, and the likelihood of rising labor costs. Potential strategies include the following:

— Create full transparency on the company’s spending and identify the most important and fastest-growing drivers, based both on historic data and expected trends.

— Develop visibility of the cost structure at product and category levels to distill the most impacted part of the portfolio.

— Consider conditional contract terms.

— Develop a design-to-value (DtV) approach to maximize product success and minimize costs.

— Further optimize product cost structures to secure accessibility for the groups of consumers most affected by inflation while preserving margins.

— Review the supply chain network and analyze potential alternatives to reduce costs.

— Increase operational efficiency and prepare for labor inflation.

Across all three areas, it is important to consider communication. Players should clarify what role to play within the difficult economic environment through a clear communications strategy. Is your priority going to be maintaining margins to protect shareholder value? Or are you going to prioritize consumers’ accessibility to products? Any assortment or price action will require a consistent story, with a clear underlying motivation.

When setting up a program to manage the impact of inflation, we suggest a phased approach, prioritizing measures based on their urgency and impact (Exhibit 4). We suggest to first set up an inflation-control tower to initiate immediate tasks. Next, revisit the assortment to adjust it to shifting consumer behavior. Finally, initiate a cost program and prepare for labor inflation.

Exhibit 4

Sporting goods companies responding to the current economy should use a phased approach, prioritizing measures based on their urgency and impact.

Illustrative phased approach

<table>
<thead>
<tr>
<th>Situation</th>
<th>Key activities</th>
<th>Revisit the assortment to adjust it to shifting consumer behavior</th>
<th>Initiate a cost program and prepare for labor inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rising inflation rates drive cost of goods sold (COGS) increases and put pressure on companies’ margins</td>
<td>• Discontinue low-margin products&lt;br&gt;• Emphasize aspects beyond price&lt;br&gt;• Selectively increase prices quickly, depending on price elasticity and non-key value items&lt;br&gt;• Consider reduction of promotion&lt;br&gt;• Create transparency on cost structures</td>
<td>Following price increases, shifts in consumer behavior must be expected, such as switches to cheaper alternatives where available&lt;br&gt;• Make downtrading less attractive&lt;br&gt;• Make part of the assortment premium&lt;br&gt;• Review gross-to-net ratios&lt;br&gt;• Review prices regionally and/or by channel&lt;br&gt;• Consider conditional contract terms&lt;br&gt;• Develop design-to-value</td>
<td>Increase of non-COGS costs, especially labor, can be expected, resulting in a need to improve cost efficiency&lt;br&gt;• Increase direct-to-consumer&lt;br&gt;• Further optimize products cost structure&lt;br&gt;• Review supply chain network&lt;br&gt;• Increase operational efficiency</td>
</tr>
</tbody>
</table>
The current economic and geopolitical environment may herald a perfect storm and requires immediate preemptive action. Individual sporting goods players should design a strategy that will enable them to build resilience, contingent on factors such as business structure, target consumers, and value proposition. Inertia is unlikely to be productive.

Therefore, decision makers should not delay in incorporating winning strategies into the business. These include undertaking a reassessment of current ways of working, preparing diligently for coming challenges, and baking in the ability to react fast to an uncertain future.

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