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Make Or Break Season For Many Retailers

Muazzin Mehrban, January 2010

Across global markets, retailers are in the midst of a defining period. The busy festive season may determine whether, going forward, their balance sheets will be strong enough to support operations through 2010. Over the last 12 months, the retail industry has suffered heavily as declining GDP growth, consumer confidence and rising unemployment have suppressed sales. Companies will have to make tough choices in what has become, over the last 10 years, an increasingly competitive market, given the rise of internet shopping.

Many experts believe the current downturn has been a litmus test for many retailers. There have been bankruptcy filings across the board from jewellers and furnishers to electronics and hardware stores. Many larger players have also been forced to retreat, closing underperforming outlets as a means of improving bottom-line performance and staying afloat. Some have adopted a leaner mentality towards operations as well as offering discount prices and promotions to attract customers. “Online shopping has also allowed first world consumers to compare prices like never before and utilise the internet to obtain the best price regardless of the retailer’s geographic location,” explains Aaron L Hammer, a partner at Freeborn & Peters LLP. “Retailers who have enhanced their online marketplace presence have benefited from increased exposure over those competitors who are hesitant to adopt this approach or are unable to move their businesses in this direction.” Online stores such as Amazon and Zappos are chief examples of major online retailers putting pressure on traditional high street retailers.

Consumer confidence in the run up to the holiday season has varied across regions. In the build up to the busy month of December, US retail sales rose for the thirteenth straight week, according to Bloomberg, as markdowns and holiday promotions begun to spur consumer spending. Since consumers put off purchases early in 2009, analysts predict this could bring on a last minute surge in holiday gift shopping in the final days before Christmas. Meanwhile, the nearby emerging economy of Brazil also posted a strong set of forecasts approaching the festive period. Government figures from Brazil showed that the third quarter of 2009 delivered consecutive monthly sales increases. The rise of retail sales in Latin America late in 2009 was attributed to the quick economic rebound experienced by its economies.

However, despite some countries defying the global trend, most businesses elsewhere have struggled, particularly those based on the high street. The UK retail sector is a prime example. The back end of 2009 saw a number of retail store liquidations, prompting even government advisers to urge the State to back online sellers, claiming they had more potential to create jobs and stimulate the economy. Some experts believe there is now a growing trend among British consumers to shop online, in particular for media and tech gadgets, which are strong sellers over the festive period. Studies by the European Union’s Eurostat Service revealed that the uptake of online shopping in the UK was the highest in Europe, with 66 percent of individuals aged from 16 to 74 reported to have purchased goods on the internet in late 2009. Given the year upon year increase in Eurostat’s online shopping figures, it appears that physical chain stores will be the retail segment likely to suffer most in 2010.

Testing times

To some degree, stimulus policies, such as the lowering of interest rates in countries like the UK, have helped to prop up some retailers. But this has not prevented some major names, including UK high street retailer Woolworths, from hitting the wall. Indeed, the Christmas period could be the last season for a number of other UK household brands. Yet the concerns many analysts expressed about a possible wave of insolvencies taking place on rent quarter days appear to have been misplaced. Landlords have, in general, through their support of Company Voluntary Arrangements (CVAs), adjusted their outlook towards ailing retailers and eased the pressure on insolvent tenants. Most landlords have chosen this option because they would struggle to recoup their arrears and experience difficulty finding new tenants.

But some of the benefits afforded to retailers are being offset by other negative factors. Rental payments, for example, are high due to rent rises before the crisis hit. Debt repayments are also a burden – a legacy of easy credit during the boom years. "Many businesses have fixed rate interest loans, or at least loans fixed by reference to interest rates that applied pre credit crunch," says Patrick Cook, a partner and Head of the Reconstruction & Corporate Recovery group at Taylor Wessing. "There is a lack of liquidity available for new working capital facilities. Suppliers are struggling in some cases and resourcing stock is harder and more expensive." Furthermore, some credit insurers are refusing to insure a supplier's credit, which can have a damaging impact on a retailer. Often a supplier will be left to demand cash on delivery from a retailer, but with cash in short supply this may not be an option.

Many retailers are also suffering from overleveraged capital structures, in an industry that is cyclical by nature. "During the period of strong economic growth prior to the recession, retailers should have been focused on paying down debt and creating liquidity in anticipation of an inevitable downturn," says Michael Goodman, a managing director at SSG Capital Advisors. "Unfortunately, most were actually increasing their debt loads and reducing their financial flexibility as a result of the easy availability of credit, highly leveraged buyouts, and mismanagement of working capital." This has left retailers with fewer options, especially given the current mentality of consumers in key markets like the US. The continuing instability and rising rate of unemployment in the US has made buyers more price sensitive towards nondiscretionary spending. This has created a spending glut, most notably in the luxury and speciality retail sub-sectors, and modest growth in the discount retail sector. Retailers that can provide lower price points and promotional discounts, but are unable to reduce operational costs, may continue sliding towards insolvency.

Liquidity issues mean that retailers are having to assess financing options in an effort to keep their operations afloat. Asset-based financing is one viable avenue that can prove cost effective. Retailers that already have a strong asset base may be able to refinance, although it is likely to be at a higher cost. "Asset-based financing is an option which is getting more and more market share," points out Mr Cook. "Retailers can raise finance against the value of their assets, including their inventory. The asset-based lenders are able to structure facilities to match the growth or contraction of the value of the asset base. This is attractive to both lender and retailer – the lender knows that the money it has lent has adequate security cover and the retailer gets a committed facility that grows as the business grows," he adds. Furthermore, the re-emergence of CVAs in the UK as a means of dealing with liquidity is likely to continue in 2010. Private equity funding is also becoming a realistic option once more, although it is a more expensive alternative to traditional lending. Above all, in order to secure credit, retailers must by now have achieved a satisfactory degree of revenue stabilisation and profitability.

For this stability to be realised, retailers must prioritise the management of cash flow and inventory. At the moment, this has been made difficult by the uncertainty of consumer spending and the absence of any significant improvement in the employment rate. "Retailers will need to develop new strategies designed to cut expenses and attract the limited US dollar," explains Mr Hammer. "This includes implementing new methods of distribution, scaling back expansion plans as well as focusing on processes that turn over inventory quickly. More specifically, reducing excess inventory will improve a retailer's cash flow." In times of distress, cash is essential. To maintain liquidity, retailers may need to adopt extended payment profiles to control rental outflows, for example. In addition, internal cost cutting measures will remain an essential element of survival, along with incentivising customers.

Customer focus

To encourage consumers to spend more in an increasingly competitive retail market, individual businesses need to concentrate on streamlining their operations and improving processes aimed at revitalising market success and customer loyalty. If shops are to avoid closure, they will need to act quickly. "The retailers that have survived are the ones that extracted costs out of their businesses swiftly and most aggressively. The largest and most utilised cost reduction for retailers has been the renegotiation of rent in an environment where landlords are desperate to maintain tenants," says Mr Goodman. "Headcount reductions and streamlining the supply chain through warehouse consolidations have also been prevalent since the downturn." Businesses will have to go through the process of assessing every aspect of their business and identifying what it does best. At the same time, expenditure in non-cash generating areas will have to be diverted into the most profitable strategies that will drive turnover, profits and above all else, cash generation.

While there is no set template for how retailers should respond to the downturn, experts concur that they can no longer spread themselves too thinly. Businesses must begin to focus on certain aspects of their operations, maximising their returns during the holiday season. Retailers must go back to basics and concentrate on putting the customer first. When they have a limited amount of money to spend, customers are on the lookout for the best possible value. Discounts and promotions not only get customers through the door, they also help to move excess inventory and generate expenditure on non-discretionary items. Some experts believe that managing the flow of inventory is the key determinant of business survival. In their current state, with little sign of future cash injections, the distressed balance sheets of most retailers will be unable to withstand high levels of idle stock.

Beyond the product line, improvements in back-end processes can also help to lower costs, improve internal efficiency and possibly increase customer satisfaction. Retailers may be able to solve issues front of shop, but have struggled to resolve issues with their banks, for example. In particular, they have struggled to persuade banks to support them when sales fall short of targets. Experts advise businesses to stay close to their existing banks and keep them up to date with any changes in performance. That way, bankers will never be caught completely unaware when the need to renegotiate terms arises and will be more understanding if there is a dip in cash flow. Furthermore, strong relations with a bank will also provide access to useful advice when exploring alternative finance options, such as asset-based lending, which is an important fall back plan if conventional restructuring methods fail to achieve their goals.

In the long-term, experts believe shopping high streets in developed economies will eventually look very different. The credit crunch, consumer uncertainty and problems with logistics and product delivery have all conspired to hurt businesses that just 18 months ago were brimming with potential. Now, the priority of businesses in the sector has changed, with the focus firmly on lowering operational costs and concentrating solely on profit making areas. For many, this will be the first period in which their balance sheets will be running on empty while trying to keep stores open and customers buying. Retailers, especially those with store chains, will be forced to make tough decisions on closures in non-performing regions. Although consumer confidence is on the rebound, competition among retailers is likely to intensify. For the time being, and over the course of 2010, the balance of power will lie firmly in the hands of consumers.