

SPOTLIGHT



THREATS & OPPORTUNITIES IN THE RETAIL SECTOR

Retailers the world over are feeling the effects of the financial crisis. Unable to access credit, they are taking a much closer look at their balance sheets, hoping that some basic structural changes will allow them to outlast the drought. This is serious enough, but everyday consumers are also suffering, forcing retailers into making price cuts that they and their cashflows can ill afford. This effect is discernible on both sides of the Atlantic, but there are notable differences between some of the major concerns faced by retailers in North America and the UK.

The North American retail sector

BY CLAIRE SPENCER

The turmoil in the North American retail sector is no different in essence to the more widespread turmoil in the global market. The contracting credit markets have created a variety of problems for the region's retailers and their customers, with even the most credible borrowers unable to access financing. In addition, unemployment levels are increasing – currently at rates of 7.6 and 7.2 percent in the US and Canada respectively, both of which are expected to rise. As such, consumer demand has weakened significantly, and spending habits have changed accordingly to either eliminate or reduce discretionary spend. Furthermore, retailers that were acquired in recent years with a high level of debt are struggling to meet owner expectations – yet another unwelcome pressure.

The effects of the larger picture are palpable throughout the North American retail sector. "Having so many lenders exit the market has definitely affected both short term and long term availability to distressed borrowers," asserts Neil B. Glassman, a director and chair of

the bankruptcy practice at the US-based Bayard, P.A. "The loss of institutional lenders has been a macroeconomic change in and of itself. For example, General Electric was once one of the larger players in the DIP financing market, and is now virtually out of it. Furthermore, rising energy prices and the increased percentage of productivity that must be allocated to public and private debt service have definitely had an impact on the retail sector of the market." The scale of these concerns is something that the market is only just beginning to appreciate.

In some cases, these factors have pushed retailers to scale back their operations and even put some or all of their businesses up for auction, observes Aaron L. Hammer, a partner at Freeborn & Peters LLP in the US. Conversely, others have gone against the tide, showing significant growth. "While many retailers struggle to stay in the game during this recession, deep-discount retailers such as Family Dollar and Wal-Mart have experienced moderate to robust growth. Even the discount retailer, 99 Cents Only Stores, said that its fiscal third-

quarter profit rose 31 percent due in part to a jump in sales at its namesake chain." Mr Hammer predicts that if the economy continues to worsen, more and more consumers will turn to discount retailers.

This trend is evidently more pronounced in the US, but the fates of the US and Canada are intertwined. Until quite recently, this situation did not present a significant problem for Canadian retailers; the close connection provided Canadian retail companies with growth opportunities across North America. "Twelve months ago the Canadian dollar was on a par with the US dollar, same-store sales were growing at a rate of about 5 percent, the labour market was tight, and consumer confidence was high," recalls Lynn Bevan, a partner in the Assurance group of RSM Richter in Canada. This is clearly no longer the case. "Now," she continues "comparing all of those fundamentals, they have all been switched to the opposite side. The Canadian dollar has dropped by more than 20 percent compared to the US, same-store sales are now declining 3-4 percent



over the prior year, and the money supply has tightened up significantly.” The declining dollar has been a significant drag on Canadian retailers as exposure to the weak US market has impaired their financial strength and flexibility to react to the retrenchment of the North American consumer.

Although Canada’s retail sector and overall economy have not experienced the same level of acute distress as their US counterparts, Canadian subsidiaries of US stores have still suffered greatly. Furthermore, companies that were acquired by private equity firms in the M&A boom are now trying to severely cut costs to avoid defaulting on their loans. These retailers are already facing higher administrative costs, rising energy expenses, declining sales and increasing interest rates. Many will not make it. As such, retailers across North America are focusing on strengthening their balance sheets, reducing costs, and streamlining processes. They have put growth out of mind, grimly aware that their sales volumes will be unable to match those seen in previous years.

With these burdens to bear, many retailers have had no choice but to seek Chapter 11 bankruptcy protection, or its Canadian equivalent. However, even these processes are changing. “With the contractions in the credit market has come unwillingness, or less willingness, of lenders and asset purchasers to fund insolvency proceedings, which has resulted in an enormous acceleration of the time lines for Chapter 11 cases and to a lesser extent insurance insolvencies. A sale case in Chapter 11 that used to last four to six months now lasts two to three months,” observes Mr Glassman. He explains that, instead of bid procedures being heard three weeks to a month after a Chapter 11 petition is filed, they are often being heard after just two weeks. This leaves a creditors committee little time to react to the proposed sale procedures. Preparing anything lengthier than a simple yes or no has become challenging as a result.

Specific issues and special measures

North American shoppers have reacted almost instantaneously to the financial crisis. They are experiencing restrictions on their spending capital in a number of ways (credit limits, increased costs, unemployment), and are altering their shopping behaviour. Retailers must work even harder to entice those who are still willing to spend. “TNS Retail Forward, which conducts surveys for the retail industry, has predicted that malls will be competing for consumer dollars in today’s challenging economy,” reveals Mr Hammer. “Today, only 30 percent of shoppers visit a regional mall monthly, down from 34 percent in 2005. Furthermore, most US retail markets are oversaturated with stores, as evidenced by vacant

buildings and mall spaces where retail chains have gone out of business.” These trends are expected to worsen as more consumers turn to online retailers, which are generally a cheaper alternative.

When consumers are spending, they are spending in different ways. Certain types of retailers are still doing well, including food, pharmacies/healthcare, cosmetics and discount stores. Kevin P. McElcheran, a partner at McCarthy Tétrault LLP in Canada, proposes that such shifts may continue for the time being. “Clearly the worldwide recession is reducing consumer spending power and curtailing consumers’ aspirations. It will be interesting to see whether lower priced diversions such as movie theatres and rentals will see an uptick in demand,” he says. The effect on the most vulnerable retailing sub-sectors has been immediate. Luxury goods, consumer durables, and other big ticket items have been particularly hard hit, after experiencing record highs in the last few years. Take General Motors (GM) for example – its North American sales for January 2009 plummeted by 41 percent compared to January 2008. Purchases have dwindled among consumers nearing retirement, who are eschewing luxury goods to save for their future.

In addition, retailers connected to real estate have experienced a severe negative multiplier effect, due to slowing home construction and delayed renovations. In Canada, it is hoped that this trend will soon end, with the government’s recently-proposed home renovation tax credit, which it hopes will stimulate retailers in that area. Of course, this change is likely to take several months, and may only work on a small scale. Some observers argue that it should have been put into place much earlier.

Acting early is also seen as key to retailer survival. Unfortunately, many retailers who thought that the downturn would be temporary were unprepared for the dismal results of the recent holiday season. “When it became clear that Christmas sales were not as strong as expected, banks started to put pressure on retailers, particularly those with lots of debt on the balance sheet,” recalls Ms Bevan. “Furthermore, it is normally very difficult for a retailer to react quickly. Commitments are made months in advance to ensure that certain products can hit the shelves in time for a particular season, and they cannot cancel those orders once paid for. As a result, a lot of retailers may now have to resort to increasingly aggressive measures to survive.” Ms Bevan explains that retailers need to evaluate how they run their businesses, the decisions they make, the money they spend, and most importantly, where they are making their returns. Then, they need to concentrate on their inventories, shifting it at lower prices if necessary. However, other reports suggest that a surprising number of

North American companies are not willing to take this measure, hoping instead that things will improve.

What next?

With so many hurdles to overcome, more retail bankruptcies are inevitable. “I expect there to be more healthcare insolvencies and more real estate investment company insolvencies such as owner/operators of shopping malls. The bottoming out of the commercial real estate area likely will occur after the residential sector bottoms,” predicts Mr Glassman. He adds that an increase in municipal bankruptcies may also be on the cards. These will occur as counties, cities and towns in the US become unable to meet maturing debt obligations, due to overly aggressive actuarial assumptions regarding retiree mortality, increased demand for services and an un-appreciating tax base. Such declines in economic prosperity could wreak havoc with smaller retailers.

Retail bankruptcy trends are already clearly identifiable in the US, but not in Canada. The only major retail bankruptcies have been Canadian subsidiaries of US companies. However, the desire of existing lenders to liquidate their loan positions and the dearth of financing for going concern purchases is dramatically affecting the outcomes of those insolvencies, observes Mr McElcheran. “The two most significant retail insolvencies that have affected Canada, Circuit City and Linens ‘N Things, appear to have gone down different routes. In both cases, the Canadian subsidiary was relatively healthy, but the US business was liquidated to pay down secured debt. In Linens ‘N Things, the integration of the business of Canada and the US made it difficult to sell the Canadian operation as a going concern. In Circuit City, the US operation was ‘big box’ but the Canadian operation was operated through small retail locations in malls and commercial concourses.” The process is yet to be completed, but Mr McElcheran thinks it likely that the liquidation of the US operation of Circuit City will pay the secured bank debt and the Canadian operation may survive if a buyer can find new financing.

This is clearly no small task, but many North American retailers are turning towards asset-based lending (ABL), which allows them to use their inventory and other assets as a borrowing base. In essence, this method is ideal for retailers, but asset-based lenders tend to heavily scrutinise the resale value of the inventory, which is currently decreasing. As such, retailers may not be able to borrow as much as necessary, if at all. There will ultimately be casualties, but overall, the landscape could be improved for other retailers – and not just from a competitive aspect. “There will be opportunities for strong retailers to find better

locations,” explains Ms Bevan. “In a mall-based environment, the number of locations is strictly limited. However, as retailers reshuffle, some of the stronger ones will come to the fore, and they will get opportunities for moving into some very attractive real estate.” She adds that a reduction in rents is also likely, although this is yet to occur.

Consumer credit remains a critical component of the equation. Mr Hammer stresses that the US in particular needs to take control of its credit delinquencies. “Payments that are past due by at least 60 days, measured by a Fitch index, rose 0.47 percent to 3.75 percent last month. After accelerating in the fourth quarter, Fitch stated that, “the previous record was 3.73 percent in February 1997,” while US credit card delinquencies reached record highs. According to a second Fitch index, total charge-offs on prime, general purpose credit

cards from the December collection period rose 0.66 percentage points to 7.5 percent, up 40 percent from a year earlier and the highest number since bankruptcy reforms caused a spike in 2005,” he says. However, denying customers credit will not jump-start spending, so a balance must be achieved between the two extremes.

It is hoped that government-assisted bailouts and programs will also begin to bear fruit in the coming months. The US government’s bailout of the Detroit Big Three is a notable example, and Mr McElcheran explains the Canadian government’s contribution. “In automotive, the Canadian government, in its recent budget, announced programs that will increase available financing for car purchases. These measures will, hopefully, combat the precipitous drop in financing for vehicle leases in Canada and help the Detroit Three to generate new vehicle

sales.” He adds that the government is trying to help other types of retailer too. For example, other measures have been introduced to encourage home renovations, which will help building supply retailers across the country.

While there are few investors willing to take a risk on a retailer in today’s market, there are plenty of distressed bargains out there for the brave. Nonetheless, with or without an investor, most North American retailers will be working on their balance sheet during 2009, but the success of their efforts is likely to hinge on the availability of some sort of financing in the coming months. Those retailers with any chance of survival will be keeping a close eye on their inventories and associated process, cutting costs and discounting aggressively where necessary to keep customers interested until unemployment rates fall, and the economy finally turns around. ■