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How Long Will The Fallout From The Financial Crisis Last?

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By Susan Reda, Executive Editor



Halloween arrived on September 15 in the form of a national financial crisis, and it's been one hair-raising moment after the next for American consumers and the retail industry.

Grisly reports from Wall Street and the chilling response retailers have received from banks have made the third quarter a nail-biter, and experts are predicting the macabre atmosphere could hang over the industry long after Santa has parked his sleigh. In fact, it could linger until the middle of next summer.

Unrelenting media coverage of the financial crisis leaves little doubt that our nation is in the middle of a full-blown economic nightmare. Buffeted by the \$700 billion bailout of the financial industry, a frightening rollercoaster ride on Wall Street, the credit market freeze

and the crumbling of once-venerable institutions like Lehman Bros., Fannie Mae, Freddie Mac, Washington Mutual, Wachovia and AIG, businesses are reeling.

For retailers, whose fortunes are so closely meshed with consumer confidence and consumer spending, the goal right now is to tread water. They're hoping to find ways to salvage the all-important holiday season. Still, with the credit markets effectively frozen and prospects for borrowing looking bleak, the first two quarters of 2009 are expected to be especially tough.

"As retailers continue to report poor sales, it's scaring the factors [providers of financing to vendors] out of their wits," says Walter Loeb, president of Loeb Associates. "There's no question that that ability to borrow will be difficult for the rest of the year, but if retailers planned their inventories right they shouldn't need to borrow much through the balance of the fourth quarter."

Loeb is more concerned about spring and summer. "Some retailers will depend on factors and some may be able to borrow on credit – albeit at higher rates. But there won't be sufficient cash available for everyone. I expect the credit agencies to be very aggressive in reviewing a retailer's performance before granting loans. Any question of creditworthiness or weak ratings will result in credit being

denied.”

Rough road ahead

Retailers are bracing themselves for a rocky stretch. Already, many have announced plans to slow or suspend new store openings; remodels also are likely to be put on hold. Some executives say they'll cut back on inventories, and nearly all are scrutinizing their operations in an effort to trim unnecessary costs.

While no one could have predicted the severity of the current crisis, retailers have been operating with tighter inventories for the better part of 2008. Most trace the early signs of a slowdown in consumer spending back to last fall, but it was when gasoline prices started to soar in the spring that shoppers began parking their disposable income. While the cost of filling their gas tanks has come down recently, consumers — feeling the pressure of declining home values, shrinking investment portfolios and rising unemployment rates — have dramatically reined in spending.

“Consumers are finding it more difficult to borrow and tap home equity lines of credit as banks tighten their credit standards,” says Frank Badillo, senior economist and global program manager for TNS Retail Forward. “This will continue to be a drag on retail spending well into 2009. Some of this will also happen voluntarily as economic conditions cause households to decide that they don't want to carry the kind of debt burdens they had in the past.”

Michael O'Hara, president of Consensus Advisory Services, an investment banking and financial advisory services firm, expects third-party consumer credit companies like Visa and MasterCard to increase their risk profiles, making it tougher to open new accounts or increase lines of credit. “As shoppers struggle to pay loans, credit scores are likely to migrate down,” he says.

O'Hara is keeping a wary eye on the retail companies that provide consumer credit cards, too. “There was a time when store credit was common for jewelry or furniture retailers,” he says. “Now, unless a store has a pristine balance sheet, they're not going to be able to take on consumer credit. The low financing, multi-year payment deals shoppers became accustomed to could really dry up.”

Working capital

Retail executives are already reporting difficulty borrowing for their working capital requirements. Revolving lines of credit have been drastically reduced — or worse. And the crisis couldn't have come at a worse time for the industry: Most retailers' working capital needs are highest in August, September and October as they ramp up for holiday selling.

Deborah Weinswig, leader of retailing/broadlines, food and drug and home improvement for Citi Investment Research, says smaller retailers “are having the most difficulty renewing lines of credit. We don't believe that the broadlines retailers will run into liquidity issues at this point.”

Rick Darling, president of Li & Fung USA, expects problems to plague a more extended group. “Those retailers that are either highly leveraged or on weak financial footing may have serious problems getting through this period,” he says. “Those with strong balance sheets and business models will capture market share and come out stronger.”

Jim D'Addario is director of SAP ERP Financials. A former banker, he recalls making credit decisions based on the review of a retail company's key financial metrics. In the current environment, he says, even retailers with pristine balance sheets and income statements will hear, “I'm sorry” from the banks.

“In the past, if a company waived on a covenant, the banks were reasonably forgiving,” D'Addario says. “Now they're assessing penalties right and left, and you can bet they'll impose higher interest rates, too.”

Therefore, retailers “need to find a way to do a better job of liquidity planning,” he says. “Typical 60 percent accurate cash forecasts are no longer tolerable for when cash flows slow dramatically and financing is hard to come by.”

Mitch Jacobs, CEO of On Deck Capital, a New York-based financing network for

small businesses, says that a growing percentage of the 25 million U.S. small businesses are already seeking alternative financing. "A central characteristic of small business owners is resiliency," he says. "They're feeling the pain, but what I'm hearing is a desire to grow their way through this period. They can't go to banks because, in most instances, they don't have a lot of hard assets."

On Deck Capital provides alternative financing to small retailers at rates ranging from 18 percent to 36 percent – more expensive than bank capital. Still, Jacobs insists that, for many small retailers, it's an attractive alternative. "Many small businesses have remarkable durable cash flow but, using traditional methods, banks can't decipher that. We're providing much needed capital to small retailers who have always been underserved."

Inventory tensions

Most retailers insist there will be plenty of inventory on store shelves for holiday selling. That's especially true for those retailers that source a majority of products from China, because those goods have already landed stateside. But if consumers pull back on spending as anticipated, retailers may have little choice but to move goods at highly promotional prices.

Weinswig concurs. "Most ordered conservatively . . . but they may not have ordered conservatively enough given the recent deterioration in the markets and the impact it will have on consumer spending," she says. "This could lead to gross margin risk."

Retailers that operate "fast" fashion-type businesses may face more difficulty in the coming weeks because they've become accustomed to compressing the order cycle and sourcing goods closer to need. If they're placing orders now, experts say they're going to have a hard time getting credit to pay for them and may find themselves scrambling to fill the shelves.

Already, there are reports of growing tensions between retailers and their suppliers. Generally, experts perceive retailers to be more powerful than their supplier base and suggest that they may be able to push inventory risk onto them — requesting, for example, that they hold more inventory in their DCs.

Others tell a different story. With the credit freeze, some say suppliers are demanding alternative credit terms and accelerated payments from retailers. Insiders report that some suppliers have begun to treat big retail companies as if they were banks; manufacturers are telling their retail partners that if they want product they're going to have to foot the bill because they're struggling to get working capital.

No white knights

In the not-so-distant past, struggling retailers found white knights in the form of private equity firms. But there's not much hope of someone with deep pockets swooping in to help retailers that may be in weakened positions now.

"We are seeing hedge funds having to sell positions in retail stocks to meet margin calls," Weinswig says. "Additionally, we're seeing some increased short selling in retail stocks as a substitute for hedges in financial stocks."

O'Hara concurs. "What attracted private equity investors in the first place was what they perceived as a predictable, steady flow of cash from a retail operation and the potential for growth," he says. "The question today is, who can predict cash flow or growth in this environment?"

Most funds and private equity firms "have likely suffered losses that will limit their ability to invest in retail going forward," Badillo says. "There may be the handful of firms that have cash and will use this as an opportunity to buy retail investments at low prices, [but these] buyers are more likely to be foreign companies than U.S. companies."

Last holiday season, a number of retailers received shots in the arm in the form of foreign tourists taking stateside shopping vacations. Lured by favorable exchange rates, tourists flocked to some of the nation's biggest cities to scoop up luxury goods. Neither industry insiders nor retail analysts expect that to be the case this holiday season.

Lease release

Some retail companies have announced plans to scale back on store openings and remodels, and word has it that they're now trying to work deals with real

estate developers, too.

David J. Rabinowitz, a partner at Sutherland's New York offices and co-chair of the Retail Practice Group, says some developers are willing to negotiate with retailers — but emphasizes that they, too, have lending requirements to satisfy as well as co-tenancy obligations to consider.

"Some developers are already sitting with vacant space based on retail bankruptcies earlier in the year, and they have a very real need to minimize the amount of vacant space in their centers," he says. "In most cases, it's in their best interest to work with retailers when they come to them for help, but every project is unique and, in balancing the risks and rewards of working with a vulnerable retailer, a developer must always consider the ramifications if that retailer ultimately files for bankruptcy."

As vulnerable retailers explore ways to minimize or mitigate risk, Rabinowitz encourages exploring all avenues. "This would include carefully reviewing their leases for exit strategies as well as talking with their developers about renegotiating or even terminating their leases."

While no one is attempting to sugarcoat the near-term challenges the retail industry faces, most acknowledge that such hardships often yield new ideas and business approaches that might not have emerged otherwise.

"Strong retailers are as good as the strong companies in any industry," Darling says. "All industries eventually find out who the leaders are and typically they are companies that adapt quickly to change, stick to the core competencies and use a down market to gain share over the competition."

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