Retail Survival in a Weak Consumer Environment

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America is in the midst of what is arguably the worst consumer spending environment in close to twenty years. The residential real estate recession, record high gas prices, evaporation of consumer credit availability, and reduction in mortgage refinancings are all negatively affecting the consumer. The result is trickling down to the retail industry in the form of reduced consumer spending. This pressure is compounded as retailers are simultaneously struggling to absorb increased shipping and raw material costs, directly affecting profits. Much of the American economy seems to be caught in this transition from a period of no-to-low inflation to one in which prices are rising once again—an environment in which retailers struggle to cope.

Challenged to maintain profit margins in the face of both a slowdown in customer foot traffic and escalating costs, retailers are forced to pass these costs on to both their customers and suppliers. This retailers' situation is further complicated by the capital markets, where corporate credit is in terrible shape and even good companies are finding it difficult to borrow money. Retailers have never been a favored category for lending, so in a tough environment it becomes increasingly difficult to access adequate financing and stay out of bankruptcy.

It is still up for debate how bad the U.S. economy will actually get, and how long the soft retail market may last, but most experts forecast that the situation is unlikely to improve before mid-2009. Some of this economic turbulence is like an earthquake, which happens quickly and does not last very long, but where the damage resonates for a long while afterward. This is, therefore, shaping up to be a very difficult year for retail and the 2008 holiday season could see dramatically negative results.

Global Impact

While most of the global retail market is concentrated in a relatively small selection of countries, these countries have become increasingly dependent on a global supply chain. While this has allowed American retailers to grow in a deflationary apparel environment for much of the last decade, it is now costing these retailers more than ever. Most Asian and European currencies are up dramatically against the American dollar, so retailers who repositioned their product supply chain by importing from overseas have seen the purchasing power of their dollar decline, while simultaneously experiencing escalating global raw material, labor, and shipping costs. They are left essentially importing inflation by purchasing goods at rising costs from overseas with devalued dollars.

The international supply chain has been affecting the retail industry for quite some time now. The perfect example is Wal-Mart, which grew so rapidly in recent decades because it leveraged an international supply chain to bring in huge volumes of low-cost products. In the early stages of this trend, many companies followed this model and imported low-priced goods from overseas while costs were low. However, that cost cycle has turned over, and Wal-Mart and these other companies are now feeling a margin squeeze due to the increasing costs associated with imported products. Thanks to the weak American dollar, as well as rising wages and taxes increasing the costs of doing business in China, a new set of pressures are just beginning to weigh down once thriving discount retailers.

Another issue for international retailers who may be operating in the U.S. is the lack of consistent bankruptcy regulations and practices across the globe. The effects of bankruptcy on an international retailer's American operations and Asian operations are quite different, and, in fact, vary widely from country to country. In some countries, when a company goes bankrupt it is simply out of business and liquidates, whereas in the U.S., there is an insolvency regime oriented toward restructuring and reorganization. For an international retailer without an American presence, there is a greater bias and likelihood toward failure and closure. An American presence might provide an opportunity for one part of the retailer's operations to survive better than their others.

Bankruptcy Risks

In my experience, retailers with the highest risk for bankruptcy have all had either bad strategy or bad execution (or both!) in common. Whether a well-run company with a poor strategy, or a poorly run company with a good strategy, both are primed for financial disaster. In recent years, it used to be that retailers could cover up their strategy or execution mistakes with growth at the sales line or the addition of new stores. In today's shaky economy, however, retailers are no longer afforded that luxury. If a company has not been managed well, and their numbers begin to taper off, mistakes that were previously easy to cover up with growth quickly become more evident.

There are too many types of retailers to categorize them into subsets of the industry, such as luxury, specialty, general, discounters, electronics, etc., that will tend either to do well or poorly as a whole in a down economy. Regardless of their target audience or type of merchandise, retail is all about execution. If you have a value proposition and an ability to execute, you are in a better position to survive and sustain growth than if you don't. For example, if you run a factory that makes a great and differentiated product, or you develop something like Google that thrives in cyberspace, you do not face the same kind of fall-down risk day to day that retailers can experience by running the wrong marketing promotion and negatively affecting sales. Again, success, and ultimately avoiding bankruptcy, goes far beyond the product in retail and relies predominantly on execution.

Certain companies are, by their nature, at greater risk of bankruptcy. It is a dangerous competitive situation if you present a full-price offering and a value competitor comes in arguing that they are delivering similar quality at a better price. It is a hard lesson from Business School 101 that low-cost suppliers ultimately have a great advantage in the market. To return to the example of Wal-Mart, their use of technology and risk management has been widely reported as a key to their dominance. The company used these tools to achieve a stronger financial position and, therefore, could afford to do things others could not, such as upgrade stores, offer the lowest prices, and improve their merchandising. No one wants to find themselves in a similar situation as that experienced by Wal-Mart's competitors over the last few decades. New retailers and suppliers will continue to come along with different mousetraps, and think they know how to get ahead in the industry. To avoid distress and possible bankruptcy, existing retailers must constantly be on the look out for competition presenting an improved value proposition for the consumer.

Retail is also highly cyclical. One would be hard pressed to come up with a retail situation that will not face high risk or heavy competition in due course. From an investor's point of view, as soon as a retailer is doing well, we look at selling, as experience dictates that performance will revert at some later point. Unlike a more simplistic widget manufacturer, where as long as the company keeps stamping out widgets a given level of success is predictable, retailers have to constantly be on the top of their game in order to stay competitive throughout the many stages of their life cycle.

Bankruptcy's Challenges and Impacts

The retail industry has several inherent strengths: a diverse customer base, cash that tends to come in the door every day, and low concentrations of accounts receivable and customers which helps to mitigate risk. This contrasts with industries where customer concentration is high and revenue and receivables are at greater risk. When managed properly, retailers can actually benefit from Chapter 11 filings because they can continue to collect their revenue while they work out their liabilities. One difficulty for retailers seeking bankruptcy protection, though, is that changes in the Bankruptcy Code have made dealing with their real estate interests much more challenging. The window allowed for making decisions on rightsizing the store base while in bankruptcy has become truncated, even though this decision is typically crucial for the retailer. For example, in most circumstances debtors in bankruptcy now have a 210-day limit before they must obtain landlord consent for further extensions of the time to assume or reject a real property lease. This can leave precious little time to adequately determine a retailer's proper store footprint.

Additional challenges for a retailer's accounts receivable and customer service during bankruptcy include consumer complexities, such as honoring gift cards and return rights. There are also many agencies and regulators, such as the Department of Consumer Affairs and each state's attorney general, that interact with consumers and bring additional burdens on retailers for behavior and compliance that may not be explicit obligations appearing in the financial statements.

Prior to 2005, there had been a noticeable paucity of retailer bankruptcy filings. With the pending amendments to the code in that year, however, there was a wave of bankruptcies in order to take advantage of the old bankruptcy rules. Since that time, though, the strong economy and industry's natural life cycle left relatively few filings, and those were simply poorly run companies from the start. Beginning in 2008, however, we began to see the weakest retailers start to file for bankruptcy protection at an accelerating pace. The cause of distress was often a combination of weak execution, weak capitalization, and/or weak strategy. Now, however, we are beginning to see the better companies running into tough situations as well, such as declining sales levels at which they cannot survive if it extends through the fall and winter shopping seasons. The weakest retailers may be failing earliest, but stronger concepts may not be too far behind.

The Government's Role

The bankruptcy code amendments enacted in 2005 have dramatically increased the risk that retail businesses do not survive through bankruptcy. Now, with the federal government and state legislatures providing stimulus packages and tax rebate checks, it is arguable that more retail companies will struggle than otherwise might have as weaker competitors are temporarily sustained in a difficult overall environment.

Keeping Track of the Warning Signs

Monitoring systems are essential for tracking a business' risks and financial condition. There are several types of systems that retailers can use, each with its own benefits. Internal auditing is extremely valuable, whether it starts with closing procedures at the store level or a corporate review to ensure that bank deposits are made every day. Mystery shoppers are also useful tools for figuring out if store processes are amiss. That way, employees don't know that their behavior and procedures are being observed, so they cannot shape up just for the day their local area manager may come in for a visit. Reviewing inventory procedures for accuracy is also helpful. If you are in an inventory-heavy business, make sure you do not go too long without a full physical count, as opposed to relying only on periodic sampling. Historically, a significant portion of accounting inaccuracy and fraud has been traced to poor information and inventory tracking systems, where employees knew management would not figure out the losses for some time.

Liquidity is clearly the number one signal of high bankruptcy risk. If you find yourself with declining sales and static inventory levels, you will end up running out of cash. If trade creditors are concerned about your performance, they too will start cutting back on the credit they extend to you. Other signals include defaults on your credit agreements; looming fixed charge obligations, like principal payments on debt; and the inability to find an alternative for refinancing. These are compounded by the current state of the capital markets in which banks are very nervous and hesitant to make new loans. The key to resolving many of these issues, and staying out of bankruptcy, is gaining control of the liquidity influencers as quickly as you can. The bigger the war chest you have, the better you can fight your way through the challenging times.

When in bankruptcy, there are many good advisers out that can help monitor controls. It is generally not a situation worth the investment of an industry-specific management team, but there is plenty a company can do to make the bankruptcy process as painless as possible. What is important to note is that some of the financial stress and bankruptcies that happen in retail can be seen coming far in advance. However, in the face of all the warning signs, many retailers (and other businesses for that matter) do not institute a preliminary inquiry and lay the proper groundwork that could make that eventual bankruptcy filing easier to manage in the end. When they see a problem that may lead to bankruptcy, many try to avoid the issue believing that they can work their way out. They postpone dealing with the issue of bankruptcy risk, but if they had recognized and planned for it earlier, they could have handled it better, and to a better result.

In just about any situation, it makes sense to involve bankruptcy counsel earlier rather than later. The skills required to run a troubled company are not always the same as the skills needed to run a healthy company, so it can often be helpful to get advice from interim management specialists or restructuring advisers. Existing management is likely already busy running the business and dealing with the reorganization, requiring them to stretch beyond their abilities and available time.

Preparing for Bankruptcy

The first and most important action item for a company preparing for imminent bankruptcy is to get control of its liquidity. If you do not know what kind of financial running room you have, you cannot plan adequately for a bankruptcy. After that, get communication programs in place to all your key constituencies. Although much of the mystery surrounding bankruptcy has faded as people have seen more companies go into bankruptcy and come out alive in recent years, communication is still a primary issue, especially when bankruptcy hits home. It is critical to communicate with the employees about the issues of highest concern for them, such as their job status and the company's future direction. This will also make sure that they are in a position to address any inbound questions or concerns from customers. Customers will want clarification on issues like: What is going to happen with the product they have on order; will returns be accepted; and will gift cards/certificates still be honored.

Without a well-defined communication program, the grapevine will take control of any business facing or experiencing bankruptcy. To beat the rumor mill, executives, managers, and other stakeholders must communicate a clear vision for the company, and explain why bankruptcy is a tool for the company to improve, not an end in itself. The worst thing a management team can do is allow a so-called "free-fall" bankruptcy filing, where they simply file for bankruptcy without a plan or proper financial support. It is incumbent upon the board, shareholders, and management to have a strategy. If you do not know where you are going, you can't correctly use bankruptcy as a tool to get there.

Prevention

Choosing the right strategy to avoid bankruptcy depends on the cause of distress. Often, retail executives have a good strategy, but poor execution, such as a loss of control over their supply chain. Some retailers are heavily reliant on particular trade vendors so, for example, if a jeweler sells Rolex watches and gets its supply cut off by Rolex, he faces significant trouble; similarly a running shoe business that gets cut off from Nike.

The causes of distress can also be either structural or cyclical. Cyclical causes include the external environment, a slowing economy, and a drop in consumer demand. Structural distress usually stems from management, strategic or governance failure, where the owners disagree on the company's direction and it becomes paralyzed.

A company's internal options for preventing bankruptcy include close management of the firm's cash flows; planning ahead and identifying where the company's cash is and controlling its commitments. By the time the check clears the bank, it is already too late. You have to get control of commitments upstream, as the purchasing agents are effectively writing the checks. Communication is critical here as well. If you do not have an adequate program of communicating with your employees, customers, and suppliers about the company's cash flow, the grapevine will take hold, and that can kill a company that might have otherwise gotten through without filing for bankruptcy.

Financial analysis is another key in avoiding bankruptcy. If done properly, it never actually ends. Smart leaders are constantly managing and watching their long-term commitments, liquidity issues, and seasonality. There are plenty of companies with lots of inventory, but no liquidity. Having regular dashboard metrics can reveal early signs of difficulty, such as a build up of accounts payable, a slowdown on vendor payments, reduced foot traffic, or shrinking liquidity. Making sure these metrics are tested and re-tested with enough frequency can help you avoid any surprises. Much of the responsibility here is on the company's CFO, who should know the company's liquidity position at all times. Tracking that position is a key part of both detecting distress and then managing it.

If you are at risk of bankruptcy, it is most critical that you have a solid finance function. The ability to know exactly where you stand with liquidity is truly a matter of life and death for a company. Some companies look for help far too late. For them, it is often a surprise that they are so close to bankruptcy because they do not have adequate tools in place to track their finances. So many retailers are used to cycles of planning quarterly or monthly, but when you are in distress, you need to know your cash position daily. The ability to manage or avoid problems can be directly related to how much cash you have, so the earlier you have the tools in place with a capable finance function, the better you are equipped to deal with it. We tell companies that we can deal with bad news, but it is much harder to deal with surprises. I can't change what happened yesterday, but if you call to tell me what might happen tomorrow, I may be able to help.

Information collection and sharing is critical in avoiding bankruptcy, and technology can be used to manage it effectively. Technology has had a major impact on the information available to retailers, as often the answer to the question of how to avoid bankruptcy can be found within the company's own database. Technology is a way to streamline execution, so wherever you can apply technology, whether in POS system or inventory tracking, consider them all arrows in your quiver for having a healthier enterprise that is less likely to fall into distress. The decision to invest in technology as part of a solution is like any other investment decision you make in a business. Healthy skepticism should be the order of the day whenever you are told that computer systems and other technologies can pave your way to prosperity, but they can give you tremendous tools and visibility into where you are and where you have been, enabling you to make better decisions about where you are going.

Increasing sales is a logical major step in avoiding bankruptcy, but it is not that easy. Unless you are able to get a clear vision on the cause of distress, it is hard to just focus on increasing sales, or pursue other methods described here for avoiding bankruptcy. The fact of the matter is healthy retailers do not walk around thinking about their risk of bankruptcy. Cost controls, liquidity controls, and sales are a great oversimplification, but ultimately, revenues and costs are what it is all about. If you cannot find a solution to a top line sales problem, it is difficult to save yourself with cost reductions. Too many retailers who start getting into trouble end up discounting or going off their strategy in order to generate quick short-term sales. Pursuing this strategy, however, may instead result in long-term damage to their business.

When examining cost controls as a driver of your company's path toward bankruptcy, keep in mind that the biggest cost categories tend to be payroll, occupancy, and cost of goods. With payroll, you only have two options: either pay the people you have less, or dismiss some of them. Retailers often have a hard time finding a way to resize their business quickly enough. If their volume is down 20 percent, they struggle to immediately figure out which 20 percent of the employees they should cut, so they often put it off, which ends up tightening their window for recovery.

Negotiating for inventory cost reductions and supplier rebates can be difficult, but the shorter the lead times, the easier it can be. For example, a large retailer of private label boys' dress shirts may have to commit to a substantial inventory since it is a custom order for the supplier. This hinders their ability to reduce the cost of their inventory. A firm buying a branded product on a spot available basis can instead say, "The environment has changed and while I need another truckload, I have to pay less for it," and begin negotiating. In a healthy economy, the best way retailers can position themselves is often to sign long-term obligations for large volumes, because it gets them the best discount. But when you get in trouble or the economy goes south, that is the worst possible position to be in as it only accelerates your decline into distress.

Using Contracts, Agreements and Alliances to Help Avoid Bankruptcy

Agreements and contracts with suppliers and landlords are always impacted during bankruptcy. Usually when suppliers and landlords find themselves with a bad situation in a retailer's bankruptcy, it is because they made an agreement when the retailers were very healthy, and then did not have an opportunity to revisit that agreement as the company made its trip down the curve of declining performance.

If a supplier extends unsecured credit, it is at risk of holding a general unsecured claim in bankruptcy. If it operates on a consignment basis, however, it might have a better chance of getting a higher recovery, depending on the strength of its claim. Retailers and suppliers need to work together to come to an agreement on these terms in their contracts. Return policies, prohibitions on discounting, and uses of trademark can all create leverage in the supplier's position in these negotiations, but retailers should strive to create flexibility in these relationships, not just seek the lowest pricing.

A company's relationship with its landlords can also impact its chance for survival. Real estate companies themselves must also remain knowledgeable about the Bankruptcy Code and common procedures/challenges. For retailers that go into bankruptcy, where they reorganize or liquidate, the Code includes some strong provisions referred to as *ipso facto* clauses that can defeat lease termination clauses arising in the event of a bankruptcy.

Companies spend a lot of time building bankruptcy protection into their contracts without saying it is bankruptcy protection. Real estate firms must beware.

A landlord must also consider what kind of credit risk it wants to take with a tenant. Many tenants will ask the landlord to build the store and include the construction costs in their rent. But then, if the tenant goes bankrupt, the landlord is out that money. Landlords who get the retailer to build instead face less risk. In these negotiations, there is a lot of give and take, depending upon the relative strength of the retailer. Big powerful companies like Target can have the ability to dictate these terms to the landlord, whereas smaller retailers will often have little choice.

Retailers are also using the notion of strategic alliances to reduce the risk of financial distress and bankruptcy with greater frequency. They can strike alliances with suppliers, or with other retailers who share similar marketing issues. Think of recent media coverage discussing strategic alliances among the airlines. To some extent, they are beneficial in giving the airlines the financial benefits of increased revenue and profitability that may help them avoid bankruptcy. With the turmoil resulting from surging fuel prices, many of these global airline alliances are giving companies another chance to survive. A similar strategy, for example, could be two retailers sharing space because one sells bagels in the morning and the other sells pizza in the evening, or it is possible for two firms to sell complimentary products in the same location at the same time. It helps both of them with the cost of the space.

Conclusion

All told, retailers need to start planning for bankruptcy early, cut further than they think they need to, and get themselves good lawyers and advisers. Whatever sacred cow you are concerned about slaying now, it will be twice as hard and painful to deal with later. Nine times out of ten, when we work with distressed retail companies and ask what precipitated their struggles, they can recite chapter and verse what went wrong. But when we ask why they did not do anything about it earlier, the answer is almost always driven by inertia and culture. Taking action early is absolutely critical in avoiding bankruptcy if possible, and preparing for it if inevitable.

There are some situations where companies have been caught by a surprise, such as a legal judgment or a massive product recall issue (both of which are probably themselves signs of unrecognized management failure somewhere up the line). It is difficult to prepare for those circumstances, but they tend to be more the exception rather than the rule. A retailer's demise is usually something that was identifiable, if not preventable, long before the day they file Chapter 11 (or even Chapter 7). To add to their challenges, recent changes in the Bankruptcy Code have made the process so daunting that, if there is a chance you might go through bankruptcy, one must begin planning long before companies did in the past. Once in court, retailers are no longer afforded the time they once had to reorganize their affairs. Management, stakeholders, and the board need to pay attention to the details and not get stuck in the forest and missing the trees. Usually the signs of distress and failure are evident long before the failure happens, so keep your eyes open.

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