Survival of the Fittest

By Mark Cohen and Anthony Karabus | May 25, 2020

Published in The Robin Report

The “once in a life-time” impact on retail created as a result of the Covid-19 pandemic has accelerated the secular shift that has gradually been impacting retail for the past 10+ years; namely the shift to digital and the declining viability of regional “B,” “C” and “D” malls. This secular shift over the past decade has resulted in a gradual decline in retailer productivity and profitability as, for most retailers, digital sales represented a cannibalization of their brick-and-mortar store volume, rather than an increase in total revenue. Many struggling malls closed or were repurposed to alternative uses over these years as an increasingly large number of department store anchors and specialty tenants have closed.

Covid-19 Has Accelerated the Pace of the Digital Transformation and Raised the Bar for the Industry

In our view, the Covid-19 pandemic has substantially accelerated this secular shift given the closure of nonessential retail stores since mid-March, thereby allowing those retailers to only do business via their digital platforms. Many struggling retailers will not survive outright, or if they do, will see significant structural changes in their current form. Those with heavily debt-laden balance sheets will be the most vulnerable as we have seen with recent bankruptcies of prominent retailers, whose outsized debt was a legacy of leveraged buyouts.

> **With the anticipated anxiety of consumers to enter enclosed malls and shop in close proximity to crowds, we expect a rapid path to digital representing as much as 40-50 percent of total company sales for retailers in many categories/sectors by late 2020.**

This massive debt has crippled mature retailers who have suffered the dual effect of having to service both interest and repayment obligations, leaving them with insufficient capital to renovate and keep stores current and invest in modern presentation and marketing programs necessary to retain existing, and attract new, often younger, customers. Unworkable debt loads in mature retailers coupled with ongoing challenged operational performance and lack of a clear go-forward strategy, have always been recipes for financial distress, now ever more so in the age of Covid-19.

With the dual effect of (1) consumers having had almost three months to build new habits and transfer their shopping online from stores and (2) the anticipated anxiety of consumers to enter enclosed malls and shop in close proximity to crowds, we expect a rapid path to digital representing as much as 40-50 percent of total company sales for retailers in many categories/sectors by late 2020.

There Are Some Rays of Sunshine

While we expect an anticipated reduction in total consumer demand for discretionary purchases of 20-40 percent prior to a slow recovery in 2021 and a return to the “new normal” by 2022-2023, we expect some sectors will actually see topline growth. These would include products for the home, home improvement centers, pet, grocery, health and beauty and casual work at home clothing/athleisure.

Even in sectors with anticipated substantial reductions in consumer demand, we expect that market share from failed or restructured retailers will move to those surviving retailers who either are already or can become the “authority” or leader in their sector.

What Does All This Mean?

In sectors where rapid digital growth results in store sales declining 20+ percent, retailers will need to reinvent their business models to be able to earn acceptable levels of profitability as well as generate enough cash to fund the transition to the new business model. This includes a new generation of stores with environments assortments and experiences that will attract both millennials and their younger Gen Z cohorts. Retailers must seamlessly integrate positioning, content, presentation, pricing and merchandise availability among their digital platforms, omnichannel and stores.

Realities Must Be Confronted

- Total consumer spending on most discretionary items will face a meaningful decline until 2022 and that decline will not abate until unemployment and consumer debt decline significantly.
- The digital sales penetration rate which has massively accelerated during the throes the pandemic, will likely increase by 20 or more percentage points. This simply continues and accelerates the already remarkable growth of e-commerce over the past 10+ years, most of which represents a transfer of sales from physical stores, rather than incremental sales.
- Marginal store locations, especially in weaker malls, will be even less likely to remain viable than they were before this crisis began. Simply saying “all my stores are 4-wall positive today” is not the answer

- Simply slashing store labor and other operational costs in poor performing store locations to prop up their 4-wall contribution is not a solution. It never has been a successful strategy and it certainly won't be as we look ahead. Customer service, in decline among many retailers before the pandemic, must be restored as a necessary pathway to recovery.
- Slashing store labor and occupancy costs will buy time in the short term but in no way changes the longer-term trajectory of weaker store locations in weaker malls.
- The demise, repurposing and re-densification of potentially hundreds of challenged malls throughout the U.S. and Canada will be far more rapid as a result of this crisis.

A Game Plan to Ensure the Likelihood of Recovery

- First and foremost, establish your realistic timeline as to when you believe the pandemic will have disappeared or will have substantially subsided. We suggest this will be in late 2021 or during 2022.
- Then, establish a near-term timeframe when you will be able to effectively and safely reopen most of your stores. We think this will be some time in Q3 of 2020.
- Based on the above, develop realistic sales and profitability forecasts by channel (online and each store), incorporating rent and occupancy expenses and other mitigation tactics you've taken.
- Build a go-forward business model now and the transition plan towards achieving it over the next months. This will include changes to store environment, assortment changes, a go-forward store fleet, a digital and omnichannel capability and capacity, and the cost and supply chain infrastructure to enable your go-forward business model. Consider retaining a dispassionate, real risk mitigation expert to help you get to your go-forward store fleet with the least disruption and cost.
- Determine your inventory and liquidity requirements, including access to cash, bank lines, working capital and capital allocation requirements quarter by quarter until a recovery to a "new normal" can be realized.
- Review your current status with your existing lenders and build a well-communicated plan to obtain the liquidity required to achieve your go-forward business model.
- Deal with the disposition of your currently unsold spring/summer inventories in stores and develop a strategy that lays out how you will obtain fall/holiday product. In so doing, consider if it makes sense to "pack up" unsold spring/summer inventory until 2021 where viable. To the extent it makes sense, retain a liquidator to help you monetize this surplus seasonal product promptly.

- For high-performing retailers, this pandemic provides a great opportunity to assess all their operations and create an even more profitable business model. A time of massive change is the best opportunity to build an even stronger "moat" around profitable businesses

About Mark Cohen and Antony Karabus

Antony Karabus is CEO and Co-Founder of HRC Retail Advisory, a leading retail strategy consulting firm based in Northbrook, IL and has been advising Retailers for almost 30 years. Visit HRC at www.hrcadvisory.com Mark Cohen has been in the retail business since 1971. He currently serves as a Professor by Contract at Columbia University Graduate School of Business and as an independent consultant to retailers, as well as marketing, manufacturing and technology partners serving the retail industry.