CONSUMER POLARIZATION **SQUEEZES** RETAILERS IN THE MIDDLE

BY ANTONY KARABUS, CEO, HRC ADVISORY

Retail is in the process of a significant transformation. Consumers are moving toward the higher end at a rapid pace, with retailers that include Neiman Marcus, Bergdorf Goodman, Nordstrom, Saks, and luxury mono-brand stores showing increases in sales productivity and profitability. Concurrently, the off-price and mass discounters sector, headed by Wal-Mart, Dollar Stores, T.J. Maxx, Ross Stores, and Burlington Stores, as well as Forever 21, Zara, H&M, and Costco, continues to grow store counts and earnings.

What does this mean for retailers in the middle, those that most often cater to price-sensitive and/or consumers hunting for the next "hot" fashion item? With the growth of the high-end and discount sectors significantly outpacing the middle, the latter is capturing a much smaller share of the total retail market than it once did.

Add to this the headwinds created by online growth—the increased competition from pure play e-retailers and the cannibalization of physical store sales by brick-and-mortar retailers' own e-commerce channels—and the resulting decline in mall traffic puts extreme pressure on retailers in the middle, with the exception, perhaps, of those located in the premium malls.

As a result, numerous retailers in the middle are experiencing declining or at best flat sales productivity in their physical stores while experiencing direct occupancy cost, labor, and sourcing cost inflation, resulting in a decline in the profitability of their physical store fleets. There is much less margin for error. Consumers are less forgiving, less loyal, and more willing to move on to the next brand without hesitation. This is particularly true with the fickle, hyper trend-sensitive teen sector, which rapidly moves from retailer to retailer based on whose merchandise is more correlated to their lifestyles at the moment.

The increased levels of competitive intensity have put increasing pressure on teen/youth retailers, such as Abercrombie & Fitch, Aeropostale, American Eagle Outfitters, Mandees, Express, PacSun, and others. PacSun is one of the few chain retailers in this space that has successfully turned around its business, regularly posting increased comparable sales and earnings. American Eagle's business has started to post improved results and appears to be doing better than most in the space.

All of these factors, coupled with the widely held view that America has too much retail square footage, have resulted in significant changes to the retail landscape in the past 24 months.

Amid this polarization in the marketplace, numerous retailers have become casualties. Few have been able to restructure and emerge stronger; in virtually every instance, they have gone straight from Chapter 11 to Chapter 7 and liquidation. Thousands of stores have been shuttered as a result, from RadioShack, Wet Seal, Deb Shops, Cache, and Coldwater Creek to Body Central, C. Wonder, Alco, Fashion Bug, Dots, and Delia's. Many retailers that operate in the middle and remain in business are closing numerous physical stores, often nationwide, including Sears Holdings, Aeropostale, JCPenney, Children's Place, and others, as they struggle to remain afloat.

Retailers in the middle are likely to survive in their current form only if they are the best in their sector and command a customer value proposition that is differentiated from price and creates an experience that brings consumers back. These retailers must effectively manage working capital/inventory to ensure that their balance sheet liquidity is adequate to carry them through these challenging times in the retail industry. They must protect merchandise margins and ensure that their inventory investment is deployed to the local store nearest the point of customer demand. Lastly, these retailers must address their cost infrastructure so that they are managing cash effectively and can redeploy their available liquidity to fund their digital and other growth transformational initiatives.

Another interesting dynamic in the retail sector has been the number of CEO positions that have turned over in the past 24 months. Top executives have been changed at The Gap, Safeway/Albertsons, Things Remembered, Sur La Table, Hollister, RadioShack, American Apparel, Yankee Candle, Brookstone, Footlocker, Justice, Christopher & Banks, Bebe, New York and Company, Body Central, Abercrombie & Fitch, Gymboree, Office Depot, Wet Seal, Michaels, Hot Topic, American Eagle, Aeropostale, Cache, Winn Dixie/Bi-Lo, and Fresh Market.

Typically, when a retailer makes such a change, it also recalibrates or refreshes its strategy. This results in a period of significant internal change in leadership, strategy and/or key initiatives, and focus. The recent announcement by Target Corporation that it was closing its Canadian business and taking a write-down of more than $5 billion came soon after the arrival of its new CEO, Brian Cornell, who was able to look at the company's failed investment and entry into the Canadian marketplace in an objective manner, rather than being emotionally tied to the original decision.

The current retail environment is not for the faint of heart. This is a complex time and survival of the fittest is an apt phrase for the industry.

To survive and thrive in this environment, five key levers for middle retailers are to:

1. Develop a compelling, differentiated customer value proposition and business model that is distinct from price and engages the customer most effectively.
2. Create a merchandising, assortment, and inventory deployment strategy that aligns with the differentiated customer value proposition.
3. Deploy their capital to the most important initiatives that will position them for the necessary transformation in the new retail environment.
4. Manage their cost infrastructure and deploy capital cost effectively while enabling the strategic agenda and meeting customer needs.
5. Design an analytics capability that produces key insights into the key drivers of profitability and customer engagement.

In addition, these retailers will need to reevaluate their real estate portfolios against their current and anticipated customer profile. Some will need to downsize their premium location store sizes to make the economics more manageable, while others that operate primarily in malls that are struggling to remain relevant in the new retail environment will need to rethink their real estate fleet based on where their customers are migrating. That could be street location or to the B or C mall that is making the transition to more relevancy and still has the right kind of consumer traffic. Additionally, they may need to close some of their stores and reduce the attendant infrastructure costs to focus their limited resources on the best stores and e-commerce channel.

Finally, the current retail environment is not for the faint of heart. This is a complex time and survival of the fittest is an apt phrase for the industry. Many of the weaker retailers have already gone out of business. Yet others are struggling and may not survive. On the other hand, there are many retailers who are thriving due to their differentiated value proposition and are meeting or exceeding their particular customers' expectations. This is a very exciting time for the latter and given all the retailers that have gone out of business, there is more market share available for those that remain.

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