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Retailing in 2002: Extreme Measures a Must for Recovery

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NEW YORK -- There's a shakeout ahead. Those knee-jerk responses to the recession were just the prelude. After last year's flourish of "friends-and-family" discounts, order cancellations and harsh demands for markdown money, 2002 could very well be a watershed year for the retail industry.

Mergers, acquisitions and restructurings will accelerate, and reviews of store and employee productivity and inventories will intensify, as merchants seek to redirect businesses and recover profits, industry executives and observers said. Speculation centers on many of the industry's leading names, including Kmart; Gap; J.C. Penney Co.; The Limited; Sears, Roebuck & Co.; Shopko; Saks Inc.; Jacobson's; Dillard's, Elder-Beerman and Ames. These companies are expected to take the most extreme measures, which in most cases means cutting the store count.

This month, shopping and markdown fever subsides, but it's still a telling time. Companies issue earnings estimates, bankruptcy rumors percolate, retailers pass around the "tin cup" pressing vendors for markdown money, and stores finalize their third- and fourth-quarter buys on imports, which represent the best margin opportunities and the biggest risks because of the long lead times required for deliveries. They must reserve manufacturing capacity, quota and fabrics.

More signs of the retail mind-set will emerge at the National Retail Federation's annual convention at the Javits Center, which started Sunday and runs through Wednesday. It's a moody affair, where thousands of store buyers and executives, consultants and suppliers seek new ideas, industry contacts and solutions.

"Many retailers feel this is a make-or-break kind of year," said Tracy Mullin, president and chief executive officer of the NRF. "They really have to figure out where they are going and who they want. The economy is uppermost on everybody's mind, and a close second is how they position themselves to attract more customers. They've got to be more creative, innovative and figure out their niche." Even with the slight pickup at the end of December, Mullin said: "The numbers, with the exception of a few bright spots, have been awful."

The convention is packed with sessions addressing the key issues, but despite attempts at making the event relevant, convention attendance will likely be below last year's 15,000, primarily due to retailers' reducing travel budgets. As of last week, registration was tracking "close" to last year, though sponsorships and exhibit-hall participation are higher, Mullin said.

Although some optimism for recovery in the second half is creeping in, the mood is far from upbeat.

"We expect to see quite a few store closings -- more than last year," said Jay McIntosh, director of Ernst & Young's retail and consumer products industry services group. "I'm not saying companies will be going out of business -- just retrenching."

And in a big way, according to Margaret Cannella, managing director and head of North American credit research, J.P. Morgan Securities. "2002 will be a very proactive year. Retailers will be looking everywhere -- at profits, financial structures and real estate," she said.

That translates into a period of deep analysis, change and uneven results. Comp sales are seen up 4 to 5 percent on average, but first-half sales are seen around flat, so it's not about to be a banner year. Like 2001, discounters will pace the industry, followed by off-pricers, with department and specialty stores trailing.

According to Cannella and many other retail analysts, major bankruptcies and mega-mergers won't happen, though speculation on a Kmart filing down the road has been mounting.

Last year, retailers got racked by downgrades, depressing stock prices and borrowing power. "We did quite a few downgrades last year, and there will probably be some more this year, but fewer," said Philip Zahn, retail analyst at the Fitch Inc. rating agency. "We won't be as negative since we made a lot of adjustments already and tried to anticipate the weaker environment. We've got a number of companies on negative outlook. Saks Inc. is on our ratings watch."

Zahn believes that the apparel specialty sector will still be the most difficult. "You will see a lot of companies slowing their expansions," he said.

Although no mega-mergers are anticipated, smaller asset sales are expected because stock prices are down and retailers will look to alleviate debt and shed noncore operations. These will be more in the form of a Federated Department Stores or May Co. picking up clusters of stores to enter markets, possibly from companies such as Saks Inc., Penney's, Sears and regional players, such as The Bon-Ton, Elder-Beerman and Marshall Field's.

Which stores will bite the dust? "Typically, those stores not contributing at least 5 percent profits on a four-wall basis; then they are not covering the allocated corporate overhead. Luxury stores might be around 7 percent, but it varies by industry and internal hurdle rates," explained Robert Pressman, president of Newmark Retail Financial Advisors. "In the last recession, a lot of retailers that reorganized were moderate and value merchandisers. This time around, in addition to those, you will see the luxury end getting restructured, either in or out of bankruptcy. There is a clear erosion of consumer confidence reflected in significant reduction in comp-store sales."

Typically, when retailers decide to cut back, they examine corporate overhead first -- those things that don't directly impact how the customer perceives a store, like corporate rents and shrinking office space, and noncore operations, Pressman said. "Retailers are fearful to close stores because it is a permanent decision -- a draconian step. It's not like having a factory that you can close down and reopen later. Unfortunately, most retail

costs are fixed. There's only so much cutting they can do" before deciding to shutter stores.

The luxury sector, where expenses run higher, seems headed for big-time retrenching after last year's poor results. Locally, Barneys may decide not to reopen its downtown store in the World Financial Center, which has been forced to stay closed due to the devastation of Sept. 11 and was never really a huge revenue generator. No decision has been made.

Saks Inc. has a cleaner balance sheet through a refinancing that postpones maturities. But as one means of saving money, the $100 million top-to-bottom renovation of the 650,000-square-foot Saks Fifth Avenue flagship has been prolonged by two years, extending possibly to 2005. At a fund-raiser last year, R. Brad Martin, chairman and ceo of Saks Inc., said that maneuver was "normal course of business," but also one that would disappoint suppliers. (Bergdorf Goodman, well before Sept. 11, put its own renovation plan on hold.)

Also, Saks Inc. department stores are shifting service levels, transforming departments where products are basic into self-service and enhancing the service in areas like men's tailored clothing.

Some even suggest that Nordstrom, which backed out of a few commitments on future stores last year, could go a step further and close a couple of units in 2002, considering the specialty chain's rapid expansion in the Nineties and declining market share.

In SoHo and on Madison Avenue, where designer stores have proliferated, subleasing is soaring. "You see people bailing out all over the place, before their leases expire," said Jeffrey Paisner, senior managing director, The Lansco Corp. retail leasing. "Many closed deals just prior to Sept. 11. The world looks different to those people, with leases signed and retail sales suffering. Many feel it's prudent to put the property back on market and get out of the obligation with the least possible liability."

Gucci, for example, will sublease space from Compagnie Financière Richemont's retail front on Madison Avenue between 69th and 70th Streets. Richemont's Cartier and Chloé units on the corners of the block are expected to stay operating, while the Montblanc, Lancel and Sulka units get transformed into Gucci. Sulka and Montblanc have already closed, although Montblanc added a store in SoHo.

Also, Robert Marc, who signed a lease at 436 West Broadway between Prince and Spring last year, reportedly wants out, and there are rumors that Prada is rethinking some real estate uptown. Gap also is seeking to sublease space at various sites in the city.

While rationalizing real estate, there's mounting pressure to rethink assortments, both in character and quantity. There's fear that retailers will play it too safe with inventory this year, after the markdown mania of last quarter, with the unemployment rate still rising and the country still stuck in recession.

"We have to challenge our people to get newness into the store and not let our inventories get too lean. If we get too conservative, the customers will revolt," said Michael Gould, Bloomingdale's chairman and ceo. "We must continue to differentiate our assortments." He did say that Bloomingdale's will beef up its contemporary assortments, including the

Young East Sider area. It's a department that best personifies the Bloomingdale's brand. "We will continue to push our organization for newness," Gould said.

However, he added, "I do not see a seismic change in the way people are buying. I don't see customers shifting in a major way to home. They are not just buying warm and fuzzy things. Our apparel business was fine last month -- better than home."

But even though many retailers are not accustomed to taking risks, the market conditions mean they might have no choice. For example, Sears, which for years has been dragged down by anemic apparel offerings, has been discarding scores of labels and private brands. However, it's now developing a master private brand to cover several categories, and surprisingly, some observers believe it could once again become a factor in apparel. It's got too much space in its stores to give up on it.

"Don't let recent negative press comments on Sears apparel turnaround plan lull you into a false sense of competitive safety," analyst Kurt Barnard warned retailers in his latest trend report. He sees Sears as a softlines contender within a year.

Other department stores also must make merchandise changes.

There's "an unholy Faustian alliance" between the leading department stores and publically listed manufacturers, including Liz Claiborne, Jones New York and Nautica, in men's and women's, "that's reached the apogee and gives stores an illusory security of protected margins and a steady advertising trough," contended Isaac Lagnado, president of Retail Tactical Solutions research and consulting service. "On the negative side, it has created a sameness that is outrageous. It has locked them into looks, price points and uniformity. It's very bland and must be reexamined."

Although Gould and other retailers insist inventories are under control, there is another point of view.

"There's plenty of stale fall goods that will be around through February," said one top executive of a men's wear chain.

"On a routine basis, we come across tens of millions of dollars worth of excess inventory, and we know there's excess inventory worth hundreds of billions of dollars," possibly between $500 [billion] to $600 billion, around the world, said Fredrick Fuest, chief operating officer of Active International, a Pearl River, N.Y., company engaged in "corporate bartering," which is different from what a liquidator does. Bartering is where stores and manufacturers exchange underperforming inventory to help finance media and business services, such as travel and printing. Active, which works with companies like Ann Taylor and Rampage by acquiring their inventory and paying for it with a trade credit, has media specialists that work with retailers and their ad agencies to fulfill media plans. Last year, it moved about $200 million worth of inventory and issued about $120 million worth of trade credit.

"There will really be a struggle on how to grow the top line, which won't happen -- not in the short term," said McIntosh, of Ernst & Young. Consequently, "retailers have to take out costs, particularly department and specialty stores, by teaming with suppliers to figure out more effective ways to manage inventory and using technology. There's continual pressure to find the lowest-cost producers of the goods and they can use technology to manage inventory better. The big thing is getting more for less, improving productivity

on every level. Better training is one thing. I don't think many retailers have an effective learning strategy. Not that they don't spend money; they just don't get the benefits."

At the NRF convention, exhibitors are hoping that retailers look to technology to help manage inventory and cut costs. Some noted that Gap Inc. is embarking on a major overhaul of its supply chain to find cheaper and more efficient sourcing to gets goods to market faster.

"Retailers are very good at collecting data, though not very good at all at extracting information and incorporating that into supply decisions," said Ananth Raman, professor of technology and operations at Harvard Business School and founder of 4R Systems., a software provider helping retailers convert data into information useful for making decisions on inventory. The software covers the life cycle of a product, from the testing phase to determining how much to buy, where to sell it, how to price it and when to drop it.

"I've been studying this inventory problem since 1989," Raman said. "Retailers stock out on a lot of product and buy too much of the wrong stuff. Roughly one-third of all women shopping for apparel fail to find the item they are looking for in their size. It's staggering."

Another exhibitor, Oracle Corp.,which offers a suite of business applications to run off the Internet, just sold Burlington Coat Factory its human resources management system to automate HR processes. Burlington anticipates savings in administrative costs and efficiencies, and possibly some staff reduction, though the chain said cutting staff was not the primary purpose. "In the last 10 years, retailers have done a better job in terms of point-of-sale systems and inventory systems on the supply-chain side," said Mike Prince, chief information officer, Burlington Coat. "Large retailers have pretty well mastered that. I don't think it's as true, applied to things not directly related to supply chain."

"Retailers are looking outside the box at the best practices at the likes of Cisco, Dell, Boeing, General Electric and Pepsi in the areas of back-office automation and operational efficiencies, taking costs out through strategic sourcing, and consolidating information," said Thomas Madigan, vice president, retail and consumer package goods at Oracle Corp. Currently, "the major focus is not on traditional point of sale. The focus is on infrastructure in the stores, and to Web-enable employees, whether it's HR or payroll, to do more of the legwork. Historically, they had to pick up the phone or a handbook. Now, they can go on the Web and initiate changes against their HR files. That cuts costs in terms of the processing and enables retailers to redistribute employees to other areas other than clerical."

"Buyers still have to know fashion and pick the item," said Jeffrey H. Singer, ceo of 4R. "Buyers will always do that, and we aren't looking to take away their jobs. But what retailers need is math and analytics to improve what they are doing. Adding science to retailing could amount to huge savings."