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Consumers to Retailers: Shall We Play a Game?

By: Jeff Bloomberg



(January 1, 2010) Recently, I watched the 1983 film “War Games” where a U.S military supercomputer attempts to find a winning strategy for global nuclear war. After running a series of simulations that always end in a stalemate, the computer ultimately determines there is no winner in a nuclear war.

As I watched the film, I couldn’t help but ponder the implications as it relates to what’s happening in retail today and, more importantly, what the outcome will be over the coming year. Consumers continue to engage retailers in a series of “war games” that are being played out every day at the cash register. For consumers, a winning strategy still equates to heavy discounts; a mind-set that began in the fourth quarter of 2008 when retailers slashed prices to move bloated inventories at the expense of gross margins. Over the first half of 2009, this mind-set solidified.

As we begin 2010, heavy discounting expectations are still the norm, with consumers trying to “wait out” retailers in the hopes that prices will eventually be cut.

With high unemployment (at +/-10%), tepid consumer confidence (indexing at 49.5 as of November 2009, up from historic lows but well below “normal” levels) and consumer credit declining (revolving credit decreased at an annual rate of 7.25% last year), don’t expect consumers to shift away from their cost-conscious mind-set any time soon. This means retailing is no longer about location, location, location. It’s about value, value, value.

But this year, value can’t come at the expense of retailers’ gross margins, which are needed to provide “breathing room” to maintain operating profits in a soft economy that’s poised for a slow recovery. Since retailers took axes then chainsaws to their cost structures last year, there’s little room to cut more this year other than fine-tuning with a scalpel. Consequently, profit increases must come from maintaining gross profit dollars.

To achieve this, retailers will create a temporary stalemate at the cash register by limiting their inventories in order to wean consumer expectations away from heavy price cutting. To increase sell-through and stave off premature markdowns, expect inventory levels to remain lean throughout the year. (In 2009, retailers reduced inventories by 1.5 to 2 times their decline in comp-store sales.) While retailers run the risk of selling out of products, the upside is that consumers will learn a new retail mantra: Buy now or miss out.

Of course, a lean inventory needs to be balanced with fulfilling consumer demand. As such, improving the merchandise mix and finding a new "normalized" inventory level will be critical throughout the year in order to provide consumers with value that is divorced of severe markdowns.

That's not to say that markdowns won't occur. However, they will be strategically administered rather than done out of desperation. The key is to present a strong value proposition as close to the initial price point as possible.

As a point of reference, I did a back-of-the-envelope analysis of 115 retailers across a variety of sectors and found that in 2009, on average, gross margins were up 5%, while inventories were down 9%.

If my outlook is accurate, when I look at those same 115 companies at year-end 2010, I would expect inventories to be flat to slightly up and gross margins to be up 1% to 2% (with the easiest comparisons coming in the first half of 2010).

Comp sales: As far as comp- or same-store sales are concerned, I predict modest gains at best. All in all, profits should continue to increase from 2009.

At the end of "War Games," the computer concluded the only winning move is not to play. In some respects, that holds true for retailers that need to bolster gross profits in 2010. When it comes to consumers pushing for severe markdowns, the only winning move is not to play. Instead, retailers must offer consumers merchandise that is priced to have intrinsic value while better balancing inventories to demand.

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