

September 2009

## Retail recovery: Surviving the economic thaw

They say that every day brings a new dawn – for many retailers the new day and the new dawn cannot come soon enough. Since mid-2008 Australian retailers have endured some of the most difficult conditions in 20 years. Most have struggled, some have prospered, some have not survived.

Among the high-profile retail casualties of the economic downturn are household names like: Crazy Clarks; Go-Lo; Sam's Warehouse; Steve Madden; EzyDVD; Midas; Kleins; Kleenmaid; Strathfield; Toy Kingdom; Not Quite Right; Babyco and Herringbone. Many more are in intensive care, surviving only through the indulgence of their bankers – hanging on to see the sun rise over a new economic dawn.

In this issue of *Ferriers Focus* we are going to examine the impact of the global financial crisis on the Australian retail sector and identify the characteristics that have differentiated between the survivors and the casualties. We are also going to look at the dangers that remain for retailers who may have survived the economic winter but now face the challenge of surviving the thaw.

The political pundits have declared the recovery has started. A number of the country's leading retailers agree. Harvey Norman boss Gerry Harvey said in July that he thought Australia was through the worst of the economic downturn. "Six or nine months ago it was Armageddon... but now the consumers are just more positive," he said.

JB HiFi CEO Richard Uechtritz announced a 45% increase in profit and expects 20% sales growth this financial year. Myer CEO Bernie Brooks is forecasting a one per cent increase in sales for the second half of the financial year – not much, but better than a predicted five per cent fall. An IPO was announced last week.

Things are looking up but it is little wonder retail businesses struggled during the financial crisis. Globally, retail sales in advanced countries fell by an average of more than 12 per cent in 2008. And while Australia avoided the worst of the downturn – through good management, low interest rates, falling petrol prices and government stimulus – that is not to say we did not suffer.

In Australia, the household goods sector saw sales for the October – November period down \$290 million compared to the same period in 2007. At this time, with the Aussie dollar plummeting more than 37 per cent in less than four months, crushing profit margins; and consumer sentiment falling 34 per cent between May 2007 and October 2008, retailers were beginning to wonder what they had done to deserve such a beating.

The largest retail casualty of the economic downturn so far has been Australian Discount Retail (ADR). This \$920m business employing 10,000 people represented a hybrid of discount variety stores across the country which had been cast aside by their previous owners in 2005 and enthusiastically snapped up by Private Equity seeking the opportunity to make something more than \$2 out of the \$2 dollar shop model.

The sale of ADR in March – arguably the nadir of the economic downturn – was an instructive outcome for the local retail sector. The transaction delivered to the buyer – Jan Cameron, a cashed-



up, savvy retailer and founder of Kathmandu – a business that dominated its sector but still needed plenty of work to perfect the model. What Cameron acquired was the opportunity to leverage the shell of this discount retail behemoth and answer the rising challenge of the Reject Shop. ADR is a business in transition and while its transformation still has some way to go, Cameron has plenty of experience and a tenacious management team led by Robert Atkins (formerly from Harris Scarfe), and there are plenty of reasons to believe the business will get its model right.

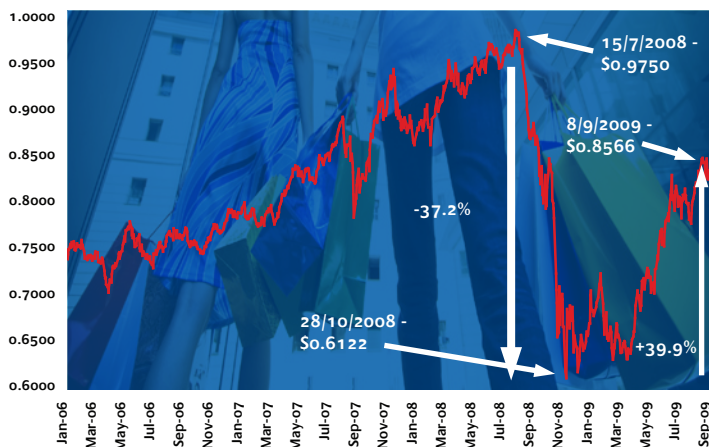
- **Undercapitalised retail privateers** who made a good living while the economic wave was rising were left exposed if they failed to reinvest earnings in the infrastructure of their business model or its balance sheet to prepare for tougher times.
- **Management which lacked the vision, skills and acumen** to develop its retail model to become sustainable and robust in what was already a competitive environment before the GFC.
- **Inadequate forex hedging strategies** which created massive and sometimes rapid margin erosion as the AUD collapsed in late 2008. Where price increases were possible, margins were often eroded through aggressive discounting to drive sales and cashflow.

From our experience with a number of struggling retail businesses, it is pretty clear that they had no strategy in place for dealing with collapsed revenue streams. Those who failed to hedge their exposure to the US dollar suffered the most. Faced with the impact of the financial crisis and the tightening of consumer purse strings, many retailers resorted to aggressive discounting strategies which – if they worked – had the impact of crushing profits.

What became apparent to us was that despite the carnage, the central rules of retail held true: good retailers with well-structured balance sheets, strong business models and the discipline to stay the course in heavy seas not only survived but they prospered when others did not. This was true for three reasons:

- When times are tough **consumers are attracted to brand safety and value**. Retailers will become vulnerable if they do not have an established presence with a trusted product offering that represents real value for money.

USD - AUD exchange rate



Source: RBA

While the collapse of ADR was impacted by a range of factors, we have seen many casualties in the retail sector sharing a number of common symptoms:

- **Massive levels of debt** – very common among Private Equity investments which relied on EBITDA performance as the ultimate driver of enterprise value. In the short to medium term this level of gearing is unsustainable for many retail businesses.
- Franchise networks, buying groups and cooperative structures which **lacked the flexibility and capital structure to adapt** to the economic winter have struggled.

**They said it...**

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|--|---|--|---|--|---|
| <p><b>August 2008</b></p> <p><b>Mark McInnes</b><br/>David Jones<br/>"This industry operates in cycles and we're at a down cycle."</p> | <p><b>September</b></p> <p><b>Michael Luscombe</b><br/>Woolworths<br/>"There is no doubt that everybody is tightening the belt a little bit."</p> | <p><b>October</b></p> <p><b>Gerry Harvey</b><br/>Harvey Norman<br/>"It's very bad... I've been holding off for a long time to avoid cutting wages and advertising, but now I am forced into that situation."</p> | <p><b>November</b></p> <p><b>Mark McInnes</b><br/>David Jones<br/>"The real pain is going to kick in next half and we're preparing ourselves for it."</p> | <p><b>December</b></p> <p><b>Gerry Harvey</b><br/>Harvey Norman<br/>"We're being affected on the sales side and the margins side."</p> | <p><b>March 2009</b></p> <p><b>Glenn Stevens</b><br/>Reserve Bank of Australia<br/>"I think the reasonable person... would come to the conclusion that the Australian economy... is in recession.."</p> |
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- Those **retailers with the financial strength to go the distance have an enormous advantage** over those that are beholden to their bankers for access to working capital. They can afford to be more aggressive in chasing the consumer dollar for longer than their weaker competitors – QED.
- **When the economy suffers, consumers stop buying discretionary items:** the cocktail dress; the new set of golf clubs; the beach house; and the new lounge suite. There have been some notable exceptions during this downturn: some electronic goods retailers have done very well, mostly from the sale of flat screen TVs and electronic games (eg: Xbox and Wii) which keep the family entertained while they stay at home.

Consumer Sentiment Index



Source: Westpac, the Melbourne Institute

The economic downturn has delivered retail winners as well as losers. The very best retailers succeeded in turning the downturn into a growth opportunity. JB HiFi, Woolworths and Bunnings remain very strong performers. JB and Woolworths have both publicised aggressive expansion plans – JB plans to double its footprint to 210 stores in six years and Woolworths is taking on Bunnings through 150 hardware outlets over the next five years. Both are likely to emerge from the financial crisis stronger businesses with even larger slices of the Australian retail pie.

The impact of the government’s \$52.4 billion stimulus package - particularly the \$20 billion distributed to consumers - should not be underestimated. Consumer spending surged in Q4 FY09 and saved the Australian retail sector from what could have become the worst recession in our history. However, most retail commentators agree it is too early to announce the arrival of a consumer-led economic recovery.

David Jones CEO Mark McInnes reports that while sales are up it is too early to call a recovery. “I’m not making the statement ‘The worst is over’,” he said. “I think the jury is out.” Reporting a 44% rise in profit last month, Wesfarmers CEO Richard Goyder underlined his concerns about the fragility of any recovery. “I think things are better, but they are not massively better,” he said.

Access Economics expects retail growth to remain stunted – at just one per cent in 2009/10 and 0.8 per cent in 2010/11 – with stronger growth of 3.7 per cent returning in 2011/12. “For the next year... we expect retail in all states to be fairly subdued as the withdrawal of policy stimulus has an effect across the board,” said Access Economics director David Rumbens last week. That means Christmas trading this year will be as critical as ever for sustaining cash flows and rebuilding profits.

This is coming at a time when the Government’s economic methadone program has come to an end, forcing retailers to go cold turkey.

With this in mind, now is the time to be particularly wary of the retail bear traps:

- **Discounting to chase sales.** Many retailers have been on a cycle of discounting to chase sales and underpin cash flow. Expect this to continue. Strong competitors will try and take advantage of weaker ones to grab market share and drive them out of business. Margins will remain under pressure and, for many, profit targets will be difficult to achieve.

**April** **Kevin Rudd**  
Prime Minister  
*“This global economic recession has... dragged Australia into recession and ... produced the single biggest collapse in tax revenues in post-war Australia.”*

**May** **Michael Luscombe**  
Woolworths  
*“There was a path into this global financial crisis and I guarantee there is a way out for all of us.”*

**June** **Mark McInnes**  
David Jones  
*“All the evidence is that consumer confidence will be better going into this half year than it was in the same period last year.”*

**July** **Gerry Harvey**  
Harvey Norman  
*“We’re certainly more confident than we were six or nine months ago.”*

**August** **Mark McInnes**  
David Jones  
*“I’m not making the statement ‘the worst is over’ I think ‘the jury is out’ is a better statement.”*

- **Dependence on weak brands.** Good retailers will be engaged in a flight to brand safety because they recognise that strong brands with good business models will continue to do well. In tough economic times consumers tend to support retailers offering stability, value and service. Retailers who had not established themselves prior to the GFC will continue to remain vulnerable.
- **Discretionary purchase offerings.** These will remain under pressure. It is no surprise the retailers who prospered during the GFC are those offering a compelling value proposition based around consumables or commodity products. Retailers of discretionary products have mostly struggled to meet sales and profit targets.
- **Rapid appreciation of the AUD.** Good news for importers, but how much of the margin gain can be protected if competitors are chasing sales through discounting? Avoid the temptation to be too optimistic about the rate at which retail profits will recover. Ultimately, good retailers do well when they have a stable AUD, not a wildly fluctuating one.
- **The credit demon.** Many retailers are in the middle of seasonal funding for purchases to achieve their Christmas sales targets. Lenders will be running the slide rule over these facilities closely. Retailers should not assume all things will be equal.
- **Taking your eye off the ball.** Stay on top of the important stuff: manage optimal stock levels and stock turns; control head office costs; be smart about store staff rostering; anticipate and react to competitor initiatives; develop and initiate activities to reinforce your brand and remind consumers why they must continue to shop with you, even in difficult times.

## Conclusion

There is no question that the big retail operators are seeing the first signs of what could well be a turnaround in the retail sector – the reporting season provided plenty of evidence of the light on the horizon. Our experience, however, is that there are many retailers still doing it tough and it may be that the time it takes to recover from the economic winter will be the hardest part of the recovery process.



**James Stewart**

Partner, Melbourne  
p: +61 3 9604 5642  
e: james.stewart@fh.com.au

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For more information about our retail services, please contact:

**Sydney:** John Melliush  
+61 2 9286 9963  
john.melliush@fh.com.au

**Melbourne:** James Stewart  
+61 3 9604 5642  
james.stewart@fh.com.au

**Perth:** Martin Jones  
+61 8 9214 1405  
mjones@perth.fh.com.au

**Adelaide:** Martin Lewis  
+61 8 8100 7657  
mdlewis@sa.fh.com.au

**Brisbane:** Will Colwell  
+61 7 3834 9205  
wcolwell@qld.fh.com.au

**Hong Kong:** Rod Sutton  
+852 2820 5600  
rsutton@fh.com.hk

**Indonesia:** Rob Jolly  
+62 21 521 1658  
robjolly@ferrierhodgson.co.id

**Japan:** Kentaro Mochizuki  
+81 3 3560 8301  
kmochizuki@fh-tokyo.jp

**Malaysia:** Andrew Heng  
+60 3 2273 6227  
aheng@fhmh.com.my

**Philippines:** Anthony Quach  
+63 9209 283514  
aquach@ferrierhodgson.com.ph

**Singapore:** Tim Reid  
+65 6416 1400  
tim.reid@fh.com.sg

**China:** Mark Chadwick  
+86 137 6126 4912  
markchadwick@ferrierhodgson.com.cn

Or find out more at:  
[www.ferrierhodgson.com](http://www.ferrierhodgson.com)

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