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Retailers at a Crossroads - Navigating Out of the Market Downturn

Q: How do you view retailers' ability to weather the economic downturn?

A: It looks like many retailers have been able to weather the Great Recession as a result of tactics initiated in early 2009. Most retailers took a very conservative approach to 2009 by keeping inventories low, focusing on efficiencies, delaying or canceling store growth, and in some cases contracting their store base as lower consumer demand rendered marginal locations unprofitable.

So far in 2010, comps (same store sales) are generally up and even the higher-end retailers are starting to see strong positive comps. The discounters that were the better performers in 2008 and early 2009 have seen a reduction in their positive comps while other sectors are improving. Department stores are generally up versus last year, and are benefiting from a marginally more confident consumer. With that said, there are some retailers whose strategies and business models were under duress prior to the economic meltdown and the tough economy has only made things worse for these players. Nonetheless, it looks like most retailers came out of 2009 in better shape than expected, and we see this in our own portfolio, where most of our clients are much more liquid than they were a year ago.

Q: What are some of the challenges retailers continue to face in the current economic environment?

A: Retailers are at a strategic crossroads this year. How quickly they build out their inventories and how fast they add new stores again remains to be seen. Those retailers with stronger balance sheets will be better positioned to take advantage of the market and real estate opportunities resulting from abandoned locations of failed competitors. Alternatively, they may also look at other ways to deploy capital via Internet and digital strategies, as well as product extensions.

Other retailers are facing fundamental changes in their segments that will require market intelligence and capital. The bookselling business has the challenge of digital book delivery. Some industries, like jewelry and furniture, are reliant on consumer credit and the availability of consumer credit is still constrained as the credit card issuers have tightened up. However, recent reports indicate that

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consumer credit card borrowings have declined and savings rates have peaked over the past few months, a function of consumers tightening their belts during the recession.

These statistics suggest that consumers may be poised to start buying bigger-ticket retail items again as long as the economy does not go into another dip.

Q: What are the weakest areas of retailing and where are you seeing pockets of strength, if any?

A: Furniture and home products have been under a lot of pressure, as they are directly tied to home sales, consumer confidence, and availability of consumer credit, and I would expect that it will take a while for this to come back. Nonetheless, the recent comp store sale reports for Home Depot and Lowes have been positive. Companies like Pier One, William-Sonoma and Bed Bath and Beyond have shown some recent positive comps, so that is promising. In particular, the bankruptcy of Linens N' Things should prove beneficial to players like Bed Bath and Beyond. Similarly several electronics retailers are taking over locations left vacant by Circuit City. As I mentioned earlier, luxury retailers are showing extremely strong comps, albeit off of extremely negative comps last year.

Q: Have you seen any signs that retail bankruptcies are starting to ease?

A: Many people expected to see bankruptcies in January and February, which is when retail companies typically file, as their inventories are low and their debts lower. Surprisingly, despite there being many companies that need to fix their businesses, we haven't seen any large retail bankruptcies.

As I mentioned earlier, the conservative approach to inventories and spending enabled many players to conserve cash, and, in fact, generate some additional cash, which helped them to see another day. After significant cost cutting, there is not much more to cut, so the top line needs to come back for some of these marginally surviving companies going forward. Perhaps, with some improved consumer spending, they may have dodged a bullet.

Also, capital has started to free up. In 2008 and most of 2009, there was virtually no "rescue capital" available, so it was hard for companies to find even dilutive incremental debt or equity given the inability to gauge when negative sales trends would stop. Investing in a retailer in 2008 and early 2009 was like catching a falling knife. Today there is more activity in terms of investors willing to help some ailing companies that need junior capital to turn their businesses around. There are several recent situations where a major investment was made in a "turnaround" situation in the form of a convertible or equity linked loan by private equity and hedge fund type investors.

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Most recently, a major retail-focussed private equity group invested \$150 million in Zales to help fund its turnaround strategy. Borders also recently received a junior loan from a group of specialty funds to help fund a transition in its strategy.



Burt Feinberg is Managing Director and Industry Group Head for the **Retail Finance** group within CIT Commercial & Industrial. The group, which he has led for the past five years, is a provider of asset-based revolving credit facilities and cash-flow term financings to retailers and restaurants in the United States; in that capacity, it provides acquisition financing for equity sponsors, refinancing and growth financing, as well as DIP and exit facilities to retailers in turnaround situations.