

Burt Feinberg, Group Head of CIT Commercial & Industrial

## Retail Industry Trends

**Q: How is the convergence of social media, e-commerce, mobile and brick and mortar creating a new blended reality for retailers?**

A: Social media, digital communication and the Internet have dramatically transformed the retail industry. This revolution started years ago with the creation of some simple Web sites and e-commerce platforms. Today, it has expanded well beyond that in terms of retailers' ability to sell products through these different media, as well as their ability to understand who their customers are and to get immediate feedback on new products. What this has done is turbocharged the retailers' ability to merchandise their products and modify their business as they go. In addition, retailers can optimize their marketing dollars by understanding and mining the data they now accumulate about their customers via their electronic platforms.

It appears that many of the better performing retailers today have been ahead of the curve in executing in these media, enhancing their businesses.

When e-commerce started, the view was that it would end brick and mortar, but instead many retailers used it to maximize their businesses. However, in some sectors, like music, bookselling and electronics, it has had a lasting negative effect on the traditional brick and mortar retailers.

**Q: Are technology trends altering in-store experiences?**

A: Absolutely! In some sectors, consumers have the ability to actually comparison shop as they walk through a store. We're also seeing consumers use social media to communicate with their friends to articulate their discovery of a particular product or deal in areas like high fashion apparel or electronics. This has magnified and accelerated "word-of-mouth" buzz. What may have taken months to spread by physical "word-of-mouth" in the past can now occur instantaneously. Social media has enabled product popularity to spread on an accelerated basis.

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**Q: How have the fluctuations in commodity prices affected retailers?**

A: Since cotton is such a major component in much of our clothing, its cost can obviously have a significant effect on the apparel segment of retail. The question is who bears the cost. In order to maintain price in this highly price-conscience market, retailers face considerable pressure from consumers and suppliers face pressure by retailers. Everyone in the chain is being squeezed. The stronger retailers have enormous leverage over their suppliers, so many suppliers are forced to take margin cuts. In addition, it’s not uncommon to see manufacturers and retailers collaborate to scale back the quality and specs of the garment in an attempt to keep prices the same. These changes may not be obvious to many consumers.

**Q: Has there been an uptick in retailers seeking financing? If so, what do you think is the main driver behind that change?**

A: I think the needs of retail financing have been relatively consistent with those of prior years. Financing is driven organically by the retailer’s expansion of inventories and/or new stores growth driven financing or often based on corporate transactions, either the sale or recapitalization of a company. There was moderate merger and acquisition (M&A) activity in 2011 that certainly created some financing opportunities. However, retailers are still playing it fairly conservative this year in terms of their store growth and building inventories. As a result, there have been few organic growth-related financings. We are all still quite concerned about consumer sentiment and unemployment in the United States, as well as the uncertainty around our national debt and European economic issues. As a result, retailers have kept inventories in check; they haven’t borrowed as much in anticipation of being more aggressive.

Nonetheless, some retailers are taking an offensive approach. We are seeing some players growing stores again to take opportunistic advantage of today’s real estate environment due to vacancies that were an outgrowth of the Great Recession.

**Q: What are the most popular forms of financing in this sector today and what are retailers using it for?**

A: Asset based lending (ABL) has continued to be the most reliable source of capital for retailers. The ABL community has found that the collateral, specifically the inventory of the retailer, allows lenders to recoup their money in the event of a liquidation. This phenomenon has held throughout the business cycle and transactions have self-correcting mechanisms and protections to ensure that lenders are well secured. As a result, there is a lot of ABL capital out there for retailers; this capital works well as an “engine” for financing their inventories.

Retailers with larger and more consistent operating cash flows—or Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) of \$50 or \$75 million or more—are able to finance on a cash

flow basis. These companies have access to institutional term debt and bonds. Even some smaller companies that may have relatively predictable cash flows because they are “niche” businesses, or due to other factors, may have access to term debt from a middle market bank and specialty middle market lenders, but it is more limited and very much a function of the specific business attributes of the retailer.

There have also been some large acquisitions of retailers the past year. In many cases, firms used an ABL revolver to finance inventories and provide working capital in combination with substantial term financing from either the bank loan market or the institutional term market and the high yield market.

**Q: Are consumers still price sensitive? Where do you see consumer trends heading?**

A: Consumers are certainly price sensitive, but it's not always about the price: consumers are really looking for value. Higher-end retailers are doing quite well based on their reported comp sales. It's essential for retailers to create the right value at the right price.

What's particularly interesting is that some of the lower-end retailers are showing lower same-store sales comps. They're having a tougher time creating demand because their consumers are more likely to be unemployed or under-employed. As I mentioned earlier, there is still immense pressure on consumer sentiment as the U.S. economy continues to struggle to recover and concerns persist about the U.S. budget deficit, European sovereign issues, and the legislative uncertainty in Washington, D.C.

However, there's still been consumer demand. To date, the consumption numbers are contradicting the consumer sentiment numbers. Most of the retail community has experienced positive same store sales comps. Not great comps, but they are doing okay, and certainly not as great as they would like if the economy were really starting to get back on track. The bigger question remains: Does that bode poorly for this Holiday Season? This we don't know. Based on recent consumer spending, it may not be as bad as the consumer sentiment numbers would suggest. But with all the economic headwinds they are facing, retailers, by and large, are playing it defensively.

**Q: How active is the private equity community in the retail sector?**

A: The private equity community has always liked retail. Private equity firms look for two types of opportunities in this sector. They look first for business that can grow, are very scalable and have a good concept. Particularly powerful is the leverage the investor gets in combining traditional brick and mortar stores with an e-commerce strategy and other direct marketing strategies. If a private equity firm finds the right concept, it can realize considerable growth due to the scalability factor, greater than in most other industries.

The other opportunity is finding situations where companies may have been managed incorrectly and could potentially be revitalized

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by a change in strategy. In this case, it's not always a merchandising fix; it could be a cost structure fix or, in some cases, a question of restructuring the business—actually closing stores and refocusing the company. Improving sourcing, optimizing labor hours, managing inventory levels and stock-keeping units (SKUs), combined with strategic store expansion and e-commerce strategies collectively have had a powerful impact on profit growth that is hard to find in other industries. This is easier said than done, so investing in retail is not for the faint of heart. For much of retail it comes down to merchandising and positioning and this is a much more intangible factor for an investor to comprehend. Retail is definitely a high beta industry to invest in, but as some of the regular private equity players in the space can attest, the upside is huge if you hit all these drivers right.

**Q: Do you believe M&A activity will increase or decrease in the next year?**

A: M&A activity is driven to a large extent by the seller. Owners have to be willing to sell their businesses. We can see an uptick in activity if a few things happen: capital markets settle down, retailers' performances continue to be steady, and equity markets improve so that sellers feel that they can get good prices for their business. Some new deal activity may also be driven by private equity firms looking to realize returns on existing properties.

**Q: Do retailers have a reason to be optimistic about their near- and long-term future?**

A: My personal view is that, by and large, over the long term, retailers should remain optimistic. Most have reasonably sound balance sheets, so if and when the consumers fully return, they should be well positioned. This is particularly true of those that have stayed ahead of the curve with regard to technology. Some retail sectors, such as traditional bookselling, are under duress, while others have been laggards in their sector, so a continued slow economy could have an adverse effect on these players. At the end of the day, there are always new retailers with great ideas that have a slightly different twist on a proven concept. If you look back 20 years to an earlier recession, there are companies that started at that time and that are now some of the best retailers that exist. There will always be new operating models and new niches. There's always opportunity.

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**Burt Feinberg** is Group Head of CIT Commercial & Industrial and Managing Director and Industry Group Head of the Retail Finance practice. CIT provides asset based revolving credit facilities and cash flow term financings to retailers and restaurants in the U.S.; 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.

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