

U.S. SMALL AND MIDDLE MARKET OUTLOOK 2009:

RETAILERS AND SUPPLIERS TAKE STOCK OF ECONOMIC DOWNTURN



IN ASSOCIATION WITH:



KEY FINDINGS

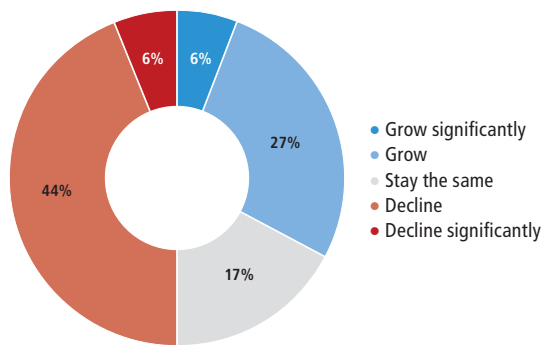
- **Middle-market retailers have been holding on tight through the 2009 recession**, delaying plans, limiting inventory spending, and watching cash as they wait for some signs that consumer spending may recover.
- **Falling revenues have caused many retailers to take steps to cut costs and conserve cash**. They have halted planned expansions, put off store renovations and redesigns, re-merchandised their shelves, and closed existing stores. They are also revising their leases, and seeking new terms with creditors.
- **Slow-turning inventory has been a burden for middle-market merchants**. Even though they are stocking less than they did a year ago, many still feel that their cutbacks have not been deep enough. As a result, discounting has been rampant as retailers look to turn slow-selling goods.
- **Caution is the word for the 2009 holiday season**, as retailers are closely watching their inventories and promising more aggressive discounts.
- **With inventories falling, suppliers of apparel, home furnishings, housewares, and other retail goods have also been feeling pain**. Nearly two out of three have been impacted by a retail customer bankruptcy this past year.
- **Credit protection—such as factoring and credit insurance—is more important than ever for many suppliers**, but the precarious financial conditions of many of their retail customers is making it harder to secure these services.
- **Retailers remain quite guarded about the future**. Most believe it will take several years for consumer spending to return to 2007 levels.

Few industries have felt the effects of the recession as acutely as retail. The impact of plummeting consumer spending on the sector has been well documented, with many retailers dealing with tumbling revenues, slow-turning inventory, steep discounts, and stressed cash flow. As a result, many middle-market merchants have spent late-2008/2009 in a state of strategic and operational stasis, limiting activity, slowing spending, renegotiating leases, and holding on tight as they wait for small signs of recovery.

The impact has not just been on retailers, but also on their vendors, the companies that manufacture and distribute the apparel, home furnishings, housewares, and other goods that retailers sell. With retailers working hard to conserve their cash and deal with declining demand, they are purchasing less from their suppliers, and may be paying those suppliers more slowly, straining their cash flow.

Still, for those retailers and suppliers that are able to weather these challenges, better times may lie ahead. While few expect consumer spending to make a quick return to pre-recessionary levels, they remain hopeful for a possible turnaround beginning in 2010 to set their industry back on course.

FIGURE 1: How retailers assessed their revenue performance over the past 12 months:



To get a clearer picture of the current state of retail, Forbes Insights, in association with financial services provider CIT, surveyed 110 executives and financial decision makers at U.S. middle-market retailers (those with annual revenues of \$25 million to \$1 billion). A separate, distinct survey was conducted with 104 small- and middle-market suppliers and manufacturers (with annual revenues of \$2 million to \$1 billion) who sell their goods through retail. In addition, qualitative interviews were conducted with executives in each group.

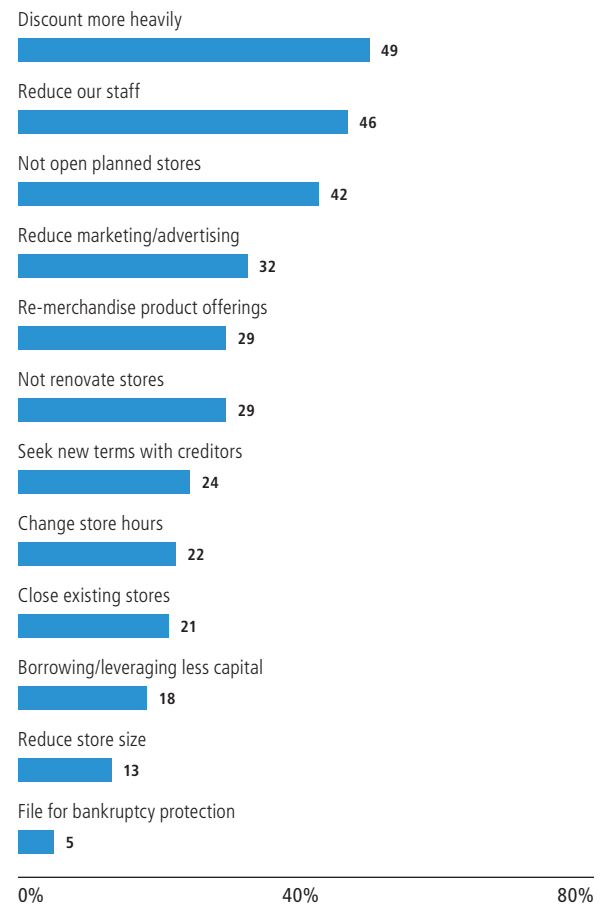
These findings examine the guarded outlook of middle-market retailers and suppliers. They provide further insights into what this sector is doing to control inventory, manage cash flow, and deal with suppliers, customers, landlords, and business partners.

STRESSED REVENUES CAUSE COST CUTTING

The 12 months running through summer 2009 were among the most difficult ever for the retail industry. With anxious consumers suddenly pinching pennies, many large chains saw revenues slip precipitously, and a number of high-profile merchants—such as Circuit City, Mervyn’s, and Steve and Barry’s—closed up shop entirely.

The middle market was not immune to the crash of consumer spending. Half of the retail respondents said their revenues declined or declined significantly in the past 12 months. (Fig. 1) While a third noted increasing revenues over this time, some of this growth may be attributed to new store openings, not same-store sales. For example, the spokesperson

FIGURE 2: Steps retail companies have taken as a result of the current economic downturn:



for a \$500 million clothing and accessories retailer said that while “overall revenues are up substantially,” this was driven by the inertia of aggressive growth plans launched in 2007 and early 2008. Nonetheless, on a same-store basis, the company’s sales are down an average of over 10%.

Not surprisingly, retailers are taking all manner of steps to cut costs and conserve cash. Growth plans have been put on hold, employees have been laid off, terms have been renegotiated, and underperforming stores have been shut. Nearly half (46%) of the respondents said they have had to cut back staff. (Fig. 2) Another 40% indicated they have had to scale back plans for new stores, and 21% had to close existing stores.

HOLIDAY SHOPPING SEASON 2009: BEING CONSERVATIVE TO STAY COMPETITIVE

The nation's retailers kicked off the 2008 holiday shopping season with what the International Council of Shopping Centers called the worst sales figures in 35 years. So it is no shock that middle-market retailers are taking a cautious and conservative approach to what portends to be another challenging holiday season in 2009.

Shelf space will not be as crowded this holiday, as retailers intend to be more watchful of their inventory levels. More than two-thirds of retail respondents (68%) said they would be stocking less inventory in 2009 than they did in 2008. (Fig. 3) Similarly, they will be making a conscious effort to turn that inventory over more quickly, with 66% planning to offer consumers greater discounts and 68% expecting to start their clearance sales before the season ends on New Year's.

David Sharp, chief operating officer at Rocky Brands, an over \$250 million footwear and apparel company, explained: "This will be the year where it will pay off to stay on top of things."

Not all retailers will be giving in to lower pricing and discounts. "We believe that this season, there will be lower spending overall, but a definite shift to quality and value," said Scott Rauch, president and chief executive Simmons Jewelry Co. The key to this season will be inventory management, he added. "If there's loads of inventory, the consumer doesn't feel any pressure to purchase."

Many retailers further believe it will take more promotion to bring thrifty shoppers to their stores. Consequently, over half (56%) said they expect to increase their ad spending compared to

2008. In addition, 69% noted they will attempt to stimulate sales through greater online and direct selling.

Added the spokesperson for a mid-sized clothing and accessories retailer, "it won't be make or break, but we're aware we need to work harder this year than in the past."

FIGURE 3: Looking ahead to the 2009 holiday season, retailers plan to:

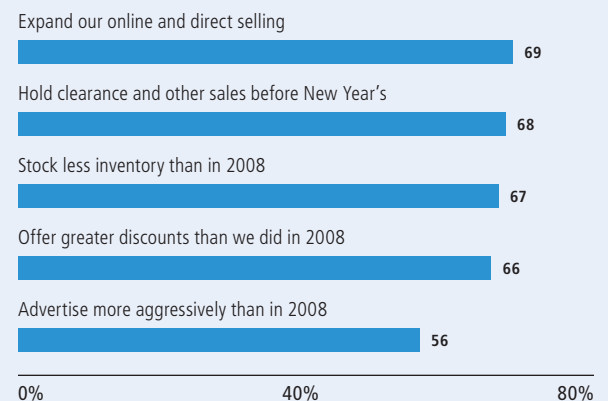
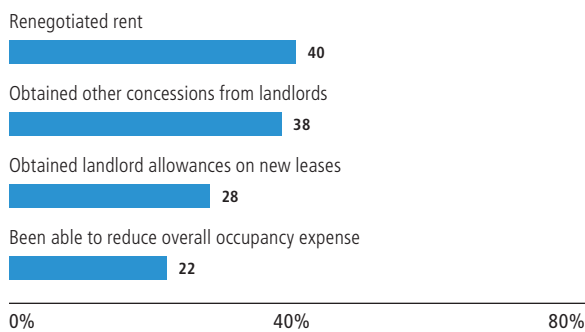


FIGURE 4: What retailers have accomplished with their landlords since the beginning of 2009:



Marketing and advertising, a mainstay for spurring store traffic, has also suffered, with 32% reducing that spending.

Larger retailers (with \$100 million–\$1 billion in revenues) were more likely than smaller ones (\$25 million–\$99.9 million in revenues) to take significant cost-cutting measures. For instance, more than 50% of larger retailers said they had not opened planned stores (compared to 31% of smaller retailers), and 26% of larger retailers said they closed existing stores (compared to 15% of smaller retailers). Smaller retailers, meanwhile, were more likely to take measures such as re-merchandising their offerings or changing store hours.

Retailers have further been able to conserve capital by working with their landlords to change their real estate terms and conditions. With so many storefronts vacant, landlords appear more willing to revise leases—40% of retail respondents said they have been able to negotiate lower rents with their landlords. (Fig. 4) Similarly, 38% have obtained other concessions from their landlords.

For example, the spokesperson for a \$350 million apparel retailer said her company is working with a major accounting firm to visit sites, study contracts, and identify opportunities for savings. “Lots of chains are pulling back,” noted the executive. “In most instances, if an anchor store leaves or if the overall property breaches a vacancy threshold, you’re entitled to rent concessions.” In many cases, retailers are also in a position to obtain “reduced common fees, more signage around the mall—and they can pressure the (real estate) management company to pay for more advertising to drive general traffic,” she added.

FIGURE 5: How do your current inventory levels compare to what they were 12 months ago? Today, they are:

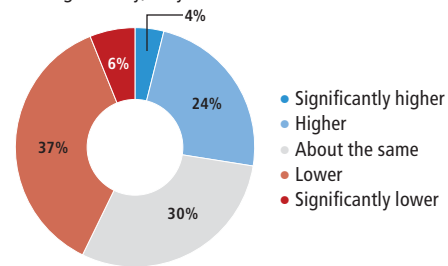


FIGURE 6: How do you anticipate your current inventory levels will compare with what they will be 12 months from now? In 12 months, they will be:

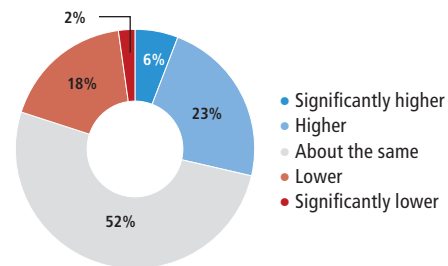
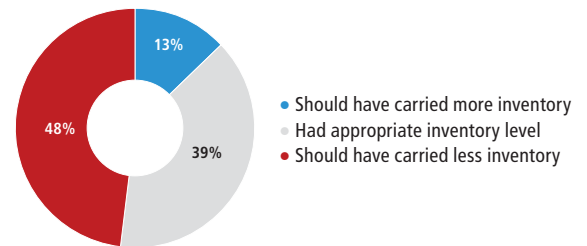


FIGURE 7: Looking back on how you managed inventory during the first part of 2009, do you think you:



WATCHING INVENTORY

No expense places greater stress on retail companies than inventory. So it is understandable that given expectations for continued lackluster consumer spending, middle-market retailers are taking vital actions to gain greater control over their inventories.

Many retailers already are reducing their inventory levels—43% indicated their current inventory levels are lower or significantly lower than they were a year ago. (Fig. 5)

FIGURE 8: Over the past 12 months, what have been your top priorities to gain greater control over your inventory?

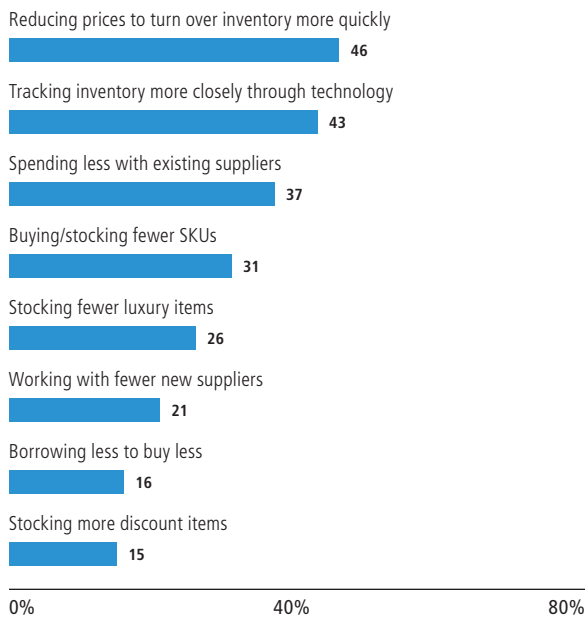
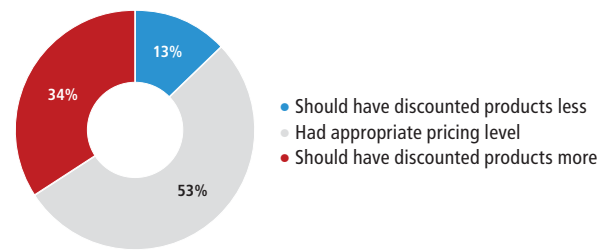


FIGURE 9: Looking back on how you managed pricing during the first part of 2009, do you think you:



And those lower levels are likely to continue well into the future, as fewer than 30% expect their inventory levels to rise a year from now. (Fig. 6)

But even with these lower quantities, inventory levels do not appear to be turning fast enough for many in the retail sector. Nearly half of respondents said they should have carried less inventory during the first part of 2009, while 39% thought they had the appropriate level. (Fig. 7)

TURNING TO DISCOUNTS

Slowing inventory turns have forced many retailers to resort to more aggressive discounting. While this may be helping to move stale inventory, these lower prices have further stressed retailer cash flow while potentially impacting bottom-line results.

For example, over the past 12 months, 46% of retailers have cut prices in order to accelerate inventory turns. (Fig. 8) Other key strategies include using technology to track inventory more closely, cutting back on the number of SKUs, spending less with current suppliers, and working with fewer new suppliers.

Like inventory levels, retailers have had trouble gauging the right level of discounting during these tough times. While about half believed they had the appropriate pricing level during the first half of 2009, more than a third (34%) said they should have discounted products more. (Fig. 9)

THE IMPACT ON SUPPLIERS

With retail inventories down, discounts up, and credit tight, vendors and manufacturers that depend on retail stores to move their merchandise are feeling equally acute pain. Small and middle market suppliers of apparel, home

SIMMONS JEWELRY: STAYING FOCUSED ON VALUE

Scott Rauch, president and chief executive of Simmons Jewelry Co., contends that in spite of an overall down economy, his group’s sales in the second quarter of 2009 were up. Even if only slightly, said Rauch, “that’s an indication we’re taking the right steps.”

For example, rather than reduce promotion, the company is actually accelerating its advertising. In this vein, said Rauch, “we’ve been aggressive in taking advantage of a lot of the media buying opportunities in the print and online worlds.”

In addition, the company is broadening its line of products. In particular, Simmons is providing a wider range of price points. “Someone might not have a lot of money to spend,” said Rauch, “but they want to purchase something the other person will appreciate.” So being able to appeal to a wider range of budgets is important “when the economy is so stressed.”

FIGURE 10: Suppliers that said they have been affected by a retail customer bankruptcy over the past 12 months, or expect retail customers to file for bankruptcy in the next 12 months?

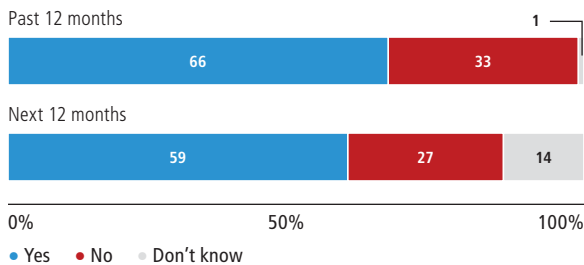
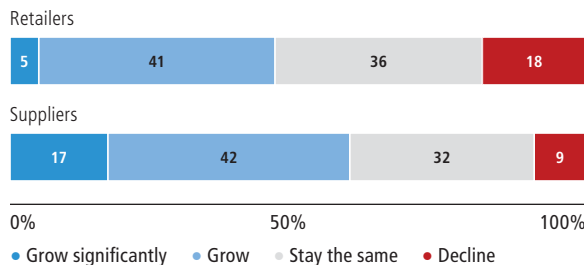


FIGURE 11: What suppliers are doing today—that they did not do 12 months ago—to manage cash flow:



FIGURE 12: Over the next 12 months, do you expect your company's revenues to:



furnishings, housewares, and other retail goods are being forced to adjust their business strategies to deal with this drearier operating environment.

How harsh have things been? Two-thirds of supplier respondents said they have been impacted by a customer bankruptcy in the past 12 months, while 59% expect additional customer bankruptcies in the next 12 months. (Fig. 10)

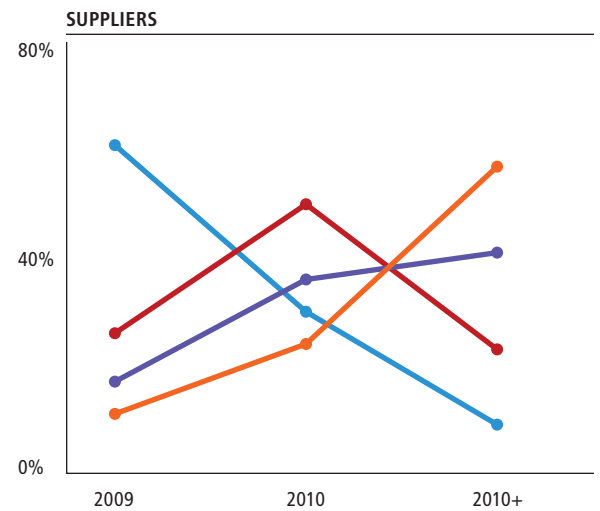
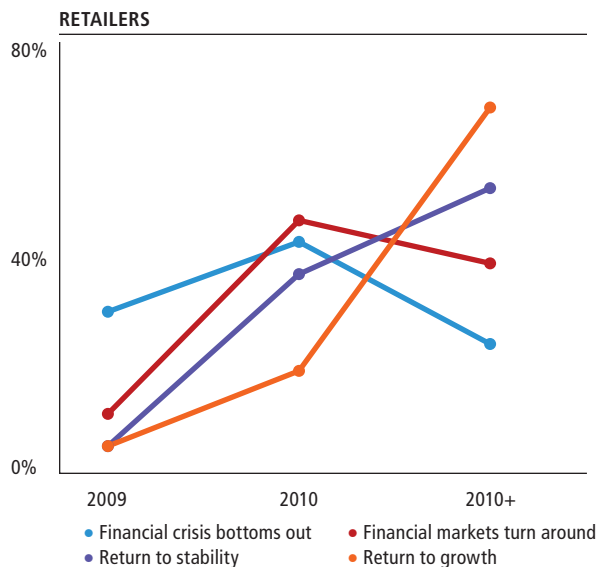
Understandably, many suppliers are responding by implementing tighter credit controls and monitoring accounts more closely. As a senior executive at a major apparel supplier explained: “We have a lot of smaller accounts who are paying very slow.” What the executive has found useful is “to take their outstanding balance and convert that credit into a short-term note.” From there on, additional business is done on a cash basis. “We have more security in the form of the note and we retain the customer because we’ve offered a form of relief.”

The biggest strain may be on these smaller suppliers’ cash flow. Over half (53%) said managing cash flow is

CREDIT PROTECTION: MORE NECESSARY

Accounts receivable credit protection is more important than ever for many suppliers—23% said they are using factoring and credit insurance more to protect themselves from possible customer bankruptcies. Still, the precarious financial conditions of many of their retail customers is making it harder to secure these services.

FIGURE 13: When do you expect the following to occur?



THE SHARPER IMAGE: A NEW MEDIUM FOR THE MASSAGER

Gadget retailer The Sharper Image was among the high-profile retailers that closed their stores in 2008. But that may have been because it did not have the right business model, according to Federico de Bellegarde, the firm’s vice president of licensing. “Our strength is a strong brand name and unique, quality products,” he said. Certainly, the company had compelling products, “but when a company has a high-cost retail presence, you have to try and hit all categories—which the old company could not do.”

But now, as a licensor, “we get our products to the outlets best suited for the category,” said de Bellegarde. As a result, the new company is moving from bankruptcy in 2007 to what it believes will be a return to prominence and profitability.

The Sharper Image views the holiday season of 2009 as critical to the resurgence of the Sharper Image brand. “What we’re counting on,” said de Bellegarde, “is that even if consumers spend less money, they’ll be more judicious,” and will focus on products featuring a better mix of “innovation, design, and quality from a trusted brand.”

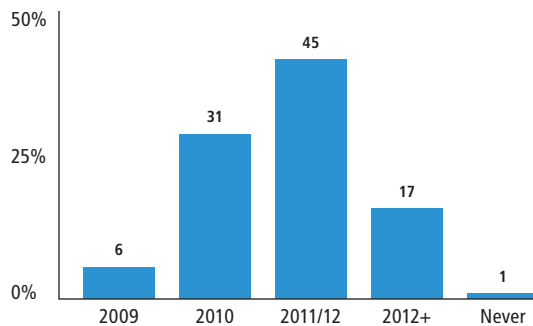
harder today than it was 12 months ago. Certainly bankruptcies have taken their toll in this area, but the greater impact may be from reliable customers who have slowed down their payments as their inventory turns have come under pressure.

As a result, many suppliers have had to implement additional controls with their customers. Nearly six out of ten respondents (58%) said they have reduced the business they conduct with slow-paying customers, 54% are imposing more stringent credit terms, and 49% have beefed up their collection efforts. (Fig. 11) On the flip-side, they are also trying to manage their own payments, with 36% negotiating new payment terms with their own suppliers and 31% stretching out the time they take in paying their own bills.

EYING A RETURN TO NORMALCY

In any recession, retail is one of the tougher places to be. Nonetheless, the industry appears to be holding its own and is in fact moving ahead. It is noteworthy that suppliers to the retail industry seem to feature the highest degrees of optimism. For example, while 46% of retailers expect their revenues to increase over the next 12 months, the figure rises to 59% among suppliers. (Fig. 12) In both cases,

FIGURE 14: When retailers see consumer purchasing returning to 2007 levels:



relatively few anticipate further declines, including only 18% of retailers and 9% of suppliers.

The most dramatic differences in outlook between the two groups relate to the bottoming out of the financial crisis. While neither group is expecting any sort of dramatic turnaround it is significant that 61% of suppliers believe the economy will cease its decline in 2009, a view shared by only 30% of retailers. (Fig. 13)

The reason for retail’s guarded outlook no doubt turns on their anxiety about consumer spending. More than 60% don’t expect purchasing levels to return to 2007 levels until 2011 or later. (Fig. 14) Until then, they will be operating more cautiously, waiting for the next opportunity to arise.

OPPORTUNITIES IN RECOVERY

Coming out of the economic downturn, nearly half of retailers (49%) see recovery as an opportunity for them to grab market share, 35% see it as a chance to find more locations, and 29% think they will be able to be more aggressive. Still, others are more cautious, as 38% indicated they intend to operate their businesses more conservatively.

Similarly, 48% of retailers said they expect retail industry merger and acquisition activity to increase over the next year. The primary reason for this increase? More than a third (34%) pointed to a loosening of capital for M&A and private equity, and 32% said there will be opportunities to acquire quality companies at reduced values.

Regardless of the timing, at least one supplier believes once the market turns, retail will recover quickly. “One thing that bodes well for us is that all the excess has been squeezed out of the supply chain,” said Rocky Brands’ Sharp. “That will mean a nice boost when spending comes back.”

METHODOLOGY

The information in this report is based on the results of two surveys and a series of one-on-one interviews conducted by Forbes Insights in July and August 2009.

In the first survey, Forbes Insights, in association with CIT, surveyed 110 executives and financial decision makers at middle market retailers. All companies had revenues of \$25 million to \$1 billion. Respondents represent a broad range of retail segments including specialty apparel, consumer electronics, appliances, sporting goods, convenience stores, housewares, and discount chains. All those surveyed had senior-level titles (including CEO, COO, CFO, VP) and functional responsibility for finance, strategy and business development, or general management.

In a second, related survey, Forbes Insights, again in association with CIT, surveyed an additional 104 executives and financial decision makers at suppliers to the middle market retailer sector. Here, revenue ranges were from \$2 million to \$1 billion with slightly under half weighing in at under \$50 million. These suppliers represent a broad range of segments including apparel and accessories, consumer electronics, housewares, footwear, home furnishings, and other suppliers. All surveyed had senior-level titles (including CEO, COO, CFO, VP) and/or functional responsibility for a business unit or department. Over half were either a CEO or owner. Companies interviewed were not clients of CIT.

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