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FEATURE

Retail Renaissance Surges to the Fore

Is it a boom for the many, or only the select few?

The retail industry may have regained its sea legs this year, but some retailers are far steadier than others, and market observers say the division between the solid winners and the shaky losers could, if anything, grow more pronounced as the economic recovery takes hold.

With the U.S. gross domestic product growing at an enormous 7.2% annual rate in the third quarter, many observers believe that the upcoming holiday season could be a strong one for retailers, as several analysts predict at least a 5% increase in store sales compared with last year. The only worrying trend is weak job growth, which has been tepid this year at best–even after the recent spate of good news–and is at odds with other indicators that the recessionary trend of the past two years is, at last, ebbing. If unemployment continues to be higher than average, that could water down holiday sales.

Nonetheless, even if holiday sales are slightly disappointing, most retailers will still be in far better shape than they were in 2002, when many former market leaders, such as the Gap Stores Inc., were hit with deteriorating comparable-store sales and stock prices. Even those retailers whose businesses are basically built around the holiday season, like specialty gift retailer Brookstone Inc., are in far healthier shape than usual. Brookstone's same-stores sales jumped 16% in the third quarter, a period in which it typically experiences very weak business.

In a sign that the worst appears over, the number of retail bankruptcies should greatly decrease in the next year, analysts said. Moody's KMV, a sister company of Moody's Investors Service, uses a qualitative charting method to predict upcoming bankruptcies in various sectors. For retail, the news is good: Moody's KMV said the typical default likelihood of retail companies is now in the 0.5% range, or roughly one out of every 200 companies. By comparison, that percentage was 2.1% last February, when roughly two of every 100 firms were expected to default. "The risk has decreased pretty markedly," says Som-lok Leung, director of client solutions for Moody's, adding that the sector's overall asset volatility has also declined in the past six months.

Haves and have-nots

Some retail sectors are improving far more quickly than others. Such sectors as apparel and drug stores are slowly recovering from recent volatility, while others, such as supermarkets, remain on the whole in dire shape. As Moody's said in a recent report: "The outlook for many food retailers is dismal."

Even in a sector as troubled as food retailing, however, a few players manage to thrive. This is just one example of what market players call a twinning phenomenon in most areas of retail, in which each sector has businesses now poised for serious growth–and other businesses that, although they serve the same customer base, are in increasingly disastrous shape.

"There are retailers that even in difficult times have been doing well, and there are those in the same niche that are doing poorly," says David Folkman, a managing director at San Francisco-based consulting firm Regent Pacific Management Corp., who in an earlier incarnation served as chief executive of a number of retail businesses. "That says to me it's more a function of retailers understanding their target customers, and the congruence between that understanding and their delivery of the right product mix and services."

The trend is apparent in nearly every wing of the retail sector. In specialty electronics, for example, there are strong companies like Sharper Image and Best Buy Co. Inc., which boast strong operating income and store sales, and then there are rivals like Circuit City Stores Inc., which has been struggling with its bottom line.

Ditto the ever-growing disparity between omnipresent superretailers, such as Wal-Mart Stores Inc. and Target Corp., and the mere mortal specialty retailers, department stores and supermarkets, which have been hemorrhaging market share to the giants' supercenters and regular discount stores. Wal-Mart is such a colossus that, as Moody's analysts note, if its U.S. revenues were to grow by only 5% per year, well below its target goals, it would still generate more revenue than most large department store chains.

Yet Wal-Mart is not invulnerable. It has been whacked again and again by lawsuits and grand jury investigations this year. In addition to an ongoing lawsuit alleging sexual discrimination, Wal-Mart is now facing federal investigation for illegal hiring practices. Late last month, a raid of several Wal-Mart stores in more than 20 states turned up about 250 illegal workers. This has led some analysts to wonder whether Wal-Mart could grow increasingly distracted by legal difficulties and thus lose some of the momentum behind its ambitious growth strategy. The company seems resilient, though–even in the midst of its latest troubles, Wal-Mart said it would open four warehouse club stores in Canada to establish what it hopes ultimately will be a Canadian-wide chain of discount stores.

The casualties

The great guessing game of the moment is: Which retailers will prove unable to take advantage of the improving economy, and may even fall into bankruptcy? By general consensus, the sector in worst shape is, unsurprisingly, traditional stores such as Toys 'R' Us Inc. and J.C. Penney Co. "It is questionable whether they will have a long life," one retail banker says.

Adds Regent Pacific's Folkman: "If you were a department store that traditionally felt good about servicing the whole family, all of the sudden you get hit from below by Wal-Mart and Target, on the side by category killers and by some excellent players at the top end. It's a tough competitive environment."

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And a traditional retailer that falls into bankruptcy has often received a mortal wound, analysts note. Even though Kmart Corp., for instance, emerged from bankruptcy last May in better fiscal shape and with a more streamlined strategy, it remains unclear whether the company can ever make up for lost competitive time.

"History would suggest that when a company goes through Chapter 11, there is a tendency for it to wind up back in [Chapter 11] at some point," says Philip Zahn, a retail analyst at Fitch Ratings.

One solution could be to invest even more in branding. For example, Federated Department Stores currently runs a number of its stores under such dual names as Lazarus-Macy's, Bon-Macy's, Goldsmith's-Macy's. In the future, because the Macy's brand has the most cachet among its customer bases, Federated will likely rename all of these stores simply as Macy's–the name with the most recognition.

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