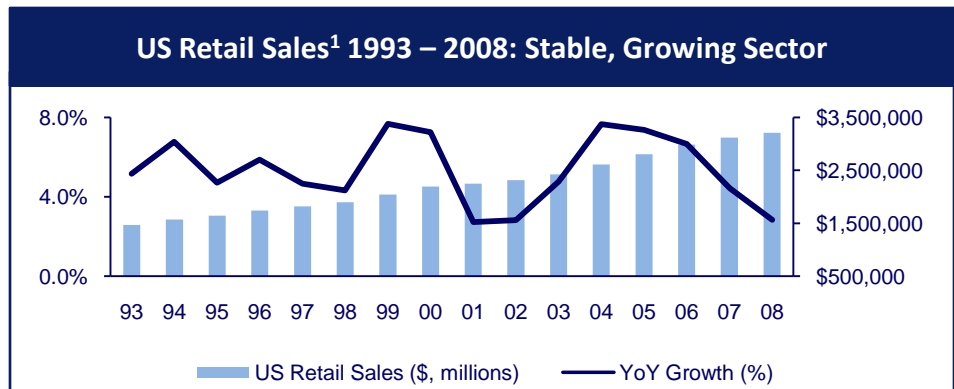


Retail Apocalypse?: Au Contraire!

The death of retail has been greatly exaggerated. Contrary to conventional wisdom, 2008 retail sales actually grew 3% over 2007, according to the Commerce Department. Let's not confuse some troubled retailers with the sector. Most bankrupt or troubled retailers, Borders, Circuit City, Bon-Ton, were in trouble far before the economic malaise. The economic downturn is not the cause of their imminent demise. Weak leadership, poor business models, and inability to adapt are the real reasons they will not survive. Despite some of the worst same store comps in 40 years, we are at the cusp of an unprecedented era of retail expansion and innovation.



Source: ¹US Commerce Department

“150,000 store closings in 2008, 100,000 stores to close in 2009”, “25% of retailers very likely to go bankrupt in 2009”, “Highest vacancy rate, top mall operators facing bankruptcy”, “Worst consumer sentiment on record”. These headlines and ensuing prognostications are enough to scare the sagest investor. Sears, Blockbuster and their ilk have done little to quell the perception that retail management teams and business models are outmoded and out of touch with consumers much like Detroit’s auto companies.

But, a rigorous examination of retail data and consumer trends reveals the sector is still growing, and is likely to be a great investment over the next decade. The seven signs why the retail apocalypse is not coming:

Stable sector benefits from consumer resilience. 2008 retail sales were \$3.2 trillion, up almost 3% over the year before. Consumers, scared as they may be of losing their home, job, or retirement income, are shopping. Retail has always managed to grow over the past 15 years even during economic downturns. People can't stop living their lives; they need stuff – food, clothing and shelter, and a whole lot more. Someone has to sell them the stuff. Obviously, there are reductions in discretionary spending. But, these seem to be more than compensated by increases in population and tourist spending. Even though 2009 may be very tough, if history is any guide, it is unlikely to deviate much from the norm – we will still have a \$3 trillion+ retail sector.

No foreign bogeymen. Foreign retailers, like Ikea, Zara, and Ahold, account for less than 2% of all US retail sales; and that is unlikely to change in the next decade. The American retail sector, for all of its shortcomings, is still the most sophisticated retail sector in the world. Unlike the auto sector, the Asian and European retailers are not only not coming here – they are struggling to survive the onslaught of Wal-Mart, Best Buy and Staples in their own markets. Also, it is highly unlikely that retailing will be outsourced to India or China anytime soon.

Survival can translate into success. Over 25% of retailers responsible for 10-15% of all retail sales are likely to be liquidated in the next year due

to changes in bankruptcy law and lack of available financing. This will create opportunities for surviving retailers to take both market share and talent from their erstwhile competitors. Also, the erosion of retailers in categories like jewelry, home furnishings, consumer electronics and women's apparel will clear the mall of "me-too" retailers, who have lost their relevance. In addition, certain retail formats have become irrelevant. For example, over the past 20 years, traditional department stores have lost 40% market share to discount and specialty stores.

Changing consumer trends. Several demographic and lifestyle trends are projected to grow at double digit rates over the next decade – far higher than retail sector or GDP growth rates. Retailers that adapt to these trends will experience unprecedented, profitable growth. These include the aging of baby boomers (10,000 people turn 50 each day), a growing ethnic population (35% is ethnic, 50%+ in the next 15 years), an obesity epidemic (40% are already obese; alarming rise in childhood obesity), and a health and wellness craze (more health clubs than McDonalds, 4 out of 5 households buy vitamins and supplements). Consumer use of the internet has dramatically changed where and how people shop – 2/3rd of all customers research products online before they buy offline, and 1/4th of all retail sales today have an online research or selling component. Some of the early winners in adapting to these consumer trends have been in the nutraceuticals, personal care, weight control, and specialty food categories.

Innovation. Tough economic times yield innovation. Netflix, Zappos, Amazon, and Blue Nile have low-cost, internet business models that provide customers with more convenience, a larger selection, and lower

prices than their lumbering store counterparts. No surprise, Amazon had its best holiday season ever in 2008 while Borders was gearing up for bankruptcy. Customer experience can also play a huge factor in creating customer visits and loyalty – in a zero switching cost, one click away world. Apple and Costco are at disparate ends on the price spectrum but produce similar passion in their customers. Retailers that can offer customers superior, relevant and personalized solutions and experiences will be the new winners.

Globalization. American retailers, on average, get less than 5% of their revenues from abroad today. They have the opportunity to secure over 20% of their sales from other countries much like their counterparts in the consumer products businesses that derive over 50% this way. The billions of burgeoning middle class customers in the BRIC and other developing nations are hungry for American brands and retail. They cannot wait to get their hands on their first refrigerator, TV, king bed, and plush toy. Wal-Mart, for example, already derives about \$100 billion - 25% of its revenues - from abroad. The internet has also made it easy for mid-size retailers to sell their wares to customers eager to snap up their piece of Americana.

Ownership and governance overhaul. Many of the major retailers that are going bankrupt – Linens N Things, Mervyns, Sharper Image and Wilson's Leather – are owned by private equity firms. These outcomes will coerce retail boards to seriously ponder issues of ownership, governance and strategy. On the other hand, there are private equity owned retailers who are doing well in this environment. For example, JC Whitney, the nation's oldest purveyor of auto parts, experienced double digit profit growth



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in 2008 – in what is perceived to be one of the hardest hit retail categories. This is a result of hiring an extraordinary management team, a focused strategy on becoming the online category leader, and launching new businesses. The catharsis in this sector can only be positive, especially as the weak players flee.

There is a lot to be bullish about in the retail sector. Also, in the short run, the stimulus package from the new Obama administration can't hurt.

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