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Preparing for an economic storm

*How retailers can thrive in
challenging times*

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Preparing for an Economic Storm

“The best way to predict the future is to invent it.”

—Alan Kay, computing pioneer

This year, retailers in many countries are facing what might be called a perfect storm of negative economic trends. Global credit markets have seized up following troubles in the U.S. housing market. The U.S. consumer economy has stalled and, given America's traditional role as an engine of global growth, has caused an economic slowdown in many other countries. In response, central banks have maintained a loose monetary policy—none more so than in the United States—spurring a dramatic decline in the value of the U.S. dollar and a flood of liquidity into financial markets. Investors, in turn, have responded by fuelling an enormous increase in commodity prices, with global commodity markets now running amok: oil prices have doubled in a year and many food commodity prices have increased by orders of magnitude.

For the world's retailers, and especially those with sales principally in developed economies, this environment is challenging, to say the least. High food and energy prices have caused consumers to shift away from non-food and non-fuel products. Declining house prices in some markets, particularly the United States, have led to a negative wealth effect. Consumer spending on durable products has, consequently, been very weak. To the extent that spending is growing at all, consumers are becoming more price sensitive, favoring discounters over high-priced stores. Finally, weak credit market conditions have made it difficult for retailers to finance mergers and acquisitions. This means that some weak retailers may simply perish instead of being acquired. All of this is occurring against a backdrop of increased governmental calls for heightened regulation and transparency.

Will this environment persist? Probably not—all economic contractions ultimately end and this one will more than likely be no exception. Yet most contractions are part of a larger process of economic restructuring and the volatility often continues even after the initial shock. Right now, troubles in credit markets are likely to outlive the economic downturn. That is, even when the U.S. economy recovers, as it ultimately will, global credit market conditions will be weak until financial markets are confident that most bad assets have been written off.

As for commodity markets, the factors that have contributed to the huge increase in prices go far beyond the current economic downturn. Rapid growth in emerging markets and weak investment in new capacity are the principal culprits in the rise of oil prices, in addition to the declining U.S. dollar in 2008. As for food prices, large subsidies for biofuel production played a major role in price increases. All of these factors will continue, although prices may be especially volatile in the near future.

Beyond the matter of economic cycles, there is increasing evidence that uncertainty and volatility may simply become a permanent condition in the external business environment. Uncertain weather patterns plague traditional retail forecasting. Huge and transformational innovation is changing the way we shop, communicate, and interact with each other. The transparency of information has shifted power to consumers, who have reacted by demanding more choice at lower prices.

Given these turbulent economic conditions, the talk around the boardroom table has taken on a gloomy, defensive tone, with management doing their best to lower expectations for the coming year. But most chief executives recognize that approaching a downturn with a negative attitude is not a winning strategy—and that such cycles and larger trends can become either an excuse for underperformance or a chance to make their businesses more competitive and take market share. The question is, then, how do you turn the challenge of a downturn into an opportunity to be a better management team and company? How can retailers emerge from this situation with increased market share and with a more competitive business model? What strategies and tactics can help position them to survive, and even thrive, during an economic storm?

The answers involve both a careful review and assessment of current processes and ways of doing business as well as bold action to make the most of the advantages a weak market can afford. Below is a discussion of the numerous challenges retailers face in a downturn and suggestions of how they can work to change their management team's perspective of negative economic news—turning challenges into opportunities.



Think of your customer

Perhaps the single most important thing for any retailer or consumer-driven business to do is to think and act for your customer. But customer values and behaviors often change dramatically during a downturn and, as such, need to be reevaluated. It is common, for example, for customers to “trade down” to offset other changes in their planned spending. For example, there is strong evidence that fuel price is now effectively part of the consumer’s market basket thinking. It’s also possible that your product and service offerings will become unaligned with demand. Suggestions:

- Understand how relative supply and demand shifts at the upper and lower ends of your market basket offering will be affected
- Evaluate your product mix and pricing strategies in the context of changes in consumer demand
- Find out which of your product and category offerings are counter-cyclical and might grow during the recessionary period
- Consider any ways you can to save your customer a shopping trip to offset rising fuel costs
- Determine whether you can use target price points based on consumer expectations to reverse-engineer and source products
- Consider which features consumers value the least and may not pay for their marginal cost with incremental value, then adjust your pricing accordingly
- Review overall pricing and merchandising to reflect changing buying patterns and drive the right mix and volume.

Build agility and responsiveness into your planning process

It’s probably time to re-examine your internal processes for planning and responding to changes in the market and in consumer demand. Most businesses use planning cycles that are tied to historical demand. As the planning process is slow, tedious, distracting, and negotiated, it is, therefore, largely static. Traditional planning cycles are also based on the calendar year and not adapted to the challenges of rapid change and transition that exist today. Companies need to think about planning differently. The concepts of planning and uncertainty may not seem to go together, but they can give you a competitive advantage if you rethink your planning cycles and create a more responsive process. A management team will often sit on their “plan” for too long in denial of the facts on the ground. But a period of economic transition requires more aggressive planning with shorter cycle times. Suggestions:

- Re-plan more frequently and aggressively based on most recent results and forecasts
- Maintain a rolling plan instead of a static annual plan
- Improve your use of economic leading indicators and economic forecasting
- Determine which economic indicators are the best predictors of your target customers’ spending behaviors
- Use flexible, demand-driven forecasting tools enabled by technology
- Run different economic scenarios against your plan to understand your risks in making sales plan and profit targets.

Conserve cash

Many companies have “lazy” business processes that miss opportunities to improve orders, collections, and consumption of working capital. Performance metrics that focus on cash flow are often missing from management goals and incentives. During a downturn, contracting demand causes most businesses to experience a combined cash and margin squeeze. Inventory turns decelerate and inventory ages excessively, driving a need for increased price reductions that simultaneously affect working capital and margin. Since it’s generally best to reduce inventory commitments early in a contracting economy, it is important to know which part of the economic cycle you are experiencing: the decline, the bottom, or the recovery. Suggestions:

- Reduce order-to-delivery times to reduce risk and capital exposure
- Reduce, defer, or spread inventory commitments
- Create flexibility in your inventory and sales plan that will allow you to course correct through the recession
- Re-evaluate your capital expenditures to determine which will permanently improve your operating model and reduce your costs and which have questionable underlying assumptions about cost and benefits
- Examine all opportunities to improve your cash flow, including looking at inventory and payables for cash flow improvement opportunities
- Take advantage of statutory and regulatory tax provisions that allow for income deferrals or deduction accelerations
- Reduce leverage and risk: leverage during a growing economy often becomes risky in a recessionary one; markets reward companies that have less risk during a downturn.





Look at variable costs

The automatic response of most companies is to reduce their overhead costs. However, consider that most businesses are highly leveraged across a large base of consumers or customers. This type of business model may deal with hundreds of suppliers and vendors, thousands of items, and sometimes millions of transactions. This means that reductions in highly leveraged, variable costs yield far greater economic benefits than slashing fixed costs. Also, keep in mind that an economic decline creates a decline in demand and an increase in supply. While this increases the customer's leverage, it can also increase a retailer's leverage with its suppliers. A management team needs to aggressively challenge variable expenses, costs of goods, and transactional costs to enable them to offer more competitive prices and to maintain margins that consumers will demand and respond to. Suggestions:

- Collaborate with suppliers to reduce shared costs
- Negotiate harder—a recession can be a good time to renegotiate some contracts and relationships. Excess capacity can create a buyer's market for merchandise, services, and commodities
- Negotiate with an after-tax perspective: consider the cash flow and permanent tax benefits in the differing characterization of items such as inventory acceptance provisions, revenue recognition, advance payments, and deposits
- Negotiate better long-term leases on commercial real estate as demand softens and real estate inventory grows
- Quantify all variable costs against merchandise categories and identify unprofitable business relationships
- Consider that unutilized manufacturing capacity during a recession can produce just-in-time or counter-cyclical buying opportunities for retailers.

Too often, buyers of brands limit their job to negotiating back margins with vendors without understanding the true manufacturing costs. However, if the share of private label merchandise increases, retailers should ensure that their buyers have a deeper understanding of the manufacturers' processes and cost structures. Such knowledge will help retailers negotiate more favorable sourcing prices and will, in general, make for more profitable and productive partnerships with private label vendors.

Find your profit contribution's winners and losers

Every business has both contributing and non-contributing components, and over time the business accepts certain practices and assumptions that should be challenged. They may accept losing money during the non-peak season if they can make it up during the peak demand period. They may accept categories of products or locations that make a negative profit contribution to achieve sales goals. Challenging these non-contributing components doesn't mean eliminating them: they can often be restructured, reengineered, renegotiated, or re-priced to become contributors. Suggestions:

- Identify different business cross-sections for looking at profitability such as products, product categories, vendors, and locations
- Determine net contributors and non-contributors
- Challenge accepted logic for supporting non-performing elements in the business model
- Look for game-changing ways to convert non-contributors to winners
- Make the challenging decisions and rationalize negative contribution components if they can't be rehabilitated.

Realign and restructure

Restructuring is never easy, but it can be easier to restructure during a challenging period. It is also better to do it before you must do it and in ways that reduce disruptions to the business. Employees recognize the imperative to be more competitive and will be more supportive of orderly restructuring. Suggestions:

- Consolidate redundant support functions
- Review your spans of control and determine how many layers of management are separating you from the people serving your customers or making your products
- Identify where your divisions share services that are currently separate support operations.

Negotiate away risk

In addition to negotiating lower costs with your suppliers, there are ways to negotiate with them so as to reduce risk. Some suggestions:

- Consider shifting some of your business risk onto these suppliers. For example, identify the risks of holding inventory—such as currency risk, obsolescence, and overstock—and then consider pushing some of these risks back onto their suppliers. By shifting risk, retailers move negotiations beyond a single focus on bargaining for the lowest price and toward a business discussion on how both parties can win by better partnering and sharing risks and rewards.
- Look at whether you can reduce risk by adapting hedging strategies to remove volatility and uncertainty from their merchandise costs. This includes evaluating currency and commodity risk exposures and opportunities as well as options and derivatives that can be used to decrease risk and volatility. The challenge is to hedge in a manner that maintains maximum flexibility in an efficient after-tax manner. Too often, hedges prematurely commit an organization to a fixed price on a fixed date. In volatile times, it might be smarter to pay more for a more complex foreign exchange contract that contains options and collars, rather than purchasing a fixed foreign exchange contract for a set amount of currency on a future date.
- Evaluate the differing tax impact of the mix of options, futures, forwards, or derivatives. The characterization (i.e., ordinary or capital), the timing of the recognition, and the sourcing (foreign or domestic) of gains or losses can have a significant impact on the total cost. In short, hedge to maintain maximum flexibility while protecting your business.

Evaluate your competitive position

This could be an opportunity to take a hard look at the competitive landscape. Suggestions:

- Conduct a competitive assessment to learn who takes your market share when budgets get tighter
- Look at your price point mix and your initial pricing strategy. A higher mix of value-priced merchandise will benefit your competitive sales position during a downturn. Also, more aggressive upfront pricing and less backend clearance pricing will produce better average margins in a recession.

Keep a step ahead

Retailers can do a number of things to maintain a forward-thinking approach. Some suggestions:

- Re-examine your supply chain. Your network analysis is probably obsolete and your sourcing strategies may not make sense with oil at more than \$100 a barrel and definitely not at \$200.
- Examine alternatives included in establishing a tax-efficient supply chain, with an eye toward minimizing overall costs and maximizing various governmental incentives or forms of doing business
- Remember that consumer sentiment and confidence that directly affect retail spending often lag behind investor perspectives
- Watch out for “shrink” during a recession, which rises during challenging economic periods
- Identify deflationary, inflationary, and high-obsolescence merchandise categories and adjust buying strategies
- Model and adjust inventory tax accounting methods to adjust for inflation and deflation with consideration of various LIFO or other tax accounting methods.

Recognize opportunities

During periods of expansion and growth, asset values often peak at levels that defy economic analysis. Conversely, during contractions assets and resources can become available at fire-sale prices. This could be the time to buy undervalued assets when competitors are forced to dispose of them under their intrinsic value, thus leading to a secondary benefit of reduced property tax assessments.

Upgrade your workforce

When growth drives demand for additional human resources, companies pay less attention to individual performance, and compensation is driven by competitive market forces. During a contraction you can align compensation with contribution and performance to retain and foster a higher performance work force. Suggestions:

- Build a more accountable culture focused on performance and results
- Retain your best people and deal with your performance problems
- Take advantage of the talent that becomes available in the market
- Enlist and connect your people to the mission of driving profitable growth and opportunity
- Restructure compensation with higher performance incentive components. This better links your revenue, profitability, and costs, and managing through a rough period without laying off valuable people
- Re-examine the employer and employee after-tax impacts of your various plans and align them with goals.

A call to action

We often fail to recognize that recessions are part of a cycle that rebalances our market-based economy. Our economy needs to reinvent itself to improve and grow—we need to accept that we live in a competitive world that is subject to increasing complexity and uncertainty. By building business models that are more responsive, adaptable, and efficient with resources and assets, retailers can survive, and even thrive, during a recession. Business leaders must understand how to turn uncertainty into opportunity.

The items covered in this report may seem daunting, and clearly prioritization is required to reflect your business needs. Some of the incremental changes discussed will very likely help the bottom line. In some cases, more fundamental transformations will be required as the pace of change increases volatility and requires more innovation. The challenge to keep up with the changing environment has never been greater, and there is no doubt that we will see the next iPods emerge—and more buggy whips sink—in the near future. The good news is that the tools to help you adapt to changes have also never been greater.

“In the struggle for survival, the fittest win out at the expense of their rivals because they succeed in adapting themselves best to their environment”

—Charles Darwin

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