The Evolving Retail Landscape: Challenges and Opportunities

November 2016
I. The U.S. Consumer

II. The Retail Landscape

III. A View From the Trenches

IV. Summary
Consumers
Retail sales since 2013 have shown aggregate growth of just 3%-4% annually vs. 5%-7% in the mid-2000’s and late-1990’s

Monthly Retail Sales
(excludes Motor Veh., Gasoline, Dining)

Source: US Census Bureau
Consumer sentiment has been trending flat over the last year, and is currently near the 2-year low.

Source: The Surveys of Consumers are conducted by the Survey Research Center at the University of Michigan. (https://data.sca.isr.umich.edu/survey-info.php)
The consumer mindset heading to 2016 holidays? Many are “sitting the fence” with 51% feeling neutral or not positive – that could impact spending

BRG 2016 Retail Holiday Outlook, August 2016, N=1026
Consumer debt burden continues to rise – personal savings rate has dipped since Q4-2015

Outstanding Revolving Credit
Consumer Credit (G.19 Statistical Release)

Disposable Income & Savings

Consumer debt burden continues to rise – personal savings rate has dipped since Q4-2015

Source: U.S. Federal Reserve

U.S. unemployment has stabilized at around 5%... while long term job growth has been positive, in the last 12 months growth has slowed

**U-3**
Total unemployed as a % of the civilian labor force
(commonly reported “unemployment rate”)

**U-6**
Total unemployed as a % of the civilian labor force
(including persons marginally attached to labor force + total employed part time for economic reasons)

Source: U.S. Bureau of Labor Statistics
The Retail Landscape
A demanding and unsettled retail environment will continue to challenge retailers and suppliers

Major Disruptive Trends in Retail

- **Evolving Consumer Demographics**: America is aging. Baby Boomers have driven U.S. retail for decades, but Millennial shoppers are now the majority.

- **Channel shift**: Online shopping has grown at over 17% CAGR since the beginning of 2010, with online sales as a percentage of total retail sales nearly doubling to 8.1% through Q2 2016.

- **Technology**: Advancements in mobile technology have forever changed retail, from the consumer experience to operations.

- **Mobility/Delivery**: The true power of mobility and emerging delivery models are trends that will have a more profound impact on retail in future years.

- **The Role of Physical Stores**: Omni-channel is NOT just about shopping online; success today involves effective integration of the online and in-store experiences.
Retailers must embrace the evolving consumer demographic – and understand the business impacts

**Evolving Demographics**

- Millennials’ total population in the U.S. has surpassed Baby Boomers
- This younger consumer is reaching their prime spending years, while Boomers fade into the sunset of their lives (and spending impact)
- Millennials are very different from the rest of the consumer population, both in the ways they shop and how they spend their money
- This shift will dramatically impact the approach retailers take to interact and connect with their customers

![Projected U.S. Population by Age Group](image)

Source: U.S. Census Bureau, Population Division
Release date: December 2014
To survive and thrive in today’s retail environment, companies must prioritize the omni-channel challenges/initiatives.

**Omni-Channel Challenges**

- **U.S. online sales** exceeded $340 billion in 2015 – expected to increase 57% to $535 billion in 2019
- **Price transparency online** is a game-changer for consumers and retailers
- **Retailers must invest in IT infrastructure** – advanced analytics drives success
- **Master logistics and inventory processes** – distribution network and supply chain are critical
- **Adapt marketing strategies to the omni-channel reality** – customer communication is a key to success in today’s retail world

**U.S. Retail E-Commerce Sales**

Source: U.S. Census Bureau, * = projections

<table>
<thead>
<tr>
<th>Year</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016*</th>
<th>2017*</th>
<th>2018*</th>
<th>2019*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$261</td>
<td>$298</td>
<td>$341</td>
<td>$385</td>
<td>$432</td>
<td>$482</td>
<td>$535</td>
</tr>
</tbody>
</table>

Source: U.S. Census Bureau, * = projections

To survive and thrive in today’s retail environment, companies must prioritize the omni-channel challenges/initiatives.
Technology has changed the way we shop...Millennial shoppers – the so-called “Digital Natives” are having a major impact

- Shoppers’ habits have changed drastically because of new technology
- Consumers rely more and more on online product and pricing information
- The shopping experience extends beyond the four walls of a store
- Shoppers are well-prepared prior to arriving to shop
- Retailers and mall owners must adapt to these changing habits

Shoppers are no longer just shopping ...... They are on a Mission!!
Stores still matter: Omni-channel success requires the right in-store experience, creating a seamless experience for shoppers across all channels

**Physical Stores Imperatives**

- **Omni-channel demands effective integration of online and in-store experiences**
- **Online shopping influences in-store expectations** (service, products, convenience AND the availability of digital tools in-store to assist with product information, payment)
- **Excel on retail basics – customer service, hassle free shopping, value, in-stock**
- **Create an overall experience that brings customers back**

**How important is it to you that stores you shop at carry items that represent the needs/characteristics of your local community?**

<table>
<thead>
<tr>
<th></th>
<th>Important</th>
<th>Not Important</th>
</tr>
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<tbody>
<tr>
<td><strong>Total</strong></td>
<td>67%</td>
<td>33%</td>
</tr>
<tr>
<td><strong>Millennials (18-35)</strong></td>
<td>76%</td>
<td>24%</td>
</tr>
<tr>
<td><strong>Gen X (36-51)</strong></td>
<td>66%</td>
<td>34%</td>
</tr>
<tr>
<td><strong>Baby Boomers (52-70)</strong></td>
<td>61%</td>
<td>39%</td>
</tr>
</tbody>
</table>

**Thinking of when you shop in-store, what are the reasons you typically leave a store without making a purchase?**

<table>
<thead>
<tr>
<th>Reason</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Could not find what I wanted</td>
<td>60%</td>
</tr>
<tr>
<td>Price was too high</td>
<td>51%</td>
</tr>
<tr>
<td>Did not have the right size or product type</td>
<td>39%</td>
</tr>
<tr>
<td>Did not like the item once I saw it/try it on</td>
<td>31%</td>
</tr>
<tr>
<td>An advertised item was out of stock</td>
<td>26%</td>
</tr>
<tr>
<td>Checkout lines were too long</td>
<td>21%</td>
</tr>
<tr>
<td>Store was too crowded</td>
<td>17%</td>
</tr>
<tr>
<td>Service was bad</td>
<td>15%</td>
</tr>
<tr>
<td>Found lower price on my mobile while shopping</td>
<td>14%</td>
</tr>
</tbody>
</table>
To create the right store experience the mall as we know it must evolve – an effort that will involve retailers and mall operators.

- Retail boom fueled by the middle class and Baby Boomers
- Anchor tenants were key to mall success
- Logistics was a key driver
- Mobile technology and social media have had major impact on consumer behavior
- Shopping in-store is less about transactions, and more about the experience
- What experiences will retailers have to offer?
- How can mall owners better serve and support their tenants?
- Can online be fully integrated with in-store in a way that drives mall traffic?
A View From the Trenches
Since the beginning of 2016, 31 retailers with assets or liabilities exceeding $10 million have filed for bankruptcy protection.

Slow economic growth, increased competition, and growth in ecommerce have forced retailers to shut down stores. Store closings include:

- Walmart (January 2016) – Announced plan to close 269 stores (154 in the U.S. and 115 internationally)
- Staples – Closed 73 North American stores in 2015 and in March 2016, publicized a plan to close 50 additional stores
- Sports Authority – Filed for Chapter 11 bankruptcy in March 2016 (converted to Chapter 7) and closed all 463 stores
- Macy’s – In August disclosed plan to close 100 full line locations in early 2017; in November 2016 announced sale of five stores to General Growth Properties for $46 million
- Sears (August 2016) – Closed 68 Kmart and 10 Sears stores
What we are seeing today with our clients

- **Major landlords waking up to the new reality of retail**
  - Vacancy rates remain at 10-11%; well north of pre-recession levels of ~ 7%
  - Simon and GGP take ownership in reorganized Aeropostale...are we moving to a different model of landlord/retailer partnerships?

- **Intellectual property as reliable collateral with a liquid market and valuation standards**
  - Behind inventory, IP has recently become the most valuable asset in distressed sale transactions
  - Private equity and hedge funds beginning to become active investors; likely moving toward bundling portfolios of IP in CLO type transactions

- **Capital structures are more volatile than most CFO’s appreciate**
  - Scenario planning is often lacking; visibility into liquidity is well behind EBITDA planning
  - Vendors are more fragile than ever, factors and credit insurers highly focused on credit exposure
  - CDS trading is on the rise; given the leverage of many retailers, this could add volatility in distressed situations
Sector spotlight: Sporting Goods industry is experiencing substantial upheaval and is at a pivot point

- **Key Events**
  - The Sports Authority bankruptcy – Chapter 11 liquidation; Dick’s purchases IP/lease designation rights
  - Golfsmith – Canada going concern sale; US liquidation with Dick’s purchasing IP/lease designation rights
  - Sports Chalet – liquidation, closed 47 stores
  - Performance Sports Group – Chapter 11 reorganization
  - Bass Pro Shops purchases Cabella’s
  - Eastern Mountain Sports and Gander Mountain – specialty chains
  - Hibbert, Big 5, Champ’s Sports, Modells – regional chains
  - Amazon, Walmart challenging for dominance in the category

- **Key Suppliers** – some segments continue to retain strong position, other struggling
  - Strong athletic brands (Nike, Adidas and Under Armor) continue to battle for share
  - Sporting Goods: Equipment sales down
  - Footwear: Highly competitive segment
  - Golf: Manufacturers have flooded market with product and cannibalized pricing
  - Gun manufacturers: Election cycle driving higher sales
  - Camping goods: TBD
  - Snow/Ski: Hoping for sales uptick following last two difficult winter seasons

- **Key Trends**
  - Athlete-Leisure market expanding rapidly, numerous brands and retailer extending into space
  - Weaken consumer interested in golf has driving substantial decline in equipment and apparel sales
  - Trend to e-commerce purchasing is tracking /leading (?) overall shift in consumer
  - Online sales shift reducing productivity of Retail space and challenging 4 wall profitability
  - Experience based / Retail-entertainment is attractive to consumer but poses challenges for retailers
Case Study: Key Takeaways from The Sports Authority

- No proprietary offerings in assortment – products can be bought anywhere, including online. Reliance on slow moving hard goods to fill large boxes
- Business had become vendor centric, not customer centric
- Lack of organic growth vs. growth by acquisition; lack of continuity across store portfolio
- Disparate channels of competition – other sporting goods retailers, mass merchants, online, specialty retailers
- Key vendors also major competitors, e.g., Nike, UA, etc., creating price competition in the segment and a “race to the bottom”
- Allocation of best product is restricted and unpredictable
- Choked on real estate – too many stores as online competition grew
- Zero wiggle room to be creative – financial leverage limited flexibility to execute a turnaround
- Dispute between term lenders and consignment vendors resulted in little to no replenishment and ultimately a liquidation
Case Study: Aéropostale

Events Leading to Bankruptcy

- Competition from big-box stores, non-branded clothing, online merchants and “fast fashion” rivals
- 800 locations in the US and Canada; 40% sales drop between 2011 and 2015
- Company accused lead lender of using a supplier it controlled to steer the chain into bankruptcy and buy it on the cheap
Case Study: Aéropostale (cont.)

Transaction
- No. 1 mall developer (Simon) teams up with No. 2 mall developer (General Growth)
- JV includes Authentic Brands Group, Hilco and Gordon Brothers
- Middle East mall model where landlords own shopping centers and retail operations of stores has been referenced
- Total sales value of $243M (240+ store chain); purchase puzzled Wall Street
- Simon’s share $33M, small compared to Company’s $65B stock market value
- Focus is mostly motivated by the prospect of hefty profit thanks to low price paid

Current Situation and Next Steps
- Overall store count increased to 500+ stores after concessions from other landlords
- Owners now believe Aéropostale could bounce back and double its store fleet
- More store profitability than Simon/GGP thought; every store profitable
- The next chapter begins 1 January when all 500+ stores will go operational
- The joint partnership transaction, a first in American history, may have longevity and could spur copycat buyout models
What keeps CEOs and CFOs up at night?

**CEO Concerns**

- Omni-channel imperatives and how it impacts the business model
- Technology capabilities – big data, logistics, inventory, marketing and communications, in-store systems, etc.
- Evolving U.S. demographic – impact on customers AND employees
- Supplier relationships, sourcing
- New competition and shifting competitive pressures
- Organizational design that addresses the ever changing retail landscape
- Cybersecurity

**CFO Concerns**

- Robust business planning process
- Management of indirect spending
- Store 4-wall profitability
- Store portfolio optimization
- Margin / pricing pressures
- Managing working capital
- Funding required capital expenditures
- Corporate cost structure (SG&A)
- Effectiveness of FP&A organization
- Creating / managing flow of information to successfully manage the business (dashboards)
We thrive in the midst of tough, high-stakes challenges.