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What Does Retail Disruption Look Like?
We'll Show You.

By Michael Eisenband

Following a pleasant reprieve from retail apocalypse stories during a generally solid 2018 holiday season, the doomsayers are back out in force on the heels of several recent Chapter 11 filings and a rash of store closing announcements. The sudden "Chapter 22" filings by Payless ShoeSource and Gymboree have been widely covered in business media, highlighting the difficulty of rehabilitating failed retailers. The lingering gloominess around retail is understandable, but bankruptcies and store closing announcements are seasonally prevalent in the first quarter of every year for retailers, so it's hard to give the recent batch of announcements their proper context, which the business headlines tend to distort.

We know a few things with certainty. America remains overstored on a per capita basis compared to nearly all other advanced economies, due mostly to the vast size of the nation and the dispersion of its population to more far-reaching suburban and exurban locales in the three decades that preceded this century. The stores followed Americans into the burbs. Overstoring was a reality before the advent of online retailing, which has worsened the glut by bringing the store and its wares into our homes. For all the headlines they tend to grab, store closings in recent years have been too modest to alter the imbalance.

Most large retailers continue to be beset by the disruption caused primarily by online competitors and the ongoing adaptation of their business models to the online channel. This has been an ongoing wrenching transformation for the industry. Despite these challenges, the overall U.S. retail sector performed rather well in 2018 and consumers are spending more freely now than at any other time this decade. How can this incongruity be explained? In a word: bifurcation. Arguably, the performance of the U.S. retail sector has never been as segmented as it is today, with the divide between leaders and laggards widening considerably in the last five years.

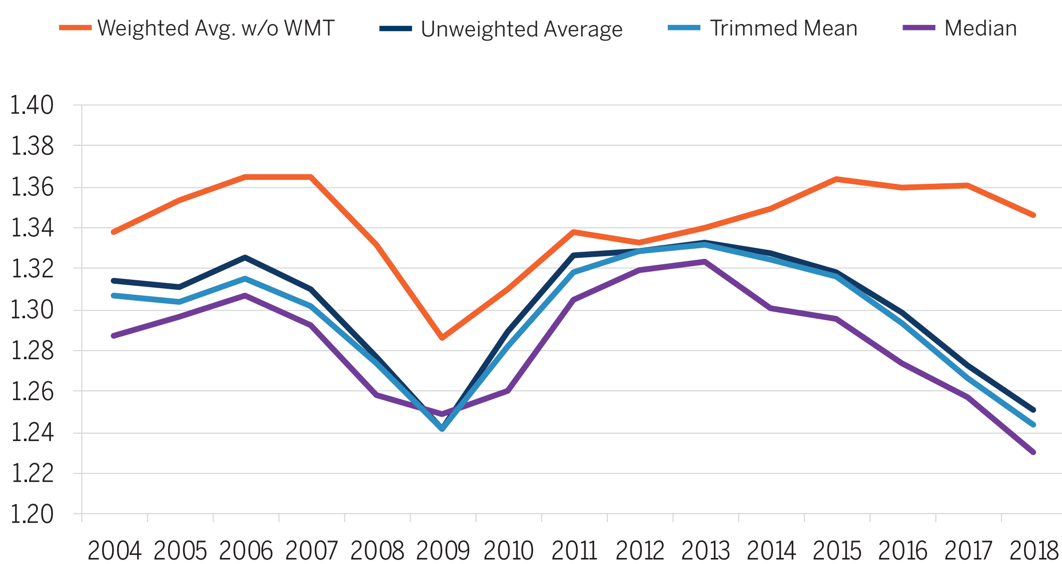
How do we know this to be so? The data spells it out pretty clearly. We analyzed the performance of one ratio — gross profit-to-SG&A ("GP/SPA") expense — over the last 15 years for 100 publicly owned retailers that reported at least $100 million of annual sales over the entirety of this period. It was a fixed set of store-based companies. Online-only retailers, such as Amazon and Wayfair were omitted, as were companies that either failed or went private at any point during this stretch and stopped reporting financial results. (We also omitted Wal-Mart due to its outsized influence on weighted average measurements.) GP/SGA is an ideal ratio for evaluating retailers' operating performance, as it captures the collective effects of sales growth, gross margin and expense control in a single metric. Furthermore, this ratio is, by definition, always greater than zero and almost always greater than one, which makes it easy to work with and interpret, and avoids the mathematical quirks of a ratio that can approach zero or be negative.

When viewed in the aggregate, that is, on a weighted average basis, the ratio has been flattish since 2014, after having rebounded from a swoon during the recession. The weighted average ratio remains slightly lower than it was in the pre-recession period, as the financial burden of competing online with peers and online-only retailers has taken a toll on most retailers' profitability, irrespective of size.

However, this impact is widely disproportionate among retailers, with unweighted summary measures of this ratio having deteriorated markedly since 2013, as we see in **Exhibit 1**. The average, median and trimmed mean measurements of our ratio have all moved sharply lower in tandem for the last five years, and recently have approached their lows of 2009 at the height of the recession. The contrast between these summary measures and the weighted average is alarming, with the gap or difference in our ratio between the weighted average and the unweighted mean widening to a 15-year high in 2018 (**Exhibit 2**).

EXHIBIT 1

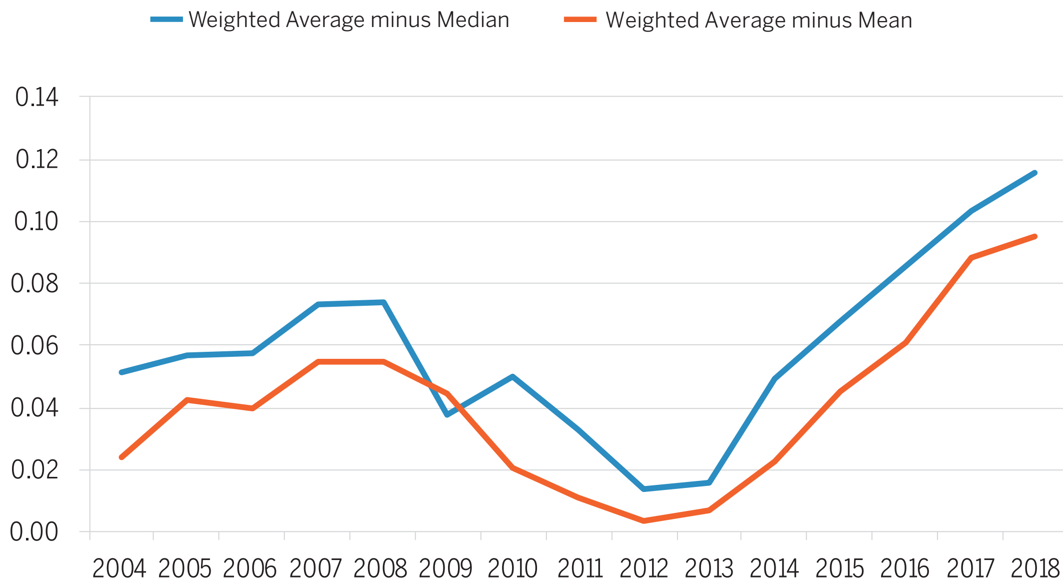
Gross Profit/SG&A Expense



Source: FTI Consulting

EXHIBIT 2

Gross Profit/SG&A Expense



Source: FTI Consulting

What do these trends signify? They primarily tell us that aggregate totals and weighted averages for the retail sector are misleading and conceal the turmoil beneath the surface. Most large retailers are faring considerably better than average or smaller retailers, however one defines that. Only 26 of our 100 retailers saw this ratio improve in 2018 compared to 2013, while just 36 showed improvement compared to 2005. Ten companies had a ratio below 1.0 (i.e. negative EBITDA) in 2017-2018 compared to none in 2005-2006. Overall, this has been quite a dismal showing at a time when consumer spending is finally strengthening — and these exclude the Chapter 11 filers!

These trends don't necessarily suggest that widespread distress and failure is the eventual fate of smaller and mid-tier chains, but it is concerning that their performance, at least by this metric, continues to weaken with little indication of reversal at a time when consumer spending is fairly robust. We can only wonder what will happen when economic growth inevitably sputters. For the moment, we expect Chapter 11 filings by retailers to remain above historical norms, even in the absence of a recession as the decade of disruption claims more casualties.

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