By Michael Eisenband and John Yozzo

The Restructuring Reprieve Is Over for the Retail Sector

Michael Eisenband
FTI Consulting, Inc.
New York

Coordinating Editor
John Yozzo
FTI Consulting, Inc.
New York

Michael Eisenband is a senior managing director and global co-leader of FTI Consulting, Inc.'s Corporate Finance and Restructuring Practice in New York. John Yozzo is a managing director in the same office.

Once upon a time, many years ago when Amazon.com just sold books, Americans loved to shop in stores. The shopping mall was the place to be seen; big box specialty chains known as "category killers" were, well, killing small specialty chains and "mom & pop" businesses; "shop till you drop" was a popular consumer mantra; and walking around the mall with lots of shopping bags in hand was considered cool.

By 2017, the U.S. had approximately 43 percent more retail shopping center square footage per capita than our Canadian neighbors.[1] However, those "essential" trips to the mall are now a bygone era (although most of that retail space is still with us), and many retail giants of that time have since disappeared. Toys "R" Us, Circuit City, Sports Authority, Barnes & Noble, Linens 'N Things and Bed Bath & Beyond come to mind, not to mention the many defunct general merchandisers and department store chains.

Even the largest of chains must change with the times in how they sell goods to consumers, or risk irrelevance. A two-year lull in restructuring activity for the retail sector following the COVID-19 pandemic has not changed this reality.

1 "Canadian Shopping Centre Study 2017," Retail Council of Canada (December 2017).

Retailing in 2024

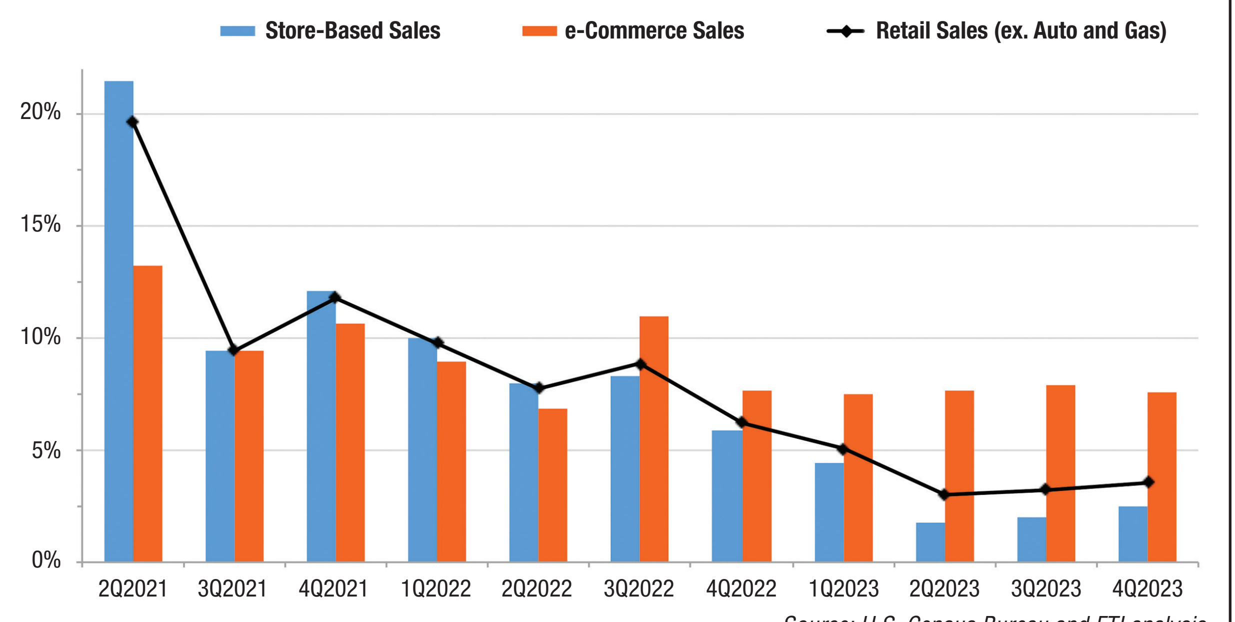
How Did We Get Here?

E-commerce has been the great disruptor in retailing this century for sellers and consumers alike. By 2019, the U.S. e-commerce channel (which includes online retail sales of both online-only and omnichannel sellers) had captured just over 15 percent of relevant product sales overall (with even larger percentages of sales captured in select product categories, such as apparel and home goods), and was adding 125 basis points of market share each year.

Lest we forget, many large retail chains already had been struggling prior to COVID-19, not necessarily at an existential level but certainly from a profitability perspective. The transition of traditional retailers from store-based to omnichannel was navigable but fraught with challenges along the way. Upfront and ongoing costs to develop, integrate and maintain an omnichannel strategy were sizeable.

Moreover, fulfillment costs for online sales, including the costs of delivery, exchanges, returns and restocking, were mostly or entirely absorbed by retailers — a costly but necessary accommodation provided to online shoppers, who are more transactional and purpose-driven in their purchases. Some

Exhibit 1: Quarterly U.S. Retail Sales Growth (Year over Year)



Source: U.S. Census Bureau and FTI analysis.

omnichannel retailers handled the transition better than others, but online giant Amazon has done it best and has steadily taken market shares across the retail sector and in most product categories for the entirety of this century, becoming a $220 billion (the U.S. Gross Merchandise Value estimate) behemoth right before COVID-19 struck, accounting for nearly 40 percent of U.S. online retail sales in 2019 by our estimates.

COVID-19 altered the narrative for a while and created a new mix of winners and losers among retailers depending on what they sold and how they sold it. We lived differently for a couple of years during the pandemic, and consumers' spending priorities changed. Personal consumption normally spent on travel and leisure was diverted toward buying more creature comforts closer to "home" — that is, consumer goods. Total nominal retail sales of goods (excluding autos and gas) soared by 8 percent and 13.6 percent in 2020 and 2021, respectively, compared to 4.5 percent in a typical year.

Many Americans took up hobbies and turned their basements into home gyms during the pandemic. We also ate and drank more and watched a lot of television, mostly streaming series and movies. Spending on home-related goods was all the rage while apparel sales hit the skids, since there was nowhere to go and no one to impress. Online retail sales soared across most product categories — at first out of necessity during lockdowns and the peak of the pandemic — but then by choice as Americans hesitated to circulate indoors and in stores again even after vaccines were rolled out nationally.

E-commerce retail sales (online only and omnichannel) gained 550 basis points of market share from 2020-21 — the equivalent of more than four years of trending pre-COVID share gains in just two years — as the pandemic forced us to rely heavily on online shopping and accelerated the conversion of holdout retailers to online channels. U.S. online retail sales had passed the $1 trillion mark by the third quarter of 2022, more than two years ahead of its pre-pandemic trajectory. Many smaller retail businesses without a formidable online presence were crushed in 2020, while large omnichannel chains survived or thrived even with reduced store traffic by early 2021.

Same as It Ever Was

Eventually, everyday life began to get back to normal by mid-2021, when most Americans became vaccinated. Primarily in-store-based retailers caught a break in the aftermath of the COVID-19 pandemic, as shoppers returned to stores in large numbers still loaded with their COVID-19-fueled cash hoard largely intact following a lengthy hiatus from in-store shopping.

For the first time since the advent of online shopping, total year-over-year store-based sales growth outpaced online sales growth for five consecutive quarters, from the second quarter of 2021 through the second quarter of 2022 (see Exhibit 1 on p. 26). During this time, large retail bankruptcies plummeted from pre-COVID norms (see Exhibit 2 below) and profitability metrics improved across the retail sector, a much-needed reprieve for struggling chains (see Exhibit 3 on p. 52).

Inflation also benefited many retail chains that were able to pass on these higher costs to customers and then some, as most shoppers absorbed price hikes through early 2023 without curtailing their consumption. Some industry-watchers had hoped that consumers had rekindled their love of in-store

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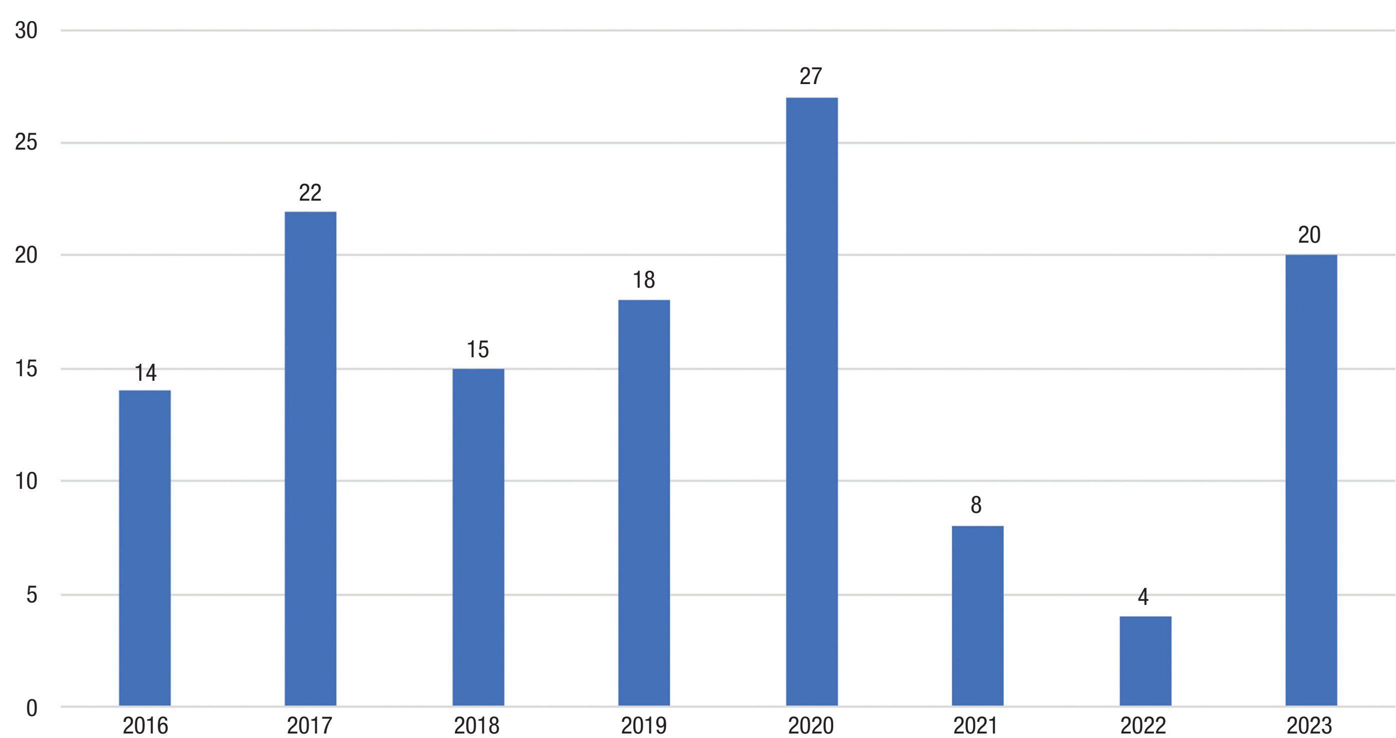
Exhibit 2: Large U.S. Retail Bankruptcy Filings (>$50 Million of Liabilities at Filing)



Source: BankruptcyData.com.

shopping after being limited to mostly online transacting during the COVID-19 pandemic, but the truth was that it was a short-lived romance.

The script has since flipped again, as total nominal retail sales growth has slowed since mid-2023. Real sales growth has turned negligible or negative. In-store-based year-over-year sales growth has weakened considerably over the last six quarters and is just slightly positive. Online sales growth hovers in the high single-digits (see Exhibit 1 on p. 26) compared to the low double-digits prior to COVID-19. U.S. e-commerce retail sales topped $1.1 trillion in 2023, having nearly doubled since 2019 and representing a 22 percent market share of total retail sales. The purported comeback of store-based shopping lasted about as long as the 3D movie craze, while key performance metrics for publicly owned retail chains have trended lower across most retail segments since peaking in mid-2022. In fact, return on invested capital is trending back to pre-COVID levels for most segments following a post-pandemic surge when consumer spending was unsustainably strong (see Exhibit 3 below).

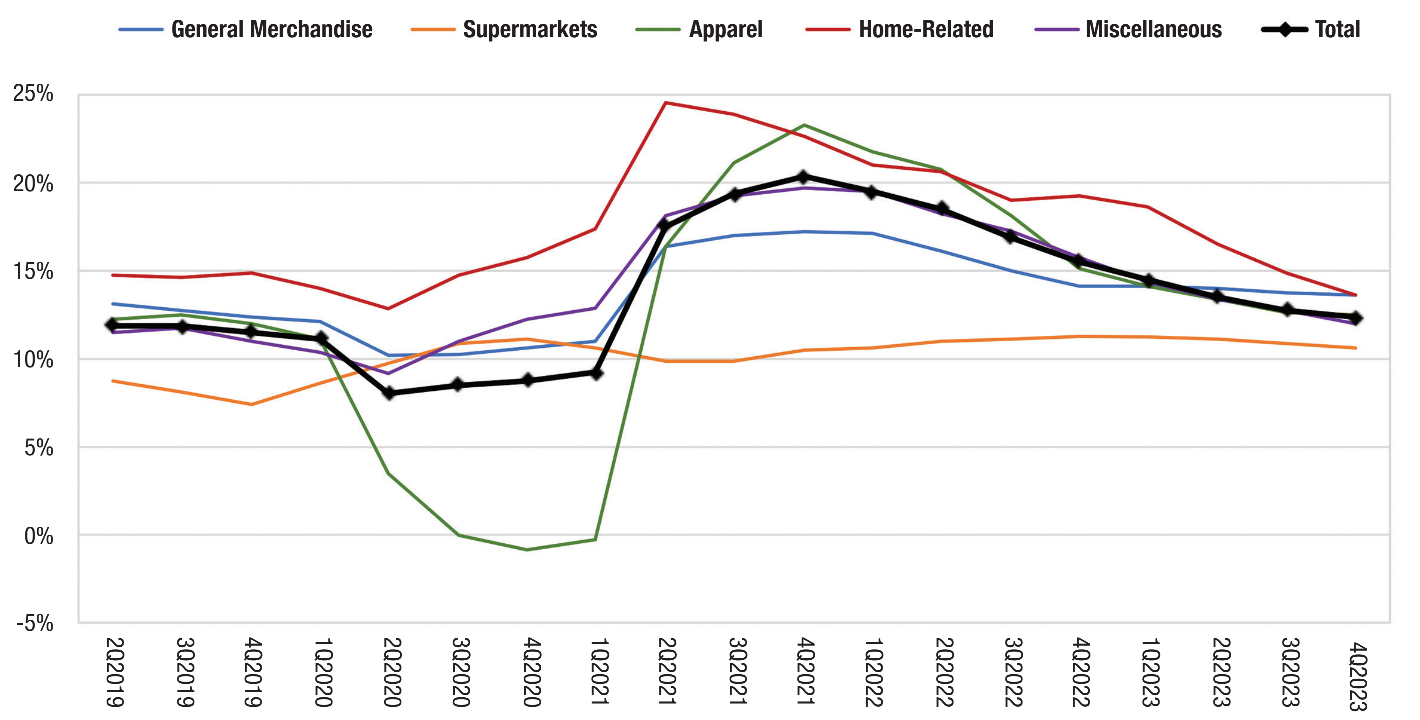
As consumer shopping patterns and preferences return to "normal" after an unprecedented period that upended our lives and lifestyles, many of the old challenges for retailers are back. Large retail bankruptcy filings shot up again in 2023 following a two-year stretch of subdued activity. This increase in filings is consistent with filing levels in the years preceding the pandemic (see Exhibit 2 on p. 27). Recent business media stories have featured a growing list of retail names that are restructuring candidates. These distressed names run the gamut of product categories and store types. Whether it is a reversion to the mean or a new cycle of retail distress, there is no denying that retail restructurings have picked up considerably.

Further compounding recent concerns about the retail sector, more shoppers are indicating that they are struggling financially, having mostly exhausted their COVID-19 savings windfall and with many having taken on new debt. With the U.S. labor market still robust and unemployment rates near all-time lows, the fault line dividing Americans' relative feelings of financial security and willingness to spend is personal indebtedness.

A recent Bloomberg article indicated that for the first time on record, households' interest payments of non-mortgage debt (mainly credit cards and auto loans) are as large as mortgage interest payments, with the former having doubled since mid-2021 due to surging interest rates on credit card debt and auto loans. There has been a $300 billion increase (35 percent) in outstanding card debt since 2020.[2] Finally, the resumption of student loan payments after a three-year hiatus is also financially burdensome for millions of borrowers. Americans with substantial personal debt increasingly are tapped out financially, and that strain is impacting their consumption decisions.

2 Claire Ballentine & Eliza Ronalds-Hannon, "American Debt Stings Like Never Before in New Era for Households," Bloomberg (March 15, 2024).

Exhibit 3: Return on Investment Capital



Source: S&P Capital IQ and FTI analysis based on 98 public retail companies.

Challenges Still Abound for the Retail Sector

In a recent CNBC article,[3] several CEOs of retail chains opined on the future of retail, and it sounded as though an unending series of backflips and contortions will be required of retailers in order to stay relevant to customers. Stores have to be "retail-tainment" (yes, that is a term) — a distribution center, a showcase and a billboard — everything except the store as a self-contained profit center, because many will not be. These CEOs sounded up to the challenge given the strength of their brands and positioning, but many others that lack the brand strength, hip factor or omnichannel infrastructure likely are not as ready.

One passage in the CNBC article seemed to strike at the heart of the challenge. Skims CEO Jens Grede commented, "So important locations are only becoming more important. I don't know where that leaves the B and C location, but I think the B and C location will struggle because they're not offering the experience. I think when people go shopping they go to an A location or they go online, but there really is very little need for the B and C locations."[4]

At a macro retail level, this sentiment conveys a discouraging reality for the industry, as most stores that dot the landscape are B and C locations. Just as all children cannot be above-average students, all of a large chain's retail stores cannot be A-type locations, and this is a fairly immutable variable. Where does that leave the others for a chain with hundreds of locations?

This dilemma goes back to the issue of retail over-storing, which had been widely recognized and discussed before COVID-19 hit. It would be a mistake to believe the slight culling of store locations that has occurred since the pandemic has meaningfully addressed over-storing. If anything, the COVID-19 pandemic placed more pressure on in-store-level economics and performance, while accelerating the online/omnichannel transition imperative. Most large omnichannel retailers are still over-stored and trying to strike the right balance between store footprint and the online side of their businesses, most notably Macy's recent announcement that it would close 150 department stores (or 25 percent of the chain's square footage) by 2026 while increasing investments in 350 others and focusing on small-format stores.

By the same token, the demands on omnichannel retailing are manifold, requiring large, ongoing investments in online capabilities, implementation of these initiatives, and integration with in-store strategy and operations. Retailers will now need to configure artificial-intelligence capabilities into their online offerings.

There is no finish line in this race. Even as new store openings have slowed in recent years for most large retail chains, relative capital expenditures (CAPEX/depreciation and amortization expenses) continue to climb as omnichannel investments remain sizeable and currently exceed pre-pandemic relative investment levels by 20 percent in three out of five retail segments. All in all, it is a heavy and expensive lift for large retailers, while customers can be unrelenting in their expectations of retailers and unforgiving when those expectations are not met, such as charging for returns or restocking fees.

> **[E]ven as in-store traffic improves, the opportunity for browsing, discovery or impulse-buying within the four walls of a store will continue to slip without stepped-up efforts by retailers to hold customers' attention.**

As previously noted, shopping is no longer the leisurely activity it once was for many Americans. The CNBC article addressed the topic of purposeful shopping. Consumers today thoroughly research a product online before purchase and know exactly what they want should they choose to buy it or pick it up in a store. Consequently, even as in-store traffic improves, the opportunity for browsing, discovery or impulse-buying within the four walls of a store will continue to slip without stepped-up efforts by retailers to hold customers' attention.

The challenges confronting much of the retail sector are not acute across the board, so let's try to zero in on where the vulnerability is greatest. Affluent Americans are doing fine and still spending plenty, so high-end and luxury brands and retailers are not hurting for business. Stalwart names selling to better-off customers, such as Williams-Sonoma and Lululemon, are still thriving even without a COVID-19 tailwind and are not overly concerned about a consumer spending pullback. Furthermore, the online side of most high-end retailers has already evolved and been seamlessly integrated with stores.

Similarly, many smaller and savvy online retailers with a small store footprint selling branded lifestyle products to a targeted demographic audience are also excelling, connecting directly with that audience (often via social media) and using stores primarily to build brand awareness. Lastly, some of the largest retail chains selling to down-market customers but who have the scale and pricing flexibility to be responsive to pinched shoppers are also performing well, even as their customer base trades down or makes other spending compromises.

It is the huge soft middle where the biggest exposure lies for the retail sector — that is, mid-sized chains selling nondescript or lower-end brands of discretionary or non-essential goods to lower and middle-income shoppers who are cutting back on spending. These middling retailers are rarely destination stores but instead rely of the weekend flow of customer traffic to a nearby strip mall or larger shopping mall to catch a rush. Struggling mid-sized retail chains today, which fail to have distinct offerings or a value proposition, are likely to fade from the retail landscape without being missed by shoppers. That is the bullseye for retail distress in 2024 and beyond.

As business adversity sets in, distressed retailers will aim to close unprofitable stores and shrink their way back to profitability and relevance despite the spotty track record of such a strategy. For them, the clock is ticking once again. abi

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3 Melissa Repko & Gabrielle Fonrouge, "What Will Retail Look Like in Five Years? Top Industry Executives Share Their Predictions," CNBC (Feb. 16, 2024), *available at* cnbc.com/2024/02/16/future-of-retail-predictions.html (last visited March 22, 2024.

4 *Id.*