Surviving a retail downturn

CONSUMER MARKETS

China has had a bumper year for retail sales, but the signs of global economic slowdown are starting to be felt across the retail sector.

For retail executives, a consumer downturn is always frightening experience. In China, a decade and a half of strong economic growth and positive consumer sentiment has seen enterprises achieve continuing growth in sales and in many cases dramatic change in the scale of their businesses.

Many may be ill-prepared to deal with more difficult trading conditions. Indeed, sales growth has often masked poor profitability or even deeper financial, structural and management weaknesses. In a recent global survey by KPMG, only 14 percent of executives said their cash forecasts were accurate, while 81 percent said they had seen flat or deteriorating working capital over the last three years.[1]

Issues to address

Prudent managers will be hoping for the best and planning for the worst. In this regard, KPMG believes there are some key issues that retail executives should be alert to as they attempt to create a resilient business.

- **Incongruent objectives, performance indicators and incentive schemes**

  Most retailers are obsessed with sales. Sales figures are the traditional measure of retail performance and are typically the basis for measuring and rewarding individual and business unit performance.

  However, shrewd retailers are constantly reminding themselves that sales do not automatically translate into profits, particularly when discounts become more common. To assess the business's real commercial performance, managers should be looking at a range of other measures, or key performance indicators (KPIs). These can include gross margin percentages, gross margin dollars, sell-through percentages, cash flows and working capital days. Thus, aggressive discounting will often meet sales targets, but at the expense of gross margin dollars. In fact, deep discounting may signal a retail business is in financial difficulty.

1 KPMG International: The importance of preserving cash in a downturn, published November 2008

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- **Weakening cash position**

  In difficult times, the need to generate gross margin must be carefully balanced against the primary need for cash. The management of the economic life line of the retailer must be paramount. In an environment where supply is exceeding demand, retailers must balance the temptation of purchasing inventory at a discount with the need to introduce greater flexibility to the supply chain and preserve cash.

- **Activity that fails to add value**

  Over time many retailers accumulate reporting and management baggage that adds little or no value to the organisation, but absorbs time and resources that could be profitably spent elsewhere in the business. There is often too much emphasis on historical reporting with insufficient attention given to leading indicators. Reporting often lacks timeliness and a failure to identify and highlight important business trends.

- **Poorly understood relationships and dependencies**

  Managers and employees working in separate 'silos' fail to grasp the enterprise business model and how their efforts add (or detract) from enterprise performance. Communication and collaboration is discouraged. Core business and resource management processes are overlooked or ignored. Misdirected cost cutting harms rather than enhances business performance.

- **Micro-management**

  Excessive, or micro, management is defined as highly centralised decision making and management by intervention rather than exception. Its symptoms include a lack of empowerment, sluggish responses to changing business conditions, inflexibility and a proliferation of paperwork. Fast growing retail businesses often suffer from micro-management because the original managers and proprietors fail to adapt their behaviour and practices to what has become a larger and more decentralised business structure.

  A transparent performance measurement framework that rewards behaviour consistent with corporate objectives eliminates the need for micro-management.

- **Excessive employee turnover**

  Retailing traditionally suffers from high employee turnover. Repeated studies of retail enterprises have shown that that high staff turnover impairs business performance. The poor performers not only experience high turnover, but also tend to lose their best workers whilst retaining the time-servers. Good employees soon learn that they can obtain more recognition and reward elsewhere.

Retailers' checklist: Steps to consider in a downturn

	Immediate/short term	Medium/long term
Store rental issues	• Engage landlords to negotiate rent relief, discounts or deferrals • Reconsider expansion plans • Defer all non-essential fit-out or renovation expenditure	• Review lease terms for early exit • Exit poorly performing stores • Downsize stores and reduce working capital requirements accordingly
Stock and suppliers	• Liquidate old stock • Conduct more targeted or micro-marketing (e.g. of VIP or loyalty clients) • Reduce or cut purchase orders not yet delivered • Work with key suppliers to squeeze more cash out of the supply chain • Avoid paying cash up front and mitigate supplier continuity risk by conducting due diligence and using multiple suppliers where possible	• Maximise stock sell-through rates (i.e. volume based sales promotions) • Consider removing slow moving unprofitable lines • Consider introducing value lines to appeal to the cost conscious customer • Develop closer collaboration with suppliers and manufacturers and rationalise supply chain
Labour	• Freeze recruitment and reduce temporary and casual staff shifts • Redeploy staff from quieter stores • Consider temporary wage cuts, voluntary redundancies, and/or increasing working hours	• Cross-train staff, shift back office staff to the front line and reduce support staff • Link staff incentives to operation goals • Redundancies – ensure that high performance staff are retained
Finance and support functions	• Ensure that cash flow forecasts are accurate and that future cash requirements are identified • Accelerate collection of receivables due from non-core trading • Defer all non-essential expenditure • Avoid using working capital for capital infrastructure projects • Be vigilant for longer duration in receivables from credit card companies	• Link incentives to working capital improvements as well as profits • Renegotiate or reschedule principal and interest payments with finance providers • Consider outsourcing options • Dispose of non-core assets where cash requirements have been identified • Consider sale and lease-back of owned stores, disposal of warehouse of back office premises • Automate the payments system
Tax issues	• Assess tax risks, plan and mitigate compliance • Look for tax inefficiencies relating to indirect tax and customs	• Consider proactive conflict resolution approaches such as advance pricing arrangements (APAs) to minimise risk of a tax audit

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Conclusion

A retailing downturn often jolts key managers into the realisation that their existing business model and level of commercial performance is unsustainable.

This is not the time to panic, however. When facing margin pressures, businesses often implement rapid and broad cost cutting measures. These may deliver short-term benefits, but not get to the heart of cost drivers. At worst, these measures impact business operations and may hamper future business growth. While companies need to act decisively, they need to balance short term concerns (for example, shoring up cash and working capital) against longer term objectives (positioning the company to recover strongly when the economy rebounds).

Even successful, well managed and financially sound retail enterprises should think about how they will manage the downturn to minimise any damage to the long-term viability of the business. They need to manage the risks associated with more financially vulnerable suppliers and vendors. They also need to position themselves to take advantage of business opportunities that can result from competitors' problems. Those retailers in a stronger position can identify opportunities for consolidation and growth.

Contact us

KPMG China has a long track record working with distressed companies as well as companies seeking to improve their performance and better manage risks. In a downturn, reviewing cash means looking beyond working capital to consider value that can be extracted in areas such as tax, treasury, property and procurement.

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