

CIT Executive Spotlight: Retail Trends with John F. Daly

Q: What are your thoughts about the current state of the retail industry?

A: No doubt, 2008 has been a tough year for the retail industry. I have been in this business for 35 years, and this is one of the most difficult retail environments I have seen in my career.

There are a number of different dynamics occurring in the economy at the present time which many say are creating the “perfect storm” for retail. Many retailers are highly leveraged and, as we have seen with the rash of Chapter 11 filings so far in 2008, they are buckling under the weight of their debt load as a result of rapid expansions, acquisitions or over-leveraging. Add to that the fact that their overhead and cost of goods are increasing while they are trying to maintain low prices to attract consumers in this tightening economy. For many retailers, comparable sales have been down dramatically. So far in 2008, there have already been dozens of bankruptcy filings in industries such as furniture, apparel and jewelry. (See accompanying chart)

At the same time, the financial markets have been in turmoil and access to commercial paper has dried up, making it a difficult climate for companies to access capital.

Q: How does the uncertainty with retailers affect the demand for factoring?

A: In general, when there have been times of uncertainty with retailers, demand for factoring has gone up.

When a major retailer files for bankruptcy, manufacturers and importers that are hit with a bad debt loss start thinking seriously about protecting their accounts receivable with credit protection or factoring services. Unfortunately, that is like buying homeowners insurance after your house had a fire; it’s important to protect yourself for next time, but you could have saved a lot of money and misery if you would have gotten the protection you needed earlier on.

Small and middle market suppliers tend to be hurt the most when their large customers go bankrupt. These companies are entrepreneurial in nature, managed by owner-operators who have much of their own capital tied up in the business.

These are also the types of companies that make up the majority of the clients of the U.S. factoring industry. These privately owned businesses generally do not want to risk additional capital by extending credit to their retailer customers. They prefer to focus their efforts on sales, marketing, design and sourcing, not credit analysis and chasing overdue invoices.

Using factoring services is another example of how vendors outsource ancillary services so they may focus on their core competencies. Just as they may outsource production to overseas factories, many vendors outsource credit



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Representative List of 2008 Retail Bankruptcies

January	Friedman’s Jewelers
February	Fortunoff Wickes Furniture Company Sharper Image Lillian Vernon
April	Home Interiors and Gifts RedEnvelope
May	Linens ‘n Things
June	Goody’s Family Clothing Whitehall Jewelers Holdings
July	Mervyn’s Steve and Barry’s Shoe Pavilion
August	Boscov’s
November	Tweeter Circuit City

protection and accounts receivable management to a factoring company. As part of a comprehensive service, the factor may also provide bookkeeping, ledgering and collection services.

By engaging a factoring company, the vendor benefits from improved cash flow, elimination of bad debts, reduced operating expenses, expanded working capital financing and real-time on-line access to detailed payment information, all at a cost that is most likely lower than if they had managed these functions in-house. Plus many vendors simply cannot get access to the skill sets and technology necessary to perform these functions efficiently and effectively on their own.

Q: How does factoring work and how do factors make decisions?

A: Factoring clients look to their factor to protect them against bad debt losses. The factor performs the credit analysis on its clients' customers (typically retailers) and then typically assumes the credit risk on accounts receivable due from their customers. In the event a retailer becomes insolvent, or financially unable to pay, the factor will pay the client for the full undisputed amount due on all credit approved accounts receivable.

Based on the factor's credit analysis, and the needs of its clients, 'credit lines' are established for each retailer, a portion of which the factor uses when its factoring clients ship to their retail customers.

The credit lines a factor establishes for a specific retailer may be millions or tens of million of dollars, depending on how large the retailer is and how many of its clients ship goods to that retailer.

Note that the 'credit lines' I am describing are not loans to retailers. Several financial institutions (CIT included) have divisions which make loans to retailers. That is a different service than factoring, although a factor and a lender often touch the same retailers.

Q: Have you changed the way you evaluate retailer creditworthiness, given the current economic environment?

A: No. Regardless of the economic cycle, we continually reevaluate the creditworthiness of our retail customers. The lines of credit that we extend to retailers reflect our confidence in their creditworthiness. Credit decisions are based on the financial condition of the retailer, its liquidity and its pay history. If any of these variables change, we may reevaluate the total line of credit for that retailer.

If we have indications that a retailer's financial condition is deteriorating, we consider lowering the credit line to that retailer. This, in turn, may affect the amount of orders approved for our clients for that retailer.

Today, it is no secret that quite a few retailers are under financial strain. Our reaction is to watch the financial performance of those retailers ever more closely and to react accordingly in an effort to cut our own losses in the event a retailer becomes insolvent.

We are keeping a close eye on retailers' leverage and margins. We are looking at the retailers' revenue stream, i.e. is it enough to pay the retailer's obligations? We are looking for early warning signs of liquidity problems. Retailers that are not leveraged are better able to withstand an economic slowdown and a protracted

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period of margin compression. Retailers that are over-leveraged will have difficulty in an environment like this.

Q: It sounds like any importer or vendor that is worried about the creditworthiness of their retail customers should call you.

A: I can tell you that factoring companies are pursuing new business as aggressively as ever. But I caution suppliers who expect unconditional factoring support in cases of obvious extreme credit risk. Generally, companies that are very market focused and inquire about factoring when they see the earliest signs of a problem at retail can get some level of credit protection. Suppliers that start looking for credit protection after they read an article in the newspaper that a retailer is going to file Chapter 11 next week won't get credit protection from any factor.

Q: What retail models are surviving or even thriving in the current environment?

A: The obvious models that are doing well are big-box value players such as Wal-Mart, the discounters such as TJX, value convenience players like Dollar General. In the apparel space, inexpensive and fast fashion retailers have a good business model for this environment, such as H&M and Zara. They turn inventories quickly and are aimed at a young audience delivering the latest trends while not over-committing deeply to any style, hence keeping risk low in what seems at face to be a high-fashion/high-risk business. Another model is the vertically integrated retail brand model exemplified by J.Crew. Control over production and uniqueness of product enable this type of company to avoid many of the pitfalls, most notably competitor price discounting, facing retailers that sell multi-branded merchandise. As I mentioned earlier, it is important to have a multi-channel approach in today's retail world.

Q: What are the implications of the current economic environment and the weakness with retailers for the factoring industry?

A: Factors need to be more vigilant than ever when it comes to monitoring customer credit. As an industry, we will be making tough retail credit decisions. Having a continuous dialogue with clients certainly helps our clients understand why we make the decisions we do, but it does not guarantee that they'll be happy with our decisions.

We believe that a factor's diligent retail credit evaluation process delivers a vital benefit to vendors in that a factor may be able to detect potential signs of concern early.

We also have to be vigilant when lending to our clients. We know retail sales are soft, and that will translate into lower sales for many vendors. We are working closely with our clients to make sure their debt levels are manageable.

Q: Do you have anything else you would like to add?

A: This is probably not the worst retail slowdown that we will endure, nor will it be the last. It's all part of the global economic business cycle. I am confident that the factoring industry will continue to work with its clients to develop credit protection and financing solutions to meet their business needs. After all, when our clients are successful, we are successful. ■

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