



AS RETAILERS SCRAMBLE TO INNOVATE, COST CONTROL SHOULDN'T TAKE A BACKSEAT

Large retailers continue to feel unrelenting pressure to deliver on all fronts in today's consumer-empowered marketplace. Shoppers have more power at hand (literally!) than ever with respect to product reviews, comparison shopping and price discovery.

As we have discussed in previous articles¹, competition across formats and channels, in combination with ever-demanding shoppers, has forced retailers to invest aggressively across shopping channels and to embrace creative or complex business strategies, from redefining brand images, revamping store layouts and revising customer reach platforms, to further integrating omnichannel elements. However, as retail executives fight to stay relevant in a fiercely competitive market, they must also be mindful of controllable costs, which can run amok amid these many initiatives. Preserving an appropriate cost structure will reinforce accountability across the enterprise and promote financial stability while business initiatives take root. As retailers are compelled to adapt and innovate, the right strategy, investment initiatives and implementation will be the primary determinants of success or survival, while a disciplined cost structure will provide more financial runway for these efforts.

1. Recent articles include "[Customer is King](#)," "[I'm a Retailer, Should I Ditch my Brick-and-Mortar Store?](#)," and [our recent retail survey](#).

Creating SG&A scale and reorienting expenses (“fuel for growth”) has been a fundamental mission of clients in FTI’s Retail & Consumer Products practice for several years. With this in mind, FTI has evaluated the statistical relationship between cost management and relative market valuation.

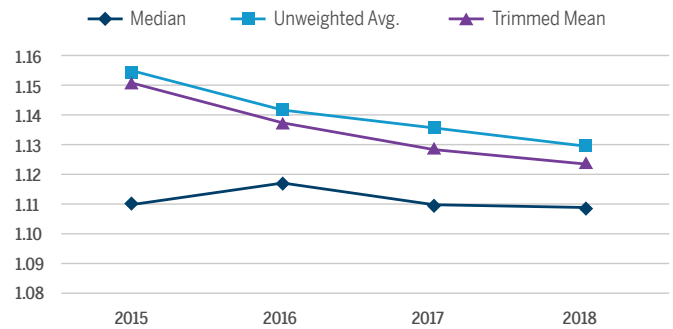
We utilized a single metric to measure the effectiveness of an organization in this regard. The resulting metric, referred to herein as the Fixed Operating Cost Coverage Ratio (“FOCCR”) is defined as gross profit divided by the sum of SG&A expenses (excluding depreciation expense) plus capital expenditures (“CAPX”). We include CAPX in the FOCCR ratio because most CAPX outlays by retailers these days are tagged as maintenance CAPX, given the falloff in new store openings. As a rule of thumb, maintenance CAPX for retailers runs at approximately 2%-3% of sales per annum. Ideally, store occupancy costs would be included in the denominator of this ratio rather than cost of sales. For purposes of interpreting the FOCCR metric, a larger value is almost always preferable. (One exception being a retailer that achieves a high FOCCR by badly under-investing in its store base). For companies in the same industry sector, FOCCR can be used to compare peers at a moment in time or to evaluate a company’s performance over time. We measure FOCCR on a trailing four-quarter basis to eliminate the impact of seasonality on the ratio if quarterly data were used. For any given company, FOCCR tends to be a relatively stable ratio from quarter to quarter; that is, it doesn’t vary significantly over short periods of time. However, there are trend effects across a longer stretch of time, where it can quickly become apparent if a company’s performance, as measured by FOCCR, is improving or deteriorating.

Consistently high or positively trending FOCCR is indicative of strong operating performance or underlying improvement. While operating costs and capital investment occasionally may spike as companies implement business initiatives, such efforts should be rewarded with stronger sales and gross profit that represent returns on these investments, thereby bolstering FOCCR in subsequent periods. Again, we mitigate much of this potential lumpiness in FOCCR by computing it on a trailing four-quarter basis.

Poor cost control in retail can come in two varieties: companies that choose to spend aggressively and too liberally as they undertake transformation initiatives in undisciplined ways or in efforts that don’t bear enough fruit; and those slowly stagnating to the point where an incumbent cost structure is no longer appropriate. If sales and/or gross margins trend weaker without commensurate reductions in fixed costs, eventually that will become evident in the FOCCR metric. When FOCCR trends lower, it likely does so because senior executives are reluctant to acknowledge that top-line weakness is persistent or irreversible and are late to make needed right-sizing adjustments. As we have heard countless times, the turnaround is always one quarter away.

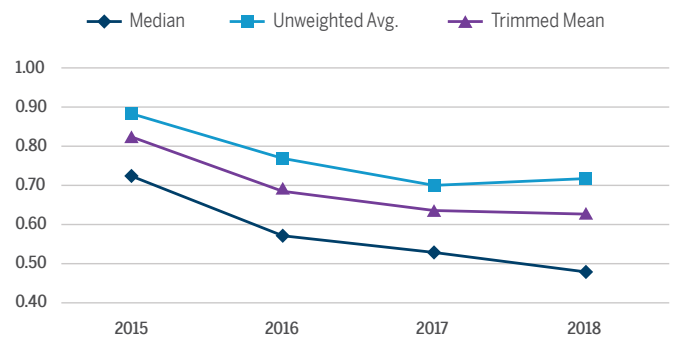
We calculated FOCCR for 96 public retailers over the most recent four-year period, which provided a “big picture” view of standouts and laggards. Generally speaking, we see that FOCCR has trended lower since 2015 for our data set as a whole (see **Exhibit 1**).

EXHIBIT 1
Fixed Operating Cost Coverage Ratio
Gross Profit/(SG&A + CAPX)



Subsequently, we computed relative market valuation multiples of these same retailers over this time frame, using Total Enterprise Value (“TEV”)-to-Sales, a less volatile metric than the more popular TEV-to-EBITDA multiple, which becomes meaningless when EBITDA approaches zero or is negative. Here too we see that relative valuations for our data set as a whole have slumped in recent years (see **Exhibit 2**).

EXHIBIT 2
Relative Market Valuation
(TEV/Sales)

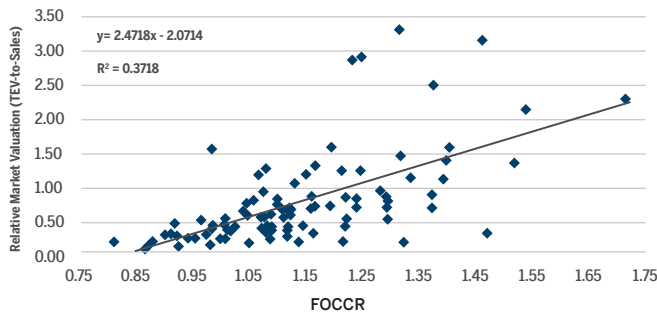


Regression analysis lets us examine the linkage between FOCCR and relative market value for our data set, and exhibits an impressively strong statistical relationship between these two variables, which underscores the importance of effective cost management to investors.

To visualize the explicit relationship between FOCCR and relative market value, refer to **Exhibit 3**, which is a scatterplot where each data point represents the coordinate of a company’s FOCCR and its relative market valuation over the last four years. As one would expect, the regression line is upward

EXHIBIT 3

Relative Market Valuation (TEV/Sales) vs. FOCCR [GP/(GS&A + CAPX)]



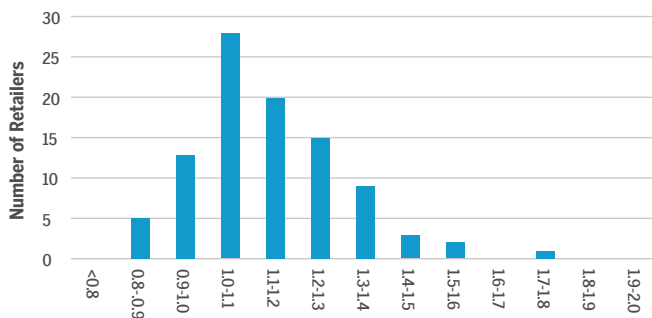
sloping, indicating a positive linear relationship between the two variables—that is, a higher value for FOCCR is associated with a higher valuation multiple. If companies' relative market valuations were solely attributable to FOCCR, then all data points would fall on the regression line. That, of course, is never the case, and the scatter of data points above and below the regression line represents the extent to which other independent variables impact relative valuation.

Our regression equation quantifies the linear relationship between FOCCR and relative market valuation, while our coefficient of determination (R-squared), which measures the strength of this relationship, indicates that 37% of the variability in relative market valuation is attributable to FOCCR, an impressively strong correlation for a single variable. The slope of the regression equation indicates that a 0.1 change in FOCCR (e.g., from 1.1 to 1.2) would impact a retailer's market valuation multiple by 0.247x sales. Alas, this is an abstraction: it's harder to achieve than it sounds.

Exhibit 4 is a histogram or frequency distribution of the FOCCR metric for our set of 96 retailers. At a minimum, any company should aspire for a trending FOCCR metric in excess of 1.0, as a lower value would indicate that controllable costs exceed gross profit. The FOCCR metric for a plurality of retailers (28) in our data set was between 1.0 and 1.1. Surprisingly, 18 retailers, or

EXHIBIT 4

Frequency Distribution of FCCR



20% of our data set, fell below 1.0, revealing an imperative for those companies to better manage costs.

Recently we've seen the interplay between FOCCR and relative valuation wreak havoc for At Home Group ("HOME"), a \$1 billion superstore-based home furnishings retailer. HOME embarked on an aggressive business strategy several years ago, more than doubling its store base since 2015 at a time when total category spending has been middling—and migrating online as well. HOME's FOCCR metric has been well under 1.0 in the four years we have tracked it, among the lowest in our data set, and has continued to weaken, mostly due to extremely aggressive capex spending. HOME has been one of very few retailers to open new stores so aggressively in recent years—a calculated business risk for a retailer without an e-commerce platform. It was a stock market darling while the story was good, but disappointing operating results of late have caused investors to reevaluate the company, whose market value has tumbled 75% since mid-2018. This is not to say that FOCCR alone foretold what would unfold but, at a minimum, HOME's persistently low FOCCR metric over several years running was indicative of a high-risk retailer that likely could not sustain its gung-ho business strategy. Conversely, Five Below, another retailer opening new stores at a rapid clip in recent years, enjoys one of the best FOCCR metrics in our data set due to the low investment cost of new stores and their rapid payback periods.

Disruption across the retailer sector has placed immense pressure on traditional retailers to deliver on innovation and technology-driven business solutions—areas not normally in the wheelhouse of most grizzled retail executives. Whether it is providing a seamless omnichannel experience, delivery/pick-up solutions or an improved customer experience, the demands on large retailers remain daunting more than two decades after the advent of online retailing. To make matters worse, retailers continue to bear nearly all costs associated with the transition and maintenance of an omnichannel business. Shoppers have shown they will not absorb costs associated with fulfillment, shipping or returns, which continues to dent retailers' operating margins and ROI.

The utmost priority for retail executives should be to continue navigating the transition to omnichannel excellence, but cost control still matters, as it always has. Spending that doesn't improve competitive advantage should be scrutinized and closely managed. This may sound like old-fashioned, common business sense, but our analysis demonstrates that effective cost management also matters to investors, who tend to ascribe higher valuations to retailers that do it well, consistently.

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