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## Industry Overview

Some 400,000 specialty retail stores operate in the US, with combined annual sales of about \$350 billion. Large specialty retailers include Gap, Best Buy, Sports Authority, Barnes & Noble, and Toys "R" Us. The market consists of **shoes** and **clothing** (\$125 billion); **electronics** and **appliances** (\$85 billion); **jewelry** (\$25 billion); **sporting goods** (\$25 billion); **books** (\$15 billion); **toys, music, luggage**, and **pet supplies**. The typical specialty retailer operates a single store, with annual revenue under \$1 million.

## COMPETITIVE LANDSCAPE

Demand for many specialty retail goods is driven by gains in **consumer income**. Large competitors can offer lower prices because they buy in quantity. Small retailers can compete with large ones by offering different merchandise or providing a higher level of service. Despite the presence of some large chains, specialty retail markets are highly **fragmented**. Barnes & Noble, for example, with over 900 stores, is the largest US bookseller but has a market share of only about 15 percent.

## PRODUCTS, OPERATIONS & TECHNOLOGY

**Merchandising** is the main preoccupation of most retailers, especially in fashion-driven markets like women's clothing and computer games. Merchandise decisions must usually be made many months ahead of the actual receipt of the product in stores. Many product purchases are made at **trade shows**, also a major source of information about new products. Purchasing terms vary widely by market. In the retail book market, virtually all unsold book purchases can be returned to publishers at full credit; in the clothing business, returns of unsold items are unusual.

**Inventory management** is closely tied to merchandising. A good inventory information system will identify which items sell well and which don't. Specialty retailers must generally stock a wide range of items, although only a limited number are big sellers. Even small toy retailers stock 15,000 items, while the typical Barnes & Noble bookstore carries between 60,000 and 175,000 titles. Theft from stores and inventory (**inventory shrinkage**) is such a big problem that many retailers put electronic tags on merchandise.

Specialty retailers sell one type or product, as opposed to department stores that sell many different kinds. Like other retailers, they acquire selling locations, hire, train, and supervise store personnel, buy merchandise, manage inventory, and market products to consumers. Unlike department stores, which offer the convenience of shopping for different products in one location, specialty retailers offer a much larger selection of items within a product category. **Numerous market segments** can exist within each product specialty. Limited Brands operates six different store chains targeting different segments of the women's clothing market.

Although specialty retailers may operate stand-alone stores in urban locations, most operate from leased space in **shopping centers** - either strip centers, enclosed malls, or newer stand-alone "superstore" malls. Some retailers lease space in department stores; Finlay operates 1,100 jewelry locations in 30 department store chains. **Lease terms** in shopping centers often call for a five- to ten-year contract; rents typically include a base payment and a percentage of sales. **Failure rates** for individual stores are high. Retailers with more than one store often operate one or several distribution centers that receive all merchandise from manufacturers.

## FINANCE & REGULATION

Many retailers have **highly seasonal sales** and therefore **seasonal inventory levels**. Toy retailers generate the

majority of their sales and profits in fourth quarter while clothing retailers depend on the spring and fall seasons.

**Bank financing** for inventory and store fixtures is common. Inventory financing for fashion-sensitive items, like toys and women's apparel, can be risky. Retailers often judge their effectiveness by measuring inventory turnover. **Receivables** are usually low since most purchases are for cash or made with third-party credit cards. Larger retailers may issue a credit card that carries their name but is operated by a third party, or may run their own credit card operations. Retailers often have **high gross margins**, close to 40 percent in many segments, but relatively **low net margins** because advertising and other expenses are high.

Although the retail industry is largely **unregulated**, state attorney generals and the **Federal Trade Commission (FTC)** enforce laws against deceptive sales and advertising practices, predatory pricing, and monopolistic behavior under state laws and the Federal Trade Commission Act.

## HUMAN RESOURCES

Wages are low, about a **third less** than for all US workers, partly because the skill level required of most sales staff is fairly low. **Personnel turnover** is high, averaging 50 percent per year. Many companies regularly use part-time workers because sales volume varies during the day and week, as well as seasonally. Limited employs 30,000 full-time and 90,000 part-time workers, not counting temporary employees hired during peak sales months.

## Recent Developments



### MONTHLY NEWS

#### [In praise of the heavy spender](#)

The Globe and Mail, 21 May, 2007, 878 words

With virtually every category of retail products a very simple segmentation exists that is potentially much more powerful than any demographic or social-economic scheme being used: the heavy versus the light spender. If you are a ...

#### [Big deals expected soon](#)

The News & Observer, 19 May, 2007, 504 words

The usual summer flood of new leases and new stores has died down a bit this month -- mostly because many of our area's retail moguls have been busy preparing for the International Council of Shopping Centers' annual convention in Las ...

#### [CLOTHES OUTSELL PCS, SOFTWARE ONLINE IN '06](#)

South Florida Sun-Sentinel, 15 May, 2007, 621 words

Maybe Americans don't need dressing rooms after all. For the first time since online retailing was born a decade ago, the sales of clothing have overtaken those of computer hardware and software, suggesting that consumers have reached a ...

### QUARTERLY INDUSTRY UPDATE

**Organized Theft Drives Up Retail Loss** - The rate of retail loss increased for the first time in four years in 2005, according to a study conducted by the University of Florida. Retail chains are blaming organized retail theft from stores and warehouses for the rise in incidents. Experts say retailers will use video monitoring to spot unusual behaviors or activity patterns and can alert store employees to potential organized crime activities.

**Personal Income, Spending Up** - Rising disposable personal income and personal consumer expenditures are major drivers for increasing specialty retail sales activity. US disposable personal income rose 4.6 percent in the fourth quarter of 2006 compared to the previous quarter. Meanwhile, US personal consumer expenditures increased 3.6 percent in the fourth quarter. Experts note, however, that rising consumer debt may slow consumer spending in 2007.

**Falling Home Sales Hurt Retailers** - US sales of new homes fell 17.3 percent in 2006 compared to the previous year. Experts say declining home sales are likely to negatively impact sales at specialty stores. The number of US consumers who said they spent more on home furnishings in 2006 than during 2005 declined 16 percent compared to consumers who said they spent more on home furnishings in 2005 compared to 2004, according to Forward Inc.

## Business Challenges

### CRITICAL ISSUES

**Retailer Revenue Tied to Job Growth** - Job growth and personal income help determine consumer spending, all indicators of retail business growth. Retail sales grow rapidly during periods of strong economic growth, as consumers spend a greater share of their income and increase the amount of debt they carry. Specialty retailers, precisely because they specialize in only one type of merchandise, may be disproportionately affected by economic fluctuations.

- ▶ The index of US personal consumer spending, a major indicator of specialty retail sales, increased 2.3 percent in December 2006 compared to a year ago.

**Competition from Mass Merchants** - Mass merchandisers like Wal-Mart and shopping clubs like Costco provide strong competition to specialty merchants by effectively creating large, low-cost specialty departments within their superstores. These stores can sell a wide range of popular merchandise at low prices because of the large volume of business they do.

- ▶ Wal-Mart and Target have begun offering extended warranties on consumer electronics that often match those offered by specialty retailers in an attempt to increase sales of consumer electronics.

### OTHER BUSINESS CHALLENGES

**Competition from Catalog, Internet Sales** - More specialty retail items are being bought from catalog and Internet retailers like Amazon, which can offer a broader selection of merchandise. Internet retail sales increased from about \$20 billion in 2000 to more than \$100 billion.

**Seasonal Cash Flow** - Typically, specialty store products are bought for back-to-school, seasonal, or holiday needs, or around Christmas time for gifts. Normally, specialty store sales are highest in third and fourth quarters. Merchants typically generate 40 percent of business around Christmas. Other sentimental holidays, like Easter, Valentine's Day, Mother's Day, and Father's Day, generate significant sales.

**Concentrated Vendor Risk** - Specialty retailers, because they have a narrower product assortment, have fewer suppliers than most other retail industries. Fewer vendors open specialty retailers to greater risk of supply disruption and pricing pressures.

**High Employee Turnover** - Employee turnover in the retail industry is very high, averaging 50 percent per year, largely because of low pay. Hiring and training new personnel is a constant activity for most retailers.

**Product Theft** - Employee theft continues to be the leading cause of product loss, known as "shrink," at retailers. Losses from employee theft have reached record levels, with internal theft costing US retailers \$15 billion annually, according to National Retail Federation (NRF).

## Trends & Opportunities

### BUSINESS TRENDS

**POS Computer Systems** - Many retailers now use bar coded sales tags to enter information into central computers at cash registers. These point-of-sale (POS) systems allow retailers to track sales of specific items daily, identify popular and unpopular items, track inventory, and automatically order more product.

**Chain Expansion** - Most retail markets remain highly fragmented, but large chains have expanded rapidly in recent years, especially in large metropolitan centers. Although some chains have expanded by buying competitors, another trend has been to open new "superstores" that follow a format successful in other markets.

**Supplier Consolidation** - The growth of specialty chains has encouraged consolidation among suppliers and manufacturers in many markets because large chains want to buy large quantities and prefer to buy from fewer manufacturers. Fragmentation continues in markets like jewelry and clothing (The Limited buys from 4,700 suppliers); however, the toy market is different: Toy Co. buys a large portion of its products from just five manufacturers.

**Credit Card Fraud** - Credit card fraud is measured by the chargebacks on transactions in clearing a bogus charge. On the Internet, chargebacks are more than three times higher than all other credit card processing mediums combined, according to Visa. Retailers are responsible for chargebacks on credit card transactions where the credit card is not physically present, incurring high fees for chargebacks, return fees to customers, and returned merchandise.

## **INDUSTRY OPPORTUNITIES**

**Frequent Buyer Rewards** - More malls and individual stores are issuing so-called "frequent buyer" cards that give discounts and other rewards once shoppers have spent a certain amount. In addition to building customer loyalty, such cards can provide valuable market research information about shopping habits.

**Sophisticated Market Research** - Consumer research has become more sophisticated in identifying the inducements that will bring shoppers into retail stores. Stores now can deploy direct mail coupons, catalogs, special promotional events, and telemarketing to zero in on exactly the type of shopper they're looking for.

**Website Sales** - Although many specialty retailers have established Internet sites where customers can order products and make credit card payments, Internet sales as a whole are a small 2 percent of total US retail sales. Some retailing specialties, such as books, are very suitable for Internet sales, but jewelry, apparel, and low-cost items, such as pet foods, haven't sold very effectively on the Internet.

**Improved Inventory Management** - Radio frequency ID tags (RFID) may soon be cheap enough to place on individual retail items as a substitute for bar code tags, greatly increasing stores' ability to manage inventory and prevent theft. Some large retailers are testing such tags as a way to track bulk product shipments, but cost is so far an impediment to wider use.

## **Call Preparation Questions**

### **CONVERSATION STARTERS**

**How does the company protect itself from revenue fluctuations caused by economic cycles?**

Job growth and personal income help determine consumer spending, all indicators of retail business growth.

**How have giant discount merchandisers, like Wal-Mart, impacted the retailer's sales?**

Mass merchandisers like Wal-Mart and shopping clubs like Costco provide strong competition to specialty merchants by effectively creating large, low-cost specialty departments within their superstores.

**How are competitors' catalog and Internet strategies affecting the company?**

More specialty retail items are being bought from catalog and Internet retailers like Amazon, which can offer a broader selection of merchandise.

**What market research does the company do (on customers and products)? How successful has the research been for increasing sales?**

More malls and individual stores are issuing so-called "frequent buyer" cards that give discounts and other rewards once shoppers have spent a certain amount.

**How is the company advantaged or challenged by offering frequent buyer or discount programs?**

Consumer research has become more sophisticated in identifying the inducements that will bring shoppers into retail stores.

**What benefits has the company gained from new Internet shopping capabilities?**

Although many specialty retailers have established Internet sites where customers can order products and make credit card payments, Internet sales as a whole are a small 2 percent of total US retail sales.

### **QUARTERLY INDUSTRY UPDATE**

**How is the company being affected by declining US home sales?**

US sales of new homes fell 17.3 percent in 2006 compared to the previous year.

**How can the company minimize loss due to organized theft?**

Many retailers blame a rise in retail loss in 2005 on organized theft from stores and warehouses.

## **OPERATIONS, PRODUCTS, AND FACILITIES**

### **What is the typical time between ordering merchandise and actual delivery to stores?**

Most manufacturers make products only after they're ordered.

### **Is a significant volume of product bought at trade shows?**

These are often used to find new merchandise and new suppliers.

### **How many stores does the company have?**

A typical specialty retailer has just one location, but there are many chains.

### **How big are the stores?**

Large retail stores can be 20,000 square feet.

### **What types of products does the company specialize in?**

### **Does the company operate a distribution center?**

Chains frequently handle their own store deliveries from a distribution center.

### **How many items does the company stock?**

There are usually thousands of items to track.

### **Are the stores in malls, strip centers, or stand-alone?**

Most stores operate out of leased space in shopping centers.

### **Does the company buy directly from manufacturers or distributors?**

Large volume purchases may be made directly from manufacturers.

### **What type of inventory replenishment does the store use?**

The majority of specialty retailers use automatic replenishment; the remainder use model stock levels.

## **CUSTOMERS, MARKETING, PRICING, COMPETITION**

### **What is the typical purchase amount?**

This varies according to the type of merchandise and the market segment, but most retailers watch this amount carefully.

### **What demographics does the company sell to? Is this a growing segment of the population?**

Many retailers target specific demographics. Mature market segments can also be lucrative.

### **How are merchandising decisions made about specific items to sell?**

Senior executives are often intimately involved in merchandising decisions.

### **Does the company price products with specific competitors in mind?**

Companies may consciously price over or under a specific large competitor.

### **Does the company have regular sales or price markdowns to move old inventory?**

Sales are frequent in the apparel business.

### **Who are the retailer's major competitors?**

Competitors can be other specialty retail stores, discount retailers, or department stores.

### **What types of advertising does the company do?**

Print, radio, TV, special events, and direct mail are all used by specialty retailers.

### **How large is the advertising budget?**

Aside from purchasing, this is usually the largest expense.

### **Does the company do its own market research on customers and products?**

Many companies hire market research firms or survey their own customers about product preferences.

## **ORGANIZATION AND MANAGEMENT**

### **How many employees does the company have?**

### **What is the split between full-time and part-time workers?**

Many retailers have a majority of part-time workers, to adjust to peak selling hours.

**How many sales personnel work in a typical store?**

**How does the company minimize employee turnover?**

To deal with turnover, which averages 50 percent annually in the retail industry, some retailers offer flexible work schedules and discounts on store merchandise.

**How does the company find and train new employees?**

**How much autonomy do store managers have about merchandise and pricing decisions?**

Many chains centralize those decisions.

## **FINANCIAL ANALYSIS**

**What are annual sales per selling square foot at the company's stores?**

In apparel, \$300 is typical, but the range is wide, depending on the type of merchandise sold: more for jewelry, less for clothing.

**How seasonal is company revenue?**

Many retailers have highly seasonal sales and therefore seasonal inventory levels. Toy retailers generate the majority of sales and profits in fourth quarter, while clothing retailers have a spring and a fall season.

**How does the company manage seasonal cash flow?**

Sometimes retailers invest extra seasonal cash or borrow from a bank for seasonal inventory.

**Does the company have a seasonal inventory buildup?**

**How often does inventory turn over?**

Rapid turnover is especially important in fashion-driven business like apparel.

**Does the company typically have losses on unsold inventory?**

Disposing of unsold inventory at a loss is typical in the apparel and toy businesses.

**How long are the company's store leases?**

Lease terms in shopping centers often have a five- to ten-year term.

## **BUSINESS AND TECHNOLOGY STRATEGIES**

**What outlook does the company expect for its product category?**

**What new products does the company plan to sell during the next year?**

**How does the company plan to compete with mass merchants like Wal-Mart?**

**Does the company plan to expand into catalog and/or Internet sales?**

Because of the low sales expense, these can be very profitable, but the costs to establish Internet sales sites and manage order fulfillment are often high.

**Does the company use a point of sale (POS) computer system that links sales to inventory and ordering systems?**

Such systems are highly useful to manage inventory and identify popular and unpopular items. Wal-Mart was one of the first retailers to invest in highly computerized operations.

**How does management analyze optimal store location?**

Marketing studies of traffic counts, demographics, and retail purchasing trends are often used.

## **Financial Information**

### **ECONOMIC STATISTICS AND INFORMATION**

#### **Retail Annual Sales Growth - Census Bureau**

| 2002 | 2003 | 2004 | 2005 | 2006 |
|------|------|------|------|------|
|------|------|------|------|------|

|  |      |       |       |       |       |
|--|------|-------|-------|-------|-------|
| <b>453 Miscellaneous store retailers</b> | 0.0% | -1.0% | 4.2%  | 5.7%  | 7.7%  |
| <b>454 Nonstore retailers</b>            | 6.3% | 7.6%  | 13.7% | 11.9% | 11.0% |
| Total US retail sales                    | 2.5% | 4.4%  | 7.6%  | 7.2%  | 5.8%  |

## VALUATION MULTIPLES

### Specialty Retail

Acquisition multiples below are calculated using at least 285 private, middle-market (valued at less than \$1 billion) industry transactions completed between 1/1993 and 12/2006. Last update: February 2007.

| Valuation Multiple  | Equity/Net Sales | Equity/Net Income | MVIC/Net Sales | MVIC/EBIT |
|---------------------|------------------|-------------------|----------------|-----------|
| <b>Median Value</b> | 0.4              | 4                 | 0.4            | 3.9       |

Equity (Equity price) = Reported selling price

MVIC (Market Value of Invested Capital) = Equity price + Long-term liabilities assumed

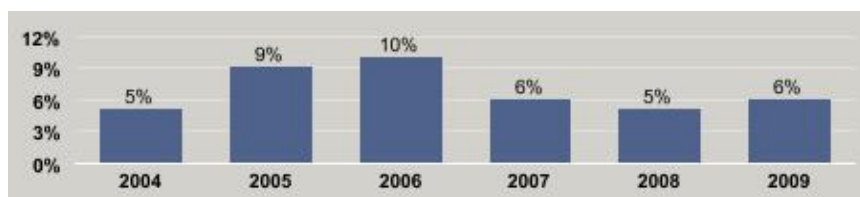
EBIT (Earnings Before Interest & Taxes) = Net Income + Interest expense + Taxes

SOURCE: Pratt's Stats™ (Portland, OR: Business Valuation Resources, LLC) To purchase more detailed information, please either visit [www.BVMarketData.com](http://www.BVMarketData.com) <sup>sm</sup> or call Business Valuation Resources at 888-287-8258.

## Industry Forecast

US personal consumption expenditures for specialty retail items, like jewelry, toys, cameras, sporting equipment, recreational boats, and aircraft are forecast to grow at an annual compounded rate of 5.5 percent between 2006 and 2009.

### Spending Growth on Specialty Retail Items Strong But Slowing



First Research forecasts are based on INFORUM forecasts that are licensed from the Interindustry Economic Research Fund, Inc. (IERF) in College Park, MD. INFORUM's "interindustry-macro" approach to modeling the economy captures the links between industries and the aggregate economy.

## First Research Opportunity Rating

The First Research Opportunity Rating is First Research's estimate of industry performance vs. industry risk over the next 12 to 24 months.



- Demand grows with consumer income
- But more competition from mass merchants
- And failure rate for individual stores remains high

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