FOOTWEAR RETAILERS

TARIFF ALERT

CURRENT TRENDS

- Tariffs hit imports of Chinese leather and textiles in September 2018, leaving retailers prone to passing along their increased costs or risk margin erosion
- The online sales channel continues to grow, albeit at a slower rate than the double-digit increases seen from 2009 to 2015
- Footwear stores' revenue declined in 2017 due to numerous store closures and the growing shift toward online shopping; the lack of growth continued for 2018 resulting in a slight decrease of 0.1% (projected)

PROJECTED VALUES
(12-MONTH OUTLOOK)

APPROXIMATE NET RECOVERY ON COST

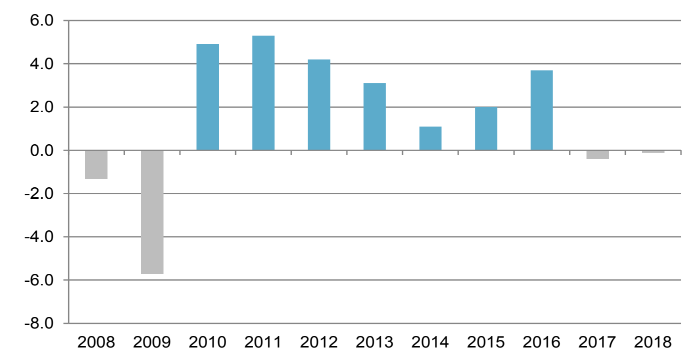
60-75%
family chains

70-85%
athletic chains

75-90%
mid-priced designer

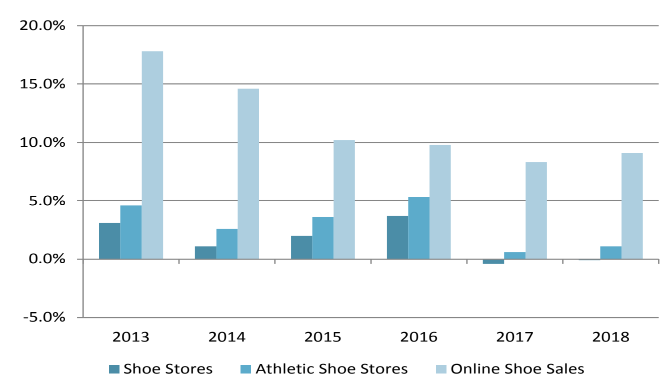
65-90%
high-end designer

REVENUE GROWTH - SHOE STORES IN THE U.S.



Source: IBISWorld

REVENUE GROWTH - BY CATEGORY



REFERENCE SOURCES: FOOTWEAR NEWS, THE WASHINGTON POST, RETAIL DIVE, CREDITNTELL, FIRST RESEARCH, IBISWORLD, AMERICAN APPAREL & FOOTWEAR ASSOCIATION, AMERICAN ENTERPRISE INSTITUTE, FOOTWEAR DISTRIBUTORS & RETAILERS OF AMERICA

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TARIFFS HIT THE INDUSTRY: Ninety-eight percent of America's shoes are manufactured abroad, with nearly three-quarters of those imports coming from China, according to the *American Apparel & Footwear Association*. In 2017, the United States imported over $14 billion worth of shoes from China, making footwear the fifth-largest category of Chinese imports, according an analysis of census data by the *American Enterprise Institute*. In September 2018, the Trump administration levied tariffs on $200 billion of Chinese imports including textiles and leather, two key components of footwear manufacturing. Footwear and apparel groups reacted harshly to the tariffs. Signaling a possible stay on current rates, on December 1, 2018 the Trump administration announced a 90-day hold on its plan to raise the tariff rate on these goods from 10 percent to 25 percent, as trade discussions with China continue to evolve.

With the prospect of increasing costs of goods, wholesalers and retailers' success will largely be determined by consumers' tolerance of price increases. For many borrowers, tariffs will be a non-issue, especially if they are able to push cost increases through the supply chain or constrain cost increases by shifting purchasing away from affected countries. From an inventory perspective, input cost increases will buoy the value of some firms' inventories in the short term. Once that product is sold, however, and is removed from inventory, that one-time gain will disappear. Thereafter the same volume of goods will require additional capital to procure and the price of finished goods must increase to maintain gross margins. Price increases may ultimately temper demand or compress margins to the extent that prices require discounting to sell through. Wholesalers and retailers are still assessing how tariffs will affect pricing to their end customers. Presently, affected products include imported Chinese and Canadian raw materials including cotton and leather.

Retailers face the perpetual challenge of assessing how much additional cost can be passed on to consumers while constraining their own costs of goods. Firms that are best positioned to do this include vertically integrated firms and those that have large buying power and relationships that enable effective supplier negotiations. To the extent that retailers can pass along these costs, and their gross margin and average discount rates remain consistent, NOLVs should also remain consistent. Lenders should continue to monitor these metrics in addition to comparable and new sales to ensure that customer goodwill remains stable. For those companies that depend heavily on products sourced from Chinese manufacturers, consumer price tolerance remains to be critically tested before customers seek alternatives or refrain from purchasing.

Values can be impacted quickly by factors including changing market prices, input costs, and altered buying patterns, among others. Given the current climate of uncertainty around tariffs and other economic factors, lenders need to monitor affected industries closely and partner with experts who can help them navigate through potential changes to current and projected inventory values.

The Expert: Becky Goldfarb

Bringing over 15 years of experience in the disposition and valuation of retail and consumer products, Becky Goldfarb oversees all aspects of retail asset valuations. Prior to that, Becky was responsible for the financial analysis of retail dispositions across all industry sectors. Read her full bio [here]

ONLINE CHANNEL CONTINUES TO GROW: The move away from mall-based retail combined with the convenience of online shopping has driven online footwear sales to year-over-year increases for the past 15 years. Amazon and subsidiary Zappos.com, along with Foot Locker Retail Inc. combine to generate over 36 percent of e-commerce shoe sales, a number that is expected to rise in the coming years. With footwear in particular, online selections make it easier for consumers to compare prices and styles of competing brands. Online retailers benefit from the shrinking market for full-priced footwear, instead capitalizing on frequent discounts and incentives. For the fourth quarter of 2018, Amazon's North America Retail sales increased 18 percent and its International Retail sales were up 15 percent, and the company's retail operations have now been profitable for three consecutive periods. For the third quarter ended November 3, 2018 Foot Locker's e-commerce sales were up 5.9 percent (on top of 6.1 percent growth for the same period last year), and now represent 14.5 percent of total sales. Foot Locker's online sales division outperformed its stores, which were up 2.4 on a comparable basis (following a 5.1 percent decline last year), indicating that its customers increasingly prefer shopping online.

Online specialty footwear retailers including M.Gemi and Allbirds continued to thrive in 2018, with both brands expanding into brick and mortar locations. M.Gemi now operates a freestanding store in Boston along with a shop-in-shop in Bloomingdale's flagship New York City store, with additional New York locations planned for 2019. Allbirds has also recently opened stores in San Francisco, New York, and London.

With mall vacancy rates at their highest in seven years, online footwear retailing can be expected to continue to represent a larger percentage of total sales. Indicative of the struggle to stay relevant, brick-and-mortar shoe retailers including the Rockport Group, Nine West Holdings, and The Walking Company all filed bankruptcy in 2018, following filings by Payless ShoeSource Inc. and Aerosoles in 2017. As of this publication date, Payless, having failed to find a going-concern buyer, confirmed that it would liquidate all of its 2,300 stores.

STOCK LEVELS DRIVE BUSINESS: In order to maintain sales volume, retailers must maintain considerable inventory levels and stockroom space. For every pair of shoes on display in a retail store, there may be a dozen or more in stock. The range of sizes, widths, colors, and fabrications by SKU needed to drive successful footwear sales can be a challenge as part of normal-course business and can present sell-through issues in a liquidation. A typical size run may include 12 pairs of shoes for a single SKU, ranging from size 6 to 10 for women and 8 to 12 for men with duplicates of the most popular middle sizes. Add less popular sizes on the high and low end, as well as narrow and wide widths, and a retailer may have 15 to 20 pairs or more in backstock for every SKU on the sales floor. Without this level of stock, retailers may suffer lost sales. In a liquidation, it is important to understand stock levels for footwear, especially as it relates to size ranges since availability of popular sizes is a primary driver of value. Broken size runs (i.e. runs missing the most popular sizes) lower gross recoveries.

Similarly, inventory mismanagement and shrink at the store level can contribute to instances of mis-mated pairs (different sizes within a pair) and single shoes (missing mates). Significant numbers of mis-mates and single shoes translate to lower gross recoveries on those units. For lenders with footwear retailers in their portfolios, partnering with an appraiser to analyze a company's in-stock position by SKU and understanding how to track sizing availability as part of routine collateral monitoring can be an important factor when faced with a liquidation.

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