Capturing Value in Retail:

UNDERSTANDING WHAT THE CAPITAL MARKETS REWARD

Retailers can often be quite frustrated with their valuations in the capital markets. Some retailers record strong sales and profit growth but do not experience a commensurate value increase in their market valuations. Others recognize performance gaps vis-à-vis stronger competitors but believe that their valuation discount relative to these competitors is simply too large. In both cases, these retailers puzzle over the same question: “why aren’t we getting more credit from the capital markets for our performance?”

The answer, according to our analysis of the financial and stock price performance of more than 475 publicly-traded U.S. retailers, is twofold: 1) the capital markets care about three things – return on invested capital, comp-store sales growth, and “new growth” over and above comp sales; and 2) the order in which these building blocks to value creation are accomplished is important (see Exhibit). Our research shows that:

- The fundamental cornerstone of value creation is return on invested capital (ROIC), which demonstrates a retailer’s ability to generate strong returns on the capital employed in its business. We have found that retailers without a strong and stable ROIC platform rarely get credit in the capital markets for the growth initiatives they may be pursuing.

- Comp-store sales growth is also valued by the capital markets and proves that a retailer’s core format is healthy and viable. Retailers who record significant sales and profit increases from new store growth, but who are viewed as having underlying health issues with their core formats, are not typically rewarded in the capital markets.

- “New” growth – growth over and above comp-sales growth (e.g., through new stores, international expansion, or development of new retail concepts) – is also a critical factor in achieving strong valuations over the long term. In fact, capital markets expectations of healthy future growth drive a significant portion of the high valuation multiples of leading retailers. Nevertheless, retailers typically do not receive credit for this growth unless the other two building blocks are already in place.

These insights have many implications for the areas on which today’s retailers should focus and how they should operate. Broadly speaking, the right next step for creating value depends on a retailer’s starting point on the metrics that matter to the capital markets. For retailers who get little respect from the capital markets despite positive results, the answer lies in understanding what is missing.

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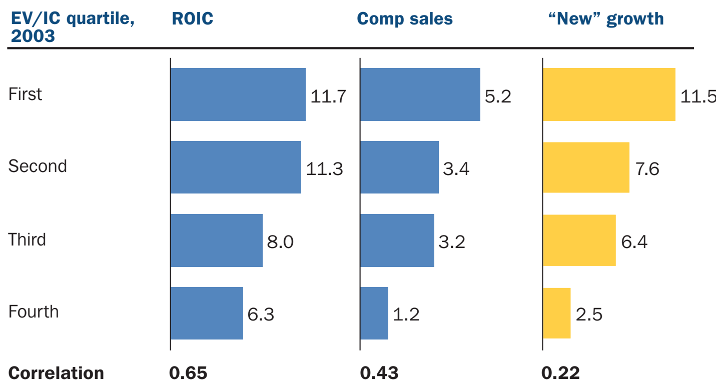
One retailer posted strong comp-store sales and had modest growth, but the markets were more concerned by its low ROIC, a sign that performance could not be delivered profitably. To ensure future value creation, this retailer would need an assortment of ROIC-boosting initiatives such as network restructuring, capital budgeting improvements, supply chain and/or merchandising redesign, and improvements in marketing spend effectiveness.

Another retailer had great ROIC performance and strong growth from its rapid rollout of new stores, but was experiencing modest declines in its comp-store sales. Despite strong performance metrics on ROIC and overall growth, the capital markets penalized the retailer for not resolving its declining comp-store results. The retailer's market valuation would likely have been higher if it had focused on revitalizing its core format – addressing consumer concerns with the format and developing specific strategies to attract and retain new customers to the store.



Source: Compustat; SEC filings; team analysis

Understanding what the capital markets reward should also influence a retailer's approach toward the strategic initiatives it chooses to pursue. For example, when embarking on a store refurbishing program, retailers with low ROIC should consider focusing on low-investment modules that they can roll out quickly to capture "quick wins" across the chain. Retailers with higher ROIC results, however, may want to consider "big bang" approaches that generate a lot of in-store excitement and drive comp sales.

Our analysis also suggests that retailers who are serious about value creation often need to rethink time, energy, and resource allocation. Taking a hard look at how a retailer's management team spends its time often leads to a rebalancing of its corporate portfolio of initiatives to ensure that, given its starting point, the retailer can deliver on its value-creating imperatives. In addition, the typical retailer will require new metrics, processes, and incentives, and may even need to rethink various aspects of investor relations.

Retailers who identify, sequence, and successfully implement the right set of initiatives should capture a "fair share" of the industry's value creation. Importantly, management's focus will finally shift from "why aren't we getting the credit we deserve?" to ensuring that everyone in the organization understands and is aligned with the right ROIC, comp sales, and "new" growth imperatives.

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