

Top News

Wal-Mart and the Retail-Stock Markdown; The world's largest retailer might not be immune to the economic slowdown after all

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1141 words

9 January 2009

BusinessWeek.com

Sometimes low prices aren't enough. The outlook for retailers has turned so bleak that even Wal-Mart (WMT) is feeling the effects of the consumer slowdown.

The world's largest retailer had looked like it was actually benefiting from the economic slowdown as consumers flocked to its low-priced offerings. Wal-Mart's stock posted a gain in 2008, one of just a handful of large-company stocks to do so.

But on Jan. 8, Wal-Mart warned that fourth-quarter profits could be 12% below previous estimates. December same-store sales, which had been rising strongly as consumers sought out deals, missed expectations by rising only 1.7% in the U.S.

Pinching Pennies

The stock market was expecting weak retail results from the holiday season, but not necessarily from Wal-Mart. Analysts and investors noted that Wal-Mart customers were buying necessities, such as groceries, rather than luxury items. Also, discount stores were attracting cash-strapped consumers who otherwise might prefer more upscale shopping venues.

But Morgan Stanley (MS) analyst Gregory Melich notes that half of Wal-Mart's sales aren't in groceries but in discretionary items. "If those categories are weak, profits can be weak," he wrote in a note on Jan. 8.

One problem for Wal-Mart: Other retailers, such as Nordstrom (JWN) or Limited Brands (LTD), offered big discounts of their own to attract stingy consumers. Retailers with heavy promotions may have won customers at the expense of "everyday value" chains like Wal-Mart, says Robert W. Baird & Co. consumer and retail analyst David Cumberland.

Hunting for Value

Also, according to Wayne Titcher, chief investment officer of AMBS Investment Counsel, LLC, consumers may be trading down to cheaper merchandise amid a weakening economy, but

they're also looking for good value. He wonders if Wal-Mart discounted the wrong items in some cases.

"It's not just trading down. It's perceived value for the money" that matters, Titcher says. Wal-Mart garnered much publicity with its "Black Friday" offerings of deeply discounted flat-screen TVs. But low-quality televisions at a discount won't attract as many buyers as discounts on high-quality TVs, Titcher notes. "Just offering merchandise that's cheaper doesn't get someone to buy it."

Of course, the Bentonville [Ark.] behemoth wasn't alone in its misery. December sales suffered nearly across the board from bad weather in many parts of the U.S. as well as from a dramatic cutback in spending.

Higher-end retailers were hit hard. Saks (SKS) last month saw same-store sales drop 20%. Abercrombie & Fitch (ANF) posted a 24% plunge in same-store sales.

At Sears' (SHLD) Kmart chain, December same-store sales fell 1.1%, but the chain's domestic same-store sales was off 7.3%.

Nordstrom reported a decline in same-store sales of 10.6% in December.

Impact on Earnings

Many chains responded to weak demand by slashing prices and offering discounts just before Christmas. But those markdowns hurt profits. Nordstrom, for example, warned that now it doesn't expect to meet previous earnings projections.

It will take longer -- until full quarterly earnings reports are released -- to find out how profit margins were affected, says Catherine Fox-Simpson, a tax partner at BDO Seidman who watches retail and consumer businesses closely.

Retailers are caught in a trap. If they discounted deeply, fourth-quarter profits will be hurt. But if they kept prices high, they're likely stuck with merchandise on the shelves. "A lot of retailers still have a tremendous amount of inventory on hand that they have to liquidate," Fox-Simpson says. Indeed, inventory figures are likely to remain a focus on Wall Street. Investors appeared to be cheered by Sears Holdings' news on Jan. 8 that it had reduced inventories from a year earlier, bidding the shares higher despite Sears' dismal sales performance.

Weak vs. Strong

For investors brave enough to buy retail stocks in this environment, a popular strategy is to seek out strong retail chains that can survive the recession and then prosper during a recovery.

Titche sees a "a major shift in people's perception of debt and risk." That's driving the slowdown in spending, which is forcing many chains to close stores or even go out of business. However, he adds, "You're starting to see winners and losers emerge." His funds own Wal-Mart shares, as well as Kohl's (KSS), Best Buy (BBBY), and Staples (SPLS) -- all of which he sees benefiting from rivals' problems.

Greg Estes, a portfolio manager at Intrepid Capital Management, warns that it could take a while for such a retail investing strategy to pay off. "There's not really going to be a catalyst anytime soon for things to turn around," he says.

Spending for Necessities

After its disappointing December sales report, Wal-Mart shares fell 7.5% on Jan. 8, to close at 51.38. Adding to investors' disappointment was weakness in Wal-Mart's Sam's Club warehouse chain and a drop in sales overseas due to the rising U.S. dollar.

"The current economy remains challenging for all businesses, and retailers have already seen customers pull back on discretionary spending," said Wal-Mart chief financial officer Tom Schoewe in a statement. "Consumers are very focused on value and necessities."

The question for Wal-Mart and other retailers is how long the consumer slump will last.

One positive for Wal-Mart may be federal economic stimulus, Estes says. Wal-Mart benefited from stimulus checks in 2008. "People took their tax checks and got groceries and necessities," Estes says, "not jackets from J. Crew" (JCG).

Discounter's Advantage

Baird's Cumberland says "consumers are very likely to continue to focus on getting the best deals." That remains good news for discounters like Wal-Mart. Now that the holiday season is over, Wal-Mart might benefit from fewer sales and promotions at other retailers, Cumberland adds. "Wal-Mart will stand out again on a relative basis."

Morgan Stanley's Melich notes that traffic in Wal-Mart stores continues to increase even if profit estimates are falling. "It is gaining customers," he wrote, "and should be one of a few retailers growing profits in 2009."

Wal-Mart remains in a strong position compared with rivals. But despite some positives, the retailer remains at the center of one of the economy's toughest industries. Consumers could be cutting back spending for some time to come, and Wal-Mart's upscale competitors appear to be fighting to hold onto business, even at a cost to profit margins.

The 800-pound gorilla of retail is finding that it's a jungle out there.

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