Private equity investment: A new bottom line

*The following is a transcript of an interview with **Brian Hume, president and founder of Martec International** as he discusses the issues and trends impacting retailers and the strategies and technologies that can help them stay ahead.*

Q **One of the things that I would like to hear your thoughts on, is the continuing acquisition of retailers by private equity investment companies. How is that impacting how retailers manage their business and why are they so attractive to these companies?**

A Well, the first thing about retail compared to other industry sectors like manufacturing and so on, is that retail has got fabulous cash flow. If you think about grocery as an example, the customer comes in the store and buys their groceries and they pay the retailer for the groceries today. Typically, the grocery retailer doesn't pay the manufacturer, for another 30 to 60 days.

Now when you go into other segments of retail the cash balances aren't quite as strong, but department stores, specialty stores, and that kind of thing, have a very strong cash flow.

If you are a private equity investment company and you buy a retailer, one of the first things you do is you negotiate 30 extra days on your payment terms. So you get to sit on that cash.

The reason that retailers are so attractive is the strength of that cash flow because I can divert that cash to pay down the borrowings I use to buy the company. Now, therefore what happens in a private equity retailer is they measure different things. One is they measure how quickly they can go from buying inventory to turning it into cash. The speed of that cash cycle, stockturn for example—inventory turn—has always been important to everybody. These measures are much more important to private equity companies, because they have the need to maximize their cash flow and investment options.

One of the great things about private equity is their model is about buying a business, spending three years improving it, and then floating it or IPO-ing it. So actually they will spend proportionately more money than your conventional retailer on things like technology and technology solutions in order to deliver those overall business benefits because if they can buy that company for $600 million and then sell it for $2 billion that's where they make their money.

So that's a couple of the critical things about private equity. It changes the rules on how they buy technology. It changes the rules on how much they're prepared to spend. And it changes the rules on what they measure and the things that are important to them.

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Q **How can performance management help these retailers?**

A The first thing the private equity guys do is look for how to squeeze productivity out of all the assets they now own. Well clearly, one of those biggest assets is inventory. So how do we get inventory productivity? They analyze sales performance, supply/chain performance, vender performance. They analyze logistics performance. They analyze a whole set of categories to understand how they can squeeze that performance harder and do the same sales volume for proportionate less dollars tied up in inventory.

And that might come through more efficient purchasing. It might come through using different suppliers that can support the business in better ways. It might come through operating your supply chain differently. It might come through renegotiating your payment terms with those suppliers and so on.

The next biggest asset is space. The selling space is the second biggest expense in the expenses section of a retail profit & loss account. Staff is the biggest, selling space is the second biggest. Now you typically can't make the stores smaller. You can't flex the size of the store—you know this year business is at a certain level, I need the store to be 5% bigger, or I need the store to be 5% smaller. So what you focus on is the yield of that space, or if we say that another way, sales per square foot or gross profit per square foot.

We focus on those kinds of metrics and then we say, how do I drive gross profit per square foot or sales per square foot. How do I drive increases in those metrics? So then we analyze which departments perform at what levels of sales per square foot, for example? And we look at changing the merchandising mix in the stores so we have more departments with a higher sales per square foot, fewer departments with a lower sales per square foot.

But we also have to remember that one of the reasons consumers come to the store is for the choice that's offered. And part of retail is you've got to carry products that individually may not sell well. But the customer just expects to find them in your store. If you sell Wedgwood China, you sell lots and lots of plates. You only sell one salt shaker. Well if you look at the analysis you might say in simple terms, don't sell the salt shaker. Don't sell the coffee pot. Don't sell the tea pot because they're not volume selling items. But if you don't sell those items you don't sell the Wedgwood dinner service because people look to buy the complete dinner service. So the volume's in the plates, the cups, the saucers, the bowls. But you've got to sell things that have a low rate of sale because it's part of the customers decision process to buy.

So analyzing product performance and understanding the relationships between product performance, what will I actually lose if I discontinue some of those products that don't appear to perform too well, what else might be threatened because the customer doesn't come to my store to buy them and they might be volume products, they might be high margin products and so on.

In an accounting sense staff is not an asset, but in a real sense it is. There have been some good analysis in the last couple of years on how some retailers have cut staff too far. And when they put more staff back in the stores they get a proportionately bigger sales increase, then they increase the cost of the staff.

So there's a whole set of, in a way you might call it yield management, things that you do based on inventory, staff, space, marketing expenses, all those kinds of things where you say, "how can I drive productivity out of those investments that I make in those areas and use that to tune your overall performance?"