Lenders and the Growing Power of the Big-Box Retailers

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We hear from lenders that customer concentration with suppliers to big-box retailers is fast becoming a fact of life. Ten years ago, customer concentrations of suppliers of 20 percent to 25 percent with one customer would raise eyebrows in the underwriting process. Today, it is becoming commonplace to see customer concentrations of 30 percent or more.

How come? For starters, the big-box retailers generate sales of $20 to $100 billion, while the revenues of thousands of their suppliers barely run into the double-digit millions. represent an enormous growth opportunity for a supplier. In addition, many large retailers are negotiating exclusive arrangements with their suppliers. Or customer concentration can increase because the retailer wants exclusive rights to a brand or nationwide service from its supplier. Maybe the retailer requires the supplier to drop-ship to thousands of stores across the country on the same day at the same time, so the supplier can't handle more than one large retailer. The end result: increased customer concentration.

It's important to keep in mind that all customer concentration is not equal. Simply put, a supplier may have customer concentration of 40 percent of its sales to one retailer, but that may be broken down into five separate departments with five separate buyers. The contracts covering the sales may be totally different from one buyer to another. With some retailers, the buyers or the store managers may have wide flexibility in negotiating contracts. With other retailers, each contract is identical. In some cases, the supplier may have five contracts with different termination dates — some contracts are multiyear, and other contracts are seasonal or promotional.

It's important to ask your borrower about each major contract, so you can determine whether the customer concentration is truly 40 percent or a collection of smaller, more manageable business relationships. If it's the latter, losing a contract may not be as significant as the former.

Selling terms to big retailers

We're often asked if the big retailers have standard terms for all suppliers. The answer is that all retailers have common contract terms for suppliers, but there can be tremendous variability between retailers. The balance of power between the supplier and retailer may be determined by how "hot" the brand is, or whether the product is simply a "commodity" that can be easily substituted.

Common themes that run through every contract include:

- *Returns:* Retailers will negotiate a set percentage of product that can be returned with no questions asked, historically 1 percent — 3 percent of the total sales. However, many retailers ask the suppliers to accept larger returns – often on an ad-hoc basis. Return requests are often couched in words (to the supplier's sales representative) like: "I need you to take back this unsold merchandise before you get the next order." Sometimes, one supplier is asked to provide credits on another supplier's merchandise in order to break into a new account.
- *Shipping:* Each contract will specify when goods are to be shipped and who will pay the shipping cost. One small detail in the contracts that's often overlooked is that the retailer may be able to change the number of distribution centers or stores. This has caused two well-known bankruptcies in the Northeast in the last three years – the retailer demanded that the supplier drop-ship to hundreds of stores. The sheer logistical nightmare of drop-shipping, plus the cost of diesel fuel broke the backs of two long-established companies.
- *Credits:* When and how is the retailer eligible for credits? Some retailers issue a flurry of credit offsets to their accounts payable in such large numbers and with so little backup that the suppliers' systems get overwhelmed. This is often manifested in large amounts of unapplied cash. Retailers can get very aggressive with suppliers on penalties for shortshipments, improper packing, and late deliveries, which makes account reconciliation time-consuming and expensive. If a retailer is experiencing financial difficulty, they will find any excuse to ask for credits from their suppliers or simply demand offsets.

As the supplier's lender, it's important that you have clear visibility on all of the key issues in the contracts to avoid surprises.

The retailer bypasses the domestic supplier

China and other low-cost countries are dominating every consumer products category they target. In the past five years, the American consumer has been the beneficiary of rock-bottom manufacturing costs in China and countries like Bangladesh. However, with upward pressure on the Chinese currency (some members of Congress in Washington argue that the Chinese currency is undervalued by 40 percent), and rising labor costs in China, American retailers are starting to experience price increases from their suppliers.

Their response has been to exert intense pressure on their suppliers to maintain, if not reduce, prices. With rising costs in everythingfrom freight to packaging materials, suppliers are facing significant margin compression. The pricing pressure is more manageable if the supplier has brands that command strong margins and perform well for the retailer. Another significant factor in resisting price pressures from retailers is the amount of shelf management that the supplier performs. We know one supplier that stocks the shelves of one mass merchant with 30,000 SKUs of nuts, bolts and other commodity hardware — 40 feet of shelf space. Any buyer who tries to replace this vendor will die in the attempt.

In order to get lower prices, some retailers are "going FOB". This is industry slang for a retailer either bypassing the supplier entirely by going directly to the factory in China, or using the supplier to design and import the products on behalf of the retailer. All of the big retailers in America have large offices in Asia which do nothing but source directly from factories. However, if the product is a proprietary brand or too complex to source directly, retailers will use the supplier to design and import the product. In some cases, the retailer will assume the inventory risk, but the gross margin for the supplier will be compressed. In other cases, the retailer will put the burden of inventory risk on the shoulders of the supplier.

Some retailers do an end-run around the supplier at license renewal time. The thinking of the retailer is this: "Our supplier licenses the brand name from its owner, and we know the license is up for grabs. Maybe we should contact the owner of the trademark, get the license ourselves, and bypass our supplier." Today, a good brand can command a license fee of 7 percent to 10 percent, so there is a lot of incentive to grab the license and go directly to China. In retailing, brands have become far more important compared to ten years ago — today, everything from curtains to cold cuts at the supermarket deli are branded. Brands can be important enough for the retailer to scuttle a longstanding relationship with a supplier by trying an end-run to grab the brand.

Lenders need to ask their borrowers all of the details of a trademark license, including: 1) What's the length of the license? 2) What are the annual volume minimums? and 3) If a retailer returns unsold merchandise, where can the supplier resell this inventory? Many brand licensors only permit a small percentage of their products to be resold through secondary channels like jobbers — if the supplier gets a big return, they may be prohibited from reselling the merchandise through a jobber. The lender may end up with obsolete inventory as collateral.

Guaranteed margins and consignment

Another sign of retailers flexing their muscles is the emergence of guaranteed margins and consignment, sometimes referred to as vendor-managed inventory.

Some retailers are saying to their suppliers, "We like your product, and we know that you're like the ham in the sandwich between your factories in China and us. If you commit to us that we'll earn a gross margin of 40 percent on your product, we won't ask you to take back unsold merchandise." When you are discussing the contracts that your borrower has with big retailers, ask whether they have guaranteed the gross margin to the retailer.

Consignment sales used to send shudders down the spine of lenders. With point-of-sale technology and demands from retailers for ever-increasing product velocity on and off their shelves, vendor-managed inventory is becoming more common. A big advantage for suppliers who are asked to manage their product on the shelves of the retailer is greater control over what goes on the shelf. The supplier can thus minimize the ill-advised orders from the retailer and avoid ugly surprises when a retailer requests an unexpected return. The suppliers who can best handle consignment and vendor-managed inventory relationships with retailers are those companies which have well-established secondary distribution channels, high-functioning, return-handling systems and a strong balance sheet. As the lines get more blurry around vendor-managed inventory, it's important for the lender to have clear visibility on where the line is drawn between the supplier and the retailer.

Winning a big piece of business with a major retailer is always exciting and can catapult a supplier into the big leagues. The challenge is to make sure that the supplier does not become a victim of its own success. The lender can be a valuable partner with the supplier in structuring these relationships with the retailers which become springboards for profitable growth.