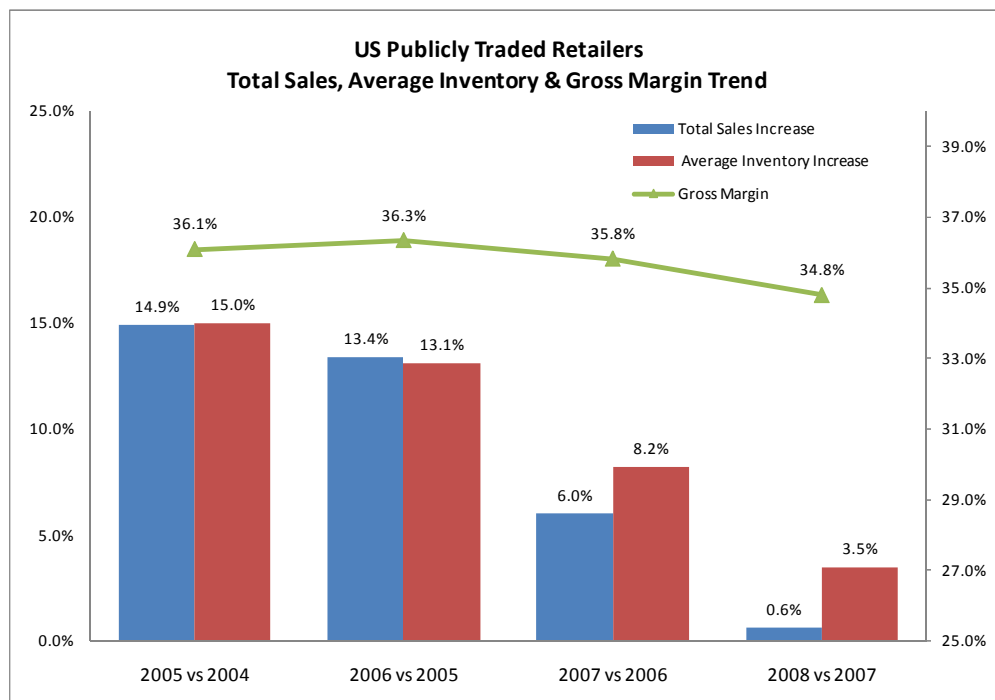


Here's Proof

So you wanted proof that the collapse of Lehman Brothers in October of 2008 caught retailers by surprise? The graph below shows that retailers increased their inventories nearly in lock-step with their sales increases in both 2005 and 2006. In 2007, sales growth began to lag inventory growth largely as a result of a weakening macro economy in the latter part of the year (recall that the National Bureau of Economic Research declared the U.S. to be in recession beginning in December 2007.) During 2007, we also begin to see margin erosion as retailers rapidly marked-down merchandise to close out seasonal inventory positions and build cash.

But look at 2008. Clearly aware that the economy was slowing, retailers reduced inventory growth significantly, not only as compared to the heady years of 2004 to 2006, but also against 2007, the year in which the recession began. And though they slowed inventory growth meaningfully, the numbers show that they still had significantly more than they needed to satisfy sales demand post-Lehman. The best evidence of the Lehman surprise, however, is that growth in sales year-over-year was only slightly up (despite the 3.5% increase in inventories) notwithstanding an overall drop in gross margin rate of over 100 bps -- a significant reduction for an industry that typically measures its gross margin performance in single digit basis point changes.

We will re-visit this graph when the 2009 RHR numbers are finalized so we can see how a year in which we had no Lehman-type sudden traumas compares to 2008. We look forward to testing the conventional wisdom about 2009: inventory and sales growth are once again expected to be aligned, while margins are anticipated to be higher than those of 2008, but not back to 2007 levels.



Source: Consensus's 2008-2009 Retailer Health Ratings™ database of 137 retail companies covered in the report

Note: Average Inventory is recorded as the average of the four quarterly inventory levels as reported in SEC filings.