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US teen apparel retailers struggle to stay 'in'

by KHAW Ker Wei

The numbers say it all. The heydays of teen casual apparel retailers in the US are over. Since the start of the decade, Aéropostale has shrunk in size year after year. As of the end of FY2015, its market capitalization was only USD 193.1mn, a far cry from the USD 3.1bn that it had in FY2010. Its more exclusive peer, Abercrombie & Fitch (Abercrombie), did not fare much better. The brand lost close to half of its market capitalization during the same period. Failing to keep up with times, these retailers have now realized that the loyalty that they previously commanded can no longer be found in their present-day target audience - teens between the ages of 12 to 18. Their customers, the millennials typically, have already flocked to fast-fashion retailers like Zara, H&M and Forever 21.

Fast-fashion, characterized as such by the rapid churning of fashion, is not merely a shift in business strategy. While US casual teen fashion retailers like Aéropostale and Abercrombie usually release a new range of fashion 2 - 4 times a year, fast-fashion retailers launch their latest range of fashion in a matter of weeks. With fast-fashion, retailers are able to absorb and re-introduce the newest fashion from runways into street wear when the trend is still raging and, therefore, reduce the risk of obsolescence of their inventory. A study done by Bain & Company showed that fast-fashion retailer Zara marks down only 15% of its inventory, in contrast to the industry average for traditional US apparel retailers of 50%. In addition, the amount of price cut that Zara takes is also much lower. As a result, fast-fashion retailers are in a better position to preserve their profit margin.

The fast-fashion disruption has already changed the landscape of the teen apparel industry in the US. Wet Seal filed for Chapter 11 bankruptcy at the beginning of 2015, following a similar move by female teen fashion retailer dELiA*s in December 2014. Among surviving retailers, many have already begun to scale back their operations. Aéropostale shuttered 120 of its stores in FY2014 and plans to close another 126 mall outlets in 2015. Its competitor, Abercrombie closed 52 stores in 2014 and another 60 are planned for shutdown in 2015. The store closures came after years of slowing growth in same-store sales. In 2013, same-store sales for US teen apparel retailers shrunk by 3.5% and subsequently in 2014, the measure dropped further by 2.1%.

As a cheaper alternative to Abercrombie, Aéropostale has been hit particularly hard by the intense competition. The lack of brand premium in pricing, coupled with the increase in sales expenses and the cost of goods, left its bottom line exposed to the price pressure from fast-fashion. Aéropostale's net income has been declining since FY2011 and in the last two years, the company booked a total net loss of USD 348.3mn. Consequently, the loss of income ate into the cash reserves of the company. Cash and cash equivalent comprised 43.8% of total company assets in FY2010 but by the end of FY2014, it had decreased to a mere 16.4%. The exhaustion of cash holdings left little choice to the management but to enter into a financing deal with private equity firm Sycamore Partners (Sycamore) in 2014. The deal provided Aéropostale with a lifeline in the form of a USD 150mn loan and in return, Sycamore was given the right to acquire up to 5% of the company at an exercise price of USD 7.25. Alongside the deal, Aéropostale also appointed an executive from Sycamore to its board of directors.

Gross margin (%)	2010	2011	2012	2013	2014
Aéropostale	36.9	26.0	24.7	17.1	18.3
Abercrombie & Fitch	63.8	61.3	62.4	62.6	61.8

Table 1: Comparison of gross margin between Aéropostale and Abercrombie. *Source: Bloomberg*

Despite these initiatives, Aéropostale's has continued to perform poorly. Sales continued to decline year-on-year during the three quarters since the financing deal. Its RMI-CRI 1-year Probability of Default (PD), which measures the likelihood of default of a company within a 1-year horizon, stood at an all-time high of 309.4bps as of the end of July 2015 (see Figure 1).

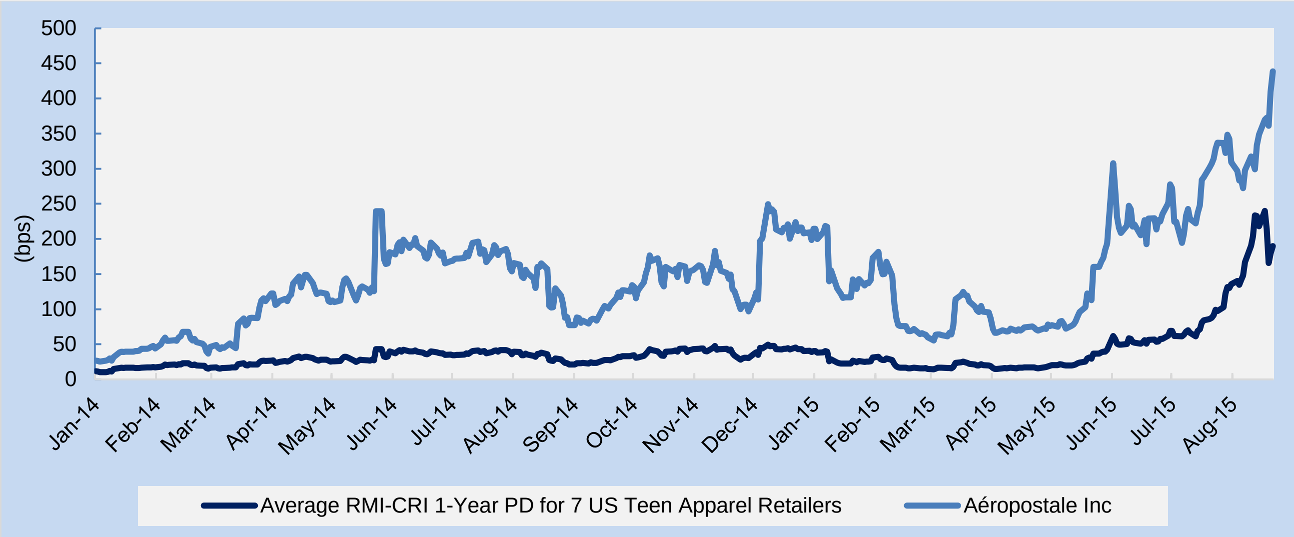

Figure 1: RMI-CRI 1-Year PD of Aéropostale, compared to the average for teen fashion retailers. *Source: RMI-CRI*

With the prevailing business conditions, it would be difficult for Aéropostale to come out of its predicament unscathed. So far, the management has not demonstrated its ability to defend from the onslaught by fast-fashion retailers. The financing deal has also weakened its capital structure, with liabilities making up 88.4% of total assets at the end of Q1 FY2016. Furthermore, Aéropostale bled, on average, close to USD 40mn in cash and cash equivalents annually since FY2010. With the company holding only USD 76mn in cash and cash equivalents during the close of the latest reporting quarter, the clock is ticking down fast on Aéropostale.

Higher-end Abercrombie, on a relatively brighter side, still has considerable room to maneuver to adapt to the disruption in the industry. Even though same-store sales have already declined significantly, premium pricing ensured that the gross profit from sales was sufficient to cover operational expenses and helped to slow down the pace of exhaustion of its cash reserves. Despite that, the company is not leaving its business to chance and has already made several critical decisions. Just before the end of last year, Abercrombie announced the departure of its CEO of 22 years, Michael Jeffries. The company also changed its marketing strategy by discarding its controversial, discriminatory messages for a more reconciliatory and inclusive tone. The move chalked up mixed responses from investors, as it was seen to have diluted the identity of the brand. Additionally, a strategic shift into the fast-fashion space would require Abercrombie to chase the curves already rounded by Zara and other similar firms.

Retailers such as Abercrombie and Aéropostale used to rule the teen apparel market in the US. Then, the advent of social technology and the economic crisis of 2008 induced a permanent shift in the shopping habits of the US teen consumers. In just a few short years, teenagers dumped specialty casual apparels carrying loud logos, which also came with steep prices, for more individualistic looks set in contemporary fashion at more reasonable prices.

Credit News

Loan write offs at US banks dropped to lowest in nine years

Aug 21. US banks are currently facing the best environment for loan losses since 2006, given that net write-offs fell during Q2 and delinquencies either maintained or improve for the 21st consecutive three-month period. According to Federal Reserve data compiled by Barclays Plc analysts, the industry's net write-off rate fell to 0.4% in Q1, which is 60% below the historical average. Furthermore, banks' reserves for losses were 1.45% of loans in Q1, below the 1.85% historical average. However, there is an increase in the proportion of mortgage borrowers who delayed their payments compared to the average over the last two decades, even though overdue loans are below long-term averages in general. (Bloomberg)

Greece makes payment to ECB, avoiding default

Aug 20. Greece made a crucial payment to the European Central Bank on Thursday, barely avoiding defaulting on its debt after receiving new aid consisting of billions of euros, from other Eurozone countries. Most of the aid package will be used to repay existing debt rather than restructure the Greek economy. Greece is required to implement a long lists of changes intended to improve the functioning of its economy in order to qualify for the aid. With this new aid, Greek citizens may be inspired to deposit cash into their bank accounts again, if they are less worried that their euros will be converted into a new Greek currency. The Greek government was forced to implement restrictions on cash withdrawals and cross-border money transfers, after depositors had withdrawn about EUR 40bn from Greek banks since December last year. (NYT)

Glencore CDS costs soar on poor results

Aug 20. The cost to insure against a default on Glencore PLC's debt escalated after the commodities firm released a terrible earnings report. Glencore reported a loss in earnings due to a fall in the prices of commodities and a slowdown in China's economy. Andrey Kuznetsov, a credit analyst at Hermes Investment Management, said that the company did not expect the slowdown in China to have such a huge effect on its earnings. Glencore CFO Steve Kalmin said that he would try his best to retain Glencore's investment grade credit rating. (WSJ)

Bank Negara steps in to stem MYR freefall

Aug 20. According to sources, Bank Negara Malaysia (BNM) has issued a circular to foreign exchange dealers of both local and foreign institutions forbidding onshore banks from taking onshore fixing orders from offshore banks. This move follows from the plunge in the ringgit to 4.10 to the dollar on Aug 14, as well as the decline of foreign reserves to below the USD 100bn threshold in July. Furthermore, fixing orders from onshore-offshore corporate clients require preapproval from BNM on a case-by-case basis. Unfortunately, this move does not seems to prevent the continuing decline in MYR, as the local currency fell by 0.58% to 4.1058 to the USD on Aug 19. (The Sun)

Indonesia central bank changes auction mechanism to support fragile rupiah

Aug 20. Bank Indonesia (BI) has revised the auction mechanism of several monetary instruments and offered longer tenures to support the depreciating Indonesia Rupiah (IDR). BI now offers a fixed rate instead of a variable rate for reverse repurchase of government bonds and BI certificates. BI also offered longer tenure instruments in a bid to prevent speculation against the IDR by absorbing banks' excess short-term liquidity. The IDR has hit a 17-year low this year as it has depreciated by 10% against the USD, and it is Southeast Asian's worst performing currency after the Malaysian Ringgit. (Reuters)

China shadow bank appeal for government bailout

Aug 18. Eleven shadow banks have requested for a bailout from the government. Analysts are worried that previous bailouts in the past few years has caused irresponsible lending as the bailouts might have created the perception that the government will not let banks default on their loans. Trust products are mostly distributed through government-owned banks thereby giving inexperienced investors the impression that the banks and government are behind them. Bailouts have protected retail investors from losses due to technical defaults on bonds and high-yield trust products in recent years. (FT)

PBOC tries and fails to lower rates as intervention drains CNY (Bloomberg)

Noble Group said to discuss move to secured financing with banks (BT)

Ukraine anticipates default saving debt deal (Bangkok Post)

Regulatory Updates

New lending restrictions eased for Auckland property investors

Aug 21. New lending restrictions for Auckland property investors have been relaxed by the Reserve Bank. This includes proposed "speed limits" on lending to residential investors and delaying of the start date for this measure by a month. In May, the Reserve Bank announced plans to introduce new loan-to-value (LVR) limits on lending to property investors in the Auckland council area, which require investors to have at least a 30% deposit. This move was implemented to cool down Auckland's property market. The Reserve Bank also claimed that they agreed to raise the speed limit of lending to Auckland residential property investors to 5%, after receiving complaints that the proposed 2% speed limit is too restrictive. The reserve banks said that the deadline for the new LVR will be in November, after receiving complains that banks require more time for the implementation of the new changes. (NZ Herald)

ASIC calls out banks on interest-only home loans

Aug 20. Australia Securities and Investments Commission (ASIC), the corporate watchdog, placed banks and other lenders on its watch list as ASIC discovered major problems in credit standards in the mortgage market. ASIC encouraged these banks to step up their game as it released a critical review on how these lenders were evaluating customers for interest-only mortgages. Major banks were in favour of the regulator's call. A National Australia Bank spokeswoman said that the banks were "supportive of ASIC's recommendations and any moves to further strengthen lending practices in the industry." CLSA banking analyst said that the report implied that the credit standards were not as high as banks had claimed initially. (Sydney Morning Herald)

ECB's next stress tests to involve fewer banks

Aug 20. According to Danièle Nouy, the Eurozone's chief banking supervisor, the next stress tests that will be held next year will include about 50 or 60 banks in Europe, compared with the approximately 120 banks for the last stress test. Currently, there are still ongoing discussions on the exact time frame and numbers of banks involved in the next stress test. More details about the next stress test will be released in a few months. (WSJ)

EBA to conduct further analysis on net stable funding requirements and leverage ratio

Aug 19. The European Banking Authority (EBA) said on August 19, 2015 that it will conduct more analysis into its calibration reports on Net Stable Funding Requirements (NSFR) and Leverage Ratio (LR). The EBA was urged to do more analysis on proportionality, the scope of application, and impact on markets of the calibration of NSFR and LR. The analysis on proportionality will be done on the judgement of the impact of requirements on banks with different business models and intends to include future reporting requirements. The Basel Committee developed the LR and NSFR requirements in 2009 after the financial crisis. (EBA)

Osborne comes under pressure to cut tax on UK banks (FT)

China considers removing regulation on loan-to-deposit ratio (Xinhua)

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Contributing Editor: Justin Hsiao