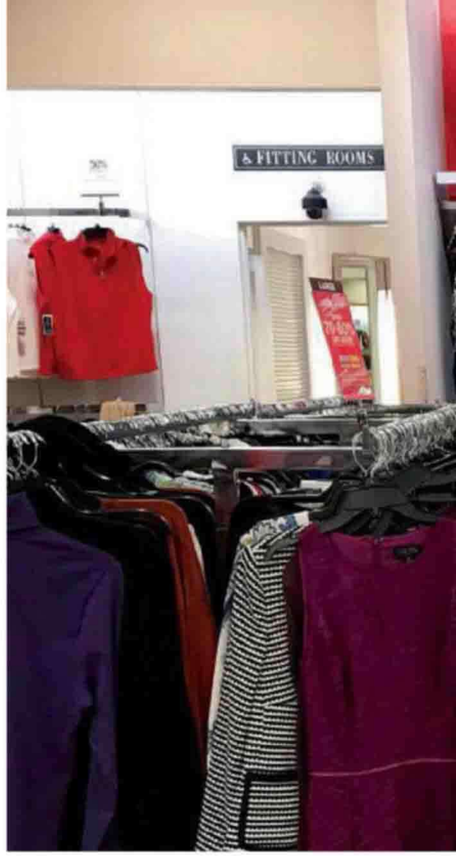
EVERYTHING MUST GO

AFTER A DISMAL HOLIDAY SEASON, THE $155 BILLION DEPARTMENT-STORE INDUSTRY IS IN UNPRECEDENTED DANGER. TO SAVE THEMSELVES, THE RETAIL GIANTS NEED TO FINALLY BREAK THEIR BAD HABITS. AND FAST. ***BY PHIL WAHBA***

The Sears at Kings Plaza Shopping Center in Brooklyn, N.Y. It closed in 2016.

PHOTOGRAPH BY **ALEX FRADKIN**

DEPARTMENT STORE BLUES



At 11 p.m. last Thanksgiving, shortly before Thursday became Black Friday, the crowds were thick at Macy's massive flagship store in Manhattan. Some 16,000 people had lined up around the block to kick off the biggest shopping weekend of the year. Five hours after the doors opened, they were still going strong.

Rabid consumers from across New York, the U.S., and the world were snapping up Tommy Hilfiger underwear and Keurig coffee machines and Macy's Hotel Collection bedding, leaving a trail of empty boxes, strewn sweaters, and toppled clothing racks in their wake. The mayhem didn't let up until the wee hours, and it wasn't unique to Manhattan—similar scenes played out at malls across the country.

But instead of portending a strong Christmas period, the hordes served only as a reminder of department stores' dwindling ability to generate excitement on an average day. For most of the rest of the holiday season, you could see tumbleweeds on their sales floors. And six weeks later, when many of the chains reported their numbers, they were downright awful: Kohl's, Macy's, J.C. Penney, and (especially) Sears all reported lower sales than the previous year. The high end hasn't been spared either: Saks Fifth Avenue and Neiman Marcus have reported soft business of late.

The defeat might have been easier to swallow if retail in general were suffering. But total retail spending rose a better-than-expected 4% over the holidays. Shoppers showed up; they just didn't show up at department stores.

In fact, outside of door-buster discount days, they have been staying away for a while. Without exception, the biggest chains have seen sales soften in the past year and a half, even as the economy improved. The holiday bloodbath deepened fears within the industry that there is much more at play than bad weather or consumers' love affair with Amazon. The bigger questions are whether big-box department stores have become obsolete and whether, in the interest of survival, they can shed decades-old habits of doing business. As Steve Sadove, a former Saks Inc. CEO and a former Penney director, puts it, "The world is moving faster than the department stores are adapting."

CLEARANCE SALE
An advertisement inside the slated-for-closure Macy's in Douglaston, N.Y. Outdated, deteriorating facilities have driven customers away from many department stores, and Macy's and other chains are closing underperforming branches.

As recently as 1999, department stores had total sales of $230 billion. Last year they came in at $155.5 billion, according to Census data. That's still a lot of money—and big chains continue to command loyalty among older shoppers. Indeed, people have been talking about the "death of department stores" for decades, and yet here they remain. University of Essex visiting professor Vicki Howard, author of *From Main Street to Mall,* a 2015 history of the retailers, says people were predicting their disappearance in the 1930s. Big chains reinvented the format by moving to the suburbs when malls mushroomed across the U.S. in the 1950s, then again in the 1970s by focusing on fashion as more women entered the workforce, and once more in the '90s and 2000s, with mergers and consolidation that weeded out the weakest.

And it's not that these chains aren't trying to innovate today. Department stores have pumped billions into e-commerce; they now derive 15% to 25% of their sales online. They've introduced new product lines to woo younger shoppers, overhauled their beauty offerings, and launched discount chains. They have even collectively culled hundreds of failing stores from their fleets.

But this time around, the reinvention isn't yield-

SHANNON STAPLETON—REUTERS

ing results. According to a rolling survey by YouGov BrandIndex, consumers' favorable impressions of Macy's fell to an eight-year low in January, with Penney and Kohl's right behind. Investors have joined shoppers in running for the exits: The S&P retail index has fallen 16% since June 2015; shares of Macy's and Sears Holding are down 54% and 86%, respectively, over that stretch. Even developers, who once built their malls around department stores because of the traffic they delivered, are now buying back weaker stores to repurpose them into establishments people actually want to frequent. Farewell, Sears. Hello, Cheesecake Factory.

If department stores are to reverse these trends, they will need to address a multitude of self-inflicted wounds. For all the changes they have made in recent years, they still tend to revert to the same toolbox: more discounts on more of the same merchandise, with uninspired product presentation in the same old dingy buildings. Their CEOs know they need to do something radical to become relevant again: Attacking fundamental problems around what they sell and how they sell it may be the boldest step they could take.

"This wasn't inevitable," says Howard of the department stores' existential crisis. And it needn't be fatal, if the industry can tackle these challenges.

SAME OLD, SAME OLD

AT THE NEWPORT CENTRE in Jersey City on a recent Friday, a shopper could visit four department-store "anchors" under one roof: Sears, Penney, Kohl's, and Macy's. And it didn't take an expert eye to notice that they were selling much of the same merchandise. Izod polo shirts. Six-packs of Hanes men's tees. Levi's jeans. Blah, blah, blah.

Retail connoisseurs have long lamented this "ocean of sameness." But the problem has gotten steadily worse. Traditional, middle-of-the-road department stores now have a 40% merchandise overlap, according to consultancy AlixPartners—that's not just product categories (e.g., pants) but specific products (e.g., slate-gray flat-front relaxed-fit Dockers).

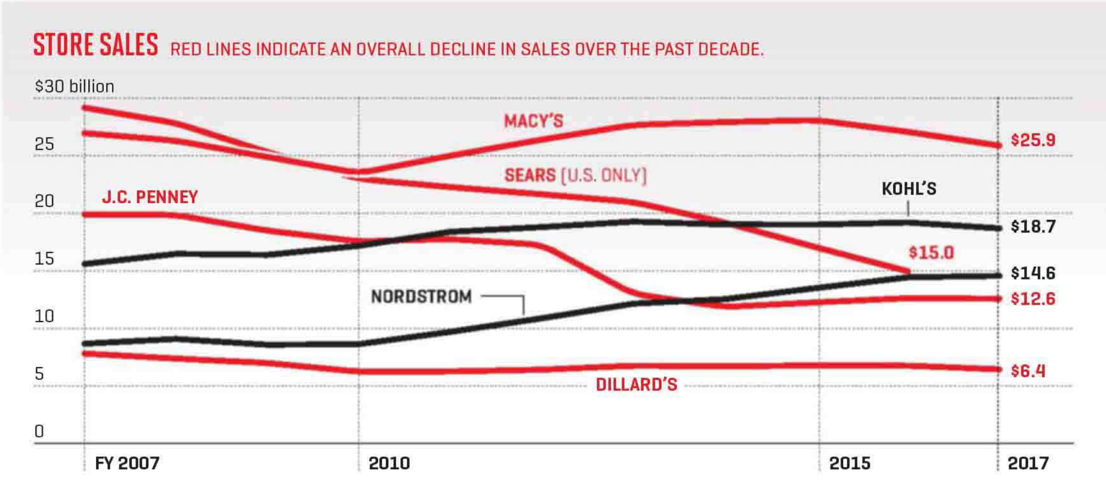
As recently as the 1970s, department stores were much more differentiated from one another. J.C. Penney sold hunting rifles back then, Sears was the Walmart of its day, and stores were famed for their toy and candy sections. But as Walmart and Target grew into behemoths in the 1980s and gradually dominated the "general merchandise" category, department stores sought refuge by concentrating on apparel. Now clothes, handbags, and shoes generate 75% to 80% of most chains' sales, compared with 50% or so a few decades ago.

Over the past few years, some department stores have diversified again. J.C. Penney, for example, has scored by opening in-store Sephora beauty boutiques, which garner four times the sales per square foot than the stores overall. Last year it resumed selling appliances, looking to benefit from Sears' years-long implosion.

The major chains have also attacked their clothes overlap problem with ... more clothes. Over the past five years, they have ramped up their house brands, the idea being to offer shoppers something "exclusive" but affordable. Still, such clothes offerings don't exactly ignite consumers' fashion fantasies, says Clark Riess, a director in AlixPartners' retail practice: "It helps

DEATH BY DISCOUNT

Discounts have played a big role in the erosion of department-store revenues. The chains have to offer deals to compete not just with one another, but also with off-price stores like T.J. Maxx and mass-merchant retailers such as Walmart and Target.



NOTES: NORDSTROM SALES INCLUDE NORDSTROM RACK DISCOUNT CHAIN. SEARS U.S. RESULTS NOT AVAILABLE FOR FISCAL 2017. SOURCE: S&P GLOBAL

[stores] drive margin, but it doesn't really help them drive traffic." Kohl's saw that this holiday season: Its house brands, which generate about half of its revenues and include the Sonoma line, saw sales fall, while national brands like Levi's and Nike did well.

DISCOUNT ADDICTION

WITH SO MUCH SAMENESS, the only way to entice shoppers is with deals. Executives bewail the "promotional" retail environment, but the stores seem only to be doubling down. Penney last year introduced promotions for items priced at 1¢. "Door-busters" used to mean Black Friday specials, but now the term is deployed year-round.

Having created the expectation that they can always get a huge discount, stores find it impossible to wean customers off the fix. A survey of holiday shoppers by predictive analytics firm First Insight found that 45% of women wouldn't even enter a store unless there were discounts of 41% or more on specific items. Ouch, poor margins. "It's a race to the bottom, and all this does is drive deflation and devalue brands," says Robin Lewis, CEO of the influential retail periodical *The Robin Report*.

Luxury players have also tapped into the discounting boom, even at risk to their upscale credentials. Nordstrom and Saks Fifth Avenue have each reported several quarters in a row of declining business in their traditional stores, but they roughly doubled their respective Rack and Off 5th discount chains over the past five years.

DEPARTMENT STORE BLUES

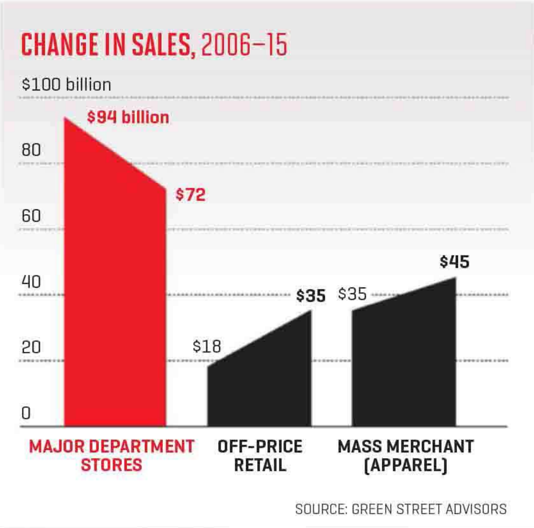
AT TRADITIONAL DEPARTMENT STORES, 40% OF GOODS FOR SALE OVERLAP; THAT IS, THEY'RE SELLING EXACTLY THE SAME BRANDS AND PRODUCTS AS THEIR RIVAL STORES.

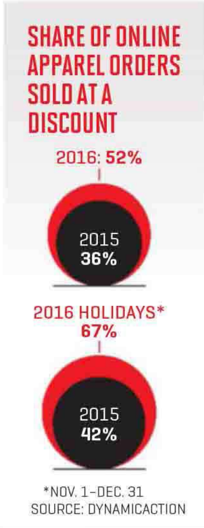
The discount dive shows how badly department stores have been outmaneuvered by "off-price" rivals. The likes of T.J. Maxx and Ross Dress for Less have unpredictable inventory, so shoppers who see something they want know they need to snap it up. Ditto fast-fashion chains like H&M and Zara, which turn over their merchandise very quickly. When those chains imply a low price is available for only a short time, their customers believe them. Not so for department-store shoppers. With a few exceptions—Kohl's and Penney are getting better at jumping on trends—traditional stores still move slowly in inventory planning and production. That leads to more unwanted and out-of-season clothes clogging showrooms and a greater likelihood of having to sell leftovers at clearance prices. Yet more discounts: Everything must go.

LOCATION, LOCATION, LOCATION

FROM THE 1960S through the 2000s, U.S. developers built hundreds of malls, most designed under the assumption that omnibus department stores would remain the retail world's biggest draw. But those big boxes no longer match many consumers' tastes. Millennials have no desire to get lost in a cavernous *Leave It to Beaver*–era barn, looking for jeans they could easily buy online. As the chains' revenue dwindles, maintaining high standards across their enormous fleets is nearly impossible—creating a vicious cycle in which deteriorating physical plants make stores even less appealing.

Department stores recognize the need to break





the cycle. Macy's, Penney, Kohl's, Dillard's, and Sears Holdings (which also owns Kmart) have together closed some 750 stores, or 20% of their fleets, since 2013, according to RBC Capital Markets. And real estate research firm Green Street Advisors estimates that 800 more across all chains would have to close for the industry to return to its 2006 sales-per-square-foot peak. "Having fewer stores means retailers can focus on giving shoppers more reason to go to their stores," says Kantar Retail senior vice president Mary Brett Whitfield.

No chain exemplifies that trend like Macy's, which has about 670 stores. It plans to lavish love on its 150 highest-grossing locations and recently finished a $400 million overhaul of the Manhattan flagship. But it will close 68 stores by this summer, with another 30 closings in the works.

VANISHING VENDORS

THE EROSION of department stores' primacy has punched a big hole in the revenues of some of their best-known suppliers—such mall stalwarts as Ralph Lauren, Coach, Michael Kors, and Tommy Hilfiger. Even when these brands don't participate in a store sale, the fact that a shopper walks past countless "50% off" signs on the way to their wares can contaminate their image.

Fed up with the discounting, Ralph Lauren CEO Stefan Larsson said last year that the brand would pull back on shipments to leading U.S. department stores, which generate about 25% of its $7.2 billion in annual sales. Michael Kors is withdrawing its goods from department-store sales events. And Coach has begun exiting 250 department stores and giving the remaining ones fewer markdown allowances. On the higher end, luxury brands like Gucci, Hermès, and Dolce & Gabbana are opening more of their own stores, to have better control over product presentation and shield themselves from dwindling traffic. That means more pain for the Sakses, Nordstroms, and Neimans of the world.

TOO BIG TO SUCCEED

MACY'S INC., the biggest of the traditional department-store chains, with $26 billion in sales last year, is also the product of the largest consolidation in the industry's history. In 2005 its parent company, Federated Stores, bought several regional chains and merged them under the Macy's flag.

THEN AND NOW
At left: a crowd inside a J.C. Penney in Oklahoma City circa 1960. Right: Shoppers hunt for going-out-of-business deals at a Sears in the Bronx.

J.C. PENNEY: BETTMANN ARCHIVE/GETTY IMAGES; SEARS: RICHARD LEVINE—CORBIS/GETTY IMAGES

But what Macy's gained in scale, cost savings, and clout, it lost in agility and the ability to cater to local tastes. Indeed, something similar afflicted the whole industry after successive waves of mergers. Paco Underhill, founder and CEO of marketing consultancy Envirosell, says the chains' expanding scale led to "management by spreadsheet," as companies transferred power from the chief merchants who assembled distinctive product offerings to executives more mindful of hitting Wall Street estimates. "The centralized buying and disappearance of brands that have some local flavor to them has really caused them a lot of grief," Underhill says.

At the same time, the chains' scale impedes their ability to adapt quickly. Macy's "Backstage" outlet-store concept is a good example. The idea was floated to the Macy's board in 2009. But it took six years for the retailer to launch the first stores, by which time T.J. Maxx had run away with the off-price market. Similarly, it took Kohl's until 2014 to introduce beauty sections, even though beauty has been one of retail's hottest areas for decades.

REMEMBER WHEN RON JOHNSON tried to radically reinvent J.C. Penney back in 2012? He strove to remake its stores as hangouts in the image of the Apple Store, swapped much of the merchandise for hipper brands, and cut off the chain's addiction to everyday discounts, cold turkey. The result: disaster. Sales plummeted 33% and almost killed the retailer, and the board quickly showed Johnson the door.

The Penney catastrophe has made retail CEOs gun-shy about radical change. But after five years of further decay, the blueprint for potential revival that outside experts recommend shares considerable DNA with Johnson's playbook. Operating sprawling fleets of mammoth, dull stores in the "stack 'em high, watch 'em fly" mold has become the road to ruin. If department stores are to get a second, or really a fifth, wind, they will need to embrace a future of fewer and smaller stores—stores that are more about experiences and discovery and less about buying the same Fruit of the Loom underwear you could find cheaper online.

Macy's incoming CEO, Jeff Gennette, knows where his chain needs to go. "We are in a transitional time. Department stores will be reimagined, services and experiences will be ramped up," he recently told *The Robin Report*. When department stores were the apex of retail, in the 1930s, they offered dazzling experiences like the indoor ski hill at Saks Fifth Avenue (eat your heart out, Dubai), dancing lessons, and the fancy tearoom atop the 16-story Hudson's in Detroit.

Many experts would like to see stores think pie-in-the-sky again. Future retail experiences should be more social and interactive, says Leslie Ghize, executive vice president of Tobe, a consultancy that advises retailers on tapping creativity. The social dimension helps explain why strip-mall retailer Ulta Beauty has poached so much market share from department stores: It presents cosmetics and beauty products in such a way that customers can play with them and learn. So how about in-store cooking classes? Why not put members-only social clubs on stores' top floors? Let your imagination go, and implement even a fraction of that, is Ghize's cri de coeur.

We are also starting to see the emerging contours of a smaller, more fragmented future for department stores. Chains are giving big-name vendors more flexibility to present their products in stores within stores. In the past two years, Macy's has opened boutiques for brands like Apple, Best Buy, Brookstone, and even Etsy, while Penney and Kohl's are implementing souped-up Nike and Under Armour shops. At the high end, Nordstrom has teamed up with J. Crew and brands like Beyoncé's Ivy Park athletic line and given them store space.

U.S. stores could eventually look like their counterparts in Europe and Asia, which rely on a concession model. Under that approach, a brand rents and independently runs space within a department store, with about 30% of the revenue going to the host. There's less upside for department stores if a brand takes off, but less risk of being stuck with unsold merchandise. With enough flexibility, the concession model could also mark a return to how department stores worked before the suburban boom. Each emporium could operate in tune with local tastes, not by the diktats of a faraway corporate office, combining national brand names with unique experiences that put the store at the center of the community.

The obstacles to transformation remain daunting. Becoming more nimble most likely means closing more stores, shedding jobs, and enduring further erosion in revenue. Publicly held chains are not likely to get much leeway from investors to spend on new initiatives; indeed, stores that want to radically retool may need to go private.

Still, the department-store format, declared dead so many times, may yet renew itself. In their decades-long expansion, many chains lost sight of what put them at the center of consumers' lives. "The department stores have lost the battle department by department," says Scott Galloway, founder of retail consultancy L2. But with ingenuity, they may have the time and resources to win the war.

DEPARTMENT STORE BLUES

SHRINKING ... IN ORDER TO GROW

Department-store sales-floor space has shrunk—but sales have fallen even faster. To make their businesses sustainable, the chains have little choice but to close more stores.

CHANGE 2006–15

MAJOR DEPARTMENT STORE SALES:
DOWN 23%

GROSS LEASABLE AREA:
DOWN 7%

SALES PER SQUARE FOOT:
DOWN 18%

SOURCE: GREEN STREET ADVISORS