

Top priority: the bottom line

With credit tough to come by since the financial crisis hit, e-retailers are focused more on profits, less on growth. The survivors are emerging stronger than ever.

By Don Davis

There's a low barrier to getting started in Internet retail because e-retailers don't have the expense of stores. But many e-retailers have relied on credit to launch a business, and often to pay for inventory or expand.

Growing e-retailers generally were able to get lines of credit from suppliers, and, in some cases, from banks. But online retailing has become a very different business since the financial crisis took hold in 2008, especially for privately held smaller and midsized companies that can't raise capital by selling shares on Wall Street.

"Last year some lenders completely exited the market; they weren't making any new loans," says Shael Wilder, CEO of multichannel retailer SportsGiant. "Regardless of the creditworthiness of the borrower, lenders were saying, 'We're going to manage the portfolio we have now and not make any new loans.'"

It wasn't just banks pulling back on credit. Many suppliers that previously would wait 60 or 90 days for payment started demanding cash in advance.

With credit hard, if not impossible, to get, many e-retailers focused on generating sufficient cash flow to pay their bills. That led some to reduce costs, often laying off workers, as well as cutting marketing spend that wasn't paying off, exiting money-losing side businesses, and sometimes taking a pass on potential acquisitions of troubled competitors.

For some, these adjustments made their companies stronger—several e-retailers say they were more profitable last year than before the downturn hit. But they entered 2010 in a cautious mood that's likely to translate into slower revenue growth and careful scrutiny of new investments.

"Right now we're working to run the business profitably," says Spencer Chesman, CEO of food e-retailer igourmet LLC. "Since we're a 12-year-old company we have the infrastructure we need already in place. If we need a new piece of equipment we're going to have to finance that through cash flows. We don't want to take on new leases and new debt."

Credit crunch

That's not entirely a matter of choice. It's been tough for businesses of all types, especially smaller ones, to get credit since the financial crisis hit in the summer of 2008.

Loans backed by the U.S. Small Business Administration plummeted to \$14.0 billion in fiscal 2009 from \$21.7 billion two years earlier, according to research firm TowerGroup. And the Credit Managers Index of credit extended to the service sector, including retail, contracted for 13 consecutive months from September 2008 through September 2009 after never being in negative territory from the time the National Association of Credit Managers created the index in early 2002.

Investor capital also dried up as private equity firms scrambled to recover from steep losses. Angel investors, who typically invest in start-ups, reduced their investments by nearly 30% in the first half of 2009 over the prior year while during the same period the average size of venture capital deals fell 23% to \$5.7 million from \$7.4 million, according to the Center for Venture Research at the University of New Hampshire.

For online retailers, obtaining loans can be especially difficult, says Stuart Rose, managing director of investment bank Tully & Holland Inc.

The low initial investment that helps make e-retailing profitable also means web retailers have less collateral in the form of buildings, equipment and stock to borrow against. And with e-retailers typically paid within a few days through credit card receipts, few have accounts receivable balances to offer as security.

That leaves e-retailers largely borrowing on the basis of cash flows and character, which was a tough sell last year, Rose says.

While bricks-and-mortar merchants also typically lack receivables to post as collateral, many banks view e-retailers, especially small ones, as less likely to struggle through a crisis because they've not had to put up the capital required to set up and stock a store, says Mitch Jacobs, CEO of On Deck Capital, which specializes in lending to small businesses. Each bank typically has policies against lending to certain types of companies, and Jacobs says web retailers with less than \$10 million in annual sales and under 25 employees would land on the restricted lists of many lenders.

There are signs the outlook is improving, including growth in credit extended to the service sector in the last three months of 2009, says Chris Kuehl, economic analyst for the National Association of Credit Managers. Last year's strong showing by online retailers also should make them more attractive to bank loan officers, Kuehl says. "If you're a pure-play Internet retailer you're not getting the quizzical looks from banks any more," he says.

Money trail

But the thaw is just beginning, and SportsGiant's Wilder predicts it will take much longer to get credit flowing than it did for lenders to slam their doors when the financial panic hit. E-retailers say they are still feeling the impact of the credit freeze, and have changed the way they do business as a result.

For DiscountRamps.com, a web-only retailer of loading ramps, the credit crisis led its bank to cut the retailer's credit line from \$2.3 million to about \$1.3 million. DiscountRamps typically keeps about \$5 million in inventory on hand, and relied on credit largely to pay suppliers, says president and CEO Joel Lederhause. With less credit available, and the economy tanking, the e-retailer spent 2009 taking a close look at every bill, looking for ways to cut costs, Lederhause says.

And it found some. For instance, instead of paying a hauling service to empty dumpsters filled largely with empty cardboard boxes, it found a company that provided a free box compacter and pays DiscountRamps \$300 per month for its compressed cardboard.

The company added technology to manage paid search and comparison shopping engine campaigns, automating processes that had been manual. "We were able to minimize growth of our staff by employing more technology and less manpower," says Lederhause, whose company employs 30 and planned to add four employees early this year.

As a result of the cost efficiencies—and aided by lower prices for materials like steel that make up a big part of its inventory—DiscountRamps.com has reduced the typical outstanding balance on its credit line from around \$1.5 million to \$500,000, Lederhause says.

Slow going

But the improved cash flow wasn't enough to help the e-retailer get a loan when it closed a deal in March 2009 for a new warehouse. While Lederhause never had trouble before getting bank loans for similar purchases, this time he had to contact several banks before finding one willing to make the loan, and then only if the U.S. Small Business Administration would guarantee half the amount.

Lederhause hired a company that prepares SBA applications, but that company was backlogged by similar requests, as was the lending agency itself, and it took from March to September to get the loan approved. Meanwhile, Lederhause was forced to rent truck trailers to store stock, and jam excess inventory into existing warehouses, impairing productivity, he says.

DiscountRamps did find one lender willing to extend more credit—American Express Co., which raised the borrowing limit on the e-retailer's business card from \$450,000 to \$700,000. Lederhause charges everything he can to the AmEx One card—including pay-per-click advertising spend, inventory and shipping charges—and says he saves hundreds of thousands of dollars each year through the discounts AmEx negotiates and the points he earns on the card.

But the AmEx charge card is designed for expenses that a company will pay off each month. When it comes to borrowing money for longer periods, including for acquisitions, Lederhause normally turns to banks, and they're not responding.

Although he's bought seven companies over several years, helping increase DiscountRamps' annual sales to about \$15 million, Lederhause says he's not pursuing deals actively now because of the lack of credit, and passed on one deal in

late 2008 because he couldn't get a loan. "We'd like to make acquisitions, but we know if it's anything bigger than \$500,000 or \$600,000 we're not going to be able to get a loan," he says. "Even though we're a financially strong company with great credit, they don't care. You're not going to get the money easily."

Even when banks do lend, e-retailers now have to jump through more hoops—at a cost—to get less money, says Wilder of SportsGiant, which generates about 75% of its approximately \$28 million in annual sales online, and the rest through two stores.

He says banks are requiring a higher ratio of cash flow to interest, which means retailers can borrow less than before. And lenders are requiring more field inspections, audits and appraisals, adding to the cost of a loan. "If the nominal interest rate on a loan is 5-6%, the additional costs might make the real cost 10% or higher," Wilder says.

SportsGiant was able to get a loan last year based on its inventory, largely because 90% of it had been purchased within six months, which made it more attractive from the lender's point of view. Banks lending against assets calculate how much they can get if they have to sell those assets, Wilder says, and new inventory is easier to sell.

While using the loan to increase inventory and marketing, Wilder says he put off discretionary spending on technology, including for analytics and marketing tools, and avoided slashing prices to boost sales, focusing instead on increasing profit margins.

He also reduced personnel costs by about 15% by identifying ways to reduce workers without significantly impacting service. For instance, the company's call center no longer is staffed early in the morning when there were relatively few calls. "Customers can't call until 9 a.m. Eastern," Wilder says. "We might lose a few sales, but a lot of those people would call back. The vast majority of calls are customer service calls, such as people tracking their orders, and they'll often call back."

Like Wilder, Chesman of Igourmet says he's sharply cut spending to boost profits.

The e-retailer of imported luxury foods has cut its work force in half from its peak two years ago, mostly by scaling back marketing initiatives aimed at growing sales. "We're in a holding pattern, waiting for the macro climate to improve before we aggressively start to grow again," Chesman says.

Igourmet also exited ventures that generated sales but not profits, such as producing gift baskets for other retailers. It's also ended relationships with some online affiliate sites that Chesman felt were cutting too deeply into profits. And it's culled about 10,000 from the 60,000 keywords it used to bid on for paid search ads, eliminating terms that generated little profit.

Cash on delivery

The e-retailer, which never had much luck getting credit from banks, now has little choice but to pay its bills on time—many suppliers that used to extend credit now require payment on delivery, Chesman says. That shift, and Chesman's reluctance to carry debt when business is weak, also led the e-retailer to slash inventory, holding 15-30 days worth of stock now versus 90-120 days a few years ago.

The down economy and marketing cutbacks combined to reduce sales by 30% last year, Chesman says. But the company, which lost money in 2008, made a profit in 2009. "We had been focused on growing the top line," Chesman says. "In 2009 and beyond, we're more focused on making sure they're profitable sales."

Chesman is not the only one chanting that mantra, or seeing the results of careful cost controls. Wilder says sales at SportsGiant were down slightly in 2009, but profits were up significantly. At DiscountRamps, sales increased only 4%—after years of double-digit growth—but profits doubled.

Only the strong—and the cash flow-positive—will survive in a period when consumers are cautious and banks even more so. Gone, at least for now, are the go-go days of growth at all costs, replaced by an era in which e-retailers must manage to the bottom line and carefully pick their spots for expansion.

don@verticalwebmedia.com

It's even tougher for start-up e-retailers

If established online retailers have trouble getting loans, imagine what it's like for the husband and wife team of Robert and Elizabeth Antunovic who began building their e-retail company, Nap Inc., in 2007.

The couple's business, selling baby carriers that Elizabeth designed, generated sales of \$15,000 in its first year, \$575,000 in 2008 and over \$1 million last year when about half its sales were online at SleepyWrap.com and the rest through wholesalers.

"To feed the growth over the last two years we needed capital," Robert Antunovic says. "Last year, we went to banks and they told us basically there was no chance you can get any money, although we already had revenue."

The couple initially turned to Elizabeth's stepfather for a five-year \$50,000 loan. But they needed more money last year for prototypes of new products and for inventory—especially since suppliers were requiring 100% payment in advance, instead of 50% before the credit crisis hit.

Antunovic says it's been hard to get bank loans because the e-retailer has little credit history. He did get a bank to okay a loan last fall, but the lender required approval from the U.S. Small Business Administration that has yet to arrive.

Seeking alternatives to banks, Robert searched the Internet and found On Deck Capital. On Deck, which launched in 2007, is one of a number of venture capital-backed companies that have arisen in recent years and that take advantage of the greater availability of business data via the Internet to lend to small companies that banks typically turn down, says Mitch Jacobs, CEO of On Deck. For instance, the lender can, with permission, view a borrower's online banking account to verify receipts, he says.

Jacobs concedes On Deck is a more expensive option than traditional lenders. The typical interest rate varies from 18-36% when origination costs are included, he says. And Nap had to begin paying back the loan immediately, paying On Deck \$250 daily.

Despite the struggle to attract financing, Nap Inc. has progressed beyond the baby-step stage and is growing. But there may be fewer such newcomers to e-retail until the credit crunch eases.

