



## Attention Shoppers: Great Deals in Retail Mergers

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Federated Department Stores' acquisition of The May Department Stores will give the company added national scope and reduce costs, but Federated will still face the challenges of department store retailing, which has been in decline for decades, according to Wharton faculty and retail analysts.



The \$17 billion deal, announced last week and expected to close this fall, will create a national network of nearly 1,000 department stores -- many of them under the Macy's flagship brand -- with sales of \$30 billion a year. As many as 100 stores, primarily in areas where Federated and May outlets overlap, are expected to close.

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The latest merger is a continuation of years of department store consolidation, points out William Cody, managing director of the Jay H. Baker Retailing Initiative at Wharton. "Department stores are at the point where consolidation at this level is one of the only ways they will ever be a viable model going forward, particularly at the mid-market, which is the bread-and-butter of this deal," says Cody.

Federated has already converted a string of regional department stores -- including Burdines, Goldsmith's, Lazarus, Rich's and The Bon-Marche -- to Macy's stores. Federated also owns Bloomingdale's, which will continue to operate under that name. Headquartered in Cincinnati, Ohio, Federated operates 450 stores and has 111,000 employees. May, headquartered in St. Louis, Mo., has 132,000 employees in 46 states. The company has 491 department stores operating under the names Famous-Barr, Filene's, Foley's, Hecht's, Kaufmann's, Lord & Taylor, L.S. Ayres, Marshall Field's, Meier & Frank, Robinsons-May, Strawbridge's, and The Jones Store. May also operates 239 David's Bridal stores and 449 After Hours Formalwear stores.

The merger of the two largest department store chains will create the nation's fifth-largest broadlines retailer, behind Wal-Mart, the newly-combined Sears and Kmart, Target and Costco. Federated had annual sales of \$15.6 billion and earned \$693 million last year while May earned \$434 million on sales of \$14.4 billion.

"Federated is better regarded strategically," says Cody. "May had some positives in some operations, but all in all, Federated is doing a much better job in retailing." Federated is more fashion-oriented while May has focused more on competitive pricing, leaving it more vulnerable to competition from a range of retailers operating at discount price-points, including Kohl's, Cody adds.

### Damaged Goods

Burt P. Flickinger III, managing director of New York business consulting firm Strategic Resource Group, says May acquired damaged goods with its 2004 purchase of Chicago-based Marshall Field's. "The Marshall Field's acquisition was more badly broken than anticipated and it brought The May Company to its knees," says Flickinger, noting that May has less management depth than Federated. May chief executive Gene Kahn abruptly resigned weeks before the merger was announced on February 28.

Federated has made strides in developing more efficient global sourcing, sharper fashion merchandising

and more sophisticated database marketing programs, which will help the company hold its own against stiff competition from lower-priced retailers as well as high-end luxury brands, says Flickinger.

Observers also note that the acquisition of May gives Federated a nationwide network of stores, allowing it to better compete against national discount chains such as Target and Wal-Mart, large specialty apparel chains such as The Gap and The Limited, and home furnishings stores like Bed Bath & Beyond. "They want to go more national," says Wharton marketing professor [Xavier Dreze](#). "The idea is you make it national, or global, and you get economies of scale in communicating the message to the consumer. You can go with more mass media, which would be more efficient." According to Dreze, Federated is likely to fold May stores with little reach beyond their own regions, such as Strawbridge's in Philadelphia. "When they look at all their brand names ... the more local ones will be the first likely to be rebranded." Federated has said it will not change any May operations until 2006.

Dreze also suggests that Federated can profit by carefully structuring its remaining store brands. "Often you see people merge and they don't coordinate across brands -- in which case it doesn't work. There are many operational and financial issues, but from a marketing standpoint the issue of managing each label and differentiating them to lessen price competition and increase profitability will be the big key -- assuming they get everybody to buy in, which is going to be tough."

Dreze predicts that various chains within the new organization will struggle to position themselves in the best light. "Everybody wants to say, 'We want to be the high-end store' or 'we should be the store for kids,' whatever is the hot one at the time, but it doesn't work that way. That's what made the mess in the first place."

According to Wharton marketing professor [Z. John Zhang](#), the merged company will also be able to cut costs and enjoy new clout with suppliers. "People have learned from Wal-Mart that size does matter. Bigger is better simply because you can squeeze the suppliers and take advantage of the synergies." Federated has said the merger is expected generate savings of \$450 million a year by 2007, Zhang adds. "At the two department stores there are all the people who order the merchandise. Now [management] can lay off a lot of those people because it only needs one set of them."

The deal will benefit Federated but may hurt consumers over time, Zhang notes. "In the short term, I think the consumer may see some benefits simply because the costs are lower and the department stores will want to keep their customers in the areas where they do compete. In the long run, though, the reduction of stores will reduce competition."

The deal will face scrutiny by antitrust officials, but Cody predicts it will be approved because there is little overlap in most regional markets; in addition, department stores as a whole are losing market share.

### **Brand Value vs. Brand Variety**

According to Wharton marketing professor [David Bell](#), the Federated-May deal reflects the usual merger goals of increased scale and leveraging costs, but the larger issue is the level of demand for department stores in general. "They are making a bold bet that the department store format is going to resonate with consumers in the future," says Bell. "I think the concern is - with the May stores in particular - that they were slipping, and the younger demographic was not shopping there."

Kim Picciola, who follows Federated and May for Morningstar, the Chicago mutual-fund research firm, agrees. "We think the merger may stop some of the bleeding at the traditional department stores, but it's not going to heal the wounds that specialty retailers and discounters have inflicted," she says.

Conventional chain department stores' share of all non-auto retail sales was 6.5% in 1987, but that dropped to 2.8% by last year, according to Retail Forward, a Columbus, Ohio, retail consulting and

research firm. By 2010, the share will decline further to 2.1% Retail Forward predicts.

Federated chairman and CEO Terry Lundgren says the company is committed to the department store business. In a release announcing the acquisition, Lundgren stated: "We are proving that department stores can be a vibrant, very much alive form of retail." But Bell says the prognosis for department stores may depend on how consumers relate to brands. For example, he points out that in some Federated stores there are separate designer boutiques along with samplings from other designers. But these boutiques may not have the depth of products and expert service that a shopper would find at a stand-alone designer store, like, for example, Gucci or Armani.

"Part of the fundamental question is to what extent do people have a deep affiliation with a particular brand versus to what extent do people want to shop in an environment with exposure to multiple brands but with each brand not having the depth or sales experience" of a stand-alone brand store, says Bell. "It's a question of brand value versus brand variety." The future of department stores is also tied to the fate of the shopping mall, adds Bell. "Part of getting people into Macy's is getting people into the mall. Federated's overall trajectory is tied to the shopping mall concept."

According to Flickinger, department store retailers and customers may benefit from continued deflation in apparel prices stemming from lower costs of production in emerging economies, particularly China. Department stores, he adds, typically pass along half of those savings to consumers, but the rest falls to the bottom line. He forecasts that price declines will translate to an increase of 25 to 45 basis points in department store profits each year over the next decade.

## **Polarized Shoppers**

Zhang points to a growing polarization among consumers who are gravitating to lower-priced apparel at Wal-Mart and Target, but also to high-end offerings at stores such as Neiman Marcus, Nordstrom and Saks Fifth Avenue. These kinds of stores are faring well at the expense of mid-priced department stores such as those operated by Federated and May. "Overall, you have a large number of value-conscious customers, and that is what Wal-Mart is tapping into," says Zhang. "At the same time, you also have very wealthy people. The income distribution has become more skewed in the past 10 to 20 years, so you have fewer people in the middle."

Lois Huff, senior vice president at Retail Forward, the consulting and research firm, says shoppers are saving so much on low-priced, commodity apparel at stores such as Target or Kohl's that they are able to set aside more money for some high-end luxury brands. "There is a lot of bipolar purchasing," she says. Shoppers "can go down and get some great fashions at the lower prices, but then they also go up and get something that really satisfies the ego." As a result, she says, business at top-of-the-line department stores, including Nordstrom, Neiman Marcus, Bloomingdale's and Saks Fifth Avenue, is booming.

Flickinger predicts the merger of Federated and May could generate more deals. "You will see this as the first of a similar wave of mergers and acquisitions that you saw about a decade ago in the first half of the 1990s," he says. "The retailers need much more size and scale to compete effectively, particularly since the department store has been dying for several decades."

Huff, too, sees more consolidation ahead. She says Dillard's, the Arkansas-based chain, and Belk Bros., the privately-held Charlotte, N.C. retailer, might have trouble remaining independent. In addition, she says, some of the regional stores that are part of the Saks organization, including Carson Pirie Scott, Proffitt's and Younkers, will come under increasing pressure. "There are too many department stores out there, but unfortunately there may be no buyers."

She and others say it will be difficult, but not impossible, for Federated or any department store retailer to succeed. "Given the competitive landscape and the pressure on the traditional

department stores, they have to change the model they have been operating under for so many years," says Picciola of Morningstar. "They will survive, but we don't see them thriving. You can live in a mature industry if you figure out where the opportunities lie and understand how to position yourself to really capture those opportunities."

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