

Retail sector insight

UK Retail: road to recovery or more of the same?

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This is a summary paper of EY's Retail webcast, 21 January 2014, which was broadcast to around 130 participants from financial institutions, private equity firms and turnaround investors.

There isn't one universal story from Christmas 2013. Retailers adopted a huge variety of strategies this Christmas, which produced a wide spectrum of results.

The festive season started with the usual tension between retailers and consumers. The fact that more retailers adopted 'Black Friday' and prices fell by record amounts in December suggests that retailers blinked first. However, the bare data hides a wide variety of discounting strategies. Many of those who managed to hold prices captured a share of rising online volumes, but successful retailers used a combination of channels to drive success and discount grocers achieved stellar results with no online offering at all. Conversely, high-end store results also shone, continuing the polarisation story between value and brand that has developed over a number of years.

What soon becomes clear is that there isn't one way to drive value on today's physical or virtual high street. Retailers need to know their customer and pick the right products and channel to suit their needs. Finding the right model to do this, retaining flexibility and deciding where to prioritise spending or invest, is becoming increasingly difficult as the pace of change accelerates.

Grocers

Online, convenience and discount were the three main themes in grocery this Christmas. It all adds up to a polarised picture for the sector, with widening gaps between high-performing upmarket grocers, the flat-lining 'Big Four' and the rapidly improving discount operators.

Grocers offering online shopping all reported a boost in orders this Christmas, with additional delivery slots helping to boost the topline, although the cost of delivery still eats into grocers' margins. 'Convenience' has also gone from strength to strength in 2013. Shoppers are increasingly shopping locally and more frequently, with fewer households performing a big weekly shop. This has obvious consequences for the big out of town supermarkets that have engaged in a space race over a number of years and are now looking to boost their local offering. Space sharing and creating destination shops with the addition of restaurants or coffee shops is one answer to this shift; but some large stores will need to close. Discount supermarkets only account for 10% of the total grocery market, but their growth story is forcing the entire sector to sit up. Rather than 'trade up' this Christmas, consumers stuck with the discounter, in good part due to their marketing shift from 'low-price' to 'value for money.' The 'Big Four' will need to decide how to compete.



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Department stores

The three key factors that affected Christmas performance in the department store sub-sector were: clarity of brand, approach to discounting and the quality of multi-channel offerings.

The most successful stores tended to benefit from a more upmarket customer base, enabling them to deliver a clear premium offer, with designer brands brought to the fore and a marketing strategy that highlighted innovative and well-presented product ranges. This enabled them to hold their prices, in contrast to those without such brand clarity and defined customer base, who found themselves having to discount heavily pre-Christmas.

Internet sales growth significantly exceeded in-store growth across the department store brands. The most successful operators offered a flexible range of multi-channel options, including next day Click & Collect from store and the ability to collect from third-party locations such as collect+.

Fashion retailers

There have been some really strong results from premium fashion, although further down the value chain, the lack of like-for-like (LFL) announcements and focus on total sales growth (i.e., some driven by increased space) tells its own story.

We have seen a wide variety of promotional strategies, as across other sub-sectors, including some early and deep discounting at odds with a better hold on price where there is strong brand confidence and tight inventory and supply chain management.

In this space, we are seeing an increasing trend of the winners being able to attain and analyse data. This ensures the right customer targeting, as well as the ability to make quick, responsive business decisions and understand the likely top line and margin impact of these.

Multi-channel is, of course, important for fashion retailers to get right. However, the need to have a good reverse logistics (returns) process is perhaps more important in this sub-sector. Customer experience is also proving key, regardless of which channel that customer is using.

Online and bottom line

Online sales now make up 12% of total retail sales, making them an increasingly significant part of the UK retail landscape, with an impact on retail's top and bottom line.

However the economics of online retailing are very challenging – customers expect lower prices; but the cost of fulfillment, including the 'last mile' of getting goods to the customer, can dilute retailers' margins. Another downside is the risk of 'cannibalisation' of more profitable in-store customers as they migrate online.

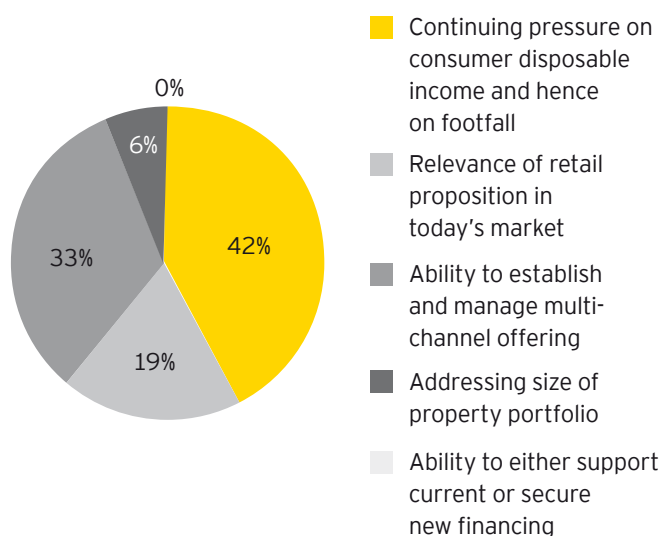
We therefore expect to see a continued push towards Click & Collect, driving down 'last mile' costs. As a result, we expect the online and in-store experience to become more integrated. In some cases, further investment in optimisation and automation technology will be required to drive down both fulfilment and delivery costs.

Finally, we expect there to be much more scrutiny of the true costs of the online divisions of physical retailers as they become a more important driver of financial performance.

The outlook

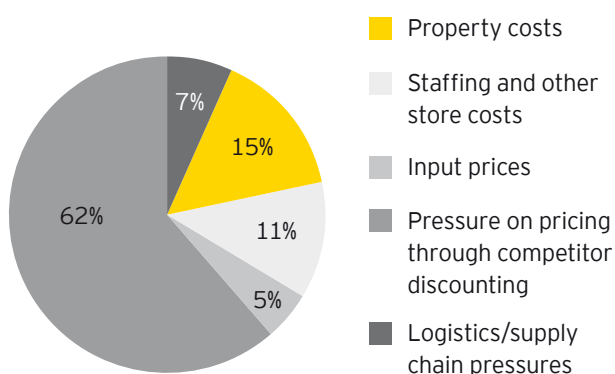
We asked the webcast attendees what they believed would be the key challenges facing retailers in 2014. 42% said it would be continuing pressure on consumer disposable income and hence footfall, whilst 33% saw the biggest challenge in establishing and managing multi-channel offerings. This illustrates the dual nature of pressures on retailers, both from external factors such as the squeeze on the pound in consumers' pockets, and internally, the need to put customer convenience at the heart of their strategy to secure their share of the spend. No one thought that securing finance would be an issue, reflecting a current perception of flexibility around the provision of financing to retailers.

Q: What do you think will be the key challenges for retailers in 2014?



In previous years, we have asked webcast attendees where they saw the highest pressure on margins for UK retailers. Last year, 60% of respondents believed this would be property costs. However, this year there was a significant swing away from property costs, with over 60% of respondents believing that pressure on pricing through competitor discounting is currently the biggest pressure on margin for UK retailers. This highlights consumers' willingness and ability to shop around, for example as highlighted by the discount grocers. Whilst the problems of extensive property portfolios have not yet been resolved, it is all relative – the responses may reflect a perception that property cost problems are currently more understood and addressable than competitor discounting.

Q: Where do you currently see the highest pressure on margins for UK retailers?



The EY ITEM Club winter forecast shows that we are looking at a lopsided economic recovery across the UK, which is being driven by consumer spending and the housing market.

The growth in house prices combined with the number of housing transactions in 2013 is expected to continue into 2014 and will have a positive effect on consumer confidence and spending. At the same time, the savings ratio is coming down as people become slightly less cautious. Although we see some increases in borrowing, the overall debt to income ratio continues to fall as the underlying trend has been for people to 'deleverage' their own personal 'balance sheets.'

As consumers begin to have an increasing confidence in their own worth, their 'personal equity,' so they will have confidence to spend more. As an aside, we have also seen an increase in Payment Protection Insurance (PPI) compensation claims which has driven the consumers' desire and ability to spend more – particularly on big ticket items.

However confidence and spend will be hard to sustain, especially across some demographics, whilst there is still pressure on real incomes. This pressure may cause a longer-term drag on sustainable retail recovery.

What does this mean for retailers? They know that the consumer spending landscape is not going to change dramatically and, therefore, they have to engage with the current market. Brand strategy is increasingly important as is understanding evolving buyer behaviours and how to respond to those. Finally, the competitive arena has changed. There is an increased fight for the consumer pound and retailers need to look to the more blurred lines between leisure and retail to understand who they are competing with.

Hot topic: cyber security

Recent cyber security attacks have been deeply concerning for all companies with retail operations. These breaches have often resulted in multi-million pound losses and reputational damage, making it a hot topic for Boards, Audit Committees, and regulators. There is also increasing interest from the UK Government, whilst the European Commission has pending legislation mandating companies to disclose both cyber risk and cyber events.

Retail's adoption of increasing digital and online channels clearly offers significant opportunities to move closer to customers. However, holding more customer information also makes retailers a more attractive target for cyber-criminals. It is therefore essential that the Boardroom, and not just IT leaders, are aware of the associated risks and take proactive action. Differential investment may be necessary to improve internal Cyber Security capabilities before the launch of new products or a move into new markets.

Organisations that address both the risks and the opportunities arising from the technology revolution have the opportunity to grasp a competitive advantage, with benefits for operational and financial performance.

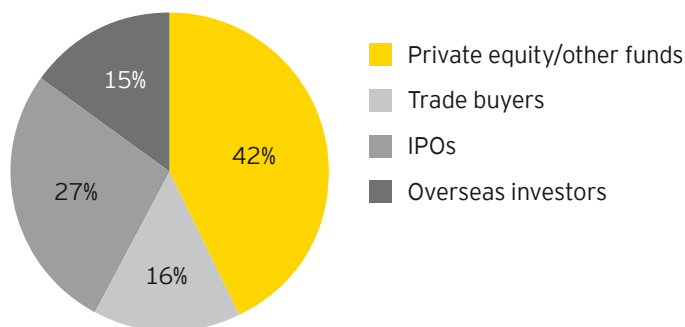
Hot topic: transactions

After a long period of relative inactivity, retail transaction activity is set to grow in 2014. This reflects more confidence by investors generally in the prospects for the sector, improved availability of debt funding and private equity's need to exit long-term investments and invest newer funds. Many companies have additionally accumulated significant cash reserves, although returning cash to shareholders seems to be favoured above corporate activity.

Initial public offerings (IPOs) are now being seen as a viable alternative exit route for many retailers, but they will need to demonstrate a credible and supportable growth story to institutional investors. This becomes more difficult as UK portfolios grow in size and growth drivers become the inherently more difficult routes of new complementary brands or overseas expansion. Therefore whilst we expect to see an upturn in retail IPO activity, we believe most candidates will be following dual track processes, without ruling out the option of an outright sale.

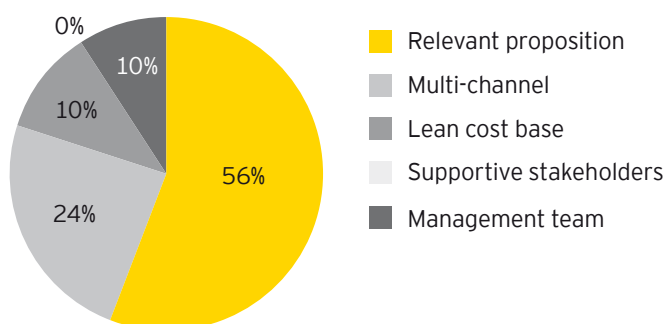
This view was supported by the results of our polling question (shown overleaf), which asked who will be the buyers of retail assets in 2014? Whilst 27% thought IPOs were the most likely option, 42% considered private equity to provide the most likely buyers.

Q: Who will be the buyers of retail assets in 2014?



Given our view that the transactions market will pick up for retailers, we then asked our audience what will be the single most important driver of value in retail? Whilst many felt that having a relevant proposition (56%) would be key, 24% said multi-channel was the most important driver. In addition, a lean cost base and effective management team also received a number of votes – this emphasises the point that there is not one single driver of value for retailers; it all depends on the individual business and the challenges and opportunities that particular retailer faces.

Q: What do you think the single most important driver of value is in retail currently?



Road to recovery or more of the same?

From the wide spectrum of Christmas results, the following key themes are clear:

1. Promotional strategies abound: from 'Black Friday' through to deep discounting.
2. Christmas.com: the continued success of online, including mobile commerce, internet and Click & Collect.
3. Flexible multi-channel models are paramount, with convenience for the consumer at their heart.
4. Polarisation between brand and value: the top performers have a clear positioning, know their customers and can make quick decisions.

In 2014 we expect a continued improvement in consumer confidence, leading to higher spending, however, the sustainability of recovery for retailers depends on real incomes rising in line with consumer confidence. Without this, the outlook for retailers is likely to remain difficult and a little uncertain.

So, is this the start of the road to recovery or more of the same? Overall, we expect more of the same, with a continuing fight for the squeezed consumer pound, however some relief may be provided by an anticipated pick-up in the transactions market in 2014.

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