Restructuring in the retail sector:

What does the future hold?

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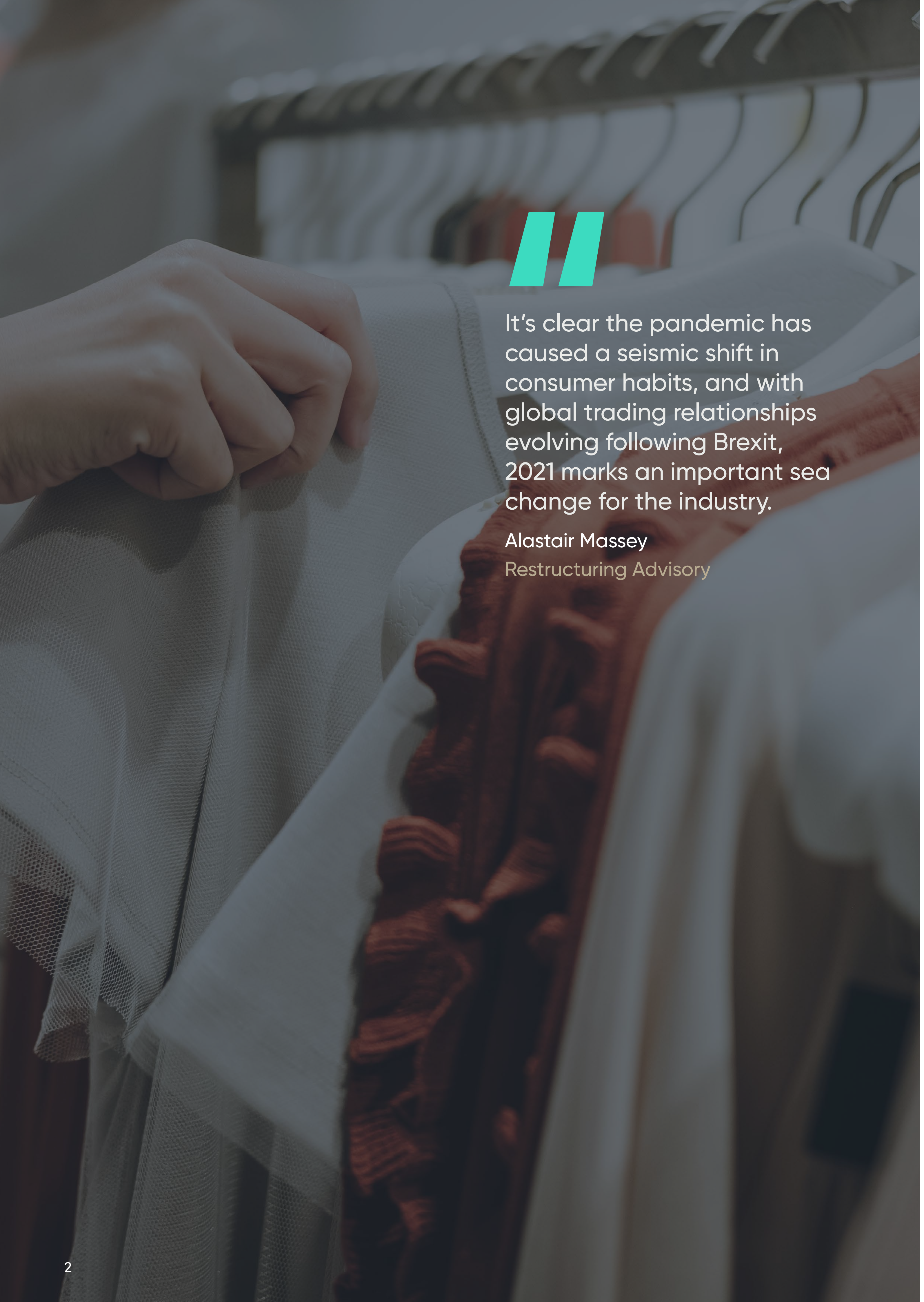

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Publication

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Synopsis

The retail sector is a mainstay of daily life in the UK. It generated almost £400 billion in the year prior to the COVID-19 pandemic – representing a third of household spend on average – employing 2.9 million people.

The sector has weathered challenging times previously, but the pandemic is unlike any event experienced before. A cycle of lockdowns and social distancing restrictions have significantly reduced footfall in cities and town centres, and no one can predict when it will return to pre-COVID volumes; if at all. While there's been an increase in the number of consumers shopping locally and supporting small businesses, social distancing measures have hampered visitor numbers, and safety concerns have inevitably deterred many from venturing out.

By contrast, online retail has continued to grow and its trajectory has undoubtedly been accelerated by changing consumer habits driven by the pandemic. While the market share of e-commerce has risen steadily since the early noughties, it jumped significantly last year, and during the second lockdown, online purchases accounted for just under a third of all retail sales, up from 21 per cent the year before.

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In comparison, shop prices declined over the year, falling by 1.8 per cent in annual terms in the run up to Christmas according to the *[1]British Retail Consortium (BRC), as non-food stores offered large discounts during this period - a bigger fall than has been typical over the past 12 months. The figures by the BRC showed retailers suffered their worst annual sales performance on record in 2020.

It's clear the pandemic has accelerated a seismic shift in consumer habits, and with global trading relationships evolving following Brexit, 2021 marks an important sea change for the industry. Here, we explore the specific challenges the industry is facing, and the immediate and long-term priorities for retailers.

What is the current state of play?

While these are troubled times for the UK retail sector, the effects of the pandemic represent a game of two halves. There's a stark contrast between businesses that have experienced a boom in demand, such as grocery and homeware brands, and non-essential sub-sectors, such as fashion, that have suffered a significant drop off in sales.

Adaptability has been key in the current climate. Non-essential retailers that have rapidly embraced technology in response to lockdown measures have fared much better than those that have failed to innovate. With physical shops closed, many retailers have found creative ways of engaging customers through virtual consultations and interactive live streaming. While they've had to invest in the necessary resource to provide virtual walk-throughs for their stores and products, the additional spend has been offset as it has helped them to drive sales of big-ticket items. Quick and savvy thinking like this will see some retailers emerge in a better position than their competitors when the pandemic subsides.

For traditional mid-range clothing brands, particularly womenswear outlets, the impact of the pandemic on physical footfall has been challenging. A large portion of the businesses affected over the last year have been bricks and mortar fashion retailers and department stores. Retailers with an older customer demographic have found that their customer base has been reluctant, or in many cases, unable to travel to physical stores. In addition, many consumers will have discovered new brands offering high quality websites that are easy to navigate and have seamless payment methods during this time. Many could well be unlikely to return to their previous shopping habits when the effects of the pandemic subside, having found online shopping a more convenient way to complete purchases.

Spring 2021 in particular will be a crunch point for retailers that are experiencing cashflow issues after Christmas, and the coming months will determine the future of many operators across the sector.

Many retailers will find that their cash levels are significantly depleted, and will need to kickstart an uplift in trading in the coming months to avoid running out of funds over Q1. It's vital that online sales perform well during this period, and their focus should be on finding ways to maximise trading to help restore cash reserves.

Some of the UK's mid-market fashion brands have suffered from chronic underinvestment in their digital presence in recent years, and are therefore not adequately equipped to keep up with the competitive appeal of newer, digitally-led brands such as PrettyLittleThing and boohoo. The financial strength and liquidity of many of these bricks and mortar retailers have been severely tested with the fall-off in demand, and many employees have been furloughed as a result.

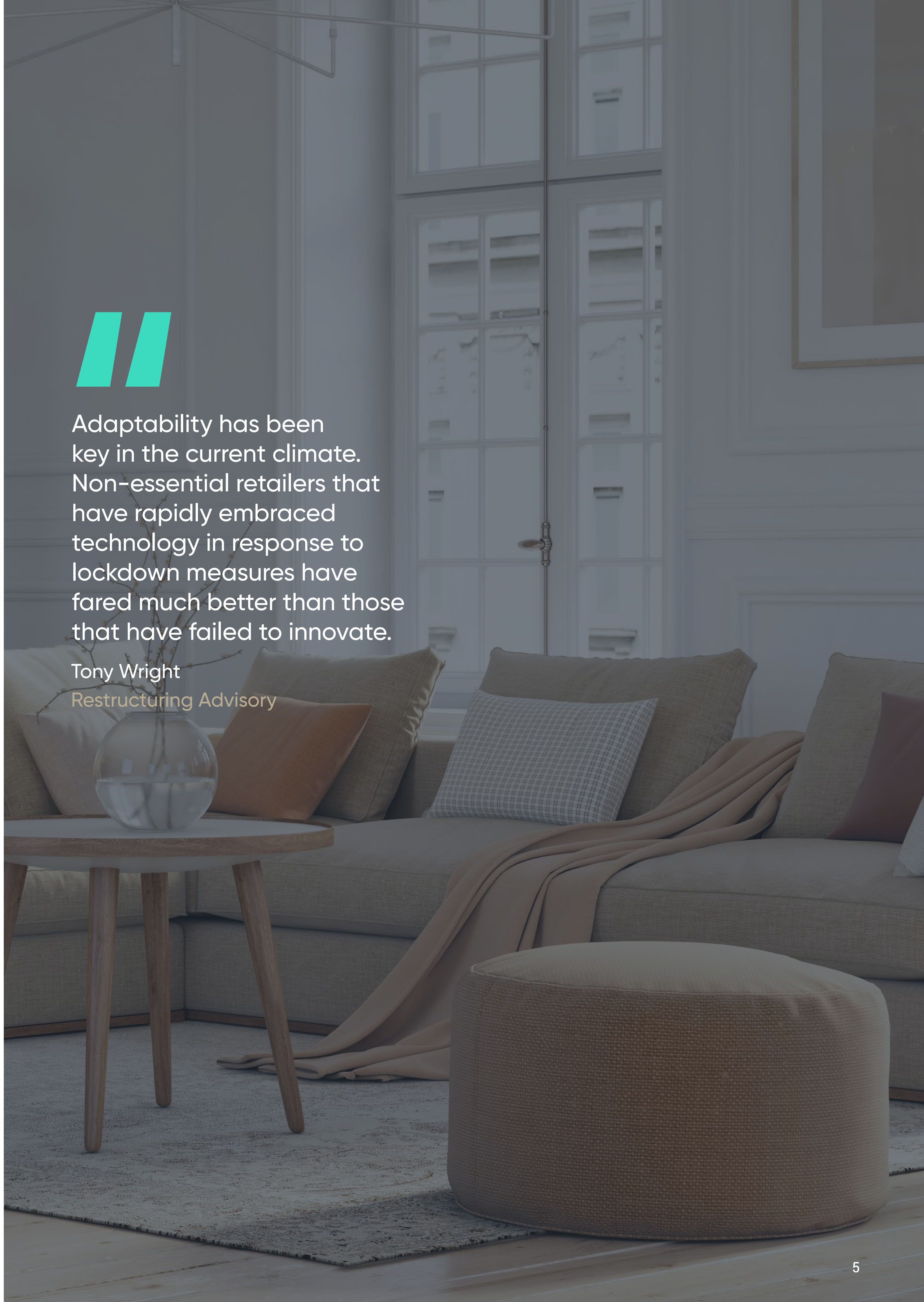
It's likely that retailers solely reliant on bricks and mortar will run out of cash in the coming months. The UK government has confirmed the moratorium on commercial property tenant evictions for non-payment of rent, which has been extended to the 31 March 2021, won't be extended any longer. It's crucial bricks and mortar retailers put in place contingency measures now before the moratorium ends when their 'deferred' rent bill will be due, which will also coincide with the end of the business rates holiday.

How has the COVID-19 pandemic impacted consumer habits?

Lifestyles across the UK have changed due the pandemic, and this has been reflected in changing consumer habits. With a large proportion of the population now working from home, sales of formal and office wear have dropped significantly, impacting retailers that specialise in these categories. Limited opportunities for social activities and the logistical challenges of returning goods have also impacted fast fashion, despite the relative resilience of this sector – although sales of loungewear have surged on balance. And with overseas travel and celebrations cancelled, consumers have had more money - and a greater desire - to invest in home improvements. Homeware stores such as B&Q, IKEA and Homebase have seen an impressive uptick in custom, leading to growth opportunities in the sub-sector.

A swathe of businesses has also circumvented the restrictions on non-essential retailers. As 'essential' retailers, supermarkets have continued to sell books, stationery and clothing while competitor stores have been forced to close, adding further profits to their already soaring grocery sales.

Perhaps the biggest change brought about by the pandemic, is the accelerated transition to an e-commerce-led market, with chains such as boohoo, PrettyLittleThing, ASOS and The Hut Group primed to grow rapidly in years to come.



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How are these challenges affecting the wider industry?

In recent months, we've seen many major high street retailers focusing on cost savings, redundancies and strengthening their balance sheets. One of the biggest factors compounding the challenges of the pandemic has been poor-quality digital infrastructure. Many of the national retailers have decades-old digital payments and e-commerce systems embedded in their operations, and their outdated websites haven't coped with the influx in customer demand – particularly during sales seasons.

Despite this, almost a third of retailers admitted that fixing their payments infrastructure had become less of a priority during the pandemic, according to research by Checkout.com at the end of 2020*[2]. These retailers risk missing out as e-commerce continues to grow, with the sector predicted to account for 40 per cent of UK retail by 2030.

With the uncertainty around when the lockdown measures will lift, non-essential retailers are facing a monumental liquidity challenge. Many will be paying back their debts for the festive period while attempting to manage cashflow and plan ahead for the Spring/Summer season, before they know when they will be able to open again. A number of clothing and home furnishing stores need to pre-order fabric and garments months in advance, creating considerable forecasting difficulties.

Two other challenges for high street retail are rent values and business rates. Many retailers urgently need to address their rent bills and negotiate with landlords to reduce their rents, if they're not already seeking to do so as part of a company voluntary arrangement (CVA) process. Retailers should prioritise turnover rents rather than fixed rents when negotiating and drawing up contracts. COVID clauses must also be embedded in any new lease deals, otherwise retailers will be faced with a fixed cost base which will be accrued regardless of whether they are open or closed. There is also the issue of business rates – retailers currently pay 25 per cent of UK business rates, despite only accounting for 5 per cent of the economy, and when the business rates holiday ends in March 2021 we're likely to see further pressure placed on an already struggling sector.

Then there's the added challenge of pension schemes. Many older chains are facing significant pension challenges, with multimillion-pound deficits to plug. Pension schemes add another layer of complexity for struggling companies to navigate, particularly if a restructuring process is on the cards.

What about the impact of Brexit and supply chain disruption?

The inevitable post-Brexit changes to the UK's global trading relationships will impact the entire sector. Added to this, shipping has become a major logistical challenge for the supply chain, with many ports closed for months. As a result, there's little capacity for cargo to come from far east suppliers, such as China and Bangladesh, and the supply chain will likely face periods of disruption as lockdown measures continue.

Post-Brexit trading difficulties have already begun to gather momentum. Northern Ireland is still in the EU's single market, and goods being sold from Great Britain to Northern Ireland are now subject to numerous new checks and controls. Marks & Spencer has been the latest high street retailer to warn its products line could be hit with new import tariffs in Ireland, due to the "rules of origin" regulations set out in the Brexit trade deal. The rules dictate whether import taxes must be paid based on where a product's ingredients come from and where it has been manufactured. In the case of Marks & Spencer, its Percy Pig line and 2,000 other products manufactured in Germany look set to face costly tariffs.

Regional lockdowns have also had an impact on stock levels, and there's now a backlog of unsold items in stores across the UK, posing a further logistical challenge for retailers struggling to shift it. Compounding the problem, a lot of stock must be ordered months in advance. With no definitive end-date for the current lockdown, and with no clarity around when non-essential retail will be given the go ahead to re-open or when we might be able to travel overseas – a key driver of Spring and Summer sales, retailers are simply unable to predict what products to buy and what consumers will be looking for when they do open their doors again.

Suppliers of all sizes have also faced significant challenges in recent months. We have started to see cost cutting and cash preservation measures as well as a series of redundancy programmes across the industry, with companies focused on maintaining cashflow, reducing costs and bolstering liquidity.

Businesses are already putting measures in place to address the issues they're facing; be that looking at headcount or deferring capital expenditure. However, for some, the main concern will be about their ability to survive the uncertainty of the year ahead.

How could changes in restructuring impact the sector?

The impact of COVID-19 has prompted a number of developments in the UK's restructuring industry. Reforms in the Corporate Insolvency and Governance Bill 2020 have provided new support – in particular a Restructuring Plan, which provides far greater scope than previous restructuring tools to compromise, liabilities and shareholders.

Additionally, we have seen increased use of 'light touch' administrations, where administrators delegate certain responsibilities back to directors in order to achieve a more collaborative, effective and lower cost solution.

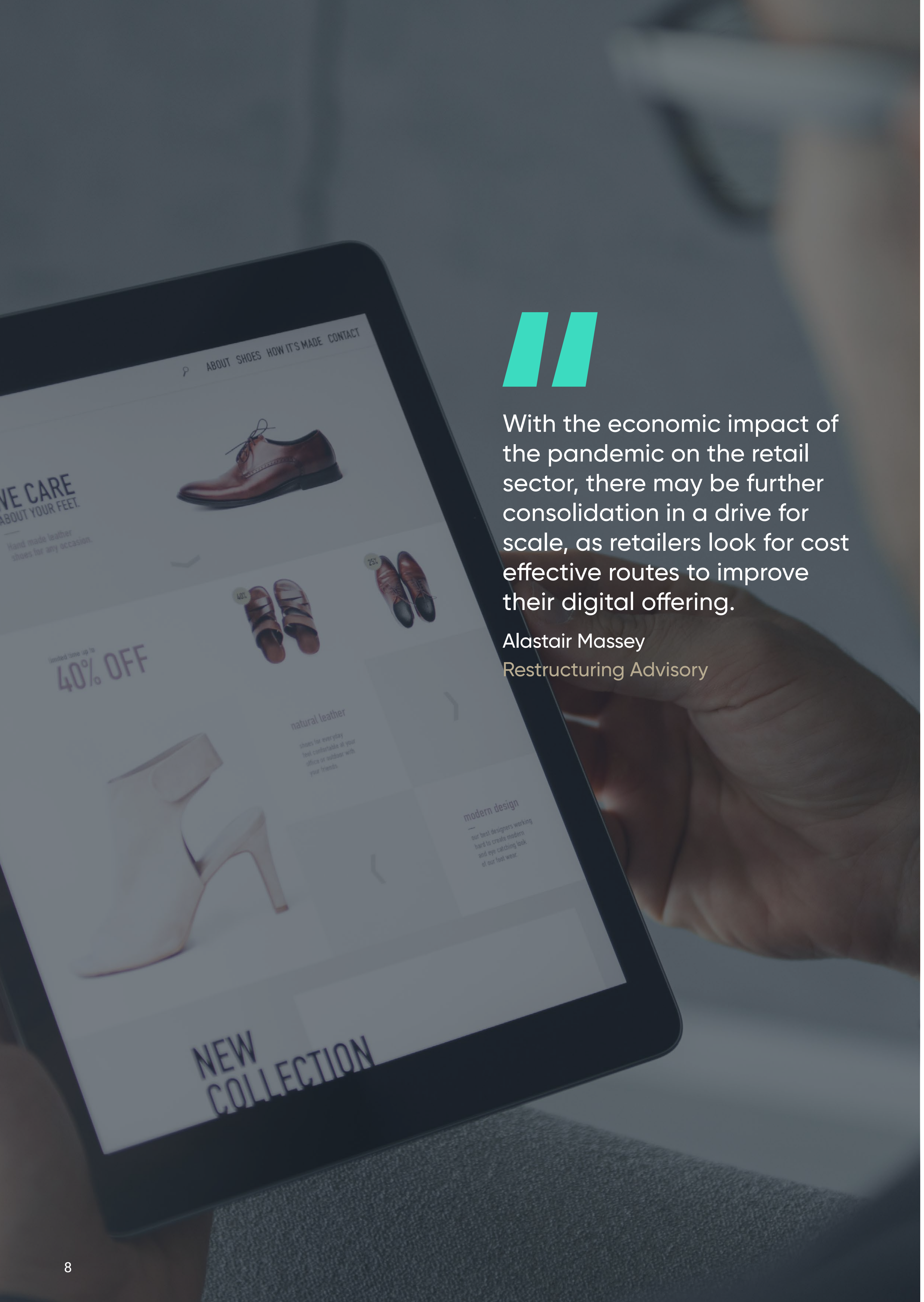
Another significant measure introduced by the UK government during the pandemic has been the temporary suspension of wrongful trading provisions, effectively giving directors the green light to prioritise their business over the position of creditors while not being exposed to wrongful trading actions.

The suspension doesn't absolve directors of fraudulent trading, misfeasance and other insolvency provisions, and directors must continue to protect themselves from any future criticism, potential personal liability, or disqualification.

Similarly, the government's moratorium on commercial evictions is not a permanent fixture. Business leaders should not be prevented from heading to the negotiating table and addressing any unpaid rent burdens in good time. And while many industry leaders are lobbying for the government to extend rates relief, this measure will not continue indefinitely.

Some business leaders may falsely believe they won't be liable for any wrongful trading during this period, or that the rent moratorium will prevent landlords from going after them for their deferred rent payments, but this is a short-term, and risky viewpoint.

The relaxation of wrongful trading rules, and the moratorium on rents has provided a temporary breather, but it's imperative business leaders consider the long-term picture. These measures won't be in place forever, and it's important business leaders address any cashflow challenges at the earliest opportunity, communicate any challenges with their stakeholders and plan a way to get through. Directors must maintain good management practice, continue to act in good faith and have open dialogue with landlords and creditors to try and establish mutual consent for deferments and standstill agreements.



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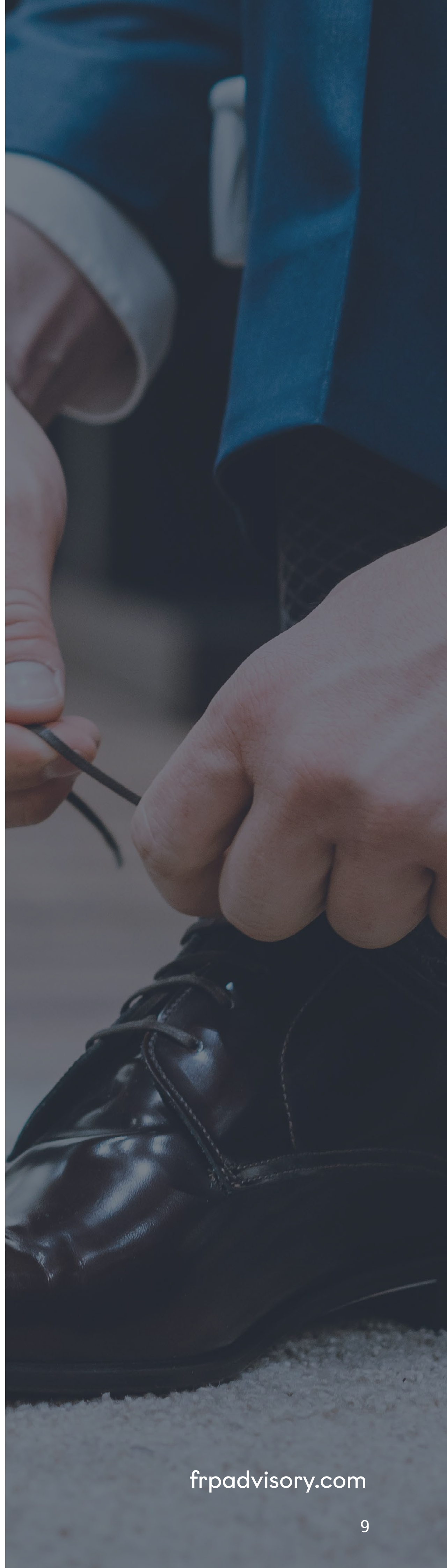
How will this impact the future of the sector?

With the economic impact of the pandemic on the retail sector, there may be further consolidation in a drive for scale, as retailers look for cost effective routes to improve their digital offering. For retailers looking to overhaul outdated websites and e-commerce platforms, the cost of doing so independently can be high, but there is the option of linking up with larger, more experienced e-commerce providers to manage fulfilment needs, so we'll likely see more market consolidation on this front.

Supply chain consolidation has been happening for some time, as customers push for lead time reductions and cost savings. This activity will likely gather pace, as profitable businesses look to take advantage of the discounted valuations of struggling companies. This in turn will allow them to increase their capabilities, customer base and technologies, meaning they emerge in a stronger position, with a more diversified and valuable proposition as growth returns.

We're seeing paradigm shifts in how and where customers are shopping, which has the potential to turn the retail property market upside down. One of the main factors driving this is consumer cautiousness around travelling, particularly on public transport, resulting in an increase in consumers shopping in their own local town centres and convenience shops.

We're also seeing shifts in consumer habits due to the impact of the pandemic on their spending power. Millennials and Generation Z experiencing employment challenges are typically trading down, while high earners are trading up and opting for high-end brands, resulting on a squeeze for mid-range retail. It's not yet clear what the impact of these changes will be on the industry - whether mid-range retail will thrive online and reduce their pricing, or whether cheaper brands will struggle with delivery costs.



Conclusion

Unfortunately, we expect further distress in the retail sector in the year ahead. The market challenges facing many bricks and mortar chains means that they will face existential challenges over the next year, with pressures mounting as lockdown restrictions continue, and with consumer shopping habits continuing to outpace the ability of larger retailers to react. Further changes to spending habits will undoubtedly continue with reduced overseas travel and continued investment in home DIY. The gap between struggling retailers and those that are performing well will continue to widen.

It is important that companies map out potential risks, put in place robust contingency plans, and have the courage and vision to explore options to streamline their business if appropriate. Businesses should focus on conserving cash, find ways to reduce costs and be competitive on price as a priority.

The ability to challenge and re-examine every aspect of the business is crucial, and it's worth noting a simple reduction approach may not always be best. The ability to identify risks, scenario plan and maximise the cash management runway is a key starting point. This is what all management teams are focused on, and they should continue to keep a close eye on operations.

Retailers that are not yet advanced in online sales will find developing an online strategy and setting up a robust delivery and click and collect function, a costly and time-consuming exercise, so it's important to plan for this carefully.

It is more important than ever that companies and their advisors explore every avenue to promote the rehabilitation of businesses, whether through solvent rescue financing or through a strategic and rationalised use of restructuring solutions. Raising and refinancing debt can be a key step in unlocking additional funds, and sources of additional funds can include asset-based lenders (ABLs), banks and other institutional lenders.

For businesses that are currently facing challenges, options such as CVAs can offer a route to rehabilitate companies while optimising value and outcomes for stakeholders. When used correctly, and in the right circumstances, a CVA can help to rebuild a resilient business model and realign economic interests for investors, employees, customers and suppliers.

Another possible solution is the 'pre-pack administration', where a business is sold in administration as a going concern, immediately upon the administrator being appointed. One of the key benefits of a pre-pack sale is that it minimises disruption to trading employees and customers, and operations can continue.

While we expect greater levels of restructuring activity in the sector in the months ahead, there are a number of possible routes for businesses to take.

There are many quality management teams in the retail sector, working tirelessly to navigate the ongoing challenges. What they need is continued support in contingency planning. The UK retail industry is world-renowned for its innovation and craftsmanship. With strategic planning, retailers have every chance of delivering growth.

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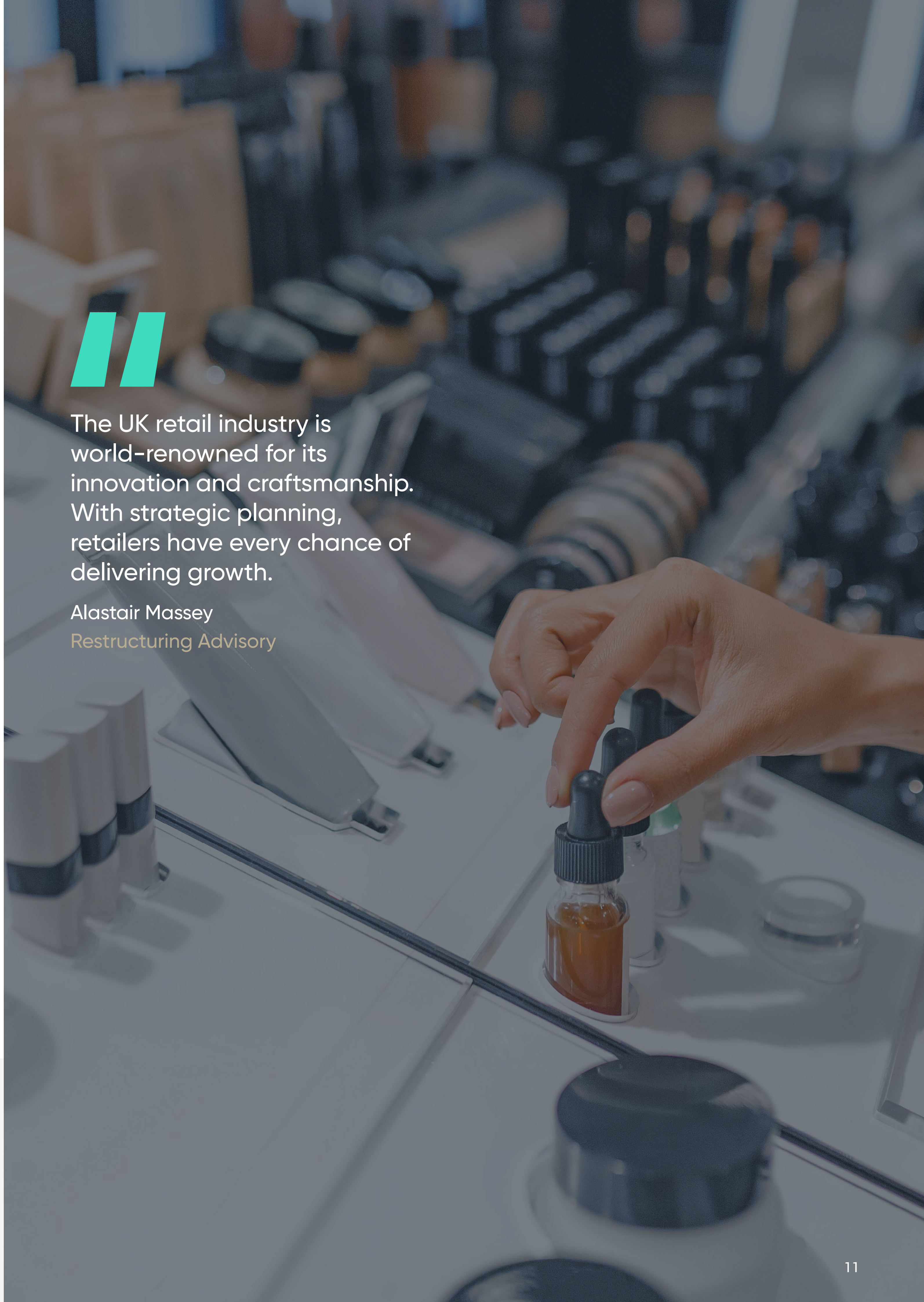
Notes

*1 Retail sales in 2020 worst on record, says BRC trade body. (2021). BBC News. [online] 12 Jan. Available at: https://www.bbc.co.uk/news/business-55625246.

*2 Walker, P. (n.d.). A fifth of online retailers fear failure this Christmas. [online] Retail Systems. Available at: https://www.retail-systems.com/rs/Checkoutcom_Online_Retailer_Survey_Christmas_Concerns.php [Accessed 4 Feb. 2021].



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