

## FOCUS ON THE UNITED KINGDOM

# What Is Driving the Change in the U.K. Retail Market?

BY BARRY GILBERTSON, CRE, PPRICS

ONE OF THE REASONS FOR WRITING THESE INSIDER'S PERSPECTIVE articles is to draw, in the mind of the reader, a similarity or contrast between the U.K. and the property market in which the reader operates. It seems to me that property markets function in very similar ways around the world, and we can all benefit by experienced practitioners and commentators sharing their opinions and expertise.

If one word was needed to describe the retail market in the United Kingdom, "restructuring" would fit that bill. The U.K.'s retail market is undergoing a dramatic change, bringing about sustained restructuring and closed stores, as well as a cautious approach by banks and other investors who normally invest in the retail market.

During the last six months, my firm has been involved in the restructuring of seven national retailers, sectors ranging from electronics to children's wear to greeting cards. Of more than 2,000 stores reviewed, on average some 27 percent were left behind as the retailer emerged from the restructuring process.

Current indications show that the store restructuring trend will continue. Even major retailers such as Gap and Thomas Cook are not immune to the restructuring, as both have announced that they will be closing stores. The latest addition to the list is Fopp Music, with 81 stores. It acquired 68 former MusicZone stores earlier this year, and has closed 37 (or 54 percent) outlets. Earlier this year, MusicZone acquired the stores from MVC.

In the U.K., retailers comprise 11 percent of all enterprises, with 182,475 Value Added Tax (VAT)-registered

businesses operating from 278,365 retail outlets in 2006.<sup>1</sup> Pulling together statistics from retailers and market data sources<sup>2</sup> suggests that there are approximately

- 850 retailers with more than 20 stores, plus
- 110 retailers with more than 100 stores, plus
- 140 retailers with more than 200 stores



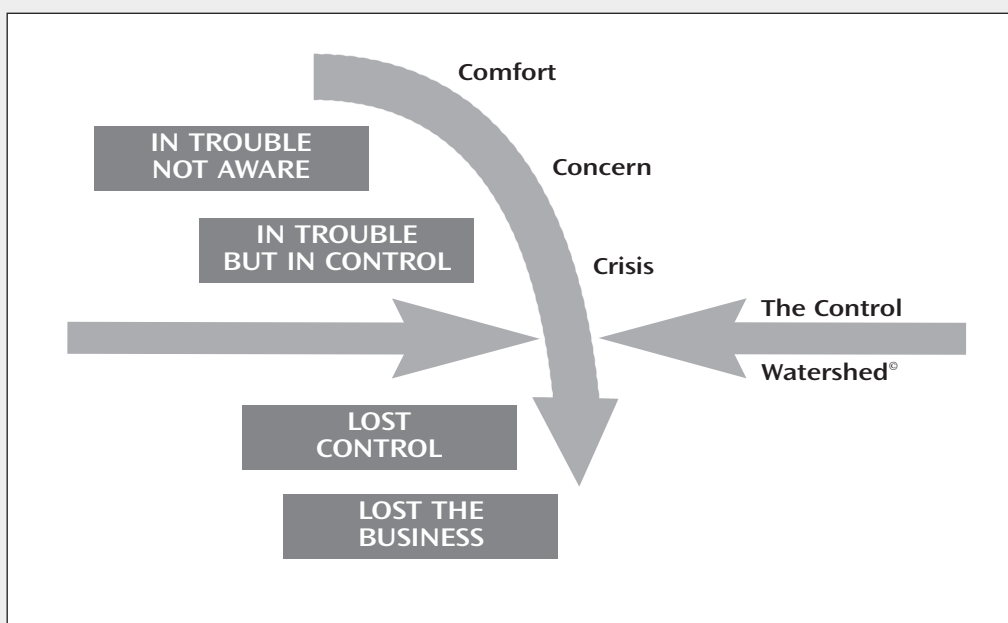
## About the Author

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If just 10 percent of the retailers in each category were to experience financial difficulties, and find the need to jettison or otherwise dispose of their leases, there could be, over the next year, more than 2,700 retail units coming onto the market. Such a flood of shops could be disastrous for the levels of rent achievable going forward, with a consequent knock-on effect on property investment values in the retail sector.

This potentially alarming picture is reinforced when Morgan Stanley's prediction of overly optimistic retail sales forecast is taken into account. If the forecasts are 20 percent too high for next year, as Morgan Stanley predicts, continued pressure on consumer retail spending by further increased interest rates will only exacerbate the problem, potentially causing further stores to come onto the market and remain vacant with little or no demand.



### The Corporate Demise Curve®

The Corporate Demise Curve demonstrates why it is so important to consider early what to do when things go wrong. All companies start from an enthusiastic base, and some become truly profitable over time. However, it is equally true to say that most companies' profitability and cash receipts will plateau at some point in their development. The successful company leaders will recognize this truism and be preparing for the plateau on their way up towards the crest. When their plans are implemented, it becomes possible to push on up again, towards the summit of success.

Company leadership that is blind to the approaching plateau may not even recognize it when they get there. They may think that their flat line trading is a blip, or that they are still profitable, so what does it matter? Cash is why it matters. Without consistently strong cash flow, no company can survive for long, and it certainly cannot grow. Instead of climbing onwards and upwards, these companies slip down the Corporate Demise Curve, sometimes at an alarming pace, as the vortex of cash deficiency spins ever faster. Comfort becomes Concern and Concern becomes Crisis. At this point, The Control Watershed, the company usually loses control of its affairs into the grips of their lenders, creditors, shareholders and other stakeholders.

Once a company's destiny is no longer in the hands of its own leadership, the end may be near. So, the lesson is to recognize the plateau before you can see it, then plan on how to get safely across it. If you find yourself slipping out of control down the demise curve, seek help sooner than you think you need to do so. With the right ropes, karabiners and winching gear, you might just be able to haul yourself back onto the plateau, and be helped to navigate your way to the foothills of Success Mountain. ■ ©PricewaterhouseCoopers

## What Is Driving the Change in the U.K. Retail Market?

U.K. retail sales were £256 billion (\$516.9 billion) in 2006, which is larger than the combined economies of Denmark and Portugal, generating 6 percent of the U.K. Gross Domestic Product. After several years of strong growth—evidenced by retail employment growing by more than 98,000 people over the past five years—the retail sector seems to be faltering, at least in the High Street (generically referred to as Main Street in the United States) and in out-of-town stores (known as suburban shopping plazas or strips in the U.S.). At the end of 2006, the retail industry employed three million people, which equates to 11.2 percent of the total U.K. workforce, or 1 in 9 people.

Is the downturn on High Street caused simply by the Bank of England's rising interest rates, which are squeezing disposable incomes? A recent report by PricewaterhouseCoopers (PwC), titled "The Internet: This Time It's For Real," suggests that the Internet has been a key driver of change. Online sales in the U.K. this year are expected to reach £14 billion (\$28.2 billion), and indications point toward double digit growth in the years ahead. For High Street retailers without effective Internet offerings, this has a negative effect. By 2011, PwC expects the market to be worth up to £35 billion (\$70.7 billion). As the U.K. retail market is expected to grow by around 15 percent between now and 2011, the majority of this growth will be in the volume of sales online (around 60 percent). It is increasingly likely that consumers will shop for products in the stores, which enable them to physically touch the items. They then are more likely to buy the product online at a lower price. This obviously is to the detriment of the retailer that provided the store in which the consumer viewed the item.

Airline and other travel have rapidly migrated from a face-to-face transaction to an impersonal search for the best deal on the Internet, causing travel agencies to increasingly move online, away from High Street stores.

So, if the move to bricks and clicks is going to save some retailers from extinction, it is clear that the stores that are retained should be the ones in the best locations, even if they are smaller in size with stock management by just-in-time delivery, and larger more impressive websites to attract the browsers, making it easier to buy online and collect in store. If the retailer can position their stores in an easily accessible location, then the consumer will collect in-store rather than wait for delivery, which for anything more than a small parcel, may need them to wait, perhaps

inconveniently, at home to take delivery. The good thing for the retailer is that once the consumer comes into the shop (importantly having parked their car nearby rather than a hurried collection with the car on yellow lines) then the retailer has the opportunity to on-sell accessories, complementary goods or insurance/maintenance agreements where profit margins are often better.

With such clear evidence of weakness in the retail property market, it is vital for retailers to continually review and churn their store portfolios. Underperforming stores need to be identified quickly and a clear decision taken to turn around the trading or to dispose of the individual shop or portfolio of stores.

### BE WARY OF MISPLACED OPTIMISM

Retailers should be wary of misplaced optimism resulting in the turnaround option becoming the default choice. Any turnaround plan requires a detailed timetable with measurable milestones of success. Failure to act will eventually necessitate more radical measures. In one of the seven retailer restructurings undertaken by my organization this year, a retailer had been seeking to sell its lease of a store in Gateshead, a town in the north of England, by offering a £1 million (\$2 million) incentive (or reverse premium) to the buyer of that individual lease, as part of its restructuring plan to dispose of 20 percent of its store portfolio to return the overall business to profitability. At a cost of £1 million a store – an extreme example to make the point – it is easy to see that restructuring can be an expensive process in order to save the trading business of a troubled retailer.

There are important lessons for landlords who will need to revise their design considerations to build smaller stores in well positioned locations, with or very near car-parking. Some may even consider drive-thru collection points.

There also are important lessons for banks and other lenders who may need to rethink their strategy regarding funding further store openings or industry consolidation when the retailer may end up with more than one shop in any town. Large investments and consolidation may not be the way of the future for in-store retailing.

There are important warning signs for investors, too. At its recent high, the retail investment market for individual shops peaked at a return of around 3 percent. Without rental growth, it will take 33 years to get the investor's money back. At the same time, the investor will be desper-

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ately hoping for capital growth by the time the investor decides to sell.

The changing profile of shopping trends will mean that investment returns will suffer as rental growth slows following a changing demand by retailers for fewer stores from which to trade.

In the out-of-town market, rental growth has slowed dramatically. Press reports have indicated that, for example, British retailer B&Q has recently negotiated zero increases in the five-year rent reviews at three of their megastores. For the next five years, B&Q will be paying the same per square foot rent that it agreed to five years ago—or, in reality, a static rent for 10 years. The consequence for property investors will be diminishing investment returns and a certain nervousness concerning any desire to build or buy more out-of-town investments.

It will be interesting to see what happens to interest rates if inflation is not reigned in, as the Bank of England believes will be the case. Increased interest rates have upped the mortgage rates, but the problem lies in that many homeowners have fixed interest rate mortgages. These fixed rates currently protect them against the storm of higher mortgage payments. Unless borrowers save for

the day when their fixed-rate mortgage expires, then their disposable income has not, so far, been unduly hit by rising interest rates. However, when the higher rates bite into the amount of money left in the weekly pay packet after paying for their mortgage, then it is almost inevitable that consumer retail demand will cool and less money will be spent on retail, in store and online.

This reduction in demand and changing consumer buying habits could lead to an increased percentage of stores being left behind after the future restructuring of struggling retailers, causing more misery for the freehold owners of the units, which may remain unlet in the short- and mid-term. This will harm their cash-flow and indeed their own ability to service the loans that they used for their initial shop investment.

The longer term prospect for retail store owners, investors, lenders and other stakeholders looks more challenging right now than it has been over the past few years. ■

### ENDNOTES

Note: This article is a variant of a piece previously printed in *Estates Gazette* and includes comments from a recent interview with *Retail Week*.

<sup>1</sup> With thanks to The British Retail Consortium [www.brc.org.uk](http://www.brc.org.uk)

<sup>2</sup> With thanks to Jones Lang LaSalle, Experian and Goad