



THE SHAPE OF RETAIL

ASSESSING THE ROLE OF PHYSICAL
SPACE IN THE U.K. RETAIL INDUSTRY



ALVAREZ & MARSAL

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Foreword

Napoleon dubbed the U.K. “a nation of shopkeepers”. He meant this as a veiled criticism, but in many senses, it was a compliment. As the Industrial Revolution took hold, town and city centres throughout the country grew into vibrant hubs for commercial activity.

As an Australian who has lived in the U.K. for 30 years, I’m aware that the High Street retains a special place in the nation’s consciousness and so it’s understandable that many stakeholder groups are concerned about the outlook: the future of the High Street is a social as well as an economic issue.

Change has not happened overnight. Driven by the aggressive acquisition of commercial space coupled with the growth of online, physical retail in the U.K. has been suffering from a long-term, straight-line decline which has only been exacerbated by wider economic and political uncertainty. Similar trends can be observed elsewhere, but in no other country does this have more resonance.

To better understand the future of physical space in U.K. retail, we partnered with Retail Economics to provide new data-backed insights into the ‘perfect storm’ sweeping through the industry. We found that the widely perceived ‘breaking point’ is indeed upon us: **store-based profit margins have more than halved** over the last decade, driven by increasing operating costs, and the legacy of inflexible lease structures. This has put a strain on **large multiple retailers which occupy up to 20% more store space than they need and can financially justify.**

While the situation may be grave, we have also found grounds for optimism. Our consumer panel has shown that **physical retail remains hugely relevant, particularly for Millennials and Generation Z** – a demographic set to become the biggest spenders in a decade. However, physical retail cannot survive in its current format as a distribution hub. Retailers will need to work harder than ever before to accommodate the demands of the experience economy, extreme convenience, digital proficiency, reliable data and new strategic partnerships. We need to see a new approach which unites all these factors in spaces better structured to serve local communities amid entertainment, leisure, dining and residential needs.

In our view, the new era in retail will require **greater collaboration between landlords, retailers and local authorities**, whether that involves striking the right balance of retail and leisure mix, creating nimble pop-up schemes, agreeing rent cuts that allow companies to reshape their debt and operational structure, or adopting turnover-based rents for rewarding those who out-perform. There are a number of levers British retailers can pull to weather the storm. Those that act quickly will not just be able to maintain their presence on the High Street; they’ll enhance it.

Richard Fleming

Managing Director and Head of Restructuring, Europe



Physical retail remains **hugely relevant**, particularly for **Millennials** and **Generation Z**



Introduction

A new era in retail is upon us. Shoppers expect to seamlessly transition from physical to digital channels, often in the same environment, while immersing themselves in retail spaces that help create memorable experiences ideal for sharing instantly for the purposes of social and online approval.

The consumer love affair with online shopping and the growing importance of the experience economy has collided with rising operating costs and over-supply of stores. Fundamentally, this has altered the economics of store-based retailing, putting intense pressure on legacy business models. This perfect storm has tested retailers, pushing many of them to breaking point.

Our research found that **store-based profit margins have more than halved** over the last decade as consecutive rises in business rates, the National Living Wage, the National Minimum Wage and relative occupancy costs spiral upward.

While this new reality unfolds, many large retailers are shackled by an excessive number of stores with space no longer fit for purpose while battling inflexible lease structures which restricts their ability to transform and develop more future-proofed business models.

Our research unveils that **large multiple retailers in the U.K. are currently carrying up to 20% of store overcapacity** as the industry transitions through a painful readjustment period.

Consequently, retail casualties such as Toys R Us have occurred along the way. In desperate attempts to pull up a barstool in the last chance saloon and carry out transformational restructuring to meet the new trading realities, others such as House of Fraser and Karen Millen have sought Company Voluntary Arrangements (CVAs). Inevitably, large-scale rent reductions are having knock-on implications throughout the industry as the negotiating power shifts away from landlords in favour of occupiers.

Critical issues facing landlords is the volatile and disparate performance of retailers and leisure businesses, unrealistic property valuations and the perceived risk for investors. While some retailers are better positioned to cope with transformative headwinds, others are succumbing to the onslaught of significant additional costs and are belatedly grappling to create more technology and experience-focused business models. Naturally, negative sentiment towards the retail property market has intensified, applying great pressure to asset values against a backdrop of falling rental income. In turn, this will inhibit the investment appetite for the sizeable CapEx outlay required to transform these assets.



This is, accompanied by an increase in the cost of capital, based on higher risk profiles and the inevitable end of ultra-low interest rates. Both are certain to have negative consequences for retailers, property owners and institutional investors such as pension funds.

Accordingly, demand for U.K. retail space is now at its lowest since 2007, with a flight toward prime mixed-use locations such as Birmingham's Bull Ring and London's Westfield in Stratford, offering retail, leisure, entertainment and amenities, while serving vibrant night-time economies. However, secondary frontages and mid-tier centres (and lower down the retail hierarchy) are highly vulnerable to weak footfall, driving a 45% decline in the total volume of retail transactions from 2017 to 2018, and **equating to a 60% drop over the last two years.**

The inevitable reality is that fewer physical stores will be present on the high streets of the future, and the role of those remaining stores will have to evolve. Despite the rapid growth of online retailing, **even on its current trajectory, physical retail will still account for 65% of all sales in the next five years** – but with a growing reliance on convenience and discount retailers, paying lower rents who are also frequented by consumers with lower disposable incomes.

The fate of the High Street lies in the hands of innovative retailers and forward-thinking landlords who embrace the inherent strength of physical stores, enhance the value of experiences and incorporate digital touchpoints to merge both physical and digital realms. Inert Local Authorities will need to become far more pro-active to ensure these essential transformations achieve critical mass in the central business districts of towns and cities.

With seismic changes afoot, **the relationship between retailers, landlords and investors is likely to result in 'game-changing' consolidation within the industry.**

Competition is fiercer than ever before, inevitably leading to both vertical and horizontal acquisitions and innovative strategic partnerships that were unimaginable just a few years ago. A sharp focus on strategic transformation is needed to burn its way through the challenges, declaring itself the overriding priority for retail and leisure. The race is on to pivot business models fit for tomorrow's increasingly digital, experience-driven age.



Part 01

**The current
composition of
the retail market and
how we got here**

In part, large chain retailers and landlords were able to turn to capital markets to fund extensive real estate buildouts.

Since the 1980s, market share increases were largely achieved by an aggressive expansion of physical space – ‘land grab’ being an intrinsic component of past development strategies.

In parallel, the grocery sector broadened its non-food proposition, while a rise in the number of restaurants and leisure outlets followed the shift in spending habits.

What ensued was a rapid expansion of physical space on high streets, new destination shopping centres, coupled with larger ‘big-box’ stores, frequently located in out-of-town retail parks. In part, large chain retailers and landlords were able to turn to capital markets to fund extensive real estate buildouts. The new developments simultaneously added to (and cannibalised) traditional town centre environments they encroached upon. Such expansion led to oversupply in many U.K. regions, creating ‘cloned high streets’ lacking the idiosyncratic retail characteristics that local communities once prided; and over time, under-investment and local authority complacency plagued these ventures. Furthermore, mass marketing strategies focused on aggressive pricing, aimed at capturing market share, but often diluted profit margins, brand equity and anonymised customer relationships.

This expansionary era dovetailed with vibrant economic growth as households (responsible for two-thirds of the economy) saw real incomes rise by around 3% each year from 1997 to 2007, and more sophisticated global supply chains drove consistent deflation across core retail categories such as clothing, electricals and homewares. Consequently, this retail growth strategy worked for decades.

The last five years have seen a reversal of many of these trends. In the aftermath of the financial crisis, households experienced a marked slow-down in their disposable cash, acting as a catalyst for shoppers becoming savvier and starting to seek cheaper alternatives. As technology improvements ushered in an era of heightened transparency in pricing, service and quality, up-and-coming discounters began to establish firmer footholds within various markets.

The rise of online

Digital transformation has paved the way for more sophisticated, multi-channel retail propositions, supported by increased uptake in smartphone usage and online shopping, ultra-convenient same-day home deliveries and efficient click-and-collect.

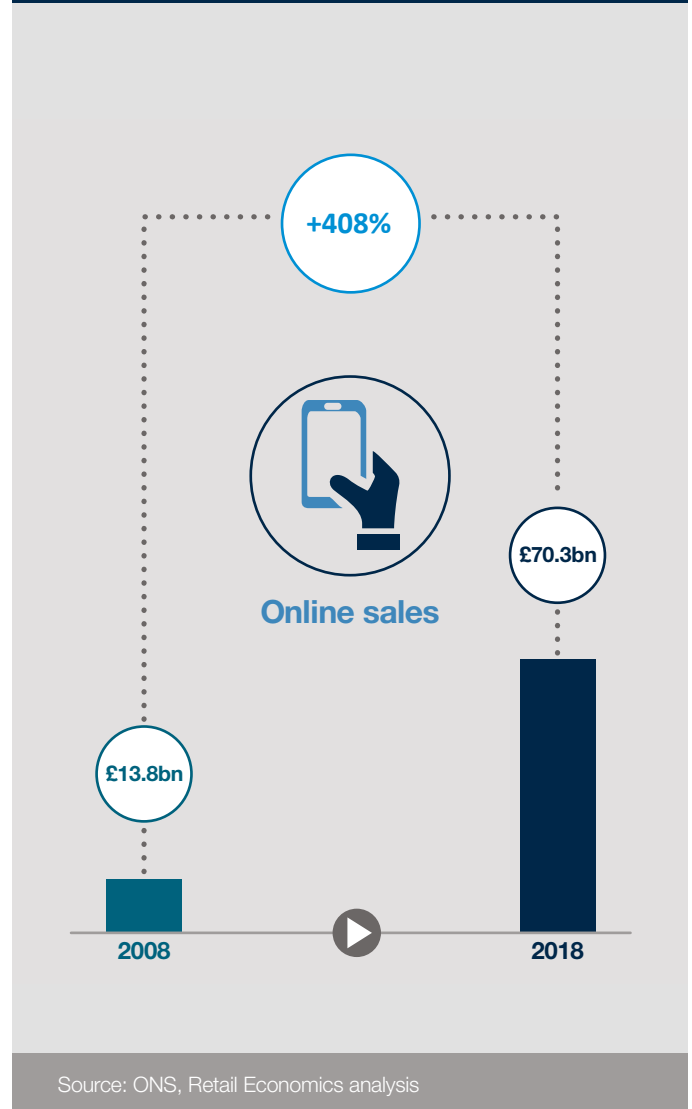
In the past decade, the **value of online retail has risen four-fold, worth an estimated £70.3 billion in 2018** and accounting for just under £1 in every £5 spent. For some sectors like clothing, this proportion rises to over a third – a sensitive issue for certain town centres where clothing retailers constitute over 40% of the physical presence.

Forward-thinking omnichannel retailers and the emergence of online-only brands offering strong digital propositions exploited these trends while advantageously amassing vast quantities of consumer data. **Efforts by retailers ‘late to the party’ that mimicked the mechanics of offering an online proposition often proved dilutive**, as additional infrastructure and investment were deployed to service the same customer and the same order.

Crucially, the fast-paced adoption of consumer technologies presented shoppers with an array of digital touchpoints which fundamentally altered their behaviour in physical locations. A linear customer journey that stood decades-long, quickly dissolved. Its regeneration bore an infinitely more complex structure. Shoppers now expect to be able to seamlessly transition between channels, redefining the boundaries between physical, digital and on-the-move.

As physical and digital realms merge, the experience economy is increasingly prominent as people reassess the value they attach to material possessions. In the Western world, we have arguably approached the point of ‘peak stuff’.

Figure 1. Online sales have risen four-fold in the last 10 years



Value of online retail has risen four-fold, worth an estimated £70.3 billion in 2018.





The experience economy

Engaging in meaningful experiences has become a differentiator of choice for many, evidenced by the shift in household expenditure.

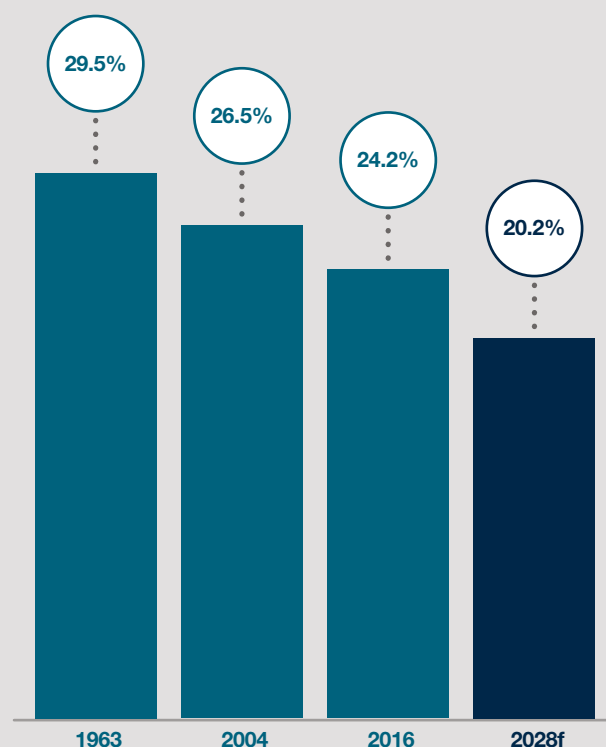
Indeed, **retail spending used to account for 29.5% of household expenditure in the 1960s and is expected to fall 20.2% in the next 10 years.**

Although the shift towards experiences has arguably come at the expense of retail, its role in the customer journey is undeniable. While consumers claim to spend more time browsing products online than they do in-store, **the relative importance in the discovery and research of retail products is more influential in physical locations**, particularly flagship destinations where 'experiences' matter.

Retailers and landlords alike recognise that staging meaningful experiences is critical in the moments that matter: moments of discovery; moments of desire; and moments of action.

What's more, shoppers expect digitally enhanced physical environments; think Instagram walls, Facebook check-ins and Snapchat codes that inspire, excite and offer experiences that cannot be replicated online.

Figure 2. Retail as a proportion of consumer spending is edging down



Source: ONS, Retail Economics analysis

Positive retail experiences can be quantified using four key themes, as defined by Retail Economics:

1 Entertainment

Surroundings that excite and build desire over brands through performances and activities.

Entertaining consumers by providing attention-grabbing and captivating content plays an essential role in delivering an absorbing overall experience. This can include anything from live product demonstrations to glitzy fashion shows to celebrity book signings or even live streaming.

2 Education

Facilitating experiences that fulfil consumers' desires to improve knowledge and skills.

Educational retailer experiences tend to involve more active participation from consumers, but they occur while still on the fringes of the event and not fully immersed. In many cases, educational experiences will be supported by in-store personnel that have good technical knowledge and increasingly by online video content, chatbots or online support.

3 Environment

Creating immersive retail spaces (virtual or physical) that delight, including ease of checkout.

Stores can offer an experience that cannot be replicated online while cultivating direct and meaningful relationships with customers. These stores engineer environments where customers feel relaxed, comfortable and encouraged to spend time browsing and discovering new products which are showcased in aspirational settings.

4 Escapism

Providing consumers with change and novel experiences to escape from everyday environments.

Providing the opportunity for shoppers to embrace time away from their normal routines is often an easy win when attempting to generate meaningful retail experiences. The central theme is that consumers increasingly desire to shop in an innovative and novel environment combined with digital touchpoints and knowledgeable service. A masterful infusion of digital technology (interactive content, storytelling, promotion and showcase), seamless convenience (click-and-collect, mobile optimised) and customer service (efficient and face-to-face) in an inspiring environment can form a powerful escapism experience.

Operating costs

Amid these seismic consumer-driven shifts, retailers have also faced a backdrop of spiralling operating costs.

Successive rises in business rates, the National Living Wage (NLW), the National Minimum Wage (NMW), logistics, utilities and other central costs have squeezed profitability, thus eroding it. The Retail Economics Retail Cost Base Index shows that operating costs rose by 2.4% in 2018. However, **over the last five years, operating costs have risen by 10.8%, with labour costs constituting over half of the increase.**

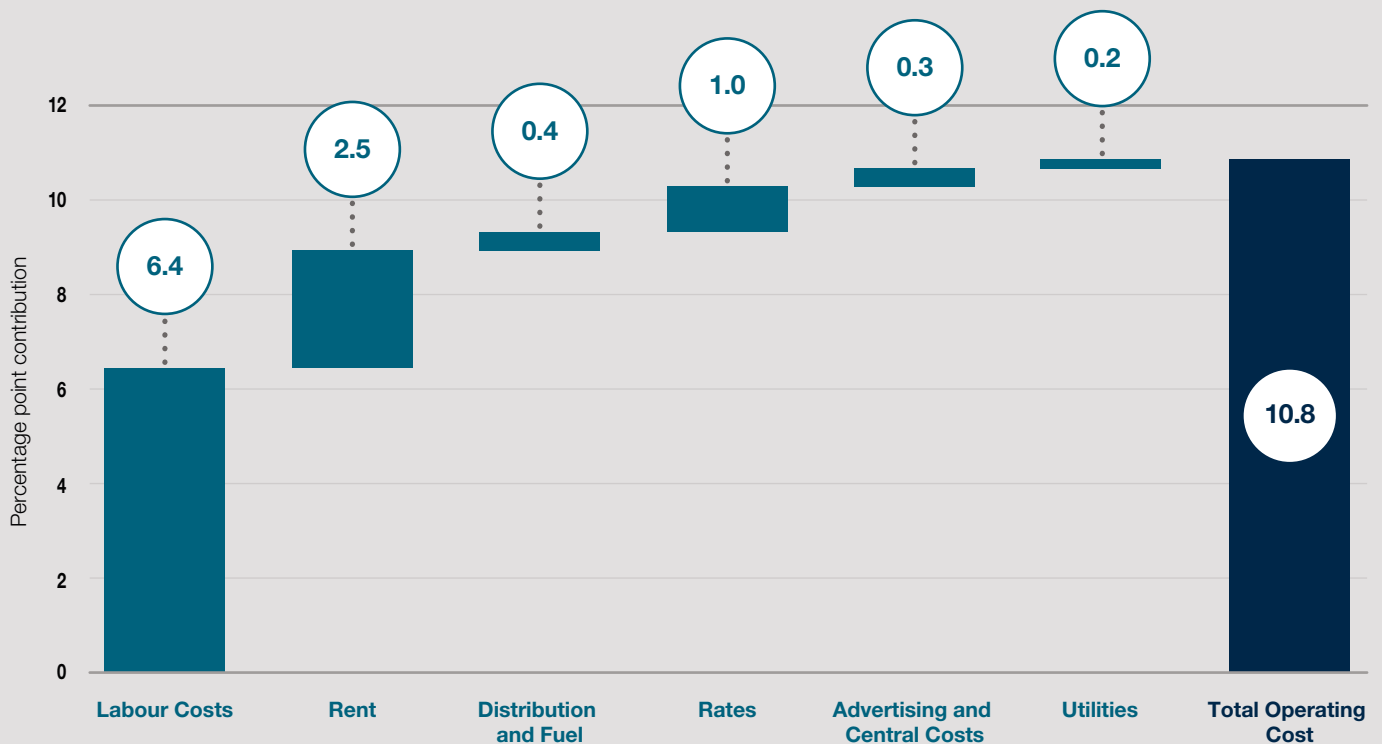
In fact, consecutive increases in the NLW and the NMW, and costs associated with the Apprenticeship Levy, have driven an acute rise in labour costs which comprise around 46% of total operating costs. Wage hikes among lower-paid groups have a 'ripple effect' across entire wage distributions as businesses retain wage differentials. **We estimate that the increase in the NLW costs the industry in the region of £1.5 billion per year to implement.**

Business rates also remain a significant burden on retailers who have a disproportionate exposure to property.

Retail Economics estimates that business rates cost the retail industry an estimated £7.5 billion in 2018, and in some parts of the country exceed retailers' rental values. Indeed, in certain highly rated centres, total occupancy costs are now exceeding store labour costs.

Against rising operating costs, profit margins have been under intense pressure. **Over the past eight years, the top 150 U.K. retailers have seen their pre-tax margins more than halve from 8.8% in 2009/10 to 4.1% in 2017/18.** This trend is unsustainable and, combined with the decline in demand, has lethal risks to physical retail, landlords, investors and creditors.

Figure 3. Retail operating costs have risen 10.8% from 2014-2018

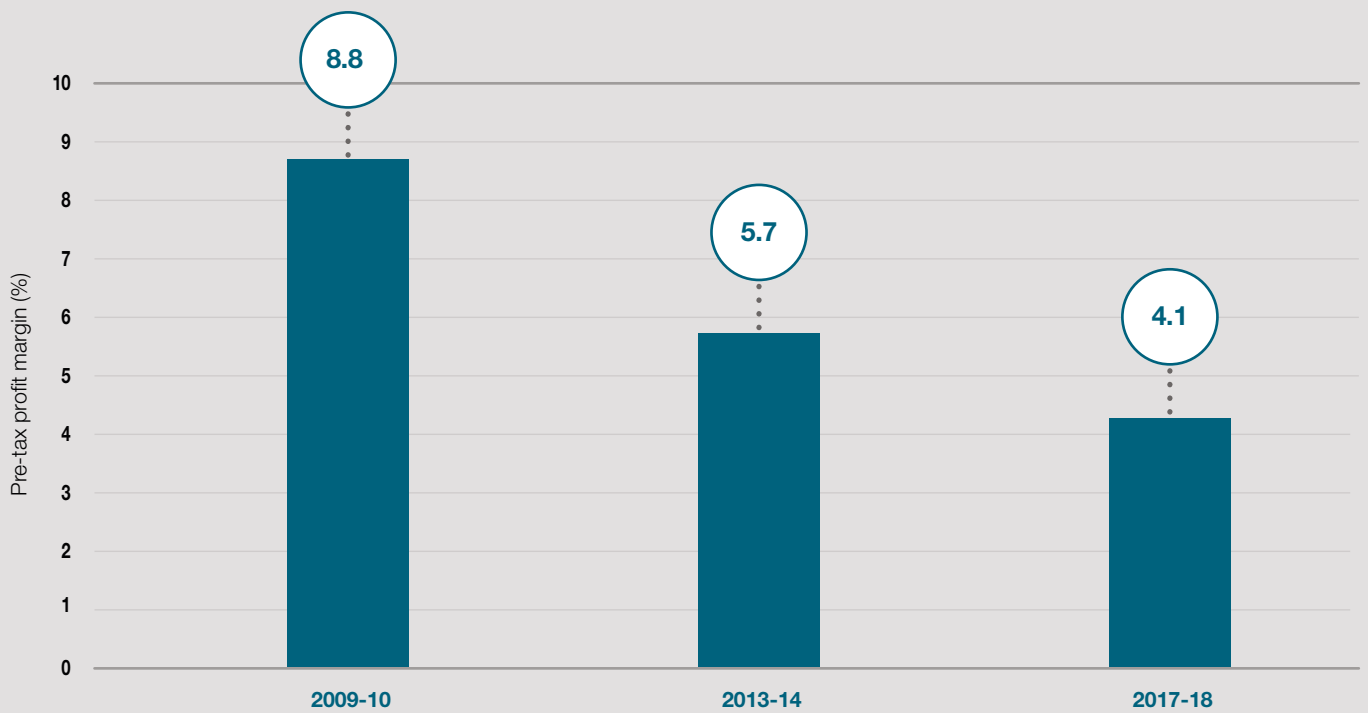


Source: Retail Economics analysis



Figure 4. Pre-tax profit margins for the top 150 U.K. retailers have more than halved in the last 8 years

Average pre-tax margin for top 150 U.K. retailers weighted by group sales



Source: Financial reports, Companies House, Retail Economics analysis

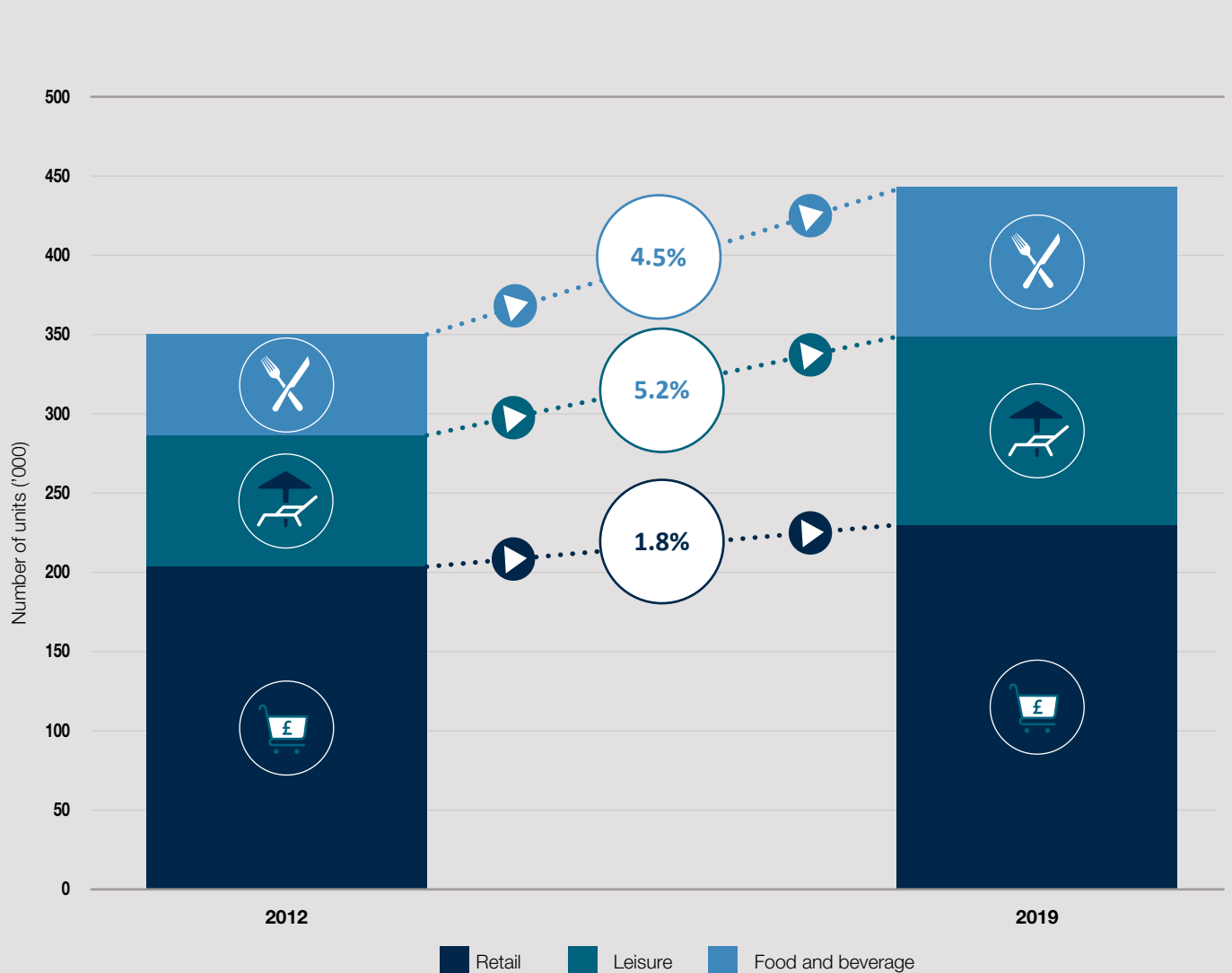
How has the industry reacted?

Structural shifts, rising operating costs and squeezed profitability precipitated a broad polarisation in the retail property market.

On the one hand, these challenges have led to a number of high-profile retailers (e.g. Toys R Us and New Look) closing their doors indefinitely or cutting back on store numbers (e.g. Marks & Spencer) as restructuring continues.

On the other hand an engine of small independent firms continues to drive overall growth in the number of outlets occupied by retailers, leisure (e.g. beauty salons, crazy golf, health clubs) and restaurant businesses alike. Indeed, **since 2012, the overall number of retail and leisure units has risen by over 60,000 units, an average 2.9% yearly increase.** This increase has been more pronounced in leisure units (+5.2%) than in retail (+1.8%) during this period.

Figure 5. The total number of retail, leisure and restaurant units in the U.K.



Source: LDC

This conceals a vast polarisation within the retail environment between independent and multiple retailers.

Through fending off some of these prominent challenges, cost-cutting plans emerged as the overriding priority within many retail boardrooms as decisions about store disposals commanded attention.

As a result, there has been a consistent loss of stores over the past six years for multiple retailers, amounting to a net loss of more than 7,000 units with the largest fall in 2018.

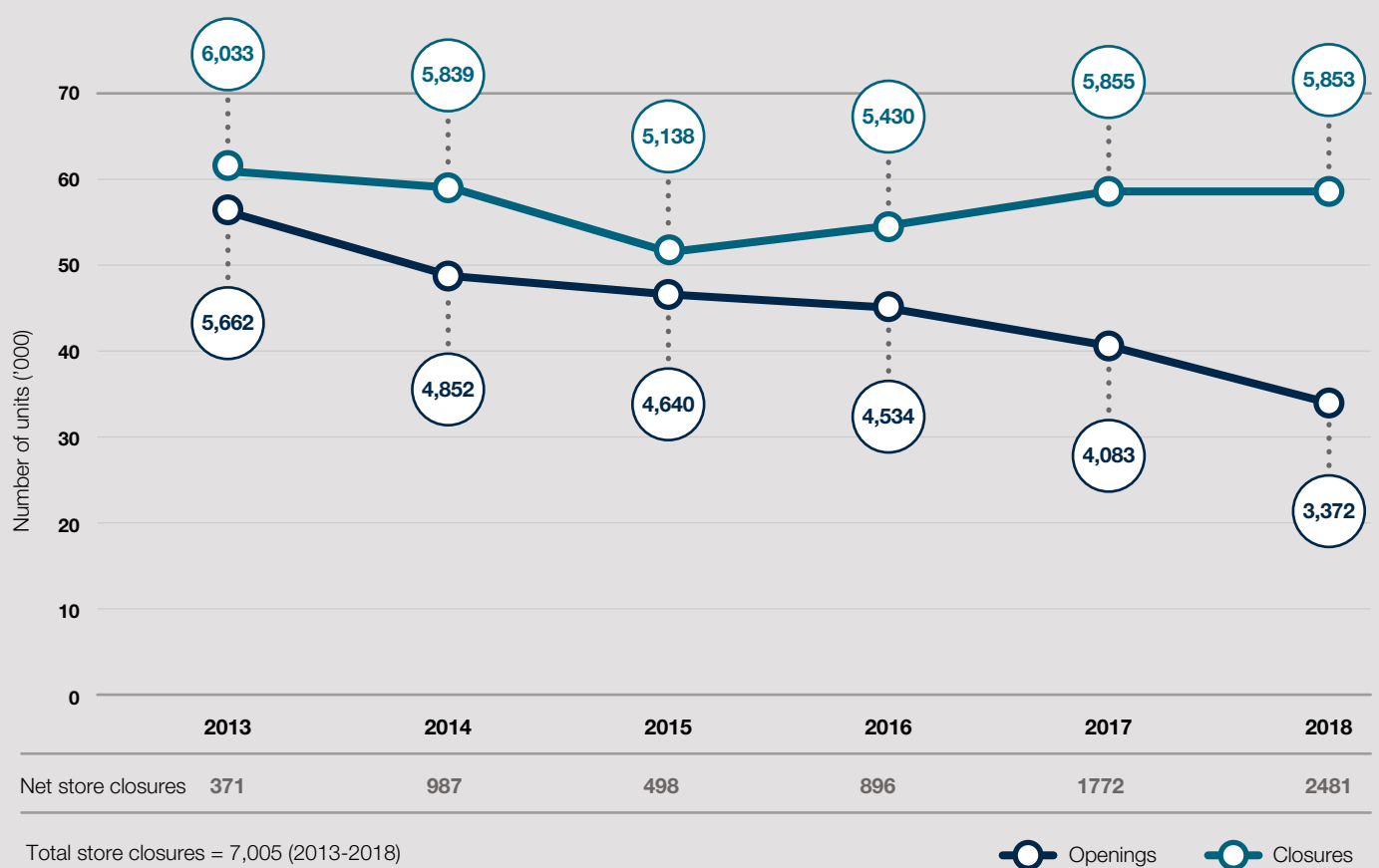
Landlords find it increasingly problematic to reoccupy empty units. Vacancy rates across high streets (11.5%), shopping centres (13.6%) and retail parks (7.1%) in the latter half of 2018 all rose on the previous year; and retail park vacancy rates are now at their highest level since 2014.

Retail Economics estimates (based on LDC data) that approximately 37,000 units lie empty across high streets, shopping centres and retail parks in Great Britain, with almost a third (11,600 units) having been unoccupied for more than three years.

Store closure programmes have been part of wider cost-cutting exercises for multiple retailers as they hustle amid rising costs and shifting consumer behaviour. They have been forced to adopt a forensic approach in reducing their cost base, involving store closures, lower headcount and simplified business models.

Consequently, retail redundancies have soared, as well as cutting back on hours and reducing employee benefits. **In the 12 months to March 2019, 4,500 retail jobs were lost every month¹** and the number of industry employees has steadily declined c.1% each year since 2015.

Figure 6. Openings and closures of multiple retailer units, 2013-2018



Source: LDC

1: ONS



Pressure on retailers' business models

There has been a war-like urgency for many U.K. retailers who have had a presence on the High Street but have been slow to adapt to transform business models.

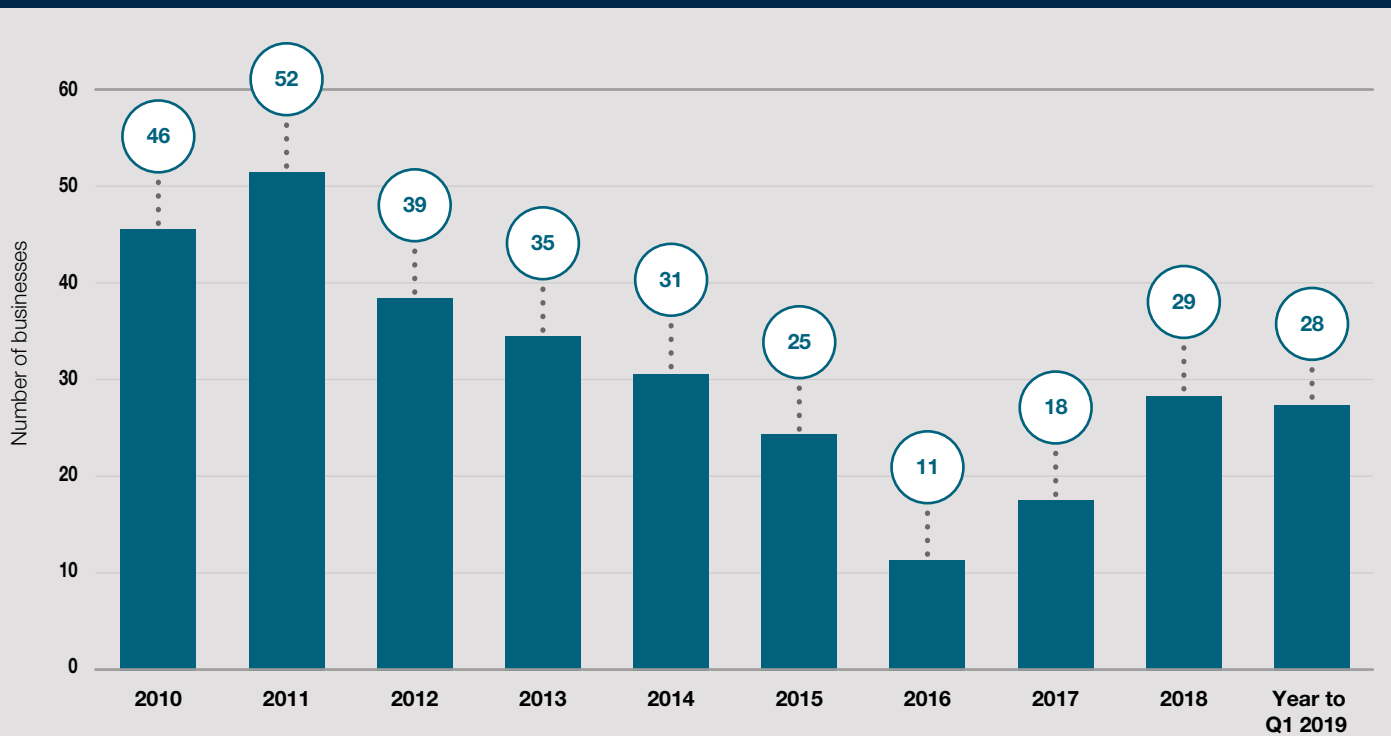
This has led to a rise in high-profile CVAs – a life raft for businesses that are holed beneath the waterline and that can only be considered when the alternative is administration – in a bid for retailers to remain relevant.

Retailers are having to strike a delicate balance between rent reductions and closures during landlord negotiations. Although retailers may favour closures, given that space is difficult to fill, landlords have reluctantly accepted retail CVAs if they predominantly include rent reductions. Analysis by Retail Economics shows that **nearly three quarters (72%) of stores affected by publicly announced CVA approvals in recent years have seen rent reductions, with only 28% of affected stores facing closure.**

Nearly three quarters (72%) of stores affected by publicly announced CVA approvals in recent years have seen rent reductions, with only 28% of affected stores facing closure.



Figure 7. The number of CVAs has risen in recent years but remains low by historical standards



Source: Insolvency Service

The impact on property dynamics

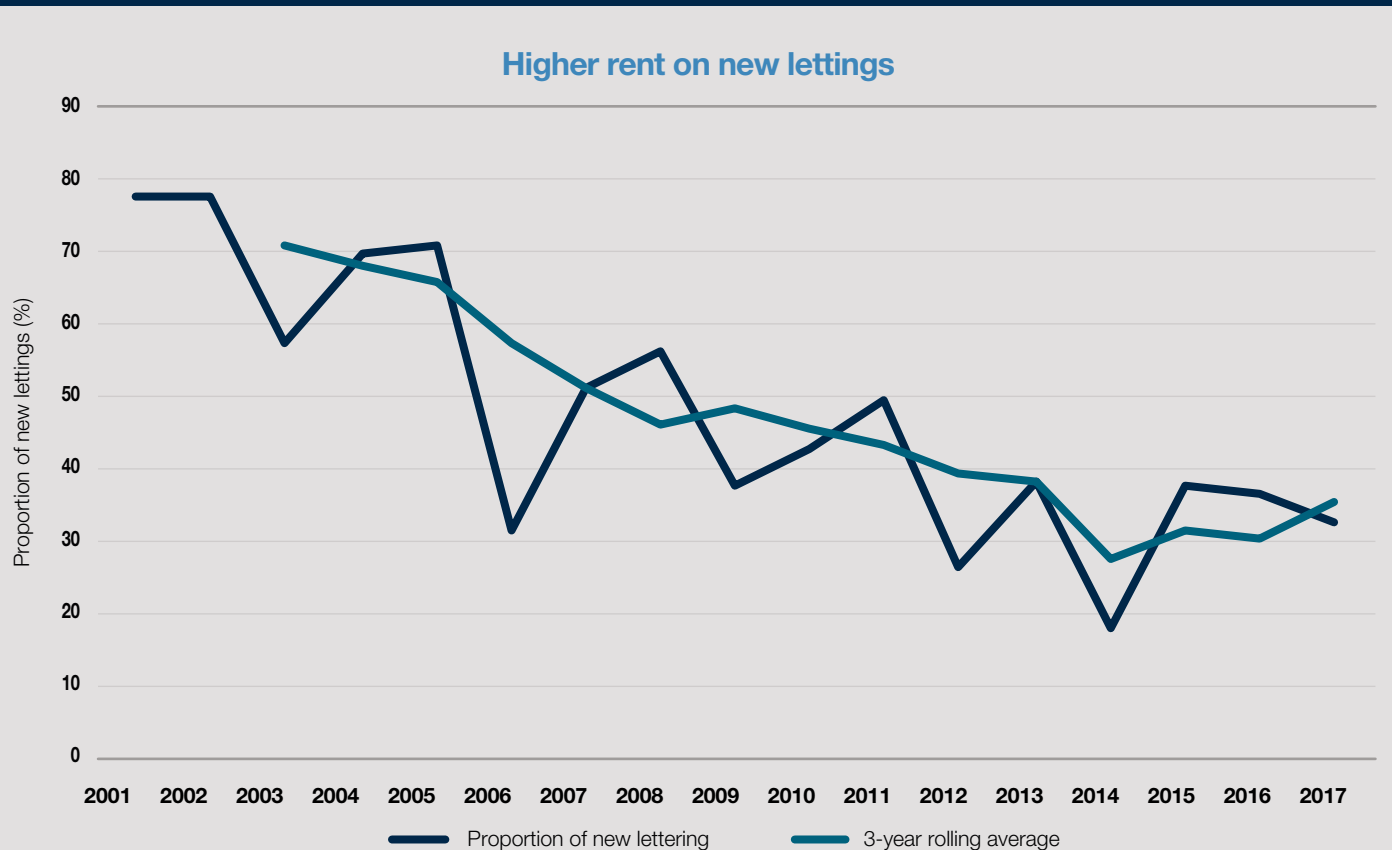
A wave of CVAs has exerted downward pressure on rental values. Rents have continued to soften since late-2017, falling into decline in late-2018 according to The Retail Economics Retail Cost Base Index.

In particular, landlords have struggled to demand higher rents on new lettings. Upward-only rent reviews (the rent payable at review is agreed not to be less than the previous rent agreed) have dominated the U.K. property market, meaning minimal movement in rental values during lease terms.

However, when rental values face correction upon renewal (or re-letting of a unit), research from MSCI shows the ability to achieve higher rent has declined in the last 15 years and was gained on just 30% of retail units in 2017 (weighted by rent passing).

Downward pressure on rents is unlikely to ease soon. Fashion giant Primark, who has thrived during structural disruption, called on its landlords to cut rents by 30% in mid-2019 despite its success, as competitors such as Arcadia and New Look benefit from CVAs. What's more, data on the levels of rental confidence, investor enquiries and capital valuations have all fallen to 10-year lows².

Figure 8. The proportion of new lettings achieving high rent is falling



Source: MSCI, Retail Economics analysis

2: RICS, DataStream

Retailers are not just looking for cheaper deals however, they want greater flexibility too. Inflexible leases intrinsically hinder their ability to transform at the required pace that markets dictate. As retailers pursue more flexible portfolios, lease lengths have fallen since the early 2000s, alongside rises in the number of agreements featuring break clauses. This peak also coincides with the business rates revaluation that produces an overall neutral valuation outcome that now appears unsustainably high.

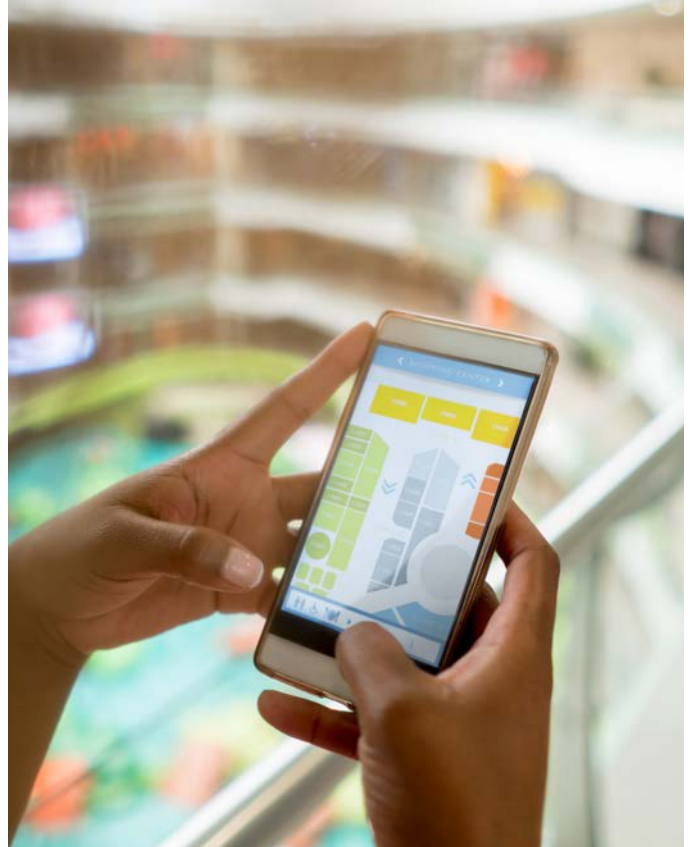
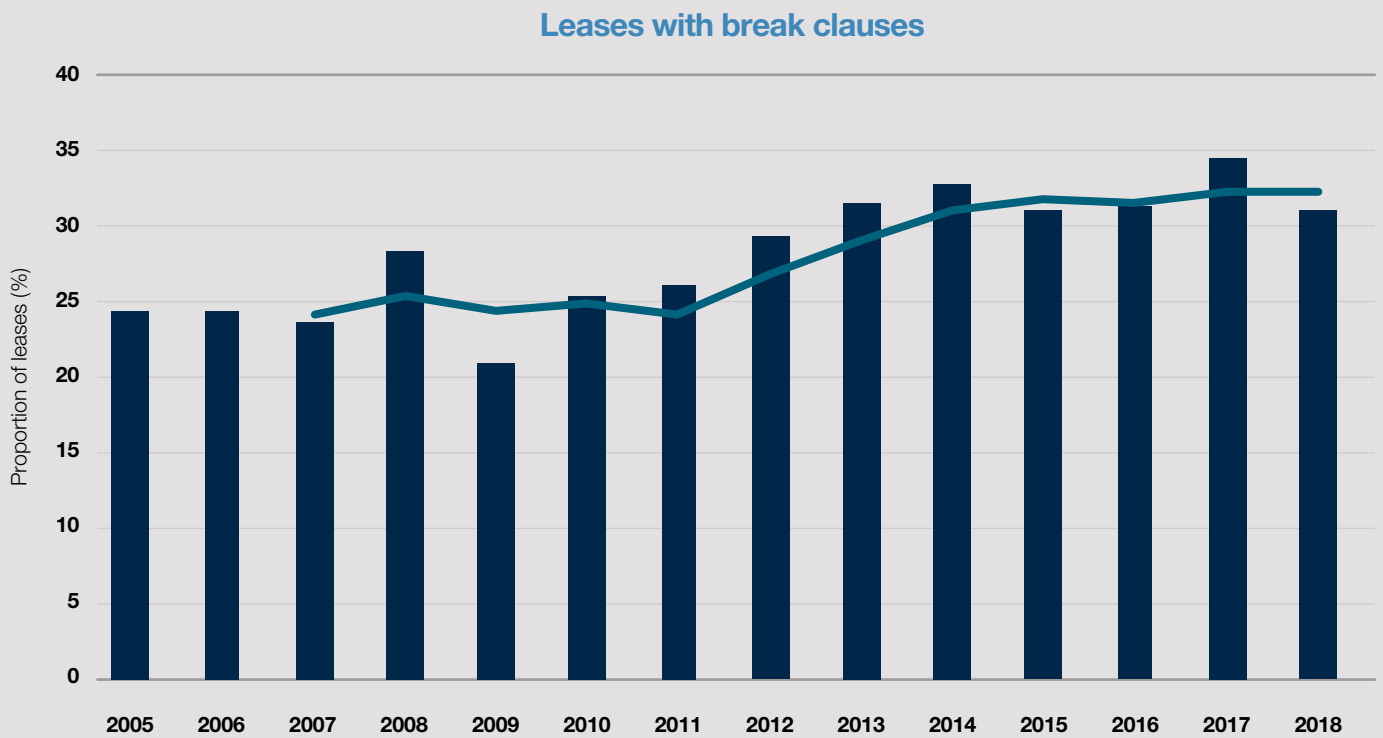
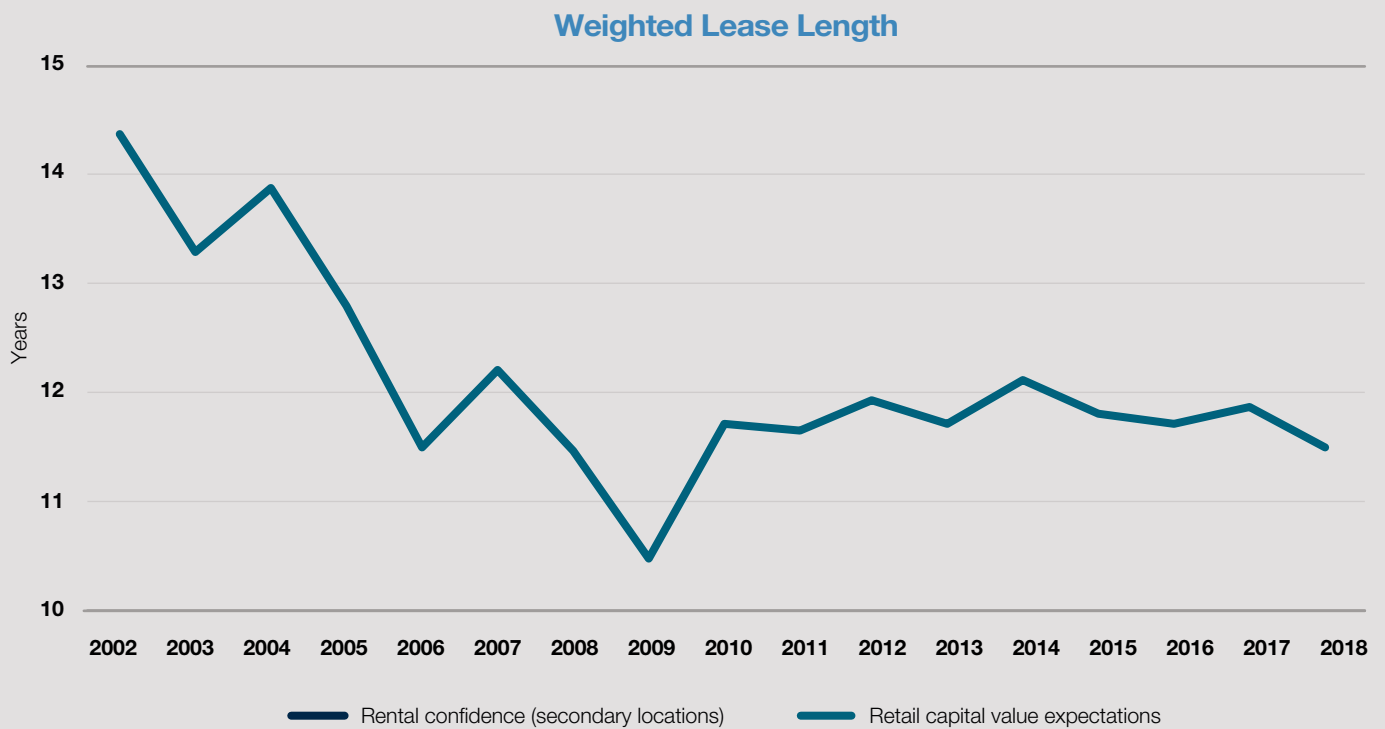


Figure 9. Rental confidence and capital value expectations have fallen to a decade-low for retail



Source: RICS, DataStream

Figure 10. Average lease



Source: MSCI, Retail Economics analysis

Yet, it's not all doom and gloom. A new balance within the tenant mix has emerged from this significant disruption as retailers invest in customer experiences and online.

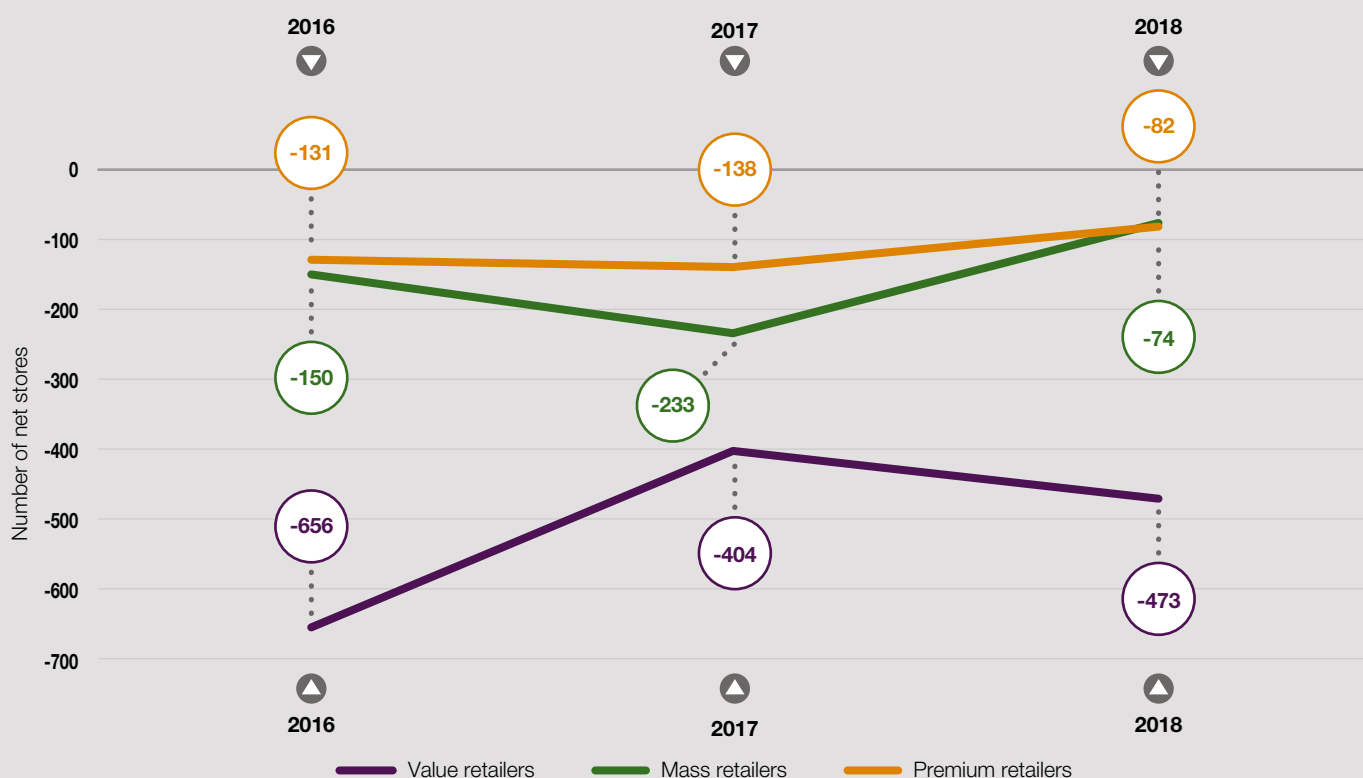
Store openings and closures in 2018 show property landscape characteristics shifting from retail units to leisure-type facilities. Categories under the most threat from net changes in store numbers are financial services and fashion retailers, both moving toward a more convenience-based and price-sensitive online environment.

At its core, there is still a stronghold in physical retailing for value, convenience and luxury, which supports market polarisation. The fashion industry neatly demonstrates this notion. The mass clothing market faces around six times the number of net store closures compared to its value and premium counterparts.

Store openings and closures in 2018 show property landscape characteristics shifting from retail units to leisure-type facilities.

Figure 11. Changing property dynamics in mid-market fashion demonstrate polarisation

Fashion sectors – the mass clothing market faces the greatest net change in store closures



Source: LDC



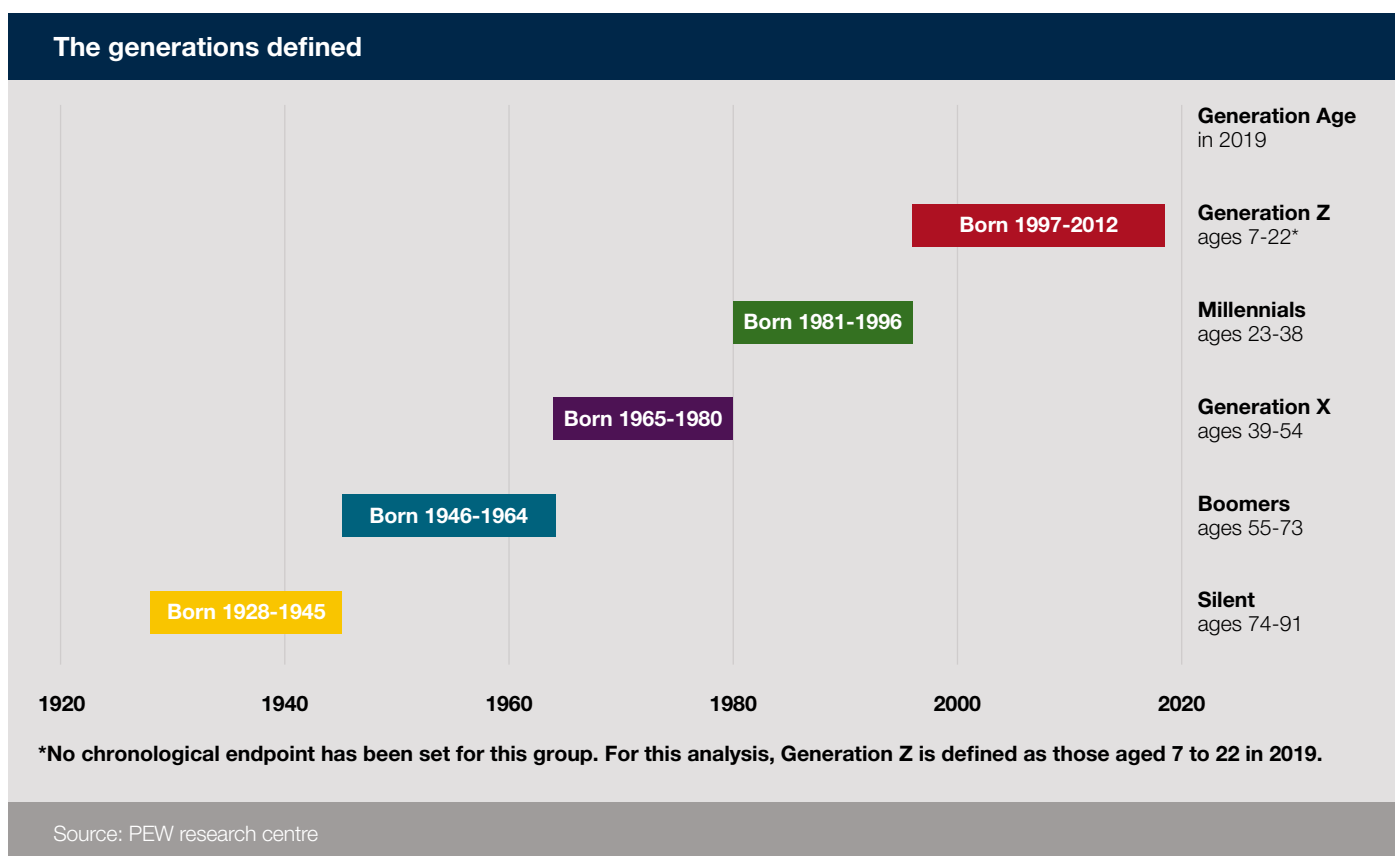
Part 02

**How shopping
habits impact stores:
present and future**

The proliferation of digital technologies has fundamentally altered the fabric of the customer journey. Customers now have more complex paths to purchase, revealing an intricate pattern of new paths to purchase, merging both physical and digital realms to form new shopping habits.

The analogue customer journey of the preceding decade has now been replaced by an infinitely more complex framework. Now, shoppers indiscriminately bounce between channels, adopting ways that better fulfil their immediate wants and needs.

Despite physical retail accounting for 80% of retail sales, our research reveals that digital platforms have a disproportionate impact across the entire customer journey — from the discovery and awareness of products, through to service and returns. Furthermore, engagement across the customer journey differs markedly by age. Although our defined age groups do not match directly with generational labels, the principles hold true. **Gen Z and Millennials value the role of physical retail more than older consumers across every stage of the customer journey.** They also value the role of retail experiences more, while displaying greater engagement complexity across digital channels.



Our research also identifies key warning signs of consumer disenchantment with local high streets. Staggeringly, **one in seven shoppers believes the high street cannot survive in its current form, with around one third suggesting they are not surviving now.** Dwindling levels of footfall in many U.K. high streets remains a key concern for local businesses. Our research shows that **37% of respondents shop less frequently in physical stores compared to just a year ago.**

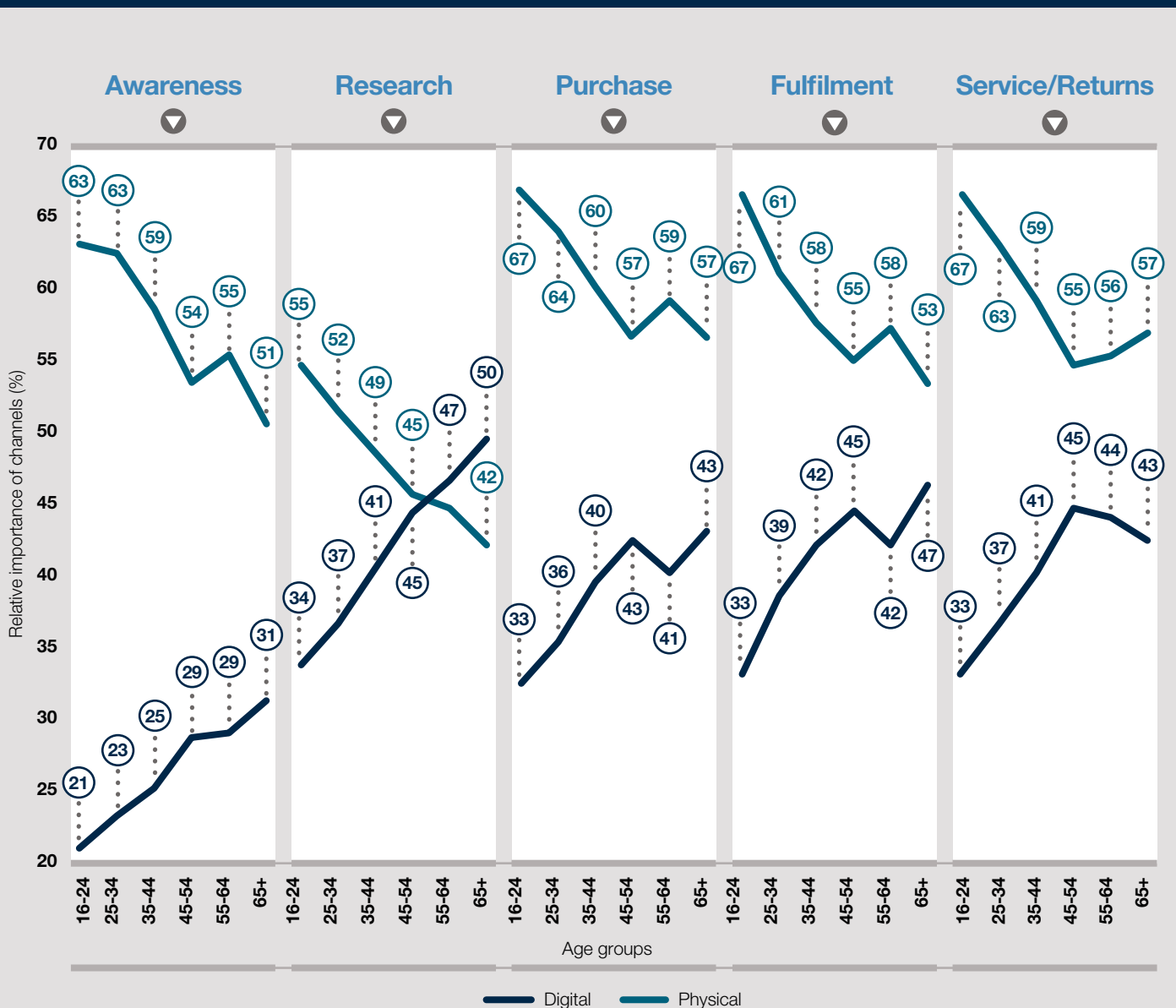
The customer journey

A wave of CVAs has exerted downward pressure on rental values. Rents have continued to soften since late-2017, falling into decline in late-2018 according to the Retail Economics Retail Cost Base Index.

The typical customer journey comprises of around five stages: (1) Awareness; (2) Research; (3) Purchase; (4) Fulfilment; (5) Service and returns.

Today, customers switch between different buying journeys, often without a clear direction or end point. These journeys are multi-dimensional, often littered with digital touchpoints, heavily consumer-centric, but remain rooted in experiences gained in *physical* locations.

Figure 12. Physical remains the most influential channel throughout the customer journey



Source: Retail Economics (*may not sum to 100 because of other channels such as outdoor advertising)



An interesting divergence of customer values emerges by age. Paradoxically, those who were born into the digital world and have grown up with smartphones in their hand are most likely to value the role of physical retail, despite spending the most time online. Conversely, older consumers value the role of digital retail more than younger consumers (across all stages of the customer journey), particularly at the research stage compared to physical retailing – they are the only group to display these preferences.

Naturally, shopping behaviour varies across product categories, age groups, household incomes and many other variables. Consumers typically engage fewer touchpoints when purchasing essential commodities such as food, whereas big-ticket purchases such as kitchens and bathrooms require lengthier consideration, thus requiring more complex digital/physical strategies for conversion.

The merging of physical and digital realms unveils a complex web of consumer preferences and retailer/brand relationships – all of which impact retail property in profound ways.

Our research condenses these insights into three distinct ‘megatrends’:

- 1 Physical retail remains the bedrock of the shopping experience**
- 2 Value of experience-led offers**
- 3 Multi-dimensional consumerism**

1. Megatrend

Physical retail remains the bedrock of the shopping experience

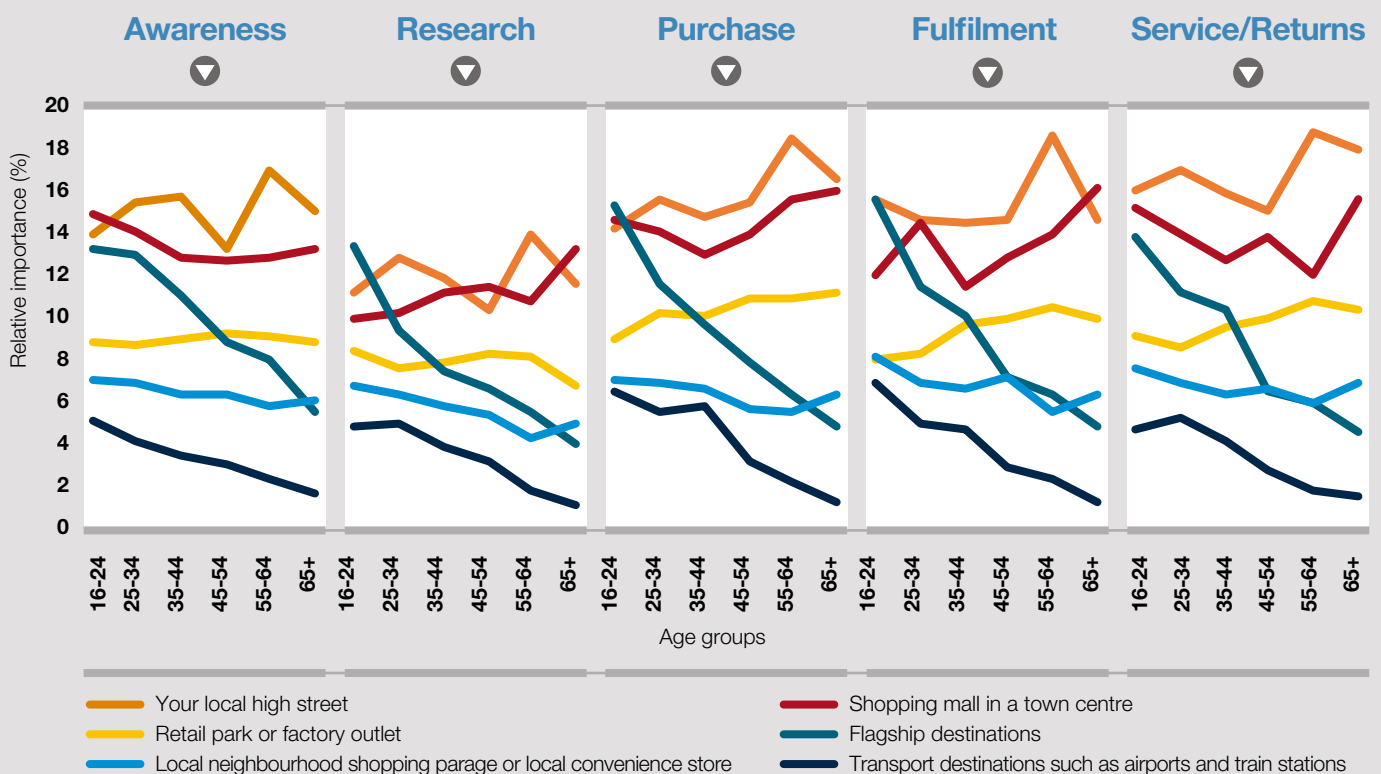
- Gen Z and Millennials value the role of physical retail locations more than older generations
- The greatest divergence across age groups arises for flagship destinations
- Yet, 63% of shoppers suggest that high streets have become less attractive places to visit in recent years meaning its future should not be taken for granted.

Physical retailing remains the dominant influence across all stages of the customer journey – despite increasing disruption from digital technologies. Generationally, the greatest disparity in sentiment occurs at the awareness stage of retail products and brands, as Gen Z and Millennials embrace the value that convenience, browsing and socialising plays in the discovery of new products.

They suggested that physical retailing was around three times more influential in the awareness of new products and brands than digital channels. The influence differential between physical and digital then narrows for subsequent stages of the customer journey.

Initially, this finding may seem counterintuitive. For young shoppers, the online world has ‘always existed’ – but there is an important distinction to make. As attention spans get shorter and more fragile, the physical act of browsing around flagship destinations to touch and discover new products was found considerably more effective for influencing buying behaviour.

Figure 13. Local high streets are the most crucial channel in the physical realm



Source: Retail Economics

63% of all respondents in our consumer panel said that their local high streets have become less attractive places to visit in recent years, despite being the most influential physical channel – reflecting the relative underinvestment in modernising the once-thriving physical locations. The majority (51%) highlighted convenience as the main attractor to their high street, as places where they can browse and touch products, and importantly, meet up with friends for a coffee or to eat out.

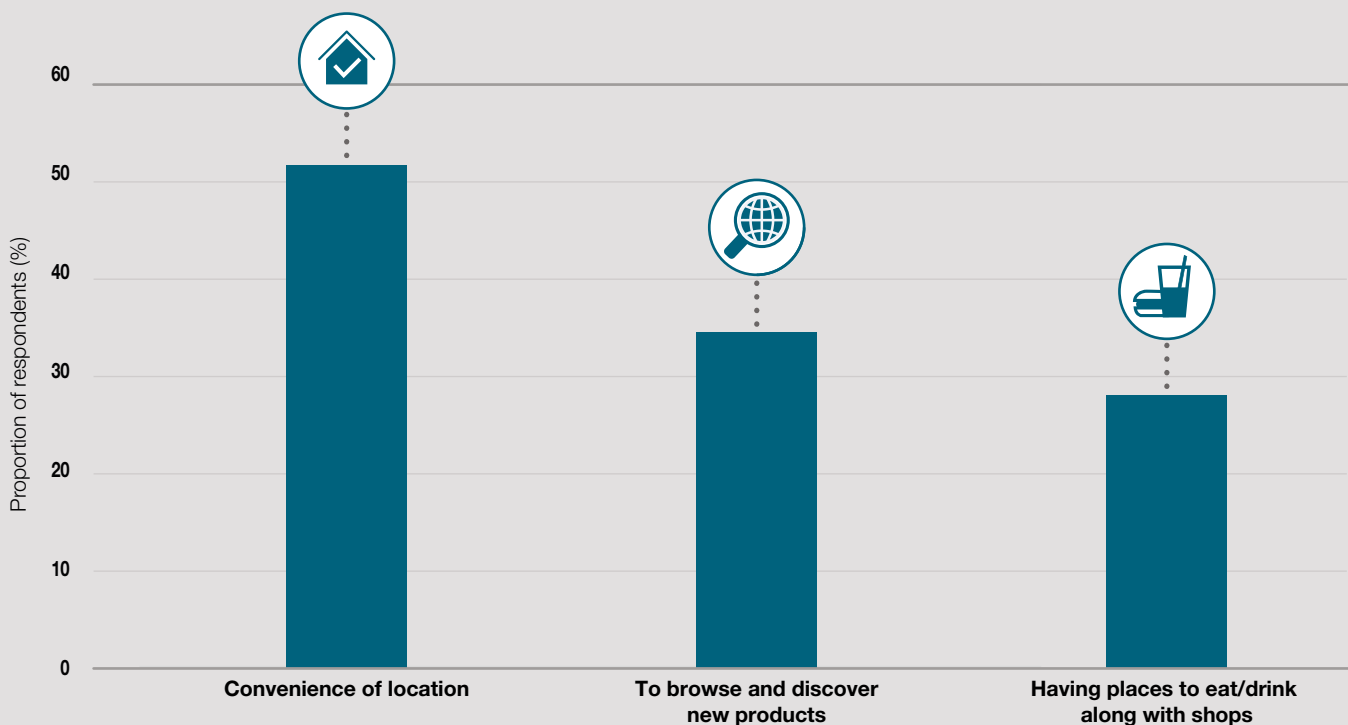
In examining reasons for dwindling footfall, car parking frustration was the biggest barrier to frequenting local shopping destinations, while shop vacancies were also cited as a key reason.

The shopping centre was the second most important channel identified by our research, with similar motivations

driving consumer visits. However, the greatest disparity across consumer segments emerges within flagship destinations such as the Westfield shopping centres in London or Birmingham’s Bull Ring. Gen Z and Millennials ranked the importance of flagship destinations considerably higher than older generations. This likely reflects preferences for shopping in mixed-use environments showcasing retail, leisure, entertainment and restaurant facilities.

In reality, it’s infinitely more complex. Shoppers channel-hop unconsciously. Hence, the optimal customer journey hinges on a blend of both physical and digital touchpoints seamlessly interwoven, often experienced simultaneously, where consumers ‘drift blissfully’ toward purchase. Clearly, physical locations are still viewed as the bedrock of the retail experience, but now they can be supercharged with high-octane digital elements.

Figure 14. Motivations to visit high streets



Source: Retail Economics

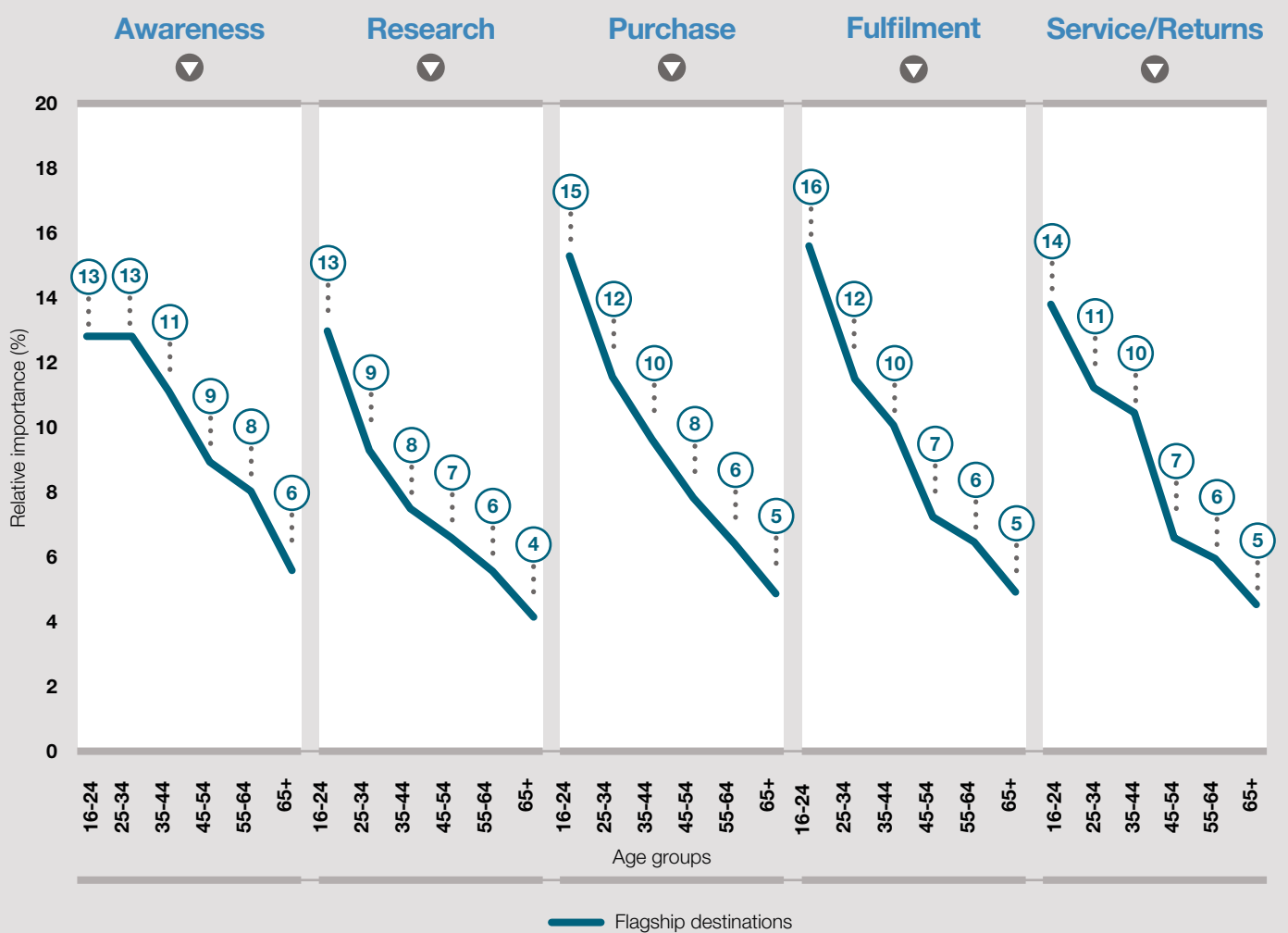
2. Megatrend Value of experiences

What is the true value of traditional stores of the future? As mere distribution hubs, they can appear impotent unless they can find new ways to inspire and excite their target audience.

As the economic value attached to material possessions diminishes, people have begun to expect to be entertained, educated and showered with accurate, easily digestible information, surrounded by inspiring environments that offer escapism.

Cumulatively, these characteristics can make the experiential proposition more challenging to create, but also a strong point of differentiation if done cleverly. This is backed up by Gen Z and Millennials, who were twice as likely to agree that they spent less on retail products and more on experiences (e.g. holidays and eating out) over the last 12 months than those in their 50s.

Figure 15. The importance of flagship destinations revealed the largest gap between generations



Source: Retail Economics

Flagship physical retail properties are an important aspect of 'experience' according to our research. Gen Z ranks the importance of flagship destinations three times higher than those older than 65-years for purchasing products. Younger shoppers also visit flagships most frequently, with around a quarter (24%) of Gen Zs visiting flagships at least once a week, compared to just 3% of over 65s. Effective execution will be mission-critical. In comparison, those in their 40s and 50s visit a flagship destination on average just once every six months.

This matters because routine behaviours become deeply engrained. Notably, the median shoppers in the 16-34 year-old groups expect to visit flagship locations 10% more over the next five years. Given that Gen Z and Millennials will account for more than half of the U.K. population in ten years' time, retailers offering flagship experiences are more

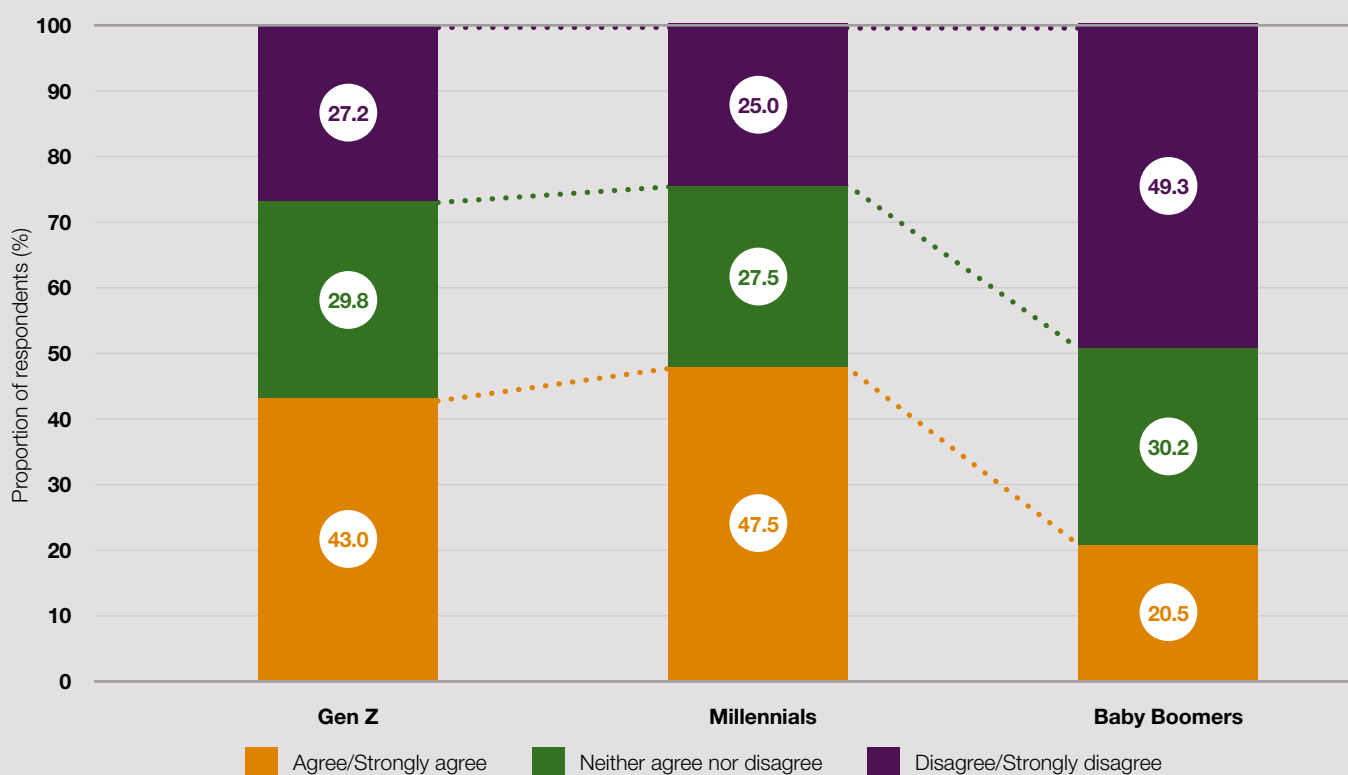
likely to attract footfall, build brand equity and enhance omnichannel operations over the next decade.

These trends are supported by economic data showing the proportion households spend on retail has fallen from around 30% in the 1960s, to a forecasted 20% by 2028 – when experiences will be paramount.

The essence of providing a meaningful and memorable experience is created wholly in the mind of the shopper who is exposed at an emotional, physical and intellectual level. This marks a clear departure from the purchase of commoditised goods to new types of services.

We expect further polarisation within certain markets (e.g. luxury) as retailers generate memorable experiences that add value to the customer journey – experiences that consumers are willing to pay a premium for.

Figure 16. I spend less on retail products and more on experiences (e.g. eating out, cinema, holidays, concerts)



Source: Retail Economics

3. Megatrend Multi-dimensional consumerism

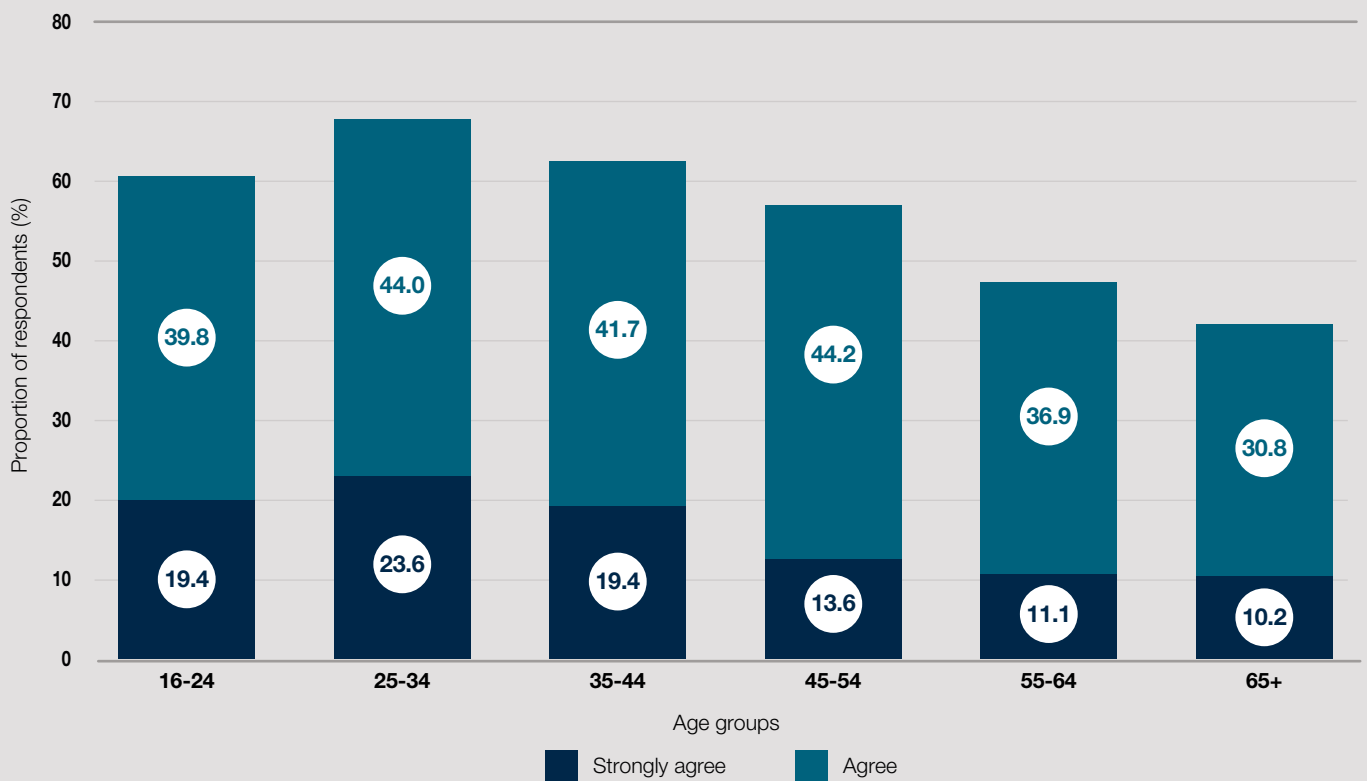
Multi-dimensional consumerism occurs at every stage of the customer journey as shoppers have come to rely on a blend of both physical and digital to usher them at each stage. Its impact has significantly altered physical retailing although this trend is only in its infancy.

Our research shows that two-thirds of Millennials have looked at retail products in-store with full intentions of purchasing them online later on – the highest proportion of any age group. This falls to 41% for consumers aged over 65-years but remains a key component of changing shopping behaviours across all ages.

A lofty 83% of shoppers aged 18 to 44 use their mobile devices in-stores³, demonstrating Gen Z and Millennials are completely relaxed with simultaneously transitioning between digital and physical environments.

Given the abundance of choice within retail, especially online, it's easy for shoppers to forget about a brand if it's not re-enforced in the physical world. Unsurprisingly, the positive impact of physical locations on online sales is well-established; and it's estimated that retailers that do not have physical stores in a catchment area, but have transactional websites, experience 50% fewer online sales compared to retailers who operate both⁴.

Figure 17. I have looked at retail products in-store with the intention of then purchasing them online later



Source: Retail Economics

3: Salesforce

4: CACI

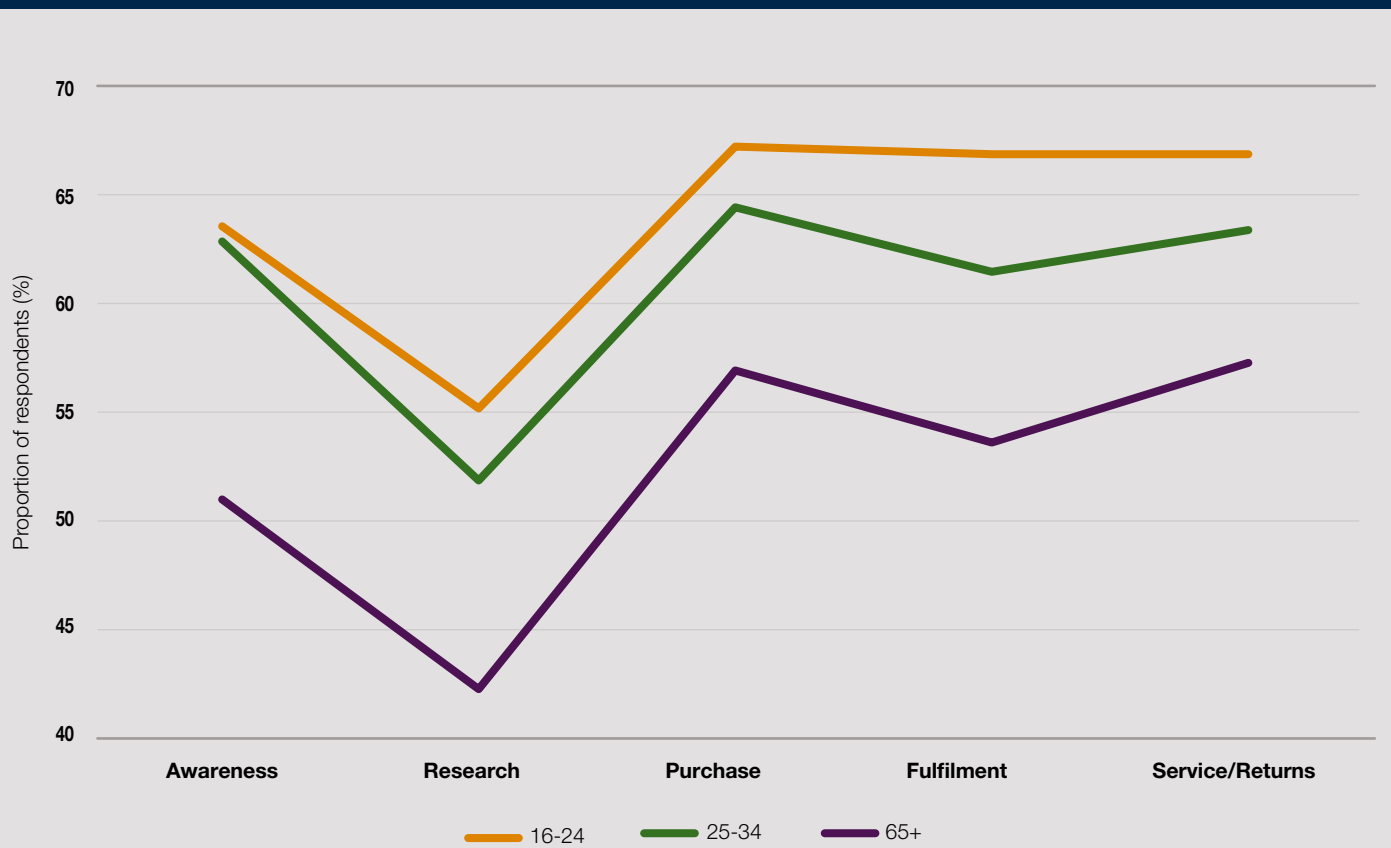
Although no age group shops exclusively through one channel, younger generations typically shop across more destinations depending on their customer journey stage.

Focusing on shoppers' top two preferred physical locations; those aged 65+ consistently alternate between high streets and shopping centre locations across all stages of the customer journey. Contrastingly, for 16-24 year-olds, their top two physical locations vary more broadly between high streets, shopping centres and flagships depending on their customer journey stage.

Older shoppers are more likely to favour the convenience of uni-channel shopping, with less reliance on stores entirely. Intuitively, shoppers over 65 are least likely to visit showroom stores – only 41% have done so – while Millennials are most likely to.

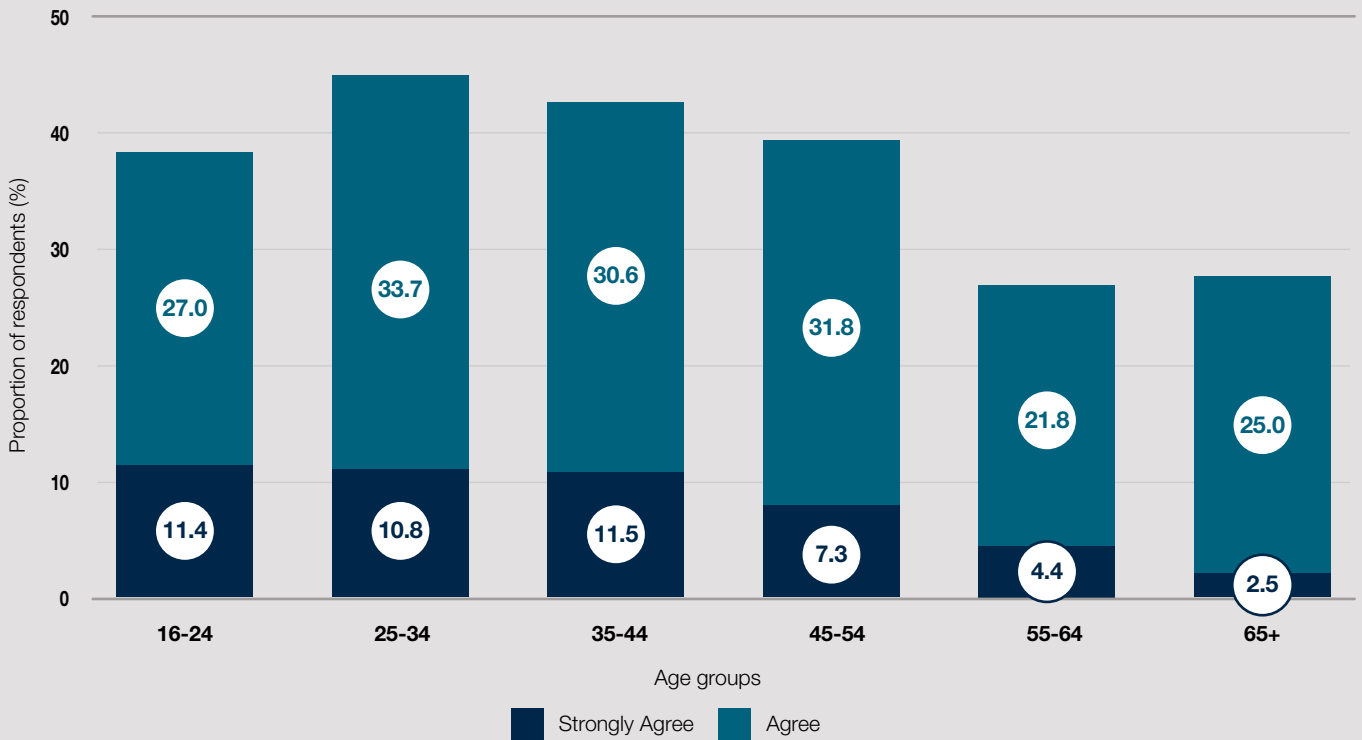
Millennials are also most likely to use stores to collect online orders. More than 40% of 25-44 year-olds do so, compared with around a quarter of 55+ year-olds. This may be due to home occupancy and commuting issues.

Figure 18. Use of physical in the customer journey



Source: Retail Economics

Figure 19. I often buy online and then pick-up my order in a store (or other physical location such as a convenience store)

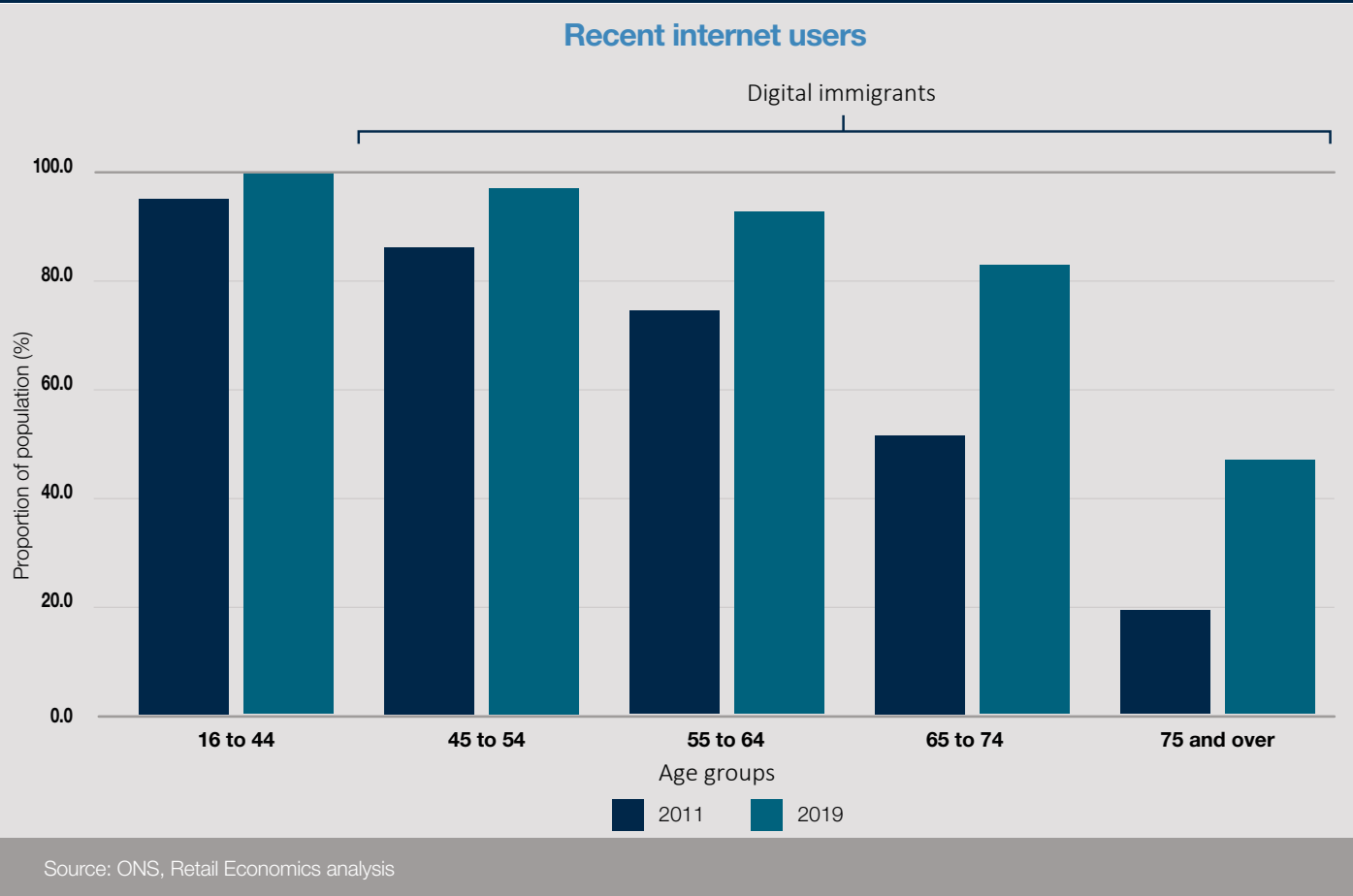


Source: Retail Economics

Older shoppers appear to rely on digital channels more than younger generations. Those who were not born into the digital age have rapidly increased their internet usage over the past decade as per ONS data showing that in Q1 of 2019, 83% of 65-74 year-olds regularly use the internet, which compares to just a half in Q1 2011.

Older shoppers appear to rely on digital channels more than younger generations.

Figure 20. The growth in internet users has been most significant across older age groups



Internet usage among older people is intrinsically reflected in their shopping habits. At every stage, over-65s place greater importance on digital compared to under 25s. For example, half of 65+ year-olds use digital to research retail products compared to just over a third for 16-24 year-olds.

The youngest of the 65+ year-olds are considered as well-established digital immigrants, having been in their late-40s and early 50s when online shopping started to truly gain traction. This could also be explained by factors such as convenience, mobility issues (e.g. health and rural locations), disposable income (e.g. seeking price transparency and online deals) and less desire to socialise.

Older shoppers have also experienced the most change to physical locations – not necessarily considered positive to incite greater store visit frequency. Those most familiar with traditional high streets (45+ year-olds) are most likely to agree that the location’s attractiveness has deteriorated in recent years.

Younger shoppers are more impulsive and less likely to research and compare prices online before purchasing – two-thirds of 16-24 year-olds versus 82% of 65+ year-olds.



Part 03

**Fit-for-purpose stores:
likely scenarios and
how retailers will adapt**

The outlook for retail property remains highly uncertain as abrupt shifts in shopping habits grate unforgivingly against decades of overexpansion. Subsequently, this has resulted in overcapacity of around 15-20% in the retail sector for multiple retailers.

As the industry undergoes an agonising transition, the purpose, composition and value attributed to stores across the whole retail landscape will alter dramatically. As the 'disruptive dust' begins to settle, a fragmented retail market will emerge.

The new retail era will see experiential-led propositions becoming the mainstay of not just flagship destinations, but also for high streets and town centres, supported by falling rental values, which will provide opportunities for a churn of independents who will occupy cost-effective and flexible units as the economics of running stores rebalances. Ultimately, thriving locations will be those offering unique propositions which stand out from the local competition, with a retail proposition relevant to the communities they serve.

In parallel, the commodity-driven part of the market will focus on developing strong distribution propositions. New fulfilment models will provide effortless convenience for consumers as online delivery costs dwindle. Deliveries 'within-the-hour' will become more commonplace, negating many reasons for shoppers to even step into stores. Furthermore, emerging business models such as subscriptions and auto-replenishment will start to define activity in these local regions.

The new retail era will see experiential-led propositions becoming the mainstay of not just flagship destinations.



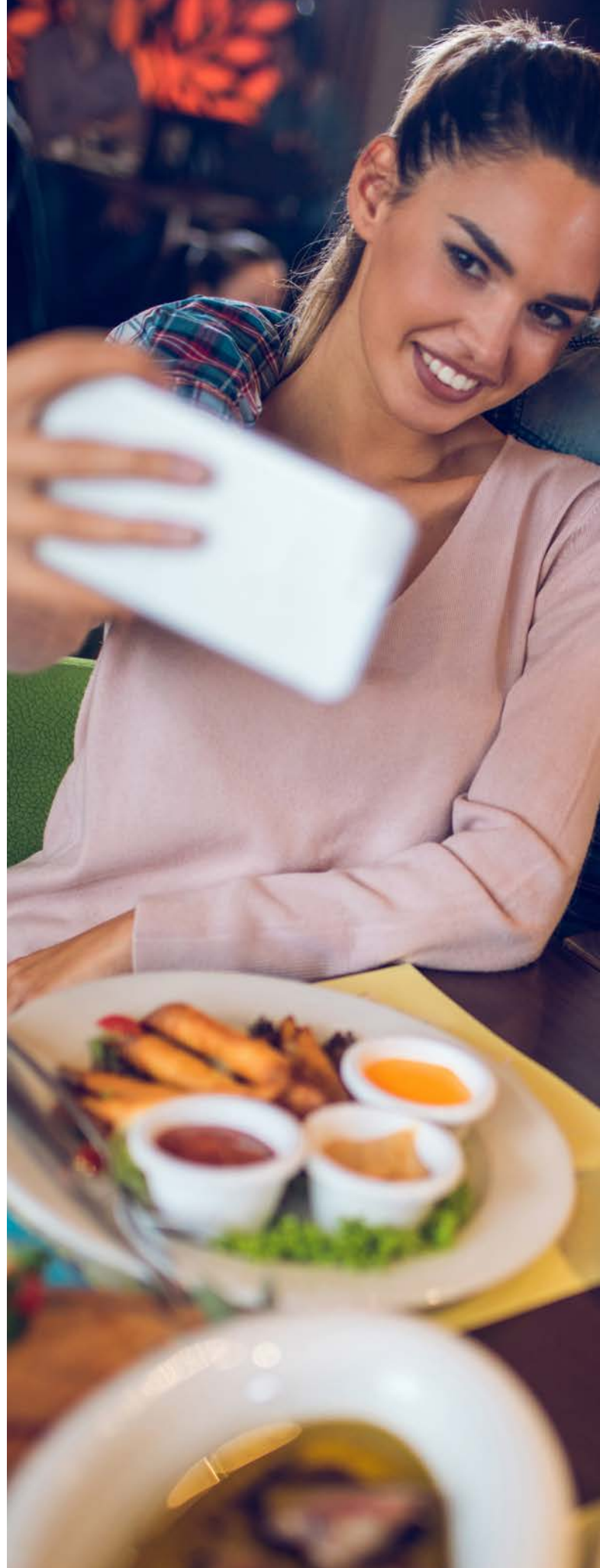
What will retailers have to do to respond to an existential threat?

Naturally, different customers obviously need different services. Common factors include age, location, socio-demographics.

However, today, retail environments also need to cater for an ever-expanding range of needs, which are often immediate (e.g. escapism, entertainment, education), meaning that convenience and competitive pricing will be most valued.

From our research, **five major trends** emerged as retailers attempt to keep stores fit-for-purpose for their businesses amid these disruptive times; these being:

- 1 **Optimising experiences and extreme convenience**
- 2 **Developing strategic partnerships**
- 3 **New business models**
- 4 **Blurring boundaries**
- 5 **Sophisticated data use**





1 Optimising experiences and extreme convenience

Progressive retail brands will increasingly merge physical and digital realms to create awe-inspiring experiences which scintillate and intrigue shoppers with limited attention spans.

The modus operandi will be to find meaningful ways to acquire new customers, build brand loyalty, improve purchase frequency (both online and offline), and enhance the lifetime value of customers, underpinned by customer personalisation across their purchase journey, regardless of channel.

The intersection of in-store analytics, customer data, social media and artificial intelligence (AI) will revolutionise store use – for both consumers and retailers. Concerning AI, previously unseen insights gleaned from sophisticated machine learning techniques will help transform the retailer-customer relationship. The result will be hyper-personalised content that speaks to a marketing segment of one.

Under the experience-first model, retailers' perceptions concerning the purpose and value of stores will shy away from pure profitability towards its value as a media channel. This will enable retail brands to have more direct conversations with customers and measure engagement using metrics capturing the 'overall immersive experience' which isn't just limited to the realms of online.

Other parts of the market will focus on 'extreme convenience', resulting in narrower product ranges, focused specialisation and operate slick logistics on a hub and spoke model to service rapid online delivery times under new business models that include subscriptions and auto-replenishment.



2 Developing strategic partnerships

The industry has already witnessed momentous industry consolidation (e.g. Tesco and Booker) and strategic partnerships (e.g. Next and Amazon) that were unimaginable just a few years ago. Innovative strategic partnerships are expected to remain a key theme as retailers attempt to streamline costs and secure a competitive advantage.

Scale, optimised distribution centres and truly integrated technology expertise will form the foundations of new flourishing partnerships, if smartly executed.

Partnerships between pure-play online retailers and those with physical stores are also likely to increase as mutually beneficial relationships emerge to relieve overcapacity for some, while providing commercially viable new routes to market for others.

What's more, new e-commerce/direct-to-consumer services will offer superior economics and already appeal to Gen Z and Millennials who have cultivated social media relationships with their favourite brands. Other retailers will continue to align themselves closely with leading brands to help co-fund expensive capital expenditure on new developments in flagship destinations.

3 New business models

Traditional retail business models will be crash-tested by torrential waves of ongoing structural change. The impact that technology has imposed on music and entertainment retailers via streaming services (e.g. Netflix, Spotify, Amazon Music) will proliferate to other sectors.

New models of consumption will emerge, further altering retailers' DNA:

1. The sharing and circular economy (rental and secondary markets)
2. Mass personalisation at scale (curated subscriptions)
3. Retail subscriptions (auto-replenishment or smart reordering)
4. Services economy ("Do it for me")

Models such as rental markets, curated subscriptions, the service economy, auto-replenishment and smart re-ordering have the potential to alter the traditional norms of retail considerably. Successful retailers are already focusing on how to merge these transformative models with existing business models to better serve their customers. The composition of board rooms should also adapt accordingly, reflecting retail's neogenesis.

These emerging models are likely to hit commodity goods the hardest, as smart re-ordering, rental and secondary market models rise to prominence. Continued investment in automation and sophisticated technology (e.g. AI and machine learning) in concert with personal data will unearth deeper insights to support the move towards subscriptions, services and personalisation.



4 Blurring boundaries

Most successful retailers will continue to fuse physical and digital realms, offering an inspiring blend that ignites customers' imaginations. As retailers harmonise with new value principles, there will be a renewed focus on getting the most out of all retail assets across store estates. Albeit, a store's success will be measured against new performance metrics that incorporate its 'media value'.

Retailers will eventually associate store customer engagement with 'impressions', that enhance overall productivity within a more complex customer journey. As physical stores are treated more like powerful media assets, surviving retailers will need to apply increasingly sophisticated techniques to assess the quality and value of physical interactions within them (e.g. in-store analytics, beacons, wi-fi, video-analytics). A particular focus will be on tracking in-store customer journeys correlated with online shopping characteristics to generate a single customer view; with success coming to those who are able to commercially respond and anticipate the customer's needs.

5 Sophisticated data use

Retailers can 'bind' consumers to their businesses and capture critical data through loyalty cards, finance agreements, social media profiling, and persuading them to download store apps. A combination of these data capture portals is essential in helping businesses optimise marketing content to engage customers at the critical moments that inform next-best-actions.

In a physical sense, smart stores optimising data collection on customer engagement (e.g. Amazon Go, smart checkouts etc.) will be crucial for leveraging competitive advantage. Thus, adopting an effective data-centric approach to store-based retailing will give companies an 'informational edge' on their competitors, particularly when combined with relevant online data.

However, this must be executed with forensic attention to costs by deploying incremental business intelligence and marketing tools to drive conversion, manage inventory and monitor labour. Additionally, where customer data is involved, it is imperative that operators continue to educate themselves on the best practice of keeping it safe and are aware of their IT security responsibilities.

The changing face of the retail property market

The jostle between retail, leisure, entertainment, flexible office space and residential will continue – a battle that carves its way through the U.K. retail property market causing organisational casualties.

Multiple retailers are suffering painful readjustment periods, slashing store numbers and reassessing their ultimate purpose and value in the current retail blitz. Online growth, dwindling footfall, profitability erosion and declining store-based sales have devastated the traditional economics of running stores – resulting in sizeable retrenchment.

The cumulative fallout has resulted in the retail property market hitting its lowest point since the financial crisis. Consequently, negative sentiment toward the retail sector has been targeted, as asset values, rental incomes and investor appetite have tumbled.

This has dramatically altered the economics of store-based retailing, paradoxically, presenting opportunities for smaller independents and pure-play online retailers to seriously consider physical as now commercially viable. The rise of independent retailers and an explosion of entertainment services and leisure outlets will be most notable over the next decade. The market adjustment will eventually eradicate ‘clone high streets’, replacing them with a more eclectic mix of tenants who are relevant and better equipped to cater to their local communities. In fact, we’re already witnessing this phenomenon.

In 2018, 1,951 new independent stores opened in U.K. shopping centres, a 1.1% growth compared to 2017⁵

5: LDC

In 2018, 1,951 new independent stores opened in U.K. shopping centres, a 1.1% growth compared to 2017⁵; partially driven by creative use of vacant space, particularly space segregation, leaving smaller units better suited for smaller players. Landlords such as Hammerson have created initiatives such as LinkStreet pop-up mall which connects Birmingham’s Bullring and Grand Central. Land Securities’ Black Box Revolution concept in Trinity Leeds also aims to bring new names to the location. A higher rate of churn may also encourage shoppers to re-visit locations as schemes are re-invigorated and made more engaging.

In other locations, shortage of residential stock and overcapacity of retail and leisure provokes the issue of repurposing – another aspect we’re already experiencing. Between 2016 and 2018, local authorities across the U.K. invested more than £800 million acquiring 26 shopping centres in town centres across the country. These acquisitions are not without considerable risk and they involve local authorities undertaking significant re-development in their attempts to achieve a commercially successful balance of retail, leisure, food, beverage, flexible office space, local amenities and residential.

In the future, certain development schemes may lead to branded ‘full service living solutions’. Against a backdrop of falling homeownership, Millennials renting homes for longer and rising living costs, current retail landlords may offer not just accommodation, but a range of additional services such as multimedia, sustainable energy supply, car-sharing services in adjacent carparks (e.g. Zipcar), gym memberships, doctor’s surgeries, online collection and delivery services, cleaning, discounted utility bills and meals delivered free of charge from the food court on the ground floor. Significant economies of scale will exist for landlords to provide utility type services (e.g. electricity, broadband, multimedia), a proportion of which is passed on to residents who occupy community living spaces which service the retail, leisure and eateries within the immediate catchment area.

While considerable uncertainty persists around the future of retail property, one certainty is that they cannot survive long term in their current form.

How A&M can help

A&M's approach is about a bias towards action and the willingness to tolerate risk in support of value creation. Our restructuring heritage sharpens our ability to act decisively. We view client challenges through a practical lens. We create practical, rather than theoretical, solutions. These are our core differences from other management consulting firms.

With our heritage in restructuring, A&M has worked with some of the largest European and global retailers to stabilise financial performance, transform operations, catapult growth and accelerate results through decisive action. Our support today goes beyond restructuring and many clients turn to us to drive performance improvement and transformations of their business. Our team's expertise in these areas covers:

- **Store operations assessment** across both store performance (sales and margin) and store productivity (costs) to deliver a better customer experience and operational efficiency.
- **Store locations, formats, sizes and rents assessment** to eliminate loss-making stores, renegotiate rental agreements to deliver improvements to EBITDA and geographic network optimisation.
- **Operating model transformation** to ensure the resources and skills of an organisation are organised to deliver the strategy and ensure future success.
- **Cash/working capital approaches** including strategic drivers, operating cash cycles and capital spend to drive sustainable change and embed a robust cash culture.
- **Margin management** to ensure the customer value proposition leads to EBITDA improvement in reduced discounting as a result of better promotions, design and pricing architecture.
- **Marketing effectiveness** to analyse and improve marketing effectiveness and efficiency to save costs and optimise budget spend to provide the best return.
- **Transforming the e-commerce platform** for improved marketing effectiveness, increased customer loyalty and spend, and integration across the organisation.

If you are interested in discussing how we could help to improve your profitability, please get in touch with one of our experts.



Richard Fleming
**Managing Director and
Head of Restructuring, Europe**

+44 (0)20 7863 4727
rfleming@alvarezandmarsal.com



Mark Firmin
**Managing Director and
U.K. Head of Regional Restructuring**

+44 (0)20 7863 4755
mfirmin@alvarezandmarsal.com



Erin Brookes
**Managing Director
and Head of Retail, Europe**

+44 (0)20 7663 0592
ebrookes@alvarezandmarsal.com



Lynn Evison
Managing Director

+44 (0)20 7071 9402
levison@alvarezandmarsal.com



Case Study

Leicester and Nottingham – a tale of two cities

In validating our proprietary analysis, we have examined various retail venues to exemplify key issues raised in this study, particularly consumers' channel preferences and their implications for physical retail.

Conducting 'on the ground' research in Nottingham and Leicester has confirmed that the cost base of U.K. physical retail and its overcapacity are endemic and certainly unsustainable.

Nottingham and Leicester have remarkably similar markets and demographics, ranked closely by population, catchment expenditure and centre ranking. Also, they both benefit from the relative strength of the East Midlands' economy, demonstrating robustness over the last decade.

However, these locations exhibit significant differences in their retail structure, layout and vitality:

Leicester

Leicester has benefited from a substantial investment from Hammerson's excellent John Lewis-anchored High Cross (redevelopment of the former Shires Shopping Centre), boasting low vacancy rates and robust footfall.

However, this investment in additional retail capacity perfectly demonstrates that Leicester city centre has excessive retail space as it has led to significant deterioration of Gallowtree Gate (former Leicester prime pitch), the decimation of Market Place and many empty units blighting the local high street.

The value-oriented Haymarket is fully let to discounters with the old Haymarket centre finding it difficult to compete – Primark's inclusion being an exception with its storefront on Humberstone Gate opposite Marks & Spencer.

Leicester city centre's future prosperity crucially hinges on credible repurposing – away from retail on many streets – to office and residential accommodation – which if successful, requires strategic master planning closely linked to a city economic growth strategy that may leverage advantage from potential connectivity with London.

Nottingham

Contrastingly, thirty miles north of Leicester lies Nottingham. A city suffering from development woes, exemplified by the 20-year redevelopment delay to the dilapidated INTU Broadmarsh Shopping Centre which competes with the INTU Victoria centre situated just 1km north.

Nottingham's city centre layout is dispersed. Overall, it is struggling to maintain cohesion with burgeoning vacancy rates. The original north/south prime pitch of Clumber Street has almost lost its dominance with absolute prime locations now limited to lower front sections of the John Lewis-anchored INTU Victoria Centre – with inherent challenges from its 1970's elongated design, suffering from poor visibility, a weak upper level, and a vulnerable House of Fraser at the far end.

An upscale area sporting fashion and premium brands was traditionally formed by Bridlesmithgate, St Peters Gate, the very short 'High Street' and Exchange Arcade. Albeit, this enclave has been seriously compromised by the sharp deterioration in the southern half of Bridlesmithgate which is almost entirely vacant; this being caused by the Broadmarsh entrance closure at the junction linking Lower Pavement.

Theoretically, Nottingham should be stronger than Leicester. However, in addition to its compromised layout and protracted development challenges; its major employers (e.g. Boots, Imperial Tobacco, Experian, Capital One) are located on outlying campuses discouraging city centre interaction, which by contrast works very well in Manchester and Leeds.

Arguably, Nottingham has major city planning issues, resulting in inconvenient and unattractive shopping prospects. These challenges are compounded by shifts in consumer behaviour and investment failure.

A major, strategic, economic master plan which includes physical retail affordability, are pre-requisites to a recovery of fortunes. The arrival of developer Alfred McAlpine in realising the £80 million redevelopment of INTU Broadmarsh centre fails to address more fundamental issues facing Nottingham – key aspects which bring the scheme's viability into serious question.

Clearly, every retail centre has its unique challenges, but there is an overriding theme – affordability of occupancy costs (e.g. rents, business rates and service charges) and overcapacity. These factors make physical retailing a progressively less attractive investment prospect. Ultimately, this is an increasing threat to institutional investors exposed to retail property, with the credibility of valuations coming in for greater scrutiny and challenge.

Overcapacity estimate

Based on current market forecasts, Retail Economics estimates that there is overcapacity of between 15-20% of retail space for multiple retailers in the U.K., and the subsequent adjustment in the industry will occur over the next 10 years to reach a steady state.

We tested over 30 individual economic variables including, but not limited to: total retail sales, online retail sales, store-based retail sales, profitability metrics, rental expectations, footfall, vacancy rates, available retail space and many others.

Our model showed that the three variables most correlated to the decline in multiple retail stores were:

- In-store total retail sales
- Store-based profitability
- Footfall

The regression model selected had an R-squared of 67%. The R-squared ranges from 0 to 100%, that is two-thirds of the observed variability in store numbers for large multiple retailers is explained by these three variables alone.

Consumer panel methodology

A consumer panel survey covering over 2,000 nationally representative households in the U.K. was conducted in July 2019.

The survey provided detailed segmentations across age, income, region and socio-economic breakdown. The data was used to provide information on the relative importance of the different stages of the customer journey by stage.

Retail Economics Retail Cost Base Index

The Retail Economics Retail Cost Base Index is a measure of operating costs facing U.K. retailers.

The index is broken down into six key components including rent, business rates, labour costs, utilities, distribution and central costs. The measure does not include adjustments depreciation or for small business rates relief.

Profitability estimates

Retail Economics collected data on the top 150 retailers in the U.K. by turnover.

Data for each financial year was taken from 2013 to 2018 from the latest annual reports and/or company filings with Companies House. Pre-tax profit margins were calculated and weighted by turnover for each of the years covered.



ABOUT ALVAREZ & MARSAL

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With over 4,000 people across four continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, help organizations transform operations, catapult growth and accelerate results through decisive action. Comprised of experienced operators, world-class consultants, former regulators and industry authorities, A&M leverages its restructuring heritage to turn change into a strategic business asset, manage risk and unlock value at every stage of growth.

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