

UK retail vs Continental EU

Research & Strategy

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UK retailers have been making headlines for a while now...

Numerous players are entering into insolvency procedures – close to 5,000 stores affected YTD

Amongst recent casualties:

JAEGER

PEACOCKS



The Edinburgh Woollen Mill

Liquidation

J.CREW
(UK)

Arcadia



Brand to go online
(ASOS)

DOROTHY PERKINS

Debenhams

Liquidation – brand
to go online (Boohoo)

L.K.Bennett
London

(UK)

ALDO

LAURA ASHLEY

Bonmarché

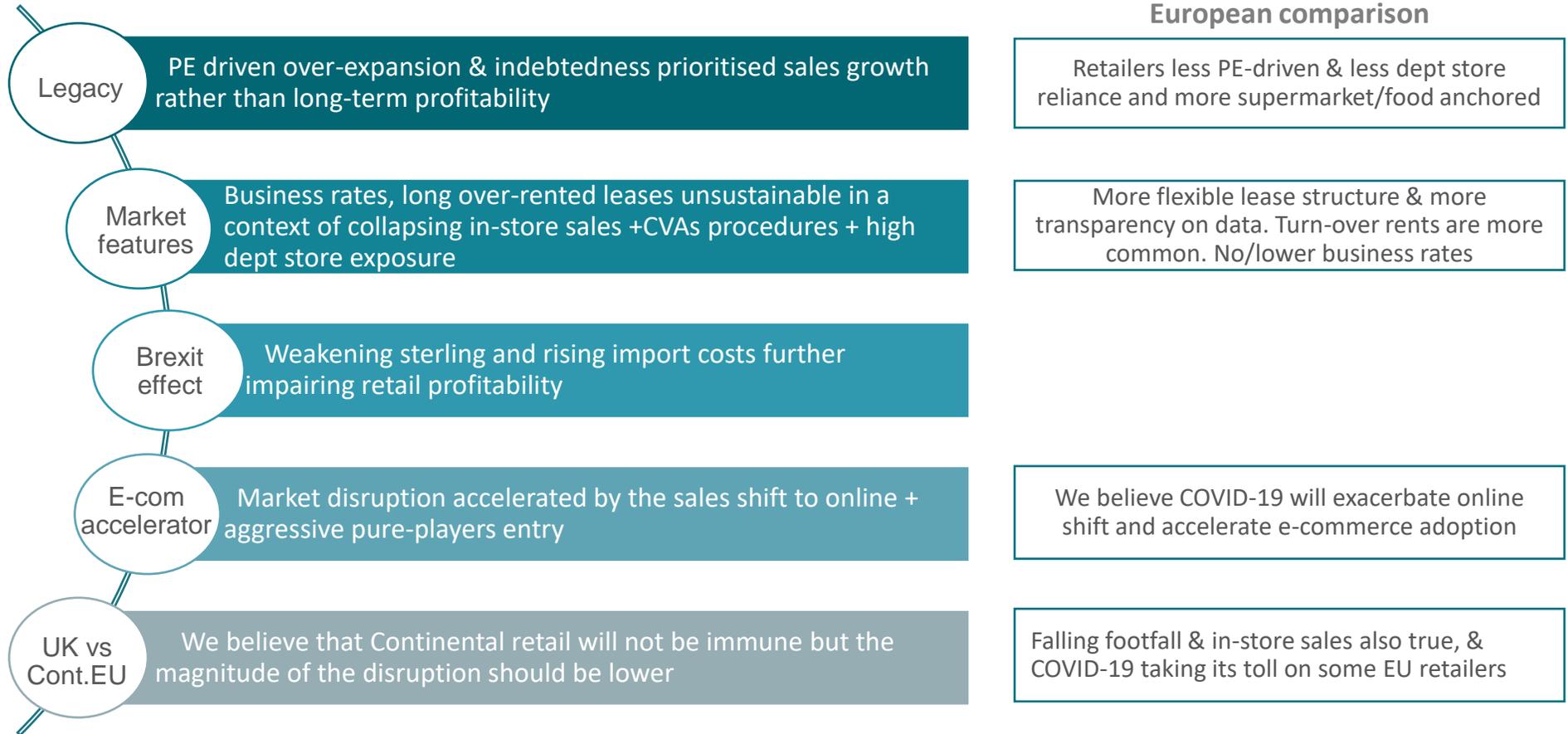
Why is the UK retail tropical storm turning into a hurricane with COVID-19 ?

Let's take a step back to understand today's situation



COVID-19 is acting as an accelerator of historical retail pressures in the UK

The UK retail story is quite specific and has exacerbated the disruption



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Some PE-owned retailers piled unsustainable amount of debt preventing key investments

“Race for space” financed by debt over the last 15 years compounded the sector issues

- **Capital structures** are usually more aggressive with PE, and **investment strategies** are usually **medium-term focused** and centred **on growing sales through store expansion** rather than considering **long-term cost management of so many stores**
- **High amount of debt prevented** some retailers to **make key investment in** reinventing store formats to remain competitive
- Same issue in the US: **10 of the 14 largest retail chain bankruptcies since 2012 involved companies that private equity*** firms had acquired. More recently Neiman Marcus after two LBO with debt burden of \$4.8bn

For some retailers the ownership structure prompted their demise

Retailers	Financial issue	Ownership when collapsed		Main issues
Toys R Us (UK stores)	Collapsed in 2018	PE	KKR and Bain Capital	\$5bn in long term loans, with > \$250 m on debt service alone, preventing key investment (e.g online)
Maplin	Collapsed in 2018	PE	Ruthland Partner	£150 million of debt (@15% rate) when it collapsed, suffered strong competition from online players
New Look	CVA in 2018 CVA in 2020	PE	Apax and Permira until sold Brait SA (2015)	1 st CVA: £1.4bn of long-term debt but managed to restructure its debt. 2 nd CVA: reducing senior debt from £550 million to £100 million
House of Fraser	Administration in 2018, extended 1y	PE, amongst others	Highland Group in 2006 then Sanpower until 2018 then SportDirect	Debt pile worth £1bn which had built up since its private equity purchase in 2006.
BHS	Collapsed in 2016		Retail Acquisitions	£1.3bn debt load at the time of its failure in 2016
Poundworld	Collapsed in 2018	PE	TPG from May 2015	Poor management, aggressive competition and weaker £ increase cost burden and business model. £5.7 million charge for onerous leases in 2018
Debenhams	Filed for administration in 2019 and 2020 – brand to go online	PE, then lenders	TPG, CVC and Merrill Lynch Private Equity	Take-over in 2003 adding £1.2 billion of extra debt + department store usual issues

Sources:

FT - Toys R Us collapses into administration in UK - FEBRUARY 28 2018

Maplin: What went wrong? – Retail Gazette MARCH, 6 2018

Newlook – Wikipedia and Retail Gazette SEPTEMBER 2020

House of Fraser - <https://www.bbc.co.uk/news/business-45127423>

Poundworld– Retail Gazette What went wrong, JUNE 2018
Debenhams - <https://www.thisismoney.co.uk/money/markets/article-6587299/Debenhams-bomb-waiting-private-equity-owners-ran-ground-says-banker.html> - JANUARY 2019

*sources: <https://www.nytimes.com/2020/05/14/business/coronavirus-retail-bankruptcies-private-equity.html>

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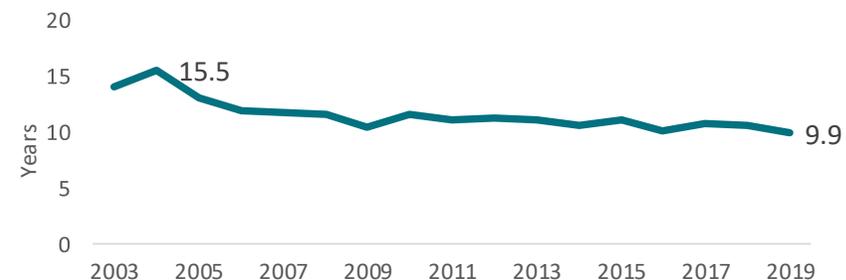
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Over-renting and rigid long-term lease structures pressured UK (historic) retailers

Legacy of onerous long leases disadvantageous compared to new players

- **Retail leases used to be bond-like income** with 20+ year tenors, 5-year upward only reviews, especially the case for historic department store players
- Average lease length **in 2004 was close to 15 years, although is now getting shorter** (See MSCI chart enclosed) which is a comparative advantage for new players – typically 5-year leases with a break at 3 years.
- High business rates also **participated to the distortion of UK occupational costs** compared to Continental Europe, where effort ratios are more common, especially for Shopping Centres. However, the UK retail lease model is being questioned with COVID-19 – cf. New Look switch to turn-over rents through the CVA
- **The combination of the rent and rates burden are weighing heavily on retailers with a legacy of large underperforming portfolios**

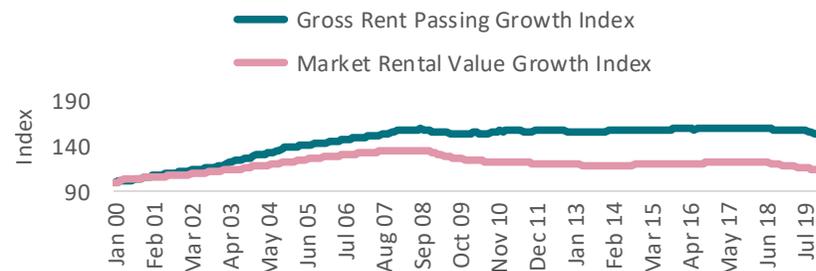
Average retail lease length



Source: MSCI UK lease event 2019, May 2020

NB: weighted full term, ignoring any breaks, including short leases)

Retail passing rents progressed more quickly than ERVs



Source: MSCI, May 2020

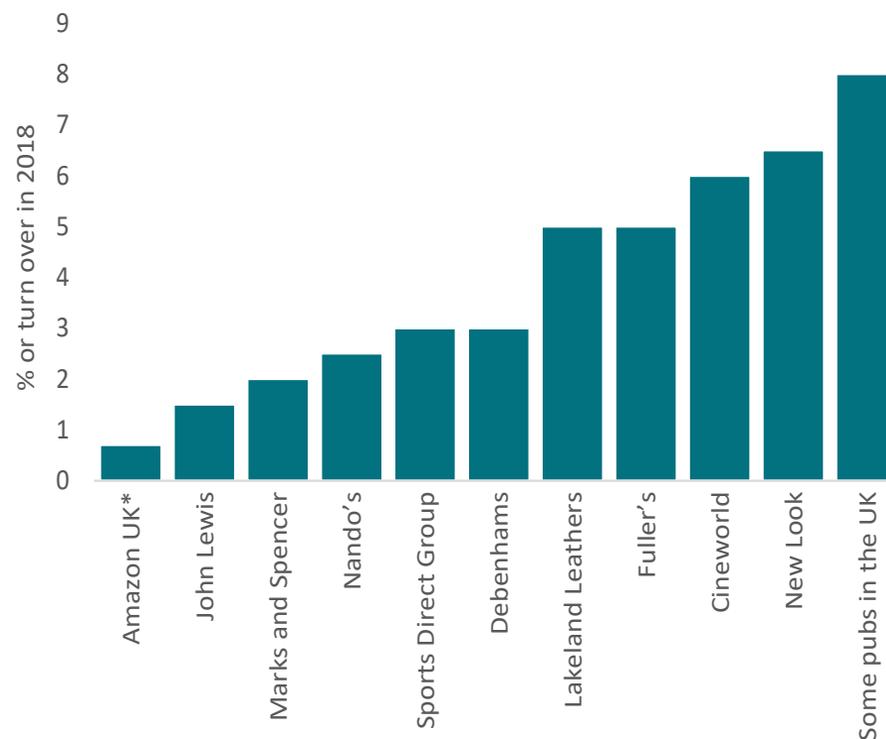
Legacy of long and over-rented leases are preventing some retailers from optimising their store portfolio

Business rates are a major cost burden for UK retailers adding to OCR pressure

COVID-19 providing short-term business rates holiday

- **Business rates (BR)** is a tax on land on properties used for *business* purposes based on ratable value and rents. The tax is reset every 5 years, last was in 2017 (but based on property values in April 2015), which increased sharply especially in Central London.
- BR growth outpaced the rate of inflation and RVG since the 1990's, according to the UK parliament study (October 2019)
- In 2018, bricks-and-mortar retailers paid £7.2bn (2.3% of their sales) in business rates for 2018-19 and online retailers only £457mn (0.6% of their sales)
- **Debenhams** alone pays about £80m a year in rates (The guardian October 2018). **Sainsbury's** business rate bill has doubled in a decade (FT March 2020)
- The increases of **the National Living Wage (2016 and 2020)**, and the **Apprenticeship Levy** are additional pressures

Business rates as a % of turnover



Source: UK parliament, October 2019

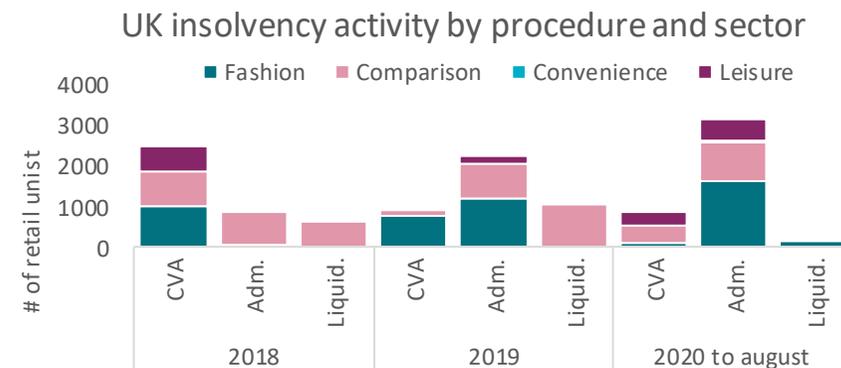
*business rates on lockers

Following COVID-19 crisis, a holiday on business rates was granted to retail businesses for the 2020/2021 tax year

UK CVA: the escape route for some retailers, but at the expense of landlords

CVA procedures are now seen as too complacent and some tenants are using it to leverage on negotiations

- **Company Voluntary Agreement** was introduced in 1986 (as alternative to administration) which gives a business the chance **to repay its own liabilities while remaining in control and continuing trading**
- Retail CVAs account for the highest proportion of them c.20% (Deloitte Research January 2020). **It usually implies large rent reductions (43% over the last 3 years) or lease exit (14%)**
- However, CVAs are said to be increasingly used **opportunistically** by retailers who are not strictly in immediate distress, **as a way to cut costs and rationalise their portfolios rapidly**. Also used for business rates reduction.
- In its 2019 CVA, **Debenhams sought to reduce rents in 105 of its stores** (some by 50%), proposition which was mostly accepted by landlords
- In September 2020, **Newlook switched 402 stores to turnover rent** up to 12%, under a CVA proposal (Retail Gazette, 15th September)



Source: Savills, AXA IM - Real Assets, August 2020



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CVAs recently used opportunistically as a leverage to challenge the lease model and rental level

UK is over-retailed with high exposure to department store compared to cont. Europe

The over-size stuck-in-the middle retail format was unable to take the online shift

We believe Department Stores main issues are:

Size

Stores are now too large & sales densities have been shrinking (OCR unsustainable)

Lease

Historic players ended with large portfolio of underperforming stores with long leases

Investment

Debt issues for most prevented key investment esp. on the online channel

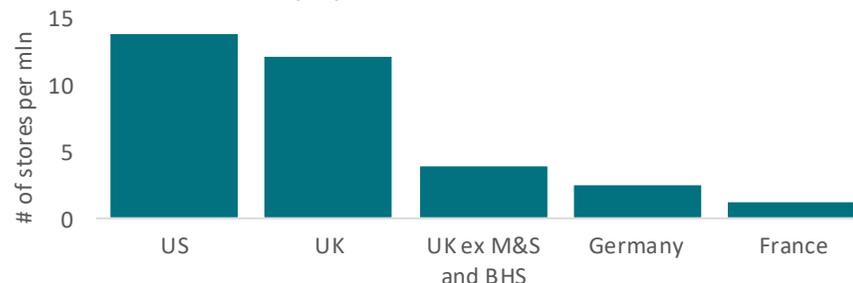
Positioning

Mid-market positioning failing to compete with fast-fashion and low-cost retailers – a lot are seen as “outdated”

Experience

Failed to provide the enhanced retail experience in the new omni-channel world

Number of Department stores per mln population in 2014



Source: Fung Global Retail & Technology 2017

Ever since in Europe

- **BHS (UK)** went bankrupt in 2016 – 163 stores closed
- **House of Fraser (UK)** went into administration in 2018-2019, 31/59 stores to close
- **Debenhams (UK)** experienced CVAs and went into administration in 2019/2020 – taken over, and brands operated online
- **M&S (UK)** to close 110/1043 by 2022
- **Galeria Kaufhof (Germany)** to close 80/170 stores-midmarket positioning
- **Galeries Lafayette and Printemps (France)** COVID-19 & tourism disruption adding pressure (store closures announced)

Brexit effect: cost of imported goods skyrocketed with GBP weakness

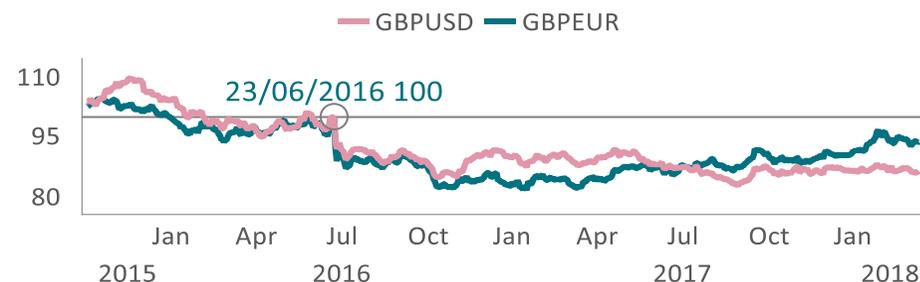
- **The consequences are two folds for the retailer equation:**

- **Costs:** cost of imported goods increased, impacting their margin as they can't pass the full impact to customers
- **Revenues:** purchase power decreased for the British as retail prices spiked (imported inflation) combined with wage stagnation affecting spending and **retail sales**

- **Case study:** A \$1.53mn dollar contract of clothes from Pakistan costing £1mn in 2013 would have cost £1.25mn mid-October 2016 (see enclosed)

- A no-deal BREXIT could cost £7.8bn in tariffs to the industry, estimate by Retail Economics (March 2018)

GBP weakened significantly in the following years after the Brexit vote



A dollar contract for \$1.53mn for clothes from Pakistan taken out in mid-2013

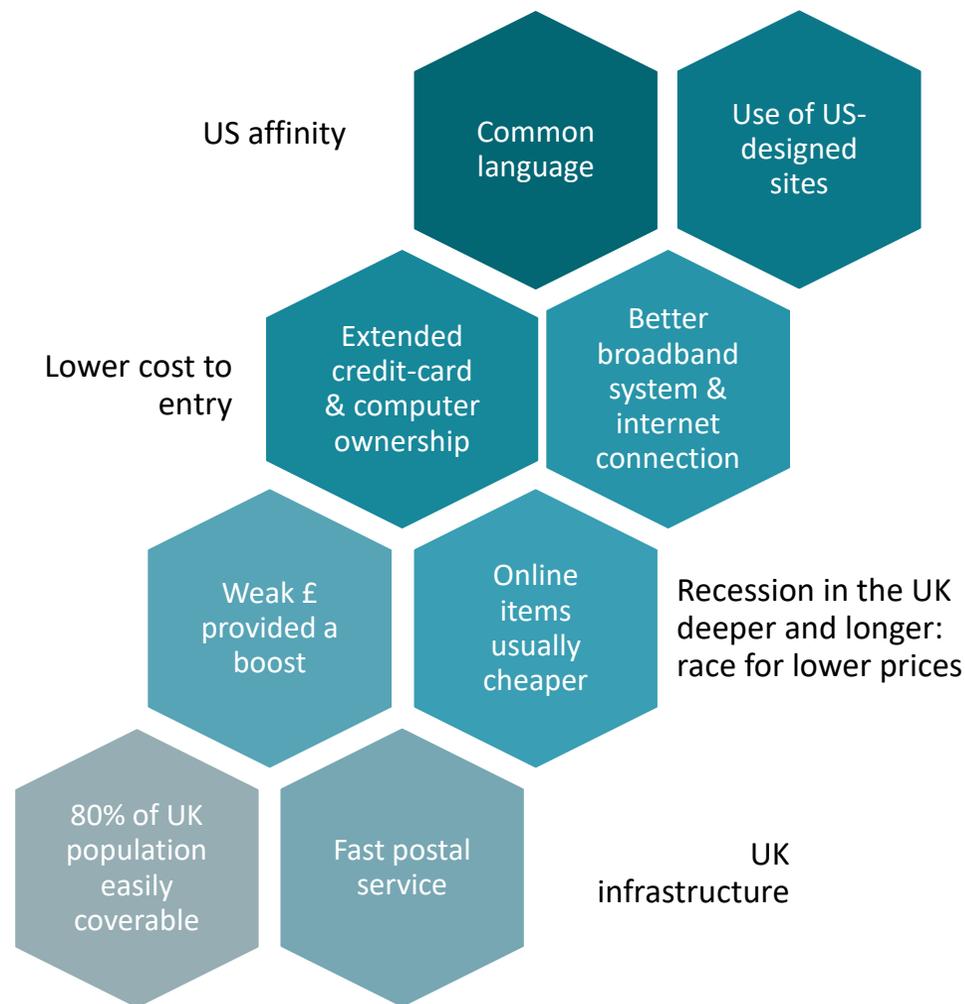
Date	Conversion rate (1£=x\$)	Price of a \$1.53mn contract in £mn
Mid-2013	1.5	1
Mid-2014	1.7	0.89
Mid-2015	1.6	0.98
Early 2016	1.4	1.07
Early June 2016	1.5	1.06
Mid October 2016	1.2	1.25
November 2016	1.2	1.23
Mid 2017	1.3	1.18
Early 2018	1.4	1.10

Source: CRR, Retail at bay 2018

Retailers equation affected both on costs and revenues by weakening of the £

The digital shift accelerated the market reshuffle: the UK was ripe for change

Lower cost to entry and closeness to the US made the country a European precursor

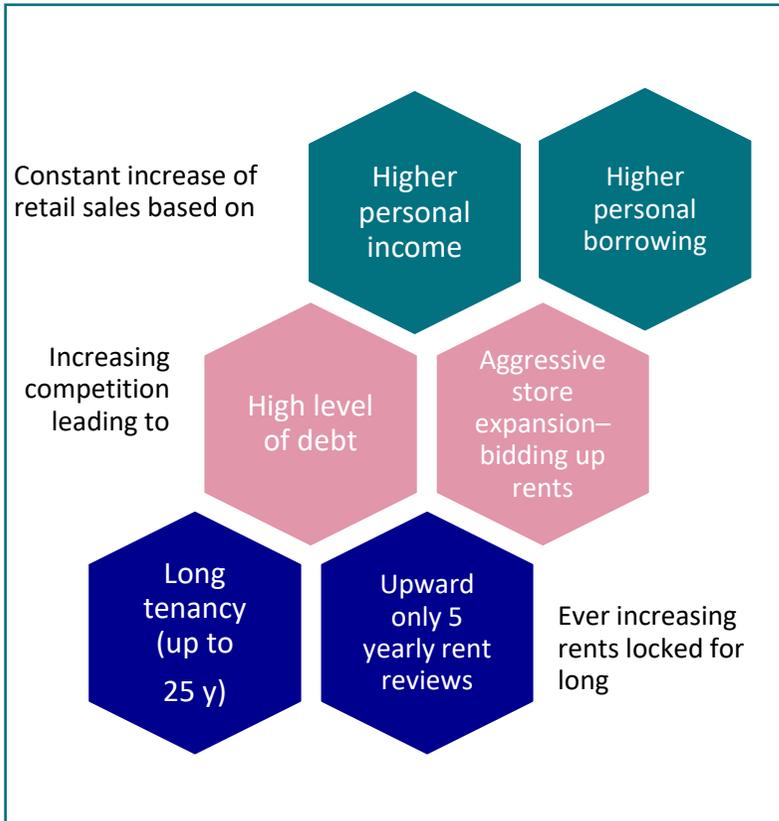


- The UK was ahead of the online shift and a European incubator for pure-players (AMAZON, ASOS...)
- Amazon was the fifth biggest retailer in the UK in 2018 (in value)
(GlobalData March 2018)
- European countries should catch-up and the COVID-19 crisis will prompt the online use

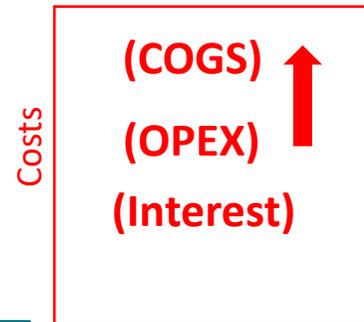
Summary: traditional UK retail model prompted the crisis

Retailers' equation broke with rising costs and falling revenues

We believe that the traditional British retail model...



...made retailers equation brake with falling retail sales



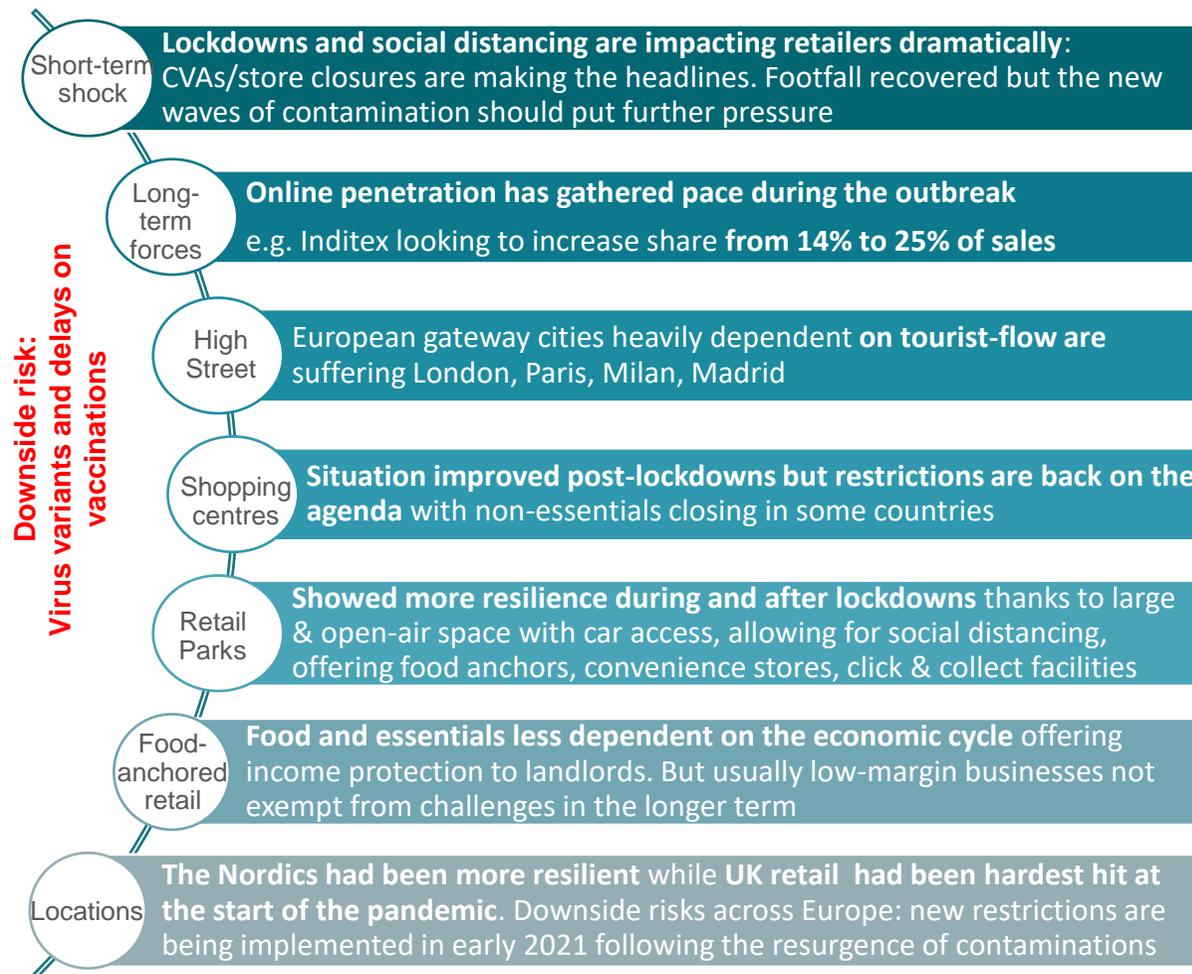
- The model worked while sales and profits were rising. But the equation broke with consumer spending collapse and online sales diversion
- Interest payment on debt became difficult
- Retailers stuck with large portfolios of over-rented long leases against falling sales productivity
- Requirement of investment on omni-channel supply-chain
- UK Specifics: business rates + wage increase & weakening £ (production pressures)
- Highly geared UK retailers with large portfolios of over-rented stores slipped first



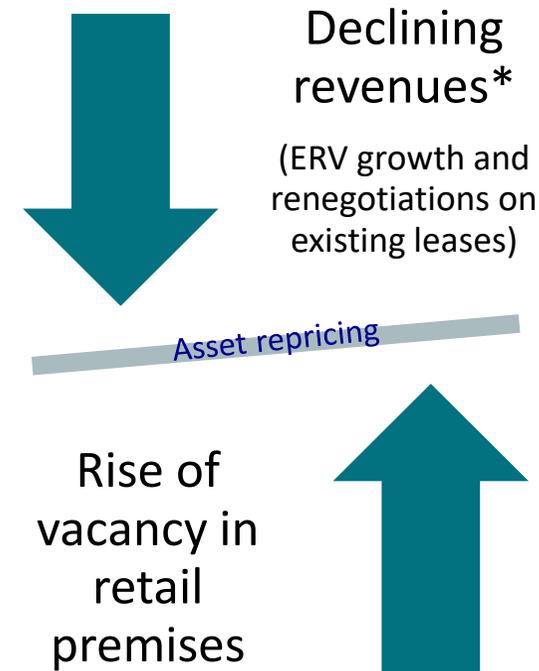
**COVID-19 is
the *coup de grâce* for
the weakest**

COVID-19 successive waves to accelerate and deepen existing disruptive retail trends

Pandora box is now opened: the sector is to experience a reset



Material impacts for landlords



*GS study show that ERV should decline 30% if retailers want to maintain margins

Source: AXA IM – Real Assets, as at January 2021

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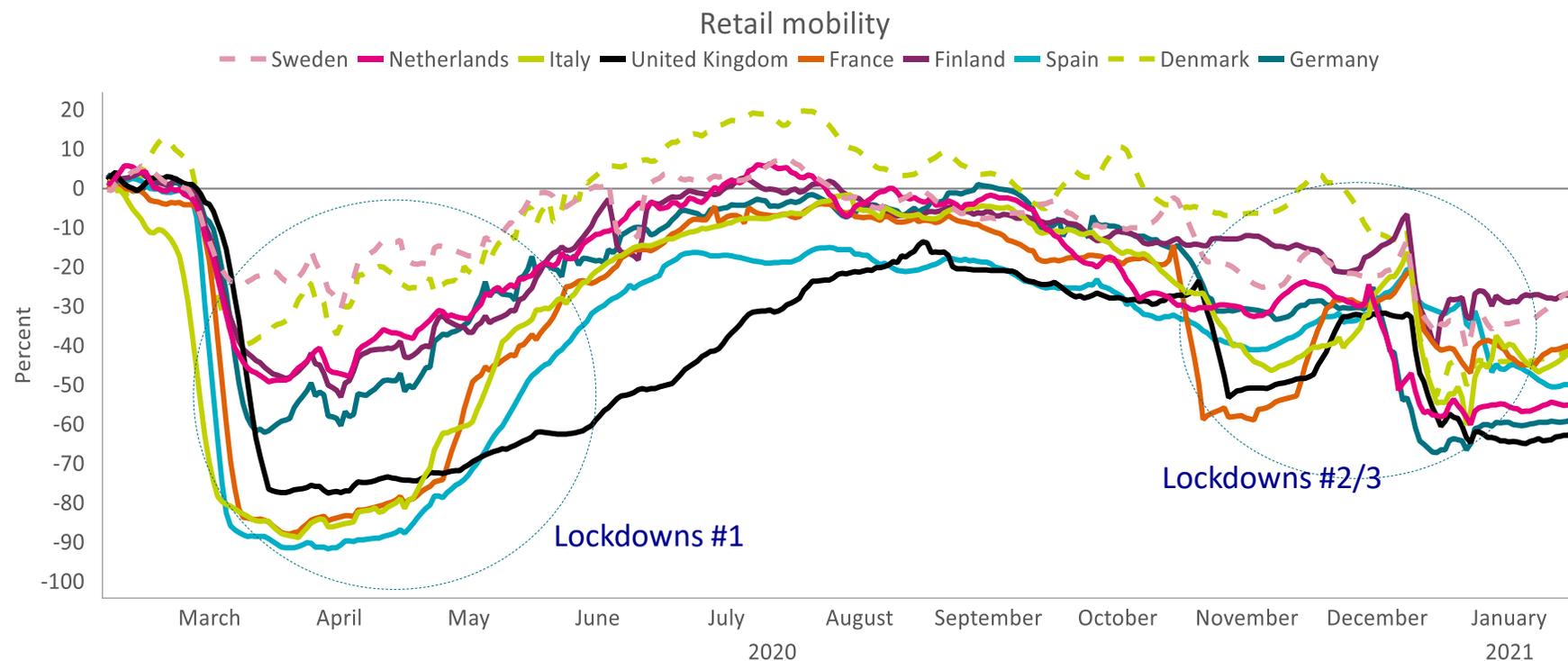
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Several lockdowns and social distancing caused unprecedented demand shock to retailers

Coup de grâce for some retailers



Source: Google, Macrobond, AXA IM – Real Assets, data as at February 2021

Demand shock adding more pressure to already struggling retailers... and government help will not last forever

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UK online habits gathered momentum; penetration expected to exceed 25% by 2024

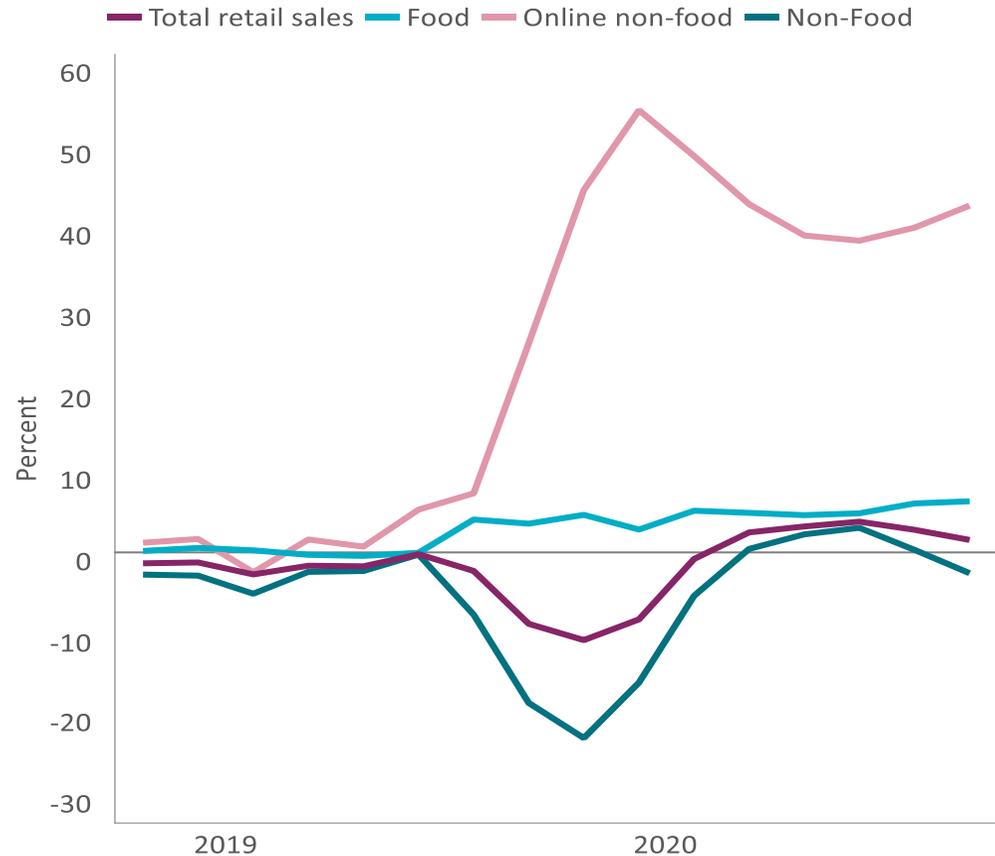
Online diversion expected to continue after the pandemic

1/4 of the brits

Say they became even more addicted to online during COVID-19

in a research, conducted by Argos and OnePoll in September 2020

UK retail sales value YoY change since Feb 20



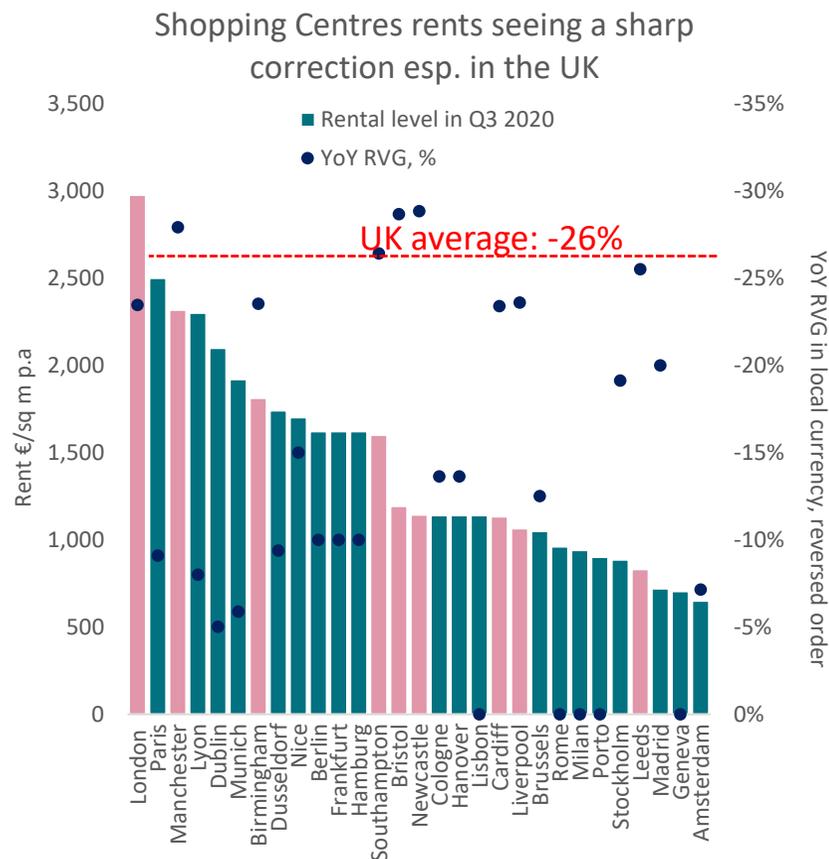
Source: Macrobond, AXA IM – Real Assets, data as at February 2021

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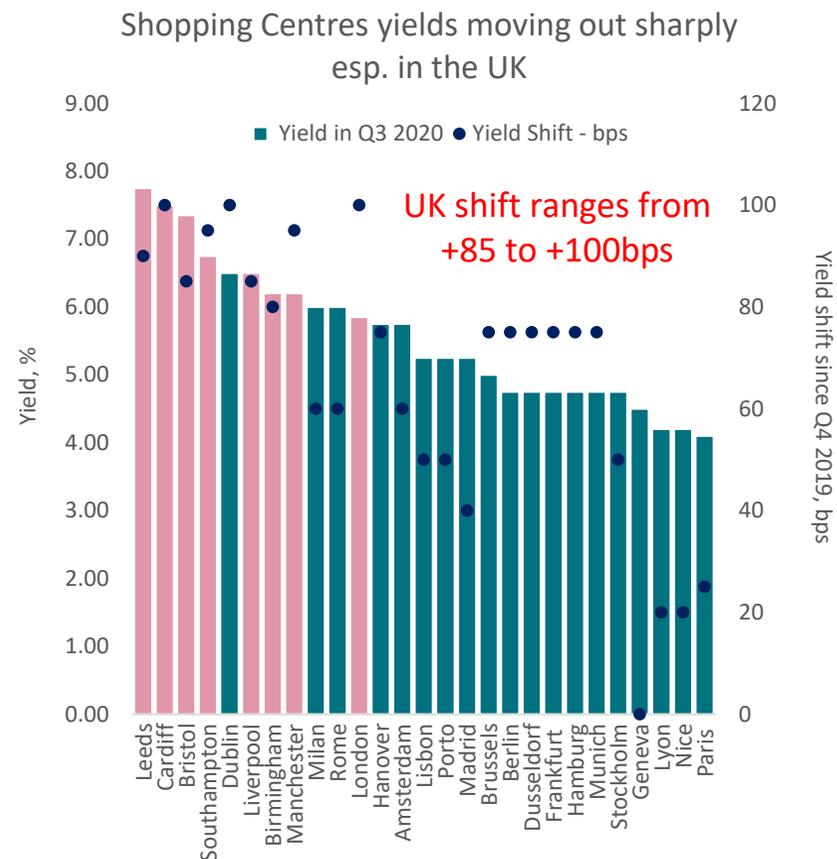
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Shopping Centres rent rebase and yield correction is stronger in the UK

Health crisis has been an accelerator of the switch towards more flexible leases



Source: CBRE, AXA IM - Real Assets, data as of Q3 2020



Source: CBRE, AXA IM - Real Assets, data as of Q3 2020

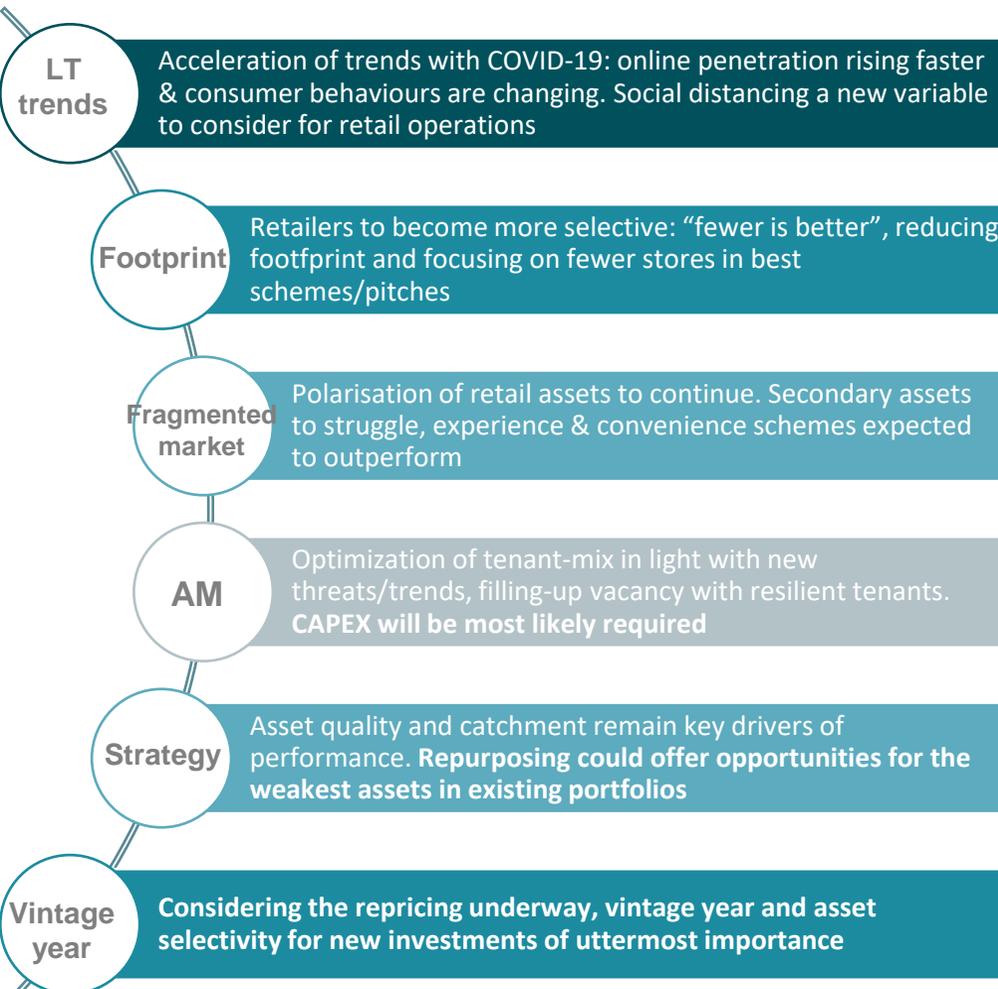
On the back of rising vacancy, a probable rebase of ERVs and changing lease structure, we expect shopping centres to suffer the most, with significant repricing underway

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Retail investment strategies to be assessed carefully on a case-by-case basis

Retail in the new abnormal



COVID-19 immediate impact and ST/MT threats

Type of scheme	Retail Concept	Features	COVID-19	ST & MT threats
Very large SC	Destination & Leisure	Dominant SC offering flagship units with omni-channel brands and leisure and F&B component		
Large SC	Destination & Leisure	Regionally dominant SC with strong anchor offering omni-channel brands and leisure and F&B component		
Medium SC	General goods or convenience-oriented offerings	Discount store, supermarket, drug, large-specialty discount		
Factory Outlet	Aspirational experience with items at discount	Manufacturers' &/or luxury retailers		
Retail Parks	OTT units or purpose built parks	Bulky good, electricals, furniture, DIY or Click-and-collect facilities		Showed some resilience during the crisis – used for C&Collect
Convenience stores	Convenience offering close to residential areas	Supermarket-anchored, personal services... Click-and-collect facilities		Relatively resilient to ST/LT threats
High Street units	Flagship stores increasingly acting as showrooms	International retailers or strong national brands in prime pitches		

Source: ICSC Research, SC Standard (2005), AXA IM – Real Assets August 2020

Social distancing Retailers' failure Travel disruption Online trend

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Source: Analysis at February 2021

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