PRAGMA PAPERS

Retail Property

The Post Covid Challenges

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Pragma View

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There is no doubt that the effect of Covid-19 is having a profound impact on the retail industry. We are witnessing unprecedented drops in footfall, spending and sales and, despite government intervention, widescale unemployment and a number of administrations of well-known brands.

But the retail sector is not without opportunities. To capitalise, we must understand what has fundamentally changed from both a consumer and occupier perspective.

In this paper we share our view of the potential winners and losers in the short and medium term, and how investors and asset managers should adapt their strategies to deal with the new landscape.

Our core view is that although change may be significant in certain sectors (e.g. grocery), lockdown will not fundamentally change consumer preferences in the medium-term, rather it will accelerate existing trends already in play that are shaping the industry today, including the growth of online and the polarisation of use of physical assets between convenience and experiential. In addition, the UK will have to deal with one of the deepest and longest recessions it has ever faced.

Consumer

Rather than lockdown, in the medium-term, consumer behaviour will be most significantly impacted by the resulting recession – you only need look back to 2008 as an indicator of change and the winners and losers:

- We expect to again see a shift towards discounting, with the increased use of value retailers such as Aldi, Home Bargains and Poundland across all socio-economic groups.

- Spend on leisure pursuits, which held up well in 2008 and accounts for a higher proportion of household spend now than in 2008, is expected to remain prominent. Activities which are cost-effective and can account for a reasonable duration of time, such as climbing walls or competitive socialising activities, should continue to prosper.

- Demand for F&B is likely to remain high, but the consumer will look to limit average spend, and many operators have little room to move on price. The casual dining sector is structurally challenged by high fixed costs and rising food prices and many operators have only recently weaned themselves off the heavy promotional activity established in the last recession. One potential outcome may be the continued growth in less formal eating out, such as street markets - which have significantly reduced occupancy and staff costs, and the continued popularity of cost-effective options, such as McDonalds.

Occupiers

Lockdown has had an immediate and will have a long-lasting impact on occupier performance and strategy. Immediate measures include tightening of budgets, significant discounting, and accelerated store closure programmes. Longer-term impacts include the rebasing of rents and lease structures, enhanced scrutiny of the role physical stores can play in wider brand performance and significantly altered store portfolios, with an improvement in the integration of online and physical.

Landlords

The impact on landlords, developers and investors will potentially be even greater than on occupiers - squeezed between a consumer that has limited ability to spend and occupiers that have limited ability or desire to pay rent, alongside national governments with other priorities beyond supporting the retail sector only.

In the short-term, those unable to prove the value of physical space across a range of metrics, including footfall, sales, profitability, and consumer satisfaction, are likely to be challenged to find occupiers at all.

In the medium-term, those able to move to a system of leasing and valuation that reflects the present-day world, and the interconnection between physical and digital, will find their assets thriving.

Now more than ever, it is fundamental that asset managers truly understand, promote and enhance their schemes' raison d'etre through a detailed understanding of consumer and occupier needs.

If you would like to discuss any of the trends or points raised, drop me a line at **a.mcvicker@pragmauk.com**

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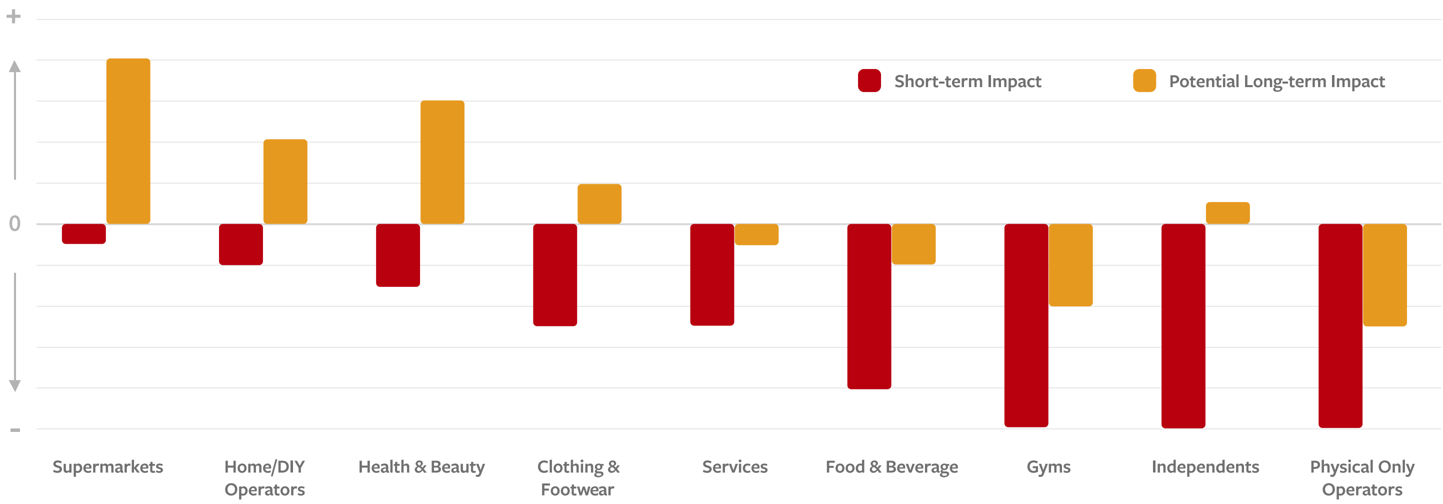
Short-Term Impact of Lockdown

Potential Short-Term & Medium-Term Impact



The short-term impact of lockdown on all merchandise categories and operator types has been almost exclusively negative, causing near-immediate administrations and challenges to specific sectors (discussed overleaf). Through a combination of consumer behaviour, competition and the inherent nature of product and offer, certain sectors appear better placed to survive and thrive in the medium-term (see page 7).

- **Supermarkets, Home/DIY** and **Health and Beauty** have at least been able to maintain trading, but sales, margin, staffing and supply chain have all been severely compromised.

- Despite often extensive online propositions, major **Clothing & Footwear** brands have been challenged by implementing social distancing and dealing with consumer demand – Next were an example of this, operating their website for just a few hours a day given restraints on capacity. Clothing & Footwear operators are likely to be hugely compromised by voiding entire seasons of clothes and having to dispose and discount stock as a result.

- **Services** have either closed (hairdressers), as have gyms, or operated limited opening hours (banks), with the majority looking to online to facilitate ongoing consumer engagement.

- Many **Food & Beverage** operators have attempted to run collection-only or delivery options, but for a large majority, the revenue generated comes nowhere near to covering significant stock, staff and occupational costs. Additionally, some that have maintained collection or delivery options have come in for criticism for placing kitchen staff at risk given the often-cramped working environment.

- **Independent and regional operators** may not have the depth of finance to cover lockdown period and may find themselves at the back of the queue when dealing with suppliers vs. larger players, as operators look to secure appropriate stock.

- Despite the forthcoming easing of lockdown measures, uncertainty regarding the degree to which staff and customers will return to physical stores places those **without an online presence** at an immediate and ongoing disadvantage.

Immediate Casualties

Popular Brands Require New Routes to Market

Government support, by way of the furlough system, direct loans and protection from eviction, has delayed the potential number of CVAs and administrations that lockdown may still generate.

Despite this support, the period of lockdown has accelerated trends already in place and subsequently, some operators have been unable to generate the required reserves and potential to stay afloat:

WAREHOUSE

OASIS

Cath Kidston

LAURA ASHLEY

Much loved brands, such as – Cath Kidston, Laura Ashley, Oasis/Warehouse – have struggled to find an appropriate route to market at the requisite scale.

These brands still possess value and may well continue to trade online and potentially in the future as concessions.

Brands Struggling To Alter An Outdated Business Model

Some brands which were struggling prior to Covid-19 have been tipped over the edge by the lockdown:

BEALES

Faced with extensive store estate in poor upkeep in locations with falling footfall and sales.

BrightHouse

FCA cap introduced on interest rate charges after a £14.8m repayment to customers in 2017.

Carluccio's

Rising competition and operating costs alongside high rents.

DEBENHAMS

Cash-flow issues whilst securing changes to future store estate.

HAWKIN'S BAZAAR

Cash flow issues derived from difficulty in managing seasonality in sales.

We have also seen the Casual Dining Group which owns Bella Italia, Café Rouge and Las Iguanas, go into administration in May 2020, with a likely closure of many outlets.

Challenged Sectors

Fashion

In young fashion, Asos and Boohoo sales continue to grow as they develop and expand their stable of brands, with improvements in order fulfilment nearly annulling the advantage physical stores historically held in terms of instant gratification. Physical stores will be further impeded by customer restrictions on touching and trying items on. In assured fashion, casualisation of dress codes and the movement to home working will challenge more traditional and formal clothing providers at the upper end. In family fashion and childrenswear, improved supermarket provision will continue to challenge brands like M&S.

Footwear

High levels of competition and the trend for athleisure has brought the likes of Office and Schuh into direct competition with Footlocker, JD, SportsDirect and the manufacturers: the strong sales potential of online can be seen to be working against operators with extensive store portfolios.

Gifting / Discretionary Spend

Recessions limit the spend on non-essentials and the likes of Neon Sheep, Paperchase and Tiger will be competing for the same customer, often in locations where footfall is dropping.

Casual Dining

A model that was already struggling with squeezed margins via rising employment costs, rising food costs, strong competition, demanding consumers and high historic rents. It is difficult to see the model working with any form of social distancing. However, demand for F&B continues to rise and typically remains high even during a recession and the potential for takeaway and delivery will play a larger role, with likely shared use of kitchen and seating areas between occupiers and significantly lower rents.

Medium-Term Opportunities

Those who have been able to take advantage of the disruption caused by Covid:

Supermarkets

have had a unique opportunity to build loyalty and respect during lockdown. Supermarkets appear well placed to meet changing consumer demand in terms of how to access product via:

- Online - 600k households reported to have tried home delivery for the first-time during lockdown.
- Multiple formats – larger stores show potential for more/improved brand partnerships given the continued appeal of free parking; local/express formats can continue to provide convenience around office locations and transport hubs.

Additionally, during a recession, when price becomes the key differentiator, supermarkets typically benefit from a rise in demand for own brands.

Home / DIY

retailers should have benefited as one of the first sectors to reopen physical stores, presenting a great opportunity for the likes of Homebase to re-engage with the consumer after the challenges of the Bunnings takeover. Stores opened in time for a key spring trading period and garden sales are likely to be boosted by the good early summer weather. Continued restrictions on movement and holidays will mean more will be spent on home improvements in the near-term by adjacent residential, offices and services.

Medium-Term Opportunities

Those that typically perform well in a recession:

Fashion discounters

such as SportsDirect and TK Maxx, should benefit from an environment where consumer demand for brands remains high but discounted prices appeal; both have online platforms though still largely look to direct custom through physical stores. With the closure of department stores, these brands are increasingly becoming the new anchors of many town centres and landlords are likely to consider offering appealing terms to secure these strong footfall drivers. Additionally, both occupiers can leverage their ability to trade in and out of town to optimise store locations and rents. TK Maxx are likely to benefit from the surplus of brand stock that has been unsold by brands.

Beauty

Hairdressers and beauty salons are likely to bounce back immediately, with reports of 2-week waits to get hair appointments in Germany post easing of lockdown restrictions. In the aftermath of the 2008 recession, services such as hairdressers and beauty treatments fared well as an 'affordable treat' and we are likely to see similar strength now.

Luxury brands

that can present quality, exclusivity and innovation tend to find their market less-impacted by recession and have the potential to thrive if they are quickly able to position themselves at the forefront of consumer trends. Selfridges' recent strong performance highlights the degree to which an iconic experience in London and providing THE aspirational offer in the regions can drive strong returns. Despite its high price point, Tesla has been able to position itself as good value by promoting its running cost savings and reduced environmental impact. Apple continues to thrive through innovation, quality and experience. Cosmetics brands often retain high spend during a recession as consumers veer away from fashion spend/big ticket items but still pursue 'affordable luxury'. Finally, bicycle manufacturers have seen phenomenal demand across the board and the likelihood is demand will remain elevated, with more commuters considering potentially high spec hybrid or electric bikes as alternatives to cramped public transport.

Medium-Term Opportunities

Those well placed based on changing demand:

Leisure Providers

With leisure spend growing twice as fast as retail spend and with consumer demand shifting to 'doing things' alongside 'buying things', leisure providers have a strong opportunity to develop market presence and growth. Significant demand will come from both consumers looking for new experiences in more accessible locations, and from landlords for operators to come forward and take the significant portions of space available, particularly in town centres. Operators should be able to largely de-risk town centre openings through working with landlords, who see the benefit of attracting a new audience and use-type to their schemes, potentially stretching appeal into weekends and evenings

Independents and Regional Operators

may not have the finances to cover the lockdown period and find themselves at the back of the queue when dealing with suppliers compared to larger players, but going forward, as national brands focus on key trading locations, there will be a surplus of space available for independents to occupy, potentially on very favourable terms. Local operators can be more responsive to local demographic requirements and evolving opportunities, and the lockdown period has shown significant potential for communities to support more local ventures.

Medium-Term Challenges

Physical Only

The immediate impact of store closures may not be easily overcome - customers may put up with social distancing in large stores like Primark (who say they can survive with closed stores until May 2021) but how many will queue for value brands or if their initial intention is just to browse? We are likely to see footfall continue to fall because of the recession and the shift towards buying online. Operators who depend on footfall typically generated by another store (i.e. an anchor), are also likely to struggle. Physical-only operators will increasingly be pursuing a focused sales strategy, trying to convert the sale on the day, which may also deter some shoppers.

The Middle Market

Recessions tend to see a split in the market between value and luxury, with middle market operators typically squeezed. Within this middle market, major brands including Hennes, Inditex and Next have the offer, scale and proposition to drive performance through a combination of strong customer engagement, online and utilisation of their store estate. Despite its current lack of online offering, Primark has the price proposition and brand strength to ensure its ongoing popularity, assuming restrictions on physical behaviour continue to be scaled back. The strength of these midscale occupiers leaves very little room for smaller operators in the same space, whose major difference is a comparatively minor difference in price.

Gyms

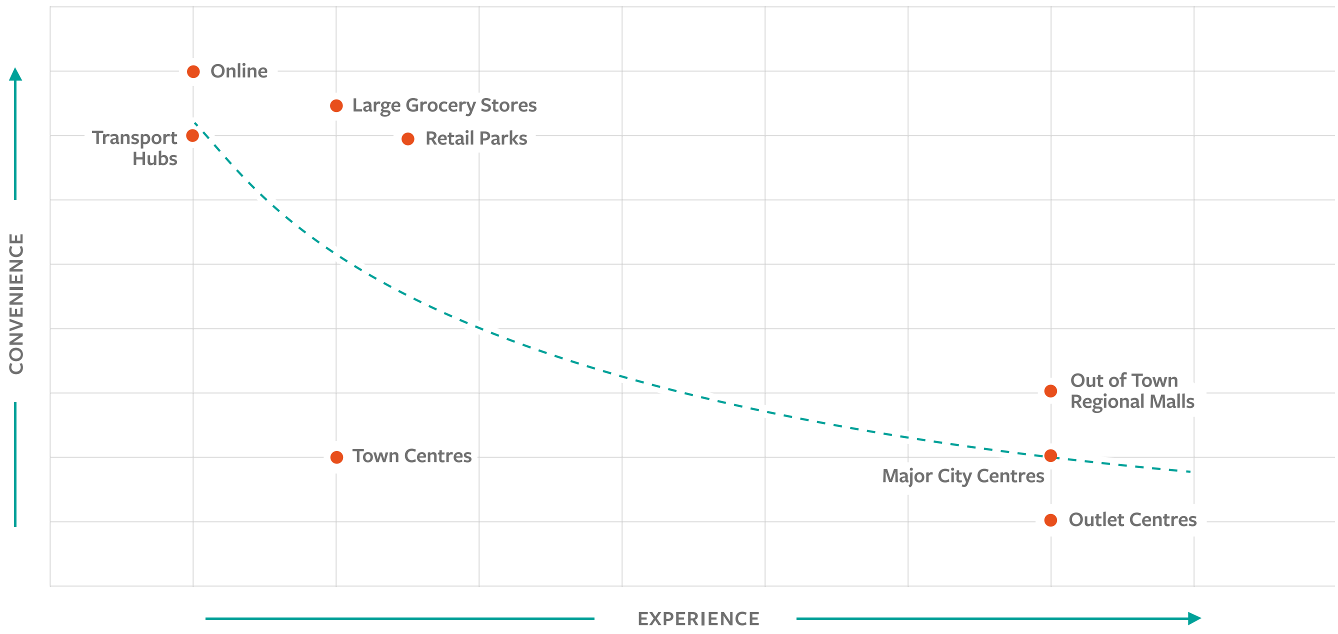
Whilst frequent users of gyms who enjoy the collaborative nature and physical facilities are likely to return as soon as the doors open, many will have tried online tutorials and services for the first time during lockdown, and this market is expected to see strong growth, particularly as a cost-effective and more flexible alternative during recession. Of the UK's 10.4m gym members, around 12% do not actively attend their gym and it is likely many of these members will not restart payments once gyms are finally reopened.

Services

With footfall across the majority of town centres down year-on-year and a continuation of this trend likely, providers such as banks, hairdressers and shoe repairers will need to be more savvy about where they offer their service, considering options including retail parks, supermarkets and travel hubs (for increased convenience), leisure destinations such as gyms, golf clubs and leisure parks to drive brand affinities or even home visits.

Other services that rely on footfall and convenience will be similarly challenged. After proliferating on the high street, mobile phone shops are increasingly partnering with larger occupiers to make use of underutilised space with florists, opticians, and shoe repairers equally following suit. Financial services may see the enforced use of online during lockdown as a rationale for further branch closures.

Outlook For Formats



The UK has long wrestled with a dynamic in which new retail space has been added to existing provision, rather than been a direct replacement for it, creating both an over-provision of retail space and a clear tiering between prime and sub-prime provision. Channel shift to online is both highlighting the amount of physical retail space that has no viable future, but also falsely generating a hypothesis that very little physical retail space is needed.

Though there is no 'one size fits all' guide, determining the purpose and opportunity for physical assets is key:

Experience – the current lockdown period highlights the limitations online can provide in terms of interaction and experience. Humans are social beings and will always be drawn to new and stimulating experiences. The largest national, regional city and out of town centres have the catchment draw to continue to drive strong experiences, through experiential retail, leisure and food & beverage

Convenience – online has yet to conquer the immediacy of a direct customer purchase from store, and the cost of last mile delivery limits the potential for significant further gains. Forms of retail that can either provide product where the customer is – transport hubs providing a convenient location between work and home – or have the facilities that equate to true convenience (long opening hours, free surface car parking) have potential to prosper.

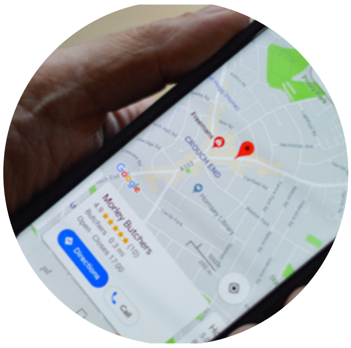
Locations that fail to convince on one or both of these dimensions risk an uncertain future, and due consideration should be given to continue to fund, support and prioritise formats and locations that may no longer be fit for purpose.

What Physical Space Needs To Do

The perception that little physical space is needed is largely predicated on the lack of evidence to show the role that physical stores play in the wider profitability of brands. Currently, a huge proportion of operators are struggling to make online profitable, given the IT, staffing and logistic costs. However, the only current measure employed to determine performance is the amount and value of sales, which is largely shifting online. Landlords must embrace wider measures of brand performance to measure the role and value of their physical space to brands.

Key Metrics Of Measurement That Landlords Should Consider Include:

Awareness



Be it passing road traffic, footfall past the door, footfall direct to store, positioning as part of a certain location or a physical adjacency/association with other brands, a physical store can play a significant role in generating, maintaining and building brand awareness. How does the cost of store and the exposure it generates compare to alternative marketing strategies/channels?

Experience

Be it part of a wider experience in a city, town or in store itself, how does the ability and cost of creating a compelling, immersive experience in-store compare with what can be achieved online? Clearly, it is fundamental that the experience be positive, and it is here that the vast majority of physical stores currently underwhelm.

Fulfilment

What is the role that a physical store can and should play as part of an omni-channel experience, rather than as a channel pitched in competition to online? What are the savings on last mile delivery, boost to in-catchment sales or efficiencies in facilitating returns that a physical store can provide?

The current outcome of utilising only store sales to value physical space is to drive down rents and values, to the occupier's (short-term) benefit. The landlord community will need to be more innovative in developing other means to prove the value of their assets if they are to alter this dynamic. It is in the interests of occupiers to work with landlords to do this; if valuations and returns continue to be driven down, occupiers may find a lack of viable physical locations in which they wish to locate.

The Insight You Need For Your Asset

Clearly, the global pandemic and resultant lockdown have created an environment that has never been experienced before – no-one has all the answers in what is a rapidly **changing dynamic**, and what works for one landlord and occupier will not necessarily work for others. A lack of guaranteed performance parameters should not however, be used as an excuse for lack of preparation.

Pragma believes it will be the investors, landlords and occupiers with both the greatest degree of insight into their circumstances, and the ability to evidence and share this information, that will be best placed to understand changing consumer behaviour and formulate strategies accordingly. **Key ways** in which Pragma can assist in the creation and implementation of appropriate strategies include:

Turnover Performance Analysis

Despite turnover being the primary tool to measure store performance, a significant portion of landlords and asset managers still have no data regarding the sales performance of their occupiers and their asset. With the expectation that a significant proportion of all occupiers will request turnover-related leases as part of reopening/renewal, it is important to have an evidence-base as to what turnover levels could be.

Pragma's free to use, Sales Trend Analysis and Reporting (STAR) tool provides an efficient way for centre managers to record and analyse actual and % changes in sales performance data from their occupiers and for asset, centre, leasing and marketing teams to shape strategy accordingly.

Occupier P&L Analysis

Pragma holds the phrase 'sales are vanity, profit is sanity' close to its heart. The opportunity for occupiers to withstand changes in consumer and competitive behaviour, as well as pay a market rent, are dependent not only on sales, but on elements including VAT rate, gross margin, employment costs and depreciation. Each are unique to each occupier and are why anyone employing 'effort ratios' or similar should be given a wide berth. At Pragma, we maintain bespoke model accounts for 350 of the UK's top occupiers to utilise in helping landlords understand who can and can't afford what level of rent, now and in the future.

Consumer Research

Be it understanding where people travel from, how often they come and how much they spend, through to understanding motivations, perceptions and misconceptions that create preferences and drive behaviour, detailed knowledge of the changing consumer is key. Consumer behaviour will continue to evolve during and post-lockdown – there never has and never will be a 'perfect' point to carry out research. However, by understanding aims and objectives, benefits and limitations of different forms of research, and what can and cannot be proved/disproved, Pragma is able to provide robust, detailed and insightful evidence to inform strategies to maximise short, medium and long-term performance.

If you would like to discuss this white paper with us, please do not hesitate to contact me:

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Pragma is the leading commercial advisor for investors and operators in airports and retail property.

We provide strategic advice to enhance the commercial performance of assets.

With over 30 years of experience in more than 30 countries, we have completed over 1,600 projects to date, successfully improving profitability for our clients.

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