What are the prospects for UK retail in 2011?

- Consumer headwinds to continue but RTT remains optimistic for retail in 2011 -
- Multichannel strategies, international expansion and expansion of grocers’ non-food offer provide growth opportunities –
- But the polarisation is set to continue apace between the winners and those with more structural issues to address, as well as across sectors and locations –

Part I: Executive Summary

Introduction
Despite recent disappointing retail market sales figures and the mixed picture of Christmas trading updates at the start of 2011 the KPMG/Synovate Retail Think Tank (RTT) feels that there is reason for the retail sector to feel some optimism about the year ahead beyond quarter 1.

At its January meeting, the RTT reported that negative pressures – political, psychological, environmental and financial – on the sector meant that the improvement in UK retail health which it had been seeing in 2010 came to a standstill in quarter 4. The group agrees that these pressures are likely to continue through quarter 1, which is also traditionally the weakest period of trading as consumers cut back on spending post–Christmas (see RTT’s latest quarterly release for details).

But having faced tough trading conditions throughout the past three years, UK retail has demonstrated remarkable resilience and avoided the devastation that so many commentators predicted at the start of the recession.

According to Helen Dickinson of KPMG: “The worry since the downturn kicked–in during late 2007 was always that retail would ‘fall off a cliff’. The last three years have provided enough evidence to show that consumers continue to love shopping and will therefore find ways to continue spending whatever the state of the wider economy. Consumers will spend more in £ terms than they did in 2010.”
However, although the RTT feels relatively upbeat about 2011, it’s not to say it will be plain sailing. In this latest white paper the RTT discusses how consumers and the sector will be affected and how retailers are likely to adjust and react to the challenges which lie ahead.

**How will the economy affect retail in 2011?**

The RTT expects 2011 to remain challenging with a number of economic factors set to affect consumer confidence and spending power.

Although unemployment is rising, wage growth is minimal and higher taxes payable, the RTT does not believe there will be outright retrenchment from consumers this year but they will face a squeeze to their disposable income. Paradoxically, this will be felt more keenly in 2011 as the economy attempts to continue to recover than at any time during the depths of the recession.

Variation in individual circumstances and levels of income across different parts of society and regions means that some consumers will be affected more than others, particularly in areas where there is a greater reliance on public sector jobs. “Real income pressure, ever-rising petrol prices and the threat of higher mortgage rates will be felt more keenly in the mass market than at the “John Lewis” end of the market,” said Nick Bubb of Arden Partners.

Shop prices will continue to rise over 2011 as retailers struggle with the "double whammy" of the VAT rise and higher input costs. Inflation and its potential impact on interest rates remains the main cloud on the horizon.

“The MPC considers that current inflationary factors are temporary, but despite a deep recession there has been little drop in core pressures,” said Vicky Redwood of Capital Economics. “Whether the MPC will hold its nerve remains to be seen but it may act to raise interest rates if it feels it is losing credibility. And while unlikely, a rise in interest rates which is either very steep or very quick will have an effect on what is seen as the ‘tipping point’ of consumer confidence.”

This, combined with the knock-on effect on the housing market, would severely dent consumer confidence. Shocks for the consumer of this kind, or anything from the wider global spectrum (e.g. European sovereign debt crisis, political instability in the Far East) would have an immediate impact on their psyche, if not on their pocket.

But, ‘shocks’ aside, as consumers feel the squeeze financially it’s not just a question of trimming retail spending; the RTT believes they will first consider other areas of the wider
consumer spending spectrum. For example, we expect leisure to be hit harder so an adjustment there will soften the blow for retail.

At the same time, although consumers have recently been increasing their saving levels with the current household savings ratio at 5% (although still well below the long-run average of 8% according to the ONS), they may well dip back into savings to continue to find the money to fund their spending.

But despite the lack of a rosy outlook, a number of the big uncertainties of 2010 have now been removed – the outcome of the election, the level of VAT, and the outcome of the Comprehensive Spending Review – so whether the news was good or bad on an individual basis, consumers now at least have more clarity about their position.

**What will the consequences be for the retail sector and how will it influence retailers’ strategies?**

Aside from how inflation affects interest rates, products have or will become more expensive, so while spending is expected to remain the same or grow slightly due to rising prices, the volume of retail purchases will be adversely affected.

Synovate forecasts that store footfall will continue to decline in 2011 by 3%, which would mean that high street traffic will have declined by 10% over the last five years.

Neil Saunders of Verdict Consulting explains: “Retail spend is becoming concentrated into fewer trips where fewer stores are visited. So, although the overall retail ‘pie’ may continue to get slightly larger, not all retailers will receive a slice. Retailers therefore need to ensure that their proposition exceeds customer expectations, to ensure any spend which is made is made with them.”

At the same time 2011 will not be the year of trading down; it’s likely to be the era in which consumers seek more value for money – perhaps trading up but buying less often in order to fund more expensive purchases. The RTT notes that lower levels of footfall provide an opportunity for retailers to serve their customers better if staffing levels are right and if combined with appropriate range and price.

The RTT anticipates that there is likely to be more divergence between non–food retailers and the grocers this year, with food retailers continuing to see a spending shift in their favour as they are able pass on price rises more easily, due to their products being less discretionary.
The RTT expects to see increased international expansion from strong retailers which have a strong position in the UK and the financial power to sustain the high entry costs and, more importantly, the cost of rapid establishment of a foreign presence. John Dawson of the Universities of Edinburgh & Stirling said: “The pressures at home in 2011 will encourage more large retailers to seek opportunities outside the UK. The large East Asian countries, including several different markets within China, Vietnam, Thailand, Indonesia, India and the smaller markets in the Gulf region are likely to offer the most attractive opportunities.”

With the UK representing a £290bn retail market, even in difficult times it represents a tempting prospect for overseas entrants with a strong business model and more inward investment is also expected this year. Neil Saunders said: “Despite the difficulties, retail will remain a lucrative market and foreign entrants will continue to land in the UK and expand; this will add to the competitive pressure facing incumbent players.”

This also puts pressure on retail property and domestic businesses and overseas players will continue to see their expansion hampered by the lack of new property. According to Mark Teale of CB Richard Ellis: “Speculative development activity is at a very low ebb and will remain so until 2014/2015 at the earliest.” At the same time the gap between primary and secondary retail property continues to widen further as trading locations become further concentrated, a trend which the RTT has been observing for some time.

Divisions between separate channels of retail are now well and truly blurred (as the RTT considered in its white paper “How is the internet changing UK retail?” in May 2010) but the group agrees that non-store retail will grow in influence this year. Richard Lowe of Barclays Corporate said: “With limited new shop space coming into play in the UK this year the real opportunities lie on the virtual high street. In order to fuel this growth I expect to see retailers, particularly pure internet players and grocers, beginning to borrow more from their banks in order to make capital investment to improve their e-tail infrastructure, whether it be investments in technology to enhance the online experience or investing in new distribution centres.”

This also highlights that the younger age groups who are switching channels more regularly and more quickly are becoming increasingly influential for retailers. With many new applications for smartphones already launched the RTT expects mobile to become much more influential this year.

**Conclusion**
The economic environment of the past three years has increased the rate of structural change in retail and 2011 will be no different.

Nick Bubb of Arden Partners said: "No doubt we will continue to see a difference between retailers affected by the supermarket competition and those with more robust market positions, and between multi-channel retailers and those less able to capitalise on the continued growth of non-store retailing."

As always there will be winners and losers, particularly in the low growth environment which has become the norm, with fewer shopping trips. Those who innovate, know their customers better than their competitors and have the right proposition and business model are more likely to be in the former category.

Tim Denison concluded: "Adversity breeds creativity and innovation providing it’s nurtured by government policy. Despite all the talk of austerity, there is every reason to look ahead into 2011 and beyond with optimism."

Part II: In detail – RTT members’ predictions for 2011

Nick Bubb, Arden Partners: “Consumer headwinds obvious in 2011”

We will never know how the key Christmas 2010 period would really have turned out for retailers, despite promising early signs, as the final picture was confused by “the snow”. But despite the snow disruption in December, particularly in the North and for out-of-town retailers, consumers managed to find their way to the strong brands and the better retailers did not need to moan about lost snow business. The weak got weaker, however and 2011 will test their ability to come up with more convincing excuses for poor trading. Who will be the first to complain that sales of winter coats and boots have fallen back in November and December because the weather hasn’t been as cold as in 2010?

The consumer headwinds are obvious in 2011. VAT has gone up to 20%, public sector spending cuts are beginning to bite and real incomes are under pressure from rising inflation...yet retailers in general will probably muddle through again, as long as interest rates don’t go up before Christmas. However, the MPC is struggling to justify its new focus on supporting economic growth rather than controlling inflation and we suspect that the spectre of rising interest rates will cast an increasing shadow over the second half of 2011, particularly in the housing market.
Assuming “normal” weather and “reasonable” inflation, retail sales in the first half of 2011 could remain quite resilient. But non-food retailer performance will be increasingly polarised: between the North and South of the country and also between the mass market and the premium market. In the North the higher exposure to the public sector is likely to hold back the consumer, but in the South the recovery in the private sector and the City will be supportive. And real income pressure, ever--rising petrol prices and the threat of higher mortgage rates will be felt more keenly in the mass market than at the “John Lewis” end of the market. And no doubt we will continue to see a difference between retailers affected by the supermarket competition and those with more robust market positions and between multi--channel retailers and those less able to capitalise on the continued growth of online retailing.

**John Dawson, Universities of Edinburgh & Stirling: “Large retailers seek overseas opportunities but risks are higher”**

The pressures at home in 2011 will encourage more large retailers to seek opportunities outside the UK. It is likely to be most evident amongst those retailers who have a strong position in the UK and the financial power to sustain the high entry costs and, more importantly, the cost of rapid establishment of a foreign presence. Where the Euro–American recession has infected least are likely to be the targets for 2011. The large East Asian countries, including several different markets within China, Vietnam, Thailand, Indonesia, India and the smaller markets in the Gulf region are likely to offer the most attractive opportunities.

But unlike a few years ago, a slow build up of a few stores in the foreign market is not going to provide the returns commensurate with the required investment, nor will it make any impact on ameliorating the slow growth at home. This used to be the approach but the higher levels of competition and faster market development in the target markets mean that this route will generate costs with little return. Rapid establishment to create consumer awareness is now the only realistic way to develop a viable international operation in the current growth markets. This means using acquisition and multi–channel operations either to build on current networks for those retailers already with international presence or as a means of entry and rapid growth for new entrants. The risks are higher and the need for help from inside the target country is greater.

A major consequence of these international moves is an acute shortage of managers able and willing to establish and consolidate the foreign operations. Not only will this be a problem of transferring UK based managers to the new markets but also, and a bigger issue,
is the rapid development of a local managerial cadre willing to work for the UK retailer. The people issue in foreign expansion is likely to move high on the agenda of UK retailers wishing to build the firm outside the UK.

Tim Denison, Synovate “Fewer retail trips but adversity breeds creativity and innovation”

Nobody expects 2011 to be a stroll through the park; more likely a fight through the undergrowth. There’s a sense of acceptance in the air that, for the majority, daily lives will become harder in some undefined way, the money in our pockets won’t stretch as far and that there’ll be more anxiety about our state of wellbeing and personal wealth. The psychological tourniquet is being tightened, constricting our propensity to go out to shop and to spend.

In practical terms Synovate expects to see the quasi-antithesis of the so-called “double jeopardy” effect: shoppers making fewer trips and visiting fewer shops per trip. We forecast store footfall will continue to decline in 2011 at 3% p.a., which, if founded, would mean that high street traffic in the non-food sector will have declined by 10% over the last five years.

The retail outlook for 2011 will, however, not be uniform across the UK. Expect regional disparities to become more extreme in the wake of public sector job losses, changes to the state benefit system and the likes of City bonuses. Expect differentials to develop further across the age spectrum, not just in spending powers, but in shopping habits, channels and interests.

Though the harsh times ahead will undoubtedly cause hardship for retailers, they could also mark the re-invigoration of retailing. Growing diversity among shoppers will create more scope to build greater contrast into the retail scene and threaten the death knell for ‘clone town Britain’. Fewer shoppers could promote better customer service. We could see the return of more tailored offers to meet local needs, more local sourcing and more entrepreneurship. It will not just be evident in the look of high streets, but in the way that retailers engage with their customers. Social networking, m-commerce as well as the likes of pop-up shops are all becoming part of the new multi-channel retail canvas. They will continue to add texture and depth.

Adversity breeds creativity and innovation providing it’s nurtured by government policy. Despite all the talk of austerity, there is every reason to look ahead into 2011 and beyond with optimism.

Helen Dickinson, KPMG: “More optimism but interest rates are crucial factor”
Over the course of 2010 I have become more not less optimistic about the outlook for 2011 and beyond. The worry since the downturn kicked in during late 2007 was always that retail sales would “fall off a cliff”. The last three years have provided enough evidence to show that consumers continue to love shopping and will therefore find a way to spend whatever the state of the economy.

This is not to say that the next year will not be a challenge, the pressure on disposable income will be greater than at any point since the downturn began. Low sales growth is here to stay and we will see total retail sales only growing in line with the growth in GDP – i.e. < 2.0% and volumes will fall. Food will continue to outperform non-food. On the non-food side, big ticket items are likely to continue to bear the brunt of impact of belt tightening consumers and the clothing sector is in for a challenging year given rising costs of cotton, Chinese labour and transport costs.

We will see shop prices rise over the year, feeding into higher inflation. However, like-for-like store non-food sales growth will be difficult to come by and only achievable by those who continue to deliver exactly what their customers want. New ways of assessing store performance will come to the fore as on-line growth will take more than its fair share, social networks and digital media greater influencers and the lines between channels continuing to blur.

Structural changes will continue, accelerated by the challenging environment, including greater concentration to prime trading locations and empty secondary high street sites. We’ll see some failures: smaller secondary non food retailers, and those whose business model was already under threat. The bigger retailers, including the supermarkets, will have to work really hard on promotions to drive real like-for-like volume growth.

The successful retailer has three things: flexibility; visibility; and sustainability. They have improved their customer insight, management of costs, cash, and forecasts across the business. The gap between them and the laggards will continue to widen. Cash (over profit) will remain King.

Although I do not see the outlook as bleak for all, an early and then sustained period of interest rate rises would risk shifting low growth into a contracting market.

*Richard Lowe, Head of Retail & Wholesale, Barclays Corporate: Virtual high street provides growth opportunities*
Retailers and wholesalers face a difficult year ahead after Christmas sales were hit by a combination of harsh economic and climate conditions. Trading over the festive period can, at best, be described as mixed and the industry is well aware that the next twelve months will not be easy as the impact of the VAT rise and Comprehensive Spending Review bite and shoppers begin to rein in their spending as concerns over jobs and their own personal finances increase.

Despite the headwinds, I remain cautiously optimistic about the sector’s prospects for 2011 and, from a banking perspective, have consistently said this is a good time to lend to the sector, in circumstances where the commercial and risk terms make sense.

With limited new shop space coming into play in the UK this year the real opportunities lie on the virtual high street. In order to fuel this growth I expect to see retailers, particularly pure internet players and grocers, beginning to borrow from their banks in order to make capital investments to improve their e–tail infrastructure whether it be investments in technology to enhance the online experience or investing in new distribution centres. Only last month, Amazon reportedly secured one million square feet in Dunfermline and last summer saw ASOS invest £20m in a new distribution facility in South Yorkshire.

I fully expect this trend to continue throughout 2011 and retailers who are able to demonstrate strong financial performance and a history of acceptable account behaviour should continue to be in a position to secure funding on competitive terms from their lenders.

Vicky Redwood, Capital Economics: “Interest rate hike remains a threat”

The UK economic recovery already appears to have lost a significant amount of momentum, even accounting for the disruption caused by the snow at the end of last year.

Indeed, there are plenty of signs of weakness. The housing market has turned down again and the labour market recovery looks fragile. Part–time and temporary work accounted for the increases in employment seen in the middle of last year and recently employment has begun to fall again anyway.

What’s more, the true test of the recovery is yet to come – namely the fiscal squeeze. This has already begun with the VAT rise on 4th January, but much worse is on its way – in particular, the biggest government spending cuts in decades. These will have obvious knock–on effects to consumers in the form of public sector job cuts and a public sector pay freeze.

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It is uncertain whether the private sector will be able to offset this fiscal tightening. Low productivity levels suggest that private sector hiring will be subdued for some time to come, as firms get more out of their existing workforces. And bank lending remains weak, limiting consumers’ ability to borrow their way through their income squeeze.

Consumers face other headwinds too. Inflation is likely to stay high for several months, but pay growth is unlikely to keep up. At least the Monetary Policy Committee has not been panicked into raising interest rates yet. But a rate hike will remain a threat throughout much of 2011.

Economic conditions therefore don’t look good for consumers. But consumers have had a tendency in the past few to shrug off whatever is thrown at them and we would be wary of underestimating their resilience this time too.

**Neil Saunders, Verdict Consulting: “Customer centric innovation will be critical”**

In retail terms, 2011 will be far from easy; indeed, in some quarters the retail gloom has already set in. While, it is unlikely that the UK will fall back into recession, this is likely to be the year that the consumer finally starts to run out of steam.

Rising unemployment, higher household costs and weak wage settlements will all combine to create a much more muted demand environment. Against this weaker level of demand, retailers will face their own cost pressures; this will make it more difficult to discount in order to stimulate the consumer and will almost certainly exert downward pressure on margins.

So, what type of specific things will we see?

It is likely that price inflation will remain in the market; this won’t be anywhere near the heady levels of the 1970s or 1980s, but it will be higher and more persistent than at any time for the past 15 years.

Unemployment will rise and the consumer mindset will be cautious and frugal. However, 2011 will not necessarily be the year of trading down; it’s likely to be the era in which consumers seek value for money – perhaps trading up but buying less often in order to fund more expensive purchases.
In a market where volume growth is virtually non-existent, more retailers will assess their routes to market and optimize their store portfolios. This will be a key way of saving money and enhancing margins.

Despite the difficulties, retail will remain a lucrative market and foreign entrants will continue to land in the UK and expand; this will add to the competitive pressure facing incumbent players.

These challenges mean that customer centric innovation will be critical. Retailers that understand their customers, and create interesting and compelling offers will do best. The bottom line is that 2011 will be a year in which retailers need to work far, far harder to secure a slice of the action.

Mark Teale, CB Richard Ellis: “Development activity at low ebb”

The constraints on retail sector expansion activity, resulting from the continuing credit famine, looks set to keep occupational cost growth subdued for a lengthy period or, at least, until credit markets begin to unfreeze. Annualised average rental growth over the 2011–15 period is currently projected to be only 2.1% pa, which compares with 4.0% pa over the five years following the recession of the early 1990s. The variation in rates of rental growth across retail property categories is expected to be wide however. Primary rental growth will be more rapid than secondary. Retail warehouse rents are expected to grow at a faster rate than shopping centres and High Streets. Within the retail warehouse sector, rent for A1 space is likely to continue growing faster than bulky goods rents. And rents in southern markets (and London in particular) are expected to continue growing faster than those in other regions.

Speculative development activity is meanwhile at a very low ebb and will remain so until 2014/2015 at the earliest. Vacancy problems will remain high in poor secondary/tertiary stock unsuitable for chain trading; the same is not true in terms of space viable for multiples. Primary supply continues to tighten. Stock shortages, particularly in larger unit categories, are already clearly apparent. With little in the way of new speculative supply on the cards, these shortages can only continue to worsen. Securing decent trading space will become progressively more difficult. The only part of the market where (non-speculative) development activity remains buoyant is on the grocery side. Grocers are continuing to grow their market share of non-food retail spending as a result (all four grocery majors are expanding their non-food offers). Overall non-food internet sales growth remains too slow.
to markedly influence this market share shift in favour of grocery retailers. The trend looks set to continue until there is a marked resurgence in shops development activity.

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Note to Editors:
The RTT panellists rely on their depth of personal experience, sector knowledge and review an exhaustive bank of industry and government datasets including the following:

Members of the RTT are:
- Nick Bubb – Independent Retail Analyst
- Dr. Tim Denison – Ipsos Retail Performance
- Jonathan De Mello – Harper Dennis Hobbs
- Martin Hayward – Hayward Strategy and Futures
- Maureen Hinton – Conlumino
- James Knightley – ING
- Richard Lowe – Barclays Retail & Wholesale Sectors
- David McCorquodale – KPMG
- Martin Newman – Practicology
- Mike Watkins – Nielsen

The intellectual property within the RTT is jointly owned by KPMG (www.kpmg.co.uk) and Ipsos Retail Performance (www.ipsos-retailperformance.com).
First mentions of the Retail Think Tank should be as follows: the KPMG/Ipsos Retail Think Tank. The abbreviations Retail Think Tank and RTT are acceptable thereafter.

The RTT was founded in February 2006. It now meets quarterly to provide authoritative ‘thought leadership’ on matters affecting the retail industry. All outputs are consensual and arrived at by simple majority vote and moderated discussion. Quotes are individually credited. The Retail Think Tank has been created because it is widely accepted that there are so many mixed messages from different data sources that it is difficult to establish with any certainty the true health and status of the sector. The aim of the RTT is to provide the authoritative, credible and most trusted window on what is really happening in retail and to develop thought leadership on the key areas influencing the future of retailing in the UK. Its executive members have been rigorously selected from non-aligned disciplines to highlight issues, propose solutions, learn from the past, signpost the road ahead and put retail into its rightful context within the British social/economic matrix.
**Definitions:** The RTT assesses the state of health of the UK retail sector by considering the factors which influence its three key drivers.

1. **Demand** – Demand for retail goods and services. From a retro-perspective, retail sales, volumes and prices are the primary indicators. When considering future prospects, economic factors such as interest rates, employment levels and house prices as well as others such as consumer confidence, footfall and preferences are used.

2. **Margin (Gross)** – Sales less cost of sales; the buying margin less markdowns and shrinkage. Cost of sales include product purchase costs, associated costs of indirect taxes and duty and discounts.

3. **Costs** – All other costs associated with the retail operations, including freight and logistics, marketing, property and people.

**The Retail Health Index – how is it assessed?**

Every quarter each member of the RTT makes quantitative assessments of the impact on retail health of demand, margins and costs for the quarter just completed and a forecast of the quarter ahead. These scores are submitted individually, collated and aggregated in time for the RTT’s quarterly meeting. The individual judgements on what to score are ultimately a combination of objective and subjective ones, drawing upon a wide range of hard datasets and softer qualitative material available to each member. The framework follows the example of The Bank of England Agents’ scoring system on economic intelligence provided to the Monetary Policy Committee.

The aggregate scores are combined to form the **Retail Health Index (‘RHI’)** which is reviewed at that meeting and occasionally revised after debate if members feel it appropriate. The RHI tracks quarter on quarter changes in the health of the UK retail sector and as such provides a useful and unique measured indicator of retail health. The index ‘base’ of 100 was set on 1 April 2006. Each quarter, it assesses whether the state of health has improved or deteriorated since the previous quarter. An improvement will lead to a higher RHI score than that recorded in the previous quarter, and with a deterioration leading to a lower score. The larger the index movement, the more marked the shift in the state of health. The RHI has two main benefits. Firstly, it aims to quantify the knowledge of the RTT members in a systematic way. Secondly, it assesses the overall state of health of the UK retail sector for which there is no official data.

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