IPE

UK retailers: tough times

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High rents, online competition and lower consumer spending are all squeezing retailers, with implications for pensions

Key points

• Several well-known UK high street names are facing severe financial difficulties
• Analysts and observers are warning of continued pressures on margins from currency weakness and online rivals
• Long-lease rents and legacy pension deficits are an additional burden for struggling companies
• UK high street retail companies are suffering one of the toughest periods in their collective history – and for some it has become an existential crisis.

Online retailers, led by the behemoth Amazon, have challenged the business models of companies that had been accustomed to dominating the country's main shopping centres and high streets.

The effects of falling high street spending, high rents and rising input costs resulting from a weak currency have eroded much of the impact of any new digital revenue streams.

According to accounting and consultancy firm EY, FTSE-listed general retailers issued 20 profit warnings between them in the first six months of 2018, double the figure for 2017.

The Centre for Retail Research paints an even bleaker picture, reporting that 23 UK retailers had failed during the first half of the year, with more than 1,800 stores and nearly 21,000 workers affected.

Department store chain Debenhams issued three profit warnings in the first half of the year, which caused its share price to collapse by 56% in the first six monthsas it struggled to compete on price across its fashion and household business lines. Chief executive Sergio Bucher warned investors in June that the company did not foresee the challenging conditions changing any time soon.

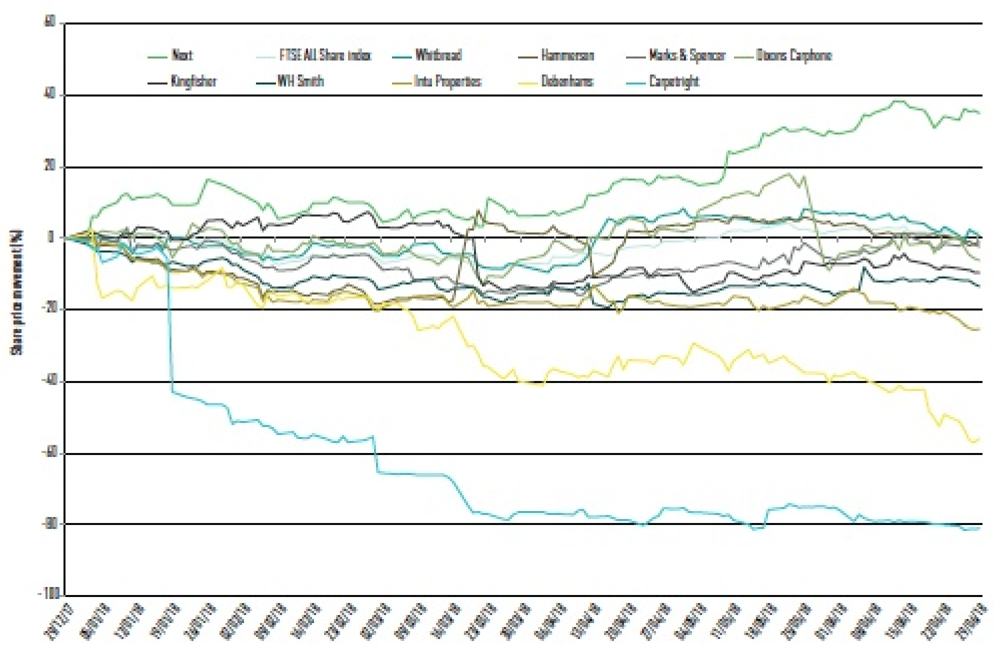
Others have had it even worse. Carpetright, a floor coverings specialist, announced the closure of 92 stores earlier this year as it grappled with spiralling debts. House of Fraser – another department store chain – collapsed into administration before being bought by Sports Direct owner Mike Ashley for £90m (€101m). Meanwhile, other long-standing high street brands including Mothercare, Toys R Us (including its US parent) and BHS have all collapsed in the past two years.

The Amazon effect

Ameet Patel, senior equity analyst at Northern Trust Capital Markets, says UK retailers are experiencing “a perfect storm” of challenges.

“Anything that can go wrong has gone wrong,” he says. “Post the Brexit referendum they’ve had deteriorating consumer spending, increasing input costs [and] the overarching impact of Amazon and online retailers.

How the UK’s listed retailers have performed – H1 2018



Source: PME, 30 June 2017

“In that environment, with all those things going wrong, it’s [having] a compound effect. Any one problem would be manageable; all three at once has made it very difficult for most operators.”

While online-only retailers are a global phenomenon, the UK has been at the forefront of the digital revolution. According to data company Statista, the UK has the third-highest online shopping penetration rate in the world, behind only China and South Korea.

The UK's island geography and established logistics capabilities made it an important market for Amazon when the internet giant began expanding beyond the US, and other online providers quickly followed.

Statista also reports that, within the UK, Amazon and eBay reign supreme in the digital arena with 23m and 20m unique mobile users as of April 2016. Argos – now part of supermarket chain Sainsbury's growing empire – is a distant third with 9m users, while other traditional high street names in the top 10 struggle to hit 3m.

Debt burdens

Emerging online retailers have two big advantages over their established high street peers: they do not have long-lease rents on outlets; and in most cases do not have large legacy defined benefit (DB) pension schemes to support.

Mothercare and Toys R Us were both forced into company voluntary arrangements (CVAs) in an attempt to reduce debts such as long-term rents on outlets they had been forced to close. While Mothercare's restructure was successful, Toys R Us was unable to reduce its debt burdens sufficiently to climb out of insolvency.

Carpetright and New Look have also negotiated CVAs this year, closing stores and cutting jobs in exchange for lower rent bills. House of Fraser's new owner has appointed property advisers to explore cost-saving measures. The company was considering a CVA prior to entering administration. Analysts broadly agree that CVAs will be used more in the future.

Andy McKinnon, chief financial officer of the Pension Protection Fund (PPF), the UK's lifeboat fund for DB pension schemes, indicates that the fund is ready for more such situations.

The PPF participated in discussions with both Mothercare and Toys R Us in an attempt to secure a better deal for the DB pension funds if the companies remained solvent. However, in the case of Toys R Us, the pension scheme ended up in the PPF's assessment period. "There have been a number of CVAs from non-food retailers – it's hard not to see similar restructurings in future," McKinnon says.

"We can only really agree to a restructuring if there is going to be a benefit to the scheme. Our concern [with Toys R Us] was that the longer it went on trading the bigger the deficit would be in the pension fund."

While the Toys R Us CVA was ultimately doomed, McKinnon says the PPF still secured the first tranche of contributions agreed in the CVA, thereby securing more assets for the scheme and reducing the burden placed on both the lifeboat fund and the other DB schemes that fund it.

The good news for high street retailers is that most of their pension schemes are currently well funded. House of Fraser reported a surplus in its latest annual report, as of the end of January 2017. Other listed retailers such as Debenhams and Marks & Spencer Group (M&S) also reported surpluses in their DB schemes in the most recent company results.

The bad news, however, is that this situation can change quickly. Should the Bank of England see fit to lower interest rates – perhaps to deal with the effects of the UK exiting the European Union – liabilities could spike. Schemes in surplus on a company-accounting basis could still be in deficit by other measures used by insurers and the PPF, and reliant on a weakening sponsor covenant.

Some schemes have sought to crystallise their surpluses through insurance transactions: the M&S scheme sealed a £1.4bn buy-in with two insurers earlier this year; and both Kingfisher and Shop Direct have conducted similar, smaller deals in recent months.

"High street retailing… has always been a sector that can prove quite troublesome for pension scheme risk management," says Simon Willes, executive chairman at sponsor covenant specialist Gazelle Pensions Advisory.

> "Employer support may be faltering when schemes most need it"
>
> Simon Willes

"Retail is pretty highly correlated with the overall equity market and the economy, so that when company performance is poor, growth asset returns in DB scheme portfolios are also likely to be poor.

"In essence, employer support may be faltering when schemes most need it… The importance of looking at pension risk exposure with covenant and investment risk integrated with each other is therefore pretty important for retail-backed schemes."

Time to grab a discount?

Contrarian or value-based investors may be tempted to look through the gloom for high street bargains.

Baupost, a value-focused hedge fund run by Seth Klarman, bought a stake in Dixons Carphone late last year. This was despite the company's gross profit margin falling year-on-year since 2015 and analysts warning of store closures. In addition, it had a shortfall of £600m in its DB pension schemes at the end of April, according to its annual report.

Although Klarman is one of the most-watched value investors, Northern Trust's Patel warns that it might still be too early to grab cheap retailers and ride a future upswing.

"It isn't clear to me that the problems are going to turn around any time soon," he says. "These kinds of companies can still be value traps."

However, others are more positive – if selective. The primary attribute necessary for success is adaptability, according to Anthea Arff-Pettersen, European equity analyst at Schroders.

In an article on the UK retail sector published on the Schroders website in June, Arff-Pettersen said: "The benefits for those that have embraced technological change [are] widespread, while the risk to those that haven't will only continue to become more acute. We expect that stock performance will differ accordingly."

Her colleague George Ullstein, global sector specialist, added that firms without the burden of long lease agreements and with the ability to streamline their supply chains were the most attractive to investors.

Patel acknowledges that long-term investors – such as pension funds – could find some attractive prospects in businesses backed up by real assets. He highlights Intu, an operator of shopping centres, as it is trading at half of the value of its property portfolio.

"At some point there's going to be a floor to this," Patel says. "If you're a pension fund or an activist investor then maybe that's something you can look at. Then you don't have to make a call on the industry, because none of us know for sure. Long-term investors should look for tangible assets."