Everything must go

AS CONSUMERS CUT BACK IN THE RUN-UP TO CHRISTMAS, PRESSURE ON THE RETAIL SECTOR IS LIKELY TO RESULT IN MORE HIGH-LEVEL CASUALTIES. **GRAHAM BUCK** REPORTS.

A healthy retail sector is crucial to the health of UK plc. It generates 8% of national GDP and employs around three million people. But since the credit crunch put an abrupt end to the consumer boom, growth has wilted, and a number of familiar high-street names have disappeared altogether – Woolworths, the Borders bookshop chain, music and DVD retailer Zavvi, and MFI furniture stores.

Over the summer the problems of Jane Norman, Habitat and Thorntons showed that tighter household budgets are adding to the list of casualties. The Co-op's chief executive Peter Marks said recently that current conditions for retailing are the worst he has experienced in a career of over 40 years. He warned that conditions were unlikely to improve in 2012: "People are spending less on food – that's a first."

Mike Thomas, risk management specialist at trade credit insurer Atradius, confirms the change of mood. "There has been a greater element of realism recently in retailers' forecasts, with an element of deliberately downplaying expectations – even from those players who have performed well," he reports.

The Confederation of British Industry's quarterly distributive trades survey, released in late August, showed retail sales volumes falling and evidence of cutbacks in investment plans and recruitment.

The previous month PwC reported that around 4,000 retail outlets had closed over the first five months of 2011 – that's around 20 shops a day. With so many existing problems, the looting and arson attacks across England in August could not have come at a worse time. The riots hit smaller, independent retail businesses hard and while many quickly resumed trading others have closed their doors permanently.

The British Council of Shopping Centres forecasts that the percentage of empty shops nationally will peak at 13–14% in the near future before easing back to around 11% from 2014 onwards. Even then, the figure will still be well above the 6–7% typical before the onset of the credit crunch in 2007.

Waning consumer confidence, reined-in spending and price inflation are resulting in buying behaviours similar to those seen in the second half of 2008 when the global financial crisis deepened. It has also accelerated the trend to shopping online, reports PwC's retail and consumer leader Mark Hudson.

Another survey by PwC, released in May, of more than 1,000 consumers found that 14% now make online purchases at least once a week, compared with only 4% in 2007, while nearly one in five of the survey respondents spent more than half of their disposable income online.

According to research by digital products specialist Head London, chains such as Tesco, Boots and John Lewis have been most adept in responding to the digital consumer revolution and their well-integrated online and offline offerings make a major contribution to overall sales. Among the laggards, the survey names Morrisons, Dixons, Phones4U and Homebase as having much weaker multi-channel offerings.

"The next challenge is going to be planning sales and securing stock for Christmas – there are going to be some tough negotiations in the lead-up," adds Hudson. Aggressive discounting, coupled with an earlier start than usual in November to the Christmas sales period, is likely to likely to characterise the end of 2011.

Yet despite gloomy headlines about its immediate prospects, the retail sector could still grow by 15% over the next five years, according to research group Datamonitor – that would take its total value to just over £312bn. Datamonitor reports that the best prospects are for electrical retailers, with projected growth of 24%, but the likelihood of a depressed property market will restrict consumer spending in a number of areas such as home furnishings.

This projected growth compares with the boom period of 2000 to 2007, when retail sales volumes rose by 33% although real disposable incomes increased only by 15%. A combination of higher commodity prices, a weak pound, job uncertainty and wage freezes have curtailed demand since then and growth will be further restricted when the Bank of England eventually begins raising base rate from its current low of 0.5%.

There is also a more upbeat forecast from Schroders, whose head of UK equities Richard Buxton forecasts that the more established retailers with strong balance sheets and sustainable valuations can

benefit from the woes of their rivals to emerge ultimately stronger.

The high street's more resilient names include department store chains House of Fraser and John Lewis, which both successfully raised funds earlier this year.

House of Fraser, whose recent sales growth has remained steady, was the subject back in 2006 of a £351m takeover bid by a consortium that included Icelandic investment group Baugur and Bank of Scotland. In May House of Fraser announced an £250m high-yield bond issue, which was quickly oversubscribed. The bond will refinance debt taken on when the group went private, reduce borrowing costs and provide an exit for lenders such as Lloyds and failed Icelandic bank Glittnir. As Thomas notes, House of Fraser's offering was well received by institutional investors as the group was able to present "a bankable business plan". The bonds, due to be repaid in 2018, have an annual coupon of 8.875% and are listed on the Luxembourg Stock Exchange.

John Lewis's offering in March was smaller and closed once applications reached the £50m level. However, as the group was following the lead of Marks & Spencer and Tesco by launching its first retail bond, the offering attracted headlines. The retailer is a partnership rather than a plc and the five-year bond, paying a fixed annual return of 6.5%, was aimed specifically at the 1.5 million customers who hold the group's store card and its 70,000 employees.

A number of retailers have approached the equity markets to reduce their debt. During 2009 there was a series of deeply discounted rights issues from companies such as Currys and PC World owner Dixons (formerly DG International) and JJB Sports. However, as Thomas notes: "Ideally, you don't want to raise additional equity when your share price is on the floor."

This option is not always available when a company is clearly struggling. Earlier this year music and books retailer HMV received a clear signal that several profit warnings had eroded investor support for a rights issue. Instead the group had to resort to asset sales and disposals and reduce the number of expensive high-street leases to raise cash. Following the disposals, HMV was able to secure a two-year credit facility of £220m with its banks to refinance its debt load.

Other companies following a similar course include chocolate retailer Thorntons, which will close up to half of its 364 outlets over the next three years to leave a "sustainable and profitable" core of 180 to 200 shops.

NO RELIEF IN THE SHORT TERM In the short term there is little prospect of relief, says Mike Jervis, an insolvency partner and retail specialist for PwC. He agrees that rising inflation and waning consumer confidence will drive more shoppers online, which will continue to apply pressure to sectors of the retail industry such as fashion. "Retailers cannot afford to bury their heads in the sand, and must think about surgery before the problem becomes terminal," he says. "They need to engage with their stakeholders early, especially banks, landlords, credit insurers and their staff. We have seen a number of successful turnarounds involving the use of consensual arrangements and early engagement with banks, landlords and shareholders which have saved retail businesses."

THE TREASURER'S JOB IS TO RECOGNISE AND ALERT MANAGEMENT TO THE EARLY WARNING SIGNS THAT THE BUSINESS COULD BE RUNNING INTO TROUBLE.

What are the early signs of danger? Julie Fabris, now treasurer for the Birds Eye Iglo group, was in the treasury team at Woolworths when its problems deepened in late 2008. "Ultimately it is the deterioration of the cash that is the first sign that a business is in trouble," she says. At Woolworths this was coupled with a refinancing risk and a reluctance to take early and drastic action. "In the retail world, the sales swing can change fortunes very quickly."

The treasurer's job is to recognise and alert management to the early warning signs that the business could be running into trouble. These include results that fall consistently below forecast, unexpected cash calls, lenders expressing concerns and breach of covenants.

Means of bolstering the company's working capital include imposing more stringent terms on suppliers and extended credit terms, although any attempt to squeeze suppliers and improve the bottom line risks jeopardising relationships.

Thomas recommends advising key stakeholders at an early stage if the company is encountering problems: "The longer you wait, the less likely it is that you will have much room for manoeuvrability."

FUNDING SOLUTIONS Businesses under pressure should reorganise by seeking effective and appropriate funding solutions. This means negotiating with creditors rather than choosing the "last resort" of restructuring, says Phil Duffy, a partner with restructuring and insolvency services group MCR. But he suggests that landlords, who have benefited from a prolonged period of upward rent reviews, must also be ready to rethink and consider lower returns despite the impact on their own loan to values (LTVs).

Duffy adds that the issue of LTVs is one that the private equity sector must review too. Retail has typically been one of the most popular destinations for private equity firms in recent years and seen a high level of buy-out deals. "Now is the time to rethink their own expectations on what they can recover from those investments, and again this has a direct impact on their own LTV," he suggests.

Some distressed retail businesses may turn to restructuring groups such as Hilco UK, which says it helps companies, their advisers and investors identify the value of business assets and monetise them either through acquisition or disposition, and leveraging assets to secure debt or equity capital. Recent Hilco UK deals have included the $3.3m purchase of 121 of HMV's stores in Canada, which will also see Hilco UK provide operating capital of up to $25m to help local management develop the business online. Hilco also bought Habitat in late 2009 and planned to revive the chain, but this summer sold the three London flagship stores to Home Retail Group for £24.5m.

Thomas suggests that retail businesses that have proved reasonably resilient should still be able to attract a bid. "There is still money out there – neither private equity nor the venture capital houses have entirely discounted the retail sector and they are always looking for attractive propositions."

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