Your World First

Taking Stock

The outlook for Consumer & Retail

2019

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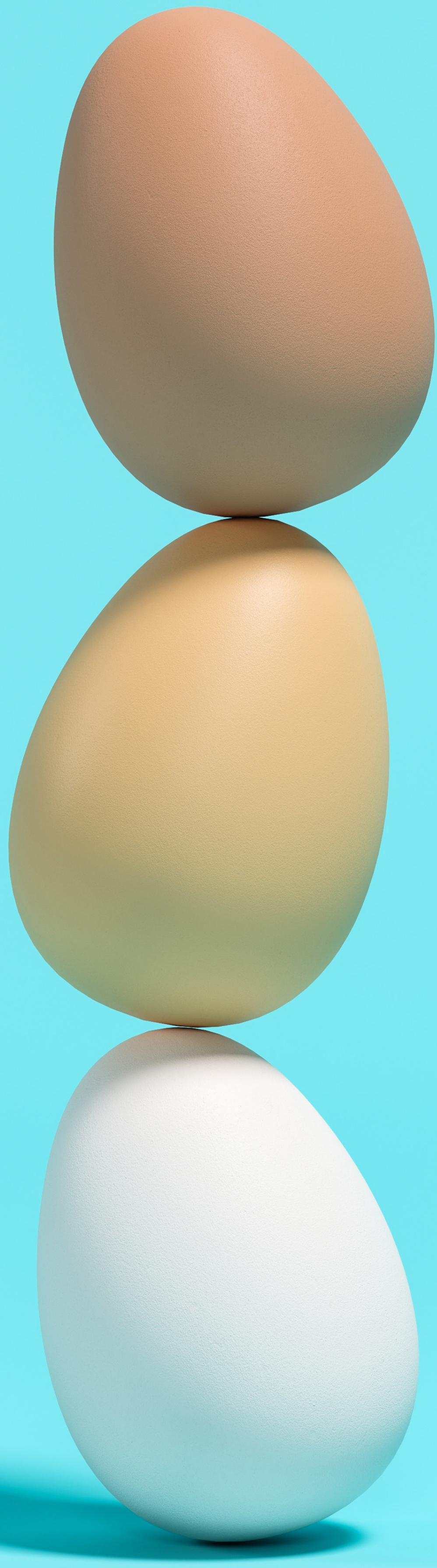

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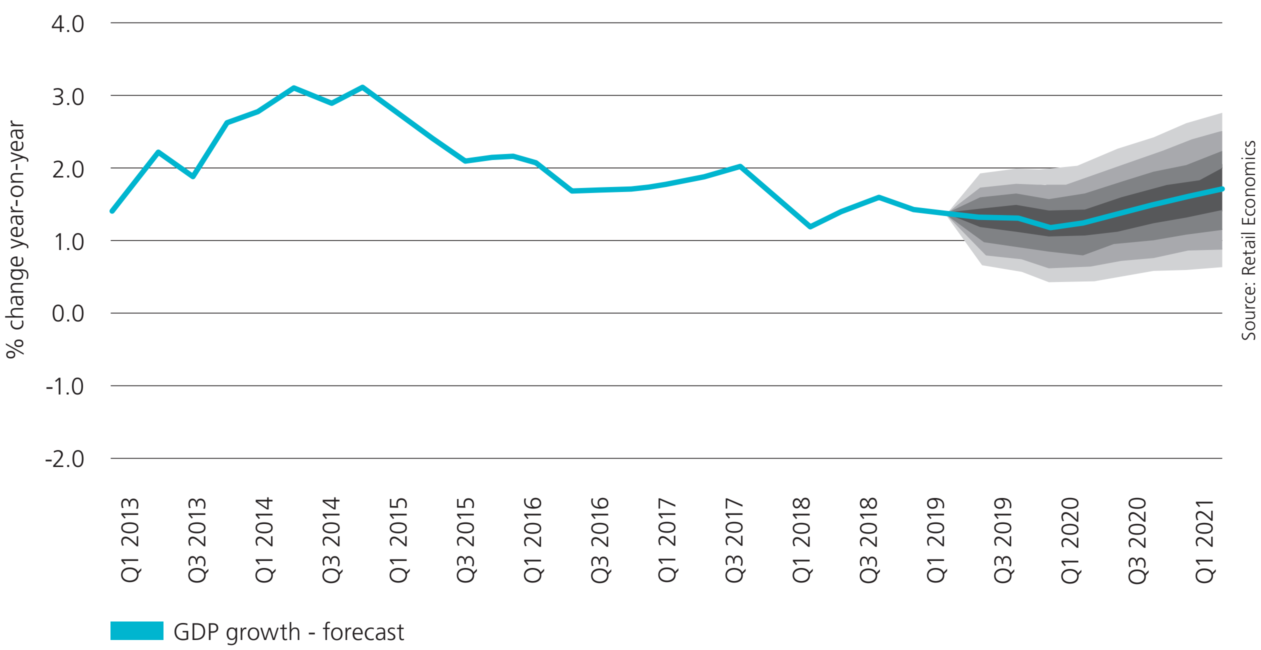
Quick take
– the economic landscape

Ongoing Brexit disruption continues to dominate the economic landscape, perpetuating a challenging scene for both businesses and households throughout 2019. The economy is expected to grow by just 1.3% this year (Retail Economics), down marginally on the previous year which was already the weakest since 2009. Importantly, this assumes that a deal with the EU is reached before the current deadline of 31 October 2019.

Should the UK crash out of the EU with no-deal, the economy is likely to stammer with significant shockwaves affecting output. That said, this is not the most likely scenario.

The economy expected to grow by just 1.3% in 2019

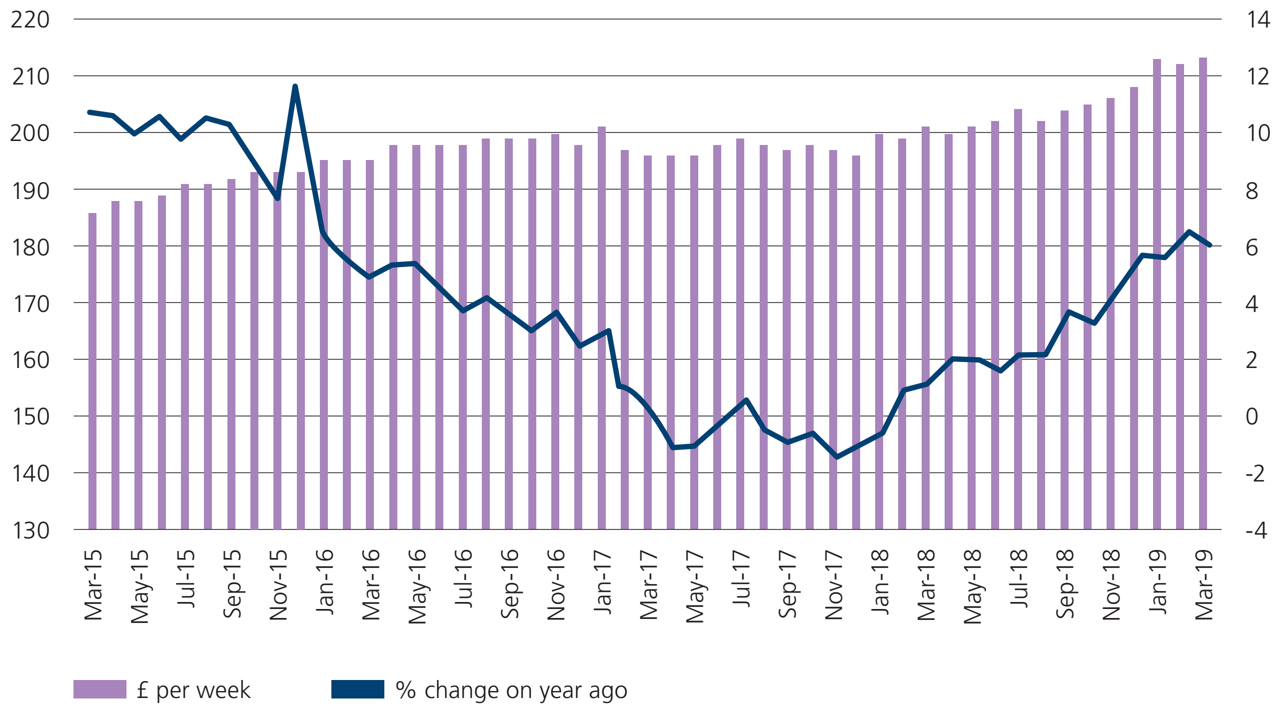


Spending power on the up…but consumers aren't buying it

Some brighter spots have emerged. Modest inflation and accelerated earnings have boosted households' spending power in recent months. Nominal earnings are rising at their fastest pace since the financial crisis with consumers enjoying the best growth in discretionary spending power (amount left after paying for essentials) for over three years – up by c.6%.

However discretionary spending is just half the equation powering the consumer sector. *Willingness to spend* is just as important. Currently, consumer confidence remains fragile. Brexit, lack of savings and debt levels topped household concerns heading into the second half of the year. Tension between robust personal finances and floundering consumer confidence has emerged, with expected aggravation continuing until government establishes a firm grip on Brexit.

Discretionary spending rising at fastest rate in around three years



Source: Asda Income Tracker

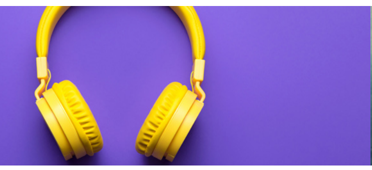
'Wait and see' – Brexit-fuelled uncertainty undermines business confidence

The Bank of England expects business investment to fall by 2.5% this year, marking the longest run of falling investment in the post-war age. Companies have been focussed on short term challenges. Data shows that two thirds of retailers had conducted some preparation ahead of the original Brexit deadline (Retail Economics) with some implementing stockpiling actions to safeguard supply. Bank of England data also indicates that 75% of UK firms have conducted contingency planning, with stock building injecting a significant boost to GDP.

If a Brexit deal is reached before the end of October 2019, it is likely that some pent-up investment will come on stream; albeit unlikely that economic benefits will manifest before 2020. This paralysis continues to plague the housing market too, characterised by low activity levels choked by dwindling numbers of homes for sale and few buyers.

Light at the end of the (Brexit) tunnel

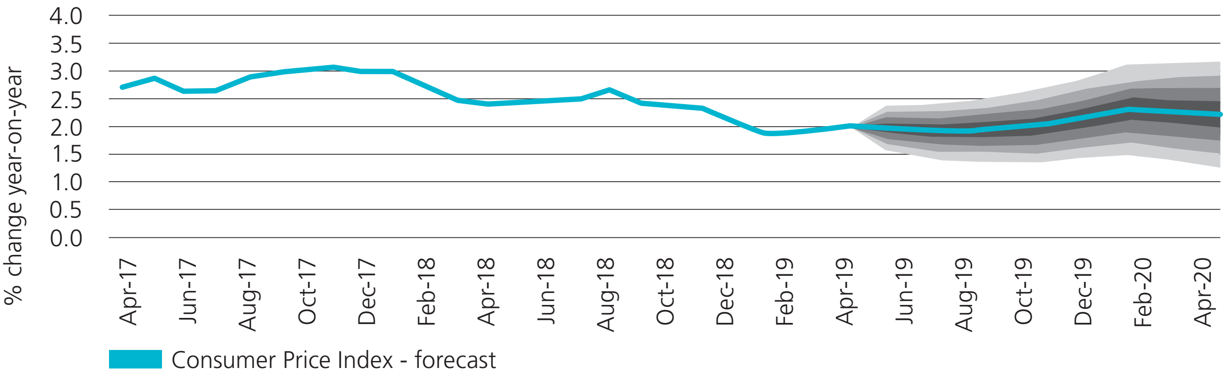
Ultimately, the economic outlook remains highly contingent on the nature and timing of the EU withdrawal. Factors include: new EU-UK trading arrangements, pace of policy transition and how households, businesses and financial markets respond. Crucially, future success may hinge on long-term preparations taken by businesses now while the 'Brexit clock' continues to tick.



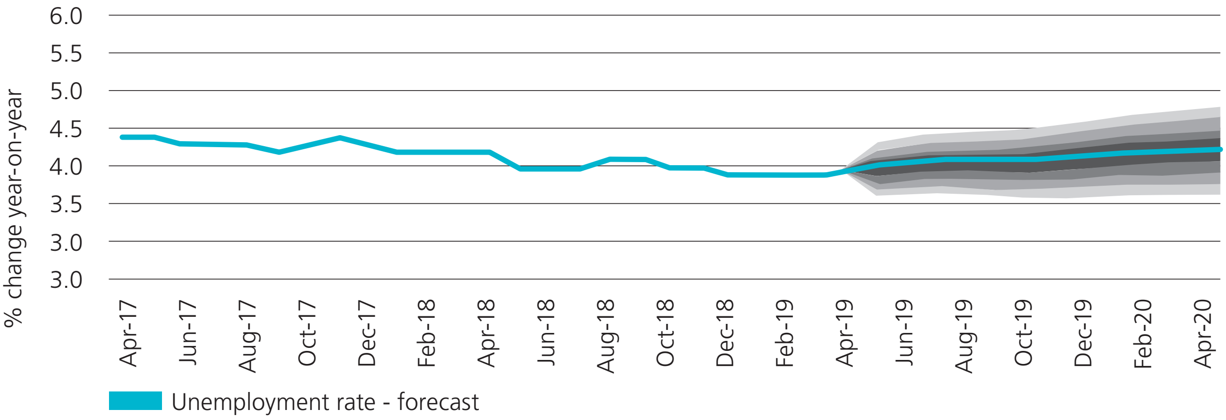
Consumer and Retail
– what's in store?

Consumer spending in six charts

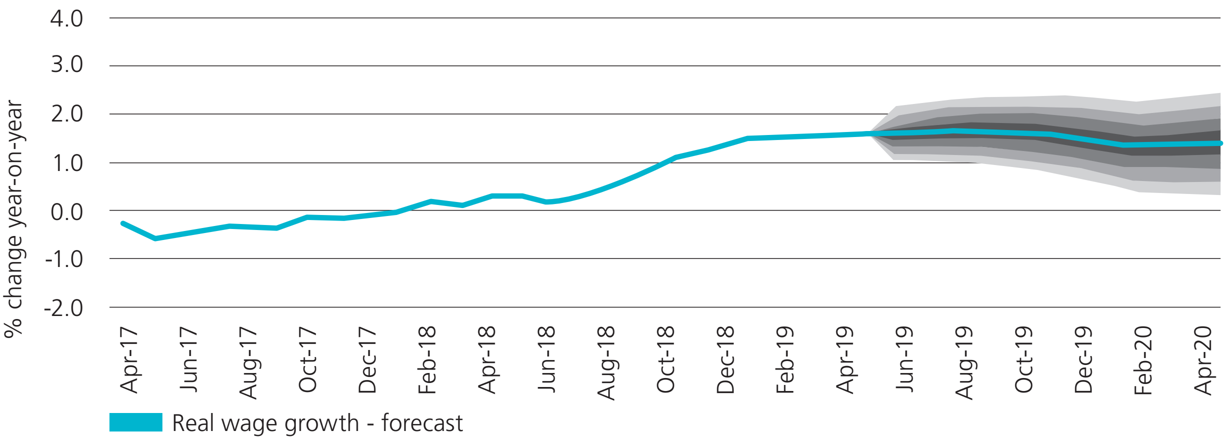
The outlook for inflation is stable and is expected to remain near to the Bank of England's target of 2% by the end of the year...



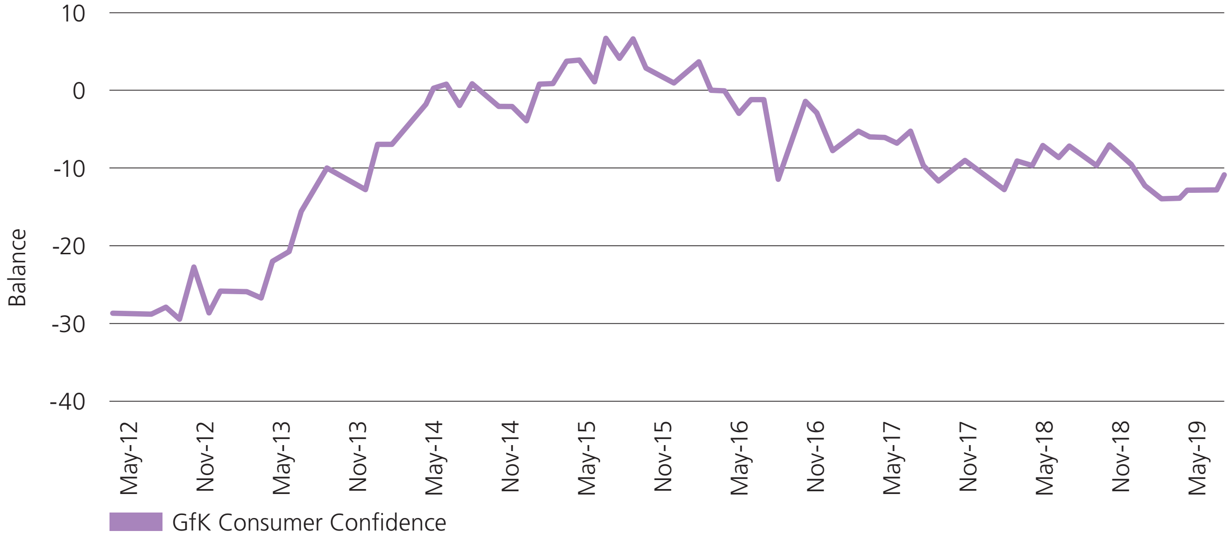
Meanwhile, the labour market is forecast to remain resilient with unemployment remaining near record-lows heading into 2020...



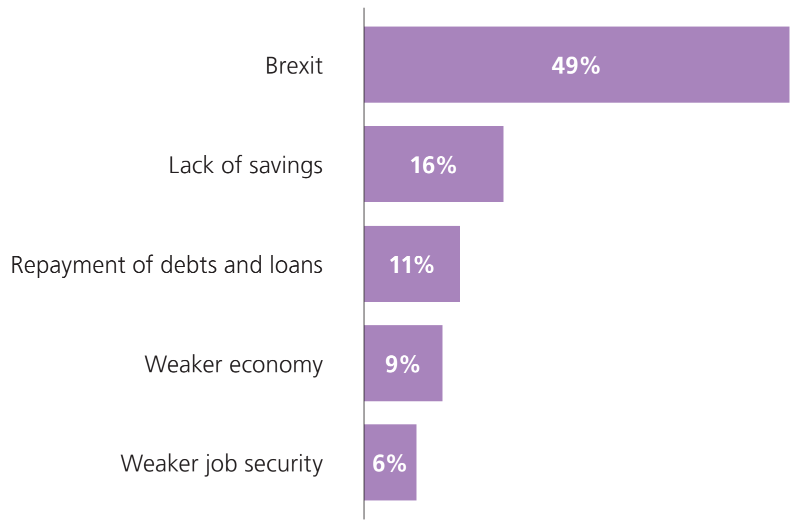
Against the backdrop of a tight labour market, earnings growth should remain near current levels of c.3% which will maintain positive household spending power heading into 2020...



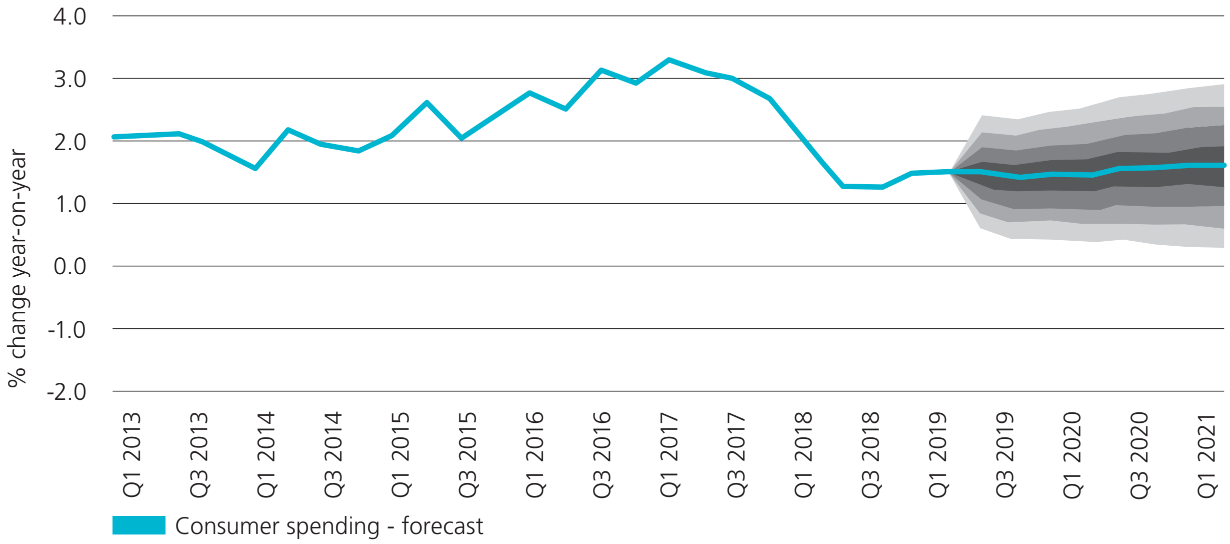
That said, consumer confidence remains fragile and susceptible to negative news on the economy, Brexit and interest rates...



Indeed, households' biggest concerns revolve around the outcome of Brexit, lack of savings and the repayment of debts and loans...



In this context, consumer spending will struggle to gain traction on the previous year and is forecast to rise by 1.5% in 2019



Sector outlooks

Food and Grocery

	£m – total market	Annual growth (%)
2018	£150,802	3.3%
2019F	£155,208	2.9%

- A defensive sector with sales expected to remain robust as shoppers focus on essential spending. Improvements in underlying personal finances will help deliver growth of c.2.9% in 2019, but lower levels of inflation will suppress top-line growth.
- The Big Four grocers remain dominant (combined c.66% market share: Kantar) but their grip continues to loosen as Aldi and Lidl have doubled their market share to over 14% since 2014. Shoppers' recessionary habits of browsing for bargains, aided by technological advancement, have become ingrained in the consumer psyche.
- Grocery's adoption of online (c.7%: Retail Economics) lacks pace behind non-food, but M&S' tie-up with Ocado to develop its online platform highlights growing risks for stagnant models.
- Digital players (e.g. Just Eat, Deliveroo, Uber Eats) also disrupt traditional grocers as improvements in the range, cost, speed and quality of takeaways drives the fast-food market beyond the £10 billion/year milestone.
- Meanwhile, the blocked merger between Sainsbury's and Asda sent shockwaves through the industry, placing doubt on further industry consolidation which has become increasingly focused on scale.

Clothing & Footwear

	£m – total market	Annual growth (%)
2018	£44,512	0.9%
2019F	£44,695	0.4%

- Clothing has taken a battering in recent years. 2019 is unlikely to provide much respite with growth forecast at a muted 0.4% for the year.
- Profitability remains under pressure as retailers battle near-continuous discounting against a backdrop of rising operating costs. Operating costs will rise by c.3.0% in 2019, driven by successive rises in National Living Wages, business rates, utilities and distribution costs (Retail Economics).
- The relentless shift to online (currently c.33% of all clothing sales) also continues to exert pressure on traditional business models. In-store experiences have become an effective differentiator of choice for many customers seeking enhanced brand interaction, particularly for flagship destinations.
- Technology has partially helped polarise the sector, enabling shoppers to be price-focused. Promotion-saturated high street environments have benefitted value-led retailers at the expense of mid-tier players, while luxury fashion's appeal entices more affluent shoppers.
- However, generations of smartphone-equipped, social media savvy shoppers, react keenly to societal trends. Recognising this, Primark and Boohoo reported market-beating results in 2019. Although possessing divergent business models, both are able to rapidly adapt to trends, supported by efficient supply chains capable of producing new lines in a matter of weeks, not months.

Health & Beauty

	£m – total market	Annual growth (%)
2018	£20,634	0.9%
2019F	£20,930	1.4%

- Health and Beauty have diverged. Health has largely outperformed Beauty as shoppers hesitate on discretionary purchases.
- Health and Beauty sales are typically insulated from personal finance pressures. However retailers have struggled with much fiercer competition from both pure online and apparel retailers expanding their propositions.
- Online accounts for just c.6% of total Health & Beauty sales (Retail Economics), however online-first retailers such as Birchbox, Look Fantastic, Revolution Beauty, Cult Beauty and others are disrupting the market.
- Emerging business models (subscriptions and 'direct-to-consumer') are also forcing traditional retailers to react to rapidly changing consumer dynamics.
- Department stores and pharmacies are particularly feeling the brunt of online players disrupting the Beauty segment. Boots' recent announcement of 200 possible store closures exemplifies retailer restructuring (e.g. portfolio reduction, disposal of loss-making stores, cost reduction focussing, more sustainable and efficient business models).

Household Goods
(Electricals, Furniture & Flooring, and Homewares)

	£m – total market	Annual growth (%)
2018	£371,258	-0.5%
2019F	£377,911	+0.2%

- Household goods have been under pressure as consumers tighten their belts amid political uncertainty. Forecasted growth for furniture & flooring and homewares is expected to be driven by improvements in real earnings and an 'improve not move' ideology that has emerged from a softer housing market.
- These underlying trends have supported some value retailers, such as ScS and The Range, with clear brand propositions and have benefited from shoppers trading down from big-ticket items. Big-ticket items remain under pressure from weaker consumer confidence and a shift towards a higher proportion of rented accommodation.
- Online retailers such as Loaf are opening showrooms, as pureplays benefit from having a space where shoppers can touch and feel high-value products. Others have found growth by implementing technology that can streamline experiences and drive inspiration in rarely shopped categories, such as augmented reality. But remaining agile requires investment; a tall order in a weak market, underlined by the collapse of Better Bathrooms in early 2019.

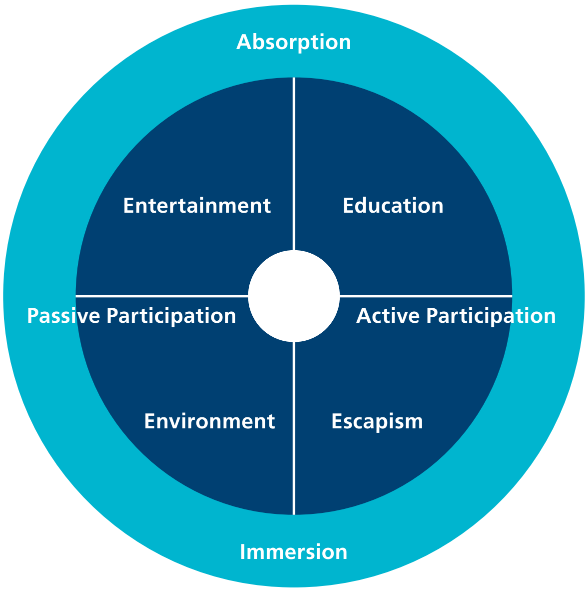
Hot potatoes:
trends to watch in 2019/20

It's all about the experience…

Excessive consumerism has arguably led to the point of "peak stuff". Consumers are simultaneously assigning less value to material possessions at a time where the rise of social media platforms compels many to be perceived as 'trendy' and 'doing the right thing'.

This has driven shifts in the perception of economic value – from products to experiences – creating opportunities for retailers to engineer meaningful and memorable 'moments' within the customer journey as a means to drive engagement and loyalty. Brands and retailers who can engineer seamless experiences that immerse the consumer in retail environments that delight and provide entertainment, escapism and relevant education are winning.

The Four Realms of Experience



Source: Pine and Gilmore, 1999

— Entertainment: a surrounding that enables consumers to passively absorb activities and performances to excite and build desire over brands and products.

— Educational: the participation and absorption in an event which is driven by consumer desire to self-educate or improve knowledge and skills.

— Environment: the immersion into a retail space (virtual or physical) and overall atmosphere including the ease of transactions.

— Escapism: the desire for consumers to seek change and novel experiences in order to escape from their everyday environment.

Out with the old (business models), and in with the new: tech, subscriptions and 'Generation Rent'

Digital innovation has challenged traditional business models, but calculated digital and physical integration can deliver seamless shopping experiences, evidenced by Farfetch (clothing) and Made.com (furniture) being among the top 10 fastest growing UK retailers according to Retail Week. Both established themselves online, but subsequently opened digitally-enhanced physical stores. Farfetch pioneers digital technology while championing the human element through its 'Store of the Future' concept, while Made.com provides touch and feel opportunities via showrooms.

Digital innovation also enables brands to engage shoppers via new models. Beauty retailer Birchbox has created a subscription model for cosmetics, relying heavily on data to understand customer preferences.

Younger consumers are also interacting more with secondary markets (e.g. Depop) for buying, wearing and re-selling fast fashion clothing, driven in part by sustainability concerns. With Gen Z shoppers being dubbed 'Generation Rent', demographic-savvy electrical retailer AO.com began offering white goods for as little as £2/week as part of a rental trial from 2019.

WhatSuP? Sustainability & Plastics

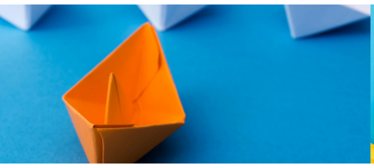
The pervasive nature of plastic has attracted significant consumer, media and legislative interest over recent years. In the absence of effective voluntary measures to address the issue, action is being proposed by lawmakers to incentivise behavioural change. Radical changes are anticipated due to measures in the UK, the EU and globally to deal with environment impacts arising from the production and the management of single use plastics ("SuP").

Example measures in the EU:

- Circular Economy Action Plan
- EU Plastics Strategy: all plastic packaging on the EU market to be recyclable or reusable by 2030.
- SuP Directive: prohibitions on certain SuP products; reductions of others; extended producer responsibility; product design changes; product labelling and information campaigns
- Possible prohibition on intentionally added microplastics to certain products
- Possible re-use and recycling targets for textile and other waste streams.

In the UK:

- Possible extended producer responsibility regimes for five waste streams, including textiles, requiring producers to cover the full net costs of recovery and disposal.
- The reform of the packaging producer responsibility regime requiring full cost responsibility.
- A potential tax on certain plastic packaging.
- Deposit return schemes.
- Growing non financial reporting.
- Legal requirement for UK net zero emissions by 2050 requiring significant emissions reduction.



Mass equal pay claims on the horizon

A wave of mass equal pay claims against the biggest supermarkets in the UK is currently hitting the employment tribunals, spear-headed by the long-running case of Brierley v ASDA. Female shop-floor staff argue they are entitled to equal pay with male depot colleagues. The indicators point to the trend spilling beyond the confines of the supermarket aisle to other retailers and quite possibly beyond.

Under the Equality Act 2010, women are entitled to equal pay with men who carry out the same/similar work, work rated as equivalent under a job evaluation scheme or work of equal value. Based on the pattern of supermarket cases to date, it is organisations where there are predominantly male and female dominated roles who are the most likely target of mass claims, if one group earns more than the other in pay, allowances and other bonuses.

The repercussions for employers who unsuccessfully defend such claims are huge. Claimants are entitled to six years' back pay (five in Scotland) and equal pay going forward. For employers who do identify an exposure, however, there are a number of robust options to consider from equalising pay to implementing pay protection, but these come with their own challenges. Creating more transparency around remuneration structures can also help make legal action less likely.

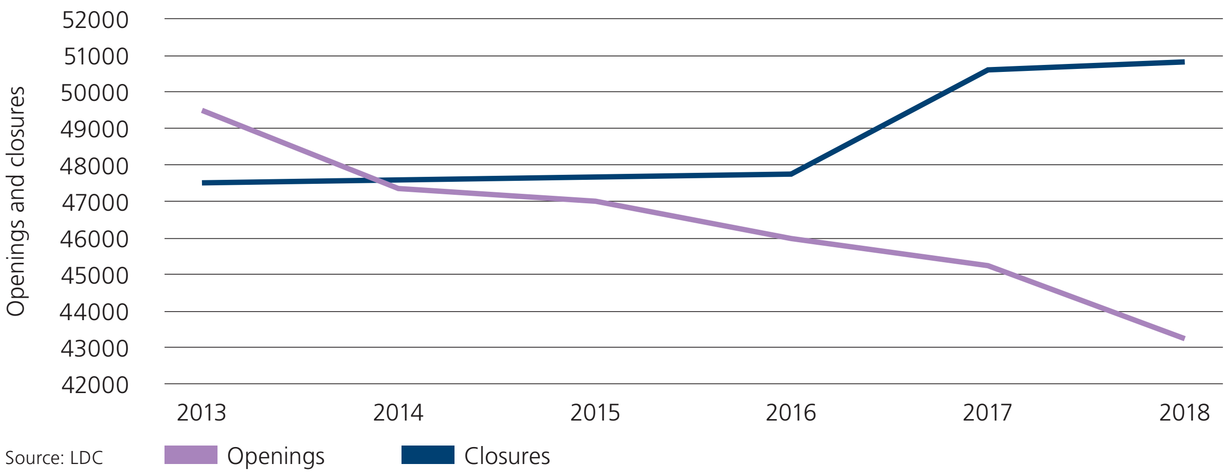
Online barriers keep on falling

Online sales already account for almost £1 in every £5 spent in retail, with that figure expected to grow over the next decade. Research from Retail Economics identifies two main barriers of online growth as: 1) the speed and cost of deliveries, and 2) ensuring first time delivery success.

Consequently, the industry has witnessed intense competition within the next-day delivery market. The adoption of in-home delivery could also boost online spending. In late 2018, Waitrose began piloting an AI powered in-home delivery service whereby drivers were given monitored and controlled access to homes using smart-lock technology to store groceries away.

Next generation online connectivity (5G) and more powerful devices will also drive further online growth. Wearable technology will allow shoppers to demand more from retailers and customer journeys are expected to become even more frictionless.

Openings and closures of stores across Great Britain



Source: LDC

Mind the store – property dynamics are changing

A significant over capacity of physical space has developed within the UK market. Despite a consistent net decline in the number of retail units, excessive physical space remains (c.30% over capacity, KPMG).

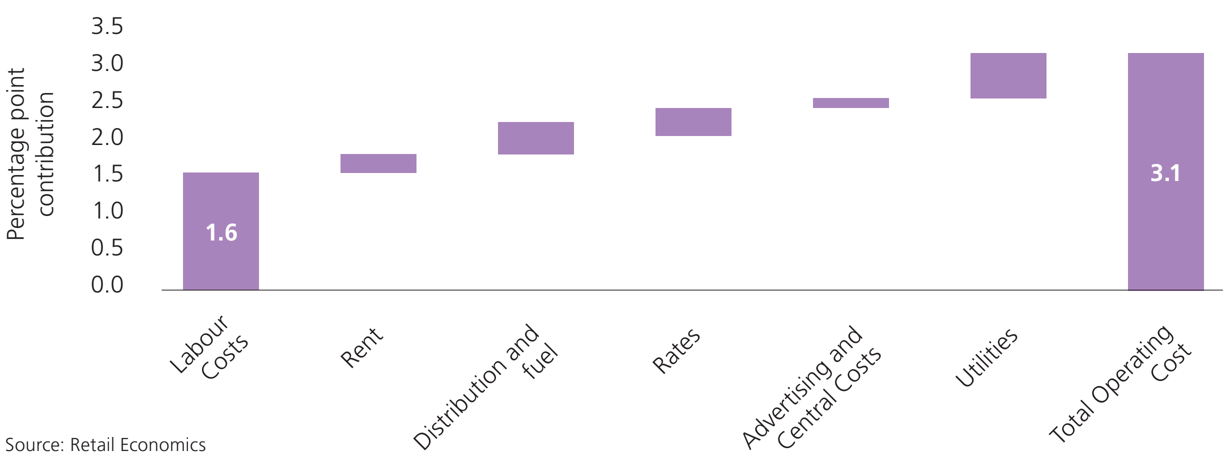
The retail property market has become increasingly polarised. Thriving secondary locations are typically sited where people live, work or near transport hubs. This has attracted value-led retailers (e.g. Aldi, B&M) with nationwide store openings predicated on stringent store selection criteria. Meanwhile, flagship destinations such as Westfield, Leeds Trinity, Birmingham's Bull Ring and others – offering a mix of retail, food and leisure – continue to attract footfall. The vulnerable middle-ground has been most susceptible to online's success and its demise could accelerate given the vicious cycle of higher vacancy rates leading to reduced footfall, and ultimately, dwindling tenant interest.

Profitability pressures hold back vital retail investments

Retail operating costs rose by around 3.0% last year, outpacing sales growth for many retailers. Labour costs – c. 46% of total operating costs – are driving operating costs higher through successive increases in the National Living Wage and National Minimum Wage. Business rates also remain a significant burden for retailers. The industry paid £7.3bn in business rates in 2017-18, over 25% of the entire business rates pool (Retail Economics estimate).

Rising fixed costs associated with managing large store portfolios will hold back investment in experiences needed to attract footfall. Simultaneously, as sales migrate online, associated rises in variable costs will put pressure on traditional business models. For example, Next revealed in March 2019 that it incurred an additional 6p for every pound of sales transferred from in-store to online.

Retail operating costs rising by over 3% year-on-year



Source: Retail Economics

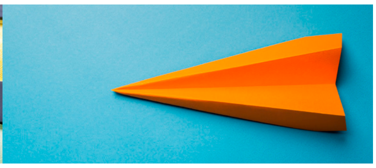
A touch of class actions – introducing "opt-out" class actions in Scotland

Class actions are a growing trend in the UK litigation market, however, currently (with one exception: the Competition Appeal Tribunal) the various courts and tribunals in the UK civil justice system only allow such claims to proceed on an "opt-in" basis i.e. where the individual claimants actively choose to participate in the action. There are often considerable practical difficulties in securing participation in such claims.

The introduction of a more radical US-style "opt-out" approach is, however, currently under consideration in Scotland. Opt-out actions include all potential claimants in the selected class without the need for them to actively participate, thus considerably increasing the value and risk profile of such claims.

The primary legislation is already in place to support the introduction of the new Scottish group procedure which has provision for both opt-in and opt-out procedures to be used. The more detailed rules required to implement the proposal are currently awaited.

It remains to be seen which type of action the opt-out procedure may be identified as suitable for, however, this could include defective product claims (motor vehicles, appliances, electronic goods etc.) false/misleading advertising claims, data breach claims, environmental hazard claims and workplace and employment claims.



Shopping for talent and innovation through Corporate Venturing

As competition in the sector intensifies, innovation is an imperative. But with legacy infrastructure and layers of internal processes and rules, adopting an agile approach to product development or challenging existing technologies or methodologies can be a high risk exercise. Consumer companies are increasingly taking a leaf out of Venture Capital's book, using corporate venturing as a means to drive innovation, launch challenger brands and respond to changes in business models.

The likes of Unilever, Diageo, Kelloggs, M&S and Coca-Cola European Partners have all set up funds that offer VC finance and/or strategic alliance to start-ups and entrepreneurial growth companies. Some of these investments may earn an attractive return, but the predominant driver behind engaging with the cutting edge of the sector is to ensure heritage brands can survive market disruption.

Not only is corporate venturing an efficient way to gather intelligence on new ideas and allow brands to respond quickly to market transformations, it is an important vehicle for bringing in new technology to support the business. Just as importantly, it is also seen as a way of bringing in talent. Attracting top software developers, as, say a food manufacturer, can be a hard slog. However investing in their start-up gives brands access to that scarce resource.

Where corporate venturing is undertaken to dip a toe into a new market, new segment or new product line, it de-risks what might otherwise be considered a risky investment. It also allows companies to quickly divest themselves of an unsuccessful project, either voluntarily or at the behest of other investors. Many corporates are not ruthless when assessing whether to abandon an internal project which has lost its focus or is not quite good enough.

The relationship is not only one-way. Corporate venturing brings a lot of value to the start-ups those companies fund. It gives credibility to the new business and enhances reputation. Start-ups gain access to skills and resources, from sophisticated manufacturing processes to teams of salespeople and marketeers. The hope for many entrepreneurs is that they will ultimately be bought out by the corporate that invested in them, which is a success story on all sides.

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