



June 2018

Virtual High Street

Impact of Footfall, Rates and the Minimum Wage



Executive Summary

Investors have been alarmed by the bad news surrounding physical stores and have delayed asset management decisions

With 85% of retail sales still involving physical stores, today's reality that the high street is dead is a far cry from the headlines

To aid with the understanding of retail profit drivers in the market, FSP has created *Virtual High Street*, a unique modelling tool which shows how changing consumer demand, rising business costs and competitive shifts affect the future of UK high streets

Looking at the impact of declining sales, and increased costs (minimum wage rises and rates) our modelling suggests that profits in the Virtual High Street *could decline by 45%* if current trading patterns continue

Of all the current pressures, declining sales has the greatest individual impact on the financial health of occupiers and the sustainability of high streets. Business rates increases have the lowest impact

An 0.05% increase in sales would offset the impact of an 8% increase in business rates, while a 3% increase in sales would be required to offset a rise in minimum wages from £7.83 to £8.75 an hour

To keep occupiers at current levels of profitability and off set declining sales and combined with rising expenditure, occupational costs (rents, service charges) would need to decline by 25%

Virtual High Street has been designed as an interactive tool and investors can approach FSP to run bespoke scenarios which incorporate their own in-house views of future change or which focus on those particular occupiers which comprise their portfolios

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fsp

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Introduction

Welcome to the Virtual High Street

Virtual High Street uses profit and loss models for over 100 retailers to explore the impact of change across a range of sales and cost drivers

Virtual High Street answers many questions for investors including:

- What do rising costs such as business rates, wages and import costs actually mean for the future profitability of the High Street?
- What is the impact of falling footfall or further digital shift?
- How much sales growth is required to return high streets to sustainability?
- What change in occupational costs would return high streets to profit?
- For how many years will rents stagnate before high streets return to profit?
- Which merchandise categories are most vulnerable?
- Which businesses are best placed to flourish in the future?



Footfall

Declining footfall has translated to a reduction in sales for many mid-tier shopping centres

In this first review of performance, we investigate the impact of changes in footfall, in combination with rising business rates and an increase in the minimum wage

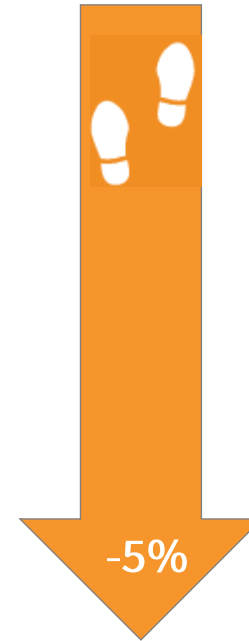
Many mid-tier shopping destinations, such as our Virtual High Street, have seen a decline in footfall which has translated into a decline in sales ⁽¹⁾

Between 2016 and 2017, across a selection of schemes monitored by FSP, footfall declined by an average of 5%, whilst like-for-like sales declined by 4%

To offset the current rate of decline, occupational costs (i.e. rents, rates and service charges) would need to reduce by 21% to prevent a 46% decline in ROTA

If the trend in footfall and sales decline continues for 2 to 3 years, our Virtual High Street will return to the levels of risk last seen during the financial crisis

Footfall



Turnover



(1) Source: FSP/STAR Data

Footfall

Above and beyond any other factors, declining sales are the main threat to retailer profitability

To assess the impact that footfall has on the health of retailers, we have run two scenarios

- Footfall declines by 5% equating to a 4% drop in turnover
- Footfall improves by 5% equating to a 4% increase in turnover

5% drop in footfall would translate to 6 retailers (3 Clothing & Footwear and 3 F&B) making a loss and reduce the overall profit on the Virtual High Street by 39%

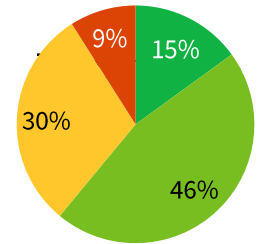
Increasing footfall by 5% is sufficient to increase the number of thriving retailers by 10, giving profits a 12% uplift, showing that occupier fortunes can change with very fine margins

This outcome should encourage asset managers to invest in effective marketing and initiatives which maintain footfall and incentives for new shoppers

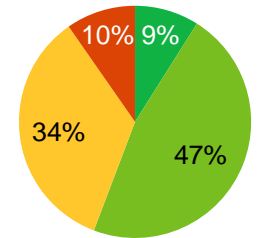
Average ROTA

% of Rent by ROTA

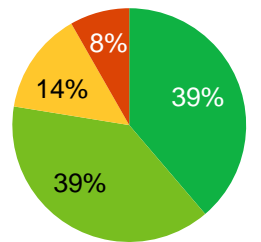
Current Footfall



5% Footfall Decrease



5% Footfall Increase



■ Thriving ■ Healthy ■ Head Above Water ■ Vulnerable



Business Rates

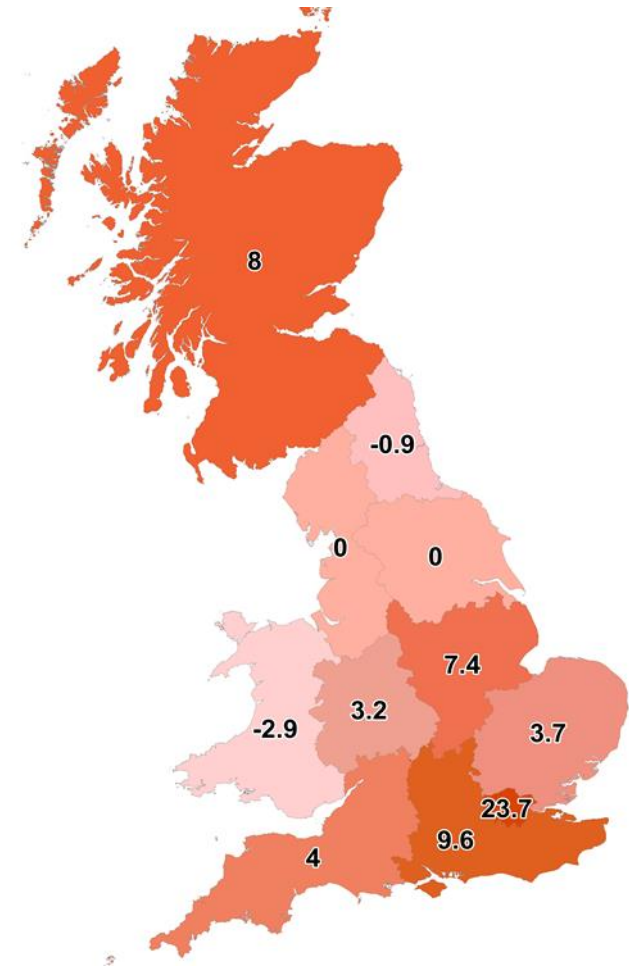
The impact of business rates is regionally dependent

Another pressure on retailers is the increase in business rates that were introduced on 2017 and being phased in up until 2022

Like any tax increase the impact of business rates gets a lot of news, but rates typically account for only 4% of a retailer's net sales

The adjacent map shows the % increases on rateable values, and therefore business rates, from region to region. So although its seldom reported, rates will remain static in the North West and Yorkshire and decrease in Wales and the North East

For the purposes of the Virtual High Street, we have assumed a national average rates increase of 8%, which reflects the distribution of retailers across the country



Business Rates

Business Rates have the lowest impact on retailer profitability

To assess the impact that business rates has on the health of retailer within The Virtual High Street, we have run a scenario where rates increase by 8% reflecting the national average

An 8% increase in rates has little impact on the ROTA of the Virtual High Street, remaining at 14%. Profits see a dip across the scheme from 5.5% to 5.3%

The impact is enough however to drop 4 retailers (2 C&F and 2 F&B) from Healthy to Head Above Water

To maintain current levels of profitability, other occupational costs (i.e. rents, and service charges) would need to reduce by 2%

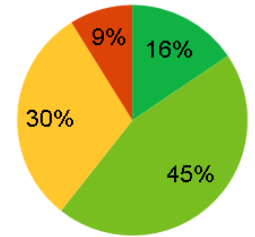
As mentioned, rates vary by region, meaning further scenarios could be run to see how these rises impact the retailers in your centre. London, for instance, has the largest rise in rates (23.7%), but this will be offset by higher sales than the rest of the country, but also higher employment costs

Average ROTA

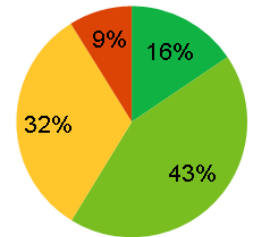


% of Rent by ROTA

Current Rates



8% Rates Increase



■ Thriving ■ Healthy ■ Head Above Water ■ Vulnerable



Employment Costs

Minimum Wage increases will have the biggest impact on Food & Beverage retailers

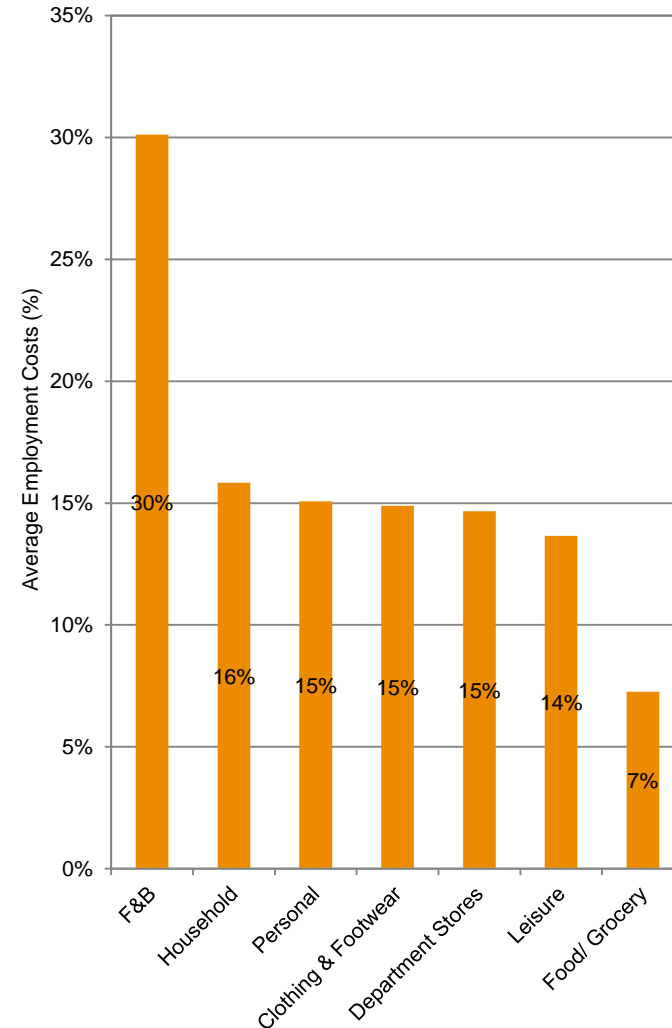
Employment costs are one of the largest fixed costs for retailers

From the 1st of April 2018, retailers who pay minimum wage will have had to account for a 4.7% uplift in staff aged 21 to 24 and 4.4% for staff aged over 25

By 2020, it is estimated that the minimum wage will increase to £8.75 an hour (a 12% rise). Stripping out the projected level of inflation, this would equate to a 7% rise if it were to come into play today

To offset the increase of employment costs, without changing the number of employees, retailers would need to increase their sales by 3%

Alternatively for store profits to remain the same, other fixed costs such as rent and services charges would need to decline by 10%



Triple Threat: Sales, rates and employment

To offset the impact of declining sales, business rates and increased wages, occupational costs would need to decrease by 25%

From the previous scenarios the most significant driver of high street profitability is sales. This is something that physical retail assets can influence through a combination of astute marketing activity and relevant occupiers

In order to provide a broad picture of the future however, FSP has considered the impact of the three profit drivers assessed earlier, acting in concert, i.e.

- 4% decline in sales
- 7% minimum wage increase
- 8% increase in Commercial Property Rates

With this combination, a total of 13 retailers will be pushed into loss, 8 of which are F&B occupiers.

The combined impacts would lead to a 45% decline in profits

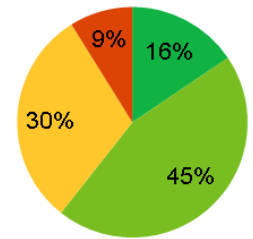
To offset these impacts, occupational costs would need to decrease by 25%

Average ROTA

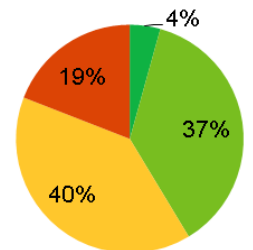


% of Rent by ROTA

Current Rates



8% Rates Increase



■ Thriving ■ Healthy ■ Head Above Water ■ Vulnerable



Returning to Health

FSP can help you make sure you have the retailers you need to fit the needs of an ever demanding shopper

How do you get the Virtual High Street back to full health again? The adjacent chart shows the increase in turnover needed for occupiers to achieve an average ROTA of 25%

FSP can help you identify issues and steer you in the direction to make smarter decisions and make greater profit. We can do this by:

- *Identifying which retailers can afford their current rents, and which are struggling*
- *Identifying your customer, what are their wants and needs and which demands are you not meeting*
- *Identifying the occupiers you should be targeting and the rents they can meet*

FSP has long been helping clients understand untapped demand from consumers and identifying a strategy to help realise that



Conclusion

FSP can help you make sure you have the retailers you need to fit the needs of an ever demanding shopper

FSP's Virtual High Street simulates how the pressures faced by many retailers across the country are likely to affect their ability to occupy physical stores

It shows that although business rates and wage increases will increase pressure on retailers, *these factors on their own will not harm the vast majority of retailers*. However, if these pressures act in combination with the decline in high street sales, we will see the numbers of levels of vulnerable retailers return to levels last seen following the financial crisis (2008/2011) within a relatively short period of time

Virtual High Street has demonstrated however, that unless landlords and asset managers continue to resist footfall and sales decline through *effective marketing and curation of an appropriate proposition* (which reflects needs and delights customers), the volume of rent concessions required may well become unaffordable

FSP has many services it can offer from trading gap analysis – to understand untapped shopper demand – to bespoke P&L analysis, to understand if your tenants and target tenants have the right underlying structures to sustain success

There are of course many other factors currently affecting retail and some that have yet to emerge; The Virtual High Street can test these out to ensure you have the full picture of your tenant's health



A wide-angle, high-angle photograph of a busy pedestrian street. The street is filled with people walking in both directions. On the left, there are multi-story buildings with white facades and a prominent black sign with a white 'W' and the word 'Waterstone's' below it. A green metal balcony railing runs along the side of the building. On the right, there are modern buildings with large glass windows. In the background, there are trees and more buildings, suggesting a city center. The overall atmosphere is one of a vibrant, active urban environment.

Appendix

The Virtual High Street Methodology

The Virtual High Street combines detailed analysis of financial accounts with FSP's understanding of the space requirements, investment requirements and trading performance of new stores, built up over more than 40 years. This published and unpublished information is used to develop bespoke sustainability models for individual retail and leisure businesses, which FSP updates and reviews on an annual basis

This technique has been used by FSP for many years to identify occupier risk and to advise investors on the sustainability of current rental income, either prior to acquisition or as part of ongoing asset management. Virtual High Street extends the approach by using FSP's in-house or bespoke client assumptions on trends in consumer behaviour and business costs as the basis for scenario testing future sustainability across a representative set of high street occupiers

In addition to standard profit outputs, FSP also calculates the Return On Trading Assets (ROTA) for each store. ROTA allows us to assess the profitability of a retailer, by comparing input (assets) with output (profit). This allows us to tell if a retailer is managing its assets over a period of time to produce a profit, and whether this profit is sustained. As a general guide:

- A negative ROTA indicates a loss and is not sustainable in the long term (Vulnerable)
- Anywhere between 0 and 10% indicates the store is making money, but potentially vulnerable to disruptions in the market (Head Above Water)
- Anywhere between 10 and 25% indicates the store is profitable, and should be able to sustain any disruptions in the market (Healthy)
- A ROTA of 25%+ indicates a healthy store and suggests medium term sustainability (Thriving)

Within this report, we looked at occupiers based on merchandise groups. For further information on individual tenants please talk to us directly

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Retailers In the Virtual High Street

Department / Variety Stores	Clothing & Footwear		Personal	Household	Leisure	Food & Beverage		Grocery/ Food
Argos	AllSaints	M&S	Accessorize	BrightHouse	Card Factory	Bill's Restaurants	Patisserie Valerie	Holland & Barrett
Debenhams	Blue Inc.	Matalan	Body Shop, the	Cath Kidston	CeX	Burger King	Pizza Hut	Tesco Supermarket
House of Fraser	BonMarche	Monsoon	Boots The Chemist	Jessops	Clintons	Byron	PizzaExpress	Hotel Chocolat
Poundworld	Boux Avenue	New Look	Claire's	Lakeland	Decathlon	Cafe Rouge	Pret a Manger	Sainsbury's Local
Wilko	Clarks	Next	Ernest Jones	MenKind	Entertainer, the	Caffe Nero	Starbucks	
	Crew Clothing	Phase Eight	Fragrance Shop, the	Poundland	Game	Carluccio's	Subway	
	Deichmann	Primark	H Samuel	Robert Dyas	HMV	Costa	TGI Friday's	
	Dorothy Perkins	River Island	Lush	White Company, The	Smiggle	Five Guys	Wagamama	
	Fat Face	Schuh	Pandora jewellery		Trespass	Frankie & Benny's	Wahaca	
	Foot Locker	Shoe Zone	Perfume Shop, the		WH Smith Retail	Greggs	Yo! Sushi	
	Gap	Shuropody	Savers		Works, the	itsu	Zizzi	
	H&M	SportsDirect.com	Superdrug			KFC		
	Hotter	Superdry	Vision Express			Krispy Kreme		
	Hugo Boss	TK Maxx				Las Iguanas		
	Jack Wills	TM Lewin				Leon		
	JD	Topshop				McDonald's		
	Joules	Yours				Millie's Cookies		
	Laura Ashley	Zara				Muffin Break		
	LK Bennett					Nando's		



FSP Credentials

FSP is the most experienced independent retail property consultancy in Europe. Having completed 3500 projects over 40 years across numerous markets, FSP has helped many of Europe's leading investors and occupiers get the best possible returns from their retail assets

FSP works with some of the world's most successful investors, including Ares, Aviva, Blackstone, Commerz Real, Landsec, Legal & General, M&G and Resolution Property, working on projects with assets worth a total of £135bn. We provide strategic recommendations and tactical support which allows clients to grow their rental income, attract target tenants, acquire new assets, prioritise investment, turn failing assets around, spot tenant risk, position assets for disposal and avoid costly mistakes

Also widely known and respected in the retail market, FSP helps leading businesses including Acuitis, Menkind, Clas Ohlson, Joules, New Balance and Sushi Shop maximise their sales and profits by enhancing their store strategies and insight

FSP's approach uses experience backed by evidence. It helps its clients first understand their consumers better (with insight on shopping catchments and consumer preferences), and second fully get to grips with the impact of emerging trends such as demographic shifts, decentralisation, globalisation and digital shopping. It all adds up to smarter decisions and more profitable places

To find out how FSP can help increase the long-term profitability on your asset, be it high street, shopping centre, OOT, outlet, mixed use or leisure, contact the FSP team



FSP Services

FISH – FSPs bespoke segmentation of the Clothing & Footwear market; segmented supply and demand for any location across Europe

MENU – FSPs bespoke segmentation of the Food & Beverage market, helping operators and landlords understand in greater detail opportunities derived by the source of demand (resident, worker or tourist) and type of demand to spot the best appropriate locations/operators for their brand/centre

The above products and methodologies allows FSP to support the activity of a wide range of players in the retail market:

Fund Managers – providing a robust, long term view of retail opportunities

Asset Managers – providing bespoke solutions to drive value growth

Marketing – determine strategies to provide best ROI on marketing spend

Leasing – provide robust and trusted independent assessments of trading opportunities for target occupiers

Centre Managers – support the collection of sales data and provide robust insight into what the numbers actually mean

Retailers – understand the most appropriate locations for their brand, the scale and nature of opportunity

