ST BRIDE'S MANAGERS

Bull and Bear

The Retail Sector

This week, Bull and Bear discuss a retail sector which has taken a battering during the pandemic, but could still offer investors the most accretive opportunities of any sector in 2021.

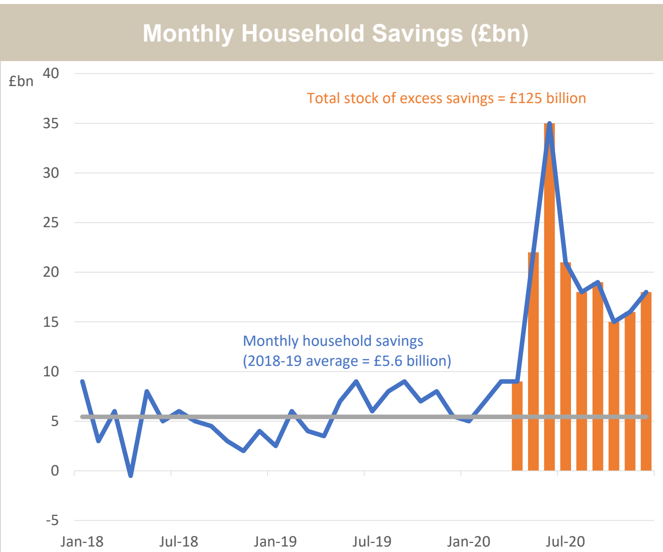
Bull: I bet you can't wait to get stuck into this week's discussion, Bear. Shuttered-up-shops, deserted high streets, department store collapses, the relentless rise of e-commerce; the retail sector seems perfectly gift-wrapped for an eternal pessimist like you.

Bear: You're right, Bull, I do have my concerns. But, I am a lot more upbeat now that we have a clear road-map out of lockdown. Shops will be open again in just 43 days' time and I, for one, can't wait to get my nails clipped. I'll be first in the queue at the nail bar!

Bull: And I am heading straight to the local barbers. This shaggy coat needs a serious trim before the weather warms up. We'll have to book early though. All that pent-up demand will mean everyone will be heading to the shops en masse. The high streets will be swarming.

Bear: Steady on, Bull. Aren't you forgetting that everyone is broke. You can't expect consumers to go on a sudden spending spree.

Bull: But that's where you are wrong, dear friend. Average wages went up 1.7% in 2020, not down. More importantly, household savings ratios have shot up whilst we've all been locked away at home. Excess savings reached £125bn in November and will likely have doubled again by June. I am expecting a "spendathon".



Source: Bank of England

Bear: That will be music to the ears of the embattled retailers. But a short-term bounce in consumer spending may be too late for many.

Bull: What do you mean, too late? I accept it hasn't been easy, but the furlough scheme and other government support measures are still in place. And thanks to the vaccines, pay day is just around the corner.

Bear: You seem to be forgetting that physical, non-food retailers have lost over £22bn in sales during the three national lockdowns and retail rent arrears now exceed more than £4.5bn. I am expecting a bloodbath once Rishi finally lifts the moratorium on landlords taking enforcement action. Perfectly viable businesses could be turfed out.

Bull: But, that's the beauty of certainty my long-clawed companion. Landlords and tenants will no longer be negotiating in a vacuum. There will be some casualties, but fundamentally sound businesses with a strong customer offer should have nothing to fear from the lifting of the moratorium – rational property owners won't simply evict them. No property owner wants empty space it cannot re-let.

Bear: Isn't that ultimately the point though, Bull. There is an awful lot of empty retail space out there and the high street vacancy rate is alarming. The collapse of Debenhams and Arcadia alone dumped an extra 15m sq. ft. of retail space onto UK high streets. When Bohoo acquired the Debenhams brand, they didn't take on any of the physical stores. Not one!

Bull: That's the nature of retailing, Bear. Old names disappear, and new ones emerge. Businesses have always needed to evolve and adapt, and those businesses that had under-invested or failed to adapt quickly enough were struggling long before Covid-19. When did you last shop at Debenhams, for example?

Bear: True. John Lewis has always been my go-to department store, but even they are eyeing up another eight store closures. And what about GAP? They are considering a switch to an "online only business" in Europe. What does that mean for the high street long term?

Bull: It means fewer shops. But re-purposing legacy department stores and challenged retail space also presents an opportunity to re-position our town centres and high streets for the future. Mixed-use redevelopment will actually breathe some life back into redundant retail space.

Bear: I think you are under-estimating the scale of the structural changes at play here, Bull. JLL predict that 80,000 shops will be obsolete by 2030. Converting a few large-format department stores into offices and residential isn't going to solve that supply-side imbalance in a hurry.

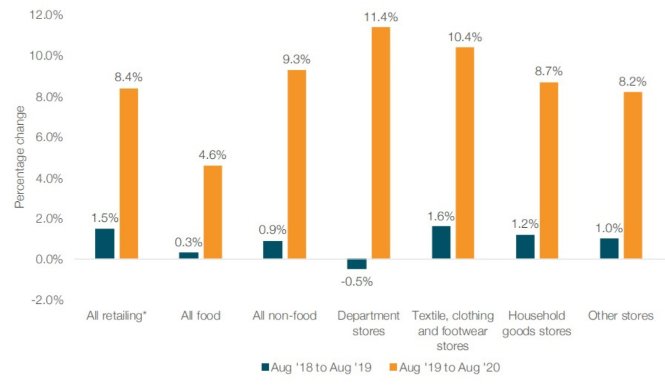
Bull: You are right Bear, but the Covid-19 pandemic has actually just accelerated the required supply-side readjustment. The pandemic has compressed five years of change into twelve months. The big question is when will we reach equilibrium again? I can guarantee you it will be sooner than the pre-Covid trajectory.

Bear: I don't think we can answer that question, without discussing the "e" word. You can't deny the huge shift to online for non-food retail sales. The percentage of online sales rose from 22% in 2019 to 31% in 2020, and the number just keeps on rising. Who's to say the enforced changes to consumer behaviour in lockdown won't become permanent?

Bull: Hold on a second, Bear, I've got to answer the door. Amazon delivery. New trainers.

Bear: Point proven!

Annual change in online sales as a proportion of retail



Source: Local Data Company

Bull: Don't sound so triumphant, Bear. Firstly, I think you are underestimating the degree of e-commerce fatigue and, secondly, there is a social aspect to the shopping and leisure experience that the online can't deliver. It is the younger age groups who will be driving the consumer recovery. They want to be out and about. And let's not forget that the retailers themselves need complimentary channels (online and physical space) to build brand loyalty.

Bear: So you think that online sales have already reached a saturation point?

Bull: I believe we are close to that natural ceiling, but government intervention is also necessary to level the playing field between high street and online retailers. The current business rates system is totally unfair to bricks and mortar retailers. The government has promised action when it finally publishes its review in the Autumn.

Bear: Okay, but what our readers are really itching to know is, what does all this mean for the retail investment market?

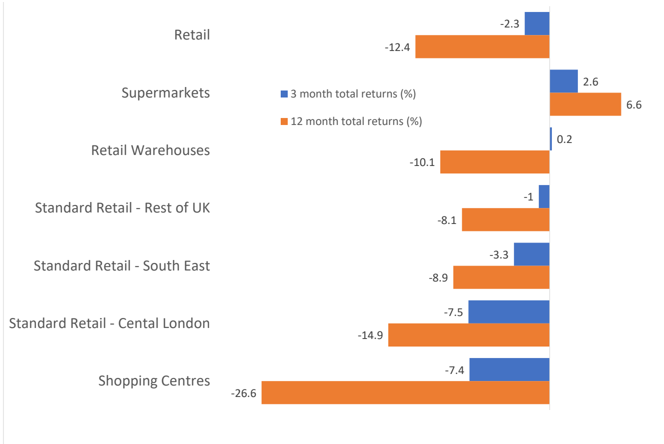
Bull: You mean, when am I setting up my new "High Street Opportunities Fund" and how can they get a piece of the action?

Bear: Well, at least you will not be short of distressed assets to choose from! You could have picked up West Orchards Shopping Centre in Coventry at the recent Allsop auction for just £4.85m. That's a fraction of the £37m it was valued at eight years ago. There are some worrying parallels here with the Global Financial Crisis here. I wouldn't want to be re-financing a Shopping centre right now.

Bull: Exactly, Bear. There will be distress in the market and, if you get it right, there will be some opportunities at bargain-basement pricing. In fact, the retail investment market may offer some of the most interesting and accretive opportunities of any sector in 2021.

Bear: So why aren't investors flocking to the sector then? Call me bearish, but it takes quite a leap of faith to buy into a sector that has delivered 12-month total returns of -12.4% and forecasts further yield decompression. Just look at those Shopping centre returns!

2020 Total Returns by retail sub-sector



Source: MSCI

Bull: Fortune favours the brave, Bear! I agree that investor demand will remain muted in the short-term, but there are clear signs that the second half of 2021 will see the bottoming out of the occupier market and a stabilisation of retail values. There will be opportunities if you pick your assets carefully.

Bear: So, let me get this straight. In the middle of a retail sector crisis, with unprecedented levels of rent arrears and business failures, your advice is to start buying shops up and down the UK?

Bull: That's not quite what I said, Bear. I'd choose my locations very selectively. There will inevitably be increased polarisation in demand, with investors rightly focusing on the best towns and cities. I'd favour the south-east and the strong university towns. The re-purposing of obsolete assets elsewhere will continue.

Bear: And what about income security? Almost every retailer is rationalising their physical store portfolio. And long gone are the days when retailers were willing to sign a 15-year lease and all the landlord had to do was pick up a quarterly rent cheque.

Bull: You are right, Bear. Retailers will demand more flexibility, and seek to better align their fortunes with that of the landlords. Shorter, turnover-based leases will become common-place, but the key for retail investors is to truly understand each tenant's business. The dynamics of the landlord and tenant relationship is changing.

Bear: I agree with that. Funnily enough, it appears that you are not the only one expressing cautious optimism in the retail sector this week. Shopping centre owner, Hammerson, was the top gainer on the FTSE 250 on Wednesday buoyed by the news that non-essential shops will be re-opening. Although they are still down at 25.75p (from 1,140p twelves months ago) so I am not getting too excited!

Bull: There you go, Bear, another bargain. Oh blast!

Bear: What is it?

Bull: Those trainers I ordered on Amazon don't fit. That's the second pair I'll have to re-package and send back. Bring on 12th April is all I can say. Same time next week?