Storm clouds on the horizon
An analysis of the UK retail sector and its financing
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Methodology

This report is based on research conducted by Debtwire and Alteri on the current state of UK retailer debt.

Debtwire conducted a survey in H2 2016 of CFOs and financial controllers (or equivalent) from 50 UK-based retailers on their views of the retail market and on their current and future requirements for financing.

Respondents were drawn from the following sub-sectors: clothing, department store/mixed goods, electricals/electronics, footwear, grocery and homewares (including furniture) – 15 respondent companies are private equity backed.

Alteri’s research is based on actual data of 100 UK retailers with turnover predominantly between £100m-£2bn across a number of retail sub-sectors – a broadly representative sample of UK retail as a whole. Data is drawn predominantly from company accounts, supplemented with other research sources including Debtwire, Mergermarket, BvD (Fame) and Factiva.
Key Findings

In H2 2016, Debtwire and Alteri Investors conducted extensive research on the current state of UK retailer debt and the prospects for the sector, combining data from 100 UK retailers with a survey of CFOs and financial controllers (or equivalent) from 50 UK-based retailers. The findings are highly polarised: some retailers are confident about their future while others acknowledge the turbulence that lies ahead.

### What's keeping UK retailers awake at night?

They are particularly concerned about:

- **Ongoing pricing pressure from consumers due to constant discounting**: 58%
- **The impact of Brexit**: 50%
- **The ongoing consumer shift online**: 38%

### Currency volatility is also on the radar for retailers, with prices rising as hedges roll off...

- **74%** of respondents have hedges rolling off in 2017
- **69%** expect their prices to go up in 2017
- **42%** plan to pass the full amount of cost increases on to consumers

### Most are not overly worried about debt levels or access to finance despite heightened trading pressures.

- **74%** say their total debt burden will be the same or lower by the end of 2017
- **88%** say that the availability of traditional bank credit stayed the same or increased in 2016

### Typical lending rates in UK retail:

<table>
<thead>
<tr>
<th>Lending Type</th>
<th>Median Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revolving credit facility/overdraft</td>
<td>2.4%</td>
</tr>
<tr>
<td>Bank term loan</td>
<td>3.1%</td>
</tr>
<tr>
<td>Asset-based lending</td>
<td>3.6%</td>
</tr>
<tr>
<td>Non-bank direct lending</td>
<td>7.3%</td>
</tr>
<tr>
<td>Shareholder loans</td>
<td>10.5%</td>
</tr>
</tbody>
</table>

*Median lending rates (% above LIBOR)*

### Long term, respondents plan to increase non-bank direct lending.

- **2%** of debt by the end of 2019
- **4%** of debt by the end of 2021

### ...yet most remain confident about the future.

- **34%** say their company’s financial results (gross margin) will suffer after current hedges roll off
- **66%** do not expect results to suffer, but many intend to offset potential losses with price rises
**Stormy times ahead for UK retail**

Storm clouds are gathering for UK retail, with currency headwinds adding to existing margin pressures and consumer confidence treading a fine line amid Brexit uncertainty. How bad is it likely to be and what does this mean for sector financing?

2016 may indeed have been the consumer’s last hurrah. Spending held up unexpectedly well in the “phoney war” post-referendum period, continuing to rise unchecked with retail sales values up 3.1% throughout the year despite consumer confidence suffering a sharp short-term slump in June. Published Christmas trading results defied expectations too, although positive headline sales figures belie the real picture in retail of massive polarisation, continued online migration and squeezed margins.

Looking ahead, there’s an air of inevitability that consumers will tighten their belts as retail prices rise, fuelled by the unwinding of currency hedges and the crystallisation of Brexit uncertainty. Indeed, sector figures from early 2017 appear to confirm this. We could expect consumers to rein in their unsecured borrowing (and spending) – total unsecured lending has accelerated sharply over the past two years to almost £200bn, not far off the 2008 peaks. If any downturn in confidence seeps meaningfully into the housing market, the cornerstone of UK middle class wealth, expenditure will take a further hit. Add the constant diversion of funds away from retail to leisure activities, and it’s fair to say that UK retail spending could be in for a rough ride.

**Zero-sum game**

The combined impact of these new measures will be dwarfed by the ongoing investment required by many retailers to ensure that they are fit to compete in today’s omnichannel world. Developing and evolving an integrated online platform – one that meets consumer demands for a seamless experience across all channels – requires significant investment at a time when capex budgets are invariably under huge pressure. And as retailers adapt their models to the way consumers want to shop and sales migrate further online, overcapacity within the physical store estate increases in what may be a zero-sum game for many.

Despite a significant degree of space withdrawal in an extended phase of sector restructuring between 2010-2013, we believe...
that there is still between 10%-15% excess store capacity across UK retail.

A growing unprofitable tail of stores represents a further squeeze on profits, yet there’s no comprehensive fix, short of a formal restructuring for the more distressed players.

So the outlook for UK retail is enormously challenging albeit with a varied prognosis by sub-sector. Fashion and footwear retailers are probably most exposed to the changing macro dynamics, department stores face significant structural challenges, home-related sectors could be affected if the housing market dips while food retailers should be able to pass on inflation to customers. Spending on leisure-related retail should hold up reasonably well, despite its discretionary nature.

Filling the lending gap
For many retailers, these trading pressures are translating into increased pressure on liquidity. Mainstream lenders have had a fairly muted appetite towards the sector for some time. Banks are adopting a cautious approach with lending restricted to the best credits at historically modest debt leverage ratios and often where assets provide some downside protection. This stance is borne out by our survey with widely divergent views about the availability of finance. Credit insurers, too, are generally unsupportive of the sector.

Consequently, access to traditional funding is tighter for many retailers than ever before at a time when demand for flexible funding is high. Alternative lenders, principally credit funds and asset-based lenders, have started to fill the gap, although also on a cautious basis. They can provide flexible financing and respond quickly with streamlined underwriting processes. Credit funds have played most heavily in the provision of stretch financing as part of mid-market leveraged transactions. In addition to Alteri’s own debt fund, Alcentra, Permira Credit, Ares, Crescent, Sankaty, Bayside and Beechbrook have all been active in UK retail. Of the large asset based lenders, Wells Fargo, PNC and Bank of America are the most involved in the sector.

Given the clear need for new money in the sector and the banks’ selective approach we believe alternative funders are only really at the start of their journey into retail. However in order to see greater deal flow, we think a more collaborative and creative approach by lenders is required. For instance, adopting split lien structures to provide an acceptable blended rate to the borrower. If lenders were prepared to find these more creative solutions with the credit fund taking on the riskier element of the capital structure, we could reasonably expect to see more joint deals between mainstream banks and credit funds and asset based lenders.

Weathering the storm
We have no doubt that UK retail, and more specifically much of the non-food mid-market, is entering a turbulent time – perhaps worse than our survey responses would suggest. But there is light among the gloom. International markets represent an enormous opportunity for the right brands yet remain largely untapped for many retailers. They also provide an incidental hedge to the weak pound. Licensing into adjacent product categories also represents further opportunities to leverage powerful brands, while many companies still have scope to operate more efficiently – whether by optimising working capital, improving pricing architecture or reducing controllable costs. Some retailers will continue to thrive, embracing the new norms, and most will weather the storm, but certainly not by battening down the hatches.
2016 was marked by major political upheaval, notably the Brexit vote and the US elections, a degree of macroeconomic uncertainty, and higher levels of (dis)stress in certain sectors, including oil & gas and shipping. Regardless – and to the surprise of some – the debt markets seem to have taken little notice (barring the occasional jitter), reaching buoyant conditions not seen since 2007. This competitive lending environment has ushered in increasingly borrower-friendly terms, with downward pressure on pricing and protection for lenders.

The main driver has been the major supply and demand imbalance in European debt markets. The appetite for lending by bank and non-bank lenders has far exceeded companies’ debt issuance. With interest rates still at historic lows, the continuous search for yield has led to a strong influx of institutional (non-bank) capital into the debt markets.

Direct lending by private debt funds to mid-market companies – in competition with (or indeed alongside) banks – has been one of the defining developments in the European debt markets over the past few years. Money has flowed rapidly into this asset class, with new funds being set up and existing funds raising more and ever-larger funds. It is estimated that private debt funds have approximately €55 billion of European dry powder, ready to deploy through direct lending. That is a huge amount, especially when taking into account bank lending’s strong recovery over the past few years.

In 2016, this influx of institutional capital and renewed bank lending appetite met lower M&A volumes, particularly in Western Europe, augmenting the imbalance between supply and demand.

In the large-cap market, re-pricings are the name of the game, with downward re-pricings for many loans after issuance. Strong demand is pushing pricing downward, with lower-priced collateralized loan obligation liabilities having an impact. Refinancing and dividend recaps form a substantial part of recent loan volumes. Furthermore, the percentage of deals done on a covenant-lite or covenant-loose basis has increased significantly over the past few years. Increasingly, loan terms have a high-yield bond flavour.

In the mid-market, terms have also become more borrower-friendly as banks and a growing number of funds compete for business. Banks and funds are also working together or lending alongside each other more often, but the number of active lending parties is larger than ever before.

In terms of market activity, S&P2 data suggests that European leveraged syndicated debt volumes in 2016 were more or less flat on the prior year at around €125 billion, with loan volumes slightly up on 2015 and high-yield bond volumes slightly down. The most recent AlixPartners mid-market debt survey, which covers mid-market deal activity by around 80 European bank and non-bank lenders, suggests that deal activity was up 1% in 2016, with 460 deals recorded versus 456 in 2015.
Mid-market unitranche lending volumes were down (93 recorded versus 120 in 2015), despite the attractive returns – typically 8-11%, but sometimes more. This may be happening because banks are becoming more competitive to avoid losing market share to private debt funds, or because owners are being more cautious about the quantum of debt they are prepared to take on.

Some lenders have also increased their deployment capacity as we have seen the larger credit funds provide some large (€200-300 million+) unitranche deals on a sole or club basis, which effectively encroaches on the syndicated large-cap markets.

Caution on retail?
The debt market’s buoyancy may not extend to all sectors. The UK retail sector is under particular pressure. From the increased migration to online shopping, the introduction of the national living wage, and rising business rates and rents to the continued discounting and cost inflation from the weaker sterling post-EU referendum, retailers are facing a challenging environment.

We have not seen any obvious signs of cutbacks in lending to retailers. Our research suggests that in 2016 the volume and value of retail financings in large cap markets was up on 2015. In the midcap market, our 2016 survey recorded 31 retail financings, down on 2015 (40) but flat when compared to 2014.

However, we believe that banks and funds have become more selective and cautious about their lending to retailers and the consumer sector in general, focusing on “safe bets” and/or acting more cautiously on leverage. Lenders’ existing exposure to the sector and how those credits are performing will be key factors. Retailers that struggle to find the required liquidity and flexibility with traditional lenders may look elsewhere. Asset-backed financing and non-bank direct lending have been and continue to be an option. Funds that offer more expensive “special situations” debt or junior debt in cooperation with traditional lenders may also play a bigger role going forward.

General outlook for 2017
At the time of writing, there are no material signs of the debt markets softening, as the imbalance between supply and demand has continued into 2017.

European default levels have remained at relatively low levels, and with the secondary loan markets generally trading at high levels, many distressed debt investors have expressed concern about a lack of opportunities.

This scenario stands in contrast with the US, where the energy and transportation sectors in particular have witnessed high levels of distress, resulting in higher restructuring activity and more distressed lending opportunities.

Many people wonder what may cause a shift or turn in the debt markets. Some lenders say the market has a “late cycle feel”. Disruption could come from many different directions: forthcoming international trade discussions, a shift in monetary policy and rising interest rates, European elections, continued pressure on the sterling impacting inflation and cost pressures for companies relying on imports, or a major shift in consumer confidence and spending.

The general expectation is that default levels are likely to rise. When, and by how much and how widely, remains impossible to predict. Having access to multiple alternative sources of financing and addressing any refinancing requirements early will be key, and a reputable debt advisor can assist with this important task.
UK retailers have been under persistent margin pressure as consumers have changed their shopping behaviour and increased their demands in terms of pricing, product and experience. Yet, they’re now facing a potential storm, as these structural challenges are being accompanied by the impact of an increasingly volatile macroeconomic and geopolitical marketplace.

Consumers now expect year-round discounting while the shift online is continuous and permanent. This year will see no let-up in these trends, but the industry will have added concerns over Brexit and the uncertainty of Article 50 negotiations, which could have a profound impact on consumer spending.

The Debtwire study, based on a survey of 50 UK retailers from across the sector in H2 2016, shows that discounting is one of the biggest worries for respondents (58%), followed by Brexit uncertainty (50%) and the increasing shift to online shopping (38%).

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The UK retail sector is being kept awake at night by three main concerns – an ongoing pricing squeeze from consumers who expect constant discounting, the impact of Brexit and the continuing move to online. But it’s also clear that retailers have widely polarised views on this shift with vast differences in the ability of businesses to compete in today’s omnichannel world.

The long-term damage of discounting
Discounting has become much deeper in recent years, driven by savvy bargain-hunting consumers and intense competition. As independent retail analyst Richard Hyman said at the end of last year, “The consensus view is that 2016 was the toughest year [UK retailers] have ever known. There [is] a whole range of reasons why, but a fundamental factor is the effect that a constant diet of discounting is having. This is the most price-driven market Britain has ever seen.”

And Hyman argues that 2017 could be “considerably harder” than last year. His research shows that UK fashion retailers are rolling out a new round of discounts, with 81% holding sales in the fourth week of January, up from 69% in 2016.

Long term, instead of improving results, these aggressive pricing strategies can damage brand perception and customer loyalty.

These fears about discounting are shared by others in the industry. For example, the Group Finance Director of a clothing retailer notes that, “Consumer expectations for year-round price discounts cannot be met due to the surge of operational costs and taxes, which restricts us from offering cost benefits in the form of discounts to our customers. This is affecting our sales performance significantly.”
The CFO of a clothing retailer agrees: “The trend has been to offer discounts. This has become a norm that has affected our business and other businesses. This is problematic as we cannot go on giving discounts and it affects our returns.”

“Discounting is a vital tool in a retailer’s armoury,” says Jane Hughes, UK Investment Director at Alteri Investors. “But for many, it is destroying value rather than creating it.”

**Brexit: boom or bust?**
Although there was an initial boost in sales following the EU referendum, recent retail sales data including statistics released by the Office of National Statistics (ONS) reveal that this uplift was temporary.

Sales volumes dropped by 1.9% in December 2016, when seasonally adjusted — the biggest drop since April 2012. And according to the ONS, this drop continued into 2017 — “the first signs of a fall in the underlying trend since December 2013”.

Bank of England governor Mark Carney voiced concerns about this consumer slowdown in a speech at the London School of Economics in January. He pointed out that the UK is relying on consumption-led growth but consumer borrowing is on the rise.

“At present, households appear to be entirely looking through Brexit-related uncertainties,” Carney said. “The saving rate has fallen towards its pre-crisis lows, and consumer borrowing has accelerated notably. In the year to November, total household borrowing rose 4%, and consumer credit rose over 10%, the fastest rate since 2005.”

This situation is compounded by rising inflation, which hit a three-year high of 1.8% in January 2017 and which the Bank of England expects to hit 2.7% this year. This has been exacerbated by the weaker pound.

Despite UK Prime Minister Theresa May delivering a “Brexit blueprint” in January, it is still difficult to determine its impact on UK retailers. While this is likely to impact consumer confidence and spending, the longer term effect of leaving the European Union single market could signal higher tariffs with trade restrictions, as well as a more limited labour supply since many retailers hire employees from the EU. But it’s clearly too early to speculate with any certainty.

The Alteri/Debtwire research reveals that some respondents are also anxious over a potential backlash on UK brands operating in Europe post-referendum, although UK retailers with European operations will have at least a partial natural hedge against sterling’s weakness.

A CFO of a homewares retailer sums it up for many UK-based businesses: “Brexit uncertainties have caused tremors in the domestic market. With most of our activity based in the UK, we had to face significant cost imbalances in our operations. Supplier agreements have been put on hold and significant loss of inventory is hampering the financial performance of our business. The weak currency value has also affected our product pricings and this has caused our profits to slip to all-time low figures.”

“Brexit uncertainties are having an immense impact on economic conditions and this is affecting public spending. Consumer expectations for year-round price discounts cannot be met due to the surge of operational costs and taxes... and this is definitely affecting our sales performance significantly,” adds the CFO of a clothing retailer.
Sales have decreased considerably and this is impacting our business significantly. Economic conditions have affected the spending habits of the public and this has resulted in poor sales for our business. The struggle is real and is mounting up considerably as the conditions worsen due to Brexit and other geopolitical issues. The clothing sector has mainly been hit, as more disposable incomes are directed to recreational activities and less on clothing.

The move to online buying
The UK is Europe’s leading online retail market. Although figures of the online share of total sector sales vary from 15%-17% according to definitions, digital migration still has some way to run. Forrester estimates that online will account for almost a fifth of UK retail sales by 2021, with retailers currently investing heavily in technology to support in-store digital capabilities and improve the customer experience and drive sales across all touchpoints.

For many retailers though, as they adapt their models to changing consumer behaviour and sales migrate further online, the flip-side is dwindling sales through the physical store estate and increased overcapacity. According to the Centre for Retail Research in the UK, store-based sales are forecast to diminish by as much as 4.3% this year – Alteri estimates that there is still 10%-15% excess store capacity across UK retail, despite significant withdrawal of space during an extended phase of restructuring in the sector between 2010 and 2013.

As both online and offline retail becomes ever more polarised between winners and losers, views on the impact of this channel shift vary enormously: “Online sales have been a boon and a bane for companies in the retail sector,” says the CFO of a clothing retailer. “Small companies have not been able to keep up with large companies especially when it comes to selling products online. Customers also expect a year-round discount when shopping online and this has impacted profits and made competition fiercer.”

There is also the pressure of consumer expectations in fulfilment. Amazon Prime’s free to members same day delivery in certain postcodes, has set the bar very high, while
weaker pound, all are facing rising sourcing costs, which potentially will have a massive impact on gross margins as hedges unwind.

As the CFO at one homewares retailer puts it: “Currency volatility is impacting our costs significantly. We have to pay more on imports as sterling is depreciating and is likely to hit a new low in several years [when we leave the EU]. This is negatively impacting the pricing of our products, which is a big concern for us.”

The Head of Finance at a similar retailer adds: “Currency volatility is one of the key challenges we are dealing with, as it has hampered our pricing in overseas markets. As a result, we are facing competition from local suppliers whose prices are not affected by the volatility in the currency.”

Hedging their bets
To mitigate the currency risk, the majority (70%) have hedges in place covering a mean of 67% of their purchasing. Breaking it down, 40% of those retailers have forex hedging in next-day delivery, nominated day, Click & Collect and Collect from a Third Party are now a pre-requisite for all retailers.

All of this means that retailers will need to invest in integrated online platforms and infrastructure at a time when many have limited capacity to make the necessary investment. There is also a significant lag between capex and the generation of operating cash flow.

“The UK retail sector has been developing at a very rapid pace,” says the CFO of a clothing retailer. “To compete, we had to create a strong online platform and invest heavily in marketing. We had to partner with online platforms to sell our products on their sites in order to reach customers. We’ve also given out a lot of concessions to help us increase our customer base.”

But for those that get it right, the payoff can be worthwhile: “The retail environment has changed to our benefit,” says the Head of Finance at a homewares retailer. “The shift from traditional retailing to online sales channels has significantly improved our business performance, and increased our sales and customer base. We are growing nearly 60% in sales every year and estimate we’ll have similar growth for the next five years. Our online-only sales are more efficient and price friendly for customers, so this change in shopping behaviour has greatly benefited our business growth.”

The impact of currency
In the midst of all this uncertainty, currency volatility has become a major issue since the EU referendum: sterling has slumped in value by around 17% against the US dollar and 11% against the euro.

Although some retailers may benefit from foreign tourists taking advantage of the weaker pound, all are facing rising sourcing costs, which potentially will have a massive impact on gross margins as hedges unwind.

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The Head of Finance at a similar retailer with overseas operations adds: “Currency volatility is one of the key challenges we are dealing with, as it has hampered our pricing in overseas markets. As a result, we are facing competition from local suppliers whose prices are not affected by the volatility in the currency.”

“While stronger retailers will be able to push through price rises without too much damage to the top-line, and others will be able to take steps to mitigate the currency impact, we would suggest that at least some retailers have yet to face up to the reality of the gross margin threat.”

Gavin George, CEO of Alteri Investors
place until the fourth quarter of 2017, with 26% hedged until the first quarter of 2018 or later. As such, we would expect to see a phasing of price increases through 2017 and into 2018.

Just over a third (34%) of respondents believe that their company’s financial results (gross margin) will suffer after the current hedges roll off, while 66% do not share this view. While price rises and a number of other initiatives, including changing product specification and sources of supply, are being explored to lessen the impact, the fact that two-thirds of retailers believe that their gross margin will not be affected is somewhat surprising.

“While stronger retailers will be able to push through price rises without too much damage to the top-line, and others will be able to take steps to mitigate the currency impact, we suggest that at least some retailers have yet to face up to the reality of the gross margin threat,” says Gavin George, CEO of Alteri Investors.

**Pricing play**

Most respondents are preparing for retail price hikes in 2017, although they differ in terms of the amount. While the majority (69%) anticipate a spike, 38% put the figure at 5% or more while 31% predict it will be less than 5%. The rest expect prices to stay the same.

According to the Finance Director at a clothing retailer forecasting a below 5% jump: “We plan to increase prices of our products marginally to compensate for any increase in prices.”

Those in the 5% and higher bracket are worried about the toll on the bottom line, as the Financial Officer of a homewares retailer points out: “We are unable to absorb the impact on our own as it will affect our ability to repay debt, including to shareholders. They could thus lose interest in our business and withdraw their investments, leaving us without capital to manage our operating environments.”

Regardless of the predictions, over half (58%) of respondents are not expecting to pass the full amount of any cost rises on to consumers. Larger firms with well-known brands will be in a better position to deal with these rises and protect their margins. For example, the CEO of clothing retailer Next, Lord Wolfson, has already stated repeatedly that the brand’s prices could rise by 5% in 2017 due to currency pressures. Undifferentiated brands, on the other hand, are unlikely to risk significant price hikes or curb discounting for fear of losing customers and damaging the top line.
Supply change?

Just over half (52%) of respondents in the Alteri/Debtwire study do not have any plans to change suppliers as a result of the devaluation of sterling.

“Overall, the cost of doing business has not increased much. We do not plan on changing our supply chain strategies as they are optimised and have not really been impacted much by the devaluation of the supply chain,” says the CFO of a clothing retailer. “If the supply chain is impacted in future, we will consider making changes.”

Others are not so optimistic and are shifting gears in an effort to become more efficient, despite the fact that many have already squeezed their supply base fairly hard: “We are negotiating our payment terms with our suppliers from overseas markets and this is going to lead to an increase in our working capital cash flows by the end of this year,” says the CFO of a clothing retailer.

The Finance Director at a homewares retailer adds, “Our strategy to mitigate currency risks is to reduce the supplies coming in from expensive countries and find businesses in neighbouring markets that can produce the same products at a slightly raised cost. This will help us reduce logistics and shipping charges from distant locations and we can align distribution through our networks in the regional market in which we operate.”

Many respondents echo this sentiment, renewing supplier contracts and revising costs as a result of the currency changes. Some are limiting production of products that may have a heavy impact on costs and are sourcing from countries where prices are more favourable. Others are tweaking the specifications of certain products and making corresponding changes to price points.
UK retailer debt: a breakdown

Alteri conducted a research exercise into 100 UK retailers representing all sub-sectors, with combined turnover of just under £200bn. The combined debt of these companies was just under £40bn, with bonds accounting for 58% of the total. Direct lending comprised 24%, dominated by bank debt while non-bank direct lending (credit funds) came in at just 1%. Undisclosed traded positions of credit funds and their participation in larger syndicated situations are not included in this data. Shareholder loans accounted for 15% of the total. Extrapolating Alteri’s data, overall UK retail sector debt stands at roughly £58.4bn with bonds comprising c.50%.

As to be expected, PE-backed businesses accounted for a disproportionate amount of debt in the study, representing just 5% of study turnover but 20% of the total debt, albeit half of the debt within these businesses is shareholder loans. It’s also no surprise that PE-backed businesses are far more likely to tap into non-bank direct lending sources, accounting for 65% of the lending by credit funds in the study.

Asset-based lending, which has gained limited traction in UK retail, is included in the overall bank debt figure with ABL providers split between the larger players including Wells Fargo, PNC and Bank of America and lenders focused on smaller loans, notably Shawbrook and Leumi.

In terms of maturities, there is limited evidence of short-term forthcoming peaks. As to be expected, bonds with long-term maturities peak beyond 2020, as do shareholder loans. There was a mini peak in bank debt maturity in 2016, skewed by a number of major retailers renewing RCFs.

Data split by lending type

Source data based on publicly-available reports and accounts.
Where next for UK retailer debt?
At the moment, UK retailers do not seem to be overly concerned about their funding positions. Almost three-quarters of respondents say that their debt levels will be the same or lower by the end of 2017.

According to 88% of the respondents, traditional bank lending remains as available now as it was in previous years, if not more so, while 74% do not expect their funding requirements to be affected this year despite the volatility wrought by year-round discounting, Brexit, online commerce and currency volatility.

Against the deteriorating climate and increased trading pressures facing the sector, are retailers right not to be overly concerned about leverage and the future availability of finance?

While the quantitative replies in our survey suggest a positive outlook, the qualitative comments from respondents paint a more diverse picture.

How would you characterise the availability of bank credit to your company in 2016 compared to previous years?

Increased greatly

- 6%

Increased slightly

- 30%

Stayed the same

- 52%

Decreased slightly

- 12%

“Non-bank lending rates are higher, reflecting the risk profile. But the real issue is access to capital. Banks and non-bank direct lenders are highly selective towards the sector.”

Fraser Pearce, Director of Lending, Alteri Investors
The situation is highly polarised: banks are still very much open for business but they are being more selective, restricting lending to the better credits at historically modest debt leverage ratios. Retailers that don’t fit these criteria should arguably be more concerned than they appear to be.

As one CFO at a clothing retailer puts it, “Banks have restructured their procedures and are lending to businesses with positive cash flows only. Other businesses are facing challenges, be it in retail or any other sector. This is mainly because of the macro-economic uncertainties and geopolitical issues, which have impacted the banks’ ability to lend.”

These views are reflected by a Finance Controller at a department store/mixed goods retailer: “We are underperforming and this has reduced the number of available creditors to our business. Bank credit is available but a lot of scrutiny and conditions are applied by the banks. This is making lending activity very challenging and unreasonable for the business.”

Even those who haven’t experienced any difficulty accessing finance are clear that it’s down to their robust performance and solid market position. As the Financial Controller of an electricals retailer says, “We approached the financial institution and, looking at our brand name and our performance, they were very open and willing to give us credit.”

Other respondents have found that banks will only participate in certain financing activities: “Banks are open to lending to the retail sector but are making strategic choices as they fear lending to businesses that have low levels of performance and growth potential,” says the Finance Director at a clothing retailer.

What proportion of your company’s total debt will comprise non-bank direct lending from credit funds (excluding any lending from shareholders/investors) by the end of 2019/2021?

<table>
<thead>
<tr>
<th>Year</th>
<th>Mean answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019</td>
<td>2%</td>
</tr>
<tr>
<td>2021</td>
<td>4%</td>
</tr>
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“Lending for refinancing has reduced considerably and businesses in those situations are considering alternate strategies to source funding through other means.”

Respondents acknowledge that they face serious headwinds, as more onerous Basel III regulations force banks to withdraw from unprofitable business lines and become more selective.

One optimistic homewares retailer believes that banks will start lending to the consumer sector again because of the massive growth potential it has displayed through technological innovation and online sales channels. These have made this sector a high-growth market and therefore “investments will start to flood in by the beginning of [2017].”

**Bond market**

Bank lending is not the only funding source going through significant change. The bond market, which has been a popular financing pool, is losing its shine due to market conditions. Since the Trump election, the rotation to equities from bonds has gathered pace although it may not be a smooth flow due to political uncertainty.

Different segments of the market have already been impacted. Take high-yield:
Debtwire’s leveraged finance data reveals that, out of a total of €14.9bn of high-yield bonds issued by retailers in Western Europe between 2010-2015, close to half (€7.03bn) were by UK retailers. By contrast, these firms were notable by their absence in 2016, with only three high-yield bond issuances that year, worth €800m.

Only 8% of respondents to our survey expect to tap the bond market, compared with 20% who have issued bonds in the past. This is mainly due to lacklustre valuations and the end of the 30-year bull run.

The CFO of a homewares retailer believes that, “The bond markets are faring badly due to the uncertainties and volatility in the market, which has caused a decrease in business performance. This has affected investor appetite and sentiment towards the bond markets, which are unlikely to fare well in the near future.”

His counterpart at a clothing store notes that, “The bond market has been facing many different problems and has changed quite a bit. Companies are less willing to invest in bonds and issue bonds, people are not willing to invest in risky bonds and there has been a major change in the way bonds are issued.”

There is also anxiety over retailers with bonds trading at a discount over the last year. As the Group Financial Controller at an electricals retailer puts it, “The lack of investors in the market has been a major problem for companies. The bond market has been very volatile and Brexit has added to that volatility. Companies are issuing bonds at a discounted rate to get investors to invest in their bonds and to help them generate a capital base in current market conditions.”

“Banks are open to lending to the retail sector but are making strategic choices as they fear lending to businesses that have low levels of performance and growth potential. Lending for refinancing has reduced considerably and businesses in those situations are considering alternate strategies to source funding through other means.”

Finance Director at a clothing retailer

Always looking for alternatives
In theory, these changing dynamics open the door for non-bank lending to make its mark. Incumbent lenders are being more cautious and selective yet there is a clear need for new and flexible funding into the sector. But the majority of funds are also taking a cautious approach to retail.

While there are opportunities for funds, this growth in non-bank lending will not happen overnight — but the study shows a steady and significant upward progression over the next four years from 0.5% of respondents’ current debt to 2% by the end of 2019, and 4% by end of 2021.

“We want to reduce our dependence on banks,” says the CFO of a clothing retailer, who was quite explicit in his wish to diversify his funding sources.

“By accessing capital from sources other than banks, it is simpler for the company to grow as there is less interference. Banks interfere in business activities and this affects our growth and strategies.”
UK retailers looking for this flexibility may also be prepared to pay above the odds for the privilege.

“Non-bank lending rates are higher than traditional bank lending, reflecting the risk profile,” says Fraser Pearce, Director of Lending at Alteri Investors. “Rates range from 6%-11%, although in the main they sit between 6%-8%. Importantly though, there’s a real opportunity for banks and credit funds to work together to find an acceptable rate that works for all parties. It demands more innovative lending solutions, but there’s significant potential for greater deal volumes.”

Some retailers seem willing to take this path, as the CFO of a clothing retailer points out: “We would like to move away from banks and tap into the market to get capital. We would not mind raising money from credit funds to fund our growth and we feel it will be better for us in the long run.”

As the Alteri research highlights, private equity-backed businesses will most likely continue to be at the forefront of the advance into credit fund lending. By definition, PE-backed businesses are comfortable seeking leverage and are open to new forms of financing.

“There’s a real opportunity for banks and credit funds to work together to find an acceptable rate that works for all parties. It demands more innovative lending solutions, but there’s significant potential for greater deal volumes.”

Fraser Pearce, Director of Lending, Alteri Investors

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Conclusion

A tale of two futures

Sector headwinds will increase the gap between winners and losers, make funding harder to source for many and could even prompt further restructuring activity. But there are also real opportunities amid the gloom.

UK retail is facing a host of strong headwinds — ongoing discounting pressures, changing consumer behaviour, including the continued shift online, and Brexit. And then there’s the currency threat to gross margins. The challenge of balancing margin protection and top-line growth in the face of rising cost prices and consumer pricing pressures, all in an intensely competitive environment, is prompting retailers to respond with different pricing strategies…which will no doubt yield markedly different results. In view of these dynamics, some of the findings in this survey, with respect to the trading climate, are surprisingly optimistic, at least for a significant portion of the sector.

If these pressures flow through to a sustained deterioration in trading performance, the apparent optimism concerning debt levels and future access to finance could also be misplaced, particularly if traditional lenders continue to adopt an increasingly selective approach to the sector.

For some of our respondents, there is already a clear appetite to embrace non-bank lending. Tougher trading conditions ahead could also signal further participation in the sector of some of the special situation non-bank direct lenders, able to plug the liquidity gap on a flexible basis.

The hugely divergent responses throughout the survey underline the enormous polarisation in the sector with the gap between winners and losers arguably wider than ever before. The weaker trading environment will expose this even further. In fact, we could see a further wave of restructuring activity.

Since 2013, there has been a limited amount of formal UK retail restructurings, following a high level of activity between 2010 and 2013 which freed up the competitive environment for the remaining players, particularly in some of the structurally challenged sectors such as electricals and entertainment.

This time round, the long tail of undifferentiated mid-market clothing businesses look particularly at risk. A slower market could also precipitate definitive action by private equity sponsors on long held stranded assets, which have been starved of much-needed investment, not to mention remaining zombie retailers. This will be the case particularly if rising inflation eventually drives a meaningful uptick in interest rates.

However, the survey also highlights well-placed optimism for the years ahead with well-funded retailers with strong, differentiated brands not only capable of weathering the storm, but ready to seize the growth opportunities, particularly in digital and international expansion.

UK retail is facing a tale of two futures.
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