A changing retail landscape
Addressing the challenges head on
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Retail in 2017 and beyond

We expect challenging times for retailers as consumer spending habits and cost pressures squeeze margins at a time where digital transformation is changing the retail landscape.

The UK retail industry continues to go through a period of rapid change, with digital transformation continuing to be a major factor impacting the high street. The role of the store is changing and this traditional asset is, in some cases, a liability.

The Q2 2017 Deloitte Consumer Tracker survey indicates that economic uncertainty following the recent General Election and Brexit developments, coupled with rising inflation is further adversely impacting consumer confidence. Consumer confidence has fallen for three successive quarters and is now at its lowest level in over three years.

To compound the demand side challenges, required investment in technology, marketing and order fulfilment, along with input cost inflation are placing further pressure on margins. In addition, our analysis indicates that prices have fallen for most of the last five years, with discounts in the run up to Christmas 2016 reaching record levels.

We would like to share with you our view of the key challenges for the retail sector and how we are uniquely placed to assist you in assessing and addressing them head on.

We hope this resonates with you and, as always, we welcome your feedback. We look forward to discussing our views on the sector more broadly with you.

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UK Lead Partner, Retail Restructuring Services
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Dan Butters
UK Lead Partner,
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“Retailers enjoyed a strong year of growth in 2016, however, our analysis shows that profitability is declining, with three year average margins falling by two percentage points between 2010-11 and 2014-15. Looking ahead to 2017, we anticipate further challenges and a perfect storm of cost pressures, which is likely to drive domestic restructuring activity and overseas owners to consider strategies in respect of their UK footprint.”

Rob Harding
Partner
UK Lead, Special Situations M&A
The retail profitability challenge

A six fold increase in e-commerce in the last decade, together with ongoing cost inflation has squeezed retailers’ profits and rendered many retailers with larger store portfolios than required.

1. Three year average profit margins have fallen between 2010-11 and 2014-15

<table>
<thead>
<tr>
<th>Year</th>
<th>Profit Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010-11</td>
<td>6.1%</td>
</tr>
<tr>
<td>2014-15</td>
<td>4.0%</td>
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</table>

Three year average profit margins have fallen between 2010-11 and 2014-15.

2. Rising importance of e-commerce requires ongoing investment to stay relevant

The rapid growth of e-commerce

<table>
<thead>
<tr>
<th>Year</th>
<th>Online Sales as a Percentage of Total Retail Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nov 2006</td>
<td>2.8%</td>
</tr>
<tr>
<td>Nov 2016</td>
<td>16.0%</td>
</tr>
</tbody>
</table>

The rapid growth of e-commerce.

3. Net reduction of occupied retail space in 2016. LDC estimate that 10% of retail and leisure units will close each year moving forward

Openings & Closures of Retail and Leisure units across UK, 2012-2016

4. Top line pressure as prices fall for past five years

Deflation in retail

<table>
<thead>
<tr>
<th>Month</th>
<th>Deflation Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan 2012</td>
<td>-2.5%</td>
</tr>
<tr>
<td>Feb 2013</td>
<td>-1.5%</td>
</tr>
<tr>
<td>Apr 2014</td>
<td>-1.0%</td>
</tr>
<tr>
<td>Jul 2015</td>
<td>0.0%</td>
</tr>
<tr>
<td>Jan 2016</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

Deflation in retail.

5. Perfect storm of cost pressures present potential for a 3-5 percentage point fall in operating margins

Perfect storm of cost pressures present potential for a 3-5 percentage point fall in operating margins.

As a consequence, it is likely that we will see greater differentiation in the market. Retailers are already responding to these challenges but the question is – are they moving fast enough in the digital age?
Consumer confidence outlook

Our analysis shows a further fall in consumer confidence in Q2 of 2017 with levels now reaching the lowest seen for over three years.

The decline in the headline rate of consumer confidence is driven by a quarterly drop across the four main measures which make up the confidence index. In particular, consumer confidence in disposable income and essentials spending fell by seven percentage points and four percentage points respectively this quarter to reach their lowest level in over three years.

With more pressure on disposable incomes consumers have started to reduce their expansionary behaviours which were on the rise over the last two years supported by low inflation and the availability of cheap debt. A possible rise in interest rates to help reduce inflation, would also raise the cost of credit and could further slow spending growth.

Despite the outlook for growth being influenced by the wider prospect of the UK leaving the EU, the question remains whether record levels of employment and cheap borrowing will be sufficient to ensure consumer spending slows rather than collapses before the end of 2017.

Source: Deloitte Consumer Tracker Q2 2017
“You can feel the storm coming but the impact on retailers will differ in each case. We know some retailers are already taking decisive action, such as hedging currency in the short term, but many could become exposed to further economic volatility. The demand challenges and significant cost pressures we outline cannot be taken lightly.”

Dan Butters
UK Lead Partner
Retail, Restructuring Services
Our expertise and how we can help

We are uniquely placed to help maximise value in retail situations

- Creating a seamless digital experience
- Understanding the challenges and designing the solutions
- Optimising the store portfolio
- Realising the power of data and analytics
- Managing the extended enterprise
- Identifying and delivering performance improvements
- Implementing the optimal outcome
- Securing capital to drive growth
- Achieving successful exits in challenging conditions
- Strategic re-positioning through M&A
“We have invested heavily in developing a suite of market leading analytics tools and building our retail advisory capability. This allows us to very quickly identify and assess key issues and design and implement bespoke solutions to maximise value for our clients, whatever challenges they may face.”

Ian Geddes
Lead Partner, Head of UK and NW Europe Retail
Our expertise and how we can help

We have developed a number of proprietary retail analytics tools to help you to identify key challenges and provide insight, working with you to design the optimal bespoke solutions.

### Realising the power of data and analytics

Retail is a data rich industry and analytics is a key driver of its evolution.

Our retail analytics team specialise in the application of skills, technologies, apps and methods to reveal insights from data to help retailers make better decisions and informed actions.

Examples:

- Helping a major UK multi-product retailer increase bottom line profit by 10%

### Optimising the store portfolio

Real estate is central to traditional retailers’ brand proposition, however multi-channel retail and the rise of click and collect is creating massive challenges.

We have developed a suite of bespoke analytics tools to help retailers optimise their store footprints. These include L3, a store location planning tool (where at the touch of a button we can visually display a retailer’s footprint together with associated demographic information and quickly assess potential portfolio challenges and optimisation strategies) and D-Rex, a virtual clearing house for retailers to acquire/exit leases.

Examples:

- Helping to support PureGym’s 5 year network expansion strategy with the property team using our bespoke analytic solution to evaluate each new potential location.

### Creating a seamless digital experience

The influence of digital channels on retail sales is unprecedented and the impact of digital activity continues to rise.

Our Deloitte Digital team assists retailers in unlocking value from digital. We work with clients in end-to-end digital transformations spanning customer engagement and experience, proposition, web design and management, eCommerce, fulfilment and back office optimisation.

Examples:

- Helping John Lewis to increase online sales by £200m (25%) a year earlier than planned.

### Identifying and delivering performance improvements

Given the rapidly changing dynamics of the retail sector and the intense pressure on margins, the ability to identify and deliver financial and operational performance improvements is key to all stakeholders.

Our performance improvement team deliver cash / EDITDA improvements through operational efficiencies with a strong record in identifying, planning, and implementing prioritised performance initiatives that deliver real and sustainable improvements.

Examples:

- Helping a major UK electrical goods retailer to reduce costs by 10%, extend terms with their credit insurers and secure a new Asset Based Lending facility.
We have the depth and breadth of retail sector, functional and situational knowledge and experience to help retailers in implementing solutions to whatever challenges they are facing.

**Managing the extended enterprise**

Your supply chain is only as strong as its weakest link. The financial impact and disruption of even a small supplier suffering distress or insolvency can be critical.

Our Supply Risk Mitigation team helps retailers to better understand the financial health of its suppliers, identify potential risks and work with management teams to develop mitigation strategies.

**Examples**

Helping a major European clothing retailer to develop an integrated supply risk mitigation strategy.

**Securing capital to drive growth**

Demands on capital continue to increase in order to remain relevant, whether funding an investment in digital transformation, restructuring of a store portfolio or M&A activity.

Our Debt Advisory team works with both high performing and stressed businesses to assist in planning, identifying and securing additional capital to fund growth plans and major investments.

**Examples**

Helping a number of UK retailers to raise £1.5bn+ in debt funding over the last two years.

**Strategic re-positioning through M&A**

Companies face a wide range of challenges across the business life-cycle; whether raising seed funding to establish themselves, obtaining new sources of finance to expand organically / by acquisition, realising value by a sale to new owners or accessing the public markets.

In addition to our traditional core M&A services, using our “iDeal” analytics platform we can analyse and synthesise multiple large datasets, building insights that can help to quickly identify and unlock value in M&A.

**Examples**

Helping the parent of a global retail business to identify a profitable core and potential hidden value using iDeal.

**Achieving successful exits in challenging conditions**

Margins are under more pressure than ever, alongside the need for continual reinvestment of capital to remain relevant at a time of rapid digital transformation.

Deloitte’s Managed Exit and Special Situations M&A teams can help clients to review and evaluate the main options, being to “fix and retain”, sell; or wind down operations.

**Examples**

Deloitte Partners acted as administrators of this iconic music, film and game retailer successfully securing a going concern sale of the restructured business saving 2,600 jobs whilst preserving a heritage brand.
Market leading digital team who help design and maintain some of the leading retail websites – uniquely positioned to assist with the online migration

Proprietary in-house benchmarking and analytics tools that can be deployed to quickly identify improvement potential within real estate, supply chain and pricing models

Hands on operational performance improvement capability, including our operational turnaround and unique in house real estate advisory businesses

Established debt advisory and M&A capabilities, including designated Special Situations M&A and Managed Exit expertise

In situations where deep restructuring or insolvency expertise is required, we have the best credentials

We have the complete integrated suite of capabilities to help retail stakeholders maximise value in all situations
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- **Major European clothing retailer**
  - We enabled our client to improve their markdown process through developing a predictive tool to optimise the selling price for the maximum margin and sell through. This was implemented using end-to-end support and change management best practice and it resulted in a c. 7.8% efficiency uplift, or over £50m per annum.

- **Large UK fashion and homeware retailer**
  - We created a data analytics tool to enable our client to understand how to utilise their store spaces to optimise profitability. This improved space optimisation resulted in a £25m increase in profits for the client.

- **Ladbrokes**
  - We developed a range of analytics tools to enable our client to optimise their estate profile and improve strategic decision-making. These tools enabled them to execute informed shop rationalisation, category management, pricing and promotions management and shop refurbishment and formatting.

- **Clinton Cards**
  - We worked for the company’s lenders undertaking an independent review of the business together with an assessment of their options following a deterioration in trading. Our work involved a full analysis of the real estate footprint and potential restructuring options. We successfully secured a sale of the lenders’ debt facilities at par enabling them to exit without the risks associated with a trading insolvency.

- **Project News**
  - We were instructed by the trustees of a UK high street retailer with annual revenues of c. £2.5bn. to advise on the implications of de-merger and the options to fund a pension deficit.
  - We supported the trustees in negotiations with the group and submissions to the regulator in respect of the proposal.

- **pets at home**
  - We helped the group solvently exit non-core entities following a flotation, a vital step in the flow of funds on the day of admission to the LSE.
  - We integrated our service with the logistically complex IPO implementation plan and flow of funds.
We were engaged by PVH who had recently acquired the underperforming Warnaco business.

We assisted the executive management team of this UK fashion retailer in preparing a wide ranging turnaround plan to address the key challenges facing the business. As part of our work we developed an integrated financial model based on a series of key performance indicators and commercial analytics to ensure that the financial projections were fit for purpose.

The turnaround plan underpinned the Group’s sale process and provided an ongoing planning tool for the management team to continue to plan and track performance going forward.

We provided advice with respect to financial restructuring and contingency planning.

A complex consensual deal between the shareholders & mezzanine lenders was agreed, with mezzanine lenders converting their exposure into equity, deleveraging the business.

We subsequently helped the company, successfully renegotiate debt facilities enabling the launch of a £310m rights issue.

We initially advised the company’s lenders in respect of the group’s performance and projections as the retailer suffered trading difficulties.

We were subsequently appointed as administrators, managing the largest retail insolvency in UK history, with 807 stores and c. 30,000 employees.

We initially carried out contingency planning, assessing funding requirements.

We were subsequently appointed as administrators and traded the business whilst successfully disposing of 238 of the 536 stores, saving over 2,000 jobs.
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