

RETAIL AND WHOLESale
BDO RETAIL FORECASTS 2010...
TURNING THE CORNER?



► HAVING COPED BETTER THAN EXPECTED WITH THE WORST RECESSION IN A GENERATION, THERE ARE SIGNS THAT RETAILERS WILL ENJOY A GOOD CHRISTMAS. HOWEVER, COULD A CHEERY FESTIVE SEASON LEAD TO A NEW YEAR HANGOVER?

THE STORY SO FAR...

With the economy in its steepest downturn for a generation, consumer confidence at an all-time low, and unemployment rising rapidly, underlying conditions for retailers could not have been worse at the start of the year. Sales across pretty much every sector had gone into free fall after the collapse of Lehman's, with little sign of any improvement.

What's more, an unprecedented wave of discounting had hit the high street, harming margins but not really boosting demand. The pressure on clothing and fashion retailers was particularly intense as the speed of the slump had left many holding excess inventory. A string of well-known retailers had been forced into administration, with some disappearing forever. Prospects for 2009 looked very bleak.

HOPE SPRINGS

Then slowly the mood started to change. A last minute surge in festive spending, which strengthened into the New Year, helped save Christmas 2008 from being a total disaster. Although sales dipped in February, not helped by the severe weather, a return to the depressed run rates of the autumn failed to materialise.

This upward trend continued into spring as consumers became more confident and the economic news gradually improved. Furthermore, helped by the swift cutting of interest rates and falling fuel bills, disposable incomes for those in employment rose. So, while consumers used some of this extra cash to pay off debts and increase savings, a significant proportion was still spent in the shops.

As a result, demand did not suffer that badly, with overall sales remaining positive. Although discretionary spend on non-food items did decrease, the fall was not as bad as feared. Lower interest rates also helped bring some stability to the housing market, which supported the beleaguered homewares sector.

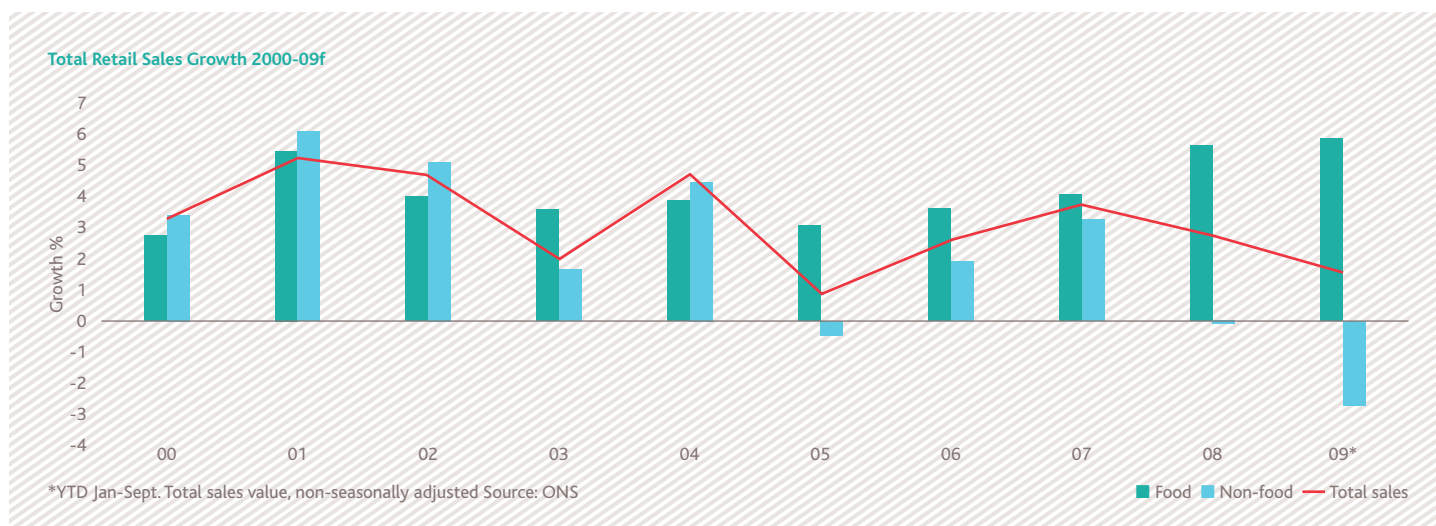
SELF-HELP

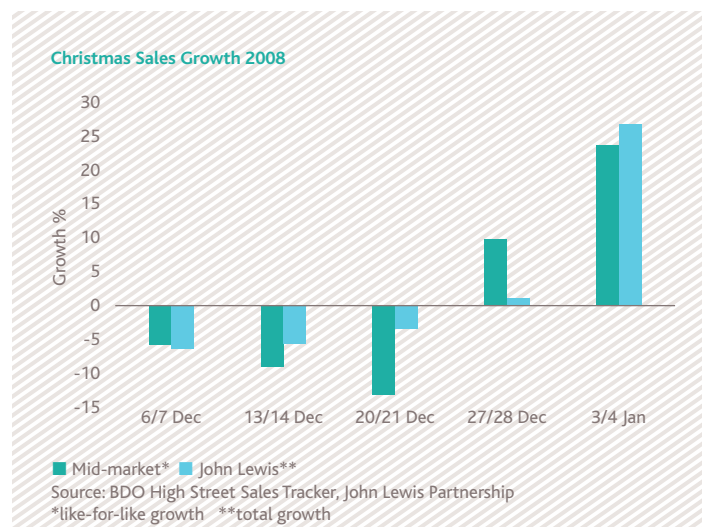
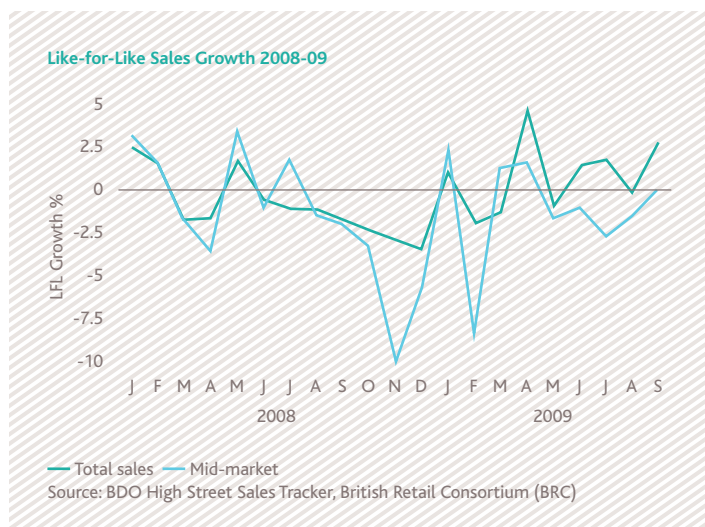
Meanwhile, from the retailer's perspective most responded very quickly and effectively to the downturn, addressing costs and adopting innovative promotional strategies. Although the weak pound had an adverse impact on import costs, this was offset to a certain degree by lower buying and distribution expenses. Around a third of stores also cunningly did not pass on the cut in VAT, pocketing the difference to boost margins.

There was also good news on the property front with rents generally remaining flat, while some retailers successfully negotiated moves to monthly payments. A sizeable shakeout of the weaker players was also beneficial, with significant retail capacity worth an estimated £4bn withdrawn. In certain categories (entertainment, childrenswear, kitchens, carpets) this impact was extremely evident, with competition diminishing to such a degree that the remaining players picked-up significant trade immediately.

BETTER THAN FEARED

All told then 2009 has not been a total write-off. Yes, conditions have been difficult, but things could have been a lot worse. There has been a sizeable shake-out of the weaker players, while discounting has been prevalent, but a bloodbath on the high street has not occurred. Britain, it seems, is still hooked on shopping despite the recession. The key question is will this addiction withstand the tax and unemployment headwinds that surely lie ahead.





CHRISTMAS 2009... STUCK IN SECOND GEAR

One trend we are hearing repeated in our discussions with retailers is that although the worst effects of the recession may have passed, and trade has bottomed out, a material pick-up in demand is not really occurring. Essentially, this is what we expect will happen at Christmas. We predict overall sales will grow by 3 per cent, allied with a modest improvement in gross margins (+50-100 basis points).

We don't expect to see a repeat of last year's very deep pre-Christmas promotion and so fewer one day 'spectaculars' run by the big department stores. Last year over 80 per cent of high street retailers either launched Sales or offered other promotions in the run up to Christmas.

However, we still believe trade will be fundamentally promotion led, especially across the fashion sector. The big difference this year is that promotions will largely be proactive and planned rather than reactive, with stores expressly buying for promotions. There may even be some cases of stock-outs of popular lines as retailers will be trading with lower inventories this year.

As in previous years we again foresee a considerable proportion of Christmas shopping happening in the last week, with consumers delaying festive purchases until the very last minute. We expect a late surge in spending once internet delivery dates for Christmas Day have passed, a date that looks increasingly likely to be impacted by a national postal strike.

TWIN PEAKS

Last year a new trend emerged in which a second very large trading peak occurred immediately after Christmas Day. We think this will be even more marked this year as retailers use the impending VAT increase as a key promotional tool. Additionally, we believe more consumers will give cash and vouchers as presents this year, fuelling extra spending post Christmas Day.

The week between Christmas Day and New Year's Day therefore looks like it will be huge. Boxing Day will be busier than ever given that most retailers are planning on starting their New Year Sales on this day rather than waiting until the 27th, which falls on a Sunday this year. Although the New Year Sales have always been popular, this ritual of hunting down post-Christmas bargains is now coming near to supplanting Christmas Day shopping itself. The implications of this mean that retailers should not get too fixated with pre-Christmas trading. Significant gains should be able to be made during the Sales, especially for stores that retain some underlying pricing power.

ONLINE CRACKERS

The other big trend we see occurring is that multi-channel retailing will become even more embedded with consumers despite the looming postal strike. Last year nearly half of all consumers bought at least one item online, with internet sales in December growing by 14 per cent, a figure we see being matched this year.

In particular, the phenomenon of online shopping on Christmas Day is set to grow significantly. Last year John Lewis enjoyed its busiest hour online on record at 1900 hours on Christmas Eve, shortly after the start of its Clearance Sale. On Christmas Day itself, visitor numbers to the John Lewis site were 12 times higher than in 2007. We expect other retailers could also experience a similar uplift this year once stores close on Christmas Eve.

MORE FORGIVING

Christmas 2008 was dominated by heavy discounting and uncertainty. This year conditions should be slightly more forgiving. However, don't expect big gains to be made, or trade to come early. As per last year consumers will leave it until the very last minute to shop, with many spending more in the week after Christmas Day than before it. The VAT reversal should herald a significant pull forward of demand. However, maintaining this momentum into 2010 won't be easy.

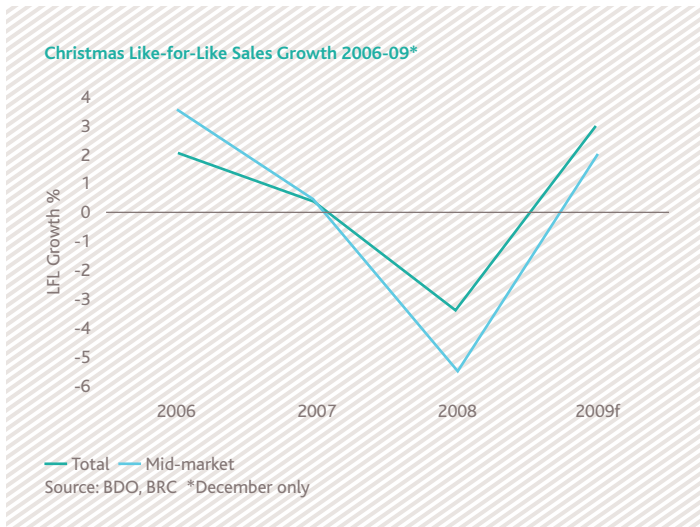
2010... LITTLE REASON TO APPLAUD, TOO EARLY TO DESPAIR

On the face of it, 2010 should see a continuation of the slow recovery in retail spending witnessed during 2009, as the economy comes out of recession. A lift in sales of a couple of percentage points looks well within reach for most retailers, with a corresponding increase in margins.

However, the retail sector rarely performs entirely in-line with the trajectory of wider economic cycles. A host of other less predictable events also play a major part. In 2010, the big unknown factor is how consumers will respond to the VAT reversal, as well as further likely tax increases.

VAT IS THE QUESTION

For all the sniping the VAT decrease has helped underpin consumer spending this year, if not directly, it has had a positive psychological impact. It has also assisted in propping up margins. Although there is a general perception that the consumer will probably wear an increase back



to 17.5 per cent, this is far from certain. In Germany, when a similar rise was widely publicised and implemented in 2006, retail sales rose steadily then plunged by nearly 10 per cent.

The other uncertainty is what impact higher VAT will have on consumer confidence. The perception of rising prices could significantly damage sentiment, especially if speculation about a further increase mounts. We expect that the General Election will be swiftly followed by a rising tax burden, with VAT used as the principal tool for revenue rising by whatever party wins power. The implications of VAT hitting 20 per cent could result in sales slumping during the second half of the year.

UNEMPLOYMENT CONCERNS

Unemployment is the other major downside risk. Forecasts suggest this will continue to increase throughout the year, exceeding the three million mark by the end of it. With so many people out of work wage growth is bound to remain subdued, eroding retail spending power. Moreover, job security fears will also probably further push-up the amount consumers save.

AND NOW THE GOOD NEWS

Nevertheless, there is still plenty for retailers to remain positive about. The recession is likely to officially end in the first quarter of the year, while house prices are on an upward curve. Consumers also currently feel more positive, with attitudes towards spending improving sharply.

In addition, retailers have done an excellent job at putting up prices this year through clever tactics and compelling product offerings. This bodes well for 2010. While we expect retailers to approach putting up prices cautiously, avoiding increases in entry level price points, in our opinion many will be successful at implementing rises despite the expected VAT increase. In this regard some will be aided by further capacity reductions, as we still foresee retail insolvencies rising in 2010, as smaller independent companies fail.

POWER TO EXCITE

Finally, we would not underestimate just how ingrained shopping has become to most people. Retail therapy is still one of our favourite pastimes, which we can't see changing even if the recession drags on.



CHRISTMAS WINNERS

- Online:** despite a likely postal strike online sales are still expected to grow by double-digit levels.
- Supermarkets:** a big push into non-food areas, coupled with high-profile promotions should ensure another successful Christmas.
- Mother and baby stores:** the recent baby boom will underpin sales, while reduced capacity will help support margin growth.
- Practical gifts, vouchers and cash:** shopping for bargains in the New Year Sales will come close to supplanting Christmas shopping itself.
- Weekend break shopping destinations:** domestic short breaks that combine shopping.
- Retailers that run targeted promotions:** phased waves of planned promotions that help retain some pricing power for the Sales.
- Alternative parcel couriers:** even without a post strike big retailers have been increasingly switching to couriers.

CHRISTMAS LOSERS

- Second/third tier shopping centres:** with many suffering from vacant units, a lack of footfall will be magnified this Christmas.
- Discount food stores:** with supermarkets increasingly stealing their thunder, discounters need to prove they are more than a one-trick-pony.
- Electrical retailers:** few 'must have' electrical products this year. Low point in the game console cycle.
- Gimmicky gifts:** novelty products will remain unwanted. Thrift will remain top of the agenda.
- Overseas travel hub retailers:** with traveller volumes down, travel hub retailers will struggle.
- Retailers that run unplanned blanket promotions:** spoiler reactive promotions may boost footfall but they will harm margins.
- Post Office:** will retailers and consumers ever trust the Post Office again if they strike during Christmas?

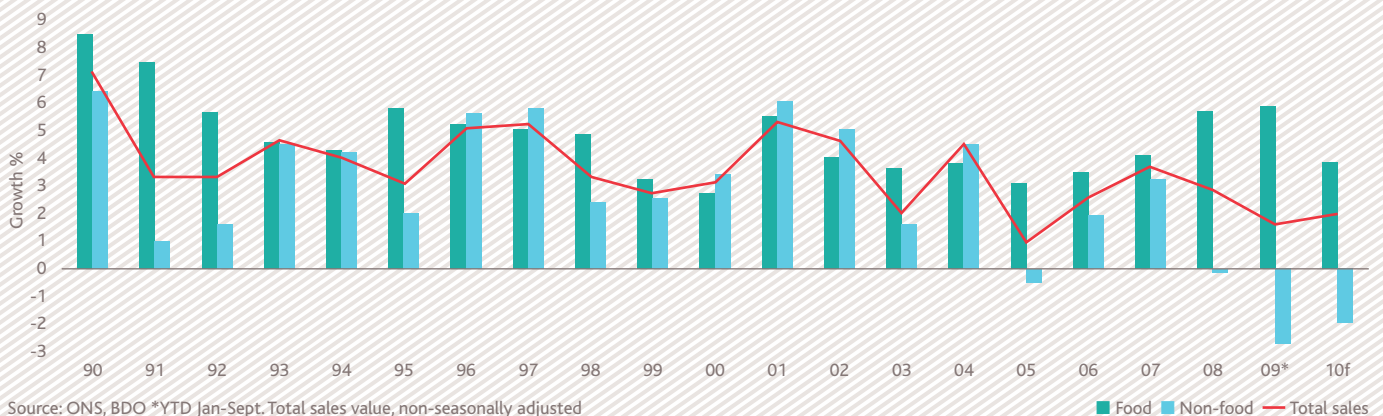
► TEN PREDICTIONS FOR 2010

- 1. Summer VAT increase:** Whoever wins the general election it looks increasingly likely that VAT will be used as the principal revenue making tool. We expect an early increase to 20 per cent to come into force on 1 July.
- 2. Hidden cost burdens:** A host of new charges and regulations will come into effect during the year. The most significant is the Business Rate Revaluation, and associated Business Rates Supplement, that will start on 1 April. Retailers in the Capital will be hit particularly hard.
- 3. Retail insolvencies peak:** The sharp increase in retail failures should peak, with banks increasingly willing to take direct equity stakes rather than forcing retailers into administration. The use of CVAs will continue.
- 4. Money markets show greater interest in retail:** Debt and equity markets will regain some appetite for retail as banks start to offload retail businesses. However, it will be a slow process. Banks won't sell until prices come back near expectations. A number of retail IPOs will be successful.
- 5. Corporate opportunities:** There will be a slow filtering through of M&A activity. Cash rich retailers will be on the hunt for bargains, as will PE houses. Overseas retailers will increasingly look to open stores in high-profile locations.
- 6. Talent shortage:** Experienced managers who have run retailers for turnaround purposes will be in high demand.
- 7. Landlords on the backfoot:** With large swathes of the high street empty, retailers will be in the driving seat on any property deal. Expect landlords to be more creative, offering short-term deals, monthly payments and fit-out cost payments. Nevertheless, some out-of-town retail parks will convert to alternative use.
- 8. New stores and formats:** A number of new brands and formats will emerge as retailers take advantage of the property situation. The most high-profile include the entry of US electrical market leader Best Buy, and a home and electrical format by John Lewis.
- 9. Online march continues:** Online sales are likely to continue growing by near double-digit levels. Most retailers will enhance or launch new sites this year.
- 10. World Cup:** June and July will be dominated by the football World Cup in South Africa. Expect a bonanza for grocers and the sports retailers, while other stores will suffer from reduced footfall.

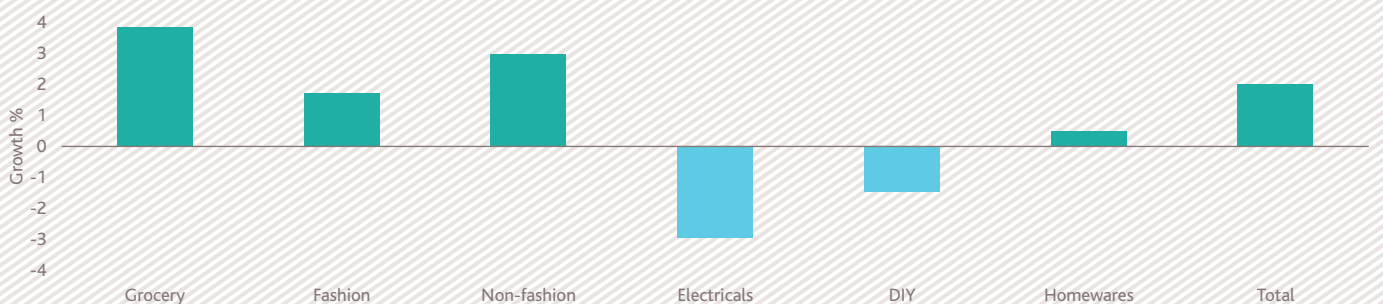
....and one final prediction

We know it's the hope that hurts, but we retain an unquenchable optimism that 44 years of hurt come to an end as England win the World Cup in South Africa!

Total Retail Sales Growth 1990-2010f



Retail Sales Growth Forecasts by Sector 2010



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