Retail Sector Council

Retail - The Great Enabler

The Future of Retail:
A discussion paper by
the Retail Sector Council

July 2023

Foreword

Richard Pennycook, Industry Co-Chair

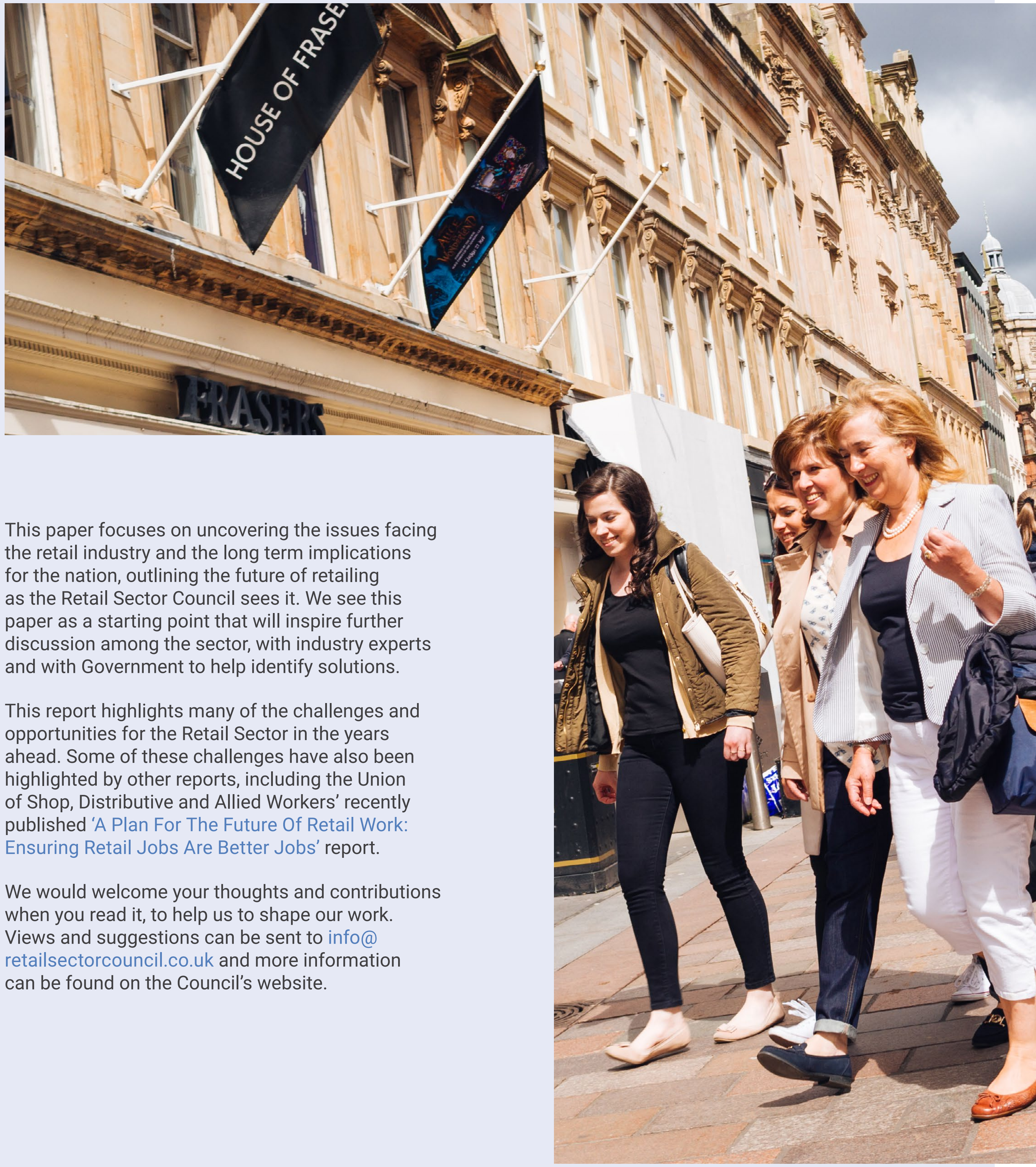
Since the creation of the Retail Sector Council in 2018, I have been the industry co-chair working alongside retail Ministers and industry experts to identify key challenges to growth and productivity for the retail sector. The Council is made up of a range of experienced senior figures from across the sector, representing its breadth both in size and type.

The Council's objectives are driven by industry and consumer needs, and focus on accelerating positive change, increasing retail sector resilience and ensuring it remains robust and sustainable to continue providing a beneficial service to consumers and the community. In order to do that, the Council informs and challenges both the sector and Government on the key issues that the retail sector faces and provides potential solutions.

Since the Council was established, we identified and focused on seven key priority areas, including business costs, skills and lifelong learning, employment, productivity, circular economy and Net Zero, consumer protections, and high streets and importance of place. As part of this work, we have put forward recommendations for Government, provided submissions to HMT on the skills needs of the sector and challenges relating to business rates. It has also successfully delivered projects like Green Street - an information source to provide actions which small retailers can take to become greener more quickly. Green Street is being piloted in Bradford with a circular borrowing scheme for reusable takeaway packaging also currently being trialled after being selected as a winner of the Bring it Back Fund. Lessons learned and an assessment of the pilot to date is also currently being conducted.

As we look ahead to the next phase of our work, it is unsurprising that we should focus on many of the issues that face UK consumers. Retail is a window through which the business world presents itself to the public. As a sector we need to lead on the sustainability agenda, informing consumers so that they can make choices in line with their priorities and challenging producers to up their game. As the UK's largest private sector employment provider, we need to be better at developing the skills our country needs if we are to drive productivity to best international levels of performance. As the main interface to the consumer for much of their economic activity, we need to work with Government to support consumer protections and awareness. We also need a healthy dialogue with Government to work on eliminating unnecessary costs to business (which the consumer ends up paying), whether that be outdated taxes or ineffective red tape.

The Retail Sector Council is now embarking on the next phase of this work, which will explore some of the key themes identified in this paper.



This paper focuses on uncovering the issues facing the retail industry and the long term implications for the nation, outlining the future of retailing as the Retail Sector Council sees it. We see this paper as a starting point that will inspire further discussion among the sector, with industry experts and with Government to help identify solutions.

This report highlights many of the challenges and opportunities for the Retail Sector in the years ahead. Some of these challenges have also been highlighted by other reports, including the Union of Shop, Distributive and Allied Workers' recently published 'A Plan For The Future Of Retail Work: Ensuring Retail Jobs Are Better Jobs' report.

We would welcome your thoughts and contributions when you read it, to help us to shape our work. Views and suggestions can be sent to info@retailsectorcouncil.co.uk and more information can be found on the Council's website.

Introduction

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The biggest risk is not taking any risk... In a world that changing really quickly, the only strategy that is guaranteed to fail is not taking risks.

The retail industry is a cornerstone of the British Economy. It is the largest private sector employer, a major driver of investment and plays a huge role in society generally. This important role is direct and indirect, with many industries feeding off the retail sector –suppliers, logistic companies, tech companies and property companies to name a few. The indirect role in society extends even further with retail helping with environmental issues, mental health issues, social mobility and levelling up. It is a great creator, collector and payer of direct and indirect taxes. It is an industry with low barriers to entry and, consequently, is an industry that gives entrepreneurs opportunities to invest and build. For several generations, many of the UK's best known business people have been retail entrepreneurs. No other industry has the same reach with the consumer, the same geographic/national coverage, or the same ability to implement rapid change - whether change is driven by legislation, by consumer demand or by the broader needs of society. In short, retail is at the centre of the economy and society, punches above its weight in all aspects and is The Great Enabler.

The retail industry operates in a highly competitive way that leads to market efficiency. But there are anomalies that create inefficiencies, that restrict welfare benefits to society and that potentially undermine many of the positives outlined above. This report looks at the issues facing the retail industry and the long-term implications for the nation. It outlines the future of retailing in England as the Retail Sector Council sees it. In the future, the Council will consider the major issues facing the sector and will introduce proposed solutions to help the retail industry remain relevant in a rapidly changing world. It is important that anomalies and inconsistencies are eliminated to present a level playing field, that the Government and Treasury understand the long-term implications if these issues are not addressed and that the industry and the Government work together for the good of the consumer, for the nation and for the environment. But the Council recognises that successful businesses should not be penalised to prop up failing and out of date businesses. Retail evolution is part of the natural business cycle. We hope to stimulate debate and engagement with all stakeholders on this work.

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The potential for retailing to drive growth and to support society is generally under-appreciated. It helps communities thrive and facilitates economic growth. Plus, there is the industry's ability to drive and implement change on many levels. With the right Government support, retail can facilitate changes in shopper behaviour (e.g. move away from single use plastic carrier bags), can help implement Government policy (e.g. can help facilitate levelling up across the country and enable social mobility) and can be a driver of growth through investment in productivity, IT and expansion. There is much that the industry can and does do for itself, but it also requires some Government support and action, with this support set to be repaid many folds over time. Support may be both direct and indirect. The measures that supported business in response to the economic impact of Covid 19 were fundamental to the sector's survival. Beyond fiscal measures Government can set a framework that is both an enabler and a catalyst for growth and investment. Getting that framework right is a key to the future of retail.

If support is not forthcoming then the future for retailing will be concerning for some companies, for some regions and for some cohorts of society. It is important that the industry and the Government continue to work together for their mutual benefit. One intention of this project is to identify areas that the retail industry can help itself even more and to highlight areas where Government help is needed to maximise retail's ability to deliver social good and economic gains.

Despite many positives in retailing, many areas face a challenging future. It is worth remembering that in some parts of the country retailing accounts for up to 20% of total employment. There are some sub sectors and some individual companies doing well, and while there are some growing and emerging retail companies, there have been many large and medium corporate failures in recent times. In 2022 there were a reported 17,000 store closures. These closures have direct local and national implications for employment, for the tax take and for society. Furthermore, many large, medium and small retailers are still a long way below previous peak profitability, and many retailers are cost cutting aggressively (including staff reductions) to try to protect existing profitability, to compete with the relentless growth of discount retailing or in some cases to just stay in business. Part of this is the natural evolution of business, but part of the problem is due to inequalities in the system and a lack of a levelling playing field. The challenges facing retail are impacting all areas of the economy, including employment, social welfare and the tax raise.

Small enterprise growth is not enough. It is easy to identify large corporate failures, while emerging businesses can go under the radar. However, given the demise of a number of large and medium retailers in recent years, and the sheer scale of store closures and business failures, there are not enough emerging retailers to fill the gaps in employment, economic growth and resulting falling taxes. It is right that retail evolution takes place, but such evolution should be natural, not due to inequalities. It is important that the implications of retail evolution are fully understood by the Government, by the Treasury and by the Office for Budget Responsibility. If issues are not solved now, there will be ramifications for several decades to come.

Long term, employment is down, corporate profits are down and the tax raise is falling with long term consequences for the Treasury and other areas. These trends are set to continue and may accelerate in the coming years. There are some sub-sectors of retailing doing well and some companies responding well to changes in consumer demand, but the overall picture raises some concerns. If retailing overall is to return to a Growth Agenda, action needs to be taken, the tax burden needs to be more evenly distributed and other changes implemented. It is important that successful companies are not penalised to help failing companies succeed, but challenged companies should not fail due to inequalities in taxation, planning systems and other areas as this will ultimately lead to market inefficiencies.

A decline in retail is a decline in the welfare of the consumer. It is a weakening of the economic well-being of the nation and is a risk to a cohesive society. Retail gives town centres a purpose, gives important points of interaction with consumers and helps society generally, including mental health.

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The Future of Retailing: This report looks at the most likely outcomes for the retail sector and the opportunities that may be lost if Government and business do not adapt their existing approach to intervention and support. We identify 15 key areas, including employment, the tax raise, technology, and numbers of stores, where we see important evolutions and discuss the implications for the economy and society.

A key purpose of this report is to inspire discussion. We recognise that some of the report's assumptions and assessments are open to a range of interpretations. Nonetheless they are a basis for further thinking and we welcome feedback and any suggestions for new areas to consider. This is the starting point from which to build a better future for retail that encourages growth and investment maximises the wider public and societal benefits.

Retail is The Great Enabler, with unparalleled potential to change society, to facilitate social mobility and to lead a growth agenda. It can deliver all this and more, with a little help and some refinements from Government.

Executive Summary

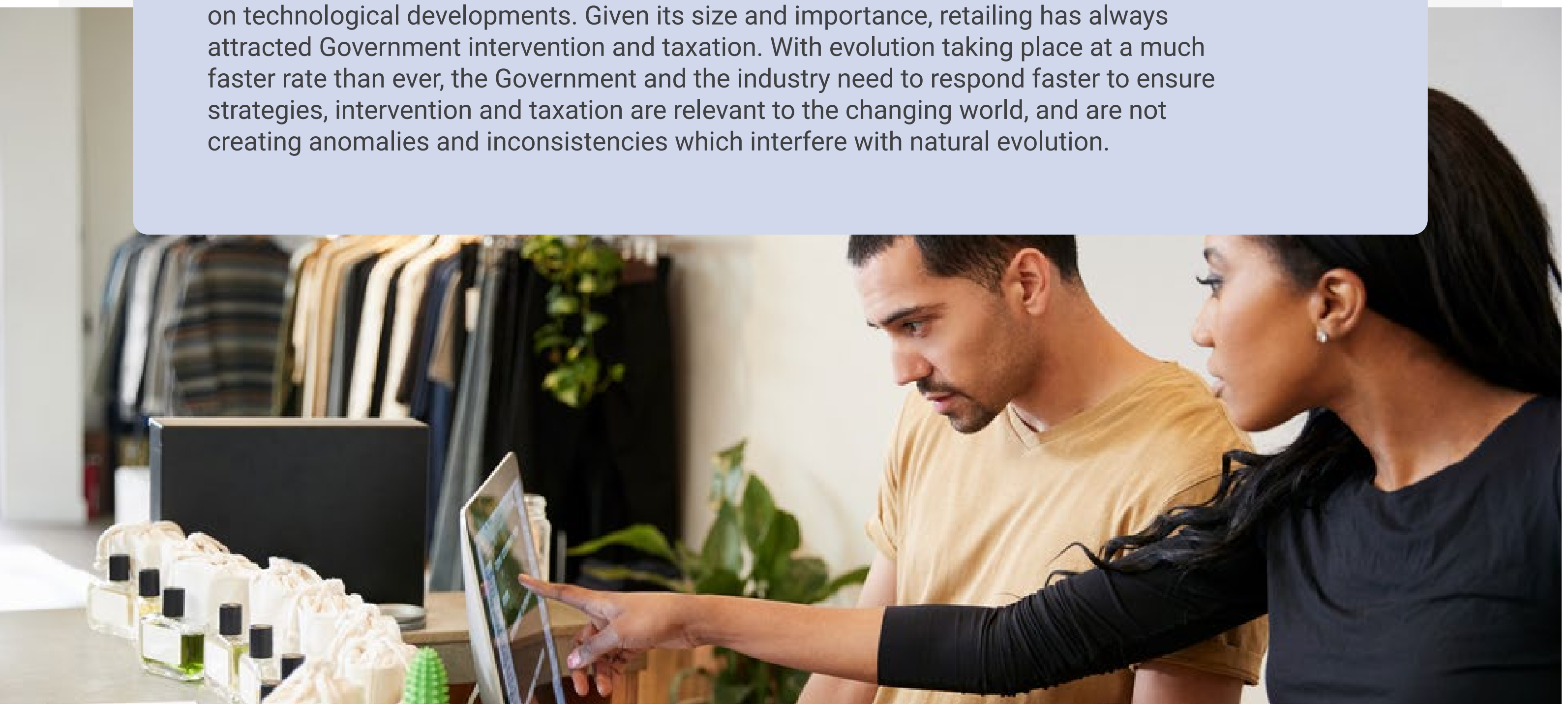
To understand the future of retailing we must understand the dynamics of the past and how retail economics have shaped retailing today. We must look at new and evolving dynamics and then make judgements on how the future structure is likely to develop. We start by examining the four principles of Retail Economics:

1. Price and income elasticity of demand at the industry level
2. Price and income elasticity of demand at the company level
3. The power of operational gearing
4. The importance of economies of scale

We then consider how the environment is changing, taking note that the consumer has never been smarter nor better informed (e.g. comparison websites, WhatsApp groups on best price, online price lists etc). In addition, we make the following points:

1. The consumer is more diverse than ever – declines in household size, more diverse diets, increased ethnic diversity etc.
2. Retailers have to deal with 3 demand factors – Demographics, Discounters, Direct to consumers.
3. Retailers have to deal with 3 supply factors – Supply, Security, Sustainability.
4. Service and product becoming blurred – Meta, Specsavers etc.

Retail evolves because it adapts to the opportunities for the new generations. Variety and department stores, supermarkets, shopping malls, hypermarkets and online specialists have all been major innovations of their time and have built on the past and on technological developments. Given its size and importance, retailing has always attracted Government intervention and taxation. With evolution taking place at a much faster rate than ever, the Government and the industry need to respond faster to ensure strategies, intervention and taxation are relevant to the changing world, and are not creating anomalies and inconsistencies which interfere with natural evolution.



We examine 15 key areas of retail evolution:

01 **Increased concentration ratios.** We expect retailing to be more concentrated with the top 5 firms in most categories increasing market share, while acknowledging that these five firms may be a different five compared to historical situation (e.g. several of the top 5 supermarkets are different today to the top 5 of a generation ago).

02 **Increased digitisation by store based retailers.** Store based retailers have been slow to embrace digitisation in their stores, but this is increasingly changing. Digitisation and data management have been drivers of online growth and now look likely to be positive drivers for bricks and mortar retailing in the future, helping to boost sales and enhance profitability. This digitisation will result in a levelling of skills between online and store based retailing. The delineation between these channels looks set to narrow with the further growth of omni-channel retailing.

03 **Further development of omni-channel retailing.** Increased digitisation by store based retailers, changing valuations of online companies and consumer demand will help drive omni-channel retailing. We expect bricks and mortar retailers to increase online operations and penetration, and stores to be opened by current pure play/largely pure play retailers. The two channels look set to merge in the middle at an increasing rate. In the future there is likely to be very little discussion, if any, about distinct retailers operating in distinct channels. But not all retailers or product categories are suited to online/omni-channel evolution as we discuss, whereas some categories have a strong advantage to being online.

04 **More innovation and more competition for online retailers.** With increased competition from store based retailers who are improving cost structures and embracing digitisation, online retailers will have to become increasingly innovative to stay ahead of the game. But will face increased financing challenges as discussed below. Innovation will also continue for store based retailers, as they develop their formats, supply chains, business models, product ranges etc. While some of this innovation will be behind the scenes as companies look to build competitive advantages where it cannot be seen, all will be important in creating winners in a highly competitive industry.

05 **Further penetration of online.** This is likely to come from some growth in pure play online retailers, but also by bricks and mortar retailers developing their online offers further. It is partly a consequence of omni-channel retailing and a merging of channels, but it is also a consequence of consumers evolving expectations and habits. However, some sectors are approaching maturity in online penetration, so we do not expect the rapid growth seen in the past to continue, while noting that some product categories are not suited to substantial online penetration or already have high penetration rates of their addressable markets (e.g. food retailing).

06 **Fewer Stores.** We are likely to see a decline in total store numbers in the future as more sales move online, and as retailers consolidate their store bases. There are also likely to be more corporate failures in the future, and we expect these to outweigh any stores opened by emerging retailers, some of which are likely to have more of an online offer. The make-up of stores will also evolve with a higher proportion of stores being discount driven, as this format continues to expand with many planned store openings (see below). According to the Local Data Company, between 2018 and 2022, over 41,000 stores opened and 79,000 stores closed, resulting in 37,700 fewer retail outlets across Great Britain over the 5 year period. LDC forecast there to be between 8,000 and 15,000 fewer retail outlets by the end of 2025.

07 **Fewer people employed but a greater need for higher-level skills.** If online participation increases and as discount penetration grows, there will be fewer people employed in retailing than currently as both channels are less labour intensive than traditional stores. This means a lower tax take for the Treasury (see below). But there is also a very important implication around skills, with more detailed and specialist skills likely to be needed in the future, which has implications for the education system. Retail needs to be imbedded into the education system and curriculum, and it needs to show the youth of today that retailing still offers a very full, exciting and vibrant career across many disciplines.

08 **Further growth of Discount Retailing.** In the main, the chains that are expanding their store count rapidly are discounters, such as Aldi, Lidl, B&M, Home Bargains, Primark, Poundland and others. These chains look set to open 1,000 stores, or more, in the next 5 years. It is important to note that these retailers tend not to have any major online operations, even though several have experimented in the past. Discounting will take a bigger share of retail sales and will account for a bigger proportion of a shrinking total store base in the future.

09 **More focus on out of town/edge of town stores.** Along with fewer stores and fewer people employed, we expect further evolution in the mix of store locations, with a shift away from town centres to large shopping centres, retail parks/strip malls and free standing units. The dynamic is that many High Street retailers are reducing store numbers, while the retailers with the biggest expansion plans, who are primarily discounters, are opening in the types of location we have just described.

10 **Falling tax take for the Treasury.** Fewer stores means les property tax. Fewer people employed means less National Insurance and less income tax. Less profits means less corporation tax. On top of this, if there is less spending by consumers, there will be less VAT revenues. The combination of these factors could reach a tipping point for the Treasury at the same time revenues from transport fall substantially due to the transition to Electric Vehicles (i.e. less excise duty on fuel, lower VAT, less road tax). There needs to be a joined up discussion of the implications of all changes planned and by all changes likely to happen due to economic forces.

11 **Societal Impact.** There are plenty of examples of run down shopping centres and high streets with a plethora of empty shops and/or charity shops (see below for the role charity shops play in the circular economy). A community can spiral down quite quickly with severe implications for the local population and the local economy. Without further support, as we will discuss in a future report, we are likely to see further bifurcation of society – the antithesis of levelling up.

12 **Sustainability and the Environment.** Sustainability will be increasingly important, but most consumers will not want or be able to pay any significant premium for it. Retailers need to find ways to improve sustainability while remaining commercial. But there are areas where Government help can facilitate change for the benefit of all (retailers, suppliers and consumers) in ways that competition laws prohibit. For example, stopping free plastic carrier bags was driven by Government intervention for the good of society, but Competition law would have prevented collaboration to reach the same aim. Not all collaboration is anti-competitive, and labelling is an area where Government help could benefit the environment, society and the consumer by allowing retailers to work together. It is also worth highlighting the role retail plays directly in recycling – whether this is through charity shops, market places for reselling pre-owned items, trade-ins for old products or just collection points for recycled items like batteries, clothes, soft plastics, electrical items etc. Store-based retailing also allows greater facilitation in the repair and reuse cycle.

13 **Electric Vehicles (EVs).** If the Government hits its targets for the adoption of EVs, there will be many more tens of thousands of charging points required. Large numbers of homes are not suitable for charging points and many homes have several cars. Consequently, out of home charging will be increasingly important. Some consumers may be influenced in their choice of where to shop by charging points at retail locations. Additionally, many petrol forecourts will need a change of use as some will not be suitable for conversion to EV charging locations. Forecourt locations may evolve into other forms of retailing (e.g. convenience) or will no longer be suitable as retail outlets. But all this depends on whether the targets for EV adoption will be hit.

14 **Valuation Changes.** As discussed elsewhere in this report, many "tech" companies/retailers have previously been given high valuations, which have been based on future perceived potential rather than being based on current performance. But with many of these companies failing to deliver forecast potential, market attitudes to valuations are changing. The unrealistic valuations given to such companies have fallen and without proof of sustainable and profitable business models, are unlikely to recover to previous highs in most instances. This will remove a structural competitive advantage that some pure play retailers have enjoyed compared to traditional bricks and mortar retailers. In many instances, pure play retailers have not been under pressure to deliver profits, have enjoyed cheap finance and have been given time compared to traditional retailers. The levelling of this particular playing field by the market, will have ramifications across the industry.

15 **Consolidation of online pure play.** Due to several of the dynamics outlined above, not least valuation changes, we are likely to see consolidation of pure play online and even mergers with, or takeovers by successful bricks and mortar retailers. Or we may just see a number of online businesses just fail and fold. It appears that the second tech bubble, while not bursting, is deflating steadily.

Conclusion

In reaching our conclusions, we have focussed on structural shifts and trends and their drivers, rather than on cyclical issues, which are best addressed elsewhere. We recognise that not all our conclusions will be to everyone's liking but we hope to stimulate debate with all interested parties, including employees, suppliers, the Government and of course the retailers themselves.

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This report is not an end unto itself. The Council will next look at the issues raised by the industry (including issues raised in response to this report) and will consider some solutions. Issues that we would expect to be addressed are likely to include:

- Business rates and other taxation
- Labour issues including apprenticeships and health and safety
- Food industry, including food security
- Property issues, including planning and change of use rules
- Cost of Living crisis
- The environment
- Implications of changing retail structure on society
- Supply chain issues and changes to "globalisation"
- Any other major issues raised in response to this report

Our focus is, and will remain on, how the retail industry is The Great Enabler. A healthy and prosperous retail industry benefits the consumer, the economy and the nation. We recognise that there is a lot that the industry can and does do for itself, but there are anomalies and inconsistencies which are inhibitors to free competition, to the creation of a level playing field and to creating a better society. In this respect, the industry needs help from the Government and greater freedom to help itself, the consumer, the economy, the environment and the United Kingdom.

The Future of Retailing

The Importance of Retailing

Retailing will always be at the centre of the economy. With its unparalleled reach across the population and society, retailing is the Great Enabler for Government policy, and is essential for the security and wellbeing of the nation. It will remain as the major private sector employer, as a major raiser and collector of direct and indirect taxes and will be the bell weather for the overall state of the nation and society.

It is easy to forget that retailing is more than just shop-keeping. Many people working for retailers are in supporting areas like distribution, finance, marketing, buying, property and human resources to name just a few areas. Plus of course there is technology, not just with online retailers, but with all retailers. Tesco, for example, with its sophisticated logistics network, its detailed store layout planograms and its loyalty card, is one of the biggest users of technology and employers of IT specialists in the country. Retail offers bright and exciting careers in so many areas, but exactly how retail will look in the future and its exact size and nature has never been more uncertain.

An exciting career in retailing. 50 years ago, anyone entering retail knew that a promising and exciting career lay ahead of them, as there were always going to be shops, competing aggressively for consumers' hard earned money. Retailing, whether traditional stores, omni-channel retailing or pure play online, still offers many exciting and varied careers and the scope for substantial social mobility. But how the industry will look in 10 years' time is a great unknown: "Will there still be shops?", "How many will there be?", "Where will the shops be?", "What is the scope for career progression?", "Do other industries now offer better opportunities?", "what skills will be needed?" are just a few examples of important, unanswered questions as the industry evolves at a pace never seen before.

Challenges abound for retailers and suppliers. With rapid change, so do new challenges and opportunities arise, and these challenges have never been so great in magnitude and number. As highlighted above:

Consumers have never been better informed: There is an abundance of information on prices, quality and service from comparison websites, WhatsApp groups and press articles, as well as product reviews from fellow consumers all easily and readily available.

Consumers have never been more diverse: demographics are changing (e.g. household size, ethnicity) and eating patterns are more varied (e.g. diets such as Vegan, gluten free etc)

Traditional retailers have never been more challenged: As well as demographic changes, there are discounters and direct to consumers channels (the three D's) which have to be dealt with

Retailers have to deal with supply factors: supply chains, security of supply, and sustainability are all increasingly important and complex (the three S's)

This makes retailing more competitive than it has ever been before with many implications for companies, consumers and the economy.

Retail Evolution. As well as these challenges, there is a blurring between products and services, in part as a consequence of online shopping. But despite all these changes and challenges, retail has survived. Many companies have prospered while others have failed. As in all evolution, those retailers that responded at speed to a changing competitive environment succeeded, while those that did not evolve fast enough struggled and failed. Once great companies like Woolworths have been replaced by alternative companies like Amazon and Walmart, who use new and different retail models to reflect changes in society, in technology and in consumer demands (often driven by a desire for lower prices). But it is the pace of change in retailing that we need to consider and its broader implications.
We need to consider the intended and unintended consequences of Government action and inaction in order to avoid adverse unintended consequences.

In this report we look at some of the key issues that will shape the future of retailing. We look at how retailing is likely to develop, based on what we know now and on underlying economic forces, bearing in mind that events, like the Covid-19 pandemic and the War in Ukraine, have shown how expectations and fortunes can change overnight. With the caveat that there are many unknown unknowns, and that things can change in an instant, we look at the most likely scenarios for the development of retail. To do this, first we must consider the underlying economics of retailing, as it is these economic forces that have created today's industry structure and it is these evolving economics which will be most influential in shaping the future. It is important that we focus on these structural drivers, rather than shorter term cyclical drivers. But first, we consider some of the challenges facing the Government around retailing.

The Future of retailing will be many factors, with main drivers including:

- Retail economics and underlying market forces.
- Government policy in a wide number of areas.

Government policy will be heavily influenced by a wide range of considerations including political ideology, fiscal policies, monetary policies, levelling up strategies, tax policies, employment policies, etc. Of course, there are always other important factors such as the macro-environment and, as we have seen recently, world events like Covid-19 and the War in Ukraine. But as we are unable to predict unknown world events, here we focus on how underlying retail economics will shape the future structure of the retail industry if these forces are left unabated.

It is for the Government to consider how it wants to influence and shape retail structures for the overall good of the consumer, the economy and society. However, there is always the danger of unintended consequences for all actions and inactions. Essentially there is a series of trade-offs for the Government to consider:

- What will the industry look like if left completely to market forces? What would be the impact of this outcome and its implications for the economy and society if the industry was allowed to evolve unhindered in this way? It is worth remembering that in this scenario, leaving the industry to market forces means leaving existing Government intervention in place, even though some of this intervention relates to by-gone eras (e.g. business rates were introduced many, many years before online shopping was ever thought of).
- What are the Government's overall objectives for the economy and how much intervention does it warrant and in what areas? We should remember that there is already huge Government intervention in retailing through The National Living Wage, tax structures (including business rates, VAT rates, National Insurance etc) and planning rules to name just a few areas. Are these rules, regulations and taxations still relevant and appropriate in today's economy?
- How does the Government want to utilise the unparalleled enabling power of retailing? Retail is the great enabler of the economy, with it touching all consumers, almost all businesses and all corners of society. No other industry has such a broad reach, and this reach can be utilised to impact society, the consumer, the environment, and the overall economy, including areas like sustainability, the tax raise, healthy eating, town centres, the mental health of the community etc.

- What tools will the Government want to use to implement its policies? How will these specifically impact retailing? Does the Government want to achieve its aims by influencing the consumer or by influencing business? What incentives or disincentives does it wish to utilise?
- The Government must also be fully aware of the unintended consequences of new interventions, of non-intervention and the reversal of current intervention. Plus of course there are the issues of a level playing field (caused by historic intervention/lack of intervention or by changes in socity, the economy, technology etc) and the levelling up agenda.
- The consumer vs business. The Government needs to make decisions around the best route to policy implementation. Are policies best implemented by legislation and influences on business, or by legislation and influences on the consumer? There is no simple and straight-forward answer and, in reality, it is likely to be a mixture of legislation and influence on the consumer and business (including the supply chain).

In considering the future of retail we will discuss some of the likely areas of future Government involvement and their implications. While the details of how the industry may look in the future are by their very nature uncertain, we can gauge the broad evolution of the industry by looking at the drivers of trends (rather than the trends themselves), how these trends may evolve and what are likely to be the drivers of these trends in the future. As always though, the starting point is underlying retail economics.

Economic Principles of Retailing

There are four underlying economic principles that drive retail structures:

1. Price and income elasticity at industry/sector level
2. Price and income elasticity at individual company level
3. The power of operational gearing
4. The importance of economies of scale

In understanding these issues, we can see what the likely winning strategies are for retailing and how these will shape the industry's future structure. We can then overlay the impact of other factors such as sustainability and taxation, for example. We will then bring all these issues together to consider the future of retailing where we list 15 likely developments.

Price elasticity at the Industry level

Price elasticity (how demand changes in relation to price changes) and income elasticity (how demand changes in response to income changes) are sector specific within retail but the principles are the same.

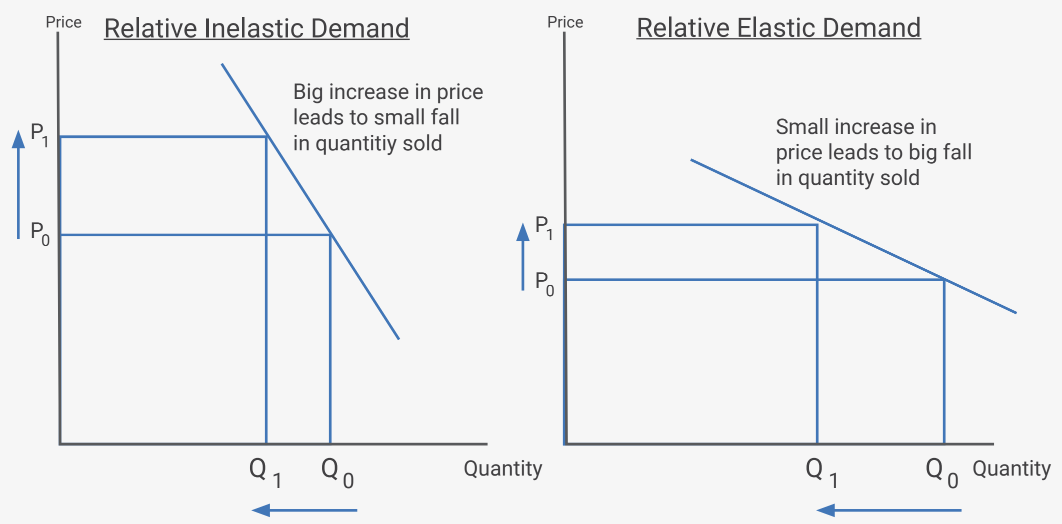
- **Price inelastic demand** is where overall industry demand does not change materially with changes in price. Food is a good example of a price inelastic market. During tough times like currently, the same number of calories will still broadly be eaten, but consumers will trade down and price per calorie consumed will be reduced. Looking at Nielsen IQ data for 4 weeks ending 20 May 2023, inflation was 15.4% but industry sales were up just 12.3%. The difference between inflation and total sales growth (3.1%) is attributable to trading down as consumers sought cheaper options, such as switching to discounters, moving from brands to own label or by purchasing cheaper calories (e.g. chicken instead of steak for protein). With food, we all have to eat so calorific demand is resilient, but for some categories there is no fundamental need to spend, and these are price elastic products.

- **Price Elastic Demand** is where demand is sensitive to changes in price, i.e. when prices rise, there is a more than proportionate drop off in demand, and when prices fall there is a more than proportionate increase in demand. Overseas holidays is a good example of a demand elastic "product". Such a product is not essential to survival. When the prices are too high consumers can switch to other options (e.g. Staycations or spending their money elsewhere, for example, cars, housing, electrical goods etc).

The basic concept on elasticity is that demand curves slope down. For inelastic demand, the slope is quite steep and for elastic demand the slope of the curve is quite shallow (see following charts). Too many companies forget this fundamental principle – that demand curves slope downwards. It is management's challenge to find the optimal point for sales and profit maximisation – for the short and the long term, with the right pricing policy alongside other elements of the marketing mix such as customer service etc.

The following charts show price elastic and income elastic demand.

Inelastic and Elastic Demand Curves



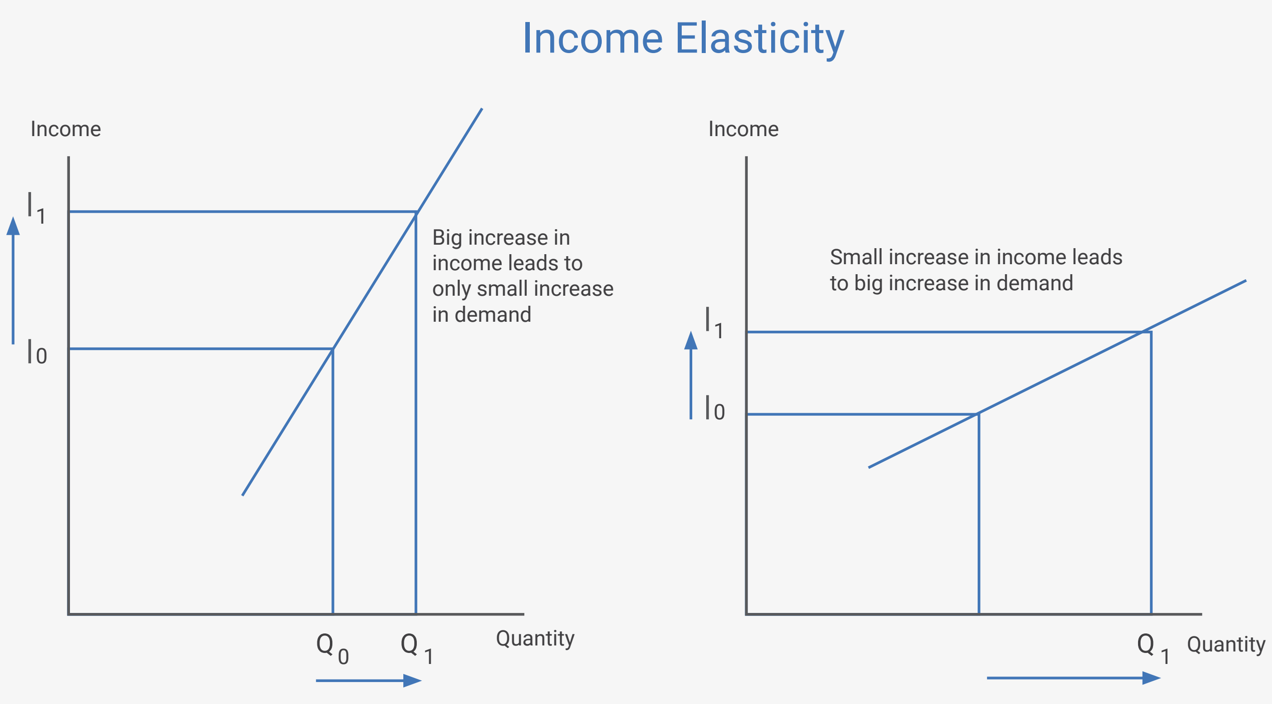
Income Elasticity at the Industry level
As well as demand being influenced by price, it is heavily influenced by levels of incomes.
As with price elasticity, income elasticity is sector specific but overall principles still hold.

- **Low income elasticity.** When income changes, there is no major change in demand for products with inelastic income elasticity. Again, food is a good example of a category with relative inelastic demand. When people get a major pay rise, they may spend a little more on food at home, with better quality products, but the overall proportion of income spent on food usually falls, and vice versa for falls in income. It is important to note that all this applies to changes in real income (i.e. income after inflation is taken account of) and this is a key issue around the current cost of living crisis as we discuss later in this report. Effectively, essentials have low income elasticity, luxuries high income elasticity.

It is important to remember that demand for all products is most influenced by changes in disposable income (i.e. income after tax), rather than headline rates of income.

- **High income elasticity** is when incomes change and there is a more than proportionate change in demand for a particular product. This applies to discretionary items as opposed to essentials which are necessary for living (e.g. food, housing etc). Demand for elastic products is most heavily impacted by changes in discretionary income (i.e. income after tax and after essentials) and there is a large gearing effect which amplifies changes as we consider in the following section.

The following charts show low and high income elastic demand:



Income Elasticity **High Income Elasticity**

Demand sensitivity and the cost of living crises
To help explain the impact of income elasticity we look at a hypothetical example of how disposable income (i.e. income after tax) and discretionary income (i.e. income after tax and after essentials like food, energy and housing) change with changes in total income and the price of essentials. We would emphasise that while we are using short term issues here to demonstrate the power of economic forces, the results are applicable to long term structural changes in prices, incomes, taxation etc. We use a simple example below for an individual in the current tax regime. We derived the figures using the Reed.co.uk tax calculator with numbers rounded for simplicity.

Base case: Someone earning £25,000 per annum, receives c£20,500 disposable income after tax and national insurance. If we assume that individual needs £18,000 for essentials, this individual receives £2,500 in discretionary income.

Scenario 1: A 10% increase in income increases discretionary income by 68%. Gross income rises to £27,500 and with the same tax regime and assuming the cost of essentials remains the same, this equates to £22,200 disposable income (8.3% increase after incremental taxes) and £4,200 discretionary income (a 68% increase). Note that in this positive scenario, that disposable income increases by less than the increase in earnings (8.3% vs 10%). This is the result of fiscal drag and is the impact of frozen tax bands.

Scenario 2: A 10% rise in cost of essentials reduces discretionary spend by 72%. Total income and disposable income stays the same as in the base case but we factor in a 10% increase in essential prices. This results in an £1800 increase in essentials expenditure and reduces discretionary income by 72% to just £700. Scenarios 1 and 2 show the power of gearing (positive and negative) on discretionary income and highlight how increases in essential inflation are causing the cost of living crisis, and demonstrate its extent, particularly on the economically challenged consumer cohorts.

Scenario 3: income increases need to be higher than inflation to preserve buying power. Although incomes and essentials rise by the same percentage in this scenario (10%), discretionary income reduces due to the incremental tax on the increase in income. This explains why wage increases have to be higher than inflation to help protect a constant standard of living.

	Base Case	Scenario 1 10% increase in income	Scenario 2 Flat income 10% rise in essentials	Scenario 3 10% increase in income 10% rise in essentials
Total Income	25000	27500	25000	27500
All Direct Taxes	4500	5300	4500	5300
Disposable Income	20500	22200	20500	22200
Essential Expenditure	18000	18000	19800	19800
Discretionary Income	2500	4200	700	2400
% change vs base case		68%	-72%	-4%

It is important for those setting strategies for retail, whether suppliers, retailers or the Government, to understand how the overall industry and the consumer behaves. But one thing that should always be remembered and is often forgotten is that demand curves slope downwards for prices. With the exception of a few special products (called Giffen or Veblen goods which we will not consider here) when real prices rise, demand will usually fall. It is only the extent of the demand fall that is debatable. Now we look at demand at the company level.

Price Elasticity at the company level and cross price elasticity

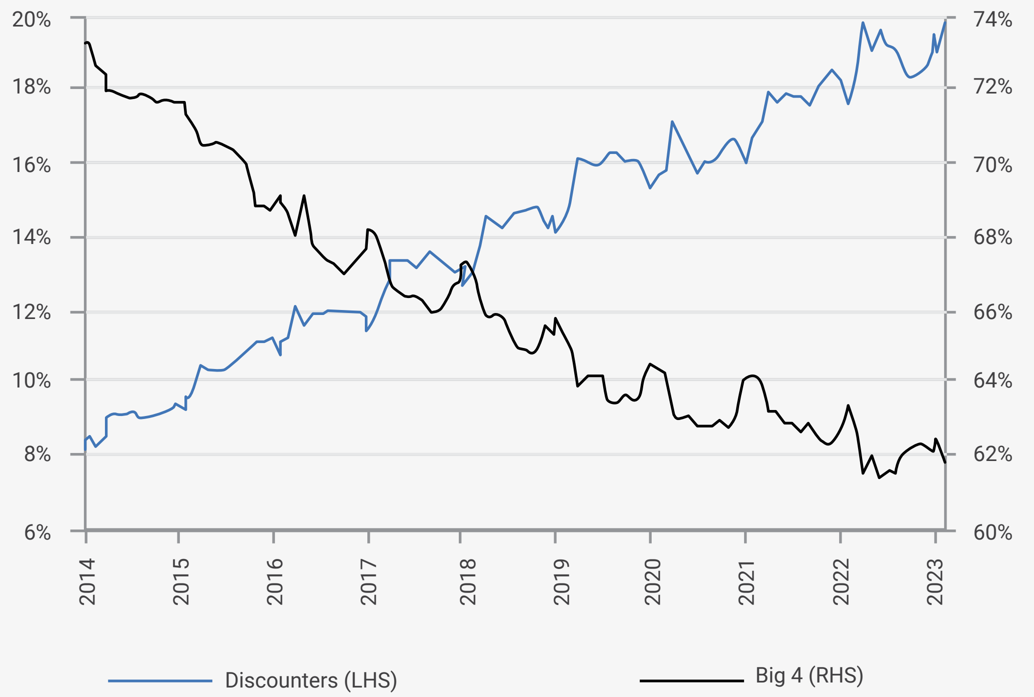
An industry can be demand inelastic at the industry level and have high elasticity at the company level. This happens when there is high cross price elasticity, when there is little differentiation between competitors or when consumers are price sensitive. This feature is often forgotten, with investors, commentators and protagonists sometimes failing to recognise that a defensive industry may not be defensive at the company level. Food retailing being a good example.

Cross price elasticity relates to the sensitivity of consumers to switching between retailers/products based on price differentials between competing brands/ retailers. If there is high cross price elasticity, then consumers are not particularly brand/retailer loyal and will change behaviour to enjoy lower prices. If there is low cross price elasticity consumers will stay loyal to the retailer/product/brand. There are many factors that determine cross price elasticity, including:

- Price differentials
- Access to cheaper alternatives
- Brand loyalty (itself a complex amalgamation of numerous factors)
- Information available to consumers (we have already discussed consumers are better informed than ever)

As with industry elasticity, cross price elasticity varies by category. But food retailing provides a strong case study of high cross price elasticity for individual companies, in an industry with low price elasticity.

Food retailing: Inelastic industry demand and elastic company demand.
In the last 10 years the two Limited Assortment Discounters, Aldi and Lidl have added over 10% market share in an industry with low real growth. Therefore, their growth has come at the expense of the incumbents. The so called "Big 4" of Tesco, Sainsbury, Asda and Morrisons have lost over 10% share between them over the same period. (See chart below, Data provided by Nielsen IQ). Clearly, consumers have switched from one group of large store operators to the smaller discount format, with the main reason being lower prices.



Food retailing perhaps exemplifies more than most how price sensitive consumers are in a market dominated by big, branded retailers supported by big marketing budgets. Consumers do not appear to be particularly brand loyal, with price and location being the biggest determinants of store choice. This is helped by consumers having few switching costs in moving to another food retailer and suggests limited differentiation (bearing in mind that the discounters offer only limited ranges).

The price sensitivity of consumers in other sectors is demonstrated by:

Amazon growth in the UK has been driven at least in part by its competitive price positioning. Its founder and CEO has reportedly stated that Amazon would be a retailer that would aim to sell as "low as it can".

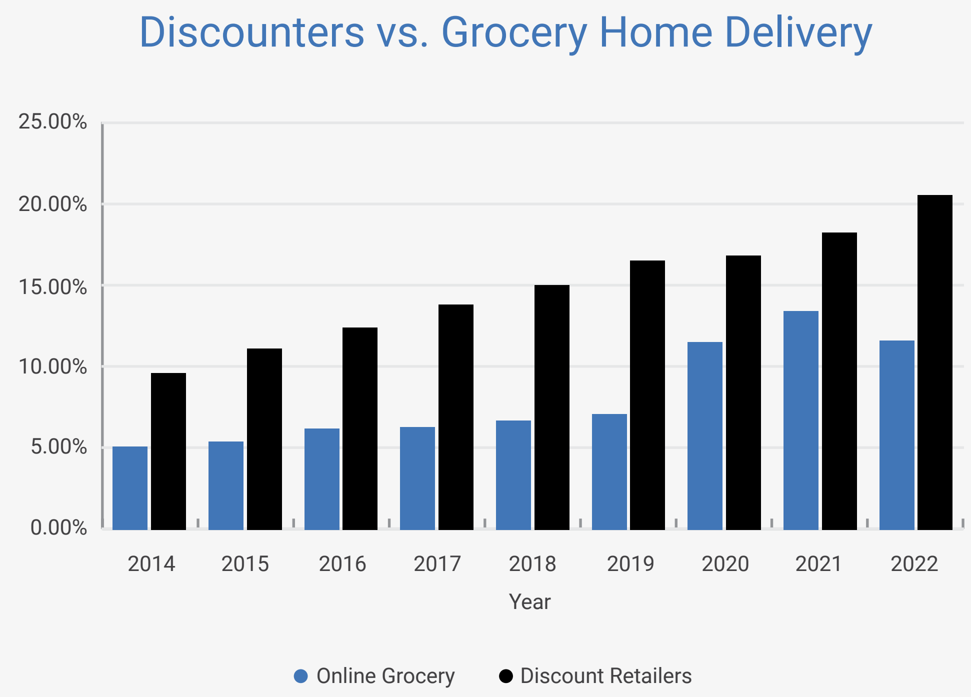
Internet retailing in many categories has claimed sizeable market share with price being a major factor, alongside convenience.

Competitive response. Store based retailers like Currys and Pets at Home have responded to the online threat by aggressive price repositioning.

The growth and strategies of broader based discounters like B&M and Home Bargains show the importance of price in food and non-food, as does the growth of companies like Primark in clothing, IKEA in home products.

Food retailing's only limited online growth is largely due to higher pricing for home delivery. There are several reasons why food retailing has only limited online participation (currently c11% after over 25years and a substantial fall from a lockdown peak of c16%). Delivery charges mean higher prices, and this appears to be a part of the lack of widespread adoption of Grocery Home Delivery. Plus, there is no Grocery Home Delivery discounter, suggesting it is not a market suitable for home delivery (food retailing is a big, bulky and heavy shopping basket, which requires the bundling of many products).

Pricing reflects costs and it is typically more expensive to run a grocery delivery service than it is to run a store, so being price competitive while offering home delivery is very difficult. Grocery Home Delivery is an expensive and complex logistics operation for which most consumers will not pay the full economic cost. That discounter growth has out striped online growth (even without considering discount products available in the Big 4) shows that many consumers want lower prices more than they want home delivery for groceries. The following table shows the combined market share of the two German discounters (Aldi and Lidl) mapped against the penetration of grocery home delivery between 2014-2022. As can be seen, the two discounters have consistently outgrown home delivery, have increased their lead over this channel and are still growing rapidly. (Source NielsenIQ).



Operational Gearing in Retailing

Profits are highly sensitive to small changes in sales for bricks and mortar retailers and this is known as operational gearing. High operational gearing in retailing is due to the high fixed cost element of in-store retailing and low profit margins. We demonstrate this with a couple of simple examples below and demonstrate how small changes in sales have a much higher impact on profits. We demonstrate operational gearing in the following chart for two different retailers in different market segments, with the following assumptions:

Scenario one: Low gross margin retailer - 10% sales change impacts profits by 30%

- Gross margin of 30%
- Fixed costs of 10% (e.g. rent, rates, energy, store managers wages etc)
- Variable costs 15% (e.g. sales staff)
- A resultant operating margin of 5%
- 10% sales gain gives a marginal contribution of 15% (fixed costs do not change). The contribution margin is gross margin (30%) less variable costs (15%)
- Marginal contribution is 3x the average profit margin (15% vs 5%), giving 3:1 operational gearing
- In this example, a 10% sales gain impacts profits by 30%

Scenario two: High gross margin retailer – 10% sales change impacts profits by 50%

- Gross margin of 60%
- Fixed costs of 20%
- Variable costs 35%
- A resultant operating margin of 5%
- 10% sales gain gives a marginal contribution of 25% (60% gross margin less 35% variable costs)
- Marginal contribution is 5x the average profit margin (25% vs 5%), giving 5:1 operational gearing
- In this example a 10% sales change impacts profits by 50% (i.e. marginal operating profit of 2.5 on a base of 5.0)

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It is important to note that although we have focussed on the impact of a sales gain, operational gearing works the same way on the downside. A slight loss of sales results in a major loss in profitability without mitigation by management.

	Base Case	10% sales gain
Sales	100	10
Gross profit	30	3
Gross margin%	30%	30%
Variable costs	15	1.5
Variable costs %	15%	15%
Fixed Costs	10	0
Operating Profit	5	1.5
Operating margin	5%	15%

	Base Case	10% sales gain
Sales	100	10
Gross profit	60	6
Gross margin%	60%	60%
Variable costs	35	3.5
Variable costs %	35%	35%
Fixed Costs	20	0
Operating Profit	5	2.5
Operating margin	5%	25%

Operational gearing is perhaps one of the least appreciated aspects of retailing. It is a key driver of the ability for retailers to offer lower prices without impacting their profit margins. Indeed it is possible for a retailer to lower prices and deliver a higher operating margin simultaneously by sharing some of the benefits of operational gearing with consumers.

Below we consider the last of the four economic principles of retailing (Economies of Scale) before we pull them all together to assess the impact on the current and future structure of retailing and where we discuss retail's virtuous circle and its vicious spiral.

Economies of Scale

Economies of scale (EoS) are important in almost all areas of retailing, with the overall importance of scale depending on the specific category. There are strategies to deal with a lack of scale and there are some diseconomies of scale, but the overall importance of economies for retailing should not be under-estimated, even though many will often try to dismiss their importance.

Measure EoS relative to profits. In a low margin industry like retailing, it is important that economies of scale are measured relative to profits, not to sales. This is perhaps demonstrated by a hypothetical example. We assume the following:

- An industry has a standard operating margin of 5%
- However, a specific retailer has what appears to be a small EoS of 0.5% of sales (e.g. through buying and cost sharing), giving it an industry leading margin of 5.5%
- This EoS represents 10% incremental profits giving it a competitive advantage. This is an important advantage if this is in a sector with price sensitive consumers and a high cross price elasticity.
- If consumers are price sensitive, the increase in profits can be re-invested into price and this will drive sales increases leading to higher cash profits, a better return on investment and a superior cash flow (a sales driven strategy). If this is in a demand inelastic industry, winning extra sales will damage competitors' sales, who would then lose disproportionate profits due to high operational gearing.
- If consumers are not price sensitive, this company would be 10% more profitable than the competition, would have a 5.5% ongoing operating margin and would have an enhanced valuation and financial economies of scale.

In general, companies do not wish to acknowledge EoS. Market leaders do not wish to draw regulatory attention to themselves and other protagonists do not want to admit that they have a structural disadvantage. But that such economies exist can be seen in the extent and range of synergies in merger and takeover proposals to investors (e.g. Sainsbury and Asda proposed merger).

Synergies are EoS achieved through acquisition. In acquisitions the importance and extent of synergies are outlined by management and the success of companies achieving these synergies is the key driver on whether the acquisition is successful and determines the future valuation of the company. Without EoS, there would be few synergies.

Types of EoS

There are numerous economies of scale throughout retail and we briefly examine a few here:

Buying power. This relates to goods for resale and also to goods not for resale (e.g. capital equipment or consumables)

Cost sharing or cost spreading

Logistics and the efficiency of supply chains

Research and development and the ability of a company to undertake projects that smaller competitors cannot (e.g. projects with a high fixed cost)

Soft economies which are not immediately obvious in financial terms, but which drive strong financial benefits.

There are many more economies but these five will help explain their importance and importantly will help set the background for how we expect the retail industry to develop over time.

Buying Power

Buying power is often misunderstood and is sometimes confused with "market abuse" by a large company. If a company is buying more than a competitor and if that results in lower average cost per unit purchased, (e.g. lower production costs per unit, lower unit delivery costs as full lorries are delivered, lower procurement costs per unit of raw material etc), then this means the retailer can legitimately command a lower price, without impacting the profitability of its supplier. Indeed, a bigger order at a lower price can benefit the retailer and the supplier with both enjoying superior profitability. But there are other considerations as well – for example, is there excess production capacity in the supply industry, what is the added value of a long term contract with a retailer, what is the store distribution of that retailer etc. All these considerations feature in buying power, without there necessarily being any form of "market abuse". In short, business is no different to consumers – if you buy more, then it is fair to expect a lower price.

Quantifying Buying Power is very difficult as it is extremely commercially sensitive and confidential. But the 2000 enquiry into the Food Retailing Industry by the Monopolies and Merger Commission (MMC), gave some insight into Buying Power at that time. For the top 26 suppliers at that time and for their top 5 brands, it appears that for each £1bn of incremental turnover of the retailer, there was an almost 30bps improvement in buying terms. As explained earlier this may not seem a lot, but with multi-billion pound differences in turnover and in a low margin industry, this is very significant. A £10bn difference in total sales would have made 3 per cent-age points difference between two retailers (ceteris paribus). It is unlikely the full relationship of 30bps per £1bn of sales still holds today, due to inflation (the key driver is unit volume) but it is likely still to be very significant as the economic drivers of buying power have not changed.

It is also worth highlighting that the Buying Power quantified by the MMC related to branded items. For own label products, buying power is likely to be greater still as longer production runs in manufacturing means that fixed costs for the manufacturing process are spread over a greater volume of units.

It is also worth remembering that Buying Power also extends to goods not for resale, such as equipment, computers, consumables like paper, etc. Giving further scale benefits in operating costs, depreciation charges and overall efficiency.

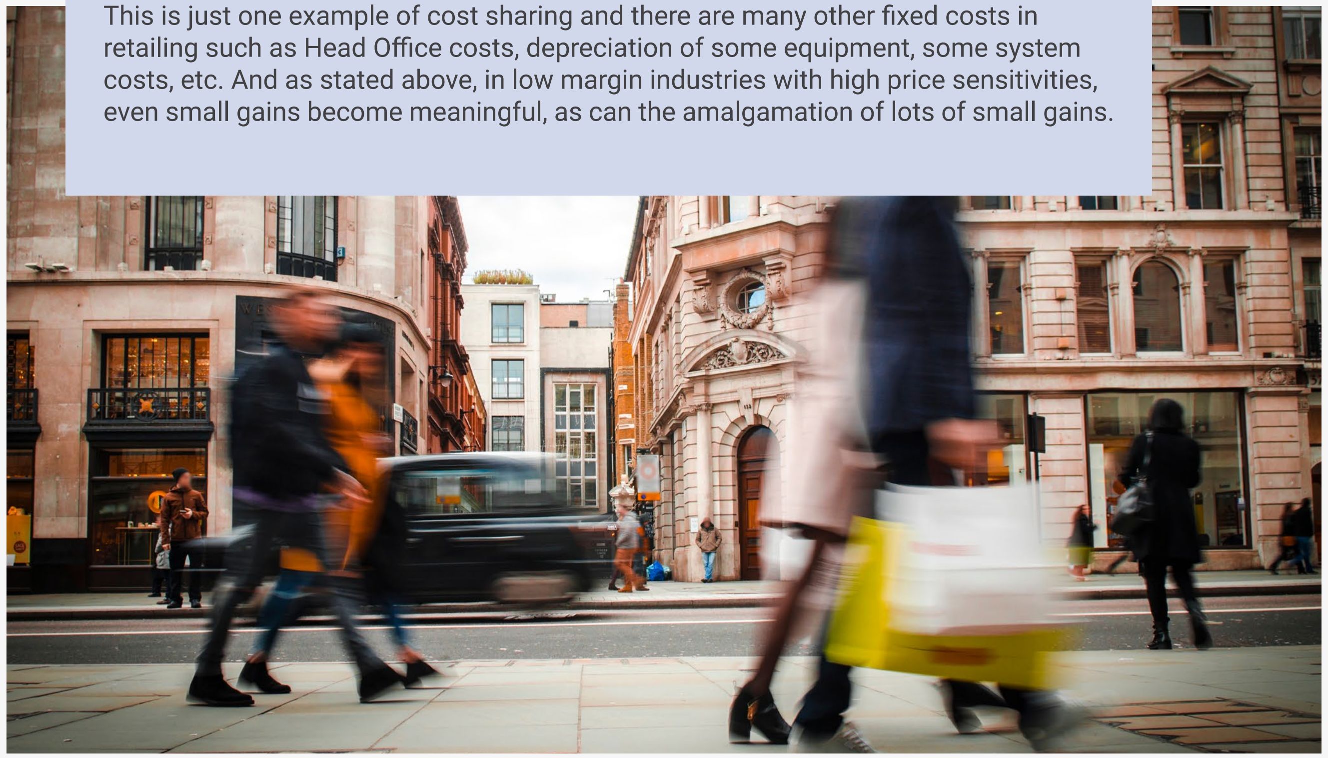
Buying Power is very important in a low margin industry and gives larger retailers lower operating and capital cost ratios, which are significant competitive advantages in an industry with price sensitive consumers.

Cost sharing

The bigger a retailer the more it can amortise a fixed cost over its sales base. We demonstrate this by using a hypothetical example:

- Two retailers, with retailer A being twice the size of retailer B
- Retailer A spends 0.25% of sales on advertising
- Retailer B decides to match A's total cash expenditure
- With only half the sales base, the fixed cost of advertising means B's ratio is 0.5% of sales
- If A has an operating margin of 5% (post advertising), then B would have an operating margin of 4.75%. A meaningful amount in a low margin industry with price sensitive consumers.

This is just one example of cost sharing and there are many other fixed costs in retailing such as Head Office costs, depreciation of some equipment, some system costs, etc. And as stated above, in low margin industries with high price sensitivities, even small gains become meaningful, as can the amalgamation of lots of small gains.



Logistics

A bigger retailer with a higher concentration of stores should be able to have lower logistic costs per unit. Consider two retailers competing in the same geographic area, but with one twice the size of the other. There are two extremes:

- **They both have the same number of depots,** but the larger retailer is pushing twice as much product through it – meaning greater asset efficiency
- **The larger retailer has twice as many depots,** meaning shorter delivery times and a more efficient use of the fleet leading to lower operating costs for delivery and greater capital utilisation of delivery vehicles.

In such a situation, the reality would likely sit between the two scenarios, but this demonstrates the point that larger retailers (in the same geographic coverage) should have lower logistic costs per unit sold.

Research and development (R&D)

R&D is a fixed cost and therefore if a retailer has a larger sales base, this fixed cost is lower as a proportion of sales. But this is more than just cost sharing. A large retailer can undertake projects, trials and experiments that smaller retailers could not afford or which would involve a higher risk if the project or trial failed. This allows larger retailers to lead the way with innovation and development, which in turn should help their sales, profits and cost controls.

For many online retailers, which have not been tasked with delivering the same profit requirements by shareholders/financiers as store based retailers, they have been able to use a bigger proportion of their cash and or profits to fund innovation, but as we discuss later, this situation is now changing and this playing field is levelling.

Soft economies

These EoS cover a wide area and are not always immediately obvious, but they are very important and very substantial. To demonstrate one area, Accessibility and Brand Awareness, we consider a hypothetical High Street. If one retailer has twice as many stores as its competitor, it can bracket its competition by having stores either side of it. If this is for a category where brand strength is not important and if the consumer will not pass one brand to get to another, then the larger retailer has two great advantages:

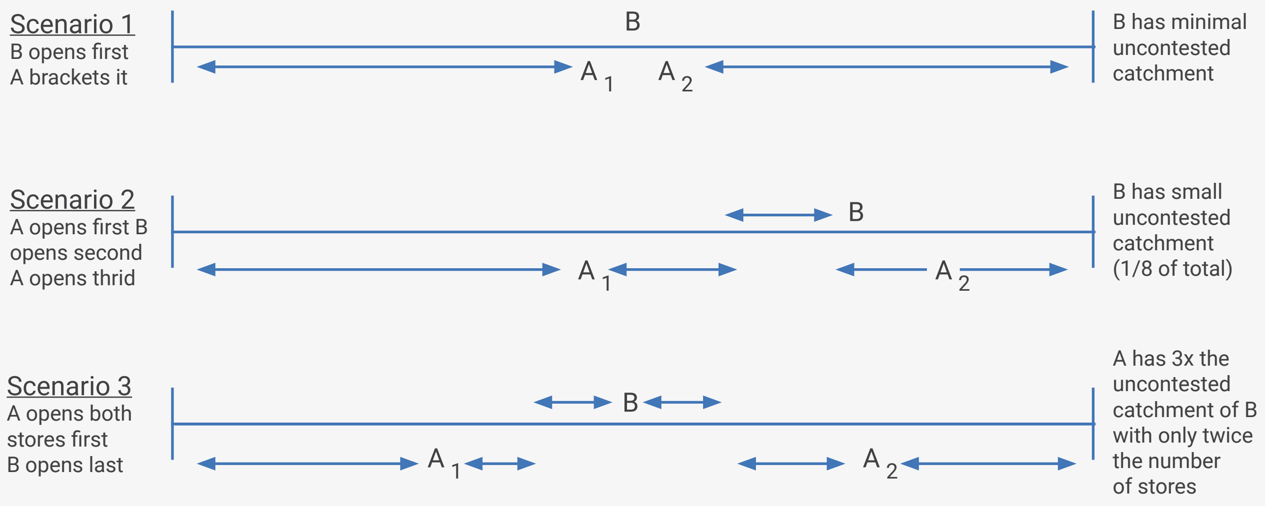
Front of mind – it is the first brand recalled and thought of as it is the most common

Accessibility – it is easier to visit that brand and to spend more in that brand than the competition.

Below we demonstrate this on a linear High Street. Retailer A has two shops, Retailer B has one shop. We look at the different options regarding store locations:

- **Scenario 1:** If B opens its store first, A can bracket it gaining almost all the catchments.
- **Scenario 2:** If A opens one shop first, B may open some distance away, but A can open its second shop closer to B and reduce B's catchment.
- **Scenario 3:** If A opens both branches first, then B's options are reduced and it will get a reduced catchment.
- **Scenario 3 is the best option for B**, but even if all stores are located in optimal distances, then B's best catchment would be ¼ of the total compared to A's ¾. So with twice the stores, A gets a minimum of three times as much of the coverage.

The Scale Advantage In Store Numbers



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Of course, this is two dimensional, and catchments are three dimensional, but the same principle holds. Numbers of stores provides a major economy of scale, but it is important that the retailer does not over extend itself or open stores that are unprofitable/do not provide an adequate return on investment just to hurt the competition. It would be a Pyrrhic victory. Retail history is full of examples of companies that have failed through over expansion. This advantage only works if the core offer is a strong one and that its offer is not inferior to the smaller competition.

Loyalty is driven by accessibility (as is market share). Using Tesco as an example. Some commentators might think that other chains have a greater "loyalty" than Tesco, but if we measure loyalty as the proportion of total expenditure spent in a specific brand, then research shows that Tesco has the greatest loyalty (Ref: "Anatomy of a Food Retail Consumer" HSBC 21 June 2023). A key driver of this is the accessibility of Tesco stores. It is easier to spend money in a Tesco branch due to their widespread locations and variety of formats, than it is for a consumer to shop in any other chain. This then becomes a virtuous circle as Tesco sales ensure its other EoS such as Buying Power are reinforced. That market leaders have the most and the most loyal customers is sometimes known as the Marketing Law of Double Jeopardy.

Competing without EoS

EoS are an important factor in retail development, but it is just one factor and while EoS are highly important and provide a real competitive advantage in many markets, it is not the only factor to determine success. Market leaders go wrong, other companies win leadership and retail structures can change due to a number of reasons (e.g. new entrants with different business model, technological changes, supply chains etc). But if a retailer does not have scale, it needs to develop a strategy to compete on different parameters to its competitors that do have scale. It is beyond the scope of this report to go into any great detail, but some differentiation strategies can be developed using:

- Lower cost structures
- Enhanced customer service
- Differentiated or specialist ranges
- Value added services or products
- Creating brand value (e.g. around sustainability, quality, etc)

EoS have been one of the major driving forces in the development of retailing for very many years and will continue to be a major driving force in the future. Hence, EoS (or lack of them) and the other driving forces outlined earlier, will continue to shape competitor strategies in the future. These strategies will in turn shape the industry structure. As we discuss in the next section of this report, EoS will help drive increased concentration ratios across retailing.

The consequences of the four economic features of retailing

Putting these four features together drives the virtuous circle of retailing:

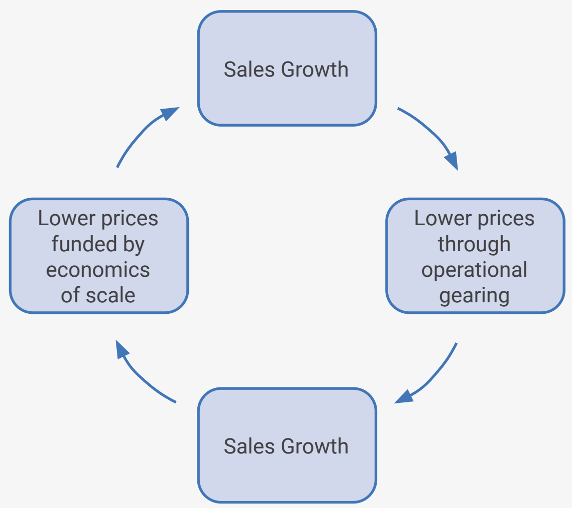
- **Large retailers have a meaningful scale advantage** that can be passed on via lower prices
- **Consumers are price sensitive** and are attracted to lower prices ceteris paribus, meaning the large retailer will win incremental sales
- **High operational gearing** means that above average profits are earned on these incremental sales
- **If the retailer's strategy** is to pass on scale benefits through lower prices, then it will gain even more sales at a high contribution margin
- **As the retailer grows share/sales** it can afford to offer lower prices, and therefore can repeat the cycle.

However, this also works in reverse and if a company starts to lose sales, it can enter the vicious spiral quite quickly, with cost ratios deteriorating and operational gearing leading to a rapid fall in profitability. The virtuous circle and the vicious spiral are demonstrated below.

Breaking the Virtuous Circle and entering the Vicious spiral

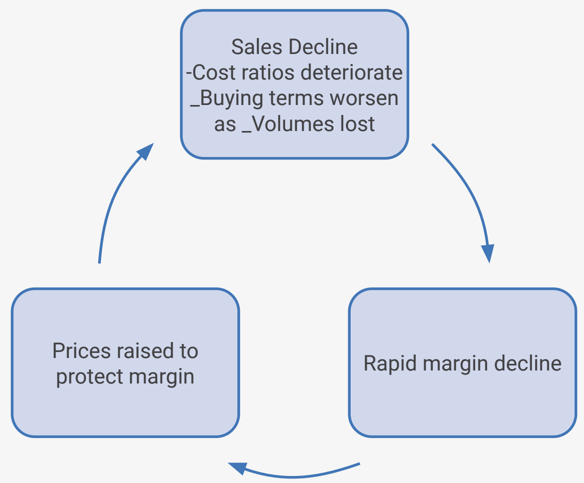
Of course, things go wrong and occasionally retailers lose market leadership to incumbents or to new entrants with new cost structures/business models. This is usually due to the failure of the market leader to recognising an evolving world (e.g. the internet), failing to adapt their strategy to new competition (e.g. grocers in the UK not responding to the growth of discounters) or through changing their strategy due to management error (e.g. pursuing too high an operating margin). The key point is that it is always down to the market leader to lose its position, and it is down to other competitors to develop strategies to work around their lack of scale. Breaking into the virtuous cycle and breaking out of the vicious spiral are difficult and challenging tasks for all management and it is outside of the scope of this report to discuss further but both are possible and have been achieved many times. Next, we describe how we expect future retailing to evolve, based on underlying retail economics and other important factors.

Virtuous circle and the vicious spiral



Virtuous Circle

Improvements in offer self funded



Vicious Spiral

Future of Retailing

The key factors that will drive the future of retailing include:

- The four economic features outlined above
- Evolving consumer demands, preferences and awareness
- Macro-economics, the world stage and Government policies
- Increased use of technology

How these all inter-play is impossible to know as exogenous events, such as Covid-19 can change things overnight. As we are unable to predict unknown unknowns, we have to base our outlook on what we do know. It is also important to separate structural factors from cyclical factors and to focus on what the long term underlying drivers are. Broadly speaking the following is a list of 15 areas where we believe retail is likely to develop based on structural factors, recognising that cyclical factors can mask, delay, or accelerate the underlying trends, as can Government action or inaction.

1. Polarisation of Retailing: Increased concentration ratios and a plethora of small firms

Increased polarisation is likely with fewer large firms controlling more market share and a plethora of smaller independent retailers, while some medium sized firms may struggle.

We are likely to see more market share concentrated into the top few firms in many sectors. This trend has been underway for many years and is driven by the aforementioned economic principles of retailing. The constituents of the top 5 may change over time in some sectors, as we have seen in the food retailing sector, with Morrisons dropping out the top 5, and being replaced by Aldi, according to data by NielsenIQ (market share data, 12 weeks to 20 May 2023).

For the top 5 firms to grow their share, other firms must lose share and we are likely to see more failures in retailing, with medium sized firms perhaps most at risk. Again, this is a trend that has been underway for a number of years, and while there are always new companies emerging, there is unlikely to be enough new companies or enough rapidly growing companies to stem the increase in concentration ratios.

But retailing does have low barriers to entry and this will always allow entrepreneurs to chase their dream of creating new retail businesses – online, omni-channel or via traditional stores. New firms will always emerge but these may find it more difficult, or importantly they may choose not to progress to operating large numbers of stores nationwide than has been the case historically. Newer firms may chose online and omni-channel as the way to achieve national coverage.

The retail industry looks to the Government to help budding retail entrepreneurs develop their businesses on a level playing field, unhindered by an outdated tax regime, unnecessary red tape and excess costs of doing business. In doing so, there will be many benefits to society as we discuss throughout this report.

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2. Increased use of technology and development of digital by bricks and mortar retailing

Bricks and mortar retailers are increasingly recognising the opportunity of digitisation in their stores, in order to serve customers better.

Digital is not the same as online. The two issues are often confused as in most instances Bricks and Mortar retailers have been slow to embrace the use of digital information in their stores and in running their businesses, but this is changing slowly but surely. Whereas an online retailer can monitor consumer behaviour in detail (e.g. time spent viewing each page), traditional retailers generally do not know who is in their stores until the consumer pays to leave. Such retailers have no idea what products customers have browsed and have no idea what purchases customers did not make after browsing, unlike online retailers. Furthermore, retailers do not know which consumers entered their stores and did not buy anything at all. Yet the technology to monitor all of this has existed from many years.

There are a number of companies that are working with suppliers and retailers in developing the methodology for bricks and mortar retailers to make greater use of digital information, through in-store monitoring, through loyalty programmes or through other means. Retailers that develop their digital capabilities to improve sales, margins and profits will be best placed to compete with low cost structure, online competitors or discounters, and will be best placed to evolve into omni-channel retailers. Tesco is one of the leading retailers to gather data on its customers via its Club Card, and as the CEO said recently “Tesco is in the foothills” of developing its data capabilities, indicating the opportunities that lie ahead for the industry.

In the future, store based retailers will have the same knowledge and connectivity with consumers as online companies and this will change a number of aspects of retailing. The information is available, as is the technology, the opportunity is just waiting to be grasped.

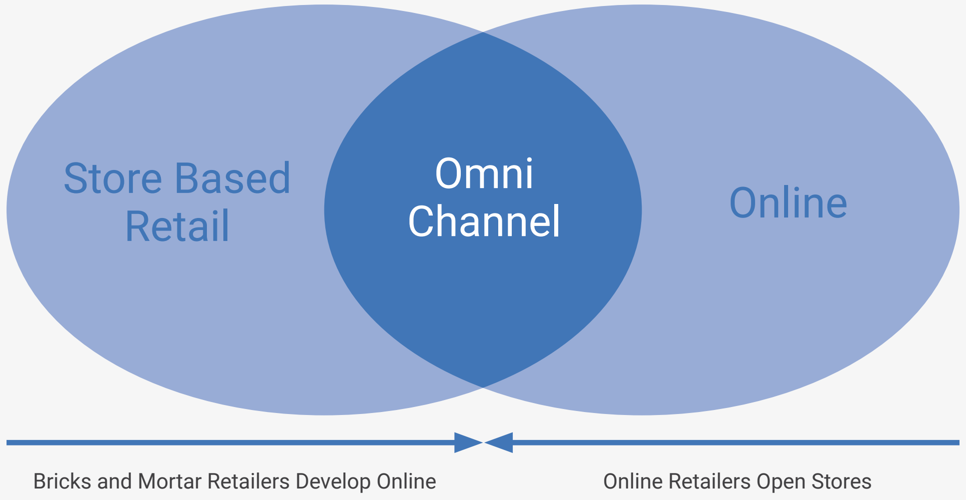
3. Further development of Omni-channel retailing

The future is likely to be omni-channel for many retailers. The distinction between online and store based retailing is reducing rapidly and will be less important in the future as the connectivity and inter-dependence of these channels become more entwined. In many instances, consumers are clients of both a retailer's online offer and their store based offer. Furthermore, a store based offer can help with click and collect service, returns and overall brand awareness.

The retailer Next provides perhaps the best example of how a retailer has evolved from being mainly a store based retailer to become a true omni channel retailer. Historically, Next had a successful store based business and a successful catalogue business. Over recent years it has steadily reduce its store count from a peak of 541 in 2013, to 466 in 2023 – a 14% reduction. (NB total retail footage has increased and we will return to this later when looking at type of store locations). The split between online and store sales is confused by lockdowns and the pandemic, but in the several years before the first lockdown, Next's online participation rose steadily from 37% in 2017, to 50% in 2020. (NB Years referred to are Next financial year's and represent to the 12 months to the end of January each year)

We expect more retailers to develop their online offer, either through developing their own capabilities or through using a third party platform. There may be tie-ups between store based retailers and speciality online retailers but overall, we expect further blurring of the channels through a variety of steps. The extent of the penetration of online will be a function of the specifics of individual categories, cost structures and consumer demands. But we note that some sectors and categories are less suitable for online retailing. For example, Food Retailing is one of the categories least suited to major shifts in online penetration, for many reasons, some of which are covered in this report (e.g. heavy, bulky products, multi-temperature products, bundled orders and low individual ticket items). A shift to more omni-channel retailing may be helped by a relative financial revaluation of online vs store based retailing, which may open up more acquisition and merger opportunities for store based retailers (discussed later in this section).

Growth of Omni Channel Blurs Channels



4. More innovation by online retailers – and by store based retailers

As many bricks and mortar retailers become more digital, improve their cost structures and develop profitable omni-channel business, and as discounters continue to roll-out, so will online pure play retailers have to innovate more, adapt to improved competition and find ways to lower costs further. Online retailers have faced limited competition from digitally enabled store based retailers and have held a comparative advantage over their access to and use of data. But with store based retailers increasingly using data (often gathered through loyalty cards) and with speciality consultants helping retailers gather and utilise data in their strategy, online retailers have lost some of this advantage and look set to lose more of it as discussed above. To stay ahead of the game, online will have to innovate at a faster rate, but this may prove difficult in some quarters as profit expectations and financing are changing, meaning that research and development will become more difficult to conduct.

As store based retailers have competed more on price, many have improved their cost structures. This has been done by stripping out layers of management, by substituting capital for labour (CapEx for OpEx) and by other means such as re-engineering their businesses. In most product markets, online retailers have harvested the low hanging fruit and further growth will be harder. It will require increased innovation by pure play retailers if they are to increase penetration. But innovation will not be confined to online operators. All retailers will look to innovate to improve their offers as retailing becomes ever more competitive.

5. Some further growth in online penetration for many, but not all categories

Online still retains a number of advantages over store based retailing. These advantages should help facilitate some further growth in this channel, and although some of these advantages have been eroded, many remain. (NB it is also important to remember that store based retailers have different advantages over online retailers) Innovation by online retailers as discussed above should help protect at least in part, some of the advantages outlined below:

- **Online offers a lower cost structure than some store based competitors** but needs scale to be as effective. However, for some categories, store based retailing can be cheaper than a delivery based option, and if the consumer is price sensitive, this presents a challenge to online specialists.

- **Many investors/owners of online businesses have previously taken a longer term view of returns.** Shareholders/financiers of such businesses are often prepared to accept losses/ low profitability over the medium or longer term, in a way that traditional store based retailers' shareholders do not. However, we believe that this is changing with a realisation by investors that online may never generate adequate returns and that in some sectors at least online may be approaching maturity. There is an increasing onus on online retailers to demonstrate they have a sustainable and profitable. business model for the long term.

- **As online penetration grows, so the profitability of this channel should increase – if the underlying financial model is sound** (the online virtuous circle). Meanwhile many individual stores will suffer lost sales to online, and due to operational gearing will suffer an even greater consequential loss in profitability, potentially leading to closures. This is the vicious spiral with retailers suffering from high operational gearing and losing economies of scale at a store and corporate level.

- **Different cost structures.** There are fundamental differences in cost structures between store based and online retailing, with perhaps one of the most controversial centred around tax. The treasury should be indifferent to whether a sale is conducted in store or online, with regards to the tax take. But in many instances, this is not the case, with online sales generating a lower tax raise. This can be short term (e.g. avoidance of excise duty by some operators) or longer term (lower business rates, reduced employment taxes and reduced corporation tax). Work needs to be done in this area to enable a more complete understanding of all implications.

- **Convenience.** Online will generally remain more convenient in ordering than a store visit and can be done 24 hours a day, 365 days a year. Online has practically and legally longer opening hours than all stores (e.g. most stores are forced to close on Christmas Day and Easter Sunday, but consumers can order online all year round). Home delivery can also be convenient for many categories, although for some categories, such as food retailing or furniture, the consumer must be at home to receive the order.

We therefore expect some further growth in online penetration for some sectors and this can create a dilemma for retailers, for the Government and for the Treasury. The pace of this growth will depend on actions by all parties. For example, how will the Government address the likely tax shortfall from retailing as stores close, resulting in less business rates, National Insurance, and income tax? Will retailers keep stores open, even if they lose sales to online as part of an omni-channel strategy? Or will stores get into a vicious spiral of closures with fewer stores meaning a reduced centre of "gravity" for High Streets and many other shopping locations, resulting in accelerating store closures?

The rate of growth of online will be determined by many factors including:

- The progress of bricks and mortar retailers to develop their online capabilities

- By the level of innovation in online offers/cost structures relative to bricks and mortar retailing

- By Government policy

- By the ability of bricks and mortar retailers to develop strategies to deal with online competitor growth, either by low cost structures or by good customer service. Discounters (e.g. Aldi or B&M) have shown how they can compete with online, and indeed substantially out-grow online, by offering low prices.

Overall, we expect online penetration to increase in some categories but not necessarily to a great degree in all. In categories where online penetration continues to grow, we expect it to grow at a slower rate than historically as this channel approaches maturity. Discounters are able to survive and prosper against online competitors as some categories are not that suited to online. Furthermore, although lockdowns associated with Covid-19 saw a major step change in online penetration, in many categories, we are seeing a normalisation of shopping behaviour and a return to stores. This is highly visible in grocery retailing. According to NielsenIQ, online accounted for 7% market share prior to lockdown and then peaked at c16%. Since then, however, this has fallen back to c11% with more than half of the gain being lost back to stores and in particular to discounters.

6. Fewer stores

We expect there to be fewer number of main stream stores in the coming years. Many consumers want to visit stores, and in most categories, this is the majority of consumers. However, due to the cost structures of individual stores, many stores become unprofitable when a significant percentage of the business goes online, either through lost sales to a pure play competitor or to that retailer offering an online alternative (cannibalisation). For omni-channel retailers, such stores could be viewed as "show rooms" for their online offers, but there will always be a temptation to cut costs and close stores when a retailer is under pressure (this can be a mistake with some retailers forgetting that online sales are helped by physical stores). Ultimately closing stores is a judgement call by management and some will get the call wrong and will close stores that should remain open, and vice versa. For some online pure play retailers, there is the opportunity to open stores but these may only be a limited number of stores in the most popular of locations. Nevertheless, it is still a move to omni-channel and a recognition that stores have an important future.

As businesses transition to becoming omni-channel, so will a national retailer likely need fewer stores than historically (a situation also helped by greater car ownership and consumer mobility). Next is perhaps the best example here and as discussed earlier, it reduced its store count by c14% from its 2013 peak and is expected to reduce its store count further in the coming years. As stores lose sales, and profits at an even faster rate due to operational gearing, so more stores close and the attraction/gravity of a given shopping area (e.g. a High Street or a town centre) is reduced and more people go online or go to larger shopping centres further afield. This is the vicious spiral faced by many towns and High Streets- the more stores that close, the more stores that are likely to close.

We need to be cautious that we understand the consequences of this strategic shift and that we treat the underlying cause and not just a symptom.

A similar situation is faced by store based retailers with no online offer and which is losing sales to online competitors (either pure play or omni-channel). These retailers will not have the comfort of merely transferring sales to their online operation and face the prospect of decline and a continual reduction in store numbers as they are forced to close in weaker trading locations. Hence this is another reason why we believe the growth in omni-channel retailing will continue, with a reduction in retailers operating only store based offers. (NB We emphasise that not all categories are suited to online and there are a number of rapidly expanding retailers without an online offer – but these are primarily discounters as we discuss later in this report and the growth of discounting is a major structural shift in the market that is not always explicitly recognised).

With low barriers to entry, it will always be relatively easy for an entrepreneur to enter the retail market. Indeed, many of the best known entrepreneurs in the UK over many decades have been retailers. But going forward we are likely to see fewer national chains with large store bases than previously – as not so many stores are needed to be "national" given online and home delivery and given the willingness of consumers to travel to major shopping centres. Therefore, evolution will see some medium and large scale businesses fail, but it is unlikely these will be replaced with commensurate new businesses and hence net store numbers are likely to fall. Where we are seeing rapidly growing businesses, these tend to be discounters as we discuss later with implications for types of store locations.

7. Fewer people employed in retailing – but more higher skills required

There are several key factors which are likely to lead to fewer people being employed in retailing in the future:

- **Fewer stores with more business done online.** Even though the total value of goods sold may not change due to online migration, online retailers tend to have higher sales per employee than stores, so more online will lead to fewer employees in direct retailing roles.

- **Growth of discount retailing.** Most chains that are expanding rapidly are discounters/low price led retailers and by their very nature they tend to have low cost structures and higher sales per employee compared to other retailers in the same segment. Consequently, as sales migrate to discounters, there will be fewer employees needed by retailers.

- **Substitution of capital for labour.** As the cost of labour rises and technology improves, so there is a greater incentive for companies to substitute capital for labour (substituting CapEx for OpEx). For example, self-scanning tills or customers self-scanning using their own smart phones. In the latter case, the consumer even provides the capital cost. Reduced employment is an unintended consequence of rises in National Living wage (NLW). A further consequence of a rising National Living wage is that it reduces the flexibility that retail offers to employment. For example, the ability of retail to pick up any slack in employment if the UK were to come out of a recession is reduced if there is a substitution of capital for labour or if retailers proactively look for productivity to keep labour costs low.

- **Unintended consequences of the impact of a rising National Living Wage.** It is worth highlighting that while the Government is fighting against a wage-price spiral, increases in the NLW are unhelpful if retailers pass on the increase via higher prices. Increases in the NLW have to be paid for by consumers, shareholders or by productivity, meaning higher prices, lower returns for investors or higher unemployment. It is also worth pointing out that discounters gain an increased competitive advantage through rising wages. Discounters tend to have lower wage ratios, so they gain a comparative advantage from rising wages, allowing a widening price differential to be funded. This then accelerates the move to discounting, which as described elsewhere leads to less employment.

- **Business re-engineering.** To compete with low price online competitors and with discounters, retailers have looked to reduce labour intensive activities. For example, many supermarkets have reduced the number of manned counters, or in some cases removed them entirely, plus the above mentioned reduction in manned check-outs in supermarkets, or the removal of customer service desks.

- **Labour efficiency.** There is evidence that many retailers have sought to reduce the number of employees by taking out layers of management and by looking for efficiencies in order to lower costs and to be more price competitive. The table below uses Tesco as an example and shows a c8% reduction in the number of total full time equivalent employees over the last 2 years. This managed reduction is designed to improve sales and profitability per employee and to reduce wage ratios in order for stores to be more price competitive. It is a good demonstration of how emphasis is increasingly on lower prices across the retail industry at the expense of service.

Tesco Full Time Equivalent Employees (UK &ROI only)

2021	**214470**
2022	**204974**
2023	**196911**

Although some retailers will try to differentiate via customer service and via trained salespeople, this is unlikely to be enough to offset the underlying dynamic of the growth of discounters and further, albeit limited growth, of online operators. The British Retail Consortium (BRC) has estimated that in 2018, there were 3.135 million jobs in the retail industry, and by March 2023, this had fallen by 2.2% to 3.06m, representing 71,000 fewer jobs. Over the same period, the total number of jobs in the UK rose by 5.4% from 34.7 million to 36.6 million. This highlights that the contribution of retail to overall jobs in the UK has fallen from 9.0% to 8.4% in 5 years. The BRC anticipate that this trend will continue as more retail-ers invest in automation and digital solutions that improve efficiency and productivity.

As discussed elsewhere, this has important implications for the tax raise and overall employment – with rising unemployment being a potentially acute issue in some regions.

With retailing becoming ever more sophisticated and with more digitisation, so there will be increased demand for higher skilled staff. This demand needs to be considered by the Government and relevant skills need to be embodied into the school curriculum and included in university education. Retailing has lost some of the glamour it had in the 1980s and 1990s, but it still overs a very varied, exciting and rewarding career. This message needs to be put across to those currently in education as these are the future leaders of this important industry.

8. More Focus on out of town/edge of town stores and large shopping centres

We have seen many chains exit the industry in recent years and other chains reduce the number of stores they operate (e.g. Boots has just announced the closure of 300 stores). However, not many new large chains have emerged to replace them. An existing firm can close overnight, but it can take decades for a new company to develop into a nationwide chain. Plus omni-channel retailers need fewer stores to be nationwide as discussed earlier, and the stores they open tend to be larger and out of town. Again, Next is a good example, with 14% fewer stores than in 2014, but with greater overall square footage. Or B&M, which continues to expand its store numbers, but with its average square store size increasing, due to the roll-out of a larger store format. We are unlikely to see many chains of 500 plus stores emerging from what are small businesses today, and if they do, they will likely be discounters.

A generation ago, to be truly nationwide, a retailer may have needed a thousand stores or more. But with the development of major shopping centres and large out of town retailing units, coupled with increased shopper mobility, this figure has fallen substantially. Today with omni channel retailing and high online penetration in many areas, retailers can be nationwide with relatively few stores, and may choose to be positioned in just 100-200 key locations. Note also that a relatively small pure play online or omni channel retailer can have a nationwide presence with no stores as distribution networks like the Post Office, DPD, Evri etc offer nationwide delivery.

For the select bunch of retailers that are not online then there remains the opportunity to expand store numbers to achieve growth. Aldi and Lidl are targeting 1200 stores each but the final figure is likely to be much higher, B&M has previously said it can open at least 950 stores (from c700 currently) and Home Bargains continues to open c15-20 store per annum. Primark also remains committed to further store expansion as is Poundland. Marks and Spencer is expanding its food only stores and many of the mainstream food retailers continue to open convenience stores. The majority of new store openings though, are either discount stores or stores where price plays a major role, plus the companies operating them have no significant online offer. We return to the growth of discount retailing later in this report.

9. Continued Lower Tax take for the Treasury

The Treasury should be cognisant of the falling total tax take of the retail industry and how the decline is likely to accelerate. There are tax inefficiencies and inequalities that are exaggerating the move from profitable, tax paying retailing to lower tax retail. This is much more than about business rates.

The trends outlined so far in this report have long term implications for the Treasury. For example, online has so far proved to be inherently less profitable than historic store based retailing and less labour intensive. Therefore, the total tax take from retailing (including National Insurance, Income Tax, Property Taxes, and Corporation Taxes) looks to have fallen in real terms and is likely to fall further. The extent of the issue can be gauged by looking at Tesco as an example.

There is a correlation between business performance and corporation tax. For example, as businesses encounter economic challenges, lose market share and experience reduced profitability, there is likely to be a commensurate drop in the corporation tax paid. With no signs of current trends changing, there is no sign that industry profitability will return to peak historic levels, with implications for the tax raise. The table below shows the corporation tax paid by Tesco during its years of peak profitability (2011 and 2012) and more recently (2021-2023 – all years are February year ends). Tesco paid over £600m less corporation tax in 2022 compared to 10 years earlier – demonstrating very clearly how the Treasury and the economy suffer when retailers suffer a decline in profitability. The problem is exacerbated further by the impact of lower taxes raised from employment (National Insurance and income tax).

Tesco Corporation	Tax (£m)
2011	864
2012	874
2021	104
2022	510
2023	247

With retailers searching for increased productivity, many have reduced their like for like workforces in relentless drives for efficiency, in order to compete with discounters and online operators. This includes the aforementioned substitution of capital for labour and other measures. But, less employment means less income tax and less national insurance contributions, and there are secondary and tertiary effects. With less wages paid in total in real terms, there is then less expenditure by employees, which means less economic activity, less VAT raised, and potentially a greater cost in welfare benefits. In recent years the slack caused by retailing's lost jobs has been picked up elsewhere in the economy, and the UK has been close to full employment, but there are some signs this may change, with interest rate rises as the Government tries to control inflation, and as tech and other firms reduce their employment costs.

Retailing is an industry that historically has been able to take up any slack in employment quickly. However, in the future, with increased emphasis on productivity and the growth of less-labour intensive formats, the ability of the industry to do "pick up the slack" may be reduced – meaning an increase in frictional unemployment and a slower recovery as the economy recovers from tougher times. Hence this benefit to the economy and this part of being an enabler may be reduced in effectiveness. The Government should be aware of this situation and should look for ways to help the industry increase employment in certain situations.

When a retailer goes wrong and fails, it is not just, employees, consumers, suppliers and shareholders that lose out, it is the Treasury and society as a whole. This is not to say failing retailers should be protected, but it is important that the causes and implications of failure are recognised and that the reasons for failure are not due to inequalities of the system. The retail industry is not trying to prevent evolution, but it looks to the Government to make sure the playing field is level and that evolution is not distorted by an uneven playing field. For example, some retailers are avoiding paying import duties and can charge lower prices, by exploiting an unintended loop hole in the tax system.

The Government should ensure that all tax loopholes which favour overseas retailers to the detriment of UK based retailers (e.g. through the excise system) are closed. The consequences of not doing this is a failing domestic retail industry, a lower tax take for the treasury and less economic growth. The full multi-faceted impact of failing retail businesses are not always considered and there are false economies in letting businesses fail for the wrong reasons.

10. Societal Impact

The impact of failing retailers on high streets, town centres and the community must also be taken into consideration. For example, already there are too many empty units and run down areas. Store based retailing offers the opportunity for interaction with others for people living alone. Therefore, declining high streets and shopping areas means a deterioration of the mental health of the community – and this in turn brings additional indirect and direct welfare costs. The impact in this are needs to be considered in detail, in order to prevent other false economies to the economy and society. This is particularly true given the longer term aspects of Covid lockdowns. Plus of course there is the broader consequence of run down areas impacting social behaviour.

11. The Environment and Sustainability

There is no doubt that consumers are very aware of issues around sustainability, the environment and global warning. However, although some cohorts are prepared to pay a premium for sustainable products, many are not, and those that are prepared to pay a premium are generally only prepared to pay a small premium.

11.1. Shorter term priorities determine behaviour. When families are struggling and have to make choices between "Heat or Eat", then paying extra to save the planet for future generations is not something they can afford to consider. Therefore, it is hard for many businesses to be more sustainable and charge a premium for sustainability when their competition are focussed purely on low prices. Businesses that are charging a premium will lose sales when customers are price sensitive. No firm should be penalised or competitively disadvantaged because they are supporting the planet.

11.2. Sustainability needs to be part of the core offer for retailers with at best a minimum price premium and preferably no premium at all. But sustainability typically brings extra costs and it is down to the Government to create a level playing field without imposing large extra costs and complexity onto the industry. For sustainability to be a major part of the future of retailing, it will require better economic conditions, substantial levelling up and greater incentives for retailers and consumers. But it can also be greatly aided by Government help, guidance, and a relaxation on competition laws around co-operation for sustainability issues.

11.3. The Government showed leadership for the benefit of all, when it legislated that plastic carrier bags had to be paid for by consumers. Not all incentives need to be cost driven, and some actions by Government can help the retailers and the planet simultaneously. Plastic bags are a great example. Retailers were spending tens of millions of pounds each year giving away free plastic bags, with the food retailers far and away the biggest spenders and issuers. Yet no retailer could unilaterally stop giving them away because to do so would leave them competitively disadvantaged. Competition laws prevented the industry from solving the issue itself via sensible collaboration. Government intervention was required and was quietly greeted with relief by the industry and by society, with no backlash from consumers. The free carrier bag situation is a great example of where "rational" decisions by individual companies can lead to an "irrational" outcome for the collective. In such situations, Government intervention is needed to deliver the optimal outcome for all.

11.4. Retail already plays a major role in the circular economy. Charity shops are essentially recycling centres, as are re-sale websites for pre-owned clothes (e.g. Vinted or Depop) or market places like Gumtree or Facebook Marketplace. Additionally, many stores are also recycling centres, whether for clothes (e.g. collection points for charities), for batteries, for soft plastics, for old electrical products etc. This is a major role being played by the retailers that is not usually implicitly recognised. Recycling will play a bigger role in retailing going forward and all channels will have a role to play.

12. Further growth of discount retailing

There is a structural move to discounting that is not usually explicitly recognised and this shift is set to continue as retailing moves onto another life stage. Price will always be important to consumers in almost every mass market. Discount retailing has been a growth channel for many years, whether through in-store retailing (e.g., growth of Aldi, Lidl, B&M etc) or through online (e.g. competitive pricing has always been a core part of the Amazon offer). Mass market retailers that fail to remain price competitive lose share (after all demand curves slope down) and ultimately fail. Too many retailers over too many years have over-estimated the strength of their own brand and have sought to charge a premium where one is not justified in the eyes of their consumers. As has been said previously:

"There are two types of retailers. Those who aim to price as high as they can, those who aim to sell for as low as they can"

Increasingly, mass market retail has been driven by retailers who aim to sell as low as they can, while price premium retailers are often more niche driven or operate in specific segments.

This can perhaps be best summarised by the below equation and we make the following points:

- Traditional Brand Power tends to focus on maximising the operating margin and focusses on percentage margins - "How high can we push prices without impacting profits".
- New Brand Power tends to focus on maintaining margin and maximising sales to maximise cash profits - "We take our brand premium through the sales line, not the margin line, to maximise profits")

Everything else being equal, price will always win – why pay more for the same product?

$$\text{ROI} = \text{Operating margin X Asset Turnover} = \underbrace{\frac{\text{Operating Profit}}{\text{Sales}}}_{\text{Old Brand Power}} \times \underbrace{\frac{\text{Sales}}{\text{Capital employed}}}_{\text{New Brand Power}}$$

12.1. Where there are rapidly growing retailers in the UK, these are mostly, but not exclusively, discounters, where price is at the core of the offer (e.g. Aldi, Lidl, B&M). John Lewis Partnership recently stated that there are approximately 2,000 more discount stores in the UK compared to the start of the great Financial Crisis. We estimate that there will be c1000 more in the next five years. At the same time, as mentioned previously, some retailers are taking service elements out their stores in order to be more price competitive. While not transitioning to being a true discounter, many retailers are trying to be more price competitive Many supermarkets are reducing their service counters and are moving to self-scanning to reduce costs and to help price positioning.

12.2. As we expect the number of discount stores to increase for the foreseeable future, so we expect more price competition, financed by low cost structures, operational gearing and improved economies of scale. In short, discounters will continue to grow as long as they remain on the previously mentioned virtuous circle – which is centred around a number of the key economic features identified in this report (i.e. operational gearing, economies of scale and cross price elasticities). It is also important to note the locations of new stores being opened by expanding retailers. Many of the stores opened by rapidly expanding retailers are often out of town/edge of town with implications for certain parts of society.

It is not exclusively about price. It is worth emphasising that although we focus on price, it is not the only variable in a consumer's decision on where to shop. There are many other considerations, such as store location, brand image, provenance, website, delivery schedule, availability, pre-and post-sale customer service, and returns policy, to name just a few. But we emphasise price as the single most important determinant/variable for many consumers. If everything else is equal, why pay more? Additionally, it is notable that growth over recent years has been much more driven on price positioning in most mass retail markets than by other factors.

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13. Electric Vehicles (EVs)

EVs will play a part in the evolution of retailing. One of the biggest issues in consumers' minds about EVs is range anxiety and the ability to charge their vehicles. Therefore, retailers and retail centres will need to offer more charging points in the future. This assumes that there will be wide-spread adoption of EVs and that the Government's targets will be hit.

This is not just about charging vehicles for their shopping trips. Many consumers do not have parking at home (e.g. terraced housing, apartments) and hence will have to charge out of home and will want re-assurance they can charge somewhere. NB there is an anomaly in charging in and out of home. Out of home charging is subject to 15% VAT, home charging to just 5% VAT. This means those who are unable to charge at home – which in many cases are the less well off in society, are being taxed at a higher rate than wealthier families who have larger homes and driveways and who can charge at home. This issue needs to be addressed.

Retailing and hospitality offer the ideal opportunity for multi-tasking - i.e. the consumer can do their shopping/eat out/be entertained while charging their cars. It is therefore important that out of town retailers, like supermarkets, shopping centres, and the High Street, offer charging points in the future. Not to do so will result in a competitive disadvantage, lost sales and the move on to the vicious cycle will start or accelerate. However, should alternative forms of transport become more widely accepted (e.g. hydrogen powered vehicles) this would change this dynamic.

14. Valuation changes

"Tech companies" valuations are reverting to more normalised valuations. For a number of years, Tech companies have been awarded high valuations that bear little relationship to short or even medium term profitability. This has given "tech" firms competitive advantages in financing and has resulted in their having a much lower cost of capital (effectively a zero cost in many cases). This has left traditional retailers at a disadvantage as they have been expected to deliver profits and cash flow while competing against new entrants who have not been judged the same way. Traditional retailers have been punished with falling share prices if they fail to deliver, while their new competitors have often been able to deliver losses and have been cash consumptive without any similar financial consequence.

This is touched upon elsewhere in this report but there are signs that this is changing and that the premium valuations afforded to tech and online competition is being eroded. This will have several impacts:

- It will be harder for these "tech" companies to raise finance and therefore their ability to grow without delivering profits, cash and returns will be diminished.
- This effectively becomes a levelling of the playing field on financing and improves the competitive outlook for traditional retailers.
- Traditional retailers will feel under less pressure to develop their own loss making or margin dilutive online operations to appease a market that expects online operations.

Overall, this is likely to lead to a slowing of online growth, although we expect omni-channel to keep growing and to less value destruction for the retail industry overall. There is likely to be renewed focus on profitable growth and on which companies that can deliver this. Growing and profitable retailers, whether online, bricks and mortar or omni-channel, will be the ones that get high valuations and lower costs of capital. Companies whose business models are unproven will find it increasingly difficult to be subsidised by shareholders and banks and so such companies may exit the retail and consumer market.

15. Consolidation of Online Companies

Due to changes in valuation metrics (explained above), investor expectations and increased use of data by traditional retailers, we expect consolidation amongst online pure play retailers, with struggling and failing companies being mopped up by more successful ones. This includes acquisitions by traditional retailers, who may want to expand their omni-channel offer or may want to expand their data management capabilities.

15.1. Economies of scale and other economic forces are expected to play a role in this development. For example, the rising cost of transport (fuel, labour, insurance etc), in particular for the last mile of delivery and the full expense of returned goods will be increasingly important. It is also worth pointing out that EoS for online businesses are different in some areas than for store based retailing and these will help shape the future as well.

15.2. In food retailing, drop density is a very important EoS. A concentrated drop density means more deliveries per hour and per van, meaning the high fixed cost of the delivery is spread over more orders. Similarly, average order size is a key profit driver, due to high fixed costs per order and due to a high contribution margin on marginal sales. If drop density and average order size can be improved, so does underlying profitability.

15.3. Outside of food retailing, delivery costs are shared by different retailers, as these tend to use third party distribution (e.g. Post Office, DPD etc), reducing fixed cost ratios. This is helped further by a "bus stop" approach to deliveries, with orders delivered in a logical and sequential order and the customer being told when the order will be delivered. For food retailing, it is "taxi stop" delivery, with the customer deciding when they will receive the order and the retailer accommodating – and this method obviously brings extra costs.

15.4. Home delivery is a complex and expensive operation and not all business models appear sustainable, despite obvious cost advantages in other areas (e.g. not subject to business rates in the same way store based retailers are). Consequently, we expect consolidation as discussed, and this may be further accelerated as retailers look to be more price competitive and reduce any cross subsidisation of online orders.

Conclusion

The Challenge for Government and the Industry

Retailing is evolving faster than ever before, and it remains an industry that touches everyone in all walks of life. Its enabling power will be largely undiminished, despite the expected changes we have discussed in this report. Retail will remain a key industry for the implementation of Government policy, for tax raising and for the very fabric of society.

Retail continues to go through rapid change. Retail sector insolvencies have risen over the past year, as cost inflation has placed financial pressure on businesses. Data from the Insolvency Service shows that in the 6-months to April 2023, retail insolvencies were 34% above the same period in 2022. However, despite the rise in insolvencies new retail businesses continue to be created. According to Companies House data, the number of retail businesses created in the six months to February 2023 was 22% above the same period in the previous year.

Several tipping points in sight. The next several years are unlikely to see any step change in the structure of the industry but we still expect rapid evolution. Over the medium term, the industry is likely to reach several tipping points, with widespread implications for the Treasury, the Government and the Consumer. The longer the Government allows things to ride with uneven playing fields and tax anomalies, and while competition laws prevent positive collaboration which would benefit society, the economy, and the environment, the less favourable is the likely outcome. The retail industry hopes and expects the Government to take action in several areas to level the playing field, including:

- **Business practices.** For example, some online retailers avoid import duty by packaging products overseas in small quantities. This is circumventing the taxation rules and is a behaviour that legislation had not anticipated. It is to the detriment of the economy and to the outlook of those retailers that pay full taxation, including VAT. Without the playing field being evened, there will be more business failures, less taxation and more unemployment.

- **Employment practices.** No business should gain a competitive advantage by circumventing employment legislation around National Living Wage, benefits etc. The so-called gig economy needs to be controlled to prevent a sub sector of the economy going in the opposite way that the Government and society wants employment practices to go. Again, the longer term consequences for this include less taxes raised and higher unemployment.

- **Property practices.** Current property laws make it difficult for the market to react efficiently for changes in retail structure. Too many retail properties remain empty rather than being put to alternative use and there are incentives for landlords to maintain the status quo – and to leave some units empty, rather than accept a new, lower paying tenant. The Government can remove the barriers to change that currently stand.

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- **Sustainability.** Society wants a circular economy and wants a sustainable environment. But individually, consumers are not willing or able to pay much of a premium for these aims, if any at all. Therefore, with a higher cost of sustainability, companies should not be economically, commercially and competitively disadvantaged by doing the right thing. At the same time, it is important that the Government does not impose extra costs onto the consumer when the consumer is already suffering falls in the real standard of living during the cost of living crisis. There is a fine balance to be struck here for the benefit of all.

- **Government intervention.** The Government should step in and help the retail industry when misplaced competition and other laws prevent the industry from helping itself. We have highlighted the example of plastic carrier bags, which cost the retail industry hundreds of million pounds in the past (resulting in higher prices for consumers), damaged the environment and which gave only limited utility to customers. Competition law prevented the industry from co-operating to reduce usage of plastic carrier bags, so it required uncontroversial Government action to solve the issue. There are other ways the industry can work together with the Government on similar issues and the industry seeks further engagement.

As stated earlier, this is the first report looking at the retail industry and will be followed by further work to explore and consider key issues and propose solutions. This report is a discussion document, intended to raise awareness of the challenges and opportunities for retail and to provide a starting point for a longer term process of thought and exploration. Its intention is to provoke debate. A follow up report will outline a range of key issues that the industry and Government needs to address and will propose working solutions to many of the issues. We welcome comment and debate around this report and any key issue. This report is the start of a process, not its conclusion.

Retail Sector Council

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