

Future of Retail Property

Future of Retail Business Models

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‘Evolve or die’ - the pressure on retail has never been more compelling than it is today, and retailers have had to meet this pressure head on with a complex mix of business models.

BCSC is pleased to present this report which takes a close look on how the ongoing transformation in retail formats is likely to develop over the next decade.

John Bullough, President, BCSC
Retail Director, Grosvenor

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Future of Retail Business Models

Researched and written by Dr Jonathan Reynolds, Elizabeth Howard, Christine Cuthbertson and Peter Snow, from the Oxford Institute of Retail Management, Saïd Business School, University of Oxford

Managed and edited by:

Dr Richard Barkham, Grosvenor
Dr Yvonne Court, Cushman & Wakefield
Marcus Kilby, Lunson Mitchenall
Kate Logan, BCSC
Dr Hayley Myers, University of Surrey

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Evolve or die

Changes in the retail environment are increasing in pace and in their impact. Retailers have always had to evolve or die, but the pressure to adapt has never been more compelling than today. The recent history of Marks & Spencer and of Sainsbury's shows how retail strategies and business models are being forced to change and become more flexible. The growth of international competition, the increasing concentration of the industry coupled with the slowdown in domestic demand and the direct and indirect effects of the internet and e-commerce will together substantially transform the sector over the next ten years.

Retail practitioners have traditionally been suspicious of strategy and business models. Sir Ken Morrison is on record as saying that running supermarkets is simple: *"It's just taking money off people, isn't it? And giving them something in return."* Many marketers and economists used to share this view, regarding retailers as little more than ciphers in the distribution channel, intermediaries smoothing the flow of goods and services between suppliers and consumers.

However, it is clear that increasingly leading retailers are now acting as proactive agents in their own right. They possess more power to forge their own destinies. They actively monitor the consumer environment and their positioning in the market and develop strategies accordingly. Their decisions regarding locations in shopping centres and elsewhere are built on longer-term perceptions and are not just reactions to changes in the retail environment.

Strategically, the retailer's goal has been to grow larger, faster and more profitably than their competitors, to differentiate themselves from their competitors, to attract and retain customers, and to achieve efficiencies in systems and procedures. At the same time, they have had to do all this within the constraints of the environment in which they operate. This has had implications for the mix of formats in both the short and long term.

The project brief required examination of:

- changing retail industry structures
- the changing structure of companies and firms in retailing
- changing retail formats
- the drivers of these changes
- the factors affecting retail change over the next ten years - with particular reference to the implications for the retail property industry.

But to do so, this report didn't just look at structures and formats at an industry level but also at issues and business models from a firm level. The first cannot be understood without reference to the second. Corporate structures and the business and external environmental drivers which underpin those structures are closely related and equally significant. Therefore, the study attempted to define what comprises a business model (see Appendix 1), to evaluate the pressures that give rise to particular formats and to identify what forces are likely to drive change.

Leading retailers are not the only business entity examined in this report. Quoted companies, both large and small, feature significantly, but unquoted companies with multiple formats and smaller, independent, family-owned and recently established firms also deserve attention if the intention is to trace the origins and understand the development of format innovation over the next ten years.

Section 1

Executive Summary



Aim and scope of the report

As part of a broader study into the Future of Retail Property, this report explores the development of, and prospects for, retail formats and the implications for the UK shopping centre industry. The approach is based on conceptual research supported by analysis of financial and economic data and in-depth interviews with

senior retail and related practitioners. The study looked not only at industry structures but also at firm level models and formats. Business models and external pressures are closely related and equally significant. It is necessary, therefore, to define what comprises a business model (see Appendix 1) and also a retail format.

The study looked not only at industry structures but also firm level models and formats. Business models and external pressures are closely related and equally significant.



A retail format is the physical embodiment of a business model. The Oxford Institute of Retail Management identified twenty-one performance indicators commonly used by retail firms. From these, six key elements - size, location, number of customers, range, frequency of purchase and access - can be derived, divided into the supply side (costs) and the demand side (sales). From these elements it is possible to devise a generic retail business model (see diagram in Appendix 1, titled

'The major elements of retail business models' on page 73).

A measure of the usefulness of such a model is whether it can distinguish between formats that look similar or detect the similarities in formats that look very different but which are based on the same underlying business model. This can be done by plotting the six basic elements on a 'spider web chart' (see the chart on pages 74-75).

The retail environment

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The formats and business models in today's shopping centres are the product of four main forces:

Economic factors

The UK economy has seen significant growth in domestic consumption over the past decade. One consequence has been the growth of retail business. In the past five years alone, retail sales volumes have grown by over 20%. This has gone hand in hand with growth in retail formats. More negatively, credit card spending has fallen over the past year; more recently, interest rates have started to rise and retail spending growth has faltered partly as a result.

In reality shoppers have benefited from substantial price decreases in a range of products over the past ten years. The debt really affecting consumers has come from higher utility, transport and housing bills, which have had a disproportionate effect on perceptions. Nevertheless, the onus is on retailers to highlight fair prices. This will benefit

retailers who demonstrate value but would be a disadvantage to those with muddled price points or value propositions.

Retailers themselves are exposed to cost inflation. Together, price deflation and cost inflation have led some retailers into financial difficulties. Confronted with this combination, retailers have several options. They can accept a fall in margin, cut costs or persuade consumers to trade up to higher margin products, especially where product innovation supports trading up. While cutting costs offers some scope, it can involve heavy initial investment.

Regulation

Regulation has affected retail formats and business models in a variety of ways, by, for instance, restricting formats to locations where these models operate less effectively. The increasing cost of access is another worry for retailers. Also, retailing, as a service sector, is proportionally more exposed to labour cost regulations.



Greater customer sensitivity to prices, increased mistrust of retailers' promises on price and easier access to information on prices over the internet have led retailers to focus on 'value' formats.

Consumer attitudes

Many consumers believe product prices are higher than they should be. Greater customer sensitivity to prices, increased mistrust of retailers' promises on price and easier access to information on prices over the internet have led retailers to focus on 'value' formats. There is more scope for development in this direction: for example, value retailers in the clothing sector represent 35% of the US market but still only 18% in the UK.

Corporate social responsibility (CSR) has become another major concern. The National Consumer Council's Active Consumer Index has risen 52% since 2000 and MORI estimates that CSR activists now comprise some 15% of consumers. The influence of these activists is significant in society.

Consumer demands for enhanced service and experience are a further pressure. These can be another source of increased cost or an attractive non-price differentiator in the face of online competitors. Prestigious department stores and flagship stores have the opportunity to create high quality retail space. But these investments raise the level generally, and such opportunities are not always open to smaller retailers.

Competition and innovation

In shopping centres, competition is also affected by policies on tenant mix. This can facilitate or hinder innovation. With increased levels of competition among larger scale retailers, achieving sustainable differentiation demands action and can be costly. At the same time, the constraints which result from these policies can discourage 'me-too' copying and so create real first-mover advantages.

Current trends in formats



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The drive for size

Well known trends include the increase in grocery format size made possible by moves to out-of-town locations and the subsequent wave of re-entry of the grocery formats into city centres with new, smaller sizes. Less well known is what has been happening in the non-food retailing sector where there has been a trend not only towards long-term growth but also a step-change in format sizes in town centres. Many retailers are choosing to introduce larger formats offering more authoritative ranges and more destination pull.

This trend, however, has led to some overshooting, and the scale of operation cannot always be consistently delivered within town centre environments. Recently, the search for the most effective balance of range and floor space productivity has resulted in the downsizing of some very large formats.

The rise of speciality formats

A polarisation in consumer behaviour is taking place involving a preference for large-scale and convenience formats alongside growing interest in speciality formats. Speciality formats cater to

today's consumer demands for a more hedonistic shopping experience, emphasising convenience and brand values as well as value for money. What sets speciality formats apart from more traditional formats is the authority of their range, their brand identity and the knowledge of their employees. For retailers, the speciality format presents a challenging business model with different location and space requirements.

The move to 'value'

There has been huge growth in the UK in 'discount' formats. But 'discount' is not adequate to describe all these formats. Driving their growth is not only the desire for low prices but also real value. The old trade-off between quality and price is no longer acceptable to consumers. Low prices are now expected even for strongly branded merchandise, given the proliferation of retail offerings, increasing competition and customers' increased ability to undertake information searching online. 'Value' formats will continue to grow rapidly, but other players will continue to demonstrate value within existing offerings.

International competition

An important driver of format innovation is growing international competition in the UK. Estimates in 2005 suggested that over 500 non-UK retailers were currently trading in the UK - numbers which have risen steadily over the past twenty years.

Two findings emerge from recent studies of the internationalisation of formats outside the UK:

- There are particular opportunities for certain formats in emerging markets, where the development of modern retailing - especially larger scale firms and stores - complement or dovetail with the expansion of the local consumer economy. Hypermarkets, Seven-eleven stores, hard discount, and cash-and-carry stores are examples of this growth.
- Internationalisation poses particular format challenges. Formats which work well in the domestic market may not transfer successfully, or unforeseen aspects of the retail environment may not be conducive to effective competition. Consumers' perceptions of format are complex and durable and can be very hard to alter. Obvious format gaps in a particular retail landscape may well persist despite attempts to fill them.

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The future for retail formats

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Retail format innovation is continuous and incremental rather than a series of step-changes. Often intuitive rather than planned, the evolution of a retail format combines innovation in both products and services, has short cycles, is easy to imitate and therefore makes speed to market essential. It is also necessary to bear in mind the effects of 'churn' in retailing, which come in part from ease of entry into the sector. Failure rates among SMEs in retailing are high and have been growing (by 9% between 2004 and 2005), reflecting the tougher business climate.

Given these uncertainties, this report has not undertaken a full blown scenario-building exercise. Instead, it examines four uncertain but potentially high impact assumptions in thinking about the future:

- The relationship between real costs and real sales will be a crucial factor impacting retailer expansion and, therefore, ease of format experimentation and roll-out
- The influence of regulation will continue to be fundamental

- Increasingly, physical formats will have to be managed as part of multi-channel offerings in the future, with possible reductions of stock in stores and more use of space to accommodate e-commerce activities
- Corporate successes and disasters will reverberate through the market. Retailing is a quick moving and competitive industry. Fashion is difficult to predict, but formats that succeed are likely to be copied increasingly rapidly by competitors.

Consumer choice will place growing pressure on retail firms resulting in a series of 'searches' that will need to be undertaken as part of an overall competitive strategy:

The search for authority

Faced with fickle and demanding consumers, retailers are moving in several different directions - towards wider ranges, deeper ranges, or towards more edited or specialist ranges. The goal of all these moves, however, will be to provide authority in range - making a product or theme appear convincing and sufficient for a consumer with particular interests.



The search for efficiency

Increasing competition, tougher demands from investors and stock markets and increasing sophistication in applying Information and Communication Technology (ICT) to measure performance throughout the supply chain will create relentless pressure to cut costs. But effectiveness is as important as efficiency; this is achieved through close tailoring of the offer to meet market demands and by ensuring that the offer is aligned with, and supported by, the right business processes.

The search for new convenience

The traditional designation of a 'convenience store' is no longer meaningful. Consumers now search for various kinds of convenience - such as one-stop shopping, edited ranges and choice guidance - and retail formats will have to evolve to provide these.

The search for difference

The 'format with no future' is the one not sufficiently differentiated from the competition and not strong enough to

attract the consumer. Differentiation may mean smaller or larger, more specialised or more wide-ranging: the key is brand. More and more, retailers will have to make a brand promise to the consumer to deliver clearly distinguishable and consistently reliable attributes. For more information see *Future of Brands*, part of BCSC's *Future of Retail Property* series.

The search for responsibility

A 'search' which is becoming increasingly significant is to identify what corporate social responsibility really means to consumers and other stakeholders and what these groups actually require of retail businesses.

Predicting how fast formats will evolve in line with these 'searches' is difficult, but two factors are certain: the importance of combining both price and non-price elements in a successful format; and the polarisation of consumer taste and behaviour. Together, these will mean that 'middling' propositions or medium-sized, moderately differentiated formats will lose ground.

Winners and losers: tomorrow's retail formats

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- Which retail formats are in danger of losing ground and which have potential for growth (see the table titled 'Formats at risk' on page 60 and 'Format types with room to grow' on page 61).
- Domestic and international formats with real potential over the next ten years (see the tables and diagrams on pages 62-64).



Inertia in the system means that the property consequences of format change are slow and incremental. Many of the shopping centres that will be completed between now and 2010 will be based on forecasts made in the past five years and allows little flexibility to accommodate change.

It is often assumed that there is an inexhaustible supply of new specialist retailers to take up space. This is by no means guaranteed if the growth of out-of-town general merchandisers and the expansion of e-commerce continue to undermine some specialist business models. High costs of entry may further reduce the number of prospective players.

The retail property sector may miss the 'next big thing' because it is too risk-averse. Future shopping destinations are in danger of shutting out the most innovative, interesting and dynamic retail business models. The industry risks 'killing the goose that lays the golden egg' through lack of recognition and willingness to accommodate the changing constraints and requirements of the speciality retailer.


Shopping places need to:

- focus on the actual proportion of rental that is available to the landlord
- accommodate those businesses that need to adopt larger formats to achieve scale, sustain their profitability and create destination pull

- recognise that the value propositions of other businesses require efficiency and high stock turn - with further implications for cost
- recognise the richness and variety represented by smaller retail businesses which choose not to move into the mainstream but nevertheless remain attractive tenants
- accept that some business models developed to counter e-commerce put a premium on high levels of experience and service in-store - which come at a cost
- encourage the growth of 'implants', or 'shop-in-shop' developments, which are one way that more diverse shopping place environments can be created
- accept that some risks have to be taken to allow the development of innovative formats - locally, nationally and internationally.

This analysis confirms the essential health of the specialist shops sector. There will always be scope for specialists to create opportunities and re-invent themselves, unless they are priced out of the market. Shopping destinations will need to play a positive and proactive role to nurture and sustain a future with a diverse mix of formats that is likely to benefit both the shopping environment and the shopper.

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BCSC
1 Queen Anne's Gate
Westminster, London SW1H 9BT