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The Perfect Storm on the High Street: Retailers Need a Radical Rethink To Ensure Long-Term Survival

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Retail is facing the perfect storm on the high street. The inflationary trends and interest rate rises of 2023 increased costs across the sector, from product and inventory to rent, energy, labour and financing. Combined with consumers who have tightened their grip on their wallets and become more selective in how and where they spend their money, the pressure on margins in the sector has been relentless from both sides.

2024 did not paint a different picture, with interest rates remaining high and changes in governments across Europe yet to have any meaningful or positive impact on either consumers or retailers. Looking to 2025, there remains plenty of uncertainty — energy prices and business and personal taxation are just some of the knowns impacting footfall, consumer spending and costs.

Retailers have taken notice. To improve margins, many have already taken decisive action aiming to increase revenue — by implementing better store layouts, extending product ranges and reducing costs by downsizing stores and store portfolios in an accelerated manner. But are these actions enough?

Retailers that want to thrive in the long term, not just survive the initial storm, will require a more radical rethink. Taking the time to evaluate the different options available and assessing how they could play out in the long term under different scenarios is a critical move that will enable retailers to unlock value and put themselves in the best position to future-proof their businesses. Retailers need to have a mindset that goes beyond just revenue growth to focusing on reducing costs. There are a number of areas where cost reduction can occur — in stores, the supply chain and the back office. Yes, looking to increase income is an important factor in increasing margins, but reducing outgoings and costs is a powerful approach when creating sustainable cash flow for the business.

Better understanding their store portfolio and planning for a strategic approach is a strong starting point. Are store closures a viable option? Could international growth whilst benefiting from a soft local market be suitable? Investment in strategic thinking could unlock growth and value creation in the long run.

Retailers that invest in evaluating all their options, assess the strategic impact of their actions and then use these insights to make decisive and bold moves will be the ones best placed to become winners in the next era of retail.

A Tough Retail Environment

Economic growth shows signs of picking up and GDP indexes in most countries have surpassed pre-2020 levels. Whilst still volatile, European retail sales are forecast to grow by 0.7% in 2024, before accelerating to 2.0% in 2025.[1] Retail leasing in Europe reflects this optimistic outlook, with landlords increasing rents in the last quarter of 2023 by 1.2%.[2]

However, despite these green shoots of optimism, the retail environment in Europe will remain challenging for some time. After gains in 2023, consumer footfall has been challenging — the UK has experienced 12 consecutive months of decline as of July 2024, with online growth rates below pre-pandemic levels.[3] While the rate of inflation has subsided, with UK and eurozone inflation rates down to 2.2% in August 2024, consumers continue to suffer from a lack of confidence caused by a cost-of-living crisis and concerns about the long-term political outlook.[4] Purchasing habits have not reverted to pre-pandemic patterns and still show no signs of changing — and perhaps they never will.

Retailers are also suffering from the political changes that have increased their operating complexity — from new sustainability regulations to new rules on the movement of goods between the UK and the EU post-Brexit, coupled with demands for wage increases exacerbated by a supply shortage of part-time and temporary workers. Geopolitical challenges add to the picture, with difficulties and restrictions for vessels moving through the Suez and Panama canals adding to supply chain and import costs. Fashion retailers and suppliers recently noted these additional expenses can increase shipping costs by between 20% and 400%.[5]

The minimum wage in many countries will see changes in the next year. In the UK, the National Living Wage will increase, wage bands will be removed and the increase in national insurance with further increase labour costs.[6] France, Germany and the Netherlands will all have seen increases as we enter 2025. This will put more money into the pockets of employees, but retailers reliant on employing a lower-skilled and younger workforce are likely to struggle with their ability to pass on the costs to consumers. Similarly, the expected ban on zero-hour contracts in the UK may further increase costs and the reduced flexibility for employers will only add to the resourcing challenges for UK retailers.

These higher costs and consumers' reduced spending have created a "scissor effect", forcing retailers to start acting decisively in order to reduce their labour costs and streamline their real estate portfolios. High-profile and long-standing brands such as Boots have been closing stores as part of their restructuring announced in 2023 with almost 300 UK stores targeted. A total of 6,945 stores in the UK closed in the first six months of 2024.[7]

For those retailers that couldn't act in time, the consequences were even harsher. The Body Shop[8] and Carpetright[9] appointed administrators, and other recognisable brands such as Iceland[10] and Le Pain Quotidien[11] announced insolvencies of some of their local subsidiaries. As of August 2024, 24 UK retail businesses had failed, impacting 759 stores and 15,359 employees.[12]

For private equity ("PE") investors and investment funds that are exposed to the retail sector, this challenging picture has translated to historically high holding periods. The median holding period for PE-backed retail companies is now 5.6 years while they wait for a recovery period.[13] Investment based on growth and expansion needs a rethink. But how long will investors hold on to companies that face lower margins, flat sales and deteriorating cash positions? Will they restructure, sell, close or reset the agenda? This challenging trading environment means the survival of many high street retailers remains in question.

Bold Actions To Unlock Long-Term Value Creation

European retailers now need to review their core market propositions before developing new and far more ambitious growth strategies if they want to prosper beyond the short term. For mid-market businesses, aiming to be a national champion may no longer be a sustainable option. Trying to compete against the big players when it comes to growth, whilst having a reduced store portfolio driven by a need to cut costs, is fundamentally a short-term play — one potentially doomed to fail. Retailers need to think about the potential for future growth before deciding where and how to cut.

Conversely, and in a counterintuitive way, retailers with a healthy core business may find international growth through **mergers and acquisitions** to be an important strategy, making the most of the challenging conditions where others might be struggling and their founders and management teams becoming more open to an exit. Expanding into stressed markets can be a fruitful choice when coupled with a strong base.

A focus on margins will be a critical success factor to generate the required free cash flow and working capital needed for investable growth. Key levers to enhance margins will not only be enhanced promotions and mark-down management, but also **more considered buying** to avoid overstocks with tighter ranges, more sophisticated planning and replenishment, and more responsive supply chains.

The same mindset of cost focus and margin improvement must be applied to one of the thorniest issues that retailers face: **online strategy**. Many retailers have failed to turn an online presence into a profitable business and still face the need for massive investments in their digital transformation programmes. If that is the case, these retailers should consider putting a stop to their current digitalisation approach and instead spend their efforts building their store brands.

Taking a **store-first approach** means undertaking a focused business review, including probing the financial performance, cash flow, cost structure, layout, product portfolio and detailed sales forecast of each store. This may lead to closing stores that could never be optimised. It could also mean having to acquire new premises in the best locations to generate the maximum returns the market has to offer, even though the sites cost more in rent and servicing.

A key factor in the store performance review is the focus on labour. Attracting and retaining the best talent is always challenging but can be especially tricky in the current environment with a shortage of skilled candidates available. Before considering increasing wages to meet the talent gap, retailers should understand how they can better deploy their store staff through increased workforce flexibility, reduced time spent on admin, increased time for selling and improved staff rostering to serve customer traffic.

Given the fact that the retail industry is one of the biggest employers in most countries, it is high on the political agenda. Politicians and unions recognising the challenges and financial difficulties retailers face leads to discussions about the regulatory framework — where can changes be made? Taxation and collective agreements have space for compromise, in such a way as to protect as many jobs as possible whilst facilitating change for retailers. It is in the interest of all parties to have a retail sector that can navigate the current challenges and one that is posed for future growth.

Act Now To Weather the Storm and Survive in the Longer Term

Many retailers will be wondering how to become winners in the next era of retail. Investing in in-depth analysis of their business to understand their available options in the face of uncertain sector trends could unlock value creation opportunities ahead, with bold and decisive action then required to deliver success. Business leaders should act now to avoid being caught in the storm still hitting the high street. Resetting their cost base to match lower volumes, focusing on short-term operational improvements to drive performance and being more agile in ranging and execution are some options. Investors need to review their investment theses and reshape plans based on the current realities and a less certain future where agility will likely win over a single formula for success.

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