A Retail Renaissance

The Price of Change 2.0

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Introduction

Renaissance: ***(noun)***; "a new growth of activity or interest in something, especially art, literature and music."

Cambridge English Dictionary

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Relating to a pan-European movement of the 15th and 16th centuries in its most literal form, the UK's retail market of the 21st century is now undergoing something of its own Renaissance.

A recovery? Of sorts, but this does not do justice to the scale of change and implies but a temporary or passing shift that could be over just as quickly as it started.

A resurgence? Far too strong, an over-statement and a perpetuation of the 'boom or bust' mentality that does not understand the profound implications of structural change.

A rebound? Implies a shift that has happened by chance, the result purely of external factors, rather than the product of extensive soul-searching, rebuilding and restructuring.

A Renaissance, on the other hand, comes far closer to reflecting the journey that the UK retail sector has embarked upon - and upon which it still has far to go, a paradigm shift from the medieval to the modern. A virtual rebirth.

Our 2018 research report "The Price of Change" brutally laid bare, in no uncertain terms, the structural failings of the UK retail sector. Too much space, a flaky and flabby occupier base, vastly inflated rents and property values, all compounded by a lack of historic investment and a huge sense of complacency. This even before the UK retail market faced its ultimate stress-test in the shape of the COVID pandemic.

A far-reaching reset, radical rebasing, a massive reality check and a voyage of self-help are key tenets to this Retail Renaissance. Few in 2018 would have wagered that retail would reclaim its crown as the top-performing commercial real estate class by 2023, but this is a reality. At the same time, few within retail would acknowledge this with any sense of triumphalism given the relativities within the real estate market and the fact that the Renaissance in retail has far from run its course.

Retail's Renaissance is ongoing. As well as addressing existing structural challenges, more are on the horizon. We explore three in this report – structural change within the online / multi-channel space, the rising influence and deployment of AI and the increasing embrace of ESG far beyond mere lip service. All challenges in their own right, but equally also opportunities for those fleetest of foot and smartest of thought.

Retail – undergoing a Renaissance, forever evolving. Therein lies both its beauty and its beast.

Key Takeaways

Retail Renaissance – a sector reborn, the direction of travel positive, but the never-ending road to redemption paved with all manner of ongoing and future structural change.

Ongoing structural change – progress to date

5.7%

Retail's ascent to become the top performing mainstream commercial real estate class (with a forecast total return of 5.7% in 2023) has been achieved by the sector addressing its 'Structural Failings' head on.

But progress on identified 'Structural Failings' such as market over-supply is only gradual – vacancy rates remain stubbornly high (13.9%), re-absorption of space highly selective and re-purposing less straightforward than it appears.

Property cost inflation has been addressed, with retail rents rebasing by an average of -4.5% p.a. over the last five years. The bottoming out process is now largely complete and a more affordable, stabilised occupier market is even returning to rental growth, albeit very modest.

33%

COVID and the knock-on effects of the war in Ukraine continue to wreak havoc with wider cost inflation metrics. National Minimum Wage increases (+33% over the last five years) are but one cost pressure that continues to weigh heavily on retailers' bottom lines.

Future structural change – challenges and opportunities to come

ESG will be huge driver of future structural change – the three component aspects presenting their own sets of both challenges and opportunities.

The vast majority of the UK's retail stock needs to be upgraded – and fast. According to MEES regulations, 4.5% of all retail stock is already 'unlettable'. This figure will rise to 38% by 2027 and a staggering 73% by 2030 if proposed targets become realities.

13%

The "S" is actually where retail can generate most value. Retail is the UK's largest private sector employer (13% of the population), retail locations the heart of communities and social fabric. Expect greater quantification on social value generated by assets to calculate ROI.

So long a driver of industry-wide structural change, the online market will be subject to its own internal structural change. This will see a lot of 'artificiality' removed in the shape of unprofitable capacity and the symbiotic relationship between online and physical stores will be reappraised.

Multi-channel will increase its share of online spend (currently 50% generally, 71% in grocery) at the expense of pure-players. Expect renewed investment in core stores that have an elevated role in the multi-channel ecosystem – and these stores to carry a real estate pricing premium.

59%

Artificial Intelligence – perceived by many to be threat, but retail is set to be one of the key beneficiaries. AI is anticipated to boost retail productivity by as much as +59% by 2035.

AI 'vanity projects' are likely to gain the most coverage and attention, but the real value from AI in retail is likely to come in solving routine efficiencies across the business, from supply chain to customer service. AI should also be instrumental in unearthing the retail holy grail – understanding the true value of a physical store in a multi-channel retail universe.

Retail Renaissance - in numbers...

10 Retail Structural Failings

Oversupply / Overexpansion / Miss-management of the 'ugly tail' / Rental & property cost inflation / Wider cost inflation / Rise of online / Over-geared balance sheets / Brand devaluation / Under investment / Complacency

Progress to date. . .

Oversupply...

11.1% PRE-COVID (H1 2018) vs **13.9%** POST-COVID (H1 2023)

(Retail & leisure vacancy rate)

+280 BPS INCREASE (2018-2023)

15.3% RETAIL VACANCY (H1 23)

10.7% LEISURE VACANCY (H1 23)

Over expansion...

23,504
UNIT CLOSURES
H1 2023 (VS. 19,803 in H1 2018)

4,000
NET UNIT DECLINE
(H1 2023) VS. -4,402 (H1 2018)

5,284
UNITS UNDER REDEVELOPMENT
VS. 549 (H1 2019)

Property cost inflation...

(4.5)%
AVERAGE ANNUAL RETAIL RENTAL DECLINE (LAST 5 YEARS)

AVERAGE ANNUAL RENTAL DECLINE

(6.9)% SHOPPING CENTRE

(5.0)% HIGH STREET

(3.5)% RETAIL WAREHOUSING

2022
marked return to positive annual rental growth (+0.1%)

+0.7%
Forecast rental growth per annum over next 5 years (2023 – 2028)

Wider cost inflation...

+68%
INCREASE IN NATIONAL MINIMUM WAGE OVER LAST 10 YEARS

£7.83
HOURLY MINIMUM WAGE 2018

+33%
INCREASE IN NATIONAL MINIMUM WAGE OVER LAST 5 YEARS

£10.42
HOURLY MINIMUM WAGE 2023

3 Key Future Themes

Online – Bonfire of the Vanities / ESG – Challenge or Opportunity? / Artificial Intelligence – an investment worth making?

...Future structural change

Online...

19.2%
Sales made online pre pandemic (2019)

24.9%
Sales made online August 2023

37.8%
Sales made online during lockdown peak (January 2021)

95%
Consumers shopped online prior to COVID-19 outbreak

8.8%
Grocery sales made online (July 2023)

71%
Online grocery serviced by physical stores

13 of the top 20
Online players are high street retailers

50.1%
of online sales are made with multi-channel operators

Environmental, Social, Governance (ESG)...

17%
Total energy used by commercial real estate stock originates from retail property

1,255
Global ESG regulations introduced in last decade (vs. 493 in decade prior)

40%
Climate disclosures made by global retailers considered to be 'decision useful'

1 leasing cycle
Left to take action on stock at risk of falling below 'MEES' 2027 thresholds

73%
Retail stock potentially unlettable by 2030

38%
Retail stock potentially unlettable by 2027

No.1
UK's biggest private sector employer providing 13% of UK's jobs

70%
of retail assets' social value is generated by occupiers

Artificial Intelligence (AI)...

1950s
Alan Turing publishes landmark paper on machines that think

28%
Retailers who view AI as top investment priority

+59%
Forecast profitability boost due to AI implementations by 2035

Top 4
UK Industry receipt of AI benefits (forecast profitability boost)

50%
Consumers cite customer service chatbots as source of frustration

40%
Retailers lack investment required to implement AI strategies

50%
Retailers claim to already use AI in 'some form'

3 days
AI-driven 'real-time' fashion production turnaround (SHEIN) vs. 3 weeks traditional 'fast fashion' (Zara)

“The (ongoing) price of change” – five years on

WORDS: STEPHEN SPRINGHAM – HEAD OF RETAIL RESEARCH

In 2018, the retail market was on its knees. A wave of CVAs, spiralling vacancy rates, rents and capital values in freefall. And then along came COVID, unannounced and uninvited, to surely put the retail market out of its misery once and for all – except it didn’t.

Key takeaways

Substantial (but varying degrees) of progress have been made against the ‘10 Key Structural Failings’ of the retail market previously defined and identified by Knight Frank in 2018.

The most significant progress has been made against some of the ‘more intangible’ / ‘less quantifiable’ Structural Failings, most notably #10 ‘Complacency’ on the back of an industry-wide reality check.

Many of the property metrics have been reset as part of this process. Retail rents have declined by an average of -4.5% over the last five years, representing cumulative rebasing of -20.4%.

#5 'Wider Cost Inflation' remains the most challenging Structural Failing as it is a factor over which operators have least control. Spiralling input, energy, supply chain and staff costs all remain an industry bugbear.

Rent rebasing was a ‘necessary evil’ in creating a stabilised occupier market. Although painful, the positive flipside is a less onerous business rates burden and a more affordable trading environment for retailers.

Addressing #1 'Oversupply' is a slow-burn process, but the direction of travel (a very limited development pipeline, slow re-absorption of existing floorspace, selective repurposing projects) is a positive one.

Progress against these Structural Failings highlights a current disconnect between a largely stabilised occupier market versus a turbulent investment market, the latter still more prey to external macro-economic forces.

“Change or die...denial is not an option”. The opening gambit of our 2018 magnum opus on the retail market, “The Price of Change”. A brutal call to arms for a sector that can be brutally tough even at the best of times – and was about to face the most brutal stress test imaginable in the shape of the COVID pandemic.

“The Price of Change” identified and explored 10 Structural Failings of the UK retail market. A warts and all assessment of what has fundamentally gone wrong in retail over the years, an unfiltered appraisal of the forces that have collectively conspired to undermine the foundations of our town centres, an exploration of a toxic combination of structural fault lines exacerbated by largely self-inflicted wounds. And 10 Structural Failings that needed to be proactively addressed head-on if the retail industry were to stage anything resembling a recovery and map out any sort of sustainable future.

Five years on, what progress has the retail sector made against these 10 Structural Failings?

> “With five years’ of hindsight, many retailers have changed and have survived (and even flourished). Others didn’t heed our call to arms: they didn’t change and sadly they died.”

> “Property costs historically rose much faster than retail sales, changing the parameters of economic viability.”

10 Structural Failings – an aide memoire

“Recent headwinds are only the tip of an iceberg that has been 30 years in the making. All too often the root causes of current pain have been swept under the carpet and what we are effectively seeing now is mistakes from the past coming back to haunt.”

This is how we prefaced our ‘10 Key Structural Failings’ in the UK Retail Industry five years ago, as well as acknowledging that the list was by no means exhaustive and was deliberately generic in scope. We also specified that not all the Structural Failings necessarily applied to every retailer and landlord – some have clearly been far better at moving with the times and managing change than others. With five years’ of hindsight, many have changed and have survived (and even flourished). Others didn’t heed our call to arms: they didn’t change and sadly they died.

1. OVERSUPPLY

There is too much retail floorspace in the UK – too many shops, no historic process of obsolescence.

2. HISTORIC OVEREXPANSION

Retailers opened too many stores – the chase for scale / market share rode roughshod over longer term profitability / affordability considerations.

3. MISS-MANAGEMENT OF THE ‘UGLY TAIL’

Store under-performance has not been addressed – retailers have not been proactive enough in weeding out weaker stores.

4. RENTAL / PROPERTY COST INFLATION

Property costs historically rose much faster than retail sales, changing the parameters of economic viability.

5. WIDER COST INFLATION

All retail costs (e.g. cost of sales, operating costs) also rising significantly faster than retail sales.

6. RISE OF ONLINE

E-commerce is about so much more than store-based sales gravitating online – every retail metric has been re-defined.

7. OVER-GEARED BALANCE SHEETS

Private equity + Retailer Ownership = Toxic Mix. Onerous debt structures have been responsible for most occupier distress and failure.

8. BRAND DEVALUATION

Retailers have sacrificed ‘brand equity’ for sales and market share – too much discounting / promotion, not enough attention to the basics.

9. UNDER-INVESTMENT

Neither retailers, nor landlords, nor the public sector, have made appropriate and consistent levels of investment in retail stock.

10. COMPLACENCY

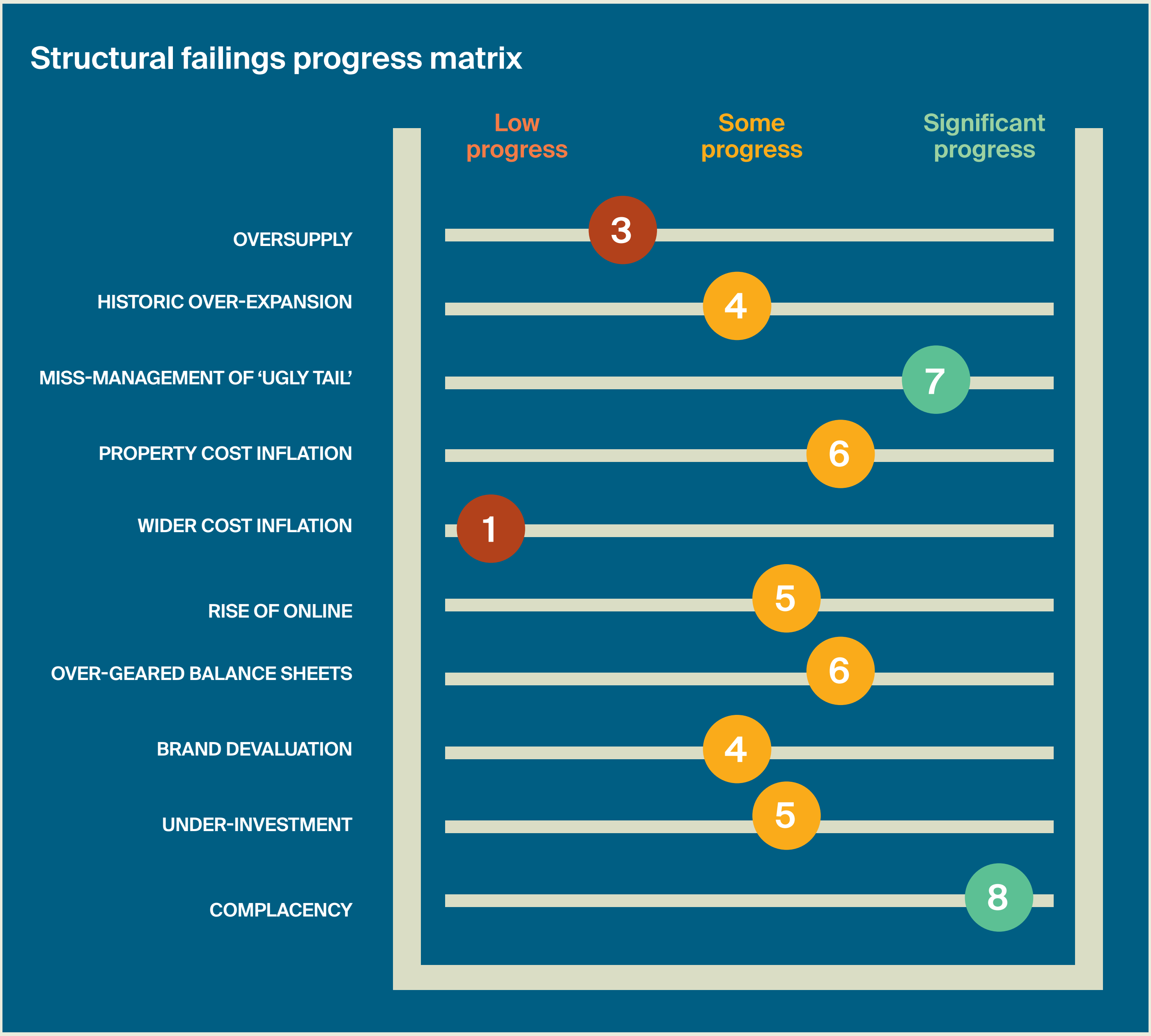
Retail has been taken for granted by too many for too long.

“The Price of Progress”

Fast-forward to now. Despite the less-than-helpful backcloth of COVID, massive political, social and macro-economic upheaval, the war in Ukraine and resulting/enduring hyper-inflation, progress has been made on all of these Structural Failings. The degree of progress varies (and we subjectively quantify this on the accompanying matrix) and in many respects reflects the level of control and influence retail stakeholders (occupiers, landlords etc) actually have in that particular sphere. In some failings, stakeholders are masters of their own destiny, in others, they remain fully at the mercy of market forces. There is only so much they can do in being proactive.

Similarly, it depends how deep-seated the Structural Failing is. As a general rule, the more entrenched it is, the longer it will take to reverse or rectify. Quick wins are few and far between. Some progress can be made within five years, but a full turnaround may take decades.

> “Quick wins are few and far between. Some progress can be made within five years, but a full turnaround may take decades.”



1. OVERSUPPLY

Rome wasn't built in a day. Nor will it be re-purposed in a day.

Progress rating 3

The issue of retail oversupply sits firmly in the slow-burn turnaround camp. The most significant progress made has probably been the very acknowledgement that the retail market is indeed oversupplied, a fact that was wilfully ignored for so long in the past. Acknowledgement is the starting point for remedial action. A limited retail development pipeline is a natural response, with very few new schemes now coming forward – those that are are largely re-developments of existing sites (e.g. St James Quarter in Edinburgh). With a lid on new development, vacancy rates are now receding, albeit very slowly, and realistically, they are likely to remain in double-digit territory for many years to come.

Repurposing is the other significant moving part in the oversupply equation, but remains largely a buzz term rather than a widespread reality. The level of retail repurposing talk is not yet commensurate with the level of actual activity, reflecting the fact that converting retail stock to other real estate uses is far from straightforward (operationally and commercially). Some retail repurposing projects are proceeding, but they are generally very piecemeal and, to date, have not really moved the needle on redressing market oversupply.

Very limited new floorspace coming onstream, slow reabsorption of vacant floorspace through renewed (but highly judicious) occupier demand, selective re-purposing of redundant floorspace. All painfully slow processes, but a positive direction of travel nonetheless.

2. HISTORIC OVEREXPANSION

What's done cannot be undone – Lady Macbeth.

Progress rating 4

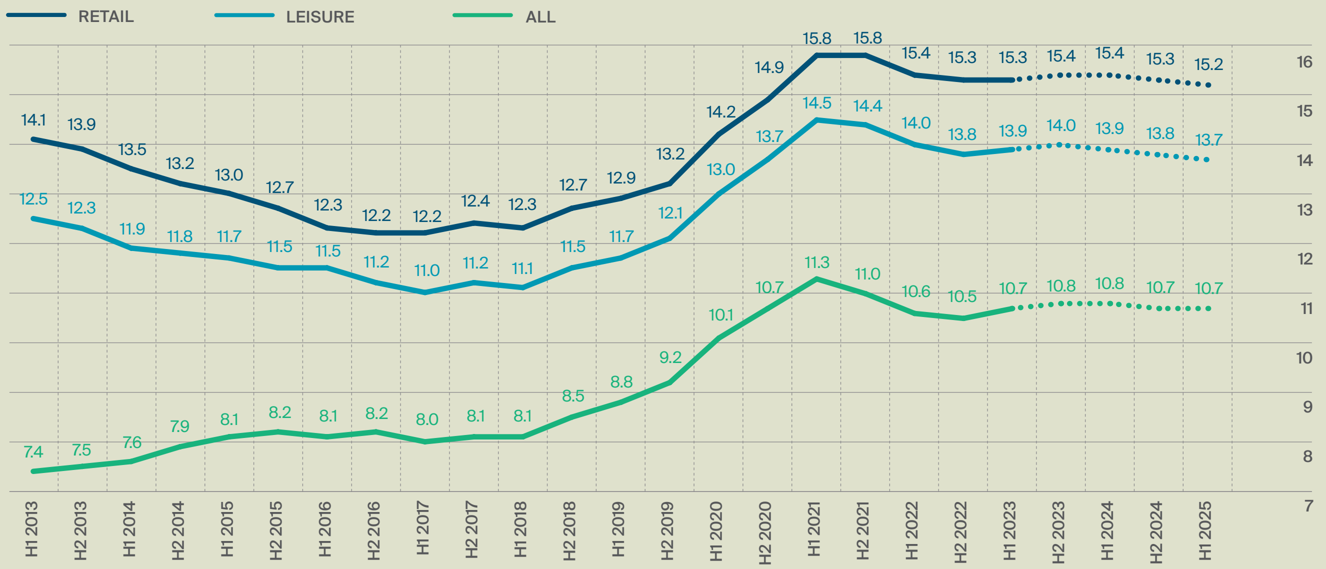
The expansion gold rush in the 2000s is proving difficult to reverse. Many retailers believed their own hype and opened too many stores during the supposed good times and have since paid the price. But obviously they are still slave to any lease commitments, unless they resort to drastic measures such as a CVA. As with the issue of oversupply, the most telling progress has probably been recognition of the problem and avowal not to repeat mistakes of the past. Those retailers that are still acquiring new space are far more conservative, forensic and selective in their approach. Maybe to the chagrin of leasing agents, the days of gung ho, aggressive expansion are over.

The other moving part in this equation is retailers managing their existing portfolio more proactively – closing under-performing or peripheral stores and channelling investment into the residual core. Overdue housekeeping in many cases, something that would have been better undertaken over a number of years on a rolling basis, rather than retrospectively now. But ultimately, better late than never. Fewer, but better stores, with high street stalwarts such as M&S amongst the best exponents of this evolutionary, but necessary change.

Less may well be so much more.

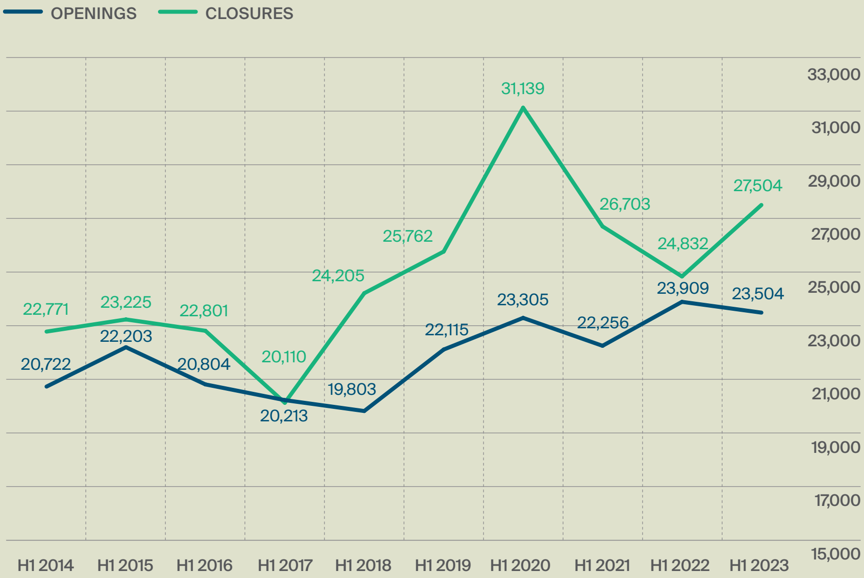
Fig 1. Retail & leisure vacancy forecasts

%



Source: LDC, Knight Frank Research

Fig 2. H1 openings vs closures
Number of units



Source: LDC, Knight Frank Research

3. MISS-MANAGEMENT OF THE 'UGLY TAIL'

The dog wagging the tail, rather than vice-versa.

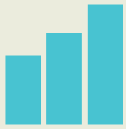
Progress rating 7

Inextricably linked to the previous Structural Failing for very obvious reasons, retailers are now far more proactive in churning their store portfolios. Whereas before, there was a tendency to ignore the 'ugly tail' in favour of the top-performing or new stores, retailers generally are now assessing their entire portfolio and strategising on each individual asset. Previously, the 'ugly tail' may have been a major drain on profitability, cancelling out the positive contribution of the better-performing parts of the business. Retailers now have far fewer qualms about closing an under-performing store or taking the necessary action to improve its performance metrics e.g. negotiating a lease re-gear.

A positive, but painful process. The reality is that no retailer ever has a perfect portfolio, some stores will always outperform others. And these performance metrics routinely change over time. Closing stores is never a good look for retailers, but it is a necessary evil that trumps any trace of vanity. Churn is proactive, a sign of progress rather than weakness. And, by its very nature, an ongoing and perpetual process.

4. RENTAL/PROPERTY COST INFLATION

The only way is up – or is it?



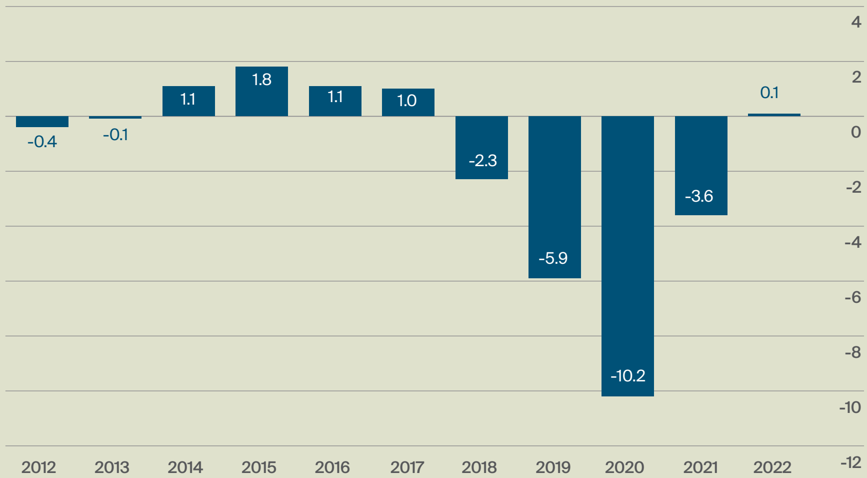
Progress rating 6

Three moving parts, not necessarily moving in the same direction – rents, rates and service charges. Rents rebased, rates revalued, service charges not doing very much.

Despite massive correction during GFC, retail rents were once again teetering on the precipice coming into 2018. A massive rebasing was imminent and duly materialised. According to MSCI, all retail rents have declined at an average annual rate of -4.5% over the last five years, a cumulative decline of -20.4%. Shopping centres (-6.9% annual, -30.1% cumulative) have fared worse than standard shops (-5.0%, -22.5%) and retail warehousing (-3.5%, -16.4%). Given these are smoothed averages, the realities in individual locations may actually have been far steeper. Grim reading for landlords and fund managers clearly, but an important rebasing process to enable stabilisation in occupier markets.

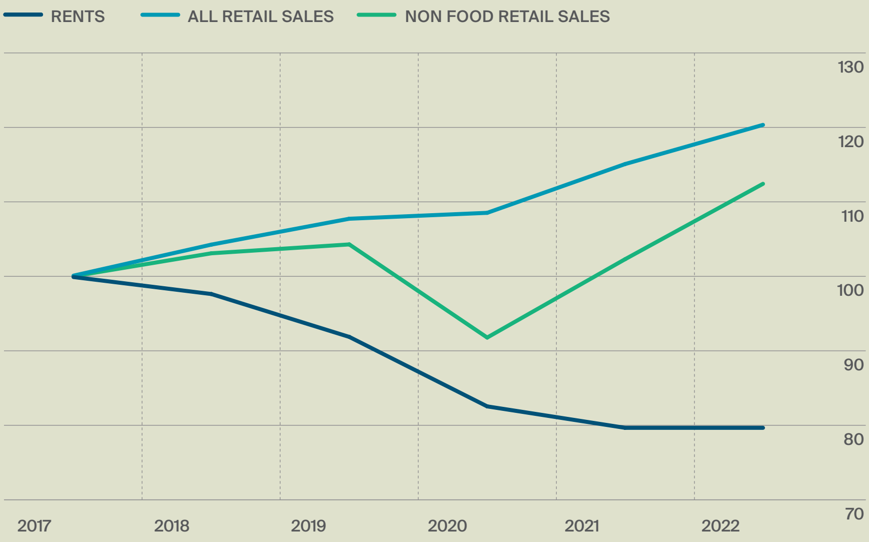
Positive movements in retail business rates, albeit not the full-scale reform the system requires (hope springs eternal).

Fig 3. All retail rental growth 2012-22
%



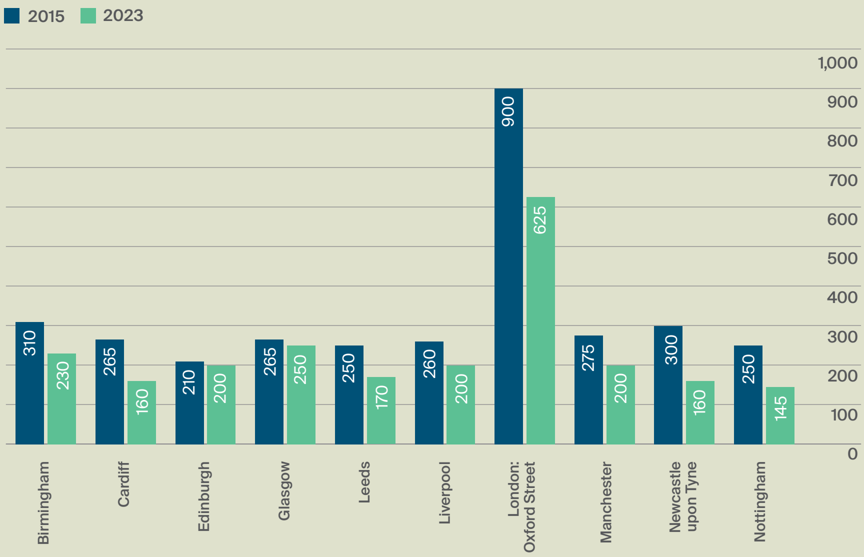
Source: MSCI, Knight Frank Research

Fig 4. Rental growth vs retail sales growth 2017-2022
Index (2017 = 100)



Source: MSCI, Knight Frank Research

Fig 5. Prime retail rent changes 2015 vs 2023 and business rate implications
Prime zone A rents (£)



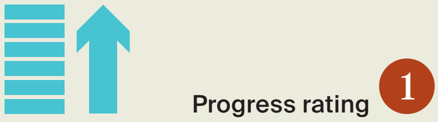
Source: PMA Promis, Knight Frank Research

Significant rebasing in rents between the two review periods (plus an end to transitional relief) has reduced the business rate burden for many retail businesses. In contrast, service charges continue to trend upwards, despite growing signs of retailer resistance.

The rent rebasing is increasingly bottoming out. Indeed, MSCI suggests that retail rents actually grew by +0.1% in 2022, although this was driven primarily by standard shops in Central London (+2.5%) and retail warehousing (+0.4%). A return to rental growth is something of a landmark for the UK retail market, but expect only anaemic growth in the coming five years (+0.7% p.a. 2023-27). Having only just found their feet, don't expect retail rents to run fast anytime soon.

5. WIDER COST INFLATION

Focus on what you can control, react to what you can't

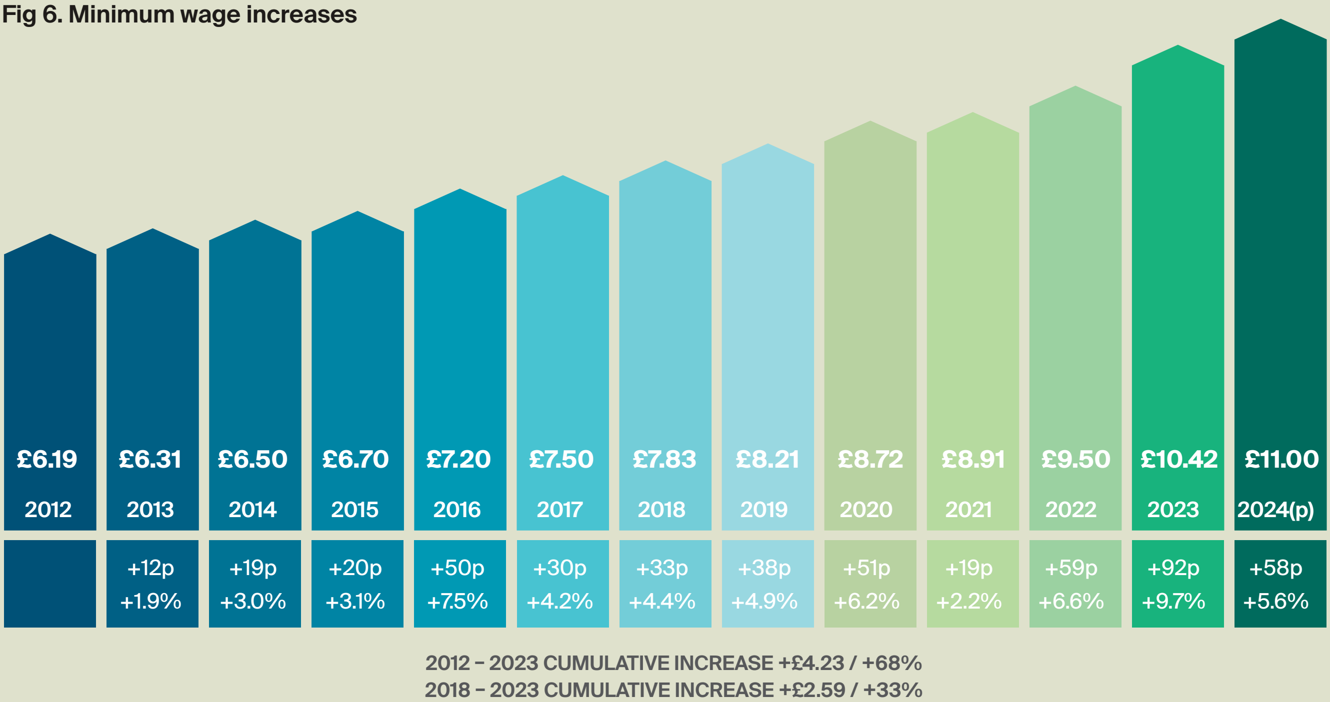


The Structural Failing over which retailers have the least control. Yet the one that continues to inflict the most turbulence on retail markets. There are any number of individual costs that feed into the modus operandi of any business, but any accountant will tell you that they generally fall under one of two headings: fixed or variable. In the context of retail, 'predictable' and 'unforeseen' may be more appropriate headings.

One key example of a 'predictable' cost is staff/wages. The national minimum wage continues to see stepped year-on-year increases and this is having a profound impact on most retailers' cost bases. In 2012, the headline minimum wage was £6.19. By April 2023, this figure had risen to £10.42, while a myriad of other complicating factors, such as threshold changes, have also been introduced. Over the last decade, the headline minimum wage has increased by £4.23 (+68%), or by £2.59 (+33%) since 2018. Very few retailers will have seen their top line grow at anything like this rate over the corresponding period. It is mildly ironic that staff costs fall under the umbrella of 'predictable' in that the annual increase is not predetermined. The only ▸

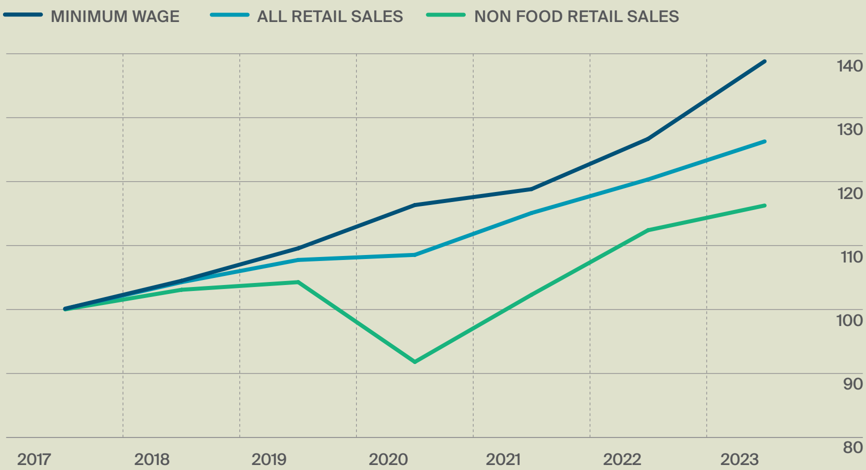
> "Retailers are increasingly cast as villains in the face of stubbornly high inflation, but the reality is far more nuanced – many conundrums, balancing acts and difficult behind-the-scenes decisions for retailers."

Fig 6. Minimum wage increases



Source: Knight Frank Research

Fig 7. Minimum wage growth vs retail sales growth 2017-2023
Index (2017 = 100)



Source: ONS, Knight Frank Research

'predictability' is that they are only going to go one way – up.

'Unforeseen' costs are equally manifold. Many came to light during COVID when retailers had to face up to the completely unknown realities of a global pandemic and the havoc this wreaked. Retailers incurred costs they never dreamed of (e.g. in-store social distancing measures) and even those operators that were classified as "essential" (e.g. grocers, health & beauty) and were therefore able to stay open during the pandemic did so under a massively inflated cost burden.

'Unforeseen' COVID-related costs has since been superseded by equally 'unforeseen' costs arising from the war in Ukraine. The consequent massive hikes in fuel and energy prices have been documented to death, but they continue to impact heavily on UK retailers in terms of both cost of sales (i.e. product sourcing) and operationally (e.g. distribution, utilities etc). Most of these huge cost pressures are ongoing.

Retailers may have limited control over these external cost pressures, but they still have to respond. Some of the cost increases have invariably been passed onto the consumer, hence spiralling inflation. Retailers are increasingly cast as villains in the face of stubbornly high inflation, but the reality is far more nuanced – many conundrums, balancing acts and difficult behind-the-scenes decisions for retailers.

"An unforgiving macro-economic environment is laying bare the operational and financial shortcomings of many online pure-players."

6. RISE OF ONLINE

Three steps forward and two steps back

Progress rating 5

The online narrative has experienced a rollercoaster ride over the last five years. Prior to COVID, meaningful progress was being made in that the debate was moving on from simplistically trite ‘online vs bricks & mortar’ arguments. There was overdue recognition that the two channels were actually far more complementary and symbiotic than they were depicted to be, that multi-channel was the way forward, with retailers making renewed strides to understand what that meant in reality and realigning their strategic thinking accordingly.

Cue a depressing reverse during COVID. All progress was swept away in favour of a renewed obsession with largely meaningless online penetration figures. The narrative was of ‘skyrocketing online demand’, when all we were really seeing was consumers shopping online by default rather than choice and online failing to pick up anything like the full slack of lost store-based sales. The reality of an online-only world was there for all to see during lockdown – and few liked it.

Cue a massive in-store bounce-back when lockdown was lifted. Rather than kick on, spurious online penetration figures went into a dramatic reverse that is only starting to stabilise in H2 2023. At the same time, an unforgiving macro-economic environment is laying bare the operational and financial shortcomings of many online pure-players. As we will discuss later in this report, this is one of the *future* structural challenges of the retail sector – how to evolve multi-channel retailing into a more commercially-viable arena.

Painful as it was, many retailers learnt a great deal about online as a by-product of COVID. These lessons are now being put into practice as the voyage of discovery resumes, with a renewed sense of pragmatism.

> “Many of the most indebted operators are no longer with us and private equity generally sees less opportunity in UK retail than it did previously.”

7. OVERGEARED BALANCE SHEETS

Neither a borrower nor lender be
- Polonius

Progress rating 6

Not that this is abundantly transparent, but retail occupiers are probably less debt-ridden now than they were a generation ago. It would be reassuring to think that this has been the result of self-help on the part of operators and more stringent management of cash flow, but the reality probably lies closer to the fact that many of the most indebted operators are no longer with us and private equity generally sees less opportunity in UK retail than it did previously.

A number of retailers understandably accrued more debt as part of their survival of COVID, a necessary evil to pay back rent arrears, for example. But little of this is likely to prove onerous as the banks and lenders were simply not in the market to provide huge amounts of new debt. On the other hand, those operators with huge legacy debts were cruelly exposed during COVID and these were the biggest market casualties e.g. Debenhams, Arcadia.

Although not the sole cause of overgearing, private equity cannot be absolved from blame. Generally, there is less PE interest in UK retail now than previously, simply because the pickings are relatively slim. While this is true of high street retail, it is not necessarily case of the F&B and leisure sectors, which are still awash with PE cash and debt. Little wonder that distress is never far away from these sister sectors of retail. Interestingly, PE within UK retail has migrated from the high street to the foodstore arena, with two of the ‘Big 4’ supermarkets (Asda and Morrison’s) now in the hands of private equity (the Issa brothers and CD&R respectively).

Manageable debt is part and parcel of sensible retail. Onerous debt is a killer.

8. BRAND DEVALUATION

Never lose sight of who you are

Progress rating 4

One of the least tangible of the Structural Failings, responsibility for brand devaluation lies firmly at the door of retailers themselves. Preservation of brand is what they signed up for, it’s what they do. But over the years, the value of brand slipped perilously, sometimes catastrophically, down the order of priorities for many operators.

A retailer may unwittingly devalue its brand through any number of shortcomings, but in generic terms, it means falling short of what customers expect from that brand. This transcends all aspects of the brand – product, pricing, customer service, in-store experience, order fulfilment, to name but five key retailing fundamentals and non-negotiables.

> “A retailer may unwittingly devalue its brand through any number of shortcomings, but in generic terms, it means falling short of what customers expect from that brand. ”

"In a new dawn of "honest pricing", retailers are being forced to trade on a different competitive playing field, one where strength of brand is paramount. There is a slow (but growing) recognition generally that investment is needed not just in restoring brand value, but taking it forward. "

There is growing evidence to suggest that many retailers are slowly, but positively, re-establishing their brand credentials, albeit as much by default as by design. Excessive discounting and over-reliance on promotions was one of the key factors that previously saw retailers devalue their own brand, but many operators were too scared to break the cycle. With input costs spiralling, retailers have had no choice but to pass on higher prices to consumers. And the level of consumer push-back has been less dramatic than they may well have feared.

In a new dawn of "honest pricing", retailers are being forced to trade on a different competitive playing field, one where strength of brand is paramount. There is a slow (but growing) recognition generally that investment is needed not just in restoring brand value, but taking it forward. Capex is needed in refurbishing stores, investing in staff and improving supply chain – and there is much more value and potential return here than in vanity projects.

(Re-) recognising the importance of brand and the need to invest appropriately is one thing – having the strategic nous and requisite capital to execute may be another thing entirely.

9. UNDER-INVESTMENT

Reaping what you sow

Progress rating 5

A seamless segue from the previous Structural Failing, underlining the fact that many of the failings are, in fact, interlinked. And a deep-seated challenge that applies across the spectrum of retail market stakeholders.

As outlined previously, retailers need to invest heavily in their brand and all that underpins it. Rather than channel all resource into online capability, capex needs to be deployed more widely across all fundamental areas of the business.

A legacy of historic under-investment continues to weigh heavily on retail property markets, particularly shopping centres. Far too many have been treated as 'cash cows' for too long, consistently delivering double-digit returns during the good times. But at the same time, many have not been asset managed nearly as proactively as they should have been, nor allocated the rolling levels of investment required to remain fit-for-purpose, let alone relevant. Many shopping centres need millions of pounds spent on them in terms of basic maintenance (e.g. the roof), in some cases this requirement may even exceed the value of the asset itself. This inevitably raises question marks as to whether a landlord will ever see a suitable return on any investment.

"As outlined previously, retailers need to invest heavily in their brand and all that underpins it. Rather than channel all resource into online capability, capex needs to be deployed more widely across all fundamental areas of the business."

There is a similar catch-22 situation for councils and local authorities. Some towns have been so neglected and cash-starved for so many years that they are almost beyond redemption – no amount of fresh investment will necessarily restore former glories.

There is a recognition that far more investment is required in retail generally, but also that throwing money at a problem is not a panacea. The conundrum of allocating the right levels of capital to the right areas of retail and an understandable reluctance not to throw good money after bad.

10. COMPLACENCY

Nobody said it was easy, but no one ever said it would be this hard

Progress rating 8

The Structural Failing against which the greatest progress has been made. Any lingering vestiges of complacency in retail were surely swept away in the maelstrom of COVID, proving that nothing focusses the mind as much as an existential crisis.

From an occupier side, retail has always been a survival of the fittest. But many retailers were flabby rather than fit when the Global Financial Crisis struck and have been trying to get in shape ever since. Many found the going too tough and succumbed to administration, but those that have endured are leaner and better-equipped to deal with the sector's manifold challenges. There is no room for complacency within retail occupier markets.

Likewise in retail property markets. Retail was taken for granted for too many for too long. Perceived as something of a soft touch, it was historically a source of easy money for some investors, real

"Any lingering vestiges of complacency in retail were surely swept away in the maelstrom of COVID, proving that nothing focusses the mind as much as an existential crisis.

estate or otherwise. But when the gift that kept giving didn't anymore, there was an abrupt realisation that retailing was a far tougher gig than anyone on the outside realised. As a real estate use class, retail was far more complex and specialised than its mainstream counterparts (offices and industrial).

Greater appreciation of the complexities of retailing is a double-edged sword. Only by shedding past complacency can the sector evolve and move forward. But at the same time, the realisation that retail can be a minefield may push some to the opposite extreme – basically putting in the "too difficult to deal with" box. Many investors have had their fingers burnt in retail and won't be returning anytime soon.

No complacency, but a balanced view that sees beyond traditional catch-all generalisations e.g. prime vs secondary and lazy geographic distinctions.

A Retail Renaissance?

When the retail sector was staring into the abyss back in 2018, few rated its chances of staging any sort of recovery. Had we known that COVID was on its way and that the war in Ukraine was following in its slipstream, any glimmer of hope would surely have been well and truly extinguished.

Yet, here we are, still with a far-from-perfect but (almost) fully-functioning retail sector. Testament surely to the resilience of retail that it is seldom given credit for. That said, the outturn would surely have been far worse if the sector had taken the "do nothing" option, as opposed to actively looking to address its Structural Failings.

Some of the initial heavy lifting is done. But much more will be needed going forward.

B+. Could do better. And will need to, if the retail sector is to survive and thrive over the next five years.

Denial still isn't an option. But as retail witnesses something of a renaissance, maybe less "change or die", more "evolve or risk getting left behind". And invest appropriately.

"A recognition that far more investment is required in retail generally, but also that throwing money at a problem is not a panacea. The conundrum of allocating the right levels of capital to the right areas of retail and an understandable reluctance not to throw good money after bad."

ESG & Retail: Challenge and Opportunity

WORDS: EMMA BARNSTABLE, ASSOCIATE, COMMERCIAL RESEARCH

ESG will focus retailers' minds on the risks posed by social and environmental challenges – but also provide opportunity to build resilience in the face of ongoing structural change.

Key takeaways

ESG presents a broad spectrum of considerations which retailers and landlords must evaluate – but the three component elements are far from being a single or simplistic unifying force.

Environmental sustainability is the most pressing and immediate issue for the retail sector. Physical stores are significant contributors to emissions, meaning retailers will invariably be a target for regulators.

Not all regulation is red tape. Compliance with reporting processes such as the Task Force on Climate Related Financial Disclosures can help set retailers apart.

The "S" in ESG presents the biggest opportunity for retail, given its position at the heart of communities, and role as a major employer.

Measuring and reporting social value in financial terms, such as via the Real Estate Social Value Index (RESVI), should prove a sea-change in that it allows investors to understand the social benefits in a currency they understand – return on investment (ROI).

While environmental regulations grow and tighten, social responsibility remains largely voluntary. Clear governance and market signals are required for more change to occur.

"From equal pay to climate change, the acronym has prompted many to grapple with the impact of their business operations on the environment and society around them, and to look internally to consider how decision-making processes could be improved."

ESG – a corporate smorgasbord

The scope of the Environmental, Social and Governance ("ESG") agenda is naturally broad, offering a 'smorgasbord' of topics for retailers and landlords to consider. From equal pay to climate change, the acronym has prompted many to grapple with the impact of their business operations on the environment and society around them, and to look internally to consider how decision-making processes could be improved.

Given so many complex and wide-ranging issues are captured under the ESG umbrella, stakeholders across the retail sector have been spending time in the last few years cherry-picking those which are most relevant to them to formulate a response. Each has their own interpretation of what they regard to be significant, and the methods by which progress can be measured and achieved.

Universally embraced?

It's worth acknowledging that the ESG term has not been embraced wholesale across the sector.

For example, Ellandi, the retail asset management and regeneration specialist, state they are 'not fans of the term ESG'. Similarly, the Social Value Portal, a social impact company, categorise 'ESG' (alongside Corporate Social Responsibility – 'CSR') as 'old school' mindsets. Neither are rejecting the basic tenets of ESG. Quite the contrary, both believe commitments to the environment and society should actually go beyond simply reducing negative impacts. Instead, business should target positive change, with the focus on maximising value creation for people and planet.

Semantics aside, there has undoubtedly been a clear shift in global corporate sentiment toward ESG. Businesses now have a better understanding of how social factors (such as the COVID-19 pandemic) can severely interrupt operations. Attention has decidedly shifted from simply understanding a company's impacts on its surroundings, to how societal and environmental dynamics can negatively interfere with 'business as usual'.

Retailer and landlord minds are fully alert to the prospect of future social and environmental disruption and are increasingly adopting the lens of ESG to build resilience in the face of change.

"Attention has decidedly shifted from simply understanding a company's impacts on its surroundings, to how societal and environmental dynamics can negatively interfere with 'business as usual'."

The “E” and the “G”

Environmental & Governance Challenges & Opportunities – in equal measure?

Under pressure: the regulatory squeeze

The “E” of ESG is arguably the most pressing for the retail sector and wider commercial real estate industry – and certainly commands the most attention.

The retail industry as a collective is the second highest consumer of energy in the UK according to BEIS, responsible for a fifth of all carbon emissions. Whilst this accounts for emissions across the whole value chain (from factory production to customer consumption), physical bricks and mortar stores (i.e. the actual real estate) are still responsible for a substantial portion.

Looking at real estate in isolation, retail property ranks as a top energy consumer, accounting for 17% of total energy used by non-domestic building stock.

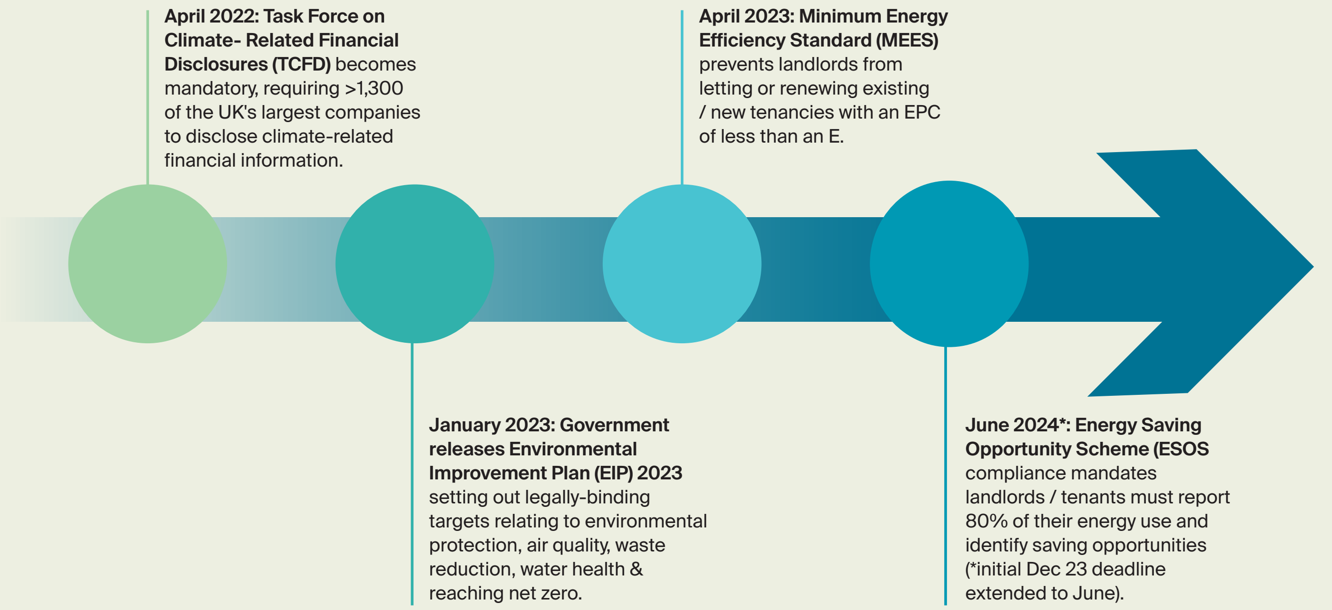
As such, the industry is becoming a key target for both regulators and government seeking to improve accountability and reach sustainability targets. Globally, ESG-related regulation has been on the rise over the past decade, with 1,255 regulations introduced since 2011 (compared to just 493 between 2001 – 2010[1]) placing far greater onus on the retail sector to align with national and global standards.

> “Globally, ESG-related regulation has been on the rise over the past decade, with 1,255 regulations introduced since 2011 placing far greater onus on the retail sector to align with national / global standards.”

What regulation should retailers be aware of?

Recent key pieces of legislation relevant to the retail sector are summarised in Fig. 8 and include mandatory disclosures aligned to the TCFD framework (requiring companies of a certain size to assess material climate risks faced), and the minimum requirement of an EPC E to let a commercial property under the Minimum Energy Efficiency Standards (MEES).

Fig 8. Regulations within the scope of ESG have been rising, with more in the pipeline



Source: Knight Frank Research

[1] ESG Book (June 2023)

The newest kid on the block – TCFD: reporting the financial impacts of climate risks

Reporting metrics aligned to TCFD became mandatory for the UK's largest companies in April 2022, including retailers such as M&S, Lidl and Boots. This marks a major step change for the sector, as climate risks must now be publicly reported in a more standardised way. The regulation is regarded as pivotal given that it will improve the quality and extent of climate reporting, enabling retailers to be globally benchmarked against 3,000+ businesses.

Principally, the framework encourages businesses to "embrace climate risk planning" to avoid financial losses and maximise opportunities presented. This means that since 2022, retailers under this framework must decide which physical environmental risks they regard to be 'material' (i.e. would cause significant harm) and disclose an estimated financial impact to their business operations.

Retailers are seen as particularly vulnerable to incurring economic losses from increased frequency of extreme weather events such as hurricanes, wildfires and flooding. This is due to the industry having typically long and complex supply chains, which often span multiple continents, meaning they are more susceptible to changing weather patterns. Disruptions to the supply of raw product materials could have major implications on product availability, creating price volatility for consumers and potentially damaging retailers' revenue and reputation.

TCFD: what are the benefits for retailers?

Proponents of TCFD highlight a few important benefits of compliance:

a. **Investor Comfort:** Capital markets are now demanding greater insight on climate risks faced by individual retailers, to allow for more accurate pricing of risk in asset valuations and support more efficient capital allocations. TCFD disclosure provides investors with greater comfort on a) how climate shocks could financially disrupt retailers, and b) how operators are practically managing climate risks.

   By establishing a clear roadmap, retailers can build credibility among the investment community by outlining how they're getting 'ahead of the curve' of any future disruption – such as by procuring lower–carbon materials from less risk-prone geographies to manufacture their goods (see Primark Case Study).

b. **Raising the profile of impacts** on the sector: Reporting via the TCFD allows insights to surface that help policymakers and governments understand how climate change is impacting the real economy and financial system, and respond accordingly.

c. **Gain competitive advantage:** By showcasing actionable climate strategies and benchmarking progress, retailers' data can be compared against competitors – who must disclose risks and opportunities in the same format.

   The TCFD isn't all about risk identification though. The framework prompts consideration of positive opportunities too, such as new market demand for eco-friendly products.

TCFD: still early days

Retailers' compliance with the framework is still in its infancy. Although the regulation itself is not new, 2023 marks only the second year of mandatory reporting for the UK.

Retailers are still familiarising themselves with best practice, with research finding not all are disclosing 'decision-useful' data. Analysis of global retailers' public disclosure filings found only 40% were 'decision – useful' compared with an average 66% across all industries[2]. This indicates the sector may be currently approaching regulation in a 'tick-box' manner by failing to provide substantial insight useful to other stakeholders.

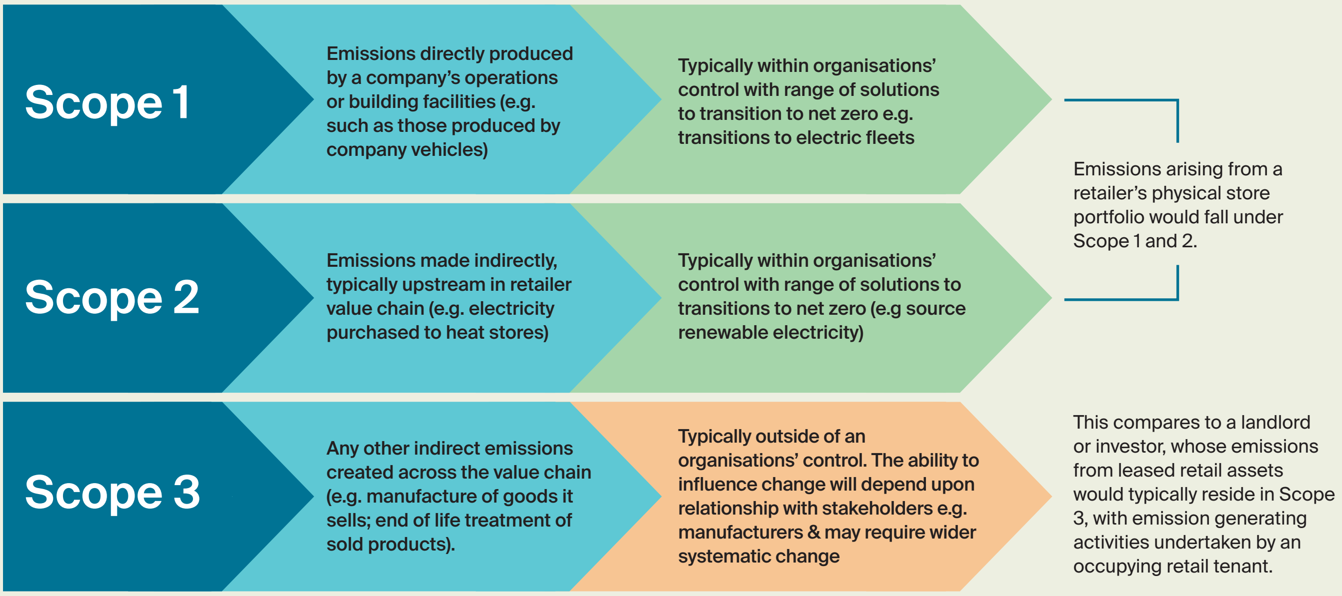
Retailers' hesitancy to quantify financial impacts show the sector is still nervous about many of the 'known unknowns' of the climate crisis. Most appear reluctant to publish specific figures, particularly given many risks lie outside of their control, and/or could radically alter under changing economic conditions and government policies.

The majority of retailers ultimately want to do the right thing. But they are also acutely aware of the reputational damage caused from accusations of greenwashing when claims are put into the public domain.

For the time being, expect retailers to tentatively navigate what is a complex, and high profile, area of regulation.

[2] Manifest Climate Disclosure Benchmark Review (2023)

Fig 9. Emissions Scopes



Source: Knight Frank Research

Who's responsible? Emission scopes

Environmentally, regulation thus far has forced retailers and landlords to consider and categorise emissions that their business operations produce. Emissions must be categorised into three 'scopes' (Fig. 9) for reporting purposes, dependent on where the emissions originate and how much control the organisation has over them.

The categorisation of emissions for reporting purposes is highly significant, as it creates contrasting and conflicting motivating drivers for landlords and tenants, which has resulted in a mismatch of priorities. Naturally, both parties are focused on reducing their largest source of emissions, typically Scope 3, which accounts for >70% of emissions for most businesses.

The problem is that a landlord's Scope 3 is typically a retailer's Scope 1/2. Attempts by landlords to reduce Scope 3 through the implementation of green leases are often resisted by retailers who view them as largely beneficial to landlords. Vice versa, landlords have been reluctant to spend capital on energy efficiency measures that directly benefit the tenant in the form of reduced energy bills.

Retailers face similar issues attempting to reduce their own Scope 3 emissions. Most retailers have limited influence over how third-party manufacturers operate factories producing their goods. Retailers often rely on a spirit of collaboration, but can also leverage a 'Code of Conduct' establishing expected standards and consequences for non-compliance, such as termination of contract.

Lynn Walker, Head of Sustainability at Primark, highlighted 86% of their emissions sit within Scope 3, with most suppliers producing garments in factories it does not own. Primark has taken steps to help suppliers transition to 'green factories' and many of its relationships with suppliers are strong, spanning over 30 years. But it also admits wider wholesale system change is required.

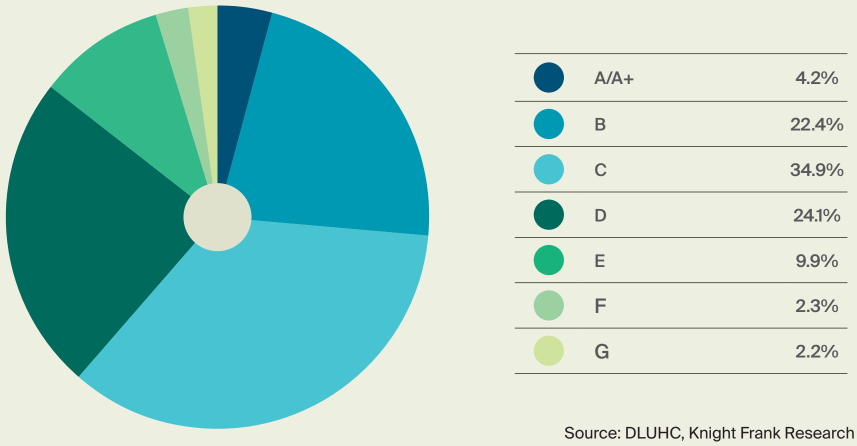
Case study: Primark – ensuring its cotton supply

Primark owner, ABF, identifies the impact of changes in climate to the cotton yields of its third-party manufacturers in Bangladesh and China as a potential risk in its most recent annual report. Cotton represents 65% of total fibre mix of garments sold in its stores, with 97% of material sourced from these two countries. Extreme temperatures, elongated monsoon seasons, and heavy rainfall are identified as potential risk factors.

Primark commissioned climate modelling analysis to conclude a 'minimal' impact to its cotton yields in the short-term. Cotton yield impact is projected to decline by a median -2% by 2030. However, the median reduction could deteriorate to -14% by 2050 as the climate situation worsens. In response, Primark states it has set out mitigating actions to minimise impacts, such as diversifying its cotton supply less susceptible locations. It has also established targets to increase the proportion of organic, recycled, or sustainably-sourced cotton to 100%, which is shown to be less at risk from rising temperatures.

"A landlord's Scope 3 is typically a retailer's Scope 1/2. Attempts by landlords to reduce Scope 3 through the implementation of green leases are often resisted by retailers who view them as largely beneficial to landlords."

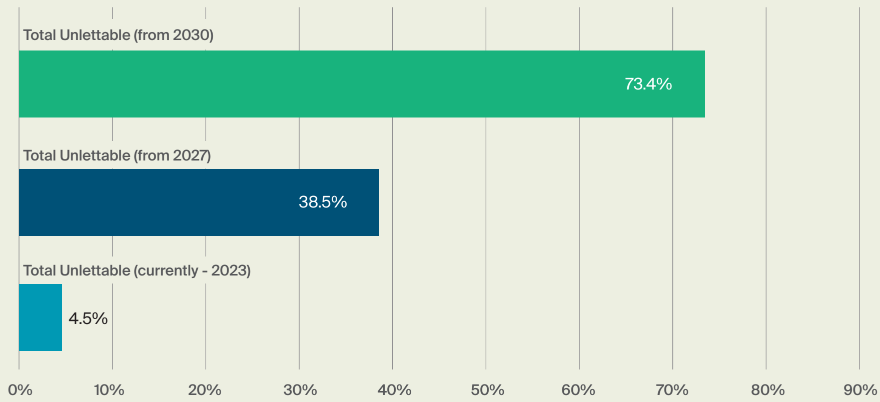
Fig 10. Only 26% of Retail property is compliant with 2030 targets (EPC B & above)



Source: DLUHC, Knight Frank Research

Fig 11. Proportion of retail floorspace at risk of becoming unlettable in next decade

% of potentially unlettable floorspace, by EPC milestones



Source: DLUHC, Knight Frank Research

Retrofit or Rebuild?

As regulations force the sector to adopt better practices and move forward, they may also paradoxically present some of its biggest roadblocks.

Marks & Spencer's (M&S') attempts to modernise its retail portfolio is a case in point. Specifically, proposals to overhaul its flagship London Marble Arch store to something more sustainable has faced a major legal challenge by UK government. Why? Proposals involve demolition of the store, rather than retrofit, sparking the debate on which is the better method to bring ageing stock up to modern standards. Government intervention has bought this discussion into the public domain, which could trigger widespread policy and sentiment change, and potentially see redevelopments prove why they cannot 'retrofit first'.

Trials and tribulations

The case highlights the many challenges retailers and landlords can face in the name of ESG. M&S earnestly consulted with local communities and environmental specialists on 16 different redevelopment proposals. It explored a variety of options ranging from 'light' to 'heavy' touch refurbishment to understand which would have the biggest carbon savings. It pursued well-known sustainability certifications (BREEAM & WELL), to ensure the building's sustainability standards registered within the top 10%. In addition, it stayed abreast of local policy changes, adapting proposals in light of the GLAs 2022 publication on Whole Life Carbon. M&S appears to be doing everything right, and yet it continues to face resistance.

The M&S test case rumbles on (on publication, M&S were legally challenging the government's decision to block demolition) – inciting nervousness for a sector which could potentially see ca. 70% of its stock potentially become legally unlettable by 2030.

Under current MEES regulation, commercial properties cannot be lawfully let if they possess an EPC rating of either F or G. This is proposed to be tightened further with a government White Paper confirming the potential future trajectory of the regulation. By 2030, the government hopes to restrict commercial lettings to only the most environmentally efficient buildings i.e. those with an EPC rating B or above. It's worth noting this requirement is not yet set in stone, with consultation ongoing on how best to encourage investment in aging stock.

How much stock needs to be brought up to standard by 2027/2030?

Regardless, the direction of travel is clear, and retail is in the firing line. The vast majority of the UK's retail stock needs to be upgraded, and fast.

Our analysis of EPC certificates show just 26.6% of existing retail stock currently complies with the 2030 target (EPC B or above), meaning 73.4% is at risk of becoming unlettable.

Whilst the sector has some time, the window of opportunity is shrinking, as a potential interim milestone target (EPC C by 2027) could be implemented to prevent a cliff-edge effect. This means 38.5% of stock is at risk of becoming unlettable by 2027. Landlords have 4 to 5 years, the equivalent of one letting cycle, left to take action.

Regions at risk: the costs of inaction

The state of retail stock across the UK is undeniably varied. Enforcement of the 2027/2030 MEES proposals will impact communities differently as a result, depending on the current state of their retail fabric.

Communities with already elevated vacancy rates and high proportion of low-standard stock could face an uphill battle to escape a spiral of decline. New regulations will mean the requirement to spend capital on upgrading retail stock will be a necessity for most. But this will ultimately present a major hurdle for regions already struggling to attract tenants and investors. Undeniably, both would prefer to gravitate toward ‘oven-ready’ stock that is already compliant (i.e. legally lettable to tenants, and able to open its doors to trade).

Our ESG Property Investor Survey, polling 45 investors with £300bn in assets under management, found that 77% of investors now have minimum environmental criteria for new investments. Investment will undoubtedly gravitate toward the greenest stock, meaning some communities will be left in the lurch, becoming even more undesirable. Expressed another way, struggling areas will be beaten with a new stick, rather than given any form of carrot.

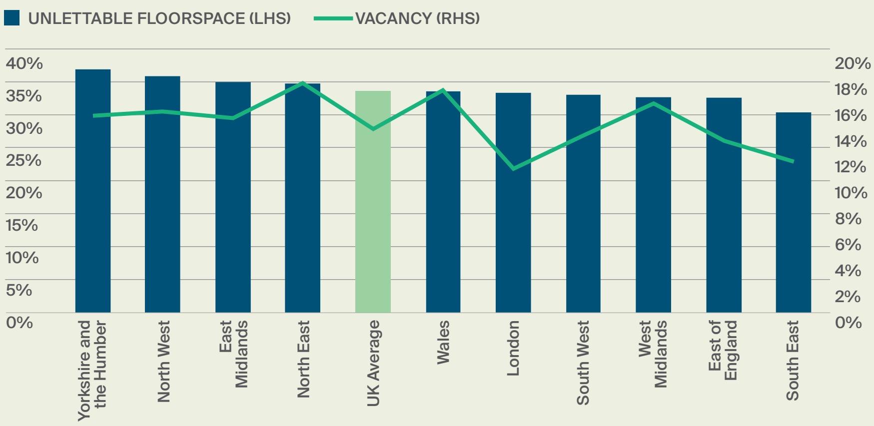
Our analysis highlights four UK regions most at risk (Table 1), possessing above UK average a) vacancy rates and b) proportion of potentially unlettable space by 2027. Regions most at risk include Yorkshire & the Humber, the North West & North East, and the East Midlands. The fact that three of these regions are located in the north underlines the urgency of ‘levelling up’ initiatives.

However, it’s worth noting the percentage margin between regions’ potentially unlettable floorspace is relatively thin. For instance, the ‘greenest’ region – the South East – has 30.3% of its floorspace at risk by 2027 whereas the ‘least green’ region – Yorkshire & Humber – has 36.8% of floorspace at risk. There are slight regional variations, but ultimately it is very much a national issue.

Although at higher risk, the further demise of these regions under tighter environmental regulation need not be a foregone conclusion. Regulation could indeed potentially provide the catalyst needed to start re-investing in fabric after years of neglect (c.f. KF Structural Failing #9: Under-investment).

Fig 12. UK regions with highest vacancy rates have most work to do to upgrade EPC ratings in next four years

% of unlettable retail floorspace from 2027 (EPC D & below)



Source: DLUHC, LDC, Knight Frank Research

Table 1: Regions at risk

ABOVE GB AVERAGE   BELOW GB AVERAGE

Regions	Total Unlettable Floorspace (%) from 2027 (EPC D & below)	Q2 23 Unit Vacancy Rate
Yorkshire and the Humber	36.8%	14.9%
North West	35.8%	15.3%
East Midlands	34.9%	14.8%
North East	34.7%	17.5%
UK Average	33.6%	13.9%
Wales	33.5%	17.0%
London	33.3%	10.8%
South West	33.0%	13.4%
West Midlands	32.6%	15.9%
East of England	32.5%	13.0%
South East	30.3%	11.4%

Source: DLUHC, LDC, Knight Frank Research

77%

of investors now have minimum environmental criteria for new investments

The "S"

Social Challenges & Opportunities – the latter outweighing the former?

What about the "S" of ESG? Environmental issues tend to dominate the narrative. But, increasingly, social issues have moved up the agenda. For retail, the social realm is perhaps where the sector can generate most value. How? The sector potentially holds the key to transforming the UK's social and economic wellbeing for two key reasons.

Firstly, retail is the UK's biggest private sector employer, providing jobs to 13% of the population. Its sheer scale means the way retailers engage with their workforce (such as providing a living wage) has a major impact on a substantial proportion of the UK's economy.

Secondly, retail locations (i.e. high streets) are traditionally viewed as the heart of many communities, providing essential everyday goods and services. Retail property is therefore an integral part of the UK's social fabric – so much so, that movement in vacancy rates are keenly watched as a barometer of a town or city's underlying health.

Town centres will be a key battleground in the government's fight against geographical inequalities. Its 'Levelling Up' agenda has a 'Pride of Place' focus, with town centre satisfaction a key metric in gauging community wellbeing. Clearly these are complex challenges, but also present sizeable opportunities, for retailers and landlords alike.

Rethinking returns: unashamedly capitalist for good reason

Interest in improving communities' social metrics is no longer purely the remit of government bodies, charity groups, and activists. The real estate community has begun to embrace value creation beyond just financial returns. Asset performance is not solely measured in terms of benefits to the bottom line – but value-add to the people within the community it serves.

13%

Retail is the UK's biggest private sector employer, providing jobs to 13% of the population

Informed investors are speaking much more publicly about social value creation and impact. And this goes beyond mere lip service. Our ESG Investor Survey found nine out of 10 of those surveyed have social-based targets, with 60% specifically targeting community engagement initiatives.

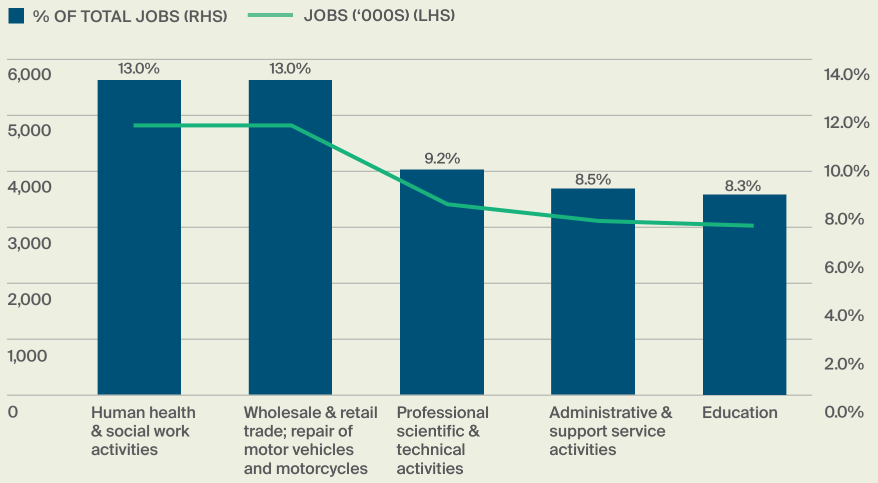
Larry Fink, CEO of Blackrock, outlined how companies' relationships with society are being redefined as a result:

'Stakeholder capitalism is not about politics. It is not 'woke'. It is capitalism, driven by mutually-beneficial relationships between you and the employees, customers, suppliers, and communities your companies rely on to prosper'.

PfP Capital's CEO, Catherine Webster, captured this sentiment as 'unashamedly capitalist, but for good reason'. Investors now realise that return on investment can be both financially and socially beneficial. And that ultimately, property is worth very little without people.

Most investors understand that the prosperity of retail property hinges substantially on the community it serves. A retail asset that aligns well with the demands of its local consumer catchment is likely to have higher capital and rental values whilst generating more social value, by providing in-demand amenities frequently used by residents and workers. In short, a near-perfect virtuous circle.

Fig 13. The retail sector is the UK's largest private sector employer



Source: ONS

Many UK high streets lack banking facilities, creating friction for the digitally disenfranchised, the elderly, and local businesses who rely on face-to-face services.

'Fit-for-purpose' = socially valuable

Arguably, too many retail locations are not 'fit- for-purpose', with properties failing to generate sufficient (or any?) social value for their communities. Some high streets across the country are failing to offer the range or type of amenities communities need, creating undesirable and unloved places. For instance, many UK high streets lack banking facilities, creating friction for the digitally disenfranchised, the elderly, and local businesses who rely on face-to-face services. These are the kinds of social repercussions faced in communities suffering from the after-effects of Structural Failing #1 ('Oversupply').

Of course, consumer demand for specific products/services will vary by location. Some catchments will demand a wide range and depth of exciting and immersive retail and leisure amenities. Yet, others will just need a selection of good quality essential neighbourhood services.

Retail operators have realised they do not require a physical store presence in every UK location (c.f. Structural Failing #2 'Historic Overexpansion'). Requirements are generally being tailored towards where there is clear consumer demand, informed by better utilisation of customer data analysis and trend tracking. M&S's current rework of its store portfolio under its 'Never the Same Again' programme is a good (if overdue) example of this process.

Naturally, a proportion of floorspace will ultimately be surplus to demand and therefore require a reassessment and potentially be repurposed for alternative uses. The scale and nature of change required should be dictated by local need. Assessment will be required as to whether the retail space is best placed to be converted to residential homes, or would attracting a new kind of occupier to the space (e.g. such as health services) be more appropriate? But, of course, the financials must also stack up.

How does a building generate 'social value'?

RESVI recognises social value can be generated across the building lifecycle, typically split:

15%
of social value generated at construction phase (e.g. employment of local labour)

15%
generated by facility management (e.g. procurement from local suppliers)

70%
generated by occupiers

Simply put – the genuine social value created by providing a catchment with the retail and leisure facilities it requires and desires is an opportunity that should not be underestimated.

Can you quantify social value?

Ensuring property generates a 'social value' can sound vague and intangible to the uninitiated. However, social value can increasingly be measured and reported in financial terms. The Real Estate Social Value Index (RESVI) assesses the value generated by an in-use asset by reviewing 67 different metrics. A calculated 'social value' is then translated into a financial value, which can be reported to investors to understand return on investment (ROI) from a social perspective.

Accordingly, the process requires rigorous data collection from all proponents – the asset owner, the property manager, key suppliers, and occupiers – to identify opportunities to generate greater social value.

Industry leaders in social value

Ellandi is the first UK asset manager to measure the social value across a portfolio of 17 shopping centres using RESVI. The process, which it conducted for the first time in 2022/23, highlighted the challenges inherent to collating data across a wide number of stakeholders. However, it also allowed it to quantify the social and financial impacts of actively managing and repurposing vacant space. It found incorporating an NHS health hub into redundant retail space had the potential to draw one million additional visitors, which could generate £27 million in additional retail and F&B sales[3].

Undertaking RESVI also revealed the need for asset managers, like Ellandi, to establish clear guidelines with centre management teams regarding delivery of social value. Ellandi now plans to roll out guidelines regarding its expectations in relation to net zero, energy usage, and the reporting of social value initiatives.

It now plans to benchmark more assets in 2023/24, meaning it can better understand the social impacts of its asset management strategies over time.

Less stick, more carrot?

Industry and sector sentiment is clearly warming towards the fact financial returns can go hand in hand with social returns. In many cases, good social returns will be a natural by-product of a fit-for-purpose retail space. But ensuring social returns are maximised will require time, energy, and resources. As Ellandi stated in its reflection of its first

[3] Ellandi Impact Report 2023

RESVI assessment, the measurement process was 'far from perfect', 'at times complicated', and 'a huge learning curve'. And that's before implementing new delivery strategies.

To date, incentives encouraging retailers and landlords to pursue better social returns are more 'carrot' than 'stick'. Whilst there are many regulations coaxing them toward better environmental outcomes, few go as far as policing the social realm.

Undoubtedly the largest and most high-profile landlords are those making the first moves. British Land (BL) injected £25 million into its 'Social Impact Fund' this year, comprising £15 million in cash contributions and £10 million in affordable space for local businesses, startups, and charities. BL has been keen to stress that the social fund 'isn't philanthropy' – highlighting longer-term net gains in rent, service charge, and business rates offsetting. It also sees value in making its social impacts explicit to visitors: claiming shoppers who rate BL's social contributions visit assets for 15% longer, and spend 14% more[4].

For retail assets to deliver ongoing social returns, strategies will undoubtedly have to be place-based, and firmly rooted in communities, which will evolve and see new challenges arise. Whilst bigger landlords are more likely to have the resources to monitor and respond to these changes, smaller players may not have the same agility, nor inclination to act.

> "Industry and sector sentiment is clearly warming towards the fact financial returns can go hand in hand with social returns."

A lack of governance in regards to the "S" of ESG is holding the sector back. Stakeholders need clear market signals alongside clear, universal objectives to enact positive change, mirroring the environmental space. So far, social value delivery has been reliant on a patchwork of goodwill amongst the most visionary retailers and landlords. Whilst larger players will do important work paving the way forward, players of all sizes will need to engage for large scale change to take place.

Property implications

- **Heightened regulatory scrutiny** especially regarding environmental sustainability and compliance with emerging standards;
- **Environmental upgrades** to meet proposed stricter environmental efficiency standards by 2030;
- **Improved performance and tenant satisfaction** for owners engaging with local communities and enhancing social value;
- **Requirement for data collection & collaboration across occupier/landlord to measure and/or enhance social returns.** Consideration of adopting indices like RESVI to measure and report on social value generated by assets to calculate ROI;
- **Adapt or repurpose retail and leisure spaces** to align with changing community needs and sustainability goals;
- **Prioritising sustainability and social goals** can differentiate assets in the market and attract tenants and investors looking for ESG compliant properties.

[4] British Land 2023 Sustainability Progress Report

Online: Bonfire of the Vanities?

WORDS: STEPHEN SPRINGHAM – HEAD OF RETAIL RESEARCH

Internal structural change within one of the key drivers of wider industry structural change. The disruptors themselves disrupted. The hunters becoming the hunted. The online landscape is entering a new chapter in its evolution and this will have a profound impact across retail markets.

Key takeaways

Online is maturing and entering a new phase in its evolution. The ‘online vs physical stores’ debate is increasingly redundant.

This structural change will see many ‘artificial’ elements removed – a greater push towards profitability generally and disruptive but ultimately unprofitable pure-plays falling by the wayside.

The strategic name of the game will be to balance the consumer-centricity of online with greater, more hard-nosed commercial viability.

Expect retailers to migrate to more appropriate charging models for online delivery and try to reduce and minimise the volume of product returns.

Although widely reported, online growth and penetration figures are becoming increasingly irrelevant. Large proportions of what is reported to be ‘online’ spend is actually multi-channel.

Multi-channel operators are likely to increase their share of overall online spending as they grow and pure-players consolidate. Rather than be disrupted, the retail market will increasingly dance to a multi-channel tune.

The rise and evolution of online has been one of the most influential factors in the retail market over the last quarter century. Period. But most of the narrative on this evolutionary and highly complex process has been woefully simplistic. Online basically a direct replacement for / tormentor to / ruin of traditional “bricks & mortar” retail, e-commerce the root cause of all high street malaise. Change the record, please.

Only marginally better informed are the more-rounded, but still binary, extreme arguments. 1) That online is an indestructible, omnipotent force, the ultimate in consumer-centricity, a panacea for all retail’s manifold challenges. Or 2) A malevolent force that is (and always will be) economically unviable, one that massively undermines industry gross margins and represents nothing more than a fatal race to the bottom for retailers.

The highly-nuanced reality lies somewhere between these two extremes. This is where online structural change will play out going forward. The digital “space race” is over in terms of retailers blindly pursuing a mythical holy grail (or just keeping up with the Joneses), but the digital arena remains an absolutely pivotal one in the retail market.

In highly simplistic terms, the name of the game going forward will be marrying these two extremes – maintaining the consumer-centricity and convenience of online, but not sacrificing economic viability.

Maximising and monetising the potential of online to make a telling contribution to both the top and bottom line. In absolute base terms, actually making money out of online.

Not about the numbers

A continuing obsession with stellar (but often spurious) online growth and online penetration figures is scant reflection of the scale of change that is playing out in the market. COVID marked a depressing backward step in this regard, highly distorted figures during the pandemic erroneously interpreted as permanent directions of travel. The post-pandemic period has laid bare just how simplistic and misguided much of this thinking was. The numbers are a mere veneer to something far deeper.

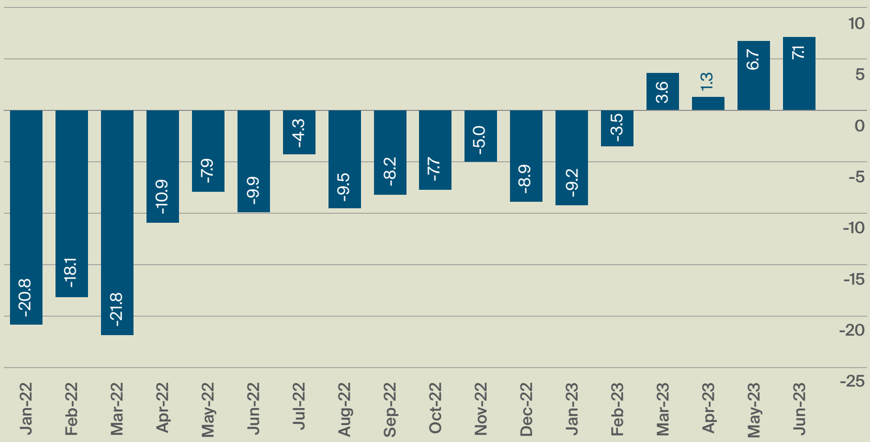
For what the figures are worth, online penetration was just shy of 20% coming into COVID. At the height of the pandemic, this figure reached a high water mark of ca. 37%. Rather than a “surge in online demand” or “consumers discovering online”, this was a combination of demand by default (stores weren’t open, consumers had no choice) and simple mathematics (consumers spent a lot less generally, but a bit more online QED the penetration figure went up significantly). The fact that ca. 95% of consumers already shopped online prior to COVID pours icy cold water on the ridiculous notion of “consumers discovering online” during the pandemic. Most were fully-versed in the mechanics of online long before COVID struck.

These heights were never going to be maintained post pandemic. But the pace and extent of rebalancing has defied virtually every expectation. Online sales went into freefall once stores reopened and declined at a monthly average rate of ca. -11% for the whole of 2022. The decline was only arrested by mid 2023. Almost in denial of the scale of this re-basing, the ONS stubbornly suggests that online penetration rates are still around 25-26% going into Q4 2023 - Knight Frank’s own calculations suggest closer to 21-22%. ▸

“Online sales went into freefall once stores reopened and declined at a monthly average rate of ca. -11% for the whole of 2022.”

Fig 14. Online sales - YoY change

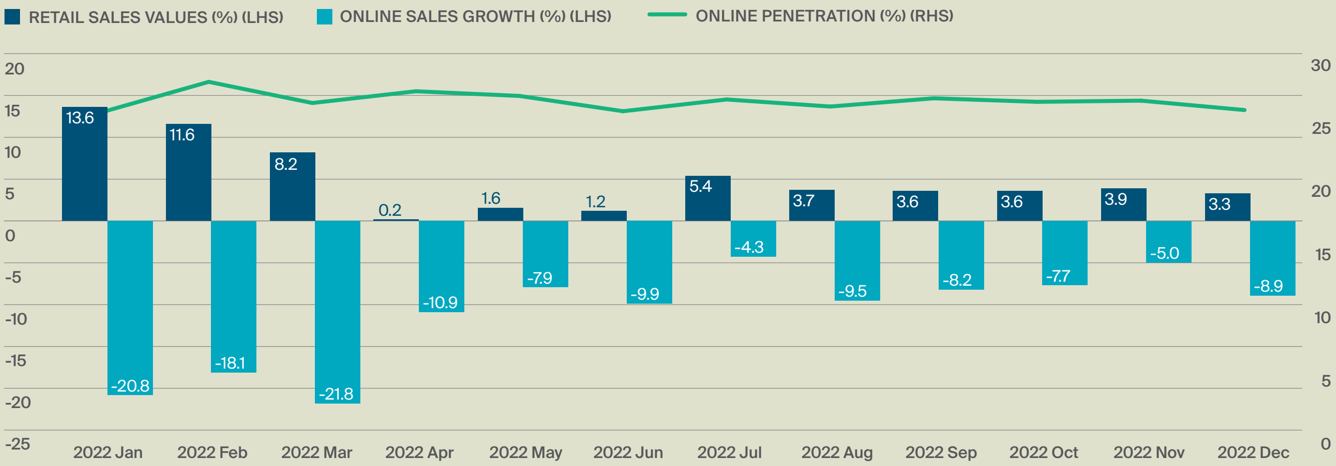
%



Source: ONS, Knight Frank Research

Fig 15. Online sales growth (YoY change) and penetration

%



Source: ONS, Knight Frank Research

The parrotlike narrative that "online penetration is still higher than pre-COVID" is irrelevant and completely misses the point. The landscape has shifted – and will continue to do so.

Grocery vs Non-Food

A deeper, more discriminating dive beyond the headline penetration numbers sheds far more light on the dynamics and realities of online retailing. Absolutely central to this is differentiating between two key aspects. 1) Grocery vs Non-Food. 2) Multi-channel (i.e. stores and online) vs Pure Play (i.e. online only).

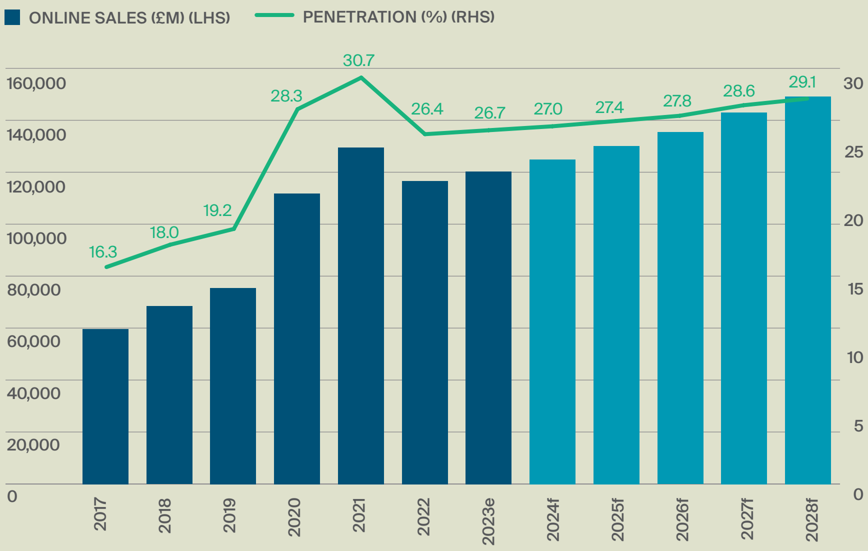
Online grocery takes many different forms (e.g. home delivery, click & collect, courier, rapid delivery) and many different types of operators are active in the space (e.g. mainstream grocery retailers, online pure-players, foodboxes, rapid delivery specialists). The grocery market generally is by far the largest retail spending category (accounting for ca. 45%-50% of all retail spend), so any slight movement in demand will carry big sway in overall online penetration numbers.

This is what we saw during COVID – very temporarily. For what the figures are worth (that particular record is not going to change), online grocery penetration is much lower than non-food and stood at just 5.2% coming into COVID. Health concerns and social-distancing saw this figure spike at 12% in January 2021, with some non-ONS sources suggesting a figure closer to 15%. But as COVID fears have abated, online grocery demand has receded rapidly and is stabilising around the 7-8% mark.

Much more significant than the penetration figures is the composition of the market. Core home delivery is by far the largest segment of the online grocery market (61.4%), followed by online pure-plays (14.9%) and click & collect (9.8%), with the niche channels making up the remainder (13.9%). Structurally, only the pure-plays (e.g. Ocado, Amazon) and niche operators (e.g. foodboxes such as HelloFresh, Gousto etc) deploy central distribution facilities, the mainstream food operators tending to employ store-picking models for virtually all their online grocery fulfilment.

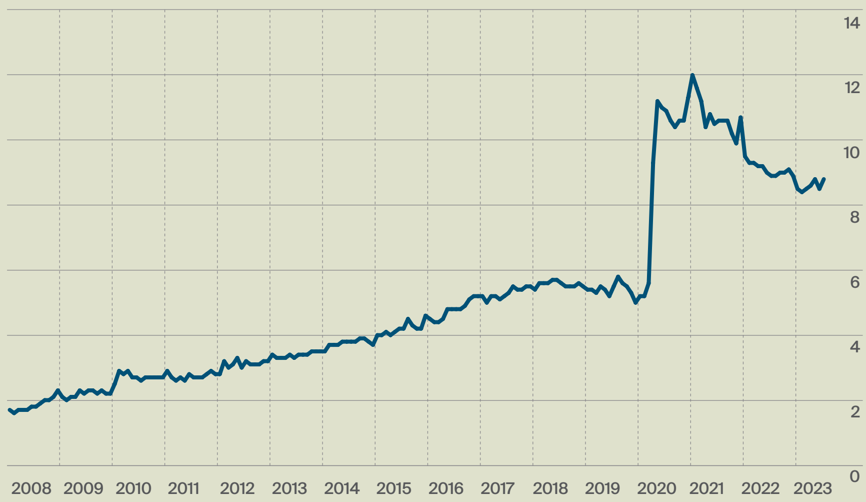
The key point is that the vast majority of online grocery demand (ca. 71%+) is serviced by stores rather than central warehouses. So, ca. 71%+ of online grocery is part of a wider multi-channel ecosystem. Expressed in blunt terms, ca. 71%+ of online grocery isn't really 'online' at all.

Fig 16. All retail online penetration 2017-2028f
£m



Source: ONS, Mintel, Knight Frank Research

Fig 17. Online grocery penetration 2008-2023
%



Source: ONS, Mintel, Knight Frank Research

> "The parrotlike narrative that "online penetration is still higher than pre-COVID" is irrelevant and completely misses the point. The landscape has shifted – and will continue to do so."

> "COVID provided invaluable, real-life, real-time lessons on online for all the supermarkets, in terms of seasonality of demand, capacity need and supply chain requirements/capability."

The million dollar question mark hanging over online grocery is whether anyone actually makes a penny of profit from it. Details on this have always been sketchy, but the fact that the most transparent operator Ocado has only really made money outsourcing its infrastructure, as opposed to actually selling food, is more damning than decisively reassuring. For their part, the Big Four (Tesco, Sainsbury's, Asda, Morrison's) are famously coy on the profitability of their respective online grocery operations, but volume has clearly always been key. Big baskets – and lots of them.

But change is afoot. For all its stresses, COVID provided invaluable, real-life, real-time lessons on online for all the supermarkets, in terms of seasonality of demand, capacity need and supply chain requirements/capability. These lessons are now being proactively deployed and financial models revisited. Expect significant structural change in the online grocery market as a result.

Multi-Channel vs Pure-Play

Equally questionable (if not to say irrelevant) penetration figures in non-food, but a multitude of largely different challenges. But a common denominator with online grocery in a quest to achieve profitability that can often be elusive.

Amazon is often considered the totem for online non-food retailing. It is indeed the largest player in the market, but is maybe not quite as dominant as many believe. Indeed, a ranking of the Top 10 Online Players by turnover includes no less than six established 'high street' names – Tesco, Sainsbury's (inc Argos), John Lewis, Next, Asda, Dixons Carphone. Nor does this trend tail off dramatically lower down the order, with 13 of the Top 20 online layers being recognised 'high street' names (e.g. Kingfisher, Morrisons, M&S, Iceland, JD, Boots, Frasers Group).

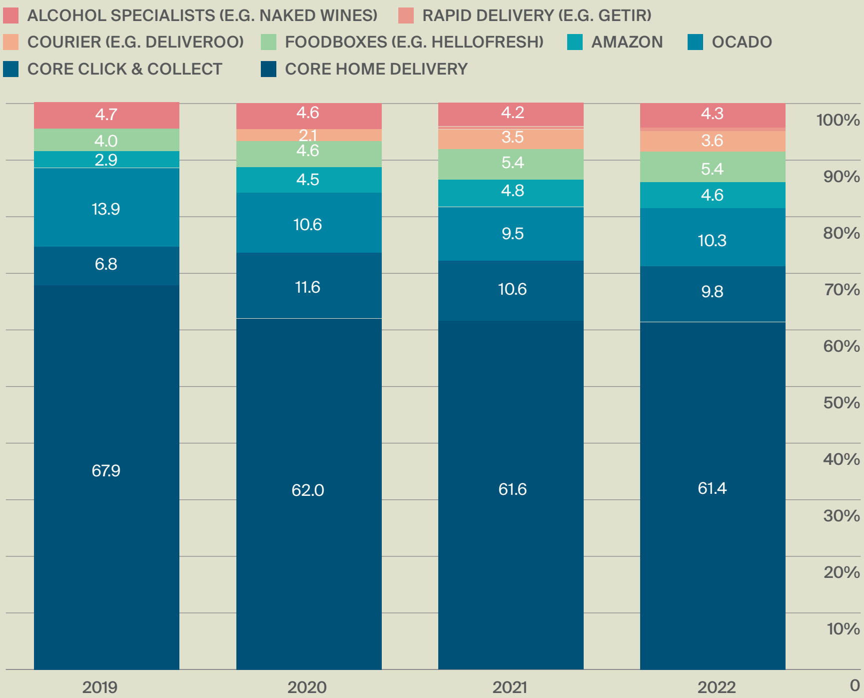
The key point is that a large proportion of non-food 'online' sales are actually 'multi-channel' – that is to say, they form part of wider ecosystem which has physical stores at its front and centre. Indeed, multi-channel commands a marginally larger share of online spend than online pure-plays (Amazon et al). In 2022, the balance between multi-channel : pure-play was 51% : 49%, but during the pandemic, there was a definite swing towards multi-channel (e.g. Feb 2020: 55% : 45%). This reflected an interesting dynamic of consumers sticking to brands they knew and trusted during the pandemic, shopping via their online channels while their stores faced enforced closure – reinforcing the adage that consumers shop brands, not channels.

We would expect multi-channel to increase its share of online spend significantly going forward on the back of structural change within the online arena. There are essentially three interlinked factors behind this gradual change:

1. **Greater convergence between online and physical retail**
2. **A lower future growth trajectory of online pure-players**
3. **Fall-out and consolidation of online pure-players.**

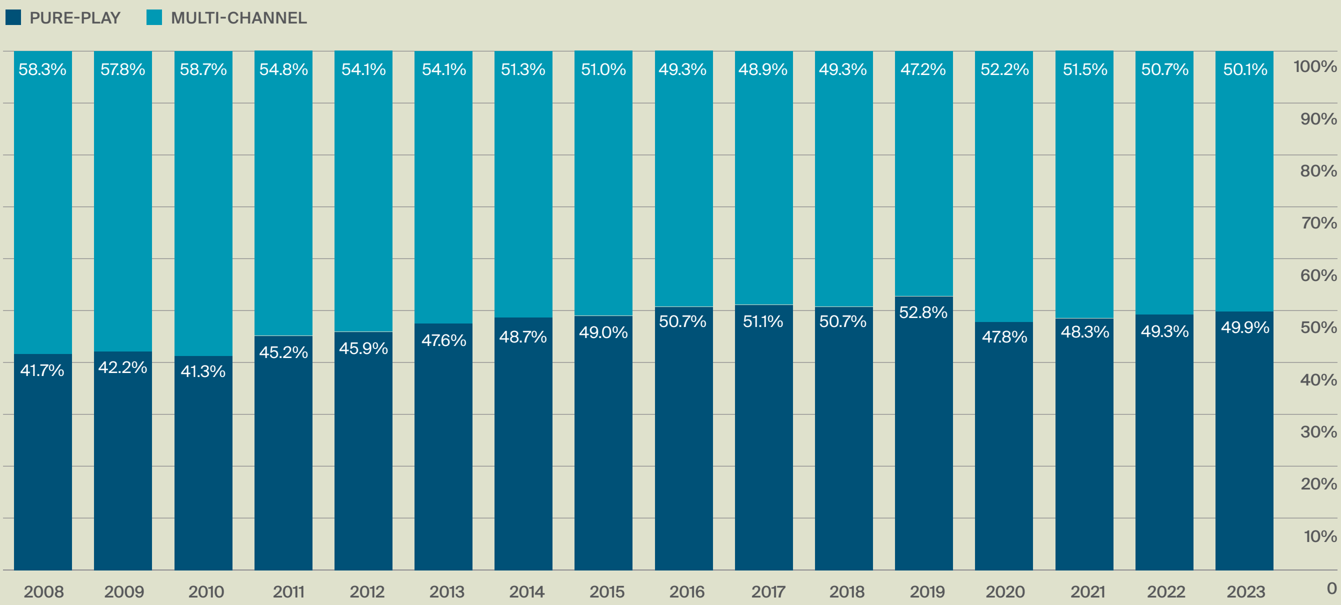
As part of the evolution of the online market, most store-based operators have transitioned to become multi-channel players by launching an integrated online arm. There are some notable exceptions to this (e.g. Primark, Aldi, Lidl) and despite a groundswell of narrative to the contrary, we do not expect any of these to adopt an online model anytime soon.

Fig 18. Composition of the online grocery sector 2019-2022
% Share



Source: Mintel, Knight Frank Research

Fig 19. Share of online sales 2008-2023 – Pure-play vs multi-channel
%



Source: ONS, Knight Frank Research

At the same time, a growing number of online pure-plays have made the transition the other way, complementing their core e-commerce business with physical stores, albeit with very varying degrees of success and endurance. Is Amazon technically still an online pure-play, given that it owns Wholefoods and has launched Amazon Fresh / Go / 4 Star / Style organically? A moot point as to classification maybe, but the fact that it has struggled to make a significant impact in the physical arena is very telling. Above all else, it underlines the fact that it is usually easier for many store-based operators to make the multi-channel leap than it is for their pure-play counterparts.

“One of the two by-products of this is a massive flight amongst retail pure-plays towards cost-cutting and far greater focus on the bottom line, rather than the just the top.”

Many pure-players are now under far greater financial pressure than they were previously. The fact is that many online pure-players have failed to turn a profit since their inception and their status as ‘disruptors’ afforded them shelter from scrutiny, for better or worse. However, a deteriorating macro-economic backcloth and tightening financial markets generally are leaving few hiding places for those operators with a shaky balance sheet. To put this into some sort of perspective, for our Retail Property Outlook Report for 2023, we identified that over one third of the ca. 60 online pure-players in the list of the UK’s Top 300 Retail Retailers were trading at a significant loss. Many more were barely profitable.

Current market conditions are dictating that this structure cannot continue indefinitely. One of the two by-products of this is a massive flight amongst retail pure-plays towards cost-cutting and far greater focus on the bottom line, rather than just the top. Even Amazon is taking a much harder line on its cost base now than it ever has in its history, both in the UK and globally. It is no longer chasing sales at any cost, in a drive that is being mirrored at virtually every pure-play operator (e.g. AO World, ASOS, boohoo). As a result, far more pedestrian turnover growth will be the order of the day for many years to come.

The other by-product of current market conditions is more severe still – fall out and/or consolidation. Investors and stock markets are far less forgiving in times of financial strife and many loss-making pure-play operators will soon burn through any cash they may still have. Rather than fail outright, many will become targets for better-capitalised multi-channel operators. The takeovers of Missguided by Frasers Group, Eve Sleep by Bensons for Beds and Made.com by Next are all good examples of what we are likely to see more of – multi-channel operators acquiring online pure-plays to bolster their e-commerce credentials. In many cases, the online brands will probably be retained and the businesses will live on under new ownership.

All of which will support a swing towards multi-channel going forward,

Structural change – what can we expect?

1. End of artificiality

- Fewer vanity projects
- An end to the mentality of "we will, just because we can"
- Less herding / operators all doing the same thing
- Less unprofitable capacity in the market
- Operators competing on the basis of brand differentiation, rather than price

2. Push for profitability

- Less aggressive pursuit of top line growth
- Far more stringent cost control
- Efficiency and productivity drives
- Deployment of AI
- Fall-out / consolidation of unprofitable operators

3. Seasonal responses

- Ramp ups in capacity to meet seasonal spikes in demand
- Wider use of AI to predict demand
- Increased flexibility in supply chain
- Temporary facilities alongside permanent ones

4. Sensible charging
(Delivery & returns)

- Retailers pushing back on free delivery
- Still offering rapid delivery options, but at appropriate cost
- Less 'frictionless' product returns
- Wider use of technology / AI to minimise returns

5. Tentative tests

- A more pragmatic approach to innovation
- More forensic cost analysis of strategic initiatives

6. De-risking

- Risks and costs shared / passed onto 3rd party operators
- Closer collaborations with 3PLs
- Joint ventures with couriers/ distributors e.g. Deliveroo, Just Eat

the numbers themselves merely a barometer of profound structural sea change within the online space.

A Bonfire of the Vanities? Certainly considerable change within the online space that will permeate through the whole retail industry. The displacement of unprofitable capacity within the market by whatever means will be of benefit to the collective whole, without necessarily making the retail market any the less competitive.

Structural change heralding the 'death of online'? Absolutely not, but the ushering in of a new chapter whereby online is no longer the disrupter, but part of the retail establishment. No longer a challenger to the status quo, more a part of it.

Property implications

1. Greater recognition of the symbiotic relatationship between online and stores
2. Reappraisal of the physical store's role in a multi-channel ecosystem
3. Renewed investment in core stores and multi-channel 'cogs'
4. Greater impetus to dispose of stores that have a limited role in the ecosystem
5. Re-evaluation of a store's 'real' contribution to the business
6. Resetting of store operating metrics, ongoing challenge to historic valuation process
7. Stores acting as pillars within the multi-channel ecosystem carrying a pricing premium
8. Investment demand strongest for foodstores that are also used for online picking

Retail & the rise of AI: an investment worth making?

WORDS: EMMA BARNSTABLE, ASSOCIATE, COMMERCIAL RESEARCH

AI will shake up retail but must deliver clear returns to avoid becoming the sector's next vanity project.

Key takeaways

Retail has lagged behind more 'AI mature' industries (e.g. finance) but is now set to be amongst the top industry beneficiaries – forecast to achieve above average increases to profitability.

Around half of retailers already experiment with AI, although not all implementations are 'futuristic', with most focused on solving routine inefficiencies across the business, from supply chains to customer service.

The need to deliver quick and measurable returns on investment (ROI) has restricted exploration to major retail players, but will ensure new technologies are approached with pragmatism by the mainstream.

AI is not a silver bullet and will not single-handedly solve the sector's structural issues. Vanity projects will gain most attention, but less glamorous, more 'mundane' interventions will likely make the greatest impact in evolving the sector in partnership with its human workforce.

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To implement AI, retailers will have to invest heavily in data across their physical and digital portfolios, which could help them quantify the true value of the physical store and aid the setting of realistic and sustainable (turnover) rents.

Artificial Intelligence (AI) – not a new phenomenon

AI has caught the attention of the world with the arrival of a human-like chatbot – ChatGPT - but the technology has been with us longer than most realise. Rather than a new phenomenon, Artificial Intelligence has been alive for decades, quietly changing the world around us since its emergence in the 1950s.

AI technologies have already massively advanced the fields of science, military, and finance. For instance, rather than rely on the whims of local bank managers, residential mortgage applications are now assessed with the aid of AI. Neat scientific algorithms crunch vast amounts of data on individuals to assess their creditworthiness, optimising decisions and minimising risk for lenders.

AI has not made waves across all sectors, though. In 2017 KPMG identified retail as a laggard in adoption, causing it to miss out on potentially major productivity benefits. In 2023, the landscape does not appear to have changed much, with just over a quarter of retailers (28%) regarding AI a 'top investment priority[5]'. There is, however, growing acknowledgment amongst retailers that AI warrants further investigation, posing the question – is AI an investment worth making?

[51] Retail Week / PwC: AI in Action, Insights from 75 Retailers on their AI Strategies (2023)

Why should retail care?

The government is anticipating AI will change the UK economy on an unprecedented scale, providing a £400bn boost by 2030. For the average UK worker, productivity gains are expected in the region of 100 hours per year, but some sectors are set to benefit more than others. GPs and teachers, for instance, could save 700,000 hours usually spent on administrative work through AI, freeing up £8bn worth of public sector resources[7].

Retail is another sector expected to be a major beneficiary of AI technology. AI could deliver a 59% boost to profitability across the Wholesale & Retail industry by 2035, compared to a wider average of 38%, positioning it as a top 4 recipient out of 16 industries assessed[8]. Those who move fastest can reap even greater rewards: early adopters expected to enjoy 8% higher profit margins[9].

But how exactly will AI drive profitability increases for the retail sector? The theory goes that by augmenting AI with its human workforce, productivity and efficiency improvements will drive profitability. For instance, self-service checkouts enabling one staff member to handle multiple transactions at once, reducing staffing costs. With AI technologies capable of optimising both operators' "back end" (automated warehouses) and "front end" (customer service chatbots), the accrual of even small implementations across retailers' value chain could lead to major gains. All basic retail disciplines can be revisited using AI technologies, such as what to stock, how much and when.

Experimentation to date

Well-known examples of AI deployment have typically been the most glamorous and futuristic, such as Amazon Go's checkout-less stores, and Ocado's automated robot warehouses. It's debatable whether these deployments have been wholly successful – Ocado pausing rollout of new distribution centres in February following a record £500m annual loss, and Amazon closing several Just Walk Out-enabled stores in July. Although it should be acknowledged the pathways trailblazers carve out do provide valuable insight into viability for the wider industry.

Lesser-known deployments are perhaps regarded more mundane, and have gone undetected by typical consumers. 50% of retailers claim they already use AI in some form[10].This is not surprising considering many retailers hold vast amounts of customer data from their loyalty schemes. Some of the best operators (Tesco, Next, Argos) have been deploying this data for years, but AI technologies are now taking this to a much higher level. For example, Morrison's, the Big Four grocer, deploys AI to assess historic sales data of individual stores, alongside local weather reports, to predict future demand – reducing shelf gaps by a substantial 30%. ASICs, the footwear brand, invested in Aura Vision in 2016 to conduct analysis across its physical estate. The London-based tech startup uses CCTV to track customer movement, providing insight on store layout and product engagement, to improve conversion of footfall to sales.

It's not just retailers themselves adopting these technologies. The New West End Company (NWEC), a retail body representing 600 retail and leisure operators across London's major streets, use of AI helped it drive £100m in additional income by keeping shoppers spending. Previously relying on analogue street surveys, the AI aggregation of mobile, spend, and flight data provided a better profile of visitors. Insights identified some of the most affluent visitors came from less visible markets, prompting it to encourage retailers to employ staff with wider language skills. ▸

What exactly is AI? A 'family' of technologies

Bizarrely, despite 65% of retailers claiming they understand AI 'very well' or 'well'[6], a UK government House of Lords report highlights there is actually 'no agreed single definition' of AI. Rather, AI is acknowledged to be a "family" of different technologies and systems, capable of performing tasks normally requiring the intelligence of a human.

Examples of AI technologies within this "family" system include:

- **Algorithms:** a series of instructions for performing a calculation or solving a problem. The 1994 "Apriori Algorithm", for example, can conduct market basket analysis, identifying that customers who purchase BBQs often simultaneously buy charcoal – aiding retailers' decisions about store layout and promotions.
- **Machine Learning:** computers learn to make predictions / decisions without explicit instructions or programming. Instead, they are trained to recognise patterns in large datasets, and continually learn from mistakes to improve.
- **Deep Learning:** a 'sister' (subfield) of machine learning using 'artificial neural networks' inspired by the brain to handle more complex, hierarchical data, including images and audio. Retailers frequently use 1989 pioneered "CNNs" (Convolutional Neural Networks) to manage their product inventory: processing images of store shelves to identify what to restock.

65%

of retailers claim they understand AI 'very well'

[6] Retail Week / PwC: AI in Action, Insights from 75 Retailers on their AI Strategies (2023), [7] Google (2023) Economic Impact Report, [8] Accenture (2017) The Art of AI Maturity,
[9] Retail Week / Nosto (2023) Demystifying AI, [10] PwC (2023) AI in Action

Fig 20. Artificial Intelligence - fuelling a new era of consumption?

Source: Knight Frank Research

> "One third of UK consumers believe customer service has worsened, with 50% citing chatbots as a source of frustration.[7]"

The AI endgame: improve profitability

Whilst the actual benefits of some AI deployments may be unclear (one third of UK consumers believe customer service has worsened, with 50% citing chatbots as a source of frustration[11]) – the ultimate goal should be driving profitability. A clearly defined ROI (return on investment) is required to prevent ventures becoming vanity projects. However, retailers appear alert to these risks. 67% of retailers allegedly possess 'clear AI investment plans'[12], but 40% see a lack of available investment as the second biggest hurdle to implementation. The need to demonstrate quick returns on investments may stifle AI progress in retail – but will force stakeholders to fully consider how AI tools could best solve their problems.

Just because we can, doesn't mean we should

Ocado's former Chief Technology Officer (Paul Clarke) once prophesised AI would become 'the new drug' to 'reduce the friction of daily life'. Although raised in a positive context (Ocado clearly at the forefront of AI retail application) – Clarke's choice of words raise concern about the consequences of unleashing such powerful technology on the world.

The rise of Shein, the online fashion pure-player, is potentially shaping up to be a case in point. The company's AI capabilities have allowed it to pioneer a new era of consumption, termed 'Real-Time Fashion', surpassing both fast, and ultra-fast fashion behaviours (Fig. 20).

What does any of this have to do with retail property?

At first glance, it may feel like AI benefits are limited to the digital retail realm. But as outlined in our 10 Structural Failings, the transition to multi-channel retailing and increasing convergence of online and physical stores will be a pivotal facet of the sector's evolution.

AI may also prove an effective way to manage many of the sector's wider structural issues too. Operators could minimise 'Brand Devaluation' (Structural Failing no. 8.) by gaining a more intimate understanding of their customers using data analytics.

Perhaps slightly controversially, it could also tackle 'Wider Cost Inflation' (no. 5) by reducing unnecessary staff costs. There is a fear AI could eliminate jobs across the sector, but the technology will still need to be carefully balanced with human instinct and experience. Retail does serve human consumers after all, not robots.

Amazon's UK Fresh stores, whose format stripped staffing to a bare minimum, are an excellent case in point. Amazon clearly has access to some of the best AI capabilities, and yet the closure of two stores this year perhaps highlighted an overreliance on data, to the detriment of other basic retailing disciplines – analysts pointing to 'clinical' stores in locations where customers were perhaps not the most

67%

of retailers allegedly possess 'clear AI investment plans'[12], but 40% see a lack of available investment as the second biggest hurdle to implementation.

[11] Capterra (2022) Customer & Help Desk Survey, [12] PwC (2023) AI in Action

tech-savvy. In effect, giving customers what they thought they wanted – but, in fact, they didn't.

Better management of the 'ugly tail' (no. 3) could also be achieved, with AI helping unveil the true value of the physical store. To effectively implement AI, retailers will have to undertake a huge amount of housekeeping, consolidating siloed data spread across their physical and digital estates. Data will have to be maintained on an ongoing basis, enabling up-to-date or even real-time access to individual stores' KPIs. This would go some way in solving the notoriously difficult quantification of physical stores' online 'halo effect' in deciphering what is a sustainable (turnover) rent.

Although good in theory, the reality is most retailers will likely remain suspicious of data sharing provisions in leases which could lead to a ratcheting of their costs. Furthermore, forensic capabilities to investigate the impact of store closures (e.g. sales uplift to neighbouring stores), would likely embolden retailers' mantra that 'no store is sacred' in landlord negotiations.

The bottom line: AI is just one tool in retailers' armoury

AI is not a silver bullet. Not every problem can be, or should be solved by AI. Where AI is implemented, it will require the guidance of humans, who must ensure the technologies effectively tackle clearly defined business objectives.

> "AI could deliver a 59% boost to profitability across the Wholesale & Retail industry by 2035, compared to a wider average of 38%, positioning it as a top 4 recipient out of 16 industries assessed[8]."

Shein case study: real-time demand driving supply

Shein constantly monitors social media and website traffic to gauge popularity of its products, insight which it feeds directly to manufacturers in real time to inform production. When a product is listed for sale, metrics such as page views and number of customers with an item in their bag are analysed, triggering automatic ordering of materials, increasing production quotas. This real-time monitoring and data crunching allows Shein to produce exactly what consumers want, as and when they want it, in theory eliminating over-supply.

The addiction loop: discovery driven retail

Shein's AI algorithms require a huge amount of data to work successfully, but are adequately fuelled by its addictive shopping experience. Shoppers are constantly recommended items based on their likes and dislikes (gauged by factors such as dwell time on certain products), creating an addictive 'TikTok' like experience in which users never really have to search for anything. Instead, they are led down a rabbit warren of delights – something of digital version of the TK Maxx 'treasure hunt' – except one which is more accurately reflective of individual style wants, and needs. All this feeds yet more data into Shein's algorithm, which it reflects back to users, allowing it to appeal to any consumer of any age, gender, or geographic location. A perfect virtuous circle?

Under the radar?

This AI-led, consumer-driven manufacturing (C2M) model is increasingly garnering attention. But some commentators believe realisation of Shein's power is still flying under the radar. Chief Investment Officer at Anatole Investment, George Yang, was quoted as saying 'Zara is a legacy player which is going to be crushed', citing Shein's response to fashion trends taking just three days, compared to Inditex's (once ground-breaking) production turnaround of three weeks. Others have pointed to Shein's relative restraint, highlighting its tech model could easily be replicated across any product category. Perusal of the website shows recent additions and diversifications including 'Fishing' and 'Camping'. Perhaps the next Amazon rival?

Shein's AI application is undeniably impressive – but has not been without controversy. The speed at which it can scrape user trends and translate into in-demand products enables it to add between 700 – 1,000 new items to its website each day, inevitably causing concern about the impact on the environment. Ethical questions have also been raised with a host of ongoing US lawsuits regarding IP infringements: artists accusing the company of stealing designs to create merchandise.

Like most tools emerging from pandora's box – regulation will take time to act. But in the meantime, we cannot deny there will also be many positive societal benefits of retailers' leveraging AI. Take Boots' recent collaboration with Imperial College, which drew upon six years' worth of customers' purchase history of painkillers and digestive aids, to detect signs of ovarian cancer up to eight months in advance of a GP diagnosis.

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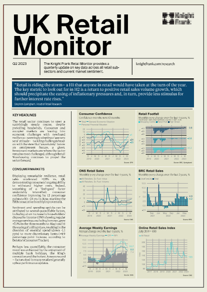

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