Executive Insights

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Building Business Resilience: The Best Investment UK Retail and Consumer Businesses Could Make in 2017

The economic implications of the U.K.'s exit from the EU are far from clear. For the retail and consumer sector, which still bears the scars of the last downturn and has shown signs of weakness in recent months, further uncertainty will expose the vulnerable. Now that the Brexit starting gun has been fired, businesses must look to build strength into their organizations to ensure they can handle the challenges and opportunities that the next 12 to 24 months will bring.

Uncharted waters and the specter of inflation

It's a reality that many thought the U.K. would never face — a complicated exit from the EU that brings with it deep uncertainty about the impacts and implications. The U.K.'s decision has already had an effect, with the prices of food and other goods rising as imports from overseas increase in price due to sterling's devaluation.

The Bank of England has provided its own forecast for the U.K., predicting a fall in GDP growth from above 2% during the final quarter of 2016 and throughout 2017, followed by weak, fairly flat growth of 1.6% through to the end of 2019.

While this headline story can be seen as positive in that the overall economy is expected to keep growing rather than enter a recession, the slowdown is likely to weigh more heavily on retail and consumer businesses for several reasons:

1. Many sectors within retail and consumer are still struggling to shake off the effects of the 2008-09 downturn and have not recovered to pre-2008 levels in terms of consumer spending.

2. The full effects of Brexit are unknown, but already we have seen inflation across consumer goods as the value of sterling falls against the dollar and the euro. U.K. businesses are paying 16% more for raw materials and fuel than they were in mid-2016, and inflation is likely to rise further as 2017 progresses, reducing household disposable income. As shoppers look to stretch their reduced spending power, retailer margins will be squeezed, exposing the more vulnerable businesses.

3. The combination of a weak economy, leading to muted wage growth and increasing inflation, will lead to a dramatic slowdown in the growth of real personal disposable income (PDI) (see Figure 1, page 2).

Retail and consumer sector facing a stern test

A look at historic economic cycles since the early '80s shows the U.K. enduring three significant downturns (see Figure 2, page 2) in this period. Reasons for past downturns have varied hugely

Building Business Resilience: The Best Investment UK Retail and Consumer Businesses Could Make in 2017 was written by **Jonathan Simmons**, a partner, and **Romain Maitret**, a principal at L.E.K. Consulting. Jonathan and Romain are based in London.

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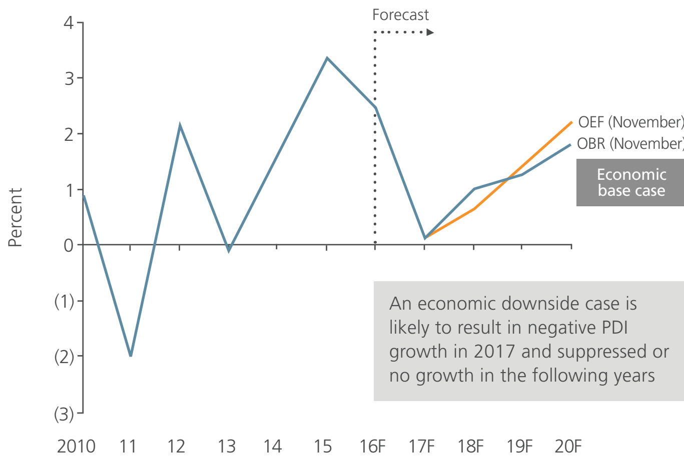
Figure 1
Real personal disposable income growth (2010 – 20F)



Source: OEF; OBR

— from rising oil prices and wage inflation in the '80s to the dot-com crash of the early millennium and, more recently, the financial crash of 2008. Each downturn had a global impact and saw disposable household incomes fall as a result.

Our analysis of ONS consumer spend by sector shows the relationship between the size of the downturn in a specific sector, in terms of its percentage decline from its pre-recession peak, and the length of the downturn in the sector, in quarters, to assess the resilience of different sectors.

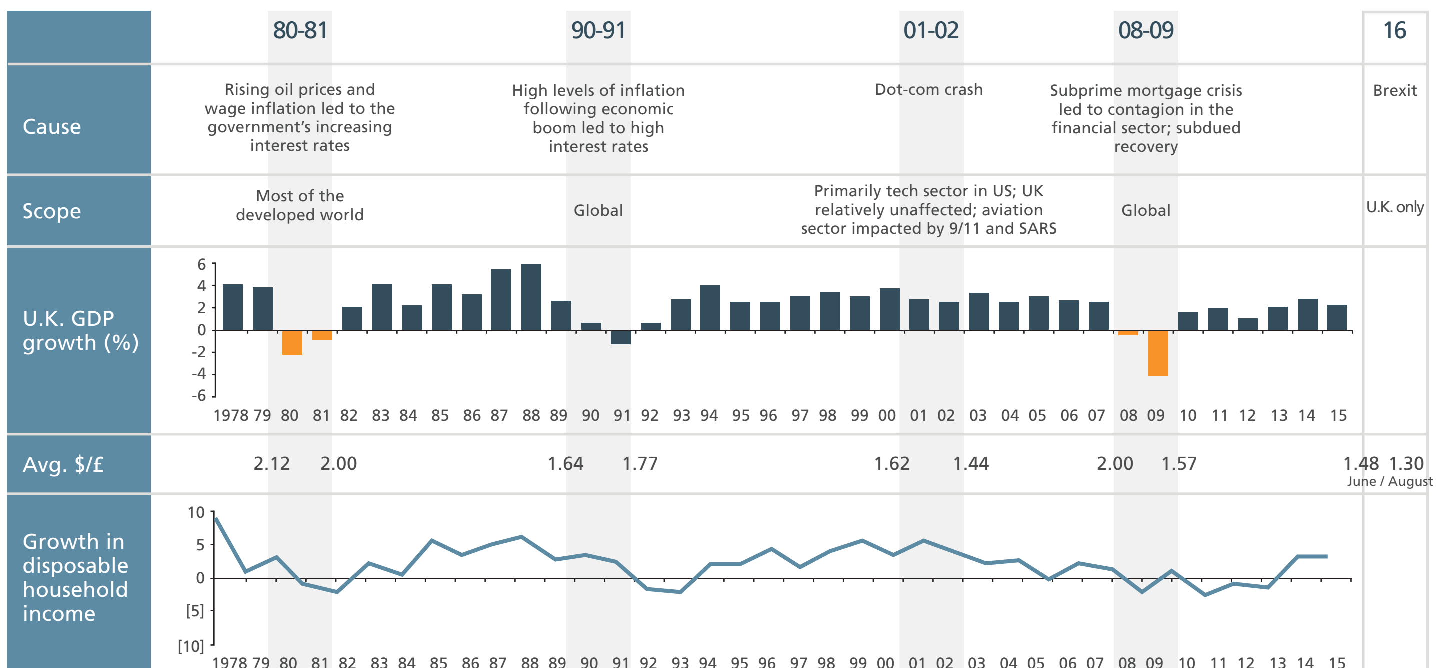
Figure 3 on page 3 shows how 28 separate retail and consumer sectors responded to the '90s and 2008 recessionary periods, divided into four quadrants:

- I. relatively small decline and rapid recovery
- II. larger decline but rapid recovery
- III. small decline but long recovery
- IV. large decline and slow recovery

The analysis shows that although many sectors fell into Category I (relatively small decline and a rapid recovery) in the 1990 recession, in 2008 few sectors were as resilient; indeed, many have still not recovered today, indicating that structural weaknesses are continuing across many sectors.

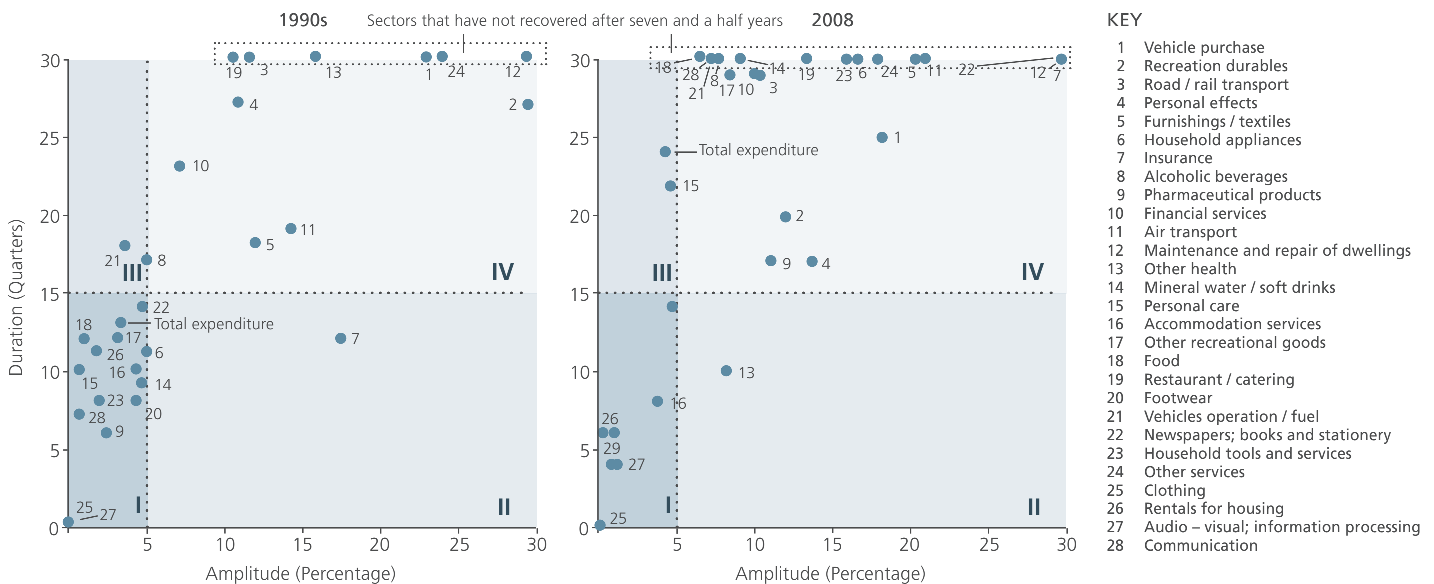
In addition, of those few sectors that did prove resilient in 2008, resilience was largely due to other structural growth factors — such as the trend for low-cost clothing imports and value fashion in the clothing and footwear sector, or the product release cycles in the world of technology — rather than true economic sustainability.

Figure 2
UK economic cycle (1980-2014)



Source: ONS; Bank of England; L.E.K. research and analysis

Figure 3
Recession amplitude and duration by sector (1990 vs. 2008)



Note: Amplitude has been calculated as the percentage difference between the peak point before the recession impact and the lowest point during the recession
Source: ONS; L.E.K. analysis

With no clear winners in 2008 and many still struggling to recover, this analysis suggests that business resilience is more important than ever this year. Any slowdown in GDP growth is therefore likely to have a widespread impact.

What should businesses do: eight key actions for companies and investors to build business resilience

1) Attack costs

Given the broad economic uncertainty, clear priorities should be cost reduction and restructuring to increase margins and reduce exposure to, and the impact of, a slowdown. In this instance, further improvements in the supply chain should be examined to see whether there are additional cost savings to be realized. This is particularly true for those companies with significant levels of imports. Companies should also look at opportunities to improve productivity, which has largely been stagnant across the U.K. for several years.

2) Keep your powder dry

Now is a time for conservation of resources until they are needed. That said, although the opportunities for obvious investments may be few and far between, it could be the time to acquire the IP or capabilities of small innovators with a weaker financial position that could in turn strengthen your own position.

3) Push out marginal participants

Similarly, now may also be the time to engage in strategies to grow market share to push out marginal or weaker competitors in your industry in order to improve your position both in the market generally and through consolidation of your position with existing clients.

4) Demonstrate value for consumers

While it's prudent to cut costs and shape up your business ahead of a possible downturn, you must be careful to maintain — and more importantly, demonstrate — value to your consumers. As they seek to maximize value for money, anything you can be seen to be doing to help them will be appreciated and could help build loyalty.

5) Look abroad

There can be hesitancy about overseas investment, since initial costs will be more expensive in pounds sterling. However, future earnings will have more monetary value, which is particularly important as a hedge if a company has a non-sterling supply chain.

6) Limit further operational leverage

The past few years have seen economies of scale used as a driver in sustaining low levels of inflation while growing corporate profits. However, a high, fixed cost base could backfire if volumes were to drop because of a slowdown, so it is important to look at ways of re-engineering your cost base so that it is more variable than fixed.

7) Limit further financial leverage, and build liquidity reserve
Businesses also need to look at their debt structure to ensure they can withstand the strains of slowing demand. With interest rates at an all-time low, some companies have taken on debt, with methods such as stock buybacks proving particularly popular recently. In tougher times, however, covenants can quickly come under pressure and risk a breach if they are stretched too far.

Businesses also need to anticipate changes in the "cash-to-cash" cycle, as clients could delay payments, threatening liquidity.

8) Sector choice will matter
For inward investors, assets priced in sterling may look attractive, but sector choice will matter. Over the past three downturns, some sectors have proven to be more resilient than others, and the right investment choice will limit risk.

Summary

The combination of slowing GDP growth, rising inflation and pressure on real PDI is a potentially toxic combination for the U.K. retail and consumer sector, particularly given the scars it bears from the previous downturn. Businesses cannot afford to wait and see, and they should look to build business resilience now, identifying and strengthening any vulnerabilities within their companies. The timetable for triggering Article 50 is agreed upon for the end of March. Ensuring cost bases and business models are resilient enough to survive and thrive, whatever the true economic outcome of Brexit might be, is the most prudent investment many retail and consumer businesses will make this year.

About the Authors

Jonathan Simmons is a partner in L.E.K. Consulting's London office. He has almost 30 years of strategy consulting experience and leads L.E.K.'s European Retail and Consumer Products Practice. Jonathan has provided strategic advice to a broad range of U.K. and European-based companies, and companies from other regions seeking European market entry, with a particular focus on specialty retail, apparel and accessories, sports retail and brands, airport retail, automotive services and grocery retail.

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