UK Commercial - 2019

SPOTLIGHT

Savills Research

The impact of CVAs on the UK retail market

The evolution of the CVA • UK impact • What's next?

CVAs give a business the chance to repay its own liabilities and ultimately continue trading

The real impact of CVAs on the UK retail market

The CVA is an insolvency procedure that allows businesses the chance to renegotiate debts with creditors, repay its own liabilities and ultimately continue trading. However, how has the process evolved, has it retained its integrity and is there a disparity between perception and the real impact of CVAs on the UK's retail market?

The evolution of the CVA

The company voluntary arrangement (CVA) has certainly been one of the biggest stories in retail in the last 18 months, with many high street brands and large multiple retailer chains using the process to consolidate, restructure and reduce costs. But where did the CVA come from? What was its original intention and most importantly is it still fit for purpose? This article looks at a brief history of the process and its recent impact on the UK's retail landscape.

Introduced in 1986 by the UK government it was seen as a possible alternative insolvency procedure that gives businesses in serious financial difficulty the chance to renegotiate debts with their creditors and allow recompense over a structured period of time.

For a CVA to be accepted as a viable course of action a vote is conducted in which three-quarters of the creditors, by value, need to give support for the proposal to be ratified. These can include other traders, employees, the HMRC and landlords. Once the proposal has been approved then all unsecured creditors are legally bound by the arrangement and the company can carry on trading as normal with the directors remaining in control.

The CVA is monitored by a licensed insolvency practitioner (IP) to which typically one agreed affordable monthly payment is made. Acting as a supervisor the IP then distributes the money on a pro-rata basis to the creditors involved. The arrangement usually lasts for between three, and to a maximum of five years and can include repayment in full, although typically involves a percentage of the overall debt.

Prior to the introduction of the CVA the only alternative that could possibly save a business that was insolvent, maintaining its legal entity, was to put it straight into administration and hope for some sort of credible investment. Failing that, as is still the case today, a company could be liquidated, the process of bringing a business to an end and distributing its assets to claimants based on the priority of their claims. This is either a voluntary or compulsory arrangement and is the culmination of many months of financial distress when the possibility of a successful turnaround has been extinguished.

The introduction of the CVA was to therefore add another layer to the insolvency process and give a business the chance to repay its own liabilities and ultimately continue trading. The intention arguably was underpinned by a spirit of fairness, allowing a company the chance to navigate its own path to survival, which included approaching their existing shareholder base in order to raise money and fund a turnaround plan. In doing so the idea was to maximise returns for stakeholders, giving creditors the opportunity to recover as much as what was owed to them as possible, more than what they may get via an administration or if the business failed completely.

Do CVAs reflect wider market issues?

However the recent widespread and liberal use of the CVA process has arguably meant their original benevolence is increasingly being lost. The suggestion is the CVA has begun to be used by businesses who are not strictly in immediate financial peril but have recognised its ability to cut costs and rationalise their portfolios overnight, a practice that appears unjust in its disproportionate effect on landlords.

The reasons we see and hear in the press for the rise in the number of failing or stuttering businesses are well-trodden; declining footfall, a shift from tangible to experiential retail, spiralling business rates, the increase in the living wage and most commonly the ongoing penetration of ecommerce. It is argued that CVAs are therefore nothing more than a symptom of the wide-ranging and tumultuous issues that are killing the 'UK retail market'. A quick Google search on this term yields result after result characterised by terms such as 'retail apocalypse', 'death of the high street' and 'the retail park slump'. Yet are the media overegging this? No one is denying these issues don't bring their challenges but unlike the events of 2008/09 when we last saw a flurry of CVAs, administrations and business failures it is less about a receding economy and more about the evolution of retail.

CVAs, administrations and liquidations
January 2018 to present

No rent reduction

39%

30%
switch to monthly rent
9% administration
currently trading

Rent reduction

37%

Between 15 – 100%
rent reduction

Closed

24%

5% CVAs
3% administrations
16% liquidations

Source Savills Research

In 2018, as much as 30% of non-store sales touched a store, be it through click and collect

This is because despite the failings we have seen many UK retailers have thrived in the last 18 months. *Savills UK Retail Warehousing Spotlight* released in March 2019 highlights this in its analysis of out of town retail and leisure store openings. Over the last seven years the sector has seen an average of 819 new openings per annum. The last few years have seen openings way above this average. In 2018 the total was 868, 53% up on the post-GFC doldrums, whilst 2017's level was at the highest in a decade at 977 units overall.

Furthermore many of the trends identified as an obstruction to traditional bricks and mortar retailing have in fact been identified as opportunity for growth by a number of the UK's most successful retail brands. The rise of ecommerce is one such example where we have seen forward-thinking operators adopt a clear and structured omni-channel approach in an evolving retail landscape. These retailers recognise the need for a well-placed store network to truly fulfil their online business going forward, as much as they do for their traditional off-the-shelf transactions. For them the store continues to play a key role in providing customers with a seamless and connected shopping experience.

This point is highlighted no better than what the retail market has coined 'the store halo effect'. In 2018, as much as 30% of non-store sales touched a store, be it through click and collect (13.3%) or being bought online having been browsed in store (16.8%). The fashion and home furnishings brand Next have certainly embraced this idea, recognising an opportunity to drive additional sales to their stores. In May this year they announced their partnership with online retailer Amazon in launching a service for customers to collect parcels from pick-up points inside hundreds of Next stores.

This is significant as in 2018, 39.2% of customers on average in the UK bought an additional item while collecting their last click and collect order. Next currently have a conversion rate of 22% with an average additional spend of £12. Their partnership with Amazon should see this improve. John Lewis fulfils half of its online orders through collection in stores. Of those customers that click and collect 44% make an additional purchase with an average added value of £18.

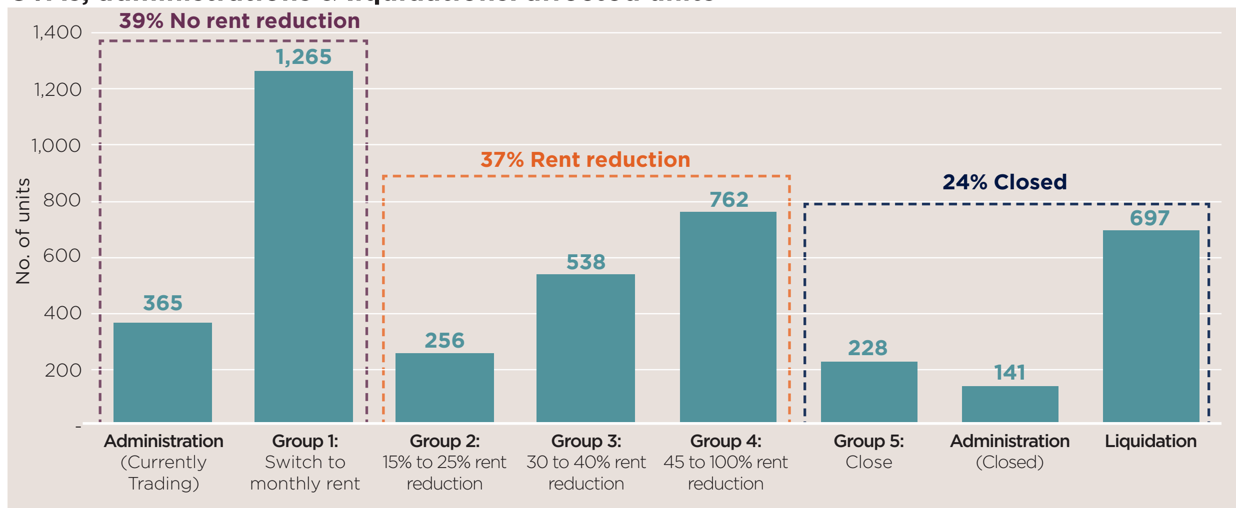
So what's the real story?

The success of some retailers and failure of others is therefore somewhat of a juxtaposition, contrary to the death of the store sensationalism. It is clear context is everything when we look into the impact of CVAs, failures and administrations in recent months. Continuing with our example in the out-of-town market last year only 3.3% of out-of-town retail units were affected by some kind of negative corporate news. By comparison just the loss of Comet, JJB and Focus alone in 2011 resulted in the same proportion of the market being affected. These three combined with earlier failures including MFI and Allied Carpets had a far more dramatic impact on vacancy rates in the sector, driving it up to 10% in 2012. Furthermore, while the post-GFC failures resulted in all the affected units being closed, only 36% of the units that were affected last year were earmarked for closure. This is less than 1.2% of the UK retail warehouse market as a whole.

These findings are echoed on our analysis of the CVAs, administrations and liquidations that have occurred since January 2018 when we look at UK retail collectively. 30% of stores that have been impacted have only switched to a monthly rent so far in the process, with a further 9% in administration but still currently trading. Conversely, only 24% of affected units have been earmarked for closure, while 37% have sought rent reductions in some capacity. This is a more positive story than what the media perhaps suggest, in that any CVA or administration is emblematic of the death of bricks and mortar retail. The numbers paint a different story with more than a third (39%) resulting in no loss of revenue to the landlord in terms of the rent they collect.

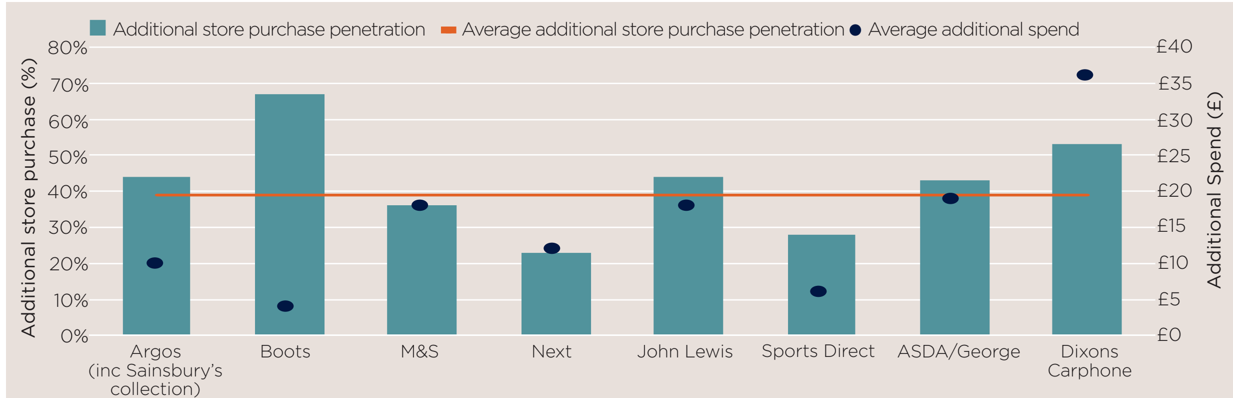
If the impact of the latest CVAs, failures and administrations has not been as bad as reported and if we are seeing some retailers thrive despite the assemblage of challenges facing the retail sector, then why are they being heralded as evidence of a retail catastrophe? Maybe the answer is the speed of their impact, compounded by their propensity to occur collectively, much to the consternation of landlords and the sector as a whole.

CVAs, administrations & liquidations: affected units



Source Savills Research

Proportion of additional sales and average spend through click and collect



Source Global Data, BBC

So what is the problem?

We have been here before. Experienced retail property investors should not be surprised that retailer's fortunes ebb and flow, and what we are seeing is just part of an ongoing cyclical process. Again if we look at the retail warehouse sector as an illustrative example, a high-level comparison of the top 25 out-of-town retailers in 2009 and 2019 makes this case very effectively. Back in 2009 Comet, Allied Carpets and Brantano collectively occupied 572 stores, and now none of these retailers exist. However, over the same period some retailers have dramatically increased their out-of-town footprint, with Lidl growing from 121 stores to 708 - making it the largest occupier by number of out-of-town stores from its position in 2009 as #22 in the ranking. None of Aldi, Iceland or Home Bargains were even in the top 25 back in 2009, and now all three are in the top 10 and occupy 1,095 stores between them.

The only difference we are seeing therefore is the speed at which this process takes place. Retailers that go through a CVA essentially exit contractual agreements overnight in their attempt to streamline their business and stop it from going to the wall. For them this helps reduce any unwanted costs, either via a reduction in their rental liabilities and/or by a rationalisation of their store portfolios (actions which in turn have the added benefit of reducing their business rates bills and making them more tax efficient). This sudden termination of a lease agreement however can put huge financial strain on a landlord which could in turn lead to their own insolvency issues.

So why do the CVA proposals get through a creditor vote that includes landlords? The answer is the system allows all creditors to vote on the process based on what they are owed by value. This means the three-quarters majority needed for the proposition to become binding is often reached, disproportionately effecting this single creditor group. Supervisors of CVAs assume that a landlord will be able to re-let a property, so the gross amount of any claim is reduced, typically by around 75%, meaning even if landlords vote against a CVA, other unsecured creditors such as suppliers and the tax authorities, whose claims are not usually compromised in the same way, usually outvote them.

What's next?

The CVA process arguably needs to be scrutinised by the government to re-establish the good intentions of the practice when it was first introduced. Fueled by the exigency of the retailers this was to save businesses and preserve jobs. Originally ordained as an additional legitimate safety net and cheaper alternative to administration it was therefore conceived as a useful measure for rescuing small businesses in particular. Its more recent widespread use by far larger retail multiples however has led to an uneven playing field on account of scale. Landlords very quickly feel the brunt of the consequential pain in that so many of their assets can lose income in such a short space of time, disproportionate to the other creditors involved in the process.

Without formal intervention the process will continue to pile more pain on landlords as well as reduce business rate income for local authorities and subsequently reduce public service spending. Moreover an industry where retailers are forced to so quickly exit a rental agreement may only deter private and public sector investment into town centres, high streets and retail warehousing going forward.

Other occupiers also argue the CVA process is penal as they have been more successful at managing their estates and business costs but are not receiving the same reduction in rents, or at least as quickly. Furthermore the process sees some retailers continue to trade, paying no rent until their landlords find a replacement tenant, meaning those paying full rent nearby are being disproportionately treated.

What the squall of CVAs have exposed is the antiquity of the current lease structure in the UK, making it apparent that many retailers require more flexibility and perhaps a more innovative approach to valuing a store which benefits both themselves and their landlord. For some operators this approach simply hasn't come soon enough and they find themselves having to turn to the insolvency process before their business fails. We have already begun to see this evolution in retail with the move towards shorter lease lengths, however perhaps a performance-related rent, whether turnover based or linked to brand exposure in a given catchment, is also worthy of investigation. Without it we will see more retailers pass through the process as opposed to implementing longer-term, wider-ranging, sustainable and fairer ways to reduce their costs and become more profitable as part of an ongoing evolutionary process.

Since going to print the wider collapse of the Thomas Cook and Co-op Travel businesses have prompted the liquidation of their high street operation and closure of c.700 UK stores. The proportion of retail units that have closed since January 2018, affected by either a CVA, administration or liquidation, could therefore grow from 24% to 36% dependant on how many of those stores are acquired by other retail and leisure operators. The full impact of the collapse on the UK high street is therefore yet to be seen, however it appears to be more reflective of wider financial issues and their £1.1 billion funding requirement to adequately recapitalise the travel business as a whole, than one directly related to the cost of their store network and emblematic of a demise in the retail industry.

Sources: Savills Research, Property Week, Financial Times, Global Data, BBC

Savills Research
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