



BREXIT BRIEFINGS 2: RETAIL WINNERS AND LOSERS



- The UK has started to experience economic turbulence from the vote to leave the EU. In 2016 and into 2017, the biggest negative effects on consumers are expected to be lower share prices, higher shop prices and falling house prices. These are most likely to impact spending by older and more affluent consumers. Younger and less affluent shoppers will feel less impact, assuming retailers keep a lid on inflation.
- We expect these effects to accelerate current trends in UK retail: more consumers will turn to price-competitive Internet pure plays and more will shop at discount stores. Retailers that can combine a strong e-commerce proposition with low prices and target a younger customer will be best positioned to outperform.
- Retailers with more affluent or older customer bases are most likely to be negatively impacted by the postreferendum economic shake-up. The principal risk to retailers appears to be middle-class shoppers trading down, so premium mass-market names such as Ocado are likely among the most vulnerable.

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ANALYZING BREXIT'S NEAR-TERM IMPACT ON RETAIL

On June 23, the UK became the first country to vote to leave the EU, sparking immediate shock effects in the global and UK economies and a period of upheaval in British politics. We are publishing a *Brexit Briefings* series of reports that examine the effects of the UK's decision. This is the second in our series; the first considered the macroeconomic ramifications of the vote. In this report, we turn more specifically to British retail, and analyze:

- Which groups of UK consumers are set to be hit hardest by the post-vote upheaval.
- The resulting shifts and trends we expect to see in British retail.
- Which of the UK's top retailers are likely to prove resilient and which vulnerable to the shifts in the macroeconomic environment.
- Which UK retailers have substantial overseas income, and so are set to see a short-term boost from weakness in the pound.
- The biggest international retailers exposed to the UK market.

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Uncertainty abounds at the time of writing, and we expect it to continue for some time. Among the unknowns are how long it will take the UK to exit the EU, what the process and its outcome will look like, and even who will be the prime minister who formally notifies the EU of the plan to leave. Prime Minister David Cameron will step down by October 2016, so his successor will lead the exit.

We expect more affluent consumers to take a greater hit from the postreferendum financial turbulence.



Source: Newyorker

Once the UK has advised the EU of its intention to leave the union, the country will have up to two years to negotiate and complete the process. This adds a great deal of uncertainty to forward estimates regarding the economy, industries and companies.

THE NEAR-TERM CONSUMER OUTLOOK: WHICH GROUPS WILL BE HIT?

Given that the UK's departure from the EU is likely a couple of years away, and given the great uncertainty over the shape that exit will take, we think it is much more useful to look at who stands to gain and lose share in retail in the shorter term (i.e., in 2016 and into 2017) than in the longer term. To identify these companies, we first need to consider which groups of consumers are likely to be hit hardest by the post-vote upheaval.

We expect more affluent consumers to take a greater hit from the postreferendum financial turbulence. Less affluent consumers and younger consumers—those who do not hold mortgages or investments tied to the stock market—look to be more insulated. If prices rise in nondiscretionary categories, these consumers may be pinched, but we see limited scope for retailers to hike prices significantly in categories such as grocery and apparel.

Figure 1. Near-Term Outlook for Selected Consumer Finance Metrics

Metric	Outcome/Likely Outcome	Who Will Be Impacted?	Who Will Be More Insulated?
House Prices	Decline	Those in the family life stage; middle-aged and retired consumers; high-net-worth individuals (HNWIs)	Young consumers
Consumer Prices Inflation	Increase	All	None
Stock Prices	Decline	Middle-aged and retired consumers; affluent consumers, including HNWIs	Young consumers
Interest Rates	Decline	Retired consumers	Those in the family life stage and middle-aged consumers (i.e., mortgage holders)

Source: Fung Global Retail & Technology

Middle-aged and retired consumers are the most exposed to a number of key consumer finance metrics and, so, are most likely to become more cautious.

Middle-aged and retired consumers are the most exposed to a number of key consumer finance metrics and, so, most likely to become more cautious. HNWIs will take the greatest hit from stock market declines and any fall in house prices. The actual spending power of these groups may not be diminished, but declines in their net worth may affect their confidence, and therefore inhibit their spending. For mortgage holders, any hit to confidence may be partly offset by lower interest rates.

Our conclusions assume that the government makes no major postreferendum changes to the budget that would substantially affect consumer finances, such as increasing taxes. An income-tax hike was threatened as part of the campaign to convince UK voters to remain in the EU. However, since the vote, the UK's Chancellor of the Exchequer has become more cautious, saying he will await official forecasts and then announce any new measures in his scheduled autumn statement.

BREXIT VOTE SET TO ACCELERATE EXISTING TRENDS IN UK RETAIL

Even prior to the Brexit vote, UK retail was in a state of flux. Discount channels have been growing fast, especially in grocery; Internet pure plays have been making headway, notably in young fashion; and long-standing middle-ground retailers across food and nonfood have been retrenching as

customers have splintered away to more targeted retailers, including those in the discount and e-commerce channels. We expect the Brits' decision to leave the EU to accelerate these existing trends:

- Grocery discounters are likely to gain from heightened consumer caution, including among family-life-stage and older shoppers.
- Internet pure plays will continue to gain share, perhaps at an even faster rate, as digitally savvy younger consumers prove a resilient segment and as other age groups switch channels in pursuit of bargains.
- Young-fashion retailers that combine value with style are likely to continue to make headway.

As a result of these trends, middle-ground, midmarket retailers, especially those whose customer base has retrenched to a middle-aged core, will see the environment become even tougher.

In short, the tailwinds beneficial to some in the sector are:

- A structural shift to the online channel.
- Mass adoption of discount formats.
- The expected relative insulation of younger consumers.

Retailers that can capitalize on one or more of these trends will be best positioned to weather the effects of the vote in the short term. For instance, we see Internet pure plays such as boohoo.com, which cater to young consumers with budget fashion, as one standout segment.

Below, we represent what we think is the ideal trilogy of elements for a retailer to prove resilient.

We see Internet pure plays such as boohoo.com, which cater to young consumers with budget fashion, as one standout segment.

Figure 2. The Ideal Trilogy for Near-Term Retail Resilience



Source: Fung Global Retail & Technology

We see middle-class shoppers trading down as the biggest risk to retailers.

IN DETAIL: EXPECTED ROBUST AND VULNERABLE RETAILERS

Below, we list a number of the UK's biggest retailers, and consider whether they will remain strong in the wake of the referendum or have been left more vulnerable by it.

We see middle-class shoppers trading down as the biggest risk to retailers, which means that premium mass-market names with a more affluent customer base, such as Ocado, look somewhat vulnerable.

The categorization we use does not, however, necessarily mean that we think a resilient retailer will grow its sales or that a vulnerable retailer will turn in negative top-line growth. Asda, for instance, has reported falling comps for seven straight quarters, yet its low-price positioning and lower-income customer base suggest, in theory, that it is less likely than some other retailers to take a near-term hit from the Brexit fallout.

Figure 3. Postreferendum Verdict on Selected Retailers

	Retailer	Tailwinds	Headwinds
RESILIENT	Aldi	Discount positioning; structural shift to smaller-store formats	N/A
RESILIENT	Amazon	Price-competitive positioning; accelerated push in apparel; entry into grocery; structural channel shift	Big-ticket categories vulnerable
RESILIENT	ASOS	Young customer base; price-competitive positioning; structural channel shift	Slowing of apparel category
RESILIENT	boohoo.com	Young customer base; low-price/discount positioning; structural channel shift	Slowing of apparel category
RESILIENT	Lidl	Discount positioning; structural shift to smaller-store formats	N/A
NEUTRAL	Asda	Price-competitive positioning; lower-income customers	Exposed to family-life-stage customers; structural shift to smaller-store formats; discounter competition
NEUTRAL	Dixons Carphone	New tech; price competitive	Big-ticket categories vulnerable
NEUTRAL	Primark	Exposed to younger customers; discount positioning	Exposed to family-life-stage customers; low-end image may limit trading down; absence of e-commerce; slowing of apparel category
NEUTRAL	Tesco	Leading positions in smaller-store formats and e-commerce; increasingly price competitive	Exposed to all shopper demographics; discounter competition/structural fragmentation away from middle ground
VULNERABLE	John Lewis	N/A	Older, more affluent customer base; big-ticket categories vulnerable
VULNERABLE	Kingfisher	N/A	Big-ticket categories vulnerable
VULNERABLE	Marks & Spencer (M&S)	Food segment: structural shift to smaller-store formats	Nonfood segment: older customer base; structural fragmentation away from middle ground; slowing of apparel category

VULNERABLE	Next	Exposed to younger customers	Food segment: premium positioning Exposed to family-life-stage customers; structural fragmentation away from middle ground; slowing of apparel category
VULNERABLE	Ocado	Structural channel shift	Premium positioning; more affluent customer base
VULNERABLE	Sainsbury's	N/A	More affluent, older customer base; discounter competition/structural fragmentation away from middle ground

Source: Fung Global Retail & Technology

Grocery

Any renewed consumer caution threatens the UK's biggest grocers with a new round of trading down.

Any renewed consumer caution threatens the UK's biggest grocers with a new round of trading down to discount retailers or brands. We have seen recent signs that a move to lower prices was helping retailers such as Tesco ease their attrition of share. On paper, Asda looks more resilient than several of its peers; its lower-income shopper base will be less affected by any downturn in the stock market or decline in house prices, and its low-price positioning is long established. However, Asda has been suffering badly at the hands of Aldi and Lidl, and that is likely to persist. Ocado, meanwhile, is exposed to more affluent customers and looks vulnerable to trading down.

Across the sector, a weak pound will push up the cost of imported food, but we see limited scope for the listed grocers to pass cost increases on to customers, given competitive pressure from Aldi and Lidl. As a result, Tesco, Sainsbury's and Asda may see not only further sales declines, but also a sliding back of margins.

Apparel

The young-fashion, value-for-money Internet pure plays ASOS and boohoo.com have been highly resilient.

The UK apparel market has proven unusually weak in recent months, as we noted in our report *UK Apparel Malaise Signals a Shift in Consumer Spending Priorities*. Nevertheless, the young-fashion, value-for-money Internet pure plays ASOS and boohoo.com have been highly resilient. For instance, boohoo.com beat consensus estimates by reporting 41% revenue growth in its most recent results. The midmarket, by contrast, has proven weak, and its dependence on family-life-stage and older shoppers suggests the environment could get tougher.

M&S has been the highest-profile underperformer, and any renewal of caution among its older customer base in fashion will make life even more difficult for the retailer. Further indicating the difficulties of the midmarket, Next, which was formerly solid, posted a 0.9% slide in sales in its most recent quarter and warned of a cyclical downturn in demand. We expect the Brexit fallout to exacerbate these trends—and Amazon's ongoing push into apparel will only heap more pressure on the legacy players.

In this environment, major apparel retailers are likely to find it difficult to pass on to shoppers the full costs resulting from a lower pound, suggesting that margins are likely to take a hit.

Big-Ticket Categories

Purchases of do-it-yourself goods and large household appliances are closely tied to the housing market, so any decline in house prices will soften demand for these categories, hitting retailers such as Kingfisher. Dixons Carphone will, however, benefit from its diversified presence in consumer technology categories, and will probably receive a boost from the launch of the iPhone 7, which is expected in September.

Luxury

Not included in the table above are retailers at the higher end of the market, such as monobrand luxury boutiques and top-end department stores. These retailers face potential weakness from HNWIs taking a more cautious approach. A boost to UK tourism as a result of the pound's weakness could help balance this out, as high-end retail relies on strong tourist flows.

EU EXPOSURE PROMISES BENEFICIAL CURRENCY EFFECTS

In the short term at least, currency fluctuations will flatter the results of those retailers that report in pounds but sell abroad. The table below shows major retailers' split of revenues by origin for the most recent full fiscal year. We show the top 15 UK-domiciled retailers, as well as the major Internet pure plays that we mentioned earlier (ASOS, Ocado and boohoo.com).

Those retailers that capture more than 20% of their revenues from outside the UK, and so stand to gain the most from currency effects in the near term, are (in descending order) ASOS, Kingfisher, Primark, boohoo.com, Dixons Carphone, Tesco and Sports Direct.

It is notable that ASOS and boohoo.com are among the leading retailers by this measure, as they are for our test of resilience, shown above. It is hard to escape the conclusion that these two pure plays will continue to be standout performers.

Figure 4. Top 15 UK Retailers and Major Internet Pure Plays: Distribution of FY16 Revenues, by Geography

Retailer	UK	Non-UK Europe	Rest of World	Notes
Tesco	77.2%	14.5%	8.3%	
Sainsbury's	100.0%	0.0%	0.0%	
Asda*	100.0%	0.0%	0.0%	
Morrisons	100.0%	0.0%	0.0%	
M&S	89.7%	3.4%	6.9%	Non-UK Europe/Rest of World split is est.
Kingfisher	47.0%	53.0%	0.0%	UK incl. Ireland
Dixons Carphone	68.0%	25.1%	6.9%	UK incl. Ireland; FY15 data
John Lewis Partnership	>99.0%	0.0%	<1.0%	Est. includes Waitrose
Cooperative Group	100.0%	0.0%	0.0%	
Alliance Boots (H&B Division)*	87.4%	10.0%	2.6%	FY14 data

Primark	52.0%	48.0%	0.0%	Est.
Next	90.5%	5.7%	3.8%	
Argos	100.0%	0.0%	0.0%	UK incl. Ireland
Sports Direct	79.5%	20.5%	0.0%	FY15 data
Iceland	100.0%	0.0%	0.0%	UK incl. Ireland
Major Internet Pure Plays				
ASOS**	42.3%	26.2%	31.4%	FY15 data
boohoo.com	66.6%	11.6%	21.8%	
Ocado	100.0%	0.0%	0.0%	

Non-UK retailers excluded. "Non-UK Europe" broadly matches the boundaries of the EU (it excludes Turkey and Russia, for instance), but may include some presence in non-EU countries such as Switzerland.

*We treat Asda and Alliance Boots as UK firms, although they are subsidiaries of US parent companies.

**Figures do not sum to 100 due to rounding.

Source: S&P Capital IQ/company reports/Fung Global Retail & Technology

There is a risk of a total EU collapse, driven by the failure of the single-currency project.

Despite bringing beneficial currency effects in the near term, exposure to the EU outside the UK is not wholly positive, for a number of reasons. First, the EU is likely to experience a short-term economic hit similar to what the UK will see. Second, there is the more severe and, apparently, increasing threat that other countries will attempt to splinter away from the EU in the wake of the UK's vote. Third, there is the risk of a total EU collapse, driven by the failure of the single-currency project. These threats mean UK retailers' exposure to mainland Europe may be much less positive than it first appears to be.

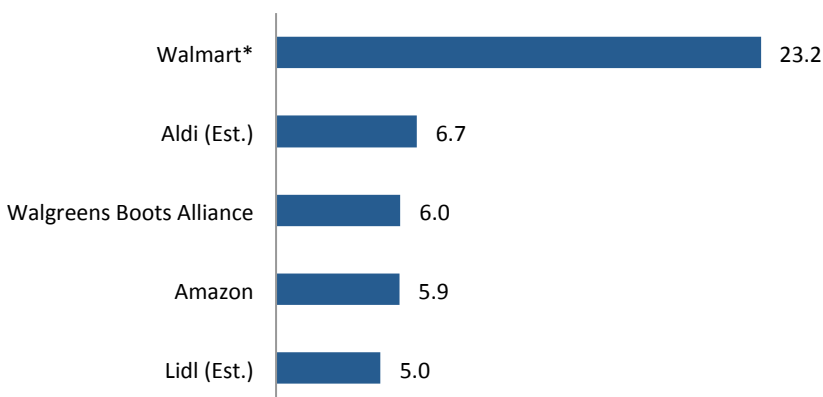
MAJOR INTERNATIONAL RETAILERS WITH UK EXPOSURE

Next, we look at the UK's contribution to revenues for those international retailers that are exposed to the UK. The five international retailers listed below are the biggest non-British retailers in the UK.



Source: Owensboroliving

Of these, Walmart is by far the biggest, through its Asda subsidiary. Of the top five, two are discounters (Aldi and Lidl) and two have strong price-competitive positions (Walmart's Asda and Amazon). For such retailers, exposure to the UK market may prove to be less of a risk and more of an opportunity to tap any consumer demand for value that arises from the uncertain outlook.

Figure 5. UK: Top International Retailers' UK Revenues, FY15 (GBP Bil.)


*FY14 data

Source: S&P Capital IQ/company reports/Fung Global Retail & Technology

How significant are these UK revenues relative to the retailers' total sales? Below, we show the geographic split of revenues for these five retailers. For most of them, the UK contributes less than 10% of their total revenues.

Walmart and Walgreens Boots Alliance are included in both the Figure 4 table above (via Asda and Alliance Boots) and in the table below, reflecting their UK subsidiaries. Aldi is the most exposed to the UK and, given that economic uncertainty could drive more shoppers to the discounters, this looks like a net positive.

Figure 6. Top International Retailers Present in the UK: Distribution of FY15 Revenues, by Geography

Retailer	UK	Non-UK Europe	US	Rest of World	Notes
Walmart	7.4%	0.0%	74.2%	18.5%	FY16 data; incl. Sam's Club
Aldi	11.7%	67.4%	14.5%	6.3%	Est. based on FY14 data
Walgreens Boots Alliance	8.9%	11.0%	78.3%	1.8%	
Amazon	8.4%	13.3%	65.9%	12.4%	Est.
Lidl	8.4%	91.6%	0.0%	0.0%	Est.

Totals may not sum to 100 due to rounding.

Source: S&P Capital IQ/company reports/Fung Global Retail & Technology

KEY TAKEAWAYS

We anticipate that, in 2016 and into 2017, a combination of stock market declines, house price declines and falling interest rates will most negatively impact older consumers and more affluent consumers who own property or who have investments tied to the stock market. Younger shoppers are likely to be more resilient.

We expect the combination of more insulated younger consumers and caution among older and more affluent consumers to accelerate major



We expect the combination of more insulated younger consumers and caution among older and more affluent consumers to accelerate major trends we have already seen in UK retail.

trends we have already seen in UK retail—namely, the growth of discount channels, especially in grocery; strong growth at Internet pure plays, notably in young fashion; and a struggle for middle-ground brick-and-mortar retailers as customers splinter away to more targeted alternatives.

Retailers that can cater to young consumers with strong e-commerce and discount propositions therefore look best placed to make gains in the wake of the referendum. ASOS and boohoo.com are among the major names that tick these boxes.

In the short term, retailers that sell outside the UK will see their results flattered by currency effects. Once again, ASOS and boohoo.com stand to gain due to their substantial shares of revenues that are generated overseas. Brick-and-mortar names such as Kingfisher, Primark, Dixons Carphone, Tesco and Sports Direct should also see a currency boost.

The global retailers with the biggest shares of UK retail are Walmart (via Asda), Aldi, Walgreens Boots Alliance, Amazon and Lidl. Although exposure to an uncertain UK outlook may be considered a risk, discount retailers such as Aldi and Lidl and price-competitive pure plays such as Amazon look well positioned to build share among cautious shoppers.

The potential negative effects on the UK consumer and the retail sector should not be overstated.

The mixed economic picture means that the potential negative effects on the UK consumer and the retail sector should not be overstated. While the pound remains firmly down at the time of writing, the FTSE 100 Index is above its prereferendum level. And while economic growth may soften in the coming months, there is no consensus that the UK is set for a dramatic slowdown or recession. So, even if retail does feel an impact, it is far from clear how long its effects will last.



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