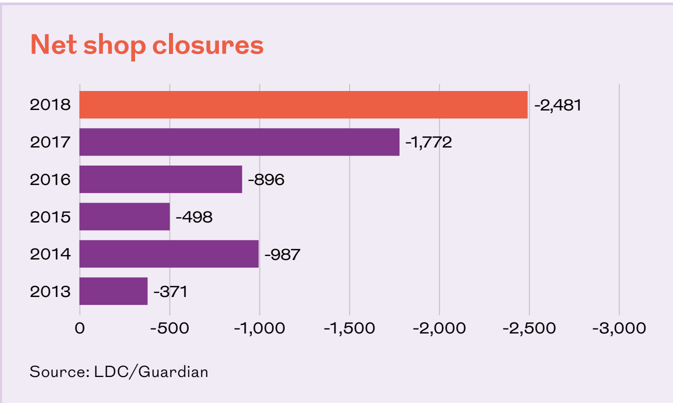
Retail therapy

By Martin Foden, Head of Credit Research

Everyone knows that traditional 'high street' retailers are struggling. Barely a week passes without another company going into receivership or announcing store closures: House of Fraser, Thomas Cook, New Look, Boots… even Poundworld couldn't buck the trend (see chart below).

And the headlines will keep rolling. Debenhams and Arcadia (whose brands include Burton, Dorothy Perkins, Miss Selfridge and Topshop) are trying to shore up their businesses. Even John Lewis, which appeared to defy gravity for years boosted by its ever-more heart-tugging Christmas ads, is retreating. It announced in March that staff would receive just a 3% bonus, the lowest since 1953, due to difficult trading conditions.

The causes are myriad. Retail is inherently economically sensitive, but there are also more prosaic challenges, such as high business rates and distorting tax rates. These are interwoven with powerful secular dynamics, including increased online penetration and changing consumer behaviour.



Closing down sale – net shop closures are accelerating as high streets struggle and retail habits change.

Every little helps?

At a more specific level, memories do not have to be particularly elephantine to recall Tesco's salutary journey. Stratospheric growth in store sizes, locations and product offering was heralded as a new paradigm in retail but, in truth, represented nothing more than the more temporary benefits of scale economies and macro tailwinds.

Throw in a dollop of management hubris and the more humdrum reality of excess capital invested and diminishing returns, and Tesco's subsequent collapse was a clear example of the sector's established trend for mean reversion. More recent signs of stabilisation, as newer management sweeps the decks and reverts to greater capital and balance sheet discipline, are further evidence of this sustaining truth.

All of which raises interesting questions for bond investors. How can we identify the retail survivors and, perhaps more relevant given the skewed risk of credit, how to protect our clients from the downside should retailers fail?

As creditors, recognising these challenges is probably the first step to mitigating them effectively, and this informs our research framework and portfolio construction. In short, where analytical foresight is limited and volatility is a given, we invest selectively and only within extremely diversified credit portfolios. And, perhaps most critically, when we do have conviction to lend our clients' money to a retailer, we typically do so on a secured basis. By contrast, a significant majority of retail bonds in an index are unsecured, meaning any performance deterioration is often amplified.

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Stores of value

For illustration, credit investors can get exposure to retail cash flows by buying specific asset backed bonds, for instance in the supermarket sector. Choose the right one and this can provide the additional safety valve of security over supermarket assets worth five times the value of the bond at yields not dissimilar to those on offer from unsecured, but potentially more visible, WM Morrison debt. Security and excess return? A 'buy-one-get-one-free' offer that really is too good to ignore.

Security is not a panacea, however, and lending in this way demands additional scrutiny and analysis, not least around the value and quality of the collateral provided and the legal protections (covenants) we have to maintain control and asset cover through our lending period.

Perhaps most pertinent when it comes to evaluating secured bonds is the correlation of asset values to the underlying performance of the retailer. Ultimately, if the value of charged property is inescapably linked to the health of the issuer's cash flows, then the benefit of this credit enhancement is clearly compromised and, potentially, entirely illusory.

Consequently, when we purchase secured retail bonds, or even less direct exposures, such as bonds secured on shopping centres, we also consider the intrinsic value of the collateral, either on an alternative use or vacant possession basis.

For instance, we lend against Westfield Stratford – an asset with obvious value as a destination for consumers and a physical showcase for retailers, even when their business models are under attack from online consumption. Further factor in our senior claim and low issuer leverage and this is clearly a fundamentally different risk proposition to buying debt secured on secondary and tertiary shopping centres.

Shopping around

As long-term investors, with multi-cycle experience and a keen understanding of skewed credit risk, we are primed to recognise the inescapable volatility of certain sectors. We are equally sensitive to the potential for this risk to be under-priced at certain points through the cycle, either due to an issuer being perceived as the next retail 'winner' or simply because of the market's predilection for name recognition.

While we may typically have lower sector exposure than bond indices, however, the existence of genuine and protective credit enhancements in certain retail and retail-related bonds and, crucially, clear inefficiencies in the market that allow us to buy these secured bonds at elevated spread levels, motivates us to find mispriced bond opportunities, even when the headlines may be less than compelling.

Contact us

For more information about our range of products and services, please contact us.

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Ref: AL RLAM PD 0023

59333 06 2019