

# Regular research papers and articles providing sector specific insights and issues analysis – Retail sector.

August edition 2011 – Retail

## Industry Intelligence Unit

Grant Thornton's Industry Intelligence Unit (IIU) blends the latest information and analysis of specific industries from publicly available sources (including the Australian Bureau of Statistics and the national press) with pragmatic, commercial and practical initiatives to improve stakeholder value.

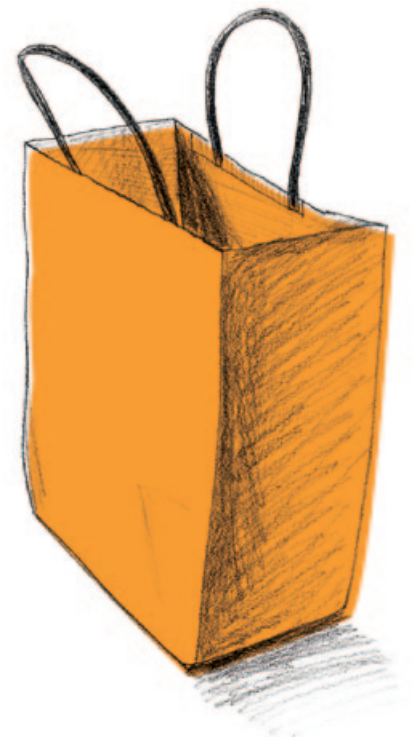
### Welcome to our latest edition of the Retail IIU.

After months of underwhelming growth and a poorer result for May (-0.6%) and June (-0.1%) than analysts predicted, most retailers would agree that the expected outlook for retail is tough for at least the next 12 months. The overriding issue facing retailers is a lack of consumer confidence, driving saving rates to the highest levels for 25 years. The Federal Government's Carbon Scheme announcements, which confirm that prices will have to rise, may only reinforce this sentiment.

This edition touches on some of the main pressures facing the retail sector, which have proven to be too much

for some household names, including the recent well publicised collapses of the REDGroup (Borders/Angus & Robertson), Colorado (including brands such as Mathers, Williams, Jag and Diana Ferrari) and the Perfume Empire. With warnings from the RBA about continuing consumer caution and the potential for further rate rises later in the year, the pressure on retailers is set to continue for an extended period of time.

Whilst this sounds like all doom and gloom for retailers, some sub-sectors, such as supermarkets (though pressure remains on the smaller independent supermarkets) and online retailers, will continue to outperform the rest of the retail market. Of course, there will be



some winners in the retail sector - the innovative and creative retailers, who outclass their opposition - and for every failure, there is an opportunity for another retailer. With retail trading figures forecast to remain flat for the foreseeable period, retailers need to be ahead of the competition to open the wallets of the frugal Australian consumer. We discuss further within this update what retailers need to focus on in the next 12 months.

Our latest edition of the Retail IIU provides a statistical update on retail performance across Australia and includes the following articles pertaining to current issues.

- **“Winners and losers – predictions for the next 12 months”**
- **“A warning for retailers”**

With PPSA reforms set to commence in October 2011, retailers and financiers need to be prepared for this significant change to protecting security interests.

- **“The great GST debate”**

Can the blame be placed on the threshold? We also provide an update on the debate, which has lost some of its original “puff” since Christmas.

- **“Secured lenders – Deeds of access/entry”**

Issues and solutions for lenders in determining their rights to access property of a borrower, whereby it is located on rental premises. David Sharpe (partner at Dibbs Barker) and Andrew Zadelis (Special Counsel at Dibbs Barker) provide their approach.



# Retail industry snapshot

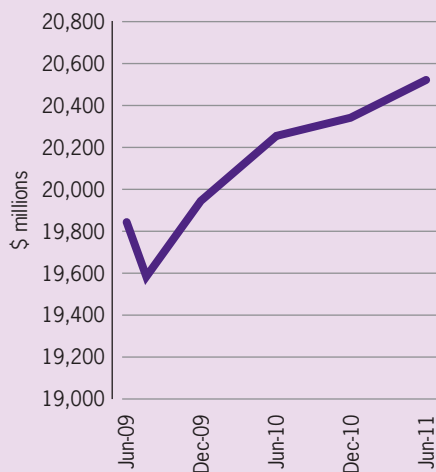
Retail business conditions have remained soft in June 2011, which follows months of marginal growth and more recently a decline in May's retail sales. March retail sales fell 0.5%, compared to growth of 0.3% in January and 0.8% in February. Following a more positive result in April (1.0% growth), sales fell unexpectedly in May by 0.6% (compared to analyst expectations of 0.3% growth) and this trend continued in June with retail sales falling by 0.1% (compared to analyst expectations of 0.4% growth)<sup>1</sup>. Whilst the headline fall was a mere 0.1% in June, which is not as bad as May's -0.6%, it is reflective of the lack of consumer confidence and continued challenges to a recovery in the sector.

Arguably, public confidence is lower now than during 2009 and 2010, with consumer uncertainty regarding interest rate rises, petrol increases and inflation, without the buffer of a Federal Government stimulus package. Consumer caution is reflected in high levels of savings, with savings having now increased to over 10% in Australia from around 2% in the 1990's. Whilst unemployment rates remain low, people are saving for a rainy day.

The data also supports David Jones' recent profit warning to the market that sales were substantially down. Department store sales were the worst affected category, falling 3.2%. This is a material variance compared to other fluctuations which have typically ranged between 1% and -1%. No other category reflected a sales drop of more than 1%.

**Retail turnover in Australia, Jun-09 to Jun-11**

Source: ABS Retail Trade 8501.0 August 2011

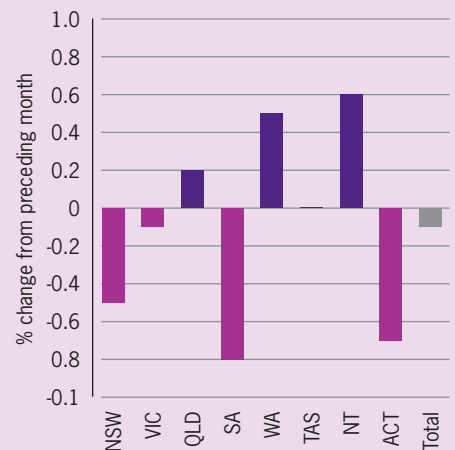


Significantly impacted by deflation, bulky goods sales fell by 1%, and electrical goods fell 0.5%.

Food (supermarket) retailing reported a rise of 0.4% and apparel, footwear and accessories were up 0.2%. 'Other retailing', which includes, newspaper agencies, pharmacies and recreational goods retailing rose 1.2%.

**Retail turnover; states and territories**

Source: ABS Retail Trade 8501.0 August 2011



## Around the States

By state, South Australia fared worst, down 0.8%, followed by ACT down 0.7%, NSW down 0.5% and Victoria down by 0.1%.

Over recent months WA has outperformed other states with sales growth of 0.5%. NT was up 0.6%, while Queensland was up 0.2% and Tasmania unchanged.

**Feedback from the retail market is that sales in July remained flat, with NSW dragging down the overall national picture.**

1. All references to percentage changes in trends refer to seasonally adjusted turnover.

# Winners and losers – predictions for the next 12 months

With Gayle Dickerson – Partner, Recovery & Reorganisation and Rob Hughes – Partner, Business Transformation.

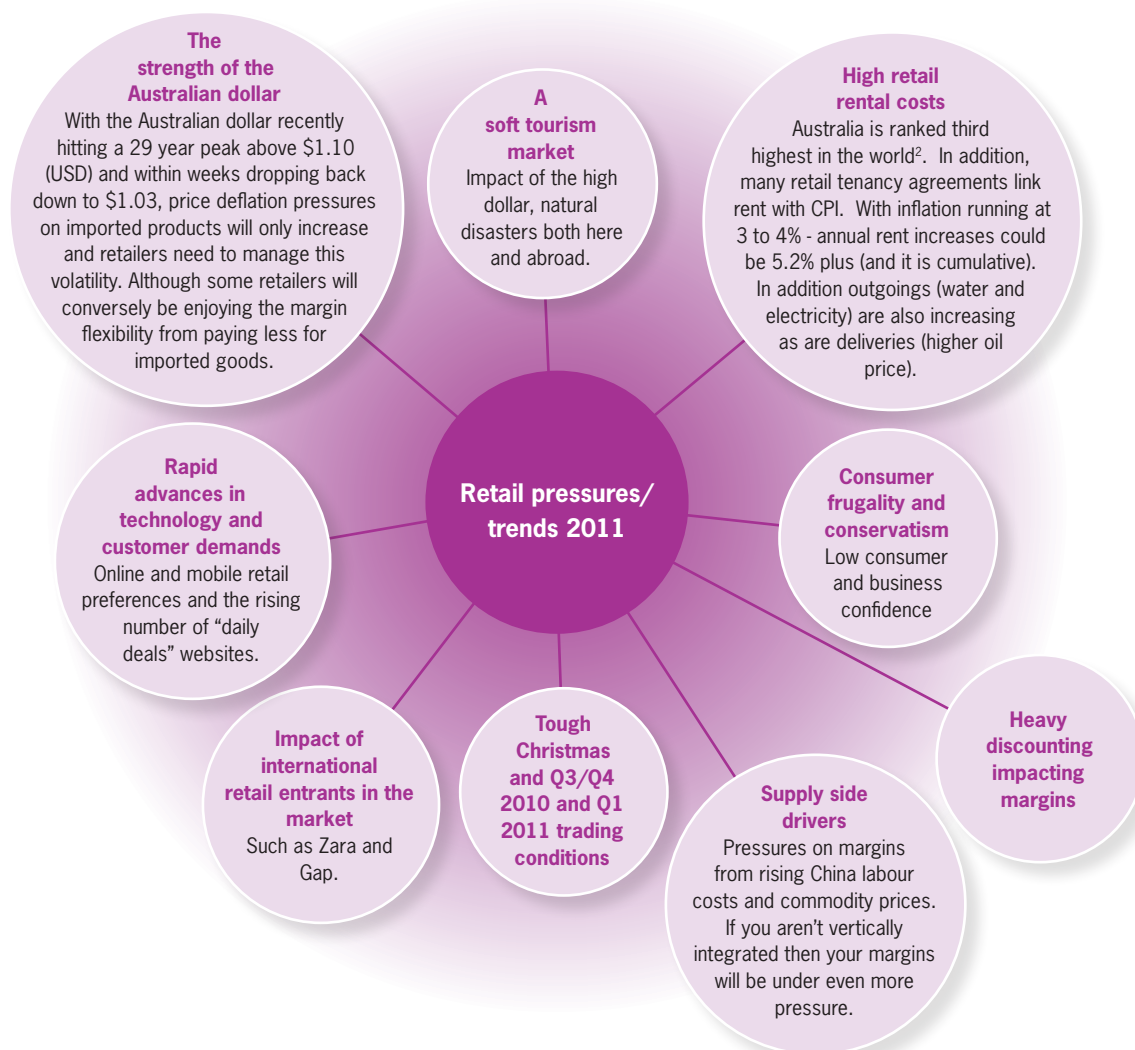
Predicting this year’s winners and losers would lose us many more friends than we would ever make, so we won’t be naming names here. Instead, we set out the issues facing Australian retailers and our predictions for trends in 2011/2012.

So where are we today? Oil prices are increasing, inflation and interest rates are rising and rental expenses and saving

rates are also heading north. Consumers remain cautious and it seems that we have “educated” customers that “you will never have to pay full price if you wait long enough”. This year, more than ever, there seem to be continual sales at stores and heavy discounting to attract customers – 70% discounts are now common. You only have to track

plasma TV prices to see that from mid 2010 the price of a standard plasma TV at a major retailer was \$1,800 compared to approximately \$1,200 now. That’s a price reduction of 33%!

These are only some of the pressures facing retailers and we provide below those key trends our retail clients are telling us are impacting their business:



### Margin headwinds

A rising Australian dollar should be a “winner” but it is being destroyed with deep and sustained discounting. Without other cost savings or improvements in margin, like for like store growth needs to be running at 3% per annum just to stand still. Whilst we can see that inflation has impacted certain categories (food, fuel, energy, cotton), the strength of the Australian dollar is driving deflation in others - so sales growth will need to be volume based as there is limited scope to improve margins.

Retailers will need to continue to drive down their costs in doing business as margins continue to be squeezed, particularly with reference to rising costs from manufacturing in China. Over the next 12 to 18 months we anticipate seeing continuing supply problems from China. However, retailers will likely be forced to try and absorb these cost increases.

### What can you do as a retailer or financier to the retail sector?

We anticipate that there will be continued pressure from retailers on lenders to provide further financial support during 2011. Lenders need to be aware of these key pressures when assessing their retail portfolio – what are your retail clients doing to address and mitigate the pressures impacting the sector?

Our view is that it's back to basics for retailers. The best defence is to focus on minimising and controlling costs and improving asset productivity. In particular, focus on what investment in technology is required to support your business model.

The in-store and on-line (including mobile) technology experience is going to play a vital part in a retailer's operating model. Retailers will need to invest capital in both distribution channels. There is a trend for a rapid increase in the number of smaller retailers developing fully transactional websites and mobile apps. In Australia smartphone sales are forecast to hit six million in 2011, and over 50% of Australians will have a smartphone. As an example, in the first week of Domino's new mobile ordering application being launched in Australia in June 2011, their mobile sales hit over \$1 million.

In addition, retailers also need to invest in technology to support their supply chain and to reduce inefficiencies in their business.

Lenders need to understand how e-tailing will impact their retail customer, and where capital is being spent. For example, the specialty retailer versus the department store – both will have a very different approach, and capital investment required, to support their e-tailing strategy.

### Conclusion

Lending to the retail industry is typically a “cash flow” lend as most retail stores hold little if any real property or fixed assets to provide as collateral in order to secure debt facilities. It is the “gap” between physical assets to offer as security and the funding needs of the business that must be managed. The challenge to the borrower is to comprehensively explain how this “gap” is filled to the lender's satisfaction through brand, product innovation and most importantly management skills and expertise.

For lenders, the key is to appreciate both the underlying fundamentals of the retailer as well as its strategies and growth aspirations. Our summary above has also highlighted some of the key current industry specific issues that lenders need to understand to fill this “gap”.

We suggest that lenders review their retail exposure across each segment of their portfolio, from the top end of town to the smaller participants. Unless your client is a major supermarket (as they continue to outperform the rest of the sector) your client will likely be impacted by the current economic conditions and changes in the sector.



# A warning to retailers – Are you PPSA ready?

With Gayle Dickerson – Partner, Recovery & Reorganisation

The far-reaching *Personal Property Securities Act* (PPSA) is due to come into force in October 2011 and businesses operating in the manufacturing and retail sectors will be particularly affected. It covers a wide range of transactions, not just security interests. It is not just limited to consumer transactions, and significantly alters aspects of commercial law and contracts law.

We touch briefly on the key concepts of the PPSA below, however recommend that all retailers and financiers seek professional advice as to how the changes will impact their business.

The PPSA reform follows a similar procedure that was implemented in New Zealand and Canada, whereby a single register will be created (replacing over 70 existing registers including ASIC and REVs), where all forms of security interest in respect of personal property must be registered.

This will impact all individuals and businesses that:

- Sell stock on credit (i.e. Retention of title)
- Lease plant and equipment, motor vehicles or other assets
- Have provided stock or other assets on consignment to third parties

Failure to register a security interest may mean that you lose your security interest through a subsequent transaction involving the personal property.

## For example:

You (Supplier A) sells shoes to a company – Trendy Shoes P/L (customer). Under the new legislation, in order to have a valid priority security interest (or PMSI) in the stock sold (i.e. a ROT claim under the old legislation system), Supplier A must:

- have an agreement with Trendy Shoes P/L which grants rights of Retention of Title until the goods are paid for
- ensure the agreement is in writing and is signed by a person with appropriate authority
- register its interest in the stock on the PPSR via a financing statement
- ensure that the written agreement is entered into and registration occurs prior to supply of the stock to Trendy Shoes P/L.

If these steps are not taken and a liquidator/administrator/receiver is appointed to Trendy Shoes P/L, you risk losing any claim to the stock or the proceeds from the sale of the stock.

Importantly, the “course of dealing” argument (where there is no written agreement but the parties have operated under implied terms of trade for an extended period) will not be sufficient to ensure a valid priority security interest against third parties under the PPSA.

Lenders and retailers need to understand what preparation should be undertaken, and also, the implications on the lender’s security arrangements. For example, if your customer is a rental equipment hire business, the PPSA legislation may have a significant impact on the Bank’s security.



# The great GST debate

With Gayle Dickerson – Partner, Recovery & Reorganisation and Rob Hughes – Partner, Business Transformation.

Reflecting back on our last Retail IIU, we predicted that with Christmas 2010 set to be an “online” Christmas, the GST debate regarding online purchasing offshore would “kick off”. However, whilst initially there was significant media attention, this issue seems to have been dropped by the major proponents such as Gerry Harvey, over recent months, which seems to be due to the backlash in consumer sentiment. In addition, VISA publically announced on 1 August 2011, that they have dismissed an inquiry from the Productivity Commission asking if it could collect on behalf of the federal government the GST flowing from online purchases made by Australian shoppers,

arguing it would be unworkable and lead to litigation and damage to its reputation.

## So why is it an issue?

Whilst the strong Australian dollar has been welcomed with open arms by those shopping online or planning their next overseas adventure, retailers have been struggling to compete with overseas competition. The collapse of the Borders and Angus and Robertson book stores, is a clear example of a casualty, which is at least in part, caused by cheap imports of books from overseas.

Under current legislation GST is collected on all taxable goods imported into Australia at the standard rate of 10%

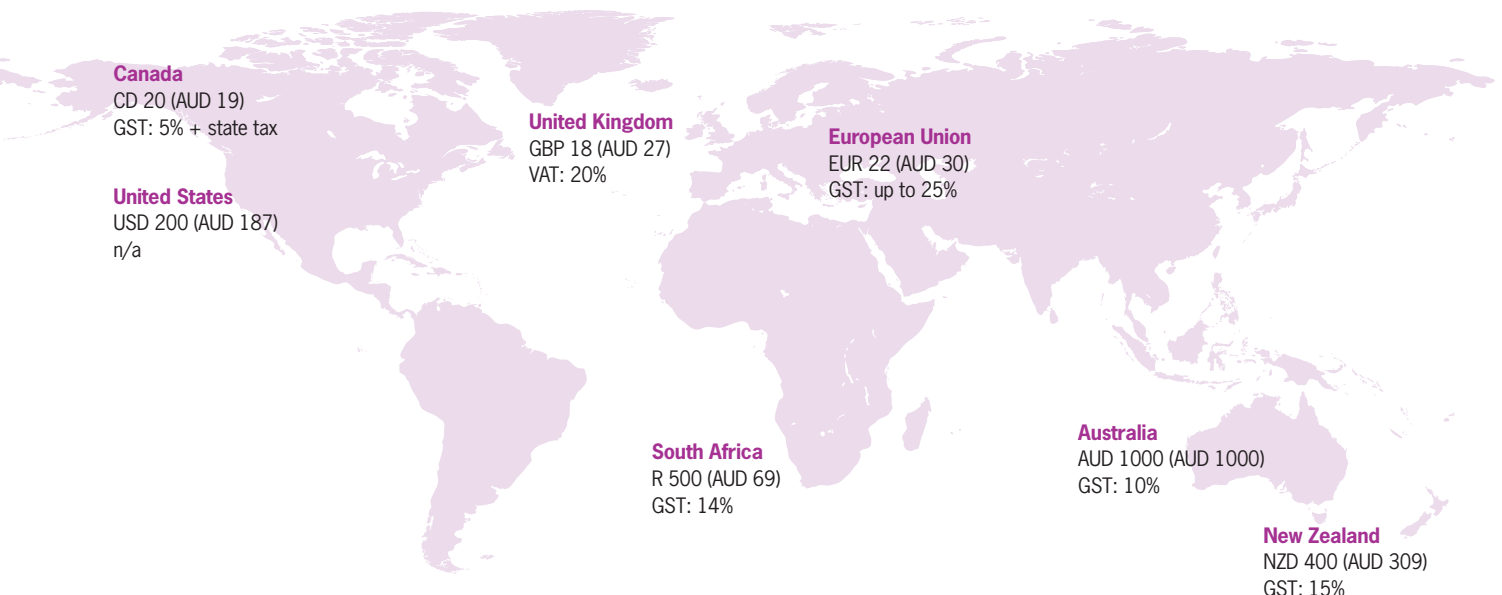
of the value of the imported product. However, this tax requirement is waived for goods considered ‘low-value’ if they have a customs value of less than AUD \$1,000, a threshold which is high when compared on a global basis.

Retailers supporting the Retail Coalition (over 2,000 stores including Myer and Harvey Norman) have requested that the Government reduce the threshold from \$1,000 to \$250.

The driving objective behind this legislation is to reduce the administrative and cost burden on the ATO, as it is simply not practical to check that GST has been collected on every package that arrives into Australia.

## Global importation tax thresholds

Source: FX rates as at 7 July 2011 (per oanda.com)



The Retail Coalition blame the high threshold, in part, for removing sales from their stores and placing them in the hands of overseas retailers giving them an unfair advantage. However, can all the blame really be placed on the threshold?

The GST exemption is only one of the attractions of shopping online where bargains can be found by purchasing from a retailer who trades in a weaker currency, has lower overhead costs and operates in a larger market fueling the need to price competitively. All these benefits, not just the importation threshold, combine to result in fewer sales for Australian retailers.

Considering the current strength of the Australian dollar, it is unlikely that the level of purchases from overseas retailers will fall any time soon. The high Australian dollar is having a far greater impact on overseas purchases than there being no GST on imports of less than \$1000 in value.

So just how successful will the Retail Coalition be? An inquiry by the Productivity Commission is currently underway although it is not likely to be concluded before the end of 2011. Prime Minister Julia Gillard has said that the Government will wait for the outcome of the Productivity Commission inquiry before formally responding to retailers. However, she has commented that she would be reluctant to see Australians who are facing cost-of-living pressures unable to take advantage of the savings received when shopping online. The Commission's draft report, released with limited media excitement on 4 August 2011, has unexpectedly recommended dropping the \$1,000 GST threshold, however acknowledges this is only a small problem facing the retail sector. It also acknowledges that as the threshold is lowered the costs of collection may exceed tax revenue and the current system is not efficient. We will have to wait until the end of the year and see what the final recommendations are.

The online phenomenon will continue to grow, fuelled by a strong Australian dollar and a permanent shift in consumer behaviour driven by rapid advances in mobile technology. Interestingly, Harvey Norman – who

indicated last year they had no immediate plans to launch a website, have now launched their own online retail store.

In the interim, Australian retailers may have no alternative but to look at setting their prices at a level which is aligned with that being offered internationally and at a price point where consumers are happy to buy locally and avoid having to wait for their purchases to arrive; which is the major downfall of online shopping.



# Secured lenders – Deed of Access/Entry

With increasing numbers of retailers facing financial distress and vacancy rates increasing to 5% in Sydney and 3% in Melbourne, the reality is that we anticipate that there will be more lenders seeking to enforce.

We have invited, David Sharpe and Andrew Zadelis of Dibbs Barker, to provide a brief overview to lenders of issues they need to be aware of when seeking to enforce, whereby the assets are located in a rented property, which is typical in a retail lend.

## Background

1. A tenant leases premises and obtains finance from a financier (lender) to fund the cost of its fixtures and fittings to be installed in the premises.
2. The lender takes security over the fixtures and fittings to secure the finance (fixed and floating charge).
3. The tenant defaults under its finance facility and the lender wishes to exercise its rights under its security in respect of the fixtures and fittings.
4. The fixtures and fittings are located in (and may sometimes be affixed to) the premises belonging to a third party (the landlord).

## Issue

The issues for the lender are determining what rights it may have in order to gain access to the premises where the fixtures and fittings are located; determining if the lender can remove those fixtures and fittings and, if so; what if any constraints

may be imposed on the lender by the landlord?

## Solution

1. The solution for the lender is to require the tenant (at the time it provides the finance and takes its security), to procure from the landlord a deed (commonly referred to as a “Landlord’s Waiver” or “Right of Entry Deed”) under which the landlord agrees to permit the lender, in the event of default by the tenant under its finance facility, to have access to the premises in order to regain possession of its security (the fixtures and fittings).
2. It is common for landlords to agree to some form of access arrangement (documented appropriately) however the terms of that arrangement can vary significantly. More sophisticated landlords generally endeavour to restrict the right of access and impose obligations on the lender if access is granted.
3. A “Landlord’s Waiver” or “Right of Entry Deed” would typically include terms such as:
  - (a) Any right of access must be subject to the landlord first being given reasonable notice
  - (b) Access is to be restricted to certain hours (such as usual business hours)
  - (c) A requirement that the landlord

be entitled to supervise the removal of the fixtures and fittings

- (d) The right to remove fixtures and fittings will be subject to the lender being required to make good and repair any damage caused by the removal; and
- (e) The landlord would require an indemnity from the lender to protect the landlord and its premises against damage or against a claim by the tenant or a third party challenging the lender’s right and title to the fixtures and fittings removed

## Summary

It is critical that a lender obtain a “Landlord’s Waiver” or “Right of Entry Deed” and that this is obtained prior to the lender advancing funds and taking its security. There is no obligation at law for a landlord to enter into such a deed and without it the lender’s rights to have access to the premises and remove its security are quite limited. The most advantageous time for the tenant to seek a deed from the landlord in these terms is prior to signing the lease at a time when the landlord is more amenable to facilitating such an arrangement.

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**By David Sharpe and Andrew Zadelis**  
Dibbs Barker

# Our National Retail Team

Grant Thornton is a national full service accounting and business advisory practice that specialises in working with retailers of all makes and types, big and small. We closely work with our retail clients, so we understand this complex and diverse market well. If you would like to discuss any aspect of the above, please do not hesitate to contact one of our industry experts detailed right.

**Gayle Dickerson**  
Recovery & Reorganisation  
T 02 8297 2706  
E [gayle.dickerson@au.gt.com](mailto:gayle.dickerson@au.gt.com)

**Andrew Hewitt**  
Recovery & Reorganisation  
T 03 8663 6003  
E [andrew.hewitt@au.gt.com](mailto:andrew.hewitt@au.gt.com)

**Rob Hughes**  
Business Transformation  
T 03 8663 6409  
E [rob.hughes@au.gt.com](mailto:rob.hughes@au.gt.com)

**Said Jahani**  
Recovery & Reorganisation  
T 02 8297 2677  
E [said.jahani@au.gt.com](mailto:said.jahani@au.gt.com)

**Mark O'Hare**  
Privately Held Business  
T 07 3222 0222  
E [mark.ohare@au.gt.com](mailto:mark.ohare@au.gt.com)

**Michael Pittendrigh**  
Privately Held Business  
T 03 8663 6264  
E [michael.pittendrigh@au.gt.com](mailto:michael.pittendrigh@au.gt.com)

**Adam Pitts**  
Audit & Assurance  
T 03 8663 6186  
E [adam.pitts@au.gt.com](mailto:adam.pitts@au.gt.com)

**Trevor Pogroske**  
Recovery & Reorganisation  
T 02 8297 2601  
E [trevor.pogroske@au.gt.com](mailto:trevor.pogroske@au.gt.com)



# Industry Intelligence Unit

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The IIU utilises the industry experience and expertise of Grant Thornton partners and staff across Australia. The IIU is predominantly focused on the following industries and their related sub industries:

- Property
- Retail
- Aged Care
- Automotive
- Hospitality
- Financial Services.

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If you want to know more, please **contact us...**

### Adelaide

Dale Ryan  
T 08 8372 6666  
F 08 8372 6677  
E info.sa@au.gt.com

### Brisbane

Graham Killer  
Michael McCann  
T 07 3222 0200  
F 07 3222 0444  
E info.qld@au.gt.com

### Melbourne

Matthew Byrnes  
Andrew Hewitt  
Greg Keith  
Nick Mellos  
T 03 8663 6000  
F 03 8663 6333  
E info.vic@au.gt.com

### Perth

Matthew Donnelly  
T 08 9480 2000  
F 08 9322 7787  
E info.wa@au.gt.com

### Sydney

Paul Billingham  
Gayle Dickerson  
Said Jahani  
Trevor Pogroske  
T 02 8297 2400  
F 02 9299 4533  
E info.nsw@au.gt.com



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