UK Commercial – 2022

SPOTLIGHT
Savills Research

UK Grocery Report

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- Operational performance update
- Strong occupational growth
- Investment volumes robust

Grocery sales reached £31.7 billion in the 12 weeks ot 26 December 2021, up 8.0% compared to the same period pre-pandemic, in 2019.

Ongoing headwinds dampen consumer confidence

Supermarkets reported strong Christmas trading results, however, consumer confidence is falling dramatically in Q1 2022 as headwinds persist and rising consumer costs pressures continue to encourage more cautious spending.

The UK consumer environment improved considerably through 2021 compared to the year before, with most restrictions easing since the height of the summer.

However, confidence began to wane, firstly in line with concerns over the Omicron variant of Covid-19. More recently it has taken a more severe down turn due to the rising cost of living, supply chain disruption and the potential impact of the conflict in Ukraine, all of which are set to continue pushing up the prices paid by consumers. GfK's consumer confidence index fell in the final quarter of 2021, reaching -15 in December. It has since fallen further still to -26, the lowest it has been since January of last year when the UK was still in a national lockdown (figure 1).

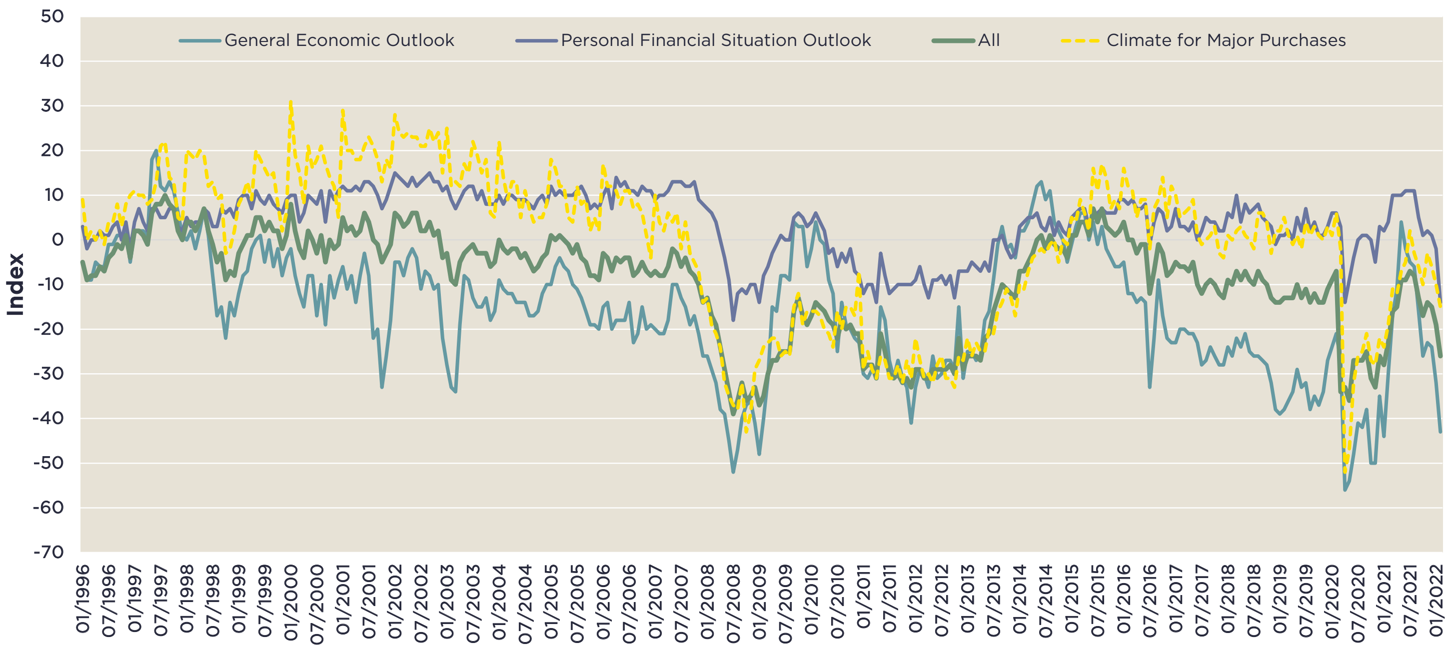
For the case of the grocery market, consumer spend did report strong monthly growth compared to 2019 equivalent levels in the 12 weeks to 26 December, reaching £31.7 billion, up 8.0% compared to the equivalent period in 2019. Despite a marginal fall compared to the heightened 2020 levels (whilst under tighter lockdown restrictions), every major supermarket chain reported increased sales during the 2021 Christmas period compared to the same period in 2019, according to Kantar data.

Following a strong end to 2021, take-home grocery figures show that supermarket sales did indeed fall by 3.7% over the 12 weeks to 20 February 2022. This fall in spending comes despite a new high in grocery prices, with inflation up at 4.3% in February. Households therefore spent on average £26 less at supermarkets in February and own-label sales did better than brands for the first time in three months according to Kantar.

Furthermore, recent figures from Ipsos suggest eight in ten people are changing their food shopping habits in response to the spiralling cost of living. Their research shows that 39% of households are struggling to cover the cost of groceries, with 37% of consumers opting for cheaper brands, while 34% have stopped buying non-essential groceries and 32% are buying "yellow sticker" reduced-price items to save money. Other measures being taken include waiting to buy items until they are on promotion; shopping around for better deals; buying in bulk, and cutting spending in other areas to afford groceries. In addition, 18% of consumers are switching their regular grocer, with almost one in four saying they will start shopping at Aldi. One in five said they will switch to Lidl and one in ten said they will now shop at Asda.

Further consumer price growth will undoubtedly generate more cautious spending amongst shoppers which in turn, is likely to support continued demand for grocers within the budget end of the scale. Aldi and Lidl put in strong performances this period and were the fastest growing retailers, both increasing their sales by 3.3%. Aldi attracted an additional 1.3 million customers compared with 2021, while Lidl brought in an extra million. This, coupled with their continued aggressive portfolio growth over the coming year, could support a boost in sales and potentially a further shift in grocery market share in 2022.

Figure 1: GfK consumer confidence index has fallen to as low as -26 in February, the lowest it has been since January of last year when the UK was still in a national lockdown



Source Savills Research, GfK

> **"Despite being up against such tough 2020 comparatives, the UK food and grocery market still rose by 0.3% in 2021, achieving £167bn in overall food and grocery spend for the year"**

Occupational growth remains strong despite rising inflation and falling volumes

The grocery sector is undoubtedly at a crunch point between supply issues and rising prices however, this will continue to drive the strong discounter portfolio growth that has been prevalent in recent years.

Significant uptick in food and grocery expenditure in direct response to the pandemic, saw the market grow by 8.4% in 2020, increasing total spend in the market by £13 bn in just one year. Encouragingly, despite being up against such tough 2020 comparatives, the UK food grocery market still rose by 0.3% in 2021, achieving £167 bn in overall food and grocery spend for the year.

The Christmas period was particularly positive with grocery sales totalling £11.7bn over the month of December alone and reaching £31.7 billion over the 12 weeks to 26 December 2021. Taking a look at the individual retailers, it is unsurprising that they each found it a challenge to secure year-on-year growth over the Christmas period following last year's highs; however, every major grocer did increase sales compared to the final 12 weeks of 2019 (figure 2).

The same is true in the period immediately post-Christmas. Kantar highlight that supermarket sales in the UK fell by 3.7% over the 12 weeks to 20th February 2022. These year-on-year figures once again reflect tough comparisons against the high demand of the lockdowns at the start of 2021 however, spending remains elevated versus pre-pandemic, 8.4% higher than it was at the same time in 2019.

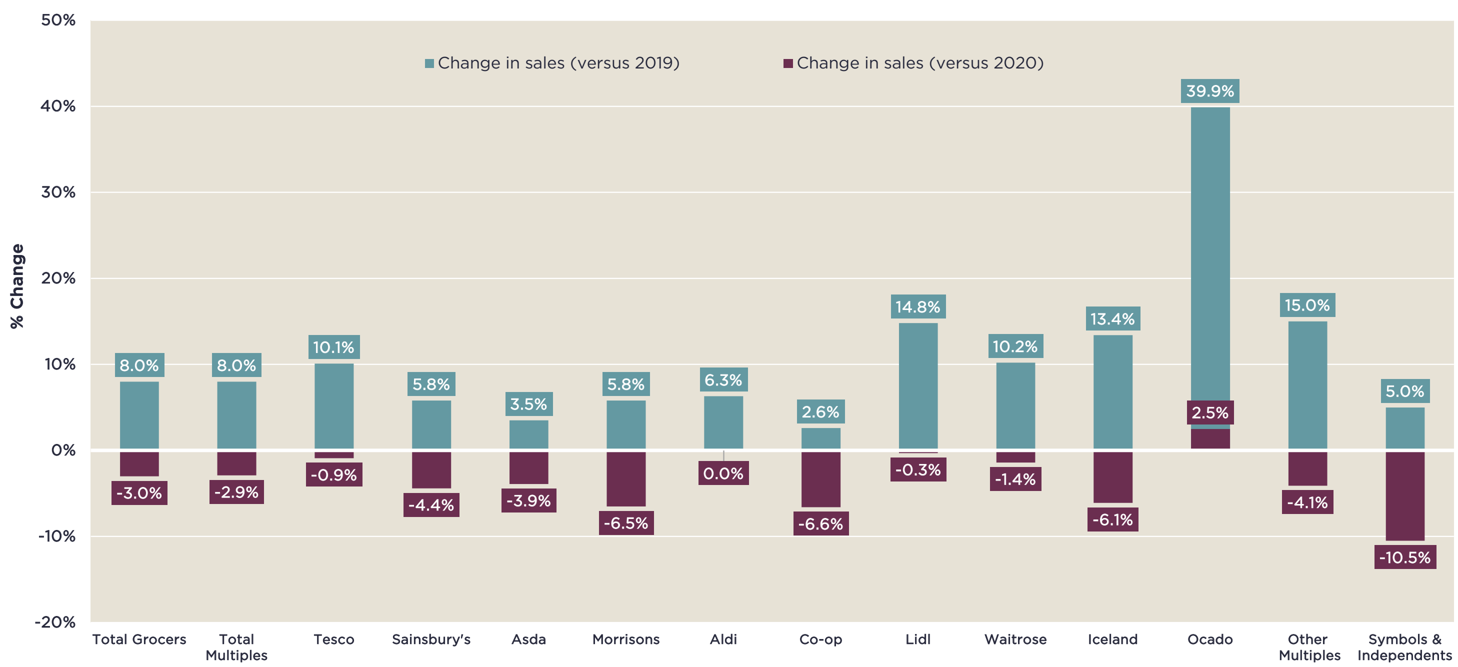
Nevertheless, it is important to remember that consumers are under increasing financial pressure as the costs of living continue to rise. The Office for National Statistics consumer prices index (CPI), which is the official mechanism used to measure inflation in the UK, highlights that average prices went up 5.5% in January, whilst the cost of food and non-alcoholic beverages had gone up 4.3% in the same time frame (figure 3).

As a result retailers are being forced to pass some of the pressure onto the customer. In fact, Kantar suggest on average the recent increase in inflation has added an additional £15 to shoppers' monthly grocery bill, as of the end of 2021. Meanwhile Which?, the 'not for profit' UK consumer group, found the eight biggest UK supermarkets were charging up to 9% more for their ranges in December 2021 than they were in January 2021, with the average basket going up 3.4% over this period.

With the Bank of England suggesting inflation will hit 7% by April 2022, its highest level since 1991, there could well be more rises to come, with households needing to prepare for future falls in disposable income, including from April's National Insurance and energy price cap rises. It is true that as this trend continues, food and groceries will demand a greater proportion of household budgets as spend in the sector is prioritised over non-essential retail sectors. However, as a result consumers are likely to trade down, limit spend on premium goods and treats, and will be more mindful of waste, all of which will continue to impact volumes.

Retailers face similar challenges, with increases in transport and energy costs, global commodity prices and domestic wages. Supply chain issues will therefore continue to plague the grocers throughout 2022, as labour shortages, rising energy and production prices, and Brexit border controls continue to disrupt product supply and availability.

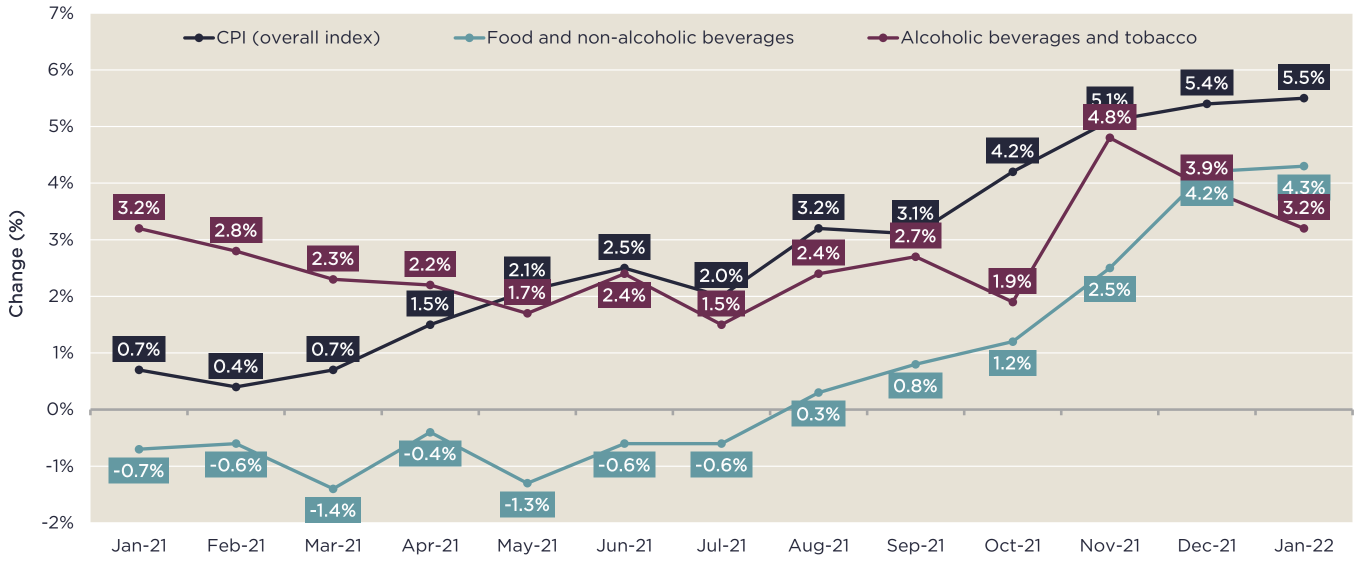
Figure 2: Total Till Roll - Consumer spend for 12 weeks to 26 Dec 2021



Source Kantar

Online penetration has almost doubled to 15.0% between 2019 and 2021, with online grocery sales reaching £25.1bn over the last twelve months (GlobalData)

Figure 3: Consumer Price Index (CPI) monthly year-on-year inflation since January 2021



Source Savills Research, ONS

Despite the explosion in online food and grocery sales at start of the pandemic, 2021 continued posting significant growth, boosted by the high demand seen in Q1 and the rise of Q-commerce in the drive toward consumer convenience.

The online food & grocery market rose 76.3% in 2020 to over £20bn in spend for the year, according to GlobalData. Grocers were forced to rapidly accelerate their online expansion plans in response to the pandemic, in order to meet with the surge in demand. Strategies included increasing the number of their delivery slots, improving their capacity for instore picking and click & collect as well as launching rapid delivery options.

Despite the high comparatives, online sales grew by a further fifth in 2021, boosted in particular by the high demand experienced in Q1 as the country remained firmly in a national lockdown. As a result, online penetration has almost doubled to 15.0% between 2019 and 2021, with online grocery sales reaching £25.1bn over the last twelve months (GlobalData).

Consumers have therefore evidently continued to use the online channel post-pandemic, with enhanced delivery availability continuing to support growth. Most recently, the continued drive toward convenience and the subsequent rise of Q-commerce is further driving consumer interest.

Q-commerce, which stands for 'quick commerce' – also known as on-demand or rapid delivery – is a new convenience-led market where shoppers buy basic groceries and everyday essentials on a smartphone app, which are then delivered to a consumers home or place of work in under an hour, or as quickly as in 10 minutes.

Investment in this sector has exploded in recent years despite tight margins and challenging economics. There are currently around 13 food and grocery delivery rivals currently battling it out in London alone, despite buy-outs of providers by some of the larger operators in the market. Getir bought UK rival Weezy at the end of 2021, whilst two other British firms, Fancy and Dija, were purchased by US giant GoPuff earlier in the year. Other big players include Germany's Flink, which has reportedly attracted interest from Amazon; Gorillas, which has done a deal to deliver Tesco food; and London-based Zapp.

As a result the major UK grocery operators have followed suit in order to remain competitive, launching their own services or partnering with existing food service delivery providers in order to avoid erosion in their market share. Ocado Zoom, Sainsbury's Chop Chop and Whoosh by Tesco all service their offers from their network of stores and have begun to increase the number of stores and indeed cities their services are available from. Tesco's trial partnership with Gorillas announced in October last year has allowed the last-mile delivery specialists to set up micro-fulfilment sites at five large Tesco stores, where they will pick, pack and deliver to customers in under an hour from a product range of around 2,000 goods (thus taking advantage of the grocers excess warehouse space in these locations). If rolled out nationally this would prove to be a major step forward for rapid delivery market. Meanwhile, Aldi, Waitrose, the Co-op and Tesco's One Stop convenience brand, have partnered with Deliveroo, whilst Asda and Iceland have paired with Uber Eats.

Clearly the major players in the UK grocery market have recognised Q-commerce as a means to further satisfy the consumers desire for convenience, which should help maintain the current level of online penetration going forward, even in a post lockdown environment where consumers are less reliant on online delivery to meet their essential grocery needs.

That said, Q-commerce will only be successful if enough consumers sufficiently embrace it, regularly putting enough in their basket to comfortably absorb the picking, packing and delivery costs associated with this fulfilment method. This of course is by no means guaranteed however, fortunately the grocery sector is certainly at the forefront of innovation with regard to investing in its online purchasing consumer fulfilment. Many retailers have rapidly invested in and improved upon their omni-channel grocery fulfilment options in response to increased pandemic driven consumer demand, many of which align with the strategies designed to mitigate recent and ongoing supply chain issues.

The grocery sector leads the way in last mile fulfilment and omni-channel retail provision.

Grocery is undoubtedly the sector where the 'last mile' fulfilment has gained the most traction over the last 18 months. The Covid-19 pandemic dramatically changed the online grocery landscape by turbo-charging demand throughout the UK and propelling online sales to 15% of the market. Operators responded impressively in increasing home delivery capacity from 1.8 million deliveries per week to 3.7 million deliveries per week, driving five years of growth in online grocery in the first five months of the pandemic.

Meeting consumer demand with the significant rise in online grocery sales however, was only actually achievable due to the network of stores already in place for those operators with an online purchasing and delivery platform. The extensive and widespread store networks of operators such as Tesco, Sainsbury's, Morrisons, Asda and Waitrose is what puts them close to their customers and enables them to get their products, particularly those that need to be temperature-controlled, on our doorsteps quickly and easily. According to Atrato Capital, Tesco increased their online weekly delivery slot capacity by 150% from 600,000 orders pre-Covid, to over 1.5m orders per week post Covid. Asda (89%), Sainsbury's (126%) and Waitrose (167%) also all more than doubled their respective capacity.

This increased online penetration has had the added bonus of transforming the profitability of omni-channel grocery fulfilment. Pre-Covid, online sales were considered to be costly and structurally less profitable than physical in-store sales however, the near doubling in online grocery penetration has materially improved delivery densities which has, in turn, nearly halved delivery costs from omni-channel stores.

Given the dominant driver of grocery home delivery fulfilment costs are wrapped up in delivery, more so than picking and packing, this new-found efficiency gain has transformed online profitability to the point whereby online sales are close to profit margin parity with physical in-store transactions, achieving a seamless integration for the operator between online and offline channels.

This new normal underpins the importance of having the right stores in the right location to be successful and empowers the operator to be truly blind to channel. Future grocery strategy can therefore be focussed purely customer focused, agnostic to where the sale takes place – in store, online with delivery or click and collect. This has huge advantages for the retail warehouse sector in particular as they are best placed in all three fulfilment options.

As a result, interest has therefore begun to return to out-of-town supermarkets with the largest floor-plates, as operators look to combine a traditional customer facing foodstore with a semi-automated picking centres. Located at the back of the brick-and-mortar store they typically require a footprint of approximately 10,000 to 15,000 sqft, allowing operators to enhance capacity and productivity. Furthermore, adding online fulfilment operations to a supermarket creates a much better in-store experience, for the customer it creates a virtuous circle with greater numbers of staff on the shop floor, increased product turnover, leading to a bigger and better range and fresher product on the shelves.

For the retailer converting a supermarket to also operate as a last mile fulfilment centre, requires minimal capital expenditure, largely because they can be supplied by its pre-existing centralised distribution centres. Tesco have recently alluded to 'owning the last mile' in this way, as a means to scale up deliveries without heavy capital expenditure. They have pointed out that in-store micro-fulfilment centres can be installed in just a few months at a much lower capital cost, as opposed to up to two years for a large automated warehouse.

Sainsbury's decision to close its 'dark store' in Bromley-by-Bow in London would suggest online fulfilment is better served from trading stores. By March this year, more than 20 stores in and around the capital are expected to expand their online packing capabilities, enabling Sainsbury's to deliver thousands more orders each week. Asda have also announced plans to shut two of its online warehouses, switching from its dark stores in Dartford, Kent, and Heston, west London, to picking grocery orders from the shelves of local stores. To make this move alongside such a huge uptick in online grocery sales, when their supply lines will have been severely tested, highlights just how much better store fulfilment works for these major grocery operators.

+180%
increase in online grocery demand (since the onset of Covid-19)

80%
of all UK online orders fulfilled via omni-channel stores

100%
online margins now at near parity with instore sales

30mins
average drivetime to customers - key to lowering fulfilment costs

Source Savills Research; Atrato Capital

New grocery store openings remain significantly above the decade average for 2021, dominated by the aggressive portfolio expansion of the discount operators

With food and groceries set to command a greater share of consumers monthly spend, many will be forced to be more considered in their purchases, as well as cut back on non-essential items. One beneficiary therefore may well be the value oriented operators that have seen significant portfolio growth in the grocery sector in recent years.

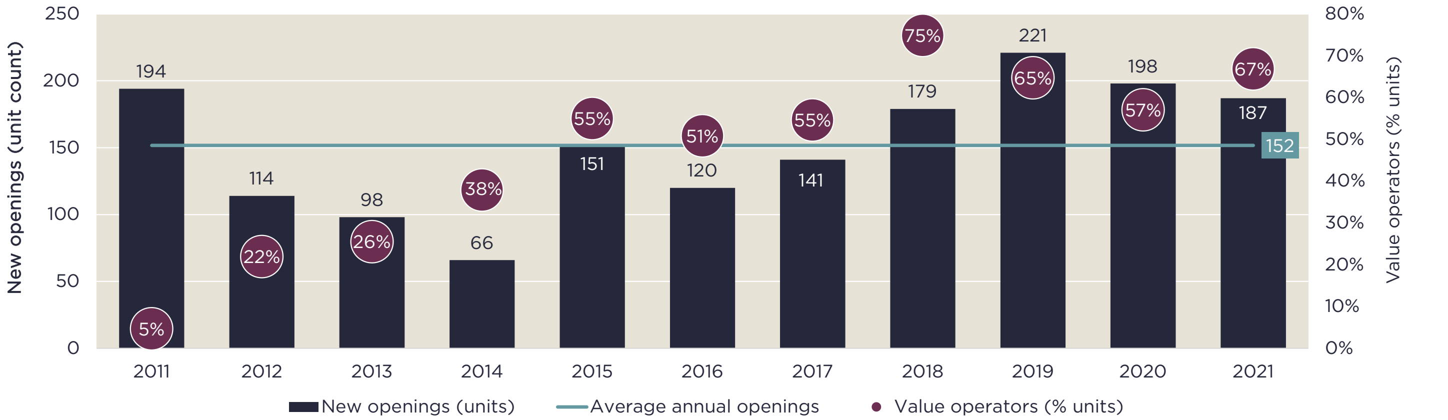
2021 once again saw the number of new store openings in the out-of-town grocery sector well exceed the decade average; there were 187 new stores last year, compared to an average of 152 new stores for each of the last 11 years (figure 4). Significantly, 67% of those units opened were done so by value orientated or discount brands (87% on a sq ft basis). A look at the most acquisitive grocery brands for 2021, draws attention to the continued aggressive strategy of portfolio expansion for each of the value grocers, even against a backdrop of rising inflation and waning consumer confidence.

Lidl and Aldi have remained the two most acquisitive brands across the whole of the retail warehouse sector in 2021 with 53 and 42 new stores respectively, a position they have occupied for each of the last 3 years. With both operators stating they are each looking for at least 50 stores each per annum for the next 3 years, the growth pattern of the discount grocers in particular looks set to continue.

The immediate post-GFC period showed the market that if consumers swing into belt-tightening mode, then it is the value end of the spectrum that typically benefits most. This suggests that in the current financial climate the strong growth in demand from the value retailers will very likely be sustained. Other mainstream grocers will need to invest in value for money and price to retain shopper loyalty and remain competitive against these discounters squeezing their profitability.

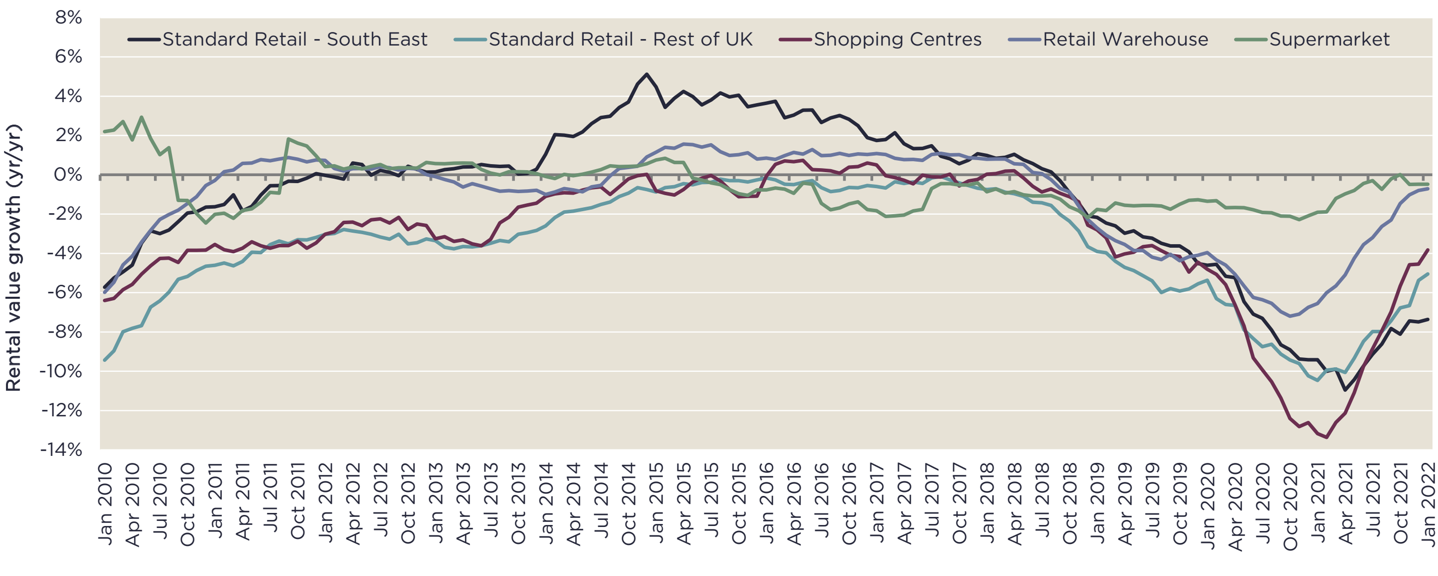
The buoyant acquisition activity we have witnessed in the out-of-town grocery sector in particular, has clearly been influenced by the decline in retail rents we have witnessed amidst the structural change in recent years. As we continue to see rents retail rents decline across the retail sector, the value-orientated brands have been particularly opportunistic, looking to expand their operations or renegotiate existing leases and seize the opportunity to acquire space at a more favourable rent. That said, Figure 5 highlights how the decline in rental value growth for supermarkets has been much less severe than for other areas of the retail market, particularly over the last twelve months. MSCI reported year-on-year rental value growth of -0.5% for supermarkets in January 2021. By contrast it stands at -5.1% for UK standard shops excluding London, -7.6% for UK standard shops in the South East and -3.8% for shopping centres, in the same month. The resilience the grocery sector has shown in regards to rental decline is undoubtedly linked to the amount of interest in acquiring stores in the market at present, coupled with the sectors ongoing positive performance and the strong relationship it has between physical stores and online sales penetration.

Figure 4: New openings per annum (including proportion of Value operators)



Source Savills Research

Figure 5: Rental value growth: MSCI monthly index (yr/yr)



Source MSCI

> “Supermarket yields averaged 4.93% in 2021, representing the keenest levels since 2014.”

Investor demand remains strong in the UK supermarket sector

Ongoing demand for secure-income on long-leased assets has supported supermarket investment through 2021.

UK supermarket investment remains elevated, with year-end 2021 volumes reaching £1.57 billion. While this is -5.9% short of the heightened volumes experienced in 2020, it does still represent an 8.3% increase compared to the ten-year annual average. Deal count totalled 67 in 2021, up 31.4% on the ten-year average while overtaking the previous peak levels of 64 deals reported in 2020.

The availability of long-term RPI-linked leases across the supermarket sector continues to attract investors seeking long-term income security. Grocery investment therefore appears particularly attractive compared to other asset classes, including traditional retail whereby lease lengths are continuing to contract heavily.

While 20+ year inflation-linked leases continue to prove resilient, we are also witnessing an increasing number of deals with shorter lease terms. For deals with lease length data available, those with an unexpired lease term of under 20 years accounted for a 69.8% share of deals in 2021, up from 60.5% in 2020. Meanwhile, more deals are completing with an open market rent review leasing structure, demonstrating that even assets that have been historically less attractive to investors are driving strong investment volumes.

Strong fundamentals maintains heightened demand from institutional investors

Investor demand for secure long-income assets continued driving volumes in 2021, with institutions and REITs maintaining their market dominance. Supermarket Income REIT's supermarket sweep has continued, single-handedly accountable for over 41.9% of UK investment volumes in 2021, with two further acquisitions completing in 2022 already. US-buyer, Realty Income Corporation, continued their hunt for UK assets, completing eight deals worth over £287 million.

Investors continue targeting larger, omnichannel stores, particularly those with strong online fulfilment capabilities. As a result, average store size has increased to over 52,500 square foot, up 17.9% compared to 2020 levels.

As noted in last year's report, investor demand from occupiers remains strong, as some supermarket chains continue to increase their freehold portfolio. Once again Tesco have been most acquisitive in this field, transacting on two key superstores in York and Bury, totalling almost £100 million. Aldi and Lidl have also been acquisitive, albeit namely site sales for future foodstore development in a bid to continue their substantial national portfolio growth.

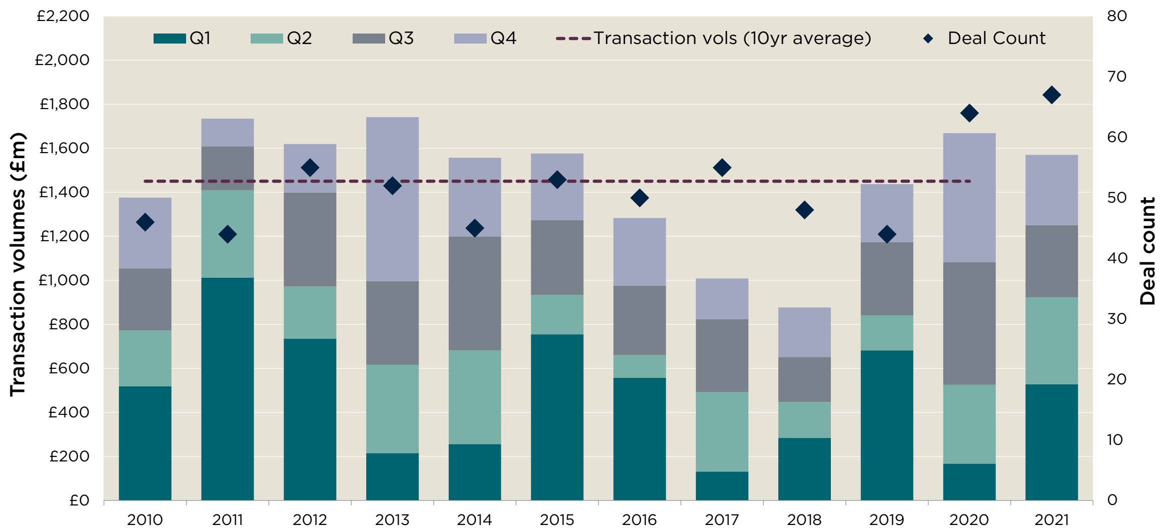
Investor demand continues applying downward pressure on prime supermarket yields

Supermarket yields averaged 4.93% in 2021, sharpening by 54bps compared to the 2020 average, equating to the keenest average yields reported since 2014. Savills prime equivalent yields remain 50bps keener than 2019 levels, at 4.25%.

Despite recent yield hardening, the spread between prime supermarket yields and ten-year government bonds has widened substantially since 2017. The yield spread as of Q4 2021 reached 330bps, considerably higher than the long-term (ten-year) average of 283bps. This has greatly increased the appeal of grocery investment as an alternative to traditional index-linked investments.

Looking ahead, the defensive characteristics displayed by supermarkets through the pandemic coupled with ongoing demand for long-term secure income bodes well for the grocery market. It's safe to presume strong investor demand for supermarkets will continue into 2022, along with a broader pool of potential buyers seeking to enter the market, which might apply further downward pressure on prime yields.

Figure 6: UK grocery investment volumes reached £1.57 billion in 2021, exceeding the 10-year average by 8.3%.



Source Savills Research; PropertyData

2021 investment grocery deal count reached 67 deals, up 31.4% on the ten-year annual average

Average size of store acquired increased by 17.9% year-on-year, to record 52,500 sq ft in 2021

The spread between prime supermarket yields and 10-year government bonds has widened, reporting c.330bps in Q4 2021

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