UK Commercial – 2023

SPOTLIGHT
Savills Research

UK Grocery Report

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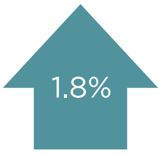
- Inflation sees market value growth but volumes fall
- Investment volumes bounce back



The overall market value for the UK grocery market grew by £3.1bn to £171.9bn for 2022, a growth of 1.8%

The gap between value and volume peaks with inflation growth in the occupational market

Grocery sales have continued to grow in 2022; however, with a slump in volumes comes shopper desertion and trading down for the big four operators as the discounters take advantage of consumer cost of living mitigation.

On the surface, it appears the UK grocery market has once again had a favourable year. The sector's overall market value grew by £3.1bn to £171.9bn for 2022, a growth of 1.8% on the previous year. It therefore remains in positive territory, despite the unusually high pandemic-fuelled comparatives of the previous two years; total market growth reached a record high at 8.4% in 2020. According to GlobalData, this positive growth is set to continue over the next five years, peaking at 6.1% in 2023 (figure 1).

Individual grocery operators have also continued to report positive year-on-year growth. The latest figures for the 12 weeks to 15 May shows that the UK's three largest grocers increased their sales at a similar rate. Asda tops the group with a growth of 10.6%, closely followed by Sainsbury's at 10.5% and Tesco at 8.9%. Morrisons has seen marginal growth at only 0.6%. However, Aldi and Lidl were once again the fastest-growing grocers in this period, with consumer sales increasing by 24.0% and 23.2%, respectively (figure 2).

Nevertheless, the continued positive growth in sales across the UK grocery market does somewhat belie the difficulties the market is facing in the current economic climate. Since July last year, we have seen double-digit price growth on food and non-alcoholic beverages, far outstripping the price growth for all consumer goods and services, which itself rose at the fastest rate in four decades in 2022 (Consumer Price Index (CPI) – figure 3).

Consequently, volumes have slumped as consumers have cut back in order to mitigate the rise in prices they are seeing at the supermarket. Figure 4 highlights the ONS monthly foodstore sales value versus volume index, compared to pre-pandemic. In August last year, volumes fell below 2019 levels and have remained in negative territory ever since, currently indexing at 97.3, 2.3% below both the same month last year and 2019 levels. Conversely, and as a direct result of inflation, the ONS report an index of 119.4 for foodstore sales value, nearly a fifth higher than we were seeing in the year before Covid.

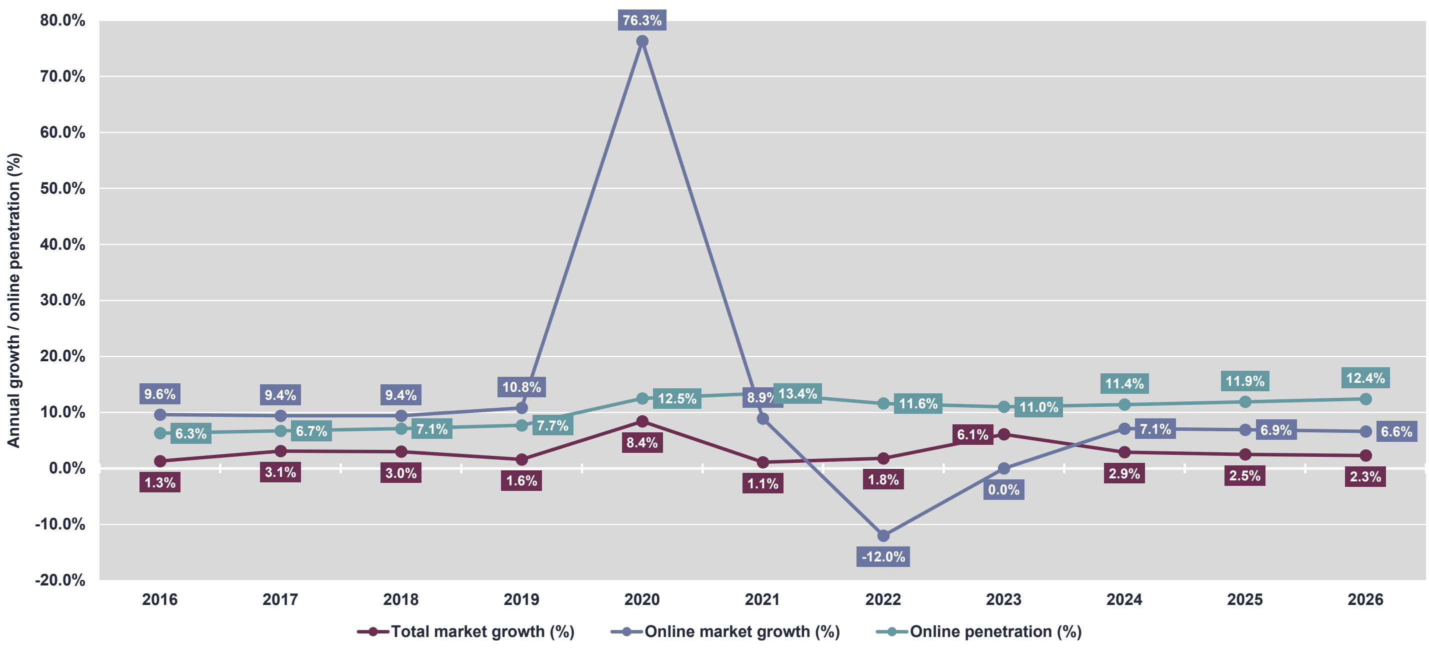
As a result, operators have suffered from smaller transaction values, shopper desertion and trading down, which in turn has made market share growth particularly difficult, with operating profits declining for some of the UK's major brands.

Profits decline for the UK's top four operators

Tesco for example, posted a fall in adjusted retail operating profit of 6.1% to £2.49bn in the year to February, versus the £2.65bn it made in FY21/22, as a result of "unprecedented levels of inflation". Furthermore, the grocer forecasts flat profits in FY 23/24 as it further attempts to shield shoppers from rising inflation.

Similarly, Sainsbury's reported an underlying operating profit before tax of £690m, a 5% fall versus FY 2021/22, despite group sales increasing by 5.3% and grocery sales by 3.0%. Nevertheless, this can be considered a strong

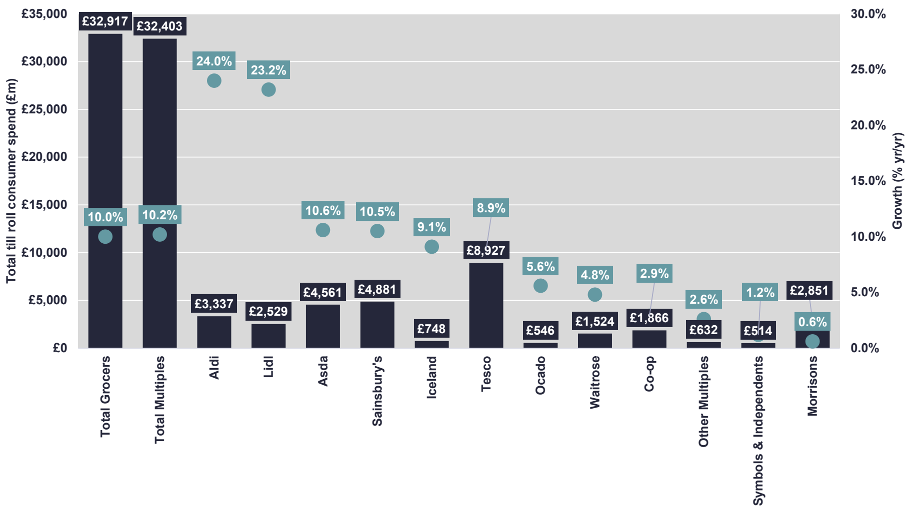
Figure 1: UK Food & Grocery annual market growth (%)



Source GlobalData

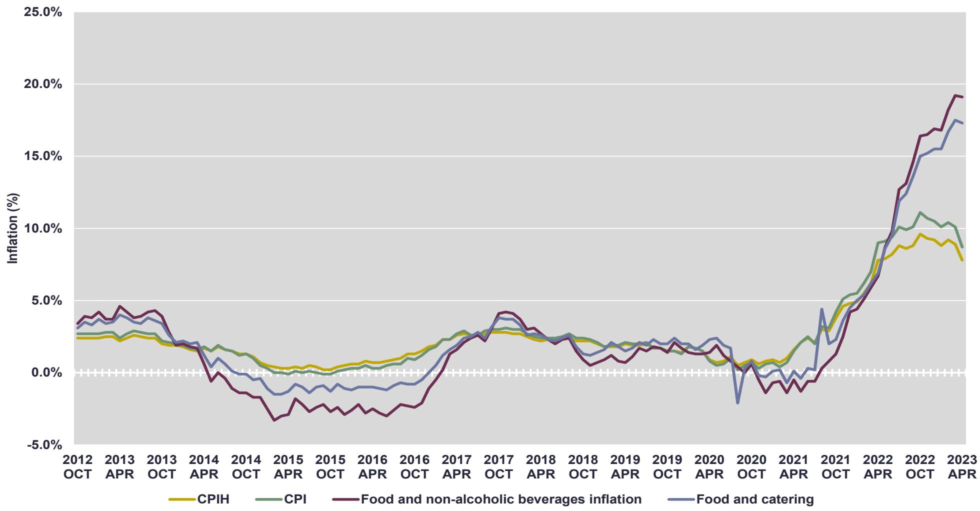
> "Since July last year, we have seen double-digit price growth on food and non-alcoholic beverages, far outstripping the price growth for all consumer goods and services, which itself rose at the fastest rate in four decades in 2022"

Figure 2: Total till-roll consumer spend (£m) versus growth (% yr/yr) - 12 weeks to 15 May 2023



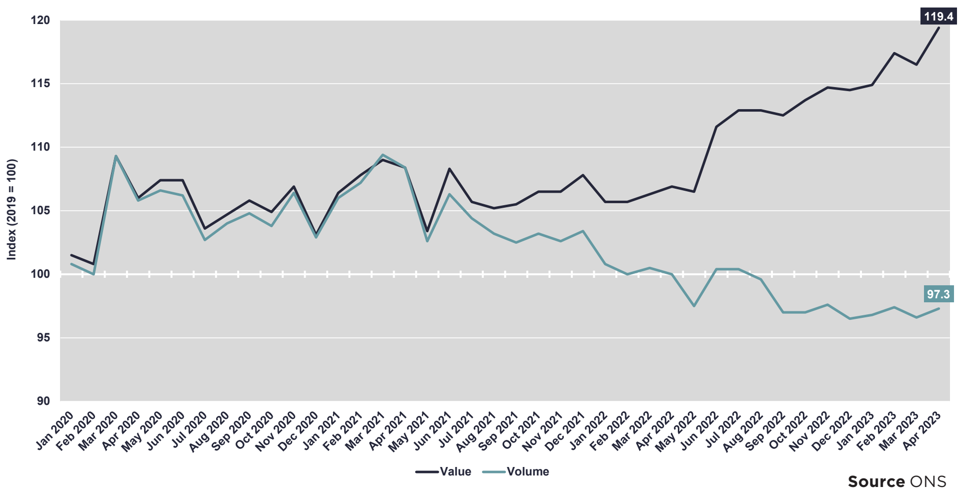
Source Savills Research: Kantar

Figure 3: Consumer Price Index versus food inflation



Source ONS

Figure 4: UK foodstore sales (value versus volume)



Source ONS

performance from Sainsbury's in view of recent inflationary pressures, having landed at the top end of its expected guidance range of between £630m and £690m and recording an 18% increase on the profit achieved in FY2019/20. Sainsbury's now expects underlying profit before tax to be between £640m and £700m in the new financial year.

Toward the end of last year, Morrisons also reported a 15% drop in full-year profits to £828m for the 52 weeks ending 30 October 2022. Asda, meanwhile, reported a 24% drop in profits to £886m for FY2022 to 31 December, despite a marginal increase in total sales of 0.1% to £20.452 billion and like-for-like sales up 5.1% in the second half of the year.

Interestingly, each of these brands has attributed a reduction in their overall profit to a commitment to support their customers by investing in strategies that alleviate the impact of inflation and keep prices as low as possible.

Tesco has committed to prioritising investment in its customer offer and attempting to relieve cost of living challenges with its 'Aldi Price Match', 'Clubcard' offers and 'Low Everyday Prices'.

Sainsbury's has invested as much as £560m over the last two years in both its 'Food First' strategy and, most recently, the launch of 'Nectar Prices' to help shoppers save – increasing its focus on value goods, keeping prices low and reducing costs across its business, that can subsequently be passed on to the consumer.

Similarly, Asda has reduced the price of more than 100 branded and own-branded lines by an average of 12% and launched its new 'Just Essentials' value range, over the last 12 months. Since it published its financial results in October last year, Morrisons has also executed a rolling programme of meaningful price cuts, price freezes and fuel promotions for its consumers, in order to sharpen its competitive position.

It is evident that the UK's largest grocers have made a conscious decision to support customers by investing heavily in strategies that mitigate the impact of inflation and keep prices as low as possible. This may result in decline in profitability in the short-term however; the strategy suggests that it will ultimately help to deliver long-term growth for each of the operators moving forward.

This approach has undoubtedly been driven by the savvy nature of the consumer in recent months, who have increasingly been trading down and purchasing more own-label goods. These lines grew by 15.2% in May. The very cheapest value own-label lines now find their way into nearly one in five baskets, with sales soaring by 46% in April versus a year ago, according to Kantar.

Branded sales are still continuing to grow, but much more slowly at 8.3%. However, the gap between own lines and brands is narrowing in most stores, helped in some cases by the loyalty discounts the operators have begun to implement. Sainsbury's Nectar Prices scheme has boosted the sale of brands bought on deal by more than a quarter in the last month.

Consumers have increasingly been trading down and purchasing more own-label goods. These lines grew by 15.2% in May

The discount operators continue to see both the strongest sales and market share growth

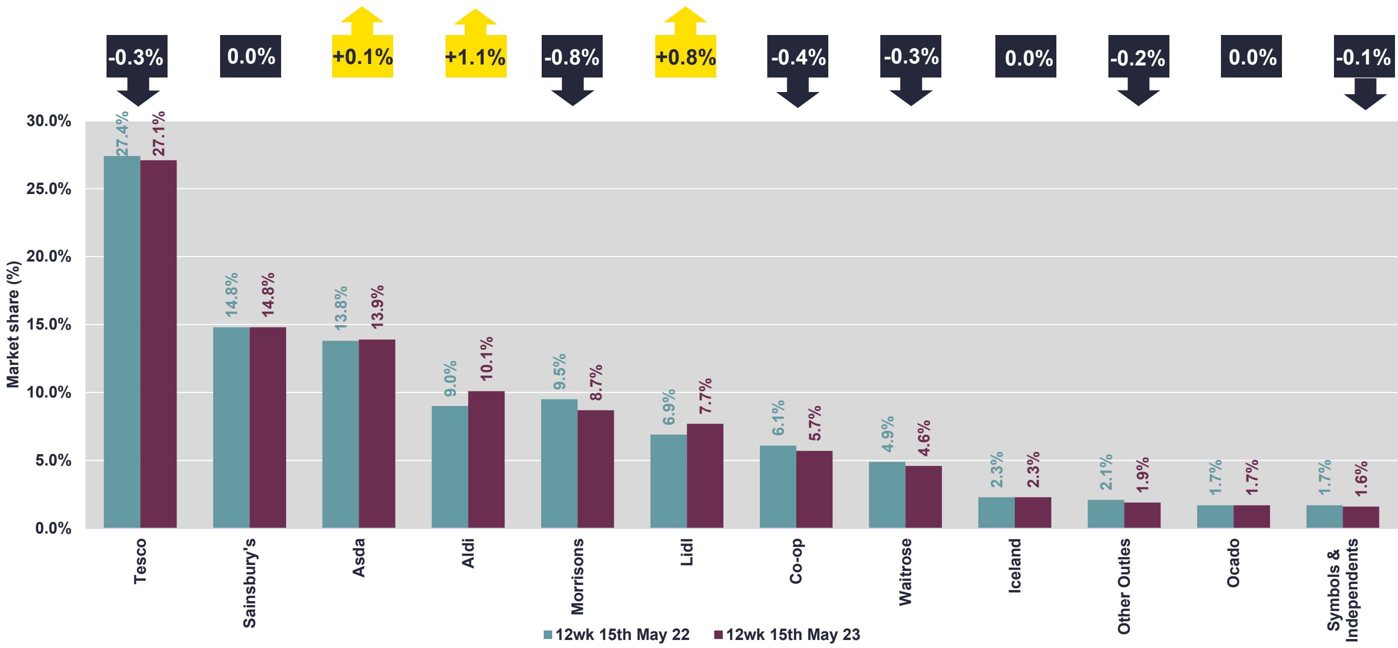
What is clear, the UK's supermarkets are fighting to offer value to shoppers throughout their range of products, undoubtedly driven by the continued success of the discount operators, and a desire to curtail their sustained improvements in market share.

The latest figures published in May see Aldi and Lidl with more than double the year-on-year sales growth of any other UK grocer (figure 2). In April they both hit new record market shares, with Aldi surpassing a 10% market share for the first time, up from 5% only eight years ago. Even before the cost of living crisis began to bite, the discounters had steadily increased their influence on the UK grocery market, driven largely by their aggressive acquisition strategies over the last five years. In September last year, Aldi overtook Morrisons to become the UK's fourth-biggest supermarket in terms of market share.

The two discounters now account for 17.8% of the market, with Aldi's share at 10.1% and Lidl at 7.7%. This represents the two largest market share improvements over the last 12-months, with 1.1% and 0.8% growth, respectively. Tesco, Sainsbury's, Morrisons, Waitrose and Co-op have all seen shares fall over the same period, hence their commitment to invest in strategies that focus on value and help the consumer combat the impact of inflation (figure 5). A survey conducted by Retail Week as early as February last year found that 82% of UK consumers were likely to switch their shopping to value and discount retailers across essential categories, as rampant inflation and surging energy prices began to deepen the cost of living crisis. Of those shoppers, 80% said they would look to save money on their food shopping by switching to a cheaper grocer.

Asda was the only other food operator to see an improvement in its share of the market, which now stands at 13.9%, a rise of 0.1 percentage points when compared to the same 12 weeks last year (figure 5). Having launched its 'Just Essentials' range 12 months ago, this operator is beginning to see the benefit of its strategy to soften the impact of inflation. Nearly two in five Asda baskets contained at least one of these value items this May, according to Kantar.

Figure 5: UK grocery market share (%) & growth (% yr/yr)



Source Savills Research; Kantar

The appetite for portfolio expansion slows a little but remains above the decade average

The success of the discount operators has once again seen them top the charts in terms of portfolio growth in the grocery sector. 2022 saw 160 new store openings in the out-of-town grocery market, above the decade average of 144 (figure 6). Significantly, 63% of those units opened were done so by value-orientated or discount brands (78% on a sq ft basis).

Lidl and Aldi remained the two most acquisitive grocers in 2022, with 50 and 25 new stores, respectively. In fact, Lidl was the most acquisitive brand overall in the out-of-town retail market, a position it has held for the last five years (Aldi came in 6th). With the out-of-town retail market undergoing a structural change in rents in recent years, the value-orientated grocers have been particularly opportunistic in order to seize the opportunity to acquire space on more favourable terms.

Nevertheless, the number of new out-of-town grocery stores in 2022 marks the lowest total in the last four years, suggesting even the discounters are undoubtedly feeling a squeeze on profits, particularly with the unprecedented hike in energy prices the sector has had to absorb in the last 6 months. This may also be a contributing factor in the continued negative rental growth the sector has seen as retailers keep a strict eye on the cost of their operations; MSCI reported year-on-year rental value growth of -1.19% for supermarkets in April 2023 (figure 7).

The good news is, inflation has begun to fall. The Office for National Statistics (ONS) announced that overall Consumer Prices Index (CPI) inflation fell to 8.7% in April, down from 10.1 % in March, as last year's energy price hikes were not repeated. This is the first time inflation has been in single digits since last August.

Subsequently, grocery price inflation has also begun to recede, which is without doubt welcome news for consumers; however, positivity remains muted in this sector. Food prices remain centre stage in the cost of living crisis, continuing to place significant pressure on household budgets. A fall in grocery price inflation does not actually equate to lower prices. Instead, it means prices are not increasing as quickly, and the simple fact is they still remain incredibly high.

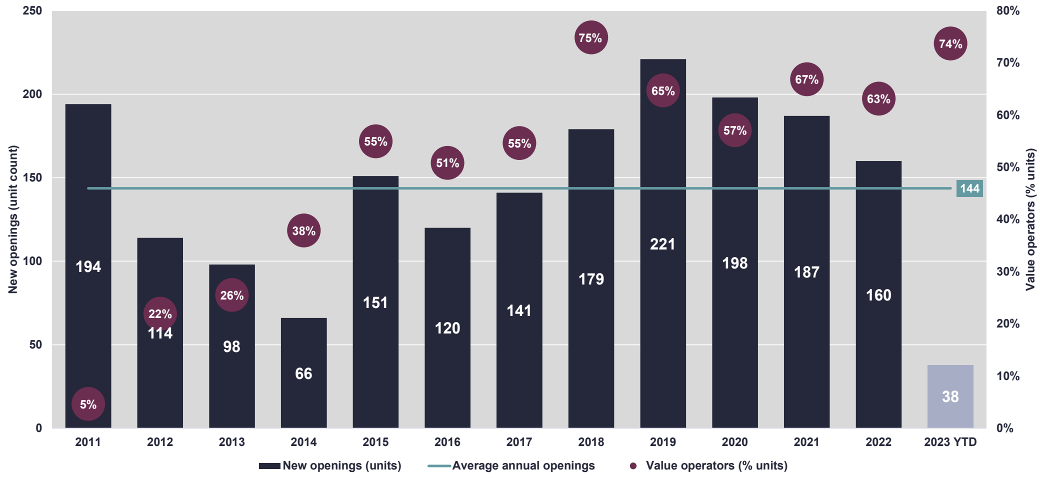
Food and non-alcoholic beverages inflation is at 19.1% for April, having fallen 0.1 percentage points from the previous month. Like-for-like food and catering inflation has fallen for the second month in a row and now sits at 17.2% for the four weeks to 14 May 2023. Although perhaps too early to call the summit, it is certainly a move in the right direction; however, this still represents the third fastest rate of grocery inflation we've seen since 2008, continuing to add an extra £833 per annum to the average consumer's bill (Kantar).

Are consumer headwinds beginning to ease?

There are signs consumer headwinds are beginning to ease. Consumer confidence has improved greatly from its September 2022 nadir, although still low by historical levels. A three-point improvement in GfK's May 2023 Consumer Confidence Index (CCI) saw levels reach their highest since February 2022 and represented the fourth consecutive month of improvement (figure 8).

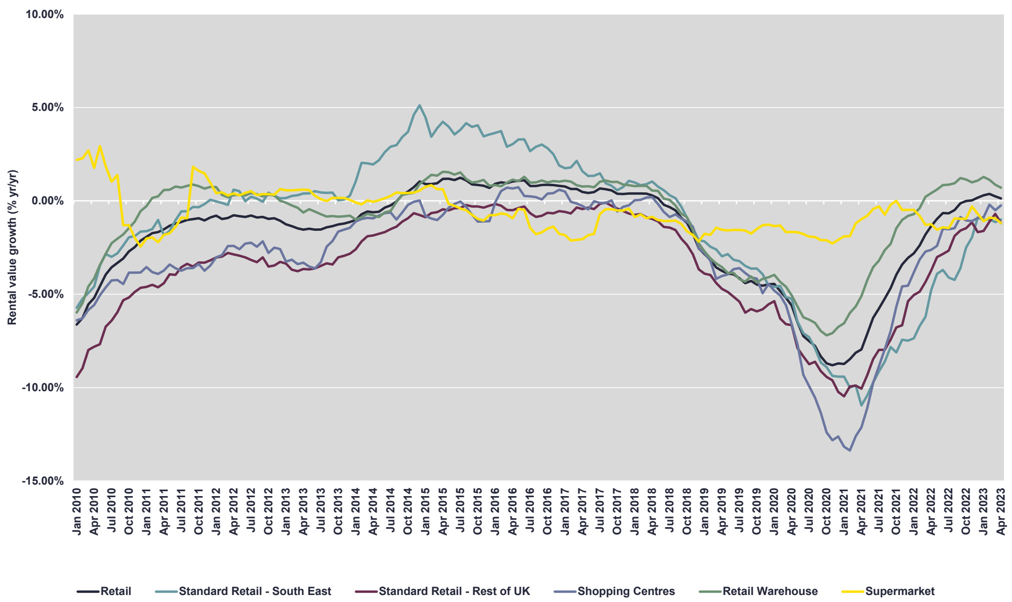
If inflation forecasts are anything to go by, this upward trajectory in consumer confidence could continue in the coming months. CPI inflation is expected to ease slightly faster than previously anticipated, down to 3.2% by Q4 2023 according to Oxford Economics. This deflation, led by less expensive energy, could begin to unlock some disposable household income this year.

Figure 6: Out-of-town grocery – new openings



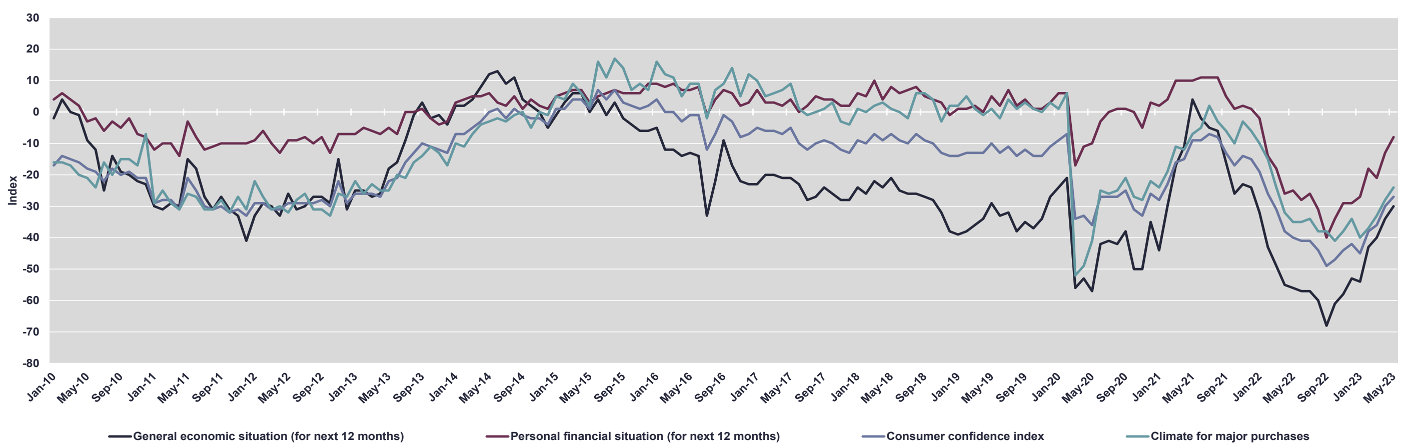
Source Savills Research

Figure 7: Rental value growth: MSCI monthly index (% yr/yr)



Source MSCI

Figure 8: GfK Consumer Confidence Index



Source GfK

Business rates reform will lead to a net tax saving for grocery retailers of nearly £550m over three years; however, the positive impact is mixed dependent on the specific format exposure of each operator

The long-awaited business rates reform has been largely welcomed by the retail property sector, with an average reduction across England and Wales of -10% when it came into effect on 01 April 2023. The good news, however, is nuanced, with the rate changes differing significantly depending on retail category, retail sector and geography.

In the grocery market, this means large supermarkets have seen significant reductions while small convenience stores have seen the opposite. It is not all good news for the discounters in the current climate either, with food stores of the size favoured by Lidl and Aldi also paying more in business rates also over the next three years.

Large supermarkets have seen average reductions of -15%. Analysis from Altus Group revealed that supermarkets over 27,000 sq ft in England and Wales will see their rateable values drop from £2.86 billion to £2.43 billion in 2023, saving around £218.6 million, which could rise to £686.78 million over the next three years. In the case of the very largest superstores, the rateable value has dropped by as much as 50%, according to Altus Group's analysis. This undoubtedly will benefit the traditional big four operators as well as Waitrose.

This year's revaluation is based on the open market rent values as of the 01 April 2021. The reduction seen on larger food stores is therefore argued to be a direct reflection of the change in shopping patterns since the previous rating list came into effect in 2017 and was based on 2015 open market rents. The growth in online shopping is said to have reduced demand for the weekly shop and shaved margins on non-food items, meaning some grocers have found they have more space than they need. The new rates will reflect the falling property values we have seen over six years as rents have undergone structural change.

As an example, a Tesco Extra in Worsley, Greater Manchester, will benefit from one of the biggest tax cuts, having seen its rateable value fall 52%, from £3.3m to £1.6m. This is closely followed by an Asda superstore in Watford, which is to benefit from a 51% reduction.

In contrast, the rateable value of smaller food stores has risen - by 8.4% for those between 8,000 sq ft and 27,000 sq ft from £651.01m to £705.5m. Stores at this format are set to pay £28m extra tax in the first year alone, taking the annual bill to £362.1m. According to Atlas Group, 2,950 stores fall into the category in England and Wales, the majority of which will be Aldi and Lidl stores. In addition, convenience stores are set to see a 12.7% increase. Overall, both formats will collectively see their business rates bill rise by £141m over three years.

The UK's biggest grocers look to take advantage of consumers thirst for convenience, with many looking to grow their c-store portfolio exposure

Clearly, the increase in rates for the discounters is a reflection of their growing success with the consumer in recent years and how that has played out in property acquisitions. However, we have also seen an increased demand for convenience from the consumer. Convenience shopping remains more popular now than it ever was pre-pandemic. In the five years between 2015 and 2020, convenience sector sales grew by an average of 2.6%, according to Lumina Intelligence UK's convenience market report. In 2020, sales shot up by three times that, rising by 6.3% in just 12 months.

This success has clearly caught the attention of the government in its business rates reform, with this sector seeing some of the largest increases in the retail market. Nevertheless, the UK's grocery operators clearly still see the advantage in growing their exposure in the convenience market.

Asda opened its 150th 'On the Move' convenience store in April, well on its way to its goal of rolling out 200 c-stores by the end of 2023. The format, launched in October 2020, is designed to allow more customers to access the operator's range of products at roadside and neighbourhood locations. Asda have also announced plans to open 30 new 'Express' convenience stores this year around residential areas and transport hubs, aiming to have 300 total stores opened by 2026. In addition, the supermarket operator has also acquired 132 convenience stores with attached petrol filling stations from the Co-op Group, subject to a review through the Competition and Markets Authority (CMA).

Asda is not the only brand looking to expand upon its convenience format. Morrisons opened its 500th 'Morrisons Daily' convenience store in January this year, whilst Tesco opened its 2,000th 'Express' store in February. In March, Sainsbury's announced that its convenience stores had achieved sales of £3 billion for the first time, with 12% more customers shopping in 'Sainsbury's Locals' than in the previous year, up 7% on pre-pandemic levels. With more than 800 c-stores, the retailer is continuing its convenience rollout, looking to add 25 new stores over the next twelve months.

Online grocery sales growth inevitably falls against pandemic-driven comparatives

The value of online grocery sales suddenly spiked in 2020 as a direct result of the pandemic, and the subsequent lockdowns and stay-at-home advisories. However, with online grocery penetration peaking at 13.4% in 2021, last year saw market growth shrink by -12%. Whilst online grocery sales generated more than £21bn in revenue in 2022, growth of the market is expected to remain muted in 2023, according to GlobalData (figure 1).

The simple fact is, as regulation surrounding the pandemic ended, the high demand for online grocery ordering has lowered in turn. The desire for consumers to avoid crowds and the risk of infection at physical stores continues to wane. Furthermore, a 2022 survey by Statista suggested that too many substituted items, not being able to find suitable delivery times, and unfresh groceries were the most common negative aspects of online grocery shopping in the UK. These factors may be part of why in 2022 nearly 42% of consumers bought their groceries primarily in stores, and only partially online, according to the survey.

Large supermarkets (over 27,000 sq ft) have seen average business rate reductions of 15% in England and Wales

In contrast, the rateable value of smaller food stores has risen - by 8.4% on average for those between 8,000 sq ft and 27,000 sq ft

In addition, convenience stores are set to see a 12.7% increase in business rates on average this year

UK supermarket investment demand bounces back in 2023

More available stock on the market is expected to boost year-end 2023 volumes, led by sale and leaseback transactions.

Grocery investment transaction volumes fell off a cliff in H2 2022, akin to themes experienced across the wider commercial property markets. Multiple interest rate hikes and the cost of debt skyrocketing limited appetite, with 2022 year-end volumes down -55.2% on the ten-year average.

However, it appears investor appetite has begun returning to the grocery investment sector. Year-to-date (January-April) investment volumes reached £804.1 million, already exceeding full-year 2022 levels by 34.7%, and up 91.9% on the three-year pre-Covid (2017-2019) January-April average. This includes Supermarket Income REIT's reversionary sale to Sainsbury's in March, involving 21 stores and totalling £430.9 million. Even when excluding this deal, year-on-year January-April volumes have more than doubled.

Investor appetite continues to be driven by the strong underlying fundamentals of the grocery market. Lease tenures tend to range from 15-25 years, equipped with upwards only rent reviews (either RPI/CPI-linked, or fixed annual growth), providing buyers with long-term secure investment opportunities, while strong tenant covenants provide an element of security. This continues to suit long leased funds and institutions, that remain particularly active.

Supermarket Income REIT remain the most acquisitive buyer in the market, accounting for a 29.3% share of volumes in 2023 to date, following a 41.6% share in 2022. Its approach to investment continues to be centred around well-located larger stores with online fulfilment capabilities, with 93% of its current portfolio involving omnichannel stores.

Sale and leasebacks are back

Sale and leaseback activity has picked up pace in recent months following the acquisition of Morrisons, and Asda's potential sale this year. Should the Issa Brothers sell Asda in 2023 near the £1 billion asking price, it is likely that year-end investment volumes will top record annual levels.

Morrisons has offloaded five stores since its takeover by CD&R in 2021, as the new buyers seek to recoup some capital following acquisition. Buyers include abrdn, and property investment companies Brydell Partners, Fiera Real Estate, and Mayfair Capital. Morrisons remains in a strong position to raise further funds, owning c.85% of its portfolio at time of writing, suggesting further leaseback deals are pending.

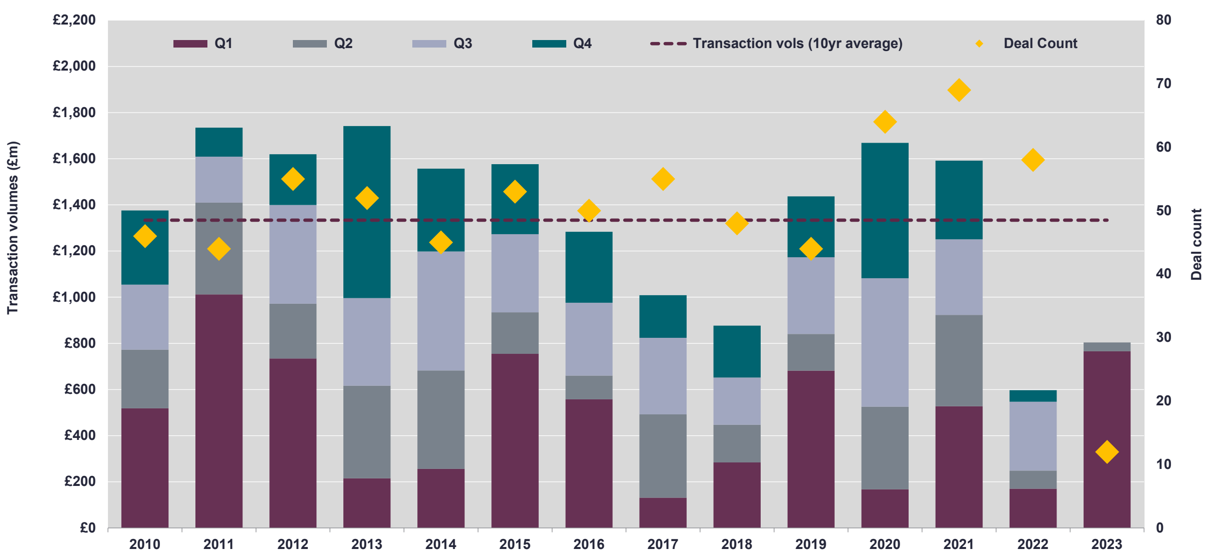
The sale and leaseback trends appear to have switched over the last 15 years. Tesco and Sainsbury's, who accounted for the majority of sale and leaseback activity between 2010 and 2014 (totalling 49 deals), now have strong financial positions to allow them to acquire assets and lower their rental overheads. Sainsbury's/Supermarket Income REIT reversionary buy somewhat epitomises this trend, whilst Tesco acquired two stores in H2 2022, including Tesco Mansfield for £19.5 million in August and Melton Mowbray for £13.8 million in December 2022.

Outlook - appetite for supermarket investment likely to remain strong despite economic uncertainty

Supermarket investment remains a comparatively secure investment option for long-term income, which is particularly pertinent in the face of current economic uncertainty. While further interest rate hikes could hamper the buyer pool in the short term, it is unlikely to impact the price of good-performing stores in well-positioned locations. Property investment companies are likely to continue dominating the buyer market, with sale and leaseback deals set to generate capital for new owners in the supermarket sector.

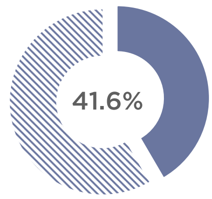
Larger, omnichannel stores continue to be the preferred option for investors, although continued stock growth in smaller units (led primarily by the discount operators or high street rollouts by the likes of Asda, Amazon and M&S) could bring more smaller units to the market over the next few years.

Figure 9: UK grocery investment volumes

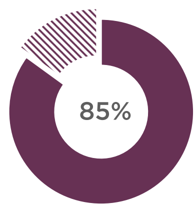


Source Savills Research; PropertyData

Year-to-date 2023 (Jan-Apr) investment volumes reached £804.1 million, up 34.7% on full-year 2022 levels



Supermarket Income REIT accounted for a 41.6% share of investment volumes in 2022



Morrisons owners, CD&R, own c.85% of its portfolio, opening opportunities for further sale and leaseback activity

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