UK Commercial – 2020

SPOTLIGHT
Savills Research

UK Grocery Report

savills

● Strong operational performance ● Significant value-orientated portfolio growth ● Investment

> “Consumer confidence remains downbeat, with GfK’s October index recording -31, compared to -14 a year prior.”

Grocery performance bucks wider consumer trends

Consumer confidence remains suppressed, however, a fall in spend hasn’t been homogeneous across all retail segments, highlighting strong resilience in the grocery sector.

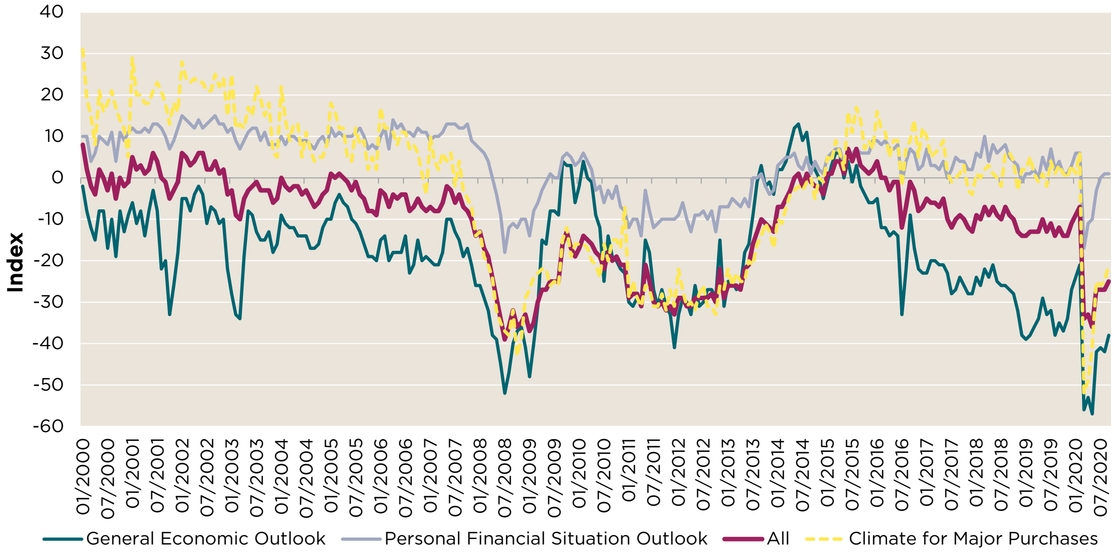
A relaxation of Covid restrictions in Q3, following the first lockdown, eased the negativity in the consumer market temporarily, with general economic outlook over the next twelve months improving from an index of -56 in March to -38 by September. However the implementation of a second national lockdown from November has further exacerbated a recovery and as a result, consumer confidence remains downbeat, with GfK’s October index recording -31, compared to -14 a year prior. Consumer attitudes towards major purchases remain delicate, with the index standing at -27, marking a six point fall over September levels. The general economic outlook of the consumer over the next twelve months also fell back to levels similar to those witnessed in March, reporting an index of -50 by October (Figure 1).

The extension of the existing furlough scheme to the end of March 2021, will have saved a number of jobs in the short-term. Nonetheless, the UK unemployment rate continued to rise in the July to September period to reach 4.8%, with added economic pressures caused by a second lockdown pointing to a further rise in unemployment as we move towards 2021.

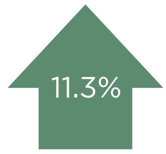
The final quarter is always a pivotal time of year for retailers, with Black Friday and the Christmas period, having great bearing on annual reporting figures. The additional pressures this year will no doubt accentuate the importance of the quarter. We could witness consumer spending behaviour swing in two directions this winter. Low consumer confidence and job uncertainty are expected to uphold high personal saving ratios until well into 2021, fostering a much more cautious approach to Christmas for some. As a result, Oxford Economics are anticipating consumer spend on retail goods to drop -4.7% in Q4 2020, compared to the year prior. That being said, we could see a portion of consumers opt to spend more enthusiastically over this Christmas period driven by pent-up demand following six months of heightened savings.

By subsector, it’s likely we’ll see a significant polarisation in trading results. While spend across more pandemic-sensitive segments such as fashion, travel and eating out are likely to remain suppressed through Q4, it could open growth opportunities across other sectors. Supermarket sales in both value and volume terms continue to perform well, exceeding the long-term average in September to reach 4.3% and 3.2% year-on-year respectively, on a rolling 12-month basis. In line with a second lockdown, as well as more people staying at home over Christmas, supermarkets are likely to continue this long run of success through the final quarter of the year. The early signs are positive, with take-home grocery sales up by 11.3% during the 12 weeks to 29 November 2020, the fastest rate of growth since August.

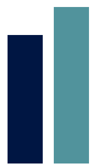
Figure 1: Consumer confidence remains downbeat, with the October index recording -31, compared to -14 a year prior.



Source GfK



Take-home grocery sales up by 11.3% during the 12 weeks to 29 November 2020, the fastest rate of growth since August



2019 saw as many as 221 new grocery store openings in the out-of-town market, a record high and well above the average at 143

153
New foodstore openings in the out-of-town market by the end of Q3 2020, already above the decade average

> **"The immediate post-GFC period showed that if consumers swing into belt-tightening mode, then it is the value end of the spectrum that benefits most."**

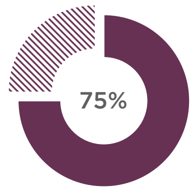
Strong occupational growth set to continue

With a significant pandemic related uptick in grocery spending, strong annual portfolio growth is set to continue, particularly from the value-orientated brands.

The appeal and provision of value-orientated brands in the UK retail market has seen significant growth over the last decade, and the grocery sector is certainly no exception. A high level comparison of the top 25 out-of-town retailers in 2009 and 2020 makes this case very effectively. Back in 2009 Lidl was the only value-orientated brand in this group, in 25th place with 121 stores. Aldi and Iceland both sat well outside the top 25 with 99 stores and 38 stores respectively. Fast forward to 2020 and there are five value-orientated brands in this group with the grocery retailers leading the charge; Lidl sits in top spot with 816 stores, Aldi second with 597 and Iceland fifth with 354.

Continuing the retail warehouse example, it is therefore no surprise the grocery sector has been recording well above the decade average for new foodstore openings in recent years. 2018 saw 179 new grocery stores in the out-of-town market, whilst last year saw as many as 221, a record high for the last ten years and well above the average at 143. What is even more encouraging, is that this strong growth performance has continued in 2020, in spite of the pandemic and the obvious disruption to trade across the wider retail market. By the end of Q3, new foodstore openings accounted for 153, already above the decade average, with a quarter of the year yet to come (Figure 2). As a result of this activity, grocery units accounted for more than a fifth of new retail warehouse openings last year, the first time it has done so since 2011. So far this year grocery has accounted for 26% of new openings, up from the 22% recorded in 2019.

A look at the top twelve most acquisitive brands in the retail warehouse market for 2020, draws attention to the aggressive strategy of portfolio expansion for each of the value grocers, even against a background of weak consumer confidence amid the global pandemic. The immediate post-GFC period showed that if consumers swing into belt-tightening mode, then it is the value end of the spectrum that benefits most. This suggests that whatever the political and economic outcome of the recent pandemic, the strong growth in demand from the value retailers will very likely be sustained. By way of an example, Lidl opened 46 new stores in 2019 totalling 908,000 sq ft. So far 2020 has seen them open 52 new stores, equating to just over 1m sq ft (Figure 3). Aldi and Iceland have also continued to pursue strong growth strategies, opening 33 and 15 stores respectively, all at over 10,000 sq ft gross. Since 2015, value-orientated brands have in fact accounted for more than half of all new grocery openings each year and as much as three quarters of all supermarket acquisition activity by Q3 2020.



Value orientated grocery operators accounted for three quarters of all new store openings in 2020

Figure 2: New openings have been well above the decade average in the last two years and had already surpassed it by the end of Q3 2020.

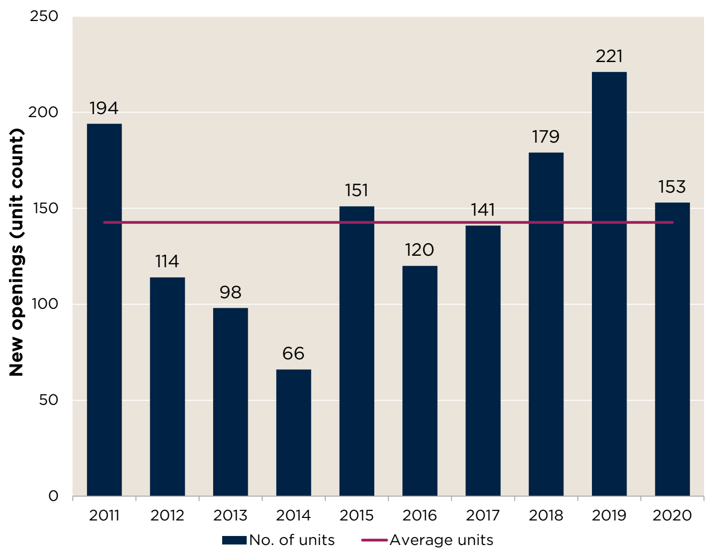


Figure 3: Most acquisitive retail warehouse brands by the end of Q3 2020, with Aldi, Lidl and Iceland leading the charge for the grocery sector.

Ranked by units					
Rank	Operator	Units	Average Unit Size (sqft)	Category	Pitch
1	Lidl	52	21,400	Grocery	Value
2	Aldi	33	19,100	Grocery	Value
3	Costa Coffee	23	2,500	Food & Beverage	Mass
4	B&M Bargains	22	28,000	Variety Stores	Value
5	Home Bargains	21	23,300	Variety Stores	Value
6	Wren	17	10,900	Home	Mass
7	PureGym	16	10,000	Leisure	Value
8	Iceland	15	12,300	Grocery	Value
9	Starbucks	13	1,900	Food & Beverage	Mass
10	Greggs	11	1,500	Food & Beverage	Mass
11	TheGym	10	9,600	Leisure	Mass
12	M&S Simply Food	10	21,200	Grocery	Mass

Source Savills Research

There has undoubtedly been a structural change with regard to rents in the UK retail market in recent years, and it is clear this has been the driving force behind the acquisition activity we have witnessed in the grocery sector in particular. 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 4 highlights how the decline in rental value growth for supermarkets has been much less severe than for other areas of the retail market. MSCI report year-on-year rental value growth of -1.1% for foodstores in 2019, whereas it stands at -5.9% for the rest of retail. 2020 looks set to repeat this pattern, recording a -0.9% year-on-year rental decline for grocery stores, much more in line with 'all property' types, and significantly less than -8.8% for all of retail.

The resilience the grocery sector has shown in regards to rental decline is undoubtedly linked to its ongoing positive performance and the relationship the market has between physical stores and online sales penetration. Food and grocery expenditure has been growing steadily for some time, with annual growth of between 1% and 3% since 2015, according to GlobalData. However, as a direct result of the global pandemic, the UK food and grocery market is forecast to have grown by 10.1% in 2020, the highest annual growth in over four decades (Figure 5). March and April saw an explosion in expenditure growth as shoppers began panic-buying and stockpiling non-perishables. According to the Office for National Statistics, overall UK retail sales declined 5.1% in March from February, the largest drop since the agency started collecting the data in 1996. However, food sales and online-only businesses were the only areas to see growth in that period, with supermarkets and other food stores recording a 10.4% increase in sales in the same period.

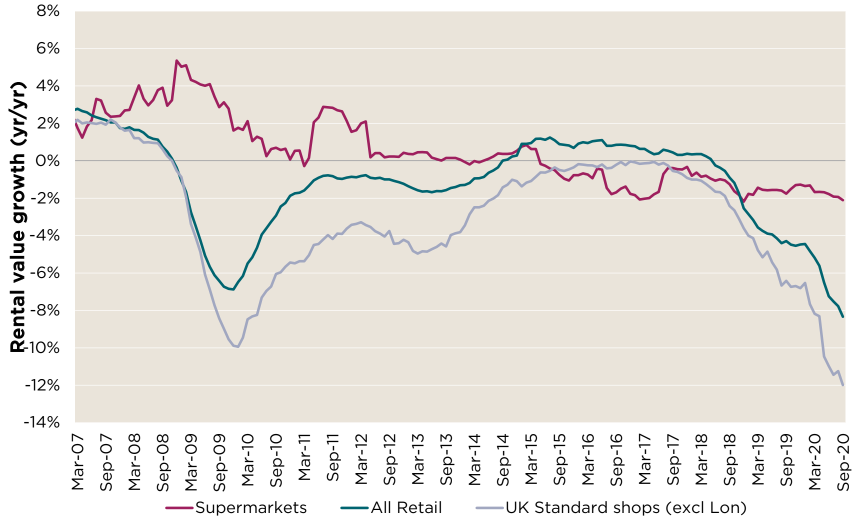
Foodstore operators have also made significant gains in the months following, as the UK remains in a state of flux between national lockdowns and the localised tier restrictions. Consumers have turned to grocery operators in the absence of hospitality and foodservice locations, with food sales set to outperform the total grocery market for the first time since 2017. This is supported by strong volume growth across core ambient categories, with other influences, such as 5.3% of UK shoppers buying a pet during lockdown, buoying secondary markets such as pet food.

A number of non-food categories in the grocery sector are also recording a significant uptick in expenditure. With pubs and bars either closed or restricted for much of the year, 2020 has seen a 14.5% increase in alcohol expenditure in supermarkets after an initial jump of 31.4% in March when the first lockdown was announced. Household products have proven to be the fastest growing sector, forecast at 21.6% in 2020, as shoppers have rushed to buy cleaning and sanitation products for protection against the virus.

As a vaccination programme is rolled out and the UK consumer once again begins to visit restaurants, pubs and foodservice outlets in significant numbers, food and grocery sales are expected to retract somewhat. We saw a glimpse of this in mid Q3, when the grocery market resumed some semblance of normality, with the government's Eat Out to Help Out scheme, encouraging shoppers to spend on food and drink at non-retail locations. That said, overall food and grocery expenditure is not expected to return to the levels we saw pre-pandemic, highlighting a noticeable and permanent improvement in advance of the sector's normal growth trajectory. As a result, the growth rate will naturally show a decline, estimated at -5.3% for 2021, but is expected to return to normal levels of growth by 2023 (Figure 5).

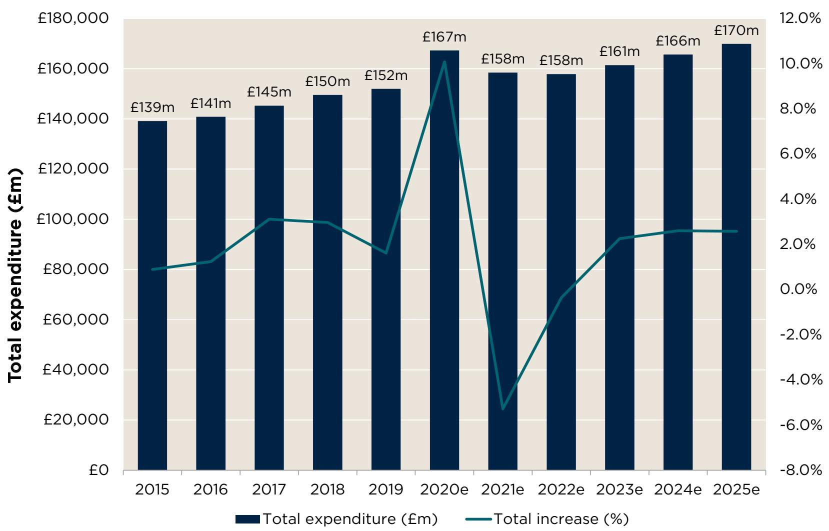
Despite the unprecedented performance in the sector in recent months, many analysts might point to the growth of online penetration in the grocery sector as a potential threat to the physical store in the years ahead. The channel shift from offline to online has been dramatic in food & grocery this

Figure 4: Rental value growth: According to MSCI, supermarket rents have fallen less than the rest of retail.



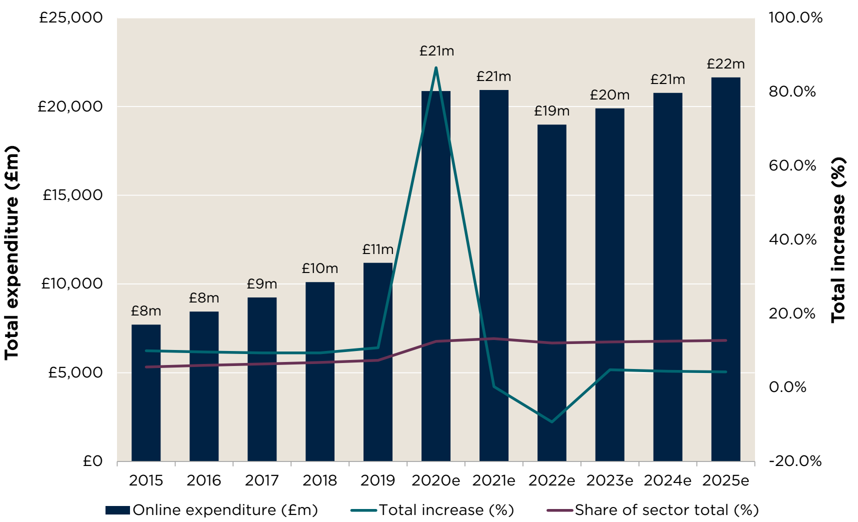
Source MSCI

Figure 5: Food and grocery expenditure growth, showed a significant pandemic related uptick in 2020.



Source GlobalData

Figure 6: Food and grocery online expenditure growth, will see its share of the whole market increase from 7.4% in 2019 to 12.5% by the end of 2020.



Source GlobalData

year, with penetration set to jump from 7.4% to 12.5% - a transference of £9.7bn. Since late May, online spend has been running at double that in 2019. Many consumers who have always shopped instore have reverted to completing their transactions online to avoid venturing into stores and potentially being exposed to the virus. The surge in demand for home delivery options in March and April was high enough to cause website crashes, however, since then, supermarkets have been quick to swell capacity to deal with this demand. Tesco for example, doubled its online fulfilment capacity in a space of six weeks. Grocers quickly realised they needed to invest in their online propositions, capabilities and loyalty programmes, encouraging shoppers to take more spend online than pre-2020 going forward. Their willingness to do so highlights a strong omni-channel approach by the UK's major grocery brands and actually alleviates the concern of the importance of the physical store going forward. Unlike much of the rest of UK retail, where the rise of ecommerce can directly impact on the volume and value of goods sold in store, online grocery orders are typically serviced by the stores themselves, making the true value of the store in the grocery sector, much greater than is initially obvious.

Supermarkets and convenience stores have of course been considered essential throughout the pandemic. Out-of-town foodstores accounted for more than a third (35%) of all the essential retailers permitted to trade immediately following the government sanctions in March. As a result we have seen significant sales improvements for individual brands, echoing that in the wider market as a whole. Figure 7 has seen Tesco's year-on-year gross sales increase from -0.8% in the 12-week period up to February 23rd 2020, to 10.4% in the 12-week period to the end of November. The online supermarket Ocado, has unsurprisingly seen the most significant sales growth, from 10.8% in the same 12-week period in February, to 38.3% in the same 12-week period in November, resulting in a market share of 1.7% of the UK grocery market as a whole (Figure 8). Meanwhile, Lidl reached a new record market share of 6.2% (Figure 8) and Aldi's sales were up by 7.0%, with a 7.7% share of the market, demonstrating the strong consumer demand for value-orientated operators and underpinning the strong acquisition activity they have continued to demonstrate this year.

With Covid cases rising again as we entered Q4, and social distancing measures therefore tightening once more, shopping habits in the final quarter are more likely to resemble that of Q2, which again could mean a significant uptick in foodstore operator performance. Consumers are expected to spend close to £12 billion in the supermarkets during December, around £1.5 billion more than last year. With consumers again likely to want to limit the number of visits to stores, we expect to see basket sizes increase dramatically on last year, as they did at the start of the pandemic. Research from Kantar suggested that the amount families spent on a shopping basket reached a record high in April, with £26.02 being spent per supermarket visit, £7 higher than the same time last year. Out-of-town foodstore locations are also set to benefit, particularly from consumers with a defined shopping mission wanting extra physical space to shop in.

The dynamics of the food & grocery market in 2021 will rest heavily on the progression of the pandemic, both in the UK and abroad. With social distancing restrictions likely to continue to at least the end of Q2 2021, we expect that increased food and grocery spend will continue in H1, before gradually reducing from July 2021 onwards. It is important to note a full transference of online spend back to offline is not expected, as for many consumers, the initial barriers to entry for online shopping have been hurdled, and the convenience it offers means the channel will retain a sizeable proportion of its newfound revenue.

Despite the positive outlook for the sector, some foodstore operators have reported that the implementation of social distancing measures has started to temper both their in-store sales and profit margins as they are simply unable to serve the same volume of consumers as before. Furthermore, they have had to increase staff levels in order to implement such social distancing measures. As restrictions tighten in the run up to Christmas, peak online delivery slots are also already at a premium for some major supermarkets, therefore how to continue to meet consumer demand and also turn a profit will remain an important consideration for many brands.

A number of supermarkets have already begun to use digital queuing systems, 24-hour trading and door marshals to avoid problems in what is expected to be their biggest ever Christmas sales period. Over 300 Tesco stores will be open for 24-hour trading in the run up to Christmas Eve, while Tesco has also installed a traffic light system in most stores to regulate the flow of shoppers. Waitrose has launched a queueing app, called Qudini, which enables shoppers to book a shopping time slot remotely, and will also be extending their opening hours. Meanwhile, Sainsbury's supermarkets will do the same, while it is also offering members of its Nectar loyalty scheme extra points if they shop in advance of Christmas week, to persuade its customers to plan ahead.

Looking into 2021, Brexit is the one potential spanner in the works, as it will undoubtedly lead to a disruption in retailer supply chains and their ability to get goods into the UK. Supermarkets have already begun to stockpile food and other goods after being told by ministers that a no-deal Brexit is on the cards. Potential shortages of fresh produce could scupper the strong performance we have seen in the grocery sector, particularly if a no deal scenario leads to tariffs and inevitably increased costs for retailers, which would in turn be passed on to consumers. That said, emergency planners are predicting that no-deal would spark panic-buying on a scale that could dwarf the coronavirus crisis.

Figure 7: Gross sales (% change year-on-year), sees dramatic improvements across all the UK's major grocery operators.

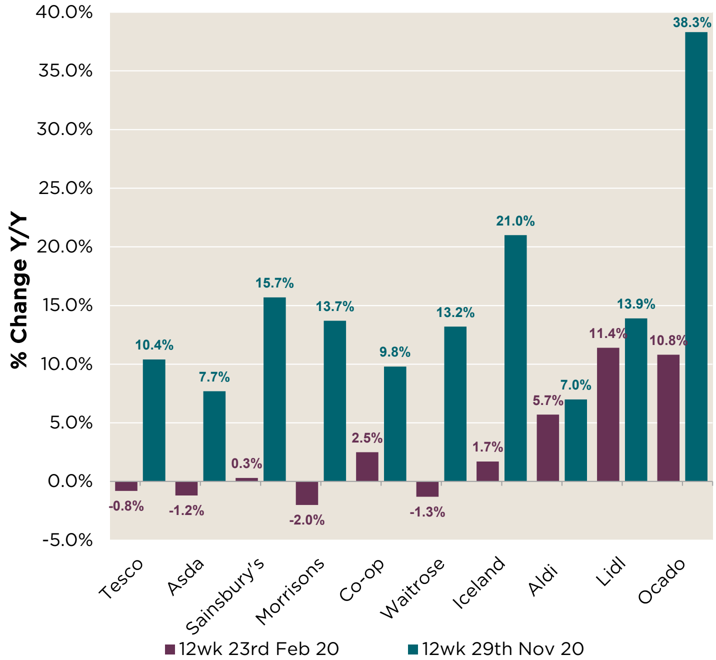
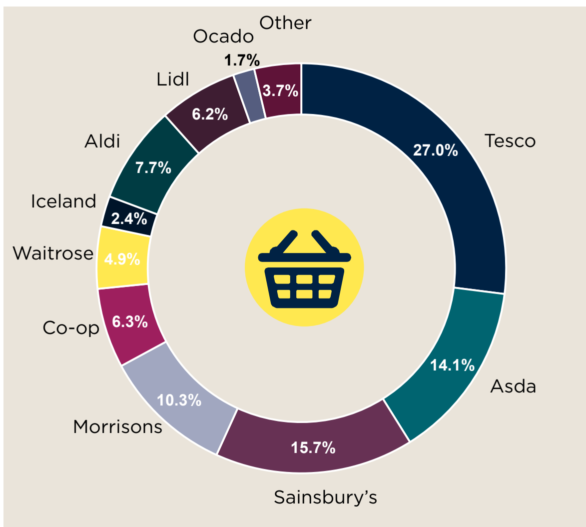


Figure 8: UK market share by grocery brand.



Source Kantar

> "The typical long-lease, inflation-linked structures associated with foodstore assets continues to entice buyers looking for long-term income security."

Resilience in the supermarket investment market

Operational resilience and long-term income security sparks strong appetite for supermarket investment.

While investor demand for retail is generally limited, the ongoing resilience of the supermarket sector has provided a secure investment alternative for many investors.

Supermarket investment volumes this year have been particularly strong considering the disruption to the wider commercial real estate market, caused by the pandemic. Transaction volumes this year to date (January-November 2020) reached £1.38 billion, representing a marginal decrease of -3.9% compared to full-year 2019 levels, however exceeding the five year average of £1.24 billion.

A number of deals due to complete in December is likely to bring full-year volumes closer in line with the heightened levels recorded last year. Meanwhile, in deal count terms, 2020 has already exceeded total 2019 levels by 11.4%, recording 49 individual deals.

Long-term security in the face of a recession supports supermarket investment

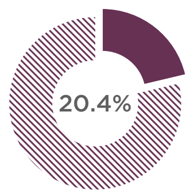
The typical long-lease, inflation-linked structures associated with foodstore assets continues to entice buyers looking for long-term income security, particularly at a time when appetite for risk has faded in the face of an economic downturn. The remaining unexpired lease term on supermarket deals this year-to-date averaged 15.9 years, while 20.4% of all deals were accounted for by inflation-linked long-income assets with over 20 years unexpired terms, representing a substantial increase compared to the 13.6% share recorded in 2019.

Meanwhile, the operational resilience shown by supermarkets this year has largely eliminated the risk of deferred/unpaid rent payments. The largest supermarket landlord in the UK, Supermarket Income REIT, received 100% of rent payments due on both June and September quarterly rent payment dates.

In terms of investor type, UK Property Companies, including real estate investment trusts, have been particularly active in 2020, accountable for a 43.2% share of investment volumes this year to date, totalling £597.4 million. This is primarily a result of Supermarket Income REIT transacting on eight key deals, including the acquisition of a portfolio of 26 Sainsbury's stores from British Land for £102 million in May, in a joint venture with British Airways Pension Fund. Amidst the strength of the foodstore market, Supermarket Income REIT also have begun diversifying their portfolio in terms of tenant mix, acquiring their first Aldi store in early November in Leicester with an unexpired lease term of 25 years. Similarly, LXi REIT Plc have broadened their foodstore network, including the recent acquisition of a mixed-tenant portfolio comprising of 11 supermarkets, totalling £61 million.

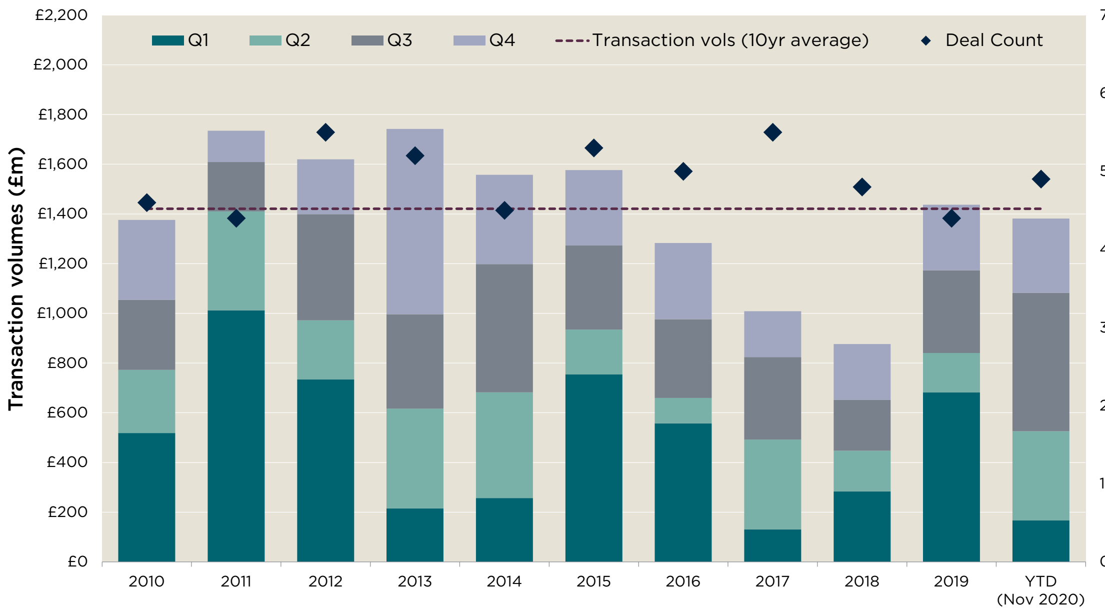
Investment volumes this year-to-date (Jan-Nov 2020) reached £1.38 billion, exceeding the five year average by 11.7%

Deal count this year-to-date (Jan-Nov 2020) has already exceeded 2019 levels, reaching 49 individual deals

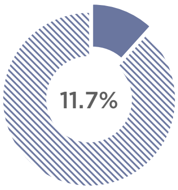


20.4% of deals this year-to-date (Jan-Nov 2020) have been accounted for by inflation-linked, long-income assets (20yr+ unexpired terms)

Figure 9: UK supermarket investment volumes have reached £1.38 billion this year-to-date (January-November 2020), while deal count has already exceeded 2019 levels.

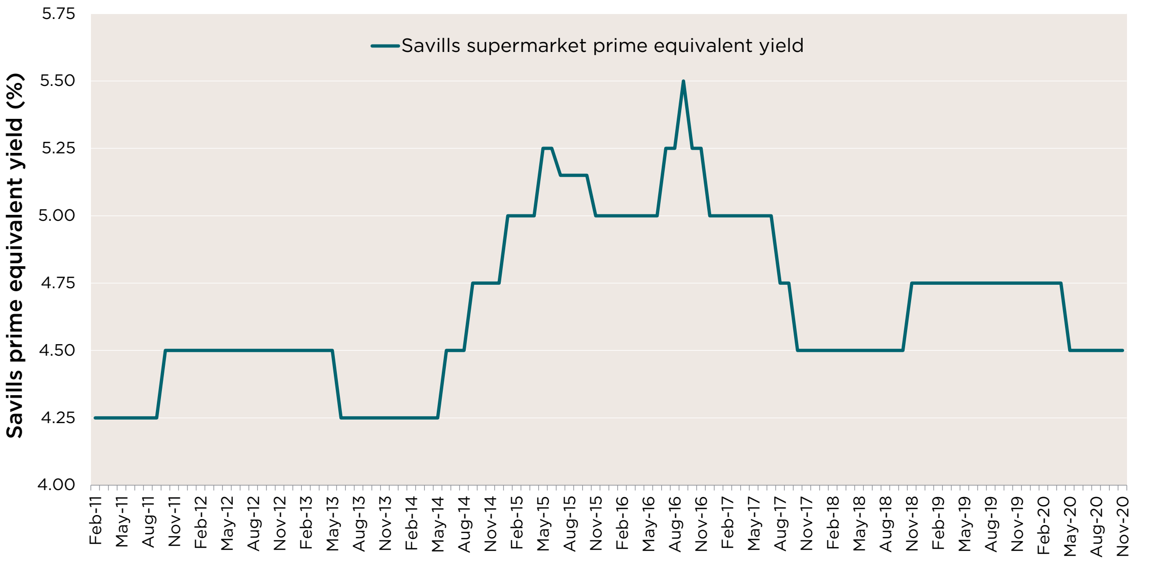


Source Savills Research; PropertyData



Owner-occupiers have accounted for an 11.7% share of total investment volumes this year-to-date (Nov-20), up from a 4.8% share recorded in 2019.

Figure 10: Savills prime equivalent supermarket yields have experienced downward pressure in 2020, reporting 4.50% as of November 2020.



Source Savills Research

Average size of foodstore units sold in 2020 reached 52,000 sq ft, up 9.4% compared to the 2019 average

Some occupiers look to reduce rental exposure while others opt to reinvest capital

One trend we've seen mature in recent years is the completion of buy-back deals, with the trading improvement experienced since the pandemic somewhat exacerbating this trend. Many foodstore operators are now in a strong financial position to take advantage of buy-back opportunities, to increase their freehold portfolio and therefore reduce exposure to future RPI-linked rental escalations and over-rented units.

We've tracked a number of deals of this nature in 2020 and can expect this to continue as we move into 2021. Tesco, for example, have been particularly active in this field, acquiring two of their own stores in Bristol and Kettering for £42 million and £53 million respectively. As a result, owner-occupiers have increased their share of investment volumes this year so far, to 11.7%, compared to a 4.8% share in 2019.

At the same time, there have been a number of deals move in the opposite direction, in the form of sale-and-leaseback transactions. Most notably, Waitrose completed two sale-and-leaseback portfolio deals to Supermarket Income REIT and LondonMetric Property, totalling £74.1 million and £62 million respectively, while involving a total of 11 supermarkets. This has allowed some chains to access capital to reinvest in order to meet the demands of a changing consumer environment – often to improve components of their e-commerce and click & collect business.

In line with rising online penetration rates for food sales, we've seen increased activity involving larger supermarket assets - with the opportunity for operators to provide traditional trading space alongside new online fulfilment centres. As a result, the average foodstore size this year-to-date has reached almost 52,000 square foot, an increase of 9.4% compared to the 2019 average.

Where does this leave pricing?

The continued investor appetite for supermarkets during the pandemic has resulted in the sector bucking the wider retail trend by experiencing downward pressure on prime yields compared to pre-Covid levels. Savills prime equivalent supermarket yields currently stand at 4.50%, representing a 25 basis point sharpening compared to levels recorded pre-pandemic, in Q1 2020.

Looking ahead, the operational strength of the supermarket sector is expected to continue as we move into 2021, resulting in sustained investor appetite. It's therefore reasonable to expect ongoing downward pressure on equivalent prime yields, bringing yields closer to their post-GFC lows of 4.25%.

Prime equivalent supermarket yields have experienced a 25bps downwards shift compared to pre-Covid levels

"The operational strength of the supermarket sector is expected to continue as we move into 2021, resulting in sustained investor appetite and further downward pressure on prime equivalent yields."

Savills Commercial Research
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