UK Commercial – 2022

SPOTLIGHT
Savills Research

UK Grocery Report

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

ONS Retail Price Index increased 7.1% year-on-year in November, the sharpest annual growth since October 1989.

Grocery market remains resilient despite ongoing headwinds

Christmas sales performance across UK supermarket chains remains strong compared to pre-pandemic levels, however cost pressures continue to impact grocery retailers.

Despite dampening consumer confidence in Q4 2021, supermarkets reported strong Christmas trading results
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 has since begun to wane in line with concerns over the Omicron variant, rising living costs and supply chain disruption. Consequently, GfK's consumer confidence index fell in the final quarter of 2021, reaching -15 in December (albeit still 11 points higher than December 2020 levels).

For the case of the grocery market, consumer spend has reported strong monthly growth compared to 2019 equivalent levels, while in-store supermarket visits reached their highest point since March 2020.

In the 12 weeks to 26 December, grocery sales reached £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.

Headwinds persist in the grocery sector, with costs pressures continuing to increase
While sales performance paints an encouragingly positive story for supermarkets, there are still a number of noteworthy headwinds facing the sector.

Most grocers are experiencing significant staffing shortfalls in the face of Omicron and self-isolation regulations. For example, Iceland recently announced that one in ten of its workforce are currently in self-isolation.

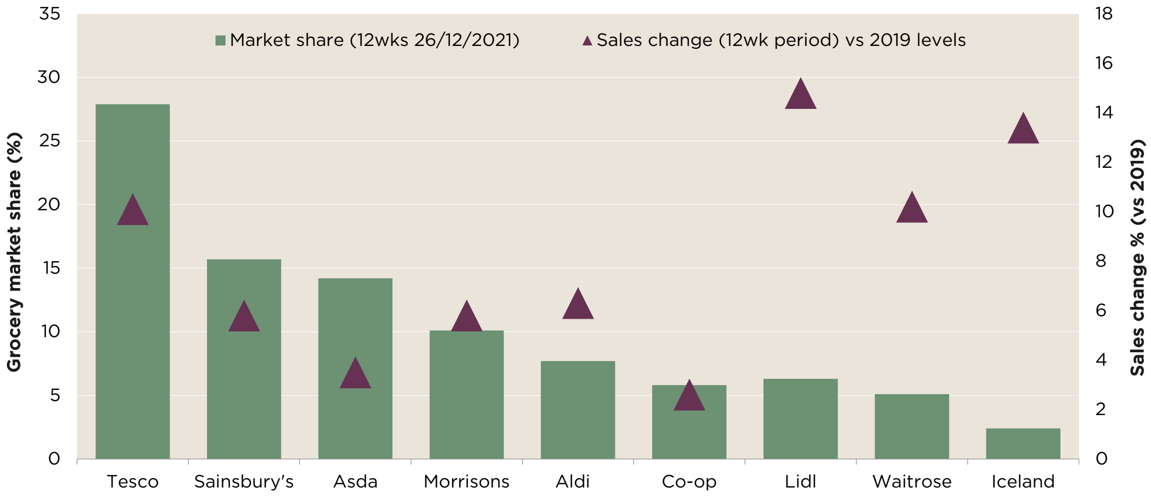
Meanwhile, global supply chain disruption and a shortage of HGV drivers continues to impact UK supermarket supply, while rising fuel and energy prices continue triggering sharp inflation. As retailers are not able to absorb all of the aforementioned cost pressures, we've experienced a rise in the price of many products. The ONS Retail Price Inflation index reached 7.1% year-on-year growth in November 2021, representing the highest year-on-year growth since October 1989. Kantar estimate that grocery price inflation increased to 3.5% in December, adding an average £15 to consumers December grocery bill.

Further consumer price growth could generate more cautious spending amongst shoppers. In turn, this could support demand for grocers within the budget end of the scale. This, coupled with substantial portfolio growth this year amongst the likes of Aldi and Lidl, could support a boost in sales and potentially a further shift in grocery market share in 2022.

8.0%

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.

Figure 1: UK grocery sales performance over Christmas reported significant growth compared to equivalent pre-Covid, 2019 levels.



Source Savills Research, Kantar

-15

GfK's UK consumer confidence index fell in Q4 2021, reaching -15 in December, albeit still 11 points higher than December 2020.

> “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 which will likely hinder positive market growth over the next twelve months but, 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 (figure 2).

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 3).

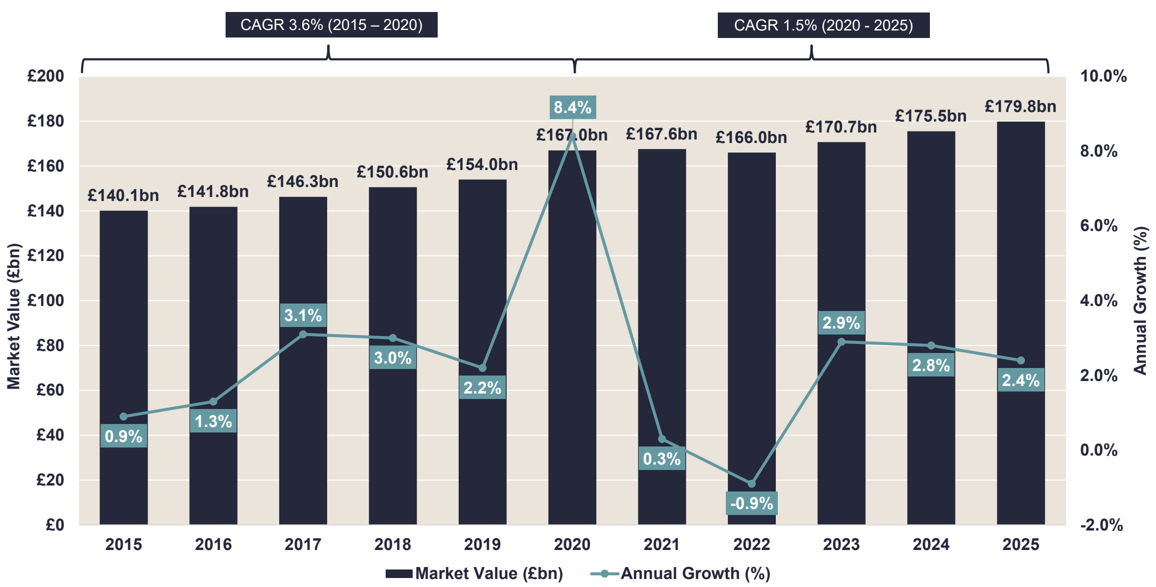
Nevertheless, it is important to remember that consumers are under increasing financial pressure as the costs of living continue to rise. With grocery price inflation set to reach 4.0% in 2022, retailers are being forced to pass some of the pressure onto the customer. In fact on average the recent increase in inflation has added an additional £15 to shoppers’ monthly grocery bill as of the end of 2021.

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 (figure 4).

Supply chain issues will also 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. According to GlobalData 39.3% of UK consumers surveyed in November 2021 stated they have noticed less products in stock than usual. This will no doubt continue to frustrate the consumer, which potentially may also lead to further reductions in spending or indeed a tendency for consumers to trade down.

In the immediate term the grocers will push back on suppliers, increase own brand sourcing, source more from UK and take a hit on profit as they invest in price and reduce

Figure 2: UK Food & Grocery Market Size, 2015-2025



Source GlobalData

With grocery price inflation set to reach 4.0% in 2022, retailers are being forced to pass some of the pressure onto the customer.

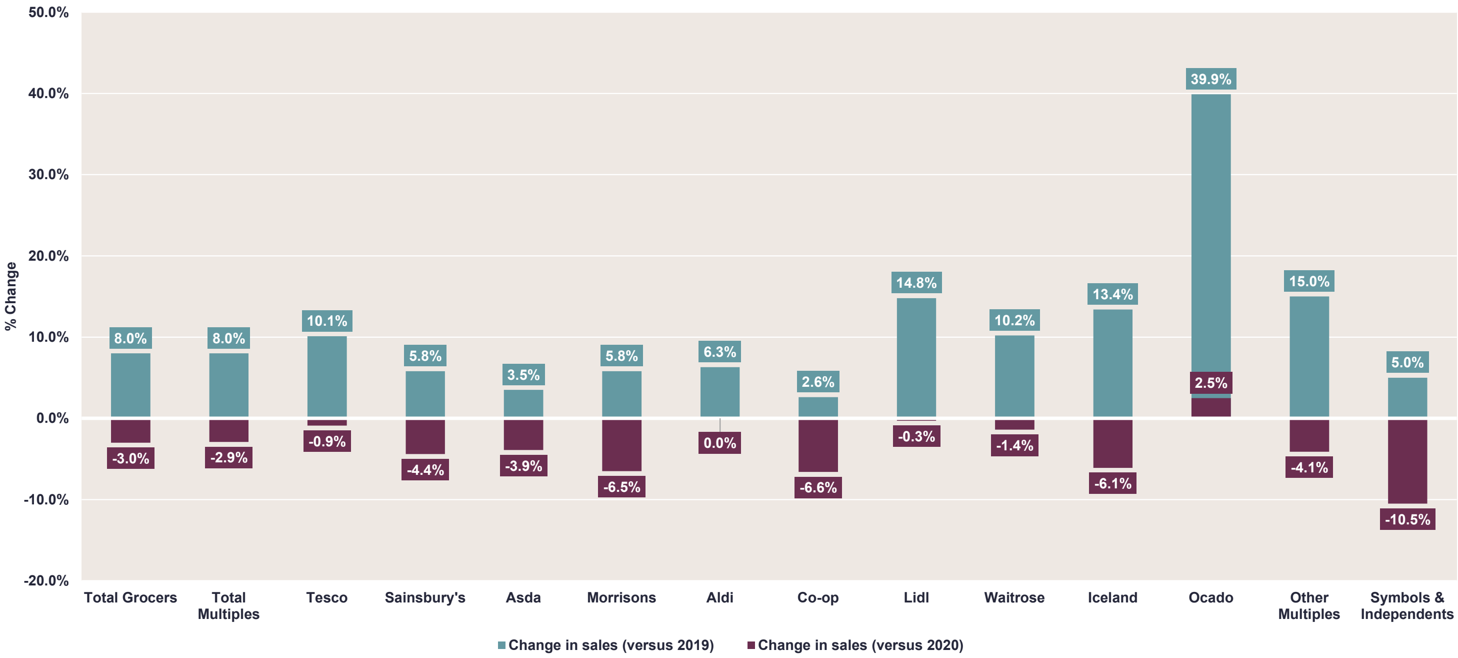
On average the recent increase in inflation has added an additional £15 to shoppers’ monthly grocery bill as of the end of 2021.

Source Kantar

margins. However, long-term, retailers will be forced to cast their nets wider in terms of their supplier base to avoid empty shelves and gaps in their propositions.

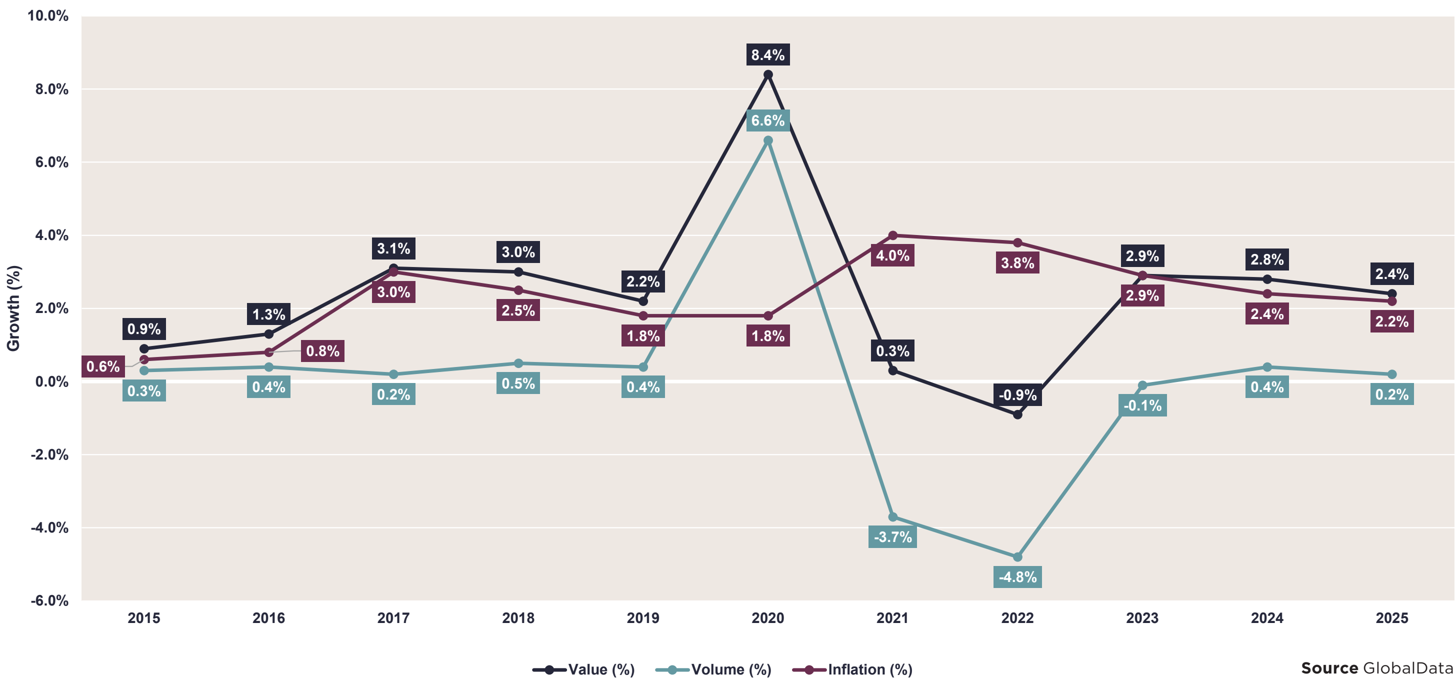
GlobalData's November survey also highlights that as much as 27.9% of consumers that have experienced stock shortages stated they didn't purchase a replacement item to replace the one they wanted, highlighting the importance of managing supply chain strategies' to avoid lost revenue. Such strategies are likely to include; fragmenting their supplier base to mitigate capacity constraints at the individual supplier level; considering long term supplier contracts to reduce price volatility; optimising warehouse efficiency and capacity; investing in a dedicated or an in-house delivery fleet to avoid disruption outside their control; and increasing their investment in automation to not only aid efficiency and the smooth running of supply chain processes but also to avoid long term labour shortages. Fortunately the grocery sector is at the forefront of innovation in this regard, with many retailers rapidly improving 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.

Figure 3: Total Till Roll - Consumer spend for 12 weeks to 26 Dec 2021



Source Kantar

Figure 4: UK Food & Grocery Market Sources of Growth, 2015-2025



Source GlobalData

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.

+180%

increase in online grocery demand (since the onset of COVID-19)

80%

of all UK online orders fulfilled via omni-channel stores

100%

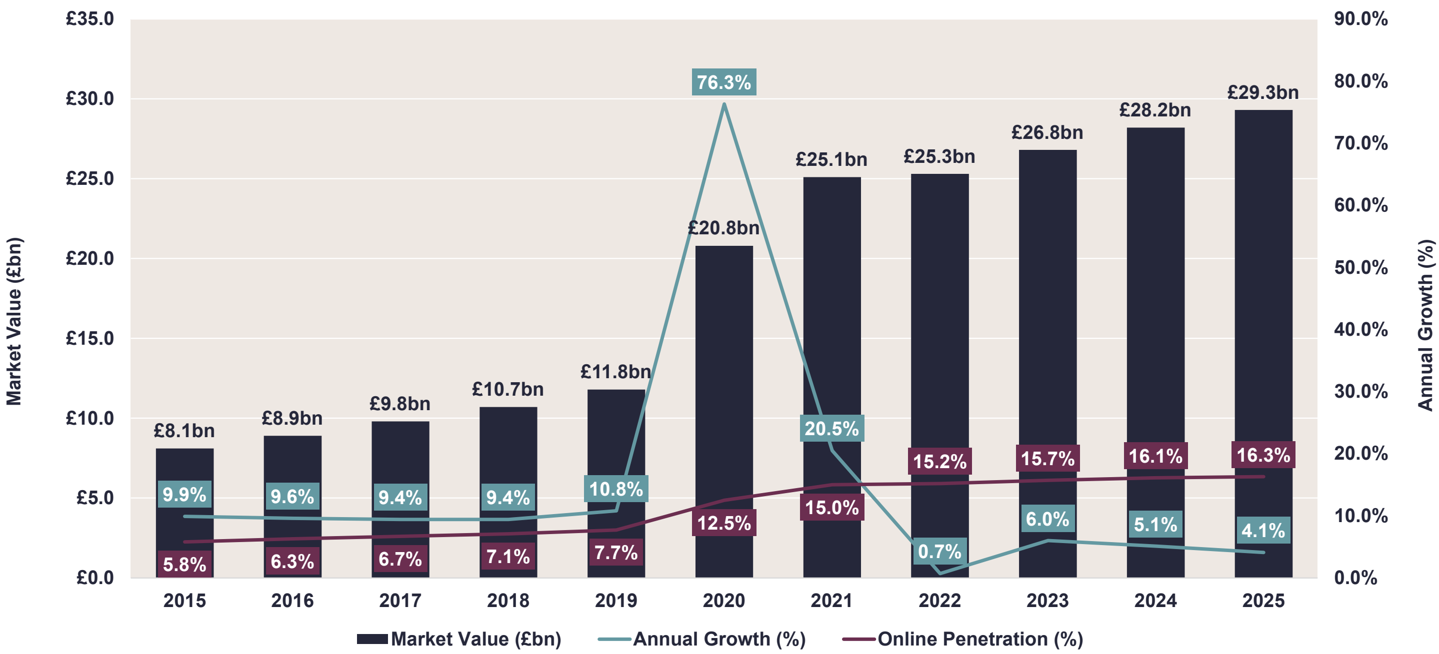
online margins now at near parity with instore sales

30mins

average drivetime to customers - key to lowering fulfilment costs

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

Figure 5: UK Food & Grocery Online Market, 2015-2025



Source GlobalData

Despite the explosion in online food and grocery sales during the pandemic, 2021 posted 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. 48.7% of food & grocery shoppers in the UK purchased grocery items online, up from 47.4% seen in 2019 - the equivalent to an extra 985,000 shoppers. When combined with existing online shoppers spending more and purchasing more frequently, grocers where forced to rapidly accelerate their online expansion plans to increase capacity, including increasing the number of their weekly slots, the rollout of instore picking and click & collect, configuring new fulfilment stores and launching rapid delivery options.

Despite these 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 (figure 5).

Consumers have 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 driving consumer interest.

Q-commerce provides convenience and agility in last mile delivery, serving customers that want to avoid visiting physical stores for small basket sizes or last minute goods. Investment in rapid delivery, partnerships with logistics specialists and the rise of grocery start-ups specialising in fast delivery will therefore continue to support spending in the online grocery sector. The ease of having items delivered to home or work within 30 minute time frames encourages spending, add on purchases and protects grocers and convenience stores from losing spend to food service providers.

Although Q-commerce has the positive benefit of supporting growth, it is indeed another channel and route to market for the grocers to get to grips with, adding further complexity to their supply chains. Nevertheless, according to GlobalData 38.3% of consumers in the UK have used a rapid delivery service in 2021 and 73.1% of these have used the services for purchasing groceries, as opposed to just food service/takeaways.

Specialists Gorillas and Getir, who make local grocery deliveries from dark stores in under an hour, have both become major international players in the Q-commerce space in recent years. As such major UK grocery operators have been forced to compete through 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 have also announced a trial partnership with Gorillas, which would prove to be a major step forward for rapid delivery market if rolled out nationally, and are further trialling a partnership between its One Stop stores and Deliveroo. Meanwhile, Aldi and the Co-op have also 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.

Q-commerce of course will only be effective if it can prove to be a sustainable channel, thus the rapid delivery specialists and the leading grocers must meet environmental demands through providing last mile delivery via bicycles, electric cycles, or two wheel delivery while also minimising their packaging.

New grocery store openings remain significantly above the decade average for 2021, dominated by the aggressive portfolio expansion of the discount operators. GlobalData forecast that by 2025 the UK food grocery sector will reach £180 bn, up 7.7% on 2020 however, that will involve very little growth in volumes over that period with consumers disposable income under increasing financial pressure as the costs of living continues to rise.

Food will continue to command a greater share of consumers monthly spend and will of course force them 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 6). 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.

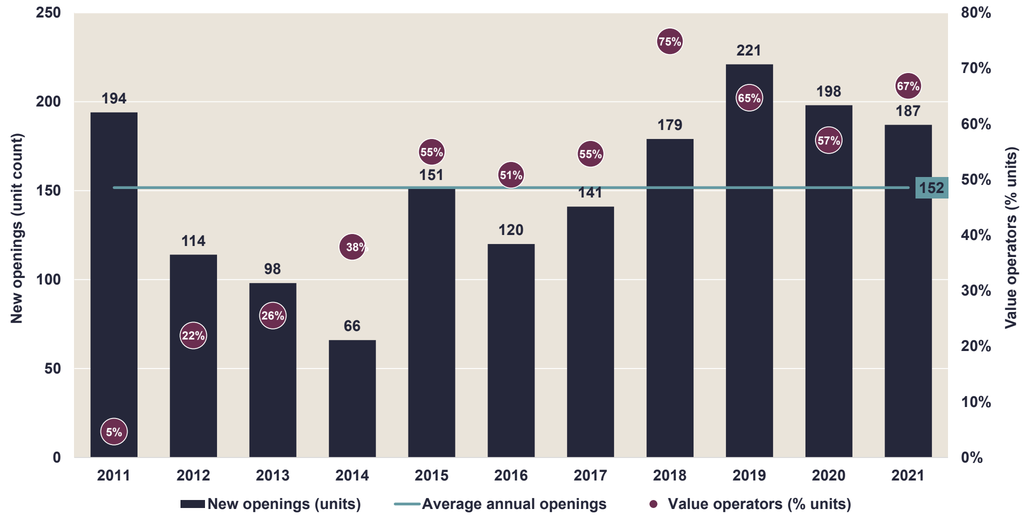
Lidl and Aldi have remained the two most acquisitive brands across the whole of the retail warehouse sector in 2021 with 53 and 42 new stores respectively, a position they have occupied for each of the last 3 years. With both operators stating they are each looking for at least 50 stores each per annum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

In GlobalData's 2021 How Britain Shops survey of 10,000 consumers, 46.1% of Tesco shoppers said they also shop in Aldi, whilst 41.5% said they also shop in Lidl. For Sainsbury's the proportions are similar with 45.6% of their customers also shopping in Aldi, and 41,6% in also making purchases in Lidl. Reducing that competitor overlap with the discounter operators by investing in value in their own offers, will be a key driver for some of the UK's major grocery operators going forward.

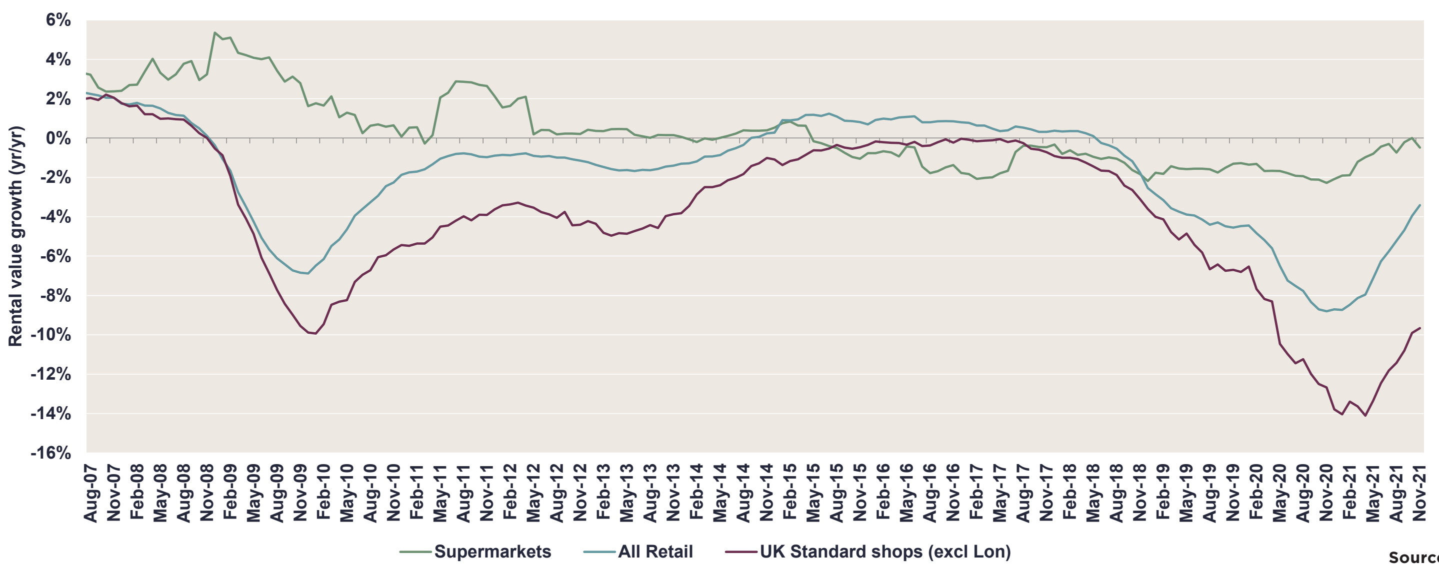
The buoyant acquisition activity we have witnessed in the out-of-town grocery sector in particular, has clearly been influenced by the decline in retail rents we have witnessed amidst the structural change in recent years. As we continue to see rents retail rents decline across the retail sector, the 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 7 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 November 2021, By contrast it stands at -9.7% for UK standard shops (excluding London) and -3.4% for all retail, 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 6: New openings per annum (including proportion of Value operators)



Source Savills Research

Figure 7: Rental value growth: MSCI monthly index



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.

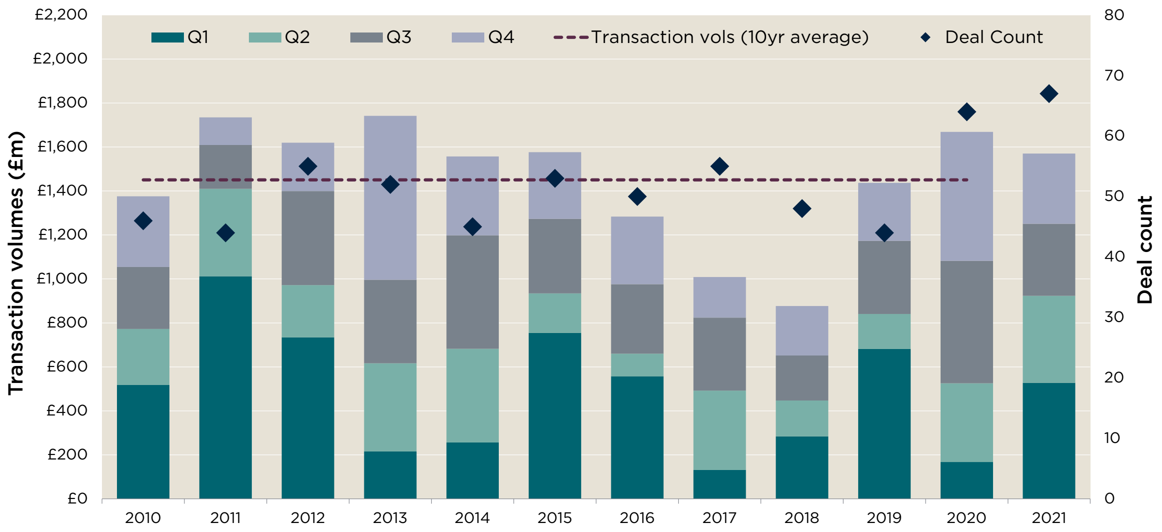
Investor demand continues applying downward pressure on prime supermarket yields

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 25bps keener than 2019 levels, at 4.50%.

Despite recent yield hardening, the spread between prime supermarket yields and ten-year government bonds has widened substantially since 2017. The current yield spread stands at 376bps, considerably higher than the long-term (ten-year) average of 299bps. 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 9: 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.376bps in 2021

Savills Commercial Research

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