The UK grocery market: ripe for disruption

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Contents

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Main responsibilities

Jonathan manages Aviva Investors' Real Estate Research Team thought leadership and insight program. He is also responsible for developing a house view on the attractiveness of specific UK and Irish property sectors and investment strategy for our UK and Ireland focussed real estate funds.

Experience and qualifications

Prior to joining Aviva Investors, Jonathan worked in JLL's Retail Research and Consulting team, in the UK and Europe. Jonathan holds an MSc in Real Estate from University of Reading's College of Estate Management and a BSc in Geography from University College London. He is a member of the ULI, SPR, Revo and the ICSC.

Introduction

This paper explores the structural change facing the grocery sector and the implications for the future of the convenience and supermarket sector.

First, we review the recent changes and challenges unfolding in the sector. Initially we do this by distinguishing between high- and low-engagement products. We then show how extensive networks have left incumbent players vulnerable as new forms of retail: online, convenience and discount have widened customer selections.

It is this increase in choice that has led consumers to shop more often. The new types of retailing and new shopping habits have forced operators to make significant changes. We see this as a trend in its infancy. Major structural change is underway and, looking ahead, more disruption and growth will be supported by technological advances.

Second, we look to the successful grocery stores of the future. In the long term, supermarkets will continue to have a major presence on the retail landscape, but demand for much of the existing supermarket space is set to weaken. At 40,000 square feet, roughly two-thirds of a football pitch, supermarkets will have enough space for a significantly broad offering. They will also have sufficient space to provide engaging in-store facilities and leverage technology and click-and-collect operating models. The outlook for well-located convenience stores is also likely to be positive. They will receive sustained consumer demand and be able to compete with e-commerce. For larger stores, the outlook is much weaker as demand from grocers is likely to be muted.

Finally, we conclude with the strategic implications for real estate investors:

- The grocery sector is ripe for disruption. A dramatic change of landscape should be expected in the medium term.
- Landlords must understand a site's catchment and competition so that they can respond to changing occupier requirements and deliver sustained performance.
- To be successful in the long term, supermarkets will have to significantly broaden their offering, embracing new technology and offering engaging in-store activities.

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For products, like soap, detergent and other household goods, there will be a **greatly reduced role** for physical stores.

The supermarket sector: recent changes and challenges

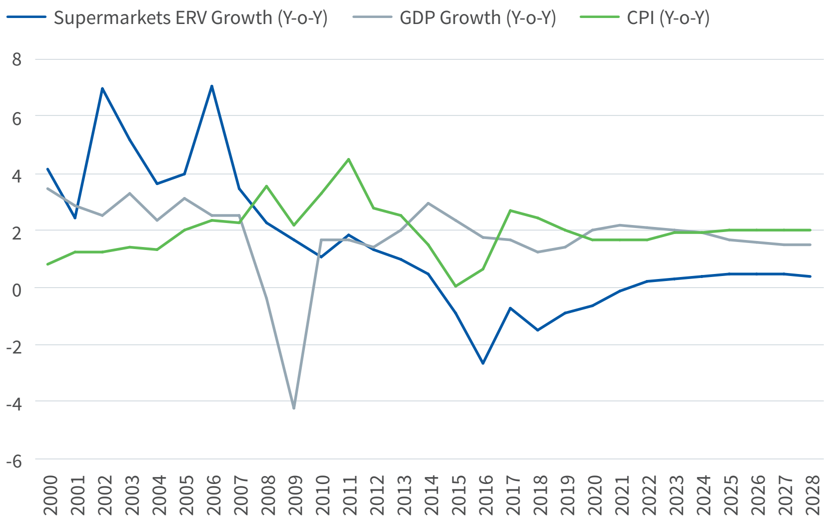
High-engagement and low-engagement products

Not all products are made alike when it comes to generating an attractive shopping experience. High-engagement products have ability to generate a shopping experience full of discovery and interaction. In the context of grocery this is chiefly fresh produce. Low-engagement products, on the other hand, are mundane purchases where speed, efficiency and price are the main concerns. For such products, like soap, detergent and other household goods, there will be a greatly reduced role for physical stores. To compete with online shopping, physical stores need to focus on high-engagement products and on creating locations with strong destination appeal.

Extensive networks left Big Four vulnerable

Historically, grocery stores were in the busiest town-centre locations as they had the best access to the greatest numbers of consumers. With the proliferation of the car and supported by the economies of scale, grocers moved to larger out-of-town stores in the 1970s. The out-of-town space race heightened after the millennium, with the Big Four of Tesco, Sainsbury's, Asda and Morrisons solidifying themselves as the main players. Grocers and investors both sought the profitability of larger sites in accessible locations, providing consumers with an ever expanding choice of products. But over the last few years, consumers have been choosing to make smaller but more frequent grocery shops.[1] Combined with the rise of the discounters, this has left large supermarket chains with too much space where their occupancy costs, chiefly rents and business rates, are too high. Rents being too high is evidenced by supermarket rental growth underperforming both CPI and GDP growth since 2012.

figure 1. **Supermarket ERV, GDP and CPI Growth**



Source: PMA and Oxford Economics October 2018

1. Mintel – UK Convenience Market Report 2018

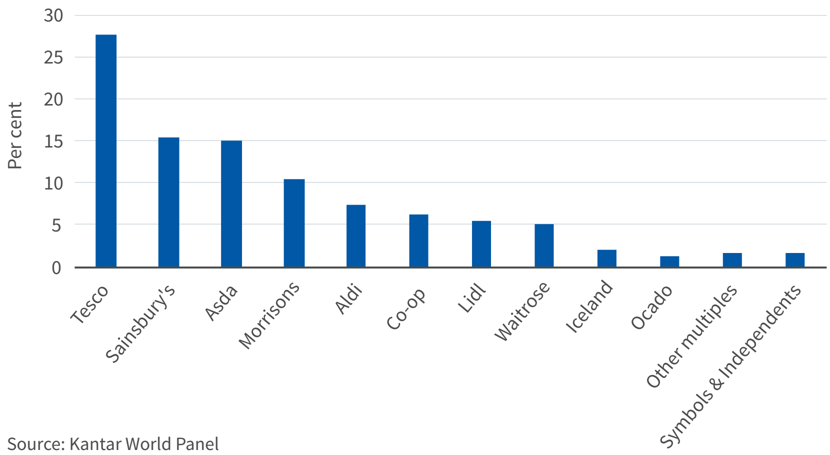
Discounters' expansion changed landscape irrevocably

The German discount grocers, Lidl and Aldi, started trading in the UK in the 1990s. Initially, catering for lower income consumers. From around 2014, they began to expand into the territory of the Big Four; both in terms of location and offering. This broadened the appeal for consumers and the superstore's importance diminished. The discounters' sales now account for 5.4 per cent and 7.4 per cent of the market respectively. As a result, the Big Four have seen their collective market share drop. Aldi and Lidl's growth aspirations show no signs of abating either. Aldi have asserted that they want to double their estate to approximately 1,500 stores. And Lidl plan to drastically expand their network further, having recently on-boarded external advisers to help realise their goals.

Consumers shop more frequently and want richness of experience

Over the last ten years, consumer preferences have changed significantly. There has been a substantial shift towards authentic and engaging shopping experiences. Control and richness of experience have become increasingly important to modern consumers. Eating out has increased, as has eating fresh and healthier food. But the most important change in consumer habits is how regularly consumers visit grocery shops. Over the last ten years, people have been doing smaller but more frequent shops.[2]

figure 2. **UK grocery market share**



Source: Kantar World Panel

Aldi have asserted that they want to double their estate to approximately 1,500 stores.

Convenience is the oldest and yet fastest growing sector

The changing consumer trend has prompted grocers to increasingly open smaller outlets. Ultimately, price but also speed and efficiency are more fundamental than ever. As a result, convenience store sales are forecast to grow around 5 per cent over the next five years.[3] It has been a fast maturing sector with significant M&A recently; Tesco-Booker and Co-op-Nisa.

Online revolutionised shopping: further crimping margins and bringing new entrants.

Online shopping has greatly reduced many of the costs and hassles related to all types of shopping in physical stores. These include transport and time costs, queuing, difficulties locating products and lack of assistance in-store. These changes have given rise to new levels of expectation of convenience and personalisation. Despite this, online food sales only sit at 7 per cent[4], compared with closer to 20 per cent for the wider retail market.[5] Grocers have struggled to operate their online businesses profitably, with the highest cost being last mile delivery. Retailers will need to do more drop-offs in smaller timeframes; outside of built up, urban areas this will be hard to achieve. Tesco and Sainsbury's both claim their online businesses are money-making, but this is in part due to scale. However, Ocado, the only UK pureplay grocer, notably makes their profits from licensing technology internationally. Morrisons has also reverted to delivering goods from their stores.

2. Mintel – UK Convenience Market Report 2018
3. Global Data - Convenience Retailing in the UK 2017

In the future, given Amazon's scale, an acquisition of any current player is possible.

Against this backdrop, supermarkets continue to restructure and change

The Big Four have lost market share and tried to match the discounters where possible on price. All have reduced costs, simplified their business models and invested in own brand products (the most profitable line). Tesco have even launched a competitor in the discount space, Jack's. Meanwhile, the Sainsbury's-Asda merger is likely to be approved by the Competition and Markets Authority, but will mean store divestments. Tesco's recent partnership with Europe's leading grocer, Carrefour, will also make the landscape more competitive.

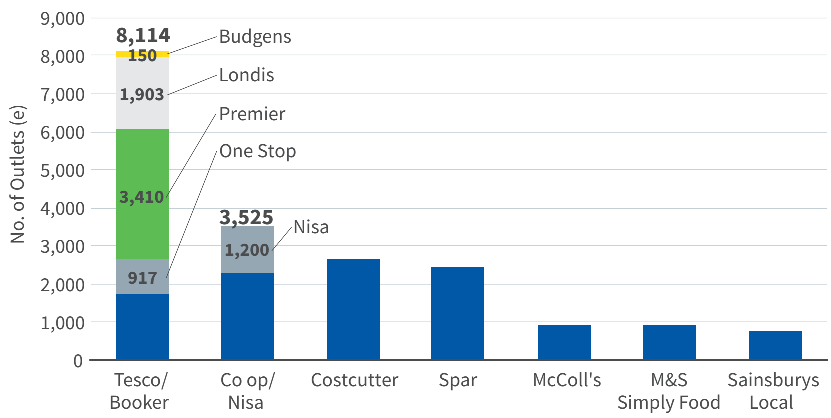
More disruption and growth expected in the UK online grocery sector

In the long term, we anticipate the Big Three (following the Sainsbury's Asda merger) to succeed in making online sales profitable. Grocers will need to find ways to reduce online distribution costs and scale will help. Sainsbury's integration of multi-channel leader, Argos, into stores points to a way forwards. The Asda deal should further improve distribution capacity. As will leveraging current space via click and collect.

Technological advances will support online profitability

Eventually, technology will have the most direct impact on online profitability. Notably, Amazon is a relatively dormant player; so far making only small waves. In 2016, it acquired upscale grocer Whole Foods, which has a small number of stores in the UK. It has also introduced Amazon Fresh, Amazon Pantry and partnered with Morrisons. In the future, given Amazon's scale, an acquisition of any current player is possible. Investors and retailers should expect further change in the sector from either the incumbents or a disruptive competitor.

figure 3. **Leading Convenience operators by Outlets (Post-Consolidation, current fascia levels)**



Source: Mintel & Knight Frank August 2018

Successful grocery stores of the future

Against the backdrop of change in and outside of the industry, to be successful in the long term, supermarkets will have to significantly broaden their offering. The outlook looks bleak for stores where shopping is a chore, but more positive for stores that are enjoyable places to spend time in. At 20-40,000 square feet, stores will be able to sell everything people need on a fortnightly basis. They will also have sufficient space to provide engaging in-store facilities, utilise technology to help the shopping experience and be able to leverage click-and-collect successfully. The outlook is also likely to be positive for well-located convenience stores. They should receive sustained consumer demand and be able to compete with e-commerce in terms of convenience. For larger stores, the outlook looks much weaker as demand from tenants is likely to be muted.

Location and competition important as ever

The economic strength of the catchment, including growth of the population and labour force, can help gauge likely investment performance.
New developments, extensions or divestments in competing markets may change shopper populations and market share. If several grocers close, being the last supermarket left in a catchment could be a positive for that location. Landlords must be aware of this before making investment decisions. Real estate is a local asset class in which deep expertise gives investors a competitive advantage.

Large stores with lots of low- engagement products are a thing of the past

The outlook for very large supermarkets, those over 60,000 square feet, is bleak. Especially in areas of low footfall and competitor saturation. These stores are most likely to be adversely impacted by e-commerce and technology. Many products sold in larger supermarkets are low-engagement. For the likes of soap, detergent and sanitary products, it is far more difficult to create a shopping experience full of discovery and excitement. Therefore, such assets are threatened by the growth of shipping direct from manufacturers to consumers.
Investors should take great care when considering investment, particularly if there is no credible alternate use such as residential.

The right size is important

Appropriate scale is critical. This trend suggests that supermarket floorplates will reduce in size in coming years. Repositioning of sites will be necessary in many cases. A 20,000 to 40,000 square foot store can accommodate between 2,400 and 4,000 product lines; or in other words, everything people need on a bi-monthly basis. At this size, supermarkets can focus more heavily on adding higher-engagement offerings and investing in in-store staff.

New experiences will broaden appeal

Successful supermarkets will continue to significantly broaden their offering to create destinations. Stores will need to offer more personalised in-store activities; like cooking courses and wine tasting evenings. New types of facilities will be needed in many supermarkets too, such as butcheries, bakeries and deli facilities. While in-house restaurants and coffee shops may provide a means of adding to the experience as well. Sufficient space for click and collect operations could increase resilience too.

New technology will improve usability

Grocers will need to embrace technology like "Just Walk Out" check-out systems or digital displays that show personalised information. In fact, 70 per cent of British millennials want more in-store technology, while over two-thirds (69 per cent) of respondents aged 24-35 claimed they would be more likely to shop with a retailer that was enhancing the shopping experience with innovative technology.[6]

4. Global Data - Convenience Retailing in the UK 2017
5. British Retail Consortium - Third Quarter Report 2018
6. Hiatchi Consulting August 2018

The outlook for very large supermarkets, those over 60,000 square feet, is bleak.

The most attractive of these are stores smaller than 3,000 square feet and situated in dense urban areas.

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Demand for speed and efficiency to drive convenience

Within the supermarket segment, convenience stores are expected to continue to meet customer needs well. These are benefiting from changing shopping patterns – online for the bulky items, convenience stores for fresh produce and other urgent goods. The most attractive of these are stores smaller than 3,000 square feet and situated in dense urban areas. They offer hyper-convenience in terms of proximity to transport nodes and are dominant in a dense, relatively affluent catchment area and can compete with e-commerce. Smaller stores must be relevant to the demands of a reduced catchment. Awareness of how profitability differs in convenience stores is important. Basics like milk, alcohol, bread and cigarettes are demanded by customers but not particularly lucrative. Higher margins are made on ready meals, fresh produce and food-to-go.

Accessibility and building specification is crucial to performance

Easy-to-shop stores are crucial to successful supermarket investments. Good visibility and access from roads, no mezzanine floors, ample free parking spaces and no travellators are essential to make shopping experience frictionless and ensuring the resilience of supermarket assets.

Strategic implications for investors

1 The grocery sector is ripe for disruption. A dramatic change of landscape via merger and acquisition activity and more importantly technology should be expected. Both could radically change the grocery sector landscape in the medium term.

2 Real estate is a local asset class in which access to information gives investors a competitive advantage. Investors with the greatest specialist expertise are therefore the best positioned to create value through asset management and by sourcing buying and selling opportunities. By developing deep expertise, investors position themselves to make the large conviction calls that are required for sustained investment out-performance. Landlords must understand a site's nuanced characteristics, the overall demographic catchments and competition so that they can respond to changing occupier requirements and deliver sustained performance.

3 To be successful in the long term, supermarkets will have to significantly broaden their offering. They will also have sufficient space to provide facilities like butcheries, bakeries and delis, for example. While in-house restaurants and coffee shops may provide a means of adding to the shopping experience.

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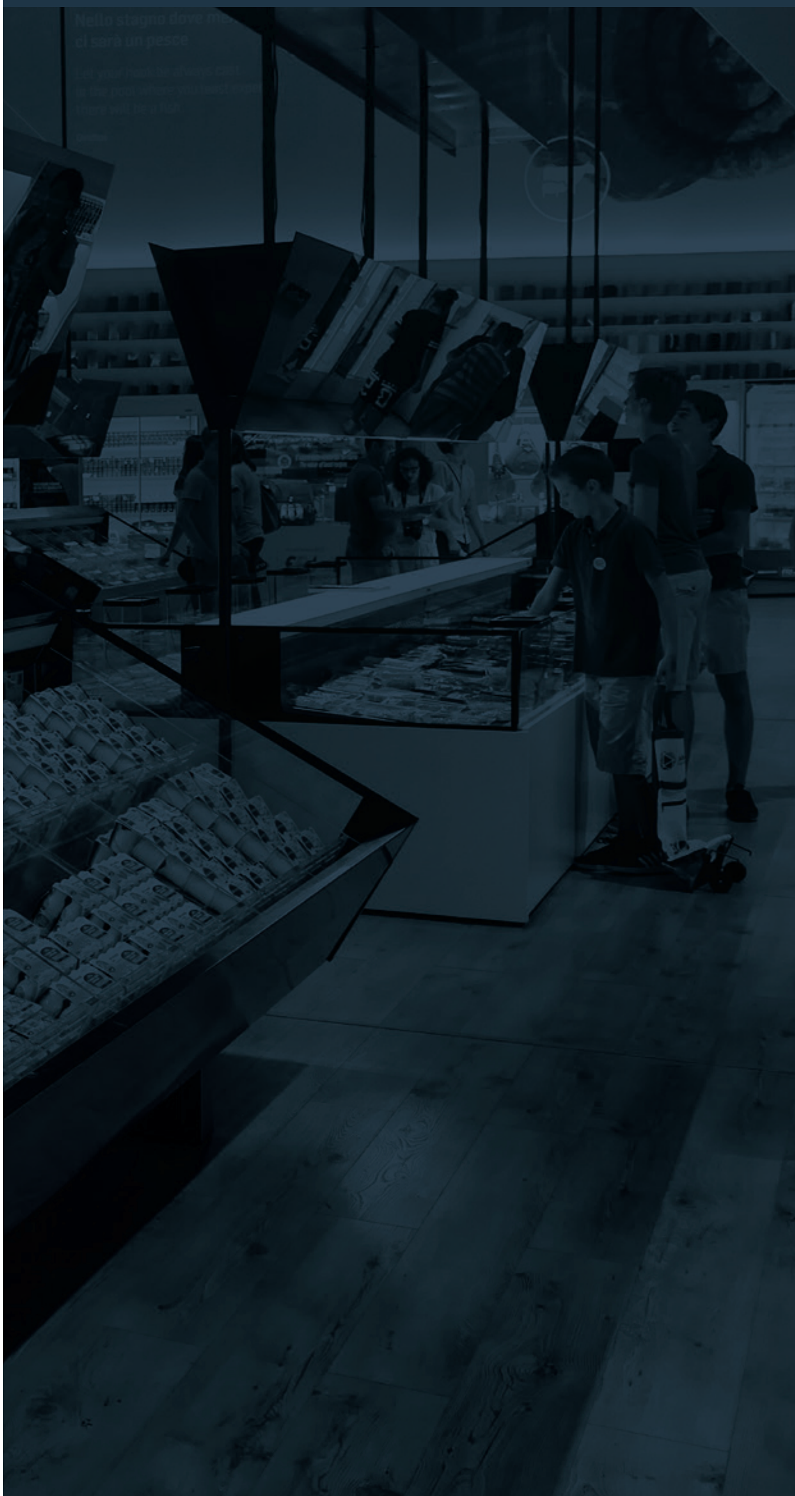
Notes



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