RETAIL NEWS

JANUARY 2016

INTRODUCTION

In our second newsletter we are featuring Supermarkets which, as a sector, has had more than its fair share of column inches in the business press in the past 18 months.

In this edition we have posed the question as to whether we have reached the nadir of the perfect storm for the 'Big Four' operators of Tesco, Sainsburys, Asda and Morrisons and also whether the discounters, who have been part of the cause of their demise, can continue their current levels of growth going forward.

There is now no doubt that the sector is far more sophisticated than most people had appreciated, with a wide number of variables which can significantly impact on the profitability of stores. Furthermore, omni-channel retailing is a fact of life for the major operators, whether they like it or not.

We are very fortunate to have been able to interview Andy Clarke, the President and CEO of Asda Stores in the UK for this edition and gain the benefit of his insight into the major issues facing Asda and his principal competitors.

Despite all the noise, the large supermarket / superstore remains the backbone of the 'Big Four's' estate. There are reasons to be cautiously optimistic and our research and insight supports this view. Whilst some of the headline statistics can be depressing from a real estate perspective, the underlying fundamentals of the sector are still very strong provided you are able to understand the market nuances at a micro and macro level.

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FOODSTORES:

WAKING UP TO A NEW REALITY

The UK foodstore market is in the throes of unprecedented change. A multitude of factors have conspired to create what is widely – but erroneously – described as a perfect storm. Storms eventually pass, whereas what we are witnessing here is permanent, structural change.

Every aspect of the proverbial rulebook is being re-written, as the foodstore operators grapple with the scale of this change. With no respite, their actions are often tantamount to open heart surgery. The major grocers are simultaneously reappraising every aspect of their respective business models, from the products they stock, to the price they sell them for. Financial models and capital expenditure plans are also subject to drastic review and there is arguably more pressure on the balance sheet than ever before.

At the heart of this malaise lies a simple but massively de-stabilising factor: the UK grocery market is currently contracting, rather than growing. In simple terms, we are spending less on our grocery shopping now than we were. This market contraction is alien to the foodstore operators, whose very ethos has historically been conditioned upon market growth, be it volume- (ie the number of goods sold) or value-based (ie the cash received for goods sold). When volumes have faltered in the past, inflation has more than compensated. In contrast, the heavy deflation we are currently experiencing is only partially being offset by patchy and erratic volume growth.

A combination of adverse factors underpin the wider industry slowdown. These include:

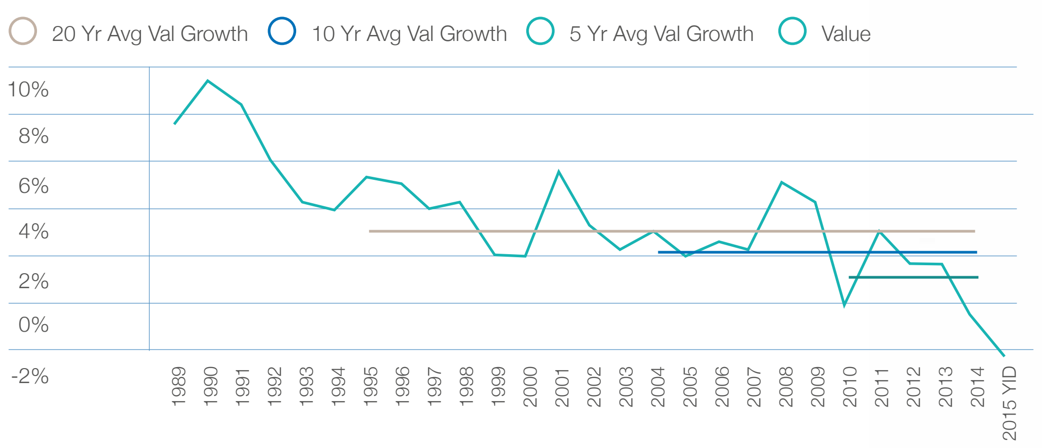
- A decline in 'one-stop' shopping at superstores
- Consumers shopping more often, but buying less
- Lower wastage
- The rise of online shopping and the cost implications of order fulfilment
- The rise of the discounters and the wider implications on industry pricing

Property is by no means immune to this reappraisal process – in many respects, it is central to it. Real estate strategies have been hastily redrawn and every accepted norm or rule of thumb has been challenged. A vibrant development pipeline has slowed to a trickle, the parameters of what makes a new site financially viable have shifted, the values of many supermarket assets have been subject to severe writedown and what constitutes an affordable rent is open to renewed debate.

Amidst the turmoil lies opportunity. As much by default as by design, the 'Big Four' operators have had to take a far more proactive approach to their respective property portfolios. So-called 'land banks' are slowly being dismantled and previously ring-fenced freehold assets are coming to the market.
The space race, as was, has certainly ended, but arguably there is more opportunity now on the property side than there was before.

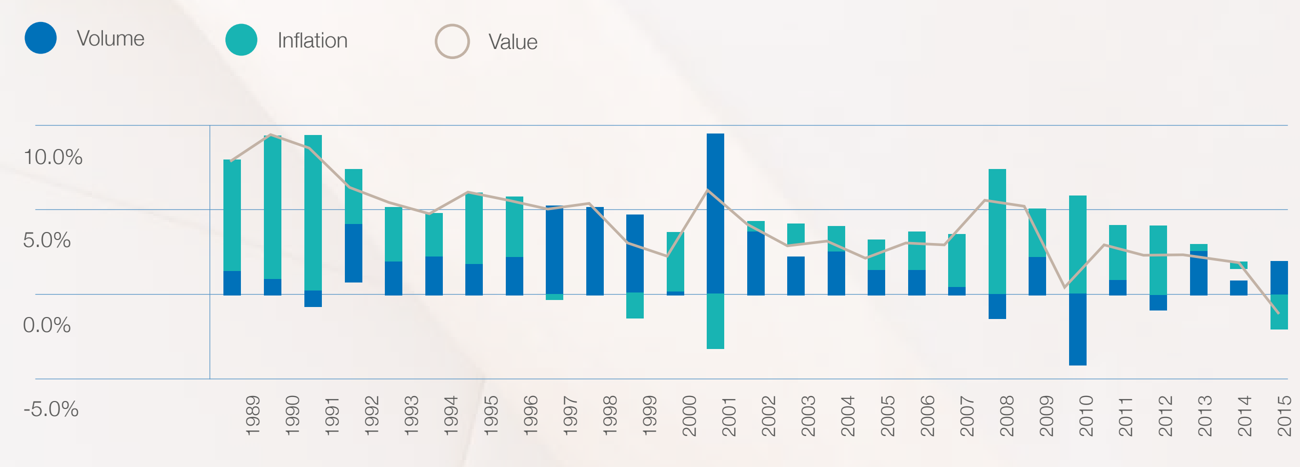
A new reality is slowly taking shape, as much for the property community as for the grocers themselves.

Foodstore Retail Sales Growth 1989 - 2015



(**Source:** ONS, Knight Frank)

Foodstore Retail Sales Volume and Value Growth 1989 - 2015



(**Source:** ONS, Knight Frank)

THE CHANGING FACE OF THE UK FOODSTORE MARKET

PROFITABILITY
LOW-HIGH

	E-COMMERCE	DISCOUNTERS	C-STORES	SUPERMARKETS	SUPERSTORES
	TESCO, ASDA, ocado, Sainsbury's	NETTO, LIDL, ALDI	TESCO express, Sainsbury's Local, M&S SIMPLY FOOD	TESCO, Sainsbury's, Waitrose	TESCO extra, ASDA, MORRISONS
Share of Grocery Spend 2015 (%)	4%	10%	14%	18%	49%
	£7.6 bn	£18.5 bn	£24.5 bn	£18.7 bn	£99.9 bn
* CAGR: Compound Average Growth Rate (H)	+19.2 %	+13.2%	+12.4%	+2.3%	+3.1%
* CAGR: Compound Average Growth Rate (F)	+11.6 %	+10.8%	+5.0%	+1.3%	+0.4%
Forecast 5 Year Growth 2015 – 2020	+£5.6 bn | +73%	+£12.3 bn | +67%	+£6.8 bn | +28%	+£1.2 bn | +7%	+£1.9 bn | +2%

Source: Planet Retail, Knight Frank

* CAGR= Compound Average Growth Rate

(**Source:** Company Data, Stifel, Knight Frank

CHANGING CHANNELS TO BALANCE THE BOOKS

The fundamental paradox that is shaping the UK grocery market is that the main channels of growth are the least profitable. In fact, the pecking order in terms of growth is the diametric opposite in terms of profitability. Online is at one pole of this extreme, 'big box' superstores the other. The other channels (discounters, c-stores, supermarkets) represent the shades of grey inbetween.

Although the pace of growth is decelerating, online grocery is still forecast to grow at around 12% per annum over the next five years. But for all this growth, profitability is still unproven. Management consultancy Kurt Salmon has calculated that the total cost of fulfilling an average £100 online order using in-store pickers is between £28 and £30, if all costs (including distribution, wages, marketing, fuel and vehicle leasing/maintenance) are taken into account. Expressed another way, each home delivery costs the retailer between £3 and £5.

Despite this drain on profitability, none of the grocery retailers are likely to walk away from online. But something has to give. And there is only room to manoeuvre on two fronts – passing on higher delivery costs to the consumer, or encouraging him/her to embrace click & collect rather than home delivery. Click & collect still carries cost, but this is marginal relative to home delivery – and it gets the consumer back where the retailer wants them, in stores. The click & collect charm offensive is already taking root and it is surely only a matter of time before delivery price hikes become commonplace for the diehard home delivery shopper.

At the other end of spectrum, the very largest grocery superstores are under intense pressure. The channel of choice for the last 20 years, many 'big boxes' are now witnessing rapidly declining sales. The superstore channel as a whole is forecast to witness annual growth of just 0.4% over the next five years. Despite this apparent fall from grace, most superstores remain highly profitable assets. Grocery retailing is all about volume and economies of scale and these are most effectively realised in a large-store environment.

But grocery retailers clearly cannot just sit and watch while their prized assets become ever less productive and their profitability eroded. As with online, the emphasis is to find a solution, rather than simply slash and burn. Few grocery superstores are likely to close. Some will be downsized, with space sublet to various, complementary third parties. Most will be reinvented to better serve the catchment in which they trade. Either way, existing superstore floorspace must work much harder. Ironically, so often pitted as enemies, online and superstores may mutually have most to gain by fully integrating rather than operating in isolation.

What of the other channels inbetween? The c-store market will continue to grow (+5% CAGR), albeit less rapidly than before. And with rising rents and greater competition for a diminishing number of sites, profitability in certain locations will be more pressured than before. Steady-as-you-go supermarkets could see something of a renaissance, particularly as the development pipeline swings ever more in favour of 25,000 – 40,000 sq ft floorplates. With in-town c-stores becoming larger and a development market skewed towards smaller edge-of-centre supermarkets rather than 100,000 sq ft superstores, there is a strong element of a market turning full-circle towards its historic mainstays of the 1970s and 1980s.

Of course, these are channel- rather than asset-specific observations. Many individual foodstores continue to fly in the face of perceived wisdom and punch substantially above their weight. For all the structural change that is taking place in the sector, the three 'Cs' still remain paramount – catchment, capacity and competition Understanding all three and tailoring the proposition accordingly remains the holy grail to which all foodstores must still aspire – one constant that hasn't changed and one that never will.

ANDY CLARKE

KEY PERSON FEATURE:

President and CEO of Asda Stores

The UK grocery market continues to be ferociously challenging. Can you put the scale of challenges that Asda and gain the other major food operators face into some perspective?

Pre-recession, through the recession and then less arguably post-recession (if you can assume we are in post-recession environment), the grocery retail market has gone through a significant level of structural change. The recession changed customers' shopping habits and as the family purse came under greater pressure, the amount of disposable income was reduced and, to be frank, mum became more 'savvy' in how she shopped and how often she shopped, and fundamentally is buying less food.

We can measure that, we know there is less food waste in the household now than there was pre-recession, so we know consumers have predominantly changed their approach. You saw that shoe repairers' sales went up as people were buying less new footwear, people bought hair colourants rather than going to the hairdressers, people did more baking at home rather than going out.

The whole industry has been undergoing fundamental structural change. What are the main factors of this structural change and how are they playing out?

Through that recession period, the limited assortment discounters grew. So that's one of the first big changes that happened structurally from a format perspective. Aligned to that, e-commerce, the omni-channel world, evolved and grocery collect or home delivery is now a material part of most grocers' businesses. In fact I read (although haven't had it confirmed) that Aldi is considering an online grocery business. The internet has fundamentally changed the way in which customers shop, but also the way in which the grocers respond to that change.

Consequently, there's less space being opened in the UK than was being opened ten years ago, because the return on space is going down as the customer changes their shopping behaviour.Whether it's sat on the couch with a mobile device ordering the delivery to home or shopping in a convenience store five times a week or shopping in a supermarket twice a week, or shopping in a large store once a fortnight, customers' shopping habits have changed forever.

Driven partly by the discounters, price has clearly risen up the agenda.

Price has always been the ultimate battleground for grocers and Asda was always at the forefront of that battle. The rise of the discounters during the recession created a market for limited range, smaller stores which is now acceptable to customers and therefore a sustainable long-term format. Discount isn't new to this market, but one thing that is very obvious is that the way in which that format, particularly the two big names, Lidl and Aldi, have grown, was through the fact that they created a price advantage over the 'Big Four' grocers at a time when inflation was in the market.

The discounters have certainly been winning the customer PR battle. What are the key messages to get across to regain that lost ground?

They're a limited assortment retailer, broadly 2,000 individual products, with a very limited assortment

outside of food. So the difference between a large store operator, like Asda, is the breadth of range, whether it's general merchandise or fashion, or the extended range within food. I can see in the next five years, and some people have already started this, we'll start seeing a range reduction exercise in food and an extended proposition into those areas that the discounters can't compete in, so it's again another reason to shop at a superstore or a supermarket rather than at a LAD [Limited Assortment Discounter].

The 'space race' ended some time ago but some committed new stores are still opening. What is your view on the development pipeline and are new stores still financially viable? Is there an optimum size for new stores?

Asda never really entered the space race because we were always prudent with our investments and took a long-term view. Consequently, we don't have the same property and land headaches of our peers. As an industry, let's assume there are 100 schemes that have been exited, and it could be more/less, but that's a big chunk of real estate that's not going to be occupied by retail. We'll still open some new stores next year and the year after, just fewer of them, and I'm sure they [the other "Big Four" grocers] will do the same.

I think with all of the big grocers, what all of us are looking for is returning our businesses back to volume growth. That's the big challenge we're all facing, and volume growth that's coming from core estate, not coming from the new businesses because it's the new businesses that are profit dilutive.

10 years ago, maybe a bit more, if you could land a 40,000 sq ft store, net, that was going to give you the highest level of return. I think they just succumbed that the size has come down to 35,000 sq ft. But the challenge with the smaller scale is that the volume goes down, the fixed costs stay the same. They are more under pressure than they were, the challenges with the larger stores are that you haven't got the visit frequency that you would've had ten years ago.

The sweetspot in terms of profitably has always been the mid-range actually, it's just the mid-range got a bit smaller, so you won't see 100,000 sq ft stores being built any more, probably not even 80,000 sq ft, but you probably will see 60,000 sq ft and 40,000 sq ft, everything's just stepped down a bit.

Goldman Sachs suggested that the UK foodstore market may be oversupplied by as much as 20% - what would your response be to these suggestions of overcapacity?

I don't recognise that from an Asda point of view. There are areas of the UK where we don't have a physical presence yet local customers would like to see us open space. Generally, population growth, if you believe the forecast, would suggest that there isn't an overcapacity. I think what is going to happen though is that there will be a greater focus on change of use for retail space, some of that will be because there's an over capacity of space rather than an over capacity of retailers, and I think the overcapacity point is more one of the number of units with the amount of space they occupy, rather than actually over time there will be a greater number of units occupying a smaller space.

> The grocery retail market has gone through a significant level of structural change. The recession changed customers' shopping habits and as the family purse came under greater pressure the amount of disposable income was reduced.

Big-boxes have been at the sharp end of this structural change and are in many respects the most pressured grocery channel. Are superstores still viable and do they have a future?

Although I think that the large store has been under pressure, if you look at IGD forecasts it would suggest that it will continue going backwards somewhere between 3-5% for all large store estates. There is a different school of thought now that large stores are going to play an important role in the future, the proposition within them is going to change and that's what's happening. That's why we recently announced that we are going to invest further in our core, large store estate and temporarily halt opening remote Click and Collect sites and standalone petrol filling stations.

If big-boxes are in need of reinvention, what would the 'superstore of the future' look like?

I think the geographic spread will continue to be populated but the space per unit will go down. To the overcapacity question, that's probably more down to there being a lot of very large space in the market that's too big, so we'll see more partnerships between shared users. For example, we've very successfully taken half of B&Q's space at a site in Belverdere. We're also at the moment trialling sharing our space with Decathlon where it's a new proposition to us that store in that location [Watford].

So I think we'll not be on our own, the largest stores across everybody's estate will see a degree of change of use. I think one of the challenges will be if change of use expands away from retail, so where we have a 100,000 sq ft store and we want to be changing its use, I think that will be something that will become more relevant over the course of the next ten years that we've seen in the previous ten years. Certainly leisure will play a role in that as well where some of the retail space will be leased/given/'pepper-corned' to leisure operators so that it's a reason to visit. We coined a phrase: 'The retail format, start off with supermarkets, to super stores, and now to super centres', the next generation will be 'super destinations' where people want to go and visit. And that's one of the reasons why I think the large stores still have a future because there will be a destination location that will be a reason to visit rather than the more hygiene factor of going to buy your milk in a convenience store.

Online – home delivery and click & collect – are evidently a fundamental channel for Asda. How does your online strategy marry up with your physical estate?

This buzz term is 'omni-channel' - the intersection between digital and physical. The broader the estate that you occupy then the greater leverage you can have with online, to use your core estates to service the online proposition, so the whole store pick model before grocery is more effective and cost effective because you already have the fixed asset of the store than it would be if you had to be of 'pure play'. I think that depending on the individual business for us, because we've got a relatively small number of overall sites, we know we'll have to open a number of picking centres across the UK to support geographies where we're under-represented. Depending on the type of store, it's always going to be about the 'what's your core store geographic spread?' and shown you need to open if you want to deliver to a wider selection of the market. I think there's a real advantage for the business that has stores over a 'pure play' because you have a location which inherently builds trust with customers.

Do you see the cost of online being gradually passed on to customers to pay for the convenience and service?

Let's not forget that Grocery Home Shopping has been around since the mid-1990s but ultimately whoever finds the solution to moving boxes at the lowest cost, whoever can fulfil an order at the lowest cost will win, because you'll end up with conversion of basket pricing where products broadly end up being the same. And what will win in the consumer's mind will be the lowest cost and quality products combined with the best service.

With sales under pressure, it follows that sales per sq ft are in decline in many locations. What are the implications for profitability and from a property perspective, rental affordability?

I think you've got to look at what's happened in the UK market over the course of the last 24 months. The operating profit of the "Big Four" grocers three years ago was about £6 billion per year. This year it'll be about £2 billion, and half of that comes from Asda. So for Morrisons, Sainsbury's and Tesco, they've taken significant public write downs of both property assets and their P&L as they're re-basing. It's going to take some time to recover that, so the impact on a property's return, whether it's a leasehold or a freehold, is going to be under pressure, I would suggest.

There is also significant pressure on business rates. Business rates are a huge issue for the retail industry and the Government is reviewing them at the moment. The last three years has seen increases in the cost of business rates that are unsustainable and it will put some companies under significant pressure.

As we face up to a 'new retailing reality', what would your key messages be to the property community (landlords, developers and agents)?

Be flexible. Be careful. Be realistic. Be open.

MARCH OF THE DISCOUNTERS

The fast-growing discounters Aldi and Lidl now control 10% of UK grocery sales – double their share of three years ago. The discounters show no sign of stopping and, with plans to open hundreds more new stores, will continue to widen their reach to the British population. They are attracting customers in greater numbers and those customers are spending more on each visit, further reflecting their broadening appeal. Such has been their rate of expansion that, in some isolated cases, potential store openings are being held up by staff recruitment, training and logistical capabilities.

Retailers with a strong focus on the south-east and London – Sainsbury's, Waitrose and Marks & Spencer – have also benefitted from growth, where sales have risen faster than in the rest of the country. This increasing polarisation continues to erode the traditional big store mid- market which the 'Big Four' control – market share having fallen by over 5% over 3 years.

As the discounters enlarge stores, broaden the range of goods and services offered and chase a more upmarket clientele, the clear distinction between a supermarket and a discounter is disappearing. The 'Big Four' fight back involves cutting costs, promoting the optimum ranges and offering a seamless omni-channel service for customers. Adding cost and complexity into the simplistic and efficient discounter model could start to work to the advantage of the 'Big Four'.

The success of French retailers in stopping the advance of discounters points to a possible way out of the crisis. Their formula: fewer complex promotions, big price cuts across the board, invest in own-brand products and gang-up on suppliers.

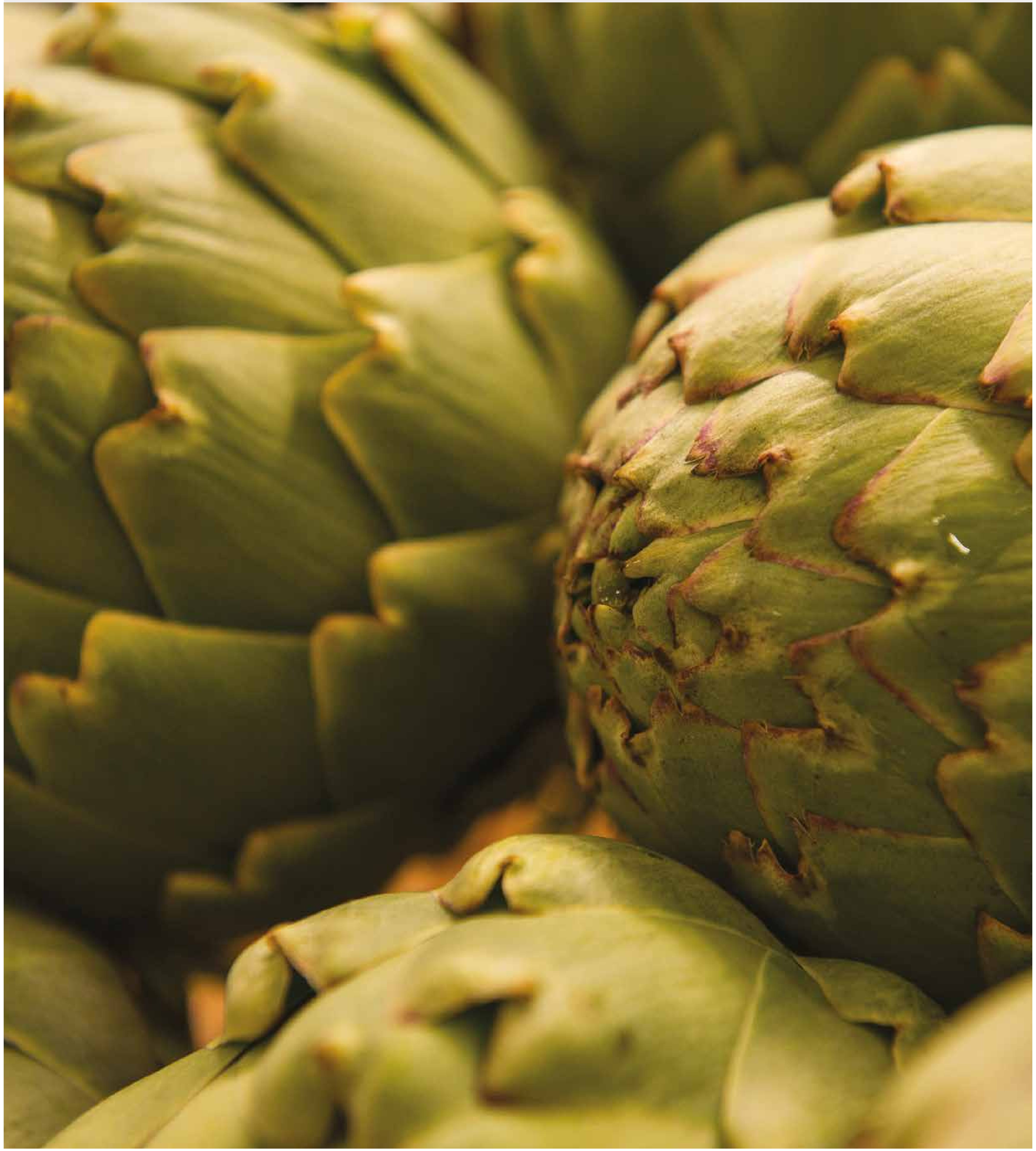
The inevitable squeeze on margins was easier to stomach for the likes of Leclerc, a cooperative of independent store owners, and family-owned Auchan than for listed groups Carrefour and Casino which are under pressure to deliver short-term returns to stock market investors. But Carrefour and Casino were eventually spurred to follow suit by years of under-performance.

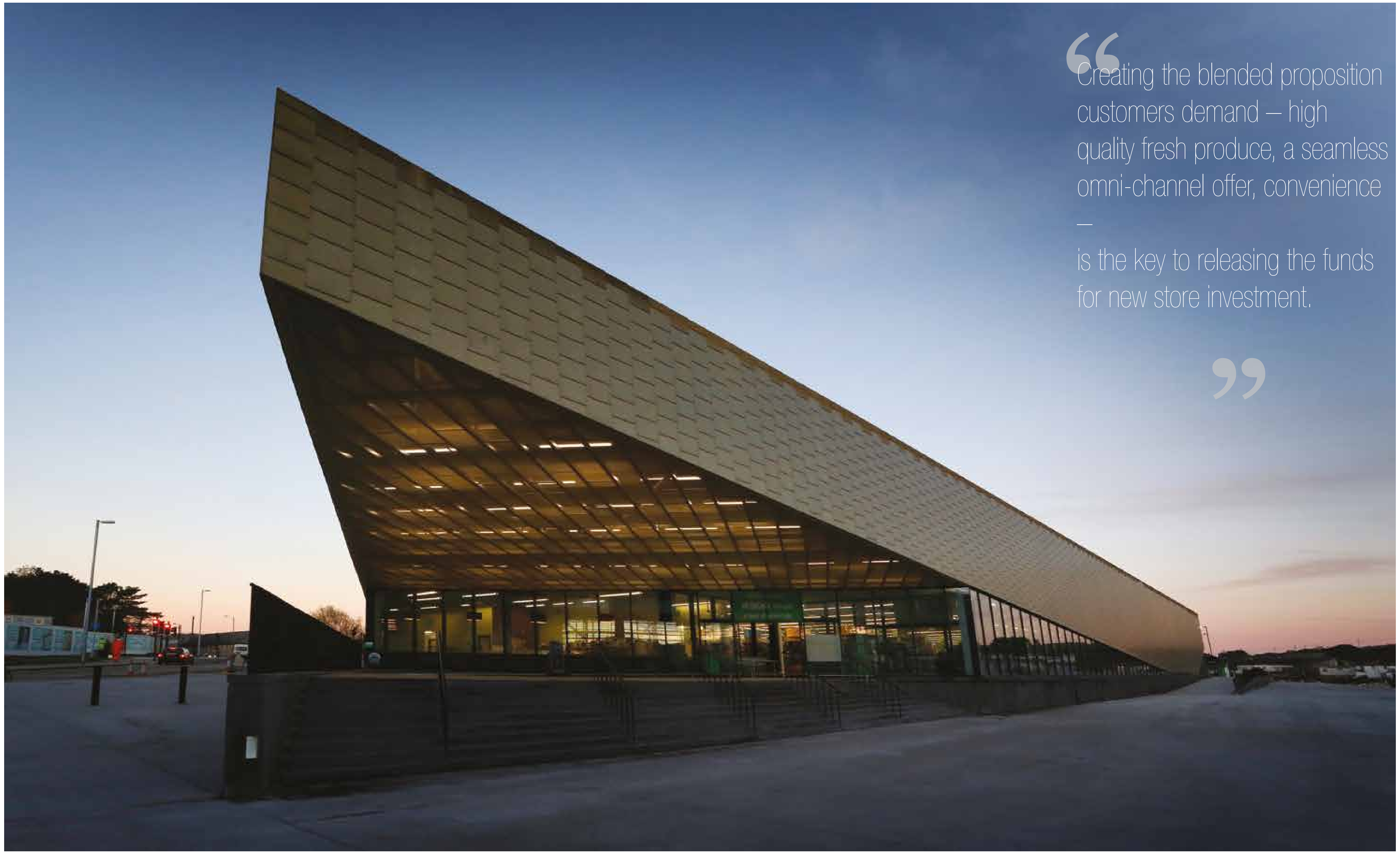
The decline of the discounters was also driven by a big roll-out of convenience stores by the major French chains as well as their investment in new pick-up points for collection of online orders, moves already afoot in Britain.

It took time to translate into improved performance and it was painful - operating margins declined by around a third - but the tide has started to turn. There may be hope yet for their counterparts this side of the Channel, but the journey is still a long and painful one.

	Market Share Nov 2015	Market Share Nov 2014	Y-o-y Change
Tesco	27.9%	28.7%	-80 bps
Sainsbury's	16.6%	16.4%	+20 bps
Asda	16.4%	17.1%	-70 bps
Morrison's	10.8%	11.1%	-30 bps
The Co-op	6.3%	6.2%	+10 bps
Aldi	5.6%	4.8%	+80 bps
Waitrose	5.2%	5.1%	+10 bps
Lidl	4.4%	3.7%	+70 bps
Iceland	1.9%	2.0%	-10 bps
Other Multiples	2.8%	2.9%	-10 bps
Symbols & Independents	2.0%	2.0%	–

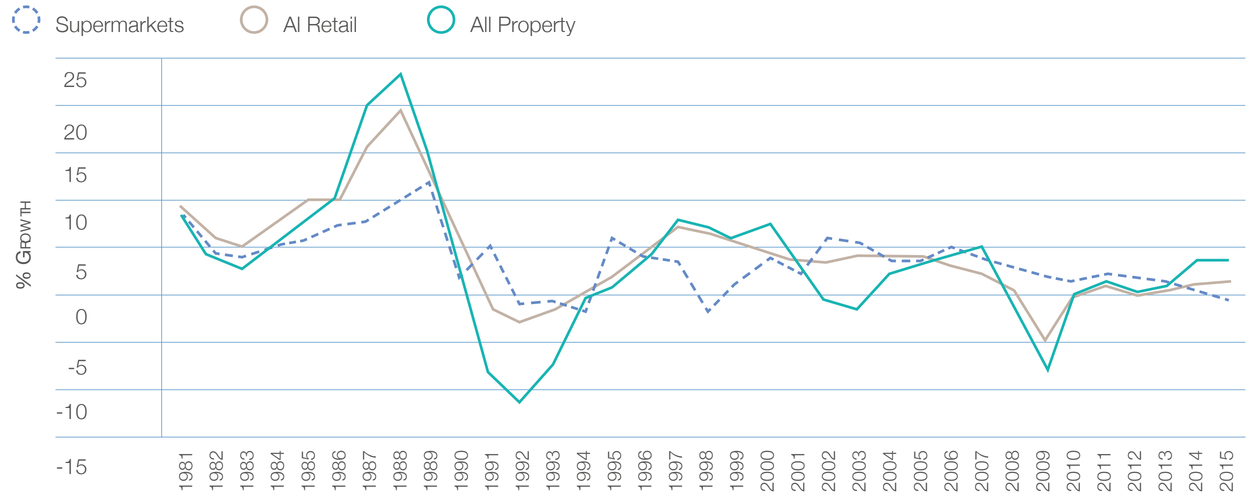
(**Source:** Kantar Worldpanel)





> Creating the blended proposition customers demand – high quality fresh produce, a seamless omni-channel offer, convenience – is the key to releasing the funds for new store investment.

Annual Rental Growth (%)



(Source: IPD)

PROPERTY MARKET IMPACT

With all this turmoil, how has this translated itself into the property market?

- The investment market has become more forensic when differentiating between primary and secondary markets (and where it hasn't, it should!). Yields have become more polarised between prime and secondary. The definition of prime has narrowed and this is now not just a question of buying income but of focussing on the underlying real estate fundamentals.

What matters are a multitude of factors, not limited to, but including the following:

- Location
- Layout
- Parking
- Existing competition
- Related trading strengths/weakness
- Micro market characteristics
- Demographic profile and fit
- New competitor threats
- Housing growth
- Planned infrastructure

Understanding how these factors interrelate is key to understanding the medium and longer term potential of an asset.

- Discounters are the new darlings of the development market and the anchors to many of the sites previously earmarked by the 'Big Four' (ironically, offering in several buildings what the 'Big Four' were offering in one.)
- Lease expiry is a minefield for the uninitiated and relocation is still unlikely in most cases, given the capital expenditure needed to fit out new stores, let alone the time, resource and costs associated with finding a new location in the first place.
- The larger stores are out of favour with the operators and some stores which have had a number of rental increases based on RPI are now significantly over-rented – buy backs will inevitably take place and Tesco have already stated their intention in this arena.
- Sub-divisions and concessions are a fact of life for the larger stores. This can mitigate exposure to overheads and on another level drive additional footfall to the store. Rightsizing on better lease terms will be the strategy in most leasehold situations in parallel with redeveloping their own trading portfolios - although how this will be financed across large and ageing estates, whilst precious capex continues to be invested in price remains unclear.
- Nil increase at rent review is the likelihood in most cases.
- There is still an appetite for new store development and opportunities certainly exist (as the discounters are showing) but the traditional evaluation methodology is out dated. Affordability underpinned by store sales growing faster than occupation costs is no longer credible in larger stores. Creating the blended proposition customers demand – high quality fresh produce, a seamless omni-channel offer, convenience – is the key to releasing the funds for new store investment.

NEW STORE AFFORDABILITY

The standard new store evaluation model used by foodstore retailers is a form of discounted cash flow, which generates key measures such as IRR, EBITDAR and NPV. For key input variables such as sales and rent, the (traditional) model would assume growth – the model will be complex but might have typically and simplistically assumed sales growth at 3% per annum and rental growth also at 3% per annum.

An example store of 40,000 sq ft net sales and 60,000 sq ft gross area trading at a £20/sq ft sales density (£800k per week) generates an annual turnover of ca. £42m. The annual rental at £20/sq ft would be £1.2m. Under the traditional model:

- The rent translates to just 2.8% of turnover
- The rent is covered in just over 1 week's trading
- The sales density covers the rental

Inputs such as these would historically generate acceptable returns for the retailer and these Rule of Thumb measures provided a quick and useful benchmark.

As the market has evolved, the way the retailers analyse situations has also changed and there will now be differences between larger and smaller store evaluations. The traditional Rule of Thumb measures are no longer relevant.

Large store sales have been falling, meaning any large store evaluation will now have a very low sales growth assumption – perhaps 1% per annum over the life of the store. If the rent review provisions state 1-3% RPI increases, the evaluation model will probably assume worst case at 3% rental growth. The impact of low sales growth against 3% rental growth over 15-20 years neutralises any affordability.

Smaller stores are still generating sales growth and are therefore, theoretically, still generating affordability. Other factors will be considered as the retailers analyse each market more forensically – and more critically - than when they were pushing for new space:

- Is there sales cannibalisation from existing stores?
- Is there low brand affinity, meaning a longer time to reach sales maturity?
- Discounters used to be ignored but are now considered very seriously
- How strong is the competitor set? The quality of site is vital.
- Can the site offer omni-channel and will this drive profitable turnover?
- How saturated is the market?

There is still appetite for new space but the attitude to risk has transformed the landscape.

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