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Welcome

The UK grocery market is going through a period of turmoil, with the Big Four – Tesco, Sainsbury's, Asda and Morrisons – under pressure from factors including shifts in shopping behaviour, the rise of Aldi and Lidl, and squeezed household incomes. In this issue, we look at where the market is now and where it is likely to go next.

FALLING OFF A WAVE

There are only four ways to make money in the grocery business. You either entice shoppers to spend more – a forlorn hope in times, like these, when household incomes are heavily squeezed. Or you try and divert trade from your competitors – an eye-wateringly expensive and time-consuming strategy in hard economic times due to the heavy investment required in new stores and/or online fulfilment, price cuts and marketing. Or you can try and slash core operating costs, which can boost short-term profits but can also be a slippery slope to long-term margin-destroying offer/service decline. Finally, if you are exceptionally lucky, you might inherit capacity released from chains that have closed-down – the retail equivalent of receiving an unexpected legacy.

It has actually been capacity release more than masterful business strategy that has tended to keep grocery markets bubbling along for the last few years. The 'Big Four' grocery retailers – Tesco, Sainsbury's, Asda and Morrisons – glided serenely into the post-2007 economic downturn, riding the tail end of a huge wave of grocery sales gifted variously by Somerfield, Kwik Save, Safeway and Netto. Like a decade-long adrenalin drip, more than 20% of national grocery sales had steadily come up for grabs: the largest sustained transfer of grocery capacity ever recorded in UK grocery markets. The Big Four's cumulative market share of main grocery sales soared from 56.1% in 1998 to an astonishing 77.0% in 2011 (81.4% if Waitrose is included).

In 2011, the capacity legacy was exhausted and with Aldi/Lidl's aggressive store opening programme capturing ever-growing market share, the upward-only market share growth trajectory of the Big Four finally came to a juddering halt, and then moved into reverse. For the first time in decades, the Big Four's market share began to contract: a contraction that no amount of new store opening or online investment has so far managed to stem. With investors now taking fright, short-term performance has taken centre stage. The Big Four have responded by launching a full-blooded price war, targeted not so much at each other but at value/discount operators. So where do we go from here?

> **"I THINK IT IS NO EXAGGERATION TO SAY THAT THE CHANGES WE ARE SEEING IN GROCERY MARKETS ARE THE MOST FUNDAMENTAL IN A GENERATION AND HAVE MAJOR IMPLICATIONS FOR ALL OF US"**

The sheer longevity of the household income squeeze has certainly altered consumer behaviour, perhaps permanently. Customer loyalty has faded as more and more shoppers scour grocery stores – any grocery store – for bargains. The Big Four grocery business models that worked so effectively in easier economic times are simply not working today. Households really are cutting back. But there are other reasons for the apparent reversal in the Big Four's grocery market fortunes.

In the articles that follow, leading UK and overseas grocery market experts turn the spotlight on the key trends and structural changes currently unfolding in grocery markets, highlighting the pitfalls and opportunities confronting both operators and property investors and the prospects for the market going forward. I think it is no exaggeration to say that the changes we are seeing in grocery markets are the most fundamental in a generation and have major implications for all of us, whether shoppers, retailers or property specialists.

I hope that you enjoy this issue of IN_*grocery*.

PHIL CANN
Head of UK Retail

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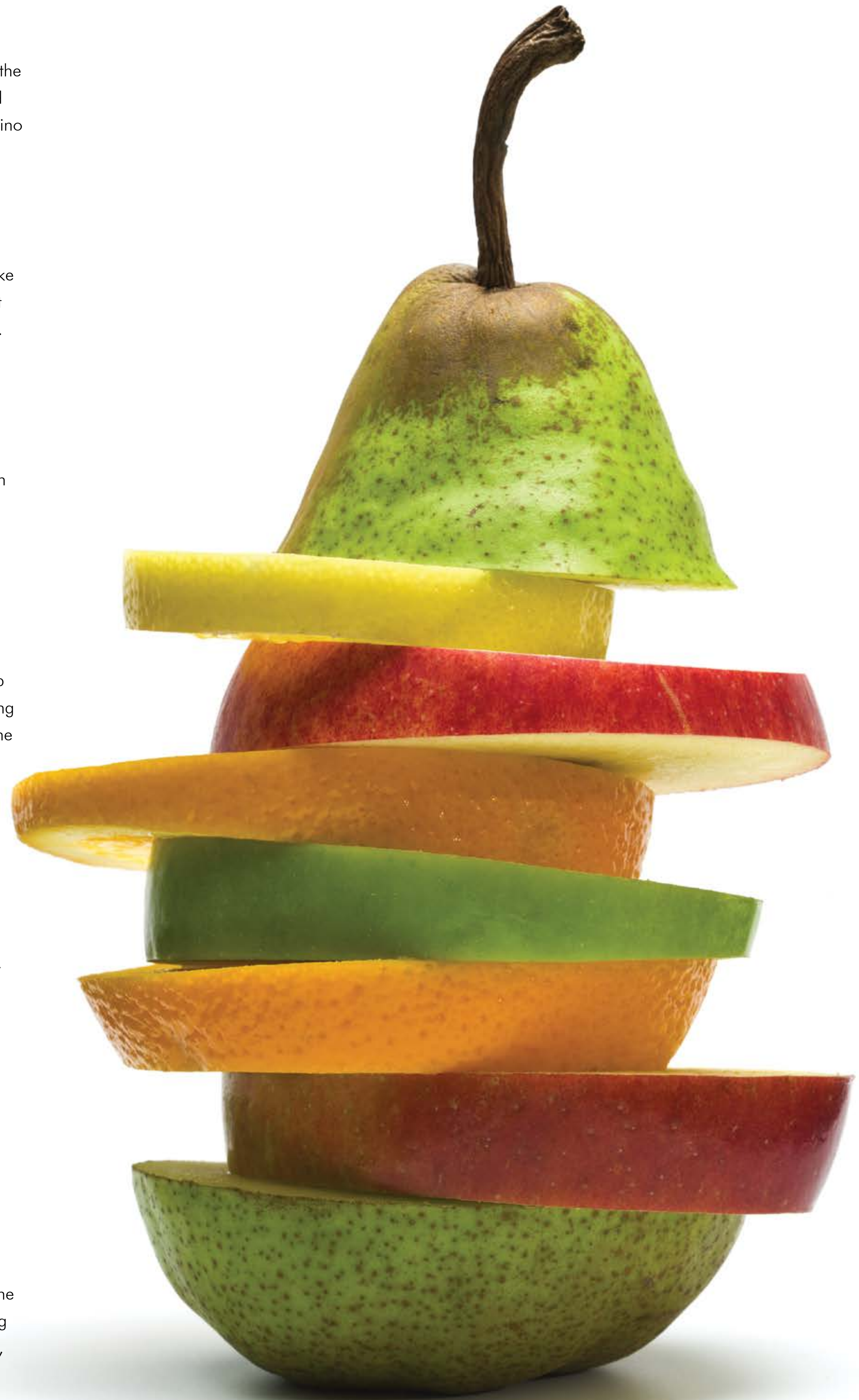

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THE ECONOMICS OF GROCERY

Grocery markets appeared to defy economic gravity following the onset of the post-2008 recession. The sector has since suffered an extraordinary reversal in fortunes. Neil Saunders of Conlumino looks at the reasons underlying the seemingly sudden crisis.

Sainsbury's, Crayford J Sainsbury plc

The grocery market seems to be something of a paradox. It was the one sector that managed to grow consistently during the recent recession, even if much of this was thanks to price inflation. However, the onset of economic recovery has not brought better fortunes, but instead has seen the market plunge into a crisis of almost unprecedented proportions.

The performance paradox is not, of course, really a paradox at all. The reason that grocery is now suffering, even as other retail sectors rebound, is because the problems are not related to the fluctuations of the economy. Rather, they are structural, related to the configuration of the sector and the way in which grocery markets have developed over the past ten or so years.

As tempting as it is to simplify the issues facing the grocery market, there is no single, overriding factor that is responsible for the difficulties. Indeed, one of the things making the trading environment so tough is the fact that there are many different factors at play.

The first of these is a simple one. It's about demand. Unlike some sectors, such as clothing or beauty, grocery is not readily expandable. It is hard to get people to spend more and more on groceries because there are limits to the amount we can eat. Ultimately, this means it is difficult to grow volumes. To a degree this has always been an issue for the sector, but in the past it was masked by higher inflation, by a consumer who was less concerned about food waste, and by a more profligate shopper who was relatively unconcerned about saving money. Today, with lower inflation and a prevailing mindset that sees reducing food spend as a critical part of balancing the household books, retailers are more exposed to this weak underlying growth.

Such an environment would be challenging enough just by itself. But it is the backdrop to a market that is highly competitive and, arguably, has too much capacity. The reason for this is simple: the amount of grocery floorspace added over the past five years has outstripped the increase in demand over the same period. Consequently, it is hardly surprising that critical metrics such as like-for-likes, return on capital and store profitability have all fallen. While many players have given lip service to the fact that the 'space race' is over, current

"WHILE MANY PLAYERS HAVE GIVEN LIP SERVICE TO THE FACT THAT THE 'SPACE RACE' IS OVER, CURRENT TRENDS SHOW THAT THE PIPELINE OF NEW STORES AND FLOORSPACE REMAINS RELATIVELY STRONG"

trends show that the pipeline of new stores and floorspace remains relatively strong. The inevitable consequence of this is that critical metrics will remain on a downward curve for the foreseeable future.

Part, but by no means all, of this space growth is attributable to the rise of the deep discounters. While these players have been around for many years, it is only in the last five that they have started to gain real traction with UK consumers. Some of this is because of the low prices they offer, but that's far from the whole story. Price is important to consumers, but so is quality, even during times of constrained finances. Aldi and Lidl's success came when their ultra-low prices were accompanied by efforts to demonstrate quality, provenance and to provide a better shopping experience. Ultimately, these things made many consumers 'look again' and assured them that they were getting great value for money. This is a problem for the 'Big Four' players, as both Aldi and Lidl are now mainstream. They are not just creaming off the poorer, hard-pressed consumer; they are attracting shoppers from all parts of the demographic spectrum. Worryingly for the big players, this trend shows no sign of reversing as the economy picks up.

Heightened competition, both between the Big Four and newer challengers, will inevitably reshape the sector. Over the medium term, it means that prices, margins and profitability will all come down: something that is good news for consumers, but far less attractive to investors. Most of the big grocers will remain profitable and successful, but they will be less so than they once were. The grocery sector will also become less consolidated. The economics of acquiring and maintaining 30% of the market, as Tesco once did, will be prohibitive. Large players will still feature in the sector, but the playing field will be more level than it once was.

Part of this levelling is down to the way business is done. Previously, retailers needed to invest in property to acquire a high market share – something that involved substantial expense and was a high barrier to entry. The same is true today, but only to an extent. Online shopping has made it easier for all players to acquire and reach more customers.

However, the idea that online retailing is a panacea for grocery players is something of a myth. In grocery, online is critical in terms of securing sales; it is hard for the big players to grow and to retain customers without it. However, due to logistical complexities and the low margins involved, it is less effective at delivering profits. This has had, and will continue to have, a corrosive effect on the bottom line. It also means that, in some ways, the large players are shooting themselves in the foot. They are actively encouraging some consumers not to shop at their cost-intensive larger stores, where they can be tempted to purchase other non-food items. Truth be told, if the big players could push a button and uninvent online shopping, they probably would. Given that that option does not exist, the sector will continue to pile more and more pressure on itself as the proportion of food sales made online grows.

Tesco's new chief executive, Dave Lewis

Tesco PLC

"THE ECONOMICS OF ACQUIRING AND MAINTAINING 30% OF THE MARKET, AS TESCO ONCE DID, WILL BE PROHIBITIVE"

It is not only the rise of online retailing that has changed the way we shop. Changing social and economic patterns mean that the model of big weekly or fortnightly shopping trips is far less relevant than it was ten years or so ago. This is especially true for young, urban consumers, where buying is piecemeal and involves topping up on food as and when they need it. This is often more economical, as it saves time and food wastage. However, these shifts in demand have led many retailers to invest in convenience stores to serve local needs. This has been a lucrative channel for growth, but it has also been part of the reason larger, big-box stores have become less relevant.

Can larger stores fight back? To an extent, yes. They can become more of a destination, incorporating strong non-food offers, leisure and services. That will help stem some of the decline. If they are used for the picking of online orders, that also helps maintain productivity, even if it is at a reduced margin. Click and collect is another way of attracting footfall, especially so because the locations are often convenient and have parking.

Tesco PLC

Providing strong non-food offers, leisure, services and catering, such as this Harris + Hoole coffee shop at Tesco Extra in Watford, can turn big stores into more of a destination to attract shoppers

"TRUTH BE TOLD, IF THE BIG PLAYERS COULD PUSH A BUTTON AND UNINVENT ONLINE SHOPPING, THEY PROBABLY WOULD"

However, all of these things are about playing for time. Ultimately, there simply isn't the need for space that there once was. As such, some grocers will need to cut back on the big boxes and reconfigure their store portfolios – an adjustment that will be painful and protracted.

With all of these forces and trends at play, it is hardly surprising that the market is in a state of rapid change in which the old order is crumbling. But as tough as things are, they could get a whole lot tougher. For instance, Amazon has a long-held ambition to be big in grocery, but has never managed to quite make it work. What if it did? What if it bought, say, Ocado? While not necessarily the stuff of nightmares, the prospect should give the big grocers cause for contemplation.

Despite all of this doom and gloom, it is important to keep in mind that we are not talking about the destruction of the grocery market, nor of all the players in it. The sector will remain the largest one in retail, it will remain one in which there is good money to be made, and it will remain one that includes some of the largest and most successful retailers. What we are talking about is a reconfiguration, a reshaping of the sector.

Perhaps the biggest paradox of all is not that the grocery market is now finding trading tough, but that it was once a market that was accused of being an oligopoly and was subject to numerous competition investigations.

That charge could simply not be levied today. Competition is alive and well in grocery and, ultimately, it will deliver innovation, higher standards, and a better deal for consumers.

NEIL SAUNDERS
Managing Director, Conlumino

Prior to founding Conlumino, Neil worked at Verdict for over seven years where, before the company's acquisition, he was a board director with responsibility for Consulting, Corporate Development and Planning. Neil serves as a non-executive director of the train operating company First Great Western, is a Visiting Fellow at the School of Management, University of Surrey, and is a board member of the Faculty of Business and Law at the University of Southampton.

TURMOIL WITHIN

UK grocery markets are embroiled in a state of transition the like of which we have never seen before. Leading retail City analyst Nick Bubb comments on the remarkable events now unfolding.

Tesco Extra, Broadstairs

Tesco PLC/R Eaton

Share prices tell you things and, although the near 50% collapse in quoted supermarkets this year has been extraordinary, the writing has been on the wall for some time. After a poor 2012, in which it underperformed the overall UK stock market by c20%, the food retail sector had another bad year in 2013 and underperformed the market by c10%. So long-term investors have been running scared of Tesco, Sainsbury's and Morrisons for nearly three years now as the pressures on the industry have intensified, although hedge funds have had a very happy time shorting the sector.

The relentless rise of the grocery discounters, Aldi and Lidl, is often linked with the growing problems of the big supermarket chains and the 20%-30% sales growth that they are putting on is certainly eye-catching. Having widened their product range to appeal to the middle classes, Aldi and Lidl have also expanded into the south of the country and invested in some clever advertising.

But although Aldi and Lidl have grown into big businesses in the UK over the last three years (Aldi's sales will be over £5 billion in 2014) and taken out an extra 3%-4% chunk of the grocery market between them, the growth of the discounters doesn't fully explain the predicament the big supermarkets now find themselves in.

The key issue for the big supermarkets is that consumer shopping habits are changing and they are struggling to cope with the shifts in the different channels. Online grocery shopping is clearly taking off, as time-poor consumers find it increasingly easy and convenient to get supermarket vans to deliver to their homes. And changes in working and commuting patterns and lifestyles mean that an increasing number of consumers also want to do 'top-up' shopping in local convenience stores.

The two growth channels of the grocery market are online grocery and convenience stores and the supermarkets that have moved with the market should be able to cope. Ironically, the embattled Tesco is as advanced as anyone in this regard, as Tesco.com and its burgeoning Tesco Express chain have big shares of these sub-sectors. Tesco's core structural problem, however, is its huge exposure to the out-of-town hypermarket format at a time when consumers are doing fewer and fewer big weekly grocery shops and buying more and more non-food merchandise online. But more of this later.

> "TESCO'S CORE STRUCTURAL PROBLEM, HOWEVER, IS ITS HUGE EXPOSURE TO THE OUT-OF-TOWN HYPERMARKET FORMAT AT A TIME WHEN CONSUMERS ARE DOING FEWER AND FEWER BIG WEEKLY GROCERY SHOPS"

One of the perceived themes of supermarket retailing at present is polarisation, with the bottom of the market apparently doing well (i.e. the discounters), as is the top of the market (i.e. Waitrose and M&S Food). The health of the more upmarket/quality players may be a little exaggerated, if the reduced profits at Waitrose are anything to go by, but they are certainly not seeing the big like-for-like (LFL) store sales declines of some of their peers. This is partly, however, to do with the fact that Waitrose and M&S Food are also part of the drive to convenience shopping: Waitrose stores are smaller, more accessible and "local" than many supermarkets, while the growth of the M&S Simply Food stores has captured a chunk of that 'top-up' or 'treat' convenience market. It is striking that some 40% of M&S food is bought to be consumed on the same day.

But what of the middle ground of the sector, the 'Big Four' (i.e. the three quoted chains plus Asda)? Clearly this is not a homogeneous group, as their relative fortunes wax and wane, and the cosy oligopoly in the past that seemed to protect high operating margins in the industry (despite what Justin King famously called "the cut and thrust" of price promotions) has long broken down.

Having helped Morrisons recover well from the self-inflicted disaster of the Safeway acquisition in 2004 by getting the core business back to basics, CEO Marc Bolland left the company in 2009 without any online grocery or convenience store exposure, which turned out to be a major strategic weakness at a time when its northern heartland was about to be hit by the rise of the discounters after the banking crisis. Under Dalton Philips, Morrisons is now desperately trying to catch up and it is still being buffeted by strong headwinds, but at least it avoided the big rush into opening lots of non-food selling space.

Morrison's great northern rival Asda is less in the public eye, although every quarter Walmart allows CEO Andy Clarke and his team to talk to the press about Asda's trading performance. And despite its heavy non-food presence and lack of exposure to the fast-growing convenience store market, Asda is actually holding its own at present, with flat LFL sales making it the best of the Big Four. Whatever Walmart brings to the party by way of extra buying muscle, Asda has always had a strong low-cost culture and a low price heritage that it has carefully protected, to minimise its vulnerability to the discounters.

Sainsbury's paid tribute to Asda's price leadership recently by making it the benchmark for its 'Brand Match' scheme and the success of its Nectar card-linked 'coupon at till' programme has been one of the main reasons why the core Sainsbury's business has been able to outperform the industry until recently. But despite the strength of its ethical values and the quality of its own-label food range, new CEO Mike Coupe has taken on a business under pressure, given how challenging the market has become, and it will be interesting to see how radical his strategic review is when Sainsbury's reports its interim results on November 12.

The delayed Tesco interim results on October 23 were overshadowed by the latest revelations in the accounting scandal, but there was no disguising the across-the-board pressure on sale and profits in the crumbling empire that new CEO Dave Lewis has taken on. And although he bravely told City analysts that two thirds of Tesco's UK hypermarkets were "to die for", he didn't explain what will happen to the other third. And the new FD, Alan Stewart, is expected to take a very prudent view of the balance sheet valuation of the store estate at year-end.

Tesco only has nine monster stores of more than 100,000 sq ft, but it has plenty of superstores of more than 50,000 sq ft. Once the new Tesco Extra opens in Rotherham in November, there will be no fewer than 250 Tesco Extra stores (which average over 70,000 sq ft in size), and these account for as much as 45% of Tesco's total UK selling space. There was a time, when 'OpCo/PropCo' calculations were all the rage, eg. in 2007, when the Qataris bid for Sainsbury's, that supermarket properties were seen as a great store of value, but now they almost seem like millstones around the necks of the major operators.

With Tesco struggling to keep its investment grade credit rating and having to make some big disposals to prop up its over-leveraged balance sheet, the time for private equity bids has passed, so that is one thing that the sector's management teams don't have to worry about. But there are plenty of other things to worry about, including the clear risk that supermarket rental yields start to soften as the investment market starts to worry about the cash flow outlook for the sector.

NICK BUBB
Independent retailing analyst and consultant

Nick Bubb has been a leading retailing analyst for more than 30 years. He retired from the City in 2011, having worked at investment banks such as Morgan Stanley and Soc Gen, but remains a well-known commentator on UK retailing in the press and is still actively involved in the industry as a consultant. Nick produces 'The Daily Retailer' email note and is a founder member of the KPMG/Ipsos Retail Think Tank.

An Aldi store in Manchester

ALDI AND LIDL LEAD THE PACK

Aldi and Lidl appear to be carving a swathe through their much larger competitors, seemingly single-handedly reinventing UK grocery retailing. It is all down to simplicity, says Ed Garner of Kantar Worldpanel.

LP Hartley begins his 1953 novel The Go-Between with the line: "The past is a foreign country: they do things differently there." Just a few statistics should confirm the truth of this statement with regard to shopping for groceries in Britain in 1973.

Back then, the independent trade held a share of 30% and the Co-operative movement 21%. "Pile 'em high, sell 'em cheap" Tesco only had a 7% share, Asda a barely noticeable 3%. Today, the shares are virtually reversed, with Tesco standing at number one (29% share) and Asda at number two (17% share), with the Co-operative at 6% and independents reduced to just 2%.

What happened? Well, lots of things, but in a short article like this I would suggest social change and technology as the most significant macro trends. The glittering prizes would go to those who were most aware of the changes in the British lifestyle and who could leverage the opportunities offered by technology (and IT in particular) to meet those changes.

As women increasingly went out to work, this left less time to spend on frequent trips to the high street's specialist shops. "Everything under one roof" would become the winning mantra, allied to a burgeoning breadth of choice to satisfy households whose appetites had been whetted by the growth of foreign travel. Then, bananas were exotic – now Romanesco broccoli, kumquats and quinoa are readily available.

The resulting increase in complexity needed the harnessing of technology and computers to operate the stores and the supply chain. Now this technology is available to all, but a few decades ago it was a barrier to entry, which helped the big get bigger. Technological advances have delivered barcode scanning, loyalty cards, targeted mailshots, online ordering, multibuys, coupon-at-till, instantaneous price-matching, QR codes. None of this was available in 1973 – the first use of the barcode did not arrive until mid-1974, when a pack of Wrigley's gum was scanned in Ohio.

The social and technological changes paved the way for the superstore and in turn the hypermarket, where "everything under one roof" went on to encompass clothing, electrical, homeware, gardening, motoring, financial services and food service. Technology also gave us promotional variety in terms of multibuys, link-saves, loyalty points and online couponing.

This could all be lumped under the overall heading of "complexity" – stores selling a bewildering range of between 30,000 and 40,000 lines, with a fistful of coupons being handed in at the till to be met with another fistful being handed out. We now have conclusive evidence that we may have already passed 'peak complexity', as shoppers rebel and seek out ways to simplify their lives.

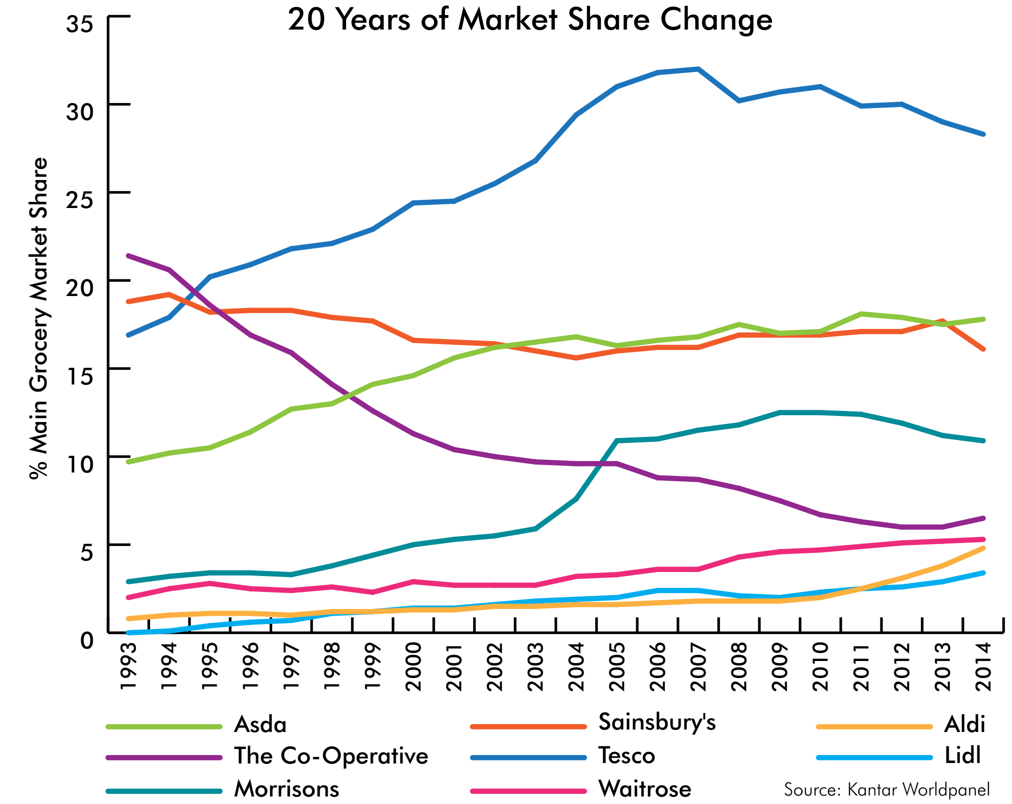
Firstly, online shopping gives time-starved households the opportunity to avoid physical shopping altogether – it's growing at 20% per annum. Click and collect goes on to remove the hassle (and cost) of arranging delivery – a growing channel here, with 3,000 dedicated 'Drive' outlets already in France.

Secondly, the 'convenience' channel offers to replace the weekly trek round the superstore with a smaller, local, top-up trip. Convenience stores are the fastest growing part of the store estate for Tesco, Sainsbury's, Morrisons, Marks & Spencer and, as the wheel turns full circle, the Co-operative.

And thirdly, there is the dramatic growth of the German outlets, Aldi and Lidl. They are characterised by a single-minded stripping out of complexity (and therefore cost) from the entire operation. By only handling approximately 1,400 lines with little or no promotional disruption, they have rewritten the financial parameters of grocery retailing, and there are signs that they are forcing the major retailers to follow suit ("prices down and staying down" being the new message from the major retailers). The resulting low retail prices have an obvious appeal, but, for some shoppers at least, the simplicity of choice and clarity of pricing are an additional attraction.

Over the decades a steady evolution has changed Britain's grocery landscape beyond all recognition and swept away a long list of names that linger on in reminiscences (Alldays, Bejam, Bells, David Greig, Fine Fare, Food Giant, Gateway, Hillards, Hintons, International, Jackson's, Key Markets, Kwik Save, Mac Fisheries, Safeway, Shop Rite, Somerfield, Victor Value, Wallis, and William Low among them).

Overlaid on this are revolutions such as the introduction of the Tesco Clubcard and the dramatic takeover of Safeway by Morrisons. When we look back on the sudden acceleration of Aldi and Lidl and their effect on the market, we may see that we're currently in the middle of another one.



Tesco, Morrisons and Asda have been the three really big grocery market share winners of the last two decades; Co-op has been the big loser. Tesco's market share peaked in 2006 at 31.8%, falling back to 28.3% by September 2014. Morrisons, Sainsbury's and Asda's market shares subsequently fell back too, while the hard discounters, Aldi and Lidl, have seen accelerating growth. Waitrose has continued to achieve market share growth too, illustrating how the middle is being squeezed while discounters at one end and upscale shopping at the other continues to prosper.

ED GARNER
Communications director, Kantar Worldpanel

Ed Garner is a highly regarded retail market commentator, with almost 40 years' experience in the grocery sector covering grocery retail trends and shopper behaviour. Ed has made conference appearances across Europe, USA, Australasia, Asia Pacific and South America for numerous organisations including IGD, Citigroup, McKinsey, PwC, Marketing Week, ADMAP, AGRA, NFU, The Grocer and many leading UK FMCG clients, in addition to occasional radio and TV work. Kantar Worldpanel is the world leader in consumer knowledge and insights based on continuous consumer panels. www.kantarworldpanel.co.uk, www.kantar.com

CONVENIENCE ON A ROLL

In a remarkable resurgence, convenience sales have moved up alongside online and discounting in the growth stakes, trouncing main grocery sales performance. James Harries of IGD plots the seemingly unstoppable rise of convenience shopping.

The UK convenience market is set to be worth almost £50 billion by 2019, generating nearly £12 billion in extra sales over the next five years, according to recently published IGD forecasts. This remarkable rate of growth positions convenience store shopping as one of the three fastest growing grocery channels, alongside online and hard discounting.

It is an exciting time in convenience markets, but to tap the potential, it's crucial to understand why convenience markets are evolving so rapidly. Symbol groups have by far the largest share of convenience goods, accounting for more than 40% of the total value spent in the sector. A symbol group retailer is an independent retailer that is a member of a larger organisation known as a Symbol group. A well-known example of a Symbol group is SPAR. Together, Symbol groups and unaffiliated independents account for almost 60% of the total market.

"CONVENIENCE MULTIPLES ARE NOW THE FASTEST GROWING SEGMENT, GROWING BY 16.3% IN THE 12 MONTHS TO APRIL 2014"

Convenience multiples, the convenience formats of the big grocery chain operators like Tesco and Sainsbury's, are, however, now the fastest growing segment, growing by 16.3% in the 12 months to April 2014. This is from a low base though, as multiples account for less than one in every five pounds spent in convenience stores. This really puts the growth of the multiples into perspective, demonstrating the vibrancy and strength of the whole sector.

Overall, store numbers in the convenience market are up 1.3%. This growth is primarily being driven by the continued focus of the multiples on their small store estates, and fewer unaffiliated independents and forecourts leaving the market. Although multiples are expanding rapidly into the market, the largest share of stores is still held by unaffiliated independents and Symbol groups, such as SPAR or Londis. These two groups represent almost two thirds of total store numbers. Again, the strength of the independent and Symbol sectors demonstrates the diversity of the market.

Convenience stores are continuing to evolve, with the bar rising in terms of standards and innovations. It is this fast-paced change which makes this such an exciting sector to work in. There is a continued move across the sector from a 'one size fits all' approach to more tailored solutions depending upon the local area. It is no longer an option to be 'all things to all men'; retailers and suppliers need to show an understanding of shoppers' needs and cater for them accordingly.

Convenience multiples aren't the only ones doing this. There are examples from across the market, such as a Premier store in Glasgow stocking a higher proportion of stationery items due to its proximity to a university. Retailers who are embracing this are putting themselves

Tesco Farnham Common Express

in the strongest position possible to stay ahead of the competition by consistently meeting customer needs.

Another trend is how the lines between the various channels are blurring. The divide between convenience, online and discount is becoming increasingly fluid. This is a reflection of shoppers using multiple channels to fulfil their shopping needs. Our recent ShopperVista research shows that 58% of shoppers now use four or more channels per month.

One of the best examples of this is Aldi's North Finchley 'city' store, which demonstrates the retailer's latest thinking on 'discountvenience'. The store is located on a busy high street, meeting both 'food-to-go' and top-up shopping needs. This new format offers opportunities for the discount retailer to target new customers,

Sainsbury's Local, Tottenham. The Big Four's convenience store push is delivering units in high streets, office areas, in and adjacent to transport interchanges, on petrol station sites, adjacent to out-of-town facilities – anywhere that is convenient to shoppers

"THE DESIRE TO SHOP LITTLE AND OFTEN PLAYS TO THE STRENGTHS OF THE SECTOR, OFFERING OPPORTUNITIES TO FORWARD-THINKING RETAILERS AND SUPPLIERS"

as well as enabling it to open stores in more urban locations. To make the offer relevant to the convenience shopper, the store features food-to-go, a comprehensive in-store bakery, chilled alcohol, and express tills for basket shops. By having a clear focus on convenience shopping, Aldi is putting itself in a strong position to capitalise on the growth of the channel.

This is likely to be a trend we will continue to see over the coming years as retailers look for innovative ways to deliver sales growth while meeting the changing needs of shoppers. The dynamics of the market are also changing in terms of ownership models. In the past year, we have seen One Stop launch a franchise model to recruit independent retailers into the business. A franchised proposition allows One Stop to offer an alternative to the Symbol group option.

From a retailer's perspective, buying into this agreement will offer positives in terms of increased support and standardisation. It does, however, involve giving away elements of control of the day-to-day running of the business as there will be strict compliance measures – something that may discourage more entrepreneurial retailers. Nisa is also exploring a franchise offer that will encourage retailers to adopt a heavily systemised and disciplined approach. Nisa's new model will offer a different option for retailers – it will demand more compliance, which in turn is designed to help deliver higher profits. From a supplier point of view, higher levels of compliance and store discipline will make serving the channel more efficient.

The continued shift towards a multichannel environment is placing an increased emphasis on convenience stores. The desire to shop little and often, in a range of outlets, plays to the strengths of the sector, offering opportunities to forward-thinking retailers and suppliers. However, increased competition and the market's constant evolution mean that retailers and suppliers are having to work harder just to stand still.

JAMES HARRIES
Senior Retail Analyst, IGD

James specialises in the UK convenience market. His role includes calculating the annual convenience market size, tracking trends and contributing to IGD's subscription and customised insight services. James brings six years' experience of working for Tesco and then Sainsbury's in site research/location planning. He has an MSc in Geographical Information Systems for Business and Service Planning from the University of Leeds. IGD's latest research, training and insight into convenience retailing can be found at http://igd.com/convenience and at #IGDconvenience.

Waitrose's new online fulfilment centre in Coulsdon, south London – a purpose-built, six-acre site featuring 80,000 sq ft of picking space Waitrose/Jeff Hopkins

Above: Click and collect at Tesco. Below: Tesco.com store, Enfield Tesco PLC

THE CHALLENGE OF ONLINE GROCERY

Online grocery sales continue to achieve double-digit growth, but squeezing profits from multichannel is proving to be much more of a challenge. Leading multichannel and e-commerce expert Chris Jones studies the cost side of the equation and how online is evolving in Europe.

Seventeen years after Tesco.com was first launched, at an analyst presentation on February 25, 2014, Tesco finally revealed the operating margins on its online grocery delivery business: £127 million on £2.5 billion of sales, or around 5%. But there was a curious caveat on the presentation slide: "All direct costs fully charged." What are we supposed to make of that? By implication, are there some indirect costs which are not fully charged? We're left suspecting that Tesco's online profitability might look more like Ocado's then it would like to admit.

And Ocado's profitability is not exactly enviable. On an average cart, according to its published data, the gross margin excluding delivery fees represents approximately 26%, a number that would make many grocers, especially in places like Germany, pretty jealous. In fact, being unable to generate this kind of margin in the first place is one of the many reasons online grocery has been slow to catch on in some countries

> "IF ONLY OCADO COULD SKIP THE DELIVERY PHASE OF THE PROPOSITION, IT COULD FINALLY BECOME A REAL PROFIT ENGINE. AND THAT'S EXACTLY WHAT'S BEEN HAPPENING FOR SEVERAL YEARS IN FRANCE AND BELGIUM, AND NOW INCREASINGLY IN OTHER EUROPEAN COUNTRIES"

(and incidentally leaves one questioning the viability of Morrison's online offer too). But the costs of getting that order to the customer is 25.8%, which doesn't leave a great deal spare to cover things like head office costs, IT systems and so on.

The really interesting bit is to breakdown that 25.8%. Roughly 1.2% is unavoidable administrative stuff, such as card processing fees. 11.3% represents the cost of the supply chain: central warehouse plus hub-spoke trunking, in Ocado's central warehouse model. One of the many costs that Tesco's caveat leaves open to question is whether the equivalent – the online business's share of the store supply chain costs – is included.

It's possible to estimate that around 3.8% represents the cost of picking fiddly 50-plus item orders. Even in Ocado's highly automated model, it still requires at least half an hour of labour to assemble a typical order. There isn't an awful lot that can be done about any of these costs – if you're doing online grocery, you have to operate a supply chain and you have to pick the orders. Obviously they can be more or less efficient, but you can't avoid them altogether. Interestingly, the anecdotal evidence there is suggests that there isn't quite so much difference in efficiency between Ocado's pick-in-warehouse model and the alternatives – pick-in-store or pick-in-dark-store – as you might think.

What you can do something about is the other big cost: last mile delivery. Some degree of assumption is needed to get to these figures, but Ocado's published data implies a cost of approximately £9.70 per delivery, in driver time, fuel and van running costs. Customers simply won't accept paying for all of this themselves, and in fact the trend is quite the opposite. What else can you do about this cost? Well pretty obviously, not offering delivery makes quite a difference. If only Ocado could skip the delivery phase of the proposition, it could finally become a real profit engine.

And that's exactly what's been happening for several years in France and Belgium, and now increasingly in other European countries – Ahold is building the capability in the Netherlands, and Real has been operating pilots of a Real-Drive offer in Germany for a few years now. According to published analyses by IGD, the online grocery market in France in 2013 was expected to be worth 6.7 billion euros (compared with 7.4 billion euros in the UK), almost entirely delivered by click-and-collect propositions, or as they are usually called in France, "Drive". In the last year, the number of locations in France where a Drive customer can collect their order has almost doubled, and they are now used by 20% of the population. The size of the business, and probably more importantly its rate of growth, is enough to have a material impact on like-for-likes.

> "ONLINE GROCERY IS SOLELY ABOUT CONVENIENCE. OTHER CONSIDERATIONS THAT MIGHT NORMALLY APPLY TO AN E-COMMERCE PROPOSITION ARE STILL RELEVANT BUT ARE ENTIRELY SUBORDINATED TO THE CHALLENGE OF MINIMISING THE INCONVENIENCE OF THE TEDIOUS WEEKLY FOOD SHOP FOR YOUR CUSTOMERS"

ABOUT IMRG

IMRG (Interactive Media in Retail Group) is the UK's industry association for e-retail. Formed in 1990, IMRG is setting and maintaining pragmatic and robust e-retail standards to enable fast-track industry growth, and facilitates its community of members with practical help, information, tools, guidance and networking. The strength of IMRG is the collective and cooperative power of its members. Email membership@imrg.org or visit www.imrg.org for more information.

There are a few basic flavours of the Drive offer. The first key distinction is in the pick-up process. Does the customer get out of their car (Casino, Intermarché, Système U), or is their role basically confined to opening the boot (Carrefour, E Leclerc, Auchan)? In either case, the total target collection time is under five minutes. The difference is largely accounted for by the sophistication of the customer-facing IT solutions at the point of collection.

The second, and probably more important, distinction is whether orders are picked in store or in some sort of nearby dark store, and also whether customers come to the supermarket or a dedicated location (which might be the dark store itself). Apart from obvious issues such as store capacity, parking space, planning regulations and so on, the most important criterion for this decision is probably the service level offer to the customer.

Online grocery is solely about convenience. Other considerations that might normally apply to an e-commerce proposition, such as advice, user experience, providing information, reviews etc, are still relevant but are entirely subordinated to the challenge of minimising the inconvenience of the tedious weekly food shop for your customers. Tesco has stated that a third of grocery orders were placed via mobile this Christmas – customers are dealing with the tiresome task while doing something else, such as sitting on a commuter train or in a traffic queue.

One way in which French retailers are addressing the convenience challenge is via ever-shortening lead times. For example, the offer from Casino Express requires the customer to wait a mere two hours between placing their order and collecting it, an ideal option for on-the-move customers ordering via mobile and dropping in to collect shortly afterwards. To provide such a service level in a pick-from-store environment is very challenging, not least because Drive order pickers will get in the way of in-store customers at all the most important times of day, i.e. those times when customers most want to shop and stores are busiest. Realistically, a dark store solution is probably the only option. (The main downside of a dark store is the size of the assortment – can you justify stock-holdings of notorious slow-movers like vanilla pods?)

Waitrose is trialling automated, temperature-controlled click and collect lockers in third party locations, allowing customers to pick up their shopping using a PIN texted to them after they place their order online

Waitrose

Back in the UK, Tesco has been rolling out click-and-collect grocery since 2010. In its Christmas 2012 trading update it stated that 5% of grocery orders were collected, and in February 2014 announced that 232 grocery collection locations were now live. Unlike Casino, Tesco is now looking to pilot another way to maximise customer convenience: collect near you, a sort of halfway house between delivery and Drive. A trial has been running in York with the aim of letting customers collect their order near where they plan to be for other reasons, such as schools and sports centres.

There's another, more subtle reason why click and collect has to be important for the grocer with ongoing online plans. The costs of last mile delivery mean that, in effect, there is a minimum economic basket size, below which any online order will make an operating loss. It's possible to estimate this at around £75 for Ocado, even with its excellent gross margins. How many grocery baskets are bigger than £75? As the trend moves more towards a regular basics shop plus convenience store top-ups, the answer is not many, and probably fewer and fewer. Eliminating the last mile cost reduces this minimum economic cart size to a manageable level, and opens up the online grocery offer to a far wider range of consumers and gross margin levels. Given that customer take-up has been huge in France, and tolerable even in the UK with its well-established delivery model, then click and collect has to make sense as an option in any country where online shopping in general has any traction at all. Most places, in other words.

CHRIS JONES
Freelance multichannel and e-commerce specialist

Chris has consulted across the world for a wide range of companies, from several of the largest retailers in the world to VC-backed start-ups. His engagements have included Tesco.com, Metro Cash & Carry, Dr Martens, where he was Interim Global E-Commerce Director, and a range of retailers in countries as diverse as India, Romania and Belarus. He is the author of The Multichannel Retail Handbook (ISBN 978-1-300-65266-3). You can find him at www.linkedin.com/in/redsock. Chris has also authored a number of recent papers for IMRG, the UK's industry association for online retail, including "A Tale of Two Cities – Competition between Digital and the High Street". http://reports.imrg.org/digitalhighstreet

TAPPING ONLINE

The relentless growth of online is reshaping global consumer markets, leaving a trail of once tried and trusted but now broken business models in its wake. Food operators are meanwhile leading the multichannel investment race, accelerating the rate of retail industry innovation. Retail grocery expert Martin Summerscales explores the astonishing growth of online in UK food markets.

The big grocery chains have been having a difficult time of late, but regardless of discounters Aldi and Lidl nipping at their heels and the recent weakening of their trade performance, there is one area where the Big Four continue to race ahead and that is online. Asda, Sainsbury's, Tesco and Ocado: all continue to report double-digit online grocery sales growth. With little sign of consumer appetite for multichannel dissipating, main store grocery operators – but not Aldi and Lidl – are under a lot of pressure to keep pouring money into online investment.

While online currently is generating substantial extra sales income for grocers, it is not adding much in the way of profit. However, the view taken to date is that it is better to maintain customer loyalty via online than to lose customers to a competitor. The grocery majors are all well aware that if you do not provide online services, the capacity, or the delivery slots when customers want them, then shoppers will walk. It is very easy to sign up for a different online grocery platform. Grocers, rightly to my mind, have taken the view that it is better to achieve low margin sales than no sales at all.

But the profitability issue is much more nuanced than that. Clawing back 100% of multi-channel fulfilment costs from consumers in grocery markets always was a forlorn hope. Margin dilution resulting from multi-channel investment is pretty well inevitable, particularly in a period of squeezed household incomes. Just think of the dynamics of the process. Grocers are taking on the substantial cost of activities that customers used to do for themselves: picking goods from

Tesco click and collect at Rayners Lane Tube station Tesco PLC/S Saunders/Digital Nation Photography

> "GROCERS, RIGHTLY TO MY MIND, HAVE TAKEN THE VIEW THAT IT IS BETTER TO ACHIEVE LOW MARGIN SALES THAN NO SALES AT ALL"

grocery store shelves, putting them in bags at the till and paying before carrying the bags to their cars and driving home. It is very expensive to have grocery staff doing the shopping for customers instead and then delivering the shopping to their homes, let alone building and managing click and collect facilities. Currently, the bulk of the fulfilment cost is picked up by grocers, not customers.

So why are grocers encouraging customers to shop online? After all, it turns the whole cost-minimising philosophy of supermarket shopping on its head.

But that misses the point: 'online' – and the 'omni-channel' activities it supports, is at one level just a continuation of the electronic payment revolution that began with credit cards and ATMs. It is downstream cost savings from technology advances – the business efficiencies – that create the unstoppable momentum of online from the operator perspective; in the case of online shopping, direct cost savings from scanning and enhanced stock control and, as explained later, the ability to 'sweat' low performing branches. So grocers don't have to squeeze every last penny back from customers to cover the direct cost of click and collect and home delivery investment: there are knock-on cost savings elsewhere.

There are also very large market share gain (and protection) opportunities associated with online. Scanning via mobiles and on-site self-scanning machines alone are changing shopping today as fundamentally as new weaving machine technology reshaped textile markets during the industrial revolution. Online price comparison and website development continues to reshape markets too. The rate of technology change now is so fast that it is all but impossible to keep track of what is going on.

Click and collect and home delivery services involve substantial implementation costs, but there are opportunities to be gained by providing them

'Scan as you Shop' at Tesco Extra in Peterborough
Tesco PLC/Peterborough Press and PR

What we do know is that, whatever the current margin dilution issues, online is growing exceptionally rapidly and will continue to do so. The Big Four are putting more and more resources into it. Tesco's online business last year was worth a startling £3.3 billion – more than the total turnover of Debenhams, in-store and online. Tesco.com is a major retail force in its own right, and just look at how fast it has all happened. It has traditionally taken many decades to build a retail business of this size. Tesco.com got there in just 17 years.

Tesco is, of course, highly unusual. Even with the recent market share losses reported, Tesco still achieves a commanding main grocery market share lead not far short of 30%: close to double that of its nearest rivals Asda and Sainsbury's. Even more remarkably, it captures almost 50% of the UK's total online grocery business. Indeed, Tesco to date has been the primary driver of online grocery sales growth in the UK. The sales growth performance of Tesco.com, by any measure, has been little short of spectacular.

Tesco, of course, has a major edge over other players in the online grocery field: it has by far the largest grocery network in the UK and is currently the only grocer in the UK that can claim, hand on heart, that it offers a fully national online sales service. Tesco is everywhere. It has more superstores and hypermarkets than anybody else and also far more small store formats.

> "THE SALES GROWTH PERFORMANCE OF TESCO.COM, BY ANY MEASURE, HAS BEEN LITTLE SHORT OF SPECTACULAR"

But online grocery is not all about Tesco. Asda is doing a great job too. It is investing ever larger sums of money in its online platform. Asda has recently announced three new fulfilment centres (or dark stores), all in the south-east of England. Currently Asda has one in Leeds and one in Nottingham. Dark stores are often imagined as mushrooming up all over the place, but actually remain very small in number – little more than a handful – and largely located in or around London, in part because London is exceptionally poorly provided with grocery stores. The per capita grocery floorspace average in London is a startling 30% below average national levels. It is something of an irony that the most prosperous part of Britain has by far the poorest grocery provision.

Planning obstructions to increasing grocery superstore provision in London has encouraged grocers to seek market share gains in London via online instead. The prosperity of London and the south-east is an added attraction from the online perspective because potential online basket spends are much higher, and higher margin lines are more likely to be purchased by customers in London and the south-east.

Tesco, for example, currently has a network of six dark stores neatly encircling London, largely designed to tap suburban London markets where Tesco superstore representation is at its thinnest. Sainsbury's, the grocery operator currently achieving the highest London market share (circa 25% against Tesco's 15%) is currently planning to build just one fulfilment centre, at Bromley-by-Bow. So it is store-picking, not fulfilment centres, that looks set to remain the primary growth driver of online grocery for the time being.

Sainsbury's online shopping grocery delivery
J Sainsbury plc

PICKING THE WINNERS

It is store networks, not dark stores – however clever the pick-technology developed for the latter might be – that continue to fulfil the bulk of online grocery purchases nationally. Dark stores currently are a market share grab or a pinch point easing strategy more than a home delivery solution for grocery networks per se – for the moment at least.

Asda's structural weakness, from a store network point of view for example, is that it is very underweight in London and the south-east: prime online shopping territory. And that is restricting its ability to compete with Tesco and Sainsbury's for online trade, simply because it does not have the stores in the right place to pick orders from. The three new planned fulfilment centres will help Asda increase its south-east online penetration. Click-and-collect vans at rail stations are another Asda strategy. But without local brand support via bricks-and-mortar superstores, it remains to be seen how things play out for Asda, bearing in mind that it is competing against Tesco, Sainsbury's, Waitrose, Morrisons, Ocado etc.

Store-picking is an interesting aspect of online. Take Ocado, for example. It is a dot-com picking service only. It has no stores. It has a fulfilment centre in Hatfield and one in Dordon in Warwickshire. It also hosts some Waitrose and Morrisons online activity, which provides a proxy branch network for Ocado, but one that supports the Waitrose and Morrisons brands, not Ocado.

Ocado is, meanwhile, the market leader in pick-technology. Hatfield and Dordon are very efficient as fulfilment centres: cutting edge. Goods from Hatfield and Dordon are put on trucks and taken to small 'spoke' units, one of which is right next door to Westfield London. Goods are then transferred to vans for local household distribution.

It's nominally an efficient model. However, the logistical costs of all the Ocado vans and lorries trundling around and all the pick/facilities investment is eye-watering. Unlike Tesco, Sainsbury's and Asda, Ocado does not have in-store customers to subsidise the cost of its online fulfilment, making it difficult to create a profitable business. Ocado is currently trying to use licensing revenues to generate additional income. But it illustrates the problems confronting pure-play grocery operators. On a market share basis, it is the in-house grocery chain operated online services that are winning hands-down.

That is not to say that there is no place for pure-play operators like Ocado, or Amazon following its recent foray into the same territory in the US, along with FreshDirect and Peapod. Or the recent Instacart/Whole Foods 'personal shopper' offer where, in effect, customers pay for somebody else to do their grocery shopping for them on an ad hoc basis. But the jury is out on whether any of these pure-play business models can profitably tap mass-market grocery, simply because the bulk of the population is not rich enough to pay somebody else to do their shopping for them and the pure-play operators do not have store customers to subsidise the service. As niche services for the wealthy they can survive, but that market is very small. If pure-play offers are to succeed, like Ocado, most operators will need to look beyond grocery customers for revenue, hosting small grocery chains or other online activities perhaps.

Store-picking comes with its own set of problems. Sainsbury's is interesting because it has fewer big stores than Tesco and is consequently forced to pick from smaller stores: store sizes that Tesco does not pick from for 'range conflict' reasons. Range conflict is where the store range is so much narrower than the online range that it is not possible to completely fulfil many orders. Substitution can help, but it is not a solution to the problem. The process of matching supply to demand in these circumstances can quickly become a costly logistical nightmare. But concentrating picking in the biggest stores – that are more or less full range – has problems too: it clogs up aisles with pickers, obstructing customers, while clearing shelves of goods customers are also looking for creates both conflict and replenishment difficulties.

Currently, online sales of grocery are just 4% of total national grocery sales. If we are hitting picking capacity problems now, which we are, what will it be like if 6% or 8% or 10% of groceries are ordered online in a few years' time? In-store picking is an intrinsically less efficient model in terms of pick rate too: barely one-third that of a top fulfilment centre. However, in-store picking does have one saving grace:

it allows grocers to 'sweat' an asset, i.e. you can use picking to increase throughputs at facilities that are not trading well while reducing picking at stores that are overtrading. So online can be used to boost trading intensity in poorly performing stores, something particularly useful in preventing food waste. If the trading intensity falls too low, then fresh food is going to go off before you have sold it. Shifting picking to lower intensity stores helps to ensure efficient stock turnover.

> "CURRENTLY, ONLINE SALES OF GROCERY ARE JUST 4% OF TOTAL NATIONAL GROCERY SALES. IF WE ARE HITTING PICKING CAPACITY PROBLEMS NOW, WHICH WE ARE, WHAT WILL IT BE LIKE IF 6% OR 8% OR 10% OF GROCERIES ARE ORDERED ONLINE IN A FEW YEARS' TIME?"

And that is another of the online nuances: the reason why obsessing about covering fulfilment investment cost alone misses the point. There is a desirable level of trading intensity – not too high to cause replenishment difficulties, not too low to create food waste problems. If you drop below the desirable trading intensity, it causes problems in terms of staffing and stock wastage. The flip side is that there is a desirable trading intensity ceiling too. High-density stores can pose real problems for online because of the additional pressures it adds.

There are usually two waves of picking: the first of which takes place in the early morning, so customers are coming in and there is an army of people already in the aisles picking online orders. It makes stores much more difficult to manage. It is a hugely complex juggling act. Tesco tends to win out at the moment simply because its network is so large that it has much more capacity to play with when managing pick activities. But even with Tesco, some stores are reportedly already at breaking point with picking. And that begs the question, where do we go from here?

Many stores will originally have been designed for maybe 15 to 20 vans of picking daily. As online demand grows, retailers are forced to try and increase the numbers, whether by extensions to freezer and chiller space or by rearranging the shop floor, having wider aisles to allow for more picking, increasing department sizes in dot-com areas – frozen or carbonates, say – that see above average ordering (because the delivery guy does the carrying).

Even seasonal issues come into play, with certain parts of stores being more badly hit by online picking at certain times of the year than others. So retailers might extend space given over to these 'danger' categories to make sure they've got enough stock left after the pick. That in turn can distort the mix for in-store customers.

As the online market matures, range conflict issues are certainly going to worsen. Moving customers from stores to online is fine because online sites can list the full merchandise range. Moving from online to store-picking is another thing altogether, as the range present is largely determined by the store size. A Tesco superstore does not have as big a range as a Tesco Extra, for example. Range varies by locality, too. So operators are very restricted in terms of which stores they can pick from.

If you've got a product like Vegemite, for example, which is ordered by a very small number of customers, it is worth having it on the online site because it is serving hundreds of thousands of shoppers. Having it on the shelf of a small store will usually not make sense because the demand is insufficient. But what do you do if you are picking from stores that only include some items listed online? You can only pick what is on the shelves. If, as is often the case, stores are part-range, you have a serious problem.

> "IT HIGHLIGHTS ONE OF THE ACHILLES HEELS OF STORE-PICKING: THE RANGE OF GOODS PRESENT WILL OFTEN BE A LOT LESS THAN WHAT IS AVAILABLE FROM FULFILMENT CENTRES. AS STORE FORMATS ARE INTRINSIC TO THE GROCERY BUSINESS, RESOLVING THE PROBLEM ON A NATIONAL BASIS WOULD IMPLY BUILDING THOUSANDS OF DARK STORES. THAT IS NOT GOING TO HAPPEN"

For example, a store in, say, Hyde in Manchester may serve a very deprived local catchment area, so the products on the shelves will largely be value products: more frozen range, less fresh, fewer premium brands and so on, and yet that store in Hyde may serve as a pick location for online customers that live in affluent areas: Hazel Grove or Marple, say. And so those customers logging on from Marple might want to order Colombian coffee beans, or premium fresh fish, or expensive cheeses that are not stocked for Hyde store customers. What you have here is a classic range conflict.

One obvious solution is to tailor the goods that appear on an online site to the location of the customer, limiting the online offer to whatever can be picked from a store locally. That is fine as long as the range broadly approximates to what the customer is used to buying in their favoured local store. The strategy so far has been to not 'move people' – i.e. to pick from stores that would result in the consumer losing more than 5% of their favourites.

But it highlights one of the Achilles heels of store-picking: the range of goods present will often be a lot less than what is available from fulfilment centres. As store formats are intrinsic to the grocery business, resolving the problem on a national basis would imply building thousands of dark stores. That is not going to happen.

In the medium term, click and collect looks likely to win out over home delivery on simple cost grounds and because store visits for collection encourage additional purchases. Currently, however, it is only really Asda and Tesco that are seriously engaged in mass-market grocery click and collect. Waitrose is active in click and collect but targets a very different demographic and is not really a mass-market grocer in the same way as the Big Four.

Click and collect is a very difficult business model to operate because it has very low margins. True, you cut out the delivery costs, but it is still a space-hungry activity and you have to have staff handling orders as well as picking. You also have the additional refrigeration costs, box costs and so on, a very expensive investment that you will have difficulty clawing back from customers. Click and collect at airports and vans in station car parks (eg. Asda) look pretty marginal in grocery retailing terms – more of a PR thing than a serious business initiative. But click and collect generally will thrive – it is already doing so. It is a win-win solution for consumers and a least-worst solution for retailers.

So where is the market going? Well, online grocery shopping investment will continue, but as store-picking capacity levels continue to fall, it seems likely that click and collect and home delivery costs will have to rise to stem demand. More dark stores will be built, but to serve areas (like London) that present store-picking problems. Click and collect looks set to become increasingly important for most grocery operators.

MARTIN SUMMERSCALES
Head of Retail Consultancy, CBRE

Martin's team specialises in store location analysis, spatial modelling, impact analysis and sales prediction modelling. Martin previously worked within the UK grocery sector and has particular expertise in online fulfilment and click and collect. He has also advised major operators on their convenience store investment and location strategies.

TWO NATIONS DIVIDED BY A COMMON INDUSTRY

The supermarket was born in the USA and for many decades the US led the way, with British and European food retailers looking to it for new ideas. Dr David Rogers of DSR Marketing Systems, Inc. compares grocery market trends in the USA and UK.

Walmart Supercenter fresh offering

Walmart

Beginning in the 1990s, the leadership of the US supermarket industry began to falter with the onslaught of Walmart's version of the European hypermarket. Walmart Supercenter progressively reduced the profitability of the American supermarket industry. Initially at least, this dulled innovation.

Walmart's impact continued throughout the first decade of the 21st Century and – despite a recent weakening in its pricing, merchandising and service levels – the impact continues to this day. With a few exceptions, such as HEB, Kroger, Wegmans and WinCo, much of the US supermarket industry reacted like the proverbial "deer frozen in the headlights" – incapacitated by weak leadership, gross margins up to 15% higher than Walmart's, and wedded to outdated, supplier-oriented practices.

In contrast, the 1990s and 2000s were the heyday of the large UK supermarket chains, led by the Big Four (Tesco, Sainsbury's, Asda and Morrisons) but especially Tesco. Innovation and overseas expansion were encouraged by high levels of profitability resulting from a number of factors, including an early and continued commitment to private brands that benefited both retailers and consumers alike; sophisticated, efficient distribution logistics facilitated by the small geographical size of the UK and extremely high population densities; and restrictive government planning policies and inflated property prices, which presented significant barriers to entry and limited competition in many local markets.

"WITH THE SALE OF FRESH & EASY, THE INVOLVEMENT OF BRITISH GROCERY RETAILERS IN THE US HAS ENDED, IN CONTRAST TO THE CONTINUED PRESENCE OF LARGER, EARLIER INVESTMENTS BY AHOLD (NETHERLANDS) AND DELHAIZE (BELGIUM)"

British retailers – led by Tesco – invested some of these profits overseas, including in the USA, where there was a perception of a stagnant market and a need for new ideas and improvements. Marks & Spencer acquired Kings in New Jersey, Sainsbury's acquired Shaw's in New England, and Tesco carried out extensive research on prospective acquisitions from the late 1980s until its ill-fated decision to develop Fresh & Easy from scratch in the early 2000s.

Fresh & Easy was loosely modelled on California-based Trader Joe's (which still goes from strength to strength) but, despite a logical but high overhead attempt to bring British best-practice to the US, foundered on the fundamental misinterpretation of extensive research on American shoppers, including some uncharacteristically weak site selection that did not fit what was a rigid store prototype to appropriate locations. With the sale of Fresh & Easy, the involvement of British grocery retailers in the US has ended, in contrast to the continued presence of the larger and earlier investments by Ahold (Netherlands) and Delhaize (Belgium).

Times have now changed on both sides of the Atlantic. In Britain, continued planning restrictions refocused the major food retailers on small, higher priced convenience stores. However, the post-2008 downturn and its extended aftermath has stimulated the development and sales of the small-format hard discount retailers from Germany (Aldi and Lidl), which are less affected by planning restrictions than supermarkets and superstores. Small boxes are all the rage, including those operated by the pound stores, and the Big Four – like their American counterparts in the late 1990s – are now the ones experiencing sales and profit declines and are in need of new ideas.

Sainsbury's has identified one potentially successful strategy with its reincarnation of the Netto hard discount format in Britain, which could diversify its sales base to include lower income and/or more price-focused shoppers.

But there are now, as in the 1970s and 1980s, also ideas that can be drawn from the US and Canada. Despite the continued survival – but progressive decline – of a lot of 'dead wood' in the US supermarket industry, North America is still a significant hotbed of innovation due variously to Walmart, the 2008 downturn and the progressive growth of online retailing. For example, retailers such as HEB and Loblaw have purchased and/or established dedicated chains aimed at the rapidly growing Hispanic and Asian populations in their operating territories. This growth strategy is of obvious relevance to some British cities, with suitable adaptation.

Sprouts store interior

Then there are the increasing education levels and concerns with health and "wellness" that are enlarging the overall natural/organic market, particularly where prices are lower than those charged by specialists, such as Whole Foods.

Finally, the demise of category-killer non-food retailers because of online competition is reducing retail rents and increasing the supply of space for "value" food retail formats, such as Sprouts and Aldi-owned Trader Joe's. The same trend is happening in the UK, as evidenced by the downsizing of some B&Q stores.

Sprouts is an excellent example of American innovation and a retailer which we have recently studied in depth. Established in 2002, Sprouts is a value-orientated, natural/organic food retailer emphasising produce and bulk foods, presented in a "farmer's market" environment. A 'super-greengrocer', in British parlance.

Sprouts stores range in size between 23,000 sq ft and 28,000 sq ft in size (gross area) and now number more than 180 branches, with a further 60 in development. Based in Arizona, Sprouts is rapidly becoming a semi-national chain, with stores from California in the west to Georgia in the east. The total sales of the chain have grown five-fold in the last five years, from $441 million in 2008 to $2.4 billion in 2013.

Sprouts has already attracted imitators (for example, Fresh Thyme in the US Midwest) and is positioned as a value alternative to Whole Foods with a deliberate appeal to the growing number of mainstream shoppers transferring to natural/organic foods. Part of its value is derived from its extensive use of cheap re-use property.

Sprouts is an interesting model for Britain's Big Four, which have the necessary supply relationships to support new formats, but also have arguably tried to do too much in small numbers of standard boxes, other than their planner-enforced convenience store ventures.

Thanks to the expansion plans of Aldi, Lidl and now Netto, price compression will continue in the UK, reinforced by Tesco's problems and a new management that has to focus on short-term impact. But price-slashing is not a long-term solution for the Big Four. They would be well advised to look at what has – and has not – worked in the Walmart-impacted US supermarket industry over the last 20 years.

"SPROUTS IS AN EXCELLENT EXAMPLE OF AMERICAN INNOVATION... A VALUE-ORIENTATED, NATURAL/ORGANIC FOOD RETAILER EMPHASISING PRODUCE AND BULK FOODS PRESENTED IN A 'FARMER'S MARKET' ENVIRONMENT. A 'SUPER-GREENGROCER'"

DSR Marketing Systems, Inc. is a market research and consulting firm specialising in retail research, including store location analysis and consumer research. It was established in 1979.

DR DAVID ROGERS
President, DSR Marketing Systems, Inc.

David was formerly Head of Site Potential Statistics for J Sainsbury plc, the British supermarket chain. He has given presentations on market research topics for a wide variety of US and British retail trade organisations, and is the Assistant Director of the annual Retail Location Analysis seminar Oxford University's Business School (Templeton College). David is co-editor of Store Location and Store Assessment Research, published by John Wiley and Sons Ltd, and is a regular columnist for a variety of retail trade magazines in Canada, the USA and UK, including Canadian Grocer, Grocery Headquarters, and The Retail Digest. www.dsrmarketing.com.

FROM SMALL TO BIG TO SMALL AGAIN

Chain grocery branch numbers have rocketed in recent years, but the most rapid growth has been in small trading formats, not large. Melitta Berrino of Retail Locations explores UK branch growth trends.

Tesco Extra, Sandhurst
Tesco PLC

Sainsbury's Local, Hasluck Green
J Sainsbury Plc

Readers that are motorcyclists or pilots will recognise the target fixation problem: collisions caused by the tendency of individuals to steer in the direction of their gaze. Fixate on something and you will most likely pile into it. Market analysis is a bit like that. Fixate on a single aspect and you are likely to unerringly reach the wrong conclusion.

Take Aldi and Lidl, for example. The main grocery market shares of the two retailers has grown exceptionally strongly in recent years, seemingly largely at the expense of the Big Four. The question is, why? Shopping behaviour has certainly been changing since the onset of the 2008 downturn. Incomes have been squeezed. Consumers are much more careful about their spending. Hard discounters have been capturing market share rapidly as a result. Identical shopping behaviour change is occurring in North America and Europe as well. But is that really the cause of the Aldi/Lidl market share increases, or is there more to it than that?

Households can ultimately only shop where retailers choose to provide branches. For individual households, main grocery store choice is actually quite constrained. If your favourite store brand is not located within a reasonable travel distance, you


Lidl has grown strongly in recent years, opening new stores at a fast rate and capturing market share

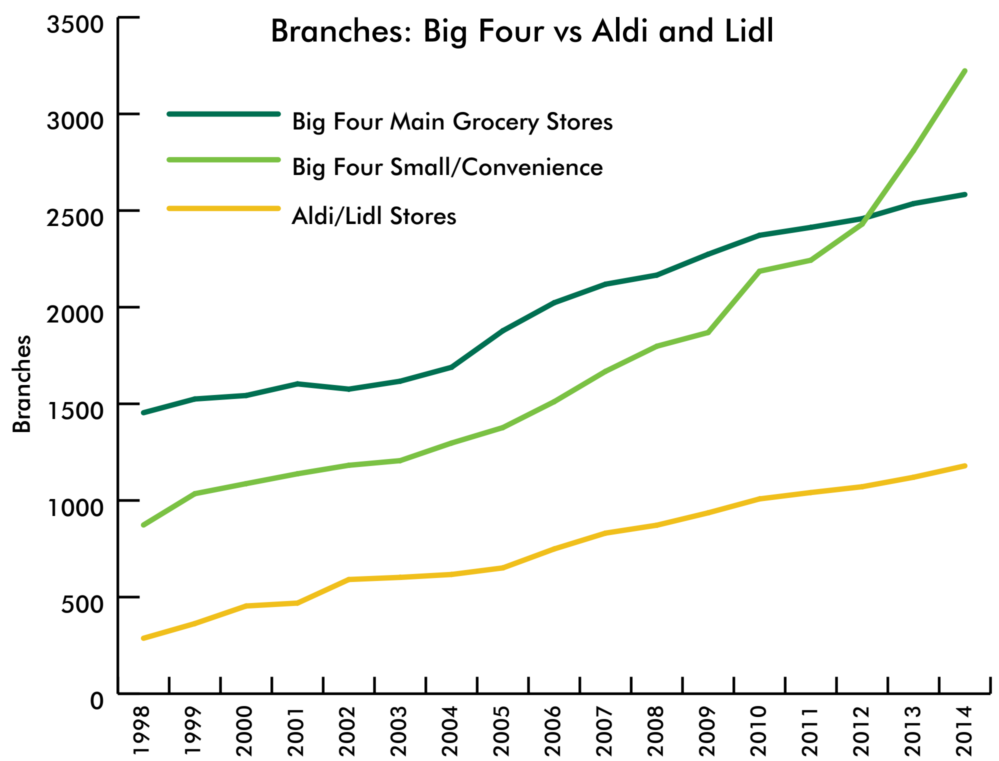
are forced to shop for your groceries at another nearby store. Very few locations have anything approaching a full representation of leading grocery brands.

The market share potentially achievable by individual chain networks is consequently contingent on the distribution of networks generally and the number and range of formats operated. The potential for households to switch operators is not open-ended. It is dependent upon the choice of operators available locally. And that choice differs substantially depending upon where you live. A great many catchments do not have Aldi or Lidl branches.

Online is changing the rules of the game, but as only 5% of grocery sales are currently transacted online, multichannel cannot explain the shopping pattern change we are seeing. Aldi and Lidl do not offer online shopping services, so their market share growth can only come from additional branch sales. Ultimately, Aldi and Lidl can only capture sales from catchments that their branches serve. Which begs the question, are they building sales due to customers switching from other brands, or simply because they have been aggressively expanding their networks, diverting trade? There is a major difference.

Currently, Aldi and Lidl capture just 8% of national main grocery sales via just under 1,200 stores. Their cumulative store network has doubled in size over the last 10 years. Doubling that total market share implies doubling their network penetrations, which means building or acquiring hundreds of additional branches. As it has taken nearly 20 years to get to 8%, it is reasonable to suppose that it will take a decade or more – with their current 12,000 sq ft formats – to double market share again, particularly in the absence of online to boost market share. And that's assuming, of course, that stores can be acquired/developed and competitors held at bay over the period – a very big if.

As the Kantar Worldpanel figures show, Aldi's market share growth has accelerated since 2010. Aldi's store openings have followed a similar trajectory. Or, to put it another way, the Aldi/Lidl market share gains are being driven more by new branch openings than by customers of other grocers switching to existing Aldi/Lidl branches: i.e. shoppers at one level are simply responding to changes in local branch provision. So if you want to know where market shares are going to go in the future, you need only look at what is happening to branch penetration rates and new branch opening programmes.



BRANCH OPENINGS

The Big Four grocers have steadily increased the rate of opening of their convenience store formats. Their convenience store portfolios have grown cumulatively from 873 stores in 1998 to 3,223 today (an increase of 270%). Main grocery store openings have remained sluggish in comparison, with branches growing in number by 77% since 1998 from 1,454 stores to 2,583 today. Many of these stores were secured by acquisition, following the failure of Kwik Save, Safeway, Somerfield and Netto, rather than by new development; far more trade was captured by capacity release over the period than by new store development diversion. Aldi and Lidl are effectively winning by out-opening the Big Four in main grocery catchments.

Source: Retail Locations

One of the most notable changes that we have seen in recent years is the soaring number of convenience stores. The growth of big grocery stores in relative terms has been much more sluggish. The Big Four, through their convenience store expansion activities, are in effect encouraging more top-up-shopping partly at the expense of their own traditional one-stop shopping offers at superstores. Meanwhile, they are also the primary online grocery investors, pushing things in entirely the opposite direction because of the pick focus on big stores.

Since 1998, the number of the Big Four's small-format branches (boosted in recent years by convenience store openings), has grown by almost 270%. Aldi/Lidl store numbers have jumped by 310% over the same period. The Big Four's large-format store numbers have grown by just 77%.

Of course, it takes a very large number of small-format grocery stores to deliver the space equivalent to that of a superstore. The Big Four grocers may be opening stores at a lower rate than Aldi, but they are still opening far more grocery space. But it is not a space issue. Aldi and Lidl are a different business model, focusing on a narrow range of grocery basics. Convenience store formats have a very limited range too; they are also an entirely different business model to a superstore. One is essentially basics/top-up and the other is broad range. If shoppers want a full-range grocery offer, they have to visit superstores (or buy an equivalent offer online). They have no other choice.

What Aldi and Lidl are doing by opening their hybrid – halfway house, no frills – hard discount grocery stores, at a much faster rate than the big four can deliver new superstores, is to inject their cut-down, value-led main grocery offer directly into the Big Four's catchment areas, increasing the potential for customers to switch for basics.

The only fly in the ointment is that the strategy is wholly dependent upon new store openings, a very time-consuming and expensive process. The Aldi/Lidl market share gains can only be sustained if they maintain their current high rates of new branch openings. Doing that, and sustaining branching profit contributions, is a tricky juggling act in a market as competitive as grocery retailing.

Which begs the question, is the reason the Big Four are losing market share now not so much because of the economic downturn or because shopper behaviour has fundamentally changed, but simply because they have progressively diverted investment from big store to convenience store expansion and online, while Aldi and Lidl have continued on their relentless expansion into the Big Four's main grocery catchments?

MELITTA BERRINO
Senior Partner, Retail Locations

Melitta joined Retail Locations in 1988 and conducted a successful MBO in 1993. The Retail Locations database is the oldest and by far the most extensive dedicated multiple database in the industry, providing a comprehensive record of chain operators in retail, service, catering and leisure markets. Retail Locations supplies the data and market intelligence for CBRE's Shop Expansion Plans publication series, as well as providing trading location-level branch data for CBRE's NSLSP programme.

GROCERY STORES IN THE PIPELINE

The grocery pipeline has grown by 18.79m sq ft (65%) since the onset of the credit crisis in the second half of 2007. The amount of new grocery space under construction in first half of 2014 was 2.47m sq ft, marginally down on the 2.95 sq ft recorded a year earlier. Convenience store openings continue apace but are still dwarfed, in aggregate floorspace terms, by superstore development.

The industry-wide shift away from very large hypermarket-style units continues, but grocery superstore development, some of it still out of town, remains buoyant. The main growth inhibiting factor, as always, is planning.

The grocery majors all have an array of stores, from full-range to convenience. Cumulatively their offers dwarf those of discounters in format, range and catchment reach. Their store networks also dwarf those of discounters in branch number terms and average size. By the end of 2013, the full-range grocery players – the Big Four plus Waitrose – cumulatively held 5,556 branches, amounting to 97.5 million sq ft of main grocery shopping stock: an average store size of 17,500 sq ft and average sales density of circa £1,150 sq ft.

Aldi and Lidl have 1,179 branches totalling 9.1 million sq ft of grocery space, a branch size average of just 8,000 sq ft and achieve sales densities of less than half full-range players (circa £580 per sq ft). Both have increased store format sizes to circa 12,000 sq ft, so in future their opening programmes will deliver 50% more space per unit, increasing the range-competitiveness of their offers. The Big Four operators have upped the size of their convenience formats from the circa 3,000 sq ft of a few years ago to 7,500 sq ft to 15,000 sq ft now. Convenience is gradually morphing back into full-line supermarkets. The locational focus of convenience store operators and Aldi/Lidl are very different however: the former aim to mop up top-up spending, the latter to capture spending on grocery basics.

At the end of 2013, Aldi and Lidl captured a market share of main grocery of 8.3%, up from 2.1% in 1998, according to Kantar Worldpanel. Aldi/Lidl have added 779 stores since 1998; the Big Four and Waitrose have added 3,847 – on average, much larger stores. The potential, via store openings, for Aldi and Lidl to seriously dent the market shares of the big full-line grocery chains looks remote simply because of the very large range differences and the sheer number of additional branches that Aldi/Lidl would need to open to achieve the required trade diversion. Further Big Four market share losses are expected because of the sheer aggression of the Aldi and Lidl expansion programme, but dramatic inroads look unlikely for simple catchment penetration reasons. You have to have stores in place to capture market share, and that takes years of network development for individual operators to achieve.

"THE BIG FOUR OPERATORS HAVE UPPED THE SIZE OF THEIR CONVENIENCE FORMATS"

The Big Four are not unassailable, of course, but the market has increasingly polarised between the full-line, multi-format players (the Big Four and Waitrose) and the discount end of the market, currently led by Aldi and Lidl but soon to be rejoined by Netto via a joint venture with Sainsbury's. There is, meanwhile, talk of other grocers in the Big Four adding Aldi/Lidl-size value offers to their networks to compete directly against discounters.

Economic conditions continue to favour discounters, but the real change in grocery markets is still occurring at the full-line main grocery end of the business.

IN SEARCH OF SOLUTIONS

The golden decade when Tesco and the Big Four grocers achieved growth simply by mopping up capacity released by Somerfield, Netto, Kwik Save and Safeway is at an end. Tesco has found itself marooned in the middle ground, facing strong competition from both premium and discount grocers, and is now faced with the painful process of adjusting to a new, harsher trading environment. The KPMG/Ipsos Retail Think Tank (RTT) met in October to discuss what Tesco can learn from other businesses which have successfully been turned around.

Tesco PLC/Richard Eaton

Tesco Extra, Dover

The RTT believes that Tesco must first identify and acknowledge the full extent of the problems facing its business. The economics of its business model no longer work in the current trading environment: its high margin strategy is unsustainable and will continue to negatively impact its market share. Acceptance needs to be followed swiftly by finding the root causes of business distress and bringing to light what is not working.

"This is not about completely reinventing the business, but it is about recognising that some things – not least relatively high margins – are just not sustainable in today's market," said Neil Saunders, Managing Director of Conlumino. "The price of trying to maintain those margins is one of continued market share erosion. This is a difficult thing to engineer, but it is something that others, such as Carrefour, have successfully done in order to get growth back on the agenda."

Customers are also confused as to what Tesco now stands for. Historically it has been the grocer which served everyone, but in today's environment, where the mass market is becoming increasingly fragmented, that is impossible to pull off. With competition fierce from the luxury and discount grocers alike, Tesco must deliver ranges and promotions designed specifically for its best customers.

It has data and cash to achieve this: Tesco has access to more consumer data through its Clubcard than any other grocer. However, the data is only valuable if it produces sharp and deep insights and the customer is put at the heart of everything the business does.

Martin Hayward, Founder of Hayward Strategy and Futures, commented: "The irony is this is a company that has one of the best insight machines in the marketplace, yet has failed to understand the change in customers' needs. Tesco should be in a tremendously strong position to connect with their customers given their pioneering investment in customer data analysis since the mid-1990s. Somehow the messages that this data must and should have been sending to the board of Tesco have been missed or ignored, in the pursuit of ever greatness and scale. The business needs to learn to listen once again."

Martin Newman, CEO of Practicology, said: "Customer loyalty demands more than a points-based rewards system. Customers want to be treated like individuals. Tesco needs to leverage its data with a programme of rewards and personalised offers aligned with customers' lifestyles and lifecycles.

> **"THIS IS NOT ABOUT COMPLETELY REINVENTING THE BUSINESS, BUT IT IS ABOUT RECOGNISING THAT SOME THINGS – NOT LEAST RELATIVELY HIGH MARGINS – ARE JUST NOT SUSTAINABLE IN TODAY'S MARKET"**
>
> Neil Saunders, Conlumino

"Once the business has understood customers' requirements, Tesco can re-engineer its people, systems and processes to deliver the new customer proposition and journey."

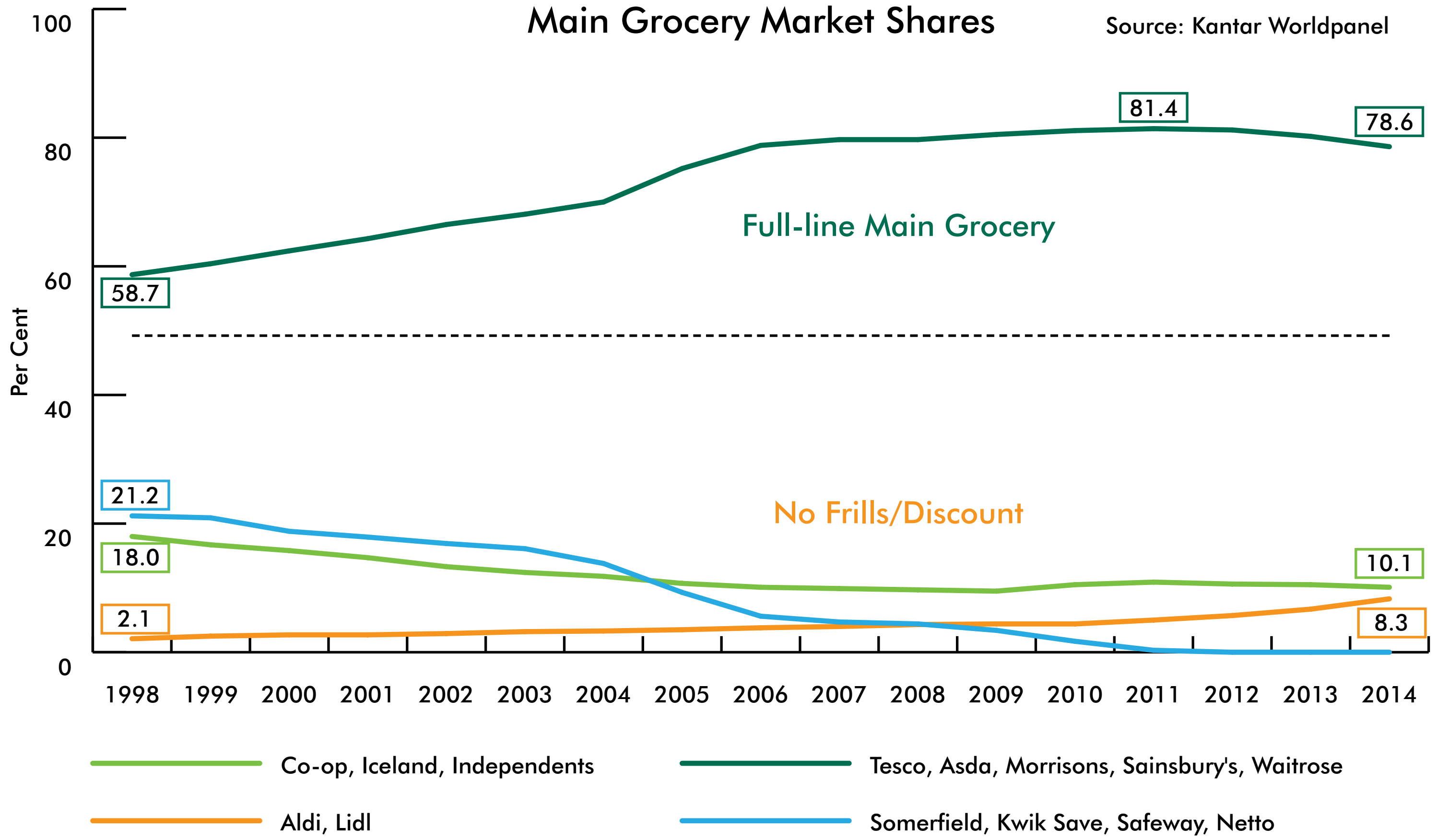
Mike Watkins, Head of Retailer and Business Insight at Nielsen, added: "With two thirds of households shopping at Tesco each month and with a considerable depth in range, there are opportunities for Tesco to tailor and edit ranges to build resonance with target audiences. Format and private label development are also key opportunities to drive new shoppers into store and to build loyalty."

INVEST, AND FAST – BUT NOT IN A PRICE WAR

In the midst of a sustained price war it will be hard for Tesco to take its foot off the gas and work out its proposition, but the company needs to make strategic investments rather than just cutting prices. For example, Sainsbury's recovery programme under Justin King saw the retailer focus on quality fresh food and own label ranges.

"There is insufficient time or information to run a traditional strategy process so the board must run a range of scenarios and make some big decisions around what the future core of the business is and where money is going to be made whilst the business is still strong," said David McCorquodale, Head of Retail at KPMG.

"It needs to make these investments to create growth – a business can't be turned around by just cutting costs or prices. Howard Schultz at Starbucks certainly cut costs brutally in his 'grip' phase, but he then made some critical decisions: the first was to focus on the company's core product – coffee – and the second, to recreate the ambience of local coffee houses. Schultz built customer affinity programs and aggressively extended the brand to return its premium position."



Retail consultant Nick Bubb said: "Regulatory investigations and changing the management team risk being a distraction in the vital run up to Christmas. The world is not standing still as Tesco gets its act together. Competitors will be moving swiftly to demonstrate their strong values, product ranges and pricing."

GIVE RETAILERS A SEAT AT THE BOARDROOM TABLE

"With analysts already questioning the level of retail experience on the board and these inquests occupying significant management time, there are question marks over whether the company will be able to achieve a significant turnaround quickly without broader management structural changes," said James Knightley, Senior UK Economist at ING.

The RTT argues that most turnarounds come hand in hand with new appointments at board level to galvanise the leadership into a change programme and Tesco needs to have experienced retailers and marketers at the top table.

"Many successful turnarounds have involved the appointment of a chief restructuring officer to drive the transformation and communicate the great change story that everyone understands, while allowing others to continue to do their jobs and the business to carry on functioning," said Tim Denison of Ipsos. "Don't be surprised if we see such a role announced at Cheshunt."

> "MANY SUCCESSFUL TURNAROUNDS HAVE INVOLVED THE APPOINTMENT OF A CHIEF RESTRUCTURING OFFICER TO DRIVE THE TRANSFORMATION… DON'T BE SURPRISED IF WE SEE SUCH A ROLE ANNOUNCED AT CHESHUNT"
>
> Tim Denison, Ipsos

MANAGE STAKEHOLDERS

The RTT warns that Tesco needs the support of all shareholders, suppliers and employees to contribute to the stabilisation of the business and the solution. For example, John Walden at Argos has maintained a consistent dialogue with stakeholders underpinned by consistency of delivery.

With vocal investors talking about their disappointment in Tesco's performance, the grocer's brand remains in jeopardy, unless it gives out strong, positive messages about the action being taken or a shareholder or supplier publicly backs it.

LOOK AT THE STRUCTURAL CHALLENGES

Unlike some of its rivals, Tesco's online grocery operation and convenience store chain are well advanced, so it is well represented in the growth parts of the market. But Tesco's major problem is that it is over-represented in the weakest part of the market, namely the big out-of-town hypermarkets with their big non-food presence.

At the beginning of this financial year, Tesco had over 3,000 UK convenience stores in one form or another (i.e. Tesco Express, Tesco Metro and One Stop) and they accounted for about 18% of Tesco's total UK selling space (excluding "dark stores" and Dobbies Garden Centres). But the 247 Tesco Extra stores (which average over 70,000 sq ft in size) accounted for as much as 45% of Tesco's total UK selling space and it is clearly here where work needs to be done to improve non-grocery productivity.

How Tesco deals with the structural challenge of its hypermarkets exposure will be a part of its turnaround strategy.

> "THE WORLD IS NOT STANDING STILL AS TESCO GETS ITS ACT TOGETHER. COMPETITORS WILL BE MOVING SWIFTLY TO DEMONSTRATE THEIR STRONG VALUES, PRODUCT RANGES AND PRICING"
>
> Nick Bubb, retail consultant

CONCLUSION

Successful turnarounds of companies in an aggressively competitive and disrupted market are not easy, but there are stories of change that could give Tesco confidence in its future.

The recovery of Starbucks, McDonald's 'Plan to Win' success and Argos's ongoing transformation spring to mind.

Tesco still generates significant amounts of cash and holds a dominant market share. This gives it significant ability to invest. It needs to research who its best customers are, what they want and deliver it.

Nick Bubb concluded: "History teaches you that it's always darkest before the dawn. Others have gone through this process and turned their business around.

"One of the greatest ever turnarounds was Asda in the early 1990s under Archie Norman, who always said that a big company with a lot of top-line sales will have enough levers to pull to make a difference to the bottom line. And changing the culture of the Asda business and unleashing the talent in the store managers was an important part of the turnaround."

KPMG/IPSOS RETAIL THINK TANK

The RTT was founded by KPMG and Ipsos Retail Performance (formerly Synovate) in February 2006. It now meets quarterly to provide authoritative 'thought leadership' on matters affecting the retail industry. All outputs are consensual and arrived at by simple majority vote and moderated discussion. Quotes are individually credited.

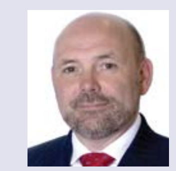
The Retail Think Tank has been created because it is widely accepted that there are so many mixed messages from different data sources that it is difficult to establish with any certainty the true health and status of the sector.

The aim of the RTT is to provide the authoritative, credible, most trusted window on what is really happening in retail and to develop thought leadership on the key areas influencing the future of retailing in the UK.

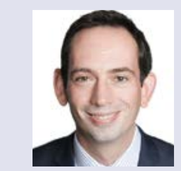
Its executive members have been rigorously selected from non-aligned disciplines to highlight issues, propose solutions, learn from the past, signpost the road ahead and put retail into its rightful context within the British social/economic matrix.

The RTT panellists rely on their depth of personal experience, sector knowledge and review an exhaustive bank of industry and government datasets.


Nick Bubb, Consultant to Zeus Capital


Dr. Tim Denison, Ipsos Retail Performance


Martin Hayward, Hayward Strategy and Futures


James Knightley, ING


Richard Lowe, Barclays Retail & Wholesale Sectors


David McCorquodale, KPMG


Martin Newman, Practicology


Neil Saunders, Conlumino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A TIME OF GREAT CHANGE AT TESCO

Things are moving very fast at Tesco. At the time of writing, new CEO Dave Lewis is at the helm with a new chief financial officer in Alan Stewart. Stewart was previously in the same post at Marks and Spencer. He replaces Laurie McIlwee, who resigned in April.

Current chairman Richard Broadbent has meanwhile announced that he will step down once the transition is complete and business plans are in place.

Details of Tesco's recovery plan are likely to take some time to emerge. At the moment, it is all hands to the pumps.

"THERE HAS BEEN A SEA CHANGE IN GROCERY SHOPPING BEHAVIOUR SINCE THE ONSET OF THE 2008 DOWNTURN. BRAND LOYALTY HAS WEAKENED. CROSS-SHOPPING BETWEEN BRANDS IS INCREASING, ENCOURAGED BY THE RAPID RATE OF SMALL GROCERY/ CONVENIENCE STORE OPENINGS"

Little Waitrose, Parsons Green
Waitrose

Sainsbury's Local, Earlsfield
J Sainsbury Plc

BACK TO THE FUTURE

Grocery store formats have gone almost full circle over the last century. Property expert John Witherell looks at the remarkable resurgence of small trading formats in the grocery industry.

We started with small high street grocery shops. As car ownership in the late-1940s/1950s was low, home delivery became all the rage, with butchers and bakers and milkman and fishmongers and grocers tearing around the countryside in their vans. Unit shops were meanwhile combined to create supermarkets, progressively combining the offers of butchers and bakers and milkman and fishmongers and grocers under one roof. Then, as grocery operators absorbed other niche food businesses, their range steadily increased. Supermarkets began to get bigger and bigger. Soon purpose-built, stand-alone supermarkets with parking began to appear.

Then the first superstores began to emerge, with even more parking. Most were built out of town. As grocery merchandise ranges continued to broaden, superstores got bigger and bigger too. Then hypermarkets appeared, mixing grocery and non-food merchandise. Hypermarkets then got bigger and bigger too, peaking at up to 150,000 sq ft-plus.

And then something strange happened. The grocery majors – Tesco and Sainsbury's, in particular – began to open convenience stores (initially circa 3,000 sq ft). Then convenience store sizes began to increase, closing the gap with supermarkets. Hard discounters got in on the act too: Aldi and Lidl, followed by mixed-goods discounters, 'pound shops' etc, which sell some dry grocery ranges. Despite record levels of car ownership, home delivery began to soar again, driven by convenience rather than accessibility.

These new large convenience stores opened by the Big Four, and Aldi/Lidl formats, are effectively hybrids, but are becoming closer and closer in size to full supermarket offers. The minimum size of units classed as supermarkets these days is about 25,000 sq ft net sales. The difference between the Aldi/Lidl stores and those of the convenience store operators is that the former are discounters and the latter are very much full price. They are different business models, targeting quite different shopper traffic. The distribution of the new convenience stock is increasingly segmented to capture domestic shoppers, office workers and commuters/ travellers, hence the growing provision at transport interchanges, including airports.

There is, however, another reason for the proliferation of small formats: top-up shopping. There has been a sea change in grocery shopping behaviour since the onset of the 2008 downturn. Brand loyalty has weakened. Cross-shopping between brands is increasing, encouraged by the rapid rate of small grocery/convenience store openings. The one-stop shop of old increasingly appears to be a thing of the past, particularly in conurbation areas. Grocery shopping frequency levels have increased, but superstore throughputs in some areas are reported to be static or falling, albeit some have attributed this to trade diversion by competitors rather than generic shopper behaviour change per se.

Hypermarkets have had a particularly torrid time during the downturn, largely because of problems on the non-food side. There has been a marked reduction in the sale of white goods, sporting equipment and other bulky items, in large part because of the impact of online price comparison on branded commodities. The core operator focus has shifted to clothing and smaller household items. Grocery operators have consequently reduced their hypermarket trading footprints, sometimes introducing ancillary brands/concessions to take up surplus space.

In some hypermarkets there is a lot of space to shift – non-food allocations can exceed 40,000 sq ft. There is now a parallel shift in emphasis from the traditional ancillary service offers, such as key-cutting, dry cleaners etc, to more dynamic mixes including other retailers, restaurant operators, fitness clubs and so on. What at first sight looks to be a problem for the operators is increasingly looking like a blessing in disguise. The really large hypermarkets have the potential to become broadly based shopping centres. With more than 120 hypermarket schemes remaining in the pipeline, it is far too early to write the concept off just because the Big Four are currently cutting back on development to fund their price war.

"WITH MORE THAN 120 HYPERMARKET SCHEMES REMAINING IN THE PIPELINE, IT IS FAR TOO EARLY TO WRITE THE CONCEPT OFF JUST BECAUSE THE BIG FOUR ARE CURRENTLY CUTTING BACK ON DEVELOPMENT TO FUND THEIR PRICE WAR"

Of more immediate importance, though, is working the standing stock. We tend to think of superstores as being 50,000 to 70,000 sq ft-plus, but first and second generation stores were quite a lot smaller. The average size is nearer 40,000 sq ft. All the grocery majors have a lot of small legacy superstores in their portfolios. There is a lot of pressure on grocers to improve net-to-gross ratios in these stores to increase productivity levels. 'Space grabs' can include removing or repositioning checkouts, installing more self-scanning facilities, reducing bulk storage, creating dual preparation/service counters for delicatessen/fresh fish/bakery/pizza and so on. The sheer range of store sizes and configurations within grocery operator portfolios means it is an almost endless job working the stock to optimise performance.

The other complicating factor is online. The Big Four and Waitrose are investing huge sums in online fulfilment, both in home delivery and click and collect. Dark stores will reduce some of the store-picking pressure in high demand areas such as London, but the bulk of fulfilment will continue to be dependent on stores. And that imposes a huge long-term investment cost in bespoke storage facilities/service areas for vans, particularly in the fuller range large stores where the bulk of picking takes space. And it all needs to be achieved with the minimum disruption to store customers. One thing is certain: formats are going to continue evolving to meet the seemingly ever-changing needs of consumers.

Aldi, Stratford-upon-Avon Simon Hadley

Tesco PLC Tesco, Kensington


Waitrose, Bloomsbury Waitrose

Tesco has been trialling new internal formats Tesco PLC/Graham Flack


Charles Sturge Lidl store

Tesco PLC Tesco Metro, Wimbledon

Romford Tesco Extra Opticians Tesco PLC

Sainsbury's, Crayford J Sainsbury Plc

Tesco PLC/Matt Sills Tesco Retro store

Giraffe restaurant at Tesco Extra Glasgow Silverburn Tesco PLC

JOHN WITHERELL
Supermarket Agency and Development, CBRE

John is responsible for providing agency and retail development consultancy advice to a broad selection of both private and public sector clients, with a focus on food store-anchored developments. John is a recognised expert in the supermarket property field. He acts as an Expert Witness for supermarket-related matters.

M&S Simply Food, Mannington Swindon
M&S

Morrisons, Crawley
Morrisons/Joel Chant

COMMUNITY VISION

What a difference 18 months makes. In spring 2012, grocery markets still appeared to be performing strongly. Tesco's share price was about to tick back up towards 400. The 'death of the high street' was still purportedly nigh and you could buy secondary shopping assets at a 9.5% yield. Mark Robinson of Ellandi reveals what happened next.

Tesco's precipitate fall from grace, the current grocery price wars and the victorious march of Aldi and Lidl are covered elsewhere in IN_*grocery*. What is perhaps more pertinent, from our perspective at least, is that opportunistic capital is today happy to pay 7.5% for convenience/grocery-anchored secondary shopping assets, despite many town centres still being viewed as in dire need of intensive care.

As secondary shop players, we never subscribed to the popular 'post-retail' apocalyptic town centre vision that has been so gleefully painted by many media pundits following the onset of the 2008 downturn: it jarred with our day-to-day experience of actually managing secondary shopping. We see things rather differently. What is happening is a recessionary shopping evolution certainly, but something that forms part of the normal business cycle – albeit life has been made much more difficult for high streets by the effects of the downturn, e-commerce and out-of-town development.

Town centre shopping is central to our business strategy. We are very picky, though. We invest exclusively in shopping centres that are the sole managed facilities in the town. The centres we buy also need to be the town's prime retail core, representing at least 30% of total floorspace. They also need to dominate the core catchment. Our centres are positioned to be the first port of call for expanding retailers – centres with the flexible space necessary to accommodate them.

Backed by investors such as Tristan Capital, Avenue Capital and Chenavari, Ellandi has invested nearly £350 million in 12 secondary schemes fitting the criteria described above in locations as disparate as Ashton, Folkestone, Bootle and Stockton. I think it is pretty clear that these assets were oversold. Being able to buy institutional quality assets at 8.75% in 2012 will, in my view, be seen over the investment cycle as being as daft as the 5.00% paid for tertiary assets in 2007 appears to us today.

Which brings me back to Aldi and Lidl. They have certainly given the grocery majors a fright, but from the high street perspective, discounters like Aldi and Lidl have a positive role, fitting in with the generational shift in consumer attitudes.

The biggest themes that have emerged for us since 2008 is the customers' desire for experience and their need for value and convenience. We appear to be seeing a sea change in secondary shopping as the big one-stop superstore shop of old morphs into more frequent top-up shopping at a variety of outlets. Some shoppers appear to be deserting the old big-box hypermarkets and superstores altogether. Whatever is happening to shopping behaviour, we are experiencing a resurgence in much more broadly based convenience shopping – something that benefits our centres directly.

"It is about blending leisure, convenience and non-food shopping offers. And we know from experience that shoppers like it. It is not a shopping environment that can be created in a superstore."

The move of the grocery majors, particularly Tesco and Sainsbury's, into non-food has been mirrored by the move of hard discounters the other way. For example, most of a family's weekly needs can already be met at single-price high street retailers. In a typical 99p Store, out of a total of 5,000 lines, 40% will be grocery goods, which are now being augmented with fresh and baked goods. So it is not just Aldi and Lidl that are upping the grocery competition. An array of other discounters are chipping away at the Big Four's market share too.

For example, within five minutes' walk of the newly refurbished mall café in the Newlands Shopping Centre, Kettering, you can pick up groceries variously at a Sainsbury's supermarket, an Iceland, a 99p Store, a Home Bargains and at Poundland, and that's before you consider that meals can be purchased at chilled counters in Boots et al. Variety is the key.

Taking another example, we are seeking planning permission for a Lidl at Crown Glass Shopping Centre in Nailsea to complement the existing Waitrose, 99p Stores and a quality independent greengrocers, S&R Burchill. That is what community focused shopping is – being able to find the evening meal or washing powder or a pint of milk when you visit the post office in Grays, or the library in Eastleigh, or the cinema in St Austell. It is about blending leisure, convenience and non-food shopping offers. And we know from experience that shoppers like it. It is not a shopping environment that can be created in a superstore.

That is the reason we call our investments 'community shopping centres' to avoid the stigma of the catch-all 'secondary' label, which is apt to be construed as something weak. Convenience-led local shopping is the most frequently accessed shopping that exists. There are two kinds of secondary in this respect. Some secondary schemes provide really potent offers that are extremely successful, some don't. I like to think that all our centres fall into the former category.

To succeed, you must provide the additional community uses that complement the retail anchoring and overall convenience retailing proposition. There are a lot of fundamentally sound centres around that are failing simply because of decades of neglect and mismanagement – the problem is often self-inflicted rather than something intrinsic to the location. Turning around failing schemes needs a lot of investment, expertise and enthusiasm, but the correct mix of accessible, multi-format grocery anchoring, community assets and local retailers creates a potent investment asset when you get the model right. The mix in shopping centres is everything.

MARK ROBINSON
Investment Director, Ellandi

Mark has 20 years' experience in town centre mixed-use property as an agent and principal. He is responsible for leading acquisition and the Asset Management team in Ellandi.

USE CHANGE OPPORTUNITIES

The government is keen to support motorists and wants to see adequate parking provision in new developments. Local authorities will be required to take a more liberal approach to parking.

No sooner has the dust settled on one set of planning reforms than a new set of proposed changes are published for consultation. Richard Lemon looks at what these new proposals mean for the grocery sector.

July 2014 saw the launch of a consultation on planning reform, featuring a number of measures which could benefit the grocery sector. Key among these proposed changes – which would apply only in England – is a 'permitted development right' allowing the conversion of retail floorspace to leisure uses, including cinemas, gyms and swimming pools.

The new permitted development right, which would remove the requirement to secure planning consent before changing from a retail to a leisure use, would benefit grocery retailers with stores in their portfolio that are surplus to requirements, making them far more attractive to a wider range of potential new occupiers.

It may also benefit those retailers with large-format stores which are too big and need to be consolidated. Larger stores could be subdivided and the surplus floorspace let or sold to a range of leisure operators without the need to secure planning consent.

The second proposed change which could benefit the grocery sector is to permit retailers to erect small buildings within the curtilage of their existing stores. This would allow food store operators to provide click-and-collect facilities without the need for planning permission. However, 'prior approval' – effectively a light-touch planning permission – would still be required so that the local planning authority has the opportunity to consider the design, siting and external appearance of the proposal. A number of restrictions would also apply. For example, the new arrangement would not apply in conservation areas or to listed buildings, and new buildings would not be permitted to exceed four metres in height or have a gross floorspace of more than 20 sq m.

A third proposal is designed to make it easier for retailers to increase their back-of-house loading bay capacity, allowing them to store more goods for home delivery and click and collect. A new permitted development right, negating the need for planning permission, would allow the size of an existing loading bay to be increased by up to 20%. In addition, retailers would be permitted to install new loading bay doors and new loading ramps in existing shops.

"THE NEW PERMITTED DEVELOPMENT RIGHT, WHICH WOULD REMOVE THE REQUIREMENT TO SECURE PLANNING CONSENT BEFORE CHANGING FROM A RETAIL TO A LEISURE USE, WOULD BENEFIT GROCERY RETAILERS WITH STORES IN THEIR PORTFOLIO THAT ARE SURPLUS TO REQUIREMENTS, MAKING THEM FAR MORE ATTRACTIVE TO A WIDER RANGE OF POTENTIAL NEW OCCUPIERS"

While 'prior approval' would not be required in this case, some restrictions would apply. For example, like the proposed permitted development right for new click-and-collect facilities, the new arrangement would not apply in conservation areas or to listed buildings.

A fourth proposal would see the government relax its approach to the installation of mezzanine floorspace. At present, planning permission is required for the installation of mezzanine floors of more than 200 sq m. The proposed change would increase the threshold at which permission will be required, allowing larger mezzanines to be installed without the need to submit a planning application.

The consultation document stops short of proposing a new threshold, but even a relatively small increase may well benefit those retailers who require, for example, additional storage space or staff facilities.

However, where planning conditions have been imposed which restrict sales floorspace, a new threshold will be of little use to those retailers who are simply seeking a larger sales area.

The fifth and final proposal that is particularly relevant to the grocery sector would see the government require local authorities take a more liberal approach to car parking. The consultation says that the government is keen to support motorists and wants to see adequate parking provision in new developments. It says that the government wants to ensure that local authorities have properly reviewed their parking policies in their Local Plans so that there is no longer a restriction on the number of parking spaces in new developments. That may well allow some new stores to be developed with a greater number of parking spaces than might otherwise have been allowed.

Experience suggests that the vast majority of changes to the planning system on which the government consults are implemented, generally with only minor changes.

The consultation period ended in September 2014, and we expect the government to move quickly to implement the proposed new measures, some of which will require secondary legislation, as there is now limited time before the next general election in May 2015.

It remains to be seen whether the devolved governments in Northern Ireland, Wales and Scotland will follow suit, but it's clear that the government's appetite for planning reform in England remains unsated, with a number of the proposed changes potentially benefiting grocery retailers. The changes are, therefore, broadly welcome.

RICHARD LEMON
Retail and Leisure Planning, CBRE

Richard Lemon is an Associate Director in the Retail and Leisure Planning team at CBRE. He secures planning permissions on behalf of developers, investors and retailers, with instructions ranging from food stores and retail warehouse units to mixed-use town centre schemes with a substantial residential component.

A MARKET VIEW

The appetite for hypermarket schemes has dwindled in recent years as grocers focus on their core grocery offers. Chris Keen looks at the outlook for rents and development.

We expect the Big Four's current trading difficulties to suppress demand for large grocery superstores in the short term, but demand pressures for small-format stores look unlikely to be affected. Sainsbury's, M&S Simply Food, Waitrose, Asda, Aldi and Lidl all remain on the expansion trail for small stores.

Convenience store expansion activity remains rapid but, because of the competition for units, it is becoming increasingly difficult to secure good space. Pressure on rents will continue. The rental picture for the big superstore end is quite nuanced. Online sales growth remains double-digit. As the bulk of online sales are picked from grocery stores and the picking takes place in the largest stores to ensure the range is sufficient, online is boosting sales intensities at the large-store end of grocery property portfolio. There have already been reports of some superstores hitting pick capacity problems.

Tesco currently captures almost 50% of online grocery sales in the UK. Sainsbury's, Asda, Morrisons and Waitrose capture the bulk of the remainder. It is difficult to see how, if online grocery is to be picked from store going forward, operators can avoid bulking up the large-store end of their portfolios. We currently think that a slow-down in large-store development activity is unsustainable in the medium term. Or at least, if large-store development does remain modest, online grocery sales growth will have to be constrained because existing grocery networks will not be able to meet the picking volumes required. Dark stores look to be an unappetising alternative on simple return grounds, except in very high demand areas. Currently, too few are in the pipeline to have a significant impact on aggregate pick volumes.

Despite talk both of saturation – which has been repeatedly predicted in grocery markets since before the first superstore in the UK was built in the 1960s – and shopping behaviour change in favour of small formats (evidenced by the market share gains of hard discounters), superstores remain by far the most profitable retail channel, dwarfing returns on online and convenience shopping. There are currently more than 500 superstore schemes of over 50,000 sq ft in the development pipeline. Many might be stalled during the current grocery market turmoil, but it still demonstrates the sheer scale of grocery catchment spending potentially still in play. Convenience store openings are large in number but contribute little in aggregate space terms and, on a like-for-like basis, much less in profit. Despite the publicity it attracts, convenience store expansion is something of a sideshow.

Getty/Image Source

"WE CURRENTLY THINK THAT A SLOW-DOWN IN LARGE-STORE DEVELOPMENT ACTIVITY IS UNSUSTAINABLE IN THE MEDIUM TERM"

Superstore development activity, in common with retail development generally, is ultimately dependent on sales growth (as well as securing planning permissions). With the grocery market borderline deflationary, there is simply not the demand pressure to sustain a boom in development activity – the reason, in part, why the meteoric pipeline growth since 2008 has now slowed. Development will continue however if only for population growth reasons. Housing growth generally is stimulating a lot of ancillary grocery development activity, as are mixed-use developments and major infrastructure schemes such as Crossrail. The government's ambitious plans for new towns and enlarged suburbs will further boost grocery space demand. And competition from grocers will push rents in catchments with growing populations. With net population migration set to remain high, pressure on UK grocery space – particularly space in southern markets – will inevitably remain strong, exerting a knock-on upward impact on rent over the medium term.

CHRIS KEEN
Director, Supermarket Landlord Advisory

Chris Keen is a Director in Retail and leads a dedicated team that advises landlords on supermarket rent reviews, re-gears, extensions, potential investments and asset strategy.

Eric Pickles, Secretary of State for Communities and Local Government, announced the much-criticised rating revaluation deferral
PAUL ELLIS/AFP/Getty Images

DEFERRED REVALUATION

The rating revaluation scheduled for 2015 has been deferred until 2017. Tim Attridge looks at the implications for grocery retailers and property investors.

The business rates system has come in for a lot of criticism of late. The retail sector has called for change, with the British Retail Consortium lobbying hard and a number of independent reviews being undertaken. In September, the BRC took a full-page article in The Telegraph calling for reform, claiming that the current system of business rates is no longer fit for purpose. Signatories for the article included major grocers and CBRE.

Current rateable values, which form the basis for business rates liabilities, are based upon rental values in April 2008, at the peak of the property market immediately before the downturn. Values are now wildly out of kilter regionally.

For many, the government has made a bad situation worse by postponing the scheduled 2015 revaluation until 2017. In large swathes of the country where rental values are yet to reach the levels of early 2008, rates bills will continue to be inflated for an additional two years.

The postponement of the revaluation is not to the detriment of all. The Grimsey report predicted that the UK's four biggest supermarkets – Tesco, Sainsbury's, Asda and Morrisons – will save £1.3 billion as a consequence of the revaluation delay.

There is further potential benefit beyond 2017. The actual valuation date for the new list will be 01/04/2015, as opposed to 01/04/2013 had the revaluation not been postponed. Many of the largest supermarket rents in 2015 may not be as high as they were in 2013. Rateable values should reflect that.

The potential supermarket gain has not gone unnoticed. Almost a quarter of England's 326 councils have joined a campaign to introduce a new tax on supermarkets – dubbed a 'Tesco tax'. The proposal consists of an extra business rates levy of up to 8.5%, which would affect any large retail outlet with a rateable value of more than £500,000. A similar scheme is currently in place in Scotland and Northern Ireland. It is estimated that such a tax could cost the major supermarkets an extra £190 million in tax.

The convenience store sector is as competitive as it has ever been. This is particularly notable in the mid-tier, led by Aldi and Lidl, with Netto soon coming back into the market. Competitive pressures are resulting in rental growth. The delayed revaluation can only result in increased rateable values. Much, of course, depends on where the expansion activity is regionally.

Despite the calls for the government to reform the system, it has stated that there is insufficient time for anything to change before the 2017 revaluation. Beyond 2017, the revised legislation states that a five-yearly revaluation cycle will resume. It remains to be seen what changes, if any, will be introduced in the mid to long term.

For now, we would advise preparing as much as possible in advance of the new rating list. The valuation date is April 1, 2015, and a draft of the list will be published in October 2016. Budget planning is crucial. With regard to business rates, forewarned is most certainly forearmed.

TIM ATTRIDGE
Head of Retail Rating, CBRE

Tim started his career with Edwin Hill, later Altus Edwin Hill, in 2000 specialising in Business Rates advice. Tim advises clients – landlord, occupier and retailer – across all regions and property sectors. Since joining CBRE in April 2013 as Head of Retail Rating, key clients have included Barclays, Westfield, Land Securities, Reiss, Pret, Itsu and TM Lewin. Tim has achieved key results on Canary Wharf offices, Westfield Stratford, Bluewater and central London retail.

LIFE AFTER ANNUITIES

Annuity funds have traditionally been at the heart of the grocery store investment market, particularly at the prime end. James Harris looks at the lie of the land following the government's pension reform announcement.

"DEMAND FOR GROCERY STORE INVESTMENT REMAINS STRONG. SOME YIELD COMPRESSION WAS SEEN DURING THE FIRST HALF OF 2014. YIELDS HAVE REMAINED STABLE SINCE THEN"
James Harris, CBRE

Chancellor of the Exchequer George Osborne has announced far-reaching pension reforms

Peter Macdiarmid/Getty Images

Annuity funds have always sought opportunities providing the longest leases and the strongest index-linked income growth potential. The changes in the UK pension rules set to come into effect from April 2015 mean that the over 55s with a defined contribution pension scheme will no longer be forced to take out an annuity policy when they retire, raising questions regarding future investor appetite for the grocery sector. The response from annuity fund clients to date is that the impact will not be significant. The changes will not affect defined benefit schemes. Although many of these schemes have now been wound up, there is a significant legacy that needs to be funded and this is a key driver of long income property investment. Even for those that can opt out of a traditional annuity policy, there will still be demand for income products in one form or another, and these are expected to remain an important option in the market.

To date, there has been no evidence of any impact on pricing. The continuation of very low interest rates in the UK has led to an increase in the level of capital targeting commercial real estate and strong capital inflows into retail and annuity funds continue. Demand for grocery store investment remains strong. Some yield compression was seen during the first half of 2014. Yields have remained stable since then.

Yield compression has, however, been greater in other sectors, narrowing the yield margin to historically low levels. The figures that follow compare the current yield margin over grocery stores versus the five-year average: prime shopping centres are currently at a 60 Bps discount vs +100Bps five-year average (-40Bps); open A1 parks are at 20Bp discount vs 70BPs five-year average (-50 bps); prime distribution 85Bps vs 190Bp five-year average (-105Bps).

While economic recovery means the next move in short-term interest rates will be up, interest rate changes are likely to be gradual and modest for the next three to five years. Long-dated property trends, typical for the sector, follow long-dated government bond yields and while these fell with quantitative easing, it was far less pronounced than in shorter dated (10 years) bond yields.

Against a backdrop of positive economic news, with grocery operators' business ultimately underpinned by strong fundamentals and capital continuing to target commercial real estate, it would seem that there is a good case for continued demand in the sector.

JAMES HARRIS
Director, Retail Valuation – Grocery Specialist

James works within CBRE's Retail Valuation team and specialises in the valuation of food stores and out-of-town retail assets throughout the UK. He acts for a variety of clients, providing regular valuation and strategic advice to a number of the largest UK institution and REIT landlords of retail property, loan security valuations to major lenders and advisory services to food store operators.

COUNTING THE COST

Tesco PLC

The role recession and shopping behaviour change has played in grocery markets over the last few years has attracted a great deal of press coverage. Rather less attention has been paid to reports of declining grocery store productivity due to poor siting. Mark Teale looks at the wider property implications.

The formal introduction of 'town centre first' planning policy in 1996 effectively ended the ability of grocery retailers in England to choose the most productive sites for their stores. The policy included a general presumption that stores should be developed on town centre or edge-of-town sites, if they were available, regardless of whether or not more productive sites could be secured out of town. According to recently published research by Paul Cheshire, Christian Hilber and Ioannis Kaplanis of the London School of Economics[1], the implementation of this policy has led to an alarming long-term decline in grocery network productivity, due specifically to the poor siting of many post-1996 stores. A link to the full paper can be found at the end of this article (page 49).

The authors report that study results, based on network-wide sales data provided by one of the UK's largest grocery retailers, reveal that the introduction of 'town centre first' policy in 1996, following an initial tightening of controls on out-of-town grocery store development in both 1988 and 1993, caused a total loss of more than 30% in average grocery store productivity in new branch developments. Extrapolate the study results across the whole grocery sector and the implied long-term grocery output losses resulting from siting stores on sub-optimal sites are simply astonishing.

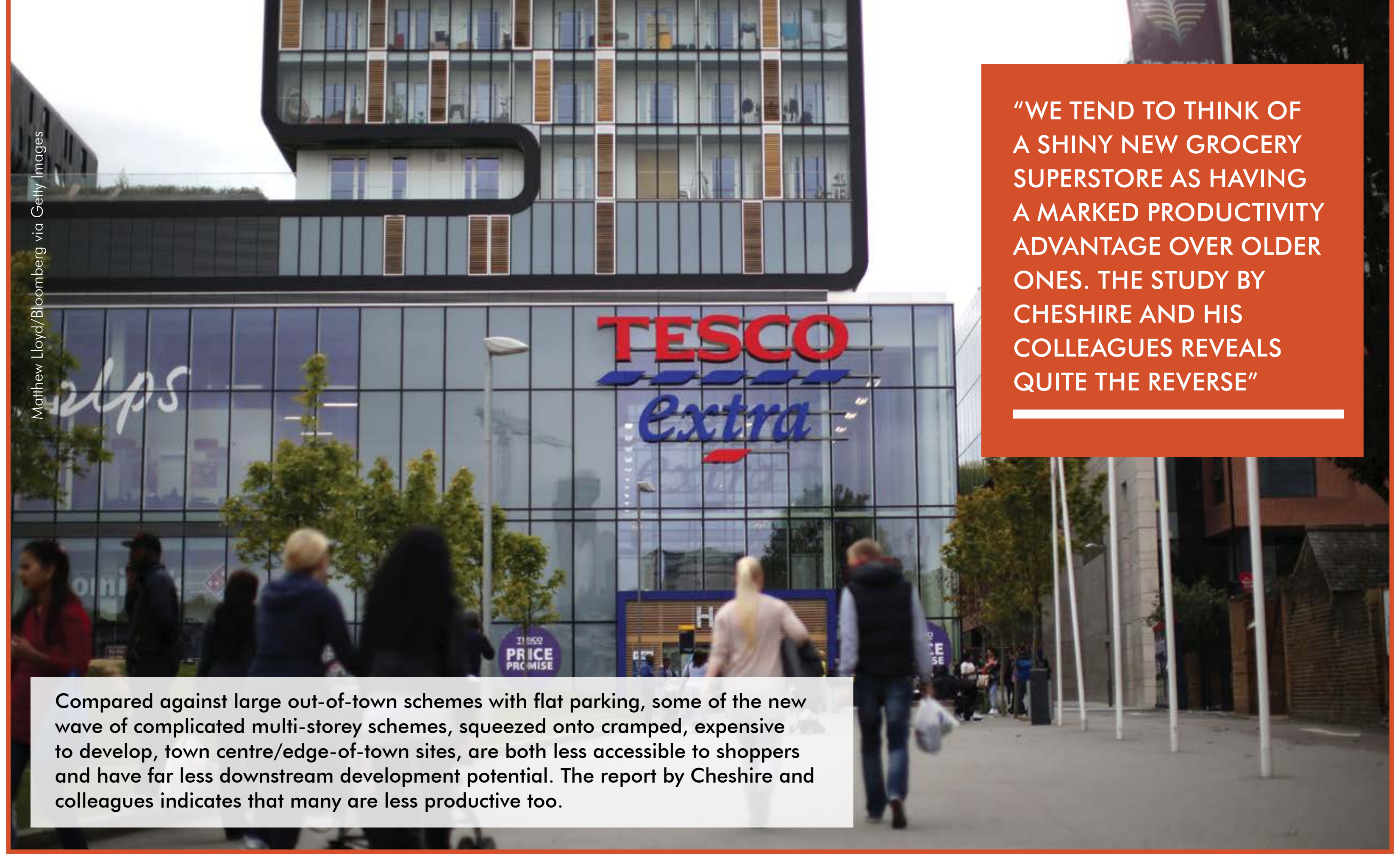
To put this decline in productivity into context, it is cumulatively equivalent to a decade of lost grocery output growth for the chain analysed. The study's authors found that a significant part of the productivity loss was not just down to directing new store development to less productive town centre or edge-of-town locations per se, but because development had been guided to awkward sites that were difficult to access and/or manage.

Supporters of the 'town centre first' policy maintain that the benefits of the policy outweigh any wider collateral damage that might be caused to the grocery sector or consumers. To date, no actual evidence in support of this proposition has been forthcoming, not because 'town centre first' policy outcomes cannot be measured, but simply because the data necessary to do so is not collected. It is simply assumed that the policy has beneficial effects. As Paul Cheshire puts it: "One of the joys of analysing the economic and business impact of planning policy is to have planners dismiss evidence of productivity loss because such analyses do not address possible beneficial outcomes of a policy that cannot be demonstrated."

Whatever the broader benefits of 'town centre first' policy might be, the issue of grocery productivity loss is important to property investors as well as retailers because

Any sustained reduction in branch profit contributions will, in time, translate into weaker property investment performance as well.

Grocery trading performance is exceptionally sensitive to site choice. Food shopping, because it is a high-frequency shopping activity, needs to be located much closer to households than comparison goods shopping: the reason why there are circa 14,000 main grocery trading locations in Great Britain, but only circa 2,500 significant non-food shopping destinations, of which just 70 or so attract almost half the population. It takes more than 1,000 of Great Britain's largest grocery superstores to achieve a comparable catchment penetration. Non-food retailing has been migrating from small trading locations to large for decades, increasing distance from households. Grocery stores, in sharp contrast, need to be very close to the population they serve, whether those populations live in town centres, in suburbs or in rural areas. That is the reason why there are so many grocery stores and so many different grocery stores formats.



Compared against large out-of-town schemes with flat parking, some of the new wave of complicated multi-storey schemes, squeezed onto cramped, expensive to develop, town centre/edge-of-town sites, are both less accessible to shoppers and have far less downstream development potential. The report by Cheshire and colleagues indicates that many are less productive too.

"WE TEND TO THINK OF A SHINY NEW GROCERY SUPERSTORE AS HAVING A MARKED PRODUCTIVITY ADVANTAGE OVER OLDER ONES. THE STUDY BY CHESHIRE AND HIS COLLEAGUES REVEALS QUITE THE REVERSE"

Grocery networks are highly complex businesses to operate in this respect. Site selection and choosing the right kind of facility/format to serve the catchment are the most important single business decisions a grocery operator makes. Everything else flows from that fundamental network location/format decision. Store location research in grocery markets is highly sophisticated. It is possible to predict the future productivity of grocery formats on any particular site with considerable accuracy. It is consequently relatively easy for operators to identify the best sites for their stores/formats. Given free rein, grocers – to optimise network performance – would site their branches in locations delivering the highest returns. Since 1996, store site choice – especially superstore site choice – and the size and nature of store facilities has, however, ultimately been determined by planners, not grocery operators. And it is that intervention by planners that is causing the productivity loss, according to Cheshire and his colleagues.

Operators do, of course, have an input into the location/facility decision, but they will not waste time proposing sites that they know they have no hope of securing planning permission for, however potent these sites might be from a retailing perspective. Site choice is consequently heavily constrained. And it is these post-1996 constraints on site choice that are undermining grocery sector productivity. Left to themselves, grocery retailers would create much more productive networks than is possible where site/facility decisions are influenced by extraneous planning goals designed to protect town centres. That is not to say that 'town-centre-first' planning goals are 'wrong': simply to observe that 'town-centre-first' planning intervention has a negative knock-on impact on grocery sector productivity in Great Britain.

Cheshire and his colleagues report that the tightening of planning controls in 1988 led to an average output loss of just under 15% on subsequent new grocery store openings. The introduction of full-blown 'town centre first' planning policies in 1996 imposed a further average output loss of more than 17%. The losses in the latter case were caused directly by development being channelled to town centre or edge-of-town sites that were inferior in locational terms (less accessible to shoppers, especially to those in cars, and for delivery vehicles). These sites also tend to be more expensive to develop than out-of-town sites, in part because of higher site prices but also because they are often of an awkward/restricted nature requiring significant development compromises, sometimes including multi-storey construction.

Finally, the authors also conclude that the proliferation of convenience store openings since the 1990s results directly from the 'town centre first' planning policy, another factor likely to have significantly affected post-1996 grocery sector productivity. The popular current narrative that 'big stores are dead, long live small stores' seems unlikely in this respect as it implies that consumer are seeking a radical reduction in the quality/range of food available to them. With grocers forced to focus online picking on the biggest stores in grocery networks, to allow range available to correspond as closely as possible to range on online sites, the opposite would appear to be true. Consumers want small convenience stores for top-up shopping and big stores for main grocery shopping. Trade losses from grocery majors to discounters are indicative of price-led trade diversion in a narrow range of staples, not a desire for lower quality or less choice. Consumers want it all.

Consumers shop where retailers provide branches. The grocery majors have been opening more and more small convenience store branches, encouraging greater top-up shopping. Shopping behaviour has changed accordingly. But it is retailers (and planners) that have caused the change, not consumers. The picture is the same on the online side: it is retailers that are encouraging home delivery and click and collect; consumers are just responding to what is offered. The push of grocery majors into convenience store markets needs to be seen in the context of the clamp-down on out-of-town superstore development.

It is apparent from the study results (and planning records) that the vigour with which 'town centre first' planning guidance is imposed locally within England varies widely. Some local authorities have taken a more relaxed view, allowing grocers to develop their preferred sites. As a result, some post-1996 stores have proved cracking performers. Many others have not. And that is of particular relevance today when questions are finally being asked about why two thirds of Tesco's biggest stores trade brilliantly, but a third don't, acting as a drag on the business. We tend to think, in this respect, of a shiny new grocery superstore as automatically having a marked productivity advantage over older ones. The study by Cheshire and his colleagues reveals quite the reverse. On average, main grocery stores completed post-1996, were found to be markedly less productive – essentially for siting reasons – than those constructed in earlier years when planning intervention in grocery markets was less prescriptive.

That is not to say that the post-1996 stores affected do not make a profit contribution, just that the profit contributions are lower – in some cases, much lower – than could be achieved on better located sites in the area. Nor does it mean that there is a shortage of sites notionally in the pipeline. Currently there are 523 grocery store schemes of 50,000 sq ft or more in the pipeline, 348 have outline or full planning consent, and 19 are under construction. The question is, how many of these schemes are significantly compromised in productivity terms because of poor site characteristics? Based on Cheshire and his colleagues' study results, probably a lot. So the issue is not about the number of sites made available, but whether the sites are any good.

From a property investment perspective, the productivity issue addressed in the paper implies, in relation to 'sale and lease back' deals, for example, that some older superstores are likely to prove better long-term performers than some newer ones, and not just because of superior site productivity. Some of the new wave of complicated multi-storey 'stores on stilts' schemes, squeezed on to cramped, expensive to develop, town centre/edge-of-town sites, are effectively bespoke – they can only be used as grocery stores.

Out-of-town grocery stores, located on much larger sites because they are single-storey and usually including lavish, free-to-use surface car parking, commonly offer a far greater range of development opportunities down the line. In older schemes, undeveloped adjacent land sometimes forms part of ownerships too, further boosting the downstream residential and commercial redevelopment potential of this type of stock. The same is not true of many of the newer town/edge-of-town schemes simply because of site constraints.

So when they are assessing 'sale and lease back' opportunities, investors need to look very closely at both the relative productivity of grocery assets and their downstream development potential. Simply paying the same yield for similarly-sized grocery stores when the assets differ substantially in nature – a high productivity one on a large site out of town, with substantial redevelopment potential, and lower productivity one squeezed onto a cramped, in-town site with little, if any, redevelopment potential – does not necessarily make a lot of sense even if the current rental value per sq ft attributed is the same.

But the productivity issue raised by Cheshire and his colleagues is important for another reason because it suggests that in sales and occupational cost modelling/forecasting – particularly where comparisons between countries are being made by investors – much more account needs to be taken of the locational characteristics and quality of the stock that is delivered and stock efficiency issues generally. Property is a key factor of production for retailers: the relative efficiency of retail markets in different countries is heavily influenced by the quality and distribution of stock delivered. In some countries, like the UK, regulatory intervention impacts heavily on retail sector productivity, while in many other countries the impact is much more limited.

[1] Land Use Regulation and Productivity – Land Matters: Evidence From a UK Supermarket Chain; Journal of Economic Geography (2014) pp. 1-31. http://personal.lse.ac.uk/hilber/hilber_wp/CheshireHilberKaplanis_2014_03.pdf

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