Foodstores: a Feeding Frenzy

Knight Frank

2023

Retail News – Issue 14

knightfrank.com/research

Introduction

Form is temporary, class is permanent

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Renewed recognition of foodstores amongst the property investment community is one of the few positive legacies of COVID. That it took a global pandemic to reinforce the grocery sector's resilience and strong investment criteria beggars belief. But general scepticism is increasingly giving way to positive sentiment.

As well it might. A sector with rock solid fundamentals, albeit brutally competitive and awash with complexities. A blueprint for all real estate investment markets even, with a very clear food chain (pun intended), where all protagonists know their rightful place? And, dare I say, where property investors are fairly low down?

The UK foodstore market is defined by its occupational base – as indeed all real estate investment markets should be. The competitor set that constitute the UK grocery market are, without exception, excellent operators. Indeed, so concentrated and competitive is the UK supermarket sector that there is no 'dead wood' and any operational or strategic shortcomings will be quickly and cruelly exposed.

Despite some changes in capital structure (and PE rearing its ugly head), investors can be confident they are investing in real estate that is being run by operators that know what they are doing – and are here for the duration.

Nor are said operators under any illusion that they are at the top of the food chain. That position is occupied by the consumer – the consumer will always be king and the supermarkets remain subordinate to their every whim. Consumer trends and tastes may chop and change at a rapid rate, but underlying consumer demand is essentially inelastic and far less volatile than in other retail sectors. We may have more or less money in our pockets, we may trade up or down, or switch between the plethora of channels at our disposal. But we all still need to eat.

Don't just take Knight Frank's word for it. We are delighted to include interviews in this report with two key stakeholders in the foodstore market, from both sides of the occupier : investor fence – Patrick Dunne, Group Property Director at Sainsbury's and Rob Abraham, MD of Fund Management at Supermarket Income REIT. The former providing fascinating insights from the coalface of grocery retailing from the UK's second largest retailer, the latter equally enlightening sapience from the largest investor in UK foodstore real estate.

A word of caution: for all the foodstore market's generic positives, asset specifics are absolutely paramount. Understanding trading performance is the holy grail, assessing catchment and competition are key secondary considerations. Conversely, geography, affluence and asset presentation could be red herrings or, worse still, false friends in any appraisal process.

A strong investment case – but not all foodstores are created equal.

Competition breeds class

Foodstores - a highly sought after asset class for good reason: long income virtually guaranteed, a savvy and covenant-strong occupier base, minimal risk of failure, surrender or vacancy, all underpinned by inelastic consumer demand.

+7%

The sector has largely weathered the inflation storm. Growth in total grocery spend in 2023 is likely to be in the order of +7-8%, but volumes will be down ca. -2-3%. However volumes should return to positive growth territory before the year-end.

'Big box' foodstores (3k sq ft+ supermarkets and 60k sq ft+ superstores) are still the mainstay of the market, collectively accounting for around 50% of sales and an estimated 80%+ of industry profits.

+1.2%

Underlying growth at 'big boxes' may appear pedestrian (supermarkets +1.2% CAGR 2022-27f, superstores +1.4% CAGR 2022-27f) relative to other foodstore channels, but this reflects a very limited new development pipeline and therefore represents healthy 'organic' growth.

+23.9%

Discounters remain the fastest growing channel (+23.9% 2022-27f) driven by ongoing aggressive expansion by Aldi and Lidl, despite question marks over saturation / cannibalisation. Very low operating margins are under even greater pressure in the current trading environment.

C-stores remain a growth channel (+12.9% 2022-27f). The convenience sector remains a priority for established operators (e.g. Tesco, Sainsbury's) and will also see fresh impetus from Asda and Morrison's making a more concerted push into what is already a highly-competitive arena.

71%

Some 71% of online grocery is served by physical stores, with store-picking the favoured and most operationally viable model for the multi-channel operators. Supermarkets that fulfil a dual role as online fulfilment centres are increasingly likely to carry a real estate price premium.

Online grocery saw a massive, but ultimately artificial spike in demand during COVID. Online grocery penetration increasingly appears to be stabilising around the 8-9% mark. Operators learnt many important lessons about online as a result of the pandemic.

64%

The concentrated and fiercely competitive nature of the UK grocery sector makes for a very strong occupier base which does much of the "heavy lifting" for the real estate market. The 'Big Four' make up 64% of the market, while 97% of the market is concentrated in the hands of just 10 players.

The capital structure of the market has changed significantly on the back of debt-fuelled acquisitions of both Asda and Morrison's. Their debt position has resulted in their covenants being downgraded and their real estate may be subject to a discount (ca. 150bps), but their stores are far from being 'uninvestible'.

5.00%

Foodstore pricing remains competitive (5.00% for prime assets subject to RPI). There was some inevitable correction post the 2022 mini Autumn budget, but this was generally swift. Investor demand generally remains strong.

Asset-specifics are absolutely key in stock selection, with trading performance (relative to rent) and affordability always trumping more superficial appraisal elements such as geography, catchment affluence and store presentation.

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Supermarket Income REIT

With Rob Abraham - Managing Director, Fund Management.

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Foodstores: The investment case

Foodstores have witnessed a resurgence in popularity, emerging as a compelling investment opportunity within the wider retail sector and compared to other property classes too.

Foodstores - a feeding frenzy

Consumerism at its most fundamental

+4.1%
AVERAGE ANNUAL FOODSTORE SPEND GROWTH SINCE 1989

+2.5%
10-YEAR AVERAGE ANNUAL FOODSTORE SPEND GROWTH RATE

+10.1%
YoY GROCERY SALES SPIKE DURING COVID-19 PANDEMIC (MARCH 2020)

+5.1%
2020 ANNUAL GROCERY SALES GROWTH (HIGHEST SINCE 2009)

£200bn
GROCERY MARKET VALUE (2022)

7-8%
FORECAST MARKET VALUE GROWTH ANTICIPATED IN FY23

3.0-3.5%
FORECAST ANNUAL AVERAGE GROWTH (NEXT 5 YEARS)

Only 3 years
OUT OF 30 YEARS HAS GROCERY MARKET BEEN DEFLATIONARY

Changing channels

90%
GROCERY MARKET SHARE DOMINATED BY PHYSICAL STORE FORMATS

No.1 *discounters*
FORECAST TO BE THE FASTEST GROWING CHANNEL OVER NEXT 5 YEARS (+23.9%)

No.2 *convenience stores*
SECOND LARGEST GROCERY DISTRIBUTION CHANNEL

50%
SALES FULFILLED VIA LARGER STORE FORMATS (SUPERMARKETS + SUPERSTORES)

20.8%
GROCERY SALES MADE IN C-STORES

£97bn
FORECAST VALUE OF SUPERMARKET CHANNEL BY 2027

+3% *per annum*
FORECAST GROWTH OF OVERALL GROCERY MARKET OVER NEXT 5 YEARS

£241bn
FORECAST VALUE OF OVERALL GROCERY MARKET (2027F)

Online grocery - fad or future?

71%
ONLINE DEMAND FULFILLED BY PHYSICAL STORES

61.4%
SERVICED VIA HOME DELIVERY

9.8%
SERVICED BY CLICK & COLLECT

14.9%
SERVICED BY ONLINE-ONLY PUREPLAYERS (E.G. OCADO)

5.2%
GROCERY SALES MADE ONLINE PRE-PANDEMIC (JANUARY 2020)

+77%
ANNUAL INCREASE IN ONLINE GROCERY SPEND DURING PANDEMIC TO £22.6BN (2020)

-22%
ANNUAL CONTRACTION IN ONLINE GROCERY SPEND POST PANDEMIC (2022)

8-9%
POST-PANDEMIC ONLINE SALES AVERAGE PENETRATION RATES (% OF TOTAL RETAIL SALES)

5 Central Themes

- Consumerism at its most fundamental
- Changing channels
- Online grocery – fad or future?
- Key players – KPIs, currencies & covenants
- The investment case

Key players – KPIs, currencies & covenants

64%
COMBINED MARKET SHARE OF THE 'BIG 4' (TESCO, SAINSBURY'S, ASDA, MORRISON'S)

18%
MARKET SHARE OF LEADING DISCOUNTERS ALDI & LIDL

No.1 *Tesco*
TOP GROCERY PLAYER WITH MARKET SHARE GREATER THAN SAINSBURY'S & ASDA COMBINED (27%)

<1%
DISCOUNT GROCERS' OPERATING MARGINS

£1,000 *per sq ft p.a.*
SALES DENSITY INDUSTRY BENCHMARK

£1,200 *per sq ft p.a.*
ALDI'S SALES DENSITY (DOUBLED IN LAST DECADE)

£6.8bn
MOODY'S ESTIMATION OF MORRISON'S CURRENT DEBT

5A 3
D&B RATING OF MORRISON'S COVENANT

The investment case

4.7%
TOTAL RETURN (10 YEAR ANNUALISED) VS. 1.9% ALL RETAIL

(0.8)%
RENTAL GROWTH (10 YEAR ANNUALISED) VS. (1.8)% ALL RETAIL

(0.5)%
CAPITAL GROWTH (10 YEAR ANNUALISED) VS. (3.1)% ALL RETAIL

7.3%
FORECAST TOTAL ANNUAL RETURN (2024 – 2027) VS 7.0% ALL PROPERTY

5.1%
FORECAST INCOME RETURN (2024 – 2027) VS. 5.0% ALL PROPERTY

5.00%
YIELDS FOR FOODSTORES WITH ANNUAL RPI INCREASES (Q3 2023)

2 *key players*
SUPERMARKET INCOME REIT & SAINSBURY'S RESPONSIBLE FOR CA. 50%+ OF DEAL VOLUMES (£856M) SINCE 2022

£1.08bn
WORTH OF FOODSTORES ACQUIRED BY REITS, IMS, AND INSURANCE COMPANIES SINCE 2022

Interview highlights

Sainsbury's

>86%
POPULATION WITHIN 15 MINUTE DRIVE OF A SAINSBURY'S STORE

25
PLANNED NEW C-STORE OPENINGS (2023/4)

£3bn
C-STORES SURPASSED £3BN SALES FOR FIRST TIME

50%
ESTATE FREEHOLD / 50% LEASEHOLD

Supermarket income REIT

55
OMNICHANNEL SUPERMARKETS IN ITS PORTFOLIO

£1.7bn
GROSS ASSET VALUE (JUNE 2023)

5.60%
PORTFOLIO NET INITIAL YIELD (NIY)

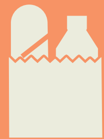
ca. **80%**
LET TO STRONG COVENANTS TESCO & SAINSBURY'S

Consumerism at its most fundamental

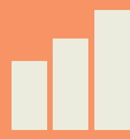
WORDS: STEPHEN SPRINGHAM – HEAD OF RETAIL RESEARCH

The foodstore market is benefiting from a sea-change in sentiment, particularly in the eyes of retail real estate investors. This new-found interest was sparked, ironically, by COVID, which served as a telling reminder of the foodstore sector's enduring resilience.

Key takeaways

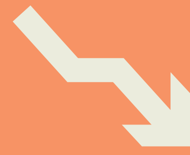


The foodstore market is underscored by largely inelastic consumer demand, rendering it much more resilient than other segments of retail.



Grocery sales have a strong track record of growth (long term average of +4.1%), with only a couple of highly challenged years (notably 2015/16).

Grocery spend is likely to grow by ca. +8% in 2023, but fuelled largely by double-digit inflation. High inflation is very challenging, but less damaging than deflation.



Inflation is slowly receding and in Q4 2023, there are welcome signs of a return to positive volume growth.

Grocery spend likely to revert to an annual average run rate of growth of 3.0% - 3.5% from 2023.

Given levels of competition in the market and low industry margins, any accusations of "greedflation" are very wide of the mark.

Perception is everything. Foodstores are currently very much in vogue for retail property investors. But this certainly hasn't always been the case – rewind to 2014/15 and the sector was mired in all manner of turmoil and disaster. The 'space race' had come to an abrupt end and there were serious question marks as to whether the market was chronically over-supplied. Market leader Tesco had posted a £6.4bn loss amidst the ignominy of an accounting scandal. This was compounded by the horsemeat scandal that stretched any last vestiges of credibility the industry still clung to. At the same time, the 'Big Four' were supposedly being squeezed into submission by the discounters, while the nascent online grocery market was expected to undermine supermarkets in the same way that online non-food supposedly had the high street. And Amazon was poised to enter the grocery market into the bargain, disrupting and destroying everything in its path.

That was then, this is now. Sentiment and perception may have changed, but the market has one constant – it is underpinned by one of the most fundamental things not just in retail, but in humankind. Inelastic demand is the flowery way of expressing it in economic language. In more basic terms, people will always need to eat. Yes, there are a myriad of intricacies beneath this basic need (e.g. how much we consume, what we buy, where we buy it from, own label vs brands, trading up vs trading down, promotions vs full price) but demand is always there in some shape or form.

> "A vastly complex industry will always have the resilience of basic human need as its core fundamental. It is ironic that it took a global pandemic to remind us of this basic fact."

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Unblemished track record of growth?

While annual grocery market growth is (almost) guaranteed, the rate can fluctuate considerably. Since 1989, foodstore spend has grown at an annual average rate of +4.1%, with the peaks very much at the beginning of this timeseries (1989: +7.4%, 1990: +8.7%, 1991: +8.0%). Over the last 20 years, the annual average rate of growth has receded to +3.2%, although abnormal market conditions during the COVID years saw this rate increase marginally to +3.3%. Conversely, a lower 10 year average (+2.5%) reflects a couple of very difficult years in the 2015/2016 period.

The one blot on the copybook came in 2015, when annual grocery spend actually contracted (-0.2%). This was the only occurrence in the 30+ year timeseries and it is absolutely no coincidence that this corresponded with all the market strife previously outlined. While Tesco's accounting irregularities and the horsemeat scandal made for better headlines and were far more newsworthy, an inexplicable setback in consumer demand rocked the grocery industry to the core. 2015 was undoubtedly the nadir for the foodstore market.

The reasons for the contraction in demand remain something of a mystery – the 'Big Four' grocers still struggle to account for it. The only tangible explanation lies in the fact that grocery was firmly deflationary at the time (2015: -2.0%) and this wiped out very modest (+1.8%) volume growth. Very different metrics back them compared with today, as we will go on to discuss. Thankfully, the nadir proved a largely temporary setback, although demand still remained relatively soft in 2016 (+1.6%).

COVID prompted major changes in grocery demand patterns. The onset of the pandemic saw consumers resort to well-documented stockpiling, ahead of enforced lockdown. Grocery sales spiked at +10.1% in March 2020, the then highest rate of monthly growth on record (since eclipsed in 2023). For 2020 as a whole, grocery sales grew by +5.1%, the highest rate of annual growth since 2009 (+5.3%). Underlying grocery demand holding up as well in the eye of a global pandemic as it did in a global financial crisis – resilience personified.

COVID will go down in the annals of history as providing a major boost to the UK foodstore sector, but the reality is far less clear-cut. Although consumer demand was strong, the supermarkets were forced to trade under deeply-compromised operating conditions to ensure

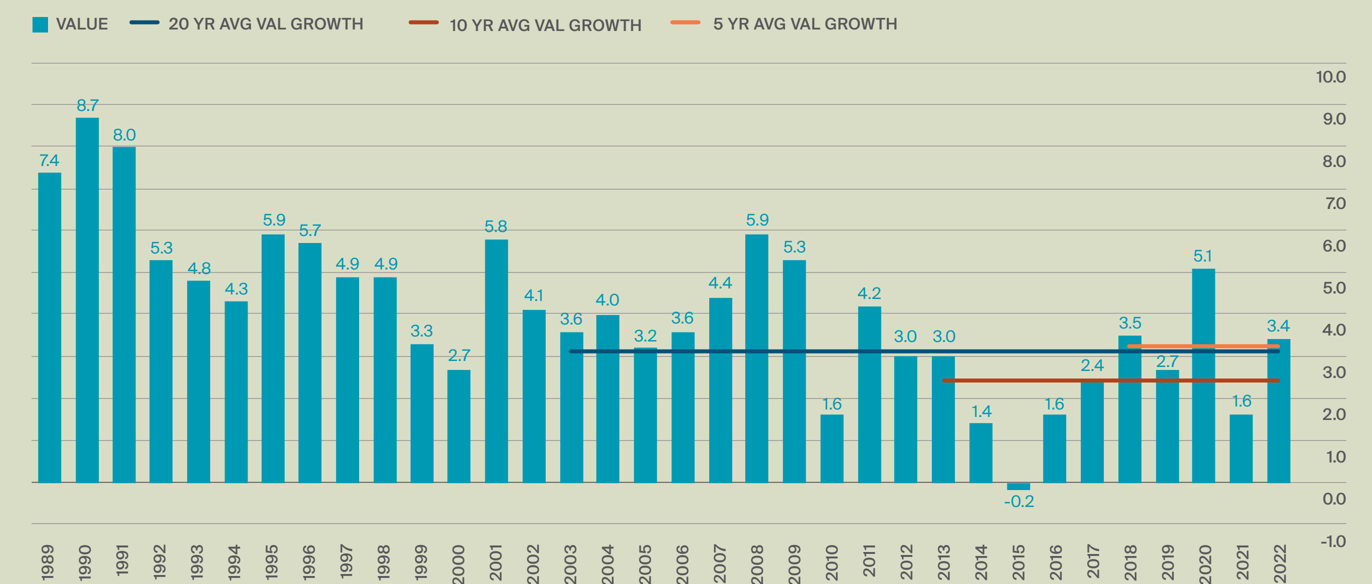


Fig 1. Annual Foodstore Retail Sales Growth 1989 – 2022

Source: ONS, Knight Frank Research

> “While the narrative may be of supermarkets making hay during COVID, very few (if any) will look back at those times with any sense of positivity or triumph.”

compliance with stringent social-distancing, not to mention huge supply chain challenges. Strong consumer demand was offset by a wall of additional operating costs. In essence, robust sales growth did not necessarily filter through to the bottom line. While the narrative may be of supermarkets making hay during COVID, very few (if any) will look back at those times with any sense of positivity or triumph.

So much for historic growth, what might we expect going forward? Probably more of the same i.e. erratic patterns, but underlying low single digit annual growth, well illustrated by forecasts produced by independent retail house Mintel.

According to Mintel (and corroborated by official data from the ONS), the grocery market was worth around £200 billion in 2022. Mintel’s forward-looking projections were produced at the end of 2022 and understate market conditions that have unfolded in 2023, notably how ‘sticky’ inflation has proved. Mintel forecast growth of just +3.6% for 2023. With the benefit of seven months’ evidence, grocery sales YTD (to July 2023) are currently running at ca. +10% ahead of last year. Allowing for some deceleration in the latter months of the year, we would now expect market growth of ca. 7-8% for 2023 as a whole.

Mintel’s forecasts for the next 5 years suggest annual growth of ca. +2.6%. We would predict slightly higher growth of +3.0% to +3.5%, not radically different from the 5 year (+3.3%) and 20 year (+3.2%) averages.

What does ‘good’ growth look like?

These ‘headline’ growth figures all refer to market value growth, to which there are a number of component parts. In general terms, these are:

- new space
- volume growth, and
- inflation.

Pertinent considerations at the best of times, they have taken on new meaning in the current operating and macro-economic environments.

The ONS does not make concession for new space in its figures. In fairness, given the limited new foodstore development pipeline, new space is likely to have a far less significant bearing on overall market growth figures than it did previously, especially during the ‘space race’ period. Overall market growth and ‘like-for-like’ growth are probably virtually one and the same in the current environment.

Value growth (i.e. total spend) therefore effectively comprises volume growth (i.e. number of products bought) and inflation. The mechanisms and co-dependencies of the two basically define the overall state of the market, with not all sources of growth necessarily being equal.

The optimum scenario is probably one of volume growth supported by moderate inflation. Grocery retailing is essentially low margin, so volume growth is always critical for the foodstore operators. Low inflation is a very useful tailwind in that it eases pressure on pricing and provides something of a cushion to wider market forces, as well as a lever of flexibility.

The worst scenario would see a toxic mix of volume decline in a deflationary environment i.e. prices are going down and people are buying less despite this. Volume declines are only palatable in an inflationary environment (and even then, they are not ideal). Deflation is far more damaging to foodstore operators than any modicum of inflation, in that they have to sell more product just to make the same money, figuratively having to run twice as hard just to stand still.

There have only been three years over the 30+ historic timeseries when the grocery market has been deflationary. It is no coincidence that it was in two of these (2015 and 2016) that the sector struggled most, with volume growth not being strong enough to counterbalance downward pricing pressure. Very strange (and different) dynamics in the other deflationary year (2001), when heavy deflation (-4.2%) was completely offset by extremely robust volume growth (+10.0%), resulting in healthy market value growth of +5.8%.

As has been well-documented, we are currently in uncharted territory, with inflation at levels not seen since the early 1980s (predating the ONS retail sales timeseries). The knock-on effects of the war in Ukraine started to permeate the wider UK economy from early 2022, with high inflation taking root from Q2 2022. With large global supply chain networks, the UK supermarkets are heavily exposed to inflationary pressures. Grocery price inflation went into double digits from July 2022 and peaked at 14.4% in April 2023, according to the ONS. It has since receded, albeit very slowly and as at Q3 2023, grocery inflation was still in double digits.

The impact on grocery demand? An inevitable decline in volumes, although not a total collapse in demand. For 2022 as a whole, grocery volumes were down -5.7%, but annualised inflation of 9.1% lifted overall value growth to +3.4%. Encouragingly, in the first half of 2023, grocery volumes showed considerable recovery, averaging monthly declines of -2.9% vs -5.6% in 2022 as a whole. With inflation remaining high, grocery values hit record monthly highs in

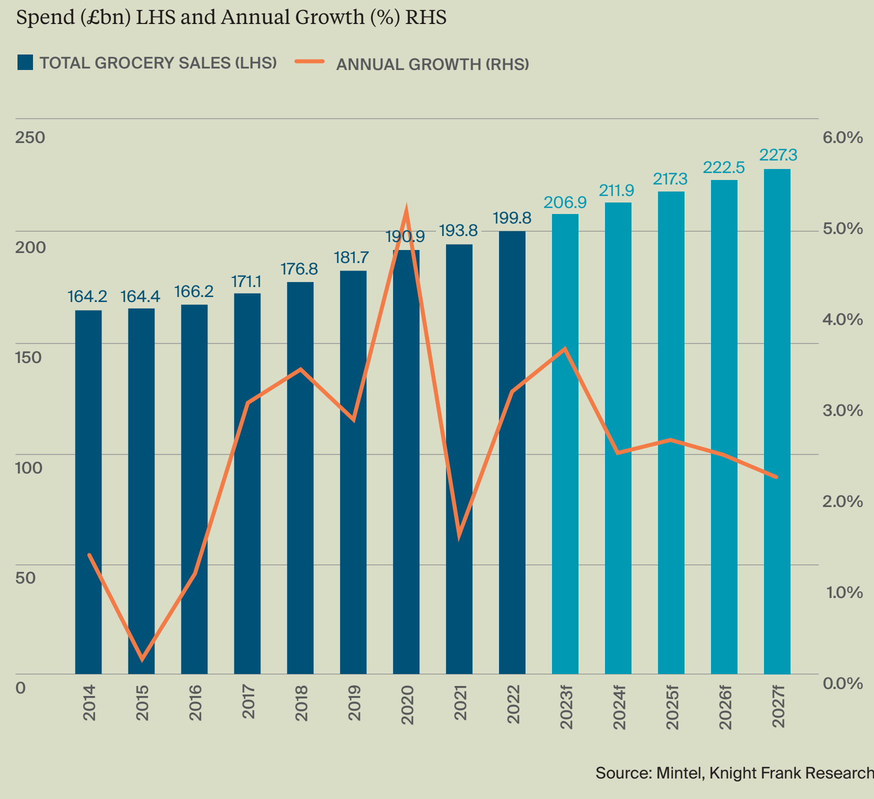


Fig 2. Grocery Retail Sales and Growth 2014 - 2027f
Spend (£bn) LHS and Annual Growth (%) RHS
Source: Mintel, Knight Frank Research

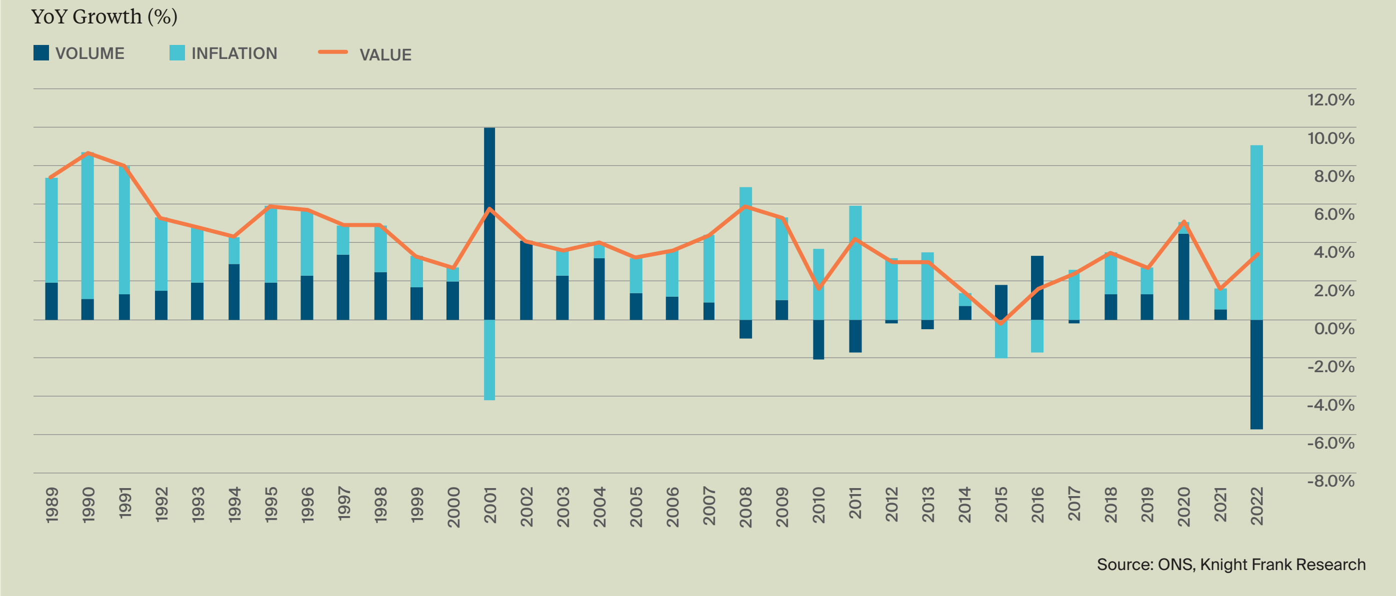


Fig 3. Annual Foodstore Retail Sales Growth 1989 – 2022
YoY Growth (%)
Source: ONS, Knight Frank Research

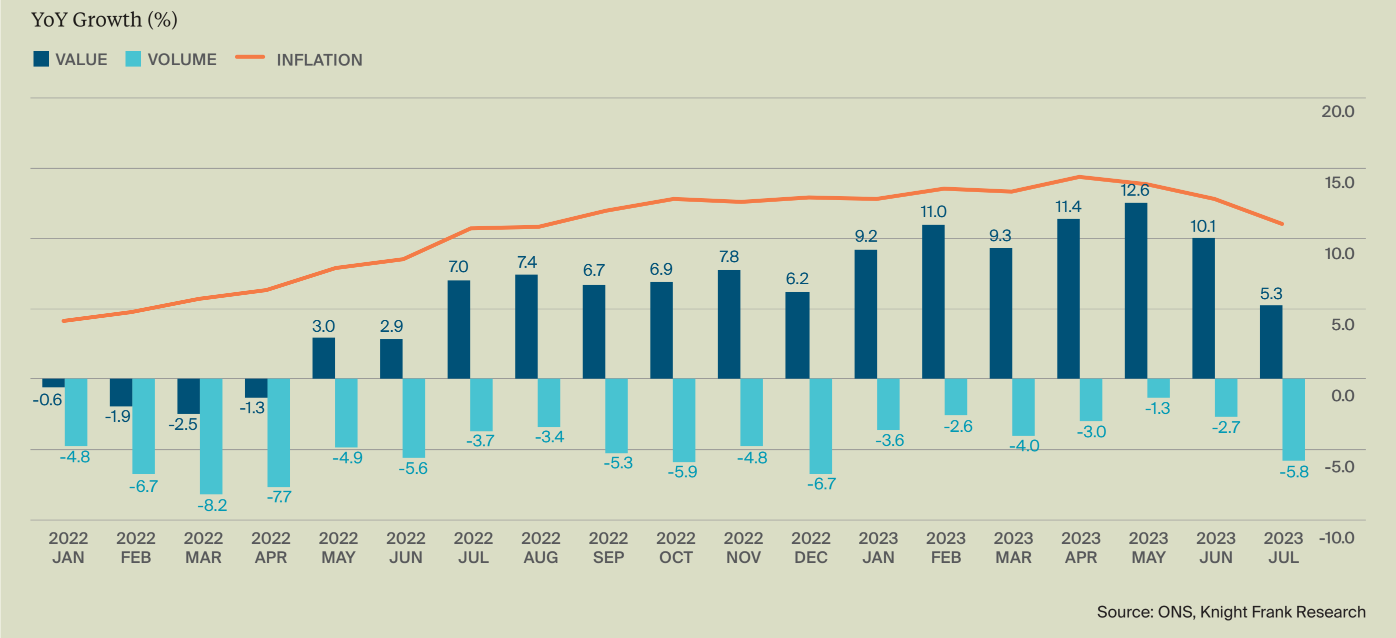


Fig 4. Monthly Foodstore Retail Sales Growth 2022 – 2023 YTD
YoY Growth (%)
Source: ONS, Knight Frank Research

May (+12.6%), while remaining in double digits from February through to June.

Where does this leave the grocery sector? Clearly, all current growth is inflationary, although there are growing signs of a return to positive volume growth going into Q4 2023. Is this ideal? Not at all, but it could be worse. Consumers are currently buying less, but spending more, an infinitely better scenario that one whereby they are both buying and spending less. Current inflation is less a helpful tailwind, much more a tornado for the foodstore operators. But for all its challenges, less damaging than deflation.

Accusations of 'greedflation'?

The foodstore operators are unwittingly in the eye of the inflation storm, in the unique position of being at the mercy of global pricing pressures and seemingly also the arbiters of what is passed onto the consumer. Master and servant at the same time.

Inevitably, the finger of blame will increasingly point to the retail sector if there are discernible reductions in raw material costs, yet these apparently fail to materialise in headline inflation figures. More politically, the same is likely to happen if the series of interest rate hikes do not achieve their ultimate aim of lowering inflation. Both of these scenarios are indeed crystallising and the retail sector is coming under increasing scrutiny. 'Greedflation' is becoming something of a buzzword, the grocery retailers the fall guys for inflation not doing what the financial and political powers-that-be want it to do.

However vociferous they become, accusations of 'profiteering' on the part of the grocers appear flimsy at best. The obvious counter-argument is that there will be a considerable time lag between decreases in raw material costs and retail prices, the two can never be instantaneous. In the meantime, the major grocers will always be very explicit on how much they are proactively investing in price. It's easy to be cynical and dismiss this as little more than marketing speak, but investment in price is a key strategic initiative for all the grocery operators and is a central part of their modus operandi.

> "The very dynamics of grocery retailing should dismiss the notion of 'greedflation' out of hand."

The very dynamics of grocery retailing should dismiss the notion of 'greedflation' out of hand. Rather than a cartel or a monopoly, the UK grocery market is one of the most brutally competitive in the world. Any retailer that is out of sync or not up to scratch (not just on price, but on the wider concept of value) will be cruelly exposed, as there is no hiding place. To put it in base terms, if they were ripping customers off, those customers would simply take their trade elsewhere.

More quantifiably, the UK grocery market operates off very low margins. Despite its size and supposed dominance of the UK retail market, Tesco's operating margins were just 4.4% in the latest full financial year. Sainsbury's and Asda's were at 3.5% and 3.0% respectively, while Aldi's and Lidl's were sub 1.0%. Such low margins hardly smack of any recognised definition of 'profiteering'.

In their respective Q1 2023/24 updates, Tesco and Sainsbury's both reported sales uplifts of ca. +9% to 10%, yet signalled expectations of flat profits for the FY. On this basis, overall operating margins would show a decline, which is again difficult to square against any accusations of 'greedflation' that may be levelled.

However flimsy or miss-guided they may be, the 'greedflation' accusations will inevitably still keep coming all the time that inflation remains higher than the Bank of England or UK Government wants it to be.

Much has changed since the dark days of 2015. Fears of over-supply have largely abated, the horsemeat scandal thankfully passed, Tesco staged a corporate recovery that hardly anybody thought possible. The threat of the discounters was a real one and remains so to this day, Amazon has indeed entered the UK foodstore arena, but with very limited competitive impact to date. Online grocery had its moment in the sun during COVID, but has since retreated to be but a small force in the market (and is actually complementary to store-based channels).

Much has changed, but one thing remains the same – we still need to eat. Consumer demand will always be the lifeblood of supermarkets. Surely the most fundamental fundamental of all?

Key expectations

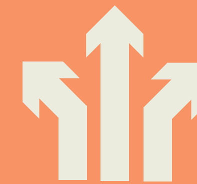
1. Grocery spend to grow ca. +8% in FY 2023
2. Fuelled by annualised inflation of 11%
3. Food volumes to decline ca. -3% in FY 2023
4. But a tentative return to positive monthly volume growth by year-end
5. More moderate spend growth of ca. 5% in FY 2024
6. Reversion to annual average growth of +3.0% to +3.5% thereafter

Changing Channels

WORDS: EMMA BARNSTABLE, ASSOCIATE, COMMERCIAL RESEARCH

A deep dive into the distribution channels that shape the grocery landscape in the UK

Key takeaways



The foodstore market comprises a wide range of formats and channels. These are at varying stages of maturity and are poised to experience contrasting rates of growth.

Growth in 'big box' foodstores will be far more pedestrian (Supermarkets +6.3%, Superstores +7.4% 2022-27f) reflecting a very constrained development pipeline for larger stores.

C-stores (+12.9% 2022-27f) are poised to be the third fastest growing channel (behind Discounters and Online). The channel is receiving fresh impetus from Asda and Morrison's both making a more concerted play for the convenience market.

Although lower growth, 'big boxes' remain the dominant force in UK grocery, generating 50% of sales and ca. 80%+ of profits. What top-line growth they do achieve will be like-for-like and will readily filter through to the bottom line.

Discounters remain the highest growth channel (+23.9% 2022-27f). This reflects ongoing aggressive expansion from Aldi and Lidl, despite growing concerns over potential cannibalisation.

From the resilience of physical stores to burgeoning online platforms – we explore the dynamics of each channel and their potential for growth.

UK grocery distribution channels

UK consumers have a diversity of options available to access their grocery essentials. These options primarily fall into two types of 'distribution channels' a) physical store formats, and b) online platforms. Whether a quick visit to a nearby local Tesco Express, or ordering a rapid Getir grocery delivery via mobile app – consumers have a vast amount of choice.

Despite growing popularity of online channels, physical store formats still reign supreme, accounting for a more than substantial 90% of the grocery market, according to the Institute of Grocery Distribution (IGD). This means most consumers still venture to bricks & mortar stores to purchase groceries, with a wide variety of physical channels available, ranging from no-frills discounters to almost department-store style superstores.

Factors differentiating the main channels of grocery distribution are summarised in Table 1, and include features such as:

- Format size
- Product selection
- Location
- Shopping mission

Table 1: The main channels of UK grocery distribution

Online	Discounters	Convenience (C-Stores)	Supermarkets	Superstores ('Big – Box')
Purchase of grocery / food items via internet-based platforms or mobile apps. Offered by mainstream grocery players (e.g. Tesco.com / Tesco Whoosh), online pureplayers (e.g. Ocado), foodboxes (e.g. Hello Fresh), and rapid delivery specialists (e.g. Getir). Takes many forms: home delivery, click & collect, courier, rapid delivery.	Retailers offering a limited selection of goods in a 'no-frills' format at low prices (e.g. Aldi, Lidl). Includes grocery sales at variety discounters (e.g. Poundland, B&M).	Store formats typically under 3k sq ft (Morrisons Daily, Sainsburys Local, Spar, Co-Op). Offers core everyday essentials (e.g. bread, milk, cheese). Located in easy-access locations with extended operating hours.	Food-focused retail formats (typically 3k – 60k sq ft) offering a wide range of food & non-food products to meet diverse consumer needs. Includes frozen food specialists (e.g. Iceland) but excludes Discounters.	The largest-scale formats (>60k sq ft) offering an extensive food and non-food offering under one roof with focus on delivering a 'one-stop' shopping experience (e.g. Tesco Extra).

LOW PROFITABILITY > HIGH PROFITABILITY

Channel dominance: who leads the way?

Larger store formats continue to dominate, capturing nearly 50% of all grocery sales, split between Supermarkets (42.1%) and big box Superstores (7.5%). This collectively equates to £107.4bn worth of sales (£91.1bn for Supermarkets and £16.3bn for Superstores), according to IGD.

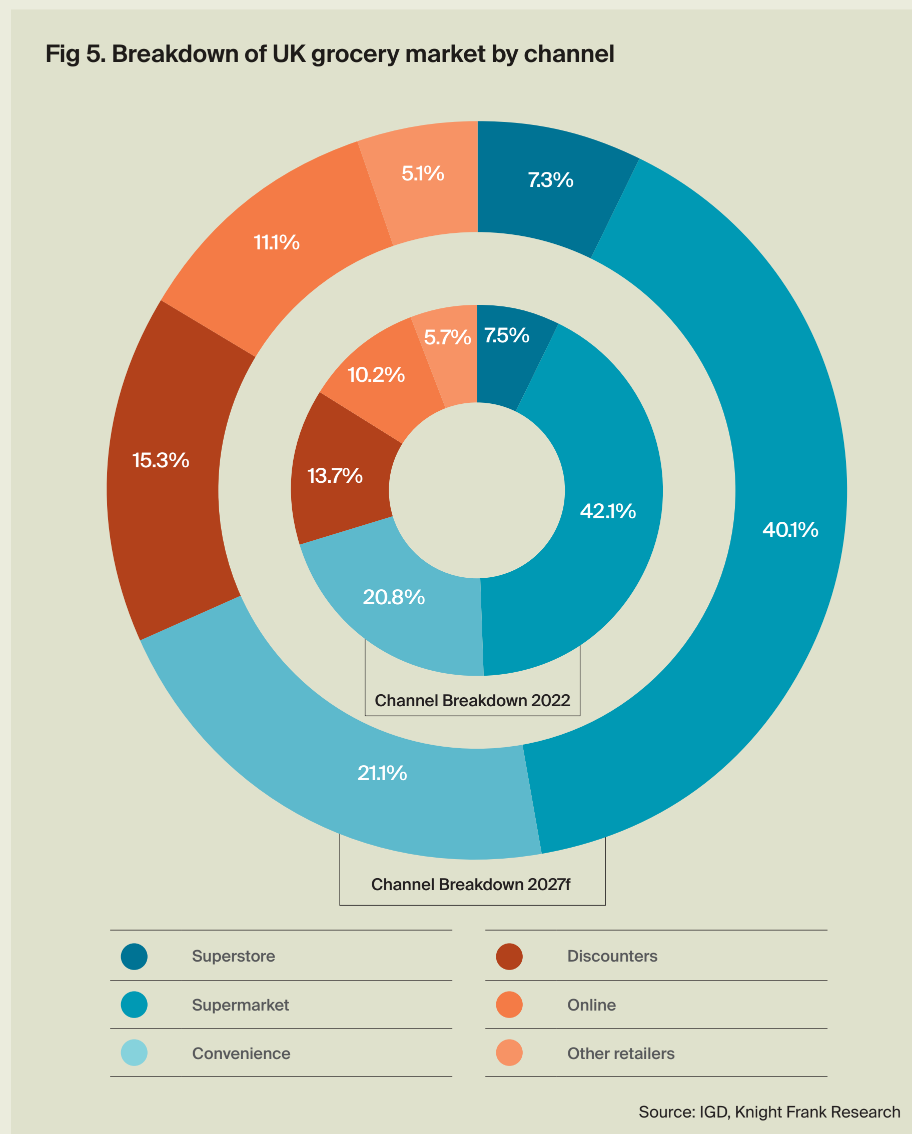
Convenience is the second largest channel, representing 20.8% of sales, valued at £45.1bn, followed by discounters at 13.7% with £29.7bn in sales. Online, while growing at pace, accounts for just 10.2% of the market with £22bn. 'Other' retailers (such as food specialists) are responsible for a small proportion (5.7%) of sales.

Channel evolution

Looking ahead, the outlook for the grocery market in the medium term (5-year horizon) is generally positive. Forecasts from IGD predict +11.3% overall growth in the UK grocery market by 2027, reaching a total value of £241.3bn, up from £216.8bn in 2022. IGD's forecasts are slightly below our own projections of ca. 3% market growth per annum.

While some channels such as online and discounters are expected to experience double-digit growth,

Fig 5. Breakdown of UK grocery market by channel



Source: IGD, Knight Frank Research

"Over the five-year period from 2022 to 2027, Discount Retailers are set to see standout growth of +23.9%, adding an additional +£7.1bn in sales."

the actual hierarchy of distribution channels is not likely to undergo significant change. Traditional supermarkets are still projected to dominate by 2027, with a 40.1% market share, despite a 2.0% loss in share to the Convenience, Discount and Online channels.

Key drivers

Over the five-year period from 2022 to 2027, Discount Retailers are set to see standout growth of +23.9%, adding an additional +£7.1bn in sales. This growth will be underpinned largely by ongoing physical store expansion strategies by key players (Aldi and Lidl). Expansion of food ranges by variety discounters (e.g. B&M) will also fuel growth, tapping into consumer demand for value-driven propositions. However, headwinds will materialise in the form of an increasingly competitive value proposition from the 'Big Four' grocers. Cannibalisation risks will also rise with new store openings, potentially tempering growth.

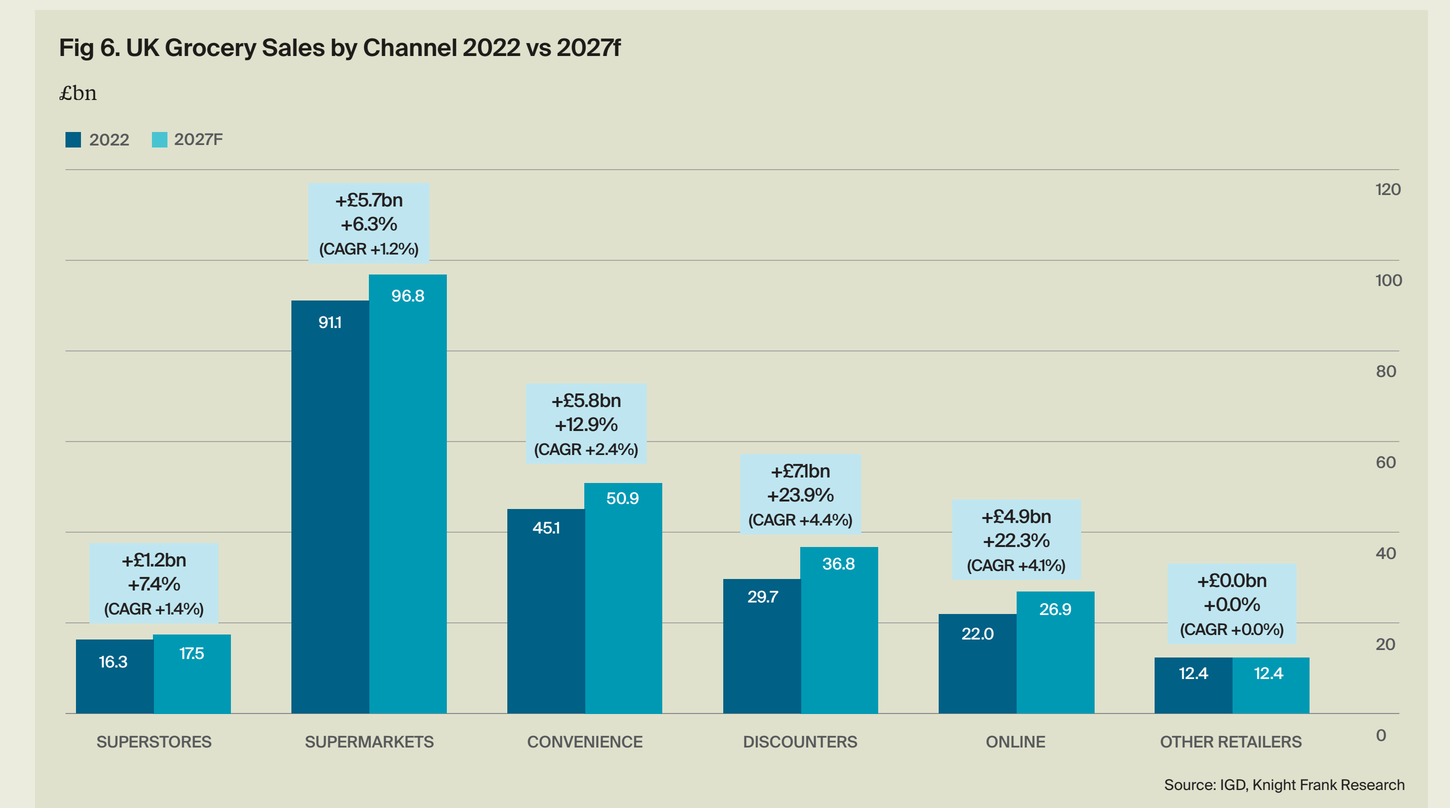
Online grocery retailing is slated to be the second-largest growth channel in the forecast period, with a projected growth rate of +22.6%, adding an extra +£5bn to the market (somewhat higher and more optimistic than Knight Frank's own projections – *see 'Online Grocery – fad or future?'*).

Growth will be largely attributable to traditional supermarket chains investing in their digital capabilities: expanding online ordering systems, optimising store layouts for fulfilment and enhancing delivery options. Overall though, online is still set to be a small portion of the market by 2027 (11.1%), despite IGD's bullish predictions.

Convenience stores are also poised for significant growth, expected to surge by +13%, which translates to an additional £5.8bn in sales. This expansion is being driven by substantial investments in neighbourhood stores, including new store openings and improvements to existing ones. This investment will help elevate convenience store market share to 15.3% in 2027, up from 13.7% in 2022.

Traditional Supermarkets will see moderate growth (+6.3% / +£5.7bn) and will be outperformed by 'big box' Superstores (+7.4% / +£1.2bn). Despite seemingly modest growth figures, Supermarkets will remain the biggest distribution channel (2027f: £96.8bn). Superstore growth is expected to be fairly pedestrian due to lack of new development opportunities, and intensified competition from other channels, such as Discounters and Convenience.

Fig 6. UK Grocery Sales by Channel 2022 vs 2027f



Source: IGD, Knight Frank Research

Channel Snapshots

2.1 DISCOUNTERS

KEY STATS

No 1.
Fastest growing retail grocery distribution channel (2022 – 2027) (+23.9%)

+4.4%
Compound Annual Growth Rate (CAGR) over next 5 years

3rd
largest retail grocery distribution channel by market share (£29.7bn)

The discounters have been thrust back into the spotlight as lingering high rates of food inflation have squeezed household budgets. In September 2023, despite a slight decrease, food inflation remained notably elevated at 12.2%, marking an entire year of consumers contending with double-digit inflation. This period also witnessed a significant milestone, as Aldi overtook Morrison's to become the UK's fourth-largest supermarket, underlining the rising prominence of the discounting channel.

The resurgence of the discounters is unsurprising given the macro-economic backdrop. But the fact that customers of all social denominations have flocked to discounters as a first port of call (rather than for occasional 'top-ups') illustrates the extent to which they've embedded themselves in the national psyche. Shoppers have become more accustomed to filling their entire grocery baskets with lower-priced 'own label' products, reminiscent of popular brands, as much of the stigma has dissipated. A Mintel survey reveals discounters now enjoy a broad demographic appeal, with households earning over £75,000 annually some of their biggest advocates.

Renewed appetite for store expansion?

Over the next five years, the discount channel is anticipated to be the fastest growing segment in the grocery market, primarily driven by new store openings. Aldi and Lidl both remain committed to ambitious store expansion programmes, capitalising on consumers' appetite for value. In contrast to the conservatism towards expansion of the traditional supermarket players, Aldi has upgraded its 2025 target to 1,500 stores (previously 1,200), whilst Lidl has maintained its goal of 1,100 stores.

However, new store openings will not be the only growth driver. Investment in existing store estates will play a pivotal role as discounters endeavour to enhance their offering. For instance, Aldi has pledged £1.4bn in investment, earmarked for new store openings, upgrades and installation of new technologies – representing a £100m increase from previous years. Discounters are acutely aware of the competitive pressure from mainstream operators, such as Sainsbury's and Tesco, which have introduced comparable discounting strategies (e.g. Aldi Price Match lines). But, conversely, isn't imitation the sincerest form of flattery?

Not all plain sailing

Headwinds in the form of challenging like-for-like growth are already materialising. Lidl's latest annual results (to February 2023) revealed a £75.9m loss despite revenues increasing +18.8%. Wafer thin margins are at high risk of erosion under inflationary pressures and rising input costs. For example, Lidl had to plough £60m into staff pay to keep pace with rising wages, to maintain its pledge to be the UK's highest paying supermarket. Attracting new customers will be the discounters' primary defence. Aldi boasted attracting 1.1 million new customers this year, whilst Lidl is actively working to lure more shoppers to store with rollout of its 'Plus' loyalty app.

Sales cannibalisation is another major risk – although so far, discounters have downplayed this concern. Aldi's decision to upgrade its 2025 target with an additional 500 new stores followed 'detailed analysis' identifying communities with access to only 'high priced groceries at traditional full price supermarkets'. Similarly, Lidl's chief executive has publicly dismissed concerns about growth limitations, asserting that there is 'no ceiling on expansion'. Despite its bravado, there are some signs to indicate Lidl's expansion via acquisitions has slowed in Q1 2023, as a notable number of property disposals came to market.

The rise of 'discount-venience'

New entrants will add new pressures. Variety non-food discounters, such as B&M, Poundland and Home Bargains, have been progressively expanding their presence into grocery. In 2018, B&M acquired Heron Foods, a specialist local convenience value chain, for £152m, expanding its footprint to 311 stores under the Heron Food and B&M Express fascias. However, more recent data indicates opening rates fell below annual averages in 2022.

Variety retailers are increasingly perceived as credible destinations to obtain groceries. Operators have significantly broadened their offerings, with the likes of Poundland introducing fresh product ranges ('PoundBakery') and Home Bargains rolling out 64 bakeries. This evolution has caught the attention of major grocery players – Asda launching a 'Home Bargains Price Match' in response. IGD now estimates variety discounters could grow food sales by a remarkable +27% 2023-2028, equating to an extra +£2.2bn in actual spend.

> "Over the next five years, the discount channel is anticipated to be the fastest growing segment in the grocery market, primarily driven by new store openings."

2.2 CONVENIENCE / C-STORES

KEY STATS

2nd
largest grocery channel by market share (£45.1bn)

3rd
fastest growing retail grocery distribution channel (2022 – 2027) (+12.9%)

+2.4%
Compound Annual Growth Rate (CAGR) over next 5 years

Convenience is still king, ranking as the second largest distribution channel worth £45.1bn, and poised to grow by an additional +£5.8bn by 2027. Consumer behaviours of the past decade have leaned towards greater convenience, fuelling considerable expansion of the channel. Shoppers have gravitated away from traditional 'big-basket' shopping, toward smaller, and more frequent, 'top-up' purchasing. Experiencing a slight reversal during the COVID-19 pandemic, shopper behaviour has since normalised, reflecting an unwavering preference or flexibility and choice.

Shifts in favour of convenience

Mintel data reveal that since 2022, the proportion of shoppers relying solely on 'big-basket' shopping fell to 46%, compared to 49% during the pandemic. In tandem, sole top-up shops, and combined top-up shops with 'big-basket' shops, increased, returning to pre-pandemic levels. In 2022, 54% of shoppers engaged in some form of top-up shop, versus 51% during 2021, signalling a subtle shift in favour of convenience.

This is not to detract from the fact performance during the COVID-19 pandemic was mixed. Neighbourhood locations generally benefitted from greater in-home demand, as consumers were unable to socialise, while urban city centre and travel-anchored sites experienced setbacks due to a lack (or indeed, total absence) of footfall. Since then, the easing of lockdown rules has fuelled a strong recovery in these locations as travel and workplace activities have resumed. Notably, Sainsbury's 2022 financial results indicated a return to normalised shopping patterns, with a -4.7% decline in online sales offset by an +8.8% recovery in convenience, resulting in sales levels broadly similar to pre-pandemic figures.

Investing in expansion

The major supermarket chains are strongly committed to their convenience store networks, regarding them as highly complementary to their traditional supermarket offering. Providing 'top up' shops in between the latter's core 'big-basket' trade, they are the perfect companion.

Tesco has the largest network of convenience stores, and opened its 2,000th Tesco Express fascia in Cambridge this March. It also owns 1,000 One Stop stores, and has access to 7,000 Premier, Londis, and Budgens sites (acquired as part of its takeover of Booker). Sainsbury's boasts over 800 c-stores, with convenience sales hitting £3bn for the first time in FY23.

Both opened several new c-stores over the past year (Tesco 50 new Express fascias / Sainsbury's 13 new Local fascias, including one 'Neighbourhood Hub'). Looking forward, Sainsbury's plans to open 25 new Local stores in FY23/24.

Investing in existing estates

Major investment has also been made in improving existing c-store estates. Both have implemented rapid delivery options (Tesco's 'Whoosh' / Sainsbury's 'Chop-Chop'), and therefore converged

with the online channel. Friction has also been reduced, with the expansion of check-out free experiences (four Tesco Express stores are now 'GetGo' tech-enabled in High Holborn, Fulham Reach, Chiswell St, and Aston University). A wider product selection is also on offer, with Sainsbury's 'Neighbourhood Hub' formats integrating floral and cosmetic ranges. Its 'Local' formats have also begun dedicating floorspace to seasonal general merchandise and Argos Click & Collect points, enabling access to the Tu and Habitat brands.

Major price investments have been made to ensure c-store propositions remain competitive. Tesco introduced Clubcard Prices to its Express fascia during H2 2023 and Morrison's also declared itself the first grocer to introduce 'entry price point products' in c-stores – offering Savers ranges into 500 stores.

Moving into convenience – again?

What of the other two 'Big Four' grocery operators - Morrison's and Asda? Both are determined to make significant inroads into the convenience sector to enhance their market positions. Asda, under new ownership through its merger with EG Group, is targeting 300 sites by 2026, which it believes will help it surpass Sainsbury's to become the UK's 2nd largest grocer. Morrison's also hopes expansion of its convenience estate can help it regain what it lost – Aldi overtaking it as the UK's 4th largest grocer in terms of market share.

The highly competitive nature of the convenience channel is underscored by the fact that both operators' market share ambitions are only likely to be achieved through acquisition (as opposed to like-for-like). Despite convenience being a major growth market, there are major challenges in growing a convenience estate organically. Established players (Tesco, Sainsbury's, the Co-op) dominate the market, making it difficult to locate suitable high footfall / demand gap locations. Those wanting to quickly build their presence have few other options than to acquire an already established convenience player.

> "Morrison's acquisition of 1,100 McColl's outlets in 2022 also marked a major new play into the c-store space – with plans to rebrand the majority to 'Morrison's Daily' formats"

Asda is off to a good start in its new c-store endeavours despite a number of previous attempts ending in vain. Its merger with EG Group will prove pivotal, with the rebranding of EG petrol forecourt sites (PFS) to the Asda Express fascia already underway. Progress has also been accelerated through the £539m acquisition of 132 Co-op PFS. Some 11 sites have been rebranded to date, with 105 sites set to be converted by Q1 2024.

Morrison's acquisition of 1,100 McColl's outlets in 2022 also marked a major new play into the c-store space – with plans to rebrand the majority to 'Morrison's Daily' formats. As outlined in our 'Key Players' section of this report, these developments could see both operators' store metrics evolve considerably in the coming years - if successfully executed.

A fickle consumer

Another aspect underscoring the intense competition in the convenience sector is the inherent fickleness of grocery consumers. 55% admit to shopping at two to three different convenience grocers within a typical month – demanding compelling reasons to switch to new stores.

The struggles faced by Amazon in its venture into c-store retailing serve as an illustrative case. In June, the tech giant decided to halt the roll-out of its Fresh formats, recognising the need to distinguish itself and enhance its economic value. Similarly, Iceland shuttered its four-strong convenience store format ('Swift') this July, just two years after launch, candidly acknowledging that the brand 'didn't work.' Instead, Iceland is preparing to introduce the 'Iceland Local' fascia across the UK, with rollout imminent.

2.3 ONLINE

KEY STATS

4th
largest grocery channel by market share (£22.0bn)

2nd
fastest growing retail grocery distribution channel (2022 – 2027) (+22.3%)

+4.1%
Compound Annual Growth Rate (CAGR) over next 5 years

Online grocery is set to be one of the fastest growing channels over the next five years, according to IGD. Whilst much speculation over the shape of its future trajectory (as covered in the next section of this report *'Online grocery: Fad or Future?'*) - what is clear is that the channel is highly complex and evolving fast.

Organic expansion by store-based operators

Contrary to popular belief, growth of online grocery will not be chiefly instigated by disruptive online-only 'pure-players' or technology giants. Instead, the major driver of growth will be traditional store-based operators organically expanding their digital capabilities. Note, the majority of online grocery demand (ca. 71%) is already met and serviced by leading (store-based) supermarket chains, using existing stores rather than central distribution facilities.

What will this organic expansion look like? Multi-channel operators will focus on cultivating new online order capabilities, creating synergies between their digital platforms and physical store networks. Anticipated investment areas may include:

- Development of user-friendly e-commerce platforms (website / apps) linking online and in-store inventories to provide accurate views of product availability;
- Optimising physical store layouts to accommodate online order fulfilment, and implementing efficient pick-and-pack processes within stores to minimise disruption to shoppers;
- Broaden delivery options: rolling out click & collect facilities and investment in last mile delivery infrastructure; and
- Integrating loyalty programs to reward customers across online and physical channels, harnessing data for personalised offers and driving in-store footfall.

The pace of growth will hinge on multi-channel operators redefining the online grocery experience – what it means to sell food and drink online – by leveraging their existing strengths in areas such as customer experience, to provide a seamless journey.

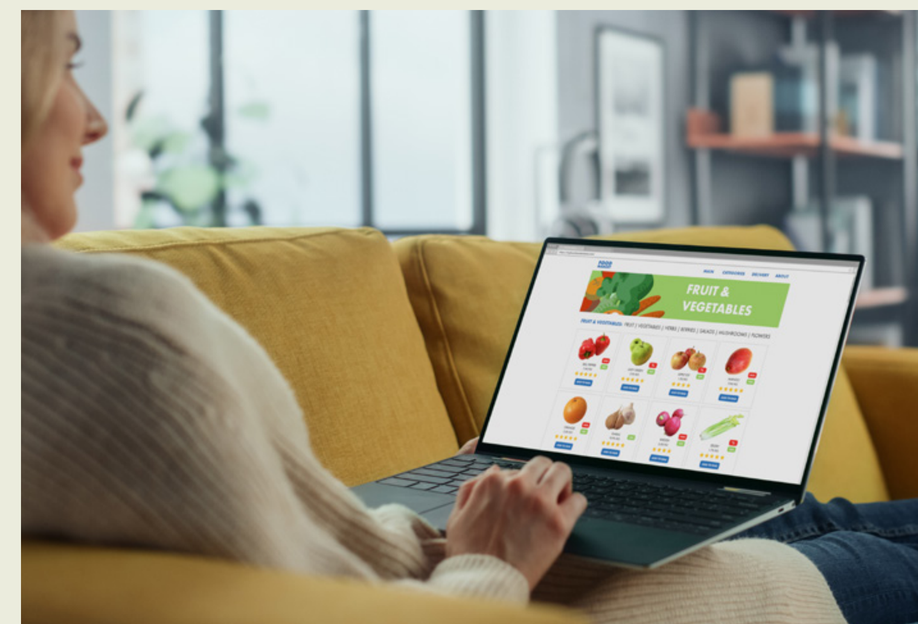
Expansion of rapid delivery (or 'quick commerce') services is just one example of how multi-channel will do this. Many of these services will be de-risked by the foodstore operators, facilitated by third party operators, such as Deliveroo, UberEats and Amazon. For instance, Deliveroo's 'Hop' app provides rapid delivery services for most of the major grocers, operating from both 'dark stores' (Morrison's most recently opening its 11th 'Hop' site in Canning Town) and customer-facing stores (Kentish Town serving as its third Waitrose site / Tottenham Hale its first Asda Express site).

Focus on profitability, not sales growth

Given there are major question marks over the profitability of the online channel, the focus will increasingly be on the bottom line, rather than purely on revenue generation.

For example, Motatos, a Swedish online discounter, exited the UK after just 16 months, citing 'tough market conditions' in regard to raising finance. This despite reportedly positive consumer reaction to its offering, but perhaps also the inevitable result of two barely profitable channels (discount and online) colliding.

Similarly, the quick commerce market has seen major consolidation in recent years, as investor capital dwindled. This summer, Turkey-based company Getir has been in talks to acquire Germany-based Flink, one of Europe's last independent grocery delivery groups. Getir itself only recently acquired Berlin-based Gorillas in a $1.2bn deal. By consolidating, these firms hope to optimise costs and boost order volumes, scale being an all-important driver in achieving long-term profitability.



Under mounting macro-economic and cost pressures, grocery operators are re-evaluating their financial models accordingly by reflecting on online performance metrics during the COVID pandemic, when sales spiked. Most will incorporate lessons learnt during that period, on aspects such as seasonality of demand, in-store picking processes and the true costs of fulfilment (e.g. click & collect vs. home delivery).

Many are already reaping the rewards of these strategic adaptions. In September, meal kit provider Gousto reported it is now back on track to return to profitability during H1 2023, having paused investment in two new production facilities and introduced delivery charges for consumers. Pragmatic responses in a push for profitability over a blind chase for sales.

2.4 SUPERMARKETS & SUPERSTORES

KEY STATS

No. 1
Supermarkets #1 largest grocery channel by market share (£91.1bn)

+1.2%
Supermarkets Compound Annual Growth Rate (CAGR) over next 5 years

+1.4%
Superstores Compound Annual Growth Rate (CAGR) over next 5 years

Supermarkets – still the dominant player

Seemingly less eye catching 'headline' growth than the Online, Convenience and Discounter channels, traditional Supermarkets are nevertheless expected to experience positive growth. Although relatively modest at +1.2% CAGR, this still translates to an additional (and not insubstantial) +£5.7bn worth of sales. By 2027, supermarkets will maintain their

"Sainsbury's Hook store in Hampshire is dubbed its 'greenest' to date, featuring 700+ solar panels, 100% renewable electricity, and 100% LED lighting."

dominant position (£96.8bn), commanding a significant lead over the second-largest channel (Convenience at £50.9bn).

Given the maturity of the Supermarket channel, scope for new store openings and expansions is fairly limited. In its latest annual report, Tesco highlighted the opening of just two new supermarket stores (in Freshwater and Cinderford). In the last financial year, Sainsbury's actually trimmed its estate, closing three supermarkets, with no new openings. However, it does expect to open three new supermarkets in the current financial year (2023/24), alongside its pipeline of 25 new c-stores.

Growth in the Supermarket channel will instead stem from investment aimed at renewing existing store estates, ensuring they are fit-for-purpose, with floorspace productivity maximised. So, essentially like-for-like ("good") growth, as opposed to new space.

For example, M&S is pursuing 400 'high productivity' Foodhalls located in 'growth locations'. In 2022/23, it plans to open 10 new Foodstores, close 20, and undertake 80 'renewal' projects – adding additional product ranges and services, such as M&S Cafes and online return facilities.

(Environmentally) Fit for the future

Another way grocers are ensuring supermarkets are fit-for-purpose is by not only investing in their financial sustainability, but also their environmental credentials. The traditional supermarket has become something of a testbed, whereby operators can figure out which environmental initiatives to roll out to their wider estate.

Sainsbury's Hook store in Hampshire is dubbed its 'greenest' to date, featuring 700+ solar panels, 100% renewable electricity, and 100% LED lighting. New innovations, such as installing doors on chiller cabinets, are being trialled to reduce energy consumption, with an eye to implementing them in other new build and retrofitted stores *(see our interview with Sainsbury's on page 26)*.

Investments are not limited to eco-friendly structures or operations. Aldi's Leamington Spa 'eco-store' concept integrates customer recycling facilities, creating a destination to deposit 'hard to recycle' materials (such as coffee pod packaging), driving a new kind of consumer and 'feel-good' footfall to its stores.

'Big box' Superstores – a finite number

The growth of Superstores is expected to lag behind other channels, primarily due to its weak pipeline of new development. Only a handful of live planning applications for 'big box' stores is in progress, EGI data highlighting just two sites: a 46,000 sq ft supermarket in Wynyard Park (Stockton) by Northumberland Estates and a new Asda store at Salisbury Retail Park.

With shopper habits supposedly turning away from the weekly shop, the appeal of one-stop Superstores has dwindled for some consumers and investors. Nevertheless, grocers still have substantial capital invested in these stores and they are often the most profitable in the portfolio. They therefore have more than a vested interest in supporting and investing in the channel for the foreseeable future. With an incentive to improve floorspace efficiency and maintain profitability, operators have been re-engineering large spaces to better align with evolving shopper trends.

There is a degree of caution amongst some investors towards 'big box' Superstores, which may be exacerbated by these relatively low growth projections. But over-spaced does not necessarily translate to uninvestible. With many Superstores already highly profitable, any forecast growth at all will have a direct impact on the bottom line. Much of the more headline-grabbing growth in Discounters or Convenience stores, will be driven by store expansion and primarily influence the top line, with a direct filter through to the bottom line not necessarily guaranteed.

Space re-engineered

Foodstore operators have successfully reimagined 'big box' spaces through a variety of means. Partnerships with third-party brands have generated new rental income streams through letting of excess floorspace, increasing footfall and attracting new demographic groups. Tesco has one of the widest ranges of partnerships of the 'Big Four' grocers: hosting brand concessions including Claire's, Timpson's, Nando's, Pets at Home, Costa Coffee and The Entertainer. Most recently in H2 2023, it expanded its partnership with the health and wellness retailer Holland & Barrett, rolling out new concessions within Extra stores in Longton (Staffordshire) and Walkden (Greater Manchester). It's also set to welcome Creams, a dessert parlour brand, to selected Extra stores later this year.

Altering and rethinking the product mix within the available floorspace has also proved advantageous, particularly within non-food categories. For example, grocers are now dedicating far less floorspace to low margin/loss-leading electricals products – recognising that much of that demand has gravitated online and that it is a space-intensive category at the best of time. Instead, the foodstore operators have increased the allocation of floorspace to higher margin categories, such as clothing, homewares and health and beauty. Sainsbury's, for instance, has primarily diversified its floorspace by incorporating its sister brands, Argos, Tu and Habitat, within many of its stores.

'Big box' foodstores – limited new development potential maybe, and on the surface a low growth channel. But where a lot of the grocers' money is made and where property investors may ultimately reap the greatest reward.

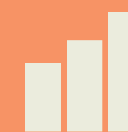
Online grocery: fad or future?

WORDS: STEPHEN SPRINGHAM – HEAD OF RETAIL RESEARCH

The future of grocery retailing or a profit-sapping rod grocery retailers made for their own back? Online grocery remains as divisive as it is misunderstood.

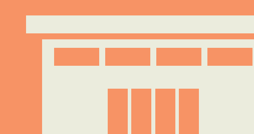
Key takeaways

Online grocery: growth stalling prior to COVID, massive but artificial demand spike during the pandemic itself, huge switch back to stores post COVID.



Online grocery penetration stabilising at ca. 8-9%, likely to remain <10% for many years to come.

But significant seasonal demand spikes, especially around Christmas (and to a certain degree other public holidays).



Physical stores are a core component of the online market – ca. 71% of online grocery is serviced through stores, through store-pick models.

Profitability of online grocery remains unproven – but major strategic shifts amongst operators to improve efficiencies and cost-effectiveness.

Q-commerce to remain a niche and regional segment of the market (just 0.6% of online grocery sales and 0.07% of all grocery sales).

Those that shop online for grocery swear by it, almost to the point of smugly questioning the sanity of anyone that still does anything as basic as set foot inside a supermarket. Detractors fail to fathom why anyone would pay for the privilege of having somebody else pick your produce for them, with no control over the quality of items selected and their sell-by dates, nor any scope for impulse purchases.

These are just the opposing consumer factions. The analyst community is equally divided between those that see it as a fast-growing channel that grocery retailers ignore at their peril and those that see it an unprofitable money pit into which retailers are throwing good money after bad.

Whatever the polarities and divergences of opinion, online grocery remains a highly complex market, and one that is evolving fast.

A growth market? Or not?

Understanding the growth trajectory of online grocery is an absolute minefield. More so than any other aspect of retail, COVID proved a major inflection point in the evolution of online grocery, to the point that it sub-divides into three distinct eras:

- 1) pre-COVID (prior to March 2020),
- 2) the pandemic period itself (March 2020 – May 2021), and;
- 3) post-COVID (May 2021 – present).

The problem is that growth across all three eras has been both atypical and erratic so it is nigh on impossible to discern any 'normal' patterns and make any sensible projections as to future growth.

1) Pre-COVID - stalling

The pre-COVID era was characterised by seemingly exponential growth. But the market was still relatively immature and much of this growth was being leveraged off a very low base. Marginal growth was magnified significantly in percentage terms. There were even valid question marks as to whether the online grocery market was stalling in 2018/2019. Online grocery spend was fairly static at around £12bn - £13bn, and indeed, online growth was lagging overall supermarket spend. Prior to the pandemic, the online grocery channel was actually losing share.

2) Artificial COVID Growth

And then along came COVID. Social distancing, health concerns and all the prevailing madness provided a major shot in the arm to the online grocery market. Demand skyrocketed from virtually all sides – fresh demand from new adopters of online grocery and organic growth through larger basket sizes and increased order frequency from existing online grocery shoppers.

A static market suddenly sprung into life. Some of the monthly figures during the early months of COVID were eyewatering. In March 2020 (when we first went into lockdown) online grocery sales surged +19.7% year-on-year, or 17.9% month-on-month. In April 2020 (the first full month of lockdown), the market grew by a further +55.8%, followed by an increase of +21.0% in May. For 2020 as a whole, online grocery sales surged by +77% to reach £22.6 billion.

Not surprisingly, online grocery penetration (sales expressed as a percentage of the total market) surged during this period. In the months prior to the pandemic outbreak, online grocery penetration was static at ca. 5.2%, according to the ONS. By

> "Prior to the pandemic, the online grocery channel was actually losing share."

May 2020, this share had more than doubled (11.2%). A high water mark of 12.0% was reached in January 2021 as the tiered system in force over Christmas transitioned into the 3rd period of lockdown. Some non-ONS sources (e.g. Kantar) suggested a higher peak online grocery penetration figure still (15% - 16%).

Amidst all the madness at the time, many wild predictions were made as to the growth trajectory of online grocery going forward. A number of research houses even predicted that the penetration rate would hit 20% (even 25%) as early as 2025. They were wrong. Most of the fanciful projections were just extrapolations of completely atypical market conditions. Under a general but somewhat lazy narrative of "permanent changes to consumer behaviour" off the back of COVID, many assumed that habits adopted during the pandemic would prove sticky and last indefinitely.

3) Post-COVID re-basing

They didn't. Lifting of the 3rd lockdown prompted a swift rebound in store-visiting and spending generally. Even though supermarkets were able to open throughout lockdown as purveyors of "essential" goods, they too benefitted from the wider groundswell of a return to physical locations.

Cue a major reversal in online sales growth, supposedly "permanent shifts in consumer behaviour" proving anything but. Since mid 2021, online grocery has consistently been declining in double-digits. For 2022 as a whole, online grocery spend contracted by -12.6%. The rebasing process has been more severe and protracted than virtually anyone predicted. Only in April 2023 did the market return to positive market growth.

During this rebalancing period, online grocery penetration receded to around 8.5% and, for the foreseeable future at least, appears to have settled around the 8% - 9% mark. Higher than the pre-COVID figure (5.2%) but considerably short of many fanciful predictions of 20%+.

Growth forecasts

More measured forecasts from Mintel suggest that the market will contract by a further -3.8% this year, which seems a reasonable projection. Their figures then suggest a resumption of strong growth of ca. +6% per annum. This would mean that online grocery spend would again surpass the artificial spike of 2020 by 2026.

Mintel's forecast figures suggest an online grocery penetration rate of 10.8% for 2023 as a whole, rising to 11.2% next year and 12.6% by 2027. Higher than the ONS figures (in part, due to different methodologies), these growth figures still seem somewhat ambitious. Be that as it may, online grocery penetration is not expected to scale the heights of 2020 until 2030 at the very earliest.

> "Online grocery penetration receded to around 8.5% and, for the foreseeable future at least, appears to have settled around the 8% - 9% mark. Higher than the pre-COVID figure (5.2%) but considerably short of many fanciful predictions of 20%+."

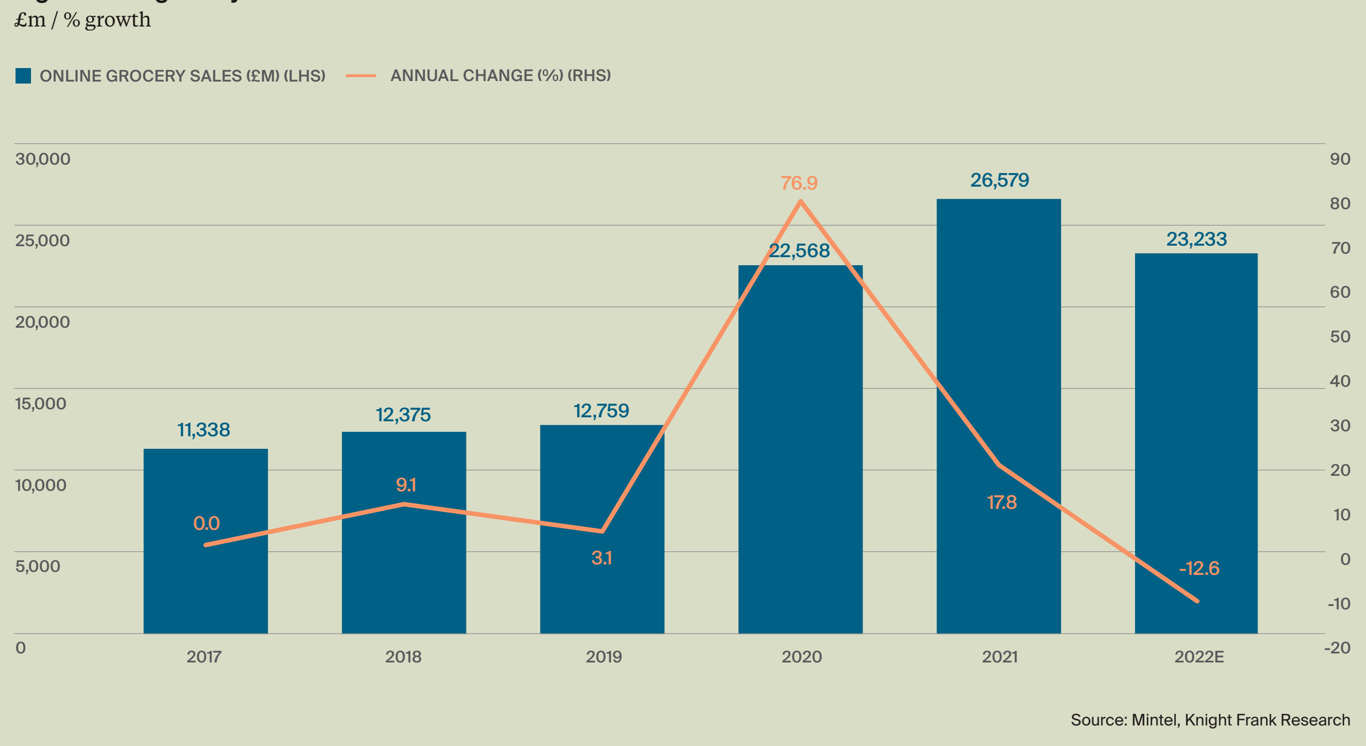


Fig 7. Online grocery sales 2017 – 2022
£m / % growth

Source: Mintel, Knight Frank Research

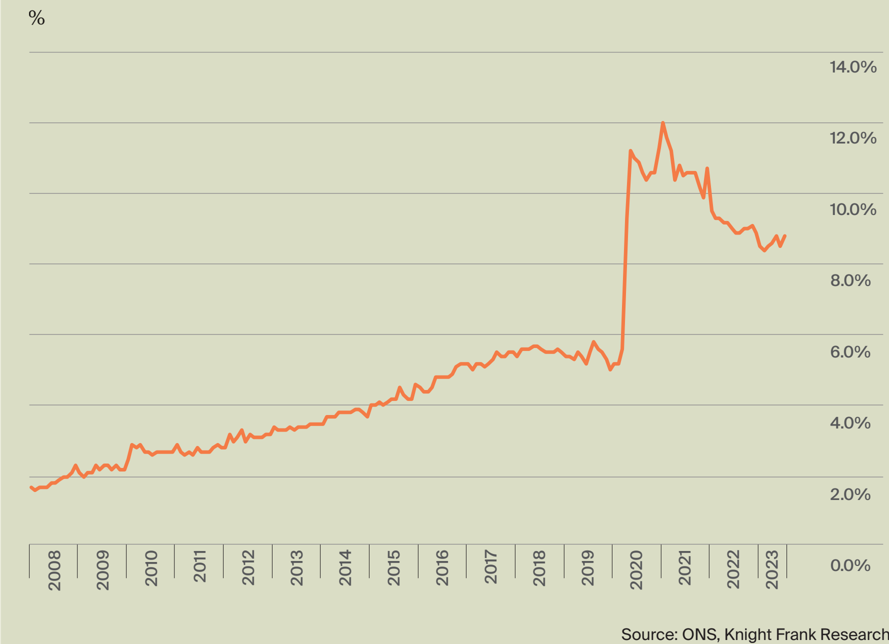


Fig 8. Online grocery penetration 2008 – 2023

Source: ONS, Knight Frank Research

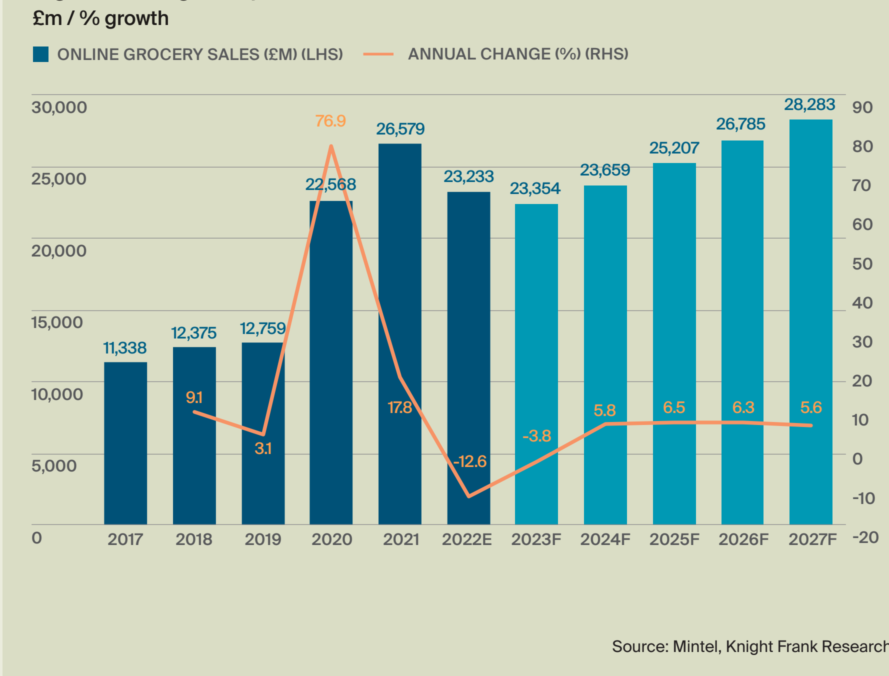
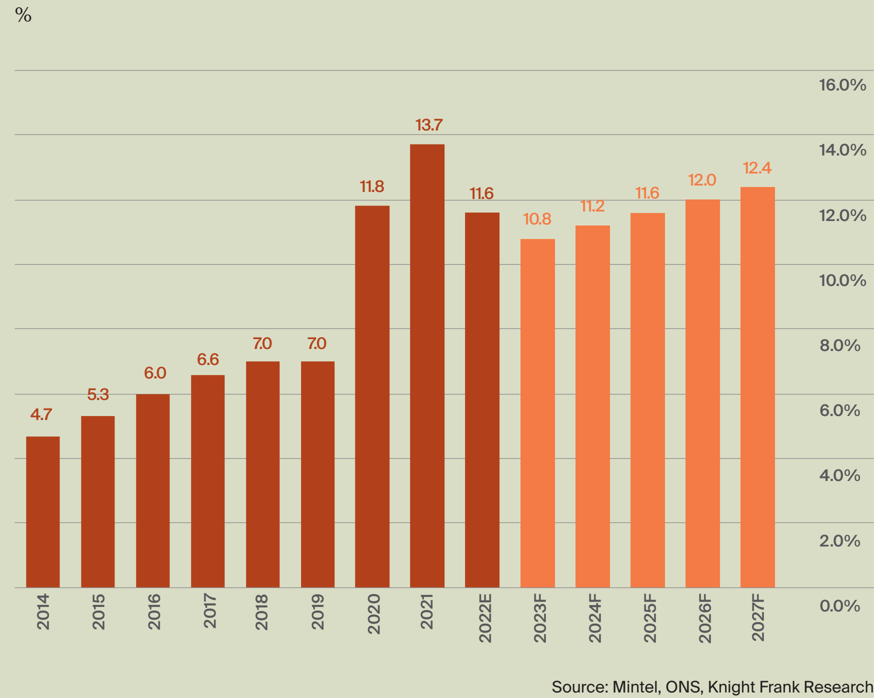


Fig 9. Online grocery sales 2017 – 2027f
£m / % growth

Source: Mintel, Knight Frank Research

Fig 10. Annualised online grocery penetration 2014 – 2027f

%



Source: Mintel, ONS, Knight Frank Research

Online / store – one and the same?

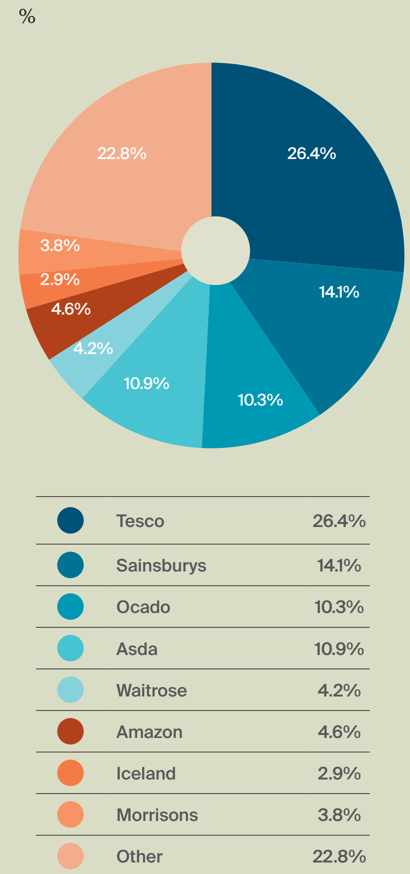
While market growth and penetration figures remain the focus for many, the market structure and the underlying economics of online grocery are infinitely more meaningful.

Much more significant than the penetration figures is the composition of the market. Core home delivery is by far the largest segment of the online grocery market (61.4%), followed by online pure-plays (14.9%) and click & collect (9.8%), with the niche channels making up the remainder (13.9%). Structurally, only the pure-plays (e.g. Ocado, Amazon) and niche operators (e.g. foodboxes such as HelloFresh, Gousto etc) deploy central distribution facilities, the mainstream food operators tending to employ store-picking models for virtually all their online grocery fulfilment.

The key point is that the vast majority of online grocery demand (ca. 71%+) is serviced by stores rather than central warehouses. So, ca. 71%+ of online grocery is part of a wider multi-channel ecosystem. Expressed in blunt terms, ca. 71%+ of online grocery isn't really 'online' at all.

Fig 11. Online grocery market shares

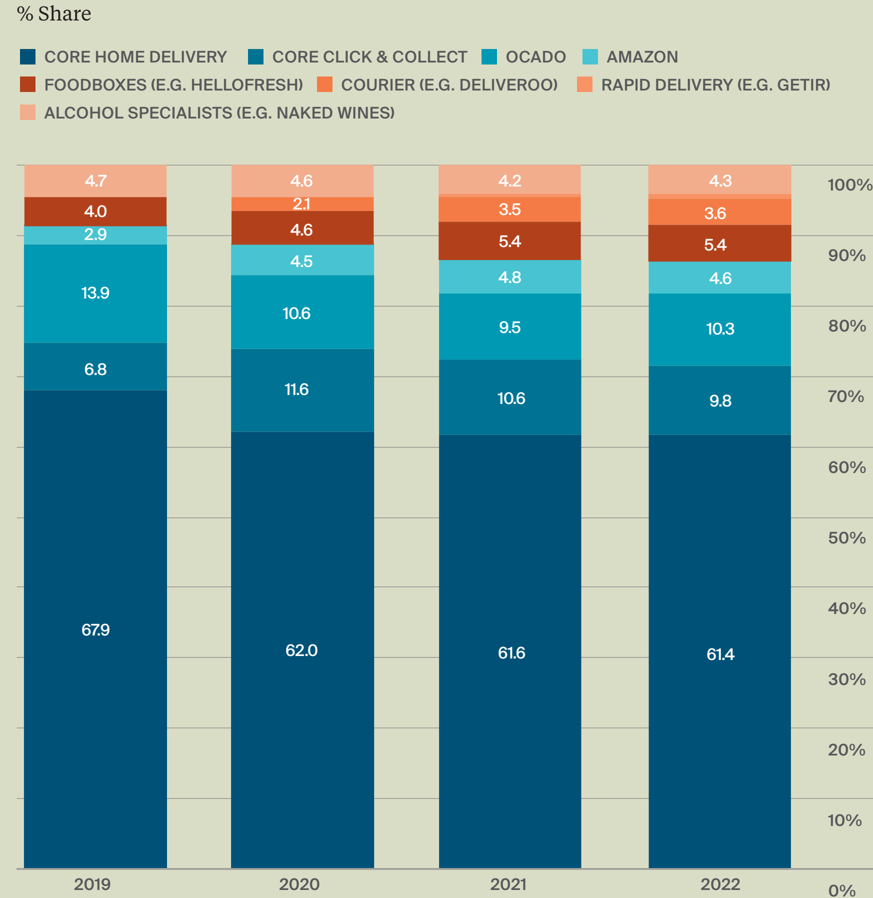
%



Source: Mintel, ONS, Knight Frank Research

Fig 12. Composition of the Online Grocery Sector 2019 – 2022

% Share



Source: Mintel, Knight Frank Research

Profitable or not?

The million dollar question hanging over online grocery is whether anyone actually makes a penny of profit from it. Details on this have always been sketchy, but the fact that the most transparent operator Ocado has only really made money outsourcing its infrastructure, as opposed to actually selling food, is more damning than decisively reassuring.

For their part, the 'Big Four' (Tesco, Sainsbury's, Asda, Morrison's) are famously coy on the profitability of their respective online grocery operations, but volume has clearly always been key. Big baskets – and lots of them.

But change is afoot. For all its stresses, COVID provided invaluable, real-life, real-time lessons on online for all the supermarkets, in terms of seasonality of demand, capacity need and supply chain requirements/capability. These lessons are now being proactively deployed and financial models revisited. Expect significant structural change in the online grocery market as a result.

Online grocery. An immature market that has matured rapidly. A market that has gone beyond fad and definitely has a future. But is by no means the *only* future for grocery retailing.

> "The vast majority of online grocery demand (ca. 71%+) is serviced by stores rather than central warehouses. Expressed in blunt terms, ca. 71%+ of online grocery isn't really 'online' at all."

Direction of travel

We anticipate four key directions of travel for online grocery:

1. Seasonality spikes in demand.

Forget any notion of exponential growth, even incremental growth on an annualised basis will be hard to come by. Rather, the online demand profile will increasingly ebb and flow throughout the year, with significant peaks around major events such as Christmas and Easter, offset by slower periods at other times in the year. Lessons learnt during COVID will enable retailers to scale up capacity at short notice, when it is needed most. A much more cost-effective response than operating at 100% capacity all of the time.

2. More pragmatic charging on online deliveries.

The delivery cost profile will increasingly reflect the true cost of fulfilment i.e. click & collect will be cheaper than home delivery, lower volume orders will carry a higher cost premium over larger ones. The cost of online deliveries will not go up wholesale, but the grocers will increasingly look to recoup a higher proportion of delivery costs. Despite any increases to delivery charges, expect only limited push back from consumers - most are likely to be willing to continue to pay for the privilege.

3. Q-commerce / rapid delivery to remain a niche market.

The economics of Q-commerce will always be challenged (the need for volume/big basket sizes versus the delivery constraints of cycles/motorcycles), such that none of the incumbent players have demonstrated any ability to trade profitably in this space. Expect considerable consolidation within the sector (as is already happening) and ongoing (but selective) experimentation in this space by established operators (e.g. Tesco's Whoosh, Sainsbury's Chop Chop). A niche market, but with certain regional hotspots.

4. Further doubling down on store-picking models.

Ocado and Amazon to remain the exceptions to stores servicing online delivery. The multi-channel operators looking to maximise synergy and efficiency between their stores and online functions, the latter even seen as a profit centre to the stores in their own right. At the same time, the real estate investment community increasingly recognising the symbiotic relationship between stores and online grocery fulfilment and foodstores doubling up as online fulfilment centres carrying a price premium (typically 100-150 bps).

Key client interview – Sainsbury's

WORDS: PATRICK DUNNE – DIRECTOR OF GROUP PROPERTY, PROCUREMENT & EV VENTURES

Q: A few words on the current grocery trading environment if you will. Grocery is seen as one of the more inelastic categories amidst a 'cost-of-living crisis' but clearly that doesn't mean life is easy nor tell the whole story?

A: It is widely recognised that the grocery market in the UK is the most competitive it has ever been and with this in mind, Sainsbury's number one priority continues to be battling inflation so that customers get the very best prices when they shop with us, particularly now as household budgets are under more pressure than ever.

In recent months, our business has continued to show strong Grocery momentum compared to the market, reflecting our investment in value, innovation, service, and availability, which has driven a return to volume growth and strengthened market share outperformance. In recent months we have also seen General Merchandise growth, driven by further Argos market share gains.

Q: With inflation stubbornly high, some accusations of "greedflation" are being levelled at the supermarkets. Given how low operating margins typically are (<5%) in food store retailing, these seem very tenuous, but what's your take?

A: In July, the CMA published its findings on food price inflation. We are pleased that its review found no evidence of "greedflation" in the grocery sector and concluded that food price inflation has not been driven by weak retail competition.

The CMA's findings also recognised that retailers are not passing the full cost of inflation on to customers - costs are going up in our operations, but because of everything Sainsbury's has done to battle inflation, customers pay less than half the headline rate of inflation when they shop with us.

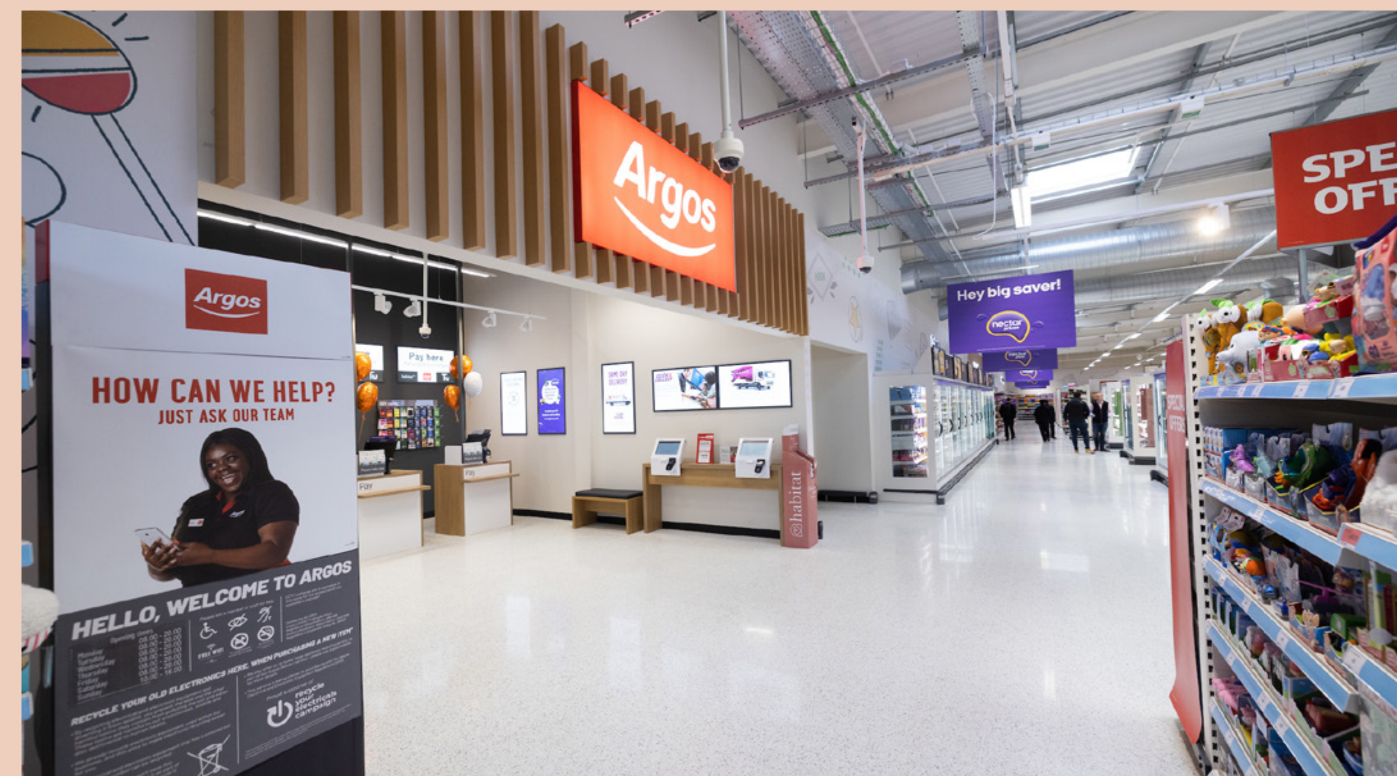
As I say, our number one priority continues to be doing all we can to keep prices low for our customers.

Q: Few would deny that the UK retail market as a whole is over-supplied, but how does this relate to the supermarket sector? Goldman Sachs' statement a few years back that there was 20% too much foodstore space in the UK set alarm bells ringing, but how do you view current market capacity?

A: In any marketplace, especially in retail, you undoubtedly always have over capacity as new entrants come in and successful retailers grow adding locations or space, some retailers "stagnate" and maybe act too slowly to right size their estates while others become outdated and unfortunately decline. One also needs to deep-dive into what we mean in retail as over-supplied and here I mean the differences between number of locations versus the size or space in each location. A great example here would be our own Argos business that has adapted quickly with the changes in consumers' shopping habits, reduced our standalone locations dramatically but increased smaller points of presence inside our supermarkets with a state-of-the-art regional logistics model to deliver orders same day, even in under 4 hours. All in all, more presence / locations but more economical costs to operate with substantially less gross retail space in total serving over 86%+ of UK postcodes within a 15-minute drive.

Overall, there has been a significant improvement in the balance between incremental supply and demand in the supermarket sector, with very little net new space added in recent years relative to historic levels.

However, we believe there are still great opportunities for new space in the form of Sainsbury's stores – the key is



to provide an excellent quality offer in the right locations, which are carefully selected to ensure they will best serve customers and are tailored to suit the needs of each community. We are very targeted in our approach to new stores and as a result, all those that we have opened in recent years are performing exceedingly well, including our supermarkets such as Sainsbury's Hook, a new 27,000 sq ft store which opened in May and is already far exceeding even our own high expectations. Key strategy approach for us is very much quality of new space openings over quantity. We are also active in removing underperforming stores from our estate that maybe over the years have become strategically disadvantaged. So, opening new high quality profitable stores and closing underperforming or strategically disadvantaged stores, a real win – win.

> "In any marketplace, especially in retail, you undoubtedly always have over capacity as new entrants come in and successful retailers grow adding locations or space, some retailers "stagnate" and maybe act too slowly to right size their estates while others become outdated and unfortunately decline."

Q: The "space race" may be over, but obviously selective site acquisitions are moving forward. Can you give some indication as to what you currently have in the development pipeline?

A: We always plan to open around 20-25 new convenience stores per year and several supermarkets. This year we will open 25 convenience stores and three new state of the art supermarkets: Sainsbury's Hook, Sainsbury's Talbot Green and Sainsbury's Southport Meols Cop. We are targeting similar levels of growth over the next few years. We will also of course look at underperforming stores and see what needs to be true to improve or close if needs be. As I say it's quality profitable new stores at the top of the estate and pruning the unprofitable or strategically disadvantaged at the bottom of the estate, a real active estates management approach to ensure the estate is maximising performance. This also of course includes our approach to what we will own and what we want to lease to ensure a healthy balanced estate that can adapt with changing consumer behaviours.

Q: Many were writing off 'big box' superstores a few years back. Clearly, that was over-simplistic, but some stores were undeniably over-spaced. How have you successfully re-engineered what might otherwise have been surplus space?

A: A key example as articulated earlier in making space much more productive is the integration of Argos stores within Sainsbury's, providing a convenient new "store-in-store" that optimises both customer-facing and warehouse space. We also work with several concession partners across the UK to provide additional services in and around our stores including Starbucks, Timpson's, Specsavers, Explore Learning, and Boparan Restaurant Group. All in all, these are concession partners that support the grocery shopping mission, not solely space fillers and I think that's

> "We plan to open at least 20-25 new convenience stores in the 12 months to March 2024 as consumer demand continues to grow."

important, the days of squeezing in any old concession to help pay the rent is long gone. It's also worth noting that we continue to pick all of our online grocery sales from within our supermarkets, adding to the productivity of the retail space. We are well placed to do this given the quality of our supermarket locations.

Q: Sainsbury's acquisition of Argos raised more than a few eyebrows when it happened. Some viewed Argos merely as a 'space filler' for over-sized superstores, but clearly there was much more rationale than that?

A: We are two and a half years into our three-year plan to transform Sainsbury's. As part of this, bolder prioritisation has allowed us to make more focused investments in our brands, including the Argos and Habitat brands that Sainsbury's purchased from Home Retail Group in 2016. These brands have continued to support our core food business while consistently delivering for customers and shareholders on their own merits. By steadily making our brands more profitable, we have been able to continue to invest in food, offer greater value, an improved product range, and better service and we find that customers who love our food will also shop with us across our brands.

Argos is a longstanding iconic UK brand, but it needed to reduce its cost base and become more relevant to the way that customers now shop. So, much more than being a "space filler" for Sainsbury's space, it enabled a reinvention of the Argos store estate, its technology platforms, adding more points of presence across the UK and a new logistics proposition that can provide multiple options to consumers, click & collect, home delivery all in under 4 hours from order to collection in very convenient locations or delivery to your home.

In the end it's a transformation that has reduced Argos' fixed costs considerably and set it up very successfully for many years to come. Argos now consistently outperforms the General Merchandise market, having built its reputation for value, and delivered better convenience and availability. Customers value the certainty and speed of Fast Track delivery and Click & Collect and earlier this year, more sales went through Argos stores inside supermarkets than standalone Argos stores for the first time. We have continued to extend the breadth of range at Argos, including more premium brands, and continue to invest in Argos's digital capabilities, with 73% of sales now originating online.

Habitat is performing well against a challenging General Merchandise backdrop, and we have recently gained value market share in several homeware categories. As well as shopping online, where customers can make use of a new digital showroom tool to learn more about products before purchasing them, customers can find more Habitat products in Sainsbury's supermarkets than ever, giving them the chance to conveniently shop the much-loved brand while picking up their groceries.

Q: Where are you at with the Argos integration programme and how do you ultimately see that panning out in real estate terms?

A: The transformation of our Argos brand as articulated earlier is almost complete, particularly our store and distribution network, which started in 2020. This continues at pace, improving availability and service for customers – we have a plan and an end position, but we constantly review how best to optimise our Argos store footprint as part of this, especially in discussions with our landlords, many of whom now see the long-term advantage of retaining a viable Argos store in their estate.

We now have over 400 Argos stores inside Sainsbury's supermarkets, as well as Argos Click & Collect points inside another 400 Sainsbury's stores. We expect to reduce our standalone Argos estate originally to 100 stores but due to the support of our landlords and changing market dynamics we are now forecasting circa 190 standalone stores in the UK by March 2024, down from 580+ when we started in 2020 (800 when we acquired in 2016) whilst we have continued to grow our points of Argos presence in Sainsbury's further. Our end estate would be circa 150 standalone Argos stores, but we will continue to be flexible.

We now have almost 20 Argos 'Local Fulfilment Centres', a distribution network that is transforming the speed at which we can fulfil customer orders, and which is improving product availability and driving improved customer satisfaction.

Under Sainsbury's stewardship Argos is now a much more successful and efficient model with more points of presence and greater customer value and service options. Clearly more than simply a "space filler"!

Q: C-stores are obviously still a growth area for Sainsbury's, although the market generally is ever more crowded. What opportunities do you still see in the c-store space?

A: Convenience growth is a key priority for Sainsbury's and earlier this year, we announced that our convenience stores had achieved a new milestone as sales surpassed £3 billion for the first time. Sales in Sainsbury's convenience business, which comprises over 800 stores across the UK, grew 10% year-on-year in the financial year to March 2023 (6% ahead of the market) and sales were up 7% on pre-pandemic levels. This was driven by more people returning to the workplace and wanting the flexibility of being able to shop how and when they want. We plan to open at least 20-25 new convenience stores in the 12 months to March 2024 as consumer demand continues to grow.

We are also making strides in the rollout of our Neighbourhood Hub store format, which launched in 2019 and is proving very successful. We now have a total of ten Sainsbury's Neighbourhood Hubs, which are larger than conventional convenience stores and sit under the 'Sainsbury's Local' brand. The vision for these stores is to be the best "in neighbourhood" one-stop offer, with great value, product choice and community at their heart – they also aim to give customers access to everything they need to complete a weekly shop locally. We will continue to invest in stores that customers will find convenient to where they work, shop or live and deliver a proposition that is high quality and comprehensive. For as long as we think we can do a better job than our competitors then we will continue to offer that to customers.

> "We continued to pick and deliver online orders entirely from within our supermarkets, proving the flexibility and efficiency of this operating model."

Q: The dynamics and economics of c-store and 'big box' grocery retailing are tangibly different, but can you give some basic colour on that?

A: Well, they are of course different in many ways mainly due to their size etc. but similar also in so many other ways. They are all standalone decisions, a store that serves a specific mission or purpose for a Sainsbury's customer but equally the capital we invest to open or refurbish each store whether a c-store or a Super must always provide a return on that investment. In the end both Supers and c-stores play critical equal roles for us in being able to build out a successful and profitable portfolio ensuring we bring the Sainsbury's offer to as many of our customers as possible. This in part explains the logic for our new Neighbourhood Hub concept which fills a gap we identified for us in the market between Supermarkets and our standard C-store estate allowing us to successfully build out the estate to access more of our customers.

Q: COVID was obviously a good, if somewhat unwelcome, stress-test of online grocery. What lessons do you think were learnt that will inform your online strategy going forward?

A: Well, I am not sure we can assess it as "good"; it was clearly a terrible time for all but one where the grocery sector alongside many other sectors truly had to reinvent our supply chains and store environments and in short "Feed The Nation". It was clearly a time of fast innovation to ensure our stores stayed as safe for colleagues and customers as possible, the costs associated with that were astronomical, but we did it. The "Feed the Nation" campaign and the success of that really showed the country the importance of a secure and sustainable food supply chain across the UK. It seems so long ago now but in reality, it was only 3+ years, clearly there was no "greedflation" claims then as we overinvested in many areas of the store, supply chain and particularly expanding rapidly our grocery online capacity to ensure people could secure their weekly groceries safely.

Sainsbury's Groceries Online sales peaked at more than 20% of our total grocery sales during the pandemic, rising from around 8% pre-pandemic. We continued to pick and deliver orders entirely from within our supermarkets, proving the flexibility and efficiency of this operating model. We've seen shopping patterns normalise since then, with customers returning to stores and online sales at around 14% of total, around 80% higher than pre-pandemic levels. This has led us to invest significantly in the proposition and since the pandemic, we have invested in new ways to make our delivery services better for customers and more efficient, with initiatives including one-hour saver slots and changes to our delivery pass model.

Customer satisfaction in Groceries Online has steadily improved relative to competitors, and we have worked to boost profitability by enhancing picking rates and van utilisation.

Q: With two of the Big Four now under PE ownership, how do you think this structural change will impinge upon the wider grocery market?

A: Put simply whether PE, privately owned, Partnership or Plc it simply brings greater diversity of investment priorities and I suppose even more competition to what many would say is one of the most competitive grocery markets in the world. We however remain laser focused on improving our customer proposition with great value and choice while delivering improved returns for all stakeholders. Over the last three years we have improved our pricing position versus all of our core grocery competitors, particularly the limited assortment discounters.

Q: All the major foodstore operators still own several freeholds. Are you able to quantify this for Sainsbury's and give some indication of your property investment strategy?

A: We carefully manage the makeup of our estate to ensure we are meeting our customers' needs, as part of our ongoing strategy to maintain a balanced portfolio of freehold and leasehold assets. This helps us to optimise operational flexibility and investment opportunities with risk and exposure across our estate. Most of our convenience estate is leasehold due to the nature of those stores and their locations, whilst over 50% of our supermarket estate is currently freehold. We always look at every leasehold supermarket that comes to market to determine if it is one we want to add to our freehold portfolio, but always with a stringent set of criteria in mind, as to what constitutes a good capital investment for Sainsbury's, before we opt to acquire.

Q: Some of your real estate is owned through joint ventures with 3rd parties. What is the rationale for this and how does it work well for both parties?

A: Historically there were several joint ventures going back some 10 to 20 years

> "Put simply whether PE, privately owned, Partnership or Plc it simply brings greater diversity of investment priorities and I suppose even more competition to what many would say is one of the most competitive grocery markets in the world."

but almost all of these have now come to an end. We have just competed the wind up of the Highbury & Dragon structure, which was formed back in 2000 and originally comprised 26 Sainsbury's supermarkets. We were able to use options, provided by the structure, to acquire 21 of our strong freehold supermarkets.

Q: Given the lifecycle of food store development, many supermarkets will approach lease expiry in the coming years. What is your general strategy around lease renewals and regears?

A: Lease renewals and regears are decided very much on a case-by-case basis. Lease terms are dictated by the strength of the store, and it is critical that the level of rent enables the store to remain viable as a minimum for the term of the lease. We will not knowingly sign leases that mortgage the future of the estate to achieve short-term gains. Our strategy over the last 5 or more years has been to create and then actively manage a well-balanced portfolio when looking at the future lease expiry profiles.

Q: Sainsbury's recently opened its most energy-efficient supermarket ever in Hook. What are the key features of the store, is it a blueprint for future openings and can features of it be replicated across the existing estate?

A: Sainsbury's Hook uses only half the energy of other similar-sized Sainsbury's stores and 25% less electricity than our other most energy-efficient supermarkets. It was designed and built to help us reach our target of becoming Net Zero in our own operations by 2035, as well as in response to significant constraints on the amount of electricity that was available for consumption at our Hook site.

Key features include:

- Using 100% renewable electricity and having no reliance on fossil fuels, like the rest of Sainsbury's estate, even the back-up generator runs on biodiesel.
- Keeping aisles at an optimum temperature using a cold aisle retrieval system, which takes any air that may leave the fridges and displaces it to other areas of the store to keep those aisles cooler. Warm air is then taken from the back of its fridges and re-purposed to heat other sections.
- Doors on chilled cabinets, keeping cold air in and reducing their energy demands by up to 60%. Further energy savings have been driven by adding lids on frozen food display cabinets, which work in the same way.
- Ambient air door curtains, which help to reduce the store's heating requirements and make customers' experience more comfortable by counteracting naturally occurring drafts.
- Over 700 solar panels on the roof, which are expected to provide up to 300-megawatt hours (MWh) of energy for the store per year.
- 100% LED lighting throughout the store, as well as shop floor sensors that allow lighting to adapt in response to the level of natural daylight so that energy is not wasted.
- An advanced storage battery that charges overnight, when the store requires less power and energy in the area is in less demand, enabling it to draw down electricity during the day when demand is higher.

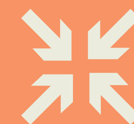
Many of these features have been and will be replicated across our estate, including in new stores we open – Sainsbury's Hook brings all these technologies together as an example of our best-in-class design for energy-efficient store operation.

Key players – KPIs, currencies and covenants

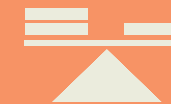
WORDS: STEPHEN SPRINGHAM – HEAD OF RETAIL RESEARCH

Aggressive competition – pillar of strength or Archilles heel? On the downside, the UK foodstore market is so brutally competitive it takes no prisoners and asset performance can vary considerably. On the upside, investors can have confidence that the operators have more than decent covenant strength.

Key takeaways

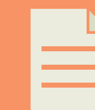


No dead wood – the UK grocery market is fiercely competitive and highly concentrated – the 'Big Four' have a combined market share of 64%.



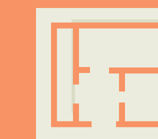
The capital structure of a large proportion of the market has recently changed through deals involving Morrison's and Asda – and there is much more exposure to debt.

This has prompted a downgrade to Morrison's credit rating and its foodstores now carry a ca. +150bps discount to other operators' (as do Asda's).



Question marks over covenant continue to override other inherent strengths of the business – neither Morrison's nor Asda has become a 'bad retailer' overnight.

The discounters (Aldi and Lidl) continue to grow market share at the fastest rate. However, their already wafer thin margins are under intense pressure in a cost-inflationary market.



Sales densities remain a key operating KPI and the 'rule of thumb' industry benchmark is ca. £1,000/sq ft. Understanding sales density is fundamental to any asset appraisal process.

The UK supermarket sector is unique. Few grocery markets worldwide are either as mature or as competitive. Market share is concentrated amongst relatively few operators. Rather than reflect a cosy cartel, this represents the diametric opposite – the ultimate survival of the fittest. Over the years, many of the weaker players have disappeared, either falling by the wayside or being subsumed into fitter players. There is no 'dead wood' in UK foodstore retailing, a key facet to the market that demands trading and operational excellence and ensures healthy, if at times brutal, competition.

The ownership structure of the market is likewise evolving, with PLCs (Tesco, Sainsbury's, Ocado) pitted against privately-owned operators (Aldi, Lidl, Iceland), partnerships (Waitrose), co-operatives (Co-op) and, latterly, private equity-owned players (Asda, Morrison's). Nothing stands still for long in UK grocery and this dynamism is generally a force for good.

Market share – long term trends

Market share data provide both a lens on the structure of the UK grocery market and a barometer of the relativities of trading performance. They may not provide the full picture as they purely reflect turnover rather than profit or any balance sheet KPI. Nor are they perhaps the currency they used to be, given how the market has evolved and the notion that 'biggest is best' does not always apply. But they are a good starting point nonetheless.

64%

of the foodstore sector market is accounted for by the traditional 'Big Four' (Tesco, Sainsbury's, Asda, Morrison's)

To give an indication of how concentrated the foodstore sector is, the traditional 'Big Four' (Tesco, Sainsbury's, Asda, Morrison's) account for 64% of the market. The 'Big Six' ('Big Four' plus Aldi and Lidl) collectively constitute a market share of 82%, while 97% of the market is concentrated in the hands of just 10 players.

These market share figures have evolved considerably over time. As recently as the 1970s, the market was far more fragmented and the market leader was actually the Co-op, its various constituent entities having a market share of ca. 8%. The Co-op was initially usurped from the market leading position by Sainsbury's in the mid 1970s, before Tesco succeeded it in 1995 on the back of its acquisition of the William Low business in Scotland.

Tesco is still far and away the market leader, its share of 27% almost that of the next two players (Sainsbury's and Asda) combined. On paper, the abortive merger between Sainsbury's and Asda in 2018 would have lifted them above Tesco. In practice, even if it had agreed to it, the CMA would have undoubtedly stipulated a multitude of store closures that would have reduced the combined business' market share considerably. In the event, the merger was blocked completely by the CMA, so it never came to pass anyway.

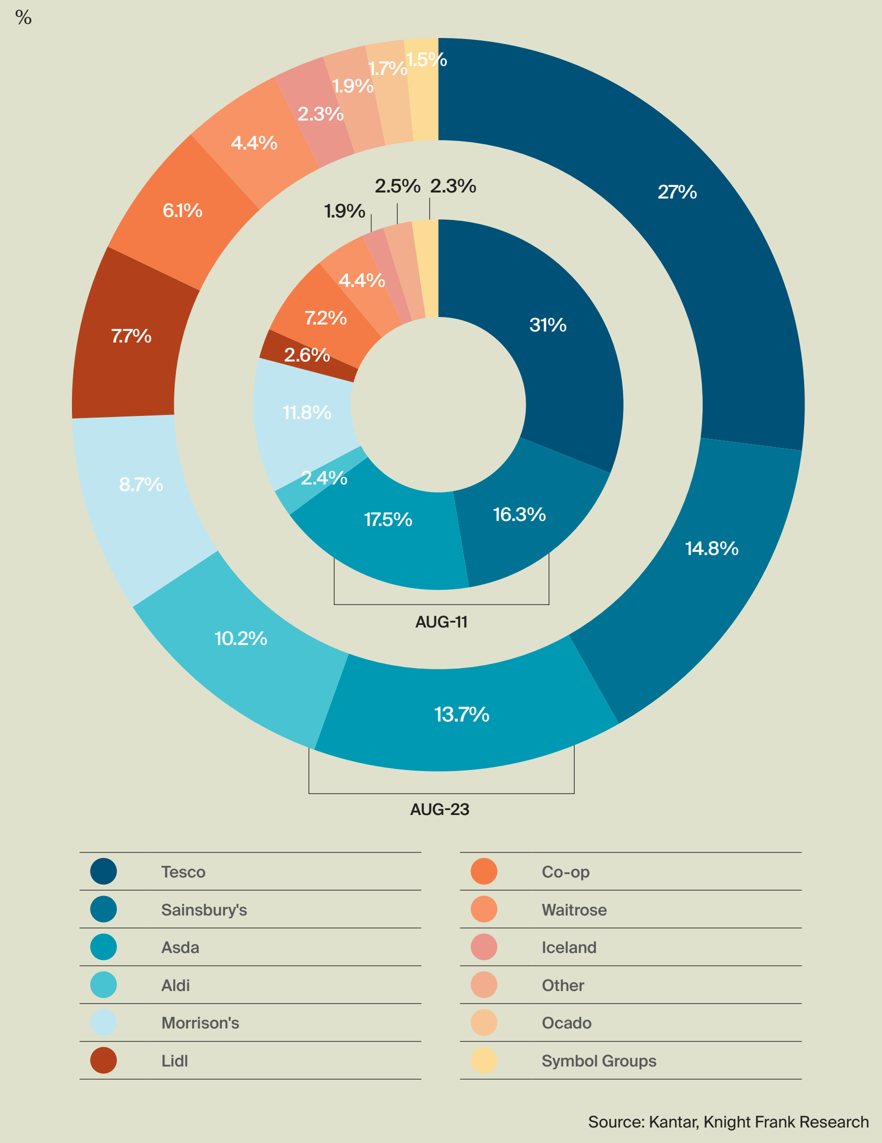
"The key structural change over the last decade has undoubtedly been the rise of the two German discounters, Aldi and Lidl."

The key structural change over the last decade has undoubtedly been the rise of the two German discounters, Aldi and Lidl. Aldi first entered the UK market in 1989, its compatriot Lidl in 1994. By 2011, their collective market share stood at just 5% (Lidl 2.6%, Aldi 2.4%). Following a decade of aggressive physical expansion and considerable like-for-like growth on the back of 'de-stigmatisation' of their respective brands, they now command ca. 18% of the market. This shift in share, coupled with the responses of the other non-discount operators, has dramatically re-shaped the UK grocery landscape.

Over the last year, Aldi has in fact surpassed Morrison's in terms of market share, effectively challenging the notion of the 'Big Four', in semantics if nothing else. Morrison's first ascended to the 'Big Four' through the troubled takeover of larger rival Safeway back in 2004. Having slowly integrated Safeway and re-established its position in the market, Morrison's was taken over by private equity firm CD&R in 2021 for a reported £7bn. This, coupled with Walmart's sale of Asda to the Issa Brothers, has marked another major turning point in the ownership structure of the UK grocery market – and one that will play out massively in the coming years and dictate considerable change in foodstore real estate markets.

Fig 13. Total grocery market shares 2023 vs 2011

%



Source: Kantar, Knight Frank Research

Recent market share trends

Tesco's market share is unassailable. But this masks considerable jostling lower down the order. Does market share still matter? It certainly does to Asda, the Issa Brothers frequently repeating their strategic aim of surpassing Sainsbury's to become the second largest player in the market. The realisation of this objective has real estate implications – to secure precious market share, Asda will make few (if any) store disposals, but will have to acquire sites as, realistically, it will not close the gap through organic like-for-like growth alone. Expect a few 'big box' openings from Asda in the coming years, but a much more concerted push into the c-store arena.

Recent market share movements are a high-level barometer of current trading performance. On this basis, Aldi and Lidl continue to make the most gains, although this is being driven largely by new space rather than like-for-like sales growth at existing sites (of which we have no transparency). Of the other operators, Tesco and Sainsbury's are stable, indicating that they are performing in line, even slightly above the wider market.

Asda and Morrison's have both lost share over the past year. Rather than terminal decline, this probably reflects post-acquisition 'bedding in' periods for both players. Given their transfer from the public domain (Morrison's was previously a PLC while Asda was owned by Wall Street-listed Walmart), there is far less transparency and lower update frequency on both company's trading performance, so market share data going forward will rise in importance.

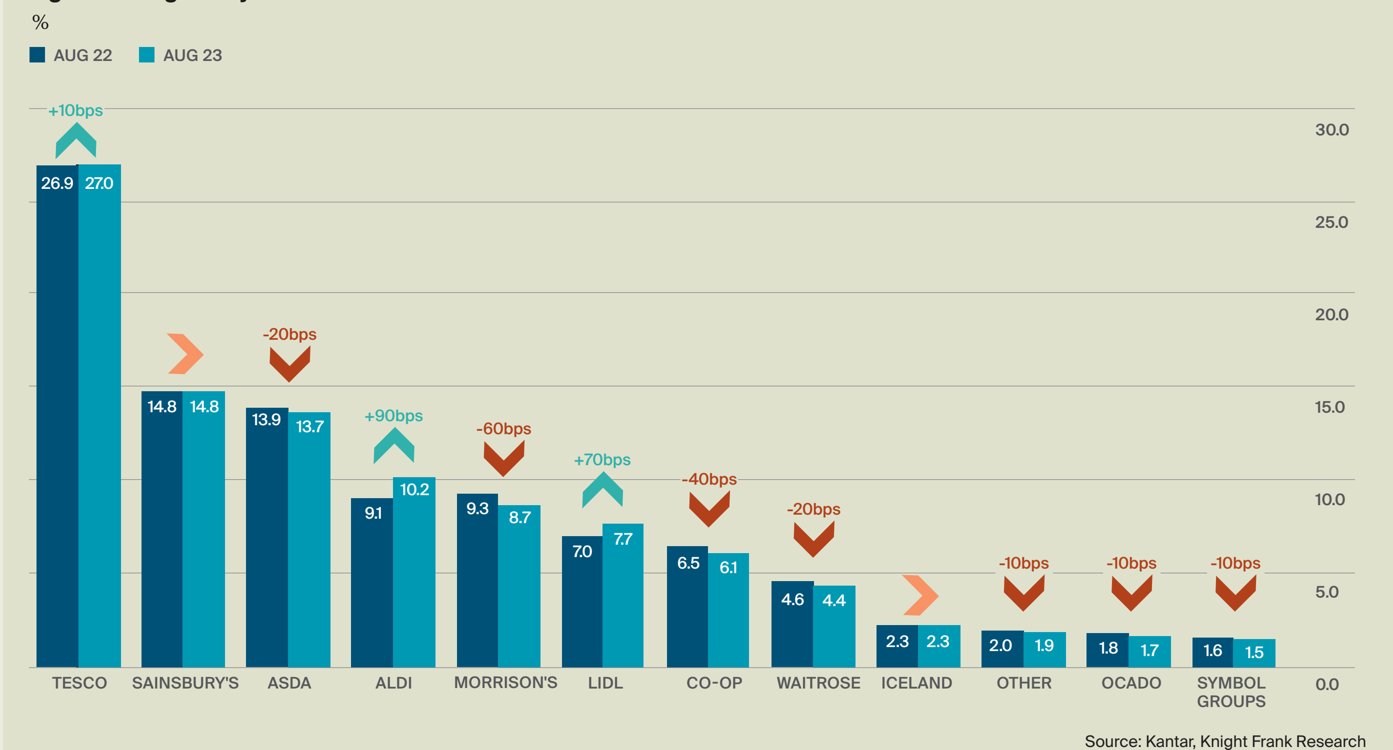
Other 'under-performing' operators based on market share movements over the past year are Waitrose, the Co-op and Ocado. A likely common denominator here is customers trading down in response to the cost-of-living crisis. Waitrose is at the upper end of the pricing spectrum and the John Lewis Partnership generally is struggling to adapt to current market conditions, making a number of highly questionable strategic decisions. Over time, the Co-op has transformed itself into principally a c-store operation, as opposed to a full-line supermarket or 'big box' operator. This market positioning saw it in good stead during COVID, but it may now be perceived to be expensive versus other retailers and other channels. Meanwhile, Ocado is sinking back slightly on the tide of a market rebalancing away from online grocery generally.

Does market share data still carry real currency in the market? Economies of scale have always been important in grocery, but experience has taught us that 'biggest isn't necessarily best'. Does Tesco have twice the buying power of Sainsbury's or Asda, or are they all on similar terms with suppliers these days?

"Aldi and Lidl continue to make the most gains, although this is being driven largely by new space rather than like-for-like sales growth at existing sites."

Fig 14. Total grocery market shares 2023 vs 2022

%



Source: Kantar, Knight Frank Research

Table 2: Grocery Operators' Key Performance Indicators (KPIs)

Metric	Tesco	Sainsbury's	Asda	Morrisons	Aldi	Co-op	Lidl	Waitrose	M&S	Iceland
Trading Performance										
Turnover 2020/21 (£m)	46,161	25,696	23,489	17,424	13,646	9,057	7,829	6,985	6,640	3,555
YoY Turnover Growth (%)	5.5%	6.6%	3.2%	-1.0%	0.8%	-3.1%	1.5%	-0.9%	10.8%	-4.3%
Operating Profit 2020/21 (£m)	2,191	1,001	693	254	60	103	79	278	N/A	37
Operating Margin (%)	4.4%	3.5%	3.0%	1.4%	0.4%	1.1%	1.0%	3.9%	N/A	1.0%
Store Metrics										
Total UK Store Count	9,557	1,738	633	497	1,102	4,269	918	332	1,035	991
Total Floorspace ('000 sq ft)	37,943	22,949	21,679	15,048	11,593	8,245	11,700	5,920	6,695	4,941
Sales / Store (£'000)	13,337	18,237	37,165	35,058	12,682	2,141	8,742	21,100	6,509	3,584
Sale Density (£/sq ft)	1,218	1,118	1,084	1,158	1,206	925	689	1,182	1,006	719

Sources: Companies, Mintel, Knight Frank Research

Probably more the latter than the former. But there is always the small matter of bragging rights – and old habits dying hard.

Trading and store KPIs

Market share in isolation is something of one-dimensional measure. A more rounded set of grocery KPIs (spanning trading performance and store metrics) is provided in Table 2.

By way of clarification, the figures refer purely to UK operations and exclude any non-UK businesses. For the likes of Marks & Spencer, Sainsbury's and Waitrose, they relate to the food operations only i.e. they exclude M&S general merchandise, Argos and John Lewis respectively. However, for the other operators (e.g. Tesco, Asda etc), they will include a significant non-food element. In terms of caveats, the figures relate to the latest full-year figures for that retailer, so they will not correspond to the same trading period. Given some operators are privately-owned, some accounts will be filed later than others and some may be lagging (and may still reflect the latter effects of COVID).

If nothing else, the KPIs reinforce Tesco's dominance of the market. Tesco is one of the few UK grocery operators to still have a presence outside the UK (group sales (exc fuel) in 2022/23 exceeded £57 billion vs ca. £50 billion in the UK) but a large proportion of the international division (South Korea, Japan, Turkey, Thailand, Malaysia) was divested as part of the wider corporate recovery programme instigated post 2015.

Aldi and Lidl are obviously huge multi-national operators, but the UK is very significant for both, representing their third largest source of revenue globally. The domestic German market is still by far the largest for both, the US being the second largest market for Aldi, while for Lidl this is France. For many years, financial information was notoriously difficult to acquire for both businesses, but now there is at least some degree of transparency and this lays bare just how their respective business models function relative to 'mainstream' operators. Both have wafer thin operating margins in the UK of <2%.

Low margins are obviously part of Aldi and Lidl's modus operandi and their heightened presence and influence in the UK continues to place significant downward pressure on industry margins. The current cost-of-living crisis should also, in theory, play heavily into the discounters hands as consumers increasingly trade down. However, at the same time, neither Aldi nor Lidl is immune to the wider economic background of rising costs. This will be exerting considerable pressure on both Aldi and Lidl, neither having significant margin to play with in formulating a response to prevailing market conditions.

All these moving parts are exposed in Aldi's and Lidl's latest annual accounts (Aldi's to 31 December 2022, Lidl's to 28 Feb 2023). Unsurprisingly, both reported record sales (Aldi £15.5bn / +13.4%, Lidl £9.3bn +18.8%).

> "Neither Aldi nor Lidl is immune to the wider economic background of rising costs. This will be exerting considerable pressure on both Aldi and Lidl, neither having significant margin to play with in formulating a response to prevailing market conditions."

> "Tesco is even more dominant in convenience than it is in 'big box' or online grocery."

Aldi's operating profit of £179m translates to an operating margin of just 1.2%. Lidl registered a very slight EBIT of £28.5m (with an EBIT margin of just 0.3%), but was actually loss-making at the pre-tax level (£76m). Stellar top-line growth, but no profit to show for it.

The store metrics KPIs are heavily influenced by the channels the respective operators play in, particularly if they have a significant c-store portfolio. Morrison's and Asda are predominantly 'big box' operators, so therefore they historically have had fewer, but larger stores and have achieved much higher sales per store. However, both are making a much more concerted play for the c-store market, the former taking over the failed 1,100+ McColl's chain, the latter by tying up and integrating with the Issa Brothers' substantial EG petrol forecourt business. Expect both Morrison's and Asda's store metrics to evolve considerably in the coming years on the back of this.

Tesco and Sainsbury's are more diversified in their respective store portfolios. Tesco is even more dominant in convenience than it is in 'big box' or online grocery. It already operated ca. 1,900 Tesco Express and a further ca. 700 One Stop c-stores, prior to its acquisition of Booker in 2017. As well as its core cash & carry and foodservice businesses, Booker brought with it ca. 6,000 more c-stores (trading as Londis, Premier and Budgens). Tesco's 8,500+ c-store portfolio dwarfs that of the next biggest players the Co-op (ca. 2,600 stores + ca. 1,700 Nisa stores) and Sainsbury's Local (ca. 820 stores).

Sales densities remain arguably the most meaningful KPI of all. While their currency may have diminished somewhat in non-food / high street retailing with the rise of online and multi-channel muddying the waters, in grocery retailing they remain far purer. £1,000/sq ft per annum remains a notional but still meaningful industry benchmark. Each of the 'Big Four' operators achieves this at a group level, although the level of productivity will vary massively (very broadly ca. £600/sq ft - £3,000/sq ft) across their respective estates. Understanding the sales density of an individual foodstore remains absolutely paramount in any real estate appraisal process.

According to Mintel's calculations, the 'Big Four's' group level sales densities are all broadly comparable at between £1,085/sq ft (Asda) and £1,218/sq ft (Tesco). Aldi now achieves a staggering £1,200/sq ft, meaning that its sales densities have nearly doubled in little over a decade. Testament to the fact that the business has not just increased its physical footprint over the years, it has also worked its existing floorspace much harder.

Debt

The two recent changes of ownership amongst the 'Big Four' have substantially changed the capital structure and financial make-up of the foodstore market. This is already having a material impact on the investment market. In essence, the market has taken on debt at the worst possible time.

The acquisition of Morrison's by private equity house CD&R was finally rubber stamped by the CMA in June 2022. The deal valued Morrison's at ca. £10bn, but was dubbed the UK's biggest leveraged buy-out in recent history and has saddled the grocer with substantial debt. Since the acquisition, macro-economic conditions have worsened considerably. Ratings agency Moody's estimates Morrison's debt pile has doubled in just one year, from £3.2bn to £6.8bn, warning that every one-percentage-point increase in interest rates could cost an extra £30m in annual fees.

Where does this leave 1) The real estate portfolio and 2) The business' covenant? CD&R publicly acknowledged the attraction of

> "Aldi now achieves a staggering £1,200/sq ft, meaning that its sales densities have nearly doubled in little over a decade. Testament to the fact that the business has not just increased its physical footprint over the years, it has also worked its existing floorspace much harder."

Table 3: Grocery Operators' D&B Ratings (@ September 2023)

Company Name	D&B rating
Tesco Stores Ltd	5A 2
Sainsbury's Supermarkets Ltd	5A 1
Wm Morrison Supermarkets Ltd	5A 3
Asda Stores Ltd	5A 2
Marks and Spencer Plc	5A 2
Aldi Stores Ltd	5A 2
Lidl Great Britain Ltd	5A 2
Waitrose Ltd	5A 2
Co-operative Group Food Ltd	5A 2

Source: D&B, Knight Frank Research

> "Concerns over debt and capital structures has tended to override any appreciation of either Asda or Morrison's as an actual operating business, their ongoing strong fundamentals as foodstore operators submerged below a sea of financial manoeuvrings."

Morrison's high proportion of freehold ownership (ca. 86%) when it bought the business and the deal was widely seen as a pre-cursor to an extensive sale & leaseback programme. To date, this has largely been restricted to the non-store property. In June 2022 it launched a substantial £750m portfolio of nine logistics assets and 15 food manufacturing sites. This was followed by launch of a £150m portfolio of five stores in October.

Something of a parallel situation at Asda. Having already built a reputation as masters of debt-fuelled deals at EG, the Issas put just £100m of cash into the initial Asda deal, matched by £100m more from TDR Capital. The rest of the buyout was funded with the largest sterling corporate bond sale on record, according to Bloomberg, as well as a loan from the parent company of EG Group. Moody's puts Asda's debt pile at ca. £7.4bn, with sister company EG's thought to be significantly higher. According to CreditSights, Asda's annual interest bill, including lease liabilities, increased to £300m last year from £90m in 2021, and is likely to surpass £400m this year.

A £1.7bn sale & leaseback of Asda's warehouse network in 2021 was followed by a £650m deal to sell & lease back about 25 supermarkets to Realty Income Corporation in late July. The first of a number of similar deals going forward.

Covenant implications

But amidst all the financial restructuring, perception towards both businesses' covenant strength has changed. Concerns over debt and capital structures have tended to override any appreciation of either Asda or Morrison's as an actual operating business, their ongoing strong fundamentals as foodstore operators submerged below a sea of financial manoeuvrings.

Early in 2023, Moody's downgraded Morrison's credit rating from B1 to B2, citing an "aggressive financial strategy, high leverage and private equity ownership" as factors in the downgrade. They also flagged concerns about "operating underperformance", saying Morrison's was suffering from lower sales combined with higher costs for energy, wages and transport. This was before Morrison's released a slightly more upbeat Q3 trading update (a fifth consecutive quarter of like-for-like sales improvement of +2.9%) but concerns about the long-term health of the balance sheet still prevail.

The D&B ratings (as of September 2023) of all the major grocery operators are listed in Table 3. Note that they relate to the name that typically appears on the leases of their stores, as opposed to the parent company guarantee (e.g. Sainsbury's Supermarkets Ltd as opposed to J Sainsbury Plc).

All the major players achieve the highest Financial Strength Rating of 5A (reflecting a Tangible Net Worth of £35m+), hardly surprising given their scale. But there is some variance on their respective Risk Indicators. Sainsbury's is the only operator to achieve a top Risk Indicator score of 1 ('Minimal Risk – proceed with transaction – offer extended terms if required').

Consistent with Moody's, Morrison's has the highest Risk Indicator score of 3 ('Slightly Greater than Average Risk – proceed with transaction but monitor closely'). Aside from Sainsbury's and Morrison's all other major grocery operators achieve a Risk Indicator score of 2 ('Low Risk – proceed with transaction'), including Asda despite it also being in a highly-leveraged position.

Are credit ratings gospel? They shouldn't be, but to many they are – and 'the many' tend to include massively influential bodies such as banks and lenders. The detailed mechanics and reasoning behind credit ratings is always somewhat opaque and experience has shown that they are not necessarily right – many a failed retailer had a decent, seemingly low risk credit rating prior to going into administration or going bust. But for all their accuracy or otherwise, credit ratings are still a major currency in financial and real estate markets.

How has Morrison's credit rating downgrade affected real estate? It has created something of a two tier investment market, with most investors generally more sceptical of Morrison's covenant and some unwilling to touch it all. Although not subject to the same downgrade, Asda has effectively been tarred with the same brush. In reality, this means that a Morrison's or Asda store may be priced at a +150bps discount to other operators. On top of this, foodstore investors generally want additional comfort before committing to a Morrison's or Asda store, namely that there will be alternative occupiers if the incumbent were to default (or worse).

Unfortunately, credit ratings and covenant strength tend to preoccupy investors' minds. To take a step or two backwards: has Morrison's become a bad business overnight? Absolutely not. But its balance sheet and P&L are less strong than they were. Is Morrison's likely to go bust? Highly, highly unlikely given the strength of the business, the value of its real estate and the inherent cash generating qualities of any food retailer. But its debt position is onerous and must be resolved at some point.

Sentiment may not always be right, but sadly it often trumps common sense.

> "Are credit ratings gospel? They shouldn't be, but to many they are – and 'the many' tend to include massively influential bodies such as banks and lenders."

Key client interview – Supermarket Income REIT

WORDS: ROB ABRAHAM – MANAGING DIRECTOR, FUND MANAGEMENT

Q: Supermarket Income REIT ("SUPR") is one of the key investors in the UK grocery real estate space and spotted the opportunity long before many other investors. Can you give us some stats on your current portfolio?

A: Sure.

- 55 strong performing omnichannel supermarkets
- £1.7 billion gross asset value, as at June 2023
- 5.6% portfolio Net Initial Yield ("NIY")
- 13 year WAULT
- Dividend yield 8%
- FTSE 250 Listed
- ca. 80% of portfolio let to strong tenant covenants Tesco and Sainsbury's
- 3.8% highly affordable average rent to turnover across the portfolio

Q: For you, what are the main attractions of grocery real estate in the UK?

A: A key aspect is the mission critical nature of the real estate to the tenants, acting as revenue centres, with the stronger stores generating upwards of £60 million in annual turnover. The logistical challenges of online grocery also mean that existing store networks of the UK's leading grocers are ideal for last mile fulfilment of online orders.

This, combined with a lack of supply of alternative locations due to planning obstacles and significantly increased costs for new build space, drives occupancy. Many of the stores in SUPR's portfolio have been grocery locations for over 30 years. The critical nature of strong performing stores is evidenced by SUPR achieving 100% rent collection and 100% occupancy since IPO.

Occupancy and income is also driven by the fact that grocery is a growth sector, which is backed by non-discretionary spend, providing a resilient income stream. The sector has seen sales growth of over 30% since SUPR's IPO in 2017, to £242 billion today, which is driving store revenue growth ahead of rental growth.

Q: What are your key investment criteria for UK supermarkets?

A: We target strong performing omnichannel supermarkets, which are stores that fulfil both in-person shopping and online (via home delivery and Click & Collect). By targeting these stores, the portfolio is future proofed, with the ability to flex resources to capture channel shift in the face of changing shopping behaviour of the consumer. In addition to this, we target top trading stores, which provide confidence in the tenants'

ongoing occupation, along with inflation linked leases delivering contractual rental growth.

Q: To what extent is store size a consideration and do you have any favoured parameters?

A: We typically target large format stores, with an average site size of ca. 8 acres. These sites are ideal for online fulfilment as they have space for home delivery vans, Click & Collect and a store which is capable of stocking a full product range. These larger plots also have capacity for expansion of facilities to service increased consumer demand.

"The critical nature of strong performing stores is evidenced by SUPR achieving 100% rent collection and 100% occupancy since IPO."

Returning to the mission critical nature of these sites for the operators, alternative sites of sufficient size in residential catchments are also very difficult to source and obtain planning for. This makes it much harder for a tenant to relocate compared to smaller format stores where other buildings can be repurposed.

Q: Does geography come into the equation, or is it totally asset- and competition-dependent?

A: We are pretty agnostic on geography, targeting top trading supermarkets across the UK – this is similar to how the operators will view a store. £1 million a week of revenue is still £1 million of revenue, wherever it is located!

We underwrite assets at the store level due to the highly localised nature of the grocery market, in which around 85% of shoppers will not travel more than 15 minutes to a supermarket. As I've already mentioned, many of the grocery assets that we invest in have been grocery sites for 30-40 years which provides long trading histories to analyse, as well as confidence in the ongoing strength of the stores in these locations.

Q: Online is often (but erroneously) seen as a threat to physical floorspace, but in supermarkets particularly, the relationship is actually symbiotic. How does the omnichannel piece play into your investment strategy?

A: Stores which provide online shopping typically carry a broader product range, while the increased trading volumes and stock turnover also means that in-store shoppers have access to fresher produce.

Proximity to customers is key and using the grocer's existing store network as distributed fulfilment hubs means greatly reduced drive times to customers (the key cost in online fulfilment) compared to a central fulfilment centre model. SUPR has stores in its portfolio which achieve six drops per hour. The average CFC by comparison achieves just two drops in the same timeframe.

The 'dark store' or centralised fulfilment centres were seen by some as the future for online grocery. These centres require very high density of demand and are typically situated where operators lack sufficient floorspace within existing store networks, i.e. London. In fact, we saw Sainsbury's close its only facility of this type in 2021, whilst Asda closed two, to instead use omnichannel stores.

From a landlord/investor perspective, the benefit is the increased strategic importance to the operator. Increased store revenues improve the affordability of rents. For a large omnichannel hub, there might not be any other existing locations from which there is sufficient capacity for the operator to fulfil the required online volumes.

"We target top trading stores, which provide confidence in the tenants' ongoing occupation, along with inflation linked leases delivering contractual rental growth."

Q: What are your views on occupier covenant? Does it have any bearing on either your interest or pricing if the tenant is a PLC (e.g. Tesco, Sainsbury's) versus private equity owned (e.g. Asda, Morrison's)?

A: Occupier covenant is of course important and it is worth noting that SUPR's largest tenants are Tesco and Sainsbury's, representing around 80% of the portfolio. Investors are understandably seeking compensation for higher risk covenants through higher yields.

However it is worth noting that the UK's leading and largest grocers have multibillion pound revenues with well-established store networks and supply chains that have been developed over many years. The non-discretionary nature of grocery expenditure produces a secure income stream.

Due to the mission critical nature of the real estate and by targeting the strongest performing stores, rents are also a priority payment for tenants to ensure that they do not lose access to a key revenue centre. Grocery is ultimately a localised market and the shortage of supply of alternative locations provides alternative occupier demand for strong trading locations.

"We are pretty agnostic on geography, targeting top trading supermarkets across the UK – this is similar to how the operators will view a store. £1 million a week of revenue is still £1 million of revenue, wherever it is located!"

"We target the UK's strongest performing grocery stores and the discounters clearly have a successful strategy, so SUPR does have some exposure as you would expect."

Q: Partly on the back of changes in ownership structure, we are likely to see more grocery real estate portfolios coming to the market in the near future. What are your views on potential portfolio deals?

A: Our very focused investment strategy of targeting top trading omnichannel stores means that we generally prefer to handpick individual stores, such that the majority of our portfolio has been acquired on a single asset basis. This approach ensures that you target and acquire only the highest quality stores. Portfolio deals can risk the inclusion of some weaker stores which would have a dilutive effect on the quality of the portfolio. As you'd expect, we do run the slide rule over portfolio transactions when they come to market, but our preference is for individual asset transactions.

"SUPR has stores in its portfolio which achieve six drops per hour. The average CFC by comparison achieves just two drops in the same timeframe."

Q: You recently sold your stake in the Sainsbury's Reversion Portfolio JV, to your JV partner Sainsbury's. Could you tell us more about that transaction?

A: Between May 2020 and January 2023, we built a ca. 51% stake in the Sainsbury's Reversion Portfolio (SRP), a securitisation which consisted of the freehold interest in 26 geographically diverse high-quality Sainsbury's supermarkets. Sainsbury's exercised options to acquire 21 stores in the SRP and agreed 15-year leases on four of the non-optioned stores. The Company generated £430.9 million of gross proceeds from the sale of the SRP. We think that this transaction highlights the Company's ability to identify strong trading supermarket assets and the ability to create value from underwriting a grocer's ongoing occupation in locations.

Q: What are your views on the discounters? Would you invest in this space, despite growing concerns around saturation and even cannibalisation in some areas?

A: We target the UK's strongest performing grocery stores and the discounters clearly have a successful strategy, so SUPR does have some exposure as you would expect. However, it is ultimately always going to be a relatively small portion of our portfolio as our focus is on larger format omnichannel stores.

Our stores also typically have 30-40+ years of trading history which you don't get with much of the discounters in the leasehold market. The smaller format discounter stores are generally a bit more homogenous and don't have the same mission critical features which I have been talking to. In the small format stores it is much easier to relocate to another site just around the corner, than it is for an operator occupying a 10 acre omnichannel hub.

"Grocery is ultimately a localised market and the shortage of supply of alternative locations provides alternative occupier demand for strong trading locations."

Q: Grocery property yields eased at the end of 2022, as did all UK real estate. However, such yields have stabilised quicker than other asset classes. How do you see pricing playing out going forward?

A: Following the asset repricing, supermarkets are producing attractive returns for investors and that has driven a very liquid investment market, which is informing valuations. Since January we have seen a relative stabilisation in yields, with transactions pricing at levels which are in-line with equivalent assets in the SUPR portfolio.

We are however conscious of the potential impact on the investment market of interest rates remaining elevated for longer, so we will have to see how that plays out. Whilst we are cautious in our outlook, I would again note the defensive characteristics and attractive returns that supermarkets provide at current valuation yields.

Foodstores: The investment case

WORDS: EMMA BARNSTABLE – ASSOCIATE, COMMERCIAL RESEARCH

Foodstores have witnessed a resurgence in popularity, emerging as a compelling investment opportunity within the wider retail sector and compared to other property classes too.

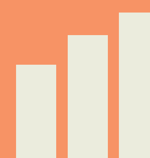
Key takeaways

As a resilient, defensive asset class promising long and secure income, there has been a resurgence in investor demand for foodstores

Recent underperformance belies a strong historic track record (annualised total return of 10.0% since 1981 vs. 8.3% for All Property)

Forecast annual total returns of 7.3% and income returns of 5.1% between 2024 and 2027 compare favourably with other use classes

2023 investment volumes likely to be largely in line with 5-year (£1.7bn) and 10-year (£1.8bn) averages, a significant improvement on 2022 (£971m)



Foodstore yields corrected swiftly over the last year and have already stabilised. At 5.00% (for prime assets subject to RPI), yields are competitive compared to other retail property use classes.

Foodstores – back in vogue?

Foodstores have emerged as a highly coveted sector in the commercial real estate world, perhaps ironically thanks to their impressive show of resilience during the COVID-19 pandemic. Achieving robust total returns of 6.6% and 15.4% in 2020 and 2021 respectively, Foodstores comfortably outpaced the performance of the wider Retail (-14.0% / 8.4%) and Office (-1.1% / 5.7%) markets. Stellar income returns of 5.3% and 5.0% also saw it even pull ahead of Industrial (4.2% / 3.8%).

Investors have been increasingly drawn to the sector's defensive characteristics. As economic uncertainties persist, the demand for secure, long-term income has taken precedence in many investment strategies. But the perception of the Foodstore sector hasn't always been as favourable. Experiencing a volatile relationship with investors, it has fallen in and out of favour over the past decade. For instance, sentiment soured after the 'space race' among the 'Big Four' grocers (Tesco, Sainsbury's, Morrisons, Asda) ended abruptly in the 2010s, the investment market stagnating as a result.

Since then, investors have again warmed to Foodstores – recognising their promise of stability, in the face of economic instability. There are several contributory factors. Despite double-digit food inflation, grocery shopping remains an essential, non-negotiable expense, even during economic hardship. Consumer retail sales values remain buoyant as a result, with operators eager to capture spend within their stores. Given physical

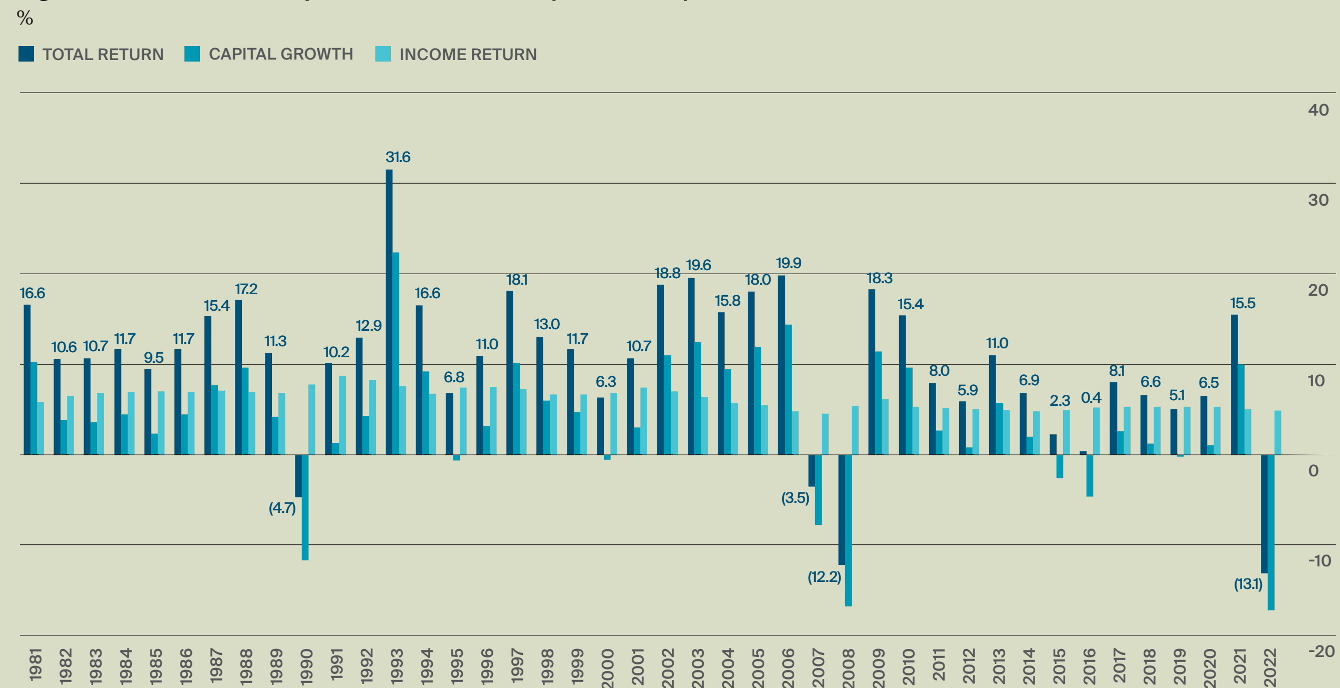


Fig 15. Foodstore historic performance metrics (1981 – 2022)

bricks and mortar locations represent their primary source of revenue, the grocers are keen to prioritise rental payments, with real estate critical to their operations. And with a lack of new stock being developed, due to a combination of relative saturation, elevated build costs and planning constraints, occupancy rates are high, with many foodstores operating robustly in the same location for several decades.

A broad spectrum of investors are now running the rule over the sector. Pension funds, sovereign wealth and private equity players are all being enticed by the security of long-income. Large, out-of-town supermarkets are no longer the sole interest (although the rise of online has added a new dimension, given the format's omni-channel fulfilment capabilities). There is growing enthusiasm for discount-orientated and urban convenience-based assets, which represent two of the fastest growing segments in the market (see 'Changing Channels').

> "Investors have been increasingly drawn to the sector's defensive characteristics. As economic uncertainties persist, the demand for secure, long-term income has taken precedence in many investment strategies."

Successful investment should be driven by the unique attributes of the asset, however – not broad-brush trends or geographic constraints. As a starting point, investors should consider prioritising:

a) Excellent store trading performance
b) Strong occupier covenant
c) Limited foodstore competition within the catchment
d) Versatile omni-channel capabilities to withstand channel shifts to online
e) Leases with rental growth link to inflation
f) Affordability

The remarkable resilience of Foodstores – historic performance

Judge on longer term trend, rather than the very recent past? Analysing historic performance metrics provides not only comfort, but strong evidence of Foodstores' viability as a long-term investment (Fig. 15). The asset class has consistently delivered positive returns over the long haul, with an average annual total return of 10.0% from 1981 to 2022. Out of the 42 years in this period, only four experienced negative returns, coinciding with the recessions and economic downturns of 1990, 2007/8 and 2022.

Notably, these were primarily driven by sharp declines in capital values (e.g. 1990: -11.6% / 2008: -16.7%), while income returns remained robust in positive territory (e.g. 1990: 7.8% / 2008: 5.4%), underlining the resilience of Foodstores due to their essential role in consumer purchases. Even in times of downturn and economic hardship, Foodstores have always produced decent income.

Historic data also show a swift and substantial rebound in total returns during the year following a recession trigger (e.g. 1990: -4.7% to 1991: 10.2% and 2008: -12.2% to 2009: 18.3%), demonstrating the asset class has a remarkable ability to recover. Any underperformance is usually temporary and tends to be quickly corrected.

Recent Performance, Recovery & Outlook – On the right track

Very recent metrics do not necessarily bear out longer term trends. In terms of most recent performance (Table 4), Foodstores have experienced a considerable downturn, witnessing a historic low in terms of total returns in 2022 (-13.1%). Although the sector has not fully recovered to positive territory as of Q3 2023 (-1.3%), there has been a notable and rapid improvement in total returns, outpacing the recovery rate of All Property. History on course to repeat itself?

Historic trends (Fig. 15) indicate that total returns tend to rebound shortly after the onset of a recession, with the sector on track to achieve this again this time around. Realfor's forecasts are projecting a return to positive total returns of 5.5% by 2024. Over the medium-term horizon (5 years), returns are set to strengthen further, to 7.3% per annum (see Fig. 16), surpassing All Retail (7.0%), Offices (6.5%), and All Property (7.0%). Of the major CRE classes, only Industrial (7.5%) is set to perform marginally better.

Forecasts also point to a positive income return of 5.1% per annum during the 2024-27 period (Fig. 17), outpacing Industrial (4.5%) and All Property (5.0%), but falling slightly behind All Retail (5.4%) and Offices (5.3%).

Pre 2015, the investment case for Foodstores centred much more on rental growth – but now, investors are placing much more emphasis on income, alongside factors such as lot size, lease structure, tenant contentment, and trading performance. And rightly so.

Investment Volumes Reviving

The flow of capital into the Foodstore sector has fluctuated over the last decade (Fig. 18). From 2013 to 2017,

Table 4: Headline Key Performance Indicators (KPIs) (Foodstores vs. Retail vs. All Property)

	Supermarkets	All Retail	All Property
Total Return (%)			
2023 YTD*	-1.3	2.9	1.0
2022	-13.1	-3.4	-7.6
5 Year Annualised	3.7	-4.0	2.0
10 Year Annualised	4.7	1.9	6.4
Since Inception (1981) Annualised	10.0	7.7	8.3
Capital Growth (%)			
2023 YTD*	-5.3	-2.2	-3.1
2022	-17.2	-8.2	-11.1
5 Year Annualised	-1.4	-8.8	2.3
Since Inception (1981) Annualised	3.5	1.9	2.2
Rental Value Growth (%)			
2023 YTD*	-0.3	0.5	2.7
2022	-0.2	0.1	3.8
5 Year Annualised	-1.0	-4.5	0.4
10 Year Annualised	-0.8	-1.8	1.5
Since Inception (1981) Annualised	2.7	2.9	2.8

* 9 months to September (cumulative). Source: MSCI

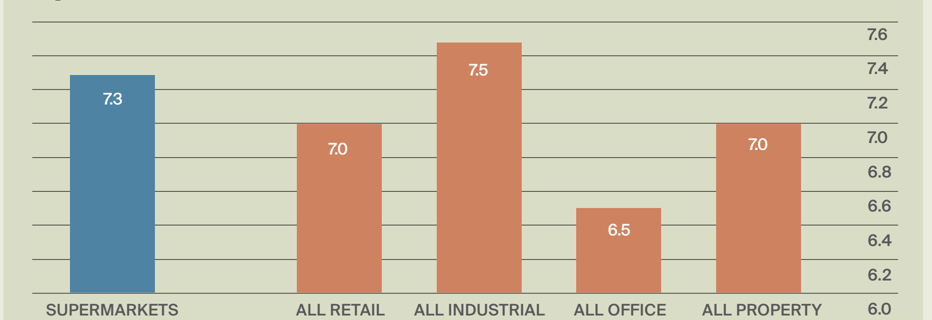


Fig 16. Forecast annual total return 2024 – 2027f

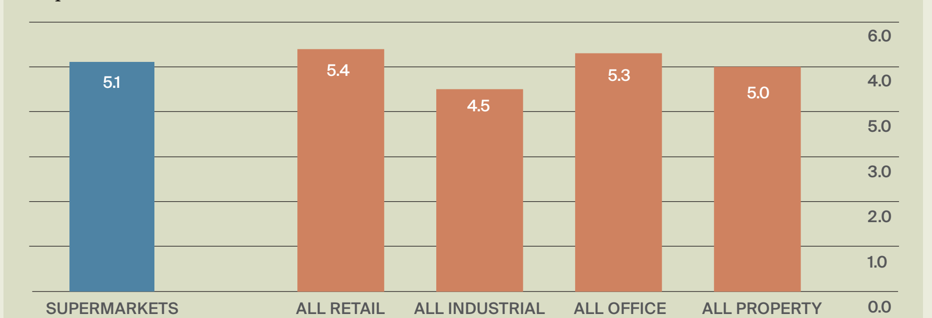


Fig 17. Forecast annual income return 2024 – 2027f

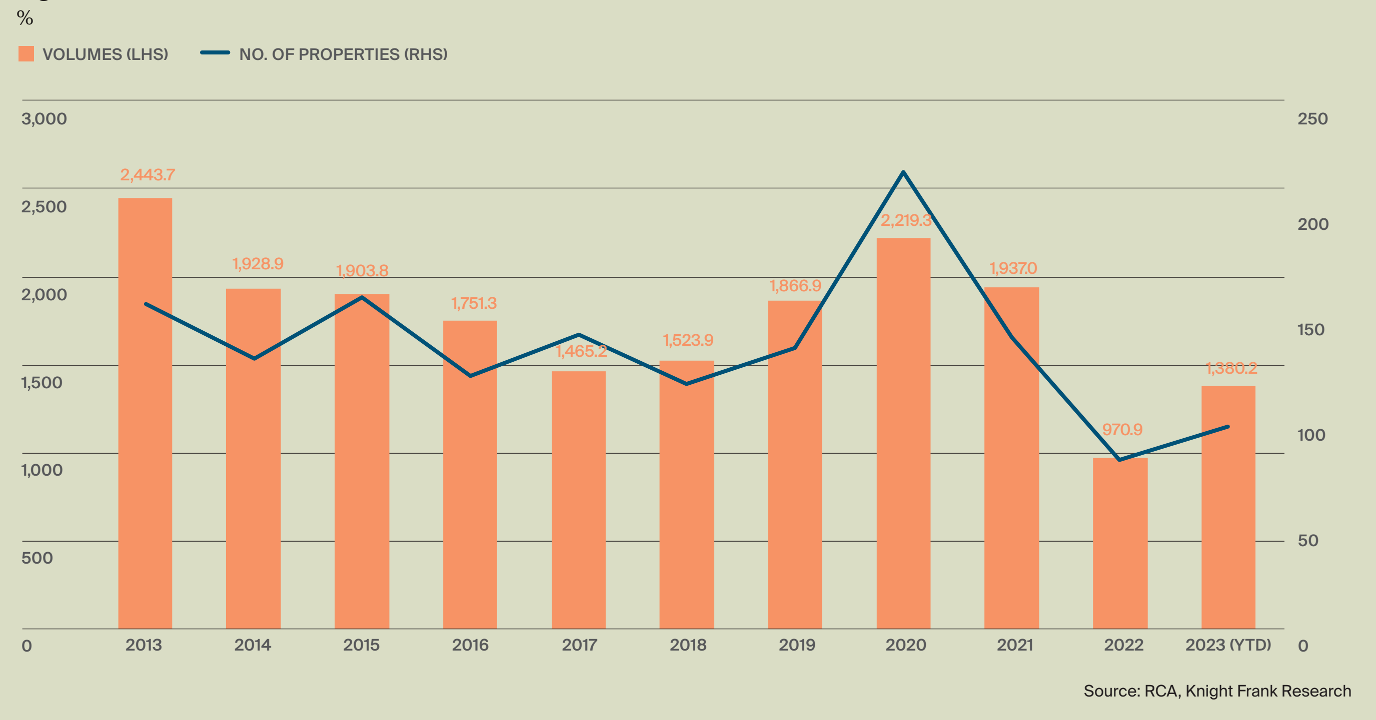


Fig 18. Foodstore Investment Volumes and Deals 2013 – 2023 YTD

transaction volumes gradually declined each year, reaching a low of £1.46 billion in 2017 as sentiment was at its lowest ebb. However, in 2018, this trend was reversed as inflows consistently increased, peaking at £2.22bn in the COVID year of 2020. But 2022 witnessed a sharp drop in volumes, hitting a recent historic low of £970 million, significantly below the 10-year (£1.80 billion) and 5-year (£1.70 billion) averages. The blip in 2022 was more a reflection of a lack of stock coming to the market than an absence of investor demand. Year-to-date (to Q3) figures for 2023 indicate a partial recovery at £1.38 billion. A busy Q4 would bring this year into line with longer term averages.

> "Given Morrison's owns 85% of its portfolio (and CD&R's debt position), it seems safe to assume that there may be more sale and leaseback opportunities in the pipeline."

Yields & pricing stabilising

According to Knight Frank's October 2023 yield guide, Foodstores subject to open market reviews (occurring every five years) now offer yields ranging from 5.75% to 6.00%. This marks a recent softening of +100bps to +125bps since October 2022, reflective of negative sentiment across capital markets generally, largely in response to the autumn mini Budget of 2022. Conversely, those subject to annual RPI (Retail Price Index) increases have witnessed a more stable performance, with a milder softening of +75bps to +100bps over the same period, currently standing at an attractive 5.00%. Discounters retain the keenest yield of the three foodstore sub-types at 4.75% (Fig. 19).

Foodstore yields have consistently been competitive to the other major retail sub-sectors since the 2010s. This trend has strengthened further since 2018/2019, when yields between sub-sectors started to diverge considerably. Notably, during the challenging pandemic years of 2020 and 2021, Foodstore yields displayed remarkable resilience, stabilising at below 4.00% (with a handful of sub 3.00% deals even completing). This was in stark contrast to other retail sub-sectors, which experienced much greater volatility. For instance, Shopping Centres saw a notable softening of +275 bps between January 2020 and December 2021, versus Foodstores mild softening of just +75 bps.

Today (Q3 2023), Foodstore yields, at 5.00%, remain highly competitive when compared to other key retail sub-sectors such as Retail Warehousing (6.00%), High Streets (6.75%) and Shopping Centres (8.00%).

Foodstores are rightly being seen as an outlier to the rest of the retail market, with limited risk of occupier default and online far less a threat. The occupational market remains very strong, with physical stores continuing to be the most profitable channel for operators (see '*Changing Channels*'). A limited development pipeline has also created slight upward pressure on rents, with limited opportunities for occupiers to relocate stores (particularly larger formats), justifying ongoing competitive pricing.

There is notable variation in prime yield spread among supermarket operators. Generally speaking, Tesco, Sainsbury's, Aldi and Lidl command some of the most attractive yields (ranging from the low 4.00%s to the mid-5.00%s). Waitrose and M&S currently trade at a slight discount, with yields generally around 5.75%. The sale and leaseback of 11 Waitrose supermarkets (ongoing at time of writing) will provide a valuable barometer of pricing in the market. Due to their higher levels of debt, both Morrison's and Asda currently trade at a further discount to the wider market, with pricing of their foodstores in Q2 2023 hovering around 6.25%.

'Long & Strong' - Standout Deals

The most prominent deals of the past 12 months highlight the ongoing appeal of prime, well-located foodstores to investors seeking the security of a reliable long-income stream. With a change in corporate ownership at both Asda and Morrison's, there is also a discernible uptick in both operators' assets coming to the market.

The £175m Morrison's Portfolio deal stands out as the largest sale and leaseback transaction of its kind in recent history. Orchestrated by PE owner Clayton Dubilier & Rice (CD&R) and acquired by Realty Income Corporation, the portfolio of 10 stores came with the security of 20-year leases and linked rental uplifts.

The off-market transaction of Morrison's Welwyn Garden City (£18.2 million) store was driven by its dominant local market position and strong trading history. The purchaser, Abrdn, highlighted the rent review structure offered by the sale and leaseback of the 60,000 sq ft supermarket and the petrol forecourt station (PFS) offered an attractive income stream accretive to dividend cover.

Given Morrison's owns 85% of its portfolio (and CD&R's debt position), it seems safe to assume that there may be more sale and leaseback opportunities in the pipeline.

The acquisition of Sainsbury's Islington store (£56.2m) by DTZ Investors revolved around the site's long-term secure income, coupled with its potential for future enhancement.

> "Supermarket Income REIT's position as the second most active purchaser is much more reflective of its position in the market."

The deal involved a 67,426 sq ft store secured on a 20-year reversionary lease, set to expire in 2044. Including annual indexed rent reviews, green lease clauses and full parent company guarantee – the asset aligned with DTZ's core asset strategy of 'long and strong income'. Its geographic positioning in the capital, and low site density, was also a major factor, with the opportunity for future intensification.

A broad appeal – the key players

The broad appeal of the foodstore investment market is reflected in actual transaction data. Anecdotally, Supermarket Income REIT and Realty Income are the two most active investors, but the actual data shows interest from a diverse array of investors.

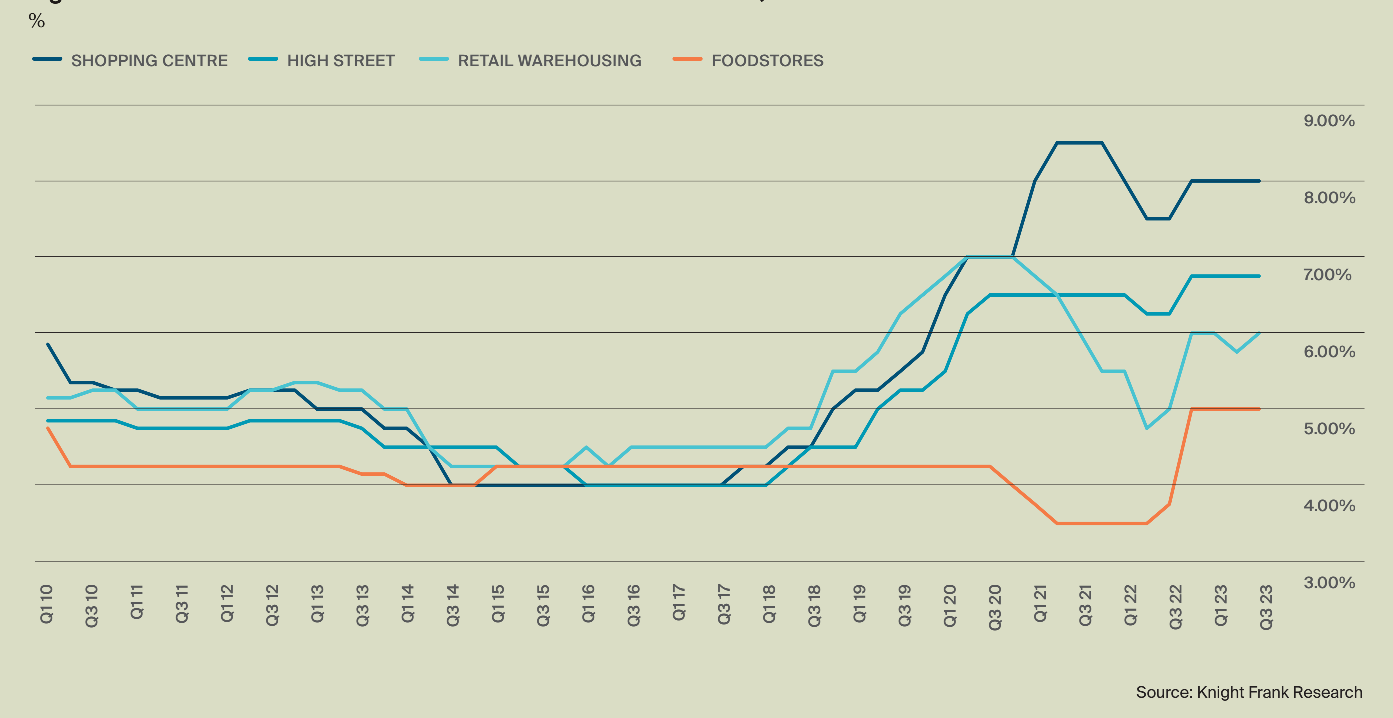


Fig 19. Foodstore Yields vs. other Retail Sub-sectors 2010-2023 Q3

Tables 5 and 6 list the Top 15 purchasers and vendors for foodstores by volume from the start of 2022 to 2023 YTD (Q3 2023), using data from RCA. The top spots in each are heavily skewed by a single transaction - Sainsbury's Reversion Portfolio. Supermarket Income REIT sold its interest in the portfolio to Sainsbury's in March 2023 for a total of £430.9m. The portfolio, which consists of 26 Sainsbury's supermarkets, was initially acquired by a joint venture comprising Supermarket Income REIT and British Airways Pension Trustees, with the Supermarket REIT's contribution totalling £108.5m, excluding costs.

This puts Supermarket Income REIT's position as the top vendor (and Sainsbury's as the top purchaser) into some perspective. Supermarket Income REIT's position as the second most active purchaser is much more reflective of its position in the market. Supermarket Income REIT invested £426m over the period in question, more than the third biggest investor (Allianz £100m) by a considerable margin.

This significant skew aside, the list of 15 key purchasers is a diverse one. The top 15 purchasers 'universe' saw £1.7bn transacted over the 2022 – 2023YTD period. Real Estate Investment Trusts (REITs), Investment Managers and Insurance Companies have collectively accounted for a significant 63% of purchaser transaction volumes, amounting to around £1.08 billion since 2022. Through the Sainsbury's Reversion Portfolio deal alone, Sainsbury's represented a substantial part (25.2%) of the remaining investment. Equity Funds and Developers, though a comparatively smaller segment, still played a significant role, with investments totalling about £197 million (11.5%).

The top 15 vendors 'universe' saw £2.3bn transacted over the 2022 – 2023YTD period. Again, the Sainsbury's Reversion Portfolio significantly distorted the figures. Supermarket Income REIT and Sainsbury's have divested a total of £1.13 billion during the period, constituting nearly 48% of the total vendor transaction volumes.

Top vendor types include REITs, which account for £698 million or 29.7% of overall transactions, followed by Investment Managers, responsible for approximately £676 million or 28.8%. Pension Funds were also active, contributing £287 million or 12.3% of the total.

Individually, professional asset managers such as M&G have undertaken substantial disposals amounting to £229 million, or 9.8% of the total. Similarly, pension fund players such as British Airways and British Steel have sold a combined £287 million. Smaller players have also played a role - Investra, Europa Capital, and Ediston Properties collectively offloading £93.6 million. Specialised sellers (London Metric - £65.5m) have offloaded smaller, though not insubstantial volumes.

A lot of sellers vs a lot of buyers = an increasingly liquid market.

Table 5: Key Foodstore Purchasers (2022 – 2023 YTD)

Rank	Company Name	Capital Type	Volumes (£)	No. of Properties
1	J Sainsbury Plc	Corp.	430,900,000	21
2	Supermarket Income REIT	Pub. REIT	426,850,196	34
3	Allianz	Insur.	100,000,000	2
4	Columbia Threadneedle	Inv. Mgr.	98,575,000	2
5	Delancey	Eq. Fund	89,075,000	1
6	Zurich Financial	Insur.	89,075,000	1
7	LXi REIT	Pub. REIT	70,458,344	4
8	DTZ Investors	Inv. Mgr.	69,235,000	2
9	LCN Capital	Eq. Fund	62,910,000	1
10	Aviva	Insur.	62,010,000	2
11	BlackRock	Inv. Mgr.	50,030,000	1
12	Realty Income Corp	Pub. REIT	45,680,000	3
13	M Core	Dev/Own	45,511,499	5
14	CBRE Investment Mgmt	Inv. Mgr.	35,020,000	2
15	British Land	Pub. REIT	35,000,000	1

Source: RCA, Knight Frank

Table 6: Key Foodstore Vendors (2022 – 2023 YTD)

Rank	Company Name	Capital Type	Volumes (£)	No. of Properties
1	**Supermarket Income REIT**	Pub. REIT	634,900,000	42
2	**J Sainsbury Plc**	Corp.	498,265,082	18
3	**M&G Real Estate**	Inv. Mgr.	229,349,721	4
4	**British Airways PF**	Pen. Fund	195,993,000	26
5	**abrdn**	Inv. Mgr.	153,075,000	3
6	**Legal & General**	Inv. Mgr.	108,350,000	5
7	**British Steel PF**	Pen. Fund	91,670,000	3
8	**CBRE Investment Mgmt**	Inv. Mgr.	91,653,334	9
9	**Lothbury IM**	Eq. Fund	74,250,000	2
10	**Londonmetric Property**	Pub. REIT	63,585,000	6
11	**Aviva**	Insur.	63,045,000	3
12	**Canada Life**	Insur.	50,030,000	1
13	**Investra**	Inv. Mgr.	32,200,000	1
14	**Europa Capital**	Inv. Mgr.	30,880,000	1
15	**Ediston Properties**	Inv. Mgr.	30,880,000	1

Source: RCA, Knight Frank

Key reasons to invest in foodstores

1. Strong Fundamentals

- Longevity & lack of pipeline development – few closures, high probability of lease renewals
- Occupier contentment
- Strong covenants
- Store operators' most profitable trading channel
- Non-discretionary spend – less susceptible to economic / political uncertainty

2. Resilient Income Stream

- Secure & long
- High income return
- Index-linked rental uplifts

3. Good value

- Yield adjustments of +100bps to +150bps since peak early 2022
- Potential capacity to fulfil omni-channel / shed functions (e.g. last mile delivery).

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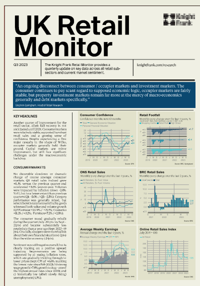

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