# UK grocery retailers: as winter approaches, inflation bites and profitability cliff looms

**Soaring inflation in the UK is bedevilling consumers, which could lead to changes in consumer behaviour. Grocery retailers face their own challenges, such as tackling rising materials and energy costs**

Grocery retailing in the UK has historically been highly competitive. Over 81% of the market is controlled by six large supermarket chains: the Big 4 of Tesco, Sainsbury's, ASDA and Morrisons (comprising around 65% of the market) and the 'Discounters', Aldi and Lidl, with around 16% of the market. All grocery retailers are furiously working to tackle an economic environment marked by soaring inflation, in which households could see their spending power cut by an average of GBP 3,000 over the next year.

In this competitive and challenging background, we see two major (and one minor) challenges to the dominant Big 4 grocery retailers.

1. As in 2008, the larger retailers will be wary of losing market share to discounters in a depressed economic environment. While early signs point to an increase in market share for discounters, the larger retailers seem to be better prepared for the enhanced competitive environment this time round. We would also expect that reduced capex slows the advance of online offerings, e.g. by Amazon.

2. To hold on to or gain market share, all retailers must be prepared for a squeeze in operating margins. Retailers will face challenges, not only in raising prices but also on the burgeoning cost side, where their own suppliers are demanding higher prices, as well as other costs in terms of employee and general expenditure. We expect a decrease of 70-100bp in terms of operating margin. Further declines could see retailers having to curtail capital expenditure or reduce investments in operational improvements.

   As a result, we expect credit metrics to weaken, although retailers will be able to absorb lower profitability without meaningful impact on their credit ratings. Paradoxically, a sustained slump in operating margins would be beneficial to larger retailers, as operating margins for UK discounters are in low single-digits, and it would then be a question of who would blink first in raising prices.

3. Similarly, while cash flows are expected to remain sufficient to support current debt levels without significant increases over the short-term, a sustained medium-term fall in operating cash flows could lead to increased borrowing, especially as the larger retailers battle to preserve market share.

   Again, while the initial responses of all players indicate that they have learned their lessons from earlier crises and seem to be able to weather the storm without a large impact on credit metrics, an extended period of recession would test retailers' balance sheets, like all other businesses.

As the United Kingdom is buffeted by spiralling inflation and various cost of living crises, consumer confidence is at an all-time low and shoppers have begun keenly scrutinising their weekly shop. As inflation remains elevated, increasingly anxious consumers will shift to smaller weekly baskets and remain there until consumer confidence recovers. Anecdotal evidence of shoppers stopping till employees when they reach pre-determined spending limits are canaries in the coal mine of a long, difficult winter ahead.

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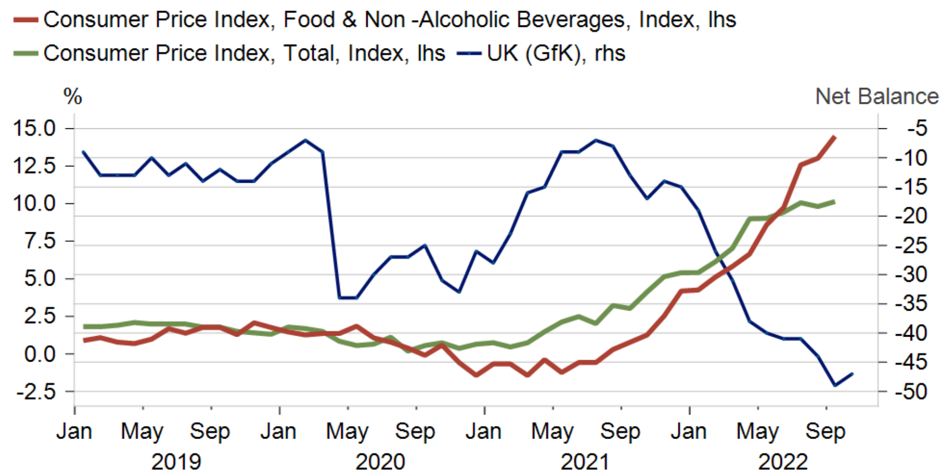
## Competitive environment in the UK

**UK grocery retailing highly competitive**

As mentioned above, the UK has historically been a highly competitive grocery retailing market with over 81% of the market controlled by six large supermarkets. The UK is also the clear leader in e-commerce in Europe: 13% of total grocery shopping happens through the online channel, against an average of 6.6% for Europe as a whole. Further, the UK leads the continent in terms of private label sales, with 50% of supermarket sales accounted for by private labels, against a European average of 35%. Despite the lower margins in the online channel, the larger UK retailers have managed to retain their operating profitability in line with other European retailers, at mid-single digit margins.

**Figure 1: Rate of inflation vs. Consumer confidence (UK)**



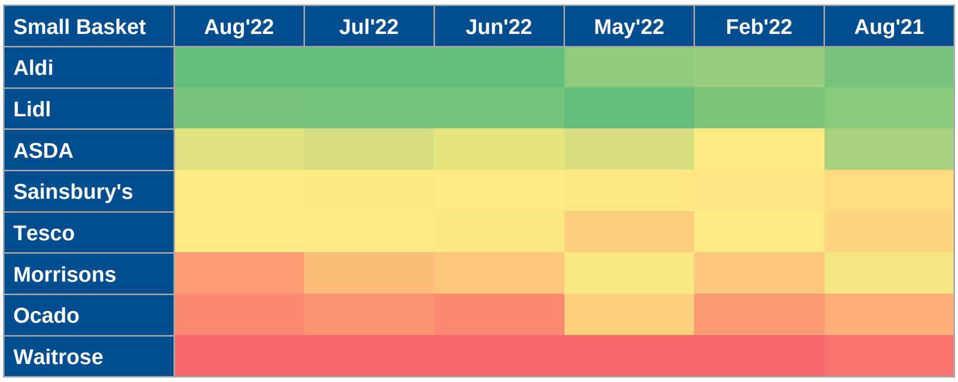

## Cash is king: who helps customers keep more of it will win

### Competitive position of Big 4 projected to deteriorate

**Big 4 market share not as open to disruption as in the last year**

While price competition has existed in the UK for a long time, the market share of the Big 4 has never been as open for disruption as over the last year. The natural advantage of the larger stores in terms of larger product choice and perceived higher value in terms of luxury come second to the need for completing the weekly shop at minimum possible prices.

**Figure 2: Heat map of average basket of same products across various stores**

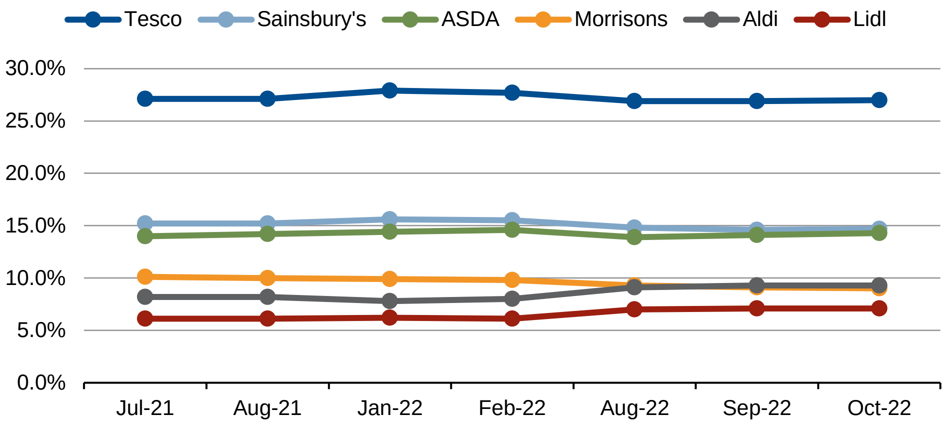



Source: Monthly surveys, which.co.uk

The discounters have consistently provided the lowest-possible price while the Big 4 have varied in their ability to provide lower prices; Tesco being notable for its ability to hold prices down in face of inflationary pressures.

In September 2022, the search for value resulted in Aldi entering the ‘Top 4’ in terms of market share for the first time, displacing Morrisons. Schemes like ‘ALDI Price Match’ by Tesco and Sainsbury’s, ‘Low Everyday’ prices by Tesco and the ‘Just Essential’ line by ASDA to name a few, will only go some way in putting up a fight against the constant erosion of market share.

**Figure 3: Market share evolution for selected chains (UK)**




Source: Kantar

**Competition amid declining consumer confidence**

As the size of the average weekly shop decreases, the short term will see all chains compete for customers against a backdrop of declining consumer confidence. In such a scenario, it is not too difficult to envisage the discounters gaining further market share over the next year as customers prioritise cash over luxuries, even for grocery spends. However, the ability of the discounters to hold on to the increased market shares as inflationary pressures cease will be the key battle for the next phase of grocery retailing in the UK.

**Figure 4: Change in market share over last 12 months (UK Grocery Retail)**

| | Aug-21 | Sep-21 | Aug-22 | Sep-22 | YOY Aug'22 | YOY Sep'22 |
|---|---|---|---|---|---|---|
| **Total 'Big 4'** | 66.5% | 66.4% | 64.9% | 64.7% | -1.6% | -1.7% |
| **Discounters** | 14.3% | 14.2% | 16.1% | 16.4% | 1.8% | 2.2% |

Source: Kantar

## Inflation is theft but who will bear the cost?

### Squeeze on margins

**Gross margins likely casualties**

Retailers’ gross margins are likely to be casualties of the inflationary environment. With core inflationary measures like food and non-alcoholic beverage inflation increasing every month in calendar year 2022, supermarkets have been caught between an uncomfortable rock of consumers cutting down on spending, and a hard place of increasing supply costs.

In normal times, most supermarkets would be able to pass on supply cost increases to customers. But in the face of unprecedented inflation, retailers must decide between turning away shoppers who would balk at exorbitant price rises or swallowing some of the increased costs to shield market share.

**Eroding relationship between retailers and supplies**

The sector's experience with inflationary pressure has already begun eroding the relationship between retailers and suppliers. Surveys undertaken by the UK Government in recent months indicate that almost 80% of suppliers have requested at least one CPI-related price increase in the previous 12 months, and a quarter said they had encountered either a rejection by a retailer to accept such a request or an excessive delay in finalising the request. As inflationary pressures bear on suppliers, expect retailer margins to get squeezed further.

With the increasing acceptance of the concept of grocery purchases via e-commerce post-Covid – weekly sales in food stores stood at GBP 294m in August 2022 vs GBP 173m for the same period in 2019 – retailers must also continue to invest in their online businesses, which offer the lowest margins of all sales channels.

Increasing operational expenditures also lie in the form of higher wages to their salesforce, which is something most retailers have already taken on board. As energy prices and employee costs escalate, retailers are looking at a percentage fall in operating profits of low-to-mid-teens. However, cash flows should remain fairly stable as part of the decline can be counteracted by positive working capital flows expected in an inflationary environment. Credit metrics, for the short term, are expected to remain stable.

## And the winner is … ?

### Capex cuts, deteriorating credit metrics point to interesting times ahead

**No extinction-level threats on the horizon for Big 4**

While there are no extinction-level threats on the horizon for the Big 4, a period of prolonged pain seems to await grocery retailers over the next 12-18 months. Preliminary actions indicate that ASDA, Sainsbury's and Tesco are focusing on protecting market share, while Morrisons seems to be focusing on margins and resisting deep price cuts.

The discounters, however, are facing their own set of issues. They may well win market share from middle-class shoppers who want cheaper food items at slightly more reasonable rates as shoppers focus on essentials. But with deep cuts in discretionary spending on non-food items, the already razor-thin profit margins of the discounters will be further dented. Already, non-food items, which typically offer higher margins, has declined to less than 10% of discounters' sales.

**Discounters need to find ways to maintain profitability as lure of middle class decreases**

While the traditional retailers need to find a way to retain their existing customers while figuring out the best way to serve them and sustain their profits, the discounters need to discover ways to welcome a new set of customers focused solely on essentials and maintain profitability as the lure of the middle aisle decreases. From a ratings perspective, a margin squeeze between higher costs and lower (relative) revenues would put pressure on the business risk profiles of all retailers.

Weaker-than-expected cash generation would herald weakening debt-protection metrics and increase potential for downward pressure on ratings. Investment-grade retailers should not expect to be downgraded to speculative categories overnight, but managements will have to factor in cash conservation strategies as a bulwark against rating downgrades.

When the best-case scenarios point to a prolonged period of weaker cash flows, limitations on capital expenditure imposed by a need to maintain financial discipline, weakening credit metrics, and higher refinancing costs because of increasing interest costs, the question is not who the winner is, but if there are any winners at all.

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