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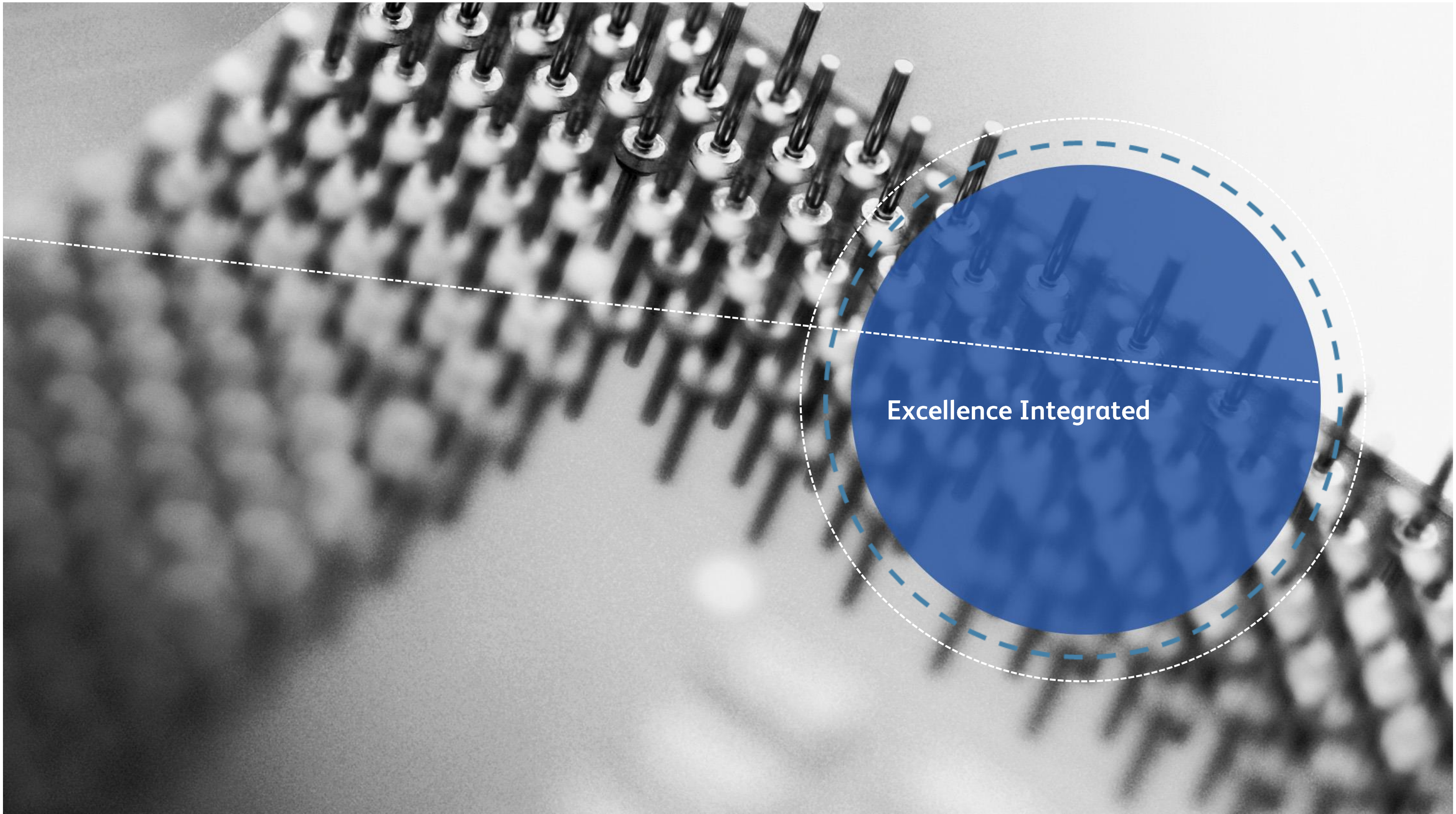
Consumer Research - A broker's perspective of the outlook for the UK & Irish food industries

A presentation with the European Food & Farming Partnership, London, October 2016



A basic law of economics oft forgotten

Simple economic principle

Where there is oversupply, margins <u>will</u> be weak; where there is balance, cost recovery etc… can be achieved with a bit of give & take; where there is a shortage, margins should be, will be robust.

UK & Irish food industry – setting the scene

1. Uncertainty rules but life must go on – the top of the economic pyramid
2. What of the consumer economy?
3. Consumer dynamics in the food market
4. The key evolving features of the retail model
5. The growing relevance of foodservice
6. Winding up…

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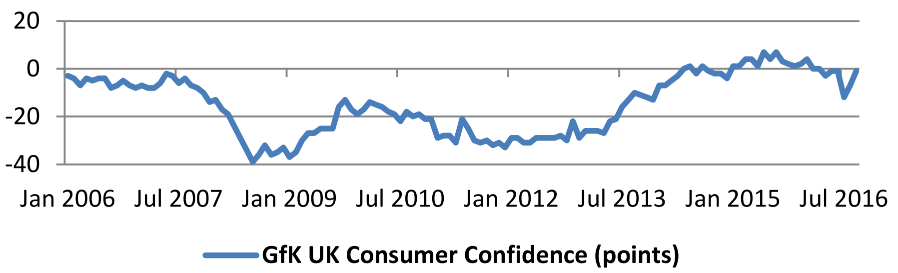
UK & Ireland economy – the macroeconomic backdrop

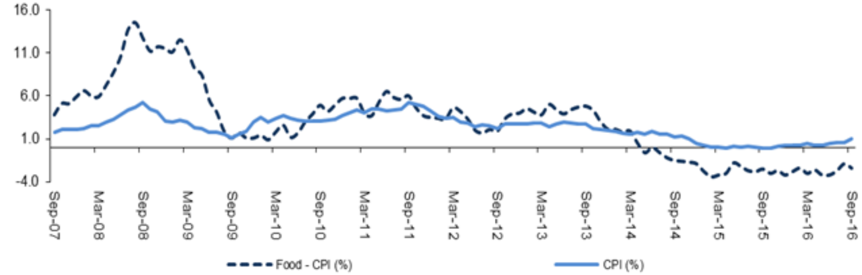
- The UK-EU Referendum brings uncertainty for sure…
- …, but campaign talk of economic Armageddon is wide of the mark…
- …the dust is settling but the carpet will be banged a few more times…
- …it is important that the perceptions of the country are understood, respected…
- …sterling is the key arbiter
- UK economy is hard to predict; c2.5% GDP growth for 2015; c2.0%+ for 2016, 1.5-2.5% for 2017?
- Ireland's growth is exploding after a deep trench… 5%+ in 2015, UK related worries for 2017
- Government stimulus is set to be reappraised in both economies
- Business confidence & investment are key to the future, currently fragile post the Referendum
- The UK is a divided nation, 'The City', 'Metropolitania' and the 'Liberal elite' are sulking; Brexiteers have their tails up…
- The only certainty is uncertainty
- …what of the consumer…?

UK & Irish consumer economy

- …, despite the worry lines…
- …employment levels in the UK are at records high, unemployment remains a problem in Ireland
- Real incomes are still growing with low inflation…
- …but growth in living standards is slowing as CPI 'creeps' in, or will it surge higher…
- …the devaluation of sterling is a key variable…
- UK National Living Wage will boost low income spending power…
- …but re-price labour versus capital
- UK housing market appears relatively resilient
- Consumer confidence (GfK NOP) is recovering but is likely to ebb & flow
- Asda Income Tracker reports highest ever weekly discretionary income in the UK… but the rate of growth in real incomes may have peaked in this cycle.
- All in all we expect UK living standards to fall in H2 2017 as CPI rises and wages ease off.

Have things 'got as good as they are going to get'? Probably for quite a while…

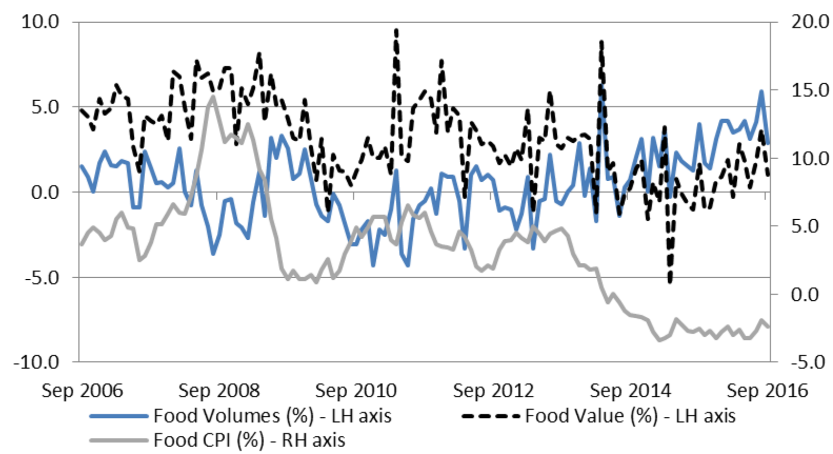




Source: GfK NOP, Bloomberg, ONS

UK consumer – the legacy of a depression - key channel trends

- The post-2008 consumer depression encouraged the 'middle class' savvy shopper who remains in-play
- Price has firmly moved up the customer agenda…
- …, the superstores allowed the discount channel to enter the mass-market phase
- The momentum of discount channel growth (LADs & HSVRs) has peaked
- The convenience channel has also peaked with the best sites taken…
- ..and the superstores are fighting back
- Online will continue to gain share
- Well-being is an important dynamic
- The 'affordable treat' will remain important throughout
- New view of the affordability of eating out of the home.



Source: ONS Retail Sales Data, ONS CPI

UK FMCG retail market – space imbalance

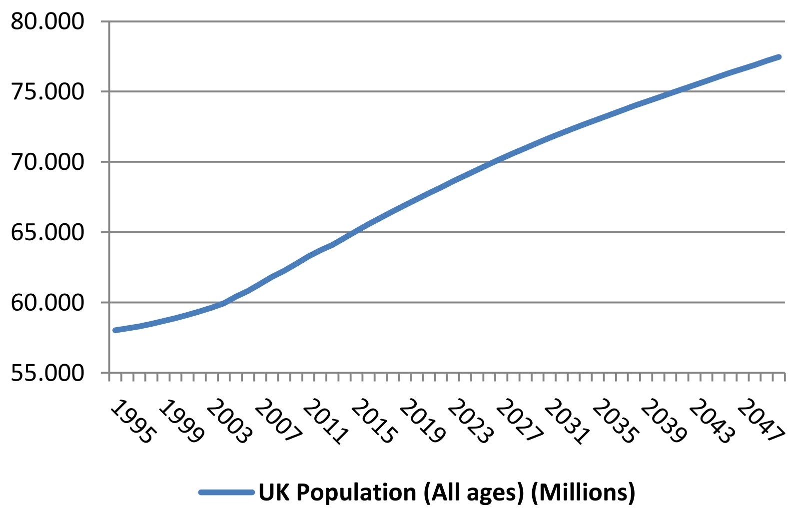
- A changing, tougher market fundamentally cuts new space growth
- Coefficient of new superstore space to sales has collapsed – reducing new store productivity & returns
- Superstore space growth has been curtailed, deferred and now cut - even Waitrose pares back
- The discounters are set to open c10%+ new space per annum for the foreseeable future in the UK, less so in Ireland; so c1% overall space addition – but we question the potency of new stores
- UK discount share is c10-11%, set to test c15% in the medium-term, LADs in Ireland are c18-19%
- Online is c5-6% share, set to be c10-12.5% by 2025; but with strong superstore participation.

Space coming on-stream at lowest rate for five decades to 2020 in UK & Ireland supporting residual densities

UK FMCG retail market – volumes

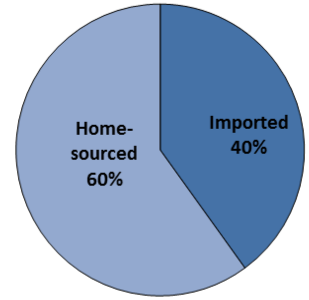
- UK population is rising by c1%+ per year; ONS forecasts a UK population of c73.5m by 2035, c78m by 2050 – even with immigration control, watch this space, the population is set to grow
- The consumer remains set on managing basket values…
- …but four years of weak industry food volumes has come to an end
- Eating out of the home volumes remains solid, driven by affordability, innovation & entrepreneurship…
- Calorific intake per person is set to fall as well-being takes hold…
- …, but shifts in food waste are likely to plateau, supporting volumes

We forecast UK food volumes of 1-2% medium term, supporting store densities



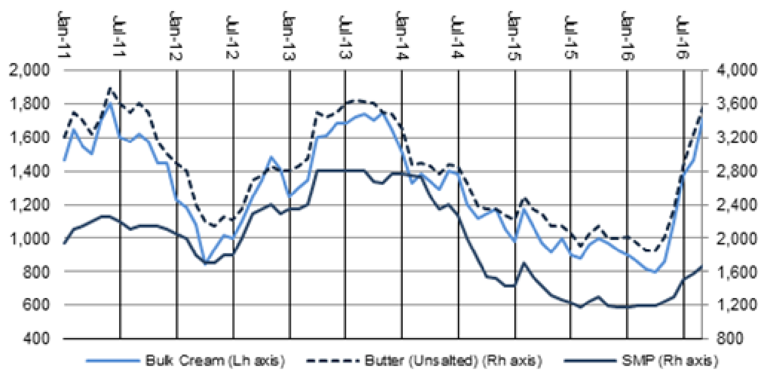
Source: ONS

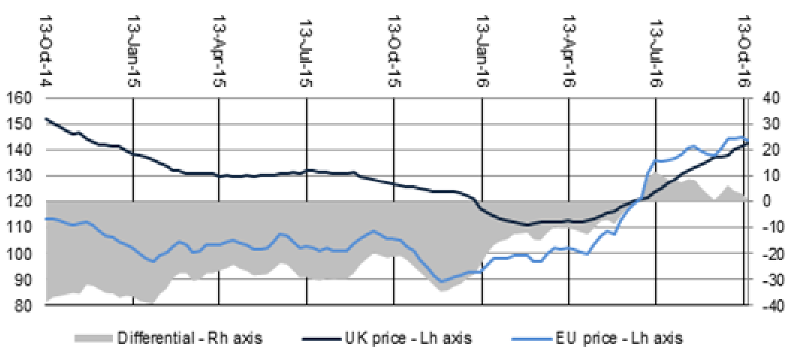
UK FMCG retail market – prices



- Sterling weakness is the new pricing dynamic; importing inflation.
- Will this stimulate import substitution and UK exports?
- What of Ireland and the UK as a key food market?
- Developing & Emerging Markets should drive long-term demand for energy & food - with ebbs & flows
- Oil prices are likely to be inflationary in 2017; Brent Future ICE $45-55/barrel
- Hot spots: sugar prices have now turned…, as has bulk cream…, as has UK pig-meat…
- Cereal prices rebased higher since 2006 but with full silos now flat-lining; watching maize & soy; intensive protein prices linked to cereals
- We saw relatively anaemic soft commodity prices for 2016/17…, but sterling changes things in the UK
- Food deflation at its deepest in over 25 years in mid-2016 set to ease…, food inflation & CPI in 2017?

Shore Capital/EFFP forecast easing food deflation, potential for inflation in 2017 even with intensely competitive grocery market





Source: http://www.foodsecurity.ac.uk/issue/uk.html, AHDB UK Wholesale dairy prices, AHDB UK & EU Pork Prices

UK FMCG retail market – mix and safety

- Trading down remains the most powerful dynamic and it is **not** expected in our models
- Living standards & affordable treats should support ongoing values but less so in 2017
- Digital expenditure is now a big part of household spend… (check your bills)…
- Clothing spend is falling, increasingly skewed by what appears the removal of weather seasons
- British Isles is becoming more food, diet and health literate; supporting eating out & well-being trends
- Sugar is the current focus of attention; salt & saturated fats in the wings; soft drink tax a terrible process
- Green was steamrollered by the recession materially lowering volumes, especially green/organic; now maybe showing signs of life through product innovation
- The never-ending importance of taste: food as a comfort & pleasure
- Horsemeat adulteration should remain a cold sweat moment

Mix to deliver benefits to retailers & suppliers on an ongoing basis.

CONTRIBUTION TO TAKE HOME SUGAR

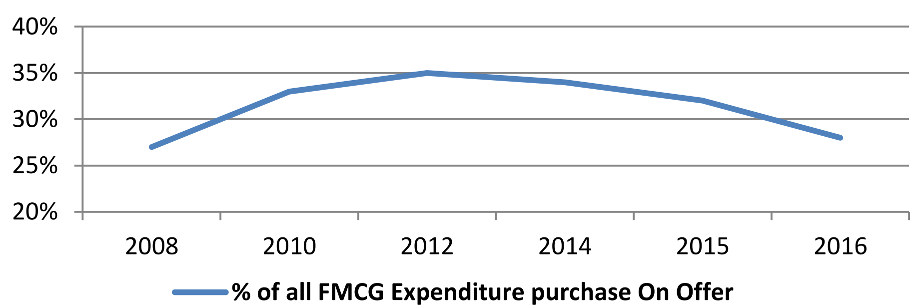
2012		2016	2016 vs 2012 % CHANGE SUGAR	2016 vs 2012 % CHANGE VOLUME
15.1%	Fruit + Veg + Salad	15.8%	+5.8%	+4.0%
12.2%	Packet Sugar	10.7%	-11.5%	-11.6%
9.7%	Milk & Cream	10.2%	+7.2%	+7.6%
9.5%	Take Home Confectionery	9.9%	+5.6%	+0.6%
10.3%	Soft Drinks	8.8%	-13.6%	+2.5%
6.3%	Biscuits	6.5%	+5.3%	+3.2%
4.5%	Cakes + Pastries	4.5%	+0.4%	+1.0%
3.7%	Sweet Home Cooking	3.7%	+2.0%	+2.1%
3.4%	Bread + Morning Goods	3.7%	+8.0%	+5.2%

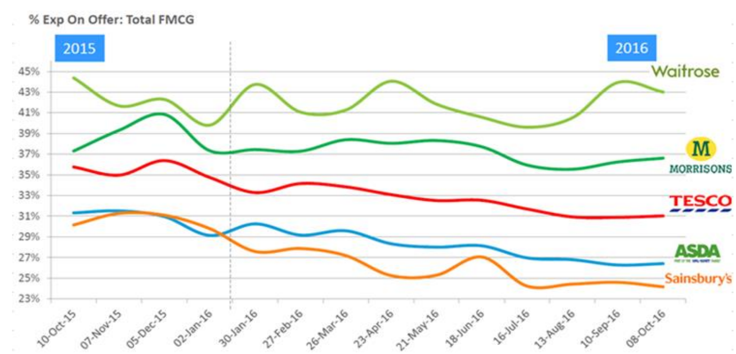
Source: Kantar Worldpanel

UK FMCF retail market – the promotion debate

- UK grocery promotional participation rose from long-standing c20-25% rate to 30-40%
- Promotional spike started as a rational supply-side response to support volumes with strong inflation…
- ...however, the promotional '*tail*' started to '*wag the dog*'…
- …suppliers lost sight of the consumer as supermarkets '*slept at the wheel*'…
- …superstore groups became a supplier rather than a customer orientated…
- …commercial income rose through the P&L…
- despite customer insight over-promotion damaged brand equity
- Consumers see-through many promotions & price matching, coupons & vouchers, fuel-based discounts and loyalty points; they want more simple, stable and trustworthy base pricing
- The superstores are now responding to promotion laziness; simplicity is the order of the day…
- …, alongside fundamental supply chain adjustment – SKU rationalisation, logistics, store operations…
- Remember…, the LADs promote modestly?

We seeing the end of the euphemism…, '*good, better, best*'…? We expect promotional participation to ease back, c27.5-32.5%; pseudo EDLP is now in – lower and more stable pricing



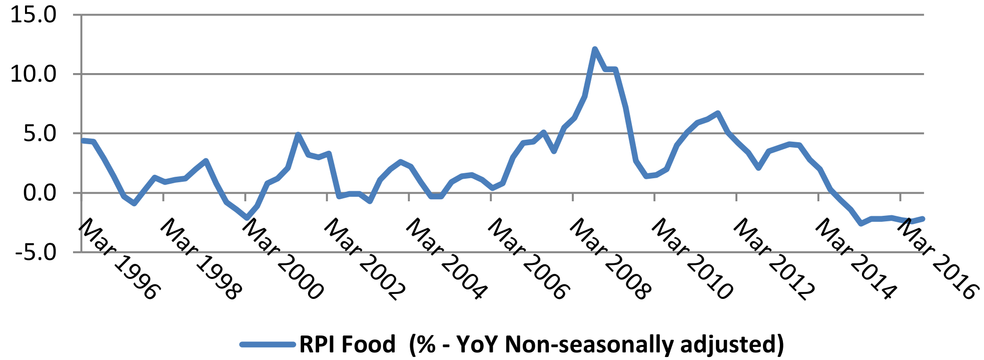


Source: Nielsen Promotional Tracker, Nielsen Homescan Grocery Multiples

UK FMCG retail market – trading environment – war?

- The 'trade' has always described 'the environment' as '*competitive*', but it really is now
- Superstores opened the door to the LADs and high street value discounters (HSVRs)
- After sustained appreciation in gross margins the trend is turning down, there is a prolonged war
- Retail gross margins, hard to build, easy to collapse; have adjusted downwards
- The focus is on lines that matter…, fresh food & proprietary brands
- The share shift is stark..., it wasn't tenable for Morrisons and Tesco to sustain such heavy sales attrition; is it so for Asda? No…
- …Asda has replaced management and commenced the long-haul to improve its competitiveness albeit in Asda's case it is not all about price
- Amongst the heat & noise, we see a still more rational market than not

Volume will take precedence over gross margins but a more rational retail industry is expected to deliver recovery; remember margin is an output…

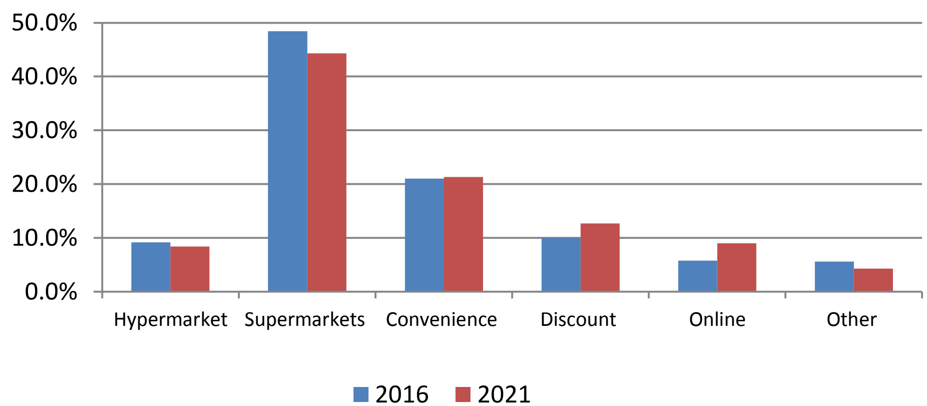


Source: ONS

UK grocery online – world-leading and evolving model

- UK online grocery market penetration is c5.5-6.0%; growing at c10-15% per annum but decelerating
- We estimate c7-9% participation by 2020; 10-12% by 2025
- UK has the No.1 spot for global non-food online penetration; over 20%, that's 1 in 5!
- Profitability is difficult to achieve for the pure online grocery retailer; 15 years & Ocado books a profit!
- Online grocery is seeking to become more rational in terms of profitability; Amazon isn't free
- Amazon Fresh's arrival maybe a threshold moment but one for much further down the line
- Prepared food online now emerging in metropolitan London plus; Deliveroo, Gousto & Hello Fresh but needs to kept in perspective
- Apps as research tools and shopper processors; social media as a regulator.

Online contributes to falling large store footfall…, especially in non-food. The genie is out of the bottle though… will there be generational change with technological advances?



Source: IGD Retail Analysis 2016

UK & Ireland – The foodservice opportunity

- Foodservice is a very different channel to retail…
- …requiring a different mind set, skill set and approach
- Product pack size, temperature and delivery to the end user is very different; utilisation, wastage & portions
- Foodservice market is segmented, varying requirements; QSR vs. specialists & hotels, coffee shops vs. cafes
- Food eaten out of the home is expected to gain share of stomach
- Entrepreneurs are providing choice, higher quality, more affordability; generally more innovative than retail
- Horizon forecast UK foodservice sales to rise from £47bn in 2015 to £56.5bn by 2019
- Foodservice is strategically more significant for supply chains
- Brake acquisition by SysCo is interesting, Booker has big ambitions in this space; what of Bidvest UK?

We forecast that foodservice will continue to gain share on a sustainable basis, with implications for supply strategies

Conclusions

- The UK-EU referendum needs to be carefully analysed about how the UK is
- Economic prospects for the UK & Ireland are less certain for sure
- The length & depth of the consumer recession structurally changed consumer perceptions and behaviour
- A gross margin re-set is happening for UK superstores; no quick fixes
- Food price deflation is set to ease, inflation may return driven by sterling
- Population & economic growth should support medium-term volumes & values
- Balance sheet re-engineering is a current superstore priority, bringing the return of the superstore
- Food eaten out of the home has structural growth credentials
- Online is expected to sustain robust share gains, not so sure about supermarket CVS, lesser so discount
- Proprietary brands vs. private label, proprietary brands and LADs remain discussion points
- Food eaten out of the home has structural growth credentials
- Innovation, focus/simplification & cost leadership feel like key corporate mantras

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