

retailthinktank

KPMG | Ipsos

2014-2015

annual review

About the Retail Think Tank

Creation of the Retail Think Tank...

The Retail Think Tank (RTT) was conceived and created in 2006 by Helen Dickinson (former Head of Retail at KPMG LLP) and Tim Denison of Ipsos Retail Performance (Ipsos) to provide an authoritative, credible and trusted window on what is really happening in retail and to develop thought leadership on the key areas influencing the future of retailing in the UK. The intended audience for the outputs of the RTT is primarily retailers as well as anyone with an interest in all aspects of retail and retailing.



Who are we?

Nick Bubb (Retail Consultant)

Dr Tim Denison (Ipsos Retail Performance)

Martin Hayward (Founder of Hayward Strategy and Futures)

James Knightley (ING)

Richard Lowe (Barclays)

David McCorquodale (KPMG)

Martin Newman (Practicology – Joined the RTT Oct 2014)

Neil Saunders (Conlumino)

Mark Teale (CBRE)

Mike Watkins (Nielsen UK – Joined the RTT Oct 2014)

What do we do?

Our primary objective is to give a balanced, considered and unbiased view of the true state of the health of the retail sector. We aim to provide an authoritative, credible and trusted window on what is really happening in retail.

We assess the 'Health' of the UK retail sector

- Traditionally it has proved incredibly difficult to get a true view of the state of affairs with different sets of statistics due to:
 - sheer volume of data; and
 - large variation in how it is generated and then interpreted
- Since inception, the RTT's activity includes:
 - a retrospective look at the past quarter - looking ahead to the next three months
 - taking into account the three key drivers of retail health: Demand; Margins; and Costs
- The Retail Health Index (RHI) outputs provide analysis and a visual snapshot of how health is changing on a quarter-by-quarter basis covering the past six years

We write White Papers

- Thought leadership on the key areas influencing the future of retailing in the UK
- Issued quarterly throughout the year
- Highlighting issues and investigating areas of topical relevance to retailers
- The 2014 White Papers are included in this review and we have previously covered topics including:
 - the impact of inflation on retail health and strategy
 - like for like sales and whether they are still a useful measure of retail performance
 - is weather just another excuse of retailers' poor business models and risk management?

Where to obtain further information?

www.retailthinktank.co.uk



contents

3

1 The state of retail health 04

2 Prospects for 2015 08

Views of members:

Mark Teale, Head of Retail Research, CBRE

James Knightley, Senior UK Economist, ING

Dr Tim Denison, Director of Retail Intelligence, Ipsos Retail Performance

David McCorquodale, UK Head of Retail, KPMG LLP

Richard Lowe, Head of Retail & Wholesale, Barclays

Martin Hayward, Founder, Hayward Strategy and Futures

Nick Bubb, Retail Consultant

Neil Saunders, Managing Director, Conlumino

Martin Newman, CEO, Practicology

Mike Watkins, Head of Retailer and Business Insight, Nielsen UK

3 White papers 22

The future of the grocery sector in the UK April 2014

Rise in interest rates could affect consumer spending if implemented in 2014 July 2014

What can Tesco learn from previous business turnarounds? October 2014



2014 retail health index review

After a strong start to the year, the health of the retail sector suffered from persistent price deflation in the competitive grocery market, while unseasonably warm weather in autumn stifled sales of clothing and footwear and the Christmas season was discount-led from Black Friday throughout. As a result the Retail Health Index improved by just one point, ending the year on 80.

2014 got off to a solid start. Strong demand from consumers boosted sales in the non-food sector, while pressure on gross margins eased a little. Consumers indicated that they felt increasingly confident about the future, helped by falling UK unemployment, rising household wealth and a rapidly improving housing market. As a result, fashion and footwear sales and spending on household products fared well in the early months.

However, not all sectors saw an uptick in sales. Food sales struggled in the first quarter, posting year-on-year declines. The grocers were impacted by the bad weather and floods across the south of England and by price deflation caused by competition for share of wallet. The market dominance of the Big 4 was being challenged by both high-end and discount players, whilst the cost of fulfilment through different channels continued to impact the health of the segment and its profitability. As a result of these dynamics, the RTT's Retail Health Index rose in the first quarter by one point to 80.

Moving forward into Quarter 2, the health of the UK retail market improved further, though the divide in fortunes between the food and non-food sectors remained marked.

Demand for non-food items increased, helped by a late Easter and better spring weather, with sales of fashion and footwear leading the way. Strong consumer confidence and higher household disposable incomes encouraged more spend on discretionary products, though demand in some sectors, notably homeware and small electricals was surprisingly languid. The level of demand in non-food generally took pressure off margins in the quarter, allowing promotional campaigns to remain on plan and in budget. The contrasting fortunes of food and non-food sales continued to impact the overall health of the UK retail market. In the second quarter the RTT's Retail Health Index climbed just one point to reach 81.

As the year progressed, food sales continued to struggle. Volumes were down and low price inflation hit sales values, making Quarter 3 benign. A poor showing by England at the FIFA World Cup and the early exit of Andy Murray from Wimbledon heaped further pressure on supermarkets, as the potential increased demand for alcohol and snacks was suddenly curtailed. The launch of price reduction programmes and the expansion of price matching strategies in favour of “BOGOF” campaigns, also diluted margins in the sector.

The small gain in retail health in Quarter 2, was quickly and unexpectedly reversed. The third quarter saw a very disappointing trading period for food retailers and saw a change in leadership at market leader, Tesco. Following a positive July and August, despite tough comparators for the non-food sector, unseasonably warm weather in September – a five week month – impacted heavily on fashion retailers and the overall results for the third quarter.

Demand recovered slightly in the final quarter, helped by the sales rush towards Christmas. However this was impaired by tightening margins as a result of retailers discounting through planned and unplanned promotions. Retail health in the quarter was also impacted by the increased costs to fulfil the growing volume of online orders. This balance of slightly stronger demand, against margin and cost under more pressure meant that retail health remained flat for the quarter.

One highlight of the last three months of the year, and one that was the topic of much discussion during the RTT meeting was the impact of Black Friday on retailers' fortunes in December. It was universally agreed that the day had proven to be a hit with shoppers and that participation from retailers and demand for discounted goods both exceeded expectations, although clearly it tested the websites and fulfilment systems of many. There was consensus that part of these additional sales were brought forward from December, but that also many of the purchases made on Black Friday were an overhang from October and November and that many were simply opportunistic bargain hunting.

Going into 2015, the RTT believes that the health of UK retail in the first three months of the year will remain pretty much ‘as you are’ following on from Christmas. Positive external influences on retailers, including stronger employment figures, potential wage rate inflation and falling petrol prices, will largely be cancelled out by the uncertainty of the General Election and developments in the Eurozone. Costs will also be a factor throughout 2015, and in the first quarter retailers will start to look at further investment in multichannel and online support, as many big retailers struggled to cope with the demand of Black Friday.



After a slow start strong employment, improving job security and resilient consumer confidence helped to drive demand through to Christmas.



prospects for 2015

View of members





Mark Teale

Head of Retail Research, CBRE

Mark Teale joined CBRE (Hillier Parker) in 1986. Initially setting up a retail project consultancy team, Mark was appointed Head of Retail Research in 1989. Mark's research team specialises in retail property related consumer market research and forecasting but covers all aspects of retail research including information development for market analysis systems, shopping development viability studies, store location analysis and benchmarking.

Mark was responsible for establishing the industry's first shopping centre trading audits for rent review purposes. Mark also pioneered The National Survey of Local Shopping Patterns (NSLSP) survey, the largest continuous household survey programme of shopping destination preferences undertaken in the retail industry. The NSLSP survey is widely used by leading store groups for locational analysis purposes and by property/planning organisations for impact forecasting. Mark is now primarily concerned with the development of local forecasting and benchmarking applications and related retail property market measurement applications.

Outlook for 2015

First grocery markets caught a cold, then clothing retailers began to complain that the mild autumn was damaging sales and luxury markets began to feel the pinch. It is a strange economic 'recovery' when the fruits of purported economic growth stubbornly refuse to percolate down to consumer markets. The villain of the piece remains sub-inflation earnings growth. True, tax changes have been hailed as creating some real income growth but there is no evidence, as yet, of this pre-election Treasury largesse stimulating a sustained sector upturn. The mass-market shopping middle remains as squeezed as ever. Remove high growth London from the equation and UK shop markets still look to be dragging along the bottom.

Real sales growth is continuing but in tandem with price deflation, particularly in food markets which is proving to be a toxic combination. The upward only sales figures persistently reported by ONS almost certainly have much more to do with discounting than any proclivity on the part of some households to go on a spending spree induced by jiggery-pokery over tax-credits. And that, from the property perspective, is the nub of the problem.

It is profitability, not turnover, that drives both retail sector expansion activity and shops development. As long as shop markets remain borderline-deflationary retail property growth (outside London) will remain elusive.

Chain expansion activity currently remains at a recessionary low, as does non-food shops development. Now, as grocers divert their financial resources to a full-blown price-war, grocery development activity is contracting too.

Online sales growth, meanwhile, is exacerbating profitability problems because of the inability of many retailers, particularly in grocery markets, to claw back the full cost of fulfilment from online shoppers. Margin dilution is the inescapable result. While online has proved brilliant at capturing sales, its record as a profit generator is much less impressive. Belatedly, this low-profit characteristic of online retailing is benefiting property by steadily shifting investment in favour of click and collect which is largely property demand neutral.

Also on the plus side the MPC is no longer championing pre-election interest rate increases, something, in the absence of real earnings growth, that risked tipping retail markets back into recession. London continues to boom too, albeit off the back of overseas money and rampant inward migration rather than the domestic economy. Primary stock shortages in London are acute, hence the soaring rents and huge premiums seen in recent years. The pending completion of Crossrail (in 2018) has meanwhile triggered a further flurry of shops construction activity.

Following years of minimal shop development activity elsewhere in the UK, primary vacancies outside London continue to fall too, a necessary precursor to rental inflation but only once chain expansion activity generally begins to lift. And the outlook for 2015 Pre-election? More of the same. Pension access changes at the end of April may trigger a short term lift in retail sales but with the public sector debt mountain hardly scratched, medium term prospects for the sector will turn on how hard households are squeezed post-election.





James Knightley
Senior UK Economist, ING

James Knightley is a senior global economist at ING with particular focus on the UK and US economies. James has written extensively on the pressures facing both the household and corporate sectors since the start of the global financial crisis and during his time there the ING economics team has consistently ranked highly in surveys of forecasting accuracy.

12

He is frequently quoted in the UK and international press and appears regularly on television and radio. James joined ING as a graduate trainee in 1998 after studying at Durham University.

UK outlook for 2015

The UK economy looks in decent shape as we head into 2015. Employment is rising strongly and consumer confidence is back to pre-recession highs. Business investment is growing and the UK's trade position is improving despite the weakness in the Eurozone economy. This positive environment should be supported by the boost to consumer spending power from the ongoing supermarket price war and the plunge in motor fuel costs. On top of this, the national minimum wage has just risen by 3%. Pay deal data is picking up and there will be another large rise in the income tax personal allowance coming through from April. When added together, the prospects for 2015 consumer spending appear very encouraging.

Given what has happened to food and fuel costs, inflation could drop below 1%YoY in the early part of 2015. This would necessitate Bank of England Governor Mark Carney writing a letter to the Chancellor explaining what (if any) action he will take to address this. Since the Bank's assumption is that the oil price fall is temporary we don't expect any policy changes. Indeed, as oil prices gradually move higher in response to improving global growth and a reduction in the level of oil over-supply, inflation will respond. We expect CPI to rise back above the 2% target in early 2016. Given that the BoE targets inflation 2 years ahead we expect to see very gradually interest rates rises next year, most probably from 2Q15 onwards, just after the General Election.

In terms of risks to the UK growth outlook, weakness in the Eurozone and Japan are the main external concerns. China has seen some softer activity numbers too, but all three economies are at least implementing aggressive stimulus measures. At the same time the US economy is looking in very good health, so global growth prospects are expected to gradually improve as we head through 2015.

The main domestic threat is likely to come from politics. The three main parties are all losing voting share to smaller parties, such as the Scottish Nationalists, UKIP and the Green Party. This means we will likely see another coalition government being formed after the May 7 General Election. There are a number of permutations with, for example, a Labour/SNP/Green coalition resulting in a lurch to the political Left, which would be perceived as less pro-business and could potentially lead to lower domestic business investment and reduced foreign direct investment in the UK.

On the opposite end of the spectrum, a UKIP/Conservative coalition would heighten concerns about the UK's relationship with its main trade partner – the EU. We would see a vote on the UK's ongoing membership of the EU by 2017, which may result in the UK leaving and potentially being denied (albeit temporarily) access to the single market. Such an outcome would be viewed very negatively by the majority of British and foreign business – why have the UK as your European hub if the UK does not have full access to EU markets? Given that opinion polls are pointing to such an unclear political future, “uncertainty” has the potential to be a drag on what is otherwise a positive outlook for UK economic activity.



Dr Tim Denison
Director of Retail Intelligence, Ipsos Retail Performance

Dr Tim Denison, BSc MSc PhD MCIM, is Director of Retail Intelligence at Ipsos Retail Performance, the UK's market leader in performance improvement systems for retailers. He is also a regular commentator, broadcaster and conference speaker on retail matters, particularly those related to behavioural issues.

Tim is Director of Retail Intelligence at Ipsos Retail Performance, part of Ipsos, the third largest market research company in the world. Ipsos Retail Performance is a specialist retail business unit, that uses technology to monitor retail footfall, shopper behaviour and capture retail trends. Tim set up its analytics and consulting services when the company was established in 1995. He is regularly invited by national and international media to comment on shopping behaviour in his capacity as a retail psychologist.

Trained formally as a social scientist and marketer, Tim has written over 50 papers, reports and publications on consumer behaviour. Before joining Ipsos Retail Performance he worked at Cranfield School of Management specialised in retail and branding issues and consulting on key research and policy initiatives on behalf of organisations such as the European Commission, the Department of Trade and Industry, BP and BT.

Outlook for 2015

We start 2015 with a stronger consumer economy than at the same time last year. Employment is at a record high, real wages are finally beginning to grow, the number of start-up businesses is on the rise and household spending is growing. Retailing is, arguably, also in a more comfortable space. Retail sales for 2014 are projected to be 3.9% higher than in 2013 and our Retail Traffic Index is expected to end 2014 showing an annual rate of decline of 1% compared to 4.4% the year before. But it hasn't been plain sailing. There have been major changes at the top of many retail companies and the big four grocery chains have been forced into eating humble pie.

The retail environment will remain tough, partly because the economy's momentum is expected to slow, but partly too thanks to the demanding and dynamic market conditions. I don't expect the general election to be much of a disruptive force to the sector. Shoppers will continue to want products to be available faster and more easily. They also want to shop at their convenience, for authentic products with proven provenance. They want outstanding, integrated and personalised customer experiences. These conditions have spawned unprecedented levels of creativity in the sector, facilitated by the extending influence of the digital and mobile era.

The rapid pace of change and complexity in processes, technology and systems as well as products will continue to accelerate in 2015. 2014 was a year of digital development, 2015 will be the first year of mass application and commercial exposure, encompassing innovations such as 3D printing, mobile tracking, facial recognition, robotic fulfilment and smart merchandising aids. It will be a year for leading retailers to redefine what they stand for and show what sets them apart, while remaining open-minded and nimble in their operations. It is also the year for them to start realising return from their investments in digital technology, leveraging the breadcrumb trail of data and effecting more fulsome and mutual beneficial engagement with their customers.

Out of every recession a changed retail sector has emerged. This one is no different. In '74/'75 retailing embraced marketing to the consumer; in the '90s it addressed supply chain management and logistics and, today, design and technology is providing the catalyst for change.

13



David McCorquodale
Head of Retail, KPMG

David McCorquodale is UK Head of Retail at KPMG and is responsible for leading and developing the firm's retail practice in the UK. An experienced M&A practitioner, he is regularly quoted in the trade and national media on retail sales trends and other key issues affecting the sector.

David has been with KPMG since 1984 and is one of the founders of KPMG's corporate finance business, advising listed and private companies on divestitures, acquisitions and fund raisings. He also leads KPMG's European retail transactions and restructuring practice and has advised on numerous high profile retail transactions, including the sales of Card Factory, Dreams, Peacocks, Blacks Leisure and JJB Sports.

KPMG is an associate member of the British Retail Consortium (BRC) and David works closely with the BRC in a number of areas including the analysis, sponsorship and administration of the BRC-KPMG Retail Sales Monitor.

Outlook for 2015 –
Election uncertainty and margin pressure ahead

As I peer into 2015 I do not see a straight path to growth in the retail world but instead see some significant forks in the road which could determine the outcome of the year.

First up is likely to be the revealing of Tesco's strategy under new leadership and this may determine whether the grocery market is in all out price war, in business model restructuring mode or in brand positioning mode, or likely a combination of each. After two difficult years in the grocery market, the journey forward will be long and arduous but the direction chosen by the market leader, a shift from 'every little helps', is likely to impact the other players.

The next fork in the road is the general election in May. The outcome is by no means certain and many permutations of coalitions are being discussed. Retail is a confidence industry and consumer confidence comes from certainty and disposable income. It is difficult to see certainty in the first half of the year, and so the hope is the election brings stability and then policies which stimulate wage rate inflation. This in turn could then drive growth in the important second half of the year.

Operationally, I see continued margin pressure as internet transparency and consumer behaviour, which waits for a bargain, continue to challenge all but the very strong. This margin pressure, coupled with the need for continued investment, will put more pressure on cash tied up in supply chains and cost control leading to a busy time for procurement personnel. Many retailers have invested heavily during 2014 in systems to link channels and get a single view of stock and customers. Fulfilment, click and collect and returns handling have also been in focus. The investment will not stop there and I see greater focus next year on data and analytics to drive greater personalisation, as well as potentially dynamic pricing models.

2014 brought many new entrants to the stock markets with some struggling to live up to their initial pricing. Others have plans to float in 2015 but it is difficult to see the traditional retailer 'window' in the first half of the year being as open next year with the election on the horizon. Instead, I see the private equity route being the favoured exit strategy in 2015. On the 'bearish' side there will be challenges ahead for the 'zombie' retailers who struggle to meet more than interest payments on their loans if the banks toughen their stance on these. This could clear out some of the under-performers.

With the growth rate anticipated at around 2% for 2015, the winners will take market share and will be those retailers who match brand consistency for their customers with operational excellence across all their chosen channels.



Richard Lowe
Head of Retail and Wholesale, Barclays

Richard Lowe has been a corporate banker for over 30 years, and has provided advisory and specialist banking services to retailers and wholesalers in the UK and Ireland for the past 16 years.

As Head of Retail and Wholesale at Barclays he and his dedicated London team of relationship directors, together with the pan UK & Ireland relationship directors are responsible for thousands of clients ranging from boutique fashion houses and high street booksellers to department stores, all with turnovers in excess of £5m. Additionally, retailers and wholesalers are offered access to the products and expertise of the other businesses in the Barclays Group including the Investment Bank and the Wealth & Investment Services division.

Richard is a regular commentator in the national, regional and trade media on retail trends and industry issues as well as retail sales figures. Away from the office he is an avid reader and when time allows he is also a motor racing enthusiast. He is married with two children and lives in Hertfordshire.

Outlook for 2015 –
the banker's perspective

The challenges facing retailers and their websites during heavy traffic periods, such as Black Friday, have been well-documented in the media. This is also reflected in the fact that we've seen increasing levels of clients approach us for funding to improve IT infrastructure. It's clearly evident that retailers need to have a robust IT platform that will work smoothly across all channels and can withstand spikes in demand.

As part of the IT piece, retailers are also talking to us about finance for building or enhancing existing web and mobile platforms. There has been speculation that Twitter will launch a "Buy Button" next year, following a trial in the US, and this will make "social shopping" even more accessible and retailers are right to take these types of emerging developments seriously.

Retailers are also seeking investment from us to develop their IT systems for their firms' international expansion. It will be challenging for retailers to experience significant growth solely in a UK market, so it stands to reason many are considering branching further afield next year. The online-only route to market is often very popular with retailers, thanks to the relative ease of bolting-on overseas delivery options to existing websites, although a country-specific focus is also critical, with tailored payment and fulfilment options and targeted marketing.

A number of our retail clients are also reviewing their supply chains and where they source their products from. As a result, this may alter their working capital requirements next year depending on where within the global market they will be sourcing from.

Looking more generally at market conditions, retailers are benefiting from improving consumer confidence but it's also clear that consumers want to spend less and buy more, and they don't want to compromise on quality. Retailers will need to hone their value for money propositions to reap the best rewards.



Martin Hayward

Founder, Hayward Strategy and Futures

Martin is the founder of Hayward Strategy and Futures, providing strategic marketing advice to the Loyalty, Retail, Insight, Financial Services, Telecoms, Media and Consumer Goods industries.

An acknowledged thought leader in the future of customer data, insight, loyalty and marketing, Martin was previously Director of Strategy and Futures for dunhumby, at the heart of the development of the innovative use of detailed customer data for marketing and communications. His previous position was as Executive Chairman of The Henley Centre, WPP's leading Strategic Marketing Consultancy.

Prior to joining The Henley Centre, Martin was the founding Managing Director of BBH Futures, the strategic consultancy arm of the Bartle Bogle Hegarty Advertising Group. He was also Head of the Marketing Services Department for Mercury Communications, during which time Mercury was voted Brand of the Year.

Outlook for 2015

As we look towards another challenging year for the retail sector, I am reminded of Charles Dickens' opening line to A Tale of Two Cities ... "It was the best of times it was the worst of times."

In theory, we should be about to enter a golden age of retailing where we know more about our customers than we have ever dreamt was possible, and have more ways to interact with them whenever and wherever they are. New digital technologies are at the heart of these potential benefits.

At its simplest, digital can be broken into two themes, more data and more channels.

More data means that theoretically, and hopefully with the consumer's consent, it will become ever easier for retailers to truly understand their customers in many dimensions. To date, customer data has been rather one dimensional, focussing on what people have bought. Tomorrow, customer data has the potential to be an altogether richer asset, bringing what people have bought together with their movements, location, social circles, media consumption, interests and even purchase intentions.

More channels means that we will have the potential to reach consumers through their various digital devices at any time, any place, anywhere, offering truly seamless multi-channel offerings.

These two together should be heralding a golden age of customer relationships as retailers finally have the ability to both understand their customers' needs in great detail, and the tools to get a targeted message to the right person at the right time in the right way in the right place.

Somehow though, this golden age still seems a little way off. The 'always-on' real-time nature of digital has tended to be adopted as a set of tools to deliver offers and deals which, although better targeted than historically, have accelerated a drift in total marketing spend away from longer-term brand building towards sales promotion activity.

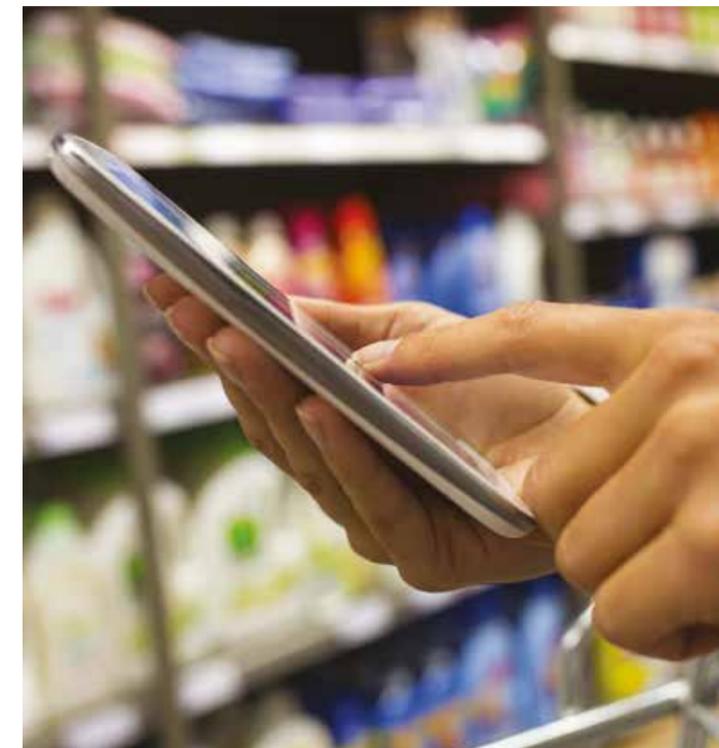
As Campaign magazine in the UK recently stated:

"The "real-time" juggernaut may lead us astray as practitioners towards doing things just because they can be done. And, worse, far worse, that it may accidentally compound the troublesome drift of marketing from an art practised for the longer-term health of a brand and business, to a science lopsidedly focused on the short term"

The proliferation of channels to talk with, and data sources about, consumers (e.g. location based messaging based on mobile signal) are leading to an era of what I refer to as interception marketing where a customer will be pursued throughout a purchase journey with incentives to switch for discounts (e.g. Retargeted advertising that crops up when online, with incentives to purchase items you've been searching for, or location based offers in the high street).

In the face of this short-term, real time world of retailing we are entering, longer term strategy has never been more important. Anyone can bribe a customer to switch in the short-term, but this will not support margins. The real winners of the future will be those retailers that create real relationships with their customers over the longer term, understanding their needs in great detail, deepening engagement that transcends short term price offers. Technology will also lie at the heart of these new relationships, but it must be integrated with physical environments and the human touch to ensure that we use technology to do things for and with our consumers, not to them.

Few are as familiar with the second line of Dickens novel as the first, "...it was the age of wisdom it was the age of foolishness". Let's make sure that we use all of these rich new tools and channels to build brands, better respond to customers and enjoy the real fruits of making business personal, and not to enter into a perilous spiral of price driven suicides.





Nick Bubb
Retail Consultant

Nick Bubb has been a leading retailing analyst for over 30 years. He retired from the City last year, having worked at a number of different stockbroking firms and investment banks (including Morgan Stanley, Société Générale and Arden), but he is still a well-known commentator on UK retailing in the press and works as an independent retailing analyst and consultant.

Nick was rated No 1 in the 'Institutional Investor' magazine 1988 poll of Stores Sector analysts. Nick has been ranked in Retail Week's 'Top 100' list of the most influential people in retailing. Nick graduated from Christ Church, Oxford (MA in Philosophy, Politics and Economics). He is married, with two children, and lives in Richmond in Surrey, where he spends much of his spare time gardening, reading and watching cricket and horse-racing.

Prospects for 2015: VAT's that big cloud on the horizon after the Election?

2015 will be dominated by the General Election on May 7th, but whoever is in power, a rise in VAT looks almost inevitable by the end of the year.

The lines of argument for the Election were set out in the Autumn Statement, with the Coalition promising more "competence" and asking for more time to finish the job and the Opposition warning that the economic recovery is not on course and that big public spending cuts are on the way. The outcome of the Election seems likely at this stage to be messy and inconclusive, which will do little to help consumer confidence.

It is an unfortunate truth that one of the easiest taxes to generate enough revenue to help with the Government deficit is VAT, as in the short term this is simply a tax on retailer's profit margins. The current 20% rate is a little below VAT rates in some parts of Europe, with the 23% VAT rate in Ireland one benchmark to consider.

Another option would be to extend VAT to zero-rated areas like food, but even without that alarming scenario food retailers have plenty of reason to worry about the outlook. 2014 saw the pennies begin to drop for the big supermarket chains, as profound structural changes in the market sent volume into decline and a combination of intense discount competition and good harvests also sent food prices into decline. Things are not expected to get any better in 2015. The beleaguered Tesco is expected to launch a major new price campaign early in the New Year, as it battles with its surplus hypermarket space and the threat of another credit rating downgrade.

The Food Retailers were easily the worst performing sector in the stock market in 2014 and it will be a surprise if they can avoid picking up the wooden spoon in 2015.

The stimulus to the housing market from persistently low interest rates has been better news for the general retailers and the sector performed respectably on the stock market in 2014, despite the drag from Marks & Spencer's continuing problems in clothing. The recent stamp duty changes could lead to a modest pre-Election boomlet in house prices outside London, but it is hard to believe that 2015 will end without an uptrend becoming apparent in interest rates, even if oil prices stay down at their current lowly level. "Big ticket" retailers should enjoy the good news while it lasts.

Fashion retailers bemoan the impact of the warm autumn, but "the weather" in 2014 wasn't always unhelpful and the fashion industry only has itself to blame if it can't adapt to shifting seasonal weather patterns, and can't wean itself off the drug of discounting.



Neil Saunders
Managing Director of Conlumino

Neil is Managing Director of Conlumino, a research agency specialising in retail and consumer research. In this role he heads up client projects working with retail and consumer related companies to help develop, evolve and implement business strategies.

Prior to Conlumino, Neil worked at Verdict for over ten years where, before the company's acquisition, he was a board director with responsibility for Consulting, Corporate Development and Planning. Latterly, he was Consulting Director and responsible for all bespoke and consulting projects.

Before Verdict, Neil worked for the John Lewis Partnership where he was involved, among other things, in the planning and relocation of new stores, the development of the John Lewis website and the creation of technical and information systems. Neil serves as a non-executive director of the train operating company First Great Western and is a Visiting Fellow at the School of Management, University of Surrey.

Outlook for 2015

It would be fair to say that 2014 represented a period of progress for retail. It was the year that growth finally resumed across almost all sectors, including ones like DIY that had been in shrink since the onset of recession in 2008. The question now is will 2015 be the year that builds on this advancement or will it be the year when things slip back? The answer, unfortunately, is not clear-cut.

On the positive side there are a number of economic indicators that look solid and which will allow consumers to ease up spending, if only to a small extent. Disposable income has started to move into positive territory, consumer confidence is generally improving, the housing market is showing signs of increased activity, and unemployment remains low. None of these measures points to a surge in consumer activity, but most indicate that spending should rise still further.

The wildcard economic factor is interest rates. Most consumers expect rates to rise and as many will be affected, it is likely that even a small increase will have a dampening effect on spending growth. That said, it is unlikely that rates will rise until well into 2015 and even then they will only be eased up.

Factor in that some mortgage holders have fixed rates and that others will not be impacted until they have had their mortgage reviews and it is unlikely that any rate increase will have a tangible effect until 2016. As such, the interest rate issue looks relatively benign for 2015.

Interest rates are not the only potential downside; there are a number of negatives most of which are structural issues particular to retail. The first of these is a highly competitive, saturated environment in which a large number of players are vying for a relatively limited pot of consumer spending. Such an environment gives rise to a turbulent trading picture in which many retailers lose out and perform badly. This is not necessarily a new development but it is something that will continue in 2015, even as the economy starts to strengthen.

Of particular note in this regard is the grocery sector where the growth of the discounters will continue to exert enormous pressure on the major multiples. Many of the big players will need to reconfigure their propositions and store estates, and it is likely that the New Year will bring weaker returns across the sector as a whole. Indeed, the grocery sector will be a lacklustre performer across 2015.

One of the responses in a highly competitive environment is to cut prices and to discount. This is something that has been commonplace across most of retail for a number of years. However, 2014 saw a heightened level of activity and this is likely to increase into 2015 as consumers, addicted to the discount drug, demand ever-greater promotions. For some retailers this will prove damaging to margins and profits.

The other area worthy of mention is omnichannel. This will, again, be a bright spot, providing the opportunity of strong growth for retailers. However, the level of investment required to provide a quality operation is high. Retailers need to ensure that this pays off through higher sales. Those that don't will be left with the prospect of a higher cost base with very little to show for it. This is something that, for some, started to happen in 2014. It is likely 2015 will see an acceleration of the trend.

Overall, 2015 will not be a bad year. Retail spending growth will increase by around 3% and many sectors will start to see better times. However, retailers will need to work incredibly hard to translate this growth into cash in their tills and harder still to ensure it is delivered profitably. Ultimately this is a good thing. It should stimulate innovation and ensure business and operating models are sharpened. The price of not doing these things, however, is higher than ever. Retailers that fail to invest appropriately and to make necessary changes run the risk of failure, no matter how big they are or how successful they were in the past.

An economic recovery there may be, but there will be no let-up for retail in 2015.



Martin Newman
CEO – Practicology

Listed on Retail Week's top 50 Retail Power List for the last 4 years, Martin is one of the most influential players in online and multi channel retailing, and judges the PayPal Retail awards in the UK, and the online retail awards of Australia and chairs numerous events including Retail Week's eCommerce summit.

He is also globally renowned as a thought leader in eCommerce and multi channel retail, and he delivers keynotes and best practice presentations around the world as well as being a regular contributor to various industry titles including Retail Week, Power Retail and Drapers.

With over 25 years of multi channel experience, Martin has had responsibility for the P&L and delivering solid growth and profitability for a number of high profile brands and he has owned direct mail, eCommerce, kiosks/instore ordering and call centre channels for a number of brands including Harrods, Burberry, Intersport and Ted Baker.

Now as CEO of Practicology, a leading global strategic eCommerce and multi channel consulting practice, within 4 years of trading, he has grown the business to have 30 full time employees, a profitable 7-figure turnover, a global footprint with offices in London and Australia, as well as clients in the US and EU. He has a list of household name clients including House of Fraser, Waitrose, Ted Baker, Hobbycraft, adidas, Nike, Thomas Pink, National Geographic, Kathmandu and Wilkinson.

Outlook for 2015

The UK will continue its globally dominant role in eCommerce throughout 2015, but there will be threats to even the most successful multichannel retailers.

Cannibalisation of store sales by multichannel/ eCommerce sales will continue, and not all retailers will be able to flex their operating models and cost bases quickly enough to respond to this. More measures to quickly reduce property costs, such as the example of Mamas & Papas this year, are likely.

As a second issue, any slowdown in the economy could damage the multichannel growth plans of established retailers with weaker online propositions.

The increased maturity of the market means retailers cannot rely on double digit online growth each year without continued investment to stay relevant and competitive either on service, price or both.

During 2009, falls in the online sales of retailers Game and HMV foretold bigger problems for those brands down the line. Retailers whose eCommerce sales decline under intense competition next year should be looked on with caution.

International eCommerce sales have powered the online growth of many well-known UK brands during 2014. This trend will continue in 2015, but domestic retailers need to be ready for cross-border eCommerce sales to become more two-way. Many US brands are investing to make their eCommerce propositions to the UK more competitive, as are European retailers such as Zalando. And 2015 could see Chinese eCommerce giants, including Alibaba, throw themselves into the mix.

It's not all bad news though. For both food and non-food retailers there will be positive outcomes for those who can use multichannel services and propositions to deliver convenience to consumers. This may be through apps or devices that allow customers to build their grocery shopping list throughout the week, through new fulfilment options or making it easier for consumers to browse and buy using the touchscreen devices they increasingly use.

In some cases convenience means personalisation, in others it might mean Sunday delivery or same-day click-and-collect services to a station or tube stop. Whatever it amounts to, providing real convenience in 2015 will allow retailers to compete on things other than purely price.



Mike Watkins
Head of Retailer and Business Insight – Nielsen UK

Mike Watkins is Head of Retailer and Business Insight for Nielsen UK and is responsible for commercial development with food, non food and eCommerce retailers. He is also a member of the Nielsen Global Thought Leadership team and a lead contributor to white papers and regularly shares his viewpoints with Nielsen clients and the media.

Before talking on this role he was Senior Manager for Retailer Services at Nielsen with responsibility for strategic planning, and for leading consultancy projects in food retailing in UK and Europe.

Prior to joining Nielsen, Mike worked for a number of Co-operative retailers with management positions within buying, marketing and merchandising, having graduated from Loughborough University with a Politics and Economics degree. Away from business, he is a keen F1 fan and is married with one daughter and lives in Northamptonshire.

Outlook for 2015

We can reflect upon 2014 as being a year when the 'once in a generation' structural change that had been building for some years, was finally recognised by the supermarket industry. It was also a year when many non-food retailers adapted business models in order to future-proof their customer offer in the fast changing digital world. So what's next in 2015 for food retailing? Well, expect more of the same.

An uncertain economic environment

Consumer confidence may have recovered to pre economic crisis (2008) levels and economic growth has improved, but this is no guarantee that consumer income will grow fast enough to mitigate the effects of the ongoing Coalition debt reduction programme. Food retail is no longer immune from the vagaries of discretionary spend.

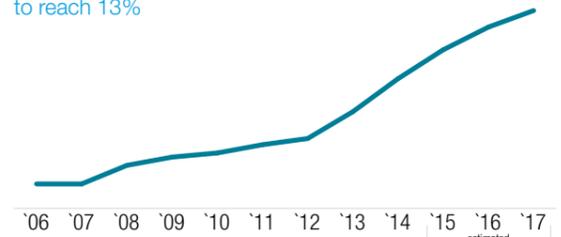
Supermarket shopping behaviour has changed irreversibly

Savvy shopping (where consumers make buying decisions based on knowledgeable trade-offs, shopping around, and offering but not always giving loyalty to any retailer) is here to stay and there will be no turning back. Deflation is going to be a big concern for at least the first part of the year and will keep many CEOs awake at night. FMCG volume growths will enter a third year of decline.

Private label will once more be a safe haven for shoppers and a suitable disruption for some retailers, as it accounts for over 50% of all food and drink spend in the UK and continues to grow ahead of brands in premium foods (source: Nielsen).

Next year, shoppers will still expect a continuation of promotions as well as demanding lower prices from the TOP 4 Supermarkets, who will duly oblige in order to try and stop the growth of Discounters (Aldi and Lidl), where market share of FMCG will increase to 11%.

Nielsen expects discounter FMCG market share to reach 13%



Source: Nielsen Homescan (Aldi and Lidl). Includes Kwik Save until 2006 and Netto until 2011.

No escalation of the Price War

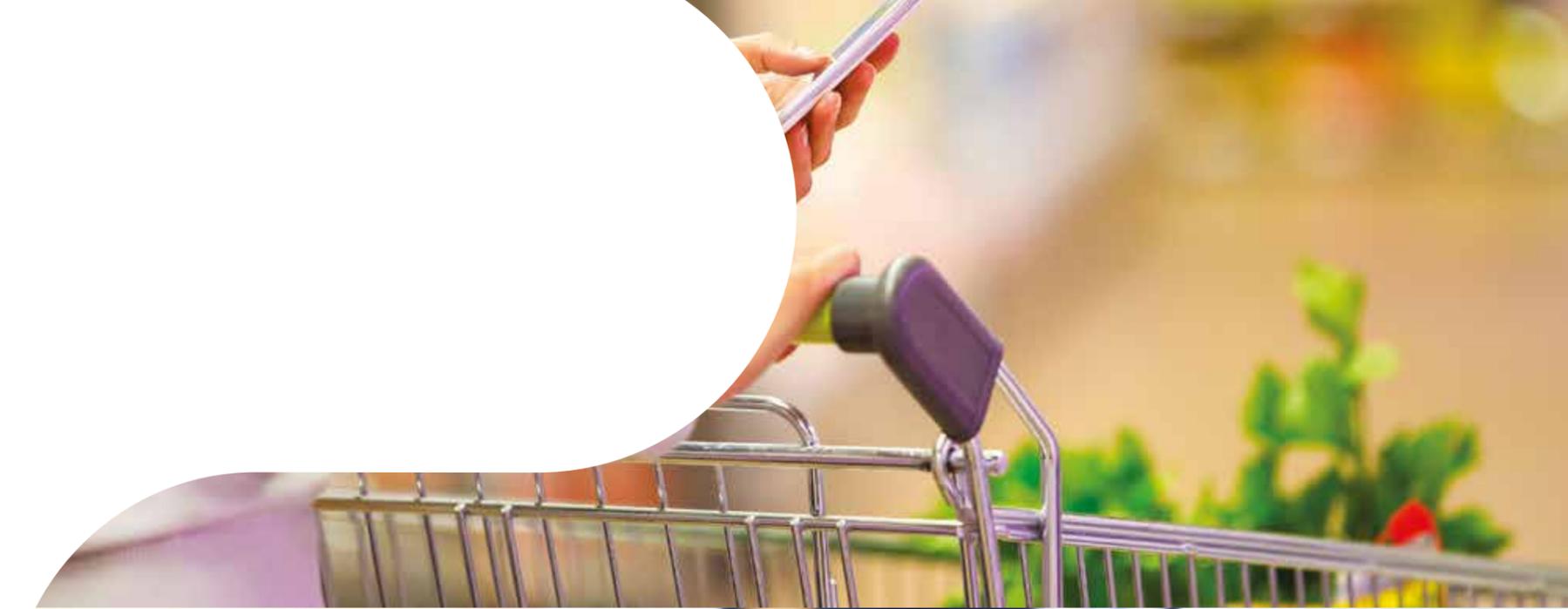
A full blown price war is possible but unlikely. Tesco with 28% of the market and the most to lose (as well as gain), will have to reposition and simplify 'price' but the overall modernisation of the Tesco UK business will include much more than changes to price architecture, and will probably take at least 3 years.

Nielsen does however expect to see a new Supermarket battle, which is for values as well as value and for the hearts as well as the wallets of consumers. Inspirational advertising and meaningful communication are possible game changers as we have seen in recent years with the evolving strategies of Waitrose, Sainsbury, Aldi and Lidl.

Shopper will be the biggest winners

With the macroeconomic environment shaping demand and channel shift and digital disloyalty impacting operating margins, working harder just to stand still could be a reasonable tactic. Retailers will still need to find new ways to differentiate that is not just around price reductions and 2015 could be year to try something different.

white
papers



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the future of the grocery sector in the UK



Part I

- price wars are a “race to the bottom” and could deter future investors
- shift to convenience store shopping has been driven by retailers – not consumers
 - but convenience stores sales are now so significant they risk rendering hypermarkets obsolete in their current form
- ‘drive through’ supermarkets and free doorstep delivery would offer consumers the ultimate in convenience and choice

Introduction

The UK's grocery sector is one of the most competitive and cutthroat in retail. It also risks being one of the unhealthiest, with demand flat lining and over capacity eroding the big players' profitability. Against this backdrop of multi million pound price wars and investor concern, the KPMG/Ipsos Retail Think Tank (the RTT) met in April to discuss what may play out in the future.

The price war is damaging the sector and putting off potential investors

The price war between the grocers has been well trailed in the press, with Morrisons announcing in May that the average price of their everyday essentials will fall by 17%.

The RTT believes that the price war between the major grocers may offer some short term gains for consumers, but it won't deliver the shift the average shopper actually wants in terms of service levels and convenience. The latest discounting also fails to give the big four grocers a competitive edge over the discounters, who offer low prices all year round. Indeed, it could play into their hands as consumers may not trust a spate of lower prices than offered yesterday.

The RTT warns that the price war could damage the sector's prospects for attracting investment in the future. Nick Bubb, Retail Consultant, said: **"The big UK supermarkets have been dismal investments on the stockmarket for some time now and share prices remain under pressure, despite the attractive dividend yields now available on Tesco, Morrisons and Sainsbury's. Equity investors are clearly worried about the impact of declining industry sales volumes and declining gross margins on near-term profitability."**

Tim Denison, Director of Retail Intelligence at Ipsos, added: **"The immediate threat to three of the big four is their potential inability to invest in the changes needed to move with the marketplace. With profit levels falling, the declared price cutting schemes and low volume sales, these grocers are becoming less attractive to investors, witnessed by the £2.8 billion wiped off their market value amidst fears of full-blown price wars. Retailers need to compete on their own strengths, not those of their competitors. The promise to consumers of lower prices will prove to be nothing more than a race to the bottom of the premier league."**

What impact are the discounters really having on the UK's grocery sector?

The rise of the discount grocers has been heavily analysed, with some commentators portraying them as playing a leading role in reshaping the grocery sector, tempting cash conscious consumers away from the established brands of the British market.

However, while there is no doubt these discount brands have eroded the edges of the big four's market share and continue to do so, the RTT questioned how significant their effect has really been. Despite recessionary-induced changes in shopping behaviour, the RTT believes it is difficult to see the big four's hold on the main grocery market being seriously challenged, simply because of their commanding (75%+) store network market penetration – a market share which has existed for almost ten years.

Mark Teale, Head of Retail Research at CBRE, said: **"Kantar Worldpanel figures do indeed show Aldi and Lidl gaining market share while both Tesco and Morrisons have sustained significant market share losses."** But the Kantar figures also show that the cumulative market share of the big four (Tesco, Sainsbury's, Asda and Morrisons) has changed little since 2008 with the market share losses of Tesco and Morrisons largely offset by gains achieved by Sainsbury's. Waitrose has also gained. Whatever switching is occurring, it is happening at both ends of the value spectrum (quality and discount).

"Tesco and Morrisons are suffering because they are caught in the squeezed middle; discounters (not just Aldi and Lidl) are chipping away from below and Sainsbury's, Waitrose et al are digging down from above, albeit post-Christmas figures suggest Sainsbury's is now beginning to suffer too. The underlying problem ultimately is the continuing household income squeeze. And the danger that the new-found consumer parsimony will become a permanent feature of the market even if economic growth is sustained."



Changing consumer behaviour

The RTT believes that the real danger to the grocers is the steady decline of the weekly shop, which could render out of town hypermarkets, a significant chunk of retailers' real estate operations, obsolete.

Nick Bubb said: **"The way we buy our groceries has changed, with many consumers favouring a bulk online order for key staples and supplementing this with visits to convenience stores during the week for fresh goods. This has shifted the emphasis away from hypermarkets and spells trouble for the mainstream grocers."**

These changes in our shopping habits mean that the grocers' property portfolios risk becoming no longer fit for purpose, as consumer trends outpace their long term development plans.

"Grocers need to question how much space they need to keep pace with online growth," said Richard Lowe, Head of Retail and Wholesale at Barclays. **"If more consumers switch from visiting bricks and mortar stores to the virtual world, grocers must consider how fast or slow this rate of growth is when planning their expansion strategies."**

As convenience stores and online shopping continue to grow, the question grocers will be asking is what do they do with the footprint they have in the larger stores."

David McCorquodale, Head of Retail at KPMG added: **"Many large stores could be refitted to become click and collect or home delivery hubs. This could prompt the rise of 'drive through shopping', the ultimate choice for the time constrained consumer."**

"However, it's not as simple as moving some shelves around and re-designating use. Omni-channel grocery can dilute margins if not done effectively. It is a service enhancement for the consumer, but won't necessarily benefit the retailer unless the consumers using the service buy more than those just choosing to shop in store."

The RTT believes that the shift to convenience shopping has been driven by the industry itself, rather than consumer demand, after grocers opted to open smaller high street sites to quickly gain a foothold in towns where they were underrepresented. Consumers have embraced convenience stores and 'top up shopping' so enthusiastically that the grocers have seen sales in their large format stores decline, cannibalised by smaller stores on the high street.

Yet despite these headwinds, expansion continues unabated. The big four supermarkets have full development pipelines, backed by eager property investors, who view grocery stores as almost rock solid investments. Nick Bubb said: "Property investors seem very relaxed about long-term prospects, as rental yields remain quite firm, implying that there is no doubt about the future cash flows from well-located supermarkets and their ability to pay market rents."

But is this untrammelled expansion sensible? Neil Saunders, Managing Director of Conlumino, warned: **"In the future it is unlikely that demand will pick up in any meaningful way. It is also unlikely that capacity will moderate or decline. Although from a sector point of view it makes little sense to bring on more space, from an individual retailer point of view it is eminently logical to expand and grow in areas where a chain is underrepresented. What this means is that the long-term financials of the sector are and will remain less healthy than they were ten years ago. This is an economic shift in the model of the industry."**

What's next for the sector?

The modern consumer wants a cheap, ideally free, online shopping service, with long sell-by dates and no substitutions. This is the golden chalice of grocery, but the cost of delivery is a major barrier to grocers and consumers. Whether grocers with significant property estates will ever strive to provide this level of service is debateable. However, the RTT believes consumers may embrace 'drive through' shopping, where consumers can quickly pick up their preordered shopping at a location convenient to them.

James Knightley, senior UK economist at ING, said: **"The cost of home delivery still puts many potential consumers off along with worries about the products selected by the packers. Greater emphasis on quality may help, but for higher value meat/fish products we could see individual photos or more specific information to allow customers to get better choice."**

However, the economic reality is that it's not in the interests of the big four to move quicker towards online sales and home delivery, irrespective of whether the demand is there. The costs of the online sales and homes delivery model remain fiercely prohibitive.

The arrival of the online rival

The RTT believes that price alone or a competitive environment will not reshape the grocery sector whilst all the players keep using similar formats. Instead, a new entrant could change the balance. This could take the form of a new online only retailer like Amazon entering the fray, or price comparison websites playing a greater role in the market. It is inevitable that this change will be greatly accelerated if a big grocer fails. This would leave room for new market entrants to come in and offer consumers something different.

“It’s possible we could see third party companies like price comparison websites providing services to pick products from different grocers to guarantee the cheapest weekly shop,” said James Knightley of ING. **“As a result, we may see grocers focus more on their own branded products, which are more difficult to compare.”**

“Such third party organisations could boost opportunities for smaller retailers offering locally sourced food or ethically produced items. Conceivably, we could see the manufacturer of the product or the farmer sell through Amazon, further diminishing the need for a traditional supermarket. All in all, advancing technology will offer greater choice for customers, but present huge challenges for the established sector leaders.”

David McCorquodale of KPMG added: **“We may see the demise or disappearance of one of the majors over the coming years but, unless there’s a change in approach, I would expect them to be quickly replaced by new entrants with ambitious expansion plans. We could end up with a Big Six or Seven occupying the market with more evenly spread market shares. However, if there is a seismic shift, caused by a new online player or a market failure, then brand will become the decider in this battle.”**

Tim Denison of Ipsos said: **“The competitive advantage Amazon has is that they know a lot more about their customers than the traditional grocers. If they can find the right local partner and target just the top 5% of customers in the UK who could deliver the majority of their sales, then this could be a game changer. Despite the wide spread use of patronage and loyalty cards by consumers, supermarkets have failed to reap the benefits of the data and insight these offer to them.”**

Conclusions: the discounters aren't the slayer of the big four

New market entrants and changing consumer buying habits have left the UK grocery market in a state of flux, and the RTT warns that the majority need to reconsider their long term strategy and assess if it is still fit for purpose.

The rising popularity of buying staple goods online and topping up at the nearest convenience store risks rendering the average out of town hypermarket obsolete in its current form, and these need to be reconfigured to reflect the rise of click and collect and the falling sales of non food items.

The discounters aren't the slayer of the big four, but they have piqued the interest of a UK consumer bored with the middle ground brands and keen to make their money go further, whilst buying food and products they can enjoy.

However, the current status quo would only be at risk if one of the big four were to disappear: in order to gain significant market share the discounters will require a stratospheric store opening programme or the failure of a competitor. The RTT believes the answer to securing sales doesn't lie on a price tag, but in strong product ranges tailored to the local market's tastes alongside delivery options, charges and times to suit the consumer. If a grocer can work out how to offer free home delivery, with no substitutions, products with a long shelf life and exact delivery times then they will pull ahead of the pack.

If a well-financed player can find the right supply chain model and partner in the UK to deliver its online grocery model service then this could be a pivotal moment in the history of UK grocery, and completely change the face of UK retail.

Either way, the old blueprint for a UK grocer is out of date and radical investment in store infrastructure, online delivery and click and collect is urgently needed if the grocery sector is to deliver the service the modern consumer demands.

Part II: In detail – Individual views of the RTT members

Richard Lowe, Head of Retail and Wholesale at Barclays

The grocery market in the UK remains a highly competitive landscape, with food inflation and price wars adding on-going pressure. Whilst challenges persist, growth does continue and we've seen a significant rise in trading square footage as grocers increase their retail store footprint both in terms of additional convenience stores and online capacity.

This expansion drive is a trend we'll likely see continue, but in a slightly different guise. The space race isn't over; grocers will carry on increasing the space they have but they won't look for the large supermarket formats. The focus will be on convenience stores – it's the c-stores they want.

This is largely being driven by a change in consumer shopping habits. People are shopping with greater frequency, choosing to "top up" shop in addition to the weekly visit to the supermarket or online shopping. Therefore as grocers look to cater for changing consumer needs we'll in turn see an increase in their c-store footprint.

This convenience approach to shopping is also influencing online growth. All the major grocers have now embraced the need to have an online offering, with the last of these being the Morrisons/Ocado collaboration. This does bring about however a challenge to the grocers as to how much space they need to keep pace with online growth. If more consumers switch from visiting bricks and mortar stores to the virtual world, grocers have to consider how fast or slow this rate of growth is when planning their expansion strategies. As c-stores and online shopping continue to grow, the question grocers will be asking is what they do with the footprint they have in the larger stores.

Value will also continue to play a significant part in the future of grocery. Whilst there is segmentation in the market around price points and offering within the good, better, best architecture, the value players are growing significantly. They certainly present a very real and current challenge, which can be seen from the significant growth they've had over recent years, and I predict we'll see these particular grocers take greater market share as their growth trajectory continues.

Mark Teale, Head of Retail Research, CBRE

Two to three years ago it was High Street administrations and vacancy proliferation that dominated the headlines. Over the last year or so attention has turned to the grocery sector. A lot of column inches have been devoted to the disappointing trading performance of Tesco and Morrisons in particular, with the finger commonly pointed at Aldi and Lidl. Hard-pressed consumers, so the story goes, are swapping allegiance to Aldi and Lidl because they are cheaper.

Kantar Worldpanel figures do indeed show Aldi and Lidl gaining market share while both Tesco and Morrisons have sustained significant market share losses. But the Kantar figures also show that the cumulative market share of the big four (Tesco, Sainsbury's, Asda and Morrisons) has changed little since 2008 with the market share losses of Tesco and Morrisons offset by gains achieved by Sainsbury's. Waitrose has also gained. Whatever switching is occurring, it is happening at both ends of the value spectrum (quality and discount).

Tesco and Morrisons are suffering because they are caught in the squeezed middle; discounters (not just Aldi and Lidl) are chipping away from below and Sainsbury's, Waitrose et al digging down from above, albeit post-Christmas figures suggest Sainsbury's is now beginning to suffer too. The underlying problem ultimately is the continuing household income squeeze. Economic growth might well be strengthening but there is little evidence of cost pressures easing for households.

It was feared, following the onset of 2008 downturn that if the income squeeze lasted indefinitely – as effectively it has – frugality would become so ingrained that it would become a permanent feature of consumer behaviour. Survey results from FIM suggest that this is occurring in the US with over 70% of households reporting that they intend living on less in the future. The same is clearly happening in the UK too. Internet price comparison is accelerating the process. A sustained surge in prosperity might, in time, undermine the new-found thriftiness (albeit evidence from Japan suggests that it might not), but there appears little likelihood at the moment of the downward pressures on grocery price easing in the medium term. Market share battles look set to intensify as a result.

Grocery market share remains a function of branch network penetration. Tesco has by far the biggest market share (circa 29%) because it has the largest main grocery network. Because of that it also has by far the largest click and collect platform (and reportedly circa 50% of online grocery sales). Tesco is meanwhile rapidly growing its convenience store portfolio, chipping-away at market shares on the convenience side. So are Sainsbury's and Morrisons. Whatever the recessionary-induced changes in shopping behaviour (including trade diversion to discounters and shopping frequency/spend reductions) it is difficult to see the big four's hold on main grocery market share being seriously challenged, simply because of their commanding (75%+) network market penetration. The performance wobble is another issue. The big four are having difficulty adapting to the new pricing realities. Unhappily for investors, it does now look as though the sector is in for protracted price wars. Factor in the margin dilution caused by multi-channel investment (the bulk of it invested by the big four) and things look set to remain 'challenging' for grocery majors.



James Knightley, Senior UK Economist, ING

Two big trends in recent years have been online shopping and greater competition for the big four from the likes of Aldi and Lidl. In terms of the latter, it will be interesting to see whether consumers stick with these "discounters" or choose "quality" as real incomes start to rise and consumer confidence improves.

As for the former, the cost of home delivery still puts many potential consumers off along with worries about the products selected by the packers. Greater emphasis on quality may help, but for higher value meat/fish products we could see individual photos or more specific information to allow customers to get better choice.

For those not willing to pay the delivery costs there is click and collect, with the option of not even leaving your vehicle. We could also see a wider range of collection points such as lockers at petrol stations, giving customers more options.

With supermarkets gradually turning into local distribution warehouses and with more options on collection points, it could mean many supermarket sites are no longer needed. This could free up large amounts of land that could be used for residential property, which would be particularly helpful in the likes of London.

Another avenue is price comparison sites. Could we see third party companies providing services to pick products from different grocers to guarantee the cheapest weekly shop? As a result, we may see grocers focus more on their own branded products, which are more difficult to compare.

Already we see the likes of Amazon breaking into the US grocery market with Amazon fresh. Such third party organisations could boost opportunities for smaller retailers offering locally sourced food or ethically produced items. Conceivably, we could see the manufacturer of the product or the farmer sell through Amazon, further diminishing the need for a traditional supermarket. The move towards convenience stores may also be brought into question should Amazon's dream of drone delivery come to fruition. All in all, advancing technology will offer greater choice for customers, but present huge challenges for the established sector leaders.



Dr Tim Denison, Director of Retail Intelligence, Ipsos Retail Performance

The RTT has referred to the structural changes underway in retailing on more than one occasion in past white papers and grocery retailers are just as exposed to the shifting sands as others. Tesco's stealthy land bank strategy was considered a stroke of genius at the time, if a little underhand, making provision for its unstoppable expansion into every neighbourhood across the land. Big box was unquestionably the format for success and the way to go. Who would have foreseen that in less than a decade, Britain's number one retailer would be caught flat-footed, failing to sell sufficient merchandise through its Extra stores and needing to embark on a re-engineering/re-invention programme to turn these mega-stores into mini-high streets under one roof? Who could have predicted the re-emergence of convenience as a popular format or the irrepressible advance of on-line food shopping?

Retailing is a complex business, moving at an unprecedented speed. The recipe for today's success will become the left-over scrapings on the plate tomorrow. The immediate threat to three of the big four is their potential inability to invest in the changes needed to move with the marketplace. With profit levels falling, the declared price cutting schemes and low volume sales, these grocers are becoming less attractive to investors, witnessed by the £2.8 billion wiped off their market value amidst fears of full-blown price wars.

Retailers need to compete on their own strengths, not those of their competitors. The promise to consumers of lower prices will prove to be nothing more than a race to the bottom of the premier league.

The two key battlegrounds for grocery retailers to advance their causes lie around logistics and patronage. There is nothing more frustrating than when items on the shopping list are absent from the store shelf, or when substitutes have been made to home deliveries which are not perceived as like-for-like. Creating an engine room that delivers better and more efficient fulfilment is something one immediately associates with Amazon, so it will be interesting to see how the Amazon Fresh trials go.

Most important of all though remains, and always will remain, the ability to understand one's customers and act on their needs. All too quickly and easily customers vote with their feet, if they begin to feel disenchanting and ignored. Some retailers have been quicker to react than others at embracing the community power of social networking to tune in and respond to today's messages. The trick is in knowing to whom to listen and how quickly one can act. In a recent talk Sir Charlie Mayfield shared the fact that 50% of John Lewis and Waitrose sales are made by 5% of its customers, however, the composition of those 5% are different every year. Therein lies the real challenge of grocery retailing, past, present and future.



David McCorquodale, Head of Retail, KPMG

The key themes in the grocery sector are format, capacity, innovation and internationalisation.

In twenty years time will 'millennials' really drive their offspring to a 'shed', push a trolley up and down aisles for an hour or so and pick items off shelves filled to capacity? Time will be too precious and grocers will have perfected delivery to a location of choice. The last two decades have been focussed on a dash for growth, but little evidence has emerged to demonstrate that national coverage from a big store network will actually meet the future consumer's demands. By 2034, the now popular convenience store may have become dated but the large format shed almost certainly will have – people won't want to combine their entertainment time with their 'weekly shop'.

In a market which, in total, is already operating at over capacity, it would be quite normal for the sector to consolidate into three or four giants with clear brands – notice the tobacco, beer and soft drinks industries. However, in the grocery sector in the UK we have flat to negative growth in volume terms, more than enough retail space devoted to grocery and yet still have new entrants, all with ambitious individual growth plans across a number of formats.

This cannot be sustainable. We may see the demise or disappearance of one of the majors over the coming years but could end up with a Big Six or Seven occupying the market with more evenly spread market shares. These players will have a clear brand proposition and physical retail space operated may be less of a determinant of market share.

Fierce competition drives innovation and we're already seeing that in terms of offering, price promotion and customer service. This will increase as the grocers invest more in technology and supply chain than in property: all of which will be good news for the consumer.

International expansion is more challenging in grocery – the supply of fresh produce – than in any other sector because of the short supply chains and local tastes. This makes international expansion all the more risky. Yet, some of the new entrants to the UK grocery market are international players and, as they take market share from our grocers, the demand for growth from investors will put pressure on our grocers to either drive new verticals or expand overseas. Foreign shores can provide a new stimulus for growth but investors ought to be prepared for higher costs and lower profitability as the price of growth.

Nick Bubb, Retail Consultant

The big UK supermarkets have been dismal investments on the stockmarket for some time now and share prices remain under pressure, despite the attractive dividend yields now available on Tesco, Morrisons and Sainsbury's. Equity investors are clearly worried about the impact of declining industry sales volumes and declining gross margins on near-term profitability.

And yet property investors seem very relaxed about long-term prospects, as rental yields remain quite firm, implying that there is no doubt about the future cash flows from well-located supermarkets and their ability to pay market rents.

This apparent disconnect may simply be a difference of timescale, but, although nobody thinks that Tesco will go bust, everybody probably agrees that Tesco's UK operating profit margins are heading downwards.

Behind the problems of the big supermarkets is an increasing change in the way we shop for groceries. Time-poor consumers can now avoid the chore of supermarket shopping by getting most of their groceries delivered to their door for only a modest extra fee, via online ordering, whilst a plethora of well-located and well-ranged convenience stores now offer plenty of opportunities for easy top up shopping.

More affluent consumers can certainly access the Marks & Spencer fresh food range in more and more convenient locations, but the extraordinary growth of the grocery discounters, Aldi and Lidl, as well as the cheap confectionery and toiletries now easily available in "pound stores" and other discount chains, make it increasingly possible for the canny shopper to make big savings in their weekly grocery spending.

The joint success of premium retailers like Waitrose and Marks & Spencer, as well as the discounters like Aldi and Lidl certainly shows that the grocery market is polarising, but the steady decline of "the weekly shop" spells trouble for the mainstream supermarkets.

A few years ago an increasing presence in Non-Food looked to be the answer for supermarkets, but the growth of Amazon and the renaissance of Argos, as well as the decline of the physical market for entertainment products, has meant that there are no easy pickings here anymore either, so the day of the big hypermarket looks to be over.

Morrisons' CEO Dalton Philips was surely right when he said in March 2012 that General Merchandise is not going to be about "big box" retailing but about goods being delivered in a "cardboard box". But this will be of little comfort to investors watching Morrison's efforts to catch up lost ground in the key growth areas of online grocery and convenience stores, while the discounters eat more and more of Morrisons' lunch in their Northern heartlands.

Morrisons has tried to mollify shareholders by slashing its capital expenditure to cut its financial gearing, but the stockmarket is worried about its operational gearing, via the much-vaunted vertical integration of its fresh food supply chain. As its market share continues to fall, what once seemed like a competitive edge may turn out to be a millstone around Morrisons' neck, as it struggles to keep its head above the water in the increasingly choppy seas of grocery retailing.



Neil Saunders, Managing Director of Conlumino

It was not all that long ago when the grocery industry used to be accused of being an oligopoly. That charge could not be made today! If anything the grocery industry, despite the limited number of players, is one of the most competitive and cutthroat in retail.

This arises from a situation where, relative to a very flat demand environment, there is a high and increasing amount of capacity. The numbers from the industry demonstrate this fact: every winner in the market creates a loser; like-for-like sales are flat or falling across the sector; and, profitability is being steadily eroded. These are the classic symptoms of a saturated and mature market.

Yet is this all such a bad thing? From the point of view of the consumer it probably isn't. Competition is driving down prices, it is forcing retailers to up the service they provide, and it is making them create more attractive and interesting store environments. These are all positive and healthy outcomes. However, in order to balance the books they must also be met with efficiency gains at the back end of the operation; something that will be hard to achieve given the leanness of the industry.

Going forward, it is unlikely that demand will pick up in any meaningful way. It is also unlikely that capacity will moderate or decline. Although from a sector point of view it makes little sense to bring on more space, from an individual retailer point of view it is eminently logical to expand and grow in areas where a chain is underrepresented. What this means is that the long-term financials of the sector are and will remain less healthy than they were ten years ago. This is an economic shift in the model of the industry.

The other issue, of course, is that of online. In grocery online is critical in terms of securing sales. However, due to logistical complexities and the low margins involved it is far less good at delivering profits. Again, over the medium term this has a corrosive effect on profits.

There are also a few wildcards on the horizon that could shake things up further. Amazon is one. It has a long held ambition to be big in grocery but has never managed to quite make it work. What if it did? What if it bought, say, Ocado? While not necessarily the stuff of nightmares, the prospect should give the big grocers cause for contemplation.

The bottom line is that over the next ten years the big players are going to have to work increasingly hard just to stand still.





2

rise in interest rates could affect consumer spending if implemented in 2014

warns KPMG/Ipsos Retail Think Tank

Part I:

- a rate rise is expected, but its timing is critical
- a 0.5% increase in the Bank Rate would increase the average consumer's annual mortgage payment by £317

A rise in interest rates could affect consumer spending and the retail sector if introduced within the next six months, warns the KPMG/Ipsos Retail Think Tank.

The Retail Think Tank believes that public confidence in the economy needs to rise significantly before interest rates are increased, or concerned consumers could reduce their spending. This warning follows the latest retail sales data published by the BRC and KPMG, which revealed that consumers have already begun to cut back on big ticket items like furniture, in anticipation of an interest rate rise.

Neil Saunders, Managing Director of Conlumino, said: **“The economy is getting stronger, but sentiment is lagging behind. People are worried about the timing and ferocity of a potential rise in interest rates. We are already seeing sales of some items decline as people formulate a contingency plan in case rates do go up this year.”**

Nick Bubb, Retail Consultant, said: **“For some consumers, who have relied on there not being an increase in rates before the Election next year, the first rise will come as a shock. And a rise in November will not be obviously helpful to uninhibited consumer spending at Xmas.”**

Unless wage growth picks up significantly and consumer confidence builds, the Retail Think Tank believes that a rise in interest rates this year could impact the retail recovery.

“The foundations of confidence just aren’t there yet across many parts of the country,” said David McCorquodale, Head of Retail at KPMG. **“If the rate rise comes at a time when the average UK consumer is not ready for it, then it could be damaging to the retail sector. But if rates rise just as the economy begins to purr then it won’t hurt retailers as much, because other factors such as wage inflation will offset the rise both financially and emotionally.”**

The Retail Think Tank believes the way in which the increase in rates is communicated will play a fundamental role in building or destroying consumer confidence. The long term benefits of the rise need to be sold to consumers, so it does not appear merely punitive and consumers also need to be persuaded that any rise is likely to be a small manageable increase, rather than a sudden hike.

James Knightley, Senior UK Economist at ING, said: **“By implementing small rises to dampen inflation the Bank of England hopes to slowly readjust the economy and avoid storing up problems in the long run. This is a positive strategy for consumers, but the message is getting lost in translation.”**

“Consumers shouldn’t be fearful of a sudden dramatic rise in interest rates: it’s unlikely to happen. Wage growth is also on their side. If pay packets rise by 3 to 4 percent then this will make a moderate rise in interest rates affordable for the majority of households.”

“In fact the psychological impact of a rate rise is likely to be more powerful than reality itself,” added

Tim Denison, Director of Retail Intelligence at Ipsos Retail Performance.



“There is also the misconception that an interest rate rise will hit consumers immediately, and this is creating significant anxiety,” said Richard Lowe, Head of Retail and Wholesale at Barclays. **“However, many people are on fixed rate mortgages for a set term, so if rates rise they will have time to prepare.”**

The Bank of England has also introduced other measures to tackle the UK’s purported property boom, which many believe to be mainly South East and London centric, thus reducing the likelihood that it will just use an interest rates rise to control prices.

Mark Teale, Head of Retail Research at CBRE, said: **“The decision of the Bank’s Financial Policy Committee to ration purportedly ‘risky’ mortgages, rather than use a national interest rate hike as a sledge hammer to stem house price inflation in inner London, has headed-off the immediate risk of a knock-on nationwide consumer spending downturn. The bank has other weapons in its arsenal to control house prices, such as the new affordability tests, which should control mortgage indebtedness.”**

The rise also won’t affect all of the population. Martin Hayward, Founder of Hayward Strategy and Futures, said: **“The almost obsessive commentary about house prices and mortgage rates does tend to obscure the reality that in the UK there are more net savers than borrowers. Recent data suggests that only about a third of the population have property debt yet their voices have consistently drowned out those who don’t.”**

Rise in rates will benefit the discounters...

However, a rise in rates will mean that some consumers will see their discretionary income fall, as higher rates push up debt servicing costs, leaving them with less to spend.

James Knightley of ING said: **“For some households, higher interest rates will push up debt servicing costs, leaving less income to spend on goods and services. For others it will make saving look a more attractive option.”**

“The most recent set of numbers published by the Office for National Statistics show that the median size of an outstanding mortgage is £84,000. Assuming that mortgage was originally £100,000 then every 0.5% increase in Bank Rate would increase the annual mortgage payment by £317 – equivalent to 1.6% of the after tax income of a typical British worker. With many households already being squeezed by the fact pay has not kept pace with the cost of living for over five years, those that are exposed will see their spending power dented.”

Tim Denison of Ipsos added: **“Consumers will be affected unequally and in different ways. There is a risk that the nation will become more polarised and economically divided. Those most affected will be households with existing debts, where even a modest rate rise would hurt their spending power and trigger rent or mortgage arrears.”**

Those least equipped to deal with the effects of a rise will be the generation of home-makers who have never experienced a higher cost of borrowing. The ageing population, though, will help counter reduced demand from the disadvantaged. New pensioners will find themselves especially welcome as favoured customers, following annuity rate rises.”

Some retailers will benefit from a rise in interest rates. The Retail Think Tank believes that the rise will cement the shift to value and discount retailers, especially in the grocery sector where price often determines where consumers decide to spend.

Richard Lowe of Barclays said: **“Value retailers will benefit from a rise in rates, as people will inevitably look at their expenditure more carefully, especially those younger consumers who have mortgages and are feeling the pinch. Aldi and Lidl’s store roll out programme will also extend their geographical reach and will mean that more people are able to shop with them.”**

“In general, retailers might want to look more closely at their value for money proposition and promotional activity to ensure single digit growth this year and beyond.”

...and is unlikely to trigger a wave of insolvencies

The Retail Think Tank does not believe that the rise in interest rates will cause a raft of retail failures. Most retailers have paid down debt over the last five years and lending levels have fallen to more reasonable levels.

David McCorquodale of KPMG said: **“Many retailers pre-recession had high levels of debt, partly to support private equity funding structures. Most have managed their debts down to serviceable levels but an increase in the borrowing costs for those retailers will put additional strain on their operating models – the same can be said for their suppliers. I do not predict a deluge of administrations but, perversely, growth can have its own strains, especially around working capital and retailers will wish to ensure that they and their suppliers are able to navigate their way to recovery. Many retailers are exploring supply chain finance to support their suppliers through this change. An increase in interest rates will be felt at this interface.”**

Conclusions:

How will demographic trends in the UK affect the retail sector?

The low interest rate policy has inflated the amount of discretionary income consumers had at a time when real disposable income growth has largely been negative. This provided a shot in the arm in terms of spending, but as the economy grows this unusual period must come to an end.

However, the Retail Think Tank believes that the right conditions must be in place before rates go up, to ensure the impact of the rise won’t do serious damage in the long term. Any move this year, when consumer confidence is still precarious, could potentially damage consumer spending and hurt the retail sector.

Mark Teale of CBRE concluded: **“If the interest rates increases occur, as seems likely, before sustained economic growth has fed through into significant wage inflation, consumer spending growth can only remain sluggish.”**



In detail – Individual views of the KPMG/Ipsos Retail Think Tank members



Richard Lowe, Head of Retail and Wholesale, Barclays

When I look back over the past 12 months, it's certainly been eventful. The UK economy has picked up, the housing market has been resuscitated, new car sales continue to climb and unemployment has dropped. Media reports have even suggested that the British economy is likely to be the strongest growing of the G7 economies this year.

All reasons to be cheerful, however, the question of an imminent interest rate rise is playing on retailers' minds. The rumoured timing of such a move has shifted from 2016 or beyond, to 2015, to later this year. At the end of 2013, nearly a third (32%) of UK retailers surveyed by Barclays thought that a rate hike would happen in 2015, while 16% thought it would be 2017 or later. Nearly a quarter (24%) said they didn't know, which serves to highlight the level of uncertainty that has, and continues to surround the thorny topic.

While a rate hike would be good news for savers, those with mortgages, loans and credit cards may feel the squeeze. Centre for Economics and Business research for Barclays from earlier this year revealed that a series of moderate rises, taking the rate to 1.25% by December 2015, would result in an increase of £21 in monthly mortgage payments, as a UK average. However, the more "drastic" model, which saw five increases in the Base Rate, to 1.75% by December 2015, would see monthly payments increase by £48 per month.

Value retailers will benefit from any change, as people will inevitably look at their expenditure more carefully in the event of a rate rise. In general, retailers might want to look more closely at their value for money proposition and promotional activity to ensure single digit growth this year and beyond.

Last year, when Mark Carney took the helm as the Governor of the Bank of England, his challenge was to bring interest rates to more normal levels, without negatively impacting the UK's fledgling economic recovery. Retailers will be watching closely and hoping that the burgeoning consumer confidence we've been seeing in 2014 won't be affected by the inevitable rate changes.



Mark Teale, Head of Retail Research, CBRE

The impact of interest rate increases on retailing will ultimately depend upon the timing and, more importantly, on the economic conditions prevailing at the time interest rates are actually increased. At the time of writing the timing, and the likely trajectory of the inevitable stepped increases, remains highly uncertain. Mixed messages from the Bank of England continue.

There is some good news for retailers though. The decision of the Bank's Financial Policy Committee to ration purportedly 'risky' mortgages (loans of 4.5 or more applicants' salaries), rather than use a national interest rate hike as a sledge hammer to stem house price inflation in inner London, headed-off the immediate risk of a knock-on nationwide consumer spending downturn.

As inner London residential price inflation, in large part, is led by cash purchasing by both overseas buyers and domestic purchasers that are free of mortgage commitments, national interest rate increases – if anything – would be likely to boost rather than reduce the attraction of holding inner London residential property: supply shortages in the capital are now so chronic.

The popular 'house price bubble' narrative is a fiction in this respect. In real terms, in large swathes of the country outside London, house prices – and the volume of house sales – remain well below their 2007 peak. It is just London that is the real outlier due – for the most part – to the weight of overseas money overhanging the market.

House price inflation in the UK is inevitable: an economic constant almost because of chronic, and ever-worsening, housing shortages (particularly in London and the south). The problem has been building for decades but has become much worse in recent years as population levels in and around London have soared. For all the complaints, there is actually little evidence of UK (or London) house prices being intrinsically out of kilter with supply/demand. Because many domestic purchasers cannot afford current prices (or because house prices are rising as a proportion of domestic incomes), does not mean market values are 'too high', it just means there is not enough property to go around and/or – in the case of London locals are being bid out by wealthier overseas buyers. If the purpose is to bring down house prices (and rents) in markets – like those of London – where demand persistently significantly exceeds supply (and has done for years) then the only obvious answer is to increase supply: build more houses. The longer house building is delayed, the greater the pressure on prices becomes.

At some point interest rates, this year or next, will start to ratchet upwards. Mortgage repayments for many will then increase, reducing disposable spending levels for those with mortgages. Savers will meanwhile gain. If the interest rates increases occur, as seems likely, before sustained economic growth has fed through into significant wage inflation, consumer spending growth can only remain sluggish though. But, for the time-being at least, consumer demand looks set to remain reasonably stable.



James Knightley, Senior UK Economist, ING

The UK looks set to be amongst the fastest growing major economies over coming years and with employment surging and confidence roaring back there is a strong possibility of an interest rate rise this year.

This will create some headwinds for the retailing sector. For many households, higher interest rates will push up debt servicing costs, leaving less income to spend on goods and services. For others it will make saving look a more attractive option. Then again, not all households have debts so they may actually be able to spend more since higher interest rates will provide them with more income from their savings.

The most recent set of numbers published by the Office for National Statistics show that the median size of an outstanding mortgage is £84,000. Assuming that mortgage was originally £100,000 then every 0.5% increase in Bank Rate would increase the annual mortgage payment by £317 – equivalent to 1.6% of the after tax income of a typical British worker. With many households already being squeezed by the fact pay has not kept pace with the cost of living for over five years, those that are exposed will see their spending power dented.

That said, only 36% of households have a mortgage with one third of these on a fixed rate, implying that less than a quarter of UK households will be directly impacted by higher mortgage costs. Households also have other forms of debts, such as credit cards and personal loans, but these are not as influenced by Bank Rate changes. The typical Briton also has £4,000 in savings, but a 0.5% increase in the interest rate paid will only yield an extra £20 per year.

In aggregate, higher interest rates will hurt the prospects for retailing in the short term, with retailers with a younger clientele likely to be more exposed given they tend to be net debtors. However, in the long term it may be a good thing if it helps limit financial stability risks from asset bubbles and high levels of indebtedness. Moreover, if pay starts to pick up and employment continues growing then I see little need to worry given the Bank of England has explicitly stated that rate rises will be modest and very gradual.



Dr Tim Denison, Director of Retail Intelligence, Ipsos Retail Performance

The Bank of England's base rate has been at a record low since March 2009. Before that time we used to await news from Threadneedle Street with bated breath, whereas now we expect to hear the non-news of a "no change" vote from the MPC and treat it with nothing more than cursory interest. For this reason, when the first rate rise is finally announced, it will be big news and will risk unsettling a great many consumers.

In fact the psychological impact of a rate rise is likely to be more powerful than reality itself. Emotional trauma takes a long time to heal and for those who have suffered real hardship through the recession they will be anxious of what a rate rise could mean to them. So preparing the ground for the change through the media and other channels is critical in safeguarding against a stutter, or worse, to the economic recovery. Perhaps it was in Mr Carney's mind, when he made his surprise, hawkish comments in his recent Mansion House speech, to test out the impact on consumer confidence and economic indicators such as retail sales, to help him judge the mental readiness of the nation and the appropriate timing of the first rise.

As long as the seeds of expectancy germinate in suitably prepared ground, the actual impact on retailing of gradual rises in the base rate over the next 2-3 years may not be that dramatic when looked at in the whole. On the demand side, people will be affected unequally and in different ways. There is a risk that the nation will become more polarised and economically divided.

Those most affected will be households with existing debts, where even a modest rate rise would hurt their spending power and trigger rent or mortgage arrears. Consumers in the provinces are most vulnerable, where in Wales and Scotland, for example, consumer confidence, even today, remains in negative territory. Those least equipped to deal with the effects of a rise will be the generation of home-makers who have never experienced a higher cost of borrowing. The ageing population, though, will help counter reduced demand from the disadvantaged. New pensioners will find themselves especially welcome as favoured customers, following annuity rate rises. Given these various ebbs and flows, retail sales are unlikely to suffer any serious slowdown as a consequence. In the short term they could actually rise; the impact of the saving minority enjoying more discretionary spend will be felt more quickly than the effect of those suffering growing debts.

In terms of retail structure, expect discounters to consolidate their market share, "honey pot" shopping destinations to become more important and shoppers to remain wedded to their promotional diet. Don't expect the sector to be propelled backwards to re-live the hardship left in the wake of the financial crisis. Those that have come through the last 6 years are fitter, more efficient and stronger for it. In other words, the change that a rate rise brings will be light enough to carry around in your pocket.



David McCorquodale, Head of Retail, KPMG

The savers and the borrowers, the old and the young. As ever in retail there are winners and losers and interest rate increases will please some and hurt others.

During the recession, a freezing of wages or worse and increasing energy bills meant that adjustments were made to family budgets. The retail world suffered in many areas yet witnessed the advance of the value retailer and the discounter. With economic recovery becoming more evident and jobs more secure, there has been a temptation to borrow again, both on credit cards and on mortgages. The latter is fuelling a recovery in the housing market which in turn is driving the potential for an increase in interest rates.

It is predominantly the younger generation who see the need to borrow to progress and it is borrowers who suffer most from an increase in rates. If wages don't rise in line with property prices, borrowing costs will take up a higher proportion of the family budget. The impact from this on the retail sector will initially be negative and will continue to drive the polarisation from the middle ground to the extremes, with the value retailers or discounters remaining relevant. Many thought that value retail would recede with an economic recovery but I believe it is here to stay.

The beneficiaries of an interest rate rise are the savers – generally amongst the older generations. Their benefit will not match the negative impact on the borrowers due to margins on savings v borrowing, but they will feel they can spend more freely again. Thus, retailers who are focussed on the 'grey pound' will also feel a lift.

Many retailers pre-recession had high levels of debt, partly to support private equity funding structures. Most have managed their debts down to serviceable levels but an increase in the borrowing costs for those retailers will put additional strain on their operating models – the same can be said for their suppliers. I do not predict a deluge of administrations but, perversely, growth can have its own strains, especially around working capital and retailers will wish to ensure that they and their suppliers are able to navigate their way to recovery. Many retailers are exploring supply chain finance to support their suppliers through this change. An increase in interest rates will also be felt at this interface.

No-one is yet talking of significant hikes in interest rates so all retailers will wish to ensure any small increase is not reported sensationally in the press as that can have a greater impact on confidence than the change itself.

Martin Hayward, Founder, Hayward Strategy and Futures

From an abnormal situation of sustained interest rate suppression, reality must soon prevail, and the retail sector has to prepare for some sections of the population finding their spending power curtailed.

However, the almost obsessive commentary about house prices and mortgage rates does tend to obscure the reality that in the UK there are more net savers than borrowers. Recent data suggests that only about a third of the population have property debt yet their voices have consistently drowned out those who don't.

For the many millions with savings, an increase in interest rates would be a welcome return to ultimately 'real returns' on their nest-eggs, perhaps engendering a feeling of wellbeing that could easily counterbalance those that might cut back due to their mortgage worries.

Additionally, for those with mortgages the impact of a rise in rates may well be less immediate than expected. Over the last few years, over 80% of new mortgages have been at fixed rates, suggesting that homeowners appreciated that rates couldn't stay low forever and that they needed to build in a buffer against rising rates. Politically, it is also likely that rates will rise slowly, rather than rapidly, again allowing the consumer to adjust to a new reality.

For the retailers themselves, and particularly those that over-extended themselves during the boom years, an increase in borrowing costs could be problematic given the tighter margins that the current market has forced upon them. Costs have remained relatively benign for the last few years as pay inflation has remained subdued and reduced demand has suppressed property costs. Pay inflation could well begin to build again soon, although retail property beyond prime could well remain subdued.

Overall, it will probably be a bit like a trip to the dentist for most retailers – it has to happen eventually, it's a bit scary, but after the event it won't seem too bad at all.

Nick Bubb, Retail Consultant

In some ways, with the monetary policy pedal pressed hard to the floor for so long (to make up for the Government's restrictive fiscal policy), it is surprising that the UK economic recovery has been so weak, but when interest rates edge up from their current artificially low level later on this year it will be a good test of how strong the economic recovery really is.

Notwithstanding the greater income that older consumers will receive on their hard-earned savings, the main focus of the impact of higher interest rates is on variable mortgage holders.

In theory, if the Bank of England is right about the upward path of interest rates from now on being slow and steady, then consumer confidence should not be dashed. Higher rates in due course should have been well discounted, but much depends on the timing of the first move and the perception of how many more rate increases will follow.

For some consumers, who have relied on there not being an increase in rates before the Election next year, the first rise will come as a shock. And a rise in November will not be obviously helpful to uninhibited consumer spending at Xmas.

Fortunately, inflation is low and employment growth is high, so consumers should take higher interest rates in their stride, but much depends on "events", in economics and in politics.

Ahead of the next Election, the Government has successfully engineered a recovery in the housing market, particularly in London, and there is no doubt that the London housing market needs higher interest rates to cool it down. But the danger of "one size fits all" interest rates is that the weaker regions of the UK may start to cool down before they've even got warm.

It is instructive to look back at what happened to the housing market in Ireland after January 1999 when Ireland joined the Euro.

Irish interest rates halved to 3%, despite strong economic growth in Ireland, because interest rates were from then on were set for the Eurozone as a whole and inflation was not a concern for France and Germany.

But rates eventually went up and easy credit dried up, bringing the Irish housing market to its knees after the collapse of the banking system.

It would be unfortunate for the rest of the UK if future interest rate policy is now set for the buoyant London housing market.

Neil Saunders, Managing Director, Conlumino

It has now been over 5 years since interest rates were slashed to 0.5% in response to the global economic crisis. Over this time the policy, which was designed to prevent the economy going into a tailspin, has been highly beneficial to most consumers. Certainly some savers have seen their incomes eroded, but the majority of households have benefitted through lower mortgage payments or lower rates of interest being added to their debts.

The ultimate consequence of the low interest rate policy is that it has inflated the amount of discretionary income consumers had at a time when real disposable income growth has largely been negative. For retail, low interest rates have provided a shot in the arm in terms of spending.

Five years is a long time. It is more than sufficient to allow consumers to form habits and, ultimately, this is what people have done with their household budgets, which are now largely configured around low interest rates.

The issue we are now faced with is that as the economy recovers interest rates need to rise. Any such rise will come as both a shock to consumers and will come with a very real cost attached. Using our consumer data, Conlumino has calculated that a 0.5 percentage point rise in rates could cost the average mortgaged household £280 more a year in repayments. Looking at all households that would be impacted by a change in interest rates (i.e. those with variable rate mortgages), the cost across the UK could be as much as £1.9bn a year.

Ultimately, with wages still sluggish in terms of growth, this additional money will need to be found from somewhere. That somewhere is, by and large, general consumer spending of which retail is a constituent part. So, in very basic terms as the drug of low interest rates is withdrawn, retail is going to suffer the effects.

There are, of course, two other more indirect implications of higher interest rates. The first is the consequential erosion in confidence it could engender as some consumers begin to feel worse off. This could result in them delaying big-ticket expenditure or seeking ways in which to be more frugal. The second is the slowing effect it could have on the housing market that may take the edge of growth in some home-related sectors.

The hope for retail is that as interest rates are introduced they will come in concert with a general strengthening of the economy, lower inflation, and some real rises in income. This will offset the pain of the increase. But regardless, over the next few years consumers will have to adjust themselves to the new reality of higher interest rates.

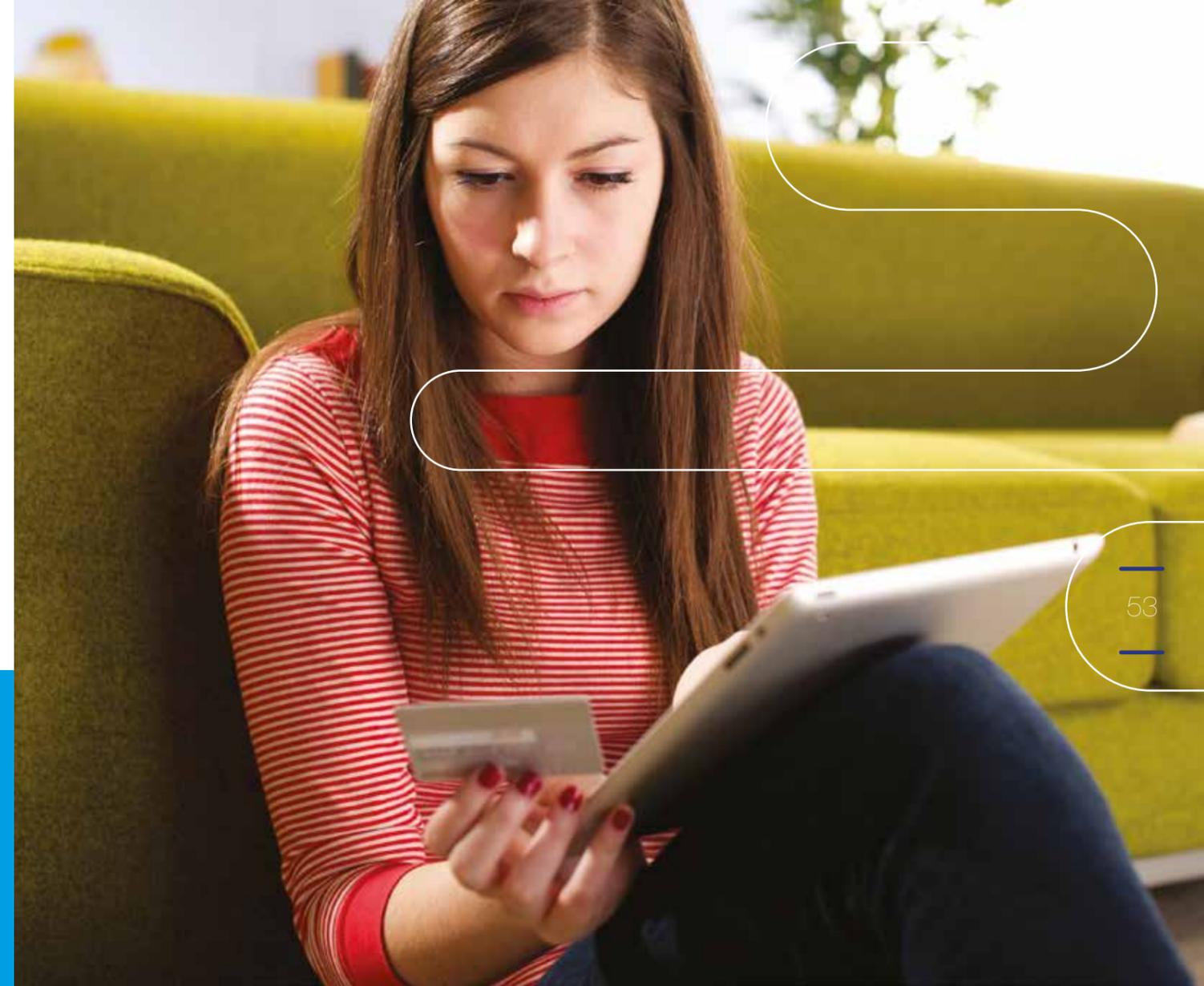
3

what can Tesco learn from previous business turnarounds?

52

Part I:

- price cuts are not necessarily the answer to Tesco's woes
 - the grocer needs to reconnect with its customers and rethink ranges
- Tesco's exposure to the hypermarket store format will need to be addressed
 - any business turnaround requires good communication with and support from a multitude of stakeholders



53

The golden decade when Tesco and the big four grocers achieved growth simply by mopping up market share from the demise of Somerfield, Netto and Safeway is at an end.

Tesco has found itself marooned in the middle ground, facing strong competition from both premium and discount grocers and is now faced with the painful process of adjusting to a new, harsher, trading environment.

The KPMG/Ipsos Retail Think Tank (RTT) met in October to discuss what Tesco can learn from other businesses which have successfully been turned around.

Change the culture and get back to serving the customer

The RTT believes that Tesco must first identify and acknowledge the full extent of the problems facing its business. The economics of its business model no longer work in the current trading environment: its high margin strategy is unsustainable and will continue to negatively impact its market share.

Acceptance needs to be followed swiftly by finding the root causes of business distress and bringing to light what is not working.

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

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

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

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

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

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

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

Invest, and fast – but not in a price war

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

“There is insufficient time or information to run a traditional strategy process so the board must run a range of scenarios and make some big decisions around what the future core of the business is and where money is going to be made whilst the business is still strong,” said David McCorquodale, Head of Retail at KPMG. **“It needs to make these investments to create growth – a business can’t be turned around by just cutting costs or prices. Howard Schultz at Starbucks certainly cut costs brutally in his ‘grip’ phase but he then made some critical decisions, the first was to focus on the company’s core product – coffee – and the second; to recreate the ambience of local coffee houses. Schultz built customer affinity programs and aggressively extended the brand to return its premium position.”**

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

Give retailers a seat at the boardroom table

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

The RTT argues that most turnarounds come hand in hand with new appointments at board level to galvanise the leadership into a change programme and Tesco needs to have experienced retailers and marketers at the top table. **“Many successful turnarounds have involved the appointment of a Chief Restructuring Officer to drive the transformation and communicate the great change story that everyone understands, while allowing others to continue to do their jobs and the business to carry on functioning,”** said Tim Denison of Ipsos. **“Don’t be surprised if we see such a role announced at Cheshunt.”**

Manage stakeholders

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

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

Look at the structural challenges

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

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

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

Conclusions:

Successful turnarounds of companies in an aggressively competitive and disrupted market are not easy but there are stories of change that could give Tesco confidence in its future. The recovery of Starbucks, McDonalds’ ‘Plan to Win’ success and Argos’ ongoing transformation spring to mind.

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

Nick Bubb concluded: **“History teaches you that it’s always darkest before the dawn. Others have gone through this process and turned their business around. One of the greatest ever turnarounds was Asda in the early 1990’s under Archie Norman, who always said that a big company with a lot of top-line sales will have enough levers to pull to make a difference to the bottom line. And changing the culture of the Asda business and unleashing the talent in the store managers was an important part of the turnaround.”**

In detail – Individual views of the RTT members

Nick Bubb, Retail Consultant

New Tesco boss Dave Lewis already faced a tough job in turning the business around, before the recent accounting scandal, and we will hear on October 23rd, with the delayed interim results, what he makes of his predicament. Ahead of that key event, what can he learn from other turnarounds in the industry?

One of the greatest ever turnarounds was Asda in the early 1990's under Archie Norman, although some would say that the real driver of change in the business was Allan Leighton, who was tasked with reinvigorating store operations. One of Archie's key messages was to make clear at the start how difficult the turnaround was going to be, so that he looked a hero when it was achieved (a precursor of the "under-promise and over-deliver" mantra of Kate Swann at WH Smith some 20 years later). But Archie also always said that a big company with a lot of top-line sales will have enough levers to pull to make a difference to the bottom line. And changing the culture of the Asda business and unleashing the talent in the store managers was an important part of the turnaround.

Fast forward 10 years or so and it was Sainsbury's that was in trouble after a disastrous distribution network and warehousing overhaul, but the ebullient former Asda executive, Justin King, came in as CEO in 2004 and soon launched his recovery programme for the business with the slogan "Making Sainsbury's Great Again".

Sainsbury's stronghold in the affluent South-East was a key asset, however, together with a reputation for quality fresh-food and own-label ranges. And Sainsbury's avoided the temptation to follow Tesco down the road of opening huge out-of-town hypermarkets and developing too big a non-food presence.

Just as the Sainsbury's business was getting back on track, Morrisons made the disastrous mistake of acquiring Safeway in 2004 and after that all went wrong, the family management called in one Marc Bolland as CEO in 2006. Resisting calls to diversify the business, he focused on getting Morrisons back to basics, which was successful, although he left the company in 2009 without any online grocery or convenience store exposure, which turned out to be major strategic weaknesses.

But part of Tesco's problem now is that its major UK supermarket competitors are not so weak anymore, whilst Aldi and Lidl have emerged as a powerful new force in the grocery market and the oligopoly that helped to preserve industry operating margins has well and truly broken down. And the structural challenge that Tesco faces in the UK, in the form of its vast over-exposure to the hypermarket store format, is replicated in Tesco's overseas operations. In a world where consumers are increasingly shopping locally in smaller stores Tesco seems rather ill-equipped. Time will tell whether Dave Lewis has the skills to succeed in what seems an almost super-human task to turn Tesco around.



Mark Teale, Head of Retail Research – CBRE

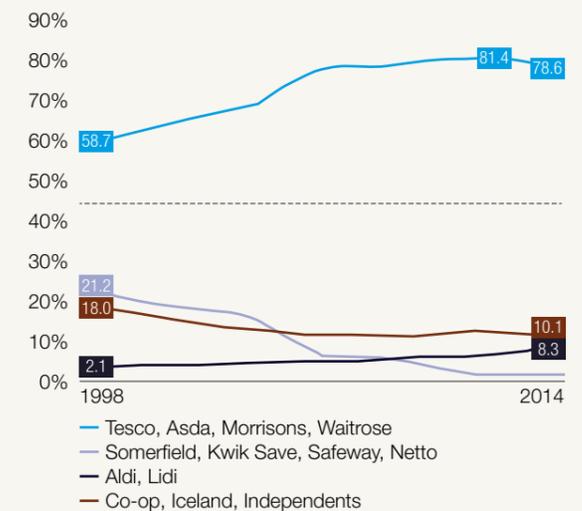
The market conditions confronting the big four (Tesco, Asda, Sainsbury's and Morrison) are highly unusual. More than 20% of GB grocery sales were released post 1998 by the demise of Somerfield, Kwik Save, Safeway and Netto. Co-op, Iceland and independents meanwhile saw their cumulative market share plummet over the same period from 18% to just 10%, releasing yet more sales. Aldi and Lidl – via an aggressive store opening programme – held their own, growing their market share steadily over the same period from 2.1% to 8.3%. But it was the big four (plus Waitrose) that really cleaned up, seeing their cumulative market share soaring from 59% in 1998 to a startling 81.4% by 2011.

The big four's market share growth stalled in 2011, not so much because of some revolutionary change in shopping behaviour favouring Lidl and Aldi (the currently popular narrative), but because capacity released by weak players at the no-frills/discount end had finally largely been mopped up. Development pipeline levels might have been ballooning, but the actual space completed by the big four has remained far too limited to alter their market share positions significantly, in part because post-1988, planning policy resulted in grocery superstores being progressively directed to lower and lower productivity edge-of-town sites: according to an LSE study, resulting in output losses exceeding 30% – equivalent to a decade of lost growth. It is capacity release not iterative development-led trade diversion that kept the big four buzzing until 2011. And it is capacity release drying up that has now brought things to a shuddering halt.

Short of one of the big four now going under, there is – short term – not much main grocery market share capacity left to play for. Or at least, market share inroads are going to be harder and harder to achieve given that the players left standing mostly have reasonably strong offers. It was only the continuing tail-end capacity release post 2008 that gave grocery markets the semblance of continuing growth while non-food markets tanked. It was this faux growth that fuelled the fantasy of a grocery development space race setting in: something, for planning reasons, that was never on the cards. Superstore completions have followed a flat trajectory for years because of the capping effect of planning controls.

With household incomes remaining under heavy pressure and little likelihood of a significant consumer spending upturn, it looks likely that the price war recently sparked will be sustained for as long as it takes the main players to re-position, which could take a number of years.

Main grocery market shares



If Aldi and Lidl manage to continue their modest market share gains for a while, and the big four continue their convenience store push as well as repositioning their offers, the attrition at the Co-op, Iceland and independent end looks set to continue albeit any big four gains will become increasingly marginal: the big four are really fighting among themselves now.

To my mind, there is consequently no great lesson to learn from past successful business turnarounds: like the economy itself, grocers are in wholly uncharted waters. The 2008 financial crisis caused a seismic market rupture. We are not going back to past growth patterns. The circumstances now confronting Tesco, and other main-grocery operators, are quite unique.

It is easy in this respect to carp from the sidelines because like-for-likes are negative for a few quarters, but grocery performance weakness is hardly surprising given the squeeze on domestic mass-markets generally. It is naïve to expect network profit contributions to be upward-only regardless of economic conditions, particular in the case of very large players that – like Tesco – are, in effect, economic bellwethers.

Mass market grocers are simply going through the same (deferred) pain now, adjusting to the harsher post-2008 trading environment that non-food traders worked through three to four years ago; a pain on the non-food merchandise side that Tesco has already shared in. Tesco still dwarfs its grocery market competitors in market share terms (store and online). It is a grocery leviathan: indeed, it is the UK grocery leviathan. What is currently happening at Tesco is more interesting for what it tells us about current grocery market conditions in the UK than about Tesco business strategies per se.



James Knightley, Senior UK Economist – ING

The retail environment has been incredibly tough since the start of the global financial crisis with several well-known high street names having failed. The combination of weak demand and the credit crunch put immense pressure on businesses that ultimately failed as they weren't competitively selling products that people wanted to buy. Thankfully the business environment has improved significantly with the UK now the fastest growing developed market economy, consumer confidence up at pre-crisis highs and credit conditions being much improved. Consequently, we are now in a much better environment to facilitate a business turnaround.

Nonetheless, the turnaround of Tesco will not be easy. Stuck in the middle market between the aggressive expansionist discounters and the higher end "premium" retailers, it has seen a significant squeeze on sales and profits. There will need to be improved merchandising strategies including refocusing the store base and the online offering and a cutting of costs to fend off discounters.

Recent news from Morrisons and Sainsbury's suggest Tesco is not alone, which suggests margins will remain under pressure for some time to come. Consequently, they will need to manage expectations on the length and scale of turnaround so as to not miss early targets that would heap more pressure on the business.

However, it isn't just the competitive problems facing the company. The perception of a management vacuum given the stepping down of the CFO and CEO followed by the acknowledgement of a £250 million profit overstatement has severely damaged the company's credibility. With the Financial Conduct Authority launching a full investigation, the Parliamentary Business, Innovation and Skills Select Committee demanding to know what has been going on and the Serious Fraud Office also paying close attention Tesco is going to remain in the headlines for negative reasons for several months to come. With analysts already questioning the level of retail experience on the board and these inquests occupying significant management time there are question marks over whether the company will be able to achieve a significant turnaround quickly without broader management structural changes.

Dr Tim Denison, Director of Retail Intelligence – Ipsos Retail Performance

The appointment of Dave Lewis may well prove to be the first step towards the re-emergence of the retail titan that is Tesco rather than a Titanic-style sinking. The company has been losing market share since 2007 and though large profits have successfully papered over the cracks, its past leadership team has failed to acknowledge, in public at least, that it had a major problem on its hands. The first lesson to be tabled by McKinsey from studying successful retail turnarounds is that leaders have to face up to the facts. To his credit, very early on in his tenure Mr Lewis openly acknowledged that the company is struggling.

Acceptance needs to be followed swiftly by finding the root causes of business distress and bringing to light what is not working, something that Bill Grimsey successfully achieved at Wickes. Inevitably this leads on to a fix plan which is action-heavy. Most turnarounds have therefore been characterised by new appointments at executive level to shake up the thinking, inject energy and galvanise the leadership into a change programme. Tesco has been criticised for having an unbalanced board composition with not enough experienced retailers at the top table. As Tim Ambler of LBS famously once mused: "At best accountants keep score; they do not make runs". Lewis is already ringing the personnel changes, some of them forced by recent events.

Turnarounds usually involve some cost-cutting, but success comes from not attaching too much focus on this task thereby risking distraction from the main initiative, which is finding what is challenging the success of the existing business model and making good.

Mr Lewis clearly has a strong view on this and has already declared that he wants Tesco to regain its position as the "customer's champion" and transform the company culture away from what has been described as one of secrecy and compliance.

Engineering fundamental changes to a business, its staff and how they operate requires ownership. Many successful turnarounds have involved the appointment of a Chief Restructuring Officer to drive the transformation and communicate the great change story that everyone understands, while allow others to continue to do their jobs and allow the business to carry on functioning. Don't be surprised if we see such a role announced at Cheshunt.

Clearly there is a lot of work ahead at Tesco. It will be fascinating to know the steps that have been taken and how much progress has been made at the end of Mr Lewis's first 100 days in his CEO role on 10th December.



David McCorquodale, Head of Retail – KPMG

Successful turnarounds of companies in an aggressively competitive and disrupted market are not easy but there are stories of change that could give Tesco confidence in its future. The recovery of Starbucks, McDonalds' 'Plan to Win' success and Argos' ongoing transformation spring to mind. Let's also not lose sight of the considerable cash generation and market share still enjoyed by Tesco, which gives them significant ability to invest.

Turnarounds are different to the normal course of business. For a start, there is huge scrutiny from stakeholders (investors, staff, pension trustees, suppliers, credit insurers, regulators) not to mention customers and the media. New faces come into key positions and typically operate without a full set of facts which they can trust. The situation evolves rapidly and is often driven by external factors: in Tesco's case, an accelerating evolution of the market.

In these circumstances, management teams often overlook the need to thoroughly stabilise the business and instead move too quickly to strategies and solutions. This backfires and stakeholders lose confidence as events and further bad news unfolds. Grip means fundamentally changing the way the business is run (its operational governance) and how decisions are made: gripping the cashflow gives the best view of the business and allows investment capacity to be built; changing the team as different skills and characteristics are needed to run a business in turnaround compared to one in growth mode; carefully planning and controlling stakeholder communications; stopping a lot of projects and gripping headcount and discretionary spend.

A lot is said about changing the culture of businesses at this point. Culture change doesn't work through tree-hugging sessions and slogans but by changing 30-40-50 small details about the way the business is run – its operational governance.

Build is about rapidly creating a new value plan for the business and building support for it from stakeholders. There is insufficient time or information to run a traditional strategy process so leaders tend to run a range of scenarios and make some big decisions around what the future core of the business is and where money is going to be made.

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

You then have to implement growth – turnaround implementation needs to be managed at a very granular level with high cadence. It is all about creating hard linkages between actions and financial impact and about having a very integrated programme to de-duplicate and de-risk delivery. You can't afford to make promises you can't keep so turnaround programmes tend to be built from the worst case up and also include measures to react quickly to trading performance.

In good turnarounds you tend to see a range of stakeholders – suppliers, staff, investors, lenders, unions – all contributing to stabilisation and the solution. This provides management with the required support and is harnessed with an excellent communication programme. John Walden at Argos has maintained a consistent dialogue with stakeholders underpinned by consistency of delivery.

Turning round retailers is difficult and takes a while – Tesco has a big stakeholder challenge on its hands. Success will be measured through customers understanding what Tesco stands for and returning in numbers to its stores.

Martin Hayward, Founder – Hayward Strategy and Futures

According to Dave McCarthy, an analyst at HSBC, Tesco's problems boil down to one issue: "It lost its emotional connection with the customer."

How many times have we heard this about large companies that have begun to believe in their own immortality, despite the changing world around them? Ironically, Tesco should be in a tremendously strong position to connect with their customers given their pioneering investment in customer data analysis since the mid 1990's. Somehow the messages that this data must and should have been sending to the board of Tesco have been missed or ignored, in the pursuit of ever greatness and scale.

There was an interesting moment in the early 2000's when Tesco proudly announced that 1 in every 7 pounds spent by UK consumers was in its stores. This line was quickly pounced upon by the press as a sign that Tesco was getting too big for its own good, and boots, but despite it being quickly downplayed, it still resurfaces even to this day.

Maybe this was an early sign of hubris, that the company was more important than the customers it served?

Another interesting question to address is which customers Tesco serves? Unique amongst UK supermarkets, Tesco has always claimed to be able to serve every section of the population, from value conscious shoppers on a budget to high-end gourmets. There are few if any examples of retailers in any sector that manage to pull this off for long. The enhanced polarisation of the UK grocery sector, driven by the discounters and Waitrose/M&S makes a one-size fits all model ever harder to sustain.

Therefore the learnings from the past are as they ever were, enshrined in the fundamental thesis of successful marketing. Clarify which customers you're looking to satisfy and examine them with forensic attention to ensure that what you offer is what they need. And then keep on talking to them to ensure that as their needs change, the offer changes in unison. It's never been rocket science, and never will be, but the bigger you get, the signs are that the harder it is to deliver against.

Neil Saunders, Managing Director – Conlumino

Retail history is littered with companies that were once the tallest trees in the forest only to have been cut down to size by changing market or competitive conditions. The problem for any company in this position, especially as one as large as Tesco, is that it takes time, effort and willpower to fundamentally change the business and to put it back on track.

Looking back at history the first thing Tesco has to do is realise that change is needed, identify what change is required and then to enact it ferociously across the business. This is not something all retailers in trouble have done. It took Marks & Spencer, for example, years to grasp the nettle of change and, in some senses, it still has not done this completely with many cultures and processes of old still surviving today.

The second thing Tesco has to do is change the economics of its business model. This is not about completely reinventing the business, but it is about recognising that some things – not least relatively high margins – are just not sustainable in today's market. The price of trying to maintain those margins is one of continued market share erosion. This is a difficult thing to engineer but it is something that others, such as Carrefour, have successfully done in order to get growth back on the agenda.

Another thing Tesco needs to do is to reconnect with the customer. HMV failed because it did not adapt to changing customer needs and tastes. Arguably under its new management team HMV has understood that people don't necessarily want to buy music from stores, they want to be entertained and inspired in those stores. They have reconnected with their customers and are, once again, growing share. Tesco has a wealth of customer data from Clubcard but it needs to use it to greater effect if it is to keep its shoppers loyal.

The final thing Tesco needs to address is the lack of retail and consumer experience on its board. It currently has too many accountants and too few people who understand retail and consumer markets. Dave Lewis provides some balance, as do the two recent appointments, but arguably there is a need for more expertise.

The slight downside for Tesco is that looking back through retail history there are far more retailers that failed at reinventing themselves than there are those that succeeded. Tesco will have its work cut out if it is to fall into the latter camp.

Martin Newman, CEO – Practicology

Tesco is stuck in the middle. Customers are unclear about what it stands for, and therefore the starting point for its turnaround should be to clarify its customer value proposition.

'Every little helps' needs to be re-energised with clarity around the customer proposition across range, price, value, channels and loyalty.

Asda has a clear focus on every day value. In addition, it has recently gone through a substantial restructuring in order to be more customer-centric, culminating with the board appointment of Steve Smith as Chief Customer Officer.

HMV has just announced a £17m profit only a year after it nearly disappeared from the high street. It's drastically cut loss-making stores and focused on making those left somewhere music lovers want to go. Perhaps Tesco should take bolder cuts to its store space over-capacity, but also act on the huge amounts of data it has about what drives customers through the doors and online.

Despite the fact Tesco has more consumer data through Clubcard than any other grocer, it hasn't taken full advantage of this and built the type of relationship and engagement with its customer base that it could have, in doing so extending the customer's lifetime value to the business.

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

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

In Australia, a similar turnaround of the grocer Coles was achieved a few years ago with a new management team and a five-year strategic plan backed by investment. In the UK, Argos is another retailer delivering on a strategic plan that has seen it respond with modern ways of thinking to the structural changes in the market it operates.

Tesco is lucky that it has access to data and insight on its customers that other retailers faced with similar challenges can only dream of.

Dave Lewis has already signalled his intent for Tesco to be customer-centric by putting more customer service staff into stores. But it will take more than this to make its customers feel truly valued again.

Mike Watkins, Head of Retailer and Business Insight – Nielsen

There are a number of consumer trends that will continue at least until the end of 2016. For example, the structural shift to discounters, value retailers and online, and shopping at smaller stores. With household budgets under pressure, shoppers still need to save money which is why 30% of the sales value of FMCG in UK is still sold on promotion and this percentage is unlikely to fall in the near future.

So savvy shopping is now the norm with planned purchasing and more and more price comparison: shoppers will continue to look to save money when shopping for groceries.

Whilst two thirds of GB households are shopping at Tesco every 4 weeks, spend per shopper on FMCG continues to fall and spend per visit was -2.5% in the last 12 months (source: Nielsen).

To help Tesco recover from the current fall in sales and go on to hold and then gain market share there is probably a need to reposition on price to some degree. However it will be the sum of the overall Value for Money e.g. price, range, format, service and availability that is the key to success.

The outcome for Tesco in the UK could be that in the future an edited/tailored range may be just as important for conversion and incremental sales, and that store format development and private label as well as online, are the best opportunities to drive new shoppers and loyalty.



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cutting through complexity

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