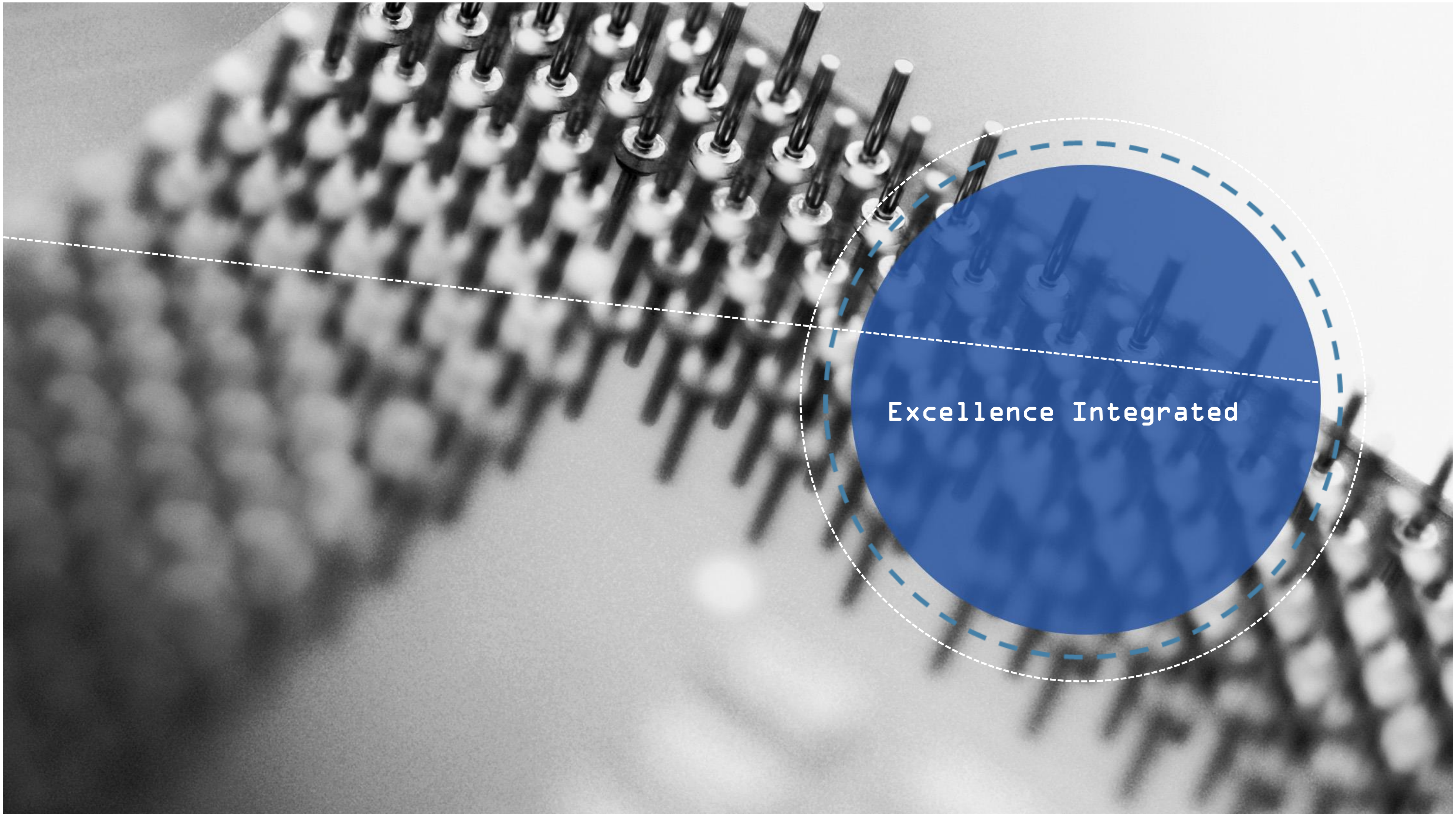
SHORE CAPITAL
CAPITAL MARKETS

NORTHERN IRELAND FOOD & DRINK

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

A presentation to the Northern Ireland Food & Drink Association conference , September 2016



UK & Irish food industry - setting the scene

1. Uncertainty rules but life must go on
2. Expectations for the grocery trade
3. The Supermarket sweep
4. The growing relevance of foodservice
5. Category overviews for the supply chain in the British Isles

UK & Irish consumer economy

- …, despite the worry lines…
- Employment levels in the UK are at records high, unemployment remains a problem in Ireland
- Real incomes are still growing with low inflation…
- …but growth in living standards is slowing as CPI creeps higher…
- …the devaluation of sterling will be a key variable
- UK National Living Wage will boost low income spending power…
- …but re-price labour versus capital
- UK housing market appears relatively resilient
- Consumer confidence (GfK NOP) is recovering but is likely to ebb & flow
- Asda Income Tracker reports highest ever weekly discretionary income in the UK… but the rate of growth in real incomes may have peaked in this cycle.
- Have things 'got as good as they are going to get'? Probably for quite a while…

UK consumer - the legacy of a depression - key trends

- The consumer depression encouraged the 'middle class' **savvy shopper** who remains in-play
- **Price** has firmly moved up the customer agenda…
- …, the superstores allowed the **discount channel** to enter the mass-market phase; that said discount momentum in the UK has peaked (Aldi LFL sales negative)
- The **convenience channel** has also peaked with the best sites taken…
- **..and the superstores are fighting back**
- **Online** will continue to gain share
- The **'affordable treat'** will remain important
- New view of the affordability of **eating out** of the home.

UK FMCG retail market - space imbalance

- The coefficient of new superstore space to sales has collapsed – reducing new store productivity and returns – as the discount store coefficient rocket.
- Market conditions have curtailed, deferred and now **cut** store development plans from the superstores, even Waitrose pares back
- The discounters are set to open c10%+ new space per annum for the foreseeable future in the UK, less so in Ireland; so c1% space additioon
- UK discount share is c10-11%, set to test c15% in the medium-term, LADs in Ireland are c18-19%, set to test c20%.
- Online is c5-6% share, set to be c10-12.5% by 2025; but with strong superstore participation.

Space coming on-stream at lowest rate for five decades to 2020 in UK

UK FMCG retail market - volumes

- UK population is rising by c1% per year; ONS forecasts a UK population of c73.5m by 2035, c80-90m by 2050 – even with immigration control, the population is set to grow
- The consumer remains set on managing basket values…
- …but four years of weak industry food volumes has come to an end
- Eating out of the home volumes remain solid, driven by affordability, innovation & entrepreneurship…
- Calorific intake per person is set to fall…
- …, but shifts in food waste are likely to plateau
- UK population is rising by c1% per year; ONS forecasts a UK population of c73.5m by 2035, c80-90m by 2050.

We forecast UK food volumes of 1-2% medium term

UK FMCG retail market - prices

- Sterling weakness is the new currency dynamic; importing inflation, stimulating import substitution and exports.
- Through the cycle Developing & Emerging Markets should continue to drive long-term demand for energy & food - with ebbs & flows
- Oil prices are in a fundamentally different place than anyone expected…; Brent Future ICE $40-50/b; more likely than not to be inflationary in the future
- Sugar prices have now turned…
- …as has dairy…
- Cereal prices rebased higher since 2006 but with full silos now flat-lining; watching maize & soy
- Intensive protein prices linked to cereals, international factors driving UK pig cycle upwards again
- We see relatively anaemic soft commodity prices for 2016/17…, but sterling changes things in the UK
- Food deflation at its deepest in over 25 years in mid-2016 set to ease…

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

UK FMCG retail market - mix and safety

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

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

UK FMCF retail market - the promotion debate

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

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

UK FMCG retail market - trading environment - war?

- The 'trade' has always described 'the environment' as *'competitive*', but it really is now
- Superstores opened the door to the LADs and high street value discounters (HSVRs)
- After sustained appreciation in gross margins the trend is turning down, **there is a prolonged war**
- Retail gross margins, hard to build, easy to collapse; have **imploded**
- Over-dependence upon promotions, coupons & vouchers, linked fuel initiatives and price-matching
- The share shift is stark..., it wasn't tenable for Morrisons and Tesco to sustain such heavy sales attrition; **is it so for Asda?** No…
- …Asda has replaced management and commenced the long-haul to improve its competitiveness; in Asda's case it is not all about price
- The re-base has arrived, focusing upon fresh food and proprietary brands!

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

UK grocery online - world-leading and evolving model

- UK online grocery market penetration is c5.5-6.0%; growing at c10-15% per annum but decelerating
- We estimate c7-9% participation by 2020; 10-12% by 2025
- UK has the No.1 spot for global non-food online penetration; **over 20%, that's 1 in 5!**
- Profitability is difficult to achieve for the pure online grocery retailer; 15 years & Ocado books a profit!
- Online grocery is becoming more rational in terms of profitability and fulfilment and dark stores will grow but click & collect (C&C) brings online to the store; charges are building, Amazon isn't free
- Amazon Fresh's arrival is a threshold moment; Morrisons move is inspired... Watch out Ocado?
- Prepared food online now emerging in metropolitan London; Gousto & Hello Fresh but needs to kept in perpsective
- Apps as research tools and shopper processors; social media as a regulator.

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

UK & Ireland - The foodservice opportunity

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

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

Tesco - back to the future

TESCO

- Dave Lewis's new team in place & now getting on with material process work…
- … but there is no quick fix
- We now see implementation of a programme of **focus, simplification** & **structural cost reduction**.
- Ongoing range and category reviews now ongoing '*Farms*' is significant
- Project Reset is being digested by customers and suppliers alike; function vs. boredom?
- Significant changes to the supply chain; reducing duplication, cutting complexity, key suppliers; there is much more to come
- What of the shopping experience; functionally better but where is the inspiration?
- Ireland remains a slog for Tesco albeit there are signs of stabilisation
- With a material curtailment of capital investment Tesco is focusing upon free cash flow...
- It needs to with so much leverage (debt, operating leases and pension responsibilities)
- Dividends have been waived for now

Tesco has stabilised, done a lot of heavy lifting…, no mean feat but returning to sustained growth in the UK and further afield is not easy; one for the patient. Perhaps the most difficult task will be to make Tesco relevant and interesting again to customers…, a start has been made.

Sainsbury - toughing it out very well; now for Argos

Sainsbury's

- Mike Coupe picked up the King baton well & Sainsbury materially exceeded our expectations through the consumer depression…sustainably gaining share from the Big Four…
- …but Sainsbury has also been the biggest beneficiary of Tesco's woes; this may be changing.
- Sainsbury's grocery business is slowing as Tesco UK speeds up?
- The business has very effectively extolled its non-price virtues; choice, product specification…
- …but Sainsbury is a price follower & must sell its assortment and specification to ever greater effect…
- …we see a tougher grocery outlook
- Slowing openings, focusing on CVS, conserving cash in grocery
- What about Argos…? Inspired financing, material real estate opportunities but implementation risk; should be fine for a couple of years but thereafter?
- Shame that Argos pushed the end of the Netto experiment

Sainsbury's operates effectively within a constrained position. We remain worried about any recovery by Tesco and what this may mean for JS; tougher times may be ahead. Argos is likely to carry the limelight though and drive near-term earnings.

Asda (Wal-Mart) - struggling to grind it out

ASDA

- Asda also slept at the wheel and so let in the LADs to detrimental effect; Andy Clarke has gone, Steve Clarke from Wal-Mart China is the new man.
- Management smelt the coffee earlier than its Big Four……cutting vouchers, reduced promotions, de-emphasised the APG and eased prices... Asda saw the benefit by Q4 2013 and outperformed until Christmas 2014…, then what happened?
- Significant management change led to a brain drain from Asda to Wal-Mart
- A focus upon costs over customers has made Asda very functional when superstore competitors are re-finding their mojos with the LADs pressing on…
- c£1.5bn+ will be invested in prices to 2018 (was £1bn); it will be a grind, £250m proposition investment too
- Project Renewal all about focus; the abandonment of smaller stores and CVS, especially in SE England
- *George* (No.2 in UK apparel by volume) understated; online strategically re-prioritised
- Asda is a focus of investor attention as to whether or not it delivers retail Armageddon; its problems are more than price, like Tesco & Morrison, it will take time to sort out.
- Will Asda enter the Republic of Ireland; not for now?

Asda benefits from a strong parent, it can be patient. However, it has not balanced simplification and pseudo-EDLP with effective selling and its parent has lost patience. The LADs are particularly hitting Asda and it must grind it out, vulnerable to an improving Morrison and Tesco. Slog time.

Wm. Morrison Supermarkets - back to the future too

MORRISONS

- Morrison's has been through turmoil…, once an idiosyncratic & thoroughbred Yorkshire superstar… Safeway UK consumed it…, the desire to be the 'northern Waitrose*'…'Fresh Formats'* was an unmitigated disaster…, negative operational gearing from a vertically integrated business led to a crash in margins
- Share buy-backs, Kiddicare and stepped up investment were calamitous (the Pennycook legacy)
- Appointment of David Potts is shrewd, Chairman Andrew Higginson has got a grip of things; swift action
- Potts has assembled a talented team to take Morrison back to its best in a modern context
- Morrison has cut its store openings, sold *M-Local* and is slashing its central overheads; focus & **simplification**
- Ocado negotiation brilliant, leveraging Amazon was a win-win…
- We see an on-going commitment to vertical integration
- Morrison has a pension surplus, is 85%+ freehold and is rapidly de-leveraging
- 2016 is a big year for Morrison's medium-term future – the future looks brighter

Morrison is a business with great heritage but lacks scale in retail. It needs to work capability to the maximum in order to go forward. Store closures hit share so it's all about working its existing assets to better effect. Could be exciting.

Shore Capital acts as broker to Wm. Morrison Supermarkets

Co-op - fighting for survival

The co-operative food

- A business with a quite wonderful and heart warming heritage
- Scandals surrounding key personnel/Bank damaged the brand integrity of an ethical and community retailer
- Steve Murrells has patiently transformed its performance and prospects; remember it is the No.5 player in the UK for now…
- …the Co-op has been re-engineering for decades but has now found its market position…
- the retail division has better management and an improved shape, focusing on CVS and small supermarkets
- Tremendous 2016 trading reflecting good basic standards, clever pricing and good fresh innovation
- The Co-op shows that price is not everything and that capability can overcome scale
- With the superstore moratorium the Coop has freer run on store openings

We applaud the manner in which the Coop seeks to remain relevant. Future growth can be expected in the small store segment albeit the business remains vulnerable to attrition and industrywide pressures outside its control such as deflation and gross margin pressure.

Aldi - is the pace setter slowing down?

- After approaching twenty years in the wings in the UK (& Ireland), Aldi's time arrived with the recession
- Aldi GB clinically filled the void left by collectively dozy superstores
- Low-cost c10k sq. ft. stores and a strong price offer; now looking at larger outlets
- Anticipated c10%+ UK space growth per annum; c60-70 per annum
- Targeting more affluent postcodes; the more expensive south & east
- More important than pure price is the value quotient – price+quality=value
- Clinical ranging albeit a rising SKU count, including more fresh & chilled; rising costs
- Tremendous scale benefits on European ambient, frozen & household sourcing; very long runs but the devaluation of sterling could hit margins
- Modest scale in UK fresh & chilled; heat rising in this area with supply chain change - piggy-backs well off the Big Four supply chain - **this may come under greater scrutiny**
- Proprietary brand mimicry is staggering!!!
- Aldi is suffering growth pains in its car parks and queues…, slowing materially in Ireland, negative LFL sales in the UK
- Alive to the German tag in the UK, hence sponsoring British athletics in Rio…

The stars have been aligned for Aldi. Everything that could have gone their way has gone their way.. Times are changing albeit the discount genie is out of the bottle; expect Aldi to grow & gain share, but more slowly.

Lidl - Aldi's poor cousin in the UK, Ireland's LAD?

- Lidl UK has been in Aldi's slipstream but has more stores at c650; much stronger in Ireland
- UK retail scene shocked by Ronnie Gottschlich's resignation; motherland calling
- Circa 10%+ annual store growth should drive the top-line in the foreseeable future
- Also targeting more affluent UK postcodes (sights set on 300 stores within the M25)
- Lidl arguably has more theatre in-store than Aldi (e.g. fresh bakery, strong *De Luxe* range & fine wine)
- Lidl & Schwarz benefits from very long pan-European productions runs but may be vulnerable to sterling devaluation.
- Inspired marketing is seeking to appeal to higher category customers; see '*Lidl surprises*'.
- The 'free lunch' period may be coming to an end as the superstores seek to fight back
- Lidl may be open to store acquisition as part of its expansion programme
- We expect further share gains albeit we are intrigued why top management has changed.

Lidl UK is gaining momentum after a being in the slipstream of Aldi; Lidl is much stronger in Northern Ireland and the Republic of Ireland than Great Britain. New stores are expected to come on-stream at pace with more focus on fresh & chilled. Lidl is here to stay, can the superstores decelerate its progress; maybe internal change will do it?

Marks & Spencer - a defined niche

M&S

- Steve Rowe is stamping his authority on M&S; autumn strategic review to come
- M&S has a more defined focus in food; the meal for tonight, impulse and high specification segment
- Bolland & Rowe (now Adcock) have reversed Rose's move to the mainstream
- **Innovation, high quality and exclusivity** are back to the fore and to pretty good effect
- Store standards have been materially improved with availability now competitive; it is no longer the shoppers' fault for turning up too late to find empty shelves!
- Store openings in the UK provide for a new source of top-line progress; 200+ outlets
- M&S Food Hall is modern & authoritative; set to evolve
- Food-2-Go now more materially featuring in the retail offer
- The market moves by the majors work to M&S' benefit as premium retailers stand-out more
- General Merchandising woes still dominate the broader M&S investment narrative

M&S has found its market position and is growing at pace, particularly through new space. In ploughing its own furrow, M&S is more protected from the main market whilst its offer is in tune with the affordable treat and the greater interest in both health, well-being, authenticity and provenance of food. Internationalisation in food may still be a growing opportunity.

Waitrose - a warm glow

Waitrose

- All great businesses have a great leader; Waitrose was blessed with one of the best; who has retired – Rob Collins now has the baton
- Waitrose makes retailing look very easy, it is a class act benefiting from the long-term perspective
- Stability and culture are part of the highly regarded John Lewis family
- Organic expansion potential appears robust although management is re-visiting the core, slowing openings
- The relationship with Ocado will be interesting; maybe a new modus operandi is evolving?
- With its premium offer Waitrose still sits well in a market where value is to the fore
- We see an outstanding private label capability whilst innovation in value is strong e.g. NPD, PYOO, *myWaitrose*…
- Service standards are robust & seeking differentiation; food-to-go/café culture
- Waitrose is expected to sustain market share gains albeit at a more sedate pace

Waitrose is a class act. The business has sustained outperformance through skill & capability, it understands its customers and place in the market. A change at the top will bring some uncertainty but continuity is anticipated. We believe that Waitrose continues to have a bright albeit less buoyant future.

Ocado - the new management consultants

ocado

- A highly distinctive concept
- Generally strong customer service standards, an excellent website and customer support, particularly in metropolitan London
- Flawed initial business model seeking to centrally fulfil to a de-centralised multi-temperature market meant it failed as a proprietary grocer; rescued twice
- The cost of the last mile – taken nearly a decade and a half to report a profit and not much at that; it capitalises technological development (1000 people of it)
- It is has become a secondary logistics provider, arguably a technology consultant & supplier
- Commissioning CFC3 and announced CFC4 in Erith; the latter with Morrisons – clever negotation
- For some time praying for Amazon to take it out, which the Morrison deal constrains…
- …now seeking to be an Amazon defence to other retailers; chameleon comes to mind?
- There is rising pure-play activity in its core markets; Gousto, Hello Fresh, Lidl acquires Kochzauber…, and now Amazon Fresh in London…
- Awaiting international deals…, still waiting…

Ocado is a peripheral player in British grocery, its proprietary business (ex-Morrisons & Waitrose is tiny). The business has had to evolve into an online service provider. International tie-ups are awaited and essential to future prospects. Maybe a disrupter for the next generation.

B&M, Home Bargains and Poundland

- Highly entrepreneurial
- Filling the void left by the general merchandise and superstores e.g. Woolworths
- Very strong value propositions – single price for Poundland, multiple-price for B&M/Home Bargains
- A clear commitment to proprietary brands migrating from informal to formal trading relations, a key difference with the grocery LADs
- Causing a rethink to prevailing industry category management, especially proprietary brands in grocery/HPC?
- Substantial store opening programmes planned in the UK; c10% per annum, Ireland too for Dealz
- Scope to consolidate the high street value retail segment; note Poundland's acquisition of 99p Stores, which has held the business back (now acquired by Steinhoff)
- Not all discounters are winners…: 99p, Poundstretcher (WEW, Instore…), Wilko…
- Potential to internationalise; B&M in Germany (JA Woll and Hafu) & Poundland is in Ireland and Spain.
- Strong balance sheets, high cash returns and the capability to become very substantial businesses

The HSVRs have bright futures gaining share in the FMCG and general merchandise channels. Store standards are strong, cost & cash management tight and the art of selling is to the fore. Roll-out and internationalisation pose strong prospects for growth. Poundland has wobbled, needs to 'get back on the bike'.

Independent trade

- Evolving into a stronger position albeit still in overall decline, marginally so
- Mr Arkwright and Patel replaced by new entrepreneurs, some third generation
- A highly political segment persists: Costcutter/NISA/Palmer&Harvey
- Higher category independent food retailers that offer authority, differentiation, range & service to grow; e.g. Wheetons in Harrogate
- Symbol groups are now more resilient, innovative and robust e.g. Premier & Family Shopper/One-Stop
- We see Booker's acquisition of Budgens-Londis, completing it portfolio
- The wholesale segment is innovative with some strong players e.g. Bestway, Booker, **Musgrave** & **Henderson's SPAR** (Ireland & UK)
- Wholesale trade and CVS offer extremely effective & competitive in Ireland e.g. Centra
- Good reaction to market concentration, standardisation and homogeneity, makes for a brighter future
- Keep an eye on the forecourt players e.g.: Applegreen, Euro Garages & Motor Fuel Group

Shore Capital acts as a b[illegible] pplegre[illegible]

A basic law of economics of forgotten

Simple economic principle

Where there is oversupply, margins <u>will</u> be weak; where there is balance, cost recovery etc… can be achieved; where there is a shortage, margins can be robust.

Conclusions

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

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