



Scale, Disruption and Brexit

A new dawn for the UK food supply chains?

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Executive summary

It's a momentous time for the UK food and grocery sector. New technology, increased consumer choice, fiercer competition and game-changing industry consolidation have all led to a big shift in power between wholesalers, retailers and consumers.

Disruption is now the new normal across the sector. To become more profitable and fit for the digital age, retailers have had to keep up with customer demands and expectations. This has led to innovative strategic partnerships that no one thought possible just a few years ago.

Technological innovation is driving increased consumer choice.

The union of the UK's largest retailer and wholesaler with Tesco's £3.7bn acquisition of Booker started the ball rolling in 2017. There's also a potential £7.2bn merger between Sainsbury's and Asda up for approval from the CMA (Competition and Market Authority) though the CMA has confirmed it requires further investigation. Add to the mix Amazon's foray into the online food market, plus the rise of the discounters and it's not surprising to see retailers taking measures to adapt to these new market forces. At the time of writing, the latest of these measures is Tesco's launch of its new discount fascia, Jack's. As retailers and wholesalers continue to form closer partnerships, it's likely that consolidation, and the formation of strategic partnerships, will continue to ripple through the sector, including down the supply chain.

Technological innovation is also driving increased consumer choice as takeaway and online options change the way people buy and consume food. Environmental considerations are also important as shoppers look to shop

closer to home, buy produce from local suppliers and be more ethical with what they put in their basket. They're also looking for a wider, more pleasing shopping experience.

Playing out against the backdrop of these developments is the UK's future relationship with the EU. How will British businesses trade with the rest of the world and at what cost? Companies need to be aware of how the challenges and opportunities for each scenario will impact on their business and put contingency plans in place.

New tariffs* of
£9.3bn
per year
could be imposed on food and
drink imports from the EU



In this report, we've included an overview of the food and grocery sector since the turn of the century in Part 1 and looked at current trends in Part 2. Part 3 focuses on the different Brexit outcomes and what this is likely to mean for the industry when it comes to costs and tariffs over the five-year post-Brexit period.

For example, a hard or no-deal Brexit could mean:

- New tariffs* of £9.3bn per year imposed on food and drink imports from the EU
- A new average tariff of 27% for food and drink supply chains compared to a 3–4% non-food average tariff
- Every consignment of goods from the EU will require a customs declaration which starts at a minimum of £50
- The average cost of complying with SPS (Sanitary and Phytosanitary Rules) on imported food and drink from the EU could be equivalent to an additional 8% duty.

No-one has a crystal ball when it comes to the future. But looking at the history of the food and grocery sector, it's likely that it will continue to rise to the challenges of this fast-evolving landscape.



Ian Gilmartin
Head of Retail and Wholesale
Barclays Corporate Banking

*For details of individual product tariffs, and how this might affect your business or subsector, please see the appendices at the end of the report.

Part 1: Societal shifts in how, when and where we shop

We have seen the shape of the grocery market shift considerably over the past 20 years, matching the way we shop as consumers.

How did we get here?

Since the early 2000s, the retail grocery market has been dominated by the domestic expansion of the Big Four supermarkets – Tesco, Asda, Sainsbury's and Morrisons. Their market share increased from around two-thirds in 2000 to three-quarters in 2007-2012. They also increased store numbers by around 60% from 2005 to 2012.¹ Along with the expansion of these large stores in out-of-town retail parks, the Big Four added more non-food products to their range, such as clothing and electricals. They also branched out to banking, insurance and restaurant services. Thanks to digital technology, retailers were able to offer customers more sophisticated shopping options, including online click and collect and home delivery services.

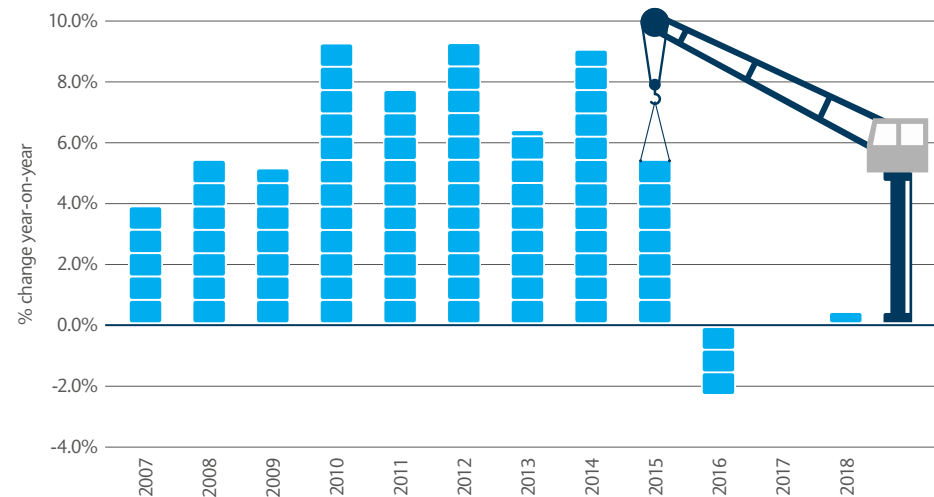
This growth was underpinned by substantial investment in new stores and regional distribution centres, as well as the IT infrastructure behind e-commerce and smarter logistics.

In part, this rapid change in market structure was led by demand. Increasingly affluent consumers wanted more choice, convenience and shopping options. This in turn changed how retailers served their customers.

All of this led to fierce competition among the major players for new sites, fuelling a sharp rise in the density of urban supermarkets. Indeed, the growth in supermarket floor space outpaced sales for much of this period, eating into sales densities and damaging productivity for many years.

Figure 1

There was significant growth in the number of food stores throughout the UK



Source: Company reports (Tesco, Sainsbury's, Morrisons), Retail Economics analysis.

Despite modest sales volume growth across the food and grocery sector from 2007 to 2014, capacity across the Big Four supermarkets is estimated to have gone up by 45%. As a result, sales densities declined dramatically, falling in real terms by around 32% over this period.

Meanwhile, discounters Aldi and Lidl have increased their store base, built a stronger proposition and created a loyal customer base. As a result, their market share has increased from under 5% to over 7% during this period.

What's behind these changes?

Many of the trends that emerged from 2004 to 2014 have since been reversed. After the financial crisis, households saw their disposable incomes go down.

And right when consumers started looking for cheaper alternatives, new technology was enabling retailers to be more transparent around pricing, service and quality. This gave discounters a much firmer foothold in the market.

¹Company annual reports.

Multiple choice

Consumers tend to buy food more often, from a wider range of outlets. Busier lifestyles, shifting preferences among younger buyers, and the popularity of 'en-route' shopping have seen a move away from supermarkets. From 2014 to 2017, their share of the market fell from 62.9% to 55.4%.

Instead, shoppers are embracing convenience, online and discount stores. The number of trips to bricks and mortar shops went up by 14.3% from 2013 to 2018. This came at the expense of the average spend, which fell by 8.5% in real terms during this period.² As households no longer needed to store a lot of food, food waste also fell by 12% between 2015 and 2017.³

This has led to convenience stores becoming the fastest growing physical channel within the traditional supermarket channel. The convenience sector was estimated to be worth £40bn in 2018, growing by 10% over the last four years, compared to 7.1% for the overall industry.⁴

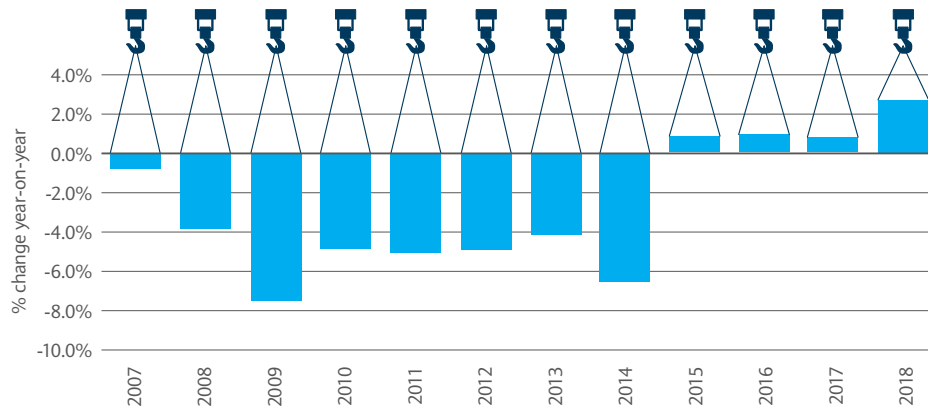
Convenience stores have become the fastest growing segment within the traditional supermarket channel.

Ease and convenience

Two main digital shifts have emerged to affect the structural composition of the sector. People are increasingly going online to order staples, such as cereals and pasta, and more bulky items before 'topping up' their shopping from convenience stores. This is behind the fast-paced growth of the online food market, which has increased by 12% on average each year since 2010. Valued at £10bn, it is by far the fastest growing channel for the major supermarkets, accounting for almost 7% of total food sales in 2017.⁵

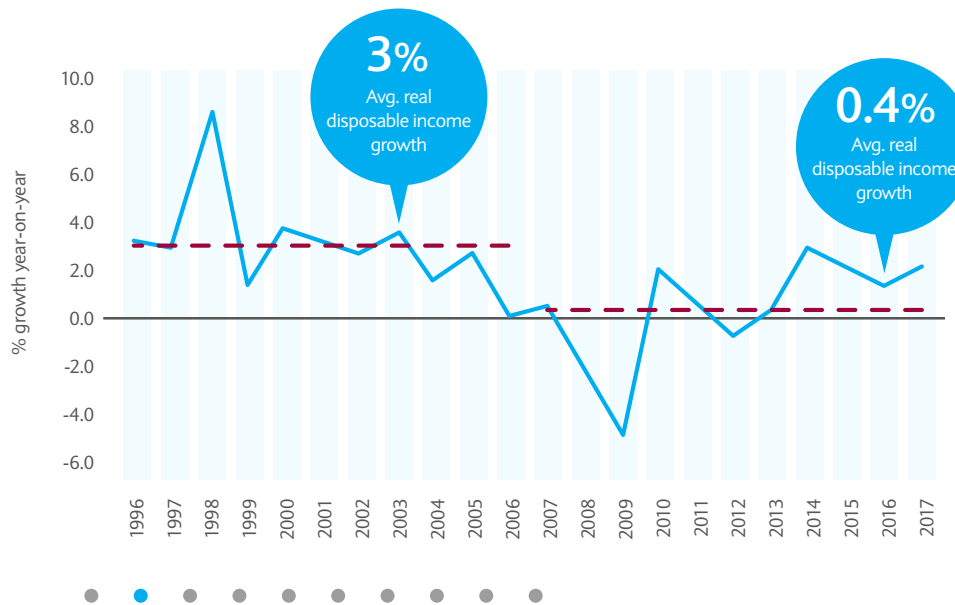
²Nielsen Homescan ³DEFRA. ^{4,5}Retail Economics.

Figure 2
Sales volumes per square foot of retail space



Source: Company reports (Tesco, Sainsbury's, Morrisons), Retail Economics analysis.

Figure 3
A reduction in real household disposable income growth put a sharp focus on value



Source: ONS.

The popularity of casual dining platforms like Uber Eats, Deliveroo and Just Eat, has also led to a boom in the range, quality, convenience and competitiveness of takeaway food. Estimated to be worth £10bn in 2017, the takeaway market has grown by 34% since 2009, almost twice the rate of the retail food sector over this period.⁶ It now accounts for around 5% of total spend on food and drink (including eating out), with a large part of this growth coming at the expense of the traditional grocery market.

Worth £10bn in 2017, the takeaway market has grown by 34% since 2009.⁷

The sector has embraced new technologies such as online and smartphone apps. Investment in the development of ordering functionality on Facebook Messenger, Amazon Alexa and Xbox, has also helped disrupt the food sector.

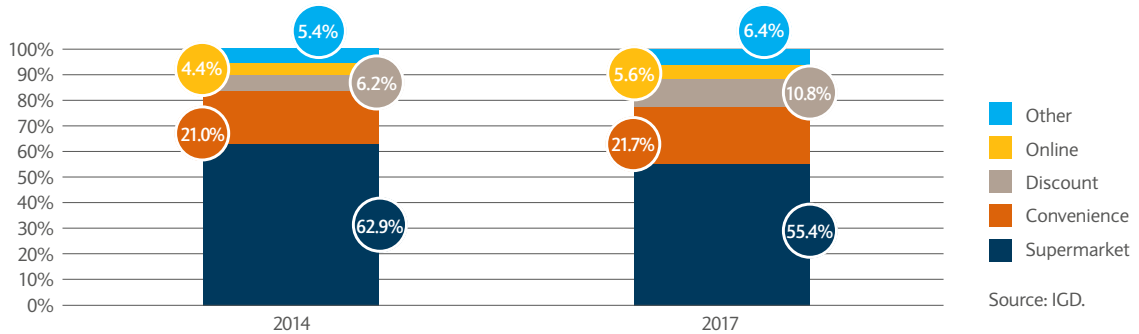
More for less

Given the pressure on household finances, consumers have prioritised value-for-money over choice. This reduced loyalty to retailers and brands has led to a sharp rise in the discounter market share. As a result, the Big Four's market share declined to 68% in 2018 from its peak of just over 77% in 2011.⁷ By contrast, Aldi and Lidl have more than doubled their share of the market over the same period while being consistently more price-competitive than the Big Four.

It's estimated that almost two-thirds of consumers visit Aldi or Lidl as part of their overall shop.⁸ The combined market share of the discounters is almost £1 for every £8 spent in supermarkets, compared to £1 in every £25 just 10 years ago.⁹ Offering value over range has resonated across all social groups. It's thought that a third of shoppers at the discounters come from the most affluent households.¹⁰

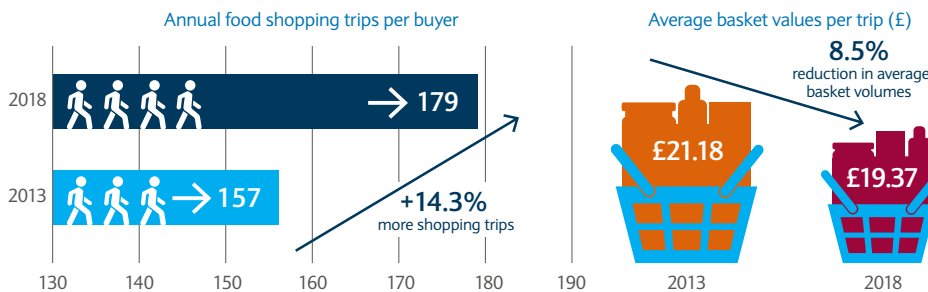
⁶The Takeaway Economy Report 2017, ^{7,8,9}Kantar World Panel. ¹⁰The Grocer.

Figure 4
The move away from supermarkets has been fast



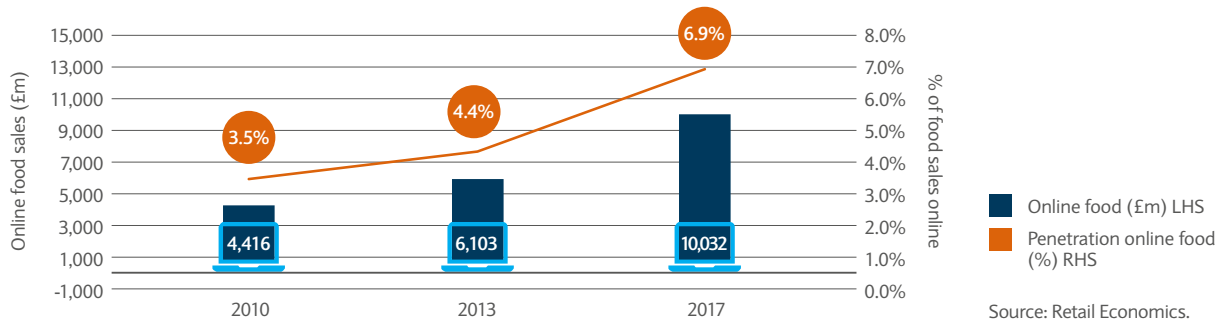
Source: IGD.

Figure 5
More visits to the shop has reduced average basket values



Source: Nielsen Homescan (2013 – 52 weeks to 4 January 2014 and 2018 – 52 weeks to 11 August 2018). Includes grocery multiples and discounters.

Figure 6
Online food sales have more than doubled from 2010 to 2017



Source: Retail Economics.

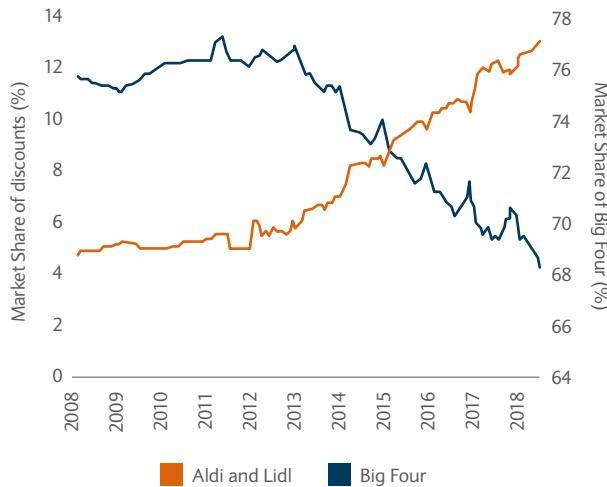
Healthier lifestyle choices

The growth in food volume is under pressure, as evidence suggests that people are consuming fewer calories than they did in previous decades. Average calorie consumption started declining in 2001 and has fallen by more than 8% over the last 10 years.¹¹

There's growing evidence that consumers are more interested in what they eat, as well as the impact this has on their health and the environment.

This trend towards the consumption of fewer calories is likely to have been driven by the popularity of healthy living. There's growing evidence that consumers are more interested in what they eat, as well as the impact this has

Figure 7
Comparisons of market share shift – Big Four vs Discounters



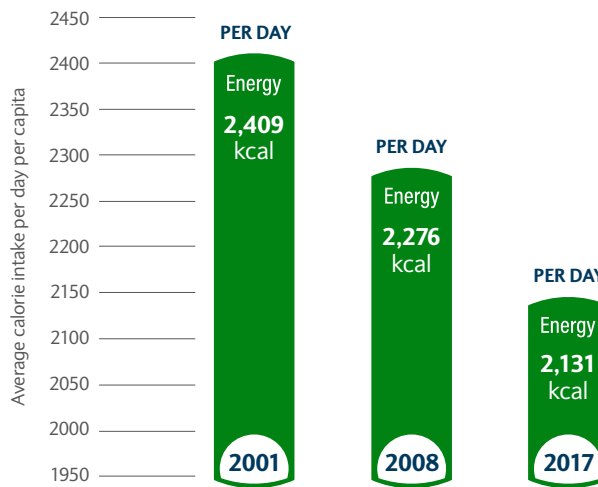
Source: Kantar Worldpanel.

on their health and the environment. Increased visibility of nutrition and 'traffic light' labelling from supermarkets and suppliers has also raised calorie consciousness.

Another factor worth noting is that calorie consumption falls as people get older. The median age in the UK was 37.6 years in 2000, which rose to 40.2 years in 2015.¹² Meanwhile, the percentage of the population aged over 65 is expected to rise from 17.7% in 2014 to 23.3% within two decades. A reduction in calorie consumption also explains why food volume growth is failing to keep up with population growth. If free movement were to end when the UK leaves the EU, this would put further downward pressure on population growth in the coming years.

¹¹DEFRA. ¹²ONS.

Figure 8
Average daily calorie intake is on the decline



Source: DEFRA.

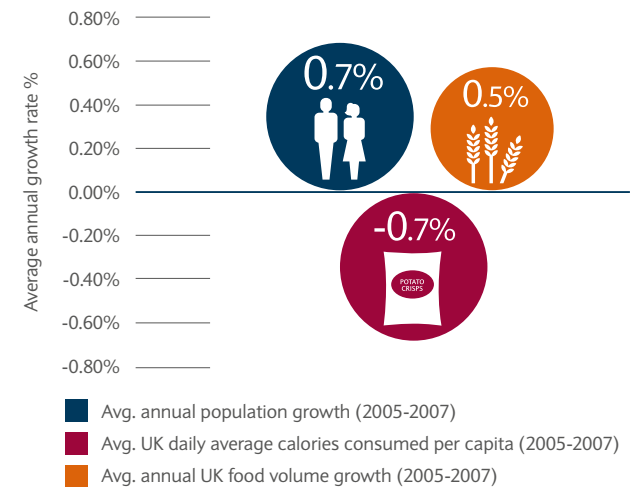
Shopping as an experience

The Retail Experience Economy touches all parts of the industry, from beautifully designed supermarkets that invite people to relax and socialise, to omnichannel services that offer same-day delivery on products they've ordered on their phone or tablet.

Meaningful experiences are becoming such an important deciding factor for consumers that, in some spheres, it has led to a polarised market. At one end of the spectrum, convenience and value have driven consumption of everyday consumables. At the other, free coffee and sushi bars appeal to consumers who value the environmental, entertainment and educational side of their experiences.

Broadly, the proportion of household income spent on recreation and culture, eating out, holidays and more general leisure pursuits has risen as consumers prioritise these activities.

Figure 9
Food volume growth has not matched population growth



Source: ONS, DEFRA, Retail Economics analysis.

Part 2: Consolidation is the name of the game

The seismic shifts in the UK grocery landscape have had a profound impact on retailers and their suppliers. A decade of rapid physical expansion and a shift in consumer preferences have also led to a disconnect between business models and consumer needs.

Retailers have shifted their strategies to become more competitive and productive, and to secure future growth. As a result, the line between wholesaler and retailer has become increasingly blurred.

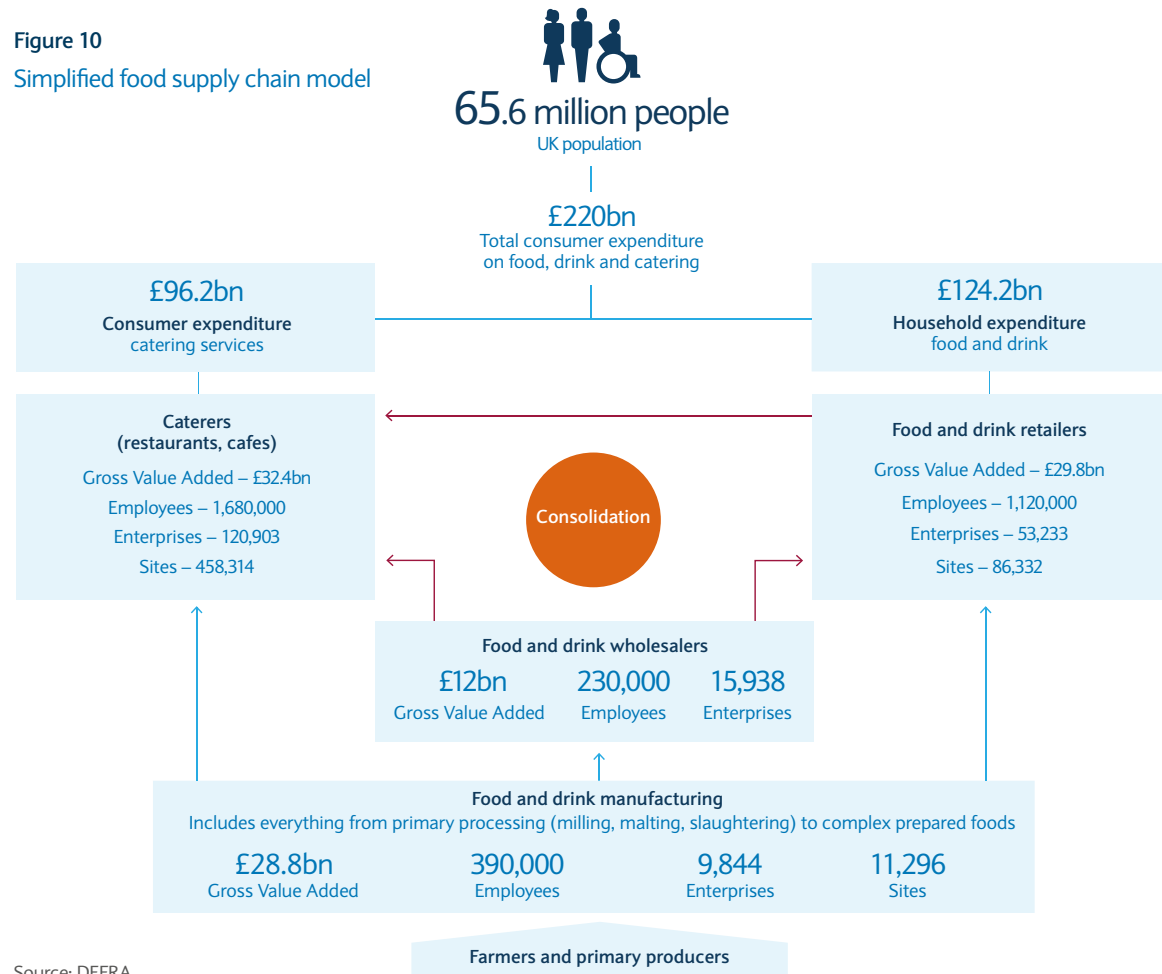
The flow chart shows a simplified food supply chain, highlighting the area under the greatest amount of pressure for consolidation.

Rebalancing costs

Operating costs for retailers rose by 2.9% in 2017, outpacing industry sales growth and putting margins under intense pressure. Part of this rise was driven by the National Living Wage, National Minimum Wage, business rates, the Apprenticeship Levy, utilities and other central costs. From 2008 to 2016, total employment costs rose by 30% for food wholesalers and 29% for retailers. And when import costs went up in 2016 after the post-Brexit currency dip, so did sourcing costs.

Despite these pressures on operating margins, consumers haven't been impacted too much. Historically, the extent to which retailers have passed through costs is closely linked to loss of market share and share price drops. The last time UK shoppers faced a 5% price rise in their food shopping bills was in 2011. This marked the start of a five-year period where the Big Four grocers lost around five-percentage points of their market share to discounters.

Figure 10
Simplified food supply chain model



Source: DEFRA.

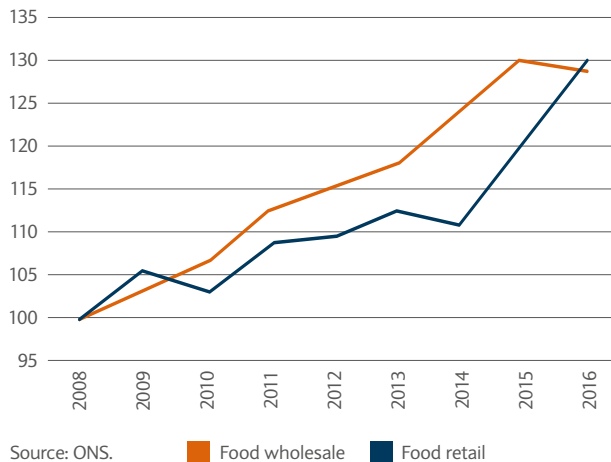


As a result, retailers have been forced to sacrifice margins and seek cost reductions in their own businesses and from suppliers to remain price-competitive. In turn, suppliers have been under similar pressure to cut costs and become more efficient. Both retailers and wholesalers have reshaped their operating cost base in three main areas: space reduction, simplifying the product range and cutting staff numbers.

Space to fill

Stores are reducing or simplifying space, or repurposing excess capacity. The number of stores across the Big Four consistently fell between 2012 and 2016. Equally, the rapid expansion of discounters has also slowed as suitable locations become harder to find. Since 2015, overall space has declined by 1.5%, although Aldi and Lidl continue to expand, even if it's at a slower rate. The German giants will have to continue adapting how they operate as they face more direct competition from retailers like Tesco, which has already taken steps to regain market share.

Figure 11
Total employment costs facing food wholesalers and retailers have been closely aligned



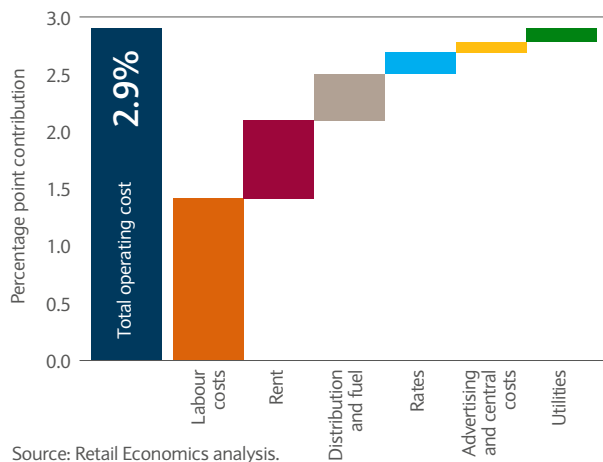
Jack's, Tesco's answer to Aldi and Lidl, is expected to open over 10 stores in a variety of locations, including underperforming stores and new sites, by the second quarter of 2019. Like its competitors, it will offer both own-brand and familiar grocery brands, with a range of general merchandise available on a 'while stocks last' basis.

The unique mix of private label, premium quality and general merchandise products, typical of hard discounters, allows them to sell at low prices while maintaining high margins.

Back to basics

Retailers have also been simplifying their range by working more strategically with fewer suppliers over a longer period of time. This has reduced the number of product lines, introduced clearer price architectures and cut the end-to-end cost of goods. Retailers are under pressure to simplify the offer for consumers, dedicating more shelf space to more popular items.

Figure 12
Operating costs facing food retailers have risen faster than sales growth



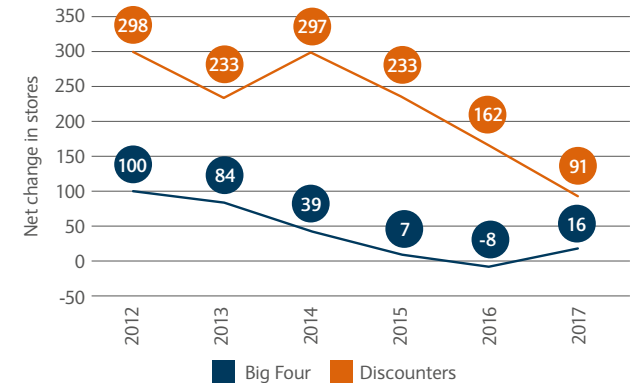
Labour cuts

Refocusing on the core food business has led to more streamlined management structures. This has meant fewer head office jobs, and a reduction in overall headcount, which has lowered costs at store level. In essence, a simpler business model needs fewer people.

Store wars

Achieving market growth for the Big Four has become a zero-sum game, with one retailer's market growth coming at the direct expense of the others. Retailers have kept cutting prices to close the gap with their competitors, while also investing in differentiating their brand and services to regain customer loyalty. While this might be less destructive than an all-out price war with discounters, it has led to increasingly smaller margins. When each retailer invests in lower prices to protect market share, profit margins go down for the whole sector.

Figure 13
Comparisons of net store changes across discounters and supermarkets



Source: LDC. (Note discounters include Aldi, Lidl, Iceland, Poundland, 99p stores (sold in 2016 to Poundland), Poundstretcher, Poundworld, Home Bargains, B&M Bargains and Farmfood).

With such big overlap between competitors, the Big Four are fighting to maintain excess capacity despite diminishing returns. In other words, retailers would rather keep a marginally profitable store open because closing it would gift market share to competitors.

Store closures can also be incredibly expensive if leases are long and inflexible. That means that marginal stores need to experience heavy losses before there's a commercial justification for closing them. Against this backdrop, grocers are turning to more innovative solutions such as acquisitions and strategic partnerships to secure their future growth.

Diversifying to grow

When Tesco announced the £3.7bn acquisition of Booker in 2017, it set the tone for the scale of disruption facing the industry. Booker owns the Premier, Londis and Budgens brands, and is the main cash and carry wholesaler to hundreds of independent convenience grocery stores.

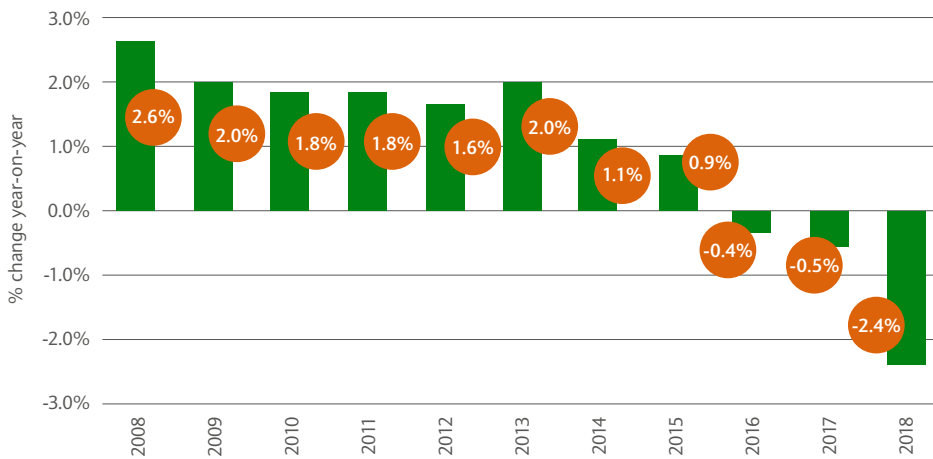
They also supply restaurant chains such as Wagamama, Carluccio's and Loch Fyne. The foodservice market was estimated to be worth £10bn in 2017, with Booker's market share around 18%, despite being the market leader. The vertical acquisition combines both the largest retailer and wholesaler in the UK with synergies between the two worth around £200m (0.3% of combined sales).

The merger is likely to drive further revenue from existing Booker customers because of the enlarged distribution network, improved access to products, increased brand recognition and competitive pricing. The deal has been the catalyst for further consolidation in the UK wholesale and symbol industry. Soon after the Tesco/Booker announcement, Sainsbury's looked to acquire NISA but didn't go ahead. This cleared the way for the Co-op to acquire NISA in a £143m takeover in May 2018.

If the CMA does approve the potential £7.2bn merger between Sainsbury's and Asda, the deal would create the largest grocery retailer in the UK, with a combined market share of over 30%.¹³ In the quest for scale and enhanced profitability, the deal would generate combined cost-saving synergies of at least £500m. These would be realised through shared capabilities, supplier cost harmonisation and operational efficiencies. Sainsbury's has suggested that the merger could lower prices by around 10% across many core products, further closing the gap between them and the discounters.

However, increased scale across the combined group would almost certainly lead to pricing pressure on their suppliers. The 10% price reduction across core products depends on the harmonisation of sourcing costs between the two retailers. So, where there is a price difference from the same supplier, the price would fall to the lowest common denominator – or at least, that's the basis of their calculation.

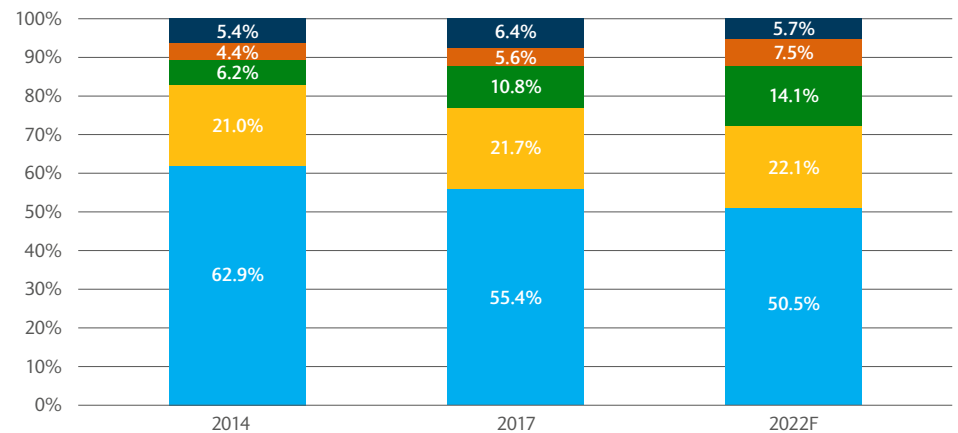
Figure 14
Tesco, Sainsbury's and Morrisons have reduced their workforce for the last three years



Source: Company reports, ONS, Retail Economics analysis.

Figure 15
Grocery market by channel

¹³Kantar – August 2018.



Source: IGD. ■ Supermarket ■ Convenience ■ Discount ■ Online ■ Other



Amazon: Hungry for more

Given their potential to disrupt the market, Amazon's acquisition of Whole Foods in 2017 has raised eyebrows. Although the company's UK market share for food remains modest, it's clear that they see the food sector as a significant opportunity. After all, Amazon has successfully transitioned across numerous retail verticals; moving from books and media to consumer electronics to household goods to apparel. It's likely that food and consumer packaged goods will experience further disruption as Amazon makes headway into the market. The merger of Today's Group and Landmark to create Unitas Wholesale with a joint turnover of over £1bn is a sign of further consolidation in the wholesale sector. It will create a more sustainable wholesale business, driven by enhanced scale, relevance and capability.

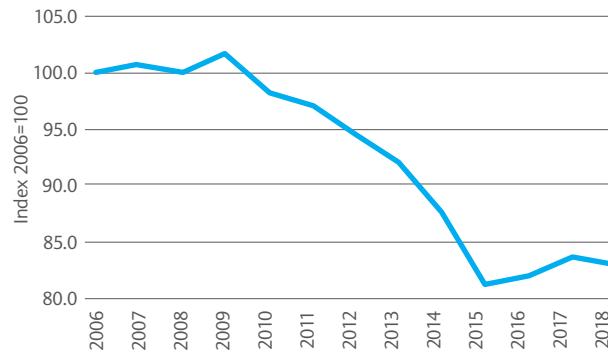
Overall, the relentless drive towards improving operational efficiencies, particularly in logistics and improved buying capability, supports the rationale for further consolidation in both the retail and wholesale markets.

All joined up

The lines between retailers, wholesalers and suppliers are becoming increasingly blurred as retailers form partnerships which span sectors, transcend supply chains and cross borders. Morrisons' 2017 supply agreement with McColl's opened the door for the supermarket to supply McColl's 1,300 convenience stores and 350 newsagents. It has also resurrected the Safeway brand as a wholesale label offered exclusively to McColl's for a limited period. And Morrisons' high-profile agreement to supply Amazon, along with its tie-up with Rontec and Sandpiper, is expected to take the company's wholesale operations past £700m in 2018 with a target of £1bn by 2020.

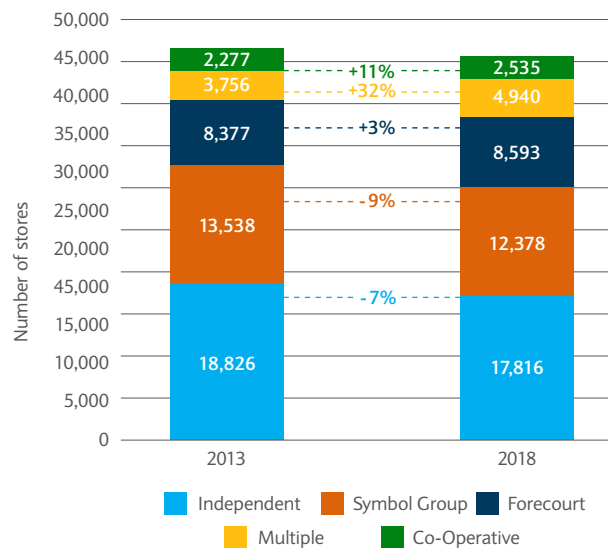
In November 2017, following the administration of Palmer and Harvey, the Co-operative Group became the exclusive wholesale supplier to Costcutter Supermarkets Group's

Figure 16
Average area per store – Big Four estimate



Source: Company reports, Retail Economics analysis.

Figure 17
The convenience market has become much more competitive as multiples grow market share



Source: ACS, Retail Economics analysis.

(CSG) network of 2,200 Costcutter, Mace, Simply Fresh, Supershop and kwiksave convenience stores. The deal also gives CSG's independent retailers the opportunity to become Co-op franchises, although a bid by Co-op to acquire Costcutter outright in 2018 was rejected.

Supermarkets are also finding other ways to use excess capacity by forming tie-ups with other businesses, including fashion retailers Next and Arcadia, Dixons Carphone, Holland and Barrett and food and beverage company Crush.

These 'store-in-store' concepts offer an arrangement that suits both sides. The supermarket can sweat their assets more effectively, while the partner typically benefits from increased footfall and an improved network of click-and-collect destinations. This trend is expected to continue. Across borders, the strategic relationship announced in July 2018 by Tesco and the French retailer Carrefour highlights the opportunity to achieve scale without acquisition. While there are considerable complexities with this approach, it won't stop suppliers fearing a further erosion of their margins.

Behavioural shifts

Changing consumer behaviour is behind the most disruptive industry changes as retailers prioritise their investment in convenience stores and online capabilities.

The distribution of grocery sales by channel shows that supermarkets still account for the majority of sales. However, the rapid fall in supermarket sales is expected to further decline as online, convenience and discounters increase their share of the grocery market.

As a result, the incumbent retailers are restructuring to capture this shift in sales. While overall store numbers have plateaued across the Big Four, average store size has fallen by over 15% since 2006.



This suggests that retailers are downsizing fast. Additionally, Aldi and Lidl don't offer full ecommerce propositions, and their operating model is unsuited to expand into the convenience market. This gives the incumbent retailers a significant competitive advantage.

With the convenience sector becoming a more important route to market for retailers, competition within the channel has intensified. The look of this offering is changing too, with many facias being retrofitted like mini-supermarkets. As well as a range of chilled foods, fresh produce and alcohol, these stores are increasingly selling 'food-to-go'.

This has put independents and symbol groups (wholesaler facias) under pressure. While the overall number of outlets has remained fairly static since 2013 (declining by 1.2%), in 2018 the value of the sector went up from £36bn to over £40bn.¹⁴ A significant proportion of this growth has been driven by the larger presence of the multiples. They increased their store numbers by 32% from 2013 to 2018 while the number of independent outlets and franchisees, for example Spar, fell by 7% and 9% respectively during this period.

Moving online

Meanwhile, the online food market grew by over 17% in 2017 compared with the previous year.¹⁵ By 2022, online food sales are expected to rise by 48% as consumers continue to become more comfortable buying online.¹⁶ What's more, Gen Z and millennials will also become more commercially important.

Technological innovation will also accelerate transformational change in the sector. Artificial intelligence will power the uptake of subscription purchasing models and automated ordering, and offer consumers more convenience. Customer preference can also be more personalised online. But as a higher proportion of food sales moves online, supply chains could narrow further. And while the online grocery model

offers an almost unlimited magnitude of stock-keeping units (SKUs), the real estate on desktop and mobile screens is limited. They might have more choice, but consumers will still be viewing things through a narrow lens.

We expect online will continue to support greater growth in the takeaway market through increased use of aggregator platforms, such as Just Eat, and hard platforms such as Deliveroo and Uber Eats. Although still in their infancy, dark kitchens (purpose-built kitchens that house multiple eateries that are not open to the public) which purely service takeaway orders, have the potential to disrupt particularly the convenience sector. Restaurants don't need to use their high rent, customer-facing kitchens to prepare takeaway food; instead they can effectively use dark kitchens. Deliveroo is pioneering this model in partnership with Wagamama, one of 80 restaurants located across 11 dark kitchen sites throughout the UK.

Own-labels the key to boosting margins

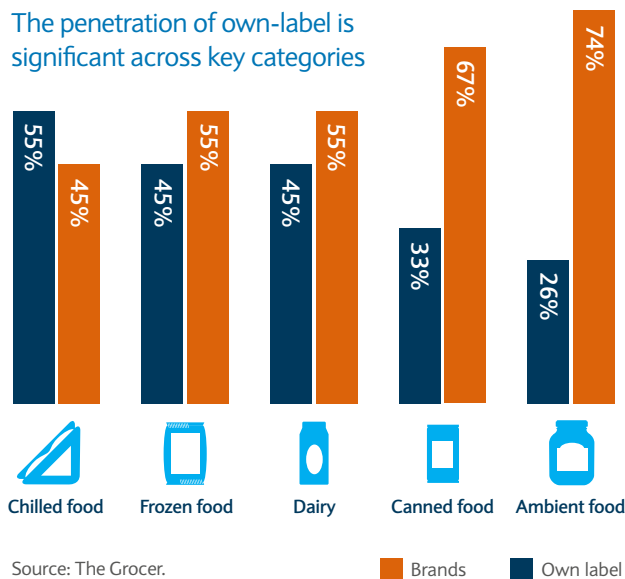
Given the intense pressure on profitability, retailers are likely to promote their own-brand products rather than branded goods. This could have far-reaching consequences for the wholesale and supplier markets. Exclusive, strong own-label and focused premium brands not only stand out from the competition; they also have higher margins. Retailers have also enhanced their value range to compete with discounters. In some categories, own-label products now account for over 50%¹⁷ of the grocery market as they continue to be one of the fastest growth categories; their growth outstripped that of branded products from May 2015 to August 2018.¹⁸ In 2018, Tesco announced that they are about a quarter of the way through launching 10,000 own brand products. They're also cutting back on the number of suppliers they work with to simplify the business, putting further pressure on suppliers.

What's next for the industry?

The food and grocery sector is going through a period of painful readjustment. The relentless focus on structural transformation through a programme of cost reduction has been central to the recovery of profitability, accompanied by improvements in industry-level productivity. The spotlight is now on the changing supply chain dynamics as consolidation and collaboration continues, driven by the need to scale. We expect to see more conversations between retailers and wholesalers, wholesalers and symbols groups, and even large-scale logistics companies.

Overall, the industry has a renewed, laser-like focus on customer's needs in the context of wider market developments. Retailers are now more agile and fit-for-purpose than at any point over the last decade. With stronger balance sheets, renewed focus and firmer strategies in mind, the pace of structural change is likely to accelerate. Nevertheless, business investment is based on certainty. And with Brexit looming, there may be reasons to pause for thought before re-engaging in the battle.

Figure 18
The penetration of own-label is significant across key categories



¹⁴ACS and Retail Economics. ¹⁵Retail Economics. ¹⁶IGD. ¹⁷The Grocer. ¹⁸Kantar Worldpanel.

Part 3: The Brexit effect

In 2017, the UK imported £48bn worth of food and drink, approximately 40% of the total UK market. Of these, 71% originating from within the EU entered the UK free of customs duties and other trade costs.¹⁹

Following Brexit, food and drink supply chains could face an average tariff of 27%, significantly higher than the average non-food tariff of 3-4% in other sectors.²⁰ While these new levies could be severely disruptive in terms of rising costs, there could be opportunities to reduce these tariff costs in a scenario that saw the UK outside the Customs Union. The government could decide to reduce tariffs quickly, especially across products where a tariff would serve no useful purpose.

Either way, UK retailers and wholesalers are entering a period of heightened uncertainty. Any outcome other than a full Customs Union will see additional costs imposed on the overall food supply chain. However, the government has proposed measures to minimise the worst effects of the new tariffs, some of which could come into immediate effect when the UK leaves the EU, scheduled, at the time of writing, for March 2019.

What would be the impact of a hard, or no-deal, Brexit?

The outcome of a hard, or no-deal Brexit (where the UK and EU apply their standard tariffs to each other's trade) would impose the highest quantum of new costs. Based on import statistics in the 12 months leading up to May 2018, this would amount to new tariffs of £9.3bn per year on food and drink imports from the EU.²¹

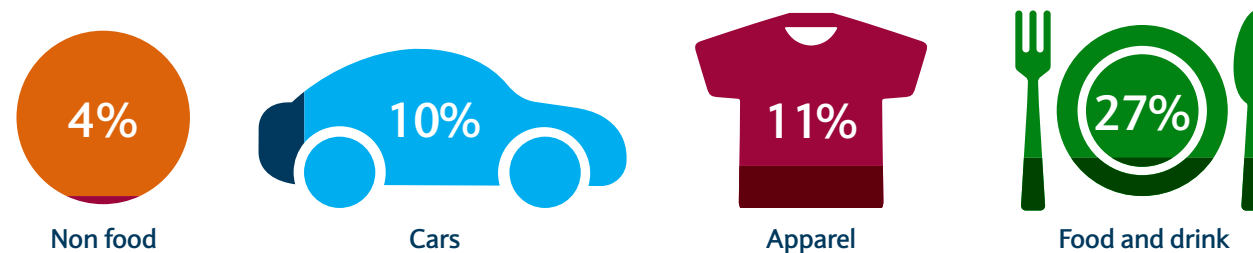
Food and drink tariff rates will be higher than those in any other supply chain. All stages within the food supply chain will experience increased costs, with retailers hit disproportionately as processed goods attract higher duties than raw materials and semi-processed goods. Wholesalers will also experience significant cost increases, but to a lesser degree.

Meanwhile, discounters at the lower end of the market, trading in meat, dairy, cereals and wine, will experience a heavier tariff burden compared with companies operating at the upper end of the market. In essence, a large proportion of the tariff burden is based on the weight of the imported produce, meaning it does not discriminate against quality.

Our analysis shows evidence of 'tariff escalation' across food and drink product supply chains, with finished products attracting a higher rate of duty than primary and semi-processed goods. This will have a much bigger impact on retailers than suppliers, and go further down the supply chain.

^{19,20,21}WTO, HMRC, Retail Economics analysis.

Figure 19
Average weighted tariff for food and drink is considerably higher than other industries



Source: WTO, HMRC, Retail Economics analysis.

Food and drink tariff rates will be higher than those in any other supply chain.

These tariffs will apply to most oil seeds. They're exempt of duty in their raw state, but attract a rate of up to 9.6% when converted to usable oils. In specific cases, duty rates are higher for goods that are packaged for retail than for bulk-packed goods, for example milk, green tea, palm oil and tinned fruit. Again, this imposes a higher tariff burden for retailers and others operating at the end of the supply chain.

Higher costs for lower value products

'Specific duties' is the term applied to food and drink tariffs when expressed as a fixed amount of *money per weight* or *volume of product*. Nearly all meat products, dairy, cereals, olive oil, wines and sugar-based foods would be subject to these specific duties.

A hard Brexit would add disproportionate cost pressures on discounters.

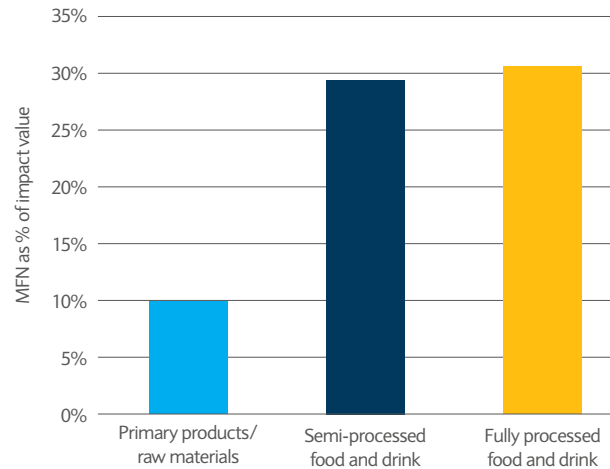
By nature, specific duties impose a relatively heavier burden on lower value transactions. A hard Brexit outcome would mean companies operating in supply chains with large numbers of specific tariffs will find that when trading with the EU, the lower the value of their goods, the higher the proportion of their overall tariff burden. Duties, particularly on meat products, can be significant. For retailers, a hard Brexit would add disproportionate cost pressures on discounters and the value ranges, given the way duties are applied.

For instance, the products that will be hardest hit are likely to be meat products, sugar, milk powder and cooked or preserved mushrooms.

There is no broad-brush approach to tariff setting on food and drink. Some products have a MFN (most favoured nation) tariff of 0%. This means that even in the case of a hard Brexit, tariffs will not apply to these imports. This would include almost all spirits, beer, spices and oil seeds.

Figure 20

Food and drink tariffs rise as they move further down supply chain



Source: WTO, HMRC, Retail Economics analysis.

Lower costs for some products

The government has announced that in the event of a no-deal Brexit, the UK's MFN tariff rates could differ from rates imposed by the EU. Although this might simply be acknowledging that the UK will be free to set its own tariffs, it's a departure from the previous narrative which suggested the UK would mirror the EU's MFN tariffs after Brexit. This might not signal a wholesale change to tariff rates, but suggests the government might take a more targeted approach, focused on reducing high tariffs on products where there is no domestic alternative. There are already a few examples of this with food and drink products such as olive oil, citrus products and tuna.

Outside of a Customs Union, the UK would be free, whenever it wishes, to reduce its MFN tariffs for products where a tariff would serve no useful purpose.

Other costs on food and drink imports

Under a hard Brexit, each and every consignment of goods from the EU will need a customs declaration, which will cost at least £50.

Food and drink marketed within the EU must satisfy stringent regulations designed to protect humans, animals and plants in a country from risks associated with additives, contaminants, toxins, pests and diseases. These are known as SPS (Sanitary and Phytosanitary Rules). Under a hard Brexit, all products of animal origin will require veterinary checks at the border.

The UK imported £13.8bn worth of food and drink from outside the EU in 2017.

Industry bodies, the Food & Drink Federation and the Agricultural and Horticultural Development Board, estimate that the average cost of complying with SPS rules on imported food and drink from the EU would be equivalent to paying an extra 8% in duty.

Imports from outside the EU

The UK imported £13.8bn worth of food and drink from outside the EU in 2017. The cost of sourcing may change for those countries that currently enjoy lower tariffs as a result of lower bilateral trade deals that the EU has negotiated. This would include South Korea, Mexico, Chile, South Africa and Canada. Tariff rates on food from existing MFN suppliers, for example the United States, Thailand, New Zealand, China and Brazil, are unlikely to change.

Meanwhile, tariffs on food from developing countries like India will remain low, as the UK Government has already committed to continue a scheme of tariff preferences for developing countries.

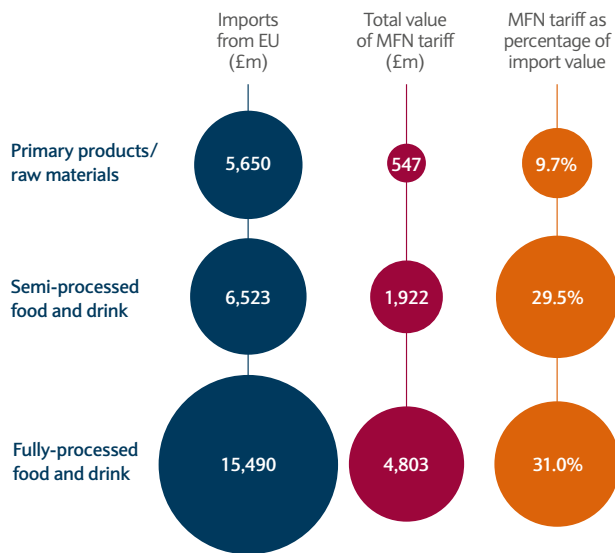


What will happen to Tariff Rate Quotas?

TRQs (Tariff Rate Quotas) are specified amounts of particular products that can be imported into the EU at a lower duty than the MFN rate. Vast amounts of TRQs operate within the EU for different food and drink products and significant quantities of these are imported into the UK under the lower TRQ rates. Select TRQs are specific to individual supplier countries, while others are available to any supplier country.

It's unclear what TRQs the UK would adopt post-Brexit. But identifying what TRQs are available, and understanding how they can be accessed, will be crucial for companies trying to minimise the burden of new tariff costs post-Brexit.

Figure 21
Evidence of tariff escalation on a sample of imports



Source: WTO, HMRC, Retail Economics analysis.

Identifying what TRQs are available, and understanding how they can be accessed, will be crucial for companies trying to minimise the burden of new tariff costs post-Brexit.

What would a full customs union mean for the industry?

Although the government has ruled out a full customs union between the UK and the EU, widespread support exists for this option within parliament and the business community. Because the EU has said that a customs union with the UK could be possible, looking at the effects of this outcome is essential for a thorough post-Brexit trade assessment.

In terms of tariff and trade costs, a customs union is the 'no change option'. A full customs union could avoid almost all the costs associated with a hard Brexit including:

- No tariffs on trade between the UK and the EU
- No change to tariffs on imports from outside the EU
- Potentially no customs declarations for trade with the EU
- Continued access to EU-wide TRQs

However, a solitary customs union agreement would only cover customs regulations. There would still be SPS checks at the border unless the UK remains within the EU system for SPS issues.

But remaining in a customs union would mean the UK would be bound by EU trade policy and unable to strike preferential trade agreements with other countries.

What would be the impact of a free trade agreement?

For ease and practicality, we've defined a free trade agreement (FTA) as: 'any agreement between separate customs territories which grants preferential terms of access (lower/no tariffs) to each other's market'. This definition takes in relatively restricted agreements, such as the one between the EU and Chile, as well as more sophisticated arrangements which include co-operation in a wide range of non-trade areas, like the EU's EEA (European Economic Area) agreement with Norway.

A UK-EU free trade agreement would avoid some, but not all, of the costs that would arise from a hard Brexit. In particular, an FTA could avoid all tariffs on trade between the UK and the EU.

However, it's worth noting that:

- None of the EU's existing free trade agreements remove all tariffs for food and drink. For example, the EU-Norway agreement excludes food and drink altogether, applying significant tariffs in both directions. It's possible that any future UK-EU free trade agreement might still keep some tariffs
- Products, including food and drink, would need to satisfy stringent rules of origin to benefit from lower tariffs. Non-compliance to these rules would lead to goods being subject to the MFN rate of duty
- Customs declarations would be required for all consignments
- Tariffs might rise for imports from non-EU countries where the government hasn't been able to extend existing free trade agreements
- SPS checks would apply at the border unless the UK remained within the EU SPS system
- A UK-EU free trade agreement would allow the UK Government to strike deals with other countries.

What would be the impact of the Chequers plan?

In July 2018, the UK Government published a White Paper (the 'Chequers plan') outlining its own proposals for a post-Brexit trading relationship with the EU. The proposal appears fairly complex, but essentially it is a policy hybridisation – a Customs Union/Free Trade Agreement that's aligned to SPS rules.

The main features are:

- No tariffs on trade between the UK and EU
- No rules of origin on trade between the UK and the EU
- No customs declarations
- UK tariff levels set independently
- UK to operate a dual tariff system, collecting duties at the UK rate (for goods destined for the UK) and the EU rate (for goods destined for the EU)
- UK alignment with EU SPS rules – avoiding SPS checks at the border.

The Chequers plan proposal appears fairly complex but essentially it is a policy hybridisation.

Theoretically, the Chequers plan will provide two main benefits: UK traders would avoid all new costs on trade with the EU, and the UK would be able to pursue new trade deals with other countries. However, the plan is seen by many commentators as highly unrealistic due to a number of factors.

What would Brexit mean for exports?

Food and drink exports form a critical part of the overall economic value of the UK's food supply chain. For exports to the EU, actual costs would depend on the Brexit terms. A hard Brexit would lead to the UK facing new tariffs on sales to the EU. At the other end of the spectrum, a customs union with the EU would mean no new tariff costs. In other markets, leaving the EU might mean new tariffs on UK exports, but what Brexit ends up looking like will have no bearing on the level of these tariffs.

In the event of a hard Brexit, restrictions on UK goods entering the EU would mirror those for EU goods entering the UK.

EU tariffs

60% of UK exports go to the EU.²² In the event of a hard Brexit, these goods would face the EU's standard MFN tariffs, along with a need for customs declarations and veterinary checks at the border. So restrictions on UK goods entering the EU would mirror those for EU goods entering the UK.

Even with a hard Brexit outcome, some UK food and drink products would avoid standard MFN tariffs by exporting through generally available Tariff Rate Quotas (TRQs) which offer lower duty rates.

Scotch whisky exports to the EU, valued at £1.38bn in 2017/18, (11.6% of the total UK food and drink sales to the EU) would be unaffected by tariffs in any event, as the EU's MFN rate of duty is already 0%.²³ Zero tariffs would also apply to other important beverage exports including gin/genever and beer.

UK food and drink exports to non-EU countries

Brexit is unlikely to have an impact on tariff rates in most of the UK's Top 10 food and drink markets, seeing as they already trade with the UK on standard MFN terms. This won't change when the UK leaves the EU. MFN markets include the US, China, Hong Kong, Australia, UAE and Taiwan, but the agreements are slightly different for each country.

The US

This is by far the largest export market for UK food and drink outside the EU, and alcoholic beverages dominate the top 10 UK export categories. Whisky alone accounts for 40% of UK food and drink exports to the US, along with significant amounts of gin, vodka, other spirits and beer. The standard US MFN rate for all these products is 0%, meaning that well over half of UK food and drink exports to the US will continue to enjoy duty free access to the US regardless of Brexit.

The US operates TRQs for some food and drink products but as none of these are specifically reserved for trade with the EU, the UK will be able to access these quotas as before.

China

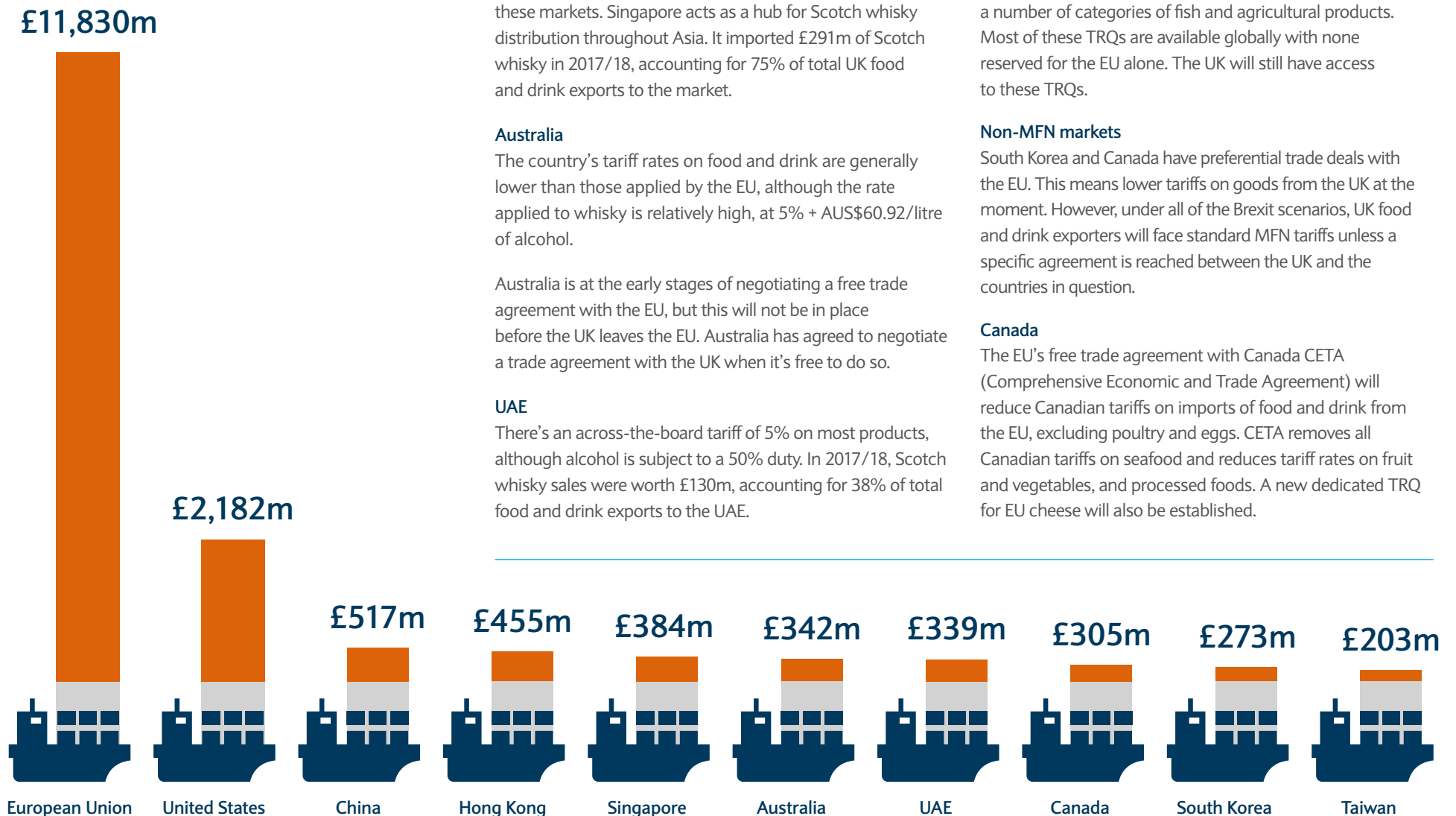
Salmon is the UK's top export to China, closely followed by whisky. Other significant items include powdered milk and pork products. Scotch whisky exports are set to benefit regardless of Brexit – in 2017, China reduced its MFN rate on whisky from 10% to 5%.

China operates TRQs for some food and drink products, but as none of these are specifically reserved for trade with the EU, the UK will be able to access these quotas as before.

^{22,23}Source: WTO, HMRC, Retail Economics analysis.

Figure 22

Top 10 export destinations for food and drink



Hong Kong and Singapore

These free ports don't levy tariffs on imports. So, Brexit will have no effect on the cost of UK food and drink exports to these markets. Singapore acts as a hub for Scotch whisky distribution throughout Asia. It imported £291m of Scotch whisky in 2017/18, accounting for 75% of total UK food and drink exports to the market.

Australia

The country's tariff rates on food and drink are generally lower than those applied by the EU, although the rate applied to whisky is relatively high, at 5% + AUS\$60.92/litre of alcohol.

Australia is at the early stages of negotiating a free trade agreement with the EU, but this will not be in place before the UK leaves the EU. Australia has agreed to negotiate a trade agreement with the UK when it's free to do so.

UAE

There's an across-the-board tariff of 5% on most products, although alcohol is subject to a 50% duty. In 2017/18, Scotch whisky sales were worth £130m, accounting for 38% of total food and drink exports to the UAE.

Taiwan

The average tariff for food and drink is 14.66% although the MFN rate for whisky is only 5%. Taiwan has TRQs on a number of categories of fish and agricultural products. Most of these TRQs are available globally with none reserved for the EU alone. The UK will still have access to these TRQs.

Non-MFN markets

South Korea and Canada have preferential trade deals with the EU. This means lower tariffs on goods from the UK at the moment. However, under all of the Brexit scenarios, UK food and drink exporters will face standard MFN tariffs unless a specific agreement is reached between the UK and the countries in question.

Canada

The EU's free trade agreement with Canada CETA (Comprehensive Economic and Trade Agreement) will reduce Canadian tariffs on imports of food and drink from the EU, excluding poultry and eggs. CETA removes all Canadian tariffs on seafood and reduces tariff rates on fruit and vegetables, and processed foods. A new dedicated TRQ for EU cheese will also be established.

Source: WTO, HMRC, Retail Economics analysis.

Failure to agree on an extension of CETA to the UK would mean that UK sales would revert back to MFN terms in Canada. However, the UK's main export categories, whisky, gin and beer, all have zero-rated tariffs.

South Korea

Although the country has high MFN tariffs, averaging 35% for agricultural products, the EU/Korea FTA will see progressive reductions in these rates for EU goods. This includes the phased removal of the 20% tariff on whisky.

The post-Brexit timeline

Depending on the outcome, some changes to costs and tariffs will come into force immediately, while others might take longer to implement.

For instance, a hard Brexit will mean significant and immediate additional costs for the food supply chain in the form of new tariffs and non-tariff costs on EU trade. In some cases, food and drink operators will be able to avoid these new costs by switching to domestic or non-EU sourcing. However, this may not always be straightforward. When it comes to UK sourcing, there will be capacity constraints in some sectors.

For example, the UK only produces approximately 10% of the fruit it consumes. For non-EU sourcing, many supplier countries are subject to MFN rates and some of them won't have SPS approval to sell their goods to the UK.

To give suppliers access to food and drink at competitive prices, the Government will want to agree to lower tariff rates through new trade deals. In some cases, they might even unilaterally reduce tariff rates.

This section outlines what we think the UK Government could realistically achieve over a five-year period. These options are mainly focused on a hard Brexit outcome but could equally apply to a UK-EU free trade agreement.

Within one year

Unilateral tariff rate reductions

In any Brexit scenario, other than a customs union, the UK would be free to set its own tariff rates. To start with, the Government says it would mirror the EU's tariff rates, although its customs and trade bills give it the power to permanently or temporarily vary tariff rates. As yet, there are no details regarding functionality, but it's likely that the Government would introduce a process whereby businesses could apply for tariff rate reductions.

Immediate period: Some changes to costs and tariffs



Within one year: UK free to set its own tariff rates

Within two years: Lower tariffs on imports from larger developing countries



Potential candidates might include food and drink categories with high duties associated with insufficient domestic production, for instance, olive oil and citrus fruits. The UK Government could deliver these tariff reductions in a number of ways, ranging from introducing permanent (or time-limited) reductions to the MFN rate, to bringing in tariff rate quotas for specified amounts of certain products.

Any such unilateral reductions to tariff rates could be made available to imports from any source, not just the EU, and the government could put measures in place whenever it wanted to.

Within two years

Lower tariffs on imports from larger developing countries

After the UK leaves the EU, it will be free to set lower tariff rates for imports from developing countries. Under the EU's existing GSP (generalised system of preferences) programme, imports from larger developing countries, like India and Pakistan, get only modest discounts to the standard rate of duties for some food and drink imports. Post-Brexit, the UK Government has promised that it will provide at least the same level of preference for imports from developing countries and improve access where possible. Relatively simple changes to the GSP scheme would allow some food and drink products to benefit from lower duty rates, such as rice from India and Pakistan.

More countries could sell food and drink to the UK

Before specific products, such as meat, can be legally imported into the EU, they first need veterinary approval at a country level. For example, in the case of pig meat, only a handful of countries have veterinary approval to sell to the EU.

After a hard Brexit, even if the UK keeps the same SPS rules as the EU, it would be free to authorise other countries that also conform with those rules to sell to the UK. This would widen the choice of supply.



Within three years

SPS rules could change

The UK Government has consistently committed itself to maintaining the highest standards for animal welfare, consumer protection, food and product safety. However, it has not ruled out changing SPS rules to allow imports, from a wider range of countries, of some products that are currently disqualified.

Terms with the EU's existing FTA partners could improve

The UK Government already has an informal arrangement with a number of countries to extend their existing deals with the EU to the UK after Brexit. However, some countries want to improve the terms of these agreements. Changes to these FTAs could be secured relatively quickly, in less than three years, as the bulk of the agreements are already in place. Further reductions to food and drink tariffs will be a priority for Canada and South Africa.

Trade with a number of other countries could become easier

This includes Canada, Mexico, Australia, New Zealand, Japan, Korea, Vietnam and other Asian countries. Earlier this year, a group of 11 countries with Pacific sea borders signed the CPATPP (Comprehensive and Progressive Agreement for Trans-Pacific Partnership). This significantly reduces trade barriers between the signatories. The US was party to this agreement until President Trump decided to withdraw from the process. Amongst other things, CPATPP will abolish all tariffs on wine, seafood and sheep meat between the participating nations.

In the Chequers plan, the government stated that it would explore the likelihood of joining the CPATPP. Although the UK has no Pacific sea border, this doesn't appear to be a barrier. Joining CPATPP would be quicker than negotiating a new trade deal because the bulk of the deal has already been agreed between the various countries.

Within five years (and beyond)

New trade deals

The government has identified the US, Australia and New Zealand as priorities for new free trade agreements (as an alternative to an agreement with these countries through CPATPP). All three are major suppliers of food and drink, including beef and dairy, sheep meat, wine, fruit, vegetables and cereals. However, imports are currently subject to MFN tariffs. Striking trade agreements is a lengthy process, so it's highly unlikely that brand new deals with these countries could be put in place in less than five years.

Staying in a customs union

The UK would have to follow all EU tariff rates, and probably all SPS rules. This means it would have limited, or no scope, to reach different trading arrangements with other countries and wouldn't be able to unilaterally reduce tariff rates.

Nevertheless, it's possible to anticipate some tariff rate changes for imports from non-EU countries as a result of new trade agreements the EU is negotiating. These include:

- Progressive reduction in tariffs on imports of food and drink from Vietnam. Tariffs on seafood, poultry meat and meat preparations will be reduced to 0% over a period of three to seven years as a result of the new EU/Vietnam deal
- New trade agreements with New Zealand and Australia should lead to significantly lower tariffs on a wide range of food and drink. As negotiations on the trade agreement are yet to start, it's unlikely that any new FTA will be operational before 2023
- In July 2018, the EU and US committed to working together to lower trade barriers. It's unclear what form any trade agreement may take, and there appears to be a difference of opinion on whether any negotiations would include food and drink. The US is suggesting it should be included, while the EU is suggesting it shouldn't.

Going for the Chequers plan

The UK would be free to develop most of its trading arrangements in the same ways it would after a hard Brexit, including the freedom to vary its MFN tariff rates, establish its own TRQs and strike trade deals with other countries.

Nevertheless, the Chequers plan would tie the UK to the EU's SPS rules and in all likelihood the EU's system for giving other countries approval to trade certain food products. This would mean that the UK wouldn't be able to independently approve other countries for food and drink exports to the UK, reducing the scope to diversify its sources of animal products.

UK food and drink exports

In general, these will face the same type of treatment as goods from those countries we import from. The implications include:

- In a hard Brexit scenario, UK food and drink exports to the EU will face the same tariff rates as imports of those same goods from the EU to the UK
- Tariff rates for UK exports to markets where the UK already trades on MFN terms will remain unchanged
- Under all Brexit scenarios, tariffs might increase for UK food and drink exports to any market which has an FTA with the EU, and to countries where the UK Government is unable to secure an extension of that agreement to the UK.



Trade wars and the food supply chain

The international trade dynamic

Protectionist US trade policies have significantly increased the pace of change in trade regulation. This has led to widespread international tariff increases, which have been put in place very rapidly and are disrupting global supply chains.

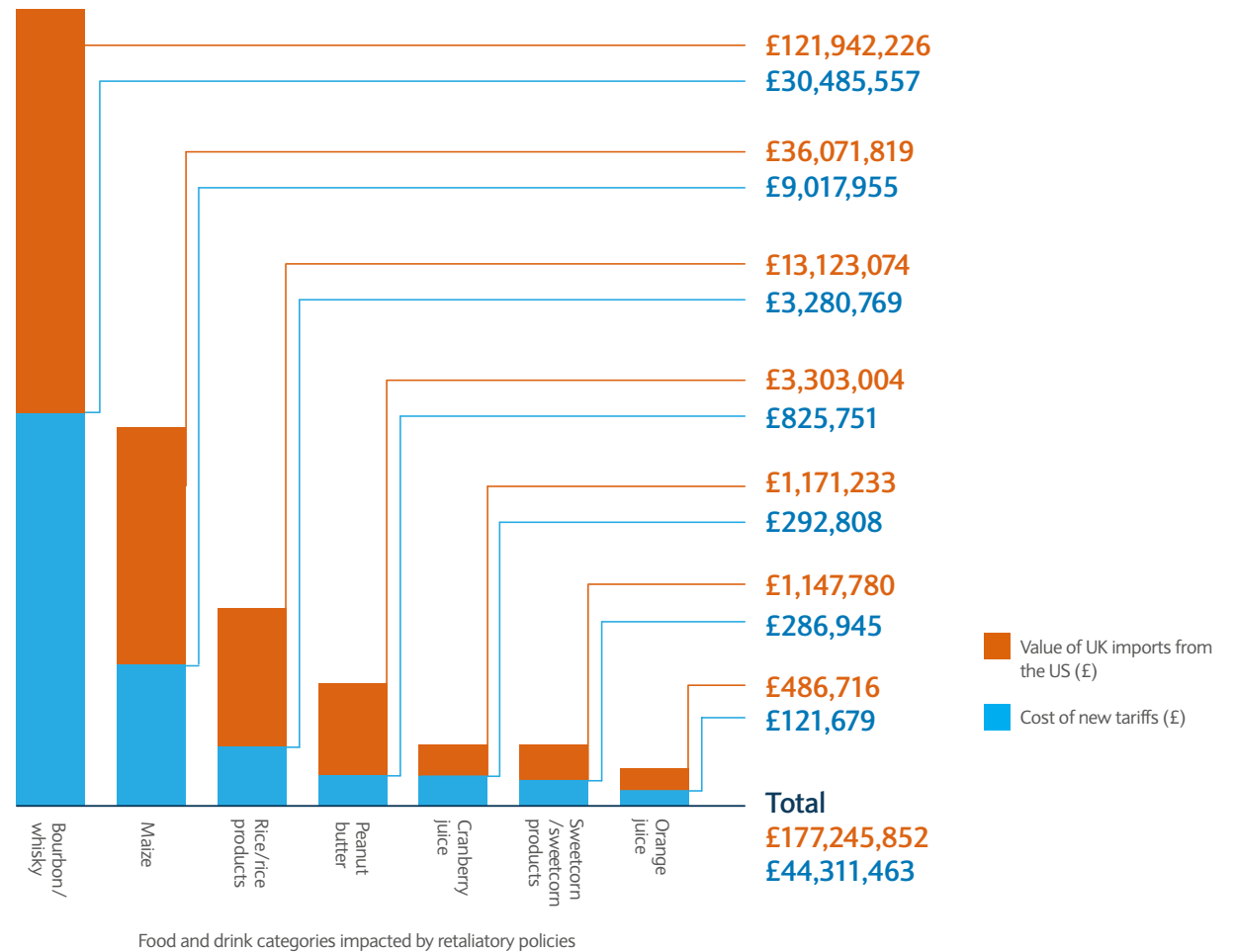
Since the beginning of 2017, President Trump has applied penal tariffs to a range of imports from various countries. On 1 June 2018, tariffs were extended to EU steel and aluminium imports, applying duties of 25% to steel and 10% to aluminium. This has sparked several reactions. Most US trading partners have retaliated by imposing tariffs on US imports. The EU and other countries have retaliated on steel and aluminium, but also on a range of other products, including food and drink.

The impact will be felt throughout the UK food supply chain in three main areas; reduced trade flows, disrupted supply chains, and the knock-on effect of higher import costs. Crucially, the indirect impact through businesses on confidence and financial disruption could also have consequences.

There are tentative signs that this increasingly hostile and uncertain trade environment is already dampening activity. Indeed, PMI data shows that global export orders and manufacturing output have fallen back from highs at the beginning of this year, while growth in US and euro-area capital goods orders fell to zero in the first quarter.

In part, this could be the result of anticipated 'retaliatory' measures from the EU implemented in June 2018. These included duties of 25% on a range of US imported goods, which go far beyond steel and aluminium and include agricultural and food products including sweetcorn, rice, orange juice, cranberry juice and Bourbon/whisky.

Figure 23
Impact of trade wars has cost UK £43m



These additional duties will remain until 23 March 2021 when they'll be replaced by a shorter list:

	Value of UK imports from US (£)	Cost of new tariffs (£)
Cranberry preparations	£9,182,027	£2,295,507
Bourbon/whisky	£121,942,226	£30,485,557
Total	£131,124,253	£32,781,063



The impact of new trade war tariffs on the UK food supply chain

The total value of UK food and drink imports concerning products affected by EU retaliatory tariffs totalled £177.2m in 2017. Based on current trade flows, the cost of new tariffs to UK food and drink importers is £44.3m.

The potential impact on the UK food supply chain

These 'trade wars' affected just a fraction of the £2.2bn worth of food imports from the US in 2017 and are highly unpredictable. It's possible that the scope of products affected, along with the burden of additional costs, could spiral. The disruption caused is partially due to the high tariff rates, but also from the rapid spill-over into unrelated supply chains.

Following the EU's retaliatory measures, President Trump threatened to impose an additional 25% tariff on US imports of European cars. In 2017, EU passenger car sales to the US were worth €34.7bn. The cost of new tariffs on this trade would have amounted to around €10bn, which would have triggered further retaliatory duties by the EU, almost certainly drawing in food and drink categories.

The EU estimated that retaliatory duties could be applied on up to US\$300bn of US exports worldwide. Independently, the Bank of England estimates that an increase in tariffs of 10 percentage points between the US and its trading partners could reduce US output by 2.5%, and global output by 1%, through trade channels alone.

The overall shock from higher tariffs would undoubtedly drag on levels of activity, but the short-term impact on the UK food supply chain would be inflationary. Quantifying the precise inflationary impact is impossible to predict given that tariffs could fall across any number of food products. And food inflation can be affected by a range of external variables, from rising oil prices to poor harvests around the world.



That said, any significant rise in food tariffs would most likely be passed on to consumers given the short supply chains and the industry working on this margins.

Retailers and suppliers have four options to meet rising input costs:

- 1 Pass the costs on to consumers and customers
- 2 Take a hit on profit margins
- 3 Mitigate the impact through the supply chain and re-engineer products
- 4 Cut costs elsewhere and absorb the price rise.

In reality, most retailers and suppliers will use a combination of all four options to remain competitive. Contracts with suppliers could lessen the immediate impact of an increase in tariffs, depending on the terms. This could also allow retailers to consider their pricing strategies.

However, things get more complex when considering each sector, or even each retailer, in isolation. Factors such as market position, pricing power, demand, length of the supply chain and profit margins will determine how much of these costs are passed on to consumers and how fast. Grocery retailers, typically working with 3-5% profit margins, will find it difficult to absorb these cost pressures, despite the fiercely competitive environment.

However, suppliers will be keen to maintain good relationships with their key clients and more willing to share adverse tariff costs with them rather than lose their trade. Of course, not all retailers will have the same influence over their suppliers. And with manufacturers' margins ranging from 20-30%, much of the tariff pain will be front-loaded on suppliers. Over the coming years, the full impact will ripple through to consumers, as retailers and suppliers rebuild their margins.

Given the complexity of supply chains and the contractual obligations in place, it will take some time for UK retailers and suppliers to adjust their relationships as they try and mitigate the impact of rising sourcing costs.

An immediate and unexpected rise in sourcing costs would almost certainly result in reduced margins throughout the supply chain, together with higher prices for consumers. The longer-term impact would depend on whether this is viewed as a 'temporary conflict' or the new normal. Productivity could also be hit along with other unanticipated consequences arising from disruptions to supply chains – such as the wholesale redundancy of capital equipment.

Meanwhile, potential reduction in trade could lead to a more fundamental restructuring in domestic relationships throughout the supply chain. The knock-on effect could mean tighter, home-produced food markets which could add to domestic inflationary pressures.



On the other hand, disruptions to trade as the result of new tariffs could also open up lucrative opportunities for UK retailers and suppliers. For example, the impact of new Chinese tariffs on US soya beans reduced their price on international markets, which in turn provided new lower cost sourcing opportunities for UK processors.

Positive developments

The threat of a trade war between the US and the EU seems to be cooling. A truce was called in July 2018 when Commission President Juncker and President Trump met in Washington. They issued a joint statement announcing that the EU and US would co-operate in removing all industrial tariffs (except automotive), non-tariff barriers and subsidies; and while negotiations continued, they would not apply new tariffs to each other.

That being said, the terms of the joint statement are open to interpretation; there has already been some disagreement around agriculture and food. In addition, the European Parliament and Council have not yet given formal approval to the European Commission to strike a new trade deal with the US. As a result, the scope of talks is limited.

In summary, the accumulation of all the issues described leave this truce in a fragile state. Past behaviour indicates that President Trump is willing to employ tariffs at short notice, leaving other countries reluctant to back down when threatened, only to respond with retaliatory tariffs of their own, often including totally unrelated products.

Uncertainty might be causing a cloudy outlook, but as long as retailers continue to prepare for every event – across their business and their supply chain – they can stay the course, and stay ahead. They might even find lucrative new opportunities.

A view from the Adjudicator

For industry insider Christine Tacon the decision to become the first UK Groceries Code Adjudicator in 2013 arose from her experiences of the relationship between retailers and suppliers and a desire to see major change.

As a production engineer by trade and head of the Co-operative Group's farming business for over a decade, I was frustrated by the inefficiencies in the supply chain that stemmed from the unequal relationship between retailers and suppliers. Too often retailers would say "jump" and suppliers would simply ask "how high?".

I took the role of UK Groceries Code Adjudicator in 2013 to help level the playing field, overseeing the implementation of the Groceries Supply Code of Practice, which exists to make sure that retailers treat their direct suppliers lawfully and fairly.

A chance to get it right

While retailers have had to comply with The Groceries (Supply Chain Practices) Market Investigation Order, which contains the Code, since 2009, it was not until Parliament passed the Act to create the Adjudicator role that the industry took serious notice. The subsequent decision to give the Adjudicator the power to fine retailers up to 1% of turnover for breaching the Code has really concentrated minds.

My year-long investigation into Tesco in 2015 was a gamechanger in terms of highlighting the Adjudicator's statutory power to obtain information from retailers and suppliers, get to the bottom of a complex issue and report on it with binding recommendations that make a real difference.

The Groceries Supply Code of Practice exists to make sure that retailers treat their direct suppliers lawfully and fairly.



But investigations are long and time-consuming procedures and I have deliberately adopted a collaborative approach to achieve reform. I do this by raising issues with the retailers either individually or collectively and ask them to look into them – always protecting the confidentiality of the source. They have to report back to me, making changes where necessary. I have found this is a swift way to make my position on an issue clear to the industry, secure progress and on occasion see the retailer repaying suppliers who have been adversely affected.

Formal action is only taken if the practice continues or I need to get to the bottom of an issue – as in the case of my current investigation into the Co-operative Group.

Cracking the Code

Over the past five years I've seen a phenomenal increase in compliance across the retailers. I measure this through my annual survey. In 2014 the percentage of suppliers reported experiencing a Code-related issue was 79% – this year it had dropped to 43%.

Compliance has improved across the board – in the first survey the lowest performing retailer scored 58% and the best 90%; this year the highest score was 97% with only two of the regulated retailers under 90% and the worst performing at 84%. It proves that my practical, business-focused collaborative approach is working.



The annual survey is also an important tool for change as it identifies areas for further improvement. In 2014, for example, 45% of suppliers flagged the aggressiveness of no win no fee forensic auditors as a major issue and the practice of retailers of making an automatic deduction from a supplier's next payment where the auditors found discrepancies going back six years. This was a significant concern for suppliers based in a fast-paced industry where it is difficult to verify older information.

I worked on this issue in two ways – first, I won a commitment from most of the retailers to time limit forensic audits to the current and previous two financial years – rather than the statutory six years – and second, I set down clear rules following the Tesco investigation. Retailers now cannot deduct anything from an invoice without first telling the supplier and giving them 30 days to challenge it. If it is challenged, then the retailer cannot deduct the amount until reaching an agreement. My survey shows a completely different picture today with forensic auditing a concern for only 7% of suppliers.

I have also worked closely with the retailers on the issue of delay in payments which was raised by 35% of suppliers in 2014. Back then there were examples of retailers taking up to a year to acknowledge a pricing error and pay the difference to their suppliers and there were concerns about deductions from invoices for disputes over deliveries.

I have worked intensively with the retailers on these systemic challenges and I am seeing the ground shift. Delay in payments still remains a concern for suppliers, but at a much lower level with fewer than one in five reporting it as an issue. Many of the improvements achieved – although they have been prompted by suppliers' concerns – also benefit the retailers by making their processes more efficient and this can save them money.

Industry trends

I currently regulate the 10 groceries retailers designated at the start, as they had UK annual groceries turnover above £1bn, but as the industry restructures and other retailers are closing in on this threshold this group will likely expand. The CMA (Competition and Markets Authority) is currently examining this very issue.

Many of the improvements achieved – although they have been prompted by suppliers' concerns – also benefit the retailers by making their processes more efficient and this can save them money.

More suppliers are also likely to come under my remit as major retailers, like Asda and Morrisons are moving up supply chain and buying directly from the suppliers rather than through the middle men. It means that apple producers in South Africa selling directly to a UK retailer are covered by the Code. Overseas awareness of this is generally poor, however, so one of my priorities is to make sure these suppliers know that there are regulations in place to protect them.

And as I visit events and meet suppliers I am seeing more and more smaller companies – such as makers of energy and nutrition bars, baby food pouches and artisan gin – becoming suppliers to the major supermarkets. For these suppliers it is so important that they learn about the Code and get themselves trained so they know how to handle any Code-related issues that arise. I publish a directory of those trainers I am aware of on my website:

www.gov.uk/gca

Making more progress

While the number of retailers I regulate looks likely to increase, I do not see my remit extending in the near future to indirect suppliers for whom price transparency is a key issue, but which is not covered by the Code. The Government recently had a call for evidence in this area and decided not to make this change but did ask the CMA to look into whether more retailers should be regulated.

The Code has tremendous potential to make a real difference across the sector as it restructures, benefiting retailers, suppliers and customers. With the continued support and co-operation of a growing number of retailers, I believe we can create a fairer and more sustainable future for the industry.



Christine Tacon CBE

UK Groceries Code Adjudicator



**Groceries Code
Adjudicator**



Taking greater control of products

Speciality food producer and distributor, Harvey & Brockless, has witnessed significant changes in the retail environment in recent years. Managing Director, Nick Martin, explains how the business has adapted.

As a producer, wholesaler and distributor of speciality food, we work with artisan food producers from around the world and sell to a wide range of customers, from small farm shops to major restaurants, hotel chains and contract caterers both here in the UK and overseas. Our focus is on quality, high-end food products, from fine cheeses to cured meats, sauces and dips – and that focus is one of our key differentiators.

Sector consolidation

The distribution sector is polarised into those that deliver large volume at low cost and niche suppliers. In recent years, we've seen some big changes, especially amongst our larger national customers. Customer preference has very much switched from dealing with numerous small suppliers, to wanting to rationalise and consolidate their supply base to deal with one or two offering more of their products, and from direct distribution to one, centralised distribution hub.

That trend has been driven by the desire to reduce both distribution and administrative cost per unit by centralising volume with one distributor. At the same time, the costs of distribution are increasing as a result of wage inflation, stakeholder pensions, fuel prices, motor insurance and other overheads. The result has been that distribution margins are getting smaller and smaller.

Taking control

We've responded by taking more ownership of the products we supply and who we supply them to, which gives us a greater share of the margin as we are both manufacturer and distributor. Creating a manufacturing base to bring production in-house has helped us achieve that control over our products and how we price them. So, in addition to our head office in London and distribution/stock centres in Edinburgh, Manchester, Worcester and Exeter, we also have manufacturing sites in London and Evesham.



Strategically, producing our own brands has been another key decision for us in terms of building customer loyalty. What we've also done is to look at adding value to our products, for example, not just manufacturing, but processing the products in some way, such as packaging cheeses with biscuits and chutney on a cheese board, which can improve our margin.

Creating a manufacturing base to bring production in-house has helped us achieve that greater control over our products, where they go and how we price them.

Adopting a vertical growth strategy

At the moment, our business is 50% value-added and 50% non-value-added, but the success of that strategy of taking greater ownership of the products we supply means that we certainly see further growth in our brand ownership and the value-added side of our business over the next five years. Our manufacturing site in Evesham is a key part of that strategy. The development of sauces, dips and oils, not only helps us achieve better margins, but it also helps with customer retention as those sauces become an essential ingredient that our customers favour, for example. It moves the business away from being a commodity supplier, say of block cheddar, to a specialist supplier of a unique sauce.



Monitoring uncertainty

Looking at the sector as a whole, I think further consolidation is inevitable, with smaller distributors swallowed up by larger groups. Rising costs and labour shortages will continue to drive that, but we're also keeping a watchful eye on the impact that Brexit will have. We have a dedicated Brexit team, but planning for the outcome remains difficult until we have clearer sight of any deal.

We have a dedicated Brexit team, but planning for the outcome remains difficult until we have clearer sight of any deal.

That uncertainty is making planning very difficult. In our situation, for example, UK suppliers don't produce enough milk to make enough cheese to meet current demand, but farmers are reluctant to invest in increasing their dairy herds until we have a clearer picture of what deal is on the table. Meanwhile, in a no-deal scenario, tariffs on dairy could be around 40-50% and with margins for wholesale products already very tight, businesses will have to pass some of these costs onto customers. Whether the market will bear that or what the alternatives are, remains to be seen, but with 40% of our products imported from Europe, we're clearly watching the situation closely.



Nick Martin
Managing Director
Harvey & Brockless

HARVEY & BROCKLESS
the fine food co



How SPAR is thriving in a challenging market

Part of a global brand operating across 43 countries, SPAR has been a presence in the UK retail market for over 60 years. Managing Director, Debbie Robinson, shares her experience of how the brand has adapted to change in the sector.

Overall, the UK retail sector has faced a number of challenges in recent years and we've seen significant structural changes as a result. Part of that is the enormous consolidation we've seen over the past 12-18 months, with moves by the Big Four to seek growth in the face of decreased profitability by entering the wholesale market, for example, the Tesco-Booker tie-up and Morrisons' relationship with McColl's.

At SPAR, we've actually prospered over the last few years in a market that's been in disarray. Why? Well, a lot of that success has to be down to our financial model and operating structure.

Stability and agility

We're actually a voluntary membership organisation working with a large number of independent, entrepreneurial and family businesses and larger multi-site retailers, who choose to operate under our brand. That partnership approach offers them services and support across format, procurement and distribution and we both benefit from being able to adapt to changing trends, local market conditions and more widespread issues that affect the sector, including seasonality. It's a model that provides both stability and agility.



It's also an area of the market that's attracting interest from the large multiples, but the challenges they face in terms of entering it successfully are numerous. These range from having to work with a third-party distributor to manage the logistics of supplying local stores, which impacts on margins, to understanding the needs of local communities. Those are areas where our business model is particularly strong.

Convenience is about being at the heart of a community and being flexible enough to offer what that community needs and that's a key differentiator that helps us to stay ahead of the competition.

Ability to adapt to local needs

Working with independent stores means we can pay great attention to local differences and community needs. That may mean that we encourage certain concessions within a store, or support stores looking to procure a license for the on-trade sale of alcohol. We also work with local producers, which means that goods are adapted to local tastes and demand. For us, convenience is about being at the heart of a community and being flexible enough to offer what that community needs and that's a key differentiator that helps us to stay ahead of the competition.



Technology-driven change

As well as consolidation, we're also seeing the emergence of new operators in the sector, from pure play operators such as Amazon, whose acquisition of Wholefoods signalled a new direction, to those that are taking 'convenience' to another level – not just location driven or type of product, but to the immediacy of delivery – such as Uber Eats and Deliveroo. These are approaching the sector with a completely different business model, which in terms of issues like not having to pay business rates, overcomes some of the challenges that more traditional retailers face.

Technology as a facilitator of many of these changes is unstoppable. The impact of the technological revolution on how we, as consumers, live and shop, will I think be as great as that of the industrial revolution. Technology will transform the way goods and services are produced, procured, distributed and, ultimately, reach the consumer. In the future, the rise of these pure play operators, the capability of AI and robotics and the use of augmented reality will all have a bearing on the UK retail sector. How robust that effect is and how legislation evolves to manage that, remains to be seen, but it's certainly something we watch with interest.

Anticipating further change

Looking ahead, I think in the short to medium term, consolidation will continue, before we'll start to see companies breaking away and returning to independence, bringing a wave of entrepreneurial thinking to the sector enabled by technology. For many businesses, the Brexit effect will be a major consideration over the coming years. However, because we're part of a global organisation, with our head office in Amsterdam, we think we're going to be better protected from some of the effects than others. Given the serious lack of clarity, we are working on a number of scenarios however. And we're watching the current situation closely.



Rather than being defined by the products you're historically associated with, it's about adapting to the changing needs of those communities.

Innovative, modern and relevant

Other trends that we're responding to, and which are likely to continue, include the focus on health and wellbeing. We've removed hundreds of tonnes of sugar from our own-brand soft drinks, for example, whilst retaining the flavour profile, which meets customer taste and means we avoid the sugar levy, keeping prices low. As a result, we've seen an increase in sales. We've also reduced the salt content of many of our goods and we're focused on improving the environmental credentials of our bottled water.

It's part of an innovative approach that continues to make us modern and relevant for the communities we serve. Rather than being defined by the products you're historically associated with, it's about adapting to the changing needs of those communities.

We're agile enough, for example, to respond quickly to trends – whether that's for cauliflower rice or coconut water – but we can move out of them just as quickly when the trend evolves into something different. Maintaining that absolute customer-focus and taking decisions with a long-term perspective rather than meeting short-term shareholder considerations, will prove crucial in maintaining and extending market share in the face of new challenges and opportunities ahead.



Debbie Robinson
Managing Director
SPAR UK



Checking out the shop landscape: Trends to watch

To help the UK food and grocery industry, Barclays conducted a thorough analysis of the changing consumer landscape from both a buyer's and seller's point of view.

Consumers are shopping more often, but buying less – [visits to the store went up by 14.3% from 2013 to 2018, according to data from Nielsen Homescan](#). This could be an opportunity for retailers to attract more casual shoppers.

[Demand for lower prices has led to less brand loyalty](#). As a result, the Big Four market share declined to 68% in 2018 from its peak of just over 77% in 2011.²⁴

Takeaway food platforms are taking off. [The market has grown by 34% since 2009](#), almost twice the rate of the retail food sector over this period.

Tighter margins and tougher competition are leading to some of the bigger brands joining forces. [This includes Tesco's £3.7bn acquisition of Booker announced in 2017, and the Co-op's £143m takeover of NISA a year later](#). The industry is also getting creative with partnerships, looking both abroad – for example, Tesco and Carrefour's 2018 partnership – and into new sectors. And Amazon has entered the supermarket arena with its acquisition of Whole Foods in the US.

In general, the online food market has increased by 12% on average each year since 2010, and [online food sales are expected to rise by 48% between 2017 and 2022](#).

[Shoppers expect retailers to do better, and be better](#). Convenience and good value is one way to attract customers, but a delightful experience – with extras like free coffee and sushi bars – can have a big impact. Customers also want to shop at places that care about the things they do, such as healthy living and sustainability.

²⁴Kantar World Panel.

The tariff effect

Our analysis shows precise calculations for food and drink trade data, quantifying the impact of specific tariffs when expressed as a percentage of the value of trade (the conversion process 'ad valorem²⁵ equivalent (AVE)' has been applied). The tables to the right feature products attracting the highest ad valorem equivalent for primary, semi-processed and fully processed foods:

Primary food and drink

Tariff code	Product	Ad Valorem Equivalent (AVE)
020210	Frozen beef carcasses	297.5%
010594	Live poultry	129.7%
020410	Lamb carcasses	82.3%
020421	Sheep carcasses	74.7%
070320	Fresh garlic	71.9%
100191	Wheat grain	62.7%
080390	Bananas	62.3%
100199	Wheat grain	61%
100390	Barley	60%

Semi-processed/lightly processed food and drink

Tariff code	Product	Ad Valorem Equivalent (AVE)
020629	Frozen beef skirt	260.3%
020610	Fresh beef skirt	146.5%
020423	Boneless fresh lamb cuts	116.7%
170199	White sugar	104.2%
020230	Beef and veal cuts	100.8%
071151	Preserved mushrooms	97.7%
170112	Raw beet sugar	95%
020443	Frozen boneless lamb	94.4%
040291	Milk powder	90.5%

Fully processed food and drink

Tariff code	Product	Ad Valorem Equivalent (AVE)
200310	Cooked, preserved mushrooms	183.7%
200919	Orange juice	180.1%
160250	Cooked beef preparations	110.2%
160239	Processed chicken preparations	109.8%
160290	Offal and blood preparations	104.7%
160232	Processed chicken preparations	100.2%
040610	Pizza cheese	99.8%
040150	Cream	80.7%
151000	Olive oil	75.6%

²⁵A tariff that is not a percentage (eg, dollars per ton) can be estimated as a percentage of the price – the ad valorem equivalent.

Appendix

Annex 1

As a general rule, finished products attract a higher rate of duty than primary and semi-processed goods. This is known as 'tariff escalation' and is evident in a number of food supply chains, for example:

Fish and seafood

Product	Duty rate for fresh/ chilled/frozen (%)	Duty rate for smoked/dried (%)	Duty rate for preparations (e.g. tinned) (%)
Trout	8-12	14	
Salmon	2-8	13-15	5.5
Halibut	8-15	15-16	
Tuna	22		24
Herring/anchovy/mackerel/sardines	15	14	15-25
Cod	12	16-20	20
Haddock	7.5	14	
Shrimps/prawns	12-18		20

Tariff escalation also applies to most oil seeds which are exempt of duty in their raw state, but attract a rate of up to 9.6% when converted to usable oils.

In specific cases, duty rates are higher for goods that are packaged for retail than for bulk-packed goods (e.g. milk, green tea, palm oil, tinned fruit). Again, this imposes a higher tariff burden for retailers and others operating at the end of the supply chain.

Meat

Product	Duty rate for live animals	Duty rate for unprocessed products	Duty rate for processed products
Cattle/beef	10.2% + 931euro/tonne	12.8% + 1,410 euro/tonne (minimum)	3,034 euro/tonne
Pigs/pig meat	412 euro/tonne	467-869 euro/tonne	857-1,568 euro/tonne
Sheep/lamb	805 euro/tonne	12.8% + 1,199 euro/tonne (minimum)	
Poultry/chicken	209 euro/tonne	262-1,024 euro/tonne	2,765 euro/tonne



Annex 2

Hard Brexit estimated to cost UK retailers and wholesalers
£9.3bn for sourcing goods from EU.

Category	Description	Total arrivals (£) from EU to UK	Total tariff under WTO (£)	Tariff as % of EU arrivals
01	Live animals	460,701,090	21,964,085	4.8%
02	Meat and edible meat offal	3,723,374,999	1,620,279,655	43.5%
03	Fish and crustaceans, molluscs and other aquatic invertebrates	690,545,985	49,024,371	7.1%
04	Dairy produce; birds' eggs; natural honey; edible products of animal origin, not elsewhere specified or included	3,038,065,789	1,592,673,545	52.4%
05	Products of animal origin not elsewhere specified or included	82,971,170	361,142	0.4%
07	Edible vegetables and certain roots and tubers	2,488,416,577	186,803,338	7.5%
08	Edible fruit and nuts; peel of citrus fruits or melons	2,003,568,192	156,450,557	7.8%
09	Coffee, tea, mate and spices	559,589,422	32,247,514	5.8%
10	Cereals	611,423,222	150,181,886	24.6%
11	Products of the milling industry; malt; starches; inulin; wheat gluten	334,212,938	105,336,304	31.5%
12	Oil seeds and oleaginous fruits; miscellaneous grains, seeds and fruit; industrial or medical plants; straw and fodder	335,507,556	5,634,113	1.7%
15	Animal or vegetable fats and oils and their cleavage products; prepared edible fats; animal or vegetable waxes	1,108,872,909	183,104,539	16.5%
16	Preparations of meat, fish or crustaceans, molluscs or other aquatic invertebrates	2,238,073,113	1,237,989,167	55.3%
17	Sugars and sugar confectionery	817,122,676	422,089,535	51.7%
18	Cocoa and cocoa preparations	1,768,051,792	137,080,123	7.8%
19	Preparations of cereals, flour, starch or milk; pastrycooks' products	2,921,745,458	679,211,921	23.2%
20	Preparations of vegetables, fruit, nuts or other parts of plants	2,465,655,740	831,497,711	33.7%
21	Miscellaneous edible preparations	2,527,730,388	408,554,177	16.2%
22	Beverages, spirits and vinegar	4,603,671,690	438,594,094	9.5%
23	Residues and waste from the food industries; prepared animal fodder	1,264,813,019	1,032,055,461	81.6%
Total		34,044,113,725	9,291,133,240	27.3%



Further information

For further information and to find out how our sector specialist teams can support your business, please contact Ian Gilmartin, Head of Retail and Wholesale.



Ian Gilmartin

Head of Retail and Wholesale
Barclays Corporate Banking

Ian Gilmartin is Head of Industry for Retail and Wholesale at Barclays Corporate Banking across the UK and Ireland, where Barclays has operated a sector specialism for almost 30 years. He and his team of Relationship Directors are responsible for thousands of clients, ranging from boutique fashion houses and high-street booksellers to department stores and listed companies.

Ian has over 20 years of corporate banking experience and has spent the last five years providing specialist banking services to retailers and wholesalers as part of the leadership within Barclays Retail and Wholesale team. Prior to that he was a Senior Relationship Director in the Technology, Media and Telecoms team, and has experience of other sector verticals from his early career. Since taking on his current role, Ian has become a regular commentator in the national, regional and trade media on retail trends and industry issues, as well as retail sales figures.

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