INFLATION: WHAT IT REALLY MEANS FOR CONSUMERS

THOUGHTS ON...

KANTAR WORLDPANEL

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In the battle for grocery shoppers, price perception is perhaps the most important weapon. Communication strategies have long centred on value-based messaging, with discount retailers Aldi and Lidl leading the charge. In this environment, changes in the prices shoppers see on shelves – and therefore in their perception of the value offered by each retailer – can be pivotal.

The grocery price deflation seen between 2014 and 2016 is evidence of the battle's severity. Collectively, the rise of the discounters and the response of their larger competitors – as well as unrelated price falls across a range of commodities – suppressed market growth.

Overall household spend was pushed back into growth in early 2017 as positive inflation returned – good news for a fairly static sector. Simultaneously, this shift increased the pressure on manufacturers to control prices and help their customers maintain value perceptions, and disagreements with retailers spilled onto a national stage.

As such, understanding how consumers alter their behaviour in response to rising prices is once again a pressing concern. Headline inflation figures can mask the true impact of pricing shifts on shoppers, so brands and retailers must look beyond them.

Product innovation and pack reformulation leave consumers with an even greater challenge in managing their spend, which has in turn created a tension for retailers between the search for category growth and the need to maintain price perceptions.

30 consecutive periods of deflation between 2014 and 2016

Understanding this interplay is fundamental in keeping shoppers on side. Retailers must establish where in store customers are feeling changes most keenly, because this is where the most dramatic changes to behaviour are likely to be seen.

Resurgent inflationary pressure

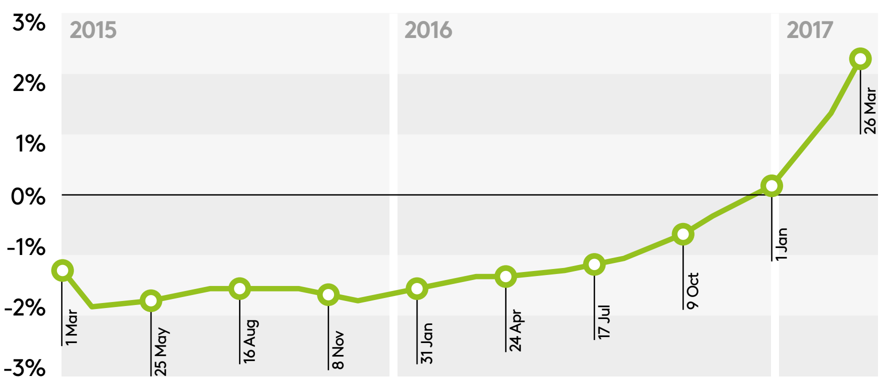
After 30 consecutive periods of deflation, year-on-year prices finally rose in January 2017, up by 0.7% for a representative basket of groceries. A number of factors were behind this change, most notably the impact of a weaker currency and rising commodity prices.

However, this headline figure masks significant variation: in the same time period that like-for-like butter prices rose almost 10%, the price of fresh poultry dropped by 1.5%. Most affected were healthcare and toiletries, where manufacturers have been able to gain retailer support to implement price increases, while frozen, fresh and chilled foods also saw rises ahead of the market.

A number of coping strategies are available for shoppers facing higher prices: trading down to cheaper products, shopping in less expensive stores, buying more on promotion, or simply purchasing fewer items. The net impact of these strategies in early 2017 meant that despite the **0.7% inflation** figure, household expenditure **grew by just 0.3%**.

Reduced promotional levels across the market have to some extent prevented shoppers from using deals to control spending, with consumers instead primarily relying on buying a smaller number of premium products. Fewer complicated promotions have also left some retailers in a quandary – those that have shifted towards everyday low pricing and 'round pound' models will be feeling added pressure to keep prices down.

Total grocery inflation, % change, 12 w/e periods



Different category, different behaviour?

In healthcare, where the impact of rising prices is currently strongest, customers are moving from specialist retailers like Boots towards bargain stores. In the discretionary world of toiletries customers are increasingly buying fewer items. High inflation in razor blades, for example, contributed to many shoppers buying blades less often or stopping buying them altogether. In skincare, by contrast, consumers barely altered their behaviour despite like-for-like price rises of 4%, suggesting an unwillingness to move away from established buying patterns.

However, there was one consistent trend in every market sector: shoppers trading down to cheaper options. Past experience shows this is a common strategy to combat inflation, representing a simple choice in the aisle which has a quantifiable impact on a consumer's total spend.

During the inflationary spike of 2008-2009, shoppers used product choice to mitigate up to 3% of the inflationary impact – a strategy which at its peak reduced total grocery market value by almost £30 million over 12 weeks.

However, the period in question also saw retailers shifting towards higher levels of promotion. A continued rise in inflation, at a time of more limited promotional choices, will likely put even greater pressure on premium lines in particular.

Retailers and manufacturers managing high-inflation categories need to ensure that their ranges contain suitable alternatives for shoppers looking to control spend, or they risk losing share to cheaper private label or tertiary brands.

Why inflation is only half the story

Range changes will also have a direct impact on pricing, particularly when new products are introduced: innovation by branded manufacturers typically comes at a premium.

In the average grocery category worth over £10 million, new products are **36% more expensive** than existing lines. Premiumisation is a powerful tool for retailers and brands in driving product and category growth. In tandem, manufacturers faced with higher commodity prices have increasingly sought to re-engineer pack sizes to maintain existing price points.

This is neatly demonstrated by recent growth in the number of new SKUs launched within existing ranges, many of which are simply pack size changes. In fact, **70% of the top 100** ranges across a selection of frequently purchased categories have introduced new pack sizes in the past year, and in almost two-thirds of cases the average price paid was higher than the existing range. In this environment, shoppers will find it increasingly tricky to avoid paying more for their favourite products.

BALANCING YOUR PRIORITIES

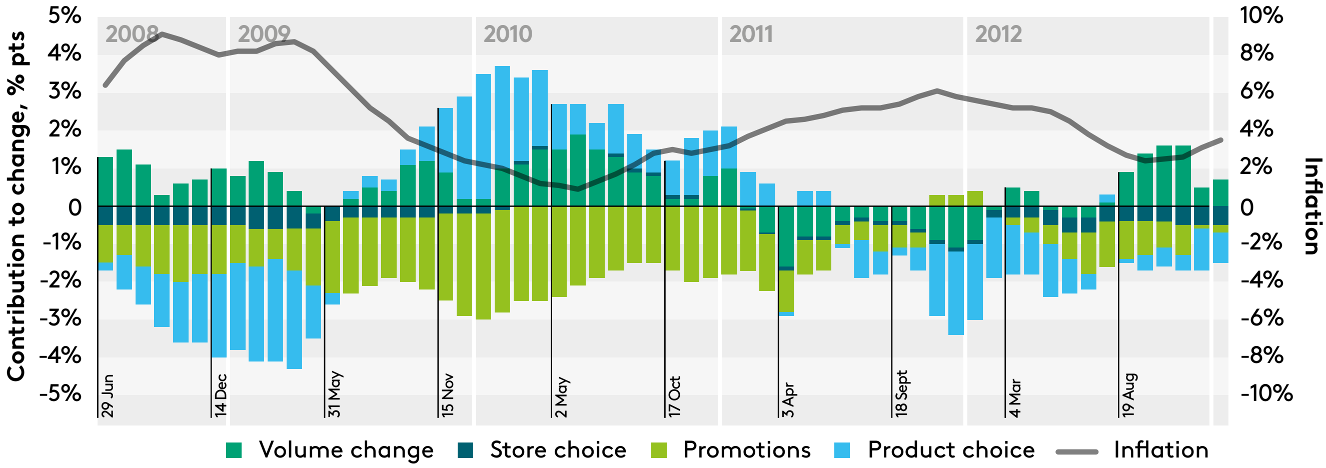
The return of grocery inflation is a major commercial balancing act for suppliers, who will be looking to deliver against expectations of market performance while still delivering profitability. For the first time in years, retailers will need to anticipate and manage price rises from manufacturers.

With shifting costs, businesses need to rediscover or reinvigorate their capabilities in negotiation, strategic account planning, and revenue control. Often this will be best achieved through the development of category growth strategies and truly joined-up business plans.

Upwards pricing pressure can be severely disruptive to established relationships. Both sides in a negotiation should use it as an opportunity to form a more strategic long-term partnership; by working closely together suppliers and retailers can mitigate the impact of these inflationary headwinds. However, it is clear there will be both winners and losers in the process.

Elizabeth McGregor, Principal Consultant at Kantar Retail

Contribution of consumer trading strategies to market growth, 12 w/e periods



As such, the headline inflation rate on like-for-like products actually masks even greater pressure on shoppers as prices are edging upwards in a variety of other ways.

The median price paid per unit of volume in the average grocery category was 1.9% higher in January 2017 than the year before – significantly ahead of the 0.7% rate of like-for-like inflation seen at the time. If this was maintained, a shopper buying an average selection of categories and not deliberately looking to mitigate the impact of inflation would end up paying £70 more per year for their groceries than the same shopper a year before.

Clear tensions exist between retailers' desire to maintain their price positioning, manufacturers' need to protect margins and innovate successfully, and the methods shoppers use to control their spending. A return to a sustained period of inflation will exacerbate this problem for everyone.

As shoppers tighten their belts value messaging will become more important than ever, further squeezing the suppliers' margins and leading to yet more pack size engineering. Ranges will need to be calibrated to offer shoppers control over their expenditure – through coherent price tiers, pack size options and more affordable innovation.

With inflation very much back on the agenda, there are a number of killer questions which retailers and brand owners should be able to answer:

- How severe are inflationary pressures in my category and my competitive set?
- What changes in shopper behaviour can I expect in my category if inflation continues to rise?
- In this environment what pack, price and promotion strategies will best maintain my brand's appeal to shoppers?

In the current climate, if you can't answer these questions you risk falling behind your competition. On the other hand, those retailers and brands which can are likely to be best placed to both retain existing shoppers and attract new ones.

Number of new SKUs within existing brands, 52 w/e periods

METHODOLOGY

All primary data used in this report comes from our grocery shopper panel, which continually measures the purchasing behaviour of 30,000 demographically representative households in Great Britain [England, Scotland and Wales].

We collect information on what they are buying, where they have bought it and why. This allows us to develop a detailed picture of the British retail market. The potential level of detail available on the panel goes way beyond that used in this report to help manufacturers and retailers really understand their performance at a granular shopper level.

Inflation figures are based on over 75,000 identical products compared year-on-year in the proportions purchased by shoppers, and represents the most authoritative figure available. It is a 'pure' inflation measure in that shopping behaviour is held constant between the two comparison periods – shoppers are likely to achieve a lower personal inflation rate if they trade down or seek out more offers.

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