



# Outlook for UK Consumer Spending

*Outlook for UK Consumer Spending*, summarises the latest ITEM Club Special Report, *The UK Consumer Outlook*, May 2011, and gives its assessment of the implications for business.

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## We expect a slow uneven recovery; the value conscious consumer is here to stay

The UK will not experience a consumer spending led recovery. Our latest research with the ITEM Club shows that expectations of a significant upturn in 2012 are premature. This is mainly due to real disposable income continuing to fall well into 2012, and it will be 2013 before consumer spending reaches pre-recession levels. The long term outlook is also of concern, as growth in consumer spending over the next decade is forecast to be subdued in comparison to the decade preceding the global financial crisis.

Furthermore, we believe that the length and depth of this recession has permanently transformed consumer behaviour. We have seen a significant shift in how people shop and what they buy. Savvier, value conscious shopping has been encouraged by increased promotional activity and availability of price comparison information. There has also been an overall reduction in average basket size due to the increased number of visits shoppers make to stores and an increase in number of shoppers using multi-channels.

The ITEM Club forecasts that consumers will continue to prioritise consumer technology and telecoms which is in line with a general trend amongst consumers where, 'the pound that lasts the longest' is preferred. Beyond 2012, it is expected that consumers will continue to prioritise longer lasting benefits over short term satisfaction. Food, alcohol and personal care goods will not lead us out of recession, all falling when we compare shopper priorities against the previous boom. Hotels and restaurants will continue to have a tough time, with the Olympics in 2012 providing only relatively limited relief.

However, the headline numbers mask some real differences. The recovery will be uneven, and whilst all consumers are going to feel the squeeze, the ITEM Club forecasts that there will be variations in the level of consumer spending by region and by segment. Londoners and those living across the south of England will continue to significantly out-spend other regions in the UK, due to a greater resilience to public sector spending cuts and better prospects for employment. Middle income groups will see their spending power shrink less than the higher and lower earners, as price inflation in essential items and tax changes have an uneven impact on wallets. Those retailers and manufacturers who are over reliant on segments that lose the most will find it most difficult.

## Implications

With subdued growth prospects, many organisations will look at opportunities beyond UK borders. For example, there are signs that the consumption patterns of emerging markets are beginning to evolve, a process which was highlighted in the February 2011 ITEM Club Special report on UK Exports. There is evidence of much stronger consumer demand from the BRICs as standards of living rapidly improve. As the BRIC economies continue to achieve rapid economic growth, household incomes will continue to grow and the ITEM Club

expects nominal household income growth to average 14% a year over the period to 2020<sup>1</sup>, offering plenty of scope for a robust increase in consumer demand over the coming decade. This is reflected in the forecast average annual increases in UK exports in related sectors. For example, for the period 2010 to 2020, telecoms and consumer product exports are forecast on average to grow 9.2% and 6.4% respectively per annum<sup>2</sup>.

Within the UK market, the environment of subdued demand will make it difficult to pass the commodity price increases through to on-the-shelf prices. We expect the total profit pool to come under increased pressure in most categories. The battle lines are drawn for increasingly intense negotiations between manufacturers and retailers as they work out who will absorb the most. These negotiations will be fuelled by the level of promotional activity which has reached record levels. Brand owners are increasingly concerned at the depth and length of time on promotion that some of their most iconic brands are experiencing. Retailers are under pressure to demonstrate low prices to shoppers and promotional activity is a powerful tool for them to use to differentiate from their competitors. As such, we don't see a significant reduction in promotional activity in the short term, whilst there is such immense pressure on either just maintaining or trying to secure a larger share of the shoppers' wallet.

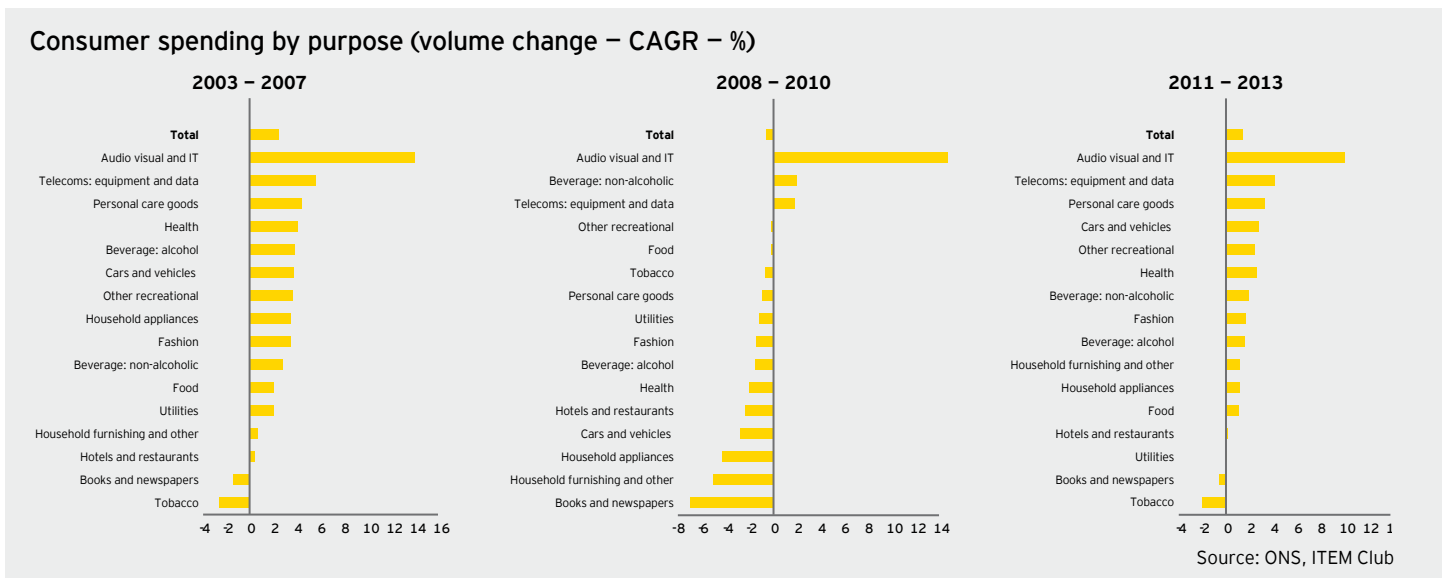
With an uneven recovery there will be a fine line between winners and losers. The unevenness of the recovery across categories, consumer income groups and regions will create both opportunities and risks. The most successful manufacturers and retailers will be those that respond fastest to these changing priorities.

### Consumer spending – the UK story so far

UK consumer spending in the last 10 years is a story of two parts. Consumption was among the main drivers of UK economic growth during the pre-crisis period. Volumes grew by 2.8% p.a. outperforming most of the Organisation for Economic Co-operation & Development (OECD) countries. Almost all consumer focused sectors experienced a solid and sustained growth in the boom years up to 2008. The technology and telecoms sectors were the stars with new technologies allowing them to out-perform all others. Tobacco suffered, as did books and newspapers as regulation tightened and consumers migrated online for their written words. Food and alcoholic and non-alcoholic beverages broadly followed the overall consumption growth.

From mid-2008 however, everything changed with significant consumer spending retrenchment. At its worst, spending was 4.9% below its 2008 peak. Housing related expenditure and vehicle purchases were hit hard, non-essentials such as personal care and alcoholic beverages saw sharp declines.

1 *The outlook for UK exports*, ITEM Club Special Report, February 2011  
 2 *The outlook for UK exports*, ITEM Club Special Report, February 2011



The economic conditions that drove pre-crisis spending have long since gone. Public expenditure cuts are likely to keep unemployment around current levels till mid-2012. Constraint on real wage growth and access to credit is expected to remain limited, with many households continuing to deleverage. With nearly 70% of homeowners on tracker mortgages, any interest rate increase will hit many wallets. Asset prices and general wealth are unlikely to return to pre-crisis values soon. Therefore, not surprisingly, consumer confidence remains volatile and far away from the pre-crisis levels. Consumers have become more cautious in their spending behaviour and are more willing to make comparisons, undertake research, consider own label brands and shop around. Retailer and manufacturer promotions have helped create a more value conscious and price sensitive consumer.

If that wasn't enough, the ITEM club expects that real income will decline for a second consecutive year for the first time since the mid 70s, a challenging period remembered for stagflation, another worry for the high street. In this economic situation, consumer demand is almost certain to remain weak. The latest Ernst & Young Profit Warning research spots some early warning signs, finding 14 retailer profit warnings in the UK in Q1 alone<sup>3</sup>. This is a stark reminder – it is the third highest we have ever recorded, and the highest level since Q1 2008.

### Consumer spending priorities

	2003 to 2007	2011 to 2020	
Audio visual and IT	1	1	↑
Telecom equipment and data	2	2	↑
Cars and vehicles	6	3	↓
Other recreational goods	7	4	↓
Personal care goods	3	5	↓
Health	4	6	↓
Fashion	9	7	↓
Household furnishing	13	8	↓
Household appliances	8	9	↓
Beverage: Non-alcoholic	10	10	↓
Beverage: Alcoholic	5	11	↓
Hotels and restaurants	14	12	↓
Food	11	13	↓
Utilities	12	14	↓
Books and news	15	15	↓
Tobacco	16	16	↓

Source: ONS, ITEM Club

### Consumer priorities in the next ten years

Overall, UK consumer spending is only forecast to reach pre-crisis levels by the middle of 2012 and then grow at 2.0% p.a. until 2020. This is well below the 3.3% seen before the crisis. We expect the recovery in spending to be uneven across categories. When we compare demand between the last boom (2003 to 2007) and the next ten years it is clear that consumers have some changed priorities (see chart left). We believe the value conscious consumer that emerged in the downturn is here to stay thanks to the prolonged recession in which meal vouchers and comparison websites became the norm. As in recent years, consumers will continue to prioritise consumer technology and telecoms when they do have some spare cash. However, we see a general trend amongst consumers where 'the pound that lasts the longest' is preferred. We expect consumers to prioritise longer lasting benefit over short term satisfaction. Food, alcohol and personal care goods will not lead us out of recession all falling when we compare shopper priorities against the previous boom. Hotels and restaurants will continue to have a tough time, with the Olympics in 2012 providing only relatively limited relief. Manufacturers and retailers who respond to the changed priorities fastest will succeed.

### Category outlook

At the headline level, both price increases and volume growth are likely to have an almost equal impact on the overall level of consumer spending yet their relevance is significantly different by category, and will change over time. Most importantly with weak consumer demand and high levels of price promotion, many manufacturers will struggle to pass on the full impact of inflationary increases that are running a pace. The total margin pool is likely to be squeezed further. The scene is set for an increasingly intense fight between manufacturers and retailers as they work out who will absorb the most.

Total spend on non-discretionary (essential) items will increase by 2.5% p.a. until 2013 as highlighted across the key subsets, however, demand will be weak, and inflationary price increases will be the main driver:

- ▶ **Food.** We expect price increases, triggered by VAT and commodity price changes, to cut into consumers' wallets aggressively, increasing 4.3% over the next three years. Over the same period we only expect food volumes to increase by 1% p.a. With such weak demand, it will therefore be increasingly difficult to pass the full impact of cost increases on to the shelf as few retailers and manufacturers will want to lose share. Whilst significant, price increases are therefore unlikely to maintain the current margin pool in most cases. In addition, many would like the overall volume sold on promotion to reduce, however, we believe any move away from promotion will be slower than some would like. Finding more non-price strategies to regain shopper loyalty and reactive base sales in an environment with such weak demand is a more difficult thing to do than say.

<sup>3</sup> Analysis of profit warnings, Issued by UK quoted companies, Ernst & Young, April 2011

- ▶ **Utilities.** Energy and fuel bills will continue to hold surprises as geo-political instabilities continue, however, at a headline level, we expect volume to remain flat until 2013, falling by 1.7% in 2011, and recovering over the following two years. Price increases of 4.2% in 2011 will be driven by recent geo-political events; although, this upwards trend should fall to 2.7% in 2012, and 3.2% in 2013. Increasingly usage conscious consumer behaviours will become an important factor as the smart metering roll out progresses.
- ▶ **Health.** The outlook for health is slightly different. An ageing population will underpin steady increases in demand. In addition, more consumers are likely to look beyond the NHS as austerity measures bite. We expect volumes for medical services and appliances to increase by 1.5% over the next three years.

The ITEM Club forecasts that discretionary (non-essential) spending is only expected to regain momentum from the middle of next year. This is the time when wage growth is expected to again outpace inflation, supporting both consumer spending power and confidence. Energy costs should stabilise as geo-political risks fade, or at least become the new norm, stabilising utility bills and stopping the erosion of money available for discretionary items. After this point we forecast that total spend on discretionary items will pick up and grow at 3.0% p.a. until 2013 and continue at 3.2% p.a. until 2020. Again demand will weaken and inflationary pricing will be the main driver in many categories.

- ▶ **Beverages.** Volume growth of non-alcoholic beverages is expected to continue with steady growth of around 1.9% p.a. in the three years to 2013. Healthy, but still less than the 2.8% p.a. recorded before the crisis. After stripping out VAT increases, price inflation is still expected to be above 3.0% in 2011, and fall to around 2.3% in 2012, and 1.9% in 2013. Alcoholic beverages should reverse fortunes with subdued but positive average volume growth of 1.6% p.a. to 2013. As we have seen in the food category, price will be the key driver of increased spending but weak demand will continue to put pressure on the margin pool.
- ▶ **Electronics.** In the short term spend on audio visual and IT is expected to increase at 5.9% p.a. to 2013. A volume increase of 9.9% is expected to be offset in part by price deflation of 4.0% p.a. We expect strong growth in consumer audio-visual as upgrades to large screens, HD and 3D continue to offset drops in ICT and photographic equipment. Whilst still important price deflation is set to reduce pace and fall below volume growth once again, a change from the pre-crisis period. Major household appliances will only outpace smaller appliances as the housing market becomes more active from 2013; before then consumers will prioritise other categories.
- ▶ **Cars and vehicles.** 2011 will still be challenging, and the outlook is far from certain. The ITEM club expects 2011 may mark the end of four tough years if energy prices stabilise or fall. If this comes true, volume will be expected to rebound and grow 2.8% p.a. until 2013. However, cars and vehicles are particularly sensitive to the impact of changes of the price at the pump on both increasingly price sensitive and energy efficient drivers. This is a category to watch closely.
- ▶ **Telecommunications.** The outlook for telecoms equipment and data is more certain. Spend is expected to maintain momentum growing at 4.1% p.a. until 2013 and continue with a 4.3% trend growth until 2020. Telecommunications is one of the rare cases where demand is likely to be the key driver of increased spending, however, this will surprise few as the key driver will be the use of smart phones in consumers' lives.
- ▶ **Personal care goods.** Personal care, one of the most sensitive categories in the downturn, is expected to rebound strongly with a 3.1% p.a. growth in volume until 2013. Volume and price are expected to have similar weight in driving an increase in spending.
- ▶ **Tobacco.** Tobacco is forecast to continue the downward trend experienced before the crisis and price is likely to play the most important role in affecting consumer spending. Volumes are expected to decrease by 2.1% p.a.
- ▶ **Books and newspapers.** Price increases are expected to prop up spending on news and media as weak volume growth is the inevitable impact of increased online consumption. Volumes are forecast to continue their decline at 0.5% p.a. from 2012, with a 0.9% reduction expected in 2012, and 0.6% reduction in 2013.

In terms of channels, we expect specialist retailers to continue to suffer at the expense of the largest players, as they are unable to match the buying power or achieve the same cost efficiencies. The convenience format will bring the biggest players even closer to consumers' homes, but large formats will still be more important in absolute terms.

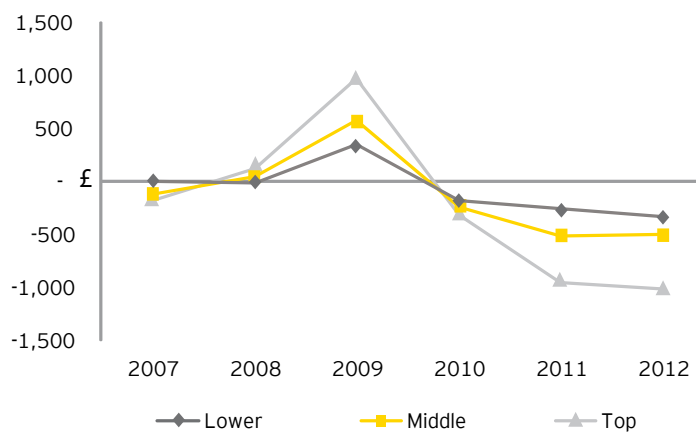
Online channels will continue to grow and widen the options for making more informed purchasing decisions and Smartphone apps may increasingly influence shoppers' decisions. Technology retailers on the high street are likely to continue to be the most exposed to this downside risk. The 'wisdom of crowds' has driven the largest web 2.0 success stories, and whilst this was previously restricted to online channels, we believe its impact will increasingly be felt in store.

### Which consumers you target where, will increasingly define the winners

Higher earners weathered the crisis better than the lower or middle income groups. Their real disposable income increased by £1,150 between 2007 and 2009. At a headline level, the changes to personal taxation that came into effect in April 2011 aiming for a more progressive system will have their desired impact. Nominal take home pay is expected to increase fastest for the lowest earners in 2011 and the middle income groups in 2012. However, when the impact of inflation is considered, all groups will see their wallets shrink further in 2011. The impact is uneven across different income groups.

- ▶ **Top earners.** The spending power of the highest earners is expected to be £690 less in 2012 than in 2010. When added together with decreases they've experienced between 2009 and today this represents a reduction of £1,960.
- ▶ **Middle earners.** Middle Britain will fare better in 2012, however, what at first appears to be an increase in take home pay will still be £260 below 2010 levels once inflation is considered.
- ▶ **Lower earners.** Lower earnings will pay less tax but any benefit will be more than offset by inflation.

### Income distribution spending power relative to pre-crisis values (£)



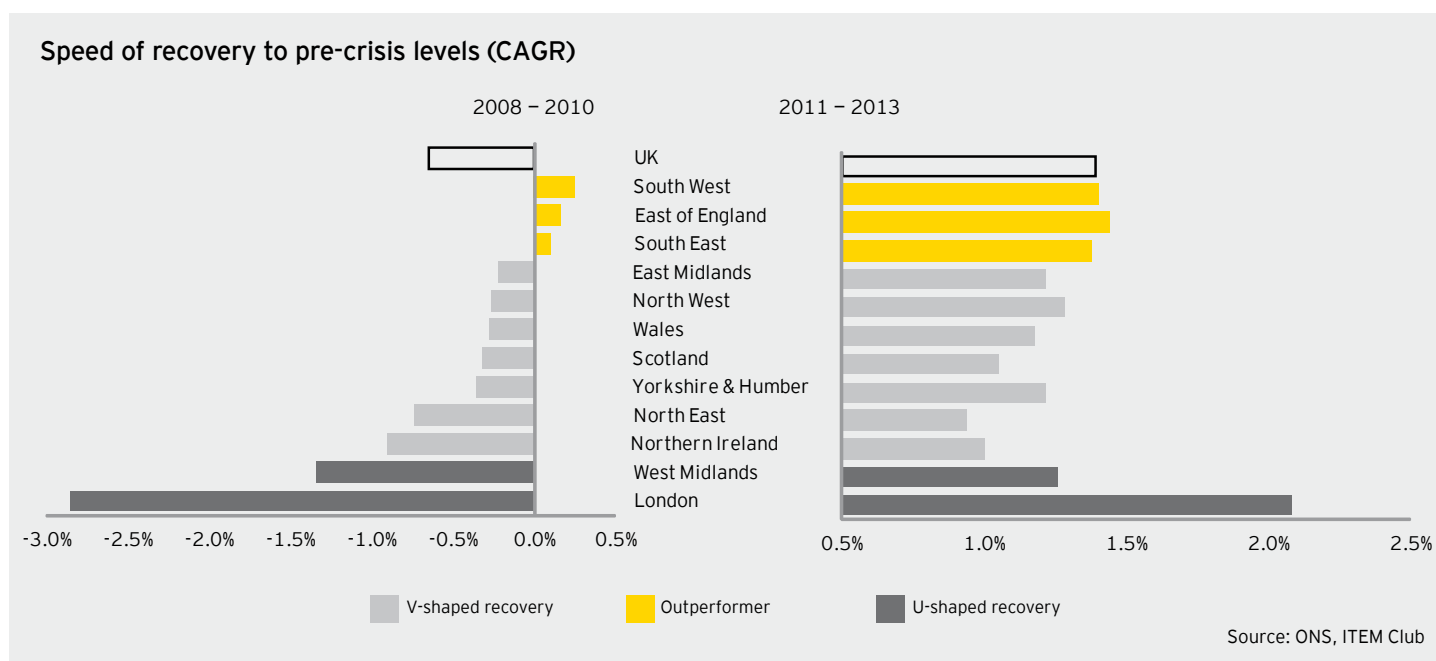
Source: ONS, ITEM Club

UK regions' performance during and after the crisis varied significantly. The South (excl. London) proved to be more resilient to the crisis than the North. Whilst government spending in the North helped drive a fast V-shaped recovery (a sharp decline followed by a sharp rise), austerity measures will likely see the North not close any gap in the short term. London and the West Midlands were most severely affected and we expect the post-crisis recovery to be a steady U-shape (a gradual decline followed by a gradual rise). Looking ahead, we expect to see the southern English regions dominate principally because of their stronger outlook for employment and household incomes.

The winners will be better able to target the income groups that lost the least, and differentiate their strategy and execution by region.

## Considerations to increase chances of growth and profitability

The only thing that is certain is that the recession has changed UK consumer spending for the long term. Exactly when a recovery emerges will to an extent depend on how hard the austerity measures, inflation and proposed interest rises will impact the economy. A greater effect than we anticipate could cause consumer spending to undershoot ITEM Club forecasts. Whilst the downside risk is almost certainly the largest there could also be some more positive surprises. If the widely discussed 'export led recovery'<sup>4</sup> becomes reality we may see the economy rebound more quickly and consumer confidence improve sooner. The key to remember is that there are few 'average consumers' in the UK so the combined impact of the sensitivities of each of the categories and consumer groups will make a difference to the overall recovery. All those who operate within a consumer market need to undertake a rigorous analysis of their business and their sector to understand what the changing consumer and economic environment means and then prepare and implement plans which helps them survive and thrive through the coming decade.



We have come up with eight key questions to think about in light of the risks and opportunities ahead:

- ▶ Do you understand the opportunity cost of defending share in the UK vs. investment overseas?
- ▶ Are there more favourable categories you can move into? Should you acquire, partner or access through direct investment?
- ▶ What are the working capital implications?
- ▶ Do you have the right finance structure to navigate a slow 2012?
- ▶ How do you manage and control the downside risks and increased volatility?
- ▶ Will this have an impact on the value of your assets?
- ▶ Do you have a plan for taking advantage of traditional and online convergence? Do you understand the ROI of your channels?
- ▶ Are you confident your pricing and promo strategy is striking the right balance?

4 *The outlook for UK exports*, ITEM Club Special Report, February 2011



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