Supermarkets

Autumn 2009

Supermarkets show potential for enhanced rental value growth

- Supermarkets have emerged relatively untouched from the global recession.
- Adjusting for inflation, as of August year-on-year sales value growth stood at 3.9% for food stores. For all retail sales have seen a growth of 0.1%.
- Supermarket yields have softened since 2007 although it has been at a slower rate than seen across the property sector as a whole.
- Supermarkets out-performance is largely based on the strength of operator covenants, ensuring its continued appeal to investors.
- Average yields have started to harden. Since June, IPD monthly initial yields have fallen by 8 basis points.
- Operational leases incorporating either index linked/ guaranteed uplifts and/or open market rents have driven end values.
- Achieved yields have ranged from 5.25% for an asset with fixed uplifts through to 6.2% based on open market reviews.
- The key driver of investment performance in the sector going forward is expected to be enhanced rental growth.

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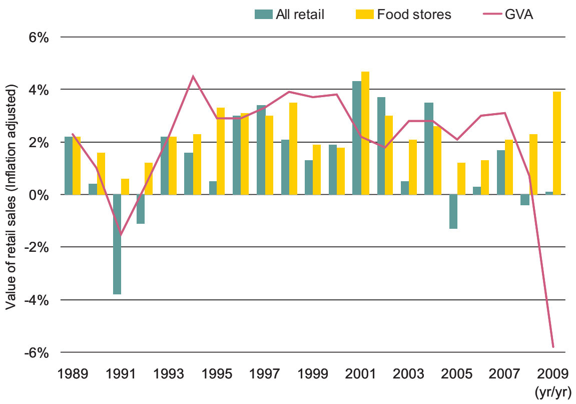
Market performance

Value growth of retail sales (inflation adjusted)



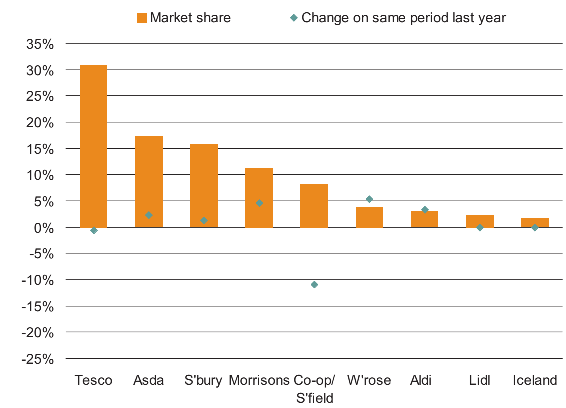
Source: ONS

Sales./ turnover growth of key operators

Source: Savills; Operators Trading Statements

*Note: *Waitrose figures include VAT*
***Sainsbury's figures based on Q2 results.*
****Tesco sales growth includes VAT*

Operators market share (12wks to 6th Sept 2009)



Source: TNS

With the onset of the global recession, retailer failures have increased as consumers tighten their purse strings and reduce spending. Despite deteriorating operating conditions, supermarkets have emerged relatively untouched. For some, such as the discounters, the recession has been beneficial leading to increasing customer numbers and sales growth as consumers look to reduce household spending.

As with the previous recession of the early 90's, food stores have continued to see retail sales growth. Adjusting for inflation, 2008 reported a 2.3% increase, with year-on-year growth as of August 2009 standing at 3.9%. This is in contrast to the retail sector generally where a 0.1% annual growth was reported.

With the continued growth in sales, operators have reported strong trading performance figures. Trading statements have remained in positive territory with like-for-like sales (excluding fuel and VAT) up between 2% to 8% over the first half of the 2009/10 trading year (Sainsbury's figures based on Q2 trading performance. Asda figures are not published). However, this is not to say that the supermarket sector has been completely immune to the onset of the recession.

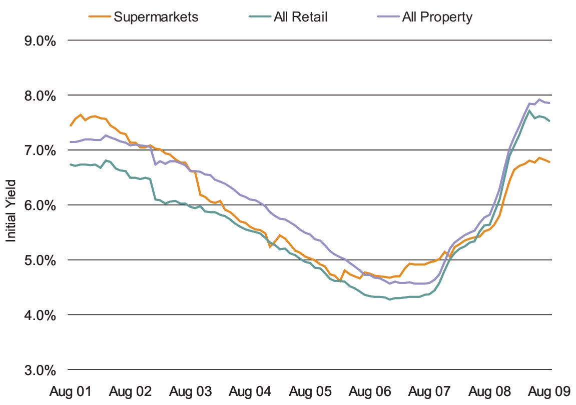
The most significant recessionary impact, highlighted in our last report, has been the shifts in market share. The traditional 'value' retailers such as Asda and Morrisons together with the discounters (Aldi; Lidl; Netto; Iceland) have seen their market share expand as shoppers look for 'value for money'. Having said this, shoppers are appearing to return to pre-recessionary behaviour. This is already apparent with Waitrose's recent performance where the operator reported a 11.2% growth in sales over the 12 week period up to the 6th September. Indeed, the previous strong growth of Aldi and Lidl is starting to tail off.

Over the last year as retailer failures became relatively common place, supermarket operators trading performance made them attractive covenants. Landlords, in particular those on retail parks, are looking to supermarket operators to fill the gap left by failed tenants. Retail parks can be attractive to operators but they can present potential planning hurdles as in most cases a change of use will be required. A case study review of the potential planning issues associated with obtaining a change of use is detailed on page 4.

The competition to maintain and enhance market share means that the expansion of convenience store formats looks set to continue. As these formats are largely dependent on leasing space it will be this section of the market that will offer the best opportunities for landlords/ investors to enter the sector, especially as operators continue to expand their portfolios.

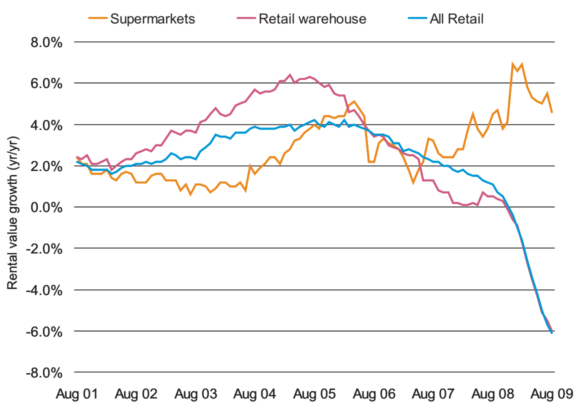
Investment opportunities

Investment performance



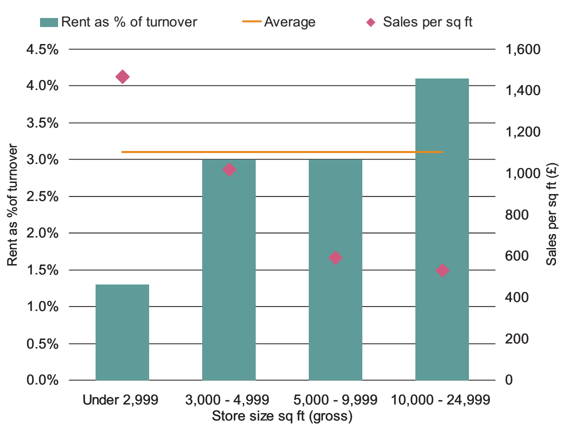
Source: IPD ©

Rental value growth (yr/yr)



Source: IPD ©

Rent as % of turnover - food stores



Source: Savills

While supermarkets have seen the same outward shift in yields as seen across all sectors, the rate of this movement has been somewhat different. Since June 2007 monthly supermarket initial yields have softened by 187 basis points (bp), all property and all retail have seen yields soften by almost double this (329 and 320 bp respectively).

This out-performance by supermarkets is largely based on the strength of its operator covenants, ensuring its continued appeal to investors. This appeal was recently demonstrated by Tesco's second property-backed bond launch this year. The planned bond issue of approximately £500m had drawn £1.3bn in orders in one day. The fall out in the property market has focused investors attention towards 'prime' assets. That is investments with 10 or more years secure income, minimal over-renting and no voids. Supermarkets strong trading performance and their commitment to locations mean they fit the bill. As a result, signs of yield hardening is starting to materialise. Since June, IPD's monthly initial yields have hardened by 8 bp. By the end of the year we expect further downward shifts in yields in the region of 25 bp.

Operators have already started to capitalise on investor appetite releasing capital from their property portfolio through sale and leaseback deals. Tesco just announced the sale of a £400m portfolio of properties, structured as a sale and leaseback, to a newly formed property investment company. Deals completed by Sainsbury's over the last six months, have achieved an average yield of 5.75%, with buyers ranging from private investors to traditional funds. Interestingly, the range in purchaser type and their preference for either index linked/ guaranteed uplifts and/ or open market rents has been reflected in end values. Institutions have largely shown a preference for assets with index linked/ guaranteed minimum rental uplifts. In contrast property companies, private investors and a handful of institutions have opted for those with open market rents. The latter's preference is based on their view that the UK will enter a period of medium to high inflation, proving open market rents to be more beneficial. This preference has seen yields range from 5.5% for a sale and leaseback deal, with fixed uplifts, for a Sainsbury's store in north London, through to 6.2% for a unit also let to Sainsbury's in Cheltenham leased on open market reviews. At the time of going to print, a unit in Byfleet, Surrey, let to Waitrose at £18.50 per sq ft with 18 years unexpired was attracting offers at circa 5.25%.

Apart from income security does the sector offer any opportunities for enhanced returns?

We suspect the strongest driver of future investment performance for the sector will be rental growth. The onset of the recession and subsequent retailer failures

Planning case study

created downward pressure on rents. According to IPD, retail as a whole has seen rents fall by 6.1% since August 2008. In contrast supermarkets have continued to report positive growth with rental growth of 4.6% in August compared to the same period last year. As operators have become more receptive to leasing and with continued competition, operators are having to pay higher rents in order to secure the right location. We suspect that this trend will continue and as a result rental growth is likely to exceed that in other retail sectors. The potential for further uplift is demonstrated by long term rental growth performance across the retail sectors. According to IPD, since 1981, the supermarket sector has lagged behind with 4% rental growth per annum as opposed to 5.6% and 5.3% for retail warehouses and shopping centres respectively.

In order to to carry out a more sophisticated analysis of the potential for further rental uplift, Savills has modelled turnover for a number of supermarkets and a matched sample of retail warehouse stores where rental data is available. Based on this analysis, supermarket rents accounted for approximately 3.1% of a store's turnover. There were some differential in terms of regional location and store size with stores in the South East and stores under 5,000 sq ft having the lowest ratio of rent to turnover (2.5% and 2.7% respectively). Interestingly, in the smaller stores, rent accounted for the lowest proportion of turnover while possessing the highest sales per sq ft (averaging £1,470). The larger stores averaged just over £500 per sq ft (stores sizes of 10,000 to 25,000 sq ft). In comparison, rents for the sample of matched retail warehouses averaged 12.5% of store turnover, with sales per sq ft averaging £424.

What conclusions can be drawn from this?

We are not suggesting the use of turnover rents and recognise that, compared to other retailers, supermarket running costs can be significantly higher. The smaller stores in particular, while having higher sales per sq ft and lower ratios of rent to turnover, are associated with higher running costs on a per sq ft basis suggesting they are more sensitive to rental levels. Yet, the difference in rent as a proportion of turnover between the two sectors suggests that the supermarket sector should continue to see further rental growth. This, combined with the fact that supermarket rental growth over the long term has lagged behind other retail sectors, points to further potential for growth over that offered by other retail sectors.

Our advice to landlords/ investors is that examining potential catchment turnover of stores held in portfolios and understanding tenants business will be key to setting sensible rents and maximising any potential uplift. With operators increasingly looking to carry out sale and leaseback deals and acquiring leasehold space, landlords/ investors may need to apply a more sophisticated approach to store site analysis, which to-date has been the preserve of the operators themselves.

Planning case study: Bowling alley site, Chester

Savills Retail Planning were instructed to secure planning permission for a food store on an existing 50,000 sq ft site comprising a bowling alley and two non-food retail warehouses at an out of town retail park in Chester. The main issues were:

- Was there sufficient capacity for an additional food store in Chester?
- Could the proposed store be developed on land closer to the city centre?
- Would the food store divert investment from sites already identified as suitable for new food stores, to the detriment of the council's retail strategy?

Chester city council's advisors suggested that planning permission should be refused on the basis that insufficient need had been demonstrated and that alternative sites in the city centre, or closer to the core retail areas, should be developed in preference. In addition, the council argued against the loss of the bowling alley as a recreational facility and associated employment. In short, there was an array of policy objections!

Savills opened a dialogue with both the city council and their advisors White Young Green (WYG) to review their conclusions. Savills argued that there was a need for food retailing in the area. They also identified that this need could not be met by developing a store in the city centre or closer to it. There were also qualitative benefits associated with converting the site to food retail, including greater employment generation than could be realised under the site's current use as industrial start up units. Further, the proposal represented an opportunity to increase food retail provision and therefore competition to the benefit of consumers

The Local Planning Authority agreed with these counter arguments and granted planning permission. In doing so, the officer's report to committee noted that the qualitative benefits outweighed the concerns by WYG. Namely, that there was not sufficient food retail provision in the area. The employment benefits of converting the site to food retail were greater than the loss in jobs associated with developing the site. It also concluded that the loss of the bowling alley had to be considered in the light of commercial realities in that it might not be a viable commercial concern.

Key contacts

For further market information please contact

Chris Blair
Agency
020 7409 8152
cblair@savills.com

Mark Garmon-Jones
Investment
020 7409 8950
mgarmon-jones@savills.com

Tim Doughty
Development
0121 634 8408
tdoughty@savills.com

Jeremy Hinds
Planning
0161 277 7278
jhinds@savills.com

Andrew Birtwistle
Agency
0207 409 9908
abirtwistle@savills.com

Andrew McGregor
Investment
020 7409 8861
amcgregor@savills.com

Kay Harriman
Landlord & Tenant
020 7409 8158
kharriman@savills.com

Marie Hickey
Research
0203 320 8288
mlhickey@savills.com

Tom Whittington
Research
0161 244 7779
twhittington@savills.com

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