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Foodstore Spotlight
Delivering income security

2017

New buyers in the market

Transaction volumes for 2016 totalled just over £1.2bn, down on 2015 levels that were buoyed by the £733m Tesco and British Land deal (graph 1). The real change on 2015 activity however, is in the profile of the buyer pool.

Institutions, who were previously major buyers of foodstores, were net sellers in 2016 primarily due to operator buy backs. This activity by operators meant they were the dominant buyers in the market last year (graph 1). Acquisitions by this group represented 49% of volumes, in part accounted for by Tesco exercising options to buy back stores previously sold on a sale and leaseback basis. However, overseas investor activity gathered pace accounting for 22% of volumes (c.£257m). Of this group it was Middle Eastern buyers who were the most active, spending approximately £180m, 70% of total overseas investment, their most active year on record. For Sharia compliant investors it is the larger stores that hold greater appeal, as the 'non-sharia compliant' portion of total revenues (sale of alcohol and pork) is more likely to sit below acceptable thresholds.

The weaker Pound post the EU Referendum did provide a boost to international buyer interest in UK real estate, and will continue to do so throughout 2017. This is also being aided by buoyant liquidity in the commercial debt market as competition amongst lenders remains strong. The current and future cost of finance is also enhancing the yield return offered by commercial property, particularly on index-linked long income assets such as foodstores.

Income security and yield spread boosting sector appeal

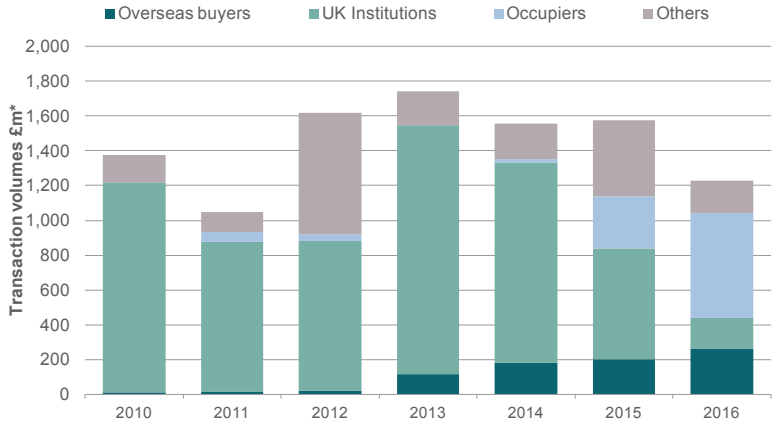
Its current yield spread means there is an additional 'value' play that is boosting the attractiveness of foodstores to overseas investors. Going into 2017 we also believe it will bring more domestic buyers into the market.

Current prime yields for foodstores on inflation linked leases range from 4.25% to 4.75%. This reflects a partial softening on their post Global Financial Crisis (GFC) low in Q214 when prime yields were c.4.00%. Negative newsflow regarding operational performance across the 'Big Four' operators started to mount during 2014 and into 2015, resulting in an upward pressure on yields. While operator performance has since improved, prime yields have not yet seen the corresponding downward shift and remain 50 basis points off their Q214 levels (see graph 2).

One of the other key attractions of the sector is its index linked income. Almost 60% of 2016 transactions were on assets with inflation linked leases (RPI or CPI). Of this 60%, just over two thirds were long income assets

GRAPH 1

Increasing activity by overseas investors



Graph source: Savills Research (Note*: data relates to all stand alone food stores)

GRAPH 2

Prime yield for inflation linked assets

Graph source: Savills Research

with unexpired terms in excess of 20 years.

This type of index linked long income has once again become increasingly appealing as the appetite for 'risk' has waned following the Brexit vote. This lease profile also makes the holding of foodstores relatively 'management' light, a key consideration for some overseas investors.

Lease structures and rental value growth

While index linked lease structures have dominated the market over recent years, we may see a resurgence in interest in assets with open market reviews.

The historical sale and leaseback acquisitions were largely based on RPI linked leases designed to provide an element of certainty to the retailers' future rental liabilities. It also created a desirable investment product where funds could match annuity liabilities against guaranteed rental performance and associated capital value appreciation. As a result these types of assets have tended to attract lower yields than those assets on open market review structures.

However, we are now seeing an increasing number of RPI linked leases looking somewhat overrented. In response we may see a resurgence in demand for those foodstores let on open market reviews where rents appear affordable and therefore provide enhanced potential for future rental growth.

Operating conditions improving....

During the height of the GFC foodstores were seen as one of the 'safest' investment options as, occupationally, foodstore operators continued to report positive sales growth and continued to expand. The entrance of the 'discounters' (Aldi, Lidl) and evolving shopping habits, which saw a shift towards more frequent and smaller food shops, started to challenge sales efficiencies and market share of the 'Big Four' going into 2014. This was more pronounced for those with a more 'value' offer and with store portfolios skewed towards large hypermarket formats.

Conditions have since improved with the most recent data suggesting combined supermarket sales increased in value terms by 1.4% year-on-year (Kantar Worldpanel covering the 12 week period to 26th March 2017). This is reflected in UK retail sales data for the sector. The value of retail sales for foodstores improved (on a rolling 12 month basis) throughout 2016 after hitting an all time low in November 2015 (see Graph 3).

Part of this improvement in operational performance is being driven by innovation with the large operators all now having credible online ordering platforms as well as 'click and collect' services. Amazon's entry into this sector with their AmazonFresh offer, as well as Sainsbury's acquisition of Argos, will undoubtedly shake up fulfilment in this area with grocers keen to improve this service.

GRAPH 3

Foodstore retail spend has improved

Graph source: ONS

What makes a good foodstore

Store size and rental affordability key to income security

The UK food retailing market has gone through a shift in recent years driven by changing consumer behaviour. Whereas 15 years ago the large weekly shop in large out of town stores was the norm, now buying less but more often dominates UK food shopping behaviour. This trend drove the expansion of the c-store (small convenience store) format across the major operators. While this remains an important growth area, expansion has slowed as saturation has been reached in many locations.

The shift in consumer behaviour, and entrance of the discounters (Lidl, Aldi), have challenged sales efficiencies across the 'Big Four' operators. This has translated into a declining interest in the large hypermarket stores by the operators. Rather the 30,000-50,000 sq ft store has an improving appeal to operators as it offers the best compromise between providing a comprehensive product line and optimum sales efficiencies. One reason why Waitrose has been so resilient since the downturn is that apart from being selective of the catchment/demographics they serve, their portfolio is already aligned to stores in this size band. Outside of their c-store strategies, Tesco and Sainsbury's are now focusing more on stores in the 30,000-50,000 sq ft size band and creating strategies for cutting their largest stores through subdivision, sub-letting, or joint ventures with other retailers.

Store size is not the only consideration. Rental affordability is also key. The best assets to own are not necessarily those that have the highest turnovers. We see plenty of average performing stores that are in good catchments, with stable trading and are relatively under rented, providing both opportunity for rental growth and secure/viable rental affordability.

Savills have analysed a considerable number of food store revenues and rents to assess rental affordability in order to develop affordability models that identify suitable 'Rent:Turnover Ratios' (RETO%). In our view, where a supermarket has a good market share and good level of turnover, a RETO% less than 3% provides a relatively secure income. However, a high market share, with poor trade and a RETO% more than 5%, may raise concerns about future affordability should market forces or increased competition impact on the store's revenue.

...with a refocus on smaller store formats

A refocus on smaller store formats and a move away from large out of town superstores is also helping to improve grocers efficiencies. This has seen operators restrict new store developments. On existing portfolios operators are looking to drive additional turnover by re-inventing floorspace within their large format stores by incorporating other uses such as soft play areas, gyms and even other retailer formats.

Discounters, who have been considerably acquisitive, tend to have store requirements between 18,000-28,000 sq ft. In addition, M&S Food Hall continue to acquire units of between 11,000-15,000 sq ft, often sitting alongside a discounter, to offer the 'cost conscious' something more luxurious if required.

This focus on smaller formats is also apparent in the recent announcement that Tesco will acquire the Booker Wholesale Chain. The deal, which is still subject to Competition Commission approval, will see Tesco acquire the local convenience formats of Budgens, Premier Foods and Londis, as well as the Booker Wholesale stores.

The residential play

There are significant opportunities to unlock value in existing commercial opportunities as demand for residential development opportunities continue, particularly in Greater London and around key infrastructure hubs. Foodstores are prime candidates for this and is reflected in London and the South East remaining the most liquid investment markets last year, accounting for 47% of foodstore transaction volumes. There are now a number of investors targeting this type of stock for this purpose.

The foodstore/residential angle is largely determined by location and site utilisation characteristics. Foodstores are often located in town centres and are typically single/two storey buildings with low site coverage. These sites can offer potential for comprehensive redevelopment opportunities, particularly where foodstore operators may wish to take a smaller store as part of a new scheme.
On more constrained foodstore sites there are also opportunities to redevelop and extend upper floors on existing buildings for residential use, subject to load bearing capabilities and the necessary planning consents.

Outlook

In an environment where income return and income security are increasingly attractive, foodstores are set to become more prized assets. Even more so in light of current pricing.

This is already apparent in the number of parties targeting the sector and competitive bidding seen on prime assets. The weaker Pound and entrance of more overseas money will no doubt intensify this and as a result place downward pressure on yields throughout the first half of 2017.

The continued appeal of index-linked income should also bring institutional investors back into the market in 2017. Although we also believe some assets on open market review structures will provide some attractive opportunities.

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