Knight Frank

Retail News

FOODSTORES:
PARADISE REGAINED?

ISSUE 8

Sainsbury's / Asda

Answers to ten burning questions

On the Rebound

Quantifying and qualifying grocery market recovery

The Investment Case

Why buy UK foodstore real estate?

Key Takeaways

- THE PROPOSED SAINSBURY'S/ASDA MERGER HAS REFOCUSSED THE SPOTLIGHT ON WHAT IS STILL ONE OF THE MOST ROBUST SEGMENTS OF THE UK PROPERTY INDUSTRY.
- THE RECOVERY STORY IN THE UK GROCERY MARKET IS BOTH A STRONG AND A SUSTAINABLE ONE. UNDERLYING MARKET GROWTH AND EFFECTIVE SELF-HELP FROM THE BIG FOUR ARE UNDERPINNING THIS RECOVERY.
- WIDER STRUCTURAL CHANGE IS STILL PLAYING OUT. THE MARCH OF THE DISCOUNTERS CONTINUES APACE, BUT NEW DEVELOPMENT ACTIVITY AMONGST THE BIG FOUR REMAINS MUTED.
- 'BIG BOX' SUPERMARKETS AND SUPERSTORES REMAIN THE DOMINANT CHANNEL IN THE UK GROCERY MARKET. DESPITE ONGOING CHALLENGES, THEY ACCOUNT FOR THE LION'S SHARE OF INDUSTRY PROFITS.
- STORE CLOSURES WILL BE MINIMAL GOING FORWARD – EVEN ANY DISPOSALS STIPULATED BY THE CMA IN ITS LIKELY INVESTIGATION OF THE SAINSBURY'S/ASDA DEAL WILL NOT RESULT IN WIDESPREAD FALL-OUT.
- THE C-STORE MARKET IS LIKEWISE POISED FOR CONSIDERABLE SHAKE-UP IN THE WAKE OF TESCO'S MERGER WITH BOOKER – CONSOLIDATION BRINGING HEIGHTENED COMPETITION AND A DEGREE OF CHURN.
- THE FOODSTORE INVESTMENT CASE REMAINS A COMPELLING ONE – LONG LEASES, HIGH INCOME RETURN (5.1% P.A.) TO STRONG COVENANTS. VERY FEW CLOSURES AND HIGH PROBABILITY OF LEASE RENEWALS.
- IMPROVING INVESTOR SENTIMENT HAS YET TO FULLY FILTER THROUGH TO PRICING AND FOODSTORES OFFER BETTER VALUE THAN OTHER PROPERTY ASSETS.

Introduction

Never a dull moment. Welcome to our latest publication, which focusses on the fast-moving and ever-changing supermarket sector.

The proposed merger between Sainsbury's and Asda has returned the grocery market to the spotlight and foodstore investments generally are back on the menu for an increasing number of funds. The enduring resilience of the Big Four has been clearly demonstrated over the last three years – each has achieved a remarkable turnaround, which has proved beyond a number of non-food retailers. Investing in prices and customer service, getting the right products on the shelf, refurbishing stores and providing a joined up multi-channel purchasing platform has paid dividends.

We explore how the retailers have pulled off this recovery, assess where the discounters fit in now and going forward and examine how the sector could evolve, particularly if the Tesco/Booker and Sainsbury's/Asda deals come to pass. This is a huge and complex market, seemingly with more winners than losers at the moment.

Margins and therefore rental values may be lower, but the security the assets provide has been reconfirmed and investors are now taking advantage.

At Knight Frank we have expertise covering all aspects of this sector from acquisition/development, funding, investment, valuation, professional and research.

We would be delighted to discuss any issues with you.

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Foodstore Dashboard

SAINSBURY'S/ASDA

£54BN	COMBINED ANNUAL SALES OF SAINSBURY'S AND ASDA
31.4%	COMBINED SHARE OF UK GROCERY MARKET OF SAINSBURY'S AND ASDA
2,800	TOTAL NO. OF SAINSBURY'S, ASDA AND ARGOS STORES
£14.2BN	COMBINED MARKET CAPS. OF SAINSBURY'S AND ASDA
42%	WALMART'S HOLDING IN COMBINED GROUP'S SHARE CAPITAL

CHANGING CHANNELS

55%	PROPORTION OF GROCERY SALES GENERATED THROUGH 'BIG BOXES'
80%+	PROPORTION OF GROCERY PROFITS GENERATED THROUGH 'BIG BOXES'
1,500	TOTAL STORE NETWORK TARGETED BY ALDI, VS. CA. 750 CURRENTLY
+17.7%	FORECAST GROWTH IN C-STORE SPEND 2017-2022
8,114	ESTIMATED NO. OF C-STORES A COMBINED TESCO/BOOKER WILL OPERATE

ON THE REBOUND

£158BN	VALUE OF UK GROCERY MARKET IN 2017
+2.6%	GROWTH IN GROCERY SPEND IN 2017
+2.5% /+0.1%	INFLATION/VOLUME GROWTH IN 2017
43	TOTAL STORE CLOSURES BY TESCO 2012-17 (CA. 1% OF ITS ESTATE)
70.4%	BIG FOUR'S COLLECTIVE SHARE OF THE UK GROCERY MARKET

THE INVESTMENT CASE

£1,031M	FOODSTORE INVESTMENT VOLUMES IN 2017 ACROSS 46 DEALS
+5.1%	FORECAST ANNUAL FOODSTORE INCOME RETURNS OVER NEXT 5 YEARS
15-20YRS	TYPICAL LEASE LENGTHS OF MANY ALDI AND LIDL STORES
4.25%	INVESTMENT YIELDS FOR FOODSTORES SUBJECT TO ANNUAL RPI INCREASES
-25BPS	MINIMUM DISCOUNT OF PRIME FOODSTORES TO PRIME DISTRIBUTION SHEDS

SOURCES: ONS, KANTAR, IGD, PROPERTY DATA, IPD, REAL ESTATE FORECASTING, RETAIL WEEK, KNIGHT FRANK

Key Points

- OPPORTUNISTIC AND DEFENSIVE – TRIGGERED BY WALMART WANTING TO EXIT THE UK AND CMA SETTING A PRECEDENT WITH THE TESCO/BOOKER DEAL.
- LESS ABOUT SCALE AND COST-CUTTING, MORE ABOUT LEADING RECOVERY IN FOOD AT ASDA AND LEVERAGING NON-FOOD BUSINESS.
- TESCO IS LIKELY TO RETAIN MARKET LEADERSHIP IN FOOD REGARDLESS, BUT A COMBINED SAINSBURY'S/ASDA/ARGOS COULD BE THE UK MARKET LEADER IN NON-FOOD.
- BOTH BRANDS RETAINED – VERY LITTLE DIFFERENCE FOR 'MAN ON THE STREET' TO SEE INITIALLY, OTHER THAN ARGOS IMPLANTS IN ASDA STORES.
- CMA WILL DEFINITELY INTERVENE, BUT UNLIKELY TO BLOCK THE DEAL OUTRIGHT OR GIVE IT THE GREEN LIGHT WITHOUT A NUMBER OF CONDITIONS.
- COMBINED GROUP UNLIKELY TO CLOSE MANY FOODSTORES VOLUNTARILY, BUT THE CMA LIKELY TO STIPULATE DIVESTMENTS IN CERTAIN AREAS.
- INTEGRATION OF THE TWO BUSINESSES CARRIES HUGE DOWNSIDE RISKS – INDIGESTION, EXCESSIVE DIVERSION OF MANAGEMENT RESOURCES AND EXECUTION CHALLENGES.

Sainsbury's and Asda: happily ever after?

WORDS: STEPHEN SPRINGHAM – HEAD OF RETAIL RESEARCH

The announcement of Sainsbury's proposed merger with Asda in April came as a bolt from the blue, with huge potential ramifications across the UK foodstore market. Our answers to ten killer questions on the proposed deal.

Q How did the proposed deal come about?

A Unlikely sources – Walmart and the CMA. Two separate factors paved the way for the proposed merger (or 'combination' as it is being termed):

1. Walmart's desire to exit the UK market
2. The Competition and Markets Authority's (CMA's) treatment of the merger of Tesco with Booker.

Asda is Walmart's largest international business. However, it has underperformed for a number of years and attempts to continually shore up the bottom line have affected wider investment in the business. Despite arguably being Walmart's best international business, Asda has become something of a 'problem child' and the US business has been quietly looking to offload its UK division for a number of years. The fact that it is writing off ca. $2 billion on the back of the merger underlines its deep-seated desire to end a 20 year association with the UK foodstore market.

Sainsbury's interest in Asda is therefore both opportunistic and defensive – they would not want Asda falling into the arms of a competitor. Ordinarily, competition concerns would have deterred any potential consolidation within the Big Four and the prospect of 'Four becoming Three' seemed inconceivable – until recently. Although a different deal altogether, the merger between Tesco and Booker was surprisingly given unconditional approval by the CMA. If Tesco/Booker received the green light, why not Sainsbury's/Asda too? That is effectively the gauntlet that is being laid down to the CMA.

Q What are the terms of the deal?

A Fairly straightforward, on paper. The terms of the merger are 'friendly' – this is not a hostile takeover. The plan is to retain the two brands and run them as complementary businesses with little front-end crossover (Argos implants in Asda stores notwithstanding). Both head offices will be retained, with Sainsbury's CEO Mike Coupe being CEO of the Combined Group and Asda's CEO Roger Burnley (formerly of Sainsbury's) continuing to run the Asda brand from Leeds.

Walmart will hold 42% of the Combined Group's issued share capital, although it will hold no more than 29.9% of total voting rights. Reading between the lines, the US giant will have very limited involvement in the day-to-day running and strategic direction of the Combined Group. Its ongoing involvement is largely notional and it will probably sell its stake at an appropriate juncture in the future.

A merger on this scale has predictably given rise to alarmist media headlines of widespread store closures, rationalisation and substantial job losses (under the guise of 'cost-saving synergies'). Even turning a blind eye to the corporate rhetoric/spin, this isn't a merger in the classic corporate sense and the ethos isn't necessarily to 'slash and burn'. These are two businesses that have drastically rationalised and streamlined their operational and head office bases in recent years and there can be precious little fat left. There may be some central cost savings to be made and some de-duplication of roles, but these alone are not the main rationale for the deal.

Q How will the deal affect the grocery landscape?

A Substantially. As the biggest deal to ever materialise in the UK grocery market, the knock-on effects would be huge. The Combined Group would operate a network of more than 2,800 stores and achieve annual revenues of ca. £50 billion.

The media have made much – too much – of the fact that the Combined Group would usurp Tesco's long-held position as the market leader in the UK grocery market. Notionally, this would appear to be true. The latest data from Kantar (from April 2018) shows that Tesco has a 27.6% share, while Sainsbury's and Asda have 15.8% and 15.6% respectively. But there are two significant moving parts here; Tesco will gain share as it integrates Booker, while Sainsbury's/Asda will lose some if it has to make store divestments. In the final analysis, we would actually expect Tesco to retain market leadership in food, albeit by a fairly fine margin.

The Sainsbury's/Asda deal may spark further consolidation, as we will go on to address. But media suggestions that the move may trigger a "price war" are frankly laughable – this is the very last thing that a merged Sainsbury's/Asda would look to achieve. And every other operator will likewise avoid at all costs.

> "Ordinarily, competition concerns would have deterred any potential consolidation within the Big Four and the prospect of 'Four becoming Three' seemed inconceivable – until recently."

Q Is the deal all about scale and market share?

A Not necessarily. Larger businesses obviously enjoy greater economies of scale, particularly in the power they hold with suppliers. But it's worth stressing that neither Sainsbury's or Asda are exactly minnows in isolation, so it's difficult to imagine them securing substantially better buying deals in unison. In the case of Asda it would actually be downscaling its buying muscle, if, as we are to presume, it is extricating itself longer term from Walmart's largest-in-class sourcing capabilities.

If there is one lesson that the UK grocers have learnt from the trials and tribulations of recent years, it is that the relationship with their suppliers needs to change. The Big Four have increasingly come to understand the value of closer working relationships, rather than treating suppliers as mere objects of negotiation. Tesco, in particular, has partially built its recovery on forging closer supplier relations rather than playing hard ball, as it did so often in the past. Against this backdrop of growing collaboration, it seems unlikely that a merged Sainsbury's/Asda will abuse its greater scale to merely beat up suppliers.

To my mind, the positive rationales for the deal are far broader than the obvious areas of scale and pricing. On the one hand, it is about improving Asda's core food offer. We have long-argued that Asda's recovery needs to be food-led, Sainsbury's would be far better placed to drive this than Walmart. Secondly, it is about non-food. Asda has historically been far stronger in this market, but Sainsbury's (even excluding Argos) has made huge inroads in recent years. Throw Argos into the mix and you have a general merchandise business (the largest non-food retailer in the UK, even?) with huge potential – with a downside risk that achieving that potential is a massive corporate distraction.

Q Will the deal be subject to investigation by the competition authorities?

A Categorically, yes. The CMA is very much the 'elephant in the room' in the whole merger proposal. The CMA inadvertently opened the door to this deal by its surprisingly 'hands-off' approach to the Tesco/Booker merger and Sainsbury's clearly saw an opportunity to test the CMA's resolve further. But it is absolutely inconceivable that the CMA will not at least investigate a merger of this size and significance. After all, this is an industry body that even saw fit to investigate something as innocuous as Poundland's takeover of 99p Stores.

And, if past experience is anything to go by (with Morrison's takeover of Safeway the best proxy), the CMA investigation will be a very protracted process, possibly lasting as long as 18 months/two years before a full ruling is reached.

Q How will the CMA rule?

A A compromised, "middle ground" ruling. It is notoriously difficult to second-guess the CMA, but we can say with some certainty that they will not just wave the

Sainsbury's/Asda deal through. As they are both largely single-branded businesses (Argos and the c-store businesses aside), it doesn't have the option of decreeing that certain fascias or divisions are excluded from the deal. So, there are only two options: it opposes the deal outright or it undertakes a catchment-by-catchment competition analysis and stipulates store disposals in areas where the merged business has an over-dominant position.

I doubt the CMA will block the deal outright. If they did, both companies would have serious comeback in the form of the precedents set in the Tesco/Booker deal (could they even ask for a re-review?) The second option seems far more likely, but is a hugely complicated and long-drawn exercise. Have we been there before? Most certainly, when Morrison's took over Safeway in the early 2000s. But that was tangibly different in that both those businesses were a lot smaller and the foodstore "space race" still had a long way to run. The competitive landscape is vastly different now.

Some of the parameters applied back then (e.g. 10/15 minute drivetimes) may still be employed, but others will need to be revisited and revised (e.g. number of competitors within said drivetime, who those competitors are (just Big Four or other players too?), cut-off store size (15,000 sq ft again?). To throw in a further curve ball, it is not beyond the realms of possibility that the CMA may launch a separate enquiry on the non-food side.

Q Will there be store closures?

A Store divestments, but not store closures. There will inevitably be some store disposals, but given the number of working parts and uncertainties around what parameters will be set, it is impossible to predict the scale of these at this stage. Also important to stress is that store disposals are not the same as store closures – many of those outlets identified will simply pass ownership to other operators.

We maintain our view that there will be minimal foodstore closures as a result of the proposed merger. Mike Coupe himself has provided assurances to the same effect. Despite cynical cries of "he would, wouldn't he", we believe this accurately reflects the combined group's strategic intention. The combined group would not close many (if any) stores of its own volition. However, the CMA may well stipulate otherwise.

The likely CMA investigation will be undertaken on an asset by asset basis – each and every store will be analysed in the context of its local catchment. The exact parameters that the CMA will employ have yet to be determined. But there are precedents.

In reviewing the takeover of Safeway by Morrisons in 2003, the Competition Commission (the CMA's predecessor) used the following metrics in its 'Competition Test':

- Focus solely on stores larger than 1,400 sq m (15,070 sq ft) – convenience stores were excluded from the analysis.
- Catchments defined by drivetime isochrones for each store – 10 minutes for stores in urban areas, 15 minutes for stores in 'non-urban' areas.
- Competitor set defined as Asda, Budgens, Booths, Co op, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose – but not M&S, Aldi, Lidl or Iceland.
- Undertake a 'Fascia Test' in every catchment to assess the number of competing fascias (see above) and whether this changes as a result of the merger.
- Broadly speaking, catchments with three or more 'competitor fascias' were deemed to be 'not a problem'

Generally, only catchments where the 'Fascia Test' saw the number of 'competitor fascias' reduced to one or two were store disposals enforced.

For the CMA's assessment of the Sainsbury's/Asda portfolio, they may or may not employ a similar methodology, albeit with revised parameters. Overlapping Sainsbury's/Asda stores may not necessarily be at risk – particularly if they have a strong competitor set. 'Vulnerable' stores are those in catchments which contain only an Asda and a Sainsbury's store, with limited external competition.

In the case of Safeway/Morrisons, Morrisons was forced to divest 48 stores. Without knowing the CMA's parameters, it is impossible to rule on Sainsbury's/Morrisons at this stage. For the stores Morrisons was forced to divest, the strict process (controlled by the OFT) set out:

- Purchaser to be approved by the OFT to maintain as a foodstore and valued at open market value (with some competitive bidding)
- Can be forced to sell for grocery use with no minimum price if little interest
- Can be forced to sell to alternative use
- Can be forced to sell alternative store in same catchment if no interest.

Q Where are there question marks?

A Contrasting market positionings. A generation ago, most would have called the proposed merger into question on the basis that there was limited fit between the two suitors, Sainsbury's effectively being far more upmarket than the more value-led Asda. The reality is that the two are now both mass-market operators and that the gap, while still there to some degree, is narrower now than it once was. You could even argue that their areas of geographic strength are actually complementary. Both have evolved to become national players, but in general terms, both continue to trade best in their respective homelands – Sainsbury's in the Home Counties and Asda in Yorkshire and the North. Geographic compatibility is one of the areas where the deal actually makes most sense.

Running a dual-brand strategy still requires a very fine balancing act. If Sainsbury's becomes too much like Asda, it will alienate large sections of its core customer base. And vice versa. But the flipside is that if both are kept totally separate from each other, there will be limited synergy and there is no point in merging in the first place, so this is effectively a circular argument. The best case scenario? Sainsbury's quality at Asda prices. But so much easier to achieve on paper than in practice.

Q What are the downside risks?

A Indigestion and shortcomings in execution generally. The merger may be defensive, but it is at the same time a very bold move and certainly not a 'no brainer'. Do not under-estimate the scale of the task in integrating the two businesses and the considerable scope for getting it wrong.

Lest we forget, the integration process for Argos is still far from complete. One of the main concerns at the time of that acquisition was that integration could prove a major distraction and take up a disproportionate amount of management time. To date, the Argos integration appears to have been executed well. However, assimilating Asda will be a far greater challenge – if Sainsbury's had bitten off more than it could chew with Argos, Asda would lead to outright indigestion.

Historic precedents do not augur well. Morrisons struggled desperately to integrate Safeway and the merger destabilised performance for years, not months. And Asda and Sainsbury's are both far bigger entities than Morrisons and Safeway, so the downside risks are potentially far greater. But Sainsbury's is not Morrisons so it may not necessarily suffer the same fate, but nagging doubts remain nonetheless.

Q How may the other foodstore operators react?

A Further deals? Unsurprisingly, the market is awash with speculation of further consolidation in the wake of the Sainsbury's/Asda proposal. Morrison's is the subject of a large proportion of this conjecture, principally because it will be left adrift as by far the smallest of the Big Three. Other potential protagonists in any consolidation activity include the Co op, Iceland, Ocado and possibly even Waitrose.

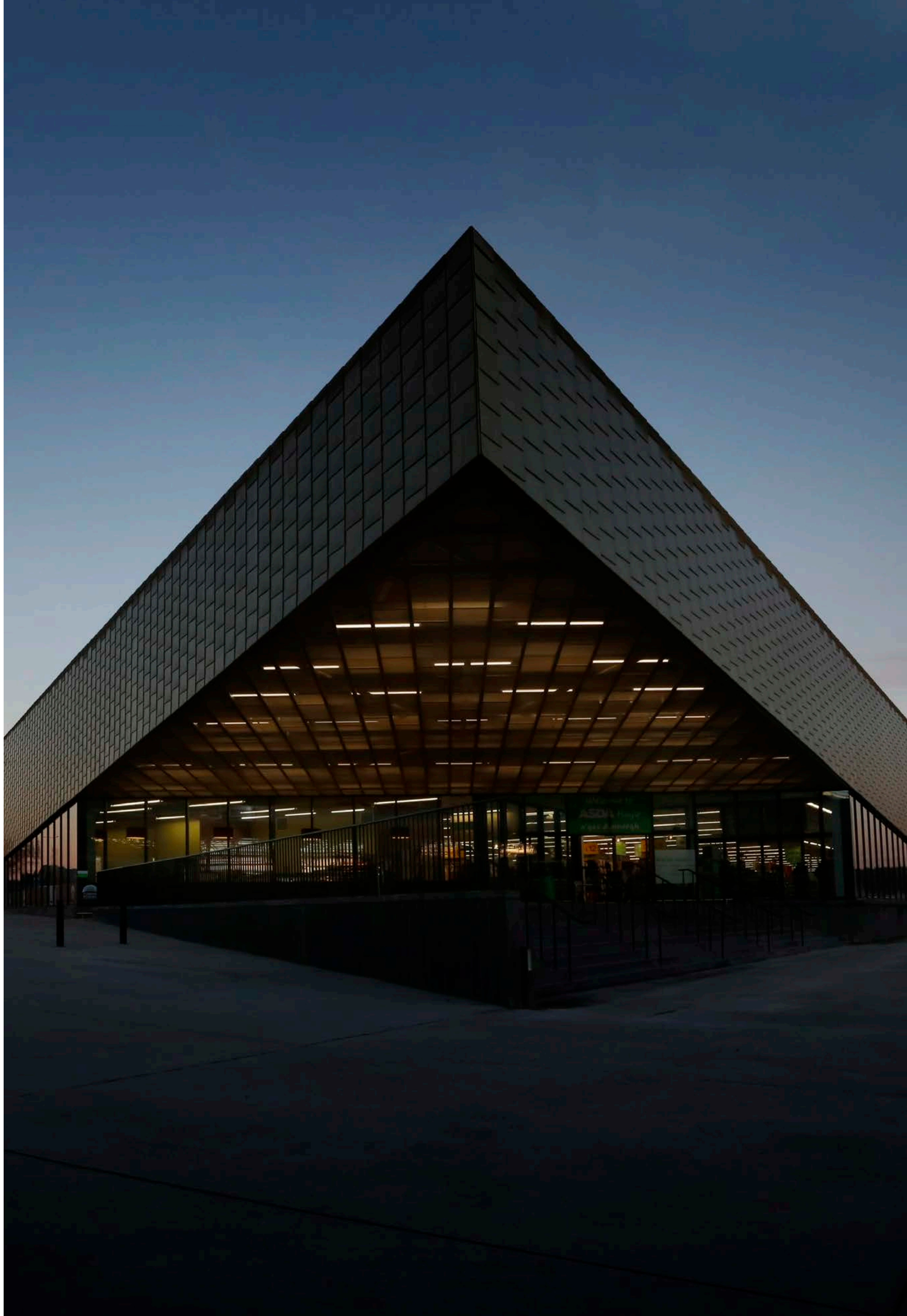
This speculation is being driven partly by historic corporate logic – any large deal will provoke similar defensive action amongst other players. But this logic is underpinned by the premise that scale is everything in business. As we have already discussed, scale is still significant, but its value in UK grocery has diminished. The best performers are actually the smaller, more dynamic players – particularly Aldi and Lidl, but also Morrison's in its own way. Morrison's may go on to do a deal of some description, but it doesn't necessarily need to in order to stay competitive.

> "Scale is still significant, but its value in UK grocery has diminished. The best performers are actually the smaller, more dynamic players."

As ever, Amazon's name is never far away from any speculation. If Amazon were serious about making major inroads into the UK grocery market, it would struggle to do so organically from its existing toehold (Amazon Fresh + Wholefoods). If it were to go down the acquisition route, the obvious suitors would be Morrisons or Ocado; Morrisons on the basis that the two already have a collaboration agreement, Ocado on the basis that its pure-play model complements its own, but with expertise in food (although it seems odd that if Amazon were interested in Ocado, it would have moved before now).

There have also been somewhat misguided suggestions that Amazon may yet scupper the Sainsbury's/Asda deal by counter-bidding for Asda. As if Walmart would sell Asda to its biggest global competitor, whatever it was willing to pay. But could Amazon bid on the combined Sainsbury's/Asda group, now or in the future? No reason why not, if it so wished. But why stop there, why not bid for Tesco instead?

Personally, I'd rather second-guess the vagaries of the CMA than the motives of Amazon.



Key Points

- AS THE NARRATIVE AROUND FOODSTORES IMPROVES, THE INVESTMENT CASE BECOMES MORE COMPELLING.
- THE UK GROCERS CONTINUE TO BENEFIT FROM POSITIVE SHIFTS IN CONSUMER DEMAND. OVERALL MARKET GROWTH OF 1.7% IN 2017 MARKED THE BEST ANNUAL PERFORMANCE SINCE 2013.
- MARKET GROWTH IS PARTIALLY BEING DRIVEN BY INFLATION. DESPITE HIGHER PRICES ACROSS THE INDUSTRY, THERE IS STILL 'REAL' (I.E. VOLUME) GROWTH.
- INFLATION ON THE BACK OF THE DEPRECIATION OF STERLING HAS BEEN A DOUBLE-EDGED SWORD. IT HAS BROKEN THE DAMAGING CYCLE OF DEFLATION, BUT PRESENTED MAJOR PRICING AND COST CHALLENGES FOR THE OPERATORS.
- STRUCTURAL CHANGE WITHIN THE GROCERY INDUSTRY IS NEVERTHELESS ONGOING AND MANY INDUSTRY KPI'S (E.G. GROSS MARGINS) HAVE BEEN RESET.
- SUPERMARKETS AND SUPERSTORES REMAIN THE MAINSTAY OF THE UK GROCERY MARKET. ALTHOUGH DELIVERING LOWER TOP LINE GROWTH THAN OTHER CHANNELS, THEY ARE BY FAR THE MOST PROFITABLE.
- 'SELF HELP' AMONGST THE BIG FOUR OPERATORS CONTINUES TO FOCUS OF MAKING LARGER STORES FIT FOR PURPOSE AND MAKING FLOORSPACE WORK HARDER.
- VERY FEW SUPERSTORES HAVE CLOSED – AND EXCEEDINGLY FEW ARE LIKELY TO CLOSE GOING FORWARD.

Foodstores: on the Rebound

WORDS: STEPHEN SPRINGHAM – HEAD OF RETAIL RESEARCH

The fundamentals of supermarkets have always been strong, but in recent times this has not been recognised. But the general narrative is slowly changing – as, more crucially, is sentiment.

Until the flurry of recent deals, newsflow on the UK grocery sector generally had been less than positive for a number of years. The Big Four (Tesco, Sainsbury's, Asda, Morrison's) have seemingly lurched from one crisis to another, be that structural (e.g. changing shopping habits), competitive (e.g. the rise of the discounters) and just plain self-inflicted (e.g. the horsemeat and accounting scandals).

Against this backdrop, the once ferocious space race came to an abrupt halt and the development pipeline has since slowed to little more than a trickle. Many still believe (erroneously) that the market is chronically over-supplied and that widespread supermarket closures are still on the cards. At worst, the big box grocery superstores are obsolete, at best, very challenged. And the rise of online grocery shopping has supposedly undermined traditional store-based channels, a trend that some believe will inevitably accelerate in the wake of Amazon's takeover of Wholefoods. Add to the mix the inexorable rise of the German discounters Aldi and Lidl, the narrative has been anything but compelling.

> "The narrative around foodstores is slowly but surely improving."

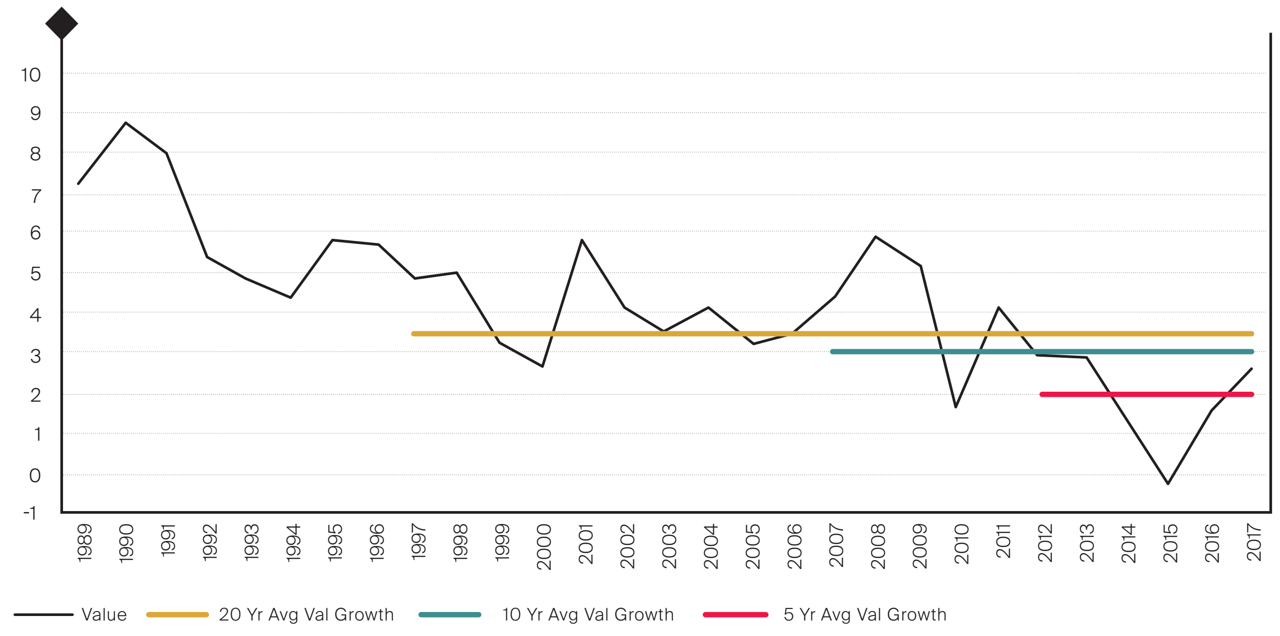
After much soul-searching and implementation of drastic self-help strategies, the narrative around foodstores is slowly but surely improving. Indeed, the performance of the Big Four operators was one of the key positive news stories to emerge from Christmas 2017. What has changed and what is the new direction of travel?

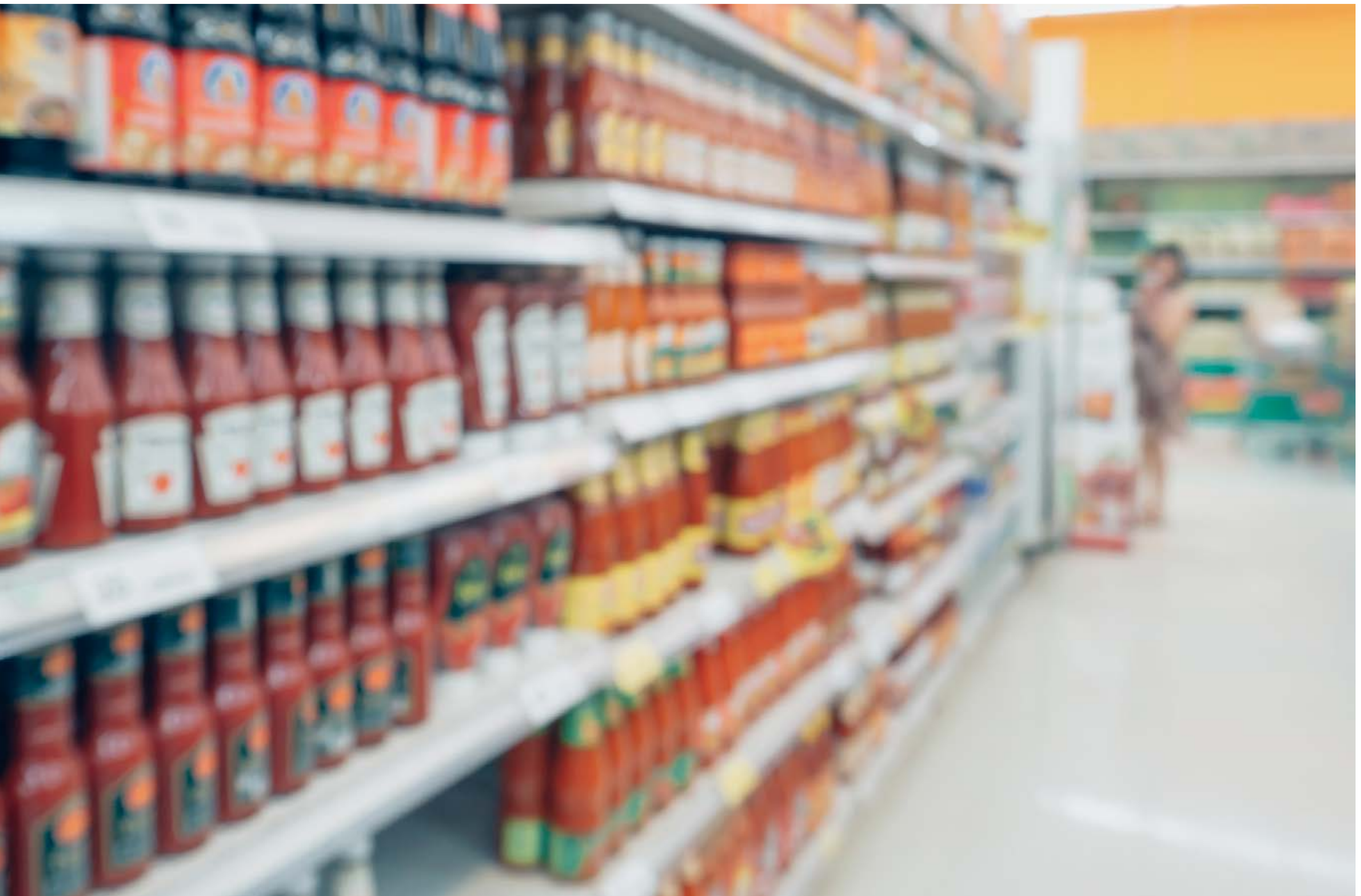
Recovering consumer demand

Few of the column inches devoted to the trials and tribulations of the grocery market have actually addressed the real nub of the issue – consumer demand, and the vagaries thereof. The fluctuating amount of money we spend in supermarkets is

FOODSTORE RETAIL SALES VOLUME AND VALUE GROWTH 1989-2017

Source: ONS, Knight Frank





as fundamental to the health of the UK grocery sector as any external, structural or competitive factor.

More so than any other retail sector, grocery is totally dependent on underlying growth. The sector is mature and highly competitive, margins are low and volumes are key. The lower market growth is, the more limited wriggle room the retailers have and the smaller the margin of error. And the rate of growth is slowly declining. Over the last 20 years, the average annual rate of market value growth was 3.5%. Over a shorter 10 year time horizon, this rate has

FOODSTORE RETAIL SALES VOLUME AND VALUE GROWTH 1989-2017

Source: ONS, Knight Frank

shrunk to 3.0%. Over the last five years, it has averaged just 1.9%.

The nadir of the UK grocery market was undoubtedly in 2015 and this was when pain amongst the Big Four was at its most intense. It was no coincidence that this was the same year that overall market growth was at its lowest level since records began in the 1980s. In fact, the market actually contracted in 2015, the first and only time this has happened. Although seemingly only a meagre decline (-0.2%), this was catastrophic in the context of a market so geared towards growth.

Thankfully, consumer demand has since recovered. Overall grocery spend increased by 1.7% in 2016 – well below long term averages, but a vast improvement on the performance of the previous year. Albeit with the benefit of inflation, this growth accelerated to 2.6% in 2017, the best annual performance since 2013. Excluding smaller specialist food stores (-1.1%) and off-licences (-12.4%), the headline pace of growth for supermarkets and superstores was higher still (+3.2%).

> "Albeit with the benefit of inflation, this growth accelerated to 2.6% in 2017, the best annual performance since 2013."

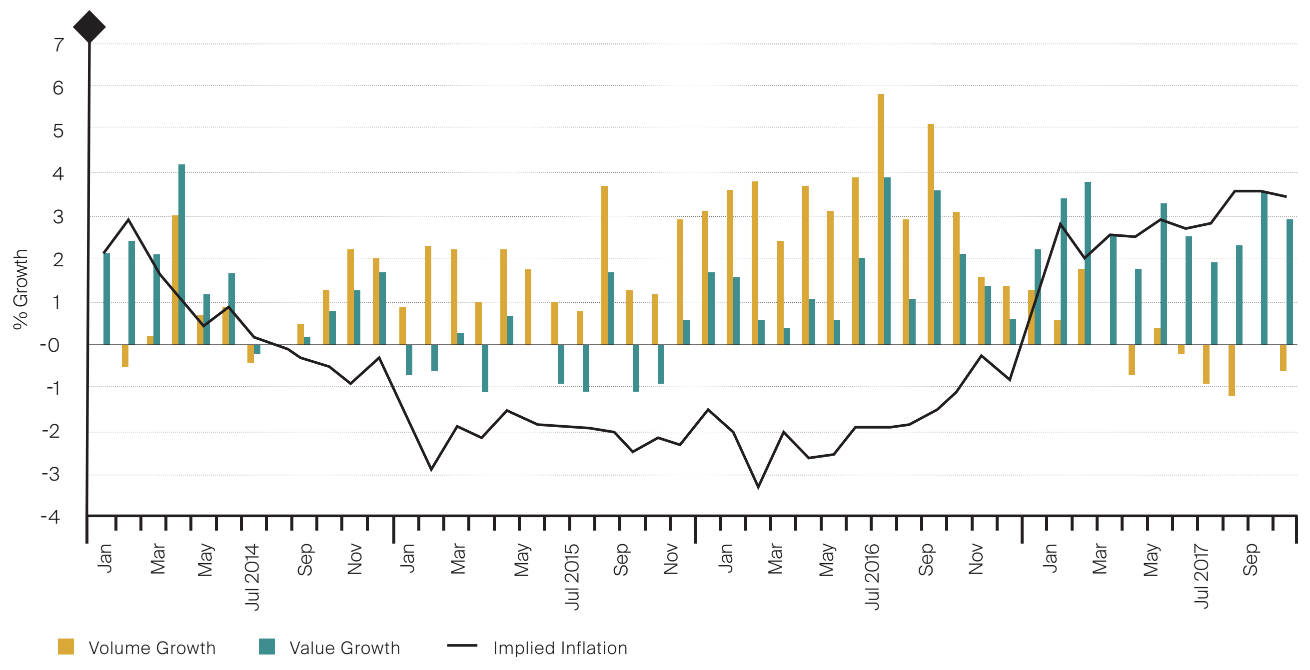
To strike a cautionary note, this does not mean that the UK grocery market is back to the 'good times'. Nor is it a case of just picking off where we left off after a few painful years. The UK grocery market has fundamentally changed in the intervening period and for all the recovery in consumer demand, the fundamental structural changes in the market are still playing out. But at the same time, there is no denying the fact that a market experiencing underlying growth is far more forgiving that one that is contracting. The macro picture is more favourable for grocery retailers than it has been for some time.

Inflation – infinitely preferable to deflation

Naysayers will inevitably dismiss this market growth as purely inflationary. Indeed, inflation is widely accepted as one of the negative by-products of Brexit and this is cited as one of the major headwinds facing the UK retail sector generally. I would argue that for the UK grocers, it has actually been more of a blessing than a curse.

FOODSTORE RETAIL SALES AND INFLATION – MONTHLY TRENDS 2014 - 2017

Source: ONS, Knight Frank



> "Further closures have since been very few and far between and we expect this to be the status quo going forward."

The well-documented devaluation of Sterling in the wake of the Referendum vote clearly increased input costs for retailers importing goods from overseas. This has inevitably led to higher prices when currency hedges lapsed, although the retailers have not necessarily passed on the full increase to the consumers. This inflationary pressure has been extensively covered by the media, but needs putting into perspective.

Firstly, we are certainly not in hyper-inflation territory – CPI has peaked at 3.1%. Secondly, Shop Price Inflation (which covers retail categories only and excludes other consumer spend categories such as travel, cars, healthcare etc.) has been significantly lower than both RPI and CPI. Thirdly, the devaluation of Sterling was a one-off event and the effects are non-recurring - as such, once it annualises (as it started to in Q3 2017), inflation will slowly ease.

But above all else, Brexit-induced inflation needs to be put into the context of the past few years. The supermarket sector had been highly deflationary since July 2014. Good for the consumer, very problematic for the retailers themselves, particularly as they were looking to implement radical recovery programmes. Inflation since the Referendum has not eclipsed the 2 years+ deflation that preceded it – in layman's terms, grocery products are still cheaper now than they were back in 2012.

Nor has inflation triggered the other macro-economic risk that many economists predicted – a slump in underlying consumer demand. Economic logic dictates that if prices go up, consumers will buy less. Despite an inflationary environment, the grocery market is still reporting volume growth. In simple terms, shoppers are buying more goods, despite the fact that prices have risen.

The negative effects of Brexit-induced inflation have been overcooked. Inflation levels have been manageable and are already receding. Higher prices has not eradicated volume/'real' growth as expected. And inflation is far less damaging to grocery retailers than deflation.

Self-help and structural change

The road to even partial redemption has been a long and painful one for the foodstore operators. It has certainly not been a case of simply battening down the hatches and waiting for the storm to pass. The Big Four have all been forced to embark on radical restructuring and self-help programmes. In very generic terms, this has entailed:

1. Simplifying and streamlining their businesses
2. Reimagining big boxes to ensure they effectively meet the demands of the catchments they serve
3. Cutting costs
4. Improving service

The process of simplifying their businesses has involved wide scale disposals - a large proportion of its international portfolio in the case of Tesco, its convenience store business in the case of Morrisons and peripheral 'non core' divisions (e.g. pharmacies) in the case of Sainsbury's. With the 'space race' coming to an abrupt halt, a number of non-developed sites have also been offloaded.

Tellingly, actual store closures have been minimal, in sharp defiance of a report by Goldman Sachs which spuriously estimated that the UK foodstore market was over-supplied by around 20%. This led to inevitable, but ultimately ridiculous media reports that one in five supermarkets in the UK were poised to close.

In the event, the most "drastic" store closure programme came at Tesco – in 2015, it shuttered 43 stores, but of these 30 were small Tesco Express units, six were Tesco Homeplus non-food stores and just seven were actual supermarkets. To put this into perspective, the closures represented only around 1% of Tesco's overall ca. 3,700-strong estate and far less than 1% of overall floorspace. And its Big Four peers have been even less ruthless than that, closing only a handful of stores between them. Nor were these early store closures the thin end of the wedge as many predicted – further closures have since been very few and far between and we expect this to be the status quo going forward.

Why have wholesale store closures not materialised? The simple reason is that, almost without exception, foodstores trade profitably, which is certainly not the case in non-food high street retailing. Secondly, foodstores remain the core assets of any grocery operator, supermarkets are "what they do", they are the basis of their cherished market share, their raison d'etre. If stores are not performing to the level required, the grocery retailers will do everything within their considerable power to fix them.

Big box superstores have definitely been at the sharp edge of structural change in the market, but many commentators were far too quick to write them off. The floorspace in each and every superstore has been subject to ongoing review and remedial action, where necessary, is being implemented. In terms of priority, the preferred option is invariably to realign space allocations and product mix 'internally' e.g. changing the emphasis in general merchandise from electricals and home entertainment towards own label fashion and homewares. In instances where this isn't feasible or there is a better alternative, space may be sublet to a complementary third party – this is the second preferred option. The third option – closing the store outright – is very much the last resort and is very rarely exercised.

This structural change is still playing out, but the tone has been set. At the same time, the playing field is again shifting dramatically. Having gone to great pains to simplify their respective businesses, the last 18 months has seen the Big Four make a series of potentially game-changing acquisitions – Tesco's merger with Booker, Sainsbury's takeover of Argos and the subsequent Asda bombshell. Costly distractions or strategic masterstokes, the jury is still out.

But one thing is certain – the UK foodstore market never stands still and is seldom dull. And as the Big Four increasingly get on the front foot, the narrative is rightly changing.

KEY MARKET FACTORS – PRE 2014 VS. 2018 AND BEYOND

MARKET CHANGES

THEN (PRE 2014)	NOW (2018 AND BEYOND)
Big Four have a collective market share of 73.3%	Big Four have a collective market share of 70.4%
Tail-end of the 'Space Race'	Very limited acquisition amongst the Big Four
Considerable residual land banks	Land banks largely disbanded
Optimum size for new 'big boxes' – 60k sq ft+	Optimum size for new 'big boxes' ca. 30k - 50k sq ft
Industry operating margins of ca. 5%	Industry operating margins reset to ca. 2-3%
High growth c-store sector	Maturing c-store sector
C-store fragmentation	C-store consolidation
Double digit annual online grocery growth	Annual online grocery growth <10%
Amazon absent from UK grocery market	Amazon has small foothold in UK grocery market (through Amazon Fresh and Wholefoods)
Benchmark rents of ca. £20/sq ft	Benchmark rents of <£15/sq ft

MARKET CONSTANTS

THEN (PRE 2014) + NOW (2018 AND BEYOND)
Aldi and Lidl highly acquisitive
Big box superstores the mainstay (and most profitable assets) of the Big Four
Limited store disposals
Occupier demand driven by changes to catchments
Quality and range remain key differentiators
Big Four trying to find optimum solution to online conundrums.

Key Points

- BIG BOXES (SUPERMARKETS AND SUPERSTORES) REMAIN THE CORE CHANNEL IN THE UK GROCERY MARKET, ACCOUNTING FOR 55% OF SALES AND AN ESTIMATED 80%+ OF PROFITS.
- BIG BOXES ALSO CARRY A MORE HOLISTIC RESPONSIBILITY OF SUPPORTING ONLINE THROUGH BOTH CLICK & COLLECT AND HOME DELIVERY. THEY COULD ALSO PROVIDE A BRIDGEHEAD TO SOLVE THE ELUSIVE 'LAST MILE DELIVERY' CONUNDRUM.
- THE DISCOUNTERS WILL CONTINUE TO ENJOY STELLAR GROWTH ON THE BACK OF THE VIRTUOUS CIRCLE OF NEW STORE OPENINGS, GREATER CUSTOMER PENETRATION/RETENTION AND INCREASING BASKET SIZES.
- BUT CANNIBALIZATION IS A SIGNIFICANT HEADWIND FOR BOTH ALDI AND LIDL. THIS IS LEADING TO A MORE SELECTIVE APPROACH TO NEW SITE ACQUISITION.
- THE MERGER WITH BOOKER WILL DRAMATICALLY CONSOLIDATE TESCO'S ALREADY DOMINANT POSITION IN THE HIGH-GROWTH BUT INCREASINGLY COMPETITIVE CONVENIENCE STORE SECTOR.
- C-STORE MATURITY AND CONSOLIDATION WILL INEVITABLY GIVE RISE TO A DEGREE OF CHURN AND SOME FALL-OUT. BUT THE NET NUMBER OF C-STORES WILL CONTINUE TO INCREASE, ALBEIT AT A SLOWING PACE.
- ONLINE GROCERY CURRENTLY ACCOUNTS FOR JUST 6% OF THE MARKET AND THIS SHARE IS EXPECTED TO PLATEAU AT LESS THAN 10%.
- GENERATING ACCEPTABLE LEVELS OF PROFITABILITY REMAINS THE CHALLENGE FOR ONLINE GROCERY. THE BIG FOUR STILL HAVE MUCH TO GAIN BY LEVERAGING THEIR STORE BASE TO CREATE A SEAMLESS MULTI-CHANNEL ECOSYSTEM.

Changing Channels: the Landscape Continues to Shift

Big boxes, supermarkets, c-stores, discount stores, online, foodservice and wholesale – the constituent parts of the grocery market are subject to very different dynamics and growth trajectories.

To paraphrase Mark Twain, reports of the death of the grocery superstore have been greatly exaggerated. Changing consumer patterns and a shift from destination, one-stop shopping towards more frequent, lower basket size convenience shopping prompted many to proclaim c-stores as the channel of the future. Coupled with the inexorable rise of the discounters and growth in the online channel, many predicted the demise of grocery big boxes.

Nothing could be further from the truth. Superstores and supermarkets remain the mainstay of the UK grocery market and while many big boxes have faced major challenges in recent years, the mindset of the major operators has been to fix rather than forego. After all, figures

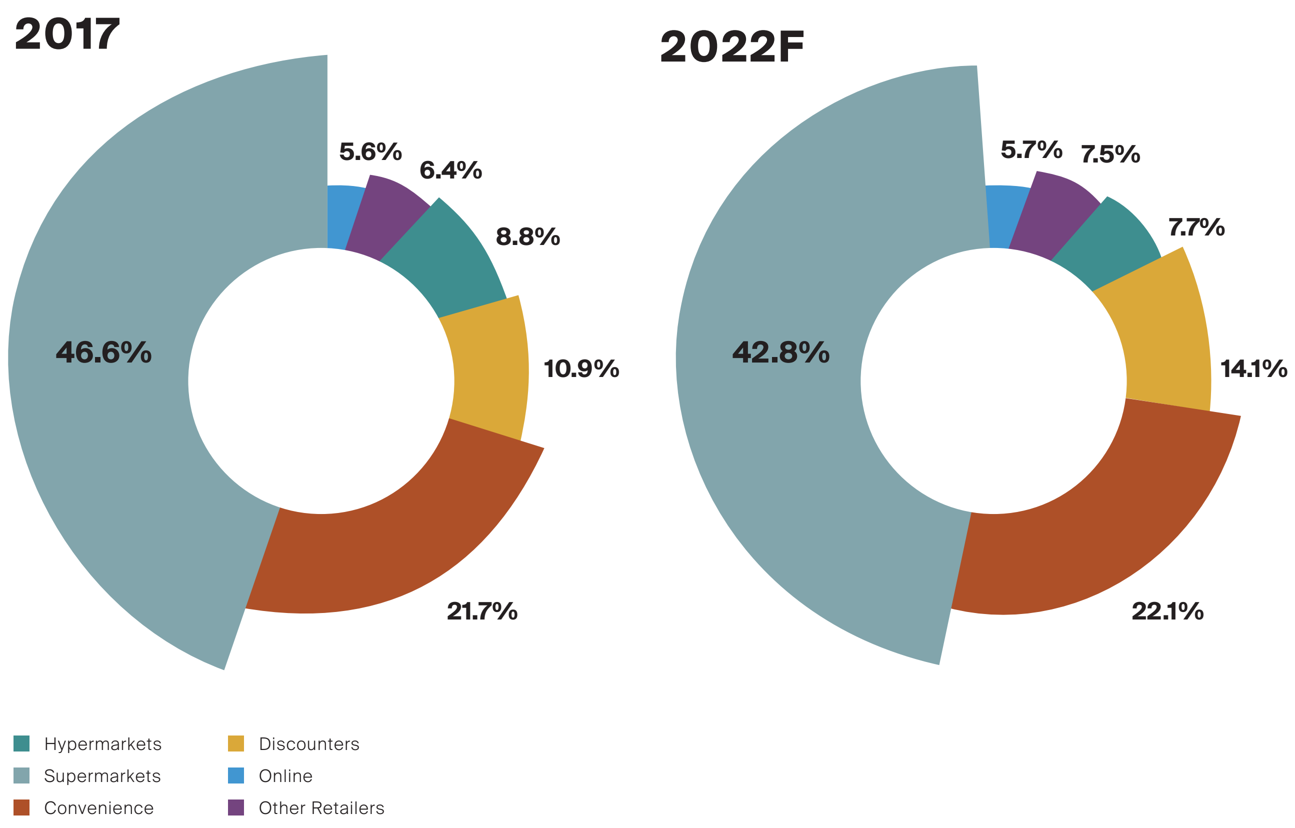
from industry body IGD suggest that hypermarkets (8.8%) and supermarkets (46.6%) collectively still make up 55.4% of all grocery sales in the UK. The corresponding figures for profit are sadly not available, but would unquestionably be much higher – we would tentatively estimate at least 80%+, possibly even 90%+. Given their more holistic role as the backbone of other retail channels such as online grocery, the enduring importance of big boxes to the Big Four should never be questioned.

Other grocery channels may promise more seductive top line growth. C-store sales are forecast by IGD to grow by 17.7% over the next five years. The discount channel is forecast to grow by 49.8% over the same period, while online eclipses both at 53.8%. But these figures need to be put into context. None of these channels come close to big boxes in terms of profitability and each is subject to its own particular headwinds. The c-store market has matured dramatically and is hugely competitive in its own right. The discounters are increasingly having to contend with the prospect of sales cannibalization. Online is unlikely to be fully profitable until delivery costs are fully recouped from the customer.

The Big Four especially are active across a multitude of these grocery channels. As a result, there is considerable blurring between channels. The challenge is not to be a master of one, but to seamlessly integrate all channels under a wider ecosystem.

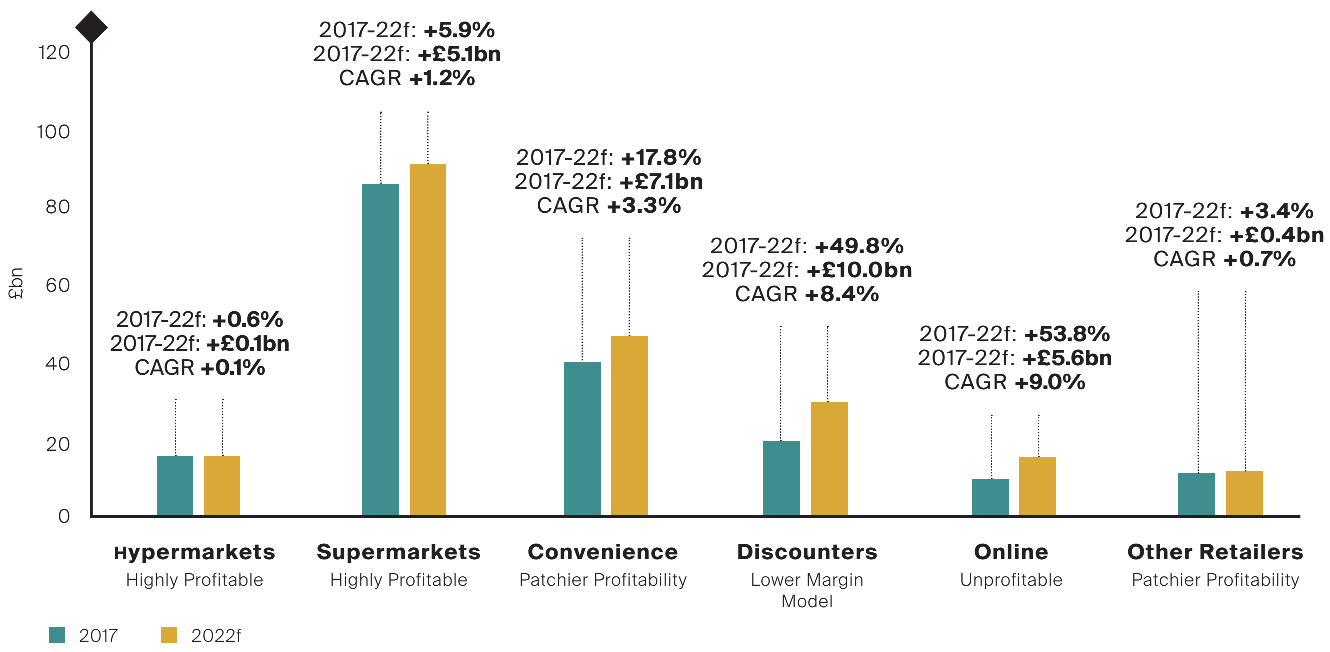
> "The challenge is not to be a master of one, but to seamlessly integrate all channels under a wider ecosystem."

BREAKDOWN OF UK GROCERY MARKET BY CHANNEL



UK GROCERY SALES BY CHANNEL 2017 VS. 2022F

Source: IGD, Knight Frank



Superstores: as Relevant as Ever

WORDS: RICHARD PETYT, PARTNER - FOODSTORE AGENCY & DEVELOPMENT

The Big Four (and Waitrose) got carried away with investing in new stores, at the expense of managing existing space. The result was an abrupt end to the 'space race', and priorities were quickly refocused. The Big Four stringently assessed their respective property pipelines and pulled away from a number of deals, paid their way out of others, litigated to terminate contracts and wrote down the value of land already acquired at competitively inflated prices.

But they didn't close many stores. Tesco closed 43, but about half were the small Express format and about ten were the ill-fated Homeplus non-food stores. Only c.10 – 15 were mainstream supermarkets and all were old, out-dated and had newer, bigger Tesco stores nearby. Morrisons closed about 15 stores – these were all former Netto stores acquired when Asda bought Netto but the CMA insisted some were excluded from the purchase to protect against local monopolies. There were also a handful of stores built but not fitted out – Tesco Chatteris, Sainsbury's Herne Bay being two high profile examples.

> "Morrisons and Sainsbury's will both open three new stores, and while they are legacy projects, smaller than originally proposed, they are nevertheless a genuine statement of intent. "

But that is it

The Big Four have now largely fixed the major issues they faced. Rampant discounter openings, negative newspaper headlines, poor customer perception, slipping in-store standards and price differentials have all been tackled head on. The focus has been to improve customer service, shop standards and perceptions of quality. They have refurbished stores, installed new management regimes and focused on the "basics". Distractions were largely ignored and trade has picked up, albeit with profit margins lower than previously.

The large stores remain the grocery retailers' powerhouses, generating the bulk of group profits. After something of a hiatus, this year will see a return to new store openings. Morrisons and Sainsbury's will both open three new stores, and while they are legacy projects, smaller than originally proposed, they are nevertheless a genuine statement of intent.

A network of big stores also provides more holistic long-term opportunities, particularly in the multi-channel arena. Online grocery shopping is not profitable, but is still growing and the omni-channel capabilities of the retailers are of paramount importance. Promoting click & collect over home delivery is better for the retailers and the bigger stores carry the full range of goods shoppers are seeing on the websites.

In-store picking for home delivery is most efficient from the bigger stores, click & collect even more so. Having to pick in the big store then deliver to a small store for collection by the customer is the worst of all worlds. Having fixed the customer facing elements of the large stores, expect the next focus to be on educating the shopper to pay more for convenient home delivery and to collect from bigger stores only.

But is there another possibility? Tesco are buying Booker as a wholesale purchase. Morrisons now supply the McColl's convenience store chain and are looking at other opportunities. Will the role of the big box store be gradually extended/refocused as a hub with a local distribution network?

C-Stores: Competitive, Consolidating and Churning

WORDS: ANDREW THATCHER, PARTNER - FOODSTORE AGENCY

Changing consumer patterns have certainly played into the hands of the convenience store market, but it is still ironic to hear talk of the 'convenience revolution'. C-stores are in fact the oldest form of grocery retailing in the UK, predating supermarkets and superstores. But it is a market that continues to change, particularly in the wake of the Tesco/Booker merger.

The c-store model is fundamentally very different from that of supermarkets and superstores. C-stores cannot simply be scaled down versions of big boxes. For obvious reasons, the product range has to be heavily edited, not just to respond to the everyday needs of a smaller catchment and passing trade but also to achieve the right margin mix. A c-store won't make much (if any) money on c-store essentials such as milk, alcohol and cigarettes, but it needs to stock them. But it will make much more margin and money on products such as ready meals, fresh and food-to-go. Achieving the right product mix to counterbalance a higher cost base is the fundamental skill of a successful (and profitable) c-store.

Despite high top-line growth, c-store retailing is anything but a gimme. Although less capital intensive, the actual cost base is proportionally much higher. More stores are leasehold and rents are usually £20/sq ft+, sometimes £30/sq ft+. Staffing costs are also proportionally higher and c-stores are therefore much more sensitive to upward movements in the Minimum and Living Wage. Lacking the economies of scale of superstores, profitability in c-stores can be far more hit and miss. Morrisons' failure with M-Local and the fact that Asda's small scale supermarkets are reportedly the only unprofitable part of the business underline the challenges of making a success of the c-store channel.

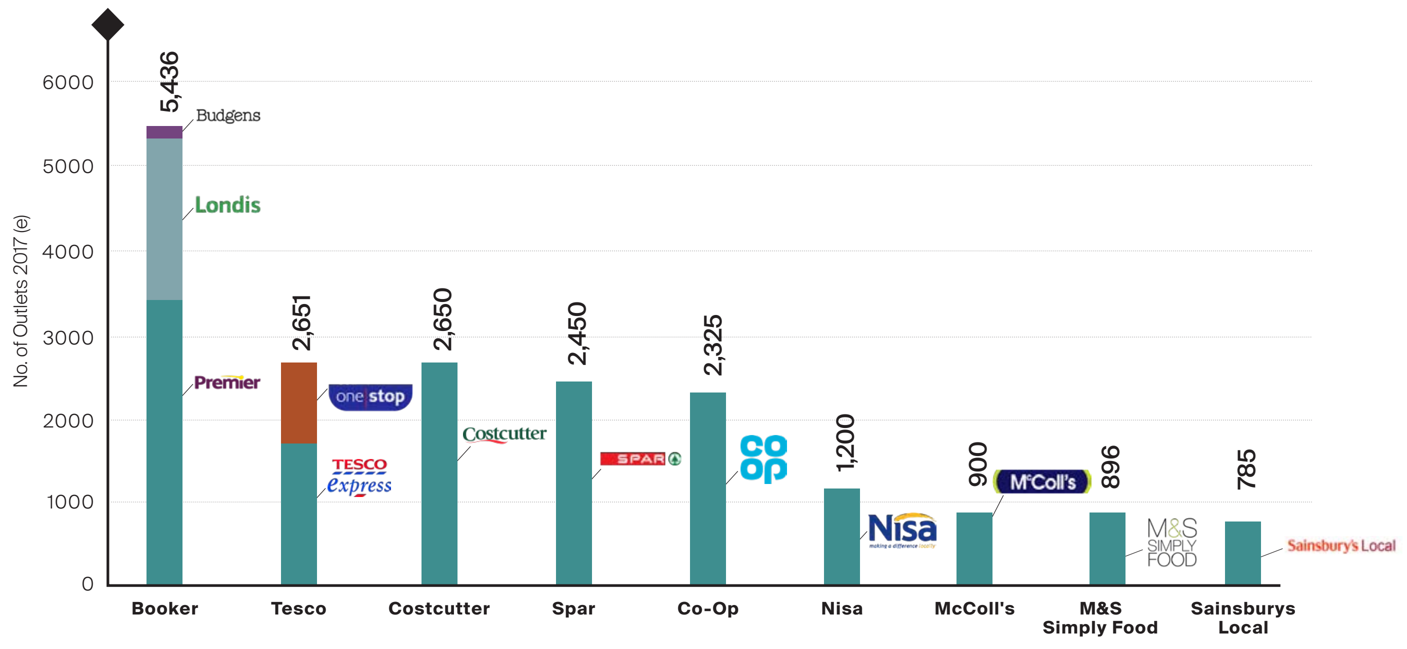
> "The c-store model is fundamentally very different from that of supermarkets and superstores."

That said, a number of operators are still actively acquiring new c-store sites, principally Tesco, Sainsbury's, the Co op and M&S. The Co op plans to open 100 c-stores this year alone (including 20 in London) as part of a wider £160m investment programme. M&S had originally planned to open a further 200 Simply Food outlets (company-owned and franchised) by 2019. However, these plans have since been revised downwards. Nevertheless, it remains committed to opening a further 36 c-store sites in the first six months of this year. Sainsbury's current annual 'run rate' for new Sainsbury's Local stores is c.25. As for Tesco, the merger with Booker will add over 5,000 new Family Shopper, Budgens, Premier and Londis sites to the existing 2,700+ strong Tesco Express and One Stop Network. There will inevitably be some organic expansion as well, but this will be buried in the midst of the integration of the various businesses. But with maturity and consolidation comes a possible degree of natural churn and fall-out. While we are confident that that grocery big box closures will be very few and far between going forward, there could potentially be some c-store closures, particularly 'first generation' sites that have been trading for over ten years. Unlike superstores, many c-stores have a finite lifespan, before they are supplanted by better located or better configured, newer units. C-stores are also very susceptible to competitor impact.

It would be wrong to interpret any c-store closures as a sign of malaise or failure. It is the natural order of progression and is churn rather than retrenchment. For every three or four closures, we are likely to see around 10 new openings. There will be a net gain in store numbers going forward, albeit at a decelerating rate than we have seen in previous years.

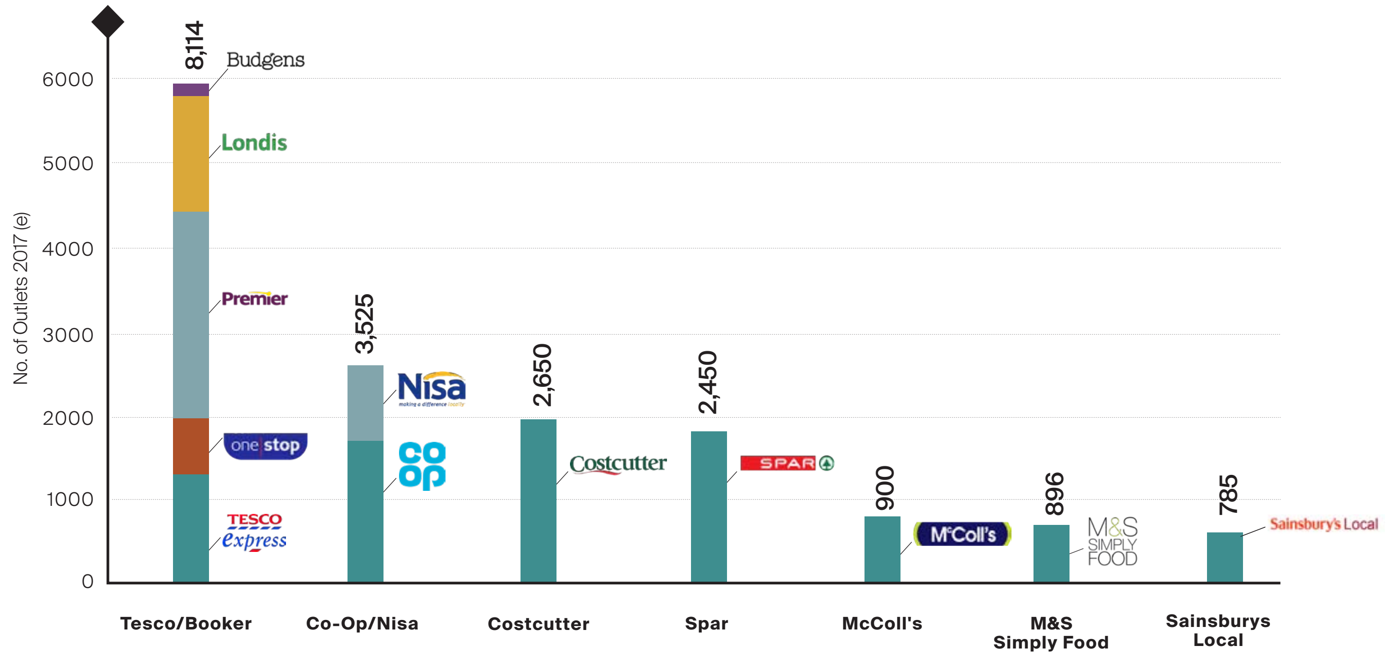
LEADING C-STORES BY OUTLETS 2017 – PRE CONSOLIDATION

Source: Mintel, Knight Frank



LEADING C-STORES BY OUTLETS 2017 – POST CONSOLIDATION

Source: Mintel, Knight Frank



Discounters: on a Roll But Facing Cannibalisation

WORDS: RICHARD PETYT, PARTNER – FOODSTORE AGENCY & DEVELOPMENT

The darlings of the media and the bargain-seeking public alike are receiving less airtime now than over the last few years. The story has largely ceased to be newsworthy as both Aldi and Lidl have succeeded in becoming embedded in the retail fabric across the UK. Everybody knows the message – no frills, good quality, low prices. The number of stores and market share captured have doubled in the space of three years. This external view will remain constant but there are some interesting property-centric factors playing out behind the scenes.

Aldi believe they can double their estate from 750 to 1,500 stores. They also state there are ca. 400 catchments across the UK with the necessary 10,000 population base to support a new store. Likewise, Lidl plan to significantly expand their network, with their decision to open up to agents and developers providing significant impetus to their ambitions. There are currently rich pickings for both developers and landowners.

"The discounters are also increasingly nervous about rental deals and committing to long leases with inflation-based rental uplifts."

But the discounters face headwinds. The proliferation of stores has created situations where new outlets are cannibalising existing sales, which can dilute returns if under-forecasted. As store numbers grow, this becomes increasingly prevalent. Aldi have a pipeline of c.300 sites with board approvals – a number of these will not be developed due to under-forecasted impact.

There are also areas across the UK – parts of the north especially – where the discounters have been so successful they have reached saturation point. But the opposite is also true and there are still large coverage gaps across parts of the south. Some areas will remain impenetrable despite the appetite to develop, given the lack of developable land and alternative values.

The discounters are also increasingly nervous about rental deals and committing to long leases with inflation-based rental uplifts. They risk walking into the same storm that the Big Four did previously, whereby sales are growing at a slower rate than costs (notably rents) are rising. The business model of strong trade with low margins means they simply cannot sell enough to generate the profits needed to cover the rising rental costs. The net result being unprofitable and over-rented stores.

The willingness to sign rental deals to secure new stores will still be there but will be more selective going forward. Leases will not go beyond 15 years before the retailer has the ability to break – or renegotiate terms to remain in occupation.

The discounters are also facing up to the resurgence of the Big Four. They are also upping their game, but the range of goods and the quality perception is a tough battle to fight. Rising input and operational costs are also hitting profitability – a bit like the owner of a secondary shopping centre, they are having to run fast to stand still.

On the face of it, the discounters will continue expanding rapidly with new store openings aplenty. This year another 70 Aldi stores will open. Market share growth will continue apace. But peer behind the scenes and new challenges are being faced. However, the war has largely been won – the discounters have doubled in size and are now embedded in the national psyche as a popular and permanent part of the retailing community.

Online: the Unresolved Profitability Conundrum

WORDS: STEPHEN SPRINGHAM, PARTNER – HEAD OF RETAIL RESEARCH

That online is just a small (6% according to IGD) part of the overall grocery market may surprise many. We would venture that it generates disproportionately extensive coverage from many retail commentators in the media and City, as they are themselves grocery online shoppers. And assume that their shopping propensities are commonplace across the country, when the reality is somewhat different.

Forecast top-line growth for online grocery is certainly eye-catching. IGD projects that the channel will grow by 54% over the next five years (off a fairly low base) to reach £16bn by 2022, an increase in absolute terms of £5.6bn. Robust as this growth may seem, it is worth stressing that the pace of growth is undoubtedly decelerating. Whereas a few years ago, annual growth was running closer to 20%, going forward it will be in single digits. By 2022, online is predicted to account for 7.5% of the market. Even allowing for ongoing growth, its share is likely to plateau at less than 10%.

Although none of the leading players are likely to admit as much, online grocery is probably not profitable, if all costs are fully factored in. Ocado, the leading pure-play exponent, just about scrapes a profit on the basis of more lucrative 3rd party contracts to the likes (plus more exciting overseas tie-ups with the likes of Casino, Sobeys and Kroger). There is less transparency around the finances of the Big Four players' online grocery operations, but the fact remains that delivery charges do not fully offset the costs of fulfilling orders to customers' homes.

Another common misconception is the fact that online grocery operates in splendid isolation from the rest of the market. In reality, pure plays such as Ocado are very much the exception rather than the rule. The vast majority (perhaps 98%/99%) of Big Four online grocery orders are fulfilled by in-store pickers, as opposed to central distribution centres or darkstores. Particularly telling was the fact that rather than rely entirely on Ocado's CFC network, Morrisons has reverted to a store-picking model for its grocery online business.

Superstores therefore have a symbiotic rather than competitive relationship with online grocery. On the non-food side there is also a mutual support in that stores (superstores, supermarkets and even c-stores) are strategically important pick up points for click & collect orders. Indeed, this goes some way to explaining Sainsbury's acquisition of Argos. Expressed another way, an army of strategically located, high footfall, easily accessible stores for multi-channel fulfilment is a competitive advantage that the grocers have over pure-plays, even Amazon.

On the subject of Amazon, we are very much in 'watch this space' territory following its takeover of Wholefoods. An impending apocalypse in the grocery sector seems unlikely, given the limited scale of both Amazon Fresh and Wholefoods in the UK. Clearly, Amazon will look to drive synergy from its new bedfellow, but this is likely to be far more acute in the US than the UK. For all the strengths of both businesses, they do have a very telling common denominator – they have very limited experience of the UK online grocery market and are years behind the Big Four in this regard. But, as with most things Amazon, never say never.

"An impending apocalypse in the grocery sector seems unlikely, given the limited scale of both Amazon Fresh and Wholefoods in the UK."

Key Points

- THE PREVIOUS INVESTMENT CASE FOR FOODSTORES WAS RENTAL GROWTH – THE CURRENT ONE IS FAR MORE INCOME-ORIENTATED.
- SUPERMARKETS ARE FORECAST TO DELIVER ANNUAL INCOME RETURNS OF 5.1% OVER THE NEXT FIVE YEARS – HIGHER THAN ALL PROPERTY AVERAGES (4.6%).
- FOODSTORES TYPICALLY STILL OFFER LONGER LEASES THAN OTHER RETAIL SECTORS – AND, INDEED, MOST OTHER PROPERTY SEGMENTS.
- COVENANTS ARE VERY STRONG, AIDED BY GREATER STABILISATION AMONG THE BIG FOUR AND PERCEIVED CLIENT CONTENTMENT.
- THERE IS STILL SOME (LARGELY UNFOUNDED) CONCERN AROUND POSSIBLE STORE CLOSURES, HENCE HEIGHTENED SCRUTINY OF STORE TRADING PERFORMANCE AND RESIDUAL SITE VALUE.
- THERE IS STRONG INVESTOR INTEREST FOR DISCOUNTER (ALDI AND LIDL) STOCK, WHICH OFFERS LONGER LEASES (15-20 YEARS) AND INDEXATION – PLUS A STRONG GROWTH NARRATIVE.
- THE ISSUE OF RE-GEARS WILL INCREASINGLY COME TO THE FORE. THE GROCERY OCCUPIERS ARE HAPPY TO AGREE RE-GEARS, RATHER THAN WALK AWAY, BUT THE QUESTION MARK IS ON WHAT TERMS.
- FOODSTORES ON HISTORIC RENTS >£30/SQ FT ARE LIKELY TO BE OVER-RENTED AND WILL BE SUBJECT TO DOWNWARD PRESSURE. THERE IS A TRADE OFF TO BE HAD BETWEEN RENT AND LEASE LENGTH/QUALITY OF INCOME.

Foodstores: the Case for Investment

WORDS: DOMINIC WALTON – PARTNER, RETAIL INVESTMENT

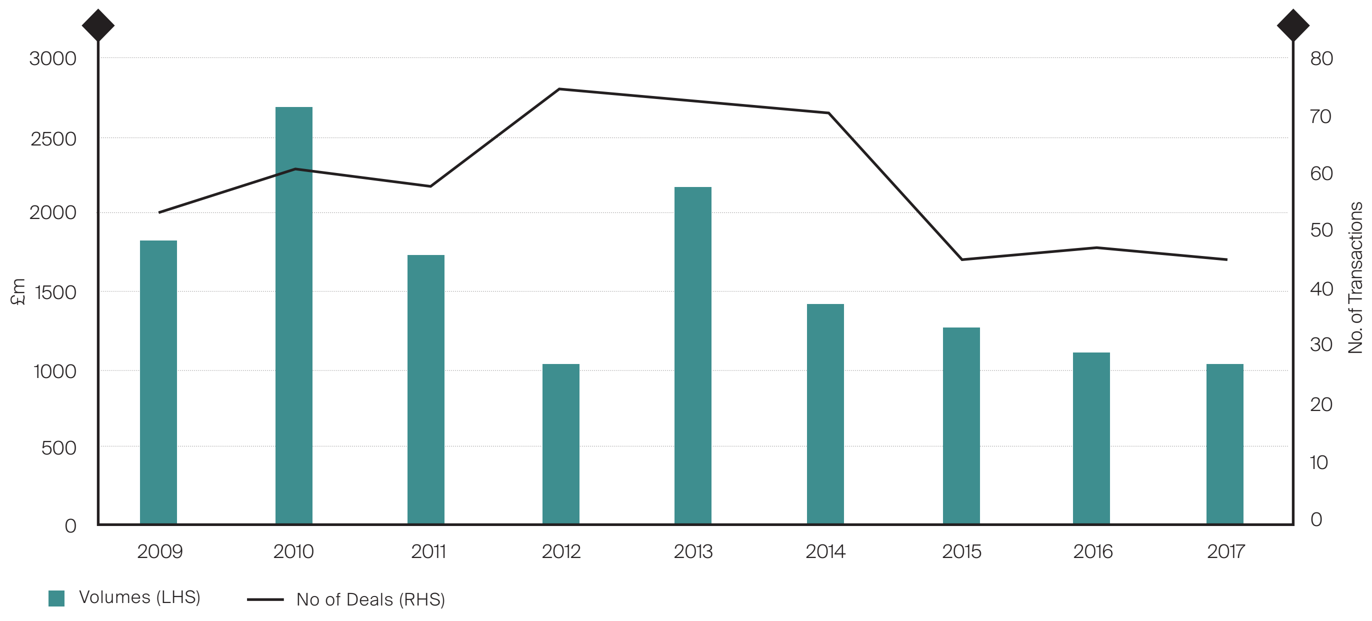
Why foodstores present a better investment opportunity, compared not only to other retail segments but also other property assets.

Foodstores have been in and out of favour with investors in recent years. The high water mark for investment volumes came in 2010 (£2.7bn) and for number of deals in 2012 (75). The initial tide of investor appetite was driven by an expectation of ongoing rental growth. As the space race ground to an abrupt halt and the Big Four hit a well-documented wall of malaise, sentiment quickly turned against the sector.

Investor demand is slowly returning, albeit on a different basis than before and not without a large degree of caution. This new tide is being driven by a perfect storm of massive growth in investors searching for income, combined with a stabilisation of the trading performance of the Big Four. The net result is that perception of the large format foodstore sector is generally improving amongst a growing number of property investors.

FOODSTORE INVESTMENT VOLUMES AND DEALS 2009-2017

Source: Property Data, Knight Frank



KEY FOODSTORE DEALS (>£20M) IN 2017

Source: Property Data, Knight Frank

TOWN	Location	Price (£m)	Yield (%)	Date	Tenant	Purchaser	Vendor
PORTFOLIO	BLT Properties	109.50		May-17	7 stores	Tesco Plc	British Land Plc
ASHFORD, KENT	Simone Weil Avenue	80.00	4.50	Aug-17	Sainsbury's	Supermarket Income REIT	NFU Mutual Insurance
PORTFOLIO	Project Alexis (part)	62.30		Mar-17	6 supermarkets + OOT property	Legal & General Property	Fairholme Estates Ltd
KETTERING	Kettering Business Park	51.55	5.84	Sep-17	Tesco	Legal & General Property	Aviva Investors
CUMBERNAULD	Tryst Road	50.00	5.50	Dec-17	Tesco Extra	Supermarket Income REIT	Legal & General Property
BRISTOL	Callington Road	46.00		May-17	Tesco Extra (50% stake)	British Land Plc	Tesco Plc
PORTFOLIO	Tesco portfolio	44.00		Feb-17	Tesco (Braintree & Tiptree)	Tesco Plc	Aberdeen Asset Management
THETFORD	Kilverstone	43.20	5.35	Aug-17	Tesco	Supermarket Income REIT	M&G Real Estate
NEWPORT	Harlech Retail Park	41.00		May-17	Tesco Extra (+5 units) (50% stake)	British Land Plc	Tesco Plc
WAKEFIELD	Ings Road, 50	39.50	5.90	Sep-17	Sainsbury's	Private client	TH Real Estate
LONDON E18	George Lane, 176	36.75	4.00	Dec-17	Sainsbury's	LaSalle Investment Man	British Land Plc
CONSETT	Hermiston Retail Park	35.31	6.25	Dec-17	Morrison's (+RW units)	St James's Place PF	Aviva Investors
LOUGHBOROUGH	Gorse Covert Centre	32.50	4.25	May-17	Morrison's	UK pension fund	LondonMetric Property Plc
BRISTOL	Lime Trees Road	28.50	4.90	Aug-17	Tesco	Supermarket Income REIT	Undisclosed
NEWRY	Downshire Road	27.25	6.10	Sep-17	Tesco Extra	Overseas investor	Aberdeen Standard Invest
FERNDOWN	Ferndown District Centre	26.00	5.65	Jun-17	Tesco	Torbay Council	TH Real Estate
CHELMSFORD	South Woodham Ferrers	24.00	4.75	Jun-17	Sainsbury's	Knight Frank IM LLP	U and I Group Plc
LONDON W13	Melbourne Avenue	22.47	4.75	Jun-17	Sainsbury's	Aprirose REI	British Land Plc
CRAIGAVON	Highfield Road	21.44	7.00	Sep-17	Tesco	Arax Properties Ltd	British Land Plc
LYMINGTON	Stanford Road	20.75	4.35	Jul-17	Waitrose	Waitrose Ltd	Knight Frank IM LLP

Strong fundamentals – and income

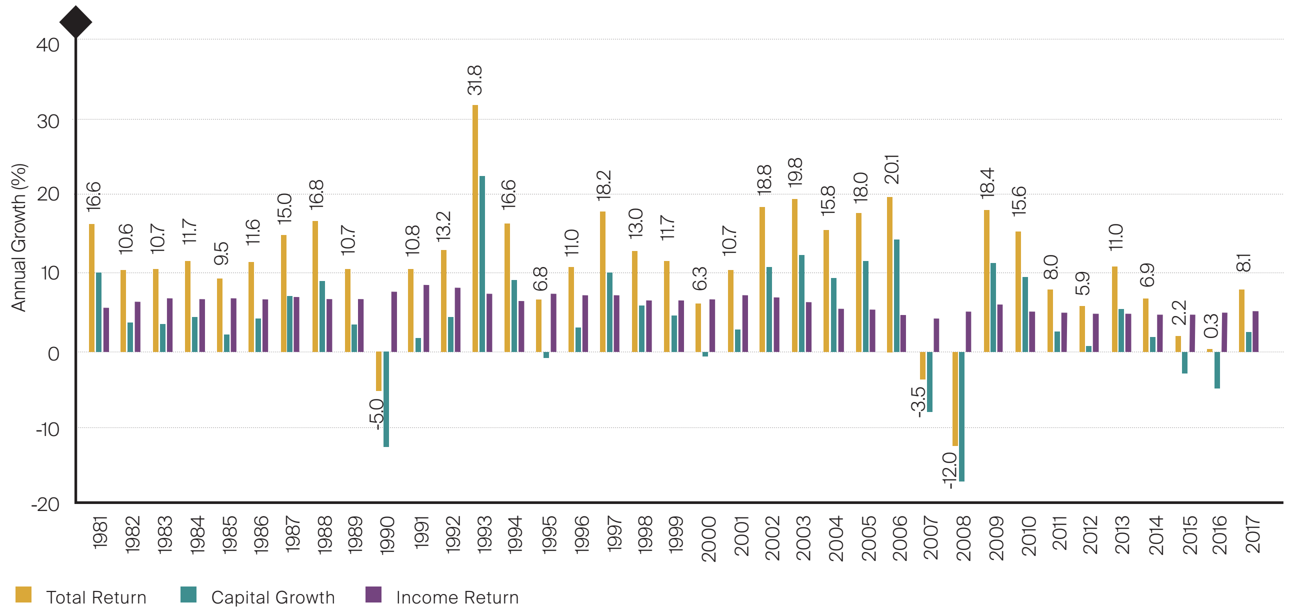
The fundamentals of grocery retailing remain strong. One of the key attractions for investors is long leases. Foodstores still offer leases typically longer than other retail sectors – and, indeed, the other key property segments, industrial sheds and offices. A run-of-the-mill 11/12 year lease on a supermarket compares favourably with many other property assets. Growth in annuity style funds has increased competition and caused significant yield compression (perhaps to past record levels) for 20+ year leases with indexation – with annual indexation definitely preferred to five yearly.

Covenants are also perceived to be strong. Despite their trials and tribulations of recent years, there is absolutely minimal risk of failure amongst the Big Four. More generally, the grocery sector is regarded as something of a 'safe haven' within the wider retail industry and the fact that its lifeblood is non-discretionary spend, it is more removed from the raft of challenges that many high street retailers face. As the last recession showed, times of austerity and uncertainty can actually play into the hands of core retail segments such as grocery.

This increasingly positive sentiment extends beyond the Big Four operators. Investor appetite for discounter

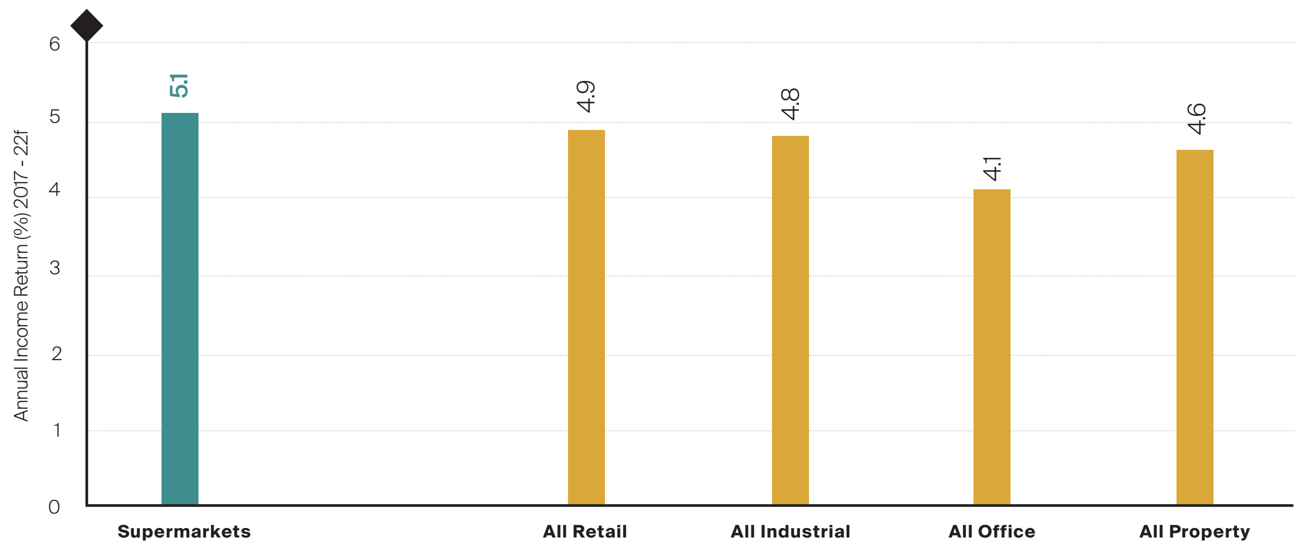
FOODSTORE PROPERTY PERFORMANCE METRICS 1981 - 2017

Source: MSCI/IPD, Knight Frank



FORECAST INCOME RETURNS 2017-2022F

Source: Real Estate Forecasting, Knight Frank



stock – Lidl and Aldi – is massive due to longer (15-20 year) leases and indexation. Tenant contentment, a key factor across the retail property investment market, is perceived to be particularly high amongst the discounters as they continue to blaze a trail and aggressively gain market share. The discounter story remains a good one, investors continue to buy into it and they generally like the trajectory.

Investors are also increasingly targeting income, and foodstores likewise score well on this measure. According to IPD, annual income returns in foodstores have averaged 5.2% over the last decade (5.3% in 2017). Our forecasts suggest that they will generate consistent annual income returns of 5.1% over the next five years. Again, this compares favourably not just with other retail assets (+4.9%) but also with other property classes (industrial +4.8%, offices +4.1%).

More fundamentally, there is a growing feeling that many of the over-supply scare stories of a few years ago may have been exaggerated. Large foodstores have been challenged, but very few have closed. They are internet compatible and are ultimately where the food operators make most of their money.

More fundamentally still – there is a finite supply of land in the UK and foodstores occupy large sites.

> "Appetite is therefore far stronger for foodstores with 20+ year leases as these seem slightly incubated from 'closure concern'."

Key questions

The two main questions investors ask are: 1) how does the store trade 2) what is the residual underwrite of the site.

Store-level trading information is gold dust in retail property investment decisions, but can be very hard to come by. Perceptions can also be deceptive. A shiny new foodstore that presents well and appears busy may actually trade on a below par sales density. Conversely, a seemingly dated and under-invested store may actually be far more productive. Understanding these performance relativities and where the store sits in the hierarchy of the overall portfolio is key to second-guessing the retailer's strategy for it going forward e.g. willingness to renew at lease expiry, possible rental upside etc.

Whilst perceptions of the sector have improved vastly, there is still a degree of nagging malaise, rekindled in part by the proposed merger between Sainsbury's and Asda. Despite all evidence to the contrary, some investors still see store closures as a risk. Appetite is therefore far stronger for foodstores with 20+ year leases as these seem slightly incubated from 'closure concern', due simply to lease length. Stores with leases of 8-12 years are subject to far greater scrutiny in terms of trade quality – and hence, the significance of residual value.

In many cases, investors are looking to underwrite the value of the land. Obviously this brings into play huge regional variations. However, residential value underwrites appear only to really work in London and South East. Few other areas offer residential land values of £1m and above.

Re-gears – unchartered waters

The subject of re-gears is a key topic and one that will inevitably rise up the agenda going forward. There is already some evidence of foodstore tenants happy to agree to re-gears and we suspect that this will gradually develop more momentum. As this unfolds, this will afford investors further comfort.

The challenge here is investors having confidence on, say, an 11 year term, that the tenant will re-gear rather than close – again, underlining the questions raised as to trade quality. Then, of course, there is the question of pricing cost of re-gear. Current evidence would suggest 12-18 months' rent free, with some rents remaining the same, some changing (depending on the level of passing rent and again, the trading story).

> "In the absence of actual evidence, there is the question of affordability and how the parameters may have shifted in recent years."

Given the search for income i.e. length of term, yield compression is obviously massive for longer leases. Clearly, some foodstores will be considered over-rented, especially any that are £29/sq ft+. This will raise the difficult question of ERV. In the current market, this is tricky as no new deals are being agreed for evidence. In the absence of actual evidence, there is the question of affordability and how the parameters may have shifted in recent years. In the past, the investment market played on this factor thinking rents would still be affordable at £35/sq ft+. The mechanics of affordability have since been re-based considerably and broadly the comparable figure now is likely to be closer to £20/sq ft (although this will vary considerably by location and by trading story).

For investors, there is clearly some rental trade off to be had in favour of longer lease terms. Few grocery retailers would be averse to cutting their rent bills for the sake of longer commitment. Clearly, there is considerable scope for two-way negotiation that benefits both parties.

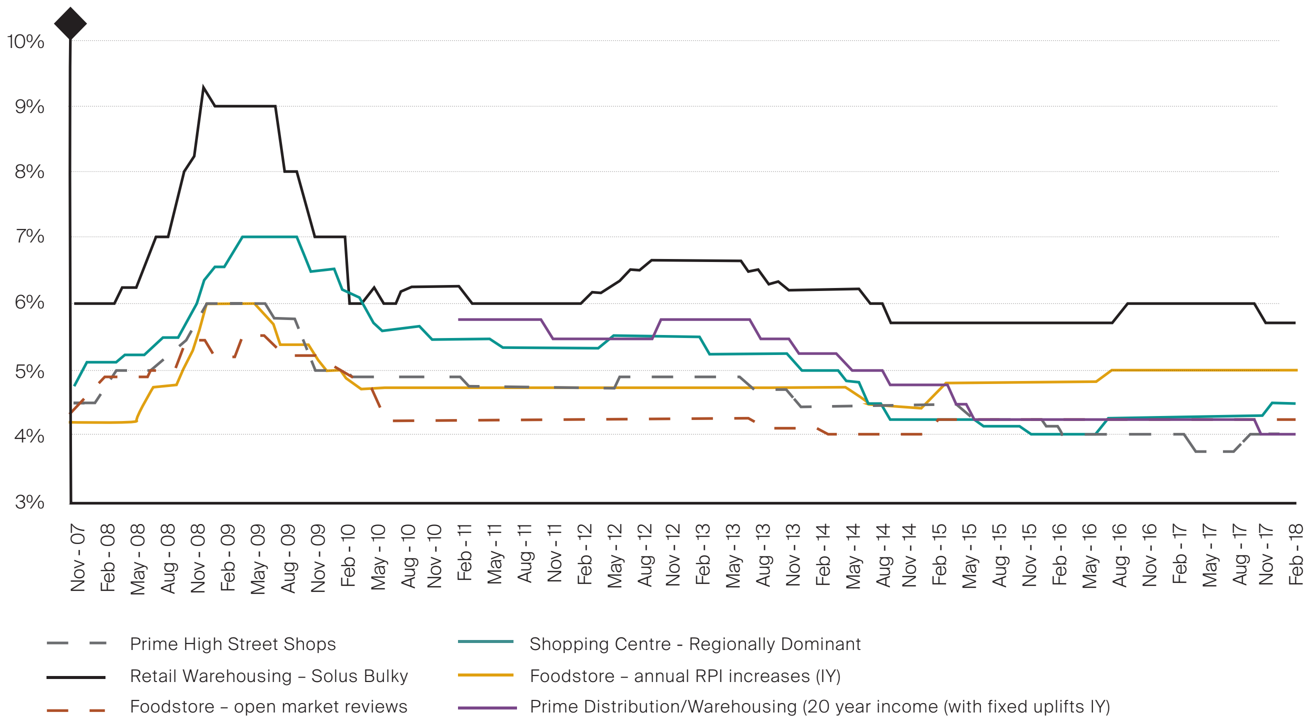
Key investors and direction of travel

The depth and type of investors currently varies, particularly by geography. In London and the South East, the key investors are the UK institutions. For large format (100,000+ sq ft) foodstores with indexation outside the South East, investor interest is largely from overseas, particularly Middle Eastern syndicated cash. Bank debt is seemingly readily available.

Looking forward, our opinion is of further improvement, in tandem with accelerating stabilisation of the Big Four and

FOODSTORE YIELDS VS. OTHER PROPERTY SEGMENTS 2007-2018

Source: Knight Frank Yield Guide



increasing 'market fitness' generally. According to Knight Frank's Yield Guide, yields for foodstores with open market reviews are stable at 5.00%. Those subject to annual RPI increases are keener at 4.25%. Although market sentiment is positive, this is still a 25bps discount to other property assets, such as prime distribution sheds.

Actual comparable evidence points to an even bigger gap. The Sainsbury's store in South Woodford traded for £36.75 (4.00%) in December 2017. Compare this with the 3.20% Net Initial Yield recently paid for a multi-let industrial estate in Battersea. Huge investor demand for logistics stock capable of fulfilling 'last mile delivery' is currently compressing yields for sheds, but the pricing gap with foodstores is questionable and possibly unsustainable. After all, foodstores should carry the same alternative use premium. As a more leftfield suggestion, they may be able to fulfil a dual function of both foodstore and 'last mile delivery' hub – what price then?

KEY FOODSTORE PURCHASERS 2017

Source: Property Data, Knight Frank

PURCHASER	Value (£m)	% of Total
Supermarket Income REIT	201.7	19.6%
Tesco Plc	153.5	14.9%
Legal & General Property	113.9	11.0%
British Land Plc	92.4	9.0%
LaSalle Investment Man	48.7	4.7%
Knight Frank IM LLP	41.5	4.0%
St James's Place PF	35.3	3.4%
Torbay Council	26.0	2.5%
Aprirose REI	22.5	2.2%
Arax Properties Ltd	21.4	2.1%
Waitrose Ltd	20.8	2.0%
Other	254.0	24.6%
Total	**1,031.5**	**100.0%**

KEY FOODSTORE VENDORS 2017

Source: Property Data, Knight Frank

VENDOR	Value (£m)	% of Total
British Land Plc	190.2	18.4%
Tesco Plc	87.0	8.4%
Aviva Investors	86.9	8.4%
NFU Mutual Insurance	80.0	7.8%
TH Real Estate	65.5	6.4%
Fairholme Estates Ltd	62.3	6.0%
Legal & General Property	50.0	4.8%
Aberdeen Asset Management	48.7	4.7%
M&G Real Estate	43.2	4.2%
LondonMetric Property Plc	38.5	3.7%
Aberdeen Standard Invest	27.3	2.6%
U and I Group Plc	24.0	2.3%
Knight Frank IM LLP	20.8	2.0%
Other	207.3	20.1%
Total	**1,031.5**	**100.0%**

Three Key Reasons to Invest

1

Strong Fundamentals

- Longevity – very few closures, high probability of lease renewals
- Occupier contentment
- Strong covenants

2

Income Strength

- Long income
- High income return
- Index linked

3

Cheap/Good Value

- Pricing is slightly lagging positive shifts in sentiment
- Cheap relative to other property assets
- Potential capacity to fulfil shed functions (e.g. last mile delivery)?
- Re-gear opportunities

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