# Research & Strategy Flash Note

# Time for UK supermarkets to be super again

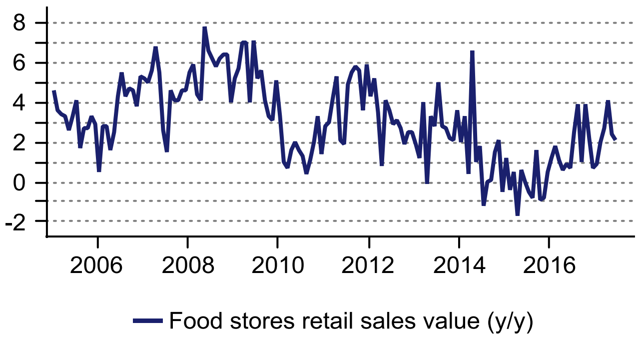
## Lower credit risk putting downward pressure on yields

After a period of falling profits, weak balance sheets and operational restructuring, UK supermarkets are turning a corner. Three of the 'Big-4' operators are reporting improving retail sales, leaner balance sheets and leaner supply chains. Although more needs to be done, these operators' credit risk has declined enough to justify lower yields. Moreover, the supermarket segment's current yield spread over UK government index-linked sovereign bonds means that there is an additional value play boosting the attractiveness of food stores to both income-focused domestic and overseas investors. Here, we issue our 'buy' rating on the UK supermarket segment.

## Rebound of the Big Four supermarkets

- After a period of soaring costs and falling profits for major operators combined with a muted property investment market, the UK supermarket segment is now improving. Major operators' investments in their own value brand ranges, everyday low prices, better customer service and online infrastructure have delivered positive trading results.
- Retail sales values for food stores have been rising since 2016 after reaching a record low in 2015 (figure 1). The Big Four UK operators – Tesco, Sainsbury's, Morrisons and Asda – increased sales for the fourth consecutive period in the three months to 16 July 2017, according to Kantar Worldpanel. Tesco remained the fastest growing of the four due to strong online sales, which are expected to grow further after Tesco's recent same-day delivery announcement.

### Figure 1: Food store retail sales value (%)

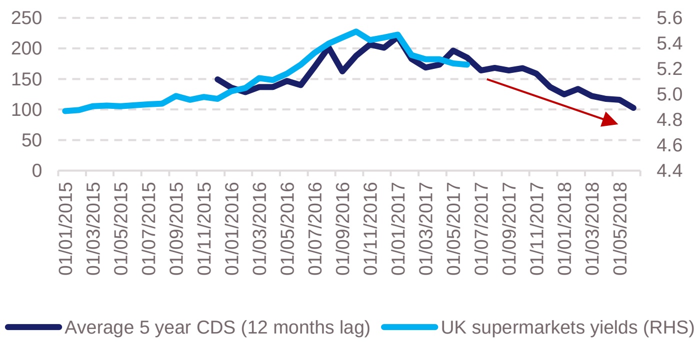



Sources: Office for National Statistics, Macrobond, Savills Investment Management

### Improving credit risk and attractive yields

- While 2016's GBP 1.2 billion food store transaction volume was lower than the previous year, the 2015 volume was bolstered by a major Tesco and British Land deal, according to Savills. International investor activity accelerated in 2016, accounting for 22% of transactions, and Savills anticipates that 2017 will bring more domestic food store buyers to market.
- The negative performance of the Big Four supermarkets in 2014 and 2015 caused a rise in credit risk and upward pressure on yields. Although supermarket net initial yields currently stand at 5.2%, according to MSCI, Savills records current prime yields for food stores on inflation-linked leases between 4.25% and 4.75%.
- With operating conditions improving since 2016 and credit risk declining, yields are on a clear downward trend. Figure 2 shows UK supermarket yields and average five-year credit default swap (CDS) spreads with a 12-month lag, indicating that yields could move down further by around 30 basis points (bps) in the next 12 months as credit risk continues to decline.

### Figure 2: Five-year average CDS (12 months lag) over supermarket yields



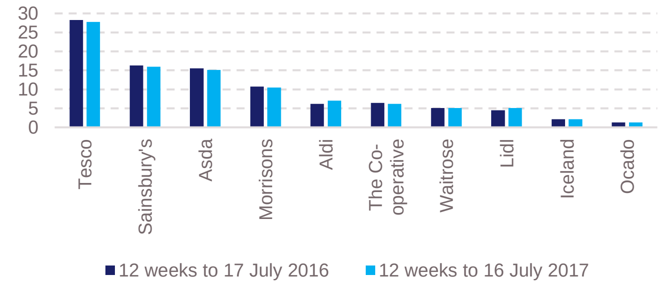

Sources: Bloomberg, MSCI, Savills Investment Management
Note: average five-year CDS of Tesco, Sainsbury's and Morrisons

- Almost 60% of the transactions in 2016 were for assets with inflation-linked leases (RPI or CPI), according to Savills. Of this just over two-thirds were long-income assets with unexpired terms in excess of 20 years. Index-linked leases remain attractive, since risk appetite has diminished after the June 2016 Brexit vote. Long-dated, RPI-linked income backed by FTSE 100 covenants offers investors attractive leveraged returns.

## Evolving discounter, online grocery and store size trends

- Strong online sales are boosting food store operator performance. Large supermarket operators are now offering click-and-collect services and same-day grocery delivery in an attempt to curb the influence of AmazonFresh, discussed in our recent flash note. Furthermore, Sainsbury's acquiring Argos and Tesco acquiring Booker, among other deals, provide operators opportunities for growth outside the core grocery segment.
- When the Big Four UK supermarkets lost market share in 2016-17, discounters Aldi and Lidl gained share as they expanded their number of stores (figure 3). According to Colliers, Aldi and Lidl plan to open an additional 60 to 70 stores per year over the next few years, but there is increasing evidence that sales growth is slowing. At the same time, discounters present intense price and investment competition, driving down Big Four operator margins.

### Figure 3: UK supermarket share (%)




Sources: Kantar Worldpanel, Savills Investment Management

- Big Four operators are reconfiguring their stores based on consumer demand for flexible, convenient shopping. Tesco and Sainsbury's are now focusing on stores in the 30,000-50,000 square foot range, according to Savills, a downsize from the 120,000-150,000 square footage optimal a few years ago. They are also developing strategies for subdivision, sub-letting or joint ventures with other retailers, Savills reports.

## Tesco

- During the Eurozone crisis and after the disruptive rise of discounters, Big Four profits dropped while their credit risk increased. Tesco's credit risk rose particularly sharply, with five-year CDS spreads jumping to 343 bps in early 2016 (figure 4). They have since come down to 132 bps, as Tesco has implemented a number of strategies to improve its performance.

### Figure 4: Tesco five-year CDS


Source: Bloomberg

- Tesco's credit risk premium remains above that of Sainsbury's and Morrisons (figures 5 and 6), and we expect Tesco's covenant to strengthen over coming years. Group sales rose 4.3% in fiscal year 2016 and 1% in Q1 2017, indicating the supermarket giant is heading towards profitability. But pricing pressures remain amid weaker sterling since the Brexit referendum combined with higher commodity prices.
- Tesco's planned purchase of Booker group will provide a strategy for diversifying its retail channels, accessing new customers, improving its logistics supply chain and maximising store space.

## Sainsbury's

- Sainsbury's CDS spreads were trading at 129 bps in July for five-year credit protection, below the average, suggesting lower risk (figure 5). Sainsbury's Argos acquisition also helps secure its growth in the nonfood segment, enhancing the click-and-collect service that could eventually drive more footfall to its stores. The deal has proved successful so far, with sales growth of 2.7% in Q1 2017.

### Figure 5: Sainsbury's five-year CDS


Source: Bloomberg

### Morrisons

- Morrisons' five-year CDS spreads trade at 44 bps, lower than Sainbury's (figure 6). Its share price has risen by nearly 36% over the past year, with sales in Q1 beating market expectations and indicating that its turnover strategy is gaining momentum.

### Figure 6: Morrisons five-year CDS


Source: Bloomberg

## Future of food stores

- Despite margins that are still under pressure, the UK's major supermarkets have shown encouraging recent trading figures. As long-dated income from relatively healthy covenants looks increasingly appealing to investors, we expect 2017-18 to be a more positive year for supermarkets.

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