UK Supermarket Property Rents 101

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Research note:
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Executive Summary

- The key metric for grocery operators when determining rent is the ratio of rent to store turnover
- In the UK c.4% rent to store turnover is the long-standing industry standard ratio
- Property valuers and index providers such as the MSCI publish their view of market rents for supermarkets.
- We believe there are three reasons why rental index providers underestimate the rent that UK grocers are willing to pay to secure ongoing occupancy at a strong trading site:
    1. The average includes all supermarket formats, all operators and weak as well as strong stores
    2. Supermarket regears are ineligible as evidence for rental index providers despite our view that they are a reliable measure of what operators are willing to pay
    3. There is no adjustment for store size
- As a result, our view is that the index market rent per sq.ft. systematically underestimates rentals that UK grocers are willing to pay to secure trading from a site
- Supermarket properties with above index market rents tend to trade at a discount to those perceived as rack rented, this can provide grocery savvy property investors with an attractive value proposition

A brief history of leasing in the UK supermarket sector

During the 90's and 00's the supermarket operators (Tesco, Sainsbury's, etc) were the largest property developers in the UK. They acquired sites, obtained planning permission and built stores. Leasing was a last resort where acquiring the freehold was not possible.

Tesco and Sainsbury's then moved to using sale and leasebacks extensively to recycle capital from completed stores into new developments. This meant that the rent was initially set by the operators to balance the rental costs and capital receipts upfront. Rents were typically set at c.4% of store turnover. Leases were usually 20 to 30 years with rental uplifts often based on RPI reviews with a cap and floor. Operators viewed their revenues as broadly correlated with RPI and there was demand from institutional investors for RPI-linked cashflows.

Of course, this assumption of correlation with RPI proved incorrect for two reasons. Firstly, the move of electricals, appliances and other non-food to online delivery. Secondly, after 2008, the emergence of discounters (Aldi, Lidl, etc) meant that the supermarket majors did not capture a proportionate share of grocery market growth during that period. Hence some stores, especially those originally designed with a large non-food component, became over rented.

More recently, we have observed strong growth in grocery sales since the COVID pandemic and the resultant long-term increase in working from home. A further tailwind to grocery turnover has been a period of persistent and high inflation. Grocery sales growth has significantly outpaced rental growth over the same period, reducing the rent to turnover ratio for the majority of stores we have reviewed. Supermarket rents have therefore become more affordable for operators and the occurrence of stores being over rented has become less prevalent in the sector.

Rent to turnover (RTO)

Although there are no 'turnover' rents in the UK grocery sector, the store level rent to turnover ratio is widely utilised by operators to establish an acceptable starting rent.

4% rent to turnover is the market standard RTO ratio, in simple terms the grocers view it as 'two weeks of trade'. The 4% RTO is of course an average and there will be some variability around this level, dependent on the specifics of a transaction. It is a level that is considered affordable by operators and compares favourably to other asset classes e.g. retail parks RTO are c.12%, hotels c.20% and shopping centres c.25%. While the grocery sector has lower margins than some of these comparable retail or leisure sectors, it is worth noting that typical store level EBITDA margins are around 12% providing approximately 3x cover of rent at the market standard RTO.

Rent per square foot (per sq.ft.)

A factor which is often misunderstood in the market is that stores vary in size, meaning that the proportion of productive space for the grocer can be significantly different. As a result, in the grocery real estate market the rent per square foot for two strong trading stores can be very different. This can be misleading when viewed in isolation.

We demonstrate this in the worked example below.

Worked example 1

Store weekly turnover	£1,211,000
Annual turnover	£63,000,000
Affordable rent (4% RTO)	£2,520,000

	Store A	Store B
Gross Internal Area (sq.ft.)	80,000	97,400
Rent per sq.ft.	£31.5	£25.9
Adjustments **(see below)**	12.5%	12.5%
Net rent per sq.ft.	£28.0	£23.0

Relative to store performance, the same affordable rent (4% RTO) produces a rent per sq.ft. which is 22% higher for store A than store B

As we can see, both stores are strong trading and would be strategically important to the operator with £63m of annual turnover. However, the operator of the larger store is unwilling to pay rent for additional space if it is not generating turnover. The result is that the rent per sq.ft. is markedly different between these two stores which have the same strong trading characteristics.

We have seen plenty of evidence that operators are willing to commit to new 15-year lease terms on existing stores, provided the new rent is reset to their acceptable RTO level. The resultant implied rent per sq.ft. is largely irrelevant.

Standard Adjustments[1]

In the grocery property sector, total rental income from supermarkets will typically include additional amounts payable, calculated as a proportion of the store rent:

- → Standard adjustments are +5% for the landlord's Fixtures and Fittings (F&F) and where applicable, an additional +7.5% for a petrol filling station (PFS)
- → Effectively for many properties the supermarket rent is grossed up by 12.5% (being 5% + 7.5%)

One common error of non-grocery market participants is to simply take the total supermarket rental income received and divide that by the GIA to produce the rent per square foot, neglecting the standard adjustments. These standard adjustments are usually defined within the lease.

[1]Allocations can vary from lease to lease but 5% for F&F and 7.5% for PFS are viewed as market standard

Taking the example of Store A above we have provided below a worked example of how to calculate the adjusted rent per square foot for that store.

Worked example 2

Store rent (£m)	2,520,000
Gross Internal Area (sq.ft.)	80,000
Store rent per sq.ft. (£)	31.5
PFS and F&F adjustments	12.5%
Adj. Gross Internal Area	90,000
Adj. rent per sq.ft. (£)	**28.0**
Rent to turnover	4.0%

‘Market’ rents

Index providers such as MSCI publish an average rent per sq.ft. for the UK grocery sector. They include weaker performing stores and discounters which naturally produces lower rents per sq.ft.

Also, as demonstrated above in Worked Example 1, the rent per sq.ft. is heavily influenced by the size of the store. As a result, just focussing on rent per sq.ft. can give a misleading view of the appropriate rent for an individual store.

It is also important to note that bilaterally negotiated rents on lease extensions (‘regears’) are not treated as evidence for open market rent reviews as they are not arm’s length transactions. Hence the index providers exclude this data when calculating their average rent.

Very few large format stores have been built in the last few years and there is therefore a lack of new open market rental evidence. Furthermore, leases on strong performing supermarkets do not tend to reach contractual maturity as they are regeared early by the operator (and are therefore not included in an index provider’s average). This all results in a dearth of open market rental evidence for large format stores in the UK grocery sector.

In our view, regears provide highly relevant evidence of the level of rents that operators are willing to pay to secure occupation of strong performing stores. We have seen many examples of supermarket lease regears which support the 4% RTO benchmark. Similarly, we have seen many examples of rent per sq.ft. well in excess of what the index providers would assume was ERV for that asset.

As a result, we do not believe the MSCI ERV of £20 per sq.ft. is representative of the actual ERV of a strong performing omnichannel store.

Regears

Given affordable rents are a function of store turnover, store operators are willing to pay higher rents for stronger performing stores. Recent regear rents have been agreed on strong performing stores at levels materially higher than the MSCI ERV but in line with 4% RTO (see examples in table in next section).

It is also important to note that strong performing stores which are oversized will produce lower rents per sq.ft. as a function of the larger store size, however they remain equally important to the operator.

Overrented stores

Within the UK commercial property market, Supermarket properties perceived as over rented tend to trade at a discount to those considered to have rent in line with the MSCI ERV. Stores which appear over rented can therefore offer considerable value as long as they are modelled correctly. The example below demonstrates the value proposition.

	Rack rented store	Overrented store
Rent roll	£1,800,000	£2,400,000
Rent per sq.ft.	£22.50	£30.00
NIY	5.25%	7.00%
Capital value	£32,102,729	£32,102,729

There is more implied credit risk in an overrented store as the landlord relies on the creditworthiness of the tenant to pay the higher rent during the period of overrent. This is somewhat mitigated when you have a strong covenant supermarket operator (i.e., Tesco or Sainsbury's) on the lease. It is key to model a reversion to market rent at expiry of the lease. The higher cash yield produces a materially higher return on investment than a rack rented store.

We continue to see material value in acquiring overrented stores, clipping the overrent until lease expiry, then agreeing a regear with a lower rent set at 4% RTO.

Example regears of over rented stores[2]

Store/ portfolio	Description	Rent per sq.ft. before regear	Rent reduction	Rent per sq.ft. post regear	RTO
Tesco portfolio	7 strong trading omnichannel stores Regeared 15 yr annual RPI	£33	28%	£24	4%
Prescot	Large strong trading, Tesco omnichannel store Regeared 15yr annual CPI	£24	24%	£18	4%
Leicester	Large strong trading, Tesco omnichannel store Regeared 15yr annual RPI	£28	23%	£21	4%
Islington	Strong trading Sainsbury's store Regeared 20yr annual CPI	£38	8%	£35	>5%

Limited range discounter rents

Market rent indices cite discounter rents at c.£15 per sq.ft[3]

This is a lagging indicator, referencing the price for new space which has recently opened. This new space, however, comprises development projects which had commercial terms agreed in previous years and in a different price environment.

Rents for new developments are largely an output of the land, construction and financing costs of the project. The recent period of high inflation has had a material impact on this maths.

In the worked example below, we have set out the impact of increased land, construction and financing costs on a typical 20,000 sq.ft. Grocery property development. The impact of these input cost increases results in a c.47% increase in the rent per sq.ft. required to develop new stores.

We believe that these increased costs are a major contributing factor to the slowdown in discounter new openings.

[2] Regear rents shown for each store are from various sources including React News, MSCI Real Capital Analytics and discussions with valuers and property agents
[3] Discounter ERV data sourced from MSCI

Worked example 3

Impact on the economics of a 20k sq.ft. new store[4]			
	2019	**2023**	
Est build cost psf (£)	180	240	+35%
Required valuation (£) (inc 20% developer profit)	**7,320,000**	**8,832,000**	
Est Yield	4.25%	5.25%	
Required rent psf (£)	**17**	**25**	**+47%**

Supermarket Income REIT's UK Portfolio

The worked example below provides a practical example of how to calculate Supermarket Income REIT's asset level rent per sq.ft.

Worked example 4

UK store rent (£)[5]	96,000,000
Gross Internal Area[6]	3,800,000
Store rent per sq.ft.	25
PFS and F&F adjustments	10.0%*
Adj. Gross Internal Area	4,180,000
Adj. rent per sq.ft. (£)	**23**
UK store rent to turnover	3.8%

**10% adjustment is a portfolio average for SUPR due to variation of PFS / F&F across different sites*

This rent per sq.ft. shown above in 'Worked Example 4' equates to a 3.8% RTO (compared to a grocery market standard of 4% RTO).

The SUPR portfolio is therefore approximately rack rented from a UK grocery perspective.

[4] Economics of a new store assumes shell & core finish, excludes fit out costs. Based on Atrato Capital Research
[5] Supermarkets portfolio only
[6] Ibid

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