

Supermarket Income REIT

SUPR takes majority interest in indirect portfolio

Supermarket Income REIT (SUPR) has acquired an additional 25.5% beneficial interest in the Sainsbury's Reversion Portfolio (SRP) from its joint venture (JV) partner. It now has a 51% interest with 49% held by Sainsbury's. SUPR's positioning in the winding up of the SRP structure is strengthened, its relationship with Sainsbury's, operator of the stores, is deepened, and it expects to further enhance the return on its SRP investment. Separately, reflecting widespread expectations that yields will continue to widen across real estate sectors, our forecast net tangible assets (NTA) per share is reduced by c 10%.

| Year end | Rental income (£m) | EPRA earnings (£m) | EPRA EPS* (p) | NAV**/ share (p) | DPS (p) | P/NAV (x) | Yield (%) |
|----------|--------------------|--------------------|---------------|------------------|---------|-----------|-----------|
| 06/22 | 72.1 | 57.4 | 5.9 | 115 | 5.94 | 0.88 | 5.9 |
| 06/23e | 97.3 | 71.7 | 5.8 | 102 | 6.00 | 0.99 | 5.9 |
| 06/24e | 103.1 | 70.9 | 5.7 | 105 | 6.00 | 0.97 | 5.9 |
| 06/25e | 107.1 | 74.2 | 6.0 | 109 | 6.00 | 0.93 | 5.9 |

Note: *EPRA EPS is normalised, excluding gains on revaluation and other non-recurring items. **NAV is EPRA NTA throughout this report.

Short-term investment: Strategic & financial benefits

As we have discussed in previous [notes](#), SUPR's investment in the SRP has been highly successful. From 2020 to date, SUPR estimates an IRR of 26%, adding 8p per share to NTA, and we expect this to increase further, including benefits from this deal. Representing its share of the sale of 21 SRP stores to Sainsbury's, SUPR will receive a minimum £380m in two tranches (£264m in March 2023 and £116m in July). It will also benefit financially and strategically from its increased/controlling interest in the remaining five SRP stores (four regeared and let to Sainsbury's and one to be sold) as the structure unwinds. SUPR's JV partner benefits from accelerated liquidity while funding arranged by SUPR for the £196m investment will be quickly repaid from the March tranche of sale proceeds, eliminating a temporary increase in loan-to-value (%).

A structurally supported sector

SUPR's investment proposition is based primarily on robust and visible income growth from long, predominantly upward-only, mostly inflation-linked leases with strong tenants. The non-discretionary nature of grocery sales supports operators in passing through inflationary cost pressures and although their margins have tightened, cash flow is strong. Rents are a small share (c 4%) of store turnover and with indexed rent uplifts typically capped at c 4%, rent affordability increases. Rising interest rates continue to force a reassessment of property valuations across the real estate sector, although with transaction volumes low, the extent is difficult to assess. Reflecting on this we have increased our assumed yield widening, reducing FY23e EPRA NTA per share by 11p to 102p, flowing through to FY24 and FY25e.

Valuation: Well-supported income visibility

SUPR's FY23 DPS target of 6.0p represents an attractive yield of 5.8%, reflected in the shares trading close to EPRA NTA, below the average 5% premium since IPO.

Increased JV investment

Real estate

19 January 2023

Price 101.5p
Market cap £1,261m

| | |
|-------------------------------|----------|
| Net debt (£m) at 30 June 2022 | 297.3 |
| Net LTV at 30 June 2022 | 32.1% |
| Shares in issue | 1,242.6m |
| Free float | 99.5% |
| Code | SUPR |
| Primary exchange | LSE |
| Secondary exchange | N/A |

Share price performance



| | | | |
|------------------|----------|-------|--------|
| % | 1m | 3m | 12m |
| Abs | 0.0 | 3.4 | (18.0) |
| Rel (local) | (6.4) | (8.5) | (18.4) |
| 52-week high/low | 133p 96p | | |

Business description

Supermarket Income REIT, listed on the Premium Segment of the London Stock Exchange, invests in supermarket property, primarily let to leading UK supermarket operators, on long, inflation-linked leases. The investment objective is to provide an attractive level of income, with the potential for capital growth, with a 7–10% pa total shareholder return target over the medium term.

Next events

H123 results February 2023

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Transaction details

SUPR has acquired the additional 25.5% beneficial interest in the SRP for £196m, previously owned by its JV partner, British Airways Pensions Trustees (BAPTIL). SUPR's beneficial interest in SRP increases to 51%, with Sainsbury's continuing to own the remaining 49%, although this ownership structure will contractually unwind in stages, in March 2023 and July 2023, as previously indicated. Although this is a short-term investment, SUPR expects it will be accretive to the already strong returns that it expects from its SRP investment. Equally important, it enhances SUPR's strategic positioning as the SRP transaction with Sainsbury's reaches its conclusion.

The SRP comprises 26 Sainsbury's supermarkets. Sainsbury's exercised its purchase option in respect of 21 of these at an agreed aggregate price of £1,040m and it is the completion of these purchases that will trigger cash returns to SUPR of at least £380m in two tranches, in March 2023 (£264m) and July 2023 (£116m). In addition, Sainsbury's has now entered into new 15-year leases (with five yearly open market rent reviews and a tenant break option at year 10) on four of the five stores over which it did not exercise its purchase option and it is expected that a fifth will be sold at vacant possession value. The beneficial interest in these five stores is now held between SUPR (51%) and Sainsbury's (49%), which also operates the stores. Although Sainsbury's opted not to acquire these stores under the terms set by the SRP, their quality is underlined by Sainsbury's commitment to them, regearing the leases on sustainable terms.

Ignoring the strategic aspects of this transaction, in very simple financial terms: for a short-term investment of £196m, SUPR has increased its share of the Sainsbury's sale proceeds (21 stores) from at least £190m to at least £380m. Similarly, it has increased its beneficial interest in the remaining five SRP stores and will benefit from any other efficiencies that may be created by the new ownership structure.

We see potential for SUPR to acquire the regearied remaining SRP stores outright, subject to satisfactory terms. Additional acquisition opportunities with Sainsbury's are also possible now that SUPR is no longer in the position of being a potential seller of stores to Sainsbury's. We note that Sainsbury's continues to undertake sale and leaseback transactions and that in September 2022 it came close to completing a £500m transaction with LXI REIT, aborted as market volatility increased.

Funding

The acquisition has been funded entirely by a new debt facility, which has no recourse to any of SUPR's assets other than its interest in the SRP. The facility has a margin of 1.5% over SONIA and an arrangement fee of 2.0% and will be repaid in full following receipt of the first payment from Sainsbury's in March 2023. Including the arrangement fee, we estimate a funding cost of c £6m, which has been built into the transaction terms and will not appear within SUPR's net interest expenses. SUPR estimates that on its last published property portfolio valuation as at 30 June 2022 (FY22), the pro forma LTV ratio following the acquisition is 39% (from 36% pre-transaction). It expects this to decline quickly to 31% following the repayment of the facility in full in March and to 26% in July following receipt of the second tranche of proceeds from Sainsbury's.

Revision to property valuation assumptions

With a weaker demand-supply balance, rising bond yields and limited market transactions, there is much uncertainty about future capital values, despite many sectors continuing to benefit from structural support, defensive income streams and increasing rents. We would include supermarket

property, especially omnichannel stores, in the latter. Nonetheless, real estate investors are anticipating a continued widening of property yields across all sectors.

Our previous assumption, and we stress assumption given the level of uncertainty, was that the valuation yield on SUPR's portfolio would increase by c 35bp from the 30 June 2022 (FY22) level of 4.6%. We now assume a 50bp increase during FY23 (an implied c 6% reduction in property values) and for yields to drift higher over the following two years, reaching 5.25%, as capital values fail to fully keep pace with rent growth.

Our FY23e EPRA NTA per share is reduced by c 11p to 102p versus 113p previously; FY24e by 10p to 105p; and FY25 by 9p to 109p.

We have made no other changes to our forecasts, including for the SRP transaction, and will review these with interim results in February 2023.

Exhibit 1: Financial summary

| Year ended 30 June (£m) | 2021 | 2022 | 2023e | 2024e | 2025e |
|--|---------|---------|---------|---------|---------|
| INCOME STATEMENT | | | | | |
| Rent receivable | 46.2 | 69.7 | 94.5 | 100.3 | 104.3 |
| Rent smoothing adjustment | 2.0 | 2.7 | 2.8 | 2.8 | 2.8 |
| Net service charge expense | (0.2) | (0.3) | 0.0 | 0.0 | 0.0 |
| Total rental income | 47.9 | 72.1 | 97.3 | 103.1 | 107.1 |
| Administrative & other expenses | (9.3) | (13.9) | (16.4) | (16.8) | (17.3) |
| Operating profit before investment property change in fair value | 38.7 | 58.2 | 80.9 | 86.4 | 89.9 |
| Change in fair value of investment properties | 36.3 | 21.8 | (117.6) | 32.9 | 61.2 |
| Share of profit of jv | 15.5 | 43.3 | 13.0 | 0.0 | 0.0 |
| Negative goodwill | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Operating profit/(loss) | 90.5 | 123.3 | (23.7) | 119.3 | 151.1 |
| Net finance expense | (8.5) | (13.0) | (18.1) | (15.5) | (15.7) |
| Profit/(loss) before tax | 82.0 | 110.3 | (41.8) | 103.8 | 135.4 |
| Tax | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Profit/(loss) for the period | 82.0 | 110.3 | (41.8) | 103.8 | 135.4 |
| Adjust for: | | | | | |
| Changes in fair value of investment property | (36.3) | (21.8) | 117.6 | (32.9) | (61.2) |
| Share of changes in fair value of JV investment property | (5.6) | (31.1) | (4.0) | 0.0 | 0.0 |
| Negative goodwill | (3.3) | 0.0 | 0.0 | 0.0 | 0.0 |
| EPRA earnings | 36.8 | 57.4 | 71.7 | 70.9 | 74.2 |
| EPRA cost ratio inc. direct vacancy costs | 16.8% | 16.5% | 17.5% | 16.2% | 16.1% |
| Closing number of shares (m) | 810.7 | 1,239.9 | 1,242.6 | 1,242.6 | 1,242.6 |
| Average number of shares in issue (m) | 652.8 | 975.2 | 1,242.1 | 1,242.6 | 1,242.6 |
| IFRS EPS (p) | 12.6 | 11.3 | (3.4) | 8.4 | 10.9 |
| EPRA EPS (p) | 5.6 | 5.9 | 5.8 | 5.7 | 6.0 |
| DPS declared (p) | 5.86 | 5.94 | 6.00 | 6.00 | 6.00 |
| Total EPRA earnings (£m)/Total dividends paid (£m) | 104% | 108% | 101% | 95% | 100% |
| EPRA NTA total return | 12.1% | 12.5% | -5.9% | 8.2% | 10.4% |
| BALANCE SHEET | | | | | |
| Investment property | 1,148.4 | 1,561.6 | 1,777.9 | 1,813.6 | 1,877.7 |
| Associate | 130.3 | 177.1 | 50.1 | 0.0 | 0.0 |
| Other non-current assets | 131.3 | 193.1 | 109.3 | 59.2 | 59.2 |
| Total non-current assets | 1,279.7 | 1,754.7 | 1,887.2 | 1,872.8 | 1,936.8 |
| Trade & other receivables | 3.1 | 1.86 | 5.0 | 5.2 | 5.4 |
| Cash & equivalents | 19.6 | 51.20 | 7.5 | 12.0 | 9.8 |
| Other current assets | 0.2 | 0.28 | 0.3 | 0.3 | 0.3 |
| Total current assets | 23.0 | 53.35 | 12.8 | 17.5 | 15.5 |
| Deferred rental income | (12.1) | (16.4) | (16.4) | (16.4) | (16.4) |
| Current tax liabilities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Trade & other payables | (8.4) | (10.7) | (15.1) | (15.6) | (16.2) |
| Total current liabilities | (20.4) | (27.0) | (31.4) | (32.0) | (32.6) |
| Bank borrowings | (409.7) | (348.5) | (549.0) | (509.5) | (510.0) |
| Interest rate derivatives | (1.2) | 0.0 | 0.0 | 0.0 | 0.0 |
| Total non-current liabilities | (410.9) | (348.5) | (549.0) | (509.5) | (510.0) |
| Net assets | 871.3 | 1,432.5 | 1,319.5 | 1,348.8 | 1,409.7 |
| IFRS NAV per share (p) | 107 | 116 | 106 | 109 | 113 |
| EPRA NTA per share (p) | 108 | 115 | 102 | 105 | 109 |
| CASH FLOW | | | | | |
| Net cash from operations | 42.8 | 63.0 | 79.3 | 84.0 | 87.5 |
| Acquisition & investment in investment property | (570.0) | (388.7) | (331.1) | 0.0 | 0.0 |
| Investment in associate | (58.7) | (3.5) | 140.0 | 50.1 | 0.0 |
| Other investing activity | (0.9) | (10.6) | 0.0 | 0.0 | 0.0 |
| Net cash from investing activity | (629.5) | (402.8) | (191.1) | 50.1 | 0.0 |
| Share issuance (net of costs) | 345.6 | 496.4 | 0.0 | 0.0 | 0.0 |
| Debt drawn/(repaid) | 284.7 | (61.1) | 200.0 | (40.0) | 0.0 |
| Interest paid and other financing costs | (9.3) | (12.7) | (60.8) | (15.0) | (15.2) |
| Dividends paid | (34.9) | (51.1) | (71.1) | (74.6) | (74.6) |
| Net cash from financing activity | 586.0 | 371.5 | 68.1 | (129.5) | (89.7) |
| Change in cash | (0.8) | 31.6 | (43.7) | 4.6 | (2.3) |
| Opening cash | 20.4 | 19.6 | 51.2 | 7.5 | 12.0 |
| Closing cash | 19.6 | 51.2 | 7.5 | 12.0 | 9.8 |
| Debt as per balance sheet | (409.7) | (348.5) | (549.0) | (509.5) | (510.0) |
| Net debt | (390.1) | (297.3) | (541.6) | (497.5) | (500.3) |
| LTV | 34.0% | 19.0% | 30.5% | 27.4% | 26.6% |

Source: Supermarket Income REIT historical data, Edison Investment Research forecasts

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