Every little £5bn helps

JULIA BERRIS TALKS TO TESCO TREASURER NICK MOURANT TO CHECK OUT TESCO'S PROPERTY SALE AND LEASEBACK DEAL.

Tesco is arguably the most exciting corporate success story in Britain today. With a large slice of UK consumers regularly selecting items from its shelves, the retail giant can apparently do no wrong.

The first quarter of 2006 shows a promising start to the year and highlights Tesco's plans for the future. Group sales for the first quarter increased by 10.1% with international operations up by 15.1% at constant exchange rates. The store group say that it is well on track to deliver its largest ever programme of new store openings this year, which will provide more than six million square feet of new selling space internationally. In terms of square footage Tesco has 45% of its business in the UK, with the remaining 55% in 12 other countries across the world.

With Tesco's plans for operating in even more stores in the UK and overseas, it is hard not to be astounded by the speed of its growth.

The company has been in the news lately for a variety of acquisitions in the Czech Republic and Poland. But perhaps a more unusual news items is its property sale and leaseback transactions, which began in March 2004. But this stepped up a gear when the company's preliminary results for 2005/6 released this April, included the announcement that £5bn of cash is to be released from its property portfolio over the next five years.

Group Treasurer of Tesco, Nick Mourant, explains why Tesco chose to release this capital and the significance it has for the food retail market.

Mourant says: "Tesco is a retailer with a lot of property. If we were a property company we would, arguably, be the largest property company in the UK.

"We have a book value of fixed assets of circa £15bn. The market value of those assets is probably in the area of £22 - £23 bn. Tesco's market capitalisation is probably about £27- £28bn. The vast majority of the value of the company sits within our freehold assets.

One of the things we were keen to do was to make our shareholders aware of the value of the asset base to the company."

The site of a store holds great value to a retail company. Mourant explains that it is important to be aware of and have control of this value and to maintain a strong presence on high streets and other prime retail spaces.

If we flashback prior to Tesco's first sale and leaseback – which was a joint venture with Topland for £675m for 33 supermarkets and two distribution centres – Tesco was primarily in a tenant position, renting property from landlords.

Mourant says: "The balance of economic risk that was being taken between landlords and Tesco, as a tenant, was too heavily favouring the landlord. The returns that the landlords were making made that form of funding inappropriate for us."

Tesco spends approximately £3bn a year on new capital expenditure. Each year over £2bn of new freehold is being added onto its books. Tesco has worked hard on property funding and making the most of the value it has in the sites it occupies.

Mourant says: "The value of our property assets is split as 85% of our property is freehold and 15% leasehold. Directionally we want to maintain a 80%:20% split between freeholds and leaseholds. We wanted to be explicit around keeping to the split and the level of property funding we would take. We said we were looking to take £5bn of sale and leaseback of property funding over the next five years."

Of the £5bn of cash being raised, £1.5bn will go into share buy backs and £3.5bn will go into funding of new opportunities and growth for Tesco.

Mourant explains that a key part of the recent unveiling of the Tesco master plan was to be clear about maintaining their 80/20% freehold/leasehold split and to ensure shareholders fully understood what these plans meant.

He says: "We wanted to be explicit about the level of property funding that Tesco would be taking on board. We also wanted to give assurance to the shareholders that we would not be looking to issue new shares but to buy in shares.

"This allows us to manage our weighted cost of capital to nearer the optimum. What we are saying is that we wish to remain as an investment grade company but that we are prepared to put operational gearing into the business."

The sale and leasebacks are primarily joint ventures. Joint ventures are a more attractive option for Tesco because of the predicted continued growth of food retail properties.

Mourant explains: "Tesco has a choice of receiving 100% of the capital and completely foregoing all future growth in the value of the properties. Or, receiving 90% of the capital upfront and retaining 50% interest and the control and operational flexibility over how we run our shops via the joint venture."

While the developments in accounting have made the last three transactions with Topland, Morleys and Consensus a more complex process, the property sale and leaseback is a major part of Tesco's continuing growth plans and realising the value locked up in its property.

Mourant explains that the company is attempting to manage its competitive position internationally and in the UK. He says: "This has made us look more closely at where we see the values in our properties and we are managing the assets more closely than we used to."

Mourant sees the involvement of treasury in how leases are structured as beneficial providing better value for the company. He says: "It is a form of funding that is much better for Tesco than a five year upwards only lease with no interest in future value growth."

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