Sainsbury's

Market Capitalisation	£5bn
Net Revenue	£23bn
Operating Profit	£81mn
Net Debt	£2bn
Net Debt / EBITDAR	4.1x
Interest Cover	7.4x
Rating	Unrated

Sainsbury's is a UK household name and supermarket with a market capitalisation of £5bn, and is a component of the FTSE 100 Index. Sainsbury's was founded in 1869 and today operates over 1,200 stores, which employs around 161,000 people.

The Bond

Sainsbury's has recently issued a hybrid perpetual with a 6.5% coupon, callable in 5 years. The bond is subordinated, unsecured and is also unrated partly due to its issue size of £250mn. As a result of the hybrid nature Sainsbury's has the option to defer the coupon if the company does not pay a dividend. However we believe this is very unlikely given Sainsbury's has a 30 year track record of paying a dividend, a dividend cover of 2x, and has continued to pay a dividend throughout the financial crisis and over the current difficult market environment. Although defined as a perpetual, the bond coupon resets every 5 years and on the first call date in 2020 there is a very punitive step up of 5%, which means at current interest rate levels the bonds coupon would reset to 11.5%. As a result, we believe this is very likely to be called in normal market conditions.

Industry Under Pressure

The UK supermarket industry has recently been hitting the headlines due to its highly competitive nature with new market entrants and the changing of customers' desires. Sainsbury's believes its price gap over the discounters was about 20-25% a year ago, but this has shrunk by 10% over the past year and they foresee the long run premium to stand at 5-10%, as only 20% of items sold overlap with discounters and consumers are willing to pay a premium for convenience. Sainsbury's is principally joint second in the market alongside Asda, with just shy of 17% of market share, trailing Tesco's dominance of closer to 30%. Sainsbury's is dealing head on with these challenges, having launched a strategic review which includes £500mn of cost savings and mothballing some new store opening plans.

Cognisant of the change in dynamics in the industry, a key metric analysed is the exposure to hypermarkets, a fashion which is quickly fading, and which is particularly poignant given Sainsbury's recent £900mn write down in their property portfolio. Sainsbury's has slightly below the industry average of food retail stores defined as hypermarkets (6%), but 23% of their square footage. Sainsbury's is being proactive at managing their land bank by working with new joint ventures to deliver cross functional facilities, including new homes, local shops, restaurants and office space.

The chief executive of J Sainsbury plc, Mike Coupe, has pledged to "reinvent" the supermarket and "push the boundaries" of shopping in an attempt to fight back against falling sales. Sainsbury's has already struck partnerships with key providers, such as Argos, to utilise floor space and make supermarkets more convenient, selling off their pharmacy unit to the owner of Lloyds Pharmacy for £125mn.

Sainsbury's is fighting back against the rise of discount stores, going into partnership with Netto. It has teamed up with Denmark's biggest retailers to start by opening 15 stores in northern England in 2016. This is a complementary move to the existing business and gives the company access to a fast growing subsector of the industry.

The convenience stores are flourishing, these make up 55% of Sainsbury's stores bringing the total to 707 and the aim to grow this by one or two stores a week. This sector now generates sales of over £2.1bn and delivered over 16% growth in the last financial year.

Sainsbury's has also signalled potential to significantly grow their financial services arm, aiming to alleviate pressure on the grocery division. The supermarket's bank already has 1.7mn customers. Sainsbury's took full control of its bank at the end of January last year after buying the remaining 50% from Lloyds Banking Group for £248mn. As the bank continues to migrate away from the Bank of Scotland system there continues to be execution risk and significant costs. At the moment its product range is limited to credit cards (a key area with 55% growth in the last financial year), personal loans and insurance, totalling £3.03bn at 28th February 2015. Unsecured personal loans are essentially the bank's core product, representing 71.6% of outstanding balances which is typically out to 7 years, with amounts loaned in the £1,000-35,000 range. The net interest margin has performed well, increasing from 2.7% to 3.6% over the recent period. The bank is already a money-spinner for Sainsbury's having made around £60mn in the past year, or nearly 10% of the group's overall profit. The bank is also employing a similar strategy to the grocer by joining forces with Western Union to offer money transfer services in 170 stores.

Although not insulated from market trends, Sainsbury's has fared better than its peers partly due to the slightly less cost sensitive clientele and focus on London and the South-East of England. Operating margins fell to 3.1%, historically on average 3.6%, this is compared to over 2% falls in margins from Tesco's and Morrison's. A similar trend was observed with retail sales falling 1.9% compared to 3.3% at Tesco's or 5.9% at Morrisons. Sainsbury's recently announced the first drop in annual sales for nine years and, after taking into consideration the property write down, a first loss in 10 years. We are of the belief that the loss is a once off, with the new management taking the opportunity to be conservative on property values and the company stating that margins will "stabilise" at around 3%. Excluding one off charges, Sainsbury's delivered a profit of £681mn, 15% down on the previous year but ahead of analysts' depressed forecasts. Total sales declined by 0.7%, excluding fuel, to £23.8bn. The fall in supermarket spending has been partially offset by the rise in convenience stores, online sales rose over 7% to £1.1bn and sales of non-food including clothing rose 9%.

Financial Analysis

Sainsbury's has a strong balance sheet, predominately with £11.1bn of property assets. The group has a net debt of £2.34bn, which we believe is reasonable given the asset base and 42.3% gearing within the company. The gearing is conservative and attractive compared to peers, for example, Tesco has 120% gearing and Morrisons 65% although this is affected by the financial structuring arrangements. Sainsbury's is in line with peers and has consistently maintained a lease adjusted net debt to EBITDAR in the region of 4x EBITDAR, currently standing at 4.1x. The fixed charge cover is slightly below historical levels of 3.1x, currently at 2.9x. This lies significantly below that of Morrisons at 4.8x but is more conservative than the 2.2x at Tesco.

In light of the strategic review we anticipate a lower level of capital expenditure going forward, improved working capital and significant cost savings to be realised all improving the liquidity of the business.

Conclusion

We believe that this is an attractive opportunity to purchase a UK household name's debt at a relatively attractive yield of approximately 6%. In particular, for UK tax payers this is pricing close to par which provides a more tax efficient yield. It is difficult to achieve this yield from a FTSE 100 corporate and we believe the structure and rating ensures this bond has priced attractively. We believe Sainsbury's is in a strong financial position and has a clear strategic plan to weather market challenges. We are given significant confidence by the size of the organisation, the ability to raise cash through the equity markets if required as well as the punitive step up in 5 years' time. As a result this is a high conviction investment and we continue to be a buyer for fixed income portfolios.

INCOMEPLUSPORTFOLIOS

The Credo Income Plus portfolios (“CIP”) are three high conviction bond portfolios across 2 currencies, each with a minimum targeted annual return that we would expect to achieve over the life of the portfolios, assuming bonds are held to maturity.

Investment Process

Investment Universe	Screening	Analysis	Portfolios Construction
- Primary market is Eurobonds in various currencies - $150m or £100m minimum issue size	- Both quantitative and qualitative - Eliminate bonds that offer inadequate compensation or have significant risks	- Balance sheet strength - Cash flow - Profitability - Reputation of issuer - Terms of debt - Interest rate sensitivity - Debt maturity	- Aim to achieve diversity across both industry and maturity - Portfolios of typically 7-12 high conviction holdings

Ongoing monitoring and analysis

Execution

Unlike the equity world, bonds are generally traded telephonically and ‘best price’ is not always shown on data sources such as Bloomberg. It is important, therefore, to have a large network of trusted broker-dealers and intermediaries to ensure that bonds are traded at the best possible levels. We have a wide network of market contacts and counterparties making Credo a very attractive house through which to purchase these instruments.

Liquidity

The corporate bond market can become illiquid especially during times of financial stress. In addition certain bonds have large minimum dealing sizes that may be in excess of an individual client’s position. It is therefore possible that an investor who wishes to redeem bonds before the stipulated redemption date may not be able to sell as and when required at the reported price if indeed at all. We will endeavour to aid liquidity for sellers.

Portfolios

Low Volatility	Medium Volatility	High Volatility
Appropriate for the more cautious investor. Bias towards high quality short dated senior investment grade bonds. The portfolio takes little risk in terms of credit and sensitivity to interest rates. A relatively low level of volatility can be expected.	This portfolio will take on a little more risk but should still not exhibit significant volatility. We may invest in longer dated bonds and subordinated debt. Some holdings may further not be investment grade. The portfolio is likely to contain more financial exposure but an emphasis on quality will be maintained.	For the more adventurous investor, this portfolio will contain significant exposure to financial paper, longer dated bonds and special situations. The portfolio is likely to experience significantly more volatility than the others. A material part of the portfolio will nonetheless be investment grade.

Current Portfolios

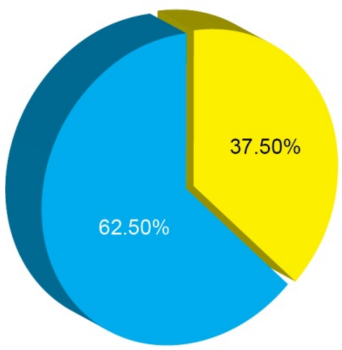
GBP	Target	Yield*
Low Volatility	2% +	2.66%
Medium Volatility	3% +	4.05%
High Volatility	5% +	5.06%

USD	Target	Yield*
Low Volatility	2% +	2.77%
Medium Volatility	3% +	4.57%
High Volatility	5% +	5.47%

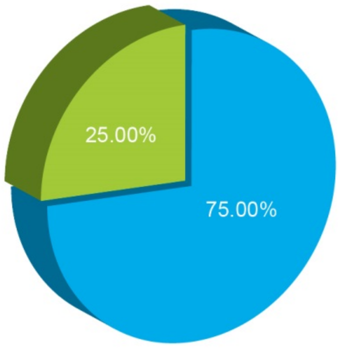
(*) For the annual yield we have estimated the most conservative likely outcome for investors.

Risk Ratings

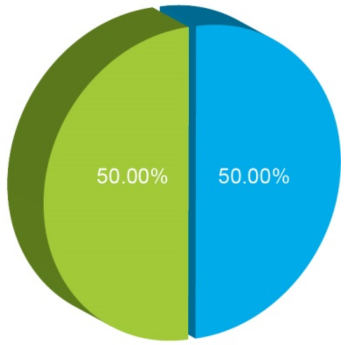
GBP



Low Volatility

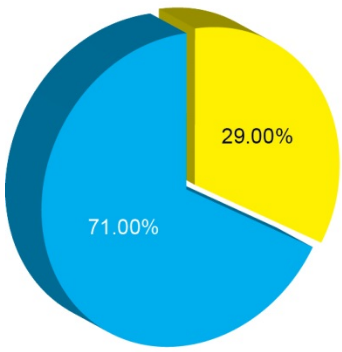


Medium Volatility

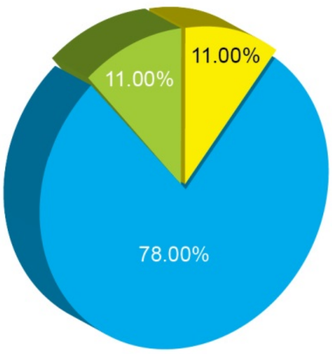


High Volatility

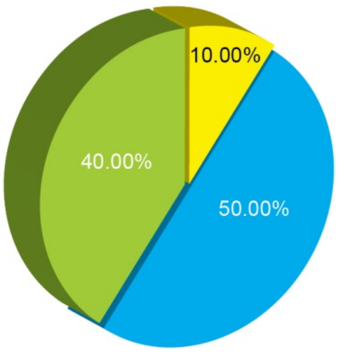
USD



Low Volatility



Medium Volatility



High Volatility

A rated and above   Investment grade   High yield

Investment Terms

Minimum Investment: £100,000 or US$150,000

Implementation

Investors should note that the minimum lot sizes of specific bonds that trade in the market are all different, with some as low as £1,000 and others as high as £200,000. Against this background, there may at times be some delay in aggregating orders. In some cases where we do not reach the minimum lot size within a suitable time frame, we may select alternative bonds.

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