

Spotlight UK Retail Warehouse Market

May 2015



Mattressman, Stevenage. Mattressman are the subject of this issue's retailer profile

SUMMARY

■ The consumer economy will continue to improve, and we expect retail warehousing to benefit both from an improving housing market and internet-driven change in shopper habits.

■ The occupational market is looking increasingly robust, with falling vacancy rates and strong tenant demand emerging across the country. We have identified a surge in demand for bulky goods units, and this may well prove to be the best performing segment of the market going forward.

■ Investor demand is still heavily biased towards prime, but we expect to see more interest in secondary assets as the occupational story improves.

■ This issue's retailer profile is on Mattressman, the latest of several retailers to transition from an online only offer to a multichannel strategy involving a store portfolio.

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"Investor demand will become more broadly focused geographically and sectorally."
Jaime Dunster, Savills
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➔ **Economic and consumer outlook**

Once the excitement, or disappointment, of the general election has died away we believe that the UK consumer economy is well set for a continued steady recovery across the UK. Retail warehouse retailers in particular should benefit from the recovery in house prices and housing turnover.

Consumer confidence has now been positive for four consecutive months, and above its long run average for 16 months, and this is pointing to a spring in the step of the UK shopper, despite a slight dip last month in shopper's attitudes towards now being the time to consider a major purchase.

While retail sales dipped unexpectedly in March, primarily due to a fall in fuel sales, the volume excluding fuel rose by 0.2% month on month, and 2% quarter on quarter. Of course, a lot of this strong spending growth is being driven by heavy discounting across both the food and comparison goods sectors and this is by no means a sustainable strategy for retailers.

Ultimately the key metric for us this quarter remains the fact that the "noflation" is providing a substantial boost to household's spending power.

The low level of inflation, whether it is marginally positive or marginally negative, is very important in the current environment where earnings growth remains weak. Indeed, despite a further drop in unemployment,

average weekly pay only rose by 1.3% in the year to February, well down on the levels seen last year.

We are forecasting that housing transaction levels will recover to around 1.3m a year in 2016, which while it is well behind the 2m turnover seen in 2004, is well up on the recessionary slump to 0.8m. There are obviously still concerns about the pace, if not the timing, of the inevitable rise in interest rates. However, we expect the rise to be gradual and over a long period, and this will not be enough to derail the consumer recovery.

Investment market overview

Retail warehousing continues to deliver steady total returns, with the average return for the 12 months to the end of March 2015 according to IPD of 13.8%. This is broadly in line with the return from shopping centres, and ahead of the returns from high street shops outside London.

The most interesting factor about the returns from this sector is the comparatively higher capital growth that is still being delivered (7.3% over the last 12 months compared to 6.7% for all retail). This points to potential for higher returns going forward as rental growth starts to recover.

Average annual rental growth for all retail warehousing has now been marginally positive since August 2014, but is still only showing 0.47%pa according to IPD. Given that rental growth in London has been nearly 2% over the last 12 months, and across the South East 0.7%, we expect to see

this recovery spread out across the rest of the UK's key retail parks over the next 12-18 months.

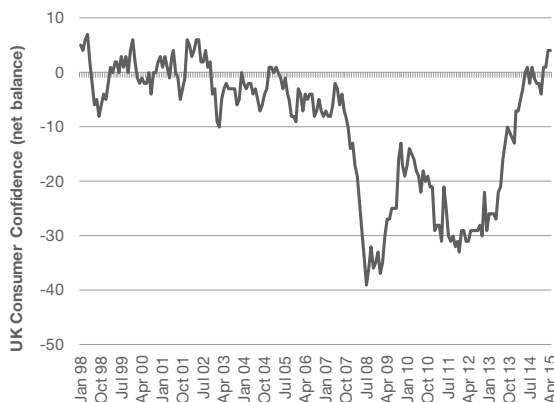
Interestingly the rate of the rental growth being delivered by the retail warehouse sector is substantially ahead of that of the shopping centre market. This is perhaps a reflection of the strength of tenant demand that is present in the bulky goods retail warehouse market, a theme that we examine more closely in the occupational section of this report.

Investor demand for retail warehousing remains heavily polarised between locations that are perceived as strong, and the rest. The weight of demand for prime parks in prime locations far exceeds supply, however searching questions are still being asked about investments that don't score an A on location and tenant demand.

The most active purchasers at present are the UK institutions, though we are seeing increasing interest in retail warehousing from non-domestic investors, particularly the opportunistic US funds who are targeting yields of 6-6.5%. In terms of lot size the current sweet spot appears to be £20-£50m, where the supply of good quality assets has been very limited over the last year. Typical of this segment of the market is the recent sale of Drakehouse Retail Park where Savills advised Hammerson on the disposal of the park to clients of 90 North for £61.7m, 6.4% NIY.

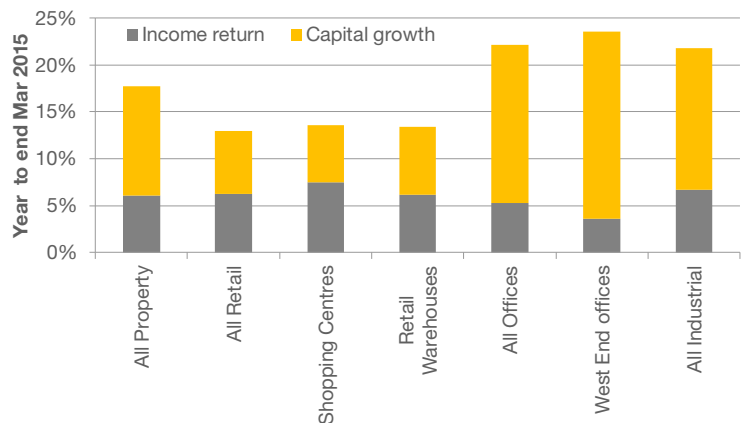
There is a danger of an impasse in the "off prime" sector, with investors ➔

GRAPH 1 **Consumer confidence**



Source: ONS, GfK

GRAPH 2 **Components of total returns**



Source: Investment Property Databank

→ over analysing potential weaknesses and valuers over emphasising the strengths, and linking values to prime.

Looking ahead we expect to see the investor caution about A- and B+ parks diminish, particularly as the positive story on the occupational side begins to feed through into investor's minds. At present we believe that these are the best value assets, offering a degree of capital value growth, as well as the potential to asset manage some rental growth as the consumer recovery gathers pace.

Investor demand will become more broadly focused on the top 80 locations, targeting areas of undersupply and swinging towards the best bulky goods parks and away from overrented shopping parks. The moment is definitely approaching when investors will begin to see a void on these types of schemes as an opportunity rather than a risk. However, there is still a question over how quickly the true rent will rise above the passing rent in much of the sector.

Occupier market overview

The occupational market is currently in far more robust health than much of the recent comment on this sector might lead you to believe. Indeed, while the received wisdom is that the Open A1 segment is the strongest part of the market, we are currently seeing more tenant demand from bulky goods retailers than from the high street retailers.

There is undoubtedly still tenant demand focused on the best shopping parks, with Next, Primark, Debenhams, and M&S all targeting 15,000 sq ft plus stores, and TK Maxx, M&S Simply Food, Outfit, Wilko and H&M all active in the 10-15,000 sq ft segment. However, the number of new entrants to the shopping park segment for the traditional 10,000sq ft store has dwindled, particularly in comparison to the demand for bulky goods parks. The key size requirement sought on shopping parks is 2,000-5,000 sq ft to cater for the new entrants that include Schuh and Fat Face, as well as other occupiers such as Superdrug that are expanding onto these schemes.

Indeed, it has been a long time since we have seen such strong retailer demand for bulky goods schemes, with more than 20 retailers actively seeking new units across the full range of unit sizes from 3,000-20,000 sq ft. The most exciting aspect of this demand is the number of new entrants to either market, including such names as Mattressman (who we profile in the next section of this report), Smyths Toys, Tapi Carpets, Cycle Republic, Evans Cycles, Sofaworks, Betta Living and Furniture Barn. These requirements are combining with those of the more established players in this segment, such as Wickes, Dunelm, Furniture Village and SCS to create an environment where real rental growth is becoming more than just an aspiration.

Certainly the supply-side story is improving, at least from a landlord's perspective. The latest trends reported by Trevor Wood in The Definitive Guide to Retail & Leisure Parks 2015 show that the overall vacancy rate has fallen from its peak of 11.8% to 7.1% at the end of 2014. The vacancy rate on Open A1 consented schemes is now as low as 6.1%, its lowest level since 2005. In comparison these rates have more in common with the City of London office market.

Interestingly, these low void rates are not just a story in London and the South East. A lack of development and recovering demand has led to some parts of the UK, including East Anglia and the North, now showing overall retail warehouse vacancy rates of less than 5.5%. With a very limited development pipeline ahead, these locations could be amongst the first to see a race for space and a swing from overrented to real movement in headline rents.

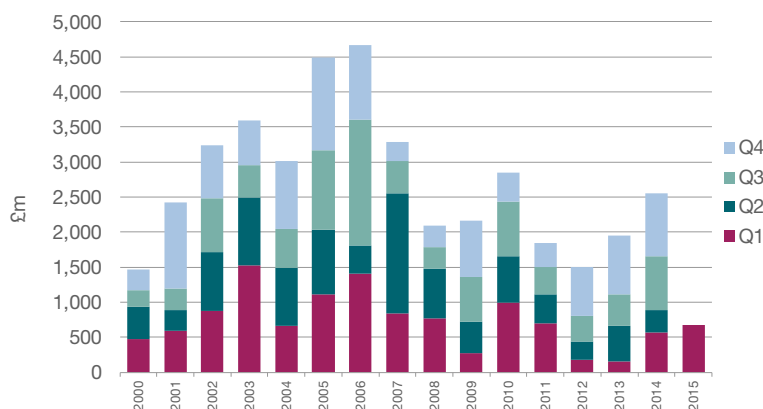
There is still potential for some significant tenant release of retail warehousing space, with both Homebase and B&Q having announced plans to reduce the sizes of their estates by 20-25%. If both these retailers were to manage such a reduction it would see around eight million square feet of space being returned to the landlords. However, this is likely to prove hard to do given both the expiry profiles of these estates, and the limited ability to sub-lease the larger units that B&Q in particular occupy. We expect that Homebase will be more successful in →

TABLE 1 **Retail warehouse yields**

	Dec 2012	Dec 2013	Dec 2014	May 2015
Shopping Park	5.25%	5.25%	5.00%	5.25%
Prime Open A1	5.25%	5.00%	4.25%	4.25%
Prime Restricted	6.00%	6.00%	5.25%	5.25%
Secondary Open A1	6.50%	6.00%	5.00%	5.25%
Secondary Restricted	7.75%	7.25%	6.00%	6.25%

Source: Savills

GRAPH 3 **Retail warehouse investment volume**



Source: Savills

→ achieving their rationalisation plans, and that tenant demand for these mid-size stores will be stronger, particularly given the current strength of demand for bulky goods units across the UK, and the increasing store size requirements of the value retailers such as B&M and Home Bargains.

Looking ahead, we expect that bulky goods tenants will remain acquisitive, and that they will be the retailers offering the strongest rental terms. Fashion tenants will continue to demand high premiums and short lease terms, as competition from neighbouring high street landlords remains intense. Development activity will pick-up, though it will remain at a very low level in comparison to the norm. There will also be a significant refurbishment programme both by retailers and landlords, as the acceptance of the need to provide a positive shopper experience even on out-of-town schemes becomes more widespread.

Retailer profile Mattressman

Mattressman is a successful internet-

based retailer looking to expand its multi-channel operation by building a national store portfolio. It is interesting both as a new entrant to the sector, as well as a reflection of an increasing trend of e-tailers who are expanding into the traditional world of physical stores.

Mattressman was established in Norwich in 2004 by Andrew Kerry as an internet mattress retailer. The business has grown steadily over the last eleven years, picking up the Sunday Times Fast Track Award in 2009 as Britain's 6th fastest growing company, and the E-Commerce Initiative Award in 2011. Mattressman is now the leading online retailer of mattresses with a turnover of c£25 million predicted this year.

Key relationships with suppliers and logistics companies mean the company is able to offer free next-day delivery – a unique service within the industry. Mattressman has recently expanded into manufacturing with the launch of a sister company, the British Bed Company, in 2012. To complement its strong online presence and become a true multi-channel retailer, Mattressman has expanded

its physical store portfolio to 14 units across the East of England and Greater London area, recently acquiring a 15th in Northampton. It is now looking to further expand this portfolio.

Mattressman is focusing on acquiring prominent stores on retail parks or busy standalone locations. Initially the focus will be on the South East / Greater London and East & Central Midlands. These stores will ideally be between 2,000 – 5,000 sq ft with a minimum internal width of 6.1 metres (20') and shared parking. Larger cities are likely to feature a hub and spoke system of a larger store of c. 7,500 sq ft serving several smaller stores to ensure Mattressman's delivery service is maintained.

Rent and lease terms will obviously vary across the country but in the initial roll out Mattressman is looking to take standard 10 year leases with a tenant-only break in the fifth year, in keeping with a number of retailers in the market at present. Mattressman's specification is very straightforward with the standard shell including an amenity block, shop front (ideally with glazing), screeded floor and signage areas. ■

Savills out-of-town retail team

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