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UK Shopping Centre and High Street Bulletin

Q1 2014

SUMMARY

■ There are still challenges ahead for the consumer economy, but a real recovery is now firmly underway.

■ Retailer requirements remain highly polarised, and in many cases new openings are being outweighed by rationalisations.

■ Investor demand for both shopping centres and high street shops is becoming less risk-averse.

"The trading environment for UK retailers will definitely continue to improve over the remainder of 2014 and into 2015."

The consumer economy

The most significant recent economic trend that relates to retailing has been the steady improvement in consumer confidence since its record lows during the global financial crisis. Over the last three months consumer confidence has continued on its upward trend and is now back around the pre-Global Financial Crisis levels, albeit in negative territory still. The latest data for April shows that the confidence level has improved to -3, which is better than the long run average for this index. Retail sales are also nearly 4% up on 2013.

Future growth in retail spending will have to be driven by more than just reductions in savings, and this means the key metric to watch at present is the growth or otherwise in real average earnings. The recent declines in CPI, from over 3% per annum in 2012 to 1.7% at the end of February 2014, has definitely started to herald a more positive period ahead for real earnings growth. Indeed, with average earnings rising by 1.5% in 2013, the UK consumer should start to feel richer in the next few months.

There are undoubtedly still challenges ahead for the consumer economy, with the bulk of public sector cuts still to be implemented, and the timing and pace of rises in the base rate still unclear. However, a real consumer recovery is undoubtedly underway, though the phasing of that recovery around the country will depend very heavily on the structure of individual regional and local economies. The latest forecasts for total household spending in the UK are for average annual growth at constant prices of 2.4% per annum over the next decade, significantly better than the 1.1% per annum that has been seen over the last ten years.

The retail occupational market

The Christmas pick-up in trading that we commented upon in the last issue of this report is symptomatic of a trend that a number of retailers have commented on, where consumer are apparently savings up their discretionary spend for the key holiday periods. This is probably a reflection of the relative weakness in consumer confidence, and our retailer clients are generally reporting that this trend has continued in the first quarter of 2014. Generally, trading has been quiet over the first three months of this year with retailers suggesting that this is because spending is being delayed until the Easter weekend which was late this year. Easter, which has always been a hugely significant period for DIY and garden retailers, is shaping up to be equally important for clothing and other general merchandise operators.

The most acquisitive segment of the market remains the convenience store operators, with continued expansion by Sainsburys and Tesco being added to by Morrison's desire for significant growth in London and the South, and newer concepts such as Boots' non pharmaceutical based convenience store offer.

There has been a wide spread of performance in the clothing and accessories sector in recent years, with higher end offers such as White Stuff, Jack Wills, Jigsaw, Radley and Joules all reporting strong growth in sales and planning further expansion. At the lower end of the scale Primark continue to expand, both opening new stores and looking to enlarge the size of their stores in existing trading locations. The mid-market remains challenging, with Marks and Spencer continuing to lose clothing market share.

The polarisation in retailer's locational requirements remains significant, with many retailers on strong pitches now reporting regular approaches from other retailers who want them to assign their leases. However, demand remains patchy away from these prime pitches.

Many of the new store openings that are being announced are not net new openings, with retailers across all segments of the market continuing to rationalise their portfolios by closing poor-performing stores. Furthermore, a number of large retailers are looking to reduce operational costs, either by cutting headcount in their head offices, or by attempting to drive down distribution costs. The latest research on store closures from PwC and the Local Data Company shows that shops are closing at a rate of 16 per day across Great Britain, though this is down from the 20 per day that was seen in 2012. Indeed, the PwC research states that the year-on-year net reduction in multiple stores has fallen by almost 80%. Interestingly, these figures hide some more recent changes, with several of the jewellers now back in a firmly expansionist phase. Furthermore, the relaxation of change of use from A1 to A2 has been met with significant interest from new and established financial services operators. For example, Metro Bank, Barclays and Lloyds banks are all currently looking for new banking hall premises. We also expect that the change to the pensions system that was announced in the Budget will lead to a sharp increase in the number of Independent Financial Advisors on the nation's high streets.

The trading environment for UK retailers will definitely continue to improve over the remainder of 2014 and into 2015. We expect that a combination of an improving housing market, and the return of real income growth will stimulate a pick-up in spending across most goods sectors. Retailers are rapidly adapting to the world of internet retail, and while this will mean that they need fewer shops, the average unit size that they require will rise. There will be further rationalisation of store portfolios to adapt to this new world of multi-channel retail, but the retailer demand to get into the best regional and sub-regional markets is already intensifying.

Shopping centre investment

Q1 2014 saw Shopping Centre Investment turnover increase 36% on Q1 2013, rising from £1.4 billion to £1.9 billion. This was in 28 deals. The average initial yield in Q1 2104 was 7.94% compared to 8.9% in Q1 2013.

Notable transactions in Q1 2014 included the:

- Acquisition by Valad of The Royals in Southend for £33.4 million from Orchard Street reflecting a net initial yield of 7.8%.
- Acquisition by InfraRed and Hark of the Eastgate Centre Basildon for £88.6 million, reflecting a net initial yield of 7.1% initial.
- Acquisition of Middleton Grange Shopping Centre Hartlepool and Four Seasons Shopping Centre Mansfield by Mars Pension Fund for a total of £53 million, reflecting a blended 8.9% initial yield.
- Acquisition by Hines and HSBC of Liffey Valley Dublin for €284 million, reflecting a 7.72% net initial.

- Acquisition by Legal & General of Overgate Centre Dundee from Land Securities for £125.3 million reflecting 7.4% net initial.
- Acquisition by Orion Capital of Trinity Walk, Wakefield for £149.5 million reflecting 6.7% net initial.
- Acquisition by Intu of Westfield Derby for £390 million reflecting 6.89% net initial and a 50% stake in Merry Hill Shopping Centre for £407.5 million reflecting a 5.21% initial.

Currently there are c.£500 million of deals under offer, a further £1.1 billion in the market and another billion pounds likely to come to the market in the coming months.

2014 has continued where 2013 left with increased investor activity and demand for the sector from all quarters from both private equity, property company, opportunity funds, institutional and sovereign wealth funds. At this early stage in the year we would therefore estimate that total transaction volumes for the year could total over £4.5 billion compared to the long term average of £3.8 billion.

The notable trend has been the increase in activity from the institutional investors. This is largely driven by the continued increase of inflows, improvement in the wider market sentiment, the quality of assets available and the weight of money. We continue to see a great deal of new entrants coming into the market backed up by increased supply, quality, cost and loan to value of debt.

This improvement in market sentiment is supported by increased confidence in the retailer outlook.

We are seeing a continued reduction in the yield gap between prime and tertiary and also in respect of the prime and secondary of the town centre dominant secondary schemes, in the right towns. This means the right assets in the right town at the right lot sizes are been eagerly contested with the opportunity funds having to lower their return hurdles.

We are also starting to see a reduction in the vacancy rates in a number of schemes and investors are keen to take the benefit of these vacant units in order that they can stamp their mark through active asset management to reduce this vacancy in the shorter term and add value.

As we saw in 2012 and 2013, the increased trend of shopping centres forming part of a number of high profile loan sales has continued. Loan sales are acting like a speed bump in the supply of stock to the investor market, as in many cases these loans are bought to sell the assets off in the short term. The area of the market that continues to have the least amount of market demand relates to those assets with a short weighted average unexpired of less than 4 years and investors are still pricing in considerable risk. In some case these assets have remained unsold.

TABLE 1

Shopping centre yields

	Q4 2013	Q1 2014
Super-Prime	5.00%	5.00% ↓↓
Prime	5.25%	5.25%
Town Centre Dominant	7.25% ↓	7.00%
Secondary	9.00%	9.00%
Tertiary	13.00%	12.00%

Source: Savills

High street investment

There was an expectation as we headed into the first quarter of 2014 that the pace and tempo that had returned to the high street investment market would continue. The reality is that this has not been the case.

Investors and agents alike saw frenetic trading activity after the 'switch had been flicked' back in August. The sudden break in transactional constipation left everyone exhausted by the Christmas break but it would be wrong to think that deal fatigue could be blamed for the static market that we have seen over the first months of the year.

January is traditionally a rather 'phony' trading month. There is huge enthusiasm to do business, and a lot of talk, but generally institutional investors are, in the majority, using the time to assess where their year end valuations leave them and finalising their strategy for the year going forward. The quietening down of the market is in our view more down to the view that demand remains strong and values may improve further as we head towards the end of the year. There was huge relief in mid-2013 as the markets 'got going' again and transactional activity for fair priced assets once again presented itself.

Demand at both fund and property company / private levels has increased and the number of enquiries has risen. Funds are still enjoying good capital inflows and the retails funds in particular will be bolstered further as investors seeing last year's performance look towards property for their financial year end ISA allocation.

Demand is also improving at the property company level where the market is seeing signs of improved access to debt which not only means that buying with leverage is becoming a reality again but also brings with it the prospects of refinancing becoming a real possibility. This heightened demand coupled with the expectation that values can only improve has caused a tightening in the market. The conclusion to this is that values should continue to rise especially for prime well secured freehold property and as we witnessed at the end of last year, premium values can still be attributable to those shops with unexpired leases in excess of 10 years.

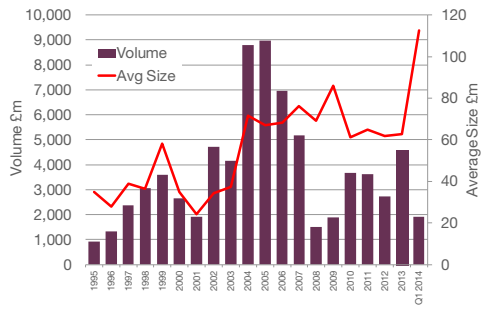
Some investors are looking to capitalise on the lack of supply and for the first time for a while we have a market that may find buyers for stock that until recently was not finding favour. Enthusiasm for risk is not there wholesale yet but there are parties who are beginning to put a toe in the water and as such may well be rewarded. The question exists, however, as to whether the investment market may have raced slightly ahead of itself.

Whilst the interest rate scenario is very different to the investment market rally in 1994, the occupational market certainly is not. It is arguably still in a generally a worse state especially in second and third tier towns. Until the occupational markets have properly found their new world footing the recovery is not complete and in our view may not be sustained.

Whilst the UK consumer's financial position is improving, the reality is that domestic debt still remains too high and if interest rates start to peg up post next years election then all bets could be off for a smooth recovery in the occupational markets and for short term rental growth on the high street. n

GRAPH 1

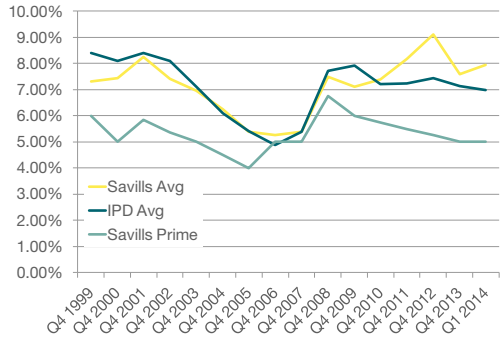
Shopping centre investment volume



Source: Savills

GRAPH 2

Shopping centre yields



Source: Savills, Investment Property Databank

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