UK Retail Warehouse Bulletin

Spring 2011

"Asset management led deals have started returning to the market."

Image: Elliots Field Retail Park, Rugby. Recently sold as part of Project Blue.

- The retail warehousing sector continues to deliver an above average total return. Will renewed investor interest in the sector lead to further yield hardening?
- 2011 will be a challenging year for retailers and consumers, with real incomes falling for the first time in nearly 30 years. Will consumer confidence return in 2012, and what segments of the retail warehouse market will benefit first?
- Our regional overview this issue is on the South of England. Is rental growth emerging in this market, and is it sustainable?

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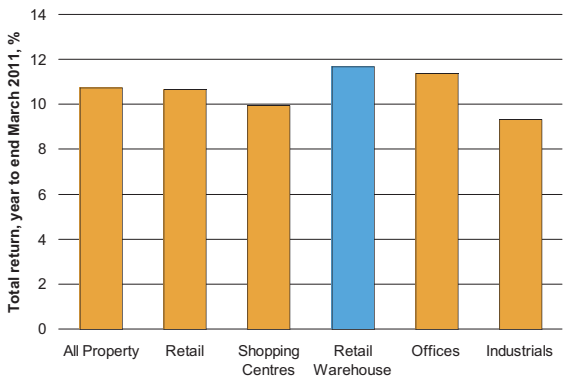
Investment performance trends

With the bulk of the downward correction in yields having passed, year on year total returns in all sectors have fallen since our last bulletin. However, as the the chart below shows, retail warehousing is still delivering an above average total return for the 12 months to the end of March 2011.

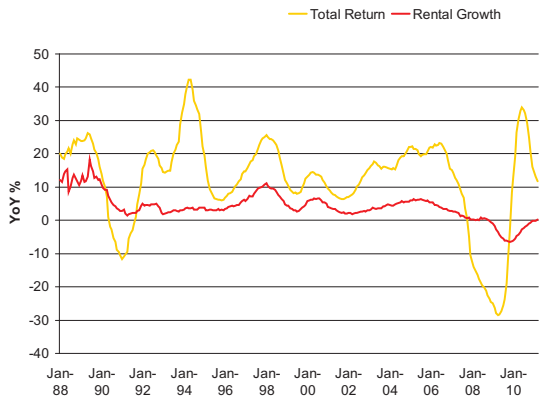
Retail warehousing is still delivering an above average total return



Source: IPD

The reasons for the continuing strong returns are twofold. Firstly, the sector is still showing some yield hardening, albeit at a more gentle gradient than before. Secondly, average rental growth across the UK is now marginally positive on an annualised and a three month average basis (+0.2%).

Rental growth has slipped into positive territory



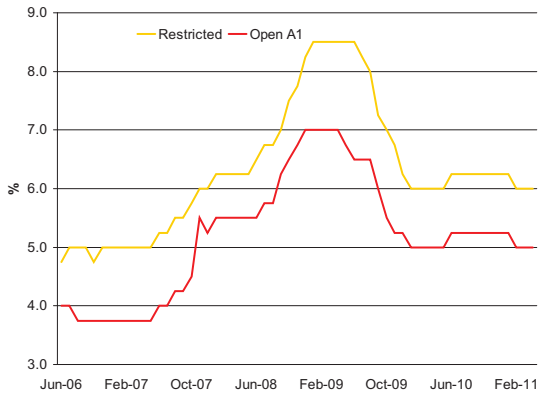
Source: IPD

The return to positive rental growth in the retail warehouse sector has led to renewed interest in the asset class from investors of all types, particularly from the UK-based institutions. Purchasers are primarily focused on prime assets, with the definition of "prime" encompassing lease length, covenant strength, catchment, and dominance of catchment. Given this increasingly tight definition of what makes a prime retail warehouse investment, it should come as no surprise that the availability of such stock is extremely limited.

Away from the narrow prime end of the market we have noticed a pick-up in investor interest in secondary assets. However, purchasers expect these assets to be priced accordingly, and in many cases vendors pricing expectations are too keen to suit prospective purchasers.

The recent trend in yields has been reasonably flat, with average yields as measured by IPD continuing to harden, while our own measure of prime yields ticked up in the second half of 2010, and have since then reverted to the slightly lower levels that were seen in early 2010.

Prime yields are broadly stable, but with some downward pressure returning to the market



Source: Savills

We believe that the volume of transactions in 2011 will be marginally lower than in 2010 due to investor's inability to find the prime opportunities that they are looking for. For owners of retail warehouse assets we believe that now may well be the time for some selective selling to capitalise on a pick-up in investor demand, a rise in interest in secondary assets, and a degree of over-pricing in the secondary market.

Prime retail warehouse yields (%)

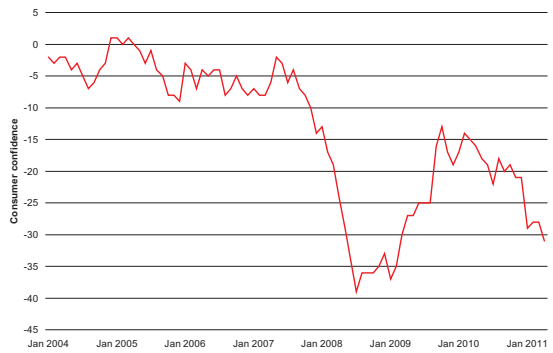
	Oct 2010	May 2011
	Initial	Initial
Shopping Park	5.00%	5.25%
Prime Open A1	5.00%	5.25%
Prime Restricted	6.25%	5.75%
Secondary Open A1	6.00%	6.00%
Secondary Restricted	6.75%	6.75%

Source: Savills

Consumer trends and outlook

The UK consumer remains in a firmly negative position in the face of concerns about job security, rising tax burdens, high inflation and speculation on the speed and gradient of the inevitable rise in interest rates. Indeed, April's GfK consumer confidence survey indicated a slump in confidence back to a low not seen since late 2008. So, when will these dampening effects on consumer confidence and behaviour begin to dwindle?

Consumer confidence remains firmly negative



Source: GfK NOP

At a macro-economic level the recent performance of the UK economy isn't as bad as the consumer might believe. At worst the economy is stagnant, and the most recent PMI surveys are pointing to a fairly firm recovery in manufacturing, construction and services. However, whatever measure you zoom in on the picture on inflation is the key issue that continues to hinder the perception of a recovery in the UK.

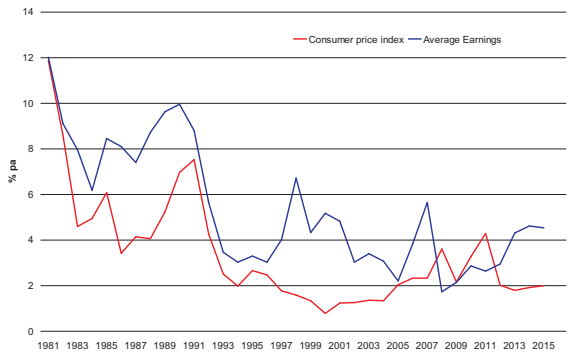
Two successive VAT rises are undoubtedly a major contributor to the current high level of inflation. Indeed, if we examine the Government's own measure of CPI with the impact of the VAT rises removed, inflation is running at a much more tolerable 2.5% level. The impact of these rises will diminish from next year, and this alone will reduce the headline rate of inflation by 100 basis points.

Inflation is also being driven up by other factors connected to the desire to reduce the budget deficit. For example, fuel duty rose by 2.76p per litre in the three stages over the last 12 months, with the ONS estimating that this contributed 0.12 percentage points to CPI. This rise was also subject to the rise in VAT.

The final driver of the current high level of inflation is commodity prices, with most commodity prices surging over the last nine months due to failed harvests, strong demand from emerging markets, and political turmoil in commodity producing regions.

The other traditional driver of inflation, wage inflation, cannot be blamed for the current high level of CPI, with pay settlements improving from their cyclical lows in 2009 to a relatively modest 2% in early 2011. Clearly this is a major factor behind the poor consumer confidence, with UK consumers facing a year of falling real incomes for the first time in 29 years.

Real average earnings growth will be negative in 2011



Source: ONS, Oxford Economics

Wages aren't rising very fast, because unemployment remains high, with the LFS measure having moved up from 5% at the peak of the last boom to its current level of 8%. Again, perceptions of job security are another dragging factor on consumer confidence. This figure would be even higher if it had not been for a massive increase in temporary and part-time working - much of it involuntary.

Bringing all these factors together it wouldn't be surprising to see a dramatic fall in retail sales. However, the resilience of the UK consumer is pretty astonishing, and to a certain degree refutes the data coming out of the consumer confidence surveys. Looking at the Government's own data on retail sales excluding fuel the three month annualised growth in retail sales is currently running at around 0%, while the year on year level remains at around 3%, rather improved on the marginally negative levels seen at the bottom of the downturn.

So, where is consumer demand going? The economic recovery will continue in its faltering fashion through the remainder of 2011 and into 2012, with the bulk of the positive growth coming from the manufacturing sector. By late 2012/early 2013 we expect that UK GDP growth will be back to 3% per annum with more balanced contributions from consumer spending, the services sector and the manufacturing sector.

As some of the drivers of inflation begin to disappear from January 2012, the need for rapid interest rate

Consumer trends and outlook

rises will diminish. One of the arguments put forward by those who favour an early rate rise is the need for the MPC to send a signal that it is not prepared to tolerate high inflation. However, even the Governor has said that this would be a "futile gesture". We would argue that at this stage a rate rise would do more harm than good. Rising rates would not reduce inflation, and would do nothing to relax the inflationary squeeze on the nation's wallets and purses. Furthermore, it is inevitable that the banks will pass any increase in the Bank Rate onto their borrowers, which would have a further dragging effect on household incomes and spending.

We believe that the recent slight slippage in the rate of inflation, and the dull Q1 growth in GDP mean that the prospects of a rise in May have now diminished, but the MPC will remain under pressure to begin raising rates in the August meeting.

Looking to the medium term the simple fact is that the current level of interest rates is an emergency one, and they will begin to rise from later summer 2011. Our latest base case is for a gentle rise in the base rate, with it reaching 4% by 2015.

As far as consumer spending on retail warehouse parks goes, there are a number of specific questions that need to be ask. Despite the recent drive of the general merchandise retailer onto schemes and parks, they still remain the preserve of the bigger ticket/bulky goods purchase.

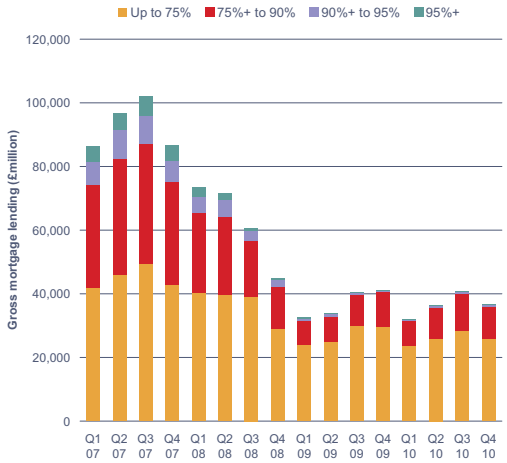
The UK consumer confidence survey by GfK asks consumers every month about the climate for major purchases such as furniture and electrical goods. In common with the main indicator this recently moved sharply downwards from -8 at the end of 2010 to -31 at the end of April 2011. This is the lowest level it has reached since the end of 2008, and not far off its recent record low of -41. Clearly, this does not bode well for traditional bulky goods retailers.

Another important driver for demand of bulky goods products is the state of the housing market. While there is not a particularly strong relationship between house price movements and sales on retail warehouse parks, there is a good correlation between housing turnover and sales of furniture, floorcoverings, white and brown goods.

However, house price movements do contribute to turnover to some degree so it is worth mentioning that the latest forecasts from our residential research team are for a 3% fall in mainstream house prices this year, followed by 1.5% growth in 2012. The real recovery in values at a national level begins in 2013, though London and the South East will see it in 2012.

Of course its not just falling or stagnant house prices that are limiting turnover. In common with the commercial property investment market the availability of debt is a big issue to the aspiring house buyer. As the chart below shows, the absolute volume of mortgage lending has shown little or no recovery from its lows in 2009. Furthermore, debt availability for those looking for high LTVs is particularly scarce. This especially inhibits the first time buyers who arguably is most likely to be buying furniture and other items on a retail warehouse park.

Housing turnover is being restrained by debt availability



Source: Bank of England, FSA

So this, combined with weak confidence, means that while the volume of housing transactions picked up in the middle of 2010, they remain at historically low levels. We expect that debt availability will improve in line with the wider economy and the housing market from 2012/13, but until then we expect that housing transactions will remain at their current low levels.

Combining all these factors we expect a staggered recovery in consumer spending and retail sales from this year. This will be led by pockets of year on year growth in sales in the fashion and general merchandise sectors. The electricals sector will also see a mild improvement in sales in 2011 compared to 2010. The more traditional DIY and furniture retailers will begin their recovery in 2012 in line with the pick-up in the general economy and the housing market. Indeed, we believe that when housing turnover does begin to recover it will recover quite strongly as four years of pent up demand hits the market in a rush (though returning to the boom levels of 2007). This could deliver above average levels of sales growth in these housing market dependant retailing sectors in 2012 and 2013.

Overall we expect 2011 to be similar to 2010. The pockets of economic recovery and equity rich consumers will deliver positive sales growth and improving retailer demand. The rest of the country is unlikely to see this until the consumer really believes that the recovery is underway in 2012.

Regional overview - The South

Following on from the North and Scotland focus in our Autumn 2010 report, in this issue we are focusing on the regional trends in the South of England. Clive Power from the out-of-town retail team in Bristol and Dominic Rodbourne from London examine the key trends affecting the retail warehouse sector in the South, and how this major market will perform over the next few years.

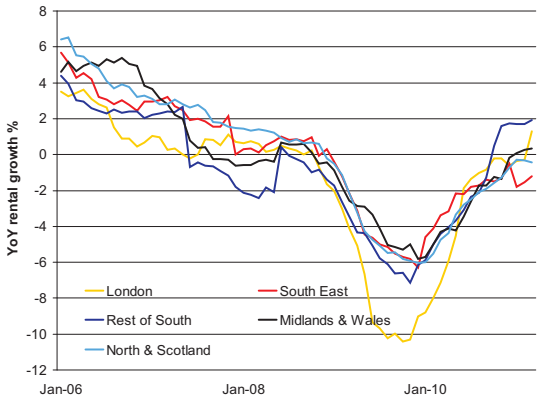
The retail warehouse market in the south has been characterised of late as one with significantly fewer units available compared to only 6 months earlier. Furthermore, retailers have increasingly found they are in competition to secure space. This, combined with Landlords no longer facing the same pressures they had experienced a year or so ago, has meant there has not been the same desperation to let space on undesirable terms. This has led to a few bidding wars between retailers to secure space and even create rental growth (above ERV levels). This has principally been brought about as, in the main, retailers are experiencing a polarisation in their trade between the various regions of the UK. The south, and the south east in particular, is fairing considerably better with stronger consumer expenditure.

Unfortunately however there have also been casualties. As we write, a private consortium called Savana Trading have acquired the goodwill, staff and stock of Allied Carpets Retail Ltd and are in negotiations with Landlords to acquire the leases of the stores they wish to remain trading in. We understand that Allied Carpets Retail Ltd will then fall into administration following this acquisition. This together with Bennetts Electrical and Easy Living being in administration and JJB's CVA having been approved, is going to result in a number of units becoming vacant, thereby increasing the supply again.

JJB will close 43 loss-making stores in April 2012, and a further 46 stores in 2013 if they remain unprofitable. Rents payable on these stores earmarked for closure will be halved from April 2010. Landlords are eager to secure new lettings on these units in order to re-establish their passing rents, and are able to gain possession from JJB with 40 days notice. This CVA will bring a raft of open A1 retail units to the market, the best of which are being taken up quickly. There will however be a few which are less easy to relet in this market.

To the landlord's benefit, asset management led deals have started returning to the market, as illustrated at Enfield Retail Park, Enfield. The Landlord, Universities Superannuation Scheme, has taken a surrender of Homebase's lease in order to extend the unit over the former garden centre and sub-divide it. The two units have been pre-let to Best Buy and Pets At Home, both of which will open late summer 2011. Whilst Best Buy have put new acquisitions on hold for the time being, they have recently opened at Hayes and will open in Bristol in the next few weeks. In response to Best Buy, Dixons Retail have prevented them from entering the market in Reading through another asset management deal. The Landlord, Legal & General, has taken a surrender of the BHS Home unit (30,000 sq ft) and pre-let it to Currys for a new megastore, after they out bid Best Buy.

Rental growth is strongest in the South



Source: IPD

In the bulky goods market, Wren Kitchens have gone from strength to strength having either opened or exchanged on 17 new units in the past 6 months. They are now open in Bristol, Basildon, Beckton, Cardiff and Poole, are currently fitting out in Southampton as well as having just exchanged contracts on Springvale Retail Park, Orpington at a rent of £38 psf. They are targeting to acquire a total of 30 stores in 2011.

The bulky goods market has received a further boost with the emergence of John Lewis Home's concept, and the continued expansion of Pets at Home and Next Home. JLP Home opened their first furniture only store in Poole in 2009, and opened their second, Mannington Retail Park in Swindon, in the Autumn of last year. They trade from a 30,000 sqft unit with full cover mezzanine. They continue to seek new units for this format, away from their established department store units to avoid cannibalisation. Pets at Home meanwhile require a further 30 stores this coming year, on top of acquiring 28 last year.

There are also positive signs in the DIY market. B&Q are selectively looking to acquire new stores in key locations, as customers continue to tighten their belts and look to invest in their existing homes, rather than move. Once again, the Easter trading period will be key to the DIY retailers success this year.

The real excitement in the market has been the continued expansion of the discount retailers. Home

Regional overview continued

Bargains have decided to venture south, acquiring units in Basildon, Trowbridge and Stevenage. 99p Stores, whilst not having acquired any further retail park units since Gallions Reach Shopping Park, Beckton in October 2009, have devised a new format called Family Bargains. They are seeking 25 stores Out of Town nationwide in 2011. Poundworld opened in late 2009 on Tottenham Hale Retail Park, Tottenham marking their expansion onto retail parks in the south. This has been followed by Gallagher Retail Park, Coventry. They now have a further 7 retail park deals exchanged, including Norwich and Swansea in the south. They too have developed an alternative format called Discount UK to diversify and provide a format with a multi-price offer. They have opened 2 stores In-town and 1 Out of Town (Riverside Retail Park, Warrington). Between the fascias they plan to open in excess of 30 stores in and out of town in 2011.

The food market continues to be the most buoyant sector across the region, with sustained growth of floor space being targeted by all the major national retailers. Morrison are perhaps leading the charge in the South where historically they have been less well represented that their competitors. However Tesco, Asda and Sainsbury are competing well for the limited stock with planning prospects. Waitrose continue to expand within selective catchments. Retailers are continuously altering their trading formats in an attempt to increase sales, which has seen Asda buy the Netto chain and Morrisons move in to the convenience market, with their 'M Local' format. Where planning consents are achieved, landlords and developers are seeing healthy returns.

Landlords are maximizing returns from their parks by exploiting the flourishing pod and drive thru markets. Small pod units are springing up across retail parks for the likes of Costa, Greggs, Subway, Johnsons and Dominos. Costa have also moved into the drive thru market, with their first due to open off Junction 16 of the M4 motorway at Swindon in May 2010. Their second is due to open in Nottingham the same month, followed closely by Thanet and have a number of others in the pipeline. Boots also now trade from 2 drive thru units and are seeking further units, adding competition for the established restaurant chains.

Stop Press: As we went to press Ernst & Young have been appointed administrators of Focus DIY Group. The 178 store DIY chain has struggled during recent years despite the turnaround efforts of its management. B&Q are expected to take 31 stores for £23m subject to OFT approval, whilst ASDA's deal to acquire 6 stores which have A1 Retail planning permission, including food, is also due to go through at a rumoured price of £19m. The remaining 141 stores are being discussed with retailers and landlords alike as we go to press.

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