UK Shopping Centre and High Street Bulletin

Quarter 4 2014

SUMMARY

■ There are still risks to the consumer recovery, but the fall in inflation will provide a welcome boost to household incomes this year.

■ 2015 will continue to see rationalisation of store portfolios. However we also expect to see a return of retailer demand in both prime and secondary locations. Indeed, secondary towns and pitches may well see a stronger recovery in rents this year.

■ We expect investor demand for shopping centres to remain strong in 2015. We also expect that this demand will swing towards more traditional town centre schemes and development opportunities.

■ In the high street retail investment market the key theme for 2015 will be a broadening of the key acquisition targets away from London and the South East to include the key regional towns and cities. These will be the locations that see the greatest yield hardening this year.

"2015 will see a narrowing of the gap between prime and secondary yields."

The consumer economy

While consumer confidence has slipped back a little in recent months (Graph 3), we remain of the view that 2015 will be the first year of a robust consumer recovery across the UK.

The combination of low inflation and further delays in the inevitable rise in the base rate will make the average UK household feel richer, and the latest employment numbers should also add to the general feeling of consumer positivity. While some coverage of the slowing rate of inflation has focused on how shoppers might see this as a reason to defer spending, we believe that the fact that the main drivers of this low level of inflation are fuel and food limits the prospect of waiting for a better deal next week.

The main lurking horrors for this year are probably around a potentially inconclusive election result, or an EU referendum. Both would have a negative impact on consumer confidence, though the former would be shorter term than the latter.

Ultimately the key retail economy theme for 2015 is the return of real earnings growth, and this can only be good news for retailers and landlords alike.

The retail occupational market

It is clear from the Christmas trading statements that generally retailers in the UK had a better time over this key trading period than they did in 2013-14. The average like-for-like sales growth for those who have reported to date was 6.9%, an improvement on the 4.8% reported last year.

Of course, the picture was not entirely rosy, with negative LFL sales reported by the food retailers in particular. Furthermore, while there were relatively few statements on margins, it is clear that they remained under pressure and those who over-embraced discounting around Black Friday suffered particularly hard. Indeed, given the general negativity of reporting around this US import, 2015 may well see a lot less noise about this event.

Looking ahead to the rest of 2015 we expect this to be a significantly better year for retailers, with real earnings growth now back in positive territory and the fall in fuel prices in particular likely to be viewed as a tax cut by the UK consumer.

While retailers will continue to run a forensic eye over their store portfolios, we expect that this year will see a net increase in store numbers, with the key battlegrounds being larger store in prime towns and pitches, as well as infill in recovering secondary markets.

We expect that this will be a year of two halves, with the first half of 2015 seeing the incentives being offered to retailers eroding, and the second half of the year actually delivering some real headline rental growth in the most sought after locations. The best locations may well not be the most obvious "prime" markets. Indeed, the higher rented towns (with Zone A rents in excess of £250/sq ft) may well show lower growth than the recently rebased markets where retailers can make a more credible story for margin improvement.

Another new trend for 2015 will the beginnings of a recovery in development activity, particularly in terms of the refurbishment and expansion of secondary malls. We expect to see new projects starting in a number of locations where the land value is sufficiently low on the owner's books to justify investment. In many case these projects will be jump started by a more mixed-use focus to combine leisure and residential with the existing retail offer.

2015 will undoubtedly be a turning point in the cycle for retailers in the UK, and while we expect to see further store rationalisation, there is demand for units that are being released by food retailers and others, and most importantly the demand will be national and not overly focused on a few prime towns and pitches in London and the South East.

Shopping centre investment

The Shopping Centre Investment market witnessed a surge in activity in 2014. A total of 100 centres transacted in 2014 representing a capital value of £6.05bn. This is a 32% increase on the £4.58bn traded in 2013.

There are also currently 21 shopping centres under offer accounting for circa c£930m and 20 centres in the market accounting for an additional £900m.

We are already aware of a further 15 shopping centres being prepared for sale in the early part of 2015, accounting for a further £500m. What is staggering is that historically we would not have seen new product being prepared for disposal after the end of October in any typical year. 2014 is perhaps a sign of things to come as investors seek to achieve prices that they wouldn't have been able to achieve over the last 6 years. In December alone we were party to 8 centres being put to us off market totalling £820m for our clients (some of these centres are not included in the above statistics). To this end we are seeing a larger proportion of assets traded off market or where they are only marketed to 2 prospective purchasers. Given the competition and resource issue this is proving highly effective from both a timing and pricing perspective for both buyers and sellers.

Notable deals in Q4 2014 involved:

- The asset swap of Princesshay, Exeter from Land Securities to TIAA Henderson for £128m reflecting 5.6% IY and Buchanan Galleries Glasgow from TIAA Henderson to Land Securities for £137.5m reflecting 5.2% IY 5.5% EY.
- Acquisition of the Mander Centre, Wolverhampton by Benson Elliot off Delancey/RBS for £58m reflecting 7.25% IY and 6.5% EY.
- Acquisition of the 50% stake in Highcross, Leicester by Hammerson off clients of LaSalle Investment Management for £216m reflecting 5.5% IY.
- Acquisition by Chris Lazari of Brunswick Shopping Centre, London off clients of LaSalle Investment Management for £135m reflecting 3.7% IY.
- Acquisition of Fremlin Walk Maidstone by M and G off L and G for £110m reflecting 6% IY.
- Acquisition by Hines / HSBC of The Centre, Livingston off Land Securities for £224m reflecting 6.4% IY and 6% EY.
- Acquisition of Carters Square Uttoxeter off Lingfield Securities by Henderson for £12.3m reflecting 6.14% IY.

Q4 2014 saw intense activity in the shopping centre market with increased investor activity and demand for the sector from all quarters.

One of the defining reasons why we believe the market will continue to surge forward in the short to medium term is the fact that we are in unprecedented times from an investor appetite perspective. We have never witnessed a market where all sectors of the investor spectrum are seeking to deploy equity at the same point alongside the debt markets. This is primarily because the sovereign wealth funds and global institutions hadn't started to deploy equity around the globe until relatively recently.

The key statistics to take away from a comparison between 2013 and 2014:

- 208% increase in property company trading volumes in £m. This translates to a 50% increase in the number of centres acquired on 2013.
- 74% increase in opportunity fund trading volumes. This is a 67% increase in numbers of centres acquired on 2013.
- 20% increase in REIT trading volumes in £m.
- 16% increase in institutional trading activity in £m.

From a market perspective we believe 2015 will see a slow down in the large loan portfolio sales from the banks. This has been a key feature of the market over the last 24 months. We believe that we will begin to see many of the large opportunity funds start to work out some of their positions – indeed this has already started to happen.

Portfolio sales will, we believe, continue to be a theme of the market. In 2014 high profile portfolios such as Project Swallowtail, The Tiger Portfolio and to a lesser extent Carbon attracted unprecedented levels of interest over the summer months as it enabled the end purchaser to acquire numerous assets and attract strong banking terms.

As yields on the more secondary assets harden we will see a number of the pan European opportunity funds look to other less mature markets to reach their return criteria. To be competitive return hurdles will have to be lowered to "core" levels of c. 10% to be able to compete.

The institutional investors for the most part continue to have cash inflows. We have also witnessed a huge influx of new buyers to the market. Indeed in 2014 there were a total of 64 parties involved in those deals. This included both the equity provider and asset manager.

In 2009 just 18 equity providers/ asset managers were involved in transactions.

It is encouraging to see that despite the frenetic activity in the sector there is still a very healthy yield gap of c. 575bps between the super prime and tertiary assets. We are not seeing the yield parity of the market sub sectors that we witnessed in 2006/7.

We are also 28% down on trading volumes from the market peak in 2005 where £8.9bn of assets were traded. 2014 has seen super prime yields come in 100bps and Town Centre Dominant assets come in 150bps. 2014 has also shown that the UK shopping centre market is truly on the global investor shopping list with investors from the US, Malaysia, Australia, Canada, Ireland, China and South Africa investing into the sector. We have seen some of the world's leading sovereign wealth funds and private individuals invest into our top retail destinations.

As we move through 2015-16 we will see the remnants of the over rented positions in many of the centres rebase to market levels.

TABLE 1

Shopping centre yields

	Q3 2014	Q4 2014
Super-Prime	4.25%	4.25%
Prime	5.25%	5.00%
Town Centre Dominant	6.50%	6.50%
Secondary	8.50%	8.00%
Tertiary	12.00%	10.00%

Source: Savills Research

Once this occurs we will then begin to see rental growth and retail development emerge in the more traditional town centres.

The shopping centre investment team at Savills were involved in 34 transactions in 2014, accounting for 8.9m sq ft of retail in £1.6bn of transactions. This equates to a c.27% market share. The team also has a further 4 assets under offer, accounting for an additional £460m.

High street investment

During 2014 the dramatic increase in levels of investment into the shopping centre and out of town sectors, left the high street trailing behind. With investors eager to deploy large amounts of cash we put this primarily down to lot size issues. This could lead to opportunities on the high street this year with yields looking more attractive and some investors are already taking advantage of this. With this in mind we also anticipate a greater supply of institutional product coming to the market in H1 2015.

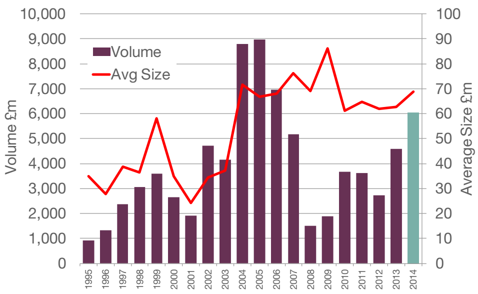
We witnessed further downward yield movement last year for the very best high street assets, principally in London. This was perhaps best illustrated by the competitive bidding for two adjoining parades of shops on St John's Road in Clapham which eventually sold for £41.5m (3.5% NIY) and the NatWest bank on High Street Kensington selling for £19.5m (2.8% NIY). It is difficult to see these prime yields hardening further.

Looking ahead into 2015, one area we would anticipate some downward yield movement would be the dominant regional towns and cities. Rental growth is now not just confined to London and the South East with retailer demand now spreading into the secondary markets where rents have been rebased sufficiently to make new store openings viable.

With green shoots of occupational demand now coming through and a reduced number of administrations in early 2015 we would anticipate investors taking advantage of perceived value in the regions. There should be a narrowing of the yield gap between prime and secondary stock which has been at an all time high. For the moment, with the right occupational advice, this is where there is value to be had in the sector.

GRAPH 1

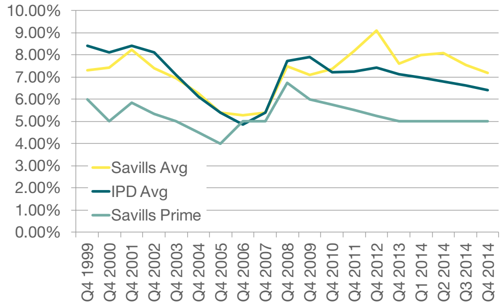
Shopping centre investment volume



Source: Savills Research

GRAPH 2

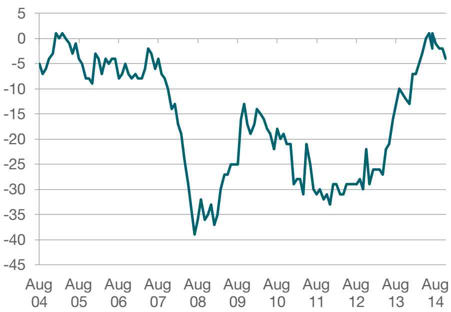
Shopping centre yields



Source: Savills Research, Investment Property Databank

GRAPH 3

Consumer confidence



Source: GfK

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