Shopping centre and high street bulletin

Q1 2009

“We take the view that the best shops and stores are undervalued’”

- Consumers continue to tighten their belts, and while some costs are falling we believe that the recessionary desire to save more will be the trend for the remainder of 2009.
- The challenge for landlords in this environment will be to work closer with their key tenants to enhance both their profitability.
- While the investment markets remain severely constrained by the pricing and availability of finance, some signs are emerging that investor enthusiasm for better locations and covenants has increased.

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Consumers and retailers

Consumer economy

Consumers are in a quandary this quarter. while consumer confidence has picked up slightly, retail sales growth has stalled and savings ratios are rising. The biggest challenge over the remainder of 2009 is going to be lifting consumer caution. Savings ratios generally rise sharply in a recession, and while household disposable incomes are actually rising, this is of little benefit to the retail sector if this is all being saved.

While the argument that low interest rates may deflect some of this saving is a rational one, we believe that caution will be the buzzword at least until Christmas 2009.

The retail occupational market

Confrontation is rife in the retail property market. Publicity on the most newsworthy disputes is everywhere, the most topical being:-

- The burgeoning campaign for monthly rents
- The recent Government climb down on rates phasing
- Widespread occupier discontent with service charge levels which has led to the BPF backed 10 point plan to target cost reductions of 20%

All these initiatives have a sound commercial base and are much welcomed but all are in practice mere side shows.

The show that should be claiming centre stage is undoubtedly the assessment of sustainable rental levels. There is no doubt that landlords are struggling with the practicalities of this concept against a background of declining values, tenant insolvencies and rapid structural market change.

To add to the challenge, most tenants jealously guard their turnover and profit figures at a micro (individual site) level like the crown jewels. The result is that through ignorance, manifested by a misguided reliance on historic values and out of date ratios, neither side in the landlord/tenant interface understands the other's business models, objectives and limitations and as a result, the expectations from a transactional negotiation on both sides of the fence are often wholly unrealistic.

A wake-up call for the retail property market is long overdue. Assessments of rent religiously based on zoning or overall rates per square foot are cumbersome and insensitive to the dynamics of an increasingly competitive and sophisticated retail market.

We take the view that the best shops and stores are undervalued and that mediocre and poor retail properties tend to be overvalued by current market practices. The range of value for a particular class of property needs to be significantly wider to generate a fair split of value between landlord and tenant for a particular site.

We predict that the principal structural change that will dominate the market will be the move to a more closely aligned correlation between an occupier's trading performance from a site and the quantum of rent that will be generated for the landlord.

Average occupational overheads for retail property in the UK are approximately 20% of turnover and can represent nearly 40% of total costs, significantly higher than in the US and virtually every other European market. Even allowing for the UK's population density and the sophisticated mature market conditions in which UK retailing operates, this differential is telling.

However, it's not all bad news for landlords. Many pay lip service to understanding their tenants' businesses without in practice having the resource, expertise or commitment to do the job properly. Lunch with a big tenant twice a year is not the panacea. It will be those landlords and their advisors with a real understanding of their customers' businesses who will be the ones able to identify the undervalued locations and individual properties where the developing link between retail profitability and property value will serve to generate serious outperformance for the enlightened few. In the future, the level of occupational deman rather than the rent may well become the fundamental factor in defining 'prime retail'.

Shopping centre investment

Q1 Statistics

- £741.7 million transacted in five deals
- Average initial yield 8.29% (up 79 bps from Q4 2008) at 7.5%
- Average deal size £138.34 million (skewed by Meadowhall)

The continued uncertainty across the markets towards the end of 2008 has continued into the first quarter of 2009 with just five shopping centres being transacted. The weakened investment market coupled with the uncertainty over occupational rents across the UK has meant that investors with equity continue to remain on the sidelines.

Interestingly, the deals that have been transacted were either acquired by UK institutions or where a vendor loan was available. Certainly at the bigger lot sizes this is becoming the only means to get traction with investors.

There are currently only three shopping centres under offer, 17 shopping centres in the market and 23 shopping centres that have failed to sell in the last 12 months. That said there remains a number of active requirements for the sector but stock selection remains pivotal.

Prospective investors are applying very bearish assumptions in cashflows particularly with regards to

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vacant units, leasing assumptions, capex and rental decline/growth prospects in the short to medium term.

We are seeing an increasing number of US opportunity funds wishing to enter the UK perceiving that we are nearing the bottom of the cycle but again almost all need a debt facility, or are at levels that vendors are unwilling to treat.

With capital values across the spectrum falling circa 43% since the peak many investors have lost their equity and now the banks face potential write downs on their assets.

Many banks are however beginning to favour the 'work out' route rather than to place the assets into administration (just five to date). This we believe will give excellent opportunities for a number of stronger retail asset managers.

In all likelihood whilst we have seen a correction in yields we are unlikely to see the broader investor sentiment return until a clearer picture has emerged on the sustainability of both retailers and rental levels across the UK. This is likely to be towards the third/fourth quarter of 2009.

	March 2009	September 2006
Prime	7.00%+	4.50%
Mid Market / Strong towns	8.25%+	5.50%-5.75%
Secondary	9.50%+	6.00%

High street investment

The Christmas break is always a time for reflection and January is inevitably a time of inertia. The institutions are busy assessing their end of year valuations and considering strategy and agents are busy trying to predict the future. This year all investors have also been licking their wounds. January is a kind of 'phony war' when there is much talk but few transactions to gain a handle on the market.

The first quarter has been remarkable for one thing only, a material hardening in high street yields for well secured long dated stock, and specifically for banks. The wealthy private investor, battered from all sides, began to realise that whilst cash on deposit seemed safe (in most banks!) it was now providing an insignificant return. After seeing only a handful of transactions in the last quarter of 2008 there was suddenly a keen appetite from the cash buyer seeking a better return on his /her money and an attractive bank in a major centre let to Lloyds Bank plc for around 17 years provided the solution. 5.25% proved the marker for such stock below the £5m mark. The depth of this market has not been insignificant with ten or even twenty buyers willing to enter the bidding for the most sought after properties. The love affair with banks continues and in some cases investors again began to completely ignore the property characteristics to achieve a better return than in the bank itself.

Whilst the strongest demand was for the smaller lots, private investor enthusiasm increased even for larger single let shops up to £10m. Five or six buyers were competing where before Christmas no interest could be had.

The institutions were swift to respond to the new price re-rating and where capital needed to be raised some good sales were achieved. Fund managers started the year with a generally neutral stance towards the High Street and except for one or two exceptions funds have been reluctant to re-enter the market with too much haste. Time will tell whether this judgement is correct but with any fund overweight in cash last year seeing the fund manager outperform IPD, no fund manager is prepared to speculate if there is any possibility that the tenant could fail or falter in the next 18 months. Posted fund requirements for large blocks remain almost impossible to fulfil as the chances are that even a prime parade in a good centre will have at least one or two retailers still sitting in the danger zone.

The auction market has remained busy as sellers, in particular of well secured assets have raced to the room to capitalise on the New Year cash buyer euphoria. Strong bidding for smaller well secured stock has pushed prices back up . However with a fragile tenant market workable and poorly let product is still finding little interest. Indeed the two markets are diverging faster than ever.

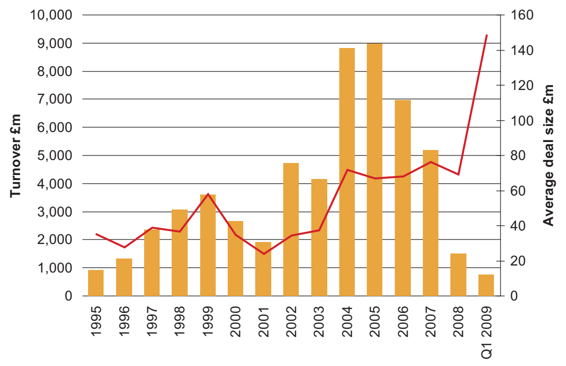
Underlying all property investment business is still a desperate need for at least some easing of the debt markets before there can be any chance of normality returning. Finding debt today is more difficult that it was even in the latter stages of last year. This will keep a natural restraint on the volume of transactions conducted. There is an argument however that this renewed interest in well secured long dated product should appeal to the banking sector. Surely lending at the margins and rates required today should present a bank with a safe and profitable area of business?

However the banking world's real focus is still on both the major and minor property companies with all sides still working hard in an endeavour to reach refinancing agreements that will give some the chance to survive.

As we gaze into our crystal ball at the year ahead what seems clear is that occupiers now 'hold the high ground'. Where legislation or lease renewals and break clauses allow tenants freedom to vacate, new open market transactions are proving that there are a number of centres where current rents are unsustainable in the current climate. Over the coming months covenant and continuity of income will remain crucial and professional advice guiding investors to where the open market rental value really lies will be vital.

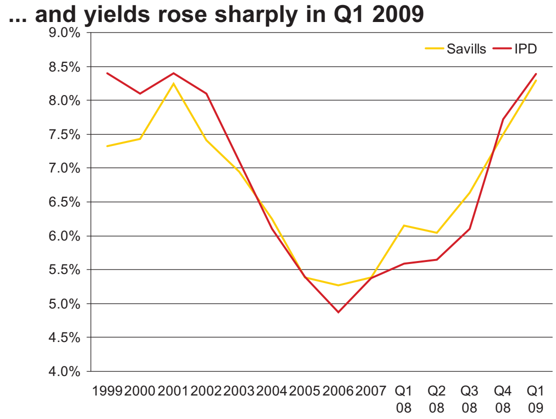
Data

Meadowhall sale swells Q1 shopping centre turnover



Source: Savills

... and yields rose sharply in Q1 2009



Source: Savills, IPD

Recent significant investment deals

Shopping centre	Size (sq ft)	Purchaser	Vendor	Price	IY
Meadowhall, Sheffield	1.5m	London & Stamford	British Land	£587.20m	7.00%
The Royals, Southend	279,000	Orchard Street	Warner Estates	£30.7m	9.00%
Victoria Centre, Harrogate	150,000	LaSalle IM	Land Securities	£24.25m	8.85%

High street	Tenant	Purchaser	Term unexpired	Price	IY
47 Milsom St, Bath	Lloyds Bank	Private investor	17.5 years	£4.00m	5.25%
5/6 Cornhill, Bury St Edmunds	Iceland	Private investor	10.25 years	£2.37m	6.09%
105/113 High St, Guildford	House of Fraser	Canada Life	30.25 years	£31.50m	8.00%

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