Shopping centre and high street bulletin

Q2 2010

"The depth of investor demand remains strong, but polarised by location and quality"

- Consumer confidence is likely to remain weak and volatile until the full impacts of tax rises and spending cuts have been absorbed.
- The occupational market remains polarised between prime and non-prime locations, with steady retailer demand for the former.
- Investor demand for shopping centres and high street shops has slackened slightly over the last quarter. However, there is still competition for the best assets in the best locations.

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Retailers

The consumer economy

The big economic news since the our last quarter's report was the relatively non-commital Emergency Budget. While it was clear on retail-relevant issues such as the raise in VAT to 20%, much was left unsaid about the size and scope of austerity measures that will be announced in the October spending review.

At the moment the last thing that the UK consumer wants is more uncertainty, and the impact of the Budget on consumer confidence has been to reverse the gradually improving trend that had been seen over Christmas and New Year.

Unemployment, at least in certain regions of the UK, is certainly not going to fall very fast over the next few years. Job, income and house price uncertainty will all weigh heavily on consumer confidence and spending. As a result of this we remain of the view that a broad-based consumer recovery in the UK is unlikely for at least another 12 months.

When this recovery comes it is likely to be highly location specific, with a sustained period of public sector austerity likely to hit some regions more than others. Some retailers have already reported a fall in sales in their stores in the northern half of the country, and it is clear that consumer confidence is going to vary significantly at a local level depending on that area's level of dependance on the public sector.

The retail occupational market

The occupational market remains polarised between prime locations and the rest. While the overall vacancy rate in the UK's major cities has remained stable over the last quarter at 12%, this hides a multitude of differences at submarket level.

The latest sales data shows an overall year-on-year increase in retail sales volumes of 3.1%, with clothing sales up 4.2% and household goods up 6.1%. Sales values have also risen, up 3.3% in the last quarter.

Improving sales and tactical expansion has led to an improvement in tenant demand over the last quarter, driven by value retailers and supermarkets, however landlords are continuing to have to struggle to maintain rental incomes in the face of aggressive negotiation amongst those tenants who are expanding, as well as continuing failures amongst some weaker retailers. Large capital incentives for "desirable" occupiers are still the norm and are increasing in value.

Lease lengths also remain very flexible with 10 year leases with a five year break now the norm, and five year leases now not unheard of. Arguably this might be one factor that is spurring a renewed interest in the UK from European and American retailers who are more comfortable with shorter leases from their experience in their domestic markets.

As we commented in our last bulletin, rent-free periods have shortened to 3-12 months dependant on location and lease length, and this is delivering some net-effective rental growth.

However, at a national level headline rental growth remains difficult to demonstrate, although the rate of decline in retail rents has slowed sharply over the last three months, with IPD's All Standard Retail index showing a 0.8% fall in rents over the last three months. Over the same period average rental growth in London and the Inner South East are now marginally positive, while the rest of the UK is still showing rental falls.

London's prime retail streets remain an island of anti-recessionary behaviour with vacancy rates of sub 4% and strong competition from domestic and international retailers for the best units.

This bias towards prime is also prevalent across the rest of the UK with expansionary multiple retailers looking to fill in gaps in their portfolios in strong trading towns, and value retailers targeting high profile units on secondary pitches where the low rents can deliver strong profits per square foot.

Looking ahead to the second half of 2010 we expect to see a continuation of this polarised market. The third quarter will undoubtedly see a rush to complete deals to enable retailers to be fitted out and trading prior to Christmas.

In these sought after locations we expect to see a further stabilisation in rents, though the balance of power will remain firmly in the retailer's hands. Weaker catchments will continue to see limited retailer demand and high vacancy rates

Shopping centre investment

Q2 has continued a pace with 16 shopping centres being transacted accounting for £695.38m. This brings the total number of shopping centres traded for the first half of 2010 to 35 accounting for £1.325bn in capital value.

By way of a comparison the first half of 2009 saw 7 shopping centres traded accounting for £977m of capital value.

Average initial yields dropped from 7.65% in Q1 to 7.55% in Q2 2010.

Notable Transactions Include:

- The Pavilions Shopping Centre, Thornaby. Sold to LaSalle Investment management for £17m reflecting 6.75% initial yield.

- Blighs Meadow, Sevenoaks. Sold to IGNIS for £27.8m reflecting 5.6% initial yield.

Whilst the depth of interest in the sector remains across the investor base and the quantum of equity seeking a home remains there is little doubt that the market has eased off.

As Q2 progressed the IMA inflows into retail funds were down by two thirds to c.£200m from the January high of c£600m and this is now beginning to impact on pricing.

Investors

Assets that are well let, well secured will continue to command premium pricing but not at the levels seen in the first six months.

The gap between the prime assets and secondary properties will widen once again as investors re-assess risk and asset fundamentals going forward.

The “bounce” in pricing seen in the first 6 months of 2010 is now under considerable pressure for all but the very best of assets and this is particularly true in respect of prospective purchasers capitalising marginally vacant units - a trend we have seen in recent months.

Banking margins have increased through the quarter and we are now seeing a number of banks beginning to actively increase their loan books.

The market continues to be starved of stock with many owners in negotiations with their bank and many losing control.

The banks will only be able to “extend and pretend” for so long as leases get shorter and buildings become obsolescent. Many of these assets will now need significant investment. These pivotal factors must ultimately be reflected in pricing particularly for the older properties where large capex will be needed.

We expect Q3 to be quiet as just 6 shopping centres are under offer and just a handful openly available in the market (many have failed to sell through unrealistic pricing expectation).

Despite the above there is now a growing feeling that the banks are now beginning to look to release assets to the market and to this end we believe we will see much more stock come to the market in the final quarter of 2010 onwards.

	Q4 2009	Q1 2010	Q2 2010
Prime	6.75%	6.00%	6.00%
Town centre dominant	7.75%	6.50% -	6.50% +
Secondary towns	9.00%-9.25%	8.50% +	9.00% +

High Street investment

Prime high street investment has continued to prove a remarkably resilient asset. Fuelled by a shortage of opportunities against a strong weight of demand, net equivalent yields have remained at 4.75 / 5.00%. With the FTSE 100 yield dividend sitting at circa 3.30% and 10 year Gilts at approximately 3.35%, prime high street is clearly an attractive asset class.

There is however a more cautious sentiment being felt which has intensified over the last three months. This has been assisted by the new government’s austerity approach to reducing the national deficit. It is to be expected that there will be some impact felt on the high street and in certain locations more so than others. The likelihood of increased unemployment from the public sector, VAT at 20% from January 2011 and further indirect / direct taxing will inevitably result in less disposable income. Locations that are heavily reliant on public sector employment could bear most of the brunt. A fall in consumer confidence and uncertainty in locations could see a softening in yields.

Prime high street in affluent locations is therefore seen as a safe and sensible investment, particularly where new post recession rents have been agreed offering the prospect of inherent rental growth where a new base has been set. Secondary high street assets pose numerous risks and the gap between the two looks likely to widen. The threat of further retailer failure is still too on the agenda.

Private investors now appear to be coming to the fore while Institutions who were the main buyers at the end of 2009 and early 2010 seem less acquisitive . The cash inflows they were enjoying over the last nine months appear to have slowed down. Property companies on the whole are still yet to be a major force in the transactional market. While debt remains difficult and expensive to raise property companies are either priced out of the market or continue to wait until the money markets become more fluid. Cash is still king.

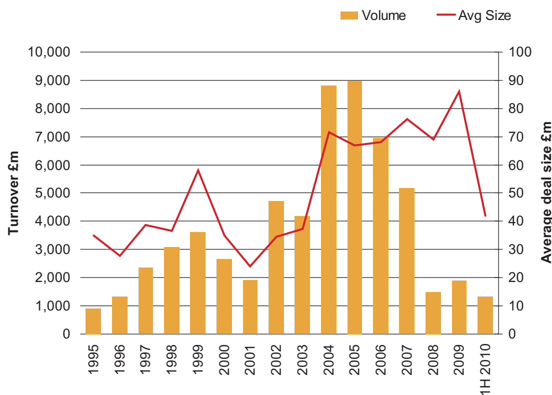
The auction market has in the last round produced mixed results with most of the houses posting disappointing success rates between 50/60%. It would appear that the sub £1m lot size is still proving popular with investors in the room while opportunities over this amount are struggling to sell primarily due to the restricted availability of funding.

Central London continues to surprise the market with record prices being achieved for the prime retail investments. 11/12 Old Bond Street, let to Omega & Damiani, sold in June 2010 for approximately £18.2m reflecting a net initial yield of 3.10%. Overseas investors are the dominant buyer who see London as the shopping capital of the world. This image combined with the low rate of Sterling has seen these investors battle for prime flagship stores which offer the expectation of rental growth. Furthermore there is an emergence of retailers buying their own freeholds in prime locations such as Bond Street. Central London gives the impression of being immune to the economic fragility and is seen by many as a safe haven. We expect to see this continue.

With the equity market currently about as dependable and sure footed as the England football team, prime high street looks an attractive and reliable alternative investment. Prime high street looks set to remain robust as investors seek to acquire well secured long dated assets in the best locations. The depth of demand while still strong is however polarised. In the main, only the very best assets are selling and selling well.

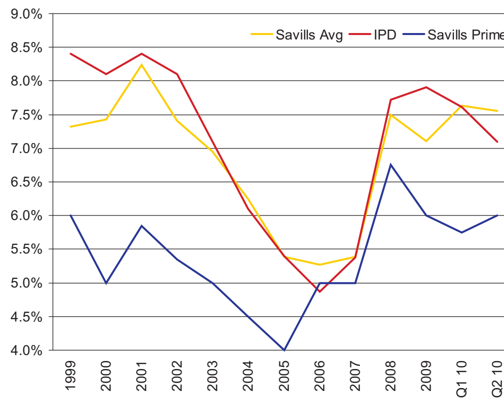
Data

Turnover in 1H 2010 almost exceeded FY 2009



Source: Savills

Average yields dipped again in Q2 2010



Source: Savills, IPD

Recent significant investment deals

Shopping centre	Size (sq ft)	Purchaser	Vendor	Price	IY
N1, London	142,000	Henderson	Delancey/Metro	£108m	5.35%
Blighs Meadow, Sevenoaks	78,000	Ignis	Ironbridge Estates	£27.8m	5.60%
The Mall, Ilford	300,000	Meyer Bergman	The Mall Fund	£71m	8.20%

High street	Tenant	Purchaser	Term unexpired	Price	IY
6/7 High St, Oxford	Ryman, Burton Mill	Henderson	1 year, 15 years	£5.05m	5.02%
27 Old Bond Street, London	DKNY	Chanel	10 years	£50m	-
7/9 Church St, Kingston-upon-Thames	Karen Millen	Private	8 years	£2.06m	4.60%

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