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UK Shopping Centre and High Street Spotlight

Quarter 3 2016

Image: Manor Walks Shopping Centre

SUMMARY

■ The weakness of the pound will represent a challenge to retailers and consumers in 2017. However, consumer confidence and savings ratios are indicating that trading over Christmas 2016 could be better than expected.

■ We expect to see continued steady demand for new stores in 2017, particularly from retailers at the value end of the spectrum and leisure operators. We have also noticed a slight uptick in demand from the major foodstore operators.

■ The final quarter of 2016 should be a busy one in the shopping centre investment market. Many sales that have been deferred over the last nine months could come to the market in the final three months of the year, and we are aware of a large number of buyers who are looking to enter the market.

■ The high street retail investment market has remained robust this year, albeit dominated by smaller deals. 2017 could see a change to this picture, with more activity on mid-sized lots as institutional investors return to this space.

"Generally we expect that the strongest demand next year will be for the most secure income streams."

The consumer economy

The UK consumer has clearly got over the initial shock of the Brexit vote, with the GfK consumer confidence measure recovering from -9 in July to its pre-referendum level of -1 in September.

This, combined with the more important fact that there has been no sign of the savings ratio rising, should give retailers a boost of confidence about trading over the crucial Christmas period. This is vital, not just for the retail sector but for the wider economy, as a poor Christmas would probably be a harbinger of flat or negative GDP growth in early 2017.

While the current data is pointing to a broadly positive story for the UK consumer economy, there are challenges ahead. First amongst these is the weakness of the pound, which is currently at a 31 year low against the US dollar. While this is good news for exporters it is bad news for importers and shoppers. While most retailers have forward hedges on currencies these will soon come to an end, and the price of imported goods for UK retailers will undoubtedly rise. Some retailers have stated that they expect this to have a relatively minimal effect on the price that shoppers have to pay, but the outlook for the shop prices in 2017 is undoubtedly inflationary. Indeed, a recent Bloomberg article pointed to the fact that the new iPhone in the UK is £60 more expensive in the UK than last year, while the same model in the USA has seen no price increase.

In an atmosphere of generally restrained wage growth even a small increase in retail prices could have a knock-on effect on sales volumes, with Next recently stating that its own experience in 2010 showed that a 5% price rise resulted in a fall in sales volumes of 5.5%.

The retail occupational market

Retailers will be facing more challenges than just rising import costs in 2017, with the minimum wage and rating revaluation both squeezing margins over the next few years in an environment of potentially volatile consumer confidence and behaviour.

While trading in central London is expected to be buoyed by more tourism due to the weak pound, this will be the area that sees the largest rises in business rates.

However, early indications for 2017 are that retailers, particularly those at the value-end of the spectrum, are still broadly expansionary. This makes sense, with the value and aspirational segments of the market having been the strongest performers during the global financial crisis.

Tenant demand from the leisure sector is expected to remain strong in 2017, with the continuing ripple effect of fast growing new brands away from London continuing (as highlighted in our recent report on casual dining).

One sector that has been relatively quiet for some years is food retail. However, we have noticed recently that while the major supermarkets are still offloading surplus land, there are also some selective acquisitions underway after a sustained period of consolidation amongst the majors.

While there are undoubtedly operating challenges ahead for retailers in the UK in 2017, the property market is moving in their favour. Rents, outside central London, are unlikely to see any upward pressure in 2017 and 2018, and given the generally more uncertain environment we expect landlords to swing into a more tenant-friendly negotiating stance next year.

That having been said, the availability of prime units on prime pitches will remain limited. Indeed, as developers become more cautious and delay planned scheme expansions this undersupply will become even more intense in some locations. This will lead to some competitive bidding amongst retailers, and hence some site-specific rental growth.

Shopping centre investment

Q3 2016 has been an intriguing period, characterised by a gradual return to 'business as usual' as the markets stabilised post the decision for the UK to leave the European Union. The first two weeks post the Brexit vote saw a number of deals pulled or renegotiated. We have however since seen investor confidence return through the quarter and although transaction volumes have been low, investors on both the buy and sell sides go into Q4 with greater confidence. A total of 6 assets traded during the quarter representing a total capital value of £111 million, 90% down on the same period last year. This is the lowest quarterly transaction volume seen since Q2 1995!

Savills is predicting a very busy Q4 as vendors who have waited for six to twelve months to place their assets on the market take the opportunity and buyers battle each other to secure the limited fresh deals. In the spring we witnessed significant overpricing in the market which led to failed marketing campaigns. Overpricing remains an issue as there is very little distress in the market and the motivation of the vendors comes under the microscope. Savills is aware of a large number of investors, both domestic and international who have significant pressure to make purchases in the UK market and the right product at the right price will see keen competition. This was witnessed with the sale of Upper Precinct in Coventry where five parties made offers for the prime retail asset and it sold at close to the asking price (completed Q4 2016).

The councils continue to be strong purchasers in the shopping centre market as many have access to attractive finance rates and see this period as a generational opportunity to take back control of their town or city centres. In addition to the significant income which can be derived from the schemes, the Councils also benefit from the political angle in that they can take control of highly visible areas within their communities which are visited by large numbers of their electorate. The largest deal in Q3 was the sale of Cramlington to the local council for £78 million, reflecting a

TABLE 1

Shopping centre yields

	Q2 2016	Q3 2016
Super-Prime	4.50%	4.50%↓
Prime	5.50%	5.50%
Town Centre Dominant	6.50%↑	6.50%↑
Secondary	9.00%↑	9.00%↑
Tertiary	12.00%↑	12.00%↑

Source: Savills. Arrow indicates forward trend

net initial yield of 7%. The scheme was competitively fought over, and ultimately exchanged in 15 days at above asking terms through the referendum period.

Property is again receiving significant focus in light of the volatility in the currency and stock markets; however, we don't anticipate the institutions making many acquisitions in the final quarter of 2016. Activity is more likely to be from foreign capital making the currency play along with the core and core plus buyers who will be increasingly prevalent in this part of the market cycle. The core and core plus buyers will be further enticed by the attractive debt terms available in the market.

The favourable financing terms have led a number of shopping centre owners to refinance rather than sell their assets, effectively enhancing their returns and enabling them to extend their business plan to perceived more stable economic times, perhaps into 2017 or beyond.

The stabilising market is supported by a good occupational backdrop with retailers trading well on the back of strong and rising consumer confidence. More and more emphasis in the shopping centre investment market is being placed on retailer performance and this is a direct reaction to the rise of internet shopping and the perception that schemes which trade poorly may wither and die in the changing consumer environment.

Transactions likely to be concluded in the quarter include Bromley and Wandsworth in addition to the stock more recently placed on the market such as Friars Walk in Newport and Stratford Shopping Centre in London.

The key for any vendor at present is to ensure you get your marketing and pricing right. Investor accessibility, focus and targeted campaigns are all fundamental factors, with assets needing to be pitched to the right groups in the right way so as to ensure a competitive sale.

In conclusion we are predicting an upturn in activity in the sector during Q4 and are anticipating a total transaction value for the year of around £2.3bn, this remains well below the long term annual average of £4.0bn. The forecast gathering of pace in the market sets the scene for a healthy level of activity in 2017.

High street investment

There are relatively few property subsectors in the UK that could lay claim to the fact that investment activity in 2016 had been higher than in 2015, but this is true for the high street shop sector. £1.5bn of transactions have taken place outside London in the first nine months of this year, a 24% increase on the same period last year. One clue as to why the activity has been so strong is average lot size, which at £1.5m points to a very strong demand from private investors for small secure income deals in the face of low cash returns.

However, the low average lot size this year also highlights another aspect to the market, which is the relatively inactive market for high street shops with a lot size of over £10m. Indeed, so far this year (excluding portfolios) there have only been 11 deals of £10m or above. The largest of these was British Land's purchase of the Royal Parade in Plymouth for £64.25m, reflecting a yield of 6.8%. While it could reasonably be argued that British Land were a special purchaser for this asset, given their other holdings in the city, it does raise the interesting question of whether other landlords should be using the current period of uncertainty to secure the future expansion of existing schemes in other key regional cities.

The limited demand for larger lot sizes is primarily down to the current lack of institutional demand for high street shops, and this has led to several post-referendum sales from the retail funds being pulled due to lack of interest. Again, the lack of institutional demand for medium-sized high street retail assets may well represent an opportunity for investors in 2017, and given the current weakness of the pound we expect to see more non-domestic demand for retail assets in the very best locations next year.

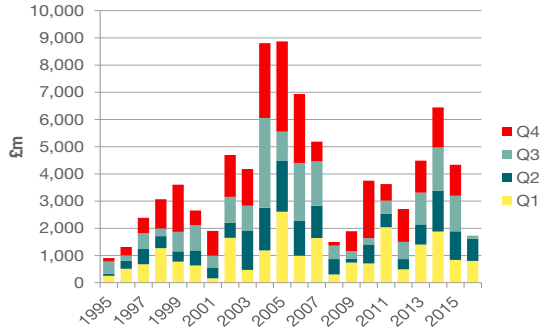
Generally, we see the trends of 2016's investment market being repeated in 2017, with private investors continuing to dominate the market for smaller lot sizes, but also becoming increasingly active in the £5-£15m price band. Non-domestic investors, particularly those who have cut their teeth in the central London market over the last few years, might do well to look to the best of the UK regional towns and cities whether investor competition is much more limited for much the same tenants and income security.

Limited institutional demand in 2017 may also present an opportunity for retailers to buy their best stores. The combination of the low cost of debt and the looming change in how leases are accounted for their balance sheets may well be enough to stimulate a few tactical approaches to landlords whether the unit is on the market or not.

2017 will see yields on small prime lots remaining stable. Indeed, over the last few weeks we have seen the beginnings of a resurgence in requirements for institutional lot sizes. Should the right stock come onto the market in early 2017, then we could see more activity in the £5-£15m size band, as well some upward pressure on pricing. Generally we expect that the strongest demand next year will be for the most secure income streams, and this may well lead some investors to look increasingly closely at cinemas, health & fitness, and the best of the regional department stores.

GRAPH 1

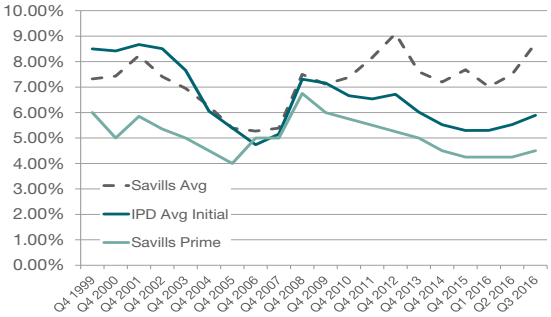
Shopping centre investment volume



Source: Savills

GRAPH 2

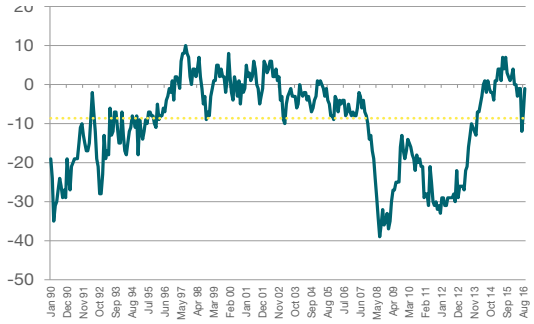
Shopping centre yields



Source: Savills, Investment Property Databank

GRAPH 3

Consumer confidence



Source: Gfk

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