

UK Shopping Centre and High Street Bulletin

Quarter 2 2013



Image: Wellington Square, Stockton

SUMMARY

- Consumer confidence has started to improve, and we expect consumer spending to continue to recovery in 2013 and beyond.
- While retailer failures are continuing, we believe that they are now being driven by a desire to dispose of poor-performing stores in advance of the further stratification of retail centres by trading performance.
- We estimate that the number of buyers for UK shopping centre investments is 35% higher than 12 months ago. Buyers are coming from all segments of the investor universe, and this rise in demand will put further downward pressure on yields in strong town centre dominant schemes.
- Investors remain wary of high street shops, other than at the most prime end of the market. Concerns about rental re-rating are rife, but we expect to see a rise in investor interest as high street yields continue to diverge from those on other assets.

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 “Could now be the best buying opportunity for high street shops in the cycle?”

➔ **The consumer economy**

While it might be too early to herald the return of a normal consumer economy, the second quarter undoubtedly saw the beginnings of the long, slow climb out of the recent swamp of negativity.

The news that the double-dip in GDP had been revised away was perhaps only of interest to economists, but the general improving tone of comments on the economy in the press has had an impact on consumer confidence (Graph 3), which rose to its highest level for two years last month. While there is still some way for confidence to rise until it hits its normal state of mild negativity, this has to be good news for consumer spending over the summer and into the crucial pre-Christmas period.

We believe that the recovery in consumer spending, which actually began last year, will be sustained in the remainder of 2013 and beyond. While higher than expected inflation will again eat away at real personal disposable incomes this year, improving consumer confidence will mean that precautionary saving levels decline, and this should deliver consumer spending growth of around 1.5% in 2013/14. The real recovery in consumer spending is still unlikely to kick in until 2015, when unemployment is expected to have started to fall and consumer confidence has returned to a level where savings ratios return to normal levels.

The retail occupational market

The trading environment on most UK high streets remained tough in the second quarter of 2013, which was highlighted by further administrations around the quarter day, albeit on a positive note the profile and numbers were lower than earlier in the year.

In most instances the administrations appear to have been driven by over-expansion, and a corresponding desire by the retailer to rid itself of loss-making stores. Dwell's founder has already re-acquired 5 out of their 20 stores, and we expect Internacionale to return with around 100 of its 140 stores intact. ModelZone's administrators are currently exploring a sale of the business.

More positively the second quarter

also saw some strong trading numbers, with Superdry reporting a 22% increase in annual profit, Primark reporting a 20% rise in sales, Halfords a 7.5% rise, and even Marks & Spencer correcting the slide in its general merchandise sales.

The reality is that a clear story is emerging of rationalisation of non-performing stores and cautious expansion into strong trading locations where there are gaps in the retailer's current portfolio.

The most acquisitive sectors remain convenience stores where Morrisons have reaffirmed their intention to expand significantly, budget and luxury fashion where those at polar opposite ends of the market continue to thrive. Coffee and family friendly A3 operators also remain very active. Indeed, there are some significant new requirements in this sector, such as Costa's plan to open a further 70-100 drive through units.

While some of the retailer failures of recent years can be attributed to a lack of appropriate response to market conditions, it is undoubtedly true that property and rents alongside rates have played their part in the redrawing of Britain's high streets. Over expansion by retailers is by no means a new story, and every boom has seen retailers chasing profits growth by opening more stores. However, the current cycle has left us with a legacy of towns and pitches that are over rented. A rebasing has begun, and this will lead to further segmentation of the UK retail market, but also provide the platform for the growth of the next recovery phase of UK retail.

We expect that towns and pitches will increasingly categorise into at least three tranches. The first will be the Grade A locations where the market will remain strong with retailers of all sorts trading well, minimal voids, and rental growth continuing from its previous peaks with little rebasing.

The second tranche, the Grade B towns and pitches, will be those where there is limited retailer demand at present but with a little rental rebasing there will be a positive future. These locations may initially need a 15%-25% fall in rents to stimulate them and make trading viable for retailers, however they will be the growth

locations of the next boom, as well as the launch pad for new retail formats aspiring for the Grade A pitches.

Finally, there are the Grade C locations which have been most dramatically affected. These are the towns and pitches where even a large fall in rents is unlikely to stimulate the market in the short term. These are the locations that will need external forces including the biggest policy response to support change of use or regeneration. They will need to evolve and adapt but could create new opportunity.

Is this segmentation anything new for retailers? Perhaps not, but we think that retailer strategies which include creating the right balance of formats including the internet, click and collect, in town and out of town will steer the locations to become ever more polarised to the Grade A and B locations, where we are beginning to see the light at the end of the tunnel.

Shopping centre investment

The UK shopping centre market has seen a steady flow of transactions through Q2 totalling £743.85m in 12 sales, bringing the shopping centre transactions in the first half of 2013 to £2.16bn. The average lot size equated to £67.62m whilst the average yield dropped to 7.7%.

Notable deals in Q2 have included:

- The Bullring, Birmingham. The Australian Sovereign Wealth Fund sold their 33% stake of the centre to a JV between Hammerson and CPP for £307m, which represents a net initial yield of 5.3%, 5.5% equivalent yield.
- Spitalfields Market, London was sold by Ballymore to Ashkenazy for £105m. The sale reflected a net initial yield of 4.20% initial yield and was concluded in 3 days.

There are currently 21 shopping centres under offer, (£578.2m) and 23 shopping centres in the market, (£1.98bn).

Examples include:

- St Enoch's Glasgow which is being marketed for £172m. This represents a net initial yield of 8.00%.
- Bon Accord and St Nicholas, Aberdeen which was marketed by British Land and Land Securities for

→ £200m. The asset is under offer at £185m which reflects a net initial yield of 7.5%.

We anticipate that c.20 shopping centres are coming to the market, representing £530m.

There are currently in the order of 80 active buyers in the market from the REITS to the UK institutions, UK property companies, opportunity funds and sovereign wealth funds. This is a c. 35% increase on the same time in 2012.

Investor demand from all types of investor has increased this year:

UK REITS

There has also been a significant movement since the start of 2013 with a true ‘flight to prime’. The UK REITS in particular have lowered their return criteria and we have seen strong bidding on prime shopping centres when these have become available. The disposals at Midsummer Place Milton Keynes and Guildford demonstrate the appetite from the REITS and UK Institutions together with the levels at which they are prepared to pay to secure a prime and rarely available asset. Prime yields in the order of 5% minus are here for the foreseeable future.

UK Institutions

At the same point last year there wasn’t a single noted institutional requirement for shopping centres in the UK. Today that position is very different and there are currently in the order of 13 active requirements ranging from £25m to £300m. This shift in demand is having a profound effect on prime yields as has already been witnessed since the start of the year.

UK Property Companies

With the improving debt markets comes the rise of the debt leveraged property companies. There are currently in the order of 25 active property companies in the market, the majority of whom are seeking yields of 7.5%+.

Opportunity Funds

As with the property companies, 2013 has seen a huge rise in the amount of interest in the sector from the opportunity funds. Many of these have been seeking large loan portfolios but typically lot size targets range from

£40 - £300m with geared returns of 15 – 20%.

Sovereign Wealth Funds

We have seen an increasing number of active wealth funds in the market looking to acquire stakes with partners in the major shopping centre assets in the UK. The most active funds being CPP (Canada Pension Plan), EPF (Employees Provident Fund Of Malaysia), TIAA, Norges and the Australian funds managed by Henderson.

Looking forward we can foresee an inward yield shift on the strong town centre dominant schemes which are currently in the order of 7.5 - 8.0% initial yield. These assets will once again begin to look good value at the top end of the sector e.g. The Lanes Shopping Centre Carlisle acquired by F&C REIT for 7.8% initial and the Grosvenor Shopping Centre Portfolio acquired for 8% initial.

TABLE 1 **Shopping centre yields**

| | Q4 2012 | Q2 2013 |
|----------------------|---------|---------|
| Super-Prime | 5.00% | 5.00% - |
| Prime | 5.50% | 5.25% - |
| Town Centre Dominant | 7.50% | 7.50% - |
| Secondary | 9.00%+ | 9.00% + |
| Tertiary | 14.00%+ | 16.00%+ |

Source: Savills

High street investment

The high street investment market has deteriorated further over the last quarter right across the board.

The only exception is at the very prime end of the market but with investors being selective ‘prime’ centres can probably only be counted on one hand. Valuing with any degree of confidence/accuracy is almost impossible. Savills are selling prime shops in over 20 towns in the UK and we can therefore boast arguably the best high street investment knowledge out of any of the major practices.

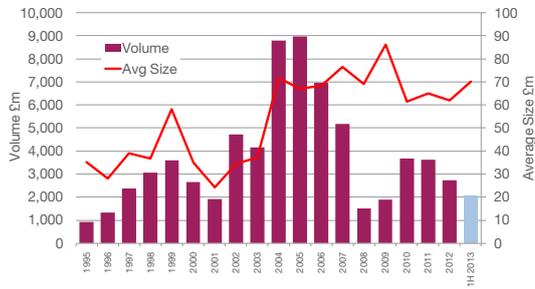
Sentiment is determined by a number of factors but in particular, covenant remains king and towns where there still remains the possibility of a future shopping centre, and therefore a possible impact on the supply / demand balance remain out of favour.

For the institutions high street investment remains the less preferred sector. Confidence in the continuity of income in a world where retailers are continuing to falter, coupled with a lack of any prospect of rental growth in the short to medium term has left the funds cautious when it comes to high street. Increasing yield pressure on office and industrial investments has however started to make high street look good value and as we head towards the last two quarters of the year it is likely we will see a return of focus on the high street and in particular for prime well secured shops in the major centres. We are already seeing one or two examples where funds are looking to make this return but it will be interesting to see whether this trickle becomes a stream.

The private investor market remains equally as selective and incredibly shallow when it comes to the number of parties for all but the very best towns. Even for quality locations in the top towns it is surprising how few buyers there are at the moment and with the market arguably as fickle as early 2009 there are definitely opportunities for buyers to pick up some excellent bargains right across the piste. This market is also heavily influenced by the action of the lending banks who remain at their most conservative when it comes to finance for the high street market. Caution must still prevail in the immediate future and until there is pressure on occupiers to take longer leases High Street remains a predominantly cash only market.

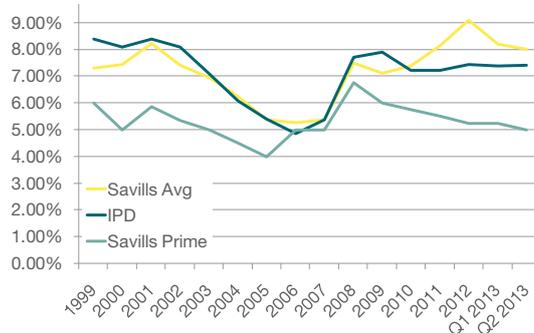
With so much sporting good news and now a bit of sunshine it would be nice to think that we are set for retailers to improve their performances and for the markets to start to turn the corner. However with shorter leases still the norm and with the last tranche of former privity of contract 25 year leases coming to an end in the next 18 months it feels that general stability and confidence will not return just yet. And therein lies the rub, could now be the best buying opportunity in the cycle?

GRAPH 1 Shopping centre investment volume



Source: Savills

GRAPH 2 Shopping centre yields



Source: Savills

GRAPH 3 UK consumer confidence



Source: GfK

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