SPOTLIGHT
Savills Research

UK Commercial – Spring 2019

UK retail warehousing

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Precautionary saving risks • Impact of CVAs on vacancy • Investment risks and opportunities

> **Retail warehousing is arguably the most defensive part of UK retailing against the rise of online retail. This is true for the goods sold, and the flexibility of the space that is available**

Caution was the watchword in the UK retail property sector in 2018, both around the continuing impact of online and the impending impact of Brexit. This led to a sharp fall in investment activity, rising yields across all subsectors, retailer failures, CVAs, and limited occupational demand.

A degree more rationality has entered the market in early 2019, with canny investors starting to look more forensically at UK retail.

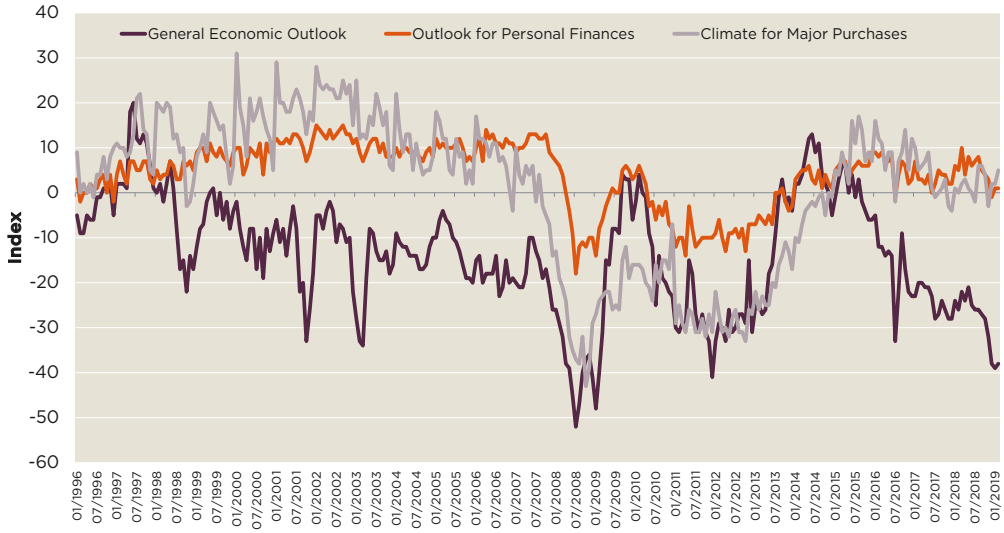
Retail warehousing is definitely attracting more investor interest this year, and we believe that this reflects a wider understanding of not only the defensiveness of some parts of retail warehousing to internet retailing, but also the fact that the best assets have perhaps repriced more than they should have done.

The last 12 months have seen prime retail warehouse yields soften by up to 100 basis points, and this combined with a number of willing sellers will mean that transactional activity will rise in 2019.

Significant questions remain about the outlook for this sector, but we believe that dominant bulky goods parks, where overrenting is limited (or can be remedied by buying the asset cheaply), will outperform the wider retail sector.

As ever, the key to bucking the wider trends will be the ability to look behind the headlines and assess the retailer and customer attractiveness of a particular scheme or location.

Consumer confidence has weakened in recent months, but people remain positive about their own financial future, and the environment for major purchases. The latter trend supports continued spending growth on bulky parks in particular



Source GfK

Consumer trends

Solid consumer fundamentals continue, but Brexit uncertainty could drag on retail sales growth.

The outlook for the UK economy remains undeniably weak, with the latest consensus forecast suggesting that GDP growth will average only 1.5% per annum over the next five years. The fact that this is in line with the projected growth for both France and Germany suggests that it perhaps has less to do with Brexit than a wider variety of factors that are slowing the global economy. However, slower GDP growth inevitably means weaker wage growth, with a corresponding drag on retail sales.

On the face of it however the British consumer should be feeling reasonably happy. Unemployment remains close to its lowest ever level at 4%, and consumer price inflation has eased downwards from its recent spike. This means that real earnings have grown by 1.1% over the 12 months to the end of December 2018, the fastest rate of growth since November 2016.

While consumer confidence has weakened in the early part of 2019, there is little sign in the official data that this is feeding through into slowing retail sales, and Christmas trading was generally up year-on-year both in terms of like-for-like and total sales.

Brexit uncertainty and consumer behaviour

With the Brexit clock at five minutes to midnight we have to indulge in some speculation about possible outcomes and what they might mean for consumer spending. Most opinion polls seem to indicate that when people are not questioned specifically on Brexit it is a minor concern. However, it is the question of a disorderly or hard Brexit that probably has the most significant implications for consumer sentiment and behaviour.

The biggest problem in assessing the impacts is that there is really no direct comparative event in the UK's recent past. While the Global Financial Crisis was a very different situation for the UK consumer, the one similarity between that and a disorderly Brexit might be that both affect consumer sentiment fairly quickly.

In early 2008 the household savings ratio was at a fairly low level of just under 7%, but as the ripples of the GFC spread this quickly rose to 12%. While the direct effects of the GFC were fairly limited at that stage on the UK population, the unremittingly negative newsflow drove this sharp rise in precautionary saving. This in turn led to an almost immediate fall in retail sales growth, and then the swing into recession.

The last three years have been a period of very low savings ratios in the UK, primarily due to the equally low interest rates on offer

0.9%
of units experienced a rent reduction due to CVA in 2018

to savers. Consumers have not just been spending the balance, some of what they previously might have saved has been used to pay down other types of debt. However, the lurking question around Brexit remains whether consumers would swing back into precautionary saving mode if uncertainty intensifies.

At the moment there are no signs that this is happening, indicating that perhaps Brexit is still seen as 'someone else's problem', but if a spike in savings ratios were to happen then we believe that it would lead to a short, sharp slowdown in retail sales growth.

While the latest CIPS surveys are pointing to the economy flat-lining in Q1 2019, they generally tend to undershoot in times of heightened uncertainty. Other surveys, such as the BRC retail sales data and the SMMT data on new car registrations support a more optimistic view of marginal positive growth, even as the stopwatch counts down on Brexit.

Assuming that a full disorderly exit from the EU does not happen at the end of March 2019 leaves us with a modestly positive view for the UK economy this year and next. There are few reasons to suggest that interest rates will move up sharply in the short term, and this combined with low savings rates will support average annual growth in both real disposable incomes and consumer spending of around 1.8% per annum over the next five years.

Occupational market

Putting CVAs and failures in context and combining them with data on new openings tells a very different story for the sector

Recent failures and closures in an historic context

2018 was a year in which CVAs, failures and administrations dominated the headlines. However, as with any happening context is everything. Last year 3.3% of out-of-town retail units were affected by some kind of negative corporate news. By comparison just the loss of Comet, JJB and Focus alone in 2011 resulted in the same proportion of the market being affected. These three combined with the subsequent failures of MFI, Allied Carpets and Brantano had a far more dramatic impact on vacancy rates in the sector, driving it up to 10% in 2012.

Furthermore, while the post GFC failures resulted in all the affected units being closed, only 36% of the units that were affected last year were earmarked for closure. This is less than 1.2% of the UK market as a whole.

Indeed, by far the largest change last year was the number of units that were switched to a monthly rent (497 units, 38% of all affected stores), which means there was no loss of revenue to the landlord.

This means that while the overall headlines were grim for the sector, the reality was that only 0.9% of the UK out-of-town retail market experienced a rent reduction.

While none of this is particularly good news for retail warehousing as an asset class, the difference between the headlines and the reality should inject some rationality into the market in 2019.

Out-of-town store openings were above average in 2018

The headlines of last year might also lead one to believe that no retailers were expanding, but once again the real story is somewhat different. Over the last seven years the sector has seen an average of 819 new openings per annum, and 2018's total was 868. While this was sharply down on 2017's level, it is still 53% up on the post GFC doldrums.

Expansion has predominantly been driven by value-orientated retailers such as Aldi, Lidl, The Food Warehouse, Home Bargains, The Range and B&M. This trend looks likely to continue into 2019, as around 250 stores were under offer to such retailers at the end of last year.

What is clear from these statistics is that retail warehousing remains an attractive proposition for a variety of retailers and leisure operators, due to its accessibility, unit sizes, car parking, and lower occupational costs. Also, while the proportion of retail sales that take place online is still rising, the type of goods sold from many retail warehouse parks are being cannibalised less than goods that are traditionally more high street biased.

Furthermore, the large units and ample car parking on offer at a typical retail warehouse

36%
of OOT units affected by CVA or administration were closed

148
OOT units affected by CVA or administration were closed

33
of these units had been re-let by the end of 2018

“Rising housing turnover, particularly amongst first-time buyers, will stimulate spending on DIY and bulky goods.”

scheme lend themselves to click and collect and returns, the latter of which we expect to be the next battleground between retailers and customers over who pays for what.

The acquisitiveness of the value retailers has also helped to soak up some of the vacancies that have arisen due to last year’s CVAs and administrations. Our data suggests that 11 of the 69 units vacated by Toys R Us have already been re-occupied, as have 11 of the 110 Maplin units, five of the Poundworld units, two of the Carpetright, four of the Homebase, and one of the three Mattressman units following a similar path.

Experienced retail property investors should not be surprised that retailer’s fortunes ebb and flow, and this is particularly true in the relatively tight retail warehouse sector. A high level comparison of the top 25 out-of-town retailers in 2009 and 2019 makes this case very effectively. For example, back in 2009 Comet, Allied Carpets and Brantano collectively occupied 572 stores, and now none of these retailers exist. However, over the same period some retailers have dramatically increased their out-of-town footprint, with Lidl growing from 121 stores to 708 - making it the largest occupier by number of of out-of-town stores from its position in 2009 as #22 in the ranking.

None of Aldi, Iceland or Home Bargains were even in the top 25 back in 2009, and now all three are in the top 10 and occupy 1,095 stores between them. Other retailers who have moved up the top tenant rankings over the last decade include Pets At Home, McDonalds, Halfords, KFC, Argos, Wickes, Matalan, TK Maxx, Frankie & Benny, Next and Sports Direct.

Where will occupational demand go from here?

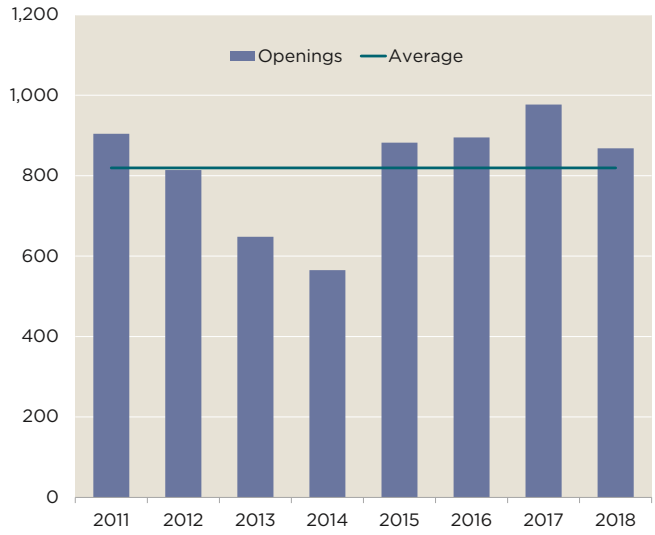
Whichever way the Brexit pendulum swings, 2019 will be a challenging year for retailers, and this will continue to affect occupational demand. However, the immediate post-GFC period showed that if consumers swing into belt-tightening mode then it is the value end of the spectrum that benefits. This suggests that whatever the political and economic outcome, the recent strong growth in demand from the value retailers will be sustained.

As we have already discussed, we believe that bulky goods retailers in particular are better insulated against the rise of online shopping than other goods categories, and that retail warehouses are generally better suited to service online sales.

There is also a strong linkage between DIY and bulky goods sales and the state of the housing market, which while it might worry those with a portfolio that is overly biased towards London and the South East, should excite those with a more Midlands or Northern bias.

While housing turnover volumes (generally the key event that drives people to spend on DIY, white or brown goods) remain low, some buyer groups have started to become more active. Most interestingly the number of mortgaged first-time buyer transactions rose from 359,000 in 2017 to 370,000 in 2018, and is forecast to reach 380,000 this year. While many pundits have suggested that millennials don’t do DIY, more first homes should mean higher spend on softer DIY, as well as the inevitable need for carpets, couches and washing machines!

Store openings in the retail warehouse sector were above average in 2018



Source Savills

Stronger house price growth also tends to stimulate home moves, so long as prices don’t hit the ceiling of affordability. Savills latest regional residential price growth forecasts that the North West and Yorkshire & Humberside are expected to see house price growth of over 20% over the next five years. Anecdotal evidence is already pointing to a corresponding pick up in turnover in these regions, with Wales, East Midlands, West Midlands and Scotland following close behind.

While the overall retail warehouse vacancy rate will tick up this year, we do not expect it to hit the double digit levels that it reached in 2008-2010. This will reduce some of the downward pressure on rents that we are currently experiencing, but by no means eliminate it.

Those retailers who are expanding, or indeed renegotiating their lease, will generally feel confident that they have the upper hand in most negotiations, and also that the majority of UK retail warehousing remains over-rented. This will keep average retail warehouse rental growth under gentle downward pressure through 2019 and 2020. The latest rental growth forecasts from Real Estate Forecasting for the next five years now stands at 0.4% per annum, with retail parks slightly out-performing this with growth of 0.5% per annum. However, most of this growth is towards the end of the period, with falling rents over the next two years.

These rates of growth, while pretty insipid, will be in excess of those being experienced across most other retail segments - a testament to the defensive and affordable nature of the subsector.

Yields	Dec 2016	Dec 2017	Dec 2018
Shopping Park	5.00%	5.25%	6.25%
Prime Open A1	5.25%	5.00%	6.00%
Prime Restricted	6.00%	5.50%	6.25%
Secondary Open A1	6.00%	6.50%	7.75%
Secondary Restricted	7.00%	7.25%	8.50%

Investment market

The investor caution of 2018 is likely to give way to selective opportunistic buying in 2019

Just over £2bn of retail warehouse assets were traded in 2018, making last year the weakest year since the nadir of the global financial crisis in 2012. While the first three quarters of 2018 were on a par with the same period of both 2016 and 2017, only £294m was transacted in the final quarter of the year.

Investor caution also had an impact on pricing last year, with the spread between prime and secondary yields continuing to widen. For example, while Prime Open A1 and Prime Restricted park yields have softened by 100bps, their secondary equivalents have softened by 125bps over the last 12 months.

The big question for 2019 is whether these corrections are enough, or whether a lack of transactional evidence has delayed further repricing.

One thing that the repricing has done is stimulate investor interest in the sector, both from non-domestic and domestic investors. Not only are these new entrants to the market speculating that the fundamentals of the sector are comparatively solid, but they are also attracted by the wider variety of willing sellers that are present in retail warehousing compared to some other asset classes. The rationale of these largely opportunistic investors is simple, the ability to deploy comparatively large volumes of capital into a sector where values have either fallen too far, or have fallen far enough to support rent cuts and hence enhanced lettability

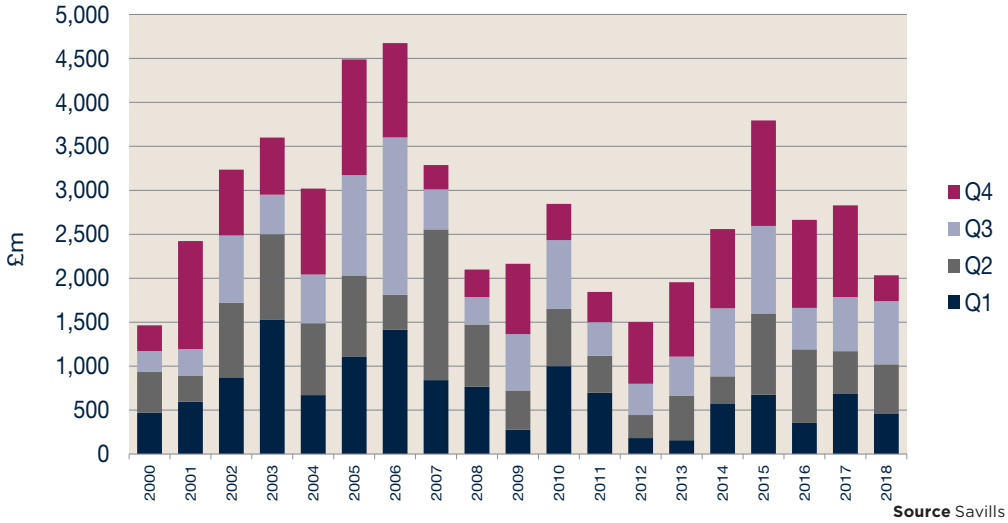
The other group of investors that are currently running their slide rule over the sector are the trader-developers. Their interest is in the low occupational density of retail warehouse parks, and the ability to deliver alternative uses such as residential or logistics either on the same site as retail warehousing, or in place of it.

Given a degree of valuation lag we expect that capital values, at least on the MSCI metrics, will continue to fall this year. This will probably inhibit some purchasers from acting, as well as meaning that some vendors will delay. However, we do not expect as much yield softening at the prime end of the market this year as we saw in 2018.

If, as we suspect they will, some major opportunistic investors enter the market this year then they will probably foreshadow the bottom of the cycle, both in terms of pricing and investment turnover.

While risk-adjusted returns are starting to look tempting there is still a wide gap between vendors and purchasers expectations. Delivering deals will depend on squaring this circle.

Retail warehouse investment volume was 28% down on 2017, but proved more resilient to investor caution than shopping centres and high street shops which were down 33% and 31% respectively



Source Savills

Outlook

Key themes for 2019

Brexit uncertainty will be the major factor hanging over the consumer economy in the short term, though there is little evidence that is has affected spending or saving behaviour to date. We expect a slight acceleration in sales growth in line with the improving real income story.

Retailers will remain cautious, particularly in relation to a potential slump in the pound if Brexit becomes disorderly. However, vacancy rates remain low in relation to previous weak points in the cycle, and tenant demand from discounters will remain steady.

Discount retailers will continue to be the most expansionary retailers in the retail warehouse space, and their performance could be boosted if shoppers swing towards a more cautious stance.

We expect that **rental growth** will be negative in 2019 and 2020, before starting to recover in 2021. Overall we predict that retail warehouse rental growth will be more resilient than some other parts of the retail market.

Investment activity will be swelled this year by an increasing number of opportunistic or repurposing buyers in the market. While further yield rises are inevitable, the attractions of the sector are becoming increasingly well understood. In particular we expect a resurgence in investor demand for rack-rented assets, or those where the rents can be re-based as a result of a lower entry price.

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