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Spotlight
UK Retail Warehouse Market

December 2016

Image: Kingsway Retail Park, Derby

SUMMARY

■ Recent months have shown that the UK consumer has remained spectacularly unmoved about the prospect of the UK's exit from the EU. As a result of this we expect that retail spending will remain robust.

■ The investor base for retail warehousing is broadening. This is driven not only by rising yields, but an increasing acceptance of the fact that the occupational market is generally very robust.

■ Tenant demand, particularly from the bulky goods sector, remains strong. Not only has the second half of 2016 seen a number of significant new entrants, but existing players in the value and bulky goods segments remain expansionary.

"Sales of retail warehouse goods will rise at 3.9% pa over the next five years, faster than overall household spending."

Economic and consumer outlook

While the political newsflow over the last six months has been heavily weighted towards the potential downside risks of Brexit, the consumer in the UK has remained largely unmoved by this background chatter. Consumer confidence did go heavily negative for one month in the immediate aftermath of the referendum result, but has since recovered to a more normal level of -3 on the GfK measure in October 2016.

The latest data for retail sales volumes shows that October 2016 saw a 1.9% month on month increase, and year on year growth of 7.4%. While some of this strong bounce can definitely be attributed to deferred spending, both due to post-referendum caution and the warm early Autumn, it still points to a clear indication that shoppers are feeling comfortable about spending.

This positivity is also seen in the recent date on savings ratios, generally the best indicator of whether consumers are feeling positive or negative. While the Q3 2016 data has not been released, the second quarter saw the household savings ratio fall to its lowest level since early 2008 at 5.1%. Some surveys are pointing to the fact that the recent spike in spending is being funded by people dipping into their savings, rather than through debt, and thus the current growth in retail sales is probably not sustainable. However, in terms of the short term outlook for retail in the UK all the measures are looking pretty solid.

When it comes down to spending on retail warehouse type goods, the state of the housing market is another important driver. In past editions of this report we have demonstrated that there is a close linkage between housing turnover and both DIY and bulky goods sales, and we expect this linkage to be sustained in the future.

While the recent trends in house prices are generally positive, other housing measures have become less strong in the months immediately after the referendum. For example, the RICS data on new buyer enquiries and new instructions showed a sharp fall in both buyer and seller confidence in June to September 2016, and this may be a harbinger of lower levels of housing turnover over the next year. Indeed, our latest forecast for housing turnover levels in the UK is for a slight fall in activity over 2017 and 2018 as uncertainty and higher transaction costs weighs on some households decision to move.

Interestingly, the anecdotal evidence from retailers in the bulky goods sector is that like-for-like sales growth has been strong this year. This would seem to refute the linkage between housing transaction levels and retail sales, and possibly points to a rise in spending on home refurbishments as people realise that the costs of moving might outweigh the benefits.

Looking to the medium term it is now very likely that inflation will rise, and this will soften real earnings growth and impact on retailer's margins. It is also likely that there will be moments of consumer uncertainty during the negotiation phase of Britain's exit from the EU. However, recent months have shown that for most UK consumers this subject is seen as someone else's problem!

This leads us towards a forecast of slightly slower growth in household spending than we have seen over the last five years (3.3% pa versus 3.5% pa). The slowdown in spending on retail warehouse type goods is likely to be more significant due to the very strong levels that have been seen over the last two years, and the lower housing transaction volume levels that we are expecting. However, we still expect total sales of retail warehouse type goods to grow at a very respectable 3.9% pa over the next five years, faster than household spending as a whole.

Investment market overview

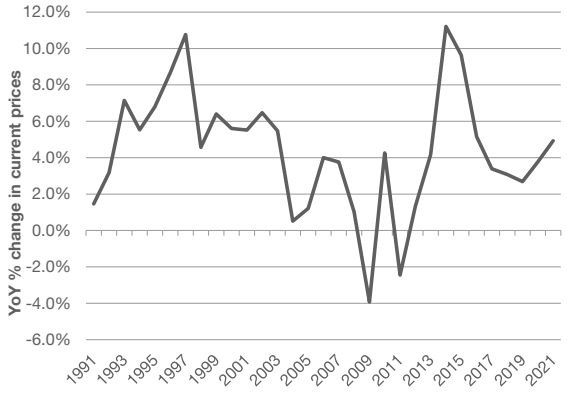
The recent trends in the retail warehouse investment sector have broadly mirrored those of the wider market, with a 36% year on year fall in investment activity.

However, as Graph 3 shows, 2015 was a particularly strong year for investment in retail warehousing, and actually 2016's total to the end of Q3 is 8.5% above the five year average.

We commented in our last Spotlight that the income return on offer from retail warehousing was likely to become increasingly popular in the future, and the gradual decay and then decline in capital value growth that has

GRAPH 1

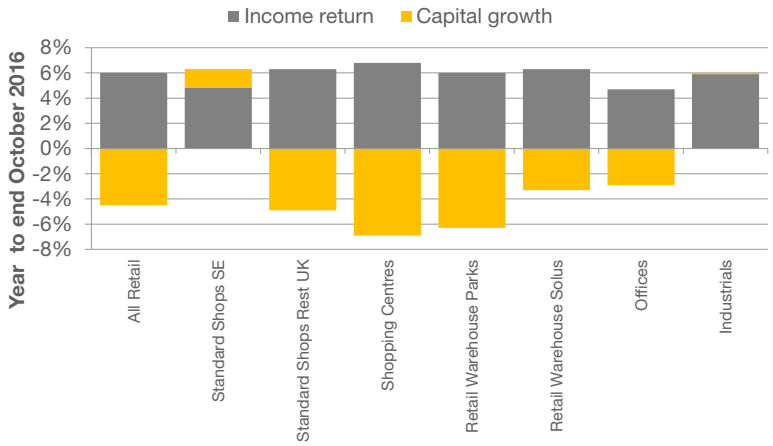
Consumer spending growth on retail warehouse goods



Source: Savills, ONS, Oxford Economics

GRAPH 2

Comparative performance



Source: Investment Property Databank/MSCI

been seen across most property sub sectors this year makes this view even more relevant.

Weakening investor demand has led to a steady softening in both prime and secondary retail warehouse yields this year, and we estimate that prime Open A1 yields are now a full 100bps higher than they were at their nadir in 2015. This puts them above their ten year average, and may well be a driver of rising investor interest in 2017.

Activity in the final quarter of 2016 is definitely hinting that the investor base for retail warehousing is widening, with more opportunistic buyers beginning to either research the sector or even bid. We expect that this broadening of demand will become more concrete as initial yields on better quality assets start to rise above 6%. Q4 2016 has been fairly active, and we expect the total investment volume for this year to exceed 2014's total of £2.5bn.

The rationale for buying retail warehousing in 2017 is not just about comparative yields. As the occupational section of this report discusses, tenant demand in the bulky goods segment remains strong, and this is set against a dwindling level of availability on the best schemes.

This supply/demand imbalance is unlikely to be rectified by development activity, as while there are several significant schemes due for completion next year, both lender and borrower risk-aversion will limit supply-side risks.

This leaves retail warehousing with a comparatively strong income return, and even some prospects of upward rental growth in some locations. This combination should prove attractive to investors in 2017, and thus the opportunities to buy the sector at higher than average yields may be short-lived.

Occupier market overview

Retailer demand, particularly from the bulky good sector remains strong in established centres across the UK, with some retailers in this segment of the market reporting double-digit like-for-like sales over the course of 2016. While such strength might seem counter-intuitive in the face of rising import costs and wages, it is clear that the best brands at all price points are trading well and profitably, and they expect this to continue into 2017.

Following on the heels of Tapi's launch in 2015, this sector has seen the return of another industry legend in the form of Lord Kirkham and his new brand Fabb Sofas. Their first store is now open in Southampton, with a further five stores already acquired and several more under offer. Typical store sizes for this national roll-out are 20-35,000 sq ft. The other recent new entrant to the bulky goods sector is Natuzzi, who have opened circa 5,000 sq ft stores in Thurrock and Brent Cross. Other rapidly expanding bulky brands include Sofology, Wren Kitchens, Mattressman, and Oak Furnitureland, with the latter looking to target another 70 stores.

Perhaps the most exciting new requirement is IKEA, who have opened new format stores in Norwich and Aberdeen. These stores range in size from 20-30,000 sq ft and are designed to compliment their existing larger format stores. We understand that the trial stores have been a success and that IKEA plan to acquire further stores in the UK, and are actively looking at opportunities.

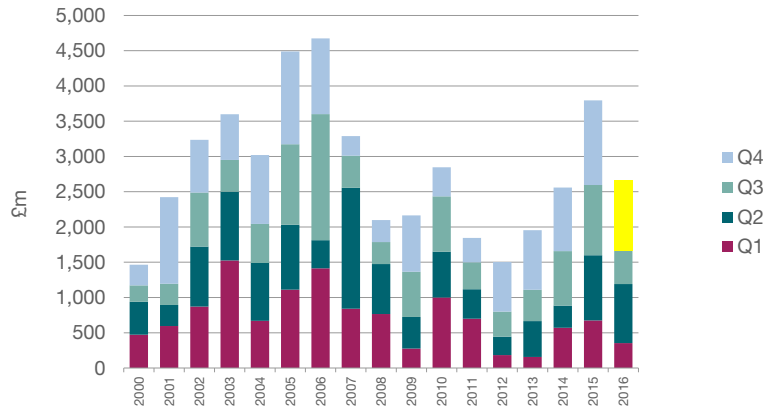
Looking ahead we are not expecting any significant retailer failures in the bulky goods segment, as many of the retailers that we had concerns about at the start of this year have either failed or reduced their liabilities through CVAs.

The story is less positive when we step away from bulky goods and into clothing, where tenant demand for new stores remains weak. As is often the case in the clothing sector the weakest part of the market is in the middle tier, where arguably many brands do not differentiate enough either in terms of product or price.

Next's fashion-only fascia continues to selectively seek new units in catchments where they are not represented, but their Next Home & Garden format continues to seek the very best destinations in order to trade their full range from 20-30,000 sq ft stores. We understand that the first two of these new concepts have traded so well that Next are now planning a significant number of openings across the UK of this 25-

GRAPH 3

Retail warehouse investment volume



Source: Savills. Q4 2016 is an estimate

TABLE 1

Retail warehouse yields

	May 2015	Sep 2015	May 2016	Dec 2016
Shopping Park	5.25%	5.00%	5.00%	5.00%
Prime Open A1	4.25%	4.50%	4.75%	5.25%
Prime Restricted	5.25%	5.50%	5.75%	6.00%
Secondary Open A1	5.25%	5.50%	5.75%	6.00%
Secondary Restricted	6.25%	6.50%	6.75%	7.00%

Source: Savills

35,000 sq ft format.

Other active clothing retailers in the retail warehouse market include Primark, who are continuing to open 25-32,000 sq ft stores, and Fat Face, who now have four 5,000 sq ft stores on retail parks across the country. In addition there has been competition in the outdoor clothing and leisure sector, with the likes of Mountain Warehouse and Trespass vying for units. This sector will develop further following JD Sports recent acquisition of Go Outdoors.

The strongest part of the non-bulky market remains the value end of the spectrum, where retailers such as Home Bargains, B&M, and GHM! are not only acquisitive, but also seen by landlords and other retailers as major drivers of footfall and sales across a whole park or scheme. Furthermore, most discounters are now prepared to sign 10 or even 15 year leases.

The size criteria of the value retailers has continued to evolve, with B&M now having stores as large as 45,000 sq ft under offer, and Home Bargains looking for 20,000 sq ft units in some locations.

While we do expect to see some rationalisation in this space over the coming years, there are still new entrants to the value sector. Most notable amongst these is Pep & Co's new 10,000 sq ft retail park format that they have branded as GHM!.

In the DIY sector there is a palpable tension around Wesfarmers' acquisition of Homebase earlier this year. Not only has the new owner reversed some of the planned store closures, but they are also looking to expand into new markets with a 60,000 sq ft format. The first store to undergo the rebrand to Bunnings is in St Albans, which will open in February 2017.

B&Q and Wickes will be closely watching how the Bunnings roll-out goes, but in the interim both are continuing to look for gaps in their market coverage where they might be able to open new stores, and keep the competition out!

The amount of vacant space on the market continues to decline, and this trend is unlikely to be derailed by the development pipeline. The capital expenditure challenge for many landlords is more likely to be around refurbishment, where they will have to balance the desire to enhance the shopper experience with retailer's understandable caution about what such spending might mean in terms of rising service charges. We believe that it is important to remember that this sector evolved out of a need for large and cheap shops. These are factors that will continue to attract retailers to the sector in the face of falling margins and the challenges of an omnichannel world.

Looking ahead to 2017 the combination of strong retailer demand and low vacancies on the best bulky goods schemes may well result in some upward pressures on both headline and net-effective rents. However, the rest of the market is unlikely to see any rental growth in 2017, which if nothing else will provide some support to retailers in what will be a tougher trading environment.

We remain convinced that retail warehousing is a strong offer both to retailers and shoppers in a multi-channel world, and the further growth of click and collect, returns and showrooming will continue to support retailer demand in this sector.

Savills out-of-town retail team

Please contact us for further information

Dominic Rodbourne
Agency
020 7409 9945
drodbourne@savills.com

Jaime Dunster
Investment
020 7409 9929
jdunster@savills.com

Charles Mocatta
Lease consultancy
020 7409 8726
cmocatta@savills.com

Johnny Rowland
Agency
020 7409 8721
jrowland@savills.com

Matthew Whiteley
Management
0161 277 7232
mwhiteley@savills.com

James Hurst
Investment
0207 409 9927
jhurst@savills.com

Jeremy Hinds
Planning
0161 277 7278
jhinds@savills.com

Ian Buchan
Agency - Scotland
0131 247 3806
ibuchan@savills.com

Nick Taylor
Lease consultancy
020 7409 8734
ntaylor@savills.com

Mat Oakley
Research
020 7409 8781
moakley@savills.com

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