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Spotlight
UK Retail Warehouse Market

April 2016

Image: Primark, Broughton Shopping Park, Chester

SUMMARY

■ We expect that the overall rate of growth in consumer spending will start to slow later this year. However, spending on retail warehouse goods is still expected to grow at an average of 5% per annum over the next five years.

■ Occupational demand is strongest in the bulky goods sectors, with furniture retailers currently particularly expansionist. We are also seeing strong demand from the value sector.

■ Improving demand and restrained supply is putting upward pressure on rents, and downward pressure on rent free periods. We expect this story to continue in the remainder of 2016.

■ The end of capital value growth bounce in this sector has meant that returns from retail warehousing have been comparatively weak. However, the rental growth story is improving, and the income return on offer from retail warehousing is beginning to look attractive.

"Investor demand for the sector remains polarised, with strong demand for prime and opportunistic assets."

Economic and consumer outlook

While economists and commentators are working themselves into a frenzy of excitement over Brexit, oil prices, the US election and Chinese growth, the UK consumer has remained remarkably unmoved by the ebbs and flows of global economic confidence.

While consumers are often accused of behaving irrationally, the fact that consumer confidence and retail sales growth are both pretty solid points to a far more rational attitude to the UK economic situation than that of many expert commentators. Indeed, with unemployment falling, real earnings growth firmly positive, household debt to income ratios falling, inflation flat, and the first rise in the interest rate still a long way off, the consumer should be feeling fairly positive about life and shopping.

As ever, there are risks to this world view, and public sector austerity will undoubtedly drag on consumer confidence in some areas. Generally though the remarkably close correlation between house prices and consumer confidence, and also between out of town retail sales and housing turnover, is pointing to a period of steady growth in retail sales volumes for the remainder of 2016 and through 2017. Furthermore, this recovery in the housing market will see the majority of UK regions house prices grow by around 15% over the next five years.

Looking beyond this year, we expect that consumer spending growth will slow as the caffeine high of low inflation fades away, and austerity bites in some parts of the country. However, we still expect that consumer spending on retail warehouse goods will grow at a very respectable average of 5% per annum over the next five years.

Investment market overview

The comparative performance of retail warehousing as an asset class against other property sectors has continued to weaken, primarily due to the low levels of capital value growth that are being delivered compared to offices and industrials. However, as Graph 2 shows, the income return on offer from the sector is comparatively strong, and this is important in an environment when investors are increasingly focusing on income.

2016 has started very slowly, with Q1 transactions only c£200m, and is currently experiencing a false market where buyers have paused for a combination of reasons including stock market volatility, fears over price falls, reduced inflows to the unit funds and Brexit concerns. The last point is most significantly felt at the large lot size end, and the fund dominated market that is retail warehousing has demand for lot sizes falling to c£60m max. Good prime property is always in demand, as proven by the recent interest in Purley Way, Croydon and Romford with both assets going under offer at c 4.5% NIY and 5.25% NIY respectively. The issue of yields easing out for most stock has bitten, and reality in vendor pricing expectations will enable the buyers to satisfy their requirements. The lifting of the current hiatus post referendum will hopefully provide the valuers with the opportunity they need to correct to market pricing.

Investor demand for the sector remains fairly polarised, with strong demand for prime and opportunistic assets, and relatively limited demand for the mid-market. This split is driven by the wider focus on income that we have already mentioned, with investors seeing the prime end of the market as likely to deliver a secure income return, and the opportunistic end of the market as offering the best potential for strong increases in rents where there is either a refurbishment or a void diminution story.

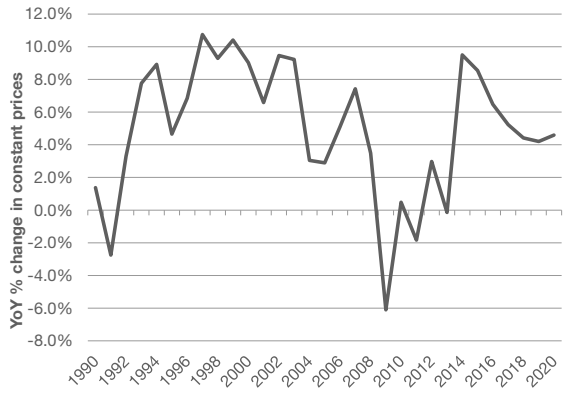
Prime assets are those where the scheme dominates the catchment, regardless of the planning status of the park. Indeed, as we majored on in the last few issues of this report, tenant demand is actually stronger in the bulky goods segment of the market than the general merchandise or Open A1 consented market.

The rental growth story has definitely improved over the last quarter, with the latest data from IPD/MSCI showing that average retail warehouse rents rose in all regions over the last 12 months, for the first time since 2007. Our current forecast is for this trend to continue, with annual average retail warehouse rental growth over the next five years of 2.5% per annum.

Retail warehouse yields have been

GRAPH 1

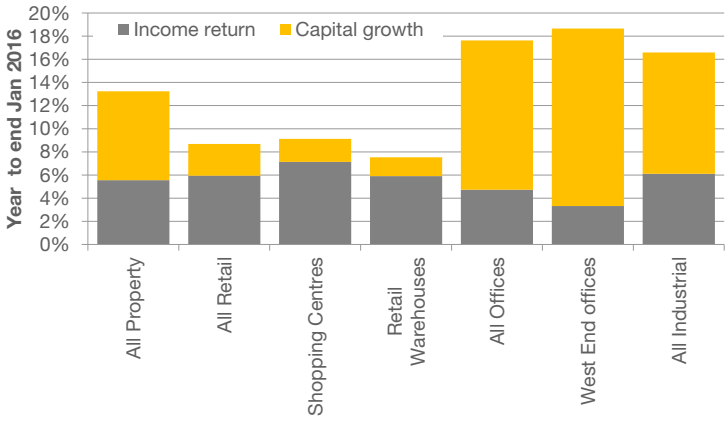
Consumer spending growth on retail warehouse goods



Source: Savills, ONS, Oxford Economics

GRAPH 2

Comparative returns



Source: Investment Property Databank/MSCI

amongst the most volatile over the last 12 months, with Savills moving both our prime Open A1 and Restricted yield measures out by 25bps and 50bps respectively last year. While we expect that prime yields will remain stable at these levels during 2016, there are likely to be similar corrections in the secondary and tertiary markets this year. This is more of a valuation issue than a transactional yield issue, with the current gap between prime and secondary yields looking a little too tight. It may well be that the major valuation houses use the period of uncertainty in the run up to the EU referendum as an opportunity to correct this.

Occupier market overview

Retailer demand, particularly from the bulky sector, remains strong. The key drivers of this are a desire by retailers to be well-positioned to capture the inevitable uptick in sales that will come as the housing market continues to recover, as well as a recognition that competition is extremely limited in some sections of the bulky goods market.

Those bulky goods retailers with the most active expansion programmes include Wren Living, Furniture Village, Sofology, and Tapi Carpets. Interestingly, following the successful launch of Tapi Carpets, which is led by Martin Harris who is the son of Carpetright's founder Lord Harris, another retail peer is reentering the fray. We understand that Lord Kirkham, the founder of DFS, is soon to return to the market with a new sofa concept.

Elsewhere in the sector we are hearing that IKEA's new 20,000 sq ft format stores are trading well, and that the rollout of the new concept will hopefully continue.

The retailer sentiment from the DIY sector remains mixed, though those retailers who reported figures over Christmas and New Year generally did better than expected. The biggest recent news in this segment is obviously the takeover of Homebase by Wesfarmers, the Australian owners of the hardware chain Bunnings. If their strategy in Australia is anything to go by then they will be aiming to take market share from B&Q and Wickes using both price competition and a strong garden centre offer. Conversely to Homebase it is expected they will also favour larger stores.

Elsewhere in the DIY sector B&Q are continuing their rationalisation programme, and Wickes continue acquiring 15-25,000 sq ft stores with external space.

The other major driver of tenant demand for retail warehousing at the moment is the value sector, where the retailer's aspiration to challenge the dominance of the major food retailers is clearly significant. Wilko are continuing their heavily out-of-town focused expansion programme for stores of circa 10,000 sq ft, as are B&M whose format is getting larger and larger. They have recently acquired on B&Q's lease expiry, a 37,000 sq ft store in Penzance. Home Bargains also continue to expand on retail warehouse schemes. The latest new entrant is GHM!, the out-of-town format being rolled out by Pepkor. The first seven will open this summer, with 25 wanted by Easter 2017. The 10,000 sq ft format is split equally between fashion, homewares and food.

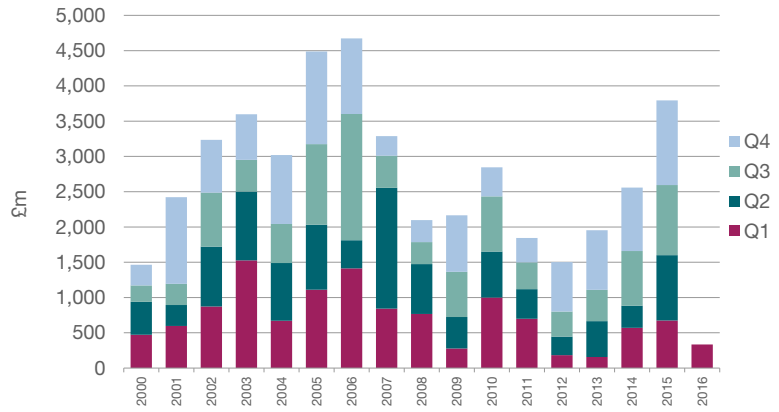
Continuing the food theme, Iceland is continuing to expand its new Food Warehouse concept and already has 12 stores open. This involves an expansion into more chilled and fresh food sales than they have done before, as well as some homewares and grocery offers.

The current strength of demand from bulky goods retailers, and falling supply, is definitely putting upward pressure on rents and downward pressure on incentives across the UK. Very few bulky retailers are now holding out for large incentives, as the demand to get stores open, and increasing competition is focusing minds on making deals happen.

This improvement in rents is beginning to enable landlords to consider park refurbishments, and a number of recent projects that have completed show that landlords are beginning to think more about the experience of a retail warehouse shopping trip, rather than just badging it as a convenience trip. This is especially prevalent on fashion parks, as demonstrated by the British Land's ongoing refurbishment at Broughton Shopping Park, Chester

GRAPH 3

Retail warehouse investment volume



Source: Savills

TABLE 1

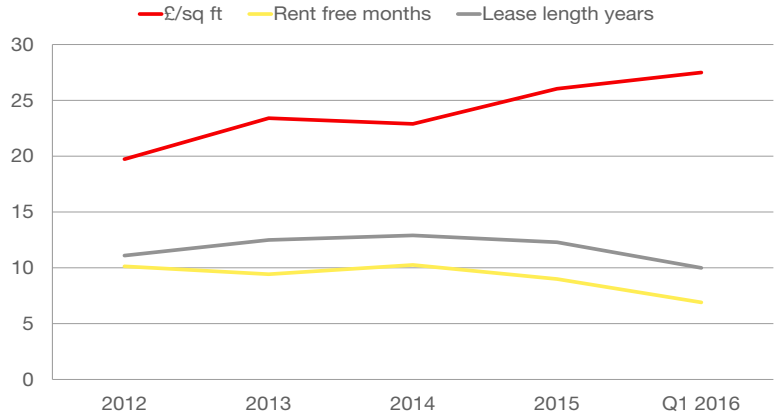
Retail warehouse yields

	Dec 2014	May 2015	Sep 2015	Mar 2016
Shopping Park	5.00%	5.25%	5.00%	5.00%
Prime Open A1	4.25%	4.25%	4.50%	4.75%
Prime Restricted	5.25%	5.25%	5.50%	5.75%
Secondary Open A1	5.00%	5.25%	5.50%	5.75%
Secondary Restricted	6.00%	6.25%	6.50%	6.75%

Source: Savills

GRAPH 4

Retail warehouse average rents and terms



Source: Savills

where Primark have just opened (front cover photo).

While all the preceding comments are pretty upbeat, it would be naive to imagine that everything is positive for retailers in this sector. The biggest non-property challenge for retailers over the next few years will be adapting to the new minimum wage. Given that staff costs remain a significant factor for most retailers, as well as the increasingly negative newsflow around "zero-hours" contracts, the pressure on margins from this element of the equation will remain considerable. Indeed, the BRC recently suggested that rising costs could result in the loss of around one million retail jobs over the next decade. Another challenge to some retailer's margins will the be impending rating revaluation. While there is very little detail on this available yet, we believe that it will hit high street retail harder than out-of-town, and that generally retail warehouse parks and schemes are likely to see stable or lower bills.

With our earlier comment that both headline and net effective rents are beginning to rise comes the final challenge to retailer's margins. Some of the renewed retailer demand for retail warehouse units that we are currently seeing must be attributed to the fact that rents have fallen to an operationally more affordable level on many parks. Indeed, while the MSCI rental growth index for retail warehousing is showing that rents have been rising since mid 2014, they remain around 28% lower than they were in Q1 2007. If the relationship between supply and demand is now swinging towards the landlord, then further rises in rents seem inevitable. RealFor are currently projecting that rental growth will average 2.6% pa over the next five years.

Will this level of rental growth be enough to negatively affect retailer's margins, and thus put a brake on expansion? While the relationship is not a perfect one, the fact that Oxford Economics are forecasting that the sales volumes of retail warehouse type goods will rise by an average of 5.8% per annum over the next five years, leads us to conclude that property costs are unlikely to be drag on the performance of expansionist retailers over that period.

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