UK Retail Warehouse Bulletin

Autumn 2010

"We are now seeing competition for space on the prime schemes as retailers begin to expand."

Image: Elliott's Field Retail Park, Rugby. Currently being marketed as part of Project Blue.

- According to the IPD monthly index, retail warehousing is now one of the strongest performing subsectors with an average annual total return for the last 12 months of 32.16%.
- We believe that the big question facing the retail warehouse investment market at present is whether current yields are pricing in as wide a variety of rental growth prospects as they should be.
- Tenant demand has picked up sharply over the last six months, and with falling vacancy rates in many locations the outlook for prime rental growth in 2011 is undoubtedly upwards.
- Also in this issue we focus in on the local trends in the retail warehouse market in the North and Scotland.

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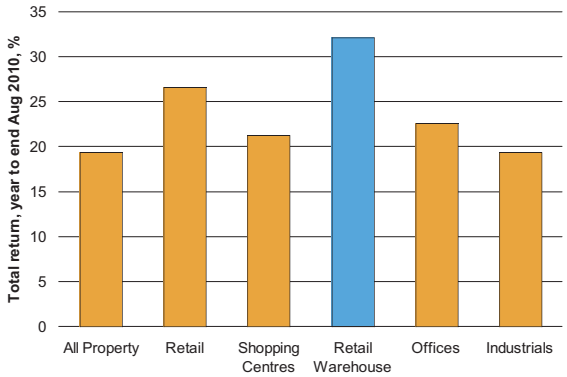
Investment performance trends

In our Spring 2010 bulletin we stated that the retail warehouse investment market had seen “a dramatic turnaround” over the preceding nine months. Rather than search for a superlative that tops “dramatic”, all we can say about the last nine months is that the drama has continued.

Even looking at average performance figures from IPD the significant repricing of the sector has delivered total returns not seen since the growth of the sector out of the early 1990’s recession. According to IPD’s monthly indices the average annual total return for retail warehousing for the 12 months to the end of August 2010 now stands at 32.16%. As the chart below shows, this makes retail warehousing the strongest performing subsector of the UK commercial property market this year. Of course one year’s total return will never tell the whole story, and it was only 15 months months ago that the sector total return was running at nearly -30%.

Comparative total returns



Source: IPD

So what has driven this recovery? While we would love to be able to point to a recovery in rental growth rates this is not yet true (although they aren't falling as fast as they were nine months ago). Virtually all the total return has been driven by a huge recorrection in capital values, with the average capital value growth over the last 12 months standing at 23.6%. Average initial yields have hardened by a further 50bps this year, on top of the 100bps hardening that they saw last year.

While many investors love a bit of volatility, the risk-averse investor in times like this still looks towards the income return component of returns. Despite the non-existent rental growth story, the average income return on UK retail warehousing remains a fairly healthy 7%, which is exactly in line with its long term trend.

Stepping away from the average performance figures there has been an even more dramatic yield recorrection in the prime market. According to our prime yield indices Open A1 schemes have seen a hardening of 75 basis points during 2009/2010, while prime Restricted parks have seen a hardening of 100bps. However, prime yields have now been stable for some months, and investors are now looking for rental growth as they accept that the performance gain from yield shift is beginning to disappear.

So where is the rental growth going to come from? According to IPD, average retail warehouse rents are still falling at a rate of around 2% per annum. However, if we look at the data for the last three months the falls have slowed to 0.1% over the last three months compared to the 2% fall in rents that was seen in the same three month period last year. In rental growth terms the one bright spot for investors is in the Midlands & Wales where rents began to rise three months ago, delivering a 0.8% average rise in rents on a three month annualised basis.

We examine rental growth prospects in a bit more detail later on in this report, but in short we expect rental growth to return to positive territory across the UK indices by this time next year. Over the next five years we are forecasting an average annual prime rental growth rate for retail warehousing of 3% per annum - in comparison to the 6% per annum that was seen coming out of the early 1990’s downturn. However, we expect that behind this figure will be an abnormally wide spread of growth between locations.

The bigger question facing the investment market is whether current yields are correctly pricing in a wide variation of rental growth prospects at regional and sub-regional level. The recovery in consumer spending is going to be patchy, and this will mean that retailer demand and rationalisation is likely to remain highly location sensitive for some time to come. Is a 150bps gap between prime and average yields a sensible spread considering the risk of nil or continuing falls in rents in some locations? Looking back to the mid 1990s the gap was more in the region of 250bps, and we believe that this indicates a degree of overpricing of secondary assets at present. Prime capital values look supportable, but the next 12 months amy well see some falls in secondary capital values. As ever in property, stock selection will be key.

Prime retail warehouse yields (%)

	Mar 2010	Oct 2010
	Initial	Initial
Shopping Park	5.00%	5.00%
Prime Open A1	5.00%	5.00%
Prime Restricted	6.00%	6.25%
Secondary Open A1	5.75%	6.00%
Secondary Restricted	6.50%	6.75%

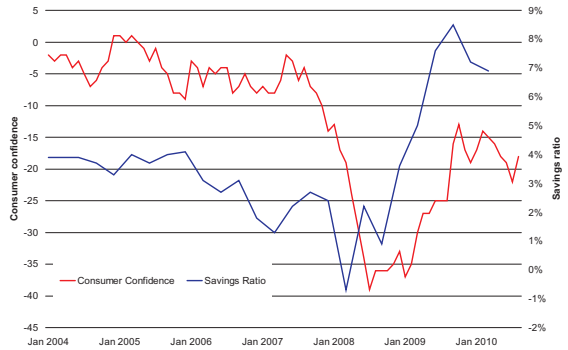
Source: Savills

Consumer trends

As the official retail sales and consumer spending data become increasingly unrelated it is worth looking around for alternative measures that might provide a better steer on consumer behaviour. The first 18 months of the recession saw real private consumption fall by 4%, the largest decline in spending over a year and a half that had been seen in a data set that goes back to 1955. While the perfect storm of rising fuel prices, banking crises and recession has now ebbed, the message doesn't appear to have fully fed through to the shopper.

As the chart below shows, the savings ratio has slipped downwards from its peak indicating a marginally less pessimistic view of the future (or the need to dip into savings to fund essential spending). However, consumer confidence remains negative and volatile, perhaps reflecting the huge uncertainty about what public sector austerity really means for each and every household in the UK.

The consumer doesn't seem convinced that the economic recovery is underway



Source: GfK NOP / Office for National Statistics

This lack of confidence is certainly a contributing factor to the fact that real household spending has not recovered as strongly as it should have. Between the third quarter of 2009 and the first quarter of 2010 real private consumption grew at 0.2% pa. However, lurking behind this very unimpressive recovery are some more positive trends.

The high level of inflation at present clearly makes real household spending look less good, in nominal terms the quarter on quarter growth rate has accelerated from -6% in early to 2009 to +6% in early 2010.

Spending on durable goods was buoyed up last year by car scrappage and the stamp duty holiday. The ending of both of these programmes caused durables spending to fall back to historic low levels. However, as consumer behaviour begins to become a bit more rational the current low level of spending implies the possibility for a much stronger than normal recovery in spending on bigger ticket items. Given the impending rise in VAT at the end of the January 2011 we believe that there might be a sharp rise in spending on higher value items as consumers rush to save themselves some money on more expensive VAT'able products.

While the conclusions of the Comprehensive Spending Review and the next report from the OBR at the end of November wont be particularly pleasant reading, they may at least bring to the end the speculation on how bad things "might" be. Past analyses of the drivers behind changes in consumer confidence show a significant drag on confidence is uncertainty. The removal of uncertainty about public sector austerity should deliver a degree of stabilisation to consumer confidence.

So if we assume that public sector austerity worries will wane over the next 12 months, and that private sector growth in many locations will more than compensate for public sector contraction or stagnation, when will the consumer recovery really begin?

Some people are beginning to worry about the likely impacts of the inevitable rise in base rates on consumer spending. Given the degree of press comment on how many people had benefited from zero or close to zero interest rates on their mortgages, you might think that the risk of rising interest rates is a big one. While most who were on a variable rate benefited to some degree, the spread between rates paid and received has widened.

Experience from the mid 1990's suggests that a 100bp rise in the base rate leads to a 75bp rise in the rates paid and received by consumers and households. Given that consumers have been paying down debt and increasing savings over the last 18 months, then the relative impact of a rise in base rates should be comparatively minimal - however this will depend on whether future rate rises are reflected in both the rates on offer to borrowers and lenders.

A sustained pick up in sales will only come once consumer confidence is back to normal, and the spectre of 25%-40% cuts in public spending has been crystallised and factored in to people's perceptions of their own financial stability. However, economic growth is returning and employment levels are rising. 2011 will see a return to near normal levels of GDP growth, and thereafter a recovery in consumer confidence, household spending and retail sales. The first half of next year will undoubtedly still feel recessionary for many people and parts of the UK, but every half a point rise in GDP growth cancels out a large amount of public sector cutbacks, so perhaps the end of the tunnel of consumer caution may now be in sight.

Retailer trends

The last six months has seen the beginnings of a turnaround in retailer's fortunes, despite the continuing volatility in consumer confidence.

This recovery is by no means ubiquitous, but if we examine the published sales figures for retailers for the second and third quarters of 2010 the average like-for-like (LFL) sales growth has been +0.3%. Interestingly those retailers who trade predominantly from retail warehouse schemes have actually reported stronger sales growth (+0.6%), perhaps reflecting a consumer perception that shopping on retail warehouse parks is a more value for money pastime than shopping in-town?

Some of this LFL growth is merely a reflection of how torrid 2009's trading was, but if we look behind the turnover numbers it is clear that for at least some retailers margins have also begun to improve - predominantly through cost control, though with some retailers highlighting price increases as a contributing factor.

Behind this generally positive overview there remains a disconnect between the results being reported and the retailer's appetite for new stores. Those retailers who are expanding are being very demanding on the terms that they want from their landlord. Shorter leases and capped rents remain very much the flavour of the moment as retailers capitalise on a still weak letting market (possibly their last opportunity to do so this cycle). However, the vast majority of quality vacant space available has now been let, which means that retailers wishing to expand are now being forced to consider higher rents in order to make the asset management stack up.

The prime schemes, where demand from retailers is strong, are performing well and we are seeing competition for space. The second and third tier stock, where demand is thin, is still seeing experiencing downward pressure on achievable rents.

Comfortingly for the landlords out there the list of retailers who are expanding on retail warehouse schemes is widening, with TK Maxx, Homesense, Boots, Argos, Dreams, Pets at Home, Halfords and Maplin all actively looking to fill holes in their national store networks.

On top of these traditional retail warehouse players there has also been a resurgence in demand from general merchandise retailers, with Debenhams, Gap and New Look all recently announcing that the shortage of suitably sized units on the nation's high streets being a factor in them beginning to look to the retail warehouse sector for the next phase of their expansion programmes. For landlords in the sector this might be the one positive impact of the credit crunch, with the cessation of in-town retail development now leading to an undersupply of larger, regularly configured shop units in the stronger catchments.

At present the supply, at least in the more desirable catchments, seems fairly well balanced with the good pick-up in demand. However, looking ahead the twin buffers of lack of debt and potentially more NIMBY'istic planning may stifle the delivery of new retail warehouse schemes. At the moment we believe that the prospects of an upturn in large-scale retail warehouse development activity are pretty minimal, unless the scheme is foodstore-led or standalone. This shrinking retail park development pipeline and the falling vacancy rate will undoubtedly be the factors that begin to deliver upward rental growth in more sought after locations, but with the national retail warehouse vacancy rate at around 12% (down from its peak of 16%), this turnaround in the balance of negotiation power between retailers and landlords is still some way off.

Looking ahead for retailer demand we believe that the next nine months will be a period of relatively muted levels of new requirements. The pick-up in activity that has been seen over the first ten months of 2010 has now stalled as retailers focus on getting their new stores open for the crucial Christmas and New Year trading period.

Furthermore, many retailers are telling us that they are unlikely to rush ahead with any further store openings until the impact of January 2011's VAT rise on their turnover and profits has been established. That, combined with significant confusion about the likely regional and local wealth impacts of the government's austerity programme will be a dragging factor on retailer expansion plans at least until the second quarter of 2011.

We believe that terms on offer to retailers over the next 12 months will remain attractive, whether they are acquiring new units or regearing leases on existing units. However, with the non-existent development pipeline likely to be a factor for the next two to three years it will not take much of a pick up in retailer demand to start pushing the retail warehouse vacancy rate quite sharply.

By the end of next year, as most of the vacant space becomes let up, we expect to see retailers having to get used to competing most of the time for the best units in the best locations, this will be when gentle upward rental growth will begin to emerge.

Regional overview

In this section of our report we are focusing on the regional trends in two major retailing markets of the UK. Mike Spens, head of retail warehousing in Scotland, and Craig Hudson, head of retail warehousing in the North, review the key factors that are in play in their respective regions.

Scotland

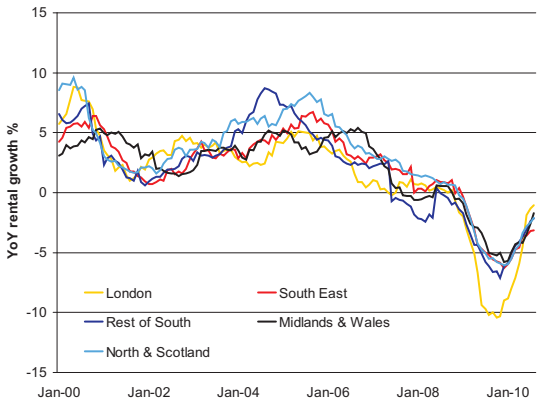
The Scottish out of town retail market has continued to improve year on year as occupational demand has picked up over the same period after a very quiet 2009. It is ironic that whilst Scotland may have been one of the earliest locations in the UK to pioneer retail warehousing it has potentially suffered more than other parts of the country with numerous corporate failures in recent years and the ability to fill voids. This is most notable in the bulky goods sector where the basket of operators is more limited by comparison to the rest of the country. Whilst the shopping parks have been able to attract leading retailers to the likes of Fort Kinnaird and Glasgow Fort it is not the same story on the bulky parks. Common to all sub-sectors has been the resulting falling rental levels and the the considerable incentive packages required to fill the voids as landlords seek to fill the vacant units.

It is arguably within the bulky goods sector that we have seen most activity of late in spite of the continuing number of retailers who have failed in the past year with Acorn Pet Centres having gone into administration and Reid Furniture having repositioned themselves since the company within which their leases are held was placed in liquidation. More encouragingly in the bulky goods sector we have seen Next Home, DSG, Dunelm, DFS, Pets at Home and Dreams all active as well witnessing two new entrants: Homesense and Wren Kitchens, seeking to open their first stores in Scotland. Incentive packages as a rule are generally around the two year mark with rental levels having fallen away from their peak in the interim. However, with more operators in the market the first signs of competition for space is appearing and has resulted in a trimming of incentives. Against this background rents are perhaps beginning to rebound from their nadir.

Across the wider spectrum of the out of town market Matalan, Boots and Sports Direct have all been active along with a number of the discount retailers including Home Bargains, Poundland, Pound World and B&M. Go Outdoors have continued their expansion into Scotland opening their second and third stores in Clydebank and Edinburgh.

Development activity remains at a low point however there are signs of activity with a number of new retail parks or extensions to existing retail parks being promoted on the back of a resurgence in interest and more favourably market conditions and lower costs. Schemes in Coatbridge, Dumbarton and Port Glasgow among others including Halbeath in Dunfermline where Royal London Asset Management are considering an extension up to 85,000 sq ft are all under review again.

Regional rental growth trends



Source: IPD

The North

The Out of Town market across the north has fared remarkably well over the last two quarters – but that of course depends upon what you benchmark performance against. Like the rest of the UK, retail parks in the regions have been hit hard by retailer failure creating voids, however, this has forced Landlords to act and whilst 'historic' rental levels remain an aspiration, generating income appears to have been a more important factor. The result has been a deluge of transactions and many new retailers acquiring units across the region.

Smyths Toys have acquired 8 units, 5 of which are in the North West including; St Helens, Wigan, Oldham and a pre-let in Bury - that's right, development has returned. A developer, advised by Savills, has pre-let 35,000sq ft off Angouleme Way. Other retailers include Pets at Home and Dreams. Development has commenced on site and practical completion is expected in March 2011. Spenhill have also submitted a revised application for Kirkby to create c 450,000 sq ft of new retail and leisure accommodation. The original application was refused at public inquiry in 2008.

Best Buy opened their new store at Aintree Racecourse Retail Park on 17th September. The unit which they acquired had been vacant and unoccupied since the demise of Courts in 2004. The park is now fully let. DSG have also opened their '2in1' Currys/PC World Megastore on the adjacent park.

Regional overview continued

Other notable activity includes H & M Hennes acquiring an 18,000 sq ft unit at the Peel Centre, Stockport due to open in November.

Turning to active regional retailers, CSL, a Wigan-based furniture retailer, have been ranked Number 1 in Business Excel magazines' 'rising stars' feature. It features the top 50 UK companies and the rankings are based not only on turnover and profit but the future growth of the company. CSL have a requirement for circa 15 stores expanding from their North West base into the North East and Midlands. In the food sector, Waitrose have recently signed a new lease at the Capitol Centre, Preston and have acquired the Boughton Centre in Chester to redevelop for a food store. Furthermore, Asda's purchase of Netto will no doubt create over laps in the region presenting further opportunities for other retailers.

On the whole, the North has fared well in bringing new fascias to parks, many of which have experienced multiple and longstanding voids. In such instances, the increased foot flow generated by these retailers together with landlords' progressive attitude is helping to reposition the schemes within the region in order to take full advantage of the improvement in the retail market as and when this returns. There are clearly exceptions to this in towns suffering from oversupply, restricted out of town planning permissions and multiple retailer failures.

The deals landlords were forced to accept in order to fill voids, reduce liabilities and generate income in 2008/ 2009 have diminished but not evaporated. The pendulum is at present swinging neither in favour of the landlord nor the retailer. However, retailer growth is being stifled through lack of either opportunity i.e. no new development/ appropriate existing units or the landlords reluctance to offer 'recession busting deals' and for this reason, retailers are improving the terms they are prepared to bid. The result is a return of asset management and in limited instances rental growth.

The future performance of the region remains in the balance. The public sector job cuts where the north has a higher than average dependence, imminent rise in VAT and high vacancy rates for some big northern towns and cities could neutralise or reverse the currently positive out of town activity.

We will be focusing in on the South and South West regions in the next edition of our bulletin.

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