

# UK Shopping Centre and High Street Bulletin

Q3 2014



## SUMMARY

■ The economic background remains confused, with falling real earnings growth yet strong consumer confidence. Despite this we expect that Christmas 2014 will be a strong trading period for retailers.

■ In the occupational market we are seeing confidence spreading from prime towns and pitches down into secondary and some tertiary markets. 2015 will remain challenging, but we expect that next year will be the turning point for UK retail.

■ Investor demand for retail is intensifying and broad based. The yield spread between prime and tertiary assets is narrowing rapidly as investors become more comfortable with risk and the concept of a wider market recovery.

“Over the next five years we expect average annual retail rental growth to be 2.5% pa.”

## The consumer economy

→ The economic news this quarter has been rather confused, particularly as it applies to the retail economy. Consumer confidence, as measured by the GfK index, continues to oscillate around the zero mark, well above its long term trend. However, pay growth remains weak with average earnings only rising by 0.7% in the year to August.

The most recent economic debate has focused on inflation, both in terms of the price of goods and labour. Annual CPI inflation fell to a five year low of 1.2% in September, nearly a third lower than predicted in the MPC's August report. This fall was partly driven by a drop in petrol and food prices, but core CPI inflation (which excludes food and fuel) also fell by 0.4 percentage points.

The forward trend looks unlikely to change this, with heavy competition in food retailing and a falling oil price likely to keep inflation low.

Of course low inflation is in some ways good for the consumer, if not the retailer, and a continuing theme of these reports has been a wish for the moment that earnings growth exceeds CPI. However, while employment levels are indicating that wage inflation should be accelerating, this is not yet the case. Average real earnings growth is continuing to fall, which is bad news for the retail economy in terms of consumer's propensity to spend, as well as being bad news for the wider economy because it means that income tax receipts will be lower than expected.

The one upside for retailers is probably the read-through to productivity, which is now rising at a faster than average rate. This means that unit labour costs will fall and enable employers to support profit margins without having to put prices up. Furthermore, the low level of inflation means that there is very little need for the MPC to raise interest rates soon or fast. Given the relatively high levels of household debt out there, the longer these rises are delayed the better it will be for UK retailing.

While retail sales volumes fell by 0.3% in September (their weakest performance since January), much of

this seems to have been due to the warm Autumn leading to poor sales of winter clothing (clothing and footwear sales were down 7.8% month on month). Despite this we expect that Christmas 2014 will be strong for retailers across most sectors, indeed we are expecting that it will be the strongest Christmas period since the start of the Global Financial Crisis.

## The retail occupational market

While it might be too early to call the beginning of a new space race, it is clear the the structure and volume of retailer demand is quietly turning.

Retailers are now looking beyond the prime towns, with rising demand for units in the secondary towns where rents have stopped falling, and tertiary towns where the bottom of the cycle is coming into sight. Retailer demand for these 'bread and butter towns' is to a large part being driven by value retailers and discounters, with retailers like Peacocks aspiring to increase their portfolios significantly. This change of tone is best demonstrated by the strong demand from a wide variety of retailers for stores within the Phones 4U portfolio.

In the food retail sector, while the recent newsflow has generally been very negative, we are seeing an increasing recognition that it would be a mistake to rush into downsizing when there are cyclical factors at play. Both the economy and population are forecast to grow over the next five years, and all these people will need somewhere to buy their food, even if the traditional large weekly shop model is changing towards an increasing number of smaller shops at local convenience stores.

We are seeing this spread of confidence from prime to secondary locations in many markets including London, with Toy Store setting a new rental high of £925 Zone A on Oxford Street.

There are still challenges ahead for retailers and landlords, but by the end of 2015 we expect to be past the peak of lease expiries in the high street retail sector. At that stage there will be a much clearer picture of where retailers want to be and where they can trade well from whatever

price point that they operate in. This will coincide with a sharp overall fall in UK vacancies, the end of turnover only rents in tertiary towns and pitches, and the return of actual rental growth in secondary markets.

Over the next five years we expect average annual retail rental growth to be 2.5% per annum, but this hides a wide divergence between some London locations that are expected to grow at 4.5% to 5.5% pa, and the rest of the country at around 2.0% per annum. However, the major change in our rental outlook over the last 12 months has been in the number of towns where we are forecasting negative average annual rental growth over the next five years. This has changed from more than 30 towns to less than five, as the aforementioned secondary market recovery, and tertiary market flattening has begun.

## Shopping centre investment

Q3 2014 saw UK Shopping Centre Investment turnover up 29% on Q3 2013, rising from £1.2 billion to £1.6 billion; this was in 38 deals.

The average initial yield in Q3 was 7.88% compared to 8.39% in Q3 2013. Notable transactions in Q3 2014 included:

- The acquisition by Orion Capital of East Kilbride Shopping Centre, Glasgow for £178 million from Delancey and RBS, reflecting an initial yield of 6.7%. Savills acted on behalf of the vendor.

- The acquisition by Standard Life of Palace Exchange, Enfield for c.£74 million, reflecting a 5.25% initial yield. This formed part of Project Swallowtail, which contained seven shopping centres and Fosse Retail Park, Leicester. Savills acted on behalf of the vendor.

- The acquisition of Cabot Circus, Bristol by Axa Real Estate Investment Managers and Gingko Tree also completed in Q3 2014 for £270 million, reflecting an initial yield of 6.20%.

- The acquisition by Cerberus and Edinburgh House Estates of the Glanmore Portfolio of six shopping centre assets located across the UK

→ for £80 million, reflecting an overall initial yield of 8.9%. Savills advised the purchaser.

Currently there are c.£1 billion of deals under offer, a further £1.18 billion in the market and another £500 million is likely to come to the market, in the short term (before the end of Q1 2015).

Q4 2014 has seen intense activity in the shopping centre market with increased investor activity and demand for the sector from all quarters; private equity, property companies, opportunity funds, institutions and sovereign wealth funds. At this stage in the year we estimate that total transaction volumes for the year will exceed £6.5 billion, significantly above the long term average of £3.8 billion.

The notable increase in activity from the institutional investors is largely driven by the continued increase in cash inflows and the sheer weight of money. We continue to see a significant number of new entrants coming into the market backed up by the increased supply and quality of the stock and the improved terms and availability of debt.

Increased retailer confidence is supporting the frenzy of activity in the sector, with a reduced number of administrations occurring, improving trading patterns, and rising consumer confidence. The improvement in retailer performance is starting to reduce vacancy rates in shopping centres and, furthermore, the spectre of rental growth is starting to be discussed in more than whispers!

We are seeing a reduction in the yield gap between prime, secondary and tertiary and town centre dominant secondary schemes with good income profiles are attracting excellent levels of demand.

The trend of shopping centres coming to the market as high profile portfolio sales has continued, most notably in Project Swallowtail, which attracted unprecedented levels of interest over the summer months; and Projects Tiger and Carbon, both of which have recently come to the market.

The one area of the market that continues to draw the least market

TABLE 1 **Shopping centre yields**

	Q2 2014	Q3 2014
Super-Prime	4.25%	4.25%
Prime	5.25%	5.25%
Town Centre Dominant	6.75%	6.50%
Secondary	9.00%↓	8.50%
Tertiary	12.00%↓	11.00%

Source: Savills Research

demand is those assets with short weighted average unexpired terms and where there is significant competition in the immediate vicinity.

### High street investment

Surely shops are now cheap? Well they certainly seem to be relative to other property sectors and all this coupled with the fact that consumer confidence is now as high as it has been since the start of the recession.

Of course there is still some occupational uncertainty. The news of Phones 4U entering administration and releasing 560 shops to the market has hardly helped sentiment, but as we have seen with other insolvencies take up of prime shops by the competition has generally been pretty good. Indeed this insolvency may even give landlords the first chance since the recession began to possibly achieve positive reversions.

Savills prime yields for M25 offices sit at 5%, multi let industrials at 5% and shopping centres at 4.5%. It is still possible to purchase good prime shops in the 5-6% range often off re-based rents.

Opportunity funds have already identified the value in the sector, and we are beginning to now see keen competition for portfolios of shops. These include properties in secondary locations. We are still an advocate of investors focusing on the UK's top centres and on finding clients rebased rents from which good growth should follow. In prime locations, as demand returns, landlords should also be able to command longer leases.

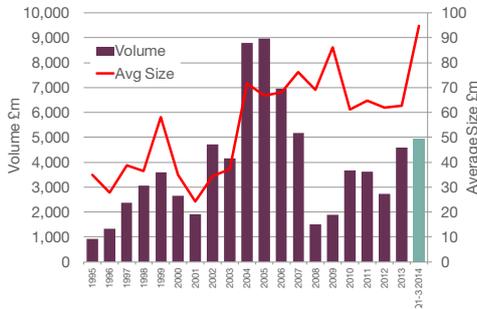
UK institutions are still selective in what they target, but with news

emerging that it is an institution who are under offer to purchase a prime block in Clapham Junction, where the residential value makes up a considerable amount of the income, it does seem clear that appetite remains strong for the right type of stock.

Property companies and private investors are also now able to obtain debt and this should see pricing improve over the quarter. The forthcoming auctions, where catalogue size certainly suggests that the market has returned, will be the real test and we would anticipate improved competition.

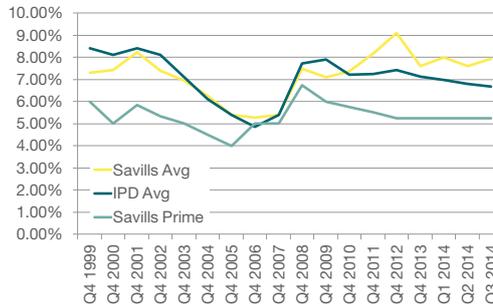
With the economic outlook remaining unsettled and with Christmas trade now looming we would expect occupational stability to return, and investment demand to increase. ☒

GRAPH 1 Shopping centre investment volume



Source: Savills

GRAPH 2 Shopping centre yields



Source: Savills, Investment Property Databank

GRAPH 3 Consumer confidence



Source: GfK

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