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UK Shopping Centre and High Street Spotlight

Quarter 2 2017

Image: Friars Walk, Newport

SUMMARY

■ Consumer confidence is weakening, at least in relation to the outlook for the UK economy. We expect that the impact of inflation on real earnings will diminish towards the end of 2017.

■ In the face of cautious consumers it is no surprise that retailer demand has become more forensic in recent months. However, there are still some expansionist segments, and vacancies in key markets remain low.

■ Shopping centre investment volumes in the first half of 2017 were 37% down year on year. However, with over £1 billion of stock in the market at the moment we expect the full year total to reach circa £3 billion.

■ High street shop investment volumes are also down year on year, most notably in Greater London. However, investor demand is intensifying for prime assets, and this is leading to strong yields being paid.

"Uncertainty in the macroeconomic environment is leading many investors to focus on income security."

The consumer economy

Consumer confidence has continued to weaken over the last few months, with a combination of rising prices, falling real earnings, and negative speculation about the outlook for the economy all weighing on shopper's minds.

While the latest headline figure of -10 is below the long term average for the GfK index, there is still a marked split between consumer's views of their own situation and that of the prospects for the wider economy (on which they are very negative). The big question for the second half of the year is whether these two measures converge upwards or downwards.

We believe that there are still several reasons to be mildly optimistic about trading this Christmas. The first is that the pattern in recent years has been very much one of weak trade in Q3 as shoppers do a little precautionary saving, followed by a better than expected Christmas. While households are now saving at record low levels, there is probably some slack in borrowing that will support Christmas trade. Low borrowing rates and high employment should ensure that consumers feel comfortable taking on a little more debt for a special event like Christmas.

The second reason why we think retail sales will pick up in Q4 2017 is around inflation and real earnings. While the collapse in sterling last year is not the only reason why inflation has picked up, it is significant. Indeed, inflation is probably the major headwind facing the UK economy at present, both in terms of the rising costs for importers and the drag on real earnings growth. While the headline rate of inflation picked up to 2.9% in May, input prices actually fell on a 3m by 3m basis for the first time in a year, and factory gate prices have stabilised. While we expect inflation to rise a little more over the next few months, this rise will be short-lived.

As inflation cools off in the final quarter of 2017, the headlines at least about falling earnings will diminish, and this should positively impact consumer confidence.

The retail occupational market

Given the recent volatility on the consumer side of the equation it should come as no surprise that retailers are becoming increasingly cautious about expansion. Leasing deals are taking significantly longer to do as retailers struggle to ensure that a new store has the ideal fit to catchment, and there is an increasing feeling that the default state is becoming one of doing nothing as this is decidedly less risky than making a wrong decision.

Retailer caution is also evident in the terms that they are looking for when they sign new leases, with the norm now being a break at year five, and an increasing number of dominant brands looking for turnover only deals. While the retailer may have no plan to exercise that break, they are seeing it as an opportunity to renegotiate the rent in what might be a very different world in a few years time.
The large global brands are increasingly comparing growth prospects between markets, and the comparatively weak prospects for the UK are making it easy to decide to open stores elsewhere in Europe rather than in marginal extra locations in the UK.

A major impact on the market in recent months has been the cooling of retailer demand from those sectors that had been very acquisitive in recent years. Both the value and A3 segments are definitely less expansionist that they have been, with the former going through a period of internal management post some large mergers, and the latter struggling with consumer resistance to some of the offers that did well in the South East at a high price point, but are perhaps less exportable to less affluent catchments.

There are still pockets of growing tenant demand out there, but site analyses are increasingly forensic and time-consuming. We have seen more demand for freeholds from retailers like B&M and Sports Direct, as well as the emergence of a new department store concept from Edinburgh Woolen Mill. The first of these recently opened in Carmarthen, and houses brands owned by this group in a former BHS store. Philip Day has stated that he plans to open four more of these in the near future, with a possible total target of around 50.

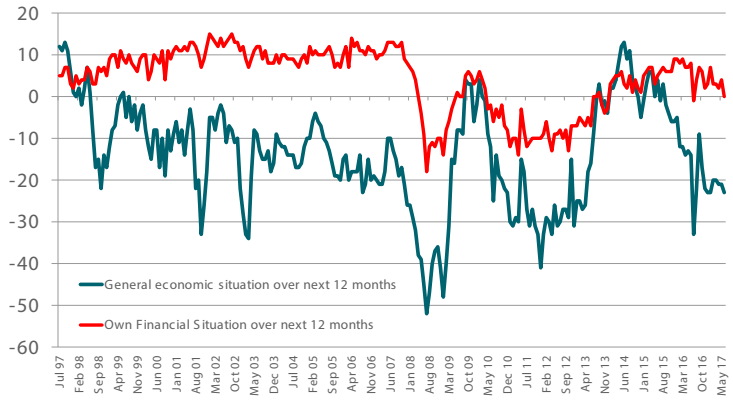
In the leasing market there is still steady growth in store openings from JD Sports and Zara, as well as a resurgence in activity from Uniqlo. Supergroup recently announced some very strong numbers and further expansion plans in Europe. In particular the group highlighted the success of their Sport collection, and we expect to see some standalone athleisure offers emerging from Supergroup soon.

At the smaller unit end of the market there is still steady demand from a variety of cosmetics retailers, but even in this sub-sector stock selection is becoming increasingly forensic.

Two other pockets of new retail demand are banking and gyms, with Metro Bank expanding across the UK and signing leases of up to 25 years, and two or three gym operators still looking at the upper floors of retail blocks. While the competition for good gym sites remains strong, rents

GRAPH 1

Consumer confidence



Source: Gfk

are not getting out of control (at least outside core central London), so we think that continued growth from this sector is sustainable.

Looking ahead retailer caution will remain the prevailing tone in the market, and while vacancies are low we do not expect landlords to chase rental growth so long as the covenants are good. Further corporate activity is inevitable, and businesses with new capital such as Joules and Holland & Barrett will also be a source of demand for new stores (or at least expansion in locations where they already trade well.)

Shopping centre investment

Q2 2017 continued in the same vein as Q1, with investor confidence hampered by the spectre of Brexit negotiations, negative retail sentiment, the unexpected General Election and the uncertainty the result has left. Investment volumes remained subdued with £578.8 million of transactions being completed in just 13 deals, down on the same period in 2016 in which £737.2 million of transactions were completed. This means that H1 turnover was £946.5 million compared to £1.508 billion in H1 2016.

However, over £1 billion of schemes have been brought to market in Q2 2017, dominated by the Bluewater stakes and the Liberty Centre in Romford. This new supply has contributed towards the fact that a healthy £700 million is presently under offer. 2017 investment volumes have been bolstered by the sale of a small number of large lots. These larger sales comprised The Stratford Centre, Stratford (£141.5 million); The Exchange, Ilford (£78 million); Southside, Wandsworth (£150 million) and Friar's Walk, Newport. If these larger transactions are disregarded, just £329.6 million of deals have exchanged so far in 2017 across 10 transactions. Only one shopping centre transacted in the UK that openly came to the market in 2017; Morgan Arcade in Cardiff (£54.9 million, 5.65% NIY), which Savills acquired for LaSalle Investment Management. The balance of the transactions were carried over from 2016.

TABLE 1

Shopping centre yields

	Q1 2017	Q2 2017
Super-Prime	4.50%↓	4.50%
Prime	5.50%	5.50%
Town Centre Dominant	6.75%↑	7.00%
Secondary	9.25%↑	9.50%
Tertiary	12.00%↑	12.50%

Source: Savills. Arrow indicates forward trend

It has been interesting to see the different buyer types in the market and rather less predictably the institutions are also making selective purchases, with DTZ IM, Invesco and LaSalle IM all active. The councils, who were the most increased and dominant buyer group in the sub £100 million market throughout 2016, have been far less active so far in 2017 completing just a single transaction to date. This seems to relate to the local and general elections that have led to changes in council power, rather than a reduction in the availability of their funding. Additionally, councils' recent activity has also attracted significant attention from the national press, not all of which has been positive.

The uncertainty in the macroeconomic climate is leading many buyers to seek even greater income certainty in potential acquisitions. Asset management angles or lease events, which 12 months ago would have been assessed by purchasers as potential upside or opportunities are now being treated as downside risks unless there is significant certainty around them. It is a subtle but significant change as many purchasers are only factoring tangible, substantiated, low risk asset management into their models. This change of approach combined with the macro climate has made it easier for parties to find reasons not to do deals.

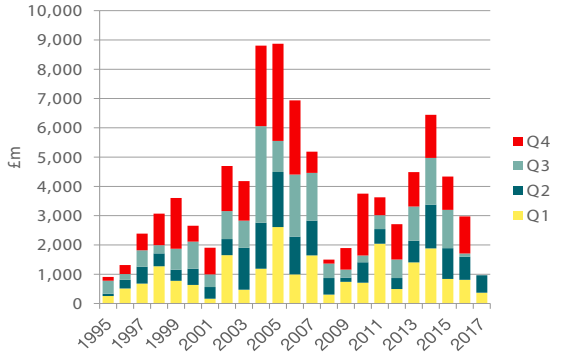
Smaller lot sizes (sub £25 million) are still being well received and are attracting significant interest from smaller property companies, family offices, councils and private companies. This is generally an 'income play' with assets producing geared returns in the mid to late teens without requiring significant capex. These assets can also still attract competitive finance terms.
We are aware of significant equity pots reviewing the market, real retailer performance and their investment strategy before they enter the market. They are from across the overseas and opportunistic investor spectrum. These opportunistic buyers need motivated vendors, which we only foresee in the secondary market if certain investors choose to divest. We believe that there will be opportunities but not through distress and not anywhere near the scale opportunistic return buyers are seeking.

We anticipate that the total investment volume for 2017 will reach circa £3 billion again, well below the long term average of c.£4 billion. We also expect that two thirds of this volume will be from a handful of large scale deals, as we saw in 2016 as well.

To conclude, demand appears polarised at present with investors focussing on two very distinctive types of asset: prime, dominant schemes, particularly with development plays at £100 million+ or sub £25 million, value-add schemes.

GRAPH 2

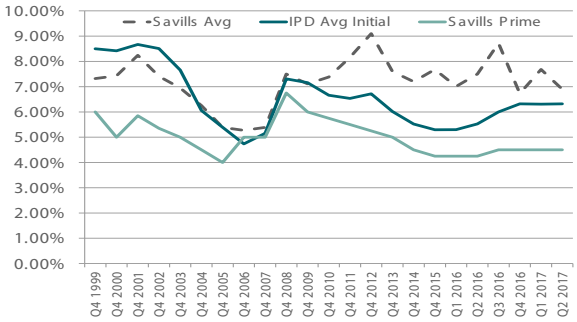
Shopping centre investment volume



Source: Savills

GRAPH 3

Shopping centre yields



Source: Savills, MSCI

High street investment

Unit shop investment volumes in the UK were marginally up in Q2 on a weak Q1, and this brings the total for the first half of 2017 to £1.1 billion. However, this is half the volume of transactions that we saw in the same period last year. Interestingly, the biggest correction in activity has been in Greater London, with the volume of shops traded outside London only down 34% year-on-year (as supposed to 71% in London).

We expect this story to change in the second half of 2017, as Q2 has been characterised by an increasing amount of capital being targeted at the high street market. While this capital is highly selective and focused on ultra-secure, high quality locations in London and the South East, when suitable lots do come to the market they are being hotly contested. Typical of this was the recent sale of a parade of shops in Richmond for £21.55 million to Knight Frank Investors, reflecting a net initial yield of 3.49%.

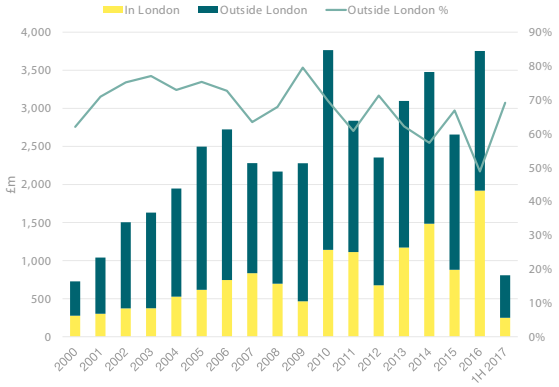
As we commented in the last Spotlight, there is increasing interest in prime shops from UK institutions, and this could result in more activity in the £10 million+ lot size market in the second half of this year. As with many other segments of the UK market the funds focus is on income security and occupational risk so any assets with ten or more years income security are expected to attract good demand. The best assets will be where the vendor can demonstrate a good fit to catchment for the retailer, regardless of where the retailer sits in the retail hierarchy.

The challenge for the funds looking to enter this segment will remain the lack of mid-sized, high-quality product. Investors who own such stock, particularly in the South East, may well find that this renewed institutional interest in the sector moves in their favour, and the right assets could see a hardening in yields in the second half of the year purely due to lack of sales.

We do expect to see investor demand for prime shops continuing to broaden away from the South East of England in the second half of the year, though investor's focus will remain firmly on the top regional cities where the quality of units and covenants is well aligned with retailer demand. However, over-renting remains a challenge in many sub-regional markets, and investors are unwilling to invest in these markets until rents have rebased.

GRAPH 4

High street shop investment volume



Source: Savills, Property Data

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