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UK Shopping Centre and High Street Spotlight

Quarter 4 2017

Image: Stratford Centre, London

SUMMARY

■ Christmas 2017 delivered mixed results for retailers and the UK consumer economy. However, we generally expect that the outlook for consumer spending will be more positive in 2018 than it was in 2017.

■ Rationalisation will however remain a key theme for retailers in 2018, with the main source of demand for new stores being international retailers and new concepts.

■ Investor demand will remain strong for convenience and community centres that trade well. We expect transaction volumes to be higher this year than in 2017.

■ The majority of investor demand for shops will remain focused on 'prime' and 'secure'. However, we expect to see comparatively few vendors of such assets, and this will keep yields at their current low levels.

"Quality of catchment and frequency of visit will be the key differentiator between strong and weak locations in 2018"

The consumer economy

January always brings very mixed messages on the health of the consumer economy, and this year is no exception. The official data on retail sales showed a 1.5% fall in sales in December on November, capping a tough year for both consumers and retailers.

Consumer confidence remains heavily polarised, with consumers being heavily pessimistic about the outlook for the UK economy, yet comparatively positive about the outlook for their own financial situation. Most tellingly the question in the GfK survey that relates to the climate for major purchases worsened in December, and is now at its lowest level since 2014.

Despite this relative confusion in the high frequency surveys, we believe that the consumer economy will be calmer in 2018 than it was in 2017. Inflation will slow, and this will return real income growth to positive territory. This will make consumers feel more comfortable about taking on debt, and the latest analysis from the Bank of England shows that most of the recent rapid growth in domestic credit levels has been driven by 'safer' borrowers.

While we do not see any reasons to be particularly optimistic about the outlook for consumer spending, we also see no reason to be particularly pessimistic. Household disposable incomes, which fell in 2017, will rise in 2018, and this will deliver steady (if unspectacular) growth in consumption.

The retail occupational market

While there are still quite a few major retailers who have not yet reported on their Christmas trading, a few key themes have already emerged that will affect occupational behaviour in 2018.

The big winners so far have been food retailers (though about half of this probably came from food price inflation), and leisure operators. Quality also appears to have triumphed, with more aspirational retailers like Fat Face, Superdry and John Lewis doing better than some of their more mid-market peers.

All in all, we estimate that the average LFL sales change that has been reported so far this year has been 3.9% (3.5% excluding pure-play internet retailers), compared with 6.6% and 5.1% in 2016. Given that inflation is higher than it was a year ago this implies that retailers will be starting 2018 fairly cautiously, however the improvement in the broader macro-economic and political story should compensate for some of this caution.

Rationalisation will definitely remain a core theme for established multiples (led by New Look with their rumoured planned 10% reduction in store numbers), with any new take-up coming from start-ups or new brands. We expect that most major multiple retailers will continue to attempt to extricate themselves from the leases on their worst-performing stores in 2018, as well as from those that are poorly configured for new ways of retailing.

Another trend that we expect to see continuing in 2018 will be the shortening of leases. Continuing uncertainty about both Brexit and the ceiling for online sales will bias retailers towards building lease flexibility into their estates, and in most cases we expect that landlords will accommodate this. As well as shortening lease lengths there will be more demand for turnover rents, though the landlord response to these requests is likely to be more measured.

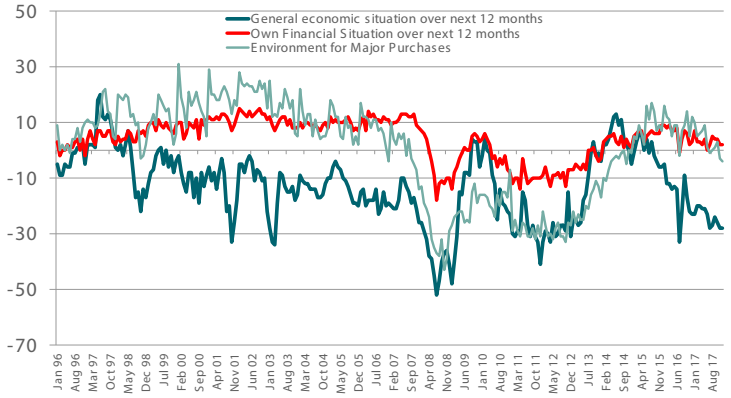
Those with large under-utilised stores in their portfolios will be looking for income producing ways to fill excess space. While this has already been a trend in terms of food and beverage, we expect to see more leisure offers emerging in store (including gyms, screening rooms and virtual reality experiences), as well as other uses such as serviced or co-working office spaces.

2018 will not all be about consolidation, and we do expect to see continued demand for new stores from personal services and cosmetics retailers, as well as from manufacturers taking control of their own sales by opening experiential stores.

The pattern of the most sought-after locations will be similar to 2017, with quality of catchment, and frequency of visit being the key differentiator between strong and weak locations. However, one size does not fit all, and we expect to see more attention being paid to fit to catchment in 2018, with some retailers looking beyond the obvious top towns for their ideal store locations.

GRAPH 1

Consumer surveys are still telling a confusing story



Source: GfK

Shopping centre investment

Q4 2017 did not see the tick up in activity and volumes which was anticipated and followed a similar path to the first three quarters of 2017. These low transaction volumes were fuelled by the continuing uncertainty of Brexit negotiations, and negative retail sentiment, particularly forecasts of poor Christmas trade. Investment volumes have remained subdued in Q4 with £520.5 million of transactions being completed in 14 deals, which is the lowest Q4 volume since 2008 and significantly below 2016 figures of £1.27 billion. However, what these numbers do not reflect is the

significant quantity of shopping centres currently under offer and improving sentiment in some sectors of the market.

Q4 has seen transaction volumes significantly in excess of those of Q3 (£205.3m), and a large number of shopping centres are currently on the market; more than £2.1 billion in 25 properties. Comparing Q4 2017 with Q4 2016 there were £1.27 billion of schemes traded in 2016 in 12 deals however this was skewed to a degree by the Edinburgh St James funding. If we exclude this transaction, volumes fall to closer to £700 million in 11 deals. Additionally there is presently a substantial number of schemes under offer, by our estimations somewhere in the region of £811 million in 12 deals and, should all these transactions complete, this will give 2018 a super-charged start!

The largest transaction in Q4 was LaSalle Investment Management's acquisition of a 50% stake in intu Chapelfield in Norwich on behalf of the Greater Manchester Pension Fund, paying £148.0 million, reflecting a reported 5.00% NIY (circa 5.25% EY). Other notable Q4 transactions included L&G's acquisition of Riverside in Stafford for £36.8 million (6.50% NIY) from developer LXB. LaSalle Investment Management (on behalf of BAE Pension Trustees) acquired the Treaty Centre in Hounslow for £57.07 million (7.35% NIY) whilst Deutsche followed-up on their 2016 acquisition of Palace Exchange in Enfield in buying the adjoining Palace Gardens from Aberdeen Standard Investments for £51.5 million (6.50% NIY).

It is customary in the Q4 bulletin to give a review of the entire year's shopping centre transactions and 2017 threw up some interesting and unexpected trends in a challenging marketplace. Investment in the UK market in 2017 totalled £1.69 billion in 41 deals, down 44% on the 2016 total of £3 billion. The average lot size was £41 million and there were five transactions over £100 million that accounted for £718m, whilst stakes in shopping centres proved popular in 2017, accounting for £592.4 million (35%) of transactions. Surprisingly, institutional investors accounted for £748 million of the total volume as buyers and £789 million as the vendors. This reflects 44% on the buy side and 47% on the sell side; a vastly increased share on 2016. The most significant deals of 2017 in value terms include the 7.5% stake in Bluewater (£155 million), The Stratford Centre, Stratford (£141.5 million), Southside, Wandsworth (£150 million), Friars Walk, Newport (£83.5 million) Castlecourt, Belfast (£123m), and Chapelfield, Norwich (50% stake) (£148m).

TABLE 1

Shopping centre yields

	Q3 2017	Q4 2017
Super-Prime	4.75%	4.75%
Prime	5.75%	5.75%
Town Centre Dominant	7.00%	7.25%
Secondary	9.75%	9.75%
Tertiary	12.50%	12.50%

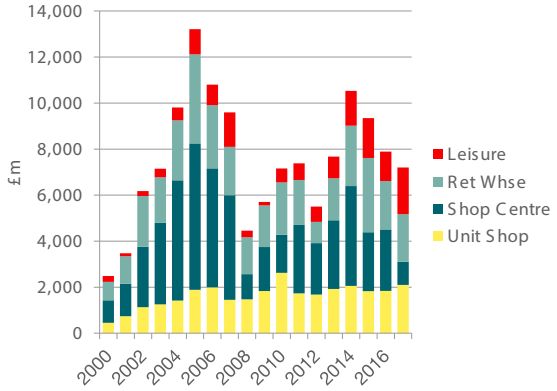
Source: Savills. Arrow indicates forward trend

Councils, who were the most increased buyer type in the sub £100 million market in 2016, invested £153.5 million in Q4 across 4 deals and their total investment for the year was £213.5 million in 7 deals giving them a market share of circa 13%. Councils spent £386.7 million on shopping centres in 2016 in 10 deals and so the spending by this purchaser group has dropped in capital value terms but their market share remained stable. Notable shopping centres bought by councils in the final quarter of the year included Castle Quay in Banbury and the Pride Hill, Riverside and Darwin centres in Shrewsbury. In spite of some negative press, and barring any central government intervention, it is expected that councils will continue to invest in shopping centres in 2018, doing so with a continued focus on assets within their jurisdiction.

Smaller lot sizes (sub £20 million) are continuing to be well received within the market and are attracting interest from smaller property companies, private companies and councils. The strong performance of this lot size is illustrated by the fact that in the full year, 16 were traded, making up 39% of the market by number and the £158.2 million represents a 9% share of the market by capital value. The property companies dominated in this element of the market with the institutions a notable vendor. These small schemes are typically of a convenience/community nature with a supermarket element and provide strong geared returns without demanding significant capital expenditure whilst others present attractive repurposing or redevelopment opportunities.

GRAPH 2

Retail investment volume outside London



Source: PropertyData

The strength of the convenience/community shopping centre market has been a theme for 2017 and has resulted in improved demand for this sector of the market. The foundation of this sector is the strong tenant trade fuelled by the consumers 'needs' as opposed to 'wants,' combined with affordable rents and falling business rates. We envisage this trend will continue strongly in 2018 where parties recognise the strong income returns available.

2017 also saw a retrenchment towards the perceived safety of the South East with acquisitions in Greater London and the wider South East accounting for approximately £880 million; almost 52% of the market. By contrast, only three shopping centres traded in Scotland during the entire year.
The factory outlet sector was another sub-sector within the wider retail sector which enjoyed a buoyant 2017 with £462 million transacted across six deals, a significant increase from the circa £31 million transacted in 2016. For clarity these volumes sit outside the total investment volumes for shopping centres stated earlier in this report.

To conclude, demand is strong for convenience and community centres that trade well. London and South East schemes also remain stalwarts for core and core plus buyers, underlined

by the surprising dominance of institutional buyers in 2017. There is a greater depth of buyers for sub-£20 million, value-add schemes driven by an attractive income yield satisfying their return criteria. That said, there remains an appetite for schemes with a robust trade story, a clear raison d' être, strong fundamentals, and value-add potential. Repurposing and redevelopment opportunities will also be sought after in 2018 but liquidity in this arena is likely to be dependent on closing the gap between valuations and market sentiment. Whilst we do not currently foresee transaction volumes in 2018 being bolstered by a flood of disposals following recent corporate acquisitions (which may take months to complete), we expect 2018 volumes to be significantly in excess of 2017, and we may yet see a portfolio transaction take place for the first time since 2015 as investor appetite, pricing expectations and vendor disposal strategies fall into alignment

High street investment

2017 was the strongest year since 2010 for investment into high street shops outside central London, with £2.1bn invested over the whole 12 months. Several factors contributed to this strong result, both of which we expect to remain prevalent in 2018. Firstly there was strong private investor demand as some investors traded out of residential buy-to-lets and into high street shops. Secondly, the average lot size transacted rose from £4.1m in 2016 to £6.4m in 2017.

The latter point is something on which we have dwelled upon in the last two Spotlights, and 2018's out turn will depend heavily on the delivery of mid-sized lots to the market. While we expect that private investors will remain acquisitive in 2018, the big question remains over institutional activity. A year ago we commented that we expected to see more institutional buyers in the high street markets outside London, so long as some suitably-sized stock emerged. 2018 will be much the same, with the UK funds focusing on the top 20 towns, and lot sizes of >£10m.

So, this begs the question of who will be selling in 2018? As ever there will be some profit-taking from those who bought earlier on in the cycle, but we also expect to see some sales from those who remain unconvinced by the prospects of a retail recovery after a fairly torrid 2017.

Some of the assets coming to the market in 2018 may not tick all the boxes to make them AAA, but we believe that now may be the moment to take a more relaxed attitude to partial voids, particularly where rents have already rebased. With the moment of maximum Brexit risk now more likely to be in 2021 than 2019, letting risks are not as imminent as they may have seemed a year ago. Also, the consumer spending story from 2018 looks much more defensible than it did in 2017.

The majority of investor demand will remain for 'safe' and 'secure'. Good shops on good pitches in good towns will continue to attract premia, and may even see some yield hardening in 2018. Defensible tenants like banks will be increasingly in favour amongst risk-averse investors. However, there will be comparatively few willing vendors of such assets, so demand will continue to exceed supply.

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