

# Spotlight UK Retail Warehouse Market

September 2014



## SUMMARY

■ We believe that the current structure of the consumer economy will strongly favour spending on retail warehouse parks over some other areas of the retail property.

■ Investor demand for retail warehousing has strengthened, with over £1.5 billion invested in the sector this year. Yields have hardened by 75 basis points.

■ Occupier demand in the South East has strengthened, and rising demand and tight supply is putting upward pressure on rents.

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 “The retail warehouse sector will benefit more from the recovery in the housing market than the high street”  
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Mat Oakley, Savills Research  
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➔ **Economic and consumer outlook**

Over the last three months consumer confidence has continued on its upward trend and is now back around the pre-Global Financial Crisis levels. Indeed, the latest data for July shows that the confidence level has improved to 1, which is better than the long run average for this index.

Future growth in retail spending will have to be driven by more than just reductions in savings, and this means the key metric to watch at present is the growth or otherwise in real average earnings. While much political hay was made about inflation falling behind earnings in March (at least when you include bonuses in earnings), July's CPI growth of 1.6% has delayed the celebration for a little longer.

One area of spending in which we are more optimistic is where spending is linked to home moves. This obviously bodes well for retail spend on traditional retail warehouse parks. Housing transactions in the UK have picked up from their cyclical lows during the recent recession, but they remain 28% below their pre-crisis average. Savills residential research team are predicting that transactional activity will rise from just over one million moves in 2013, to 1.3 million in 2018.

There is a strong correlation between the level of housing transactions and retail spending on what we have termed "new home related goods" e.g. white goods, brown goods and carpets and an even stronger correlation

between transactions and DIY spend, with spending on DIY leading a recovery in housing transactions by around a year.

These correlations sound broadly logical, with an initial pick-up in DIY spend as people prepare to sell their homes, or have just moved in, followed by a pick-up in new home related goods.

The housing market recovery is by no means going to be ubiquitous, or a steady ripple outwards from London. Our research shows that some sub-regions tend to recover much faster than their parent region, due to pools of affluence and/or confidence. Furthermore, there appear to be wide regional disparities in DIY spending, with consumers in the North West, Midlands, and South far more likely to spend higher than normal levels on DIY than those elsewhere in the country.

We expect that the steady recovery in the housing market will continue to impact positively on sales volumes of retail warehouse park goods. Indeed, our latest forecast for out-of-town sales shows stronger growth in bulky good sales than in fashion and general merchandise.

**Investment market overview**

The market has moved 75 bps this year and is holding. The lack of supply of good quality assets, which is likely to continue, and the pent up weight of money on the demand side has led to the re-pricing over the year to date. The hoped for flood of properties has

failed to materialise and is unlikely to come forward sufficiently to satisfy the requirements by the year end. Some vendors are giving in to the temptation to over price assets of insufficient quality and these will prove difficult to sell. The demand levels are likely to be maintained in the short to medium term, however it is not price inelastic.

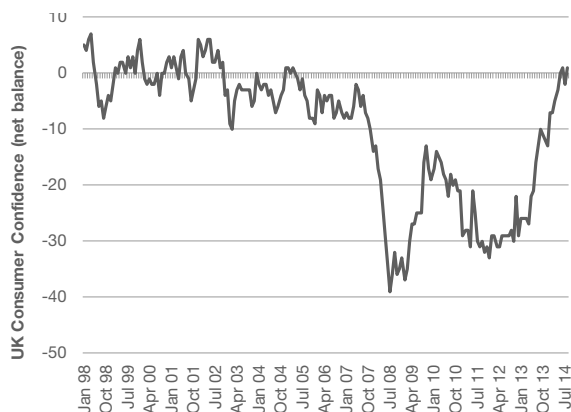
The main level of demand is still for prime however this will be in short supply as the tight ownership matrix, whereby the owners are those who wish to buy more, will restrict the release of product until their own buying requirements are satisfied.

The overall transactional volume has risen, with approaching £2 billion traded so far this year (a more than 50% increase on the volume in the first three quarters of last year), but investor requirements still outweigh the supply of stock.

Retail warehousing continues to be one of the better performing segments of the retail market, with an average total return for the 12 months to the end of August 2014 of 14.4%. However, according to IPD rents are still falling on an annual basis, though they have flattened over the last three months.

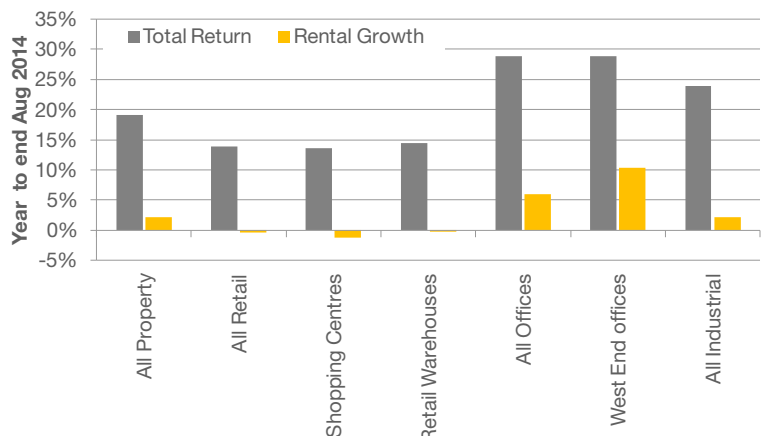
Of course the investors job is to look beyond current leasing market trends, and it is clear that inward investors to the sector are becoming less risk-averse. We are seeing less caution about historic voids, and fewer concerns about retailer covenant strength. 2014 has also seen an

GRAPH 1 **Consumer confidence**



Source: ONS, GfK

GRAPH 2 **Comparative total returns and rental growth**



Source: Investment Property Databank

→ increase in non-domestic investor interest in retail warehousing, as well as a broader rise in interest in forward-funding opportunities.

While many of those who are looking at purchasing UK retail warehouse investments would like to buy prime, we do not expect many such opportunities to come to the market in 2014, and this will put continued downward pressure on prime yields. Those investors who do wish to increase their exposure to retail warehousing will have to become comfortable with assessing the strengths and weaknesses of secondary schemes, and this will become easier as overrenting continues to diminish.

Strong demand continues to put downward pressure on yields, with schemes like Leamington Spa and Blackwater demonstrating that 4.25% is achievable.

We expect that investor interest in the sector will be sustained for the foreseeable future, though transaction volumes will be broadly similar to the £2 billion that was sold last year.

There will be a continued investor bias towards prime, but the lack of options will lead investors to look at assets that are more secondary in their location, tenant profile, planning use, or rental characteristics. We expect over-renting to become less of an issue, though long-term vacancies will still cause investors to pause.

### Occupier market overview: South East

The South East of the UK, with its affluent consumers and housing market recovery, remains high on most retailers lists of markets in which they would like more stores.

A great recent example of the rising strength of retailer demand for units in the South East is the out turn of the recent administration of Paul Simon. The bulk of this home furnishing retailer's stores were in the south of England. Over a dozen have been acquired by retailers direct from the administrators and we understand that a number of other units are in the process of being re-let, some of which will be at higher rents than Paul Simon were paying.

The key trend of note in occupier requirements across the South East is a rise in the size of requirements. Retailers across most sectors are looking to the retail warehouse market as an opportunity to offer their full product range in store, something that they would not be able to do economically in a high street shop. Typical of this trend is Next's new format which has two mezzanines. We believe that this trend is being driven by the recognition that the internet-savvy consumer is increasingly demanding that their trip to a real store should mirror the range of SSUs that are available on the company's website. As such, we expect to see the trend to larger stores spreading across all segments of the markets, and all economically viable geographic locations.

The housing market recovery is stimulating expansion in the bulky goods sector. Indeed, for the first time in a considerable period the bulky goods sector is far more acquisitive than the fashion sector. Active retailers in this segment include Dunelm, Harveys, Oak Furnitureland, Wren Living, Betta Living, Sofaworks, DFS as well as the re-emergence of retailers such as ScS. Again, most of these retailers are looking for larger stores than they have been in recent years, with the typical requirement now increasing from 7,500 -10,000 sq ft back to 10-20,000 sq ft, so back to the size requirement of the late 90's/early 2000's. A good example of this trend would be Wren Kitchens whose typical requirement used to be around 10,000 sq ft. Their new requirements, under the Wren Living brand, are for 15-20,000 sq ft.

The demand from furniture retailers has also been swelled by several new entrants. These include both Furniture Barn and County Furniture Stores. We expect other new entrants to emerge and some of these will no doubt emanate from the internet, following the success of both Oak Furnitureland and Wren Living.

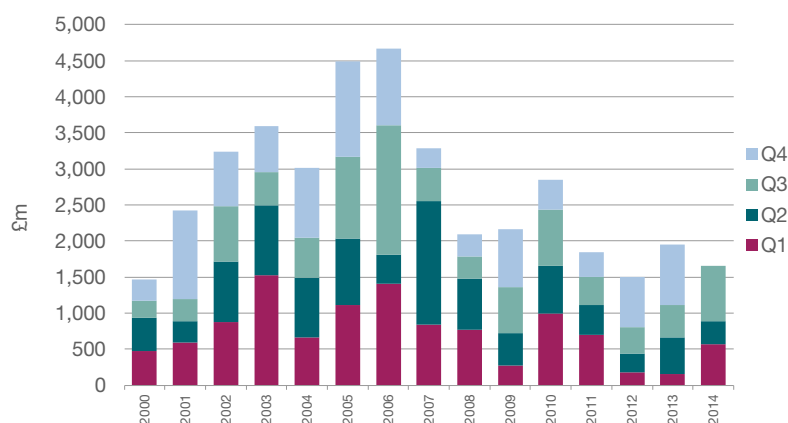
While the first generation DIY retailers are generally still in rationalisation mode, the newer entrants such as Screwfix, Wickes and Travis Perkins are all currently acquisitive. We expect that demand from this sector will increase across the South and the rest of UK as the recovery continues. →

TABLE 1 **Retail warehouse yields**

	Dec 2011	Dec 2012	Dec 2013	Sep 2014
Shopping Park	5.25%	5.25%	5.25%	5.00%
Prime Open A1	5.25%	5.25%	5.00% ↓	4.25%
Prime Restricted	6.00%	6.00%	6.00% ↓	5.25%
Secondary Open A1	6.50%	6.50%	6.00% ↓	5.00%
Secondary Restricted	7.50%	7.75%	7.25%	6.00%

Source: Savills

GRAPH 3 **Retail warehouse investment volume**



Source: Savills



→ The smaller food retailers continue to be active across the South East, with M&S Simply Food, Aldi and Lidl all competing for 10-15,000 sq ft stores. In the case of both Aldi and Lidl they are both now considering retail parks, having previously preferred standalone freeholds. Clearly this is owing to the scarcity of finding suitable sites and the speed for which these occupiers want to expand, having attracted so many new customers from the so called big four. With their current momentum, the opportunity to expand quickly is best served through acquisitions on existing retail parks.

The last few years the discount sector has attracted much of the press, through the phenomenal growth of these retailers. The recession tightened household budgets, which forced consumers to look further afield for value. In much of the south east, the recession is turning into a distant memory but the affluent consumer is not shunning these retailers. In fact, the likes of B&M, Home Bargains and Poundstretcher are particularly focused on this corner of the country.

The level of availability has continued to fall, with the national vacancy rate

in the latest research from Trevor Wood Associates now at 8.8%. The vacancy rate in the South East is even lower, and has fallen from 8.8% at the end of 2012 to 7.1% at the end of 2013. We do not expect this increasing undersupply to be alleviated by development starts, though we are aware of several projects in the South East where new retail warehouse development is being jump-started as part of a residential-led schemes.

Rising demand and tight supply in the South East is beginning to put some upward pressure on net effective and headline rents in prime locations. Indeed, in some locations recent lettings have rebased headline rents to above their 2007 peak. Tier 2 towns and schemes with historic voids are still experiencing falling rents, but at a slower rate. We expect to see more landlords willing to do deals at lower rents in these locations, with the rationale for this being to fill voids and eliminate the risk of their scheme transitioning from secondary to tertiary. Their ultimate expectation will be to achieve rental uplifts at the first review, and this fits in with our current forecast of accelerating rental growth in the sector from 2016-17.

## Outlook

Confidence will undoubtedly continue to improve over the course of 2015. The retail warehouse sector will arguably benefit more from the recovery in the UK housing market than the high street. We expect that overall rental growth will remain broadly flat in 2014, but behind this there will be some locations where supply shortages will drive rents back to and above their previous peaks.

Secondary and tertiary locations will continue to see falling rents this year, but by 2015 we expect that the average rental growth for the sector as a whole will be positive. Our current forecast for average annual rental growth for all retail warehousing is now just under 2% pa for the period 2014-18. Investor demand will remain strong, particularly for the very limited supply of prime assets.

As a result of this we expect that prime yields will harden by a further 25bps this year, with average yields following a similar trend with a lag of around a year. Total returns on retail warehousing are expected to continue to be better than most other retail segments. ☒

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