UK Commercial – Q1 2019

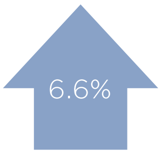
SPOTLIGHT

Savills Research

Shopping Centre and High Street Spotlight

savills

- Retail environment remains mixed
- Interest amongst opportunistic investors grows



6.6%
UK retail sales growth rate in March 2019 on a year-on-year basis

UK retail consumer and occupational trends

Retail sales are holding up but it's the rising costs of servicing online platforms that's really shaping occupational demand

Consumer confidence is clearly feeling the effects of Brexit uncertainty having reached its lowest level in five years in December, albeit February did see a one point improvement. However, the read through to retail sales has been minimal. Retail sales volumes increased 6.6% in March year-on-year, its highest increase in 28 months, reflecting an upward trend that first materialised in November which places current growth well ahead of that seen in the 12 months immediately after the EU Referendum.

An acceleration in real wage growth, supported by slowing inflation, has been key to this as well as a certain degree of consumer ambivalence to Brexit mirrored in the consumer confidence measure holding at the same level for the last three months.

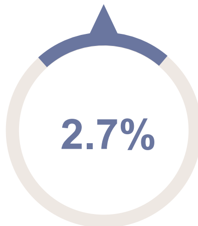
How long real wage growth, and in turn retail sales growth, can be sustained will be dependent on wider economic conditions in a post-Brexit scenario, which at this point is hard to call.

It's cost, not growth, of online that is shaping occupational demand

While the overall retail sales data paints a positive picture much of this growth can be attributed to online and has been reflected in retailer trading statements. E-commerce retail sales, on a value basis, reported a 12.4% growth in March year-on-year whereas store sales growth was estimated to have grown 2.7%. The positive is that this is growth off a much higher base and does point to an upward trend on a rolling 3-month basis.

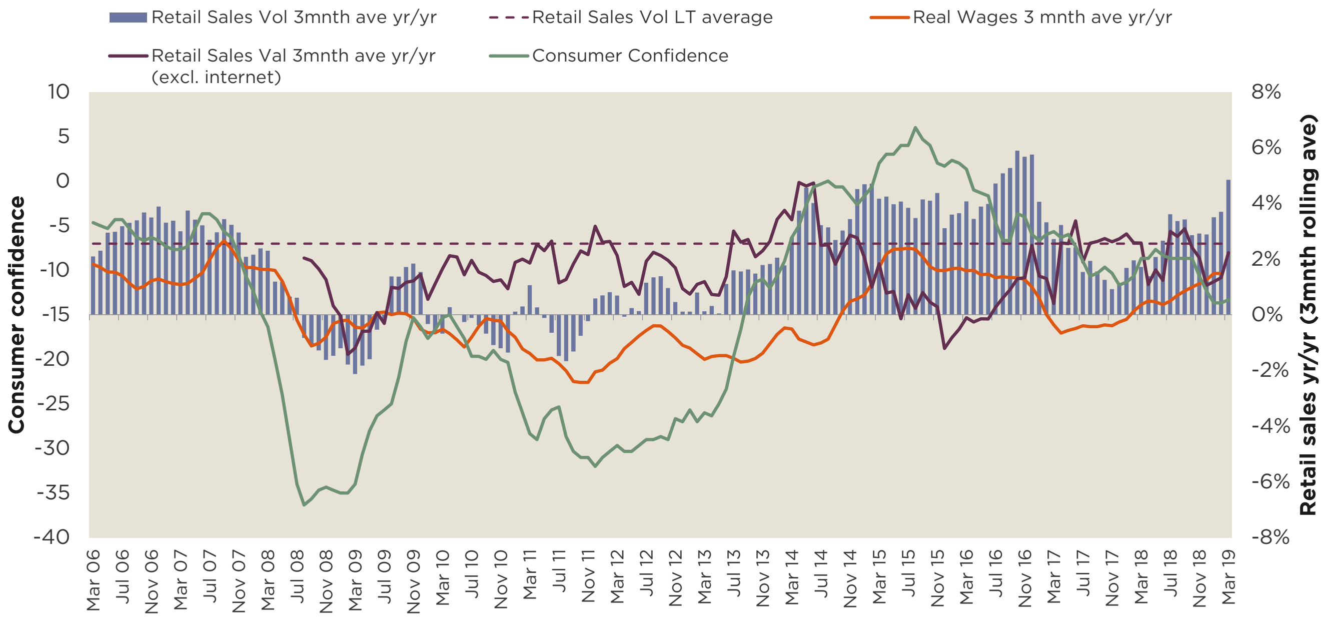
There is no doubt that migrating spend online, plus structural shifts in spending habits towards more leisure and experiences, will reduce store requirements with the fashion sector more exposed than others. But, the biggest immediate challenge is its impact on costs and margins. In their latest annual statement Next noted that for every £1 that migrates to their online platform there is an additional cost of six pence. Yet, at the same time they noted the important role their store network plays in servicing their online business and mitigating these additional costs. These increasing costs were reflected in a small softening in Next's operating profit with a similar trend seen across a number of other fashion retailers that have expanded their online platforms. In contrast, Primark, who have no online presence reported a 25% growth in Group operating profit.

Estimated year-on-year UK store sales growth in March 2019, on a rolling 3-month basis



Year-on-year real wage growth in February 2019, on a rolling 3-month basis

Despite weak consumer confidence, Q1 UK retail sales continue to improve reaching 4.8% YoY in March 2019, on a rolling 3-month basis, in terms of volume of sales



Source Savills Research; ONS; GfK

> “Shopping centre landlords are pursuing more flexible terms in order to minimise vacancy.”

Weaker shopping centre rents under the most significant downward pressure

These rising costs and weaker margins are reflected in recent leasing activity. Utilising Savills retail deal activity across the UK, including new lettings, extensions and assignments, we have examined leasing and rental trends. What this analysis highlighted is that it is shopping centres, in particular secondary weaker centres, that are currently more exposed with landlords pursuing more flexible terms with larger incentives in order to minimise vacancy.

While UK shopping centres reported a small increase in average lease lengths to 6.3 years in Q1 2019 on its 2018 average, rent free periods increased by two months to 7.5 months. This is in line with the average rent free's secured on high street lettings, but has resulted in a more significant impact on net effective rents. Average shopping centre net effective rents agreed in Q1 2019 declined by 33.2% compared with the 2018 average. In contrast high street net effective rents largely held with only a 0.1% decline on its 2018 average, albeit we expect rental declines were largely factored in prior to 2018.

However, this decline in shopping centre net effective rents masks the disparity that exists between the weaker and stronger centres. At the weaker end, on a like-for-like basis, some centres have seen declines of between 40-60% in Q1 2019 versus the 2018 average. In contrast stronger centres have seen net effective rents increase by an average of 3.9%.

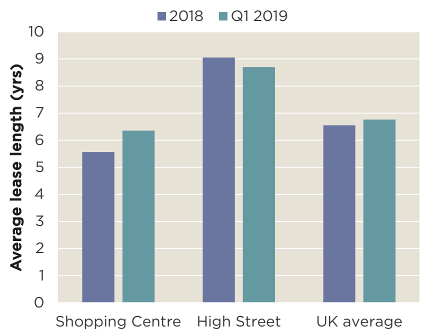
Who's been acquisitive in 2019?

In terms of deal count over Q1 2019 the top five retailer subcategories, as outlined below, remain largely unchanged to 2018. Fashion (including specialist menswear and womenswear stores) has overtaken F&B to account for the majority of new lettings in the first quarter of 2019.

Where we have seen a shift is the entrance of charity stores into the top five, on very short terms, no doubt reflecting the challenges facing occupational demand and landlords preference to reduce vacancy.

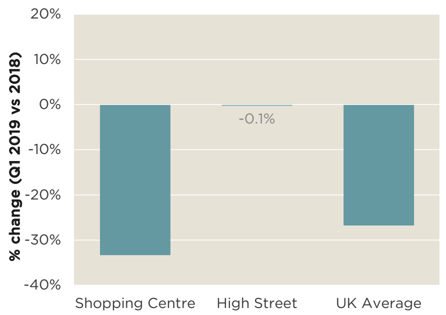
Unsurprisingly there are no stand out retailers who are being particularly acquisitive nationally. That being said Lidl, B&M and Oliver Bonas are rumoured to be looking to add to their UK portfolios in 2019.

Average lease length (years)



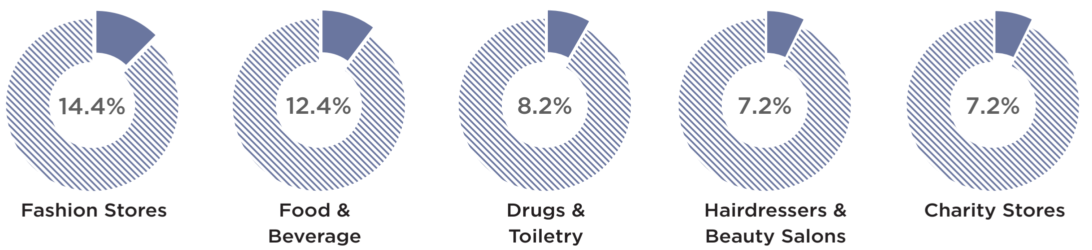
Average rent free (months)

Net effective rental trends (Q1 2019 vs 2018)



Source Savills Research
Note: Based on Savills UK retail deals, excluding London & SE

Top five retail subcategories by deal count (Q1 2019)



Source Savills Research

LOOKING AHEAD

The biggest challenge occupationally going forward is not the consumer environment but rather the expected increase in CVA activity.

For some retailers struggling with declining margins as a result of a poor offer and/or rising costs linked to online platforms, entering into a CVA can be key to survival. For the more cynical in the industry, CVA's are a quick way to reduce costs.

Whatever your viewpoint, with more CVA's expected to come to the market in 2019 there will be further downward pressure on rents. This year is forecast to be the nadir for rental value declines with the All UK retail forecast from RealFor suggesting that positive rental growth will not return to the market until 2022.

As seen with recent leasing activity it will be weaker retail locations that will be more exposed with strong retail markets/centres likely to outperform the All UK average supported by stronger occupational demand. However, this demand will become more mixed with the dominance by fashion retailers to wane as the growth in online penetration is forecast to be the strongest in this part of the market (35% of fashion spend to be online by 2023). Considering that returns are more of an issue for fashion retailers there will still be a strong case for brands to maintain a physical presence, what this will look like may be where we see the most significant change.

"Opportunistic investor interest in retail is rising."

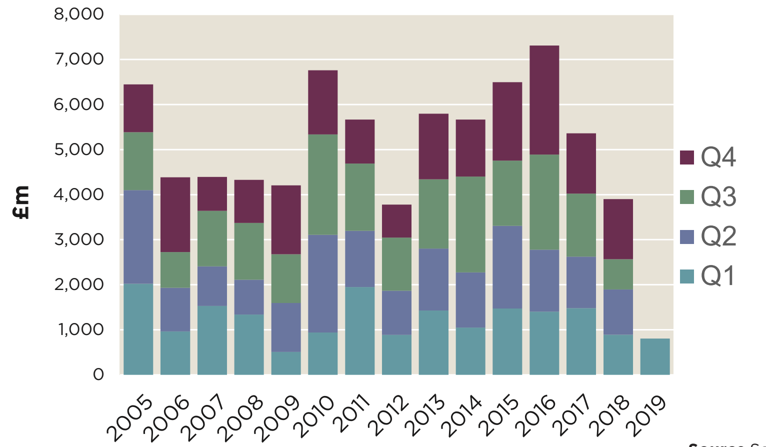
Investment Overview
Investor sentiment towards retail property in the UK remained firmly negative in the first quarter of 2019, with the average prime yield on retail property rising from 5.35% at the end of 2018 to 5.40% at the end of Q1 2019. This means that the prime retail yield has risen nearly 100 basis points from its most recent low point in Q1 2015.

While the yield softening in some retail subsectors has been even more significant than this, prime shop yields are only 2bps higher than their long-run average, and prime shopping centre yields are still 20bps lower than their average.

Investment activity in the retail sector has also fallen dramatically over the last five years, with retail accounting for 20% of all investment deals by volume in 2014, and only 8.2% in the first quarter of 2019. Indeed, according to Property Data, only £788m was invested in retail property in the first quarter of 2019, the lowest level of investment activity since 2000.

However, while the transactional activity is low, the opportunistic investor interest in the sector is rising. This means that the outturn for the remainder of 2019 could be stronger than the first quarter figures suggest.

High street shop investment was 9.6% down YoY but central London was 134% up on Q1 2018



Source Savills Research

UK retail investment market

High street shops

Investment in high street shops remained fairly restrained in the first quarter of 2019, totalling £805m. This is 9.6% down on the same quarter last year, and 39% below the long run quarterly average. A markedly divergent story sits behind these headline figures, with the turnover outside central London being 65% below average and in central London being 21% up on its long term average.

Generally the most active group of investors across the UK remain private investors, with corporate and institutional interest in the sector continuing to be very muted. Even in the previously very strong central London retail occupational markets questions are being asked about the forward trajectory of rents on all bar the primest of pitches. This in turn is leading to questions about prime high street shop yields, which at 4.75% are only 75 bps above their cyclical low (compared for example to prime retail warehouse yields which are 175bps higher than they were in 2015).

Investor demand is currently strongest for long and secure income streams. Locationally speaking there is, as always, a hierarchy of locations which are most in demand with investors. This list has tightened in recent months, and is very London and South East focused. However, even central London is no longer the blanket buy that it was a few years ago, with Bond Street remaining desirable, while Oxford Street's attractiveness has slipped.

Outside central London private investor demand is steady for the affluent suburban locations and strong commuter towns, albeit with forensic questions being asked about rental affordability. Indeed, it is rents that now seem to be the biggest sticking point in the investment market with buyers unwilling to invest in anything that they perceive as being overrented, unless the price paid enables them to consider taking a rent cut at the next review.

As we have commented on in previous Spotlights it is here that the biggest imbalance between vendors and purchasers expectations lies. Unlike the shopping centre market there are no notable forced sellers in the high street space, and this means that the price corrections that have been seen to date are probably smaller than they should be. Buyers are aware of this, and that means that the transactional volumes are likely to remain low until the gap between buyers and sellers expectations on price closes. This situation is further complicated by the fact that the majority of high street shops are owned by private investors, who may be less willing to accept that prices have fallen than an institutional owner.

Our opinion is that this moment of clarity may not be far away. The combination of the fall out from the Debenhams administration and a CVA by Arcadia could be seismic enough for vendors to accept that a tectonic shift has happened, and thus rental and capital values should be adjusted. This would be enough to reactivate a stalled market, as there is definitely more opportunistic investor interest in the high street shop market, just not at the current yields.

Shopping centres

Shopping centre investment transaction volumes reached £280 million during the first quarter of 2019, with six schemes changing hands. This compares to volumes of £333 million, across eleven deals, in the first quarter of 2018, and reflects a decrease of 16% year-on-year.

Whilst a delay to the UK's withdrawal from the EU will not have helped market sentiment, it is the occupational story that sits firmly at the forefront of investors' minds. Debenhams' slide into the hands of administrators may prove to be a watershed moment for the market if it provides buyers - and sellers alike - with greater clarity around the future of a retailer that anchors so many schemes across the country.

The much-anticipated restructuring of the Arcadia portfolio, whether through a CVA or otherwise, may also end up being a catalyst for improved liquidity, even if the cost is value erosion. After all, pricing on the basis of yield goes only so far when the sustainability of an income stream is under such duress.

Of the six schemes that traded in the first quarter, it was the repurposing opportunities that were most sought-after. The Nicholsons Centre in Maidenhead was acquired by Areli Real Estate, in partnership with Tikehau Capital, for £25 million. Although this price reflects a net initial yield of circa 4.00%, the acquisition was underpinned by the scheme's wider redevelopment potential, which is driven by its affluent South East location, strategic, 4.46-acre town centre site, and the scheduled arrival of Crossrail in the short term. For these reasons, Maidenhead attracted significant interest with in excess of ten offers and multiple rounds of bidding. In the same vein, LaSalle Investment Management's acquisition of The Galleries, Bristol from InfraRed Capital Partners for approximately £32 million also illustrated the depth of demand for schemes whose value can be underpinned by redevelopment potential. Assets with provable repurposing potential, whether as a whole or on part, will continue to be highly sought after and the key will be an appreciation of the array of uses that can be incorporated, beyond simply residential.

In addition to those schemes with repurposing potential, community and convenience shopping centres also continue to draw the focus of investors who appreciate the resilience of this silo of the sector. Q1 2019 acquisitions of Killingworth Shopping Centre, Newcastle (£7.5 million, 10.00% NIY), and The Pavilion, Thornaby (£8.5 million, 10.00% NIY) by Evolve Estates and LCP, respectively, demonstrate this. Both schemes dominate their immediate retail catchment and benefit from food store anchors to support the trade of convenience retail and community uses on-site.

The largest asset to trade in the quarter was Kensington Arcade as Ashby Capital acquired the 15-unit arcade leading into High Street Kensington London Underground station, alongside the neighbouring 127 Kensington High Street, for a total of approximately £200 million. Much like Shop Stop, Clapham in 2018, this acquisition shows investor confidence in prime London retail around transport hubs. Even if neither can Shop Stop or Kensington Arcade can easily be classified as being representative of the wider shopping centre market, transport hubs, just like community and convenience assets, are increasingly seen as robust tranches of the retail sector, given the sustainable footfall and needs-based retail spend they capture.

Local authorities remain a key buyer in the shopping centre market, even as they appear to be taking a step back from other sectors, where acquisitions may not carry the same political capital as shopping centres that can unlock wider town centre regeneration. This quarter, Test Valley Borough Council acquired Chantry Shopping Centre in Andover from Aviva for £7.2 million, reflecting 9.50% NIY. As has often been the case, Test Valley Borough Council represented a special purchaser, acquiring Aviva's long leasehold interest from a position as the existing freeholder. With further council transactions already being delivered early in the second quarter, and five further schemes under offer to local authorities, we anticipate a steady stream of council deals throughout 2019. This is in spite of the a brief delay during Q2 as some councils work through local elections in May.

Looking forward to the rest of the year, Savills is now anticipating volumes that volumes will be in the region of £1.25 to £1.5 billion for the year. This would broadly be in line with 2018, but significantly short of the long-term average of £3.85 billion. We envisage the lion's share of these transactions will be delivered towards the end of the year, with a significant pipeline of stock expected to come in the final quarter, once there is greater clarity around not just Brexit but key occupational market factors.

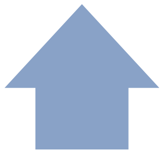
In the interim, churn will continue among the smaller, sub-£20 million lot sizes with attractive (double digit) initial yields whilst, at the more prime end of the spectrum, REITs are likely to continue their deleveraging, with news of Cale Street's JV with intu breaking at the time of writing. As pricing moves out further, we anticipate greater liquidity towards the end of the year. In parallel, the buyer pool is also likely to grow. Savills continues to see new money, both domestic and overseas, monitoring the sector and waiting for the opportune moment to enter the marketplace. These buyers will seek to take advantage of vendor distress and the oversold story to secure best-in-class assets at a sizeable discount to long-term yields; a theme we are also seeing in the out-of-town retail investment market too. However, the challenge for some of the opportunistic buyers out there will be securing scale so we still envision a portfolio deal before the year is out.

Shopping centre yields	Q1 2018	Q4 2018	Q1 2019
Super-prime centre	4.75%	5.25%	5.25% ↑
Prime centre	5.75%	6.50%	6.75%
Town centre dominant	7.50%	8.25%	8.50%
Secondary centre	9.75%	10.50%	11.00%
Tertiary centre	12.50%	14.00%	14.25%

Source Savills Research

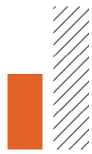
16%
Year-on-year fall in shopping centre volumes

9.6%
Year-on-year fall in high street shop investment volumes



134%
Year-on-year rise in central London high street shop investment volumes

75bps
Rise in super-prime shopping centre yields over the last 12 months



175bps
Rise in tertiary shopping centre yields over the last 12 months

Savills Commercial Research

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