UK Commercial – Q1 2020

SPOTLIGHT

Savills Research

Shopping Centre and High Street Spotlight

• Q1 2020 trends in leasing and investment • Outlook for 2020 and 2021

> **“When lockdown is over, might the relief at being free to behave normally overcome more traditional recessionary behaviour like precautionary saving?”**

UK retail consumer and occupational trends

The key questions are how fast we come out of lockdown and how liquid retailer’s balance sheets are

There is very little new to say about the current state of the UK consumer economy, other than to point to the GfK consumer confidence survey’s headline number of -34 for March and April 2020. This is its lowest level since the post Global Financial Crisis period, and we expect that April’s measure will be even weaker.

When we try and look ahead the key question is around when the UK comes out of lockdown, and how long that return to normality is staggered. This, more than any other metric, determines the rate and timing of the UK economic recovery.

At the moment the variation between the most and least optimistic economic forecasters views is particularly wide. At the more pessimistic end is the OBR’s scenario (3 month lockdown followed by a 3 month phased return), that leads to a 12.8% fall in UK GDP in 2020 and a 17.9% rise in 2021. At the more positive end is Oxford Economics (-5.1% in 2020 and +6% in 2021), which is pretty typical of the V-shaped recession school.

However, it worth noting that the overall tone of the top 50 or economic forecasters is generally worsening on a week-by-week basis, rather than improving. While the majority continue to see a global recession lasting for two quarters this year, significantly more are now suggesting that the recession could last for up to six quarters.

As far as metrics that affect consumer confidence go, the most significant is unemployment, which Oxford Economics expect to rise from 3.4% at the end of 2019 to 6.4% at the end of Q3 2020. While the fall is reasonably rapid thereafter, the overall rate does not return to its end 2019 level until the end of 2024.

A rise in unemployment has wider effects than just on those who lose their jobs, as it normally results in a surge in precautionary saving and paying down of debt as people try and improve the state of their safety net. The post-GFC period saw the savings ratio in the UK rise from 8% to 13%, which in turn drove a 4% fall in retail sales.

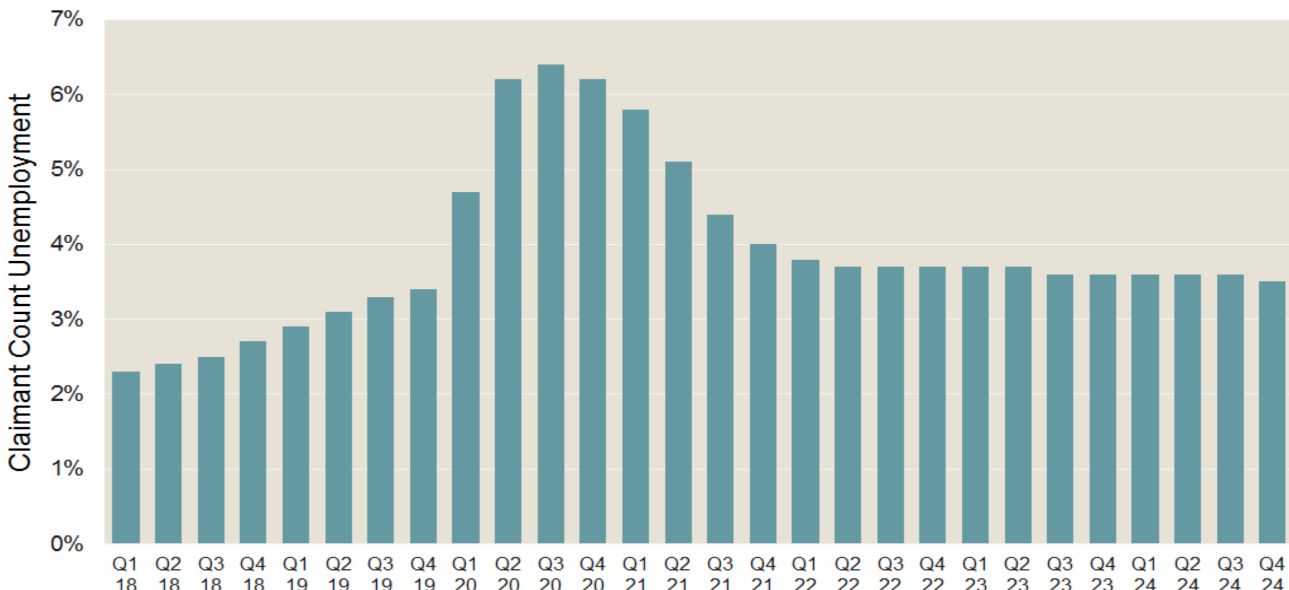
The household savings ratio, which was at a record low level in Q1 2017, has been rebuilt a little over the last two years (probably as a result of concerns over Brexit), and was 6.2% at the end of 2019. We do expect this to rise, though not to such high levels as were seen in 2008/9.

The major area of uncharted territory for the consumer economy over the next six to nine months is around behavioural science not economics. How will people respond when they can finally go out and shop and enjoy themselves after a period of enforced isolation? Might relief at being free to behave relatively normally overcome more traditional behaviours like precautionary saving? Shopping malls in China are not quite back to normal footfall levels

Households are saving 6.2% of their income

Consumer confidence has fallen to -34, its lowest level since -39 in the GFC

The outlook for unemployment is key, but behavioural science might be as important as economics for the pace of economic recovery



Source Oxford Economics (9th April 2020 forecast)

> **"Continued social distancing post-lockdown will have implications on store performance and it's likely to be mass market retailers, F&B and leisure operators that will be the most exposed to this."**

a week after lockdown has ended there, but our local teams suggest that at weekends they are up to 80% of normal levels. Luxury and aspirational brands seem to recover faster (the treat factor that was seen during the GFC), and F&B is trading around normal levels at lunchtime, but below average in the evenings.

In the UK we then have to turn to the question of Christmas, and a number of retailers and retail analysts have suggested that the combination of some household savings that were made during lockdown with relief at being out of lockdown, could lead to a stronger than expected Christmas period in retail. While this will not compensate economically for the recession in the summer, it could be the factor that supports a V-shaped recovery in Q4, even when some other factors suggest that the recovery should be slower than the collapse.

The initial occupier response

Lockdown has had a major impact on occupiers cash flow, financial reserves, operational structures and expansion appetite, particularly for those not deemed 'essential'. Government support, such as the 12 month Business Rate holiday, has helped mitigate some of these pressures. But, with social distancing measures likely to continue for some time post lockdown, these operational challenges are set to continue for some time leading to some fundamental longer term shifts.

The initial response to lockdown from occupiers was to seek a raft of concessions from landlords. These ranged from rent holidays/deferments for a typical period of three months, a move to monthly rents and/or adoption of turnover rents for the period of the crisis. Service charge reductions with payment on a monthly basis was also sought. Some occupiers have been willing to extend leases and/or push back breaks in return for rent free and in some cases rebased rents. The response by landlords has varied with requests dealt with on a case by case basis.

While some retailers are battening down the hatches to preserve cash to ensure their survival and pausing expansion there remains a number using the current situation to identify expansion opportunities. These tend to be supermarkets, discount retailers and some well capitalised new international entrants.

Looking beyond lockdown

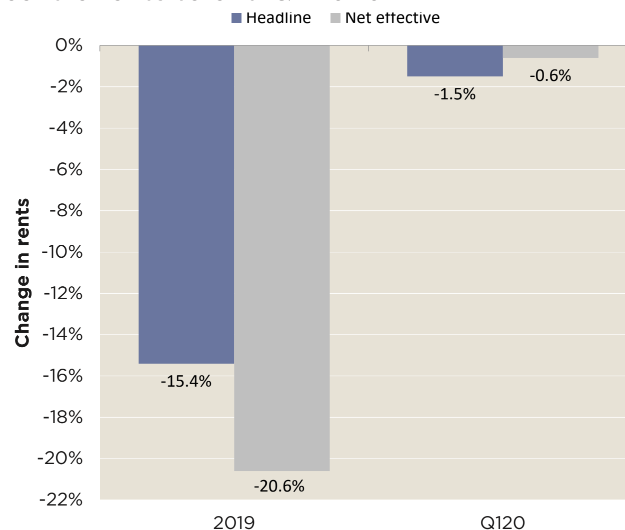
We know that coming out of lockdown does not mean a return to normal. The new normal will be continued social distancing, which will have implications on store performance. As we are currently seeing in Germany, its likely to be mass market retailers, F&B and leisure operators that will be the most exposed to this.

Controlling customer numbers in store will reduce footfall and in turn in-store like-for-like sales; there is little customer appeal to queuing to get into a store. The additional costs associated with ensuring social distancing in-store may also have a bearing on margins. Although this may be offset by savings due to the Business Rate holiday and the VAT payment deferral. The challenges to store performance have been flagged by a number of grocery retailers following the initial stockpiling that boosted trade in the early weeks of lockdown. With F&B and leisure potentially being the last part of the market to exit lockdown, the capacity restraints that may be required to ensure social distancing may mean it would be unprofitable for some sites to re-open.

These operational challenges in the face of social distancing will lead some retailers to shift business models and look to ways to improve the convenience of a store visit. For example, we could see greater investment into online platforms, which could lead to an acceleration in the shift of spend online over the medium to longer term. Aldi, for example, have launched an online service delivering food parcels having not done home delivery before. The question is whether this service will continue post lockdown. In addition, retailers may look to boost remote click & collect services, whether these are outside existing stores and/or at convenient drop points in residential neighbourhoods.

The read through for property is that total vacancy will increase in response to further insolvencies and as occupiers rethink property strategies in the wake of covid. In response, net effective rents will resume their downward trajectory seen over the last two years. The first quarter of 2020 did provide some respite from this as the General Election result helped boost occupier confidence. Average net effective rents on high street and shopping centre deals over Q120 was only 0.6% down on the 2019 average with headline rents down 1.5%. This followed a 20.6% decline in net effective rents in 2019. We could see full year 2020 declines in net effective rents in excess of that seen last year, albeit the level of softening may be more muted for those locations and units attractive to expanding grocery and discount retailers.

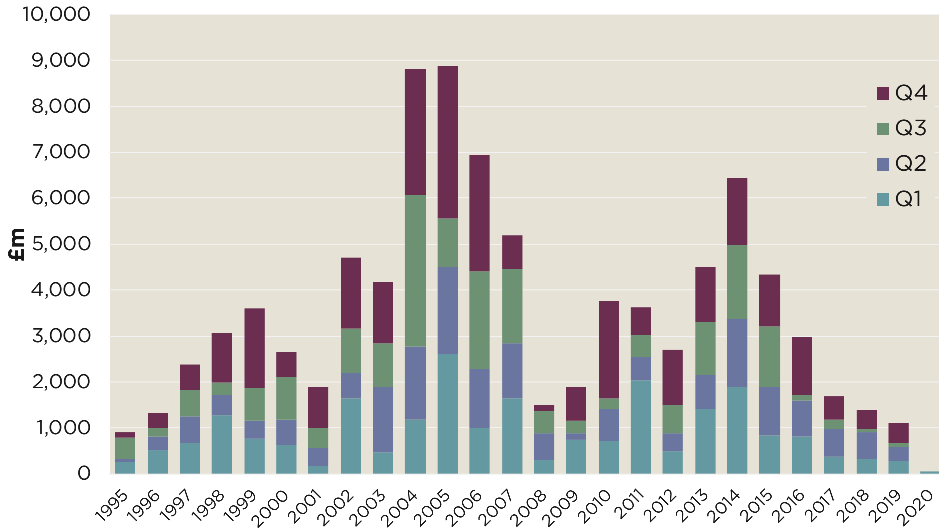
Change in average high street & shopping centre rents to end Q1 2020



Source Savills Research (note: rents based on lettings, regears & assignments excl. SE)

> “We expect to see more sale & leaseback opportunities brought to the market this year”

Shopping centre investment falls to £39.5m in Q1 2020



Source Savills Research

UK retail investment market

High street shops

Q1 2020 saw investment in unit shops fall to its lowest level since the first half of 2000, totalling just over £240m across the UK in the first three months of this year.

This is a continuation of a trend that we have been commenting on for some time, which is now being exacerbated by COVID-19 related issues. There is no doubt that investor demand is limited and likely to remain so for the foreseeable future. At the start of Q1 2020 UK institutional investors continued to view the prospects for voids and rental growth in high street retail with caution, and we felt that without institutional participation market volumes would remain low.

This leaves relatively few buyers for UK shops, the majority of whom are either private investors who are looking for relatively stable income opportunities, or opportunistic investors who are looking at change of use of larger retail assets to generally bed-based uses.

Q1 2020 has seen one other group of investors entering the high street shop market, and that is the local authorities. While they have been very active in the shopping centre market for a number of years, they have been less active in the unit shop market. However, the first three months of 2020 has seen local authorities purchase shops in Bristol, Lancaster, Nuneaton, London SE15, and Saltburn. In all these cases the rationale would appear to be more about regeneration and social return than tactical investing, but it is good to see another group of buyers emerging for local retail assets.

We do not expect to see this behaviour being challenged by the potential changes to what local authorities can borrow from the Public Works Loan Board for, as the lot sizes are relatively small and the rationale for the deals are clearly regeneration.

Looking ahead to the next two quarters we do not expect to see an uptick in investment activity, as the technical challenges of transacting will be considerable until the lockdown is over, and furthermore there will be a desire amongst non-opportunistic buyers to understand which tenants have survived the worst of the lockdown before they commit to buying.

One side effect of the current crisis is the need for businesses in the retail and leisure sectors for liquidity, and as a result of this we expect to see more sale-and-leaseback opportunities to be brought to the market this year.

As far as the outlook for pricing goes, the challenge for the next two quarters will be a lack of transactional evidence. Our core view is that yields will continue to rise on all but the longest and safest income streams, and that yields on the rest will continue to drift upwards. There will obviously come a point where prices stop falling, but that nadir is not on the calendar for 2020 as a result of COVID-19.

Shopping centres

In Q1 2020, Savills tracked only one shopping centre transaction with the sale by Elmsleigh Centre in Staines to the Local Authority for £39.5m – more on that theme later. However, this lack of activity is not a sentiment shared across the whole retail sector. The out-of-town market has been the primary beneficiary of occupational costs reducing; a key consideration for the value players. Looking forward to Q2 and beyond, investors will continue to perceive the current turbulence as an opportunity and will seek to snap up assets in distressed, bank-led sales. There is no shortage of money poised to capitalise on these opportunities and further corporate activity is also anticipated. They just want some semblance of understanding the income.

The election result delivered greater certainty around Brexit, which brought a flurry of stock to the market in Q1 2020. The Oracle, Reading was brought to the market on behalf of the Abu Dhabi Investment Authority, for an asking price of £225 million, reflecting 6.25% NIY. Additionally, The Broadwalk Centre, Edgware was taken to the market on behalf of Aberdeen Standard. The site offers the purchaser a 13-acre freehold site within 40 minutes of the West End, adjacent to Edgware tube and bus station. Unsurprisingly, the site has generated substantial levels of interest on an underlying site value basis, given the potential residential-led redevelopment play. The Thistles scheme in Stirling went under offer at circa £60, 14% NIY, that reflects the impact of an oversized department store.

Finally, the well-documented troubles of Intu continued in Q1 2020. A failed equity raise, coupled with declining footfall and rental income resulted in a £2 billion loss, up from a £1.17 billion loss the year before. The sale of two key Spanish assets has gone some way to improving the short-term

liquidity of the company and we expect a variety of key assets to hit the market in the forthcoming months.

The Coronavirus pandemic has consumed the whole global capital market, dampening investor appetite and reducing the positive sentiment post the Conservative landslide win at the General Election. The coronavirus pandemic has had a serious impact on both investor appetite, given the detrimental effect on the retail sector as a whole. As the virus spreads further beyond China, economic uncertainty is increasing but similar to previous health crises we think commercial property markets will overcome them in the medium to long term. Many are looking to a combination of elements of the Global Financial Crisis (GFC) in 2008/9 and the SARS outbreak of 2003 to guide thinking. In the latter situation we saw capital markets rebound strongly the moment the frequency of new cases was considered to have peaked.

Investment volumes in the first half of 2020 are likely to be suppressed to GFC levels as sellers withdraw potential disposals citing weaker economic growth negatively impacting pricing. Alongside this, operational constraints will prove hugely challenging to schemes where retailers are under strain. The recent rates holiday announced by the Chancellor will go some way to alleviating this, but how landlords (and their debt and equity providers) react to further challenges to collecting rents and service charge suspensions is a dynamic situation that will come into even closer focus as the June quarter day gets closer. Many believe that the collection statistics will be far worse at June owing to tenant failures.

While our wider view on the likely evolution of the current crisis for UK property is one of limited price corrections as a result of limited distressed selling, this is not the case for the shopping centre sector. Even before COVID-19 reached Europe there had already been examples of banks 'taking back the keys' on UK malls. This debate has intensified over recent weeks, and we expect to see more of this in the coming months. These distressed assets may not hit the market in 2020, as we expect that many lenders will prefer to be seen as altruistic during the peak of the crisis. However, we do expect an uptick in distressed selling thereafter.

If this crisis has shown anything so far it is that what we promoted with some really informative research in 2017 on Community and Convenience schemes (or today perhaps rebranded to Essential and Food anchored schemes,) still has real relevance, and these schemes will remain reliable and useful.

This also brings us back to the Local Authority theme mentioned at the top. We are continuing to see and advise pro-active Local Authorities on the opportunity to carry on the Community momentum and look to regenerate their town and city centres by taking control of schemes. This crisis will make these locations even more important to their customers, they need to be relevant and they need to give the residents what they need and want, and it may well not be retail.

£39.5m
Q1 2020 investment in shopping centres

£240m
Q1 2020 investment in high street shops

Shopping centre yields: Revo centre classifications

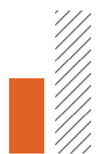
	Q4 2019	Q1 2020
Prime	7.75%	8.00%
Regional scheme	6.00%	6.25%
Sub regional scheme	7.50%	7.75%
Neighbourhood scheme	9.00%	9.50%
Local scheme (successful)	9.50%	9.50%
Local scheme (challenged)	14.00%	15.00%

Source Savills Research.

125bps
The rise in Prime shopping centre yields over the last 12 months

Shopping centre yields: Savills classifications	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020
Super-prime centre	5.25%	5.25%	5.25%	5.50%	5.75%	6.25%
Prime centre	6.50%	6.75%	7.00%	7.25%	7.50%	8.00%
Town centre dominant	8.25%	8.50%	8.75%	9.00%	9.25%	9.50%
Community & convenience	8.50%	8.50%	8.50%	8.75%	9.00%	9.50%
Secondary	10.50%	10.75%	11.00%	11.25%	11.50%	12.00%
Tertiary	14.00%	14.00%	14.00%	14.50%	14.50%	15.00%

Source Savills Research



300bps
The rise in Prime shopping centre yields since Q4 2015

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