

# SPOT LIGHT

Retail Revolutions  
**2018 Outlook:  
Confidence to return**



### Spending squeeze to subside next year

Over a year on from the EU Referendum we are still to find out what Brexit will actually look like. Unsurprisingly this has tempered consumer confidence and with it retail sales volumes. Yet, both measures remain well above their long term average. Retail sales volumes to August were up 3.0%. It was also the first month since May 2015 that we saw three consecutive months of sales volume growth.

Despite the uncertainty Brexit has generated, the fundamentals supporting retail sales remain relatively robust. Namely unemployment remains at historically low levels and the economy is continuing to report growth, albeit this is slowing. Rather it is the squeeze in household spending that is generating the most significant headwinds to sales performance over the short term.

Real wage growth moved into negative territory at the start of 2017 as inflation, driven by the weaker Pound, started to outpace nominal wage growth (Figure 1). Consensus forecasts suggest inflation will start to wane as we move through 2018, aligning with a positive growth in wages, both of which will help alleviate some of the headwinds facing retail sales performance.

While Brexit continues to generate headwinds for retailers nationally, it has buoyed performance in London's West End. The weaker Pound has boosted overseas visitor spending with the latest data for July pointing to a 5.4% annual increase in West End retail sales (rolling 12 month ave). In June 2016, the month of the EU Referendum, a 3.8% decline was reported.

Resilience is also being seen in other parts of the retail market. Value retailing always tends to perform well during periods of economic

uncertainty, but we have also seen robust sales volumes in other parts of the market. Electrical household appliances reported a 9.7% growth year-on-year in August, over 600 basis points (bps) above its five year annual average. Volumes of watches & jewellery sales saw a 18.7% annual increase, we suspect driven by increased overseas spend in London.

Performance is more mixed when it comes to clothing and footwear. This is nothing new as performance is often skewed by unseasonal weather. What is reassuring is that over the last 12 months clothing sales volumes are up 4.3%, in line with the 20 year annual average of 4.7%.

### The structural shift matures

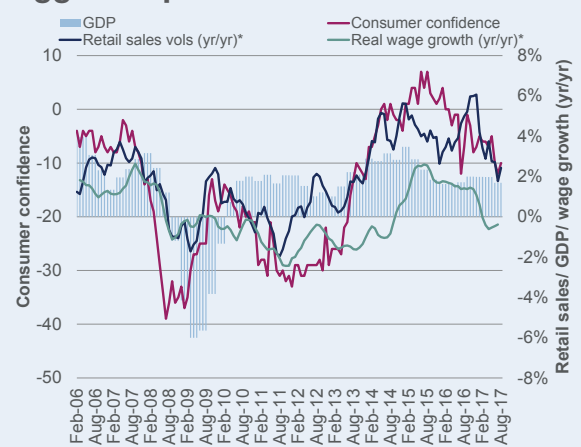
The growth in online retailing is the primary driver of the structural shift facing in-store retailing. Online accounted for 14.9% of total retail sales in 2016, yet growth has slowed from 14.4% in 2012 to 7.9% in 2016, pointing to increasing maturity as a sales channel.

Forecasts from GlobalData suggest that growth will slow further to 5.3% by 2022 with online accounting for 18.5% of total sales. This means the majority of sales (81.5%) will continue to take place in physical stores (although the pre-purchase research may take place online). For some sectors, such as health & beauty, homewares and luxury fashion, this will be even more pronounced.

But, this is not to say that online's influence on physical retailing is set to diminish. Retailers are increasingly recognising the important role the store plays in the total retail experience of their customers. A store can help drive online sales particularly where there is a preference amongst customers to 'touch and feel' a product before purchase.

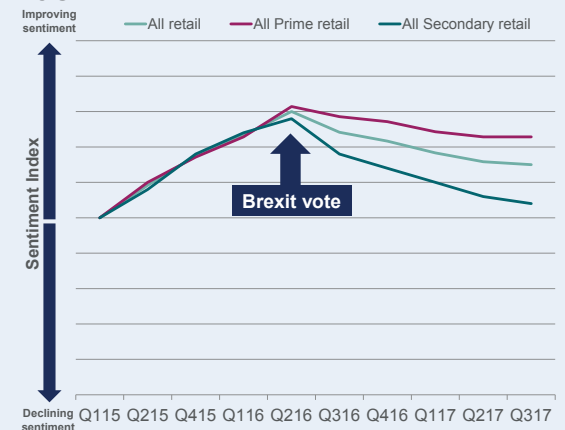
UK retail entered a 'perfect storm' this year but the outlook for 2018 and beyond looks brighter. We examine the key trends for next year and what this means for landlords.

FIGURE 1 Negative 'real' wage growth having biggest impact on sales



Source: ONS; GfK (\*Note: Retail sales and wage growth is on a rolling 3-month ave)

FIGURE 2 Savills Retailer Demand Sentiment Index



Source: Savills Research (methodology: Agents state whether retailer sentiment/demand is up, down or holding on the previous quarter).

#### 2018 OUTLOOK IN NUMBERS

**5.4%**

Annual increase, on rolling 12-month basis, in West End retail sales reported in July.



**81.5%**

The proportion of retail sales forecast to take place in physical stores in 2022.



**150-200k sq ft**

Net trading space Next are planning to add to their estate in 2018.



This is apparent in the number of pure-play online retailers that have moved into 'bricks & mortar' retailing. Since 2012 we have tracked 17 pure-play retailers who now operate their own standalone stores in the UK, 35% and 29% of these being fashion and furniture brands respectively.

While the role of the store will not diminish, for certain parts of the market it is likely to mean fewer stores in more strategic locations over the longer term. This 'rightsizing' of store portfolios is unlikely to be good news for landlords, however, it does offer some potential opportunities, particularly in shopping centres, some of which we explore in the box opposite.

### Occupational confidence to return next year

Brexit has had the most immediate impact on retailer confidence. Savills retailer demand sentiment tracker (Figure 2) recorded its first softening in the months following the EU Referendum. Prime retail locations are demonstrating the greatest resilience, albeit all parts of the retail market have seen some level of softening or stagnation in occupational demand over the last 12 months.

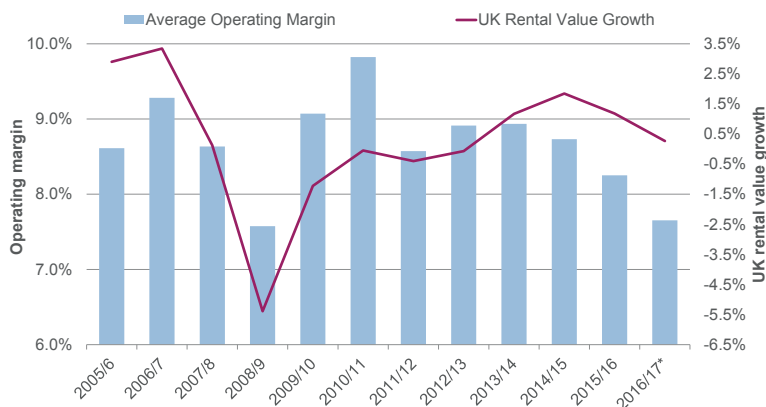
While wider economic uncertainty has played a key role in dampening occupational demand, it has been the more tangible squeeze in operational margins that is having the most significant impact.

UK operating margins post the Global Financial Crisis (GFC) have, on average, been under downward pressure since 2012/13 (Figure 3). Currency fluctuations post the EU Referendum has exacerbated this as retailers have largely tried to avoid passing on higher costs to consumers in a potentially weaker trading environment. For those retailers with a sizeable store portfolio in London and the South East the recent Business Rate revaluation has generated a further margin squeeze.

This softening in margins has already fed through to weaker rental value growth, which we expect will continue over the next six to 12 months. However, we expect an improvement in rental growth will materialise over the second half of 2018 as cost pressures start to wane. This diminishing of cost pressures will no doubt result in a resurgence in retailer confidence and activity.

Improving conditions in 2018 has been expressed by a number of retailers. Next recently upgraded their sales and profit guidance for the full year encouraged by Q2 performance noting that prospects appeared less challenging than they did six months ago. They also stated their intention to add a further 150,000 to 200,000 sq ft of net trading space to their estate next year. ■

FIGURE 3  
**UK rental value growth tends to track retailer profitability**



Source: Savills Research; Retailer Annual Report & Accounts; MSCI  
Note: rental value growth is for the calendar year whereas Operating Margin tends to cover Financial Year.

## REPURPOSING SHOPPING CENTRES

### Rightsizing & the alternatives

Reports from the US suggest there is an 'Armageddon' facing shopping centres with some malls being mothballed and even demolished. The question is, could this happen in the UK?

While UK retailing is facing the same structural shifts it is relatively more insulated as the quantum of retail floorspace per head is far lower here than in the US.

That is not to say some level of 'rightsizing' is required to ensure centres have the right quantum of space in line with retailer and consumer demand. This does not mean centres will become redundant; even secondary and tertiary centres play an important role in convenience retailing, but many were built before the arrival of e-commerce and some are simply too large.

So what to do with the excess space?

To date the focus has been on allocating excess retail space to food & beverage provision, a useful tool in enhancing a locations attraction to shoppers and increasing dwell time. However, there are a number of other alternatives, some of which are listed below, that can also help deliver a more mixed and vibrant environment as well as generating additional footfall to support the existing retail element.

■ **Residential:** Better suited to locations where demand and values ensure conversion is feasible. While residential can increase values it also translates into a larger resident population helping to support retail sales and in turn retailer demand.

■ **Public space:** While not generating 'direct' additional value the demolition of excess of space could provide an opportunity to create appealing public spaces ultimately enhancing the attractiveness of the location as a place to shop to the benefit of the remaining retail element, whilst also reducing rating liability on long term void space.

■ **Offices:** John Lewis is reportedly on the cusp of repurposing unused retail space as co-working offices in some of its larger stores. As shopping centres are typically well connected, as well as offering retail and leisure amenities on-site, they could prove attractive workplace locations.

■ **Logistics:** With high demand for 'last mile' logistics space to fulfil online deliveries, using redundant space as distribution hubs or 'dark kitchens' could be a valuable alternative.

## OUTLOOK

### Confidence to make a tentative return in 2018

#### Retailer activity to improve

Occupational demand, on the whole, stalled this year on the back of Brexit and the subsequent operational cost pressures this generated. We expect these cost pressures will start to subside throughout 2018 translating into improved retailer confidence and occupational demand, albeit this will be tentative and largely focused on prime retail locations initially.

#### Rental growth to be subdued but will improve post 2018

All UK rental growth is forecast to be relatively subdued over the next two years, with average growth of 0.3% per annum forecast for 2017 and 2018. Beyond this, growth is forecast to improve to 1.4% per annum through to the end of 2021.

The best performing parts of the retail market will continue to be destination retail locations with All Central London and out-of-town destination shopping centres forecast to see average annual rental growth of 2.2% and 1.5% per annum respectively between 2017-2021. We also expect to also see strong performance in more 'convenience' locations where trading performance is robust and total occupational costs are more affordable.

#### Rightsizing picks up pace

One key trend for 2018 will be the growing acceptance that there is perhaps too much

retail floorspace in the wrong locations. Rightsizing will not just extend to total provision but also store sizes in some instances.

Rightsizing unit formats, primarily through subdivision of larger units, is nothing new in secondary and tertiary locations. However, in prime retail locations, particularly in London and the South East, it could become more common. Retailer demand in prime locations will continue to be skewed towards large flagship stores over the longer term. Yet, with many retailers looking to drive their online platforms they are now considering their store portfolios more carefully. This is likely to be more pronounced in prime locations as the cost associated with operating these stores has increased significantly, particularly in the wake of the recent business rate revaluation.

A slight shift towards smaller formats does have its benefits to landlords. Firstly the reletting risk is often lower as the pool of potential occupiers is larger. It can also help to improve the vibrancy and attractiveness of a location to shoppers as smaller stores can mean a greater number and variety of retail brands.

#### Shorter leases seen more favourably

Average retail lease lengths have been shortening for a number of years. The introduction of IFRS 16 in January 2019

could see it shorten further. The new IFRS accounting standards will bring all leases onto a company's balance sheet, effectively increasing assets and in turn liabilities particularly for large retailers with sizeable estates. This could further enhance the attractiveness of shorter leases to retailers as it will minimise liabilities. For prime retail locations, however, we believe there will remain a preference to secure longer terms.

Shorter lease lengths does pose some potential valuation issues. On the flip side, it does offer some operational advantages to landlords, particularly in shopping centres, as it provides greater flexibility around retailer mix.

#### New types of retail occupiers and formats

Retail space occupiers are set to move beyond traditional retailers. Manufacturing and car brands, such as Dyson and Tesla, have already started to appear in high footfall retail locations. Unlike traditional retailers where the store is required to generate direct sales, for these occupiers the store is envisaged as a way to raise brand awareness and to improve customer engagement. Likewise we also expect to see some traditional out-of-town retailers move onto the high street with smaller concepts. ■

## SAVILLS TEAM

Please contact us for further information



**Sean Gillies**  
Head of UK Retail  
+44 (0) 20 7409 8159  
sgillies@savills.com



**Anthony Selwyn**  
Central London Retail  
+44 (0) 20 7758 3880  
aselwyn@savills.com



**Mark Simms**  
Shopping Centres  
+44 (0) 20 7409 5943  
msimms@savills.com



**Dominic Rodbourne**  
Retail Warehouses  
+44 (0) 20 7409 9945  
drodbourne@savills.com



**Marie Hickey**  
Research  
+44 (0) 20 3320 8288  
mlhickey@savills.com

#### Savills plc

Savills is a leading global real estate service provider listed on the London Stock Exchange. The company established in 1855, has a rich heritage with unrivalled growth. It is a company that leads rather than follows, and now has over 500 offices and associates throughout the Americas, Europe, Asia Pacific, Africa and the Middle East.

This report is for general informative purposes only. It may not be published, reproduced or quoted in part or in whole, nor may it be used as a basis for any contract, prospectus, agreement or other document without prior consent. Whilst every effort has been made to ensure its accuracy, Savills accepts no liability whatsoever for any direct or consequential loss arising from its use. The content is strictly copyright and reproduction of the whole or part of it in any form is prohibited without written permission from Savills Research.