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# UK Retail Warehouse Spotlight
# Negative headlines hide steady prospects

April 2018

## Consumer headwinds easing

■ After 2017's perfect storm of falling real earnings growth, rising wage costs and Brexit-related increases in import costs, there are signs that the headwinds in the consumer economy are starting to ease.

■ The latest inflation report shows that price inflation has eased to 2.5% and regular pay growth has now risen to 2.8%, which means that real earnings growth is back in positive territory for the first time since the Referendum.

■ Following two consecutive months of falling retail sales volumes February saw a return to growth. However, food sales were the only segment that saw a significant rise (1.2% mom), while clothing and department store sales dropped.

■ Speculation about the timing of the next interest rate rise is intensifying and one rise before the summer is looking increasingly likely. Thereafter we expect that slowing inflation will reduce the pressure for another rise.

■ Interest rate rises are by no means bad for consumer spending, with a comparatively small proportion of the population exposed to them through variable rate mortgages, so generally we expect modest rises to have a negligible effect on retailing.

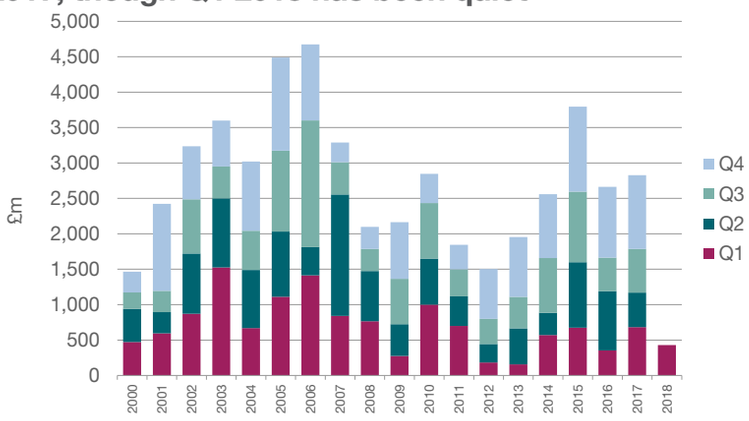
## Retailer distress has more to do with 2017 than the future

■ The string of actual and rumoured retailer failures has undoubtedly knocked confidence and activity in the first quarter of this year. However, we believe that they say more about how bad 2017 was, and indeed individual business models, than acting as an indication of the future health of the sector.

■ Voids on retail parks will undoubtedly rise due to the failures of Maplin, Toys R Us and the CVA at Carpetright. However, if we assume

GRAPH 1

### Retail warehouse investment volume picked up in 2017, though Q1 2018 has been quiet




Graph source: Savills

**1.0%**
Rise in retail park footfall in 2017

**-9**
Latest consumer confidence index (Long term average -9)

**1.5%pa**
Forecast average annual retail warehouse rental growth (2018-2022)

**2.6%pa**
Forecast growth in sales of retail warehouse goods over the next five years

TABLE 1

### Retail warehouse yields

| | Dec 2016 | May 2017 | March 2018 |
|---|---|---|---|
| Shopping Park | 5.00% | 5.25% | 5.25% |
| Prime Open A1 | 5.25% | 5.25% | 5.00% |
| Prime Restricted | 6.00% | 5.75% | 5.25% |
| Secondary Open A1 | 6.00% | 6.00% | 7.00% |
| Secondary Restricted | 7.00% | 7.00% | 7.50% |

Source: Savills

that only 20% of these units are re-let by the end of 2018 (very much a worst case scenario), this only takes the overall retail warehouse vacancy rate from 5.96% to 7.82%.

■ On a square foot basis the impact on vacancy rates is even lower, with the worst case scenario being a rise from 3.62% to 5.17%.

■ To put these figures into context the latest MSCI UK vacancy rate for offices is 12.35%.

■ Whatever the eventual out turn might be for retail park vacancies, the short term impact will definitely be on decision-making. Weaker retailers will be looking closely at expansion plans, and stronger retailers will be looking to do more opportunistic deals.

■ The rationale for opportunism is twofold. Firstly, there might be the opportunity for a retailer to achieve better terms in a few months time than today. Secondly, some acquisitive retailers will definitely be speculating as to whether better units might come to the market as a result of these failures, and will want to keep some of their purchasing power in reserve to spend on these new units.

■ Bulky goods and value-food retailing remain the most active parts of the market. Lidl and Aldi are both expansionary at present, and landlords are increasingly aware of broadening customer base, willingness to take long-leases, and role as footfall drivers. We delve into this segment in more detail later on in this Spotlight.

■ In the bulky sector Oak Furniture Land, Tapi and Wren all have plans for further store openings in 2018, reflecting the predicted strength of sales in this segment that we have already mentioned.

■ For landlords the next six months is undoubtedly going to be challenging, with those tenants who are acquisitive being fully aware of the strength of their negotiating position. Landlord flexibility on terms will undoubtedly be the key to making deals happen over this turbulent period, though we do expect a more balanced story to begin to emerge towards the end of 2018.

■ Landlords who already own parks and schemes in the best locations will benefit from the continuing polarisation of retailer requirements towards the best over the rest. Furthermore, while capex might seem a bitter pill to swallow at the moment, it will pay dividends in the future as both retailers and shoppers become more focused on prime schemes and experiences.

## Investment market remains strong for the best assets (at the expense of the rest)

■ As Graph 1 shows, the final quarter of 2017 saw a surge of investment into the retail warehouse sector, reflecting the wider interest in retail warehousing that had been brewing throughout last year. This brought the total investment volume for the year to £2.8bn, which is 6.2% up on 2016 and 14.4% up on the ten year average.

■ Investor interest in prime assets has been sustained during the first quarter of 2018, but the recent turbulence in the occupational sector will definitely cause a brief hiatus in the investment market while owners and potential investors take stock of the news.

■ There is also an increasing depth of demand for secondary assets, but only at realistic pricing.

■ Any short term cessation in activity will, we believe, have more to do with some investors speculating that specific deals might be cheaper later this year, rather than reflecting any lack of interest in the asset class as a whole.

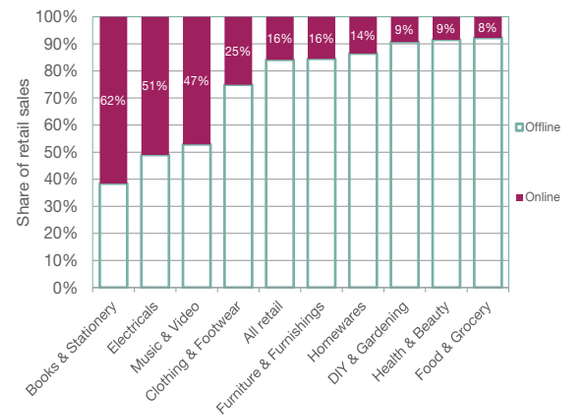
■ Investors will increasingly realise that CVAs are not administrations and that retail warehousing remains more defensive than other areas of retail.

■ We remain of the view that prime bulky goods schemes are the most defensive segment in retailing at present, a drum that we have now been banging for several years. As Graph 2 shows, the types of goods that are generally sold on bulky goods parks exhibit the lowest levels of internet penetration.

■ Furthermore, Global Data are predicting that household goods sales

GRAPH 2

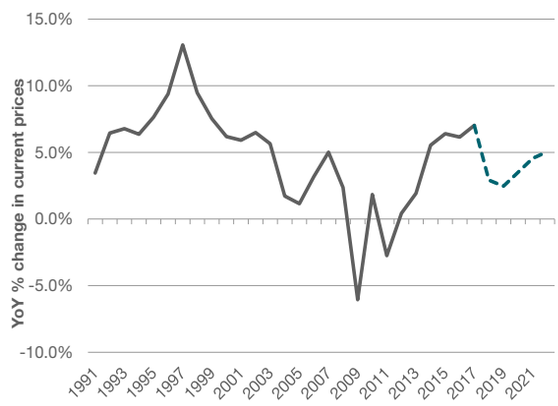
### Online and offline retail sales 2017




Graph source: Global Data

GRAPH 3

### Spending on retail warehouse goods




Graph source: Savills from Oxford Economics data

**2.3%**
**The year on year rise in household goods sales in January 2018**

**9.97%**
**The average total return on solus units in 2017 (MSCI)**

**6.67%**
**The average total return on retail parks in 2017 (MSCI)**

will rise at 2.3% per annum over the next five years, the fastest growth of any of the major product segments.

■ We expect that yields on prime bulky goods parks will remain stable over the remainder of the year, but the weakening tenant sentiment around secondary schemes will result in continuing yield softening on BBB parks.

■ This is likely to cause some investors to have a more forensic look at secondary schemes, as higher yields and rebased rents make a value-add and asset management focused strategy more persuasive.

## The growth of value-orientated retailers in the out-of-town market

■ Economic pressures continue to impact all retail sectors with a number of high profile retail brands going into administration or CVA in 2018 including Maplin, New Look and Toys R Us. However, following on from previous Savills research that examined 'The Growth of the Value Sector in the Out of Town Retail Market', as recent economic pressures begin to take hold growth in the out-of-town Value sector shows little sign of slowing down.

■ This analysis looks at a number of key Value orientated brands across three retail sectors that have all enjoyed a sustained period of growth since the last recession; for grocery they include Iceland, Lidl, Aldi and Farmfoods, for fashion Primark, Peacocks, Peo&Co, Sports Direct, Matalan and TK Maxx and for comparison the brands examined include Poundland, Poundstretcher, Poundworld, Home Bargains and B&M.

■ Value brands such as these are often able to capitalise on administration failures and take space where lower rents and the accessibility of large units have ensured that out-of-town shopping and retail parks remain an attractive choice for such operators, particularly in secondary locations and smaller out-of-town schemes where they can appeal to a wide customer base driving maximum profit from low margin products.

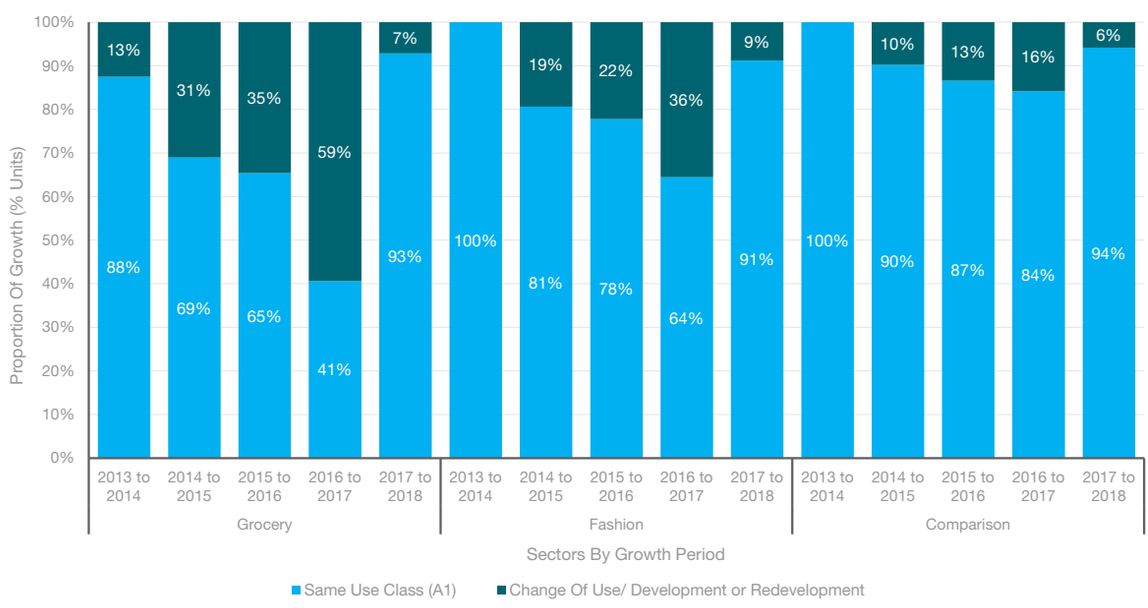
■ In 2014 alone 18% of growth (c.22 units) for these Value brands collectively came as a result of redundant stock from a number of multiple retail brands falling into administration before that time, including Allied Carpets (2009), Focus DIY (2011), Comet (2012), JJB Sports (2012) and Blockbuster Video (2013). In 2015 17% of growth came from units previously occupied by these failed brands (c.26 units). In 2016 this grew to 32% (c.33 units) thus a third of the growth of the Value brands analysed came from space that had been vacant for at least 3 years as a result of these administrations.

■ Value retails success and speed of this growth is also highlighted in the sectors attitude toward obtaining planning permission. For each sector Graph 4 outlines the proportion of the annual growth for the Value operators in this study, that has come as a result of taking units with the same overall use class (A1 shops and retail outlets) or indeed space that has required a complete change of use or is part of a new development or redevelopment.

■ Although there are planning considerations and potential hurdles within the A1 use class (when a retailer wants to take space and change the use from bulky to open A1 for example) it is generally considered easier to make those changes when the focus is still a retail one.

GRAPH 4

### Value operator growth by use class category (% units)




Graph source: Savills

■ However for many Value retailers there has also been a willingness to go through the much more difficult and drawn out process of obtaining permission on a complete change of use or new development as is evident in Graph 4.

■ This was most prominent between 2016 and 2017 when for grocery as much as 59% of Value retailer growth was by way of a change of use/ new development, for fashion over a third (36%) and comparison as much as 16%.

■ Consumers' shrinking budgets will therefore maintain Value operators appeal over the coming years as shoppers increasingly rely on them for frequent, essential fashion, comparison and grocery purchases. This will only fuel store openings further as demand for accessibility rises, with landlords also keen to bring in retailers with a wide demographic appeal to drive footfall and anchor their developments.

■ Current the out-of-town vacancy by unit stands at 5.96%. However if 80% of Maplin and Toys R Us units were to become vacant overnight, the overall vacancy would only grow to 6.67%. This highlights that despite recent failure the retail warehouse market remains robust.

■ To put this into perspective Retail Warehouse vacancy by units is much lower than that for Shopping Centres for example and remains so even with the recent failures (6.7% for Regional Malls, 11.0% Prime City Centres, 9.9% Prime Town Centre, 14.7% Secondary).

■ What we are seeing then is the continuation of a cyclical process whereby retailers that have struggled to adapt to consumer demand and subsequent market position are being replaced by those that have. Value retailers remain very relevant therefore with the evidence suggesting an attitude change has accounted for the growth of the out-of-town Value retail market, not only for the consumer but for other occupiers and for landlords in tenant selection.

■ As Value retailers across all sectors have grown their portfolios, their covenants have become some of the strongest on offer, often taking longer leases than many other traditional out-of-town retailers, hence the strong appeal from a landlord perspective, something they are in a strong position to benefit from with the units that will come to market as a result of the recent administrations.

■ Landlord (and shopper) enthusiasm for the value segment is also being seen in the increasing number of new developments that are anchored by a value retailer, often sitting aside a more aspirational brand such as a M&S Foodhall.

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