UK Commercial – Q1 2023

SPOTLIGHT
Savills Research

Shopping Centre and High Street Spotlight

- Increased distress in Q1 but occupational market remains buoyant
- Retail investment market has continued to cool

Annual CPI inflation reached 10.1% in March 2023, easing marginally from the 10.4% increase reported in February 2023.

UK retail consumer and occupational trends

Following a challenging Q1 for retail, the outlook appears brighter with early spring figures already pointing at improvements.

Marginal deflation and improvements to consumer confidence suggest healthier times for retail are imminent, following what has been a relatively challenging start to the year.

CPI inflation recorded 10.1% in March, down 0.3% on February levels although still exceeding many economists' forecasts. The largest contributors remain housing/household services, up 26.1% year-on-year, and food and drinks, up 19.1% and representing the largest annual increase for 45 years. Rising prices of essential goods/services are largely unavoidable, meaning the pinch is still being transferred to sectors reliant on discretionary spending, despite a promising fall in prices for the likes of clothing/footwear and furniture, which reported monthly falls of -0.9% and -0.7% respectively.

In volume terms, retail sales declined -3.2% year-on-year in March 2023, evidencing ongoing cautiousness. However, on a quarterly basis, Q1 sales reported a marginal 0.6% uptick versus Q4 2022, marking the first three-month on three-month improvement since August 2021.

Akin to recent years, retailer results have been noticeably uneven. Pressures facing more challenged retailers has led to a rise in distressed activity in early 2023. M&Co confirmed the closure across its 170-store portfolio, whilst Paperchase shuttered its 106 stores before the brand and remaining products were acquired by Tesco. Next continued its run of acquiring distressed retailers (following Joules and Made.com in 2022) by snapping up Cath Kidston, bringing more stock to Next's inventory.

Other large scale operators have begun amending their sentiment. Superdry removed its 'break even' profit guidance following challenged trading, while John Lewis continue to seek structural change to ease financial headwinds.

However, there are still many noteworthy out-performers, largely led by value retail. Primark reported a 19% uplift in its half-year figures to March 2023 and Poundland owner, Pepco, saw Q1 2023 like-for-like revenue growth of 8.5% versus Q1 2022. Peacocks look set to take over 20 recently closed M&Co sites, while value pharmacy chain Superdrug are aiming for 25 new openings in 2023.

Despite household goods reporting one of the largest year-on-year declines by sector in March of -8.5%, there are still notable positive movements. Dunelm bucked the trend with a 6.1% year-on-year sales increase in Q1, whilst both B&M and Screwfix progress with extensive UK store expansion plans.

Are consumer headwinds beginning to ease?

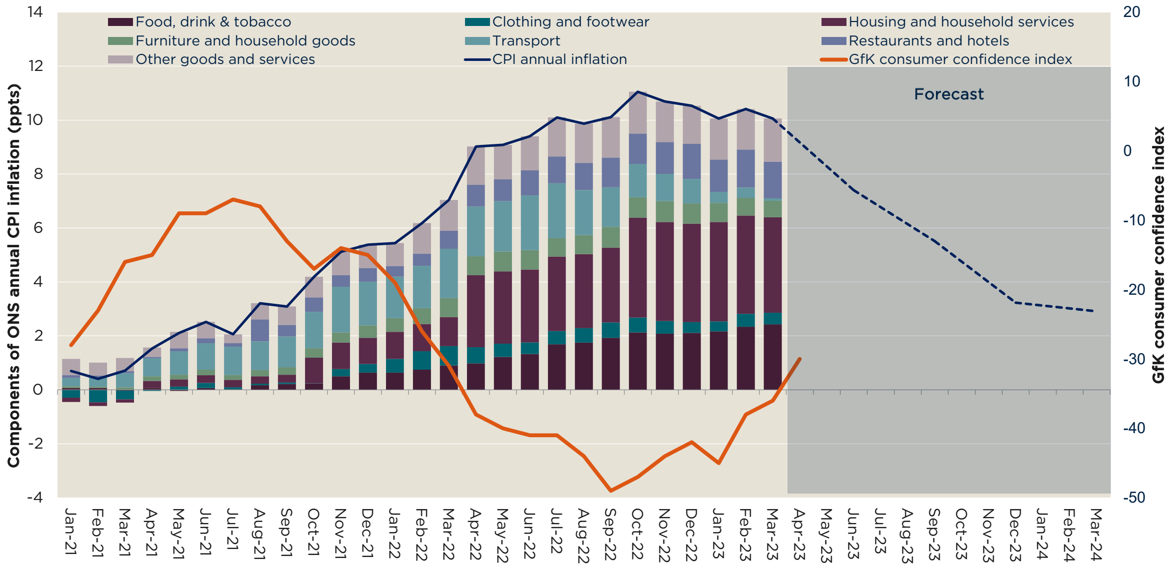
Consumer confidence has improved greatly from its September 2022 nadir, although still low by historic levels. A six-point improvement in GfK's April 2023 consumer confidence index saw levels reach their highest levels since February 2022 and represented the third consecutive month of improvement.

-3.2%

Retail sales (by volume) dropped -3.2% year-on-year in March 2023 as cost of living challenges persist

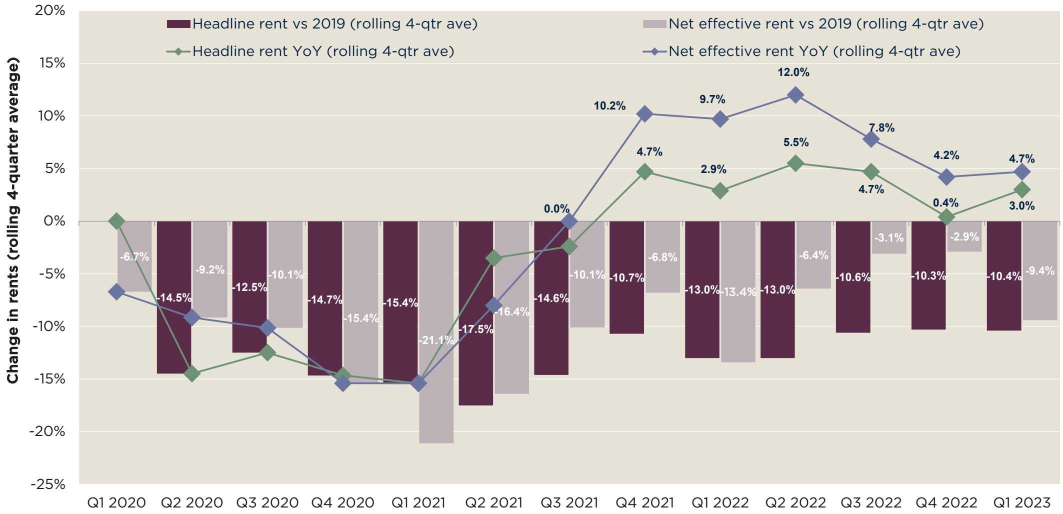
GfK's consumer confidence improved 6 points to -30 in April 2023, its highest level since February 2022

Graph 1: Components of consumer price inflation versus consumer confidence



Source Savills Research, ONS, GfK, Oxford Economics

Graph 2: Average headline and net effective retail rents



Source Savills Research.
***Note:** Based on Savills UK retail deals outside London and the SE.

Q1 2023 reported the sixth consecutive quarter of positive year-on-year headline and net effective rental growth

If inflation forecasts are anything to go by, this upward trajectory in consumer confidence could continue in the coming months. CPI inflation is expected to ease slightly faster than previously anticipated, down to 3.2% by Q4 2023 according to Oxford Economics. This deflation, led by less expensive energy, could begin to unlock some disposable household income this year.

Events and public holidays ready to give footfall and in-store sales a boost

March footfall dropped -2.8% month-on-month, largely hindered by poor weather and continued strain on disposable income, however the Easter weekend provided a glimmer of positivity. Footfall rose 14.2% over the week according to Springboard, as better weather supported domestic trips.

Monthly footfall levels are likely to pick up in May, following three Bank Holidays. Inbound tourism flows continue to gain momentum (Heathrow arrivals recorded their strongest performance versus 2019 levels in March 2023, down just -4.4%), supporting major tourist destinations. Largescale events are likely to have boosted inbound tourism, notably the King's Coronation, although bad weather did dampen footfall levels slightly on the Saturday.

Grosvenor are forecasting a 25% footfall uplift at Liverpool One during the Eurovision weekend, following an already strong set of sales results in early 2023, up 16.5% year-on-year amidst noteworthy store openings including Under Armour's first UK flagship.

Further rental stabilisation amidst renewed occupier demand

The rise of administrative activity has been somewhat offset by renewed leasing demand from some operators, with the outlook for 2023 looking healthier than the preceding 12 month period. This has been reflected within Savills leasing data, with deal count in Q1 2023 up 11.8% on the five-year Q1 average.

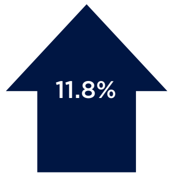
As a result, we have not seen any material change in rents in Q1 2023. Year-on-year rents remain in positive territory for the sixth consecutive month, highlighting the lasting improvement from the peak-Covid period in 2020-2021.

When comparing against 2019 levels, headline rents have reported very little change over the last four quarters, suggesting rents for the most part have rebased by c.10% on pre-pandemic equivalent levels. Net effective rents reported a 9.4% fall compared to 2019 equivalent levels. While this is down on the equivalent change reported in Q4 2022, it still represents a 4.0ppt improvement on the Q1 2022 versus 2019 change, and is off the back of a particularly strong set of results in Q1 2019.

On prime pitches, we are beginning to see landlord incentives fade in light of increased leasing demand and multiple offers being received. Rent free periods averaged 5.7 months in Q1 2023, down -20.1% compared to the height of the pandemic in 2020. Additionally, lease lengths on prime pitches are beginning to rise once again, albeit very marginally. Average shopping centre and high street lease lengths reached 6.1 years in Q1 2023, up 6.0% on the 2020 average, while largely in line with 2019 levels.

So while closures may have increased in Q1, it appears new and planned openings should largely eclipse concerns over vacancy increases. LDC's latest forecasts still suggest vacancy will fall this year, albeit very marginally, to 13.7%, down 0.1% on H2 2022.

Rebased rents, coupled with the business rates revaluation, provides financially stable retailers with an attractive opportunity for store portfolio growth and resulting in an uptick in tenant activity. Despite significant market variations in the business rates revaluation, the general movement will help ease some pressures facing tenants. On average, rateable values have fallen 10% across England and Wales, extending to 25% for prime high street and shopping centre locations.

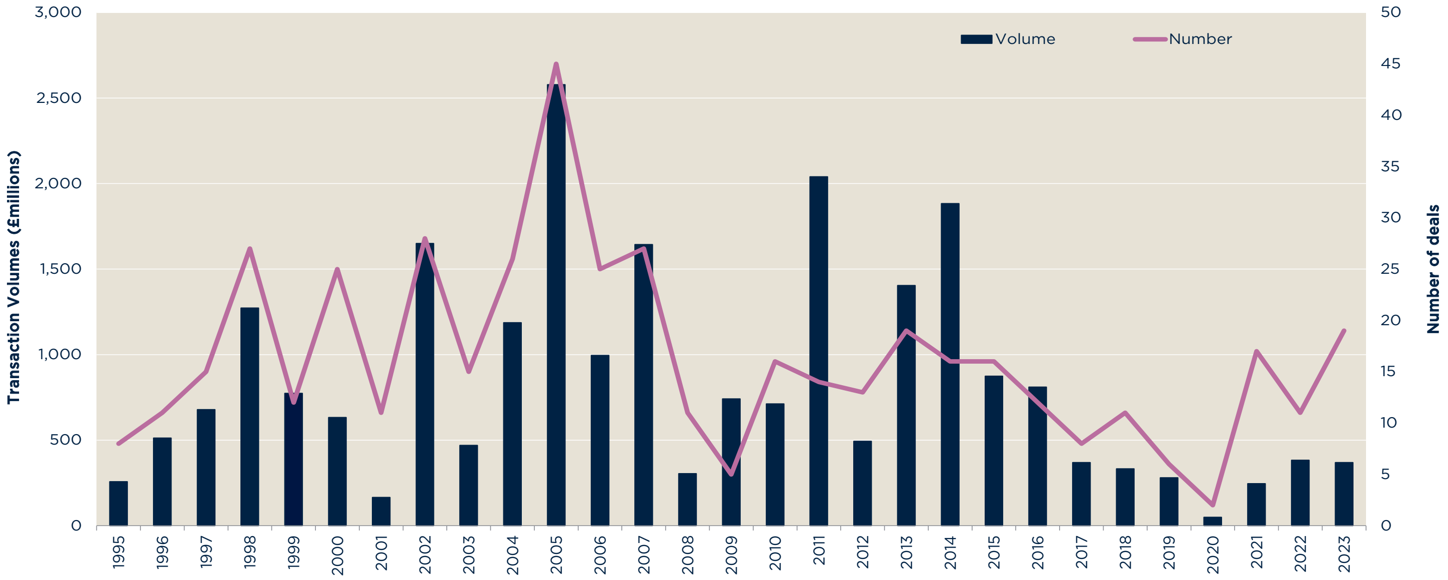


Q1 2023 retail leasing deal count exceeded the five-year Q1 average by 11.8%

Prime high street and shopping centre rateable values dropped 25% on average in April 2023

“Prime shopping centre and high street shop yields will peak this year”

Graph 3: Quarter 1 shopping centre investment volumes



Source Savills Research

UK retail investment market

Turnover in line with recent years, but prices still slipping across the board

Shopping centre investment

While the Q1 shopping centre investment volume was directly in line with the five-year average, prices continued to fall as sentiment has worsened across the commercial property markets.

£369.2 million was transacted in Q1 2023 in 19 deals. As the chart above shows, this is a marked increase in the number of transactions on previous first quarters. However, while the average deal size of £19.4m is higher than seen in Q1 2021, it is the second lowest Q1 average in the last 20 years.

The small lot sizes that are being traded in the shopping centre investment market are a reflection of the continued bias amongst purchasers towards private investors and small property companies.

The first three months of 2023 have also been characterised by a reduction in the amount of stock that is being brought to the market, though this has been matched by a slimmer buyer pool as those who have been active in this sector over the last few years take stock of what they have bought.

At the time of writing we estimate that there is around £400m of stock under offer, and a further £500m in the market. We expect that overall transactional volume for 2023 will be similar to that of 2022, at around £1.5bn, though this could be lower if sentiment towards commercial property in general does not improve in the second quarter.

The steady improvement in the occupational story has not fed through into a similar theme for investment pricing, with the average shopping centre yield moving from 11.33% at the end of Q4 2022 to 11.54% at the end of Q1 2023. Average prime yields moved by a similar quantum, from 8.63% to 8.88% over the same period.

While there is a strong argument that prime shopping centre yields should be close to their peak (given that they have been rising since 2015), an imminent plateau feels unlikely with the wider real-estate markets still adjusting to the new debt environment.

As we have pointed out before, the cost of borrowing should not be as important to shopping centre investment as it is to other sectors. However, wider investor caution will ensure that this remains a buyer’s market over the remainder of 2023.

Prime yields should stabilise this year, but this raises the interesting question of who the buyers might be for UK shopping centres when yields start to harden.

The bulk of investor demand in recent years has been driven by a degree of counter-cyclical opportunism, and there will come a point in the recovery when this rationale falls away. In previous cycles it has been the return of the institutional investor that has supported a recovery in capital values, though this time around there is little evidence that the UK institutions are preparing to re-enter this segment.

High street shop investment

On the face of it high street shop investment was one of the few success stories of the first quarter of 2023. According to Property Data the volume of unit shops traded rose from £638m in Q4 2022 to £1.1bn in Q1 2023. However, a significant proportion of this total was in foodstores, which when stripped out of the total leads to a more in line with the market story of a 50% quarter-on-quarter reduction in high street shop investment.

The stronger investor interest that we saw at the back end of last year did carry over into very early 2023, though this has cooled since the Credit Suisse and Silicon Valley Bank shocks.

In common with the shopping centre investment market changes in the cost of borrowing or lender behaviour should not be affecting investor demand for unit shops as much as is affecting other parts of the commercial property investment market (because debt availability was already limited here). However, there is no doubt that the weakening of investor sentiment towards commercial property in general has led to a reduction in investor activity in the high street shop submarket.

The investor rationale for buying high street shops remains unchanged i.e. either income return or potential change of use. However, a comparative lack of prime stock is expected to result in lower overall transactional volumes in 2023 than 2022.

Our prime high street yield for units outside central London has now been stable at 6.5% for seven months. Given the better than expected Christmas trading amongst retailers, and overall improved outlook for the UK economy, we expect that the next move in prime high street yields will be downwards. This comparatively optimistic view would be derailed by worsening news around occupational failures or distressed selling from the banks. However, as the occupational section of this Spotlight has explored, the occupational outlook seems to be improving.

The evidence that pricing has started to improve will depend on whether investors choose to bring prime shops to the market in the second half of this year. At present there appear to be relatively few being prepared for sale, but we are not ruling out the prospect of a quarter point hardening in our prime shop yield before the end of 2023.

Thereafter, while yields on other commercial property sectors might benefit from a fall in the overall cost of borrowing, we do not expect that this will lead to a sharp downward movement in either prime or secondary high street shop yields.

Shopping centre yields:

SC equivalent yields: Revo classifications	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Q1 2023
Dominant Prime	8.75%	8.75%	8.75%	9.00%	9.25%	9.50%
Regionally Dominant	7.50%	7.50%	7.50%	7.75%	8.00%	8.25%
Regional Scheme	8.00%	8.00%	8.00%	8.50%	8.50%	8.75%
Sub-regional Scheme	8.75%	8.75%	8.75%	9.00%	9.00%	9.25%
Neighbourhood Scheme	10.00%	10.00%	10.00%	10.50%	10.50%	10.75%
Good Secondary	11.25%	11.25%	11.25%	11.50%	11.50%	11.75%
Secondary	13.00%	13.00%	13.00%	13.50%	13.50%	13.75%
Local Scheme (Successful)	9.50%	9.50%	9.75%	10.00%	10.00%	10.25%
Local Scheme (Challenged)	16.00%	16.00%	16.00%	16.50%	16.75%	17.00%

SC equivalent yields: Savills classifications	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Q1 2023
Super-prime centre	7.50%	7.50%	7.50%	7.75%	8.00%	8.25%
Prime centre	8.75%	8.75%	8.75%	9.00%	9.25%	9.50%
Town centre dominant	10.00%	10.00%	10.00%	10.50%	10.75%	11.00%
Community & convenience	9.50%	9.50%	9.75%	10.00%	10.00%	10.25%
Secondary	13.00%	13.00%	13.00%	13.50%	13.50%	13.75%
Tertiary	16.00%	16.00%	16.00%	16.50%	16.50%	16.50%

Source Savills Research

£279m
of high street shops traded in Q1 2023

£369m
of shopping centres traded in Q1 2023

8.25%
The highest our super-prime yield has ever been

+342 bps
The rise in the average shopping centre yield over the last five years

Savills Commercial Research
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Retail

Mark Garmon-Jones
Shopping Centre Investment
+44(0)7967 555 593
mgjones@savills.com

James Stratton
High Street Investment
+44(0)7787 513 060
james.stratton@savills.com

Toby Ogilvie Smals
Investment
+44(0)7972 000 045
tosmals@savills.com

Alan Spencer
Occupational Advice
+44(0)7967 697 905
aispencer@savills.com

Stuart Moncur
Occupational Advice
+44(0)7787 795 506
stuart.moncur@savills.com

Research

Mat Oakley
Commercial Research
+44(0)20 7409 8781
moakley@savills.com

Josh Arnold
Commercial Research
+44(0)20 7299 3043
josh.arnold@savills.com