UK Commercial – Q4 2022

SPOTLIGHT
Savills Research

Shopping Centre and High Street Spotlight

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- Strong retailer trading results, but cautious outlook
- Occupational sentiment improves
- Shopping centre investment led by redevelopment or opportunism

> Despite a difficult trading period in the first half of 2023, the vast majority of retailers remain confident with their previous profit guidance.

UK retail consumer and occupational trends

The outlook for 2023 remains complex for retailers, despite overwhelmingly strong Christmas trading statements

While headlines regarding the cost of living, surging product prices and a recessionary environment took hold in late 2022, the recent spate of retailer results have not quite reflected this narrative. But more complexity is hidden behind the headline figures.

On the face of it, Christmas trading was resoundingly positive. Total sales reported a 13.7% year-on-year uptick on average (up 9.7% on a like-for-like basis, for those who report it), albeit off the back of the Omicron concerns that plagued demand over Christmas 2021.

Aside from discount grocers, who continued their strong run of success, it was fashion retailers with a strong omnichannel presence that outperformed this Christmas, using conveniently located store portfolios to navigate the postal strikes. In turn, physical store sales increased 18.5% year on year on average, for those reporting a breakdown. The subsector was also supported by a return to festive socialising and demand for partywear in what was the first festive period since 2019 to not be impacted by restrictions or variant concerns.

However, with inflation in double-digit territory, there is a stark difference in the volume of products sold versus the value of sales. ONS year on year sales by value grew 7.2% in December on a rolling 12-month basis, while sales by volume fell -2.6% over the same period, down from -2.1% in November (Graph 1).

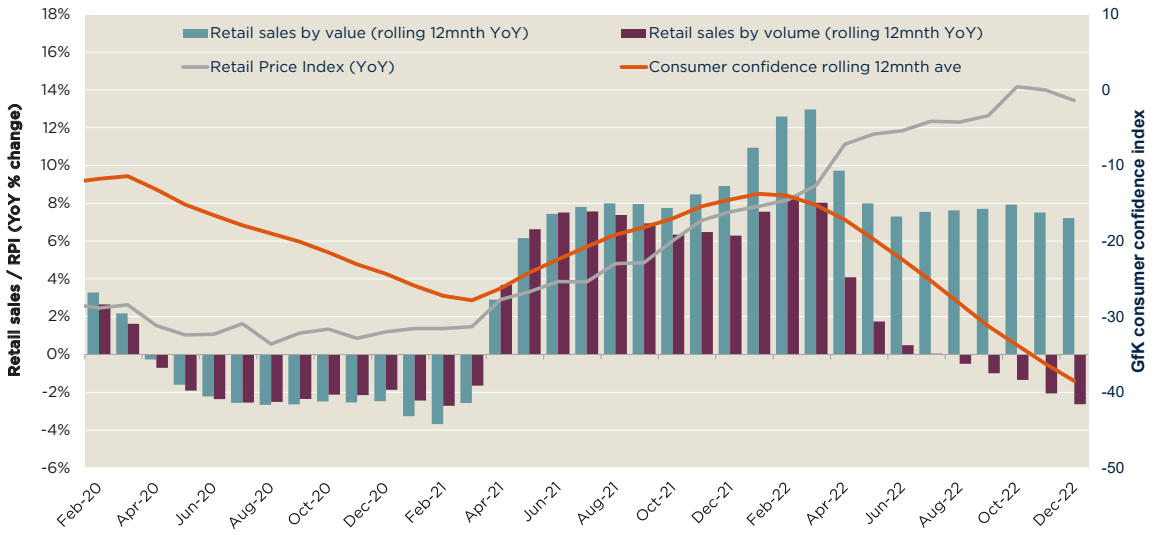
Looking ahead - what does 2023 have in store for retail?

A combination of the cost of living squeeze, high wage inflation and government support for energy bills beginning to fade is applying further strain on operator gross margins. In turn, a handful of retail failures have already occurred in 2023 (most notably Paperchase and M&Co), with more failures likely.

However, the financial health of the largest retail occupiers is currently far stronger than during previous economic shocks. In terms of the top 30 occupiers by unit count in 2022, only four were considered to have a significant level of risk, compared to 15 and 9 in 2009 and 2015, respectively. This suggests that the bulk of retailers should have the resource to weather a turbulent start to 2023.

This general sentiment was reflected within recent trading statements, with most retailers confident with their previous profit guidance. While it is promising that most retailers have avoided any further downgrades, it should be noted that these previous forecasts were generally drawn up during turbulent economic periods of 2022; whether affected by Liz Truss's mini-budget, the early prevalence of the Russian invasion of Ukraine or the unknown outlook for inflation.

Graph 1: Retail sales volume versus value, consumer confidence and RPI inflation
The gap between retail sales volume and value widened in recent months



Source Savills Research, ONS, GfK

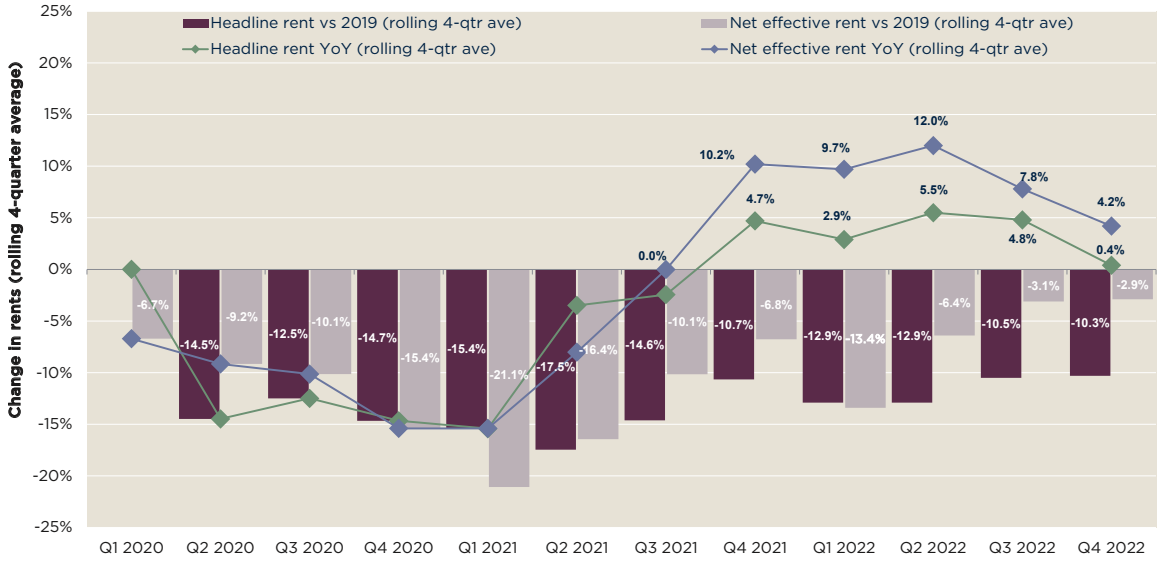
+13.7%

Christmas trading statements revealed an average growth of 13.7% year on year (up 9.7% on a like-for-like basis)

RPI inflation peaked at 14.2% year on year in October 2022, before softening marginally to 13.4% in December

The gap between the value and volume of retail sales increased to 985 bps in December 2022, on a rolling 12-month basis

Graph 2: Average net effective rents in the year to Q4 2022 were down 2.9% on equivalent 2019 levels, representing the smallest gap since the start of the pandemic



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

What is also promising is that the Bank of England recently revised their forecasts to expect a shorter and shallower downturn than previously anticipated. As inflation eases through 2023, alongside low unemployment and a return to real wage growth, retail sales by volume should begin to improve. Oxford Economics forecasts suggest real retail spend will dip to -6.5% year on year in Q1 2023, before gradual improvement until a return to positive growth in Q2 2024.

Are we seeing a turning point in occupational sentiment?

Following a better-than-expected Christmas trading period, many retailers have disclosed renewed expansion plans for 2023. Promisingly, this is not restricted to just discount operators.

M&S is planning 20 openings in 2023, focusing on prime shopping centres and capitalising on the closure of Debenhams sites. Dune is also seeking sites near to where previous Debenhams/House of Fraser concessions existed. JD Sports, Mango, Crew Clothing, Flannels and Hotel Chocolat have all outlined further portfolio expansion in recent weeks, while even Monsoon has renewed growth plans with 22 openings planned this year following its administration in June 2020.

This renewed occupier sentiment has been reflected within leasing activity. Using Savills retail leasing data, deal activity picked up in the second half of 2022, resulting in year-end deal count exceeding the four-year average by 5.6%. In turn, UK retail vacancy rates have continued to fall, reaching 13.8% in Q4 2022, down 70 bps from its peak in Q1 2021, according to Local Data Company.

High street and shopping centre rents have subsequently continued to stabilise throughout 2022. On a year-on-year basis, headline and net effective rental growth softened in Q4 2022, although still up on equivalent 2021 levels. Compared to 2019 equivalent levels, both headline and net effective rents improved to their smallest gap, down -10.3% and -2.9%, respectively. This represents a significant improvement compared to the nadir in Q1/Q2 2021 (Graph 2), adding further evidence to suggest that we have reached the upwards curve of the rental cycle.

While UK retail vacancy may have improved, Q4 vacancy remained 170 bps above equivalent 2019 levels, and so it is unlikely that average rents will begin surging against pre-pandemic levels in the near term. Instead, we could see a further rental divergence between well-occupied retail places and weaker locations exposed to high vacancy, as operators continue to reposition their portfolios, or look more strategically at growth opportunities.

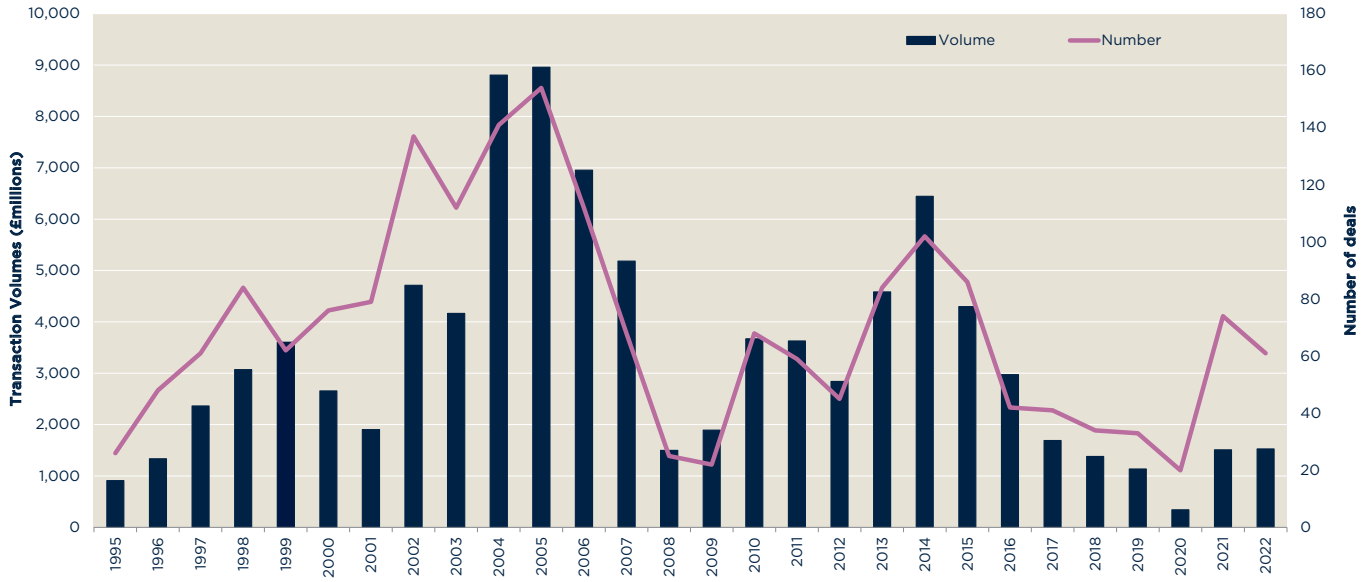
The business rates revaluation could also provide more competition for prime pitches, which over time could result in a positive impact on rents. Rateable values (RVs) are set to fall by 10% for retail properties on average from April 2023, increasing to a 25% reduction across prime high streets and shopping centres. However, the savings vary by subsector in what appears to be somewhat linked to recent performance trends; department stores are set to save 40% in RV, while convenience/takeaways will average a 10% rise. For some operators, these savings are likely to provide a timely lifeline in the face of unavoidable operational cost increases. For others, it may increase the appeal of store expansion, especially while rents remain low by historic levels.

Year-end retail leasing deal count exceeded the four-year average by 5.6%

UK vacancy fell for the fifth consecutive quarter, reaching 13.8% in Q4 2022, down 70 bps from its peak in Q1 2021

> 2023 will see a modest increase in transactional volumes compared to 2022, along with a quarter point downwards movement in prime yields

Graph 3: Annual shopping centre investment volumes



Source Savills Research

UK retail investment market

Market returns to "normal" after the Truss turbulence

Shopping centre investment

Given the twin shocks of both the worst hit to household disposable income for 50 years, and the short but turbulent Truss era, it would be reasonable to have expected a collapse in investment activity at the back end of 2022.

However, as the chart above shows, £1.53bn was transacted last year in 66 deals, with the Q4 activity the third highest over the last ten years. This was 1% up on the previous year in £m, but more notable was the change in the number of transactions. 2021 saw 74 deals, while 2022's higher volume was reached in 66 deals, indicating an increased appetite for mid-sized assets. The biggest year-on-year change was in the £50-£100m price band, where only three schemes were traded in 2021 and nine in 2022.

The key motivations amongst buyers of UK shopping assets remain the same as they were at the start of 2022, namely redevelopment or opportunism. We estimate that 44% of the schemes that were traded last year had a development angle, compared to only 14% in 2021. Notable amongst these were The Meadows, Three Spires and Golden Square.

Surprisingly, given the rapid rise in the cost of borrowing, 2022 saw a fall in the proportion of sales that were bank-related, from 55% in 2021 to 48% in 2022. However, the actual volume was up year on year.

2023 has started strongly, with significant investor interest in 'hangover assets'. At the time of writing, there are 20 schemes under offer, with a total capital value of £875m. We estimate that at the start of February, there were 23 schemes in the market, with a capital value of £505m.

On the positive side, we are seeing more widespread interest in the sector, from as wide a base as small property companies, family offices, owner occupiers and international investors. This positivity is being driven by the perception that the sector has been oversold, particularly the more positive news that has emerged in 2023 around consumer behaviour and retailer performance, and their use and reliance on physical stores.

The capital market has also not been as reliant on debt with only 8% of transactions needing debt ahead of exchange and also 60% of buyers being cash purchasers.

However, it would be disingenuous to suggest that the occupational risks have disappeared. While Christmas trading was better than expected, we remain cautious around Q1 and Q2 retailer news in the face of high energy and mortgage costs and their effects on consumer spending. Furthermore, government support for companies' energy bills will start to taper off, at a moment when the cost of servicing corporate debt is hitting its highest level for over a decade.

The sweet spot for opportunistic investors this year will be freehold schemes with proven retailer performance, convenience anchors, and no over-renting. ESG credentials are starting to become an important factor in stock selection in the shopping centre market, though this might have more to do with limiting capex than any firm desire to reduce carbon impact. The final tick in the box comes from a viable story around alternative uses for the whole of the site or parts.

Assuming the scheme is not too large for a non-institutional audience, and ticks most of the above boxes, then the prime equivalent yields listed overleaf and factoring in the capex, are achievable.

High street shop investment

The high street shop investment market started 2023 with a similarly positive tone to the shopping centre market.

2022 saw £1.2bn of unit shops traded (excluding supermarkets), compared to £1.1bn in 2021. Similar to the shopping centre market, this volume was achieved in a smaller number of deals, indicating that buyers are perhaps becoming less risk-averse.

Generally, the motivations for buyers of high street shop investments remain the same as they were a year ago, splitting between those looking for the long-term income provided by something like a banking hall, or those playing the cycle and attracted by the high yields on offer.

While we maintained our prime high street yield at 6.50% in January 2023, this now comes with a downward arrow indicating that the pressure is beginning to suggest that the next move may be downwards.

This view is supported by two recent deals in always-desirable Cambridge. We believe these assets (on Sidney Street and Rose Crescent) have both exchanged at a net initial yield of 6%.

Buyers of high street shop investments remain predominately private, and we do not sense any change in attitudes towards this sector from institutional investors who will remain the principal vendors.

Echoing the definition of prime in the shopping centre market, buyers are looking for freehold assets with prominence and control over the whole building. Elsewhere, buyers remain attracted by the high yields on offer, and, to a degree, betting on either a future cyclical bounce or a medium-term change of use story.

While Q1/Q2 will be a tough period for retailers in the UK, this is nothing that they haven't gotten used to in recent years. More importantly, the fall in business rates will give the sector an important foundation to enable it to weather the end of the household spending crisis.

We expect that 2023 will see a modest increase in transactional volumes compared to 2022, along with a quarter point downwards movement in the prime high street yield.

£1.2bn
Unit shop investment activity in 2022

£1.53bn
Shopping centre investment activity in 2022

Shopping centre yields:

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

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

Source Savills Research

7.75%
The highest our super-prime yield has ever been

+39 bps
The average change in shopping centre yields in 2022

Savills Commercial Research
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