SPOTLIGHT

Savills Research

UK Commercial – Q2 2023

Shopping Centre and High Street Spotlight

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- Rising interest rates expected to drag on the consumer economy in H2
- Investment activity predicted to be stronger in H2 than H1

1.2% per annum is the consensus forecast for UK GDP growth over 2023-2027

UK retail consumer and occupational trends

Mixed messages around a surprisingly resilient consumer economy

The consumer economy is currently a swirl of mixed messages ranging from the better than expected economic outlook and wage inflation, to the continued high price inflation and consumer concerns around what the Bank of England might do to kill off inflation. On top of this, we have a recent cluster of retailer administrations and failures, and another winter ahead when heating costs could again become a major challenge to household incomes.

How much inflation is too much?

At the start of 2023 the economic outlook for the UK was looking pretty bleak for retailers and consumers alike. The Bank of England was forecasting a shallow but sustained recession, the medium term outlook for the UK economy was to be the worst performer amongst the European economies, and we were still concerned that a colder than normal Q1 could have a dramatic impact on those households who were struggling with higher food and energy bills.

Six months on, you could argue that all of these negative concerns have disappeared. A UK recession is no longer the consensus view, the winter of 2022/3 was warmer than expected, and wage growth has accelerated. However, we are now struggling with the 'second-round' effects of some of these changes, which are looking likely to be more persistent than the direct and indirect effects of the initial shock of high energy prices.

From a retailer's point of view there are definitely reasons to be cheerful. Generally it appears that higher input and operating costs have, to some degree, been successfully passed onto the shopper. Added to this are some areas where costs are lower (such as business rates and rents). However, the 7.3% increase in basic earnings for the three months to end May cuts both ways in terms of retailer's pay bills and the ability of their customers to pay higher prices.

While the latest wage growth data surprised on the upside, the rise in the unemployment rate from 3.8% to 4.0% surprised on the downside. While we do not believe that this rise is enough to derail the steady recovery in consumer confidence about the future that has been underway since late last year, it might give the Bank of England some comfort that the tight labour market is beginning to loosen, which in turn might mean that wage inflation is on the cusp of beginning to cool.

This is particularly important for the outlook for the consumer economy, as the negative impact of 13 back-to-back interest rate rises appears to have been relatively minimal so far. However, we do not believe that this consumer resilience can last in the face of further rises in the cost of money.

Interest rates and the consumer economy

The academic research suggests that on average there is an 18 month lag between an interest rate rise and its impact being felt in the wider economy. This

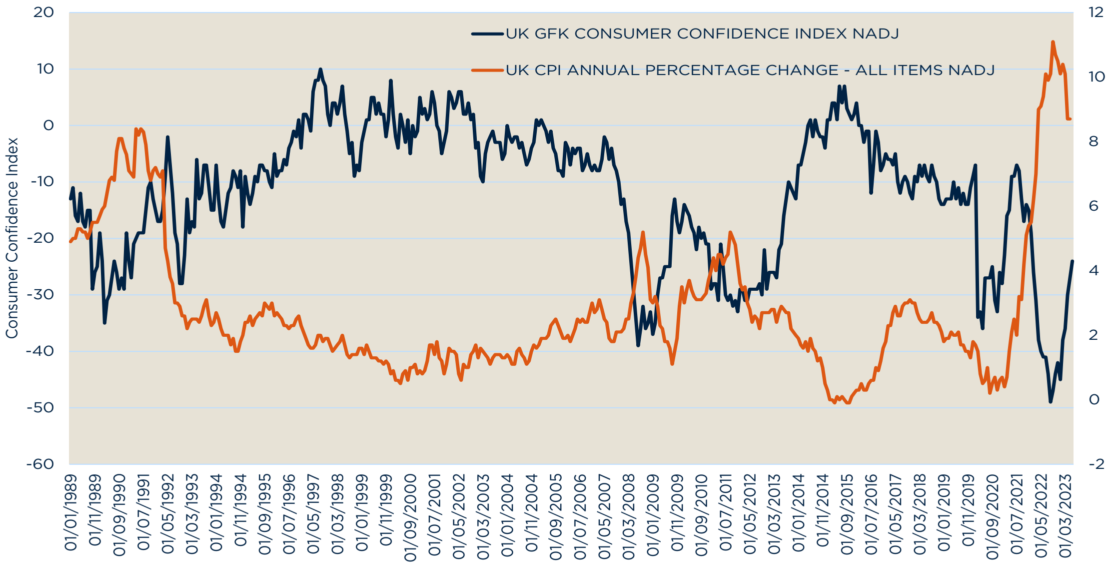
-3.3%

The change in retail sales volumes for the most recent three months, compared to the same period a year earlier

+7.3%

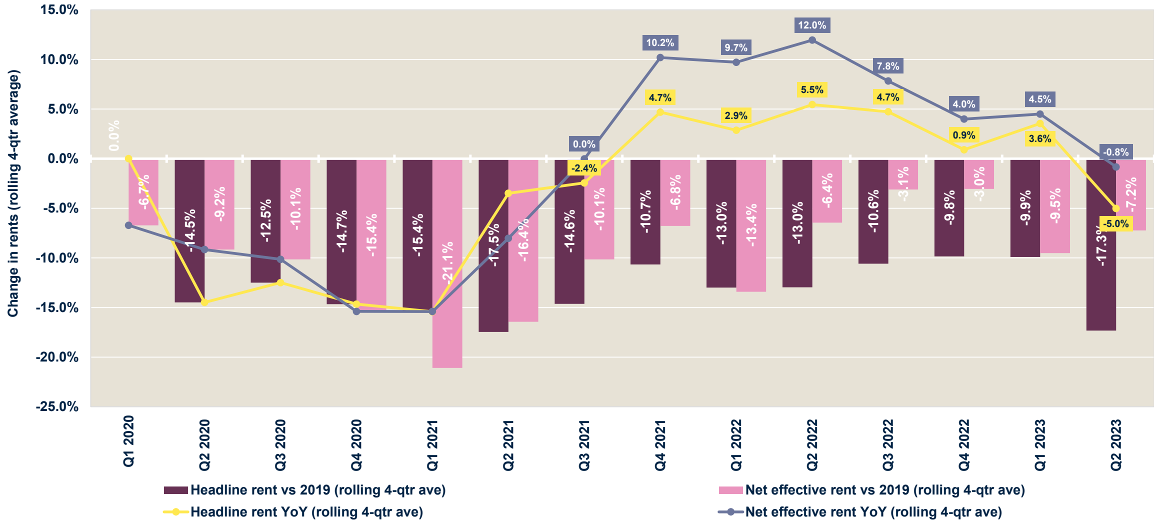
The rise in basic earnings over the last three months compared to the same period a year earlier

Graph 1: Inflation and consumer confidence



Source Datastream, ONS, GfK

Graph 2: Average headline and net effective retail rents



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

3.08%

The July consensus forecast for the UK base rate at the end of 2025

means that we should be feeling the early impacts now, and also that the Bank of England might well pause for a moment to see if its changes last year are really impacting the wider economy and starting to bring inflation down.

The optimistic view for the autumn is that as the inflationary impact of high energy prices fades, so will worker's demand for high wage growth. This would definitely be aided by further modest rises in the unemployment rate. However, if consumers are now expecting higher inflation to remain the norm in the future, then they will continue to ask for higher wages (even if this isn't necessarily required), and that becomes an embedded problem for the Bank of England.

The traditional way to deal with such a problem is to keep putting up interest rates until consumers worry more about the future and reign in their spending. However, there are arguments to suggest that the old ways may not be as effective as they used to be, with less than one-third of UK households actually having a mortgage, and the minority of mortgages being on variable rates. There is no doubt that the MPC is aware of this, and our hope is that our optimistic view for the autumn comes true. However, a 50bps hike in August is looking pretty likely, before a pause for reflection.

Recent data on retail sales has been confused by the extra bank holiday in May, but the overall tone is unlikely to be anything other than one of rising sales in value terms, but falling in volume terms. A variety of surveys suggest that consumers are cutting back in some areas, but not in others. This suggests that wage inflation and improving job security are supporting consumer confidence, something that is definitely showing through in the GfK survey question about people's perception of the outlook for their own personal finances. While this remains negative at -8, the long term average for this metric is -6.

Consumer uncertainty has begun to feed through into retailer decision-making

While our own data on the number of new leases being signed in the first half of 2023 suggests that activity is around 30% below normal levels, Q2 2023 was better than Q1 in terms of activity.

However, as Graph 2 shows, the recent trend in both the headline and net effective rents being achieved in Q2 2023 is a return to falling rents for the first time since 2021. The fact that the fall in net effective rents is the lower of the two suggest a degree of resilience around rent-free periods and premia, a trend that has been prevalent throughout this latest downturn.

Headline rents being once again more than 17% below their 2019 level is probably a good thing if we are about to enter another period of heightened consumer uncertainty, and this combined with the recent business rates review should reduce the need for any new phase of downsizing in retailer's store portfolios over the next six to nine months.

Looking to the future we expect that heightened consumer and retailer uncertainty in the second half of 2023 will lead to further downward pressure on rents, other than in the most sought-after locations. There is no doubt that there are pockets of undersupply emerging on some prime pitches in prime cities, and rents in such locations are expected to continue to rise.

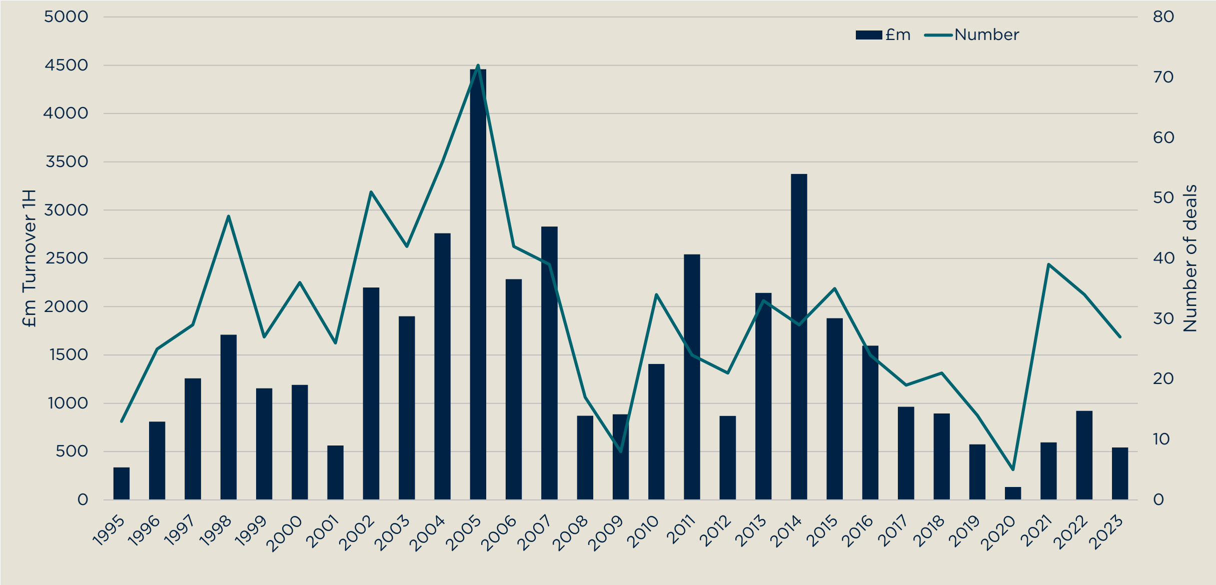
Our medium term forecast for average retail rental growth is for a return to positive average growth in 2024 in most regions, with the five-year forecast being a modest 2.0% per annum.

While the cost of living crisis is expected to continue into 2024, we do expect to see an increasing consensus next year that base rates will have peaked. This, combined with rebased rents and rates, should give financially stable retailers an attractive environment in which to consider portfolio growth.

The year-on-year change in headline rents being achieved

> “The primary motivator for sales remains some degree of bank involvement”

Graph 3: Shopping centre investment volumes in the first six months of the year



Source Savills Research

UK retail investment market

Weak turnover in 1H, but some promising signs for Q3

Shopping centre investment

The second quarter of 2023 saw only eight shopping centres traded, totalling £175.2m. This brought the first half investment turnover to £542m, which is a 41% fall year-on-year, and is broadly in line with the wider commercial property market.

Comparing the first six months of this year with the average for the same period over the last five years presents a little more positive story with volumes only 13% down on the average. However, there is no doubt that the shopping centre investment market is being affected by the rising cost of debt, and thus we do not expect volumes to return to average levels until the base rate is seen as having peaked.

Forward looking indicators for the remainder of this year look more positive, with £400m under offer and a further £680m in the market.

The primary motivator for sales remains some degree of bank involvement, either in terms of the bank having taken full control of the asset, or by debt events motivating the sale. We estimate that 54% of all the sales this year (by asset value) have been bank-led, and this trend is expected to continue for the foreseeable future.

The most active group of buyers of shopping centres this year has continued to be property companies, who accounted for 72% of all acquisitions by value. The rationale for buying remains twofold, with some investors purely focusing on the cyclical recovery play, and others looking at some degree of repurposing or complete redevelopment to residential.

Smaller, but interesting, groups of buyers over the last six months include local authorities and owner occupiers. The fact that local authorities have accounted for 5.6% of purchases over the last six months is not exactly new news, but given the high profile misadventures of some councils in property investing it is comforting that others are still committed to owning and stewarding the health of their key town centres by owning the dominant retail asset.

Frasers Group’s purchase of the Mall in Luton and the Overgate Centre in Dundee is interesting for a different reason. While we do not expect to see a rush of retailers moving towards owner occupation, traditionally the return of owner occupiers to the retail market has always been a good sign that real-estate is cheap and the bottom of the cycle is close. We expect to see this boosting property company confidence in the second half of 2023, or at least compensating for the enhanced concerns around retailer covenant strength, and potentially rising voids that have risen in recent months.

Institutional investors have been out of the shopping centre market this year, though we are noticing a rise in interest from impact-focused funds who are interested in the social return as much as they are interested in the total return.

As the table overleaf shows, yields on all grades of shopping centre have moved out 25bps in the first six months of this year, and while there was a degree of stabilisation in the second quarter we expect to see further upward pressure on yields in the second half of 2023. This expectation has much to do with maintaining the spread with comparable other sectors as it has to do with the forward expectation on the cost of borrowing. As we have examined in previous Spotlights, debt is seldom being used to buy shopping centres, and thus the only impact of the rising interest rate is when refinancing events occur.

High street shop investment

The second quarter of 2023 was a very quiet one for the standard shop segment, with less than £300m transacted.

We do not expect that this low level of activity will continue into the third quarter, as there are a number of good quality mid-sized assets having been offered to the market and sales agreed in recent weeks, including the John Lewis in Cheltenham, a parade anchored by Primark in Bath, and a residential development play in Harrogate. All of these locations would fall firmly into most private investor's definition of a prime town, and consequently are attracting a reasonable depth of market engagement.

Our outside London prime shop yield has now been stable at 6.5% for nine months, which makes it one of the most stable subsectors in the face of the turbulence that we have seen over that period. This is a reflection of both realistic pricing prior to the interest rate shock, but also the income-focused buyer rationale that has been prevalent in the market for a number of years.

There is also a reasonably persuasive argument that the high entry yield that has been on offer for the last few years has to some degree insulated owners of shops.

However, we do not expect this resilience to last into the second half of 2023, and weakening sentiment towards commercial property in general in the second half of this year will impact shop pricing, and we do expect to see a further 25bps rise in the prime shop yield in the second half of 2023.

This rise will be more about comparative pricing than any change in the outlook for high street shops. As such, when the wider commercial property market does bottom out, we would expect to see a similar recovery in high street shop capital values.

Shopping centre yields:

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

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

Source Savills Research

£1.4bn
of high street shops traded in 1H 2023

£0.5bn
of shopping centres traded in 1H2023

+25bps
The average change in shopping centre yields in 2023

82bps
The spread between the current average prime retail yield and the average prime office yield

Savills Commercial Research
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