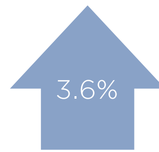
UK Commercial – Q3 2019

SPOTLIGHT

Savills Research

Shopping Centre and High Street Spotlight

- Q3 trends in leasing & investment
- Outlook for Christmas and 2020



Average growth in wages in the three months to the end of September

UK retail consumer and occupational trends

No signs that political uncertainty is affecting consumer behaviour, but the story is very different for retailers

The key metrics within the overall GfK consumer confidence survey remain broadly favourable for continued steady growth in retail sales in the UK. While the overall consumer confidence index remained at a very downbeat -33 at the end of October, this was entirely down to consumer's being very bearish about the prospects for the UK economy.

The two most important questions in the survey in terms of understanding actual consumer behaviour are the ones that ask about people's perceptions of the prospects for their own finances, and whether they think that now is a good time to make a major purchase. Both of these have generally remained positive throughout the post-referendum period, and this more than anything else explains why retail sales growth has remained fairly robust.

Looking ahead there is no reason why this situation should not continue. There is no evidence that consumers are responding to uncertainty by saving more, and household finances are being supported by high levels of employment and real income growth.

The change in real earnings growth is the most dramatic that we have seen in recent years, given that only two years ago real incomes were falling, and now they are growing in line with their long-run average level. The ONS data on inflation that was released in November brought further good news for household finances, with consumer price inflation slowing from 1.7% in September to 1.5% in October.

This is the slowest pace of inflation for almost three years, resulting in the growth of average earnings (excluding bonuses) reaching 3.6% in the three months to the end of September 2019.

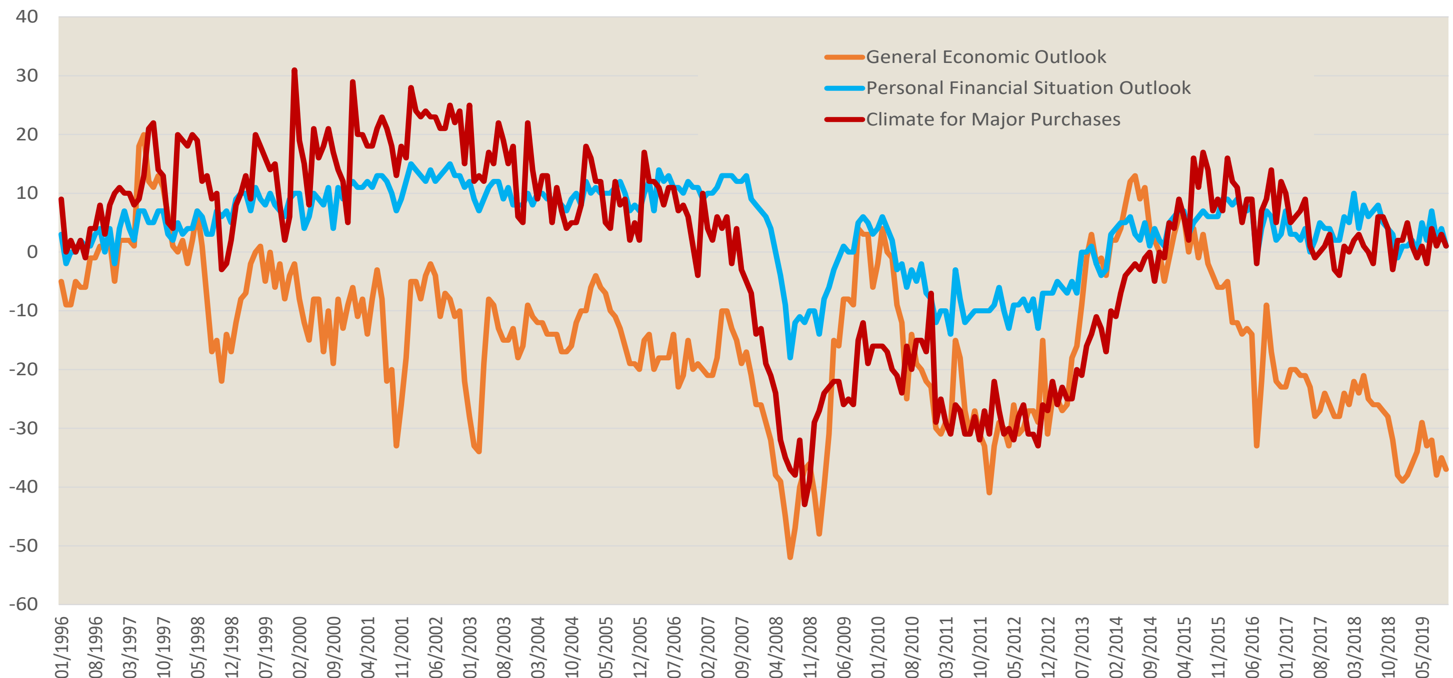
While there are some signs that pay growth has cooled off since the middle of this year, this level of earnings growth (combined with a record low savings ratio) implies that the consumer will continue to spend through Christmas and into next year at slightly better levels than we were seeing 12 months ago.

This leads us to conclude that despite the traditional cautious noises being made about Christmas trading, sales levels will once again surprise on the upside. As ever, Black Friday will result in some of these sales being made at discounted price points, but generally we expect that retail sales growth will be solid over this crucial trading period.

UK households are saving less than 7% of their wages

Retail sales growth has averaged 3.4%pa this year

Consumer confidence is not as bad as the headline measures suggest



Source Savills Research; GfK

> "Q3 saw a stall in the rental decline, but is this going to last?"

The big unknown at present is how are rents actually faring against a backdrop of weaker occupational demand as wider uncertainty continues.

According to MSCI, UK shopping centre rents have softened by 3.7% between Q418 and Q319, high street rents are down 2.7%. Yet this is miles away from what is being reported anecdotally by agents and asset managers, largely because the MSCI benchmark is valuation based meaning that it can lag market realities.

So what is the reality? The retail occupational market is fundamentally opaque but drawing on Savills deals (open market lettings, assignments and regears) does provide a more accurate picture. As of Q3, year to date average rents for UK shopping centres and high streets were down 26.8% and 24.9% respectively, with retail parks faring better with a 7.5% decline. However, it is important to note that this is a national average with some centres and high streets out or underperforming this average. What was interesting on a quarterly basis was that the decline in rents slowed during the middle part of 2019 with Q3 shopping centre and high street rents reporting a marginal 0.3% quarterly increase on a rolling 12-month basis.

Whether this stall means that we've hit the bottom of the market is all dependent on what happens in Q4. But, with the Brexit delay and upcoming general election we may see further rental declines in Q4 albeit not to the same degree we saw in 2018. The real question is what does 2020 hold for rents?

Taking MSCI as a benchmark, during the GFC (global financial crisis) shopping centres reported their largest annual decline of 5.2% in Q409. As of Q319 year-on-year rents are down 5.1%. Of course the fundamentals shaping retail occupational demand are different to that seen during the GFC, but it does suggest we may have seen the worst of the rental declines particularly as the current economic backdrop is better than what was the case in 2008/9 even with the Brexit uncertainty.

Yet, whether we see a return to growth will be dependent on the general election delivering some degree of certainty and strong retailer performance during the all important Christmas trading period. Weak Christmas sales coupled with an election that delivers no political clarity could result in a flurry of new CVA's and administrations in the new year, and with it further rental declines. In contrast a strong Christmas and some positive Brexit developments could mean the return of rental growth in the latter part of 2020 albeit focused on stronger retail locations and centres. For underperforming retail centres we may see rental stagnation at best.

Perhaps the biggest supporter for a return to growth for the better performing retail locations, subject to wider conditions, is the fact that rents in some locations have already been rebased and this rebasing can have a significant impact on individual store profitability but also overall retailer profitability. For example, by applying a very simplistic 25% value cut to a retailers lease commitments across a quarter of their stores could boost group operating profit by an average of 28%. As a result margins, which have been under downward pressure over the last three years, could return to pre-EU referendum levels. As Next stated in their 2018-19 Annual Report "we do not have too much space, we have too much rent, rates and service charge".

As retail space becomes more profitable we could see a resurgence in retailer activity for stronger retail locations, which in turn will support rental growth. However, the structural shifts shaping retail means this growth will lag historical averages. Where we expect to see the biggest changes however, will be in how stores are valued with a move away from a traditional store turnover approach to one that takes into account the impact a physical store can have on brand profile and in turn online sales.

Year on year change in net effective rents to end Q3 2019

Source Savills Research

> "New entrants continue to be drawn to the counter-cyclical play of investing in retail. The question is when will research turn into action?"

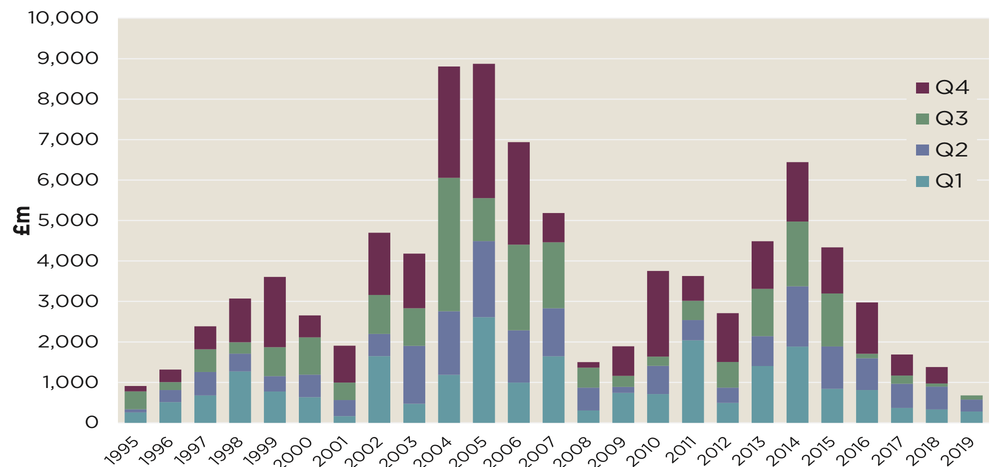
Key questions that investors will be focusing on in 2020:

1) How much further do rents have to fall to make locations viable for retailers?
While the rental falls on Savills indices have already been significant, this is yet to be mirrored by the valuation-based indices. Past cycles show us that generally rents tend to fall 30-40% before the nadir is reached, and we believe that in many locations this kind of correction has already taken place. Once this fall has been factored in across many retailer's estates we believe that a lot of locations that were previously seen as unviable will be economically sustainable.

2) What is the right price for an asset today?
While our average net initial yield across the shopping centre market has risen by 160bps since 2017, the lack of transactional evidence is creating a wide gap between vendor's and purchaser's expectations on price. We believe that 2020 will see a narrowing of this gap, particularly as more banks take control of assets that are in breach of their LTV covenants. Once the market finds its level, then investment activity will return.

3) Is re-purposing of redundant retail schemes practical and viable?
2019 has seen huge interest in alternative uses for retail assets, though little clarity on where and how this might work. For more information on this topic please get in touch with us to obtain a copy of our **RE:IMAGINING RETAIL** report.

Shopping centre investment is on track for its lowest ever annual volume this year



Source Savills Research

UK retail investment market

High street shops

Investment in high street shops has, on the face of it, held up reasonably well in 2019. We estimate that to the end of the third quarter £2bn has been transacted, compared to £1.9bn for the same period last year.

As ever, there have been a cluster of larger deals in London this year, including Ashby Capital's purchase of Kensington Arcade for £200m back in February 2019 and a private Chinese investor's £74m purchase of a unit on New Bond Street. However, these two deals are indicative of wider trends that are taking place in the market, most notably increased interest in redevelopment opportunities from property companies and rising private investor interest in high street retail due to pricing and a re-allocation away from residential investment.

We estimate that 41% of the purchases of unit shops across the UK this year have been by private investors, with 81% of these investors being non-domestic.

Another interesting, and arguably utterly logical, trend in the high street shop market this year has been a sharp increase in purchases by owner-occupiers. A combination of opportunism and a reaction to the new regulations on how leases are accounted for on balance sheets has definitely caused some well capitalised retailers (or the families that own them) to seek to own some of the locations that they are most committed to for the medium to long term.

While the level of turnover in the market looks reasonably healthy, at least on a year-on-year comparison, there is no doubt that investor demand is limited and likely to remain so for the foreseeable future. UK institutional investors continue to view the prospects for voids and rental growth in high street with caution, and until they return to the market we expect that volumes will remain low. While the light at the end of the tunnel for shopping centre and retail warehousing investment volumes might be a major opportunistic investor taking a large stake in the market and thus setting the 'right price', high street retail is too granular for these investors and unlikely to attract large scale opportunistic investor interest.

While there is unsatisfied appetite for high street shop investments, what investors are looking for (long income investments with no exposure to mid-market fashion) is in scarce supply. This, combined with continued uncertainty around how far rents still have to fall will limit investment volumes in 2020.

We expect that prime high street yields will remain flat in 2020, though the remainder of the market will see continued softening. A turning point will happen when investors feel comfortable that the tenant does not have the upper hand in all rent negotiations, and that is unlikely to be the case next year.

Shopping centres

A subdued third quarter witnessed the completion of just six shopping centre investment transactions, totalling only £102 million. After three quarters, volumes across the sector stood at £677 million across 20 deals, compared to £974 million across 27 deals in the same period in 2018. This 38% fall in like-for-like volumes year-on-year is reflective of the continued uncertainty that stalks the market. Savills is now expecting only £1 billion of total volumes for the year, down 28% year-on-year and almost 75% below the long-term average of £3.85 billion.

The most significant of the last quarter's transactions was the sale to Franklin Templeton of Oaktree and Hunter REIM's Cameron Toll Shopping Centre in Edinburgh. Franklin Templeton, a new entrant to the market, acquired the Sainsbury's-anchored scheme for £38.25 million in a corporate transaction, showing 8.65% NIY. This was following

a competitive bidding process for a property that combines a re-based, community and convenience-led income stream with a 24-acre strategic site in Edinburgh. Savills acted for the Vendor on what was the first shopping centre transaction in Scotland in more than 2 years.

Elsewhere, an overseas investor acquired Henry Boot's The Mall in Bromley for £20 million, showing 8.50% NIY. Gylo also acquired The Belvoir in Coalville from Columbia Threadneedle for £9 million, reflecting approximately 12% NIY. In a further example of local authorities' continued role as a key buyer of in-borough shopping centres, Castle Point Borough Council secured the Knightswick Shopping Centre in Canvey Island from LaSalle Investment Management for £11.2 million (8.75% NIY).

As at the end of the third quarter, councils had made six acquisitions, worth £103 million, and reflecting a market share of 15%. With a similar quantum of deals already signed at the start of the final quarter of 2019 as in the previous three, the councils' role is one that we envision continuing unabated, even despite an increase in PWLB borrowing costs in recent weeks. A purdah ahead of the General Election on 12 December may temporarily hold back some ongoing deals but we see no sign of appetite falling.

Uncharacteristically given the summer recess, the early part of the quarter saw a relative flurry of new stock, notably in Scotland. Cerberus, via Savills and BNP Paribas, brought to market Edinburgh's The Gyle, which sits across a 50-acre site adjacent to Edinburgh Airport, quoting £125 million (6.75% NIY). Aberdeen Standard's sales spree also continued, with The Thistles in Stirling the latest shopping centre sale from this house. The Category 1 Debenhams-anchored scheme came to market with an attractive quoting price of £60 million, reflecting almost 10% NIY. Also north of the border, BMO also launched Bon Accord & St Nicholas Shopping Centre in Aberdeen for £110 million, reflecting 8.50% NIY.

Even in a market characterised by an apparent dearth of liquidity, new entrants continue to be drawn to the countercyclical play the sector appears to offer. Franklin Templeton will not be alone as new names to spy an opportunity to secure fundamentally robust assets at yields materially in excess of long-term averages. For instance, the average net initial yield across the sector in the first three quarters of 2019 stands at 8.7%, an increase of 120 bps on the average across 2018, and 160 bps on 2017. What is becoming increasingly clear is that, as the market is beginning to find its level, portfolio valuations are still a key impediment to liquidity in the short term. However, with increasing pressure on borrowers from the banking sector, we expect a steady stream of evidence to wash through, forcing valuations to catch up.

Looking forward towards the final quarter and early part of 2020, we are naturally seeing a lot of focus on the forthcoming UK General Election and the next in a succession of looming Brexit deadlines. However, we are also keeping a keen eye trained on Christmas trading. With little relief anticipated for the retailers, we expect further tenant failures and CVAs, on both sides of the Christmas break. However, investors will continue to perceive the current turbulence as an opportunity and will seek to snap up assets in distressed, bank-led sales. Appetite will also be not just for direct investment. There is no shortage of money poised to capitalise on these opportunities and further corporate activity is also already in the pipeline with South African Growthpoint poised to acquire a majority stake in Capital & Regional and its South East England-focused, community-facing portfolio of shopping centre assets.

Shopping centre yields: Revo centre classifications

	Q2 2019	Q3 2019
Prime	5.25%	5.50%
Regional scheme	5.50%	5.75%
Sub regional scheme	7.00%	7.25%
Neighbourhood scheme	8.50%	8.75%
Local scheme (successful)	10.00%	10.25%
Local scheme (challenged)	14.00%	14.25%

Source Savills Research.

Shopping centre yields: Savills classifications	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019
Super-prime centre	5.00%	5.00%	5.25%	5.25%	5.25%	5.50%
Prime centre	6.00%	6.25%	6.50%	6.75%	7.00%	7.25%
Town centre dominant	7.75%	8.00%	8.25%	8.50%	8.75%	9.00%
Community & convenience	8.50%	8.50%	8.50%	8.50%	8.50%	8.75%
Secondary	10.00%	10.25%	10.50%	10.75%	11.00%	11.25%
Tertiary	13.50%	14.00%	14.00%	14.00%	14.00%	14.50%

Source Savills Research

£677m
Shopping centre investments sold in Q1-3 2019

£2bn
High street retail investments sold in Q1-3 2019

50bps
Rise in Super-prime shopping centre yields over the last 12 months

100bps
Rise in Prime shopping centre yields over the last 12 months

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