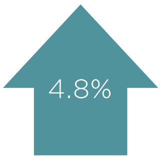
UK Commercial – Q3 2020

SPOTLIGHT
Savills Research

Shopping Centre and High Street Spotlight

- Q3 2020 trends in leasing and investment
- Outlook for Q4 and 2021



4.8%
UK unemployment rate edged up marginally in the July-September period.

UK retail consumer and occupational trends

Consumer confidence remains suppressed with the second national lockdown underway ahead of the Christmas period.

A relaxation of Covid restrictions in early Q3 eased the consumer market temporarily before the implementation of a second national lockdown from November. The extension of the existing furlough scheme to the end of March 2021 will have saved a number of jobs in the short term. Nonetheless, the UK unemployment rate continued to rise in the July to September period to reach 4.8%, with added economic pressures caused by a second lockdown pointing to a further rise in unemployment as we move towards 2021.

As a result, consumer confidence remains downbeat, with GfK's October index recording -31, compared to -14 a year prior. Consumer attitudes towards major purchases remain delicate, with the index standing at -27, marking a six point fall over September levels.

UK footfall levels have tapered off in line with updated government regulations

Despite noteworthy improvements in early Q3, footfall levels have tapered off in recent weeks, with the second national lockdown expected to temporarily undo recent recovery to some extent. In the final week of October, high street footfall remained -41.5% below 2019 levels, with shopping centres marginally higher at -33.2%, according to Springboard.

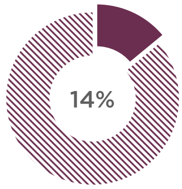
Large cities continue to feel the pinch in line with the ongoing absence of international tourists as well as the reissued guidance regarding working from home where possible. However, this has supported high streets across some outer-city boroughs and market towns, which tended to have reported much softer year-on-year footfall declines over Q3.

Whilst the second national lockdown is underway, we can expect a similar shift in footfall patterns as the first lockdown, whereby retail parks are slightly more resilient than high streets and shopping centres, owed to the presence of essential foodstore retailers.

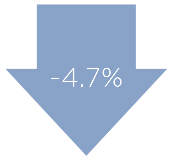
Retail sales outlook for the final quarter

The final quarter is always a pivotal time of year for retailers, with Black Friday and the Christmas period having great bearing on annual reporting figures. The additional pressures this year will no doubt accentuate the importance of the quarter.

We could witness consumer spending behaviour swing in two directions this winter. Low consumer confidence and job uncertainty are expected to uphold high personal saving ratios until well into 2021 (see chart below), fostering a much more cautious approach to Christmas for some. As a result, Oxford Economics are anticipating consumer spend on retail goods to drop -4.7% in Q4 2020, compared to the year prior. That being said, we could see a portion of

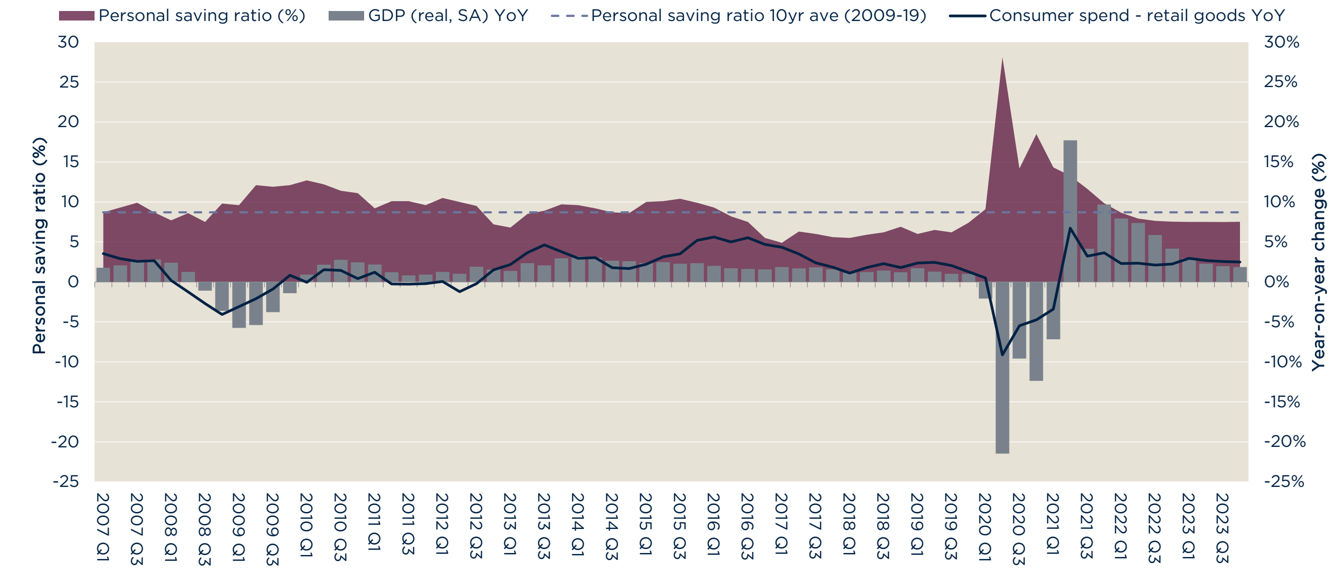


Personal saving ratios remained elevated in Q3 2020 at 14% of disposable income



Projected Q4 2020 year-on-year decline in UK consumer spend on retail goods

Personal saving ratio remains above the long-term average in line with uncertainty as to job retention and the general economic outlook.



Source Savills Research; Oxford Economics

> **“While a great deal of leasing activity continues to be in traditional formats, we are beginning to see a marked increase in the number of turnover-related deals.”**

consumers opt to spend more enthusiastically over this Christmas period driven by pent-up demand following six months of heightened savings.

By subsector, it's likely we'll see a significant polarisation in trading results. Structural changes concerning more permanent working from home coupled with an increase in home-ownership will continue to bode well for DIY and homeware retailers, which enjoyed a 21.6% like-for-like growth in October according to BDO. Meanwhile, electronics retailers could witness a surge in sales following the release of new Xbox and PlayStation consoles, as reported already by both Game and Smyths.

Despite the Eat Out to Help Out scheme providing a temporary boost for many F&B operators, the winter period will unquestionably generate further pressure within parts of the market. Tighter social distancing measures over the Christmas period will heavily impact capacity and therefore cash-flow in many instances, with the latest Oxford Economics forecasts projecting Q4 spend in restaurants and bars to fall -33.7% year-on-year. Some operators may pivot back to the popular take-away/shopfront arrangement that saw many through the initial lockdown. For others however, the added pressure could generate further insolvency activity within this sector.

While spend across pandemic-sensitive segments such as travel and eating out is likely to remain suppressed through Q4, it could open growth opportunities across other sectors. In line with a second lockdown, as well as more people staying at home over Christmas, supermarkets are likely to continue their long run of success through the final quarter of the year.

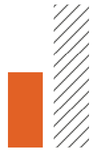
Covid-related headwinds drive further downward pressure on net effective rents

Damaged occupational sentiment continues to urge retailers to apply pressure on landlords to renegotiate rent agreements. Taking a look at Savills leasing deals, a slightly more active third quarter has begun to reveal the true impact that Covid-19 is having on rental levels. Despite marginal improvement compared to the quarter before, headline rents remain in double-digit decline at -11.0% year-on-year, on a rolling four-quarter basis. Net effective rents, however, moved further into negative territory, reporting a year-on-year decrease of -7.8% over the same period.

The well-acknowledged trend regarding lease flexibility appears to have amplified this year. Rent-free periods continue to grow, with shopping centre and high street deals collectively averaging rent-free periods of 7.4 months in 2020, up 28.1% compared to the 2019 average. Lease lengths have continued to shrink, with leases on shopping centre and high street deals this year averaging 5.4 and 7.5 years respectively.

While a great deal of leasing activity continues to be in traditional formats, we are beginning to see a marked increase in the number of turnover-related deals. Many landlords continue to view turnover contributions as a temporary solution to the current headwinds. However, notable deals such as the approval of New Looks' CVA, which involves over 85% of their UK store portfolio shifting to turnover-based rents, suggests this could be a much more concrete fixture within the retail landscape going forward.

For the aforementioned reasons, the final quarter could generate further pressures in the consumer market, prolonging occupational uncertainty. While the government's extension to banning commercial evictions will act as an immediate relief for some retailers, it might be delaying an inevitable leap in vacancy until the New Year for those unable to rebound through the Christmas period. Continued downward pressure on rental levels can therefore continue to be expected as we move through the following six months.

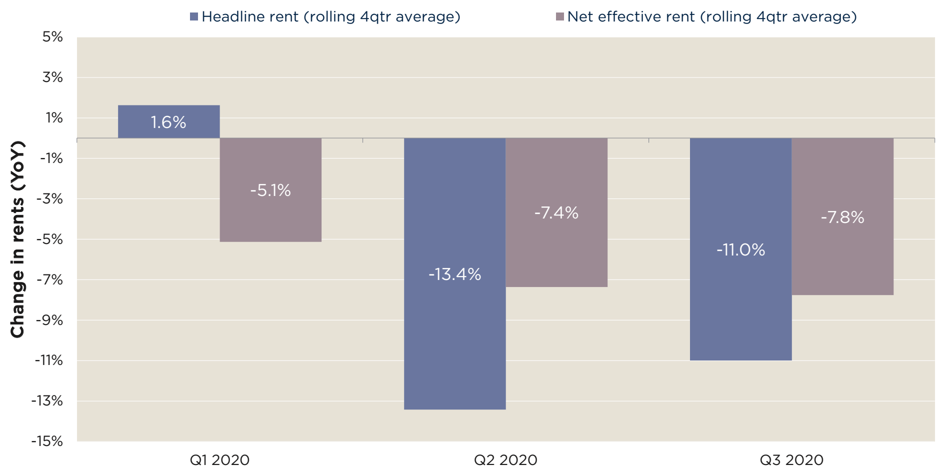


Rent-free periods have increased to 7.4 months on average in 2020 YTD

Lease lengths continue to shrink, averaging 5.4 and 7.5 years for shopping centre and high streets respectively in 2020 YTD

High street average net effective rents declined -7.8% year-on-year in Q3 2020, on a rolling four-quarter average

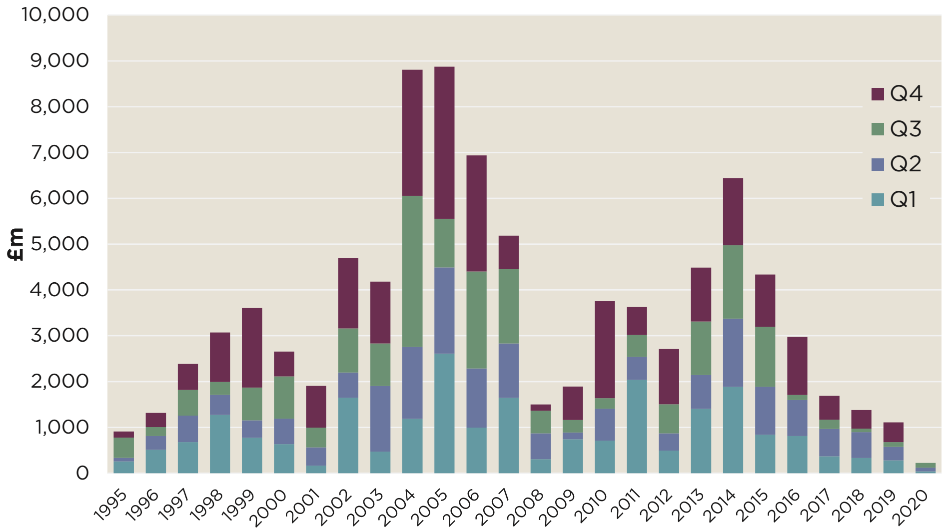
Change in average high street and shopping centre rents highlights the acceleration in net effective rental decline since Covid-19.



Source Savills Research
Note: Based on Savills UK retail deals, excluding London & SE

"Q3 saw private investors return to the market with some gusto"

Shopping centre investment



Source Savills Research

UK retail investment market

Shopping centres

Q3 saw private investors return to the market with some gusto, with the completion of six shopping centre transactions - two more than in Q1 and Q2 combined, and more than doubling total investment volumes for the year, to £251 million, compared to £677 million across 20 deals in the same period in 2019. Needless to say, this 37% fall in like-for-like volumes year-on-year is reflective of the significant uncertainty across the market and economy following the Covid-19 lockdown.

The most significant of last quarter's transactions was the acquisition of Project Rock Portfolio comprising three supermarket-anchored schemes located in Northampton, Seaham and Warrington. The portfolio completed for £80 million. Savills acted for the Vendor on what was the first three-asset portfolio sale since 2015.

Councils were relatively subdued throughout the quarter, with just one acquisition – The Pavillions in Waltham Cross, for £12.7 million. Cash remains king and buyers continue to be attracted by the pricing and low capital values, as well as lucrative development opportunities. Liquidity is particularly high below £15M lot sizes, where due diligence is kept light and purchasers are willing to accept market pricing.

As we transition in Q4 we expect to see more schemes coming to the market including The Trafford Centre, Touchwood in Solihull and Centre Court in Wimbledon. Solihull and Centre Court have been brought to market at £130m (7.5%) and £75m (5.5%) respectively; although no official quoting price for The Trafford Centre, it is understood that the debt secured against the asset is c.£1 billion.

The Q3 rent collection stats are reasonably positive relative to the previous two quarters. According to Savills research, on average across all commercial properties, September rent collections were at 60% and service charge collections at 47% - in both cases, a marked improvement on H1. As expected, Shopping Centre collection fell below average across all sectors, with a collection rate of 28%. This is, however, an improvement on the previous quarter, attributed to the reopening of retail and leisure in mid-June. A major theme during the pandemic has been the regearing of leases to extend terms, which has partially helped to mitigate the impact of significant arrears.

Furthermore, the popularity of turnover rents is increasing, with outcomes of various CVA proposals of major retailers, such as New Look, leading the way. Performance-related rents have become prominent in 2020, particularly amongst distressed retailers, with requests for changes in rent to reflect turnover accounting for 33% of all units which have passed through a CVA, compared to 0% in the previous two years.

Our benchmark yields are equivalent yields. An acceleration in acknowledged levels of over renting in the sector has quickly inflated, commonly referenced, initial yields, which now typically sit a significant margin above the equivalent yield. Initial yield inflation is more extreme amongst more over-rented, over fashion supplied and traditional department store anchored assets.

The market remains slow to move with scarce availability of willing lenders. Despite historically low interest rates, the retail investment market continues to be a challenging place to secure senior debt. Lenders are taking an increasingly forensic approach, and cashflow analysis has become critical as a result of the COVID-19 pandemic; lenders are finding particular issues with LTV covenants and debt service covenants in instances where rent has not been paid and significant arrears remain. In addition to core changes in leverage and pricing, we are seeing greater protectionism measures, such as greater use of interest reserve accounts and tighter covenants. However, as with all challenges comes opportunity, and there are now non-mainstream lenders tentatively re-entering the market, who consider lending on stronger schemes, albeit with reduced LTV ratios and higher margins.

The UK Government extended the eviction moratorium to the end of December, intended to protect retailers' Christmas trading. Landlords are now prohibited from seeking legal remedies for unpaid rent until 2021, a decision which has received to varying degrees of content. The moratorium further delays rent deferment negotiations and has had huge implications on landlords cash-flows and, where they have debt, their ability to honour their loan obligations.

The British Chamber of Commerce has written to the Prime Minister calling for a new package of business support to avoid a flurry of retailer insolvencies in the new year; but while some Covid-19 support measures have been extended, the government has so far resisted prolonging the furlough scheme or extending the availability of state-backed company loans.

1st September marked a seismic change to the Town and Country Planning (Use Classes) Order 1987 (as amended) introduced in order to simplify and speed up the planning process. The change seeks to provide flexibility for developers, enable the repurposing of buildings on high streets and town centres and allow buildings to assume different uses at different times of the day. Classes A, B and D were revoked while Class C was not affected. Class E (Commercial, Business and Service), Class F (Local Community and Learning) were introduced. Class E covers the uses previously defined in classes A1/2/3/,B1,D1(a-b) and 'indoor sport' from D2(e). Class F covers the uses previously defined in classes D1 and D2(e) as well as new local community uses. A transition period has been defined from 1 September 2020 to 31 July 2021 whereby change of use permitted development rights as set out in the General Permitted Development Order (GPDO) will continue to be applied based on the existing use class as at 31 August 2020. New permitted development rights will be introduced from 1 August 2021. The changes were implemented in England only.

Q3 brought about a once in a generation opportunity to acquire the iconic shopping and leisure destination, The Trafford Centre. The 147-acre estate is the most visited super-regional shopping centre in the UK, with a dominant position to attract an affluent population across the North West. With over 200 brands the shopping centre has positioned itself to become one of the region's leading destinations for entertainment and hospitality. The success (or not) and pricing of this process will start to show greater light on the value of the very best schemes, closely followed by the Touchwood in Solihull.

High street shops

The high street retail market has seen little change in tone over the last quarter, with a similar level of turnover in Q3 to Q2. This leaves the sector nearly 50% down year-on-year in terms of turnover.

What little investor demand there is for high street shops remains focused on either income security or change of use opportunities. On the income front, food retail leads the pack, with also steady interest in retail banking premises with long leases.

The only change in investor tone that we have noted over the last three months is a wider acceptance amongst both buyers and sellers of how far rents have (or should have) fallen. Previously a lack of acceptance of this had led to a wide gap between purchasers and vendors expectations.

However, the early indications for Q4 2020 are that liquidity is increasing and the volume of unit shops that have either traded or under offer is almost equivalent to the total volume that was traded in Q3.

With reversionary yields now becoming increasingly accepted we do expect to see a slight increase in investment activity going forward, though by no means a return to 2018/19 levels. The key vendors will continue to be institutions who are trying to reduce their overall exposure to retail, and banks who have unwillingly taken control of high street assets.

The main challenge for buyers will continue to be putting a value on assets where rents may not have been paid for nine months, even if a tenant is in situ. While, as we have discussed earlier, we do expect that Christmas trading will be better than expected, some retailers will definitely only struggle through that crucial trading period. This will mean that landlords are unlikely to see a substantial rise in the percentage of the rent and service charge that they receive at either of the next two quarter days, and further tenant failures or CVAs are inevitable.

We do not expect to see a change in the prevailing yield trend for the next six months, with even the best locations seeing continued yield softening in line with weakening rental growth expectations.

SC equivalent yields:
Revo centre classifications

	Q2 2020	Q3 2020
Dominant Prime	8.00%	8.50%
Regionally dominant	6.25%	6.75%
Sub regional scheme	7.75%	8.25%
Neighbourhood scheme	9.50%	10.00%
Local scheme (successful)	9.50%	9.75%
Local scheme (challenged)	15.00%	15.50%

Source Savills Research.

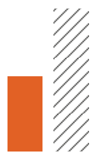
SC equivalent yields: Savills classifications	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020
Super-prime centre	5.25%	5.50%	5.75%	6.25%	6.25%	6.75%
Prime centre	7.00%	7.25%	7.50%	8.00%	8.00%	8.50%
Town centre dominant	8.75%	9.00%	9.25%	9.50%	9.50%	10.00%
Community & convenience	8.50%	8.75%	9.00%	9.50%	9.50%	9.75%
Secondary	11.00%	11.25%	11.50%	12.00%	12.00%	12.50%
Tertiary	14.00%	14.50%	14.50%	15.00%	15.00%	15.50%

Source Savills Research

£251m
Q1-Q3 2020 investment in shopping centres

45%
of rent due on shopping centres collected in Q3

125bps
The rise in Prime shopping centre yields over the last 12 months



350bps
The rise in Prime shopping centre yields since Q4 2015

Savills Commercial Research
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