UK Commercial – Q3 2022

SPOTLIGHT

*Savills Research*

# Shopping Centre and High Street Spotlight

● Cost of living rises ● Occupational slowdown but rents stable ● Opportunistic buyers dominate investment

> Headwinds over the next six months are likely to significantly challenge profit margins, although the financial health of the UK's largest retail tenants remains relatively robust.

# UK retail consumer and occupational trends

## Tightened consumer wallets and more selective spending is expected this winter, as high inflation and low consumer confidence continues

As the UK gets to grips with the everchanging economic climate, consumer sentiment has remained pessimistic to say the least. GfK's October consumer confidence index reported further decline into record low territory, with the climate for major purchases index dropping three points to -41. Meanwhile, the personal financial situation outlook index reported marginal improvement to -34 (albeit still 35 points below October 2021).

In turn, spending habits have begun turning to more typical recessionary behaviours, with consumers cutting back where possible. This downward momentum was evidenced in the September ONS retail sales volume index, which reported declines of -6.9% year-on-year and -1.4% compared to August 2022.

### What's the outlook for the retail sector?

All eyes are now fixed on the crucial Golden Quarter for retailers and consumers alike. Retail Economics recently forecast a £4.4 billion drop in non-essential spending this Christmas, representing a 22% year-on-year fall in UK spending as almost 60% of customers suggest they will be cutting back. While all sectors are likely to feel the effect, previous downturns suggest bigger ticket items such as household goods/appliances, and non-essential goods such as clothing and footwear could experience a more pronounced squeeze.

As a result, retailers are downgrading their sales expectations, with some issuing profit warnings despite a relatively robust Q2-Q3 performance across the sector. Next, for example, recently trimmed their full-year 2022/2023 sales and profit forecasts, despite its half-year 2022 group sales exceeding expectations, reaching +14.9% year-on-year.

While inflationary headwinds are likely to stunt consumer spend across most sectors this winter, there are still some opportunities for spend across certain subsectors to surprise on the upside.

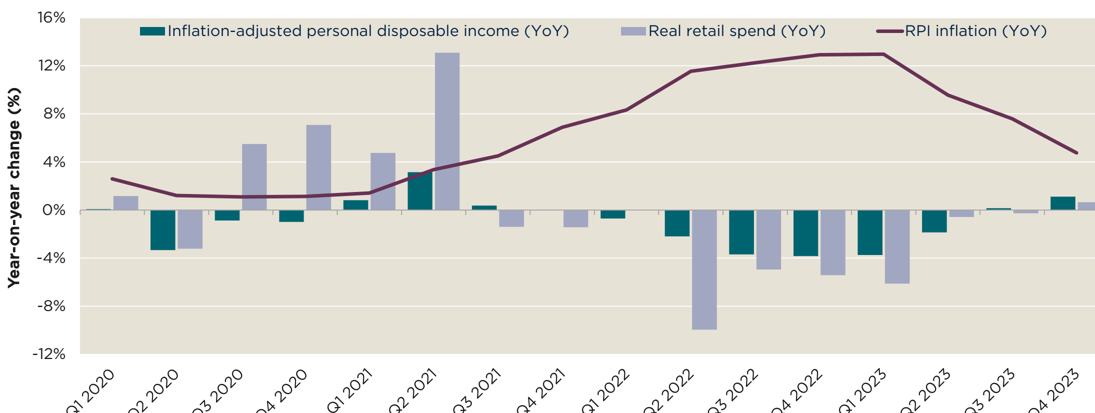
Firstly, it's likely this winter will deliver the first Christmas period unaffected by Covid-restrictions, meaning more events and pre-Christmas socialising will occur compared to the last two years. Meanwhile, the first ever winter FIFA World Cup is likely to generate additional food and drink sales through November-December. Similarly, international travel is likely to remain unrestricted, which, when coupled with the weak value of the pound, could support inbound tourist spend, particularly across international gateway cities such as London and Edinburgh.

In terms of the timing of winter shopping, we could be faced with a longer lead-in to Christmas as UK households look to spread their spending more strategically across paychecks, supporting sales as early as October. In a similar manner, monthly repayment methods such as Klarna can expect an uptick in transactional activity.

Where we envisage a more pronounced decline in discretionary spend is in early 2023, when inflation is expected to remain in double-digit figures, whilst fuel/energy usage costs are due to remain high (and potentially growing further depending on what measures replace the energy price cap in April 2023).

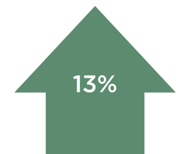
Oxford Economics are currently forecasting a year-on-year drop in real retail spend of -6.1% Q1 2023, accelerating from the -5.4% fall predicted for Q4 2022.

**Graph 1: Real disposable income and retail spend** is expected to return to positive year-on-year territory in the second half of 2023, in line with inflation stabilising




**Source** Savills Research, ONS, Oxford Economics

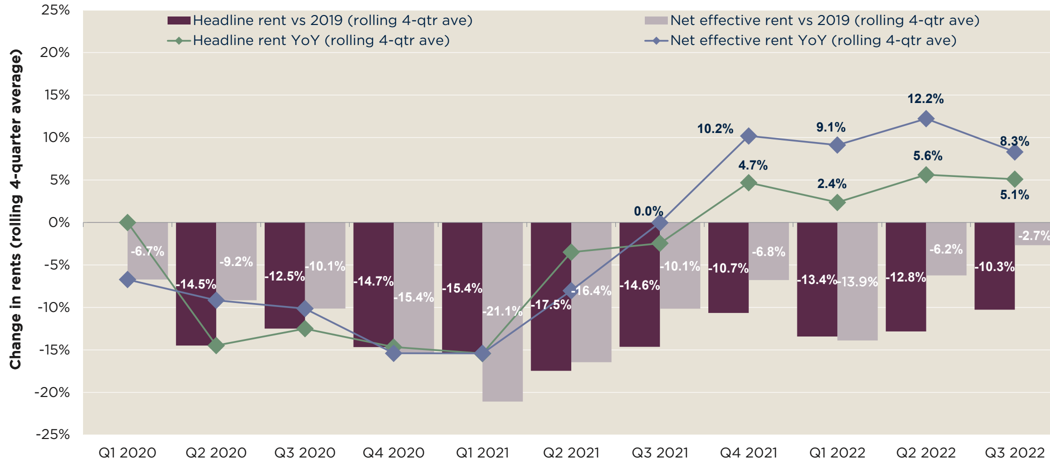
The GfK index for the climate for major purchases reported a three-point drop to -41 in October 2022




Current forecasts suggest RPI inflation is likely to peak at 13.0% in Q1 2023

UK retail spend is expected to return to growth in H2 2023, in line with a return to positive household disposable income growth

**Graph 2: Average net effective rents achieved in the year to Q3 2022** were up 8.3% year-on-year, but remain below pre-Covid equivalent levels




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

Retail spend is then expected to return to positive territory by H2 2023, in accordance with a return to positive real disposable income growth (see Graph 1).

**How are mounting economic headwinds expected to impact occupational markets?**

Rising operational costs (notably utility, staffing and supply chain costs) alongside a softening consumer environment is potentially too strong a cocktail for some operators to tolerate, applying intense strain on profit margins. While Christmas spend might be enough to maintain business over the festive period, we could begin to see insolvency activity climb in early 2023.

Murmurs in the press have already emerged, with the likes of Joules reportedly exploring CVA options after softening trading figures in H1 2022. Meanwhile, Made.com is attempting to secure a rescue deal this month whilst Wilko drafted in advisers to seek restructuring options to support its balance sheet.

What is promising, however, is that the current health of the UK's largest retailers is relatively robust for now. A great deal of the retailers facing serious financial concern were already subject to failure pre-Covid, during the periods of high insolvency activity between 2016-2019. When analysing the financial health across the 40 largest UK retailers (totalling c.32,400 stores) using Income Analytics, the average risk of failure within the next year is just 2.8%, with only three retailers reporting a risk score of over 10%. This suggests a relatively strong financial health of the main physical retailers, thus the likelihood of dramatic vacancy hikes in the near-term is relatively minimal. The latest LDC forecasts reinforce this, with UK retail vacancy rates predicted to fall from 14.0% as of H1 2022 to 13.7% by H1 2023, although this does remain above the long-term average.

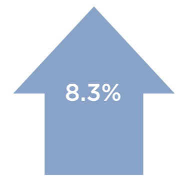
In terms of which sectors are still securing sites, retailers towards the budget end of the spectrum have been slightly more bullish in terms of their expansion strategies, although cautiousness still exists. Gregg's reported a 9.7% like-for-like sales growth over the 13 weeks to 1 October, with a year-end objective of 150 new site openings. Aldi have set out a further 29 locations for new openings, shortly after securing its position as the UK's fourth largest supermarket chain, whilst Poundland's owner, Pepco, announced plans to expand its portfolio in line with consumers trading down to cheaper alternatives. A few other retail and leisure operators have reported expansion plans, including Spanish retailer Mango and bakery chain Paul, looking for franchisee opportunities to propel growth outside of London.

Despite select examples of retailer growth, many other operators are reevaluating their existing expansion plans, perhaps until consumer sentiment improves. This has been somewhat reflected within new retail leasing deals recorded by Savills. Deal count this year-to-date (Q1-Q3 2022) fell -21.1% compared to the heightened 2021 levels, albeit only -9% below pre-Covid levels.

Despite a marginal slowdown in deal count, there is no evidence to suggest rental tone has experienced any similar movement, largely due to the significant rebasing in rents that has been experienced over the past five years. Average net effective rents in Q3 2022 reported year-on-year growth of 8.3% on a rolling four-quarter basis, softening slightly from the 12.2% reported in Q2 2022. At the same time, net effective rents declined -2.7% compared to pre-Covid levels. This represents the smallest gap to 2019 levels since the onset of the pandemic, although a number of deals completed on prime city centre pitches such as Glasgow's Buchanan Street and Manchester's Deansgate have somewhat supported this improvement.

A marginal slowdown in leasing activity is likely to continue into Q4 against the backdrop of a weakened consumer environment, with the final quarter likely to be more telling of the current headwinds facing the occupational market.

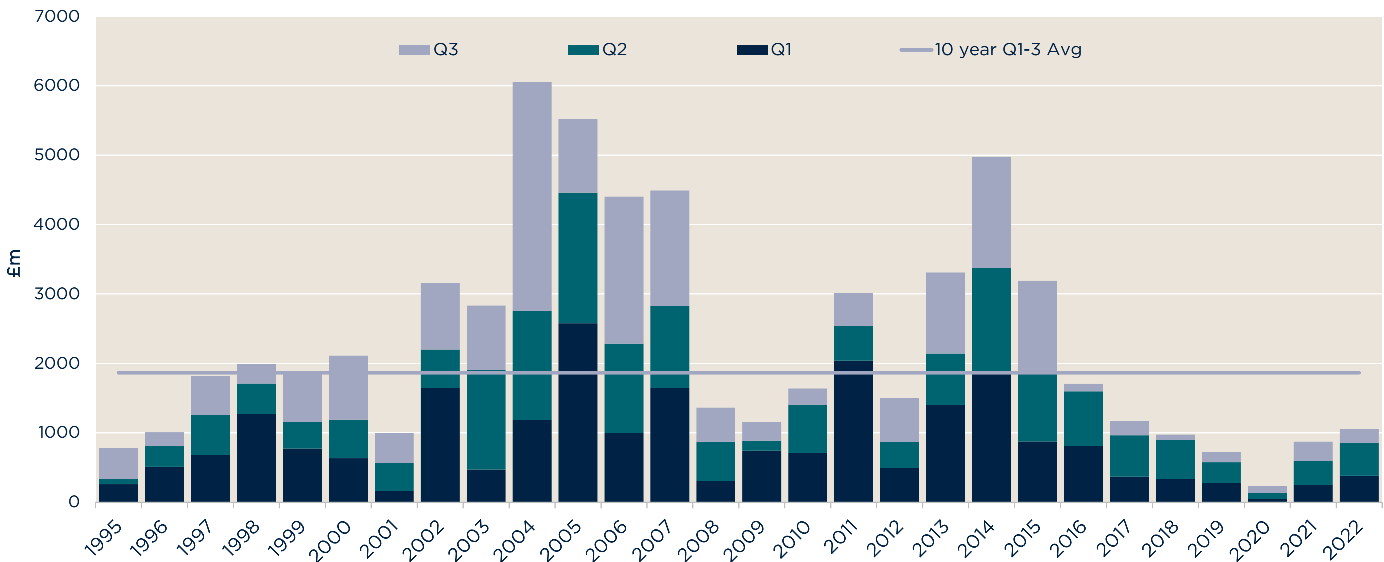
UK vacancy forecasts still point to improvement, dropping from 14% in H1 2022, to 13.7% in H1 2023




Average net effective rents increased 8.3% year-on-year in the year to Q3 2022

> "Opportunistic buyers will continue to dominate the sector over the next 12 months."

**Graph 3: Shopping centre investment for quarters 1-3 £m**




**Source** Savills Research

# UK retail investment market

Income buyers fall away, leaving the field clear for the purely opportunistic investors

**Shopping centre investment**

Last quarter we commented that the high yields that were already on offer in the sector should remain attractive to investors, even in the face of a weakening economic outlook. This still appears to be true in the shopping centre investment market, despite the dramatic price correction that has been seen in some other commercial property sectors. Furthermore, the lack of debt that has been available for shopping centre purchases over most of the last decade should mean that further rises in the cost of borrowing need not translate like-for-like into asset pricing

However, there is a credible argument that continued yield softening in parts of the market that are perceived as "low risk" will mean that some softening is also required in the shopping centre space so as to maintain the pre-existing discount.

In common with the rest of the commercial property sector, the level of turnover in the first three quarters of 2022 looks good. £1.16bn was traded, a 36% increase in transactional activity compared to the same period in 2021. However, the third quarter saw a slowdown in transactional activity, with only £310m traded, 12% up on the same quarter in 2021. What is interesting to note about the third quarter stats is that they appear to have been more resilient that those of the wider market, where activity was 42% lower than the same quarter a year ago.

While the high yields on offer in the shopping centre space were already pricing in little or no forward rental growth, the heightened political and economic turbulence over the last three months has driven an even more forensic focus on risk than we were seeing three months ago.

As far as the forward drivers of pricing go, we do not expect to see distressed selling rise as a result of NPLs, but the next challenge will be more in line with other asset classes, refinancing risk. So far this year 26% of sales by capital value have been bank-related in some way, though this was only 12% in the latest quarter.

Our core thesis for investment pricing in the sector remain that it was always opportunistically priced, and thus a marked softening in the prime yield is not required. As the tables overleaf show, we have moved most of our yield indices out by 25-50bps this quarter, a reflection of the comparative pricing point that was made earlier. However, what is clear across the whole of the commercial property sector is that a new level of opportunism is rife, and all buyers are looking for heavily discounted prices if they can get them. Thus, while further price falls might not be required on shopping centre investments, they might be demanded by opportunistic buyers who are keen to capitalise on such a febrile environment.

Opportunistic buyers will undoubtedly continue to dominate the sector over the next 12 months. However, making deals happen will depend on a degree of understanding of how cheap the asset class already was, rather than just demanding even greater price cuts.

## High Street Shop investment

The main difference between the shopping centre investment story and that in the high street sector, is that investor sentiment and activity had been steadily improving in the high street shops market over the summer.

The last two quarters have seen a lot of stock brought to the market, with a generally positive reception, leaving prime high street shops as the only segment of the UK commercial property sector where we did not soften yields over the summer. However, the turbulence in the economy and wider property market over the last quarter has hit deal volumes, with activity in Q3 2022 being 42% lower than a year earlier.

The buyer profile has however changed over the last few weeks, with long term income-focused investors becoming scarcer, and opportunistic investors flexing their muscles. Typically we believe that opportunistic investors are looking for around 50 bps more yield than they would have got at the start of the summer, and recent deals suggest that generally buyers are getting the price reduction that they are hoping for at the prime and long-income end of the market.

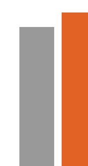
The higher yielding end of the high street shops market, where redevelopment might be the eventual end-game, remains stable. Double-digit yields remain supportable where the buyer has confidence about the medium-term development prospects, regardless of any recent or future fluctuations in the cost of debt.

We do expect income-focused investors to return to the market in mid 2023, but in the interim the thinner pool of buyers is likely to put downward pressure on both prime and secondary prices.

+36%
The year-on-year change in shopping centre investment activity

£310m
Shopping centre investment activity in Q3 2022

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



**+38bps**
The average rise in shopping centre yields this quarter

## Shopping centre yields:

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

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

**Source** Savills Research

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