UK Commercial – Q3 2023

SPOTLIGHT
Savills Research

Shopping Centre and High Street Spotlight

savills

- Solid Christmas trading expected as inflationary pressures reduce
- Investor attitudes to retail about to be tested by large mall sales

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

UK retail consumer and occupational trends

The consumer economy is past the worst of the latest shock, but a tangible recovery won't be felt until late 2024

The rate of inflation has almost halved and interest rates are widely perceived as having peaked. This should feed through into improving consumer confidence, better sales, and ultimately retailer demand over the next twelve months, though the latest retail sales figures show that volumes fell by 0.8% in Q3 compared to Q2. However, living and operating costs are still rising at much stronger rates than people and companies have been used to in recent years, and we expect this to result in further caution in 2024.

Goods price inflation to ease, but pay growth to remain strong

Consumer price inflation was stable at 6.7% in September, due in part to a rise in petrol prices. This was offset to a degree by a month-on-month fall in food prices and slower growth in prices on other household goods.

There is some speculation that events in the Middle-East could stall the fall in the rate of inflation, and forward gas prices are up more than 30% on a month ago. This looks more speculative than supply-led, so we do not expect it to translate into an inflationary pressure at the moment.

Private sector wage growth is showing some signs of easing, but overall pay growth will only slow gradually over the course of 2024. From a household point of view this is of course not a bad thing. Employees are going into the crucial Christmas shopping period in an atmosphere of low unemployment, strong wage growth, and in some areas falling prices. This should ensure that Christmas trading is respectable, particularly given the fact that the UK consumer has not spent much of their Covid-era extra savings.

2024 to see inflation to fall below the BofE's target of 2%, and this will be the spur for return of consumer confidence

We expect that headline inflation will continue to fall over the remainder of 2023 and 2024, primarily due to lower input costs. The first downward movement in the UK base rate is not likely to occur until the autumn of 2024, but that will be an important sign that the Covid and Ukraine-related economic shocks have passed.

The challenge for 2024 and beyond is that the UK (and many other) economies are forecast to show very weak economic growth. A lack of momentum next year will dampen the return of consumer confidence, but we still do expect to see it return to positive territory next year.

The degree of caution that is present in the consumer economy is well illustrated by Graph 1, which shows the widest spread between propensity to spend and save that there has been on the GfK survey since they started asking about savings in 2015. In part this is due to higher interest rates on offer for savings, but more generally it is a reflection of the

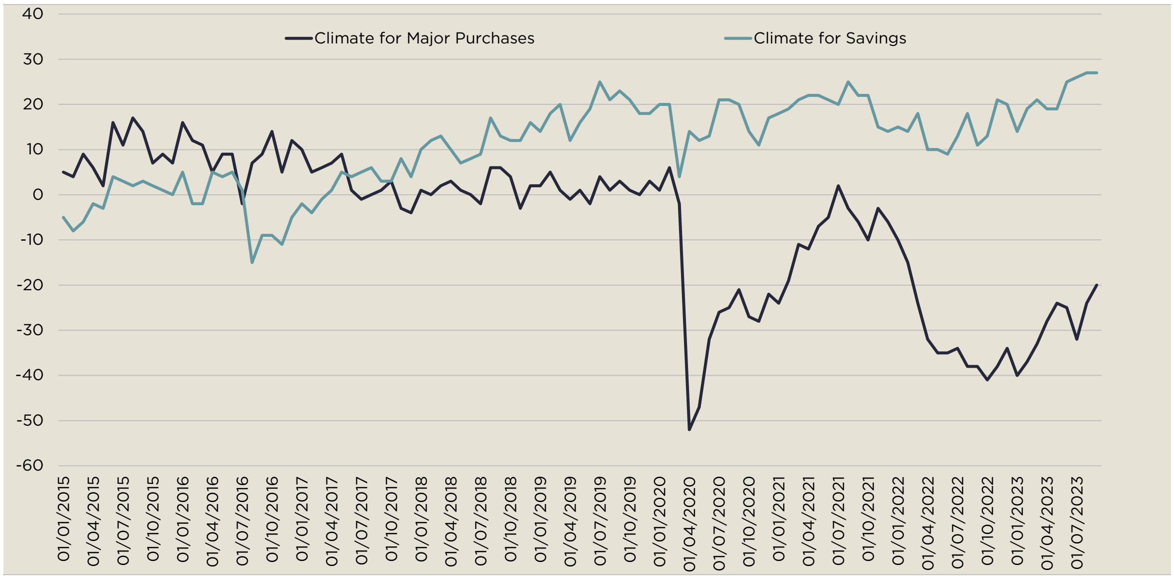
-1.0%

The growth in retail sales volumes in the UK in Sep 2023 compared to Sep 2022

+6.7%

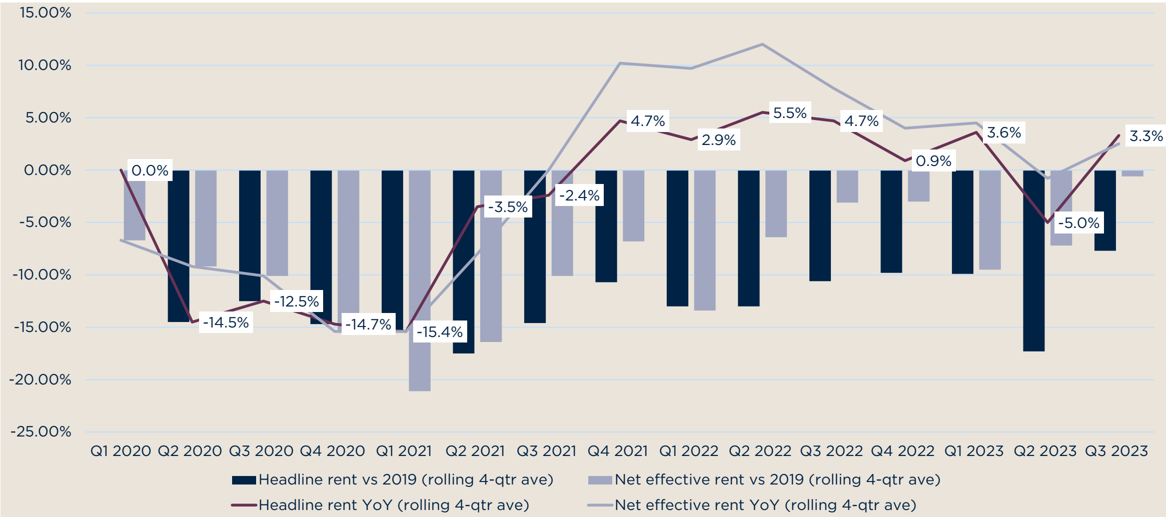
CPI to September 2023

Graph 1: Consumers remain in precautionary saving mode



Source 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.

string of shocks to consumer confidence that have taken place since the arrival of Covid.

Retail vacancy rates have fallen, but remain high, and Q3 data suggests that both headline and net-effective rents are higher than they were a year ago

Both the shopping centre and the high street vacancy rates have fallen from their post-Covid peaks, but they remain high in a historic context at 18.2% and 13.8% respectively. In the retail sector the most under-supplied segment is retail warehousing, where the vacancy rate is only 4.6%, which is lower than the equivalent number for offices and logistics.

As far as tenant demand goes, the last quarter has seen a continuation of recent trends, namely: retailers coming out of weaker pitches in favour of a new opening on a stronger pitch; large brands taking smaller stores than they have done historically; and the continued strength of leisure and athleisure in particular.

Overall, the occupational trends are pretty typical of this stage of the rental cycle, with a degree of consolidation, as well as relocations to take advantage of how much rents have rebased. While we have seen some modest upward movement in both headline and net effective rents in 2022 and 2023, the overall story is one of rents being on average 21% lower than they were in 2017, and 30% lower in shopping centres. This combined with a 25% fall in business rates on prime shopping streets and centres has helped retailers through a period of seemingly endless rises in all other operational costs.

Looking ahead to 2024 we do expect that the rate of increases in some operating costs will slow, or even go into reverse in some areas. However, medium term challenges such as the costs of de-carbonising both their store network and more expensively their entire supply chain, will drag on retailer's enthusiasm for new store openings.

In more positive news for landlords, our data on both headline and net effective rents suggests a return to upward pressure on rents in Q3 2023, and we do expect this trend to continue in 2024 as both the consumer economy recovers, and some of the cost pressures that have been challenging retailer's business models recede.

There will also be a widening of the gap between strong and weak trading locations next year, both in terms of vacancies and rents. Overall vacancy rates will remain higher than normal due to the still unanswered question of whether there is a viable alternative use for large former department store units.

However, strong pitches in major cities and top tier malls will continue to see steady demand from both expanding and rationalising brands. Previous periods of high retail vacancies have to a degree been turned around by the emergence of a new and rapidly growing segment such as mobile phones or coffee. At the moment it is hard to point to a hot new sector, but overall we believe that there are some positive demand trends out there, not least the push from leisure operators into previously unexplored locations. This is reflection of how the world of work is changing, with people spending fewer days per week in their central business district office than they used to, and more in their home catchment.

It does feel that 2024 will be a more positive place for both consumer and retailers alike. However, economic growth is likely to be muted next year and this is likely to mean that it will not feel like the retail market has returned to its pre-Covid levels of activity until early 2025.

3.3%

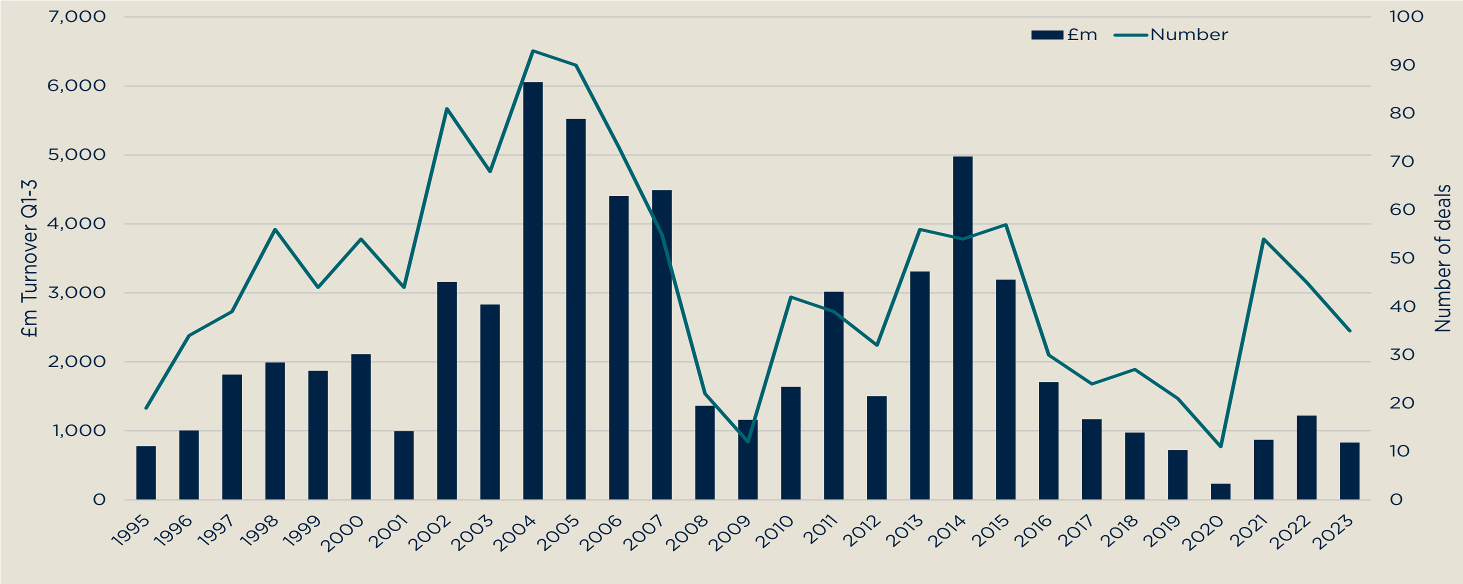
The change in headline rents achieved compared to a year ago

-21%

The total fall in All Retail rents since 2017

> "The turning point for prime shopping centre yields will not be until late 2024 at the earliest"

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



Source Savills Research

UK retail investment market

Large centres coming to the market will test institutional interest in shopping centres

Shopping centre investment

We have been commenting since 2015 that a lack of large and prime shopping centre sales has made it hard to assess whether there is institutional demand for shopping centre investments in the UK. With stakes or full sales of Liverpool One, Meadowhall and Centre: MK totalling 4.4 million square feet now available, the next six months will finally test whether there is a market for large and prime malls.

Given that overall investment volumes for all sectors in the UK are down 46% on average, and as the chart above shows, investment activity in the shopping centre market is 41% lower than in Q1-3 2022, now might seem an odd time to bring large assets to the market. However, the yields on offer are compelling, and the fact that prime shopping centre yields have been stable for three quarters might well indicate that a buyer today will be buying in at the perfect moment.

So far this year the purchaser and vendor groups and motivations have been broadly the same as they have been for all of the last five years. The dominant group of vendors remains the institutions, who accounted for 38% of all sales. We estimate that 43% of all the transactions this year were in some way "bank-related", though less than 2% were by Administrators. The proportion of sales that were bank-led fell in the third quarter, possibly another sign that worst might be over for the sector.

The dominant buyer group has remained property companies, either speculating that yields are about to peak, or more commonly looking at uplift from a complete or partial repurposing of the scheme.

Looking at yield trends, it is starting to feel that a very typical bifurcation in the market is underway. While 2023 has seen stabilisation in both prime and secondary yields, we believe that there is potential for further softening at the secondary end of the market.

The increasing acceptance that interest rates have peaked in the UK should provide some support to pricing at the prime end of the market by removing one reason not to buy, namely the perception that prices might be more attractive in six months time.

We do not expect to see the UK base rate start to fall until Autumn 2024, and the turning point in prime shopping centre yields might be equally slow in coming. However, with more than £2bn of stock in the market at present there is the liquidity at the prime end to demonstrate price shifts as and when they occur.

Transactions are taking longer than normal to complete in all sectors of the UK commercial property market, so the fact that there is currently £660m of assets under offer will not all feed through into a strong final quarter. We expect that 2023 will see approximately £1.2bn of investment turnover, which will be 21% lower than 2022, but less of a year-on-year fall than we will see in the office and logistics sectors.

Looking to 2024 and beyond, we do expect to see concerns about the challenging consumer and retailer environment keeping some investors out of the market. However, the biggest change is likely to be a reduction in the value-add/opportunistic rationale for buying shopping centres. We expect that some opportunistic buyers will move on to offices as an asset class, as the liquidity is good and recent falls in value are larger. Furthermore, higher debt and construction costs have stretched the viability of some retail to residential schemes. As a result of both these trends we expect to see fewer opportunistic buyers of shopping centres in 2024/5, and thus the return of the institutional buyer to the sector is even more important.

High street shop investment

While £530m of high street shops have been traded this year, less than £100m of that was in the third quarter of the year. The final quarter of the year looks like it will be slightly more active, with a marked pick-up in retailers looking to buy their own stores in key locations.

Volumes remain muted in part because vendors are comfortable with the relative stability of market pricing, and there are no particular signs of any distressed selling bringing supply to the market.

Our prime (outside central London) high street shop yield has now been stable at 6.75% for three months, its highest level since our records began in January 1990. Assuming that the base rate and the cost of debt do start to fall in 2024, this should begin to make the best of the high street shops market look quite attractive in yield terms.

While the Wilko's failure has both knocked investor confidence, and led to a rise in the overall vacancy rate, we do expect that falling inflation and interest rates next year will give a boost to consumer confidence and hence retail sales.

Our analysis of the headline and net-effective rents being paid on new lettings suggests that net-effective rents are now only 0.6% below their 2019 level. We are currently forecasting very modest (but positive) rental growth on standard shops over the next five years, averaging 0.4% per annum of the next five years.

A gentle return of confidence in the occupational outlook, combined with a widening perception that prime yields might have peaked, should drive some tactical buying in 2024 as investors look to buy the best locations at yield of 7% or above to capture the income return and speculate on an improvement in the exit yield.

£530m
of high street shops traded in Q1-3 2023

£831m
of shopping centres traded in Q1-3 2023

Shopping centre yields:

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

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

Source Savills Research

+33bps
The average movement in shopping centre yields in the last 12 months

Prime shopping centre yields have now been stable for three quarters

Savills Commercial Research
We provide bespoke services for landowners, developers, occupiers and investors across the lifecycle of residential, commercial or mixed-use projects. We add value by providing our clients with research-backed advice and consultancy through our market-leading global research team

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