UK Commercial – Q2 2020

SPOTLIGHT
Savills Research

Shopping Centre and High Street Spotlight

savills

- Q2 2020 trends in leasing and investment
- Outlook for 2020 and 2021

3.9%
UK unemployment rate in the March-May period remained largely unchanged due to the furlough scheme.

UK retail consumer and occupational trends

While the easing of lockdown has supported footfall improvements, unemployment remains a major challenge to the retail sector.

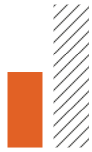
The pivotal question mark hanging over the UK consumer market is the anticipated rise in unemployment rates in the coming months, in line with the Coronavirus Job Retention Scheme coming to an end and employers feeling the financial pinch following the Covid-19 outbreak. ONS revealed the March-May unemployment rate remained largely unchanged at 3.9%, just 0.1 percentage points higher than the same period in 2019. This marginal change somewhat downplays the true story, with employees on company payrolls falling by 649,000 between March and June, while Claimant Count figures increased 112.2% over the same period, suggesting we could see a more pronounced shift in unemployment rates over the following quarter.

As a result, consumer confidence remains tempered, despite GfK's Consumer Confidence Index recording a marginal improvement to -27 in its latest Covid-19 'flash' report for the period 18-26 June, after falling to its lowest post-GFC level of -34 in April and May. The slight improvement was driven primarily by a boost in the Major Purchase Index, in line with the widespread reopening of non-essential retail, while attitudes regarding the general economic situation remain highly volatile.

Consistent with previous periods of economic uncertainty, household saving ratios have spiked with Bloomberg estimating savings averaged over 21.0% of household disposable income in Q2, up from 8.4% in Q1. Despite the lockdown easing, we can expect elevated levels of household saving to continue as a precautionary measure while job retention remains unhinged, resulting in reduced retail spend.

Oxford Economics suggest inflation-adjusted spend on retail goods will fall by 11.1% year-on-year in 2020, with clothing and footwear among the worst hit subsectors with a collective decline of 29.6%. However, gradual improvement in spend is expected over the remainder of the year in accordance with the staggered reopening of business for many retailers coupled with the expected return to positive quarter-on-quarter economic output from Q3. Current projections suggest a significant bounce in retail spend in 2021, led by those subsectors more adversely impacted this year, with clothing and footwear spend expected to increase 33.7% year-on-year.

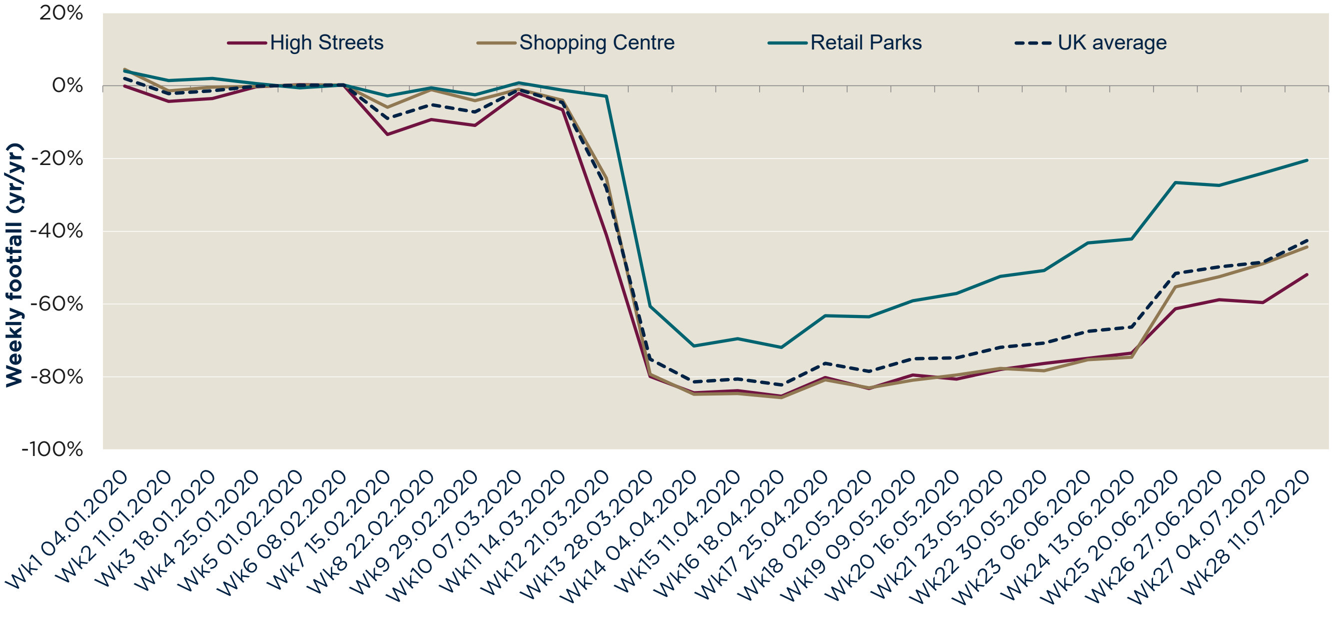
While the short-term implications of the lockdown are a serious concern for many retailers, there are some noteworthy measures that could help relieve pressure within parts of the consumer market.



Household saving ratio estimated to have increased to 21% of disposable income in Q2

Projected year-on-year decline in UK retail spend in 2020

Year-on-year footfall continues to improve in line with the widespread reopening of all retail subsectors with UK average footfall standing at -42.6% YoY in the week ending 11 July



Source Savills Research; Springboard

> Rent-free periods have increased sharply across shopping centre and high street deals in H1 2020 to average 7.5 months, up from 6.0 months in 2019.

Consumer Price Index inflation remains subdued, recording 0.6% year-on-year in June, down from 1.7% in February, and is projected to slow to near zero over Q3 which could in-turn boost household spending power. Additionally, the recent government announcement to reduce the VAT level from 20% to 5% for the hospitality sector may spark further consumer spend momentarily, encouraging footfall improvements in town centre high streets.

Footfall figures continue to be driven down by larger urban centres

Footfall figures across the UK have gradually improved since the height of the lockdown period in April. The reopening of all non-essential retail provided the most pronounced improvement in weekly footfall figures since pre-lockdown, with Springboard reporting a 40.3% week-on-week increase on average across all UK retail destinations in the week to 20 June.

The reopening of hospitality from 4 July coupled with the reduction of the two-metre distancing rule provided a second boost to footfall, with shopping centre and high street locations being the primary beneficiaries. Despite considerable weekly growth, high street destinations remain 51.9% below 2019 levels with shopping centres slightly ahead at -44.3% in the week to 11 July. It's expected that local regional high streets are responsible for driving the recovery to footfall, while the feed through to larger urban centres may be delayed due to the heavy reliance on both public transport usage and local workforce populations.

Retail parks have remained more resilient over the entire period, benefiting from schemes anchored by essential retailers, the earlier reopening of homeware retailers as well as being more accessible by car and consisting of more spacious stores, allowing for greater distancing.

Tougher tenant-landlord negotiations to apply further downward pressure on rents

The mounting financial pressures caused by the lockdown have adversely impacted occupiers and in turn landlords. The quarterly rent collection somewhat emphasizes the severity of the current situation for retail tenants. Savills Property Management reported 19% of shopping centre rents being received on the June quarter date, whereas single-let and high street retail received 58%.

However this isn't homogeneous across the entire sector, with foodstore landlord UK Supermarket Income REIT receiving 100% of its rents due in both March and June quarterly rent payment dates. Issues lie within those sectors already experiencing margin pressures which have been exacerbated by the financial burdens caused by the lockdown, including mid-market fashion and F&B - both of which being sectors heavily reliant on high footfall to drive turnover. The reopening of sites under stricter cleaning protocols could require the hiring of additional staff, resulting in further short-term margin pressures.

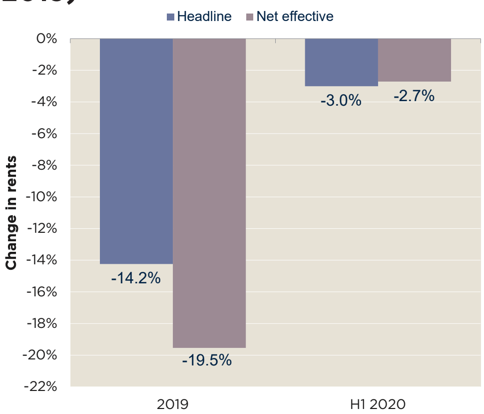
Government support, including blocking any evictions of retailers unable to pay rent as a direct result of Covid-19 related financial burdens, will help relieve some of the immediate stresses. Many tenants are also seeking concessions from landlords to help alleviate financial pressures in the first instance. A recent Savills survey revealed that UK landlords expect over half of leases to be impacted in some way due to the pandemic. Landlords are anticipating that 24% of leases to have a rent-free window applied in 2020, while rent reductions are expected to account for 22% of leases and the likelihood of switching to turnover based rents representing a further 7% of lease negotiations.

These trends have been mimicked in leasing activity over the first half of the year. Rent-free periods have increased sharply across shopping centre and high street deals in H1 2020 to average 7.5 months, up from 6.0 months on average in 2019.

Rising rent-free periods as well as landlords using capital contributions to entice potential tenants, has continued to place further downward pressure on net effective rents. Combined high street and shopping centre deals experienced a decline in net effective rents over H1 2020 of -2.7% compared to the 2019 average. While this may appear relatively marginal on the whole considering the current situation, it's worth noting that this does represent a much smaller number of deals in light of the lockdown period tempering occupier demand, therefore slightly skewing results towards pre-Covid Q1 2020 deals.

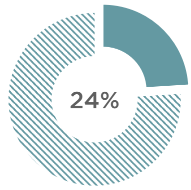
Tougher retailer-landlord negotiations are expected to continue throughout the remainder of the year, presumably resulting in further falls to both headline and net effective rents. Our recent survey suggests landlords are projecting headline rents to fall by an average of 22% on high streets and 30% on shopping centres in 2020. This will become more apparent as further deal information is recorded in the coming months.

Change in average high street and shopping centre rents (H1 2020 vs 2019)

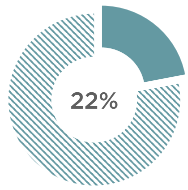


Source Savills Research
Note: Based on Savills UK retail deals, excluding London & SE

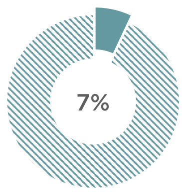
Savills landlord survey headlines 2020



Of leases expected to have a rent-free window applied in 2020



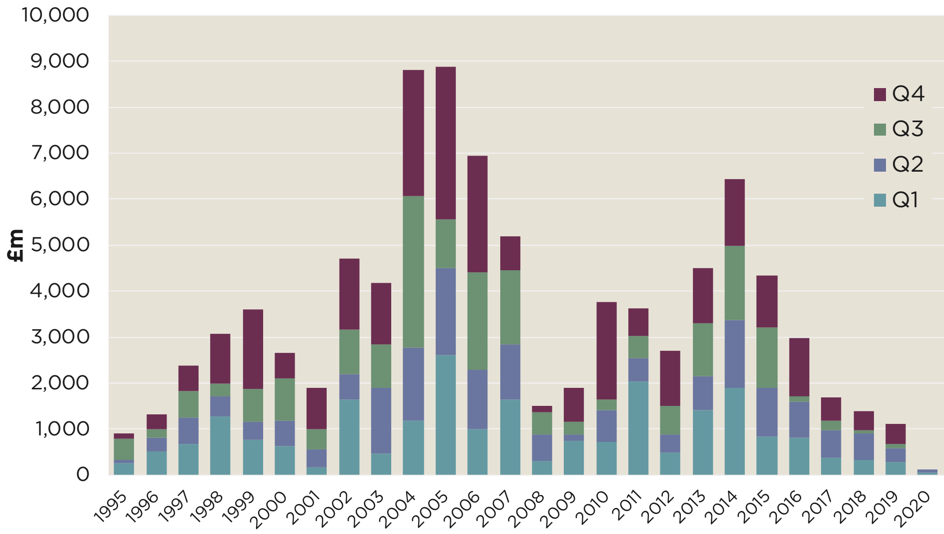
Of leases expected to experience rent reductions in 2020



Of leases likely to move to turnover based rents in 2020

"Q2 rent collection stats made for uncomfortable viewing"

Shopping centre investment falls to its lowest ever 1H total of £118.5m



Source Savills Research

UK retail investment market

Shopping centres

In what are unprecedented times the retail investment landscape has been impacted by a number of factors which present challenges in addition to opportunity. There can be no denying that consumer confidence is at an all-time low, exacerbated by rising unemployment, the closure of retail and leisure, and a hesitancy to travel to city centres. As with every crisis comes an opportunity, to those well-funded and able to move quickly the retail investment market presents a good opportunity to procure assets previously unattainable. We are expectant of a wave of distressed stock coming to the market before the end of the year, which may entice investors who previously have been dormant for several years.

Rent & S/C Collection Issues

Perhaps unsurprisingly, the Q2 rent collection stats made for uncomfortable viewing for all landlords. According to Savills research, on average across all commercial properties only 48% of rent was collected, and only 40% of service charge. Shopping Centres endured a particularly tough quarter, with only 19% and 23% of rent and service charge collected respectively. The collection statistics are expected to improve in Q3 and Q4, with emergency Government tenant protection falling away, the re-opening of shops and leisure and proactive landlords seeking regears extending terms in exchange for rent-free periods linked to arrears.

Government Issues and Tenant Protection Regulation

At the end of Q1 the Government legislated to temporarily ban the eviction of tenants due to non-payment of rent until the end of September. Tenants have been encouraged to 'pay what they can', something the landlords report has generally been practised in good faith. Both landlords and tenants have been heavily impacted by Covid and have been asked to pull together to get their businesses back up and running. Once the protection falls away the question of arrears will no doubt be a thorny one, especially given the rental collection statistics.

Intu & Distressed Sales

The first major Landlord casualty of Covid perhaps unsurprisingly was Intu. Intu ultimately succumbed under the strain of a £4.5bn debt pile, despite the best efforts of the business to secure short term waiver covenants. Whilst perhaps the most high profile, Intu won't represent the last victim of this pandemic. Poor rental receipts and increasing vacancy through tenant failure, have driven down net income which has in turn reduced values, and this has been exacerbated by softened yields. These factors represent a noxious combination and have put significant strain on LTV covenants. As a result we anticipate a raft of distressed debt-driven sales over the forthcoming months. Ultimately, this will be determined by the flexibility of lenders to allow short term waiver covenants, which are likely to be forthcoming if the lender believes that values will recover over the medium to long-term. This is best evidenced by British Land & Norges securing waivers on the Meadhowhall Finance securitisation.

Food Store Resilience

A positive to take from these difficult times is the fact that it has highlighted the resilience of supermarkets and supermarket anchored shopping centres. Looking ahead, the hardiness of the UK supermarket sector in the face of Covid-19 should continue to entice investors and support transaction activity. Similarly, the typically longer leases associated with food store assets will also support investor appetite post the current crisis, particularly from investors seeking long-term income security. 2019 saw volumes up 80% year on year with investment into the food store market totalling £1.78bn with this appetite remaining robust despite the adversity of Covid-19. Savills have recorded over £700m of supermarket transactions in H1 2020. Most notably London Metric acquired a portfolio of 5 food stores let to Waitrose on new 20-year leases with CPI linked rent reviews for £62m.

The shift in consumer behaviour and entrance of the discounters (particularly Lidl and Aldi) has challenged sales efficiencies across the "Big Four" operators (Tesco, Sainsbury's, Asda and Morrisons). This has translated into a declining interest in the large hypermarket stores (over 50,000 sq ft) amongst food retailers (albeit those larger stores are in some ways easier to run at the moment given the requirement for social distancing). Instead, the appeal of the 25,000-50,000 sq ft store has improved as it offers operators the best compromise between providing a comprehensive product line and optimum sales efficiencies.

Convenience supermarkets have benefited from people shopping more often and following guidance to stay closer to home. According to Kantar, collectively smaller branches of the major supermarkets and independently owned food retailers increased their share of spend to 13.3%, growing sales by 30% compared with the same period a year ago.

Leisure Impact

The leisure industry has been one of the hardest hit by Covid-19. The vast majority of the sector was closed for the entirety of Q2. Whilst the Chancellor's decision to temporarily decrease VAT within hospitality to 5% and the introduction of 'Eat Out To Help Out' will drive footfall in Q3, and most businesses will be back open and trading, the long term impact of Covid and it's impact on consumer behaviour is yet to be properly understood. It is anticipated that it could be some time before tenants see trade recovering towards pre-Covid levels.

Debt

Debt has been very difficult to source so far in 2020 and will be important to the shape and pace of the recovery for the retail investment market. Before the outbreak of Covid, the ability to source or staple debt was becoming a vital component for the liquidity of assets. As the market went into lockdown, so did lenders. However encouragingly, much like the rest of the world, the debt market is slowly resurfacing. Securing senior debt still remains a challenge regardless of the sector, yet lenders are progressively welcoming and entertaining the prospect of new clients. Previously the sector had only been interested in existing clients for understandable reasons. Major high street lenders remain closed at the time of writing and there still may be some way to go before core retail debt lending is back on the menu. However, for sites offering good repurposing opportunities, positive pre-apps and proactive councils the debt market's wheels are slowly starting to turn.

Sales

Q2 saw just the two transactions, taking total volumes for the year to £118.5m. The largest transaction being the acquisition of Aberdeen Standards Broadwalk Centre in Edgware by Ballymore. The scheme offered the unique opportunity to acquire a freehold 13-acre site ripe for redevelopment. Ballymore paid a net price of £71m, reflecting 4.59% net initial yield. The business case will almost certainly be long term given the unexpired lease term held by Sainsbury's. Yet, the opportunity to potentially build 2,500 home directly adjacent to Edgware tube station attracted a significant level of interest and demonstrates the resilience of repurposing led opportunities in convenient commuter locations. Finally, Captain Cook Square, Middlesbrough was purchased by the council. Further evidence of Councils purchasing key strategic sites within town centres induced by protectionism and the need to gain control over the redevelopment.

High street shops

The high street retail investment market struggled through a similarly challenging second quarter as the shopping centre sector, with Property Data recording only £30m of high street shop transactions in Q2 2020.

Those buyers who are in the market are mainly private investors and property companies looking at change-of-use opportunities, and this segment will be given a boost by the recently announced changes to the planning system.

We expect that the second half of 2020 will see low levels of high street stock being brought to the market, as some investors resist realising capital value decreases, and others focus on bigger lot-sized issues in their portfolios.

We believe that there is some merit to the suggestion that consumers have fallen back in love with their local high streets, and this could support retailer survival in those locations. However, our forward view on yields is for continued softening.

Shopping centre yields: Revo centre classifications

	Q1 2020	Q2 2020
Prime	8.00%	8.00%
Regional scheme	6.25%	6.25%
Sub regional scheme	7.75%	7.75%
Neighbourhood scheme	9.50%	9.50%
Local scheme (successful)	9.50%	9.50%
Local scheme (challenged)	15.00%	15.00%

Source Savills Research.

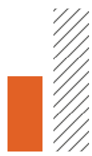
Shopping centre yields: Savills classifications	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020
Super-prime centre	5.25%	5.25%	5.50%	5.75%	6.25%	6.25%
Prime centre	6.75%	7.00%	7.25%	7.50%	8.00%	8.00%
Town centre dominant	8.50%	8.75%	9.00%	9.25%	9.50%	9.50%
Community & convenience	8.50%	8.50%	8.75%	9.00%	9.50%	9.50%
Secondary	10.75%	11.00%	11.25%	11.50%	12.00%	12.00%
Tertiary	14.00%	14.00%	14.50%	14.50%	15.00%	15.00%

Source Savills Research

£118.5m
1H 2020 investment in shopping centres

19%
of rent due on shopping centres collected in Q2

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



200bps
The rise in Prime shopping centre yields since Q4 2015

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

Retail

Mark Garmon-Jones
Shopping Centre Investment
+44(0)20 7409 8950
mgjones@savills.com

James Stratton
High Street Investment
+44(0)20 7409 8880
james.stratton@savills.com

Toby Ogilvie Smals
Investment
+44(0)20 7409 8162
tosmals@savills.com

Alan Spencer
Occupational Advice
+44(0)20 7758 3876
aispencer@savills.com

Stuart Moncur
Occupational Advice
+44(0)131 247 3706
stuart.moncur@savills.com

Research

Mat Oakley
Commercial Research
+44(0)20 7409 8781
moakley@savills.com

Marie Hickey
Commercial Research
+44(0)20 3320 8288
mlhickey@savills.com

Josh Arnold
Commercial Research
+44(0)20 7299 3043
josh.arnold@savills.com