UK Commercial – Q1 2022

SPOTLIGHT

Savills Research

Shopping Centre and High Street Spotlight

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- Prices and costs rising
- Rents appear to have plateaued
- Investor demand recovering

> “Past downturns have shown us that people do not cut back as much on leisure and pleasure as they do in other areas.”

UK retail consumer and occupational trends

Consumer recession ahead, while retailers’ costs are also rising

As the Office for Budget Responsibility pointed out in the Spring Statement, UK households are facing a decline in real disposable incomes on a scale that hasn’t been seen since the second world war. There can be no doubt that this will negatively affect spending behaviour at a time when retailers are also facing dramatic rises in their costs.

The fall in real incomes that is currently being experienced is not just about the high inflation that is occurring due to Covid reopening and Ukraine, but also due to a rising tax burden due to the National Insurance increase and the freezing of income tax thresholds.

While UK consumers came out of the Covid period with higher than normal levels of savings, the household saving ratio has already fallen below its pre-crisis level, and the fact that the higher levels of savings were concentrated in higher-earning families leaves middle- and low-income households with little or no cushion against rising prices.

We expect that CPI will peak at just under 9% in Q2 2022, and be back below the 2% target by late 2023. Some of the coming pain will also be offset by stronger wage inflation, though this will not be enough to protect the retail economy from a period of falling real incomes and the inevitable knock-on effect that this will have on consumer spending.

Oxford Economics is forecasting that consumer spending will fall quarter on quarter through the remainder of this year, a recession in all but name.

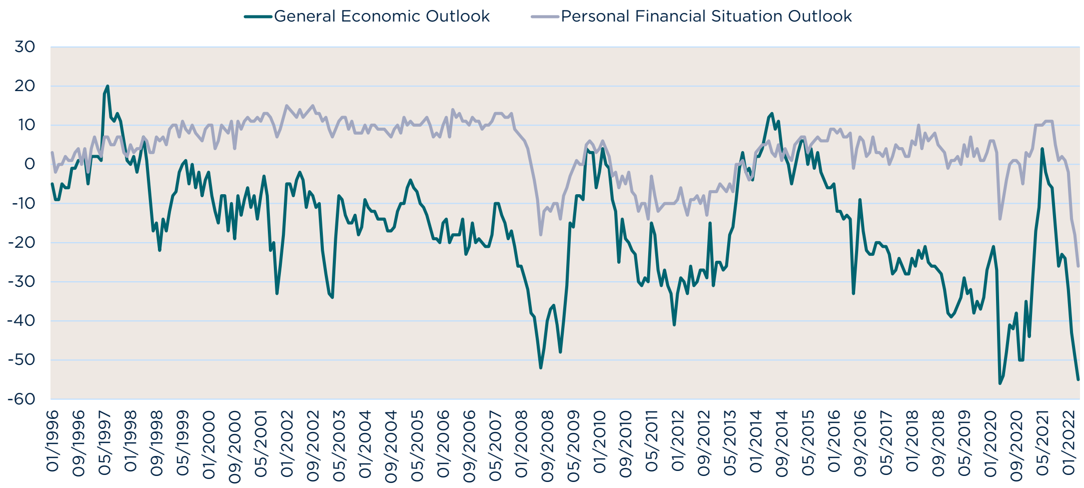
However, things will improve as energy prices start to fall in 2023 and the state benefits also rise sharply due to their linkage to inflation. The planned 1p cut in the basic rate of income tax in April 2024 will also mean that the consumer recession is comparatively short and shallow.

Because poorer households tend to spend a higher proportion of their incomes on food, fuel and energy, the pain will definitely be felt harder in some parts of the country more than others, and this could mean that discounters (who have fared very well in previous downturns), might not be so insulated this time around. That having been said, the latest Kantar data shows that Aldi and Lidl have continued to take market share from their mid-market rivals which indicates that some trading down is already taking place in terms of family food spending choices.

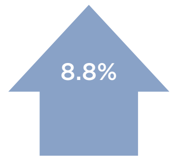
What people cut back on in hard times is a fairly well-rehearsed story, with spending on discretionary items and bigger ticket items likely to see the largest falls. While bigger-ticket household items such as carpets, furniture and white goods have had a good run recently, on the back of a strong year in the housing market last year, we expect spending on these items to fall back in 2022.

Leisure spending is arguably the most discretionary area of household spending, and is often not recognised as the single largest. The ONS Living Costs and Food Survey suggests that spending on recreation, culture, restaurants and hotels accounts

Graph 1: Consumer confidence about the future has collapsed to almost record low levels



Source Savills Research from GfK data.

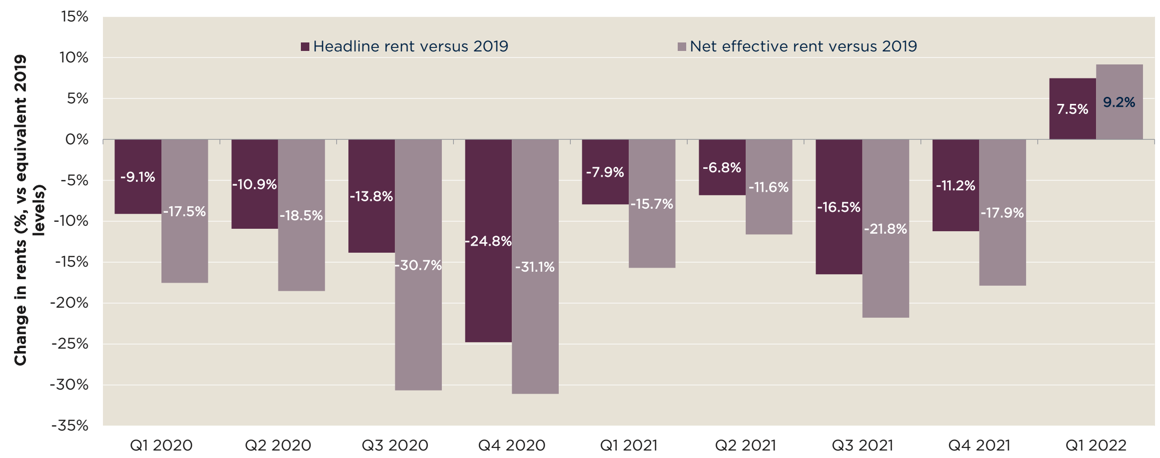


The likely peak for CPI in Q2 2022

The GfK index for people’s views on the outlook for their personal financial situation (the lowest ever level)

UK wage inflation accelerated to 4.8% over the year to end March 2022

Graph 2: Average rents achieved in Q1 2022 were higher than those achieved in the last pre-pandemic year



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

for 21.9% of a typical household's spending, far in excess of housing (13.6%), and transport (13.7%). However, past downturns have shown us that people do not cut back on leisure or pleasure as much as they could, with the desire for a treat in difficult times meaning that spending in some segments holds up better than might have been expected.

This time around we expect spend on eating and drinking out to fall slightly, as people treat themselves to home-delivered food and supermarket-bought alcohol.

Clothing and footwear typically account for only around 4% of family spending, and thus while cutbacks are likely in this segment they will not have a huge impact on how much money people are saving or diverting to less discretionary spend. However, the latest ONS data suggests that clothing and footwear prices are 8.9% higher than they were a year ago which indicates that retailers are being quicker to pass on rising costs to the consumer than they have been in previous periods of high inflation.

One area that might prove more defensive is DIY, with Kingfisher and Wickes's recent statements appearing confident that people will carry on spending on their homes, and there is definitely some evidence from past downturns that DIY spend actually increases as people become more cost-conscious.

The speed at which some retailers appear to be passing costs on to consumers is a clear sign that cost pressures in retail, manufacturing and distribution are just as (if not more) significant than they are in household budgets.

We should not forget that companies do not benefit from an energy price cap, so the dramatic rise in gas bills is already being felt in retail stores and schemes across the country. Added to this is a similarly large increase in the price of diesel, and rises in the operating costs of the retailers who supply shops with their products.

Staff costs will also be a challenge, with workers and unions demanding that wages rise in line with inflation, and this was the single largest area of cost increase that was highlighted in Next's recent trading statement.

Next also made the point that they had made significant reductions in property costs in recent years, with an average rent reduction of 44% on 49 stores. Kingfisher echoed this view, with an average rent reduction of 20% last year on those stores where leases were renegotiated.

While the property cost savings alone will not be enough to fully insulate retailers from margin erosion, they will help. This means that we probably see some equally forceful negotiations in 2022.

The Q1 trends in terms of rents and terms agreed were a continuation of the gradual improvement in the rent levels being achieved, with the most notable change this quarter being that the headline rents achieved were actually 7.5% higher than were achieved in Q1 2019.

On a year on year basis the headline rents achieved were up 16.7% this quarter and net effective up 29.5%, which suggests that the nadir of the rental cycle in some locations was reached last year. The most acquisitive retailer groups continue to be F&B and Value brands, with Athleisure still on the expansion trail on the back of a strong Covid period.

Looking ahead, while there have been a few recent announcements on large-scale expansion programmes, we expect caution to prevail against the background of rising operating costs and falling sales. This should mean that rents plateau for a while, rather than continue to grow at their recent pace.

16.7%

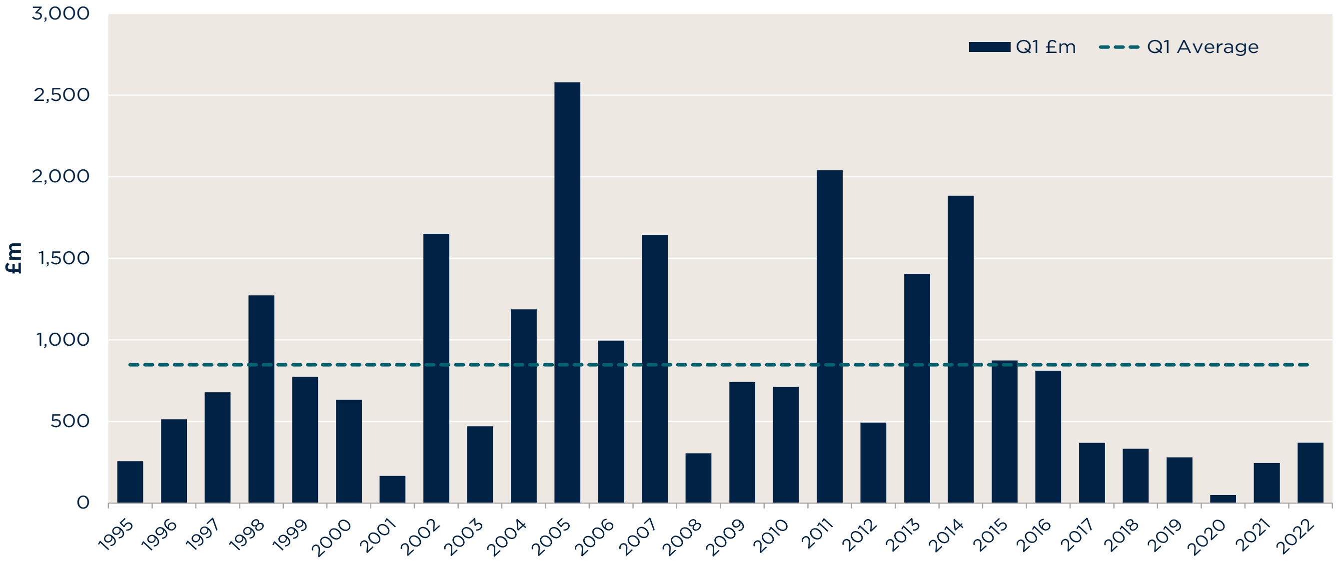
The year on year increase in headline rents achieved

9.2%

The increase in net effective rents achieved in Q1 2022 versus 2019

"It is clear that some investors want to buy shops again"

Graph 3: Q1 shopping centre investment £m



Source Savills Research

UK retail investment market

Buyer confidence building, but is there the right product to buy at the right price?

Shopping centre investment

Investment turnover in Q1 2022 was the strongest Q1 figure that we have seen since 2016. However, the £370m transacted in the first three months of this year was still well below the Q1 average of £847m.

As we commented upon in the last Spotlight, there are clear signs that the strong performance of retail warehousing last year is turning opportunistic investor's eyes towards shopping centres. However, the overall tone of the first quarter of 2022 is one of lack of suitable product, which begs the question of why owners are unwilling to sell at the moment?

As ever, this simple question has a variety of answers. Our view is that they all orientate around pricing. While there is investor appetite for the sector, the prices that they wish to pay for the larger and better quality schemes are still out of line with many vendor expectations. It seems odd to suggest that there hasn't been enough distress in a sector that has seen seven years of falling prices, but some potential buyers are still hoping for more.

Another challenge to liquidity is liquidity itself. While 2021 and early 2022 have seen solid improvements in trading volumes, the evidence that has been produced is not necessarily relevant to the large prime malls that the opportunistic investors would like to be buying. This lack of price discovery means that both purchaser and vendor expectations on yields may well be wrong, and we are unlikely to see the two align until some real comparables emerge at the "institutional" end of the market.

A further challenge to liquidity is the question of why you would sell a prime mall at the moment, just as voids are starting to fall and some positive news is emerging around forward rental growth prospects? While the macro-economic situation around retail has undoubtedly worsened since our January Spotlight, some of the things that we were worrying about then (most notably the impact of the end of the moratorium) do not seem to have been as challenging for the market as they could have been.

While our overall prime benchmark shopping centre yield has remained at its near-record high of 7.50% through the first three months of 2022, we remain of the view that some downward pressure on this is likely in the second half of the year. The most likely first mover in this trend will be strong performing community & convenience focused centres, where we have already seen a 25bps hardening in the yield in the second half of 2021.

Looking beyond that segment, which has arguably been boosted by the rise in agile working, the next movers will be mid-sized, freehold, and food-anchored. As we discussed in the occupational section of this Spotlight, we do not expect to see fashion spend being hit excessively by the current consumer crisis. However, investor aversion to fashion-led schemes will definitely be sustained by the perception that fashion is not essential at a time when the cost of living is rising so sharply.

Stepping away from the topic of shopping centres as going concerns, we should not forget that a key driver of investor demand in recent years has been the highly opportunistic re-purposing agenda. The sharp rise in both borrowing and construction costs over the last three months will definitely make some re-purposing opportunities look less attractive. However, where the end-use is a hot and high priced sector such as housing, logistics or science, the numbers should still stack up.

At the beginning of 2022 we suggested that the turnover this year was likely to exceed £2.5bn for the first time since 2016. This may have been a touch optimistic given the cross-sector indecision that has crept in since the invasion of Ukraine. However, the second half of 2022 will definitely be stronger than the first, and this should get turnover to at least £2bn, making it the most active year since 2016.

For prime shopping centre yields to fall across the board in the remainder of this year we would need to see some prime assets actually being brought to the market. While there are definitely some owners of such assets who are willing to sell, the potential buyers will have to get themselves into the head-space where they can justify bidding at better than 7.50% to get the best assets.

High Street Shop investment

With more than £1.6bn traded over the last two quarters it is clear that some investors want to buy shops again.

The biggest change in purchaser profile over the last six months has been the return of income-focused investors who are hoping to call the retail and capital value cycle.

While these buyer's confidence will definitely be knocked by worsening consumer sentiment over the second quarter of 2022, we do not expect it to last long enough to drive a rise in retailer failure or voids, and as such the occupational confidence story that was driving this group at the start of 2022 should remain. This confidence should be boosted by the Q1 rent collection figures, which showed an 8.6% rise on the previous quarter.

We expect that the main group of vendors of high street shops will remain the institutions, and the main buyers will be private investors.

Non-domestic private investors will be focusing on the well-known streets in the largest cities, while domestic privates will be chasing 8%+ yields on the high streets in smaller towns and suburban locations.

The lack of institutional buyers in the market will mean that the average lot size transacted will remain low, and that evidence for larger parades in prime locations will be hard to find.

Given that we have already hardened our prime high street yield from 6.75% in October 2021 to 6.25% in March 2022, one could argue that the window to call the cycle has already closed. This might mean that the depth of the buyer pool for true counter-cyclical investments might have shrunk. However, the fact that high street retail yields were as low as 4.25% in 2018 should be enough to assure some chartists that more yield compression is to come.

We certainly expect to see a further 25bps fall in the prime high street yield over the next nine months, predominantly on the back of limited prime stock coming to the market. However, the recent suggestion that landlords might be forced to let vacant shops is yet another potential speed bump on the road to recovery.

SC equivalent yields: Revo centre classifications

	Q1 2021	Q1 2022
Dominant Prime	9.00%	8.75%
Regionally dominant	7.25%	7.50%
Sub regional scheme	8.75%	8.75%
Neighbourhood scheme	10.50%	10.00%
Local scheme (successful)	10.00%	9.50%
Local scheme (challenged)	16.00%	16.00%

Source Savills Research

SC equivalent yields: Savills classifications	Q4 2020	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022
Super-prime centre	7.00%	7.25%	7.25%	7.50%	7.50%	7.50%
Prime centre	8.75%	9.00%	8.75%	8.75%	8.75%	8.75%
Town centre dominant	10.25%	10.25%	10.25%	10.00%	10.00%	10.00%
Community & convenience	10.00%	10.00%	9.75%	9.75%	9.50%	9.50%
Secondary	12.75%	13.00%	13.00%	13.00%	13.00%	13.00%
Tertiary	15.75%	16.00%	16.00%	16.00%	16.00%	16.00%

Source Savills Research

£370m
Shopping centre investment activity in Q1 2022

£245m
Shopping centre investment activity in Q1 2021

200bps
The difference between prime shop yields today and in 2018

50bps
Downward movement in successful local shopping centre yields over the last year

Savills Commercial Research

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