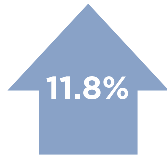
UK Commercial – Q2 2022

SPOTLIGHT

Savills Research

Shopping Centre and High Street Spotlight

- Cost of living squeeze
- Leasing and investment trends
- Outlook for 2022-23



The ONS Retail Price Index inflation rose by 11.8% year-on-year in June 2022, up from 9.0% recorded in March.

UK retail consumer and occupational trends

Consumer spending power damaged by cost-of-living crisis, but not all sectors are feeling the pinch to the same extent.

The intensifying cost-of-living crisis continues to influence the consumer market, as rising costs of energy, groceries and transport continue squeezing disposable income for many households.

As inflation continues to rise to new heights, wage growth has struggled to keep up, with inflation-adjusted regular pay falling by -2.8% between March and May, compared to the year prior. Oxford Economics suggests real disposable income per person will remain in negative year-on-year territory until Q4 2023 (Graph 1). GfK's consumer confidence index has subsequently nosedived, with the July 2022 index for personal financial situation over the next 12 months reporting -26. Despite marginal two-point improvement from June, it remains 37 points lower than July 2021.

One would assume the direct knock-on effect would be detrimental to the retail and leisure sectors with much more considered spending patterns, but does the latest spend data correspond?

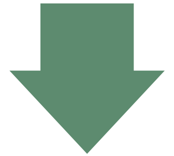
Which sectors are feeling the pinch?

Ordinarily, rising inflation and squeezed cost-of-living would result in a reduction of non-essential spend, however the latest data displays a far more varied trend, as consumers become more selective over their discretionary spending habits.

Parts of the leisure market have continued a relatively strong run, with Barclaycard spend data revealing a 26.6% year-on-year uptick in the entertainment sector in June 2022. Cinema releases, the early summer events/festival calendar and ongoing strength in domestic tourism have no doubt supported growth, as some households look to celebrate a summer period undisrupted by Covid restrictions.

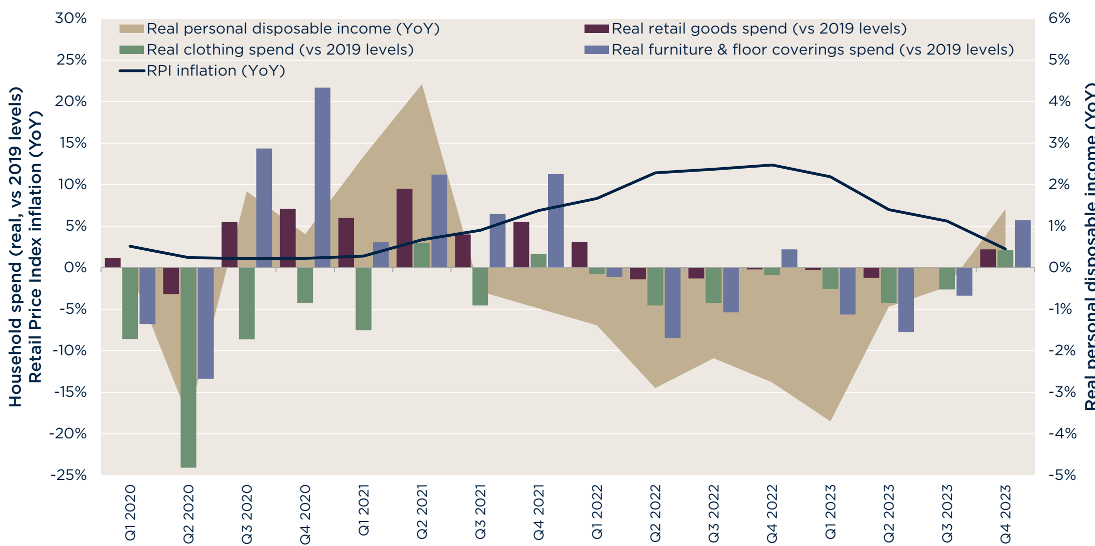
Some clothing retailers reported an early summer bounce, supported by a return to holidays and festivals. Quiz reported a revenue uptick of 62% year-on-year in the three months to 30 June, albeit mentioning a cautious outlook later in the year in the face of the cost-of-living crisis. Other fashion retailers have felt the effect of tightened spending, with inflation-adjusted clothing spend in Q2 2022 down -4.6% compared to Q2 2019, according to Oxford Economics (Graph 1).

Homeware and subscription services appear to be the non-essential categories that consumers are prioritising the least. Barclaycard reported that digital subscriptions dropped -4.2% in June 2022 compared to the previous month, while household goods experienced a -5.1% fall over the same period. While this follows a period of particularly strong growth in 2020-21, it does emphasise the move to



Inflation-adjusted household disposable income fell -2.9% year-on-year in Q2 2022

Graph 1: Personal disposable income and household spend are both waning in line with retail price inflation reaching double-digit growth in Q2 2022.



Source Savills Research, ONS, Oxford Economics

Consumer spend on household goods experienced a -5.1% month-on-month fall in June 2022

> “Rental tone has continued to improve in 2022, however some economic-related cautiousness is likely to enter the leasing market through the second half of the year.”

trade down on larger-ticket purchases. GlobalData’s May consumer sentiment survey reinforces this outlook, as 20% of respondents suggested they would stop buying furniture products due to the inflationary environment.

Conversely, some retailers on the budget end of the spectrum are capitalising on slightly more savvy consumers. Matalan, for example, reported revenue growth of 29% year-on-year in the 13 weeks to 28 May, while also outperforming equivalent pre-pandemic revenue.

Essential retail spend grew +4.4% year-on-year in June 2022, perhaps expected in line with surging transport and energy prices. Grocery sales, however, have dipped, with ONS reporting year-on-year food store sales down -5.8% in June. This comes as households seek more value in their grocery shopping (supporting a growing market share for the discount grocers), or are indeed forced to reduce the volume of goods bought whilst grocery inflation nears double-digit growth.

The latest Oxford Economics forecasts suggest further inflation hikes in H2 2022, and with the energy price cap to be lifted further in October, the consumer outlook for Q4 appears relatively bleak, particularly after the current summer holiday bounce. Heightened household savings during the 2020-21 period might offset these concerns for some households, and the likelihood of further government support packages could provide a lifeline for others. However, it’s likely we’re due to experience further tightening of wallets as we move through Q3 and into the ever-important Q4 period.

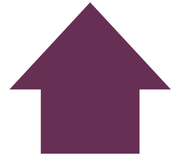
Rental improvements continue, despite cautious outlook for H2 2022

In similar fashion to the Q1 report, new leases signed continued to report slight rental improvement. On a rolling four-quarter basis, net effective rents in Q2 2022 were up +13.9% year-on-year, while headline rents reported an +8.1% growth over the same period. This follows some leasing confidence creeping back within certain parts of the market, off the back of the pandemic restrictions in the previous year.

Compared to 2019 equivalent levels, both net effective and headline rents continue to fall, albeit more marginally than that experienced throughout 2020-21. Net effective rents were down just -4.9% compared to pre-Covid equivalents, whilst reporting quarter-on-quarter improvements, continuing to suggest that we have already reached the bottom of the cycle.

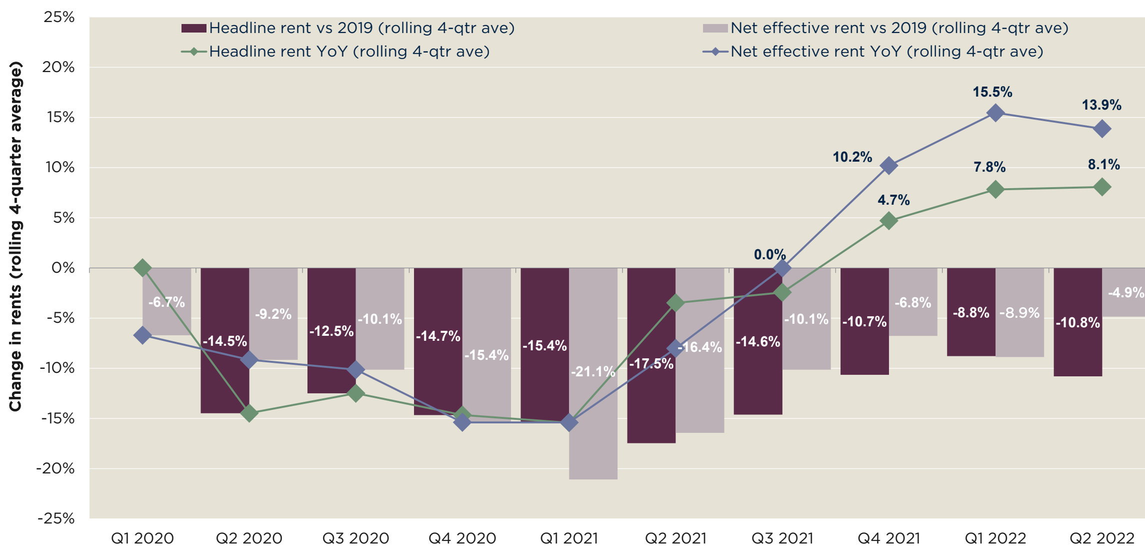
Savills new retail leasing data reflects this slight pick-up in confidence, with deal count increasing 8.9% in H2 2022 compared to the same period in 2021. Numerous retailers are progressing with growth plans, with Aldi listing a further 55 target locations, whilst the Fragrance Shop aims to open 100 new sites over the next three years and JD Sports opening a further 12 stores this summer. Meanwhile, requirements across the Food & Beverage market remains strong, with numerous smaller chains looking to expand.

However, the impact of the high inflationary environment on discretionary consumer spend will continue to be a key gauge for retailers to assess their current expansion/contraction plans. As a result, we could begin to see deal volume slow once again, in the latter half of 2022 in the face of some hesitancy developing.



Savills retail leasing deal count increased by 8.9% in H1 2022 compared to H1 2021

Graph 2: Change in average high street and shopping centre rents year-on-year and compared to 2019 levels

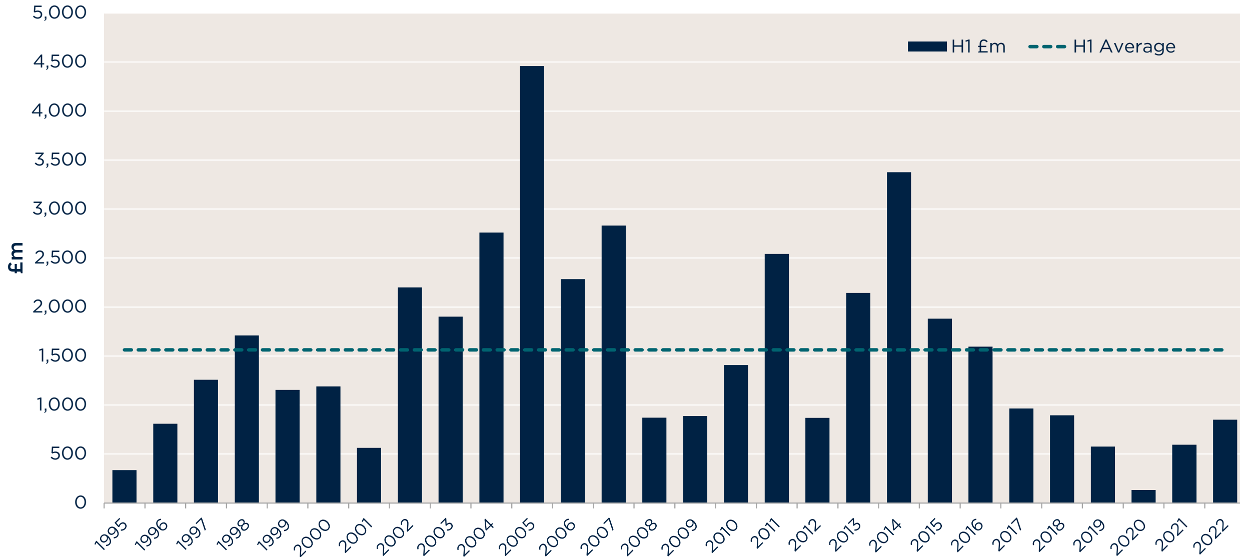


Source Savills Research **Note:** Based on Savills UK retail deals, excluding London & SE

Net effective rents increased 13.9% year-on-year in Q2 2022, marginally lower than the 15.5% reported in Q1 2022

> "While there are undoubtedly new questions being asked about the health of the consumer economy, the rationale for buying remains much as it was at the start of the year"

Graph 3: H1 shopping centre investment volume



Source Savills Research

UK retail investment market

Concerns about occupational shocks start to drag on sentiment

Shopping centre investment

The second quarter of 2022 saw a gentle improvement in transactional activity, with £467m traded in 19 deals compared to £382m in 11 deals in the first three months of the year. However, the combination of the rising cost of borrowing and concerns about a potential consumer recession in the UK have now started to push entry yields upwards again in some segments.

While it might seem odd to say that the rising cost of borrowing is impacting a market where debt was virtually impossible to achieve, the recent increases have affected pricing on other asset classes, and investors in retail are keen to see the attractive comparative yield gap between shopping centres and other assets maintained.

As a result of this we have maintained our shopping centre prime yield at 7.50%, a marked change of tone from the end of Q1 when we were poised to start hardening this indicator.

We have explored the occupational challenges earlier on in this Spotlight, and there is no doubt that investors are now more cautious on forward rental growth prospects in all commercial property sectors, not just retail. However, this does not seem to have caused a wholesale shut-down of the sector, with 27 centres under offer at the end of July 2022. We also expect that a similar number will be brought to the market once the summer holiday period is over.

While some investors who were thinking about dipping their toes into the market this year might now choose to wait and see what happens to both asset pricing and Christmas trading, the opportunistic buyers who have been active in this sector through 2021 and 2022 are expected to remain (albeit at a higher yield).

Even without the latest economic shocks the sector was challenged by lack of liquidity and consequently a lack of price discovery in some segments. We expect that this will remain the case for the rest of this year, most notably at the primest end of the market.

The best evidence for prime pricing is yet to come, with Nuveen's sale of the Bullring in Birmingham standing out both in terms of lot size and quality. At the time of publishing (late July), this deal had been successfully concluded by the Savills team. The transaction supports our view on the super prime equivalent yield.

Stepping away from the rarefied super-prime end of the market, we expect that the strongest investor interest will remain around dominant local schemes that have a community or convenience focus. While the current situation might limit the prospects of imminent further yield hardening in that segment, we expect to see consumer spend and retailer trends being more defensive in these locations than others. This should also mean that yield stability is more supportable, given the fact that voids are low and there is some upward pressure on both headline and net-effective rents in the best of these schemes.

We commented in our last Spotlight that the rising costs of construction and borrowing might dampen investor interest in pure re-purposing plays, and this does appear to have happened over the last three months. However, where there is a clear and credible potential for conversion to residential there remains an active pool of opportunistic investors.

Looking ahead to the remainder of the year, we do expect that the definition of "prime" will become even more tightly scrutinised by buyers. However, the high yields on offer across the shopping centre segment will remain attractive to the types of investors that have been active in this space over the last few years. Given that these yields are already pricing in little or no rental growth, the weakening economic outlook should not prove as much of a challenge to pricing as it might in other segments of the commercial property market.

High Street investment

A similar realism about rental growth prospects is also present amongst buyers in the high street shop market, albeit against a background of lower yields than in the shopping centre segment.

Transactional volumes remained low in the second quarter, primarily due to a very limited number of assets of over £10 million being traded.

Buyers of high street shop investments continue to be predominantly private, and comparatively unconcerned about covenant risk as they are buying off yields in reversion. This strategy continues to be supported by the recognition that in many locations the 'escape route' is conversion to residential or other uses.

While the actual volume of investment transactions remains fairly low in a historic context, there is no doubt that liquidity has improved over the last quarter and there is little sign at the time of writing of a summer lull.

We have speculated over the last few issues of this Spotlight about when institutional buyers might return to the shops market, and thus deliver some evidence of what prices prime parades might achieve. Well there was a brief moment at the start of the second quarter when we felt that this could be about to happen, the rising concerns about the impact of the cost of living crisis on retailers and rents have probably once again delayed the return of the larger and more analytical buyers to the market.

Last quarter we suggested that we expected to see a further 25 bps fall in the prime high street yield over the remainder of 2022, predominantly on the back of limited prime stock coming to the market.

Evidence of this is definitely occurring, with the most notable example in the last quarter being the sale of 61-67 Clarence Street in Kingston-upon-Thames. These three units, let to non-fashion tenants, were on the market for £5.6m (equivalent to a NIY of 6.75%), and achieved £5.67m (6.7%). This, and other similar market activity, gave us the confidence to move our prime benchmark (outside London) shop equivalent yield from 6.25% to 6.00% in May, and have kept it at that level in June and July.

Looking ahead to the remainder of 2022 and early 2023 we expect the broad theme to be more of the same. Private buyers, both domestic and non-domestic, will continue to dominate the market, and lot sizes will generally remain small.

While there are undoubtedly new questions being asked about the health of the consumer economy, the rationale for buying into the high street retail segment remains much as it was at the start of this year. While institutional interest is likely to remain scarce, the return of income-focused investors who are hoping to call the rental and capital value cycle is very much a trend, and this should boost transactional volumes over the next 12 months.

SC equivalent yields: Revo centre classifications

	Q1 2022	Q2 2022
Dominant Prime	8.75%	8.75%
Regionally dominant	7.50%	7.50%
Sub regional scheme	8.75%	8.75%
Neighbourhood scheme	10.00%	10.00%
Local scheme (successful)	9.50%	9.75%
Local scheme (challenged)	16.00%	16.00%

Source Savills Research

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

Source Savills Research

£849m
H1 2022 shopping centre investment volume

£594m
H1 2021 shopping centre investment volume

-75 bps
The change in prime shop yields over the 12 months to end July 2022

Savills Commercial Research

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