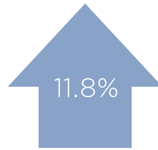
UK Commercial – Summer 2020

SPOTLIGHT

Savills Research

UK Retail Outlook Report

- Consumer demand outlook
- Latest insolvency activity
- Changes to leasing structures



Average year-on-year increase in UK restaurant covers during the first three days of the Eat Out to Help Out Scheme

Consumer and consumption trends

The reopening of hospitality has accelerated footfall recovery in some markets, however the feed through to city centres remains hampered.

The easing of lockdown measures has been met with a staggered recovery to footfall.
Consumers have been tentatively returning to high streets and shopping centres across the UK since the reopening of the retail and leisure sector. The graph below represents Google mobility data, detailing movement across retail and recreation locations indexed against a five week period pre-Covid. In the week to 2 August, total UK movement recorded a fall of 28% fall on average compared to pre-Covid. What's evident from the data is the significant surge in movement since the reopening of hospitality from 4 July in some locations, reinforcing the strong relationship between hospitality and physical retail.

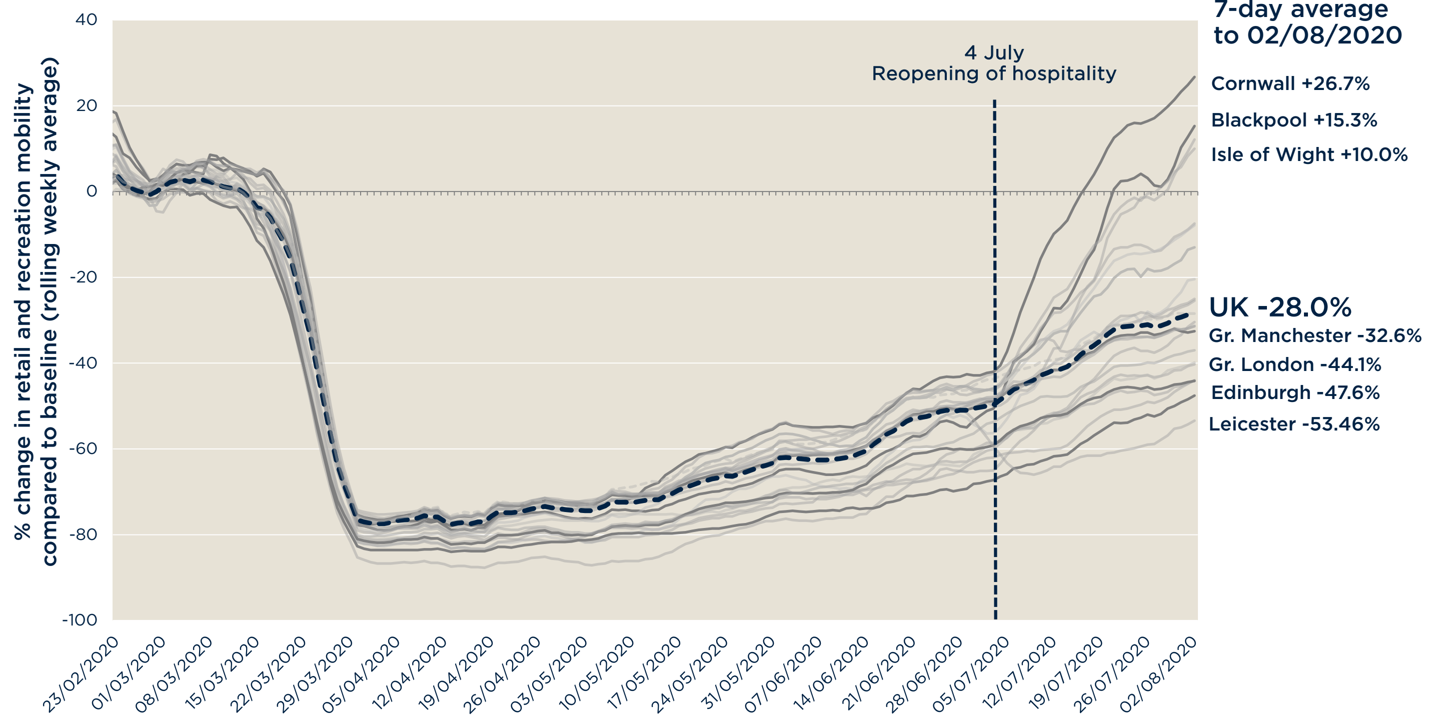
The majority of recovery has been steered by traditional leisure-led domestic holiday destinations, including Cornwall, Blackpool and the Isle of Wight, which are all now reporting positive growth compared to pre-Covid levels. The feed through to larger municipalities remains delayed in line with the ongoing absence of local office workforce and international tourism, while local lockdowns have been detrimental to recovery levels in locations such as Leicester.

In the leisure sector, a great deal of operators remain shut, emphasizing the current weakness in occupier confidence. However, government support packages and easing of some local planning laws are beginning to entice consumers back in many cases. OpenTable figures suggest year-on-year seated restaurant covers were in positive territory for the first time since pre-lockdown on 3-5 August (graph 2), in line with the inaugural week of the Eat Out to Help Out Scheme which was used more than 10.5 million times over the three days, suggesting it's contribution to the F&B sector could be instrumental at this time.

What do recovering footfall levels mean for retail sales?
The lasting economic effect caused by the pandemic and subsequent lockdown continues to restrict any major bounce in consumer confidence, with GfK's latest monthly index suggesting sentiment for spend remains subdued whilst personal saving is up. The potential increase in unemployment post-furlough drives ongoing uncertainty in the consumer market, during which the continuation of distancing measures and safety restrictions will hinder the potential for physical retail sales to flourish in the short-term. Savills data from key UK retailers indicates that trade has been slow to recover in destination-led retail places, with consumers continuing to favour local and convenience-based retail locations (table 1).

£20.1bn
Year-end 2020 retail spend is expected to be £20.1 billion below pre-Covid forecasts

Graph 1: Google mobility data suggests the recovery to footfall is being steered by leisure-led domestic holiday destinations, while city recovery lags behind.



Source Savills Research; Google Covid-19 Community Mobility Report

> “Early indications suggest that the peak in ecommerce seen in May, with 32.8% of retail being online, is now settling to a new level. The question is where to?”

Table 1: Retailer trade like-for-like data compared to early August 2019 emphasizes that consumers are favouring local and convenience-based retail locations.

Trade like-for-likes compared to early August 2019:	
London	-80 to -90%
Regional malls & city centres	-50%
Town centres	-20 to -30%
Retail parks	-8 to -10%

Source Savills Research

As a result, 2020 retail spend forecasts have dampened significantly with GlobalData estimating year-end volumes to be down 3.9% year-on-year, and £20.1 billion lighter than pre-Covid projections. This drop in spend is expected to be led primarily by those more exposed subsectors including fashion and footwear. However this isn't homogeneous across all retail segments with some submarkets enjoying a return to sales growth, above that of the same period last year. Foodstore performance continues to outperform, with take-home grocery sales up 16.9% for the 12 week period to 12 July, according to Kantar. The homeware sector also appears to have thrived as of recent, with the BDO July sales barometer recording a 33.6% year-on-year growth in like-for-like sales - a stark contrast compared to other subsectors and outstripping the UK average of -4.6%.

Since physical retail reopened, the sector has experienced a very measured recovery with spend likely to lag behind pre-Covid levels for some time. As a result, government support will continue to be pivotal for the survival of many businesses. However, recent improvements within parts of the market have begun to highlight elements of progress within the UK retail market.

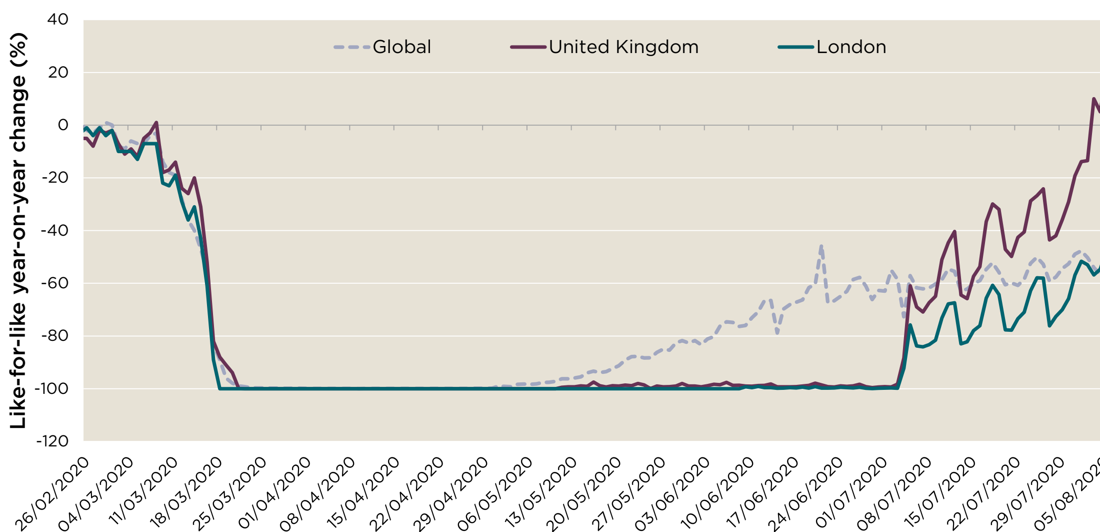
What is the future for ecommerce?

Early indications suggest that the peak in ecommerce seen in May, with 32.8% of retail being online, is now settling to a new level. The question is where to? Centre for Retail Research forecast that by the end of 2021, penetration will account for 24.3% of retail spend (up from 19.4% in 2019); this fits with our own analysis. If true, then this sees a five year acceleration in the move online.

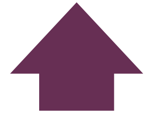
While footfall and hospitality sales may have begun to slowly recover, the latest figures show little abatement in the inexorable rise of online grocery shopping. Online sales for the period soared 92%, with one in five UK households having utilised the channel in some form to buy groceries. Online is now worth 13% of the total grocery market, up from just 7.4% in March when lockdown began and continues to be a compelling proposition for those that have already switched.

However, while online growth has been substantial, a significant proportion of all retail transactions remain instore. The increase in penetration will not affect all spaces equally, but will inevitably reduce some store portfolios and increase retail vacancy where the offer is not sufficiently in tune with the needs of the catchment.

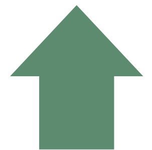
Graph 2: OpenTable year-on-year daily restaurant covers demonstrates the substantial increase in UK restaurant covers during the first week of the Eat Out to Help Out Scheme.



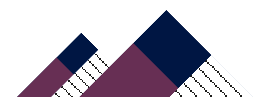
Source Savills Research; OpenTable



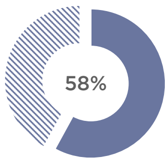
16.9%
Growth in take-home grocery sales for the 12 week period to 12 July



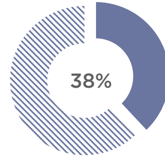
33.6%
Year-on-year increase in like-for-like homeware sales in July 2020



24.3%
Forecast year-end 2021 online penetration rate for retail spend in the UK, up from 19.4% in 2019



58% of stores to pass through an insolvency procedure in 2020 are 'town centre' assets



38% of stores to pass through an insolvency procedure in 2020 are 'out-of-town retail warehousing' assets

Retail and leisure insolvency activity

This year has seen levels of insolvency activity similar to that of 2019 however, with Q4 still remaining, we are likely to see an increase in the prevalence of operators facing financial difficulty in 2020.

How has retailer insolvency fared in 2020 in light of the pandemic?

This year a total of 4,158 retail and leisure units have been through an insolvency procedure up to the beginning of August, spread across 71 brand fascia's and 39 holding companies. This compares to 4,283 units, 45 fascia's and 38 holding companies the previous year.

The results suggests 2020 has thus far experienced insolvency activity on a par with the overall levels seen in 2019 however, with a quarter of the year remaining it is likely the overall volume of insolvency activity will eclipse the previous year in terms of the number of units that will be affected by one of the three procedures.

Interestingly we have seen 58% increase on the number of brand fascia's that have experienced insolvency in 2020, than in the previous 12 months. This highlights a recent emergence of a number of multi-fascia brands that have been met with financial difficulty, particularly in the leisure market. The Casual Dining Group's recent administration for example covers five fascia's including their Bella Italia, Café Rouge and Las Iguanas brands.

Which sectors have seen the worst of the insolvency activity?

Fashion and comparison goods retail were the sectors with the most insolvency activity in 2019, respectively accounting for 1,977 units (46%) and 2,070 units (48%) of all those that underwent either a CVA, administration or liquidation in that year. It is a similar story in 2020 with fashion (1,851 units, 45%) and comparison goods retailing (1,417 units, 34%) remaining the most prominent sectors to see insolvency activity so far. However, leisure now accounts for just over a fifth (21%) of all units to have entered an insolvency process in 2020, compared to only 6% the previous year, accounting for 857 units in 2020 compared to only and 263 units in 2019 (graph 3).

With much of the leisure sector unable to trade at all during the lockdown and the sector seemingly being the last to see some return in consumer traffic, it is unsurprising the sector has seen an increase in brands facing financial difficulty, particularly as the industry is service led and much less able to serve consumers online.

Conversely, the convenience sector sees a very low proportion of units subject to an insolvency procedure in 2020 (less than 1%). This is again unsurprising when supermarket and other food store operators were considered essential and allowed to remain open and trading after the government imposed sanctions on store closures in March. These operators recorded a 10.4% increase in sales in the following month in the early panic buying phase (ONS). Many have been reporting above average trading figures ever since.

2020 sees an increase in the prevalence of administrations as many operators seek outside investment to save their businesses.

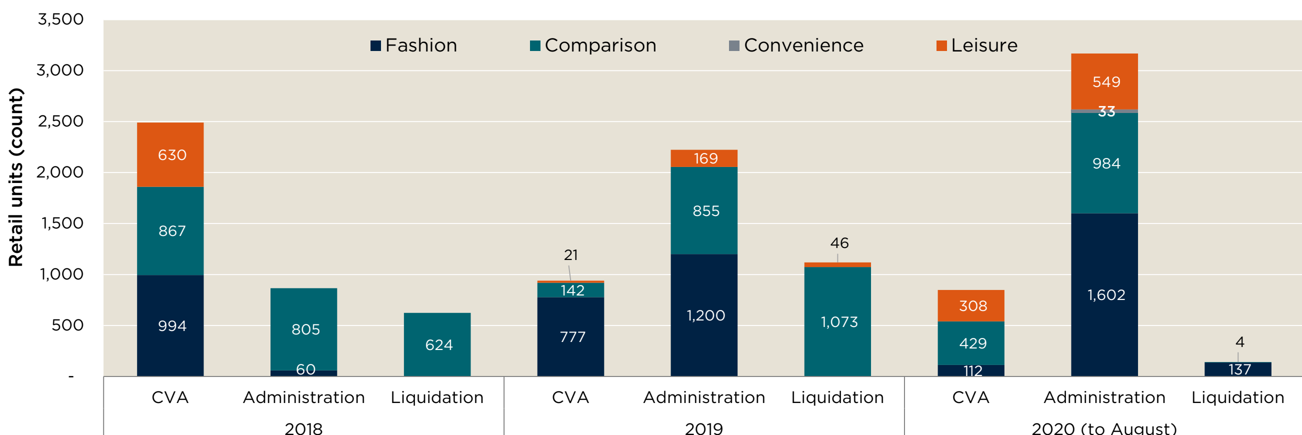
Administration has been the insolvency procedure most prevalent thus far in 2020, accounting for 3,168 and 78% of all insolvent units. The previous year this figure stood at 2,224 and 52%. Some degree of comfort can be taken from the fact that so far 2020 has not led to as many stores being liquidated as the year previous (141 units , 3% in 2020 versus 1,119 units and 26% in 2019). However, 2019 was skewed by the loss of a few brands with a lot of stores. Thomas Cook provides the most poignant example accounting for nearly 600 units, all of which were acquired by Hayes Travel and thus very quickly re-let. Many of the retailers to enter administration in 2020 will be still be looking for buyers so it remains to be seen how many stores or indeed brands will be lost altogether through liquidation.

Nevertheless, thus far 1,091 stores have closed as a result of an insolvency procedure in 2020, representing 26% of those that have passed through one of the three insolvency procedures. This compares favourably, at least for the time being, to the figures recorded for 2019 where 1,921 stores closed, representing 45% of those that had passed through a CVA, administration or liquidation that year.

In 2020 more units have been subject to a rent reduction, albeit marginally than was seen in 2019 (621 representing 15% versus 550 and 13% respectively). However, more units in the current year remain trading and honoring their rental agreement (1,646, 59%) than was the case by the end of 2019 (1,460, 42%).

Before Covid-19 the retail and leisure industry was already seeing a structural change in terms of rents. This has been compounded further by the pandemic where a reduction or complete lack or trade has meant many more retail operators have sought to reduce costs more quickly through an insolvency procedure, to ultimately to lower their rent roll or streamlining their portfolio of stores. How much worse 2020 will prove to be in this regard compared to the previous year due to the added pressure of a global pandemic remains to be seen, however we almost certainly haven't seen the last retail operator to pass through an insolvency process.

Graph 3: Annual insolvency activity highlights the volume of retail and leisure units affected annually by each procedure and market type.



Source Savills Research

> **Turnover rents have been discussed in the industry for years, with 90% of retailers already having existing turnover leases within their portfolios.**

Rents and lease negotiations

Covid-19 has adversely impacted much of the retail sector, resulting in increasing demand for alternative leasing models.

What impact will Covid19 have on rents?
As the fallout from the pandemic takes its toll on the property sector, £1.5bn of March rent payment remain unpaid in UK commercial property. Savills analysis shows that retail park rent collections were at 53% and 52% in June and March respectively, while shopping centres went from 45% in March to 39% in June. This puts significant pressure on landlord's own income streams, while forcing the issue on whether current rental levels and leasing formats are sustainable.

As a consequence, 86% of landlords expect shopping centre rents to fall, with rents anticipated to fall by 22% on high street, 30% in shopping centres, 13% on retail parks and 34% on leisure schemes, by the end of 2021, following the Covid-19 pandemic (graph 4). RICS forecasts rents for retail properties to fall 10%-14% this year alone.

On average retailers are typically seeking an average of 30% reduction in rent across their estates, or are seeking alternative lease models, such as turnover rents. At the end of 2019 turnover deals accounted for <10% of UK leases, but have come under the spotlight recently due to Covid-19 forcing a rapid reflection by the whole retail industry of the future role that affordability should play in what tenants commit to paying their landlords.

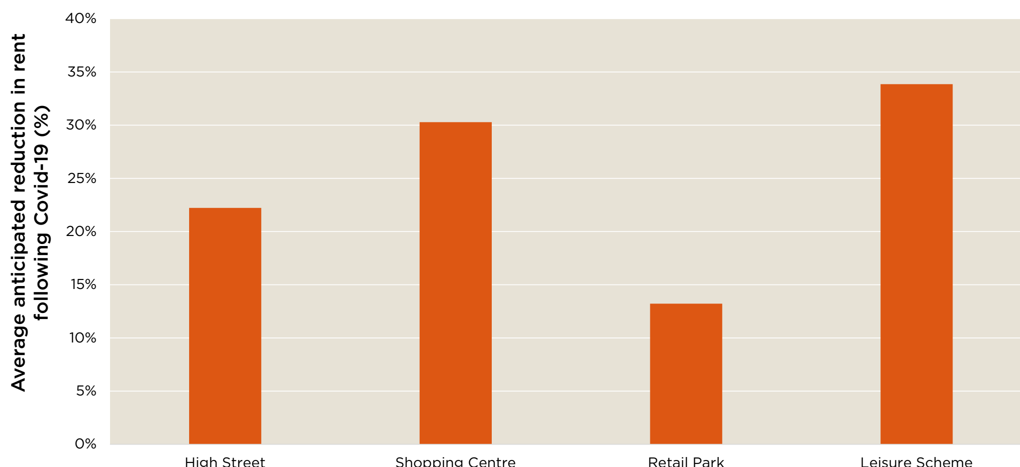
Will turnover rent negotiations change the retail sector for good?
Turnover rents have been discussed in the industry for years, with 90% of retailers already having existing turnover leases within their portfolios. With challenges in the retail sector over the last decade more retailers have been keen to seek more affordable rent agreements. Landlords have traditionally been reluctant to commit to turnover leases in the long term as they rely on the security of income and valuations that are still based on upward only rent reviews.

However, landlords are proving to be much more open to restructuring their leases and a significant proportion of the discussions Savills are involved in include negotiations around turnover based rents. However, recent negotiations are not necessarily intended by landlords to be a permanent fixture, but more of a way of navigating the current challenges in the sector; 74% of landlords anticipate current arrangements to only be in place for up to 24 months.

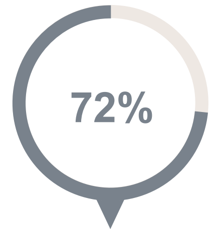
Turnover rents are by no means a straightforward alternative to traditional upward only market based rent reviews, with few deals being identical and the terms agreed retailer, product category or location specific. Analysis of Savills rent negotiations shows that turnover rents requested by retailers range from 1%-15%, with an average of 7%. However, the detail is far more complex. Almost all deals are in some way unique, either from the turnover percentage, or baseline with ratchet top-up, or inclusion of service charges. Turnover rents may be separate from service charges, or be higher and include provision. The advantage of the latter is that the retailer has a clear view on affordability. In many parts of Europe, rents are based on Effort Ratios, where total property costs as a proportion of turnover are designed to create sustainable rental affordability.

Balancing affordability with transparency
It could be argued that a margin based rent makes even more sense than turnovers. Margins vary significantly across the sector and could therefore be a fairer approach for each type of retailer, regardless of the products they sell. Two retailers with the same turnover could have very different levels of profitability depending on what they sell and their price point. The problem is transparency. Increasingly retailers are prepared to share their turnover with landlords, but not their full P&L. And yet if they did landlords could make more

Graph 4: Percentage of landlords anticipating rent reduction and average rent fall expected

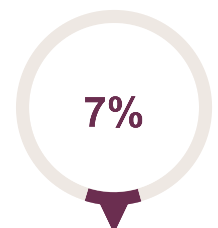


Source Savills Research



72%
of landlords already had some turnover deals on their assets

Turnover deals current account for an average of **10%** of leases



7%
is the average turnover percentage sought by retailers

> Savills analysis has recorded a threefold increase in leases shorter than two years between 2018 and 2020.

informed decisions about their assets and invest accordingly to help secure the long term futures of the schemes, to the benefit of both parties.

Another added complication of turnover based rents is how a sale is attributed to a store. Some brands have a significant proportion of online sales, but use the stores for showrooming, click & collect, or returns. While a lot of work has been done on the 'true value of the store' in a multichannel world, no-one has yet worked out the true value that a specific store in a specific location has in an ecommerce transaction. For F&B/leisure measuring the performance of a specific property is more straightforward and we already see quite a few tenants within this space on turnover based arrangements.

Challenges with valuation

A secure income is likely to remain the landlord's preference and therefore fixed-rate leases over a longer term will likely still be the first choice. Of course in the current environment this doesn't mean landlords will get what they want. Leases are shortening (graph 5) and several landlords are looking to opt for a hybrid model with a base rent plus a turnover top-up. This can be preferable for a retailer compared with a fixed-rate lease and still provides the landlord with some level of income security.

Perhaps the biggest challenge for the property sector of turnover based leases is with asset valuation. Firstly, valuation based on turnover leases typically reviews the previous three years sales evidence and asset values become closely aligned to the volatility of market economics and consumer confidence, rather than based on landlord guaranteed income over the long term. Secondly, in many markets where there is little history of turnover leases there is no comparable evidence. Thirdly, property value becomes heavily weighted to the turnover of a specific store rather than the benefit that store has in the retailer's supply chain. While Valuers in Europe have contended with these problems for some time, it is evident that it remains incredibly challenging and is far from a perfect solution.

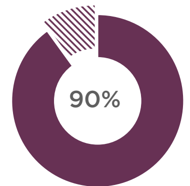
How are lease lengths reducing?

Lease lengths have reduced significantly in recent years. Savills analysis has recorded a threefold increase in leases shorter than two years between 2018 and 2020. In 2016 leases of 6-10 years accounted for around 55% of deals, but by 2022, 90% of new leases are anticipated to be shorter than five years.

Lease terms requested by retailers average 5.5 years, with several retailers keen to fix terms for 10 years. However, it is currently more common for landlords to agree and switch to turnover terms for shorter periods (two years) to help navigate the current market challenges, but not commit for the long term. However, this cannot happen within the L&T54 Act as that would make any new agreement a permanent fixture. Therefore several landlords are looking to agree short term deals outside of the Act; which many in the industry already see as applying outdated constraints to leases.

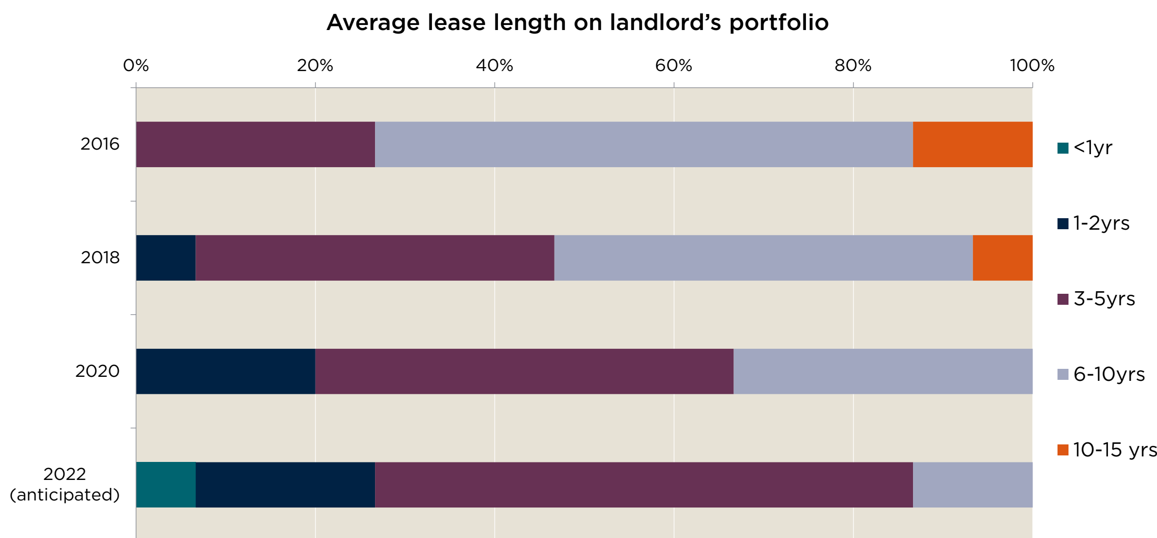
It is worth highlighting that the vast majority of leases will remain untouched by the end of the crisis and current projections suggest that at the end of 2020 turnover leases will still account for fewer than 10% of leases.

Without a lease expiry event on the horizon there is little impetus for landlords to consider re-gears or alternative leases, so much of the noise we are seeing at present is a trickle of deals being agreed. The majority of leases that have no events coming up are likely to remain on traditional rents for the time being. However, L&G and Hammerson have both voiced their intention to introduce a more flexible approach to lease structures over the coming years.



By 2022, 90% of new leases are anticipated to be shorter than five years

Graph 5: Average lease length on landlord's portfolio indicates that lease lengths have reduced significantly in recent years.



Source Savills Research

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

Alan Spencer
UK Retail
+44(0)20 7758 3876
aispencer@savills.com

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

Research

Tom Whittington
Commercial Research
+44(0)161 244 7779
twhittington@savills.com

Sam Arrowsmith
Commercial Research
+44(0)161 277 7273
sarrowsmith@savills.com

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

Savills plc: Savills plc is a global real estate services provider listed on the London Stock Exchange. We have an international network of more than 600 offices and associates throughout the Americas, the UK, continental Europe, Asia Pacific, Africa and the Middle East, offering a broad range of specialist advisory, management and transactional services to clients all over the world. This report is for general informative purposes only. It may not be published, reproduced or quoted in part or in whole, nor may it be used as a basis for any contract, prospectus, agreement or other document without prior consent. While every effort has been made to ensure its accuracy, Savills accepts no liability whatsoever for any direct or consequential loss arising from its use. The content is strictly copyright and reproduction of the whole or part of it in any form is prohibited without written permission from Savills Research.