UK Commercial – Winter 2019

SPOTLIGHT

Savills Research

UK Retail Warehousing

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● Robust store openings despite falling rents ● Price gap narrowing between vendors and purchasers

> **Consumers remain marginally positive about the prospects for their own financial situation, and whether now is a good time to make a major purchase.**

2019 looks set to have been the weakest year for the retail warehouse investment market since the recession. However the last few years have been somewhat of an anomaly as investors have held fire for two reasons, namely to see how far prices may fall given the structural change in rents and what will happen in the investment climate post a decision on Brexit.

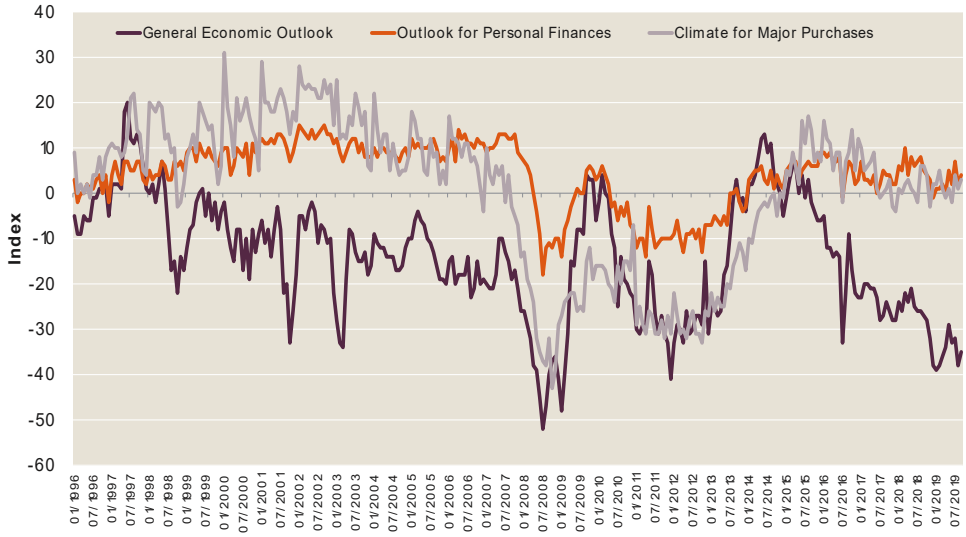
The outlook for 2020 has a few rays of positivity around it, with a reasonably positive consumer story and signs that retailers are selectively expanding their retail warehouse portfolios.

While much of the focus on the market in recent years has been on closures, it is less commonly noted that the number of store openings across the UK market in 2017 and 2018 was well above average. This story looks likely to have continued in 2019.

Given that the bulk of this demand is driven by value retailers, it is reasonable to assume that the pace of store openings will continue in 2020, even against a background of weak consumer confidence.

The major challenge for next year will be around the gap between purchaser's and vendor's expectations on price in the investment market. We believe that 2020 will see some major new opportunistic entrants into the retail warehouse sector, driven by both the correction in prices and the comparatively sustainable story around retailer demand and its internet compatibility.

Figure 1: Consumer confidence



Source GfK

Consumer trends

Surprisingly strong retail sales growth might be about to cool.

While retail sales growth in the UK remains surprisingly strong, growing by 3.1% over the year to the end of October, there are one or two worrying trends that have emerged in the recent data.

The most recent GfK consumer confidence data shows a continuation of the trend of the last two years, with consumers remaining marginally optimistic about the prospects for their own financial situation over the next 12 months, but very negative about the outlook for the UK economy over the same period.

While the various PMIs are pointing to the UK avoiding a second consecutive quarter of falling GDP growth, the latest labour markets numbers are hinting that consumer confidence might weaken over the next few months.

The latest employment data showed a slight fall quarter-on-quarter in the employment rate, but a rise year-on-year. However, the unemployment rate remains low at 3.8%.

There was also a decline in job vacancies, indicating that companies in the UK might be reining in growth plans in anticipation of a weaker than expected 2020.

Most importantly for the retail sector, the data on average earnings also showed a slight easing in earnings growth, and we suspect that the earnings growth may have now peaked for the short-term.

None of these metrics are particularly worrying, given that employment is still not far off its record high, and the jobless rate is also close to a record low. Also, the low rate of inflation is supporting stronger real earnings growth. However, people's spending and saving patterns are very susceptible to changes in sentiment, and as we have commented upon in the past, the biggest risk to the UK consumer economy is probably a rise in precautionary saving.

The UK savings ratio remains close to record lows, and this leaves households with a relatively thin cushion if they feel that there is a need to tighten belts. We believe that a hard Brexit would result in a sharp rise in consumer uncertainty, and a corresponding rise in the savings ratio (and hence a fall in spending).

The fact that a Brexit decision has now been delayed is probably good news for retailing in the short term, as it limits the risk of consumer shock in the final 'golden quarter'. However, we are now entering the time of the year where it has become traditional for some retailers to make cautious noises about Christmas trading (which are then dis-proven in February trading statements). We expect trading once again to surprise on the up-side, but retail sales growth is likely to be slightly weaker in 2020 than 2019.

Occupational market

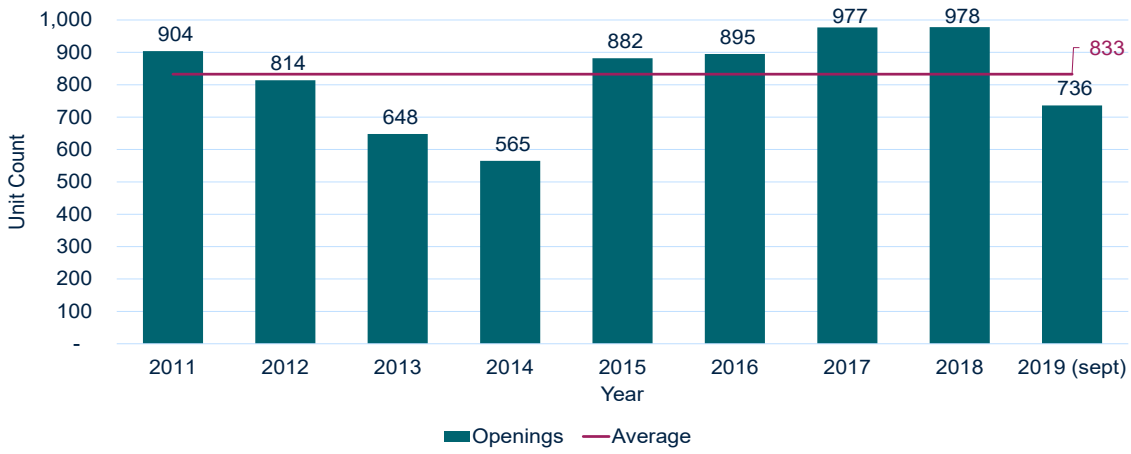
Out-of-town store openings remain robust as value-orientated operators look to take advantage of falling rents.

The retail warehouse market is in the midst of a structural change with regard to rents. Many of the 25 and 15 year leases signed up to the millennium are reaching maturity and going forward retailers are requiring more flexibility in their lease terms. We have already begun to see this evolution in retail manifest with the move towards shorter lease lengths in the market. However, what the flurry of CVA's and administrations in the last eighteen months or so has taught us is perhaps a more innovative approach to valuing a store is worthy of investigation, one which benefits both operators and their landlord. A performance related rent might be one such example, whether turnover based or linked to brand exposure in a given catchment. In the meantime alongside shorter leases we are seeing headline rents fall across the UK retail warehousing market, particlarly on the sectors largest units; how much further such rents will fall is yet to be seen.

The decline in rental values however has not been indicative of a market struggling to get deals over the line. Figure 2 highlights an above average number of store openings over the last four years. 2019 looks on course to follow that trend with 736 new openings to date, with less than 100 openings required to meet the average of the last eight years. It is yet to be seen whether 2019 store openings will reach the heights of the previous two years, c.250 lettings are still needed to reach that level. However what is clear is a number of retail operators, especially the discounters and value-oriented brands, are seizing the opportunity to acquire space at a more favourable rent. Figure 4 highlights how 8 of the top 10 brands that have taken new space are value based retailers when ranked by number of units, 6 out of 10 when ranked by overall floorspace.

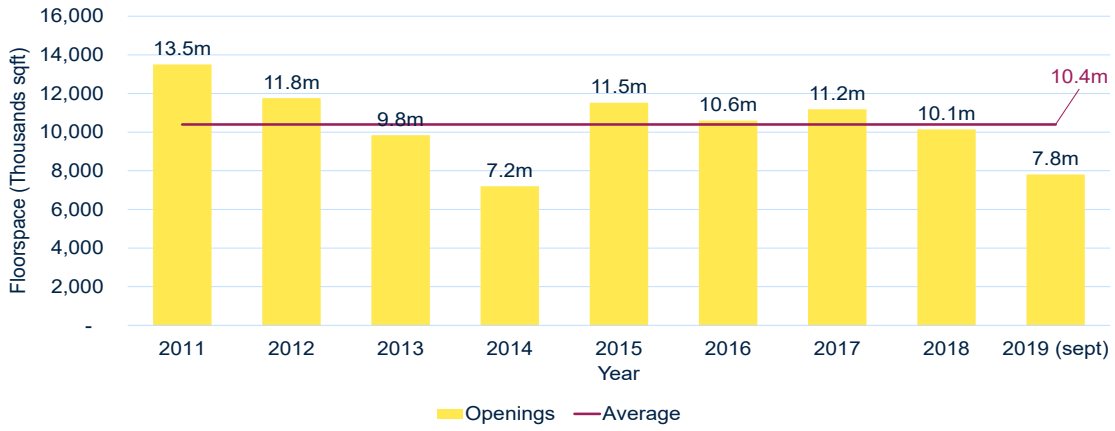
This trend goes beyond just the most acquisitive brands. When we look at the UK market as a whole value-orientated retailers now account for a greater proportion of new openings than mass market brands,

Figure 2: Annual out of town store openings by units



Source Savills

Figure 3: Annual out of town store openings by sqft



Source Savills

736

new openings in Jan-Sep 2019, with less than 100 required to meet the

49%

of new openings have been by value orientated operators in 2019

197

new leisure openings in 2019 (including F&B) making it the leading sector

> **Schemes Savills have been involved with have seen a 17.8% decrease in rents since 2016, from an average of £28 psf to £23 psf at present.**

albeit by the smallest of margins; value brands have accounted for just under half of all new units so far in 2019 (figure 6).

Whatever the answer to the Brexit question, 2020 will undoubtedly continue in the same vein as 2019 and prove to be a challenging year for many retailers, and this will continue to have an affect on occupational demand. However should consumers prove to be more cautious in their spending habits it is likely to be the value end of the spectrum that will benefit most, suggesting the strong growth in demand from value retailers will likely continue.

On a sectoral basis comparison, grocery and leisure retailing are at the forefront of out-of-town openings (figure 5). This is unsurprising when you consider B&M, Home Bargains and The Range from a comparison point of view and Aldi, Lidl and Iceland from the grocery perspective, are leading the charge of store openings both in terms of place and space. Analysing out of town openings by sqft provides further interesting insight. Aldi, Lidl, B&M, Iceland, Home Bargains, M&S, Smyths Toys and The Gym are all taking small to medium sized units that are on average between 10,000 and 20,000 sqft. As a result the last three years have seen total additional floorspace in the UK broadly in-line with the average for the last 8 years at 10.4m sqft (figure 3), significantly less than the space being taken in the pre-recession big box era of the late nineties and early two-thousands.

Those retailers that are expanding their portfolio's or renegotiating existing leases will continue to have the balance of power in most negotiations as the market continues to see structural rental change. Coupled with the fact much of UK retail warehousing is still over-rented we are likely to continue to see a fall in rental income in the short-term, as well as a downward pressure at the very least, on what is already a gentle growth forecast in the longer-term. Over the next five years Real Estate Forecasting estimate retail park rental growth of 0.5% per annum, with most of that growth towards the end of that period, with falling rents over the next two years. Nevertheless vacancy remains comparatively low compared to other sectors at 4.9%, marginally higher than this time last year at 4.7% but lower than it was in H2 at 5.0%, on a sqft basis. This will help reduce the rental encumbrance, but certainly not eliminate it all together.

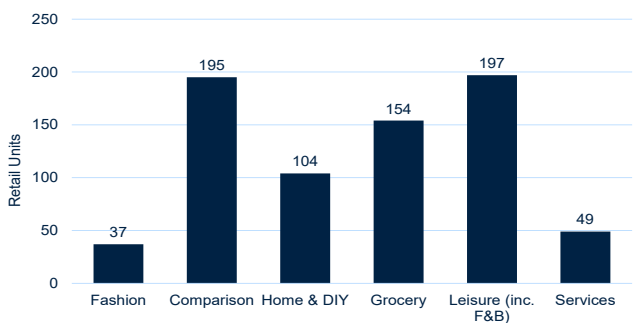
Figure 4: 2019 YTD top ten out of town store openings by operator

Ranked by floorspace			
Rank	Operator	Units	Floorspace (sqft)
1	Lidl	38	758,300
2	B&M	37	744,800
3	Range	15	686,000
4	Aldi	41	657,300
5	Home Bargains	22	467,900
6	Iceland	34	352,000
7	IKEA	1	350,000
8	M&S	14	172,000
9	Smyths Toys	10	156,400
10	TheGym	11	121,400

Ranked by units			
Rank	Operator	Units	Floorspace (sqft)
1	Aldi	41	657,300
2	Costa Coffee	39	68,800
3	Lidl	38	758,300
4	B&M	37	744,800
5	Iceland	34	352,000
6	Greggs	25	35,100
7	Home Bargains	22	467,900
8	Range	15	686,000
9	M&S	14	172,000
10	One Below	14	81,800

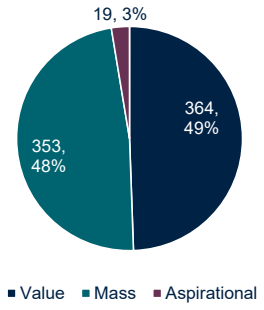
Source Savills

Figure 5: 2019 YTD out of town store openings by category



Source Savills

Figure 6: 2019 YTD out of town store openings by retail pitch



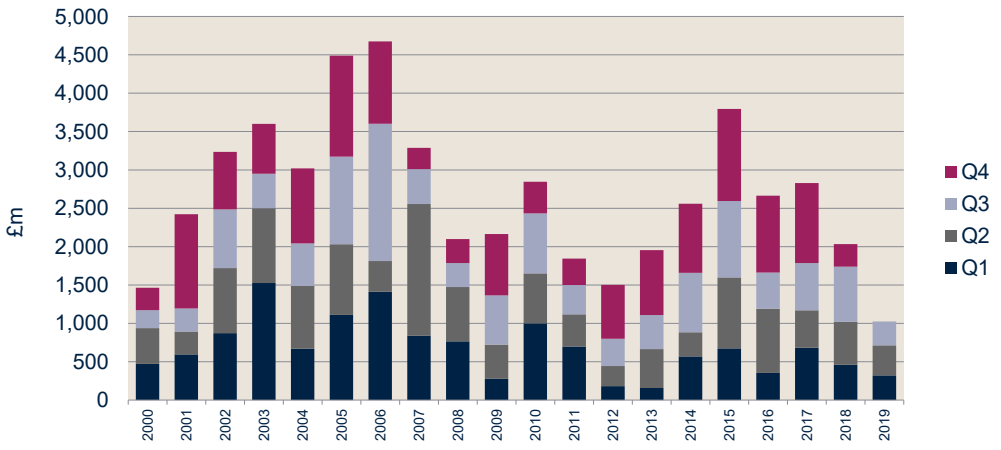
Source Savills

> **What is clear is that a number of retail operators, especially the discounters and value-oriented brands, are seizing the opportunity to acquire space at a more favourable rent**

Investment market

Opportunistic buyers have waited longer than expected, but the gap between vendor's and purchaser's expectations on price is drawing ever narrower.

Figure 7: Retail warehouse investment volume



2018 saw the weakest trade year for retail warehouse assets since the global financial crisis with just over £2bn worth of transactions in total. 2019 looks set to be even more exiguous with just under £1bn of assets traded by the end of Q3, broadly where volumes were at the mid-year point the previous year. As was the case in 2018 we are unlikely to see a rush of activity in Q4 either, as investors remain cautious as Brexit drags on and lack of transactional activity confuses pricing expectations. The lack of activity seems therefore to be more about timing, than the suggestion of a paucity of transactional activity on the horizon in the long-term

The pertinent question for 2019 was whether the impact on pricing brought about by investor caution the previous year was enough to stimulate a number of opportunistic buyers. However it seems the lack of transactional activity has delayed repricing further and many investors have chosen to wait to see how far capital values may fall before seizing any opportunity.

Furthermore the retail warehouse market is undoubtedly undergoing a structural change in terms of rents. The squall of CVA's in the last eighteen months have exposed the antiquity of the current lease structure in the UK and the retail warehouse market is no exception. Investors have therefore also been holding out to see where the bottom is in terms of rental income and what further effect that will have on the pricing of assets in the sector.

Nevertheless the gap between vendors expectations on an assets value and a purchasers speculation on how far prices might fall have narrowed, particularly where values have fallen far enough to better support the rent cuts and hence enhance lettability.

Of course a decline in rent and fall in capital values has subsequently led to further softening in yields throughout 2019. There is an increasingly wide gap between primary and secondary assets. For example, while Prime Open A1 and Prime Restricted park yields have softened by 25bps, their secondary equivalents have done so by 75bps and 50bps respectively since December of last year.

Investor interest in the sector therefore remains robust as its fundamentals remain comparatively solid. Once a degree of certainty has returned to the UK following a decision on Europe the foundations are in place for investors to deploy comparatively large volumes of capital into the sector where both current values and potential future earnings look attractive.

We expect prime yields to remain broadly stable in 2020, though further softening in secondary and tertiary yields is inevitable. The most in demand assets will be those that dominate their catchment and offer a mix of retailer types, as well as offering comparatively long WAULTs. We believe that the sweet spot for investors will be mid-size schemes that are too large for private investors, but too small for the global opportunity funds.

Investors looking to take advantage in the not too distant future would be wise to move swiftly when the time is right. Although there is a wider variety of willing sellers present than in other asset classes it is a myth to suggest that the whole of the market is up for grabs – when the current stock of investable assets is gone, it's gone!

Outlook

Key themes for 2020

Brexit has once again been delayed, however this may prove to be a welcome hiatus for UK retailing, limiting the amount of reactionary belt-tightening that may have occurred in the approach to the key Christmas trading period.

Rents have been falling amidst a structural change in leasing that has taken place over the last few years, which includes a move toward shorter lease lengths. Despite this we have seen above average store openings in the same period with 2020 looking likely to follow suit. What is clear is the more acquisitive operators are using the opportunity to secure space on more favourable terms.

Value orientated brands continue to be the most expansionary retailers in the retail warehousing space and that trend looks set to continue especially if consumers adopt a more precautionary stance on saving in a (eventual) post Brexit era.

Leisure operators (including F&B) continue to lead the acquisition league tables from a sectoral point of view, as the quality of such space that supports the existing retail provision continues to rank highly for the needs of the consumer.

Comparison and grocery are not far behind in terms of the number of new openings by sector. This is unsurprising considering Aldi, Lidl and Iceland and The Range, Home Bargains and B&M are all in the top 10 list of retailers acquiring space.

Vacancy remains low and has barely moved since this time last year. This will ease some of the downward pressure on rents we are currently experiencing but by no means eliminate it.

Savills Commercial

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Retail warehouse services

Dominic Rodbourne
Leasing
+44(0)20 7409 9945
drodbourne@savills.com

Jaime Dunster
Investment
+44(0)20 7409 9929
jdunster@savills.com

Charlie Mocatta
Professional
+44(0)20 7409 8726
cmocatta@savills.com

Matthew Whiteley
Management
+44(0)161 277 7232
mwhiteley@savills.com

Research

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

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