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Spotlight
UK Retail Warehouse Market

March 2013

Image: Forbury Retail Park, Reading. Recently sold on behalf of.UBS.

SUMMARY

■ We expect 2013 to be a better year for the UK consumer than 2012. Inflation will fall and real earnings growth should move back into positive territory.

■ Retail warehouse investment volumes fell to their lowest level for a decade in 2012. However, we think that 2013 could offer some interesting opportunities for investors.

■ The leasing market remains extremely polarised, both in terms of tenant's locational requirements, and sectors where there is growth and contraction. We believe that the majority of retailers have now adapted to the "new norm", and that 2013 will see some tactical expansions against a background of rental rebasing.

■ In our special feature this issue, we speculate on why non-domestic investors have generally avoided investing in retail warehousing.

"2013 might offer a unique opportunity for some retailers to capitalise on change and sentiment."
Dominic Rodbourne, Savills

Will 2013 be a better year for the shopper?

While the Christmas period is arguably less important to the more traditional retail warehouse retailers than to the high street, it is still a time of year when every retailer hopes for a boost in trade. So, how did retailers perform over Christmas and New Year 2012?

Now that the euphoria of the Olympics and Royal Jubilee has long since passed, it is clear that the UK economic outlook has worsened over the summer. The majority of forecasters, including us, were expecting inflation would have fallen further by now. However, external factors such as the drought in the US this summer, as well internal factors like the rise in student fees, have kept CPI stubbornly above its target rate of 2.0% (2.7% at present).

This is a decent slowdown from a year ago when prices were rising by more than 4% per annum, but it still is not quite as low as it needs to be to stimulate a pick-up in consumer confidence and behaviour. Indeed, as Graph 1 shows, consumer confidence remains resolutely weak (despite a strong improvement this month).

We remain of the view that not only is the path of inflation downwards, it will remain at 2% or below for a sustained period. This is vital for UK retailing as at present real earnings growth is virtually zero, and that is a major drag on households' willingness to spend - even before you add in the widely perceived need to save for a rainy day, or at least to pay down some outstanding debt.

However, consumer behaviour doesn't have much to do with statistics, and the last three Christmas periods have taught us that after 11 months of austerity the UK consumer likes to loosen his or her belt. 2012 was no diffferent, with an overall average LFL sales increase of +2.1%. However, what was notable this year was even less clarity than normal on margins, which leads us to guess that sales were delivered at the expense of margins once again.

Generally we expect that the UK economic recovery will be more tangible in 2013 than it was in 2012. Unemployment will fall, albeit rather slowly and with a southern bias. The amount of spare capacity in the economy will mean that inflation falls below 2% in 2013, and heads on downwards to around 1.5% through 2014 and 2015.

This will be combined with the beginnings of real earnings growth, and a corresponding pick-up in consumer spending. If we don't see a recovery in consumer spending in 2013, then the UK will be in a very poor economic situation, as government consumption will be falling in 2013 and 2014.

Our current view is that consumer spending will rise by 0.5% next year, and this will contribute to overall GDP growth of just under 1.5%. 2014 will be better, with consumer spending rising by more than one percent, and the UK economy growing by 2.5%.

Investment market overview

2012 was the quietest year for investment in retail warehousing in the last 13 years (Graph 3). However, this has more to do with lack of stock coming to the market than the actual investment performance of the sector.

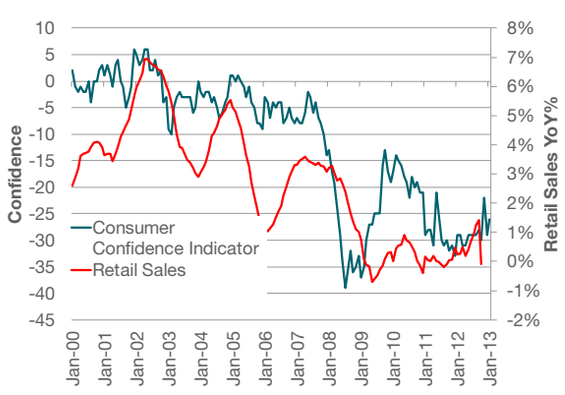
Indeed, as Graph 2 shows, retail warehousing has continued to out-perform IPD's All Retail and All Shopping Centre indices for the 12 months to the end of January 2013. However, with an annual average total return of 1% on IPD's monthly index, it looks likely that 2012 will be one of only a handful of years in the last 25 that the sector has delivered an annual return of below 10%.

Average retail warehouse rental growth over the last 12 months has been broadly flat (-0.15%), and while this is pretty unexciting it isn't too bad in an environment where rents on virtually every IPD subsector outside London are falling for the same period. Indeed, when we analyse retail warehouse rental growth by region it is only schemes in London that have shown any rental growth over the last 12 months (1.11%).

Elsewhere in the UK retail warehouse rents have continued to fall, with the latest IPD monthly index for the Midlands & Wales showing a slight fall of -0.39%, and the North & Scotland a similarly modest year-on year decline of -0.49%.

GRAPH 1

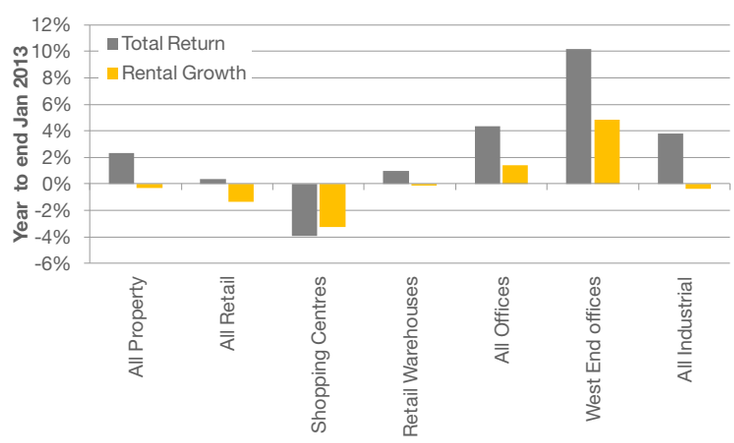
Consumer confidence and retail sales



Source: ONS, GfK

GRAPH 2

Comparative total returns and rental growth



Source: Investment Property Databank

Average yields on retail warehousing have softened slightly over the last six months, from 5.84% to 5.99% on IPD's All Retail Warehousing initial yield measure. Our own monthly analysis of prime retail warehouse yields has shown remarkable stability over the last 12 months, with Restricted parks standing at 6.00%, and Open A1 consented parks at 5.25%.

In common with most of the rest of Europe's property markets, the biggest pricing change in the retail warehouse sector this year has been in the spread between prime, secondary and tertiary yields. Investors remain highly risk-averse and for many this means that they won't look at any assets other than prime. This has led to a steady rise in secondary and tertiary retail warehouse yields, and we estimate there is now over 125 basis points between prime and secondary yields in the sector.

Liquidity in the sector has remained low, in part due to the majority of investors wanting to buy prime and nobody wanting to sell it. Furthermore, we believe that with the very low level of development activity in this sector and the traditional lifecycle of a park being developed by a property company, then sold to a fund has broken down. An increasing proportion of the UK's retail warehouse stock is owned by a handful of investors who have built up significant knowledge of the sector. In general, these funds and property companies are focusing on the income stream from their investments, and have no plans to sell them until they go ex-growth. This means that investment volumes are likely to remain low for the foreseeable future, and that when an occasional high quality asset does come to the market, then it could be hotly contested.

Looking ahead, we do expect the retail warehouse rents will return to growth in 2013. However, the average annual growth rate is likely to be fairly anaemic, and highly location dependent. Overall we are predicting that the national average rent will rise by 3% per annum over the next five years, but this is heavily skewed upwards by strong growth in and around the M25.

Average yields will continue to

TABLE 1

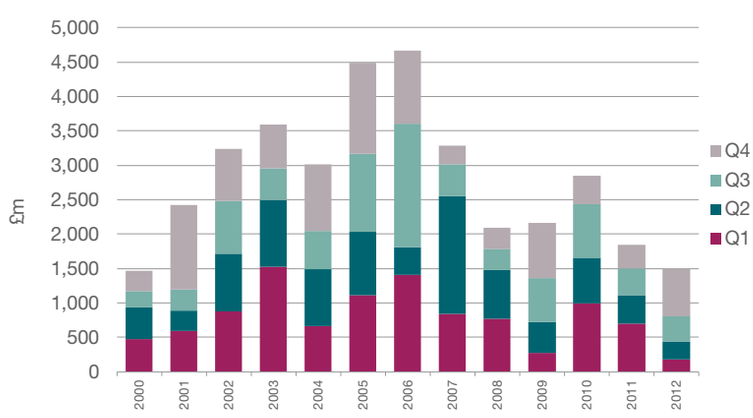
Retail warehouse yields

	Dec 2009	Dec 2010	Dec 2011	Dec 2012
Shopping Park	6.50%	5.00%	5.25%	5.25%
Prime Open A1	6.75%	5.00%	5.25%	5.25%
Prime Restricted	8.50%	6.25%	6.00%	6.00%
Secondary Open A1	8.00%	6.00%	6.50%	6.50%
Secondary Restricted	9.00%	6.75%	7.50%	7.75%

Source: Savills

GRAPH 3

Retail warehouse investment volume



Source: Savills

Investment outlook

Jaime Dunster looks ahead to the investment market in 2013

2013 has started with renewed enthusiasm from agents and investors, ready to consign the travails of 2012 to history. Hopefully turnover levels will improve from the 12 year low of last year and the cash is certainly there to be invested. The biggest issue is if there is going to be anything suitable to invest in? The old problems of the DNA of the owners being too similar is still prevalent and unlikely to change quickly. Requirements are showing signs of optimism, and whilst principally crowding round the high calibre end of the spectrum, the lot sizes are increasing but still the £20m - £40 m sector being the most densely populated. Interest up to £100m and beyond can be readily identified for the right product. Interestingly , and very welcome, is the return of some opportunity funds to freshen up the process.

The investment optimism seem to be at odds with the occupational picture. Certainly, there is generally too much retail space, which means too much retail warehouse space, and yet it is a format that the retailers are keen on. Tenant failure seems to be constantly in the news and whilst the level of failures is unwelcome it should not come as a surprise. Retailers fail in good times and bad, now just seems to be worse than most situations, and thus investors in retail need to be prepared for these eventualities. Fewer tenants coupled with less tenant demand will put increasing pressure on poorer schemes, especially where lease expires are looming. Quite a lot of towns have more units occupied than the retailers need and forthcoming lease expiries could shake the tree a little too firmly for some. Hence, the predilection amongst the investors for good and/or dominant schemes.

Those brave enough to venture into less crowded waters will have not only have fewer competitors, but some yield comfort as well. It may be for the brave of heart but there will still be some gems to be found.

Generally we seem to be adapting to a new normal. Owners are keen to let vacant units as quickly as possible, very different to the early 1990's and 2000's when preservation of historic ERV was the holy grail. True rental clarity is now available and the valuing of over rented units commonplace.The current climate is placing pressure on traditional aspects of retail warehouse ownership; long leases, good covenants, limited supply through planning, asset management and continued rental growth, and many cause some investors to pause for breath in their investment strategy. A little more activity and 2013 could be an exciting one, hopefully not merely wishful thinking. None of us may like the current conditions, but we are all becoming more comfortable with them.

soften, particularly in locations where rents are being rebased, however we expect prime yields to stay stable at their current levels. Indeed, the likely scarcity of prime retail warehouse investments could support a small amount of yield hardening on the best schemes in the best locations.

Leasing market overview

We have long been of the view that retail warehousing was one of the most anti-recessionary segments of the UK retail property market. Given that the sector evolved to deliver large units at low rents, it should be a more sustainable option for high street retailers who are looking to preserve margins, as well as the more traditional DIY and bulky goods players. 2012 has, to a degree, supported this view, and while the sector has by no means been immune from retailer downsizing, it has also benefited from the growth of the value retailer and its comparatively lower rents.

It should probably come as no surprise that the value retailers such as B&M Bargains, 99p Stores and Poundworld have all followed The Range out-of-town. Retail warehouse rents remain on average 30-40% lower than the equivalent high street, and for the discounters this means that they can offer a much wider range for a similar rent package. While their move onto parks might have been held up slightly by some landlords concerns about covenant or image, the twin factors of evolution and necessity have led to a steady stream of new value retail openings on retail warehouse parks this year (often filling in gaps left by retailers who have failed.)

The rental differential with the high street has not just been attracting expansion from value retailers. This year we have continued to see requirements from high street retailers who have become comfortable with the out-of-town format such as Next and Boots. Next have long been a supporter of the format, but their new Ipswich store is an indication of a desire to experiment with a more department store type format, offering homewares and gardening products in addition to their traditional clothing. Anecdotally we are hearing that these new stores are trading extremely well, and we expect to see further openings in 2013 and beyond. Again, the rationale for this move harks back to the roots of the sector - lower rents and the chance to offer a wider variety of stock.

Clearly the differential rent argument doesn't work everywhere, and some of the highest rented retail warehouse parks in the country are now having to compete with aggressive rental discounting on their neighbouring high streets. This will undoubtedly challenge their ability to attract new retailers, unless there are no suitably sized units on the local high street.

Amongst the more traditional retail warehouse park retailers the story is more subdued. The biggest news of last quarter is obviously the failure of Comet. Clearly some of the stores will be cherry picked by the competition, but this is another blow to landlords following the withdrawal of Best Buy from the UK market (the majority of whose units were acquired by Morrisons for Kiddicare).

The demise of Comet continues a trend of the last decade, with a handful of increasingly dominant retailers emerging to almost monopolistic positions in their segment of the out-of-town retail market. Currys and PC World reportedly saw a sharp uplift in footfall even before any Comet stores had closed, and it is them and Argos who will pick-up much of Comet's estimated 7% share of the UK electricals market. Electricals remains a tough sector with low margins, but it is clear from recent comments by retailers such as John Lewis that electricals sales are rising. Certainly online retailers such as Amazon will continue to compete for a share of this market, but the upside for pure-play electricals retailers is that the supermarkets appear to be withdrawing from this segment. Furthermore, the consumer's desire for new gadgets appears insatiable, and the latest data on spending on maintenance of electrical products shows that it has halved over the last 20 years. Either devices are getting more reliable, or we are using a device's failure as an opportunity to upgrade.

While we don't expect the electricals sector to be very expansionary over the next 12 months, the remaining retailers are well placed to grow their market share. This will support their ability to pay the lower rents in the out-of-town locations that they all favour. After a lackluster spring the DIY sector has remained pretty level, with B&Q saying that they are "bumping along", and Homebase expressing similarly steady sentiments. Multi-channel continues to influence these retailers' strategies, with Homebase reporting a 31% rise in click and collect sales, to 1.5% of total sales.

Both the major DIY retailers are still rationalising their portfolios, with Homebase having 65 lease breaks or expiries falling in over the next five years. While we expect both to be net disposers of stores over the next few years, they are also still acquiring new stores and trying new concepts (for example the inclusion of Habitat and Laura Ashley concessions in Homebase's new Ruislip store).

The furniture sector has been broadly stable over the last six months, with CSL, DFS, Oak Furnitureland and Wren Kitchens still mildly acquisitive. The majority of expansion amongst the furniture retailers remains focussed on London and the South East, in reaction to or anticipation of a pick-up in house prices and hence housing turnover.

The floorcoverings sector remains subdued with Allied withdrawing again, and Carpetright rumoured to be having second thoughts about their beds initiative. Again floorcoverings sales are closely linked to the state of the housing market, and our residential research team's latest forecast might offer a glimmer of light to the beleaguered furniture and floorcoverings sector. This shows that while the last five years has seen a dramatic slump in the number of home purchases, the next five years will see a gradual year-on-year pickup in housing transactions to relatively "normal" levels by 2017. This should present a steady recovery in demand for home move and preparation for move-type goods.

Indeed, with as many as six million home moves delayed over the last five years there is potential for a bit of a rush to the DIY counters to start doing up houses in advance of moves, as well as a gradual rise in sales of carpets, furniture etc in line with local recoveries in house prices and turnover.

This should reverse some of the stagnation in DIY and bulky goods tenant demand that has been seen in the retail warehouse sector over the last few years, as well as start to put some upward pressure on rents.

Why don't cross-border investors invest in UK retail warehousing?

There was some debate at last year's Accessible Retail conference about why retail warehousing was not proving attractive to international investors. Certainly a lot of the comment on the UK investment market over the last few years has been about the rise of the equity-rich cross-border investor, however is this actually true and what have they been investing in?

In this, our first retail warehouse commentary of 2013, we thought we should set out to examine whether the sector is missing out on the "global wave of equity", and if so, why?

Cross-border investment rose in 2013. We estimate that nearly 25% of the investment in commercial property globally last year (equivalent to around €100bn) has been by cross-border players, a sharp rise from the doldrums of 2010 when the cross-border investors had mostly refocused on their domestic markets.

The main reason why cross-border investment has been such a topic of debate in the UK is that this country has been the most popular destination for cross-border property investment for all of the last six years.

However, the bulk of this has been focused on London and the London office market. So, while nearly half of all the money invested in UK commercial property last year was by non-domestic investors, more than 70% of that was invested in London. This shouldn't come as a surprise to anyone involved in property investment, as on average London soaks up around 60% of the total volume of property investment in the UK.

Generally around 70% of non-domestic investment is in offices, with 25% going into retail. This bias towards office investment has risen steadily over the last three years, reaching 80% last year. Within the retail segment the vast majority of non-domestic investment has gone into shopping centres, with only around 2.5% of cross-border investment ending up in retail warehousing. This proportion peaked at 6% in 2008, and since then has steadily fallen to less than 1% of the total in 2011 and 2012.

This is clearly out of line with the overall structure of the UK property market, seeing as IPD estimate that retail warehousing accounted for 19% of the capital value of their UK commercial property universe as at the end of 2011.

Some international investors are clearly enthusiasts for the sector, with three out of the top 20 owners of UK retail warehousing being non-domestic (LaSalle Investment Management, CBREi and Ikea). The big question must be why those investors who have been most active internationally in recent years have not been investing in UK retail warehousing, particularly since many of them are invested in similar sectors in their home countries. We set out to assess this in a fairly unscientific way, by asking six of the most active inward investors to the UK whether they had looked at retail warehouse investments, and why they had chosen not to invest.

The most commonly cited reason for not investing was "it's a very niche sector". While this might be true in comparison to the office sector, the capital value of the retail warehousing sector in the UK is fairly similar to that of shopping centres. When we dug into the thinking behind this statement it became apparent that there was a widely held perception that retail warehousing "requires a high degree of specialist knowledge", and the sector is "sown up by a handful of specialist owners". Tied up in this was the issue of liquidity, with all those that we spoke to saying that they always needed to be certain of being able to liquidate assets when the equity was needed 'back home'.

Whether this is more true in the retail warehouse sector than say the shopping centre market is debatable, but there clearly is a prevalent view both amongst domestic and international investors that retail warehousing is more difficult to manage and let than some other segments of the market.

Leasing outlook

Dominic Rodbourne looks at what's in store for 2013

The last few years have been characterised by the emergence of a new breed of retailers, the discounters, which has meant retail parks have diversified and are continuing to adapt to what looks set to be the new norm.

So what of this new breed of retailers and concepts? History has shown consistently that fast growing sectors eventually have to consolidate, as businesses can only continue their growth through a merger/acquisition or conversely the intense competition leads to a failure. We expect this to occur in the discount sector at it reaches maturity. This might be accelerated through the restrictive covenants that certain retailers are insisting upon to prevent competitors onto a park. However, these retailers are highly sophisticated operators that by their very nature are used to low margins. Also, the demise of JJB has provided a gap that new entrants are now looking to exploit. The first of these is Nike, who opened their first store at the end of last year and have subsequently placed several other units under offer. Matalan are also looking to expand into this market by developing a sports fascia. They have the backing of several of the leading sports brands and are planning to acquire a handful of stores to open this summer. If successful then this will see them looking to expand further in 2014.

Interestingly, considering the amount of time we read about the supposed death of bricks and mortar retail, it is the retailers that originated from the internet, namely Wren Kitchens and Oak Furnitureland, that are driving the bulky goods market in terms of quantity of acquisitions. CSL's push southwards and into new markets has been successful and they continue to seek further opportunities. By all accounts, DFS' first store of 10,000 sq ft in Stirling has also worked. We think this format will allow them to expand into smaller catchments.

There's no getting away from it, there will be fewer transactions in 2013 but that won't stop retail parks continuing to evolve. For Landlords, it's about grasping the nettle and sometimes that might be one that stings more than you'd want it to at first by taking some valuation pain. Better to have no voids and some new entrants than a stagnant or declining scheme. For the retailers, it will be those with the courage to invest in new concepts and formats, or to expand into new markets, that have the most to gain. Sometimes this might mean not trying to take every last penny out of a transaction. Looking back over time, this might be a really unique opportunity, through the sudden availability and quantity of space, for retailers to make hay whilst the sun shines.

The second most commonly used reason for not investing was location, or as one cross-border investor put it "we have never heard of any of the places that these parks are in". Non-domestic investors are always pretty wary of investing outside the capital city of their destination country, so this shouldn't be a huge surprise. While the uncharitable might say that there is a degree of 'board room wall stock selection' here, it is also a fairly astute analysis of the current state of UK retailing. The best prospects in UK retailing aren't likely to be the big regional cities, but the small affluent suburbs and hinterlands of those cities. These will be the markets with the best retail warehouse parks, and they probably aren't places your average international fund manager would ever have heard of!

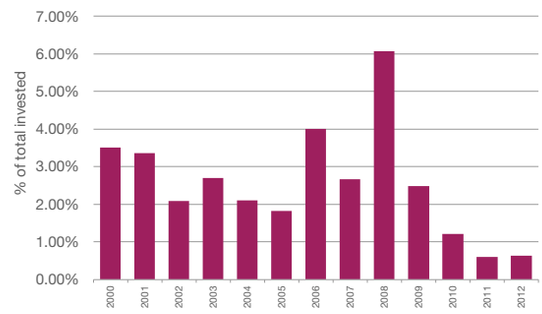
The third most common reason for not investing in retail warehousing was the lot size. This is undoubtedly a very big reason for the larger cross-border funds not to invest. We estimate that the average lot size of all retail warehouse investment deals over the last three years has been £19m. However, the average office purchase by a non-domestic investor over the last two years has been £60m, and the majority of those that we questioned said that their ideal lot size was in excess of £100m.

Several respondents to our informal survey mentioned the performance prospects of the sector, commenting that they felt the potential pool of tenants for retail warehousing was shrinking, and this made the sector less risk-averse than shopping centres. However, several other investors stated that they liked the fact that the UK government was so anti out-of-town retail as this would limit new supply.

Generally it seems that the sector does have a bit of an image problem with international investors. It is viewed as being more complicated and less liquid than shopping centres, and these are the two biggest factors that will need to change to increase non-domestic investor interest in retail warehousing. Will these attitudes change in 2013? Certainly not in general, but we do expect that low prime yields in London might cause some non-domestic investors to look beyond the M25, and this might lead to a few retail warehouse parks being considered.

GRAPH 4

Investment in retail warehousing by non-domestic investors as % of their total invested



Source: Savills

Savills out-of-town retail team

Please contact us for further information

Dominic Rodbourne
Agency
020 7409 9945
drodbourne@savills.com

Jaime Dunster
Investment
020 7409 9929
jdunster@savills.com

Charles Mocatta
Lease consultancy
020 7409 8726
cmocatta@savills.com

Johnny Rowland
Agency
020 7409 8721
jrowland@savills.com

Matthew Whiteley
Management
0161 277 7232
mwhiteley@savills.com

James Hurst
Investment
0207 409 9927
jhurst@savills.com

Jeremy Hinds
Planning
0161 277 7278
jhinds@savills.com

Craig Hudson
Agency
0161 277 7219
cphudson@savills.com

Katie Taylor
Investment
020 7409 8711
ktaylor@savills.com

Mat Oakley
Research
020 7409 8781
moakley@savills.com

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