UK Commercial – Spring 2020

SPOTLIGHT

Savills Research

UK Retail Warehousing

savills

● Investment market subdued but fundamentals of the sector remain good ● Rental falls plateaued in Q1 2020

> Unemployment is only forecast to recover slowly over the next five years

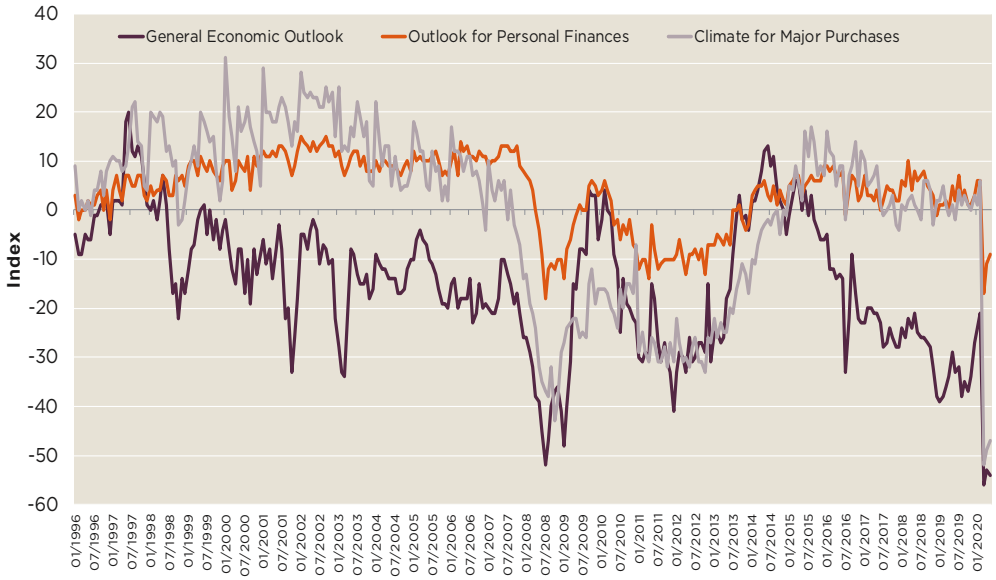
2020 started with a feeling that retail warehousing, at least in terms of investor interest, had reached a turning point in what has been a fairly negative story in recent years. The arrival of the current pandemic has undoubtedly delayed the recovery amidst questions about retailer and landlord stability.

While the behavioural changes that might remain after lockdown are impossible to predict, the retail warehouse sector has had a slightly better lockdown than other parts of the UK retail hierarchy. More stores have remained open due to selling essential goods, and retailer's margins have been supported by the business rates holiday and generally forgiving attitudes by landlords towards rent holidays and regearing.

Overall we believe that the fundamentals that were beginning to revive investor interest in the sector in the first few months of 2020 will be rediscovered later on this year, and as the analysis in the occupational section of this reports shows, vacancy rates remain comparatively low, and store openings have continued.

While we do not expect to see a bounce in new leasing activity this year, the fallout of the current crisis may well be less bad than was originally expected, and this combined with the social distancing friendly nature of retail warehouse parks and schemes should support a quicker recovery to normal trading levels than in some other parts of retail.

Figure 1: Consumer confidence



Source GfK

Consumer trends

The outlook for the rest of 2020 will depend on unemployment, consumer confidence and precautionary saving levels

There is no doubt that the UK economy, in common with most of those across the world, is in recession. As ever, the next question is how quickly we will come out of this, and how long it will take to get back to normal levels of GDP and retail sales growth.

Massive government intervention to stop people losing their jobs has undoubtedly helped to stop consumer confidence and retail sales plummeting to record lows. However, questions remain about what happens when furloughing and other support measures end.

At the start of May 2020 the consensus view of most economists around the UK was that Q2 was going to be the low point of the current cycle with a 13% quarter on quarter fall in GDP. Q3 and Q4 are then expected to show modest positive quarterly growth rates, though not at a rate that could be described as a V-shaped recovery.

GDP growth recovering from Q3 is definitely good news, but may not tell the whole story for the retail economy. Unemployment, which was at near record low levels at the end of last year, is only forecast to recover slowly over the next five years. Indeed, the consensus view at present is that it will not get back to its 2019 low level until 2025. Higher levels of unemployment will impact consumer confidence, savings ratios and ultimately retail spending.

In the short term there are likely to be several relief bounces in spending, as consumers treat themselves when they come out of lockdown, and possibly again when the leisure sector re-opens. This is a trend that we have seen in China over the last few weeks, and it seems possible that it could happen here.

Then comes the question of Christmas, and a number of retailers and retail analysts have suggested that the combination of some household savings that were made during lockdown with relief at being out of lockdown, could lead to a stronger than expected Christmas period in retail. While this will not compensate economically for the recession in the summer, it could be that the factor that supports a sharper recovery in Q4, even when some other factors suggest that the recovery should be slower than the collapse.

A strong Christmas would undoubtedly help retailers through this crisis, but significant questions still remain about the pace of economic recovery in 2021. Most notable for the UK are those around what happens when government support is removed and whether the Brexit transition period ends this year.

Occupational market

Retail warehousing shows signs of resilience amid the pandemic after a strong start to the year for new lettings and a marginal return to rental growth

2019 was a record year in terms of the number of new openings in the retail warehousing sector. 1,021 units were let, well above the decade average of 854. Taking closures into account, by year end the sector had an additional 479 stores than it had 12 months prior.

Value orientated retail led the way in terms of acquisitions, accounting for just under half or all activity. Aldi, Lidl, Iceland, B&M, The Range and Home Bargains accounted for as much as 44% of new space in the market.

Despite the record number of lettings the total additional floorspace in the sector accounted for no more than the decade average at 10.4m sqft in 2019, with a preference for units of between 10,000 and 20,000 sqft for the majority of the sectors most acquisitive brands.

A structural change with regard to rents was the driving force behind the acquisition activity. With much of the market considered to be over-rented the balance of power in most negotiations remained in favour of the retailer, leaving both landlords and potential investors wondering where the bottom was in terms of rental decline.

Value orientated brands were particularly opportunistic, looking to expand their operations or renegotiate existing leases and take advantage of falling rents. Figure 2 highlights how the schemes Savills have been involved with have seen a 22.7% decrease in rents since 2017, falling from an average of £28 psf to £22 psf at by the end of 2019.

This is turn had a knock on effect when it came to vacancy in the market. Comparatively low compared to other sectors, vacancy was at a healthy 4.9% by December last year as retailers looked to snap up the supply of retail warehousing on more favourable terms.

At the start of this year the pertinent question therefore became what, if anything, would change in the out of town supply and demand cycle. It was our view at the end of 2019 that the low vacancy position in the market would begin to help reduce the rental encumbrance, without necessarily eliminating it all together. Indeed by the end of Q1 vacancy in the market has remained low, creeping up by only the smallest of margins to 5.0%, however it seems the slide in rental income has, at the very least, begun to plateau. Analysis on the deals Savills have been involved in, have returned to positive territory for the first time since 2017 with a 1.7% growth on the average headline rents reported the previous year (figure 2).

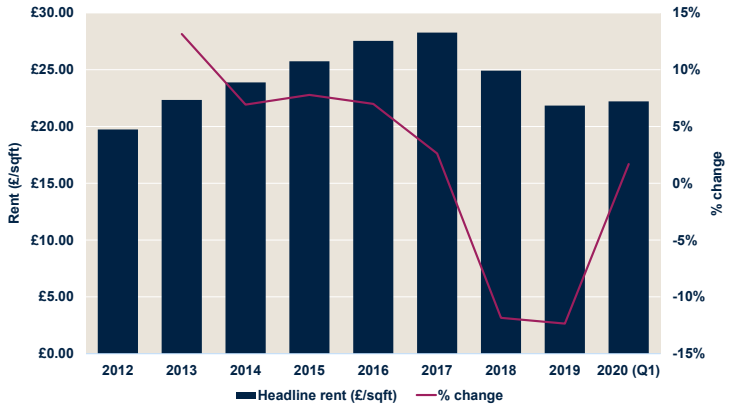
Before the true onset of Covid-19 and a global pandemic, and despite what an optimistic analyst might describe as the very early shoots of a recovery in terms of rental growth, lease terms still remained attractive in the first quarter and plenty of retail and leisure operators continued to be very active in the market, with the usual suspects leading the charge.

302 stores were let in Q1 with value orientated retailers again at the front of the pack. Figure 3 highlights the top 10 acquisitive retailers in terms of both units and square footage with Aldi, Lidl, Iceland, B&M, The Range and Home Bargains accounting for as much as 47% of activity in terms of additional retail warehousing space. Having already achieved just under a third of last year's record total by the end of Q1, retail agents could be forgiven for getting excited over the prospect of another bumper year in terms of operator lettings, the strong pattern of acquisition activity showing no signs of slowing down.

However, as we approached the end of Q1 the elephant in the room was growing increasingly larger. Like every other facet of our lives the retail warehouse market has not been immune to the impact of coronavirus. The question now becomes what effect will the pandemic have on the pattern of activity we have been witnessing over the last eighteen months?

With many retailers unable to trade from physical stores for many weeks and a decreased trading efficiency as they begin to re-open their stores, will we see a number of business fail and fall out of the market altogether? Will we see additional rental decline on top

Figure 2: Annual headline rent trends for Savills schemes



Source Savills

Figure 3: 2020 YTD top ten out of town store openings by operator

Source Savills

Ranked by units

Rank	Operator	Units	Floorspace (sqft)
1	Lidl	27	555,442
2	Wren	12	131,124
3	PureGym	12	119,466
4	Costa Coffee	12	29,420
5	Home Bargains	11	255,869
6	Aldi	11	210,270
7	B&M	10	271,986
8	Iceland	8	98,484
9	The Gym	8	77,178
10	Nandos	8	26,949

Ranked by sqft

Rank	Operator	Units	Floorspace (sqft)
1	Lidl	27	555,442
2	B&M	10	271,986
3	Home Bargains	11	255,869
4	Aldi	11	210,270
5	The Range	3	131,437
6	Wren	12	131,124
7	PureGym	12	119,466
8	M&S	5	105,983
9	Iceland	8	98,484
10	The Gym	8	77,178

1.7%
growth in Q1 on average headline rents compared to 2019

5.0%
vacancy remains low in the retail warehouse sector

302
stores let in Q1 across the UK retail warehouse market

47%
of Q1 acquisition space has been taken by Aldi, Lidl, Iceland, B&M, The Range and Home Bargains

> 61% of the floorspace in the retail warehousing market was designated as essential

Figure 4: Essential retailers by asset class (by sqft) as a proportion of (a) all UK retail and (b) essential UK retail only (as of March 27th)

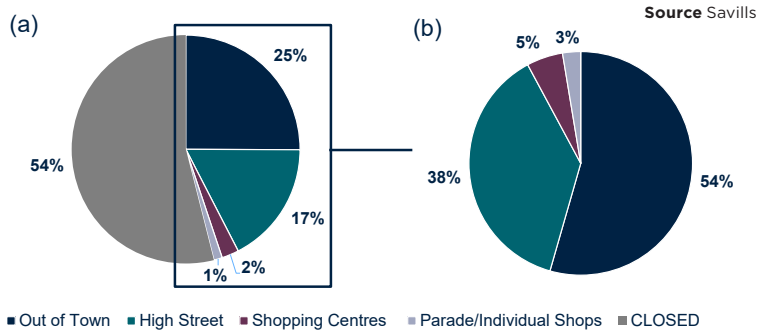
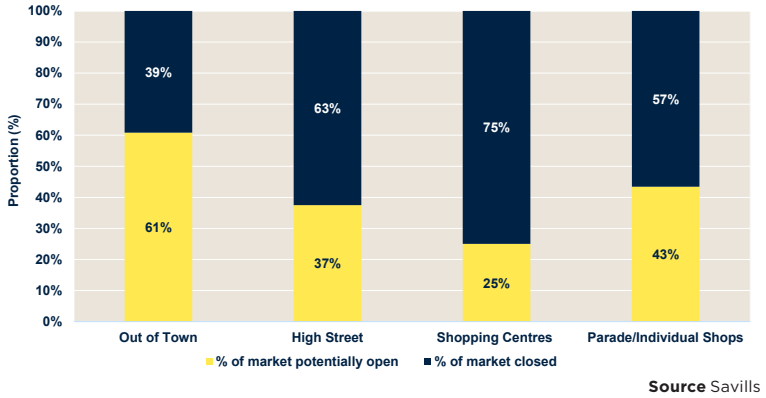


Figure 5: Proportion of each market that is deemed essential (by sqft, as of March 27th)



of what we have witnessed in the last few years as retailers profit margins continue to suffer with the disruption in trade? Will this put an end to the strong acquisition activity we have been witnessing and lead to a rise in vacancy in the market?

Of course whilst we are in the eye of the storm it is impossible to answer all of those questions with any degree of certainty. However, looking at the data we do have on the initial impact of Covid-19 on the retail and leisure market, for retail warehousing there has been at least some positives of note from what undoubtedly has been one of the most significant changes within the UK retail market in living memory.

Firstly, despite the widespread retail and leisure closures, the out of town market displayed some level of resilience with a quarter of all UK retail floorspace remaining open via the out of town market after the government imposed sanctions came into play at the end of March (figure 4a). In the week following the beginning of the lockdown restrictions, 73% of all retail and leisure operators were classified as 'non-essential' with only 27% of the market being eligible to stay open. However, of the retail floorspace that was eligible to stay open, the out of town market accounted for more than half at 54%, in comparison with the high street, shopping centres and individual shops (as shown in figure 4b).

Furthermore, as much as 61% of the floorspace in the retail warehousing market was designated as essential due to large supermarkets and DIY stores accounting for a significant proportion of the sector. In comparison, high streets have seen just 37% of the floorspace considered essential, with shopping centres seeing only 25% (figure 5).

As restrictions begin to ease we expect retailers to prioritise opening their stores on retail parks over those in other locations as the open air environment and expansive car parks make them easier to operate any necessary social distancing measures. As a result we may see shopping habits in the retail warehouse market return to normality slightly earlier than in other sectors.

For some retailers in the sector the initial impact of the lockdown was actually a positive one. Supermarkets and other food stores recorded a 10.4% increase in sales in March from February. Out of town convenience retail has remained open and trading throughout accounting for more than a third (35%) of the essential retailers permitted to trade immediately following the government sanctions. Research from Kantar suggests that the amount families spend on a shopping basket has also reached a record high with nearly all meals now consumed at home; on average the UK consumer spends £26.02 per supermarket visit, £7 higher than this time last year. The rise in grocery spending has reflected well across the UK's major supermarket brands. In the three weeks to April 19th Sainsbury's sales grew by 8.4%, Tesco's were up 7.2% while Morrisons and Asda had rises of 4.3% and 3.5%, respectively. Both the Co-op's and Ocado's sales rose by a fifth in the same period.

Other retailers with a strong presence in the retail warehousing sector have also reported positive results. B&M has revealed it has defied the challenges plaguing the UK retail industry after posting an uptick in revenue growth of 13.8%, including like-for-like growth of 3.9%. With the UK in a recession it is expected that the value orientated brands will continue to be the most expansionary retailers in the retail warehousing space especially if consumers adopt a more precautionary stance on saving as a result of the pandemic. B&M for example have said they are on track to open 45 stores in the next year and relocate a further five.

It is not all good news for out of town operators however. Some foodstore brands have reported that the implementation of social distancing measures is now starting to temper both their in-store sales and profit margins as they are simply unable to serve the same volume of consumers as before. Furthermore, they have had to increase staff levels in order to implement such social distancing measures. Anecdotal reports suggest that one value grocer has seen a recent 40% decline in in-store sales due to social distancing rules. Although it seems supermarket operators were initially the biggest winners with large sales increases during the panic buying phase, as the situation progresses and social distancing measures become more commonplace they too may feel the squeeze on their ability to turn a profit, suggesting thus far they are perhaps the retail industry's smallest loser instead of its biggest winner.

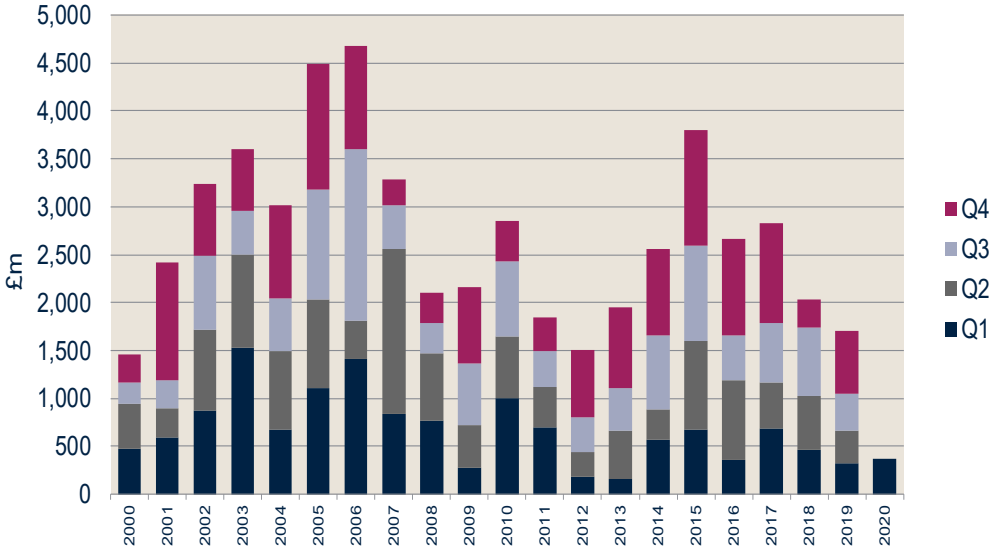
In order to support businesses that have had their income dramatically reduced, government intervention has led to a series of measures including loans, grants, business rates holidays and the staff furloughing scheme. Despite this we have still seen some failures from a number of high profile retailer and leisure operators who were struggling even before the onset of the pandemic.

However, the resilience out of town assets have shown in the wake of the closures is echoed when collectively analysing the portfolio spread of the operators currently under administration. Currently more than 1,500 units have a question mark over their future, belonging to one of the retailers that have filed for administration in the last 6 months. Out of town assets however are responsible for only 12% of these whereas high streets and shopping centres have far greater exposure accounting for 43% and 37% respectively. This is undeniably a feather in the cap for retail warehousing however it must be noted that with a small pool of brands in the sector overall, the market could easily be exposed if one of those retailers ran into difficulty.

Investment market

The reasons to invest remain valid, but the anticipated recovery has been delayed by the pandemic

Figure 6: Retail warehouse investment volume



The retail warehouse investment market started 2020 with a spring in its step due to improving investor interest. The anticipated sale of £400m of Hammerson's parks to Orion was expected to continue this trend and demonstrate where pricing for high quality assets had reached against a background of greater faith in how sustainable ERVs were. Covid-19 has trampled on some of these green shoots, but some of the market fundamentals that were behind January's optimism will still remain.

Even without the Hammerson deal, retail warehouse investment volumes in the first quarter of 2020 were 14% up on the same period in 2019. Q2 2020's transactional activity will be sharply down on Q1's £369m and this reflects a pause to assess the impact on the occupiers and their ability to pay rent and thus re-assess ERV levels where necessary.

The pandemic has undoubtedly brought the questions of retailer covenant strength, void rates and ERVs back to the table. Erring on the side of optimism it is worth noting that a higher proportion of retailers on parks have remained open during the crisis than in shopping centres or on high streets. We also believe that retail warehousing, with its large units and car parks, is more social distancing friendly than other parts of the retail hierarchy, and thus should recover more quickly as lockdown subsides during June and July. It was the preferred retail sector for investors pre-lockdown and we expect this case to be enhanced coming out.

The pool of potential retailers in the sector has always been small, and this means that it is sometimes more susceptible to retailer failures than shopping centres or high streets. If consumer aversion to big-ticket purchases continues, then this will continue the strain on bulky goods and electrical retailers balance sheets in particular.

The story on rent and service charge collections at the end of Q1 should give investors some comfort, with the percentage collected being higher on parks than elsewhere in retail. We expect that this trend will continue through the next quarter day, though the overall it is expected to be worse than it was at the March quarter day. There is a heightened concern about the sustainability of ERVs, even at the levels they started this year, and more evidence will be needed over the next six months to support investment decisions.

With limited transactional evidence in April and May it is hard to be sure about pricing. However, we have continued to move our prime yields outwards for the sector and they now stand at 7.00% for Prime Restricted and 6.75% for Prime Open A1. In both cases this represents a full 100bps softening since late 2018, and is one of the reasons why investor interest was starting to focus on retail warehousing at the start of the year. Open A1 yields are being supported by a belief in the performance of the discounters rather than fashion, and we expect this split to remain.

Looking ahead, we expect investment activity to pick up, driven by an appreciation of how attractive prime pricing has become, and an interest in re-purposing or densifying assets. We do not expect that this will lead to a rise in capital values in the foreseeable future, but it will call the bottom for some segments of the market. The investor market was predominantly debt led and clarity on rental levels and covenant strengths will be needed to provide comfort to the lenders especially for less prime stock.

Schemes that are dominant or convenient will be at the top of investor's wish lists, and a foodstore on or adjacent to the scheme will provide an added degree of comfort.

Outlook

Key themes for 2020 and 2021

The path out of lockdown will be more complicated corporately, legislatively, economically and personally than the path into lockdown. Key issues that will affect the occupational and investment markets over the next 12 months are:

The shape of the economic recovery and inevitable rise in unemployment will affect saving and spending across the economy. We believe that retail offers that minimise the need to rely on public transport, and that offer a lot of space for shoppers to feel safe in will recovery most strongly over the summer and early autumn, but this recovery will be tempered the macro-economic questions that are typical to any recessionary period.

Retailer profitability and stability will be challenged by these recessionary factors, and some retailer failures are inevitable. This will cause some investors to question the depth of tenant demand for retail warehousing compared to other parts of retail, a question that has been common in this sector through every crisis since its inception. We remain of the view that value and food retail will be comparative winners through this period and while they may not be net acquirers of space in 2020, their footprints are likely to remain stable at least. More questions exist around discretionary areas of the sector such as electrical and bulky goods, and some further rationalisation of store portfolios in these sectors is inevitable.

Given that the pricing of prime retail warehouse assets was increasingly being seen as attractive at the start of this year, we expect that this view will be sustained and will lead to more opportunistic investor interest towards the end of 2020.

Savills Commercial
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 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