UK Commercial – August 2023

SPOTLIGHT
Savills Research

UK Retail Warehousing

savills

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UK retail consumer trends

Mixed messages around a surprisingly resilient consumer economy

The consumer economy is currently a swirl of mixed messages ranging from the better-than-expected economic outlook and wage inflation to the continued high price inflation and consumer concerns around what the Bank of England (BoE) might do with interest rates. On top of this, we have a recent cluster of retailer administrations and failures, and another winter ahead when heating costs could again become a major challenge to household incomes.

How much inflation is too much?

At the start of 2023, the economic outlook for the UK was looking pretty bleak for retailers and consumers alike. The BoE was forecasting a shallow but sustained recession, the medium-term outlook for the UK economy was to be the worst performer amongst the European economies, and we were still concerned that a colder-than-normal Q1 could have a dramatic impact on those households who were struggling with higher food and energy bills.

Six months on, you could argue that all of these negative concerns have disappeared. A UK recession is no longer the consensus view, the winter of 2022/23 was warmer than expected, and wage growth has accelerated. As a result, we have seen a perhaps surprising steady recovery in consumer confidence about the future, which has been underway since late last year (figure 1). Nevertheless, we are now struggling with the 'second-round' effects of some of these changes, which are looking likely to be more persistent than the direct and indirect effects of the initial shock of high energy prices.

Academic research suggests that, on average, there is an 18-month lag between an interest rate rise and its impact being felt in the wider economy. This means that consumers should only be starting to feel the early impacts now. The BoE's announcement for August has been to increase interest rates by a further 25 bps (now at 5.25%), which perhaps explains why we have seen a downturn in GfK's consumer confidence index in recent months, including consumer sentiment around their economic situation for the next year, as well as their appetite for major purchases.

From a retailer's point of view, there are definitely reasons to be cheerful. Generally, it appears that higher input and operating costs have, to some degree, been successfully passed onto the shopper. Added to this are some areas where costs are lower (such as business rates and rents). However, the 7.3% increase in basic earnings for the three months to end May cuts both ways in terms of retailer's pay bills and the ability of their customers to pay higher prices.

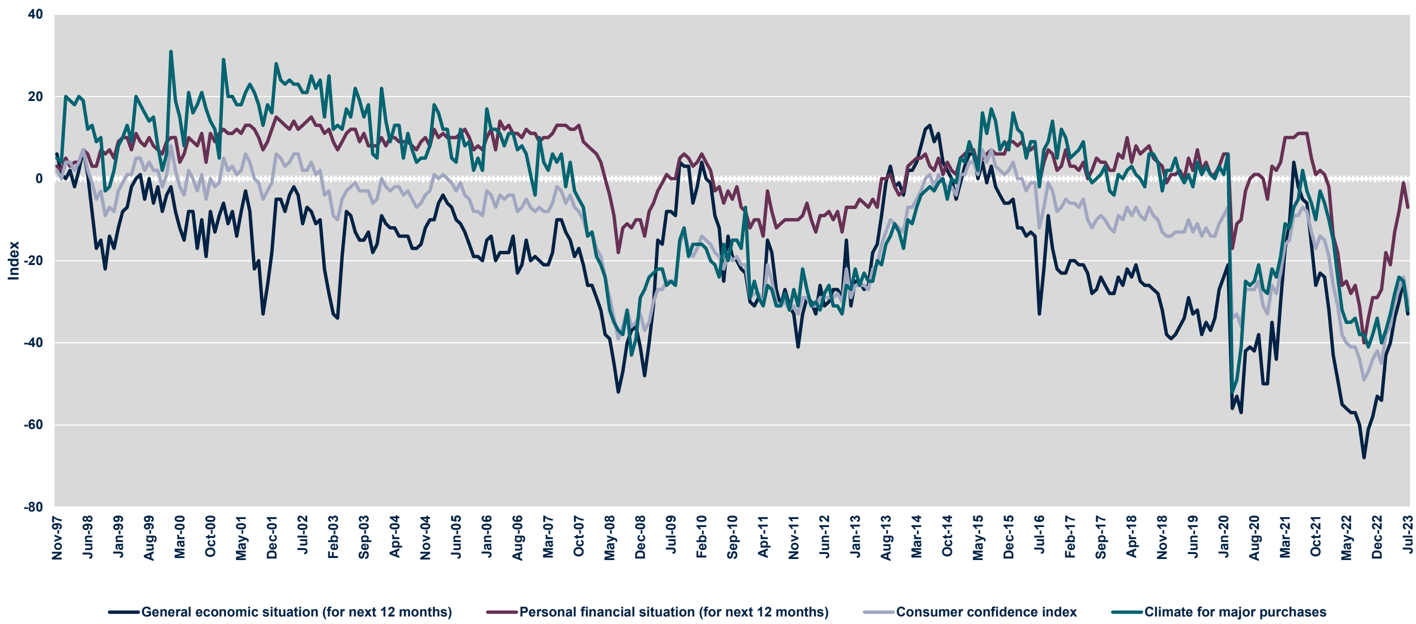
While the latest wage growth data surprised on the upside, the rise in the unemployment rate from 3.8% to 4.0% surprised on the downside. While we do not believe that this rise is enough to derail the steady recovery in consumer confidence about the future that has been underway since late last year, it might give the BoE some comfort that the tight labour market is beginning to loosen which, in turn, ,might mean that wage inflation is on the cusp of beginning to cool.

This is particularly important for the outlook for the consumer economy, as the negative impact of 14 back-to-back interest rate rises appears to have been relatively minimal so far. However, we do not believe that this consumer resilience can last in the face of further rises in the cost of money.

-30
GfK's consumer confidence index falls 6 points in July

-32
The climate for major purchases index also fell a further 7 points in the same month

Figure 1: GfK Consumer Confidence Barometer



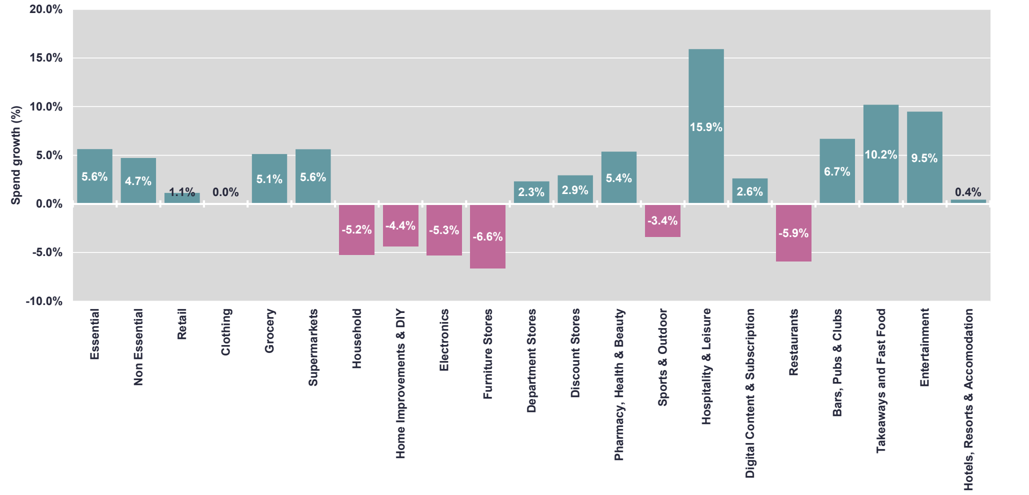
Source: Savills Research, GfK

+1.7%
Footfall for the first week in August was above levels pre-pandemic for retail parks

Occupational market trends

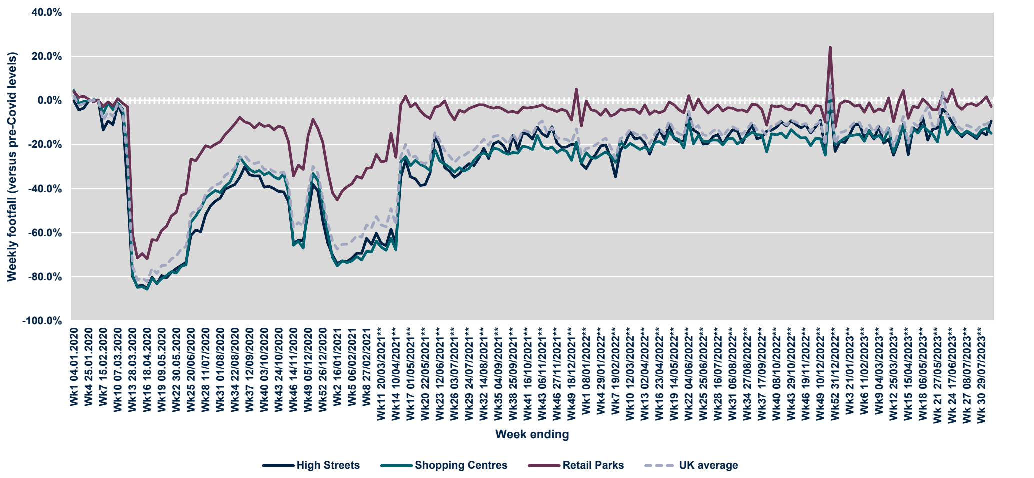
Despite the strength of the UK's economic headwinds, the occupational market remains resilient, spurred on by the performance of retailers who sell essential goods and the expansion ambitions of the value-oriented operators

Figure 2: Barclaycard consumer spend index: average month-on-month spend growth (June 2022 to June 2023) – key categories



Source: Savills Research, Barclaycard

Figure 3: Springboard UK footfall by retail sector (vs pre-pandemic)



Source: Savills Research, Springboard

The retail warehouse market has once again proved its resilience occupationally, despite the increasing strength of the UK's economic headwinds over the last twelve months.

With consumer budgets increasingly tightening, the casual observer may assume the worst for a sector with a traditional focus on bulky goods and 'big ticket' retailers, including furniture, carpet, kitchen and electrical operators. GlobalData's UK Retail Consumer Sentiment Tracker sees itsindex for 'big ticket' purchases down to -39.0, -18.8 lower than this time last year.

Consumer demand has certainly softened for this crop of retailers; the data in figure 2 from Barclaycard covers nearly half of the nation's credit and debit card transactions and highlights a tempering of average month-on-month spend over the last year in household goods, home improvements and DIY, electronics and furniture stores.

However, as we explored in the December issue of this Spotlight, much less of the market is exposed to these sub-sectors than was the case a decade ago. Back in 2012, 40% of occupied floorspace in the market was attributed to bulky goods brands (including DIY, electrical, motoring, furniture and fixtures and fittings, such as kitchens, tiling, carpets and other floor coverings). At present, that has fallen to a quarter of all occupied space. As a result, we have seen growth in the coverage of grocery, particularly with the expansion strategies of Aldi and Lidl – grocery now occupies 31% of all occupied floorspace, up from 18% a decade ago.

We have also seen a number of discount homeware brands significantly increase their exposure in the retail warehouse sector. The growth of the likes of The Range, B&M, Home Bargains and Poundland has increased homewares from 8% of the market in 2012, to 14% of the market currently.

The growth of value-orientated operators in the last decade will also go some way to mitigate the challenges the retail warehouse sector faces in a period of consumer austerity. In 2012, just over a quarter (28%) of the brands in the market were value-based or discount-led. Today, that figure has risen to 38% and is increasing all the time (a third of all new openings so far in 2023 have been value-led brands).

A decline in consumer spend is therefore not expected to impact all occupiers across the market equally. Retail warehousing is now much more focused on essential product categories so, despite seeing a retraction in discretionary spend, it is operators in this space that are best positioned to mitigate the impact of the economic headwinds.

According to KPMG UK's Consumer Pulse survey conducted in June, over half of consumers polled say they have cut non-essential spend in thefirst half of 2023, with nearly 40% of consumers saying they are buying more own brand or value produce this year. Barclays consumer spend index supports this with essential spend up 5.6% a month on average over the last year, versus 4.7% for non-essential spend. Grocery is one such essential sub-category which has seen an average 5.1% increase in spend each month for

> "GlobalData's UK Retail Consumer Sentiment Tracker sees its index for 'big ticket' purchases down to -39.0, -18.8 lower than this time last year"

the last twelve months, whilst discount stores have also seen a 2.9% average MoM increase in the same period.

It is, therefore the retailers with a focus on essential product categories that have continued to drive footfall to out-of-town schemes, which remain at near parity with the levels seen pre-Covid. According to Springboard, footfall across retail parks continues to outperform the rest of the UK retail market, peaking on Easter weekend this year, 4.5% above the levels we saw at the same time in 2019 (figure 3). In the most recent weekly figures (week ending 05/08/22), high street footfall was down -15.6%, while shopping centre footfall recorded a -12.7% gap. Retail parks, however, saw footfall levels 1.7% above the same week in 2019, significantly above the UK average of -10.8%.

Retailers that sell 'essential' product lines continue to require more space

With consumer budgets squeezed like never before, it is once again the operators that focus on essential products that have dominated the 'new openings' league table. Figure 4 highlights 510 new openings in H1 2023, just under halfway to the record total of we witnessed last year (and well above the out-of-town annual average of 843).

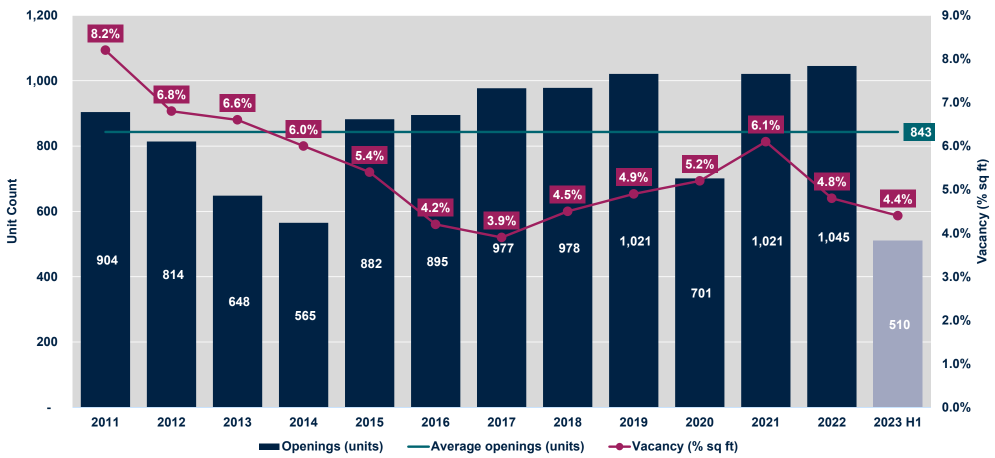
Figure 5(a) highlights how it is the discount grocers and value homeware brands that continue to dominate the list of the top 20 most acquisitive brands for H1 2023, much like they have done for the last five years.

The continued appetite for store expansion has continued in driving down voids in the retail warehouse sector (figure 4). Having peaked at 6.1% in 2021, vacancy has continued to gradually fall, picking up pace this year having fallen from 4.8% in January to the 4.4% we see currently.

However, vacant space is even more scarce than you might think. The current void rate suggests there is 17.9m sq ft of available space nationally. However, 54% of this space has been vacant for three years or more, either due to lengthy planning obligations or suggesting it is no longer fit for purpose.

If we remove this from the space that is theoretically available, vacancy falls to 2.0% nationally, equating to only 8.2m sq ft of available space at this moment. When you consider net take-up in recent years has averaged 4.8m sq ft per annum, we essentially have less than two years of supply in the market, assuming we see no significant retail warehousing development or failures from a number of the market's leading operators.

Figure 4: Retail warehousing new openings (year-on-year)



Source: Savills Research

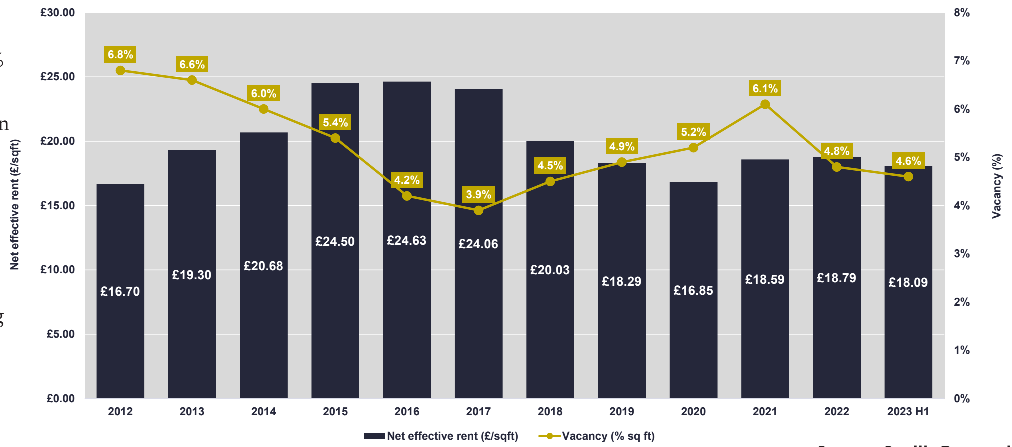
Figure 5: New openings H1 2023 – top 20 operators

Ranked by units					
Rank	Operator	Pitch	Units	Total Floorspace	Average Unit Size
1	PureGym	Value	29	325,700	11,200
2	Lidl	Value	22	425,300	21,300
3	Greggs	Value	20	38,400	1,900
4	Home Bargains	Value	19	446,500	23,500
5	Starbucks	Mass	19	40,400	2,200
6	Aldi	Value	15	292,600	19,500
7	B&M Retail	Value	15	470,700	33,000
8	Costa Coffee	Mass	12	19,300	2,400
9	JDGyms	Mass	11	118,300	12,400
10	Poundland	Value	11	212,600	19,300
11	Burger King	Mass	7	19,800	2,800
12	McDonald's	Mass	7	18,300	4,200
13	Hobbycraft	Mass	6	47,800	8,000
14	KFC	Mass	6	8,800	2,200
15	Taco Bell	Mass	6	12,100	2,300
16	Tim Hortons	Value	6	16,500	2,700
17	Farmfoods	Value	5	88,800	17,800
18	M&S	Mass	5	121,400	29,200
19	Iceland/Food Warehouse	Value	4	50,600	12,600
20	Jollyes Pet Centres	Mass	4	25,500	6,400

Ranked by SQ FT					
Rank	Operator	Pitch	Units	Total Floorspace	Average Unit Size
1	B&M Retail	Value	15	470,700	33,000
2	Home Bargains	Value	19	446,500	23,500
3	Lidl	Value	22	425,300	21,300
4	PureGym	Value	29	325,700	11,200
5	Aldi	Value	15	292,600	19,500
6	Poundland	Value	11	212,600	19,300
7	M&S	Mass	5	121,400	29,200
8	JDGyms	Mass	11	118,300	12,400
9	The Range	Value	4	93,300	23,300
10	Farmfoods	Value	5	88,800	17,800
11	Sainsbury's	Mass	2	85,000	42,500
12	Tenpin	Mass	3	79,200	26,400
13	B&Q	Mass	2	65,300	32,000
14	Travis Perkins	Mass	2	60,300	30,100
15	TheGym	Value	4	54,300	13,600
16	Tesla	Aspirational	2	54,000	27,000
17	Picture House	Mass	2	52,300	26,200
18	Iceland/Food Warehouse	Value	4	50,600	12,600
19	Next	Mass	4	49,200	16,200
20	Hobbycraft	Mass	6	47,800	8,000

Source: Savills Research

Figure 6: Savills annual average net effective rents (year-on-year)



Source: Savills Research

wilko

1.21m sq ft

Should Wilko not be rescued from administration, 1.21m sq ft of retail warehouse floorspace will return to the market, raising the UK vacancy rate to 4.7%

“Drive-Thru & Drive-To net effective rents now stand at £47.19 psf on average, an increase of 27.9% versus pre-pandemic”

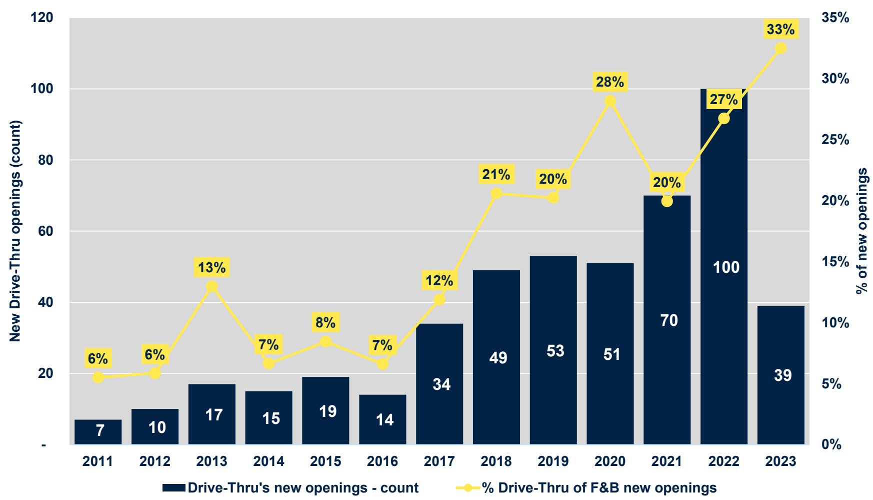
Should Wilko not be rescued from administration, 1.21m sq ft of retail warehouse floorspace will return to the market. This would only raise the UK retail warehouse vacancy rate to 4.7% temporarily, with plenty of suitors poised to compete on securing that available space.

Will we see net effective rental growth?

The lack of available space in a market where, for many operators, performance is strong and thus their expansion ambitions remain, should lead to some competitive tension in terms of net effective rents, moving forward. We are confident about the possibility of net effective rental growth over the next 12 months, albeit incremental, as inflation begins to stabilise. That said, nobody quite predicted the severity of the headwinds we have experienced to date over the last twelve months, which is why average YoY growth on all of the agency deals Savills has been involved with up to the end of H1, remains flat (figure 6).

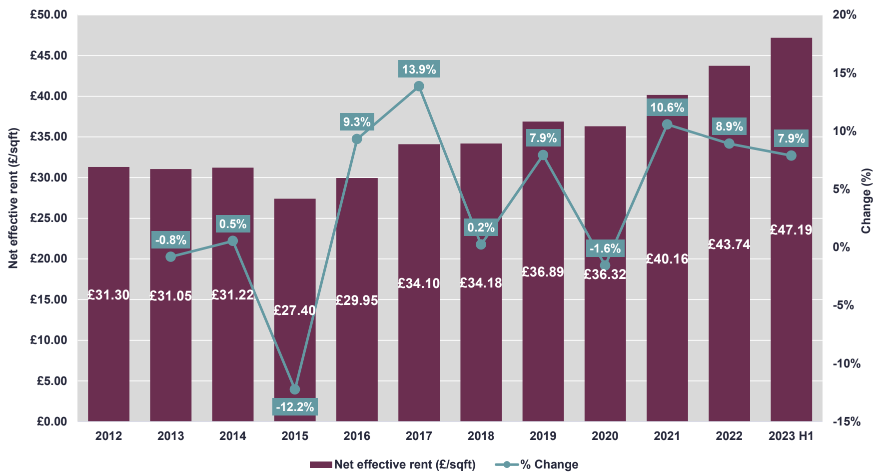
On reflection, this in itself is a positive result. Despite spiralling energy costs, record levels of inflation and 14 consecutive interest rate rises, retailers are still looking to expand their reach and are doing so on terms no worse than they would have 12 months ago. What is most important, however, is it hasn't so far led to a lack of appetite for deals or a desire to only do a deal at a reduced cost, in order to better safeguard their return on their investment.

Figure 7: Drive-Thru new openings (year-on-year)



Source: Savills Research

Figure 8: Savills annual net effective rents (year-on-year) – Drive-To and Drive-Thru



Source: Savills Research

Demand for F&B operators increases, with competition for space fierce resulting in strong rental growth

Contrary to popular belief, it is not just the discounters that have been driving take-up in the market. F&B operators have increasingly featured in the top 20 most acquisitive operators in the last few years. H1 this year included Greggs (20 units), Starbucks (19), Costa (12), Burger King (7), McDonald's (7), KFC (6), Taco Bell (6) and Tim Hortons (6) (figure 5).

Having become so popular with the UK consumer during the pandemic, Drive-Thrus are the format of choice for these operators. Last year we saw 100 new Drive-Thru openings in the market, just under double the number opened in 2019 pre-Covid (figure 7). The truth is the most acquisitive F&B operators would like to do more were it not for scheme configuration and planning constraints.

With Drive-Thru and restaurant vacancy so low, there is very little opportunity to satisfy further demand, which is why many of the new Drive-Thru openings are newly constructed roadside developments rather than the reparation of voids.

As a result, rents have increased dramatically, as firstly, the competition for space has become so fierce, and secondly, in order to make a development viable to the landlord, due to the recent and significant increase in construction costs. Drive-Thru & Drive-To net effective rents now stand at £47.19 psf on average, an increase of 27.9% versus pre-pandemic (figure 8).

By comparison, the average net effective rent on retail parks of £18.09 highlighted in figure 6 covers the rest of the market and excludes units below 2,500 sq ft and therefore any Drive-To or Drive-Thru deals Savills has been involved with. The level of competitive tension for new space at this format is so high it skews the level of growth we are seeing across the rest of the market.

Gym operators are another such amenity provider that have increasingly increased their exposure to the retail warehouse market. The convenience and accessibility of retail parks, so key to their appeal to the consumer, has seen PureGym top the list of new openings so far this year with 29, while JD Gyms has opened a further 11.

Along with F&B, these operators improve consumer appeal and dwell time on schemes, which has the added advantage of driving additional big box leisure operators such as Rock Up, We Are Padel and swim!. Vets, charity shops, and healthcare operators are also increasingly diversifying tenant line-ups as they too seek customers drawn to schemes for their convenience.

“ H1 has seen a total of £1.1bn in retail warehouse transactions, -13.5% down on H2 2022, and -17.9% down on the same period last year ”

Investment market trends

Retail warehouse pricing moves out with the cost of money and UK Bond yields, but should investors take a second look given the strength of the occupational market?

The retail warehouse investment market is in a state of flux. Prime Open A1 yields started the year at 5.50%. Currently, they sit at 5.75%, having moved out 25 bps in the last month and softened by as much as 50 bps from a low of 5.25% in April/May. Prime restricted yields have behaved no differently, now at 6.25%, 25 bps higher than in January, having dipped as low as 5.75% in the spring.

Meanwhile, UK Bonds have experienced a similar undulation. The 10-year UK gilt yield currently stands at 4.37%, having started 2023 at 3.67%. It briefly reached as low as 3.00% at the beginning of February; however, since then, it has continued to consolidate gains above the long-term average of 4.25%, moving out to this year's peak of 4.66% in July, as investors prepared for the BoE's August policy meeting.

The upshot of all this ebb and flow is that overall, retail warehousing, like the rest of UK commercial real estate, has seen a correction in pricing over the last twelve months. The main factor depressing capital values has been the rise in interest rates and the subsequent adverse switch in investor sentiment, rather than any fall in occupier demand or negative rental growth.

In June, interest rates reached 5% for the first time since 2008, with the BoE making a 50 bps increase in order to try to curb inflation. As a result, prime yields in the retail warehouse sector moved in step and immediately with the increasing cost of money and subsequent softening of UK Bond yields. Since then, an additional 25 bps increase in interest rates has just been announced for August (now at 5.25%). Time will tell if it will impact pricing further in the retail warehouse investment market.

However, those that take more than a cursory interest in this sector will know, even in the not-too-distant past, when interest rates were below 1%, retail warehouse yields have experienced fluctuation. This begs the question, what else in the market typically influences its pricing?

The answer to this question is undoubtedly the volatility or indeed vitality of the sector occupationally. In 2019 we saw a great deal of investor interest in the retail warehouse sector; pricing looked attractive considering the strength of the occupational market and the potential to add value.

Nevertheless, the pandemic put the brakes on any significant investment activity, as the market paused to see how such a shock event would play out. Since then, we have had a war in the Ukraine, which like Covid, has compounded the current cost of living crisis in the UK. The question is, are the fundamentals that peaked both institutional and overseas investor interest pre-Covid still present in the occupational market?

As discussed in the occupational section of this report, there is plenty of evidence to support the argument for; the good news is the occupational market continues to show its resilience. A strong, appetite for expansion remains, which means voids are low and creeping ever lower. Retailer performance has been strong for many key operators, particularly the discounters. Despite the trepidation surrounding the fortunes of the traditional bulky goods 'big ticket' retailers (furniture, carpets, kitchens and electricals), grocery, F&B and value homeware operators have posted impressive revenue results as consumers have swung into belt-tightening mode. As a result, we have seen no significant reduction in the average net effective rents achieved across the sector, which despite the strength of the recent economic headwinds, remain at c.£18 psf, as they have done for the last 2/3 years.

In fact, it can be argued that average market rents, on prime assets at least, are in some cases artificially lower than they perhaps should be. Fully let schemes seldom present an asset manager with the opportunity to justify an increase in rental value on a new deal. Lengthy WAULTs following the rebasing of rents, strong revenue performance and therefore the majority of retailers choosing to regear rather than vacate, are all contributing factors.

Similarly, the arrival of the never seen before insurance lease less than 3 years ago, and their subsequent swift departure, highlights how much those that understand the market believe in its existing strength. The market is so short of space, retailers have been prepared to put in the time and effort in negotiating a pre-let, despite the likelihood the opportunity to take that space will ultimately not materialise – just to be at the front of the queue in case it does. However, landlords have all but ended this practice, instead preferring to get any such space back and use it to demonstrate value and improve on rental income.

With competitive tension still noticeably present, why then are retail warehouse yields closely mirroring the rising cost of debt and UK Bond yield movements? It is our view that investors are simply not putting enough weight on the bedrock that underpins the occupational market. We have arguably been at this juncture before, with the relative naivety of some

5.75%

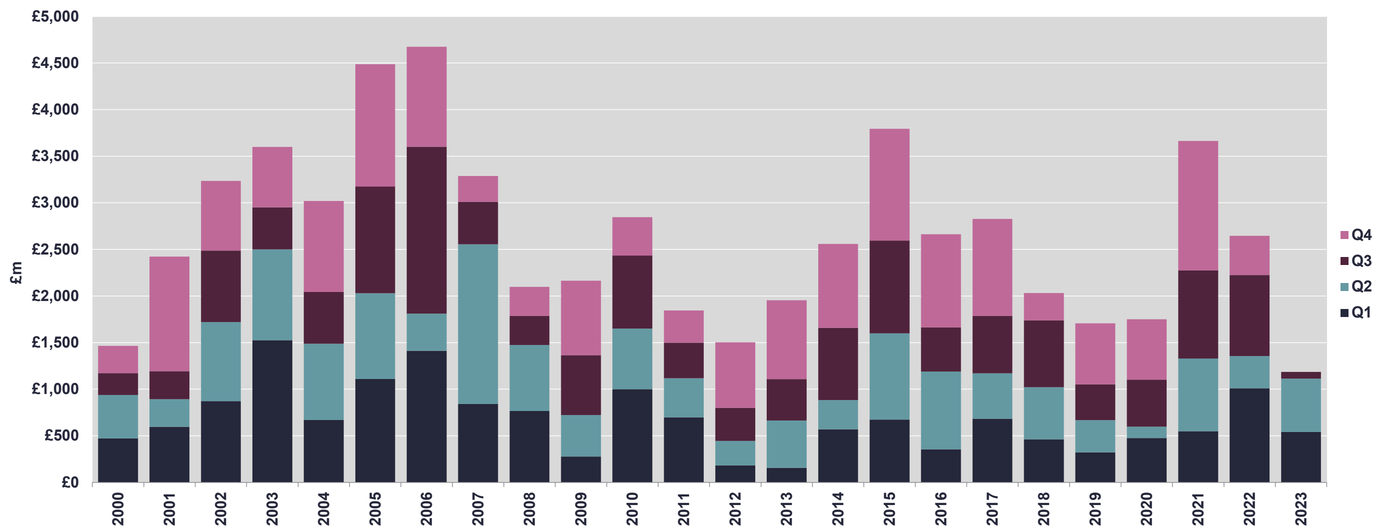
Prime Open A1 yields, having moved out 25 bps

5.25%

Bank of England increase interest rates by a further 25 bps in August

> **Currently, financial markets are pricing in interest rates peaking at 5.75% in November**

Figure 9: UK retail warehouse investment volumes



Source: Savills Research

investors in tarring all types of retail with the same brush. However, negative sentiment must catch up with the reality.

Investors have seemingly been left with a choice to make. Do they put their money in lower-risk bond yields. or is there any part of UK commercial property, at its current price, worth the gamble with a potentially stronger return?

Understandably, occupational resilience alone hasn't been enough to persuade investors to take that gamble in any great numbers in the retail warehouse market. The consumer economic outlook only six months ago was particularly austere, and in reality, many institutional and opportunistic buyers have paused on the predication that assets may indeed get cheaper still; fuelled by the negative impact of 14 consecutive interest rate rises still at the forefront of their minds.

As a result, H1 has seen a total of £1.1bn in retail warehouse transactions, -13.5% down on H2 2022 and -17.9% down on the same period last year. This represents a -14.6% reduction on the H1 average of the last two decades.

Nevertheless, not all investors have been put off by the negative sentiment surrounding the strength of the UK's recent economic headwinds. 2023 has continued to see activity in the smaller and arguably more liquid lot size arena in particular, as the desire for Prop Cos and high-net-worth private investors to explore opportunities in this sub-sector remains. Particularly with the most recent outward drift in pricing.

There is perhaps cause for even more optimism. As we move into H2, you could argue that some of the negative concerns around the UK economy have significantly dissipated. A UK recession is no longer the consensus view, the winter of 2022/23 was warmer than expected, and wage growth has accelerated. UK Bond yields look to have stabilised for the time being, with 10 Year Bonds currently at 4.3% and 20 Year Bonds currently at 4.5%, following the positive news of a slowdown in inflation on 19 July.

However, this could be tapered by the BoE's August increase in interest rates. In reality, up to now, the messages around the UK's economic outlook have been mixed, and the latest news on interest rates may suggest we are not at the nadir in terms of pricing; in the short term, we may see some further rises before we see any falls.

Recent weaker-than-expected economic data has tempered expectations regarding the peak level of BoE interest rates. Currently, financial markets are pricing in interest rates peaking at 5.75% in November.

In the interim, it is our view we will see a pause in yield softening, provided the BoE also pauses for a moment on any further interest hikes, with some clarity needed on whether the changes it started implementing last year are really impacting the wider economy and will bring inflation down further.

On a positive note, with vacancy across the sector so low, and little to no development pipeline in the sector, satisfying retailer demand for acquisitions will only get more difficult, which will continue to inflate the pressure for rental growth. Couple this with clear evidence of sustained interest rate stabilisation in the long term, we expect to see transactional activity in the sector increase over the next twelve months, with a focus on core plus assets for institutional investors and secondary assets for opportunistic buyers, attracted by the softer pricing and opportunity to add value.

Analysts might argue that such a result hinges on two additional key factors. Firstly, the assumption we won't see a handful of retailer failures in the sector in that time frame. Secondly, how retail warehousing stacks up versus other commercial property asset classes that may have seen pricing move out further and potentially offer a more attractive return.

The counter-argument is again wrapped up in the sector's strong occupational backdrop. With a finite number of key operators, retail warehousing is indeed exposed to a flurry of potential failures. Current vacancy tells us the market could indeed absorb one or two significant failures that release units back to the market; any more may begin to undermine the sector's performance.

However, INCANS Tenant Global Score, which is a measure of the financial strength and stability of a retailer based on its public accounts, tells us the financial stability of the sector's top operators is solid. Of the top 25 larger format operators, in terms of the number of units they have across retail, leisure and shopping parks combined (excluding F&B and gyms), 20 are considered 'low risk' or 'very low risk' in terms of failure. It is therefore our belief that the risk and return relationship looks much more favourable for retail warehousing than it does other sectors, which don't have such strong occupational fundamentals.

The fly in the ointment may, of course, be a mismatch between seller-buyer expectations. Vendors will be well aware of the occupational resilience their schemes continue to show, which means fewer could be willing to sell at current pricing levels unless they have to.

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