SPOTLIGHT

Savills Research

UK Commercial – Winter 2020

UK Retail Warehousing

- Q3 investment activity recovered following a pause in the market at the onset of the pandemic

Consumer trends

Consumer confidence remains suppressed in the approach to Christmas following the second national lockdown and the implication of the localised tier system.

Like most economies around the world, the UK is undoubtedly in a recession. The length of time it will take to recover and once again report positive levels of GDP and retail sales growth is wrapped up in a myriad of intrinsically linked socio-economic factors, most of which relate to the ongoing global pandemic.

These include, but are not limited to, the length, frequency and specific conditions of any future government-imposed lockdowns and/or the on-going localised tier restrictions that are currently in place. Furthermore, the length of time it takes to successfully secure a vaccine and implement an effective nationwide inoculation programme will also play a significant role in the speed of the recovery. The level and length of support the government provides for consumers and businesses alike, such as extensions to the furlough scheme and the temporary ban on commercial evictions, will also determine how far the least fortunate will need to travel in order to post a successful return to the black.

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. Q3 and Q4 were then expected to show modest positive quarterly growth rates, though not at a rate that could be described as a V-shaped recovery. Figure 1 indicates that for Q3 at least this assumption was a sound one with consumers' general economic outlook over the next twelve months improving from an index of -56 in March to -38 by September.

A relaxation of Covid restrictions in this period certainly eased the consumer market temporarily; however, the implementation of a second national lockdown from November has further exasperated a recovery. As a result, consumer confidence remains downbeat, with GfK's October index recording -31, compared to -14 a year prior. Consumer attitudes towards major purchases remain delicate, with the index standing at -27, marking a six-point fall over September levels. The general economic outlook of the consumer over the next twelve months also fell back to levels similar to those witnessed in March, reporting an index of -50 by October.

The extension of the existing furlough scheme to the end of March 2021 will have saved a number of jobs in the short term. Nonetheless, the UK unemployment rate continued to rise in the July to September period to reach 4.8%, with added economic pressures caused by a second lockdown pointing to a further rise in unemployment as we move towards 2021.

The final quarter is always a pivotal time of year for retailers, with Black Friday and the Christmas period having great bearing on annual reporting figures. The additional pressures this year will no doubt accentuate the importance of the quarter.

We could witness consumer spending behaviour swing in two directions this winter. Low consumer confidence and job uncertainty are expected to uphold high personal saving ratios until well into 2021, fostering a much more cautious approach to Christmas for some. That being said, we could see a portion of consumers opt to spend more enthusiastically over this Christmas period driven by pent-up demand following six months of heightened savings.

By subsector, it's likely we'll see a significant polarisation in trading results, with retail warehousing subsequently set to demonstrate stronger resilience in its performance than other areas of the market - some submarkets with a focus weighted toward the out-of-town market have even enjoyed a return to sales growth. Structural changes concerning more permanent working from home coupled with an increase in home-ownership will continue to bode well for DIY and homeware retailers for example, which enjoyed a 21.6% like-for-like growth in October according to BDO. Meanwhile, electronics retailers, also with a strong out of town presence, could witness a surge in sales following the release of new Xbox and PlayStation consoles, as reported already by both GAME and Smyths Toys.

While spend across more pandemic-sensitive segments is likely to remain suppressed through Q4, it could open growth opportunities across other sectors. Supermarket sales in both value and volume terms continue to perform well, exceeding the long-term average in September to reach 4.3% and 3.2% year-on-year respectively, on a rolling 12-month basis. In line with a second lockdown, as well as more people staying at home over Christmas, supermarkets are likely to continue this long run of success through the final quarter of the year. The early signs are positive with take-home grocery sales up 9.4% for the 12-week period to 12 October, according to data from Kantar.

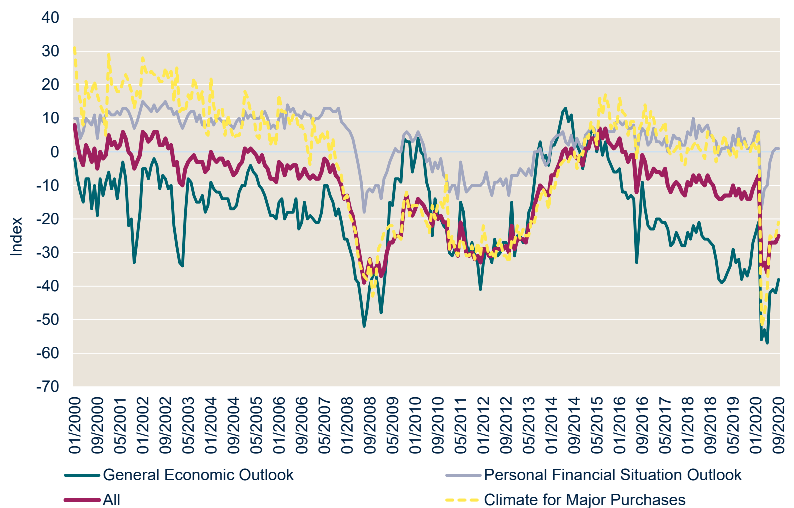
Q2 investment activity recorded the smallest uptake of any quarter in the last 20 years at £141m as the market paused to assess the impact of the pandemic

Investment activity in Q3 swiftly recovered posting a 32% growth on the same quarter the previous year accounting for £505m of transactions

32%

32% of units that have passed through an insolvency procedure in 2020 have been in the out-of-town market, comparing favourably to the high street that has accounted for 61%

Figure 1: Consumer confidence



Source GfK

Occupational market

The comparative durability retail warehousing has historically shown has stood the market in good stead, allowing it to demonstrate continued resilience since the onset of the pandemic.

Resilience was the watchword in our spring edition of the retail warehouse spotlight and not much has changed from an occupational perspective as we approach the ninth month of the global pandemic.

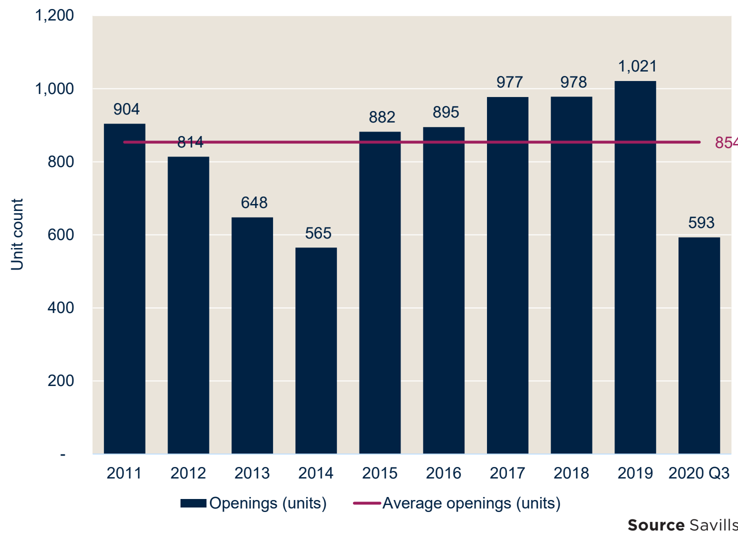
It is Savills' view that retail warehousing has been showing comparative resilience for some time. In previous reports, we have explored the notion that retail sectors with a predominant out-of-town presence have proven to be much better insulated from the rise of online retailing than is true of a number of goods traditionally sold on the high street.

Similarly, click-and-collect has also been a feather in the cap for out-of-town retail destinations as the large and comparatively low-rented units, combined with high car parking provision, means the sector has proven itself to be ideally suited for servicing click-and-collect orders, customer returns and home deliveries. When you consider spend in this arena is forecast to increase by £3.1bn in the next five years, rising 45.8% to reach £9.8bn by 2024, the outlook for a physical store presence remains positive in the sector, notwithstanding the fact click-and-collect is also a significant driver for capturing additional sales in the market at the point of order fulfilment.

The resilience the sector has shown to the rise of ecommerce and the transactional growth opportunities that have subsequently stemmed from it, have helped lay the foundations for number other key advantages that have emerged in the retail warehouse sector in recent years, all of which have allowed the market to show further resilience since the beginning of March when we first saw the impact of Covid-19 on the UK retail economy.

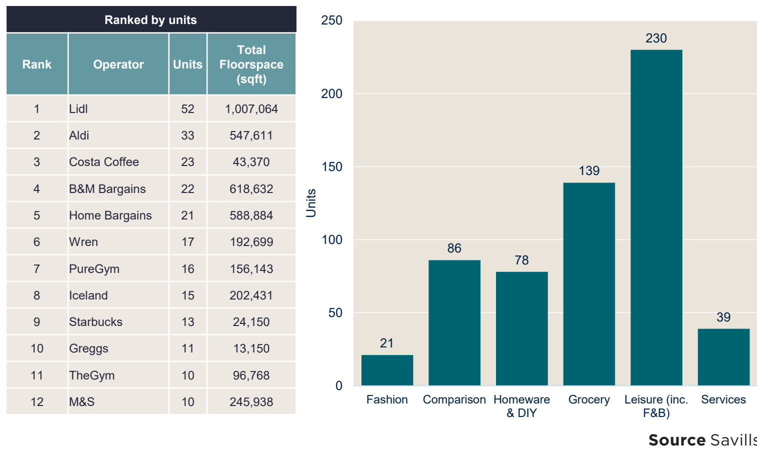
Firstly, despite the unforeseen reduction in consumer activity across our physical retail environments, retail operators have still been keen to take space in 2020. Last year was a record year in terms of the number of new openings in the retail warehousing sector, with 1,021 units let, well above the decade average of 854. This year the overall pace of store openings certainly appears to have eased

Figure 2: New openings by year (units)



Source Savills

Figure 3:
(a) Top twelve acquisitive retailers (units, by Q3 2020)
(b) New openings by sector (units, by Q3 2020)

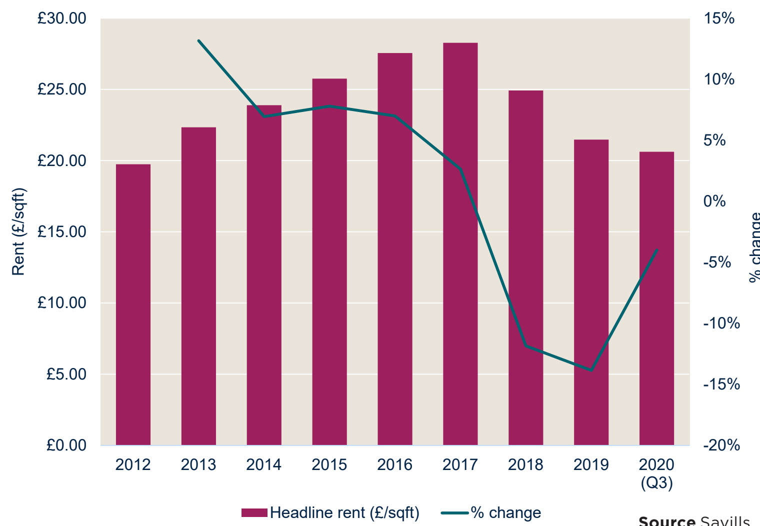


Ranked by units

Rank	Operator	Units	Total Floorspace (sqft)
1	Lidl	52	1,007,064
2	Aldi	33	547,611
3	Costa Coffee	23	43,370
4	B&M Bargains	22	618,632
5	Home Bargains	21	588,884
6	Wren	17	192,699
7	PureGym	16	156,143
8	Iceland	15	202,431
9	Starbucks	13	24,150
10	Greggs	11	13,150
11	TheGym	10	96,768
12	M&S	10	245,938

Source Savills

Figure 4: Annual headline rent trends (Savills schemes)



Source Savills

-4%

fall in average headline rents compared to 2019

5.5%

vacancy remains low in the retail warehouse sector

593

stores let by Q3 across the UK retail warehouse market

32%

of units to pass through an insolvency proceedure have been out-of-town

as a result of the pandemic - by the end of Q3, the number of new openings had reached 593 (equating to 6.8m sq ft). This may be some way off the record total for the previous year however, this is by no means a disaster with the number of openings in the final quarter still to be reported. Simple arithmetic tells us if Q4 equals this year's quarterly average, the market will end on circa 800 new openings for 2020 - not a million miles from the 854 decade average and a strong result considering all but essential retail was closed to the public for a large part of the year. Consider also that each year a superfluity of new openings usually manifest in the final quarter, it is not overly optimistic to assume the final total of new openings may be closer to that average than is immediately obvious (Figure 2).

It is no surprise that the bulk of the demand in 2020 has again been driven by value-orientated retailers. Those brands identified in Figure 3a have maintained a relatively aggressive acquisition strategy, even in a disrupted market and against a background of weak consumer confidence amid the global pandemic. The immediate post-GFC period showed that if consumers swing into belt-tightening mode, then it is the value end of the spectrum that benefits most. This suggests that whatever the political and economic outcome of the recent pandemic, the strong growth in demand from the value retailers will very likely be sustained. By way of an example, Lidl opened 46 new stores in 2019 totalling 908,000 sq ft. So far 2020 has seen them open 52 new stores equating to just over 1m sq ft. This trend goes beyond just the most acquisitive brands. In 2020, value-orientated retailers have accounted for as much as 42% of new openings, a significantly higher proportion than the existing provision at 18% for the retail warehouse market and 22% for UK retail as a whole.

Leisure as a sector also continues to see strong growth in the out-of-town market, predominately driven by value-orientated gym brands and convenience F&B operators such as Costa Coffee, who so far have opened 23 new units in 2020 and who have consistently post strong acquisition numbers over the last five years (figure 3b). Many landlords have long since realised the value of the support these operators bring to a consumer shopping trip. The most resilient schemes going forward are those where the consumer can adequately refuel, subsequently increasing dwell time, or can make their shopper journey multi-purpose with a visit to the gym or other such leisure activity. Strong acquisition in the leisure sector has seen the demand for smaller units increase significantly in the last few years. In fact, units under 2,500 sq ft were the only format to see positive growth in net effective rents between 2016 and 2019 at +2.0%. This may be surprising considering much of the leisure industry has been unable to operate during the lockdowns and has accounted for as much as 29% of all units that have gone through an insolvency process nationally. Clearly, the more secure operators in the leisure sector still see a strong future in the retail warehousing sector despite the recent turmoil.

The acquisition activity has, in part, been responsible for keeping voids low in the retail warehouse sector and provides another example of the market's constancy. Since the end of 2019 vacancy in the market has only increased by just over half a percent to 5.5%. This despite the increase in insolvency activity across UK retail as a whole, as many operators struggle to get to grips with the impact of the global pandemic (we will return to this subject later in this section). Compared alongside other asset classes, the sector's strong occupational demand is clear. High street (11.2%), shopping centres (14.7%) regional offices (7.1%) and even UK logistics (6.2%) all have a greater proportion of voids. The low base in retail warehousing is particularly reassuring in comparison to the industrial market who have seen unprecedented demand for space with the growth of ecommerce in recent years, not to mention the recent surge since the onset of Covid-19 and the resultant uptick in online retailing as a result; this sector remains the current asset of choice in the UK investment market.

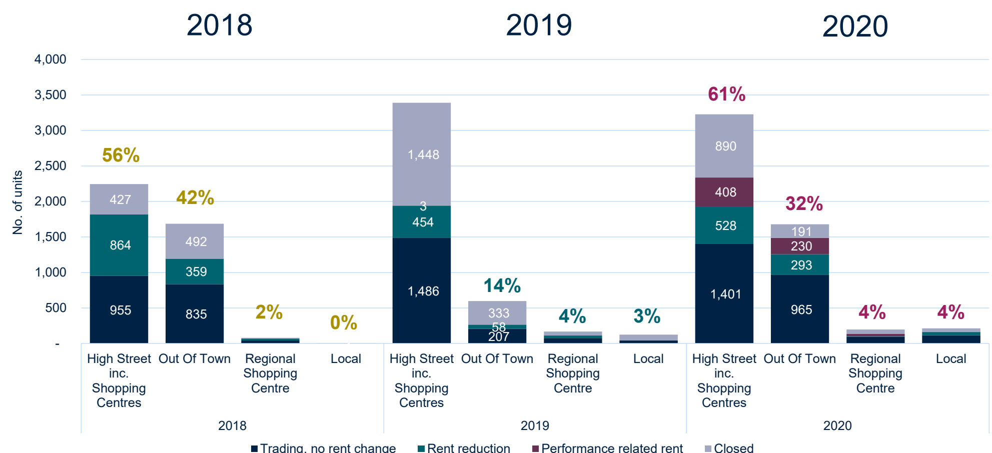
It was our view at the end of 2019 that the low vacancy position in the market would therefore begin to help reduce the rental decline we have seen over the last three years, without necessarily eliminating it altogether. Indeed, by the end of Q1 with vacancy in the market remaining low, it seemed the slide in rental income had, at the very least, begun to plateau. Analysis on the deals Savills has been involved in has, on average, returned to positive territory for the first time since 2017 with a 1.7% growth on the average headline rents reported the previous year. However, as we approached the end of Q1 and the potential impact of the pandemic loomed large, inevitable questions of further rental decline and even operator survival began to emerge.

Not immune to the impacts of the pandemic, retail warehousing has indeed seen rents fall further than what was evident at the end of Q1, unsurprising considering at that point we looked set for another bumper year in terms of acquisitions with 302 stores already let, half of the current 2020 total and already just under a third of 2019's record haul. However, once again, the performance of the sector has not been a disaster in this regard and further underlines its comparative resilience versus other asset classes. Savills deals have seen rents fall from an average of £21 psf at the end of 2019 to £20 psf by the end of Q3 2020, equating to a decline of just -4.0% (figure 4). This is much less severe than declines of between 12-14% we have seen year-on-year going back to 2018.

Furthermore, on top of a marked deceleration in rental declines over the last twelve months, out-of-town schemes have seen falls of more than half of those witnessed on the high street and in shopping centres which together have seen average headline rental decline of -13.8%. The pattern of resilience evident across Savills deals is echoed in the wider market also. MSCI report shopping centres continue to present the most pronounced year-on-year rental decline of -11.4%, while out of town retail has been more robust, reporting declines of -7.0%. As we have witnessed, the fall in rents has not discouraged acquisition activity in the sector. It has in fact done the opposite with opportunistic value orientated retailers continuing to take advantage of more favourable lease terms. It does appear, however, that the early shoots of a recovery in rental terms, that seemed close in March, have been put on hold for a little longer whilst the economy adjusts to the ongoing impacts of the pandemic.

Rental decline on new deals is one thing, but what is happening with rents on leases already in place?. The pandemic has seen many retailers struggle to make payments due to prolonged trade inactivity throughout the lockdowns. However, with much more of the retail warehouse sector considered to be 'essential' during these periods, the sector's resilience has been further reflected in the proportion of rent and service charge payments that have been made, especially in

Figure 5: Insolvency activity by asset class (2019 v 2020)



Source Savills

comparison to other sectors. Tenants on Savills-managed retail parks paid 40% of rent due and 24% of service charge due on the June quarter day. In comparison, on the same date tenants in shopping centres had only paid 19% of the rent due, and 23% of service charges. These figures have since improved. On the September quarter day, rent payments by tenants on retail warehouse parks had grown to 53%, 36% for service charge due. Shopping Centres, however, remain much lower at 28% for both rent and service charge collection .

The rent collection statistics are less surprising when analysing the data on footfall. As the first lockdown ended across all parts of the UK retail economy, footfall on retail warehouse parks recovered more quickly than in other retail destinations, and as of the start of October, was only 11.8% down year-on-year. We would suggest that the combination of large units and adjacent car parking makes shopping on retail warehouses parks more easily done in a socially distanced fashion than in other types of retail location. Despite the noteworthy improvements in early Q3 across all sectors, footfall levels have tapered off in recent weeks, with the second national lockdown expected to temporarily undo recent recovery to some extent. However, we can expect a similar shift in footfall patterns as was evident after the first lockdown ended, whereby retail parks are more resilient than high streets and shopping centres, owed in part to the presence of essential foodstore and DIY retailers.

It, therefore, follows that retail warehousing has also been comparatively less affected by retailer failures than is true of other retail segments, which, in general, is due to their lower exposure to mid-market fashion. Fashion operators accounted for as much as 46% of units to pass through an insolvency process in 2019, decreasing slightly to 44% in 2020 by the end of Q3. However, with the recent news that both the Arcadia Group and Debenhams have entered into administration, the fashion sector is likely to be compounded further as we wait to see how much of their respective portfolios we will lose from the retail landscape.

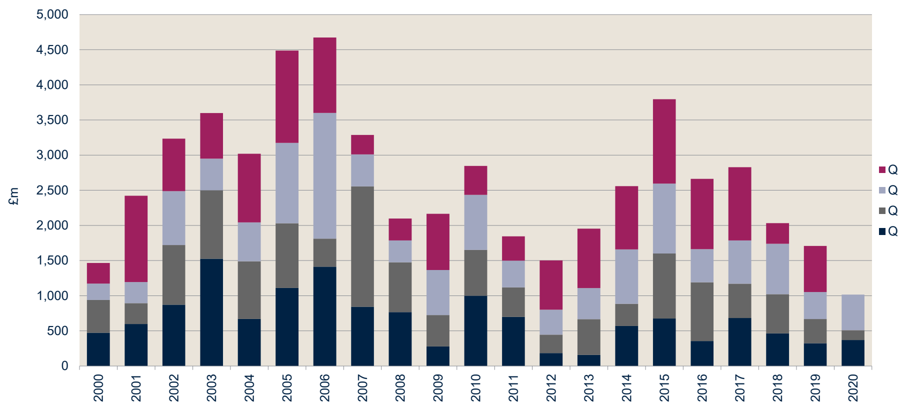
Analysing the impact by asset class, it is the high street that has accounted for the largest slice of insolvent activity in each of the last three years accounting for 56% of units in 2018, 79% in 2019 and 61% in 2020. By comparison, the out-of-town sector accounted for as little as 14% of activity last year, whilst so far in 2020 it accounts for a third of units that have been through an insolvency process in the retail market as a whole (with more than half of those, 57%, seeing no disruption in trade and no reduction in their rental income thus far, Figure 5).

More significantly, insolvency-related closures have been much more pronounced in the in-town market than they have out-of-town. So far 2020 has seen only 191 closures in the retail warehouse sector (only 11% of all units to pass through an insolvency procedure in that market). High street units have seen 890 closures, equating to more than a quarter of insolvent units (28%). Of course, this will worsen as we wait on the outcome of the Arcadia and Debenhams administrations. Interestingly however, of Arcadia's c.6m sq ft of retail space, the out-of-town market accounts for only 18%, predominately through their 'Outfit' brand.

Investment market

After a notable pandemic-related pause in transactional activity, the market has witnessed an acceptable level of recovery but without the anticipated furore

Figure 6: Retail warehouse investment volume



Source Savills

The retail warehouse investment market got off to a good start in Q1 with volumes up 14% on the same period in 2019 equating to £369m in transactions. Unsurprisingly, Q2 investment activity took a nosedive, recording the smallest uptake of any quarter in the last 20 years at only £141m, a 59% fall on the same period the previous year; clearly, the market paused to assess the impact of the pandemic on the sector's occupiers and their ability to pay rent, enabling investors to reassess ERV levels where necessary.

Nevertheless, activity in Q3 swiftly recovered, posting a 32% growth on Q3 2019 and accounting for £505m worth of transactions. We have been banging the drum on the resilience of the retail warehouse sector for some time, and it was certainly the preferred retail sector for investors pre-pandemic. The quick and significant return to growth in Q3 highlights how this position hasn't changed and indeed has been enhanced upon given the durability it has continued to display over the last nine months. A higher proportion of retailers remained open during the initial crisis than in shopping centres or on high streets and as a direct result rent and service charge payments have been higher. With less exposure to mid-market fashion, the sector has also seen less insolvency activity than the rest of retail, whilst its large units and ample car parking provision have also meant it has proven to be more social distancing friendly, culminating in stronger footfall recovery and more robust trading performance across a number of retail warehouse-focussed subsectors.

However, although transactional activity saw a marked improvement in Q3, the sentiment in the market suggests what we have seen so far is a trickle, not the anticipated flood. In previous editions of this Spotlight dating back to this time last year, we have highlighted the comparative appeal of retail warehousing as an asset class with the expectation that a number of overseas investors in particular, all with plenty of liquidity, were on the precipice of pulling the proverbial trigger and significantly expanding their exposure to UK retail warehousing. Debt availability has certainly got the ball rolling, particularly for Prime assets. This is set to improve over the next twelve months with more lenders coming to the party than has historically been the case, primarily as a result of the low loan to value ratios and high margin potential, coupled with the strong occupational story of resilient consumer behaviour and the defensibility of income across the sector.

The question therefore becomes what else needs to happen to convince the other investors that have been circling to open their cheque books? It is important to remember that in light of the pandemic, something that of course wasn't even on the radar when we first pre-empted that the retail warehouse sector was on the cusp of a significant uptick in investment performance, investors in the current climate would be buying assets where a significant proportion of tenants have not paid rent for twelve months, not to

mention the spectre of further insolvency activity. Some investors have therefore seemingly been waiting a little longer on the assumption capital values may fall a little further, particularly whilst concern remains about the sustainability of ERVs. However, the evidence suggests Q4 marks the beginning of this uptick with plenty of transactional activity underway, albeit with the width and depth of demand across secondary assets further to travel.

In terms of pricing our prime yields have again moved inwards back to levels seen twelve months prior, now standing 6.50% for both Prime Restricted and Prime Open A1 (a sharpening of 25 and 50 bps respectively). This is indicative of investors that have begun to move, supported by the belief in the performance of the discounters rather than fashion and recognising the value in the stronger metropolitan alternative-use assets that aren't always available in the market.

There does, however, appear to be a gap forming between prime and secondary assets, as well as Shopping Parks. Yields have moved outwards to 9.50% on both Secondary Restricted and Secondary Open A1 (a 25 and 75 bps softening respectively). Meanwhile, Shopping Parks have softened by more than 100 bps to 8.50%, unsurprising considering the fashion sector has been one of the hardest hit since the pandemic with the most insolvency activity to date. However, with interest on borrowing at around half the yield on these assets, they too could tickle an investor's fancy in the not-too-distant future.

Nobody is suggesting that investors are waiting to buy at the absolute nadir of the market, only that they have wanted to get closer to it. It is our view that with a vaccination programme well underway, coupled with some encouraging noises from retail operators on their Easter performance, this may be what tips those investors that have been wavering into action, assuming owners are realistic on price. This will also give lenders the comfort they need by providing greater clarity on rental levels and covenant strengths, especially for less prime stock.

Schemes that are dominant or convenient will continue to be top of investors' wish lists, particularly those with a foodstore anchor. Brexit is the one potential spanner in the works as it will undoubtedly lead to a disruption in retailer supply chains and their ability to get goods into the UK. If this coincides with the moment that shoppers are free from the shackles of the pandemic and poised to spend at levels previously seen, not being able to get their spring bulbs, bikes and garden furniture may well prove to be an opportunity missed.

Outlook

Key themes for 2021

There is no doubt that 2021 will continue to be a challenging year for retailers and retail landlords across all locations. Q1 2021 will probably see more retailer failures and questions over rent collection, though we expect these to have less of an impact on retail warehouse parks than high streets or shopping centres.

The next key date in retail warehouse retailers calendars will be Easter 2021, and given the recent positive news on vaccines, it is reasonable to assume that the lockdown situations will generally be looser by then. This will translate to a more normal trading period, and possibly even a relief bounce in spending. This should boost rent collection and retailer performance across the sector.

This should mean that by summer 2021 the falls in rents that we have been seeing for a number of years in the retail warehouse market should continue to diminish, and we may also see some upward pressure on rents in locations where rebasing has taken place.

We expect to see more investment activity across the retail warehouse market, with rising focus on parks that dominate their catchments and have a bulky goods bias and a food offer, or a foodstore adjacent to the park.

While the pick-up in investor demand will be welcome, we do not expect it to have much impact on the yield or pricing trajectory in 2021. The volume of retail warehouse assets that are actually or potentially on sale remains high, and this will enable buyers in the sector to be very selective on what assets they do and do not want. This will mean that prime yields should plateau in 2021, the wider trajectory for retail warehousing yields next year will be one of continued softening (albeit at a slower rate than in recent years).

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

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