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UK Shopping Centre and High Street Spotlight

Quarter 2 2018

Image: Whitefriars, Canterbury

SUMMARY

■ Consumer trends and confidence remain fairly muted, with the recent rise in the base rate unlikely to impact saving or borrowing behaviour significantly.

■ The occupational market remains similarly flat, with most retailers struggling with the twin effects of last year's weakening margins and the uncertainty about Brexit going forwards.

■ Landlords are also increasingly cautious about the future, and are more prepared to offer better terms to maintain occupancy levels.

■ Shopping centre investment turnover in the first half of 2018 was 39% down year-on-year. This is being driven by uncertainty around the occupational outlook, and a mismatch between vendor and purchaser expectations on price.

■ A similar story of mismatched expectations is true in the high street shop investment market, though the first half investment volume was in line with year-on-year.

■ We expect the investment market to remain quieter than normal for the remainder of 2018. However, opportunistic buyers are out there and will strike once they see value.

"Increased volatility in the occupational sphere has compounded the existing uncertainty in investment markets as volumes have drifted further, but opportunistic investors are starting to gather."

The consumer economy

With August seeing the MPC finally raise interest rates to 0.75% there will undoubtedly be some who see this as yet another straw loaded onto the back of the fragile retail sector. However, the forward guidance remains that any further rises will be "gradual" and "limited", so we do not see this anything other than a statistician's moment.

Indeed, commentary around interest rate rises often over-focuses on what it means for the comparatively few people who are on variable rate mortgages, and ignores the positive impact of the far larger number of savers that should get more interest from their savings than they have received for nine years.

While the household savings ratio has picked up a little from its record low this time last year, UK consumers are still only saving 4% of their earnings, while borrowing at an enthusiastic level. If interest rates do continue to rise (without substantial earnings growth), then we do expect that borrowing will slow and this will drag on retail sales.

However, the recent very weak trend in retail sales volumes did strengthen sharply over the last quarter, with the three month on three month rate rising from -0.3% to +2.0%. While some of this can probably be attributed to a surge in good weather related sales, we may also be seeing the beginnings of a recovery in consumer sentiment as incomes continue to rise faster than costs. As Graph 1 shows, while the overall consumer confidence measure has weakened in recent months, the responses to the question on people's perceptions of the outlook for their own finances has been more positive in the first seven months of 2018 than the same period in 2017.

The retail occupational market

After the turbulence of 2017 and early 2018 the occupational market has entered a period of relative stasis (albeit at a low level). The last few months have seen few good or bad changes to the retailing environment, which means that operating margins remain tight.

Most retailers are as confused as every other industry as to what the numerous vague Brexit scenarios might mean for their businesses going forward, and this means that the easiest decision to make is to not do anything too dramatic.

Rationalisation continues across most segments of the retail market, with limited store openings underway or planned. Where retailers are expanding or consolidating into new stores they are finding that landlords are becoming increasingly flexible on rents and terms, and we expect this to remain the tone of the market for the foreseeable future.

As we commented upon in the last Spotlight, some retailers are scaling back openings in the hopes of a better deal in the months to come, or in case another retailer's failure makes a more desirable unit come available.

GRAPH 1

Consumers are more positive about the outlook for their own finances than they were in 2017

Source: GfK

Looking ahead we expect the balance of power in the occupational market to remain firmly in tenant's hands for the foreseeable future. While retailer's operating margins are unlikely to improve noticeably in the next 12 months, some are in a more dominant position than they were a year ago because of the failure of their competitors. This, in time, should improve profitability, and in turn deliver a degree of comfort for any retailer who is considering expansion.

However, we expect that the overall tone of the retail occupational market will mirror the current stasis until real clarity emerges around what type of Brexit we are facing.

Shopping centre investment

The shopping centre investment market's malaise has continued into 2018, after 2017 saw the lowest volumes since 2008, with only £1.69 billion of shopping centres trading over the course of the year. Volumes for the first six months of 2018 reached £592 million, down 39% on the same period last year, and indicating that 2018 volumes will remain some way below 2017's figures, and significantly short of the long term average of £3.8 billion.

Nine transactions completed in the second quarter of 2018, equating to an aggregate capital value of £260 million. The largest of these was DTZ Investors' acquisition of Shop Stop in Clapham from Delancey for £128 million, reflecting approximately 3.2% NIY, and comprising the only shopping centre to have traded in 2018 with a value in excess of £100 million (there were five such deals in 2017 and seven in 2016). A rare exciting prospect this asset was keenly fought after but, much like Brixton Markets earlier this year, should not be considered reflective of the wider shopping centre market. Other notable transactions in the quarter include Talisker Corporation's purchase of Wembley Central from St Modwen for £40 million (6.0% NIY) and NewRiver's acquisition of Grays Shopping Centre, Grays for £20.2 million, reflecting 8.2% NIY (pricing includes a vacant office building with residential development potential. Apportioned pricing on the core shopping centre income is understood to be in the region of 9.4%

NIY).
The lack of liquidity in the market has been fuelled by a number of factors but unprecedented uncertainty in the occupational sphere, caused in part by a clutch of retailer CVAs and administrations in the early part of the year, has weighed heavily on investor confidence. Announcements of store closures for high street staples such as Marks & Spencer and Carphone Warehouse have also hampered appetite for secondary shopping centre assets, especially those anchored by department stores or with significant exposure to mid-market fashion multiples. Aversion to these tenants has manifested in the fact that only two department store-anchored schemes having traded so far this year, in both cases anchored by Fenwick, whilst no investor has acquired in a scheme anchored by Debenhams, House of Fraser, or Marks & Spencer.

Despite the statistics, certain silos of the market are proving more resilient. Demand for London and South East assets remains strong as the retrenchment towards the perceived security of these geographies continues. During 2017, London and the South East accounted for 52% of shopping centre transaction volumes. In the first half of 2018, this has increased to 78%. Money also continues to be raised for deployment in the community and convenience sector, where assets have shown themselves secure in the face of uncertainty and volatility in fashion and department store-anchored schemes. A shortage of suitable assets means that there is untapped demand for these assets, such that they are well received when they do materialise.

Compromised (or failing) shopping centres are increasingly perceived as opportunities for repurposing; a process which sees shopping centre assets that are not fit for purpose either downsized or redeveloped completely, reducing or reconfiguring the retail footprint, and bringing higher-value uses into centres, such as residential, hotel, student, office, or community uses. We have seen examples of such assets trading this quarter with Reef Estates securing St George's Shopping Centre in Gravesend as a keystone for a residential-led development, and NewRiver's aforementioned purchase of Grays Shopping Centre. Local authorities are also at the forefront of this trend, acquiring shopping centres in their town or city centres as a catalyst to drive regeneration where the private sector, for one reason or another, has been unable to deliver; whilst also bolstering future revenue streams to protect council services. During the last quarter, acquisitions of Crompton Place in Bolton by Bolton Council for £14.8 million (4.6% NIY) and of Liverpool Central for £13.25 million by Liverpool City Council have exemplified this.

Local authorities have therefore remained a key buyer group in 2018, directly acquiring seven of the twenty schemes that traded in the first half of the year, including two in the last quarter. This equates to a market share of 32% by volume, which is more than any other buyer type, and significantly above local authority market share of 13% in both 2016 and 2017. Scratching beneath the surface, local authorities are also playing a key role in facilitating other transactions, beyond direct investment. For example, the respective local councils either funded (in whole or in part) or entered joint venture agreements involving private sector investors in Gravesend, Bolton, and Stroud during the second quarter of 2018.

TABLE 1

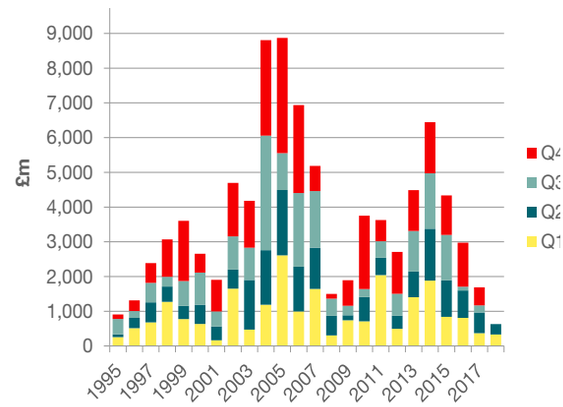
Shopping centre yields

	LT Avg	Q2 2017	Q1 2018	Q2 2018
Super-Prime	4.66%	4.50%	4.75%↑	5.00%
Prime	5.66%	5.50%	5.75%	6.00%
Town Centre Dominant	6.86%	7.00%	7.50%↑	7.75%
Secondary	8.86%	9.50%	9.75%↑	10.00%
Tertiary	11.42%	12.50%	12.50%	13.50%

Source: Savills. Arrow indicates forward trend

GRAPH 2

Shopping centre investment



Source: Savills

Across the sector, liquidity has also been held back by an arbitrage between vendor pricing expectations and their valuations, and sentiment-led purchaser returns criteria. However, as evidence starts to emerge and sentiment persists, we anticipate this gulf to narrow as those investors without the appetite (or ability) to make the requisite capital expenditure to deliver business plans seek an exit. This will galvanise opportunistic purchasers, who are starting to circle the sector, especially where bank-led distress emerges. Elsewhere, we anticipate that the arbitrage between prime shopping centre assets and other asset classes, such as industrial and logistics, will start to make the sector more attractive, particularly where passive stakes may be made available through the likes of Hammerson and intu seeking to deleverage their balance sheets. With the turmoil in the occupational markets not expected to let up in the short term, we do not envisage a step-change in sentiment in the investment market during the remainder of 2018. With approximately £440 million of shopping centres currently under offer, we consider it unlikely that volumes will reach 2017 levels of £1.69 billion before the year end. That said, we do expect there to remain activity among the smaller lot sizes, particularly where there are deliverable repurposing opportunities, as well as for prime and London and South East assets, and community and convenience led assets.

Having fallen between 2014 and 2015, yields across the sector have drifted

outwards during 2016 and 2018, with movements of at least 50 basis points across the quality spectrum in the last 12 months. The prevailing uncertainty in the market has led to yields now exceeding long-term averages across the sector. However, community and convenience schemes - distinctive to secondary centres - are proving more resilient.

High street investment

Investors in high street shops have also paused for breath over the last few months, with many expecting that pricing will be more attractive for buyers later on this year.

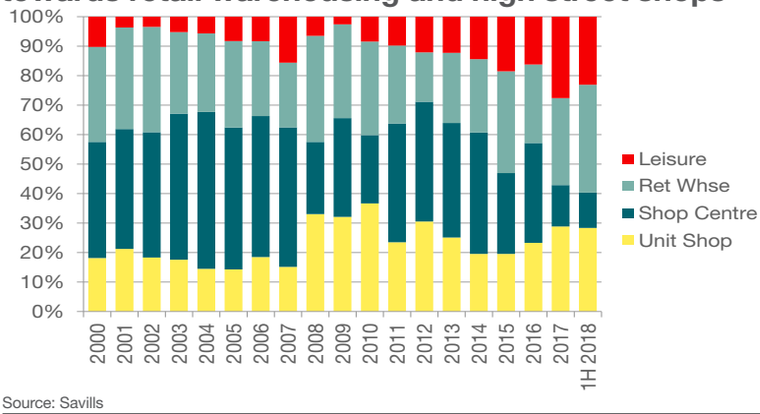
According to Property Data there was only £309m of high street shop transactions outside London in the second quarter of 2018, a 34% fall on the previous quarter. However, this brings the total investment volume for the first half of the year to £882m, which is in line with the total for the same period in 2017.

Often a lack of activity can be attributed to lack of stock, but the last three months has seen an increase in the number of units being marketed for sale. These are primarily coming from institutional owners who are finding themselves overweight in the sector. The challenge for these vendors is that there are very few buyers at today's prices, even for prime stock. While our indicative prime shop yield has been stable at 4.25% for the last three months, this is probably flattered by a few "jewels". Long leases to strong covenants in prime southern towns are still capable of achieving this, but very few centres can attract a sub 5% yield for their best shop.

Looking ahead to the remainder of 2018 and early 2019 we do expect a little more rationalism to enter the market, and this will lead to a better alignment between vendors and purchasers expectations. Some assets will be found to have repriced too much, particularly where they offer limited occupational risk (and are not significantly over-rented), and these will be the assets on which canny buyers will swoop on in the New Year.

GRAPH 3

Investors in retail outside London have swung towards retail warehousing and high street shops



Source: Savills

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