

UK Shopping Centre and High Street Spotlight

Quarter 3 2018



Image: The Sovereign Centre, Weston-super-Mare

SUMMARY

- Consumer confidence about the future remains surprisingly strong (so long as you don't ask about the UK economy). The biggest risk to retail sales is a rise in precautionary saving which might occur in the event of a disorderly Brexit.
- In the retail occupational market tenants continue to have the upper hand in all types of negotiation. We expect that landlords will continue to focus on maintaining or growing occupancy, over pushing rents or terms.
- Shopping centre investment activity fell to its lowest ever level in the third quarter of 2018. This has more to do with the chasm between vendor and purchaser aspirations on price than a lack of interest in the sector.
- In the high street shop market the last quarter has seen a rise in liquidity. While further gentle upward pressure on yields is likely in 2019, the gap between vendor and purchaser expectations on price is less wide than in the shopping centre segment.

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 "Dominance, strong tenant trade and affordable rents will define the prime retail schemes in the UK."

➔ **The consumer economy**

The two most important questions about consumer confidence have continued to improve over the last quarter (Graph 1). While Brexit noise is undoubtedly dragging on people's perceptions about the outlook for the UK economy, it does not appear to be negatively affecting their views on their own financial prospects, or on whether now is a good time to make a major purchase.

This looks unlikely to change in the short term, with the official statistics in October showing that average weekly earnings in the three months through August were 3.1% higher than a year ago. This is the biggest increase since January 2009, and puts wage growth firmly ahead of inflation.

While retail sales growth is continuing, footfall has been down since the summer boost, and this will probably be the tone until the Christmas rush begins. While consumers are confident, the pattern of spending in recent years has been one of saving in Q3 for the Christmas period.

On the subject of saving, we believe that the biggest risk to the UK consumer economy at present is around Brexit sentiment. Savings ratios, while not quite at record lows, are still low. Furthermore, while the growth in unsecured borrowing has slowed, it is still growing at 10% per annum.

There is a strong possibility that a disorderly Brexit would lead to a rise in precautionary saving similar to what was seen in the immediate aftermath

of the Global Financial Crisis. Back then the savings ratio rose from just under 7% to over 10% in the space of a year, and while many consumer maybe did not need to save more, it had an immediate impact on consumer spending and retail sales.

The retail occupational market

Little has changed over the last quarter in terms of the generally downbeat tone that has been prevalent in the occupational market over the last two years.

While the actual number of CVAs and administration announcements has been lower this quarter, this has not stopped the speculation on who will be next. Our own analysis of all the announcements to date shows that less than 1.3% of UK stores have been affected, and that only around one-third of those units have been closed. Despite this, the blow to retailer and landlord confidence of the last two years cannot be underestimated.

Not only has the number of new store openings reduced dramatically, but the terms on which landlords are doing new lettings have softened considerably. Even where ten year leases are being signed, a break at the fifth year is now the norm. We have also seen examples of landlords giving away two year incentive packages on five year leases in some of the best schemes and locations in the UK.

This tension is not just occurring in the new letting market, but also at rent review and lease renewal. Landlords who are expecting further

rationalisation amongst the larger store chains appear to be prepared to do very soft deals to ensure that occupancy levels remain as high as possible.

There are one or two bright spots in this relatively dour story. 36 international retail and leisure brands have opened their first ever UK outpost in London this year, already exceeding 2017's full year total. We expect the total for 2018 to reach 45, a sign that there is still strong retailer interest in some parts of the UK. 22 of these entrants were from outside the F&B sector, with the majority of the brands coming from mainland Europe.

However, even in the most desirable locations across London and the UK many retailers remain challenged by the high rents. This means that 2019 is likely to see further downward pressure on rents, particularly where landlords lack confidence in their scheme or the market.

While we do not expect the consumer story to worsen next year, it is likely to be a similar year to 2018 in terms of a lack of large-scale new store rollouts, and continued rationalisation of the underperforming elements of retailer's existing portfolios.

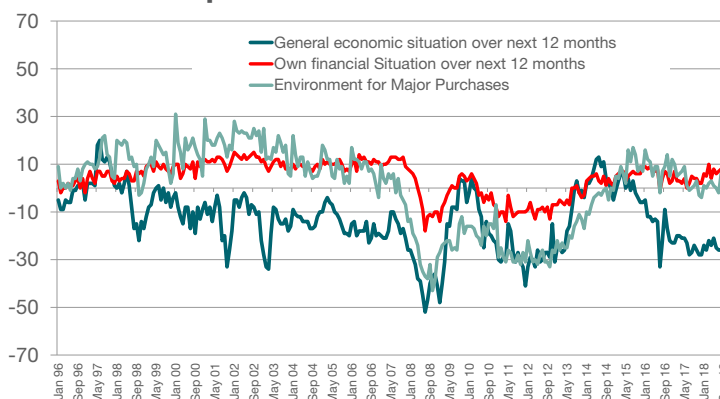
This will continue to put downward pressure on rents in 2019, though our forecast for the next five years remains one of a marginal positive level of rental growth over the forecast period.

Shopping centre investment

As at the end of Q3 2018, shopping centre investment volumes for the year stood at £662 million across 25 deals. This compares to £1.17 billion in 27 transactions during the same period in 2017 (down 44%) and £1.71 billion in 29 transactions in the first three quarters of 2016 (down 61%).

Q3 2018 saw shopping centre transaction volumes reach their lowest level on record, totalling a miserly £73 million across only five transactions. Prior to this quarter, the previous low was £79 million in Q4 1995, underlining the extent to which the market is experiencing an unprecedented lack of liquidity. The picture painted by the statistics, however, masks the reality of the marketplace, which is

GRAPH 1 **Consumers are positive about their own situation**



Source: GfK

→ characterised not necessarily by a lack of demand for shopping centre assets but by an arbitrage between vendor aspirations and purchasers' risk-adjusted returns criteria.

Given the uncertainty present in the occupational sphere, investors are also rightfully increasingly selective when considering opportunities. Dominance, strong tenant trade and affordable rents give reassurance that passing levels of income are sustainable and these factors are crucial considerations to understand when assessing assets. Where these criteria fail to be met, increasingly, assets need to demonstrate deliverable repurposing potential.

The most notable transactions this quarter include Cheyne Capital and Ellandi's sale of the Sovereign Centre in Weston-super-Mare to Legal & General (who simultaneously granted a 35-year under-lease to North Somerset District Council) for £21 million, reflecting 8.83% NIY. Although another council acquisition, Savills oversaw a competitive bidding situation for the asset with a third party investor, underpinning the council's purchase price. Vicar Lane in Chesterfield also sold for £21.15 million, reflecting a NIY in the region of 11.00%. We consider this a fundamentally robust asset, mispriced by the market, that demonstrates the opportunities that are starting to emerge.

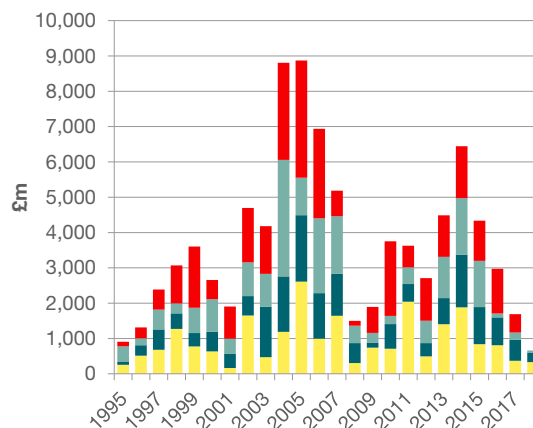
In line with reduced overall volumes, it is noteworthy that average lot sizes have also fallen. For example, to date in 2018, the average deal size is £26.5 million. This compares to £41.2 million in 2017 and £70.7 million in 2016. This is partly as a consequence of the changing buyer profile, as demand for larger lot sizes from institutions, sovereign wealth

funds and REITs has waned and their places taken by property companies and local authorities. Combined, the latter two buyer types account for fifteen transactions this year and a 47% share volumes. On the other hand, opportunistic buyers primed to come into the market are increasingly concerned by achieving scale so, once these parties make their play, expect upwards pressure on the average lot size.

We are now anticipating transaction volumes for the year to reach in the region of £1.25 billion, boosted by the recent exchange of contracts on Hammerson's sale of a 50% share in Highcross, Leicester (a deal that falls into Q4) and with a further £320 million of assets under offer, the vast majority of which stems from two London development opportunities: Liberty, Romford and Edmonton Green Shopping Centre, Edmonton. Despite this, volumes of £1.25 billion would be the lowest since 1995 when volumes reached only £909 million.

As the tenth anniversary of the collapse of Lehman Brothers passes, it is notable that the data appears to show the market to be more challenged than during the depths of 2008 and 2009 when annual transaction volumes reached £1.5 billion and £1.89 billion respectively, ahead of our forecast of £1.25 billion for 2018. The reality is quite different, however, and helps to explain why there has been comparatively little activity. The bank-led distressed sales of 2008 and 2009 have yet to materialise. This is because as lessons learned ten years ago mean, even though valuations are falling and sentiment remains poor, there is comparatively less debt in the market, at least at the same LTV levels as previously.

GRAPH 2 Shopping centre investment was at its weakest ever level in Q3 2018



Source: Savills

This means that there will be less distressed selling of assets than there was in the post-GFC period, which will give landlords time and space to reinvest in their assets. While that will mean that a bounce in transactional volumes is unlikely, it should put a floor on how far down values will move.

At a corporate level, the resurfacing of a potential takeover of intu, this time by a consortium led by existing shareholder, John Whittaker, Brookfield, and Saudi Arabia's Olayan is a key development to track. Once again, the proposed takeover illustrates that there remains demand for the UK's top-quality retail and shopping centre assets, including from blue-chip investors such as Brookfield. In a sector devoid of confidence, the value of this statement of intent should not be underestimated.

High street investment

The third quarter of 2018 saw turnover in the high street shop market outside London of £340m, virtually identical to the Q2 figure. This brings the total for the year to date to £1.3bn, 18% down on the same period last year.

The actual number of deals so far this year is only 11% down, and this echoes a point that we have stressed in previous spotlights that there have been few large standard shop transactions. Indeed, this quarter has seen no deals in excess of £6m.

TABLE 1 Shopping centre yields

	LT Avg	Q3 2017	Q2 2018	Q3 2018
Super-Prime	4.66%	4.75%	5.00%	5.00% ↑
Prime	5.66%	5.75%	6.00%	6.25%
Town Centre Dominant	6.86%	7.00%	7.75%	8.00%
Secondary	8.86%	9.75%	10.00%	10.25%
Tertiary	11.42%	12.50%	13.50%	14.00%

Source: Savills.

What has changed over the last quarter has been the level of liquidity in the market, with a number of UK institutions looking to sell prime assets as part of a wider strategy to reduce exposure to retail. There is evidence of investor demand for this type of product, with the recent sale of the LK Bennett unit in Guildford for 4.5% indicating the achievable tone for prime yields in the south.

Deals to watch in the final quarter of

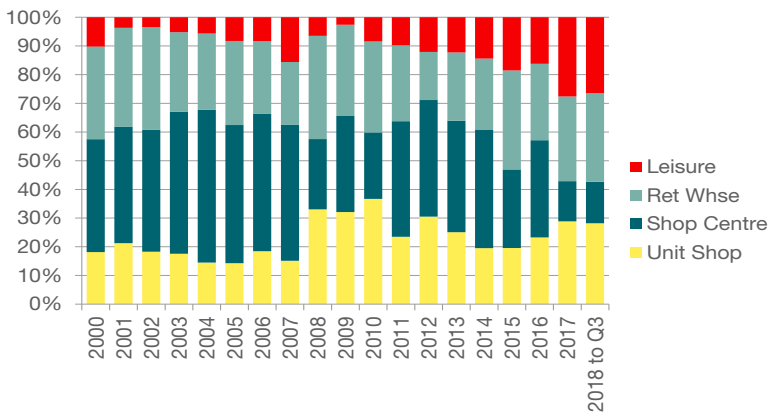
the year will be the sale of the 139,127 sq ft Debenhams in Clapham Junction, and 21-27 Church Street in Kingston-upon-Thames (let to Molton Brown and White Stuff). Both assets have their attractions for certain types of investors, and the depth of bidding for each will give a good steer as to how the market is likely to start 2019.

Generally we expect that next year will see more of the same as this year, with steady demand for prime lots of

£5m or less, particularly in the south, and gentle upward pressure on yields across the rest of the market.

Assets that do not sell are more likely to be withdrawn than markedly discounted, and this will keep investment volumes low for the foreseeable future. ■

GRAPH 3 Retail investment outside Greater London



Source: Savills

Savills Retail team

Please contact us for further information



Mark Garmon-Jones
Investment
020 7409 8950
mgjones@savills.com



James Stratton
Investment
020 7409 8880
james.stratton@savills.com



Toby Ogilvie Smals
Investment
020 7409 8162
tosmals@savills.com



Sean Gillies
Leasing
020 7409 8159
sgillies@savills.com



Stuart Moncur
Leasing
0131 247 3706
stuart.moncur@savills.com



Jonathan Stott
Professional
020 7409 8167
jstott@savills.com



Mat Oakley
Research
020 7409 8781
moakley@savills.com

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