UK Shopping Centre and High Street Spotlight

Quarter 4 2016

Image: Stratford Centre, London

SUMMARY

■ Christmas trading was strong for the majority of retailers, but the December retail sales data highlighted that prices have started to rise in the UK. This will be a challenge to both consumers and retailers in 2017, and will combine with other factors to put pressure on retailer's margins.

■ Occupational demand in 2017 will be framed around the expectation of tighter margins. We expect the out-of-town market as well as the Midlands and North to benefit from these changing priorities.

■ 2017 will see a more normalised shopping centre investment market, with volumes in line with the average and up on last year. There will be a continued investor bias towards prime stock.

■ High street retail investments will remain very popular with private investors in 2017, and this could put some downward pressure on yields in the best locations. Demand for larger lot sizes will remain limited, though this may present an opportunity for institutional investors.

"The average reported like-for-like sales over Christmas 2016 was 5.1% up on Christmas 2015."

The consumer economy

The bears around the prospects for the UK economy in a post-referendum world have found little evidence yet to prove their cases. GDP in the final quarter of 2016 was estimated to have grown by 0.6%, exactly the same as each of the preceding two quarters. This brings the total growth for 2016 to 2%, only marginally lower than the 2.2% achieved in 2015.

December's retail sales volume was 1.9% below November, a result that was largely unexpected. Part of this fall can probably be attributed to the very strong growth in October and November 2016, and part may be due to seasonal adjustment relating to Black Friday. It is also worth noting that even though December's figure was a surprise, Q4 2016 still delivered a rise in sales volume of 1.2%, well above the quarterly average of 0.5% that has been the norm since the last recession.

So, while the retail sales data might not be as bad as it first seemed, the December read on shop price inflation is definitely a harbinger of challenges to come in 2017. This showed that inflation increased from 0.1% in the year to November 2016 to 0.9% in the year to December. This is the fastest rise in shop prices since 2013 and is the beginning of the expected squeeze on retailers' margins and household incomes that stems from the weakening of the pound in 2016.

Consumers are yet to react to this, and both consumer confidence and the household savings ratio were stable in the final quarter of 2016. However, with wage growth stable, it is inevitable that real earnings growth will be muted in 2017. This will definitely feed through into weaker consumer spending and retail sales growth.

The retail occupational market

The most important lead indicator at this time of year for how retail property strategies will evolve is how well retailers traded over Christmas. Comfortingly the story of Christmas 2016 was generally good, with an average reported rise in like-for-like (LFL) sales of 6.6% for all retailers, and 5.1% if we exclude those who only trade online. Indeed, while this year has seen a slight increase in the number of retailers who reported total sales rather than LFL, it is the first year that we can remember that only one retailer reported negative LFL sales.

A strong Christmas should give retailers a confidence boost at the start of what is undoubtedly going to be a challenging year. 2017 will definitely see retailers' margins being compressed, both by the rise in the minimum wage, and by the weaker pound. As we commented earlier, shop prices have started to rise, and this will continue over the course of 2016 as retailers' currency hedges run out. The big question is how much of the extra cost will be passed onto the consumer, and how that will impact on sales volumes. Another challenge in 2017 and beyond, particularly for retailers whose store portfolio is biased towards London and the South East, will be the rise in business rates.

The segment of retail that we expect to be most stretched by this variety of rising costs is the value end of the market, particularly those who trade off a fixed price point. While this group of retailers will probably benefit from rising consumer uncertainty, they have less flexibility on raising prices and thus will see the sharpest pressure on their margins.

As far as broad occupational strategies go, we expect 2017 to be similar to 2016. There will definitely be continuing expansion away from London in both the A1 and A3 sectors, and we expect that the Midlands and North will rise in popularity due to both the smaller impact of the changes in business rates and less caution around the impacts of Brexit.

This view is born out by our latest Retail Town Ranking. While there has been no change in the top four towns (Cambridge, Guildford, Oxford, Richmond), some more northerly towns and cities have moved up the rankings since last year. These include York, Cheltenham and Edinburgh - all of which have strong structural drivers as well as good growth prospects.

We also expect to see some changes in the type of space that is in demand. The last few years have seen a definite trend of retailers rationalising from a number of small units into one larger unit, and over the next few years we believe that this trend will see more retailers seeing if they can trade from bigger boxes out-of-town. The rationale for this being twofold. Firstly the bigger units are more internet-sales friendly, and secondly the occupational costs are lower than on the high street.

The biggest challenges for retailers in 2017 and beyond will be around maintaining their margins, and this will definitely impact on property strategies. While we do expect to see continued expansion, this will be more measured than in recent years, particularly in the A3 sector where rents have risen significantly. We also expect to see particular stress in the mid-market fashion arena where margins are typically tight, as well as in central London due to business rates.

For those retailers who are still looking to expand, the challenge will be a lack of availability of good units on good streets. This problem will be exacerbated by developer caution which will limit the number of new schemes and expansions that start in 2017.

Shopping centre investment

The UK shopping centre investment market had an unusual year in 2016, largely due to the impact of wider themes including the result of the EU referendum. We witnessed a period of hesitancy from investors prior to the referendum and the shock result then led to a subdued Q3. However investment volumes rebounded strongly in Q4 as investors re-entered the market and we saw a return to ‘business as usual’.

The total amount invested into UK shopping centres in 2016 reached £3 billion. This compares to a total of £4.3 billion in 2015 and a long term average

TABLE 1

Shopping centre yields

	Q3 2016	Q4 2016
Super-Prime	4.50%	4.50%↓
Prime	5.50%	5.50%
Town Centre Dominant	6.50%	6.50%↑
Secondary	9.00%	9.00%↑
Tertiary	12.00%	12.00%↑

Source: Savills. Arrow indicates forward trend of £4 billion per annum. Several large transactions, increased purchasing activity from councils and a rise in non-domestic investment all contributed to the sector's bounce back in the latter part of 2016 after a slower than usual start.

Key transactions in 2016 included Hammerson's £335 million purchase of Grand Central, Birmingham, APG's purchase of a 75% stake in Edinburgh St James and Intu's £410 million purchase of Merry Hill, Dudley, which inflated total investment volumes for the year considerably. In terms of deal count, 42 shopping centre transactions completed in 2016, compared to 86 in 2015 and a long term average of 78.

While councils did not purchase a single shopping centre in 2015, they emerged as key players in 2016, making £386.7 million worth of acquisitions across 10 schemes. These transactions accounted for 13% of all UK shopping centre deals in 2016 and 44% of deals below £100 million. Additionally, non-domestic investors significantly increased their presence in the market, accounting for £1.35 billion of total transactions. Interest came predominantly from Europe, the Middle East and US, and was prompted by the fall in the sterling. Conversely, investment from UK-based institutions was the lowest since 2001 at £68 million.

The third quarter of 2016 was the quietest quarter on record, with just £111 million worth of shopping centres traded through 6 transactions, compared to 12 in every other quarter of the year. However, the fourth quarter saw volumes return to a robust £1.27 billion. This is broadly in line with the long term average and comparable to the £1.35 billion traded in Q4 2015. These figures demonstrate that the market has righted itself and we expect the high levels of transactions to continue into 2017 with far less irregularity and volatility.

10 centres are currently under offer in 2017, accounting for an investment volume of circa £590 million which once complete will provide a strong start for the year. Notable deals expected to complete in Q1 2017 include: the 50% stake in Southside Shopping Centre, Wandsworth; The Stratford Centre; Friars Walk, Newport; The Belfry, Redhill; and Exchange Shopping Centre, Ilford. We are also aware of circa £1 billion of stock currently being prepared for sale, in addition to the £545 million of stock in the market which has carried over from 2016.

Last year's Christmas trading results have painted a generally positive picture, boosting retail sector confidence going into 2017. Fashion retailers, general merchandise and foodstores are showing strong like-for-like sales, and anchor retailers like Marks & Spencer (LFL sales up 2.30%), John Lewis (LFL sales up 2.70%), Primark (total sales growth up 22%), House of Fraser (LFL sales up 2.70%) and Debenhams (LFL sales up 5.00%) are all reported strong Christmas trading. In addition, investors are also taking comfort from the fact that, unlike in recent years, no national retailer administrations have been announced thus far in 2017, and so the closing down sales and void units which have become typical in January have so far been avoided.

The rates revaluation, coming into effect on 1 April, should also provide an additional boost for retailers with regional stores, where generally they can expect to see significant rates reductions. This is particularly relevant for retailers with Scottish stores, where transitional relief is not applied and the change in rates payable will be immediate. This should result in an improved occupational market which has already been seen in Northern Ireland, where a rates revaluation came into force in 2015.

The triggering of Article 50 might result in a brief period of uncertainty later in 2017, but we do not envisage that investment volumes in the sector will fall to the levels seen in Q3 2016. Overall, we believe the outlook for 2017 is positive and expect it to hail a return to a 'normalised' market, with a number of institutions opening new funds with retail requirements and continued availability of debt. We anticipate that assets priced correctly will trade well in 2017, although a continued preference for prime stock will remain prevalent.

High street investment

The high street shop market had a strong year in 2016, with more than £4.5bn of transactions, which is the highest level since 2010. However, there was a strong London bias in investor focus, and the volume outside London was stable at £1.8bn (Graph 4).

The story outside London over the last two years has been one of an increasing number of smaller deals. This has been driven by a sharp rise in private investor interest in the sector due to the low interest rate environment, as well as some investors having moved out of residential buy-to-lets and into high street shops.

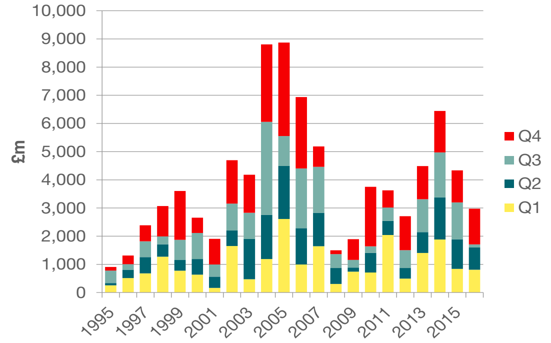
The big question for 2017 is whether we will see more institutions targeting the high street retail sector. As we commented in the last issue of this report some of the lack of fund activity has been down to a lack of suitably large lots coming to the market, though the final quarter of 2016 did see an uptick in the number of £15m+ lot sizes being brought to the market. Perhaps the most significant factor that has limited the funds is the low yields on offer in the prime high street retail segment. We do not expect this to change in 2017, as the depth of private investor demand (both domestic and international) is expected to rise. However, higher yielding opportunities will emerge in B+ locations, and the rental growth prospects in these markets might not be dramatically different to those in some AAA locations. If the UK institutions can get comfortable with the local supply and demand fundamentals in these markets, then buying in less sought-after submarkets may well be an interesting strategy for 2017.

Generally we expect that prime shop yields will remain stable in 2017, though the sheer weight of private investor demand for AAA locations could put some downward pressure on yields.

The best opportunities for vendors in 2017 will definitely be in selling AAA towns where rents have gone as high as they are going. These assets will remain popular with private investors who are transitioning into this sector more for income security than any expectation of growth.

GRAPH 1

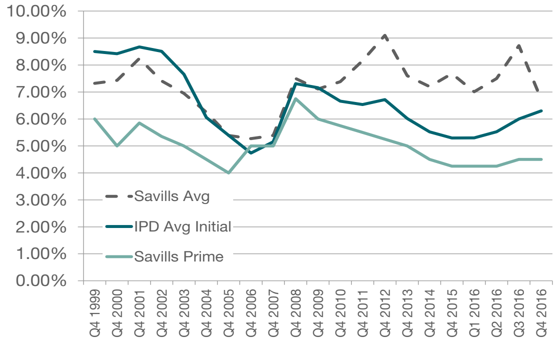
Shopping centre investment volume



Source: Savills

GRAPH 2

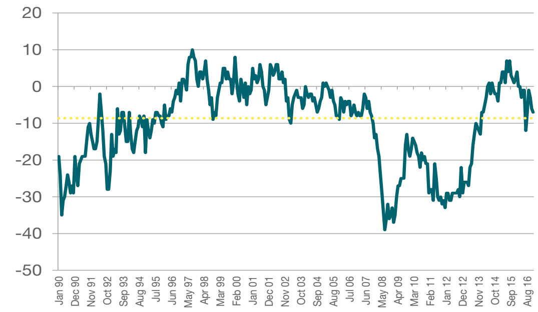
Shopping centre yields



Source: Savills, Investment Property Databank

GRAPH 3

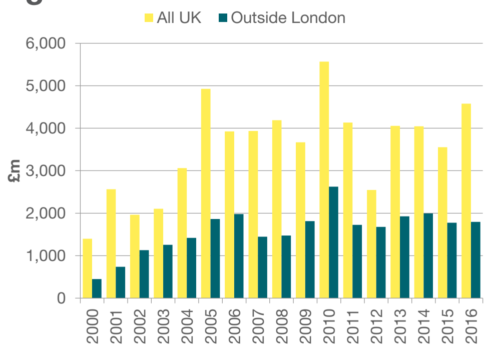
Consumer confidence



Source: Gfk

GRAPH 4

High street investment volume



Source: Savills, PropertyData

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