savills

UK Shopping Centre and High Street Spotlight

Quarter 1 2018

Image: Whitefriars, Canterbury

SUMMARY

■ Forward looking economic indicators are turning upwards, with real earnings growth back in positive territory for the first time in over a year, and consumer's views on the prospects for their personal financial situation at their highest level since 2007.

■ This positivity is yet to feed through to the occupational markets where even expansionary retailers are pausing to consider the implications of the recent rash of retailer failures.

■ Demand for high street retail investments remains strong so long as they are prime in terms of location, tenant, and most importantly lease length.

■ Investment activity in the shopping centre market is being hampered by liquidity and caution. However, we expect to see more stock in the market this year with an increasing number of investors to look beyond the obvious prime plays and towards defensive community-focused centres.

"Unrealistic pricing expectations, propped up by unattainable valuations are hampering liquidity in the shopping centre market."

The consumer economy

The first quarter of 2018 has been very bipolar in terms of retail news. While the bulk of the headlines have been about retailer failures, CVAs and downsizing, the actual data on the state of the consumer economy has been increasingly positive.

While the 'best from the east' definitely did have a negative impact on trading and footfall, the forward looking indicators for consumer spending have picked up. Employer's intentions have continued to swing away from mild cuts and stagnation towards increasing headcount. This, in an already tight labour market (the unemployment rate has shifted down to 4.2%) points to further upward pressure on wage inflation.

While last year's weakness can definitely be partly attributed to the imbalance between high inflation and low wage growth, the latest data is showing that we have finally returned to real earnings growth. Headline average weekly earnings growth rose to 2.8% in January (the highest rate since September 2015), and growth in regular pay rose to 2.8% in February. With consumer price inflation slowing from 3.0% in January to 2.5% in March this bodes well for the rest of the year.

Improving optimism is definitely a story that is coming through from the GfK consumer confidence indices, with the response on personal financial situations over the next 12 months rising to +10, its highest level since 2007.

As ever there are a few wrinkles that could slow this recovery down, with this April seeing an increase in automatic employee and employer pension contributions. While this does mean a net pay cut for affected employees, we do not feel that it is significant enough to slow the positive story on incomes going forward.

While retail sales rose by a stronger than expected 0.8% in February, March's data is likely to be weaker due to the short period of bad weather. This view is supported by the footfall data, which showed a fall across all types of retail, though the following week saw a correspondingly strong rise in footfall.

We remain of the view that consumer spending will pick up in the second half of 2018 in line with the return to real earnings growth. While the increasingly hawkish tone of the MPC definitely points to an interest rate rise in 2018, slowing consumer price inflation will limit the likelihood of further rises in 2019.

Furthermore, while interest rate rises are generally painted as a bad thing for consumer spending it is important to note that actually they are only a significant drag on the relatively small proportion of the UK that have variable rate mortgages. Indeed, much of this drag could be balanced out by a more optimistic feeling amongst the nation's savers.

The retail occupational market

The scale of the weakness in the retail occupational market last year is summed up by the latest research from PwC and the Local Data Company on store openings. According to this analysis 10% fewer high street stores opening in 2017 than in 2016, with 5,855 outlets closing last year. While there was continued growth from the service sector and food and beverage operators, this still means that there was a net loss in store numbers of 1,772, the second consecutive year of overall reductions.

While the forward looking story on consumer spending is definitely much stronger for 2018 than it was this time last year, the flurry of negative news about retailers over the last few months will definitely put a drag on store openings in 2018.

The next quarter will be quieter than normal, as weaker retailers look closely at their existing portfolios, and stronger retailers defer decision-making to consider opportunist responses to this weakness.

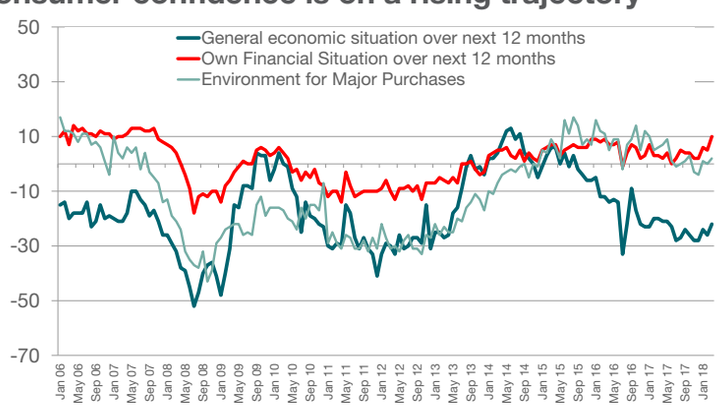
The rationale for opportunism is threefold. Firstly, there might be the opportunity for a retailer to achieve better terms in a few months time than today. Secondly, some acquisitive retailers will definitely be speculating as to whether better units might come to the market as a result of these failures, and will want to keep some of their purchasing power in reserve to spend on these new units. Finally, some retailer's covenants and market shares definitely will improve because their competitors have fallen by the wayside. This will definitely be the case in both the Toys and Electricals sectors.

Generally we expect that expansion will be limited in 2018, and where it does take place it will be driven by needs and not wants. Independent retailers will play a bigger part in the market this year, and we are already seeing robust demand from independents across Greater London and the South.

There is still a steady level of interest in the UK, particularly London, from new international entrants. However, these requirements lack urgency and are prepared to wait for the ideal location or indeed for more clarity around how Brexit might turn out.

GRAPH 1

Consumer confidence is on a rising trajectory



Source: GfK

The landlord reaction to the continuing weakness of occupational demand will be more of the same, with the prevailing view remaining one of void management rather than attempting to push rents and terms either on new leases or rent reviews.

Rental growth is unlikely to be a feature of the market this year, with our overall forecast for the UK of +1.1% hiding a tale of two markets. London remains robust and delivers average rental growth this year of +1.4% However, this leaves the rest of the UK seeing an average fall of -0.2% this year (marginally better than the -0.3% fall that was seen in 2017).

Shopping centre investment

In many ways, it was a story of déjà vu in the UK shopping centre investment market in Q1 2018. However, behind some of the all too familiar statistics and headlines, there are emerging themes that would challenge the prevailing narrative in the sector.

Total transaction volumes in the first quarter amounted to £337 million with eleven schemes trading. This is three more deals than in Q1 2017, albeit actual volumes were down 9% year-on-year. Q1 2018 transaction volumes were also the lowest since Q1 2008 (£304 million). A key driver of this was continued negative sentiment towards the sector, reinforced by a series of retailer administrations and "bad news sells" reporting.

Unrealistic pricing expectations, propped up by unattainable valuations, which have been part of the investment market in the last couple of years, have also continued to hamper liquidity. However, we are starting to see valuations bridge the gap with buyer returns criteria whilst other sellers are adopting a more pragmatic approach to their end of business plan or fund expiry disposal programmes. Subsequently, evidence is starting to emerge that will assist valuers to corroborate investor sentiment with Savills shopping centre yields now in excess of long-term averages across the quality spectrum.

TABLE 1

Shopping centre yields

	Q4 2017	Q1 2018
Super-Prime	4.75%	4.75%↑
Prime	5.75%	5.75%
Town Centre Dominant	7.25%	7.50%↑
Secondary	9.75%	9.75%↑
Tertiary	12.50%	12.50%

Source: Savills. Arrow indicates forward trend

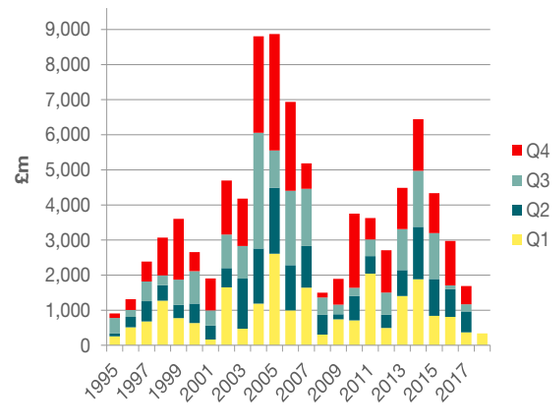
Notable transactions in the first quarter included Canterbury City Council's acquisition of THRE's 50% stake in Whitefriars Shopping Centre in Canterbury (the council acquired the other 50% stake in 2016) for in excess of £75 million, and British Land's acquisition (on a conditional basis) from Hermes of the Royal Victoria Place Shopping Centre in Tunbridge Wells for £96 million. Savills acted for THRE on the disposal of Canterbury and for British Land on the acquisition of Tunbridge Wells.

Other transactions in the quarter include the acquisition by a private investor of Salmon Harvester's newly-developed, Mulberry Walk scheme in Mere Green, Birmingham for £21 million (circa 6.00% NIY). Surrey County Council have also signed an agreement to fund the Brightwells regeneration in Farnham, reflecting £42 million (5.85%), whilst a developer has also acquired the Harlequin Centre in Exeter for £7.4 million. The scheme is expected to be converted student accommodation in what we expect will be an increasingly common repurposing exercise.

Despite continued question marks over local authority activity in real estate investment markets, they were the main buyer group for shopping centres in the first three months of the year. Completing five of the eleven transactions in the quarter and reflecting £155 million of acquisitions, councils accounted for 46% of volumes. This compares to total activity of £214 million in the whole of 2017. The vehicles used by local authorities are becoming increasingly sophisticated as the councils become more commercial with ongoing and recently completed transactions seeing a local authority acting as a third party lender, working as part of a joint venture with a developer, or providing development funding.

GRAPH 2

Shopping centre investment



Source: Savills

We therefore expect local authority presence in the market to remain a key theme throughout 2018. The Councils are performing the right purpose in many cases of regenerating their town and city centres.

The proposed merger of Hammerson and intu, which was expected to result in a significant boost to transaction volumes during 2018, now appears to be off (unless one party goes hostile). These corporate mega mergers would have had a positive impact on volumes. For example, as well as the much-rumoured Hammerson / intu £2bn disposal programme, will Unibail-Rodamco's proposed acquisition of Westfield impact the proposed Croydon development with Hammerson as partner? The irony is that, with actual shopping centre investment volumes at near record lows, there is a game of shopping centre top trumps taking place at a corporate level with billions of pounds primed for investment into the sector. Although the ultimate outcome of these three proposals remains unclear, we still consider this a vote of confidence in the long-term future of the high-quality assets in the respective portfolios.

As well as the established players' activity at a corporate level, we are encouraged by the emergence of a number of new buyers entering the market. Whilst Klépierre, Hammerson and Unibail-Rodamco's focus is on the experiential, regionally-dominant schemes, these new entrants are seeking opportunities in the community and convenience sphere, acknowledging the resilience of these

schemes in the face of uncertainty elsewhere in the sector. Consequently, whilst there will be continued local authority activity across the quality spectrum for the rest of the year, and the trading of secure, prime lots in London, the South East and top regional cities, we also expect to see more activity in this silo of the market. This will likely result in more transactions but is not expected to necessarily boost volumes given that these generally comprise smaller lots (sub-£20 million) unless anchored by a foodstore.

Even excluding murmurings around the Hammerson and intu schemes earmarked for disposal, there remains an extensive pipeline with nineteen schemes currently in the market, totalling almost £1.5 billion. Taking into the account the fact that there are also thirteen schemes under offer ,worth £874 million, we anticipate volumes getting close to £2.5 billion in 2018, which would be materially above the £1.7 billion in 2018 but still some way below the long-term average of £3.9 billion.

High street investment

Investment turnover outside London in the first quarter of 2018 was £406m, which is 31% higher than the first quarter of 2017 and 10% higher than the long term average for the quarter.

The strong trading activity this quarter was driven by a higher than normal number of deals in excess of £10m, with the largest being the sale of 36/40 Northumberland Street in Newcastle to Sports Direct for £31.6m. We discussed the increasing demand for larger lot sizes in the last edition of this Spotlight, and while some investor caution has entered the market this year due to the weak news from the occupational market, there is still demand for larger prime shop units from UK institutions.

Investor caution is leading to an increasingly polarised market between the best and the rest, with income security in prime towns and pitches being the most sought after segment of the market. Even shops in strong locations are failing to achieve guide prices if the lease is too short. Typical of this is the WH Smith in Guildford that was recently brought to the market by DTZ Investors with 5.4 years left to run on the lease. We understand that the vendor was targeting a 4% yield, but failed to sell it at this price. However, the Pret A Manger on Church Street in Kingston upon Thames, with 15 years unexpired on the lease has been agreed at a sub 4% net initial yield.

Investor aversion to letting risk is absolutely understandable, but we do expect it to ease as the consumer story improves and the occupational news becomes less bad. However, in the interim this does mean that shorter income and secondary assets will be hard to sell, while prices for the very best are likely to remain stable.

We do not expect that this polarisation of demand will have a significant downward impact on prices over the next six months, as there are few investors who have to sell. However, some degree of repricing will have to be applied in situations where a sale is needed and investor demand is thin. The volume of assets traded over the next quarter is likely to be low, and this may continue into Q3.

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