

UK Shopping Centre and High Street Bulletin

Quarter 3 2015



SUMMARY

■ We expect that the current robust level of consumer confidence will lead to a strong online and offline Christmas.

■ 2016 will see a steady improvement in retailer confidence, with new entrants to the UK retail space from the USA, Asia Pacific and Europe. We are also expecting to see more pure-play online retailers following the O2O trend and opening stores.

■ With 23 shopping centres currently under offer, and a further 44 in the market, the final quarter will be a busy one. This could lead to a well above average turnover level of £7bn this year.

■ The high street shop investment market in 2016 will see a broadening investor base, and a more diverse spread of requirements.

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"Retail is the only one of the three main sectors where there is still a significantly wider than normal spread between prime and secondary yields."
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→ The consumer economy

The tone of the UK consumer economy story remains firmly positive, with consumer confidence remaining at an above-average level of +3 in September (albeit down from +7 the preceding month).

Retail sales growth slowed a little in August, as did price inflation. However, we think this had more to do with weather and discounting than any change in consumer behaviour, and the September inflation figure showed a slight rebound in prices, while the September BRC retail spending survey pointed to a 3.9% year on year rise in retail sales (2.6% LFL).

We expect this resilience to hold through the crucial Christmas and New Year trading season, whatever the noise or lack of it there is around Black Friday this year.

2016 will undoubtedly have its challenges for UK consumers and retailers, as the domestic and international economies are by no means out of choppy waters. There remains a wide spread in performance and confidence between the manufacturing and services sectors, and this has implications for the leaders and laggards in the regional economic recovery.

A second challenge is the continued programme of welfare cuts, which are by no means as fast or deep as was hinted at in the election campaign, but will still drag on consumer spending in some markets more than others.

On the positive side, the inevitable rise in interest rates keeps on being pushed out amongst dovish noises from the MPC, and this bodes well for household spending in 2016.

We expect that by 2017 the rate of growth in household spending will slow from 3.0% to 2.0% per annum as rising interest rates combine with slowing GDP growth to limit consumer confidence and spending.

The retail occupational market

The strong consumer economy is spurring a sharp increase in confidence amongst retailers, particularly around the prospects for Christmas 2015. Consequently we expect that this will be the best digital and physical Christmas since the last boom, with both LFL sales and margins expected to show an increase on last year.

Of course, this does not mean that everything is plain sailing, and sales figures were generally disappointing over the summer. Another challenge in the run up to Christmas will be Black Friday, with the consumer clearly keen to find bargains, but retailers unwilling to divert sales from the lucrative Christmas shopping period. We expect to see tighter stock control around Black Friday, with less widespread bargains on offer this year than last.

Furthermore, the impact of the rise in the living wage is only just beginning to be explored, and we expect this to hit the "fixed-price" retailers hardest as they have no leeway to raise prices.

The last few months has seen a continuation of the strong levels of retailer demand for well-configured space in prime locations that we commented on in our last report. This demand is primarily being driven by value retailers (both in the food and clothing segments), but we are also sensing rising confidence amongst the mid and mass-market brands.

This confidence is being demonstrated in rising rents in the core locations, as well as an increasing number of deals being signed with no breaks on a 10 year lease, a real turnaround from the situation a year ago.

Looking ahead to 2016 we expect to see more new entrants to the UK market, many of whom will have larger requirements in terms of numbers and sizes of stores. These new entrants will increasingly come from Europe and Asia-Pacific, rather than the USA (which has been the key source of new entrants over the last few years).

Another area of growth will be the rise in the number of pure-play internet retailers who will move to an omnichannel strategy (online-to-offline

or O2O). Our recent Retail Myths report went into this trend in more detail, and identified 22 retailers who had already made this transition.

Finally, we also expect to see a continuation of the trend for brands to operate their own stores and showrooms. These will undoubtedly be confined to London and a few major regional cities and malls, but the diversity of brands who are considering this (New Balance, Tesla, Dyson) indicates that this is by no means a flash in the pan.

Shopping centre investment

The shopping centre market in Q3 2015 has continued in the same strong vein as the last 18 months, with 18 deals completed, accounting for £1,172 million of transactions. The statistics for the full year of 2015 now read as 55 deals transacted accounting for £3,047 million. This compares to £4,798 million at the same point in 2014 in 72 deals. However, when we consider the 23 shopping centres under offer equating to around £1,294 million and the fact that there are a further 44 schemes in the market totalling £2,173 million, the numbers are set to climb significantly in the final quarter. Notably our figures do not include the Project Jewel (Dundrum, Swords, and Ilac) numbers which would add a further €1.85 billion to the totals. Project Jewel is currently under offer to Hammerson and Allianz but is excluded from our numbers as it is located outside the UK.

Should all the assets in the UK and Ireland that are under offer and those in the market complete, this would take the total investment volume for the year to around £7 billion, ahead of 2014 and significantly above the long term average.

The average net initial yield in 2014 was 7.65% and so far this year it has nudged south of 7% and currently sits at 6.97%. This reflects the better quality of stock on the market and the continued demand for this asset class from investors.

Notable deals in Q3 include the sales of Angel Central in Islington for an initial yield (IY) of 3.9%, West One Shopping Centre on Oxford Street for an IY of 3.50% and Eastgate in

→ Inverness for an IY of 6.75%. These transactions saw extremely strong bidding, which demonstrates the continued demand for London assets and assets which dominate their catchment. For the right assets there continues to be significant demand, leading to competitive bidding and values in excess of quoting.

The secondary and tertiary markets are becoming increasingly constrained as investor appetite for risk seems to fall, whilst the leasing markets improve. Increasingly demand is more sensitive to geographical location, dominance, income profiles, asset management angles and unrealistic pricing expectations. Concerns are being raised that assets are being put to the market at overpriced levels and these over inflated values combined with the option to refinance are reducing fresh sales to the market. Some commentators and investors have stated that they are finding debt more difficult to obtain, but in many cases this is for those parties now looking to maximise their loan to value.

The secondary market has seen a shift from distressed sales, which are still well received by the market, versus those assets well managed by property companies and private equity houses looking to exit ahead of business plan. The nature of the sellers means that there are typically far fewer 'asset management angles' to model and the assets are generally perceived as relatively 'dry'.

We are not anticipating a great deal of new stock coming to the market but we have already seen the likes of St Johns, Liverpool and St Enochs, Glasgow come to the market. As we come into the Autumn demand will continue to polarise with prime assets attracting significant interest and secondary shopping centres being received in a far less uniform, more

selective manner.

We are still anticipating that in excess of £5.5 billion will be transacted in 2015, well ahead of the long term average of £4 billion, but below the £6 billion in 2014 and our projections earlier in the year.

Income and its diversity is a massively attractive element of the shopping centre market and those parties who have lower return criteria, the right asset management skills and sensible debt aspirations will come to the fore in the secondary market going forward.

High street investment

We predicted in our last bulletin that the remainder of 2015 would see a rush of new stock coming onto the market, particularly in the previously starved prime end of the market. This has undoubtedly been the case in Q3, and we expect to see more prime high street shop sales in Q4.

Investor appetite for prime shops remain strong, and this increased liquidity at the prime end of the market will ensure that prime yields move in a quarter point to 4.0% by the end of the year.

This renewed investor appetite for the sector is being driven by two themes. The first being a simple improvement in investor's perceptions of the high street retail market, and the second being a rising belief that there are good opportunities to reinvest any proceeds from sales.

It was the latter of these two themes that was creating the biggest logjam earlier this year, with many experienced high street retail investors unwilling to sell prime assets as they felt at the time the opportunities at the secondary end of the market were too limited and risky. This has changed over the last few months, with a rising interest in secondary assets.

Despite this renewed interest in secondary, the bulk of investor demand remains for prime shops in lot sizes of £15m and above, with the main buyers for these being the UK institutions. However, we expect that there will be limited numbers of opportunities in this size and quality

band over the next 12 months, and those investors who are looking to increase their weightings toward high street retail may have to consider smaller or poorer quality assets to fulfill this aspiration.

Looking ahead to 2016, we expect to see a continuation of the key trends that have been prevalent in the high street investment market this year. This will include a broadening investor base, with demand from both risk-averse and opportunistic buyers.

There is on average a 50bps yield spread between the £5-£15m bracket and the £15-£50m bracket. Will we see therefore more activity in the smaller lot size market? Some investors will undoubtedly be looking for the next area where reducing risk-aversion will drive a closing of yield spreads, and this will be one of them.

Retail is actually the only one of the three main commercial property segments where there is still a significantly wider than normal yield spread between prime/secondary (nearly 200bps), and prime/tertiary (over 400bps). Given that the long term average spreads for these two categories are 122bps and 294bps respectively, there is still some potential for the improving confidence around the future for the sector to drive some closing of these spreads.

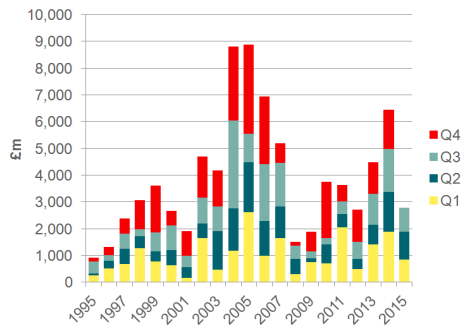
The all-important question will remain whether the rental growth prospects for the sector are going to improve, and which streets and pitches will deliver growth. Our current forecast for national average retail rental growth is pointing to a recovery in rental growth rates from 1-2% pa in 2015/16 to 2-3% per annum in 2017-2019. However, as is always the case with this segment of the market, stock selection will be the key to out-performance.

TABLE 1 **Shopping centre yields**

	Q2 2015	Q3 2015
Super-Prime	4.25%	4.00%
Prime	5.00%	5.00%
Town Centre Dominant	6.25%	6.00%
Secondary	7.75%	8.00%†
Tertiary	10.00%	12.00%

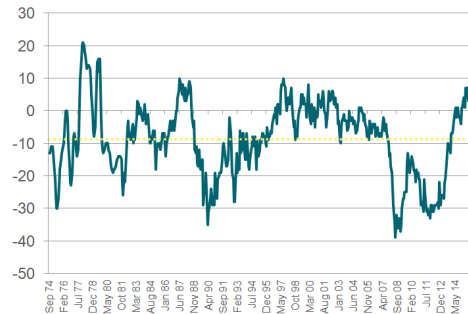
Source: Savills

GRAPH 1 Shopping centre investment volume



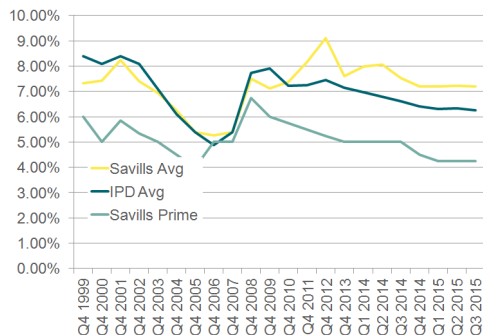
Source: Savills

GRAPH 3 Consumer confidence



Source: GfK

GRAPH 2 Shopping centre yields



Source: Savills, Investment Property Databank

Savills Retail team

Please contact us for further information



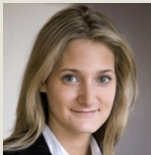
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