

UK Shopping Centre and High Street Bulletin

Quarter 1 2016



Image: Whitechapel, Liverpool

SUMMARY

■ The EU referendum debate is starting to drag on consumer confidence. At the moment it is hard to tell whether it was this, or the early Easter, that have impacted retail sales. However, if other political campaign periods are anything to go by, there may be an uptick in spending on leisure as people get bored of the debate.

■ Occupational demand is generally more positive than negative, with rising levels of requirements from food, A3, and value retailers in particular.

■ The Brexit debate is definitely weighing on investor confidence in the shopping centre market. A 'remain' result will definitely lead to a surge of activity in the second half of the year. However, even with this the 2016 investment volume is unlikely to hit average levels.

■ The high street retail investment market has remained more resilient in the face of the referendum debate. This is probably because of its comparatively lower dependence on institutional investors. Over the rest of 2016 we expect prime yields to remain low, and secondary yields to soften slightly.

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"Average retail rents will rise gently over the next five years. Growth will range from 2-3%pa in the South, to 1-2%pa in the rest of the UK."
.....

→ The consumer economy

It is clear from the latest GfK surveys of consumer confidence that all the negativity around both sides of the EU referendum debate are affecting shoppers' confidence.

The overall index remained at zero for the second consecutive month in March, its lowest level since December 2014. While this is still well above the long run average for the UK, it is clear that despite recent positive data on inflation, unemployment and interest rates, the generally scare-focused newspaper headlines on the referendum are having an effect. This is even more true when you examine the question on UK consumer's expectations for the economy over the next 12 months, which was 18 points lower than in March 2015, at -12.

Retail sales growth, which is generally very volatile on a month-by-month basis, is also showing a slowing trend from a three month average annual rate of growth of 5.3% pa in the first quarter of 2015, to 3.7% pa in the first quarter of 2016.

It is worth noting that the official referendum campaign only started on 15th April, so there will be an acceleration in coverage and polls during May and June. Whether this will further slow retail sales growth is debatable. We suspect that boredom will set in soon, and that certain parts of the high street, particularly leisure operators, may well see an uptick in sales as people start to go out to avoid the blanket coverage of the referendum debate.

Leaving the referendum aside, the economic picture if we choose to remain (the most likely option on the basis of the last six polls that had been released at the time of writing this report), is generally pretty solid.

The inflation outlook remains pretty flat, though the recent rise in the oil price has caused petrol prices to ease up a little. Earnings growth remains a little weak, which is good for inflation but not so for retail sales, and an interest rate rise still looks very far away.

Generally we expect that the UK will under perform its long term average rate of growth, but this is pretty typical

of the prospects for most western economies at the moment. Much of the expected 2% per annum growth will continue to come from the consumer, so the sooner the referendum passes the better!

The retail occupational market

As is usually the case in the retail occupational world there is a mix of positive and negative news flow. However, for the first time in a while there are probably more segments that are expanding than rationalising.

Chief amongst the bad news stories was the unsurprising CVA by BHS (fairly swiftly followed by the retailer going into administration on the 25th April 2016). More than 95% of the creditors, including the chain's landlords, voted through the plans which included reduced rents of 50-75% on some stores, and 25% on others. Given that several large landlords had indicated they would not support the CVA when it was announced, perhaps this change of heart is an indication of quite how overrented some of BHS's stores were.

Moving to more positive trends, the food retail sector appears to be recovering a little from the negativity of the last few years. We are seeing a rise in requirements for mid-size (10k sq ft plus) units from M&S, Lidl and Aldi, with rents being paid in the mid to high twenties inside the M25.

The A3 sector has remained one of the most active net acquirers of both high street and shopping centre units over the last quarter, with continuing national rollouts from Itsu, Leon, Five Guys, Busaba and Wasabi. We are also seeing a few new entrants and brands to the sector, with Muffin Break trialling a new dining concept called Jamaica Blue for example.

The continuing strong demand from restaurant operators has driven up A3 rents significantly in prime locations, and some landlords and operators are beginning to question how much margin there might be off £60/sq ft + rates, particularly with the minimum wage and imminent rent reviews likely to drag on profitability.

The value segment continues to be one of the most acquisitive, with Pep &

Co, Peacocks and Wilkos all targeting significant numbers of new openings in 2016/17.

The two main trends in terms of unit sizes are strong demand for small units (<1500 sq ft) by operators like Kiko and Pandora, and upsizing of existing units (to 25-30k sq ft) in centres from fashion retailers like H&M and Zara. Both options are in relatively short supply on both prime pitches and in centres, and thus competition is strong.

The recent trends in rents and terms generally remain pretty tenant friendly, though we have experienced some growth in ERVs in the better centres over the last quarter. Prime pitches in top tier towns, where actually rental growth has been increasingly common over the last year, may well have reached their rental plateau for the moment, though the shortening of rent free periods in these locations may still offer landlords some net-effective growth.

Where there is particularly strong competition we have seen one or two situations where premiums are being paid, but this remains the exception rather than the rule.

Looking ahead we are forecasting that average retail rents will rise gently over the next five years. Rates of growth are likely to be 2-3%pa in outer London and the South, and 1-2%pa in the rest of the country.

Shopping centre investment

The year started in fairly negative fashion with yet more uncertainty in the Far East which greatly impacted the financial markets. This was swiftly followed on by increased focus and uncertainty on the Brexit position with the vote on 23rd June. This uncertainty has led to £772m worth of transactions being done in 10 deals in Q1. This compares to £845m in the first quarter 2015 in 14 deals and £1.88bn in 16 deals in Q1 2014.

Notable deals in this quarter have been the increased stake purchased by ADIA from Grosvenor, Redevco and Hermes for c.£300m reflecting a 4% initial yield. We also saw completion of the purchase of the Grand Central scheme in Birmingham by Hammerson from Birmingham City Council and Network Rail for a net figure after costs

→ and excluding the office element for £235m at a figure quoted at c.4.5% equivalent. So these two deals alone reflected £635m of the £772m. There are however a good quantity of deals under offer and the trend continues to be one of the acquiring parties being non-doms from around the globe and there is also an increasing trend of Local Authorities taking strategic long term investment decisions by buying in the likes of Stockport.

Whilst the market believes that there is a lot of stock in the market, most of it is overhangs from last year where we have seen either failed sales due to aggressive quoting pricing or we have seen abortive deals being re-launched. In terms of fresh product openly marketed that was seen in Q1 they were both small and they related to Erith and Shirley in the West Midlands.

We do however see a number of more selective marketing campaigns focussed on those parties who have raised good amounts of money or from new entrants to the market. The largely institutional and UK based market remains reticent to transact at this time hence why we have seen total investment volumes across all sectors nationally down by c.45%.

There is clear uncertainty around the 23rd June where depending on the turnout many investors wish to remain in the EU. If we were to remain this would re-open the markets and provide greater certainty but we are fearful that there could well lead to an oversupply issue, which would also impact on values through the second half of 2016.

Despite all this we continue to see some sale launches postponed as a result of ongoing positive value accretive asset management on the back of an improved leasing market.

The supply chain of debt for the investment market continues strongly and we suspect that some of the most proactive buyers will be those core plus pots of money that are targeting the sector going forward.

Based upon the Brexit vote we anticipate that the market for the year will be compacted into the second half but, given the slow start it would be optimistic to suggest total transactions and volumes will hit the long term average of £4bn by the end of 2016.

High street investment

The pent up demand for prime high street shop investments that we have commented on in the last two issues of this report is still very much a feature of the market. Indeed, the hardening in the prime yield that we saw in the final quarter of 2015 has resulted in some prime stock being prepared for sale in early 2016.

Typical of this tone are the recent sales of 40 Clarence Street in Kingston, and 181 Western Road in Brighton. Both of these assets are in strong locations with strong tenants (North Face, H&M), and are lot sizes of £10-20m. We understand that both are currently under offer to non-domestic private investors, for prices in excess of asking.

That having been said, the first quarter of 2016 has seen a little more vendor caution, with an increased number of assets being marketed off-market. This undoubtedly has something to do with the general atmosphere of caution around the EU referendum, however it is definitely worth noting that the high street retail investment market is one of the segments where investment activity has been least affected by the slowdown in activity.

So why are investors in high street retail feeling less worried about the future than other sectors? The first, but probably less important reason, is the smaller lot size. The average unit shop transaction in Q1 2015 was £7m, which while still a considerable investment is still less of a commitment than the average office deal of £26m.

The main reason why we think that the demand for unit shop investments has held up so well is the composition

of buyers. While it is a relatively sweeping generalisation, there is some truth in the view that the investors that are most worried about the referendum are the UK institutions. They have been relatively inactive in the unit shop market for a long time, so a slowdown in demand from that source is less of an issue. Private and overseas investors, in particular, appear to be less worried about domestic political concerns, and thus remain focused more on the fundamentals of the asset and the comparative returns to other assets. It is these two groups of buyers that have been amongst the most active buyers of high street shop investments over the last quarter.

Away from the prime end of the market, where investor demand is still strong, even at the lower yields that we have seen on offer over the last six months, demand is more patchy. While there is a good pool of buyers for secondary assets or pitches, this demand is fairly price sensitive. A number of secondary assets have recently failed to sell at 7%, and we feel the current sweet spot for secondary assets or pitches is more like 8%. This caution is probably driven by lingering concerns about tenant demand in secondary locations, as well as a fairly flat view on the rental growth prospects.

Looking ahead to the remainder of the year we expect prime high street yields to remain at 4% for the best locations.

The secondary market is seeing some yield correction, and we think that a number of canny investors may well view that as a buying opportunity around the referendum date.

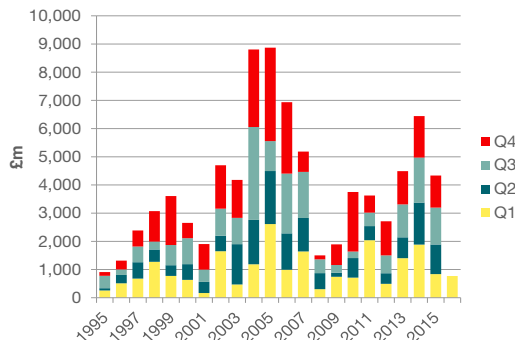


TABLE 1 **Shopping centre yields**

	Q4 2015	Q1 2016
Super-Prime	4.00% ↑	4.25% ↑
Prime	5.00% ↑	5.25% ↑
Town Centre Dominant	6.00% ↑	6.25% ↑
Secondary	8.25% ↑	8.50% ↑
Tertiary	12.00% ↑	12.00% ↑

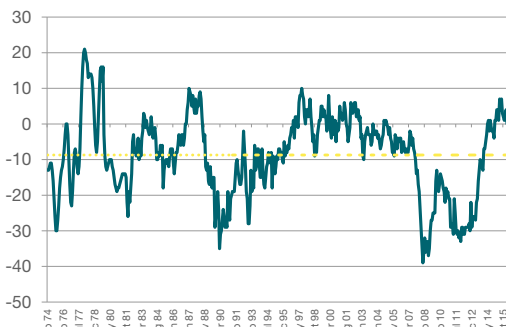
Source: Savills. Arrow indicates forward trend

GRAPH 1
Shopping centre investment volume



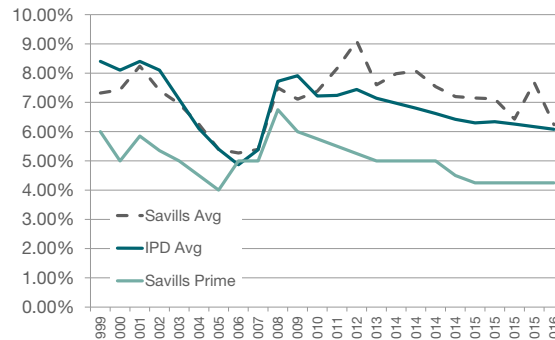
Source: Savills

GRAPH 3
Consumer confidence



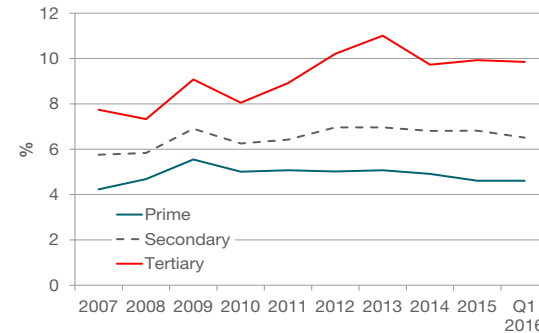
Source: GfK

GRAPH 2
Shopping centre yields



Source: Savills, Investment Property Databank

GRAPH 4
Average unit shop yields outside central London



Source: Savills, based on yields achieved

Savills Retail team

Please contact us for further information



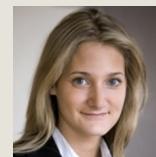
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