RESEARCH

Knight Frank

SPRING 2013

UK RETAIL

Occupational & investment markets

HIGHLIGHTS

- With the initial estimate for Q4 GDP growth suggesting a contraction in the economy, the outlook for 2013 remains somewhat sluggish.
- Overall retail sales growth remains muted, but retailer results from the Christmas trading period were generally better than expected. However, as the internet accounts for a growing proportion of total spending, structural change will continue to mean store closures in weaker locations.
- Retail development is expected to remain well down on its peak of 2008, but an increasing number of new proposals are emerging in both the shopping centre and retail warehouse markets. A strong leisure and catering component is becoming an increasingly important part of the retail mix.
- Investor interest continues to focus on prime assets in the strongest locations, but there is evidence that demand for good secondary shopping centres is increasing.

ECONOMIC & CONSUMER OVERVIEW

The initial estimate of Q4 GDP showed a 0.3% contraction in the economy, albeit this was largely due to a decline in North Sea oil and gas production. However, the UK economy remains weak and Moody's has downgraded the country's credit rating to AA1 on the back of a more pessimistic outlook. In addition, the recent Italian elections have re-ignited concerns over the Euro area.

CONSENSUS FORECASTS SUGGEST SLUGGISH GDP GROWTH OF AROUND 1% IN 2013.

The ONS retail sales data for December showed that year-on-year retail sales growth (volumes) was just 0.3%, followed by an annual -0.6% fall for January, indicating the continuing tough trading conditions being faced by the sector generally, with several major retailers falling in to administration either side of Christmas. Growth in food sales was negative at -2.6% following a weak November and December, while sales of clothing and footwear continued their mini-rebound with growth of 1.2%.

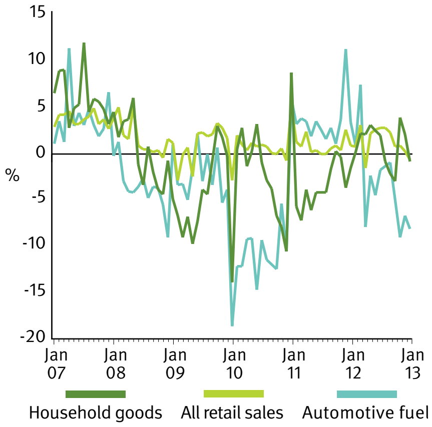
Trading reports from retailers suggested a polarised Christmas. While the top performing retailers – such as Next and John Lewis – produced strong trading results, many retailers continue to struggle and the major food retailers turned in a decidedly mixed bag of results.

Internet sales have continued to increase (up 15.5% year-on-year) and accounted for 10.6% of total retail sales in December. Retailer feedback to the ONS suggested that the Internet accounted for a much higher proportion of overall sales than expected, with some of the major department stores for example reporting online sales growth of over 40% during the Christmas period.

Indeed, consumer habits continue to evolve, not just in terms of e-tailing, but also in terms of less frequent but higher spending shopping trips which involve longer dwell times. On the whole, this trend favours larger and out-of-town schemes, in particular those which are accessible and provide a strong leisure, entertainment and catering offer.

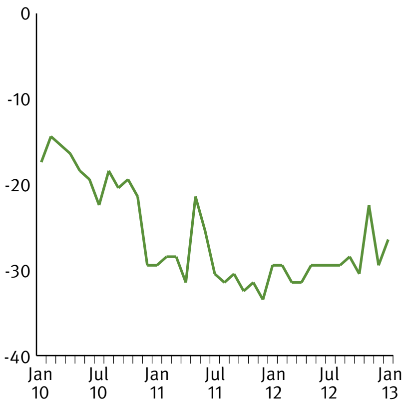
Looking forward, the overall consumer environment will remain challenging in 2013 and is expected to show little change on last year. While the pressure on real incomes should alleviate as the gap between inflation and pay growth narrows, inflation has proved to be more stubborn than anticipated. However, the relatively bullish employment data should reduce the chances of a further significant dip in consumer sentiment.

Figure 1
All retail sales, household goods & automotive fuel



Source: ONS (volume year-on-year growth)

Figure 2
Consumer confidence index



Source: GfK NOP

Retailer trading performance

Retailer	Latest results/comment	Trading period
John Lewis	Like-for-like sales up 13%; online sales up 44.3%	5 weeks to 29th December 2012
House of Fraser	Like-for-like sales +6.3%; online sales +48%; Christmas trading "best ever"	6 weeks to 5th January
Debenhams	Like-for-like sales +5%; online sales +40%; Christmas trading "toughest ever"	5 weeks to 5th January
Waitrose	Like-for-like sales up 4.3%; record Christmas trading period	4th November to 24th December
Dixons	Like-for-like sales +3%; UK like-for-like sales +8%, with multichannel sales +7%. Sales were down in Southern Europe	12 weeks to 5th January
Argos	Like-for-like group sales +2.7%; online sales accounted for 42% of total sales; M-commerce sales up +125% over the year	18 weeks to 5th January
Tesco	Like-for-like UK sales +1.8%; online food sales +18%	6 weeks to 5th January
J Sainsbury	Like-for-like sales +1.5% (+0.9% excluding fuel); "record breaking Christmas"	14 weeks to 5th January
Next	Next Retail +0.8%; Next Directory +11.2%; total +3.9%	1st November to 24th December
Marks & Spencer	Like-for-like UK sales -1.8%; food +0.3%; General merchandise -3.8%; multi-channel sales +10.8%	13 weeks to 29th December
Morrisons	Like-for-like sales -2.5%	6 weeks to 30th December

Source: Various, company press releases

OCCUPIER TRENDS

UNPROFITABLE SHOPS CONTINUE TO CLOSE AND A NUMBER OF OPERATORS REMAIN UNDER THREAT FROM TOUGH TRADING CONDITIONS AND HIGH LEVELS OF DEBT.

Central London and much of the wider south east had a very good 2012 on the back of a unique set of events which brought a global focus to the capital, where a seemingly endless queue of domestic and international retailers continue to open stores.

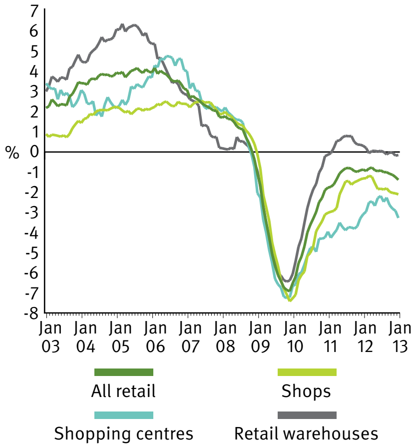
Elsewhere, while the larger regional cities and shopping centres have performed well, many smaller/weaker towns continue to suffer from elevated vacancy rates and falling rents on back the leakage of retail expenditure to more attractive retail destinations, not to mention the internet.

Recent failures of HMV, Jessops, Blockbuster and Republic will push national vacancy rates up and put further downward pressure on rental values. However, we are seeing renewed interest and aggressive bidding for the best stores within these portfolios. On a positive note, some retailers who went into administration in the early part of last year re-emerged with new owners who retained significant proportions of their store portfolios and employees. However, unprofitable shops continue to close and a number of operators remain under threat from tough trading conditions and high levels of debt.

As a result, there will be further polarisation of both high streets and shopping centres between the regionally dominant and sub-prime locations, led by not only the continued growth of internet shopping but also the lack of appetite from fashion retailers for more secondary stock.

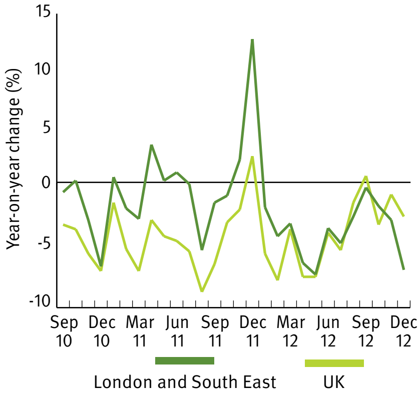
Voids in such locations are likely to increase during 2013, with landlords needing to offer a more flexible approach to leasing in order to act as a catalyst for increasing tenant demand and helping to redress the imbalance with the larger competing centres.

Figure 3
Annual rental growth



Source: IPD

Figure 4
Footfall in London and South East, UK

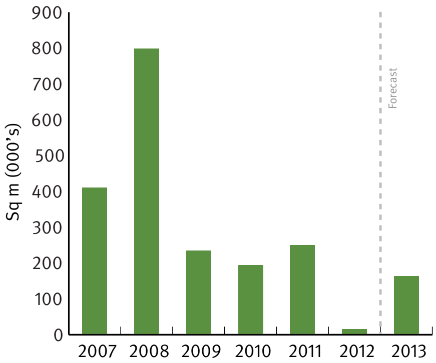


Source: Ipsos Retail Performance

DEVELOPMENT

The only opening in 2012 was the Swan Centre in Yardley which opened in February and delivered 15,600sq m of new space, anchored by Tesco. The remaining openings comprised extensions to existing schemes.

Figure 5
New shopping centre floorspace



Source: Knight Frank

The amount of space under construction in early 2013 represents an increase on last year. The projected pipeline for this year comprises five shopping centres, totalling 165,150 sq m, with the largest scheme being Land Securities' Trinity Leeds (75,900 sq m). The other three schemes are New Square in West Bromwich (43,900 sq m), Whiteley Shopping in Fareham (28,000 sq m) and the former Lewis' building in Liverpool (15,900 sq m) which is part of the Central Village development. However, beyond 2013 there are no significant schemes with definitive completion dates.

In January, Westfield and Hammerson announced they had entered a joint venture to redevelop central Croydon, with construction to start on site in 2015. The other potential development include Hammerson's Eastgate Quarters which is planned for 2015 and will provide approximately 102,193 sq m, the Westfield Broadway Shopping Centre in Bradford with the commencement of construction expected in late 2013 and British Land's proposed Canal Corridor North in Lancaster targeted for 2017 completion.

Major shopping centres in the pipeline

Scheme	Location	Size (sq m)	Date due	Developer
Trinity Leeds	Leeds	75,900	2013	Land Securities
New Square	West Bromwich	43,900	2013	Spenhill
Whiteley Shopping	Fareham	28,000	2013	British Land/ USS
Central Village	Liverpool	15,900	2013	Merepark
IntoOutdoors	Evesham	12,000	2014	Eagle One
The Old Livestock Market	Hereford	28,800	2014	Stanhope/ British Land

Source: Knight Frank

INVESTMENT

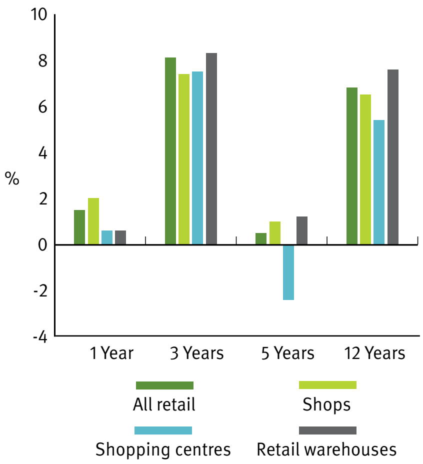
INVESTORS HAVE CONTINUED TO TARGET PRIME LOCATIONS WITH SOLID TENANT LINE-UPS AND AREAS WITH UNDER-SUPPLY.

Investment activity picked up significantly in the second half of 2012, with £4.4 billion of retail assets transacted. Q4 in particular saw a notable acceleration in activity. Nonetheless, over the year as a whole, overall retail investment volumes totalled £7.3billion, a 26% decrease on 2011.

On the high street, London continues to experience a solid level of investor interest and assets in the prime/tourist locations are sought-after, notably by institutions and overseas investors. Reflecting the strength of 'trophy streets' in the capital, Bond Street yields remain at 3.25-3.50% and Oxford Street yields were still at 4.00% in February. Outside London, whilst major cities/historic towns are seeing a reasonable level of demand, sentiment is cautious in respect of secondary locations and towns with high vacancy rates. The national headline yield for prime shops is currently at 4.85% but we expect this to soften in 2013.

This year has got off to a robust start in the shopping centre investment market, with numerous exchanges and likely completions in the coming weeks. Investor appetite is expected to remain robust for prime shopping centres, while sentiment for good

Figure 6
Annualised total returns
(to December 2012)



Source: IPD Quarterly Digest

Major retail investment transactions

Property	Purchaser	Vendor	Price (£m)	NIY (%)
Meadowhall (50% stake), Sheffield	Norges Bank Investment Management	London & Stamford	760.0	5.1
Star Portfolio (4 retail parks)	Hammerson	The Junction LP	254.5	7.0
Ealing Broadway, London	British Land	Wereldhave	142.5	6.9
Victoria Quarter, Leeds	Hammerson	Bank of Ireland	136.2	5.3
Beehive Centre, Cambridge	Orchard Street	British Land	109.2	5.3
The Lanes, Carlisle	F&C Asset Management	Aviva Investors	65.1	7.5
Whitgift Shopping Centre, Croydon	Hammerson	Royal London Asset Management	65.0	n/a
Great Central Way, London	Orchard Street IM	British Land	61.9	5.5
Springvale Retail Park	BlackRock	Kames Capital	55.4	6.1
Dolphin Centre, Poole	Legal & General	Wereldhave	57.7	7.8
Talbot Green Retail Park	NFU Mutual Insurance	Scottish Widows	43.8	5.8
Riverside Retail Park	Brockton Capital	PRUPIM	30.8	8.0
385-389 Oxford Street, London	Private Investor	F&C Commercial PT	28.1	3.6
Priory Fields Retail Park, Taunton	Orchard Street IM	AXA Real Estate	27.2	6.8

Source: Propertydata.com, Knight Frank

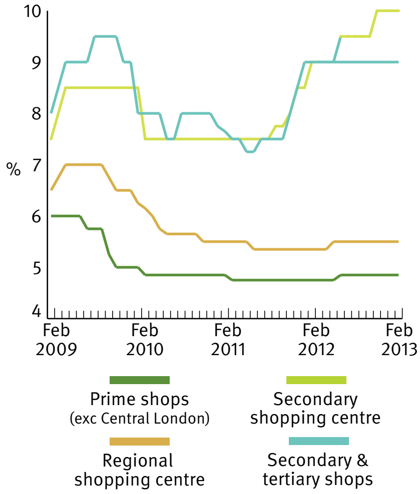
secondary stock with asset management opportunities is improving. We anticipate prime yields hardening during the year, with sentiment only deteriorating for the weaker secondary and tertiary products. Yields for both prime shopping centres and good secondary assets stand at 5.50% and 8.00% respectively in February.

Whilst retail warehouse transaction volumes showed a noticeable decline on an annual basis, investor sentiment towards the prime out-of-town sector remains positive. Investors have continued to target prime locations with good tenant line-ups and areas with under-supply. Prime yields for both Open A1 and bulky goods schemes stand at 5.35% and 6.50% respectively in February.

The majority of retail investment activity is focused on prime and to some extent, good secondary stock, a sign that investors are still cautious in terms of moving up the risk curve when looking for opportunities.

Figure 7

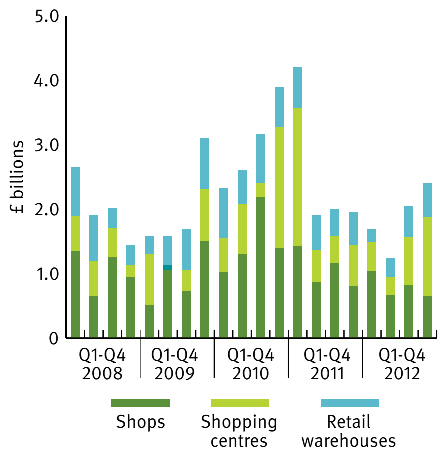
Prime retail yields



Source: Knight Frank

Figure 8

Retail investment volumes



Source: Propertydata

KNIGHT FRANK VIEW

2013 will likely prove another tough year for the UK retail sector, with the difficult economic environment and higher costs putting additional pressure on retailers to prune less profitable stores from their portfolios. This will hasten the structural trend being driven by the internet towards fewer stores (albeit bigger and better), with demand focusing on locations with critical mass and strong footfall. While the “pruning” process may take some years to complete, anything from 25-50% of some of the larger store networks may be shed eventually.

One of the key challenges for landlords and retailers will be to understand how they can further integrate the continued growth of multi-channel retailing with their physical assets, notably through greater use of technology such as in-store wi-fi to facilitate mobile commerce. Technology is impacting not only on location strategy, but also on store layout and the use of space, so expect more flexible units, with smaller ranges and less space devoted to storage. Leisure and entertainment will also feature increasingly alongside the traditional shopping offer, with restaurants for example now regularly accounting for 20% or more of a scheme’s units.

Darren Yates, Partner, Research

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