RETAIL

Knight Frank

RETAIL PROPERTY OUTLOOK 2018

OVERVIEW

- Not out of the woods yet by any means – 2018 is likely to be just as challenging for the UK retail sector as 2017 has been. Some pressures may have eased but there is no greater sense of certainty than there was 12 months ago. Almost without exception, retailers remain cautious.

- The three key headwinds UK retail faced in 2017 will continue to play out in different ways in 2018. On the positive side, many of the post-Brexit inflationary pressures have now annualised and will increasingly drop out of the equation. However, the business rate revaluations are continuing to work their way through the system (with Central London particularly at the sharp end). On the negative side, April will see another step increase in the National Living Wage.

- The dividing lines between online and bricks & mortar will continue to blur. Retailers will accelerate their efforts to make their stores and online propositions as complementary as possible and a seamless supply chain will remain the 'holy grail'.

- There will be little respite for UK retailers and most remain on a mission to cut costs. Expect further rounds of staff reductions and operational rationalisations. Retailers will continue to right-size their respective portfolios, and this will entail a rolling programme of closures and downsizings, counterbalanced by selective re-locations and strategic new openings. But the backcloth of cost sensitivity will provide little stimulus for rental growth generally.

- Retail occupier markets have generally proved more resilient post-Brexit than retail investment markets, which tend to be more influenced by sentiment. While occupier markets will remain challenged in 2018, retail property investment is likely to see a recovery. Investors increasingly looking for income are likely to target Retail over other major property classes – Retail is now a stronger source of income return than either Offices and Industrial.

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HIGH STREETS

- The occupational market remains fairly subdued. There are limited new entrants willing to take large amounts of space. New occupiers from Continental Europe are still tending to stick to landmark locations (e.g. Lindex - Westfield London and Reserved - Oxford Street). The 'clicks to bricks' phenomenon is still in its infancy and many online pure-plays are choosing to remain online. There are a few exceptions (e.g. Missguided), but even then the focus is still on flagship stores in select locations.

- Outside London, tenants are more cautious still and given the lack of depth in the market, it is relatively tenant-friendly. For example, H&M recently agreed a completely funded store in an undisclosed location. Towns in the South East (e.g. Guildford, Kingston) remain strong, as do major cities such as Manchester, Birmingham and Leeds.

- On the investment side, the next 12 months will see increased institutional demand for good secondary towns (e.g. Leamington Spa, Worcester, Crawley), where yields of 6%-7% NIY provide a highly attractive discount to prime Cathedral towns at 4% NIY.

- 2017 saw a number of prime freeholds being acquired by occupiers such as Sports Direct, Metro Bank and Days. We see this trend continuing into 2018. However, there is a finite number of sites they can take and 2018 will be the last year in the short term these retailers acquire freeholds in significant numbers.

- We anticipate increased demand from Councils for High Street retail in their own jurisdiction, as heightened political pressure will shift their focus away from investing in high value out-of-town business parks and distribution sheds outside of their remit and back to investing in their town centre on prime, well-let retail.

- 2018 will also see investors paying a greater premium for new long leases (15 years + term certain) due to the scarcity of occupiers signing up for long term leases on the High Street and continued demand for income from a wide variety of investors.

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SHOPPING CENTRES

- Shopping centres will still be the relative ugly ducklings of the investment market in Q1 2018, with investors continuing to shy away from large retail lots that carry significant exposure to the vagaries of the occupational market.
- Valuers have still not caught up with the actual movement in market price (not just a secondary market problem) and so we anticipate a further six months of negative capital movement in the IPD index.
- However, we sense a wind of change by the middle of the year as investors look for higher income returns. Historically, faced with a need for higher income, investors have turned to the industrial sector. In 2018 retail will be the most readily available source of that higher income and “good secondary” (a.k.a. community, convenience, town-dominant) centres will be back under consideration.
- Watch out for assets that are genuinely available at true market pricing – there could be some decent opportunities for the savvy investor next year, but you will need to stick close to your core principles of what does and doesn’t work in the new retail world.
- Focused on just their own boroughs for investment opportunities, Councils will continue to be very active in acquiring local shopping centres in their areas of jurisdiction.

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OUT-OF-TOWN

- Volumes in the retail warehouse sector are likely to fall short of the £2.4bn traded in 2016, by perhaps 15%. However, we have seen a sharpening of prime yields by at least 25 bps in four sub-sectors - secondary open A1; bulky goods parks; solus open A1 and solus bulky. On the other hand, open A1 fashion parks have moved out by 25/50 bps, partly due to lack of evidence, and partly the continued pressure on rents.

- Institutional interest in the sector remains solid at ca. 40% of the investment market, but the big swing in 2017 was buying volume by local authorities and overseas investors. Both reflect the relative value in the sector, especially in schemes worth £40m+. We expect legislative pressure to negatively impact on the Councils in 2018, while overseas interest could well increase to ca. 30% of the market.

- Next year the polarisation will continue of what is perceived as “the best”, or at least “good” versus the “difficult” or mis-priced. The former being anything with longevity of income, where geography is unquestionable and the trading platform is strong. The latter being poor demographics, challenging asset management and rents too high.

- A trend we will also see continue is the relative depth of demand for smaller assets. The average lot size in the OOT sector in 2017 was ca. £18m. We expect interest in single let, or sub four unit schemes to increase next year, reflecting many of the traditional fund buyers wanting more passive investments. The depth of demand for assets north of £30m, perhaps requiring some “heavy lifting”, will decrease. We would expect relative pricing to follow suit.

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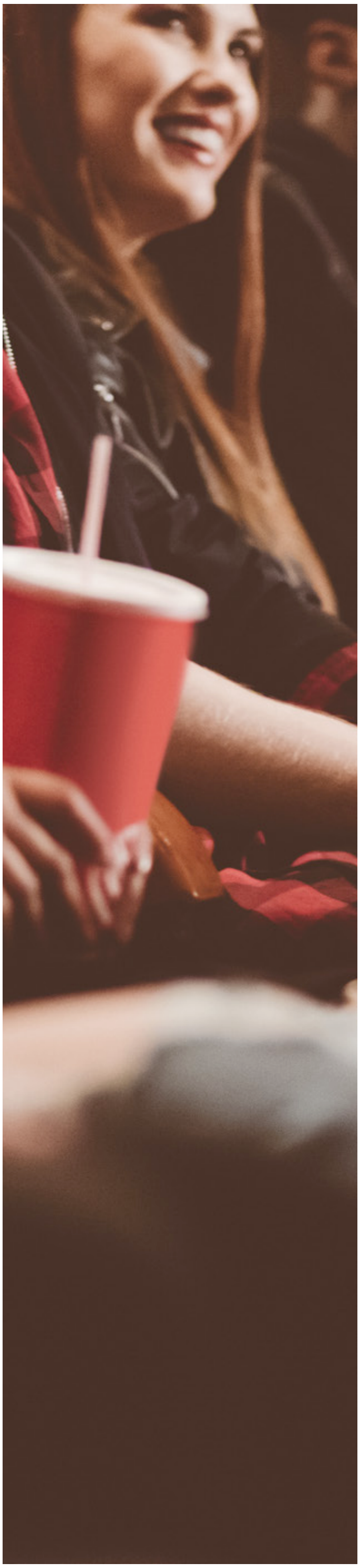

LEISURE/A3

- There is an argument we have reached saturation point in the A1 food sector. Operators are far more cautious and considered in their decision making than we have seen over the last few years. The number of operators actively acquiring space has diminished considerably, but for the right product at the right price, there is still demand and this will continue.

- The trend of landlords seeking small, fledgling brands to serve as an amenity / USP to the building will continue, some sacrificing income for the right brand for their asset. The need for many institutional landlords to attract a fledgling and exciting coffee-focused operator for their building in order to attract the right office occupiers and rent for the upper parts has resulted in a number of landlords offering fully fitted units on a turnover only basis to selective operators.

- The A3 Central London market has softened somewhat, especially the levels of premiums that are being paid for prime sites. We expect this trend to continue and we do not foresee any rental growth in prime markets.

- There is still an appetite to open sites but operators are struggling with multiple headwinds, including rising cost of goods, rates revaluations, minimum wage increases and the possibility of losing a huge resource of staffing if Brexit happens and many Europeans head home.

- These headwinds, coupled with concerns over record rental levels agreed over last 24 months, leave the sector very sensitive and vulnerable to any decline in consumer spending. This has yet to materialise, but remains a perennial risk as the gap between inflation and wage growth widens.

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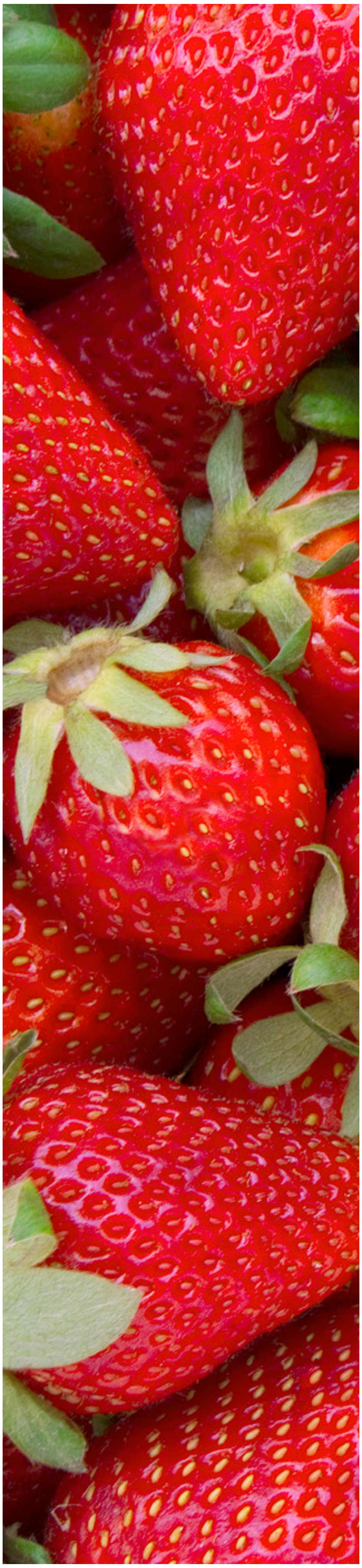

FOOD STORES

- A polarised development pipeline. New store opening rates for the discounters will continue apace, although there will be signs of a slowdown in some regions for new site acquisition as a result of some over exposure and concern over sales cannibalisation. There will be limited but visible new store acquisition activity by some members of the Big 4 (especially Morrison's and Asda), although the main focus will remain on existing portfolio trading performance, and absorbing newly acquired businesses.

- Retailers will continue to rationalise their convenience store portfolios with some weaker sites exited, as part of natural retailer evolvement. There will be continued new store openings in demographically-strong and densely-populated areas. There will be some slowdown as a result of corporate rationalisation, despite takeovers being cited as wholesaler deals.

- Improved trading results from the Big 4 have stoked investor interest but the market is increasingly polarising. The best sites, sensibly rented with RPI uplifts are trading at a premium. Discounts are applied individually and cumulatively for any compromises such as rental levels, perception of being over-sized, over rents, open market rent reviews, location and trading performance.

- The sector will witness further consolidation. Heron, Nisa, Booker/Budgens will all be under new ownership with resultant impact on strategy, with the focus more on integration than further acquisition. There will be funds available for acquisitions, but only after a period of bedding in.

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