RESEARCH

SUMMER 2013

OUT-OF-TOWN RETAIL & LEISURE

Occupational & investment markets

HIGHLIGHTS

- While overall economic growth is expected to be weak for 2013, recent data suggests that the macro outlook for the UK is improving.
- However, in the out-of-town retail market, headline rents have fallen and continue to edge down in many locations. This is due to general market weakness and also to the increasing dominance of discount retailers, who take a more aggressive approach to property costs.
- Yields for better quality retail park assets have been hardening; conversely, values for more secondary assets have fallen. Yields for prime leisure assets meanwhile are now within 75-100bps of their prime retail equivalents.
- Out-of-town retail investment volumes for the year to May 2013 are in line with 2012, while leisure investment volumes (excluding hotels but including pubs) almost reached £500 million.

ECONOMIC OVERVIEW

The second estimate for Q1 2013 GDP confirmed that the UK economy grew by 0.3%, driven by a strong contribution from the service sector (0.6%) and a smaller contribution from production (0.2%). On the downside, the construction data was weak (-2.4%), as was manufacturing, which declined for the second successive quarter (-0.3%).

However, on a positive note, the latest forward-looking PMI surveys have been more upbeat across the manufacturing, construction and service sectors. There are also signs that consumer confidence is returning, following a long period of gloom, with GfK's consumer confidence index rising by 5 points in May. While the overall figure remains negative at -22, the recent improvement continues a more upbeat trend seen since the start of 2013, which has been reflected in the latest retail sales data.

The inflation picture has marginally improved in recent months, but remains above target and somewhat "sticky". Indeed, ONS data showed that CPI inflation rose from 2.4% to 2.7% in May, higher than most forecasts, on the back of a rise in transport and clothing costs. The increase takes the headline rate of inflation back to the levels seen between October 2012 and March 2013.

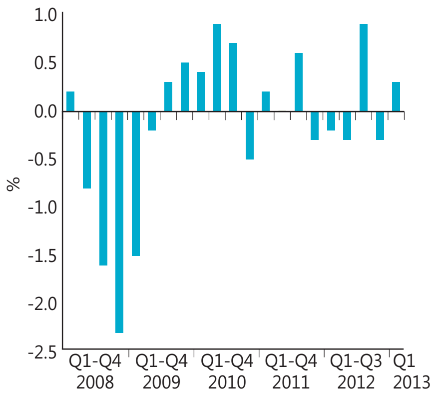
Recent pay growth figures meanwhile show a marginal improvement – albeit still running at half the rate of inflation – with the three-month average figure rising to 1.3% for April. While the pressure on consumers has therefore eased, real incomes are still being squeezed.

Unemployment remains one of the brighter spots of the UK economy and remains very low in comparison with many European countries. The unemployment rate for February to April was 7.8%, unchanged on the previous three months, with the number of people out of work declining by just 5,000 to 2.5 million. The more precise count of Jobseeker's Allowance showed a fall of 8,600 to 1.51 million in May.

The outlook continues to improve for most parts of the UK, although the path to a more sustained recovery will remain slow and bumpy and will vary by region. Medium term forecasts suggest that the strongest economic growth will be in London and the South East. Relatively high levels of employment and improving consumer confidence should filter through to consumer spending as the year progresses.

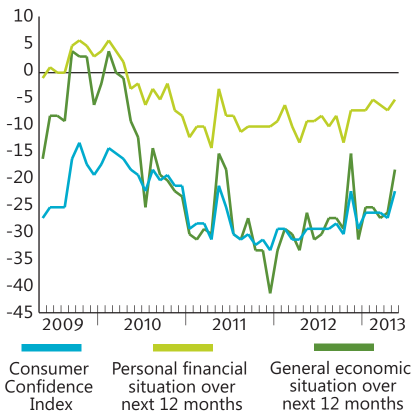
The Eurozone remains weak but at least appears more stable and, despite high unemployment, positive growth has returned to the US.

Figure 1
Quarterly GDP growth



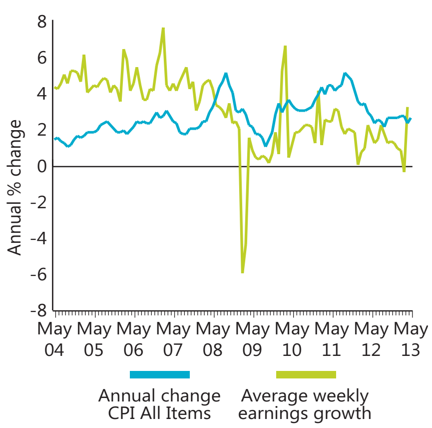
Source: ONS

Figure 2
GfK consumer confidence



Source: GfK NOP Consumer Confidence

Figure 3
CPI and pay growth



Source: ONS

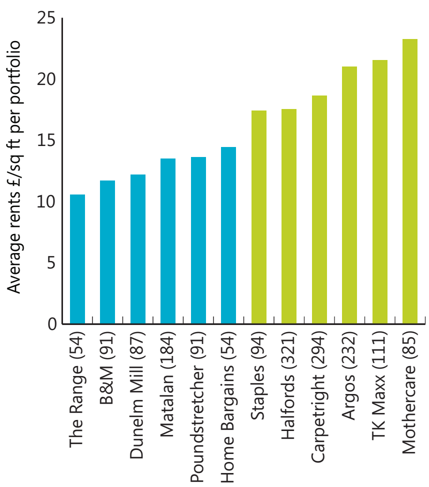
TRENDS – DISCOUNT RETAILERS

The out-of-town retail landscape has changed significantly in recent years, with the balance of power now firmly in the hands of the discounters. While the property industry may have reservations about some of these brands, consumers have clearly embraced the value end of the market.

Top 5 increases in floor space in 2012

- B&M – 410,000 sq ft
- Kiddicare – 350,000 sq ft
- Dunelm – 250,000 sq ft
- TK Maxx – 240,000 sq ft
- Home Bargains – 230,000 sq ft

Figure 4
Discount retailers



Source: Trevor Wood Associates
Numbers in bracket relate to sample size of store for each retailer

A number of discounters have undergone dramatic expansion. These include operators such as Poundworld, which was founded in 1997 and now has over 170 stores, of which around 120 are out-of-town, with another 170 stores targeted. Similarly, 99p Stores, which was founded in 2001, now has over 190 stores, aided by the addition of over 40 former Woolworths stores. The company also trades out-of-town as Family Bargains. Both companies have achieved very strong sales growth in an environment of low margins and fierce competition. Indeed, Poundland recently reduced some prices to 97p to undercut its 99p rivals.

In the discount food sector, Aldi's sales growth has easily outpaced its larger rivals, with growth of 31.5% in 2012. It has gained significant market share through its offer of cheaper versions of classic products, without compromising on quality.

Analysis suggests that the leading discounters have some of the highest profit margins in the retail sector, with Dunelm at 15.8% (source: Oriel Securities). While the strength of demand from these operators should in theory drive higher rents, the reality is that they are very focused on margins and costs in the current environment – including property.

Figure 4 above shows the rents paid by some of the more aggressive retailers in recent years, including four of the top five space takers in 2012. A comparison of this data against some of the more established out-of-town players suggests that headline rents have fallen steadily. Therefore, while landlords have been able to fill the voids left by retailer closures, this has been at the expense of lower rents. The only established player in the top five space takers is TK Maxx, which is expanding to take advantage of strong consumer demand for quality products at low prices. However, the average rent on their existing store portfolio is higher than the more recently established players.

Average rents for The Range across a sample of 54 stores is £10.55 per sq ft, while B&M pays just £11.71 per sq ft across a sample of 91 stores. These figures are much lower than for the more established operators which expanded before the recession. Carpetright for example pays £18.64 per sq ft on average (based on a sample of 294), while Mothercare's average rent across a sample of 85 stores is £23.26 per sq ft.

DISCOUNT RETAILERS TAKE OVER
1 MILLION SQ FT
OF NEW SPACE IN 2012

OUT-OF-TOWN RETAIL

Occupier market

Data from the ONS for May showed that retail sales of non-food (2.2%) increased over the year, while sales of both food and household goods remained weak, falling by 0.5% and 3.4% respectively, reflecting the recent trading performance of a number of key retailers in the out-of-town sector.

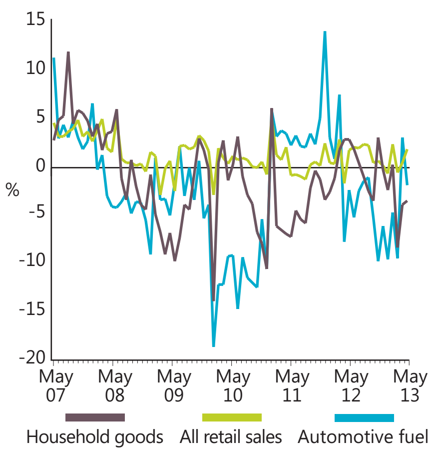
With all retail sales up by 1.9% year-on-year, it provides a boost for a more sustained recovery in the wider economy, despite fears that a continued squeeze on household earnings could put the brakes on any growth.

Vacancy rates on retail parks edged up to 9.9% (source: Trevor Wood Associates) at the end of 2012, compared with 9.1% in the previous six months. This is the biggest increase since 2008 and was largely driven by the collapse of Comet, JJB Sports and Peacocks during the second half of 2012. This figure obviously does not take into account the failure of HMV, Dreams and Blockbuster in the first quarter of this year and it remains to be seen whether the vacancy rates will continue to edge up as take-up levels soften.

There remains a degree of caution towards some retailers, though the 'watch list' has shortened. There is evidence of demand from a wide array of more secure retailers from discounters to fashion brands. However, this demand is at a rental level below most landlords' aspirations. Whilst this is not surprising, the fact that so many retailers are attempting to pursue expansion strategies is a positive.

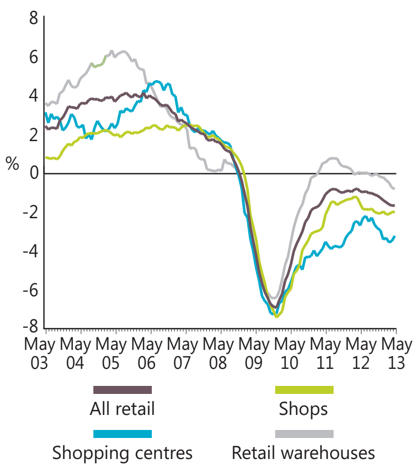
IPD figures for May suggest that rental growth in the retail warehouse sector was mildly negative on a monthly basis at -0.05%, with an annual decline of -0.78%. However, it remains the best performing sector compared with shopping centres and high streets.

Figure 5
All retail sales, household goods & automotive fuel



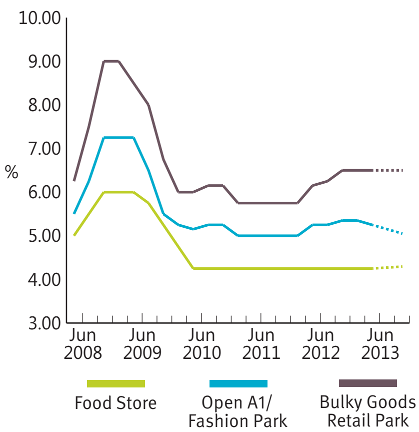
Source: ONS (volume year-on-year growth)

Figure 6
Annual rental growth



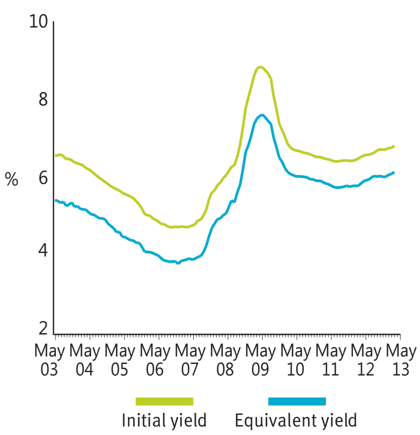
Source: IPD

Figure 7
Prime out-of-town retail yields



Source: Knight Frank

Figure 8
Long-term retail warehouse yields



Source: IPD

Investment market

The second quarter saw approximately £444m worth of out-of-town investment deals (although 27% was made up of large portfolio sales), showing a 146% increase in volume on the previous quarter and a 25% increase in the number of transactions.

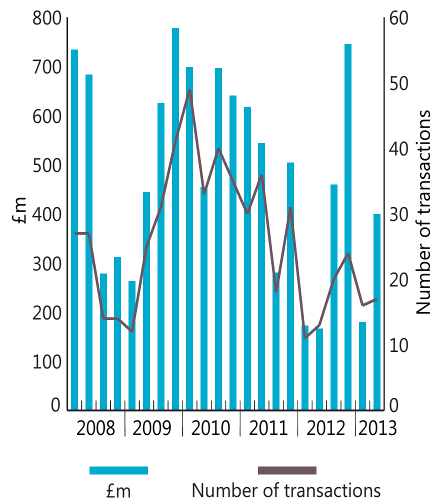
Recent key transactions include the sale of Coliseum Shopping Park in Ellesmere Port. The Crown purchased the park from Equitable Life for £81m, reflecting a reported NIY of 5.25%. In addition, KKR and Quadrant Estates recently completed the purchase of the Tuscany retail park portfolio from Resolution for £112.5m.

Whilst the good secondary Open A1 market has been quiet in the last 18 months, Q2 witnessed two deals, including the acquisition of Gala Retail Park in Galashiels by Prudential for c.£11.2m (reflecting a NIY of 6.25%) and the purchase of Suffolk Retail Park in Ipswich by Orchard Street for £18.75m (reflecting a NIY of 7.10%).

Gallions Reach Shopping Park in Beckton came to the market in May with a quoting price of £110m, reflecting a net initial yield of 6.00%. The availability of prime solus stock has been limited, although there have been two benchmark transactions, namely the Wickes in Bicester which sold for £5.7m, reflecting a net initial yield of 6.15%, and the B&Q unit in Southend-on-Sea which sold for £24.25m, reflecting a net initial yield of 6.50%.

Overall investor sentiment is more positive than earlier this year. However, there is still a degree of yield polarisation between prime and secondary assets, in particular the bulky goods sector where rents are under pressure. Yields for prime Open A1 schemes hardened from 5.35% to 5.25% in June, while yields for prime Bulky Goods parks moved out to 6.50%. We expect this trend to continue.

Figure 9
Retail warehouse investment transactions



Source: Propertydata

Major retail investment transactions

Retail Park	Purchaser	Vendor	Price (£m)	NIY (%)
Tuscany Portfolio	KKR and Quadrant Estates	Resolution	112.5	7.50
Stone Lake Retail Park, London	Aberdeen	LXB	32.95	6.50
Purley Way, Croydon	Standard Life	Aviva	31.70	5.90
Anglia Retail Park, Ipswich	Starwood Capital	ELAS	29.50	7.80
Suffolk Retail Park, Ipswich	Orchard Street	Aberdeen	18.75	7.10
Lady Bay Retail Park, Nottingham	Threadneedle	LaSalle IM	16.30	8.80
Gala Retail Park, Galashiels	Prudential	Aviva	10.87	6.40

Source: Propertydata.com, Knight Frank

CASUAL DINING ON RETAIL PARKS

The expansion of the casual dining restaurants such as Frankie & Benny's and Nando's into out-of-town retail parks began in earnest in 2007 – somewhat behind the traditional fast food outlets such as McDonald's, which peaked over ten years ago.

Unsurprisingly, openings in both sectors declined in 2009. However, 2012 saw at least four times the number of new A3 (casual dining) openings on retail parks, compared with fast food outlets.

Operators are currently faced with how to grow turnover in a weak consumer environment. The answer has mainly been organic growth, particularly amongst the casual dining operators such as ASK, Pizza Express, Nando's, Frankie & Benny's and TGI Fridays. These brands have traditionally been seen in the high street, shopping centres and/or leisure schemes.

Most of these companies have chosen to locate on shopping parks, where the type of consumers and long opening hours create an attractive location for restaurants. Indeed, unlike some out-of-town leisure schemes, shopping parks often trade successfully throughout the day. Our analysis shows that the average rent across a sample of 206 restaurants on retail parks is £24.36 per sq ft, with the average size of units being 3,450 sq ft.

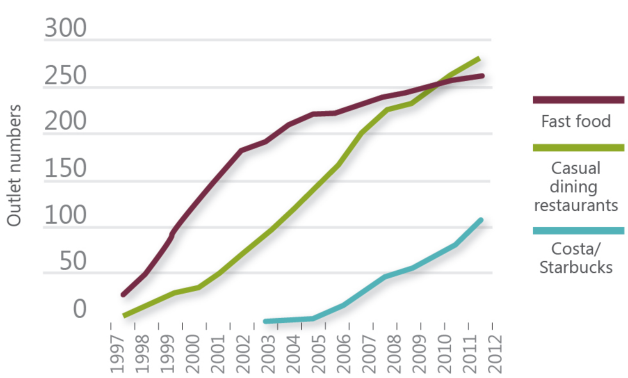
The rapid increase of restaurant operators on out-of-town retail parks reflects their desire to grow organically and changing consumer habits, whereby eating out has become a more important part of the shopping experience.

Tesco's recent acquisition of Giraffe might set a trend for more restaurants in out-of-town superstores. This could allow supermarkets to make use of space no longer required for electrical goods, as well as meeting consumer demand for casual dining while shopping.

Fast food openings have fallen significantly, in part due to saturation in certain locations. It is also because of changing consumer preferences and landlords seeking a better quality offer which complements the retail experience – not just 'grab & go'. The drive-thru model adds limited value to the retail mix and is unlikely to improve footfall and/or dwell time.

BIRMINGHAM FORT ADD VALUE WITH RECENT LETTINGS TO HARVESTER AND FRANKIE & BENNY'S

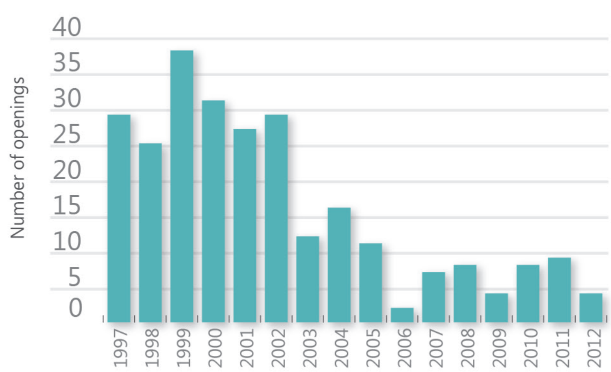
Figure 10 **Cumulative growth of food & beverage outlets***



Source: Trevor Wood Associates

* Relates only to openings since 1997, as data is not available before this date

Figure 11 **New openings of fast food restaurants on retail parks**



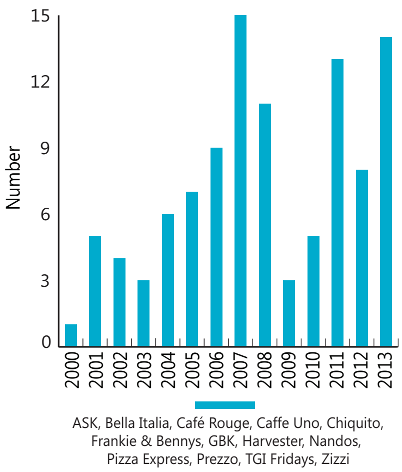
Source: Trevor Wood Associates

Coffee shops have shown an even greater appetite for retail parks, having only started to break into this market in 2006/2007. In the last 10 years the number of Costa and Starbucks units opening on retail parks has increased exponentially, from one or two units a year, to over 20 new units in 2012. The average rent paid by Costa and Starbucks across a sample of 67 units is £37 per sq ft.

The food and beverage offer is becoming an essential part of the retail experience in the UK. It is now widely acknowledged that an attractive leisure mix leads to increased dwell time, as well as an improved consumer experience.

Figure 12

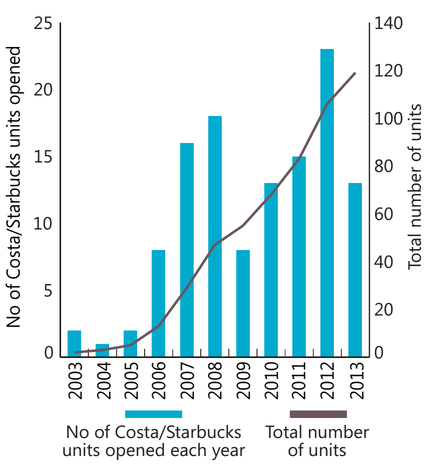
Growth of casual dining on retail parks



Source: Trevor Wood Associates

Figure 13

Growth of Costa and Starbucks on retail parks



Source: Trevor Wood Associates

LEISURE MARKET

Occupier market

The leisure occupational market continues to go from strength to strength, perhaps with the exception of pubs and the late licence/ nightclub venues. The former are feeling the effects of the debt structure and property legacy issues, while the latter are experiencing changes in consumer preferences (Atmosphere Bars and Clubs have gone into administration).

The major cinema chains, led by VUE, Cineworld and Odeon, continue to seek new opportunities, often in competition. This might be seen as an attempt to boost their market value, as much as a desire to grow organically, especially in the case of Odeon. However, the main three players are expected to open new cinemas and over 50 new screens in places such as Broughton (Cheshire), Cramlington and Gateshead in the north east, Quayside Gloucester and Newport (South Wales). In the case of Cramlington, the headline rent is £15 per sq ft and Gateshead at £14 per sq ft.

Activity in the health and fitness sector is polarising towards the "value" sector, driven by the likes of Pure Gym, Easy Gym and Gym Group. The latter was recently sold to Phoenix Equity Partners for just under £100m and expects to add at least new 20 clubs to their portfolio. Fitness First, which has recently emerged from its CVA process, is committed to spending £20m CAPEX on refurbishing their 85-strong portfolio.

Continued growth is also being seen in the casual dining sector. The Restaurant Group, having reported more encouraging sales growth figures, is on target to open 35 new units in 2013 (including 5 Coast to Coast). TGI Fridays have also recently committed to the old Aroma unit in Braintree at £34 per sq ft. In contrast to the traditional pub estate, the likes of Toby Carvery and Hungry Horse continue to seek new opportunities (Greene King has suggested it may double the Horse estate to 400+). Slug & Lettuce is also looking for up to 40 new sites, mainly in prime retail locations such as Westfield and Bluewater – in an acknowledgement of the ever-increasing synergy of leisure and retail.

Investment market

While the most recent benchmark yield for a prime leisure asset remains c. 6.20% paid for Bury St. Edmunds late last year, market sentiment has improved in 2013. Consumers appear to have resisted the temptation to reduce leisure spending – albeit "value" is paramount – which in turn has led to occupational demand and higher rents for the better schemes.

Major investors in the leisure sector such as Land Securities have been attracted by the length and stability of income (long leases) and rental growth prospects (open market and indexation). Early purchases suggested a greater demand for in-town assets with strong retail synergy, such as Cornerhouse (Nottingham) and Kingsmead (Bath). However, Land Securities' purchase of the majority stake in X-Leisure provides exposure to the out-of-town market, as well as an experienced management team and access to key occupiers. Obsolescence and competition may be a challenge for some of the schemes, for example Poole will be threatened by new in-town supply in Bournemouth.

We would expect that the next dominant prime leisure scheme (15-year income, with indexation and sub-£20m) will trade at, or around, 6%. This will take prime leisure yields to within 75 bps of their prime equivalent in the out-of-town retail sector.

HEADING

Leisure park	Purchaser	Vendor	Price (£m)	NIY (%)
Odeon, Richmond	Available	Odeon	9.975	5.75
Junction Leisure Park, Llandudno	U/O	Prupim	8.25	6.50
i-Scene, Ilford	U/O	Santander	19.50	8.40
The Light, Leeds	Legal & General	Kames Capital	91.80	n/a
Cineworld, Cardiff	Henderson UK PUT	Spectrum Asset Management	18.96	6.89
Larks Wood, Chingford	BA Pension Fund	Private	6.78	8.25

Source: Knight Frank

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Knight Frank

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