Knight Frank

Retail News

SHOPPING CENTRES: EVERY STORM RUNS OUT OF RAIN

ISSUE 9

THE ELEPHANT IN THE ROOM

The year of the CVA

INVESTOR VIEWS

Landsec and Ellandi

COUNCILS GRASPING THE NETTLE

The rationale behind an often maligned move

Key Takeaways

- RELATIVE TO OTHER SECTORS AND OTHER GEOGRAPHIES, UK SHOPPING CENTRES NOW OFFER VERY ATTRACTIVE YIELDS.
- INVESTORS ARE STARTING TO GATHER, SPYING THE COUNTER-CYCLICAL OPPORTUNITY.
- THERE WILL BE WINNERS AND LOSERS - IT IS NOT A MARKET IN WHICH TO GENERALISE. DETAILED INDIVIDUAL ASSET ASSESSMENT IS ESSENTIAL.
- CVAS HAVE DESTABILISED OCCUPIER MARKETS BUT ARE LIKELY TO BE SUBJECT TO FAR GREATER SCRUTINY AND CHALLENGE GOING FORWARD.
- LANDLORDS ARE HAVING TO THINK LATERALLY ABOUT HOW TO KEEP THEIR SCHEMES FULL AND BUSY, BUT LATERAL THINKING IS PROVIDING SOME SOLUTIONS.
- PRIME REGIONAL CENTRES HAVE A STRONG FUTURE, BUOYED BY THEIR EXPERIENTIAL ATTRIBUTES. YIELD VOLATILITY SHOULD ONLY BE A SHORT TERM ISSUE.
- STRONG COMMUNITY CENTRES CAN OFFER INVESTORS A SURPRISINGLY RESILIENT CASH FLOW FROM A HIGH YIELDING STARTING POINT.
- THE TREND OF COUNCILS ACQUIRING CENTRES IS SET TO CONTINUE, ESPECIALLY WHERE THEY OFFER AN ESSENTIAL LOCAL REGENERATION PLAY.

Introduction

Another tough year for the shopping centre sector. Our retailers have experienced multiple headwinds, some of which are the much publicised tech “disrupters”, but some are much more subtle economic cost pressures.

In reality, no one single issue is causing the retail distress in the UK. It is the combination of multiple issues arising at the same time that has done the damage.

The much publicised occupational distress has led to a significant fall in rental and capital values, along with low volumes of investment turnover. This is, however, now starting to attract a new wave of capital, drawn to the potential of a counter-cyclical investment. Whilst sheds, beds and other alternatives boom, retail now presents itself as the highest yielding option in the UK. It is certainly the only sector offering cap rates higher than long term averages. It is, to my mind, the only sector offering any sort of “opportunistic” play in terms of market cycle timing.

Whilst the current malaise has given us all a challenging year to date, it’s safe to say we have been here before. Calls of “the end of the high street”, “retail Armageddon” or “institutions never returning to shopping centres” have been heard several times this century already, and they have always been shown to be wrong.

Once again though, the vultures are now gathering, looking for the seller and the 200 bps discount over what would perhaps be a sensible price. Once again those only here to bag a bargain are most likely to be disappointed or to get it wrong. The sector demands greater scrutiny and greater expertise. Investors will be better served to push harder for the right assets, rather than simply bottom-fishing for double-digit assets in distress.

Which brings us to our latest report, this time focusing on shopping centres. We are often asked which assets should investors be considering, at what price point and when is the right time? For the answers you need to come and see us – publicising these opinions widely is probably not the best way to help our clients! However, we hope the following articles help to improve your understanding of this complicated sector.

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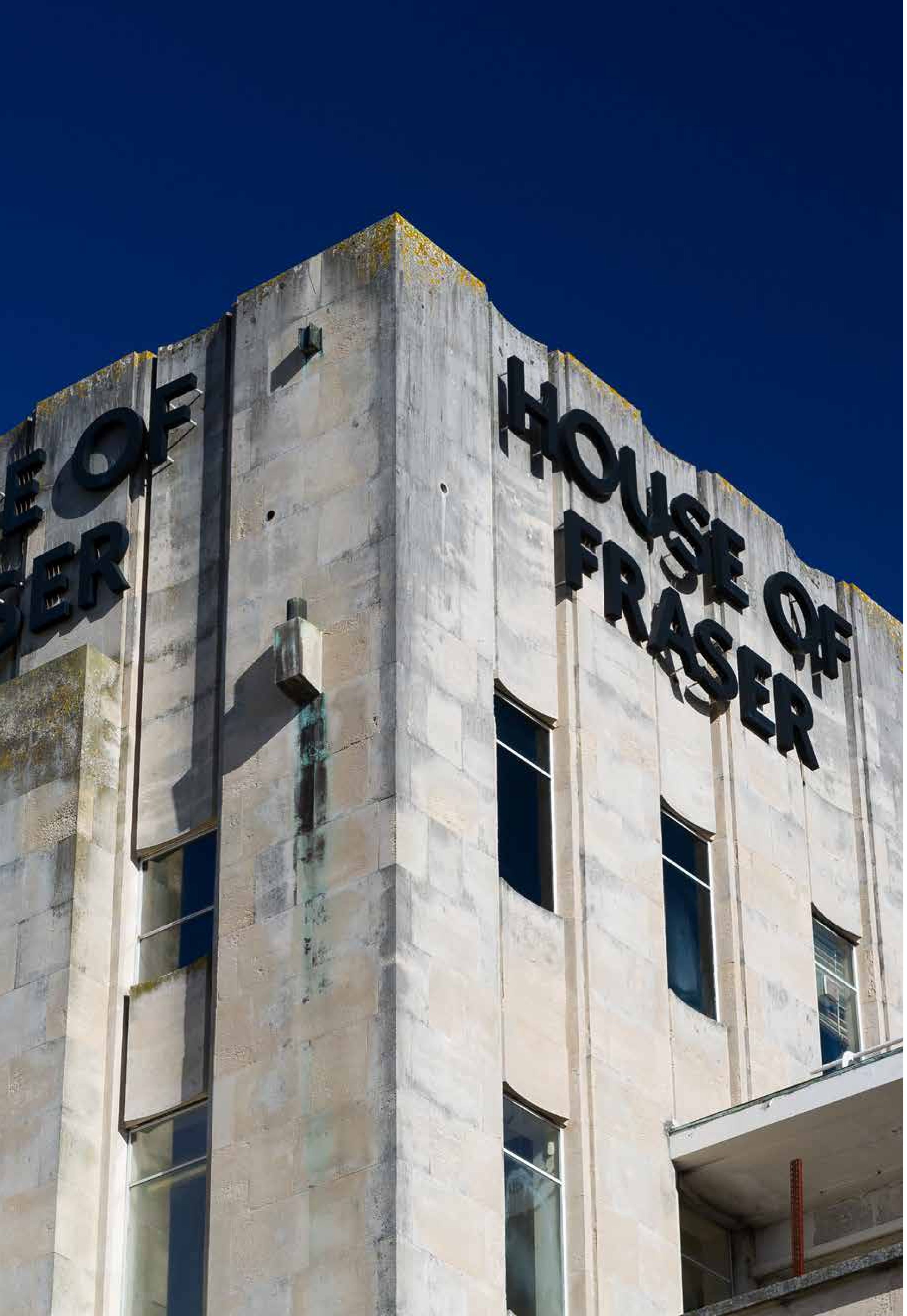


CVAs: the Elephant in the Room

WORDS: STEPHEN SPRINGHAM – PARTNER, HEAD OF RETAIL RESEARCH

2018 will probably go down in the annals of time as 'the Year of the Retailer CVA'. But it could also conceivably be a turning point in what is an increasingly inequitable process.

The retail doom mongers have had much to feast on in 2018, with a few high profile administrations (Toys 'R' Us, Maplin, Poundworld and East) and a number of controversial CVAs (New Look, Carpetright, House of Fraser, Mothercare and Original Factory Shop) shining an unwelcome spotlight on the retail sector. Cue predictable retail soul-searching, calls of 'Retail Armageddon' and renewed proclamations of the 'Death of the High Street'. Sadly lacking generally is a sense of perspective as to why the retail sector is apparently so challenged.

Why the distress?

Contrary to virtually every media report, the malaise is not consumer driven. The supposed 'consumer squeeze' actually ended in Q1, with wages growth again outstripping inflation. But this has been a red herring all along and will have no more material impact now than it did over the preceding 18 months.

The UK consumer continues to spend, despite all commentary to the contrary. ONS figures showed that overall retail sales values in 2017 were up 4.5% year-on-year. Even stripping out inflation, retail sales volumes were still up by a far-from-disastrous 2.1%. Nor has there been a discernible slowdown in 2018 to date. Q1 dipped slightly, but has been more than counterbalanced by a very strong Q2 (values ca. +5%, volumes ca. +3%), thanks in large measure to a sustained period of good weather.

The distress amongst some operators cannot be attributed to any single one factor or flashpoint. Rather, it is the result of a toxic mix of multiple cost and competitive pressures. Some of these are fairly recent (e.g. rising staff costs, business rates revaluations, higher input costs), but most are longer-standing, deeper-seated failings coming home to roost (e.g. over-expansion, lack of investment, failure to move with the times, product shortcomings, lack of brand relevance). The simple fact is that the UK retail market is over-supplied, both in terms of floorspace and number of operators. Periodically, something has to give.

Nor is the fact that a number of the CVAs have followed in quick succession a total coincidence. Retailers are renowned for their herding instincts and when one breaks rank in revealing its distress, others see it as a good time to 'follow suit'. The window for undertaking a CVA will not stay open forever, so anyone wishing to exploit it must do so sooner rather than later. A collective and periodic airing of dirty laundry, if you will.

Private equity ownership (past or present) is often the monkey on the back of the elephant in the room. A common denominator across retail failures (recent and past) is a history of private equity ownership – BHS, Comet, MFI, Toys 'R' Us, Maplin, East, HoF, New Look, Poundworld, Original Factory Shop, Byron Burger, Jamie's Italian, Prezzo, the list goes on.

> "Private equity ownership (past or present) is often the monkey on the back of the elephant in the room."

Of course, it would be wrong to tar all private equity with the same brush – some private equity owners are clearly more forward-looking and visionary than others. But the 'traditional' private equity model has no place in retail. Retailers may seem attractive to investors in that they are cash-generative, but they also are capital intensive (or rather, they should be if they are run properly). The notions of hefty financial leveraging, extracting cash, asset stripping and flipping may have worked (or seemed to have worked) in the so-called 'good times', but now have no place and are increasingly coming back to haunt. Retailers need to be run as retailers, by retailers, not as cash cows by financiers.

Why the controversy?

CVAs are probably the most contentious issue in retailing at present. They bring to a head many of the simmering grievances of both landlords and tenants, while also laying bare

many of the structural failings of the wider retail industry. And also give the ghouls in the media plenty to feast upon in their constant endeavours to write off the high street.

For retailers, CVAs buy breathing space, if not a stay of execution. Rather than be liquidated outright, they can significantly reduce their cost base by 'renegotiating' their financial obligations, not least by cutting their rent roll and shuttering stores they no longer want.

Store closures always provoke disproportionate consternation in both the media and among the general public. However, few people outside the property industry will ever have been privy to any retailer's full store list of P&Ls. These always show huge variances in trading performance across the estate, but a common factor for high street retailers is an 'ugly tail' of severely under-performing stores, some of which may be heavily loss-making. They may not always have been so, but trading patterns can change dramatically over the length of a lease term (10/15/25 years). To put it bluntly, there is not a single established high street retailer that wouldn't want to jettison at least 10% of their store portfolio, if they were given half the chance.

This is why CVAs are met with such cynicism from landlords – they regard a CVA as 'a get out of jail free' card for the retailer, a way of worming its way out of legal and financial agreements that it previously signed up to voluntarily. But given the current state of retail occupier markets and far from rampant retailer demand, landlords are effectively held over a barrel and have few alternatives other than to agree to whatever is proposed. Less a compromise, more blackmail on the part of retailers – if you don't agree to these terms, we'll go bust anyway and you won't get any rent at all.

There is also considerable controversy as to whether CVAs reflect genuine distress, or whether retailers are abusing the system to simply exit underperforming stores and renegotiate lease liabilities that they previously entered into of their own free will. Is a profitable publicly listed company with manageable debt and a solid balance sheet really on the brink of collapse? Trading underperformance and failing to match City expectations is a questionable definition of distress.

The mechanics of the actual CVA process spark yet further controversy. Officially, a CVA requires 75% creditor approval to be passed. But there is a distinct lack of transparency around 1. who all the creditors are and 2. how their influence is weighted. The feeling amongst landlords is that their collective weighting is disproportionately low relative to the level of financial liability that they bear. Even if they vote against a proposed CVA en masse, it still seems likely to go through. It's much easier for suppliers and bodies such as the HMRC and PPF to vote in favour of something for which they will not have to shoulder any of the financial burden.

CVAs also have a damaging knock-on effect across retail property markets, with prospering operators seeking to establish comparable terms with their 'distressed' counterparts (e.g. Next reportedly seeking 'CVA clauses' in its property leases). Why should they pay a full rent, when their adjacent tenant is going cap in hand to the landlord on account of failings of their own making? Expressed another way, why are successful retailers effectively being 'penalised'?

CVAs may be a necessary evil in retailing, but they are still deeply unsatisfactory. If they prove the turning point in a retailer's fortunes and that retailer goes on to prosper, then fine. If they just delay the inevitable and are the first in a string of subsequent failures, then absolutely not fine.

Thin or thick end of the wedge?

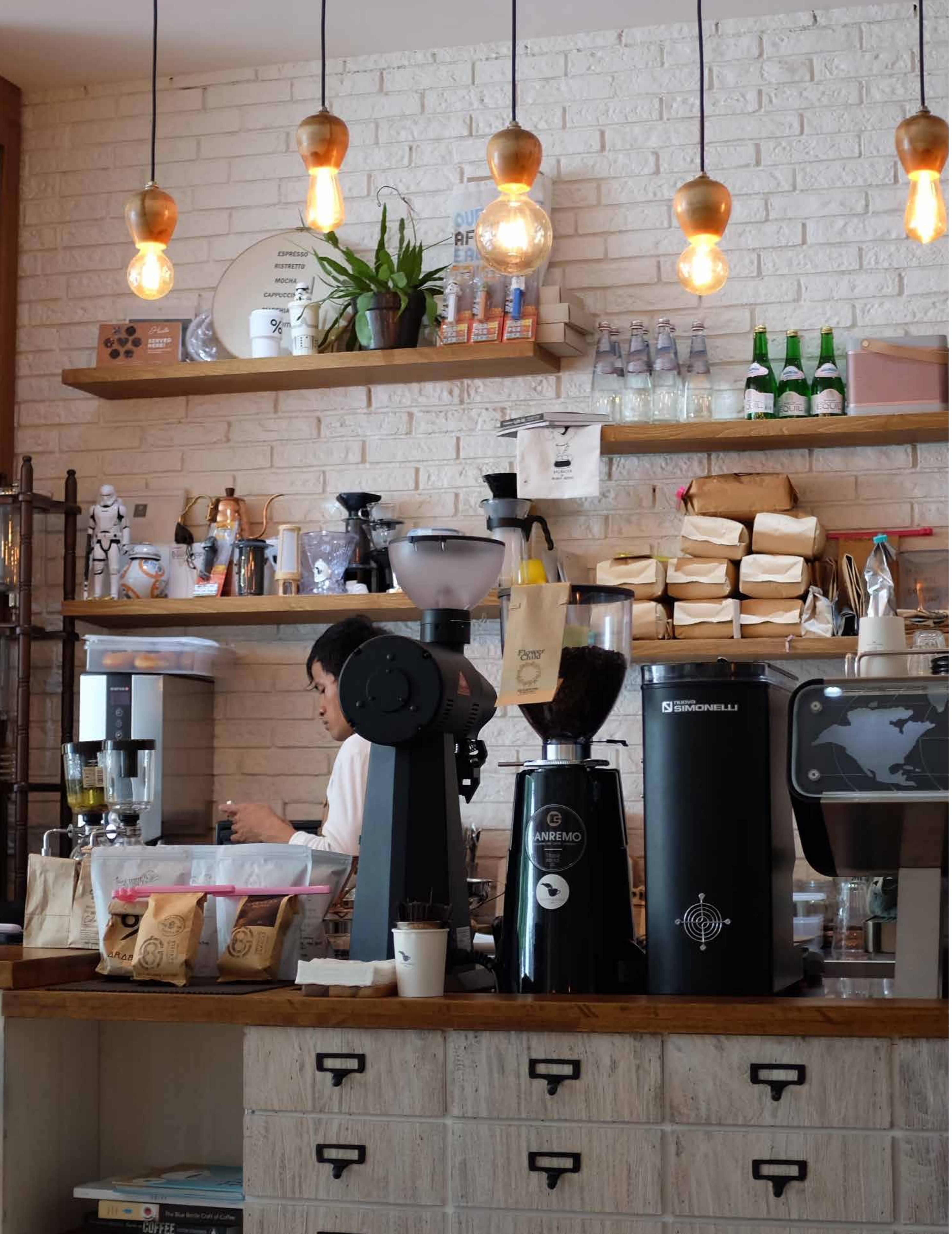
The rumour mill is constantly in overdrive as to which retailer will be next. Undoubtedly there will be further CVAs and administrations before the year is out. But the tide is slowly starting to turn. With something of a groundswell amongst landlords, CVAs are likely to face greater challenge and scrutiny going forward. Indeed, the British Property Federation is becoming increasingly vocal in its lobby for the whole CVA process to be reviewed.

But to some degree, the damage has already been done. The uncertainty around CVA-based store closures and contagion-related shifting rental tones has left the retail occupier market in a state of limbo. Retailers are not committing until there is greater certainty and this is unlikely to materialise in the immediate future.

It is still disappointing to see retailer CVAs interpreted as 'Retail Armageddon' or symptomatic of the 'Death of the High Street'. The fact is that the UK market is highly competitive and over-supplied. As such, retailing has always been survival of the fittest – and some operators are fitter than others. Harsh as it may sound, maybe it is better in the longer run if the weaker ones are left to fail, rather than propped up by artificial means.

	BHS	JJB Sports	HMV	Peacocks	Mothercare	Poundworld	New Look	House of Fraser
DATE OF CVA/ ADMINISTRATION	Mar-16	Sep-12	Jan-13	Jan-12	May-18	Jun-18	Mar-18	Jun-18
IMPACT OF CVA/ ADMINISTRATION	CVA initially approved, on basis of 50-75% rent reductions on 50 stores and 25-50% reductions on 30 more.	Entered pre-pack administration. Sports Direct bought 60 of the 180 JJB stores.	Placed into administration by Deloitte, ca. 100 stores were closed. Residual 141 store business acquired by Hilco.	Placed into administration by KPMG. 244 stores closed, remaining 388 acquired by Edinburgh Woollen Mill.	CVA approved, 50 stores to close by June 2019, rent reductions on a further 19 stores.	Despite interest from founder Chris Edwards, no buyer found for business.	CVA approved, 60 stores to close and rent reductions of 15-55% on 393 other stores.	CVA initially approved, 31 stores to close, rent reductions of 25% on 10 others.
WHERE ARE THEY NOW?	Collapsed into administration in April 2016. All 164 stores closed and 11,000 staff made redundant.	Business collapsed with debts of ca. £150m and the JJB name disappeared from high street.	Achieved annual sales of ca. £300m in year to Dec 2016 and earnings of ca. £11m. Portfolio of ca. 130 stores.	Achieved annual sales of £382m in the year to Feb 2017 and PBT of £65m. Ca. 485 stores still trading.	9 stores added to initial closure list. Raised £32.5m through share offer in July 2018.	All 3,500 stores are being closed in stages and 5,300 staff made redundant.	Transpires that not all 60 stores may close. Still trading, but with ca. £1.2bn debt.	Legal challenge derailed CVA and business acquired by Mike Ashley through a pre-pack administration.

Source: Knight Frank



Don’t forget the little guy.

WORDS: DAVID LEGAT – PARTNER, RETAIL AGENCY

With relative inactivity from national retailers, landlords are thinking laterally to keep their centres full and vibrant.

As the occupational markets continue to challenge, landlords and their advisors need to be agile in their thinking, firm with their decisions and efficient in their delivery. The market is moving fast and the ability to close deals is crucial to avoid missed opportunities. Against the backdrop of a re-think of how we categorise shopping centres, there is an acceptance in centres of all shapes and sizes that it is about much more than just national retail.

There has been a structural shift in the retail world. The way we shop has changed. As a result, landlords are battling the basic economics that the supply of retail space outstrips demand and so alternative solutions need to be found to fill surplus space. Non-retail occupiers and independent retailers need to be sought out, engaged and accommodated into shopping centres to help fill the voids.

Alternatives to retail

Gyms were the trailblazer of the non-retail uses and are now an established sector with over 7,000 gyms in the UK and total gym membership approaching 10 million. Like many non-retail uses, gyms not only fill vacant space but also add a different dynamic to a shopping centre; different customers, different hours of usage, all of which start to create a more vibrant and diverse sector.

Soft play, healthcare, adventure leisure, competitive socialising, communal workspace, markets, libraries, the list of uses now going into what was traditional retail space is extensive and diversifies the traditional retail line up. They create reasons for people to visit and complement the retail offer.

Specialist market operators are emerging as ‘problem solvers’ to create and run spaces which are let to a host of independent operators all under one roof; Make Shift and their Pop Brixton and Peckham Levels schemes are good examples. While these types of operations are still London-focussed, there is no reason the concept of diversifying the offer by facilitating small, independent and genuinely interesting operators cannot be rolled out across every town.

Independents enjoying a renaissance

The focus on non-traditional retail users has been borne out of necessity and is now an integral part of the leasing strategy on any centre, but by no means can retail as a whole be dismissed. Often overlooked and perpetually undervalued, the independent retailer offers a category of occupier which is bucking the trend of the national markets.

Small, independent and local retailers by their nature are relevant to their catchment. To survive they must provide what their customer wants, and they also provide what a conscientious landlord wants; differentiation, experience, a sense of place. All buzzwords commonly quoted with no substance on how to deliver.

Smaller retailers do not have the weight to throw around that the national retailers do when taking on new leases, and so are not pushing the deals beyond the limits of commercial viability. In the current market, this pragmatism makes them a category which cannot be ignored.

Concerns are still attached when agreeing deals with smaller retailers over covenant strength. But in a market littered with CVAs there is now often a question mark over some larger tenants previously thought of as safe income.

There is no doubt the most active parts of the occupational markets at the moment do not include many national retailers, discounters aside. The future is not certain, but one thing that is certain is that there needs to be a fundamental shift in the way smaller occupiers, be they retail or non-retail, are viewed, accommodated and valued. The deals take more work. Landlords need to put the effort in to truly understand their potential new tenant, and importantly need to be flexible on the deal structure to allow a genuine partnership to be formed. If done well, the end result helps create the Holy Grail which landlords are striving for – a sustainable centre with flourishing tenants, who pay rent.

Don’t forget the little guy.

Ensuring Prime remains Fit for Purpose

WORDS: RUSSELL LOVELAND – SENIOR PORTFOLIO DIRECTOR, LANDSEC

A little over three years ago, Landsec saw the way retail was evolving and repositioned the Shopping Centre portfolio to focus on resilient and regionally-dominant destinations.

These assets demonstrate resilience even when times are tough by continuing to attract new brands, providing opportunities to add value and being places where a great experience can be curated for our guests.

Russell Loveland

To maintain these strong fundamentals means constantly reinventing our destinations to ensure the offer remains fresh, relevant and engaging for the people who visit.

This starts with the strength and breadth of the retail offer, ensuring that our brands are in the right space to provide a compelling offer. This means proactive asset management to understand the space that brands require, then seeking opportunities and reinvesting in our assets to form that space.

In the last few months alone we have opened newly-created stores for Arket at Bluewater, River Island at White Rose, New Look at Trinity, Bershka at St David's and are in the process of delivering newly-formed space for Victoria Secret at Buchanan Galleries and Primark and JD Sports at Bluewater.

We know retail is only one part of a successful destination; a strong restaurant and leisure component tailored to the catchment is essential to the attractiveness of the centre. At White Rose in Leeds we identified the need for a food and cinema offer to serve our loyal guests and move the positioning of the centre to a full day out experience. The leisure extension of six new restaurants, an IMAX Cineworld and new children's playground opened fully let this year.

At Bluewater it was a case of building on an already successful leisure offer with the conversion of under-utilised space to form a trampoline and climbing park operated by Gravity and an extension to the Showcase cinema to ensure a market-leading cinema experience was on offer for our guests.

When developing Westgate, we put the guest experience at the heart of the design. From smart parking that directs you to a free spot and knows your number plate to let you out if you have paid, to the creation of a roof terrace offering panoramic views and new exciting restaurants for the city. Each element of the centre is designed to ensure a brilliant day out.

Technology also has a part to play, not only as a direct revenue driver through digital advertising screens, but also allowing us to understand our guests better through analysis of phone and Wi-Fi data and our web based 'share your thoughts' feedback tool. Innovation has allowed us to bridge the online and physical retail worlds at Bluewater by offering guests the ability to browse the retail offer on-line then move straight through to a shopping portal to purchase.

Finally, guests are seeking that extra reason to visit. We provide these reasons through 'everyday wonder' at our centres. Recent activity has seen an eight metre tall robotic T-Rex at Trinity, an indoor safari trail at Bluewater enjoyed by 38,000 people and daily drama performances at Westgate.

In this challenging environment the retail destinations that succeed will be the ones that dominate their catchment, continue to re-invent themselves and understand that the experience guests have at every level really matters.

“ In this challenging environment the retail destinations that succeed will be the ones that dominate their catchment, continue to re-invent themselves and understand that the experience guests have at every level really matters. ”

Isn't Everything a Community Centre?

WORDS: MARK ROBINSON –
FOUNDER AND PROPERTY DIRECTOR, ELLANDI AND VICE PRESIDENT, REVO

For a number of years, Ellandi has been describing itself as 'The UK's Leading Investor in Community Shopping Centres.' Now, you may choose to agree or disagree with this slightly hubristic statement, but I hope that most people in the industry would recognise that we were one of the first and most vocal companies to articulate the role of our successful investments in the community.

Now it seems that every retail location, from world class retail destinations to out-of-centre retail parks, make claim to their role at the heart of a community.

So in trying to answer the question above, it's perhaps worth revisiting what it means to Ellandi and why we chose this tag line.

It starts with polarisation, the global societal change that is seeing the informed, purposeful shopper choose which retail channel best meets their specific needs. These are the result of three desires: experience, value and convenience. Very crudely put, this results in the relative outperformance of Westfield, some internet retailers and Coulby Newham (which is expertly managed by Knight Frank!).

The end of polarisation that Ellandi has chosen to play in is very much based around value and convenience retailing. So much so, we even initially embraced the phrase VCSC (Value and Convenience Shopping Centres). However, there was a very rapid realisation that the 'C' was driven by the fact that in our successful retail locations people shop as part of a linked trip, that is to say they shop whilst they are doing something else.

This 'something else' can range from a trip to a gym, dropping the kids off at school, getting a hair cut and, the often overlooked, popping to the shops en route to and from work or at lunchtime. Our annual intercept surveys have proven that 80% our customers visit our centres over once a week. They are, put very simply, at the centre of day-to-day life.

Some of these other uses or 'draws' are unlikely to be accommodated in existing shopping centres, which is why it has always been important to consider where the investment sits in relation to these other community drivers. Where is the bus station? The college? The health centre? Has the local authority committed to keeping its staff in town?

There is a danger that the word 'community', as now frequently adopted, is almost in danger of becoming meaningless due to overuse and does not fit its intended definition.

To assist us all in defining not only our 'Community Centres' but all of the Centres in the UK, Revo have recently undertaken a consultation around adopting a comprehensive classification methodology for shopping centres. This should bring the UK into line with global best practice and help our industry better articulate the attributes of the many types of places where consumers choose to shop.

As key industry players, Knight Frank have taken a proactive role in the process and we hope all the readers find this useful in explaining the roles of our Centres in today's rapidly evolving retail world.

Mark Robinson

ATTRIBUTES OF A COMMUNITY CENTRE

- ☐ A scheme that is the beating heart of the local community.
- ☐ A retailing offer focused on everyday 'needs' as opposed to 'wants'.
- ☐ A centre used for daily top-up shopping trips.
- ☐ A centre that offers more than just shopping – post office, health centre, library, job centre or local market.
- ☐ Likely to house a meaningful grocery offer.
- ☐ Needs to be let off an affordable base that works for both national and local retailers.
- ☐ Benefits from a degree of isolation from / dominance over alternative daily shopping options.
- ☐ Offers accessible and affordable parking to facilitate short visits.

Source: Knight Frank

Councils Grasping the Nettle

WORDS: MARK SMITH, PARTNER – RETAIL CAPITAL MARKETS

As Local Authorities take on challenging shopping centres in a falling market, we look at the statistics behind deals done to date and the rationale of an often maligned move.

There has been plenty of dialogue on the activity of Local Authorities (LAs) in the commercial property market over the past 12 months, but how much have they actually done and is this the new panacea for reinvigorating our town centres whilst supplementing local authorities budgets, or are they taking captaincy of sinking ships?

What is actually happening?

Since the start of 2016 there have been 26 shopping centre acquisitions by LAs: ten in 2016; six in 2017; ten to date for 2018. Over the period, that is only 13% of total volumes, but around a quarter by number of transactions. All of these transactions have been "within borough."

In the quarter just past, LA deals had risen to half of all shopping centre transactions. With at least three deals also under offer to LAs and numerous conversations going on, 2018 will comfortably represent the most active year to date for LAs acquiring shopping centres in their borough.

> "Prior to 2016, stretching back nearly 20 years, we previously only recorded four instances of LAs buying a shopping centre."

Prior to 2016, stretching back nearly 20 years, we previously only recorded four instances of LAs buying a shopping centre. This activity therefore represents the emergence of a truly new wave of capital.

The shopping centre market is not on its own in experiencing the emergence of LAs as active buyers. Our industrial and office colleagues saw an earlier, sharper rise in this phenomenon as LAs seeking income more readily digested the single let, secure opportunities, on offer.

Can the increasing activity be justified?

As with any new source of capital that emerges into an established market, there has been much discussion around LAs buying shopping centres. In this instance, whether it is because of the uncomfortable mix of public sector interfering in the market, the trajectory of the retail market or because, as UK tax payers, it is all of us taking the risk, the debate and press has been particularly barbed with its criticism.

LARGEST 10 ACQUISITIONS BY LOCAL AUTHORITIES

1

TOWN CANTERBURY
CENTRE WHITEFRIARS
DATE Feb-18
VENDOR TH Real Estate
PURCHASER Canterbury City Council
CAPITAL VALUE £155m
NIY 6.50%

2

TOWN CAMBERLEY
CENTRE THE MALL
DATE Nov-16
VENDOR Capital & Regional
PURCHASER Surrey County Council
CAPITAL VALUE £86m
NIY 5.90%

3

TOWN STOCKPORT
CENTRE MERSEYWAY
DATE Jun-16
VENDOR Recievers
PURCHASER Stockport Metropolitan Borough Council
CAPITAL VALUE £80m
NIY 7.00%

4

TOWN CRAMLINGTON
CENTRE MANOR WALKS
DATE Jul-16
VENDOR Hammerson
PURCHASER Arch (Northumberland County Council)
CAPITAL VALUE £78.2m
NIY 7.05%

5

TOWN WOKING
CENTRE WOLSEY PLACE
DATE Feb-10
VENDOR IM Properties
PURCHASER Woking Borough Council
CAPITAL VALUE £68m
NIY 8.10%

6

TOWN BANBURY
CENTRE CASTLE QUAY
DATE Dec-17
VENDOR Aberdeen Standard
PURCHASER Cherwell District Council
CAPITAL VALUE £58.2m
NIY 6.85%

7

TOWN SHREWSBURY
CENTRE DARWIN/PRIDE HILL
DATE Dec-17
VENDOR Aberdeen Standard
PURCHASER Shropshire County Council
CAPITAL VALUE £50.8m
NIY 6.00%

8

TOWN FARNHAM
CENTRE BRIGHTWELLS
DATE Mar-18
VENDOR Crest Nicholson / Waverley Borough Council
PURCHASER Surrey County Council
CAPITAL VALUE £42m
NIY 5.85%

9

TOWN BOOTLE
CENTRE THE STRAND
DATE May-17
VENDOR Ellandi / Avenue Capital
PURCHASER Sefton Metropolitan Borough Council
CAPITAL VALUE £32.5m
NIY 8.70%

10

TOWN ST HELENS
CENTRE CHURCH SQUARE
DATE Oct-17
VENDOR LaSalle
PURCHASER St Helens Council
CAPITAL VALUE £26.6m
NIY 5.00%

At Knight Frank we are supporters of the principle of LAs buying the centres, provided they proceed with due caution. As well as all the usual benefits that a property investment carries, LA owners benefit from making a success of their local centre in many other ways, including:

- Improvement to the environment of their town centre
- Generation of local employment
- Sustaining or possibly growing revenue from commercial rates
- Encouraging 3rd party investment into the wider area
- Taking control of town centre regeneration, including potential key residential sites
- Unlocking marriage value where they are already freeholders.

Aside from the need to "take control" of what is probably the local area's largest and most important commercial asset, there is also a sound financial case behind LAs acquiring shopping centres. It should not be overlooked what an incredible opportunity is being presented to these buyers with lending rates of 1% or lower. They can borrow either from the PWLB or other sources with such low rates on offer due to the perceived strength of the borrower.

Even with full amortisation, which we generally recommend, all-in costs are typically 2-3%, leaving a large margin over interest payments. With 100% LTV on offer and long term deals of 25-50 years available, buyers can fully amortise their loan, retain a significant sinking fund for future capex, employ an asset manager and still generate a healthy annual cash surplus.

Offered anything like these debt terms, there would be a myriad of Private Equity and Prop Co buyers chasing these deals down, even in the current climate.

> "Offered anything like these debt terms, there would be a myriad of Private Equity and Prop Co buyers chasing these deals down, even in the current climate."

Of course, the argument is not purely a financial one. LAs should be careful to accurately appraise these assets, taking best advice from agents and from expert asset managers throughout the process. They need to allow for likely capital expenditure and should consider the scale of the steps that are needed to stabilise / turn around the asset.

There is more to debate and the complexities are meaningful. However, for me the headlines are this:

A. If the shopping centre is strong then the financial support available to LAs make an acquisition a very attractive income proposition.

B. If the shopping centre is weak then the LA may need to take action where others will not, invest time and money into these key commercial assets and get these town centres back on the right track through a proactive approach.

Whether it is a new panacea or not, with the lack of the traditional buyers, LAs buying in a retail investment market that is so out of favour, LAs can find themselves in a position to underwrite a plan that will allow them to have their cake and eat it!

Lessons from Previous Cycles

WORDS: CHARLIE BARKE – PARTNER, HEAD OF RETAIL INVESTMENT

An exciting counter-cyclical opportunity, but only for the right stock.

At the turn of the century, like now, some 100+ shopping centres were available "off-market" to any credible buyer willing to come forward at a sensible price. Many of these centres had been marketed and withdrawn, as is also the case today.

2009/10 saw another downturn, with a significant fall in values leading to an excess of investment supply over demand.

So, what lessons can we learn from these two previous cycles? And how best can one position oneself to take advantage of the fall in pricing?

After the fall in values of the late 1990s, there was a general market recovery where virtually all assets then benefited from the boom period to 2007. One of the early counter-cyclical investors were Kevin McGrath's REIT Asset Management, who acquired numerous distressed sales, in total around 20 centres, at an average yield of close to 8%. REIT then sold out of these assets at an average yield of 6.75% within just a few years, arguably too soon as the sector continued to boom for several years thereafter.

Another to take advantage of the cycle were Charterhouse, who built a portfolio of 11 schemes over several years. They exited as a portfolio in 2003 at in excess of £325m, selling at ca. 30% more than their respective acquisition prices. CIT, the buyer of the Charterhouse package in 2003, went on to also make a significant return, selling on all of these properties again within three years, capturing significant capital growth off the back of further yield shift.

The 2009/10 downturn was shorter and the upside mirrored that. However, despite the short cycle, several savvy buyers got in and out, making significant profits simply by holding for yield shift, rather than by making significant further investment to transform assets. Some examples of these are provided below.

What this latest cycle points to is careful stock selection. Individual deals fared very well but a blanket strategy of just buying the market en masse has left a few investors in difficult positions.

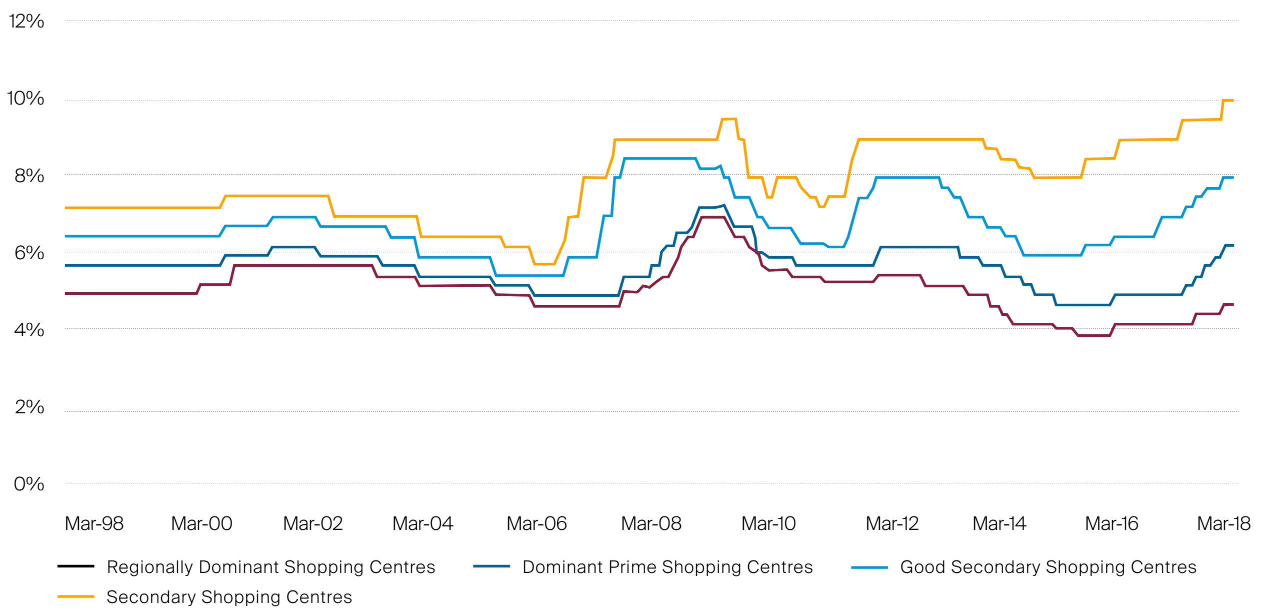
Also, notable from the list below is that schemes are generally at the better end of the market. Therefore, the best strategy was to buy good value prime stock, rather than chasing double-digit yields.

We are firm believers that we are being presented with a similar counter-cyclical opportunity now. Whilst part of the market has further to fall before stabilisation (or at least the valuations of such assets need to crystallise a further correction), the market is starting to offer some good value set against historic contexts, other sectors and other geographies. It is this relativity, combined with the eventual stabilisation of the local occupational market, that will encourage investors return to shopping centres in due course.

> "What this latest cycle points to is careful stock selection. Individual deals fared very well but a blanket strategy of just buying the market en masse has left a few investors in difficult positions."

SHOPPING CENTRE YIELDS - 1998-2018

Source: Knight Frank



PURCHASER	TOWN	DATE OF ACQUISITION	PRICE	DATE OF SALE	PRICE
Doughty Hanson	Salisbury	Dec-08	£60m	Jul-11	£80m
Matterhorn	Finchley	Mar-09	£92.5m	Apr-10	£126m
Europa Capital/Scoop	Maidstone	May-09	£69m	Dec-10	£91.6m
Aus. Future Fund	Birmingham	Sep-09	£210m	May-13	£307m
LaSalle IM	Bexleyheath	Nov-09	£98m	May-16	£120.3m
Meyer Bergman	Kingston	Feb-10	£130m	Feb-15	£180m
Henderson Warburg	Islington	Jun-10	£111.7m	Aug-15	£171.8m
Blackstone/Catalyst	Stratford	Jun-10	£90m	Feb-17	£141.5m

Source: Knight Frank

Re-Classification

Over the past few months, Revo have been undertaking an exercise to produce a new classification for UK shopping centres, to get away from the old narrative of the market having (a narrow selection of) prime shopping centres and (a long tail of) secondary centres.

Knight Frank are playing a key role in this exercise as we feel it will be progressive for our sector to offer greater clarity over its subdivisions.

Whilst the new categories will not lead the witness on the degree of success of any one centre, they should help to identify the purpose of each centre, the audience it targets and the peer group into which it falls. It should make a high level assessment of a centre easier, it should prevent the negativity that the generalist term "secondary" carries and hopefully it will help our valuers track any movements in market pricing more closely, which is something surely the whole sector should try to do going forwards.

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