RESEARCH

Q1 2012

# UK RETAIL

## Occupational & investment markets

**Knight Frank**

## HIGHLIGHTS

- Whilst there were a number of retailer failures and the economic backdrop remains uncertain, the worst forecasts for Christmas trading were not realised.
- However, the occupational market is polarised, with retailer demand focused very keenly on the best high streets, shopping centres and retail parks. In contrast, for many weaker locations, exceptionally high vacancy rates are likely to persist for some time.
- Knight Frank's research suggests that the retail development pipeline for the next 1-2 years is limited, which will help support property values at the prime end. We sense, however, that there are tentative signs of some mothballed proposals being re-appraised.
- Investor demand for the better quality assets is firm and whilst there remains interest in more secondary stock, overall retail investment volumes for 2011 were down 25% on 2010, due to the limited availability of debt and concerns over retailer trading.
- The significant growth in internet shopping has continued, with record online sales achieved in the last few weeks of 2011 and further growth anticipated in 2012.

# ECONOMIC & CONSUMER OVERVIEW

**Late 2011 was dominated by a continuous trickle of bad news on the Eurozone sovereign debt crisis and the UK economy registered a mild contraction in Q4, with initial estimates suggesting that GDP declined by 0.2%. Most economic forecasters have lowered their growth expectations for 2012 and the consensus for UK GDP is now below 1%.**

CHRISTMAS WAS BETTER THAN EXPECTED, BUT CONSUMER CONFIDENCE REMAINS FRAGILE.

However, while the near term outlook remains uncertain and challenging, a number of forward-looking PMI surveys published at the end of last year were encouraging and economic growth may yet pick up more quickly than many expect.

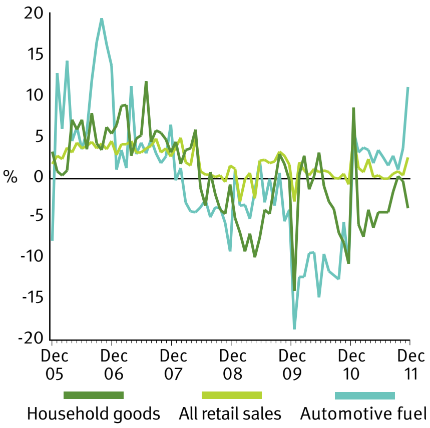
For retailers, the Christmas trading season was better than many had predicted, with the ONS figures recording 2.6% annual growth in volumes for December and even the BRC figures showing progress. However, heavy discounting by some is likely to have impacted on profits and sales of household goods remain weak, reflecting consumers' continuing reluctance to make large ticket purchases. Higher fuel prices have also added to the economic and structural headwinds facing the retail sector, particularly the out-of-town market, which is heavily dependent on car-borne shopping – although fuel costs now appear to be easing slightly.

The Nationwide consumer confidence index declined to 38 in December, its second ever lowest reading. Consumer sentiment may yet deteriorate further in the coming months and is not expected to rebound quickly. The latest unemployment data showed a rise of 118,000 to 2.68 million in the three months to November and public sector job losses are expected to continue.

There is, however, a small ray of light at the end of the tunnel for consumers, namely that inflation may have peaked and could fall sharply in 2012. Price inflation has been double the rate of earnings growth for some time, placing consumers' real incomes under pressure. The good news is that inflation declined for the third successive month in December, with the recent announcements of reductions in electricity prices also raising hopes that the worst of the squeeze on consumers may begin to dissipate.

Figure 1

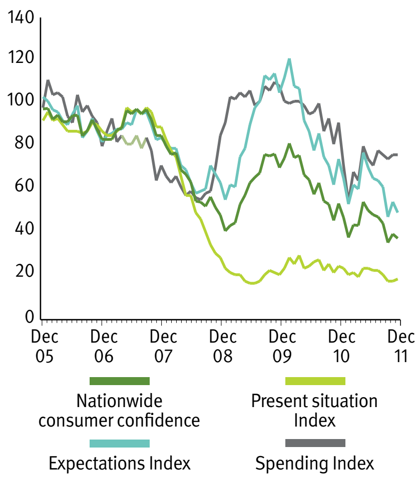
**All retail sales, household goods & automotive fuel**




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

Figure 2

**Nationwide consumer confidence**




Source: TNS-RI Research for Nationwide

**Retailer trading performance**

| Retailer | Latest results/comment | Trading period |
|---|---|---|
| John Lewis | Like-for-like sales up 6.2%; internet sales up 27.9%; "outstanding Christmas" | 5 weeks to 31st Dec |
| Waitrose | Like-for-like sales up 3.8%; "best ever" Christmas trading | December |
| Tesco | UK like-for-like sales down 1.3%; online sales up 14%; "disappointed with seasonal trading performance" | 6 weeks to 7th Jan |
| HMV | Like-for-like sales down 8.2%; strong growth in technology sales | 5 weeks to 1st Jan |
| M&S | Like-for-like sales up 0.5%; online sales up 22.4%, food sales up 3% | 13 weeks to 31st Dec |
| Debenhams | December like-for-like sales (inc VAT) up 6.5%; strong Christmas results | December |
| Morrisons | Like-for-like sales up 0.7% (exc. fuel and VAT) | 6 weeks to 1st Jan |
| Next | Next brand +3.1%; Next Retail 2.7%; Next Directory +16.9%; "slightly disappointing" store sales | 1st Aug - 24th Dec |
| JJB | Like-for-like sales up 5%; better than expected Christmas trading | 4 weeks to Boxing Day |
| Dixons | Group like-for-like sales down 5%; online now accounts for around 20% of sales | 12 weeks to 7th Jan |

Source: Various, company press releases

# OCCUPIER TRENDS

**At the prime end, the retail property market has remained remarkably resilient in the face of various major challenges – both economic and structural. Rents have mainly stabilised but, whilst rental uplift has been seen in select locations, any talk of growth across the wider market is premature. The major regional shopping centres continue to see solid demand and minimal voids, along with the best open A1 retail parks – although the out-of-town bulky goods market remains fragile.**

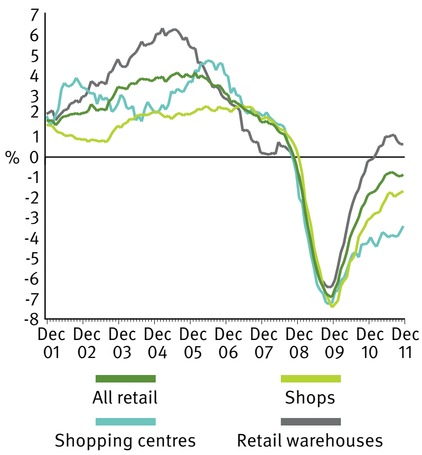
The contrast with many weaker towns/ secondary locations could not be more stark, with vacancy rates running at 20-30% in some small to medium-sized towns, particularly in the Midlands and Northern England.

The internet – which is helping to reinforce this polarisation – recorded year-on-year sales growth of around 20% for December and now accounts for around 10% of total retail sales. Mobile commerce has really come of age, with 17.6 million mobile phone Internet users registered in 2011, more than double the figure for 2009. For some retailers, it has become clear that growth in internet sales has come at the expense of store sales, although most (if not all) UK retailers have expanded their online presence and adopted the 'click & collect' concept, indicating their acceptance of it.

Q4 2011 recorded a smaller number of retailer casualties but, with slower growth likely and unemployment edging up, consumers may retrench further – putting weaker retailers under renewed pressure in 2012. Indeed, many retail landlords will be waiting with bated breath for potential tenant failures in the coming weeks and months.

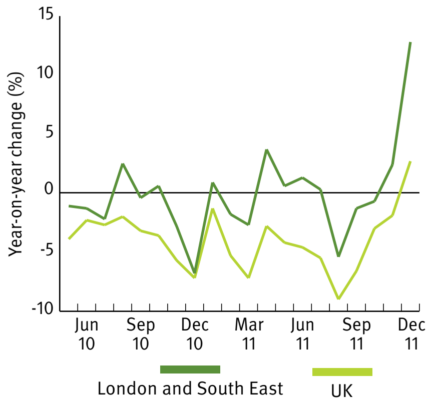
PRIME RETAIL PROPERTY HAS REMAINED RESILIENT IN THE FACE OF VARIOUS MAJOR CHALLENGES.

Figure 3
**Annual rental growth**




Source: IPD

Figure 4
**Footfall in London, South East and the UK**




Source: Synovate Retail Performance

NO SIGNIFICANT SCHEMES WILL BE DELIVERED IN 2012 AND THE PIPELINE FOR 2013 CURRENTLY LOOKS VERY LIMITED.

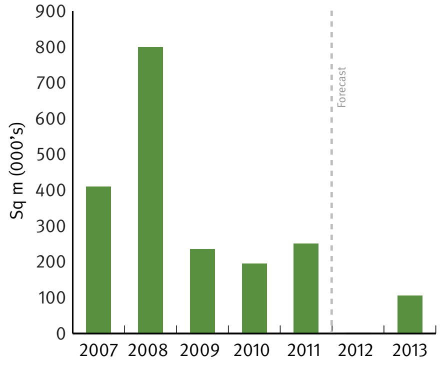
# DEVELOPMENT

**Post-credit crunch, retail development has been significantly curtailed, with lack of debt funding initially bringing construction to a virtual standstill and weak retailer demand subsequently denting hopes of a speedy recovery in activity. Indeed, the amount of new space delivered in 2009 was just 30% of the 2008 figure, with 2010 faring little better.**

Last year saw just over 250,000 sq m of new shopping centre space, a significant proportion of which was accounted for by Stratford City in East London. No significant schemes are expected to be delivered in 2012 and the pipeline for 2013 currently looks very limited.

Given the continuing restrictions on finance and weak economic growth outlook, it is difficult to foresee a pick-up in retail development activity until at least 2014. A number of developers are trying to push ahead with new schemes, but in reality only the largest REITs/property companies are currently in a position to undertake major new developments due to the difficulties in obtaining debt.

Figure 5
**New shopping centre floorspace**




Source: Knight Frank

**Major shopping centres in the pipeline**

| Scheme | Location | Size (sq m) | Date due | Developer |
|---|---|---|---|---|
| Trinity Leeds | Leeds | 93,000 | 2013 | Land Securities |
| Whiteley Village | Fareham | 22,500 | 2013 | British Land/USS |
| Outdoor Pursuits Centre | Evesham | 12,000 | 2013 | Eagle One |
| The Old Livestock Market | Hereford | 28,800 | 2014 | Stanhope |

Source: Knight Frank

# INVESTMENT

**Investor demand remains sharply focused on the best quality assets across all the retail sub-sectors and, with a limited supply of product on the market, yields at the prime end should hold firm.**

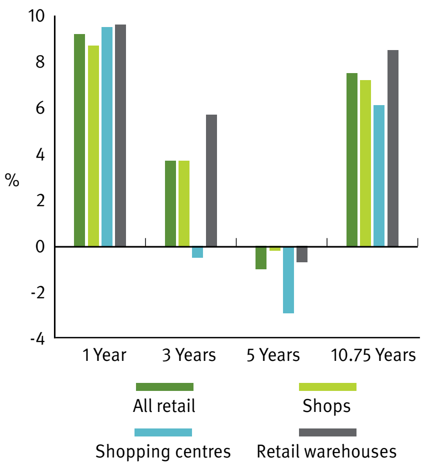
## CONTINUED POLARISATION BETWEEN PRIME AND SECONDARY STOCK IS EXPECTED.

For high street property, London and the stronger market towns in the South East continue to experience a solid level of interest, notably from the UK institutions and overseas investors, with private UK investors largely absent from the market. Yields for super prime shops stood at 4.75% in January, with London's Oxford Street at 4.00% and Bond Street yields still at 3.25-3.50% or below.

Investment demand for prime out-of-town retail exceeds supply and is being led by the institutions and specialist out-of-town property companies seeking to add value through asset management. However, the recent sale of the struggling Comet chain and Best Buy's withdrawal from the market highlight the ongoing fragility of the occupational market.

Secondary stock meanwhile has fallen foul of the uncertain economic outlook and concerns about the strength of the occupational market. Indeed, yields on good quality secondary shopping centres softened from 6.25% in October to 7.50% in January. Yields on poorer quality shopping centres have also moved out significantly in recent months to anything up to 8.50-10% and secondary/tertiary high street yields are now at 8.50% plus. We anticipate further potential outward yield shift in

Figure 6
**Annualised total returns**
**(to September 2011)**




Source: IPD Quarterly Digest

**Major retail investment transactions**

| Property | Purchaser | Vendor | Price (£m) | NIY (%) |
|---|---|---|---|---|
| 17-20 New Bond Street, London | LVMH | NAMA | 300 | 3.0 |
| Ealing Broadway SC, London | Wereheldave | Legal & General | 148 | 6.35 |
| Houndshill SC, Blackpool | Catalyst Capital/ Blackstone | Receiver (KPMG) | 85 | 7.4 |
| Grange/Pyramids SC, Birkenhead | La Salle Investment Management | Warner Estate Holdings/Lloyds Banking Group | 70.5 | 10+ |
| Willow Place SC, Corby | Helical Bar | Land Securities | 69.9 | 7.75 |
| The Meadows SC, Chelmsford | Legal & General | Lend Lease | 57.0 | 7.45 |

Source: Propertydata.com, Knight Frank

secondary/tertiary stock, with some of the biggest challenges for valuers in 2012 being the assessment of true rental values and re-lettability. However, we believe that good quality secondary stock will offer a recovery play in the latter part of 2012.

Despite retail's continued popularity among investors, overall investment volumes for 2011 amounted to almost £8.7bn, against £11.5bn for 2010 – a 25% fall (source: Propertydata), although shopping centre activity held up well. Investment returns have also slowed across the board in line with more limited yield compression, although retail warehousing generated a creditable total return of 8.4% over the year to December, easily exceeding the 5.1% for shopping centres and 6.2% for standard retail (source: IPD Monthly Digest).

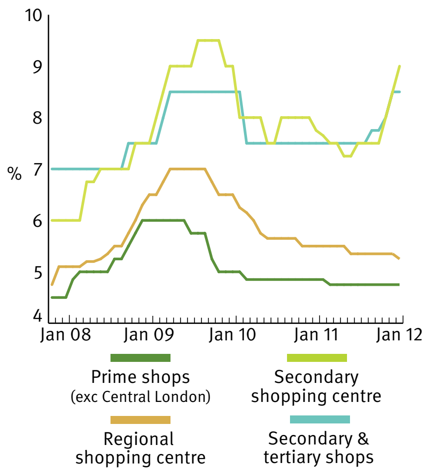
## KNIGHT FRANK VIEW

The report on the UK's high streets by Mary Portas has reinvigorated the empty shops debate. In many town centres, the established prime pitch has had to compete with new development in recent years – both in-town and out-of-town. Much of this newer stock offers an attractive tenant mix, good accessibility and "right size, right configuration" units – and is sought-after by retailers. The resulting increased competition – combined with the rise of the internet – means that many consumers will only shop in locations which have an attractive retail offer. So, what's the antidote to all these empty shops? Legislation, market days and better town centre management may well be part of the answer, but more will be needed to provide viable long term solutions for these properties, many of which are obsolete. This is a long term, structural problem to which there is no easy answer but tackling it will require close cooperation between landlords and local authorities, in order to overcome change of use, funding and site assembly issues.

Ian Barbour, Partner, Retail

Figure 7

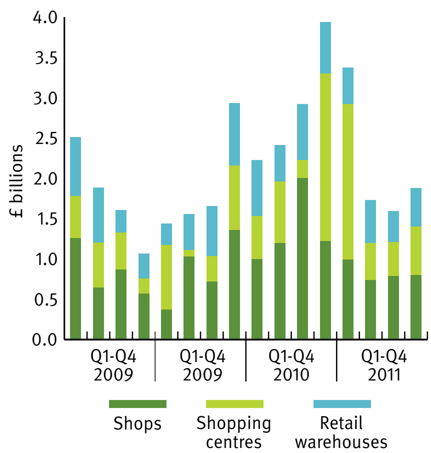
**Prime retail yields**




Source: Knight Frank

Figure 8

**Retail investment volumes**




Source: Propertydata

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