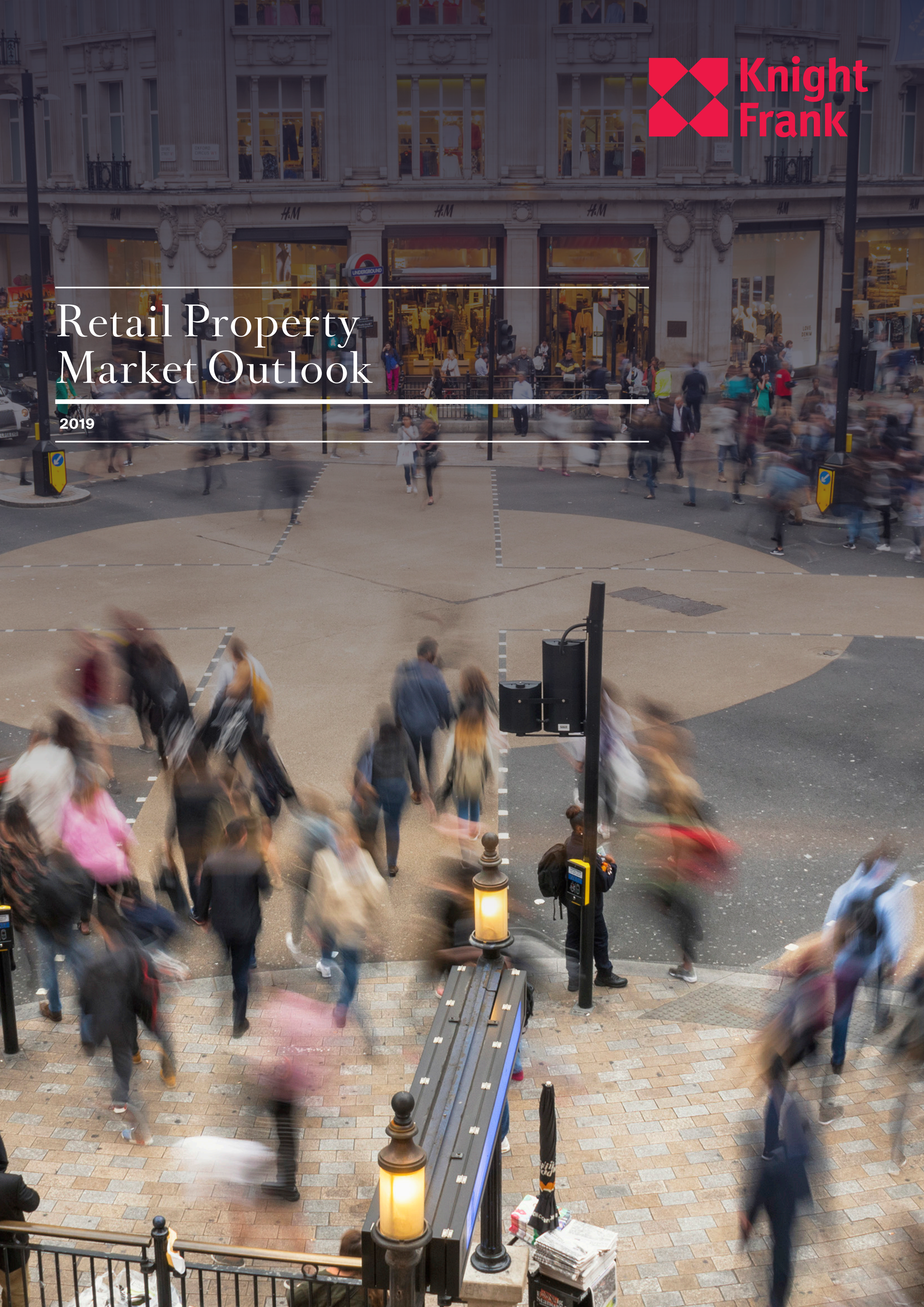

Knight Frank

Retail Property Market Outlook

2019

Macro-economics

UK economy forecast to grow by 1.5% in 2019 with **RPI inflation** kept in check at 3.1% due to stepped increases in **base interest rates** to 1.25%.

Relatively modest growth in **consumer spending** of 1.2%, again significantly outperformed by **retail sales** growth of 4.2%.

Ongoing strong employment markets – **employment growth** of 0.6% and an **unemployment rate** of 4.0%.

2019 Property Prospects

All Retail forecast to achieve **total return** of just 2.7%, depressed by further depreciation of **capital values** of -1.8%.

Forecast **rental decline** of -0.7% across the retail sector; **Central London** achieving positive rental growth of +0.9%, **standard shops** elsewhere in the country declining by -0.7%, **retail warehouses** by -0.5%, **shopping centres** by -0.8% and **supermarkets** -0.9%

Softening of **yields** across the retail market. **Prime shops** moving out to 5.25%, **regionally dominant shopping centres** to 5.50%, **prime open A1 OOT fashion parks** to 5.75%, **prime solus bulky retail warehouses** to 5.50% and **foodstores (with RPI increases)** more stable at 4.25%.

Longer Term Prospects

Short-term pain, but medium-term recovery. **Annual average total returns** between 2019 and 2023 are forecast to rise to 5.0%, with 5 year **annual average capital growth** of 0.4% and 5 year **annual average rental growth** of 0.5%.

Retail remains a solid income play, with **annual average income returns** between 2019 and 2023 of 4.6%.

Sources: Knight Frank, Real Estate Forecasting, Experian.

Overview

- The ‘annus horribilis’ of 2018 has proved an overdue wake up call for the UK retail market. 2019 needs to go beyond basic soul-searching and the whole industry needs to proactively address the structural shortcomings that threaten to undermine it.
- Further retailer CVAs and administrations cannot be ruled out, but the tide is slowly turning against a system that needs to be more equitable and transparent. Retail occupier markets will remain in a state of flux as CVA contagion and uncertainty prevail. There is next-to-no stimulus for rental growth in any retail sub-sector.
- The fate of Debenhams in 2019 will be a watershed moment for UK retail. As the largest occupier of non-food floorspace in the country, the outcome of its negotiations with landlords and the prospect of “up to” 50 stores closing will set the tone generally – particularly as to whether the necessary compromises are to be made to future-proof the whole sector.
- Retail property investment markets will remain subdued against this backcloth of occupier uncertainty and negative sentiment generally. Investment markets remain hamstrung between the gulf in historic valuations and buyers’ expectations.
- The investment case for the right retail stock (strong fundamentals, relevance to its catchment, a good trading story, realistically priced) remains a compelling one. But retail needs to be experiential and / or convenient, rather than merely perfunctory.
- Longer term, the outlook for UK retail is brighter than most over-sensationalistic media reports would have us believe. The high street has proved time and time again that it is more resilient than it is given credit for. But proactive intervention is still desperately needed to right the structural wrongs of the past.

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National Occupier Markets

- Flexibility remains a key aspiration, with break clauses or multiple break clauses a prerequisite for many retail occupiers and a key component of future adaptability against changing business and economic influences. This is now a structural reality and is unlikely to change.
- The occupier outlook for 2019 is very cautious, with the general perception that the market will continue to become more challenging and may worsen, hurdle rates being adjusted accordingly and often assume year-on-year percentage declines in physical store sales. Despite ongoing movement to online, most agree that physical and online sales platforms can be used to help drive each other.
- Total occupancy (rent, rates and service charge) cost parameters are being reviewed. In particular, there is huge pressure on service charge levels, caps are becoming more commonplace and marketing / other non-core service charge items are heavily scrutinised. Any rates savings or reductions that can be obtained are mutually beneficial to both tenants and landlords.
- Turnover rents are becoming more commonplace, including inclusive turnover rents at higher percentage levels, typically 10 – 15%, to include rates and service charge. This structure is the only basis that would be considered by retailers, particularly fashion operators, to take space in perceived high risk or lower category markets. It “de risks” trading position by effectively capping total cost base in line with a general 10 – 15% cost/turnover ratio.
- Retailers will continue to undertake strategic reviews of their entire portfolio and this will be used to drive acquisition and disposal strategy. Increasingly, in town / shopping centre and out-of-town / retail parks will become an “either / or” option (as opposed to dual representation), as many retailers look to reduce the number of stores in their portfolios as part of wider cost-cutting programmes.
- Re-gear and lease restructuring deals will account for a significant percentage of transactional activity in the retail sector, rather than new lettings. Rightsizing (be that upsizing or downsizing) will still be the key transactional driver.
- Larger city centres, key regional shopping centres and “coffee circuit / affluent market / commuter towns” generate higher levels of demand than secondary locations and towns with multiple shopping centres, which are generally over-shopped. There are clear affordability issues in some of these locations, particularly when it comes to seven figure rents and in very select locations where “tone” surpasses £400 - £450 ZA.
- Occupier demand is very selective and requirements very specific, with retailers unwilling to compromise on space, location or cost parameters. The current marketplace is offering opportunities for more dynamic retailers to reshape and adapt their stores, lowering costs and building in future flexibility across the portfolio.
- In terms of individual sub-sectors, Fashion, Sports / Leisure and Beauty / Cosmetics are all showing signs of positivity, but a number of value / discount retailers are also still active. Department Stores far less so – we expect more break up and redevelopment of department stores aligned to specific retail demand by location and size, with upper floors opening up to leisure, hotel and even residential / office use possibilities.
- More CVAs are expected in 2019, which is clearly not a good outcome for the sector as a whole. More than anything, it is creating a dual market with those that might benefit form discounted rents under CVA, compared to those retailers that run their business successfully and engineer portfolio restructuring and cost saving through negotiated means.
- 2019 will see a great deal of transactional activity on the part of retailers, but reflective of individual parameters and business aims. As in 2018, flexibility and cost will be the key drivers.

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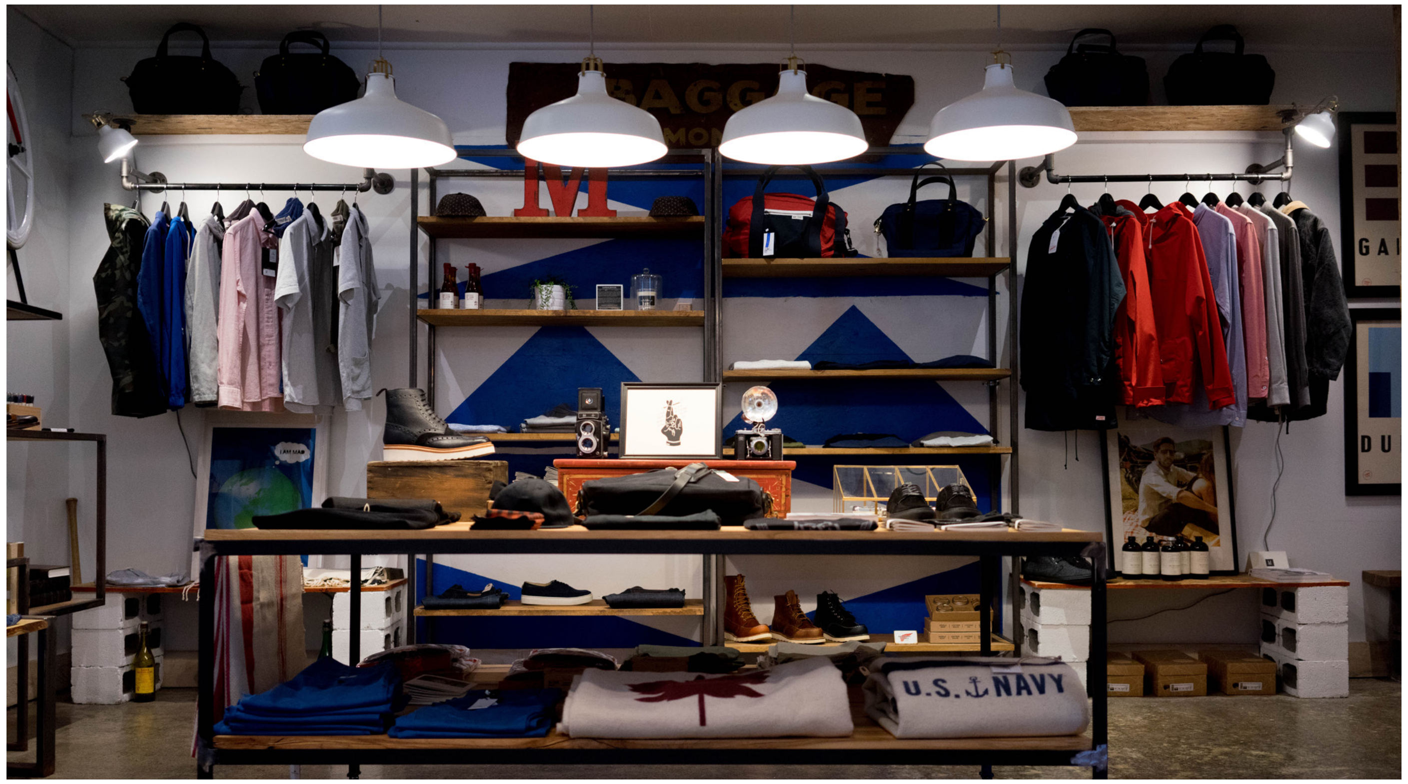

Central London Occupier Markets

- A burgeoning tourist market and the prospect of vastly improved transport infrastructure on the back of Crossrail continues to partially incubate operators in the capital against more general pressures facing retail markets.

- Paradoxically, continued macro-economic and political uncertainty continues to provide a boost to the Central London retail market in the shape of higher numbers of in-bound international visitors. Ongoing weakness of Sterling will ensure a continuing influx of tourists.

- Travel retail will continue to be a bright light, particularly on the back of the long-awaited opening of Crossrail. All the Crossrail station hubs have benefited from heavy investment and some have given rise to wider infrastructure improvement projects. The Paddington Square project (on which Knight Frank is instructed) will be delivered in late 2021, while Westminster Council has also launched their new plan for Oxford Street and the West End, which will be a key aspect of improving accessibility and the retail environment over the next few years.

- London will retain its status among the world's leading luxury brands as a global market with unprecedented appeal. "Experiential" will remain an industry buzzword, with brands seeking to sell experiences, not just products, at their stores and developing ever more engaging store environments for consumers, as well as launching new concepts.

- Rents in certain locations (particularly the main thoroughfares) have been kept in check by increases in business rates. However, propositions that are priced correctly will continue to appeal to retailers. Alternative / leisure uses will continue to pick up larger space that becomes available.

- A string of F&B CVAs in 2018 has taken some of the froth out of the casual dining sector generally and the A3 market will continue to consolidate. Again, the notion of "place-making" becomes all-important and landlords are increasingly taking a more pragmatic view to secure the correct brand and concept, rather than necessarily chasing income.

- Key buzzwords for 2019 – "accessibility", "consumer engagement", "health & wellness" and "experiential".

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Investment

High Street

- Prime high street (e.g. Guildford, Cambridge, Bath, Brighton) values in 2018 have been fairly resilient compared to the other retail sub-sectors. Whilst investor appetite has clearly thinned over the course of the year, prime stock has generally traded at sub 5%, with UK private investors the most active buyers in the market.

- Prime, well-let high street is currently trading at 4.50% - 5.00% NIY. We expect a slight softening in values over the course of 2019, driven by general negative investor sentiment. However, we expect this fall to be slow and marginal (ca. 5 - 10%). 20 year average yields for prime cathedral towns stand at 4.70% NIY, so securing prime high street at capitalisation rates of 5.25% - 5.50% could start to look attractive to a greater pool of buyers.

- We anticipate an even greater degree of polarisation in values between prime, well-let, rack rented stock and similar assets with shorter leases and over-inflated rents, as investors become increasingly nervous about downward pressure on the occupational / rental market.

- Recent convenience parade sales have attracted the strongest depth of interest. Online competition and multi-national CVAs have not had a real impact on the local neighbourhood occupational market - low rental bases and higher yields offer an attractive opportunity for some.

- Look out for good buying opportunities in top regional cities (e.g. Glasgow, Liverpool, Manchester). Stock selection is key but these top retail locations will remain popular with occupiers (places to shop, live, play and work) and with UK Funds expected to be inactive during the start of 2019, investor competition could be fairly limited for larger ticket assets.

- With the right stock selection, the high street sector could be the place investors turn to in search of relatively safe mid-income later in 2019.

Shopping Centres

- 2018 saw the lowest level of shopping centre trading volumes this century at just over £1bn. This is approximately 25% of the long-term average for the sector (i.e. down 75%).

- 2019 is likely to start in the same vein, with vendors declining the opportunity to sell at today's revised market pricing levels. However, as the year goes on we foresee a narrowing of the gap between buyers and sellers, which should improve liquidity and trading volumes.

- Sellers are likely to show a greater acceptance of reality, especially as valuations start to fully reflect the changes we have seen in the sector over the past 24 months. On the other side of the equation, we do, however, foresee a greater appetite for appropriately priced stock, with buyers becoming more comfortable that the sector's occupational market is reaching a new equilibrium.

- Polarisation is likely to continue, with prime, experience-orientated destinations and the convenience needs-based centres at the other end of the spectrum both faring well. However, those who seek to make generalisations across the sector will often find themselves caught out, with the prospects for assets being increasingly individual and down to a multitude of local factors, as well as evolving national trends.

- Caution is needed across the board but when a sector has been as negatively impacted as shopping centres have been in 2018, there are always good opportunities where the better product is unduly tarred by the wider sentiment in the market.

- Watch out for good buying opportunities in London and the South East, as well as high-yielding supermarket-anchored convenience schemes across the country.

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Out-of-town

- 2018 volumes for retail warehousing were down on 2017 by approximately 15 – 20%. Less dramatic than the fall in volumes for other retail sectors (e.g. shopping centres), but substantial nonetheless.

- There is currently almost no institutional demand for retail warehouse stock. Most institutions are overweight in retail generally and this includes retail warehouses. The key exception to this is London, where demand remains strong, as much for potential alternative use.

- The out-of-town market has not been immune to CVA activity amongst retailers (e.g. Toys 'R' Us, Maplin, Carpetright, Homebase). On the occupational side, there are still concerns over further CVA activity and general lack of rental growth prospects.

- We would anticipate outwards valuation realignment in 2019, which would play particularly to Private Equity. There is significant PE money waiting in the wings, having identified retail warehouses as an opportunity, as the number of vendors increases and yields soften.

- The out-of-town market remains very much cognate to online retailing, offering easy access, free parking and flexible accommodation. There is still a largely untapped opportunity for retail warehouses to assume a broader role in the retail supply chain process.

- The relatively low site coverage of retail warehousing offers alternative use potential for all or part of a scheme. Viable alternative uses are very location specific, but include residential, hotels and possibly logistics. Some of the vacated Homebase units are already undergoing transformation to other uses, particularly in London.

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Leisure/A3

- The leisure market has not been immune to the controversial CVA process, including Prezzo, Jamie's Italian, Carluccio's, GBK and Byron Burger. The common theme – rapid expansion, including a number of marginal locations, encouraged by their PE owners. The worst is likely to be over in the casual dining market, but beware over-leveraged operators.

- On the plus side, there are still a number of well-capitalised operators such as Pizza Hut, TRG and Nandos who are not only riding the storm, but investing in their brand and real estate portfolio.

- There is an even more positive story in the "experiential" leisure sector, including cinema and bowling. We expect almost record results from these sectors in terms of visitor numbers, and crucially like-for-like revenue growth and EBITDA. The 'Big 3' cinema players have all been investing in their circuits, with often staggering effects, and the bowling operators have to some extent "piggy-backed" on the continuing appeal of the better destination leisure schemes.

- The headwinds in the occupational market have already impacted on rental growth and will continue to do so. There is still a high proportion of index-linked leases, and relatively long leases (even for new lettings), but open market growth in the A3 sector will be tough to achieve in the short term.

- Partly because of this, and partly a knock-on effect of any consumer-facing occupational market, the sector is suffering from negative investment sentiment, especially among the UK institutions. We expect to see a softening of prime and particularly secondary yields in the first half of next year.

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Food Stores

- Sainsbury's takeover of Asda will grind through 2019, with the CMA assessing a whole raft of issues including sales of groceries, fuel, electricals and clothing, as well as online, pricing, range, quality and supplier relationships. We anticipate an approval subject to store disposals - perhaps 50 – 100. Who will buy these stores and, more particularly, at what value could determine the final outcome.

- Trading levels of the 'Big 4' have stabilised to the point they are no longer newsworthy. Investor sentiment has tracked the story and the sector is again in demand. But stores are assessed on an individual basis - trading performance is fully considered as this will impact future strategy. Long, index-linked income will prove increasingly popular to buyers. Nervousness remains where a store is considered to be over-sized, over-rented, performing poorly, or with less than 10 years unexpired.

- The number of available discounter investments, especially Lidl stores, will increase through 2019 and investor sentiment will remain strong. However, there will be increasing perceptions and concerns over future over-renting and the impact this could have on profitability.

- The discounters' expansion will continue, but they will have increasing difficulty in filling their pipeline for new stores. The real lag will be 18-24 months away. There will be more non-standard format acquisitions, especially available retail warehouse space, which does not fit the traditional discount foodstore trade model. Is the race for space going to shore up problems?

- Omni-channel will be increasingly relevant, despite the cost burden falling to the retailers. Large stores will continue to provide the online platform for the 'Big 4', rather than so-called 'dark stores'.

- 'Last mile' property expansion will continue but the costs of securing space will grow to the point where, in some cases, logistics space is more expensive than retail space – an unheralded conundrum that cannot last.

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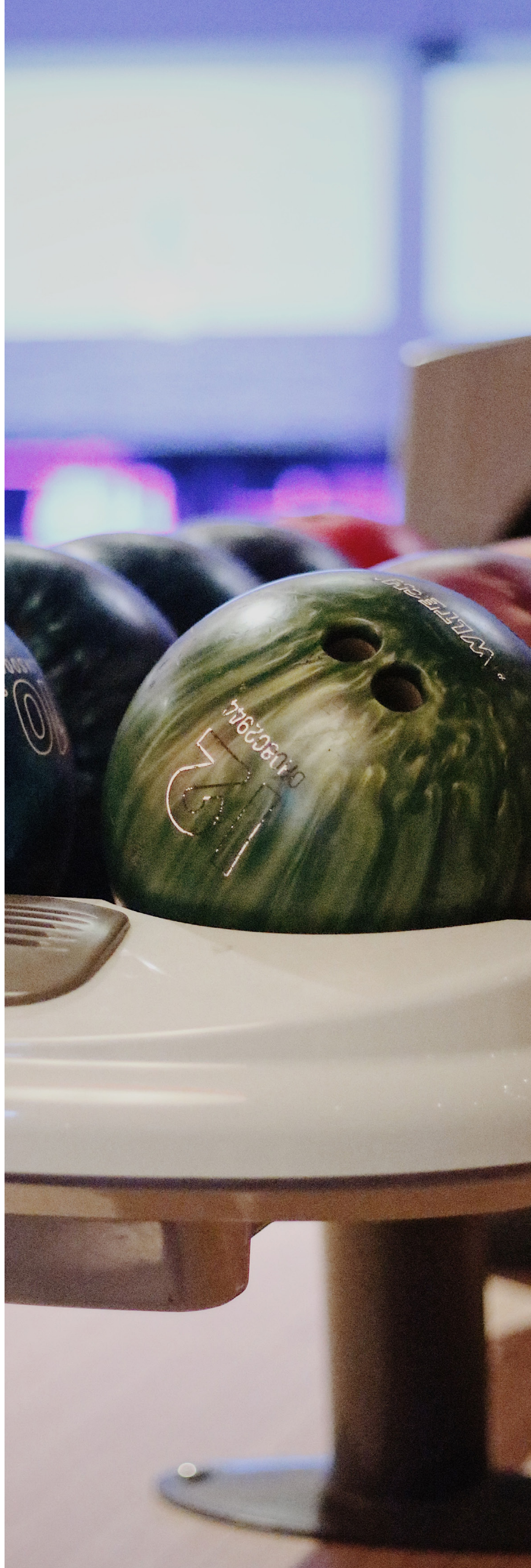
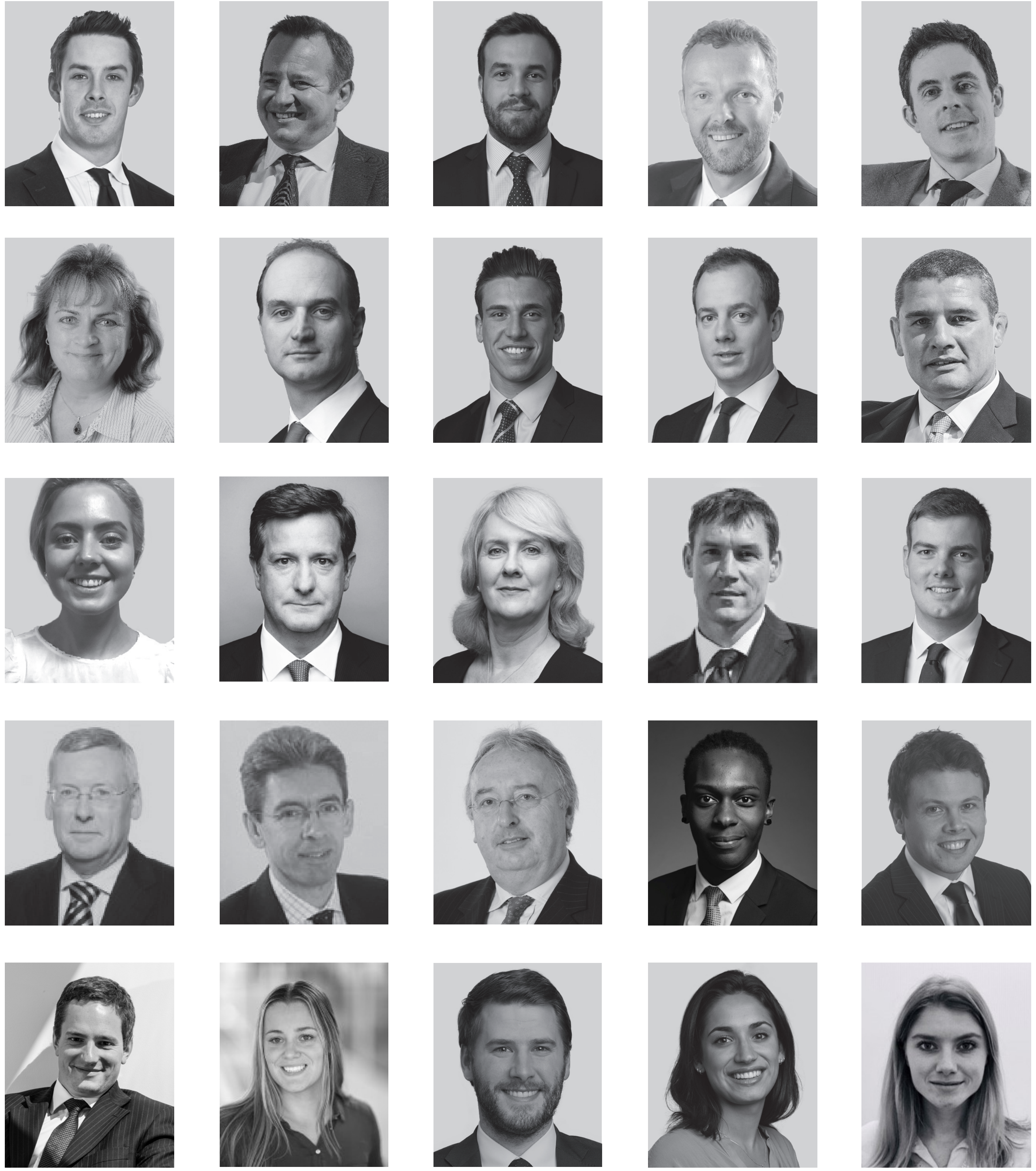
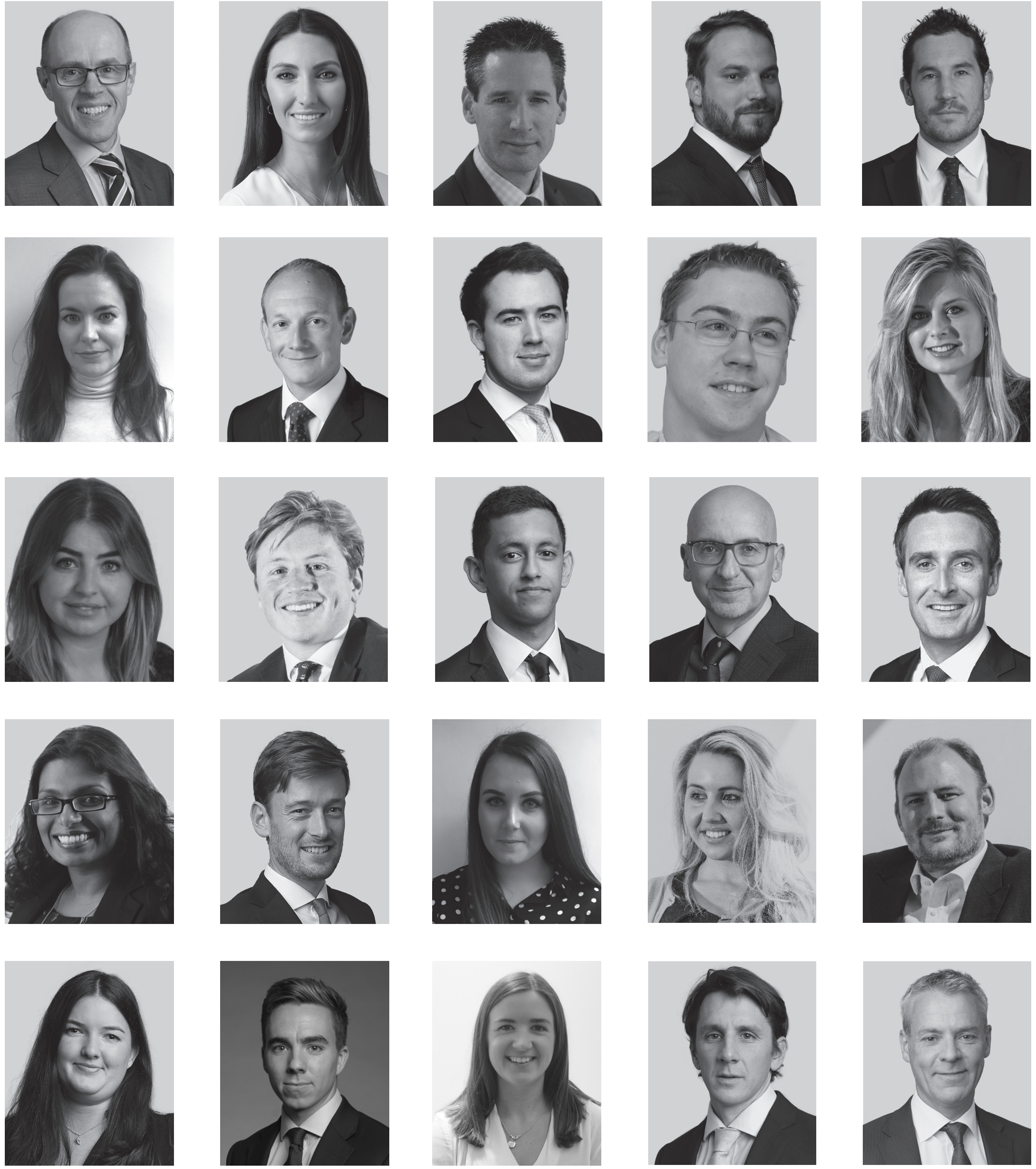


Our retail people





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