2020 Predictions for
Occupier and Investment Markets

Retail Property Market Outlook

2020

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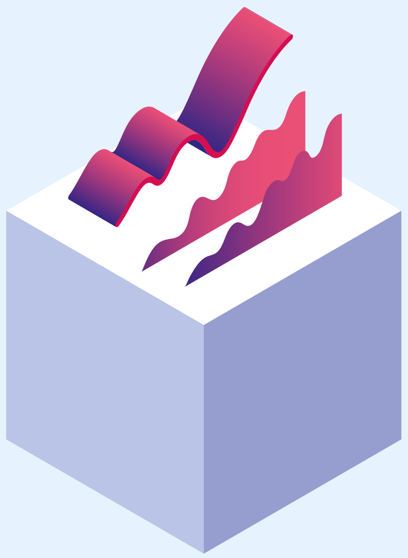
MACRO-ECONOMICS



MACRO-ECONOMICS

UK economy forecast to grow by 1.0% with **RPI inflation** easing to 2.5% on the back of a recovery in Sterling. **Short-term interest rates** fairly stable at 0.85%.

Retail sector buoyed by strong employment markets – **employment growth** of 0.4%, an **unemployment rate** of 3.8% and **average earnings growth** of 2.9%.

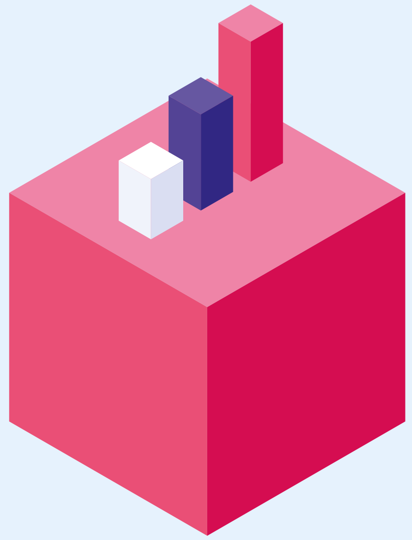
Relatively modest growth in **consumer spending** of 1.2%, again significantly outperformed by **retail sales value** growth of 3.5%.

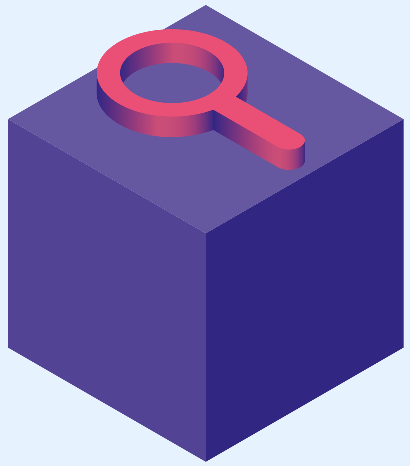
2020 PROPERTY PROSPECTS

All Retail forecast to achieve **total return** of just 1.1%, depressed by further depreciation of **capital values** of -4.0%, mainly caused by valuation lag.

Forecast **rental decline of** -2.0% across the retail sector; **Central London** achieving positive rental growth of +0.5%, **standard shops** elsewhere in the country declining by -4.0%, **retail warehouses** by -1.8%, **shopping centres** by -2.3% and **supermarkets** -0.9%.

Softening of **yields** across the retail market. **Prime shops** moving out to 6.00%, **regional shopping centres** to 6.50%, **open A1 OOT fashion parks** to 7.00%, **solus bulky retail warehouse**s to 7.50% and f**oodstores (with RPI increases)** more stable at 4.25%.





LONGER TERM PROSPECTS

No return to **underlying capital growth** until 2022, although this is likely to come sooner for some assets (especially out-of-town) through yield correction.

Annual average total returns between 2020 and 2024 are forecast to be 4.9%, despite a 5 year **annual average capital decline** of -0.3% and 5 year **annual average rental decline** of -0.1%.

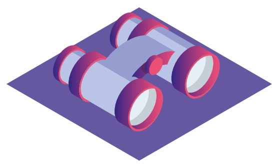
Retail remains a solid income play, with **annual average income returns** between 2020 and 2024 of 5.3%.

Sources: Knight Frank, Oxford Economics, Experian, Real Estate Forecasting

OVERVIEW

Stephen Springham
Partner, Head of Retail Research

The retail landscape in 2020 (and beyond) will be defined by 6 "Ps" – Perspective, Purpose, People, Place, Profitability and Pricing.



PERSPECTIVE

The UK retail market is not going to a stage a Lazarus-style recovery, nor is it a case of waiting for the storm to pass. At the same time, the high street most definitely has a long-term, sustainable future and it is short-sighted to write off the whole retail sector as many are doing.

PURPOSE

Forget the rather flowery buzzword "experiential", the keys to retail locations' sustainability are relevance and a sense of purpose. Without these two things, retail will struggle. In many cases, this purpose must be redefined and will invariably mean different things in different locations.

PEOPLE

The lifeblood of any successful retail location. Where there are bodies, there is spend potential and related retail/F&B need. Transport hubs and office-based locations in particular provide a substantial consumer demand base upon which to build a prospering retail proposition.

PLACE

If a town or location doesn't benefit from a captive audience or high passing trade, it must work that much harder to become a retail destination. It must create a sense of place that makes shoppers want to visit, through a combination of aesthetics, public realm and an imaginative mix of retail/F&B/A3.

PROFITABILITY

Retailers have undertaken their own "bonfire of the vanities" and are much more selective in their location planning requirements. There is a far greater pre-occupation in understanding the profitability in each and every site, coupled with that store's role in a wider multi-channel offensive.

PRICING

Capital values have rebased dramatically across all retail property market segments. Such drastic price revision will make retail increasingly good value versus other property investment classes. But effective stock selection (and understanding the other "P's") is a pre-requisite now more than ever.

2020 SPECIFICS

ON CVAs

What we'd like to see

Fewer CVAs come to pass, averted by proactive and adult dialogue between landlords and tenants. Retailers ultimately realising that CVAs don't provide a "quick fix" and are very damaging to their brands.

What we're likely to see

Further CVAs, including a number of second-time offenders. As landlord challenge to the CVA process mounts, a move back towards pre-pack administrations, only slightly the lesser of evils.

ON BUSINESS RATES

What we'd like to see

A full, root and branch review of the antiquated business rate process and creation of a level playing field with the online pure-players. Any shortfall in potential business rate revenue recouped through tech companies paying an equitable rate of corporation tax commensurate with their turnover.

What we're likely to see

Government continues to pay the issue lip-service at best and not fully understand the realities of modern day retailing. Any additional relief likely to focus on units with low rateable values, rather than those at the other end of the spectrum, where the issue and pain is actually far more acute.

ON SUSTAINABILITY

What we'd like to see

ESG to rise up the agenda. Growing social awareness of the unsustainability of many aspects of online shopping, particularly the carbon footprint realities of 'last mile' logistics. Retailers and consumers proactively addressing the growing issue of product returns.

What we're likely to see

ESG to rise up the agenda, but with an overriding focus on packaging, waste and product sourcing, rather than online logistical issues.

OCCUPIER MARKETS

NATIONAL PICTURE

Patrick Keenan
Partner, Head of Retail Agency

- Occupier sentiment will remain very cautious, particularly during the first half of 2020. Affordability, sustainability and flexibility remain key themes for retailers. Profitability remains the key performance metric.
- Increasingly limited market for units where fixed rents are in excess of £500,000 per annum. With a few exceptions, flagship operators are seeking to mitigate risk by looking at alternate rent structure, particularly turnover-based rents and regularity of break clauses, commonly now after 5 and 7 years, but 3 and 4 year breaks also becoming commonplace.
- Occupier outlook generally working to a six month horizon, which limits development opportunities where pre-lettings are required. Edinburgh St James (due to open in 2020) one of very few large new retail developments.
- Increasingly commercial view taken on lease renewal strategy and break activation. Traditional valuation / evidence-based approach to these type of negotiations will become increasingly irrelevant in 2020 and ultimate outcomes and rental levels will be reflective of specific store profitability, alternative demand, and occupier desire to retain a particular store.
- Lifestyle, sports fashion, cosmetics, health and beauty sectors all likely to hold up well in trading terms and remain solid. Food, value retail, and jewellery also expected to remain resilient. No sign of respite or rejuvenation for department stores - will Frasers make headway in 2020?
- Leisure and fitness operators continue to be very active both nationally (mainstream / budget / cinema), as well as in London (boutique, studio-based and mainstream).

Leisure and fitness brands will benefit from additional opportunities from breakup or reconfiguration of traditional A1 retail buildings and surplus department stores.

- International retail brands focusing on their domestic markets, with UK brands similarly curtailing plans for international expansion. Online platforms allow for a much less risky way for brands to test and build initial cross-border options.
- Increased pressure on some occupiers to rationalise their portfolios, with further store closures and vacancies and heavy leveraging against lease expiry and break events. More CVAs are expected, but fewer than in 2019. Some midway through CVA (e.g. Debenhams, New Look, and Arcadia) remain at risk of failure.

- Some traditionally blue chip regional and prime shopping centres and top 30 retail locations under pressure particularly in shopping centres where rental levels have been pegged at unachievable “tone“ and hidden behind CVA rents rather than market reality. Affluent market towns with strong demographics remain popular particularly those where there is a "coffee circuit” / recreational shopping attitude.
- Occupier acquisition strategy and value perception have no correlation with traditional valuation methods. 2020 will see reinforcement of the deal-by-deal store-by-store approach, with greater variation on deal / rent structure. Smarter investors / owners may then reinvent their business model to be more closely aligned with occupational drivers.
- By the end of 2020 some element of stabilisation can be expected and occupier caution may abate. There may be a platform to move forward, with more deals starting to happen. The ‘in store vs online’ debate and symbiosis between the two will be another year closer to understanding how to drive efficiencies from each channel.
- 2020 will be a year of two halves, but retail will continue to reinvent itself and occupiers will still take stores. It is not Armageddon. Good retailers will remain active, recognise the benefits of an online and in store offer, and the leisure sector will continue to push forward. Structural change has taken place and the new paradigm will become clearer offering continued opportunity to occupiers and also disruptor owners / investors willing to consider more creative and market reflective strategies.

CENTRAL LONDON

Richard Griston
Partner, Retail Agency

- Retailers will continue to err on the side of caution when assessing new opportunities, with affordability the key criteria. However, we would like to think that with the right General Election result and greater certainty over Brexit, we might see renewed confidence in the London occupational market as part of a wider economic bounce. This will dictate, to a large degree, in which direction we head next year.
- Regardless of the political and macro-economic situation, occupier demand will remain strong for well positioned and correctly priced assets. However, anything secondary or over-rented will stick.
- On the flip side, London will still retain its international appeal as a location for global brands to have and need representation. The established luxury streets will maintain their status and, while retail rents nationally remain under considerable downward pressure, we may even see records rents being achieved in these Central London locations.
- Guaranteed footfall, especially around travel hubs, will continue to drive strong occupational demand.
- Brand power will reign supreme - those operators who position their brand correctly, offering unique experiences being top of the list for major landlords. Place making will continue to be a key theme throughout the year, with landlords looking for a point of difference in order to drive people to their sites/estates.
- On the leisure side, there will be continued growth and emergence of new ‘competitive socialising’ concepts, as consumers increasingly seek out varied experiences and not just a meal / drink.
- Health / wellness as a sector will also continue to see strong growth, with wellness hubs a major focus for landlords. However, we would question the sustainability of some of the rents being paid in this sector (especially D2).

INVESTMENT

HIGH STREET

Alastair Bird
Partner, High Street Investment

- Whilst prime high street values have fallen in 2019, these declines have been relatively modest compared to the other retail sub-sectors. Prime 'cathedral towns' are currently trading at 5.25%-5.50% NIY and we anticipate values will continue to soften to close to 6.00% NIY by the end of 2020, driven by continued negative sentiment towards the retail sector overall and ERV declines. Prime yields of ca. 6% should then start to look fairly attractive to some investors when compared to 20 year average yields, which stand at 4.70% NIY.
- Investor sentiment towards certain locations is evolving as a number of affluent 'cathedral towns' that were once in vogue such as York, Chester and Harrogate have fallen from grace due to strong competing out-of-town centres, lower footfall and unaffordable rents. Conversely, we are seeing stronger demand than ever for Greater London locations (zones 2-5), especially those with strong or improving transport links such as Ealing, Wimbledon, Uxbridge, Romford and Twickenham. These locations will remain popular with retailers as they are vibrant, accessible, busy centres providing young and growing populations.
- The majority of retailers will continue to take shorter lease lengths (3-5 years term certain) and rents will largely remain under downward pressure. As a result, any lease agreed on a 10+ year term at a materially reduced / re-based rent will attract strong investor interest. We foresee greater polarisation between short vs long term income and re-based vs over-rented income.
- Look out for good buying opportunities in top regional cities and towns with strong office markets (e.g. Manchester, Birmingham, Brighton, Cambridge). Strong office communities provide good bedfellows for retailers in town centres as office workers enhance day time presence, create leisure demand and add to the expenditure pool. Brighton is an excellent example of a city remaining popular with both retailers and investors due to it benefitting from a dynamic workforce, tight office supply, two universities, significant tourist expenditure and a destination retail centre offering an attractive mix of national relevant brands, independent boutiques and strong leisure.
- We have seen a spike over the last six months in high street acquisitions by Councils and this will continue into next year as they take advantage of low borrowing rates from the PWLB. The principal other buyers are largely property companies and private investors who have a strong and established track record for buying retail. They are buying prime retail at an attractive discount to long term values. UK Funds remain inactive on the buy side. However, we do foresee them replenishing their portfolios in the medium term once they have exited some of their problematic shopping centres and retail warehouse parks.
- Stock selection as ever is key but 2020-2021 could provide an opportune period for well financed investors to buy institutional stock at a historic discount in preparation for the Funds returning to the market thereafter.

SHOPPING CENTRES

Charlie Barke
Partner, Shopping Centre Investment

- Shopping centres have witnessed falling values for over four years now. Alongside this, trading volumes seem to get lower and lower every year. Values have fallen by 50% (or more) in many instances. So, are there now pockets of value emerging out of the carnage in this sector?
- When it comes to degree of change, Local / Neighbourhood schemes (see Revo updated definitions) have seen quicker and more radical value movement. Arguably, these were more exposed to occupational distress earlier. Or perhaps it was just that investment evidence came through more transparently in this market.
- There is a sense, however, that if you can secure good schemes in this category with a "bottomed out" cashflow showing ca. 8% running yield then they reflect fair value. With the "tenants at risk" list still being quite lengthy and with over-renting in some areas quite acute, a bottomed out 8% running yield might be a net initial yield of 10%, 12%, or perhaps even higher. However, if you can get comfortable that such product will continue to produce at least an 8% income return over the next few years then, even without growth, this is a decent premium to other sectors.
- In the same vein, in our (Super) Regional centres (old school Prime) then a sustainable 6% starts to look appealing against the alternatives. Over-renting in this area can be less acute but rents are still moving and caution is needed. This certainly means 6.5% NIY and it could be 7%+ in some instances.
- Re-positioning / re-purposing plays remain the holy grail – everyone wants these, especially in the South East of the country. The reality is that these are not easy buy-side opportunities to unlock. Few are "no-brainers" and most require the investor to take a positive view on house prices or favourable planning decisions. These will remain keenly sought after, but investors could well miss the simpler and more lucrative deal that makes money through income return and yield shift if they focus solely on trying to score the perfect goal that is the ideal "mixed use redevelopment".
- A confident prediction for 2020 is that we will see more stock. In 2019 we have seen some reluctance from sellers to expose their assets into a falling market. However, as we begin to feel a sense of stabilisation and a slight improvement in liquidity we could then see many more centres openly offered. The REITs have prime stock to sell, as do the institutions. Private equity funds (and their lenders) also have much they would like to offload if only they felt they had a chance of having a sensible conversation with a buyer or two.
- The buyers in 2020 will consist of a number of new players. Knight Frank have helped the likes of Cale Street and Areli buy schemes in 2019. We expect that we will continue to see new names enter the market next year, attracted by the counter-cyclical opportunity and unusual market dynamics the recent distress has left.

OUT-OF-TOWN

Dominic Walton
Partner, OOT Investment

- In line with high street and shopping centres, investment volumes in the retail warehouse space have fallen significantly, with a ca. 40% reduction on 2018, which itself saw massive reduction from previous years.
- Retail warehousing has suffered its fair share of tenant failures / CVA issues – we expect there to be further failures in the first half of 2020, along with effects following other tenants pursuing portfolio rationalisation.
- The rising level of occupational costs over recent years has created significant over-rent across most schemes, some more than others (especially Shopping Parks comprising comparison good / fashion retailers). Similarly, historic rental levels have created unsustainable rates payable. Combined with weak tenant demand, the medium term picture is of nil rental growth.
- We expect continuing institutional selling of retail warehousing as fund managers seek to rebalance portfolios and redirect capital to 'growth' sectors. Supply will continue to outstrip demand. While there is significant capital targeting the sector due to perceived 'value', most of the capital is private equity or similar seeking relatively high returns. Combined with a restricting debt availability, this directs a softening yield profile.
- Throughout 2020 the market characteristics may well result in pricing aspirations of buyer and seller merging, especially against a backdrop of a low return environment, both in other property sectors and alternative investment media. Evidence today and current trajectory suggests attractive equivalent yields in the sector.
- Throughout 2020 we see tenant activity, albeit reduced, along with ongoing asset management resulting in a continuing rebasing of rental values. We anticipate more transparent / predictable rental levels thus being welcomed by the investment market.
- In and around London we are seeing continued interest in the sector from investors attracted to potential alternative use opportunities, be they residential or industrial. We are seeing such investors adopting a longer term investment approach in this space. Further away from London and the South East, existing use values will need to move out massively before alternative use values compete.
- With tenants seeking ever more flexible occupational terms, we are witnessing ever shortening WAULTS and therefore future investors in the space will need confidence of income – and perhaps an evolution of the valuation approach.

FOOD STORES

Richard Petyt
Partner, Foodstore Agency and Development

- The ‘Big 4’ are in the vanguard of the changing and challenging UK retail sector. They are obsessed with the customer, pricing is forensically managed, they innovate with product, they make the shopping mission convenient, they invest, they are promoting connected and complementary services. Competition is intense, performance is cyclical, they are not perfect but there is much to admire – a blueprint for the wider retail market?

- The discounters’ growth continues apace. Investor sentiment to the format has strengthened with some prime location deals reported at sub 4%. There is a strong focus on gaining representation in London and the South East. This represents an expensive expansion requiring non-standard store formats.
This is potentially a risk in the medium term, given the higher operational costs inevitably faced, weighed against a very tight low operating cost model. Committing to high rents which increase with indexation will surely lead to over-rented stores. Perhaps a “portfolio approach” to profit generation is driving this.

- Active supermarket portfolio management will continue with some, but not many, new store openings and some underperforming store closures. The threat of mass closures has passed but so too the worry about negative PR impact from selected closures. Convenience growth will continue to prioritise stronger demographic areas - higher product pricing against the discounters in the price sensitive locations can make the multiple chains model unviable, helping fuel discounter sales growth across the regions.

- Investor sentiment for supermarkets remains strong with prime, long income, index-linked assets selling at sub 4%. Conversely, over-rented, over-sized stores with OMV reviews in marginal locations have sold at ca. 7%. The devil is in the detail and purchasers are quite rightly becoming increasingly obsessed with the occupational trading story – there are examples of expensive mistakes having been made with red-faced investors left with vacant stores. Being close to the retailers and having the ability to discuss individual stores directly with them is a vital part of any investment analysis.

- Expect more tie ups and diversification. Wholesaling is now a key part of the Tesco and Morrisons business model and a growing part for Iceland. Walmart are likely to look for investment in Asda through an IPO, although lack of brand differentiation may limit investor appetite. Sainsbury’s will continue to focus on integrating Argos and invest in its existing estate.

- M&S will open new foodstores and gradually roll-out its highly promising new store format. Amazon may possibly expand Whole Foods UK trading presence, as they develop physical trading formats to complement their traditional business. Much-hyped Amazon Go may finally see the light of day in 2020, but the level of likely media coverage will be disproportionate to its actual impact on the market.

OUR RETAIL PEOPLE

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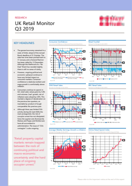

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