2023 Predictions for Consumer, Occupier and Investment Markets

Knight Frank

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Riders on the Storm

Retail Property Market Outlook 2023

2023 – RECESSION VS RESOLVE

STEPHEN SPRINGHAM
PARTNER – HEAD OF RETAIL & LEISURE RESEARCH

To quote The Doors for our 2023 retail predictions: "Riders on the Storm."

A tempest is definitely brewing and will fully hit landfall in 2023. So often viewed a lame duck in times of trial and tribulation, retail may surprise on the upside this time around, riding the tidal waves more resolutely than other aspects of the economy.

Having been a disruptor and catalyst for change for many years, the online retail market will be subject to its own structural change in 2023 and beyond and more questions will be asked than ever before.

My Radiohead-inspired impassioned plea of "No Alarms and No Surprises. Please" a year ago evidently fell on deaf ears. Domestic and world leaders either didn't read our predictions for 2022, or just blatantly ignored them. To our chagrin, we didn't foresee the war in Ukraine, nor that inflation would hit double-digits. These two oversights aside, we would firmly stand by everything we predicted a year ago.

Uncatchy as it may have been, we dubbed 2022 "The Year of the "Re-"" and predicted that the retail landscape would be defined by:

- **Rebuilding**
- **Resolving**
- **Reengineering**
- **Reevaluating**
- **Rebasing**
- **Repricing**
- **Redefining**
- **Repurposing**
- **Rebalancing**
- **Renaissance**

Despite all geo-political and macro-economic upheaval (both domestically and globally), all these factors have indeed played out across the retail spectrum over the past year. Indeed, most are ongoing and have not fully run their course.

2023 will be defined by another, sadly all-encompassing "re" – recession. But the counterpoint for the retail sector will be another "re" – resolve. This resolve the product of progress on the 10 other "re-s" previously identified.

2023 will undoubtedly be tough, no recession is easy for the retail sector. But consumer demand is unlikely to collapse completely. As previous recessions have shown, shopping may actually prove a haven for the consumer in the eye of the hurricane. Having been through COVID and come out the other side, retail occupiers are battle-hardened in a way they certainly weren't coming into previous crises. Widespread fall-out is far from a foregone conclusion. Equally, the re-basing and re-pricing of retail property stock leaves it far less exposed to inevitable upward movement in interest rates.

Watch this space on e-commerce in 2023. Having been a disruptor and catalyst for change for many years, the online retail market will be subject to its own structural change in 2023 and beyond and more questions will be asked than ever before.

RETAIL PROPERTY OUTLOOK 2023

2023 will undoubtedly be tough, no recession is easy for the retail sector. But consumer demand is unlikely to collapse completely. As previous recessions have shown, shopping may actually prove a haven for the consumer in the eye of the hurricane, people preferring to spend than merely feel sorry for themselves.

These are **"Strange Days"**. Recessions always are and no two are the same.

"People are Strange". Consumers are not robots and rarely behave as economists expect.

Not **"The End"** for retail by any means. Although there will inevitably be some casualties.

But in 2023, it will be one of the key **"Riders on the Storm"** and its mettle will once again be tested.

Ultimately, retail will **"Break on Through (to the Other Side)"**, by virtue of its new-found resilience.

But **"Waiting for the Sun"** is not an option just yet...

2023 SPECIFICS

STEPHEN SPRINGHAM - PARTNER, HEAD OF RETAIL & LEISURE RESEARCH
EMMA BARNSTABLE - SENIOR RESEARCH ANALYST

ON HOW THE RECESSION WILL PLAY OUT

What we'd like to see

Recession proves much shorter and shallower than anticipated. High inflation to recede swiftly from Q1 2023. Consumer demand continuing to hold up. Retail sales values remain comfortably in positive territory (>3%) and the current decline in retail sales volumes reverses from Q2 2023. Retail property investment markets stabilise after quick, decisive correction and volumes return. Perspective rather than hysterical over-reaction.

What we're likely to see

A more protracted period of recession, given that tighter fiscal policy is backloaded. Bank Rate to peak at around 4% in early 2023. Inflation to peak in Q1 2023 (possibly even by Q4 2022), but the descent will be slow (CPI not hitting <2% until 2024). Retail sales values stay in positive territory, but volumes do not recover until Q4 2023. Hysterical over-reaction rather than perspective.

ON CVAS / FALL-OUT

What we'd like to see

No occupier distress whatsoever. Retailers so streamlined and battle-hardened post-COVID that they are able to ride out the storms that will inevitably brew in 2023 virtually unscathed. Those that do experience distress seek alternative re-financing means rather than launch a CVA and proactively engage with landlords as part of any restructuring process. Occupier consolidation / M&A rather than outright fall-out.

What we're likely to see

Less occupier distress and fall-out than many are anticipating – certainly less than in previous recessions, when the retail market was in a far more bloated, ill-prepared state. A growing number of online pure-player casualties as tightening debt and finance markets raise question marks over the viability of perennially loss-making businesses. A number of online pure-players being acquired by multi-channel operators.

ON BUSINESS RATES

What we'd like to see

The Chancellor's surprise package from the Autumn Budget proving a launchpad to a full review of the Business Rate system, rather than a temporary, short-term fix. Following through on the pledge to abolish downwards transitional relief caps and potentially reducing (rather than just freezing) the multiplier over the longer term, with a view to levelling the playing field and neutralising the burden on store-based operators.

What we're likely to see

Something of 'pause for breath' as the new measures are implemented and the effects wash through. Inevitable protestations and lobbying from the industrial sector as the full effects of rental growth percolate through to taxation. The freeze on the multiplier unlikely to be extended beyond a year and then likely to increase rather than reduce. The possibility of an online sales tax explored further - but parked for now.

ON ESG

What we'd like to see

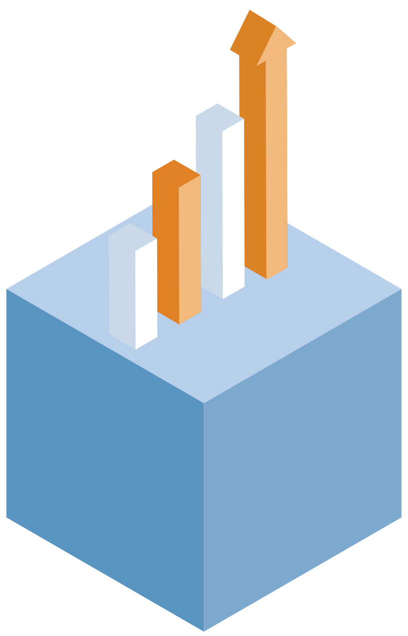
- **Accelerated action on at-risk assets:** with just seven years left to 2030 (when a minimum EPC Grade B is required) time is running out. Assuming a 5-year average lease, assets most at risk are just over one letting cycle away from being stranded. As much as 90% of retail property will need to be improved by 2030.
- **Meaningful and measurable strategies:** realistic roadmaps that address the impact of business models, with due attention given to all three facets (E, S, & G). A concerted move beyond corporate jargon and ESG clichés regurgitated in most CSR / ESG annual reports. More innovative responses to the challenges.
- **Retailers' claims challenged and substantiated:** universal clampdown on deceptive "green-washing" tactics which mislead consumers (to a degree, this is already underway, with the CMA investigating the likes of ASOS, Boohoo and George).

What we're likely to see

- **Some clarity over what constitutes a 'green' investment:** transparency over sustainable investment fund criteria with the conclusion of the FCA's consultation on Sustainable Disclosure Requirements & investment labels due in June 2023 (but note, only with a focus on specific green investment products, rather than relative 'greenness' of more general investment).
- **Test of priorities:** some operators temporarily renege on ESG promises due to cost / supply chain pressures (e.g. Iceland using palm-oil products following a reduction in sunflower oil supply).
- **More head-scratching / exploration:** understanding what ESG really means for each stakeholder in the sector. Understanding and owning what they are responsible for (e.g. Scope 1, 2 and 3 emissions) and formulating a response. Increased investment / recruitment of ESG-specialists / consultants to formulate supposedly slick (in reality, corporate cookie cutter) strategies.
- **Increased action on the 'E':** likely to be promoted as an ESG-led initiative, but realistically sparked by spiralling energy costs.
- **Attempts to quantify / leverage the 'S':** highlighting social benefits of their assets to local communities during recessionary periods.
- **More "green-washing" / ESG employed as a marketing tool:** more promotion of net zero / science-based targets. More reporting to the TCFD. Increased uptake of green certifications by retailers (e.g. B Corp status).

MACRO-ECONOMICS

EMMA BARNSTABLE – SENIOR RESEARCH ANALYST



MACRO-ECONOMICS

UK economy forecast to contract by -0.9% in 2023, with **RPI inflation** easing slightly to 10.3% on an annualised basis (vs 11.5% in FY 2022). **Short-term interest rates** rising to 4.4% by 2023 year-end.

Macro- and retail economies maintained by tight employment markets – an increase in **working population** of +0.2%, but **labour supply** declining by -0.3% resulting in a moderate rise in the **unemployment rate** to 4.4%. **Average earnings growth** of +4.8% will lag inflation.

High inflation will result in a polarised consumer outlook. **Nominal consumer spending** is forecast to grow +9.3% overall, but dip -0.7% in real terms. **Retail sales value** (exc fuel) growth of +4.0%, above long term (30 year) averages of +3.7% and 10 year averages of +3.4%, but **retail sales volumes** down -4.0%.

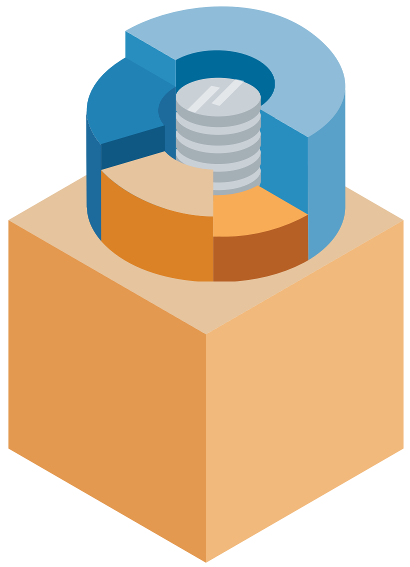
RETAIL PROPERTY OUTLOOK 2023

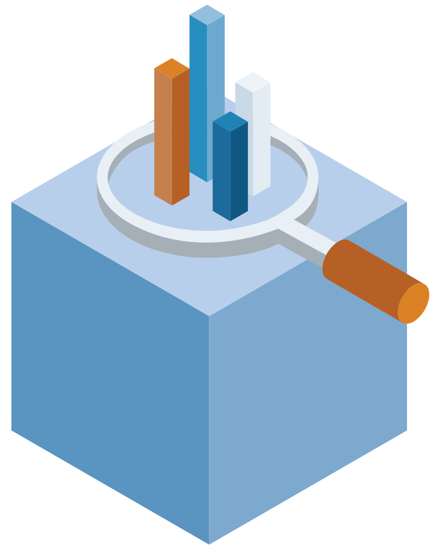
2023 PROPERTY PROSPECTS

All Retail forecast to achieve **total return** of 3.1%, despite negative **capital growth** of -1.9%. Very variable performance between retail sub-sectors, with **retail warehouses** (+0.7%) and **supermarkets** (+0.2%) achieving capital gains, but **standard shops** (-2.7%) and **shopping centres** (-5.6%) seeing declines.

Forecast **underlying rental decline** of -0.6% across the retail sector; but **retail warehouses** (+0.4%) maintaining positive growth after several years of re-basing. **Supermarkets** (-0.1%) and **standard shops** (-1.6%) to see a further underlying rental decline. Rents in **Central London** down -0.5%, but a return to growth anticipated by 2024.

Wholesale softening of **yields** across the retail market in reaction to interest rate rises. Yield movement of 100bps at **retail warehouses** to 6.00% and 50bps at both **prime shops** to 6.50% and **regional shopping centres** to 8.50%. New interest rate environment to impact **foodstores (with RPI increases)**, softening by 150bps to 5.00%.





LONGER TERM PROSPECTS

Return to **underlying rent growth** by 2024, with all retail sub-sectors in positive growth territory by 2025. Underlying retail rents forecast to grow an average annual rate of +0.4% between 2023 and 2026.

Annual average total returns between 2023 and 2026 are forecast to be 5.4%, with 4 year **annual average capital increases** of +0.2%. The majority of retail property sub-sectors to deliver positive **total returns** in 2023, with the exception of shopping centres (0.0%).

Retail remains a very solid income play, with **annual average income returns** between 2023 and 2026 of 5.2%, higher than **offices** (4.2%) and **industrial** (3.7%).

SOURCES: KNIGHT FRANK, OXFORD ECONOMICS, EXPERIAN, REAL ESTATE FORECASTING

RETAIL PROPERTY OUTLOOK 2023

RETAIL OCCUPIER MARKETS: A FRESH WAVE OF FALL-OUT?

With the first whiff of economic distress, attention naturally defaults to retail occupier markets and the assumption that many operators won't go the distance. Why we think fall-out may be less severe this time around and what pinchpoints there are may surprise many.

STEPHEN SPRINGHAM – PARTNER, HEAD OF RETAIL RESEARCH

Overview

The storm clouds are gathering. The cost of living crisis will inevitably give way to full-blown recession and 2023 will again prove to be a survival of the fittest. Many, particularly in the property investment community, are already predicting another retail occupier bloodbath, with an inevitable spate of CVAs, collapses and administrations. After all, retail does have considerable track record in this area and during previous recessionary times, many household names fell by the wayside and former high street stalwarts were consigned to the annals of history. But is the past necessarily a portent for what is to come this time around?

In what we see as a major turning point and direction of travel for next year, the majority of 'failing' retailers are online pure-plays.

2022 YTD: all quiet on the fall-out front

By all accounts, there has been very little retail occupier distress in 2022. According to the Centre of Retail Research, there have been 22 companies 'failing', with 1,678 stores and 30,276 staff 'affected'. Compare this with 54 'failures' (and 5,214 / 5,793 stores 'affected') during the maximum stress years of 2020 and 2008 respectively.

Even these figures significantly overstate the scale of actual fall-out. On the one hand, they include a number of operators that barely qualify as retailers (has anyone heard of the likes of Dawnfresh, J C Rook, Tree of Life, Carzam, Jupiter Group?). On the other hand, any hint of distress is logged as fall-out, whether that operator survives or not. For example, c-store chain McColl's went into administration in May but was subsequently acquired by Morrison's. Morrison's has since declared that of the 1,165-strong McColl's portfolio, only 132 stores will actually close. This reduces the 'stores affected' figures reported by the Centre of Retail Research by over 1,000 (62%) at a stroke.

The wheat has effectively already been separated from the chaff during the pandemic, the weaker players already succumbing to leave a much fitter residual competitor set. The decks have already been cleared, to a certain degree.

Of the 22 companies 'failing' in 2022 YTD, only McColl's and Joules could be classified as store-based operators of any scale. In what we see as a major turning point and direction of travel for next year, the majority of 'failing' retailers are online pure-plays. The highest profile of these were undoubtedly former e-commerce stars Missguided, Made.com and Eve Sleep (all subsequently acquired by multi-channel operators). Other lower profile online pure-players to collapse this year include Big Home Shop, Studio Retail, Shabby Store, Click It Local and Spirit.ed.

These failures aside, activity has thankfully been very muted this year, for two key reasons. Firstly, for most of the year, the trading environment for retailers has been fairly benign, a period of relative calm bookended by the chaos of COVID/lockdown and the mounting cost of living crisis. Secondly, the wheat has effectively already been separated from the chaff during the pandemic, the weaker players already succumbing to leave a much fitter residual competitor set. The decks have already been cleared, to a certain degree.

The latter is a key factor in our conviction that the degree of occupier fall-out will be less severe in 2023 than in previous recessions. Trading will undoubtedly become far tougher in 2023 than it has been in 2022, particularly in terms of rising operating costs. But most retailers are much fitter than they were coming into previous recessions and while by no means immune to the storm, they at least have stronger defences. There will undoubtedly be casualties, but maybe fewer than the market is anticipating – and no bloodbath.

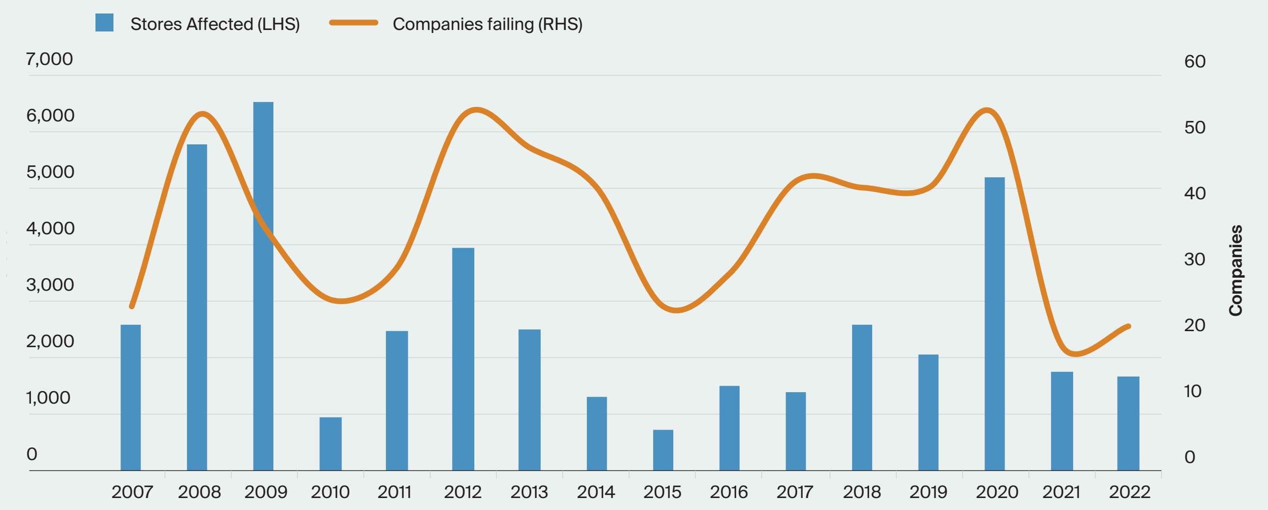
KF's Watch List – what constitutes a red flag?

Be that as it may, we anticipate considerable recourse to our internal Retailer Watch List in the coming weeks and months.

The Knight Frank Retailer Watch List is our assessment of occupier health and likelihood of distress. The base data is Mintel's 2022 Retail Ranking, which is a listing of the UK's leading operators based upon annual turnover. Our Watch List focusses on the Top 300 retailers in Mintel's ranking, all of which generate turnover of £50m or more.

Each operator is allocated one of six colour-coded classifications. Four of these apply to store-based and multi-channel operators, the other two to online pure-players (Table 1 below).

Fig 1: Retail Failures 2007 - 2022YTD



Source: Centre for Retail Research, Knight Frank

Table 1 **Retailer Health Classifications**

STORE-BASED / MULTI-CHANNEL

- **Red:** already in administration or currently/recently undertaken a CVA
- **Pink:** major risk: severely under-performing or CVA/ administration rumoured
- **Orange:** moderate risk: some downsizing/ store rationalisation likely, or already being implemented
- **Green:** no immediate apparent risk.

ONLINE PURE-PLAY

- **Brown:** major risk: severely under-performing or CVA/ administration rumoured
- **Yellow:** no immediate apparent risk.

Source: Knight Frank

Although the assessments are largely subjective, they are driven by a host of considerations and datapoints and are thoroughly sense-checked against our own retail intelligence and experience. Key factors that determine our ratings include the following:

- **Previous distress.** Experience shows that many CVA protagonists are effectively 'repeat offenders', previous restucturings having only bought that operator breathing space and time, rather than permanent salvation.

- **Ownership structure.** Publicly-listed PLCs or family-owned operators tend to be more transparent and robust than those under private equity ownership. Again, there is a strong historic correlation between retailer failures and private equity ownership (current and past) that is hard to ignore.

- **Trading performance**. Top level analysis of operators' profit and loss accounts to understand the robustness of current and historic trading, with a particular focus on operating profit (and margin). Loss-making companies, particularly over a long timeframe, are more likely to raise a red flag.

- **Balance sheet.** Top level analysis of operators' balance sheets to assess their financial strength. High levels of debt / gearing and creditors / liabilities far outweighing assets are more likely to downgrade an operator's overall rating.

- **Consumer demand.** As recession bites, the level of consumer demand will vary massively between retail sub-sectors. Some sub-sectors will see a marked and sudden deterioration, providing greater challenges for weaker operators in those markets.

- **Market rumour.** We would also factor in 'market talk', although we are by no means slave to rumour. There is a trade off behind the notion of 'no smoke without fire' and the dangers of Chinese whispers.

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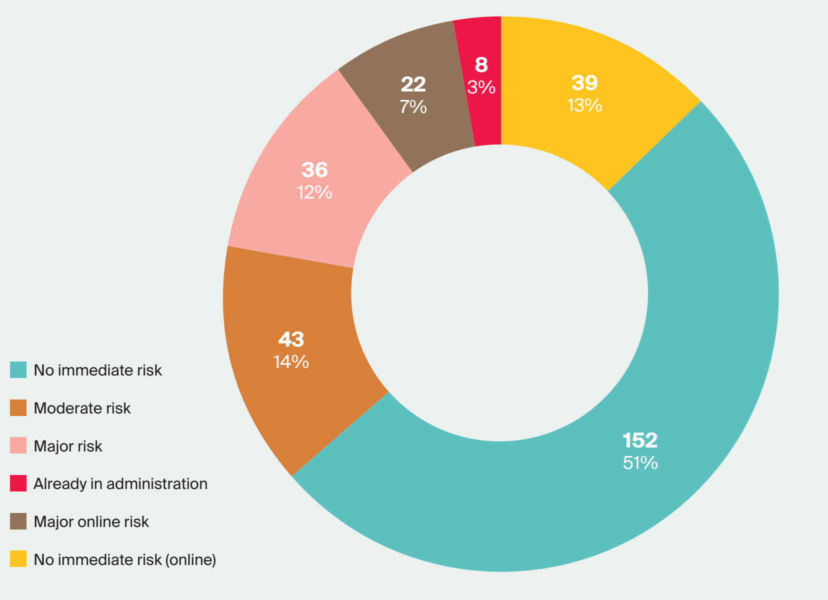
KF Watch List – anonymised outputs

The KF Retailer Watch List is an internal resource used by our agency, capital markets and valuation teams to inform their respective advisory services. Although clients may have access to it through these channels, the information is highly sensitive and it is therefore not publicly available. For this reason, any public outputs or disclosures must be anonymised.

Figures 2 & 3 provide breakdowns of the Top 300 Retailers by classification.
We can be explicit on the eight (3%) that are classified as Red as these are already in the public domain. As Mintel's ranking is slightly lagging, the Reds include Debenhams and Arcadia, both of which failed during the pandemic and whose brands were acquired by Boohoo and ASOS respectively. The list also includes Gap, which, although not an administration as such, marked a complete withdrawal from the UK market (excluding a partial tie-up with Next). More recent failures included Missguided and Studio Group (both acquired by Frasers Group), McColl's (Morrison's), Made.com and Joules (both Next).

The outputs of KF's Watch List are not wholly negative by any means. Just over half of the Top 300 (152, 51%) are rated Green. Coupled with the online pure-play Yellows, a total of 191 (64%) of the Top 300 retailers present no immediate apparent risk of failure.

Fig 2: Knight Frank rating of top 300 UK retailers Retailer count



Source: Mintel, Knight Frank

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Our Watch List currently identifies 58 operators 'at risk' (19%). Of these, 36 (12%) are multi-channel/store-based (Pink) and 22 (7%) are online-only (Brown). Many of the former fall into the 'previous distress' camp, while the latter tend to tick the 'poor trading performance' or 'flaky balance sheet' boxes (usually both).

Key messages

"Knight Frank says one in five retailers is at risk of failure" would be the somewhat lazy conclusion to draw from our Watch List analysis. The reality is that not all of these failures will come to pass by any means and this is the absolute worst case scenario.

In terms of wider messages, there are two key takeaways. 1. Scale and longevity are important. 2. Being online-only does not provide immunity.

To the first point, no retailer is "too big to fail". Former market leaders such as MFI, British Shoe Corporation, Sears Group, Woolworths, BHS, C&A and more latterly Debenhams and Arcadia are (non-) living proof that scale is never a guarantee of survival. But our analysis suggests fewer 'at risk' operators in the Top 100 versus those ranked 101 – 300. Extrapolating this further, the very smallest operators and independents are going to find 2023 exceptionally tough, hikes in operational costs likely to prove too much for many to bear.

The second point goes against perceived wisdom, that online pure-plays are sufficiently nimble to adapt to any challenge in the market and are effectively bullet-proof. On the contrary, many lack the experience, operational nous and firm financial footing to ride out the impending storm that will undoubtedly unfold during 2023.

Perceived wisdom is about to about to undergo a severe reality check...

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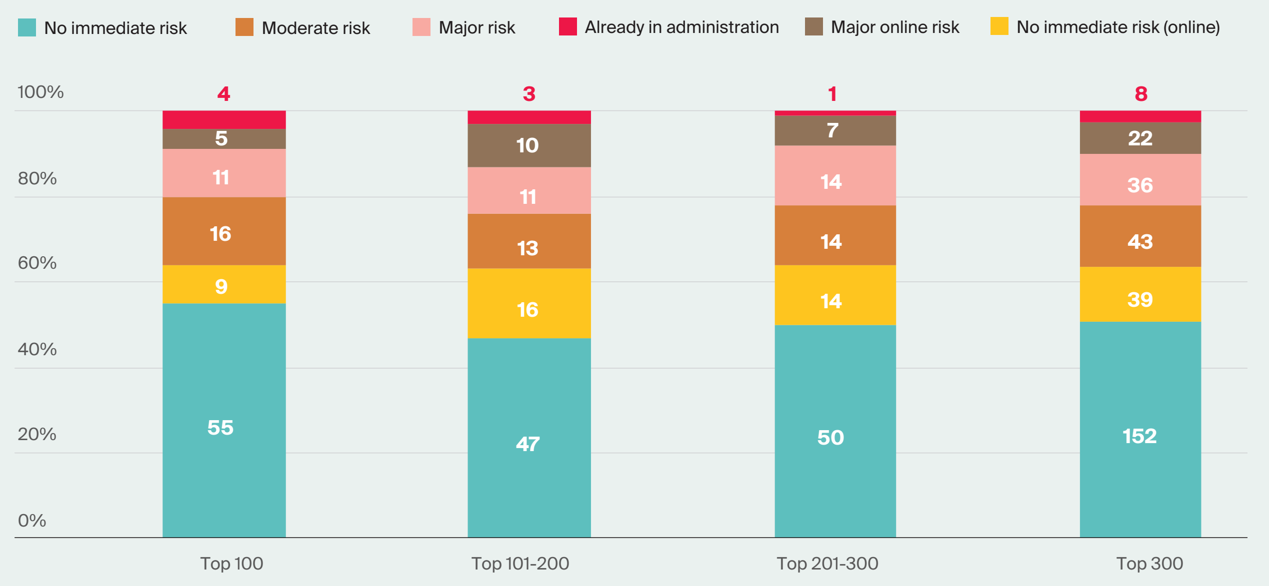
Fig 3: Breakdown of ratings (% & count)



Source: Mintel, Knight Frank

END OF THE LINE FOR ONLINE?

The hunter becomes the hunted, the disruptors become the disrupted. Why 2023 is likely to prove a painful inflection point in the evolution of e-commerce.

STEPHEN SPRINGHAM – PARTNER, HEAD OF RETAIL RESEARCH

Overview

Amazon's announcement in September that it was scaling back on warehouse development amidst a dramatic cost-cutting programme first sent shockwaves through both the retail market and investment community. Subsequent profit warnings from a whole string of online pure-play darlings such as ASOS, Boohoo and AO World have seen their respective values crash by as much as 90% from previous peaks. Other online pure-play poster children have succumbed to administration – first Missguided, then more recently Eve Sleep and Made.com, the latter two all the more amazing in that they had both achieved a stock market listing.

Against a backdrop of monthly year-on-year declines in online sales values of ca. -10% (or -20% in volume terms), the e-commerce arena is one of the bleakest places in retail at the moment – and it is going to get far worse before it gets better.

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Misconceptions come home to roost

That the rise of e-commerce has been one of the defining factors for the retail industry globally over the last 20 years is beyond dispute – it has been the catalyst for monumental change and, by and large, a force for good. The issue is that its influence is frequently misunderstood and our grasp is often derived from pure fallacy. If these fallacies persist, we are no better placed to understand online's relative fall as we were its meteoric rise.

One of the main fallacies is that online is an omnipotent force, it is a silver bullet to all retail challenges and online-only operators are somehow immune to wider market forces. It isn't, they aren't. True, online pure-players are not encumbered by a cost-heavy and often inflexible store

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base. This can often render them much more fleet of foot. But without the profile and visibility of a high street presence, elevated marketing costs often mount up to eye-watering levels.

Online pure-players being impervious to wider market forces is a total myth and this is increasingly being laid bare. Put simply, if demand for any product is soft for any reason, it is likely to be that way across the retail spectrum. Expressed another way, if people aren't buying clothes, they aren't buying clothes from anywhere and there is no magical reason why online channels should benefit from this at the expense of store-based ones (lockdowns being the only conceivable exception to this).

Consumer demand is just one market force, there are a multitude of others too, both economic and operational. Spiralling inflation and supply chain challenges are prevalent and current examples of each. One could argue that many online pure-players are less well-equipped to deal with market pressures. Most are fairly young businesses, many are but start-up fledglings. They have zero experience in managing or adapting to negative market change, their business is fully geared to full-throttle growth on calm seas. Many do not have the necessary wherewithal (and equally crucially, financial strength) to adapt.

Not immune to wider market forces, in many cases more exposed.

A post-pandemic hangover?

Depressingly, these fallacies are perpetuated by lazy narrative. Take the demise of Made.com as an example. The media narrative unsurprisingly majored on the "cost of living crisis" and the fact that prevailing economic conditions have prompted a massive slump in discretionary big-ticket items such as furniture. Others that have tried to dig a little more deeply have pointed to the fact that performance of online pure-players such as Made.com skyrocketed during the pandemic and that it has since been unable to live up to those lofty expectations in times of non-lockdown.

This demand-based argument only stands up to a certain degree of scrutiny. Economic logic would suggest that during times of consumer squeeze, large household items would be amongst the categories to suffer most. But ONS figures do not bear this out. In fact, furniture sales have grown at an average monthly rate of +14.9% in the first nine months of 2022, albeit boosted by a weak comp-infused Q1 of +42.5%. But despite the odd month of decline (May, July, August) furniture sales in Q2 and Q3 have still grown by +0.5% and +1.4% respectively. Patchy demand at worst, not a total collapse by any stretch.

To the second point, of course online demand spiked during the pandemic, but many of the online-only operators were already flying close to the sun before COVID-19 even came along. Very few were coming into the pandemic off a low growth trajectory, surely even fewer were foolish enough to extrapolate on lockdown trends as the basis of their business model going forward (although Peloton does seem to be something of a standard-bearer for this flawed logic).

Made.com was neither the victim of a collapse in consumer demand, nor did it merely succumb to supply chain challenges. Without going into minute detail, the business failed, in generic terms, because it was neither operationally nor financially robust to withstand market pressures. There is always devil in the detail, but the fact is that the basic business fundamentals were not there. Many other online pure-players are sadly in the same boat and will struggle to ride out the storm.

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RETAIL PROPERTY OUTLOOK 2023

61

Number of Online Pure-Players to Rank inside the Top 300 Retailers

22

Number of Unprofitable Pure-Players amongst Top 300 Retailers

Show me the money

What makes the demise of Made.com significant is that it was a quoted company. It listed on the Stock Market in June 2021 with what now seems a staggering market capitalisation of £775m. £775m to zilch in less than 18 months (or rather, a paltry £3.4m, the figure Next reportedly picked it up for).

Herein lies another of the fundamental flaws of many online pure-players – they are often massively over-hyped because of the aforementioned fallacies of online retailing. There is, of course, a long history of dot.coms being massively over-valued and this still rings true for many online pure-plays to this day – or rather it did until recently. In simple terms, online-only operators are classic 'boom or bust' plays.

As start-up businesses, many online pure-players are still loss-making. The notion is that when they reach a certain scale, imperious top-line growth starts to filter through to the bottom line. Only sometimes it doesn't. And in many cases, the business itself doesn't even last that long for us to ever find out.

Operating losses are part and parcel of a start-up, disruptor business. But they cannot go on indefinitely. And that time horizon shortens significantly in times of macro-economic strife. The online pure-players may not necessarily be doing anything different or feeling the pinch, but banks and stock markets are far less forgiving in times of crisis. Woe betide any online operator with a weak P&L and flaky balance sheet – again, probably more the rule than the exception, sadly.

There is often no Plan B, other than the vain hope that someone will buy the business at an inflated value. When that doesn't happen, there is very seldom a Plan C.

Online demand – the rebase goes on

The numbers themselves actually cloud the issue rather than provide any clarity. Online penetration figures (the % of retail sales that e-commerce accounts for) have always been false friends, in theory offering watertight quantification, the reality a far more murky and nuanced picture. The issue is that online and physical retail are not binary forces and are increasingly converging (click & collect, showrooming, returns, brand building etc) rather than diverging.

Online penetration figures can be a distraction from something that is still very real, but ultimately unquantifiable. Multi-channel retailing is far less about the numbers, much more about the on-the-ground realities. Sadly, the pandemic saw a depressing reverse in thinking and a renewed preoccupation with the penetration figures.

"Permanent changes in shopping habits and a surge in online sales" was one of the echo-chamber mantras during the pandemic, but is proving to be a very transient trend. Of course online penetration peaked during periods of lockdown on the back of two basic moving parts – overall retail sales slumped as people couldn't visit stores, but a portion (but not all) of that spend went online instead. Online effectively claimed a bigger share of what was a substantially smaller pie.

For the number obsessives, online penetration was just shy of 20% coming into the pandemic. At the height of lockdown, it peaked at around 37%. But has receded considerably post-lockdown. Where it is now is a very moot point, the figures from the ONS looking increasingly suspect. Back in January, online penetration had reduced to 25.3%. Despite near double-digit declines in every month since (against wider retail sales value growth of ca. +5-6% YTD), online penetration is supposedly still at 26.4% as at September. A quirk of mathematics at best, dodgy 'seasonal recalibration' of the numbers at worst.

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As start-up businesses, many online pure-players are still loss-making. The notion is that when they reach a certain scale, imperious top-line growth starts to filter through to the bottom line. Only sometimes it doesn't. And in many cases, the business itself doesn't even last that long for us to ever find out.

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As the cost of living crisis really starts to bite, there is increasing evidence to suggest that online is actually feeling the pinch more than other parts of retailing.

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"Still higher than pre-pandemic levels" is the frequent but ultimately flimsiest apology for the online penetration numbers. The fact is that the post-lockdown re-basing process has extended far longer than anyone expected and is still ongoing. Indeed, as the cost of living crisis really starts to bite, there is increasing evidence to suggest that online is actually feeling the pinch more than other parts of retailing. No one would have ever conferred online as 'discretionary' as it is a channel of distribution as opposed to a product category. But that is a unexpected reality we are increasingly having to face up to.

Thin end of the wedge

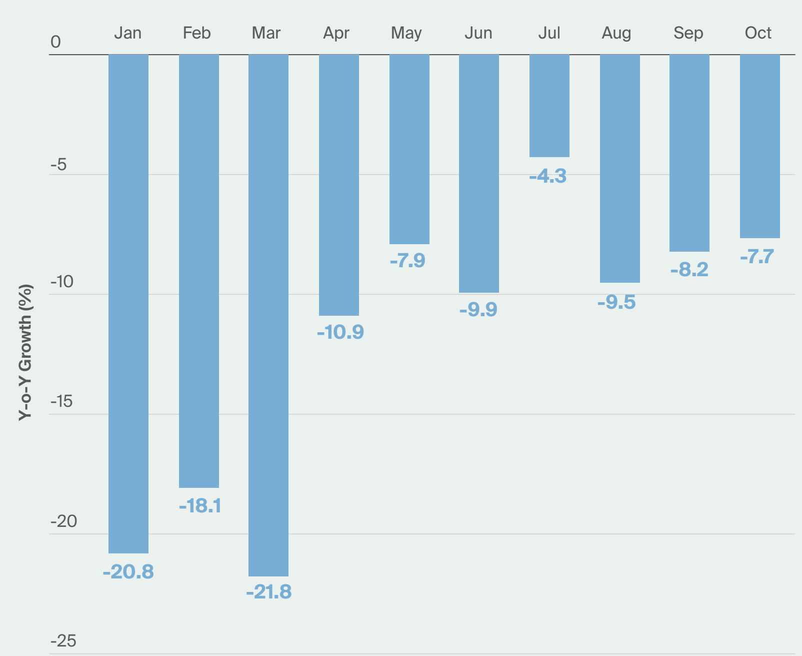
With market conditions set to tighten further, the issue of potential retail failures is again rearing its ugly head. Having been through the mill during the pandemic, most of the store-based and multi-channel operators are pretty battle-hardened and far better equipped to ride out the storm this time around. The same cannot be said for all the online pure-players, for the reasons already outlined. On this basis, we anticipate considerable fall-out from the online pure-players throughout 2023.

The nature of this fall-out will vary. One important factor to acknowledge is that the barriers to entry in online retailing are essentially very low – in very simple terms, all a start-up needs is stock and a transactional website. But the flipside to this is that the barriers to exit are equally low – if an operator hits a wall or runs out of cash, it has very little to fall back on. Whereas a store-based or multi-channel operator has a portfolio of sites that can be used as a bargaining tool (for fair or foul means), online pure-plays do not have this privilege. Whereas a store-based operator can buy time through a CVA, this option largely does not exist for online pure-players.

Rather than outright administration, consolidation is a more likely outcome. The takeovers of Missguided by Frasers Group, Eve Sleep by Bensons for Beds and Made.com by Next are all good examples of what we are likely to see more of – multi-channel operators acquiring online pure-plays to bolster their e-commerce credentials. In many cases, the online brands will probably be retained and the businesses will live on under new ownership.

Of course, this is by no means the beginning of the end for online retail, far from it. It is a coming of age inflection point. The irony is that online, for so long a catalyst for structural change within the retail industry, is now subject to its own internal structural change. The love for online hasn't gone, but many of the hiding places have – and many of the fallacies surrounding it need to as well.

Fig 4: Monthly online performance 2022 YTD (%)



Source: ONS, Knight Frank

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The irony is that online, for so long a catalyst for structural change within the retail industry, is now subject to its own internal structural change.

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RETAIL INVESTMENT: A HARBOUR IN THE TEMPEST?

Already re-based and re-priced, is retail more insulated to macro-economic pressures than other property classes?

CHARLIE BARKE – HEAD OF RETAIL CAPITAL MARKETS

Overview

The last 10 years have seen the retail market fall out of sync with the other key commercial property sectors. Whilst sheds have had their darling moment, prime offices also experienced a strong cycle from 2015 to 2020. Similarly, long-income and the ever-popular alternatives have performed extremely well for their investors.

In the meantime, parts of the retail market have chronically underperformed. Town centre retail has been experiencing a downturn since well before COVID. Rents have fallen by 40% or more and capital values by 50% or more. Over five years, MSCI have shown shopping centres return -11.2% per annum and 10 year returns are still negative (-2.4%).

Whilst colleagues in the other commercial sectors were talking of their markets being "late cycle" in mid-2022, it felt that the retail market was in a completely different position. We have been in a downturn for a long period of time and one cannot help but feel that this tough period surely now leaves part of the market re-based and attractive for the next cycle of investment.

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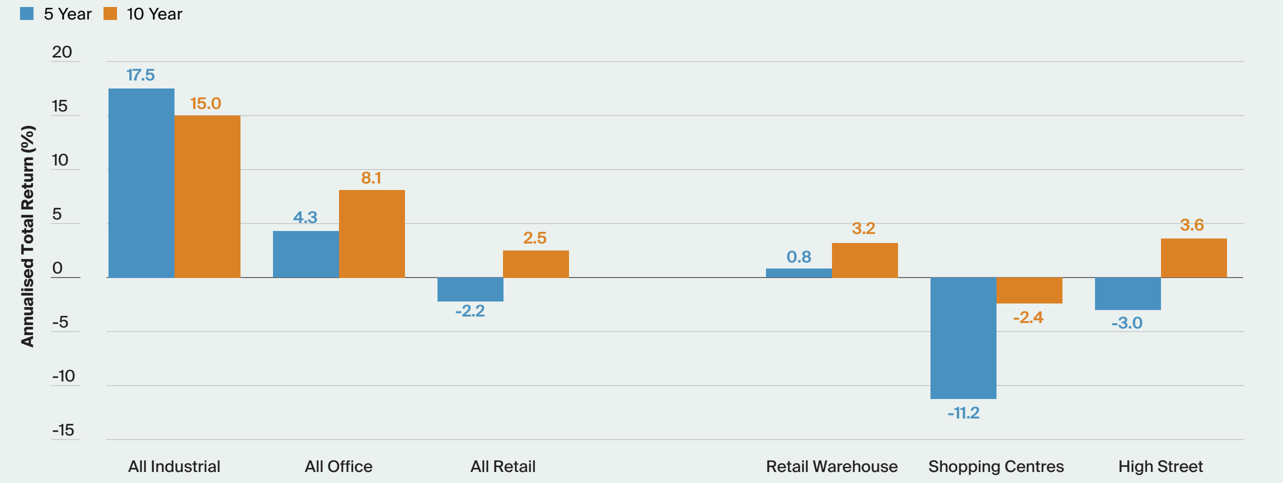
Certainly with the situation experienced in Q4 2022, when swap rates rose to 400bps+, retail's higher yields did, to a degree, cushion the fall. It should be noted that shopping centres have been the top performing sub-sector in the MSCI index in recent months, for the first time in more than a decade, albeit still showing a negative return. With the cost of debt increasing to 5% plus, the low yields seen in the other "late cycle" sectors had to correct more sharply than the 7%+ yields on offer in the retail sector.

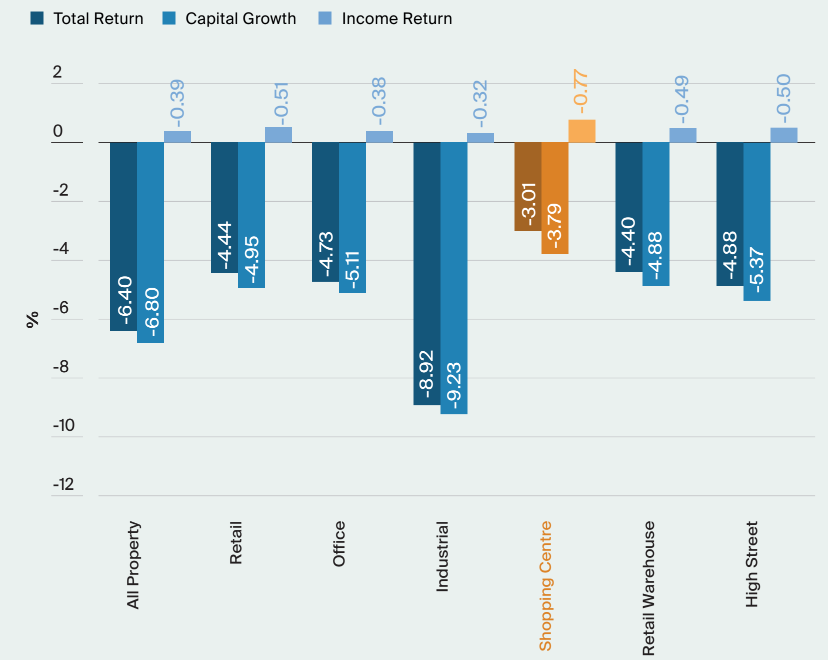
So, does the fact that the retail market is out of sync with the other key commercial sectors mean it is right-priced and now the most appealing area for investment?

Fig 5: Total returns by property class (5 and 10 year)



Source: MSCI

Fig 6: Monthly performance by sub-sector (October 2022)



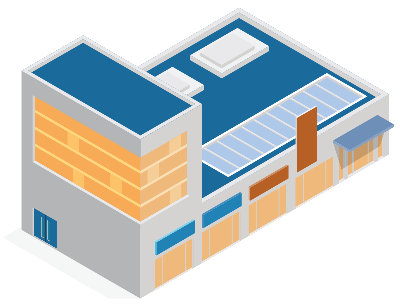
Source: MSCI

Table 2: Historic performance summary, by sub-sector

	ALL RETAIL	ALL OFFICES	ALL INDUSTRIAL	ALL PROPERTY
Total Return (%)				
2021	8.6	5.2	36.6	15.5
5 Year Annualised	-2.2	4.3	17.5	5.5
10 Year Annualised	2.5	8.1	15.0	7.6
Since Inception (1981) Annualised	8.0	8.2	11.2	8.7
Capital Growth (%)				
2021	2.8	1.2	31.6	10.7
5 Year Annualised	-7.0	0.3	12.6	1.0
10 Year Annualised	-2.6	3.6	9.3	2.6
Since Inception (1981) Annualised	2.1	2.0	3.6	2.6
Rental Value Growth (%)				
2021	-3.6	0.7	10.1	2.0
5 Year Annualised	-4.2	0.7	5.0	0.1
10 Year Annualised	-1.8	2.8	3.6	1.1
Since Inception (1981) Annualised	3.0	2.5	2.7	2.7

Source: MSCI

Few large shopping centres come without some challenges and these investors tend to talk themselves out of making sizeable investments until markets are showing clear evidence of upturn and there is a pack movement in which to find comfort.



Stock selection trumps location (location, location)

As ever, the answer lies in stock selection. The retail market remains dramatically over-supplied in the UK and this imbalance is not being redressed quickly. For a number of years to come, over-supply will continue to hamper performance in certain markets, the most extreme case being in the middle market where locations are neither experiential nor convenient.

However, thriving locations that offer a customer an appealing overall experience should now be considered. With rents having fallen by 30-40% and yields still at all-time highs, many of these properties will make excellent medium-term investment propositions.

Equally, affordable convenience that is showing low vacancy, sensible rents and high yield could produce a sustainable income return that is hard to match in any other sector.

Stock selection will insulate an investor from the worst of the occupational challenges in 2023 as tenants will continue to renew leases or take new space in thriving locations. There will, of course, be a disparity in performance within the sub-sectors and we comment on each of these as follows:

Shopping Centres – fortune to favour the brave?

2023 is likely to be another year of low volumes as there will be few sellers of the best performing prime malls at today's pricing, at least in the first half of the year.

There are plenty of "equity" investors who believe these assets make appealing long-term investments, albeit they all typically look for the same rare characteristics. These investors are, however, by their nature not the bravest bunch and are typically hampered by having to make decision by committee. Few large centres come without some challenges and these investors tend to talk themselves out of making sizeable investments until markets are showing clear evidence of upturn and there is a pack movement in which to find comfort.

For smaller lot size assets we have seen a number of investors such as Evolve, the Adhan Group, The Martin Property Group and the Gluck Group make multiple investments in 2022. Let's give credit to them for making these counter cyclical investments amongst the turmoil. We are all hoping their bravery is rewarded as who would begrudge them a decent return after having made their move in the eye of a storm?

High Street – the forgotten child

High Street remains the unappreciated retail sub-sector with most institutional investors turning their back on what was once their darling asset class.

It feels to us that the strength of good High Street investments has been forgotten. They are typically easy to own, are very undemanding in terms of capital, offer huge diversity of risk and high levels of liquidity. Furthermore, they are unlikely to demand the capital other commercial assets will need to comply with ESG regulation going forwards.

If investors can buy high quality High Street assets and look to aggregate ownership, either in specific locations or across similar quality locations, we feel they will be rewarded with high income return and good capital recovery prospects in the medium term. And just to remind you again, relatively low risk and effort along the way.

Out-of-Town Retail – service resumed after mild correction

Much the easiest sub-sector to like, any recent cooling of demand is merely a minor reaction to the earlier rapid price improvement seen in 2021. In 2023 things will settle quickly, demand will improve and transaction volumes will be quite reasonable.

There are so many things to like about good retail parks, from their excellent track record, to their simplicity and their flexibility. Likely to be the target for the lion's share of institutional retail weighting going forward, the limited supply of this stock will ensure sufficient pricing tension to return yields to their normal levels in the short term.

Don't overcomplicate matters – stock up on these, especially those in the South East, as fund managers will always find these more appealing.

Leisure – a curate's egg

A market that has the potential to be somewhat bi-polar this year.

On the face of it, the long term trends are set to support further investment into the leisure sector. The consumer is likely to use more of their disposable income on experience and less on goods, not least due to environmental conscience. The leisure sector continues to innovate to attract greater custom and there is certainly more to come in this area.

However, therein also lies the problem. With rapid expansion through many new concepts opening every year, both social experience and dining, there is bound to be some degree of short-term over-supply. Not all of these new concepts can be winners and not all locations will justify the expenditure and efforts made to draw in high numbers of customers.

As such, the sector, whilst inherently carrying opportunity, also harbours considerable danger. What's more, it's hard at this stage to spot the danger, to know who will be the winners and who the losers.

Which brings one back to stock selection; in the best locations a landlord will be able to readily replace failed concepts. In weaker locations that will be harder and more expensive. So, beware the unproven destination and over-exposure to the new kids on the block.

Supermarkets – lower return and risk

2022 has seen yields move out ca. 100bps and off that higher base, these carry significant appeal. That said, even with this movement, yields remain fairly low and in a higher interest rate environment that will mean they don't suit everyone.

However, the right assets offer very low risk, some modest rental growth and some potential for capital recovery. The returns are unlikely to set the world alight but investment here won't keep you up at night either. The safest and easiest bet in the sector. Expect to see ownership change at Asda and Morrisons to draw discounted yields for the foreseeable.

Shopping centres have been the top performing sub-sector in the MSCI index in recent months, for the first time in more than a decade.

	2020 YIELD	2021 YIELD	2022 YIELD	2023P YIELD	2020 VOLS	2021 VOLS	2022P VOLS	10Y AVE VOLS	2023P VOLS. VS 2022	2023P VOLS. VS 10 YR AVE	KEY BUYERS	KEY SELLERS	TRENDS
High Street	6.50%	7.00%	6.00%	6.50%	£0.57bn	£0.80bn	£0.90bn	£1.15bn	▲	▼	Private / Overseas Investors + PropCos	Institutions	Low management in quality locations to appeal to the private investor markets.
Shopping Centre	8.00%	8.50%	8.00%	8.50%	£0.34bn	£1.23bn	£2.15bn	£2.42m	▼	▼	Overseas Investors + Small PropCos + Private Equity	Any SC owner with debt + REITs & UK funds	Demand to focus on smaller lot sizes and distressed sellers until debt market stabilises.
Retail Warehousing	8.00%	6.50%	5.00%	6.00%	£1.67bn	£2.75bn	£2.70bn	£2.63bn	▶	▶	UK Institutions + Private Equity + British Land	Institutions	Swift repricing underway before strong demand soon returns.
Foodstores	4.00%	3.75%	3.50%	5.00%	£1.73bn	£1.75bn	£0.70bn	£1.43bn	▲	▼	Specialist Funds + Institutions + Tenants	Institutions	New interest rate environment to impact low yielding demand. Limited availability of stock to continue.

KNIGHT FRANK INVESTMENT DEALS

Over the course of 2022, Knight Frank have advised on over £1 billion of retail investment transactions. We have represented a broad spectrum of clients, ranging from Private Investors to Private Equity, Institutions and Lenders. We thank them for their continued business and look forward to working with them further in 2023.

The High Parade Streatham, London

Tenure: Freehold
Client: Acquisition on behalf of Criterion Capital
Price: £7,400,000
NIY: 8.66%

59/61 & 63/65 Northumberland St, Newcastle

Tenure: Freehold
Client: Disposal on behalf of NFU Mutual
Price: £2,800,000
NIY: 6.44%

86-92 George St & 72-74 Rose St North Lane, Edinburgh

Tenure: Freehold
Client: Disposal on behalf of CBRE Investment Management
Price: £15,250,000
NIY: 6.21%

Lidl, Redditch

Tenure: Freehold
Client: Acquisition on behalf of US Realty
Price: £6,400,000
NIY: 4.25%

RETAIL PROPERTY OUTLOOK 2023

Sainsbury's, Park Hill Road, Garstang, Preston

Tenure: Freehold
Client: Acquisition on behalf of CBRE Investment Management
Price: £10,000,000
NIY: 4.50%

The Mall, Blackburn

Tenure: Leasehold
Client: Disposal on behalf of Capital & Regional
Price: £40,000,000
NIY: 11.50%

Broad Street Mall, Reading

Tenure: Freehold
Client: Disposal on behalf of Moorgarth Group & Texton Property Fund Ltd
Price: £57,500,000
NIY: 7.10%

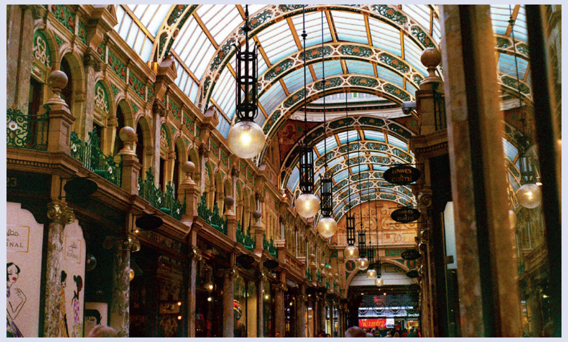
Clifton Moor Retail Park, York

Tenure: Freehold
Client: Acquisition on behalf of Melford Capital Partners
Price: £32,600,000
NIY: 7.61%

50% of Deepdale, Preston

Tenure: Freehold
Client: Acquisition on behalf of Melford Capital Partners
Price: £30,300,000
NIY: 9.00%

Victoria Quarter, Leeds



Tenure: Freehold
Client: Acquisition on behalf of Redical / Rivington Hark
Price: £120,000,000
NIY: 8.00%

KNIGHT FRANK LEASING DEALS

Knight Frank's Regional and Central London leasing teams have advised on over 300 deals worth >£150m, across a series of global flagship acquisitions, lease restructurings and portfolio optimisations.

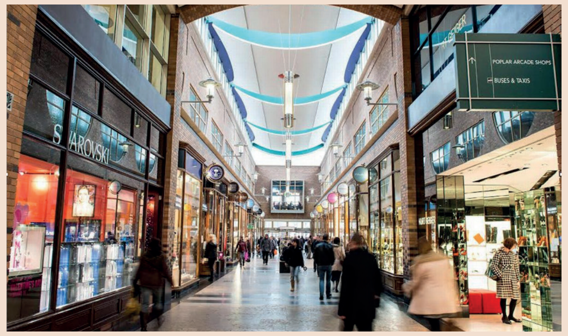
Fremlin Walk

July 2022

A re-gear of the lease to Zara retaining the tenant at the passing rental level.

Client: M&G

Touchwood Solihull Shopping Centre



November 2022

A new flagship letting to Mango on a new 10 year lease.

Client: Ardent / Sovereign Centros

Touchwood Solihull Shopping Centre

October 2022

A re-gear of the Nespresso lease to secure the Tenant for a further 5 year term.

Client: Ardent / Sovereign Centros

The Beacon Eastbourne

October 2022

A new letting to Saltrock on a 5 year unbroken term.

Client: L&G

Culver Square Shopping Centre

May 2022

A re-gear of the Hotel Chocolat lease securing a further 4 years term certain.

Client: M&G

46-47 Burlington Arcade

October 2022

Acquisition of debut London boutique.

Client: Cara Jewellers

95-97 Fulham Road

April 2022

Acquisition of flagship showroom.

Client: Occhio

190 Kensington High St

June 2022

Letting to Shoryu as part of ongoing asset management of the block.

Client: British Grolux

Old War Office

September 2022

Letting of flagship restaurant space to premium Italian restaurant, Paper Moon.

Client: Westminster Development Services

93 Strand

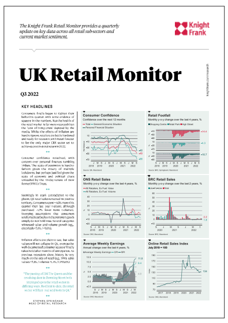
July 2022

Letting to Six Studio.

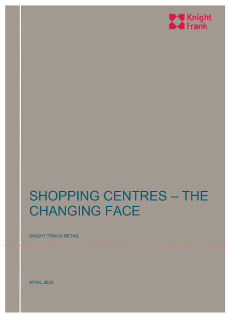
Client: Private Landlord

Recent market-leading research publications

Retail News Issue 12: Leisure: responding to an experiential crisis



Retail Monitor Q3 2022



Shopping Centres - the Changing Face

Knight Frank Research Reports are available at knightfrank.com/research

Knight Frank Research provides strategic advice, consultancy services and forecasting to a wide range of clients worldwide including developers, investors, funding organisations, corporate institutions and the public sector. All our clients recognise the need for expert independent advice customised to their specific needs.

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