UK Retail Economy

The UK economy continues to defy Post-Brexit negative expectations, with strong consumer spending remaining the driving force behind growth. As expected, with the pound devaluing by around 12% against the dollar, strong export expansion has also been behind 0.5% GDP growth in Q3 2016.

Despite the generally better than-expected data since the referendum, indicators of investment have clearly weakened – with investment expected to fall markedly in 2017. Overall, BNP Paribas expect GDP growth averaging 2% this year and 1.1% next year. A period of near stagnation is expected through the middle of 2017 as uncertainty over UK’s future relationship with the EU intensifies, which is likely to weigh on business sentiment and consumer spending.

Next year’s forecast growth in inflation will be the defining issue for retailers in 2017. Despite a slight dip in October caused by falling prices on toys, hotels and non-alcoholic drinks, inflation is expected to pick up again in November. Unilever’s brief scuffle with Tesco over pricing is likely to be repeated over the course of next year - Birdseye and Walkers have already requested price increases of up to 12% from the supermarkets. The debate surrounds the issue of who will pick up the bill for rising costs - suppliers, retailers or ultimately, the consumer.

Retail sales in November grew by 1.3% compared to a year earlier according to the BRC, outperforming the 12 month average growth rate of 1.1%. Crucially though, the figures did not include Black Friday, suggesting that the slowdown in sales may have been due to consumers putting off purchases until the discounted retail event. Online sales for the same period grew by 10.9%.

The jury remains out on Black Friday, with both British retailers and consumers still split over its usefulness to the sector. Despite this, initial signs point to another record breaking year for sales in the UK. The event does now appear to be very much focussed around online sales channels, ensuring that we didn’t experience the chaos which descended across US and British retail destinations in the past couple of years. Footfall was down by 0.7% on the day and 9.2% on the week according to Ipsos Retail Performance. Conversely, IMRG found that online sales were up by 12% yoy, with £1.23bn spent on the day.

Despite solid sales growth, consumer confidence took a sharp downturn in November. The GfK Index fell by 5 points to -8, following a 2 point decline in October. The fall in confidence has been triggered by the prospect of an uptick in inflation, eroding household income in 2017. The apparent lack of a clear plan heading into Brexit negotiations has also weighed heavily on public sentiment.

At a Glance

UK SHOPPING CENTRE & OUT OF TOWN RETAIL MARKET
DECEMBER 2016

The Headlines

ONE Record sales on Black Friday
Black Friday broke records once again, with £1.23bn spent online on the day - a 12% increase on 2015.

TWO Investment down on 2015
Volumes fell by around a third for both the retail warehousing and shopping centre markets, though in line with rest of the commercial market.

THREE Occupier demand remains robust
Whilst take up slowed after the EU Referendum vote, occupiers in both the out of town and shopping centre markets have continued to expand selectively.
Occupier

Retail vacancy rates across the UK shopping centre market remain highly polarised, ranging from 19.3% in the North West to 10.2% in Greater London. The improved occupier conditions at the beginning of the year ensured that the majority of regions initially witnessed falling rates. However, in Q3, most regions witnessed an increase, due to both the slowdown in take-up post-Brexit and from the several high profile administrations over the course of the year.

Shopping Centre Vacancy

The second half of 2016 was not as eventful as the first, at least in terms of administrations and corporate failures. However, there have been several announcements by high profile retailers which could potentially cause concern for the high street and shopping centres.

In November, M&S announced that they plan to close around 30 clothing and home stores over the next five years and convert many more into Simply Food stores, with the food business line outperforming the rest of the business. With M&S stores being the focal point of many shopping centres and high streets across the UK, it may represent a rare opportunity to acquire prime high street and shopping centre space.

Struggling fashion retailer Store 21 entered into a CVA with its landlords in H2, with around 80 stores shutting and rent cuts on many more. According to The Local Data Company, the retailer reduced their exposure to shopping centres by 29 stores in the past 12 months.

Also in November, Banana Republic and American Apparel both announced that they would be pulling back from the UK market. Gap owned Banana Republic will close their 8 UK stores after seeing sales slip globally. In addition, basics fashion retailer American Apparel fell into administration after emerging from bankruptcy in February this year. Their 13 UK stores will close in the New Year.

Shopping centre owners have continued to increase their exposure to the leisure sector over the past year. However, despite the coverage which the sector has been attracting in recent months, the explosion of new brands has not been felt to any great extent within regional shopping centres. Whilst new brands such as Chip+Fish and Sugar Dumplin have been making exploratory inroads into the regional shopping centre markets, it remains established brands such as Byron, Las Iguanas, Prezzo and Bill’s who have been responsible for taking a larger quantum of space over the past year.

According to the IPD October 2016 Index, Shopping centre rents grew by 0.4% on an annualised basis. Whilst this marked a pickup in performance for the subsector, it underperformed the rest of the retail market which saw rents grow by 0.9%. In turn, the retail sector significantly underperformed the rest of the commercial property market, with rents for all property growing by 2.4% on an annualised basis.

Key Post Brexit Deals

<table>
<thead>
<tr>
<th>Address</th>
<th>Size (000s sq ft)</th>
<th>Purchaser</th>
<th>Vendor</th>
<th>Price (£m)</th>
<th>Yield (%)</th>
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Source: BNP Paribas Research, Propertydata
Shopping Centre Investment

The shopping centre investment market has been fairly sluggish throughout the entirety of 2016. Volumes to date were down by 33.2% y-o-y. The decline in volumes has been exacerbated by a lack of prime regional stock being traded, with only Grand Central (Birmingham), Liverpool One (Liverpool) and Merry Hill (Dudley) being the only truly regional centres traded in 2016.

Property companies were the most active investor group over the period, injecting £1.14 bn into the sector so far. Interestingly, councils represented 10.4% of total transactions over the period, investing £204m. Deals included Arch Commercial Enterprise buying Manor Walks Shopping Centre (Cramlington) for £78.2m and Surrey Heath Council’s purchase of The Mall, Camberley for £86m, which reflected a 5.9% IY.

Rather than being driven by a lack of appetite, pricing has been the main obstacle within the subsector, particularly post-Brexit. A significant mismatch between buyer and seller expectation of pricing led the market to stall, with buyers expecting a 5-10% discount in response to the uncertainty following the vote. With fewer distressed sellers, the market stagnated.

Following the bull market of 2014 to Q3 2015, when the yield gap between prime and secondary shrank to around 175 bps, the price gap has now increased to 250 bps. Whilst not a level witnessed before, the increased risk premium for secondary assets may provide investors with an incentive going in to 2017.

Whilst the volume for 2016 will finish the year quite a way below 2015, we are aware of around £1.3bn of product either on the market or under offer. We anticipate that whilst some of these deals will complete before the year end, several large centres such as Southside (Wandsworth), Stratford Centre (Stratford) and Friars Walk (Newport) could provide solid volumes early in Q1 2017.

2017 Outlook

For the shopping centre investment market, 2016 didn’t turn out to be anywhere as near as busy as had been predicted. The market stalled in advance of the Brexit vote and arguably went in to reverse for 3 months afterwards. The election of Donald Trump as the next US president served only to increase market uncertainty.

The only major bright spot for the market was the emergence of local authorities as keen buyers of shopping centres in their own towns and cities. The factors that encouraged local authority investment are still relevant. Firstly, there are many town centre schemes that have declined, or at least stagnated due to lack of investment. Most of the local authority acquisitions that have been made are ostensibly to repair the damage made by the lack of profit-driven private sector investment.

Long-term interest rates were at an all-time low in September 2016 and, whilst not as low today as they were then, are still at a considerable discount to shopping centre investment yields. This will encourage further local authority investment.

Retail demand remains positive and, with the likelihood of inflation, there is also the potential for rental growth. London and the South East has the highest growth potential and this will be reflected in the demand for centres across this region. Elsewhere, other than for the top 50 major regional centres, good value will be key. M&S closing down in yet more smaller towns and Next opening many more large edge of town stores highlights the continued polarisation of retail destinations. There will continue to be retail failures and mid-market ladies’ fashion seems to be one of the key areas of concern - particularly in the department store sector as the M&S decision shows.

Prime yields are likely to remain firm but secondary yields may be under pressure to drift out, particularly if interest rates start to rise and vacancy levels increase.

In our opinion, 2017 will be a year in which to be cautious, with a focus towards quality and value.

Source: BNPPRE Research
Occupier

For the most part, vacancy rates have been falling in the majority of regions, with the overall out of town retail vacancy rate falling to 7.2% in Q3 2016. The only exceptions were Greater London and the South West which saw their rates increase to 6% and 6.6% respectively. Whilst the rate of decline has slowed slightly, the out of town occupational market remains in good health.

As one of the primary drivers of occupational demand in the out of town market, the housing market has proven remarkably resilient in the wake of the Brexit vote in June. This provided homewares and furniture retailers the incentive to selectively expand across the UK.

There are several furniture retailers who have expanded their store portfolios in 2016. Fabb Sofas opened their first store at Hedge End Retail Park, Southampton, and plan to open 5 more imminently. The brand is a joint venture between the founder of DFS (Lord Kirkham) and the founder of Tapi (Lord Harris). Furniture Village have continued to expand their portfolio, opening 4 new stores this year with three further openings planned. According to the Local Data Company, in the past 12 months Oak Furnitureland have taken 7 stores whilst Sofology have opened several new units.

In the bulky segment of the market, Bunnings announced that they would be opening their first store in 2017. The store will replace an existing Homebase unit in St Albans. The Australian retailer is aiming to have 4 more stores converted by the end of June. With Kingfisher also in the process of improving their store environments and rationalising their portfolio, the DIY sector will be one to watch in 2017.

The UK supermarket sector remained murky in the latter half of 2016. Recent results from the Big 4 have shown significant divergence in performance. According to Kantar, in the 12 weeks to November 6th, Tesco saw their sales grow by 2.2% - its fastest growth rate for three years. Sainsbury’s, Morrisons and Asda all saw declining sales for the same period. Sales growth for the discounters Aldi and Lidl fell to their lowest levels witnessed since 2011, though still up by 10.2% and 6.1% respectively.

Out of Town Investment

The out of town investment market has not performed particularly strongly over 2016 so far. There has been £2.2bn invested in the year to date, representing a 35% decline compared to the same period in 2015. Sentiment for the prime end of the sector started to change going into Q4 2015 and slowed further in 2016. The bulky segment of the market attracted solid interest throughout 2016, predominantly due to the solidity of the occupier story.

We are aware of around £650m of product which is currently under offer and estimate that the total volume for 2016 will be around £2.7bn.

Since the vote, much of the market anticipated a flood of stock to come to the market at 10% - 15% discounts; however this was not the case. Instead we have witnessed the retail funds target specific investors quietly off market, with better quality, more liquid stock where achieving a sale price at or as close to valuation levels as possible is likely.

Despite the redemptions following the Brexit vote, UK Institutions remained the most prolific investor group, representing 43% of all purchases in the year to date. Overseas buyers were also fairly active in 2016, spending just shy of £400m. At face value, it appears overseas buyers were attracted to the sector by the discount created from the falling value of the pound, with a significant chunk of capital arriving in Q3.

The biggest disposer of retail warehousing in 2016 were Property Companies, who sold 37% of the product transacted. With pricing expected to soften further in 2017, there is a degree of ‘cashing in’ on decent product purchased earlier in the cycle.

Key deals so far this year have included TH Real Estate’s purchase of Thurrock Shopping Park for £93.07m, at a 5.30% NIY and Pramerica buying Templars Shopping Park, Oxford for £67m, reflecting a NIY of 4.99%.

Pricing for the retail warehousing sector softened across the board in 2016. Open A1 parks and Open A1 solus saw the largest shift, with yields moving out by 50bps. Prime Fashion parks and Bulky Goods witnessed pricing slip by 25 bps. For the most part, this has been due to the dent in sentiment following the EU Referendum vote.

Retail Warehousing Volume (£m)

Pricing
Key Post Brexit Deals

<table>
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<tr>
<th>Address</th>
<th>Size</th>
<th>Purchaser</th>
<th>Vendor</th>
<th>Price (£m)</th>
<th>Yield (%)</th>
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<td>Hammerson Plc</td>
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Source: BNPPRE Research, Propertydata

Investment Trend: What will be demanded in 2017?

As we move into 2017, the market will begin to focus on what type of product will be most in demand from different investor groups. Requirements from each segment of the market have changed considerably over the past 7 years. From 2010 to 2016, the average lot size has increased from £15.98m to £19.78m. Whilst this in itself is fairly insignificant, the divergence between the investor groups is noticeable.

Overseas investors became increasingly involved with the retail warehouse sector from 2013 onwards (Fig 1). Since that point, £520m of foreign capital has targeted the sector on average each year. As can be seen in Fig 2, the lot sizes purchased by overseas buyers have grown considerably. The spikes in the average volume in the past years have been caused by large portfolios such as the Arena Trust Portfolio (£156.5m) in 2013 and Elmo Portfolio (£273.6m) in 2015. We anticipate that this will continue to be the case, as overseas groups seek to grow their exposure in the sector by acquiring prime, large scale assets when they become available. Longer term investment horizons and focus on income makes them less reliant on the real estate cycle than other investors.

PropCo’s involvement within the retail warehousing sector has been dictated by the market cycle. Early in the cycle as capital values began to increase, PropCo’s were net buyers of retail warehousing. When the market reached its peak in 2015, they had already become net sellers, crystallising their profits. In terms of lot sizes, they have remained fairly resolute targeting assets between £15m-£20m. In 2016, average lot sizes fell to their lowest level of £14m as investor confidence towards the sector faltered. With an uncertain outlook in 2017, this is set to continue, with the optimum lot size of around £15m.

The UK Institutions pro-cyclical behaviour has meant that the average lot size which they have purchased at has been higher than that of the PropCo’s. They have been net buyers of retail warehousing since 2014. Inflows of capital into these institutions increased as capital values recovered. Benchmarking obligations of the UK Institutions have encouraged them into acquiring retail assets, so a focus on value is more evident. Following the outflows after the EU Referendum and the uncertainty going in to next year, a move towards smaller lot size assets which provide the retail funds with extra liquidity is likely.
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