BNP PARIBAS REAL ESTATE

Real Estate for a changing world

At a Glance

RETAIL FOCUS

Q4 2017

RESEARCH

The Stats... At a Glance

GDP
1.20%
▼ Forecast '18

CPI
3.0%
▼ December '17

GfK Consumer Confidence
-13
▼ December'17

Employment
75.1%
▼ November '17

Source for all charts BNP Paribas Real Estate//Property Data/ BRC Nielsen/ ONS

The Retail Market

Whilst 2017 was an extremely volatile year for both the UK economy and the retail sector, the close of 2017 was perhaps slightly more positive than many had predicted.

The Christmas trading period is generally viewed as a fairly accurate bellwether for the health of the retail sector – so far this picture has been mixed. By now, most retailers have reported sales for the festive period - a few themes have become pretty clear, perhaps most importantly the outperformance of specialist, aspirational and discount retailers. Outstanding growth from retailers such as Joules, B&M, Superdry, Ted Baker, Mountain Warehouse, Quiz and Oxfam demonstrated that this outperformance was not been restricted to particular sectors. Once again, the common denominators for the majority of Christmas winners were fantastic product and supreme multichannel platforms. The latter, including click and collect, which continued to grow strongly for retailers such as Next and John Lewis, proved itself to be an indispensable element of modern retailing.

High inflation was the most influential driver of the UK retail sector in 2017. In December, CPI inflation fell slightly to 3.0%, representing six months of inflation over the target growth rate of 2.0%. The silver lining is that the inflationary period is unlikely to extend beyond the end of the year. This rhetoric has been reinforced by industry leaders - Next's chief executive, Lord Wolfson, stated in the retailer's Christmas results that cost-price inflation will ease over the course of 2018.

UK consumers' reliance on credit continued apace in Q4, with Christmas 2017 borrowing particularly voracious. Research from USwitch found that on average, consumers within the UK borrowed £452 to cover the cost of Christmas, totalling £8.5bn for the period across the country. In addition, in December 2017, almost 1 in 10 people were still repaying credit cards from the previous Christmas. With interest rates likely to increase over the course of 2018, consumers will likely continue to save less in order to fuel their discretionary spending.

From a corporate retail standpoint, 2017 concluded, and indeed has begun 2018 on a potentially worrying note, with administration for Toys R Us narrowly avoided. The toy retailer will now enter into a CVA which could see at least 26 stores closed and up to 800 people lose their jobs. However, on the whole, 2017 did not see either anything close to the number of staff affected by retail failure as in 2016.

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2018 Outlook

The consumer environment will appear fairly unchanged in the New Year. In terms of consumer confidence, a sense of caution will prevail - confidence fell to its lowest level in four years in December 2017, with pessimism surrounding the economy the biggest drain on confidence. With little obvious to cheer about in the coming months, confidence will remain below zero and this will continue to negatively impact retail sales.

The growth of fitness culture in the UK has meant that Health & Beauty is forecast to be the fastest expanding segment of the retail market over the next five years according to recent research from GlobalData, with the sector growing by 21.2%. Clothing and footwear is also expected to see robust growth over the period, influenced by popular culture's heightened interest in appearance and fashion. At the other end of the spectrum, Electrical goods and Home retailing (DIY, gardening, furniture, floorcoverings & homewares) are anticipated to underperform the total retail market, albeit still growing by 9.7% on average. In the short term, both will be affected by the slowing housing market; however after 2020 the outlook for homewares in particular will begin to improve.

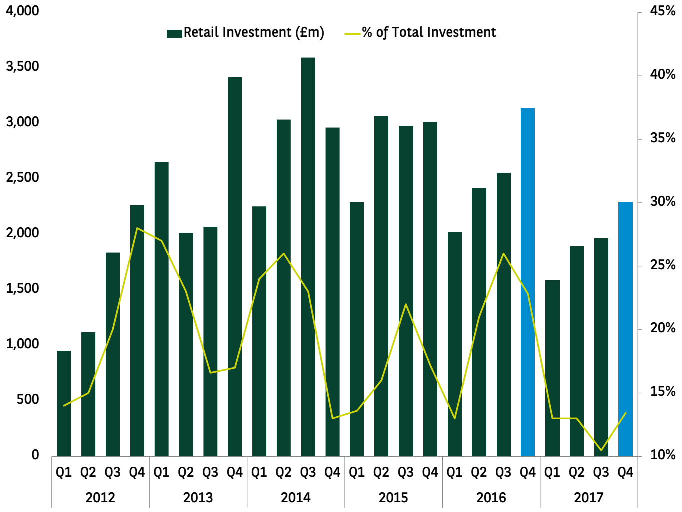
Generally speaking, occupier intentions will remain divided in 2018. Prime high streets and regional / experiential shopping centres will continue to attract the top tenants. Whilst demand for this type of space is relatively robust, we do not anticipate much rental growth on the high street in general in 2018. Vacant secondary space will struggle as the depth of retailers taking this type of space is limited. With a couple of high profile retailers potentially seeking CVAs, the market looks more fragile than it did in 2017.

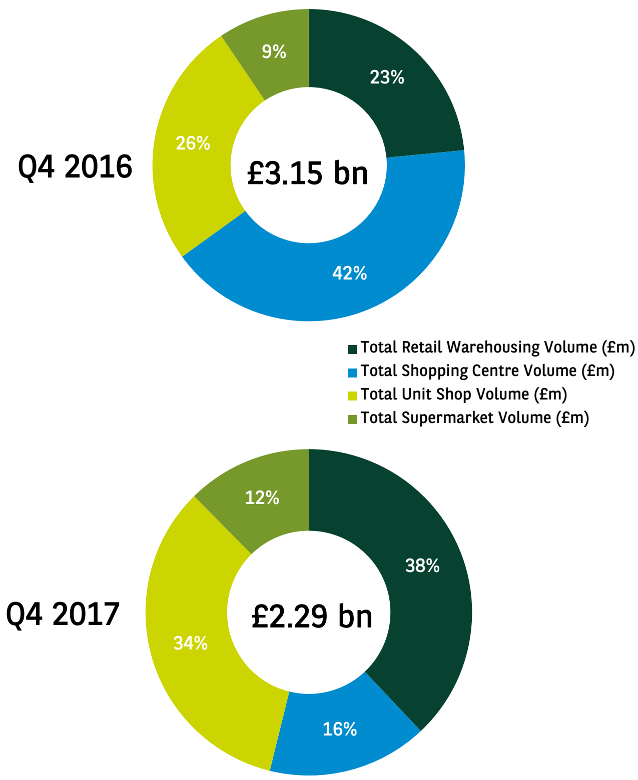
The other key demand driver for 2018 will be regional polarisation. London, the South East and key regional cities will remain the focus for occupiers. Outside of these select locations, demand is thin, with an oversupply of space in some areas still very evident.

The grocery sector is set to be shaken up in 2018. Budget grocer Aldi has already announced ambitious expansion plans which would see them entering the 'Big 4'. Aldi grew rapidly over 2017, adding 76 stores. Additionally, the discounter is planning on reaching 1000 stores by 2022. Co-op is also on the expansion trail, with plans to expand its portfolio by 100 stores this year. The physical store growth of both retailers is in contrast to the vast majority of the sector, who remain committed to rightsizing their portfolios.

2018 will be a key moment for the F&B sector within the UK. The market has seen phenomenal growth over the past few years. While consumer preferences have undeniably shifted, spending on experiences rather than 'things', commentators have questioned the sustainability of the growth. With 2018 likely to see a slowdown in the wider economy and consumer spending, the fundamentals for the F&B sector perhaps will not look as robust as in previous years. Potential CVAs and closures from established restaurant operators have already demonstrated the importance of acquiring units selectively, as opposed to driving sales growth through rampant expansion. As is the case with much of retail, a pessimistic outlook exists for the mid-market, whilst casual and fine dining look less exposed to a cyclical downturn.

The Investment Market





Overall, the retail investment market in Q4 concluded the year relatively robustly, with £2.29bn invested, bringing the grand total for 2017 to £8.16bn. Whilst this was the lowest annual volume since 2012, it perhaps was not as bad as many within the industry had predicted, representing an 18.0% decline on 2016. The overriding theme across all retail segments in 2017 was polarisation, with many investors shying away from assets which were deemed over and above an acceptable risk profile in light of weakening occupier markets.

Retail Warehousing

Total transaction volumes for 2017 equated to £2.67bn, representing an 8.65% increase on 2016. As expected, Q4 saw the largest quarterly volume, with £870m invested in the sector as investors looked to commit capital before year-end.

In line with the trend seen across 2017, there was strong appetite from institutional investors for prime assets in the £10m - £25m lot size bracket, which saw some of the keenest yields being paid, most notably Alton Retail Park which traded at 4.50%, Harrogate Retail Park at 4.65% and Mid Sussex Retail Park at 4.72%, all beating their quoting price by at least 50 bps.

Across the course of the year we have seen pricing move. Changing sentiment across the market in 2017 meant that pricing moved in opposite directions, drifting for the Open A1 segment and sharpening for the Bulky market. However, pricing is very much on a case by case basis and is highly dependent on park fundamentals.

Looking forward into 2018, we do not expect to see further yield compression but appetite to remain for prime stock in solid trading locations, with long-let secure income streams with some indexation. Specifically the South East where the underlying residual element must also be considered. At the larger end, we expect that the market will become even more polarised. We anticipate yields will drift further on assets with profiles slightly tarnished with short income, overrenting or exposure to retailers who might be on the 'watch list'.

Indicative Prime Yields (NIY)

	Q4 2016	Q3 2017	Q4 2017
Open A1	4.75	5.00	5.00
Bulky Goods	5.75	5.50	5.50

Key Deals

Address	Price (£m)	Yield (%)	Purchaser	Vendor	Date
Harrogate Retail Park, Harrogate	18.55	4.65	South Tyneside PF	Aviva Investors	Dec-17
Alton Retail Park, Alton	11.12	4.50	Fidelity UK REF	Canada Life Assurance	Dec-17
Mid Sussex Retail Park, Burgess Hill	17.33	4.72	DTZ Investors	Goldman Sachs	Nov-17
Horizon Retail Park, Farnborough	38.78	5.25	Royal London PF	Steamrock Capital	Dec-17

Shopping Centres

The Shopping Centre market witnessed a fairly weak conclusion to 2017 with Q4 volumes reaching only £319m, a 75.0% decline on Q4 2016- by far the weakest quarter of the year. This brought the annual volume to £2.19bn, again a noticeable decline of 26.2% compared to 2016. Outlet centres accounted for £485m of this total.

Rather than a noticeable negative shift in sentiment towards the shopping centre market over the course of 2017, the volume was repressed by the fact that there were no transactions in excess of £155m, compared to five transactions in excess of this figure for 2016, with a total value of £1.85bn.

The largest deal of the quarter was LaSalle Investment Management purchasing a share in Intu Chapelfield, Norwich. LIM paid £148m for the 50% stake, which represented a 5.00% net initial yield. Chapelfield is the dominant scheme within Norwich and is home to retailers such as H&M, Apple and House of Fraser.

The corporate activity driving consolidation in the sector was the most important news for the shopping centre market in Q4. Unibail-Rodamco SE's purchase of Westfield and Hammerson's acquisition of Intu will have a real impact on the direction of the sector. The creation of giants within the shopping centre market is a clear sign that economies of scale are required to operate large schemes effectively. The impact on the availability of shopping centre stock from the Hammerson – Intu tie up could be an interesting feature in 2018.

When examining pricing, we have seen prime yields move out in Q4 2017 from 4.50% to 4.75% and we expect this level to be maintained. However, we are experiencing a widening yield gap for secondary centres as an impact of further uncertainty in the occupational market.

Indicative Prime Yields (NIY)

	Q4 2016	Q3 2017	Q4 2017
Shopping Centres	4.50	4.50	4.75

Key Deals

Address	Price (£m)	Yield (%)	Purchaser	Vendor	Date
Intu Chapelfield, Norwich (50% stake)	148.00	5.00	LaSalle IM	Intu	Nov-17
Treaty Centre, Hounslow	69.10	6.40	LaSalle IM	Angelo Gordon / Quidnet Capital	Dec-17
Church Square, St Helens	26.60	7.25	St Helens Council	LaSalle IM	Oct-17

High Street

Whilst uncertainty in the wider occupational markets was evident at the tail end of the year, the high street investment market did not perform as badly as perhaps expected, with the decline in volumes more down to the fact that a lack of large lot size product traded. Q4 volumes reached £774.5m, bringing the total volume for 2017 to £2.04bn. Whilst this represented a significant decline on the volumes witnessed over the past couple of years, it was only 9.5% below the long run average for annual investment into the high street market.

UK Institutions were by far the biggest net sellers of high street property in 2017, with many viewing current sharp pricing as an ideal point to crystallise returns on prime high street units.

The gulf in pricing between prime and secondary towns became even more pronounced at the tail-end of 2017. With investors becoming increasingly concerned about the overall health of the retail occupational market, towns which are outside of the top 20/30 locations within the UK are being viewed with increased caution.

This was well illustrated in Q4 with the purchase of two properties in Guildford and Bedford. The former, let to Anthropologie with just five years remaining on the lease, was purchased by M&G Real Estate and achieved a NIY of 3.66%. Guildford boasts one of the wealthiest catchments within the UK, has extremely high levels of occupational demand and subsequently has seen rental growth in excess of the national average. The latter property, 7-11 Midland Road, Bedford was purchased in December 2017 by Kames Capital for £5.18m at a 6.85% NIY. Despite being a prime unit located in a secondary, but still relatively affluent town, extremely focussed occupier requirements have ensured that the yield gap between 'good' and 'bad' towns remains substantial.

Indicative Prime Yields (NIY)

	Q4 2016	Q3 2017	Q4 2017
High Street (Provincial)	4.00	4.00	4.00

Key Deals

Address	Price (£m)	Yield (%)	Purchaser	Vendor	Date
109-127 Market Street, Manchester	87.00	4.90	AM Alpha GMBH	Noe Group	Dec-17
149 High Street, Guildford	10.25	3.66	M&G Real Estate	Aberdeen Standard	Nov-17
7-11 Midland Road, Bedford	5.18	6.85	Kames Capital	Aviva Investors	Dec-17

Supermarkets

The total transaction volume for foodstores stood at £1.26bn for 2017, across 46 deals; a sizeable increase of 51% on 2016 at £830m. However, whilst positive, this level is still some way off the height of the market witnessed back in 2015 where volumes were just shy of £1.8bn.

The biggest individual buyer of 2017 was The Supermarket Income REIT which completed on £200m of transactions. The revival in the sector has been due to investors directing capital into properties with long-leased secure income streams with indexed-linked reviews, due to the current economic and political uncertainty that Brexit has created.

Like most of the other long income markets, the 'best in class' foodstores have experienced yield compression and now sit at 4.25%, a 25bps compression on where they sat at the tail end of 2016. Given the lack of activity within the sale and leaseback market, coupled with the arrival of some new developments, investors are being forced into the second tier market, defined as strong trading stores with indexed-linked reviews, but with slightly shorter (sub 15 years) lease lengths. Each asset in this category needs to analysed on a case by case basis, with particular consideration given to the rent level, as the majority of these stores will have had at least 5 years of RPI growth. That said, this second tier has also seen yield compression in the last 12 months of 25 bps with yields now standing at 4.75%.

Going forward, we expect to see sustained demand for foodstores given the weight of money currently out there for long-income product. A good barometer will be Waitrose, Haywards Heath that is due to come to market shortly. The property has a straight 20-year lease with five yearly 3.00% fixed reviews and will no doubt attract a strong level of institutional interest.

Indicative Prime Yields (NIY)

	Q4 2016	Q3 2017	Q4 2017
Supermarket	4.75	4.25	4.25

Key Deals

Address	Price (£m)	Yield (%)	Purchaser	Vendor	Date
Sainsburys, South Woodford	40.00	4.00	LaSalle IM	British Land	Oct-17
Tesco, Tryst Road, Cumbernauld	50.00	5.50	Supermarket Income REIT	Legal & General Property	Dec-17
Waitrose, Station Road, Cheadle Hulme	17.45	4.85	Knight Frank IM LLP	Private Trust	Nov-17