Research briefing

UK Retail Warehouse Sector

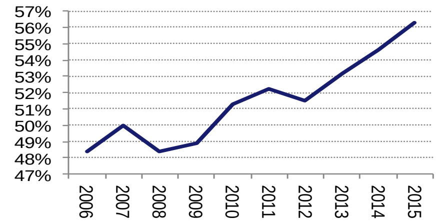
Overview

- Healthy occupier demand and lack of supply, particularly in the form of new developments, has reduced **retail warehouse vacancy levels** to 5.9%, a **fourteen year low** (Source: Trevor Wood Associates).
- While we may expect a limited increase in assets coming to the market for sale, following disposals from retail funds in the immediate aftermath of the EU referendum in the UK, this is unlikely to be more than seen in 2015.
- Outside of retail fund holdings, low leverage and strong bank liquidity, compared to the previous crisis, indicates a relatively **stable intersection of investment demand and supply.**
- Low gilt yields, a currently liquid lending market and **depreciating sterling makes the retail warehouse market increasingly attractively priced** for overseas buyers**.**
- In our view, based on current forecasts, there is value to be found in dominant retail parks with low rents, quality and value retailing tenants, particularly in areas where ecommerce channels are less established.

Retail warehouse market metrics

- The UK retail warehouse market is worth £52bn and comprises 7% of all UK commercial real estate (CRE) assets (Source: BPF).
- There are circa 1,000 Retail Parks across the UK, making for a significantly liquid market.
- In 2015, the total UK retail warehouse market comprised 184.5mn sqft. Comparison goods retailers (excl DIY) dominate, taking 56% of space in 2015 (see figure 1 below).

Figure 1: Comparison goods (excl DIY) as a % of retail warehouse space

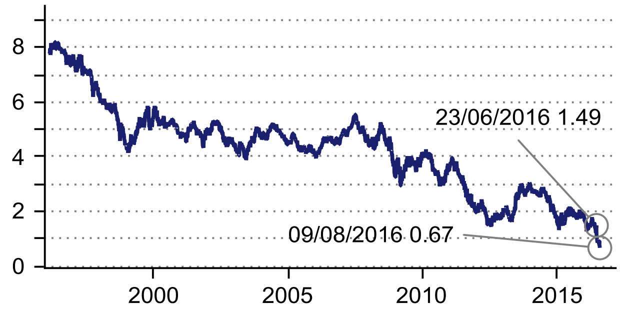


Source: Trevor Wood Associates, Savills Investment Management

UK economy

- Following the UK vote to leave the EU, ten year gilt yields have more than halved (see figure 2). The Bank of England (BofE) has also instituted its first rate cut since 2009, to 0.25%. Therefore, despite UK downgrades associated with the Brexit vote, the cost of financing remains low. Additionally, the significant reduction in the risk free rate is helping to counteract upwards pressure on risk premiums.

Figure 2: Ten year Gilt yield

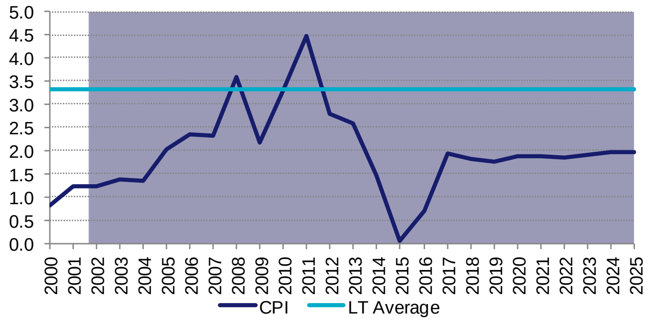


Source: Macrobond, Savills Investment Management

- The bank lending market is still active following Brexit and the UK banks are well capitalised. Additionally, the Bank of England has removed the counter cyclical capital buffers, required under Basel III regulatory capital rules, until spring 2017. This will increase lending ability in the UK by circa £150bn. The BofE has also restarted quantitative easing.
- Additionally, CRE leverage is at a lower level than during the global financial crisis (GFC). When combined with low interest rates, this means that the debt driven forced sales previously seen are unlikely to rematerialise.
- Inflation is also currently below the long term average of 3.3% (see figure 3 overleaf) and forecast CPI is not expected to exceed this over the medium to longer term, according to Oxford Economics. Even if weakened sterling applies pressure on pricing, any increase in CPI will be from a low base. Additionally, many retailers are hedged through 2017. Therefore, it is less likely that cost push inflation will significantly impact upon the retail warehouse sector in the near term. Cost push inflation is an increased risk from

2018 onwards however, depending on the ability for retailers to pass on costs to the consumer.

Figure 3: Forecast CPI in the UK (%)



Source: Oxford Economics, ONS, Savills Investment Management

Retail warehouse investment market

- Investment volumes have been robust in this sector. Cushman & Wakefield reported a 27% yoy increase in retail warehouse investment volumes for 2015, with 140 transactions totalling £3.63bn. This was a ten year high.
- The main retail warehouse investors comprise of funds (57%), private equity (15.5%) and REITs (12%) (Source: Cushman & Wakefield).
- Funds have also been the most active disposers of retail warehouses, with retail funds disposing £1.5bn of retail warehouse stock in 2015. This is circa six percent of the £25bn retail property funds have under investment (Source: FT, Cushman & Wakefield) and is not unusual for the market.
- In the aftermath of the Brexit vote, several retail funds did apply discounts to, or suspend redemptions, advising they needed to undertake liquidations. This has now largely reversed however and many of the disposals have been at a smaller discount than initially thought. Therefore, we do not expect markedly higher retail warehouse disposals in 2016 than for last year.
- Assets coming to the market by retail funds are likely to be in the sub £60mn bracket.

Yields

- Since the end of 2014, retail warehouse property yields, with the exception of shopping parks, have widened by 50-75 basis points (see figure 4).

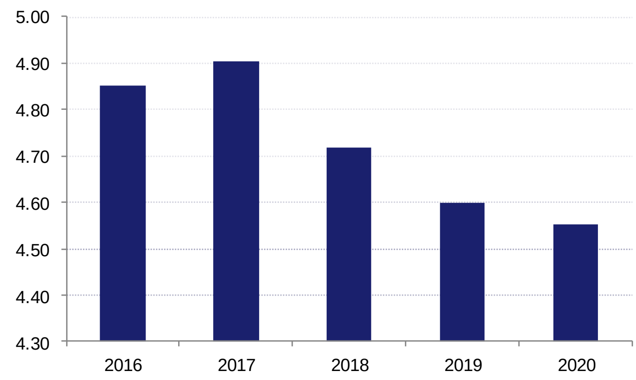
Figure 4: Retail warehouse yields by type

	Dec-14	May-15	Sep-15	Mar-16
Shopping Park	5.00%	5.25%	5.00%	5.00%
Prime Open A1	4.25%	4.25%	4.50%	4.75%
Prime Restricted	5.25%	5.25%	5.50%	5.75%
Secondary Open A1	5.00%	5.25%	5.50%	5.75%
Secondary Restricted	6.00%	6.25%	6.50%	6.75%

Source: Savills, Savills Investment Management

- However, PMA forecast that while, following the referendum result, there may be short term widening of prime yields up to 4.9% in 2017, yields will narrow through to 2020, see figure 5. They advise this is driven largely by rental growth and a fall in the liquidity premium, as markets settle following the referendum. Additionally, the significant fall in gilts (figure 2) should help keep yields low.

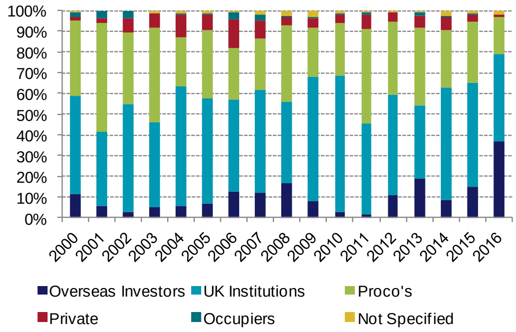
Figure 5: Prime retail warehouse forecast yields



Source: PMA Soft Exit, Savills Investment Management

- Typically purchasers within the retail warehouse market are from within the UK. However, as figure 6 below illustrates, international investors are increasing as a proportion of transactions by value.

Figure 6: Retail warehouse purchasers by value

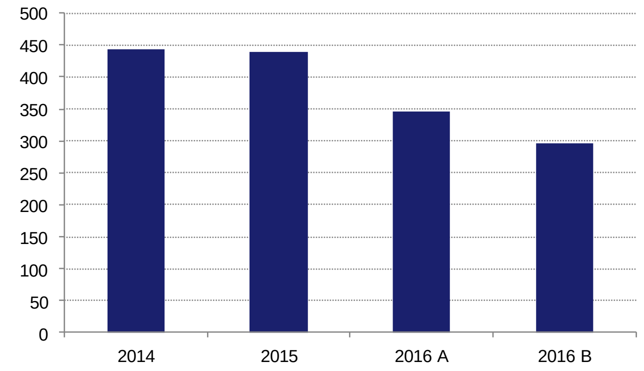


Source: PMA Soft Exit, Savills Investment Management

- The weakening of the pound may serve to make retail warehousing attractively priced, potentially fuelling an increase in overseas investment as the market matures.
- Figure 7 demonstrates the fall in *dollar* denominated capital values for UK prime retail warehouses.
- Scenario '2016 A' shows the relative current pricing of prime UK retail warehousing ($346 psf) at an exchange rate of 1.29 US dollars per 1 pound, compared to $438 psf in June 2015, a fall of $92psf.

- Assuming a downside case of a 10% fall in capital values on pre-Brexit levels and a further 5% fall in Sterling, capital values in dollar terms would become even more attractively priced at $296 psf, see, scenario B.

Figure 7: Retail warehouse capital values psf (USD)



2016A, Capital values psf using exchange rate as it 1 July 2016

2016B, Capital values psf assuming a 10% fall in capital values and a further 5% fall in GBP:USD exchange rate

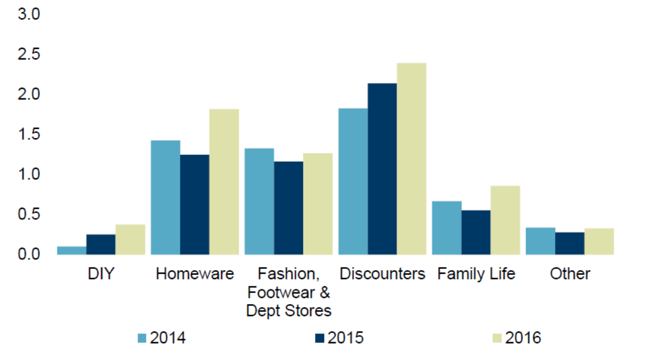
Source: PMA, Macrobond, Savills Investment Management

Occupier Market

Demand

- Prior to the vote to leave, Cushman & Wakefield forecast an increase in occupier demand of 6% over 2016, representing demand for 11.49mn sqft.
- They additionally forecast that 169 out of the 210 tenants in this sector planned on opening at least one new store during 2016.
- 39 of these tenants are planning on opening over ten new units over 2016.
- 29 are targeting in excess of 100,000 sqft of space.
- At the start of 2016, CBRE additionally advised that value retailers such as B&M and Home Bargains were looking to open circa 50 stores over the coming year and at the moment, the fundamentals do not suggest that this is forecast to change.
- Demand in the UK retail warehouse market has been relatively buoyant. Over 2015, the ten fastest growing occupiers signed leases on over of 2.5mn sqft of retail warehouse space.
- Discounters currently have the greatest demand for space, with significant increases in the demand for space (see figure 8) forecast by Cushman & Wakefield in the Homeware and Family Live stores over the year and to a lesser extent, DIY.

Figure 8: Non-food retail warehousing demand (mn sqft)

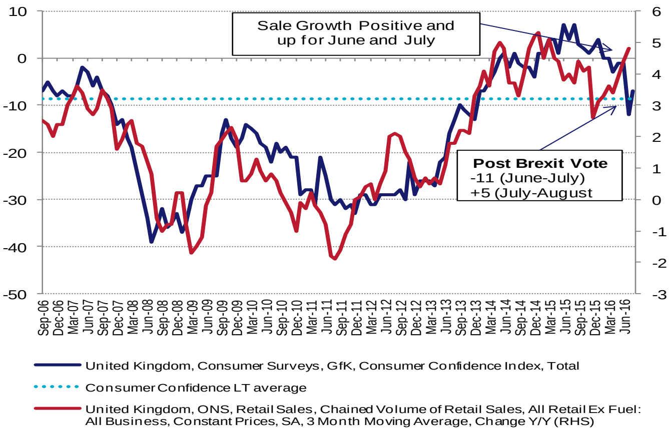


Source: Cushman & Wakefield Retail

Consumer Sentiment

- In July, during the immediate aftermath of the UK referendum on EU membership, the GfK Consumer Confidence Barometer (CCB) of consumer sentiment fell by 11 points to -12. This was the sharpest drop for 21 years (see figure 9 overleaf).
- For the same period, the three month moving average sales volumes remained positive at 4.8% yoy growth however (Source: ONS, see figure 9). While this is a smoothed figure incorporating volumes prior to the vote to leave, the number is still an increase on the equivalent numbers for the previous two months (3.9% yoy growth for May and 4.4% yoy retail volumes growth for June).
- The CCB consumer sentiment barometer has also recovered by five points in August, to the level of -7, leaving consumer sentiment back above the long term average of -8.71 (see figure 9 overleaf).
- GfK suggest this lift in sentiment has been driven by reduced interest rates, lowering prices and high levels of employment, as well as a drop in propensity to save in August.
- While, it is still too early to tell the full impact, the recovery of the CCB, in combination with retail sales volume growth suggests that the short term impact of Brexit may so far not be as severe as feared.
- Should the August recovery prove temporary and consumer sentiment decline, the retail warehouse sector could still be relatively insulated due to many of the larger tenants operating in the discounted goods end of the market. This is because, consumer sentiment indicates how consumers feel about the economy and their personal financial situation, including stability of income. Declining incomes typically lead to a shift towards spending on ‘inferior goods’ available within the discounter end of the market.

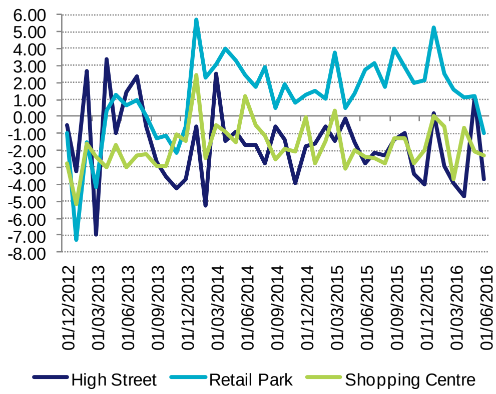
Figure 9: GfK Consumer Confidence (blue), Retail Sales yoy change (red)



Source: GfK, ONS,Macrobond, Savills Investment Management

- Yoy change in footfall is negative for all retail segments for June, however retail parks have been the only sub-sector until June, to see sustained positive yoy change in footfall (see figure 10). It remains to be seen whether the decline in footfall for retail parks is temporary or not, but history suggests a relative resilience of retail parks.

Figure 10: Footfall yoy change (%)

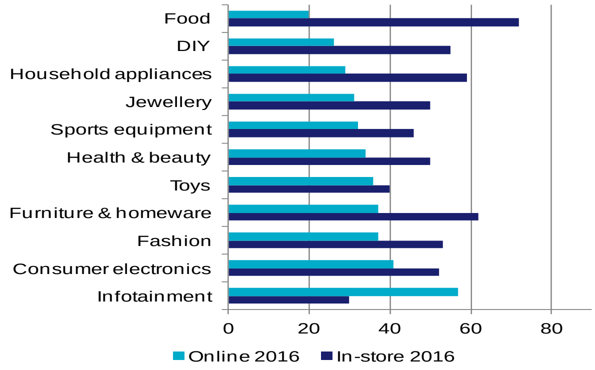


Source: BRC, Savills Investment Management

Ecommerce

- The UK, at 15% in 2015 and a forecast 16%+ by the end of 2016 (source Centre for Retail Research), has the highest proportion of retail sales through online channels in Europe, with a forecast shrinkage of traditional store sales by 3.4% as a whole in 2016.
- However, e-commerce market penetration is substantially lower in certain sectors (see figure 11).

Figure 11: Preferred purchase method (%)



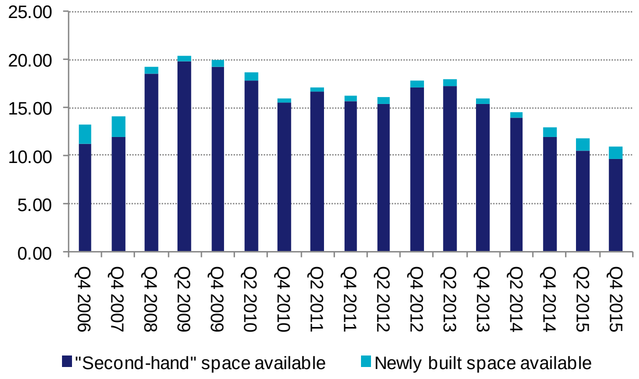
Source: Centre for Retail Research, Savills Investment Management

- As figure 11 shows, several of the sectors with high preferred physical retailing coincide with retail warehouse sector demand (see figure 8), such as homeware.
- Many furniture, DIY and electrical sectors are also embracing e-commerce and digital technologies, incorporating, for example, transactional websites, 'click& collect' and beacon technologies. Previously pure play e-commerce retailers are also starting to take physical space.
- These are the forms of retail business that typically trade in big box / retail park locations.
- Well-located retail parks and other big box locations could indeed benefit from their accessibility, convenience, free parking and low occupancy costs, not only as points of sale but also as places to showroom brands, engage with customers and offer 'click & collect' facilities, particularly parks with household goods (furniture, DIY, electricals) and food/supermarket sectors.
- The location of many of the retail warehouse schemes (see figure 1), may also benefit in the short term because, the majority of quick end to end delivery schemes, for example 'Amazon Now' and 'Amazon Fresh' are currently geographically limited to central London.

Supply

- There is limited new supply in the UK retail warehouse market. Most of the supply is currently coming from second hand supply (see figure 12 overleaf).

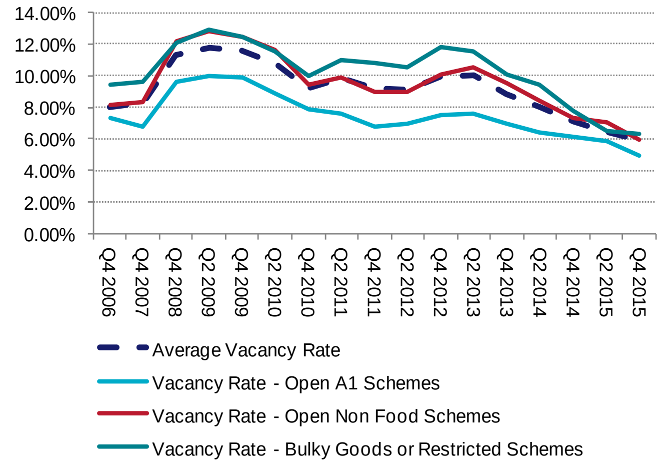
Figure 12: Retail Warehouse vacant space (mn sqft)



Source: Trevor Wood Associates, Savills Investment Management

- Growth in demand and lack of new supply has reduced the vacancy rate to 5.9%, the lowest since 2002 and down from 10% in 2013 (see figure 13).

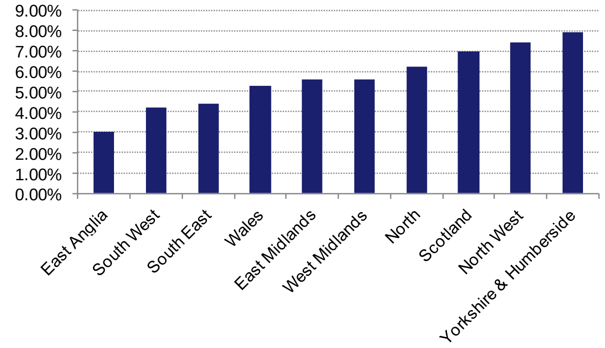
Figure 13: Retail warehouse vacancy by type (%)



Source: Trevor Wood Associates, Savills Investment Management

- Historically prime A1 retail warehouse schemes have exhibited the lowest vacancy (see figure 13), however over the last year, vacancy levels have converged across schemes, as the supply pipeline has fallen.
- Vacancy levels were fragmented across the country as at the end of 2015 (see figure 14). However, areas with higher vacancy were largely driven by temporary dislocations due to closures by occupiers such as B&Q.

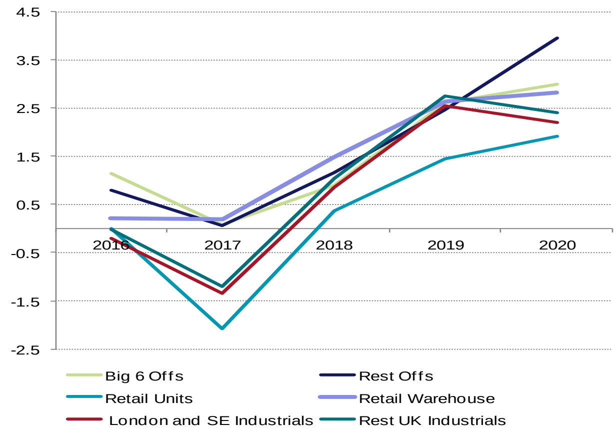
Figure 14: Retail warehouse vacancy by region (%)



Source: Trevor Wood Associates, Savills Investment Management

- Prior to the EU vote to leave, Trevor Wood Associates were predicting a continued undersupply of new development relative to the forecast demand for 2016 and 2017. This undersupply may help insulate the retail warehouse market, should there be any reduction in demand following Brexit.
- There has also been strong demand by Food and Beverage outlets in the warehouse schemes, which should help continue to keep vacancy levels low.
- Savills advise that healthy demand and limited supply was forecast to continue to put upward pressure on rents and reduce rent free periods.
- Based on the above, Savills suggest there is still a case for income return in retail warehouse. This is supported by the forecast prime retail warehouse income return by PMA under their 'soft Brexit' scenario, which most closes follows the consensus on forecast GDP (see figure 15).

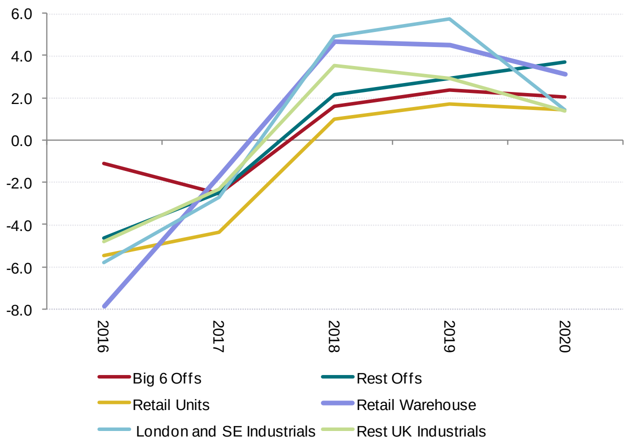
Figure 15: Prime retail warehouse income return



Source: PMA 'soft Brexit' scenario, Savills Investment Management

- It is also forecast that retail warehouse will have among the strongest capital growth recovery, due to the supported underlying occupier demand and lack of supply, in both the investor and occupier market (see figure 16 below).

Figure 16: Prime retail warehouse capital return



Source: PMA 'soft Brexit' scenario, Savills Investment Management

Conclusion

- Occupier demand, due to tenant mix, is forecast to respond well to falls in consumer sentiment. Many of the occupiers have indicated intention to expand into further units in the near term.
- On the supply side, there has been a shortage of new supply, pushing down vacancy and preserving rents.
- Stock availability may experience some increase from the retail fund market in the short term following the EU referendum, however it is unlikely these levels will significantly exceed those of the prior year.
- The robust economic fundamentals of a strong lending market, low leverage, low gilt yields and good liquidity, combined with a fall in sterling, makes the retail warehouse sector attractive on the investor demand side, particularly to international investors, as capital and income return hold up in the medium term.
- In our view, based on current forecasts, there is value to be found in dominant retail parks with low rents and quality, value retailing tenants, particularly in areas where ecommerce channels are less established.

For further information, please contact:

Andreas Trumpp MRICS
T. +49 (0)89 203020 216
E. andreas.trumpp@savillsim.com

Irfan Younus CFA, ACA
T. +44 (0)20 7409 5989
E. irfan.younus@savillsim.com

Kerrie Shaw
T. +44 (0)20 7409 9946
E. kerrie.shaw@savillsim.com

Norbert Schley
T. +49 (0)69 27299 1605
E. norbert.schley@savillsim.de

Victoria Ormond
T. +44 (0)20 7409 5986
E. victoria.ormond@savillsim.com

Will Johnson MRICS
T. +81 (0)3 6893 1865
E. will.johnson@savillsim.com

Judith Fischer
T. +44 (0)20 7409 3616
E. Judith.fischer@savillsim.com

Savills Investment Management

33 Margaret Street
London W1G 0JD

Tel: +44 (0)20 7877 4700
Fax: +44 (0)20 7877 4777

Email: info@savillsim.com
Web: www.savillsim.com

Disclaimer

This document has been prepared by Savills Investment Management LLP, which is authorised and regulated by the Financial Conduct Authority under registration number 615368. The registered office is at 33 Margaret Street, London W1G 0JD. This document may not be reproduced, in whole or in part, in any form, without the permission of Savills Investment Management. To the extent that it is passed on care must be taken to ensure that this is in a form that accurately reflects the information presented here.

Whilst Savills Investment Management believes that the information is correct at the date of this document, no warranty or representation is given to this effect and no responsibility can be accepted by the Manager to any intermediaries or end users for any action taken based on the information. As Savills Investment Management and its subsidiaries operate and manage funds which invest in property, this research is not represented as being impartial.

Certain statements included in this document are forward-looking and are therefore subject to risks, assumptions and uncertainties that could cause actual results to differ materially from those expressed or implied because they relate to future events. Accordingly, no assurance can be given that any particular expectation will be met and readers are cautioned not to place undue reliance on forward-looking statements which speak only at their respective dates.

Property can be difficult to sell and it may be difficult to realise investments when desired.

This is a marketing communication and it has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and it is not subject to any promotion on dealing ahead of the dissemination of investment research.