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UK RETAIL INVESTMENT MARKET

Q2 REVIEW

RICS

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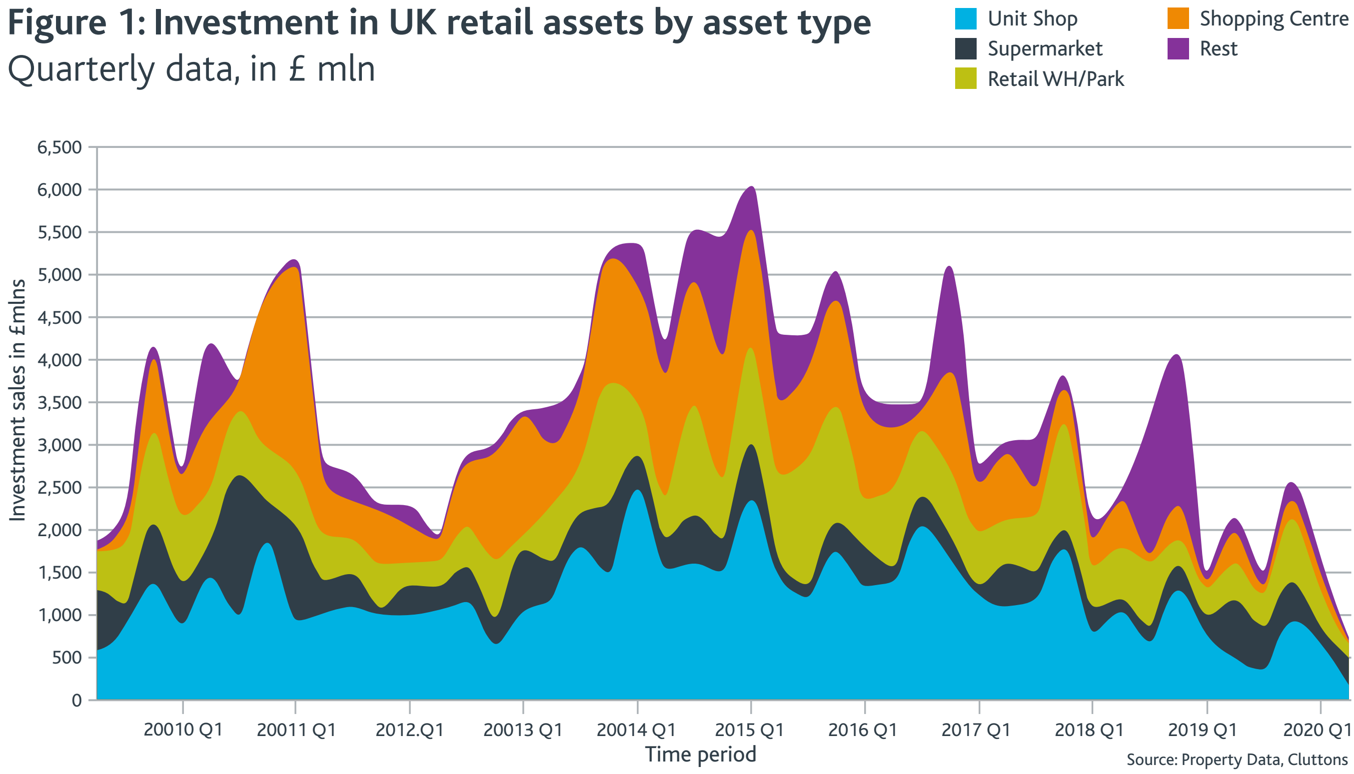
RETAIL INVESTMENT MARKET SHUTS DOWN DURING THE COVID-19 LOCKDOWN

The security of (future) income, the basis of investment value, has found itself on sudden shaky ground. Economic, leasing and investment activity nosedived during the second quarter (Q2 2020) after a national lockdown was imposed on 23rd March to decrease the spread of COVID-19. The lockdown was eased with non-essential shops reopening from 15th of June.

A halt in all but the most essential activity put a strain on cash flows for occupiers and investors. Genuine distress and opportunism by some retail tenants meant that rent payments to landlords were on average an estimated 32% lower than usual. Listed REIT Hammerson only received 37% on the rents on the quarter-day at the end of March. The blow to physical retailing was likely to have played a big part in the decision by Orion Real Estate Fund in May to walk away from its purchase of seven retail park assets from Hammerson, forfeiting its deposit of £21m. The £401m deal had been brokered at a 22% discount to valuations dating to June 2019.

In a break with tradition income receipts are now less certain, especially for sectors more affected by the pandemic such as retail. Generally, investors take a long-term view in their asset allocation. Investors were already in the process of re-balancing their property portfolios with a decreasing share in retail and a greater share in alternatives, logistics and residential. The current health crisis is by most considered to simply have accelerated existing trends, and no immediate strategic action was needed.

Figure 1: Investment in UK retail assets by asset type
Quarterly data, in £ mln



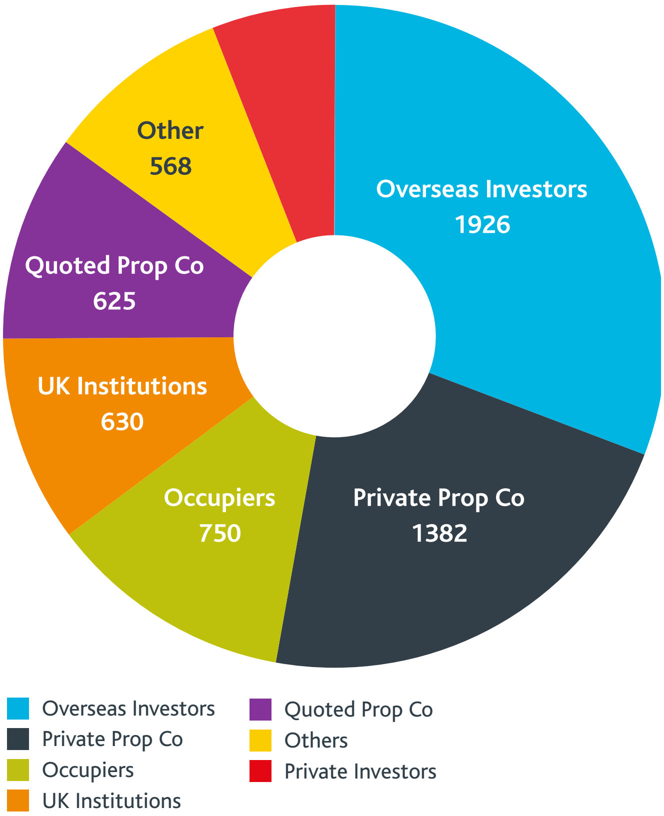
Source: Property Data, Cluttons

However, investors do not like uncertainty, and those able to do so sat on their hands, waiting to see how the situation would develop. They will hope for better, possibly distressed, opportunities over the next few years. In Q2 c.£630m was invested, 71% lower than the £2.18bn invested in Q2 2019, as can be seen in Figure 1. The main bulk of investment (61.1%) was invested into supermarkets, with another 22.6% into retail warehouses. Shopping centres represented a mere 0.5% of the total.

The investment market freezing up lowered transparency and market volatility at the same time. A lack of property transactions and thus market comparables, frequently led to a valuation uncertainty clause being invoked during Q2 2020. With a relaxation of the lockdown in Q3 2020 activity is expected to come back noticeably yet be relatively subdued going forward, with many investors keen to wait and see. A side effect of low liquidity is that you cannot take money out to reposition afresh.

Figure 2: Retail asset purchases

In £ min by type of investor, 12 months to June 2020



Source: Property Data, Cluttons

OVERSEAS INVESTORS REMAIN THE DOMINANT INVESTOR GROUP FOR RETAIL ASSETS

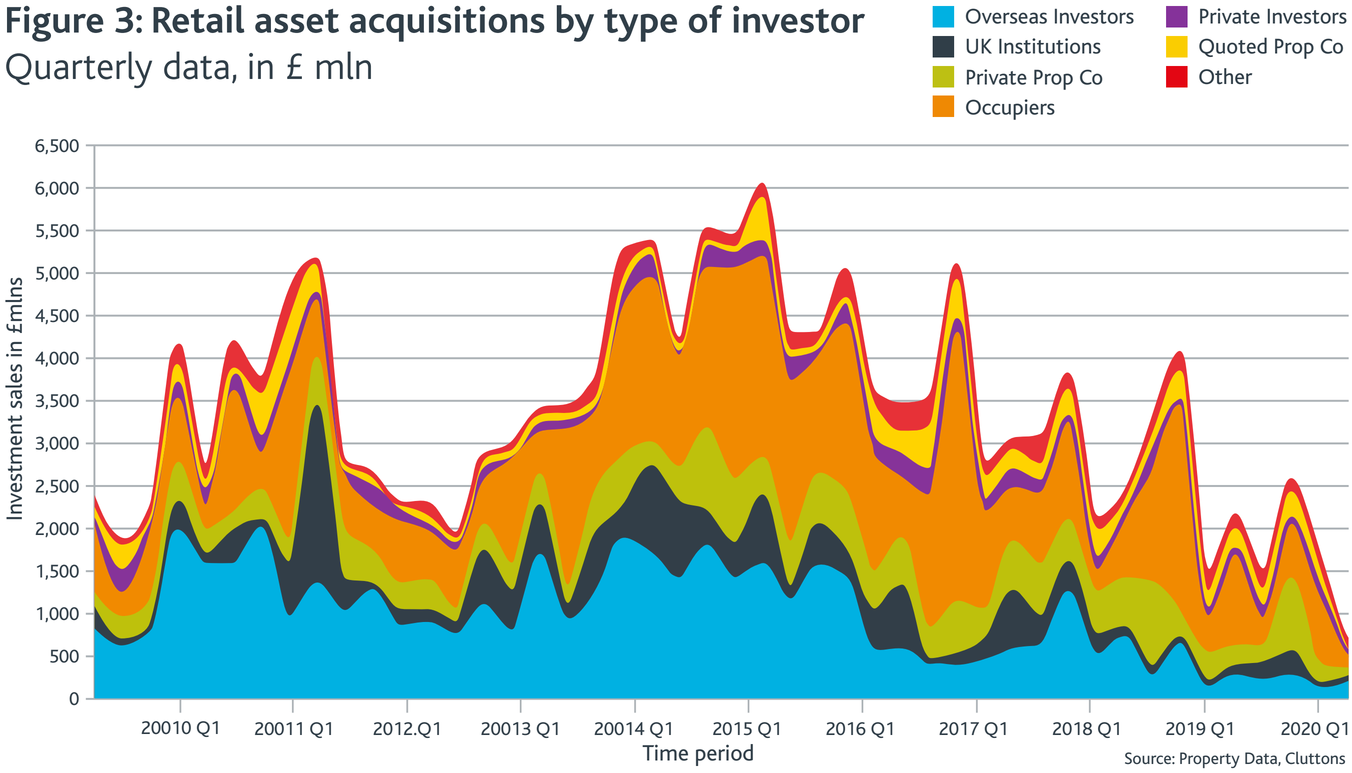
Overseas investors have become a dominant force in the retail investment market since 2013, peaking at £3.2bn of investment in Q4 2016. In Q2 2020 they still made up the biggest group at 34%, followed by quoted property companies with a 18% share.

Unlike UK institutions and property companies, many overseas investors are still in the process of building up their retail portfolios. Going forward we expect them to remain the largest investment force, with investment from Asia-Pacific increasing further. If at some point the influx of money from them were to be reversed this would have a marked impact on the investment market, but this is unlikely to happen in the short-to-medium term.

The investment market is likely to remain subdued compared to the high transaction levels witnessed over the last few years (Figure 3). But the bond market faces a lower-for-longer environment, and property yields – akin to 'fixed income' – remain relatively attractive on that basis. Investors with 'dry powder' money to invest are waiting for attractive opportunities to appear.

Figure 3: Retail asset acquisitions by type of investor

Quarterly data, in £ mln



Source: Property Data, Cluttons

TABLE 1: PRIME EQUIVALENT YIELDS FOR SELECT RETAIL SEGMENTS ACROSS THE UK

EQUIVALENT YIELD	DEC-19	MAR-20	JUN-20	TRENDING	COMMENTS
Prime West End shops	2.50-2.75	2.50-2.75	2.75+	weaker	
Prime unit shops	5.25-5.50	5.75	6.25+	weaker	Reflects prime yield in say Cambridge, Oxford
Secondary unit shops	8.00-9.00	8.50-9.00	8.50-9.25	weaker	
Supermarkets	4.75-5.00	4.75-5.00	4.75-5.00	stable	Reflects open market reviews, 15+ year lease
Prime fashion/open A1 park	6.50	6.75	7.00-7.25	weaker	
Prime bulky solus	6.50+	6.50+	6.75+	weaker	Assumes 10 year lease
Prime bulky goods park	6.50+	6.50+	6.75+	weaker	
Dominant shopping centres	5.75	6.00-6.25	6.5-7.00	weaker	Limited sales evidence exists
Weaker shopping centres	8.75-11.00	9.25-11.50	10.00-14.00	weaker	

Source: Cluttons

THE IMPACT OF COVID-19 VARIES ACROSS THE RETAIL SECTOR

During the lockdown, essential shops including supermarkets could remain open. This retail segment, benefitting mostly from non-discretionary retail-spend, fares better in economic downturns than those that depend on discretionary spending. Consequential relatively positive sentiment meant that the prime equivalent yield estimates for supermarkets for Q2 2020 remained stable at 4.75-5.0%.

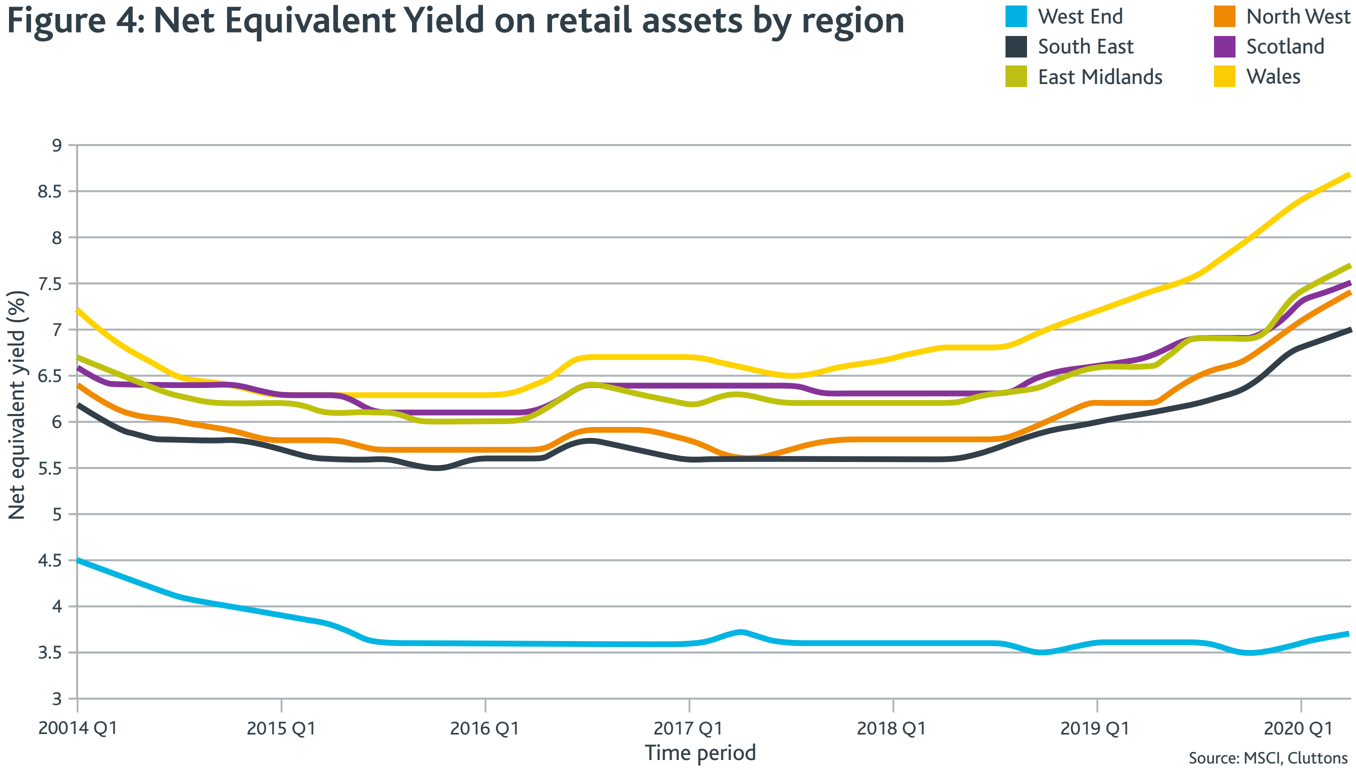
Another sector where yields have remained stable, for very different reasons, is the prime bulky goods retail warehouse sector. This retail segment has had a rebasing of rents to a low, affordable level. In contrast, prime fashion open-A1 retail warehouses tend to have much higher rental levels and falls are likely to be substantial going forward.

Retail parks have suffered an above-average share of retailer failures in the past few years, making many investors averse to this sector. In the current crisis some typical retail park retailers have been trading well such as Dunelm, Pets at Home and Halfords. They have benefitted from trends emerging as people stuck at home seek new pass-times. Retail parks also offer safe and convenient shopping for car owners.

As the government furlough scheme unwinds, more retailers will struggle, and many will become insolvent. Letting activity will be reduced and retailers will ask for more flexibility in lease structures and rental payments. Oddly enough many large tenants that were considered to have a strong covenant have used their weight to get concessions while some of the smaller players, traditionally seen as not having such a great covenant, have continued paying.

Many retailers have asked for rent free periods, rent holidays or other concessions, but not all landlords are willing to accommodate this. Landlords deal with each request on a case-by-case basis, and investors prefer to keep arrears on account, hoping to recoup them at some point in the future. Retailers are seeking turnover rents to match their income flow. Landlords have been resisting this as accepting turnover rents is similar to investing in the underlying retail business on a side by side basis. Besides worrying about opening hours, landlords have practical concerns such as how to get independent, honest, audited turnover figures.

Figure 4: Net Equivalent Yield on retail assets by region



Source: MSCI, Cluttons

TOP QUALITY RETAIL ASSETS HAVE SEEN OCCUPIER DEMAND PLUMMET STRONGLY, WILL THIS IMPACT WEST END RETAIL VALUES?

So far West End prime shop yields have held firm, but reduced footfall and an increase in CVAs and similar will have an impact. West End prime shop valuations generally reflect high rental levels and low yields. There is relatively more risk for this retail segment; investors that have bought a low yielding asset will find an adverse impact on asset performance if the yields move out by just 25bps based on investor sentiment, ignoring any possible gaps in rent collection.

The West End is traditionally considered low-risk with only a finite supply of quality retail 'pitches' and plenty of retailer demand. Low yields also tend to imply superior rental growth prospects. The West End maintained the lowest Net Equivalent Yield (3.7%) in MSCI's UK quarterly property index in Q2, with the best retail assets on Bond Street starting at 2.75%. This expensive market, with its current lack of footfall and tourism, could suffer in the short-term. That said, Bond Street is more exclusive, and rents have been more resilient than in nearby Oxford Street and Regent Street. The test for the Bond Street market will be the sale of Chanel's flagship store which is expected to attract significant interest.

COVID-19 ESCALATES INVESTOR CONCERN FOR BRICKS AND MORTAR STORES

Figure 4 shows the Net Equivalent Yields on retail assets as reported by MSCI in its quarterly index over time. It shows how retail yields have been rising since 2017, bar for prime West End shops. Rental growth turned largely negative since mid-2018 for most markets. MSCI reports a fall by 3.0% for retail rental values during Q2 2020, worse than the 1.1% fall experienced by the index as a whole.

Retail property performance has been dragging down property returns for the UK index, with total returns on retail assets underperforming in the short-, medium- and long-term. According to the MSCI quarterly index capital value growth on retail assets since June 2009 has been wiped out, and capital values are lower now than in the year 2000.

TABLE 2: INVESTMENT PERFORMANCE OF RETAIL PROPERTY VS ALL PROPERTIES IN THE QUARTERLY INDEX @ Q2 2020

ALL RETAIL STANDING INVESTMENTS	3 MONTHS	12 MONTHS	3 YEAR	5 YEAR	10 YEAR
Income return (%)	1.3	5.4	5.2	5.2	5.5
Capital Growth (%)	-5.5	-17.3	-9.1	-5.7	-1.8
Total Return (%)	-4.2	-12.7	-4.3	-0.8	3.6
Market Rental Value Growth	-3.0	-7.7	-3.8	-1.8	-0.9
ALL STANDING INVESTMENTS	**3 MONTHS**	**12 MONTHS**	**3 YEAR**	**5 YEAR**	**10 YEAR**
Income return (%)	1.1	4.6	4.6	4.7	5.3
Capital Growth (%)	-3.0	-7.2	-1.5	0.0	2.0
Total Return (%)	-1.9	-2.9	3.0	4.7	7.4
Market Rental Value Growth	-1.1	-2.0	-0.1	0.9	1.1

Source: MSCI UK Quarterly Property Index, Q2 2020

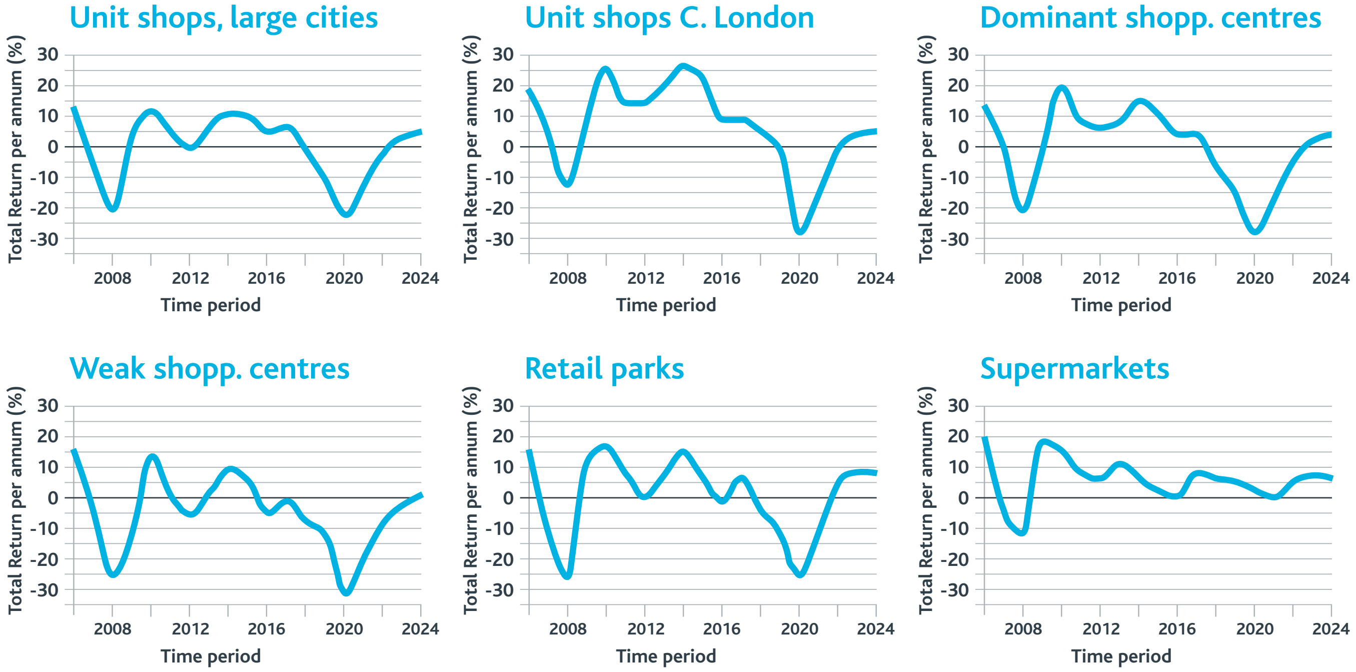
Table 2 shows how over the 12 months to June 2020 retail total returns were -12.7% versus a more benign -2.9% for the index. A gradual repricing of retail assets has been taking place due to structural change and increased levels of risk to investors. This slow, gradual repricing has caused concern among some market participants over the last few years.

There has been criticism that some valuers have been slow to rebase rents in shopping centres and fashion retail warehouses sufficiently, with fund valuations changing more gradually than debt valuations. Further reductions in values must be on the cards now with threats to income becoming even clearer and a shake-out of the sector being accelerated.

In a time of crisis investors go back to core in a flight to safety. Security of income becomes even more important. The investment market prior to COVID-19 was contradictory in that investors were looking for secure income, yet were moving up the risk curve in the face of lower returns due to a wall of money looking to invest, accessing niche investment plays. There are those that continue to look for a repurposing play wherein they buy a redundant or underperforming retail park to convert to last-mile or urban logistics. The purchase by Amazon of a £65m retail park in Mill Hill in Q2 is a shining example of this type of play. Slated changes in the planning system, such as extension of the Permitted Development Rights, will help convert redundant retail units to residential.

Investors' concerns about the impact of online shopping on demand for physical stores have only increased, and the expectation is that online retail sales continue to grow as a share of retail spend structurally going forward. Another concern is that how people shop has changed. For example, will the weekly food shop become a permanent feature, away from the previous trend for small, frequent, convenience-based shopping which was more profitable for supermarkets?

Figure 5: Annual retail total return forecast by retail type



Source: Cluttons, MSCI

GROWTH FORECASTS TO REMAIN NEGATIVE OVER THE NEXT FEW YEARS

A fall in GDP of 20.4% during the second quarter of 2020 would have been unimaginable even as late as last New Year's Eve. Retail property values will not see a commensurate sharp movement, firstly because the property market lags the economy and, secondly, because the current crisis has an external temporary cause. The potential does exist that, if the virus lingers, structural damage will be inflicted on the economy.

Forecasts tend to be worse than initially expected in a downturn and too conservative on the upside during a recovery. Bearing this in mind looking at a relatively negative scenario as a point of reference appears sensible. Forecasting is difficult, and rents are usually the most accurate to forecast over a period of up to two years maximum. Currently it is not certain where rental levels are. Investors are keen to understand the future path or total returns, which is even harder to forecast with any level of accuracy.

Figure 5 shows the quarterly returns by retail type from 2008 with a forecast from 2020 to 2024 assuming a crisis scenario. Assuming a crisis, retail asset total returns in 2020 are expected to be negative between 20.5 to 31.5%, with weak secondary shopping centres receiving the worst predictions. Expensive retail units in the West End are also a prime candidate for a price correction. The big exception is supermarkets which should see a positive total return of c. 2.5% in 2020 even in a crisis.

Total returns might return to positive territory towards the end of 2022 for some retail sectors, but we expect investors to start buying select opportunities at attractive pricing from 2021 onwards. More convincing capital value growth should take place across the board from 2023.

The silver lining is that more efficient business practices can arise due to this crisis leading to a higher productivity and more sustainable economy within the UK. Employment should increase once more, in turn boosting spending power and consumer confidence. With the help of a supportive government and a more flexible planning system the fundamental overprovision of physical retail property can be addressed, and new opportunities created. Property evolves slowly but surely into a new future.

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