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UK RETAIL LEASING MARKET

Q2 REVIEW

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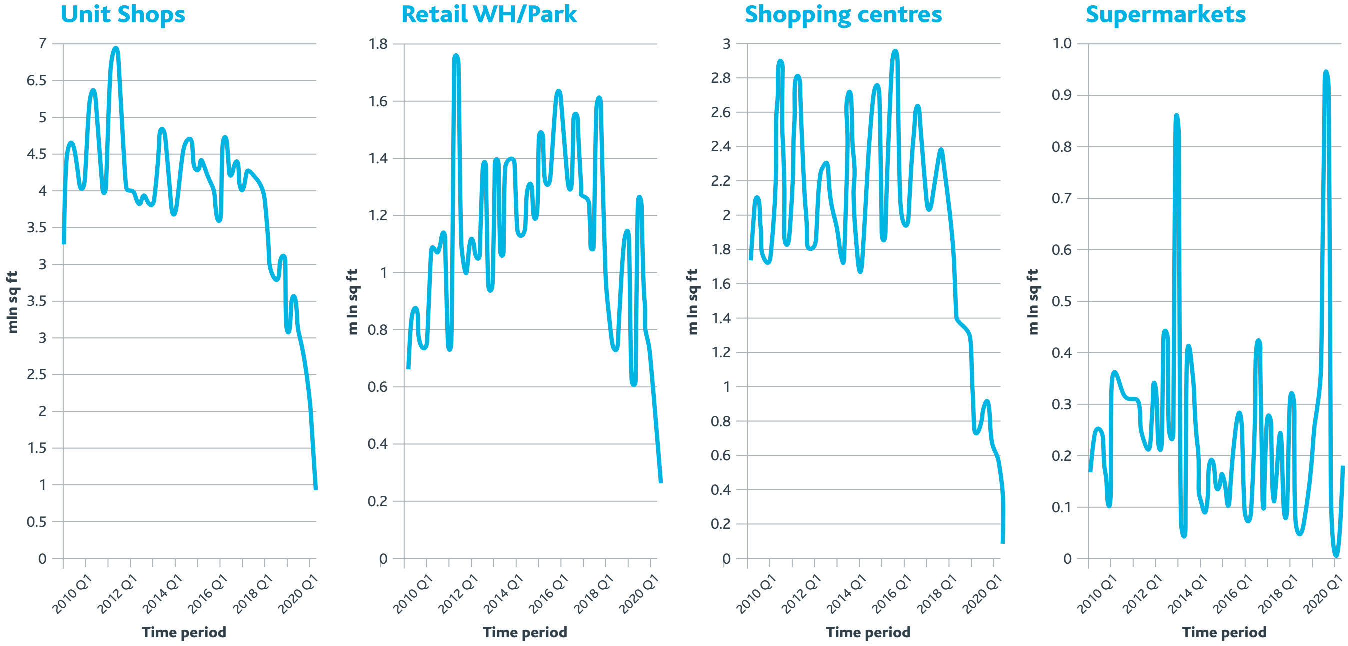
ESSENTIAL RETAIL TAKES THE CROWN AS LANDLORDS AND TENANTS SHARE THE STRAIN OF PANDEMIC LOCKDOWN

COVID-19 is accelerating the trend in the shake-out of retail. The second quarter of 2020 bore the full brunt of a shutdown of large parts of the economy as a lockdown came into force on 23rd of March, shuttering all but the most essential shops until a reopening from the 15th of June. This uniquely uncertain and challenging time put a strain on retail occupiers and landlords, which come in all shapes and sizes, each with their own concerns.

Retail occupiers have had to cope with shrinking profit margins due to cost increases such as higher import and wage costs, while business rates and rents have always been a larger part of total costs in the UK compared to many other countries. Most businesses had to shut temporarily and those that did not have enough cash reserves struggled to stay afloat. Emergency grants and loans were not instantly accessible. Consequently, retailer insolvencies accelerated and will remain elevated over the next few years.

Figure 1: Retail leasing activity by selected retail type

On quarterly basis, includes new leases and lease renewals



Source: Cluttons

In these uncertain times few occupiers take on new financial commitments. Most focus on surviving. Those deals that did take place in Q2 and did not get cancelled or put on hold were in a minority. Businesses tried to renegotiate new leases where possible, but generally rental levels at completion during Q2 are reflective of pre-COVID-19 negotiations.

Leasing activity fell most sharply for the highest-cost top-quality units, down nearly 94% on the 5-year average. Supermarkets saw queues of shoppers stock-piling and emptying shelves. The sector did a roaring trade and leasing activity was down by a modest 14.5% on the 5-year average. Not all was rosy, supermarkets incurred costs due to the implementation of social distancing measures, and supplies were interrupted—in a struggling economy customer spending suffers.

The boom in online food shopping is not really a blessing for supermarkets. Deliveries cost the retailer more than they can charge to the customer. Costs to supermarkets can be £12-14 per delivery depending who picks the items where. Online shopping eats into profits and reduces convenience shopping (the most profitable supermarket segment).

Enclosed shopping centres remained closed throughout Q2 2020, impacting the shopping sector segment, and leasing activity in Q2 2020 reflects this. Shops that depend on workers returning to offices will have a tough time for a while yet. The UK government has offered various schemes in support, helping retailers in varying degree. The furlough scheme helped, but the end of this scheme will trigger redundancies or business failures. Business rates support schemes were only helpful for the smaller retailers.

RICS

average to Q2 2020

TABLE 1: QUARTERLY RETAIL SECTOR LEASING ACTIVITY IN SQ FT VS 5-YEAR AVERAGE IN Q2 2020

	TOTAL RETAIL LEASING ACTIVITY IN SQ. FT.						Q2 2020	
	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020		5-yr avg	vs 5yr avg
UK	**7,010,352**	**6,421,947**	**4,525,517**	**3,452,377**	**1,610,767**		**7,339,212**	**-78.1%**
BY BUILDING/UNIT QUALITY								
Prime quality - all	869,889	933,974	736,300	545,776	103,080		1,659,002	-93.8%
Medium quality - all	4,711,705	3,856,220	2,591,216	1,980,887	1,063,871		4,008,394	-73.5%
Poorest quality - all	1,428,758	1,631,753	1,198,001	925,714	443,816		1,671,816	-73.5%
BY RETAIL TYPE								
Unit shops*	3,571,577	3,046,067	2,687,181	1,953,357	928,804		4,242,070	-78.1%
Retail warehouse/park	1,254,469	838,402	712,566	450,176	251,075		1,081,165	-76.8%
Shopping centre	737,164	777,742	907,512	657,857	556,065		1,759,952	-68.4%
Regional prime	56,763	153,765	58,478	28,190	0		210,814	-100.0%
District centre	238,612	199,825	190,904	64,939	7,169		371,055	-98.1%
Major urban centre	229,552	392,045	270,909	352,310	66,328		620,812	-89.3%
Leisure park	7,254	82,779	14,634	36,157	4,539		54,893	-91.7%
Supermarket	356,495	943,734	98,225	4,931	180,763		211,415	-14.5%

* Unit shops contain typical storefront shops, and include banks, pharmacies & convenience stores, but excludes department stores and low-grade.
Units such as auto repair, auto dealerships, funeral homes, bar/nightclub, restaurants, fast food, garden centres, day care centres, etc.

Source: Cluttons

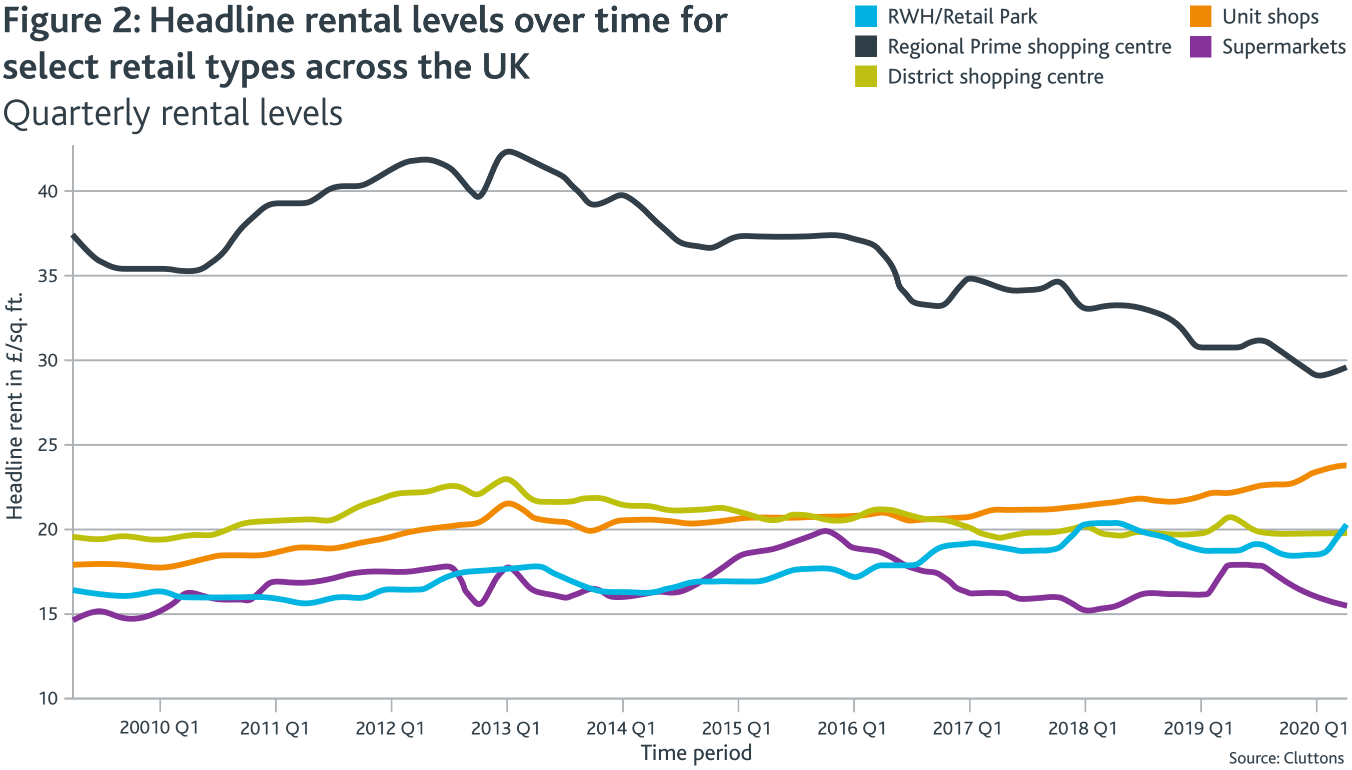
Table 1 shows retail leasing activity (representing new leases and lease renewals) sharply down in Q2 2020, nearly 80% down on the 5-year average. Leasing had been declining due to uncertainty surrounding a no-deal Brexit and other headwinds including a slowing global economy and changes in shopping behaviours hurting some types of physical stores. Large retail chains have been shrinking their store footprint over the years.

The cash flow issues retailers faced meant many approached their landlords to discuss their lease and rental payments. Approaches were dealt with on an individual basis. Discussions about monthly rental payments, rebased rents or rent holidays were common. In only a minority of cases, mostly where there was a strong covenant, were leases lengthened in exchange for a change in rental payments. Landlords look to keep arrears on accounts, not charging interest. This will be a recurring theme for the next year at least.

Flexibility is important. Landlords do not want to see retailers fail, leading to a larger gap in income and re-letting costs in what will be an unfavourable leasing market. But not all landlords are able to (temporarily) waive rents (for example, if debt covenants are being breached). Landlord Intu struggled to keep its head above water. To no avail, in the end.

Figure 2: Headline rental levels over time for select retail types across the UK

Quarterly rental levels



Source: Cluttons

WEAK CONSUMER CONFIDENCE MEANS LIMITED RENTAL VALUE GROWTH

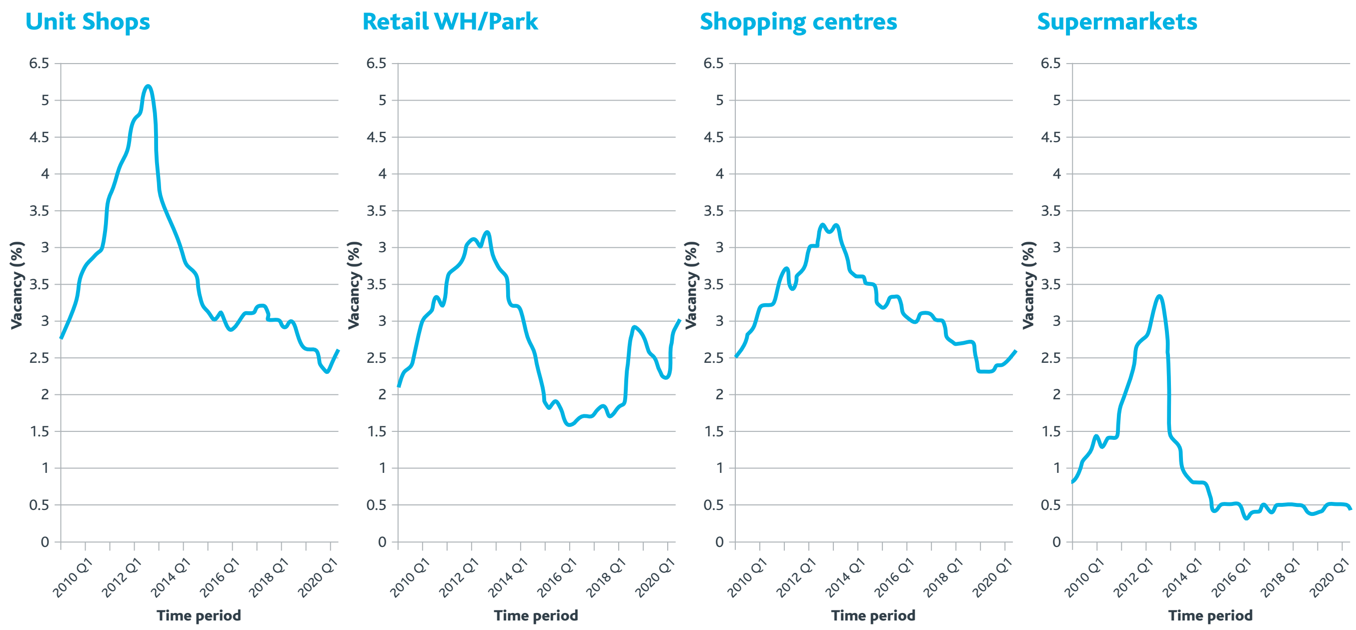
Headline rents have declined most markedly for regional prime shopping centres, which command the highest rental levels. Prime high street shops have seen their rents increase. The not-so-prime high streets had been kept alive in many cases by charity shops, money lenders, betting shops and fast food outlets. These high streets will continue to struggle with rising vacancy. Lease incentives such as rent-free periods or landlord contributions to fit-out costs will become more generous before headline rents start to fall.

Figure 2 shows headline rents over time. Counter-intuitively, rents on retail warehouses and retail parks have continued to rise slightly to-date. This will likely change by the end of 2020, with a step-change predicted.

Retail parks have suffered an above-average level of retailer failures, yet in this health crisis some retailers trade better in retail parks accessible by car rather than from city centres. Some traditional retail park retailers like Pets at Home and Halfords have benefitted from the trend to get a pet or a bicycle.

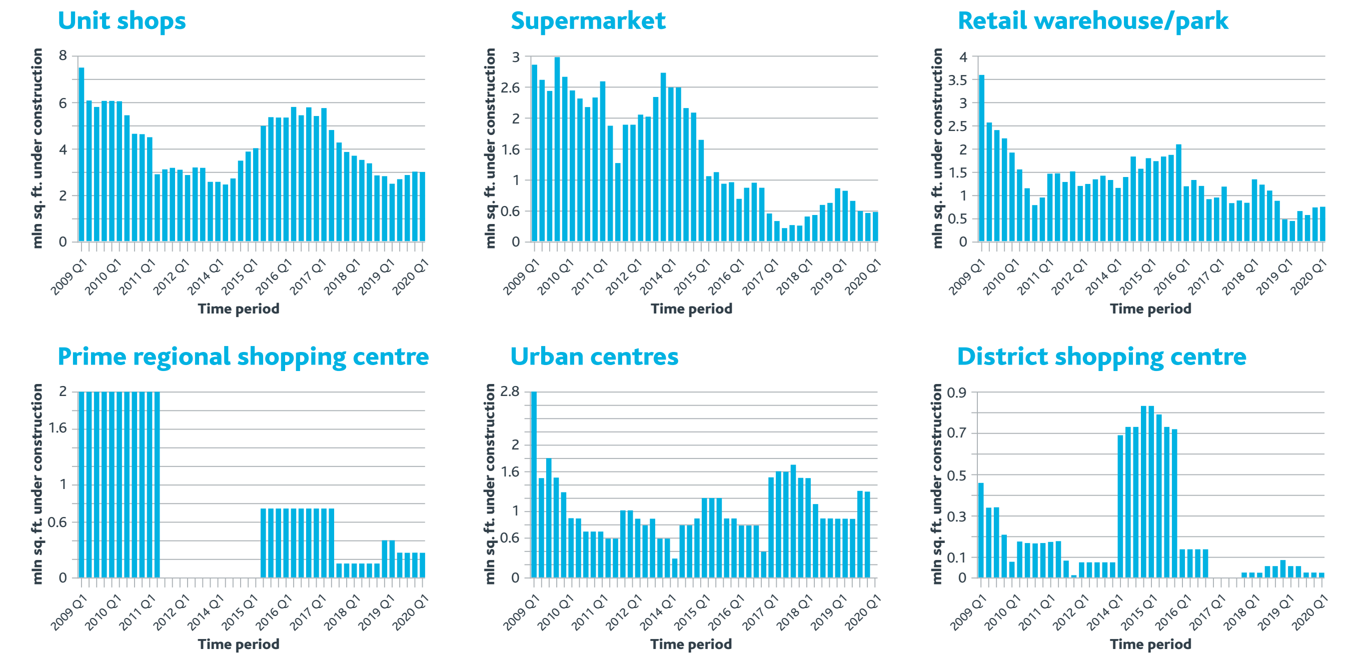
Forecasts for weak consumer spending and low consumer confidence translate into limited market rental value growth – even for the current strongest sector of supermarkets. Restaurant operators and fashion retailers will look on a formulaic basis at what is the maximum rent they can pay. Absolute rental levels matter. For example, fashion open-A1 retail warehouse units have higher rental levels that can fall further than bulky goods units where rents were already rebased to a lower level.

Figure 3: Percentage vacant stock by selected retail type
Quarterly data



Source: Cluttons

Figure 4: Retail space under construction across the UK, by selected retail type
Quarterly data



Source: Cluttons

DEVELOPMENT LEVELS ARE LOW FROM A HISTORICAL PERSPECTIVE

Rents are closely connected to stock levels, new supply, vacancy and availability. Once vacancy rises above a certain threshold rents feel downward pressure. Availability is impacted by the amount of supply coming to the market, including developments and space being returned. Figure 3 shows vacancy levels increasing for high street shops, retail warehousing and shopping centres, but stable figures for supermarkets across the UK.

Figure 4 provides an overview of the amount of space currently under construction and due to be delivered within the next few years. No sector shows a strong current development peak, although high street shops and urban centres have seen a slight increase recently. Shop closures will have a greater impact on vacancy rates than development deliveries going forward, particularly if, given the current climate, proposed developments are halted or delayed.

Cluttons' Building Consultancy team report that smaller jobs continue, and work like fitting-out held up better than expected during Q2 2020. But larger jobs and developments are not as forthcoming as pre-pandemic, and competition to win such work is fiercer.

STRUCTURAL, LONG-TERM VACANCY, OR ALTERNATIVE USE FOR SUPERFLUOUS RETAIL SPACE?

Changing shopping habits have changed the demand for space by retailers, and the fundamental over-provision of physical retail property needs to be solved. As part of sweeping reforms to the planning system, the government is planning an expansion of the Permitted Development Right scheme to include conversions from commercial property such as retail to residential use. Once this policy becomes reality, the difficulties faced when refurbishing buildings to a different use are the next hurdle.

Shopping centres in the north of the UK suffer from low land values, which means alternative use is not possible due to demolition costs. Government intervention may be required to help repurpose now redundant retail space.

> Planning will have to change to account for structural retail vacancies. You get retail warehousing moving to distribution warehousing but it takes a year to drive change in the mindset of local planners.
>
> Steven Cooper, Planning & Development

Amazon has taken the plunge and acquired two retail schemes to repurpose as urban or last-mile logistics centres. One is a vacant former Toys-R-Us retail warehouse in Croydon and the second a retail park in Mill Hill called Pentavia. In the past, retail use had a rental premium over logistics use—this has been turned on its head.

It is wrong to declare the death of the high street. Retail has always changed and will continue to change. Fast-forward to post-COVID-times and there will be a new world where old habits return. Consumers will want to go out and shop, meet friends, and have a coffee again. Dwell-times, wherein uses are blended to create a retail and leisure experience, will become a focus once more. Planning policy has not embraced this in high streets, and fragmented ownership makes planning a retail-mix harder. Government regulation which supports and enables this would be a welcome intervention.

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