RETAIL

RETAIL PROPERTY OUTLOOK 2017

OVERVIEW

- 2017 will be a year of reckoning for UK retail. Uncertainty will not necessarily give way to absolute clarity, but it is a cloak that retailers will find it increasingly hard to hide behind.

- The pressures on retailers are likely to be more bottom-line than sales-based. Consumer demand has held up remarkably well since the Referendum vote and shoppers are unlikely to rein in spending in 2017. Correspondingly, retail sales are expected to remain in positive growth territory and also out-perform the wider economy.

- Increased sourcing costs on the back of Sterling's weakness will be the major pinch point when existing currency hedges lapse. Contrary to popular belief, few retailers are likely to have sufficient faith in consumer demand and belief in their own brand to pass these directly onto customers. Shop Price Inflation will remain below both RPI and CPI.

- Factoring in these cost increases (coupled with others such as the National Living Wage and Business Rates) will be a major conundrum for most retailers. Occupier markets will remain under pressure and it will again be the survival of the fittest. But UK Retail has shown time and time again that is more resilient than it is usually given credit for.

STEPHEN SPRINGHAM

Partner, Head of Retail Research

stephen.springham@knightfrank.com

+44 207 861 1236

HIGH STREETS

- Any predicted 'occupier bloodbath' in the wake of Brexit has not materialised. There may be isolated instances of retail casualties in the New Year, but these are unlikely to bring undue destabilisation to the high street. But the prevailing undercurrent of retailer caution is also not a stimulus for rental growth in many high street locations.

- The rates revaluation will play out very differently in areas across the country. At the one extreme, there is likely to be a significant rise in property costs next year for occupiers in Central London. However, it now transpires that the revaluation is not going to deliver the immediate savings in the provinces that many hoped it would. As a result, the costs of occupation are not going to reduce as much as is needed to regenerate some centres.

- One of the high street growth stories of recent years is entering a new, more challenging chapter. The single price point retailers are starting to feel the pinch as input costs increase. The sector has already seen consolidation (99p Stores and Poundland) and these retailers are starting to move away from the single price sales model and are introducing more expensive higher margin items.

- On the investment side, there is continued demand for the best prime stock, maintaining yields of close to 4.00%. We anticipate stronger demand from the institutions, as the defensive qualities and good liquidity of high street stock continue to appeal to active funds.

London suburbs will be increasingly appealing due to affluent and growing catchments, improving transport links, retail/leisure 'experience', rental growth prospects and increasing scarcity of stock.

- We anticipate a fall in value for the majority of high street department stores, as the market becomes increasingly concerned with the covenant strength of some of the main national operators, the physical nature of the stores, lack of alternative occupiers and rental values.

ALASTAIR BIRD
Partner, High Street Investment
alastair.bird@knightfrank.com
+44 20 7861 1232

MIKE WIMBLE
Partner, Retail Agency
mike.wimble@knightfrank.com
+44 207 861 1569

SHOPPING CENTRES

- In 2017 retail should start to look reasonably good value again, especially against the other mainstream property sectors, most notably offices. Similarly, retail will finally end its several-year run of market underperformance, due to the stability of prime assets (income and yield) and the relatively high income return offered by non-prime.
- The gap between "the best" and "the rest" in the shopping centre sector will grow, with the continued outperformance of prime. The "non-prime" sector remains a market where only the better operators and managers will deliver outperformance.
- Next year will also see the re-establishment of global demand that waned in 2016. However, market volumes are likely to remain low, with especially low levels of "on-market" transactions. London and the South East will benefit from significantly greater liquidity than the rest of the UK.
- Some owners of "non-prime" assets will start to accept the need to sell at lower levels than those to which they originally aspired, which should create a greater degree of liquidity in this market. Yields look relatively stable but where non-prime assets are still seeing income erosion, values could suffer further falls.

CHARLIE BARKE

Partner, Head of Shopping Centre Investment

charlie.barke@knightfrank.com

+44 207 861 1233

OUT-OF-TOWN

- Tenant demand for the better OOT locations will remain positive, encouraging re-gear opportunities, accretive asset management and new lettings, where planning allows. Schemes bought in the last 2/3 years may have a longer WAULT by 2018 as a consequence.

- However, rents remain under pressure given retailer margins and the legacy of 'better days'. Investors will continue to seek 'market-rented' schemes, or build in a risk premium to make the rents right.

- OOT yields softened in the last two quarters of 2016, increasing liquidity (volumes in Q1 ca. £350 million versus Q3 ca. £550 million, in spite of Brexit). We expect trading levels to drop next year, in a sector still dominated by UK institutions and hence yields may harden for the better product. The clamour for long (15 year+) income will drive down yields further, especially in the sub £20m market.

- We expect to see a continuation of new money entering the sector, especially for the 6.0%/6.5%+ assets. Attractive leveraging for long(ish), stable income will attract PE money, overseas equity (backing asset managers), leveraged funds and some private investors will seek representation. However, we may see more of the larger specialist REITS dis-invest further from the sector.

ANDREW MCGREGOR
Partner, Head of OOT Investment
andrew.mcgregor@knightfrank.com
+44 20 7861 1531

LEISURE/A3

- The A3 market (particularly in Central London) faces something of a reality check in 2017. On the back of the rates revaluation there is likely to be a significant rise in property costs next year, over and above the expected inflationary price rises and additional cost of both produce and staff. The uncertainty around Brexit will not help matters, with the fate of the skilled migrant workers, upon which the Central London restaurant scene relies, far from certain.

- Rents are already at record levels in Central London. Mayfair is £150/sq ft + and Soho is reportedly not far off this level. The higher anticipated costs in 2017 could prompt a period of consolidation on the A3 front. These record rents are bound to claim a few casualties, taking into account expected higher operational and occupancy costs, despite the transitional relief that some operators will benefit from when it comes to the rate increases.

- In the face of a potentially over-heating market, we would expect rents to plateau and operators to take a more considered approach in assessing the viability of opportunities when they present themselves.

- From the perspective of the landlord, the highest rent-payer may not necessarily always be the right option. The sustainability of any business is likely to be the deciding factor, rather than just the operator who will pay the most rent.

RICHARD GRISTON

Partner, Retail Agency

richard.griston@knightfrank.com

+44 207 861 1188

FOOD STORES

- The relentless growth of the discounters will slow rather than recede. 2017 will be something of an inflexion point, when Aldi and Lidl reach full coverage in certain markets and have to increasingly contend with cannibalisation and declining like-for-likes at existing stores.
- Conversely, trade at the 'Big Four' will continue to stabilise as heavy investment in pricing, range and service will increasingly bear fruit. Tesco's recent market share gains are sustainable and will continue, while Morrison's and Sainsbury's will also return to market share growth in 2017.
- The big-box development pipeline is still very limited, with few (if any) new store acquisitions. But expansion will slowly come back onto the agenda as the year progresses, albeit in a very measured form.
- Investor sentiment will increasingly warm to the sector as trade stabilises and newsflow from the major operators becomes more positive. However, prospective purchasers will be far more forensic on trading performance and understanding property fundamentals than may have been the case in the past.

RICHARD PETYT

Partner, Foodstore Agency and Development

richard.petyt@knightfrank.com

+44 207 861 5374