RETAIL DEVELOPMENT PROPERTY BRIEFING PAPER 6

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END OF YEAR ROUND-UP:
THE RETAIL PROPERTY MARKET

Introduction paragraphs

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General Economy

- General economic outlook uncertain following global market turmoil – mixed messages from industry and retailers make predictions difficult.

- Stock Market is recovering from its low on 5 October 1998 but remains volatile although recent gains suggest inherent strength.

- Two consecutive quarters of negative growth = recession. No prediction of UK economy achieving this position but banking sector pessimistic.

- Average earnings growth slowing to 4.3% from high of 5.6% reflecting reduction in expenditure potential.

- Export orders have plummeted to 1993 levels but volumes have remained constant over the past three years despite sterling's strength.

- Unemployment has continued to fall (50,000 for three months to August) but employment rate is slowing.

- Primary problem with the UK retail property is the loss of consumer confidence.

- Retail sales volumes rose by 3% over the summer but have since fallen back to 1%.

- Consumer confidence will decline next year, probably starting with a poor Christmas, depending upon retailers' realistic expectation.

- Interest rate cut, although necessary, is unlikely to provide stimulus but may prevent further fall in consumer confidence and expenditure.

- Many retailers at the worst performing end of the Stock Market, including the food sector, eg JJB Sports worst performer in FTSE 250.

- Recent survey by Merrill Lynch that UK buyers of UK equities outnumbered sellers by 32% with under-valued sectors identified as engineering, construction and retail.

- The UK economy is likely to exaggerate a north/south divide to reflect the problems associated with new technology and motor car industries. This will filter through into consumer expenditure and hence South East likely to be strongest region in foreseeable future.

High Street Retail

- In-town demand rose by 13.3% from 23.87 million sq ft in 1997 to 27.05 million sq ft in 1998 (Focus) but peaked at the end of Q1 1998 with current trend downwards as consumer confidence falls.

- Average number of requirements percentage rose from 72 to 80 = 11.1% increase (Focus).

- Average size of requirements grown by 2.1% from 6,625 sq ft to 6,763 sq ft.

- As predicted last year, major city centres subject of greatest demand.

- Average retail rents increased 1997 to 1998 by 6.8% but retail sales only increased by 3.5% (DTZ Debenham Thorpe).

- Rents in major city centres rose by 18% on average (Chase & Partners).

- Market rocked by M&S fall in profits in decision to withdraw £385 million from development programme, but much of this was overseas. However, capital expenditure in 1997/1998 almost double normal investment level.

- Profit warnings issued by several retailers reflect over ambitious target returns rather than any failure in retailers' activities. Nevertheless, retailers' return and fortunes are very unpredictable. Secondary stock is once more under threat.

- Arcadia reported profits up by 19% on increased sales of 7.6% yet share price has fallen by 32% since its de-merger from Debenhams. Debenhams also reported aggressive figures with profits up 16% but share performance remains lacklustre despite 5% sales growth.

- Oasis, New Look, TJ Hughes, Ottakars and Alexon show improved performance.

- BhS are demonstrating confidence with their committed expansion programme.

- Shoe retailers are still finding life very hard.

- Some resurgence on mens fashions, eg Burtons.

- Sports retailers have peaked. Merger of JJB and Sports Division reflects polarising of market.

- Music continues to growth – HMV, Virgin, Andy's and MVC.

- Coffee shops filtering into the high street rapidly.

- Concept/themed retailers such as Borders are new entrants.

- Prime pitch has performed well with few vacancies and lack of supply.

- Retailers have gravitated to quality locations and are now cutting back requirements and hardening terms on which they will take space.

- Rental levels holding steady but inducements on the rise again, including longer rent free periods and improved specifications.

- Some retailers see softer market as a good opportunity to expand provided relocations do not result in surplus vacant accommodation.

- Regional centres and major cities to increase market share with the emergence of super centres.

- Rental levels reached in some of the major cities have growth too fast and may be unsustainable.

- Second tier cities where rental growth has been slower may be more sustainable.

- Lease lengths now steady with 25 years for anchor traders and 15 years for unit shops. However, requirements for more flexible terms – eg break clauses and wider alienation provisions. Retailers paranoid about future liability.

- No evidence of rush of disposals as experienced in 1991.

- There are weak retailers who are vulnerable and therefore we anticipate company sales/closures.

- Car parking provision and charging policies becoming increasingly important. Will public transport fill the void?

- Mixed use developments more popular.

- Potential for greater partnerships between LAs and private developers but CPO powers will be an important factor.

- Retailers appear to be taken action earlier to remedy problems than they did in the early 1990s.
- Seven major shopping schemes opened this year (excluding Central Manchester).
- At least 15 schemes in the pipeline with a real chance of success.
- Regional shopping malls are at top of the league for both sales and profitability, with Metro Centre, Meadowhall, Lakeside and Merry Hill all in the top five.

Retail Warehousing

- The limited number of retail warehouse traders are likely to expose the inherent risks of the sector. About 80 traditional retail warehouse traders of which only a dozen or so now active.
- Retailers who have disappeared recently include Maples, Office 1, Shop for Shoes, Carpet City, Byte, Sofa Workshop, Cantors, Norweb and Seeboard.
- Furniture and carpets suffering most from downturn. Shares have under-performed by about 50% of FTSE.
- Profits warnings from DSF, MFI, Allied Carpets, Harveys and Carpetright.
- DIY sector continuing to polarise following Do It All sale to Focus.
- B&Q taking initiative in depressed market with requirement to expand warehouse chain by 96 stores to 125 stores by 2003.
- Homebase upsizing requirements to compete.
- Collapse of Essex Furniture into administration demonstrates pattern of retailers on the market being the first to fall.

- Rationalisation still a feature, eg Currys purchase of Byte and Seeboard.

- Letting of new schemes much harder despite difficulties of securing planning permissions. Only prime sites will generate interest and competition for space.

- Incentives including substantial reverse premiums offered by developers to maintain rental levels. (Do investors in new schemes appreciate the position?).

- Rental growth falling (FPD Savills, 12.3%, Q1 1998 to 9.6% Q2 1998). (Colliers Erdman Lewis return down to 19.9% for 1998 from 26.2% in 1997).

- Fashion parks are relatively few and far between and should not be confused with traditional retail warehouse parks. However, high street retailer searching for opportunities, eg Co-op HyperTravel, Boots, Woolworths and music retailers.

- With a sharp change in fortunes, rent reviews are likely to be bitterly fought. Implications of the Arbitrators Act 1996 still to filter through.

- Merely having open A1 consents will not automatically secure premium rents unless the right profile of tenants and right size of units can be secured, eg Marks & Spencer. But open consents do extend potential for lettings, eg Matalan, TK Maxx and sports operators.

- Solus stores in good locations still in demand by retailers such as B&Q Warehouse, Wickes, Focus, Matalan, Staples, DFS and Uno but rental levels are lower.

- Still limited number of voids, reflecting pre-let nature of market.

- Landlords will need to concentrate on assets management activities based on sound strategies. Better partnerships required with tenants working to improve the environment.

- 57 retail warehouse park schemes scheduled to open in 1998 comprising 7 million sq ft just 12% short of 1989 record (CB Hillier Parker). With delays and planning problems total more likely to be 5 million sq ft.

- South East currently has less retail warehouse development in the pipeline than any other region.

- Development pipeline will shrink to reflect both demand and planning restrictions. Edge of town and town centre locations will be the focus of new development.

- For most of 1998, demand for retail warehouse has been strong.

- First half of the year 36 shopping centres were sold/acquired.

- Large investments in prime locations attracting premium values not discounts with equivalent yields @ 6%.

- Secondary schemes with lot sizes above £25 million @ 7% to 8.5% equivalent yield.

- Institutional investors have been the main purchasers during 1998. The reverse of the period between 1993 and 1995.

- Total net investment in property by institutions was over £1 billion for both first and second quarters of 1998.

- Insurance companies made their lowest level of sales since 1986.

- Property has performed well in 1998 against equities:-

Commercial property returns	@ 16.1%
Bond/Gilt returns	@ 28.2%
Equity market returns	@ 5%

- All property capital values have risen @ 8.8% this year (IPD).

- Commercial property offers defensive qualities for investors when compared to volatility of other asset classes at the moment.

- Property shares performing relatively well against the rest of the market with the FTSE Property Index falling less than 1% between the beginning of August and the end of September compared with 5% to 7% drop in the All Share Index.

- Increase in Stamp Duty to 3% for higher value properties has come at the wrong time. Property dealing much harder to achieve needing 10% return just to cover costs. This has resulted in inertia in the property investment market place.

- Volume of investment sales is reducing with a 39% fall in first six months of 1998. Lowest level in two years.

- Falling equities have raised the percentage of property held by value encouraging pension funds to reduce allocations for further property acquisitions or undertake sales.

- Speculative development has been limited, restricting the amount of new investment supply.

- Nominal bank property lending @ £35 billion in 1998 (£42 billion in 1991).

- Valuation yields higher than 1990. Between 1986 and 1989 Land Securities reported initial valuation yield of 5.5% or less. Land Securities' initial yield over the past two years has been 6.8% and 7.8%.

- Prime yields:-

High Street Shops	4.5%
Retail Warehouses	5.5%
Secondary Shops	8%-10%
Secondary Retail Warehouses	10%

- Fewer retail warehouse park investment transactions in 1998 than 1998.

- 40 retail warehouse investments placed on the market since September. Many of poor quality but tends to reflect nervousness of market and lack of confidence particularly secondary stock.

- Pillar dominated retail warehouse investment acquisition market:-

    - ♦ Pillar and two others in trust acquired Monks Park for £88 million, reflecting net initial yield @ 5%.

    - ♦ Pillar and two others set up offshore fund to acquire Fosse Park for £205.5 million to show net initial yield of 2.9%.

    - ♦ Pillar acquired Broughton Park for £74 million reflecting net initial yield of 5%.

- Investment market in retail warehouses has softened since September by approximately 0.5%.

- No evidence yet of shopping centre or prime high street shop yields softening but this is likely to happen.

- Leisure investment remains strong, fuelled by good demand and led by MWB Leisure Funds, together with other institutional requirements encouraged by long leases and good covenant strength of tenants.

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