RETAIL DEVELOPMENT PROPERTY BRIEFING PAPER 14

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END OF YEAR ROUND-UP
THE RETAIL PROPERTY MARKET

MARKET OVERVIEW

Defying gravity is the way some describe the current commercial property market; strength and stability in bricks and mortar in a volatile world is the alternative. There is no denying that despite weak occupational demand, investment in commercial real estate is at record highs. With over £100 billion in loans to property companies and other investors coupled with frantic buying by institutions it is no surprise that capital values are rising.

As capital growth reaches its peak the question is can low yields continue without rental growth? At the present time the answer is yes as low interest rates and volatile equity markets encourage the flight to property investment.

In the retail sector there are a number of characteristics which strengthen the investment argument further. Yields, for good quality shops between 5% and 7% look attractive. Shops are still being let on relatively long leases to good covenants and benefiting from few voids with over renting limited to only some of the major city centres. Shopping centres offer even greater discounts on yields but where asset management provides opportunities to improve tenant mix and increase rental income.

In the retail warehouse sector the restrictive planning policy regime has provided only limited new development over the past four years strengthening the position of existing schemes.

Current market circumstances are unique with few guides from the past. Property is a good bet but like anything else caution must be exercised when pricing the product. Getting carried away will be the real danger but for the moment the fundamentals on retail property both in town and out of town and for the occupier and investor look good.

SHOPS

Lease Flexibility

- Commercial Lease Code – concern over landlords response.
- Flexibility on terms to be tested by Government.
- TK Maxx have secured 10 year break clauses on 99% of their portfolio (now 110 shops).
- Secondary space most problematic from landlord's perspective with some notable voids.
- Issue of higher rent for more flexibility still to be addressed.
- Consider overall void cost of a retailers disposals book, more flexible leases would allow this to be significantly reduced which will produce lower overheads to the company.
- Are funding agreements restricting a developers approach to flexible lettings?

Retail Growth

- Consumer expenditure supporting cautious retailer demand.
- View from BCSC is a market of extremes.
- Some retailers making good money, some bad but not much between.
- The market is signalling uncertainty which suggests that the prospects for future growth may be patchy.
- Demand is strong from major multiples for modern well configured stock in the right locations where rents will continue to rise.
- New Look moving off pitch on a new business model and no longer competing in prime market.

Small Towns/Large Towns/Cities

- Large cities and major centres have fallen back in terms of growth this year.
- Still a general perception that the bigger centres continue to take trade from weaker catchments but some slight shift back to second tier towns.
- Some of the larger cities are overrented.
- If retailers can't make money then they won't go there! See New Look also Superdrug and Habitat.
- Following Sanity's purchase of Our Price a decision has been made to expand in smaller towns.
- If there has been an overcorrection in the downward movement on rentals in smaller towns retailers have an opportunity to make better returns.

- Debenhams small store scenario circa 40,000/50,000 sq ft for smaller catchments, still providing a full store offer but with the help of mail order and internet channels.
- Market readjusting just when the industry was about to write off small towns.
  The indicators above suggest small towns still have a future.

Shopping Centre Development Process

Anecdote

*The agents board is up on the vacant car park site and the **local retailer** rings up (as many do).*

"I want one of those new shops !"

Agent
"Well, we're still negotiating with the council. Then, we've still to get planning where some of your locals are not being too helpful. We can't start the CPO and RCO until we obtain planning, then there's the Public Inquiry and a wait for the Inspector's decision, before the judicial review period. Although we are well on the way to securing the major retailer pre-lets, we are still to go unconditional which will allow us to start on site, but it's then a 2 year build period to deal with the phased road and car park requirements of the council."

Retailer
'Well how long for my shop?'

Agent
'About 5-7 years!!"

The next call is from a **multiple retailer**

"5 years. You must be joking! I've got 40 units to acquire over the next 2 years – we'll have to go elsewhere."

The final call is from the **developer client**

"Does my return warrant the risks of the whole process ?"

- With an increased planning burden due to environmental assessments, etc and increased dialogue and engagement with councils as well as the public, upfront costs are increasing, leading to greater risk at an earlier stage of the development process.
- Developers are likely to seek a greater return for the management of an increasingly difficult and risky process.

- Ultimately in the case of many town centre developments this will lead to lower residual land receipts and even longer lead in times.
- Only one major town centre development opened in the UK during 2002 – Basingstoke (85,000 sq ft).

Anchors in the High Street

- The width and variety of tenant mix is really the High Street's anchor.
- Quality and ambience of the shopping environment ie, paving, furniture, lighting, signage, planting and security are becoming more important.
- Good transport links, are critical.
- Markets draw support.
- Car parks continue to act as anchors.
- What is the future of Littlewoods now owned by the Berkeley Brothers?
- M&S coming back strongly but will they always be in the traditional High Street?
- Bhs continues to thrill.
- Next increase the size of their stores again.
- Size continues to be important.
- TK Maxx and JJB on upper floors 12000 – 30000 sq ft stores (efficient space syndrome).
- Hennes, Uniqlo and Zara rolling out national acquistion programmes.
- Food stores in town Tesco and Sainsburys go head to head with M&S.
- Gap does not have the cachet it once had.
- Dixons now seeking single units of up to 40,000 sq ft in town for XL format.
- Some leaving such as Habitat where rents are too expensive i.e. Glasgow, Buchanan Galleries.
- Certain operators starting to realise the strength of their brand.
- As size, and brand take over as the dominating influence then edge of town or peripheral rather than out of town locations with good access will become viable as an alternative to the High Street for major players.

Mixed Use Development

- Is this relevant to non-food retail?
- More likely to be high street shops plus residential.
- Mixture of residential and leisure?
- Food with residential above? Already happening in London.
- Non-food retail still edge of town but rarely truly mixed.

- In the South East, the high residential values can help to make sites viable.
- With town centre living more common in the major cities – Manchester, Birmingham, Glasgow, Liverpool, etc increasing values will help to improve viability, even in fringe locations.
- A3 pub and restaurant uses need to be treated carefully due to noise, cooking smells, servicing, etc.
- Tenure, service charges and options for the future redevelopment all add to the difficulties of funding vertically integrated blocks.
- In London there may be more affordable housing requirements but every commercial scheme will have some residential use which might be best on the first floor i.e. 'above the shop'.
- Romford Brewery site has some residential but not immediately adjoining the leisure or retail.
- Hemel Hempstead – non food retail of 60,000 sq ft changed to a mixed use shopping centre.
- CPO powers needed to create large and suitable single sites which are rare, for example Brintons Carpets at Kidderminster and Railtrack/Gazeley Properties at Norwich.

Covered versus Open Centres

- The planning process now calls for greater engagement with the community.
- Developers now appreciate that as part of this process there are direct benefits to their development from wider improvements outside of the immediate development area.
- This approach will continue to take us away from the isolated and inward looking spaceship approach of the 80's.
- Open centres or a combination of covered and open sections will allow better integration with rest of town centre.
- The whole town centre environment rather than just an enclosed scheme will also encourage more shopper visits.
- Witness the feel good factor of walking in the open with strong civic architecture and quality landscaping ie recent improvements in Manchester following the IRA bomb.
- There are financial benefits of working with an open scheme - lower build costs, lower service charges which leave a greater opportunity for increased rents.

- Easier to integrate A3 pub and restaurant uses.

Food in Town Centres

- Greater dining at home, more town centre living and mixed use development – people need food on their doorstep!
- Public Transport integration with the high street is becoming more important – food is an obvious neighbour.
- Planning pressures will reduce out of town options
- Surface parking is a prerequisite of most food operators is generally uneconomic in town centres but the improvement in quality of design of decked and multi-storey parking means supermarkets are prepared to consider these options.
- Money rich, time poor syndrome will perhaps mean that people will no longer be prepared to waste time on 2 shopping trips, one out of town food trip and one in town comparison trip. (eg Kingston, John Lewis store with Waitrose in the basement).

RETAIL WAREHOUSE SECTOR

DIY Sector

- B&Q
  - Expansion drive – 4,000 jobs in 17 proposed new stores in 2003 including trial 'mini' warehouses.
  - Considering further two storey Warehouses inside M25.
- Focus/Wickes
  - Flotation pulled in July leaves the group concentrating on Wickes brand.
  - Focus Wickes Warehouse to be limited to major conurbations.
  - Wickes "extra" trial format 50,000/60,000 sq ft.
- Homebase
  - Small town requirement – 20,000 sq ft.
  - Large Swindon store opens with concessions.
  - Mezzanines increase sales space of existing stores.

Electrical Sector Powers On

- Currys
  - Contemplating 40,000 sq ft stores in 'most' towns through extension and relocation.
- Comet
  - 20,000/25,000 sq ft rather than 30,000 sq ft stores.

- Norweb
    - Retail Limited MBO completed in October.
- Powerhouse
    - Future target for flotation.

Administrator of Tempo sells the leases, not the business.

Development/Refurbishment

- Pipeline gradually reducing.
- Tendered sites obtain 'top dollar' i.e. Exeter, Digby Hospital.
- Big shopping parks letting well e.g. Castlepoint, Bournemouth.
- Complete redevelopment of first generation parks proposed.
- Refurbishment, rebranding, resigning creating improved retail environment.

Other areas of Activity

- Kingfisher
    - Comet to be sold to leave B&Q and Castorama.
    - Chartwell Land disposals announced November.
- Childrenswear
    - Mothercare still at toddler stage. New format in reduced area.
    - Mamas & Papas announce new openings.
- Furniture/Carpets/Home Furnishings
    - MFI link with Ethan Allen (opened two shops).
    - MFI buy Sofa Workshop, Oct.
    - Courts successful downsize programme with new trading format including mezzanine trading.
    - IKEA, appeal turned down at Stockport, Oct.
    - Kingdom of Leather rebranding.
    - Marks & Spencer Home Store requirement – first deal at Gateshead for 60,000 sq ft ground floor plus mezzanine. Bought the site to build it themselves.
    - Texstyle World disposals south of the border.
    - Homeform rumoured sale, Nov.
- Halfords sale from Boots to C.V.C. Capital Partners: look out for their excellent property website.
    - Smaller store requirement.
- Clothing/fashion/footwear
    - Next open stores not on 'fashion park'.
    - Uniqlo/Deichmann – concentrating on the high street.
    - Matalan continue expansion, including large shops in London high streets.

- Argos opening aggressively.
- Borders, Brantano, Staples continue expansion plans.
- John Lewis opened food/non-food store in Cheltenham.
- Brown & Jackson
    - Demerger of WEW and Famous Brunswick Shoe Factory.
    - Poundstretcher now on its own with Angus Munro at the helm.
- Migration from the high street to out of town continues including Early Learning and Clintons for the shopping parks.
- Drive through restaurant expansion, i.e. Pizza Hut, McDonalds, KFC.

Mezzanine Trading Floors

- More tenants are using mezzanines for trading.
- Occupiers now include Homebase, Courts, Next and other fashion retailers.
- Rent is payable on the ground floor area only so retailers are able to increase sales space by investing in the mezzanine floor as part of the fit out.
- Implication on developers to provide floor strengthening and sufficient height (6.5m min).
- Landlords seeking to ensure their park or ones they buy have ability to allow mezzanine trading.

Two Storey Developments

- While retailers have included mezzanines (and IKEA have had a two storey format) B&Q opened their first double decker Warehouse in March at Sutton.
    - Dealing with their sister company Chartwell Land helped the negotiations on the innovative store.
    - Initial results are good but format likely to be copied only in certain locations e.g Castlepoint in Bournemouth.
- Planning requirements in London forcing retailers to look at providing residential use above the ground floor shop.

Areas of Concern

- Daewoo administration, Oct.
- Lack of new businesses launching out of town concepts.
- Second hand accommodation in poor locations remains difficult to let.
- Signs that restricted planning policies are stopping new retailers as rents go up and cost of entry increase.

Lease Flexibility	• Little evidence of Code of Practice being referred to on Retail Parks and no change in style of negotiations reflecting competitive market and tenants drive to secure space. • No evidence of retailers offering to pay a higher rent in order to have more flexibility. • Short leases of 15 years – increased in last 12 months.

Issues in Retail Warehouse Rent Reviews and Valuation	• Divergence in Value depending on
	  o Scheme size – critical mass crucial.
	  o Quality – though should not be confused with lack of maintenance.
	  o Age – Increasing problem of obsolescence.
	  o Planning permission – open A1 v bulky goods.
	• Evidence
	  o Relative lack of open market evidence, particularly for solus/cluster developments.
	  o Abundant rent review/arbitration evidence and units officially/unofficially on market – is this good evidence?
	  o Limited evidence of shorter terms i.e. sub 25 year leases and those with break clauses.
	• Analysis of Evidence
	  o Capital contributions/rent free/enhanced specifications – all are incentives and should be treated similarly.
	  o Amortisation period – 10 years becoming accepted as compromise position by most in market and by Arbitrators and Experts.
	  o Accounting standards procedure viewed as not relevant.
	  o Existing mezzanines on lettings – how do we analyse – rental or amortisation of equivalent capital cost approach.
	• The "Hypothetical Tenant"
	  o Is it necessary to identify an occupier – tenants are increasingly arguing so.
	  o This is never an issue in other commercial markets.
	  o Can be to landlord's advantage e.g. evidence of furniture and electrical retailers in bidding wars for the right product.
	  o However, in general the need to identify a "hypothetical tenant" will cause more problems than it solves.

- Quantum Allowances
    - Broad brush approach not appropriate.
    - Differentials dependent on strength of town retailer representation coupled with demand for example electrical competition for large units - planning consent – Matalan/TK Maxx becomes potential tenants if open A1.
    - In some situations, where competition is strong for large units, differentials may not be appropriate for up to 30,000 sq ft.
- Homebase v Allied Dunbar
    - Will this case mean that the inability to sublet at less than passing rent becomes an onerous lease term, requiring an adjustment in rental.
    - Case to proceed to House of Lords.
- Independent Surveyor Appointments
    - Despite last years additions to the RICS Dispute Resolution Panel, it is becoming increasingly difficult to find Independent Surveyors without conflicts.
    - RICS having to approach 5, 6 or even 7 before an appointment can be made.
    - Problem with practitioners in this small market.
    - If you are in the market, you are likely to have a conflict.
    - If you have no conflict, you may well not be in the market.

LEISURE MARKET REVIEW

Health & Fitness

- Period of consolidation following strong growth.
- Fitness First & LA Fitness reduce expansion plans.
- Duke Street takeover Esporta - merge business with Invicta.
- Proposed merger of Cannons and Holmes Place called off.
- Topnotch in discussion with banks.
- More selective expansion predicted.

Pubs

- High street saturation.
- Down turn in trade.
- Casualties SFI Group plc, Old Monk.
- Reduced expansion.
- Predict emergence of venture capitalist backed operators eg Broken Foot Inns, Porter Black, Wizard Inns, Barracuda.
- Limited rental growth predicted.

Cinemas

- Limited activity.

- Cine UK sold to Providence Capital, US Private Equity firm.
- Attendance resurgence. 174 million – 31 year high.
- Rent Reviews – little up to date open market evidence available.

Ten Pin/Bingo/Night Clubs

- Limited expansion in these sectors.
- Few operators in each sector.
- Limited rental growth prospects, unless criteria right.

Restaurants

- Fast food expansion continues. McDonalds, Burger King, Pizza Hut and Dominos.
- Frankie & Bennys, Outback Steakhouse continue expansion.
- Rental levels neutral, investor sentiment cautious.
- Fish bankruptcy, Aberdeen Steakhouses in administration.

SHOPS AND SHOPPING CENTRE RETAIL INVESTMENT MARKET

- Heated Shopping Centre Market
  - Yields at historically low levels: common perception of market peak being reached;

- Shopping Centre Stock Pile
  - Estimates of amount of stock under offer or on the market as at November 2002 put at circa £2bn; (estimated 30 to40 centres available at any one time).

- Divergence in Capital and Rental Performance
  - Yields low whilst rental growth perceived to be stalling – questionable market fundamentals?

- Strong Monthly Returns
  - Returns for retail sector, October 2002 put at circa 13% against circa 9% for the All Property measure: peaking market?

- Attractive Sector
  - Against ailing general office sector, retail still perceived as robust performer;

- Fuelled by Finance
  - Historically low interest and medium term money rates still fuelling performance and demand for the sector, especially from non-institutional purchasers;

- Fuelled by Limited New Supply
    - Limited supply of new shopping centre stock during previous decade aiding performance;

- Institutional Appetite
    - Strong appetite for stock from institutional sector seeking yield against backdrop of poor equities performance;

- Heated Small Lots Market
    - Finance rates still heating the auction markets: record performance;

- Perception of a Peak?
  Mispriced "dry" shopping centre stockstarting to stick – some portfolios of centres "bouncing back".

RETAIL WAREHOUSE INVESTMENT MARKET

- Strong demand for retail warehouse investments - increasing as the year went on. Yields moved in 0.50% since January 2002.

- Demand from full range of purchasers - Pension Funds, Insurance Company's, Property Companies, the 'Debt Market' and Private Investors.

- Reasons:-
  1) retail warehousing still the sub-sector predicting the best rental growth over the next 3 years. Generally strong covenants in this sector, tight planning / limited new development - pressure on rents,

  2) Consistently low interest rates - cheap borrowing,

  3) Poor performance of the stock market - investors looking for returns elsewhere - property a good bet relatively.

- Prime Retail Park yields

open A1	- 5.50%
bulky goods	- 6.00%

- Prime solus yields - 6.00%
- Secondary - 7.25% - 8.00%

(NB Yields are equivalent yields).

- Relatively little stock available, particularly prime retail parks, but more as the year went on as some owners tried to take advantage of the 'hot' market - for eg Haslemere sold virtually all their retail warehousing (2 through C&P). All sold quickly and for good prices.

- Deals - few examples - Hammerson buying Grantchester, Haslemere portfolios, Kew Retail Park Richmond (Henderson at 3.85% net initial from AXA)

- Wessex Gate in Poole (Prudential at 4.5% net initial, 6.00% equivalent).

TOWN PLANNING

- No further guidance on the issue of retail "need" has been provided over the past year. In truth, the government has provided precious little advice or guidance on the issue of need in the context of leisure.

- Notwithstanding this, the government's interpretation of other elements of PPG6 continue to evolve and recent appeal/call-in precedent provides an insight into the extent to which the government is committed to the class of goods approach and its relationship to the sequential approach to site selection. In this connection a proposed extension to a Tesco superstore in Kettering was called in and rejected by the Deputy Prime Minister.

- Amongst other things, the DPM decided that any new comparison goods floorspace should be accommodated in the town centre. At Cherwell, two new superstores and an extension to Tesco were all rejected, despite agreement on the need for further provision. In this case he was not persuaded that the applicants had been sufficiently flexible in considering their preferred formats.

- Now that the Deputy Prime Minister has set up the Planning Control Casework Division (PCCD), to supervise the decisions of government offices, we can expect a higher level of consistency in decision making, and the message emanating from the above decisions is clear!

- What this does is elevate policy to an even higher position in decision making, thereby reducing the practical scope for consideration of other material issues. Moreover, in recent months the Deputy Prime Minister has shown zealous enthusiasm in overriding the recommendations of experienced Planning Inspectors where he has felt that policy has not been strictly adhered to.

- We are not the only practice to notice that at local plan level, retail policies are starting to look and sound the same up and down the country. National policy is not just followed, but slavishly adhered to. Few local plans seem to be moulded by local circumstances. A Case of National Policy dictating without sensitivity to local needs and circumstances.

- Finally, as the sequential approach is applied to a wider range of land uses (retail, leisure, offices), and as the supply of town centre sites is in practice very limited, will we now have to prioritise the need for a particular land use on any particular site? If so, how can it be argued that retail development is more "needed" than residential?

CONCLUSIONS

Retail property remains a dynamic market place. Investment sentiment is strongly supportive with retail across the board a buy – however weaker tenant demand must not be ignored although low interest rates continue to fuel consumer expenditure.

The relationship between in town and out of town is getting closer, after all the sale of goods is a single market activity, its just a case of where can it best be achieved. Cost is a vital factor and margins continue to be scrutinised.

Planning is failing the economy and property market. It can only be hoped that the Planning Bill has been thought through and can reduce bureaucracy costs and time. Without a better planning approval hamstrung property sector in the UK will lose out to foreign competitors over time.

FURTHER INFORMATION

Further copies of this and previous briefing papers may be obtained from Graham Chase as may additional information or assistance on planning and development issues.

Chase & Partners provide comprehensive retail planning and development services to the private sector and Local Authorities, including 'health checks' and retail impact assessments, and the sequential approach. Graham Chase and Jim Morrissey, Directors of Chase & Partners, have advised over 100 private sector clients and 50 Local Authorities on retail planning matters in the past 4 years.

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