RETAIL DEVELOPMENT PROPERTY BRIEFING PAPER 9

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END OF YEAR ROUND-UP:

THE RETAIL PROPERTY MARKET

Following on from our successful end of year conference held in conjunction with Law firm Trowers and Hamlins, Chase & Partners has pleasure in setting out its views on the market place activity over the last 12 months and its prediction for next year.

Executive Summary

Last 12 months

1. Strong economy but weak consumer expenditure.
2. High Street demand in decline but prime is full.
3. Value retailers re-emerge with strength.
4. Next and Gap take bigger stores and market share from M&S.
5. Sports retailers rationalising.
6. Lease lengths stabilising at 15 years for shops, 25 years for retail warehouse.
7. Movement in retail warehouse market through "churning".
8. Large formats lead market and race for space.
9. Food superstore traders go for flexibility.
10. Investment market strong for all retail property products.

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Predictions

1. Hardening economy in second half of 2000.
2. Internet shopping impact will differ depending on trade.
3. Internet/Mail order searching for high street base.
4. Tighter planning regime will put squeeze on existing space.
5. Considerable change expected in the "High Street" as old hierarchy of shopping will be altered.
6. DIY and electricals will dominate retail warehouse market.
7. Better use of mezzanine and first floor space for retailing.
8. Rent Reviews will be battle ground.
9. Home delivery will grow.
10. More innovative investment vehicles will be created.

GENERAL ECONOMY

- The state of the economy and its affect on the retail property market is more difficult to gauge than ever before. A buoyant housing market with rising prices, strong employment and above inflation wage rises should encourage consumers to spend. This is not happening perhaps reflecting a more educated consumer with different priorities and a weather eye on debt, but more likely signalling fundamental changes in the retail market.

- Inflation fears persist, the underlying trend of 2.1% falling below the Government target of 2.5%, encouraging the Bank of England to raise interest rates twice since September to 5.5%,

- With unemployment approaching a 20 year low, a buoyant corporate sector, increasing credit availability and pressure on wage inflation there are concerns of the UK returning to a boom to bust cycle economy.

- House price inflation is increasing and is currently at an annual rate of 10.8%. The increase in October of 2.8% was the fastest rise recorded in a single month since 1988.

- Despite these indicators expenditure by consumers in the "high street" has been muted to the extent that some observers are fearful of deflation.

- Some of the best retailing names in the UK have struggled and although some of the pain has been self-inflicted it reflects a more fundamental shift in consumer attitudes. M&S's profits for the financial year are estimated at just over £500 million; 50% of those achieved just 3 years ago. Storehouse's weakness, where profits have also halved and the closure of 68 Mothercare units, are providing constant rumours of a break-up.

- Many UK retailers have failed to heed the need to be competitive and concentrate on their margins. Further competition from overseas retailers, internet shopping and "category killers" benefiting from international market exposure and considerable buying power will continue to impact on the UK retail market.

- A hardening economy in the second half of 2000 is likely to exacerbate the difficulties currently being experienced. Consequently there is likely to be more change in the future, not less, with domestic based retailers taking the brunt.

HIGH STREET RETAIL

- In-town demand decreased by 9.1% from 27.05 million sq ft in 1998 to 24.6 million sq ft in 1999 (Focus) reflecting a downwards trend since the first quarter of 1998 for 7 successive quarters.

- Major city centres and regional shopping centres continue to be the focus of consumer expenditure offering the greatest choice.

- Rental growth in market towns continues to struggle particularly in the Midlands and North and where out of town regional shopping centres have affected consumer travel patterns.

- For the first time in a number of years, average size requirements have fallen by 17.2% from 6,763 sq ft in 1998 to 5,602 sq ft in 1999.

- Fashion retailers pressing good first floor accommodation into retailing use to improve efficiency and margins, i.e Internacionale, Next, Gap, Ottakars, JJB Sports, River Island, Etam and Arcadia.

- Discount/Value retailers demonstrate signs of resurgence. Good examples are Peacocks and Bon Marche gearing up for flotation, Mark One acquiring a number of British Gas units and T J Hughes and Wilkinsons expanding southwards from their northern base.

- Arcadia, despite profit reductions have taken market share from M&S and acquired Sears ladies fashion chains from Phillip Green and Barclay Bros. Future plans to promote greater emphasis on value and discount.

- Next and Gap also taken market share from M&S. Next targeting major city centres and regional shopping centres for up to 60,000 sq ft stores on multi-levels reflecting potential for stores of this nature to achieve more of an anchor status. This is against the background of the decline in the fortunes of the traditional variety store retailers. Hence, shopping centres concentrating more on tenant mix and groupings of a diverse range of large fashion traders to replace the traditional anchor facility.

- New Look now recycling existing stock and looking for larger stores, up to 6,000 sq ft sales but only on ground floor.

- Mobile phone market set for rationalisation over next 2 years.

- Sports retailers showing signs of indigestion with rationalisation programmes and portfolios of surplus accommodation being placed on the market.

- Retailers moving forward or backwards but rarely hold middle ground with result that the market is becoming more volatile and polarised.

- Despite the fact that prime high street locations are full and have been for the past 18 months, the future will see considerable change.

- Lease lengths have settled at 15 years on standard institutional terms. No pressure for downward reviews. Shopfitting costs rising and being written down over longer periods.

- New accounting standards may have significant impact on landlords and tenants profit and loss accounts.

- High street retailers are recognising threat of Internet shopping and setting up their own designated web sites (e.g Arcadia, Boots, Dixons and W H Smith).

- Internet shopping will affect different goods in different ways with travel, bulk food, books and music obvious targets.

- The danger of the Internet for high street shops is that their margins are so low that any impact on sales lost or diverted will affect their ability to pay rent. But there are problems with Internet shopping relating to speed of sales, costs of distribution and sales and consumer preferences for immediate ownership. In addition, many Internet sellers need High Street bases. Catalogue shopping still the most likely casualty to Internet.

- By contrast there is evidence of mail order converting to high street retailing and not internet, e.g Tiny, Time and Gateway.

- Retail/leisure offer in the high street has to be upgraded. Shopping centres, particularly traditional town centres will have to be improved and effectively promoted, in similar fashion to regional shopping centres. Town centre management must be a key area for activity and better co-operation between the public and private sectors.

- The tightening of planning policy against out of town retail, although has come late, may well forestall the activities of category killers such as Wal-Mart, Decathlon and The Big W. Considerable hype has raised the issues but no evidence that town centres will have to face significant threats from these retailers.

- Disability Discrimination Act 1995 will have considerable impact on costs and the operation of retail property.

RETAIL WAREHOUSING

- Retail warehouse park development continues to decline reflecting current retailer demand for new space and restrictive planning policies. (15 schemes projected for year 2000 by Colliers Erdman Lewis).

- "Churning" of existing accommodation providing opportunities for both new retailers such as Holiday Hypermarket and established players amending their trading formats such as Currys and PC World and also Comet for the future.

- Development market focusing on the new large DIY formats being promoted by B&Q and Homebase, with space requirements for up to 130,000 sq ft plus external areas.

- Furniture, furnishings and carpet sector continues to struggle with rationalisation programmes being pursued, e.g MFI and Uno. Profit warnings from leaders such as DFS and Allied with the latter sold to Tapis Saint-Maclon, a French retailer. Bright spots do exist with Rosebys acquiring both Fabric Warehouse and A G Stanley trading as Fads.

- Electrical sector promoting a strong image reflecting technological advances and consumer demand. Currys and PC World, subsidiaries of Dixons Plc are market leaders with new larger format stores but being pursued by Comet. Other electricals including Powerhouse and Tempo continue to exploit current buoyant trading conditions.

- Sports retailers have experienced difficulties in a competitive market. Sportsmax were a receivership casualty, JD Sports have struggled to expand out of town and Decathlon have been slow with only 1 trading store but with 2 more now committed. Market leader JJB have spent the last year absorbing previous years expansion.

- The shoes sector which appeared to have failed to achieve its potential in the past is now experiencing a revival as the Belgian retailer Brantano rebadges its recently acquired Shoe City chain and is encouraged from the results to consider expansion.

- Value retailing, as for the high street, continues to be popular with one of the strongest retailers in the market, in terms of growth and profitability, being Matalan. Other active traders include What Everyone Wants and Poundstretcher with T K Maxx forecast to expand next year.

- Argos, following the GUS purchase, have identified a policy for out of town expansion for 10,000 sq ft units. By contrast last year's new retailers, the travel agents, have had to review their expansion programmes.

- Mezzanine floors now being considered for sales and storage areas (same reason as for the high street).

- The large stores which have emerged as category killers in the DIY and electrical sectors have been followed by the first Decathlon sports store opened at Surrey Quays. This approach is now opening up the way for the all embracing operations of Big W and the proposals by Wal-Mart following their acquisition of Asda who as a result, withdrew from their merger negotiations with Kingfisher.

- The Wal-Mart focus on the UK retailing market has generated considerable media coverage and defensive action by domestic retailers including Boots and the food supermarket operators with the latter looking to expand their non-food product lines.

- Rent reviews are more keenly contested with the number referred to third parties increasing to record levels. This reflects uncertainty in the market coupled with a limited number of new open market transactions following the decline in development.

- Evidence from lettings of existing space is often challenged as reflecting one off transactions and consequently is not reliable evidence.

- Quantum of space, specification, assumptions in respect of user and the treatment of rent free periods and incentives are all subjects currently in the spotlight of rent review negotiations.

- Fashion parks are at last being understood with recognition that true opportunities are few and far between. Only those anchored by Marks and Spencer or a major department store, coupled with a food offer will achieve Fosse Park status.

- Open A1 consents are no guarantee of premium rental levels with each case having to be judged on its own merits. In many cases, traditional bulky goods uses will continue to predominate with rental levels as appropriate.

FOOD RETAILING

- Discounters continue to expand but growth is limited as market matures with many new stores purchased by occupiers as freeholds and the difficulties of Kwik-Save/Somerfield overhangs the market.
- Mainstream food retailing from superstores is continuing to undergo change.
- Introduction of a wider range of non-food items is notable. Joint ventures with high street retailer concessions likely to be a feature in the future.
- Food store operators accepting flexibility in respect of physical criteria of floor size, location of storage on first floors and reduced number of car parking spaces.
- Town centres providing greater opportunity for food sales but sites difficult to identify and secure.
- Acceptance of low pricing policies, further emphasised by the threat of Wal-Mart entering the UK market.
- Internet and house delivery services will grow but place additional demands on food traders logistics and methods of retailing.
- To demonstrate difficulties, even stores regarded as state of the art in terms of physical criteria are not immune to changes and competition. Good examples are the Safeway closures and disposals of their stores at Enfield and Brent Cross, London, to Currys/PC World and Homebase (ultimately) respectively but where purchasers have quickly been secured at substantial sale prices.

RETAIL & LEISURE

PROPERTY INVESTMENT

- First quarter of 1999 saw investors return to the property market as fears of a UK recession, as forecast by many in September 1998, subsided.
- Demand for prime and good secondary high street retail property, including shopping centres, has steadily recovered throughout the year. Prime shop yields now at 4.25%, secondary shop yields between 7.5% and 9% and prime leisure at 6.5%.

- Demand for retail warehouse parks has also grown despite a fall in rental growth potential with prime yields remaining at 5.5%.

- Returns from retail warehouses are falling. IPD Index for 1997 was at 25.1%, at 12.2% for 1998 and for 1999 is anticipated to be 9.7%.

- Returns from shop property are more stable but now higher than retail warehousing. IPD Index for 1997 was at 16.3% and for 1998 was 10.5%. For 1999 it is anticipated to be the same at 10.5%.

- Lack of stock for both high street and retail warehouse investments. Demand for suitable product from investors remains high fuelled by low interest rates and an expensive equity market, despite increases in stamp duty and lower income growth potential.

- Tighter planning regime has restricted supply of retail warehouse investment product just at a time when there was a danger of over supply. Consequently, low yields have been maintained. Knock-on effect on secondary market where yields have also fallen, encouraged to a greater extent by lower interest rates. UK property auction market has benefited with high sales and prices.

- Low interest rates have allowed property companies to compete effectively with institutional investors, adding to the pressure of demand for prime investments.

- Small property companies securing finance from city investors and venture capitalist providing liquidity and flexibility.

- Low turnover of retail park investments sold during 1999, reflecting owners reluctance to sell. Most disposals have been smaller lot sizes below £10 million and solus stores, where rental growth is perceived to be more limited.

- Forward funding for new retail developments, where they exist, are attracting strong interest from investors. Yields paid usually the same as market values for completed schemes and low fixed interim finance provisions. Profit share arrangements increasing in importance, particularly tied in with pre-letting and rental growth performance during development period.
- Investor caution to leisure property market reflecting changes in fortunes of multiplex cinemas with operator rationalisation. More realistic approaches now being adopted as true potential of cinema audiences and growth in attendances is identified.
- Rapid growth in public house and bar accommodation coupled with well publicised corporate transactions has made investors nervous about the future and potential for returns.
- Increasing interest rates will affect both prime and secondary markets.
- Y2K will stagnate market between September 1999 and March 2000.
- Securitisation now being considered by UK Treasury positively for tax transparency status after several years of suspicion.
- More flexible and imaginative arrangements will be considered for investment, particularly through joint ventures between property companies and occupiers and limited partnerships between institutions and property companies.

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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