HEADING OUT OF TOWN
THE CHANGING LANDSCAPE OF THE RETAIL WAREHOUSING MARKET
HIGHLIGHTS

Property returns look attractive relative to other investments. Whilst post-Internet retail investment is a risky arena, retail warehousing looks best placed to serve the modern, multi-channel customer. A significant yield gap to peak pricing and the possibility of more freely available debt stimulating interest in secondary assets, suggests scope for modest yield compression over the coming year.

Whilst an increasingly diverse range of occupiers have driven vacancy rates below pre-recession levels, pressure on margins from multi-channel retailing, communication between operators and the spectre of a downturn have diminished retailer appetite to compete for units. This lack of direct competition, combined with limited evidence on parks with low turnover, makes driving rents forward challenging and, as a result, overall rental growth is proving elusive.

A lack of supply is making development viable again in pockets of the country, particularly the South. However, a shortage of suitable sites, high alternative use values and town centre protectionism are limiting the pipeline of new build retail warehousing, with development instead being existing asset led.

There has been a blurring of the boundaries in the retail warehousing market as:

- Operators increasingly see Retail Park stores in the same space as the rest of their portfolios
- The same selection of investors and asset managers are active across shopping centres and retail warehousing
- High Street brands have moved heavily into the out of town sector
- Landlords have gradually widened planning restrictions on parks
- Retail warehousing developments on the edge of centre sites and greater leisure provision on parks are challenging the concept of retail warehousing as being ‘out of town’

RETAIL WAREHOUSING INVESTMENT VOLUMES AT A NINE YEAR HIGH

Retail warehousing investment volumes exceeded £4bn in 2015 as the quantum of deals in the sub-market returned to pre-recession levels.

As figure 1 shows, retail warehousing transactions exceeded shopping centres for the first time since 2009, reflecting an increased focus, particularly from overseas investors, in this traditionally institutionally dominated market.
**YIELD STAGNATION WITH A SIGNIFICANT GAP TO PEAK PRICING**

However, these increased volumes have not driven significant yield compression in the retail warehousing market. Figure 2 reveals marked hardening of high street and shopping centre yields over 2014 with these assets now sitting only 20bps and 55bps from peak pricing, respectively.

By contrast, retail warehousing yields moved in over the first half of 2014, but have since stabilised or arguably, in the case of secondary assets, drifted slightly towards the back end of 2015.

Whilst there is an argument that structural changes from the shift to online retail are challenging the relevance of peak pricing, changing consumer shopping habits have also impacted upon the shopping centre and unit shop markets and yet we have seen yields come right back in to pre-recession levels in these sub-sectors, although with great polarisation between primary/secondary and London/Regions pricing.

[![Figure 2: Gap to Peak Pricing by Retail Sub-Sector](image)](image)

Source: MSCI/IPD
PROPERTY RETURNS ATTRACTIVE VS OTHER ASSET CLASSES

The past two years have been a period of exceptionally high property returns and, whilst retail returns have not been as impressive as the office and industrial sectors, both High Street shops and Shopping Centres delivered a double digit total return in 2014 and 2015 (figure 3). In an era of declining required rates of return, retail property can still provide a compelling opportunity through the right assets.

Retail warehousing returns lagged behind in 2015 as significant yield compression failed to materialise, but income growth still supported a c. 7% return. We expect 2016 to 2020 to be a period of lower property returns, in the region of 4% to 6% across most of the retail sub-sectors, with retail warehousing one of the strongest performers over the next four years as rental growth begins to trickle through.

Nevertheless, these lower returns look highly attractive when placed next to alternative investment assets in the current macro-economic environment. We expect UK interest rates to remain low throughout 2016, with any rate rise only incremental at first.

Looking globally, there are a handful of countries facing the threat of negative interest rates, incentivising investment in other assets. The equity market has been volatile thus far in 2016 and, whilst we have seen a recent recovery in the FTSE, the nervousness in the market as a result of global uncertainties from the Chinese slowdown, unexpectedly low oil prices, Brexit and the possibility of Donald Trump as US President mean returns are unlikely to improve in the short term.

The resultant picture is shown in figure 4 where, even with an outlook of falling returns, the opportunity cost of investing in property looks negligible with neither gilts nor equities providing a compelling alternative.

FIGURE 3: TOTAL RETURNS BY RETAIL SUB-SECTOR (IPD 2011 TO 2015, COLLIER'S INTERNATIONAL FORECAST 2016-2019)

FIGURE 4: TOTAL RETURNS BY ASSET CLASS
RETAIL WAREHOUSING IS PARTICULARLY RELEVANT TO THE MULTI-CHANNEL CONSUMER

The challenge remains justifying retail property investment in the post-Internet era as the sector establishes a new equilibrium with online which, over Christmas, accounted for nearly £1 in every £5 spent.

Projected population growth and early signs of stabilisation in online growth rates should mean the structural challenges faced in physical locations over the next few years are less dramatic than those already confronted.

Perhaps one initial indicator of this is the January 2016 Springboard footfall monitor, which recorded rising footfall across all three location types for the first time in five years. Nevertheless, in terms of footfall there remains great disparity between the retail locations, with shopping centres and high streets broadly flat, while retail parks recorded a 25th consecutive month of growth with an impressive 5.2% year-on-year increase.

As figure 5 reveals, retail parks have been the standout sub-sector in terms of footfall for the past two years, recording growth in customer numbers against a backdrop of consumers deserting physical retail destinations. This strong performance is likely the result of three main factors:

- Low fuel prices - consistently low prices at the pumps are increasing the appeal of out of town retail destinations.
- Increasing popularity of Click and Collect - ample free parking and larger back of house space make retail warehousing units particularly suited to Click and Collect. Uptake of this delivery method has increased significantly over the last 12 months in the face of rising home delivery prices as retailers increasingly try to cover the burgeoning cost base of online fulfilment.
- Greater occupier diversity - the face of retail parks is changing as an increasing number of high street retailers and restaurants explore the out of town arena.

REWARDS STILL TO BE REALISED IN RETAIL WAREHOUSING

These factors have helped drive footfall as they cover off the two central tenets of the modern shopping trip; convenience (low fuel prices, click and collect) and experience (occupier diversity).

On the one hand, increasingly time poor consumers want goods and services as quickly and easily as possible, in a way that minimises disruption to their day to day lives. On the other, consumers increasingly spend their money on eating out and leisure, looking for destinations that offer a full range of experiences and justify an extended visit.

Retail warehousing schemes that fulfil neither of these needs will struggle to succeed, but the right assets, managed intelligently are well-placed to serve the modern consumer. Whilst post-Internet retail investment is a risky arena, there are rewards still to be realised in retail warehousing through informed decision making and careful stock selection.
NEW BRANDS, GRADUAL WIDENING OF CONSENTS

The face of retail warehousing is changing. Gradual widening of restrictive planning consents, often unit by unit, on parks over the last 30 years has enabled a wider base of retailers to consider these locations.

The raft of administrations during the recession, most notably MFI, Comet and Focus, supplied a significant volume of large units to the market and many of these voids have been filled by retailers outside of the traditional bulky goods space, particularly where sub-divisions were carried out.

Amongst the most prolific in absorbing supply were the value operators, including B&M and Home Bargains. As figure 6 shows, whilst other retailers were reviewing their portfolios in light of the recession and the rise of online shopping, the non-food discounters were taking advantage of the surplus of available units and, often, re-based rents to support ambitious opening programmes.

With limited competition for units and a demonstrable appetite from consumers for this type of retail, the value operators managed to secure sites on a broad range of parks from predominantly bulky goods through to open A1 food and non-food anchored retail parks.

In many cases they succeeded in gaining consent to widen the range of goods sold from the premises to enable the sale of dry groceries which, in the case of B&M, can account for up to 30% of their sales area. Looking forward, we expect the rate of value openings to continue to tail off into 2016 as the availability of units at affordable rents for these low margin operators, diminishes.

While the value operators quite comprehensively absorbed units between 5,000 and 12,000 sq ft, it was homeware brands such as The Range and Dunelm Mill that occupied many of the larger voids. These retailers continue to look acquisitive, with The Range opening over 450,000 sq ft of new space on parks last year and with a further 32 stores in the pipeline.

Spending in the home furnishing and furniture sectors has been boosted over the last year as a result of the wealth effect from rising house prices, combined with burgeoning consumer confidence.
HIGH STREET RESTAURANTS AND COFFEE SHOPS DIVERSIFYING PARK F&B OFFER

Across the food and beverage sector too, there are an increasing number of names more associated with the high street now opening in out of town retail warehousing developments.

Historically, the food offer on parks was restricted to the fast food restaurants and a handful of operators such as Frankie and Benny’s and Pizza Hut. Now there is far more competition from a range of restaurant brands, particularly on larger open A1 and shopping parks, with Nandos, Chiquito and Pizza Express alone opening 21 new restaurants over the past two years.

But expansion in casual dining looks muted in comparison to the coffee revolution, being led by Costa, on parks. Figure 7 shows the growth by year of the major coffee shops, along with Greggs and Subway, who will often be competing for the same units.

Arguably, there has been great activity in the coffee shop market on retail parks for nearly 10 years now and many of the suitable existing units for a coffee offer have already been taken.

As a result, a large number of the coffee shops now opening are drive-through pods in car parks and, whilst the drive-through model requires smaller unit sizes, they remain relatively space hungry owing to the incorporation of the drive through lane.

The shortage of supply and the number of occupiers vying for locations in this market are creating ideal conditions for driving rental growth on parks and, in fact, this is one of the few sub-sectors where it has been possible to use competition between occupiers to push rents on. As a result, adding coffee pods to parks remains one of the most popular ways to drive value/maximise income from a retail warehousing asset.

RETAILERS WARY OF INCREASED RENTAL LIABILITY

Outside of food and beverage, occupier demand appears equally robust and diverse from the continued expansion of value retailers, homeware retailers and bulky retailers, such as new entrant to the carpet market Tapi. The one exception is fashion, where other than TK Maxx, there is thin demand for units, particularly on more expensive shopping parks.

Nevertheless, in previous economic cycles, this healthy occupier demand would have driven rental recovery, but with multi-channel diminishing the value of physical stores and squeezing margins, retailers seem wary of overstretching themselves. As a result, other than with food discounter rivals Aldi and Lidl, getting retailers to bid against one another to drive rents is generally proving unsuccessful, with scaled back opening programmes reducing the pressure on retailers to fill large pipelines with sites.

FIGURE 7: COFFEE SHOPS AND FOOD-TO-GO NEW STORE OPENINGS (COSTA, STARBUCKS, CAFFE NERO, GREGGS, SUBWAY)
VACANCY RATES LOW ACROSS ALL PARK TYPES

Nevertheless, vacancy is low and falling across all park types. As figure 8 shows, vacancies are now below 2006 levels on all park types, measuring less than 6% of floorspace on Open A1 schemes and 7.2% on bulky or restricted consent schemes.

This represents a sharp fall in voids on bulky schemes from nearly 12% back in 2012, clear evidence of the weight of occupier demand in this segment of the market.

On the open schemes there has been a convergence between food anchored and non-food anchored as the challenges facing the grocery sector mean food is no longer viewed as a panacea for park occupancy.

FIGURE 8: VACANCY RATES BY PARK TYPE

Source: Trevor Wood, Colliers International

ALTERNATIVE SOURCES OF UNITS TO DRIVE RENTAL GROWTH

On some parks these low vacancy rates are perpetuating the static rental story, with a lack of available units and tenant turnover creating a vacuum of rental evidence. Particularly on strong parks or in the South East, where supply is constrained, there can be little or no evidence of rental growth for rent review.

Recently, there have been examples of landlords serving notice on tenants in order to redevelop and derive additional value. For example, both the B&Q in Tonbridge and Homebase in Crawley will be taken back by the landlord for redevelopment into a handful of smaller units to satisfy high levels of occupier demand in the South East.
PIPELINE DOMINATED BY EXISTING ASSET RECONFIGURATION

The break-up of larger units and small scale development through mezzanines, small extensions and construction of pods are likely to be the primary forms of development over the next few years, given the patchwork of demand and supply across the country.

However, a severely constricted pipeline over the past few years has made development viable once again in pockets of the country. This led to recovery in the development pipeline in 2015, as shown in figure 9, but last year there were no major new park developments further south than Banbury Gateway Shopping Park.

A lack of suitable sites, high alternative use values, particularly residential, and town centre protectionism have all contrived to hold back development in the south and will remain challenging going forward. As a result, although there are some exciting smaller schemes planned for the south in 2016 and 2017, including Paignton and Epping Shopping Park, the majority of development will be existing asset led.

Source: Trevor Wood, Colliers International

FIGURE 9: DEVELOPMENT PIPELINE BY YEAR AND SCHEME TYPE

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NEW DEVELOPMENTS, NEW OCCUPIERS AND NEW OWNERS ALL BLUR THE BOUNDARIES

This sub-dividing and repositioning of existing assets is manipulating the traditional boundaries between bulky goods parks and open consented retail warehousing schemes. In fact, looking at the upcoming developments, we predict that much of the open consented space will in fact be occupied by bulky retailers as a result of the current depth of demand in the occupier market.

Whilst the permission on a scheme, therefore, remains relevant to investors in terms of the attractiveness of the asset, to occupiers it seems that the market is becoming more fluid, with some retailers such as TK Maxx occupying parks across the spectrum from standalone retail warehousing through to shopping parks, not to mention their continued expansion on UK high streets.

Retailers are, therefore, beginning to see retail warehousing in the same space as high street shopping, as the opportunities to deliver a shopping experience that is compatible with the Internet become self-evident.

In fact, even the positioning of retail warehousing as the antithesis of the high street is beginning to be questioned through the construction of schemes that look like warehousing developments but form the town centre of a settlement, such as Princes Gate in Catterick.

When combined with a diversifying ownership base, many of whom were previously active in the shopping centre market, such as NewRiver, the homogenisation between the retail destinations begins to gain clarity.

The asset management angles being explored on many parks, such as the addition of food and beverage outlets, are not dissimilar to those in the shopping centre space, but this shift to retail warehousing assets could be representative of the greater potential returns in light of a lack of yield compression and continued relevance of parks in the post-Internet world.

The challenge remains converting the low vacancy rates into marked rental growth in the face of understandable cautiousness from retailers who are seeing their margins squeezed by online.

With the diminishing opportunity cost of not securing or retaining a physical location, the potential leverage to drive rents, particularly on fashion parks, is reduced.

By contrast, the weight of occupier demand and limited supply in the bulky goods and value segments of the market are building pressure, and competition between coffee shops and casual dining already provide scope to move rents on.

Therefore the key becomes stock selection and an understanding of the strengths and limitations of this changing and diversifying sub-sector.