MONTAGU EVANS PRESENTS... OUR RETAIL MARKET UPDATE

2024

RETAIL BACKDROP

IT HAS BEEN A DIFFICULT FEW YEARS FOR PHYSICAL RETAIL IN THE UK. HAVING FACED THE STRUCTURAL CHALLENGES AROUND THE GROWTH OF ONLINE, IT WAS HIT FIRST BY COVID-19 AND THEN BY THE INFLATION SURGE AND COST OF LIVING CRISIS OF 2022.

WHILE SOME CATEGORIES, NOTABLY FOOD, HAVE BEEN ROBUST OVER THE PAST YEAR, AND DISCOUNT AND CONVENIENCE BRANDS HAVE THRIVED, THE THEME ACROSS MUCH OF THE SECTOR HAS BEEN SURVIVAL.

RETAIL SALES GROWTH IN VOLUME TERMS FELL BACK IN EARLY 2022 AS INFLATION RAPIDLY ATE AWAY AT CONSUMERS' BUYING POWER, EVEN IF IN VALUE TERMS IT REMAINED ROBUST.

RETAIL SALES FIGURES ARE NOW SHOWING STRONGER SIGNS OF AN IMPROVEMENT. ANNUAL GROWTH IN VOLUMES MOVED INTO POSITIVE TERRITORY IN MARCH, A TREND THAT SHOULD ACCELERATE AS 2024 PROGRESSES.

INFLATION IS FORECAST TO FALL TO THE BANK OF ENGLAND'S TARGET OF 2% BY THE YEAR END. This alone will reduce the pressure on consumer disposable income.

THE BANK OF ENGLAND WILL SLOWLY REDUCE BASE RATES, which will gradually translate to lower mortgage and debt costs. This will enhance spending power but will take time to filter through owing to the structure of the mortgage market.

WAGE GROWTH IS FORECAST TO BE JUST UNDER 4% OVER 2024, lower than in recent years but with one key difference: it is now ahead of the rate of inflation. This means it will also translate into higher levels of real income.

THIS MEANS THAT RETAIL SALES WILL GROW IN REAL TERMS for the first time in two years in 2024, with stronger growth forecast in 2025.

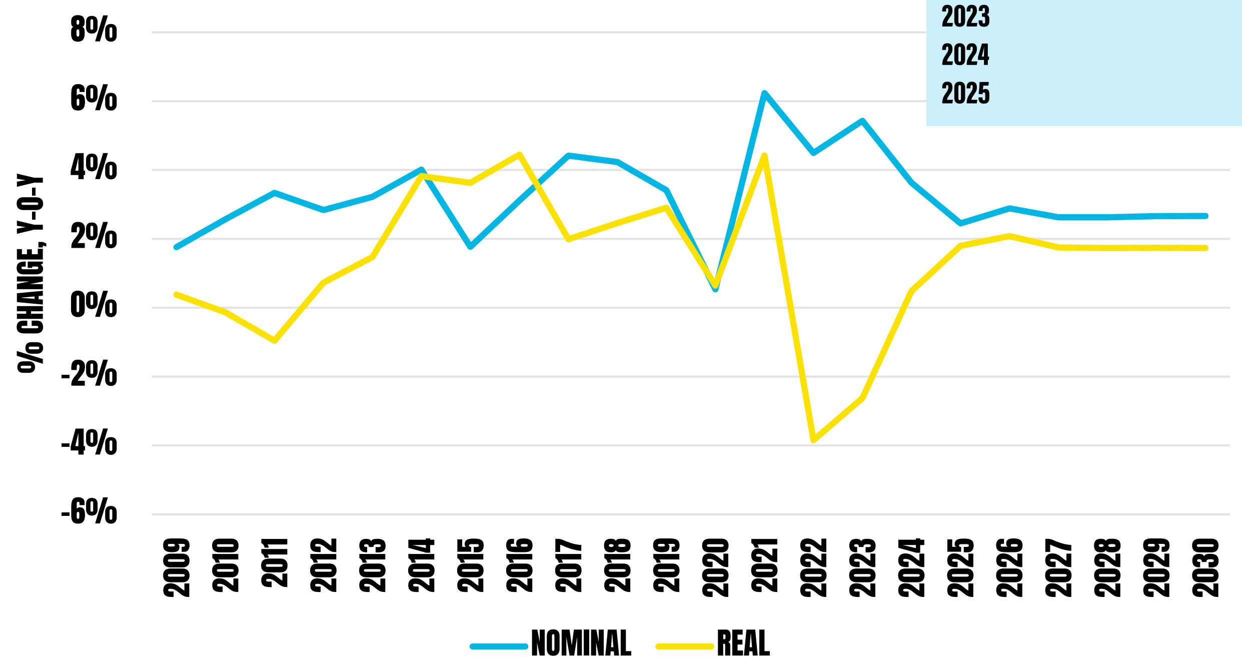
There are naturally some risks to this positive outlook. The most obvious is that tensions in the Middle East could escalate, leading to rising oil prices and a further inflationary shock. The other relates specifically to housing costs. Rents have increased sharply over recent years, putting pressure on the spending power of younger people, as they are far more likely to be private tenants than older households.

Housing rental growth should fall back over the next few years, which combined with rising wages, should ease the pressure on the under-45 purse. But the income of younger demographics, once housing costs are accounted for, has been under severe duress.

There is a geographic element too. As younger people have increasingly congregated in urban areas, the squeeze on their effective incomes looks set to affect cities disproportionately. This may be most apparent in London, where rents are the highest as a proportion of income, and mortgages in terms of income multiples also tend to be highest. In contrast, spending in suburban and rural areas with older demographics should see stronger performance. This is particularly the case in the more affluent South.

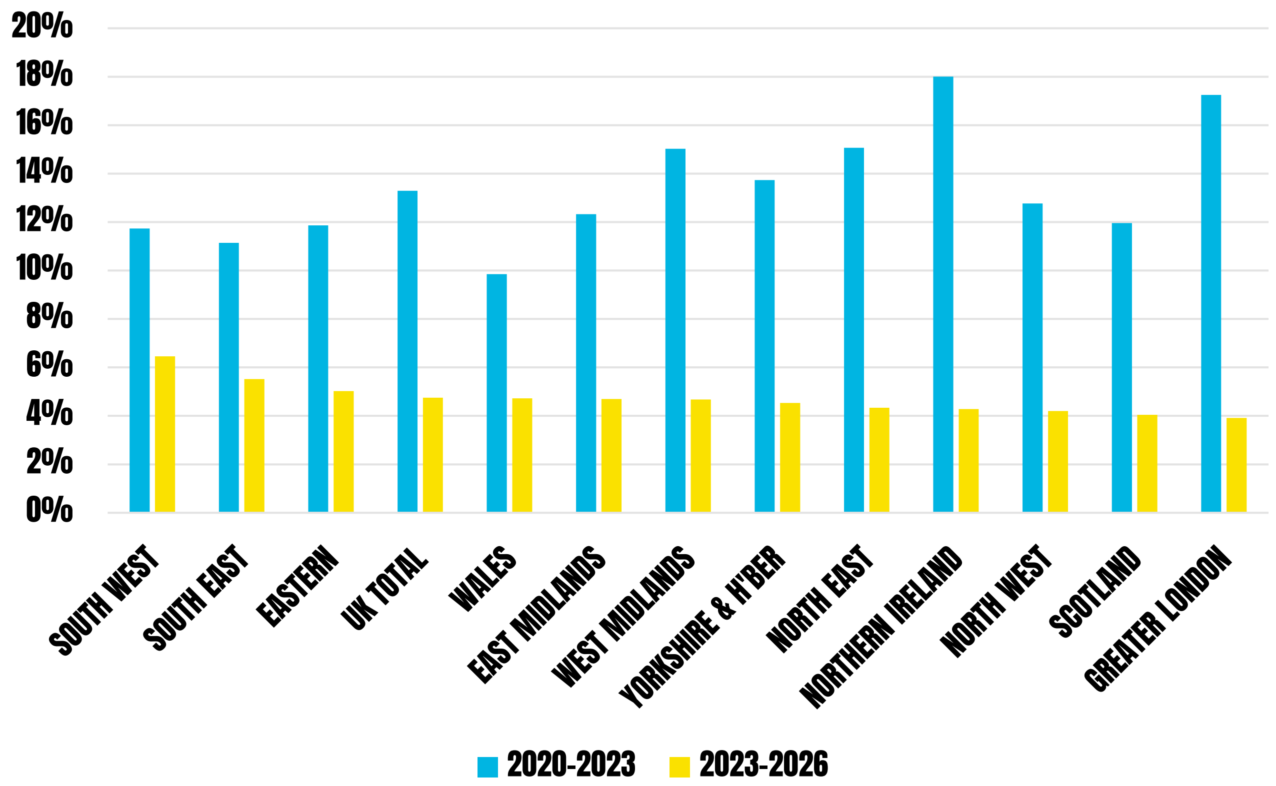
RETAIL SALES WILL RECOVER IN 2024 AND STRENGTHEN OVER 2025

INFLATION-ADJUSTED (REAL) SALES GROWTH	
2023	-2.6%
2024	+1.3%
2025	+2.5%



Source: Oxford Economics

CONSUMER SPENDING FORECASTS - NON-LONDON SOUTH TO SEE STRONGEST GROWTH



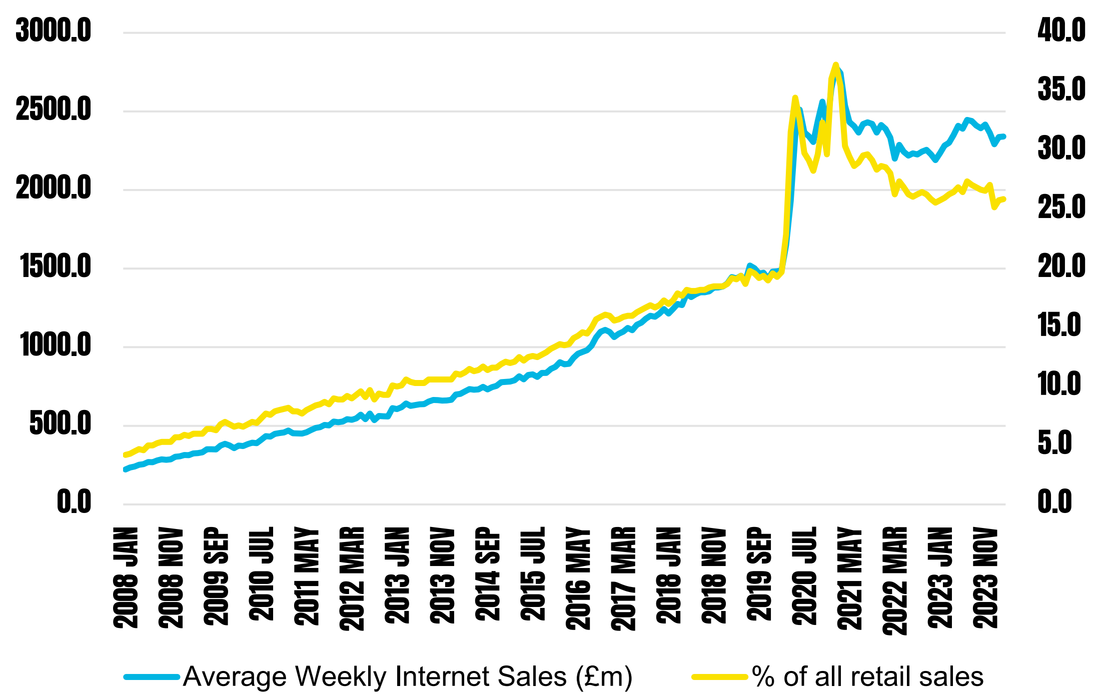
Source: Oxford Economics

Decreasing inflation has meant that the disconnect between value and volume has begun to close over the past year as inflation unwinds. This should continue, with inflation set to fall back to around the 2% target by the end of the year. Meanwhile, rising disposable incomes and greater confidence will support spending. According to Oxford Economics, real retail sales (i.e. with inflation taken into account) will recover from -2.6% in 2023 to 1.3% this year, 2.5% in 2025 and 2.3% in 2026.

It could be argued that this might not necessarily translate into benefits for physical retail, as online sales now represent a high proportion of sales. However, the most recent figures show that this has been in decline since the 35%+ recorded at the height of the pandemic and is now at 25% of the total. This appears to line up the pre-Covid trend, but the fact that it has been roughly static (and perhaps in slight decline) over the past two years perhaps also implies that it may have reached a plateau. The next year or two will provide further evidence.

INTERNET SALES

Penetration has reduced since the pandemic and appears to have reached a plateau



Source: National Statistics

This argument would also ignore other changes in the retail market, which is increasingly polarised between experience and convenience. High-end or independent/speciality shops – generally those in prime retail spots in city centres or tourist/commuter towns - appear in some datasets to have outperformed. This is also apparent for convenience or discount retailers and supermarkets, which tend overwhelmingly to be in out-of-town locations.

Physical retail also has a generally unrecorded role in online purchases, through supporting the brand and allowing consumers to examine products before buying.

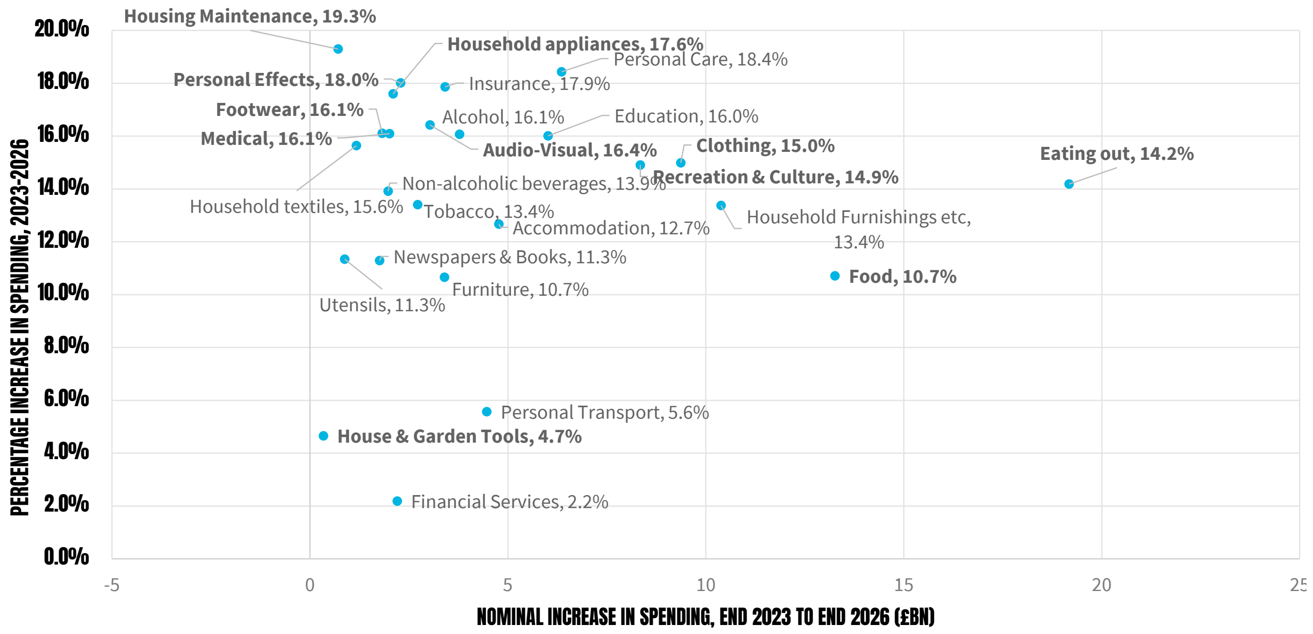
Equally, online retailers continue to struggle with profit margins given their rising cost base, in particular issues around delivery and in particular returns. Retail warehousing already plays a significant role in click-and-collect operations, which may expand in years to come.

SECTOR OUTLOOK

The chart below shows the forecasts for sales growth in various retail subsectors. The x-axis reflects the overall increase in spending (in £m) between the end of 2023 and end-2026; the y-axis the % change , so the top left quadrant represents subsectors that are smaller and fast-growing; the bottom right those that are slower growing but important because they are large.

The most important sectors for the retail & leisure sector over the next three years will be Eating Out and Food, closely followed by Household & Furnishings, Recreation & Culture and Clothing. Fast-growing, but less important in terms of scale, are areas such as Housing Maintenance & Appliances, Personal Care, Personal Effects, and Footwear.

SALES GROWTH FORECASTS, 2023-2026, BY RETAIL SUB SECTOR



Source: Oxford Economics

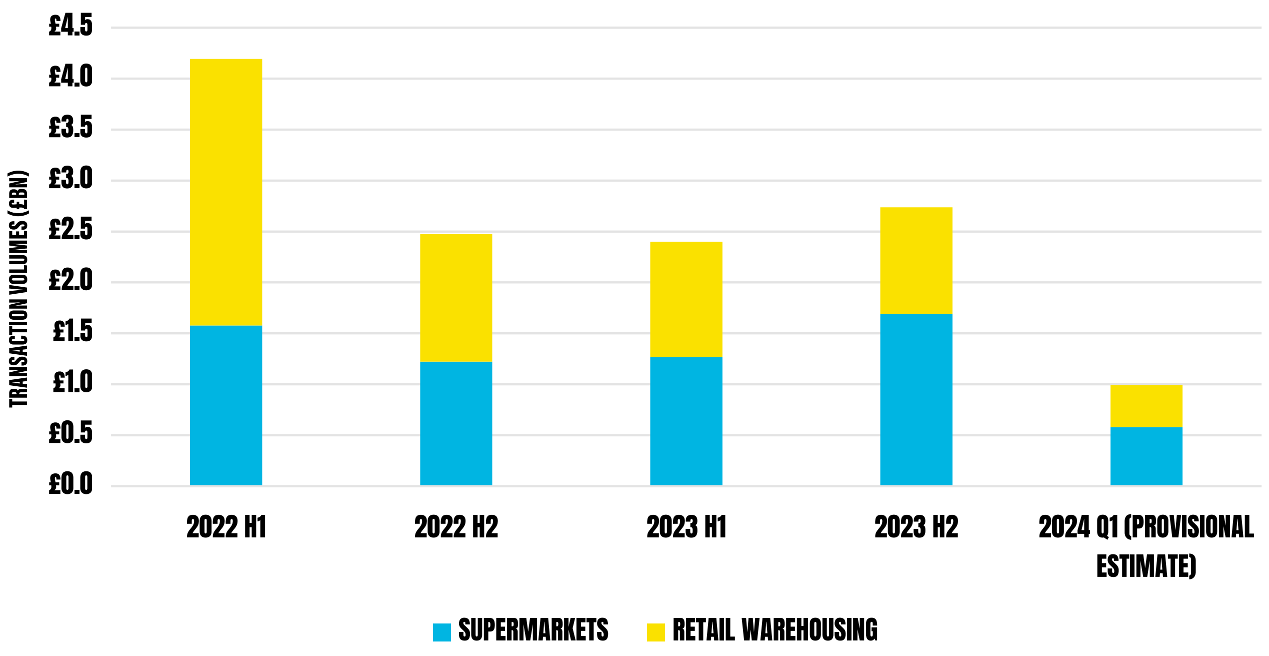
This implies two areas of strong growth: home-related expenditure (but not DIY-related equipment), leisure and clothing. This reflects a bounce back after these sectors were among the most hard-hit by the Covid period. There are also geographic implications. Leisure growth will impact throughout the country, and clothing retailers tend to have a mix of locations, but the household and food sectors are disproportionately located in retail parks and other out-of-town locations.

Another theme over the past few years has been the growth of smaller operations (employing fewer than 100 people). They have seen a 9.3% increase in sales volumes (from a lower base) compared to just 0.1% for larger shops. This likely reflects consolidation among larger operators, but also the increasing popularity of independents and small chains, not just among consumers, but also among developers and investors in "curating" the mix of amenities in their premises. This is more a phenomenon in town and city centres than in out-of-town locations, however.

REAL ESTATE TRENDS: THE OUT OF TOWN MARKET

While transactions in retail property generally have been at low levels, the out-of-town sector has remained comparatively buoyant, even if volumes have declined somewhat from the high H1 2022 level. This sector now consistently accounts for the bulk of retail transactions, given the relative dormancy of the shopping centre segment. Long leases, low vacancy, strong covenants and inherent supply shortages – alongside robust sales dynamics – help explain the resilience and resurgence of this sector.

TRANSACTION VOLUMES



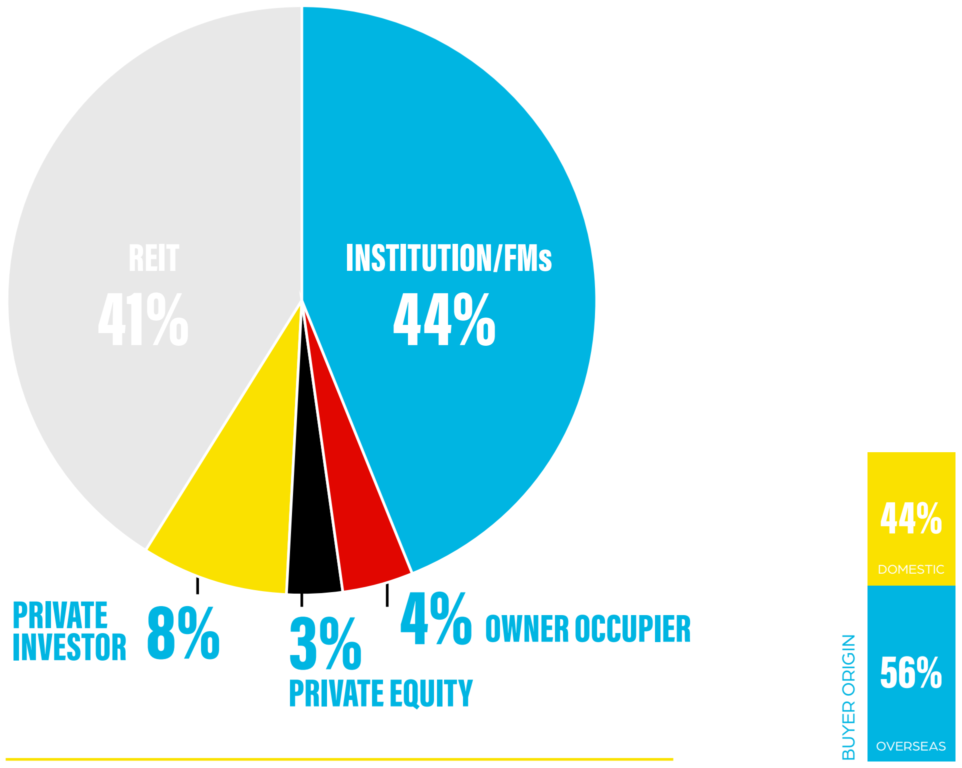
Source: Montagu Evans

Looking specifically at the retail warehouse sector, institutions and fund managers are both the largest group of buyers (44%) and vendors (76%). In contrast, REITs are more active buyers (41%) than sellers (10%), with private investors showing the reverse trend. The most obvious difference is in the source of capital. 56% of buyers (by volume) were from overseas, while only 82% of vendors were domestic. This presents a contrast with the supermarket sector, where 89% of buyers were domestic.

REITs are also active in the supermarket space, accounting – for the largest share of buyers at 37%. Despite being close behind at 36%, institutions are overall net sellers. Perhaps more notable is that private equity is increasingly acquisitive in this sector. While despite some buying back their stores, supermarkets themselves remain net vendors.

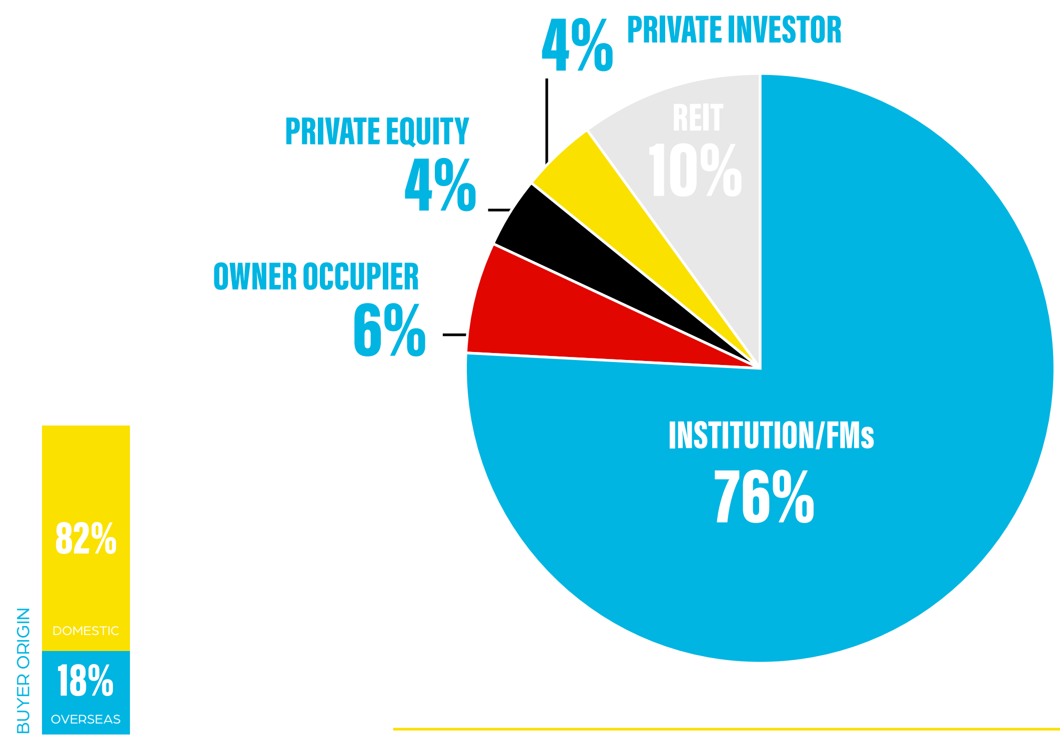
RETAIL WAREHOUSING 2023

WHO'S BUYING



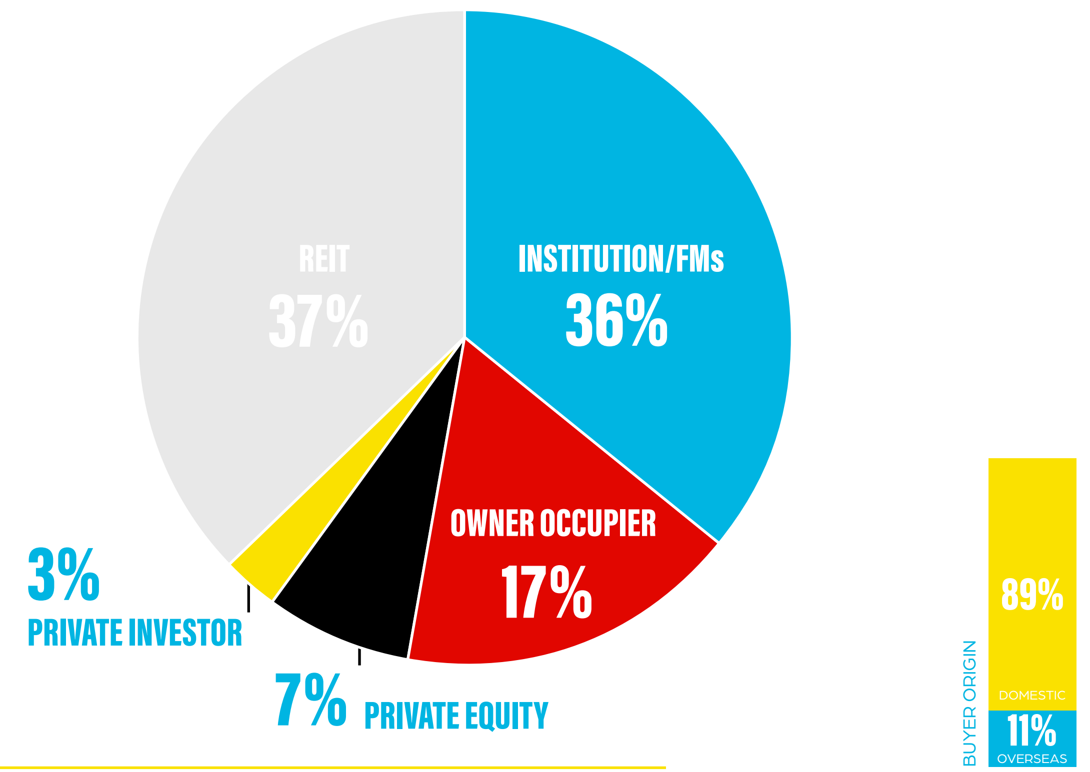
Source: Montagu Evans

WHO'S SELLING



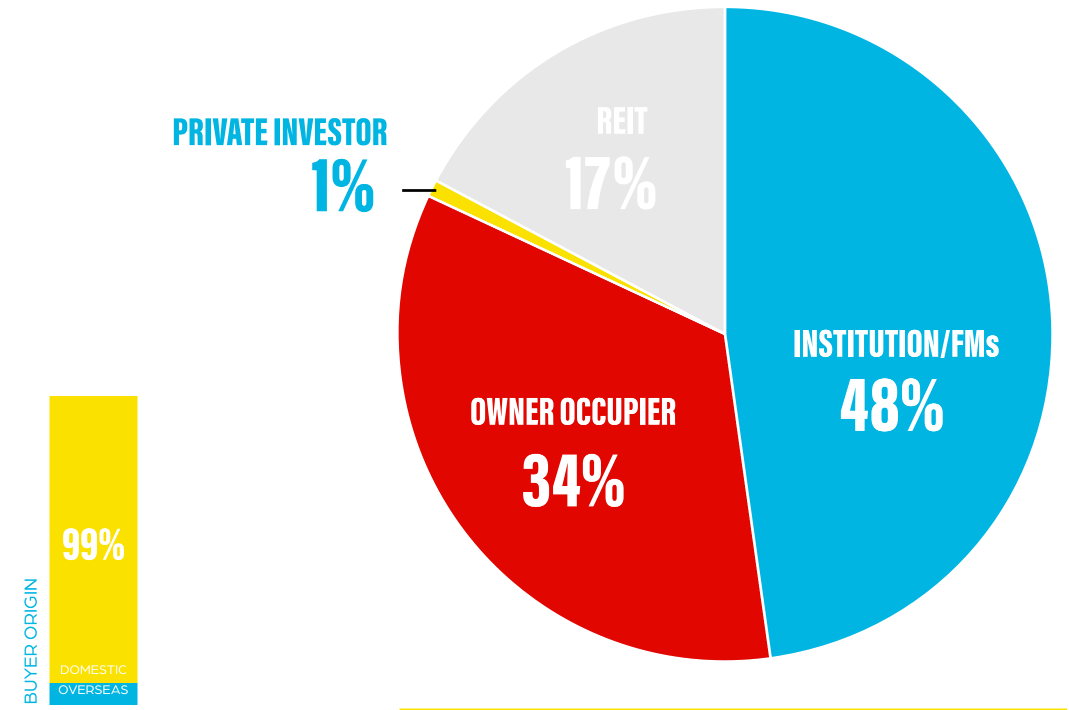
Source: Montagu Evans

WHO'S BUYING



Source: Montagu Evans

WHO'S SELLING



Source: Montagu Evans

THE ONGOING POPULARITY OF THIS SEGMENT IS BASED ON STRONG FUNDAMENTALS, INCLUDING:

RELATIVELY LOW VACANCY RATES, CURRENTLY STANDING AT 5.8% FOR RETAIL PARKS COMPARED TO A RECENT HIGH OF 11.8% IN 2019

Despite significant occupiers such as Wilko going into administration, the expansion of the growth of the likes of Home Bargains, Pure Gym and B&M has meant that vacancy has increased only slightly over the past six months.

LOW LEVELS OF NEW BUILD - TOTAL FLOORSPACE HAS ONLY INCREASED BY 2.5% OVER THE PAST FIVE YEARS AND CONSENTED SPACE STANDS AT JUST OVER 0.5M SQ FT, OR LESS THAN 0.3% OF EXISTING STOCK.

This reflects a general opposition to new retail warehousing in planning policies, as well as ongoing viability challenges in developing new space.

THERE ARE OFTEN OPPORTUNITIES FOR ADDING VALUE THROUGH MANAGEMENT, REDEVELOPMENT OR EXTENSION.

LONGER LEASES AND STRONG COVENANTS

According to the MSCI Quarterly Index, total returns* for retail warehousing were 1.7% over the 12 months to Q1 2024, compared to 0.0% for the retail sector as a whole. However, the segment has one of the highest income return levels in the MSCI index, at 6.4%, compared to an all property average of 4.9%. Unlike other high-income segments, market rental growth is positive at 1.7%. This reflects the fundamentals of limited pipeline and strong demand. This implies that retail warehousing will see much stronger returns in 2024 and 2025 and will remain one of the most compelling UK real estate sectors.

Some of these characteristics – notably relatively fixed level of supply – also apply to the supermarket sector. High inflation over the past few years has eroded returns in this segment given the structure of many leases, but its inherent strengths and appeal to long-term investors will reassert itself as the situation normalises. The out-of-town leisure market has seen relatively little activity over recent years, but vacancy rates are low at circa 4% and demand is likely to grow over the coming years , given the forecasts for renewed strong growth in leisure spending.

RETAIL WAREHOUSE PRIME YIELDS	5.75% ↓
SUPERMARKET (LONG LEASE) PRIME YIELDS	5.0% →
LEISURE PARK PRIME YIELDS	8.0% ↑

MSCI UK Quarterly Property Index

FOR MORE INFORMATION AND INSIGHTS TALK TO ONE OF OUR TEAM...

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