

Deloitte.



Living with the New Normal

The clock is ticking for UK
secondary shopping centres

Restructuring



Contents

Living with the New Normal	02
Squeezed retailers, squeezed consumers	04
Decline and fall	06
Thinking widely and deeply	10
Failure to accept the New Normal	14

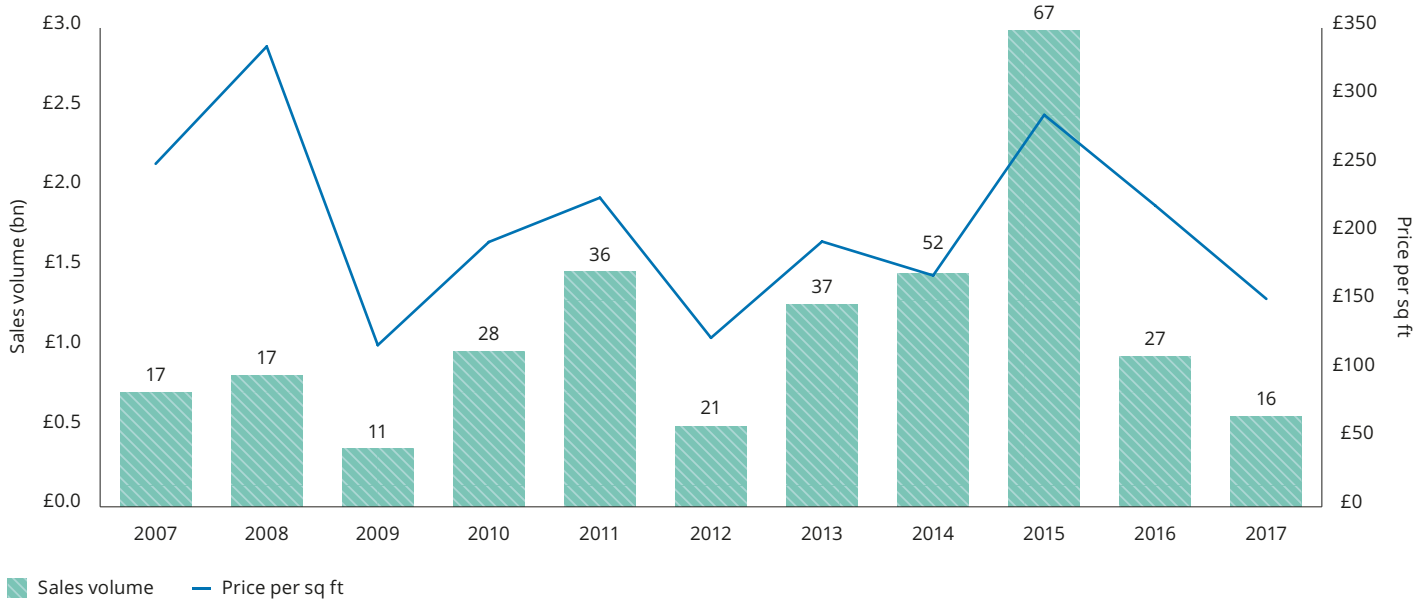


Living with the New Normal

The best things in life are worth waiting for, or so the maxim runs. However, the UK's shopping centre owners, and their lenders, should be careful. In many cases they are waiting for an upturn in fortunes that will never come: many centres are beset by flat or declining revenue, increasing costs and thinner margins, and a high risk that all attempts to reverse this will fail. This reflects not merely the particular problems of individual centres, but commercial problems for shopping centres as a whole.

Transaction volume by year

Label indicates no. of shopping centres transacted



Responding to these problems, owners and lenders must make a realistic appraisal of a centre's prospects, utilising all available asset management initiatives and exit routes. They need to do this now, before the deteriorating prospects of the country's schemes depress asset prices further – the average sales price per square foot has already plummeted from almost £300 in 2015 to little more than £150 in 2017. Optimists may regard this as an Uncertain Interlude, but we think owners and lenders must instead open their eyes and accept that there is a New Normal for the sector, which is much less benign than what they have been used to.

Having said this, a small group of super-prime sites – about 50 to 70 of the country's 1,400 or so shopping centres – are performing well. They attract the highest-quality anchor tenants because they have higher footfall, which makes the centres attractive to other high-quality tenants that can afford expensive rents. An example is the new John Lewis store that anchors the extension opened in March 2018 at Westfield London, the largest shopping centre in Europe. These super-prime sites usually have vacancy rates of zero, or close to it. Some prime centres outside this small circle are also performing well, supported by excellent anchor tenants and leisure facilities, such as cinemas and bowling alleys, which make them go-to "experience" destinations.

To a degree, the more poorly performing prime centres, together with many of the country's secondary and tertiary sites, are performing badly because others are doing well. The sector divides shopping centres into these different categories, based on a combination of size, sales/rental value per square foot, age and general attractiveness, because each category behaves differently. The super-prime centres are taking market share within the shopping centre universe away from smaller and less prestigious schemes.



Squeezed retailers, squeezed consumers

Shopping centres as a whole are suffering at the hands of e-tailers, and of out-of-town retail parks that boast the advantages of easy parking, ample space and, in many cases, proximity to a leisure offering.

Other supply and demand factors are affecting the UK retail landscape as a whole. Business rates and rents have risen in London and many other parts of the country. Wage bills have grown faster than usual, because of the 2016 introduction of the National Living Wage for people in their mid-twenties and above, and the introduction of the apprenticeship levy a year later. The fall in the pound since the 2016 vote for Brexit has raised the cost of many goods imported by retailers.

From a demand perspective retailers' revenues have also been hit, because the pound's fall has squeezed consumers too: depressing their real incomes by boosting consumer price inflation. In addition, the political uncertainty caused by Brexit has further weakened consumer sentiment, and a tightening of consumer credit is reducing their ability to spend. The challenge has been especially acute in casual dining, which in recent years has been used by asset managers to compensate for departing retail tenants. Belt-tightening in consumers is forcing restaurant closures in a sector that had rapidly over-expanded, often under private equity ownership.

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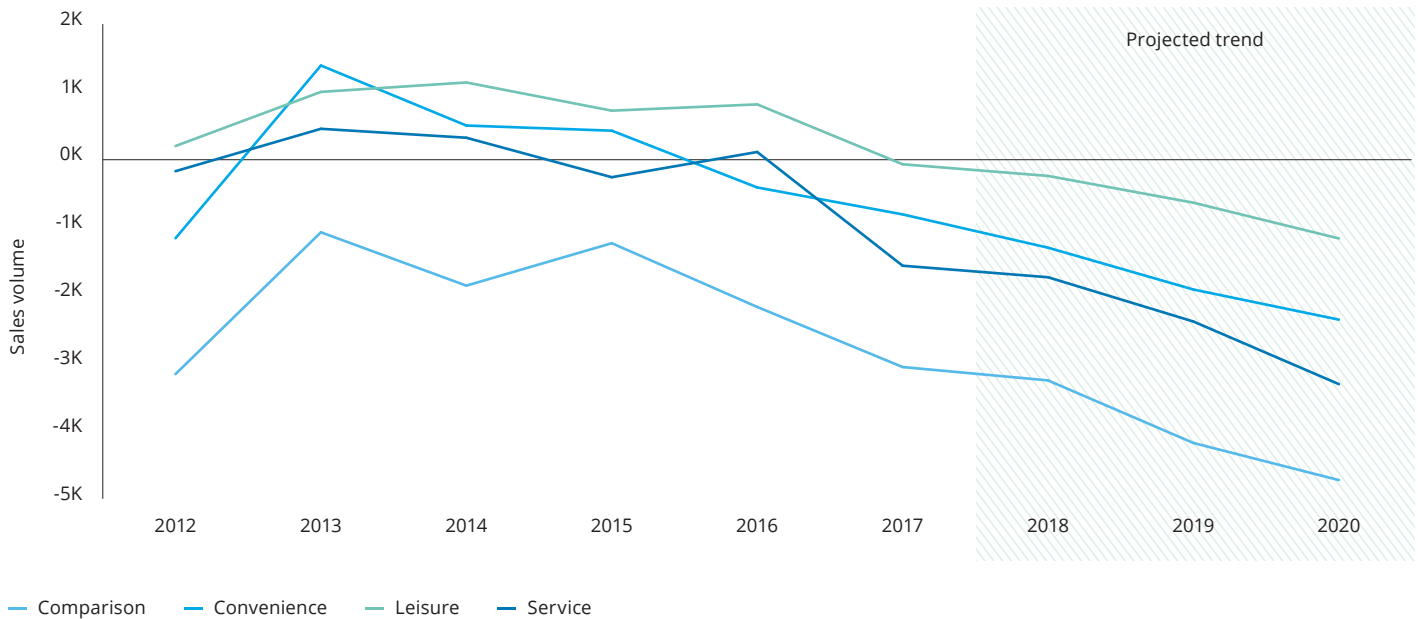




Decline and fall

This general malaise in retail and casual dining has played out in a very different way in different types of shopping centres. Using Creditor Voluntary Arrangements (CVAs), companies have cut outlet numbers, usually by closing those located in secondary and tertiary centres while keeping outlets open in prime and super-prime sites.

Net store closures: actuals to 2017, and forecast 2018-2020

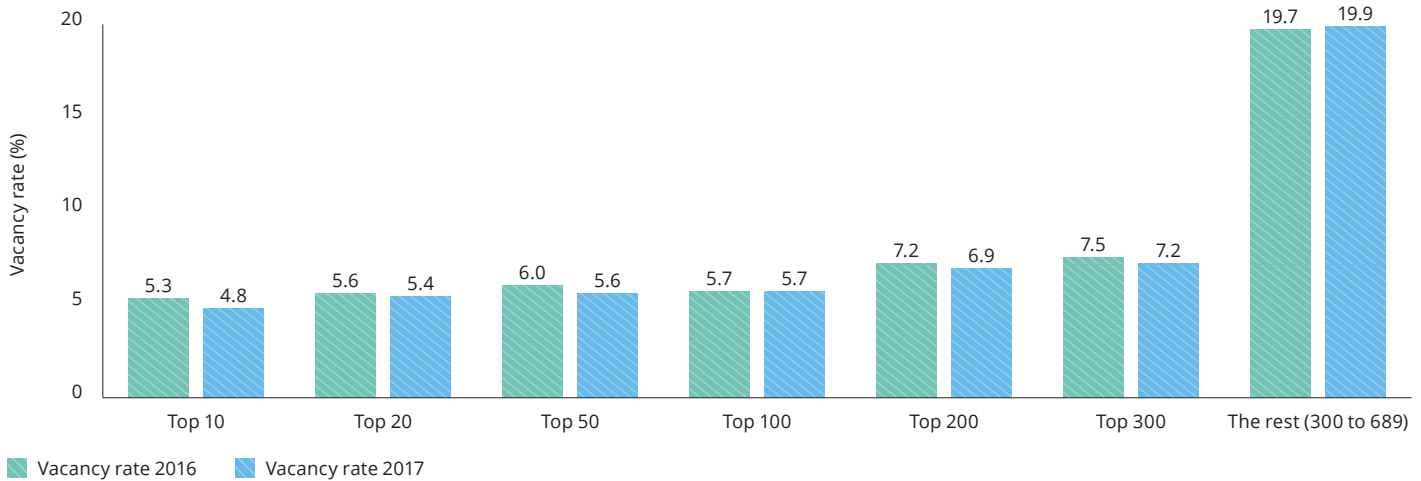


Shopping centre owners have responded creatively to their troubles, and some have succeeded in turning around their fortunes. But many have not, against the backdrop of widespread store closures in a troubled environment for consumer spending. Deloitte has analysed information on closures of all consumer-facing outlets from the Local Data Company – casting the net wide to include not only shops but also businesses such as restaurants, pubs, petrol stations and estate agents.

Our research finds that 429 more outlets opened than closed in 2014. But the following year saw 338 net closures, and by 2017 5,493 more outlets shut than opened. Based on the recent trend, Deloitte predicts that between 2018 and 2020 UK retail will see 27,000 net store closures.

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Shopping centre vacancy rate by Health Index rank across GB



Source: LDC

Because of these closures, we predict that average vacancy rates in secondary shopping centres will rise to more than 25% by 2020. Data from LDC's latest Retail and Leisure Trends report shows that according to their Health Index barometer, more than half of the 689 shopping centres included in their review already have vacancy rates of 19.9%. Back in 2017, the LDC reported an average vacancy rate of 12.6% across UK shopping centres. Some secondary and tertiary centres are already closing, as property companies streamline their portfolios.

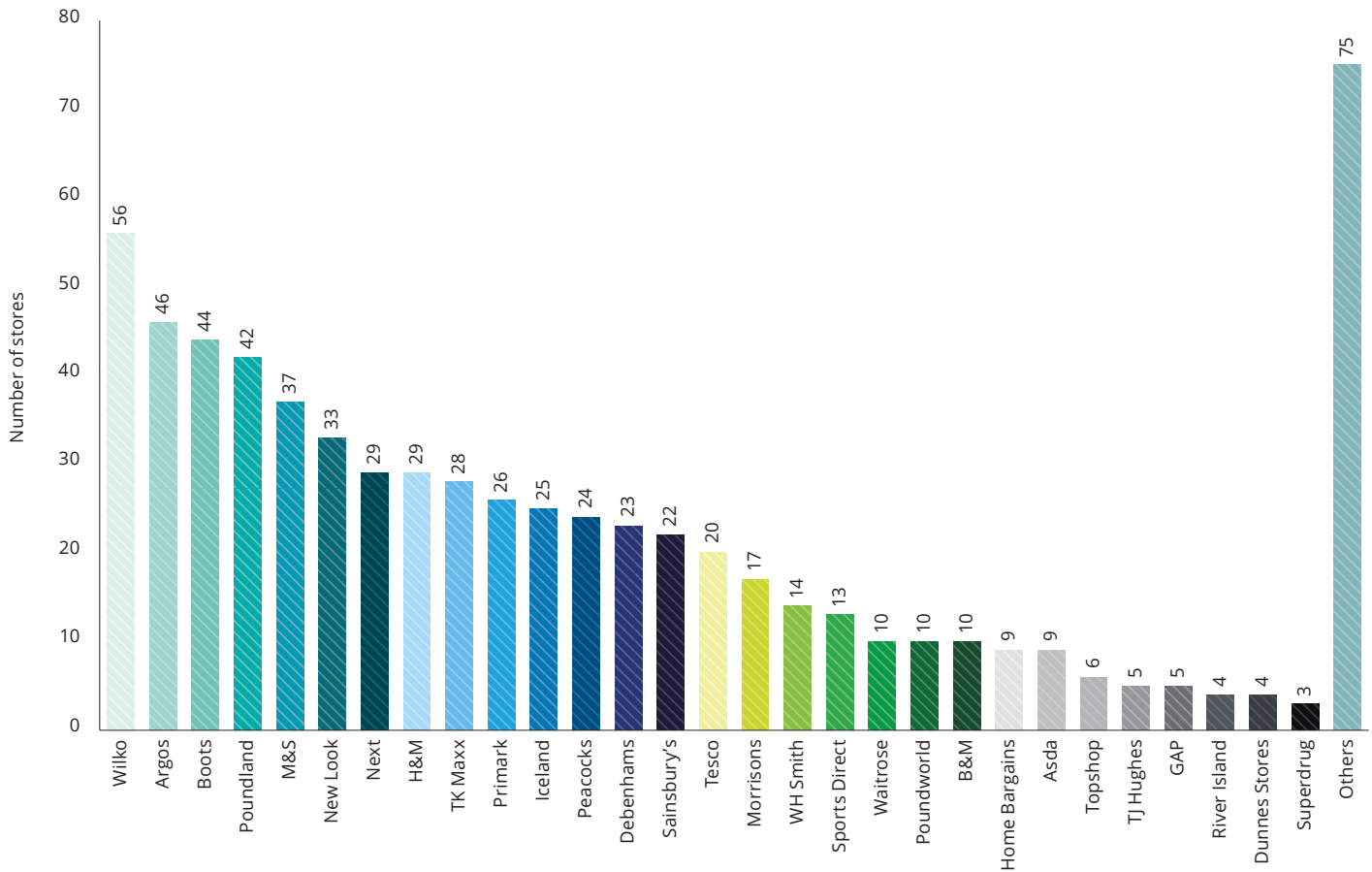
A specific problem lies with anchor tenants. Our analysis suggests that secondary and tertiary shopping centres are increasingly dependent on a dwindling pool of core anchor occupiers, many of whom are publicly reviewing their portfolio of stores.

Moreover, the sector is especially sensitive to the failure of large, multiple retailers. On top of this, it is suffering from the steady attrition of units, as occupiers across the spectrum of general retail face up to their own particular online disruptions by downsizing their portfolios – emptying the rental income bucket faster than hard-working asset managers and agents can refill it.

For owners and lenders assessing the risks to their assets, it helps to consider how the face of decline tends to look. First of all, a highly desirable anchor tenant, which brings in affluent customers, leaves because of disappointing local performance or corporate crisis: classic examples are H&M's recent round of closures, and the 2016 failure of BHS.

The space is filled by tenants, such as discount retailers, which sell lower margin goods and are less likely to attract shoppers who spend money on high-margin goods. Other tenants respond to the diminished commercial opportunities by exiting the centre. The owner tries to fill the vacated space with low-rental booths and even lower-rental market stalls, cheap gyms and other tenants that provide much lower income. After a few years the asset has a 40% vacancy rate, a string of charity shops paying no rent, a leaky roof without the rental income to mend it, and negative income because capital expenditure and operational costs are higher than rents.

Top "anchor" tenants in secondary shopping centres transacted 2007-2017



Six of the top eight "anchor" tenants have publically announced restructurings of their store portfolios resulting in a downsizing of their UK footprint. The restructurings range from a staggered exit from leases upon expiry to the more drastic use of CVAs where, in some cases, retailers are almost halving their store numbers.

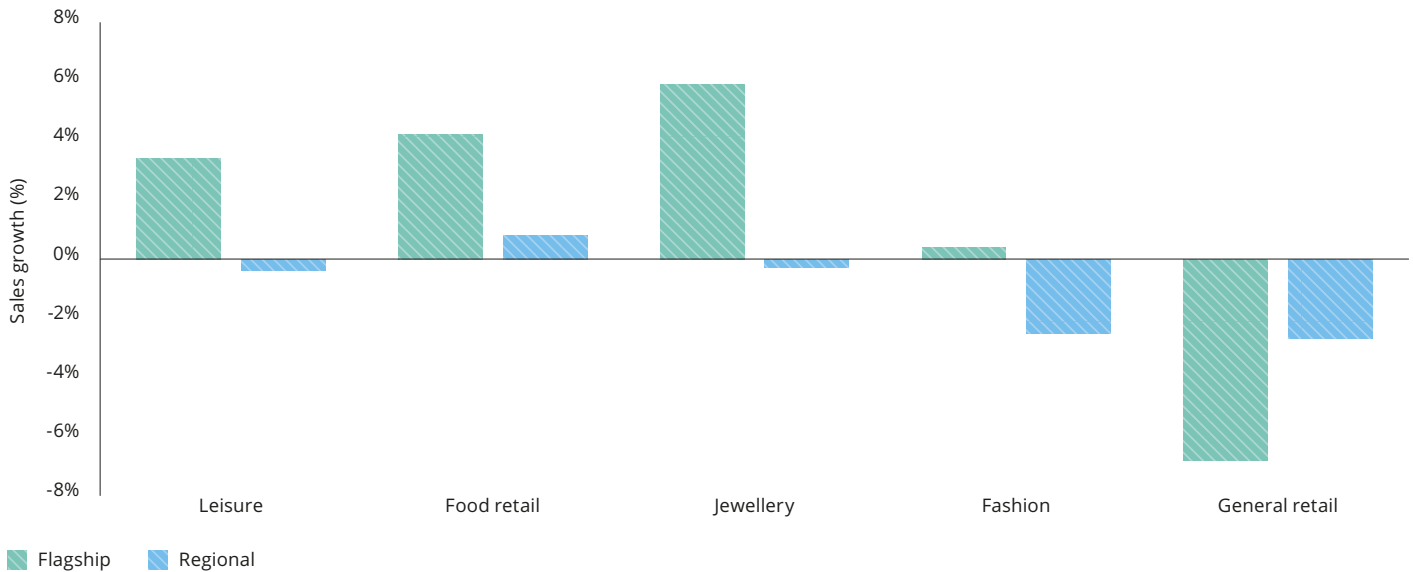


Thinking widely and deeply

How should owners respond to this environment?

Owners need to evaluate the whole range of asset management strategies that can be applied to their particular shopping centre. These include an assessment of the additional operational and marketing costs, and above all the capital spending, that will be needed as part of any plan to rescue the asset from decline.

Speciality retail sales growth (full year 2017)



Source: Westfield 2017 financial results presentation

Installing a leisure facility, such as a cinema, may increase footfall (if the scheme allows), but possibly not enough to justify the large capital costs involved in remodeling the site. Taking on casual dining tenants may do little to increase footfall in an ageing centre that is an inherently unattractive place to spend time in. The very different contribution made by leisure to the health of different categories of shopping centre is shown by Westfield's breakdown of sales growth into flagship (prime) and regional (secondary) centres.

Doing this appraisal well requires a wide set of skills. These include not only financial analysis, surveying and asset management, but also people well-versed in development and planning.

Knowledge of development and planning is increasingly important because of the progressively more activist attitude of local councils towards shopping centre land. It is impossible to choose the best among all possible options, without knowing the council's overall strategy for its district. Factors include the desire for shopping facilities that bring commerce within its borders, and its needs for affordable and other residential housing. In the New Normal of hard times for shopping centres, knocking down the asset and using the space for housing may be an attractive exit route for owners, and a housing solution for local authorities.

But while in London and most of the south-east there is a housing shortage, many parts of the north of England and Scotland are suffering a surfeit. This may explain why there have been so many sales of shopping centres in the south of England recently – and at higher prices and lower yields – compared with the rest of the UK.

Lenders need to make the same all-encompassing appraisal as owners, to maximise the recovery of interest and principal.

It also pays both sides, quite literally, to create a cooperative rather than hostile environment for distressed properties. To understand why this matters, consider two scenarios.

Scenario one is a hostile approach by the lender: enforcing the loan and taking control immediately, rather than trying to secure what it wants by seeking cooperation. The owner meets hostility with equal hostility, refusing to provide any information (such as tenancy schedules) that would help the lender work out a fair value for the centre to maximise the chance of a satisfactory sale.

The lender is also left with responsibility for managing the facility – a responsibility that will have to be passed on to an external management company. The paucity of data also increases the risk that a sale will fall through or that price chips – a whittling down of the sales price – will happen at the due diligence stage, when the buyer discovers nasty surprises. This is the “hard landing” scenario.

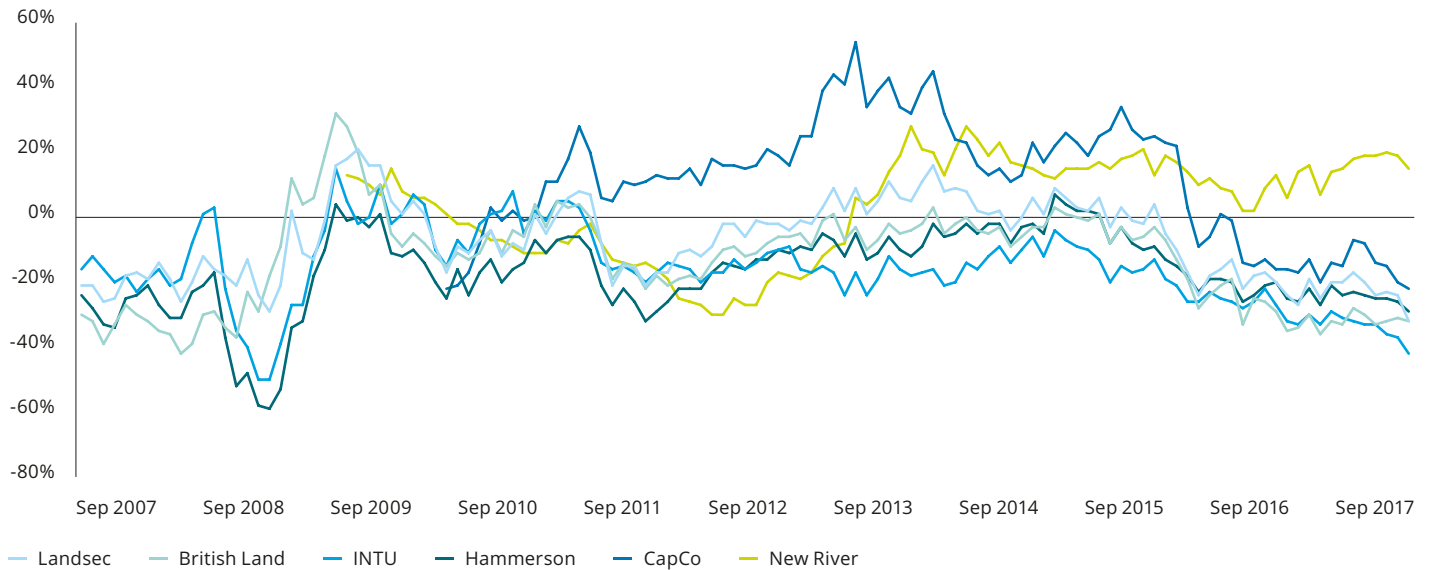
Transaction volume

Annual sales volume vs. yields achieved



In the above chart, each circle indicates the yield achieved for the centre transacted. The trend line indicates if yields are increasing or flat in the relevant region. The numbers on the bars indicate the number of transactions. The height of the bar indicates the total volume of all transactions in a year.

NAV premium/discount



Source: Lazarus research

Scenario two occurs when the lender approaches the borrower peaceably, in the knowledge that, because of where the value breaks, it ultimately holds the power. The borrower provides all relevant data, and continues to manage the centre. In this atmosphere of collaboration, even if the lender eventually takes control of the asset, the former owner receives a management fee for continuing to run it. The process of selling the centre is made much easier, because of the ample information available to the buyer. This is the “soft landing” scenario.

During the last real estate downturn Deloitte was involved in many examples of distress within the secondary and tertiary shopping centre sector.

Key takeaways include (1) there needs to be a “gritty” and realistic approach to asset management, (2) a change to bring in specialist asset managers can provide real benefit, (3) be ready for a confrontational enforcement but co-operation with the borrower invariably delivers optimum returns and (4) access to up to date and accurate information is important to ensure financial valuation and forecast appraisals can be delivered swiftly to enable rapid decision making. Ultimately, asset owners must strike a careful balance. It is defeatist to assume that they can never turn around declining performance without uneconomic capital spending. But at the same time, they must be realistic about the prospects of their centre.

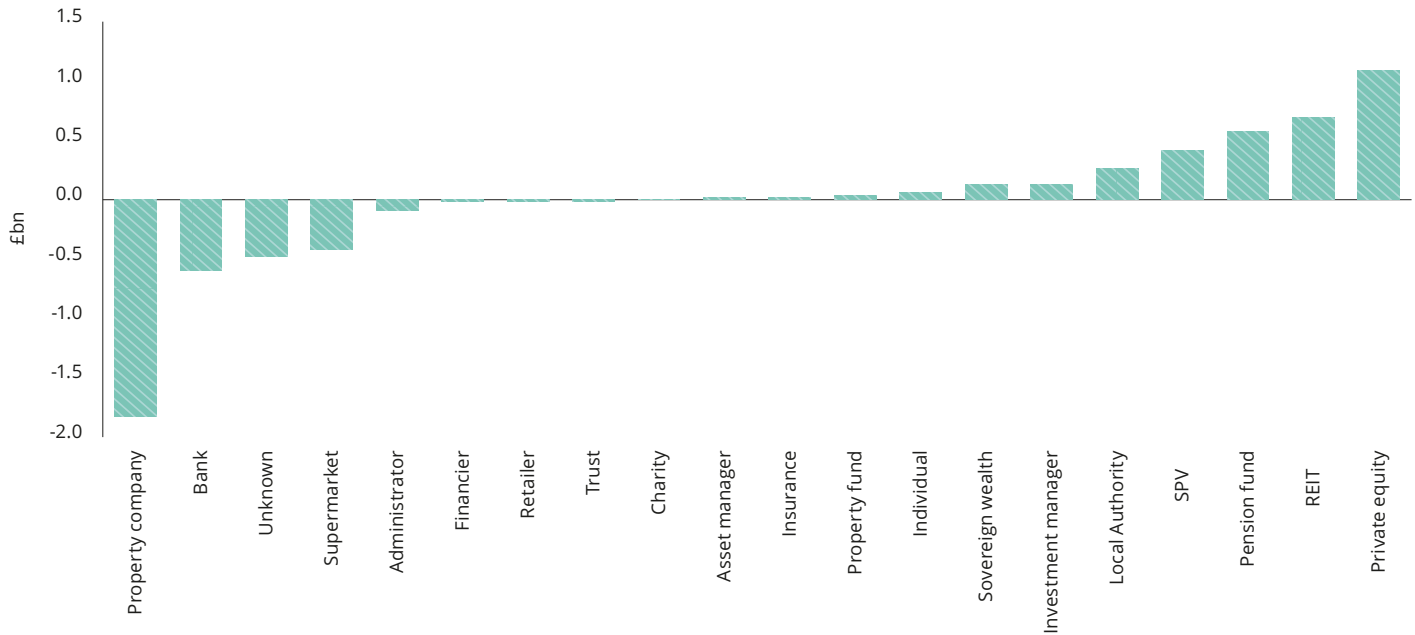
The pricing of Real Estate Investment Trusts in the public market suggests that many investors in property companies are already pricing in this downbeat assessment. Many REITs trade at a significant discount to NAV, revealing market scepticism about the long-term yield prospects of much shopping centre stock.



Failure to accept the New Normal

However, the evidence suggests that far from staring the New Normal square in the face, many owners are desperately trying to spy better times on the distant horizon. Owners have taken a number of asset disposals off the market after these failed to reach their asking price, and the number of schemes sold fell in 2017 to its lowest level since 2009. This suggests that many owners are not pricing their schemes realistically.

Net sales and purchase by entity type



Two recent examples illustrate this. Callendar Square centre in Falkirk, once valued at £26m in 2006, reportedly sold for £1m in October 2017. Abbeygate shopping centre in Nuneaton, once valued at £17m, sold for £4.3m in February 2018.

Understanding the New Normal should be a particular concern for the private equity firms that have snapped up so much shopping centre stock in recent years. Deloitte research shows that they have been net buyers of more than £1 billion-worth since 2007 – largely taking ownership from property companies, which have been net sellers of almost £2 billion.

Private equity firms have made these purchases in the hope of a sustained market recovery and improved occupier demand. But they have failed to find buyers for a number of their investments, with exit strategies frustrated by the market’s perception that they are asking too much. A typical private equity response has been to refinance and wait for the market to improve. The flaw with this strategy is that, if current times prove to be the New Normal rather than an Uncertain Interlude before better times begin, the market will never improve markedly. This will leave private equity owners with a net internal rate of return that is very poor indeed.

It will leave yield-based investors such as REITs and pension funds, the second and third biggest net buyers, as owners of assets whose yields are gradually but in many cases inexorably trundling downwards.

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