Summary
- Investors are whittling down exposures to retail property, although niche sectors are still attractive.
- Logistics are the flavour of the month but opportunities are thin on the ground.
- Alternatives such as hotels, student and social housing and healthcare are creating a lot of buzz.
- The most important features are the quality and sustainability of the income.

Shopping around

Lynn Strongin Dodds considers whether investing in retail real estate is losing it edge

As the recent Postings transaction demonstrated, retail property is a hard sell. Shopping centres, retail parks and high streets have seen their value wane due to changing consumption patterns. Pockets of opportunities exist but there are more interesting prospects within the logistics sector that are booming thanks to both online and traditional shopping.

The Fife-based Postings sale created a stir because of the £1 reserve price. Built in 1981, the £4.25 million centre went on the auction block from Columbia Threadneedle with 14 of its 21 shops vacant. The hammer came down at £310,000 and the property will now be redeveloped.

However, the deal is only part of a long-running story that has seen several retailers, most notably Toys R Us, House of Fraser, Maplin and BHS, either file for administration or run into trouble. Patisserie Valerie was just saved from the brink by a management buyout and private equity firm. Overall, a white paper published by Fidelity International last year showed rising costs, faltering consumer confidence and the switch to internet shopping caused over 24,200 shops to close their doors in the first six months of this year – the highest level in at least five years.

A shrinking high street

While online shopping is a factor it is not the only reason, according to Savills Investment Management CIO and acting CEO Kiran Patel. "Around 85 per cent of shopping is still done from bricks and mortar stores. "The problem is that it is growing at a slower rate than e-commerce and retailers are realising that they do not need to be in the same number of stores than they were in the past. If you take the UK, this has led to the shrinking of the high street but it hasn't disappeared. Instead of being in 300 locations, retailers are looking at the top 120 locations and they are also using click-and-collect facilities."

Changing macro-economic trends have also taken their toll. "The headwinds have been evident for some time," says UBS Asset Management managing director head of real estate – UK Howard Meaney. "We cleared out the shopping centres from our portfolio around five years ago, taking our weighting to zero from 20 per cent. After the global financial crisis, occupancy rates were down and there were an increasing number who were highly leveraged and in the hands of private equity firms. With hindsight it looks like the right call."

Fidelity Investment director, real estate Adrian Benedict, agrees adding: "Over the past 10 years, people have less money in their pockets and how they spend their money has changed. The increased competition from internet shopping sits alongside these trends. The result is that the real estate investments trust (Reit) stocks repriced by the direct market did not. However, our white paper forecasts UK retail real estate capital values will fall 20 per cent to 70 per cent depending upon the nature and quality of the assets."

Drilling down in more detail, the report shows that the UK listed market for retailers slid 20 per cent to 40 per cent last year with shares of prime shopping centre landlords plummeting. For example, Land Securities, as well as retail specialists Hammerson and Intu, traded at 30-50 per cent below the book value. In addition, several retail-focused Reits

sat on 20-40 per cent discounts to net asset values, and the reduction for retail Reits was substantially larger than the average for all Reits, many of which hold non-retail assets.

By contrast, the report revealed that the direct retail real estate market only dipped by about 5 per cent. However, their days of reckoning have come as Fidelity predicts a 10-30 per cent de-rating as rents are adjusted downwards by 10-40 per cent to make them more affordable for retailers. Given the outlook it is no wonder that investors are increasingly wary although they will have a big gap to fill – retail assets comprise roughly 41 per cent of a UK non-listed property portfolio. In other major markets they equal about 20-25 per cent of total holdings.

A different fashion

Retail though will still have its place. "Investors do not have to avoid retail but look at the more resilient ends of the market," says Patel. "We take a barbell approach to retail, with one end of the value spectrum being luxury brands that are growing and not planning to sell their goods online. The other end is bargain retailers such as Primark, which are less reliant on an online presence, as well as designer outlets and convenience stores where there is still strong demand."

As to other sectors, there is no doubt that uncertainty over Brexit and slowing economic growth is hanging heavily over the broader UK property market. The latest consensus forecast published by the Investment Property Forum (IPF) shows most investors expect, on average, returns to slow and capital values to move into negative territory. Total returns are predicted to slide from 6.2 per cent this year to 3 per cent in 2019, while capital values will fall across all sectors.

One bright spot is industrials where capital values are forecast to rise by 2.7 per cent. This is particularly true of logistics, which continues to outshine other commercial areas. Figures from Cushman & Wakefield show distribution warehouse and standard industrial recorded respective total annualised returns of 17.7 per cent and 22.1 per cent in the second quarter. Demand is being driven by brand-name retailers, as well as Amazon, Ocado and other on-demand providers, which are looking to automate production and last mile delivery solutions – a product's journey from warehouse shelf to customer doorstep.

Space is at a premium, with total take up reaching 6.5 million sq ft in the third quarter 2018, up 43 per cent on the same period in 2017. The report also revealed that an increase in speculative development combined with pent-up demand for high-quality space has led to the highest amount of speculative space absorbed over a single quarter since 2012's 1.8 million sq ft.

However, as Meaney notes: "If you are buying now, it could be challenging. Our UK fund is overweight to the sector with a focus on London and south east. We are taking advantage of investor demand to sell poorer assets and replace these by forward funding new stock to improve the quality of the portfolio. The sector is dynamic with are new concepts being talked about such as multi-story logistics facilities being built for the likes of Amazon."

As for other prospects, the alternative sector of student and social housing, hotels, leisure, healthcare and private-rented sector is high on the agenda. Although they have different characteristics, they share the common threads of long leases, income generation and a hedge against inflation. "They offer liability matching cashflows with inflation indexation, which are important to a UK DB scheme," says UBS.

Some fund managers also see relative value in the often-neglected office, which has been hit by a slowdown in building. A survey by Deloitte revealed that office space currently under construction in popular central London locations stood at 11.8 million sq ft, a 13 per cent decline from six months ago, albeit still above the long-term average of 10.5 million sq ft.

"I would not write off the office markets because by and large corporations have done exceptionally well especially if they have sizeable overseas operations," says Benedict. "They have healthy cashflow balances and the ability to extract rental growth and or retain tenets. We have also looked at high-quality office buildings outside the main centres such as Solihull, which is near Birmingham. We have found a highly diversified range of tenets and been able to generate an additional yield of 1 to 1.5 per cent."

Whichever sector, "the most important thing is the quality and sustainability of the income," says Aberdeen Standard UK real estate Mike Hannigan. "The questions we ask is whether the property is in a good location, has good transportation links, who are the managers, tenants and what are the debt levels. We also adopt a more flexible approach and can for example, dial down or up in terms of occupational period."

Written by Lynn Strongin Dodds, a freelance journalist