Retail to see further M&A as investors lurk on the sidelines

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As a string of retailers continue to disappear from town centres and high streets in a wave of company voluntary arrangements, administrations and store closures, retail lenders and investment funds are finding it trickier to generate investment returns.

Concerns around declining rents, teamed with the growing pressure on landlords to keep their retail occupiers incentivised, have sent the share prices of major property groups in the UK into the doldrums.

But that in itself brings opportunity and a host of private equity firms now stand on the sidelines looking for a way in, including through listed M&A.

Speaking at Retail Rocks 2018, Ellandi's annual retail property conference held at the Royal Geological Society on Piccadilly, panellists discussed the ways in which investors could find value in the beleaguered sector.

The problem with valuation

Michael Old, managing director at Jeffries, flags that shareholders of retail companies are the biggest losers in the listed sector in terms of total investment returns over the past three years.

Sector specialists, such as self-storage provider Safestore, on the other hand, are the clear winners.

With companies trading at heavy discounts for prolonged periods, this has in turn heaped pressure on valuers, which Old argues has made the sector particularly vulnerable to takeovers.

"Investors are active," he says. "But valuation is the key. When you see [companies] trading at 30%-45% discounts and there isn't M&A activity, it means people either do not believe in the valuations or they are uncertain [of the way the market is going]."

Lawrence Hutchings, Capital & Regional chief executive, says: "There is a consensus from everyone we speak to that the implied value of the assets for the companies that are listed does not reflect what those assets could be realised for in the market. So I think there is a 'disconnect', but we've seen this before – it's not the first time."

A slippery slope

With valuations coming under the microscope, Tim Vallance, director and head of UK retail and leisure at JLL, believes that some foreclosures could be on the horizon.

"The banks have been sensible, so I don't think we will see a rate or scale of foreclosures – we might see some. But refinancing is prevalent at the moment," he says.

Will banks withdraw support for retail assets?

"People will struggle to refinance at any significant rate without values being affected. The whole valuation piece is crucial to this market moving again, and the banks are a huge part of that."

However, Hutchings, who spent five years working for Blackstone in Australia, offered a different view: "I'm not saying it won't happen, but I think [the private equity players] will work very hard to ensure they don't default.

"Most of us here have reasonable cash returns, still have equity funding. I'm just not getting that feeling from the market that they're under an enormous amount of duress.

"I'm talking about the major players, though – there might be smaller players in different situations. But I'm not sensing from that group of investors that they are heading for the exit doors at high speed."

Prime is active

Despite the reluctance stemming from valuers, there are investment opportunities. Old reckons 2018 will be "the year of M&A" for retail, pointing to very low interest rates, cheap and available debt and high-quality targets.

"I think investors are very discerning about the operators [where] they have choice nowadays," he adds.

Barring Unibail-Rodamco's corporate acquisition of Westfield, which completed last week, Vallance says the direct shopping centre market is particularly sluggish.

Councils buying shopping centres: a way to save town centres or a disaster waiting to happen?

Local council investments to drive retail and town centre regeneration have continued unabated despite their controversy.

Spending on commercial properties reached £3.8bn in the four years to 2017, according to findings by Carter Jonas and Revo published in April this year.

The financing arrangements involved are appealing, since councils can finance their purchases on a 100% loan-to-value ratio.

"You could hold as long as you like without worrying about liquidity at the back end," says Charlie Barke, head of retail investment at Knight Frank.

"You could amortise your debt down to zero and still keep the funding rate at 2-3%. That's an incredibly attractive financial proposition."

Other clear incentives for local authorities are that they can receive the standard property benefits a third-party owner would find itself getting plus additional rates if they create extra rental value; additional employment through making sure centres are fully let or creating additional space; and the ability to attract third-party investment.

However, there are a host of issues that need to be considered. Barke outlines four key criticisms levelled against local authority investment:

- A lack of technical know-how when it comes to managing shopping centres. "A lot of people feel local authorities are inexperienced, perhaps under-resourced and don't have the time or expertise," says Barke.
- Local authorities, arguably, overpay on assets.
- Concerns about the amount of capital expenditure needed for the whole duration.
- The assets are in terminal decline, risking inactive ownership.

Capital & Regional's Exchange in Ilford – a rare shopping centre trade of 2017

He refers to estimates that shopping centre assets worth £360m have been sold so far this year – around 60%-70% down on the same time last year, and roughly 25% down on a five-year average.

On the other hand, he notes that "prime is on the move", citing DTZ Investors' £130m acquisition of Delancey's retail parade in Clapham Junction as an example.

Vallance also identifies out-of-town retail as another active area of the market, referencing M&G's respective acquisitions of Selly Oak shopping park in Birmingham and Haymarket in Edinburgh in recent weeks.

"There have been 40 deals in the retail warehouse market this year. Both consumers and retailers seem to like retail warehousing, and it seems able to maintain its value," he says.

"Unpalatable" messages

From the other side of the occupier/landlord table, Hugo Clark, head of retail property strategy at Deloitte, says that in the long term, retail assets will not necessarily deliver in relation to the business plans that underpinned the original acquisitions.

"I suspect the future in the short to medium term is going to typically be delivering fairly unpalatable messages to landlords and investors about what the two-dimensional future prospects are for their scheme," he says.

"There will be an interesting challenge as to whether some of these private equity investors will get dragged, willingly or unwillingly, into taking action [in relation to] that asset and the long-term future of that town centre, and having to start working in these partnerships, which is not what their business model is," he adds.

Rethinking uses and locations

For Clark, the first step to repositioning retail destinations is for owners, investors and retailers to harness data to fully assess the demographics of their catchment areas in relation to the assets: "There is so much data available today; [everyone has] the ability to understand what is going on in a location like never before," he says.

"Rather than lean in and out, take a step back and really understand that location – who lives there, what they do, how much money they have.

"There are a lot of places that function in completely different ways. You need to create spaces that reflect the needs and requirements of that local population. And that might have nothing to do with retail."

Reinvestment is crucial

In Capital & Regional's case, reinvestment is the key to balancing the assets it will retain with those that it views as winners in the long term.

Hutchings explains that it is about making locations "more relevant". He cites the company's acquisition of the Exchange Centre in Ilford last year – which "knowledgeable people" in 2012 said "would be flattened" – as an example.

He points to a £1.7m investment in improving customer touchpoints, resulting in footfall growth of 5.5% year-on-year during Q4 2017 and a 7.7% increase during the first two months of 2018.

He says: "It doesn't take much to re-establish connection and to build again. But the harsh reality in Ilford is that the high street is contracting. "What's up and what's left will be [potentially] more valuable if you get it right. Reinvestment is key."

On several of these points, Barke views it as an "absolute necessity" for councils to consider appointing third-party asset managers. "It's important they get good advice, negotiate hard and think about where third-party market pricing will be and not just pay what the seller wants them to pay," he adds.

He also sets out the importance of advising local authorities to retain reserves, such as a sinking fund throughout a loan term.

And to offset concerns that commercial assets in town centres are in terminal decline, Barke highlights that the mentality among local councils will not be to abandon one asset in favour of another, as a third-party investor might.

Speaking from a local authority perspective, Keith House, council leader at Eastleigh Borough Council, urges more organisations to take the plunge.

"One of the problems for many councils is they are so wary of risk. [But] we have taken the view for many years now that the risk of doing nothing is much greater than the risk of intervening," he says.

"By being active and interventionist, we have solved more problems than we have created along the way, to the extent now that if we look at our wider commercial property portfolio – which is a mixture of retail, hotels, hotel parks and housing – our income from that is greater than the combined income from council tax, business rates and [government] grants."

There are evidently hurdles in the investment market – valuation being a key challenge in particular – but opportunities do exist, as long as the nature of the UK's town centres and high streets is reshaped to become more relevant to catchment areas and local demand.

Reinvestment presents another way to potentially reposition. Although the stakes are high, it seems there is more to be gained than meets the eye.