Research Blast

UK Real Estate Market, January 2018

Are affordability pressures starting to bite in London?

Recent rise in lease assignments raises questions

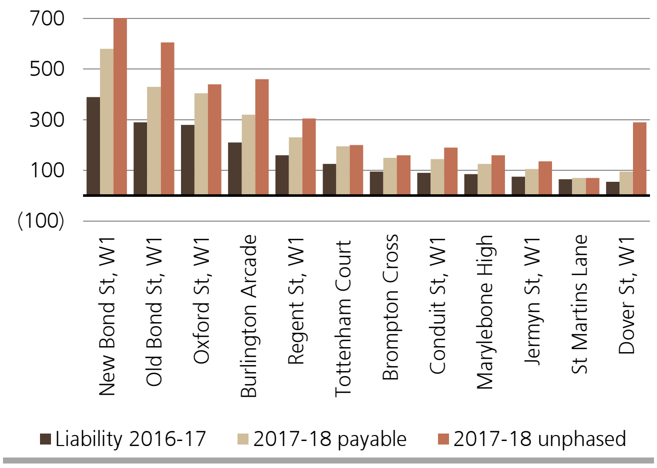
Are business rate hikes in London starting to hurt retailers?

The impact of structural change underway in the retail sector has been well documented, in particular, the impact of the growth in on-line retail. This has prompted retailers to proactively review their overall retail operations including their store network in terms of contribution to brand sales and ultimately, profit. Retailers have become increasingly forensic in analyzing their store portfolios and more proactive in closing stores that are no longer profitable. In location terms, the store types that have been most affected to date are those in smaller towns that are less dominant in retail terms. High street and shopping center retail units in secondary and tertiary towns have been closed as part of a retail network review. Looking back 15 to 20 years, an average retailer may have had a store network of c.300 stores but now it has been suggested that retail store networks could be efficient with c.100 stores with a strong complimentary multi-channel offering including on-line. Thus, the inevitable outcome is store closures in smaller, less dominant retail centers. This year alone, Mothercare announced plans to reduce their 152 strong store network to just 80-100 and similarly, fashion retailer French Connection recently announced they are targeting a network of c.30 stores by 2019, down from 75 stores 5 years ago. Gap Inc. owned Banana Republic exited UK bricks and mortar retail (8 stores in prime locations) last year citing tough trading conditions from Zara, H&M and Mango as well as high occupancy costs. Debenhams have also signalled that up to 10 stores are at risk in their portfolio (6% of UK stores). Other retailers include Argos which has closed 40 stores this year following the Sainsbury's takeover last year and more closures are likely.

Restructuring in the retail sector gained pace during the global financial crisis and we have seen a gradual polarization of locations throughout the UK and within central London since then. Generally speaking, dominant retail schemes (High streets, shopping centers and retail parks) have tended to continue to attract and retain retail critical mass and the less dominant and less successful schemes have struggled. To date, London has largely been unscathed by this trend. However, the recent rating revaluation has, to a certain extent, helped struggling towns and cities outside London as property values (since last valuation in 2010) have declined in many towns/retail areas since the last valuation. London, conversely has seen a significant increase in rateable values and thus, rates payable by retailers (see figure 1). The difference in rates payable is especially noticeable in areas that have regenerated during the period, for example Shoreditch to the east of the City of London which has become a micro destination retail and leisure location. Rates have more than doubled in some areas in Shoreditch from 2010 to 2017 revaluation.

The retail industry had the highest expectations in the commercial property sector for the 2017 UK rating revaluation after a long period of reduced consumer spending and austerity, paying rates based on trading performance prior to the financial crisis. Trading performance has only improved more recently now that we have seen some improvement in retail sales levels.

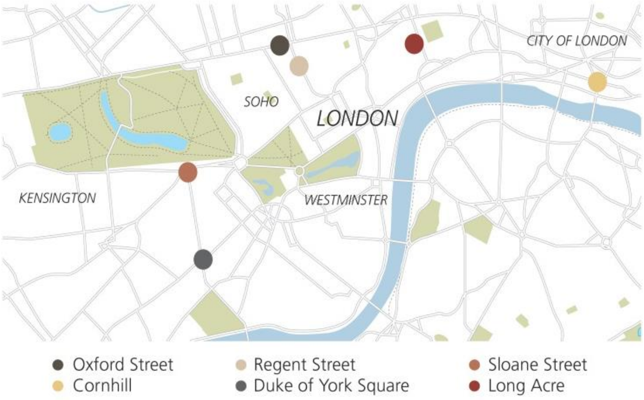
Figure 1 Change in rate liability – London retail centres



Source: JLL, The Rating Revaluation 2017

Retail business rates on New and Old Bond Street and Regent Street have almost doubled (2017 v's 2010), whilst rates on Oxford Street were very close to that level of increase. Clearly, this translates into a significant increase in occupancy costs for retailers and could push affordability levels and upset the increasingly delicate balance between store location and profitability. During the past few months, we have started to see evidence of a number of retailers that are attempting to assign their leases in good quality central London retail locations. We have seen some retail units become available for assignment on New Bond Street and Regent Street that are considered prime West End retail, Sloane Street, Knightsbridge and Kings Road, Chelsea (See figure 2). At the same time, these locations have all seen a significant rise in business rates due this year since the rating revaluation. We wonder if the significant rise in business rates is now starting to push affordability thresholds for retailers in London. Anecdotally this year we have witnessed a rise in the number of independent store closures in established, affluent London neighbourhood commuter locations.

Figure 2 London - Retail areas



Source: UBS Asset Management, December 2017

According to elocations.com French connection are looking to assign two of their central London stores, one in the City of London on Cornhill and another on Long Acre Covent Garden. As noted earlier, French Connection is looking to rationalize their store network and two of the proposed store closures are in London. The Covent Garden store is located within an established retail location that is very popular with tourists. The unit is not prime pitch but there are strong retailers nearby. Whereas, the Cornhill location is not an established retail location with similar adjacent retailers, it is primarily a city of London office location offering amenities to weekday office workers. We understand assignments are being sought for both of these stores, which have lease expiries in 2020 and 2025 (Covent Garden and Cornhill). Both locations have seen a substantial rise in property values since the last rating valuation in 2010. Rates have risen 53% in Covent Garden and 29% in Cornhill in 2017 (See figure 3).

Figure 3 Lease assignments

Tenant	Address	Lease expiry		Rent	Ratable value 2017	Ratable value 2010	Change in ratable value %
Hawes & Curtis	156 Oxford Street, W1D 1ND	November 1, 2030	(assignment)	£525'000	£560'000	£325'000	72
Michael Kors	29 Sloane Street, SW1X 9NE	March 1, 2022	(assignment)	£600'000	£730'000	£435'000	68
Michael Kors	11-15 Duke of York Square	March 1, 2018		£450'000	£475'000	£397'500	19
Juicy Couture	198 Regent Street, W1B 5TP	March 1, 2022	(assignment)	£800'000	£615'000	£407'500	51
French Connection	66-67 Cornhill, EC3V 3NB	June 1, 2025	(assignment)	£190'000	£182'000	£141'000	29
French Connection	99-103 Long Acre, Covent Garden	June 1, 2020	(assignment)	na	£920'000	£600'000	53

Source: https://www.tax.service.gov.uk, November 2017, elocations.com, October 2017, UBS REPM Research calculations, November 2017

Juicy Couture is reportedly preparing to exit both of its UK stores amid tough trading conditions on the high street (press release April 2017). The Retailer is looking to assign their prime retail unit on Regent Street, leased until Mar 2022. The unit is very well located. According to the valuation office, rateable values have increased 51% from 1 April 2010 to 1 April 2017. Similarly, Michael Kors is also seeking to assign the remaining years on their lease (to 2022) in the upmarket Sloane Street in Knightsbridge. The unit benefits from a good location and upscale retail adjacencies. A new tenant is also being sought for another Michael Kors unit on Duke of York Square, Chelsea. Again, the store is well located in a strong retail area, just off the Kings Road. It is understood that Michael Kors is reducing its store portfolio to reduce operating costs and boost profit. In this example, there are numerous Michael Kors stores in a condensed area of West London and these were in close proximity to their concession at the world famous department store, Harrods (0.1 miles away from the Sloane Street store and 0.1 miles from Duke of York Square). However, like the unit on Regent Street, the rateable value increased by a staggering 68% from 1 April 2010 to 1 April 2017. Obviously this would raise occupancy costs considerably and perhaps affordability for the unit, given there has been no material improvements in market conditions in line with this increase. However, it must be noted that demand for units in these locations remain reasonably robust and new retailers have been acquisitive in this location in Chelsea. Boden, the British primarily on-line retailer has just opened their first physical store on Chelsea's Kings Road at Duke of York Square.

Clearly, this paper has focused on a short snapshot of time (October 2017) and has highlighted the on-going rising cost challenges facing retailers. The examples shown illustrate how affordability constraints may be spreading to London. It seems costs pressures may now be increasing in London, as retailers are seeking to assign leases in locations where the delicate balance between occupancy costs and retail sales can no longer be met. However, what is certain is that affordability pressures are likely to persist in the retail sector in the short term and this only adds to the scrutiny now involved in analyzing new store openings.

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