Are European shopping centre values set to fall?

MALL OF SCANDINAVIA IN STOCKHOLM

Evidence is emerging that a market correction is on its way in the European shopping centre sector, led by the UK

BY **JANE ROBERTS**

On 17 May, Unibail-Rodamco's shareholders meet to vote on the takeover by their company of retail peer Westfield.

It is by any measure a significant deal and, assuming the recommended offer goes through smoothly, it will create the largest listed property company in Europe with €61 bn of gross market value *(see also article on p44)*.

The timing of their decision to merge is also viewed as particularly interesting for what it says about the future of the shopping centre sector. Unibail is respected by those who've had dealings with the company over the years as a disciplined machine which implements strategy rigorously. Westfield has had a similarly long-standing high reputation.

In short, the deal is seen as the consolidation of two strong players which makes sense because even the most prime retail assets face headwinds in a difficult trading environment where physical sales and margins are falling.

The merger could coincide with a turning point for the wider market. The well-known challenges facing retail have not yet fed through into European shopping centre valuations. On the face of it, the shopping centre investment market is still very healthy. There are lots of centres on the market and lots of buyers, though price discovery is getting harder for many of these deals.

UK MARKET

Even in the UK, there is little hard evidence in the shopping centre transaction market of values falling. This is despite the UK being further through the property cycle; and – with the highest internet penetration at 17% of all sales (according to the Office of National Statistics) – having too much physical trading space which is causing problems for strong as well as weak retailers.

The other sector merger proposed, between UK-listed REITs Hammerson and Intu, provides further clues about what lies ahead. Both companies' portfolios include high-quality assets. Two years ago, Hammerson

Auction sales reflect ‘today’s reality’ for UK secondary centres

Shopping centre investment volumes have been low in the UK for the last couple of years and few secondary centres have traded, with potential sellers reluctant to risk crystallising value falls. However, evidence of the losses suffered by secondary UK schemes with persistent voids has surfaced in the auction market.

Last October, Colony Capital sold the 125,000 sq ft (11,600 m²), multi-level Callendar Square shopping centre in Falkirk’s High Street, one of three centres it had acquired in 2015 which were part of a larger, distressed ‘Gemini’ portfolio once owned by Glenn Maud’s PropInvest.

In 2006, just before PropInvest lost control of the assets, Callendar Square was valued at £25 mln. It sold to a private buyer at an Acuitus auction for £1 mln.

More recently, in March, UK core/core-plus fund manager Royal London Asset Management sold The Abbeygate (pictured), a two-storey, 90,000 sq ft 1960s shopping centre in the Midlands town of Nuneaton, for £4.3 mln, again at an Acuitus auction. RLAM paid £17 mln for the scheme in 2005. Abbeygate was better let than Callendar Square.

‘The sale of the Abbeygate shopping centre in Nuneaton attracted a lot of publicity when it sold at our latest auction for £4.3 mln in contrast to the £17 mln it achieved in 2005,’ says Acuitus chairman and auctioneer Richard Auterac. ‘But the world has been transformed in the intervening 13 years and the property market is reflecting that.

‘There are actually considerable positives to be taken out of these corrections. The Nuneaton asset attracted a lot of interest because prospective buyers could be confident that it had been well-managed by its previous institutional owner, had strong support from the town’s shoppers and offered the prospect of a new owner to put their own mark on the centre. These sales are transitioning assets to the next phase of their evolution with a more appropriate risk-return profile based upon rents that reflect today’s shopping reality.’

Auterac believes an increasing number of these secondary shopping centres will come onto the market as sellers ‘get real’.

APAM, the UK asset manager now owned by Catella, is another company which believes there will be many more assets trading at a loss in the coming few years. ‘We believe there are about £5 bn of secondary centres which will come under strain. Often they are in the hands of investors who don’t hold for long and who use leverage,’ says director and co-founder William Powell.

‘This is a lot healthier for the market than – as is happening in many instances – assets coming to market, not selling and then being refinanced at precisely the same values that they have just failed to achieve,’ Auterac adds. ‘This is simply “kicking the can down the road” and will continue to sustain false expectations in some areas of the market.’

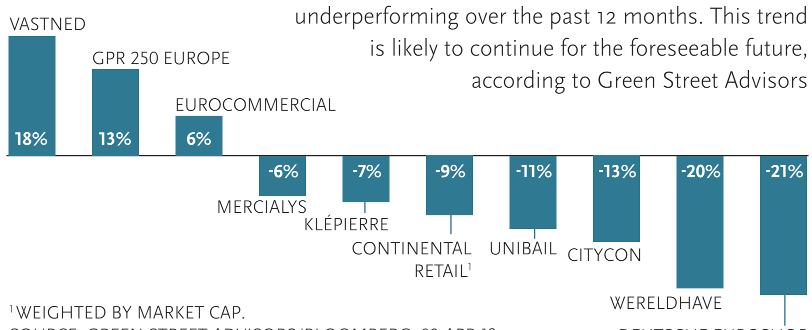
bought into Value Retail which is said to have the fastest and most consistent growth in sales of any retail owner in its best outlet villages. The UK REIT says it will sell £2 bn of lower growth UK centres and focus on faster-growing economies like Spain and Ireland after the merger. Yet Hammerson and Intu continue to trade at significant discounts. At the beginning of April Hammerson released a first-quarter statement with a valuation of £10.5 bn for its portfolio, but its market capitalisation was just over £4 bn. It appears that investors and analysts just can’t believe there is the prospect of enough medium-term rental growth to justify Hammerson’s 15% five-year return forecast.

Analyst Green Street Advisors estimated in its UK majors sector update published in March that Hammerson has set the bar for total levered returns approximately 7% higher than its unwelcome French-listed suitor Klépierre, whose two takeover approaches were both rejected by the Hammerson board as significantly undervaluing its portfolio before Klépierre withdrew. At around the time the first Klépierre offer became public, Green Street wrote in the same update: ‘Intu rejected an indicative 425p offer at a modest premium in 2010, yet accepted 254p and a big discount recently. What has changed? Perhaps the market outlook, amongst other things, has deteriorated significantly. While Hammerson’s board finds an 8% discount to reported values wholly inadequate – and didn’t encourage Klépierre to make a firm offer at a higher level – Intu management are willing to accept a 15% discount.’

Hammerson and Intu have also been criticised for being too highly geared for this advanced stage of the proper-

Continental retail sector underperforms

Slipping away: the Continental European retail sector has been an underperforming over the past 12 months. This trend is likely to continue for the foreseeable future, according to Green Street Advisors



[1] WEIGHTED BY MARKET CAP.
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PARTNERSHIP INVESTMENT DEVELOPMENT LEASING MANAGEMENT RETAIL EXPERTISE ty cycle, although there are other, European retail REITs which are similarly levered at levels of 40% or slightly higher. Despite a benign macroeconomic backdrop and supportive monetary policy, continental retail REITs have returned -9% in the last 12 months.

Florencio Beccar, head of EMEA retail at CBRE Global Investors, says that many generalist, rather than specialist, investors in particular have been 'scared off' the sector. 'Retail has had negative headlines, particularly about the US and what is going on there which is not necessarily reflected in continental Europe,' he notes. 'The UK has also been quite affected. Investors are reacting, they don't want to take a lot of risk.

'If you are bringing an asset to market which is neither a strong, dominant, experiential centre nor a good convenience centre you will meet resistance and difficulty selling it at a nice price.' Beccar says that some pricing has begun to adjust, but still not very widely. 'People are trying to hold on to their assets, trying not to sell them at low prices. But that will have to come to an end and I would expect 2018 and 2019 to be years when we start to see some trading at higher yield levels.'

Earlier this year at the Urban Land Institute conference in Berlin, Alexander Otto, the CEO of ECE which is continental Europe's largest unlisted shopping centre landlord/developer, was disarmingly frank. In a discussion on the future of retail he said: 'Looking back, a lot to do with the world of retail was too good to be true. Rental growth and net operating income was fully distributed to owners instead of it being spent on the assets. But that time is over. It is a continual management effort now and it is getting more and more management-intensive to do a good job.'

On the plus side, Beccar says, 'this is an interesting point in the market, and for a specialist which knows retail well and for assets which have very strong fundamentals but which still are punished by the current environment, there will be quite attractive deals out there in the next 18-24 months.'

The narrative fashioned by the property sector of two types of shopping centres that will hold their value, dominant experiential centres and convenience shopping, is about to be tested. The centres attractive to the most buyers will be those with growth.

Sources say there are shopping centres on the market now, such as two of four French shopping centres Hammerson has been trying to sell – O'Parinor and Espace St Quentin – which have not sold because they do not trade as well as others in the REIT's portfolio and Hammerson was not prepared to offer a yield premium.

The prices that investors are prepared to pay over the next 12-24 months are likely to shine more light on which centres are strong performers and others where maintaining rental levels will be a battle. ■

Retail replaced by residential and leisure in Harlow makeover

In Harlow, a UK town of 85,000 people built in the 1950s, the town's shopping precinct, the Harvey Centre, is getting a makeover which involves a substantial cut in retail floorspace. Tristan Capital and Addington Capital bought the scheme in 2011 as part of a portfolio of three centres.

Martin Roberts, principal at Addington, explains the Harlow changes: 'We've taken out about 80,000 sq ft (7,400 m²), the centre's first floor, and converted it to a cinema plus restaurants. A further 100,000 sq ft of retail plus ancillary space will come out of the Little Walk site, which we are replacing with 400,000 sq ft, of which 40,000 sq ft will be retail. So we've halved the retail content.'

The bulk of the additional space is residential, spread over four new buildings ranging from three to 16 storeys, which will provide 447 flats for sale.

The investment works, says Roberts, because of achievable residential sale values – even though the £300-plus per sq ft expected is not quite as high as best retail site values. Also, he continues: 'The net additional we are building is in airspace, and so effectively came at nil value, while storage or ancillary space would have been worth a fraction of that (prime retail) sort of number. So the increased density helps the equation as well.'

HARVEY CENTRE IN HARLOW

Roberts believes UK landlords need £300 per sq ft or more to make knocking down retail work. 'Harlow is a big enough town and has the connections in the south east... Other places will be more challenging.'

Not all the Harvey Centre was failing by any means: the main pitch remains strong and Addington and Tristan took back the Marks & Spencer store which had dual access from the centre and from the town's core Broadwalk and relet it to seven retailers. But Roberts agrees: 'There is probably too much retail floorspace in many town centres, and focusing retail in a more concentrated footprint and introducing different uses looks like the way forward... we'd certainly be interested in doing more of this.'