TALKING SHOPS Andrew Jones

Prime club isn't the only place to find retail's star performers

There is a growing feeling that the retail property market is in the middle of a material dislocation between asset pricing in the investment market and what is happening in the occupational market. Yields for most retail space have bounced back substantially over the past 18 months or so, and are now at levels that imply high degrees of income growth over the next five years.

However, we have "lost" a number of retailers, others are hanging on and many are struggling to maintain like-for-like sales growth, operating margins and underlying profits. We therefore have a mismatch between limited demand and excessive supply in many shopping locations across the UK.

This begs the question of how these destinations will create the demand required to increase rents to support capitalisation yields. Or is the underlying occupational picture telling us that the cap rates for these assets are too aggressive, and the next move on yields will be outward?

High street blues

We didn't need the British Retail Consortium or recent trading updates from the main retailers to tell us that life on the high street is challenging. The occupational market is becoming tougher and retailer demand a lot more polarised than it has been for a very long time.

The common thinking is that prime retail assets will be OK, but secondary property is where the greatest pain will be felt. However, I'm not sure that it's as simple as that.

Part of the problem is that people's definition of prime is generally far too wide – everybody claims to have the prettiest child in the playground. Income length, covenant strength, occupier contentment and a limited need for defensive capital expenditure are all prerequisites. In simplistic terms, landlords who tick all these boxes will be better placed – but how many realistically can? We think a lot less than are currently claiming to be able to do so, to justify their membership of the "prime club".

That leaves the rest, where there are income concerns, poor trading, impending lease expiries, obsolescence, new competition or a need to spend capital just to keep the doors open, the lights on and the rent flowing.

Occupiers are facing strong headwinds from the downturn in consumer spending, threats posed by out-of-town centres and the growing share of spending heading to the internet. There is a real risk that one or more of these weaknesses will be exposed and the prospect of being able to maintain current income levels, let alone achieve rental growth, is going to be seriously undermined.

The top 30 retail destinations seem to be in a much better position to ride this out than the rest, as the likes of Apple, and US fashion chains Hollister and Forever 21, are keen for representation in the best retail locations.

But what are the performance prospects for the rest? In locations where there is at best limited balance between demand and supply, where is the rental growth going to come from to justify the growth implicit in current yields?

In the same way that not all prime is good, not all secondary is bad. Most secondary space is, at best, running to stand still: paying to maintain occupancy levels; absorbing high, irrecoverable service charges and empty rates; struggling to maintain retailer representation at lease renewal (let alone the passing income); and facing demands for defensive spending to "refresh" the shopping experience.

However, if you look hard enough there are opportunities in secondary subsectors where occupiers continue to trade well, rents are affordable, accretive asset management initiatives exist, competition is limited and – despite some possibly short income – retailers don't want to leave at lease renewal.

They may be called secondary and priced as such, but their potential will allow them to substantially outperform many occupiers in the "prime club".

Therefore it is not as simple as prime v secondary. In this environment, the performance of prime assets outside the top 30 destinations will struggle to justify their "premium" rating – but similarly, not all secondary assets will drift in line with the wider subsector.

Taking a bottom-up approach feels like a better bet than taking a macro-decision that all prime will outperform secondary. After all, not all boats will rise on the next tide.

Andrew Jones is chief executive of Metric Property Investments

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