WHITEPAPER

London Calling?

The outlook for retail property in London

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For today's investor

AVIVA INVESTORS

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Main responsibilities

Jonathan manages Aviva Investors' Real Estate Research Team thought leadership and insight program. He is also responsible for developing a house view on the attractiveness of specific UK and Irish property sectors and investment strategy for our UK and Ireland focused real estate funds.

Experience and qualifications

Prior to joining Aviva Investors, Jonathan worked in JLL's Retail Research and Consulting team, in the UK and Europe. Jonathan holds an MSc in Real Estate from Reading University's College of Estate Management and a BSc in Geography from University College London. He is a member of the SPR, Revo and the ICSC.

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Introduction

This paper outlines why we are positive on the outlook for London retail and how we can identify the London sub-markets with the best medium-term investment prospects.

Retail is experiencing major upheaval. Retail and food & beverage occupier markets, are chronically weak in many parts of the country. This is reflected in pricing and overall activity.

Much of this upheaval reflects the well-documented structural change resulting from the rise of online shopping. Sales, especially of low-engagement products, are being diverted from uninspiring physical stores to online delivery channels. As a result of this shifting dynamic, the most resilient physical stores will be those focused on high-engagement experiential retailing. These stores will create a shopping experience that is rich, empowered and personalised and be crucial to the future multi-channel retailing landscape.

Not all markets will be equally equipped to deal with such a transition. For example, scale is vital when looking to create a strong destination. Equally important are factors like:

- The economic strength of a market's catchment
- Strong retail productivity
- A good food and beverage offering
- Alignment of the retail offer to catchment demographics

London appears particularly well-placed to deal with the structural changes underway. As a retail market, it clearly offers scale. As an economy, it also offers exceptional dynamism. Compared to the rest of the UK, London has a much higher concentration of younger and more affluent demographic groups[1]

In the coming years, Oxford Economics forecast growth in London will outstrip all other UK regions. As a result, population and spending power are set to become increasingly concentrated in the capital.

London is not a single retail market. The UK's capital encompasses a host of centres with a wide range of characteristics. These range from the very large, nationally or even internationally-prominent centres to smaller sub-markets with a more local catchment and character dynamics. Not all of these are equally well placed to become destinations for high-engagement, experiential retailing.

Investors therefore need to be tightly focused.

1 https://www.caci.co.uk/blog/who-are-londoners-and-how-do-they-shop.

Regent street, Oxford circus , London.

Retail sector difficulties are well established

Retailer failures and restructurings are putting upward pressure on vacancy and downward pressure on rental streams. In turn, retail and leisure operator market weakness is feeding through to prices and deal activity.

Retail occupier markets have tended to struggle throughout the period since the Global Financial Crisis (GFC).

According to the IPD Monthly Index, retail rents fell by almost 13 per cent in the period 2008-14, and have effectively stagnated since. This is in sharp contrast to office and industrial trends where rents have managed significant recovery in the period since 2012/13.

Oxford Street, London.

Online redefining shopping

Although the period since the GFC has seen some retail-specific headwinds that may well be cyclical (such as sterling weakness and declining real incomes), the structural change due to the rise of online shopping has been clear for all to see. Data from the Office for National Statistics (ONS) shows that online sales as a proportion of all sales (excluding fuel) exceeded 20 per cent for the first time in November 2018; in 2008 the share was less than five per cent[2].

Yet even numbers as pronounced as these do not capture how the maturing of online retailing has altered the very nature of the shopping experience. Online shopping can help eliminate many of the customers' costs as well as the challenges related to shopping in physical stores. Transport and time costs, queuing, difficulties locating products and lack of in-store assistance are all good examples of this. However, the trend toward online has also introduced and popularised new features such as customer reviews, price matching, instant customer support, fast returns, order tracking and multiple shipping options.

These developments have significantly changed consumers' expectations regarding the shopping experience by raising the bar in terms of convenience, personalisation, service and choice. Yet they do not affect all product types equally. It is important to distinguish between two classes of products: low and high-engagement.

Low-engagement products, or those with a low "mind share" are typically routine purchases where speed, efficiency and price are the chief concerns. For these, there will be a greatly reduced role for physical stores as "auto-replenishment" and "direct-to-consumer" retailing becomes the norm.

By contrast, ***high-engagement products*** offer the potential for an interactive, tactile and personalised customer experience. The fate of physical stores is especially tied to these products, that offer outlets the potential to be a space for discovery, engagement, experience and interaction with brands. These stores will no longer simply provide a distribution channel but will aim to create an experience that is rich, empowered and personalised. Ideally, they will create an experience that rivals or surpasses what buyers can get online. Stores will be used as the physical interface in a seamless multi-channel experience.

Not all markets can play this role

But only some markets are likely to be able to reinvent themselves as destinations for high-engagement, experiential retailing. In particular, **scale** is vital when looking to create a strong destination and this suggests that the **major cities and regional centres** offer the greatest potential. By contrast, smaller centres are likely to struggle to establish themselves as destinations for high-engagement retailing.

Scale alone is not likely to be sufficient, however. Additional necessary factors include the economic strength of a market's catchment, strong retail productivity, a good food and beverage offer and the alignment of the retail offer to catchment demographics.

Markets with these attributes are likely to be resilient in the face of rising online sales. Identifying such markets allows us to focus portfolios on growth locations and manage the risks inherent in a period of major upheaval[3].

2 "Retail Sales, Great Britain: November 2018", Office for National Statistics.

3 https://www.avivainvestors.com/en-gb/views/aiq-investment-thinking/2017/10/retail-real-estate-future/

The unique appeal of London

London's scale is undeniable, particularly as a retail market. As an economy, it also offers exceptional dynamism. According to Oxford Economics, London has been by far the fastest-growing UK region in recent years. Its average GDP growth has been almost twice that of the rest of the country in the period since 2008. Europe's busiest high street, Oxford Street, has a catchment that extends far beyond municipal and physical boundaries of the city.

London Oxford Street's primary, tertiary and secondary catchments.

Source: Javelin 2017, Aviva Investors 2019

This fits with a trend in many developed economies over recent decades whereby the largest cities within a country have tended to strongly out-perform smaller centres[4]. This appears to be a consequence of economic globalisation, the digital revolution and the rise of the knowledge-intensive service economy in the developed world.

London: the Global City

London's credentials and scale as a centre for talent and knowledge-intensive industries are remarkable not just on a UK-wide comparison but at a European and global level too. In terms of talent, London has:

- The highest percentage of residents with tertiary educational attainment in Europe, at over 55 per cent[5]
- The greatest number of highly-ranked universities[6] and business schools of any European city
- A diverse and talented workforce. Its four million workers have 230 languages, 318,000 digital tech jobs, 400,000 creatives and some of the world's best professional services partners[7]

These strengths in human capital underpin London's major concentrations in a broad range of knowledge-intensive sectors. For instance, London has:

- Europe's highest-ranked **financial centre**[8]
- Vibrant and diversified **technology and creative sectors**. It registers the largest number of tech start-ups as well as tech "unicorns" in Europe and is ranked as the top destination for foreign companies to invest in software and IT services globally over the last 10 years[9]
- A notable **professional services** centre including legal services, accountancy and management consultancy

Evidence shows that cities with the most prosperous economies have significantly more office space in their city centres, and as a result stronger retail and leisure environments[10]. Enhancing the quantity of people with high disposable incomes living and working in city centres, is the most sustainable strategy to keep retail sales resilient. It is a much more efficient strategy than giving tax relief on business rates or incentivising consumers to visit with initiatives such as free parking[11].

London: the tourist destination

An additional boost to London's economic performance comes from its position as one of the world's great tourist destinations. London played host to over 19.8m international visitors in 2017 making it the second most visited city globally[12]. The retail sector is particularly boosted by tourist visits, with those from the Middle East and China especially important in terms of share of transactions. It is estimated that 30 per cent of retail expenditure in the prime West End streets comes from international tourists with luxury goods sales particularly supported[13].

4 https://www.avivainvestors.com/en-gb/views/aiq-investment-thinking/2018/05/real-estate-the-rise-of-the-metropoles/

5 Source: Eurostat.

6 https://www.topuniversities.com/qs-world-university-rankings

7 Source: Financial Times business schools rankings.

8 Source: London & Partners.

9 Z/Yen Financial Centres Index

10 JLL City Momentum Index 2018 Centre for Cities 2018 Building Blocks report

11 Centre for Cities Building Blocks report

12 Mastercard's 2018 Global Destination Cities Index

13 Central London Retail Report, Spring 2017, BNP Paribas Real Estate.

A relatively young and wealthy population

While international visitors provide a very welcome boost to London's retail scene, of even greater importance is the financial strength of many of its permanent residents. Compared to the rest of the UK, London has a much higher concentration of younger and more affluent demographic groups. For instance, CACI's Acorn[14] geodemographic segmentation analysis finds that:

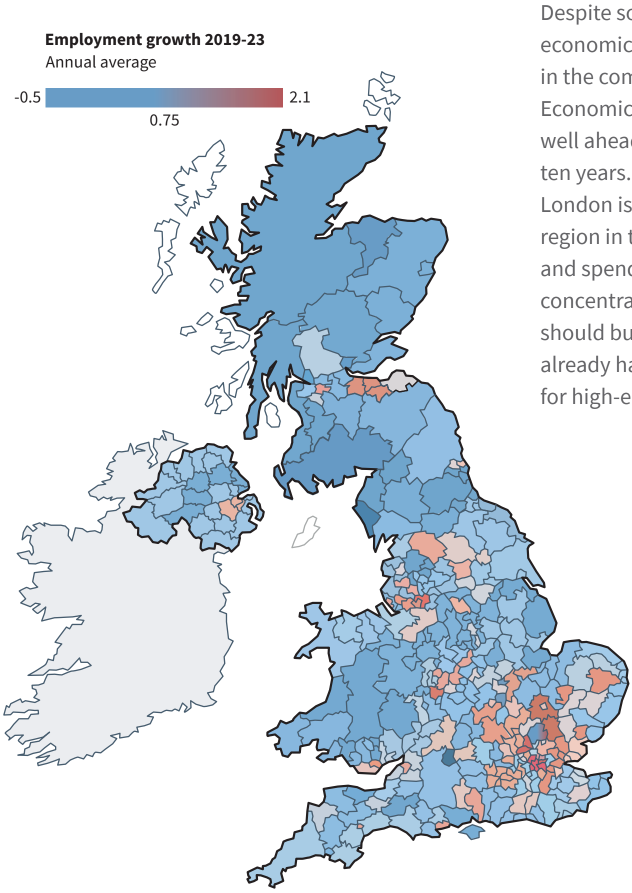
- Two per cent of London households fall into its "Lavish Lifestyles" category, compared to one per cent for the UK overall. These households have an average house value of £3.8m and savings and investments in excess of £100k
- London's most prevalent demographic is what CACI terms "City Sophisticates". These inhabit houses valued at £1.5m or more and have incomes 56 per cent higher than the UK average. 24 per cent of London residents fall into this category

These demographics lead to behavioural differences on the part of London shoppers. Londoners visit the shops more often than average, for instance. They also spend far more on dining out than residents of other UK regions. These characteristics are a boon for the capital's retail scene when it comes to creating destinations for high-engagement, experiential retailing.

14 https://www.caci.co.uk/blog/who-are-londoners-and-how-do-they-shop

Oxford Street, London.

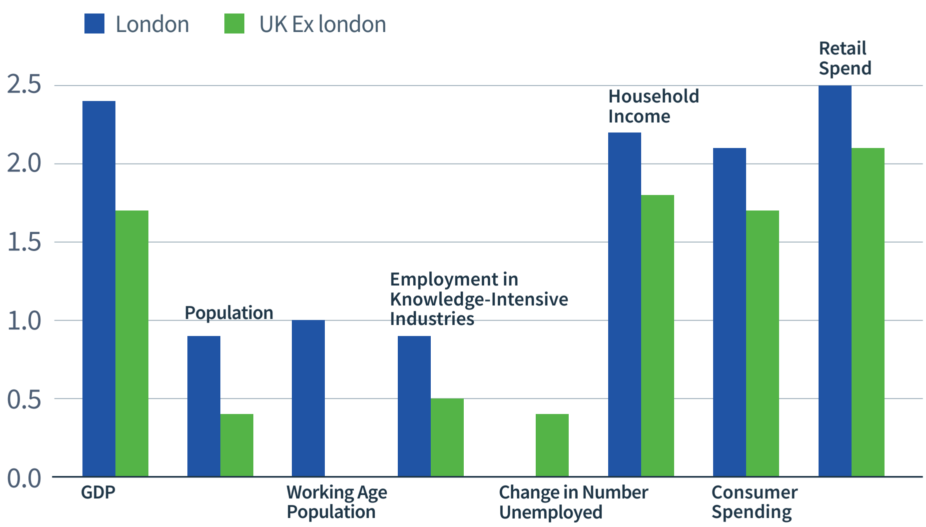
London's economic out-performance expected to continue



Source: Oxford Economics March 2019, Aviva Investors April 2019

Despite some political uncertainty, London's economic out-performance is expected to continue in the coming years. According to Oxford Economics, growth in London is expected to run well ahead of the European average over the next ten years. And in a UK-wide context, growth in London is expected to be far ahead of any other region in the same period. As a result, population and spending power are set to become increasingly concentrated in the capital. This performance should buttress the advantages that London already has when it comes to creating destinations for high-engagement experiential retailing.

Figure 1. **London's forecast performance compared to the rest of the UK, 10 year (2019-2028) Average growth per year**



Source: Oxford Economics January 2019, Aviva Investors April 2019

London's diversity challenges investors

More than 200 retail centres can be identified in the Greater London area. These range from the very large, nationally or even internationally-prominent centres to smaller sub-markets with a more local catchment and character.

Not all of these are equally well placed to become destinations for high-engagement, experiential retailing. In order to identify which London markets are most suited to that transition and therefore most resilient to structural change, we have divided the sub-markets into a number of categories based on size and other quantitative and qualitative characteristics.

The first category comprises the ***very large and established*** London centres. These share characteristics such as a very large catchment, highly productive centres, and retail offers that are well aligned to their catchments and elevated purchasing power. Examples are the West End, Covent Garden, Kingston and the Westfield shopping centres. These markets are expected to continue to perform strongly in coming years. They should offer the most robust investment performance. They are growth locations and are on many investors' radars. In our view, these are very desirable locations for investment, though competition for assets in these centres tends to be intense.

Oxford Street

Oxford Street is at the centre of London's West End, the largest concentration of retailing in Europe. Overall the location has very strong current performance and its retail offer is well aligned to its catchment. It is a location that has a 24/7 global appeal and is a major tourist attraction in its own right. As a result, demand from well-established global brands is strong. Looking forward, the centre will benefit from strong regional labour force growth and the catchment will continue to have very high purchasing power. It will also be boosted by investments in major infrastructure projects like Crossrail and continual improvements to the public realm.

Kingston

Kingston's existing scoring as a retail destination is strong but not meaningfully above average. At this time, it displays a dynamic retail offering with an average shopper population. Yet it is anticipated to see substantial development as a retail destination in the near future. This market shows a higher level of available spending and, with labour force growth likely to be very strong, the economic well-being of its catchment is a major attraction. Its retail offer is aligned to its demographics and the replacement of floorspace in Kingston will boost its appeal to shoppers.

Kingston upon Thames.

London's most promising sub-markets enjoy affluence and a strong retail offer

Unsurprisingly in a metropolitan area comprising almost 10m people, there are major disparities across London in terms of affluence and the economic strength of the catchment, as well as the retail offering. For instance, CACI's[15] analysis shows that, as well as its over-representation of more affluent demographic groups, London's population also includes a disproportionate share of low-income families. These comprise 23 per cent of London's population compared to just seven per cent nationwide.

Therefore, detailed local-level analysis is needed to identify the most promising markets. Economically, these will have an affluent catchment and expected healthy borough-level growth. In addition, they will have an attractive retail offering.

Quantitative analysis can be used as a screen to eliminate centres that do not offer these advantages. Local socio-economic demographic indicators and forecasts of borough-level growth are readily available. Analysis of the retail offering seeks to identify centres with high retailer productivity[16], low exposure to online retailing and a retail offer that is aligned to its catchment. Macro analysis can rapidly eliminate the weakest markets. However, further micro-level analysis is necessary to identify those centres with the greatest potential to flourish as retail destinations in the current environment. The best centres will demonstrate a number of the following characteristics:

- Pleasant environment and public realm
- A plentiful food and beverage offering
- Strong tenant line up
- Variety of unit sizes
- Public and private sector investment
- Strong connectivity

London Bridge

An example of what we class a larger centre, London Bridge has seen enormous and ongoing change in recent years. It has a strong resident, worker and tourist population. The £1bn redevelopment at London's oldest mainline station has brought a near-doubling of capacity. It has also significantly opened up the landscape allowing c.40,000 pedestrians to walk through the station per day. The mixed-use developments have added greatly to the area's connectivity credentials and destination potential, as have major developments such as the Shard Quarter and its large numbers of office workers. Borough Market is another key footfall driver. It is a globally-recognised food and beverage hub. This centre is one of the most productive centres for retailers. It is, however, weaker on retail brands, though the 92,000 sq. ft. of new retail space in the station and further developments in the area should help to address this issue.

Chiswick High Road

This is an example of a sub-regional centre that looks positioned to perform well. Though not a pre-eminent retail destination, its dynamic retail offering is bolstered by a very affluent catchment. Of as much note, however, is its public realm and environment. This is a unique location with wide pavements where people clearly enjoy spending time. Looking ahead, its current tenant mix appears well positioned for a changing multi-channel world with many of its retailers being fashion and independent-led. In addition, it has a very strong food and beverage offering, an important driver of footfall to the area. A key example of this is the Soho House Hotel/Brasserie.

15 https://www.caci.co.uk/blog/who-are-londoners-and-how-do-they-shop

16 Source: Javelin Group Retail Strategy Consultants. This is determined by looking at retailer store-level sales figures for different centres with the most productive locations likely to enjoy advantages such as high levels of footfall and extended trading hours.

Strategic Implications

Real estate investors who generate outsized returns are patient and disciplined with their convictions. We will seek to build positions over the medium to long term in the London retail sub-markets that demonstrate strong credentials as we have a high degree of confidence in the indicators we have identified.

London should continue to out-perform the wider UK retail market and looks particularly well placed to deal with the structural changes unfolding in the retail sector. There will be winners and losers in the capital. Not all of London's sub-markets are equally well placed to flourish as destinations for high-engagement, experiential retailing. Investment needs to be patient as well as tightly-focused on the most resilient submarkets.

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