Retail

Annual review of UK shopping-centre performance — 2005

Received: 15 November 2005

Bryan Duncan
has been head of the Retail Division at Donaldsons, an independent property consultants in the UK and Europe, since November 1999. Bryan is responsible for heightening Donaldsons' retail presence, servicing key clients and schemes, and ensuring continual contact with retailers and landlords alike. In particular, he provides expert advice on strategies for the development of and investment in shopping centres and other large-scale projects. Bryan is also chairman of Donaldsons Property Management, the 1,000-person management company servicing retail and leisure sites throughout the portfolio.

Abstract
This paper reviews UK shopping-centre performance in 2005 and asks a number of questions. With yield compression disappearing is enough in the pipeline to deliver total returns via improvements and development? Who are the true deliverers of asset management? How do the specialists fare against the generalists?

Keywords:
rental value, capital value, yield, returns, interest rates, investors, shopping centres

PERFORMANCE SUMMARY

Rental value growth

— Retails did well relative to other sectors in 2004, but in-town occupational demand was mostly fragile.
— Centres continued to outpace shops in rental growth, with an average uplift of 3.9 per cent in 2004 against 2.3 per cent for shops. Out-of-town rental values rose faster still, up 6.1 per cent last year (Figure 1).
— While industrials improved modestly from the previous year, office values simply stopped falling.

Capital value growth

— For the third year running, the three retail subsectors produced the strongest capital gains (Figure 2).
— Retail warehouse values grew fastest last year (17.0 per cent), followed by shops (14.3 per cent). Centres, with 11.2 per cent, fared substantially less well than shops for the first time in ten years.

Bryan Duncan
Donaldsons LLP
48 Warwick Street
London W1B 5NL, UK
Tel: +44 (0)20 7534 8543
Fax: +44 (0)20 7434 0045
E-mail:
bryan.duncan@donaldsons.co.uk

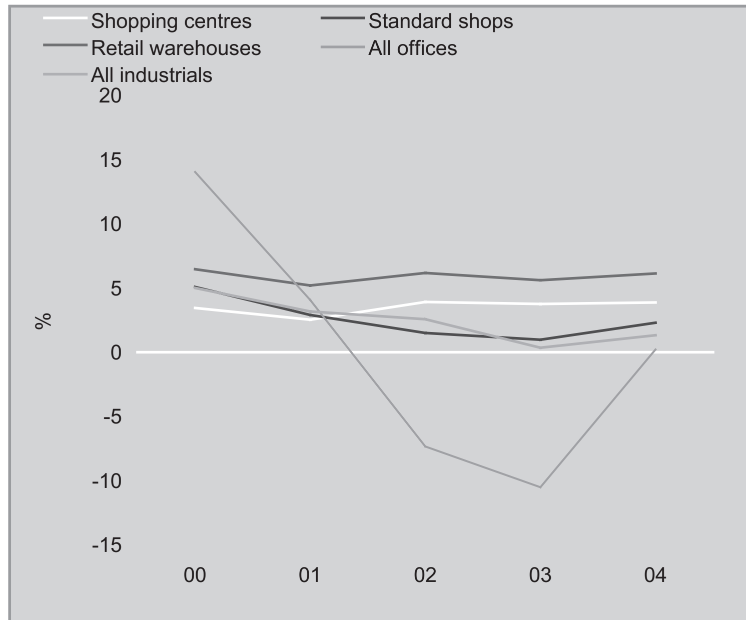

Figure 1: Rental value growth

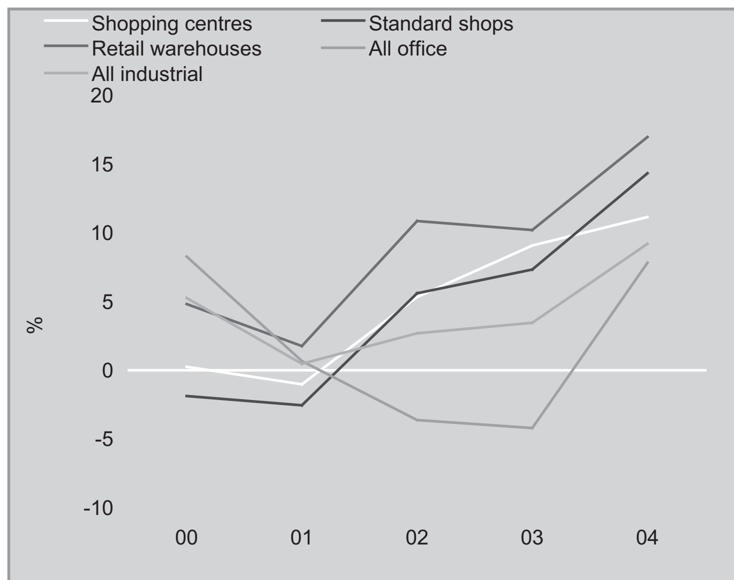

Figure 2: Capital value growth

— In 2004, offices almost made up for the capital value they lost in 2002–2003, rising 7.8 per cent despite static rental values. Industrial capital values rose 9.2 per cent.

Equivalent yields (continuous estimates)

— Within retails, shops secured the most advantage from falling yields, which sank 75 basis points (bp) (100bp = 1 per cent) in the year. Centres gained the least, with a 51bp decline. Retail

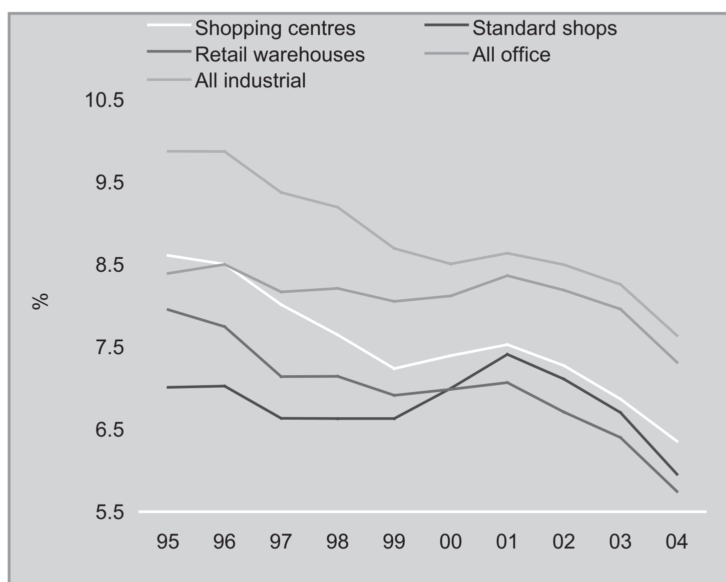

Figure 3: Equivalent yields

warehouse yields fell in line with all-property yields, dropping 65bp (Figure 3).

— Over the three years from December 2001, retail sector yields fell 132bp, to give the strongest three-year run on record in terms of impact on capital values. At the end of 2004, retail yields were respectively 130bp and 160bp below office and industrial yields.

Total returns

— Retail performance of 20.4 per cent in 2004 has been bettered only during the boom of the late 1980s. It was driven mainly by falls in yield, as nearly all property types were rerated, but partly by strong retail warehouse rental growth (Figure 4).

— Centres' performance was the weakest of the retail types, at 17.4 per cent against 21.0 per cent for shops and 23.2 per cent for retail warehouses. The total return for centres was below the all-property average of 18.4 per cent.

SHOPPING CENTRES IN CONTEXT

The property market in 2004

The most notable thing about the property investment market in 2004 was that its extreme vigour confounded the forecasters. For the last few years the hunches of the property traders have been proved right, while research forecasts have proved very wide of the mark. At the turn of 2003–2004 the Investment Property Forum's *Consensus Forecast*[1] was for a total return in 2004 of 6.9 per cent, and at least one of the top three advisory firms was looking for no more than a 5 per cent return. In fact, the outturn for the year was, at 18.4 per cent, on another planet to the *Consensus Forecast*.

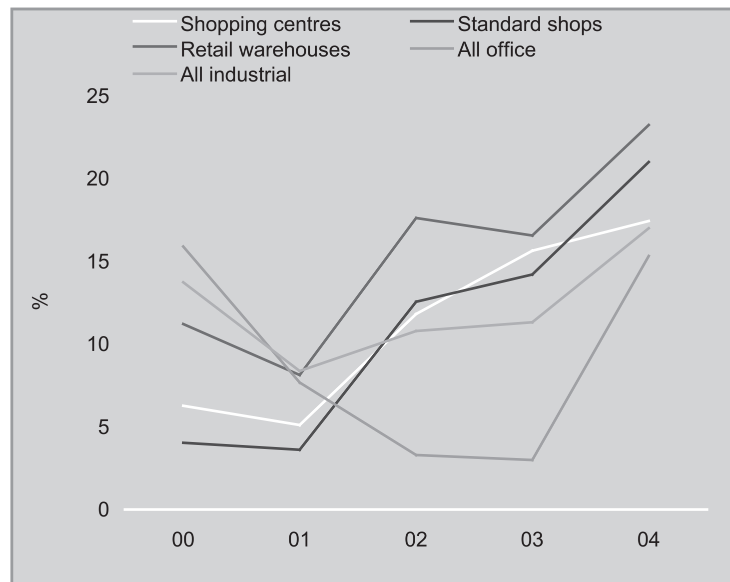

Figure 4: Total returns

In spite of several years of outperformance and talk of rising allocation levels, in 2003 the funds made a very major strategic play by becoming hefty net disinvestors from property for the first time. So, as things stood at the end of 2003, it was no surprise that the *Consensus Forecast* was for the return in 2004 to be well below the short-, medium- and long-term averages. But then, as one moved into 2004, there was a total *volte face*. In spite of the forecasts, and in spite of their major sell-off in the prior 12 months, institutional investors piled back in. Funds committed their fourth largest net annual investment ever. On seeing a £2bn sell-off one year, accompanied by bearish forecasts, followed by a £3.6bn acquisition scramble over the next 12 months by sophisticated fund investors, one has to ask if the investing public was well served.

The forecasters expected rental growth would be negative, and that rental values would fall marginally. Occupational markets were not as weak as forecasters expected, however, and growth was well up on the two previous years. The positive outturn meant that part of the forecasting error was a 3 per cent underestimate for rental growth.

Income return is not a figure that forecasters can seriously misjudge, since it has not varied by more than 6bp from year to year, outside the early 1990s' gyrations. Thus, for the source of the error, one is left with the remaining ingredient to the forecasts, namely capitalisation rates. Since the *Consensus Forecast* was for nil capital uplift, and the actuality was an 11.5 per cent capital uplift, then given the static rent forecast one deduces that a seriously wrong assessment of the prospects for yields was made. Instead of holding close to the end-2004 level of 7.3 per cent as expected, they

fell to 6.6 per cent. The year witnessed the third strongest yield impact on capital values ever, and the *Consensus Forecast* never saw it coming. There is a lesson to be learnt.

Values have been rising under competitive pressure for potentially low-growth income streams capable of supporting borrowing. As noted two years ago,[2] the key property fundamental has changed from a total return target that incorporates medium-term rental growth prospects to an emphasis on the yield gap between income return and interest rates. Low interest rates at home and (importantly) abroad, and increasingly sophisticated debt and tax strategies, have kept down the effective cost of medium-term debt available to owners of UK property. Yields paid were uncoupled from occupational markets; a situation that will be maintained until income flow is seen to be in jeopardy. Simplistically, the forecasters' tools today are cost of debt, income level and income security, not total return targets and implied rental growth rates.

Taking shopping centres as an example, Figure 5 shows centre equivalent yields at the end of 2003 matching their previous lowest. This was judged as a precarious level by the more traditional valuers and forecasters. Nonetheless, by the end of 2004 yields had set another low, 6 per cent, and looked even more exposed. In both 2003 and 2004 centre rental growth was about 1 per cent below its real long-term trend level, and was fragile. But turning to the graph line marking centre income return, it was not especially vulnerable, at about 75bp above its lowest level. Although the income return trend matches equivalent yields, the difference between them reflects

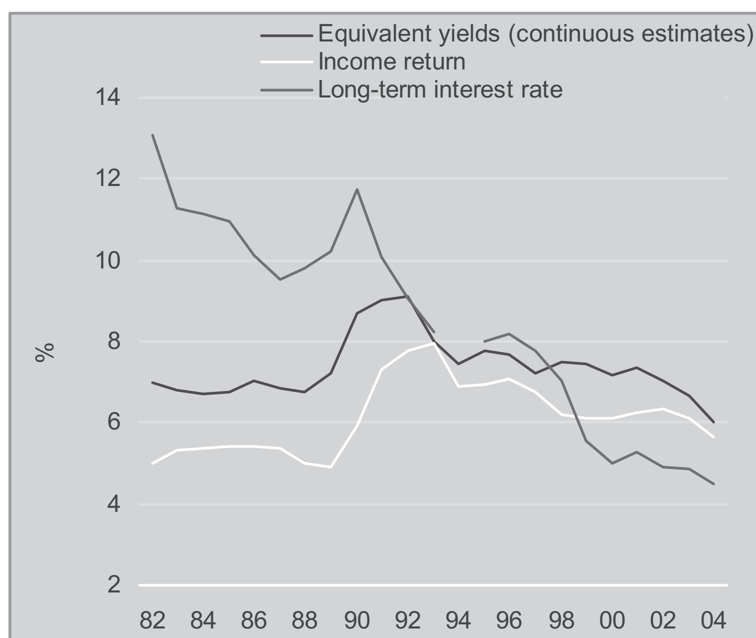

Figure 5: Centre affordability

the strength and volatility of nominal rental growth, strong at the end of the 1980s but lower and steadier today. On the basis of income return levels, centres were not obviously exposed.

The graph line marking interest rates is taken from HM Treasury's series of long-term interest rates based on ten-year benchmark government bonds. It shows that these rates have dropped dramatically, and since 1999 have actually been below shopping-centre income returns. This new relationship between the cost of money and income returns is key, because it puts centres at one of their most favourable, affordable, buying points for the last quarter of a century, not at one of their least favourable. For sure, this new order may be short-lived and one does not know yet what a normal relationship under it should be, but for the last three years centre income returns have moved in the range of 120–150bp above interest rates. It is also known that shopping-centre income returns fell 40bp in the first six months of 2005 while interest rates fell 30bp, so the relationship is remaining constant; it was over this affordability issue that the *Consensus Forecast* for 2004 went awry.

This changed view of key pricing and valuation inputs, from rental growth and yields to borrowing costs and affordable income returns, may not be the natural approach of fund managers, but, as mentioned last year,[3] actuarial advice had been to increase property exposure. To achieve their revised property weighting, institutional investors needed to accept debt-benchmarked purchase yields, accept gearing, or seek higher yielding and riskier holdings that are not ideal security for bank loans, or a combination of all three. In 2002–2003 the institutions did not compete in the property market, misreading its level of affordability, but in 2004 they did compete. They were spurred on by the cash being sucked into indirect property vehicles, whose leveraging ability introduced yet further cash from lenders.

In the search for income stream quality the market assumed that the longest leases to the most secure covenants, with the lowest void rates and best reversionary potential, were to be found in retail warehouse parks and shopping centres — which also had the widest covenant spread. This made these retail types the investments of choice in 2004. That they also had the best recent rental growth record was not incidental, but neither was it the main attraction.

Investment strategies

One perfectly valid reason for funds to have traded in and out of the market with such unusual timing as they did in 2003–2004 would be for the purpose of rebalancing portfolios. The total of trading (acquisitions plus sales) by the funds has remained constant in the range of 20–25 per cent of capital value per year for several years. It was not that funds suddenly started frenetic trading in 2003–2004, but that the balance of their activity moved negatively in 2003 and positively in 2004. Further, the 2003 disinvestment was entirely from offices — when over 8 per cent of the office portfolio

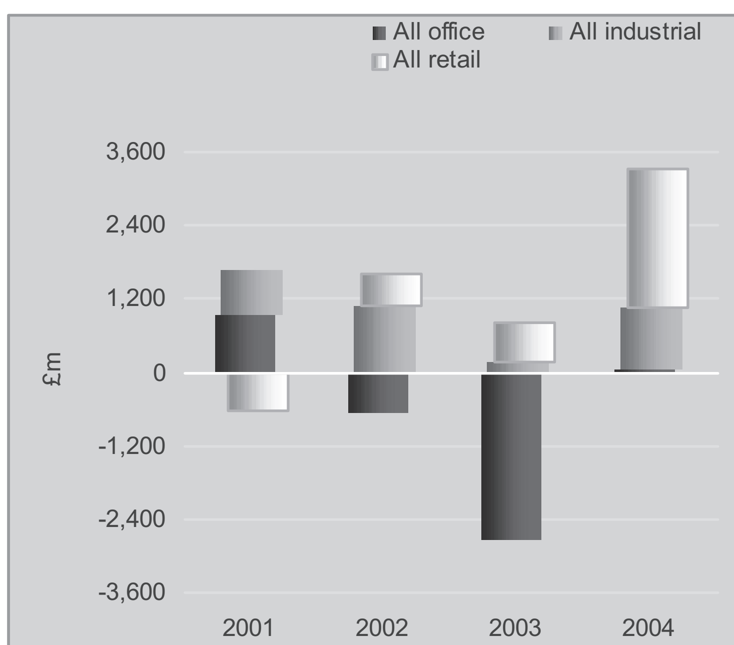

Figure 6: Sector net investment

value was sold — while the new-found enthusiasm in 2004 was for the retail types identified above. Figure 6 shows these net investment trends.

Table 1 gives the strategic changes in exposure effected by funds over the three years to the end of 2004, together with the percentage change relative to sector or subsector exposure at the start of the period. There was a 16 per cent increase in retail exposure and a 25 per cent reduction in office exposure. This was a very significant movement in fund strategies. Within this, the switchovers in 2003–2004 were probably the largest strategic 'bet' that fund managers (including those of indirect funds) had ever made.

It would be wrong to assume that either the negative office investment or the positive retail investment movements had a heavy impact on yields either way; they fell with broad uniformity in all three sectors, as shown by the Performance Summary section above. Thus, the heavy buying/selling regimes were not the cause of yields moving in or out, which then caused forecasts to be upset.

Table 1: Total portfolio exposures

	2001 %	**2004** %	**Change** %
Shops	13	13	0
Centres	17	20	16
Warehouses	13	18	36
All retail	46	53	16
All office	37	28	–25
All industrial	14	16	11

The office sector has had the weakest performance over short and long terms, and has also been more volatile than other sectors. Very poor relative performances in 2002 and 2003 were some of the triggers to the sell-off in 2003. Conversely, retails had very strong returns in these two years, which equally were a prompt for their being heavily bought. Previously, in 2000 and 2001, retails had underperformed, and funds were net disinvestors from the sector in 2001. They then ran a record centre sales programme in 2002. Now, painfully, institutions seem not to be able to find sufficient stock to satisfy their enormous demand for centres.

To be brutal, the latest major strategic shifts by the funds would have been the optimum short-term calls had they been made 15–30 months earlier. Moving when they did, funds lost out quite badly and dissipated asset value; it is too soon to tell if the strategic shift will benefit them in the longer term. One is reminded of J. K. Galbraith — the economist who coined the phrase 'conventional wisdom' — who suggested that the best time to do anything is always last year. It seems that, *en masse*, funds are not adept at forecasting the short-term future — here meaning 15–30 months. If they cannot make short-term calls successfully, maybe they should not attempt to run short-term strategies but should invest for the longer run, a dictum that they observed until the mid-1980s.

This is not a tiresomely negative point, but philosophically fundamental. The whole market focus on short termism is now being entrenched in the drive towards full liquidity and zero risk via indirect investment, as discussed later. Unfortunately, the instinct for mass migration into and out of the currently best-performing products is intensifying, leading to much greater potential volatility in a market of finite supply, and further divorcing investment capital flows and total returns from the underlying occupational performance.

The solution to the forecasting failures and indirect market shortcomings is seen to be the development of hedging tools and property synthetics, where actual properties are not owned by any of the transaction participants, where the market is infinite and where price movements are immediate. That is the point which is now being reached. Gradually, the real market is spawning a parallel universe of virtual property investment, one built for short-term volatility and likely to be driven by experiences of the moment rather than by strategic vision and forecasting. The direct property market has been criticised for unrealistic smoothness and the stickiness of its values, but its offspring may have a level of volatility that is just as removed from fundamentals. There is a weakness here, from potentially distorting virtual property market feedback, as valuers interpret capital values in the real market under the influence of the mass-market reactions among virtual property traders.

The safeguard is that the affordability approach to valuation, referred to above, flattens out yields and, in compressing their

range, it happily tends to reduce volatility. With that, however, go other weaknesses. The inherent yield compression means that there is a natural tendency to squeeze out the other investment features that differentiate all-risk yields. Instead of rental growth quality, property type, physical quality, legal quality — covering tenure and lettings — and so forth, the emphasis moves to income cash flow quality. With the loss of landlords' privity of contract and with shorter leases, judgments about income quality are harder than ever to make and then to use as a discriminating factor when comparing, for example, centre yields. These difficulties are capable of being resolved within new processes, but these will only develop over time, assuming that affordability remains the valuation driver.

Sector investment performances

Over the long term, industrial property has proved the most consistently good performer. As shown in Table 1, it accounts for 16 per cent of portfolio value. Offices have been the poorest, and they account for 28 per cent of portfolio value. Retail property has the best performance over periods of ten years and less, and accounts for 53 per cent of fund value. Actual sector performances are shown in Table 2.

The more detailed performance comparison for 2004 in Table 3 shows that retails, with the lowest income returns, benefited from the strongest rental growth and gained the most from declining yields — yield impact shows the capital value change resulting from yield movements only, excluding the rental value change element in capital value.

Stimulated as they were by the notion of affordability, the recent change in relative yields is not an ongoing process, and can be expected to rank as a one-off adjustment. Then, if the relationship between income levels and interest rates persists, one presumes that

Table 2: Total return per year

	24 yrs %	10 yrs %	3 yrs %	1 yr %
All retail	11.6	12.2	16.6	20.4
All office	9.1	9.6	7.1	15.3
All industrial	11.9	12.1	13.0	17.0
All property	10.5	11.3	12.9	18.4

Table 3: Performance in 2004

	All retail %	All office %	All industrial %
Rental growth	4.2	0.2	1.3
Yield impact	10.5	8.8	8.1
Capital growth	14.1	7.8	9.2
Income return	5.7	7.0	7.2
Total return	20.4	15.3	17.0

property types will have to grow a new range of yield relativities and risk adjustments, with future income quality to the fore.

Retail sector overview

The values and trends reported here and elsewhere are from the largest UK sample of independent valuation results, specified to reflect both investment and occupational market movements and fully accounting for all landlords' irrecoverable outgoings — ie the most reliable fully netted figures available.

Table 4 shows that the total return from retail warehouses continued to outperform the other retail types, in spite of noticeably lower income return. The key to their success has been rental performance. Conversely, rental growth for shops was the weakest, but they produced a better performance than centres because their capital growth was boosted by the strongest fall in yields. Centres were left with the lowest total return, below the all-property average.

The rerating of retail warehouse yields is shown in Figure 7.

Table 4: Performance in 2004

	Centres %	Shops %	Warehouses %
Rental growth	3.9	2.3	6.1
Yield impact	8.0	12.6	11.4
Capital growth	11.2	14.3	17.0
Income return	5.7	5.9	5.4
Total return	17.4	21.0	23.2

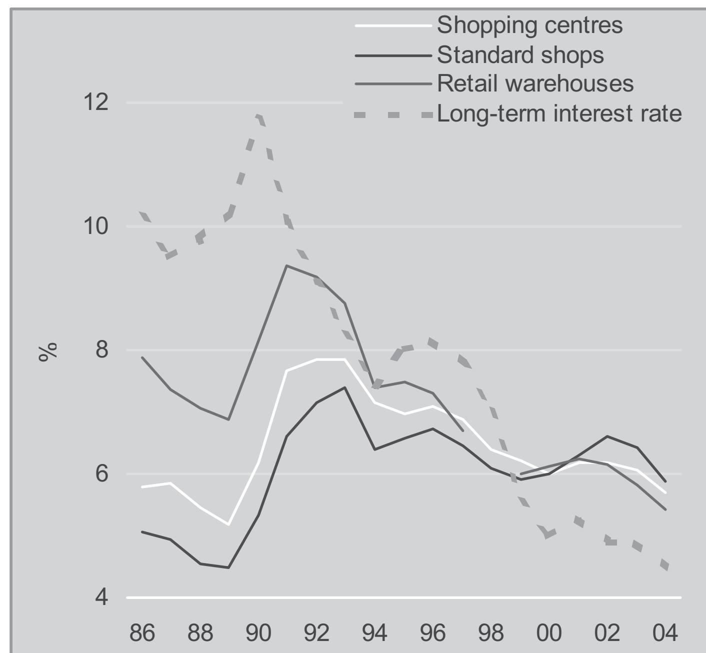

Figure 7: Income return

Warehouses now have both the lowest yields and the lowest income returns of the retail property types. Looked at historically, retail warehouses and shopping centres have yields that are at all-time lows. Shops, having been discriminated against in yield terms for the whole of the 1990s, have actually benefited more from the impact of falling yields than the other retail types for the last two years, but nonetheless their yields stand just above all-time lows. Sector yields are definitely not low relative to interest rates, however, and if income growth prospects increase and/or long-term interest rates continue to fall one can envisage there is scope for income returns to be bid down further.

The most obvious trend in retail sector yields is how they have coalesced over the last 20 years, and at the end of 2004 they were within 60bp of each other. Plainly, if one is looking to place subsector yields in relative order without taking into account any growth in income levels, one would expect this close setting. The base position is identical yields, subject to discriminating factors connected to the risks of income quality and growth, and income default.

Figure 8 shows how retail warehouse rents have maintained their relative outperformance. They have had the best rental growth since 1990, virtually without a break. Furthermore, there is no immediate prospect of this position changing, and in all probability it will intensify before growth rates then subside back to in-town levels as in-town and out-of-town locations reach a cost/benefit parity.

For now, also, centres are expected to outperform shops in the predicted low-growth environment. They allow their owners to manage the rent review and reletting processes more actively than can landlords of individual shops, they receive income unrelated to

Figure 8: Sector rental growth

current market rentals, eg from ground-rented anchor stores and car-park charges, and they are more likely than individual shop holdings to represent prime locations or otherwise by their size to present a robust retail presence that gives comfort and trading safety to tenants.

SHOPPING-CENTRE INVESTMENT

Net investment

The Property Data figures for centre transactions given in Figure 9 show that institutions were the buyers in 2004, while the other classes of investor were sellers.[4] As the outlook for profitable trading gradually dimmed over 2003–2004, the public and private property companies were vendors. They fed the institutional appetite last year, as did overseas investors. (UK investors in offshore co-owned vehicles are not in the 'overseas' classification.) The institutions are shown as vendors or neutral in 2001–2003, highlighting their combined lack of short-term vision or underlining their need to limit risk by waiting for trends to be well under way before participating.

Figures from IPD use different definitions and timescales, and are not directly comparable with the trading figures from Property Data, but they show similar patterns.[5] Figure 10 summarises what the UK funds were up to, buying plenty in 2002 but also selling heavily, to leave a neutral position over 2001–2003, and then buying very substantially in 2004. In fact, their 2004 net investment in centres was

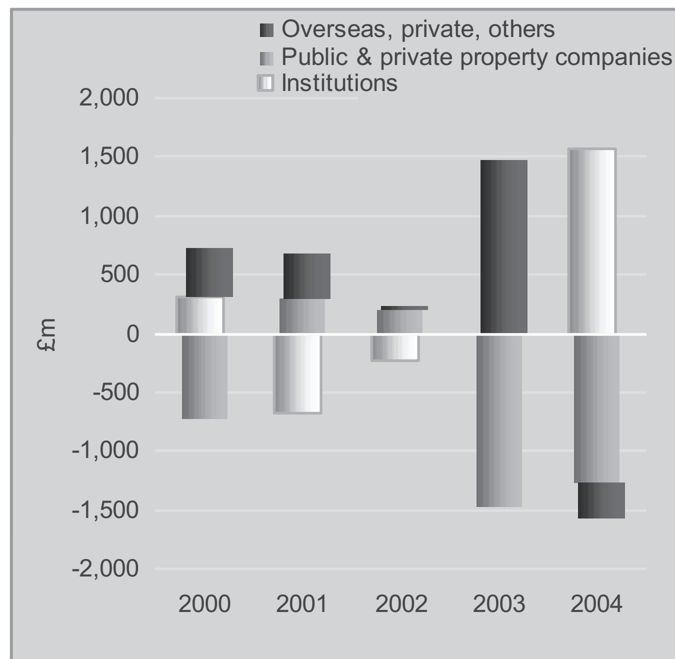

Figure 9: Centre trading

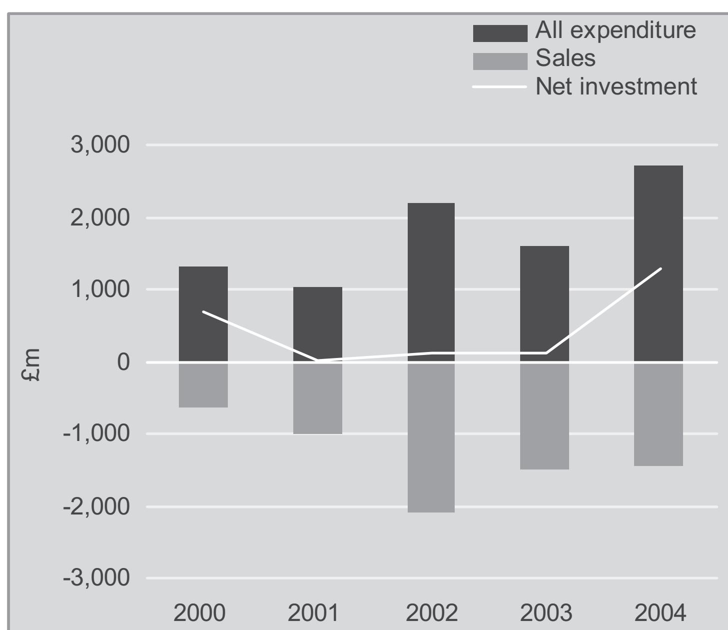

Figure 10: Institutional centre investment

their heaviest for ten years and the second highest net inflow ever, producing near-record overall turnover. For the first time, centres' share of year-end portfolio value broke through the 20 per cent mark.

The 2004 total expenditure was indeed the record, but it was partly offset by above-average selling. The most disheartening aspect — unless one is an investment broker — is that the 2002 centre sales programme carried out by the funds was an all-time record £2bn. It could well be that funds were selling their likely non-performers and buying the ideal kit for the future, but, for the record, capital values rose some 19 per cent between the middle of their heaviest 'sell' and 'buy' phases of mid-2002 and mid-2004. In the net balance of trading, funds tended to sell low and mostly to buy high. As the Property Data figures underline,[6] if the trading was a zero-sum game, then property companies and overseas, private and other owners benefited at funds' expense.

Improvement and development spending

For a decade at least, the institutions have spoken about the active management potential of shopping centres and how centres can be improved and worked with teams of specialists. The specialist indirect funds (overwhelmingly included in this sample) have made a heavy point of their focus on such issues. One has every right, then, to expect to see the cost of this effort reflected in improvement expenditure, which covers all outlay. The improvement spending definition covers not just the irrecoverable landlords' costs for physical works, but also the costs of regearing ground leases, buying in individual units etc, and the professional

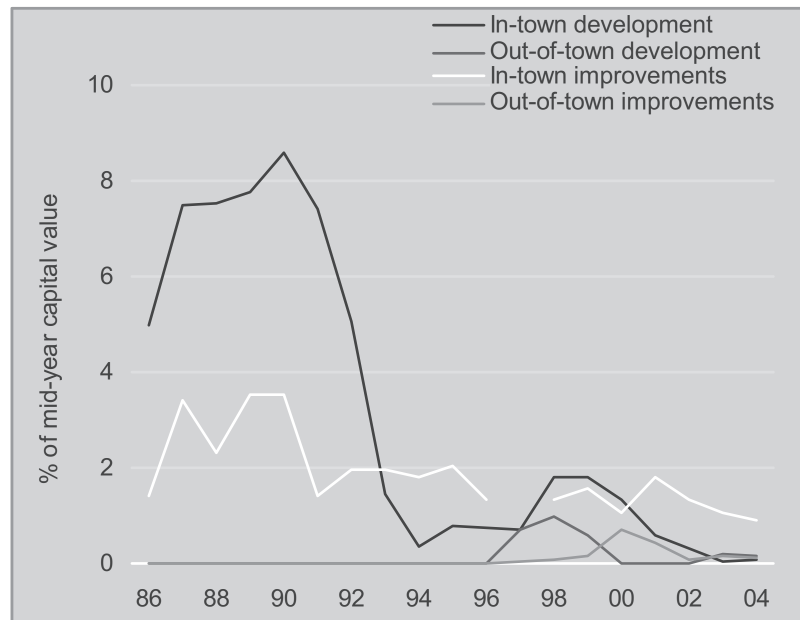

Figure 11: Development and improvement spend

fees associated. The sad fact is that improvement expenditure in 2004 fell to another record low. It is now down to under 1 per cent of centre capital value annually, which is about 30 per cent down on the average of the last decade and is barely half the long-term average.

Figure 11 highlights this gradual decline in improvement spending, as a proportion of capital value, which has been reported by fund owners to IPD.[7] Talk of inner-city regeneration and proactive management seems to be just that. In place of modernising their holdings via improvement, funds have continually bought newer schemes than those they have sold, leaving entrepreneurs to upgrade those centres that they sell and take the benefit. They have kept their portfolio of centres up to date by trading rather than by working the assets themselves. At least this means that the lower proportion of value they are spending on rejuvenating their holdings is not being spent on stock that is ageing fast. Nonetheless, some 60 per cent of institutionally owned schemes are over ten years old, and most centre managers would expect these to require regular injections of cash. Donaldsons' Retail Asset Management team is stating categorically that there will be a price to pay for this neglect, in terms of reduced value and/or reduced performance. One is forced to question if this is not a strategic failing by institutional funds.

Perhaps a useful insight into funds' current attitude to improvement strategy is to be had from a representative of one of the largest property fund management groups, very much into centre ownership. Talking about rearrangement to their debt

Table 5: Centre investment activity

	10-year average £m	2004 £m
Purchases	1,191	2,450
Sales	−1,087	−1,431
Net trading	104	1,019
Development	179	48
Improvement	244	228
Net investment	527	1,295

structure, he said: 'It provided the means to asset manage capital as well as property. Net of costs, it saved us.' Debt is classed here as a capital asset, and improving debt terms is equated with safeguarding asset value. It also confirms how the cost of debt is deeply entrenched, with leverage, as the key to pricing.

Centre development being funded by institutional investors is essentially non-existent (Table 5). Having been badly burned by their late rush into development in the late 1980s, the funds are wary of repeating the fault. There are fewer opportunities for retail schemes now than previously, with most cities not held back by under-provision of floorspace, especially given retail warehouse and supermarket non-food sales space increases. One might add that current planning regimes are not encouraging either, taking planning in its widest sense to cover planning taxes (106 agreements, planning gain supplements etc), physical hurdles (mixed-use schemes) and transport and traffic policy.

Centre trading strategies

On the basis of broad averages, one can say that funds have rejuvenated their portfolios by selling and restocking, have not actively managed their existing holdings vigorously and have avoided development. In their selling and restocking, institutional fund strategies on shopping centres made poor use of the most recent market cycles. A likely justification for the vast trading programmes, then, would appear to be the repositioning of the funds' centre ownerships. Therefore one can look now at the latest changes wrought in the total portfolio of centres, in which, at the end of 2004, some 80 funds shared an overall portfolio consisting of 312 holdings worth £24.4bn.

In the three years to the end of 2004, funds sold 122 holdings and bought 130, these trades having a combined value of £11.5bn. It has been the largest sell-off and acquisition programme undertaken among centres by institutional funds. This very heavy trading actually made surprisingly modest differences to the overall centre portfolio. The details of the changes over the past three years are given in Table 6.

The changes can be further analysed as follows.

— Age profile. There were two modest changes in the age profile. First, over the three years the funds reduced by 5.5–22 per cent

Table 6: Total return per cent pa

	10 years	3 years	1 year	Sample change % of total, 2001–2004
Age				
1960–1969	10.8	14.6	**18.5**	0.5
1970–1979	11.9	**15.4**	17.1	–5.5
1980–1989	**12.4**	14.2	17.6	1.3
1990–2004	12.2	15.2	17.4	**3.8**
Range	*1.6*	*1.2*	*1.3*	
Size ('000 square feet)				
50–75	12.4	**19.2**	**21.6**	0.7
75–150	10.9	15.3	18.4	–4.9
150–250	11.1	15.6	19.2	**4.6**
250–500	12.1	15.5	18.0	–1.0
500+	**13.8**	13.9	16.0	0.5
Range	*3.0*	*5.3*	*5.6*	
Region				
London	12.7	**16.0**	18.8	2.4
South East	11.2	15.6	17.4	–1.8
South West and Wales	10.0	15.1	18.0	**3.1**
Eastern and East Midlands	**13.0**	14.3	15.4	–1.8
West Midlands	11.8	15.9	18.2	2.4
North West	10.8	13.2	18.8	–1.4
Yorkshire and North East	12.8	14.6	**19.3**	–2.1
Scotland	11.3	14.1	15.8	–0.7
Range	*3.0*	*2.8*	*3.9*	
Hierarchy				
Major city	12.1	13.2	13.7	0.7
Major regional	11.9	14.1	15.7	0.0
Regional	12.3	14.3	17.6	–0.1
Sub-regional	11.0	**16.2**	**18.9**	–2.5
District/local	**13.2**	16.0	18.8	**2.0**
Range	*2.2*	*3.0*	*5.2*	

NB: Highlighted numbers indicate the highest in each set. Range shows the difference between the highest and lowest in each set.

their proportion of 1970s' centres, and at the start of the period increased their 1990s-built holdings by 3.8–38 per cent of the portfolio. The tendency to buy newer schemes than those sold is not peculiar to the last three years, but is a long-term trend; however, the lack of development since the early 1990s meant that by 2003 some of this modernising pressure was being transferred further down the scale, with the proportion of post-1990 schemes holding steady and that of the 1980s' generation increasing. The other change worthy of comment was the reversal in the slow reduction over time in the number of 1960s' schemes held by funds, which went as low as 8 per cent in 2003. In 2004, funds boosted this segment of their holdings to 11 per cent.

— Size profile. The proportion of holdings in the various size bands has changed slightly. There was a 4.9 per cent increase to 25 per cent of those in the middle band, 150,000–250,000 square feet, at the expense of the next band down, 75,000–150,000 square feet. The smallest and largest bands of centres increased very slightly over the 2001–2004 period.

— Regional profile. Changes in geographic spread of fund centre holdings were not rousing either: nothing above about 3 per cent

of scheme numbers in any region over the three years. But two consequences were, first, a drift away from the north, and, secondly, a tendency to a more even distribution. Thus the proportions in Scotland and Yorkshire and the North East reduced, but so did the proportions in the South East and the Eastern and East Midlands region. Conversely, London, the West Midlands and the South West and Wales have benefited.

— Shopping hierarchy profile. Similarly to regional spread, the changes in the balance of investment across the categories of retail location type were only at the margin. While there was a 2.5 per cent reduction in exposure to shopping schemes in sub-regional centres, the expansion continued among district/local retail centres, to 28.7 per cent of numbers, although major city schemes also upped their proportion very slightly to 8.7 per cent. The trend towards investing in smaller places continues, and there is no sign that the recent peak in dealing was motivated by the persistent call from some forecasters for funds to invest only in large retailing locations.

— Quality profile. Until ten years ago this was a live issue, with funds consistently buying more 'prime', lower-yielding centres than those investments which they held or sold. Since 1995 the quality level, as evidenced by valuation yields, has remained pretty constant.

About 30 per cent by value of institutional fund shopping-centre holdings has been acquired in the last three years, accounting for 40 per cent of holdings numerically. Yet this caused so slight a set of changes in the make-up of the overall portfolio that one has to conclude that the average judgment of what is likely to be a performing asset has not transformed over the period. Repositioning may have allowed individual funds to vary their type of exposure, but as an average, funds' centre choices are pretty much unaltered. So, having discounted forecasting, market cycles and now asset positioning as reasonable motives for the very high level of trading, one needs to look elsewhere.

The paper has thus far considered institutional funds as a single entity, but in fact they divide into five key groups — insurance and pension funds, specialist and short-term funds and other funds. Specialist funds are those that focus exclusively (in this case) on shopping centres, while short-term funds comprise principally the unit trust and indirect funds. 'Other funds' refers to the traditional and landed estates such as the Crown and Church. The buy/sell trading patterns of the separate groups give two clear extremes: insurance and pension funds, and specialist and short-term funds.

Figure 12 shows that specialist and short-term funds have been the major net investors. This group could be viewed as more susceptible to pressures to grow their funds and they are also more in the performance spotlight. Meanwhile, the insurance and pension funds have been regular net sellers of centres for the past four

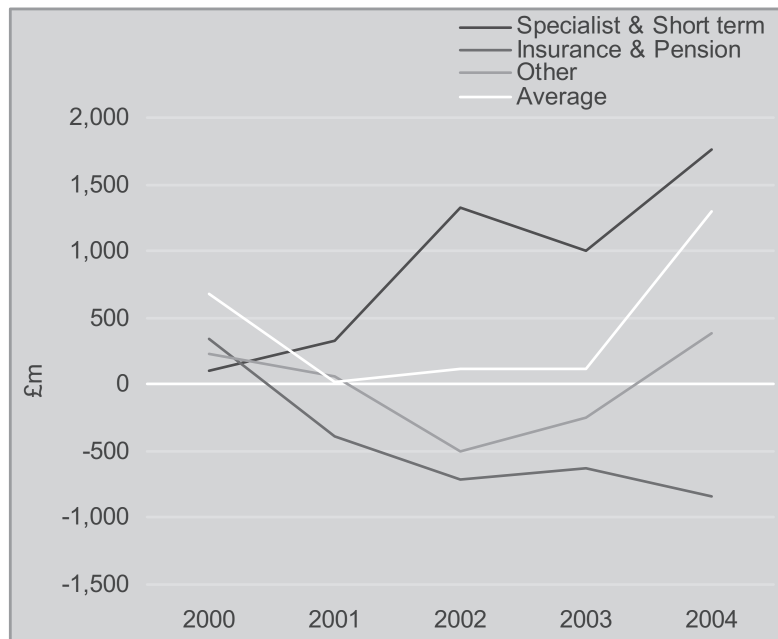

Figure 12: Net investment by fund type

years. This, together with the influence of other funds, is a worthwhile part of the explanation for the overall recent highs and lows of centre trading and investment by institutions as a single entity. Looked at another way, the direct holding of centres by institutional funds has fallen steadily for the last few years, while their indirect holdings — and net indirect investment by non-institutional parties — have grown hugely.

It helps to remember that virtually the same number of shopping-centre holdings are in institutional hands now as in 2001. It is easier, then, to accept the suggestion, supported by known fund movements and a wealth of anecdotal evidence, that the trading patterns discussed here at least in part reflect the institutional shift from direct to indirect investment. Indeed, there is evidence that even the same centres are involved, and it is known that 31 per cent of 2004 institutional transactions involved sales to another IPD-monitored institution; this would include sales from, say, an insurance fund to a specialist fund. If one adds ownership transfers into newly created vehicles and 'in specie' transfers, the figure would be higher.

Nonetheless, there is sufficient disparity between the styles of centre bought and sold recently for the notion of funds simply moving from direct to indirect to be only part of the explanation for the major trading hiatus. A comparison of sales against purchases over 2002–2004 uncovers clear differences (Table 7), even though certain transactions have had to be screened out of the sample for confidentiality reasons.

Thus, in 2003, the average floorspace of centres acquired was 46

Table 7: Purchases and sales compared

	2002	2003	2004
Age in years	– 1.5	0.7	– 6.0
Floorspace	–10%	46%	–11%
Lot size	2%	8%	10%
Equivalent yield	0.3	0.0	0.1

per cent larger than those sold, and in 2004 the average floorspace of acquisitions was 11 per cent less than those sold. Last year, purchases were of 10 per cent greater value on average than those sold, and they were six years older. It is interesting to see that over the last three years, although the total centre portfolio quality has not changed much, there is evidence that, in trading, there is a tendency towards marginally lower quality, with equivalent yields of purchases higher than those of sales; this has been at a time of falling yields.

Market cycles, forecasting and asset positioning do not seem to account for the very high level of trading, but there are reliable signals that a good part of the trading was caused by the sale of direct holdings and the acquisition of shopping-centre stakes in indirect vehicles. Many of these stakes will be in the fast-expanding specialist shopping-centre vehicles.

Specialist funds and performance

Specialist shopping-centre funds are worth separate comment. They now hold 16 per cent by number of the total sample, but account for 37 per cent of total portfolio value; it is no surprise that specialist funds have targeted the larger centres and biggest lot sizes, and have grown quickly. As shown in Figure 12, other funds have been net sellers of centres in the last three years and, although total net centre investment was £1.5bn, specialist funds invested £2.6bn. As authorities on the strategy, ownership and management of shopping centres, specialist funds might be expected to have outperformed non-specialist centre investors, those other four groups referred to above, which hold centres as part of mixed ('balanced') portfolios.

The recent performance data show no outperformance by specialist funds, however; rather, they mark an underperformance at every tier of performance ranking, from best through to worst (looking at pure asset performance, excluding the effect of any leverage from debt but before fund management fees are netted off). At the total return level, the underperformance extends to an average 1.5 per cent per year for the last three years, a meaningful although not extravagant margin of difference. The main measures are given in Table 8, from which it is clear that the specialist funds, with lower yields and income returns, have suffered by holding a bias to more prime-quality stock, which has done less well than higher-yielding

Table 8: Specialist and balanced fund performance

	5-year average	3-year average	2004
Total return			
Specialist funds	9.1	13.9	15.2
Balanced funds	10.1	15.4	18.6
Income return			
Specialist funds	4.4	5.6	5.4
Balanced funds	5.0	6.1	5.8
Capital growth			
Specialist funds	4.6	7.9	9.4
Balanced funds	4.9	8.8	12.1
Rental growth			
Specialist funds	2.9	4.3	3.4
Balanced funds	2.8	3.8	4.1
Equivalent yield			
Difference in	2000	2002	2004
balanced above specialist	2.0	0.8	0.1

stock. Over the last few years specialists have reduced the overall quality of their holdings, such as now to have an average equivalent yield almost the same as the average for balanced funds; this change was separate from the general reduction and compression effect of yields, however, in any event the recent retargeting may have come too late. The largest centres, however, have benefited less than smaller centres from declining yield impact. Specialist funds, with larger schemes in their portfolios, have been caught here too, although there has been no consistent effort to reduce their average scheme size.

The underperformance by specialist funds may therefore partly be down to their holdings being too large and/or too prime to benefit from recent yield rerating and compression. A third option is simply that their holdings were performing below par. The specialists' size and quality strategy should not have penalised them by as much as it did. The fact that their holdings' rental growth has been no better than that of balanced funds, and was inferior last year, is important. Schemes with lower yield ratings should have seen clear rental growth outperformance, and larger schemes, too, should have outperformed noticeably, but specialist funds failed to secure either of these market-wide advantages in an area where their skills should have given them an even greater edge. In fairness, looking at the level of voids, overrentedness and reversionary potential, specialist funds do have a better forward profile — as one might expect if the stock is of better quality.

Broad generalisations are dangerous things, but the conclusion is that there is some validity in all three reasons given for the underperformance of specialist funds. The market also surmises, on no evidence but with justifiable suspicion, that a shrewd way to dispose of large schemes with a less successful future is to part-sell them into the indirect market. If true, this would be a further element towards explaining the balance of direct/indirect net

trading and investment, the level of trading itself and some portion of the underperformance of indirect specialist funds — and be a typical signal of general market ferment.

There is one other difference between the two types of owners and their sets of centres to bring up. Over the last five years, specialist funds have spent in the range of 50–60 per cent of the amount on improvements that balanced funds have spent. If improvement expenditure, as defined in the Improvement and development spending section, is a proxy for levels of active management, then specialist funds are even less proactive than balanced funds. Not only is that quite a feat, but it runs counter to specialist funds' carefully cultivated image and undermines conventional beliefs.

© Bryan Duncan

References

1. Investment Property Forum (IPF) (2004) *Consensus Forecasts*, available at ipf.org.uk.
2. Donaldsons (2003) *Donaldsons Shopping Centre Commentary*, Donaldsons, London, UK.
3. Donaldsons (2004) *Donaldsons Shopping Centre Commentary*, Donaldsons, London, UK.
4. Property Data, data supplied to author 16 May, 2005. See www.propertydata.com
5. IPD, bespoke data search for Donaldsons, Spring-Summer 2005. See www.ipdindex.co.uk.
6. Property Data, ref. 4 above.
7. IPD, ref. 5 above.