IPF Research Programme

Chopping Shopping? Implications of Retail Structural Change on Sector Allocations

DECEMBER 2019

SUMMARY REPORT

This research was commissioned by the IPF Research Programme **2015 – 2018**

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This research was funded and commissioned through the IPF Research Programme 2015–2018.

This Programme supports the IPF's wider goals of enhancing the understanding and efficiency of property as an investment. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high-quality analysis on a structured basis. It encourages the whole industry to engage with other financial markets, the wider business community and government on a range of complementary issues.

The Programme is funded by a cross-section of businesses, representing key market participants. The IPF gratefully acknowledges the support of these contributing organisations:

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Report

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Disclaimer

Retail real estate has traditionally been seen as an attractive investment class. Historically it has provided superior returns, long-term stability and income growth. It has also preserved residual value, allowed for diversification and enhanced the scope to deploy substantial capital in a single transaction. Nonetheless, with the emergence of e-Commerce and the slow recovery from the Global Financial Crisis (GFC), some of these attributes for the key international markets are becoming more difficult to replicate through new investments in retail.

This report analyses trends in the retail market and in retail real estate investment performance to identify implications of e-Commerce for property investment allocations to the retail sector. It provides high-level directions as to whether other property sectors could be an alternative to retail.

Introduction

Technological advancement, the emergence of the internet as a marketplace, growing competition, shifts in consumer tastes and preferences, accelerated globalisation of the retail sector and wider economic uncertainties have been driving major changes in retail.

Such changes require a re-evaluation of real estate investors' strategies. The central research question is, therefore, in line with the evolution of the retail sector: should investors remain loyal to retail assets, historically a highly profitable strategy, or should they focus on other market segments? If so, which segments should they choose? The aim of this research is to gain an understanding of what (if any) impact the changes in retail have had on allocations to the sector within major institutional real estate investment portfolios and to investigate what future portfolio allocations might look like.

The research covers six key real estate investment markets: the UK, US, France, Germany, Spain and Australia. These countries together represent almost 60% of the total professionally managed global real estate investment market.

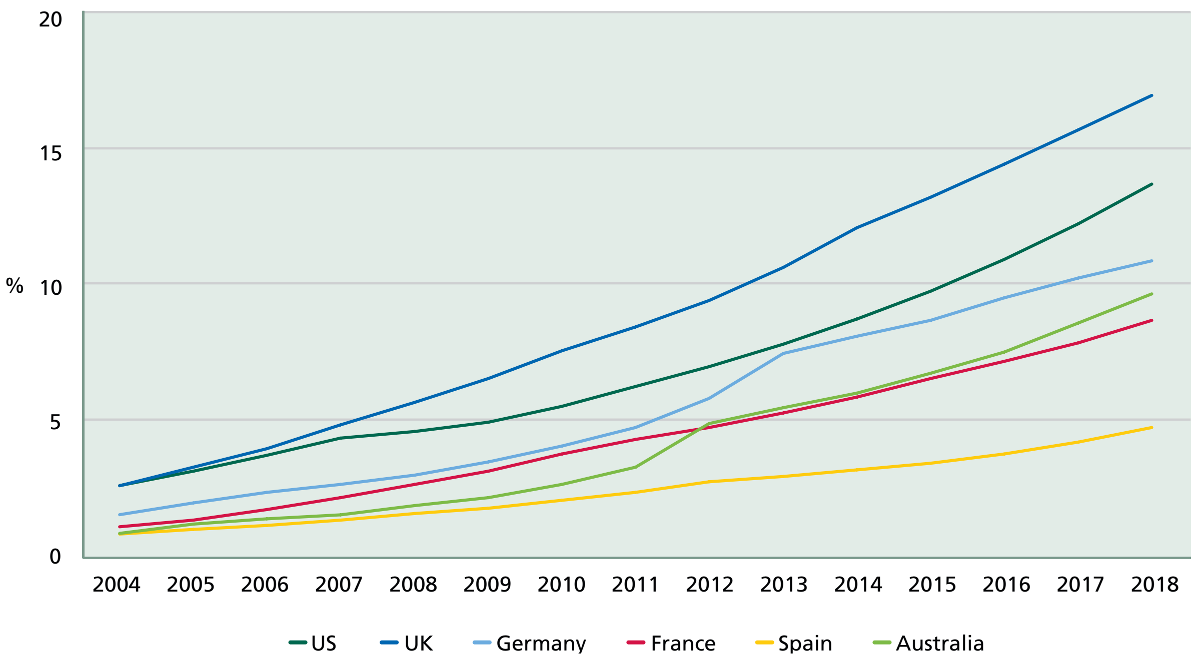
The full report includes a review of previous research on the major factors affecting developments in retail spending and the structural changes of the retail property sector in response. The report also covers literature on investment portfolio optimisation in response to these changes in the retail sector. This is mostly of a qualitative nature, indicating only potential avenues or current investors' sentiments, which are not necessarily reflective of what the long-term changes in investment allocation may look like.

Quantitative analysis of past trends and long-term retail allocation projections was based on a number of annual benchmarks provided by MSCI and Euromonitor using the autoregressive integrated moving average (ARIMA) method.

Retail Market

Since the early 2000s the retail market has undergone substantial changes, driven to a large extent by e-Commerce cannibalising bricks-and-mortar retailing. Internet retailing is growing at a steady pace, infiltrating more and more retail categories and resulting in the stabilisation or decline of in-store retail.

Figure 1.1: Internet Retail Sales versus Total Retail Sales, 2004-2018



Source: Euromonitor (2019)

These internet retail sales trends are expected to continue. At the same time, retailers are responding to the fall in store-based retail sales by streamlining their property portfolios thereby reducing demand for physical retail transaction space in all markets, with the possible exception of Australia. In-store retail sales for certain retailers are arguably falling below a sustainable level. In the UK, particularly, this has led recently to a number of retailers falling into administration or announcing company voluntary arrangements.

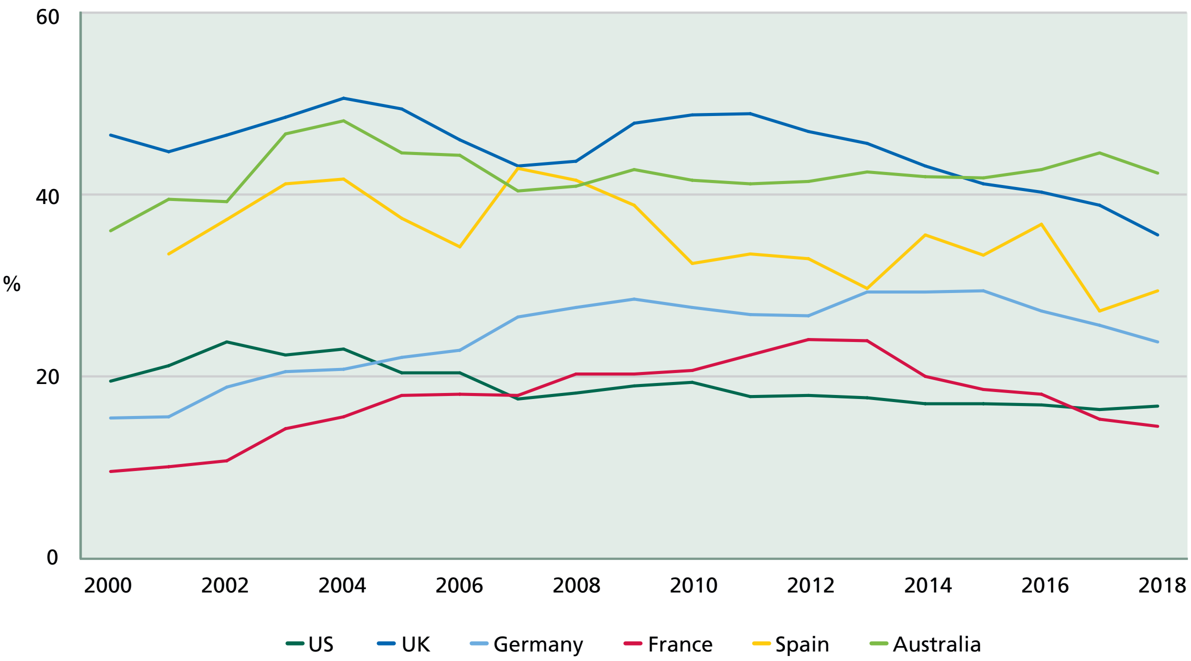
Despite positive net migration in most of the countries analysed, this study suggests that, between 2018 and 2030, there is potential for significant reduction of demand for retail space, e.g. in the USA by 20% and in the UK by 10%, accompanied by nearly doubling share of internet sales in the USA and the UK.

Figure 1.2: Projected Share of Store and Non-store based Retail, 2018 and 2030

Retail Investment Market

The average allocation to retail within professionally managed real estate investment portfolios differs by country. At the end of 2017, retail's share ranged from between 15-20% in France and the US to around 40-45% in the UK and Australia. Despite the widely discussed challenges facing the retail sector, the allocation to retail real estate across institutional investors has been reasonably resilient. However, in recent years the share of retail has declined, especially in the UK and to a lesser extent in France and Germany. This was accompanied by net gains in investments in non-mainstream sectors or the industrial sector.

Figure 1.3: Share of Retail in Total Real Estate Investment, 2000-2018



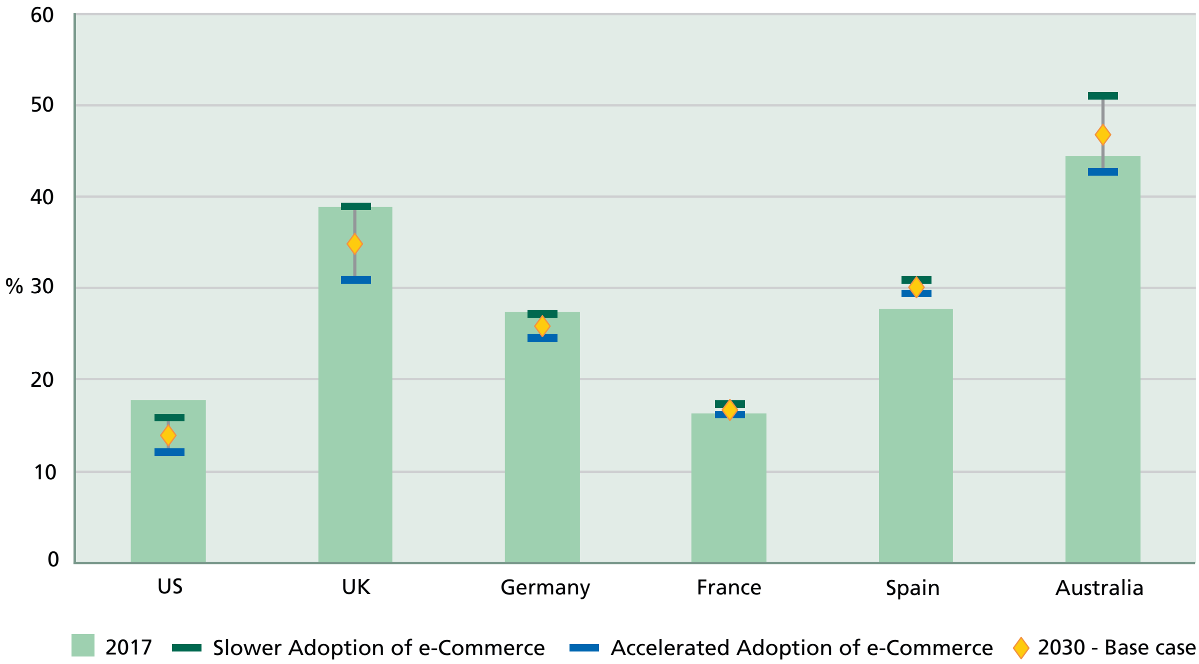
Source: Based on MSCI (2019)

Modelling used in this study suggests that, between 2018 and 2030, there is a potential for the allocation to retail real estate to reduce materially, particularly in the US and the UK.

Under the base case scenario presented in the report, the size of the retail property investment sector is projected to fall by 22% and 11% in the US and the UK respectively, while an accelerated adoption of e-Commerce results in larger projected falls of 33% and 21% respectively. However, assuming a slower adoption of e-Commerce, results in the UK suggest no reduction. Furthermore, other countries, notably Australia and Spain, are projected to see smaller impacts and may actually see some growth.

Figure 1.4 provides a comparison of the changes to retail real estate investment allocation under the different scenarios, assuming no changes to the total real estate investment market size.

Figure 1.4: Scenario Comparison – Allocation to Retail Real Estate Investment, 2017 versus 2030



Implications for Future Investment

To maintain acceptable investment performance from retail assets within an institutional real estate portfolio, a key consideration will be the evaluation of the long-term potential of individual retail schemes and their ability to respond to changing consumer needs. These decisions will result in:

- Proactive redesign/upgrade of remaining schemes; and
- Repurposing of surplus retail space (where suitable alternative uses are viable).

Retained schemes will need to change to provide experiential space with far less conventional retail space and more space for other (often more flexible) uses, suited to the catchment population.

Surplus or redundant assets, depending on location, may be converted to other uses. For some investors, that may mean a transition from core towards core-plus and value-add strategies for assets. However, within the existing portfolios, the appropriate moment for conversion may be some time in the future because in many cases the existing retail use will remain the highest and best use of the property vis-à-vis other uses. Changes to existing schemes are likely to take time and the market adjustment may be delayed, resulting in a temporary reduction in the profitability of retail real estate investment.

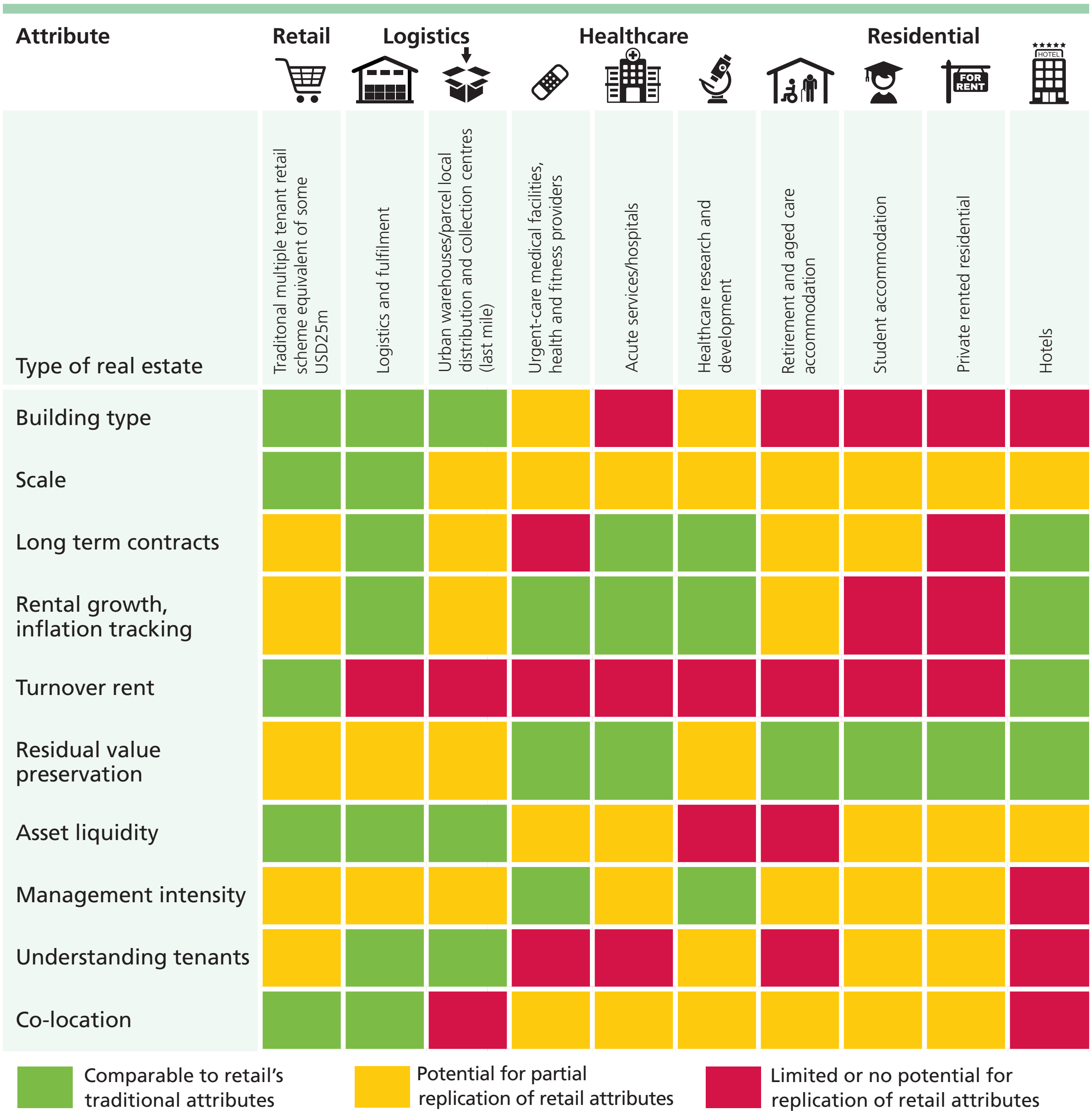
Trade-offs will be required, e.g. shorter and more flexible leases, potentially smaller individual real estate asset values and more complex management.

Some investors may choose to dispose of their retail assets and redeploy the capital and the other mainstream property sectors (offices and industrial) could be the beneficiaries of such reallocation. Exposure to other less traditional sectors is also likely to rise. In particular, the following uses may be deemed as attractive alternatives to retail property allocation going forward:

- Logistics and fulfilment, including urban warehouses;
- Healthcare; and
- Accommodation, including student, retirement and aged care and hotels.

Neither the surviving retail schemes nor the alternative uses will provide the same investment attributes as retail property investments have done in the past. No specific alternative real estate sector is expected, therefore, to drive money out of the retail sector, although some may benefit disproportionally in the short term. Table 1.1 provides a summary of key investment attributes of the above-mentioned types of real estate relative to retail real estate.

Table 1.1: Comparison of Key Investment Attributes of Real Estate Sectors versus Traditional Attributes of Retail Real Estate Investment



It is possible that some proceeds from the sale of retail property investments will need to be deployed outside of the property market, into other asset classes such as equities, bonds or wider infrastructure. This research is limited to an exploration of the MSCI samples, which represent players proactively managing their real estate portfolios. It , therefore, considers what investors could do with their retained retail investments and what other property investment sectors may benefit from reallocation away from retail. The size of the total real estate investment market over time was not considered within the scope of the research.

UK Outlook

In the UK, consumer behaviour is changing so rapidly that many retailers are unable to adjust quickly enough. Politics, dominated by the uncertainty of the EU exit process, is another strong influencer inducing a 'wait-and-see' attitude. Property news media is dominated by retailers' bankruptcies and CVAs as their shops become economically obsolete due to e-Commerce (e.g. HMV, House of Fraser, Maplin and Toys 'R' Us). Some researchers suggest the UK retail environment is headed for a longer and more protracted slowdown during 2020. However, the EU exit-linked inertia cannot last forever as investors believe in the long-term strength of the market. The reduction in demand for retail is, therefore, likely to be compensated for by growing demand for real estate in other sectors (logistics and residential).

The leading UK retailers seem to stay ahead of the competition and stand out in terms of product reviews, apps personalisation, generous return and refund policies and easy navigation across channels. However, many have a long way to go in supplying a streamlined, persuasive online experience to customers.

UK active investors have been slow to react, in comparison to those in the US, to a changing retail market, which has left the UK with more retail space than required. Retailers' investment will continue to be challenging as further shop closures can be expected, leaving investors with empty units. This slow market response and retailers' distress will create greater polarisation of the market. This translates into stronger demand for the winning, highly differentiating schemes and an accelerating decline of the less competitive schemes. Substantial regional differences mean there will continue to be opportunities requiring careful investors' consideration.

In line with the past trends, the allocation to retail in the UK is gradually falling from the exceptionally high level of nearly 50% in 2011 and as of 2018 stood at 35%. These statistics confirm the results of the model, with the logistics and hotel sectors being major beneficiaries of the reduced exposure to retail.

Total returns have gradually fallen since 2014, turning negative in 2018 at -1.7% according to the MSCI Annual Property Index. Given that the whole UK market is suffering falls in total returns, there are mixed views with respect to current retail asset valuation. In the short term, if the oversupply continues, value corrections are likely to occur, putting further downward pressure on retail real estate investment returns.

In the UK the major sectors to gain from the distressed retail market are logistics and residential.

Given the announced shop closures, and other retailers anticipating closures, an increase is predicted in planning applications for change of use from retail (A1) to other, multiple uses. This may not be a long-term solution as the use classes will need to be defined more broadly to allow for simultaneous and flexible uses. In the meantime, pro-active investors, together with local authorities, need to work out feasible re-development solutions to replace surplus retail with more socially and economically sustainable land uses.

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