

CONTRARIAN VIEW PROVIDES FOR INVESTMENT OPPORTUNITIES IN PHYSICAL RETAIL



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S

tories about the death of the high street shops and retail outlets in Europe have been much exaggerated.

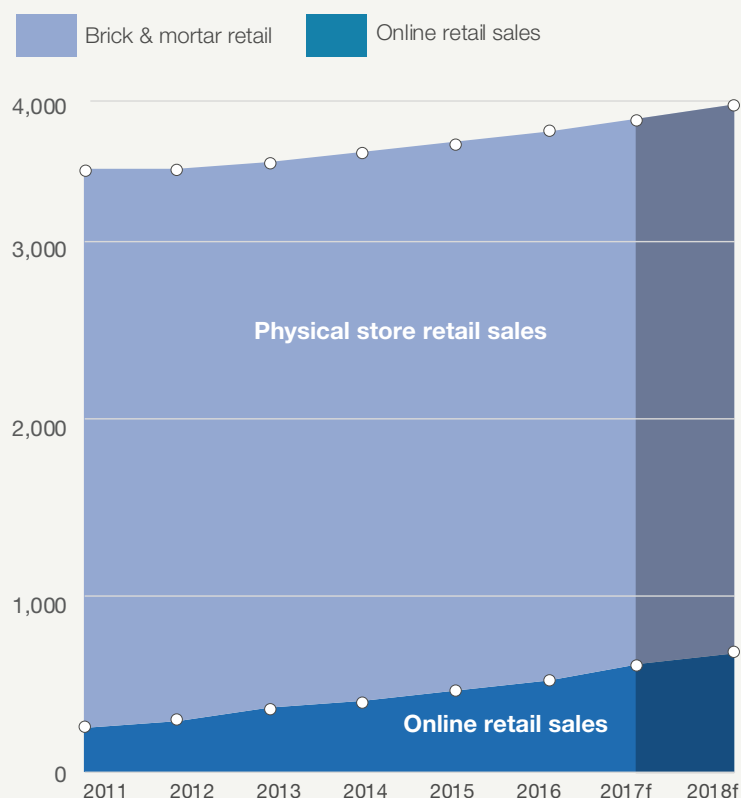
A common view is that physical retail is being superseded by online retail, and although online sales in Europe increased between 2011 and 2017, the rise is slowing in mature markets. Equally, physical sales account for 85% of total European retail sales.

However, it is certainly true that consumers' purchasing patterns have changed and many retail outlets run the risk of becoming dated if they fail to adapt.

Smart phones and tablets have added whole new dimensions to shopping behaviour while the younger generation of shoppers are displaying unique characteristics. For example, many of them cannot afford to purchase their own home and will be serial renters, inevitably taking a significant chunk out of the DIY market.

They watch TV and films via Netflix and read books on a tablet or a Kindle. Importantly, many are happy to order white goods, TVs and many other items online with next or even same-day delivery, fitting in with busy lifestyles.

Retail sales forecast (end-2016-18, EU-28, EUR billions)



Sources: Oxford Economics, Ecommerce Europe Savills Investment Management
Note: 'f' denotes forecast

SIX RESILIENT FORMATS FOR RETAIL

In our view, there are six broad categories of resilient retail formats:



Experience

Retail stores that offer the right mix of physical retail combined with leisure, entertainment and food and beverage outlets will succeed. For example, retail parks provide a convenient shopping experience, substantial car parking facilities, food and beverage outlets, cinemas and bowling alleys giving additional reasons for customers to visit.



Luxury goods

It is rare for people to buy these online, with over 90% of luxury items purchased in physical stores.



Value stores

There is no point in buying goods online if it will cost more to mail them than to buy them in store. Primark is a good example of this.



Convenience stores

If shoppers want essential items such as food or household groceries straight away, then they need to go and get them.



Infrastructure

Trains, metro stations, airports and other hubs draw large crowds. Retail outlets in such location have captive audiences.



Outlets

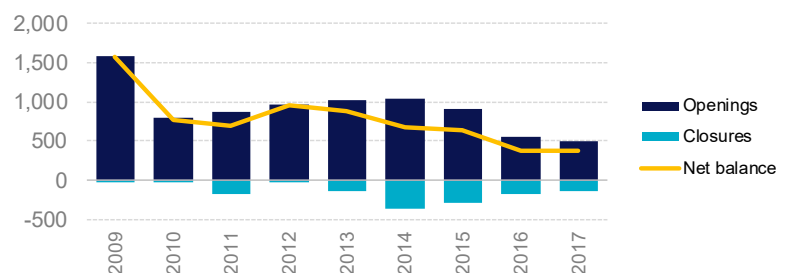
Malls where luxury brands are sold at value prices are increasingly popular, with examples such as Bicester Village and Cheshire Park in the UK attracting coachloads of tourists.

Physical retail is at an inflexion point

The empirical evidence certainly shows that physical retail is alive and well in Europe, with more store openings than closures. In 2017, there were **500 store openings** in Europe versus **100 closures**, giving a net balance of **400 openings**.

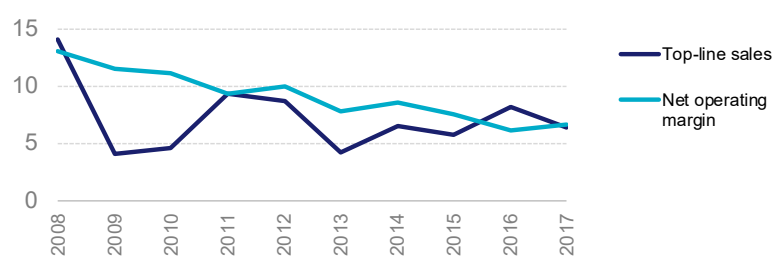
In terms of net operating margin, this has declined from around 13% in 2008 to 6.5% in 2017. Physical retail stores have certainly been impacted by deflationary pressures over the last few years, with the volume of goods increasing but overall retail value declining. However, based on our analysis of company reports, we believe average physical retail sales are at an inflection point and we expect sales growth to stabilise.

FIGURE 1:
Store openings/closures



Sources: Company accounts, PMA, Savills Investment Management

FIGURE 2:
Sales growth and profit margins (%)



Sources: Company accounts, PMA, Savills Investment Management

WHERE THE OPPORTUNITIES LIE

How this translates to specific locations in Europe depends on where these are in the overall retail cycle. For example, London's high street shopping market is likely to bottom out over the next 12 to 18 months. The uncertainty created by Brexit is impossible to ignore, but at the same time, the world's most dynamic city will continue to see tourist inflows, helped by the lower value of sterling.

In other parts of Europe, Italian and Danish markets are ahead of the curve, with Milan, Rome and Copenhagen approaching the peak. This has been gratifying for us because we bought a substantial volume of high street assets in Copenhagen three years ago.

The locations we see as having strong potential to grow include selected opportunities in Tier Two cities including the Netherlands, Germany and Denmark. Core retail properties in or close to the big five German cities and those in Stockholm are particularly attractive, as are well-located retail warehouses close to transport links in Spain, Sweden and the UK.

Spain and Portugal also look promising; they are benefiting from the diversion of tourism from North Africa and their economies are recovering from a low base.

Stock Selection Differentiation



RETAIL WAREHOUSES



OUTLET CENTRES



SHOPPING CENTRES



HIGH STREET & OTHER RETAIL

LOCATION



- Proven depth of occupational market
- Catchment area dominant
- Convenience based occupiers adjacent to, or at the asset
- Ease of car borne access and free parking
- Stringent planning controls

- Catchment dominant
- Profitable sales point for retailers
- Ease of car borne access and free parking
- Destination retail

- Catchment dominant
- Neighbourhood centres
- Extension to, or integrated in, the high street
- Community "meeting places"

- High street locations where rental growth can be achieved through repositioning
- Strong underlying demographic and investment fundamentals

ASSET MANAGEMENT POTENTIAL



- Opportunity to extend or build additional units and create trading mezzanines
- Opportunities to improve tenant mix
- Planning improvement opportunities
- Ability to influence trading patterns and add F&B / leisure

- Opportunities to extend, build additional units or expand to right size occupiers
- Opportunities to manage proactively to drive sales and thus rent
- Opportunities to refresh tenant mix and increase turnover density

- Capitalize on under management via refurbishment, introduce new retail formats
- Increase NOI via rental growth, commercialisation income, reducing non-recoverables
- Improve WAULT, covenants strength and functionality

- Retail and residential backed schemes that create strong city hubs
- Conversions into retail
- Planning improvement opportunities

FORMAT



- Opportunity for retailers to display whole product range
- Historically low vacancy rate
- Affordable rents
- Resilient and complementary to online shopping e.g. click & collect

- Minimum area: 16,000 sq m
- Minimum turnover density: €2000 sq m
- Ability to display extended product range
- Complementary to online shopping
- Resilient trading patterns in periods of austerity

- Target size: 15,000 sq m+ GLA
- Strong food / non-food anchor, tenant mix, inc. leisure & F&B
- Design to suit retailers; structural grids, unit depth, ceiling heights, customer customisation
- Online resilience through diversity and "experience" retailing

- F&B backed investments on high footfall locations
- Under-priced / mixed price assets
- Under capitalised assets

ADAPTABILITY



- Flexibility to accommodate changing retailer requirements
- Improve tenant mix, creation of "attractions"
- Improve style, ambience and customer satisfaction
- Multi-modal shopping

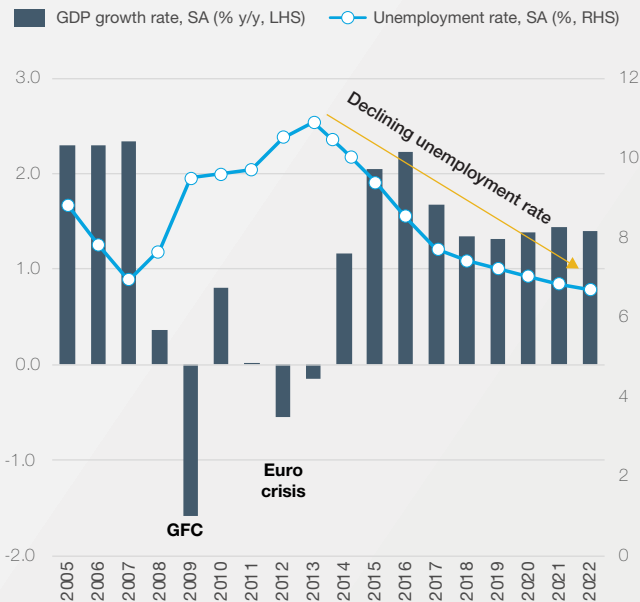
- Attract new retailers, due to strong retailer offering/ brands and improve tenant mix
- Increase F&B offering to increase dwell times
- Ability to drive stronger marketing; digital and social media campaigns

- Diversify non-shopping / restaurant offering, coffee shops, gyms, interactive play
- Improve tenant mix, creation of "attractions"
- Improve style, ambience, customer satisfaction

- Development opportunities in town centres
- Assets that can be repositioned

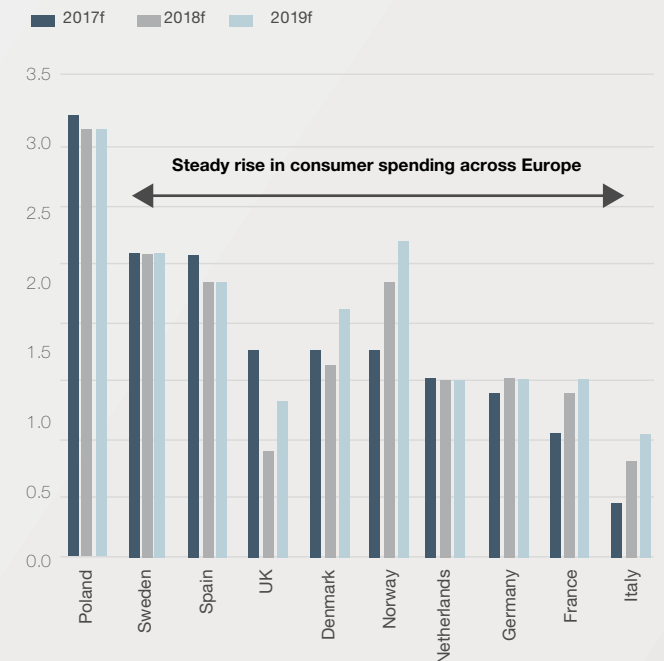
DEMAND

FIGURE 1:
EU-28, GDP growth rate and unemployment rate



Sources: Oxford Economics, Macrobond, Savills Investment Management

FIGURE 2:
Consumer spending growth (y/y, %)



Sources: PMA (Spring 2017), Macrobond, Savills Investment Management
Note: 'f' denotes forecast

SUPPLY

Urban Planning Protections



Sources:
Cushman & Wakefield,
Savills Investment
Management

DIFFERENCES BETWEEN EUROPE AND THE UNITED STATES

Europe

- Per capita retail space is lower in the UK (11 sq ft), France (13 sq ft) and Germany (15 sq ft)
- In the UK, France and Germany, Europe's three largest markets, online sales penetration is comparable to or even higher than the US
- Aging populations mean retailers will have to develop strategies for more immobile but also often tech-savvy 'silver buyers.'
- High street locations play an important role in European retail, and shopping centres have a wider array of anchors. Scarce supply in city centre locations has driven up rents, giving landlords the upper hand in lease negotiations

United States

- At 24 square feet (sq ft), per capita retail space is greater than in Europe
- Online sales account for 9% of overall retail sales and may increase to 11% by 2020
- Millennials account for 25% of the US population and contribute increased purchasing power
- US shopping centres rely on department stores as anchor tenants. As many US retailers face competition from discounters and online platforms, they are downsizing or closing stores despite preferential leases

Nordic retail

The retail sector in the Nordics is benefiting from the region's strong economic and employment growth, with several international brands looking to expand here. Medium-sized regional centres and neighbourhood schemes in locations with good economic foundations and socio-demographics offer a more enhanced shopping experience and attract footfall via food and beverage providers, leisure facilities and entertainment.

Despite the strong growth of e-commerce sales, the majority of Nordic retail sales still take place in physical stores. Consumers across the demographic spectrum prefer to shop in store for social and entertainment experiences as well as dining and trialling products. While many, especially technology-savvy millennials, embrace e-commerce, as retailers evolve to meet consumer needs, physical shops continue to offer a multichannel experience that online platforms alone cannot.



CATERING TO THE OVERALL EXPERIENCE

As much as the support is there for physical retail, a key challenge for retailers remains how they adapt simultaneously to the online consumer model and the need to showcase products. This challenge continues to evolve, but success for many retailers will depend on their ability to focus on both models. Many retailers feel it is imperative that their propositions serve both requirements, with even Amazon opening physical books stores after having been linked to the closure of so many in the past.

Nor are penetration levels of online sales significant across all countries. Sales growth is certainly more of a

consideration in the UK, for example, than in Italy. What is certain is that catering to the overall experiences of shoppers is the winning strategy.

Savills IM is cognisant of risk factors in retail but believes that there are opportunities for those who are capable of discerning between attractive and unattractive opportunities. As such, it is essential for investors to be mindful of the key factors driving both success and failure and to draw confidence from those investment managers who have the experience and market knowledge to pick the winning assets.

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