



Retail is not dead and regionally dominant shopping centres offer an attractive value play

Executive summary:

- The consumer has taken control of the retail relationship which is putting pressure on retailers' margins, as they face increased competition and a need to invest in a full reconfiguration of their supply chain to offer an "Omni-channel" distribution model
- This pressure on retailers' margins is likely to limit rental value growth prospects over the short-term, as traditional bricks and mortar retailers' space consolidations leave more voids than online pure play retailers establishing a physical presence absorb
- In our view, regionally dominant shopping centres and second-tier tourist-oriented city high streets represent an attractive "value play" for investors, as we feel the entire sector is being tainted by the same doomsday brush despite the fact that the operational performance of these schemes remains strong
- The sector is not without risks, as highlighted by the continued raft of retailer failures and bankruptcies which could be exacerbated if an economic downturn materialised over the short term. In addition, for those schemes that remain viable and in demand, the retailer-landlord relationship has to respond to a shorter retail life cycle and increased ambiguity across ultimate sales channels
- Ultimately, we do not think the developed world will stop consuming but rather that the retail landscape is evolving and store footprints are changing to be focused on the highest footfall locations where retailers can engage with consumers to showcase their brand
- In addition, the rising global middle class and subsequent increase in tourism should continue to support growth in the Factory Outlet Centre (FOC) model, which offers investors a defensive late-cycle play, as it combines the experience, discount and luxury offer being demanded by consumers



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The retail market is under pressure as it responds and adapts to the disruptive force of the internet on its traditional business model. However, retail is far from dead as consumers will continue to shop – only in a different manner – and brands which are able to adapt to the new “Omni-channel”¹ retail model will end up in a stronger financial position, making them viable credit tenants for retail landlords. Furthermore, this increasingly complex and new retail environment emphasises physical retail formats that cater to either convenience or the retail experience. The latter having become increasingly important to shoppers. During this transition phase, retailers would be extremely vulnerable to an economic recession but we feel the sector has fallen so far out of favour – with limited differentiation by scheme quality – so as to provide an attractive entry point for long-term investors able to cherry pick the top, dominant locations with high footfall which successful retailers will continue to target for occupancy.

Ever-demanding consumers are making the shopping journey more complex

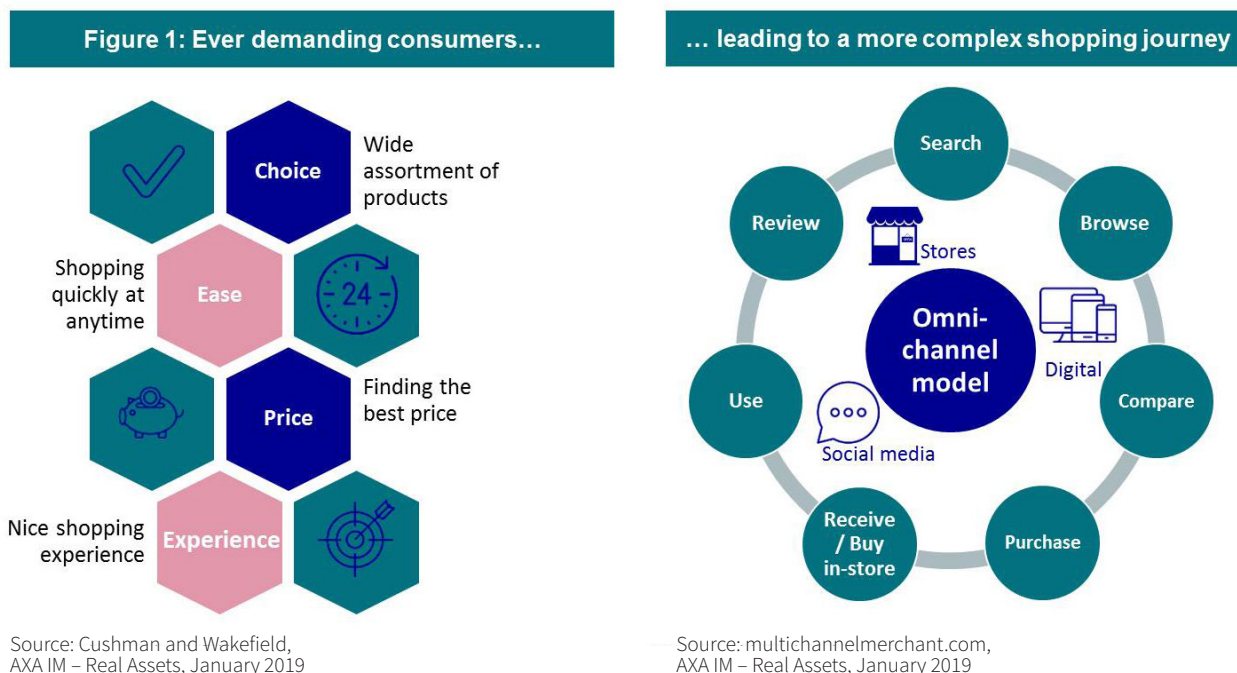
The retail sector has evolved rapidly over the past decade, as the internet has fuelled price transparency and expanded consumers’ retail offer. This has empowered consumers to become increasingly sophisticated and demanding in terms of how, when and where they want to shop. Immediacy, cost and quality have become their new expectations: “See now, buy now, and get a.s.a.p.” (Figure 1). The launching of the first iPhone in 2007 accelerated this trend, making mobile e-commerce (m-commerce) easier, enabling consumers to shop from anywhere and at any time. Technology has further empowered consumers with price transparency while social media, has made browsing and

brand substitution easy increasing competition between retailers.

This new retail model requires retailers to invest in a full reconfiguration of their supply chain to cater for “Omni-channel” distribution and achieve seamless inventory management, now critical for success. The evolution of the business model is putting pressure on the key drivers of a retailer’s financial equation: sales – costs = profit margin.

Many retailers are finding it difficult to maintain market share, as technology (e.g. online platforms) has lowered barriers to entry for new players and widened the shopping landscape available to consumers. Furthermore, being at the leading edge of the “Omni-channel” model requires

Figure 1



¹ “Omni-channel” combines physical and online commerce, but also increasingly involves social media as a new trading channel

an online distribution infrastructure, which comes at a significant cost to retailers. This investment consists of building a new logistics network and improving inventory management systems (utilising RFID— for example) to ensure they can track items and communicate delivery or provide click-and-collect options to consumers in real time. Retailers also need to optimise their bricks and mortar presence, through the opening of new stores where they can engage with consumers to showcase their brand and closing underperforming stores. (Figure 2). In addition to the footprint rationalisation, there has been a rise in the number of retail failures over the last few years. This coming at a time of global economic recovery and expansion raises the risk of acceleration in the number of retail failures should an economic downturn materialise as their current financial position makes them extremely vulnerable to a recession.

Physical retail is not dying, just evolving

Retail products vary in their suitability to the online sales channel. Commodity retail segments, such as household appliances, electronics, toys, books and music are more exposed to the risk of being offered online only as their purchase requires less experience and sense stimulation. The experience required for items such as clothes, homeware, health and beauty is less replicable online and therefore more suitable to the “Omni-channel” model. Retailers embracing this model are most likely to occupy the best high streets units and shopping centre scheme with flagship units going forward. Landlords are now actively engaging and managing the tenant-mix of their schemes to ensure that retailers within their schemes have the correct store format. This may require capital expenditure (capex) to combine units into the larger footprint

required to house the modern flagship unit store format.

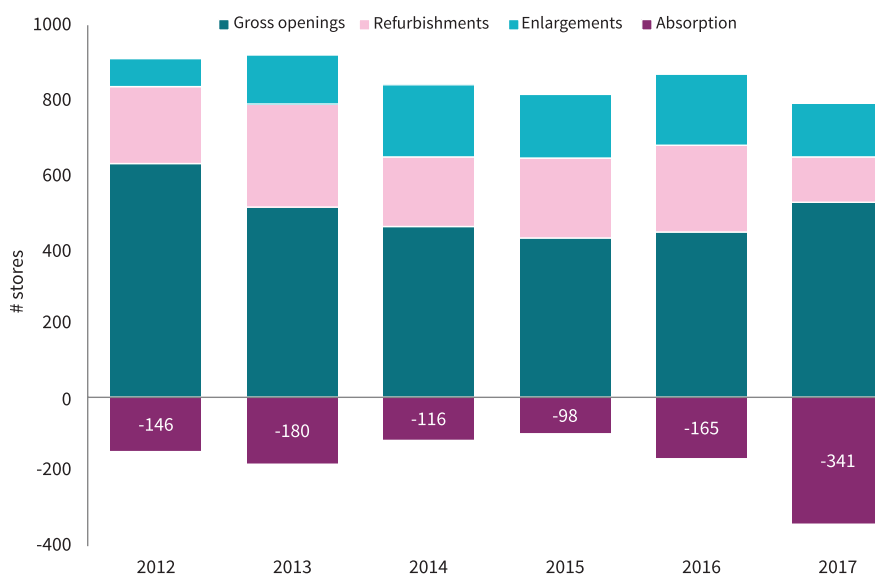
However, not all retailers are affected in the same way; brand positioning is also highly correlated to a retailer’s success. In the apparel sector for example, mid-market retailers are struggling to find their place in a polarised market. After leading the clothing segment for years in the UK, Marks & Spencer (M&S) is to close over 100 stores by 2022, most of which are clothing and home branches. This strategy of selectively closing stores should allow for increased support and growth of the online distribution platform by optimising their physical presence. M&S has struggled with fast fashion competitors offering new collections on a regular basis at an attractive price. While department store troubles have been well documented, the M&S hybrid model (between a high street shop and a department store) makes it an interesting case study.

Department stores the world over have been struggling and closing stores: Macy’s, JC Penney and Sears

in the US, BHS and House of Fraser in the UK and V&D in the Netherlands. Mid-range department stores with indistinct positioning, delayed online presence and a lack of innovation have struggled to compete with fast-fashion, discounters and online players in the affordable segment and high-end stores at the other end of the spectrum. The US market is the most exposed to the troubled department store segment, as the market is overbuilt in the context of total retailer space requirements in the “Omni-channel” world³.

Physical retail remains relevant as it offers an irreplaceable avenue for retailers to engage with consumers directly. But, the number of physical stores required to serve a defined catchment is falling as retailers are focusing purely on the highest footfall locations. The result is that the retail property investor is now more focused on size and wealth of the local catchment area and footfall figures rather than traditional retailer focus on underlying store sales density and occupancy cost ratios. The end result

Figure 2: Inditex store strategy reflecting retailers response to new retail trends



Source: Inditex annual report March 2018, AXA IM – Real Assets

² RFID: Radio-Frequency Identification uses electromagnetic fields to automatically identify and track tags attached to objects

³ According to PMA data released in Q4 2018, shopping centre stock per 1,000 capita reached at 1,516 sq m in the US, whereas the European average is 262 sq m per 1,000 persons)

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being a change in the key asset criteria which characterise prime retail property investment targets.

What does the future hold for retail?

The retail evolution is far from being over and technology and social media are key facilitators. Retailers continue to experiment and find new ways to engage with consumers to articulate their brand. Instagram for example is becoming a new marketing tool, and the frontier between social media, augmented reality and retail is increasingly blurred and will continue to spur change.

Furthermore, landlords are now using big data and new technologies as tools to better understand consumers' behaviour: computer vision and beacon technology to name a few. These new technologies are used in shopping centres to identify dead spots and optimise asset management accordingly. However, the use of data is not as easy as expected given the increase of data protection regulations, especially in Europe, making it difficult for operators to extract value from these new devices.

Limited income growth prospects place emphasis on existing income

In the context of retailer margin pressure, we expect real estate income prospects to remain subdued in the short term. Retail landlords should be engaging with tenants on their "Omni-channel" plans in order to collaborate and ensure the ultimate success of the physical bricks and mortar presence. As retailers prioritise supply chain investment and rationalise their store networks to optimise their "Omni-channel" offering they are unlikely to be able to support rental increases over the short-term.

The growing number of bankruptcies and CVAs⁴ is putting additional pressure on landlords' existing revenue. Possible rent reductions resulting from the latter are seen as a short-term fix that is not

necessarily enough to avoid final store closures as they do not address the underlying issue of an underperforming brand/concept. While there is an increasing trend for online offerings to begin opening physical stores, we do not feel this will be enough to offset the closures emerging from the combined effects of bankruptcy and store count rationalisations.

The recent increase in retailer bankruptcies during a period of economic growth highlights the downside risks that could materialise should the economy fall into recession. However, once the winning retailers emerge with the infrastructure to deliver an "Omni-channel" model and successful brand concept, we believe the sector will likely be able to support rent increases again. The increasingly competitive retailer landscape is also likely to shorten brand lifecycles, which may require a change in lease duration and flexibility should a retail landlord want to ensure they have the most attractive tenant mix in their scheme.

High Street: rising rates and affordability issues key risk for global gateways

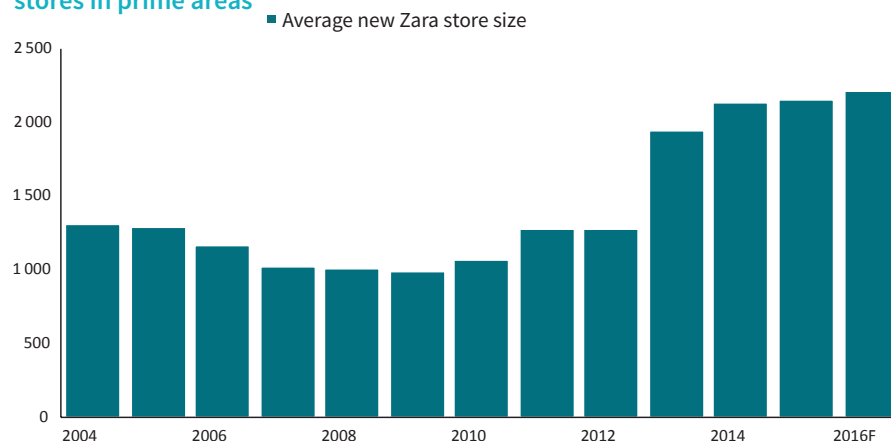
Retailers are increasingly looking at their store networks as a flagship

showcase of their goods and an opportunity to directly engage with their customers. In addition, they are utilising stores as part of their distribution network for their products. As a consequence, they are redefining their requirements, with a preference for fewer but larger stores that can act as both a flagship showcase and a distribution node for click-and-collect as well as potential online order fulfilment.

Large high street flagship stores located in prime locations of gateway cities remain a focus for retailers (Figure 3), but affordability is becoming an issue following five years of strong gains. As a result, retailers also looking at growing exposure in tourist-oriented second-tier cities that offer good value retail space and high brand visibility.

The prospect of meagre rental growth (if not rental declines) in global gateway high street retail locations, combined with current low yield pricing levels, limits the attractiveness of this segment in the context of a rising interest rate environment. As a result, we are relatively cautious about global gateway high street investment at this point of the cycle as we expect the best performing high streets to be in tourist-orientated second-tier cities.

Figure 3: Inditex is refocusing on larger retailers flagship stores in prime areas



Source: SG Cross Asset Research Equity, data as at August 2016

⁴ Company Voluntary Agreement: is an insolvency procedure allowing a company with debt problems to reach a voluntary agreement with its business creditors regarding repayment of all, or part of its corporate debts over an agreed period of time. This includes the possibility to cut rents or terminate a lease.

These city high streets have not experienced the same level of rental growth as the global gateways and are therefore relatively more affordable and still offer some upside for rental value growth. At the same time, they are at an attractive yield premium relative to the global gateways. As with all retail locations in the “Omni-channel” retail world of today, buildings capable of catering to flagship stores remain a key differentiator.

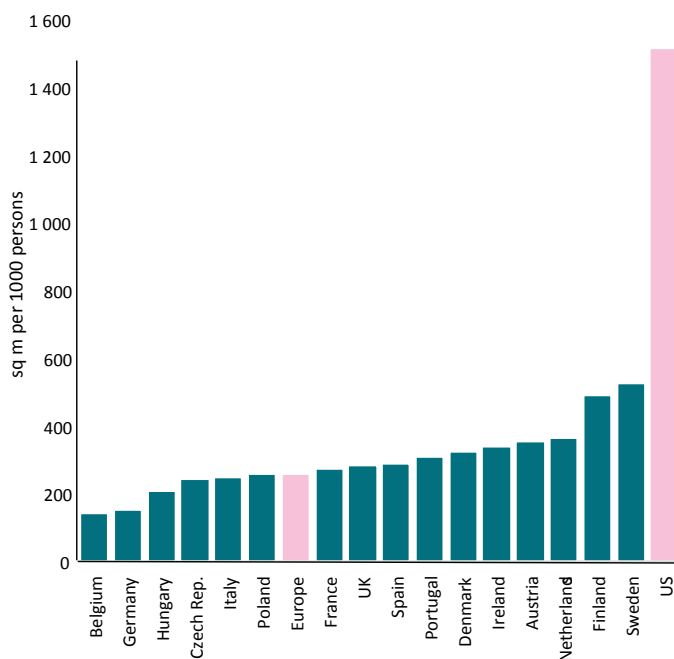
Dominant shopping centres are ecosystems able to weather the retail storm

The shopping centre industry has been subject to severe criticism over the past few years, with press headlines referring to a looming “retail apocalypse” in the US⁵. Furthermore, listed shopping centre REITs have experienced a marked level of underperformance vs the regional benchmarks with current share pricing implying a c.5-6%⁶ net initial yield and c.10-20% discount to NAV⁷. There is also limited variance in implied pricing based on portfolio quality suggesting the listed market is sending a clear signal in its assessment of the underlying risks being faced by shopping centre owners.

The US shopping centre industry is often characterised by its high level of supply (Figure 4) with shopping centre stock per 1,000 capita reaching 1,516 sq m for the US while most European countries have stock density levels under 500 sq m⁸. In addition, the US market has a heavier reliance on the struggling department store anchors who are finding it difficult to compete with online retailers (Figure 5). As these pressures continue to challenge poorly positioned Grade C/D malls, anecdotes of “zombie malls” proliferate in the US press. One could be tempted to transpose the US situation to Europe, suggesting it is just a matter of time before the same trends occur in Europe. However, there are certain dynamics in Europe that we believe could limit the potential read across for European shopping centres.

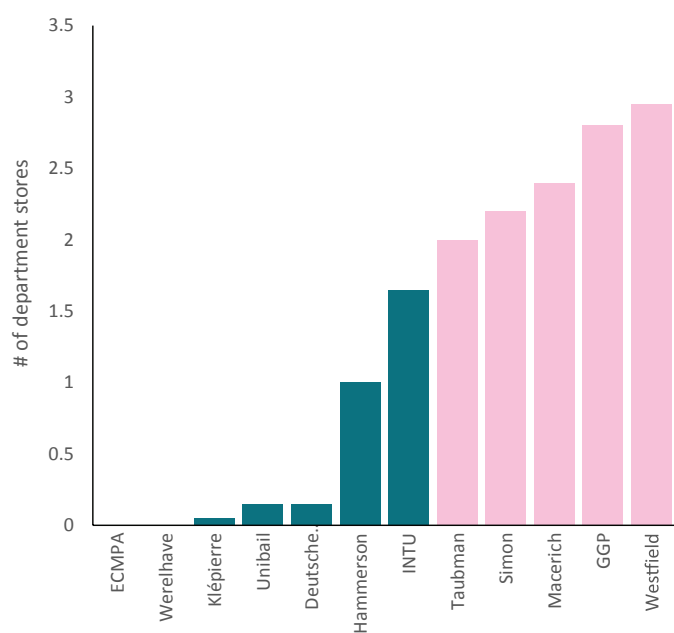
Regionally dominant shopping centres in Europe benefit from having less competition than their US counterparts, as the underlying provision is significantly smaller. Additionally, increasingly stringent planning requirements are one reason that shopping centre supply pipelines are more focused on the extension and refurbishment of existing sites than on a material increase in newly built shopping centres. Moreover, the prevalence of hypermarket/food-driven anchors has provided a defensive element to their rent roll.

Figure 4: US seems oversupplied compared to most of European countries



Source: PMA, AXA IM - Real Assets, data as at Q4 2018

Figure 5: Average # of department stores per SC higher in US big players’ portfolios



Source: Euromonitor; BofA Merrill Lynch Global Research, September 2017

⁵ “The retail apocalypse has officially descended on America”, March 2017, Business Insider “Will the death of US retail be the next big short?”, July 2017, Financial Times

⁶ Morgan Stanley, data as of 17 September 2018

⁷ UBS, data as of October 2018

⁸ PMA data as at Q4 2018, shopping centre stock by 1,000 capita

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While the past decade of increased NOIs emanating from rising OCRs has clearly come to an end, the headlines suggesting all shopping centres will be rendered obsolete is a gross exaggeration in our opinion. This being supported by the strong operational performance of the listed shopping centres owners, highlighting that fundamentals remain sound. (Figure 6)

The consumer culture that characterises the developed world is expected to remain a key part of our economies (i.e. the internet is not going to stop us from shopping) but the advent of internet technology is clearly changing all aspects of our lives, including the way we consume.

As more and more retailers adapt to the “Omni-channel” retail environment, we continue to see further evidence of the critical importance a physical store has in the way brands connect and interact with consumers. There remains a grey area however, in the way sales are tracked and differentiated between online and in-store channels, with a number of shopping centre operators accusing retailers of reducing in-store turnover figures by the amount of online sales returned in-store. Further transparency and an agreed solution will need to be found in order to remedy and realign landlord and tenant interests.

Given the high footfall that regionally dominant shopping centres command, it is no surprise that retailers would

continue to consider a presence in these schemes as a means of brand awareness and consumer engagement. This is why asset management initiatives by retail landlords will continue to focus on growing footfall traffic and increasing dwell time through higher food and leisure offerings, but the underlying shopping centre operator is critical to the ultimate shopping centre performance and investors must carefully consider which players they decide to work with.

Asset repositioning is a key industry response to the ever-changing retail universe and we feel that owners of shopping centres that are able to invest in and adapt their schemes by improving the leisure and entertainment offer will continue to enjoy the relatively stable and diversified income streams that shopping centres have long been valued for. As for middling schemes which are struggling, landlords may find accretive redevelopment and repurposing opportunities to residential and urban logistics for example.

Given the significant repricing this sector has experienced, both in the listed and private markets, we think there is an adequate margin in the net initial yield to cover the capex requirements needed to ensure a regionally dominant shopping centre scheme remains a viable going concern. While the underlying thresholds will vary from market to market, the critical criteria to determine which schemes qualify as being regionally dominant include

level of footfall, sales density (i.e. sales per floor area), local catchment wealth and economic prospects, competing schemes/supply risk, leisure offering and tenant mix.

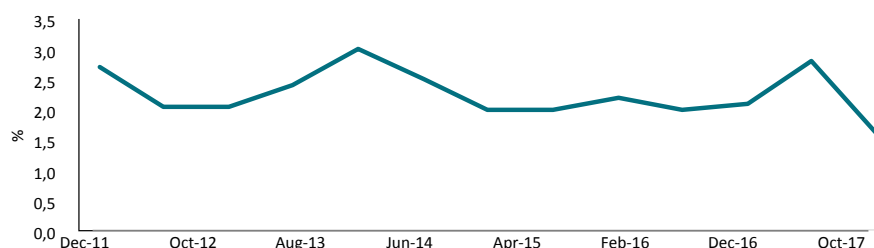
Factory Outlets Centres (FOCs): solid underlying fundamentals in a challenging retail environment

After the global economic downturn, consumers became more price sensitive and had a more cautious approach towards spending. It started with the middle-classes being increasingly attracted to discount food stores but rapidly spread to travel and discretionary retail. Despite the subsequent economic recovery and recent growth, consumer demand remains strong for discount retail offerings. This dynamic is well summarised by Steve Tanger, CEO of Tanger Factory, a US REIT operating FOCs in the US: “In good times, people LOVE a bargain, in bad times folks NEED a bargain”.

In addition to changing consumer preferences domestically, another strong tailwind supporting demand for FOCs has been the growth of international tourism. The growing middle class, particularly in emerging Asian economies, has driven a sharp increase in international tourism and retail consumption has formed a large part of the travel itinerary. This is evidenced by the fact that Bicester Village¹¹, a designer outlet centre located close to Oxford, is the second most visited destination in the UK for Chinese tourists after Buckingham Palace. While the growth of international tourism has been strong in recent years, it is expected to increase significantly over the next decade to almost one billion arrivals for leisure purpose in 2030¹².

FOCs combine experience, discounts and a luxury offer now at the core of consumers’ preferences. From a retailer’s perspective, this format can be complementary to the full price offer in

Figure 6: European REITs’ average like-for-like shopping centre rental growth



Source: Company data, Datastream, Morgan Stanley, data as at Sept 2018

Note: based on LFL growth for British Land, Eurocommercial, Hammerson, Intu, Klépierre, Landsec, Mercalys, Unibail-Rodamco and Wereldhave

⁹ NOI: Net Operating Income

¹⁰ OCR: Occupancy Cost Ratio

¹¹ Inside Bicester Village – the bizarre shopping centre that’s as popular as Buckingham Palace with Chinese tourists, October 24th 2017, The Telegraph

¹² World Tourism Organization (UNWTO), forecasts at 2015

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its strategy but it is not at the centre of its “Omni-channel” model. Some brands use it as a good way to sell collection excesses, some even create dedicated outlet lines, but other luxury brands remain relatively cautious towards this model because of the risk of brand image erosion.

One key advantage of this specific retail format for both retailers and landlords is the lease structure that includes an element of risk sharing. The concept offers retailers relatively cheap rents for locations with such high footfall and retail densities. In exchange, landlords are offered more control over retailers’ operations, via performance clauses or control over discounts on items sold. However, one drawback for landlords is that revenue can be more volatile due to shorter lease terms and the element of turnover rent.

As FOCs benefit from positive fundamental tailwinds and an experience that combines both discounts and a luxury offer, we feel the sector offers a relatively attractive and defensive portfolio diversifier. While the sector is fairly well developed in the US and Italy, in particular, the segment is

still small and therefore offers both core standing asset investments as well as higher risk development opportunities needed to build out the stock. Similar to the shopping centre segment, this unique retail format requires specialist management skills so operating partners must be closely vetted to ensure a scheme’s success.

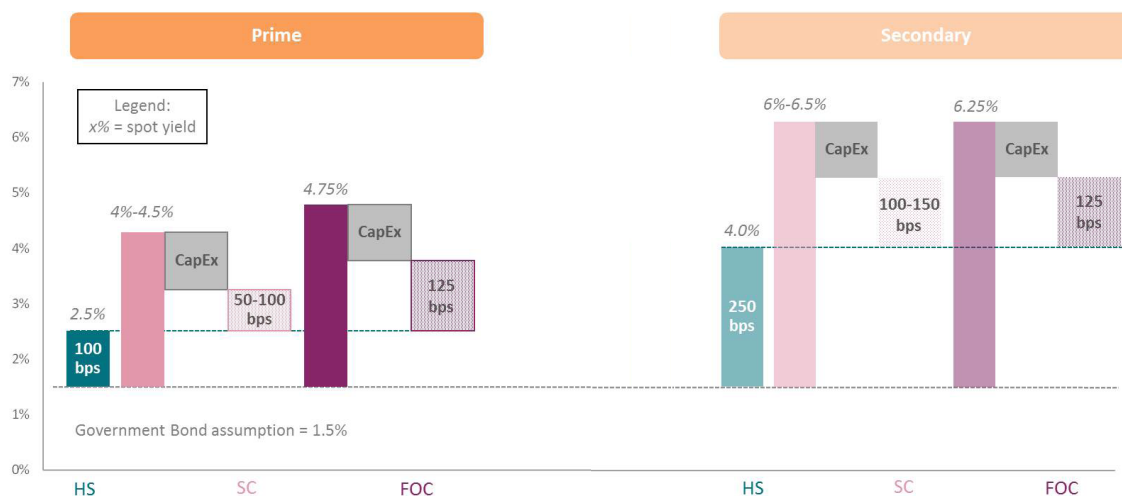
Value plays in regionally dominant shopping centres and second-tier high streets

With future rental value growth expected to be limited for retail assets, it would be prudent for investors to focus on in-place yields and consider the underlying sustainability of the income stream. In the context of a rising interest rate environment, we feel the lowest yielding global city high streets do not provide an ample yield buffer to compensate investors, particularly as recent rental growth has been so strong in this segment that there is likely more downside risk to rents on an affordability basis than upside risk. In contrast, we think there is potential rental upside in the tourist-oriented second-tier city high street rental market, as retailers continue

to target these locations and rents are substantially more affordable. Investment in this segment combines an additional yield spread over the global gateways and liquidity, which tends to be underpinned by local high net worth individuals, providing an attractive relative value proposition.

The more controversial shopping centre segment, which has been garnering all of the headlines, is currently priced at net initial yields of around 4-4.5%¹³, which for prime stock leaves between 50-100 basis points of additional yield premium over high street units after allowing for 100 basis points of capex to facilitate the extensions and refurbishments necessary to remain relevant in the ‘leisuretainment’ retail world (Figure 7). While we acknowledge there are downside risks to retail failures should a potential downturn in the economy materialise, we feel regionally dominant schemes run by experienced local managers will continue to remain viable income generators. At current market pricing, we feel this segment provides a “value play” and an opportunity to add incremental yielding assets as a portfolio diversifier in an otherwise yield starved world.

Figure 7: Shopping centres and FOCs offer an attractive yield premium to high street



Source: AXA IM – Real Assets for illustrative purpose only, as of Q4 2018

Note: Prime shopping centre refers to very large, dominant centre; secondary to large, regionally dominant centre
Yields represented are current property yields

¹³ CBRE data, as at Q3 2018

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