The demise of retail malls has been prophesised in media headlines since the advent of online shopping. Yet, to date many centres remain resilient. What is the future of retail property in the face of the e-commerce evolution? Will any landlord be able to increase rents when competing against the internet?

AMP Capital Global REITs team

Some 34 years ago, in 1979, Michael Aldrich, working for Tesco piloted a system, enabling transaction processing between consumers and businesses. This was the first demonstrated concept of what would come to be known as e-commerce. Almost two decades later emerged what would become two of the most dominant online players, Amazon and E-bay.

Since those early days, e-commerce has slowly but consistently taken a larger proportion of consumer time and spend. The Commonwealth Bank of Australia estimates that in the US, online shopping accounts for 6% or US$257 billion, while in the UK online shopping is equivalent to 39% of retail industry growth. This surge in online spending has led to e-commerce encroaching on the doorstep of the traditional bricks and mortar shopping mall.

What is driving consumers to shop online?

In the developed world, 77 out of every 100 people are now connected to the internet. This high level of internet penetration coupled with a generation brought up online and familiar with the digitally connected lifestyle, we think has led to comfort in sharing their personal details online. With this comfort in using both the internet and sharing personal details, it seems inevitable that savvy retailers would capitalise on these favourable market characteristics.

According to research by Macquarie Bank, the online drive by consumers is being driven primarily by three things:

**Price** – in a largely price transparent world, consumers are able to use the internet to quickly and easily compare prices online. Websites such as Static Ice and Shopbot aggregate pricing from various retailers and display them sorted by price. International retailers who have the existing advantage of lower labour and occupancy costs have been further helped by the strength of the Australian dollar, which made their prices relatively cheaper still.

**Convenience of the shopping experience** – Consumers cite convenience as being one of the reasons of their shift to buying online. Consider that you can do all your research, order and have your goods delivered to your doorstep without setting foot outside of your own home, or looking up from your mobile screen.

Source: Reserve Bank of Australia, as at October 2013
The range of products available online – Physical constraints can inhibit retailers from displaying or carrying a full range of items, in contrast to online-only retailers who can display any and every product they sell, and only pay for warehousing and postage costs. Amazon for example, has an operating cost to sales ratio half that of its in-store peer average. Furthermore, certain products are simply unavailable offline, for example, media and entertainment content available from US and UK that do not have local distribution licenses.

There is evidence to suggest that as consumers become more comfortable with the experience of purchasing online⁴, that convenience and product range become relatively more important as a deciding factor to continue shopping online. Price is the gatekeeper.

What are the impacts to retailers?
Analysis by Exane BNP Paribas⁵ shows that in Europe, retailers face the combination of stagnating retail sales, rapidly rising online sales and modestly growing space; causing reduced sales density – a measure of sales productivity on the basis of space.

On the other hand, retailers are being forced into investment spending in order to develop new channels to compete with the online entrants.

Combining these issues, European retailers are facing a deteriorating external environment, existing high fixed costs, as well as increased capital expenditure, which means that retailer margins are likely to decrease.

Exane BNP estimate that the shift to multi-channel by European retailers will lead to a 24% reduction in operating profits. It’s likely however, that this fall in profit will not simply be borne by the retailer alone.

Non-Food Retail EBIT margins

![Non-Food Retail EBIT margins graph]

Source: Morgan Stanley as at June 2012.

What are the retailers doing about this?
Globally, retailers have had to adapt to the changes ongoing in the market in order to survive. The retail response to changes facing the industry appears to be toward strong, more personalised engagement, flexibility and community. PSFK in its 2012 report The Future of Retail described several key trends (amongst others) emerging in retail:

> Shoppers and retailers trading data for more personalised service
> Retailers using shopper data to construct personalised shopping experiences

What are the risks to shopping centres?
Rental expenses can account for anywhere up to 45% of a retailers operating costs base⁶. The strength of rents has been driven predominantly by structural factors such as retail zoning laws, a landlord market and the two decades of favourable macro conditions. These factors combined have led to a low vacancy environment and strong returns for investors.

In Europe, where the prevailing culture of online shopping is more mature, retailers are investing in developing multiple channels with which to do business with shoppers. The multi-channel approach means that retailers are ideally indifferent to where a purchase occurs, in person, online, through a mail order catalogue. The key to success in this strategy appears to be a seamless integration across the different channels to ensure a consistently engaging, quality experience for the customer.

Neiman Marcus the United States luxury store is a great example of integrating multiple channels. Neiman developed a location-aware iPhone application called NM Service, which enables an opt-in service letting customers program the app with their preferences which are pushed to sales staff as the user enters the store. The sales associate at the store is provided with the user’s social media information as well as the selected preferences of the application. The app also works in reverse, allowing customers to set up appointments with sales staff and identify who the manager of a store is.

Australian retailers currently enjoy the highest retail margins globally, according to Macquarie Bank⁷. The high retail margins are driven by unique structural factors in the Australian retail market, mainly labour and occupancy costs. Occupancy costs drive around half of a retailer’s operating cost base. Retailers are pursuing productivity gains as a way of reducing their labour costs and there is evidence that this investment in productivity is resulting in price competitiveness. This increased price competitiveness should help traditional ‘Bricks and Mortar’ (‘B&M’) retailers clawback some of the substitution away to online retailers by customers.

B&M retailers appear to be undertaking an integrated, multi-channel approach.

In order to compete against online players, it is clear to us that retailers are focussing on shopping centres that provide the following favourable characteristics:

> High productivity
> Growth potential
> Efficient layouts
> Positive competitive dynamics
> High shopper traffic

These characteristics are critical for landlords to ensure that their shopping centres perform. Ultimately, landlords must have a clear understanding of the value they are creating. If landlords can satisfy retailers on the above characteristics they will have a strong shopping centre.
As these conditions change, it is inevitable that landlords will also need to adapt with the changes to their lessee requirements and consumer spending habits.

Certain retail sectors are more at risk from the structural changes flowing through economies at present. Research has shown that as the penetration of online shopping increases the contours of the online purchasing landscape become more pronounced.

As online shopping penetration increases, shoppers are focussed on purchasing electronics, books, music, apparel, sporting and outdoor goods. On the flipside, food and beverages, supermarkets, liquor, do-it-yourself and gardening, Luxury fashion and healthcare tend to be less affected by the flight to retail and subsequently strong performers.

**How have shopping centre landlords and retailers responded?**

Headlines have been predicting the demise of shopping centres since they were first constructed in 1956. But to date this never eventuated. Shopping centre landlords were able to focus on providing the right leasing mix, right design and targeting the right customers, consequently adapting to the changes facing the industry and the best shopping centre operators have been able to do this on a consistent basis.

Again today, the strongest asset managers and shopping centres have remixed their portfolios, shifting away from industries which face the strongest headwinds, and improving their engagement and lifestyle offerings. We believe the key to their continued success will result from offering real points of difference over the internet shopping experience, embracing the online evolution, introducing internet parcel pick up points and creating a retail marketing mix that will minimise online comparisons.

By Spring 2015, Simon Property Group will transform a wing of its new Long Island shopping mall into a luxury wing, featuring Neiman Marcus and potentially other luxury retailers as its anchor tenants6. Similarly in Melbourne, Chadstone shopping centre is an example of how strongly the luxury segment of the retail sector is performing with a proposed expansion to the shopping centre including a hotel, multi-storey offices and expanding the food and entertainment quarters.

The European experience shows, however, that a reliance on entertainment and food and retail will not sustain the landlord’s profitability, food and cinema operators do not pay as much as non-food retailers. Therefore, either: food and cinema rents will go up, another industry will need to take up the slack or rental income will decrease.

On the convenience side of the flight to online, landlords have begun investing in their shopping centres to increase convenience in parking as well as offering digital solutions to make it easier for consumers to navigate their centres.

Shopping centre owners have invested in mobile apps to help customers find what they’re looking for, including their car on the return trip. To add to the parking convenience, Westfield has developed a parking guidance system, a mobile app and provides valet parking at its centres. CFS Retail Property Trust Group and GPT are following suit, with parking guidance systems of their own as well.

**How should Investors think about positioning their portfolios?**

With the benefit of global exposure, investors can track different parts of the online retail story. In the US, online shopping has captured 19% of the $110bn retail industry growth since 20057.

Since online retailers have become prevalent in the US, the department store category and the shopping mall property format have faced a significant decline.

Not all US shopping malls look set to suffer this fate, Simon Property Group, for example has significantly outperformed relative to other US names.

**Simon Property Group versus DDR stock performance**

Source: Bloomberg as at September 2013.

In the UK, internet retailing has taken the 39% of industry growth since 2005, more than double penetration in the US8. This is primarily driven by the different structural market factors such as: a high population density, a well-established catalogue shopping industry, high rental costs and long working hours.

Lessons from the UK show that the most exposed categories to internet retailing are: video games, music, computer products and clothing8.

Land Securities provides a great example of the changes that have occurred over two decades in shopping centres. In their most recent development, Trinity Leeds, Leeds, UK, 20% of occupancy is in food and beverage, as opposed to 20 years ago where only 5% of a shopping centre would have food and beverage tenants11. Land Securities has fully embraced the notion of providing consumers with an experience, and given their strong portfolio of assets, their share price has reflected how they’ve adapted to changes in industry.

**Hammerson versus Land Securities stock performance**

Source: Bloomberg as at September 2013.
Conclusion

The face of retail has changed; today, retailing means going into shopping centres, going online and going mobile. Property investors therefore need to look for quality assets to hold in their portfolios in order to benefit most from these emerging changes. Global REITs that have the right product and are able to respond to changes by actively remixing tenants we believe are most likely to prove resilient in the long term.

REITs that have dominant, high quality assets which are located in key growth corridors we believe are likely to outperform their peers. Expect a divergence between high quality assets and lower quality assets as retailers consolidate to the highest quality in order to get exposure to the highest footfall.

Global managers with access to knowledge about the transitions occurring in more advanced e-commerce markets will have an edge in taking more informed stock positions.

Sources:
11. Asia Insight: Internet Retailing Boom 3.0 Morgan Stanley June 2012.

About the Global REITs team

AMP Capital is a leader in global listed real estate and received awards for our Global REITs Fund (Asia Asset Management 5 years performance 2011 and 2012).

We have one of the world’s largest global listed property teams with 14 experts on the ground in London, Chicago, Hong Kong and Sydney with over 160 years of combined investment experience. They use a bottom-up investment process utilising local expertise in a globally integrated approach complemented by top-down analysis.

The team is headed by Matt Hoult, head of global listed real estate.

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