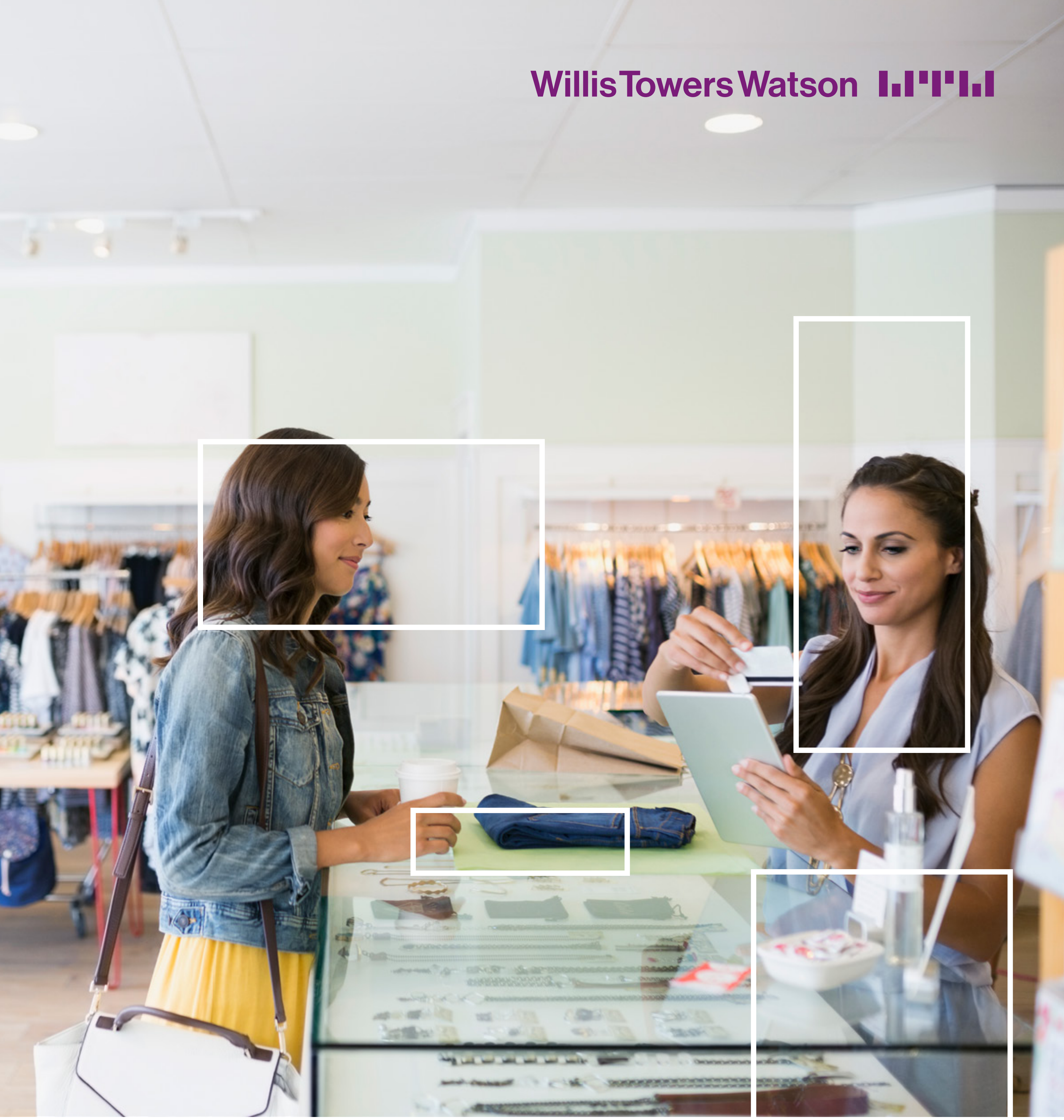

Investment outlook: The future of retail

Leading into COVID-19, the Australian retail sector was under considerable pressure. While the full impact of the pandemic is yet to be felt, structural and cyclical factors have already considerably diminished the sector.

Until recently, the local retail sector typically comprised the largest proportion of unlisted real estate in Australian investors' portfolios. Primarily this has been due to retail assets delivering strong income and capital returns with low volatility and resilience through market cycles.

But times have changed. Even before COVID-19 shut down retail across the country, weakened consumer sentiment and spending propensity has resulted in declining profit margins for many bricks and mortar retailers. Indeed, the viability of many businesses has been called into question.

Likewise, investor sentiment on the sector has plummeted and there have been sizeable redemption requests in Australian wholesale retail property funds in the last 12 months or so.

This paper provides specific commentary on H2 2019. Given the prevailing market conditions both domestically and globally resulting from the COVID-19 pandemic, our commentary on this is from more of a short-term lens.

Cyclical factors affecting retail

Cyclical factors have had a significant impact on household consumption levels. Throughout 2019 Australia's GDP growth of 2.2% for the 12 months to December 2019 still fared well in a global context, but it has remained muted and below expectations. This can be attributed to the weak household sector, defined by high debt levels, low wage growth and high underemployment. It is not surprising then that fiscal stimulus in the form of recent tax cuts did not reach the end consumer, instead being used to pay down household debt.

Additionally, monetary policy saw the interest rate cut three times over 2019 to a historic low of 0.75% yet this was equally ineffective at stimulating growth. As consumer sentiment and spending propensity plummeted against a challenging economic backdrop, retailers have felt the impact on their bottom line, resulting in slowed rental growth across the sector. We note that the RBA has since cut the interest rate further to 0.25% and has announced a raft of stimulus programs to try and steer the Australian economy through the COVID-19 pandemic.

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Structural factors affecting retail

While the economic environment paints a picture of tightened consumer spending overall, several structural changes are simultaneously redefining retail. Consumer behaviour is transforming, in terms of what they spend on, how they spend and where they spend. This is primarily driven by:

- **The penetration of e-commerce.** The share of online retail trade in Australia overall has climbed to ~9.3% in the 12 months to December 2019 . This is more than a 50% increase from a share of ~6.1% in the 12 months to December 2015 . While the penetration of online retail in the Australian market is lower relative to the UK (~20%) and US markets (~11%), it is only expected to increase over time. This has had implications for traditional bricks and mortar stores which have noted material decreases in foot traffic, and ultimately, declines in sales growth.
- **Changing consumer preferences and expectations.** Australia's demography is playing a vital role in redefining the future of retail. The ageing population will have greater demands for the provision of healthcare and recreation services, whereas, increasingly influential Millennials and Gen Z are highly concerned with sustainability and are instrumental to the rise of the "ethical consumer". Overall, contemporary consumers will demand fully immersive and personalised in-store experiences, driven by technology. This means that traditional buy-and-leave shopping models no longer hold; in order to remain resilient, retailers will need to evolve with the changing preferences and expectations of their consumers, and this will be largely supported by data analytics.
- **Increasingly competitive landscape.** The retail environment has become increasingly challenging for domestic retailers due to the entry of mini majors – such as H&M and Zara – into the Australian market, and discretionary retail has suffered the most overall. The depreciating Australian dollar has increased the cost of goods for smaller domestic boutiques, who struggle to achieve economies of scale as executed by larger international brands. Subsequently, as some retailers grapple to remain viable and the future remains uncertain, many retail tenants are opting for shorter leases.

  Additionally, the popularity of sale-days such as 'Click Frenzy', 'Black Friday' and 'Cyber Monday' are promoting a disinflationary discount-driven market, further tightening profit margins and creating a tough "survival of the fittest" environment. While these phenomena can boost sales dramatically for retailers overall, it is typically to the detriment of smaller domestic bricks and mortar retailers.
- **Swing towards the service/experience economy.** The Under normalised conditions, there has been a material uplift in the consumption of services overall, many of which require a physical storefront for their provision, such as beauty salons. This further aids the argument for the perpetual need for bricks and mortar.
- Food is surpassing other categories in terms of consumption; however, leisure and entertainment are also performing well and highlight a shift away from consumption based primarily on material things. This has important implications for shopping centres as, for example, the capex requirements to continually refresh assets to retain footfall will be structurally higher than in the past. Additionally, repurposing spaces such as to fit out a food and beverage retailer (and potentially change the use of this space down the track), would be much greater than say, a fashion boutique.

Response of core retail funds

As a result of negative sentiment towards the sector, some investors have reacted by withdrawing their allocations, leading to some Australian retail funds facing sizeable redemption requests. Some significant sales (both whole asset and partial) in the sector include Westfield Marion (SA) and Garden City (WA) shopping centres, which are a direct result of the redemption requests facing these funds.

In response, many funds are re-positioning their strategy. There is a movement towards all-in-one shopping destinations, or mixed-use "amenity hubs". These function as a consumer's one-stop-shop for all shopping and service provision needs, ultimately increasing consumer dwell time and therefore, spend. These "hubs" will have a sustainability focus and promote community engagement.

[1] National Australia Bank [NAB] (2020), NAB Online Retail Sales Index December 2019, Business Research and Insights, NAB Group Economics (accessed 14 February 2020)
[2] NAB (2016), NAB Online Retail Sales Index: In-depth Report – December 2015, Business Research and Insights (accessed 18 February 2020)
[3] Office for National Statistics (2020), Internet sales as a percentage of total retail sales (ratio) (%), Business Industry and Trade, last updated: 19 June 2020 (accessed 10 March 2020)
[4] United States Census Bureau (2020), Quarterly Retail E-Commerce Sales, 1st Quarter 2020, Monthly Retail Trade, U.S. Census Bureau News, U.S. Department of Commerce, Washington D.C. (accessed 25 May 2020)

COVID-19

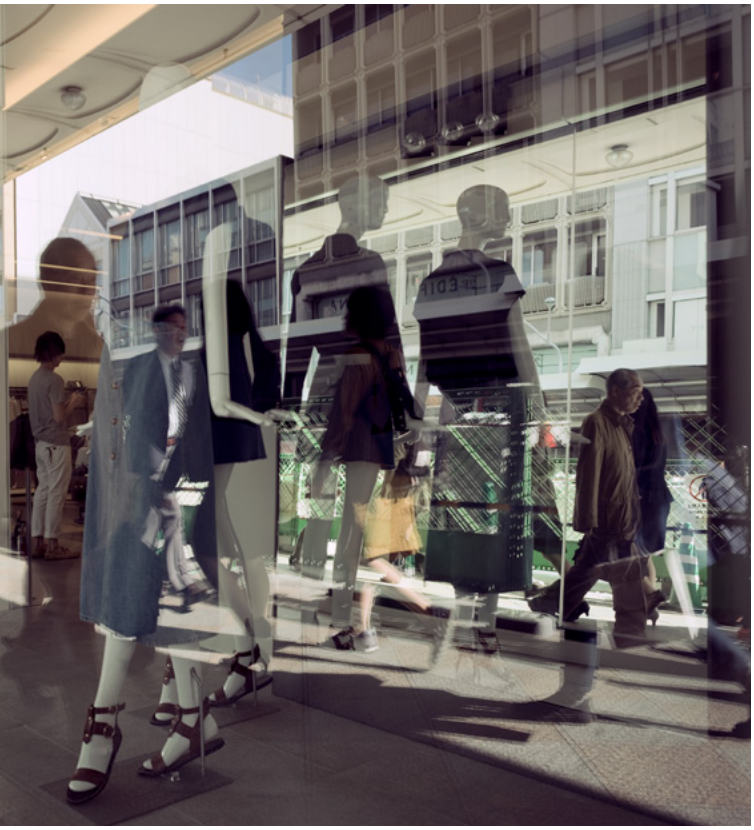
It goes without saying that financial markets globally are facing unprecedented challenges in the wake of the COVID-19 pandemic, and commercial real estate is no exception. In the space of a short few months, government restrictions on trade, strict social distancing measures and declining consumer sentiment as a result of the virus are having profound and deep impacts on the Australian retail sector well beyond those previously mentioned.

As many “non-essential” retailers (such as discretionary retail) have closed indefinitely and/or have significantly reduced their operations in response to government trading restrictions, the sector overall is subsequently seeing a rise in requests for rental assistance in the form of rent reductions, rent-free periods, rental deferments and capped occupancy costs as many retail tenants are experiencing an immediate hit to their bottom line.

At the same time, however, several essential service retailers such as supermarkets and pharmacies continue to trade as normal and have remained resilient, seeing strong sales growth due to their non-discretionary nature. CBD-based supermarkets are an exception to this, as they have generally suffered from reduced consumer footfall resulting as businesses move to full or partial working-from-home operations, as tourism has ground to a halt, and due to trading restrictions on discretionary retailers that would have otherwise driven a stable inflow of consumers

That said, a number of retailers have adjusted their operations to meet the changing needs of consumers in the current climate; for example, many food courts and restaurants continue to operate takeaway-only services, health-related clubs facilitate online fitness classes, doctors are offering virtual appointments etc. As such, online retail continues to offer opportunity for many businesses to continue trading in the short term until conditions stabilise. However, while there are indeed opportunities for the expansion and uptake of online retail – at least in the short term – there continues to be a strong need for bricks

Given the current market environment in the wake of COVID-19, listed retail has seen a more immediate impact to stock market valuations with a number of REITs having shown significant discounts to NAV particularly in Q1, even below historical averages.



and mortar, at the most basic level being the provision of service-based retail as well as consumer preference. Arguably, post-pandemic consumers may have a renewed appreciation for the freedom to purchase in person.

Generally speaking, the listed market offers an avenue to access high quality/prime Australian retail, which might not be as easily accessible via unlisted property vehicles. Given the current market environment in the wake of COVID-19, listed retail has seen a more immediate impact to their stock market valuations with a number of REITs currently showing significant discounts to Net Asset Value, even below historical averages. As such it might be more attractive from a valuation standpoint to access high quality retail through listed real estate in the current environment.

But listed property plays a different role in investor portfolios and an investor must start with an assessment of objectives and constraints for the portfolio rather than allocating purely based on valuations (or perceived valuations). An alternative interpretation of the large retail REITs discounts is that the stock market is pricing in continued weakness in retail capital values.

Conclusion

It is obvious that the Australian retail sector is undergoing significant transformative change, due to the interplay of complex cyclical and structural changes. In addition, COVID-19 presents significant challenges to the sector as well opportunities for certain sub-sectors of the retail market.

As the sector navigates these challenges and redefines the future, supply of new retail remains muted. The key here is to focus on the characteristics of an investment at the asset level, and leveraging the points mentioned above to truly remain competitive and relevant to today's consumer. Investors must be selective in terms of catchment area, quality, positioning of retail 'hubs' as community centres, and have a focus on non-discretionary spending which tends to be more resilient throughout the cycle.

However, it is important to note that the retail sector has undergone significant transformations in the past and will do so again in the future. With these changes will come new opportunity for investment and so investors should be ready to pounce when the time is right, particularly in light of COVID-19 should we see significant stress in the retail sector.

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