UBS Asset Management

The shifting retail opportunity

For millennia, retail has required a physical place for the exchange and bartering of goods, with trading points both initially determined (and constrained) by geography, accessibility and, over time, transport infrastructure. The biggest change came in the early years of the 20th century with the introduction of the car. This gradually offered the consumer more flexibility and enabled the development of a new retail offering. The freedom afforded by this automotive revolution has supported the development of more specialised retailers by expanding the catchment area, with new retail goods–distribution formats, such as shopping centres and retail parks, emerging on the back of this revolution. These new distribution formats have challenged traditional retail locations and put pressure on secondary and tertiary high streets, while at the same time offering new investment opportunities.

Despite all these changes, one constant has until now remained unaffected: a physical location where physical goods could be bartered or sold. This constant, however, has been transformed with the introduction of the internet and the digitalisation of payment. For the first time, the contractual exchange of a good and a payment unit are not dependent on a physical location. Today, it is up to the consumer to decide how they wish to trade: in person or virtually. A store becomes a potential location for distributing a good, but not the only option. As such, e-commerce is revolutionising the physical distribution network, as retailers look to find a balance between different distribution channels.

Europe

The European retail sector continues to be a source of weakness, both in terms of low demand and structural oversupply. Fast-fashion retailers that, for example, have traditionally needed 100 to 150 retail outlets to cover the UK may, in the future, be able to do so with only 50 physical locations. The former narrative used to be that the squeezed middle would suffer, while prime dominant assets and more local amenity-driven centres would outperform. However, URW's results in September stated that, even in the two super-prime Westfield centres in London, rents have been falling. The stress varies by segment and geography; it is thought that shopping centres are more affected than high street and retail warehouses.

Vacancy continues to rise in most markets due to increasing amounts of CVAs (particularly in the UK) and heightened caution among retailers still trading. This is attributed to a combination of weak market conditions and the impact of e-commerce, which has radically reduced the number of stores required to achieve national coverage. While there is not much available data covering European supply, first quarter 2019 PMA data showed that vacancy rates had increased again in both high street and retail warehouses. Interestingly, prime retail parks saw an uptick in vacancy, while secondary parks remained stable. Within the retail warehouse segment, standalone units have fared better, as they tend to cater to more traditional warehouse occupiers (such as DIY, home furniture, etc.) and have not seen the high rental growth of many managed schemes, particularly fashion parks with open A1 consent. This reflects the greater exposure of prime parks to fashion tenants and comparatively higher rents. Overall, it is unlikely the rental and capital declines have ceased for now, as there is a significant amount of stock in most European countries in need of capital expenditure and repositioning.

Regent Street, London

So what does this mean for the European retail sector and potential opportunities? While we remain very cautious on the outlook in the short term, we feel there may be buying opportunities in the medium term. Those opportunities are likely to arise first in the UK, but continental markets may follow after a short time lag. Much of the eventual value correction is likely to be overlooked by sentiment-driven investors looking to dispose of assets as quickly as possible (and switch to logistics). While many retail assets do not necessarily have a future as retail centres, many tertiary shopping centres are centrally located in towns and cities and will therefore have a high residual land value. Indeed, the popular multifamily sector is still in its infancy in most European markets, and the conversion of excess retail stock could be a route to achieving the increase in product many investors are craving. Equally, disused retail warehouses in edge-of-town locations could be converted to last-mile logistics, another particularly undersupplied sector.

Strategies for capital-value preservation are likely to focus on high streets in university towns with a strong appeal to domestic tourism because consumers who may have bought the item online at home are spending the euro in stores while having excess time budget. Convenience is another area where stores are likely to survive. Centrally anchored food stores along commuter routes are likely to perform well, but they may also act as distribution hubs for online grocery purchases.

The outlook for European retail may not be great; however, there are certainly possibilities for landlords and investors willing to think flexibly.

Fifth Avenue, New York City

United States

US retail investors are navigating a transitionary stage as the landscape of retail evolves and traditional tenant mixes become obsolete. Consumer preferences are developing, as evidenced by an allocation of consumer dollars away from apparel and towards health, beauty and dining out. Bankruptcies and store closings capture media attention as the ongoing tenant shuffle continues, but the reality is more complex. Transition has not led to a downturn for all retail types and may actually present new opportunities for select retailers.

The tide has shifted over the past five years. Retail was the highest-performing sector in 2012, 2013 and 2015 but is now a drag on overall returns, with depreciating shopping malls the main culprit. The three major subtypes have seen positive (although below-index) total returns, with power centres and neighbourhood and community centres performing better than traditional malls.

US retail has endured another year of substantial store closings, sending a stark message to traditional retailers. Landlords have also shifted their focus to attract the next wave of retailers and are increasingly distributing capital to repurpose large vacancies. The short-term expectation is a continued attrition of tenants that inefficiently occupy buildings and disenfranchise their target demographic.

Minimal retail development is expected to remain in place, as the pace of new construction has fallen from its post-recession heights. In the early 2000s, new retail buildings flooded markets, increasing total stock by 2 percent to 3 percent on an annual basis. Since the 2008 recession, construction of new retail buildings has been low, and virtual stores have stepped in to seize market share. As retailers improve and add new channels for customer contact — including mobile, delivery and in-store services — landlords increasingly need to adjust to the changing retail environment.

Despite dire headlines about store closures, the US consumer remains strong. Traditional demand drivers, such as employment and retail sales, are increasing. Consumer income growth remains on a steady upward path, and total consumer debt levels are rising. Historically, retail sales growth has served as a proxy for healthy demand, but in recent years, space available for lease increased even as retail sales attributed to brick-and-mortar stores rose.

E-commerce as a share of retail sales continues to make gains, but it is important to note that brick-and-mortar sales have also increased, albeit unevenly across categories. E-commerce giants tend to occupy large square footage of warehouse space instead of physical retail stock rooms. The shift in consumer spending has tilted preference away from large square footage occupants and will drive the efforts to identify the next wave of retailers. As a measure to solve the complexity of the last mile, we anticipate that trends, such as in-store pickup, intraday delivery and cashier-less stores, may lead to some e-commerce retailers — especially retailers looking to drive sign-ups for subscription programs — leasing traditional store space.

Mixed-use redevelopment will be an essential element to retail survival. Underutilised retail is well located but is likely to incorporate new uses, like hotel, converted office and apartment developments. Consumers gravitate towards experiential retail and convenience, and mixed use helps optimise the experience.

Despite the dire headlines — or arguably because of them — there are opportunities in the retail sector. In the US, consumer spending dominates the economy. Retail is a diverse asset class by property size, location and tenancy. Today, investors focus on diamonds in the coal mine: retail centres with strong locations, great demographics and attractive pricing. Smart approaches to investing in US retail analyse the performance of the retailers carefully and refrain from overspending on acquisition or capital expenditure, including tenant improvement allowances. Still, US retail owners are experimenting with the effectiveness of various retail repositioning strategies. Even retail experts need to be agile enough to plan for changing consumer preferences in the future.

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CORPORATE OVERVIEW

UBS Asset Management

UBS Asset Management's Real Estate & Private Markets business actively manages investments of around $109 billion globally and regionally within Asia Pacific, Europe and the US, making it one of the largest asset managers in real assets worldwide. Our capabilities reach across the risk / return spectrum, ranging from core to value-add and opportunistic strategies. We offer both direct real estate and infrastructure equity and debt investments, as well as indirect exposure to leading real estate, infrastructure and private equity managers. Investors can access our diverse product range across open- and closed-ended private funds, investment trusts, listed funds, REITs and bespoke separately managed accounts.

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CORPORATE OVERVIEW

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UBS Asset Management's Real Estate & Private Markets business actively manages investments of around $109 billion globally and regionally within Asia Pacific, Europe and the United States, making it one of the largest asset managers in real assets worldwide. Our capabilities reach across the risk/return spectrum, ranging from core to value-add and opportunistic strategies. We offer both direct real estate and infrastructure equity and debt investments, as well as indirect exposure to leading real estate, infrastructure and private equity managers. Investors can access our diverse product range across open- and closed-ended private funds, investment trusts, listed funds, REITs and bespoke separately managed accounts.