



RETAIL REVIVAL - UNCOVERING VALUE IN A CHANGING LANDSCAPE

RESEARCH BRIEFING NOTE

Q1 2022

INTRODUCTION

Retail has been at the epicentre of cyclical and structural change. Prior to COVID-19, the sector was grappling with strong ecommerce growth and changing consumer habits. The pandemic rapidly heaped more pressure onto retailers through forced closures, restricted consumer mobility, stringent social distancing requirements and turbo-charged online sales. Occupier closures, rental defaults and vacancies rose significantly whilst investor sentiment collapsed.

It is not all doom and gloom though. Aggregate market trends hide pockets of retail resilience. As the pandemic is gradually mitigated, a retail revival is emerging. Retail occupiers that have endured or thrived in the pandemic are expanding again. Higher vacancy has created opportunities for new occupiers, concepts and typologies attuned to future physical demand in an ecommerce infused world to take space which would otherwise have been unobtainable. Consumers crave the experiential benefits in-person shopping provides that were impossible during the pandemic. They are also relishing the chance to spend some of their significant excess savings accumulated during the pandemic. Savvy investors are successfully diversifying the offer of retail locations and reorientating them towards experiential uses to entice shoppers. For retail assets that are the right size, well-located and good quality, a golden age awaits.

This briefing note sets out our views on the future of physical retail. It considers the factors which have created such challenging short-term conditions.

THE TAKE-AWAYS



Retail has endured a tumultuous period at the epicentre of cyclical and structural change accelerated by the pandemic



For future-proofed retail assets in resilient locations, the future is bright as consumers have the desire and means to spend, successful occupiers are expanding and capital value growth is projected



A new golden age for retail beckons for future-proofed assets in resilient locations. Investors can access the opportunity it brings by applying a robust occupier, asset and locational strategy

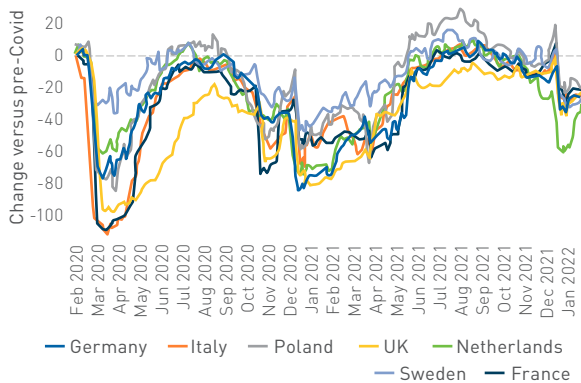
It looks forward to determine what the future holds and the types of physical retail that will be needed. It concludes by determining investment strategy implications to uncover immediate value and long-term value in the retail sector.

WHAT HAS HAPPENED?

Pandemic-induced lockdowns had an immediate and dramatic impact on physical retail across Europe. Non-essential retailers were forced to close and high street footfall collapsed (figure 1). Even as restrictions ease, lingering concerns about the virus, ongoing social-distancing requirements and prolonged homeworking mandates continue to have an adverse impact.

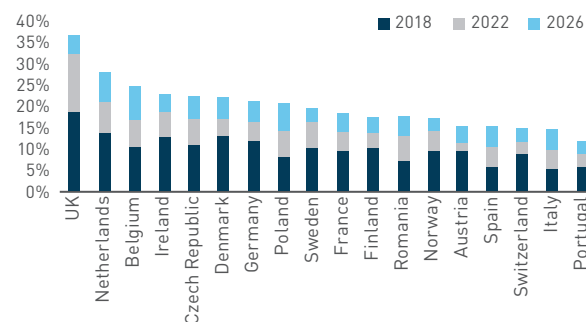
The pandemic forced significant retail spending online, bringing forward three to five years' worth of ecommerce demand growth into a matter of months. European economies are reopening but online spending patterns have become ingrained given the length of the pandemic. They will permanently settle at much higher levels and further growth is likely (figure 2). This reflects network effects; as ecommerce platforms grow they become better at serving customers which aids further growth. The pandemic has also cemented consumer trust and familiarity with online merchants, especially amongst the oldest age cohorts which have historically been the least reluctant to shop online. The erosion of this barrier supports a stronger propensity to shop online again.

Figure 1 Retail & recreation mobility: Footfall declined significantly and has yet to return



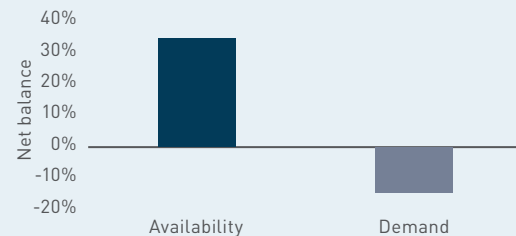
Source: Macrobond/Google (Q1 2022)

Figure 2 Online spending penetration rates: Sizeable growth with more to come



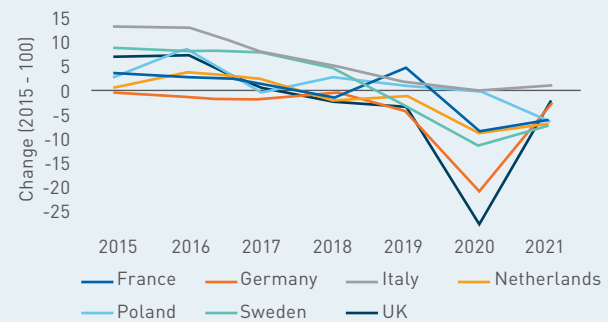
Source: CBRE (Q4 2021)

Figure 3 Retail occupier demand: Retail floorspace supply far exceeds demand



Source: RICS (Q3 2021). Refers to global retail demand

Figure 4 Capital values: Sharp decline in most countries



Source: CBRE ERIX (Q1 2022)

These developments have compounded pressure on retailers already struggling to adapt to fierce competition from ecommerce growth and changing consumer habits. Permanent store closures and retailer administrations have markedly risen as availability exceeds demand (figure 3). This has adversely impacted rents and capital values across Europe (figure 4). Investor sentiment and investment volumes are weak and pessimism pervades.

As with other structural changes though, the pandemic merely acted as an accelerant to changing shopping patterns rather than being the creator of them. Dramatic structural change would have occurred anyway but it would have taken longer to manifest, prolonging the pain for retailers and investors alike. With this change having now largely occurred, the retail sector is able to grow from its new base to deliver the type of offer modern consumers want and to create new value.

It is also the case that some retailers have benefited from the pandemic and are expansionary. Higher vacancy provides them with the unparalleled opportunity to acquire new sites in desirable locations which would otherwise have been unobtainable due to a lack of availability or prohibitive costs. For investors who own or acquire stock which is or can be aligned to the future retail landscape in resilient locations, future performance potential is compelling.

HOW WILL CONSUMER DEMAND CHANGE?

The pandemic has forever reshaped consumer shopping habits. Higher online retail spending is here to stay and retail must work harder to attract shoppers for whom physical shopping is no longer a necessity. However, the pandemic has served to highlight the benefits of physical retail such as the ability to touch and feel products before buying and the social interactions it provides (figure 5). Consumers have missed these benefits. It has emphasised the pitfalls of online retail too such as fulfilment time, product issues and the convoluted returns process. Thus shoppers have a strong desire to return to physical retail once they feel safe in doing so again and plan to shop frequently (figure 6).

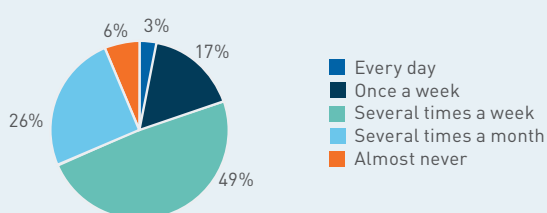
Unprecedented government support for jobs and incomes during the pandemic coupled with the inability to travel or shop in person strengthened household balance sheets which are extremely robust. Savings rates rose rapidly and European households have amassed some €820 billion of excess savings (figure 7). Even if only a small proportion of this is spent when consumers have more freedom to live, work and shop in person, it would equate to a sizeable expenditure impetus. In our view this additional spending is relatively immune to the risk of higher inflation given the extent of pent-up consumer demand. In any case we expect high inflation to be a

Figure 5 The appeal of physical retail: Factors that shoppers most value



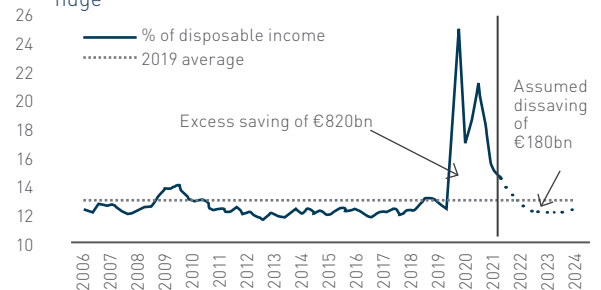
Source: Cromwell Property Group (Q1 2022)
Based on internal poll of workers in nine countries

Figure 6 Physical retail attraction: How likely are you to shop in person post-pandemic



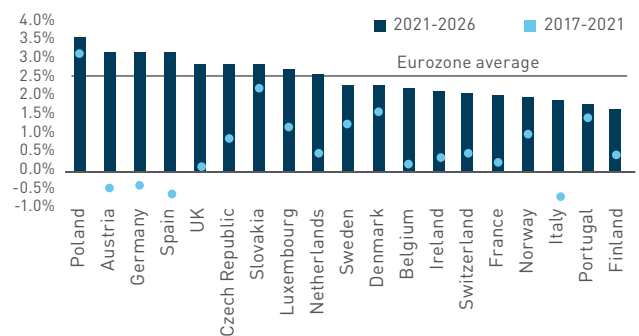
Source: Cromwell Property Group (Q1 2022)
Based on internal poll of workers in nine countries

Figure 7 Eurozone household savings: Revenge spend potential is huge



Source: Oxford Economics/ Haver Analytics (Q4 2021)

Figure 8 European retail sales: Consumer spending growth to be pronounced



Source: Oxford Economics (Q1 2022)

short-term phenomenon. Were it to persist for longer, it should be reflected in wage growth which would mitigate some adverse impact on consumer spending capacity. Just spending 20% of these additional savings would amount to €180 billion for the retail sector, most of which would be directed towards physical retail shops and experiences to which consumers had previously been denied access.

The combination of pent-up demand and balance sheet strength means the revenge spend potential is huge. This is projected to support strong European consumer spending growth over the medium term to 2026. European consumer spending growth is projected to average 2.5% per annum between 2021-26 compared to 0.7% between 2017-21². This suggests that despite enduring ecommerce growth, a new golden age for physical retail looms.

Not all physical retailers will benefit. Consumers will be fickle meaning retailers must be extremely attuned to providing exactly what they want, where they want it and creating strong reasons to visit. Physical shopping will become tactical as consumers have full price transparency and are better researched and informed about product availability than ever. This creates greater challenges for retailers but if they get the offer right, they should be assured of enduring sales, profitability and performance.

1 Oxford Economics/ Haver Analytics, Q4 2021

2 Oxford Economics, Q1 2022

WHAT IMPACT WILL ECOMMERCE HAVE?

The structural change creating such high levels of physical retail disruption predominately relates to the shift from physical to online retail. This has challenged existing retail models, created demand for new physical formats and reshaped the fundamentals of successful physical assets and locations. The investment potential for retail is thus intrinsically tied to ecommerce.

Ecommerce market share varies across Europe. This reflects a range of factors such as digital and mobility infrastructure, internet access, cultural norms, density, geography and affluence. Whilst ecommerce will ultimately

settle at different levels, all European countries will absorb rising penetration rates the next decade (figure 2). Today's penetration rate implies specific investment strategies for each country related to their ecommerce market maturity. Typologies to represent these can be created to inform investment opportunities (figure 9).

WHICH TYPES OF PHYSICAL RETAIL WILL BE RESILIENT?

To remain successful in an ecommerce infused world, physical retailers must provide at least one of four distinct characteristics: experiential; convenient; discount; or integrated (figure 10).

Figure 9 European retail market typologies: Different ecommerce penetration rates and growth forecasts can identify investment opportunities

Growth stage	Online penetration	Investment strategies
Fledging	<15%	<ul style="list-style-type: none"> - Limited physical disruption - Niche ecommerce consumer engagement - Traditional physical retail formats dominate
Escalating	>15-25%	<ul style="list-style-type: none"> - Significant physical disruption in progress - Limited online/physical integration - Higher risk of retail capital value erosion - Physical space oversupply
Mature	<25%	<ul style="list-style-type: none"> - Physical disruption largely realised - Online/physical integration - Online retailers taking physical space - Repositioning of excess space

Source: Cromwell Property Group (Q1 2022)

Figure 10 Physical retail resilience: The four characteristics needed to remain successful as ecommerce penetration rises



Source: Cromwell Property Group (Q1 2022)

WHAT DOES THIS MEAN FOR INVESTMENT STRATEGY?

Retail is set for a revival as space is either repositioned to align to the modern nature of retail or repurposed for non-retail usage. Retailers still needed in the ecommerce infused world are expanding and taking space. This will lure shoppers back to retail locations in greater numbers, further supporting occupier-demand in a virtuous cycle. This revival is in progress now although it will not be until the pandemic passes before it is fully visible. This creates the potential for investors to access future-proofed assets in resilient locations at a discount.

To capitalise on the unique opportunities current conditions present and avoid the pitfalls, investors must be mindful of the characteristics necessary to thrive in the future. These relate to occupiers, assets and locations.

OCCUPIERS

As a high business cost, occupiers are highly sensitive to retail store rents. High rents are acceptable for modern units which support business objectives and directly drive physical or online sales but unacceptable for those that do not. They will be strategic in determining where to take space, focussing on efficient occupation and requiring lease flexibility to enable termination if locations do not deliver.

Investors can meet these needs by working collaboratively with occupiers to understand and fulfil their needs. The future of retail is about partnerships, not the adversarial relationships of the past. This may expose investors to perceived higher risk, through shorter leases or turnover-based rents, but it will also allow them to gain a greater share of the upside too.

Investors can work with occupiers to manage space in a beneficial manner for all parties. A carefully curated retail cluster will attract more shoppers, create greater trading potential and ultimately sustain higher rents. Integrating technology and data within assets and locations to allow space adaptation in real-time to better align to customers and which demonstrates value to occupiers, will support performance.

ASSETS

Modern occupiers are focused on efficient operation and maximising real estate value. This means resilient assets will be the right size without excess space which will lead to a preference for smaller units. Most retailers no longer need large back-of-house areas to store product. Shopping precincts themselves will likely become smaller with more space dedicated to non-retail uses such as entertainment, office or residential. This will benefit retailers by creating a larger customer base and higher footfall throughout the day and week. It may challenge investors used to managing single-use assets in single-use locations.



For investors this suggests modern units which enable modern occupation and technological integration are attractive, or assets which have the potential to be refurbished to modern standards to create new value. The ongoing evolution of demand and rapidly-changing nature of consumer demand means flexibility and adaptability will be key. Retail units will need to reinvent themselves regularly to entice fickle customers for repeat visits, which will require them to have the ability to easily reshape and redesign space.

Retail assets which do not conform to the modern nature of retail occupation are unaligned to structural change. For misaligned assets in strong locations which can be adapted, repositioning will enhance value and represent opportunities to access rising occupier demand and stronger performance. If assets are incapable of being repositioned for alternative retail usage due to their format, age or other physical features, repurposing for non-retail usage will be needed.

LOCATIONS

A range of different retail locations will be resilient to structural change, but they will share one commonality – they will all be easy for customers to reach. This may mean accessibility to a high number of people through excellent car and public transport links, or locations embedded close to where people live, work or spend time which, increasingly, is the same place.

This suggests the following locations will see robust demand:

- Large destination-style retail centres with a broad offer and excellent connectivity
- Small local shopping centres servicing dense and growing urban populations
- Well-connected retail warehouse parks within or close to growing urban areas
- Large and small supermarkets embedded within urban areas and easily accessible by car
- Drive-thru clusters within urban areas
- High footfall public transport nodes such as train, tram and underground stations
- Service stations/petrol filling stations on higher order road networks

Stronger retail demand will also emerge in non-traditional areas such as office and residential locations as retailers seek to be as close to consumers as possible. The addition of suitable retail in such locations can increase locational appeal and support additional income.

As recognised previously, different European countries are at different stages of ecommerce market maturity. Their current level and the projected future growth speed can be used to guide unique investment strategies (figure 11).

RETAIL REVIVAL: THE TIME IS NOW

Retail is at an inflexion point. It has endured a traumatic period due to the shift to online retail and evolving consumer habits. This has been accelerated by the pandemic bringing forward change which would have taken far longer otherwise to manifest and given retailers more time to adapt. The pain has largely now been wrought. Occupiers misaligned to modern retail demand have folded and the space they once occupied has been released. Capital value growth is forecast and it is likely that there will be some mispricing of future-proofed assets in resilient locations.

From a new base retail is rebuilding. Future-aligned occupiers are confident. They are expanding again, aided by the opportunity to take space in locations which would have been unavailable pre-pandemic. European shoppers have a huge amount of savings and are eager to get out and spend it physically on goods and experiences they were denied during the pandemic. The stage is set for a sustained retail revival as it enters a new golden age attuned to customer desires in the ecommerce infused, post-pandemic world.

Given market sentiment it takes courage to invest in retail at this time. But with capital values having reset and the future growth story compelling, a robust investment strategy which considers occupiers, assets and locations offers rich opportunity. Fortune favours the brave.

Figure 11 Investment strategies by market maturity: Ecommerce market maturity supports unique investment strategies

Growth stage	Investment strategies
Fledging	<ul style="list-style-type: none"> - Buy/hold traditional core retail - Acquisition of segments resilient to online retail growth prior to their performance being tested e.g. supermarkets, retail parks - Disposal of misaligned assets ahead of potential value erosion
Escalating	<ul style="list-style-type: none"> - Selective acquisition of resilient assets/locations at a discount - Repositioning of weak assets in strong locations - Acquisition of segments proving resilient to online retail growth - Creation of new retail uses in non-traditional locations e.g. offices - Disposal of misaligned assets
Mature	<ul style="list-style-type: none"> - Buy/hold resilient assets/locations - Investment into mixed-use locations with a diversified offer - Acquisition and creation opportunities in segments with proven resilient online spending growth - Creation of new retail uses in non-traditional locations e.g. offices

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