

This document is for professional clients, financial advisers and institutional or qualified investors only. Not to be distributed to, or relied on by retail clients.

Bentalls

AVIVA INVESTORS THE FUTURE OF RETAILING AND THE IMPLICATIONS FOR RETAIL REAL ESTATE

BY CHRIS URWIN

October 2017



CHRIS URWIN

HEAD OF GLOBAL RESEARCH -
REAL ESTATE

Main responsibilities

Chris leads Aviva Investors' Real Estate Research Team, which develops investment views of markets and sectors for our direct, indirect and multi-manager real-estate strategies.

Experience and qualifications

Prior to joining Aviva Investors, Chris was a senior commercial property market analyst at CBRE and an economist at the Institute of Public Policy Research. Chris holds an MA in Economic History and a BA (Econ) in Economics from the University of Manchester, and is a member of the Society of Property Researchers.

Contents

Introduction & conclusions	3
1. The future of retailing	4
2. The retail real estate future - not all markets are equipped to transition to high-engagement retail destinations	6
3. The retail real estate future - segments	8

INTRODUCTION & CONCLUSIONS

This paper seeks to examine the structural pressures facing the retail sector and their implications for the outlook for retail real estate. Firstly, we look at some of the trends unfolding in retailing, notably the impact of new and maturing technologies, and conclude that:

- Store-based retail is set to decline significantly due to further e-commerce penetration, particularly for low-engagement products (routine purchases).
- This suggests that the UK retail sector will need significantly fewer stores in future. In addition, with much bulky, low-engagement retailing set to move to online channels, the remaining stores are likely to be smaller on average than now.
- The role of stores is set to change significantly. Stores will no longer be just a distribution channel through which retailers merchandise products and process payments but will become platforms for discovery, engagement, experience and interaction. They will form part of a multi-channel strategy for many retailers that will see a blurring of online and offline retail formats.

We then look at the implications of these trends for different retail markets and conclude that:

- In order to compete both with online shopping and the proliferation of services and experiences available to consumers, physical retailing needs to focus on high-engagement retailing and on creating locations with strong destination appeal.
- Scale is vital when looking to create a strong destination and our analysis produces a *bias towards the major cities and regional shopping destinations*.
- Among the major cities and regional markets, it is possible to identify those with the most potential to become high-engagement retail destinations. More promising locations will demonstrate:
 - *Strong retail productivity and a good retail mix;*
 - *Strong food and beverage offer;*
 - *Economic strength in their catchment;*
 - *Alignment of retail offer to catchment demographics;*
 - *Beneficial development pipeline.*

Finally, we look at the implications for retail real estate formats and conclude that, for all retail segments, of increasing importance will be:

- The need to establish themselves as destinations;
- An experiential offer through increased leisure offer and increased food and drink provision;
- Greater unit flexibility to accommodate the shift to smaller, more dynamic stores;
- Polarisation between prime and secondary with prime offering far greater potential for high-engagement retail and secondary gravely threatened by e-commerce penetration.

In addition to these general changes, future trends in retailing also imply some specific impacts for different types of retail format and these are also explored.

1. THE FUTURE OF RETAILING:

Shoppers' expectations are being radically altered by technology:

Technological change is having a major impact on the retail sector. In particular, the maturing of online shopping has had a massive effect on consumers' expectations regarding the shopping experience by raising the bar with regard to features such as:

- Product information – specifications, comparisons, reviews etc.;
- Price comparisons – personalisation of offers;
- Ease of buying;
- Instant customer support;
- Multiple delivery options and ability to track delivery.

Online shopping of course can also eliminate many of the costs and hassles related to shopping in physical stores such as:

- Transport and time costs;
- Queuing;
- Difficulties locating products;
- Lack of in-store assistance.

These changes give rise to levels of expectation with regard to convenience, personalisation and service that simply did not exist until recently. Instant gratification will need to become the norm, not the exception.

Physical stores are struggling to match shoppers' expectations:

Many, perhaps most, retailers are struggling to keep pace with consumers' rising expectations of the shopping experience. According to CapGemini¹, on

average 40% of consumers across a range of countries report that they consider shopping a chore – almost as many report that they would rather wash dishes instead! The biggest frustrations that shoppers report relate to difficulties comparing products, long queues, difficulty locating products, non-personalisation of offers and promotions and lack of in-store guidance and demos².

Physical stores need to offer an experience that rivals or surpasses what buyers find online:

Of course, physical stores also have attributes not available online, notably their ability to make shopping into a more rounded tactile and social experience and this suggests the ways in which physical stores might be able to retain their relevance to consumers. While in the past, cost, choice and convenience have been the key to consumer satisfaction, control and richness of experience have become increasingly important to modern shoppers. Technology is leading to a proliferation of service provision and, as well as competing with online, shopping in stores is competing with an ever-growing range of services available to consumers, many emerging in the sharing economy, the personalisation economy and the on-demand economy.

Technology may well help physical stores in this fightback. Emerging technologies including virtual reality, artificial intelligence, the internet-of-things, robotics & drones and custom manufacturing & 3D printing all have the potential to create a more rounded experience for shoppers in physical stores. But, however they get there, the destination for retailers must be the provision of an experience that is rich, empowered and personalised.

¹ CapGemini Future of Retail Store Survey

² Ibid.

Not all products lend themselves to creating an experience:

Of course, not all products are created equal when it comes to creating such an experience for shoppers. It's possible to distinguish between high-engagement products which appear to offer potential and low-engagement products around which it is far more difficult to create a shopping experience full of discovery and excitement.

Low-engagement products are typically routine purchases where speed, efficiency and price are the chief concerns. These lend themselves to commoditised management through automated channels with "auto-replenishment" set to become the norm. For such products, there will be a greatly reduced role for stores.

High-engagement products, by contrast, are those which do offer the potential for an interactive, tactile and personalised customer experience. For products like this, stores offer the potential to be a space for discovery, engagement, experience and interaction with brands. Such stores will no longer be just a distribution channel.

The future of retailing - conclusions:

The above analysis suggests a number of strong conclusions, notably:

- **Store-based retail set to decline significantly:**
The main driver of this will be further e-commerce penetration, particularly for low-engagement products as described above. However, a number of other factors also point in this direction, notably the UK's relatively large provision of mature retail infrastructure and our view that future household income growth looks set to be relatively muted.

The retail pie is set to grow relatively slowly in future and physical stores will capture a smaller share of that pie overall.

- **Fewer and smaller stores:**

This suggests that the UK retail sector will need significantly fewer stores in the period ahead. Some high engagement stores will be large, particularly flagship stores. But with much bulky, low-engagement retailing set to move to online channels, the remaining stores are likely to be smaller on average than now

- **The role of stores is set to change significantly:**

These smaller stores will no longer be just a distribution channel through which retailers merchandise products and process payments but will become platforms for discovery, engagement, experience and interaction. They will form part of a multi-channel strategy for many retailers that will see a blurring of online and offline retail formats.

- **Clear winners and losers in terms of geography and store types:**

We expect to see clear winners and losers amongst different markets and significant changes for different retail formats. The implications for real estate are discussed in the following sections.

2. THE RETAIL REAL ESTATE FUTURE – NOT ALL MARKETS ARE EQUIPPED TO TRANSITION TO HIGH-ENGAGEMENT RETAIL DESTINATIONS:

In order to compete both with online shopping and the proliferation of services and experiences available to consumers, physical retailing needs to focus on high-engagement retailing and on creating locations with strong destination appeal. Not all markets are all equally well placed to achieve this transition, however, and for investors, it is essential to form a view on which markets have the most promise. In particular, scale is vital when looking to create a strong destination. Greater scale implies more consumer choice and a wider offer. Our analysis produces a ***bias towards the major cities and regional shopping destinations*** with smaller retail locations generally expected to struggle to establish themselves as destinations for high-engagement retail.

Among the major cities and regional markets, however, it is also possible to look at a range of economic and retail indicators to try to determine which have the most potential to become high-engagement retail destinations. On the basis of our analysis above, the types of factors we are looking for include:

- ***Strong retail productivity and a good retail mix:*** these give an indication of the current strength of a market with stronger locations having a retail mix that will provide high levels of future customer engagement and low exposure to negative online impacts;
- ***Strong food and beverage provision creating experiential offer:*** strength in this area should help to increase customer engagement, increase the destination appeal of the venue and increase

shopper dwell times. Other leisure activities, including cinemas, theatres and gyms can play an important role too;

- ***Economic strength of the catchment:*** measures such as current shopper population and expected labour force growth can help to gauge the economic outlook for a market;
- ***Alignment of retail offer to catchment demographics:*** a retail offer which aligns to the catchment demographics will boost customer appeal and engagement;
- ***Impact of development pipeline:*** new developments and extensions in a market and in its competing markets may see additional shoppers being captured due to an improving offer or decreasing shopper population as competing venues attract a greater share of activity. New developments make a quantitative and qualitative difference. They don't just add more space but can add better space if they take the opportunity to create the type of space that retailers need to meet changing customer wants.

Analysis of these factors allows retail markets to be ranked in order to focus our investment expertise on those that appear to have greatest potential. On this analysis, London, Kingston, Manchester, Birmingham, Glasgow Exeter, Bath, Cambridge, Edinburgh and Oxford score highly. Kingston is described below as a case study.

Manchester and Kingston

Manchester scores strongly as a current retail destination with the size of its catchment area shopper population especially impressive, second only to Glasgow in fact. Its current retail productivity is robust.

Manchester's retail mix appears key to its outlook. It has a very strong food and beverage presence and is host to a broad range of retailers who look well placed to offer high levels of future customer engagement. On both of these measures it is well ahead of most of its major regional peers, such as Glasgow and Birmingham. These provide very strong destination qualities for its large catchment and, even if this catchment is not especially affluent, suggest a healthy outlook for central Manchester.

In the case of Kingston, its current scoring as a retail destination, while healthy, is not significantly above average. It currently exhibits a productive retail offering with an average shopper population.

It is, however, expected to see considerable improvement as a retail destination over the coming years. This market exhibits an elevated level of available spending and, with labour force growth expected to be very strong, the economic health of its catchment is a major attraction. Its retail offer is attuned to these demographics and the replacement of floorspace in Kingston will boost its appeal to shoppers.



3. THE RETAIL REAL ESTATE FUTURE - SEGMENTS:

As well as blurring the distinctions between offline and online retailing, we expect future retail trends to create a blurring of the distinctions between different types of retail asset. This is because, for all retail segments, of increasing importance will be:

- ***The need to establish themselves as destinations***, with critical mass and tenant mix key to achieving this goal;
- ***Increased leisure offer*** will be important for many shopping locations in increasing their destination appeal as shoppers search for a more varied and rounded shopping experience;
- Likewise, ***increased food and drink provision***;
- And a ***wider variety of social and economic activities*** generally may come to take place in retail centres, co-working and libraries for instance, again offering greater potential destination appeal;
- ***Greater unit flexibility*** to accommodate and promote the shift to smaller, more dynamic stores;
- ***Polarisation between prime and secondary*** with prime offering far greater potential for high-engagement retail and secondary gravely threatened by e-commerce penetration.

Nonetheless, in addition to these general changes, future trends in retailing also imply some specific impacts for different types of retail format:

Shopping Centres:

A key issue here relates to the availability of **anchor tenants**. Traditionally, most shopping centres have had **department stores** as an anchor but the outlook for these is particularly uncertain against the emerging backdrop of fragmentation and hyper-specialisation in retailing. It is uncertain that department stores can ensure image control in a retail environment

moving towards experiential, high-engagement retailing. High-end department stores may be an exception, but generally there may well be less of a role for department stores as shopping centre anchors and other uses may have to fill the anchor role. The potential for leisure operators to anchor shopping centres may be one possibility in the future.

To succeed in future, shopping centres need to be more than just a collection of retailers. They need to embrace disruptive technologies, focus on adaptability and flexibility and provide a setting for a wider range of economic and social activities. The polarisation between prime and secondary, already well under way, is likely to be particularly pronounced in the shopping centre segment. Prime centres with destination qualities are expected to fare best.

Retail Parks:

Many of the traditional attractions of retail parks, convenience in particular, are of less prominence given the rapid growth in the online shopping offer. Shoppers now have so many online options for the bulky goods that used to make up the mainstay of many retail parks that a further significant contraction in this kind of use appears likely.

Instead, in order to survive, retail parks will need to significantly broaden their offer to increase their destination appeal. Increased leisure facilities, or even the fusion of retail and leisure parks, could become the norm. An increased food and drink offering will also be needed. Many parks are currently underdeveloped in these areas which suggests a significant opportunity for repositioning. Adaptability of site is a key requirement to effect such changes. For the most part, however, this will only be feasible for larger parks so scale here will be vitally important.

Designer Outlets:

In many ways, these already embody destination retailing and the model appears reasonably sound. Sales in general are less impacted during a downturn and their very nature revolves around strong brand images. In addition, the lack of online outlet shopping penetration improves the designer outlet physical offering. Tenant mix is critical with headline retailers such as Ralph Lauren serving to attract visits. The growth of food and beverage provision at many existing outlet centres is needed to improve the experiential offering.

Supermarkets:

Supermarkets are a segment where significantly less physical space is likely to be needed in the period ahead, with very large supermarkets (60,000 sqft+) likely to be especially affected. A very large proportion of what is sold in supermarkets falls into the low-engagement category that is threatened by the growth of shipping direct from manufacturers to consumers that is being facilitated by new delivery channels such as Amazon Dash. This trend is likely to mean that much less large supermarket space will be

needed in coming years. Very large supermarkets are simply too big and will need repositioning to provide different offerings.

In future, 40,000 sqft or so will probably become a more suitable size for larger supermarkets. At this size, supermarkets can focus more heavily on their higher-engagement offering. This scale is also sufficient to provide features such as butchery, bakery and deli facilities. In-house restaurants may also feature as a means of adding to the shopping experience. Sufficient space for click and collect operations could bolster the resilience of such stores.

Within the supermarket segment, **convenience stores** are expected to continue to proliferate. These are benefiting from changing shopping patterns – online for the bulky items, convenience stores for fresh produce and other urgent goods. The most attractive of these are stores in London that offer hyper-convenience in terms of proximity to transport nodes and that are dominant in a dense, relatively affluent catchment area.



[illegible]

CONTACT US AT :

Aviva Investors

St Helen's

1 Undershaft

London

EC3P 3DQ

www.avivainvestors.com

Important Information

Unless stated otherwise, any sources and opinions expressed are those of Aviva Investors Global Services Limited (Aviva Investors) as at 22 September, 2017. This commentary is not an investment recommendation and should not be viewed as such. They should not be viewed as indicating any guarantee of return from an investment managed by Aviva Investors nor as advice of any nature. Past performance is not a guide to future returns. The value of an investment and any income from it may go down as well as up and the investor may not get back the original amount invested.

Aviva Investors Global Services Limited, registered in England No. 1151805. Registered Office: St Helen's, 1 Undershaft, London EC3P 3DQ. Authorised and regulated by the Financial Conduct Authority.

J23110 - RA17/1255/30032018

