AF Advisory

REAL ESTATE DEBT & EQUITY

AF ADVISORY - THE HOLISTIC VIEW

Contents

AF ADVISORY - THE HOLISTIC VIEW

Retail? It’s not only e-commerce – it’s the customers!

<u>Three major threats to retail</u>

A lot has been written about the threat of internet shopping. We at AF Advisory believe that this is only one of three major factors reshaping the retail landscape over the next decade and it has only just begun!

The headline “Amazon kills the High-Street” is in our opinion a short-cut of the changes that are resetting the need for retail space in the developed Western World.

Until very recently (the date depends on the country) high-speed internet penetration and propensity to shop online were much lower than today and retail space was developed based on the

1. Purchasing power of the catchment area / Disposable income
2. Propensity of the relevant population to shop in that location, possibly enticing them away from other locations
3. Space requirements of the retailers satisfying the demand arising from a) and b) above

Developers kept adding retail space and still continue to do so.

<u>So what are the key factors changing the requirement for retail space in the developed Western World?</u>

<u>Three key factors are:</u>
1. Internet shopping, i.e. the ability to migrate key value drivers for vendor and purchaser online
2. Disposable income of potential shopping population
3. Possession vs. Experience

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1. Internet shopping

Investment into retail property has been volatile for a while. As recently as 2011, investments in food retailers' superstores where the hottest item to buy, "because everybody has to eat- don't they?"

Yes, everybody has to eat, but not everybody is keen on drudging around a shed-like food store to pick up his staple food, week after week. The need for food has not changed but the way many of us buy it has and food delivery is nothing new. Upmarket food stores have long since delivered their clients' orders; the internet only facilitated the efficiencies required make it mainstream.

Internet shopping affords convenience, saves time and enables a curated and personalised shopping experience, which, at least for low-cost consumer goods cannot be replicated offline economically. For all these reasons, customer and vendors alike are pushing sales online.

Both purchaser and vendor benefit from internet shopping which allows sellers to offer competitive pricing and value-add services, from reminding their customer about forgotten items to missed special offers and recipes, product and service suggestions etc: "Would you like some travel insurance with your sun tan lotion?", while customers ask themselves, if they really have to go to the shops for that purchase or if they are better off buying it online? Interestingly, price, the main driver in the early adoption phase, is becoming less of a differentiator, convenience and the certainty to return faulty or unwanted goods without having to deal with a time-intensive and often not hugely competent staff member is becoming a real differentiator: "We have to send your phone to the Samsung repair centre. It will be back within 3-4weeks and we have no replacement. Do you want to go ahead?" (A genuine proposal from a John Lewis representative to the author.)

The same is true for the retailer, who for cost, staffing and various other reasons ask themselves, if they need to have a physical presence?

- Apple has physical shops, Amazon doesn't, the latter benefitting from the former's investment into physical shops.
- Prada and Gucci do have physical shops, online luxury retailers don't – again the latter benefitting from the former's investment into physical shops.
- Banks are reducing their footprint by outsourcing some of their space- and staff intensive functions to apps, ATM's, currency delivery services, safe deposit box centres, etc.

The question is, what are the key value drivers for the vendor/manufacturer/service provider and can these be achieved offline worse, equally well or even better than online? Would Apple phones be as desirable, expensive and popular without their cool flagship stores full of highly trained staff who can fix or replace any issue/item on the spot? No. Could Hollister have created its brand exclusively offline, without its exceptional store architecture, instore audio and olfactory stimulation and models/sales staff running around less than ambitiously underdressed for the prevailing temperature? No.

Would a Gucci bag still be as coveted if it were only available online, in a brown standardised carton flung into the hallway of your block of flats by a delivery driver in a hurry, while other luxury manufacturers provide a high-end shopping experience in their well located, stylish shops with well-trained, multi-lingual sales staff? The price-conscious shopper may not bother, but the discerning, sophisticated and high-end purchaser will.

The follow-on question is: Which retailers are dependent on physical outlets and which consumers are willing to pay for the physical outlet experience?

2. In many countries disposable incomes are falling or growing slower than inflation

Most retail-spending takes place in the middle phase of life, as in the early phase, individuals often have limited earnings and in old age, consumers have other priorities. Young, childless adults have typically had the highest level of disposable income.

However, with wages stagnating for the last decade (see graph below) and the cost of living, especially housing, rising sharply, disposable incomes available for retail expenditure have stagnated or fallen, leaving less money for discretionary purchases.

Homeownership still desirable

Contrary to popular belief, the authors of this paper propose that Millennials still aspire to home ownership, maybe a bit later than previous generations as they want the experience (see below) of working in other cities and countries, but the desire is there.

The main issues preventing Millennials from joining the housing market like previous generations are:

1. an ever more expensive housing market, combined with
2. ever stricter mortgage regulation and
3. a labour market, where salaries have risen significantly more slowly than the cost of housing plus
4. ever increasing student debt, due to increased cost of education

Not a recipe for broad participation in the housing market and a motivational, social and economic stumbling block for every nation suffering from the significantly reduced affordability of housing and home-ownership.

3. Here is the Big One: Experiences vs Individual Ownership vs Shared Ownership
We believe that this point is equally important, but much less node than points 1. and 2.

Past	Present
I own, therefore I am!	I experience, therefore I am!
I have to own the asset, if I want the experience.	Sharing economy gives me the ability to access the experience element for a specific time.
Ownership is generally more desirable than part-time use.	Fully-serviced use is, with certain exceptions, more desirable.
Exclusive ownership is more desirable, than joint-ownership.	Managed joint-ownership often more desirable, than sole ownership.
Prime emotional attachment to asset.	Prime emotional attachment to experience.
Exclusive access to asset a priority.	Hyper-Convenience a priority.
Career and progress are important.	Life's too short to only chase material wealth.
Collective interests have precedence over individual's.	Individual's interest has presumed equivalence to collective's.
Clear-cut desirable vs. not-desirable.	Everything is relative.
Achievement based view.	Demand/Entitlement based view.

Previous generations often defined themselves by what they owned, goods were status symbols and there was kudos to owning the latest flat screen TV, car, electrical gadget ….

Millennials often see this differently and as they mature into their prime-earning-age, their spending patterns become more important for retail and other sectors.

Consumers question the need for ownership of goods, previous generations would have seen as desirable.
Millennials have a more utilitarian, rather than an ownership-focussed relationship with many goods. Why own a car, which you have to clean, service, MOT etc. when you only use it very rarely and then in different parts of town/country; if you have the option of car sharing, which gives you a car most of the time you need it, gives you different cars as and when required and relieves you of all the hassle of car ownership while working out cheaper for the irregular user. Sharing is not only economically sensible it also is hyper convenient, another advantage consumers nowadays focus on.

Functionality replaces status.
The internet of things has changed the functionality of items significantly. What, other than conveying wealth, can an expensive designer watch do, compared to an iWatch linked to a smart-phone showing emails, reminders, text messages etc?

The utility and convenience of the expensive classic watch is now far below its cheaper rival and therefore it has become much less desirable. And why spend a lot of money on a large TV, when most of the watching is done on one's phone during the commute or on a tablet in the kitchen or gym while cooking or working out?

Experience vs Ownership.
Most importantly Millennials value experiences higher than ownership (see above).

Everything is about the experience, about making the most of today and enjoying the moment. Influencers on various platforms extol the value of experiences from distant travel to experience packages, courses, festivals….

The music industry as an example.
A good example is the music industry. Previous generations of musicians earned the majority of their income via the sale of CD's etc and used concerts to promote new albums, as the former was the mainstay of their income.

Today, the situation has reversed and consumers are paying significant amounts of money to attend concerts, festivals etc. to see/experience the artist(s) live, while spending only a small amount on purchasing music or the right to play it via Spotify etc.

The main threat to much of the current retail offering.
This focus on experience is the main threat to the current retail offering, especially shopping malls, which have too often been designed and managed to solely facilitate sales in a sterile and monotonous atmosphere. Many centres make shopping an efficient but uninspiring process. And that is not the environment today's consumers want, as it is very difficult to have a sustained pleasant experience in these "hermetically closed exchange-money-for-goods-facilitation-boxes". As Milan Kundera put it, albeit not talking about retail, "Life is elsewhere".

Of course, there are certain centres that have a long-term justification and purpose, depending on location, size, management and environment, but it is a fallacy to believe that size is the answer or lining up a few restaurant chains etc. will save a failing centre. "Darling, can I take you out tonight for a romantic dinner?" – "What a lovely idea! Where would you like to take me?" – "How about the XYZ shopping centre just off the A123?" - "Let me come back to you Darling and don't call me, I'll call you!"

Size and choice can be a benefit, but size also demands more creativity filling vacating retailers' premises and keeping the centre fresh, relevant and appealing with a decent customer flow in all areas.

Summary Q & A

Q:Are you negative on all retail? **A:**No, there will be many losers, some survivors but also winners.

Q:Is any type of centre immune to the above changes and is bigger always better? **A:**No, each centre has to be assessed individually, in line with the English idiom "Horses for courses" and Fischbaum's corollary "And no elephants for dressage, please!"

Q:Is any element of retail suitable for a passive buy and hold strategy? **A:**No, it is a management-intensive investment, with market risk one can only partially manage. But, at the right price and the opportunity to maintain or create value, it might be a very interesting sector for investors able to hold on to an asset for as long as it needs to fix it and if the price reflects the risks.

As always, we would be delighted to hear from you at +44 20 8004 6868 or london@afadvisory.com if we can be of any assistance or if you have any comments regarding this newsletter.

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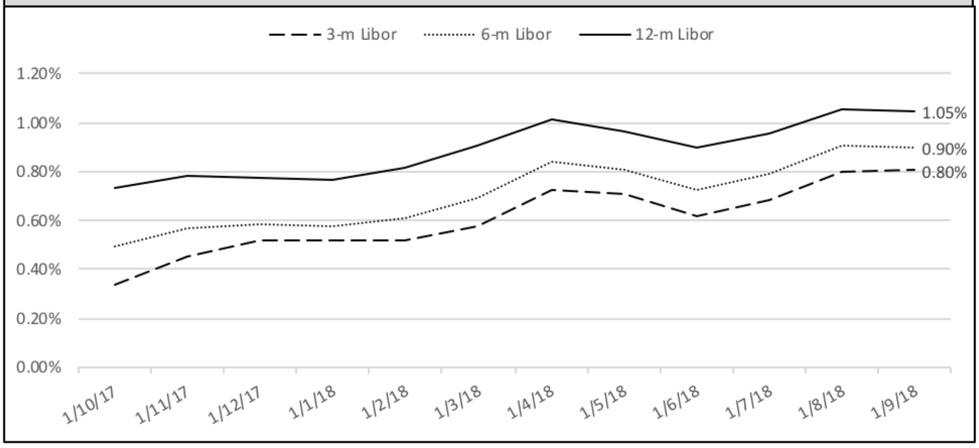
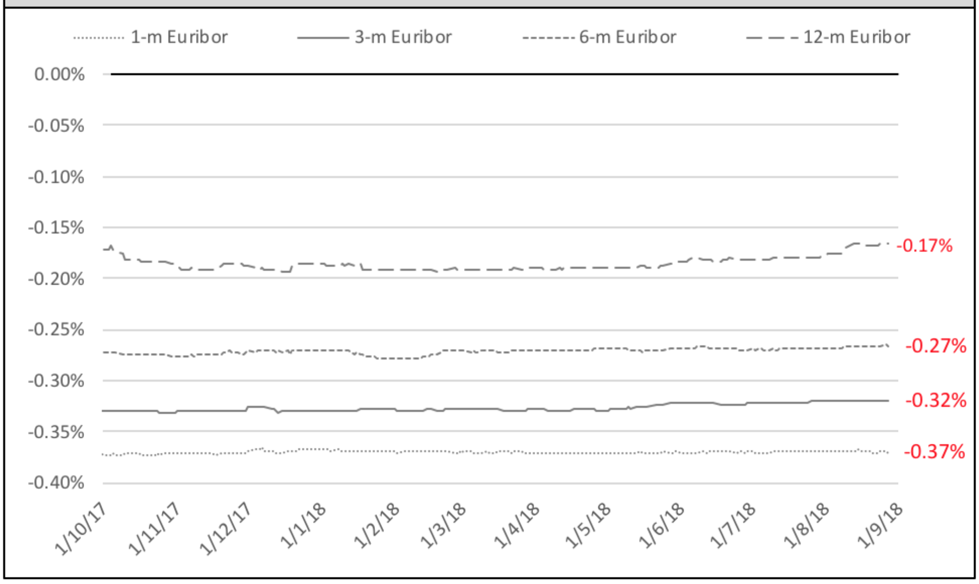
REAL ESTATE DEBT & EQUITY

MARKET DATA

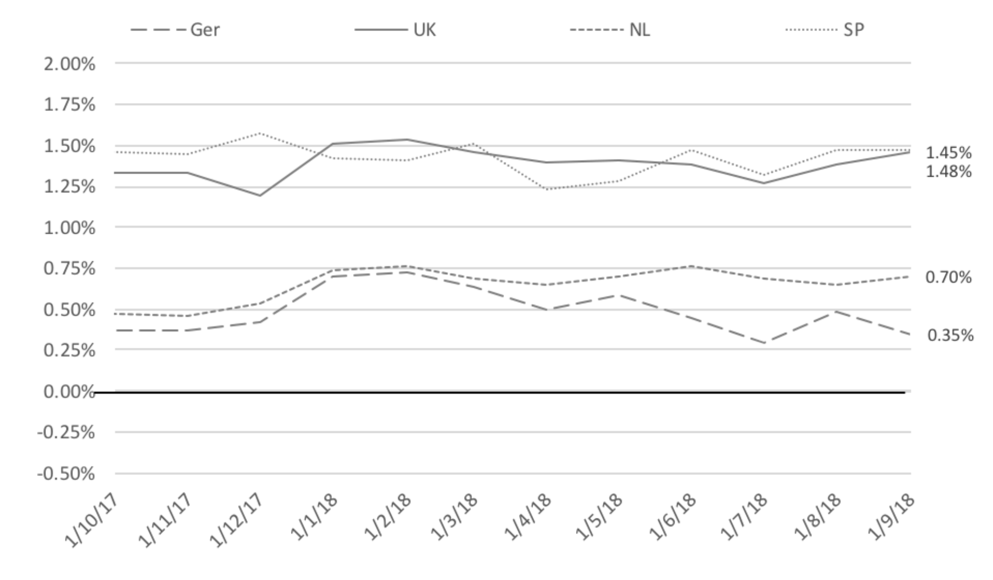
GBP-Libor interest rate



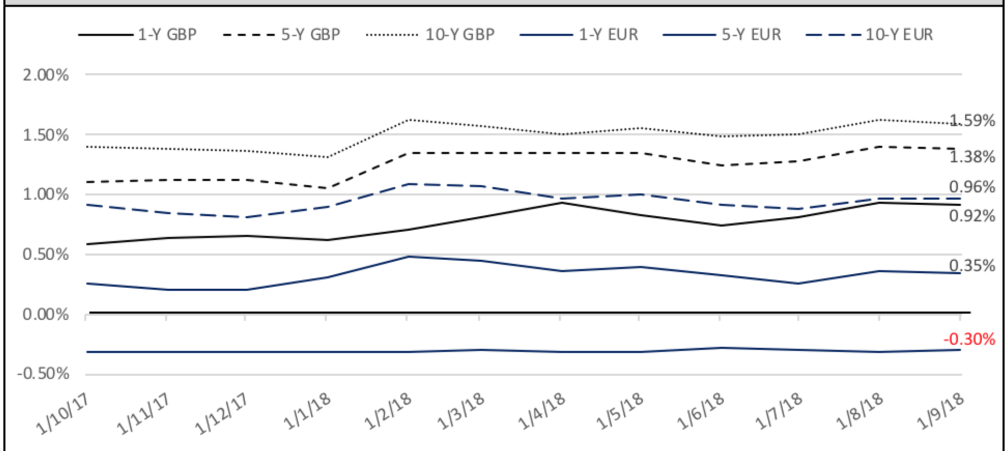
EUR-Euribor interest rate



10-Y Gov. bonds



SWAP rates past 12 months



Exchange rate	Rate	52-W high	52-W low	1-Y change
EUR/USD	1.17	1.26	1.13	-1.7%
GBP/USD	1.30	1.44	1.27	-3.8%
CNY/USD	0.072	0.160	0.160	-4.04%
EUR/GBP	0.90	0.93	0.86	-2.06%

Index	Symbol	Rate	52-W high	52-W low
FTSE EPRA/NAREIT Eurozone Index	EPEU	2,731	2,786	2,431
FTSE EPRA/NAREIT UK Index	ELUK	1,784	1,866	1,696
STOXX® Europe 600 REITs	S8670R	104	110	99
STOXX® Europe 600 Real Estate	SX86GR	192	195	169
Dow Jones Europe Select REIT Index	DWEURT	1,066	1,224	996
DJ Europe Select Real Estate Securities Index	DWEURS	3,216	3,558	3,006

	Unemployment %		GDP growth QoQ %		Inflation YoY %	
Country	Q1 2018	Q2 2018	Q1 2018	Q2 2018	Q1 2018	Q2 2018
UK	4.2	4.1	0.2	0.4	2.5	2.4
Germany	3.5	3.4	0.4	0.5	1.5	2.1
Spain	16.7	15.3	0.7	0.6	1.1	2.2
Netherlands	4.0	3.9%	0.6	0.7	1.1	1.8

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