Property trusts: What could go wrong (Part 2 - Retail meltdown?)

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This is the second part in our series on "Property trusts: What might go wrong?".

You can understand the concern. Last year in the US, nine retail chains went belly up according to The Atlantic. So far this year, including the demise of Payless and RadioShack (for the second time), that figure has already been equalled.

Department stores JC Penney, Macy's and Sears have announced massive store closures while the share prices of high profile retailers like Lululemon and American Eagle have been pounded. Against a backdrop of low unemployment, increasing wages and GDP growth, the sector is struggling. The obvious conclusion – that the era of the mall is coming to an end – has not escaped Australian journalists.

Egged on by the announcement of Amazon's arrival – as if it hadn't sold anything to Australian buyers before – headlines like Amazon plans to smash Australia's retail sector one toaster at a time, Retail ruin as Oz brands fail to keep up with global rivals and US retail crisis will hit Australia have commercial property investors worried.

The concern is understandable, if somewhat misplaced. The fears have more to do with emotion and the need for a good headline than the facts. Whilst it's true that in the US retail is struggling, the parallels currently being drawn between it and Australia don't stack up for three primary reasons.

1. The US has too many malls; Australia doesn't

Starting in the 1970s, the US went crazy covering the land with shopping malls. Cowen and Company research suggests that the rate of mall construction was double that of US population growth. It was bound to end in tears.

The result, according to The Atlantic, is a country with "40 percent more shopping space per capita than Canada, five times more than the UK and 10 times more than Germany." ICSC data suggests there's 2.2 square metres of retail space per capita in the US compared with only 1 square metre in Australia.

This oversupply shows up in the numbers. The better Australian real estate investment trusts' mall assets typically enjoy very low vacancy rates of between 0.5% and 1.0%. In the US they're around 4 to 5%[1]. Little wonder that the number of malls is expected to contract by 25% over the next decade[2].

The United States has too many shopping malls. The death of many of them doesn't signify a fundamental problem with the concept of shopping centres but rather a failure of US centre developers and owners to match demand with supply and adapt to changing retail tastes.

This blows the first hole in the argument that Australia's retail sector will follow the recent traumatic experience of US malls. Australian shopping centres, currently in good health, are a very different proposition to ailing and ageing US malls.

2. The US doesn't lead Australia in malls, it follows

Whilst the US may lead the world in many industries, building leading edge shopping centres isn't one of them. Again, the figures bear this out. US malls typically have a much larger proportion of floorspace devoted to apparel at 57%, a sector where spending is contracting. Apparel takes up a far more modest 29% of floorspace in Australian malls. In the US only 14% of floor space is devoted to entertainment, non-retail and food and beverage, a sector where spending is increasing[3]. The comparable figure in Australia is 22%.

The disparity is even greater in the struggling department store sector, where US malls allocate 46% of floor space to the likes of JC Penny's and Macy's. Australian malls sniffed the wind long ago, which is why about half the space is occupied by Myer and David Jones[4] compared with their US counterparts.

The difference highlights the discrepancy between a static industry and one responsive to customer needs. US consumers have been let down by an excess of malls and managers that have failed to keep pace with changing tastes and income. Australia, meanwhile, leads the way in making shopping centres interesting, desirable places to visit.

If there is a comparison to be made between the two country's malls, it's in how far US centres lag Australia's. The relevant data contradicts the notion that the diminishing prospects of US malls are somehow a canary-in-the-coal-mine for their Australian counterparts. They're not. If anything, Australian malls show the US where it needs to head.

3. The online "threat" is overstated

Ah, say the skeptics, won't the growth of online retailing eventually spell doom for the shopping centre?

The data suggests not. In the early part of the century, your scribe remembers forecasts that claimed online retail sales would reach 15-20% of total sales by 2015. The Australian Bureau of Statistics (ABS) believes that the current figure is 3.6%. NAB and Quantium estimate it to be about 7.2%. Either way, it's a surprisingly small number.

Nor is it growing quickly. In fact, the evidence suggests that the rate of growth in online sales is actually slowing. In December 2011, year on year growth in online sales was 27%[5]. Between December 2016 and December 2015 was just 10.4%. In the US, online sales accounted for 8.3% of total sales in calendar year 2016, remaining steady in the second half.

This suggests online sales may be reaching a peak at less than 10 cents in every dollar spent. With Internet penetration in Australia at 85%[6], it may well be that the bricks and mortar adjustment to online retailing, at least for most shopping centres – we'll soon address that qualifier – is nearing an end.

Two more factors illustrate how binary thinking about online and conventional sales misrepresent what's really going on. First, it's estimated that conventional retailers account for around 80% of online sales[7]. Most retailers with an online presence aren't losing sales; their customers are merely changing channels. It is those retailers that fail to adapt that are most at risk.

Secondly, conventional stores still work well for products that customers prefer to smell, touch or feel prior to purchase. This is a lesson not lost on online retailers. Peter Alexander, initially an online retailer of homewares, now has over 100 stores around the country.

Witness, too, the arrival of global retailers like H&M, Uniqlo and Zara, all of which are rolling out stores across Australia, supported – but not led – by an online presence. The reason is the all-important "upsell" (the sale of additional goods), which is far easier in-store than online.

So, the picture is more nuanced than a binary battle between online and bricks and mortar. Conventional retailers are adapting to the new world and online retailers are building store networks where customers can physically engage with their products. Online is now viewed as what it really is, another retail channel, just like a shopfront. Both have their place, and not necessarily in opposition.

All of this points in one direction. Shopping centres are moving from performing a functional role to one which retailers call 'experiential'. Whether it's eating out, going to the gym, or running your fingers over some Peter Alexander pyjamas, the aim is to deliver something that cannot be easily replicated online.

Where does this leave APN Property's investors and advisors? We're certainly not saying that the future of every shopping centre is assured. Some will continue to struggle, others may close. For investors, the trick is to spot which ones are likely to prosper and avoid those likely to suffer.

Our strategy is to avoid what we call "middle ground" assets. If a centre cannot deliver an attractive experience then it must be perfectly convenient, a place where shoppers go for their regular spend on everyday items because it's either close or there's no other choice.

"Experience" assets are also easily accessible, offering discretionary and non-discretionary goods in an alluring physical environment with an interesting mix of conventional retail, food, beverage and entertainment. This increases dwell time and the prospect of additional sales. These centres are also located in established, high density locations, with little prospect of competition as well as diversified, high quality tenancy bases and exceptional management.

Where we don't want to invest is in centres that are neither experience or convenience-based. In practice, this means we'd rather invest in Westfield Sydney City and Chadstone Shopping Centre in Melbourne than a retail shop in Whyalla, South Australia. It is in regional or suburban areas where most "middle ground" assets are located. More closely resembling the suburban US shopping strip, these are the centres we avoid.

In summary, these are the reasons why we think Australian retail is doing just fine and that the comparison between the local sector and its US counterparts is misplaced. But there's one other issue we have yet to touch on; one that has probably popped into your head already – what about the impact of Amazon launching in Australia? That's the subject of our next article in this series. Watch out for it shortly.

1. SCG & WFD, FY16 results
2. The Atlantic, The Great Retail Apocalypse of 2017
3. Source: UBS, March 2017
4. Source: Citi., February 2017
5. NAB Online Report, December 2016
6. Internet Live stats
7. NAB Online Retail Sales Index /Quantium data December 2016

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