SPOTLIGHT
Savills Research

Europe Commercial – 2019

The Evolution of Retail Destinations

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Drivers of change • Shifting occupational demand • Implications for investors & landlords

Millennials who said that they would rather spend money on experiences than buying 'stuff'

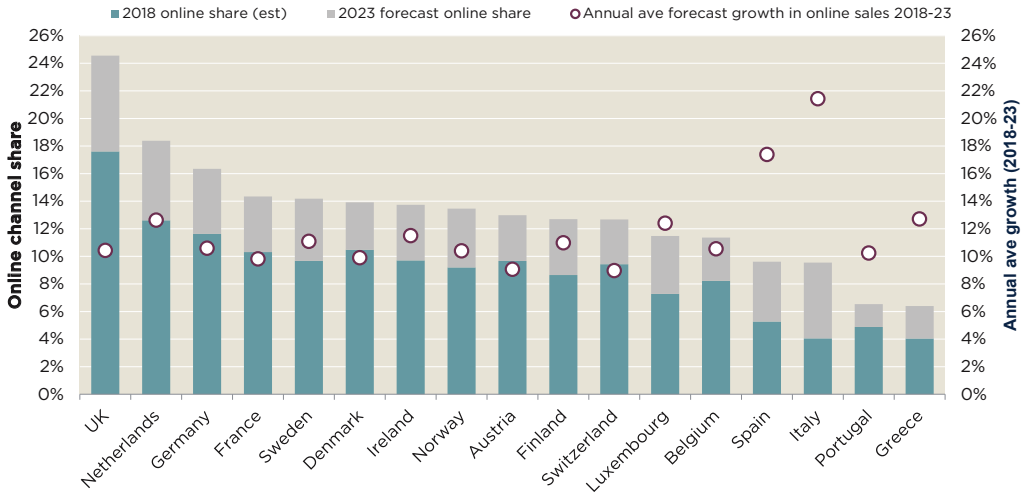
Over the last 50 years the creation of destinations have tended to be anchored on retail. Yet, the growth in e-commerce, diverging generational consumer demands, increasing urbanisation and expanding global travel are all shaping occupational demand and in turn how retail destinations need to evolve to remain current and appealing.

The specifics of location, size, mix, design and ownership of retail assets will determine the scale of challenges and opportunities presented by these structural shifts. However, for landlords and investors it will fundamentally mean a greater need for investment into assets in order to maintain values rather than to solely drive returns.

A key aspect of this investment will likely require a move to a more service orientated offer, similar to the co-working model. A flexible, service focused offer will have obvious appeal to occupiers, but so too for landlords as it has the potential to enhance revenues through additional income streams while also helping to keep the offer fresh and varied, all the more important when meeting the demands of younger consumers. Albeit this approach will require closer attention to margins. Other opportunities include the intensification of uses and repurposing of excess retail space to alternative uses, ultimately to the benefit of the retail that remains.

These are all themes we explore in more detail in this report with a particular reference to what it could mean for landlords and investors.

Online penetration forecast by country Online retail sales to expand by an average of 11.5% per annum with an average penetration rate of 15.0% by 2023



Source Savills Research; Forrester Analytics

Drivers of change

The way we want to spend our time and money is having a fundamental impact on the nature of 'retail' destinations

The emergence of e-commerce and structural shifts in terms of how we, as consumers, want to spend our time and our money are shaping the nature of retail destinations, be they shopping centres, high streets and retail parks.

The growth in online retailing is having the most significant and immediate impact on retailers space requirements. European online sales are forecast to expand by an average of 11.5% per annum through to 2023 with physical sales expanding by 2.0%. The UK will continue to lead with an online penetration rate of 25% by 2023 with the Netherlands and Germany coming in second (18%) and third respectively (16%).

While this growth will pose a challenge to physical retailing it is important to note that a significant share of this online spend will touch a store. GlobalData suggest that in the UK approximately 29% of online sales touch a store either through click & collect (15%) and where a customer has browsed the product in store first (14%). Considering that click & collect sales are forecast to increase 38% by 2024, accounting for 16% of online sales, the store will continue to play a key role.

It's all about experience

But, it is not just how we shop but also how we want to spend our money and our time that is also shaping retail destinations.

Over the last five years experience related consumer spend, such as eating out and staying in hotels, has outstripped the growth in total consumer spending. It has also outperformed traditional retail sectors such as fashion. This is even more pronounced for western Europe's most affluent core cities, that is those with a regional and international pull such as Paris, London and Munich. For example, eating out spend across the top 15 affluent core cities has grown by 2.3% per annum in real terms, 39bps (basis points) higher than fashion spend. In certain cities this trend is amplified. Munich consumer spend on fashion has grown 0.3% per annum since 2013 whereas recreation spend has expanded 2.6% with forecasts to 2024 suggesting hotel spend will expand 4.0% per annum.

This shift in spend towards experiences can be seen across all age groups, but has been largely driven by millennials (those currently aged under 38) and baby boomers (aged 55-73 years).

> **"The shift in spend towards experiences can be seen across all age groups"**

Europe is the largest tourist market in the world accounting for 51% of international arrivals in 2018

For baby boomers this partly reflects increased leisure time due to retirement but also the fact they are more affluent than previous older generations. For millennials and their younger counterparts, Generation Z (aged under 22 years), it is about shifting priorities which are centred on experiences rather than owning 'stuff'. For example, a recent survey found that 78% of millennial respondents said they would rather spend their money on experiences.

But, it is not just this preference for experiences that makes them unique. Millennials are the first digitally native generation, they tend to be more demanding, are less affluent than previous generations and are more health conscious as well as more environmentally and socially aware. All of which are influencing consumer behaviour and will continue to do so considering that global millennial spending power will overtake that of their older counterparts, Generation X, in 2020. Yet with baby boomers remaining the wealthiest generation until 2030, they will remain a key consumer group and one that should not be ignored.

Expanding cities

Urbanisation across Europe's core cities, that is those cities with a regional and international pull, is forecast to accelerate. As a result occupier attention on urban locations will intensify.

Oxford Economics forecast that working age population of Europe's top 15 affluent core cities will expand 2.4% over the next five years outperforming the 0.4% decline expected to be seen nationally.

The growth in urban populations is also evident in the decline in driving license registrations and in turn car ownership seen in these area, particularly amongst younger residents. For example, in the UK there has been a 20% drop over the last decade in the number of under-25s learning to drive.

The rising importance of tourist spend

While residents may be shifting their retail spend in response to changing preferences, the growth in tourist arrivals into Europe and its gateway cities could mean they become an ever more important driver of spend.

Europe is the largest tourist market in the world accounting for 51% of international arrivals in 2018, with seven of its cities in the top 25 most visited globally. With the UNWTO forecasting that arrivals will increase a further 7% by 2025, the ability of these visitors to shape spending in key destination cities is set to increase.

Chinese visitors in particular have been a very important consumer in Europe, most notably when it comes to luxury as 76% of their luxury spend takes place when they are travelling.

However, like their European counterparts Chinese visitor spend is also starting to evolve. The balance of luxury spend is forecast to shift towards domestic markets with Bain & Company forecasting that by 2025 50% of Chinese luxury spend will take place at home. At the same time Chinese tourists are increasingly valuing cultural experiences over shopping.

While this trend is likely to reduce average transaction spend, the greater number of Chinese tourists visiting European cities means total spend will continue to increase. But, like European consumers, an increasing amount of this spend will be experience based.

Luxury brands are already adapting to these changes. For example, LVMH acquired luxury hotel group Belmond in 2019 for a reported $3.2 billion with Prada acquiring a stake in Milan patisserie Marchesi 1824 opening its first site outside Italy, in London last year.

European annual average growth in consumer spending 2013-18

Growth in experience related consumer spending outpacing the wider market

Source Savills Research; Oxford Economics ***Note** - inflation adjusted

€462 bn

total online sales in Western Europe by 2023

37%

average uplift in traffic to a retailers website when they open a new store

39bps

outperformance in eating out spend over fashion for the top 15 affluent cities in Europe

50%

of Chinese luxury spend will take place at home

Faster population growth in Europe's core cities will refocus occupier attention on more dense urban locations

Shifting occupational demand

The store will play an ever more important role to retailers but the opportunity will be beyond retail

Overspaced retail markets, where the growth in online penetration is forecast to be significant, are expected to be the most exposed to the shifts in consumer spending. This is already evident amongst a number of legacy retailers who are rightsizing their portfolios.

Rightsizing portfolios to become the norm

The potential need to shrink store count will differ across retailer types and geographies. However, mass and mid-market fashion is expected to see a significant degree of rightsizing due to a strong growth in online sales. For example, an estimated 28.5% of fashion sales in Western Europe will be online by 2023, an 87% growth on current levels (include clothing & footwear).

This is already playing out across retailers' portfolios. Across the largest mass and mid-market fashion groups and brands, store portfolios in western Europe expanded by only 0.7% per annum between 2014 and 2017 with some, such as Arcadia and C&A, reducing store count by 0.6% and 1.2% per annum respectively.

Refocus on urban locations

Faster population growth in cities, particularly Europe's core cities, will refocus occupier attention on urban locations with good public transport links. This is already leading some traditional out of town retail occupiers to devise urban concepts, alongside click & collect services. Ikea recognised the need to get closer to where their customers live, work and shop having opened their first urban concept store in Madrid in 2017.

The role of the store to become elevated

With some retailers shrinking store footprints it would be easy to assume that stores are set to become less important. Yet, the opposite is the case.

Firstly, what we are seeing with those retailers who are shrinking portfolios is a renewed focus on strategic and/or strong convenient locations with larger stores in some cases. This is apparent when we look at Zara parent Inditex whose average store size increased 11.2% between 2014 and 2017 to 624 sqm, outstripping the 1.1% growth in store count.

A move to fewer larger stores in key locations by some is an acknowledgement of the role a store plays in raising brand awareness and driving sales, including those online.

A US study by ICSC in 2018 found that where a brand opened a new store there was, on average, a 37% increase in traffic to their website within the store catchment. The opposite was the case where retailers closed stores.

What is becoming clear is the need for brands to meet the customer where they are; having a physical store is one way to achieve this. Everlane's CEO Michael Preysman reiterated this in a recent interview. Everlane , which started as an online only brand in 2011 and previously swore off physical stores, but now have four stores in the US with its CEO conceding that they needed to open stores in order to be profitable. The thinking that an online only brand is more cost effective as it avoids store costs did not stack up once the costs associated with shipping orders and acquiring customers (marketing costs) were taken into account.

Its not all about retail

Structural shifts in consumer spending may be generating occupational challenges, but it is also creating new concepts and occupiers looking for physical space in retail destinations.

Rising consumer spend on eating out and leisure has seen a growth in food and leisure operators looking to take space in retail areas. Beyond the traditional types of operators in this space, we are seeing new concepts centred around VR (virtual reality), eSports and wellness.

We are also seeing totally new retail concepts emerge, driven in a large part by changing consumer preferences and attitudes to owning stuff as well as environmental concerns. These include rental retail, online market places and wellness concepts.

Rental Retail

What is it?
retail services where consumers can rent items.

Brand example
Rent the Runway (US)
Year established: **2009**
Total funding raised to date: **€430 million**
Number of customers: **est. 6 million**
Number of physical locations: **4**

Online marketplace

What is it?
online shopping community where users can buy, sell, discover and explore.

Brand example
Depop (UK)
Registered users: **13 million**
User profile: **90% under the age of 26**
Number of physical locations: **2**

VR leisure

What is it?
immersive leisure experiences utilising virtual reality technology.

Brand example
Sandbox VR (US)
Investment raised to date: **€65 million**
Number of physical locations: **7** (5 already secured in pipeline)

eSports

What is it?
competitive video gaming.

Brand example
Wanyoo Esports Studio (China)
Annual visitors: **30 million**
Number of physical locations: **1,000+** (first European location opened in London in 2019)

What does this mean for investors & landlords?

The ultimate outcome from these evolving trends will be a softening in overall demand for traditional retail space, restricting future rental growth and in some cases placing downward pressure on rents. To counter this landlords will need to increase the level of investment into their assets, in order to maintain values rather than to solely enhance returns.

Prime retail destinations in urban locations with strong footfall are likely to be less exposed as are strong convenience led locations with strong catchment fundamentals. However, they will not be totally immune. For secondary and tertiary retail destinations in more peripheral locations the outlook is likely to be more challenging.

So what can landlords/ investors do to mitigate these challenges and even capitalise on this shift?

Growing appeal of luxury

Luxury retail has been one of the most insulated to the growth in online to date. However, e-commerce will play an ever more important role in driving sales and improving engagement with customers. Current forecasts from Bain & Company suggest that 25% of luxury spend will be online by 2025, more than double the current share of 10%.

Despite online accounting for a larger share of spend occupational demand for key luxury destinations will remain robust. This is down to the fact that luxury brand store portfolios in Europe are relatively constrained compared to mass market brands. Likewise, the target premier luxury area for expanding brands remains limited being largely confined to a given street or pitch. With an increasing number of luxury brands looking to develop and expand their own stand alone boutiques in order to better engage with customers, the demand/supply imbalance is likely to remain in the landlords favour.

This divergence in performance is already being reflected in pricing in some markets. For example, prime high street yields in Paris held in Q219 whereas shopping centre yields softened by 25bps. Similarly, Düsseldorf has seen prime high street yields harden 25bps since the end of 2018 while shopping centre yields have held.

Less retail destination, more destination

For retail destinations, particularly shopping centres and retail parks, a greater focus on experience and intensification of uses that attracts more people could be key.

This may include introducing more innovative leisure concepts that generate additional footfall, such as eSports arenas and VR experiences. Intensifying land use and/or repurposing excess retail space, where viable, for other uses including residential, offices, co-working, urban logistics, hotels, medical, student housing and community uses, will also bring additional people on site to support and rejuvenate the existing retail.

Enhancing the public realm experience

The space between retail is often overlooked but can play an important role in enhancing the attractiveness of a place. Beyond the traditional aesthetic concerns, events and gamification of the public realm through visitor apps, may offer opportunities to bring in new types of consumers and in turn occupiers helping to generate additional footfall.

Mix it up with independents

In some cases there can be very little to differentiate destinations in terms of their retail offer due to the dominance of listed and international brands. These types of occupiers will continue to be a key draw for consumers, however with some of these legacy retailers now rationalising store portfolios there may be an opportunity to fill the void with good quality local independents that offer a point of difference. ▶

Introduction of new occupational & rental models

Demographic, technological and social shifts are shaping consumer preferences and demands, many of which are increasingly focused on flexibility, convenience and service. Retailers and brands are already responding to these changes, yet the property they occupy is yet to respond.

The premise of space as a service is already being embraced in the office sector with the rise of a new generation of serviced office and co-working providers such as WeWork. The question is, should retail property align?

We believe there is demand for this type of space offer within destinations from both emerging and established brands. For landlords this may mean 'white-boxing' space with additional services, including customer data analytics, design, performance measurement, last mile logistics and marketing, on an all-in cost basis similar to the co-working model.

Some landlords are already testing this approach as part of their overall offer. Macerich, a mall REIT in the US, launched 'Brandbox' in 2018, a turnkey concept largely aimed at digitally native brands who want to make the leap to physical stores. The offer is a complete package of flexible real estate and services including design, retail analytics, technology and marketing.

It's not just the occupation model that may need to shift, how a store is valued in regards to rent will also need greater examination. The growing symbiotic relationship between physical stores and online should be taken into account. However, the ability to develop a new rental model that is fair to both occupier and landlord will be reliant on a more collaborative relationship being fostered, one that could be achieved through a more service and data orientated approach by landlords.

This new approach does have its potential benefits; enhanced marketability to prospective occupiers, and in turn visitors, and additional revenue streams through the add on services. However, a greater focus on service does have its challenges. Firstly it requires investment, plus the ability to maintain and even improve margins will require more intensive management and in-house expertise while the flexible occupier terms could raise valuation issues.

What is clear is that retailing and retail destinations are going through significant change and landlords and investors need to respond. But rest assured we are not seeing the death of retail destinations rather an evolution and intensification of their offer.

> **"The premise of space as a service is already being embraced in the office sector with the rise of co-working providers like WeWork. The question is, should retail property align?"**

The German Perspective

Having examined the development of retail destinations in more mature e-commerce markets like the UK and the US, the question arises: will we see a similar development in Germany? We say: yes.

At present Germany lags the UK in terms of e-commerce penetration but with it forecast to reach 16.3% by 2023, similar to that now seen in the UK, it is only a matter of time until Germany will face the same challenges.

This is already becoming evident with some retailers trying to use their stores differently and/or rightsizing their portfolios. At the same time we are seeing occupational demand intensify for prime strategic and/or strong convenience led locations. In contrast demand for secondary locations is softening.

In response landlords and investors need to be thinking about what they can do with their retail holdings in order to mitigate these issues where they exist, but also consider what opportunities these structural shifts could offer. In light of this we have considered, from a very high level perspective, what these drivers of change could mean for different types of retailing in regards to their strengths, the transformational strategies that could be adopted and the investment perspective. All of which are detailed opposite. However, we appreciate that the the specifics of location, size, mix, ownership and design, amongst other factors, will have a major bearing on these considerations.

We hope this paper raises thoughts and debate to the future of retail places and would be delighted to advise you on future strategies on how to reposition or repurpose retail property and what the investment opportunities could be.

District Shopping Centres

Strengths

Increasingly acting as distribution centres for click and collect services.

Often are community destinations.

Typically enjoy high footfall as meeting daily retailing needs.

Transformational options

Intensification and repurposing of space for senior living, rental housing, medical uses.

Investment perspective

Will continue to offer stable and long term value.

City Centre Shopping Centres

Strengths

Continue to be key retail destinations enjoying robust footfall.

Scope to include additional gastronomy, leisure and cultural concepts, further enhancing visitor numbers and dwell time.

Transformational options

Intensification and repurposing of space for co-living, co-working, offices, educational uses, student housing and hotels.

Investment perspective

Highly attractive transformational asset, but pricing will be crucial.

Rent volatility may increase due to greater instance of shorter leases making it difficult to forecast future rental performance.

Hybrid Mall/ Out of Town Shopping Centre

Strengths

Typically have a large food anchor, therefore act as strong community hubs with a high frequency of visit particularly for more price sensitive consumers.

Increasingly acting as distribution centres for click and collect services.

Transformational options

Diversifying the occupier profile to include additional gastronomy and leisure offer in order to increase footfall and dwell time.

Investment perspective

For the time being it can deliver a stable cash flow that offers value. However, is perhaps the most exposed to the challenges facing retailing.

Retail Parks

Strengths

Tend to have a large food anchor, therefore act as strong community hubs with a high frequency of visit.

Potential to act as distribution centres for click and collect services particularly when located close to large urban areas.

Transformational options

Typically smaller so can be more difficult to fully transform. Where located close to urban areas there may be options for residential and/or logistics.

Investment perspective

Very functional asset class strengthened by its strong food offer.

High Streets

Strengths

For the key gateway cities the key high streets remain major destinations attracting tourist shoppers.

Already benefit from a mixed use, well connected, urban location that can deliver robust footfall. Scope to include additional gastronomy, leisure and cultural concepts, further enhancing footfall.

Transformational options

Very good transformational opportunity, subject to scale of ownership. Options include co-living, senior housing, co-working, offices, educational uses, student housing and hotels.

Investment perspective

Stable outlook for top locations, however rents to become more volatile due to shorter leases. This means difficult to forecast rent performance, but top 20 cities should remain relatively stable.

To remain very low yielding compared to alternative asset classes.

Key luxury locations to be more stable in terms of rents and pricing compared to mass market fashion locations.

Savills Commercial Research
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Europe Cross-border

Oliver Fraser-Looen
Retail Investment
+44(0)20 7409 8784
oflooen@savills.com

Larry Brennan
Retail Agency
+353 1 618 1302
larry.brennan@savills.ie

Carlotta Matteja
Retail Agency
+49 69 273 000 28
cmatteja@savills.de

Marie Hickey
Research
+44(0)20 7409 8288
mlhickey@savills.com

Eri Mitsostergiou
Research
+30 6946500104
emitso@savills.com

Germany

Jörg Krechky
Retail Investment
+49 40 309 977 144
jkrechky@savills.de

Markus Flaig
Retail Investment
+49 69 273 000 84
mflaig@savills.de

Daniel Kroppmanns
Retail Agency
+49 69 273 000 24
dkroppmanns@savills.de

Draženko Grahovac
Corp. Finance - Valuation
+49 30 726 165 140
dgrahovac@savills.de

Jennifer Güleryüz
Research
+49 30 726 165 135
jgueleryuez@savills.de