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The impact of technology on real estate: Implications for retail and logistics

Introduction

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Short term performance of global property markets will be largely determined by the speed and scale of economic growth; investor demand remains highly focused on those developed markets that offer economic stability or emerging markets with exceptional growth prospects. It is important, however, that investors do not lose sight of some of the structural changes that will determine long-term real estate winners and losers.

Technological evolution will have a significant impact on demand for property and should be a key consideration in both portfolio management and investment strategy. With online shopping growing in popularity, landlords certainly need a defense strategy to ensure their retail assets remain viable, while those that ignore it risk obsolescence. There is no shortage of commentary about the threat that online retailing poses for bricks and mortar retailing, but little about the opportunity it presents to landlords that exploit it.

This report looks at how rapid growth in e-commerce is shaping demand for shops, as well as logistics and warehousing facilities, and how property investors can gain exposure to this growth.

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Growth in multi-channel retailing

The pace of change in the retail market continues to gain momentum and the notoriously sluggish property market is battling to keep up. It is nearly impossible these days to have a conversation about retail without it turning into one about multi-channel. The store versus online debate has been live for a long time, with retailers and consumers increasingly backing the internet, while landlords feel obliged to make the case for the store. It is becoming clear, however, that neither of these single channels, on their own, will win the fight for market share. It will be an effective collaboration of the two that will win this battle, namely multi-channel. Customers certainly expect a seamless service across both channels, which is what some now term omni-channel. Retail is multi-channel, and we must stop thinking of it as a specialist strand of the retail market. It is top of the agenda for most retailers and it should be for landlords too.

Examples of a multi-channel shopping journey include:

- Order online and pick up in store (commonly known as click & collect)
- Visit the store and order online via a kiosk or i-pad
- Visit the store and shop on the retailer's website via their mobile phones
- Visit the store and shop on another retailer's website for a better price (also known as show rooming)
- Visit the store, compare prices via a barcode scanner and find the product at another physical store at a lower price.

The good news for landlords is that the store remains very relevant in the multi-channel future, but there is no denying that demand for traditional stores will shrink and the role of the store will inevitably change.

Drivers of e-commerce

At present, consumers are driving growth in e-commerce with price, choice and convenience being the strongest forces. Transparency of price on the internet means customers feel confident they are getting the best value possible, and indeed there are websites that will do this research for them. In addition to securing the best price online, shoppers often have a greater choice on the internet, with the offer not being constrained by in-store shelf space. Plus, they will have immediate information on stock availability and product reviews from other customers.

Whether shopping online is more convenient for customers is up for debate. It can certainly save carrying heavy goods and avoids time consuming journeys, but shoppers are increasingly frustrated at having to wait at home for their goods and expectations for delivery speed and specified delivery slots are rising. The strong growth in the click & collect concept (buy online, collect in store) reflects this.

Retailers have little choice but to respond to customers, who will vote with their feet (and increasingly their fingertips), and most are investing heavily in their multi-channel offering. The incentive for retailers is the ability to reach a wider customer base, global in theory. Those retailers that are able to make their online business scalable are likely to see it having a positive impact on profitability.

At present, the internet is having a positive impact on retailers' volumes and market share, but the cost of packaging and distribution can erode profit margins. Retailers are under pressure to find the optimal e-distribution model, and with e-commerce growing and evolving so rapidly, there is a growing focus on distribution and logistics facilities (which we look at later in this report).

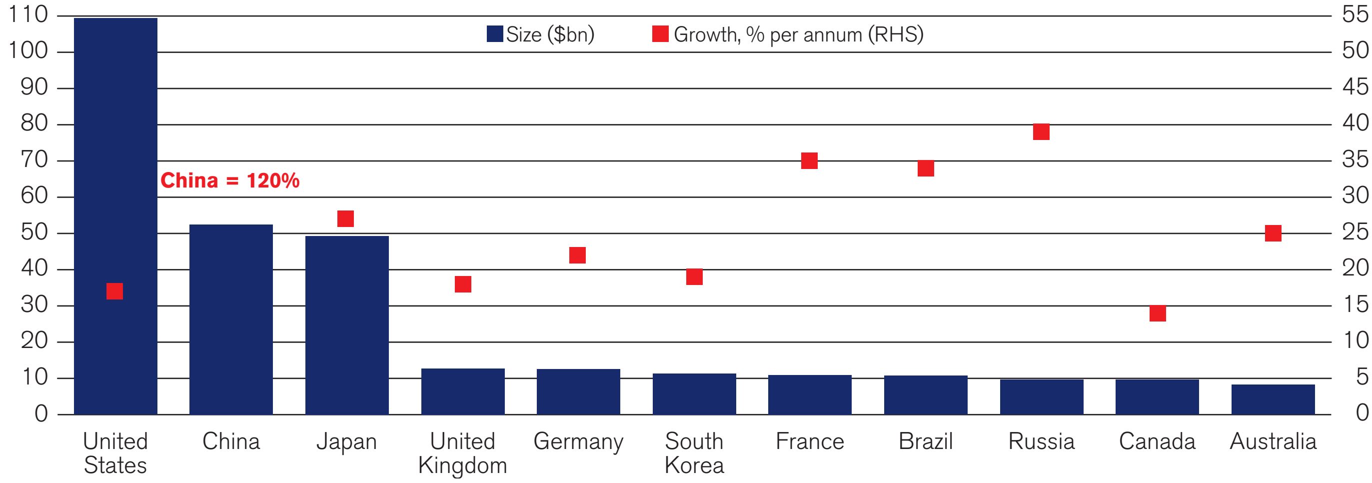
Regional variations

The impact of multi-channel retailing is far from uniform; the rate of growth differs markedly by geography and goods types. What is consistent, though, is that most economies are recording significantly stronger growth in internet sales than store based sales. Those retailers in developed economies cite strong growth in their multi-channel business, while same store sales for all but the strongest retailers are declining.

In terms of penetration of retail sales, the **UK** is one of the most advanced e-commerce markets globally (only **South Korea** is higher). This reflects high levels of broadband subscription and affluence, but primarily the fact that both are small, densely populated countries make distribution of goods relatively easy. This means retailers can offer an efficient, convenient service to their customers. In absolute terms, the UK is estimated to be the 4th largest e-commerce market globally. It is estimated that around 12-13% of all retail sales in the UK are now accounted for by the internet, with very strong growth forecasts. Some commentators expect penetration to reach 25% by 2020, if not sooner.

The **USA** is the largest e-commerce market globally, but the internet accounts for a much smaller proportion of available sales than in the UK at around 5%. The market here is

Fig. 1: Size and growth of e-commerce market



Source: Henderson Global Investors, Datastream, Q1 2013
Note: Online retail sales volume as at end 2011, growth = % per annum since 2003

expected to grow but at a much slower rate than for the UK, suggesting there is a lower ceiling for growth. The big difference is geography, the US is much larger and more sparsely populated than the UK, making distribution a challenge. At the city level, however, the US has led the UK in terms of e-commerce initiatives. Supermarkets offer very short delivery times; Amazon offers same day delivery service in 10 cities and Ebay is offering a same day delivery service in San Francisco and New York in alliance with a number of big name retailers.

China, being one of the fastest growing consumer markets globally, is the fastest growing e-commerce market and arguably the one to watch. The sheer size of the Chinese market means that it will likely soon become the world's largest online shopping market. At present, the internet accounts for just 1% of all retail sales but this channel has enjoyed growth in excess of 100% per annum in recent years. Rapid growth in affluence, take-up of broadband and m-commerce, plus retailer-led initiatives should see continued strong growth in China.

Highly aspirational consumers in China are using the internet to access international brands, and this is reflected in the very high penetration of the internet in Tier 4 cities (estimated to be c.25% of retail sales) where highly sought after brands are not necessarily available in stores.

Being a relatively immature retail market, albeit enjoying very strong growth, it will be very fascinating to observe what happens to the Chinese retail landscape in coming years. New entrants to the market do not have the legacy of store portfolios and there is speculation that some retailers may even by-pass this "generation" of shopping and jump straight to online orders. For this to be successful, it would require an established brand recognition, which usually comes from having a store presence.

However Asos, Europe's largest pure-play fashion retailer, has recently announced it will spend up to £6m a year on its attempt to break into China's booming e-commerce sector and will set up a dedicated distribution hub in the country. Tesco has recently announced a rollout plan for their online shopping business across 40+ Chinese cities, with speculation that they are no longer committed to stores in this market.

Given the scale of the country, distribution in China will be an issue and it seems likely that for an online business to work efficiently for customers and profitably for retailers it will be, at least at the outset, constrained to major cities, as in the US. This is less relevant for high value or luxury goods where high margins can absorb delivery costs and customers are prepared to wait for longer.

The Australian e-commerce market is trailing other developed retail markets, largely due to its location and the size of the country which makes delivery logistics a challenge for retailers. Estimates of the proportion of retail sales in **Australia** accounted for the internet range from 4-6%, with growth of around 25% per annum. Where Australia differs from the UK or US is the proportion of internet sales that are accounted for by overseas retailers; around 50% of online sales can be attributed to customers importing brands unavailable domestically or taking advantage of favourable exchange rates.

This trend will have encouraged domestic brands to invest in their online offer and we expect to see a greater impact of e-commerce on traditional bricks and mortar retailing in Australia.

In terms of goods categories, there are areas that have already seen a major restructuring – notably books and music which, in developed markets, are mostly now traded online, and in many cases there is no tangible product involved at all. In these instances, there will be little need for traditional stores in the future. We are nervous about the consumer electronics sector where the internet continues to gain market share, as shoppers use this channel for price comparison. No goods type is, however, entirely immune to the internet, and consumers will be increasingly comfortable buying goods online from across a wide spectrum of categories and price brackets.

Implications for retail sector

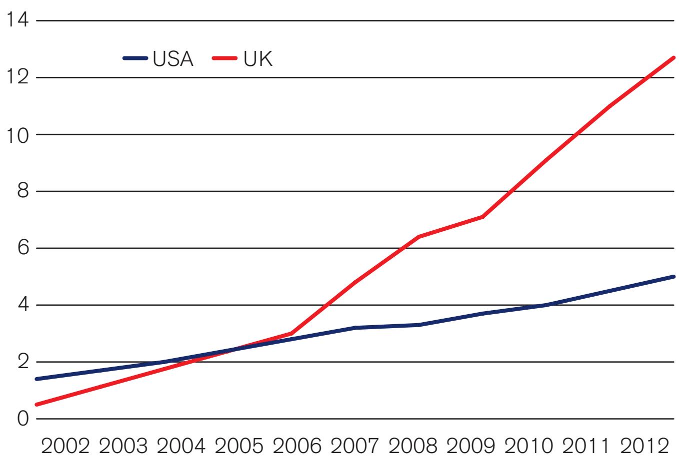
The challenge multi-channel retailing presents landlords is fairly clear cut. Quite simply, retailers need fewer stores. They will seek to consolidate their operations in locations that have critical mass and are able to generate footfall, while servicing other geographies, and maybe even new markets, with the internet. The store will remain important in the multi-channel future, but the role it plays might be quite different. Stores may look more like showrooms for their internet business, or collection points for goods ordered online. This begs the question – even for landlords with the best assets on their books – of how we will calculate rent affordability. While most retailers will tell you the presence of a store strongly supports their online trade, when the transaction happens somewhere in cyberspace how do you prove your role as the landlord in helping that retailer grow his business?

Landlords need to work their assets to ensure they do not only remain viable trading locations in the future, but that they are the destinations customers will go out of their way to visit and where retailers will pay keenly to secure representation. Environment, catering, car parking, accessibility and entertainment will all be crucial in creating an experience that cannot be replicated online. The return on capital expenditure may not be immediately or financially obvious, but will pay for itself in the longer term, through footfall generation and attractiveness to tenants.

Shopping centres need to have a social media strategy, as this is how younger shoppers stay connected and share experiences. Social media: Facebook or Twitter, for example, offers a great tool for monitoring the shopping habits and profile of customers and the scope to influence them. WiFi within shopping centres will be a necessity, not a luxury. Retailers already make smart use of technology to track their customers and understand their behaviour, and landlords need to follow their lead and work more closely with them.

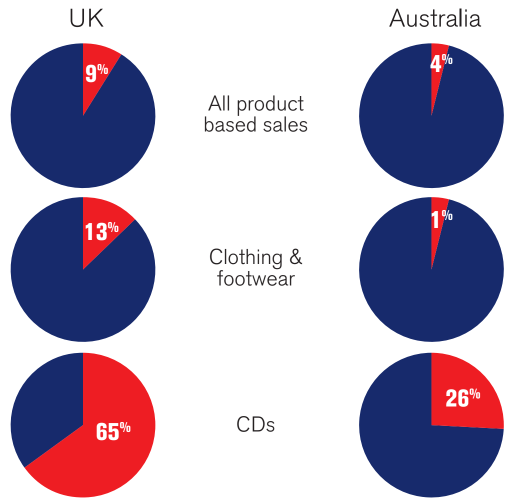
As bricks-and-mortar stores become more like showrooms where consumers go in, play with the product they want, and then go home and buy it online, analysing consumer behaviour will be vital for the landlord in lease negotiations with the retailer in proving the role of the store.

Fig. 2: Online sales as % of total: UK vs. USA



Source: Henderson Global Investors, Datastream, Q4 2012
% of sales accounted for by the internet

Fig. 3: Online sales as % of total: UK vs. Australia



Source: Henderson Global Investors, Datastream, Q4 2012
% of sales accounted for by the internet

The opportunity for landlords, at the premiere locations, is to work with tenants in helping grow their multi-channel business. Stores need to be dynamic, relevant and wired up. Bringing the internet in-store, via e-boutiques, iPad ordering or click & collect facilities, for example, creates vast potential to enhance the shopping experience, improves footfall and most importantly improves sale densities and rent affordability. Retailers can effectively carry a full range of stock in all their stores, irrespective of size, if they have the right digital offering.

We believe that the ongoing diversion of sales to the internet will see a greater proportion of retail sales being channelled through fewer locations. This is a trend you would expect to see as the retail market matures, even without the presence of the internet, but e-commerce will just serve to accelerate this trend. As retailers rationalise their store portfolios, of course an increasing amount of spend will be captured by the internet, but there is also the opportunity for those locations with critical mass to increase penetration of their wider catchment areas.

In terms of location types, town centres probably have the most to lose in the multi-channel future, with their fragmented ownership making it hard to defend against e-commerce. However, major cities and historic locations globally, where there is significant tourist top-up spend, are possibly the most defensive locations. The shopping centre market is likely to be highly polarised with larger schemes and those in the hands of savvy managers performing well, while secondary centres, unless reinvented, seem set to struggle.

Perhaps the greatest opportunity, though, is not for traditional retail assets as we know them, but where retail meets distribution. Strong growth in multi-channel retailing will inevitably put pressure on distribution channels and should ultimately generate a material increase in demand for physical real estate, for the storage of goods before they are mobilised or collected. While the boundaries between store and internet are being blurred, so are the roles of retail and logistics.

Where retail meets logistics

It is becoming clear that e-commerce is not all bad news for landlords and that some segments of the retail market will not only prove more defensive than others in light of these changes, but can even offer traditional property investors an opportunity to capitalise on multi-channel growth. However, to really exploit e-commerce growth, property investors should perhaps turn to another sector altogether – logistics or warehousing. This rather unglamorous, underinvested part of the property market has suddenly, and quite rightly, found itself in the limelight.

"The last mile"

Clearly one of the barriers to growth of e-commerce is the cost and speed of distribution and in particular, the biggest challenge is the "last mile" – that last bit of transportation required to get the parcel to the customer's front door. Packages will often not fit through a standard letterbox and expensive packages need to be signed for, which is an inconvenience for the customer. From the retailer's perspective, the last mile is also where the costs get higher. The marginal cost of fitting one more box into a van to get from a fulfillment centre to an urban area is next to nothing, but the marginal cost of one more stop on a delivery route in that urban area is not.

At present, click & collect is the fastest growing multi-channel retail format in developed markets, and is perhaps the simplest solution to the "last mile" problem. It works well for customers, retailers and landlords. For the customer, it offers the convenience of being able to collect goods at times that suit them. For the retailer, is means passing on some of the cost of delivery to the shoppers, as well as the opportunity to up-sell when that customer is in-store. For landlords, click & collect is a great footfall generator and can often mean the sale is attributed to that store, even though it transacted online.

In the UK, 70% of Tesco's non-food online orders are handled in this way and they are looking to enhance their grocery service offer. Click & collect can pose logistical challenges for pure-play retailers as they do not have a store network from which to offer collection. Many of these retailers have entered into alliances with small convenience retailers or post offices to offer collection points, or have set up collection lockers in shopping centres, on industrial estates or at railway stations. For example, Amazon collection points are now a common feature in UK shopping centres, while in Germany it is reported that 90% of the population live within 10 minutes of free lockers operated by Deutche Post DHL.

Collection points are not generally warehouses, although there are some instances where they are. For example, John Lewis has opened a warehouse which fulfils this role in Exeter in south west England – and if this shopping channel continues to grow, then warehouses play a bigger role.

Shopping centre and retail park owners should be looking at providing click & collect facilities where retailers go, even offering a collection point for a retailer who does not trade from a store, and accommodate collection lockers wherever possible. Such initiatives could be the reason why someone chooses to visit one asset over another.

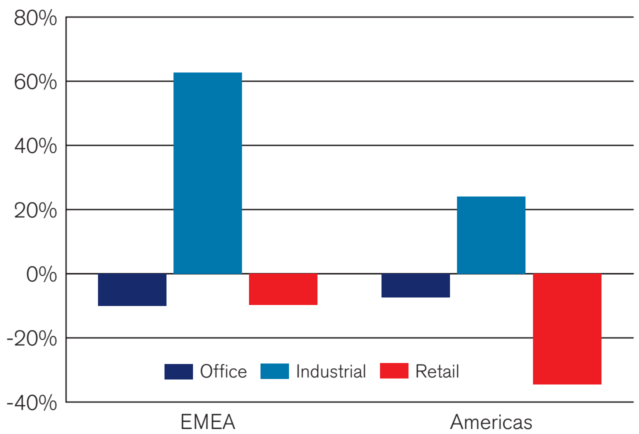
For investors, there would appear to be an opportunity to provide click & collect facilities off-site, perhaps a facility in an out-of-town or warehouse location to complement a shopping centre in the town centre. This is not dissimilar to the e-drive concept that is popular with grocery retailers in France. The idea being that you do not need retail planning consent and are unconstrained by trading hours because the transaction does not happen on-site. The effective sales densities generated by a click & collect facility could be higher than on the high street, but where rents are considerably lower.

Clearly, distribution is a big issue for retailers with consumers expecting increasingly faster response times, plus the ability to return goods. Click & collect is a great solution for retailers in terms of getting customers to pay for the "last mile" and we would expect to see landlords embrace this concept further. But the strongest structural growth in demand from retailers is likely to be for customer fulfillment centres, distribution hubs and dark stores.

Distribution and logistics

The changing shape, size and locational requirements for multi-channel retailers, and specialist internet delivery providers, in response to the boom in online selling is transforming the investment appeal of the logistics and warehousing market. Industrials have always accounted for a small proportion of institutional property investment, offering investors high income returns, but very little scope for rental growth or potential for asset management. Recent transaction activity, however, has shown significant increases in investment volumes for industrials globally, with investors recognising the space demand that online shopping is generating.

Fig. 4: % change in transaction volumes Q1 2013 vs. Q1 2012



Source: Real Capital Analytics, Q1 2013

E-commerce is transforming the way goods are distributed to customers and the way supply chains are working across the world. There is still the need to service existing stores on the high street and in shopping centres but also the need to cope with the level of demand retailers and logistics operators are experiencing from online sales, which are often international.

The growth of online retailing is fundamentally changing the size and shape requirements for distribution centres and where they should be located. Many retailers have outgrown their existing supply chain infrastructure and are having to work out the best logistics model to service the growth of multi-channel retailing. Their strategy will depend on the type of products they are selling, the volume of internet sales handled and the speed at which they seek to deliver.

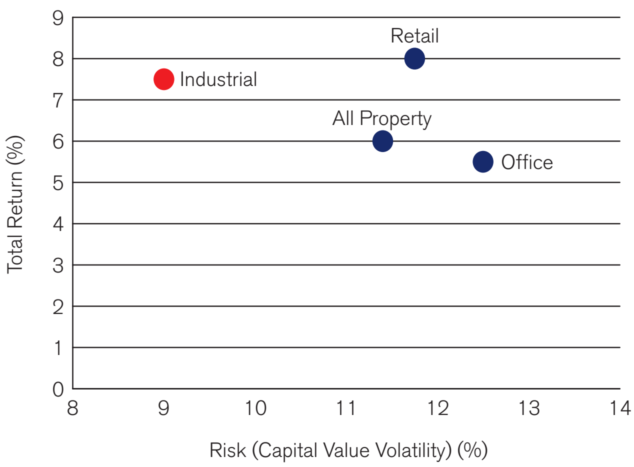
Many retailers are now looking for dedicated e-commerce warehouses, as opposed to trying to service both stores and home delivery from one location. Some retailers will look to despatch all their home deliveries from one customer fulfilment centre, located somewhere centrally, and this might be something in the region of 100,000 sq m – there are few warehouses of this size available in most markets. Most retailers will look to support this central facility with smaller distribution hubs located close to major conurbations. As expectations of speed of delivery rise, there will certainly be more demand for satellite hubs. The larger the country (geographically), and the less densely populated it is, the greater the network of hubs is likely to be.

It is estimated that retailers in Europe will need as much as 25 million sq m of additional logistics space in the coming five years, significantly surpassing previous requirements. Demand in emerging markets, where the supply chain network is less established, could be greater still.

Unsurprisingly, property investment flows into the sector has risen, especially in the most developed online markets and the core real estate economies. Q1 2013 data show that transaction volumes in the industrial sector were up 60% and 25% per annum in Europe and the US respectively, while investment in both retail and offices was down in both regions.

It should be noted that while transaction volumes are up, industrials still account for a modest proportion of overall investment and the continued lack of prime product will continue to hold this back to some extent. Nevertheless, this sector should grow in importance. Industrials, in most markets, should offer investors better value in terms of yield than the other core sectors, plus lower volatility of capital values and high income returns. The yield discount available does not reflect inherent risk and smart investment in this sector should mean occupational risk is modest. Traditionally industrials have delivered very little rental growth, but this could be set to change. With rapidly growing demand and limited supply that meets modern requirements, there could be a structural uplift in rent levels for the right product. And over time, as the sector becomes more liquid and attractive as an investment market, we could see a lowering of equilibrium yields.

Fig. 5: Historic performance by sector



Source: CBRE, IPD 2012
Note: Total Returns, IPD 2000-2011

As with the retail sector, investment in logistics or warehousing should be highly selective and focused on those assets that will benefit from e-commerce growth. The nature of these assets will vary widely according to geography and the type of retail operator. Traditionally, investors have paid keenly to access strong retail covenants on the high street or within shopping centres, a sector where long term occupational demand is waning. Real estate investors looking for those strong covenants today, should perhaps seek to gain their exposure via their allocation to industrials or logistics where we expect a structural uplift in demand.

An additional hook for landlords is the significance of the investment in technology that major retailers and logistics providers are putting into their centres. Huge investments in automation and carefully selected catchment areas mean those retailers are unlikely to be going anywhere soon, providing the landlord with a strong, committed, covenant.

Summary

Technology is having a dramatic impact on shopper behaviour and is rapidly reshaping the retail hierarchy. This means that we need fewer traditional stores and some trading locations will cease to be viable – certainly from an investment perspective, exacerbating the polarisation that already exists across global retail markets. Retailers are being increasingly selective and investors should be likewise. The growth in multi-channel retailing is generating new retail formats that investors need to incorporate into their assets, and those that embrace the digital future should thrive. Investors should continue to target prime, dominant shopping centres for superior long-term outperformance but need to be prepared to work their assets in response to a rapidly changing occupier market.

In light of this rapidly changing occupier market and the global growth in e-commerce, a sector that should be monitored carefully for investment opportunities is warehousing and logistics. The lure should be the potential to access strong retail covenants at high yields, where rents are low, in a sector that should enjoy strong structural growth in demand as opposed to decline. The effective sales densities that could be generated through a strategically located logistics facility could mean we see a structural re-pricing of the sector in terms of both affordable rents and investment yields.

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