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Rethinking
Retail
Lessons from
China

Keppel Capital watch



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Executive Summary

In recent years, the rise of e-commerce has shaken up the retail sector with many asking whether brick-and-mortar retail space will still be relevant in the digital age. China leads the world in the size of its online retail sector and is among the highest in terms of e-commerce penetration rate. In other markets where e-commerce penetration is much lower than in China, there is tremendous room for growth. We believe the trends emerging out of China could give some clues as to how physical retail space can still be relevant.

In China, the cost advantage online retailers (e-tailers) previously enjoyed over traditional physical retailers is diminishing as marketing expenses rise especially in higher-tier cities. While traditional retailers had been going online, there is an increasing trend of e-tailers seeking physical presence. Alibaba plans to take that further under its concept of New Retail, where online and offline are integrated, supplemented with big data analytics and supply chain management.

Retailing is becoming omnichannel. Hence physical retail space still has a role to play in the future, but space usage will have to change to be relevant. Retail malls are no longer for shopping and eating; they have to be lifestyle malls to facilitate the creation and exchange of social, lifestyle and cultural experiences. Mall managers have to move away from the traditional tenant mixes, focus on place-making and events, engage customers more directly on social media, facilitate omnichannel retailers and employ more technology enablers, especially big data analytics. There will be hits and misses, as mall owners invest and learn to cope with the changing landscape

Retail property investors have to be more discerning going forward. Location and catchment sizes are no longer the only key successful factors. The quality of the mall manager and design of the mall in facilitating lifestyle experiences will play a decisive role in the mall's success. The performances of well-managed malls compared with poorly-managed ones, even if well-located, will become more divergent. New retail developments should "leapfrog" the traditional mall concept and instead adopt the new lifestyle and omnichannel concepts to stand out from the crowd of traditional retail malls that are fast becoming obsolete.

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Introduction

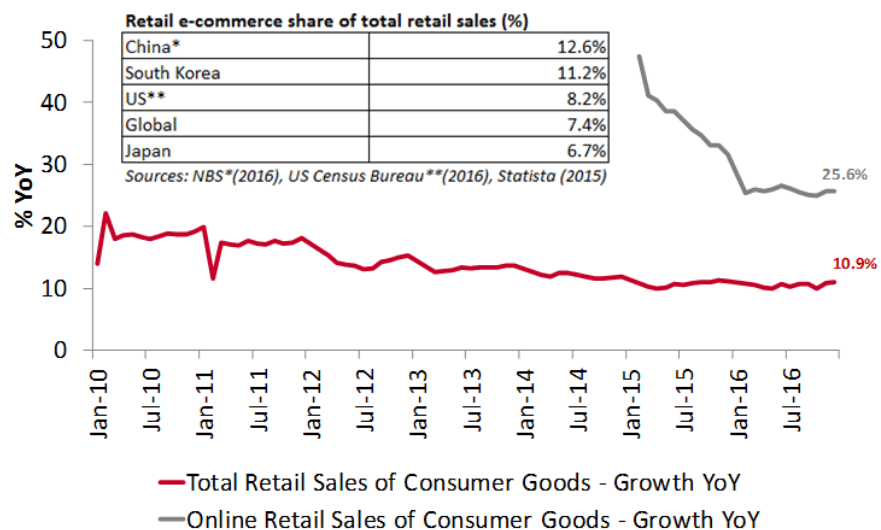
Brick-and-mortar retailers from China to the US have been facing strong headwinds for the past 3-4 years. Fast-changing consumer behaviours and the rapid rise of e-commerce have shaken up the retail scene, leading to concerns that physical retail space may soon become irrelevant in today's increasingly digital world. In this paper, we discuss the evolving role of physical retail space, drawing on examples from the world's largest e-commerce market, China, and the implications on retail property investments.

China leads in e-commerce

Online retail sales growing more than twice as fast as total retail sales

Over the last 5 years, China's e-commerce market experienced tremendous growth to become the world's largest by value today. Officially, retail e-commerce made up 12.6% of China's total retail sales in 2016 (see Figure 1), higher than the 8.2% penetration rate in the US.

Figure 1: China's e-commerce growth rate and penetration rate



Source: Bloomberg

Technological advances such as the introduction of 3G services in 2009, increased adoption of mobile devices and the ease of use of e-payment methods like Alipay and WeChat Pay have been the main catalysts for e-commerce growth. Social media also plays an increasingly important role in shaping consumer demand and driving impulse purchases, particularly through WeChat, the popular all-in-one messaging app with nearly 900 million active users.

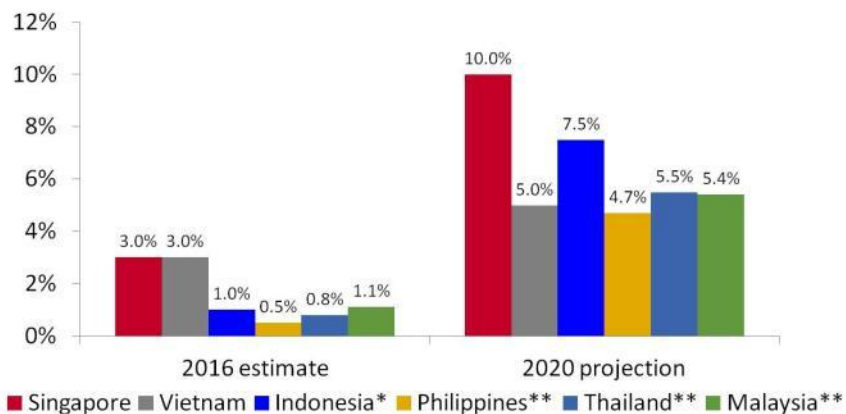
China's online sales growth rate has eased from nearly 50% in 2014 to about 25% in 2016 after coming up from a low base. Nevertheless the growth rate will continue to be strong as e-commerce makes more inroads in the lower-tier cities. Although the proportion of population in the higher tier cities that shops online is reaching saturation levels, there is still room for growth as consumers are no longer just shopping online for convenient access and for low-cost commoditised products. They are increasingly comfortable with

purchasing better-quality products at higher price points online, which means the e-commerce impact is becoming more broad-based. To exacerbate the impact on physical retail is the growth of cross-border e-commerce and overseas shopping, although the former is still subject to some uncertainty before formalisation of policies effective from 1 January 2018.

ASEAN markets have strong growth potential

The growth potential of e-commerce in ASEAN is strong given its very low penetration rate (see Figure 2) and the expected growth in mobile broadband penetration. Incumbents had made little progress in gaining meaningful market share as the region is dominated by fragmented small players and other challenges include high operating costs, lack of IT talent, poor infrastructure and inefficient logistics.

Figure 2: E-commerce share of total retail sales in selected ASEAN markets



* Graph shows midpoint of McKinsey's projection for Indonesia of 7-8% by 2020
 ** For these countries, estimates were for 2015 and projections for 2025

Source: Singapore MTI, Vietnam E-commerce Association, McKinsey, Google/Temasek

However, this is set to change with the entry of e-commerce giants Amazon and Alibaba into Singapore this year and government plans to boost e-commerce penetration. For example, the Singapore government announced an industry roadmap to drive e-commerce growth through innovation and higher investments in skills training in fields like digital marketing and data analytics. In Malaysia, the government intends to make strategic investments in e-commerce players and promote local brands to boost cross-border e-commerce.

The two giant players could be the catalysts for faster growth as they use Singapore as a springboard to make their forays into ASEAN. Given their experience and financial strength, e-commerce penetration in the region is expected to increase more meaningfully than before, though it may not be as rapidly as seen in China due to challenges like the diversity of local preferences and poor infrastructure. Nevertheless, landlords in the region have to be ready to face stronger headwinds and adapt quickly to future-proof their malls.

Relevance of brick-and-mortar

Blurring lines between online and offline

Faced with the threat posed by e-tailers, traditional physical retailers have been increasingly establishing online presences to complement their physical operations. In China, Alibaba's Tmall is the most popular platform for retailers to build brand awareness, with many going on to set up their own standalone branded websites. A growing number of offline retailers have recognised WeChat's vast potential in reaching out to consumers via social media or influencers. These retailers are setting up public accounts to engage directly with consumers and tap on impulse purchases, giving rise to the C2B phenomenon called social commerce.

Conversely, a more recent trend is that of e-tailers going offline. For instance, smartphone maker Xiaomi departed from its online-only business model in 2016 and plans to open 1,000 offline stores in China by 2020.

The advantages provided by physical stores include:

- a) Access to more consumers, including the less mobile savvy;
- b) Showrooming for customers to validate product quality;
- c) Ability to provide personalised, face-to-face shopping experience;
- d) Additional distribution points for last mile fulfilment; and
- e) Enhancement of retailer's image

Online advantage waning as online-offline costs converge

Online retailers (e-tailers) are experiencing rising costs. The average customer acquisition cost of an e-tailer on Alibaba group's platform (i.e. marketing expenses and commissions per active buyer) increased by 31% yoy in 2016 to RMB241, based on Morgan Stanley's estimates¹. That is higher than the average customer acquisition cost of in-store retailers (rental per active customer) of RMB205 in Tier-1 city malls, and converging towards the average of RMB324 in Tier-2 city malls. This suggests that the average e-tailer no longer has a cost advantage over its in-store competitors in the Tier-1 cities.

New Retail could be the future

In October 2016, Alibaba's Chairman Jack Ma introduced the company's concept of New Retail. He said: "The era of pure e-commerce will gradually vanish over the next 10 to 20 years. In its place, online, offline and logistics will integrate to create 'New Retail' – offline enterprises must go online, and online enterprises must go offline, and integrate with modern logistics, using big data."

By integrating online and offline retail with digitalised supply chain and big data analytics, New Retail will create a single value chain. New Retail will hasten the shift from B2C to C2B, where consumers play an active role in shaping demand, feeding digitally to retailers through big data analysis on their needs and preferences via multiple avenues.

¹ Morgan Stanley, "Picking winners amid an improving industry dynamic", February 2017

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Offline is an element of New Retail

The wave of strategic tie-ups undertaken by Alibaba is evidence that physical retail is an important element of New Retail. For instance, Alibaba is in the process of a USD2.5 billion privatisation of Intime Retail, which has a portfolio of 29 department stores and 17 shopping malls across China. Alibaba has also announced a strategic partnership with Bailian Group, one of China's largest retail conglomerates with 4,700 stores across the region. By bringing physical retailers into its ecosystem, Alibaba will be in a better position to influence the transformation of the retail sector and reap economies of scale.

As online and offline retailers converge towards omnichannel strategies, physical stores still have a role to play. We can also expect new retail formats incorporating data technology to emerge.

Implications on malls and landlords

Active mall management will be crucial

"Build and they will come" is no longer a given. Retail space per capita in future should be expected to fall compared to past norms. Particularly in markets and areas where there is excessive retail space based on traditional norms or overbuilding, mall managers must be more proactive to revamp their malls and mode of operation in order to attract shopper traffic and the best tenants.

In line with the trend towards greater consumer engagement, malls are introducing more experiential F&B concepts, entertainment offerings and children-related services and product offerings. However, there is a limit to how much F&B offerings a mall can provide, unless it is a small community or urban mall serving local dining needs. Traditional retailers like generic fashion, department stores and hypermarkets will face more competition from online shopping and be phased out or downsized significantly. There will be hits and misses, as mall owners invest and learn to cope with the changing landscape. Successfully repositioned malls will weather the storm better.

Go large or go local

The size of the mall will depend on the target market. Large regional malls serving a regional catchment area, e.g. within a 5-km radius, or located in prime shopping areas can serve as destination malls. Successful malls with a wide variety of offerings and experiences targeted at families can retain the shoppers for longer periods of time and increase the probability of retail conversion.

On the other end of the scale, community malls serving localised catchments such as the surrounding residential areas (typically within 3-km radius) need not be too large. Such malls should be positioned to serve the immediate needs of the locals, such as dining, downsized supermarket or convenient store and some services. Traditional medium-sized malls that are too large to serve local needs and too small to be destination malls will be caught in between and lose relevance.

Facilitating omnichannel retailers

Malls and retailers are introducing more retail concepts that adopt omnichannel strategies, such as click-and-collect, product showrooms or hybrid stores where customers can make purchases either offline or online. One example of a hybrid store is the O2O fresh foods concept called He Ma Xian Sheng (盒马鲜生) which was first introduced in Shanghai. A consumer can shop for the fresh produce in-store and have it delivered to his doorstep within 30 minutes if it is within a 5-km radius of the store. He can also get the fresh produce cooked and eat on the spot. Payment is made through the He Ma Xian Sheng app and paid electronically via Alipay. The store also serves as a distribution centre for online orders made through the same app within a 5-km radius.

Pop-up stores may become more of the norm than just space fillers going forward. Despite lower rents and short tenures, dedicating a small allocation (e.g. 10%) of a mall's space to pop-up stores serves to inject variety on a frequent basis. It is also an avenue for e-tailers going into omnichannel to build brand awareness and test the market before committing to higher capex and a longer lease term for opening a permanent store.

Sales leakage and change in tenant mix impact rental income

Retail tenants traditionally pay base rents, variable rents (i.e. a percentage of gross turnover) or a combination of both. With more sales leaking online, landlords will require higher base rents going forward or formulate new ways to track online sales. However they will have to earn their keep as the more successful mall managers will have stronger bargaining power. Rental negotiations are likely to come down to convincing the tenant of the benefits of being located within the mall, which in turn deserves a higher base rent.

The mall's rental income may also be negatively impacted as malls undergo changes in trade-mix, losing the traditional higher rent-paying fashion tenants and replacing with lower rent-paying tenants such as F&B, pop-up stores, educational centres and co-working space. With lower rents from tenants, mall managers will have to find other ways to make up for the loss through better usage of space and activities.

Rethinking malls as purely points-of-sales

To differentiate themselves from competitors, mall operators are also placing greater emphases on place-making efforts. Malls are no longer purely points-of-sales, but also a place for culture, lifestyle and experiences. Activity-generating events and offerings, such as exhibitions and concerts, can turn malls into a preferred gathering place, attracting footfalls that can convert to higher in-store sales. One such example is the K11 Art Mall in Shanghai, which had showcased art pieces from masters such as Claude Monet and Salvador Dali.

Embracing tech enablers

Mall operators will have to use technology to directly engage with shoppers and understand them better. Landlords have tried using mall-specific websites and apps to limited effect, but with the rise of social commerce, social media apps prove to be the more effective channel for digital marketing.

Within the malls, landlords will have to increasingly employ technology enablers like beacons and other location-based services first to capture customer behaviour such as number of footfalls and visitor flow, and secondly to push personalised promotional messages and value-added services based on information gathered using big data analytics.

Customer service levels can also be improved with technology, for example using Artificial Intelligence chatbots to answer customer enquiries and in-mall interactive maps to locate stores or car park lots.

Higher operational risks in less developed markets

In the less developed areas such as China's Tier-3 and below cities, income levels and brand awareness are generally lower than more developed ones. Physical retail stores in these cities tend to offer generic, low-priced products with little retail innovation and the mall culture is less ingrained due to the availability of mom and pop stores.

Due to the ease of mobile commerce, the growth potential of online shopping is much stronger in less developed markets as smartphone adoption increases, posing stronger competition to existing physical retailers. Hence, malls in these areas will face higher operational risks until the purchasing powers of the consumers improve and they demand better quality products and services and shopping experiences.

Strategies for investors

Separate the wheat from the chaff

Location and mall management are two key determinants in the likely success of a retail mall. In a survey conducted by the China Chain Store and Franchise Association in 2016, retail tenants ranked these two considerations ahead of rental costs in importance when considering mall options.

Well-located malls easily accessible by public transport and those catering to sizeable or growing population catchments are better-placed to receive higher shopper traffic. Mall management has to be progressive and creative to adapt to the evolution in the retail scene and make use of big data.

Investors will do well working with established mall managers that have strong track records. The difference between well-managed malls and the poorly-managed ones (including department stores and strata-titled malls) will become starker, and the latter could see more closures as they fail to compete effectively. If a mall is well-located but poorly managed, it presents value-add opportunities for investors if a stronger manager takes over the operations.

Matured markets less risky

Well-positioned malls in the more developed cities will be relatively resilient to the e-commerce impact, due to the more ingrained mall culture in the population, higher income level and propensity to spend and better developed transport network.

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New mall developments in emerging commercial or residential clusters are best-positioned to incorporate new lifestyle and omnichannel concepts from Day One to differentiate themselves from the crowd. The caveat is that cities which are oversupplied with retail space in the first place will remain challenging in the medium term until the overcapacity is significantly absorbed or more irrelevant space withdrawn.

Conclusion

The rise of e-commerce has catalysed the structural transformation of the retail landscape and landlords are being forced to adapt quickly. The world's largest e-commerce market China has offered some clues that brick-and-mortar is not dead. Convenience and pricing attract consumers, regardless of whether the channel is online or offline. Physical space thus still has a role to play in an omnichannel landscape, albeit in a different way from the past.

Landlords have to seriously rethink about malls as not just points-of-sales, but more as a place to build and enhance customer experiences and meet their desire for convenience. If Alibaba's vision of New Retail represents the future, landlords have to use technology to their advantage to incorporate big data analytics and supply chain management. Mall managers have to engage more directly with consumers by upgrading customer service and creating more activity-generating spaces and events to attract footfalls. The retail evolution in China gives other Asian markets a glimpse of things to come, particularly as Amazon and Alibaba prepare to enter ASEAN. Landlords should quickly adapt and future-proof their malls.

For investors, location fundamentals such as proximity to transport nodes and sizes of population catchments remain key. Experienced and creative mall management is now an additional fundamental success factor. Investment opportunities can arise in the form of well-located malls which are poorly-managed, particularly in the more matured markets. New malls in emerging commercial or residential clusters are best-positioned to stand out from the crowd by incorporating new lifestyle and omnichannel concepts from Day One.

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