Keppel Capital
ResearchCOMMENTARY

25 September 2018

Retail Real Estate: Brick-and-Mortar's Silver Linings

- New Retail in China is evidence that physical retail remains relevant
- Australia's omnichannel push a much-needed retail experience upgrade
- Retail malls must keep evolving with customer experiences in mind

Taking stock of retail

In this paper, we take stock of how online and offline retail in China have evolved and impacted physical retail space over the past year since our last paper titled *"Rethinking Retail: Lessons from China"*. We then compare it with Australia, the latest battleground for Amazon, whose entry potentially threatens to shake up the retail scene there.

China: Blurred retail lines

Online retail sales of physical goods continued to show robust growth in China, rising by 29.8% yoy in 1H2018, compared with a 9.4% yoy growth in total retail sales of consumer goods. Online retail penetration rate reached 17.4% of the retail market as a result. Native e-commerce retailers are accelerating the expansion of their physical footprints. This convergence towards an omnichannel strategy will continue as we see more examples of New Retail taking shape.

Pioneers of New Retail

Alibaba founder Jack Ma first introduced the concept of New Retail in October 2016. Since then, Alibaba has been going on an offline offensive. The most visible and aggressive example is in the fresh foods space. Alibaba's Hema supermarket, first opened in Shanghai in Jan 2016, now has 66 operational outlets across China's Tier-1 and -2 cities. Alibaba's goal is to open 2000 branches over the next three to five years. By combining physical stores with "mobile-first" e-commerce elements, Hema aims to make each customer's path-to-purchase as seamless as possible. Besides Hema, Alibaba is also working with Sun Art Retail to leverage Alibaba's digital ecosystem and big data to transform Sun Art Retail's network of over 400 hypermarts into smart stores.

Alibaba's main rival, JD.com (JD), plans to roll out 500 high-tech supermarkets of its own over the next five years under its brand 7Fresh. JD is also collaborating with two other supermarket giants, Walmart and Yonghui, to share resources and big data to drive both online and offline sales and provide home delivery services. These expansion plans bode well for demand for physical retail space and also illustrate how physical stores are doubling up as distributed fulfilment centres for online sales.

New Retail also extends to other segments of retail. For instance, Alibaba expanded into home furnishings in collaboration with home improvement chain Easyhome, with a view of having more than 600 retail stores by 2022. JD is partnering local mother and baby care brand Beiquan to open 5,000 smart stores across China within the next three years, leveraging JD's big data and smart logistics capabilities.

Physical and virtual realms can be symbiotic

The benefits of converging online and offline retail strategies can be best observed from China's shopping festivals. A key feature of Singles' Day (11 Nov) in 2017 was online-to-offline (O2O) integration, as retailers extended the same online discounts to offline customers and introduced smart technologies such as augmented reality (AR), facial-

recognition payments and scan-and-deliver services to enhance the customer experience.

This year, JD's 6.18 (1-18 June) Shopping Festival shed further light on how O2O can be a boon for traditional retailers. For the first time, JD worked with half a million physical stores in its promotional campaign. Sales achieved by Walmart and Yonghui stores in this year's 6.18 were four and five times the amounts last year respectively. This was enabled by leveraging JD's Daojia crowdsourcing delivery platform, which allows customers to place orders via the app and orders are fulfilled out of the partners' physical stores for delivery within an hour. Shortly after, Walmart announced a USD320 million investment into Dada-JD Daojia as the former seeks to enhance its omni-channel footprint and deliver better O2O experience to customers.

A key motivation behind e-tailers expanding into the physical realm is that margins for e-commerce are not necessarily higher than traditional retail. For instance, operating margins for Vipshop, a pure-play online discount retailer, compressed from 4.8% in FY2016 to 3.7% in FY2017, mainly due to increased promotional activities. E-tailers face high customer acquisition costs amid stiff competition and many now see omnichannel strategy as the preferred model to expand customer engagement, improve customer retention rates and maximise customer lifetime values.

Malls are also becoming O2O. Tencent announced a joint venture with mall owner Wanda in May 2018 to transform the latter's properties into smart shopping malls and drive online traffic through mobile platforms like Tencent's ubiquitous WeChat. Alibaba opened its first wholly-owned 40,000 sqm shopping mall in Hangzhou called "More Mall" in April 2018, which showcases a number of its O2O concepts. These examples underline the relevance of brick-and-mortar even in the era of New Retail.

Australia: Amazon effect

Australia became Amazon's latest port-of-call, following the launch of Amazon.com.au in December 2017. Even though online retail penetration in Australia is relatively low by advanced economy standards at 8.4% as of June 2018 (TTM)[1], its growth rate of 17.7% yoy was significantly higher than the 2.5% yoy growth in total retail sales. Amazon's entry has brought some consternation to Australia's incumbent retailers, landlords and mall owners. Is Australia set for a huge retail shakeup?

Wake-up call for incumbents

Australia has a fairly unique retail market, with most of its retail segments operated by oligopolies. Woolworths and Wesfarmers are two of the largest groups, with operations in supermarkets (Woolworths and Coles), discount department stores (DDS) such as Big W, Target and Kmart and liquor outlets like BWS. Department stores (DS) have traditionally been mainstays in the retail scene and are predominantly occupied by the duopoly of David Jones and Myer.

Based on Citi's estimates, the DS and DDS categories are major tenants in retail malls, together occupying 25% of all shopping centre floor space (6 million sqm of GLA) in 2017. However, some DS and DDS have been under sales and margin pressures in recent years, even before Amazon's market entry. Myer, for example, has reported declining net profits every year since 2011. Among the DDS, Big W and Target have negative EBIT margins and are expected to undertake store space rationalisation, with Target confirming it will reduce its overall floor space by 20% by 2023 and revamp its product range. Kmart is one of the few DDS that is still experiencing healthy comparable sales growth. Overall, Citi expects DS and DDS to reduce their footprints by 15% (~1 million sqm) over the next 10 years.

Besides facing increased competition from online shopping for commoditised products, other key reasons for the general drop-off in DS and DDS' sales include their inability to keep pace with changing customer preferences, a lack of product differentiation and poor value proposition. All these while the costs of doing business continue to rise.

Going the omnichannel way

Australian retailers have tried to adopt online sales strategies for years. Early attempts were multi-channel rather than truly omnichannel, i.e. the

[1] NAB Online Retail Sales Index (NORSI), June 2018

channels operated as distinct sales outlets. The lack of integration in inventory and supply chain management often resulted in poor customer experiences.

Unlike in China where the omnichannel revolution is driven by internet giants, Australian retailers have taken the initiative to increase investments to overhaul their online infrastructure more recently, attempting to create more customer-centric, truly omnichannel experiences. These also include enhancements to click & collect, returns and delivery services. As of June 2018, Woolworths reported a more than 30% yoy growth in online sales for its Australian foods business, while Myer reported a 49% yoy growth in online sales for 1H2018. Citi estimated that online penetration for the major Australian retailers remain relatively low at between 2% to 7% in FY2017, suggesting room to grow to catch up with the national average.

Australia is characterised by low population density, even in the key metro areas like Sydney and Melbourne, thus lowering logistical efficiencies. This is where physical retail space can play an enabling role in retailers' omnichannel strategies. For instance, click & collect effectively passes the last-mile burden to the customer and increases the likelihood of additional incidental purchases as the customer picks up the items in-store. Given that a significant proportion of goods sold online typically gets returned (~30% in the US[2]), these collection points can double-up as return points, lowering the cost of reverse logistics and makes the returns process less stressful for consumers.

Leveraging the store network, online orders can be fulfilled by the nearest outlet rather than a centralised fulfilment centre which may be located some distance away from the customer, similar to what Hema is doing in China. The store network can be an incumbent's moat against Amazon, which currently only operates out of a fulfilment centre each in the suburbs of Sydney and Melbourne.

Taking a cue from Canada

The Canadian retail scene could give better insights into how Australia's is likely to evolve, as the two countries have similar retail markets in terms of retail sales per capita, low population densities, relatively high concentration of incumbent retailers and similar e-commerce penetration rates (9% of Canada's total retail sales[3]).

Amazon's Canadian platform has a 7-year head start over its Australian counterpart, but its product range remains limited relative to the US one. Even though Amazon's first Canadian distribution centre opened in 2010, the rise of e-commerce penetration in Canada remains slower than in the US and the UK. The sprawl of the metro areas and long distances between major cities are key logistical challenges, both in terms of costs and timeliness.

Nonetheless, Canadian mall owners are not standing still. The top malls are creating more convenient, enjoyable and entertaining shopping experiences. Landlords are bringing in more F&B tenants and international brands, such as UNIQLO and MUJI. Consequently, the average sales productivity of non-anchor tenants in Canadian malls have been improving every year since 2014[4].

Landlords need to adapt quickly

It is clear that neither offline-only nor online-only retail models is the most optimal. As more retailers become omnichannel, retail mall owners must adapt to keep pace with the industry transformation.

1) Be omnichannel-ready. Retail malls can facilitate their tenants' O2O integration by catering more space for click & collect, collection points for online returns and potentially reconfiguring loading bays to facilitate ship-from-store logistics. Landlords' use of technology must increase, such as providing free wi-fi access, leverage location-based services to push personalised marketing and study footfalls and be prepared to share big data with their tenants.

2) Customers come first. Landlords can create a customer-centric environment within their malls so that shoppers want to spend more time and money in it. Placemaking and experiential offerings like

[2] https://www.invespcro.com/blog/ecommerce-product-return-rate-statistics/

[3] www.eMarkerter.com

[4] Retail Council of Canada

theme parks, events, and exhibitions, can serve to attract footfalls into the mall. This can bolster the showrooming effect for retailers and the probability of upselling and increase conversion rates for impulse buys.

3) Proactive retail asset management. This requires stronger emphasis on the customer. Besides non-discretionary retail tenants like supermarkets, landlords can diversify their tenant-mix with more lifestyle and service offerings like co-working spaces, education centres, medical centres and casual dining to reduce the concentration of merchandise retailers. In markets like Australia, where international brands remain under-represented at less than 30% of the market, landlords can differentiate themselves by bringing in new-to-market brands and concepts.

4) Asset enhancement initiatives (AEIs). Landlords should continue to optimise productive use of space. Like in China some 10 years ago, DS and DDS remain major anchor tenants in Australia's sub-regional and regional malls, but their layouts and offerings are less appealing to today's shoppers and often result in low sales productivity. With retailers like Target announcing store rationalisation plans, this presents an opportunity for landlords to work with them to reduce their floorspaces in favour of smaller-format specialty stores which have higher sales productivity and hence the ability to pay higher rents.

Conclusion

Online sales will continue to grow stronger than offline sales, but that does not signal the impending demise of physical retail space – brick-and-mortar just needs to keep evolving to remain relevant. Landlords have an integral role to play in facilitating the omnichannel experience provided by the retailers. Importantly, they have to offer customers a more enjoyable overall experience from their time spent within the mall. This will require greater use of technology, creativity and proactive asset management. Landlords and mall owners that can do this well and differentiate themselves from the crowd can eventually emerge stronger from the ongoing retail transformation.

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