MaxCap
Investment Management

MAXCAP AUSTRALIAN RETAIL MARKET UPDATE

JULY 2021

AUSTRALIAN RETAIL MARKET UPDATE 2021

OVERVIEW

- The Australian retail sector experienced profound disruption over 2020 as lockdowns and border closures led to fundamental shifts in trading conditions and consumer behaviour.
- Retail spending increased, particularly in sub-sectors such as groceries and household staples ("non-discretionary goods") however, consumer demand for "discretionary goods", such as apparel, footwear and entertainment fell as declining employment and wages growth reduced consumer confidence, decreased disposable income and increased savings rates.
- Shifts in discretionary retail spending in some states was greater than others, as consumers redirected travel/holiday spend towards homewares, clothing and home improvement.
- Over the short-to-medium-term, retail real estate (new and established) is expected to perform most strongly in assets primarily exposed to non-discretionary trade, such as neighbourhood shopping centres or large format retail centres, which are generally more attractive due to their relatively stable source of income, rental growth, resilience and valuation preservation.
- As the COVID-19 vaccination program continues to rollout and the domestic economy continues to stabilize over the medium to long term, consumer sentiment is expected to improve and lead to recovery in discretionary retail over the medium-to-long-term.

RETAIL COMPOSITION

The Australian retail sector is generally defined as comprising the following sub-sectors.[1]

TABLE 1 - THE AUSTRALIAN RETAIL SUB-SECTORS

ASSET TYPE	DESCRIPTION	% OF TOTAL GLA
Regional	At least one full line department store, at least one full line discount department store, at least one supermarket and a minimum of approximately 100 specialty shops	40.4%
Sub-Regional	Incorporating at least one full line discount department store, a major supermarket and approximately 40 specialty shops	22.3%
Neighbourhood	Comprising a supermarket and approximately 35 specialty shops	19.7%
Large format retail	Typically consists of medium to large sized shopping centres dominated by bulky goods retailers (furniture, white goods and other home wares), occupying large areas to display merchandise and warehousing. They can often contain a small number of specialty shops	11.6%
City centre	Arcade or mall development within a major central business district	4.0%
Other	Includes themed, market and outlets and accounts for c. 2% of all retail by GLA.	2.0%

On a square metre basis, retail real estate is dominated by regional and sub-regional shopping centres (>60% of the GLA) servicing wide, multi-suburb catchments. Assets are generally owned by REITS or major institutional investors (such as superfunds) reflecting the sector's high capital values ($100m+) and relatively intensive management requirements (comprised of a high number of speciality tenants).

Neighbourhood shopping centres (the most common type of retail asset by number: 1,120 of 1,630 total centres[2]) and Large Format Retail centres generally service smaller, defined catchment areas generally owned by mid-market private investors or syndicates reflecting the assets' attractive investment characteristics: generally lower capital values ($10m-$50m), attractive lease covenants to long-term anchor tenants (such as major supermarket chains) and less intensive management requirements.

DEMAND

Increased non-discretionary expenditure from COVID-19

Aggregate retail turnover growth was relatively stable at c. 3.5%[3] throughout 2019, declining to 2.0% over 2020 as a result of impacts from COVID-19.

Despite the overall decline, the impacts of COVID-19 in 2020 were not uniform across all sub-sectors with declining employment, wages growth and consumer confidence shifting consumer behaviour toward increased household goods and food spending ("non-discretionary" goods) and away from fashion and department stores ("discretionary" goods):

TABLE 2 - AUSTRALIAN RETAIL SPENDING

Non-discretionary	Household goods	+6% ▲
	Food	+9% ▲
Discretionary	Fashion	-2.5% ▼
	Department stores	-4% ▼

FIGURE 1 - IMPACT OF COVID-19 BY RETAIL SUB-SECTOR

Source: MaxCap Research and CBRE[3]

As a result of these trends, CBD stores and regional centres (most heavily exposed to these discretionary goods and with greater reliance on smaller specialty tenants) experienced the greatest fall in sales and capital values, whereas large format retail and neighbourhood shopping centres (weighted toward non-discretionary retail and offering more attractive lease covenants) experienced increased interest in both consumer demand and capital values. Consistent with consensus estimates, we expect this trend to continue over the short-to-medium term as current conditions persist.

The continued rise of online sales

The ongoing shift in retail spending away from traditional 'bricks and mortar' shopping to online platforms has accelerated from COVID-19, with lockdowns and social distancing measures materially increasing e-commerce penetration rates (the proportion of online retail sales to the total amount of total retail sales for a given period).

ABS data[4] reports growth in online shopping of +45% for the 12 months to December 2020 spiking in April 2020 following the initial wave of lockdowns and social distancing (Figure 2). Online shopping now accounts for 9.38% of total retail spend in Australia (or 16.3%[5] excluding cafes, restaurants and takeaway food).

Despite recent growth in penetration rates, online sales in Australia) remain below peer economies including:

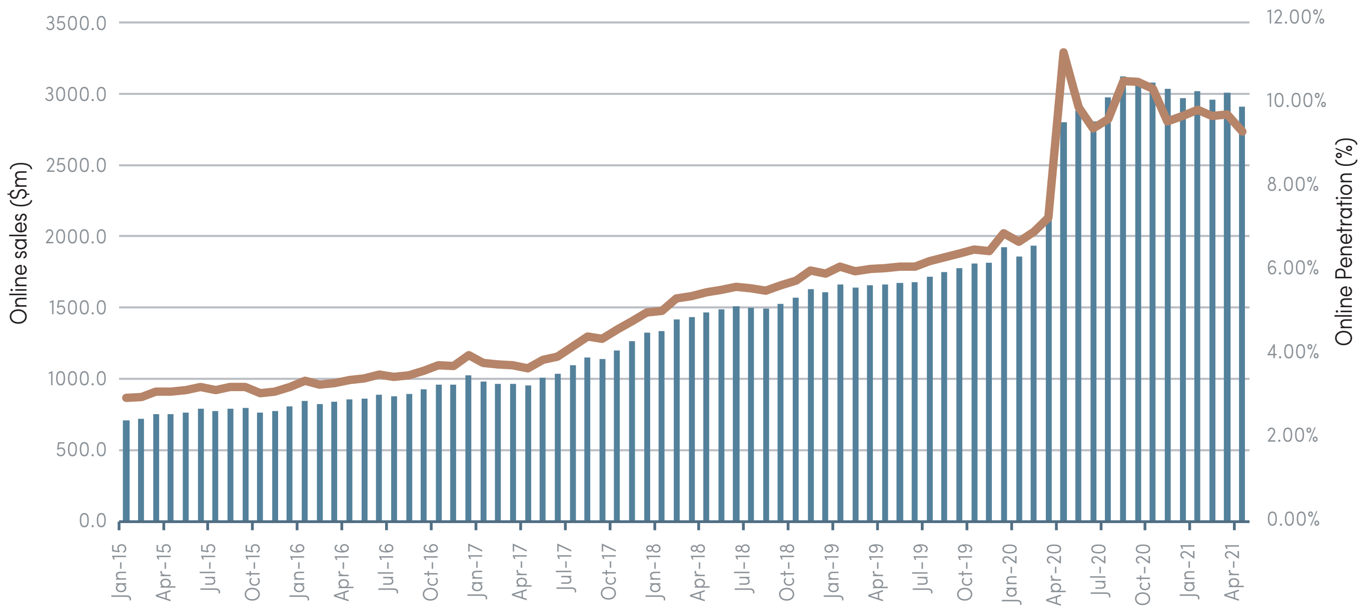
- North America, which has an online penetration rate of 19.5% as at Q1 2021.[6]
- The United Kingdom, which has an online penetration rate of sitting at 29.4% as at Q1 2021.[7]

Despite structural differences to the US and UK (such as sparser population density), we expect this trend away from traditional 'bricks and mortar' retail toward online sales to continue. Consistent with this outlook, CBRE[3] forecasts that by 2026, online penetration will be approximately 20% and closer to 25% by 2030.

The shift to online shopping, particularly for discretionary goods (already experiencing depressed demand), has seen further reduction in demand for discretionary retail real estate. The relatively fragmented nature of fashion, high-end apparel, footwear and homewares retailers also results in increasing competition and exacerbates this impact of online penetration, further weakening lease covenants exposed to tenants in this space.

Australia's major non-discretionary retailers (such as Coles, Woolworths and Bunnings) benefit from relatively high market shares within their sub-sectors and greater financial strength to establish and maintain both an online sales platform and 'bricks and mortar' retail outlets. As such, we expect profitability of these businesses to be maintained and to remain attractive from a lease covenant perspective. The introduction of 'dark stores' (non-customer facing fulfillment centres, via a warehouse/logistics centre; to service online orders) is not expected to materially impact this outlook,

FIGURE 2 – ONLINE RETAIL SALES GROWTH



Source; ABS Online Sales Data[4]

with in-person shopping expected to remain prevalent (e.g., allowing customers to inspect and choose fruits and vegetables) and operators generally undertaking significant market due diligence on customer catchments to avoid cannibalising existing stores.

Based on these trends we expect further demand for development of smaller neighbourhood shopping centres, warehouses and dark stores (to service online demand), and bulky good home improvement centres.

SUPPLY

Consistent with expected demand drivers, we see key opportunities in new supply in the following sectors:

- **Non-discretionary**

  Together with refurbishment of existing non-discretionary assets in existing population centres, we see the greatest value of new supply as population growth resumes and new population centres are established – particularly for outer, regional suburbs requiring new supermarkets, liquor stores, hardware and bulky goods (neighbourhood shopping centres or large format retail centres).

- **Discretionary**

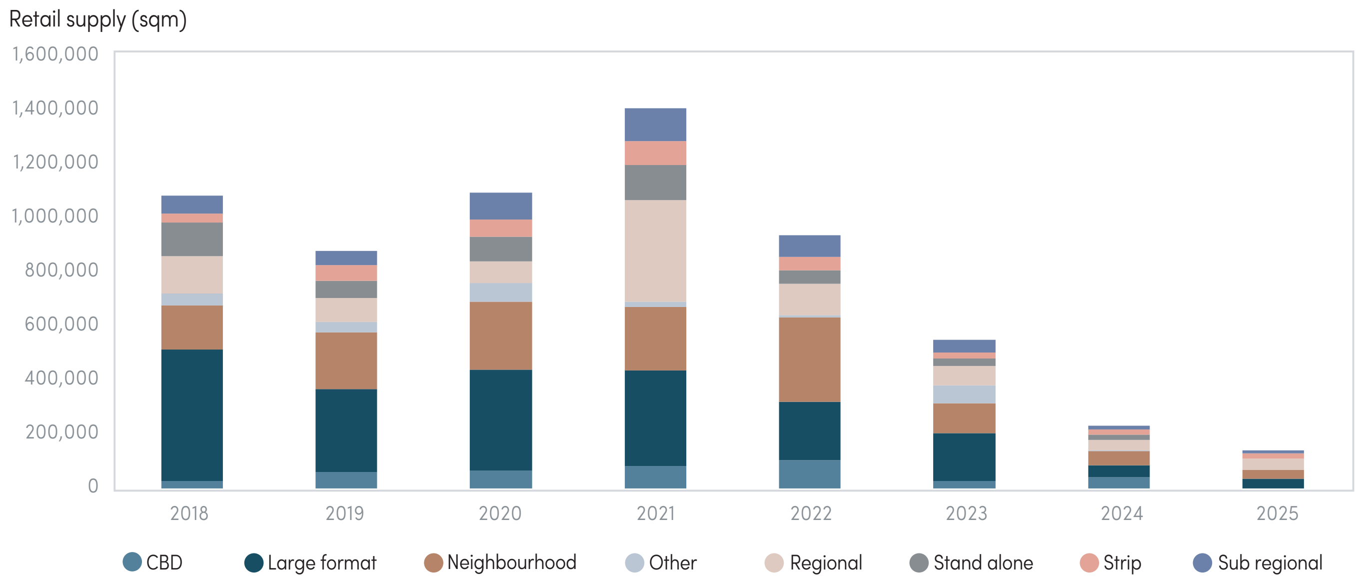
  The convenience of online grocery shopping via 'click and collect' or delivery is likely to appeal to those living close to the CBD, in higher density mixed use accommodation and in close proximity to universities and other public amenity. Per Census 2016[8] data there is now around one occupied apartment for every five occupied separate houses in Australia - compared with one to every seven in 1991. This trend further supports the expected supply of dark stores and logistics assets, with UBS forecasting[9] a potential of double the historical 10-year average by 2023.

  As high-density apartment living continues to rise, particularly amongst urban areas, it is becoming increasingly commonplace for apartment buildings to include food and beverage outlets, restaurants, cinemas, gyms and other experiential retail outlets for residents and local community members. Mixed-use developments of this nature are therefore expected to present an attractive supply opportunity.

  Conversely, consistent with the demand outlook, supply of department stores and CBD retail is expected to decline.

Consistent with this outlook, CBRE research[3] indicates retail supply reached a peak in 2021 with forecast declines in supply expected to be greatest in regional, subregional and CBD assets with proportionate growth in the supply of neighbourhood and large format assets (Figure 3).

FIGURE 3 – RETAIL SUPPLY FORECAST



Source: MaxCap Research and CBRE

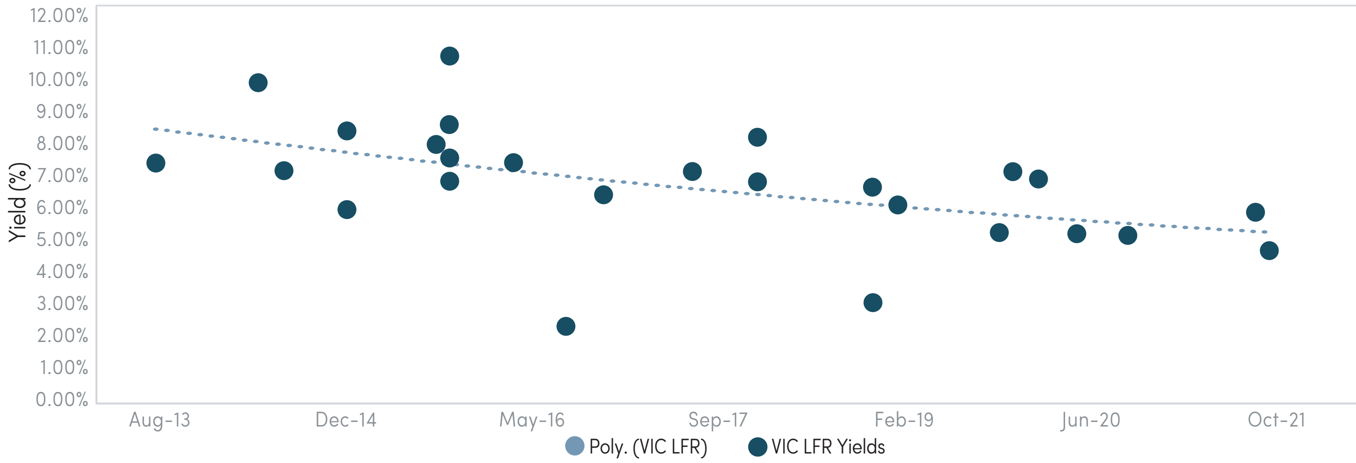
RENT AND VALUATIONS

Consistent with our central thesis (changing demand fundamentals favouring mid-market assets with non-discretionary lease covenants), CBRE reports[3] as at Q1 2021:

- Neighbourhood centres and large format retail – continuing rental growth and downward pressure on yield curves (Figure 4)
- Regional and sub-regional shopping centres – declines in rental growth

In addition to the consumer demand benefits to large format retail, Aventus (Australia's largest owner, manager and developer of large format retail centres) reported[10] the relative affordability of large format retail centres and neighbourhood shopping centres compared to other sub-sectors, increasing the stability of tenant profitability and providing upside scope for rental growth.

FIGURE 4 – LARGE FORMAT RETAIL YIELD TREND, VICTORIA

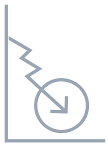


Source: MaxCap Research

OUTLOOK

Retail sector outlook remains positive for refurbishment of well-positioned neighborhood assets and construction of new neighborhood assets and large format retail

Weight of capital seeking steady income profiles with limited exposure to discretionary retail



Further downward pressure on yields, particularly for large format retail and bulky good centers which have become a more attractive retail asset

MaxCap has observed that the discretionary component of the retail market is far more subject to fluctuations and is substitutable with online shopping, whereas retail assets with an income profile more weighted to non-discretionary goods is seeing more consistent and stable growth and is more resilient. As online penetration rates continue to grow, MaxCap expects that non-discretionary retail will be able to weather the change.

From a portfolio management perspective, and noting institutional investor's fixed allocation to retail assets, we see a continued flight from assets which are underperforming to these more resilient assets over the medium-term, further compressing yields and increasing valuations.

As such, we expect a concentrated level of Large Format Retail development or Neighbourhood Shopping Centres, noting the downward trend in cap rates, attractiveness from an investor perspective and rise in e-commerce warehousing (particularly in new population centres in outer-city areas). From a CRE debt investment perspective, these are the most attractive opportunistic investment proposals, with income upon completion to be underpinned by major retailers and government services.

Conversely, CBD, regional and sub-regional size assets have become relatively less attractive due to declining demand. However, the selective repositioning of these types of assets presents for a value-add debt investment opportunity. Noting regional assets are typically tightly held by A-REITS (Scentre Group, Vicinity, GPT, Stockland, etc.), MaxCap's participation in these sub-sectors may be the funding of the development from a carve-off of excess land, or the funding of development over air rights in the form of a mixed use development consisting of smaller format retail or collection hubs.

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