TWM Research Note - Focus on Retail

October 2018

The Grocery and Retail Warehouse Sectors

1. Introduction

Activity in the Irish Investment market has continued to be buoyant with turnover this year expected to be over €3bn. Rental values in the office sector are almost at pre-crash levels however the retail sector continues to lag behind. Investor sentiment towards the retail sector has been weak given frequent negative news on store closures, in Ireland and abroad and the impact of online shopping etc.

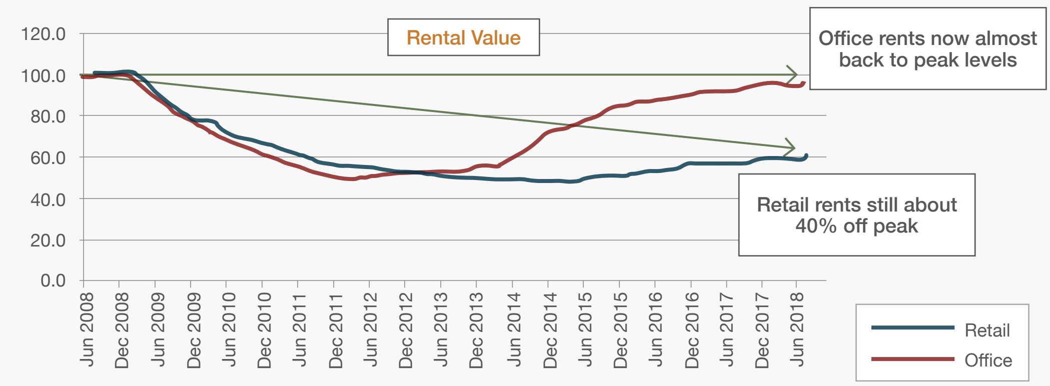
However, should all retail be tarred with the same brush? Are there subsectors of the retail market that have positive drivers that could buck the trend of the overall retail sector?

This short report looks specifically at the Grocery and Retail Warehouse sectors to see if there are different influencers for those sectors that might provide scope for differentiation for investors in these areas.

2. Rental Values – Office V's Retail

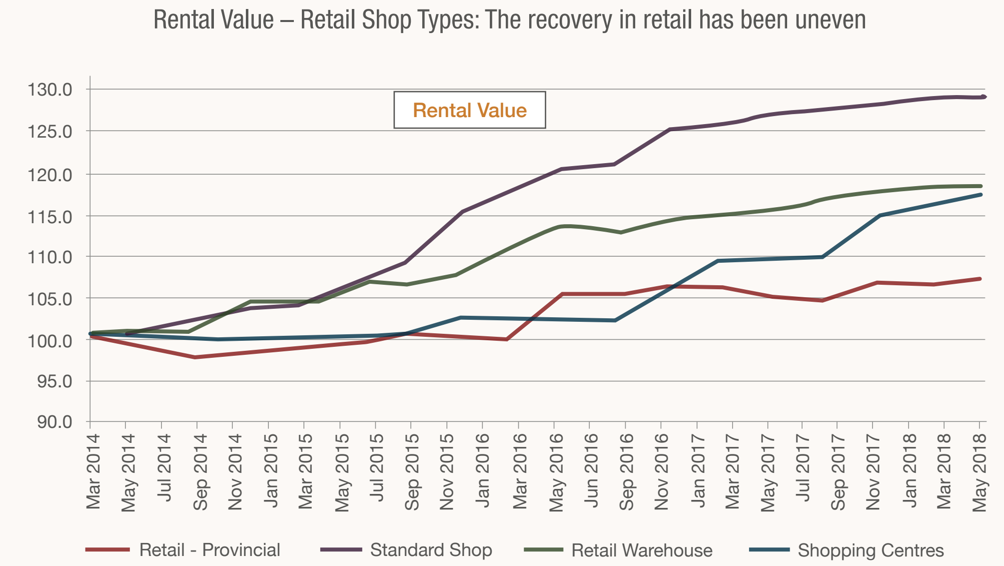
Rental values in the retail sector had grown from June 1998 to the pre-crash peak, by almost 150% compared to approximately 94% for offices (based on MSCI/IPD data).
Following the crash, retail rental values fell by 50% with office rents falling by just under 50%.
The recovery has been strongest in the office sector, with rents up 87% from the bottom of the market compared to just over 22% for retail.
As a result office rents are now less than 4% off their peak, with retail lagging behind and still about 40% off their highest values.

Rental Value – Retail and Office Sectors: The decade of the fall and rise



Base: June 2008 = 100. Source: MSCI/IPD, Irish Digest, Quarter 2 2018

3. Recovery of the different retail types



Source: MSCI/IPD, Irish Digest, Quarter 2 2018

Rental values for standard shops have increased by almost 30% from the bottom of the market (early 2014) but by only about 17% for retail warehouses and shopping centres. Provincial retail has recovered by less than 10%.

4. Drivers of the retail sector

Recovery in the retail sector is heavily contingent on general economic growth and increased consumer spending. The key questions in determining consumer demand which underpin the retail sector include:

Do potential customers have jobs? →	**Employment**
Are they earning good wages? →	**Earnings**
Are they confident about the future? →	**Consumer Sentiment**
Are they ready to spend? →	**Spending versus Saving**

In addition, population change will impact the overall level of demand

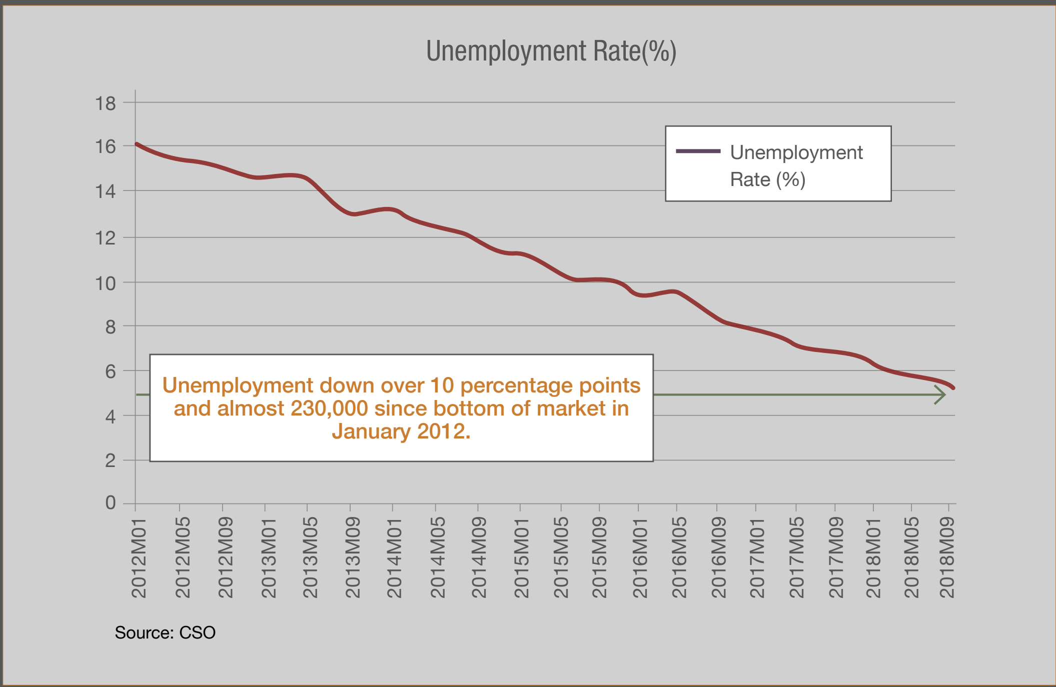
4.1 Employment and Unemployment

Source: CSO

Employment has risen by almost 128,000 in the past two years, by almost 74,000 in the past year and by over 360,000 since the bottom of the market.

4.1 Employment and Unemployment (continued)

The unemployment rate stood at 16% in January 2012. The chart below shows the unemployment rate from January 2012 to September 2018.

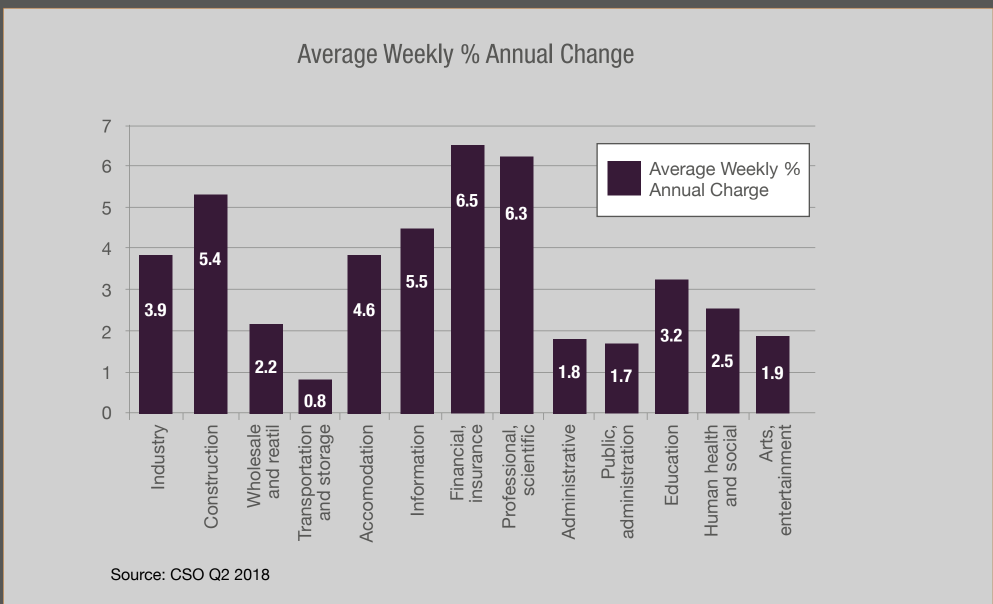


Unemployment has fallen to 5.4%, down 1.1 percentage points in the year and now stands at just below 130,000, down almost 27,000 in the past year and 227,000 since the bottom of the market in January 2012.

4.2 Earnings

Average weekly earnings rose by 3.3% in the year to Quarter 2 2018. They rose in each of the 13 identified sectors indicating that wage growth is now being spread more widely across the economy.

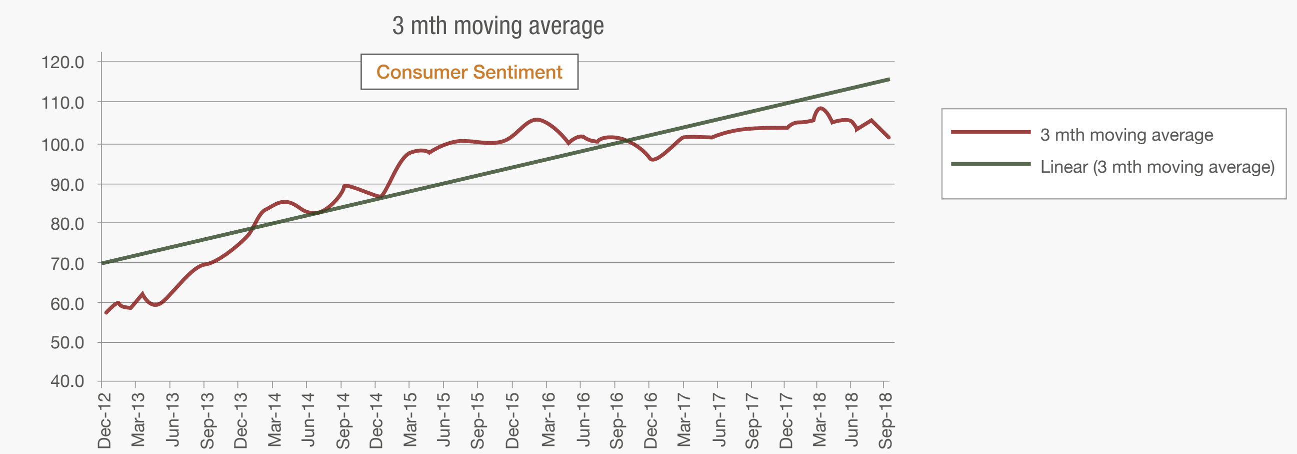
This means that more workers are benefiting from increases in earnings.



The largest increase was in Finance Insurance and Real Estate Services where earnings grew by 6.5% in the 12 month period, closely followed by Professional, Scientific and Technical Activities and Information and Communication at 6.3% and 5.5% respectively.

4.3 Consumer Sentiment

The Consumer Sentiment Index is now almost 75% above the level of end 2012. The Index can be volatile on a monthly or even a rolling three-monthly basis and fell in September 2018 to its lowest point since December 2016. The authors of the Index Report attribute the fall to some concerns about Brexit, rising energy prices, housing costs and little optimism about the Budget, which was imminent at the time.
A noteworthy recent feature of the Index is the decline in the 'Major Purchasers' sub-index which is down over 4.5% in the year. If sustained this could have implications for demand for large ticket items. However, the Index has been on a strong upward trend in the past six years as shown below and the short term movements may not indicate a change in the broader trend.



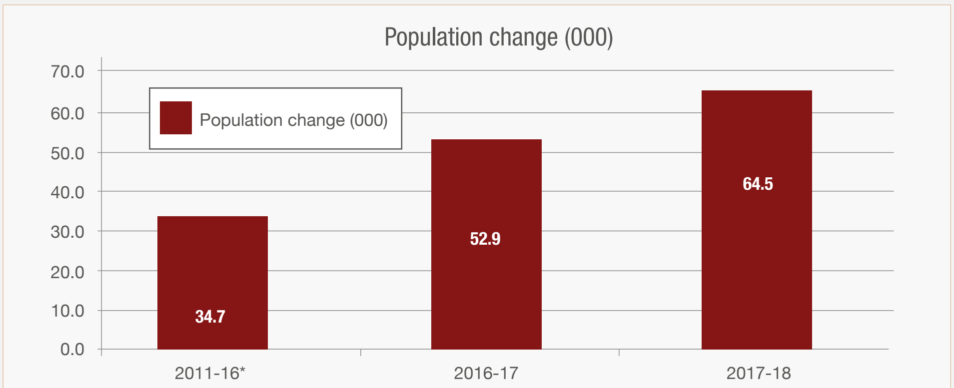
Source: KBC Bank/ESRI, September 2018

4.4 Spending versus Saving

The Bank of Ireland/ESRI Savings Index was almost 2% above its October 2017 base of 100 in September 2018. While it can be volatile on a monthly basis, the lowest level it has fallen to in the past twelve months is 98.5 in March 2018 while the highest reading was 105.4 in August 2018. The fall in the index in September may indicate some increase in the willingness to spend. The August survey also measured consumers' attitude to an unexpected monetary gain. Two-thirds of consumers indicated that they would save rather than invest such again. This is consistent with the Consumer Sentiment Index in relation to major purchases. This, in itself, would not support continued demand for large purchases but the reversal of attitudes in September may be more positive from a demand point of view.

4.5 Population change

Population growth has accelerated from an annual average of just under 35,000 in the 2011-2016 period to almost 65,000 (1.35%) between 2017 and 2018. This will support the retail sector depending on the level of population growth in specific locations and supply of retail space.



Source: CSO *Annual Average

Summary of key drivers of retail sector

- ➔ Employment is up ➔ 128,000 extra jobs in past two years.
- ➔ Earning now rising at rate well above inflation rate, indicating that real wages are increasing.
- ➔ All sectors are benefiting from earnings increases indicating that the fruits of the recovery are benefiting workers across the economy.
- ➔ Consumer sentiment has been on a very positive trend over the past number of years although there has been some decrease recently.
- ➔ Two out of three people would opt to save rather than spend any windfall gains.
- ➔ Population is growing at almost 65,000 (1.35%) a year.
- ➔ Overall trends in the key indicators of the consumer economy are favourable to continued growth in demand although the most recent measures of consumer sentiment and attitudes to savings are showing some increased caution in the lead up to Brexit.

5. Other drivers of demand

Whilst the key drivers of the retail sector are positive the overall sector in terms of property is not feeling the momentum that these would normally provide. Whilst this can be dependent on the type and supply of retail in particular locations there is also a general consensus that a major inhibitor is the impact of online shopping in a growing number of sectors.

The Irish Consumer Spending Index for August 2018, produced by IHS Markit, shows that the growth of on-line sales (eCommerce) outstripped traditional sales in the last year, although the gap narrowed somewhat in recent months.

As mentioned, however, some sectors within the retail market are unlikely to be as impacted by the internet or indeed will have an additional driver that may counteract this somewhat. Whilst experience / destination retail and leisure uses are obvious sectors which are less exposed, there is also a case for other sectors such as retail warehousing and convenience / grocery being less exposed. Below we provide some information in relation to same.

5.1 Retail Warehousing

TWM has examined the correlation between the sales of household goods and a number of key economic drivers.

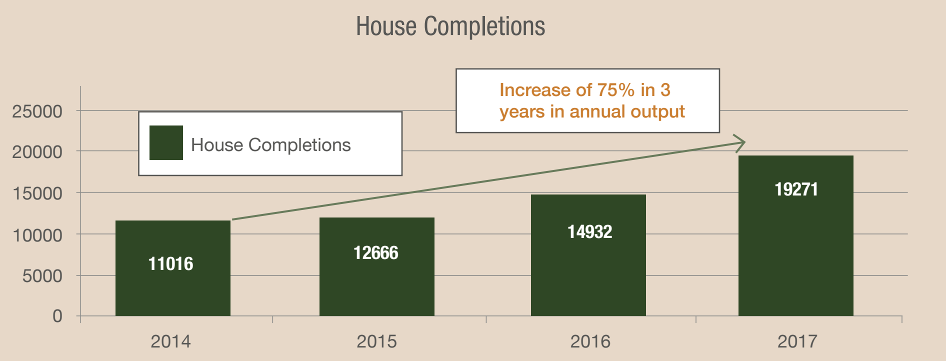
Household Goods: Correlation with key indicators

Correlation Coefficient	Unemployment Rate	Unemployment Number	Consumer Sentiment	House Completions
Furniture	-0.96	-0.96	0.50	0.77
Electrical	-0.95	-0.94	0.51	0.81
Hardware	-0.93	-0.92	0.53	0.86

Source: TWM Research from CSO, ESRI/KBC Bank, and Department of Housing, Planning and Local Government

For all three categories of goods, the correlation is very strong with both the unemployment rate and the number unemployed. It is slightly less but still strong with house completions. Correlation with Consumer Sentiment is lower at about 0.5.

Therefore, house completions appear to have a strong influence on the performance of typical elements within the retail warehousing market. Given this important link and the current focus of public policy on the housing sector, we examined the recent level of house completions. While the absolute numbers remain below the long term requirement, they are now growing year on year.



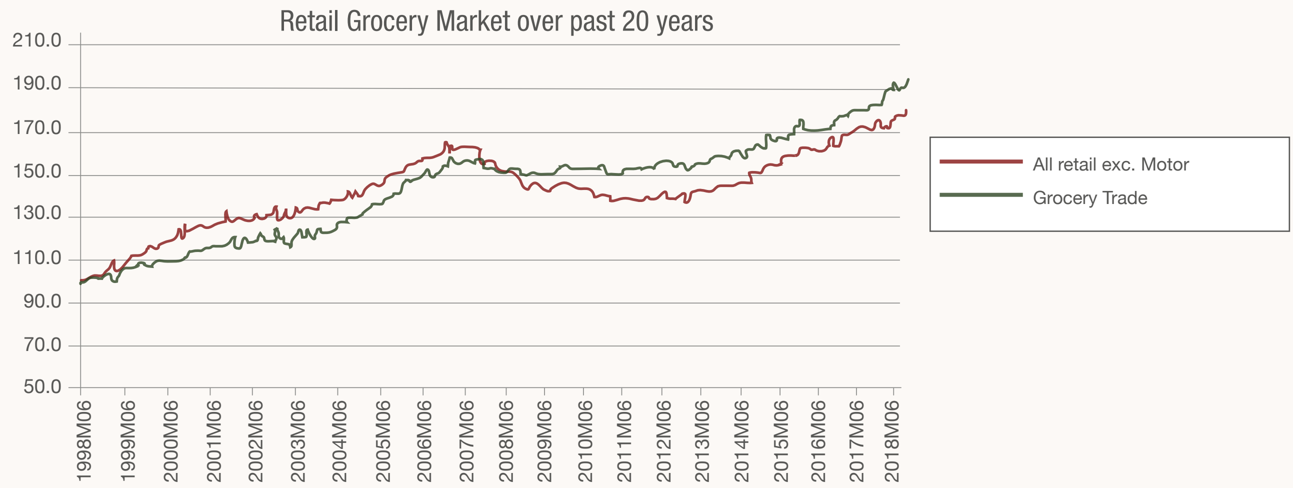
Source: Department of Housing, Planning and Local Government

The 2019 Irish Budget Statement, published recently, indicates that the Government is committed to increasing the level of completions in the medium term, either through state intervention or private sector provision.

The current level of and growth in house completions suggests that demand for household goods will increase. This excludes additional demand generated by consumers upgrading or replacing equipment in existing houses and apartments, which is likely to increase as the general consumer economy indicators remain positive.
This may present an opportunity for investors to obtain some benefit from this growth through the retail warehousing sector, through increased occupier demand and / or rents. Yields may remain under pressure until the impact of these drivers become more evidence.

5.2 Retail Grocery Market

While the retail warehousing sector may offer potential growth opportunities, the retail grocery market, as a more defensive play, may offer stable, secure returns with steady growth. The grocery trade is less susceptible to volatile swings in demand that can affect other sectors. Put simply, people have to eat and this is the least likely purchase to be cut in a recession.
The graph below shows the performance of this sector of retail sales over the past 20 years.



Source: CSO

Grocery sales grew by almost 60% from mid-1998 to the pre-crash peak. However, these sales only fell by 6% post-crash and have now recovered by 28% from the bottom of the market to stand 20% above the previous peak. By contrast, overall sales (excluding motor) increased by a little more at 65% but fell by over 16% from the pre-crash peak, two and a half times the fall for the grocery trade. While these sales have recovered by 30% from the bottom of the market, they are less than 9% above the previous peak, half that of grocery sales.
The attraction of the grocery business as an investment opportunity is reflected in the establishment of the UK Supermarket REIT , 'SUPR'. This was listed in mid-2017 and has delivered a return to investors of over 8% since then, made up of 5.5% dividend and 2.5% share price increase.

6. Outlook

The outlook for the key consumer economy indicators is positive.

Indicator	Expectation
Employment	Continued growth expected – over 50,000 extra people in employment in 2019
Unemployment	Expected to fall close to 5% in 2019
Consumer spending	ESRI forecast of 2.5% growth in 2019 following growth of 2.9% in 2018
Consumer confidence	Medium term trend is strongly upward but can be volatile on a shorter term basis. Difficult to predict.
House building	Medium term target is for approximately 25,000 units a year.
Population	Project 2040 forecasts significant rise in population. Recent trends have been very positive.

The combination of the expected increase in supply in the residential market combined with the general economic recovery points to increased demand for household goods. A rising population and falling household size will further fuel this. **The economic recovery is now more deeply embedded with employment and earnings growth on a firm upward path. As discretionary purchases, demand for household goods is likely to accelerate as the recovery strengthens.**

7. Review and Conclusion

The buoyant consumer economy will support demand in the grocery business making investment in supermarkets an attractive proposition for risk-averse investors. Even in recessionary times the grocery sector experienced sales growth. Most property investments leased to supermarket operators comprise long leases many with rents linked to the consumer price index and hence are seen as a defensive play. **There may also be opportunities in the retail warehousing sector on foot of the expected increased supply of housing leading to the establishment of a greater number of households and the consequent demand for household goods. In general, therefore, the attraction of any particular asset in this sector should be viewed in the context of the outlook for increased housing supply in the area and also the location of competing retail parks.** Obviously the purchase price and specific asset management opportunities will ultimately determine investment performance. Whilst the general perception of the retail market is cautious due to some fundamental changes in parts of the market, one should remember that some retail assets, locations and sub - sectors can be influenced by different growth drivers and should stand to benefit from ongoing wider economic and demographic changes.

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