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Neighborhood Retail in Asia

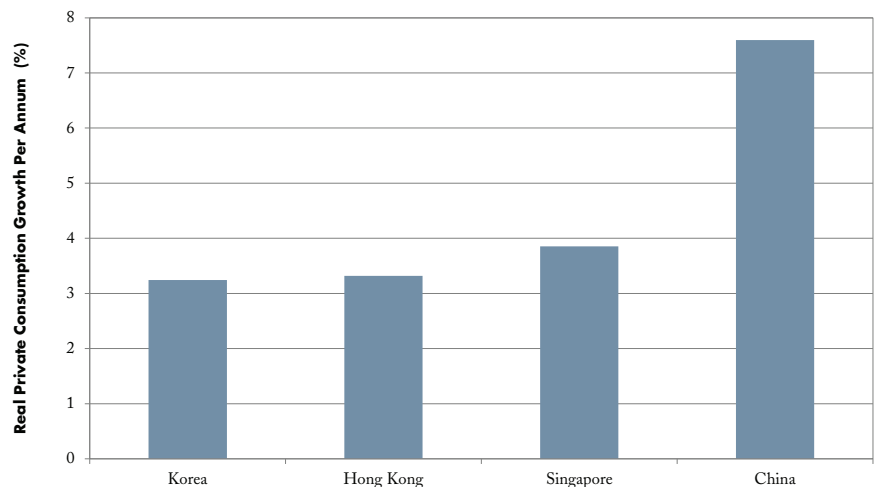
This paper focuses on investment in the neighborhood/necessity retail segment of Asia's high-growth gateway markets. We believe this segment of the retail sector can provide investors the opportunity to access consumption growth in the region with lower risk. Neighborhood retail generates returns from everyday necessity spending patterns, which can provide stable income and strong risk-adjusted returns. We believe the opportunity exists to acquire properties in this segment that suffer from deferred maintenance, but are located in markets that are benefiting from infrastructure investment.

First, we will highlight the structural factors underpinning the growth in the retail sector; second, we'll identify how neighborhood retail in Asia differs from Western markets; third, we will demonstrate how the segment offers strong risk-adjusted returns; and we will conclude with some details on the investment opportunity.

A SOLID FOUNDATION FOR THE FUTURE GROWTH OF RETAIL

AEW Research has previously highlighted the long-term drivers propelling Asia forward.¹ Among the most important drivers for the future performance of the retail sector are the growing consumer class and their increased purchasing power. Figure 1 shows that over the next five-years (2015 to 2019) real private consumption growth is forecast to range between 3.0% and 7.5% per annum in Singapore, Hong Kong, Korea and China. We believe this growth in private consumption will support demand for necessity-based retail properties, which provides for essential, everyday goods and services.

FIGURE 1: Five-Year Outlook for Consumption Growth



Source: Oxford Economics, September 2014

¹Asia Pacific Property: A Primer. June 2013

In this environment, where the consumer sector is expanding, we believe developers will be unable to deliver enough retail space to keep pace with the growth in consumption and the demand for additional space from retailers. Development in many of Asia's gateway cities can be challenging. Many of these cities are characterized by high population densities and apartment living is commonplace. On top of that they are usually highly-built-out urban environments with limited available and appropriately zoned development sites. Rather than developing new properties, refurbishment is often a viable option. Upgrading existing assets, which are usually impaired by some level of deferred maintenance, provides a way to modernize the retail offering. It enables owners to refresh the image or reposition their asset and could include elements that are front of house, such as signage and floor reconfiguration, but also may include upgrading mechanical and electrical systems, if necessary. This also provides an opportune time to ensure the building is fully code compliant.

CHARACTERISTICS OF NEIGHBORHOOD RETAIL IN ASIA

Neighborhood retail in markets outside Asia, such as the U.S., UK and Australia, is typically a small shopping center or strip mall. They are usually single-story with a grocery store anchor and are in residential locations with ample parking. The grocery is often complemented by a variety of specialty shops including food & beverage (cafes or bakeries), as well as services such as banks.

Due to the aforementioned density of many of Asia's gateway markets, neighborhood retail can be somewhat different than Western markets. Neighborhood retail in these cities can be ground-level street shops, strip malls or retail podiums below a residential or commercial tower. The majority of the customer base will walk or use public transport to travel to the shops, unlike Western markets where driving is more common. In most cases, there will not be a grocery anchor, but rather specialty retail, with a focus on everyday goods and services, such as cafe's or banks. In the context of Asian cities, this paper uses the term suburban to refer to areas outside the city center that are primarily residential neighborhoods. While suburban in the U.S. describes low-density living, usually dominated by single-family dwellings, in Asia's gateway markets, suburban locations may be heavily built-up and have urban qualities, but remain residential neighborhoods.

Typical Neighborhood Street Scape in Hong Kong





Investing in properties that capitalize on everyday/necessity spending can provide investors with stable income, a lower overall risk profile and stronger risk-adjusted total returns.

SEGMENT OFFERS POTENTIAL FOR STRONG RISK-ADJUSTED RETURNS

Neighborhood retail provides investors the opportunity to capitalize on the benefits of necessity spending. Everyday spending patterns tend to be more stable when compared to luxury/discretionary retailing. For example, in Hong Kong, high-end luxury retail spending categories have benefited from Mainland Chinese tourists spending. However, with the government crackdown on corruption, many high-end Hong Kong retailers have been negatively impacted. The often used bellwether for luxury spending is the Jewelry, Watches and Clocks, and Valuable Gifts retail sales category, which in July 2014 was down 22.2% from a year earlier. We can compare this to the retail sales categories that draw more trade from domestic spending. Categories such as Food, Alcoholic Drinks and Tobacco (other than supermarkets), which increased 7.5%; Supermarkets, which increased 5.8%; and Other Consumer Goods, which increased 9.6% over the same period.²

Investing in properties that capitalize on everyday/necessity spending can provide investors with stable income, a lower overall risk profile and stronger risk-adjusted total returns. To analyze the performance of this sector, AEW Research looked at the performance of Singapore’s retail real estate sector over the last decade. Due to the lack of available data, we used suburban shopping centers to proxy the performance of neighborhood retail and compared this against retail in the city center. The latter has a higher exposure to tourism spending, luxury retailers and discretionary spending. Figure 2 highlights the performance of these two segments of the retail market and indicates the potential outperformance on a risk-adjusted basis of the neighborhood retail segment. In addition, suburban centers had a higher proportion of their total return from income, reinforcing their lower overall risk profile.

FIGURE 2: Singapore Shopping Center Total Returns Per Annum, 2004 to 2013

	City Center	Suburban
Average Total Return	10.4%	10.6%
Income Return	5.8%	6.9%
Volatility	9.0%	5.2%
Total Return per Unit of Volatility	1.2%	2.0%

Source: JLL, AEW Research

²Census and Statistics Department Hong Kong Special Administrative Region

AEW is focused on neighborhoods that have shown some level of revitalization or investment in infrastructure, for example, the opening of a new public transportation link, such as a metro station.

THE INVESTMENT OPPORTUNITY

AEW Research believes investment demand for retail assets in Asia will continue to build over the medium-term. Recent research indicates that institutional capital “is seeking greater retail exposure...” and “will increase its allocation to retail”.³ We have seen an increase in the amount of capital targeting the sector, as well as more sources of capital, including freshly-raised equity funds. Also, the regions debt markets are increasingly liquid. As retail assets are primarily held by long-term ‘hold’ owners, such as pension funds and REIT’s, and new supply is limited, transaction volumes in the established markets may be constrained by a lack of available assets for sale. Due to the lack of assets for sale, institutional investors may shift their attention away from the large dominant shopping centers to smaller retail assets, which would increase liquidity for neighborhood retail.

We estimate neighborhood retail investment volumes in Hong Kong, Singapore and Seoul by analyzing retail asset transactions between USD 25 million and USD 150 million from 2009 to 2014, transactions in this range have averaged 44% of all retail transactions⁴, indicating a liquid and dynamic market.

In addition to the previously mentioned stability, part of what attracts investors to this segment of the retail market is the comparatively higher yields. Figure 3 shows retail yields by Central and Suburban locations in Hong Kong, Singapore and Seoul. The average Central yield is 3.75% while the average Suburban yield is 4.7%, suggesting a yield premium of almost 100 basis points.

FIGURE 3: Illustrative Market Yields by Category

	Central	Suburban
Hong Kong	3.00%	4.25%
Singapore	4.25%	4.75%
Seoul	4.00%	5.00%

Source: JLL

In identifying investment opportunities in this segment, AEW is focused on neighborhoods that have shown some level of revitalization or investment in infrastructure, for example, the opening of a new public transportation link such as a metro station. We also look for favorable or changing demographics. The property should have a very visible street profile and benefit from a high volume of street-level foot traffic. From our experience, buildings that fit this profile may suffer from deferred maintenance. This provides an opportunity to refurbish the asset and re-lease it at higher rents. In these cases, we analyze the floor plate and the building structure in order to increase the efficiency of the tenant configuration and improve the shopping experience.

We believe a successful leasing strategy for neighborhood retail should focus on food and beverage tenants, in particular fast casual dining (TGI Fridays) or cafes (Starbucks or Coffee Bean), convenience shopping (7-11), as well as services such as medical clinics/dentists, banks, and health and fitness. Moreover, while leases may typically be short (two to three years) actual tenancy may be much longer as renewals are common. The right retailer in the right location produces a very sticky tenant.

³Redefining Retail Investment, JLL

⁴Real Capital Analytics, September 2014

One challenge to investing in neighborhood locations is the fragmented ownership. Owning a property that is part of a larger street shopping area can mean individual landlords are not in full control of the total retail experience, as they typically are with en-bloc shopping centers. This lack of control may create some challenges in organizing common promotion or marketing, as well as optimizing the streets tenant mix. However, it does provide for the opportunity to improve the asset's prominence and visibility. Some light capital expenditure focused on branding the asset can positively impact the perception of the property and can make it more attractive to tenants and shoppers.



For more information,
please contact:

Glyn Nelson
glyn.nelson@aew.com
or +65 6303 9016

CONCLUSION

We believe neighborhood retail in Asia's large gateway cities may provide an excellent opportunity for investors to access the region's rising consumption with a lower risk profile. Retailers that rely primarily on everyday spending have more stability than those that are reliant on the more cyclical luxury/discretionary spending sector. As noted in Figure 2, this stability of income has allowed the segment to achieve higher risk-adjusted returns for investors with a higher proportion of total return coming from income. AEW prefers smaller assets in neighborhoods that serve everyday retail needs of the local population. We believe returns can also be enhanced by investing in assets that will benefit from future infrastructure investment and changing demographics and by refurbishing and repositioning assets that have suffered from deferred maintenance.

Prepared by AEW Research,
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6 Battery Road
#21-01
Singapore 049909
+65 6303 9000



Two Seaport Lane
Boston, MA 02210
+1 617 261 9000
www.aew.com