# Briefing note

# European retail investment: Time for sale & leaseback?

August 2018

"A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty." Winston Churchill

## "Adapt or die"

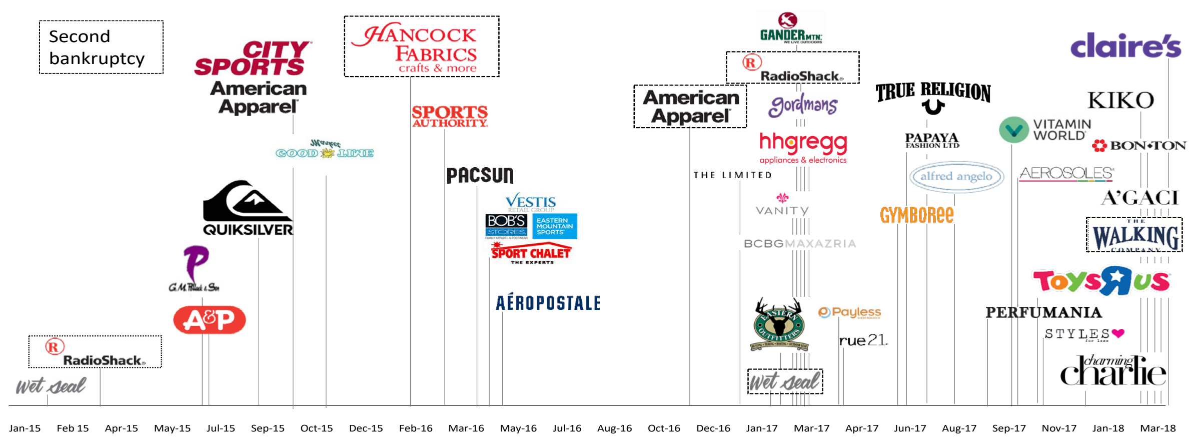
Over the past 24 months, sensational headlines about the "retail apocalypse" have been on the front pages of all media. Some long-established retailers went bust (e.g. Toys 'R' Us), are closing stores (e.g. American Apparel) or are reducing their number of employees, regardless of their retail property formats. Although this phenomenon relates today mostly to US and UK retailers, it may have an impact at a pan-European level through the closures of their international stores.

Yet, behind these headlines, some retailers are growing and expanding across Europe. One example is the Spanish retailer Inditex, which posted a net sales rise of 9% in 2017, with 10% of total sales online. Sixty percent of its turnover came from European sales. They opened 524 new stores worldwide and closed or absorbed 341 smaller units reflecting a net opening of 183 stores. They invested €1.8bn in 2017 "into the introduction of efficient technology, the expansion of their logistics capabilities and the strategy for differentiating and optimizing their selling area". Inditex is not an isolated case, other retailers that play the game well in this challenging new retail scene include notably Ikea and Aldi.

In fact, European retail sales increased by 2.3% pa on average over the course of the past five years and it grew by 2.9% in 2017 according to Oxford Economics. This is notably due to the expanding economy, stronger labour markets and improved consumer sentiment.

The reasons behind the divergence between blossoming and vanishing retailers lie in their commitment and rapidity to adopt strong online experience, to invest in technology, to reorganise their supply chains and redesign their sales areas to meet the new on-demand inclination of customers.

FIGURE 1
**US Retail bankruptcies timeline**




Source: CBinsights

## The blurring line between retail and logistics

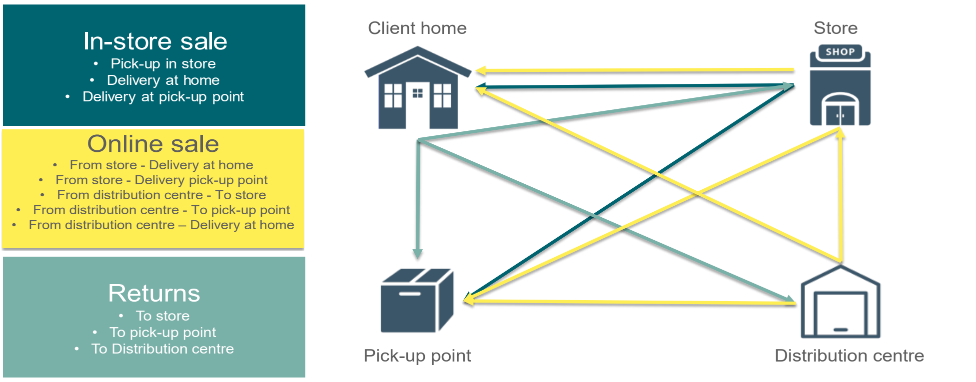
Online sales have increased 2.5 times over the past decade, reaching various degrees of penetration, from 3.5%-5% in Central Eastern Europe and Southeastern Europe, to 7.5% -10% in Western Europe and up to 15.1% in Germany and 17.8% in the UK. According to Forrester, e-commerce in Western Europe will grow at an average of 11.9% pa over the next five years. Online sales, excluding groceries, will account for 20.2% of total retail sales by 2022, from 12.4% in 2016. E-commerce is growing at a faster pace than overall retail sales, hence becoming a major driver in the retail sector.

Whilst in the past retailers used to expand their footprint by opening new stores in new catchment areas, the structural decline in in-store sales requires a rationalisation process which focuses on locations with strong existing footfall or with potential for growing footfall. Additionally, the panoply of combinations between sales channels and delivery “from and to” routes is forcing retailers to revise and reorganise their entire supply chain.

Generally, retailers have a regional distribution centre in the vicinity of their consumers base but the booming demand for e-commerce puts pressure on their delivery strategies. In order to compete with pure online players, retailers have to leverage their distribution centre with their stores and adopt omni-channel rather than multi-channel strategies. The standardisation of same-day delivery also raises the stakes for retailers who have to include smaller urban warehouses in their network in order to shorten delivery routes and provide quick delivery services to online customers.

FIGURE 2

### New delivery routes




Yet traditional brick and mortar retail floor-space should play a crucial role in this new retail landscape, led by convenience in small catchment areas and by experience in both destination-city centres and out-of-town locations. Although it may not translate into on-site sales, physical stores have become a gateway for retailers to “show-room” their products and brand philosophy to their customers and to get to know their clientele better.

## The yield gap between retail and logistics assets is closing

With logistics becoming a key element of a successful retail strategy, property investor demand for logistics assets is growing, often at the expense of traditional retail assets. The share of logistics has increased to 13% in H1 18 from a 5-year average of 11%. Nevertheless, the line distinguishing the two sectors is becoming increasingly blurred as retailers generate much of their profit from their logistics warehouses, which are used as fulfilment centres for their online trade.

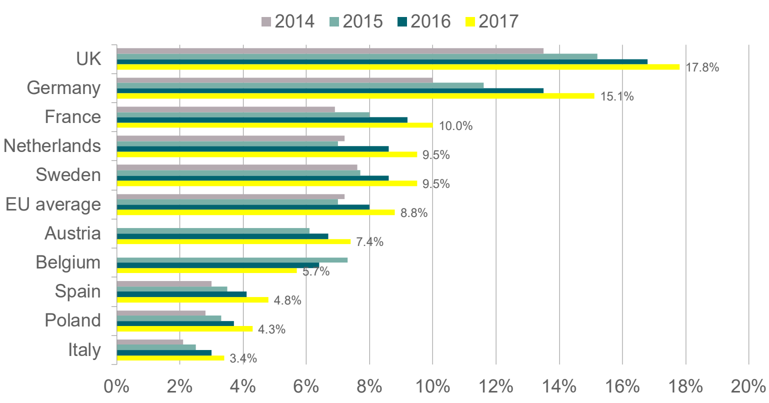
Rising volumes are putting some downward pressure on yields. Prime logistics yields experienced the highest compression of all sectors, -38bps yoy on average across Europe between Q1 2017 and Q1 2018. The average prime yield is at a historic low at 5.5% compared to the 6.3% five-year average.

At the same time, within the retail sector, prime high street yields hardened by 17bps and the European average stands at 4%, prime retail warehouse yields moved in by nearly 16pbs (4.8% on average), while prime shopping centre yields have stabilised across the European markets (4.5% on average).

Hence the gap between shopping centre yields, retail warehouse and logistics yields is closing, resulting from the blurring of lines between the two sectors.

FIGURE 3

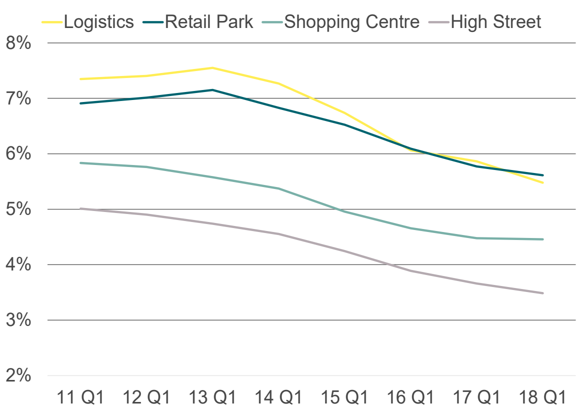
**Share of e-commerce** The end-year volume is expected to be in line with the past two years




Source: Statista

FIGURE 4

**Prime retail and logistic yields** Are converging




Source: Savills/ RW Retail Warehouse

## Investors are seeking to limit their retail exposure

Despite improving economic indicators, disruption in the retail industry has caused investors to limit their exposure to the sector. Since the final quarter of 2015, the 12-month rolling retail volume has been slowly but consistently decreasing. The share of retail investment out of the total turnover fell from 15% in 2015 to 13% last year. This trend is taking place across Europe, although more pronounced in core countries, most particularly in the UK, than in other European countries. The three core countries (Uk, Germany, France) used to account for more than 60% of the total retail volume in 2015, it now accounts for 40%.

During the first quarter of the year, €9.3bn was invested in retail properties. This is 3% down compared to Q1 2017 and 1% below the average of the past five Q1s. A few retail investment spikes were recorded in Portugal, Poland and Spain, where large portfolios were transacted. High street, notably in key touristic cities, remains the favoured format, representing nearly half of the deals.

Based on first estimations, the retail volume in the second quarter of the year should total approximately €8.8bn, 17% down compared to Q2 last year and 23% below the Q2 five-year average. This is notably due to fewer portfolio transactions.

## Time for sale & leasebacks?

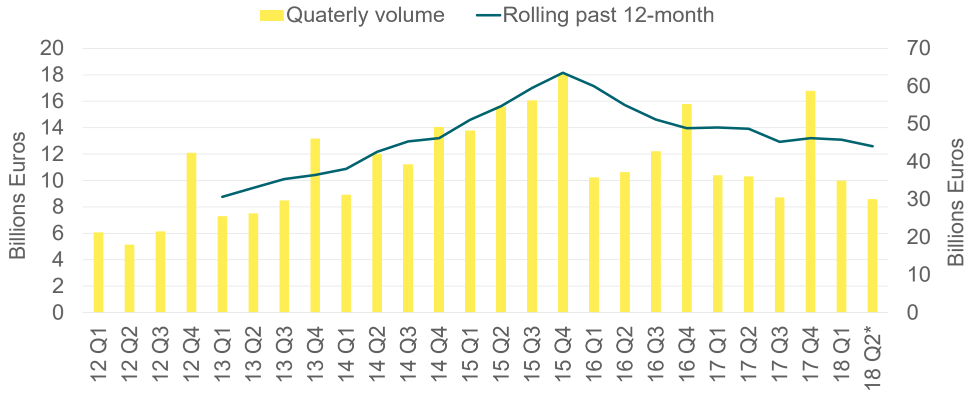
According to RCA, some €1.1bn of retail properties were sold and leased-back (SLB) over the course of the past 12 months, suggesting a pick-up in activity. During the first half of the year, retail SLB amounted to approximately €850m. This is six times the amount sold and leased-back during the same period last year and 28% above the average of the past five H1s. Retail SLB currently accounts for 4% of the total retail investment volume. SLB activity was concentrated in Spain and Italy mostly but also in the Netherlands; mature markets where retail ownership still offers opportunities for investors.

Since SLB transactions often relate to portfolios and large deals, it is too early at this stage to predict if the trend toward more sale and leasebacks will expand. However, pending transactions and discussions around the subject suggest we can expect more of this type of deal during the remainder of the year.

In this challenging landscape, sale and leaseback transactions are a great financial opportunity for retailers seeking to raise capital to reinject in their core business. From an investor's perspective, as long as the retailer offers a strong covenant and retail units are in prime locations, it is an alternative opportunity to source property and to invest large amounts of capital which in return will provide secure income streams.

FIGURE 5

**Retail investment** Volume is decreasing

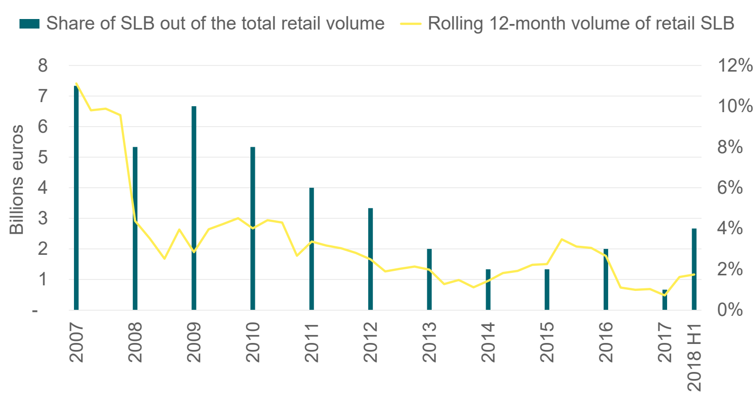



Source: Savills / *first estimations

> "Investors are attracted to the SLB principal on account of its secure cashflow, so long as the income covenant is strong enough. We believe that this trend will continue on the condition that both sides feel like they are getting a good deal."
> Oli Fraser-Looen, Savills Head of Retail investment EMEA

FIGURE 6

**Retail sale and leasebacks** Are on the rise




Source: Savills / *first estimations

FIGURE 7

**Notable retail SLB transactions**

| Date | Name of property/ porfolio | Type of retailer | N. of properties | Country |
|---|---|---|---|---|
| Q2 18 | Ores | Fashion | 4 | Spain |
| Q1 18 | Eroski | Supermarkets | 6 | Spain |
| Q1 18 | Tigros | Supermarkets | 8 | Italy |
| Q1 18 | Zara | Fashion | 14 | Spain |
| Q1 18 | Coop | Supermarkets | 29 | Italy |
| Q4 17 | Diesel flagship | Fashion | 1 | Italy |
| Q3 17 | Albert Heijn | Supermarkets | 15 | Netherlands |

Source: Savills

FIGURE 8

## Pros and cons for retail sale & lease-back

| Sale & lease-back | For retailers | For investors |
|---|---|---|
| Pros | ■ Improve finance on balance sheet<br>■ Transfer obsolescence and residual risk of ownership<br>■ Unlock capital for growth and operations<br>■ Maintain long-term control of property through long-lease<br>■ Rental levels are generally stable or decreasing (except in high street locations), therefore terms of the long-lease should be reasonable<br>■ Retail yield compared to LTA very favourable | ■ Long-term, stable and predictable income return<br>■ Alternative opportunity in the European market where available product for sale is scarce<br>■ Size of the portfolio deal enabling to invest a large amount of capital in one deal |
| Cons | ■ Decrease capital in case of M&A<br>■ Annual or monthly rents appear on the balance sheet | ■ Covenant of the tenant and locations of the retail units should be carefully considered<br>■ Retail yield compared to LTA not particularly favourable<br>■ In certain cases, there is the risk of inflated rents being advocated by the seller |

# OUTLOOK

■ We expect competition between retailers to intensify. Clearly, the winners will be those who are quickly adapting. As logistics is becoming an integral component of the retail industry, retailers should reorganise their supply chain to comply with omni-channel needs. A merger or a partnership with a logistics entity could be an alternative solution.

■ According to Oxford Economics, growth in retail sales is expected to slow down in the coming years. However, it will continue to show a robust growth of 2% on average pa in EU28, until 2022. At the same time, the share of online sales will continue expanding and is expected to account for 20.2% of total retail sales.

■ Retail investments will continue to be concentrated in prime high streets in key European cities and in ultra-prime shopping centres and retail parks. But overall, investors will restrain their exposure to the sector. We expect to see more sale and lease-back transactions before the end of the year. This will fuel the total retail turnover, which, at year-end, should be in line with that of 2017.

■ The sale and lease-back option is a great alternative opportunity for value-add investors to source property in a European market where property available for sale is rare, as long as the retail tenant is showing “future-proof” strategy and their properties are in prime locations. Actually, retailers with visionary strategies, seeking to invest in technology or logistics, may well raise their hand to sell their properties.

■ We expect yields to continue hardening in the logistics sector until the end of the year, whilst overall retail yields will start stabilising. The line between the two sectors will slowly disappear since part of the logistics activity is absorbed by the retail industry.

# Savills teams

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