

# Retail outperformance may prove hard to repeat

### Key Highlights

- Property performance improved across Continental Europe in 2010, with retail outperforming (Source: IPD).
- However, retail income returns may not reflect the risks of future rental declines.
- Higher income returns in the industrial sector provide a solid base for total return outperformance.

## Retail outperforms in a positive year for property

Results from IPD<sup>1</sup> for 2010 show that ungeared total returns for property improved in all of the Continental European markets it covers (see Figure 1). Even in the weakest economies on the Eurozone's periphery (Ireland, Portugal and Spain for example), total returns improved during 2010.

The retail sector produced better total returns than offices in most countries, while comparisons with industrial performance were mixed. Nonetheless, average total returns for retail stood at 7.3% in 2010, compared to 5.9% for the industrial sector and 5.3% for offices<sup>2</sup>. Bearing in mind how weak the underlying economic drivers of retail property performance have been, we believe that two key factors have been responsible for retail's outperformance:

- Firstly, investor sentiment towards retail has been on an upward trend since the onset of the global financial crisis in 2007. This is reflected in the pattern of property investment turnover which shows retail's share rising from 20% in 2007 to 33% in 2010 (see Figure 2). This has largely come at the expense of office investment turnover, which has fallen from 60% to 42%. On top of this, surveys indicate that preferences amongst property investors for retail remain higher than for both the office and industrial sectors<sup>3</sup>. Overall, these trends have led in 2010 to stronger rates of yield compression in retail property, and hence faster capital growth.
- The second factor has been the relative outperformance of retail rents. Historically, retail rental growth has outperformed office and industrial in both prime and average areas of the property market. This remained true during the recent recession: from their peak levels, prime Eurozone retail rents have fallen by only 2.9% compared to falls of 7.6% for offices and 8.4% for industrials<sup>4</sup>. Where available, data from IPD shows that since 2008 retail rental growth has tended to slow rather than turn negative, in contrast to the office and industrial sectors.

Undoubtedly the 'defensiveness' of retail rents historically has been a major attraction for property investors in the past few years and helps to explain the sector's outperformance in 2010. However, we think this will be difficult to maintain given the relatively weak outlook for retail rental growth, better growth prospects from this point in the cycle for the office sector and higher industrial income returns.

<sup>1</sup> Investment Property Databank (IPD), which is an independent provider of property performance indices and analysis covering 14 countries in Continental Western Europe.

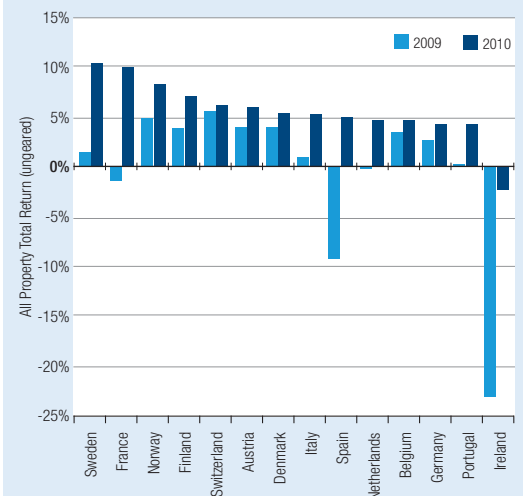
<sup>2</sup> Data sourced to IPD representing the IPD Eurozone databank.

<sup>3</sup> PMA's Survey of Investor Preferences Q1 2011 shows that across Continental Western Europe the average net balance of investors preferring retail was 33%, compared to 24% for offices and 12% for logistics.

<sup>4</sup> Data sourced to CB Richard Ellis' prime rent indices for the Eurozone. Rental peaks occurred in Q1 2008 for office, Q3 2008 for industrial and Q4 2008 for the retail sector.

Figure 1

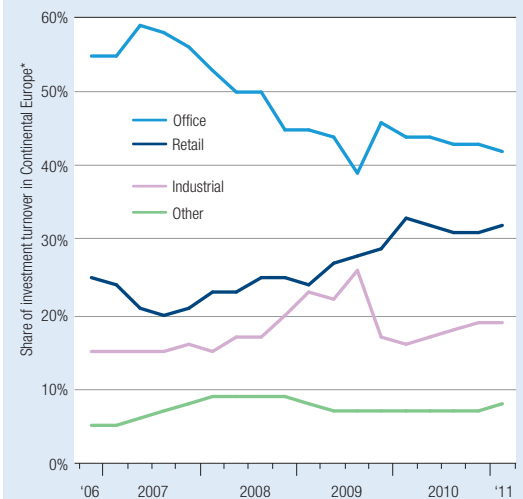
### Property performance improved across Continental Europe in 2010



Countries are ranked according to total returns in 2010. Source: IPD.

Figure 2

### Retail's share of investment turnover has risen steadily since the global financial crisis



Source: CB Richard Ellis. \*Continental Europe excludes UK.

## A new dawn for European retail?

There are good reasons to be concerned about retail rental growth prospects for the next five years. Consumer spending power is being eroded by short and long term trends, not least the fact that wage growth across the Eurozone turned negative in real terms during 2010<sup>5</sup>. Spending growth will also be constrained by high private and public debt levels, unemployment rates which have returned to the high levels last seen in 1998 and subdued house prices which remain under pressure in some countries.

The net effect of these trends is that consumer spending growth is forecast to slow sharply in many Continental European countries (see Figure 3). Historically low interest rates have offered some respite to consumers in the past two years, but the ECB has already signalled its intentions to bring inflation back down to its medium-term target range with higher interest rates.

The impact on retailers has been mixed, with some international groups continuing to enjoy high profit margins, notably luxury brands and mid/high end fashion. However, there are many examples of retailers suffering low and falling margins due to rising costs and competition from the internet and supermarkets. On the supply side, although retail development activity has fallen in recent years, vacancy rates are higher in most countries and according to PMA the development pipeline has started to pick up again. This would add to retail provision at a time when consumer spending is slowing and could cause rents to soften in some markets<sup>6</sup>.

<sup>5</sup> According to the "Indicator of Negotiated Wages" published by the European Central Bank.

<sup>6</sup> Data sourced to Property Market Analysis (PMA), representing shopping centre completions across 17 countries.

## Relative value in a low growth world

Historically, income returns have represented over 90% of total returns<sup>7</sup> in Eurozone property markets. However, there is a marked difference between office and industrial sectors, where capital values have edged lower in the past ten years, and the retail sector which has seen strong capital growth top up its annual total return to around 8% (see Figure 4). Looking forward, in an environment where capital growth drivers are forecast to be subdued, we think the retail sector could be at a disadvantage against the higher yielding industrial sector.

Furthermore in countries such as France and Sweden, consumer spending growth is forecast to slow markedly and according to IPD retail rents have not yet fallen. Here, we believe the risk that capital values suffer due to falling rents may not be reflected in yields and income returns which remain far below those yields available on logistics and industrial property.

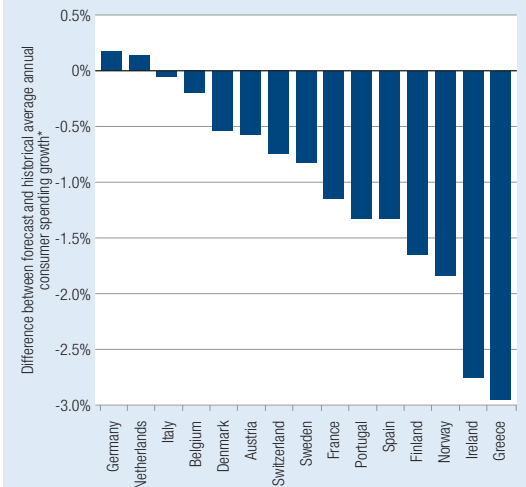
However, this trend is not limited to France and Sweden, and indeed in most countries the gap between industrial and office/retail yields has widened in the past two years. Even taking into account differences in average lease lengths and vacancy rates, which we think generally provides retail with a slight advantage, we would argue that in a world of limited rental growth higher income returns should help to form the basis for total return outperformance.

Overall, we think investors will continue to favour properties with long leases to tenants with strong credit ratings, which may lead them to the retail sector. However, we believe that outside the small number of dominant centres and prime locations, retail yields probably do not reflect the risks of future rental declines. Given the lack of rental growth generally, we think that the higher income returns in the industrial sector will provide a solid base for total return outperformance.

<sup>7</sup> Income return as percentage of total return, using IPD Eurozone Index data from 2001 to 2010.

Figure 3

Consumer spending growth is forecast to decelerate in most countries

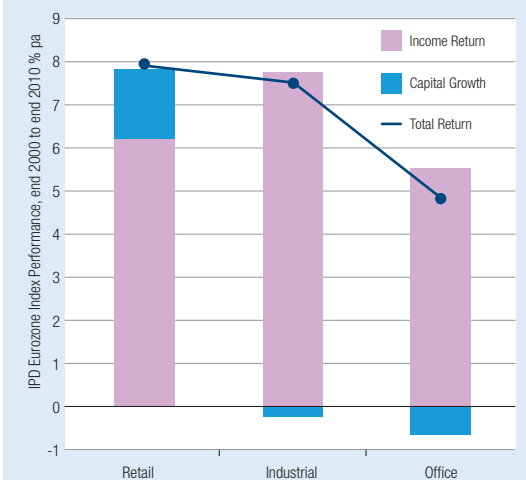


Source: Economist Intelligence Unit.

\*Historical period covers end-2000 to end-2010; Forecast period covers end-2010 to end-2015.

Figure 4

Historically, retail outperformance has been driven by capital growth



Source: IPD.

## Contacts

**Katie Robertson**  
Marketing  
Telephone  
+44 20 7153 9433

**Tim Francis**  
Research  
Telephone  
+44 20 7153 9423

**Disclaimer:** Invista Real Estate Investment Management Limited ('Invista') confirms that reasonable skill and care has been used in the preparation of this document and any forecasts expressed within it. This document and associated information is the property of Invista which reserves all intellectual property rights in it. It should not be copied or used by any other person or distributed to any other parties. All features in this document are current at the time of publication but may be subject to change in the future. Unless otherwise stated, the source of information is Invista. Any forecast, opinion, projection or target where provided is indicative only, is not guaranteed in any way and may change in the future. Past performance is not a guide to future performance and the past performance of property funds is not always represented by the performance of the property market as a whole. This document should not be considered to be an offer or solicitation to invest in the funds referred to, or in the shares of Invista itself. This document is intended only for investment professionals. No modifications or amendments to this document may be made without the prior permission of Invista.

Issued by Invista Real Estate Investment Management Limited, authorised and regulated by the Financial Services Authority. Registered in England and Wales. Registered Number 04459443. Registered office: 107, Cheapside, London, EC2V 6DN, United Kingdom.

Published May 2011. Ref: inv-770.

