Real Assets Quarterly: Update on the Australian retail sector

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frontier

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Australian retail property update

Summary

Australian retail is gradually recovering from COVID-19 induced lows of 2020 despite sporadic lockdowns throughout 2021

Backdrop

- Discretionary bricks and mortar retailing had already been experiencing structural impacts from the growth in online retailing prior to the onset of the COVID-19 pandemic.
- The pandemic accelerated the uptake of e-commerce as many physical stores closed due to social distancing restrictions. Australian unemployment rose and the outlook for retail appeared dim, with valuers meaningfully writing down unlisted retail assets.
- Following a series of government-mandated lockdowns and border closures, the Australian economy has emerged in reasonably strong shape, aided by significant fiscal and monetary support and relatively positive healthcare and vaccination position. Employment has rebounded and the number of business insolvencies due to the pandemic have been fewer than initially feared.
- Throughout the pandemic, non-discretionary retail performance has been robust, as supermarkets and essential services remained open. Neighbourhood shopping centre valuations were supported by meaningful market transactions, as the likes of boutique fund managers and syndicators sought smaller assets (typically sub-A$150 million equity investments) on relatively attractive yields. Discretionary retail, however, was significantly impacted, which flowed through to valuations as valuers increased rental allowances. Valuations for larger retail assets have begun to stabilise.
- By late 2021, investor sentiment towards large retail assets had improved, with significant transactions including Pacific Fair, Macquarie Centre, Westfield Warringah and Wollongong Central. Some fund managers believe retail rents and asset values have re-based to more sustainable levels and offer relative risk-adjusted value compared to office and industrial. However, we are yet to see meaningful, sustainable improvement in rents and occupancy costs. Retail asset valuations edged higher in 2021, with more positive movements later in the year.

Outlook

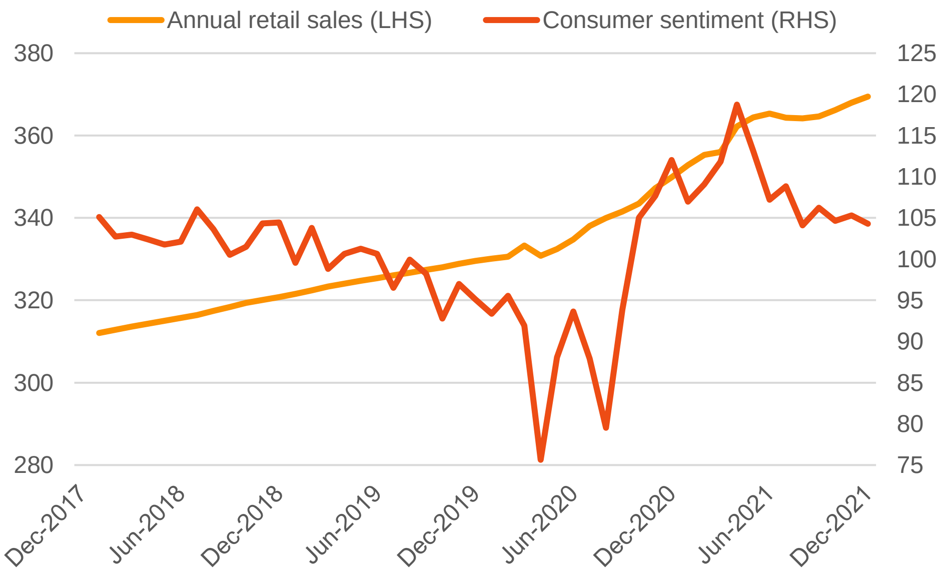
- In this research update, we provide an overview of macroeconomic conditions, valuations, rents, portfolio performance and recent Australian retail property transactions. With the re-opening of the Australian economy and improving investor sentiment, we may have reached an inflection point for discretionary retail property. Although the structural trend of e-commerce will continue, so too will the evolution of shopping centres to adapt to changing consumer demand. Furthermore, large high-quality centres in well-located catchment areas with close transport links have future upside potential through mixed-use development.
- Retail property remains a core component of Frontier's long-term sector configuration.

Macroeconomic conditions

Some positive signs leading into 2022

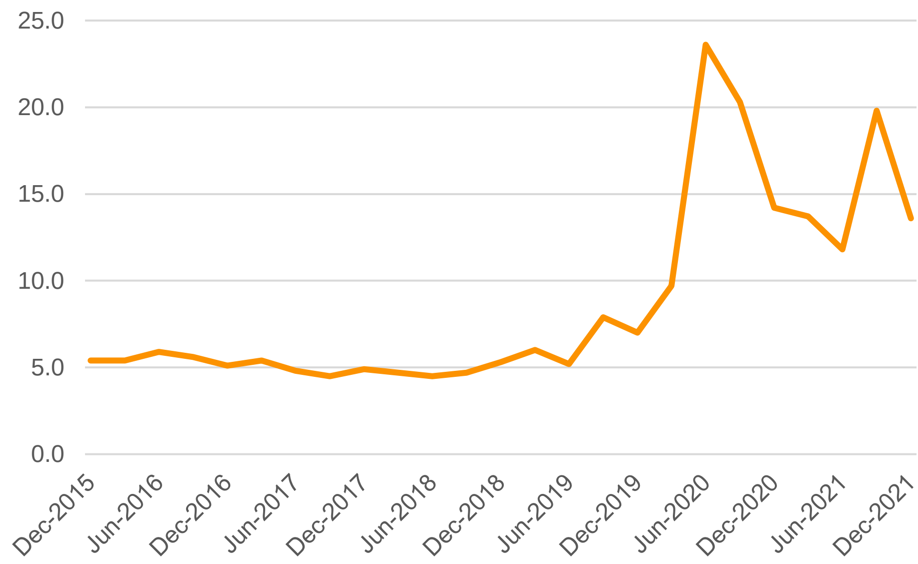
- Retail sales continued their buoyant trend from 2020 driven by continued e-commerce channel sales and more shoppers returning to physical retail settings across Australia. Government assistance through COVID-19 underpinned some of the euphoric sales year-on-year mid-2021.
- Consumer sentiment varied through the year with figures initially reaching highs above pre-COVID measures at the beginning of 2021, spurred by the lifting of lockdown in some states and a pent-up spending spree. Subsequent lockdowns are likely to result in elevated annual sales online as shown in Chart 1 whereas in-store sales should be flat or at diminishing levels. Consumer sentiment and household saving ratios reflect these patterns.
- The Australian household savings ratio was volatile throughout 2021 due to uncertainty around the economic outlook and enduring lockdowns in VIC and NSW, with drops recorded from November 2021 onwards following the lifting of restrictions from October 2021.

Chart 1: Australian annual retail sales and consumer sentiment



Source: ABS

Chart 2: Australian household saving ratio (%)



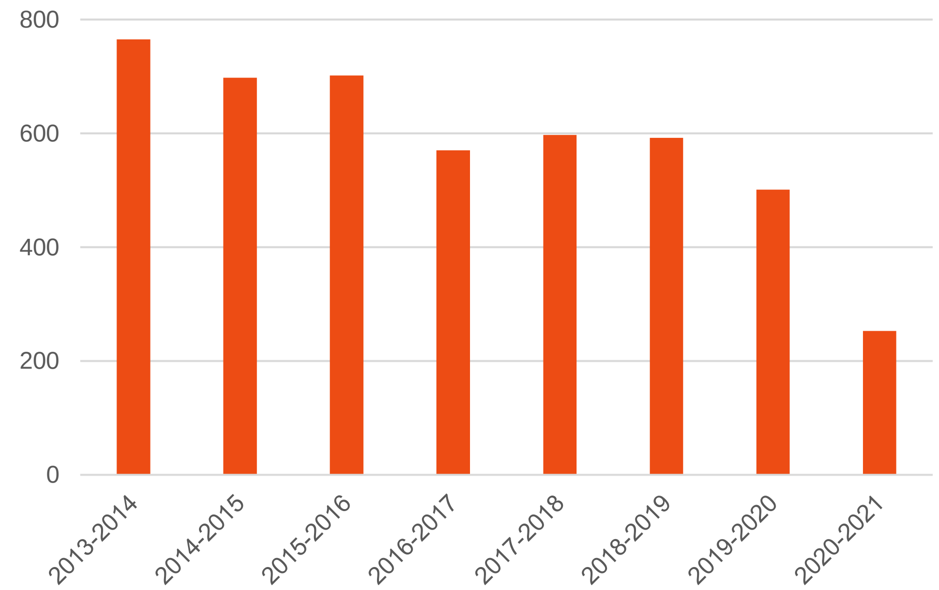
Source: ABS

Macroeconomic conditions

Some positive signs leading into 2022

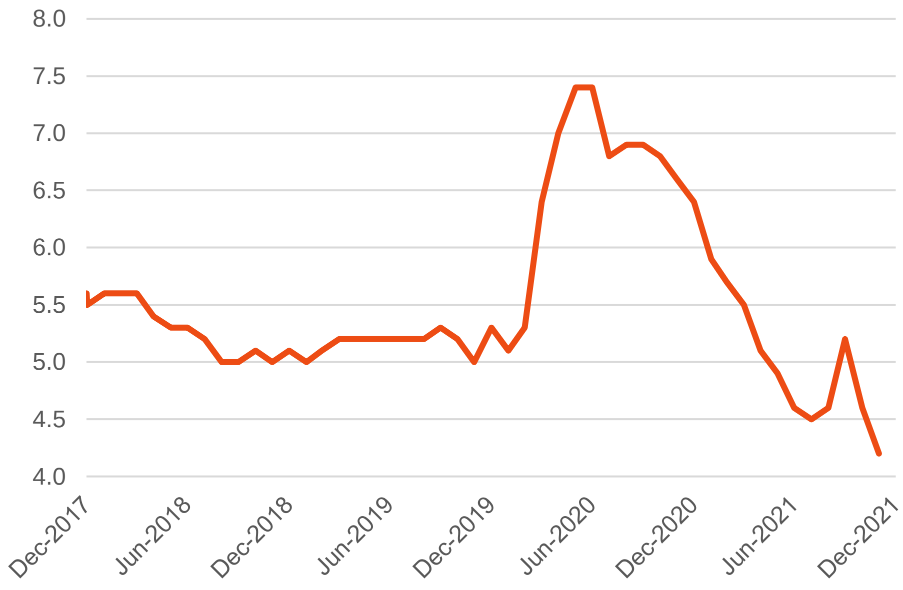
- ASIC figures for retailers entering administration were at historical lows for 2021. This has largely been due to business support packages provided by local, state and federal governments to assist retailers through lockdowns to continue to pay employees and rents that fell due. Though, we expect this to increase in the near-term as numerous insolvent businesses finally file for bankruptcy, having remained in a 'zombie' state in the latter part of 2021.
- A number of nimble retailers were able to switch to a purely 'click-and-collect' model during lockdowns to supplement some income when restrictions on in-person shoppers were in place.
- The Australian unemployment rate reached record lows of 4.2% during December 2021 according to data from the ABS, as employers continued to face shortages due to closed international borders over 2021.
- Despite the reopening of international borders, this downward trend in unemployment is expected to continue, with the RBA announcing in its recent economic outlook for February 2022 that it expects the unemployment rate to drop as low as 3.75% by the end of 2023.

Chart 3: Australian retail trade companies entering administration



Source: ASIC

Chart 4: Australian unemployment rate (%)



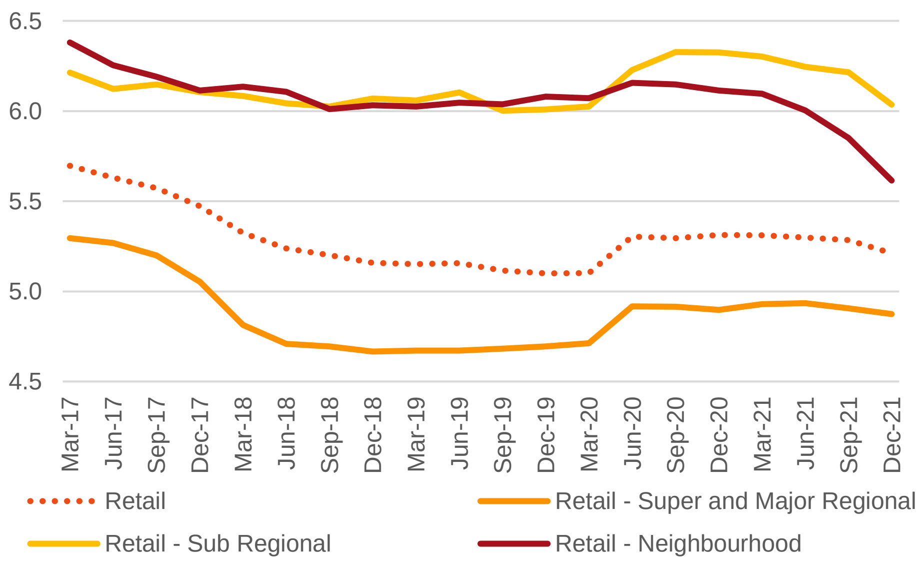
Source: ABS

Valuations

Cap and discount rates continue to decrease with capital growth varying between retail classifications

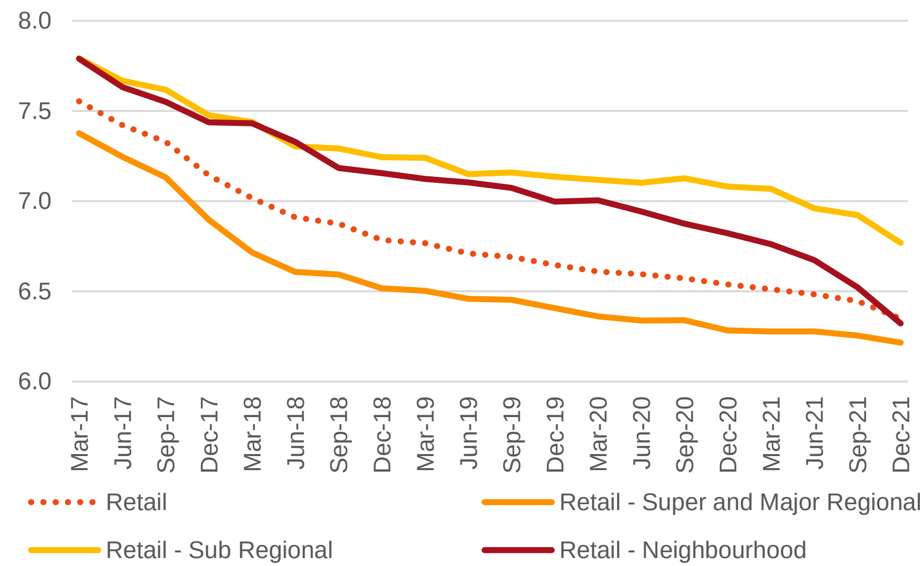
- In 2021, capitalisation rates compressed for neighbourhood and sub-regional retail assets, while super and major regional retail cap rates remained relatively stable.
- Retail property discount rates continued the downward trend during the pandemic, with the neighbourhood classification reporting the largest decrease in 2021.
- As at December 2021, the PCA/MSCI All Property returns highlighted that the ‘neighbourhood retail’ segment outperformed all other retail segments with a total return of 13.7% p.a. (income 5.5% p.a.; capital 7.8% p.a.). Office produced 9.2% p.a., whereas industrial outperformed all sectors at 30.2% p.a.
- Retail specialist funds recorded significant capital losses (up to 17% p.a. according to MSCI) in 2020, and then recorded modest capital gains in 2021 relative to other property sectors. Specialist retail valuations still have some way to go to return to pre-COVID-19 levels.

Chart 5: Australian cap rates (%) as at 31 December 2021



Source: MSCI

Chart 6: Australian discount rates (%) as at 31 December 2021



Source: MSCI

Valuations

Cap and discount rates continue to decrease with capital growth varying between retail classifications

Retail AREITs

- Table 1 highlights select retail AREITs and their performance for the six months to 31 December 2021.
- Of the four AREITs, CQR and SCP experienced significant capital growth during the period, with valuations up 8.5% and 9.7%, respectively. This growth has been driven by the outperformance of neighbourhood supermarket-based retail properties, relative to all other retail classifications.
- In contrast, SCG, with a portfolio holding super and major regional retail assets, recorded immaterial capital growth in the period relative to others in the peer group.
- As discussed in the next section, cap rates have compressed almost solely due to capital growth, as rents largely stabilised despite sporadic lockdowns across Australia during different periods in 2021.

Table 1: Current AREIT retail valuations (6 months to 31 December 2021)

Retail AREIT	Valuation (AUD)	Cap Rate	Portfolio characteristics
Charter Hall Retail REIT (ASX: CQR)	$4.0 billion (+$314 million, +8.5%)	5.38% (-0.43%)	Neighbourhood and service station
Scentre Group [AU only] (ASX: SCG)	$32.3 billion (+$166.0 million, +0.1%)	4.82% (-0.01%)	Super and major regional
Shopping Centres Australasia Property Group (ASX: SCP)	$4.7 billion (+$384 million, +9.7%)	5.41% (-0.49%)	Neighbourhood and sub-regional
Vicinity Centres Trust (ASX : VCX)	$14.3 billion (+320.1 million, +2.3%)	5.35% (-0.14%)	Diversified

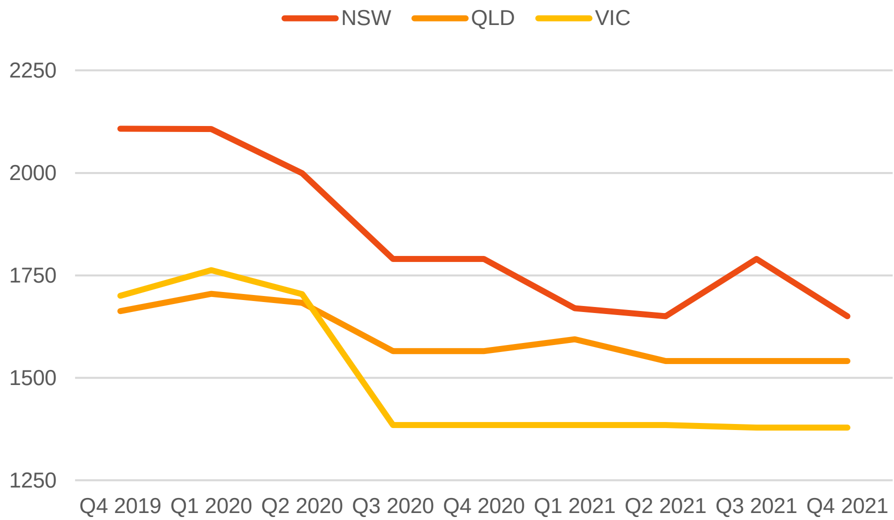
Source: Company disclosures

Rents

Stabilising with a high volume of leasing activity - questions remain on incentives and occupancy costs

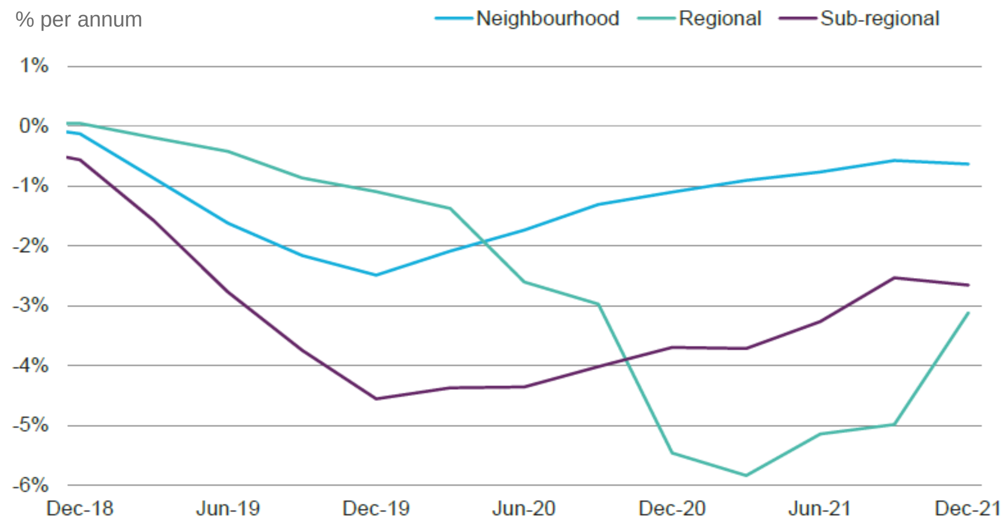
- According to CBRE Research, shopping centre rents stabilised over 2021 across Australia's major regions.
- In line with total returns and valuations, rents for neighbourhood and supermarket anchored assets have been more resilient compared to regionals and sub-regionals throughout the COVID-19 affected period.
- Leasing spreads have been improving since reaching double digit negative growth in 2020 (SCG: -13.1% and GPT Group: -14.1% for the 12 months to December 2020). VCX recently reported an average leasing spread of -6.4% across 643 deals in the first half of FY2022.
- Although negative leasing spreads have persisted, managers have stated this is already reflected in valuations in many instances and, therefore, major regional asset valuations have been relatively steady. However, it is unclear whether occupancy costs (proportion of rent to sales) have adjusted to more affordable levels for retailers.
- Retail AREIT landlords have also reported an increase in the number of leasing deals in 2021 versus 2020, as well as continued fixed rent increases and strong portfolio occupancy.

Chart 7: Shopping centre rent (A$ per sqm)



Source: CBRE Research

Chart 8: Australian market rent change (% p.a.)



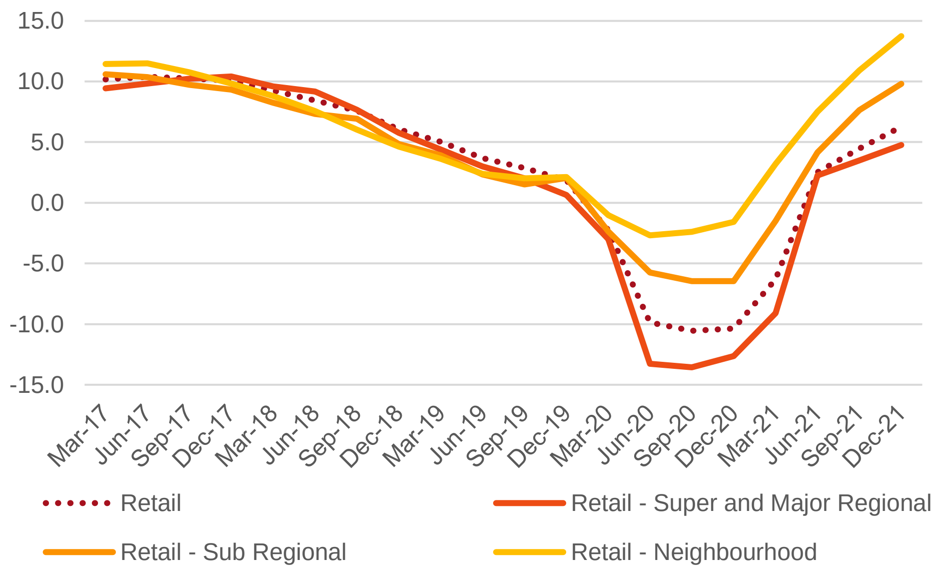
Source: JLL, Dexus Research

Performance

Recovering but still largely below pre-pandemic watermarks

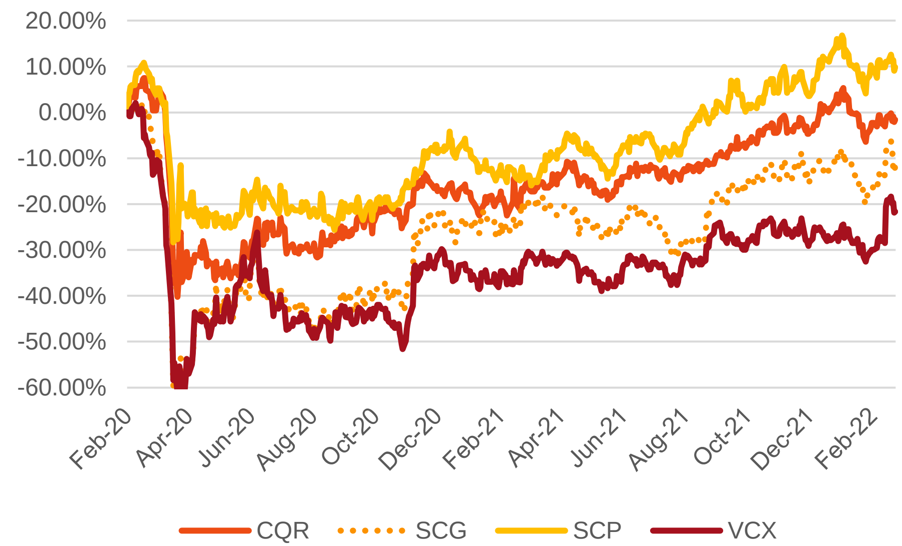
- Retail property return spreads by type (major regional, sub-regional and neighbourhood) were relatively tight prior to COVID-19 according to data provided by MSCI. The experience since has been quite dramatic, with smaller, non-discretionary retail assets strongly outperforming. Total returns of larger assets has rebounded along with investor sentiment, though return spreads remain elevated.
- Based on MSCI data, retail specialist funds have underperformed on a total return basis relative to office and industrial counterparts for 2021, despite income return hovering between 3.5% p.a. and 4.2% p.a. for all property classifications. Effectively, the sole difference in 2021 total returns between property sectors was driven by differing levels of capital growth in office and industrial versus retail.
- Analysis of the performance (since February 2020) of select retail AREITs traded on the ASX indicates there has been varying degrees of recovery. SCP, with its super and major regional retail portfolio, has recovered in excess of its share price just prior to the COVID-19 pandemic. In contrast, VCX is still approximately 20% below its February 2020 share price.

Chart 9: Australian retail rolling 12-month total returns (%)



Source: MSCI

Chart 10: Selected retail AREIT performance since Feb 2020



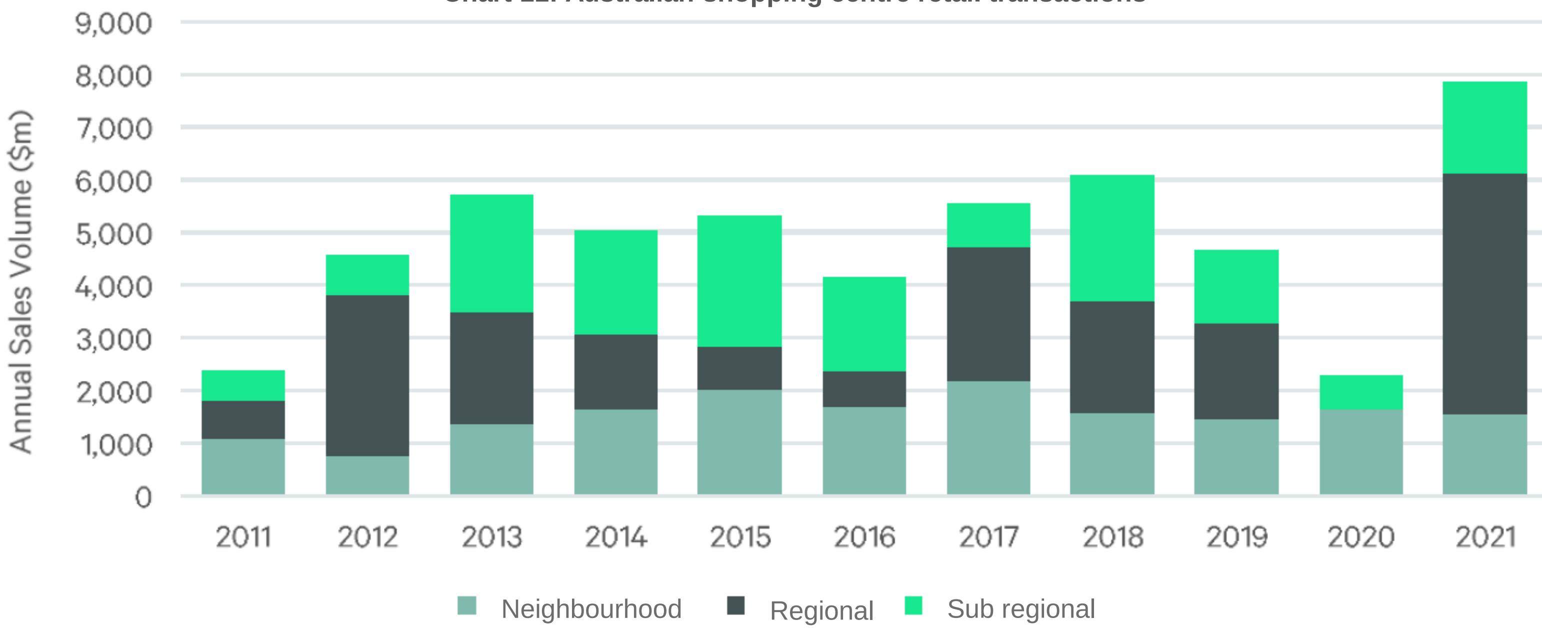
Source: Bloomberg

Transactions

Australian retail property hit record transaction levels in 2021 as opportunistic investors dived in

- Australian retail property transactions rose significantly in 2021 relative to volumes in 2020 (totalling A$11.9 billion, up 124% on calendar year 2020 and the highest annual total on record, according to CBRE Research), driven by large regional centre sales including Macquarie Centre and Pacific Fair. *Much of the activity was driven by sell down of assets due to mergers or the need to satisfy redemptions in wholesale retail funds.*
- Market sentiment towards major regionals appeared to reach a turning point late in 2021, sparking renewed interest in the sector. Despite the emergence of the Omicron COVID-19 variant, there remains a pipeline of sizeable regional assets either on the market or being prepared for sale.
- Chart 11 highlights neighbourhood transaction activity which remained relatively resilient in 2020 and 2021, as investors sought higher-yielding and less discretionary opportunities.

Chart 11: Australian shopping centre retail transactions



Source: CBRE Research

Recent major Australian retail property transactions

Select Australian retail property transactions (1Q'2022 and 4Q'2021)

Date	Asset	Vendor	Acquirer	Ownership interest (%)	Details
February 2022	Casuarina Square	GPT, GWSCF	Sentinel Property Group	100	A$397 million transaction, circa 6% discount to June 2021 book value, 6.3% yield
February 2022	Grand Plaza	Invesco	EG	50	A$220 million transaction, sub 6% cap rate
December 2021	Westfield Helensvale	QIC Property Fund	IP Generation	50	A$185 million transaction, discount to book value
December 2021	Strathpine Centre	Blackstone	YFG	100	A$267 million transaction, 6% yield
November 2021	QVB, Strand Arcade, The Galeries	GIC	Link REIT/EG	50	A$538 million transaction, 5.0% yield
November 2021	Westfield Warringah	AMP Capital Shopping Centre Fund	Dexus Wholesale Property Fund	25	Circa A$410 million transaction, premium to book value, 5% yield
November 2021	Runaway Bay Centre	Vicinity Centres	Greenpool Capital, Qualitas	50	A$132 million transaction, 5.75% yield,18% premium to book value
November 2021	Macquarie Centre	Dexus ADPF	AMP Capital Shopping Centre Fund	25	Circa A$420 million transaction, in-line with book value, 4.5% yield
November 2021	Pacific Fair	Dexus ADPF	AMP Capital Retail Trust	20	Circa A$335 million transaction, in-line with book value, 4.8% yield
October 2021	Macquarie Centre, Pacific Fair	AMP Capital Retail Trust (CPPIB, ADIA)	AMP Capital Retail Trust (UniSuper, Cbus)	50, 80	A$2.2 billion transaction, understood to be in-line with book value, 4.6% yield
October 2021	Harbour Town Gold Coast	Lendlease APPF Retail	Vicinity Centres	50	A$358 million transaction, 5.0% yield, premium to book value
October 2021	Wollongong Central	GPT Wholesale Shopping Centre Fund (GWSCF)	Haben Property Fund, JY Group	100	A$402 million transaction, in-line with book value, 5.9% yield

Sources: ASX disclosures, media reporting, JP Morgan

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