Retail’s Next Act

Could a right-sized retail sector offer a compelling risk-adjusted opportunity for real estate investors?

Hines

Hines believes a transformed retail sector has emerged after years of turmoil. Investors may very well have missed that brick-and-mortar retail fundamentals have been performing surprisingly well. This, combined with robust job and wage growth, strong consumer sentiment and stabilizing global inflation levels are all signals that the fundamental turnaround in retail should continue. If anything, capital markets have lagged. We believe that these realities are all converging into a compelling investment opportunity. In this environment, four key themes are emerging.

1. Retail fundamentals appear strong and/or improving globally; regional variations may offer diverse investment opportunities.

2. Positive net operating income (NOI/rent) growth + a reset in pricing = A potentially compelling argument to invest in the right locations and sub-types.

3. Limited retail supply in a sector "right sized" for lower demand could help to drive up prices in the next market cycle; a potential bonus are signs that retail demand could be set for a cyclical and secular rebound as wage growth supports consumption and the trend of increasing e-commerce share normalizes.

4. In searching out the "right" retail, Hines research suggests that having a grocery anchor matters for open-air retail subtypes in the U.S., including power, neighborhood and community centers. We believe this holds for all regions, but tourism may also play an outsized role in specific global markets.

> **"Given that historically the most optimal time to invest is when pricing is inexpensive and fundamentals show signs of strength, we believe that market trends are currently converging to form a potential sweet spot for global real estate investors in certain areas of the retail sector.**

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A New Era in Retail

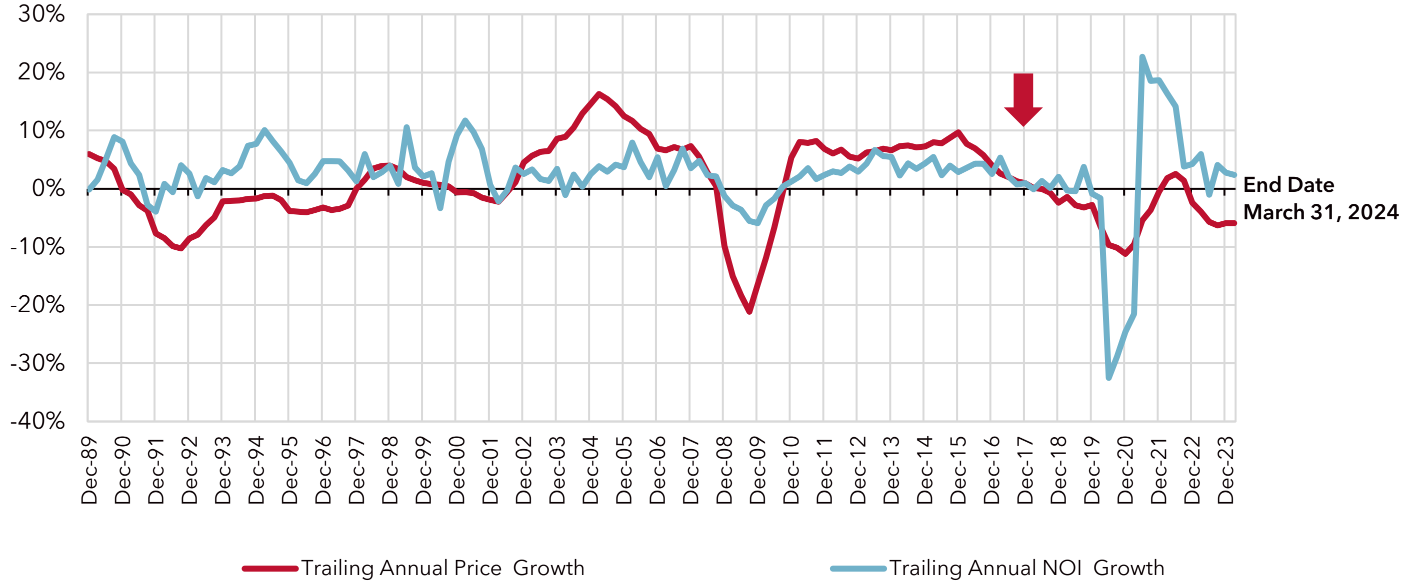
Right Sizing to a New Demand Reality

Starting in the second half of 2017, the retail sector experienced a steep drop in demand in the face of rapid growth in e-commerce activity. This moment marked the beginning of a structural downward shift in the sector in which U.S. retail NOI slowed to 0% or lower—with prices following suit (see Exhibit 1).

Key Takeaway

There's evidence that the global retail sector has entered a new era in which it has found its footing after years of disruption.

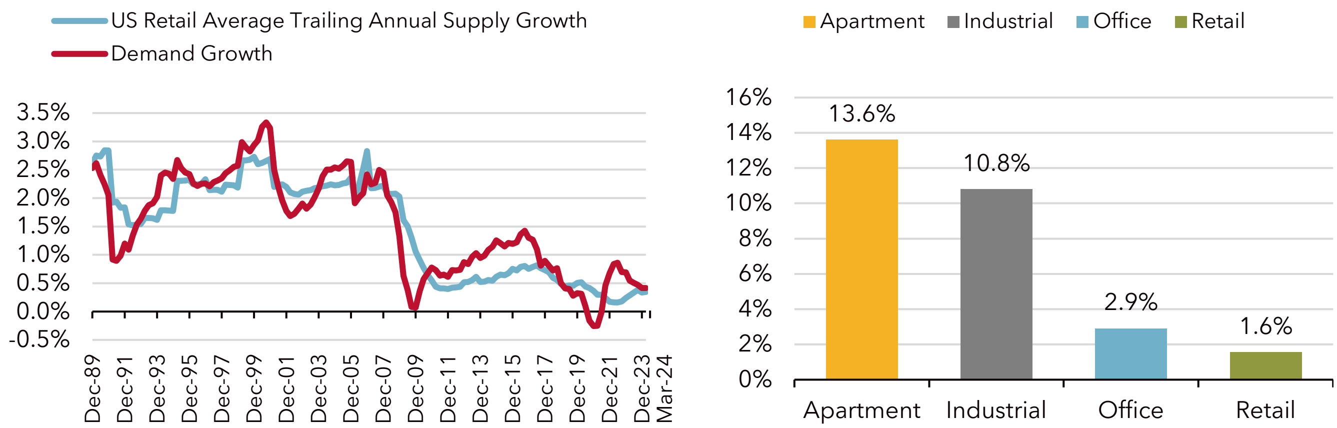
EXHIBIT 1 | U.S. Retail Trailing Annual Price and NOI Growth



Sources: Costar, NCREIF and Hines Research. As of 1Q2024.

Retail had already endured significant disruption due to the Great Financial Crisis (GFC), in which demand for U.S. retail space dropped significantly (see Exhibit 2). The sector also endured simultaneous shocks from both the growing popularity of e-commerce and impacts from COVID. The resulting drop in supply from these forces has translated into historic lows in vacancy rates in the U.S. (see Exhibit 3).

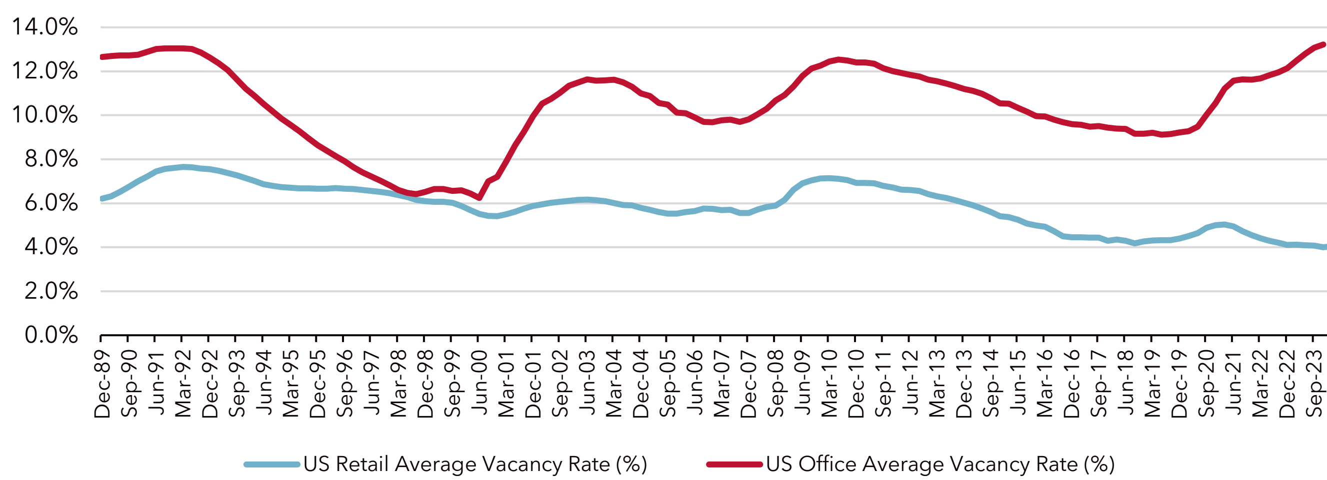
EXHIBIT 2 | U.S. Retail Supply and Demand Growth Together with Supply Growth by Sector



Sources: Costar, NCREIF and Hines Research. As of 1Q2024.

In other words, it looks as though the sector has entered a new era in which it has pivoted to meet lower demand. It is important to note the comparison to office in Exhibit 3: Retail is no office, having already made its journey to a sound fundamental footing. This is a story that echoes in European and Asian markets, where supply constraints in certain geographies could have an outsized impact on the next market cycle.

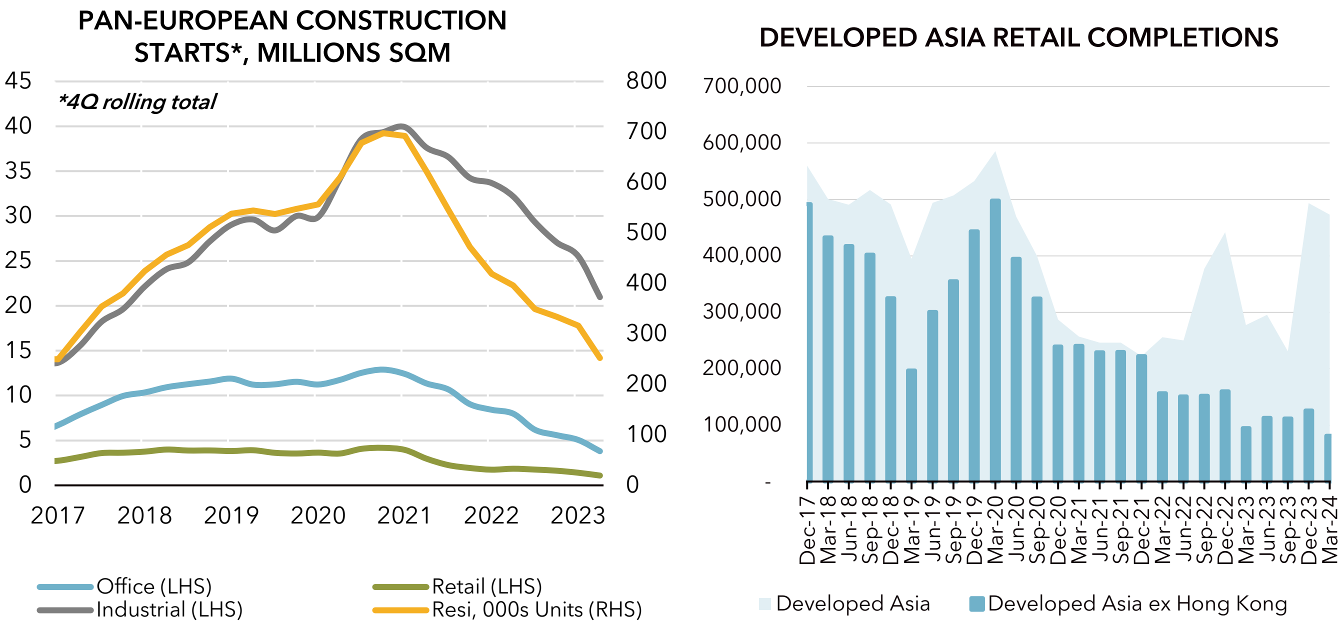
EXHIBIT 3 | Vacancy for U.S. Retail and the U.S. Office Market



Sources: Costar and Hines Research. As of 1Q2024.

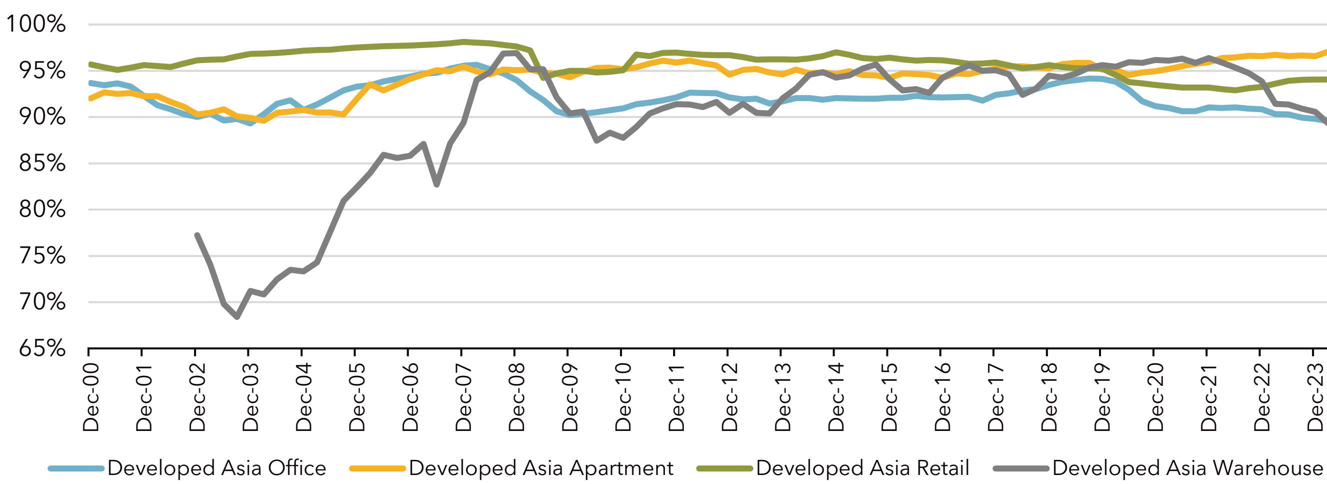
Europe's retail sector has seen some of the lowest number of construction starts since 2017, an impressively controlled supply response. Developed Asia[1] has seen more volatility in supply, but that's been driven by Hong Kong. Other key markets where we have supply data (including Australia, New Zealand, Singapore and Korea) are seeing a similar longer-term decline in supply as well (see Exhibit 4). In fact, these trends in Developed Asia have already helped to precipitate increasing retail occupancy levels since the midpoint of 2022. Today, those levels are approaching 95%—second only to the apartment sector (see Exhibit 5).

EXHIBIT 4 | Supply Constraints Could Also Play a Key Role in the Current Cycle Globally



Sources: MSCI Real Capital Analytics, JLL and Hines Research. As of 1Q2024.

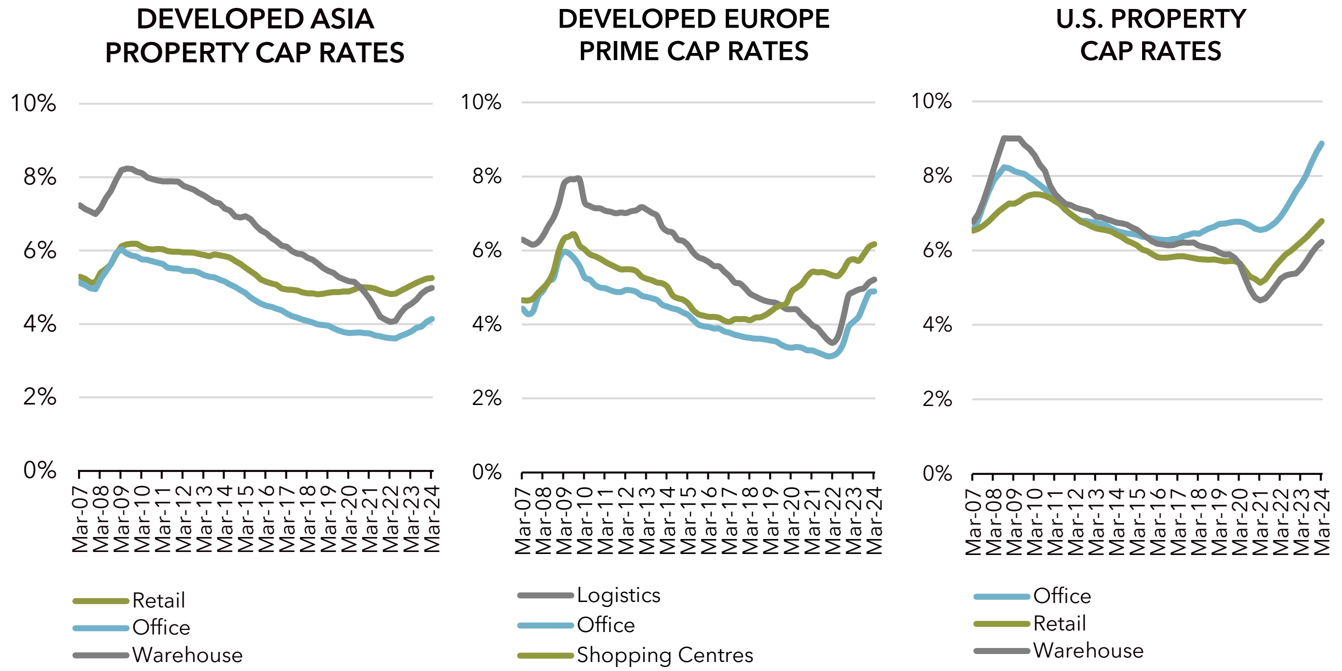
EXHIBIT 5 | Historical Occupancy Levels for Developed Asia Property Markets by Sector



Sources: JLL, CoreLogic, ARES and Hines Research. As of 1Q2024.

Meanwhile, as retail real estate values have fallen globally, yields look more attractive relative to other sectors across all three regions. It's worth noting that historically this hasn't always been the case. In fact, retail cap rates traded lower up until around 2020 (see Exhibit 6). In the U.S., retail cap rates are trending lower than office, but higher than warehouse (the historic yield play) since 2020.

EXHIBIT 6 | Retail Capitalization Rates Compared to Other Major Sectors

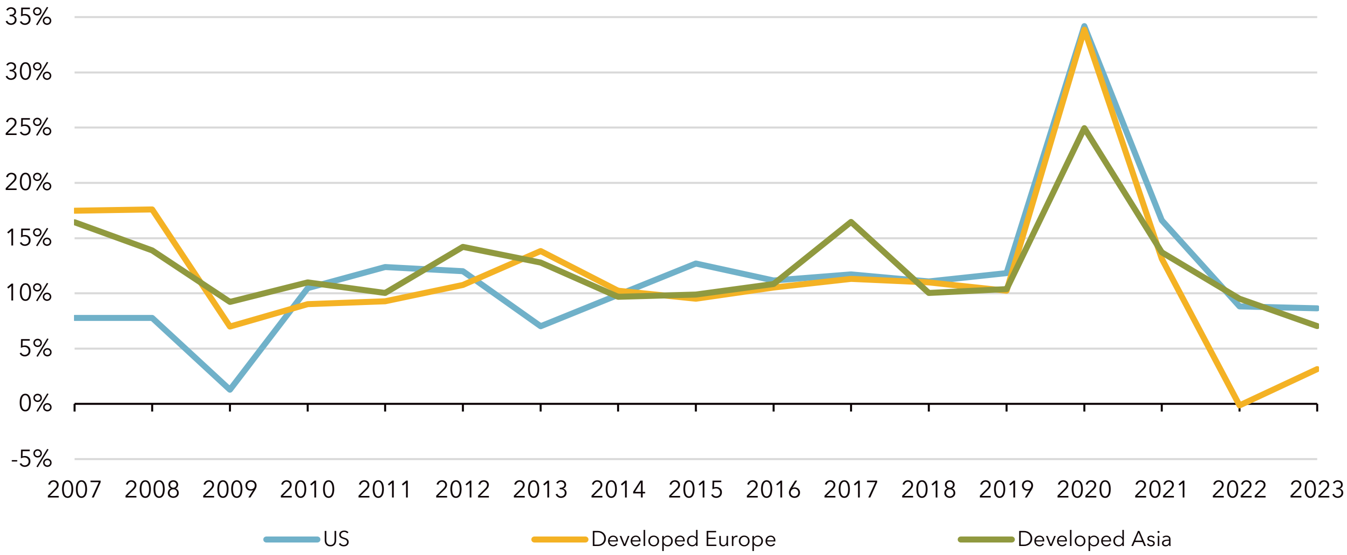


Sources: Costar, NCREIF, JLL, CBRE and Hines Research. As of 1Q2024.

BRICK-AND-MORTAR RETAIL DEMAND HAS RE-SIZED

As previously noted, e-commerce has long been chipping away at brick-and-mortar sales. This was especially true during the COVID pandemic when in-person shopping levels dwindled during lockdowns. However, with the COVID "bump" now behind us, global e-commerce growth rates have declined sharply. In fact, currently, they sit lower than pre-2019 levels (see Exhibit 7).

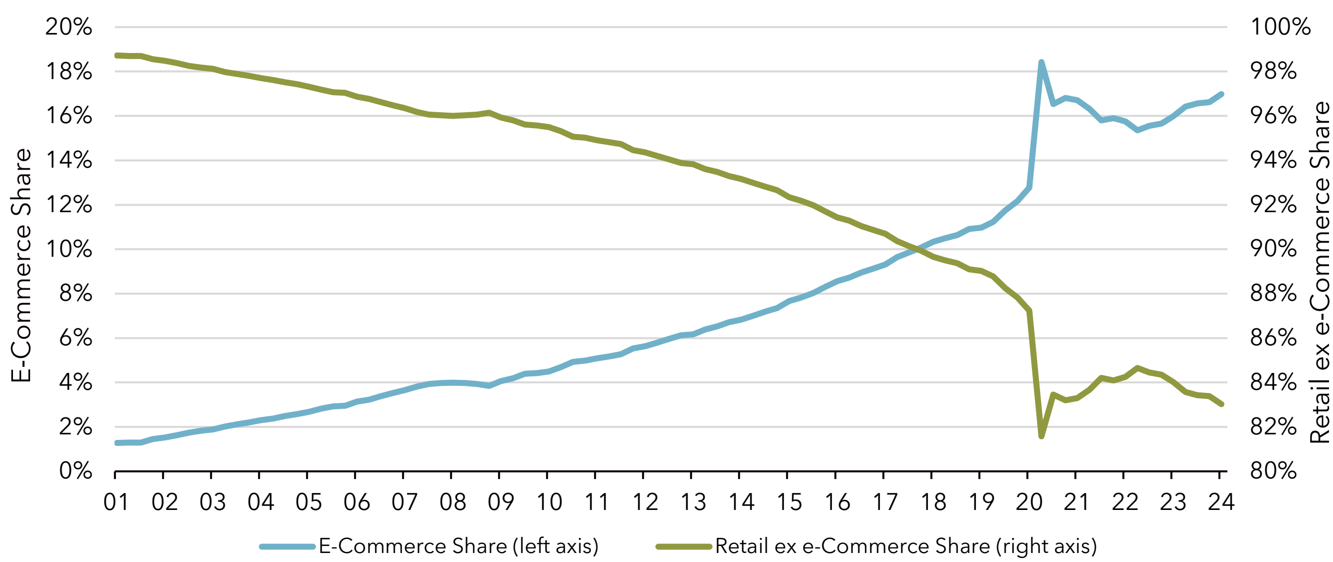
EXHIBIT 7 | Global Regional YoY Growth in E-Commerce Retail Sales by Value



Sources: Euromonitor and Hines Research. As of 1Q2024. Leveraging annual data, with the last data point of 4Q2023. To compute growth rates, we used the sum of e-commerce retail sales for European countries in EURO and in USD for Asian economies. Exchange rates are fixed to eliminate the impact on localized growth rates.

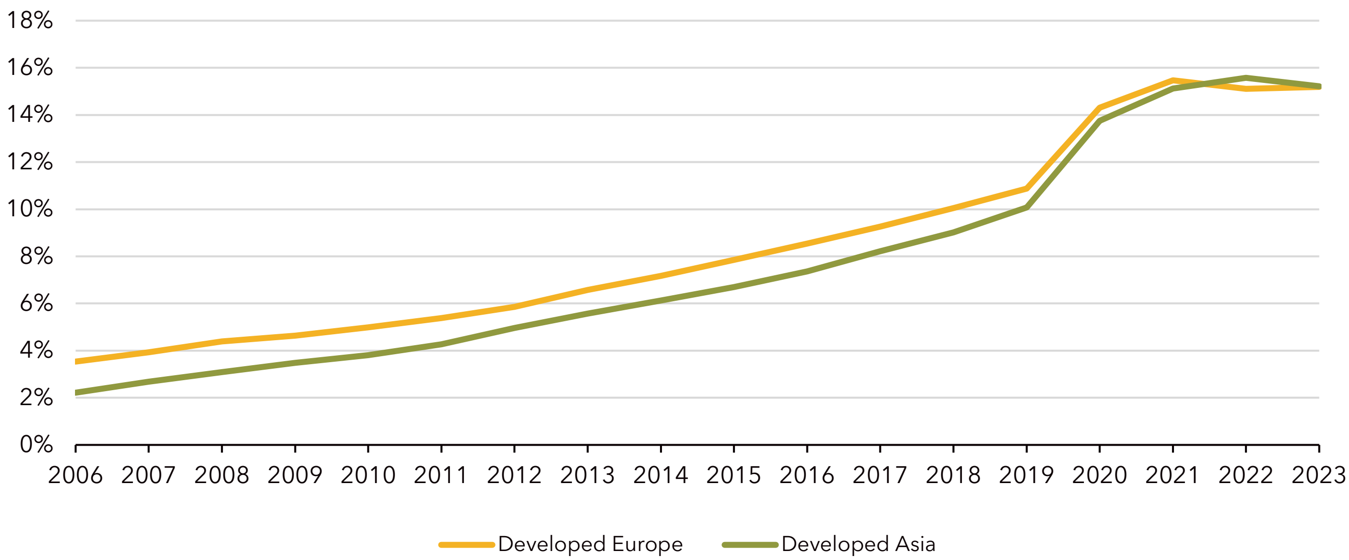
Although e-commerce activity has long been taking a growing share of the retail pie, the percentage of that activity has stabilized to around 17% in the U.S. (see Exhibit 8). Exhibit 9 reveals that a similar leveling off has occurred in Europe and Asia as well, perhaps more convincing compared to the U.S. where the share has, admittedly, shown recent signs of moderate increases again.

EXHIBIT 8 | E-Commerce and Store Shares of Total U.S. Retail Sales and Food Service, ex Auto



Sources: Census Bureau and Hines Research. As of 1Q2024.

EXHIBIT 9 | Global Regional E-Commerce Share of Total Retail Sales: Penetration Rates



Sources: Euromonitor and Hines Research. As of 1Q2024, but using annual data so last data point is as of 4Q2023. Uses averages of e-commerce penetration rates for the countries analyzed.

It's also important to point out that there's an increasing share of sales recorded as purely "e-commerce," that do, in fact, involve the store. Store-facilitated sales that are reported as e-commerce have risen from about $80 billion in 2019 to over $140 billion as of the latest available data for 2023.[2] This represents a crucial source of brick-and-mortar "omnichannel" activity that could, moving forward, be an even bigger demand driver than the stabilization of e-commerce market share.

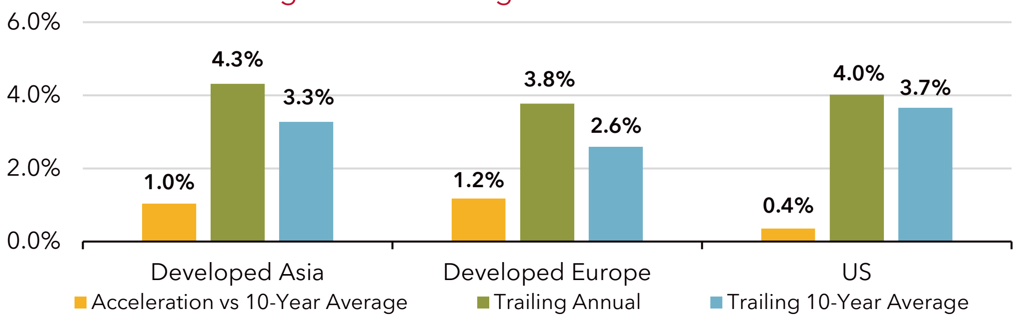
Healthy Global Labor Markets Have Helped to Fuel Strengthening Consumer Consumption

At the same time that in-store sales activity continues to build momentum in a post-COVID world, we're also seeing continued and broad-based strength in global labor markets. Employment growth has been healthy on a global basis, with 29 of the 35 economies closely tracked by Hines Research posting positive year-over-year (YoY) growth as of 1Q2024. Not surprisingly, wage growth has followed a similar trajectory. In fact, the most recent YoY growth in wages is outstripping the 10-year average in all three major global regions (see Exhibit 10). Meanwhile, private consumption continued to trend positively around the globe (see Exhibit 11).

Key Takeaway

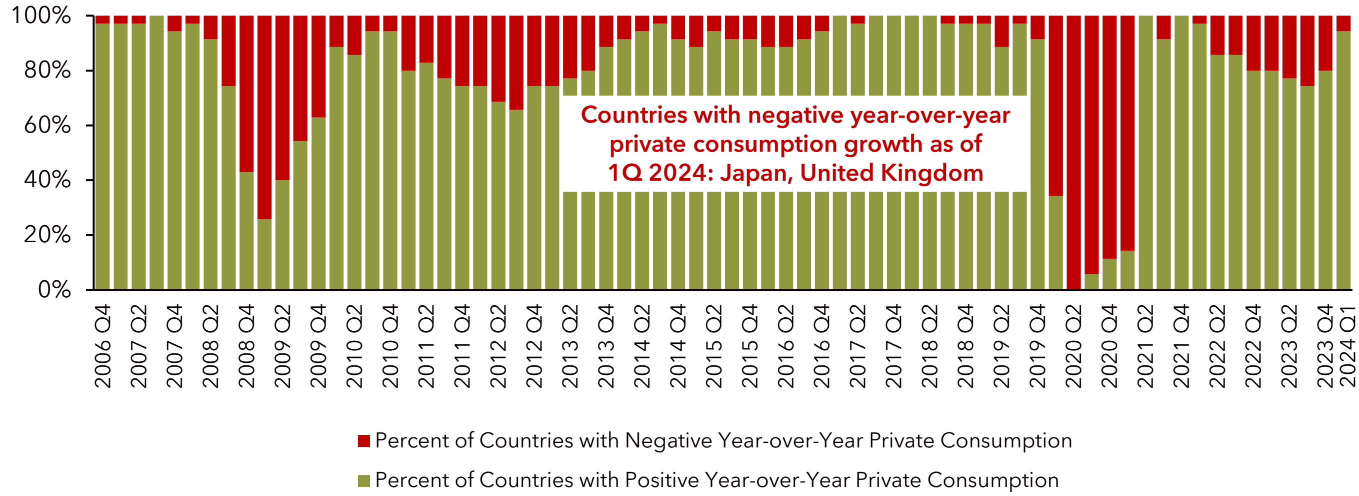
Positive economic trends, including increasing wage growth and strong private consumption, could indicate that better days are ahead for the retail sector.

EXHIBIT 10 | Current YoY Wage Growth, Relative to 10-Year Trailing Annual Average



Sources: Oxford Economics and Hines Research. As of 1Q2024. Constructed from the 35 economies tracked most closely by Hines Research wherever wage growth data is available.[3]

EXHIBIT 11 | Share of 35 Economies with Positive YoY Private Consumption Growth



Sources: Oxford Economics and Hines Research. As of 1Q2024. Constructed from the 35 economies tracked most closely by Hines Research.

Europe could be on the cusp of above-average growth in consumer spending due to several factors that may help shore up household balance sheets and, consequently, boost spending:

- Wage growth in the region has been healthy since about 2021.
- Inflation seems to be stabilizing, meaning that increasingly, those wage increases are outstripping price increases, so consumers aren't just earning to keep up but increasingly able to buy more.
- Housing prices had corrected in response to higher interest rates but are now stabilizing (and in some cases rising). This is likely to boost consumer confidence, which is already recovering and is close to long-run averages.

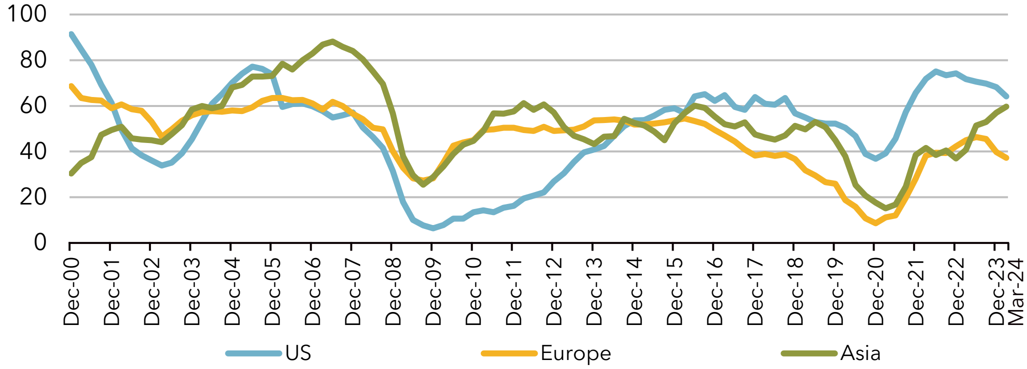
The Potential Investment Opportunity

Exhibit 12 analyzes the retail sector's fundamental health across major economies globally. The data tells us that the U.S. led the charge on growth but that global retail fundamentals have generally stabilized. Overall, U.S. retail fundamentals have experienced a recovery to above-average levels after years of structural headwinds. Meanwhile, Asia remains in the midst of a continuing recovery and almost equals the U.S. in average regional retail fundamental performance. Europe has lagged, but it's worth noting that this data is limited to "High Street,"[4] a sub-type that had been hit by lower foot traffic in many European downtown submarkets (that looks to be changing for the better, as we'll see below).

Key Takeaway

Our research finds that for some retail sub-types, NOI growth has tracked upwards, but prices have moved in the opposite direction. This could translate into a positive investment thesis based on an implied mispricing for the right locations and sub-types.

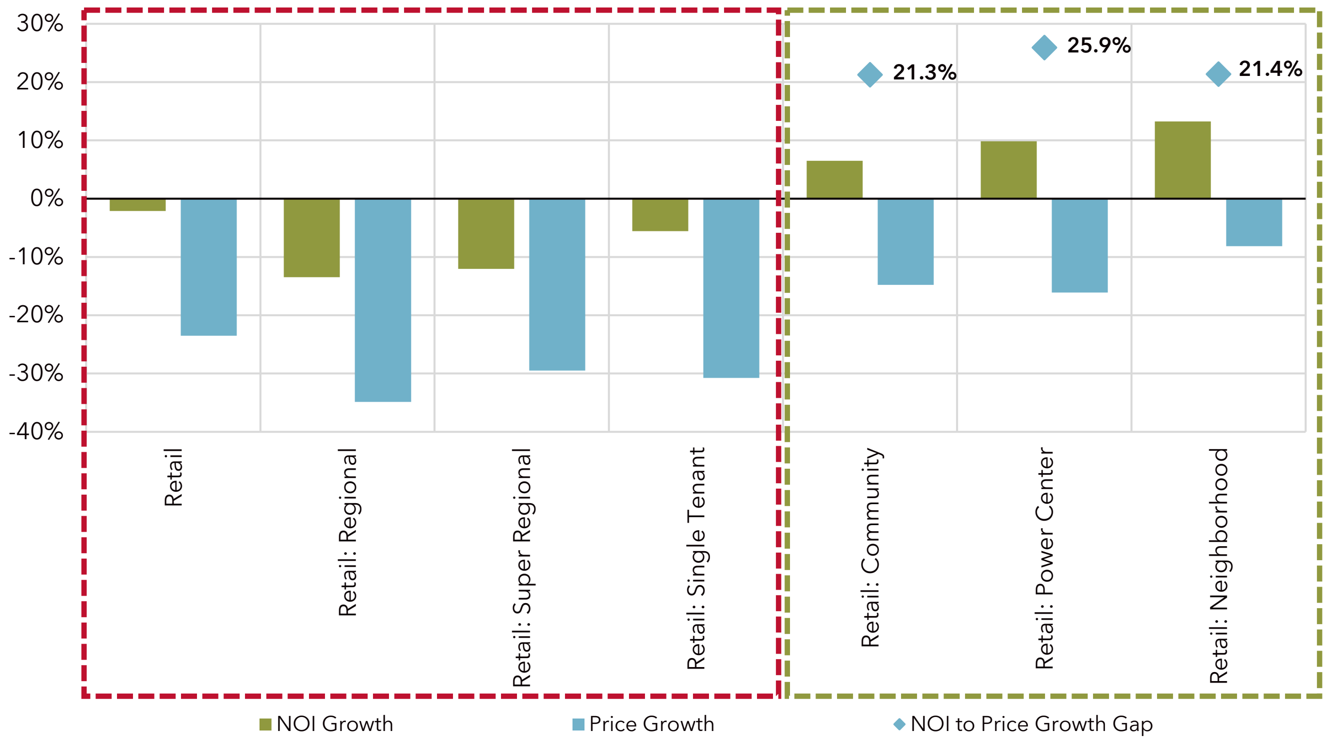
EXHIBIT 12 | Retail Leasing Environment Health Score Across Major Economies



Sources: JLL, CoStar, CBRE, Moody's, Oxford Economics and Hines Research. As of 1Q2024[5]

Focusing on the U.S. specifically, the overall U.S. retail sector has experienced both NOI and price declines since 2017 (see Exhibit 13). Over the last cycle, excluding recessions (specifically from 2010 to 2019), NOI growth and price growth were about the same across the four major property types, at 4.3% to 5.3%, respectively, per year[6]. Generally speaking, price growth should trend in line with NOI growth.

EXHIBIT 13 | Average Trailing Annual NOI and Price Growth from End-of-Year 2017

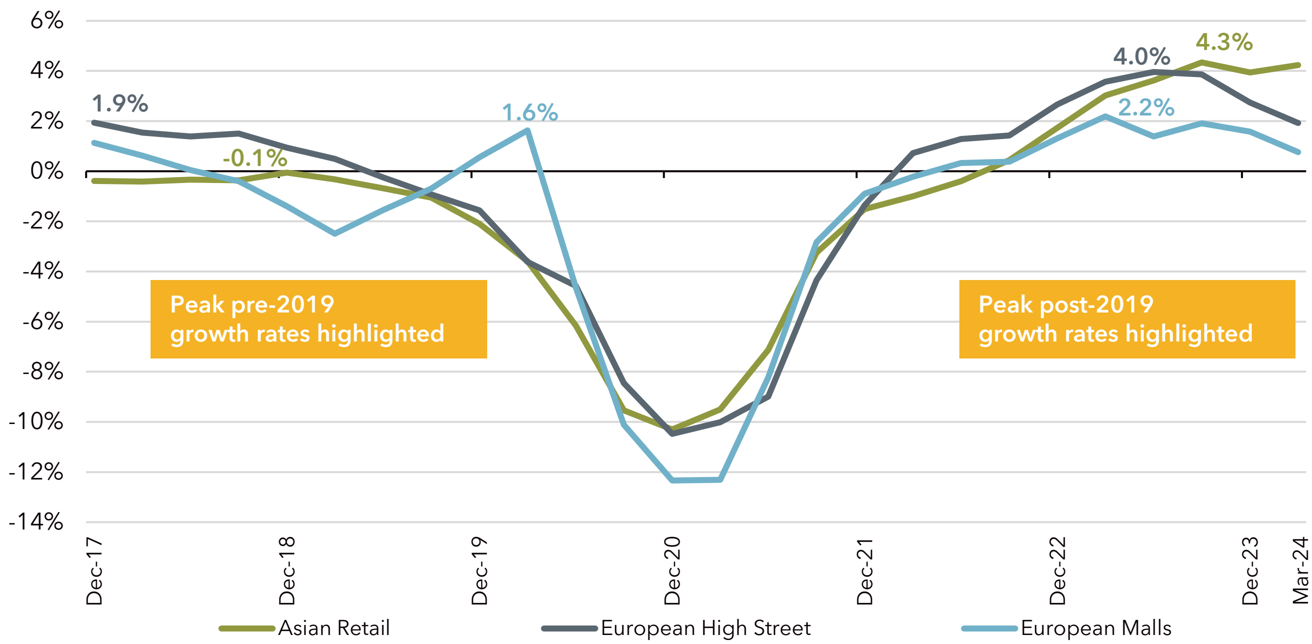


Sources: NCREIF and Hines Research. As of 1Q2024. The gap between NOI growth and price growth is only shown for property types where the NOI growth has been positive, as this justifies positive price growth, in our view. Hence, we are highlighting property types/subtypes where price growth has not reacted rationally to positive NOI growth. We start this analysis from the end of 2017 to align with the period in which retail price growth has been close to 0% or negative.

However, multiple U.S. retail sub-types have averaged positive NOI growth since 2017, while prices have actually fallen. This could very well mean that investors have thrown out the good with the bad. If that's the case, there could be a compelling investment opportunity emerging for the right retail locations and sub-types. This would be driven by the apparent mispricing, or at a minimum, better pricing with better than expected fundamentals.

And we believe this investment thesis applies across all three regions. In both Europe and Asia—where NOI data is not as reliable as in the U.S.—the trajectory of rent growth underlines a similar story of deterioration followed by recovery (see Exhibit 14). This analysis highlights the importance of location as well, with recent growth in European High Street concentrated in either a few luxury-oriented streets like via Monte Napoleone in Milan or Bond Street in London (where retailers compete for a small handful of available units) or rebased mass-market-oriented locations, such as Manchester, Glasgow and Dublin. Once again, pricing is down, yields are up and fundamentals should now inspire confidence.

EXHIBIT 14 | Rolling YoY Rent Growth for Europe and Developed Asia

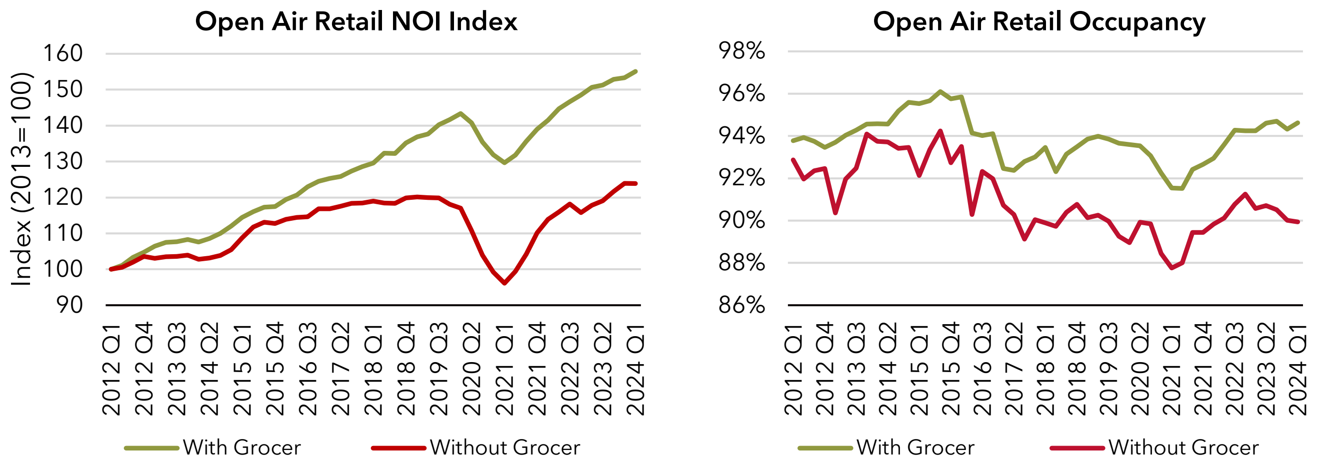


Sources: JLL, CBRE and Hines Research. As of 1Q2024. The figures shown are peak YoY rent growth rates pre-2019 and post-2019. Note: Data from EOY2017 to align with the U.S. period shown in Exhibit 1, simply for comparative purposes

In terms of what retail opportunities appear most attractive, it's well understood that having a grocer matters across multiple retail subtypes in the U.S. market, but Exhibit 15 provides convincing evidence that the difference in performance has been stark from as early as 2013. Additionally, the phenomenon works across various sub-types of open-air retail including neighborhood, community and power centers. Grocery-anchored retail centers should, in our view, continue to outperform competitors with their ability to draw shoppers, increase foot traffic and boost occupancy rates. Retail also has a critical role in "place-making," providing the amenities that may help both the retail and complementary uses (e.g. apartments, office) within mixed-use developments generate rent premiums relative to similar standalone uses.

All this appears to be the case across global markets as well.[7] We believe experiential retail and food & beverage are critical elements for developers and owners looking to create that optimal mix.

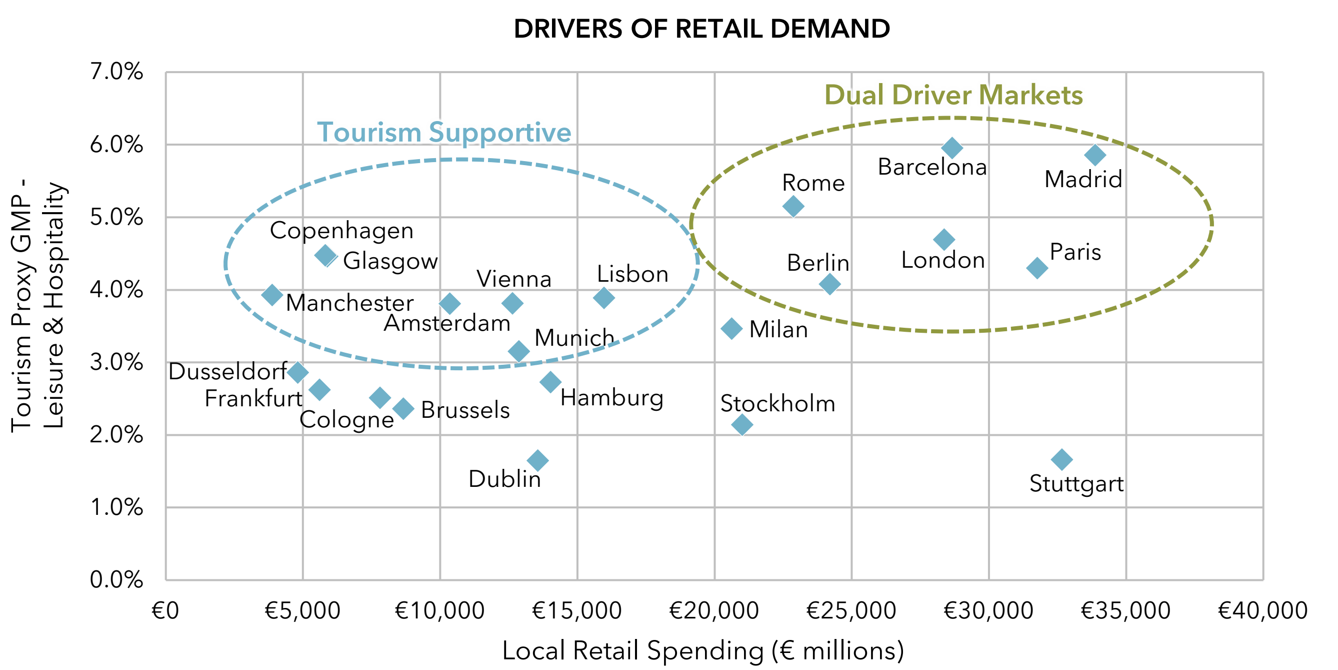
EXHIBIT 15 | Performance for Open Air Retail With/Without Grocery Anchors



Sources: JLL, CBRE and Hines Research. As of 1Q2024.

In Europe, metros with both local retail spending and tourism concentration (also known as "Dual Driver Markets") stand out relative to peers. These areas may offer opportunities for High Street investment, but also for sub-types that rely on non-discretionary spending (see Exhibit 16).

EXHIBIT 16 | Drivers of European Retail Demand

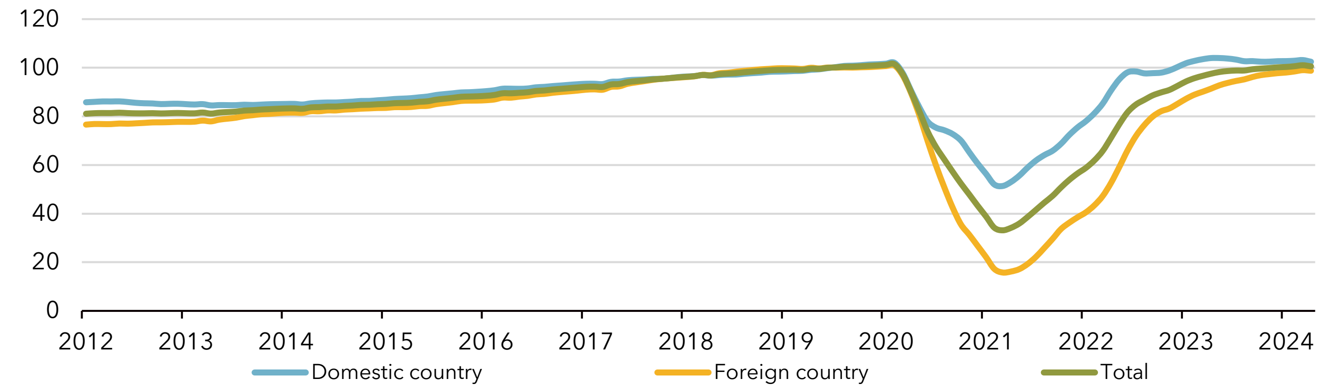


Sources: Oxford Economics, CBRE and Hines Research. As of Q42023, using annual data by metro.

TOURISM'S ROLE IN RETAIL'S RECOVERY

As we noted previously, European High Street fundamental performance can benefit from footfall that comes from local shoppers—but also from tourism. Tourism dropped precipitously during the pandemic, but is just now returning to 2019 levels (see Exhibit 17). Among the top 20 markets in terms of total nights spent in hotels in 2024 (out of 242 analyzed), we find several important High Street markets (including Rome, Amsterdam, Paris, Barcelona and Milan) with totals now above or just slightly below pre-COVID totals.

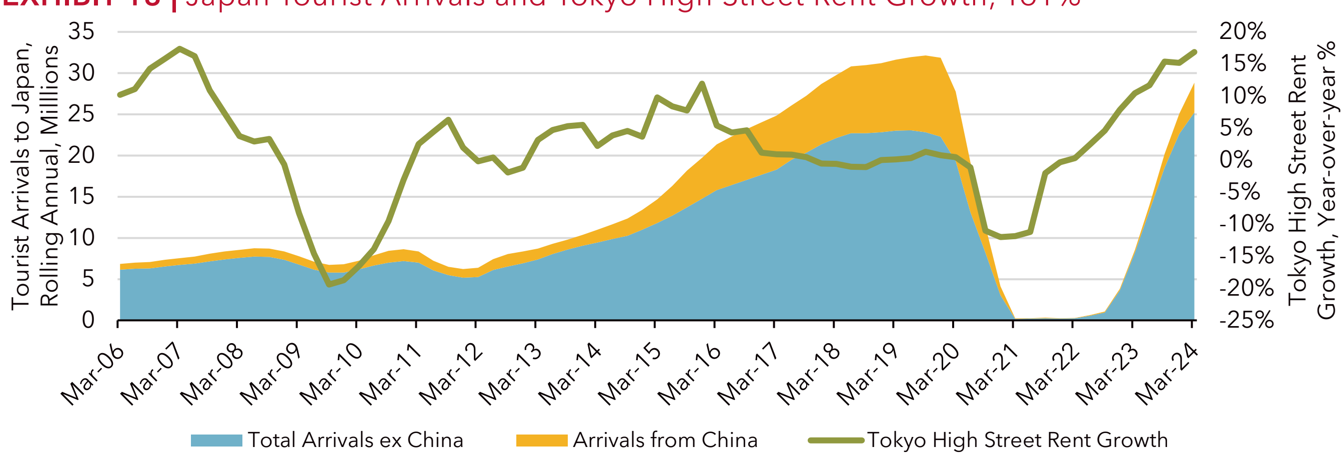
EXHIBIT 17 | Nights Spent in EU Hotels



Sources: Eurostat and Hines Research. As of April 2024. Note: Trailing annual sum compared to 2019 average, with 2019=100.

In Asia, the retail sector as a whole is on an improving trajectory, aided by phenomena like post-pandemic "revenge" spending and, like Europe, an overall boost in tourism. Tourism specifically has helped to drive retail sales in key metros like Tokyo, Seoul and, to a lesser extent, some major Australian markets. As an example, in Tokyo, growth in High Street prime rents has picked up dramatically (see Exhibit 18) – showing how regional tourism can support retail activity and consequently retail property fundamentals.

EXHIBIT 18 | Japan Tourist Arrivals and Tokyo High Street Rent Growth, YoY%



Sources: CEIC, Japan National Tourist Organization, JLL and Hines Research. As of 1Q2024.

Conclusion

Improving fundamentals point to a continuing recovery in retail after years of disruption caused by factors including digital and e-commerce transformation, the GFC and COVID. We're now observing encouraging signs of strength in retail globally as the space has evolved in the face of structural change.

In this environment, some key themes are emerging:

- Constrained supply over recent years means that retail has essentially "right sized" to meet a new demand reality.
- Opportunity is emerging as record low vacancy rates combine with positive global economic trends including rising wage growth and strong consumer demand.
- Multiple retail subtypes have positive NOI growth (in the U.S.) and rent growth (in Europe and Asia) while also experiencing declines in pricing.
- This is likely a sign that investors have thrown out the "good" retail with the "bad" and investors can take advantage of that potential mispricing.

Given that the most optimal time to invest is when pricing is inexpensive while fundamentals show signs of strength, we believe that market trends are currently converging to form a potential sweet spot for global real estate investors in certain segments of the retail sector. This investment thesis applies across the U.S., Europe and Asia.

About Hines' Proprietary Research Team

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Joshua Scoville (Head of Global Research) and his team, including Senior Managing Director Michael C. Hudgins, a lead contributor to this paper, together with Tim Jowett, Ryan McCullough and James Purvis, are responsible for constructing the Hines macroeconomic view and outlook for commercial real estate market fundamentals and pricing. Hines Research is also responsible for assisting with the development of investment strategies for the firm's investment programs; working closely with the local and fund management teams, clients and partners; and supporting U.S. regional and international country heads in identifying market/submarket opportunities and risks. The views of the local and fund management teams on the latest market developments are exchanged regularly via biweekly conference calls and quarterly market updates. They are essential for reviewing investment strategies and fund portfolio allocations. Additional team members include Erik Thomas, Michael Spellane and Anthony Witkowski.

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ENDNOTES

[1] Developed Asia includes Australia, Hong Kong, Japan, New Zealand, Singapore and South Korea. Developed Europe is defined as capital cities or major cities in the original EU-15 countries: Austria, Belgium, Denmark, Germany, Finland, France, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the U.K.

[2] Sources: Census Bureau Annual and Monthly Retail Trade Surveys and Hines Research. As of 1Q2024, but on an annual-based analysis.

[3] The 35 economies tracked most closely by Hines Research where wage growth data is available include: Australia, Austria, Belgium, Brazil, Canada, China, Czech Republic, Denmark, Finland, France, Germany, Greece, Hong Kong, Hungary, India, Indonesia, Ireland, Italy, Japan, Malaysia, Mexico, Netherlands, Norway, Philippines, Poland, Portugal, Russia, Singapore, South Korea, Spain, Sweden, Switzerland, Thailand, United Kingdom, and the United States.

[4] The European retail market is comprised of various subtypes similar to the categories of the U.S., but with an additional sub-type called "High Street." This category includes smaller shops, usually on busy shopping streets which may offer luxury items for tourists as well as local shoppers.

[5] The Leasing Environment Health Score measures the relative health of a market's current leasing environment. It combines vacancy rates, trailing annual rent growth, and trailing annual demand growth into a composite score. The score is a historical-looking snapshot of where the market is today. It can predict fundamental performance over the next 1-2 years but is not predictive of medium-term performance (3-5 years). The score measures the environment relative to the prior environment in the market's own history; a score of 100 is a strong leasing environment, stronger than 100% of the market history. A score of 10 is a weak environment, worse than 90% of a market's history.

[6] We chose this period to approximate a period of equilibrium in which capitalization rate movements were not impacting prices dramatically, as they do around recessions, both to the downside and then in recovery. Note: the period is aligned with a single cycle and avoids recessions.

[7] While the research was done in the fourth quarter of 2022 by CoStar, but is no longer replicable, it identified that retail, apartment and office uses within a mixed-use context generated rent premiums relative to the same standalone uses within the same submarket. CoStar Advisory Services, Mixed-Use White Paper. As of 4Q2022.