THE EVOLVING SHOPPING MALL IS WINNING

- Matthew Strotton, QIC

There is a tendency for every generation to think that the world of their time goes through the most dramatic changes in history. Everything is "bigger, faster, best/worst, unprecedented", and on it goes. Until the next generation says the same thing.

Recall some of the overblown commentary during the internet bubble years (1995-2000). The buzzwords of that era were "paperless office" and "telecommuting" and, wait for it, office space was dead. Fast-forward to today and office space did not die but has grown in tandem with the white-collar workforce. And despite the proliferation of digital documents and cloud services, we have not eliminated paper from our offices.

These days, there is plenty of chatter about "disruptors" caused by changes in technology, affecting all manner of industries and investment classes globally. One of these oft-reported industries is that of the shopping mall and retailing generally. Disruption in all its forms is nothing new in retail. There has been disruption since the modern shopping mall first appeared about 60 years ago.

Evolution, disruption, call it what you like, is part of the "creative destruction" of market economies and free societies. Every industry, every company, faces disruption from new business models, changing lifestyles and social behaviours, and yes, technology. 'Twas ever thus.

A LITTLE HISTORICAL PERSPECTIVE

None of this implies mall owners and retailers should dismiss disruption as a beat-up.

It is, however, a call for perspective because forward-looking mall owners and operators, and retailers, are not standing still. Notwithstanding broader economic factors currently affecting personal consumption, those forward-thinking owners are upping their game to meet the needs of today's consumer. They are winning the battle for the hearts, minds and wallets of consumers and shoppers.

Amazon or "Amazonification" is the word on everyone's lips when disruption gets mentioned, which seems more frequent every day. A valuable paper by BCA Research[1] shows that on a historical scale, Amazon's disruption is of a smaller magnitude than the impact of "big box" stores such as Walmart. Furthermore, Amazon's market share is growing more slowly than Walmart's did in its stratospheric growth years from the 1990s to the early 2000s.

Bain & Company has also dug deeper into the digital challenge issue[2], beyond just the Amazon impact, noting that e-commerce growth rates have already begun to slow, heading toward equilibrium. Research by Chilton's REIT team reveals that e-commerce growth seems to have stalled at around 15%.[3] That is still an impressive number, but down from the figures of a few years ago.

Economic laws eventually catch up with all industries and companies. Otherwise, a single company would end up being larger than an industry or economy.

There are two reasons for the plateauing of e-commerce growth. First, not everyone wants to buy everything online. Second, the economics of e-commerce are not as attractive as most people think.

Amazon's slowing US growth rate may help to explain the company's decision to set up operations in Canada and Australia, two high-cost locations from a logistics and distribution dimension due to both being vast countries with low population densities.

Despite Amazon having established onshore operations in Canada since 2010, Canada's online retail penetrations rate remains muted at about 7%. Given Canada's greater similarities with Australia compared with Amazon's core markets (the UK, Germany, France and the US where penetration rates are in the teens or high single digits), it is more likely that Canada's experience will be mirrored in Australia despite Amazon's impending on-shore launch in coming weeks.

JOINING THE CLUB

As it is, rather than persisting with the dead-end "digital versus physical" argument, Amazon took a step towards the omni-channel club with its Whole Foods acquisition. This gives the company instant access to the grocery store business, which accounts for $636bn per annum.[4]

The transaction underscores the importance of omni-channel platforms, incorporating a blend of physical establishments with an online footprint to drive traffic and sales.

The grocery sector has been e-commerce resistant. While online sales have gained strong traction in a wide range of retail segments, internet sales of groceries have notably lagged: in-store sales represent ~93% of all grocery sales.[5] The thriving in-store grocery sector is part of a far deeper story.

While digital penetration is notable in durable goods categories like clothing and apparel, and electronics, the in-store and in-mall experience remains strong for many other categories.

Even using the most generous definition, e-commerce only accounted for about 9.2% of total retail sales (ex-food) in the US in 2015. After adjusting for mail order drug delivery, items shipped from store

[1]Did Amazon kill the Phillips Curve? Appeared in The Bank Credit Analyst. September 2017 – Vol. 69 – No. BCA Research.
[2]Bain Retail Holiday Newsletter 2016-2017 Issue #4, December 2016. Bain & Company. http://www.bain.com/publications/articles/retail-holiday-newsletter-2016-2017-4.aspx
[3]REITerating our conviction on high quality retail REITs: Malls. July 6, 2017. Chilton REIT Team. Chilton Capital Management.
[4]Some storms on the horizon. UBS Retail REITs, May 22, 2017.
[5]Ibid.

inventory and 'non-merchandise items' (includes shipping and handling costs), estimates suggest that the actual figure was 5.7% in 2015. By making estimates based on 2016 data, the e-commerce figure was about 6.4% of retail sales in 2016.[6] So much for digital taking over the world and the demise of physical shopping.

SHIPPING

The reasons for the lasting relevance of physical shopping and why it is difficult to be profitable with an online-only strategy include 'free' returns, 'free' shipping and low conversion rates.

According to CBRE, e-commerce returns are somewhere between 15% and 30% of products sold. When an e-tailer maintains a policy of free returns, the customer often orders many different items with the intention of keeping only a few (i.e. multiple sizes).[7] Not only is the e-tailer losing money on the shipping back and forth of items to a customer, but it also could lead to having to discount or even dispose of the returned item, depending on the type and condition.

In contrast, brick-and-mortar returns average about 8% – much lower due to the ability to experience the product and assess quality. Furthermore, returning an item to a physical store allows the retailer to avoid shipping costs, and, on average, the customer buys additional items equal to 107% of the value of the item returned.[8]

WE ARE SOCIAL CREATURES

But the case for retail goes well beyond the limitations of a purely digital business model. At the end of the day, human beings are social creatures and the role of the mall goes beyond buying products. Consequently, retailers that provide consumers with experiences that cannot be enjoyed over the internet are likely to increase their footprint in malls.

Millennials are a powerful case in point. The 75 million millennial Americans are the #1 workforce demographic in the US and account for $1.3tn in direct annual consumer spending, which is forecast to grow as their annual income reaches $8.3tn by 2025.[9]

Millennials are drawn to locations that remain open beyond the standard "9 to 5" business hours, allowing them to meet friends to eat and shop at a time that suits them and their lifestyle. The destinations they choose offer them not only the shopping opportunities they seek but also more of the healthier casual dining options they crave, rather than just the traditional fast food outlets.

Dining is just one of the winning points-of-difference for forward-looking malls. The US is actually under provisioned in food and beverage categories, and entertainment.[10] Notwithstanding this observation, the number of restaurants located at or adjacent to malls is at an all-time high, having increased by 40,000 net over the past five years. Americans now spend more eating out than eating at home. According to Census Bureau data, through January 2017, restaurant sales were up a robust 5.6% over a year earlier.[11]

The Bureau of Labor Statistics (BLS) revealed that the number of restaurants in the US increased by about 2% in 2016 and approximately 11% since 2011. This group is being fuelled by independent restaurants which represent about 66% of the total.[12]

Malls that are e-commerce resistant have many restaurants, movie theatres, fitness centres and outpatient facilities and a greater range of salons, health services and medical centres to name some categories. Recently, more movie theatres are entering malls as anchors and restaurants are being incorporated into the malls as opposed to occupying traditional 'pad' sites.

Apple and Tesla are producing the highest sales per square foot of any mall tenant and are acting as major drivers of traffic, as are powerhouse international fashion labels.

The same e-commerce channel that many are afraid is going to kill bricks-and-mortar today is currently incubating the great brands of tomorrow. Brands like UNTUCKit, Ministry of Supply, b8ta, INDOCHINO, Athleta, Blue Nile, Bonobos, Interior Define, Allbirds, Madison Reed and the list goes on and on.[13]

Digital commerce has hastened, in some degrees, the demise of irrelevant brands that have lost their way with the shopper, but more importantly is incubating the creation of new businesses. Instead of critiquing the physical space in which these retailers may have occupied, these individual retailer models should instead be queried. Did they evolve their model to suit shifting consumer preference?

Technology is making the birth of new brands far more efficient than the old model where people had to create an idea and then go out and take the risk of testing that idea with a series of bricks-and-mortar.

Digital commerce, far from being a threat to physical gathering places, is a friend of the shopping mall. Technology is fostering the creation of integrated, digitally born brands that create a sense of community and loyalty in the digital world. Before they decide to open their first store, and when they do begin to round out their omni-channel strategy, they are able to attract shoppers that are already following their brand and then visit their brand with a sense of purpose and intent.

Retail has long been an industry characterized by creative destruction that has produced winners and losers at the retailing game. The biggest winners have been consumers, as it should be. Mall operators and retailers can only thrive if we evolve to serve them better. We are up to the challenge and succeeding.

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[6]Chilton REIT Team. Op cit.
[7]Ibid.
[8]Ibid.
[9]Marketing to Millennials. Simon Hudson, Endowed Chair in Tourism and Hospitality, University of South Carolina. http://hotelexecutive.com/business_review/4563/marketing-to-millennials.
[10]Stewart Rubin, Senior Director, New York Life Real Estate Investors, Challenges confronting regional malls intensify.
[11]Ibid.
[12]Ibid.
[13]Macerich's Q2 2017 results earnings call. August 6, 2017 transcript