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Invesco Real Estate Webinar: The Outlook for Consumer-Related Real Estate Sectors

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Introduction

The retail and logistics real estate sectors are now both closely tied to consumer spending. The COVID-19 lockdown sped up the shift of retail to e-commerce as stores shuttered and consumers ordered goods delivered to their homes to minimize exposure risks. Retail and logistics real estate are effectively two sides of the same consumption coin; logistics has been sought after amidst the intensifying e-commerce trend, while the retail sector struggles to regain investors' attention. In this webinar, we discussed how we could be best positioned to capture consumer demand, where to find value in the capital-crowded logistics sector and what type of retail could remain post-COVID-19.

Webinar Summary

Metrics of performance

During COVID-19, the logistics sector has performed well, while retail sector performance suffered the most. Structural forces create new winners and losers in real estate, and these vary over time. The shift to e-commerce has affected retail and logistics real estate performance. Retail had been the strongest performer in the early 2000's and remained in a good position until 2014, after which it fell to be the worst performing sector for each of the last four years. In contrast, logistics performance has fluctuated over the last 20 years, but it has been the sector with the best performance almost every year since 2013. Online sales as a percentage of total retail sales continues to increase. The lockdowns resulting from the COVID-19 pandemic have pushed even more retail sales to online platforms. Net operating income (NOI) growth of logistics has outpaced that of retail in many markets over the last five years, particularly in the US and UK.

The investor response to these trends is clear when we look at the transaction volumes over time. Transaction volumes of industrial real estate have surpassed that of retail assets since Q2 2019 (Figure 1). Yields/cap rates of logistics have compressed significantly amidst stronger growth expectations. An ANREV investor survey of Asia Pacific investors from July 2020 showed that most investors plan to decrease their allocation to retail and increase their logistics allocation. Similar trends are occurring in the other regions. We intend to focus on how to extract value out of this capital-crowded sector as logistics continue to be an interesting investment.

Private consumption

For a top down view on how private consumption is likely to grow and provide some context for capturing consumer demand, our panelist Ben May from Oxford Economics discussed the current state of consumer spending and how it might be expected to recover over the next few years. Consumer spending plummeted sharply in April following the COVID-19 lockdowns. So far, there appears to have been an almost V-shaped recovery in retail sales, similar to what was seen in Hong Kong in the early 2000's around the time of the SARS outbreak.

Retail sales of goods are only a small portion of household spending. Spending on services has not recovered as strongly as spending on goods, likely due to a combination of lockdown restrictions on certain businesses and consumers' reluctance to venture out to social situations. Spending on goods may have benefited from consumers spending money meant for holidays that were cancelled because of the pandemic.

The number of hours worked by employees has declined since the beginning of the year, in line with the declines in GDP. The effect of decreased working hours has not trickled through to impact household spending as governments have stepped in to subsidize the underemployed. Examples include the furlough scheme in the UK and the US CARES act. This support is temporary and, as we move into the second phase of recovery, it may be harder to generate strong growth in consumer spending. Policy support may also impact the recovery; historically the evidence suggests that a low spending response by governments and central banks tends to have greater negative medium-term impacts on GDP than a high spending response.

The risks around Oxford Economics's GDP projections lie firmly to the downside: There might be a second wave of COVID-19 infections leading to renewed lockdowns, slower medical advancement in treatments, or the current economic weakness could morph into a banking or financial crisis. Upside risks would include quicker vaccine development and rollout or prolonged government stimulus of the economy.

People's perception of risk tends to fluctuate before, during and after pandemics. These perceptual changes may influence spending as people feel they are at less risk of infection and venture out of their homes. As behaviors normalize, we may see consumer spending revert to normal.

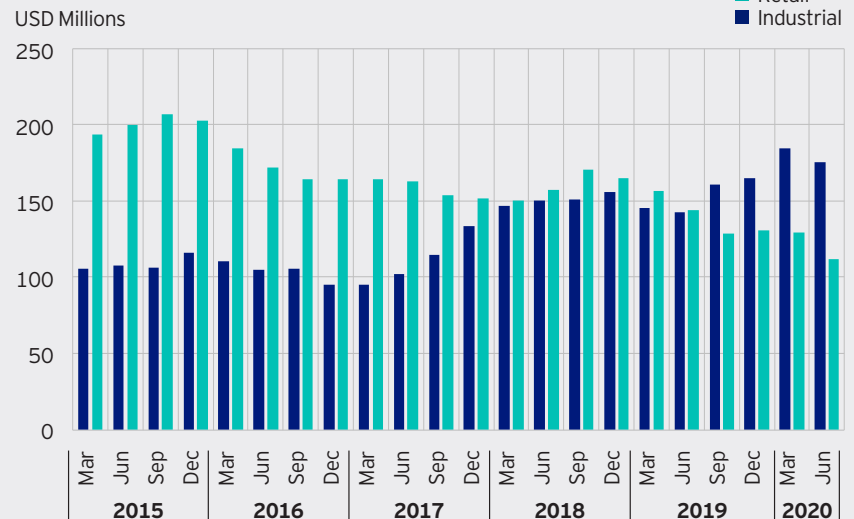
Panel Discussion

How is the global supply chain evolving?

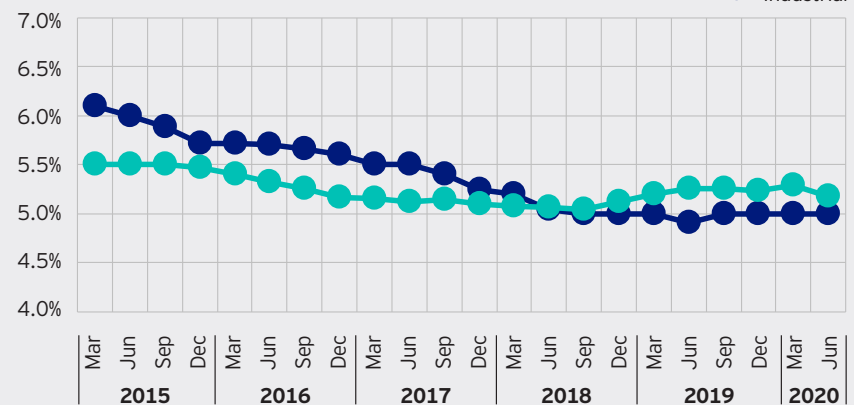
Global supply chains were established to maximize returns by optimizing labor costs and lowering overheads. This globalization led to a decrease in manufacturing centers in Europe and the US by moving many of these centers to low-cost countries, primarily China. This trend has been reversing since 2008, diversifying the location of production and moving some production centers back closer to the centers of consumption. According to a recent Bank of America survey, companies in more than 80% of the global sectors experienced supply chain disruption during the pandemic and consequently plan to re-evaluate their current supply chain. The disruption caused by the pandemic, geopolitical conflicts and trade disputes is causing companies to diversify their supply chains. Localization, reshoring, nearshoring or multi-shoring of production, may be the most dominant structural shift in the post-pandemic world.

**Figure 1 - Transaction volume and pricing:
Logistics yield to fall further?**

Global transaction volumes of retail and industrial



Top quartile cap rate of retail and industrial



Source: Real Capital Analytics, August 2020

Which segment of the sectors are likely to benefit the most?

From the viewpoint of tension in geopolitics, sensitive sectors involving technology are likely to be a focus for supply chain disruption and re-shoring, including cybersecurity, space research, AI, communication technology, cellular equipment, chip design, enhanced materials, defense industry, and rare earth materials sectors. Other sectors that support PPE may also benefit. Luxury retail goods have been negatively impacted.

Sectors involved in the decoupling of supply chains and setting up of factories may also benefit: machinery, electrical and electronic equipment, factory automation, application software firms and robotics. Companies looking to relocate supply chains may choose to rent out industrial locations for warehousing instead of building or buying their own. Apart from the US, other favorable locations for global logistics may include India and Southeast Asia, especially Vietnam. Poland and Mexico could also be areas of interest.

We may see a surge in the next five to six months in transport and logistics services that support temperature control and drug delivery for global vaccine distribution.

Is it costly to relocate supply chains from China or adopt a China-plus-one model?

It is not easy to move out of China because it offers the right combination of cost, quality, efficiency, infrastructure and human resources. In addition to being time consuming, there is a high one-time cost associated with setting up new factories and supply chains. Firms may not choose to invest a lot of capital to reinvent supply chains in order to build resilience. Governments may be the ones pushing deglobalization with geopolitical tensions and tariffs. Historically, we have seen that tariffs can increase quickly, but they fall back slowly in environments of slow growth.

Warehousing on demand may become more widespread as companies diversify their supply chain and seek a more distributed network of warehouses. Logistics with greater levels of automation may fare better due to greater resilience and less dependence on human workers.

What do you see as key risks for investing in logistics globally?

With the future projected to be a slow growth environment, it is likely to have low inflation and low interest rates for some time. One of the risks to logistics is the prevailing low yield/cap rate environment, but current macro financial conditions may be favorable for real estate because other income-producing asset classes are at least as highly priced. With investors hunting income, the yields/cap rates of logistics real estate remain in very strong demand. Every risk creates an opportunity and the opportunity for consumer real estate lies in the changes in supply chains. Demand for real estate generally relies on either growth or change. Geopolitical and technology factors are additional risk factors, but they also generate opportunity. COVID-19 has reinforced the changes in retail and logistics that were already underway.

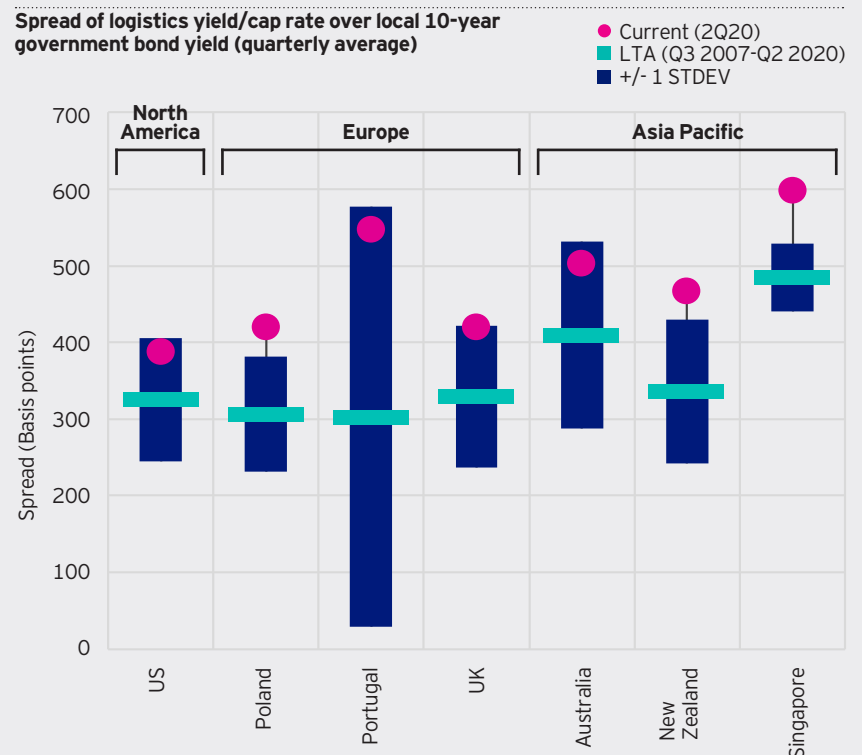
Where do you see the best relative value for logistics investing?

Logistics prices are high everywhere, but relative to other asset classes, they are favorably priced. They look relatively favorable, especially looking at the spread of the yields/cap rates over local long-term government bonds (Figure 2). As the COVID-19 monetary responses have brought down bond rates, the spread of the real estate yield/cap rate is above the long-term average in most places around the world. The difference is particularly marked in the US, Portugal, Poland and the UK in Europe and New Zealand, Singapore and Australia in Asia Pacific.

Where are the best opportunities in Asia Pacific for logistics across different strategies?

E-commerce penetration is consistent across the markets we monitor, but market structures are all quite different across the Asia Pacific region. In Singapore and Japan,

Figure 2 - Logistics yield spreads over 10-year government bonds¹



Source: Invesco Real Estate using data from CBRE, Oxford Economics, Real Capital Analytics, Macrobond, NCREIF and Moody's Analytics as of July 2020.

logistics real estate is well-suited to core investing with strong cash-on-cash yields and long leases. Korea continues to be our highest conviction logistics market in the region. It has the highest e-commerce penetration globally but an under-developed physical market for modern logistics; less than 10% of the Korean stock is modern Grade A logistics space. NOI yields for high-quality stabilized assets have fallen to the high 4% to low 5% range, while forward purchase deals with leasing exposure are close to 6.5% yield on purchase price and 7%+ cash-on-cash yield upon stabilization.

What would make sense for an investment in retail given the current weak outlook of retail as a business sector?

We have held a cautious view on retail for many years. Neighborhood non-discretionary grocery-anchored centers may be the least susceptible to e-commerce disruption. Additionally, the best-in-class centers, super-regional malls with high productivity may retain retail tenants better than other locations. There may be increasing opportunities for adaptive reuse of retail assets as well.

In previous quarters, we communicated our interest in experiential retail as a promising direction for the retail sector. While experiential retail was hard hit during the lockdown phase of the pandemic, best-in-class experiential retail assets may be an interesting opportunity as lockdowns are lifted and people seek out experiences once again.

What role should retail and logistics play in a portfolio going forward?

Increasingly, it seems appropriate to frame consideration of real estate sectors into three broad groups based on the economic driver common to the group: where we work, where we live, and where we consume. The retail and logistics sectors are the main components of the third category, driven by the consumption side of the economy. Historically, consumer real estate made up about 40% of global portfolios most of which 32% was in the retail sector and 8% in logistics. The overall exposure has trended down to 36% but the composition has also shifted with 22% in the retail sector and 14% in logistics. This trend seems likely to continue. With a shift to logistics assets we will consider locations involved in the retail supply chain from port cities to last-mile locations.

Conclusion

Consumption growth will likely be modest in the short to medium term. Consumer-driven real estate performance is therefore likely to continue to be driven by the shift from offline to online sales with the COVID-19 pandemic acting as a tailwind for the increased move to e-commerce. With this shift, logistics may become a more attractive asset class and comprise a greater share of real estate portfolios. We will continue to be selective in our investments and may look to locations important in supply chain growth: from major hubs to last-mile deliveries.

Notes

1. Current spread is calculated as the spread between the Q2 2020 cap rate and the June 30 2020 local 10-yr government bond rate. Long-Term Average (LTA) 2007-2020.

Risk Warnings

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Property and land can be difficult to sell, so investors may not be able to sell such investments when they want to. The value of property is generally a matter of an independent valuer's opinion and may not be realised.

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