

GfK GeoMarketing asset class portrait

Opportunities and security in uncertain times

Shopping centers, factory outlet centers
(FOC) and neighborhood centers

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A real estate expert's perspective on shopping center, FOC and neighborhood center investments

A palpable sense of anxiety can be felt in the investment market since the financial and real estate crisis. The reason for this is that even top-class retail real estate was included in questionable portfolios and sold at inflated prices. Portfolios of this sort led to massive and even existential problems for banks and investors. However, the current aversion to risk deflects attention from promising opportunities that exist in the current market beyond the mainstream.

Shopping centers: Reliable investments, but only with professional guidance

Despite the current economic crisis, well-functioning shopping centers can be secure, sustainable investments, especially in Germany. Most investors are interested in core objects, which has resulted in a premium market characterized by scarcity.

So what is it that makes for a good shopping center, or, more precisely, how can one know whether an investment object constitutes a risk or a rent guarantee?

An optimum interplay of success- and quality-promoting criteria with regard to location, product offering, conception and management determines the long-term success and sustainability of an investment. A professional evaluation of all of these criteria is necessary in order to accurately assess the opportunities and risks associated with a given retail real estate object or shopping center.

Assuming these criteria are met, shopping centers continue to represent one of the most attractive asset classes, particularly in Germany. Most investors are looking for core objects, which has led to scarcity in the premium market. Product offering and demand determine the price, and fears of a real estate bubble effect are not unwarranted.

Only real estate expertise can illuminate whether a shopping center will enjoy long-term success and reliable returns. Shopping center investments are risky without a thorough due diligence assessment of these criteria.

An alternative to the popular but expensive shopping centers are lesser known objects that can only be clearly evaluated by insiders. Two asset classes deserve particular attention: factory outlet centers and neighborhood centers.

Quality at a bargain price - FOCs coming to Germany

Compared to the rest of Europe, Germany has meager offerings when it comes to the number and sales area provision of FOCs. While the FOC scene has rapidly developed in Italy, Spain and France in recent years and even reached market saturation in Great Britain, this development has proceeded much more slowly in Germany due to the lack of a favorable market.

The cause for this lack of FOCs were the restrictive regulations governing large-area retail in Germany's federal states. A good example is the regulatory system of the federal state of North Rhine-Westphalia, which made it almost impossible to establish a FOC. However, regional planning laws in this federal state faced vehement opposition in 2009. North Rhine-Westphalia's Constitutional Court declared the regulations regarding the establishment of FOCs null and void. Also, the EU Commission initiated treaty violation proceedings against some of Germany's state governments, citing an infringement of the freedom of establishment law and provision of services directive (§24 a LEPro NRW).

These developments and the fact that most federal states have begun to view FOCs more favorably give reason for hope. In the mid-term, FOCs will begin to take root in Germany. A new asset class thus looms on the horizon.

Germany provides excellent conditions for FOC development. With an index value of 170.1, Germany has an above-average level of purchasing power (Europe = 100) as well as Europe's largest potential customer base with 82.4 million inhabitants. The average German's desire to acquire fashion and brand-name products as inexpensively as possible is an additional positive. These factors suggest a promising future for the establishment of FOCs in Germany.

The combination of Germany's favorable conditions for FOCs and restrictive planning permission policies have resulted in the establishment of factory outlet centers on the country's borders. This allows developers to profit from Germany's potential while avoiding legal difficulties. Successful FOC locations have been established directly on the Austro-German border in Roermond, Massmeckelen and Salzburg, and the FOC sites in Roppenheim, France and near Konstanz in Switzerland are also strategically positioned near the German market.

These FOC markets in neighboring countries have now achieved a high degree of market saturation. Germany's recent relaxing of its strict planning permission policies suggests that FOCs will begin to take root in this country. The high number of planned FOCs in Germany is a good indicator that the FOC market is in ascendency. This development should provide lucrative investment opportunities even in the short-term, with the FOC emerging as a new and promising asset class. However, it's important to secure partnerships early, as investors will move quickly on these opportunities.

Even given these very favorable conditions with regard to demand, it's essential that FOC ventures also be evaluated with regard to the following **real estate- and location-specific factors**:

- **Accessibility:** FOCs draw potential from larger distances - a drive-time radius of 100 minutes and more is common. Accessibility via the transport network is a key factor here.

Decisive for the success of factory outlet centers is proximity to major supra-regional transport links with good accessibility and connections to areas of important economic activity with high levels of potential.

- **Location:** FOCs have better chances for success when positioned near major transport junctions that feature above-average holiday-related traffic, popular leisure venues, vacation destinations or tourist attractions. The provision of ample, ground-level parking is a must.
- **Concept & sales area provision:** Concept is particularly important - just like shopping centers, factory outlet centers must plan carefully with regard to size, product line and layout. Factors to take into account include achieving sufficient "critical mass" and providing expansion areas. Too little sales area diminishes the drawing power of the product offering, resulting in fewer customer visits.
- **Product offering:** The success of a given site also hinges upon the correct product offering. Fashion should be a key point of focus. Successful FOCs devote 60-75% of their sales area to clothing items and feature high-priced brands (e.g., Versace, Boss, Aigner) and/or trendy brands (e.g., Nike, Puma, Fishbone). FOCs also need anchor tenants with significant drawing power, such as Nike, Hilfiger and Adidas.
- **Management:** Professional management secures long-term success for FOCs. It's vital to arrange for a comprehensive and wide-ranging product mix that reflects current customer and market requirements. Facility management, event-planning and marketing also demand professional attention.

McArthur Glen, Realm, Value Retail and Neinver are among the most well-known and successful FOC developers and operators in Europe. The small number of already established factory outlet centers in Germany profit from very favorable conditions with regard to demand and generate a correspondingly high level of turnover.

FOCs must meet the same quality standards as shopping centers with regard to product offering, conception and management. It's risky to disregard these criteria when assessing factory outlet center portfolios. Factory outlet centers are and will remain a specialized form of real estate that requires professional know-how.

Neighborhood centers offer good investment opportunities

The German retail market is characterized by a high degree of diversification in the neighborhood supply sector: Food discounters, supermarkets and power centers shape Germany's retail landscape.

They may not be particularly flashy or cool, but neighborhood centers are reliable investments: This format fares relatively well even in crisis periods, because signs of an economic slump tend to first impact longer-term purchases. With their focus on meeting daily needs, neighborhood centers are more recession-proof than other formats.

Discount stores still comprise the most rapidly growing segment. After significant expansion in recent years, this format continues to achieve the highest sales area expansion rates. Turnover remains comparatively stable despite the crisis, although a high degree of consolidation characterizes this segment in 2009/2010.

The discount format will go on expanding both within and beyond the grocery store sector. Specialty discounters are ever more frequently adding value to neighborhood centers. The discount format increasingly depends on the implementation of a specific success strategy. The clearer the business concept, the greater the success it is likely to enjoy. GfK GeoMarketing anticipates a structural adjustment of the discount formats in the coming years. While the market is profiting from new entrants in the non-food sector in the form of TK maxx and Primark as well as further strengthening through robust concepts such as KiK, some merchants - such as Avanti - have already disappeared from the scene.

Beyond the discount segment and amidst the significant consolidation in the full-service grocery store and drugstore markets, the high-performing chains Edeka, Rewe, Kaufland, dm and Rossmann have come out ahead and promise to remain reliable, recession-proof tenants.

Well-planned and managed neighborhood centers constitute an attractive asset class. New objects with lengthy rental periods are particularly alluring, giving buyers secure, long-term cash flow.

But among these promising opportunities are many weak objects that are not attuned to prevailing market conditions, consequently causing headaches among some equity fund holders. The importance of high-quality operators and tenants usually becomes clear after an acquisition. Struggling chains can regain healthy turnover levels after the introduction of a name change and new business concept. Good locations are thus always justified, assuming the quality of their operators is also good.

A location's quality is ultimately the decisive factor in its prospects for long-term success. Objects in good micro-locations constitute low-risk, sustainable investments. The trend here is for neighborhood centers to geographically position themselves ever closer to the consumer. City center locations near residential areas translate to a long-term supply of customers and can be easily re-rented after the rental contract expires. In sound micro-locations, re-renting is usually

unproblematic should a key tenant pull out prematurely or the rental contract not be extended. In the case of older assets, a refurbishment can often generate significant upside potential. Finally, retail evictions amidst the currently restrictive planning permission policies have sustainable value in and of themselves.

Conclusion

The German real estate investment market already offers investors attractive and promising asset classes that can achieve success even during periods of crisis and economic dry spells. **The most favorable risk-return profile for 2010 belongs to FOC and neighborhood center portfolios.**

Even so, the key criteria governing success should always be taken into account for each investment, whether it's a shopping center, factory outlet center or neighborhood center.

As a general rule, real estate investments should always be evaluated beforehand by real estate experts via objective due diligence studies and thorough analyses of the market and competition.

About Manuel Jahn

Manuel Jahn works as a real estate and investment consultant and serves as head of investment and financing in GfK GeoMarketing's Real Estate Consulting division. In his many years as a shopping center project developer with the Westdeutschen ImmobilienBank and in his role with GfK GeoMarketing since 2004, Jahn has acquired comprehensive knowledge of the real estate sector through his Europe-wide location and real estate object consulting.



About GfK GeoMarketing

GfK GeoMarketing is one of the leading independent providers of consultancy services in the area of real estate and location research. The company produces studies and reports for customers from the retail, public authority, investment, banking and project development sectors.

More information can be found at www.gfk-geomarketing.com/rec.

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