Key themes to look out for in the retail property market in 2022

By John Loos

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The retail property market of late appears to have been the "middle of the road" performer, sandwiched in between the underperforming office property market and the outperforming industrial property market.

Source: www.pexels.com

It is important when analysing this property class' prospects to point out that it remains a relatively expensive property class by historic standards. Since the mid-1990s, it has seen very strong rental inflation, operating cost inflation and capital growth to become expensive in every way compared to back then.

Using MSCI annual data, adjusting for general inflation in the economy to get to "real" values, real retail property net operating income (inflation adjusted using GDP inflation) had fallen by -20.9% from the peak 2015 level to 2020, while real capital value per square metre had fallen -18.8% over the same period. However, these real values in 2020 were still a massive 60.2% and 72.3% up respectively on 1995 levels.

Meteoric rentals rise in consumer boom years

Much of retail property's meteoric rise in real rentals, income and values came during the consumer boom years prior to the

Global Financial Crisis (GFC) recession of 2008/9. Interest rates had been reduced sharply from the late-1990s, consumers with far lower indebtedness levels back then went on a credit-driven spending spree, and economic growth was an almost unthinkable 5%-plus in the years just preceding the GFC.

The pre-GFC economic and consumer environment justified a sharp rise in real retail property rentals and values. It was the "darling" property class, as one would expect in a consumer boom.

However, after a post-GFC decade of economic growth stagnation and gradually rising financial pressure on consumers, this property class has been due for a significant correction in its values in order to better reflect economic fundamentals.

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Challenge of growing online retail

And indeed, since around 2016, these values did start to broadly correct. In addition, of course, it faces the challenge of growing online retail.

It is important to mention this because the longer-term big picture informs our thinking in a "post-lockdown" world. After a dramatic retail lockdown around the second quarter of 2020, it was to be expected that the retail property market's performance would bounce back significantly off a very low base. But the bigger long-term picture arguably informs us on the "bounce back to what" question.

Almost all the important economic and other data related to the retail property market point to a far better situation in 2021 compared to 2020, as one would expect. But the myriad of structural challenges that the South African economy faces suggest that we are returning to "mediocrity" at best, and indeed this is what many related economic numbers also tell us.

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Retail property tenants worst affected by lockdowns

TPN tenant payment performance data tells us that retail property tenants were worse affected than the office and industrial tenant populations during the 2020 hard lockdowns, and despite having recovered to where 66% of tenants were in good standing with landlords regarding rental payments by July 2021, a massive improvement from 41% in May 2020, the level remained well below the 71% measured just prior to lockdowns commencing late in March of 2020. In addition, by October 2021 the tenants in good standing percentage had receded slightly to 64%, suggesting that the last part of the full recovery may be the toughest part of the recovery, and the percentage remains below the 71% of the industrial market and 70% of the office market.

So, the retail property market is significantly better off of late, but continues to have its challenges. The 2022 economy is expected to reach "fully recovered" status, by which we mean return to 2019 levels of real GDP. And working on the assumption that vaccine rollout continues, and the Covid-19 threat recedes, we assume further normalisation in economic activity. This has positive spin-offs for physical retail, especially the entertainment and eating out parts. Retail for the pleasure aspect is thus expected to receive a boost.

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Ongoing financial constraints of households

However, consumer constraints are expected to remain significant. Real GDP growth is projected to recede in 2022 from 4.8% in 2021 to 2.2%, constrained by the higher GDP base of 2021 compared to 2020, as well as by rising interest rates. Real household disposable income growth is forecast to be even slower at 0.2%, after an estimated 2.8% last year, constrained by very weak employment growth, rising interest rates and rising effective personal tax rates.

So, while less Covid-19 restrictions and concerns are a positive boost for less essential retail spending items, the ongoing financial constraints of households still point to non-essentials underperforming the more essential food, grocery and health item spending for instance. Smaller retail centres focusing more on high frequency essentials are thus likely to continue to outperform the larger regionals, although that performance gap could narrow somewhat in 2022.

The improved GDP since 2020 is also expected to lead to the rising vacancy rate trend across retail property as a whole to peak in 2022, but this rate may still be too high to alleviate significant pressure on real rentals just yet.

Rising interest rates domestically and globally, coupled to further expected rise in levels of government indebtedness in South Africa, leads us to believe that government long bonds (a key driver of the local bond market) will continue their multi-year broad drift higher, which in turn will drive capitalisation rates on property higher too.

Improvement in tenant performance expected in 2022

But we do expect further mild improvement in tenant performance in 2022 as the 2020 recession effects fade and positive property income growth can be achieved. This, in turn, leads to an expectation of very low positive capital growth in the order of 1% this year, which would be a big improvement on the -10.3% in 2020 and expected -4% in 2021. But it would translate into ongoing decline in values in “real” terms when adjusting for general inflation in the economy.

And given what we’ve said about retail property having become a very expensive property class by recorded history standards, we believe further gradual real correction is realistic in order to align this market’s values with what are now very weak domestic long-term economic fundamentals.

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Ongoing gradual real value correction

The 2022 expectation in a nutshell, therefore, is one of significantly improved retail property performance from the past two years, but still a mediocre one with ongoing gradual real value correction, influenced by an economy vastly different from the pre-2008 boom period. That would seem realistic in the current period of long-term economic stagnation (looking longer term than Covid-19).

This expectation continues to see it performing in between the relatively strong industrial market and the very weak office market. Structural changes in the form of online retail and greater levels of working from home (WFH) have significant implications for industrial property's logistics area, retail property and office. But it seems as if online retail is a "slower creep" on retail property compared to the jump in forced WFH that was a major shock to the office market.

ABOUT JOHN LOOS

John Loos is Property Sector Strategist: FNB Commercial Property Finance

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