Retail Market Overview

CZECH REPUBLIC | RETAIL

Q3 2016

Summary

- Consumer confidence has been high and 2016 has been the most positive in years, reaching an all-time high earlier in the year. Real growth in spending power/ wage growth pressure is therefore evident in the economy. Consequently, there is growing footfall and turnovers being experienced at shopping malls and by the retailers themselves.
- Investor interest in the retail property sector again this year is proving robust with €550 million out of a total market investment volume of €1.45 billion having targeted the sector by end Q3 2016. A number of other retail investment transactions are currently in play and expected to close by year end with at least two of them to be in capital value terms in excess of the €100 million mark.
- Despite this rise in consumer spend, the number of new shopping centres being constructed is rather low (i.e. only two underway). Even taking into account the time lag between economic indicators and reaction of the development pipeline, the construction activity of new shopping centres is constrained largely due to market saturation across the Czech Republic compared to consumer spending power; expectations for stronger retail demand for new space may bring a change to this situation in the medium to long term only.
- Interest of new retail brands and entrants on the Czech scene continues with Cremieux, Barbour, FCUK, Hamleys, Pupa Milano and Martes Sports all making their Czech debuts this year. The lack of availability at prime locations is one of the barriers preventing more retailers setting up new stores. Food retailers (FMCG sector) have also upgraded their formats with brands such as Lidl revamping the interiors of many of their stores.
- Previously classed niche retailing (e.g. delicatessen, tailored made clothing, barbers and hand crafted jewellery) has adopted a more aggressive expansion drive in recent years. Many of these artisan type of stores can now be seen on traditional high street locations or within shopping centres. This has come largely come about due to changing consumer tastes and patterns.
- There seems to be little to halt on-line sales increasing its share retail spend with sales growth demonstrating a growth of over 20% per annum. Plus some retailers that started out on the on-line environment have started to move into brick & mortar stores while the more established retailing brands are all trying to ensure they have a good on-line presence to help drive their sales / profits.

Economy

Consumer Market

After last year's stellar momentum, the Czech Republic experienced further GDP growth in both Q1 and Q2 2016, scoring 3.0% and 2.6% respectively. This present growth rate has a strong fundamentals underpinning, having shifted to a combination of sustained external demand and increasing momentum in household consumption. The drivers of last year's statistically higher growth rate were external demand and EU-led inward investment flows.

The Czech National Bank (CNB) continued regulatory measures, keeping the exchange rate between the Czech Koruna (CZK) and Euro (EUR) artificially above the level of 27 CZK/EUR: The incoming governor of the CNB announced that the "currency cap" intervention is not going to end before mid-year 2017, and most likely then only after the summer break. In theory, these regulatory measures should contribute to inflation: but in the first half of 2016 CPI was basically flat, with maximum growth in August of 0.6% year on year (y-o-y) as a result of growth of tobacco and alcohol prices as well as cost of accommodation. This is still far from the CNB's inflation target of 2.0% y-o-y. Higher real growth with little inflation is a promising combination for consumer demand in the short term.

Considering the labour market, positive economic conditions generated employment growth. The unemployment rate dropped to 4.5% at year end, which was the second lowest in the whole of the EU (after Germany). The trend continued into this year with the unemployment rate persistently tracking down to 4.0% in May (Eurostat). With graduates entering the labour market, that decreasing trend seemingly stabilised at a rate of 4.2%. Overall there is a lack of workers across all sectors, thus putting upward pressure on salary levels.

The average salary reached CZK 26,480 per month (€979) in Q1 2016. Nominal salary growth reached 4.4% y-o-y, real salary growth was 3.9% y-o-y. Substantial wage hikes in the public sector are particularly noticeable.

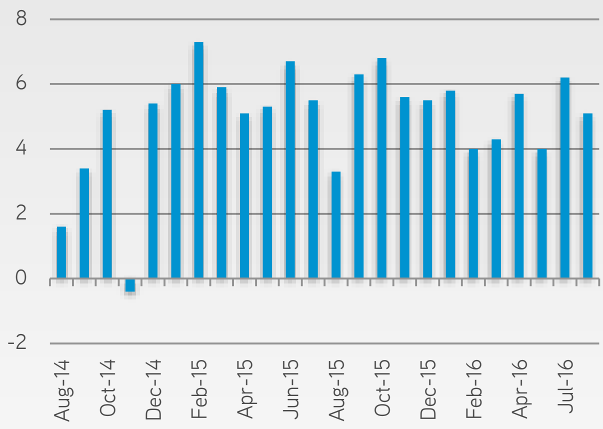
All of the above-mentioned factors contribute to relatively strong consumer confidence. Overall, the level of consumer confidence seen in 2016 has been the most positive in years, reaching all-time high earlier in the year. Consequently, there is growing footfall and turnovers in shopping centres, both for prime and secondary properties, resulting in growing retail sales. From around November 2014.

Consumer Confidence

Source: Czech Statistical Office

Note: Czech Statistical Office consumer confidence indicator is the average of four indicators: expected financial situation of consumers, expected total economic situation, expected total unemployment (with inverted sign) and savings expected in 12 months to come

Retail Sales (% change, y-o-y)



Source: Czech Statistical Office, Tradingeconomics.com

Investment

Volumes

Year to date investment volumes into commercial real estate reached €1.45 billion by the end of Q3 2016. Retail remained very attractive for investors, making up for 38% of total investment volume.

The largest retail transaction in 2016 to date was the acquisition of a portfolio of hypermarkets, purchased by Palmer Capital (now Arcona Capital) for €102.6 million. The second largest transaction was Forum Usti nad Labem, purchased by NEPI for €82.6 million.

The most notable transaction of the year thus far is the purchase of the Kotva department store by local investor PSN for approximately €80 million. Kotva is an iconic retail property located in the city centre of Prague with a unique design and potential for significant performance improvement.

The retail investment pipeline for the remainder of 2016 remains strong, especially with two large properties in the pipeline: Olympia shopping centre in Brno and Letnany shopping centre in Prague. Olympia Brno is the largest shopping centre in the Czech Republic and was bought in 2011 for approximately €250 million. We expect it to sell for over €300 million in the coming months.

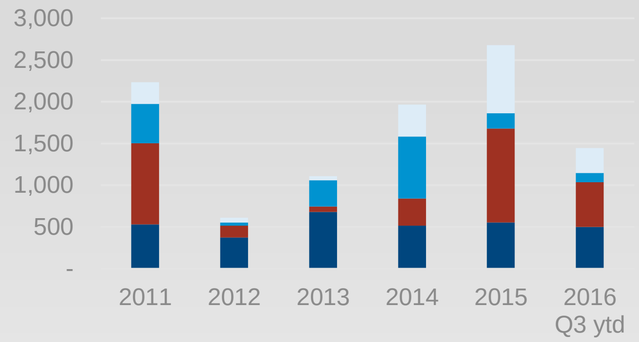
Yields

Strong investment demand for prime product helped yields to compress to record low levels. Combined with a lack of available prime properties, further yield compression looks likely to us.

Prime shopping centre yields stood at 5.25% by the end of Q2 2016, yields for high street retail reached a new low of 4.00%. There is a strong evidence in the market to suggest that yields for long leased city centre assets in Prague would command a yield that is 50 basis points below quoted prime average yields.

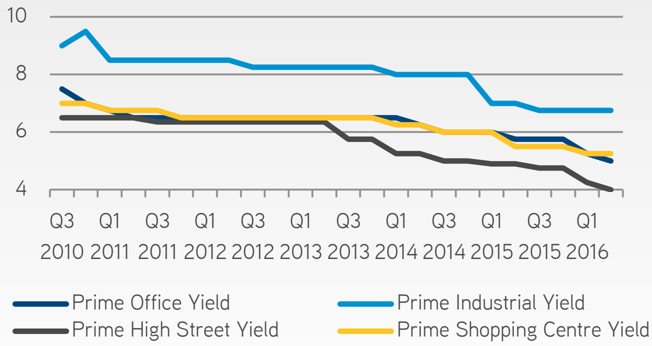
Investment Volumes in the Czech Republic

(€ millions)



Source: Colliers International

Prime Yields (%) in the Czech Republic



Source: Colliers International

Retail Market

Existing Stock

The retail stock in the Czech Republic in the last decade developed at a rapid pace. As the growth was organic with limited regulation, it led to oversupply in some cities. In many regional cities retail stock exceeds the 800 sq m per thousand inhabitants level, which we consider at current levels of spending power as a saturated market. The national average stock is approximately 229 sq m per 1,000 inhabitants, based on stock level year to date of 2.4 million sq m.

When including other types of retail (retail parks, outlet centres etc), the average retail saturation increases from 229 to 277 sq m per 1,000 inhabitants. However, on a city level, the saturation in some location exceeds 1,000 sq m, which we also interpret as oversupply.

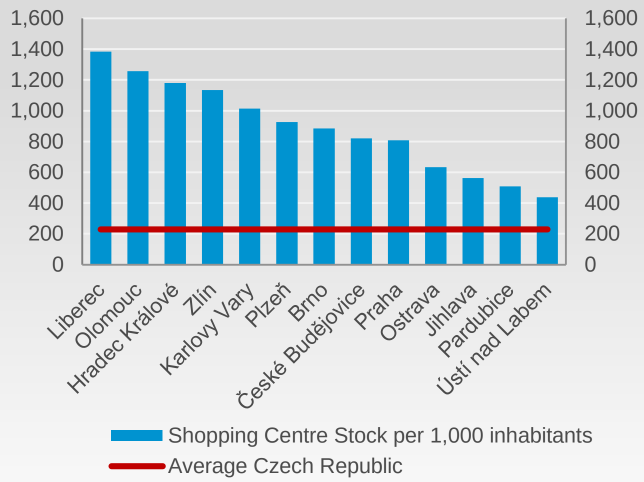
This market stock per thousand inhabitants in the regional capitals is highlighted in the chart below.

Pipeline

Developers have taken a more cautious approach lately and became more selective as a result of the growth of stock to population ratio across most regional markets. Thus, the development pipeline shrank significantly and there are no immediate prospects for significant increase in our view, even though some fundamentals (such as spending levels) of the retail market are improving.

The current development pipeline focuses on refurbishment and extensions of first and second generation shopping centres and on filling the few gaps in regional towns with retail parks. Retail parks are often tailor-made to local needs and do not typically exceed 5,000 sq m in size. These smaller schemes are then the target of local developer and investor interest only.
A couple of newly-built shopping centres such as Jablonec or Prerov are on sites of former city centre department stores and more in line with an improvement of existing retail stock.

Shopping Centre Stock in Regional Capitals of the Czech Republic (sq m)



Source: Colliers International

Retail Pipeline under Construction

Property	Size (sq m)	Planned Delivery	Developer/ Owner	Type of development
Aupark Hradec Kralove	25,900	Q4 2016	HB Reavis	New build
Centrum Chodov, Prague	39,000	2017	Unibail-Rodamco	Extension
IGY Ceske Budejovice	9,600	Q3 2017	CPI	Extension
Central Jablonec	13,000	2017	Crestyl	New build
OC Rotunda, Havirov	6,777	2017	Averro	New build, retail park
Retail park Saller, Havirov	7,700	2017	Sallerova vystavba	New build

Source: Colliers International

New Completions

Given the growth of retail stock over the last 15 years it comes as no surprise against the backdrop of absolute Czech consumer spending power that new retail developments are thin on the ground.
Galerie Přerov by Reality Management is the only shopping centre completed in the first three quarters of 2016. This is a typical example of a regional town, where previous shopping options were limited to the local high street, hypermarkets and a retail park. The gallery has a GLA of 13,000 sq m and built in a central location on the site of an outdated department store.
A small retail park MyBox was also recently completed in Brandýs nad Labem. In line with current trends, it serves as an expansion to the existing retail zone which already had a hypermarket and food discounter and thus the retail park size was only 3,355 sq m.

Rents

Following the rental growth of prime rents experienced between 2000 and 2008, a minor drop appeared in 2009. Since then, the rents remained fairly stable with a minor growth in 2015 of some 5-10%.Since then the rents were again stable but positive economic indicators may lead to a mild increase in prime rents over the short to medium term.

Property type	Prime (Prague, €/sq m pm)	Secondary (large regional cities, €/sq m/pm)
Shopping centre	185	100
High Street	190-200	80
Retail Parks	9-11	7-8

Source: Colliers International

*"Male grooming
and male fashion are of growing
importance on the Czech market"*

Retail Trends

New Retailers

We saw several new names stirring the waters of the Czech retail market brand composition: Cremieux and FCUK secured space in Centrum Chodov, Barbour opened its first store at Galerie Myslbek. Prague's prime luxury high street Parizska welcomed two new tenants: Rolls Royce and Rolex. The world's oldest toy store, Hamley's, opened its Czech flagship store on Na Prikope Street in May 2016 and intends to expand throughout the CEE region. Pupa Milano have also opened their first brand store in Centrum Cerny Most, similarly to Spanish jewellery and accessories chain Tous.

Potential new major fashion occupiers have one thing in common: their criteria is to first secure prime retail space, either on the high street or in a shopping centre in Prague. However, given the constraint on prime retail stock and high occupancy rates, this limits their chances of opening their store and thus new brand entrants are rather low.

Surprisingly, one of the largest Polish sports retailers Martes Sport chose the regional city of Liberec for its market debut, which given the current oversupply is one of the most challenging locations in the Czech Republic. On the other hand, if the concept proves viable there, it should be able to succeed in other cities across the country. Since then, Martes Sport also opened their second store in the recently completed Galerie Prerov. Martes sport is however facing a stiff challenge given that the largest sports retailer Sportisimo has a new investor on board and plans to strengthen its market leader position.

Centrum Chodov extension is a unique opportunity for retailers seeking prime retail space

We are aware of other brands ready to enter the Czech market and some of those brands are seeking to secure retail space in the phase II of one of the prime shopping centres in Prague – Centrum Chodov, which is currently undergoing a significant extension (39,000 sq m). This is a unique opportunity for these new brands to establish a foothold in the Czech market, as the other well performing shopping centres such as Metropole Zlicin, Novy Smichov or Palladium are currently 100% occupied.

Fashion

We are seeing a growing trend of fashion retailing, expanding from secondary locations to more mainstream outlets, e.g. high street and shopping malls. Higher specialisation towards a diversified clientele is also a factor of this trend. This can range from male to kids' fashion, specialised sport stores, design shops, tailor-made clothing, male shoe shops, barber shops and other niche retailing.

To date, fashion brands have largely focused on the female and youth demographic and we are now seeing that some retailers have recognised the potential of male clientele.

Some of these retailers have emerged from the world of e-commerce and after establishing themselves in the on-line retail environment, their next step was to open brick-and-mortar stores to serve as click and collect locations and eventually as fully functional retail units (e.g. Alza, CZC, Friendly Suits or various perfume retailers). It seems only a question of time before more of these types of tenants find their way on to the main high street or into shopping centres.

E-retail

In common with many other countries, online retail is growing at a fast pace in the Czech Republic. Between 2005 and 2015, retail sales of online shops grew on average at 21% y-o-y and a similar level of growth is again expected in 2016. The fastest-growing segments are fast moving consumer goods (FMCG) and do-it-yourself (DIY); both were previously overlooked in the Czech online market and lagged behind consumer electronics and cosmetics sectors.

E-commerce in general is changing not only the world of retail, but also the world of logistics. Same day or next day delivery is increasing demand for urban distribution centres, typically in urban areas with population exceeding 500 thousand inhabitants. In case of the Czech Republic there are two to three locations (Prague, Brno and possibly Ostrava) where we expect urban distribution centres to emerge in medium to long term.

Mall.cz, the second largest online retailer in the Czech Republic was acquired by Rockaway earlier this year. Together with other online stores it was brought under the umbrella of Mall Group and we expect that it will further strengthen their position as number two on the market, if not aim higher.

Another big expectation on the e-retail market is with the world's second largest e-retailer Amazon (after Chinese Alibaba). Amazon has established a distribution centre near Prague international airport, as well as returns centre and also opened offices. There is a general public expectation that following the establishment of offices and warehouses, Amazon will also look to establish themselves in the Czech online retail environment with a dot-cz domain. However, the largest online stores (Alza and Mall) are well established on the market and it would be interesting to see how Amazon impacts their business.

Fast Moving Consumer Goods

FMCG has experienced some consolidation, especially in the sectors with high competition. It went through a consolidation phase in 2005-2006 with exit of J. Meinl, Delvita and Carrefour, followed by the exit of Interspar in 2014.

The growth in FMCG is apparent mainly in the upmarket segment and despite Julius Meinl's recent luxury food retail concept failure in downtown Prague, other concepts such as Delmart and Wine Food Market seem to be more successful and are expanding. Marks & Spencer also announced an expansion of its food retail concept. On the high street, numerous smaller concepts are expanding – bakeries, wine stores, coffee shops as well as restaurant concepts run by the larger brewery chains who are trying to gain market share which is getting highly competitive with the growth of microbreweries.

The often pronounced focus of the Czech customer on the price of food is starting to wain as the quality of produce starts to also heavily influence consumer behaviour.

Even food discounters such as Lidl and Penny Market have recognised this trend and are investing in a store concept change in order to shake off their "cheap" image.

Do-It-Yourself (DIY)

In 2015, the mother company of Austria's BauMax made the decision to exit the Czech market. Fortunately, one of the biggest DIY operators in Poland, Merkury Market stepped in and took over 18 of the 24 stores originally owned/operated by BauMax. Interestingly, Merkury Market has decided and agreed with BauMax to leave the trading name under the established brand. Four of the remaining BauMax stores were taken over by the competing German retailer OBI. Merkury Market has plans to expand the number of stores under the BauMax brand. Similarly, the Czech DIY operator UniHobby continues to grow and is looking for expansion opportunities.

Outlook

Following the strong economic growth from 2015, the Czech economy is expected to continue growing, albeit at slower pace. For 2016 the estimates are for annual GDP growth at the rate of 2.5% and continue growing at similar pace in the following years.

Inflation for 2016 shall not exceed 0.6%. The CNB regulatory measures and the currency cap will not be removed before mid-year 2017, which could then have an immediate impact on the exchange rate and consequently consumer prices. We expect the currency cap removal to have a positive impact on consumer spending in the medium term as the cost of imported goods fall.

Growth in retail sales combined with limited construction activity could increase demand for new retail space, however we do not expect the developers to increase activity significantly. They are likely to continue with the current trends of filling in the last remaining gaps on the market or remodelling, expanding and repositioning ageing existing centres.

E-retailing will continue to gain a market share in the coming years. At the same time, we will see more originally online retailers make their way to the brick and mortar world.

The Czech parliament passed a new Act which would ban the opening of shops on seven bank holidays, effective as of October 2016. We expect that the Act will be taken to The Constitutional Court as it limits the closing of shops by their size and type and is thus considered unconstitutional. A similar Act was implemented in Hungary but removed a year later due to impact on economy (as it involved Sunday trading ban). In Croatia, a similar Act was also taken to the constitutional court which decided it was illegal and the trading ban was also removed.

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