Bricks and Clicks: Are S- REITs smart ready?

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The Singapore's e-commerce market amounted to S$1.5 billion in 2016, nearly three times the amount from 2011. According to a report by Temasek and Google, it is expected to exceed S$7 billion by 2025, making up 6.7% of retail sales in the country.

Whilst customers move away from the traditional way of buying in favour of ever more immersive ways enabling them to engage with the brands/products they are interested in, retailers and all players in the retail sector have to adapt or face extinction. The issue goes far beyond the fact shoppers looking for bargains might purchase goods online. As marketing pundits have repeatedly explained, retailing in the digital era is not about price but experience.

In hindsight, since the first wave of disruptive online retailers appeared in the late 1990s (e.g., Amazon, Ebay), it has never been a good idea to resist changes stemming from radical innovation in retail especially if they are underpinned by strong societal changes like those linked to millennials today. That's a textbook illustration of what 20th century Austrian-born American economist Joseph Schumpeter called "the gale of creative destruction".

Among the players in the retail sector, S-REITs which operate shopping malls are prime candidates for massive, and potentially deadly, disruption. As incumbent firms, they have to drastically rethink the way they add value to their tenants. By law, REITs' business model is focused on rental income. According to MAS guidelines, a S-REIT should not derive more than 10% of its revenue from sources other than rental payments from the tenants of real estate held by it, or the interest, dividends, or other similar payments from special purpose vehicles and other permissible investments of the REIT.

The impact of digital technologies on retail spaces goes against this traditional view of commercial real estate. Space has moved from being a cornerstone of value creation for tenants to becoming an increasingly commoditized component of their value chain. Considering that customers have the choice between online and offline shopping, expensively rented space is no longer enough to create a competitive advantage for brands, and in some cases it is not even necessary (e.g., pop-up stores).

Hence, from a physical asset with relatively fixed features attached to a given location, retail space has to become a platform with a bundle of services supported by digital technologies and enabling tenants to offer seamless offline-and-online (O&O) customer experiences while fostering customer engagement.

As phone manufacturers discovered at their expenses that smartphones had little to do with phones, shopping mall owners will come to the realization that classic shopping malls and digital malls are very different animals. REIT managers do not want to be left with managing commoditized structures while value added is provided by others. Consequently, successful retail REITs' business model will irremediably shift.

In the traditional view stemming from the US REIT regime which was first devised in the 1960s, retail REITs are providers of top quality spaces commending high and sustainable levels of rent. To thrive in the digital era, they have to turn into purveyors of value-added services catering to tenants and shoppers alike. Admittedly, leading retail space operators are already focusing more on services than on real estate per se.

This trend will accelerate to the point that retail REITs' Net Asset Value (NAV) might no longer account for the bulk of their valuation in the future. Value will be derived from REITs' ability to support their tenants and help them "delight customers" (Amazon's motto from day one) thanks to smart technologies which encompass not only hardware and software but also data.

Furthermore, digital disruption will debunk the belief that REITs are best for stabilized assets, or mature properties without much growth potential. In the digital era, sustainable income will come from agile, future-enabled and smart properties supported by state-of-the-art technologies and management. This has little to do with maturity. In this context, sponsored REITs which can leverage on their sponsors' digital strategy should have an advantage. External managers and REITs without a strong sponsor will have to develop digital initiatives of their own to remain competitive.

Another important point will be who owns the IP of the digital expertise materialized by software and data that enable smart retailing, i.e. sponsor, REIT manager or REIT. One can imagine a model whereby the REIT manager licenses to the REIT for a fee the sponsor's proprietary technology. That would be indifferent from the viewpoint of the sponsor, but not for minority unitholders who would have to pay for a technology their assets contribute to, even though they do not own any of it. REITs' valuation models will therefore have to account for REITs' expertise in smart retailing and where in the ecosystem the ownership of this expertise is located.

Faced with potentially drastic changes, are S-REITs operating shopping malls ready to compete in the digital era? What do they do to lead in view of massive disruption around the corner? A quick review of S-REITs public information shared since their latest annual reports (2016) shows that the concern for what digital technologies mean to their business model is shared by many, but only a few are proactively implementing solutions to turn disruption into opportunities.

Capitaland is clearly leading the pack. Among an array of digital initiatives, the developer has implemented a very forward looking omni-channel approach in China with the launch of its first smart mall, CapitaMall Xinduxin (Qingdao) in 2016, as well as recent partnerships with Alibaba in Shanghai and Lazada in Singapore. CapitaLand C31 Ventures, the group's dedicated venture capital fund with S$100 million under management, has been set up to invest in new economy start-ups around the world in view of providing the group with new strategic capabilities. While many initiatives are taken at the group's level, CapitaLand S-REITs seem to be less active locally with the exception of the last-mile-delivery initiative implemented in cooperation with IDA last year. This could indicate that for CapitaLand, digital innovation has to be located at the sponsor level.

Retail properties in Singapore are already at the forefront of digital disruption but a lot more is to come. The digital revolution will turn the REIT model on its head. In the short term, due to the high level of capital expenditures necessary to smart up properties in S-REITs portfolios, the Business Trust model might be more suited to enable retail property owners to transition towards smart retail than the REIT regime.

In the medium term, as most of the value in smart retail will be created from digital technology and initiatives implemented to achieve high levels of customer experience, the focus will shift from REITs as owners of physical assets to REITS as service providers. Is the current REIT regime the best possible regime to account for smart retail properties' value drivers? The question is open. In any case, if S-REITs want to remain the income-producing investment vehicles they were designed to be, they should be ready to totally reinvent themselves, starting with aiming to delight shoppers even more.