Retail Cannibalization—All Are Guilty!

Retailers, Developers and Bankers Contributed to Over-Development in South Africa

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Abstract: *Retail cannibalization has occurred in South Africa due to over-development of shopping-center space. Developers, retailers and bankers were all guilty of excessive optimism. To avoid cannibalization in the future, all constituencies need to return to the basics of shopping center development and store expansion.*

Retail cannibalization is the scourge of the retail and retail real-estate industries. It occurs when a retail chain opens new stores in close proximity to existing ones, with the result that many of the new store's customers are not new at all but are customers of the older store who, for whatever reason, prefer the newer store. Cannibalization also happens when two or more shopping centers open in the same trade or catchment area with the same tenant mix and little to differentiate one center from another. In such circumstances, centers face a zero sum game: sales at one center are sales lost at another.

Following the global economic downturn, cannibalization has become a problem in many markets where there has been significant expansion in recent years of stores and shopping centers. But what were the causes? Are the retail and retail real-estate industries the victims of an unexpected and unforeseeable weakening in economic conditions? Or has cannibalization occurred because retailers and developers ignored warning signs of retail over-development? South Africa provides an interesting case study of a "perfect storm" in which unjustified optimism regarding the number of stores and centers local markets could support collided with a sharp drop in consumer spending as the global recession reached the horn of Africa. What role did developers, retailers and bankers play in creating this unfortunate situation?

Limited Retail Concepts in South Africa

Cannibalization has been especially pronounced in South Africa because of the limited number of major retail tenants available to ensure center differentiation. The same tenants move into all the same-sized centers. Additionally, the same chains are found in centers located in middle- to low-income neighborhoods and in centers catering to more affluent markets. Developers want to recruit these retailers because they are the brands that consumers know and prefer. There are few alternatives; very few international retailers operate in South Africa, and there are insufficient up-and-coming regional or small chains with the necessary financial resources to expand into the plethora of new centers that have opened in recent years. In markets with a larger number and wider range of retail chains, it is possible for shopping centers in the same market to offer a relatively unique tenant mix and so to avoid significant sales cannibalization. In the U.S. Atlanta market, for example, Lenox Square and Phipps Plaza look quite different. In South Africa, the limited number of retail chains limits the number of shopping centers that a local market can absorb without cannibalization.

From Economic Boom to Bust

In the decade leading up to 2008, South Africa's economy was in strong growth mode and avoided the volatility often experienced by developing economies. But inevitably the good times did not last forever. Table 6-1 shows a large number of economic indicators that have both a direct and an indirect influence on shopping-center development. A green arrow indicates a positive trend and a red arrow a negative trend, while an orange arrow signifies no change. During 2006, all indicator arrows were green, except for the price of oil. Retail and retail property performances were at a peak, and many of the new shopping centers, as well as those still in the pipeline, were conceived during this time. In 2007, a number of indicators were orange and most turned red in 2008 when the global recession hit South Africa. While

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Table 6-1

Economic Indicators Influencing Property Development

Attributes	Trend 2006	Trend 2007	Trend 2008	Latest 2009 Q4	Comments
GDP growth	↑	↑	↓	→	2009Q3 showed a positive 0.9% increase, taking South Africa out of recession. Overall growth in 2008 was 3.1% compared to approximately -2% in 2009.
Inflation CPI	↓	↑	↑	↓	Currently: November 2009 = 5.8%. Dropped from 13% a year ago.
Rand/Dollar	↑	↑	→	↑	Currently around ± R7.40 as of January 14, 2010.
Building plans passed	↑	→	↓	↓	January-October 2008 versus January-October 2009 (constant prices): Residential (-41.4%); Non-residential (-9.9%;), Addition/ Alteration (-12%). Total plans passed were down 25.9% .
Building plans completed	↑	→	↓	↓	January-October 2008 versus January-October 2009 (constant prices): Residential (-27.3%); Non-residential (-1.3%); Addition/Alteration (7.8%). Total plans completed was down 14.1%.
Domestic cement sales	↑	↑	↑	↓	Moving annual total October 2009 versus October 2008 was down 13.8%.
Car sales	↑	→	↓	↓	Record sales in 2006 of 714,000 units. In 2009 new car sales dropped by 25.9% compared to 2008. Total sales 395,000 in 2009 versus 497,000 in 2008.
House prices	↑	→	↓	↓	Real year-on-year change: September 2009 -3.9%; October 2009 -2.4; January-October 2009 -7.8%.
Formal employees	↑	↑	→	↓	Unemployment in 3Q09 was 24.5%, up from 23.6% in the previous quarter. Employment decreased in 3Q09 from 2Q08 by 3.6%.
Retail sales (Real value)	↑	↑	↓	↓	October 2009 year-on-year change -6.5%
SACCI: Business Confidence Index	↑	→	↓	↓	83.5 points in December 2009, a 0.6 point decrease from November 2009.
Interest Rates	↓	↑	↑	↓	Repo rate of 7% and prime rate of 10.5% since August 14,2009.
Oil prices	↑	↑	↓	↑	About $80/barrel in January 2010.

Source: Urban Studies, 2009

most indicators were still red at the end of 2009, the fourth quarter was more positive than the first quarter, with inflation and interest rates, which have a significant impact on property development and consumer spending patterns, turning to green.

Positive Demographic and Socio-Economic Trends

Demographic and socio-economic changes in the first decade of this century also indicated a rosy future for South African retail, although there were some clouds on the horizon that should have counselled caution.

South African population has continued to grow in this decade. By 2009, the official population of South Africa had grown to 49 million.[1] The actual count could have been as high as 53 million, given that the official statistics do not include foreigners living and working in South Africa. Strong economic growth in South Africa, as well as economic and political problems elsewhere in the southern part of Africa, resulted in a significant inflow of migrant workers. However, the rapid spread of the HIV/AIDS virus among South Africans is likely to lead to a lower population growth rate than in the past, even if the doomsday scenario of a decline in population to some 44 million seems improbable.

One of the most important drivers of demand for more and better shopping facilities is the change in the

[1] Midyear Population Estimates, July 2009; statistical release from Stats SA, P0302

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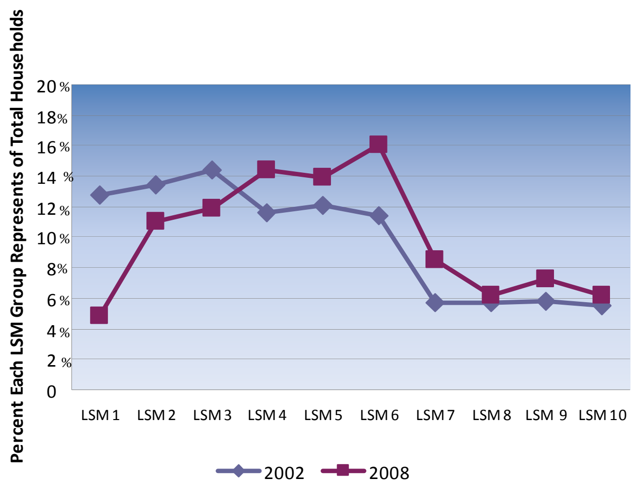
Chart 6-1
Change in Share of Households Represented by Each Living Standard Measurement Group, 2002 and 2008



Source: SAARF, 2009

living standard measurement (LSM) categories since 2002 (see Chart 6-1). LSM is a classification derived from annually updated census data, with LSM 1 representing the lowest income category and LSM 10 the most affluent. Since 2002, there has been a substantial decrease in the number of households represented in the lower-income LSM 1-3 categories, with substantial increases in the middle-income LSM 4-6 and in the more affluent LSM 7-10 categories.

Most of the households moving into the middle-income and more affluent LSM categories are black Africans, whose rising contribution to total household expenditures in South Africa can be seen in Chart 6-2. Between 1993 and 2008, the contribution by black African households increased from 35% to 48%, while the contribution of white households decreased from 53% to 39%.

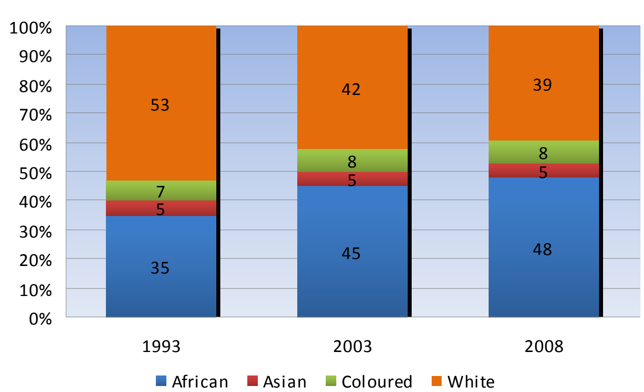
These socioeconomic and demographic changes also resulted in a growth in the number of new households, especially in the metropolitan areas, further supporting higher demand for modern retail space. However, the number of residential units completed in these areas peaked in 2006 and grew at a slower pace thereafter. Unfortunately, too many developers and retailers overlooked the impact that the slower growth rate would have on the capacity of metro markets to absorb new stores and shopping centers. As the recession hit, residential construction slowed to a standstill, further exacerbating the poor performance of stores and centers already experiencing cannibalization.

The change in the LSM profile of the South African population also led many shopping centers to widen the profile of their target customer. Centers that previously catered only to LSM 8-10 customers now compete for a broader LSM 5-10 profile. This change exacerbated cannibalization as it increased the number of centers competing for the same customer.

Significant Recent Growth in Shopping Center Space

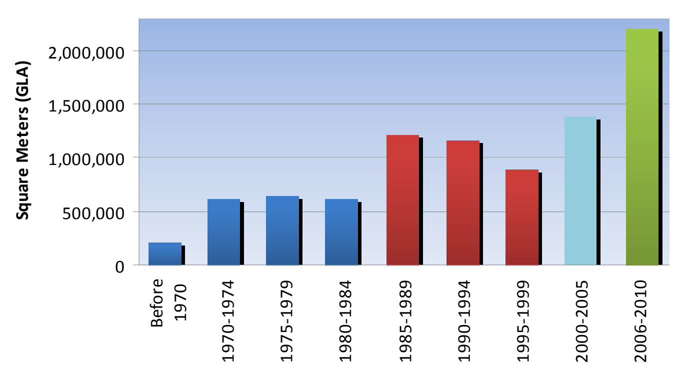
South Africa has seen a significant increase in retail space since the mid-1980s (see Chart 6-3). Encouraged by South Africa's high economic growth rate, as well as the improved socioeconomic profile of its population, the number of shopping center openings has grown in the last 10 years and significantly accelerated in the last five. In the five years from 2000 to 2005, a number of large superregional centers were completed with an addition of close to 1.4 sq m of new retail space. In the current five-year period from 2006 to 2010, an incremental 2.8 million sq m of shopping center space will have opened.

Chart 6-2
Percent Contribution of Total Household Expenditure Per Population Group Per Year



Source: Bureau for Market Research, 2008

Chart 6-3
Additional Supply of Retail Space 1970-2010



Source: South African Council of Shopping Centres Directory 2009/10

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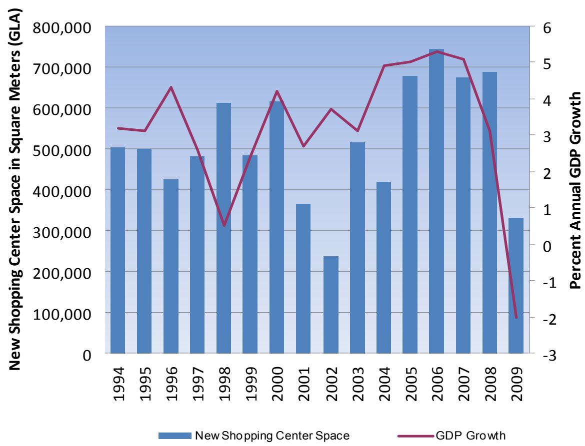
Chart 6-4
New Shopping Center Space 1994 to 2009 Versus Percent Annual GDP Growth



Sources: South African Council of Shopping Centres Directory 2009/10 and Statistics SA, 2009

Chart 6-4 shows how the increase in new shopping center space during this century followed the increase in GDP. It also shows how the retail real estate industry was unable to adjust promptly when GDP fell sharply in 2008 and turned negative in 2009. And 2008 saw the addition of nearly 700,000 sq m of shopping center space, with an incremental 200,000 sq m opening in 2009.

The number of shopping centers in South Africa larger than 30,000 sq m grew significantly from 36 centers in 1993 to 116 in 2009, with the total floor area for these centers increasing from just under 1.9 million sq m to almost 6.0 million sq m (see Table 6-2). The rate of growth increased in recent years; while the annual growth in floor space between 1993 and 2009 was 8%, it increased to 12.4% between 2006 and 2009.

Significant Retail Growth

Spurred by favorable demographic and socio-economic changes, as well as the large number of new shopping centers, South African retailers significantly increased their footprint over the last decade. Table 6-3 shows the increase in the number of stores of nine national retailers: Foschini Group, Mr Price Group, Truworths, New Clicks Holdings, Pick 'n Pay, Spar, Shoprite Group, Edgars and Woolworths. The total number of stores for these nine retailers increased from 4,445 in 2000 to 7,542 in 2009, representing an average annual growth rate of 6.1%. All of these retailers accelerated the growth in the number of stores and floor space in the last four to five years. Most retailers increased their floor area by 7%-8% annually in this period. In most cases, this growth was accompanied by strong sales increases.

However, the pace of retail expansion exceeded the capacity of many local markets to absorb new stores, and in some cases retailers' sales productivity has come under severe pressure. Many of the new shopping centers were in markets that were already saturated with retail space and thus placed stores in competition with sister stores in centers in the same trade area. Some of the centers were badly planned and based upon faulty analysis of the size, profile and potential of the local market. Retailers followed the herd, fearful of losing market share to competitors if they did not open a store in a new shopping center. Fashion retailers, in particular, were eager to seize opportunities to gain market share.

With the onset of the recession, declining consumer spending resulted in weaker store performance and rising vacancies at shopping centers. A few shopping centers have experienced vacancies in excess of 40%. Often it

Table 6-2
Total Number of Shopping Centers by Size Category 1993-2009

Size	1993	1999	2007	2009
30,000-50,000 sq m	12	19	51	68
50,000-100,000 sq m	24	39	37	48
Total number of centers >30,000 sq m	36	58	88	116
Total floor area in sq m	1,879,246	2,772,949	4,746,069	5,994,847
Growth rate in supply of new shopping center space 1993–2009	8.0%			
Growth rate in supply of new shopping center space 1999–2009	8.9%			
Growth rate in supply of new shopping center space 2007-2009	12.4%			

Source: South African Council of Shopping Centres Directory 2009/10

Table 6-3
Change in Number of Stores of Eight Major Retailers[2]

Group	Number of Stores 2000	Number of Stores 2009
Foschini	1100	1539
Mr Price Group	650	971
Truworths	300	495
New Clicks	355	541
Pick n Pay	330	782
Shoprite Group	370	1349
Spar		855
Woolworths		410
Edgars		600
Total	**4445**	**7542**

[2]Shoprite Holdings, Pick n Pay, Truworths, Mr Price Holdings, New Clicks, Foschini, Woolworths, Spar, Edgars

was restaurants and other eating places that suffered the most from the decline in consumer spending. National retailers often enjoy leases that allow them to exit a store if vacancies exceed 20%, exacerbating vacancies and affecting prospects for the remaining tenants.

There are no statistics on cannibalization as such. However, sales productivity data in tandem with floor-space expansion data provide a reasonable proxy. The industry's expansion trajectory and its negative impact on sales productivity are illustrated by what happened to Mr. Price Group, Truworths and Woolworths. However these three are not the only retailers to have been lured by an overly rosy view of how much and how quickly they could profitably grow their footprint; other retailers also found themselves in the same situation.

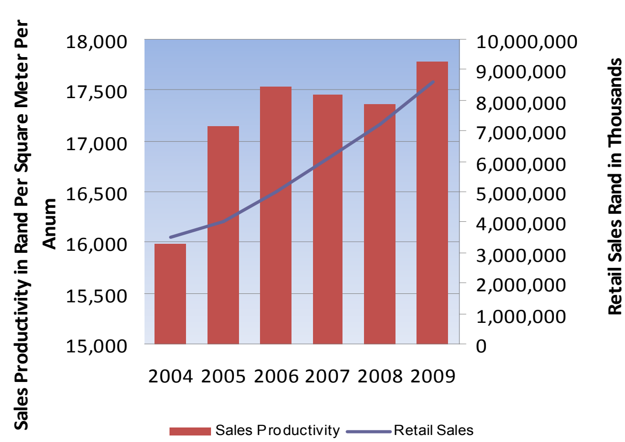
Mr Price Group, a major textile and housewares group, has expanded quickly in the last five years, especially through the growth of Mr Price Home Stores, as Charts 6-5 and 6-6 show. The average annual increase in floor space was 14.4% from 2004 to 2009, and the number of stores increased from 699 to 971. However, while sales increased 19.6% per year on average in this period, the average annual growth in sales per square meter was only 2.2%. The impact of the recession was particularly hard on the housewares and décor chain, Mr Price Home segment. Although revenues at Mr Price Home grew 13.3% between 2008 and 2009, retail sales per square meter were down by 8.9%.[3] In the case of Mr Price Home, the weak economy has probably had a stronger impact on its results than cannibalization as sales productivity rebounded in 2009. Mr Price Home has announced that growth in additional space will be lower in 2010 and that its focus will be to increase sales productivity

Truworths, a major textile retailer, has also seen a mismatch in the increase of floor space and the increase in sales productivity. Floor space increased 9% between

Chart 6-5
Mr Price Group: Number of Stores and Trading Area

Source: Mr Price Annual Report 2009

Chart 6-6
Mr Price Group: Sales Productivity Versus Retail Sales



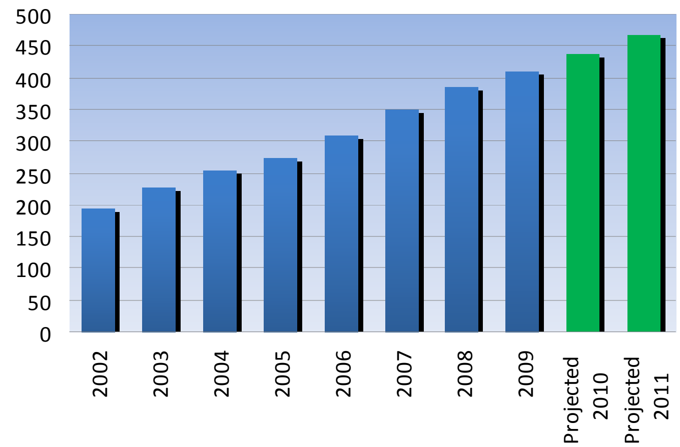
Source: Mr Price Annual Report 2009

[3] Mr Price Annual Report 2009

Chart 6-7
Truworths: Sales Productivity Versus Percent Growth in Sales Productivity

Source: Truworths International Annual Report, 28 June 2009

Chart 6-8
Woolworths: Increase in Number of Stores 2002 to 2011



Source: Woolworths Holdings Ltd., 2009 Annual Report

June 2008 to June 2009, while the annual sales productivity during the same period increased by only 4.0% (see Chart 6-7). The company's latest report indicated a slight decrease in sales productivity between June 2008 and 2009.

Woolworths, the retailer of textiles, food and housewares, reported greater than expected sales cannibalization as an explanation of weaker than anticipated sales and earnings growth in its fiscal year 2009.[4] In the period 2003 to 2009, the retailer opened a significant number of new stores and floor space, growing on average 6% a year. (See Chart 6-8.) In 2010, floor space will increase by 6.8% and by 7.7% in 2011.[5] Between 2008 and 2009, floor space devoted to apparel increased by 4%, while floor space for food increased 11.4%.

And the Bankers Enabled

Over-expansion would not have happened if developers and retailers had not had easy access to inexpensive capital from the banks. Some bankers did raise concerns about cannibalization, but they knew that if they did not provide funding another bank would. Just like the retailers, the banks went with the crowd, fearing loss of market share and profits if they did not lend for virtually any development or to any retailer hell-bent on opening new stores.

Since the economy turned down, the opposite has been the case. It is now very hard for any developer or retailer to obtain funding for new development, reflecting poor performance of centers and stores. The credit spigot remains tightly off, posing challenges for companies that need to refinance. The National Credit Act[6] in South Africa is currently strictly controlling lending; this is one of the main reasons why banks in South Africa were not so hard hit by asset-quality problems.

Avoiding Cannibalization in the Future

The experiences of South African retailers and retail real estate suggest a number of lessons that are applicable in markets worldwide:

- All constituencies—developers, retailers and lenders—need a realistic understanding of the size, profile and potential of the local market in which a store or center is to be located.
- In areas of residential growth, it is extremely important to "follow the roofs" by making sure that the threshold number of new homes is exceeded before any new development commences.
- Retailers should enhance their understanding of their own product and how their concept and its merchandise would perform in a particular market; this requires higher-quality market research studies, as well as a better understanding of consumers and their behavior.
- Retailers also need to ensure that they gain critical mass in a market to provide sufficient drawing power

[4] Woolworths annual report published August 27, 2009.
[5] According to the Interim Report of December 2009 of Woolworths Holdings.
[6] National Credit Act promotes and advances the social and economic welfare of South Africans; assented to by the president of South Africa, March 15, 2006. See http://www.ncr.org.za/publications/Brochure%20(English).pdf

and to leverage operating costs without over-expanding, a difficult balancing act.

- Retailers must be brave enough to walk away from centers if the following occurs:
  - the market size is not large enough;
  - it is too early to open a store;
  - the center is ill-conceived;
  - the market profile does not fit their product position; and/or
  - growth prospects are not good enough.
- Retailers, developers and bankers should avoid following the herd and base their decisions on rigorous analysis of current and future business conditions.
- Retailers and developers need to be efficient, with low operating costs.
- Developers should make sure that older centers are revamped in time to remain attractive.
- Developers should focus on filling their centers with the right tenants rather than taking on any tenant that can pay the rent.

Developers, retailers and bankers must remember that the economic cycle has not been superseded. Downturns that sharply reduce economic growth and consumer spending will happen. New stores and center developments should be driven by a realistic view of GDP growth.

It is of utmost importance to return to the basics of shopping center development, to focus on a location that has very good accessibility and visibility, to offer something new, and to never overlook the basics of retail site selection.

Walt Disney once said, "You can dream, create and build the most wonderful places in the world, but it requires people to make the dream a reality."[7]

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[7] Sourced at http://quotationsbook.com/quote/11434/