

RETAIL PROPERTY MARKET

The increase in retail sales continued – retail benefited from a favorable consumer climate and the growth in retail spending of Czech households.

Most investments in the sector are directed at redevelopment and refurbishment, new construction is only carried out to a limited extent.

There is a convergence of traditional "brick and mortar shops" and the online world; omnichannel is a new trend.

The market continues to show a high volume of transactions, there was a change in the owners of a number of commercial complexes.

SUCCESSFUL PERIOD FOR CZECH RETAIL

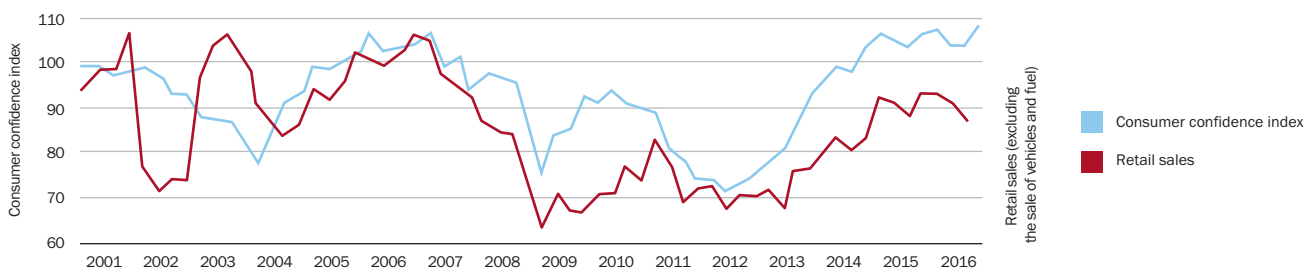
2016 was very successful for Czech retail. The positive turnover trend that started at the turn of 2013/2014 continued. The economic growth and favorable consumer climate positively impacted the volume of expenditure of Czech households in retail.

Consumer confidence has again reached the values that we were accustomed to before the downturn at the turn of the decade. The greater willingness to spend is reflected positively in the development of sales in most retail categories.

This is very clearly evidenced by the attendance development index of Czech shopping centers. According to data from the International Council of Shopping Centres (ICSC), in 2012 and 2013 the number of visitors declined year-on-year. Since 2014, we can see an increase in attendance. Although the increase in attendance was not as high in 2016 as in the previous year (+0.9 % vs. +3.5 %), the high turnover growth is more important; in 2015, sales in shopping centers grew by 8.4%, and in 2016 this value was increased by a further 5.9%. This incidentally exceeds the growth rate in the whole Czech retail market.

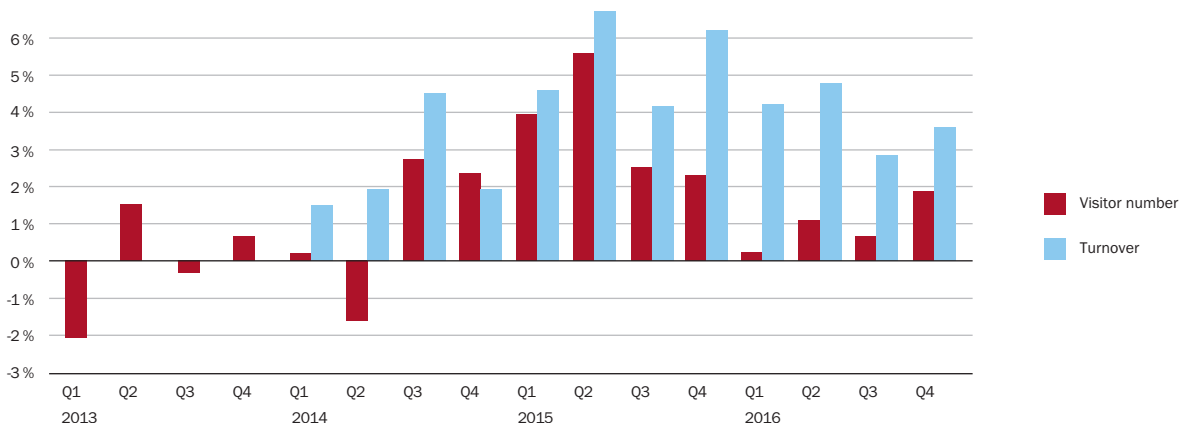
GRAPH Development of retail spending and the consumer confidence index.

Source: ČSÚ (retail sales), GfK (consumer confidence index)



GRAPH The development of visitor number and turnover of shopping centres in the Czech Republic. (yoy comparison)

Source: ICSC



GENERAL TRADE DEVELOPMENT TRENDS

The project GfK RETAIL VISION 2020 dealt with current development trends in Czech retail, which also addressed dozens of executives of leading trade and supply companies. This survey showed that experts and top people in the industry perceive customers as the most important force influencing the form of Czech retail. Their shopping habits will change in relation to the development of lifestyle (whether that is increasing online presence or emphasis on a healthy lifestyle) and sociodemographic composition, of course, along with the development of purchasing power. This will be largely determined by how the Czech and European economy will flourish, and how the CNB can handle the loosening of the crown exchange rate, but also by geopolitical influences on a European and global level.

Customers will have increasing demands on shopping convenience, quality, services and customer service, shopping speed and delivery of goods, as well as information – about the goods, among other things. They will be more sophisticated and more discerning. Many things will be accepted automatically – the previously added value will become a standard. They will want favorable prices without compromising the quality, so it will be increasingly difficult to satisfy them.

One of the key areas will be the emphasis on a shopping experience and shopping convenience. The importance of time devoted to shopping and the simplicity and seamlessness of the entire process will increase dramatically – this will be reflected in the use of technology in stores (and not only there), as well as in the decreasing willingness of customers to travel for shopping. This will significantly affect the point of sale – both preferred retail formats and the further development of the shopping environment and technology. At the same time, the differences between retail segments and customer segments, between "fast pragmatic shopping" and "experiential shopping" will deepen. The personalization of products and services and adapting them to a specific customer will also be a strong topic.

The main threat to the development of retail is the shortage of qualified staff. A large part of requirements for change is linked to the increasing quality of people in the store – at all levels.

MARKET AND RETAIL FORMAT DEVELOPMENT

Retail in the Czech Republic still has a lower concentration than in Western or Northern Europe. Ten of the largest fast-moving chains currently control 74% of the market. In the last measured period, the fastest growing turnover was in Kaufland Czech Republic and

Lidl Czech Republic. These are incidentally chains that have a very different range of items offered (more than ten times higher in Kaufland), but both originally based their market success on low prices, and both are placing increasing emphasis on raising the quality of products and the shopping experience.

The ten largest retail chains in the Czech Republic only include chains that primarily operate fast-moving consumer goods stores. The key point of sales of non-food categories of goods, however, are shopping centers, to which a separate chapter is devoted in this text.

Consolidation of the retail market will continue in the coming years, both in the e-commerce segment and the classic brick and mortar store. It will primarily affect smaller companies, but some larger companies may also "get caught" in the net.

The main wave of expansion is already behind us, but thanks to investments in modernization and actions aroused by demand, the retail network is undergoing a gradual transformation.¹ Existing definitions of the format are ceasing to apply – especially supermarkets and discount stores will continue to converge. The growth of retail formats will be primarily driven by productivity rather than expansion. There will be a further reduction in the area of hypermarkets (especially those that are unable to provide sufficient surface efficiency), and the market will cover convenience concepts in a better way.

Quality specialists have good prospects ahead, online retail will grow across all segments, and particularly non-food categories will ride the economic growth wave (if it lasts till the end of the decade). There will also be a development of hybrid formats (retail+gastronomy or services, etc.).

The connection of retail and services will be one of the key trends. It will show the variety of services provided by retailers in and outside stores, as well as in the development of technology. The "social function" of trade will strengthen – stores will increasingly become a meeting place for people, from rural stores and petrol stations to shopping centers.

Online retail will continue to grow at double digit rates. Online/offline integration will become increasingly sophisticated, and it will become a necessity for retailers. The motor of e-commerce growth across all sectors will be the increase

"The lack of staff and hence the increase in its price, appreciation due to the crown's exchange rate and other regulations by the state, may represent a barrier to growth."

David Pažitka, Klépierre

TABLE The largest retail chains in the Czech Republic (with a turnover of over 20 billion CZK – sales according to balance sheets from 2015 and 2016)

Source: GfK, Commercial Register, information available on January 18, 2017, number of stores as of January 1, 2017

COMPANY	NUMBER OF OWN STORES	TURNOVER IN CZK BN (EXCL. VAT)
Kaufland Česká republika	126	55,2
Ahold Czech Republic	330	48,3
Tesco Stores ČR	298	43,6
Lidl Česká republika	232	33,7
Penny Market	361	32,1
Makro Cash & Carry ČR	15	30,1
Geco (prodejny Geco tabák-tisk)	261	30,0
Globus ČR	15	22,9
Billa	212	21,6

¹ See more in separate subchapter "Remodeling shopping centers" on page 63.

TABLE Largest shopping centers in the Czech Republic (according to number of tenants).

Source: GfK, public sources, data from March 1, 2017

SHOPPING CENTER	MUNICIPALITY	NO. OF TENANTS	TOTAL GLA IN SQM	OWNER
Centrum Chodov	Prague	214	55 000	Unibail Rodamco
Galerie Šantovka	Olomouc	200	46 000	SMC Development
Forum Nová Karolina	Ostrava	193	58 000	Meyer Bergman
Olympia Brno	Modřice	186	102 000	Deutsche EuroShop
Galerie Harfa	Prague	179	45 000	Wood&Co
OC Letňany	Prague	176	120 000	Union Institutional Investment GmbH
Centrum Černý Most	Prague	169	82 000	Unibail Rodamco
Avion Shopping Park Ostrava	Ostrava	165	85 000	Inter Ikea
Palladium	Prague	162	39 000	Union Institutional Investment GmbH
Nový Smíchov	Prague	158	57 000	Klepierre

in shopping convenience and time savings, the development of online retail outside large cities, and the extension of the "presence" of the retailer in all environments where the customer is. The key condition – on the customer's side – will be the full integration of all channels and a smooth transition between them. The term "omnichannel" will only begin to fill with real content, also thanks to new media. The barrier to faster online development is the still functioning and efficient security of product distribution.

SHOPPING CENTERS

Shopping centers are still the most popular place to buy non-food goods in the Czech Republic. There are currently more than four hundred shopping centers of various types and sizes operating in the country: shopping malls, retail parks, hypermarkets with small shopping malls with an area over 5 000 m², specialized centers, etc. Their total lettable area is 4.5 million m².

According to the categorization by the ICSC, about ninety shopping centers are large or medium-sized, with their total area amounting to 2.3 million m² of GLA. Almost a quarter of these centers (and a third of the area) are located in Prague. More than twenty shopping centers exceeded the amount of one hundred retail units.

DEVELOPMENT OF RETAIL PROPERTY

The main expansion wave of new shopping centers in the Czech Republic is over. The degree of saturation in the market is relatively high, and therefore the vast majority of investments are not directed at new construction, but rather redevelopment – the modernization or extension of existing buildings, resulting in record low total acquisitions of retail space. In addition to complexes built by retailers, only two new shopping centers – AuPark Hradec Králové (21,000 m², developer HB Reavis) and Galerie Přerov (14,000 m², developer DBK; however, in this case it was a complete reconstruction of the old Prior building) and several retail parks entered the market.

The overall amount of shopping centers per 1,000 inhabitants is slightly below the EU average. With a conversion according to the real purchasing power, the Czech Republic is suddenly included in the group of countries with above-average retail space capacity.

Due to the high competition, some regions and specific cities have an excessive supply above the real purchase-capable demand. This negatively affects shopping centers in these locations – about a fifth of them have problems with attendance and occupancy.

In addition to competition, there are also other reasons for this condition. One of the most common reasons is improper location, the lack of demand potential of the catchment area or unsuitable dimensions and layout of the center. For many of these centers, the only solution may be a fundamental change, either in the layout, targeting, tenant mix, overall functional use or ownership change.

The pressure for economic efficiency is growing. One implication is "downsizing", that is the reduction of many retail areas, especially large-scale ones. With the strengthening of e-commerce and the associated pressure on the effectiveness of brick and mortar stores, this trend will continue to deepen in many market segments.

New larger commercial projects in the coming years will only emerge to a limited extent. The results of the ARTN survey are also skeptical about the growth of new spaces by 2018 – the percentage of responses expecting such a low growth in retail space was not this low in any other real estate segment.

According to respondents, the main reason is the high degree of saturation in many locations. As the survey shows, there is still space for new development. New retail parks will be created especially in certain district cities, which will allow traders to expand at favorable rents and low operating costs.

GRAPH What increase in new retail projects do you expect in 2017 – 2018?

Source: ARTN survey

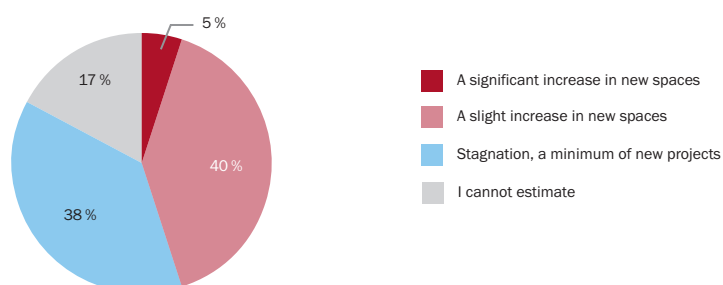


TABLE Selected shopping centers in the construction or project preparation stage.

Source: CBRE, public sources

SHOPPING CENTER	CITY	STATUS, SCHEDULED COMPLETION	TOTAL GLA IN SQM	DEVELOPER
Centrum Chodov	Prague	under construction, 2017	40 700	Unibail Rodamco
Central Jablonec	Jablonec	under construction, 2017	11 300	Crestyl
IGY II	České Budějovice	under construction, 2017	9 000	CPI
Bořislavka	Prague	planning, 2018	10 000	KKCG
Palác Stromovka	Prague	planning, 2018	13 000	Lordship
NC Královo Pole	Brno	planning, 2018	7 600	Bainbridge
The Style Outlets	Tuchoměřice	under construction, 2017	20 000	The Prague Outlet + Neinver

Despite sobering forecasts for expansion, we can look forward to a number of interesting projects in the future. The main event of 2017 should be the extension of the Prague shopping center OC Chodov, by another 41,000 m². It will take place in two stages, after which the number of shops, restaurants and other establishments at the end of the year will be close to three hundred, which will be 50% more than the second largest shopping center in the country offers.

The opening of new outlet center The Style Outlets near the Prague airport is also scheduled – strong international investor Neinver joined the project in 2016. We can also expect additional investments in the construction and expansion of centers in Prague and in the regions. In the coming years, the greatest hopes are placed in development projects of some of Prague's railway stations (Smíchov, Bubny).

INVESTORS AND TENANTS

In previous Trend Reports we predicted that retail will become increasingly attractive to investors. This trend became fully apparent in 2015, and it was exceptional in terms of investment activity. A high volume of transactions was also characteristic for 2016 and the first quarter of 2017.

Two really large retail transactions (shopping centers OC Letňany and Galerie Harfa were acquired by new owners) were carried out in recent months in Prague. However, the highest amount was paid by investment company Deutsche Euroshop, which acquired the large successful regional center Olympia Brno from Rockspring and ECE.

The activity of investors in retail will not decline in 2017. Negotiations for the sale of other centers are underway – we therefore expect the volume of investments to be above-average this year.

Investors seek retail real estate (and often overpay), despite the risk of diminishing returns. Due to the high investor interest, retail yields are further declining. According to CBRE, the yields in 2016 dropped to 5%, and on high street they even dropped below 4%.

Buyers naturally assume that they will get a return on their investment with a sufficiently high rent income. However, most experts believe that rents will not change much, or that they will only increase slightly. Speaking about average rent is simplistic – the differences between rents of successful and less successful centers

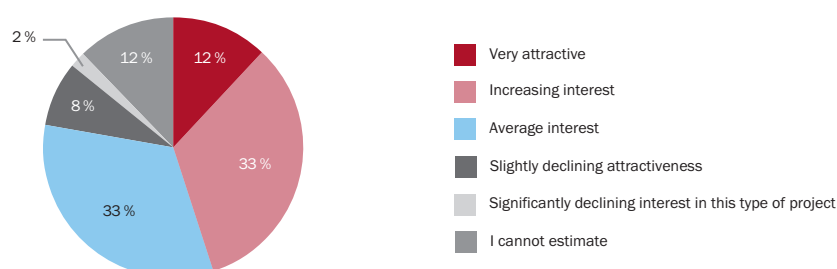
TABLE Selected retail transactions in 2016 and the first quarter of 2017.

Source: CBRE, public sources

PROPERTY	CITY	VENDOR	PURCHASER	PRICE EST. (MIL. EUR)
Olympia Brno	Modřice	Rockspring + ECE	Deutsche Euroshop	374
OC Letňany	Prague	Tesco	Union Institutional Investment	240
Galerie Harfa (+ Harfa Office Park)	Prague	Lighthouse	Wood & Company	120
Atrium portfolio	ČR	AERE	Arcona Capital	103
Forum Ústí nad Labem	Ústí nad Labem	Meyer Bergman	NEPI	80
Forum Liberec	Liberec	Tesco	Rockcastle	80
OD Kotva	Prague	Markland	Pražská správa nemovitostí	80
Bondy Centrum	Mladá Boleslav	Raiffeisen Leasing	CPI Group	50
OC Šestka	Prague	Immo Group	Wood & Company	x

GRAPH Will retail space be attractive to investors in 2017–2018?

Source: ARTN survey



² See more in the chapter "Investment market" on 96.



GRAPH What is your view on the future development of retail rent in 2017 and 2018 compared to 2016?

Source: ARTN survey

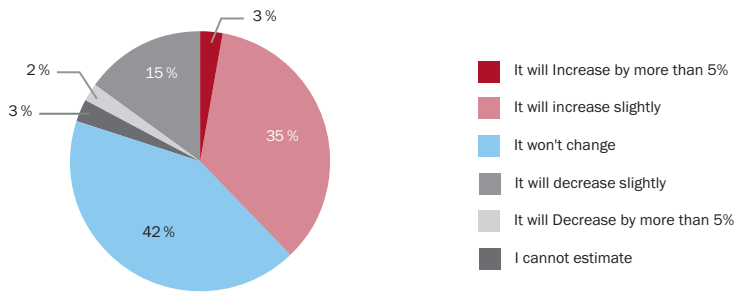


TABLE Prime rents. (in EUR/m²/month)

Source: CBRE

	PRAGUE	REGIONS
Prime high street rent	215	70
Prime shopping centre	125	65
Prime retail park	12,5	11

are increasing every year. While some successful centers in exposed locations increased the rents for smaller areas to more than 120 EUR/m²/month, in centers that are losing visitors and tenants the value often dropped to about 10 EUR/m²/month. This methodology is also affected by the combination of the deduction of part of the sales and other methods of paying rent.

The rent level is also greatly diversified according to the tenant's strength. Simply put, the stronger the brand, the more difficult the developer's or owner's negotiations are (unless it is a greatly profitable shopping mall), and the

more convenient the offers are for the tenant.

There are brands on the market that are necessary for an attractive and well-established tenancy mix. Conversely, strong centers can choose between dozens of candidates, and they take advantage of this possibility to the fullest. To them, a new tenancy means higher rental income or a reputable brand, optimally both.

PROSPECTS OF THE SHOPPING CENTER SEGMENT

In the coming years, investments will be directed at modernization, redesign and possibly expanding some

existing centers. The return to city centers will continue, while many centers in the periphery will have to cope with a decline in attendance.

The differences between successful and unsuccessful centers will grow (both in attendance and turnover, as well as the rent). If the market growth stops, centers that are not in ideal locations, centers with a non-complex offer or a less attractive tenant mix than that of their competition in the catchment area, will face a difficult situation.

Quality management and the continuous upgrading of centers will be the conditions for success. Customers and retailers will primarily look for centers with continuous innovations that offer more than before and more than the others. More so than today, centers will focus on quality leisure opportunities.

Fashion will continue to be the main product assortment in shopping centers. Services, gastronomy and entertainment will play a larger role in their offer. Good shopping centers will increasingly become a meeting place for the local community. Shopping centers will also build a clear profile and their position as a brand more strongly than before.

"Quality property management will be crucial for the growth of project value."

Karel Klečka, Patria investiční společnost

TOMÁŠ DRTINA
GfK

REMODELING SHOPPING CENTERS

The topic of remodeling shopping centers has only become current in recent years. This is due to the fact that this market is still relatively young in the Czech Republic. Despite this fact, in recent years there were several major remodelings of shopping centers, which were opened in 1996–2006, that is during the first boom in the construction of shopping centers in the country.

The subject of this short probe are not small adjustments to shopping centers, which tend to be for marketing

response to changes in customer behavior and preferences. A large part of the new retail space will be occupied by restaurants and entertainment, which many surveys indicate as the future dominant features of the tenant mix of successful centers. Other future magnets will include services and distributing points of major internet retailers.

Another reason or impulse that I believe is important, is the change of the owner of the shopping center.

Since the center was realized by the developer or even

TABLE Shopping centers opened in Prague between 1996 and 2006 .

Source: David Pažitka

CENTER	OPENING	CENTER	OPENING
Budova Myslbek	1996	Metropole Zličín	2002
Park Hostivař	1996	Palác Flora	2003
Černý Most	1997	Galerie Butovice	2005
Avion Shopping Park Zličín	1998	Eden	2005
Letňany	1999	Chodov	2005
Nový Smíchov	2001	Novodvorská Plaza	2006
Europark Štěrboholy	2002	Šestka	2006

purposes, but rather major remodeling worth millions of euros. We must view this type of remodeling as an investment, as we would the construction of a new shopping center. There are several reasons why owners would choose such an investment. The main reason is always a long-term increase in the shopping center's value, both through the growth of expected revenues from rent and increased yields.

In markets that have worked for decades (with an appropriate dose of regulation), such as in France, remodeling is viewed as a part of a natural cycle. After a certain amount of time (about 20 years), it is necessary to fundamentally change the center, and the owner, who is usually a long-term investor, is more or less willing to implement this change.

I dare say that because of how young the Czech market is, this is not yet a natural cycle in our country, despite the fact that the main impulse for the renovation of Nový Smíchov (2010–2011), which is owned by our company, was the abovementioned natural cycle and its phases.

REASONS FOR REMODELING

The largest and most successful achievements in remodeling in the Czech Republic are associated with expansion. We can see additional commercial space being attached to the existing functioning center, the size of which is significant. Since it is not conceivable to offer customers a visibly "old" and "new" part of the center, the original part is modernized.

A side effect is the use of new technology, which either leads to increased customer comfort or savings in future operating costs. Černý Most, Letňany or the ongoing expansion of OC Chodov are good examples.

Incidentally, in the case of Chodov we should also mention one more significant effect of remodeling, which is the

planned, many factors have changed. Whether in the field of transport (metro stations, Prague tunnels, etc.), competition, but especially different customer behavior in the center or in its catchment area.

Changing the interior design, vertical connections within the center or even replacing one or more anchor tenants with appropriate structural modifications, are some of the only possible answers of the new owner with a long-term strategy, who often buys the center with a specific remodeling plan. We've seen this in Novodvorská Plaza.

REMODELING TRENDS

We can assume that both of the abovementioned reasons for remodeling shopping centers will begin to fade in future years. There is no longer as much space in the area of expansion (especially in exceptionally successful centers), and the possible extension of centers is and will be more challenging in terms of administration. Centers that still need revolutionary change deal with the situation with partial gradual remodeling.

I therefore expect that remodeling will become a natural part of the life cycle of shopping centers in future years. Changes will take place regularly based on the development of design and technology, and this process will be driven by the competition, which may in rare cases be associated with repositioning the center and/or the arrival of a major new anchor tenant, such as Primark. On one hand, remodeling will become an obligation, whose omission the market – tenants and customers – will not forgive; on the other hand, it will be a regular opportunity to review and correct the strategy for each shopping center.

DAVID PAŽITKA

Klépierre