The Bulletin

Retail: Structural Divergence Amid the Pandemic

AUTHOR

Mathieu Parisien, Analyst

Mathieu Parisien is an analyst at Presima covering North American stocks on Presima's investment team.

We all hoped it would be over by now, but with COVID-19 infection numbers re-accelerating and several western economies in some form of economic lockdown, the damaging impact on commercial real estate has been massive and has left many investors wondering what financial ramifications lie ahead.

One of the most impacted real estate sector has been retail real estate such as malls and strip centers which were already facing pressure before the global shutdown. Amazon and its peers have been gradually taking market share of retail sales away from traditional brick-and-mortar retail with the share of US e-commerce penetration in 2019 reaching 15%. Amid the pandemic, e-commerce trends dramatically accelerated and increased 77.8% to more than 25%, as of April 2020[1]. The impact of e-commerce is perhaps most telling when comparing Amazon's 3-year stock price return of 281% versus America's pre-eminent mall REIT Simon Property Group which has dropped -67%.

STOCK PRICE RETURN (%) SINCE 2017

Source: Bloomberg L.P.

DIVERGENCE WITHIN THE RETAIL SECTOR

Behind the global trend of brick-and-mortar (bad) and e-commerce (good), however, there is also an important divergence occurring within retail real estate. Strip centers, often typified by an open-air center anchored by groceries, pharmacies and other daily necessities haven't fared as poorly as traditional mall real estate which is largely anchored by large department stores and apparel-based tenants.

REITs were created to give investors access to the benefits of commercial real estate ownership, most notably the stable income stream derived from receiving rent payments. Investors will pay for income stability which is a trait that several mall REITs have started to lose. The first chink in the armor is unstable occupancy.

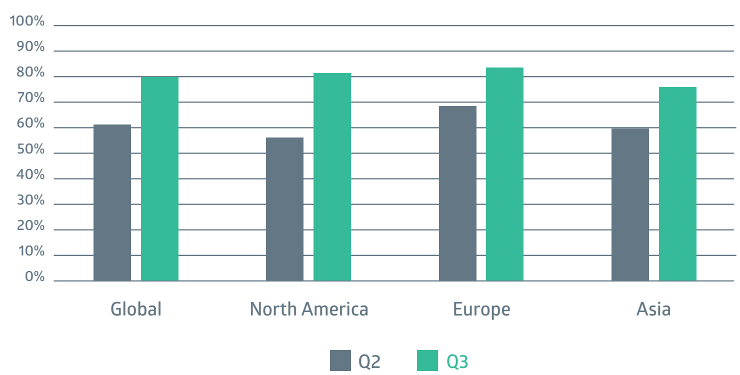
The department store has long been a key anchor in malls, taking up approximately 30% of the space[2]. Unfortunately, the department store model has also been slowly fading away. US mall staples such as Sears/Kmart, JC Penney and Neiman Marcus have fought their way through bankruptcy proceedings, while survivors, such as Macy's, continue to rationalise store counts.

According to Creditntell, store closure announcements have already reached a new high in 2020 with 15,225 compared to 9,185 and 4,905 in 2019 and 2018 respectively[3]. The math is simple, no tenants equals no rent. And more recently, a new worry for landlords is the increasing number of non-paying tenants due to the financial and operating strains resulting from COVID-19. Rent collection is now top-of-mind for all investors as mall tenants, some who are even open and profitable, refuse to pay rent. This has been seen globally as rent collection are at a fraction of pre-COVID-19 levels.

Fortunately, there has been an incremental improvement in collections in the third quarter. It remains uncertain if unpaid rents will ever be recovered which is detrimental for income stability. In some cases, such as with CBL Properties in the US and Intu Properties in the UK, operational woes coupled with elevated leverage has crippled the company and led to bankruptcy.

> While retail might still be a bad word in commercial real estate, we believe there is an opportunity in strip centers as headwinds persist for malls.

MALL REIT RENT COLLECTION AS AT 2Q2020 AND 3Q2020



Sources: Rent collection of the four major mall REITs per region (North America: SPG US, MAC US, PEI US, WPG US; Europe: LI FP, URW NA, ECMPA NA, HMSO LN, WEHB BB; Asia: VCX AU, SCG AU, 0823 HK), simple average; Presima Inc.

MALL LANDLORDS NOT GIVING UP YET

Mall landlords, however, are not sitting idly on the sidelines.

SPARC Group is a partnership between mall REIT, Simon Properties and brand development company, Authentic Brands. The partnership first made headlines in 2016 with the acquisition of failing retailer Aéropostale. More recently, we have seen SPARC acquire bankrupt retailers Forever 21, Brooks Brothers and JC Penney. SPARC isn't alone, real estate giant Brookfield Asset Management has also pledged $5 billion towards a retail revitalization program[4]. If successful, as it has been the case for Aéropostale, mall REITs like Simon Properties get to maintain occupancy by not closing stores in their portfolio and generate a return on their initial investment.

Returns now lean closer to that of an equity investment compared to steady coupon-like return. In both the UK and Australia, we have seen a push towards rents as a percentage of sales instead of the standard fixed rent payment. Although landlords have the potential to receive higher rents if retailers succeed, the important characteristic of income stability is tempered and, understandably, valuation risk premiums are higher.

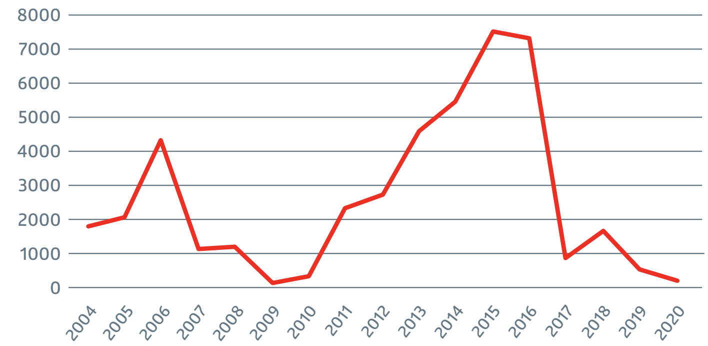
DIFFICULT TO PRICE RETAIL-ORIENTED REAL ESTATE

A long-held advantage for accurately pricing REITs is the ability to value the underlying asset portfolio, most commonly by way of cash flow analysis or comparable transactions.

With greater cash flow variability of mall REITs, investors would typically look at comparable transactions to benchmark current pricing. Comparing a public company's implied yield with private market valuations can help to determine how in or out of line the market is compared to private investor assumptions.

Unfortunately for malls, both valuation techniques have become more challenging. Cash flows are proving to be highly variable and private market transaction volumes have all but gone away, leaving very little indication of what an investor is willing to pay for mall assets. This might change in the future with the pandemic behind us or when e-commerce growth starts to plateau, but for now, the bid-ask spreads still appear too wide.

US MALL TRANSACTIONS OVER TIME (IN MILLION US$)



Source: Green Street, Date Download, November 23, 2020.

THE ADVANTAGE OF NECESSITY-BASED RETAIL AND THE OMNI-CHANNEL STRATEGY

Although not everyone has been to a mall since March, it is more likely that you have stood in a queue outside waiting to enter your local grocery store. Herein lies the resiliency of strip center retail.

Grocery has remained essential throughout the pandemic and unsurprisingly, grocery retailers have thrived and are now looking to take up more space.

Other typical anchors such as Walmart, Target, and Home-Depot have all seen success before and throughout the pandemic. The focus on daily necessity-based retail and non-discretionary spending has provided a level of stability to the center's occupancy. Furthermore, a new trend is emerging where typical mall tenants are looking to crossover into the open-air space.

Cost alone provides an incentive to do so. Retailers often focus on their occupancy cost ratio (OCR), that is rent paid as a proportion of sales, and which can vary significantly between mall and strip center assets. Mall properties of REIT's like Simon Properties have OCR ratio's around 12.5%. When looking at open-air locations, that number is closer to 7.5%. In speaking with REIT management teams, there have even been cases where a tenant's rent at a strip center is less than the common area charges that mall landlords charge back to tenants.

CONCLUSION

Omni-channel is now commonplace terminology in the world of retail. Brick-and-mortar retailers have learned the benefits of a strong online presence and online retailers the benefits of physical locations.

This brings about another reason to prefer strip centers over malls, the structural ability to adapt to new omni-channel trends. This was on full display in recent months as buy online, pick-up in store (BOPUS) became a popular, COVID-friendly way to shop.

Landlords and tenants have worked together through the pandemic to reconfigure parking spots as designated pick-up areas. The adoption and success of BOPUS has also changed the inside of stores. More and more, stores are reserving space to be used for micro fulfilment. This not only leads to increased store sales but also helps retailer profitability as they avoid high shipping costs associated with owning or outsourcing specialised distribution and fulfilment centers. Increased cost savings and optionality for tenants result in more stable occupancy levels of strip centers which in turn leads to higher rent visibility and higher valuations.

> We believe strip centers have a greater ability to adapt to new omni-channel trends through buy online, pick-up in store (BOPUS).

FINDING VALUE IN CHALLENGED SECTOR

There is no denying that all retail is having a challenging time across all property types, and it remains difficult for investors to identify clear winners in the current context. That said, we continue to monitor the retail space for our portfolios and clients, keeping a close eye on the changing dynamics in the sector and any catalysts that may arise.

And despite the broader sector challenges, we believe that strip center retail is currently better positioned due to the differences outlined above between malls and strip centers.

While malls are losing their largest occupiers of space and are forced to take on equity-like risks, strip centers are seeing increased demand from "essential" retailers and are structurally more adaptable to changes in omni-channel trends.

References

(1) Prologis research, COVID-19 Special Report #6: Accelerated Retail Evolution Could Bolster Demand for Well-Located Logistics Space, June 2020.

(2) https://www.nytimes.com/2020/04/21/business/coronavirus-department-stores-neiman-marcus.html

(3) https://www.citivelocity.com/rendition/eppublic/documentService/

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PRESIMA

CONTACT

Amina Si Chaïb,
Senior Associate,
Client Service & Marketing
asichaib@presima.com
(514) 673–1224