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Doomsday scenarios oversimplify state of U.S. retail

The factors creating disruption in the retail sector are complex and varied, yet doomsday scenarios splashed across the news paint with a broad brush and are being extrapolated to the entire industry rather than to its most vulnerable segments. The shuttering of mediocre retailers and shopping centers is prompting the industry to transform and adapt in ways that improve operating efficiency and create a more curated, experiential and personalized shopping experience. We examined some of the recent headlines and found that while it's likely that average- and low-performing retail centers will die a slow death or be repurposed, certain segments of the sector are poised for sustainable growth, assuming they continue to respond to the rapidly changing environment.

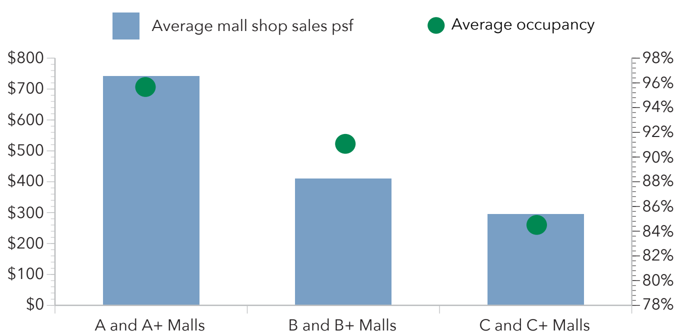
Headline: Shares of retail REITs are trading at discounts of 20 percent to 30 percent to net asset value, suggesting values for privately held retail real estate will fall by as much.

Reality: We believe retail REITs holding high-performing retail properties are undervalued in the public markets. In our view, the average- to low-performing retail centers are seeing value declines, but there is no evidence of value declines for high-performing malls and shopping centers.

As shown in the graph below, A and A+ malls and 4- and 5-star shopping centers are outperforming average- and low-performing retail centers in terms of occupancy, sales productivity and rental rates.[1] High-performing malls and shopping centers attract more traffic which, in turn, drives occupancies, rental rates and sales-per-square-foot higher.

Data from the NCREIF Property Index (NPI), which serves as a proxy for high-performing institutional-quality retail properties, suggests that retail operating fundamentals have been solid during this most recent cycle. Vacancy rates for retail properties in the NPI have fallen more than 350 basis points since 2010 and stand at 7.4 percent as of Q2/2017. Net operating income has grown, on average, around 3.5 percent per annum since 2010 for retail properties in the NPI, similar to the growth seen for offices and warehouse properties during the same time period.

A-rated malls are outperforming B- and C-rated malls



Source: Green Street Advisors

High-performing shopping centers experience low vacancy and high rental rates

	Average vacancy rate	Average asking rent (NNN)
1-3 stars	8.8%	$12.89
4-5 stars	2.9%	$20.29

Source: Costar. Includes neighborhood, community, lifestyle center, power and strip centers of 75,000-350,000 sf in Atlanta, Austin, Chicago, Dallas, Denver, Houston, Minneapolis, Phoenix, Portland, Raleigh, San Diego, Seattle, Tampa, and Washington, DC.

Headline: Online retail sales account for a small fraction of total retail sales, but online penetration has forced a number of retailers to file for bankruptcy protection.

Reality: Online retail sales are pushing weak retailers out of business faster than ever before. The end result will be a set of financially healthier retailers and shopping centers that offer customers more compelling products and curated experiences.

The convenience and ease of online shopping is undeniable. It allows consumers to find the best prices on thousands of products instantaneously, while delivering those goods within a day or even an hour. Ultimately, online will make retailers more efficient, but it will require substantial investment to create a seamless, interactive in-store experience that resonates with consumers. While it raises the bar for success, the end result will be happier and more engaged consumers.

Rising online retail sales are not the sole reason why many retailers are struggling. Many merchandise categories, such as teen apparel, sporting goods and home goods, have excess store capacity with little differentiated product. According to Creditintell, 40 percent of traditional department stores have overlapping products, so traditional department stores struggle to differentiate themselves from each other. By comparison, companies like TJX, Ross Stores and Burlington, which have minimal online retail sales, have opened 1,705 stores since 2010 and grabbed $18 billion in retail market share with an off-price strategy. In this competitive environment, carefully curated merchandise offerings, compelling value, quality brands, high levels of customer service and experiential components are crucial for success.

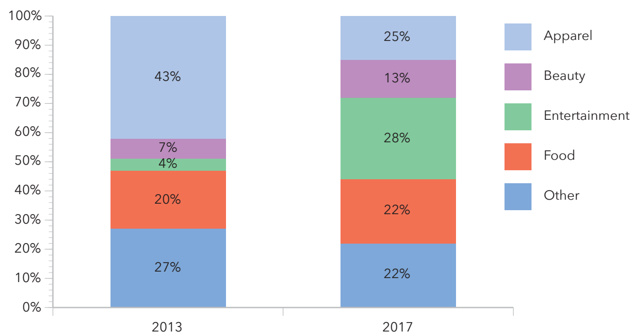
Headline: Consumers, and particularly Millennials, prefer experiences to material goods which will cause ongoing sales declines at physical stores.

Reality: Consumers of all ages are spending more on experiences than material goods which is why high performing retail centers and malls now feature experiential components and tenants.

Among all consumer spending categories, Mintel expects spending on experiences, such as dining out and vacations, to grow the fastest during the next five years.

The changing mix of tenants and uses at the nation's top malls and shopping centers reflect the shift in consumer behavior. As shown below, entertainment and food accounted for 40 percent of General Growth's leasing activity in 2017 compared with 24 percent in 2013. Apparel's share of leasing activity fell from 43 percent in 2013 to 25 percent in 2017.

Leasing by tenant type



Source: GGP Investor Presentation, June 2017

Examples of experiential retail include:

- Cooking classes and demonstrations at Williams Sonoma
- Yoga classes at lululemon athleta
- Collections of sit-down restaurants
- Upscale movie theaters and cinema draft houses
- Upscale bowling alleys
- Microbreweries

The mix of retailers at high-performing shopping centers changes frequently in response to consumer preferences and behavior; this adaptive quality is both essential and one of the reasons for their ongoing success.

Headline: Amazon's purchase of Whole Foods will disrupt the grocery industry and put grocers and grocery-anchored shopping centers at risk.

Reality: Financially weak grocers failing to offer value, quality and unique products are at risk while select national, local and specialty grocers are more insulated.

We agree that the grocery industry is ripe for disruption. Grocers offering little in the way of value, differentiated products or ease of shopping face a difficult future. At the same time, grocers like Wegman's, Trader Joe's, Whole Foods and Sprouts should continue to thrive, driving demand for physical retail space. Should financially weak national, regional or local grocers be forced out of business, there may be opportunities to back fill space with a more compelling grocer or another large format retailer.

Currently, online grocery shopping accounts for less than 4 percent of total grocery shopping, but FMI-Nielsen estimates online grocery shopping could account for 20 percent by 2025. Amazon's acquisition of Whole Foods could accelerate the growth of online grocery sales. The Whole Foods acquisition provides Amazon with a rich database of spending habits of affluent households. Amazon can mine this data to drive sales through the same cross-selling and marketing techniques that it brought to books, music and other products.

Similar to the rest of the U.S. retail market, the need for physical grocery stores will remain, but weak grocery operators may be forced out of the market if the grocer industry is forced to become more efficient.

Conclusion

We feel that taking the headlines at face value without considering a broad range of factors is shortsighted. With greater context and understanding of the nuances of the current situation, we are taking a somewhat contrarian view to pervasive narratives about the retail sector and pursuing the compelling buying opportunities this market disruption is creating. These are mainly with high-performing power centers, lifestyle centers, neighborhood/community centers, grocery-anchored centers, and malls. We don't believe e-commerce will fully extinguish consumers' desire to shop in physical stores and expect that retailers fostering online retail sales growth, creating in-store experiences that resonate with consumers and adapting to shifts in consumer behavior will be successful in the years to come. For investment managers, the challenge is to identify and acquire retail centers with tenants that are making the necessary adjustments to remain competitive in the long haul.

Author
Melissa Reagen is the head of Americas research for TH Real Estate, an affiliate of Nuveen (the investment management arm of TIAA). It is one of the largest real estate investment managers in the world, with $107 billion in AUM.

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[1]Our definition of high-performing malls are those rated A or above, and high-performing shopping centers are those with 4 or more stars. See Costar Building Ratings System for definitions of 1–5 stars.