nyrej

The end of “brick-and-mortar” is not near–Retail assets continue to evolve to meet consumer needs - by Yoel Kranz and Evyn Rabinowitz

November 21, 2017 - Spotlights

Yoel Kranz,
Goodwin

Evyn Rabinowitz,
Goodwin

Last summer, Macy’s chairman Terry Lundgren famously described the glut of retail property in the U.S as “ridiculous.” Indeed, the U.S. currently has the most retail space per capita of any country–with no close second. While numbers vary widely, the U.S. reportedly has over 7 billion s/f of commercial retail space, or over 20 s/f per capita, which is well in excess of the low single-digit s/f per capita prevalent in Western Europe and Japan. “Overstored” is the term now commonly used to explain the current state of U.S. bricks-and-mortar retail.

Not entirely unrelated, the online retail market continues its steady march towards capturing a more significant share of the overall retail market. In the second quarter of 2017 alone, e-commerce sales were estimated to have increased 16% year over year, from approximately $97 billion in the second quarter of 2016 to $111.5 billion, and most analysts agree that e-commerce will continue to drag on sales at physical stores. The world finally did turn upside down when Amazon completed its 2017 acquisition of grocer Whole Foods, and once-proud Lord & Taylor just announced the sale of its flagship store to shared office start-up WeWork.

But the reports of retail’s demise have been greatly exaggerated. The fact is that brick-and-mortar retail continues to enjoy a very healthy majority of the total U.S. retail market. Over 80% of all U.S. retail sales still take place in physical stores. For example, compare the $111.5 billion in second quarter 2017 e-commerce sales referenced above to the $1.3 trillion in overall retail sales estimated for the same period. Yes, there are many retailers experiencing steep declines and store closures but there are also a select few, such as Nordstrom, Dick’s Sporting Goods, Burlington Stores, T.J. Maxx and Target, that are undertaking significant expansions this year. And, coming full circle, a handful of retailers who have historically had only online presences, such as Gilt, Warby Parker, Bonobos, Altheta and even Amazon itself, have opened physical stores as well.

So it would seem the question is not whether the end of US brick-and-mortar retail is upon us but which brick-and-mortar retail – what type, which use, what location, what demographic – will carry retail assets in the next phase of the commercial real estate cycle. These are the considerations that capital allocators are carefully weighing every day, from private investors to institutional real estate funds to publicly-traded REITs in the retail sector.

Looking at this last group, listed retail REITs, as a microcosm, the share prices of these companies have certainly taken a beating since late July 2016. Shopping center REITs are down nearly 30% on average during that period and mall REITs by nearly 35%. No doubt, each of these companies is hard at work developing long-term strategies to best position itself in response to the shifting market trends, but how deeply the current portfolios of these companies should be discounted is not at all certain. For example, grocery-anchored shopping centers typically serve the basic need of consumers to purchase food and other staple goods and services–this type of brick-and-mortar retail asset is not going anywhere for the foreseeable future. Instead, what we are likely to see is the increasing adoption by shopping center operators of a multi-pronged approach to maintaining relevance: shifting from power centers to grocery-anchored centers with a higher percentage of restaurants, banks and pharmacies; redevelopment of some assets as mixed-use properties with residential and entertainment components; and converting excess parking or other square footage to flexible use space that might include, for example, pop-up retail and/or electric car charging stations.

For investors in retail brick-and-mortar real estate today, it is worth putting the current state of the market in perspective. While the culling of less-profitable retail properties may be an unavoidable reality, high-quality commercial real estate in submarkets with optimal demographics will also continue to be a mainstay of the retail economy. For example, it is important to note that only a small fraction of the “overstored” 7 billion s/f of commercial retail space in the U.S. is owned by the pubic REIT sector–and the portfolios owned by these companies in most cases represent high quality shopping centers in high barrier to entry markets with desirable demographics. These are unlikely candidates for failure in the near term. Conversely, roughly 25% of all shopping malls in the U.S. are grade “C” or worse but these account for less than 2% of aggregate national mall value. The same can be said of the retail portfolios owned and operated by many private institutional real estate vehicles.

So, while the current fears over declining retailer results and e-commerce growth may be justified, and the stress in the retail real estate sector is certainly real, the primacy of high quality and well-managed brick-and-mortar retail assets appears to be safe in at least the near term.

Yoel Kranz is a partner in Goodwin’s REITs and Real Estate Capital Markets Practice; and Evyn Rabinowitz is an associate in Goodwin’s Business Law Department, New York, N.Y.