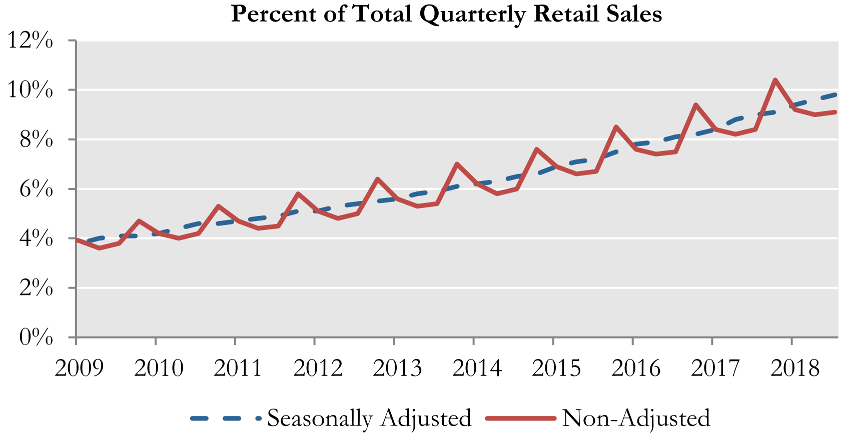
The Decline of Retail: Implications for the CMBS Market

December 2018

Retail bankruptcies and store closures have filled news headlines in 2018. Notable chains such as Toys-R-Us and Bon-Ton, ingrained in our culture and economy for decades, have gone into liquidation. Others such as Sears and Kmart have filed for bankruptcy after many years of weak performance. Store closure announcements seem to be a regular occurrence, even for healthy retailers. To put these statements into perspective, figures tabulated by Bank of America CMBS research show nearly 5,000 store closings in 2018 thus far, representing over 130 million square feet of retail space. In this piece we examine the current and future states of the retail sector along with the associated implications for the CMBS market.

Retail has always been a dynamic segment of our economy. From Sears' introduction of the mail-order catalog in the late 19th century to the growth of the suburban mall in the mid-20th century, the retail industry has relied on periodic reinvention to attract shoppers. With the rapid rise of e-commerce in the last decade, traditional retail stores have been forced to change at an even faster pace in order to maintain their relevance. JCPenney, for example, has experimented with the store-within-a-store concept, bringing Sephora into over 600 of its locations. Others, such as Neiman Marcus, have embraced Internet sales, with 36% of its 2018 fourth quarter sales generated online. Despite these attempts, however, the market share of online retailers has continued to increase over the last ten years, intensifying the challenge and creating a sense of urgency for their brick and mortar competitors. Online sales represented 9.8% of 2018 third quarter retail sales in the United States, with Amazon representing almost half of those online sales.

Estimated Quarterly U.S. Retail E-commerce Sales as a Percent of Total Quarterly Retail Sales



Source: U.S. Census Bureau

Annual Retail Space Closed Since 2016

Source: Bank of America Research

These trends have reduced the demand for physical retail space and have put retail tenants and their landlords under pressure. The Toys-R-Us bankruptcy resulted in 735 store closings this year, with Sears and Kmart closing 403 locations and counting. Bon-Ton's liquidation resulted in 256 closures and the list continues well beyond these high-profile names. Retailer bankruptcies affect landlords by generating lease terminations and increasing anchor and in-line vacancies at properties. The tenants that do survive are emboldened to seek better terms at lease expiry or opportunistically based on their specific situation.

In some malls, the closure of an anchor may be an opportunity for a landlord to recapture a low-rent space and replace it with more productive tenants or to repurpose it entirely for a more popular restaurant/entertainment use that cannot be replaced by a few clicks online. This has meant adding restaurants such as The Cheesecake Factory, entertainment tenants such as Dave & Busters, and in some cases, even casinos to draw in foot traffic and shoppers. But this opportunity requires time and capital;

with landlords as with retailers, there are haves and have-nots. Simon Property Group, whose portfolio generates $650 per square foot in sales on average, has continued to grow rents by over 10% each year since 2012. On the other hand, CBL Properties, whose portfolio generates only $376 a square foot in sales on average, has struggled with annual rent declines of almost 7%.

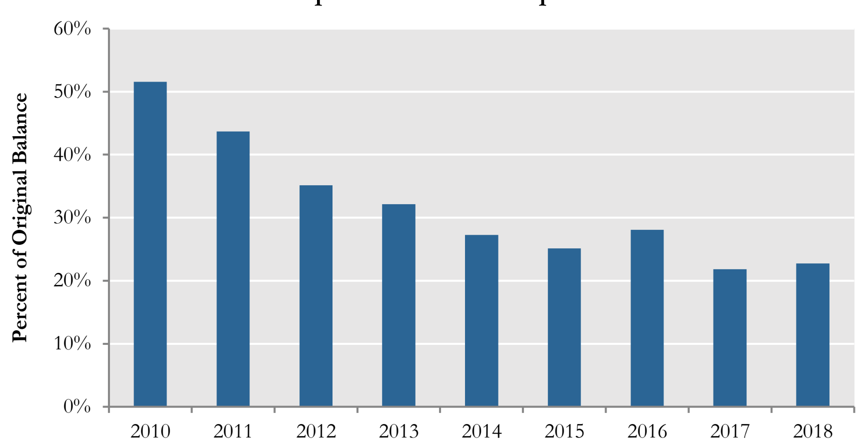
While one closed anchor tenant may be an opportunity, two or more closed anchors could be an existential threat to the viability of a mall. Many mall tenants have "co-tenancy" clauses that allow them to lower rental payments or even terminate their leases if a certain number of anchors or percentage of mall occupancy is not maintained. The equity market has re-priced retail REITs downward given these risks and, in effect, limited their available capital. CBL, for instance, is down over 50% year-to-date.

From our perspective as a CMBS investor, these details make the underwriting of both the real estate and tenancy all that much more important. The old adage "location, location, location" still holds true to a large degree. A landlord can readily get a replacement tenant at workable rents in a prime location, even in the current environment. However, filling the weak locations in this retailer downturn has become uneconomic in many instances, as tenants and landlords face difficulty in finding a zone of agreement. Landlords in these weak properties face a dilemma as failure to invest capital puts a mall on the path to becoming a "dead mall" while investing capital risks deploying good money after bad if a viable lineup of retailers and tenants cannot be maintained. Thus, scarce capital is forced to flow to strong malls while "dead malls" are allowed to degrade. As a result, the weakest tier of malls has lost value the most rapidly and has produced eye-popping losses in CMBS trusts. As noted by Moody's, six troubled malls were liquidated this past quarter at an average loss severity of 86.9%!

In general, cashflow stability is a main focus when we make CMBS debt investments. In addition to assessing property level sales productivity and rent costs on a loan-level basis, our underwriting also considers the credit profile of the underlying tenants. Many investors are rightfully concerned about lending against properties with a high percentage of short-term leases. However, we believe that investors often give too much credit to long-term leases in mitigating a property's risk without considering the tenant's ability to survive through the lease term. We are skeptical of long leases to tenants with negative cashflow, nearing debt maturities, or corporate debt trading at distressed levels. Instead of relying on stated lease maturities, we take a more nuanced view of longer-term tenants and carefully consider the impact of the loss of one or more tenants on the ability of a property to carry loan debt service.

The inclusion of retail assets has decreased in CMBS over the last few years, which is unsurprising given the prevalent investor concerns regarding the sector. The more critical credit eye of the investor community has been a positive filter for pool composition in recent CMBS conduit deals, although the overall retail allocation is far from zero. While the inclusion of retail is something of a necessary evil within the CMBS conduit sector, it is much less widespread within the Commercial Real Estate (CRE) CLO sector. We have favored CRE CLO securities in recent months, especially in our lower risk funds, due to their floating rates, shorter durations, and significant amounts of credit enhancement, which are all very desirable characteristics in this turbulent market. Another added benefit of the CRE CLO sector is the minimal exposure to retail, which makes up only 7% of 2018 CRE CLO issuance, in contrast to 23% in 2018 conduit transactions.

CMBS Conduit Exposure to Retail Properties as of Issuance



Source: Bank of America Research

Very few, if any, could have predicted the profound effects the Internet would have on all aspects of our lives during the past two decades. Similarly, we cannot readily predict the retail tenant landscape going forward, as change continuously seems to be happening at a more rapid pace. While we do not see retail going extinct (anytime soon, at least!), we recognize that the sector remains volatile and are managing portfolio composition accordingly.

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