UCLA ECONOMIC LETTER

REAL ESTATE AND THE MACROECONOMY

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Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, David Shulman, Senior Economist for the UCLA Ziman Center for Real Estate and UCLA Anderson Forecast, reports on the options of the real estate retail industry in response to continued e-commerce onslaught.

In the E-Commerce Revolution, Brick-and-Mortar Defenses are Limited and Costly

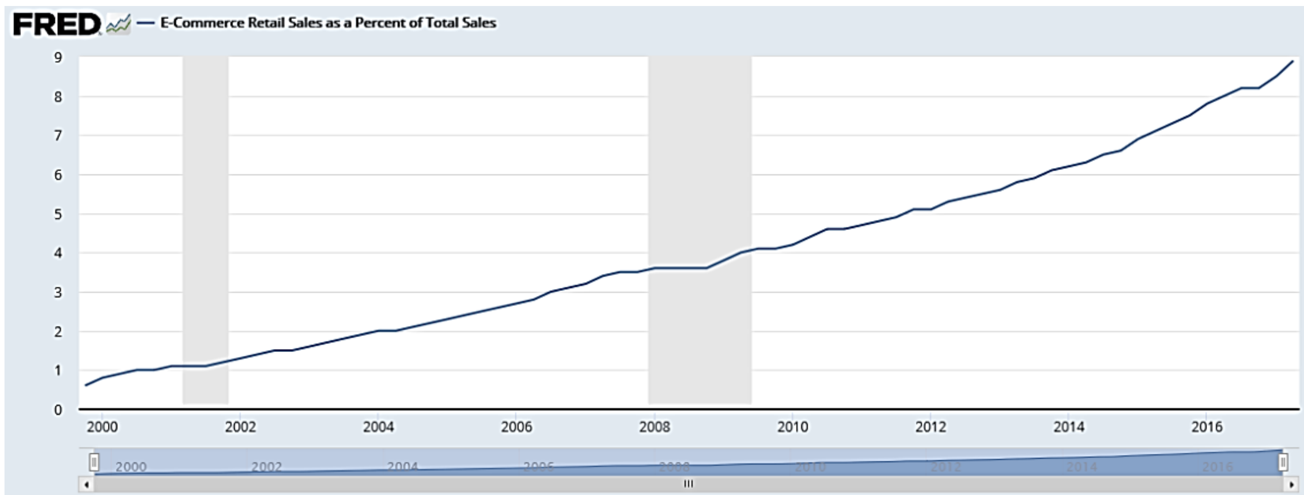
By David Shulman

The Amazon announcement of its acquisition of Whole Foods last June rang the bell on the grocery sector that was hitherto thought to be immune from e-commerce competition. Put bluntly, e-commerce has gone from being a sideshow to the main event.

Although it represents just 8.9% of all retail sales, e-commerce has increasingly taken share away from traditional retail (See Figure 1). Since December of 1999 through June of 2017, e-commerce accounted for 20% of the growth, and over the five years ending in June 2017, e-commerce accounted for 27% of the growth in all retail sales.

"One solution is buying online and picking up in store (BOPIS). But this requires significant reconfiguration of existing locations."

Figure 1. E-Commerce Retail Sales as a Percent of Total Sales, Q4:99 – Q2:2017



Source: U.S. Department of Commerce via FRED

But even these data understate e-commerce pummeling of retail sales. Total retail sales include automobiles and parts, gasoline and restaurants which are not amenable to e-commerce competition. Thus, rather than 8.9% of retail sales, e-commerce actually accounts for 15% of its addressable market (revenue opportunity available). In terms of market growth, e-commerce has captured 33% of retail sales in its addressable market since 1999 and 44% of the growth over the past five years.

And it will only get worse for physical real estate. According to recent research by Goldman Sachs, e-commerce shopping will take anywhere between 50% -110% of the growth in grocery sales by 2027.[1] As of 2016, the e-commerce share of grocery sales amounted to a meager 2.8%. But according to Goldman's low-end analysts, e-commerce will account for 10.4% of all grocery sales in 2027. And the high end estimate is for 20.4% of grocery sales by 2027.

There is one area where retail real estate may grow. A chunk of e-commerce sales will come buying online and picking up in store (BOPIS). This applies to retail in general as well. The need for a physical delivery point remains, but this will require a significant reconfiguration of the existing stock of supermarkets and their shopping centers locations.

The eight-billion-square-foot retail real estate industry is reeling with store closings estimated to exceed 8,000 this year, well above the 6,000 reported in the recession year of 2008.[2] That equates to 140 million square feet of closings, well above the 100 million recorded in 2008.[3] And with Sears and JC Penney tottering and Macy's under stress, huge blocks of space have yet to come back on to the market.

Even assets once held sacred by the investment community, street retail in gateway cities, are under pressure. In Manhattan's trendy SoHo, rents are off 21% since peaking in 2014, and vacancies abound.[4]

The stress continues to show up in employment (See Figure 2). Declines in this sector are typically restricted to recessions; not this time. As of August, the 16-million job sector reported a year-over-year decline of 31,000 jobs. However, because non-store retailers (i.e. Amazon) reported a gain of 29,000 jobs, it means store retailing lost 60,000 jobs over the past year. And remember, the macroeconomic environment has been benign; it will get much worse when it turns hostile. Nevertheless, because e-commerce jobs tend to pay more than retail jobs, the income effect will less than at first blush.

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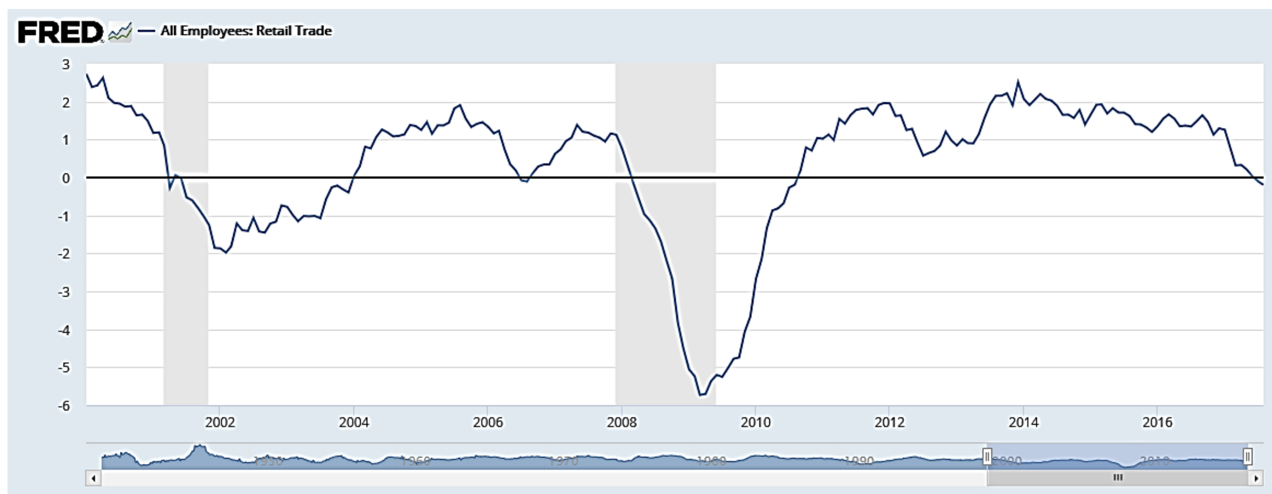
[1] See Tenal, Stephen et.al., "Supermarket Shift: Expect Measured Destruction," Goldman Sachs, August 9, 2019 and Terry Heath P. et.al., "Supermarket Shift: The Blue Sky Scenario," Goldman Sachs, August 9, 2017

[2] See "Will the Death of US Retail be the Next Big Short," *Financial Times*, July 16, 2017.

[3] Ibid.

[4] Bagli, Charles V., "In a Thriving City, SoHo's Soaring Rents Keep Storefronts Empty," *The New York Times*, August 23, 2017

Figure 2. Retail Employment, 2000 – Aug 17, Year-over-Year Change in Employment, In Hundred Thousands



Sources: U.S. Bureau of Labor Statistics via Fred

So what are real estate retailers supposed to do?

One tactic is "Omni-channel distribution," or beefing up their web presence, as Wal-Mart is going head-to-head with Amazon. And stores are experimenting with BOPIS. This requires enormous capital spending, but most retailers simply don't have a choice. It involves the reconfiguration of space to allow for pick-up and delivery as well as reconfiguration of the tenant mix.

The theme for most mall operators is "experiential" retail. That includes restaurants, fitness centers, theaters and medical services – areas where e-commerce does not compete. However, e-commerce does compete with theaters, as Amazon and Netflix are fundamentally changing how entertainment is delivered. Restaurants make sense, but they too require significant capital spending and it certainly can be overdone: 10-15% of gross leasable area might make sense for restaurants, but aiming for anything over 25% would be a cause for concern.

THE BOTTOM LINE: VALUATION

The days of automatically increasing rents for high quality shopping centers are over. The economics are simple: Sales growth is declining, gross margins are squeezed, and there is less margin for rent. And responses such as BOPIS require significantly higher capital spending. Mall capital spending as a percent of net operating income will likely increase from 10% to 20%. Once real estate investors recognize these facts, valuations will adjust, reflecting judgement of the stock market. In fact, investors have already accepted that judgement with respect to lower quality malls.

Shares of the major Class A mall operators are off 34% from their 2016 highs, causing them to trade at 28% below what Wall Street ascribes to be their net asset value. Class B mall operators have done worse, and strip center operators have done somewhat better. I have written elsewhere that the Wall Street consensus estimates for net asset value are way too high.[5] In very rough terms capitalization rates for high quality malls will increase from 4.5% to 5.5%+. The operators of shopping centers will likely experience similar valuation adjustments as online grocery shopping comes into its own.

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[5] See https:shulmaven.blogspot.com, "A New Look at Mall Valuations," May 4, 2017 and "A New Look at Mall Valuations- Part 2," May 29, 2017.