INVESTMENT BRIEF

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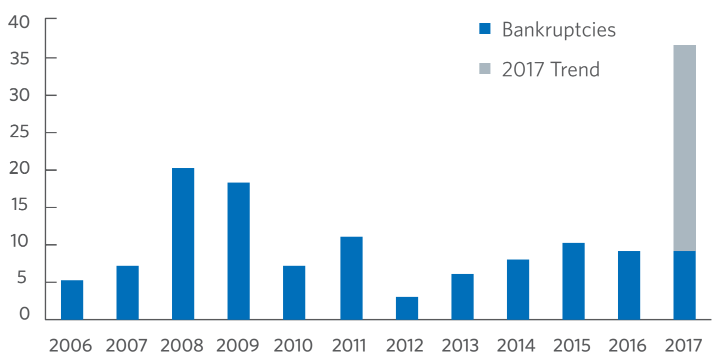
Strategic Investment Group®

Retail Rout

Techology and tastes change and, as they change, disrupt markets. The evolution of the retail sector is a notable recent example that has far-reaching economic and investment implications. Store closures are at high levels and bankruptcies in the retail sector so far in 2017 are on pace to exceed the levels of the great financial crisis. The retail rout is taking place in the context of an otherwise healthy real estate market, and a growing economy generating a steady increase in employment and consumer spending. The roots of the rout lie in excess capacity and changing consumer preferences encouraged and enabled by the Amazon effect.

EXHIBIT 1:
Retailer Bankruptcies by Year
Data as of March 31, 2017.
Sources: Strategic and Alix Partners.



Amazon Effect — From Books to Groceries?

The U.S. retail sector has developed inherent vulnerabilities that make it especially susceptible to disruption from online shopping. A boom of store completions in the run-up to the great financial crisis and the economic bust that followed boosted retail vacancy rates. Despite recent store closures, retail space per capita in the U.S. exceeds other countries by a wide margin.

The rapid growth of online shopping is accelerating the pace of store closures and retail bankruptcies. Despite its rapid growth, online shopping still represents a small share – little more than 8% – of total retail sales. Online shopping has taken a much larger toll in certain segments of the retail sector, however, and it is in these segments that the distress is most acute. Department, general merchandise, apparel, and furniture stores have been particularly hard hit, with e-commerce sales capturing as much as 30% of total sales.

As consumer preferences change and the range of products that consumers feel comfortable purchasing online expands, more retail segments will be at risk. Amazon's purchase of Whole Foods is especially noteworthy as a foray into a very large segment of the retail sector that has hitherto not been much affected by online shopping. A shift in how consumers purchase groceries would have ripple effects throughout the retail sector as grocery stores are more regularly frequented than other stores and are anchor tenants of many shopping centers.

Marketing Impact of the Retail Rout

The distress in the retail sector has reverberated across asset classes. In the U.S. equity market, declining profitability and rising bankruptcies have led to unprecedented levels of underperformance of retail stocks relative to the consumer discretionary sector. The market cap of traditional retailers has plummeted, while the market cap of Amazon has skyrocketed.

In the credit markets, bonds issued by retailers are trading at much higher yields than the broader market. In the high yield market, this spread hovers near recent highs, with distress most acute among bonds issued by department, electronics, and clothing stores. Distress begets distress as the tactic of slashing prices by firms on the verge of bankruptcy undermines the competitiveness of healthier stores who respond in kind, triggering a race to the bottom. Jitters over the risk of default by retailers have indiscriminately infected the entire commercial mortgage-backed securities (CMBS) market, opening up selective opportunities.

In the real estate sector, while high quality malls in wealthy and growing areas are faring well, many others are being mauled. The loss of an anchor tenant can infect the entire mall as other stores break their leases in the face of reduced traffic. Given high levels of excess capacity and continued pressure from e-commerce, the prospect for Class B and C malls outside of prime locations is bleak. The big box stores of old also face a challenge from changing preferences as consumers are bifurcating between upmarket street retail and deep discounters offering cut rate prices.

Hedge funds are taking advantage of the distress. As a group, hedge funds have been net short retailers since late 2015. Three retail segments – home furnishings, department stores, and computers and electronics – are the largest net short industry bets. Some hedge funds have played the retail versus e-commerce theme by taking long positions in courier services, warehouses, and bar code scanning firms against short positions in malls and CMBS linked to the retail sector.

We see e-commerce as a modern phenomenon, but home delivery was a staple of 1950s America. From this perspective, the battle between "bricks and clicks" for preeminence in consumer spending is a step back in time. The technology may be changing, but the taste for convenience and value appears constant.

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