Research

USAA Real Estate Company

E-COMMERCE:
Implications for Retail Real Estate

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E-Commerce: Implications for Retail Real Estate

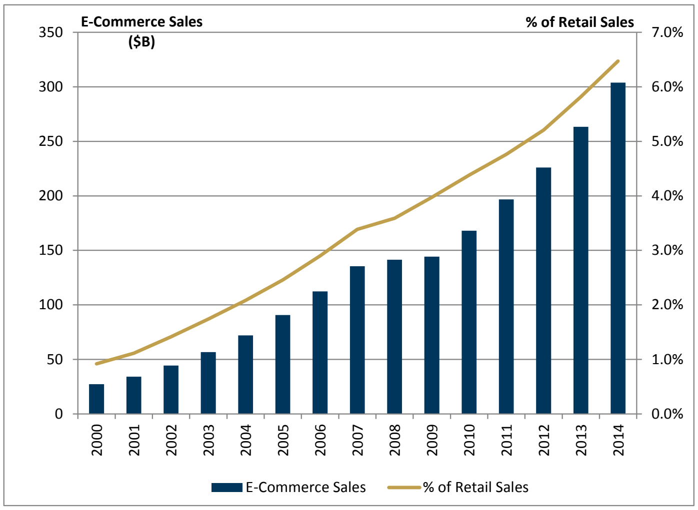
Radio Shack, Abercrombie & Fitch, Aeropostale, and Sears collectively plan to close nearly 2,000 stores over the next few years. [1] On the heels of the Great Recession, it comes as no surprise that malls with vacancy rates over 40% – known as *dead malls* – have increased threefold since 2006.[2] Despite ominous news headlines, we believe that e-commerce and traditional retailers will eventually find an equilibrium that supports storefronts and online platforms. This paper will highlight the relationship between retail property and online sales growth, explore e-commerce driven real estate trends, and review our outlook going forward – specifically for the retail sector.

Then & Now

During the 1990s, the Internet became the foundation for modern e-commerce. eBay, for example, was a pioneer in the field, from its first item listed in 1995, a $14.83 laser pointer, to its largest transaction to date – a $4.9 million private jet sold in 2001. Conversely, Pets.com was equally notable for failing. The company was exalted as the first online dog food/accessory vendor but eventually lost $147 million in nine months, resulting in 300 layoffs. Overall, the 1990s were a volatile period for e-commerce as more businesses failed than succeeded. By the end of the decade, online sales accounted for barely half of one percent of U.S. retail sales. Yet a few startup companies found success in internet-based retail.

Over the next 20 years, e-commerce became the country's fastest growing retail channel, maintaining positive annual growth even during the Great Recession in 2008 and 2009. Internet sales increased significantly by 15.4% in 2014, but accounted for just 6.7% of total retail sales as shown in *Exhibit 1*. Forrester, a global research company based in California, forecasts that online purchases could reach 11% of total retail sales by 2018. This trend is likely to continue in the near future, particularly as millennials approach their prime spending years and more people adopt online shopping.

Exhibit 1: E-commerce Sales as a Percentage of Total Retail Sales in the U.S. (2000-2014) as of Q4 2014



Source: USAA RealCo; U.S. Department of Commerce

Online Versus Off-line

Evidence suggests that consumers prefer to purchase certain products online while other products are more e-commerce resistant. Using U.S. Census Bureau data, we analyzed historical retail sales figures for each product segment. As part of the analysis, we created three categories (high, medium, and low) to delineate between products that shoppers are most or least likely to purchase online. The respective categories and product descriptions follow:

I. ***High:*** Products in this category experienced what we would classify as a high level of interest from e-commerce customers, with online purchases accounting for more than 25% of sales. The category consists of music/videos, books, computer hardware/software, toys/hobbies/games, and office supplies. Over 40% of music/videos and books, for example, were sold online as of 2012, a 300% increase from 2006. Toys/hobbies and games have historically been popular online items as well, with total sales of 29% in 2006 – the highest percentage of any product type at the time. Yet, market penetration for toys/hobbies and games remains surprisingly steady, only increasing 3.4% in six years to 32.4%, potentially signaling a sales plateau in this product type. Lastly, office supplies experienced 25.4% online sales in 2012, a 47% expansion from 2006 to 2012. Property

[1] McIntyre, Hess, "Nine retailers Closing the Most Stores." March 12, 2014, USA Today, www.usatoday.com.

[2] Kapner, Whelan, "Struggling Malls Suffer When Sears, Penny Leave." May 12, 2014, The Wall Street Journal, www.wsj.com.

owners with tenants in these industries should be concerned about in-store sales erosion due to online shopping. As e-commerce continues to expand, tenants within these industries must accommodate for online sales or risk going out of business.

II. ***Medium:*** Products in this category have experienced what we would classify as a medium level of interest from e-commerce customers, as online sales account for 10% to 25% of total sales for each product. The category consists of non-computer electronics and appliances, clothing accessories and footwear, home furniture, and sporting goods. E-commerce penetration at least doubled for all products in this category from 2006 to 2012, with the exception of sporting goods, which increased 81%. Non-computer electronics and appliances represent the most compelling online growth; sales grew 119% in six years. In contrast, sporting goods and clothing/accessories/footwear only grew 14% over the same period. Property owners should monitor tenants in these industries, especially retailers that rely heavily on electronics/appliances, as they seem most susceptible to sale erosion due to online shopping. Generally, consumers tend to balance e-commerce and traditional retail purchases for products within this category.

III. ***Low:*** Products in this category have experienced what we would classify as a low level of interest from e-commerce customers, as shoppers prefer traditional retail channels for these items. E-commerce accounts for less than 10% of each product type in this category. The products include health/personal care, food/beverage, and gas station purchases. E-commerce sales in health/personal care products more than doubled from 2006 to 2012, yet only accounted for 4.1% market penetration. Food/beverage products (including grocery and associated services) are even more resistant, as e-commerce sales were essentially flat (just 0.03%) for the last six years. Lastly, gas station purchases have almost zero e-commerce penetration, which will likely be the case for the near future. Property owners should have minimal concern for tenants in this category because these companies currently are resistant to sales erosion due to online shopping. Consumers either prefer to purchase these products via traditional outlets, and/or technology has not made it practical for consumers to purchase these items online.

Current Trends in the Retail Sector

Not surprisingly, traditional retail real estate has suffered from e-commerce sales growth. Property owners and vulnerable tenants share significant risk from sales erosion. Radio Shack, for example, filed for bankruptcy and has plans to close roughly 1,100 stores in 2015.[3] Similarly, Circuit City vacated several million square feet en route to bankruptcy in 2009.[4] Office Depot and Office Max recently announced a merger that could result in as many as 600 store closings.[5] Staples will not only close stores, but will reduce the size of several remaining locations, in some cases by more than 50%.[6] The retail market will absorb more than 18 million square feet of space just from these office supply companies over the next three years.[7] For the most part, retail market fundamentals have been lethargic. While net absorption in other property sectors has been robust, occupancy rates for retail real estate only increased by 90 basis points (as of the first quarter of 2015) since hitting their trough in the third quarter of 2011. Vacancy declines have been modest despite retail construction being significantly below pre-recession levels, as investors have been hesitant to build speculative properties due to stagnant demand. While the prognosis for the overall retail sector appears uncertain, a few subsectors have an optimistic outlook.

High-quality retail space, for instance, positioned in the right demographic area has proven to be resilient despite growing e-commerce demand. For instance, grocery and drug-anchored retail has performed well primarily because it is far less sensitive to e-commerce than non-grocery-anchored centers. These properties have maintained solid fundamentals with significant investor interest. Acquisition prices for grocery-anchored retail stores increased 30% from 2010 to 2013. Property owners have targeted e-commerce resistant retailers with a focus on specialized services and niche retail.

As a result, we have seen more power centers and neighborhood retail complexes shift to food-based tenants in recent years. According to Cassidy Turley, grocery stores and restaurants now account for almost 60% of all the planned retail growth in the U.S. Stores like Trader Joe's and Whole Foods have become sought-after anchor tenants due to a loyal customer base and repeatable foot traffic. Average sales per square foot for Trader Joe's and Whole Foods are $1,723 and $973 respectively, dwarfing the industry average of $521.[8] Fast casual restaurants such as Chipotle saw an increase in foot traffic that resulted in a record $2.1 million per store sales average in 2013, despite raising menu prices for the first time in five years. Many retail vendors have

[3] Chen, "Next RadioShack? Here are the Most Troubled Retail Stores." February 10, 2015, Forbes, www.forbes.com.
[4] NY Daily News, "Circuit City closes its doors for good." March 8, 2009, Daily News, www.nydailynews.com.
[5] Townsend, "Staples May Be Winner in Office Depot-Office Max Merger." February 20, 2015, Bloomberg Business, www.bloomberg.com.
[6] Nelson, E-Commerce and Retail Property Markets: (When) Should We Panic, October 17, 2012, RREEF Real Estate.
[7] Brown, Thorpe, National Retail Review Summer 2014, Cassidy Turley, ww.terranomics.com.
[8] Data provided by Packaged Facts.

succeeded in large part by providing high-quality products and just as importantly, an exceptional customer experience.

In fact, a recent study from McCann World Group found that 66% of consumers surveyed wanted to be inspired while they shop. As a result, new and existing retailers have begun to create elaborate storefronts in an effort to improve their customers' experience. Retailers strive to entice consumers with extensive construction and design elements, including hardwood flooring, indirect lighting, modern architecture, and integrated technology. For property owners, these expenses influence effective rent rates during lease negotiations. Tenants have become more aggressive in pursuit of these concessions because they are under pressure to maintain market share while improving customer experience.

Among other solutions, many retailers have embraced an omni-channel retail strategy to improve their customers' experience. As shown in *Exhibit 2*, omni-channel shopping includes the use of multiple conduits to reach consumers, such as mobile internet devices, computers, brick-and-mortar, television, radio, direct mail, and catalogs. Successful retailers typically have a traditional retail location, a strong online presence, and several other channels available to engage consumers. Several retailers have even used traditional locations as distribution centers, allowing customers to pick-up items purchased online.

Exhibit 2: Retail Progression to Omni-channel Shopping

Source: Aaxis Commerce

The most notable retail shift toward customer experience strategies has come from mall operators. Some forward-thinking malls have transitioned to lifestyle centers that encourage consumers to do more than just shop. According to a recent issue of *REIT Magazine*, several lifestyle activities are already in place in various malls. Among the services offered are:

- Free and/or discounted electric car charging stations, which allow electric car owners to shop while their vehicle recharges;
- Regularly scheduled yoga, exercise, and spinning classes to encourage recurring foot traffic;
- Regional restaurants that offer local flair versus chain restaurants that offer a uniform experience;
- Frequently updated inventory encouraging consumers to return often and see new merchandise, while also directing them to their online presence for immediate products;
- Treadmills in sporting stores to allow customers to test specific athletic footwear and other products;
- Local events that engage area customers, such as a temporary snow park for dogs during the summer;
- Mall-wide personal shoppers that provide fashion advice across all stores in the complex.

Clearly, the retail business model is evolving as consumers shift to online shopping. Many successful retailers have embraced an omni-channel approach that allows customers to choose when, where, and how they want to shop. Additionally, stores are emphasizing customer experience, while some malls are trying to rebrand themselves as lifestyle centers. These trends are a result of retailers' efforts to identify growth opportunities within a dynamic real estate environment.

Retail Outlook

While e-commerce growth is outpacing that of bricks and mortar, it is important to note that aggregate sales for both platforms are increasing. Deloitte, a global consulting firm, predicts online purchases will account for roughly 30% of all U.S. retail sales by 2030, leaving the other 70% to traditional retailers. In the near term, however, the division between the winning and losing retail centers may widen. Nearly a tenth of shopping centers are already obsolete, and e-commerce growth will only result in more bankrupt retailers over the next decade. This abundance of vacated space will also create opportunities for other tenants. Most downsizing box-stores are abandoning 30,000 to 40,000 square feet spaces. Traditional big-box retailers like Target and Walmart are testing smaller concept stores in select markets. Successful non-grocery tenants, such as At Home (previously Garden Ridge) and Burlington Coat Factory, are likely to consider these vacated spaces as both stores plan to expand over the next couple of years. Other e-commerce resistant users will eventually occupy the space vacated by defunct retailers, but the initial drag on the market will be substantial, particularly as the space requirements for emerging retailers tends to be smaller.

We expect an increased level of uncertainty and volatility within the retail market in the near term. Niche retailers with fresh concepts should perform well due to an improving economy as more consumers embrace the "wealth effect." In contrast, poor-performing retailers will scramble to reduce overhead expenses and may abandon low-quality real estate centers to focus their efforts on stores in stronger trade centers. Some companies will thrive with reduced square footage and fewer stores, and successful retailers will seek the best locations alongside other e-commerce resistant businesses. Grocery-anchored centers, high-quality malls, and shopping centers near population hubs (with robust economic demographics) should perform well. Meanwhile, many big-box retailers in low-quality spaces will suffer a gradual decline. Retail property owners will look to mitigate risk by aggressively pursuing high-quality tenants. Owners of low-quality retail centers will likely attempt to upgrade their property to compete with Class A projects; otherwise, they will experience a sharp decline in occupancy.

Lastly, retail lease renewals may experience volatility as market fundamentals and the effects of e-commerce converge. From 2008 to 2010, the recession created historically low rental rates, and many retailers secured below-market leases (five to ten years) that began to expire in 2013, and will continue over the next several years. In the meantime, as the economy has improved, retail rental rates have trended higher. Conversely, many retailers are under pressure to reduce space due to online sales erosion. Inevitably, friction will occur as property owners look to increase rents upon lease expiration, and tenants try to reduce their footprint. Tenants in Class A space with fresh concepts and a strong online presence will likely maintain the majority of their footprint, but low-quality properties could experience a decline in occupancy rates. Overall, the retail property outlook is bifurcated, as retailers face tremendous opportunities and obstacles due to surging e-commerce sales.

Conclusion

Forrester's projects e-commerce to account for 11% of total U.S. sales by 2018; therefore, online retail will likely continue to disrupt various market segments. Some analysts forecast e-commerce growth will mirror a bell-shaped curve, where it expands, plateaus, and ultimately declines. Even if that prediction is correct, one can only guess how long that process will take. Most research suggests that e-commerce is in a multi-year expansion phase that will have ongoing repercussions for the real estate industry. This article focused on retail real estate since it is the most adversely affected sector, but the ramifications of e-commerce permeate other property types as well. With every retail company that goes out of business or downsizes because of online sales, the office sector is potentially vulnerable to a loss of administrative jobs. When jobs are lost, the housing market (residential and multifamily) tends to suffer as well. Conversely, the industrial sector has been the strongest beneficiary of e-commerce growth, due to rising demand for modern warehouse space.

In the end, the e-commerce outlook is fluid, thus investors must be agile. Retail real estate is clearly sensitive to online sale growth; however, the negative impact of e-commerce should lessen as omni-channel retailing expands. Eventually, rising online sales will displace obsolete retailers and give way to new ideas and fresh concepts. While some investors will elect to bypass the retail market due to uncertainty, innovative investors with a knack for identifying the right property, in the right location, and with the right tenant will find success in the evolving retail real estate sector.

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