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RHETORIC VS REALITY (PART TWO)

Quantifying the Long-Term Outlook for U.S. Mall Sales

Matthew Strotton and Matthew Peter

Bricks and mortar vs e-commerce

E-commerce in context

Key takeaways

- The online challenge is not uniform across all retail segments. E-commerce penetration has been especially notable in highly commoditised, non- perishable and digital goods segments
- Sales from brick and mortar establishments (including foods services, but excluding autos and gas) have expanded by an average 3.2 per cent per annum since 2010
- We expect brick and mortar sales growth to average 3.4 per cent per annum over the next decade, only 70 basis points below overall retail and food services sales (ex-autos and gas)
- Omni-channel sales are increasingly important for brick and mortar retailers; around 40 per cent of e-commerce sales are generated by brick and mortar retailerss)

The macroeconomic environment is clearly supportive for the U.S. consumer and retail sector. The question is, how will these sales be shared between brick and mortar retailers, and e-commerce?

E-commerce has experienced rapid growth since the 2008/09 recession. Total e-commerce sales, as reported by the U.S. Census Bureau, have grown at an annual rate of 15 per cent on average over the past eight years.

This has seen the e-commerce share of total retail sales more than double from 4 per cent in 2009 to 8.9 per cent in 2017. However, e-commerce has not wiped-out sales from brick and mortar establishments.

Retail sales at brick and mortar establishments (including foods services, but excluding autos and gas) have still managed to expand by an average 3.2 per cent per annum since 2010. The disruption and headwinds from online retailing has led brick and mortar sales growth to underperform growth in overall retail sales by just 75 basis points per annum over this period (Figure 11).

Online threat is not uniform across retailers

Not all retailers are equally threatened by e-commerce. At one end of the spectrum, gas stations are highly immune to competition from e-commerce, losing only a small share to online sales of auto accessories and magazines.

At the other end of the spectrum, highly commoditised, non-perishable and digital goods have seen e-commerce take significant market share with around 50 per cent of music and video sales now

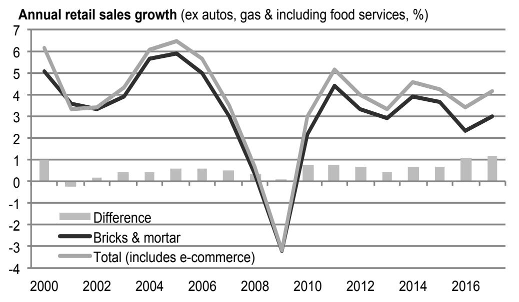
The quote

By embracing an omni-channel strategy, retailers online and offline strategies are increasingly being used to complement each other.

online. Of course, most retailers lie somewhere in between these two extremes (Figure 12).

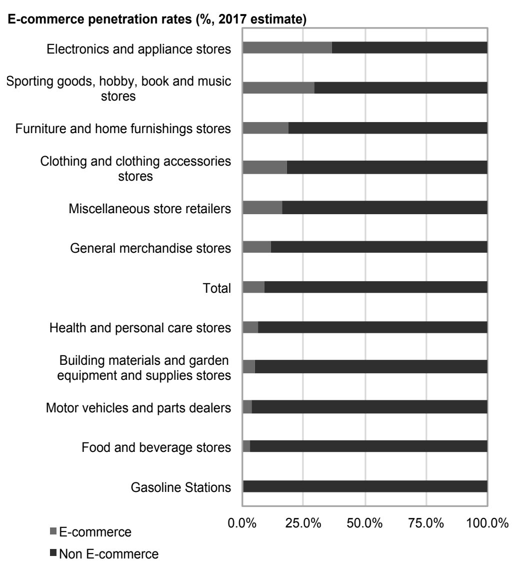
Our analysis suggests that electronics and appliance stores have been the most significantly disrupted, with an e-commerce penetration rate of around 36 per cent in 2017. This is followed by sporting goods, hobby, book and music stores, where the e-commerce penetration rate has risen to 30 per cent, while furniture and home furnishing stores and clothing and clothing accessory stores both have e-commerce penetration rates of 19 and 18 per cent, respectively.

Figure 11. Brick and mortar sales continue to grow



Source: U.S. Census Bureau, QIC
Note: Data is seasonally adjusted

Figure 12. Disruption from e-commerce is not uniform



Source: U.S. Census Bureau, QIC
Note: Data are QIC estimates based on U.S. Census Bureau data

Not all online sales are the same

Focusing on aggregate e-commerce sales data overstates the disruption facing traditional retailers. U.S. Census Bureau data highlights that in 2016, around 42 per cent of e-commerce sales stemmed from online divisions of traditional brick and mortar retailers.

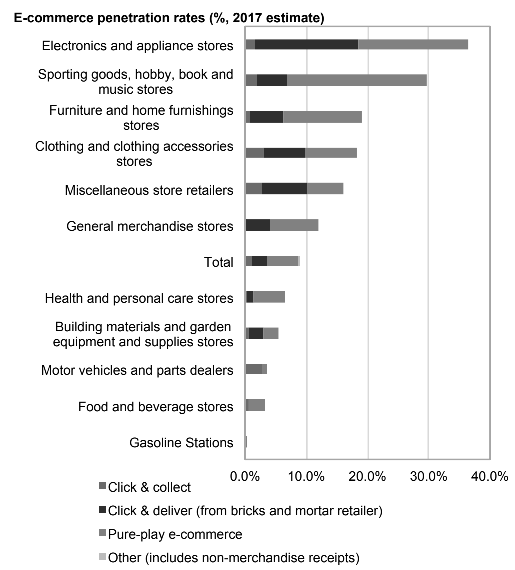
Although this proportion is likely to have fallen slightly over the past year, we estimate that around two-fifths of total e-commerce sales in 2017 were from traditional brick and mortar retailers. In addition, online sales by traditional brick and mortar retailers outstrip e-commerce sales from pure-play e-tailers, such as Amazon, across many categories (Figure 13).

This is particularly the case for clothing stores. While we estimate that 18 per cent of clothing and accessory store sales were conducted online in 2017, more than half of the sales are via existing retailers' online platforms with only 8.6 per cent stemming from pure-play e-commerce retailers.

Electronics and appliance brick and mortar retailers also capture more than half of total e-commerce sales. This is led by Best Buy, where online sales now account for 20 per cent of the firm's domestic revenue.

By embracing an omni-channel strategy, retailers online and offline strategies are increasingly being used to complement each other. Heavy investment in integrated inventory management systems are providing increased choice to customers, allowing them to choose whether they will have their products shipped to their door, or picked-up from their nearest store without additional delivery cost or even at a discount.

Figure 13. Omni-channel sales are substantial



Source: U.S. Census Bureau, QIC
Note: Data are QIC estimates based on U.S. Census Bureau data

Brick and mortar retailers also have an advantage around e-commerce returns. Not only do in-store returns save shipping costs, customers can also replace the products immediately once in store.

While Amazon customers can now return products to a Kohl's store, the e-commerce giant will likely lose out on sales as customers seek an in-store replacement during their return visit (either at Kohl's or another store). Retailers are also beginning to view physical space as a way to build brand awareness, enhance customer engagement and even as showrooms for their products. This is underscored by moves by a number of pure-play e-commerce players into adopting a physical presence, including Amazon bookstores, its Whole Foods acquisition, Bonobos, UNTUCKit, Athleta, Madison Reed and many more.

E-commerce outlook

There is no doubt that e-commerce will continue to gain market share over the coming decade. Generic, commoditised, low-cost and non-perishable products will increasingly be purchased online.

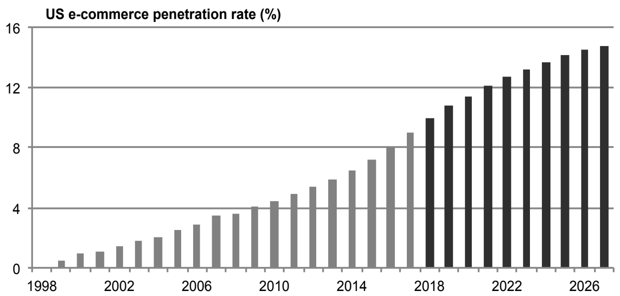
Existing brick and mortar retailers will also continue to embrace omni-channel strategies, providing further impetus for e-commerce sales. Our assessment is that total e-commerce sales are likely to rise from 8.9 per cent of retail sales in 2017 to around 15 per cent by 2027 (Figure 14).

Ongoing strong e-commerce growth is expected in electronics and appliance products, where online sales are expected to reach almost 50 per cent of sales (Figure 15 on next page). Likewise, online sales will continue to gain market share across sporting goods, hobby, musical instrument and book stores.

Food and beverage stores are likely to see an increased take-up of online sales in coming few years. Walmart has announced plans to expand its online delivery service to 100 metropolitan areas by the end of 2018, while also expanding its curbside grocery collection service from 1,200 to 2,200 locations this year. Amazon will also continue to ramp-up its grocery delivery business across the U.S. in 2018 following its acquisition of Whole Foods last year.

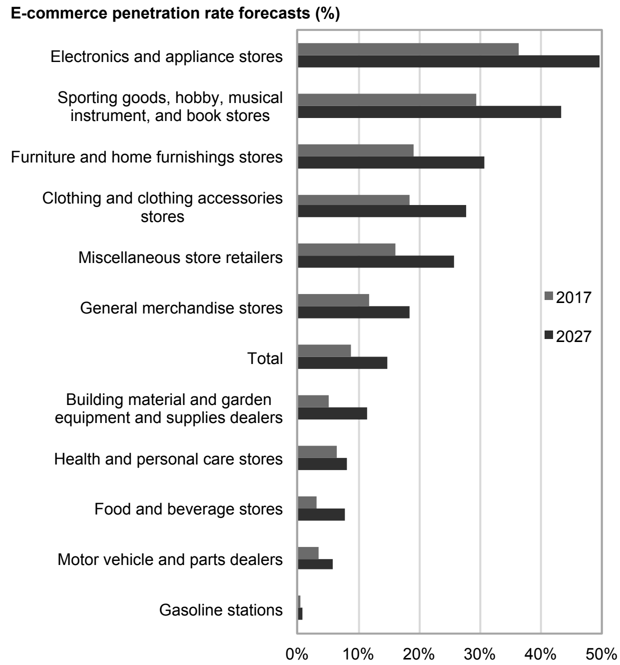
However, even incorporating further growth in e-commerce penetration, brick and mortar retail sales will continue to expand at a solid rate. Over the next decade, brick and mortar retail sales (including food services and excluding autos and gas) are forecast to expand by an average 3.4 per cent per annum (Figure 16 on next page). This is only about 70 basis points below the 4.1 per cent growth expected for overall retail sales during this period.

Figure 14. E-commerce projections



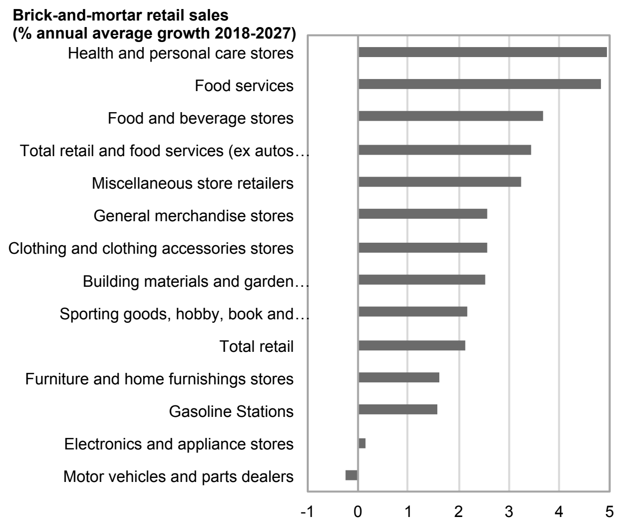
Source: U.S. Census Bureau, QIC
Note: Black columns denote QIC forecast

Figure 15. E-commerce projections by category



Source: U.S. Census Bureau, QIC
Note: Data are QIC estimates

Figure 16. Brick and mortar retail sales forecasts



Source: QIC
Note: Data are QIC estimates. All food service retail sales are allocated to brick and mortar establishments. While e-commerce is increasingly used to order fast-food (e.g. Postmates, Uber Eats etc.), the sales continue to flow through each store

Malls vs other brick and mortar

Key takeaways

- While shopping malls have a greater exposure to e-commerce than overall brick and mortar retail, simple proxies for mall e-commerce penetration rates are likely to be overstated
- Nonetheless, a further loss of market share to e-commerce and consolidation amongst department stores is expected to see mall sales underperform aggregate brick and mortar retail sales by about 1.7 percentage points per annum over the next decade
- Despite these headwinds, aggregate mall sales are forecast to expand by 1.7 per cent per annum over 2018-2027
- These projections assume an unchanged mall tenant mix. Active landlords can mitigate the headwinds confronting the sector by shifting towards more internet-resistant and faster-growing tenants.

Despite the ongoing shift towards e-commerce, sales at brick and mortar retailers will continue at a reasonable pace over the coming decade. While this may apply to the overall retail sector, can the same conclusion be reached for shopping malls that are more exposed to embattled department stores and apparel retailers?

Mall exposure to e-commerce

Clearly, super-regional and regional malls have a greater exposure to e-commerce than the overall retail sector. Hardly any gasoline or motor vehicles are sold out of malls and sales of groceries and building materials/hardware are also very limited; these are all stores which have a much lower exposure to e-commerce than the total retail market (Figure 15).

One simple approach often used as a proxy for mall sales is to exclude all food, gas, autos and building material and supply store sales from aggregate retail sales.

Put another way: Aggregate retail sales – food, gas, autos and building material, and supply store sales = mall sales

Based on this approach, an e-commerce penetration rate for malls is close to 20 per cent.

However, in our view, this estimate is inflated for two main reasons. First, it assumes that no pure-play e-commerce sales relate to goods sold out of food and beverage, gas, auto or building material and supply stores. Using our methodology for allocating pure-play e-commerce sales across store classifications, the mall-proxy e-commerce penetration rate drops to 17.6 per cent in 2017.

The second reason why this share could be too high is that it ignores the fact that malls are becoming increasingly exposed to services, which are much more internet-resistant. In other words, by excluding all food services, personal care services and entertainment, this mall-proxy e-commerce penetration rate is biased upwards.

Outlook for shopping mall sales

To ascertain a more accurate e-commerce penetration rate for malls, we applied our estimates by store type outlined in Figure 15, on the previous page, to mall inline sales data reported by the ICSC. For anchor store sales, we relied on sales shares from QIC's portfolio of 12 malls across the U.S., adjusted for differences in GLA between anchors in our portfolio and the average U.S. mall.

Under this approach, we estimate that the e-commerce penetration rate of shopping malls was 17.7 per cent in 2017. Coincidently, this is in-line with our simple proxy estimate.

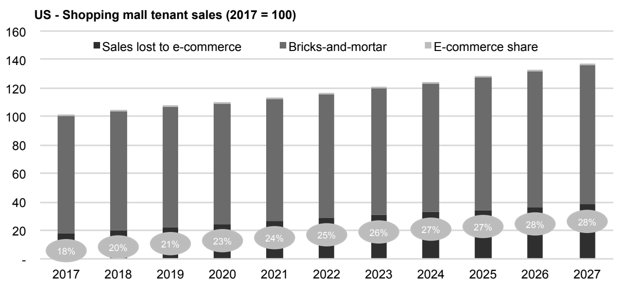
The reason the estimate is not lower is that for the average U.S. mall, the benefit from modest exposure to services is offset by a relatively higher exposure to department stores and apparel retailers than the entire U.S. retail market. However, the benefit of our bottom-up approach is that it allows us to assess e-commerce exposure for different malls based on their underlying tenant mix.

Looking ahead, our estimated mall e-commerce penetration rate is forecast to reach 28 per cent by 2027 (Figure 17). While this forecast is based on the assumption of an unchanged tenant mix, which may prove unrealistic given landlords will adapt to the changing retail environment, it can provide a useful benchmark of what would happen under a status quo scenario.

Even under this extreme scenario, growth in brick and mortar sales out of U.S. shopping malls is still forecast to grow by an average 1.7 per cent per annum over the next decade (Figure 18). In other words, further loss in market share to e-commerce and consolidation in department stores is expected to see U.S. mall sales underperform total brick and mortar retail sales by 1.7 percentage points per annum over the next decade.

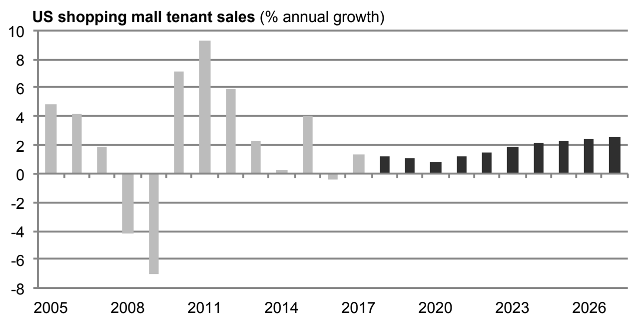
The previous section focused on aggregate sales from U.S. shopping

Figure 17. E-commerce projections for U.S. malls



Source: QIC, ICSC, U.S. Census Bureau, CoStar
Note: Mall sales are estimated by QIC

Figure 18. Brick and mortar sales growth for U.S. malls



Source: Green Street Advisors, QIC
Note: Black columns are QIC forecasts

malls. However, lower quality malls face especially significant challenges from e-commerce owing to their commoditised product offerings and high exposure to department stores and apparel retailers.

By contrast, higher quality malls with more exposure to services are much more internet resistant. How are sales expected to be distributed across these different quality malls?

Bifurcation in mall performance

Key takeaways

- Lower-quality malls are most at risk from e-commerce due to their commoditised product offerings and high exposure to department stores and apparel retailers
- Sales at C-grade malls are expected to decline by more than 25 per cent over the next decade as anchors continue to close stores at underperforming locations
- Higher-quality malls can reposition their tenant mix towards more internet-resistant offerings, particularly food and beverage stores, restaurants, medical services, fitness centres and other experiential services
- Sales at A-grade malls are expected to outperform, with growth expected to be 75 basis points above the mall average. Over 2018-27, we project A-grade mall sales growth to average 2.4 per cent per annum

Lower quality malls are under pressure

The U.S. market is widely considered to have too much retail space given the size of its population. Reflecting this oversupply and shifting consumer trends, hundreds of lower quality malls will need to be repurposed or closed over the coming decade. In our view, the closures will be concentrated in weak performing C/D grade malls.

These underperforming malls will struggle to maintain relevance for consumers, particularly facing a loss of anchors as major department stores seek to reduce their store count. With high exposures to generic apparel and department store offerings, these malls are most susceptible to e-commerce.

Underperforming trade areas and inadequate capital investment have also contributed to a tired center that has not kept up with modern consumer demands. Over the next decade, we expect most D-grade malls will need to be re-purposed for more economically efficient uses, as well as many of the 300-plus C-grade centers. Reflecting closures and ongoing weak underlying performance, we expect sales out of C-grade malls to decline by more than 25 per cent over the next decade.

Opportunities for high quality malls

The closures of underperforming malls provide an opportunity for higher quality malls to gain market share. While some of the sales from the closed malls will be lost to e-commerce, a large portion will be gained by nearby A and B grade malls.

Although C and D grade malls represent less than 5 per cent of total asset value, they still account for slightly more than 10 per cent of mall sales (Figure 19). This means that high quality, A-grade malls can capture a substantial uplift from a likely consolidation in the market.

Higher-quality malls should also experience less leakage to e-commerce due to their more internet-resistant tenant mix. Reflecting this, we expect sales growth from A-grade malls to average 2.4 per cent over the next decade, around 75 basis points above the predicted growth for aggregate mall sales. Sales from B-grade malls are forecast to rise by 1.7 per cent on average, in-line with the mall average (Figure 20).

Inline sales

Key takeaways

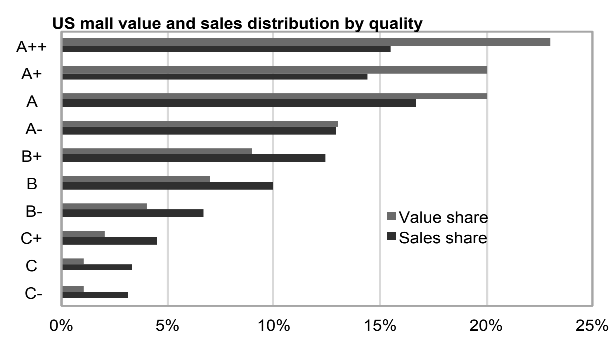
- Inline tenants have fared much better than department stores by evolving their product offering
- We forecast inline sales growth will outperform total mall sales by around 1.2 percentage points per annum

Focusing on overall tenant sales can also overstate the headwinds facing mall owners. Much of the weakness is concentrated in anchor department stores, where sales have been under pressure for the past decade due to the failure of department stores to evolve to meet shifting consumer demands.

Inline tenants have fared much better, benefitting from a more nimble evolution in their product offering. In fact, in many instances inline tenants are attracting market share away from department stores, particularly in fast fashion (e.g. H&M).

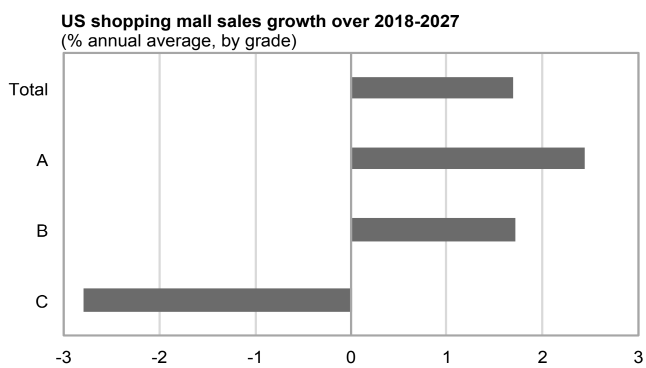
With the performance of inline tenants a much more significant

Figure 19: Breakdown of U.S. mall value and sales



Source: Green Street Advisors, QIC

Figure 20. Sales forecasts by mall grade



Source: QIC

driver of mall operating income, focusing on total mall sales can be misleading as an indicator of mall health.

Over the next decade, we expect growth in inline tenant sales to average 2.9 per cent, around 1.2 percentage points above the mall average which remains constrained by department stores further reducing their store footprint (Figure 21).

For A and B malls, we forecast average annual growth of inline sales of 3.4 per cent compared to 2.2 per cent for total sales.

Tying it all up

Despite the state of transition currently facing the retail sector, the outlook for sales over the next decade is positive. This is supported by the robust macroeconomic environment, which is underpinning a strong outlook for nominal personal consumption.

While retail sales will underperform growth in overall consumer spending, this will largely be confined to the auto sector, with retail sales including food services but excluding autos and gas forecast to rise at a solid rate.

Headwinds from the ongoing growth in e-commerce will continue to weigh on sales growth and mall performance will also be impacted by further consolidation of department stores. Nonetheless, lower-quality malls will bear the brunt of the adjustment, with higher-quality malls more resistant to e-commerce and less affected by the closure of anchor tenants.

Figure 22 charts the key findings of our research. We begin with the outlook for overall consumer spending in the U.S., which we and the survey of expert economists reported in Consensus Economics expects to grow at robust annual average rate of 4.3 per cent over the next 10 years; around one percentage point higher than the average annual growth of the previous decade. After excluding auto and gas sales, and adding in food services, retail sales are forecast to grow at a robust annual average rate 4.1 per cent.

However, brick and mortar establishments can be expected to leak some growth to e-commerce as the retail sector continues to lose market share to online sales over the coming decade. Nonetheless, given the strong macro backdrop, brick and mortar sales will still grow at an average annual rate of 3.4 per cent.

Shopping malls will underperform the average of brick and mortar due to malls' greater exposure to e-commerce and department stores. Our forecasts for shopping mall sales growth is for 1.7 per cent, on an average annual basis.

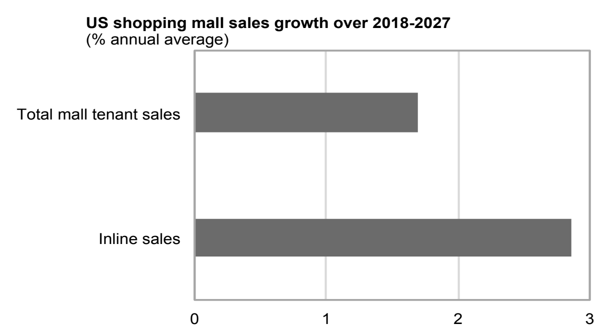
It should be remembered, however, that we have taken a very conservative approach to our forecasts of mall sales growth. In particular, we have assumed no change in tenant mix nor have we attached any omni-channel brick and mortar sales to mall sales.

Within the mall sector, lower-quality malls will bear the brunt of the adjustment, with higher-quality malls more resistant to e-commerce and less affected by the closure of anchor tenants, reflected in their current tenant mix vis-à-vis low-quality malls. We are forecasting the average annual growth rate of A and B grade malls to outperform the average mall growth, rising by an average annual 2.2 per cent rate over the next 10 years.

However, focusing on total mall sales can be misleading as an indicator of mall health as the performance of inline tenants is a more significant driver of mall operating income. Over the next decade, we expect growth in inline tenant sales at A and B grade malls to average 3.4 per cent, around 1.2 percentage points above the mall average which remains constrained by department stores further reducing their store footprint.

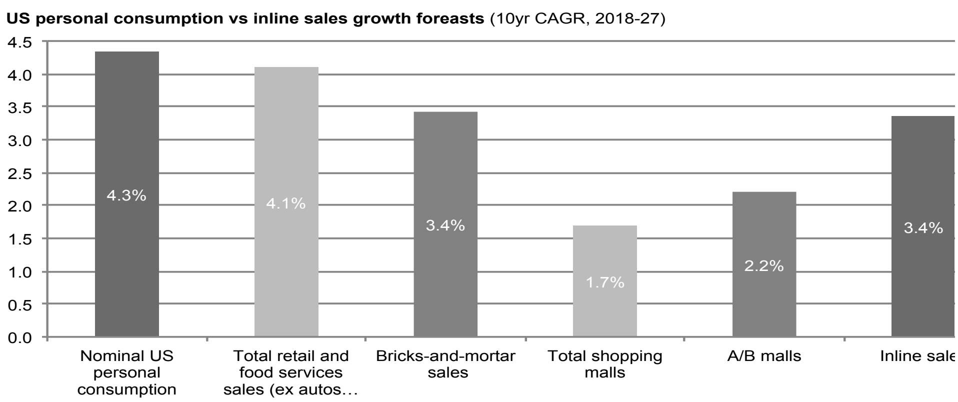
Despite the raft of negative headlines around the challenges facing the retail sector, it is important not to lose sight of the underlying drivers of mall sales growth. FS

Figure 21. Total U.S. mall sales vs inline sales



Source: QIC
Note: Data are QIC estimates

Figure 22. Decomposition of U.S. shopping mall sales forecasts



Source: QIC