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retail market analysis

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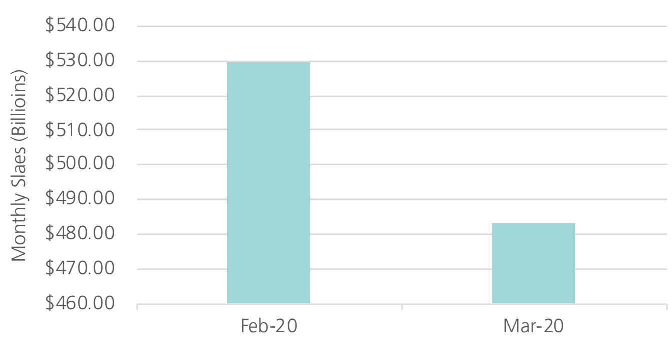
In the last issue of this publication, the story of the retail real estate market had been one of slight growth throughout the nation overall and slightly above average growth for the Portland metro area market. It seemed that most people had an idea that retail was changing, but no one could foresee what was on the horizon. The Covid-19 pandemic has effectively changed the way that the entire country operates. This virus has served to be the catalyst that disrupted the unprecedented economic growth that the United States had been experiencing.

Jerry Johnson, the Managing Principal of Johnson Economics, said it best in the Winter edition of the PSU Quarterly. He wrote, "Economic expansion continued through the fourth quarter of 2019, with the current GDP estimate indicating a 2.1% rate of growth during the quarter. The duration of the current cycle is now greater than 10 years, with the previous trough in June 2009. While the expansion cannot continue in perpetuity, there has been no apparent trigger for the next correction. The current coronavirus pandemic is likely to serve in that role." In terms of its effects on the retail industry, Johnson's words could not have been more true. According to the US Census Bureau, an April 10, 2020 report stated that retail sales in March were down 8.7% compared to the previous month. Retail patterns and thereby the retail real estate market changed dramatically.

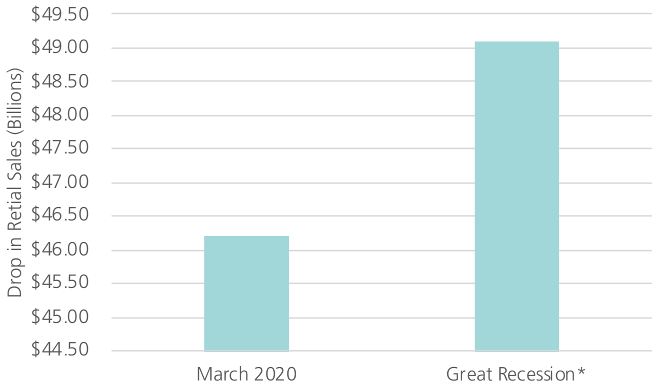
MONTHLY SALES FOR RETAIL AND FOOD SERVICES



COVID-19 EFFECTS ON RETAIL

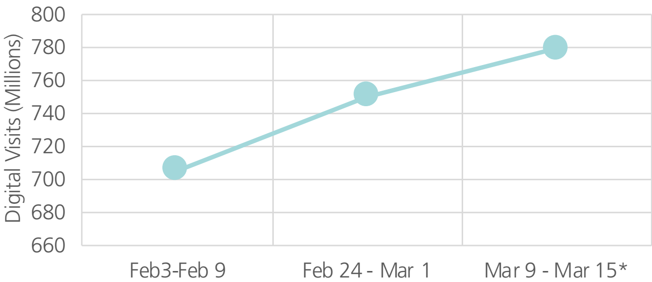
The effect of Covid-19 on retail has not been spread evenly across the market. There are multiple reasons for this. For one, the virus has caused most of the US population to stay home and avoid people. Because of this, businesses that thrived on social interaction and discretionary spending have suffered immensely as people have avoided these places in order to protect themselves. Yet, businesses that hold essential items and are considered "necessary" have performed extremely well. This leads into the second factor that has caused the uneven spread of Covid-19 effects – the government. Many state governments have created lists of "essential" and "non-essential" businesses. Although these lists often vary by state, they generally are split by the same general principle – "is the business 'life-sustaining'?" Life-sustaining, in this question, is used in a very broad sense and seems to include everything that is necessary for everyday life. For retail, this is grocery stores, liquor stores, pharmacies, and other similar retailers. Because of this, many of those retailers that have been deemed essential have done incredibly well during this time. The US Census Bureau reports that sales for Food & Beverage Stores have gone up 12.2% from 2019. So, while some retailers have actually gotten a boost in sales during this pandemic, others have suffered tremendously. As previously mentioned, those businesses that rely on discretionary spending like restaurants, bars, antique shops, clothing retailers, and other similar retailers have lost most of their business. Even if these businesses still had customers that desired to purchase goods from them, in an abundance of caution, governments have ordered them to temporarily close or severely limit their operations to prevent unnecessary spread of the virus. The effects of this can be seen in a report put out by the NRF which shows that the sales of clothing stores dropped by 50.5% from February while furniture and sporting goods stores' sales decreased by 26.8% and 23.3% respectively. These numbers emphasize the intense impact that Covid-19 has had on the retail economy which has been a story of winners and losers. While much of the impact was initially in response to government mandates, consumer preferences have likely shifted as well. If these preference shifts are sustained over a longer period they may continue to impact the retail market well beyond the current pandemic. The recent shift may reflect an acceleration of current trends from brick and mortar to online sales, with the marginal shift in sales sustained after the health crisis.

DROP IN RETAIL SALES DUE TO COVID VS THE GREAT RECESSION



* sixteen month peak-to-trough decline in Great Recession

TOTAL DIGITAL RETAIL VISITS FOR TOP RETAILERS (AMAZON, TARGET, WALMART)

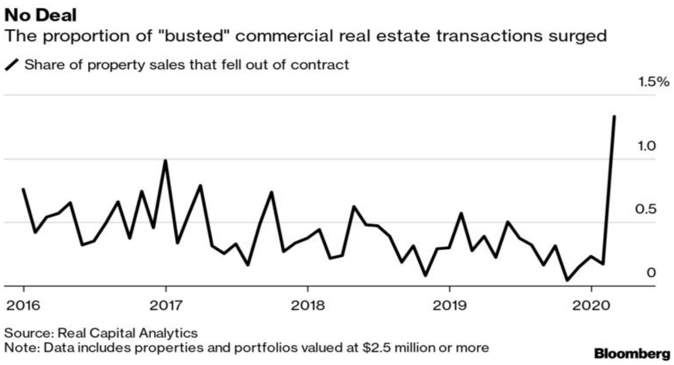


*highest week of retail visits in 2020

Sources such as LoopNet and CoStar suggest that with the impact that this virus is having on the retail market there are likely to be many stores that will not reopen, with the majority of their sales going online. According to LoopNet, there are likely to be at least 100,000 closures of retail stores in the next five years. Although the story of brick and mortar retail stores closing and transitioning online is nothing new, Covid-19 has sped up this process significantly. According to one broker, "COVID-19 has crushed commercial real estate. The retail market was slow before coronavirus, and this enhances and expedites the upcoming recession." Another commented that," A large majority of retail tenants will be behind rent or forced to vacate. The retail vacancies will significantly impact the value of buildings. The amount of vacancies will bring down asking rents and projected rents, lowering investors' projections." Because of the virus, people are now going online to order what they need. This has led to significant increases in traffic volume and sales on the websites of companies such as Target, Amazon, and Walmart.

RENT COLLECTION

With all of these widespread problems created for retailers, there has been a focus on the landlords and what they will do in order to help their tenants. This is especially true when it comes to the landlords of restaurants. Restaurants already operate on small margins, and now that they have to either shut down or move their business to completely takeout and delivery, many of them cannot afford to pay themselves, much less pay their rent. According to the Wall Street Journal, only about 46% of retail rents were collected this quarter in New York. Although these numbers could not be obtained for the Portland market, it can be assumed that the numbers are also dismal. Within this sad news, there is a glimmer of hope for many restaurant owners in Portland which has long been known for its friendly inhabitants who pride themselves on local goods. Many landlords have forgiven rents for their tenants in an effort to protect their tenants. Kevin Cavenaugh of Guerilla Development forgave rent for all 32 of his restaurant and retail tenants while many other landlords are finding creative ways to help their tenants through this time. While this is a genuinely helpful act for the tenants, this also will benefit landlords who hope to hold onto their tenants. Other owners are cutting rent and then amortizing it at some date later in the future without interest. These steps have been effective thus far, but the question remains how long can this last.



LEASING

With retail showing signs of decline even before the pandemic, landlords and tenants will need to be creative in order to maintain occupancy and leases. Not only are leases being broken, Bloomberg reports that the number of commercial real estate deals that have been broken in March have increased sixfold from February. Another sign of distress that Covid-19 has caused for the real estate retail industry comes through the news that Macy's is looking to back the selling of new bonds with their real estate holdings. This is yet another sign of the failing of larger format stores in the United States.

With this effective collapse in the retail market, two large questions arise for the real estate side of retail. The first is what will the future effects of this virus be? And the second is what should landlords and tenants currently be doing in light of these economic circumstances? In regard to the future effects of the virus, one should look at the trends preceding it in order to get a better understanding. For the retail real estate market, the trend for the past five years or longer has been one of minimal growth. According to CoStar, "Sluggish growth for mall space impacted retail rent growth in 2019. Cumulative rent gains for Portland retail at 25% are far below the performance of office, industrial and multifamily rents over the past decade." Unsurprisingly, retail has been performing poorly compared to every other major real estate sector in Portland with its growth primarily coming from Portland's strong economy. With so many people moving to Portland and the area's median income consistently increasing, discretionary spending has continued to increase in Portland. With the virus having shut down most discretionary retail spending, the demand for retail services has been shut off for a significant portion of time. This bodes poorly for the retail sector which has always relied on this spending to stay afloat. The impact of this is expected to be persistent and the retail sector will take time to recover. The devastation on retail has been immense. According to Reuters, "The $46.2 billion decrease in sales in March was almost equal in a single month to the $49.1 billion peak-to-trough decline that unfolded over 16 months in the Great Recession." With the problems being both a conglomeration of government bans, consumer caution, and the virus, it seems quite plausible that the problems for retail will only be exacerbated in the future.

EFFECT OF COVID-19 ON THE FUTURE OF RETAIL

If this is the case, and the future of retail and thereby the future of retail real estate is in question, what then should tenants and landlords be doing? As pointed out previously, many landlords are giving their tenants either complete rent forgiveness or cutting the rent and allowing the tenants to amortize out the payments on a later date. Paul Del Vecchio, founding principle of Ethos Development, said "It's the right thing to be doing to give tenants relief, whether it's commercial or residential, we're going to be the buffer, and we're prepared to be. We've proactively cut rent and told our businesses to pay their employees first. We want them to come out the other side." This policy of tenant relief may be a good one to follow if the property owner has adequate capacity. By giving tenants relief, both the tenant and the landlord benefit. The tenant is able to have a break on rent payments which allows them to use what little funds they have to pay themselves and their staff. The landlord is able to keep a tenant and not have to deal with the cost of finding a new tenant in this tough climate. The question though, is how long this can continue. Marc Strabic, Director of Leasing for Gramor Development, put it this way, "This entire situation boils down to how long retail deemed non-essential needs to remain closed and what limitations will be placed on it when it is allowed to open. Obviously, the longer the closure and more stringent the operating limitations, the worse the impact. On the ownership side, it is better to be invested in grocery/hardware anchored than fashion right now. Investment exposure to local retail is also of concern. Gramor is doing what we can to help these tenants, but this situation is acutely difficult for local retailers." How long can tenants ask for rent concessions from landlords and landlords ask for debt-service concessions from lenders? Only time will tell if the government policies such as the Paycheck Protection Program and CARES Act will benefit retail.

IN CONCLUSION

With retail sales being down as much as 50% in some sectors, rent being collected from only 46% of tenants in some areas, and overall retail sales down 8.7% compared to the previous month, retail and retail real estate is struggling. For an industry that was already experiencing less growth than any other in real estate, retail has little reason for hope except for food and beverage which has gone up 12.2% compared to 2019. Tenants are looking to their landlords for rent relief and landlords are looking to their lenders for debt-service relief. One of the primary drivers for retail sales was Portland's strong in-migration, but that may be severely affected in the wake of this pandemic. This is the first time that the state of retail real estate is not reflected in a statistic of rental prices, but rather in a statistic of tenants paying or not paying rent. Where there is encouragement is in seeing how local landlords such as Guerilla, Beam, Ethos and many more have stepped up and found creative ways of protecting their tenants.

SOURCES

1 PSU Real Estate Quarterly, Winter 2019

2 US Census Bureau, Retail and Food Services Sales, March

3 Aprio, Essential and Non-Essential Businesses

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5 National Retail Federation, March Sales Plummeting

6 Loopnet, 100,000 More Retail Stores Will Close by 2025

7 WWD, Retailers and Landlords Hard-Pressed to Find Common Ground

8 DJC Oregon, Relief Arriving for Some Small Business

9 Bloomberg, Macy's Financing Deal

10 CoStar, Portland Retail Sector Challenges

11 Reuters, Coronavirus Knocking Retail Sales in March

12 DJC Oregon, Relief Arriving for Some Small Business

13 DJC Oregon, Relief Arriving for Some Small Business