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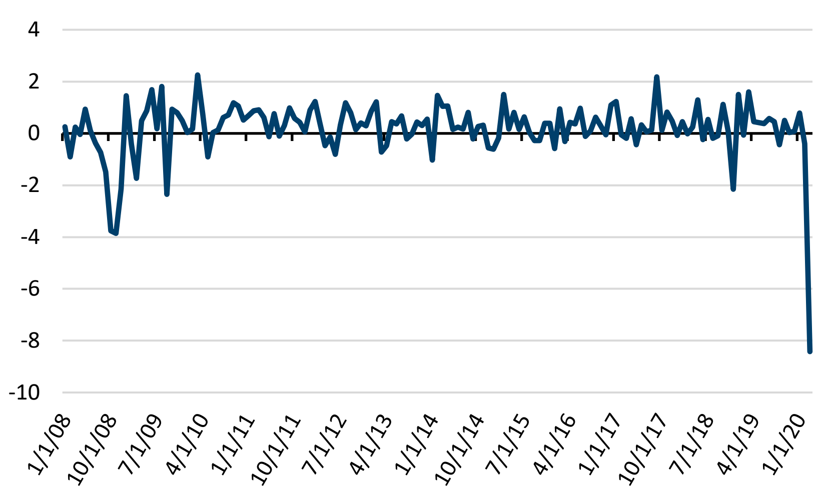
THE OTHER SHOE DROPS: WHAT'S NEXT FOR U.S. RETAIL

The challenged state of brick and mortar retail has been exacerbated by the COVID-19 pandemic and the economic shutdown. Retailers J. Crew, Neiman Marcus and J.C. Penny have filed for bankruptcy. Nordstrom announced plans to permanently close 16 of its 116 stores; Lord & Taylor will reportedly liquidate merchandise in all its locations when it reopens, and Gap reported that it suspended rent payments for its North American retail stores in April. The recent April retail sales data showing a drop of 16.4% merely confirmed the mounting anecdotal evidence.

To be sure, the coronavirus is a catalyst rather than the cause for many retailers' woes. Our real estate colleagues have previously pointed out that America has too many stores. While the U.S. is the world's largest retail market (in terms of personal expenditure) it has an outsized, and in some cases outdated, retail footprint. According to the International Council of Shopping Centers (ICSC), the U.S. has 23 square feet of retail space per person, which is about five times the average for most European countries. This surfeit of space has accrued at the same time that Americans have been shifting a greater percentage of their spending to online platforms, most recently out of necessity.

Food and retail service sales (% change from prior month)



Source: Columbia Threadneedle Investments and Macrobond

In March, retail sales in the United States fell 8.7% (a record monthly drop). An even greater contraction was expected for April given widespread shelter in place orders. Many companies have laid off or furloughed workers in an effort to survive, and suspended and canceled clothing orders. Given the challenging environment for retailers, we provide our views on what's ahead as state economies begin to reopen:

New operational expectations

Even when stores do reopen, the retail experience will have to be altered to comply with social distancing policies and customer expectations. Several retailers have already announced additional cleaning and sanitizing policies, requirements for health screenings and masks for employees, as well as limits on the number of customers in stores and store hours. Macy's announced customers will no longer be permitted to touch makeup samples, try on dress shirts and will be required to use hand sanitizer before trying on accessories.

Inventory oversupply

The inventory overhang could take 12 to 24 months to resolve depending on how fast demand returns, which is bad for retailers with long lead times (e.g., handbags, traditional apparel brands) but good for off-price retailers.

Sales outlook

The wide variation in states' reopening plans mean that a resumption in consumer activity is likely to be uneven, and the second half 2020 sales outlook looks increasingly uncertain. We may see ongoing negative earnings revisions given that we don't know what consumer behavior will look like yet later this year. Will consumers go into lockdown again (either by will or mandate)? Will schools/stores need to close again? Or, will more widely available and dependable testing help consumers resume their old shopping behavior? In China, consumers have been slow to return to stores, relying on digital platforms to make purchases.

Margin pressure

Given the costs to implement the operating procedures above, margins are likely to be pressured. This is bad for retailers with a store-based business model but may become a relative advantage for players with a healthy digital footprint/sales mix. Consensus earnings estimates tracked by Bloomberg are aggressively modeling fiscal year data three years out (FY3) on par with the current fiscal year (FY0) levels and FY3 EPS ~80% of FY0 for mall-based retail. Valuation on FY3 looks in line/reasonable for these names. Retail stocks may struggle to find a firm bottom until earnings estimates stabilize.

Further mall closures

Mall-based retail store closures are expected to accelerate in the near term. Green Street Advisors expects more than half of mall-based department stores will close by the end of 2021. This could trigger a wave of subsequent store closures based on co-tenancy clauses. This is bad for department stores, mall-based specialty and traditional apparel selling into department stores but good for off-mall retailers and strong digital/omni-channel players.

Conclusion

Based on the observations above, we believe that the path forward from here for the retail sector will be challenging. The story is not entirely bleak, however. Structural share gainers remain — strong digital/omni-channel players with integrated inventory and distribution models, companies that have been able to make themselves essential to homebound consumers through apps like workout routines, for example, as well as the athleisure category. The resiliency of global luxury demand has also been a positive surprise. Given the expected dispersion in results, intensive research is critical to finding companies that will thrive in the altered retail environment.

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