Challenges confronting regional malls intensify

A look at the three major causes of retail contraction

by Stewart Rubin

Within the spectrum of commercial real estate, no property type is facing such profound challenges as regional malls. U.S. malls are confronted by: (1a) income stagnation, (1b) income concentration, (2) retail oversupply and (3) e-commerce. The challenges are not distributed equally; high-end regional malls as well as dominant malls are well positioned to cope with the pressures. Conversely, these threats are not being met successfully in many demographically and economically challenged parts of the United States. Malls that focus on experiential tenants — discount retailers, theaters, restaurants, fitness centers, unique entertainment venues and medical outpatient services — that cannot be replaced via online stores and services will be at an advantage.

There are 1,035 malls in the United States, according to Green Street Advisors, which classifies 337 as being most at risk for closing due to such factors as declining occupancy and sales of $305 per square foot or less. A Green Street Advisors report asserted department store companies need to close as many as 800 more locations — or one-fifth of all anchor space in U.S. malls — to return to the levels of productivity they experienced 10 years ago. According to Retail Metrics, department store earnings growth has lagged other retail in every quarter since the start of 2012. A recent Deutsche Bank report,

Cross Sector: Hightail from Retail?, estimates upward of 6,400 net stores will close over the next several years. According to a CoStar Group analysis, the U.S. retail market would require a 10.7 percent decline in supply (a removal of 864 million square feet of retail space) at current real buying power and e-commerce levels to achieve equilibrium.

An April 2017 Credit Suisse report maintains year-to-date store closings are ahead of the previous peak in 2008, which portends a record-breaking year for store closures. We expect further mall and store closings ahead. Malls in metro areas with less than 1 million people and those in non-metro areas are most vulnerable to closure. The store closings are predominantly in class B and C malls. Class C malls are common in smaller metro areas and non-metro areas.

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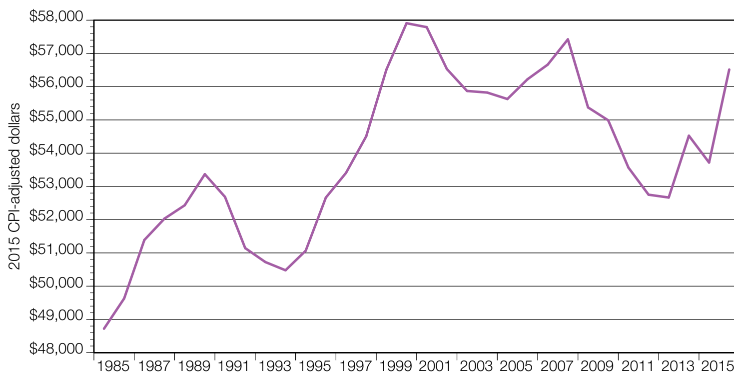
Their trade areas could barely support many of these malls and their stores. When confronted with the dual challenges of stagnant wages and e-commerce, some of them folded and others are threatened. Considering the United States has more retail per capita than any other nation, it is no surprise a significant shakeout is occurring. Ironically, many less-populated areas that were serviced more than a century ago by peddlers and mail catalogues are reverting to a modern version of these in the form of e-commerce. Many of these places were barely big enough for one mall; now — with losing 8 percent to 15 percent of sale revenue — their malls often cannot survive.

Real median household income in the United States



Sources: U.S. Census Bureau, Federal Reserve Bank of St. Louis

Malls situated in locations with weaker demographics are more reliant on anchor tenants, such as J. C. Penney & Co., Sears Holdings Corp. and Macy's Inc., and are more exposed to department store closures and to the fallout such closures bring. A reported 88 percent of C+ malls include either a J. C. Penney or a Sears store (or both), according to Green Street Advisors. Only 31 percent of A++ malls have one or the other (or both). There is a shortage of feasible replacement tenants, and other tenants in the mall may trigger co-tenancy clauses when anchors vacate, allowing them to pay lower rents or break their leases. Most important, the failure of a department store in such an area is likely an indication the area is not able to support such a mall in the current economic environment.

Other manifestations of retail stress include the decline of retail jobs in certain subsectors and the reduction of mall foot traffic. According to the Bureau of Labor Statistics, net year-over-year job losses for the year ended March 2017 were recorded in the sporting goods, hobby, book and music store category (–4.0 percent); department stores (–3.0 percent); electronics and appliance stores (–2.1 percent); general merchandise stores (–1.6 percent); and clothing and clothing accessories stores (–0.5 percent). Nonstore retailers (up 4.4 percent) is the best-performing retail category.

Visits to malls are down materially overall, and the drop seems to be most acute for class B and C malls. According to Retail Next, retail traffic declined 13.4 percent for December 2016 as compared with the previous December. Why is declining foot traffic important? Less mall foot traffic (1) leads to fewer spontaneous purchases and (2) less business even for "e-commerce resistant" tenants such as restaurants, fast-food establishments and entertainment.

Income stagnation/concentration

The stagnant income growth of most segments of U.S. society and the corresponding concentration of income in the highest decile and centile of the U.S. population are revealed by several metrics, including real median household income, employment to population ratio and the Gini ratio.

Despite recent improvements, the real median household income of $56,516 in 2015 is still lower than the $57,795 recorded in 2000. Real median household income has yet to fully rebound in the aftermath of the Great Recession (see "Real median household income in the United States," left).

The costs of many categories of nondiscretionary purchases ("needs") have gone up faster

than the rate of inflation. This has led to a shift of dollars away from discretionary uses. According to Deutsche Bank and based on data from BLS, nondiscretionary spending increased from 80.4 percent in 2000 to 83.0 percent in 2015, while discretionary spending decreased from 19.6 percent to 17.1 percent during the same period. Consumer dollars are shifting away from discretionary uses, perhaps because nondiscretionary expenditures are rising significantly faster than the rate of inflation. Therefore, in addition to stagnant-to-declining real wage growth, net income for the lower portion of the income spectrum is actually declining. "Wants" such as electronics cost less, but "needs" such as housing, education and healthcare are costing more.

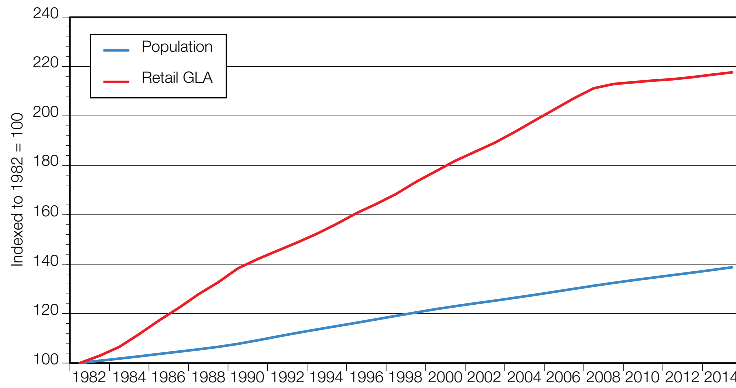
When income is concentrated in the upper centiles and deciles, it limits the amount that will be spent in malls, as wealthier people spend a smaller percentage of their income at malls than middle-class persons.

Another cause of stress in the U.S. economy is the decline in the share of prime-working-age Americans in the workforce. The employment to population ratio for all Americans aged 25–54 was 77.2 percent as of 2015, compared with 81.6 percent in 2000.

The United States has become a significantly less-equal society over the past 45 years. According to the U.S. Census Bureau, the U.S. Gini ratio — a measure of income concentration — rose from 38.6 percent in 1968 to 47.9 percent in 2015. (The higher the Gini ratio, the less evenly distributed is income.) Consequently, income and its corresponding spending power have shifted away from the shrinking middle-income and growing lower-income brackets in favor of a smaller upper-income segment. The top 1 percent of the U.S. population received 22 percent of national income, which — with the exception of 2007 — is the highest level since 1928. The share rose from 9.4 percent in 1980. The top decile now earns 50.5 percent of the national income, which is at its highest level in nearly a century. The share rose from 32.2 percent in 1980.

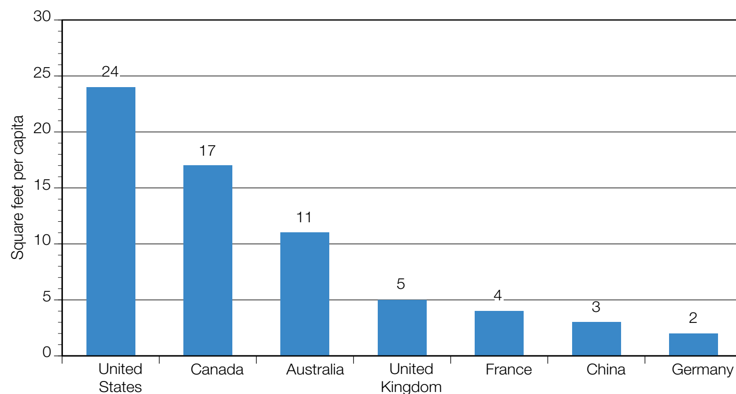
When income is concentrated in the upper centiles and deciles, it limits the amount that will be spent in malls, as wealthier people spend a smaller percentage of their income at malls than middle-class persons. A number of regional malls in high-end areas significantly outperformed older malls in less wealthy areas. This is an oft-repeated story that may become more intense as Macy's, Sears, J. C. Penney, the Limited Brands

U.S. retail space and population growth since 1982



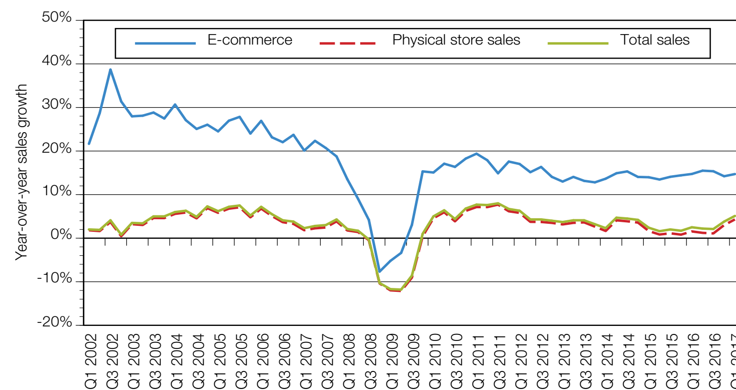
Sources: Cushman & Wakefield, CoStar Group, Reis, Federal Reserve Bank of St. Louis, U.S. Census Bureau

Retail space per capita around the world



Sources: ICSC Country Fact Sheets, Green Street Advisors, GGP

Year-over-year growth of sales by retail channel



Source: U.S. Census Bureau

and others follow through on store closures. The top retail locations significantly outperform all other categories, in concert with the increased share of national income received by the top decile of U.S. society.

Too much surplus retail

Currently, the United States has nearly 24 square feet of retail space per capita, as calculated by the International Council of Shopping Centers. This number rises when small shopping centers and independent retailers are added.

Over the past 30 years, retail real estate growth has run well-ahead of population growth. Since 1985, total retail space in the 209 markets tracked by CoStar has expanded by 75 percent (2.4 percent per year), while the national population has grown 41 percent (1.3 percent yearly). (See “U.S. retail space and population growth since 1982,” top left.)

U.S. retail space oversupply comes in sharp relief when compared with other nations with large landmasses, such as Canada (17 square feet per capita) and Australia (11 square feet per capita). It is significantly higher than countries with smaller land areas, such as the United Kingdom (5 square feet), France (4 square feet) and Germany (2 square feet). (See “Retail space per capita around the world,” middle left.)

Retail overbuilding is particularly acute for U.S. department stores, which constitute 46 percent of all retail space, compared with 27 percent in the United Kingdom and 23 percent in Australia. This partially explains the accelerated pace of department-store closure announcements in the United States. The United States is actually understored in the entertainment, specialty, and food and beverage categories compared with other nations. This suggests the possibility that a shift to these undersupplied categories may bolster malls.

E-commerce

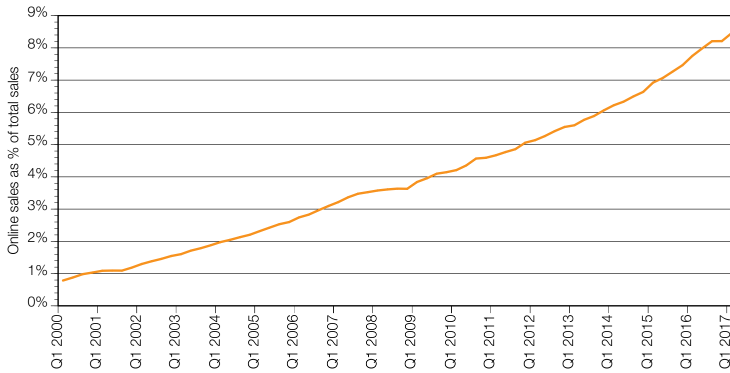
Retail formats evolve over time in response to changes in technology, lifestyle and other disruptive trends. After World War II, suburbanization and the proliferation of the automobile shifted U.S. shopping patterns away from the center-city department stores that had been dominant in U.S. cities for decades. Suburban malls replaced downtown department stores in urban centers. Wal-Mart Stores emptied small towns of their general stores. E-commerce is likewise reshaping shopping patterns. The growth rate of e-commerce sales has far outstripped total retail sales since 2000. Online shopping has grown in the United States at an annual rate of approximately 15 percent since 2009, compared with physical store sales of only 3.5 percent (see “Year-over-year growth of sales by retail channel,” bottom left).

E-commerce’s share of total domestic retail sales has expanded from 2.0 percent in 2004 to 8.5 percent as of first quarter 2017. This represents 50 consecutive quarters of share growth, and the share has not contracted quarter-to-

quarter since the Census Bureau started tracking the metric in 1999 (see "Seasonally adjusted estimated e-commerce sales as a share of total U.S. retail sales," below).

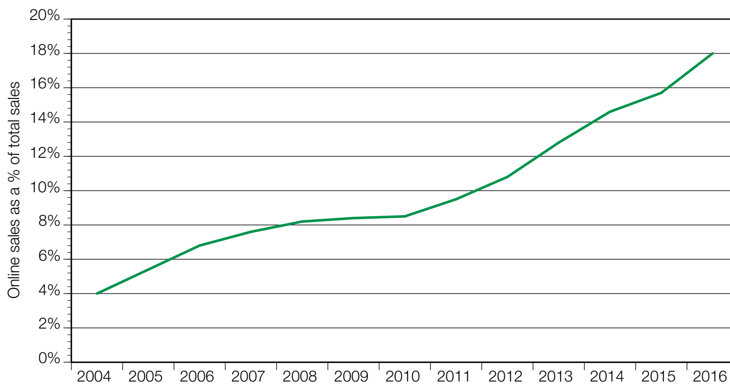
These numbers, however, do not reveal the real impact on malls. When discounter/dollar stores are excluded, the figure rises to 15.5 percent. The apparel and accessories category's share of online sales to total sales was 18 percent in 2016 compared with 4 percent in 2004. Because total apparel category growth was up 2.1 percent in 2016, online sales accounted

Seasonally adjusted estimated e-commerce sales as a share of total U.S. retail sales



Source: U.S. Census Bureau

Share of apparel and accessories sales online



Sources: Deutsche Bank, company filings

for 145.7 percent of total apparel and accessories growth, implying physical store sales were down –1.2 percent (see "Share of apparel and accessories sales online," above).

Apparel and services are down from 25.0 percent of discretionary spending in 2000 to 19.3 percent in 2015. We have become a more casually dressed nation. This gradual trend first manifested itself in leisure-time wear and eventually to the workplace wardrobe. The "food away from home" category increased from 28.6 percent in 2000 to 31.5 percent in 2015, and entertainment from 25.0 percent to 30.0 percent. Within discretionary expenses, consumers are shifting away from apparel to entertainment, beauty, travel and restaurants. In addition, the millennial generation is aiding a shift toward spending more on experiences versus goods.

Conclusion

In his book *The Sun Also Rises,* Ernest Hemingway presents the dialogue of two of his characters; "How did you go bankrupt?" Bill asked. "Two ways," Mike said. "Gradually and then suddenly." This is also a good characterization of how certain malls decline. The mall gradually experiences declining sales and occupancy over a long period of time. Eventually, it loses one or more anchors, a flight of inline tenants ensues, a rapid deterioration in cash flow occurs, and the mall is suddenly no longer viable.

The triple threats of net median income stagnation/concentration, oversupply and e-commerce have taken their toll on U.S. malls, and the next recession may result in a violent shakeout. Successful malls will be resistant to the three challenges. High-end malls with sales exceeding $600 per square foot and catering to those in the upper economic tier should prosper despite income stagnation and will benefit from income concentration. This is particularly true of upper-decile malls. According to Green Street Advisors, U.S. households that earn $100,000 or more account for 65 percent of all apparel and entertainment spending, while those that earn $150,000 or more account for 28 percent. Malls that dominate their markets may continue to do well, despite having lower sales. They may be the only mall for dozens of miles in any direction, with healthy occupancy-cost ratios, acceptable sales trends and stable occupancy.

Certain types of retailers have thus far proven resistant to e-commerce. The two largest dollar stores, Dollar General Corp. and Dollar Tree, as well as off-price retailers T.J. Maxx and Ross Stores provide the consumer with a scavenger hunt–type experience, with the offerings changing constantly. TJX Cos., owner of T.J. Maxx, Marshalls Inc., and HomeGoods Inc. added 47 stores in the first fiscal quarter of 2017 and intends to add 150 more in the balance of the year. This is in the wake of adding 219 stores last year.

Retailers that provide consumers with experiences that cannot be enjoyed over the Internet are likely to increase their footprint in malls. The United States is actually understored in the entertainment and food-and-beverage categories compared with other nations, even though the

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number of restaurants is at an all-time high, having increased by 40,000 net over the past five years. The Bureau of Labor Statistics revealed the number of restaurants in the United States increased by about 2 percent in 2016 and approximately 11 percent since 2011. It is important to note this group is being fueled by independent restaurants, which represent about 66 percent of the total. In addition, Americans now spend more eating out than eating at home. According to Census Bureau data, through January 2017, restaurant sales were up a robust 5.6 percent over a year earlier. Same-store sales of chain-store restaurants, and especially fast-food establishments, however, have been low or declining recently.

Restaurants and entertainment represent about 15 percent to 20 percent of regional mall tenants, so a pivot away from waning apparel tenants to more restaurants in regional malls may mitigate some of the decline. Malls that are e-commerce resistant have many restaurants, movie theaters, fitness centers, outpatient medical centers, etc. Recently, more movie theaters are entering malls as anchors, and restaurants are being incorporated into the malls as opposed to occupying pad sites.

While mid-market department stores have suffered, some other large retailers have done well. Certain supermarkets and warehouse clubs, such as Costco, have been doing well despite the rise of e-commerce. Such stores are increasingly sought out as a big-format substitute for vacating apparel-anchored department stores. Omni-channel retailers exploit the Internet with sales and delivery systems that benefit from a physical presence:

- Online ordering with pickup at the store
- In-store buying with delivery to the home
- Use of mobile apps by shoppers as a tool while shopping at the store
- The online sale of services, such as skilled installation, to support sales out of stores such as Home Depot
- Use of the store to build brands as Apple Inc. and Microsoft Corp. have been doing, among other examples

Online retailers such as Warby Parker Retail, Blue Nile Inc. and UNTUCKit LLC are also opening physical stores in malls because the merchandising advantages and brand-building effects of omni-line retailing runs both to physical retailers and players that started in the digital realm.

Retail has long been an industry characterized by creative destruction, and although the pace of destruction in some quarters has picked up, there will continue to be winners and losers at the retailing game. Nevertheless, the pace of change in retailing has accelerated, and the impact among the losers may be severe. Many malls are in the process of decline, and the next recession may result in a fierce reckoning resulting in an avalanche of mall closings. More near-term events that may precipitate an acceleration of the process include a Sears or J. C. Penney bankruptcy, or more store closures as retailers curtail their physical-store presence while relying more on online sales. Upper-tier malls and malls with an entertainment, restaurant or other experiential focus should continue to thrive. ❖

Stewart Rubin is senior director at **New York Life Real Estate Investors,** an investment group within NYL Investors, a wholly owned subsidiary of **New York Life Insurance Co.** This article is an abridged version of a white paper published in 2017. The full paper can be accessed at https://www.newyorklife.com/content/dam/nyl-cms-dotcom/pdfs/rei/Challenges-Confronting-Regional-Malls-Intensify.pdf.

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