VIEWPOINT
U.S. RETAIL

Retail Recovery Varies by State and Category

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EXECUTIVE SUMMARY

- The impact of COVID-19 has put additional pressure on the retail industry, which will continue. However, with retail sectors being impacted so differently, their recoveries will have different trajectory paths.
- The overall availability rate is expected to rise and reach its peak in Q1 2021 at 12.5%, or 380 basis points (bps) higher than the Q1 2020 level.
- Rent is forecasted to reach its trough at Q2 2021, with an 8.5% decrease compared to Q1 2020.
- This is a challenging time for retailers as many close their stores and more retail space becomes vacant or converted to other property types.

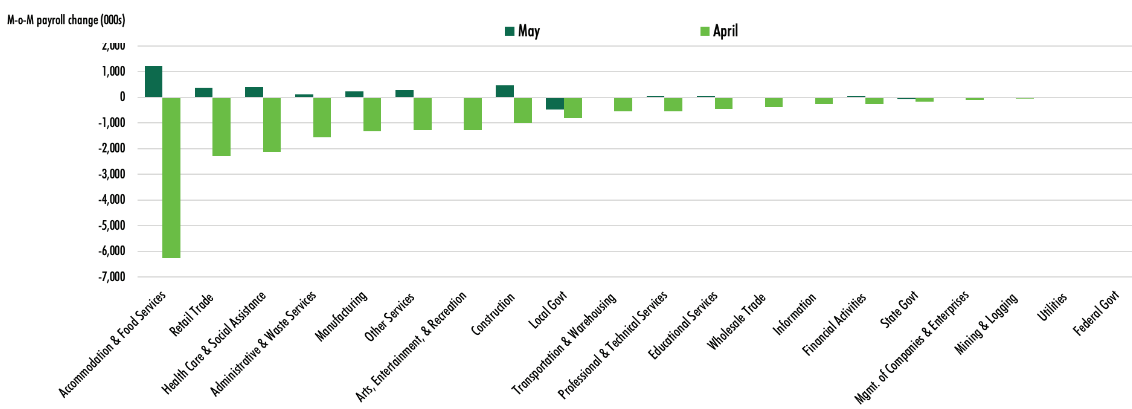
Retail, especially the Mall sector, has been going downhill for a few years before COVID-19 due to the competition of e-commerce and changing consumers. This pandemic has again brought new challenges for retailers and their landlords. In the past few weeks, we have seen retailers gradually reopen their stores, with variation among different states and by category. Retailers now aim to re-enter the markets and adjust to the post-COVID-19 environment in which consumer psychology and economic condition has changed and retailers are having to operate at limited capacity and adhere to various safety guidelines.

MACRO ECONOMY

COVID-19 is taking an historic toll on the U.S. economy. Most states went into lockdown by mid-March causing the economy to shrink by an annualized rate of 4.8% in the first quarter. With entire industries grinding to a halt, the second quarter is expected to contract by 36%, annualized. The U.S. should return to growth during the second half of the year limiting overall losses for 2020 to roughly 5%, like other large OECD economies. CBRE Econometric Advisors (EA) expects that the rebound will extend into 2021 with average annual growth of 6%.

The labor market has deteriorated significantly. Initial jobless claims have totaled nearly 45 million since early March, equating to over a quarter of the labor force. Unemployment claims have been notable in states with a sizable travel and tourism sector, such as Hawaii and Nevada. The nature of these layoffs is different from previous recessions. Because many firms expect to resume operations as lockdowns end, many layoffs are temporary rather than permanent separations, though may become permanent.

FIGURE 1: The May Employment Report Shows Firms are Bringing Workers Back



Source: Bureau of Labor Statistics.

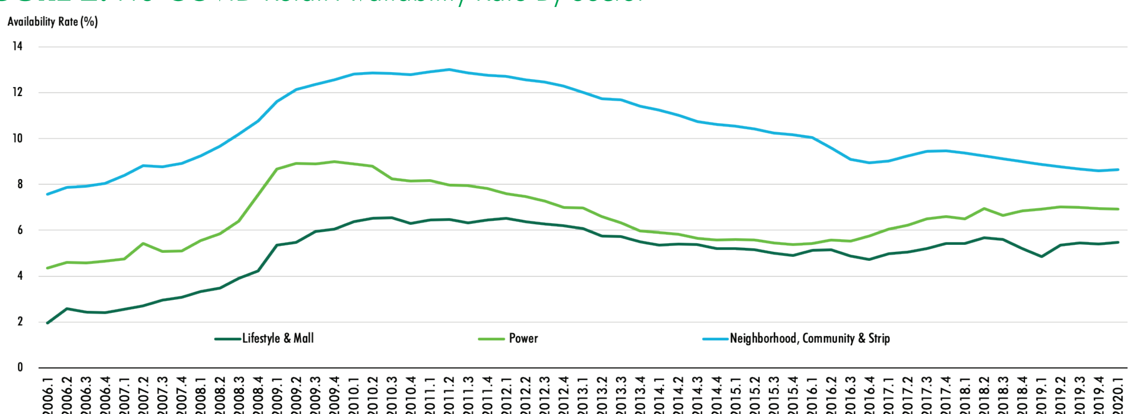
This recession may find a floor quickly, but it will be a long recovery for some sectors. Because the current contraction was caused by intentional policies rather than private sector imbalances, the shape of this cycle will be different than past recessions. Hotel occupancies, airline passenger traffic and restaurant clientele have all stabilized and have begun to tick upward—albeit they are bouncing off an extremely low base.

RETAIL BEFORE COVID-19

Before the crisis, the availability rates of Power, Lifestyle and Mall properties were trending upward, but Neighborhood Community and Strip (NCS) was trending downward and reached its lowest level of 8.6% in Q4 2019.

Figure 2 also shows that supply is increasing, though the pace is slowing (especially after the Great Financial Crisis), and that most of the additional supply are added in NCS. EA believes the crisis will take different tolls on different sectors.

FIGURE 2: Pre-COVID Retail Availability Rate By Sector



Source: CBRE EA, Q1 2020.

RETAIL SALES DATA DURING THE PANDEMIC

Retail sales in March and April declined dramatically for almost all sectors except Grocery and Non-store retail. April total retail sales dropped 16.5% from March and 21.6% from April 2019. Clothing & Clothing Accessories posted the highest decline of 79% and almost 90% Y-O-Y. Other sectors like Electronics & Appliance, Furniture and Home Furnishing stores also saw retail sales fall by more than 60% Y-O-Y; Department stores dropped 29% from March and 47% from April 2019. On the other hand, April Grocery stores grew 13% Y-O-Y. Non-store retail is the only category that experienced growth in both March and April. April Non-store retail sales grew 22% from last year.

May retail sales signal a strong consumer spending recovery; total retail sales grew 17.7% from April. The top recoveries include: Clothing & Clothing Accessories Stores grew 188% from last month; Furniture & Home Furnishing Stores grew 89%; Sporting Goods, Hobby, Book & Music Stores grew 88%; and Non-store retail continues to grow despite the reopening of brick and mortar stores in many states. However, it is worth noting that most categories are still not recovering if we compare the May sales number with last year's May data. Total retail sales in May are still down 6% compared to May 2019. Clothing & Clothing Accessories Stores is down 63% from May 2019; Food Service and Drinking Places, which grew 29% in May, still registered a 39% decline compared to last year.

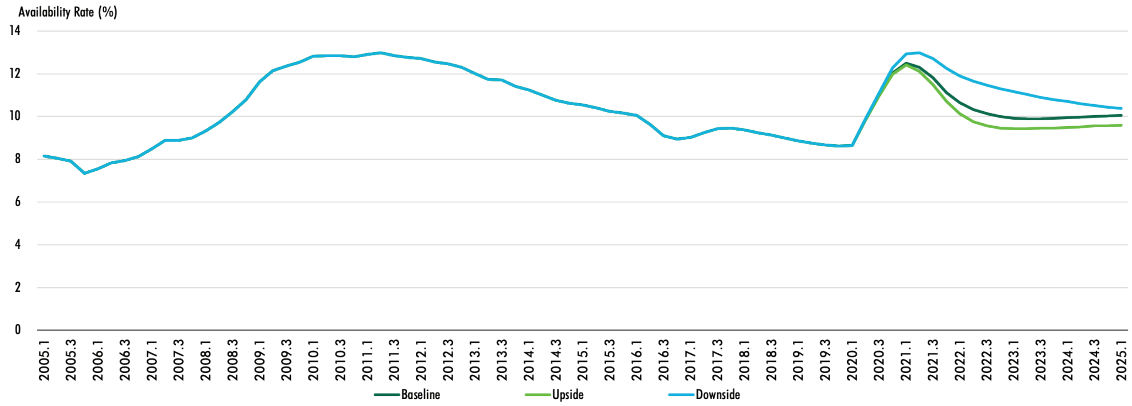
The strong sales recovery in May are also inflated by factors including the stimulus checks and unemployment benefits. It would be important to see the retail sales number in the following months to understand the strength of pent-up demand.

VACANCY RECOVERY TO START IN Q2 2021

EA currently only forecasts the NCS category. We project the NCS availability rate to rise 1.2 percentage points to 9.8% in Q2 2020 and continue to grow at a slowing speed to 12.5% in Q1 2021. This is 380 bps higher than our current availability rate. This increase will also surpass the negative impact from the GFC, which produced a 370 bps increase in availability rate at its peak. Availability rate should begin to decrease in Q2 2020 and stabilize in Q1 2023. However, it will not return to its pre-recession level of 8.7%. Instead we forecast that it should stay near 10%.

Although we currently do not forecast the Mall category, we expect Malls to be hit harder than NCS. The Mall sector is mostly anchored by department stores and has high exposure to the apparel industry, both of which have been experiencing unprecedented sales drops during the pandemic and face more risk of retail bankruptcies and store closures.

FIGURE 3: Forecasted Availability Rate for Different Scenarios



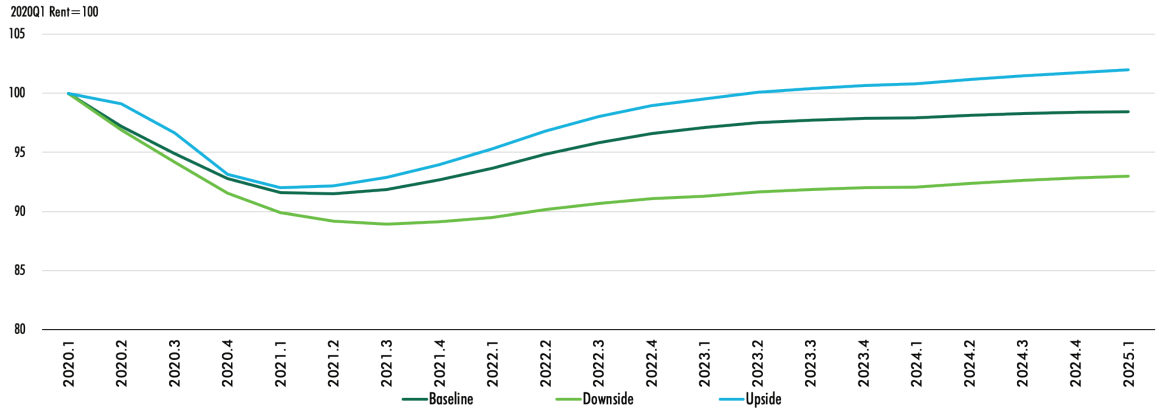
Source: CBRE EA,Q1 2020.

RENT PROJECTED TO FALL AND REACH ITS TROUGH AT Q2 2021

NCS rent is expected to decline from the current level of $21.10 to $19.30 in Q2 2021, a drop of 8.5%. Positive rent growth will start at Q3 2021. The nominal rent will reach the current level in 8 years at Q1 2028 in our Baseline scenario and more than 10 years in our Downside scenario.

Comparing this to the GFC, the rent growth decline looks steeper. There are several reasons, the main one being that there has been huge unprecedented and swift job loss, far worse than during the GFC. Consumer spending is also experiencing record lows. And with shelter-in-place and non-essential retail closed, generating very limited or even no sales, this damage to retailers is much deeper than during the GFC. Another perspective is that e-commerce accounted for less than 4% of retail sales in 2008 compared to 11% now and is likely to gain more share.

FIGURE 4: Forecasted Rent for Different Scenarios



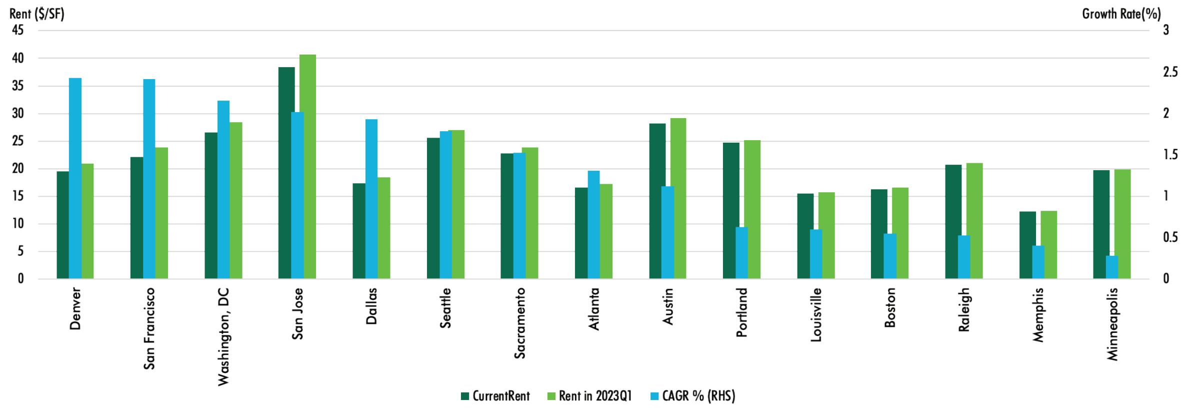
Source: CBRE EA,Q1 2020.

RETAIL MARKETS WITH BETTER RECOVERY

According to our forecast, which is mainly driven by employment, the markets highlighted in Figure 5 will have a quicker recovery than others.

Cities like San Jose, Dallas, Seattle and Atlanta have been experiencing steady rent growth in recent years before the pandemic and we believe this momentum is likely to continue after the crisis. Cities like San Francisco and Boston, which have high percentages of employment in finance, information and professional services, are also less impacted by the pandemic given that the job loss is mostly in other industries. Cities like Washington, D.C. and Sacramento are more government industry focused, so we believe they are also in better shape. Cities with high exposure to leisure, travel, and entertainment will be in a worse position to recover.

FIGURE 5: Cumulative Rent Growth (%) for the Next Three Years



Source: CBRE EA,Q1 2020.

STORE CLOSURES AND RETAIL BANKRUPTCIES

There have been quite a few high-profile bankruptcies in the past two months, including department stores Neiman Marcus, JC Penny and Stage Stores, apparel tenant J. Crew, and footwear retailer Aldo Group. Along with the bankruptcies, we've seen announcements of store closures. Macy's has implemented a plan to close more than 100 stores in the next three years. Nordstrom will close 16 of its stores; Pier 1 Imports will be closing all remaining 540 stores. Victoria's Secret and Pink will close more than 200 stores this year and more next year. Other retailers are also planning to postpone expansions and delay store openings due to the uncertainty of this crisis.

In addition to those national chains, local small businesses are heavily affected by the pandemic. According to a survey from the National Bureau of Economic Research (NBER), three-quarters of small businesses surveyed only have enough cash on hand to cover two months of expenses or less and will find it extremely difficult to stay in business if the crisis lasts longer than four month. Many of the small businesses surveyed are retailers, restaurants, and personal services.

E-COMMERCE WILL CONTINUE TO RISE

Many consumers turned to a digital platform to shop during stay-at-home orders and store closures, which accelerates increased e-commerce penetration to retail sales. The assumption is that once a consumer overcomes the initial barrier and masters the learning curve, it becomes second nature and convenient for them, and thus they are likely to remain online shoppers. We believe this pandemic has created a permanent upward shock to the e-commerce penetration, which will continue to rise.

Retailers and their landlords are also keeping up with the trend and adapting to changes by quickly rolling out digital platforms and implementing measures like curbside pick-up to serve customers. Retailers with omni-channel in place are benefiting from their ability to fulfill orders and provide convenience and safety to their customers.

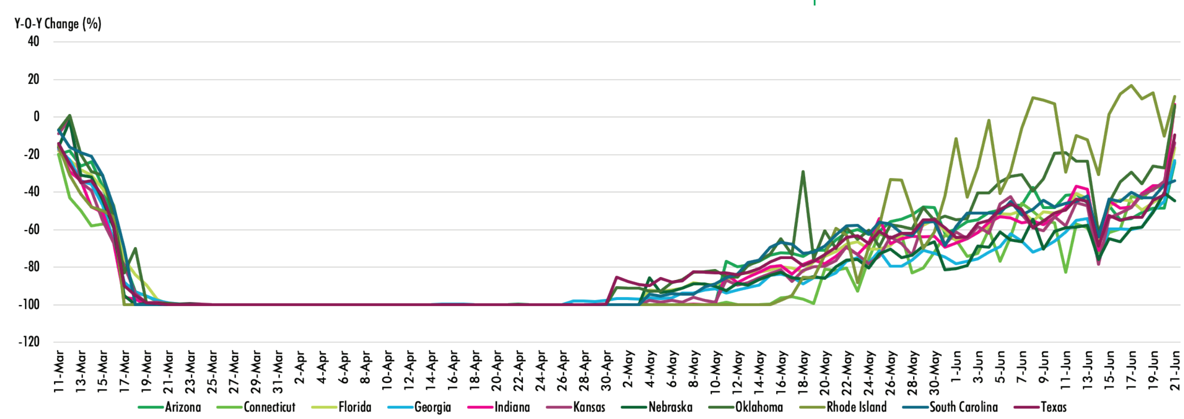
LANDLORDS EXPERIENCE PRESSURE ON RENT COLLECTION

A CBRE Property Management survey shows that landlords collected 63% of their May rent, however, the range varies greatly depending on the tenant mix. Landlords collected more rent in centers with an essential retailer that remained open. Collection rates were lower in Outlets, Malls, and Lifestyle Centers that predominantly have non-essential retailers.

PENT-UP DEMAND

With more states opening, daily OpenTable data shows promising signs of customers returning to F&B even with these stores operating at limited capacity. An ICSC survey also showed people wanting to come back to physical stores once the pandemic is over. However, with retailers operating at limited capacity, having to adhere to safety guidelines and consumers fearing public places, the recovery will likely be slow.

FIGURE 6: Year-Over-Year Seated Diners at Restaurants on the OpenTable Network



Source: OpenTable.

IN CONCLUSION

Retail continues to be challenging and complex with different sectors of retail being hit differently. We will likely see more retailers and their landlords struggle to keep up with the changing landscape. Although the recovery seems long, there will still be winners. From a real estate point of view, locations with population and income growth will continue to attract foot traffic and drive rent growth. For landlords, a healthy mix of tenants who can provide stable and predictable cashflow is key. Those who are collaborating with their tenants and being innovative about their brick and mortar space will likely outperform others who do not. For retailers, those who have good liquidity, omni-channel, and keep engaging their customers through online and brick and mortar channels, and those who continue to provide value, convenience and experience to their customers are more likely to prevail.

However, with the current COVID-19 crisis, retailers and their landlords still must engage with the changing environment and consumer psychology. The coming quarters are crucial to see how retail gets back on its feet and adapts to the changes, and we will continue to monitor the trend as it unfolds.

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