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Brick and Mortar Retail Is Not Dead

Investors today are panicked that brick and mortar retail is dead. Yet research shows that over 50% of online sales are occurring through brick retailers, and that this share is growing. Furthermore, net retail asking rents have risen over 13 consecutive quarters, including an increase of 6% year-over-year in 2016. Lifestyle centers and mall rents rose even more. In addition, about 38.3 million square feet of shopping center space was absorbed in 2016, slightly down from 41.7 million square feet in 2015. In the first half of 2017, non-mall shopping centers saw 12.7 million square feet of net absorption.

Non-mall shopping center vacancy rates dropped from 7.7% and 7.3% at year-end 2015 and 2016, respectively, to 7.1% in the second quarter of 2017. NCREIF's retail vacancy rate stood at 7.4% in the second quarter of 2017, up 70 bps from the previous year, but down from the 10.8% peak seen in 2010.

Strong fundamentals are clearly reflected in the historical, as well as more recent, operating performance of retail REITs. From 2012-2017, Simon Property Group averaged quarterly annualized same-store NOI growth of 4.4%, while Regency's and Taubman's comparable metrics averaged 3.1% and 1.4%, respectively.

On a year-over year basis in 2016, Simon Property's leasing spread rose 13%, and NOI was up 3.8%, while Federal Realty's leasing spread was up 11%, and NOI was up 4.3%. Similarly, Macerich's leasing spread was up by 17.5%, and NOI by 2.2%. Kimco's leasing spread grew by 10.9%, and NOI increased by 2.2%, while Developers Diversified's leasing spread and NOI were up by 2.2% and 0.1%, respectively. Yet despite these performance metrics, the media peddles the myth that brick and mortar retail is dead.

Studies show that people are still shopping at brick stores. In fact, it may surprise you that in 2016, 95% of all retail shoppers shopped at a Walmart, 71% at Dollar Tree, and 77% at Walgreens, versus only 42% at super convenient Amazon. Furthermore, 43% of Americans shop at a brick and mortar store at least once a week, and 90% of Millennials shop at local stores, as do 87% of Boomers.

Brick and mortar retail stores are simply changing and evolving, which has always been the case. We have

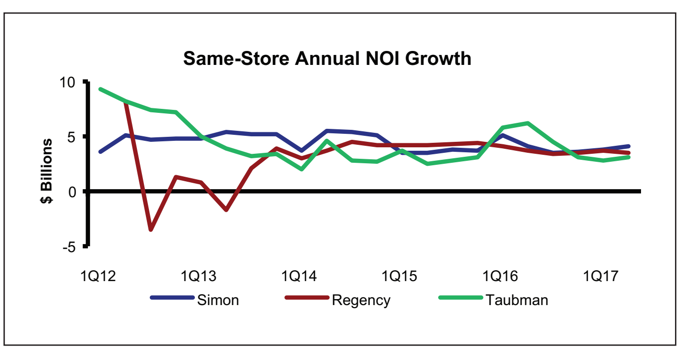

figure 1

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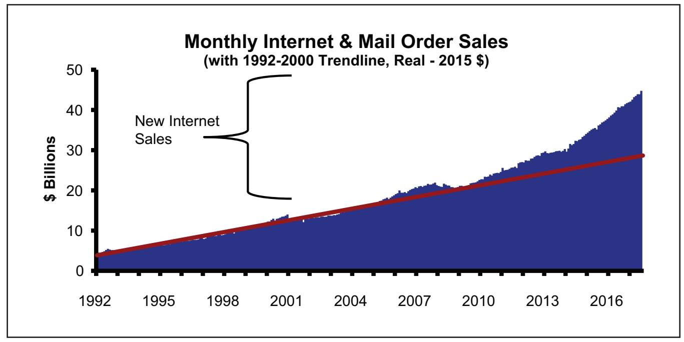
seen local downtown shops replaced by strip centers and overwhelmed by mega malls, only to be pushed aside by big box retail, which were then partially usurped by trendy open-air malls and specialty shops with a downtown feel! And the products available to consumers have changed dramatically as well. Thirty years ago, the food available at malls was awful. Today it is healthier, better presented, and more culturally diverse. As an example, Whole Foods' full buffet of hot prepared gourmet foods is a significant step up from yesterday's sad grocery salad bars.

In short, retailers have always died. The sector has a long history of once revered retailers meeting an unexpected demise. The retail cemetery is full of once strong retailers: McCrory, Ames, Corvettes, John Wanamaker, A&P, Marshall Field's, Montgomery Wards, Grants, Woolworth, to name just a few. All of these were once strong retailers who were killed by new and better retailers.

It is important to note that the Internet is not the killer of most dying retail centers. The enemy for retail centers and malls is an excess of retail space. Today's dead or dying centers were already mortally wounded 10-20 years ago, long before the rise of online sales. Built in the giddy days of suburban retail, they have been cut off from the customer base by newer and better centers or are located in neighborhoods which no longer are capable of supporting sufficient sales. These properties have managed to survive solely because tenants locked in cheap 20-30-year leases signed many years ago. This allows weak retailers to operate profitably in spite of dismal sales. As these ancient leases expire, these centers will die whether online sales exist or not.

Witha a record high of roughly 5,000 stores expected to close this year, headlines will continue to bemoan failing brick retailers. But to only focus on closures is like saying Penn graduated 4,000 students this year and suggesting that it will have no students in three years. The media inherently loves misery, as witnessed by their endless focus on murders, massacres, and obituaries — but not births. A die-hard media follower would think the nation's population is rapidly declining as thousands die daily, but no one is born. But with death comes birth. Nearly 200 online retail stores opened in 2016 and we expect more this year, as these new retailers seek profitability by reducing costs on the last mile.

The media gives short shrift to brick retailers recording strong results. These include Zara, H&M, Costco, Best Buy, TJ Maxx, IKEA, Home Depot, Aldi,



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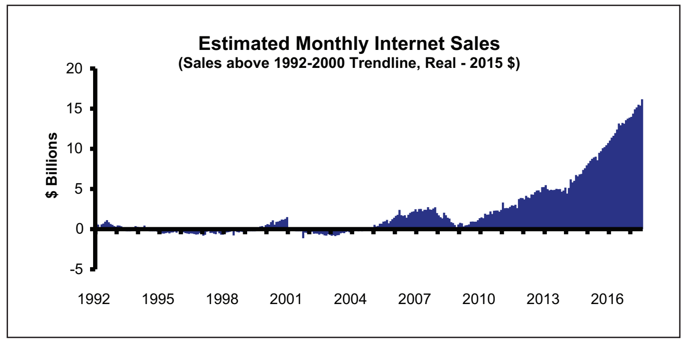

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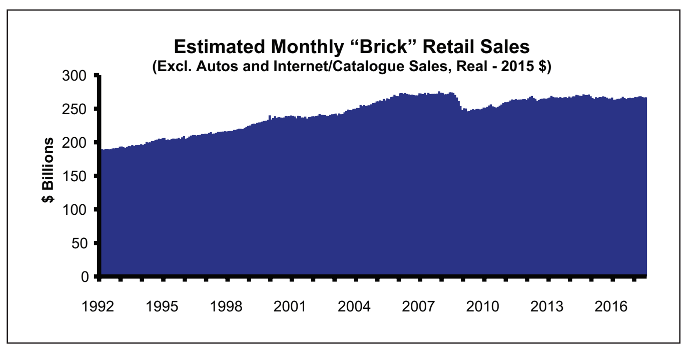

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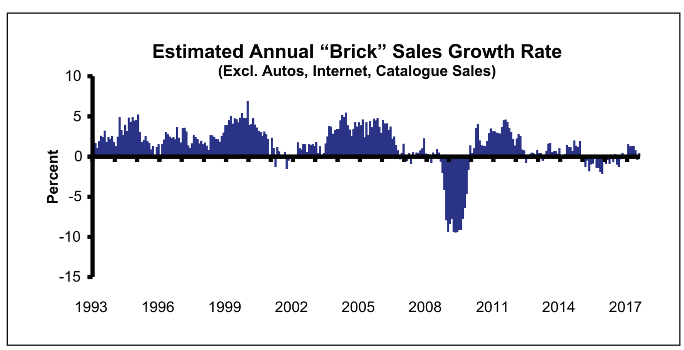

figure 5

and Walmart. Dollar General alone plans to open 1,000 new stores, Aldi another 900 over the next 5 years, and Lidl (Aldi's German rival) has plans for at least 100 U.S. stores, with rumors of up to 600. In fact, Lidl entering the U.S. grocery market and Amazon's purchase of Whole Foods indicate that these firms do not believe brick and mortar grocers are dead. And surely Whole Foods will seek to expand under Amazon's ownership. While Amazon will likely use Whole Foods stores as order fulfillment sites, their primary purpose will still be to provide a traditional grocery shopping experience.

Amazon, now a 20-year-old company, is the poster child of the supposedly unstoppable onslaught of online retailing. This onslaught was heralded in 2000 as an Armageddon that would wipe out all brick and mortar retail sales by 2020. Is the success of online retail really as dramatic as the headlines scream?

In 2000, prior to online retail, roughly $156 million of real retail sales were done via catalogs. This represented about 3.8% of real retail sales. We examined real electronic shopping and mail order sales from 1992-2000 (which were overwhelmingly transacted offline) and applied a linear trend line, which was projected forward starting in 2001. As illustrated by Figure 2, the projected trendline is far below actual electronic and mail order sales in 2017. The 1992-2000 trendline suggests that absent the appearance of online sales, real catalog sales would have averaged $27.6 billion per month in 2016 ($331 billion per year). This compares to actual inflation-adjusted catalog/online sales of $40.2 billion per month ($483 billion per year). Subtracting predicted real catalogue sales from actual real catalogue/online sales allows us to approximate the growth (an additional $152 billion per year) in online sales which have come at the expense of brick sales as opposed to the disintermediation of catalog sales by online sales.

Contrary to headline hysteria, real sales via bricks have merely slowed, not fallen, as online sales have soared. Netting out estimated catalog and online sales from total real retail sales (excluding autos) generates an estimate of real sales through bricks of nearly $3.2 trillion in 2016 and $3.3 trillion in 2017 (first half annualized), up from $3.1 trillion in 2010 and $2.8 trillion in 2000. So brick sales have hardly died as online sales occurred.

About Dr. Peter Linneman

Dr. Linneman, who holds both Masters and Doctorate degrees in economics from the University of Chicago, is the Principal of Linneman Associates. For over 30 years he has provided strategic and financial advice to leading corporations. Through Linneman Associates, he provides strategic and M&A analysis, market studies, and feasibility analysis to a number of leading U.S. and international companies. In addition, he serves as an advisor to and a board member of several public and private firms.

Dr. Linneman is the author of the leading real estate finance textbook, *Real Estate Finance and Investments: Risks and Opportunities*, now in its fourth edition. His teaching and research focuses on real estate and investment strategies, mergers and acquisitions, and international markets. He has published over 100 articles during his career. He is widely recognized as one of the leading strategic thinkers in the real estate industry, and was named among the top 30 "Most Influential People in Real Estate" by Commercial Property Executive in 2013.

He also served as the Albert Sussman Professor of Real Estate, Finance, and Business and Public Policy at the Wharton School of Business at the University of Pennsylvania until his retirement in 2011. A member of Wharton's faculty since 1979, he served as the founding chairman of Wharton's Real Estate Department and the Director of Wharton's Zell-Lurie Real Estate Center for 13 years. He is the founding co-editor of *The Wharton Real Estate Review*.

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