Retail REITs:

Identifying Value vs. Value Traps

Over the last fifteen years, REITs have offered portfolios a consistent source of alpha over the S&P 500, as well as diversification benefits. However, retail REITS have been hard-hit lately. The sector is trading at record lows relative to their valuation, nearly two standard deviations below the historic mean.

The decline can be attributed to a trifecta of conditions that have merged to create the perfect storm for the space. An oversaturated supply of retail square footage, the rise of e-commerce, and structural shifts in consumer habits have slowly eaten away at the profitability of traditional brick-and-mortar retailers. As a result, some experts project 20-30% of regional malls will close within the next 10 to 15 years. Below we discuss headwinds the Retail REITs sector is currently facing:

- **Oversaturation of retail space.** The US has more retail square footage per capita than any other country; nearly five times that of the UK, France, and Germany. There is simply too much retail competing for a share of the consumer's wallet. This year the market has seen a record number of store closings as companies fail to capture the attention of potential buyers. As businesses fail and stores close, mall owners are trying to figure out the most profitable way to repurpose the glut of empty storefronts. High end grocery chains, new entertainment concepts, more dining experiences, and service-oriented businesses are just some of the new tenants appearing in malls as owners attempt to stay relevant and solve their declining foot traffic problems.
- **E-commerce.** Online retail has experienced significant growth over the last several years, slowly chipping away at the revenues of brick-and-mortar stores. The U.S. Census bureau estimates that e-commerce as a percentage of total retail trade was up 14.0% from 2014 to 2015.[1] With e-commerce taking a growing share of the market, brick and mortar retailers will need to figure out a way to lure the consumer back. Increasingly, malls are shifting to an experience-driven model, like American Dream Meadowlands, a New Jersey retail and entertainment complex scheduled to open March 2019. The new destination mall is set to include an indoor ski slope, theme park, and water park, in addition to over 400 retail stores and 15 restaurants. Other retailers like Wal-Mart are trying to boost online sales while simultaneously bringing the consumer back to the store by offering discounts to customers who use in-store pick-up for merchandise purchased online.
- **Generational Change.** Millennials are reshaping modern consumer behavior, spending less time shopping in malls and more time online. They are much more cost conscious than previous generations, less brand sensitive, and are attracted to experience-driven living. One notable exception to this trend is the share of their income they are willing to spend on electronics. Their consumer habits are vastly different than preceding generations leaving companies with the challenge of how to lure them into physical stores.

[1] U.S. Department of Commerce, *E-Stats 2015: Measuring the Electronic Economy*

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Investors should approach the sector with caution when bargain hunting as such secular shifts have a tendency to turn inexpensive stocks into value traps. Secular shifts in spending patterns and consumer buying behavior have wreaked havoc on brick and mortar retail operations, with store closures and retail bankruptcies achieving levels only seen at recession depths in the past. Despite the intense short- and medium-term challenges facing retail REITs, we continue to find select areas that offer longer-term potential. We believe the old adage "Location, Location, Location" matters more today than ever before. Our focus is on quality – A+ locations, best in class real estate, quality balance sheets, and management teams that understand these secular shifts and are consciously evolving their tenant base to meet the changing customer preferences. We think these companies will not only survive the current storm but thrive in its aftermath.

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