Pandemic Accentuates Pressures on U.S. Commercial Retail Space as It Turbocharges Online Shopping

Admir Kolaj, Economist | 416-944-6318

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Highlights

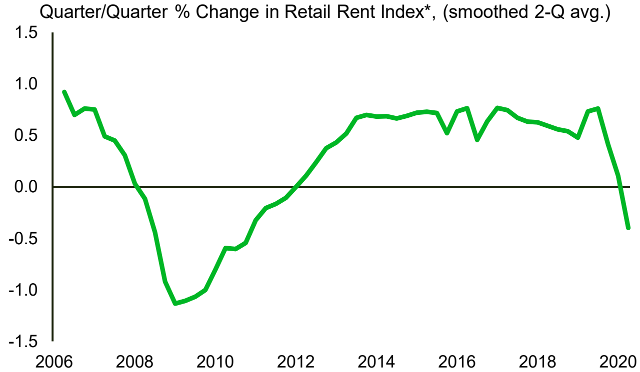
- COVID-19's double whammy of a soured labor market backdrop and a shift of consumer spending online will hit brick-and-mortar retailers and their space providers hard. The pain has already set in, a theme highlighted by rising retail bankruptcies and an increasing vacancy rate.
- Ongoing restrictions to stem the spread of COVID-19 will continue to weigh on demand and profit margins, with retail occupancy poised to erode further. The volatile nature of health crisis presents a great deal of uncertainty to the outlook. But, all factors considered, we expect the retail vacancy rate to peak at around 6.5%-7.5% in the quarters ahead.
- Despite a relatively thin construction pipeline that will help avoid excessive pressures from new inventory coming to market, the above vacancy rate range reflects a sharp jump from pre-pandemic levels of around 4.5%. This is in line with the unprecedented pressures that retailers and food services establishments will continue to experience during the health crisis.
- For all its negative impacts, the pandemic may also present some upside potential for select pockets of retail throughout the country. As consumers shift away from urban centers to less densely populated suburbs – a trend accelerated by the pandemic and the rise of remote work – consumer spending patterns are also poised to change. This could intensify downside pressures on demand for retail space in urban centers, while softening the pandemic's blow on suburban retail markets.

The COVID-19 pandemic is casting a long shadow on the U.S. commercial real estate market. In a previous report, we looked at its impacts on the office segment, where, among other things, a rise in remote work would be a key challenge for demand in office space in the post-pandemic world. In this report, we turn out attention to the retail market, another heavily impacted commercial real estate segment.

Like leisure and hospitality activities, traditional retailing through bricks-and-mortar stores took an early hit from the pandemic. While certain pockets of retail trade were able to keep the ball rolling, including supermarkets and grocery stores (which were deemed essential) and restaurants with preestablished delivery services, in-store activity in most other branches of retail ground to a halt soon after the pandemic struck. With many stores closed and consumers hunkering down at home under lockdown orders, online shopping gained in popularity.

Despite several headwinds, the commercial retail sector had managed to keep vacancies in check until recently. The pandemic has been a game changer, with the forced shift to online shopping

Chart 1: Commercial Retail Space Rent Growth Dives into Negative Territory



Source: CoStar, TD Economics. *Q3 is estimate.

adding to the woes of a bruised labor market backdrop. Together, a softer income profile and the tilting of consumer dollars toward e-commerce will weigh heavily on demand for retail space in the near-to-medium term. In this vein, an already-rising vacancy rate is expected to increase further, potentially rivalling the highs exhibited during the Great Recession. Meanwhile, already weakening rent and price growth are projected to fall further into negative territory (Chart 1).

The economy's recovery path, and that of the retail sector, will ultimately be determined by the progression of the health crisis. Nonetheless, in the pandemic's aftermath, a large proportion of consumers that increased their online spending during the health crisis are likely to stick to their new shopping habits in some capacity – an element that will also limit growth prospects for the commercial retail sector as it comes out of the crisis.

Pandemic Pain Sets In

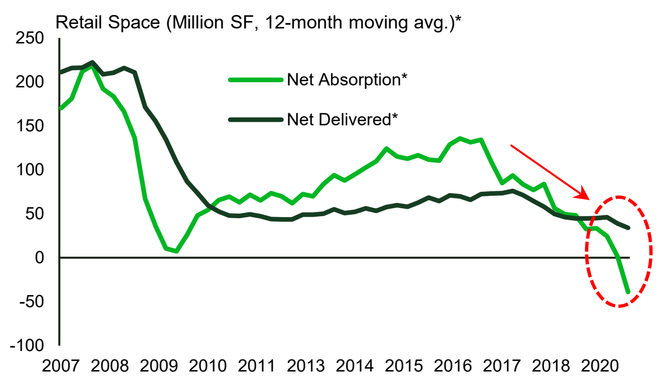
Up until the start of this year, the retail sector had a fairly low vacancy rate. In fact, the share of unoccupied commercial retail space in early 2020 was even lower than that prior to the Great Recession. This may seem counter-intuitive given news of large retail failures and bankruptcies in recent years. But, while bankruptcies have indeed been a problem, more conservative planning when it came to the construction of new retail space had been a major factor in helping the market digest new deliveries and keeping the vacancy rate low. As seen in Chart 2, the level of new deliveries in the past decade had been well below that prior to the Great Recession. And while demand for commercial retail space slowed notably in 2016, builders also eased off the accelerator, with net absorption of space still above net deliveries – that is, until recently.

The narrative has changed considerably this year with the outbreak of COVID-19. Not only is net absorption of retail space now undershooting supply, but it turned negative starting in the first quarter of the year. This is consistent with the immense pressures that the pandemic has brought to the sector.

Given the widespread lockdowns that took effect in late-March and April, retailers, like many other businesses in the country, suffered a severe falloff in commercial activity. Total retail sales recorded a decline of over 20% between February and April, but some sectors performed much worse. Sales at food and drinking establishments, furniture and home furnishing stores, and electronics and appliance stores all fell by over 50% during the two-month period, while sales at clothing and accessory stores – the worst performing category – fell over 85%. This weakness was echoed in the job market. Industry payrolls fell by 30% between February and April, with food and drinking places particularly weak as they shed about half of their headcount.

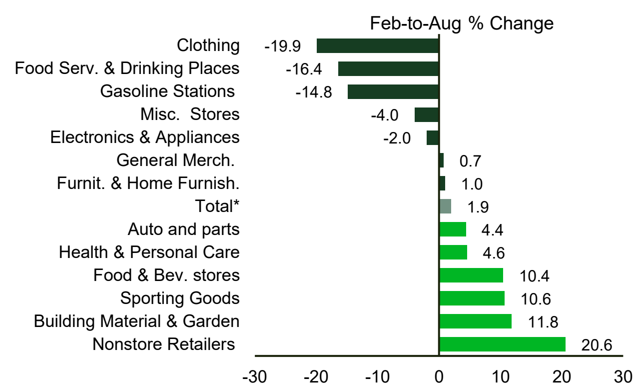
As lockdown orders were lifted and stimulus was injected in the economy, the sales trend improved considerably in the months that followed, with retail sales surpassing their pre-pandemic level as early as June. Retailers and food and drinking places rehired plenty of workers, with combined payrolls in August down only 11% from the pre-pandemic level. Meanwhile, as indicated by a recent survey of retail

Chart 2: Vacancy Rate Rising as Absorption of Retail Space Undershoots Deliveries



Source: CoStar, TD Economics. *Q3 is estimate.

Chart 3: Pandemic Delivered Huge Blow to Retail, but Some Categories Faring Better than Others



Source: BEA, TD Economics. *Retail sales and food services.

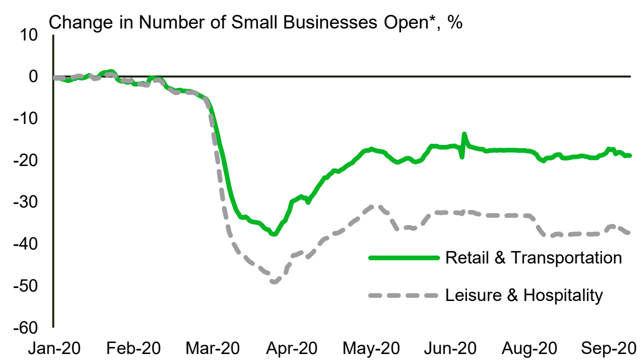
executives, the improved cashflow also allowed more retailers to meet a substantial part of their rent obligations.[1]

The speedy rebound in retail sales above pre-pandemic levels (and the more gradual recovery of related payrolls) is certainly a welcome development. But, after the initial rebound, the pace of gains has already slowed down notably in recent months. More importantly, beneath the headline, the story remains more nuanced (Chart 3). Several pockets of retail trade continue to struggle under the weight of the pandemic, most notably food services and drinking places, and clothing stores were sales are still down 16% and 20% respectively. And, while sales at many other categories may be at or above pre-pandemic levels, in many cases this has been accomplished in part through a massive rise in e-commerce. Gains in the latter would certainly help support a retailer's bottom line, but don't bode as well when it comes to demand for retail space.

Vacancy Rate Rises On Retail Closures

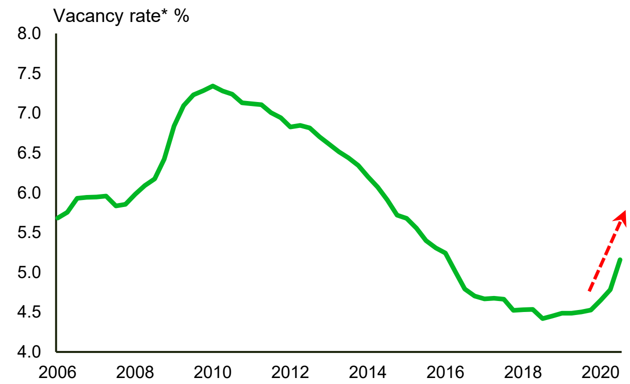
While federal stimulus measures, such as the Paycheck Protection Program (PPP), have helped some businesses stay afloat, many have had to close shop as the health crisis has unfolded.[2] Data from Yelp, a popular platform that offers crowd-sourced reviews about local businesses, indicates that permanent business closures are increasing, with restaurants leading the trend and retail establishments a close second.[3] Small business data from Womply corroborates a similar narrative, with the share of related businesses that are open still well below the pre-crisis level (Chart 4).

Chart 4: Share of Open Businesses Still Well below the Pre-crisis level



*Calculated as a seven-day moving average seasonally adjusted and indexed to January 4-31, 2020.
Source: Womply, TD Economics. Last observation September 13, 2020.

Chart 5: Retail Vacancy Rate Has Picked up, Expected to Rise Further



Source: CoStar, TD Economics. *Q3-2020 is last estimate.

Closures are expected to continue under a reduced-demand environment. Smaller independent establishments, which have more limited resources, appear to be at greater risk. Pressures appear to be particularly acute for smaller services-based establishments in densely-populated cities, including those with mass transit (think New York City), where persistently low foot traffic has dried up revenue and resulted in a high failure rate.

Larger chains, which have seen increased competition from e-commerce, aren't being spared either. Examples of large-scale retailers pressured by current climate are plentiful. For instance, the iconic Brooks Brothers, the oldest U.S. men's retailer, filed for bankruptcy and was subsequently sold to Simon Property Group. The buyer has committed to continue operating at least 125 stores. But, before the pandemic, the company operated more than 400 stores globally, with more than half located in the United States.

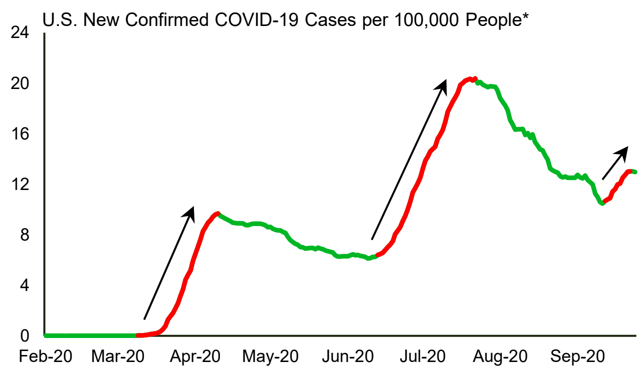
The list of retailers that have recently filed for bankruptcy is long, and it includes many more familiar names such as Neiman Marcus, J.C. Penny, GNC, Lucky Brand, J. Crew and Stein Mart. While filing for bankruptcy does not necessarily mean a full shuttering of operations, as in the case of Brooks Brothers, retailers are likely to come out of the restructuring process with a severely shrunken footprint. Bed Bath & Beyond marks another example, with the chain set to close 200 stores between now and 2022 in a restructuring move. As a result, the retail sector's vacancy rate, which has already perked up, is expected to head much higher – a trend that will be accentuated by the expiration or curtailment of moratoriums of commercial-real-estate evictions (Chart 5).

Reduced Activity, Restrictions To Continue Posing A Profitability Challenge

While restrictions on physical retail shopping eased somewhat as we headed for the summer, a surge in new COVID-19 cases in the late-June and early-July period caused many states exercise caution and hit the pause button on their reopening plans. A few states even rolled back some measures. For example, Texas, Florida and parts of California shut bars back down in late June as a response to a rising number in COVID cases. The virus' spread has risen again in recent weeks (Chart 6). The still-elevated spread and measures to contain the virus are likely to lead to a slower jobs recovery – a point corroborated by recent jobless claims data – and ultimately, a slower overall economic recovery. Combined with the expiry of some stimulus measures, such as PPP loans, or the more generous $600-per-week federal unemployment top-up, the elevated infection spread is likely to accentuate the pandemic's near-term sting.

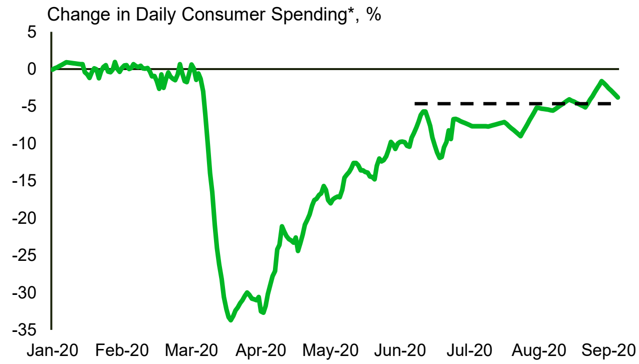
It is important to acknowledge that the country is not moving in uniform fashion when it comes to the spread of the virus. As such, the negative pressures will vary widely at the state and regional level, with areas under a stronger grip of COVID-19 to fare worse. That said, it is also worth noting that the pandemic will continue to prove challenging from a profitability standpoint even for retailers in areas that have managed to keep the virus' spread mostly under control. Given risks of a resurgence in the virus, many state and local governments that have eased restrictions still require retailers and food service and drinking establishments to operate at reduced capacity.

Chart 6: Elevated Infection Spread Likely to Slow the Recovery Process



*7-day moving average.
Source: NYT COVID-19 Repository, TD Economics.

Chart 7: Consumer Spending Trend Mostly Flat after Sharp Initial Recovery



*Seasonally adjusted credit/debit card spending calculated as 7-day moving average relative to January 4-31, 2020 in all merchant category codes (MCC).
Source: Affinity Solutions, TD Economics. Last data point September 13, 2020.

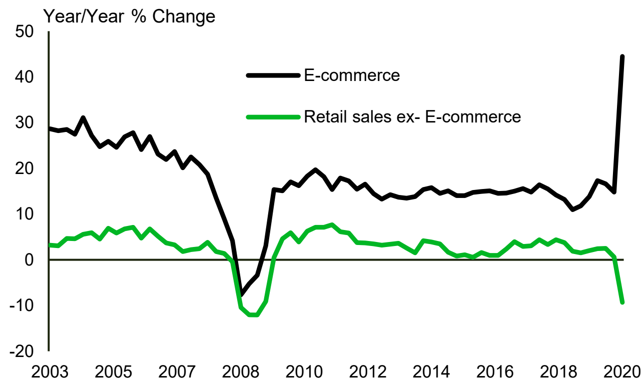
Other elements, such as beefed up cleaning and disinfecting procedures, or the need to provide employees with personal protective equipment (PPE) will also drive up costs and weigh on profitability.

Moreover, the health crisis has also brought to the forefront vulnerabilities from a consumer perspective, such as the inability of millions of Americans to afford paying rent. An eviction moratorium that has been extended through December, has helped. But, come the new year, a significant share of American households will face evictions and will each owe thousands of dollars in back rent. In the absence of an extension to the moratorium and additional income supports, these conditions would imply a pullback in consumer spending. For the here and now, consumer confidence and spending data also corroborate a more cautious view, with confidence measures still well below pre-pandemic levels and high-frequency spending data pointing to softer momentum (Chart 7).

Pandemic Accelerates Transition To E-Commerce

Intensive competition from e-commerce, which continues to grow its share of the sales pie, poses another major challenge for retail space, both in the near and longer term. Monthly retail sales data confirm the notion of an abrupt shift to e-commerce soon after the pandemic struck. While traditional bricks-and-mortar retailers struggled during this period, online retailers saw a surge in demand. Sales at non-store retailers, a category that is predominantly made up of online sales, shot up at the onset of the pandemic, and are up 21% from their February level, making this the best-performing retail trade

Chart 8: E-commerce Sales Shot up in the Second Quarter



Source: Census Bureau, TD Economics.

subcategory despite eased momentum in recent months. A more precise measure of e-commerce sales from the Census Bureau[4],which comes at a quarterly frequency, reaffirms this theme. It shows that e-commerce sales shot up 44.5% year-over-year in the second quarter of 2020, while retail sales recorded a leg down (Chart 8).

The pandemic is leading to a stronger reliance on e-commerce, both by intensifying online shopping for existing users, but also by bringing along plenty of new customers as it forces those that were reluctant to shop online to give it a try. With respect to the latter, surveys show that even a large share (close to 50%) of boomers, a segment of the population that overwhelmingly favor shopping in store, increased their online spending during the health crisis.[5] These trends are reflected in increased e-commerce penetration rates in a variety of product categories, including those traditionally dominated by physical shopping, such as grocery shopping. E-commerce food and beverage sales for instance, spiked 220% year-over-year in the second quarter – a major factor behind the recent surge in total e-commerce sales.

Consumer spending patterns tend to be sticky. Given the conveniences of e-commerce, we expect a good part of consumers to stick to their newly-developed online shopping habits in some capacity over the longer term. Investments to improve the online shopping experience, such as those in the delivery infrastructure, will help in this regard. Meanwhile, competition between established online retailers and more traditional brick-and-mortar stores that are stepping up their e-commerce efforts (i.e. Walmart and Target, which saw their online sales spike recently), is likely to yield added value for consumers, further improving the lure of online shopping and chipping away at in-store activity.

Down But Certainly Not Out

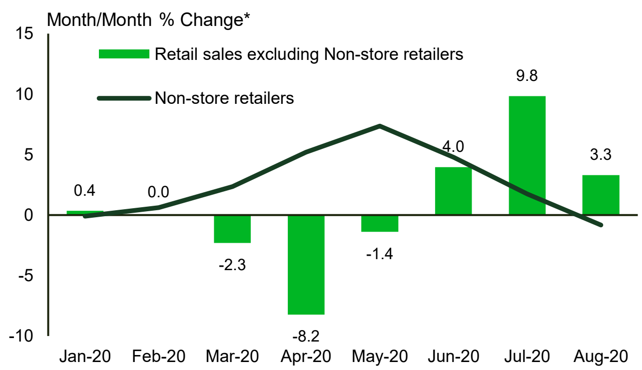
The longevity of the health crisis, which is ultimately tied to the virus' capricious path, is a major wildcard and presents a great deal of uncertainty to the outlook. But, ultimately, consumer spending and demand for commercial retail space are expected to recover in lockstep with gradually improving public health and labor market conditions. Fiscal stimulus measures, such as the $300-per-week supplemental unemployment benefits (less generous that previously, but still supportive), and more aid that's currently being considered in Congress, are added elements that should assist the recovery process.

Even as the labor market backdrop improves, in-store consumer behavior is likely to remain conservative until a vaccine is available. But, learning how to live with the virus is likely to translate into some resilience even in the absence of this silver-bullet solution. Businesses and consumers are now better prepared to deal with the virus than they were coming out of last winter. What's more, parts of the country have increasingly mandated mask usage within indoor public spaces, which is helping give consumers the confidence to return to retail outlets.

Earlier in this report, we cited the fact that consumer spending habits tend to be sticky, as an element that will support e-commerce sales in a post-pandemic world. The 'stickiness' to spending patterns however, cuts both ways, meaning that as the pandemic eases, a large share of consumers will also flock back to their older habits, such as shopping in-store and dining out. Patterns in monthly retail sales data lend credence to this view. As states eased restrictions in May and June, consumers flocked back to stores, while easing off the spending accelerator at non-store retailers (Chart 9). These concepts are not at odds with each other. To square the circle, while the online channel will continue to carve out a larger share of the sales pie as it grows at a faster pace, the vast majority of shopping will continue to be done the traditional way through bricks-and-mortar.

Improving public health conditions and the gradual return of demand will spur the creation of new businesses and support the signing of new leases, a trend that will be helped along

Chart 9: As Stores Reopened, Consumers Eased off the Spending Accelerator at Non-store retailers



*3-month moving average.
Source: Census Bureau, TD Economics.

by improved leasing terms (from a tenant's perspective). The latter include a generally lower rent environment and greater flexibility through the use of pandemic clauses, which have gained in popularity. Some landlords for instance, are allowing tenants to defer part of their rent payments in the event of another government-mandated shutdown. Increased flexibility through the use of these clauses will help move retail inventory along, as it helps would-be tenants commit to leases during periods of increased uncertainty.

For all its negative impacts on the commercial retail market, the pandemic may also present some upside potential for select pockets of retail throughout the country. As consumers shift away from urban centers to less densely populated suburbs – a trend accelerated by the pandemic and the rise of remote work – consumer spending patterns are also poised to change. This trend, together with a falloff in immigration inflows, could intensify downside pressure on demand for commercial retail space in urban centers. Conversely, it could help soften the pandemic's blow on suburban retail markets, especially if the crisis proves protracted and population shifts become more permanent.

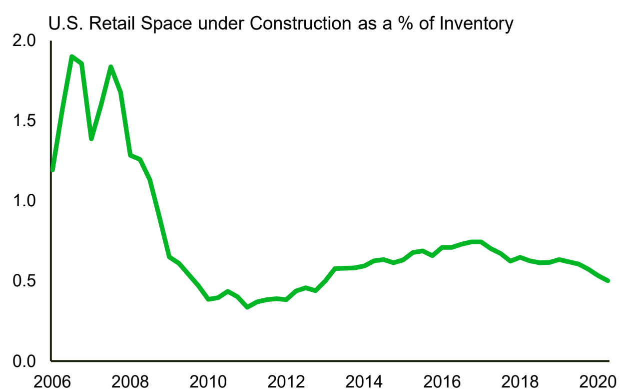
Supply Side To Help Limit The Pandemic's Blow

A relatively thin construction pipeline is another important element that will help limit the pandemic's blow. Pockets of excess space do exist in some large metros, such as in San Francisco and Miami, but these are few and far between. Overall, the amount of total retail space currently under construction in relation to available inventory (0.5%), is much lower than at the start of the Great Recession (over 1.5%; Chart 10). This means that during this downturn, the retail segment won't feel the excessive burden of an onslaught of new space hitting the market.

The repurposing of retail space should also help soften the pandemic's impact on vacancies at the margin. The U.S. has a lot of retail space, with "square footage in shopping centers per capita twice the rest of the world" according to Savills.[6] When space sits empty for a prolonged period, it is often repurposed. This strategy is expected to see greater use as occupancy erodes further. A recent NAR study found that the main alternative uses for vacant mall space were: warehouse and distribution centers (16% combined), mixed use (i.e. residential, office, retail; 16%), multifamily/residential (7%), health care facility (4%) or education facilities (4%). With more consumer dollars tilting toward e-commerce, transforming retail space into a warehouse or logistics hub could certainly be a feasible option in some cases. In this vein, Amazon is considering turning J.C. Penney and Sears stores into fulfillment centers. On the other hand, given that pressures from the health crisis and the ensuing recession span the other branches of real estate (i.e. office and residential) and will squeeze a government's fiscal space, the other alternative uses mentioned above are likely to prove less popular.

All factors considered, we expect the retail vacancy rate to rise further in the quarters ahead – a trend that will exert significant downward pressure on both rents and prices – and peak at around 6.5%-7.5%, with the wide range reflecting elevated uncertainty under the current environment. Evidently, the midpoint of this vacancy rate range is still somewhat below the 7.3% peak experienced during the Great Recession. While this may seem counterintuitive, re-

Chart 10: Moderate Supply Pipeline Will Help Limit Some of the Downside Risk



Source: CoStar, TD Economics. *Last data point estimate: Q2-2020.

call that the vacancy rate is starting from a much lower base of around 4.5% this time around, instead of around 6% just prior to the start of Great Recession. The relative jump from these levels to the respective peaks is higher this time around – a theme that's in line with the unprecedented pressures that retailers and food services establishments are experiencing during the pandemic, including a complete halt to operations. However, pressures will vary widely throughout the country, with densely-populated urban areas generally at higher risk.

Bottom Line

COVID-19's double whammy of a soured labor market backdrop and a shift of consumer spending online will hit brick-and-mortar retailers and their space providers hard. The pain has already set in, as highlighted by rising retail bankruptcies and an increasing vacancy rate. With restrictions to help stem the spread of COVID-19 to continue weighing on demand and profit margins, retail occupancy is poised to erode further, while rent and price growth are headed for deeper negative territory.

The virus' path is a major wildcard and presents a great deal of uncertainty to the outlook. But, while the pandemic will indeed bruise demand for stores and the shift to e-commerce will weigh on the speed of the recovery, it's important to recall that physical retail locations, bars and restaurants are here to stay. Consumer spending and demand for retail space are ultimately expected to recover in lockstep with improved public health and labor market conditions.

Regional experiences will vary, with densely-populated urban areas likely to bear the brunt of the pandemic. But, all factors considered, we expect the nationwide retail vacancy rate to peak at around 6.5%-7.5% in the quarters ahead. This implies a sharp jump from pre-pandemic levels, which is in line with the unprecedented pressures that brick-and-mortar retailers and food services and drinking places will continue to experience during the health crisis.

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