October 02, 2020

Economics Group

Special Commentary

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Retail After the Pandemic

The COVID-19 Crisis Has Upended Retail, but Better Days Are Ahead

The economy appears to be firmly on the path to recovery. After collapsing in the second quarter alongside the COVID-19 induced lockdowns, all signs point to a consumer-led bounce-back in real GDP this past summer. Consumer spending, which drives a large share of economic growth, turned around fairly quickly despite massive job losses thanks to fiscal relief measures which provided direct stimulus checks and expanded unemployment benefits. Moreover, employment in professional services, construction and parts of the manufacturing logistics sectors rebounded fairly quickly. Further, spending on goods that help consumers adapt to more time at home has increased. Spending on goods such as groceries, cars, home furnishings, electronics and sporting goods have all risen beyond the highs seen at the start of the year. On the contrary, close-contact services spending remains depressed and will likely remain so until a vaccine is successfully developed and widely available.

While the economy is on the mend, the climb to higher altitudes will likely endure some turbulence. For starters, uncertainty surrounding the trajectory of COVID-19 continues to loom large. The summer surge in COVID-19 cases across the southern half of the country appears to have subsided, but infections are now on the rise in some Mountain and Midwest states. The concern is that cooler temperatures may intensify the spread of COVID-19 throughout the country as many stop-gap measures such as outdoor dining and curbside pickup become less viable and people spend more time indoors. The pace of improvement in recouping jobs lost to pandemic mitigation efforts has also slowed, as employers have rebalanced headcounts with new occupancy limitations and softer demand. Moreover, funding for expanded unemployment benefits (prolonged by executive order after expiring in July) is running dry. Absent another round of fiscal stimulus, a still-cautious consumer may go into hibernation later this fall and winter. In short, the economy continues to improve, but continued progress will be more challenging.

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Figure 1

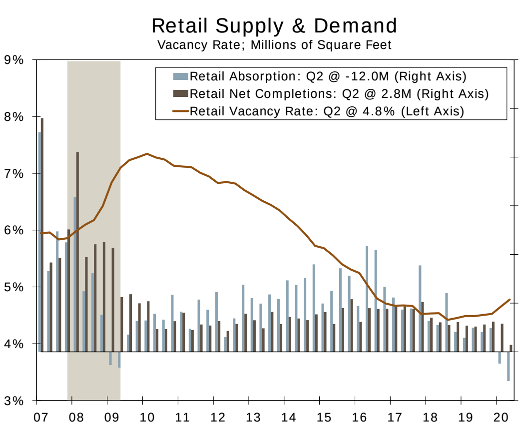
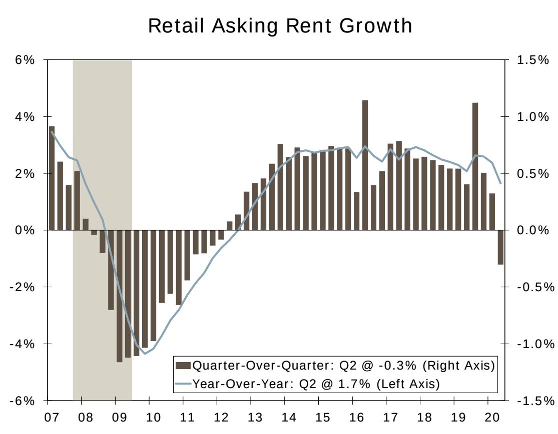


Figure 2



Source: CoStar, Inc. and Wells Fargo Securities

Together we'll go far

Retail vacancy rates rose to 4.8% in the second quarter, the highest since 2016.

While the economy is in a much better place compared to just a few months ago, the same cannot be said of the retail sector. Vacancy rates rose to 4.8% in the second quarter, the highest since 2016. Similarly, asking rents registered their first contraction since 2013, falling 0.3% over the quarter. Retail's struggles have continued into the fall, even as broader economic activity has improved, and leasing activity is still running at about half of its pre-pandemic pace. Furthermore, occupancy limits and the reluctance of consumers to spend a meaningful amount of time shopping inside physical stores have pushed a growing list of retailers into bankruptcy. Shopping malls and power centers have been hit particularly hard, as have many smaller centers that had shifted their focus to entertainment, experiences and dining (all of which are less susceptible to online competition) have found themselves in an uncomfortably weak position amid prolonged business shutdowns and social distancing requirements.

That noted, it is hard to blame retail's recent hardships entirely on the coronavirus crisis itself. Large numbers of brick-and-mortar retailers were struggling well before the outbreak. Department stores, which are often key anchors at malls and shopping centers, have been under tremendous strain for decades, losing market share initially to discount stores, later to big box category killers and more recently to warehouse clubs and online competitors. And then, there is the question: how many retail stores do we even need? According to Cushman & Wakefield, the United States is estimated to have both the most square feet of retail space per capita and the lowest retail sales per square foot when compared to other industrialized economies. This outcome was achieved even as new retail development has slowed to a crawl for much of the past few years. Even without a pandemic, the rationalization of some of this supply was predictable.

While some correction in terms of supply was probably in order, the coronavirus crisis is nevertheless a demand shock which will hasten the demise of formats that have been slow to adapt to shifts in consumer behavior and increased competition from online retailers. Many retailers were already struggling to catch-up to the increasing share of sales executed on online, a trend which has turned sharply higher on the back of social distancing and general aversion to public spaces. Not surprisingly, non-store retail sales have surged over the past six months and remain elevated despite many areas of the country re-opening (Figure 3). Considering that the high cost of social interactions has forced many to discover the benefits of online shopping quicker than they otherwise would have, we expect this higher share of e-commerce sales to be long-lasting.

Not every segment of retail is in dire straits. Retailers that offer curbside service and provide products that augment or enhance home living spaces, including furniture, appliance and home electronics, have generally outperformed. Building material stores, such as Lowe's and Home Depot, and big box stores with robust e-commerce platforms, such as Walmart, Target, Staples and Best Buy, are holding up well. Grocery stores and pharmacies, especially those providing online-ordering, and delivery, drive-thru and pick-up services, have also faired relatively well.

Figure 3

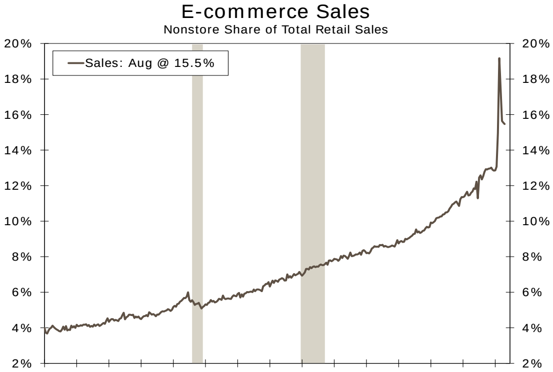
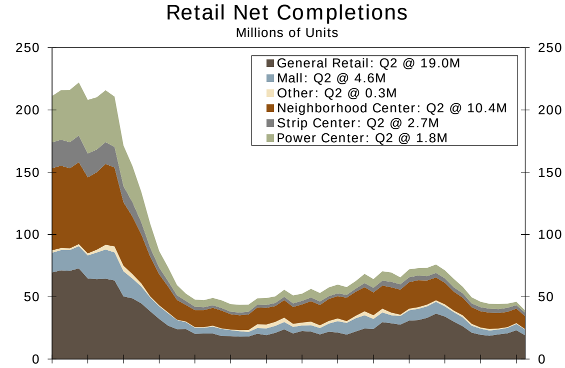


Figure 4



Source: U.S. Department of Commerce, CoStar, Inc. and Wells Fargo Securities

While some have been successful, most retailers are likely wondering when business can get back to normal. A safe, effective and widely-available vaccine is likely a prerequisite to a return to a more typical business environment. While a vaccine does looks promising, with a number of vaccines currently in Phase 3 trials, full approval of a vaccines likely will not be available until next summer (although targeted rollouts may begin late this year). In the meantime, rapid antigen tests, which are cost-effective and produce results in minutes, may allow some close-contact retail businesses to resume more normal operations sooner. Still, even with these advancements, it will be some time until the retail sector finds a more secure footing.

Looking further ahead, the COVID-19 crisis will likely serve to accelerate several prominent trends that were already in place before the pandemic. For example, town-center properties, which are mostly outdoor and walkable, stand to benefit in a world of social distancing and preference for open-air activities. The resiliency provided by these outdoor shopping and entertainment venues is likely to remain in high demand, even after the pandemic. Many of these spaces incorporate residential, office and entertainment, as well as nontraditional options such as playgrounds, gyms, banks, hair salons and medical facilities. Not only do we see town-center formats flourishing, but we also see many traditional enclosed shopping malls transitioning toward this format. This would offer some protection if we saw the virus or a variant reemerge. There is some precedent for this as China and East Asia have dealt with a series of viruses over the past 20 years. Here in the United States, the last major pandemic, the 1957-58 Asian Flu Pandemic, reappeared 10 years later in 1968.

Rising homeownership should be a solid tailwind for centers that feature restaurants and experience retailers.

Another trend that seems poised to gain momentum is the move by e-commerce companies to open brick-and-mortar locations in highly trafficked areas. These locations, with showrooms that allow customers to test newly introduced products, enable firms to build their brands and deepen customer relationships. Rising homeownership should also be a solid tailwind for operators of neighborhood centers and smaller strip centers that feature restaurants and experience retailers. Along those same lines, demographics will play a key role in shaping the retail landscape over the longer-term. Retail tends to follow population growth, and we expect that the move away from high-cost city-centers towards the more affordable suburban areas will induce a similar shift in retail investment. We do not expect consumers to abandon urban areas, but rather see city-centers account for a smaller proportion of metropolitan area growth. Suburban areas are also expected to become more urbanized and more walkable.

There is still a lot of uncertainty on how the COVID-19 crisis will alter consumer behavior. Differing consumer preferences among age cohorts will present new opportunities for retailers. The baby boomer generation are transitioning out of their prime spending years and being replaced, in terms of purchasing power, by Generation X, millennials and Generation Z, who have sharply different preferences when it comes to shopping. In contrast to the generations before them, millennials tend to prioritize the overall experience of shopping as opposed to actual product ownership. One residual effect of more virtual and less social interaction will be an increased need for more experience-driven and communal endeavors outside the home once the pandemic subsides. Properties that go beyond the typical mixed use shopping centers and have concert areas, locally-sourced artisanal eateries, gardens, and art galleries should continue to draw in a high number of this cohort.

Retailers that cater to Generation Z should be poised for success in the coming years.

Several distinct preferences appear to be emerging for Generation Z (those born after 1996). Having spent their formative years during the Great Recession and its recovery period, the Generation Z cohort prioritizes savings over spending, yet quality over price. They also have never known a time without access to internet and thus consume media and information more than products. They utilize technology like no prior generation to source opinions from both friends and outside influencers, and also vet products for quality and authenticity. While millennials are experience-driven, Generation Z appears to value in-store shopping in order to validate the quality of a product. They also prefer to visit stores to develop their own opinions on products and become influencers themselves, for example through in-store classes or product tutorials. Retailers that cater to this generation by offering high-quality products, brick-and-mortar locations and a high degree of digital access and knowledge of sharing capabilities should be poised for success as Generation Z usurps millennials in terms of purchasing power in the coming years.

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