Commentary
The Grand Reopening Experiment: What it Takes to Thrive After the Pandemic

DBRS Morningstar
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DBRS Morningstar Perspective

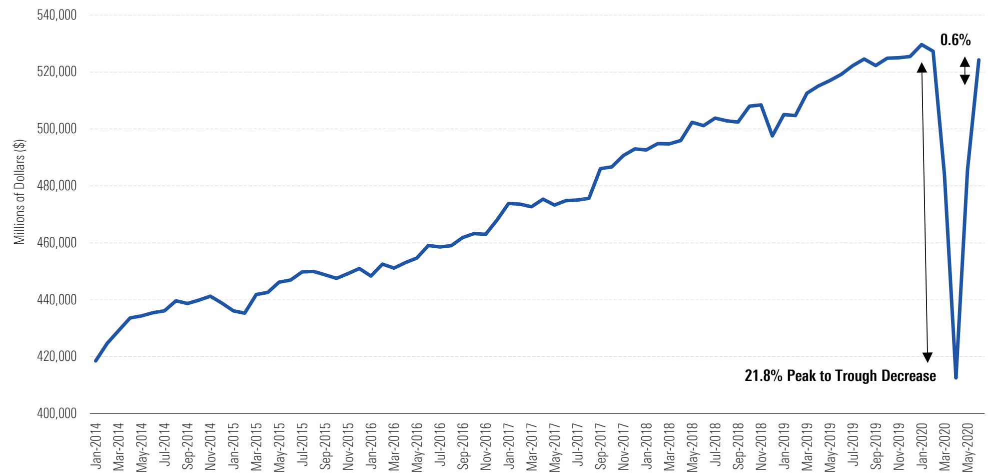
Although the Coronavirus Disease (COVID-19) pandemic has continued to take its toll on an already struggling retail industry, it's not all doom and gloom. Yes, falling consumer demand and nonessential businesses staying closed have caused several major retailers to file for Chapter 11 bankruptcy protection and announce store closures. However, DBRS Morningstar found several trends in the retail industry that will continue to benefit certain retailers. Companies that have created an effective omnichannel marketing strategy are more likely to succeed compared with their less-adept competitors. In addition, as e-commerce takes a larger share of the retail pie, retailers that invest in technology as part of their omnichannel approach may see higher returns on their investment than their weaker competition. As more people work from home, businesses with strong suburban operations could benefit as people move further out from cities. Finally, everyday consumers are looking to save money, favoring discount retailers, while wealthy shoppers will still gravitate toward luxury brands.

The Present State of Retail

Before diving into the potential future, it's important to reflect on the what's happening now. Bankruptcies since the pandemic began include J.C. Penney Company, Inc., Pier 1 Imports Inc., Neiman Marcus Group LTD LLC, Stage Stores Inc., and Tuesday Morning Corp., among others. They have also announced hundreds of store closures. Even otherwise healthy companies have closed stores, such as Microsoft Corp.'s announcement in June that it will shutter all 83 of its retail outlets to focus on online sales and reimagine select stores as experience centers. Since March, 214 U.S. retail loans in commercial mortgage-backed securities (CMBS) have transferred to the special servicer because of coronavirus-related stresses. According to our Viewpoint platform, this translates to approximately $10.7 billion, which represents approximately 6.4% of the entire universe of CMBS retail loans.

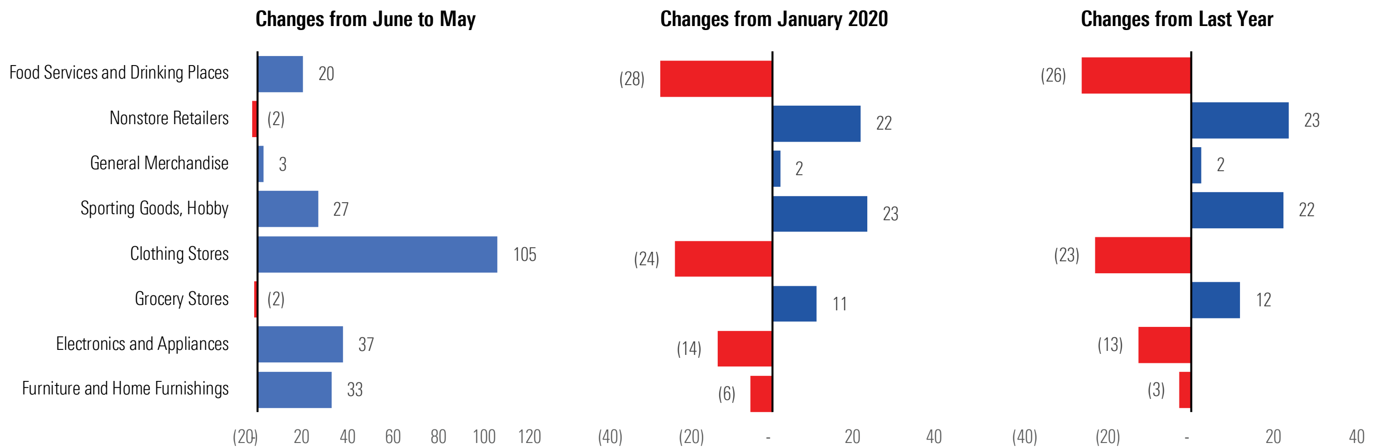
Since March, more than a quarter of the job force, at least 47 million people, have filed for unemployment benefits as of mid-June, according to the U.S. Department of Labor. In April, consumer spending dropped to a revised 14.7%. Although retail sales rebounded a revised 18.2% in May and a further 7.5% in June, sales over the April to June period are down 8.1% year over year across all sectors; clothing sales and food service retailers look to be hit the hardest, down 23% and 26%, respectively, from a year ago. With an increasing number of retail loans going into special servicing, retail has been and will be strongly affected by the coronavirus pandemic. In a moderate scenario, DBRS Morningstar estimates U.S. GDP will decline by 5.0% for 2020 and that unemployment will average 10.0%, indicating long-term economic effects from the coronavirus. For more information, please read *Global Macroeconomic Scenarios: June Update*, published June 1, 2020.

Exhibit 1 Monthly Retail Sales



Source: U.S. Department of Commerce.

Exhibit 2 Monthly Retail Sales Across Categories (%)



Source: U.S. Department of Commerce.

Even with the slow reopening of the U.S. economy as lockdowns begin to lift, social distancing measures may continue for months. The stores that will open are set to have social distancing guidelines and measures in place that reduce transmission possibilities, which could reduce foot traffic and keep a lid on sales as consumers continue to shop from home.

The pandemic has become an existential threat to many retailers, especially to those that were already experiencing declining performance. With the onset of the pandemic, these businesses faced even lower sales as stores shut down and consumers held back on discretionary spending in the face of an economy on shaky ground and a murky job market. Businesses with high levels of debt are most

affected by these changes; however, across the board, companies have requested deferments of rent or simply have stopped paying. For instance, Simon Property Group, Inc., the largest mall operator in the United States, sued Gap Inc. (Gap), claiming that it "failed to pay more than $65.9 million in rent and other charges during the coronavirus pandemic."[1]

The Winners and Losers of the Future

Below are some key trends that DBRS Morningstar believes will differentiate the winning retailers from the losing ones.

Omnichannel

Omnichannel retail describes retailers that sell products across different physical and digital channels and integrate each channel seamlessly. An example would be a robust e-commerce offering that seamlessly integrates with physical spaces. Greg Melich of Evercore ISI, an investment banking advisory firm, told CNBC that before the coronavirus hit, its consumer survey showed that customers wanted to shop more at stores that had multiple channels and less at those with only a physical or digital presence. Diversifying away from a singular mode of sales is essential, with emphasis toward building a strong e-commerce capability. Average daily online sales jumped 25% between March 11-13 and March 1-11, according to Adobe Analytics, compared with a 14% compound annual growth rate over the past four years. However, even retailers with a large physical footprint have chalked up strong online results. Walmart Inc. (Walmart), for instance, which benefits from a powerful logistics and distribution network, reported a 74% increase in sales through its Walmart.com platform in Q1 2020. In addition, it acquired Bonobos several years ago. The men's fashion retailer doesn't hold inventory in store, but rather completes all orders online.

In addition, Target Corporation (Target) has been able to successfully leverage its omnichannel offerings to drive business during the pandemic. During its Q1 2020 earnings call, Target indicated that stores fulfilled nearly 80% of its digital sales, which rose 141%. Further, 80% of its digital comparable sales were fulfilled online, and Target was able to sustain a digital order volume that it was not expecting for the next three years because it used stores as fulfillment centers. Target was able to utilize its omnichannel infrastructure to meet customer demand effectively.

Grocery stores have also shown their ability to shift into the online space with increased online sales of 22% in 2019, according to the Coresight Research U.S. Online Grocery Survey 2020. In what may portend a shift in the grocery business, Stop & Shop announced three new "warerooms" and at least 50 more pickup locations. Although it also uses delivery services like Instacart and Peapod for order fulfillment, customer comfort with buying food online has clearly increased and may reduce the need for physical locations in the future. There are also several new companies, including CloudKitchens, that are starting to operate ghost kitchens that serve as delivery order fulfillment centers.

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1. Lauren Thomas/CNBC, The Biggest U.S. Mall Owner, Simon Property, Sues Gap Over Skipped Rent Payments, 2020.

By contrast, one brand that has struggled is Victoria's Secret and its parent company L Brands, Inc. While it has failed to capture changing consumer tastes regarding body positivity and female empowerment, it has also not made enough of a shift to reducing its reliance on in-store sales. Morningstar, Inc.'s (Morningstar's) equity team estimates that "80% of consolidated transactions occurred in store during 2019, and as such, the company has spent more than three quarters of capital expenditures ($458 million in capital expenditures, or 3.5% of sales in 2019) refurbishing stores and updating retail locations. We admit this could change in a post-COVID-19 world given expected store closures over the next few years… Still primarily concentrated in malls, which have seen declining footfalls in recent years, L Brands has failed to expand consolidated margins."

A company like GNC Holdings, Inc., which filed for Chapter 11 bankruptcy protection on June 23, is another example of a company that has struggled with managing its high debt load with its reliance on in-store sales. The vitamin and health product provider said it plans to close between 800 and 1,200 stores.

Changing Consumer Behavior

As people continue working from home, several company leaders have had to navigate what the future of their office and working balance would look like. Morgan Stanley's chief executive officer indicated in an interview with Bloomberg Television that more of its employees would work from home in the future and that the company would have to re-evaluate its real estate needs as productivity remains consistent with before the pandemic. The likely result will be that companies will embrace a hybrid work-from-home and work-from-office policy that means employees will spend more time at home.

This rapid shift in behavior will both challenge and benefit retailers as consumers change their behavior. As people work from home, companies operating in comfortable athleisure will be able to capitalize on existing trends and increase their growth. One such retailer is Lululemon Athletica Inc., which has seen strong growth over the past couple years as a provider of high-quality athleisure. Although the company reported net revenue dropped 17% year over year, with same-store sales down 36.3%, this may be the result of fitness centers being completely closed during the pandemic shutdown. As gyms begin to open and more people venture outside, we may see the company's sales performance turn around.

In contrast, Brooks Brothers, a high-end clothing retailer, is a casualty of increased work-from-home trends. The company was already struggling before the pandemic hit because of relaxed dress codes among white-collar workers. Then on July 8, it filed for Chapter 11 bankruptcy protection after temporarily shuttering stores and furloughing 80% of its employees, per Business Insider, as states issued stay-at-home orders. According to CNBC, citing people familiar with the matter, potential bidders are looking to buy the company out of bankruptcy and to reduce its bricks and mortar footprint, presenting further headwinds for the brand and its operations.

Further, with more time at home, there has been an increased investment in home goods and home improvement, with brands like The Home Depot, Inc. (Home Depot) and Lowe's Companies, Inc. (Lowe's) reporting higher sales for Q1 2020. Home Depot has also benefited from booming omnichannel sales,

announcing 79% year-over-year online sales growth during its quarterly earnings call. Online sales made up 15% of sales, with curbside pickup accounting for approximately two-thirds of these sales in the quarter, representing just under 10% of total sales in April 2020.

These are also examples of brands that are likely to benefit from the trend of dedensification, as people move out of the cities and toward suburbs. It's too early in the coronavirus pandemic to know definitively how many people will leave cities, but the shift began before the pandemic. William Frey, a demographer at the Brookings Institution, told the New York Times before the pandemic "there was a dispersion from larger metros to smaller metros," as the country's three largest metropolitan areas—New York, Los Angeles, and Chicago—all lost population in the past several years.

As these cities become significantly more expensive, and have high levels of population density, workers are exploring alternatives to public transportation. Working professionals, who will be working from home increasingly, may explore more spacious and affordable places to live, as discussed in our piece titled *Expand or Contract? Ramifications of Coronavirus on the Office Market*. The volume of people reconsidering city living appears to be growing since the pandemic hit. According to real estate company Redfin, page views of homes in small towns (populations less than 50,000) more than doubled during the last week of April compared with last year. And according to a survey of New York City residents conducted by Jefferies, the investment bank, 23% of the respondents said that they would move out of the city within the next 18 months. Retailers with strong suburban exposure may benefit from this shift, with Lowe's being one example.

Midtier Retailers Possibly Squeezed

With declining discretionary spending, rising employment uncertainty, and the omnipresent fear of the coronavirus, consumers are looking to save money, demonstrated by the U.S. savings rate hitting a record 33% in April as Americans stockpile on cash. One sector that is bucking the online trend is discount apparel. The TJX Companies, Inc. (TXJ), which owns T.J. Maxx, Marshalls, and HomeGoods, among others, essentially shut down their small online channels with no plans to reintroduce them. These brands, which have seen strong sales in recent years, rely on a treasure hunt experience in stores. The low pricing, combined with varying inventory across stores, may be more difficult to replicate in an online platform. TJX, for example, targets undercutting conventional retailers by 20% to 60% by using its flexible merchandising network, no-frills stores, and in-store experience to drive sales and inventory turnover. TJX reported positive reopening numbers after shutting down its stores because of the pandemic, with 85% of its stores currently open. TJX has been able to sell merchandise via massive discounts, increased demand in its home decor goods, and initial excitement behind its stores reopening. T.J. Maxx is also doubling down on gearing consumers toward stores, confident in the experience that it has created. For example, it uses its online platform to promote in-store pickup. E-commerce lowers the company's margins.

On the other end of the spectrum, high-end retailers such as Hermes and Louis Vuitton have also experienced reopening success, with a Hermes store in Guangzhou, China, selling $2.7 million worth of items in its first day open, according to Women's Wear Daily, citing multiple sources. A prepandemic

world saw spending on luxury physical products dropping as shoppers started to spend more on experiences. However, caution behind traveling, going to restaurants, and other in-person experiences, should draw the rich to spend more on luxury products, creating strong momentum for luxury brands. These stores will have to also account for the hesitation for in-person experiences by developing a more robust omnichannel shopping experience, as foot traffic will likely fall.

By comparison, retailers in the middle price bracket will likely suffer. Companies such as Gap, which is closing stores throughout the world and holding back rent payments, is one such company that is feeling some of the effects of customers curtailing spending, among other things. Gap's three major brands are Old Navy, Gap, and Banana Republic, which all have significant name recognition. "Gap claims 89% awareness of its namesake brand in the U.S.," per Morningstar's equity team that covers Gap, "We do not think any of them has the differentiated product or brand strength for sustainable premium pricing. While Gap is a share leader in some categories, it is highly dependent on basic apparel like T-shirts, jeans, shorts, polo shirts, and sweaters. Moreover, we do not believe Gap has any cost advantage as its outsourced production process is like that of competitors." Gap is being squeezed in terms of costs by the lower-priced discount retailers and fast-fashion brands like H&M and Zara on one end and by e-commerce providers like Amazon.com, Inc. on the other. As consumers move toward lower-end and discount prices, companies like Gap, without major product differentiation, are providing products at higher costs compared with its competitors.

Old Navy is Gap's strongest performing brand. "According to a recent presentation, Old Navy generates about 80% of Gap's operating profit," said Morningstar's equity team. It is the one brand among the three that offers lower prices. Comparatively, Gap and Banana Republic are in the midtier price range, with several competitors and no pricing advantage to capitalize on pandemic-related trends. Banana Republic also sells more upscale clothes than Gap and Old Navy, often intended for business-casual settings. However, the casualization of clothing adds additional difficulties for the company.

The Future of Retail

How are things going to open back up? With people feeling uneasy about shopping for fear of contracting coronavirus, brands will have to open their stores with caution. Stores are going to have reduced maximum capacities as they try and maintain social distancing, but other features of the standard in-store experience will have to change as well. For instance, Macy's, Inc. announced that it will require everyone that tries on watches to sanitize their hands first and that any clothes customers try on will be held as inventory for 24 hours. These are also some of the changes that the United Kingdom implemented when it opened nonessential retail businesses on June 15, 2020. With these changes to the shopping experience and reduced foot traffic, especially until there is a vaccine, investments in omnichannel customer engagement will remain a significant trend, with a prosperous e-commerce channel essential. For instance, brands like Warby Parker, an eyewear retailer that began online, introduced an offering last year on its website where shoppers can try on different glasses at home through an augmented reality-based technology. Allowing customers to mimic an in-store experience as closely as possible, through technology, remains essential.

For retailers to succeed going forward, DBRS Morningstar believes that an e-commerce offering as part of an omnichannel strategy, adapting to changing behaviors because of coronavirus, and honing on price differentiation will be key. There are already examples of businesses achieving this. Several upstarts over the past few years that began as purely e-commerce brands, have ventured into the brick-and-mortar space with success, combining their initial online offering with in-person experiences to help develop the brand. These brands are called digitally native vertical brands. Companies like Warby Parker and Casper Sleep, Inc. (Casper), which sells mattresses and other sleep products, have seen positive momentum behind their hybrid online and in-person shopping models, building into companies worth hundreds of millions of dollars. According to Dror Poleg's book Rethinking Real Estate, "brands are using stores to acquire and onboard new digital customers, to handle returns and service for good purchased online, and to increase brand loyalty and customer engagement with existing customers." The book also said a co-founder of Casper noted that markets with physical stores experienced higher growth than markets without stores, indicating the importance of physical stores for digitally native vertical brands. Further, successful retailers are customer-centric rather than product-centric, recognizing that consumers seek experiences not just products.

As mentioned previously, Microsoft announced in June that it will close all of its retail locations and reimagine select stores as "experience centers" in major cities around the world. Presumably, the intention is to have consumers not only buy products but also experience the Microsoft brand. Brands are looking to increasingly target consumers wherever they are. The relationship with the customer needs to be "seamless, consistent and helpful," according to Richard Kestenbaum, a contributor for Forbes.

This shift in the retail landscape will likely lead to higher vacancies and possibly lower rents if that vacancy persists. Reis, Inc. projects the retail vacancy rate will increase to 13.1% by 2022 from 10.2% in 2019. Before the pandemic, landlords were successfully retenanting vacant spaces with experiential retail or pop-up operators. However, as people shy away from in-person experiences, properties without stable occupancy will need alternate uses. One example that we have seen is successful big-box retailers taking mall space at significantly reduced rates. For instance, as first reported by Reuters, Ikea's shopping mall arm is looking to open 45 new locations in the U.S in central locations, looking to take advantage of depressed prices. Several retail landlords are also trying to innovate within their physical spaces. One example is Related Properties' Shops and Restaurants at Hudson Yards, in which there is a floor dedicated to digitally native brands and new retail concepts.

Consumer Experiences Pivotal

There's a lot of uncertainty how the retail landscape will evolve after the pandemic as the coronavirus has caused an unprecedented disruption of commerce and accelerated the trend toward digital shopping. As stores reopen, retailers that invested in an omnichannel strategy to capture the changing tides of the industry several years back have a marked advantage compared with those that did not. Retailers that have chosen locations that rely less on a flood of consumers commuting to work each day are in a better position to succeed as well as those that eschewed the digital divide and emphasize their price point and treasure hunt experience. But traditional retailers that have been struggling to adapt to

changing consumer behaviors for years may be out of time, which will likely influence real estate demand.

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