CMBS Retail Outlook: transformation accelerating

January 4, 2018

- The retail business is going through a large and undeniable transformation. Following up on our 2018 CMBS Year Ahead Outlook, we provide a detailed overview on retail, its transformation and what we believe are the implications for CMBS.
- From a CMBS perspective, these changes – and especially the financial markets' reaction to them – appear to have accelerated and are now occurring faster than we were anticipating a year ago.
- Our expectation is that retail bankruptcies and store closures will not abate and we will likely see another wave hit, early this year, following the holiday selling season. This should weigh on retail vacancy rates and rents, which, so far, have only had some downward pressure. This current decline in sector-wide performance may have been slower than many anticipated.
- Additionally, we have seen adjustments in cap rates and valuations over the past year, as well as a reduction in financing available to retail owners and especially malls, which we believe is a more concerning change to us. Although we believe many retail loans are likely able to perform over the next few years, the lack of financing could spell trouble at maturity.
- We still believe that, for the most part, the best quality malls, especially those in major markets, run by better landlords, have improved long-term prospects and will have a significantly higher survival rate.
- While looking at past CMBS performance can be somewhat instructive, we hesitate to place too much weight on its usefulness in predicting future outcomes. Analyzing the legacy data set can help in determining some of the characteristics that make a loan more likely to default.
- We try to take a holistic approach in our evaluations; we do not believe in hard cutoffs in measures, such as sales per square foot.
- For now, we do not see a catalyst for news flow and sentiment to change. The path of least resistance for mall/retail-heavy CMBX indices and cash bonds seems to be toward wider spreads, as we expect negative headlines will continue to dominate, especially early this year, after the holiday selling season.
Retail transformation accelerating, triggering greater CMBS uncertainty

The retail business is going through a large and undeniable transformation. While the sector has endured cyclical shifts in the past, the current metamorphosis appears to be different, seemingly secular in nature, with larger and more permanent adjustments to the business model. This has already affected the CMBS market and we believe will continue to do so in momentous and not fully predictable ways.

From a CMBS perspective, these changes – and especially the financial markets’ reactions to them – appear to have accelerated and are now occurring faster than we were anticipating a year ago. The mounting pressure on retailers to figure out their brick and mortar strategy and right size their store fleet (space rationalization), as they adjust to these changes, has led to increased store closures last year. This includes both department store retailers, that serve as mall anchors, as well as many inline tenants. In addition, 2017 brought another long list of retailers filing for bankruptcy. The number of retail-related companies declaring bankruptcy this past year surpassed 2016’s pace, but remains below the recessionary level, according to data from S&P (Figure 1). One caveat about these numbers is they also include non-brick and mortar retailers. In fact, about one-third of last year’s Chapter 11 retail bankruptcies are by internet and direct marketing firms.

Our expectation is that retail bankruptcies and store closures will not abate, and we will likely see another wave hit, early this year, following the holiday selling season. The possible candidates often discussed include some of the larger department store companies, whose locations serve as anchors, many at malls, as well as some big box tenants. The negative rhetoric around retailers can be self-fulfilling and hasten or force some of these companies into bankruptcy, as suppliers and vendors tighten credit in reaction to these concerns.

The good news is that, so far, despite the closures, there have only been some modest changes in the aggregate retail property fundamental performance, at least across the sector as a whole. While retail vacancies are modestly higher, over the past year, rental rates and net cash flow have been flat to up, on average. However, we believe it is only a matter of time before the compounding effects of ongoing store closures have a greater impact on property level fundamentals. Additionally, as we often stress, average performance does not tell the full story and the risk in CMBS is skewed toward the outcome of underperforming properties.

The one place we have seen a change is in cap rates and valuations. There have been a number of Class B mall payoffs and liquidations in CMBS over the past year that have reset investor expectations lower and indicated a much steeper cap rate curve, between higher and lower quality retail. Furthermore, across all of retail, overall price indices have slowed with some showing price declines. With transaction volume down, pricing has become more opaque, specifically for mid- to lower-tier malls. We believe this presents risks in CMBS, especially as servicers will have to navigate potential resolutions for assets with little to no comparable valuations.

Perhaps the more concerning change we have seen over the past year is the reduction in financing available to retail owners and especially malls. There appears to be a dramatic pull back in the capital available to finance retail properties even as commercial mortgage lending has, on the whole, increased. The reduction in lending, to the retail real estate market, is among our chief worries for the sector, especially as existing CMBS loans reach maturity. While we believe many of the loans on malls are likely to be able to perform over the next few years, the lack of financing could spell trouble at maturity.

We remain cautious on the performance of CMBS backed by retail. What we wrote a year ago still holds: “We believe the retail sector will remain under considerable pressure, for the foreseeable future, due to changes in economic, demographic, technological and behavioral trends.” The country is clearly over retailed and this, combined with other systematic changes, leads us to firmly believe that the number of shopping centers and malls will shrink over time.
It remains our view that while the demand for retail is shifting and declining, it will not completely vanish. We are convinced there will be winners and losers in the retail sector. In the end this will be a story of the “haves and have nots” and a detailed understanding of the seismic shifts that are taking place across the industry and what is causing them is mandatory for CMBS market participants.

We still believe that, for the most part, the best quality malls, especially those in major markets, run by better landlords, have improved long-term prospects and will have a significantly higher survival rate. While the risk of term defaults may increase, with store closures, it remains our opinion that the majority of defaults are likely to occur at maturity. As such the financing landscape for retail assets bears meticulous monitoring.

For now, we do not see a catalyst for news flow and sentiment to change. The path of least resistance for mall/retail-heavy CMBX indices and cash bonds seems to be toward wider spreads, as we expect negative headlines will continue to dominate, especially early this year, after the holiday selling season.

In this section we lay out some of our thoughts on the retail sector. The full implications for CMBS remain unknowable, at this juncture, but a good understanding of the changing dynamics helps frame the situation and allows for more informed reactions to future news.

The changing retail landscape – over-supply, weaker demand & ecommerce

To be perfectly clear, we do not believe all of retail, or every mall, is going away. The demise of the malls has been widely forecasted for more than 20 years and yet the sector has, until recently, fared reasonably well. While some of the recent negativity has been overblown, there are several factors that have changed our longer term outlook for the sector.

A rising supply of brick and mortar retail has left the US over retailed, in our view. Compounding the effects of too much supply is a change in consumer behavior, including the exponential growth of online shopping that has dramatically reduced the demand for traditional retail space.

The changes in the retail landscape have come on both the supply and demand side and we believe understanding how and why these shifts are taking place is essential to understanding the retail market and the individual credits backing CMBS loans and CMBX reference obligations.

The supply side – the US is over retailed

A rise in retail shopping centers, across the US, has left the country with more retail space per capita than other leading economies, as we show in Figure 2. While this comparison captures US retail space, relative to other countries, we believe consumer spending habits here are also different.

**Figure 2: Retail real estate space and retail sales per capita**

<table>
<thead>
<tr>
<th>Country</th>
<th>Retail Sq ft Per Capita</th>
<th>Retail Sales Per Capita (right-axis)</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>$14,614</td>
<td>$10,953</td>
</tr>
<tr>
<td>Canada</td>
<td>$9,239</td>
<td>$8,437</td>
</tr>
<tr>
<td>Australia</td>
<td>$6,495</td>
<td>$3,282</td>
</tr>
<tr>
<td>UK</td>
<td>$2,000</td>
<td>$6,323</td>
</tr>
<tr>
<td>France</td>
<td>$2,000</td>
<td>$8,375</td>
</tr>
<tr>
<td>China</td>
<td>$2,000</td>
<td>$10,953</td>
</tr>
<tr>
<td>Germany</td>
<td>$2,000</td>
<td>$14,614</td>
</tr>
</tbody>
</table>

Source: General Growth Properties, International Council of Shopping Centers, Planet Retail and Knight Frank Research
Perhaps even more relevant is the growth of outstanding space leading up to the recent financial crisis. From 1970 to 2007 shopping center space in the US more than quadrupled while the US population increased by slightly less than 50%. We show the growth in malls over this time, compared to the increase in population, in Figure 3.

**Figure 3: Mall space increased at a much faster pace than the US population into the crisis**

![Mall space increased at a much faster pace than the US population into the crisis](image)

Source: International Council of Shopping Centers, US Census Bureau, Credit Suisse

It was not just the addition of mall space either. There was even greater expansion in other retail formats such as lifestyle, community and power centers, all of which helped to drive traffic away from the mall sector.

**The demand side – ecommerce and changing spending habits**

Just as US retail space was expanding, there were numerous changes in consumer spending habits taking place. The most obvious of these is the growing prominence of online shopping (ecommerce) pulling sales away from traditional brick and mortar retailers. However, ecommerce growth is not the only factor contributing to the decline of American shopping malls, and we believe it may be receiving too much weight, at least from some watchers.

**There is no doubt that ecommerce growth has been stunning and cannot be ignored as it accounts for an increasing percentage of retail sales.** Ecommerce purchases rose to 9.1% of total retail sales in the most recent quarter, up from 8.2% a year ago and 5.4% just five years ago, according to Census Bureau data (Figure 4).

**Figure 4: Ecommerce as a percent of total retail sales**

![Ecommerce as a percent of total retail sales](image)

Source: US Census Bureau, Credit Suisse

**Figure 5: Mobile commerce as a percent of total digital dollar sales**

![Mobile commerce as a percent of total digital dollar sales](image)

Source: comScore, Credit Suisse

* Excludes auctions, autos and large corporate purchases
Moreover, the proportion of electronic purchases seems destined to continue to grow as it has gained wide spread acceptance. While Amazon does not release statistics regarding its Prime membership, it is estimated that more than 60% of US households are now members. Ecommerce has gotten easier to use too, fueling a rise in mobile commerce, which has grown from 2% of digital spending to 23% of the total, since 2010 (Figure 5).

Brick and mortar sales continue to rise, albeit at a much slower pace. This is shown in Figure 6 where we look at total retail sales, ecommerce sales and retail sales excluding ecommerce (the gray line). Retail sales have grown at an annual rate of 3.9%, over the past five years, while retail sales excluding ecommerce rose at a 2.9% annual rate.

**Figure 6: Retail sales continue to grow, even when excluding ecommerce**

While ecommerce is undeniably important, and growth remains strong, the vast majority of sales remain in-store. In fact, data show that about 3% to 4% of total retail sales take place on retailers’ own websites and some online orders even take place inside the store itself. As we discussed in more detail in our 2017 Outlook, the growing physical presence of the born online retailers (such as Warby Parker, Bonobos, Apple and even Amazon, to name a few) highlights the importance of brick and mortar retail and the importance of so-called “omni-channel” strategies.

While ecommerce has clearly had a negative effect, a move of 9% of all retail spending to online is not, by itself, enough to explain the decline of lower-tier retail malls. We strongly believe there are other associated ramifications to this change reflected in consumer shopping habits. For example, research for new purchases used to be done in-store and often that entailed several trips to the shop, during which other purchases were likely made. With buyers’ research now more easily done from home, many larger in-store purchases now require fewer trips to the mall, reducing foot traffic and the discretionary spending associated with them. The result, we believe, is a dramatic drop in foot traffic, especially at malls, even if the conversion rate (transactions as a percentage of traffic) had been mostly higher.

**Foot traffic has been declining at an annual pace of around 5% to 10% a year** for the past several years, as we show in Figure 7. Until recently this decline was partially offset by higher sales per shopper, which was up during 2014 and 2015, but began to decline in 2016. As the figure shows, sales per shopper appear to have also turned negative, during the past several months.
While retail traffic has been declining, it is only recently that sales per shopper have begun to decrease. **Source:** RetailNext

Shopping habits have also changed coming out of the recession and, along with changing demographics, this too has affected the performance of brick and mortar retail. The recession led consumers to search for better values and be more frugal. Now with the economy improving there appears to be a shift away from spending on apparel and other goods and more toward entertainment and experiences. To this point, the percentage of consumer spending on entertainment, since 1984, has remained nearly the same, at around 5% (Figure 8). On the other hand, spending on apparel, as a proportion of income, has been mostly in decline since 1991, dropping from around 6% then to 3% in 2016. We note that while the share of spending towards apparel has been declining, the average amount of dollars spent remains relatively stable as income and consumer expenditures have been increasing over time.

**Figure 8:** Unlike entertainment, the share of consumer spending on apparel has declined

Additionally, the other beneficiary has been travel and dining. To this point, consumer spending on food away from home has rapidly increased since 2014, rising by 20% (Figure 9). On the other hand, expenditures toward food at home have been nearly flat over that time period. We believe part of this shift is generational with surveys showing millennials are more focused on experience-related purchases than older consumers. If this is indeed generational, it would imply the trend is likely to accelerate as buying power shifts more and more to millennials over time.

**Figure 9:** Consumer spending on food away from home has rapidly increased since 2014

Source: Bureau of Labor Statistics, Credit Suisse
Not all retail will be affected equally – lower quality malls remain the worry point

The fundamental changes in the landscape are important for the entire retail sector but we believe there are certain areas and segments where the damage will be more severe. While malls only represent 15% of the total retail square footage (Figure 10) they have received the most attention both in the press as well as from CMBS investors.

**Figure 10: Malls represent 15% of all retail square footage**

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**Figure 10: Malls represent 15% of all retail square footage**

Attention from CMBX investors is warranted because loans backed by these properties carry a disproportionate share of the credit risk and the indices provide a liquid way to take a short position. We show in Figure 11, for each CMBX series, the proportion of retail properties and the subset backed by malls.

**Figure 11: CMBX retail exposure**

We remain very focused on malls not only due to their large loan size but also because of the concentration of department store tenants, an industry we have been highlighting in structural decline. Department stores still occupy nearly half of the US mall space. While these locations generally contribute little or sometimes no rent to the landlord, they have traditionally served as a draw to the mall, enhancing consumer foot traffic and profitability of the mall’s other tenants.

Department stores have not performed well with sales on the decline since 2001, falling by more than 35% since the peak (Figure 12) even as total in-store retail sales have been growing, albeit anemically, as we discussed above. We detailed several reasons for the decline in the department store model in our 2017 Outlook including the advent of ecommerce, shifting consumer habits, changing demographics and urbanization as well as swings in income distribution.

**Figure 12: Department store sales**

Given the above, it is not a surprise that our analysis suggests that over 1,200 department stores have shut since 2011. That figure does not include late 2017 and 2018 store closures, already announced, from Sears (64 stores) and Bon-Ton (40 stores). We expect 2017 announced department store closings alone will total over 400. Despite the closures, department store sales have fallen at a faster pace than store space. Given the decline in department store productivity we would expect to see ongoing store closures, across the sector, in 2018 and on.
We are finding many of these department store closures are, unsurprisingly, in the lower quality, lower performing shopping centers. We think this is both emblematic of the problem with lower-tier quality malls as well as highlights the ongoing risk to these assets.

**Mall quality is key – the survival of the fittest**

It remains our view that, for the most part, the best quality malls, especially those in major markets, have better long-term prospects and will have a significantly higher survival rate. Lower quality retail assets (Class B and C properties) and the weaker malls, even in primary markets, need to shrink and in many cases will fade away, over time. Even as this segment contracts, there is a need for middle market retail but the challenges for these assets are far greater in terms of productivity, sponsorship and competition, at this end of the quality spectrum.

When an anchor tenant, even a poorly performing one, leaves a lower-tier mall, it often puts pressure on the other retailers at the property and it is difficult to find a new, better drawing replacement. It can also be expensive to reposition the vacant property and often the landlord is unable or unwilling to invest further in the property. The damage can be compounded by co-tenancy agreements which can allow tenants to reduce their rent. Strong sponsorship from the property’s landlord can mitigate such risks.

**Class B and C malls also face much more competitive pressure.** On one end, these properties are losing out to the Class A malls, which attract a high quality tenant and consumer. On the lower end, they are facing pressure from the discounters, the big box retailers and the shift toward ecommerce.

In addition, the loss severity on malls in less well located areas can be very high. Generally speaking, the alternative use and redevelopment options for lower-tier malls are dramatically reduced.

**We have of course seen underperforming anchors close at better malls but this can prove to be a net positive for the property as the landlord may attract a higher quality, higher paying and higher drawing tenant.**

Several retail landlords have proactively bought out, invested in and successfully redeveloped numerous anchor and big box locations with alternative uses such as supermarkets, entertainment venues and other large-scale users, adding uses consumers want. Similarly, the Seritage Growth Properties spin-off of Sears and Kmart space was done with an eye of redeveloping and re-tenanting those properties with better retailers. The space that Seritage has been able to release is garnering a rent of nearly $18 per square foot compared to around the $4.31 rate that Sears was paying for the same space, a 4.2x releasing multiple.

A breakdown of mall quality from Green Street Advisors shows that more than one-third of US malls are C+-quality or lower. However these malls account for only about three to four percent of the total value, across the entire universe. On the other end of the quality spectrum, A-rated malls account for about 25% of the total, by count, but represent approximately three-fourths of the total value.

**It is the middle portion of the curve, the B-quality malls, where we believe the outcome is the most uncertain.** This is also where much (although definitely not all) of the CMBS exposure lies, especially in the slightly more seasoned post legacy vintages. The fate of these malls will in part depend on what the future retail model looks like and how many stores a typical retailer will wind up with, in five or ten years’ time. It is our view that many of these malls will have trouble competing, over the longer term, but others will, in the end, be fine and survive as a going concern.

Of course there can be slippage across the quality spectrum and we believe that more malls are likely to drop from higher quality to a lower quality, over the next several years, than vice versa.

**It is not just malls – keep an eye on other retail formats too**

Many of the same problems facing malls (overbuilding, changing consumer habits, growth in ecommerce) are confronting other retail sectors as well. For CMBS investors the non-mall (non-portfolio) retail loans tend to be smaller but they are still worth keeping an eye on.
We believe that as the retail landscape continues to shift, tenants are becoming property-type agnostic; malls, power centers and community centers are increasingly competing for the same tenants and store owners are going to head toward the best opportunity.

We believe that mall owners will continue to be aggressive in trying to attract traditional big box retailers to replace departing department store anchors. The ability to attract such tenants will not be based solely on rental rates. If an anchor tenant is leaving a mall it may convey something about that mall’s future prospects as well.

While we have some concerns over the fundamental performance of other retail property types, in addition to malls, we note that many other factors need to be accounted for when analyzing loans collateralized by these properties. Specifically accounting for the quality of underwriting, including but not limited to leverage levels, debt yields and debt service coverage ratios, as well as loan level and deal level structure are crucial in evaluating credit risk of CMBS.

Grocery anchored centers are not as concerning, for now

Grocery anchored centers on the whole appear healthier than other retailer centers. Grocery store closures have been fairly low this year, and we have seen some new entrants into the market such as Aldi (which plans 900 openings over the next five years) and Lidl (which plans 100 openings by this summer).

In large part, this is because ecommerce has yet to make a substantial dent in this sector’s productivity, as consumers have been slower to adapt to purchasing food online. One recent survey, by Statista, indicated that of the major categories, an overwhelming number of consumers continue to prefer to purchase groceries in person (Figure 13).

Of course while the outlook remains more benign for now, the possibility of future disruption from e-grocery providers remains. Amazon’s purchase of Whole Foods last year is a strong signal that they intend to continue to search for ways to reinvent this business model as well.

What else do we look at when analyzing retail?

As we noted, we believe that A-rated retail properties will generally fare better and the lower quality assets are more likely to have problems. Asset-level quality is important but there are many factors that affect the performance and value of a mall. We look at many of these as we try to parse through the retail landscape and analyze specific credits.

Additionally, we try to take a holistic approach in our evaluations; we do not believe in hard cutoffs in measures, such as sales per square foot.

To be fair, many of these asset qualities are highly correlated on the overall grade level, but there are exceptions. For example, we might view the credit risk of a loan backed by a B-mall, owned by a strong sponsor, with little nearby competition lower than a loan on the third best A-rated mall in the area. Things we try to evaluate include:

Nearby competition: We believe that the most dominant malls in the area have the greatest probability of surviving and even benefitting from the demise of inferior retail assets. While new developments are increasingly rare, we also keep our eye on what is getting built nearby. There are several properties that ran into problems only after a newer, better competing center was built. As retailers right size their footprint they often look to locations that are in close proximity of each other. The better quality, more productive mall, or even large retail center, usually wins out.

Figure 13: An overwhelming number of consumers continue to prefer purchasing groceries in person

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Books</td>
<td>32%</td>
</tr>
<tr>
<td>Electronics</td>
<td>33%</td>
</tr>
<tr>
<td>Office supplies</td>
<td>49%</td>
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<tr>
<td>Sporting goods</td>
<td>56%</td>
</tr>
<tr>
<td>Pet supplies</td>
<td>66%</td>
</tr>
<tr>
<td>Tools</td>
<td>67%</td>
</tr>
<tr>
<td>Household goods</td>
<td>71%</td>
</tr>
<tr>
<td>Clothing and apparel</td>
<td>76%</td>
</tr>
<tr>
<td>Consumer packaged goods</td>
<td>77%</td>
</tr>
<tr>
<td>Food/grocery</td>
<td>92%</td>
</tr>
</tbody>
</table>

Source: Statista
Demographics: The population density and affluence of a given area are important factors in the success of retail destinations. A mall’s performance is not only tied to the level of these but also their growth trajectory. We caution that demographics can shift over time as well, for better or worse.

Locations/Alternative use: We find greater value in some mall locations because we believe there are opportunities for redevelopment to an alternative or better use. We are increasingly seeing landlords look to add non-retail uses, such as apartments, hotels and offices to shore up their properties. This “densification” will continue to grow and makes strategic sense. Residential and retail can serve as complementary property types. So does adding office space. The sale of the Lord & Taylor building to WeWorks, for its new global headquarters, is a great, large example, but by no means the only one.

Mall productivity: Often the most quoted measure of a mall’s productivity is the sales per square foot and this metric is often closely related with a property’s level of foot traffic. We also look to tenants’ occupancy and occupancy costs, when available. Properties with low occupancy cost ratios indicate the ability of the landlord to raise rents.

Tenant quality: With the change in consumer spending habits we would argue this has grown in importance. Malls that attract more selective, “hot” tenants, such as online retailers, tend to appeal to more affluent consumers. We note that for a mall to entice these types of tenants, the property is likely already located in an area with these types of consumers, which lies into our demographic factor.

- Department store tenants: We believe malls that have higher end department stores (such as Nordstrom or Bloomingdale’s) will perform better than those with a lower tier option (such as a Sears or JCPenney).
- Apple/Tesla: These stores tend to be found in top retail locations. While Apple may skew a property’s productivity numbers, its presence acts as a strong draw for consumers.

Tenant and product mix: Related to the quality of tenants is the mix of tenants and the products they offer. This has grown in importance as consumers have moved away from apparel and toward entertainment and dining options (Figure 8). Tenants that are relevant and not struggling are clearly a plus.

Mall operators that have been quicker to adapt to changing consumer preferences have seen their properties outperform. We caution though, these entertainment options still need to be traffic drivers rather than just backfilling options.

Overall attractiveness and feel: The attractiveness of a property and its surroundings remains important for drawing foot traffic. If a property is not well maintained or, worse, not safe, it will lose customers. Additionally, properties in need of significant capital expenditures are going to be less valuable.

Strong sponsorship: Given the vast changes in the sector strong sponsors, a quality we highly value, are generally better positioned to continue to invest in their assets, to attract both tenants and consumers.

- Redevelop space: We have seen such sponsors redevelop space vacated by department stores or, in some cases, preemptively buy out these stores to attract new and more relevant tenants to keep the asset fresh. The willingness to invest in properties we believe is strong signal about a location’s future viability.
- Strong balance sheet: Good sponsors are also generally well capitalized. As we discussed, financing for retail is changing and having a strong balance sheet and access to capital should not be underestimated.
- Ability to attract tenants: Tenants arguably have the upper hand right now in negotiating with mall owners. That said, a landlord with a portfolio of desirable malls at least mitigates the tenant’s advantage.

A look at the recent shift in fundamentals

While retail fundamentals continue to deteriorate, we would argue the rate of the decline is less severe than what the rhetoric and headlines might indicate. A large number of stores have closed and many retailers have filed for bankruptcy this year. Nevertheless, many national measures on the health of the sector are little changed, year over year. While the downward pressure on these indicators seems likely to accelerate, the decline in sector-wide performance may be slower than many are anticipating.
That said, the caveat to this, as we discussed in our 2018 CMBS Year Ahead Outlook, is the economy has been performing reasonably well. The country has seen growth in personal income and consumption, over the past few years, and the economic trajectory is expected to stay on track during 2018. A shift in the economic outlook would only compound retail issues.

Store closures and openings

Our colleagues in equity research have tallied the total store closures and currently put the number of announced closings in 2017, through November, at close to 7,800, well above the prior year and even above 2008’s levels (Figure 14). Interestingly, on a square foot basis, the announced closures total 106 million square feet, above the prior year’s 86 million square feet announced, but lower than the 2001 high watermark (Figure 15).

Figure 14: Retail store closings – number of units

Figure 15: Retail store closings – square feet

While the number and square footage of store closings remains relatively high, we note that some of these closures are offset by openings from other retailers. To this point, there are over 3,400 announced store openings in 2017, a 50% year-over-year increase, according to Fung Global Retail Tech. Nevertheless, it appears, on net, that there will be more store closures than openings in 2017.

Mall productivity – department stores are losing; others winning

Estimates of mall productivity show sales per square foot are on pace to decline 0.9% in the first three quarters of 2017, to $463 per square foot, on a seasonally adjusted basis, versus the prior year (Figure 16). This would be flat to down for the fourth consecutive year since it peaked in 2013, falling a cumulative 2.5% over that time.

The data also show that since that peak year, sales per square foot for retailers with merchandise normally sold in department stores (GAFO) is down about 4% with apparel and shoe retailer sales per foot down 9%. Food service sales are up 1.2%, per square foot, over that time, and other stores (non-GAFO sellers) have seen sales increase 8.6% per square foot.

Figure 16: Mall sales productivity has been trending lower

* 2017 YTD is first three quarters seasonally adjusted

Source: International Council of Shopping Centers, Credit Suisse
Vacancies have started to turn higher

Despite the increase in store closures, retail vacancies are little changed, so far. Across neighborhood and community centers, vacancies have ticked marginally higher, in the second and third quarters of last year, and are now back to levels last seen in the third quarter of 2015 (Figure 17). On the other hand, there has been an uptick in mall vacancy rates in recent quarters putting it 50 bp higher, year over year, in the third quarter. Given the continued store closings, we expect retail, and especially malls, will see pressure on their occupancy rates in the coming quarters.

Figure 17: Vacancy rates for malls have recently picked up at a faster pace than neighborhood and community shopping centers

![Vacancy rates for malls have recently picked up at a faster pace than neighborhood and community shopping centers](image)

Source: Reis, Credit Suisse

New construction remains modest

As we noted before, retail supply did not slow down heading into the recession (Figure 18). This has caused the sector to lag the recovery enjoyed by other property types.

Figure 18: TTM net completions as a percent of inventory

![TTM net completions as a percent of inventory](image)

Source: Credit Suisse, CoStar

Figure 19: Under construction as a percent of inventory

![Under construction as a percent of inventory](image)

Source: Credit Suisse, CoStar

New supply being delivered over the past six to seven years has been relatively low. With new construction also subdued (Figure 19), with the exception of a small bump in 2015, we expect new supply to remain relatively muted.
Rental rates continue to rise but at a slower rate

Even as pressure mounts on vacancy rates, rents for retail properties continue to grow, albeit at slightly slower rates (Figure 20). While growth rates for rents at neighborhood and community centers have recently plateaued, at around 1.7% to 1.8%, year over year, annual growth for mall rents has been on a steady decline, since the fourth quarter of 2015. We expect mall rents to continue on this path as store closings increase and sales productivity declines.

**Figure 20: Year-over-year growth in mall rents continues to decline; rent growth across neighborhood and community shopping centers has plateaued**

Transaction volume has plummeted

Retail transaction volume has been trending lower since the end of 2015 and recently has plummeted. Over the second and third quarters in 2017, retail transaction volume totaled $29.1 billion, down 25% from the same period last year, according to Real Capital Analytics. Volume is down across the board but the decline in shopping center transaction volume has been fairly sharp.

As Figure 21 shows, this is the eighth straight quarter to experience year-over-year declines in transaction volume.

**Figure 21: Eight straight quarters of year-over-year declines for retail transaction volumes**
Price growth stalls/reverses as cap rates flat to slightly higher

Although retail prices continue to increase, the growth rate has notably slowed over the past few years. Annual growth levels across the Real Capital Analytics CPPI declined from 2.4%, at the end of 2016, to 0.8% in June and July of last year before picking back up to 3.7% in the most recent period (Figure 22). Additionally, the CoStar value-weighted index has a similar trend, with year-over-year growth dropping to 2.9% in the third quarter.

On the other hand, Green Street, which in part uses an appraisal-based methodology, shows prices for malls down 5%, in the past three months, and 11%, year over year. Given the index’s use of appraisals, we believe these results may be more forward-looking and could be indicative of the future direction of the other indices.

From a return perspective, retail cap rates had been trending lower, until the second half of 2015 (Figure 23). Since then, cap rates have been flat to a touch higher over the past few quarters, which coincide with the waning price growth and slowing transaction volumes.

Availability of financing appears to be waning

There appears to be a growing reluctance to finance retail properties and especially malls. This can clearly be seen in the proportion of retail securitized in CMBS conduit deals over last year (Figure 24).

CMBS Retail Outlook | January 4, 2018
We also believe this pullback in retail-related lending is universal across other lending platforms as well. The Mortgage Bankers Association data shows that retail was the only property sector to experience a year-over-year decline in lending volumes, as of the third quarter. We show the overall lending index and the retail component, on a four-quarter moving average basis, in Figure 25. On this basis retail has been on a steady decline since it peaked at the start of Q1 2016, down 22%. Over the same time the overall lending index is up 11%.

Lending on retail has not completely dried up, however, and is available for some of the sub-sectors at the right leverage.

Corporate borrowing by retail REITs has stayed relatively robust, through the first three quarters of last year (Figure 26), and this may, in part, be a reaction to the pullback in mortgage financing. There has also been a decided switch away from mall-oriented REITs and toward shopping center REITs, compared to the prior year.

A brief overview of legacy and recent retail performance

While looking at past CMBS performance can be somewhat instructive, we hesitate to place too much weight on its usefulness in predicting future outcomes. Analyzing the legacy data set can help in determining some of the characteristics that make a loan more likely to default. However, we believe extrapolating such loss and severity outcomes and using them to estimate performance of post crisis bonds is naive; the path of commercial real estate performance will likely be very different, in this part of the cycle. This is especially true for retail where there are fundamental and structural changes occurring that are new and were not present in the previous decade. Nevertheless, we thought a brief examination of legacy retail performance is warranted.

In our analysis we looked at all legacy conduit loans, the percentage of those loans that took a loss1, the severity of those losses and the corresponding total loss to the pool. We show the results in Figure 27.

Figure 26: Corporate borrowing by retail REITs has been robust

Figure 27: Compared to the other property types, legacy retail conduit loans have had higher severities but less liquidations

<table>
<thead>
<tr>
<th>Property type</th>
<th>Orig bal ($mn)</th>
<th>Liq loans orig. bal ($mn)</th>
<th>Liquidated (% orig bal)</th>
<th>Loss (% of orig bal)</th>
<th>Loss sev. (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail</td>
<td>254,343</td>
<td>39,544</td>
<td>15.5%</td>
<td>6.2%</td>
<td>39.9%</td>
</tr>
<tr>
<td>Office</td>
<td>241,793</td>
<td>51,579</td>
<td>21.3%</td>
<td>6.9%</td>
<td>32.2%</td>
</tr>
<tr>
<td>Multifamily</td>
<td>153,767</td>
<td>29,900</td>
<td>19.4%</td>
<td>4.6%</td>
<td>23.6%</td>
</tr>
<tr>
<td>Lodging</td>
<td>67,732</td>
<td>14,625</td>
<td>21.6%</td>
<td>8.1%</td>
<td>37.7%</td>
</tr>
<tr>
<td>Industrial</td>
<td>44,801</td>
<td>8,724</td>
<td>19.5%</td>
<td>6.1%</td>
<td>31.2%</td>
</tr>
<tr>
<td>Mixed Use</td>
<td>32,675</td>
<td>6,378</td>
<td>19.5%</td>
<td>5.2%</td>
<td>26.7%</td>
</tr>
<tr>
<td>Other</td>
<td>49,954</td>
<td>6,425</td>
<td>12.9%</td>
<td>4.0%</td>
<td>31.1%</td>
</tr>
<tr>
<td>Total</td>
<td>845,065</td>
<td>157,175</td>
<td>18.6%</td>
<td>6.1%</td>
<td>32.7%</td>
</tr>
<tr>
<td>Ex-retail</td>
<td>590,722</td>
<td>117,631</td>
<td>19.9%</td>
<td>6.0%</td>
<td>30.2%</td>
</tr>
</tbody>
</table>

Source: Credit Suisse, Trepp

1 For this exercise we included low-loss severity (<3%) in the results. Excluding would have only marginally changed the total loss by property type. It also would have raised the severity of retail and others by a similar amount.
We found that legacy conduit loans, backed by retail, had a higher loss severity than all the other property types (40% vs 30%). The higher severities appear to be largely driven by term defaults, whereas losses on retail loans that defaulted around maturity were notably lower and more in line with severities on other property types. We believe, however, that this will not be the case for post legacy loans, as the change in the financing environment could push losses higher for liquidations at maturity.

While severities for legacy retail conduit loans have been higher, this was offset by a lower percentage of such loans that actually incurred a loss (15.5% for retail versus 19.9% for the others). As a result, the total losses incurred for legacy retail loans (6.2%) were very similar to the remaining universe (6.0%).

Turning to the post legacy performance, we note that the current delinquency rate for retail loans is a touch below the remainder of the conduit universe. On the other hand, for post legacy retail conduit loans that reached their maturity date last year, the successful payoff rate is well below the rest of the universe. We note, however, the sample size is relatively small with only four loans still outstanding past their respective maturities.

While post legacy credit metrics have overall been relatively benign, so far, there has been evidence of some deterioration in financial performance, as measured by net cash flows, across retail. While 2016 net cash flows for post legacy CMBX malls were higher on average, by 1.3%, year over year, we note that there was a wide distribution. Across these assets, nine malls had cash flows that dropped in excess of 10%, year over year, and twenty have cash flows more than 10% lower than their underwritten levels (Figure 28).

To get a more recent view we also looked at net cash flows (NCF) for the trailing 12 months, ending June 2017, versus full year 2016 figures. Only a little more than a third of these loans reported for both periods, but those properties indicate that NCF fell by roughly 0.5% over that period.

Performance of CMBX vs REITs and department store equity

The lower-rated parts of the CMBX stack, especially CMBX.6 and CMBX.7, were down significantly in 2017, as the negative retail rhetoric continued to pick up steam. While we anticipate continued pressure on these indices, as retail fundamentals deteriorate, we recognize that there may be better, more pure-play, avenues to take bearish retail and mall views.

In Figure 29 we show the simple price performance, over 2017, for CMBX as well as several department store and retail REIT stocks. The performance across both the REIT and department store sectors has varied tremendously from name to name.
Figure 29: 2017 price performance of CMBX and retail and REIT equities

<table>
<thead>
<tr>
<th>CMBX</th>
<th>Retail / department stores</th>
<th>Mall / retail REITs</th>
</tr>
</thead>
<tbody>
<tr>
<td>A.6</td>
<td>-2.4%</td>
<td>S15DEPT -14.1%</td>
</tr>
<tr>
<td>BBB-.6</td>
<td>-9.5%</td>
<td>JCP -62.0%</td>
</tr>
<tr>
<td>BBB-.7</td>
<td>-6.4%</td>
<td>M -29.7%</td>
</tr>
<tr>
<td>BBB-.8</td>
<td>-1.3%</td>
<td>JWN -1.1%</td>
</tr>
<tr>
<td>BBB-.9</td>
<td>2.3%</td>
<td>SHLD -61.5%</td>
</tr>
<tr>
<td>BBB-.10</td>
<td>-3.7%</td>
<td>BONT -76.7%</td>
</tr>
<tr>
<td>BB.6</td>
<td>-12.1%</td>
<td>KSS 9.8%</td>
</tr>
<tr>
<td>BB.7</td>
<td>-6.3%</td>
<td>DDS -4.2%</td>
</tr>
<tr>
<td>BB.8</td>
<td>1.1%</td>
<td>HBC -14.5%</td>
</tr>
<tr>
<td>BB.9</td>
<td>5.9%</td>
<td>SSI -61.6%</td>
</tr>
<tr>
<td>BB.10</td>
<td>3.0%</td>
<td>SSI -61.6%</td>
</tr>
</tbody>
</table>

Source: Credit Suisse, Markit, the BLOOMBERG PROFESSIONAL™ service

Furthermore, there has been, as we show in Figure 30, using indices, far more volatility in the stock prices than there has been in the price performance of CMBX. Even if the retail-heavy CMBX series come under further pressure, which appears likely, we believe there remain perhaps better, unadulterated avenues to take a negative view on US retail.

Figure 30: BBB-.6 and BB.6 dollar prices have been less volatile than retail stock prices

Uncertainty and risks with more changes coming

Ultimately, there are a number of factors at play that are altering the landscape of retail. As we have discussed, the sector is fundamentally changing, at an accelerated pace, as ecommerce continues to grow and consumer spending and shopping habits change. This has been compounded by the fact that the US is over retailed.

Additionally, we believe there will be other emerging factors shaping the retail environment that will most likely negatively affect brick and mortar. While not likely to cause an impact in the near- to intermediate-term, technological advances, such as driverless cars and 3D printing, have the potential to result in retailers reducing their store counts.

Despite all these changes, we believe better quality, better positioned retail will persist. While areas with supportive demographics are helpful, it is also important to have strong sponsors that invest in transformations and improvements in their properties to adapt.
Nevertheless, there are still more immediate issues that concern us, the largest being the financing environment and servicer risk, which we believe will weigh more negatively on middle-tier malls and other similar quality retail assets. As we noted, retail transaction volumes have plummeted and lending activity for these assets has trended lower. While we expect there are B-quality malls that will be fine, a drop in financing and comparable price points could lead to servicer risk where cash flow positive assets wind up being modified or incurring losses.

As a result of all these changes, we believe, from the CMBS investor standpoint, it will require careful underwriting and understanding of these wide ranges of risk, which we have laid out. While cash flows for some, but not all, retail assets will trend lower, term default risk will be more dependent on the underwriting and how quickly performance changes before the asset can no longer service the debt. The larger risk this year for cash flows stems from store closures, their impact on future cash flows and how well positioned the sponsors are to replace those tenants.
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