Invest in Retail REITs at Your Peril

Description

In 2017 legendary investor Warren Buffett announced the end of the department store as we know it, heralding that retailing is now online. At the time, both he and many analysts who were bearish on traditional bricks and mortar retailing were labelled by some pundits as misguided.

Since then, leading retailers, including what was at one time the largest U.S. department store **Sears Holdings,** have faltered. The value of many North American retail REITs have declined sharply over the last two-years. This includes **CBL & Associates** (NYSE:CBL) plunging 84% and Canada's **Slate Retail REIT** (TSX:SRT.UN) losing 14%.

Store closures have yet to end

The retail apocalypse is far from over. According to business intelligence firm CB Insights, nine North American retailers have already declared bankruptcy in 2019 and 17**,** including Sears Holdings**,** did so in 2018.

Analysts estimate that over 1,660 retail stores across North America will close during 2019, deepening the sense of doom enveloping the industry and retail real estate investment trusts (REITs) in particular. The trend to closing bricks and mortar locations will only continue to gain momentum as the acceptance of online shopping grows and retailers push to reduce costs and focus on their online businesses.

This has been an unmitigated disaster for many North American retail REITs, particularly those operating second and third tier malls. Among the worst affected is U.S. second tier mall owner CBL Associates, which owns 115 properties, over half of which are shopping malls. In 2018, it completed US$100 million of property sales and earlier this year secured US$1.2 billion credit facility.

The havoc wrought by the shift to e-commerce can be seen from its 2018 financial results, with revenue between 2014 and 2018 plummeting 19%, leading to a US$99 million full-year loss.

REITs find themselves in the unenviable position that despite declining revenues caused by the steady attrition of tenants through store closures and bankruptcies, operating expenses have increased because of rising inflation, maintenance costs and wages. That is squeezing already tight margins to a point where some, like CBL Associates are becoming unprofitable. For the five years from 2014 to 2018, its expenses surged by 13%.

The transformation of retailing isn't restricted to south of the border. Canadian retail REITs are also under increased pressure from rising store closures and bankruptcies, but that has yet to be reflected in their performance.

While Slate Retail REIT, which owns 85 properties, remains relatively flat, gaining a mere 3% over the last year, one of Canada's leading REITs, **Choice Properties** (TSX:CHP.UN) has surged by an impressive 23% despite the difficult operating environment.

That growth can be attributed to its diverse portfolio, which aside from 599 retail properties that were responsible for 81% of its 2018 net operating income**,** Choice owns industrial, office and residential properties. This has offset the impact of the bricks and mortar retail apocalypse.

Choice's net operating income from its retail properties shot up by an impressive 41% to $825 million, but that can be attributed to the addition of properties from the acquisition of Canadian Real Estate Investment Trust, which was completed in May 2018. On a same properties basis, net operating income was flat**,** rising by a modest 2% year over year.

Slate Retail REIT**,** which is more vulnerable than Choice because its properties are in the U.S.**,** reported a 19% year-over-year increase in 2018 net operating income, although property operating expenses shot up by a worrying 36%.

It appears that Canadian malls are thriving compared to the U.S. This is due to a number of factors, including the explosion of lower tier retail properties in the U.S. over the last two decades as major department stores sought to aggressively expand their businesses.

They did this by entering deals with REITs to finance the development of properties, where they then agreed to be anchor tenants for a lengthy fixed period. That in turn attracted smaller retailers seeking to profit from the considerable traffic they generated.

Many Canadian malls have been quick to renovate and focus on attracting other lifestyle tenants aside from bricks and mortar retailers to attract customers such as restaurants and cinemas. This strategy, aimed at increasing foot traffic and repeat visits from consumers, appears to be working, with Canadian malls generating more sales dollars per square foot than their U.S. counterparts.

Is it time to invest in retail REITs?

Regardless of the more promising outlook for retail REITs in Canada, it is still an unappealing industry in which to invest. The decline of bricks and mortar retailing will continue for some time as the acceptance of online shopping progresses at a furious rate. It will be a while before the dust settles and it can be determined which retail REITs can consistently deliver value.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:CBL (CBL & Associates Properties)
2. TSX:CHP.UN (Choice Properties Real Estate Investment Trust)
3. TSX:SGR.UN (Slate Retail REIT)

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1. Msn
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