Trump’s Trade Policy Will Cause the Retail Apocalypse to Accelerate

Description

Retail bankruptcies and store closures are accelerating at a disturbing rate. Way back in 2017, legendary investor Warren Buffett announced that traditional department stores were dead. According to industry consultancy Coresight Research, over 7,000 store closures were completed by U.S. retailers by the end of April 2019, which is more than all the stores shuttered during 2018, and there are signs of more to come.

An example is major chain store Payless Shoes, which is in the process of closing 2,600 stores across the U.S. and Canada. Investment bank UBS believe there will be around 75,000 more store closures in the U.S. alone by 2026, and this will spill over into Canada as the acceptance of e-commerce and online retail grows.

This is weighing heavily on the performance and very viability of shopping malls as well as retail REITs. While Canada has escaped relatively unscathed compared to the U.S., there has still been a string of store closures and bankruptcies with much of it representing fallout from the retail meltdown occurring south of the border. While it is having a sharp impact on the fortunes of retail REITs, Canada’s have proven more resistant than in the U.S. This, according to analysts, is because there are significantly fewer tier-two and -three retail properties, more lifestyle tenants, and Canadian malls are better designed and more productive.

Many U.S. retail REITs were caught off guard by the retail apocalypse and even tried to downplay the consequences; they suffered disastrously as a result. **CBL & Associates Properties** (NYSE:CBL) has been one of the hardest hit, losing 82% of its market value over the last year because of rising occupancy rates, sharply deteriorating funds from operations (FFO), and ever-growing losses.

For the first quarter 2019, CBL's FFO fell off a cliff, plunging to almost half of what it was a year earlier to US$0.22 per diluted share, while its net loss ballooned to a worrying US$0.29 per share, which was almost five times greater than the same period in 2018. Despite words of assurance frommanagement, CBL's fortunes continue to deteriorate. It is the failure of many major department stores,which were crucial anchor tenants for malls, that is responsible for the marked decline in the fortunesof retail REITs, particularly those like CBL, which owns predominantly tier-two and -three properties.

The latest threat is that Trump's approach to trade — more specifically, his push to slap a 25% tariff on a hit list of US$300 million of imports from China — will accelerate the retail meltdown. That list includes most of the goods you would find in the average suburban shopping mall, including sneakers, clothing, jewelry, and other fashion accessories.

This would be an unmitigated disaster for brick-and-mortar retailers, triggering further margin compression and loss of profitability in an industry where earnings are already under extreme pressure, causing store closures and bankruptcies to accelerate. That would spill over into Canada, placing pressure on retail REITs like **Choice Properties REIT**, curtailing their growth opportunities.

Nonetheless, Choice would not be severely impacted because of its high-quality retail properties, focus on necessity-based cornerstone retail tenants like grocery chains, and diversification. It is smaller retail REITs, such as **Slate Retail REIT** (TSX:SRT.UN), that are particularly vulnerable.

Slate Retail's 84 properties are in the U.S., placing it firmly in the storm engulfing retail. While Slate Retail's first-quarter 2019 overall occupancy rate only declined by 0.4% year over year, it fell by 1.1% for non-anchor grocery tenants, which can be attributed to retail store closures and bankruptcies. For that period, FFO declined by 12%, while net income plunged to US$1.6 million, which was less than 16th of the US$27 million reported a year earlier.

More worrying is the deteriorating sustainability of Slate Retail's distribution. For the last trailing 12 months, distributions exceeded adjusted FFO with a payout ratio of 104%, which can be attributed to declining earnings. If cash flows continue to weaken, which, for the reasons discussed, is highly likely, Slate Retail will be forced to cut its distribution, bringing an end to its extremely juicy 9% yield.

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