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Credit FAQ:

How Is E-Commerce Changing The Retail Real Estate Landscape For REITs?

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An old rule in retail says go where the customers are--and now they're online. It's no longer enough for retailers to provide satisfying customer experiences in their stores. Now, the successful ones must meet increasingly demanding consumer expectations on e-commerce sites and smartphones as well. Clearly, the rapid growth of e-commerce is changing the traditional retailing model, and among the most significant impacts is on the way retailers use real estate.

Even though Internet sales still account for a small share of overall retailing, 6% of total sales as of June 2014, they're having a disproportionately large impact on retail real estate. One reason for that is the growth rate of Internet sales growth now far exceeds that of traditional retailing. Standard & Poor's Ratings Services estimates e-commerce will reach about 10% of total retail sales, or about $600 billion, by 2020. Many retailers see e-commerce as one of the main avenues for growth because they recognize bricks-and-mortar sector has matured as consumers increasingly shop online. Therefore, as retailers expand their e-commerce platforms and pursue an integrated retailing strategy, or an "omni-channel strategy," the use of real estate will continue to evolve.

Following are answers to questions we often get from investors regarding the growth of e-commerce and its potential impact on real estate investment trusts (REITs) that specialize in retail and industrial/warehouse space.

Frequently Asked Questions

How is real estate demand changing given e-commerce's rapid growth and retailers' adoption of the omni-channel strategy?

We see three main trends developing in retail real estate: repurposing of existing real estate, weaker, lower-quality malls (or B and C malls) becoming obsolete, and distribution and logistics facilities expanding.

Many retailers are repurposing their existing real estate by finding new uses for their stores, such as distribution centers that can enhance store productivity and shorten delivery times. With initiatives such as buy online/pick up in store or shipping products directly from stores, retailers can significantly shorten delivery times compared to shipping from a traditional distribution center because existing stores are generally located closer to consumers. As growth in same-store sales (sales at stores open a year or more) decelerates and store productivity declines, retailers are leveraging their existing real estate to compete against pure e-commerce retailers such as Amazon and Ebay and reallocating resources across channels to capture a sale no matter where the consumer shops. An omni-channel customer is more valuable to a retailer because of the potential for increased sales frequency and transaction size. Plus, the omni-channel model can enhance customer loyalty and add potential lifetime value. Even online giant Amazon is trying to be all things to all consumers, as shown in a limited U.S. test of "pop-up stores"—temporary stores often set up in vacant retail space--to be closer to customers.

We believe bricks and mortar can co-exist with e-commerce because physical stores remain the primary shopping channel. Still, as retailers develop an omni-channel strategy and attempt to maximize the productivity of their real

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estate assets and improve inventory management, we think they'll likely shrink their store sizes in the longer term, say, the next 5 to 10 years. Recent examples include Sears subleasing a portion of its stores to Primark and Best Buy allocating in-store space to Samsung and Apple to showcase their products.

We think the big-box store format will undergo significant changes as retailers continue to expand their e-commerce sales and achieve greater operating and inventory efficiencies, therefore requiring less square footage at stores. Given shifting consumer preferences toward convenience and shorter delivery times, we expect a transition toward developing smaller formats that are closer to consumers. Along with smaller stores will be tighter and more edited selections of merchandise that allow for more efficient inventory management as a way to remain competitive. Both Wal-Mart and Target are opening smaller formats such as Wal-Mart Express and City Target to offer convenience and proximity to customers.

Among the major consumer product sectors that are more vulnerable to e-commerce competition are apparel, consumer electronics, books/music, and home furnishings. But e-commerce will not affect all real estate equally. Restaurants, grocery stores (especially smaller "convenience" versions), and service-oriented retailers will feel less competition from e-commerce and will see different demand trends than the rest of the retail sector.

The development of e-commerce and omni-channel makes life for lower-quality regional malls particularly difficult. B- and C-quality malls located in secondary or tertiary markets are more vulnerable to e-commerce and the threat of a slow economic recovery, and are at higher risk of becoming obsolete. Retail REITs including Simon, Vornado, and American Realty Capital Properties (ARCP) are pursuing the spin-off of B and C assets to reduce their risks of owning weaker-performing mall assets with struggling retail tenants such as Sears or J.C. Penney that can hurt overall traffic. Still, we believe B-quality malls that are "the only game in town" remain well positioned and profitable. Such B malls can realize upside potential by recapturing the space of a departed underperforming anchor tenants such as Sears and J.C. Penney by re-leasing it at higher rate given relatively tight supply. For example, the combined Washington Prime and Glimcher portfolio of shopping malls has occupancy of about 93%.

We expect REITs with top-quality centers (A malls) will continue to do well as they invest in their assets to stay relevant with changing consumer trends. They're reinventing themselves by investing in consumer-friendly technologies such as free Wi-Fi and increasing their malls' entertainment components with restaurants and movie theaters, with the objective of creating a complete retail experience for consumers that can't be replicated online. REITs are also responding by exploring new distribution systems such as same-day delivery service to support retailers' omni-channel strategies, by forming alliances with same day delivery service such as Deliv to offer mall shoppers same day delivery in select malls across the country. Another trend in retail REITs is an adjustment of the tenant mix. REITs are seeking to diversify their tenants by adding a range of retailers that e-commerce can't replace, such as grocery stores, personal service, and urgent care clinics.

Growth in warehouse and logistic facilities are creating healthy demand for industrial facilities, such as warehouses and distribution centers. Retailers are accelerating their investments in technology and infrastructure to integrate the omni-channel strategy so that it's capable of supporting rapid growth of online sales and shortening the supply chain. This has been a positive development for industrial REITs. As pure-play e-commerce retailers continue to demand space for storage and as traditional retailers increase their demand for similar space due to their online efforts, industrial real estate is experiencing above-average growth. Distribution centers have become a major development opportunity for industrial REITs, and we expect continued demand for such space over the next few years, with lease rates and occupancy levels both likely to increase.

How are the rated retail REITs positioned to withstand the shifting retail landscape toward e-commerce? And what are their longer-term prospects?

We believe the 19 retail REITs we rate are well positioned for the next one to three years despite growing threats from e-commerce and omni-channel sales. Retailers that are successful in omni-channel can benefit retail REITs because they'll remain stronger and viable tenants for the long haul, helping retail REITs sustain occupancy levels and rent increases.

We expect the rated retail REITs to remain well positioned to benefit from the continued, though slow, recovery of commercial real estate with relatively stable occupancy rates and modest rent growth potential. Supporting these REITs are limited supply with little new mall development, population growth, and improving asset portfolio quality. Retail REITs continue to cull their assets, divesting lower-quality properties and investing in higher-quality ones, resulting in overall stronger portfolios. While development has picked up, the overall exposure to speculative development activity relative to the size of the asset portfolio remains modest. Retail REITs are also recycling proceeds from the sale of noncore assets and from redevelopment to enhance their cash flow.

What impact is the growth of e-commerce having on demand for industrial real estate?

Industrial REITs are feeling significant impact from the e-commerce boom. Retailers and consumer product companies are responding to an improving economy, higher consumer spending, and rising e-commerce by increasing their demand over the past few years for industrial building space to house strong logistics infrastructure and efficient distribution networks.

After a period of limited growth, businesses are now seeking to develop distribution centers near populated areas for two primary reasons. First, this cuts down on delivery time, but also it also offers reduced logistics costs. Pure-play online retailers such as Amazon and Ebay have also boosted demand for industrial space. With complex operations and business models focused on quick, efficient turnaround (same-day delivery) for major metropolitan areas, they need modern, customized facilities. Thus, demand is significant for extremely large, built-to-fit distribution centers within a day's drive of major metropolitan areas.

Fulfillment centers that Amazon employs, for example, require effective use of space and typically feature taller buildings, larger parking lots, more loading docks, ample transportation routes for trucks, and the potential for future expansion.

What are the potential development risks for industrial REITs?

We believe development risks for industrial REITs are increasing but remain modest. Absorption (rate at which available space in the market is leased) has been positive since early 2010 and likely to remain positive for the next couple of years. Although the construction pipeline is ramping up, new building has not kept pace with demand, resulting in a continued trend of positive net absorption and falling availability (ie. vacancy) rates.

The demand from both existing bricks-and-mortar and pure-play online retailers for distribution centers and fulfillment centers close to metropolitan areas has created a gap in supply. One of the most significant gaps is for mega-facilities (500,000 square feet or more). Correspondingly, industrial REITs and other owners of industrial properties have been raising lease rates and improving their profitability. Still, the e-commerce and omni-channel business models are evolving, and real estate needs to fulfill e-commerce orders can change as retailers determine the optimal model to handle sales and returns.

To mitigate development risks, many industrial REITs are engaging in build-to-suit projects. To finance new development, REITs are taking advantage of low interest rates. Speculative building has decreased significantly since 2007, and industrial developers' appetite for risk has not returned to what it once was. For reference, in 2012, total square footage started was 58 million square feet (50% of it, or approximately 30 million, build-to-suit). Pre-crisis, this number was closer to 150 million square feet per year, almost all speculative.

Overall, we see the outlook for industrial REITs as better now than it was in the years immediately following the financial crisis. E-commerce growth is a major reason for this outlook because constrained supply and increased demand will push rents and occupancy rates higher.

What is our ratings outlook for retail and industrial REITS?

Our outlook for the REITs sector overall is positive as about 17% of the ratings have a positive outlook. The rating trend for retail REITs is similar with two positive outlooks and one rating on CreditWatch positive. We placed the rating on Glimcher Realty Trust on CreditWatch with positive implications and revised the outlook on Washington Prime Group to negative following the announcement that Washington Prime has agreed to acquire Glimcher in a stock and cash transaction valued at $4.3 billion. Major players such as Simon, Kimco, Regency, and Weingarten all have stable outlooks, while Equity One has a positive outlook. We upgraded DDR to BBB- from what 'BB+' in August 2014 because it steadily improved the overall quality of its portfolio while strengthening its balance sheet. We also raised the rating on National Retail Properties to 'BBB+' from 'BBB' in July this year because of its consistently good operating results, conservative underwriting, and prudent growth strategy.

The outlook for industrial REITs is also positive. We currently have positive outlooks on Liberty Property Trust and Lexington Realty Trust, while Duke Realty, Prologis Inc., and First Industrial Realty all carry stable outlooks (see table 1).

Table 1

Ratings And Outlooks

	Corporate Credit Rating	Outlook/CreditWatch
Retail/Triple-Net		
Simon Property Group Inc.	A	Stable
Federal Realty Investment Trust	A-	Stable
Realty Income Corp.	BBB+	Stable
National Retail Properties Inc.	BBB+	Stable
Tanger Factory Outlet Centers Inc.	BBB+	Stable
Kimco Realty Corp.	BBB+	Stable
RioCan Real Estate Investment Trust	BBB	Stable
Regency Centers Corp.	BBB	Stable

Table 1

Ratings And Outlooks (cont.)		
Weingarten Realty Investors	BBB	Stable
W. P. Carey Inc.	BBB	Stable
Washington Prime Group Inc.	BBB	Negative
Equity One Inc.	BBB-	Positive
DDR Corp.	BBB-	Stable
American Realty Capital Properties Inc.	BBB-	Watch Neg
Retail Opportunity Investments Corp.	BBB-	Stable
Excel Trust Inc.	BB+	Stable
Spirit Realty Capital Inc.	BB-	Positive
Glimcher Realty Trust	BB-	Watch Pos
Brixmor LLC	BB+	Stable
Industrial		
Prologis Inc.	BBB+	Stable
Liberty Property Trust	BBB	Positive
Duke Realty Corp.	BBB	Stable
DCT Industrial Trust Inc.	BBB-	Stable
Lexington Realty Trust	BB+	Positive
First Industrial Realty Trust Inc.	BB+	Stable

We believe the growth of e-commerce has reached a point where it's having a significant impact on retailers and changing their business models. However, we expect its impact on the rated REITs to be limited in the near to intermediate term (one to three years) given the limited new supply and improving economic fundamentals amid a slow but gradual economic recovery.

Longer-term, retail REITs might need to look at other acquisition and development options, such as integrating bricks-and-mortar locations with online sales facilities, expanding their portfolios to include warehouses, distribution centers, in-store online shopping technology, and delivery services to provide full service to retailers. Industrial REITs are increasing the amount of build-to-fit distribution and fulfillment centers to fill the current void, especially for mega-facilities. Above all, for both retail and industrial REITs, the two critical points are tenant mix and the quality of building location. Facilities must be close to metro areas, and the tenant mix is important to remain an attractive venue for the changing consumer.