



# Perspectives

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## E-Commerce and the Changing Retail Environment

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Internet sales, commonly called e-commerce, have been increasing at a rapid pace for over a decade. Driving the explosive growth in online retail is the myriad of benefits offered to the technologically-equipped shopper: convenience, flexibility, “24/7” access, time savings, ease in comparison shopping, avoiding crowds, discounts and, in some areas, sales tax savings. Though these benefits appear to have universal appeal, internet shopping is not for everyone and not every product is adaptable to e-commerce.

In this issue of “Perspectives”, we explore e-commerce as a component of total retail sales, take a brief look at the current state of retail shopping centers and some current trends, and see how some investors evaluate the retail sector of commercial real estate.

### Retail Sales

According to reports by Forrester Research, on-line retail sales will account for \$523 billion of retail sales by 2020, a jump from an estimated \$335 billion in 2015. That’s a compound annual growth rate exceeding 9% and a 56% increase from 2015 to 2020. Numbers vary based on the source and the method of analyzing, but, it is clear from Exhibit 1 that e-commerce is growing and cannot be ignored.

Internet sales are not sourced across the economic spectrum but are heavily focused on a subsector of the American consumer. One report indicates that households in the top 20% of incomes account for a third of total retail sales and almost 75% of e-commerce...more than twice the share of online as overall retail sales!

### Retail Shopping Centers

The commercial real estate market has enjoyed a steady path to recovery from the recession’s downturn. The recovery, however, has not been uniform. Stagnant wage and salary growth coupled with sluggish consumer spending has restrained the market for retail space, particularly in shopping

centers catering to middle and lower-income households. Online sales have adversely affected low quality malls and strip shopping centers with big box retailers. In the retail sector, the primary beneficiaries of the recent recovery have been the better malls and high-end street retail, together with coastal and gateway markets. In this segment of the market, sales are currently at or near historic highs, occupancies are up and rental rates are stable to increasing. It is becoming clear that there is a widening gulf between best- and worst-performing shopping centers.

**Exhibit 1:** E-commerce continues to grow as a percentage of retail sales

Year	Retail Sales (\$000,000)		E-commerce as a Percent	Percent Change From a Year Ago		E-commerce vs total retail sales
	Total	E-commerce	of Total	Total	E-commerce	growth rates
2000	2,979,354	27,391	0.9%	-	-	-
2001	3,062,271	34,099	1.1%	2.8%	24.5%	21.7%
2002	3,129,682	44,365	1.4%	2.2%	30.1%	27.9%
2003	3,261,958	56,776	1.7%	4.2%	28.0%	23.7%
2004	3,461,388	72,110	2.1%	6.1%	27.0%	20.9%
2005	3,687,622	90,711	2.5%	6.5%	25.8%	19.3%
2006	3,880,181	112,449	2.9%	5.2%	24.0%	18.7%
2007	4,001,025	135,467	3.4%	3.1%	20.5%	17.4%
2008	3,938,896	141,395	3.6%	-1.6%	4.4%	5.9%
2009	3,630,809	144,252	4.0%	-7.8%	2.0%	9.8%
2010	3,839,849	168,094	4.4%	5.8%	16.5%	10.8%
2011	4,132,679	196,810	4.8%	7.6%	17.1%	9.5%
2012	4,339,249	225,941	5.2%	5.0%	14.8%	9.8%
2013	4,526,982	263,361	5.8%	4.3%	16.6%	12.2%
2014	4,696,881	303,939	6.5%	3.8%	15.4%	11.7%

Source: U.S. Census Bureau, J.P. Morgan estimates.

Adding to the strain in retail fundamentals, there have been various structural shifts in demographics as younger households show a growing preference for urban living. While there have been only a handful of traditional enclosed malls built in the last decade and other retail construction has been low, there is a noticeable increase in “Main Street”, open-air shopping centers located close to new multi-family developments. The early trend is for store locations to move closer to shoppers (incidentally, affecting industrial and warehouse demand).

Landlords of retail space are projected to shift toward smaller stores for tenants thus fitting more retailers into the same amount of space and creating more exciting retail environments. At the same time, retailers are evaluating the role of stores in their platform and how to leverage technology. Many retailers have begun to shift away from an exclusive brick-and-mortar retail model. Some large stores have begun to downsize floor plans and decrease the number of new store openings. The premise of “bigger and more is better” is giving way to a leaner model of “smaller and fewer”.

### **Investing In Retail Commercial Real Estate**

Investors are influencing the complexion of the retail scene, too. Many of today’s investors are more selective about assets, preferring good locations and specific shopping environments and shunning inferior locations and struggling centers. “Pure play” retailers, with little or no physical presence such as Amazon and e-Bay, challenge the brick-and-mortar retailer. It does not mean, though, that e-commerce will lead to the demise of retail centers, generally, or the big box retailer, specifically. Retailers are recognizing the need to mesh physical and online presence into a seamless shopping experience. An omni-channel experience incorporates the internet (e-commerce) with mobile applications (m-commerce) and provides for improved delivery and distribution. Retailers and shoppers should benefit from a more comprehensive

approach to marketing in today’s evolving and dynamic retail environment.

Investors can be selective and focus, from a collateral perspective, on quality and well-tenanted retail centers and malls in primary and secondary markets while avoiding turn-around stories, tertiary markets and struggling retailers, as a general rule. Recognizing that considerations such as loan or deal structure and metrics (loan-to-value, debt coverage ratios, etc.) play a vital role in mitigating risks, the quest for the highest quality retail investments can judiciously include a reasonable exposure to other retail assets.

The retail landscape is forever changing. The continued growth of e-commerce and emerging mobile applications geared to the consumer should not deter investors from considering an investment in brick-and-mortar retail. Investors in commercial mortgage-backed securities (CMBS) are often able to gain exposure to the retail sector across diverse markets and a variety of retail types (malls, neighborhood shopping centers, single-tenant stores, etc.). **With a careful selection of bonds backed by favorable collateral and having certain structural features, investors can enjoy strong protection from losses, obtain favorable cash flow treatment, and mitigate risks in ways not available to the single property owner or lender.**

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