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Out of Stock or Out of Business?

Authors: Kira Hall, *Analyst, Commercial Mortgages*
Levi Lawrence, CFA, *Senior Analyst, Commercial Mortgages*
In collaboration with: François Desjardins, *Editor*

From the onset of the COVID-19 pandemic, Canada has been fighting dual crises: one of public health and one of economics. The lockdowns that began in March 2020 were expected to expedite the retail apocalypse that had been threatening for the last decade. As retail traffic plummeted at brick-and-mortar locations, demand for at-home goods remained resilient, specifically through online channels.

The forced business closures and the resulting layoffs of nearly 2 million people throughout the spring of last year gave real estate investors even more reason to have concerns about their retail assets. Prior to the pandemic, many landlords had focused on leasing to experience-oriented tenants, such as restaurants and gyms, to escape the growing threat of e-commerce. Investors in retail properties had to fear that not only were thousands going to be without jobs and the discretionary income that came with it, but those that were still employed could not go out and spend their money either.

One year on, here we are. So what now? **While investors had every right to be worried when the pandemic first hit, we believe that wisely chosen retail assets still hold a promising future.** In this piece, we will lay out a few reasons supporting our view.

The Power of Staple Tenants

As it turns out, the polarization of the landscape reinforced the importance of having consumer staple anchor tenants like banks, grocery stores, pharmacies, dollar stores, and liquor stores. Going into the pandemic, our Addenda Commercial Mortgages Pooled Fund (ACMPF) had 90% of its retail assets anchored by a tenant in one of the previously listed sub-industries. It did not have any exposure to interior malls which would have taken the brunt of the wave of closures in specialty retailers.

To get perspective on where things stands now, let’s first go back to the spring of 2020.

An unemployment rate over 13%, combined with forced closures, immediately created an environment where retail sales from coast-to-coast plummeted to depths not seen since the Great Recession. If that wasn’t enough for brick and mortar retail, e-commerce sales increased 250% from pre-pandemic levels which investors feared had finally sounded the death knell for their struggling tenants.

In the spring months of 2020, 138,000 more businesses closed compared to 2019, which signaled that it would be the end for many retailers. Disproportionately affected were those retailers that couldn’t move their product online, a group including fitness centres, bars and restaurants, hotels, and places intended to provide an experience like coffee shops and bookstores. Seemingly overnight, the Government of Canada introduced a multitude of aid programs directly intended to support small businesses by providing rent relief, wage subsidies, and interest free loans.

By the summer of 2020, it was appearing that the government stimulus, combined with Canada's spendthrift culture, had averted the retail apocalypse for the time being. Just three months after the first cases of COVID-19 arrived in Canada, retail sales were above their pre-pandemic levels. E-commerce as a percentage of total sales nearly halved, moving from almost 11% to under 6%. This being said, those headline numbers do not describe the full picture as the retail landscape became polarized with some still barely hanging on while others feared not being able to keep enough inventory.

Fast forward to 2021.

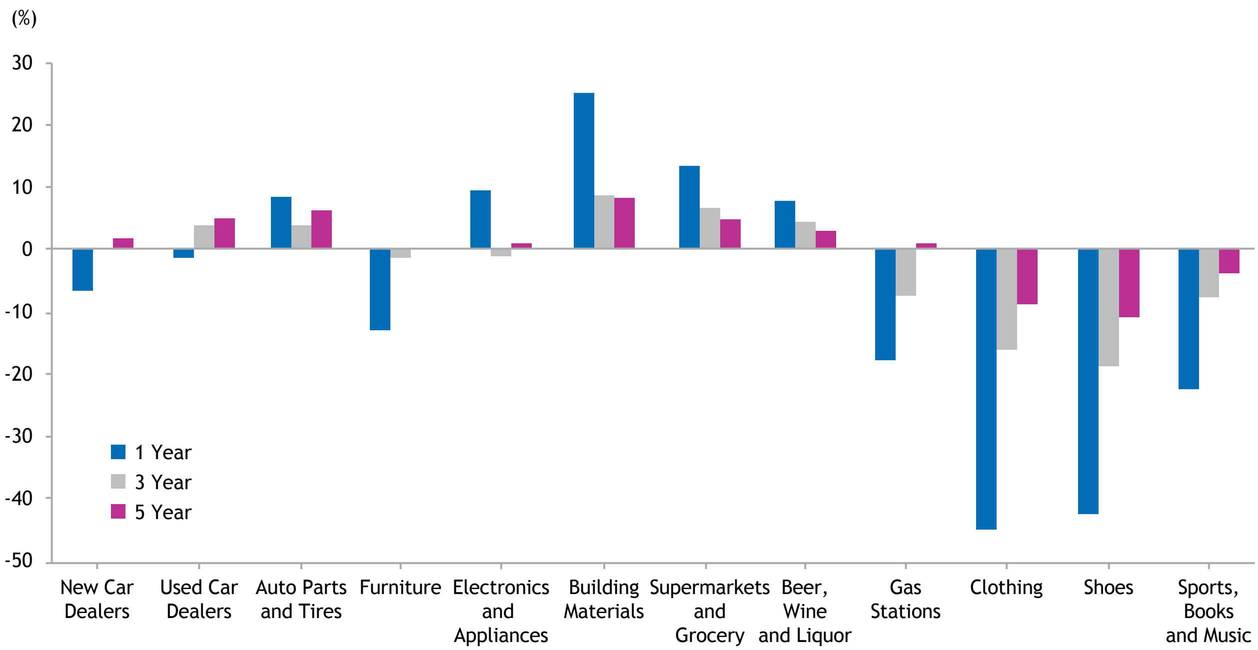
With five consecutive months of business openings outpacing closures, 71% of businesses that closed in the initial lockdown have now restarted operations. Although the trend is promising, the number of continuing businesses in Canada is still 5% below pre-pandemic levels.

Trends

The ongoing recovery in retail sales should give optimism to both investors and lenders of retail properties. The overall recovery is turning out to be K-shaped, with some retailers doing exceptionally well while others continue to struggle.

Year-over-year (YOY) growth for at-home items like groceries, fitness equipment, electronics, and building materials are all up over 10% with retailers unable to keep enough inventory to meet demand. On the other hand, sales at gas stations, clothing and shoe stores, and bookstores are all down at least as much and more in the case of clothing and shoe stores.

Average Annual Retail Sales Growth by Industry



Source: Statistics Canada

A consumer trend to note is gas station sales compared to automobile sales. Gas station sales immediately plummeted 50% in March 2020 and have stayed depressed into 2021, still 18% below pre-pandemic levels.

The same cannot be said for the sales of automobiles. After their initial 66% plunge, they recovered and turned positive just five months following the initial lockdowns. With more time spent at home, in conjunction with gas station sales down 18% YOY, it seems that consumers would have less use for vehicles and would be delaying purchases. Yet this resilience of auto sales may be a prelude to the post COVID-19 retail recovery in Canada. Given the means to spend and the opportunity to do so, consumers are willing to buy even when not necessary.

As retailers open and safety concerns subside, investors in retail properties can expect their tenants to be supported by consumers as they were pre-COVID-19. E-commerce sales have also pulled back as many consumers opt to go back into stores, which bodes well for property owners. After the initial spike, e-commerce sales quickly decreased to just over 6% of total retail sales in July 2020 and have since only ticked up to 7% as of January 2021 with daily new COVID-19 cases still stubbornly high. This is still up 50% from pre-pandemic levels, but it shows that given the opportunity, most consumers did go back into stores even as the threat of COVID-19 was still prevalent.

Retail fundamentals indicate a modest recovery in the next few quarters. CoStar forecasts national retail vacancy will gradually decline starting in Q3 2021, reaching pre-COVID levels by Q4 2022. In addition, CoStar predicts that net absorption — more square footage being occupied than is becoming vacant — will be positive for all major cities over the same period.

However, this is largely due to the lack of new development. There is currently only about 7.4 million square feet of retail space under construction, which will lead to a below-average number of new deliveries in the next few years. While forecasted fundamentals such as vacancy and net absorption provide a stable view of retail, the sector still faces the risk that lockdowns and social distancing restrictions will continue for longer than expected, increasing the chance of additional retail closures and subsequent higher vacancies.

Takeaway

The short-term risk for property owners is rent collection, as rolling lockdowns continue and many of their retail tenants that re-opened must temporarily close their doors again. The longer-term risk is the amount of businesses that permanently closed or may still permanently close as conditions remain bleak. As severe lockdowns continue across much of the country, many temporary closures will become permanent. It is not yet known what kind of lasting impact the business closures will have on vacancy rates in the aftermath of the pandemic, whenever that may be.

But the positive takeaway is that the resilience of consumer spending has never been more apparent with an added focus on spending local. Shop local groups and ad campaigns have emerged in all of Canada's major cities to counter the e-commerce giants. Going forward, with the means to do so, and with the prospect of safety concerns subsiding in the coming months, consumers are anxious for a shopping experience that does not involve a delivery truck.