CHASE PROPERTIES

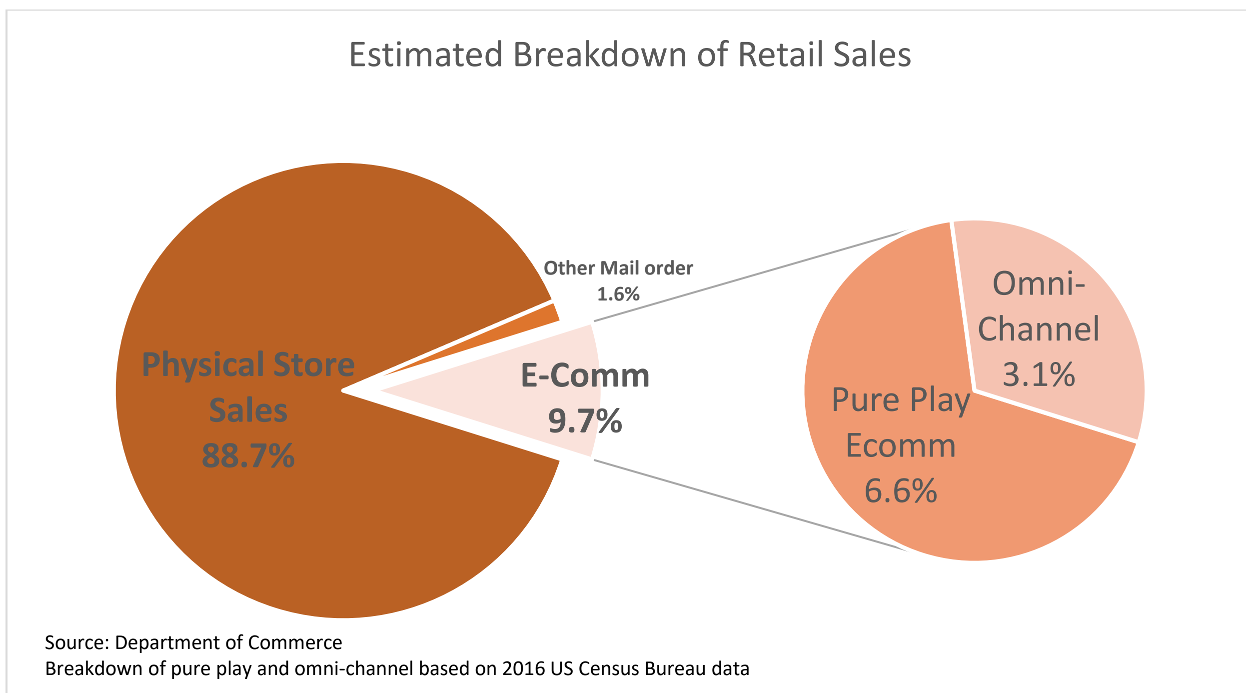
2018 Industry Observations

CHASE PROPERTIES
America's Small Market Experts™

January 31, 2019

2018 was a year in which brick and mortar retail continued to stabilize while the gap between retail winners and losers became increasingly evident. Retailers that have been able to adapt to consumers' changing buying behaviors flourished in 2018 while those that have been slow to change saw continued challenges and, in some cases, saw their eventual demise. As we have invested over the past several years in retail properties, we have been cognizant of these winners and losers and have been able to successfully navigate these changes.

Early indications for the 2018 holiday period indicated that this was the best holiday season in six years, with retail sales increasing 5.1%. The Department of Commerce estimates that e-commerce sales accounted for approximately 9.7% of total retail sales through the first three quarters of 2018 and a significant amount of the e-commerce sales are generated by omni-channel retailers. The International Council of Shopping Centers ("ICSC") estimates that 93% of holiday shoppers bought products from brick and mortar retailers, including those who bought online from brick and mortar retailers.



The widening gap between winners and losers was evident in 2018 as retailers such as Target, Walmart and others benefited from significant investments in omni-channel platforms, while retailers such as Sears, Toys "R" Us and Mattress Firm suffered from a lack of investment, over expansion and significant debt loads. One of the investments that paid off for retailers was the ability to purchase products online and pick them up in the store ("click and collect"). According to a study conducted by Adobe, click and collect increased by 46% during the period from November 1st to December 6th and Kohls' CEO recently commented that Black Friday was "a record day for the retailer's buy online, pick up in store orders." Retailers have recognized that consumers want convenience, whether it is fast delivery or the ability to pick up in store. As an example, Home Depot has added lockers to the front of its stores in order to make it easy for customers to pick up orders, while both Target and Best Buy removed free shipping minimums during the holiday season. Those retailers that have had the financial ability and strategic vision to invest in click and collect and other platforms that cater to creating a seamless online/offline experience for the consumer outperformed their competitors in 2018.

Grocery orders can be picked up at 1,800+ stores and delivery is being expanded to cover 40% of the U.S. population b, year-end[1]

Walmart

Restaurants experienced digital sales grow.th of 48%[3]

Stores today fulfill 50% of the retailer's online orders, which is expected to rise to 75%-90% five years from now[5]

DSW

Interconnected • Complementary • Interdependent

Online

In-store

Target partnered with Shipt to offer same-day delivery from over 1,100 of it's stores an. counting[2]

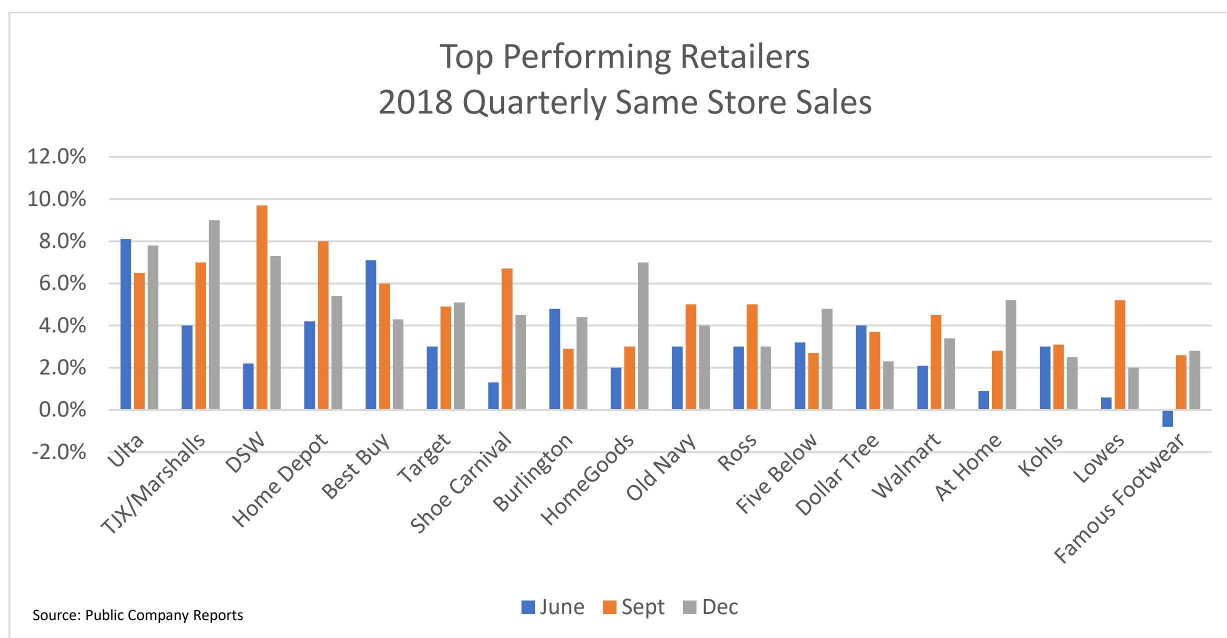
TARGET

47% of online orders are picked up in store[4]

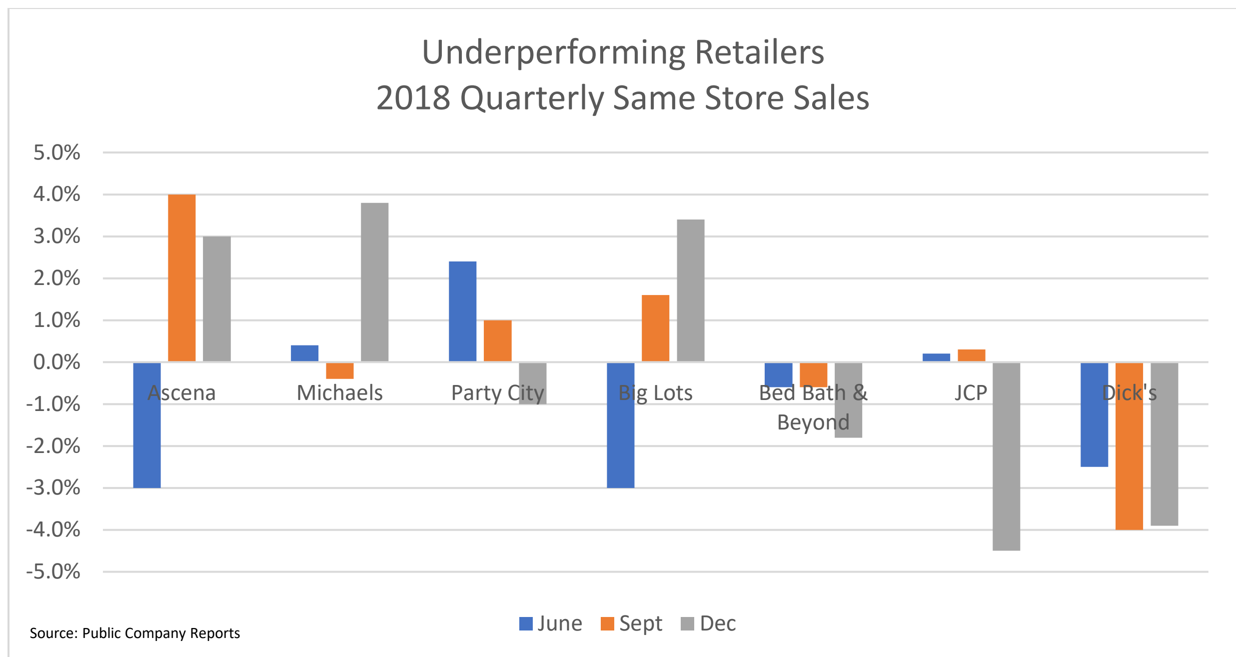
Mobile payments for in store pick up have grown to over 40% of total tender .n the U.S.[6]

Source: Kimco Realty

We also saw outperformance in 2018 from certain retail categories, while others faced continued headwinds throughout the year. As you'll see in the chart below, many of our top portfolio companies saw positive same store sales throughout the year. Those categories that outperformed were discount/value-oriented retailers (Target, Walmart, TJ Maxx, Ross, Burlington), shoes (Shoe Carnival, DSW, Famous Footwear) and home goods (Home Depot, At Home, HomeGoods, Lowes). We also saw continued outperformance from retailers that have differentiated themselves through merchandising assortment (Five Below) and the creation of an experience (Ulta).



We saw inconsistent performance from other select retailers, as shown in the chart below. We have been encouraged by recent quarterly performance from some of the Ascena brands as well as Michaels and Big Lots, while Dicks' performance has struggled in large part due to their decision to discontinue the sale of many guns following the Sandy Hook shooting. While these retailers were inconsistent in 2018, we have not been concerned about their long-term viability provided they can continue to improve merchandising assortments and adapt to the changing retail and consumer dynamics.



This contrasts with others that have seen fundamental shifts that have negatively impacted performance and we believe will continue to impact performance. These include JC Penney as well as other department stores. Sales at department stores have shifted in recent years to specialty retailers, such as Ulta Cosmetics, and value retailers, such as TJ Maxx. In 2007, value retailers had $18 billion in sales and department stores had $85 billion. By 2016, value retailers had grown to $75 billion while department stores had dropped to $26 billion. While this shift has impacted JC Penney in open air shopping centers, it has primarily impacted the enclosed mall space as department stores such as Macy's, Sears and Bon-Ton have closed stores. We believe that this trend will continue to impact "B" and "C" malls.

While 2018 saw some high-profile bankruptcies, the overall number of filings declined from 2017. Several, including Sears and Toys "R" Us, had been anticipated for years as a result of mismanagement and underinvestment. Toys "R" Us suffered from years of a lack of investment in stores and systems, over-leverage, competition from online and discounters and a shift in their core customers' habits (namely, the shift from traditional toys to electronic games, iPads and cell phones). This combination was insurmountable and ultimately resulted in the complete liquidation of the chain, which created a significant amount of available square footage. Many of their stores were well located and we have seen a substantial portion of them either purchased by other retailers or re-leased by their former landlords. We also saw the bankruptcy and continued slow liquidation of Sears/Kmart, which also suffered from years of mismanagement and a lack of investment in stores. As we have noted in prior letters, we have viewed this as a slow liquidation for years and we believe it will continue even if they are able to emerge from bankruptcy.

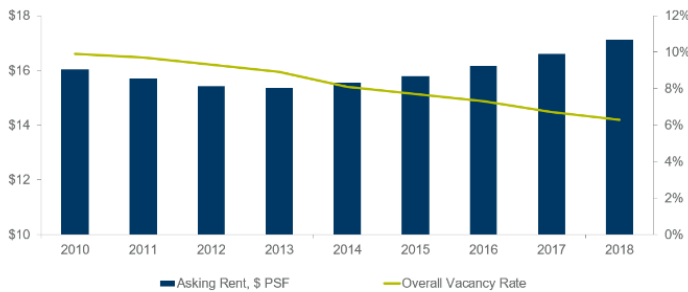
The final category of retailers that have struggled this past year are those that over-expanded. These include Mattress Firm, which filed for bankruptcy and subsequently emerged with a smaller store count, and the two major pet store chains, PetSmart and Petco. These two companies have grown their store count significantly since 2010 as demand for pet services such as grooming, veterinary and boarding has increased. This overexpansion has resulted in increased store overlap over the last 5 years, contributing to both companies' declining same store sales. According to Creditntell, store overlap increased by 50% within a 5-mile radius during the five-year period from 2013 to 2018. This has occurred under private equity ownership with both retailers taking on significant leverage. The result has placed both retailers on our credit watchlist. We expect that both will be viable in the long term, but we have been careful to underwrite their credit appropriately and focus on high performing locations.

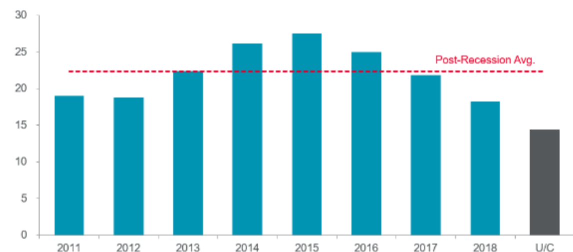
Another dynamic that we continued to see play out in 2018 was the expansion of retailers that had traditionally sold online only. According to a recent study by JLL (Jones Lang LaSalle) of the top 100 digital retailers, it is expected that these e-commerce retailers will open 850 physical stores over the next 5 years. This has been driven by several factors. The first relates to the cost and value of online advertising versus the value of physical locations. Bloomberg discussed

this dynamic in a recent article by saying that "the competition for eyeballs has pushed up the cost of ads even as those ads become less effective because there are so many of them clamoring for attention. Much the same thing is happening offline too with subway ads, direct mail, podcasts and television." This same article quoted the founder of Untuckit, an e-commerce retailer, as saying that "customers who didn't want to buy a $98 shirt because they weren't sure if we're just another fly-by-night e-comm company started taking us very seriously [after opening stores]." And an ICSC study discussed the value of omni-channel, indicating that "opening one new physical store in a market results in an average 37 percent increase in overall traffic to that retailer's website, compared with web traffic prior to the store's opening". This was even more pronounced for emerging brands (defined as less than 10 years old). The converse was also true, with web traffic declining when retailers closed stores in a market. In one retailer's case, the share of web traffic across the markets where they closed declined by 77%.

Source: ICSC

Another factor causing many e-commerce retailers to open stores is the high rate and cost of returns. In-store shoppers typically return approximately 8% of the products that they buy, while the return rate for online shoppers is 30%. In addition to the reduced cost of handling returns in physical stores, these retailers also benefit from the consumer making additional purchases when they come into the store. As was noted in the Bloomberg article about Untuckit, "profit margins were better, too, without paying for shipping or as many returns. Plus, offline customers bought more."





As we look forward, we continue to see opportunities in the retail sector. Despite store closures, the industry overall remains healthy, with strong occupancy, rent growth and very little new construction. We believe that "A" quality centers will continue to see strength and will be the beneficiary of the weakness in lower quality malls and strip centers. We have experienced this benefit first-hand within our own portfolio. Our fund portfolio is 95% leased and throughout this past year over 91% of expiring tenants renewed their lease at an average rental increase of approximately 6%. Furthermore, we have already secured new tenants for 50% of the spaces that were vacated this past year. In reviewing new acquisition opportunities, we remain intently focused on tenant performance and we remain disciplined in how we underwrite tenant credit risk. We will continue to do our best to manage through the changing retail environment and maximize returns to our investors.