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The Tale of Two Retails

It is not the strongest of the species that survives, nor the most intelligent, but the one most responsive to change. ~Leon C. Megginson

Summer is here—the make-or-break season for many retailers. For some it will be summer lovin', but for others it will be the summer blues.

Retailers need to adapt to the new landscape or they will not survive. We feel there is value in specific names, while others are to be avoided. Concerns over malls are specific in nature and we see pockets of value there, too.

At Western Asset, we are able to utilize a "combined-arms" approach, with specialists in each market segment. In this paper, DeAndre discusses the challenges facing retail sector investment-grade companies, while Suzanne covers the high-yield segment. Finally, Harris explores the impact on the commercial real estate arena. We'll discuss how to find value in the retail sector and take a closer look at how major macro themes, most notably the online retail craze, are affecting a broad array of retailers and their securities.

It Was the Best of Times, It Was the Worst of Times

Some might say the fundamentals for retailing have rarely been so good. Energy prices and interest rates are low, the consumer is confident, retailers' balance sheets are bolstered by strong home and stock prices, and even the prospect of tax cuts is on the horizon. Retailers also enjoy low financing costs while, generally, their inventory levels are low. Even the weather has been good. "It was the best of times," indeed.

Yet every day we hear "worst-of-times" stories about the plight of struggling retailers. Where is the disconnect? Certainly tastes and shopping habits change quickly these days and, as always, some businesses are unable to adapt. Some of the recent shifts in retail were hard to predict, such as the millennials preferring services and experiences over stuff. But other changes seem secular, as the evolution and adoption of new technologies continue to drive the growth of online shopping.

Exhibit 1
Secular, Not Cyclical, Shift in Retail

*Source: Bloomberg Finance L.P. As of April 2017 *Extrapolated*

Executive Summary

- Changes in the retail sector, especially online shopping, are secular not cyclical.
- For retailers, the writing is on the wall: adapt or die.
- As a value-oriented investor, Western Asset still manages to find pockets of value in those adaptable, brand- and customer-service-oriented retail companies.
- Bondholders, however, may continue to suffer losses and the list of retailer casualties grows by the day.
- The "bricks and clicks" trend —such as Amazon's acquisition of Whole Foods—won't be the last of its kind.
- Like a store frustrating its customers, the lines at the checkout can be long and time-consuming, especially for the investor who wants to exit in a hurry.

With many a premature obituary written[1], Amazon and other online retailers have now become the scourge of the legacy retailer by increasing market share while broadening the products they sell. Every weakness is now exploited, from convenience and flexibility of product range, to price discovery and price comparison and even the length of supply chains. Certain legacy brick-and-mortar retailers suffer supply chains stretching six to eight months to deliver goods, while new entrants such as "fast-fashion" retailers have wrestled those same wait times down to just six to eight *weeks*. These advantages have not come without cost to online retail, and Amazon in particular has sacrificed profit for market share[2], just as many of those 1990s epitaphs suggested it would be forced to do. But in the end, this disruption will favor the nimble, the innovative and the financially flexible.

Start at the History Section

So where did legacy retail in the US go so wrong? Initially, it grew excessively fast with floor space growing twice as fast as population. Its biggest error, however, appears to have been a continuing lack of flexibility in the face of enormous changes in tastes and technology—truly disruptive secular forces. True, some malls are adapting toward broader convenience and experiential visits, but the older legacy stores continue to lose out. Malls that are predominately occupied by such weak retailers risk being dragged under in the wake.

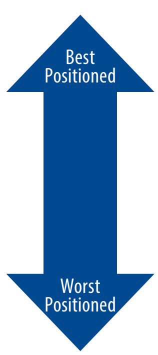
The consequence is what we see today with both large and small retail groups filing for bankruptcy protection and closing stores. As we see in Exhibit 1, during the first four months of 2017 retailers have announced nationwide store closures at a rate set to handsomely exceed the record numbers seen in 2008. Furthermore, with significant numbers of workers in the retail sector, store closures risk becoming self-fulfilling as the loss of income forces weaker demand for viable local stores. Individual communities that rely on retail for employment are particularly vulnerable.

Overall, the sector looks to be "for sale."

The Tale of Two Retails—Those Who Adapt Can Thrive

As with every case of secular creative destruction, some businesses adapt and survive, while others fail. As a value-driven investor in fixed-income—where gains (usually income) are typically dwarfed by potential losses (default of principal)—it is crucial to understand the raw fundamentals businesses face. We can see from the earlier discussion that recognizing these forces as secular and not cyclical is a first step. But there are also important stock- and subsector-specific issues that drive winners and losers within an industry, and in Exhibit 2 we list some of the important ones, including how they stack up for a variety of players in the retail space.

Exhibit 2
Factors Driving Success in Investment-Grade and High-Yield Retail Bonds



Investment-Grade

Mass Merchants
- (+) Size and scale
- (+) Financial flexibility
- (+) Commitment to investment-grade ratings
- (–) Millennials prefer services and experiences

Example: Wal-Mart

Department Stores
- (–) Highly promotional
- (–) Lengthy supply chains
- (+) Solid online presence

Example: Nordstrom

High-Yield

Niche Retailers
- (+) Breadth and depth of merchandise
- (+) Channel-exclusive products
- (+) Higher-margin services
- (–) Need to invest in online capabilities

Example: PetSmart and Jo-Ann Stores

Apparel Retail
- (–) Low barriers to entry
- (–) New entrants with less financial leverage
- (+) Valuable brands

Example: Gymboree and J. Crew

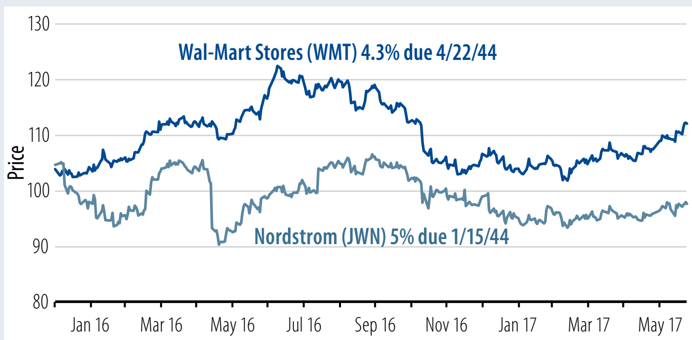
Source: Western Asset

1 Tom Osenton, "Will revenue growth rates run out of steam before Amazon can achieve efficiency levels that will allow it to deliver sustained earnings? That is the $64 question." *The Death of Demand*, FT Press, 2004

2 "Amazon Posts Surprising Profit," *Wall Street Journal,* (July 23, 2015)

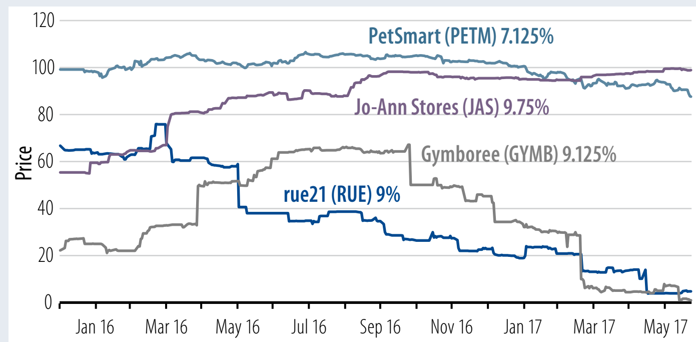
Within the investment-grade sector we favor Wal-Mart Stores, Inc. (WMT) and view it as a core holding. Among the positive credit factors, we feel management has the ability and willingness to maintain its current ratings. As a low-cost "producer" in a very competitive business, its unprecedented economies-of-scale and technological leadership give the company a sustainable competitive advantage whenever it enters a new market or product segment. The company is able to use the leverage of its size to lower its costs when dealing with suppliers. WMT's technological capabilities, in the form of strong systems, allow the company to control costs by streamlining the product-delivery chain. The firm has generated significant free cash flow ($21 billion in 2017), allowing it to support aggressive e-commerce strategies and store remodels. However, WMT competes in a highly cyclical industry in a state of secular decline. Furthermore, it has been increasingly difficult for the company to generate return on capital as it grows larger. Exhibit 3 shows just how solid the performance of this name has been within the investment-grade space, while Exhibit 4 details our chosen high-yield examples.

Exhibit 3
Price History of Two Investment-Grade Retail Bonds



Source: Bloomberg

Exhibit 4
Price History of Four High-Yield Retail Bonds



Source: Bloomberg

We apply the same methodology to the high-yield space using a similar list of factors and it's worth noting a few. One clear factor is brand—the security and respect for brand. In some cases this may be endemic to the business, perhaps specializing in a niche or specialty area. One of our favorite retailers in this vein is Jo-Ann Stores (JAS), a leading craft and fabrics retailer, which benefits from the move toward leisure and crafts that an aging demographic promote. In addition, JAS has ample financial flexibility and free cash flow that has been applied to debt reduction.

Another example is pets, where the all-around specialty service provided has been leveraged by an emphasis on "revering" the recipient—in this case the pet—with the notion that "pets are people too." Other businesses selling pet products have lowered this stance to a corner of the store with limited breadth and depth of pet merchandise. Both PetSmart (PETM) and PetCo (PETC) offer unique services, such as grooming, veterinary care and boarding, in addition to exclusive products that are not sold in the mass-merchant channels, so their retail models can't easily be "Walmartized" or disrupted by Amazon. Also, PETM recently purchased Chewy.com, in line with a growing trend of optimizing its omni-channel retail strategy through "bricks and clicks."

For Some It's a Tale of Woe—Who Isn't Adapting

The turmoil in retail is acting to erode even larger players, some of which are long-established brand names in the sector. It's clear that no business is safe, and as a bond holder, even an investment-grade rating is little comfort.

Thankfully, while passive investors exist in this space, there will often be a buyer of last resort, to mop up these securities as they fall toward restructuring. But bondholders can face substantial losses here, so avoiding the losers is crucial. With our value-oriented, diversified philosophy, Western Asset is comfortable in this stock picker's pool and we have been fortunate to avoid many of the recent casualties. Again, the online and alternative retail disruptor phenomenon is secular, not cyclical in nature. We believe that the retail metamorphosis is just beginning, especially since "millennials" are not typically loyal to brands and wage inflation will continue to pressure margins.

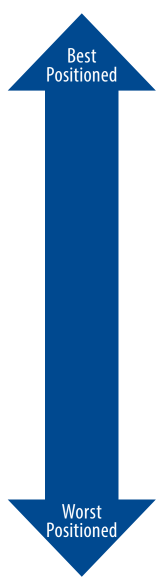
Within the investment-grade sector, we're underweight virtually all retailers due predominantly to the continued secular decline of the department stores. For example, Western Asset has been cautious on Nordstrom (JWN), which announced on June 8, 2017, that members of the Nordstrom family were exploring the possibility of going private. Taking Nordstrom private could be accomplished with significantly more leverage without tripping the change-of-control covenants. This would result in a highly leveraged, sub-investment-grade balance sheet. The performance of the company's bonds is shown in Exhibit 3.

Within the high-yield sphere, Gymboree (GYMB) and rue21 (RUE) went private with the assistance of private equity firms in 2010 and 2013, respectively, but they were unable to adapt to the threat from online competitors. In addition, both specialty retailers were leveraged buy-outs financed with heavy debt burdens that resulted in lease adjusted leverage exceeding 7x, limiting free cash flow and financial flexibility. Also, the children and teen segments of apparel suffer from low barriers to entry and lack pricing power. Ultimately, these businesses were unable to grow into their highly leveraged capital structures due to deteriorating margins and lack of free cash flow. We can see the results in Exhibit 4; the bonds of both companies have suffered tremendously. Looking forward, other retailers such as J. Crew (JCG), who are unable to adapt to the "buy now, wear now" trend, may be the next casualties of the online surge. Their lack of easily monetized hard assets threaten very low recovery rates, perhaps in some cases as low as pennies on the dollar. Furthermore, the formal recovery process can be extremely time consuming.

The Bigger the Mall, the Harder the Fall?

As discussed earlier, some of the larger stores are cornerstones of individual malls. While the other occupants may be strong and durable, their fates seem to be interlinked. Our approach is again to look for value while attempting to avoid the disasters. Many of the factors we evaluate are identical to those for individual retailers, as can be seen in Exhibit 5.

Exhibit 5
Factors Driving Success in Commerical Real Estate



Commercial Real Estate (CRE) Sector

Single Tenant
- (+) Historically stable operating performance
- (–) Binary default risk and relative difficulty in repositioning

Grocery-Anchored Centers
- (+) Strong operating performance, most are functionally fully occupied
- (+) Even as rent spreads moderate they will remain positive, far different than in 2008–09
- (–) New entrants from Europe and AMZN/WFM could pressure incumbent anchors and occupancy

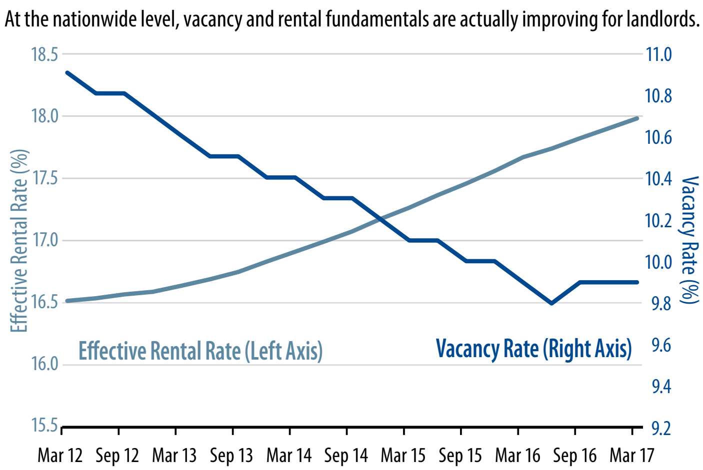
Regional Malls
- (+) Inline sales >$600/sf have tenant rosters with more resistance but not immune to tech disruption
- (+) Owners of properties at the lower end, but dominant in trade area, will have opportunities to reinvest capital to reposition
- (–) Continued store closures especially in apparel will negatively impact performance
- (–) Repositioning or re-letting large blocks of space is capital- and time-intensive; potentially requiring loan modifications
- (–) Increased local tenant occupancy at some malls

Lifestyle Center
- (+) Similar performance to malls, higher-end centers have done well and we expect that will continue
- (–) More dependent on apparel than most malls with relatively less ability to reposition

Source: Western Asset

These factors apply not just to malls but to all the various subsectors of retail. In fact, the retail-related property sector is perhaps the most dynamic and varied property type in commercial real estate. Despite the torrent of negative headlines in the mall sector, it's notable that at least at the nationwide level, their rental and vacancy metrics have been improving recently (Exhibit 6).

Exhibit 6
Nationwide Rental and Vacancy Metrics



Source: REIS, Bloomberg

Exhibit 7
Online to Bricks

Company Name	Online Store Start	Current Physical Stores	Acquired by	Notes
Amazon	1995	8		460 Whole Foods stores
Apple	2008	490		
Athleta	2009	120	Gap	
Bonobos	2007	100	Walmart	Planned by 2020
Fabletics	2013	18		
Microsoft	2009	75+600		Stand-alone and store within a store (Best Buy)
Renttherunway.com	2009	6		App store
Shinola	2011	32		10 scheduled to open this year
Warby Parker	2010	47/80–100		Current/planned
Trunk Club	2009	8	Nordstrom	

Source: Company filings and websites

Furthermore, we note the strong positive signal Amazon's (AMZN) intended purchase of Whole Foods (WFN) sends. Online retailing has weaknesses too, and in surveys, the biggest drawback recorded by customers is an inability to make physical in-store returns. In addition, the convenience of also having physical locations results in higher sales as customers that can buy products online and pick them up and return to a store typically make additional in-store purchases (resulting in $1.07 in net sales per dollar of sales online compared to net sales of $0.77/$1 for pure-play online retailers)[3]. As a result, Amazon is not the first online-only retailer experimenting with physical stores and it will not be the last. While these store openings will not replace all the stores that have closed recently it does represent an emerging demand driver for space, which will provide another option for property owners to repurpose floor space. Exhibit 7 shows the current or planned physical footprint of the major online-only retailers.

How do we distinguish between good and bad malls? First, we focus on the strength of the property's cash flows and their tenants, taking heed of all the characteristics described earlier. We carefully examine the current rent roll to identify the rents being paid relative to market, the trend observed from recently executed leases and the nature of the tenants and leases (e.g., temporary tenants vs. strong national brands, long-term vs. month-to-month). Second, we look for assets with strong sponsors who show commitment to the properties in terms of the amount of capital invested and their ability to manage the asset, and malls that are dominant in their trade area with strong sales-per-square-foot statistics and occupancy costs. We also evaluate the historical stability of the occupancy and cash flows, the physical condition of the property, the local competitive factors and demographics. After our collateral review is complete, we review the structure of the loan securitization. We place an emphasis on strong loan covenants to better align our role as a lender.

Once again, our objective as investors has been to capture the highest income available in the sector, without becoming ensnared by the weaker malls, and Exhibit 8 shows how two comparable securities have performed in the space. The securities depicted are two different CMBX contracts which each reference 25 BBB- rated securities issued during 2012 and 2014, respectively.

Clearly, BBB 6 have suffered from a higher exposure to weak retail tenants, although the price of this contract has been roughly flat for nearly four months; our preferred selections mirror the behavior of BBB 9, whose performance has been strong throughout. We have largely avoided purchasing securities in the large loan commercial MBS (CMBS) market where transactions can be 100% backed by retail assets; we prefer transactions that display many of the characteristics already discussed. The CMBS deal collateralized by the Mall of America is one such deal while another large loan CMBS transaction, which is backed by 235 wholly owned Sears and K-Mart stores (SHLD) totaling over 37 million square feet on a master lease to Sears. This is an example of a transaction with poor fundamentals, and spreads that do not compensate investors for the risk. Therefore we would not participate in the transaction.

3 "Shopping Centers: America's First and Foremost Marketplace" ©2014 International Council of Shopping Centers, Inc.

Exhibit 8
Relative Performance in CRE Debt Driven by Exposure to Weak Malls

Source: Markit, Bloomberg

Investment Implications

To reiterate, it is clear to us that the changes we see today in retail are secular not cyclical.

The online internet genie cannot be thrust back into the bottle, and the economy must deal with the implications for employment, income and therefore retail demand. As such, this theme adds to our caution regarding the strength and durability of growth and inflation within the broader economy.

Regarding retailers, the writing is on the wall—adapt or die. It's been a theme of ours for quite some time, and we've still managed to find pockets of value in those adaptable, brand- and customer service-oriented companies. However, bondholders continue to suffer losses and the list of casualties grows by the day.

We also noted that the big-name retailers threaten the commercial real estate (CRE) market, and there too, we've had to tread carefully. Even there, however, we see pockets of value in many strong locations, while in some cases malls offer the online retailer potential to grasp the missing "brick-and-mortar" solution to their "delivery-and-return" inefficiencies. Amazon's acquisition of Whole Foods won't be the last.

In some cases, CRE-related securities with heavy exposure to the "ugly" malls will indeed fall victim to the disruptors. We will continue to avoid those affected, and remain choosy in this sector. As we enter the summer months, expect the potential working capital drain to force a predictable surge of failures in the retail sector.

In this note, we've taken a tour of the aisles of the retail sector, examining it from three investment angles (investment-grade, high-yield and commercial real estate). We've described the challenged environment, but also explained how a value-oriented investor like Western Asset shops for value. Like a store frustrating its customers, the lines at the checkout can be long and time consuming, especially for the investor who wants to exit in a hurry. Caveat emptor.