BANKING & FINANCE

Could Retailers' Struggles Extend to Banks?

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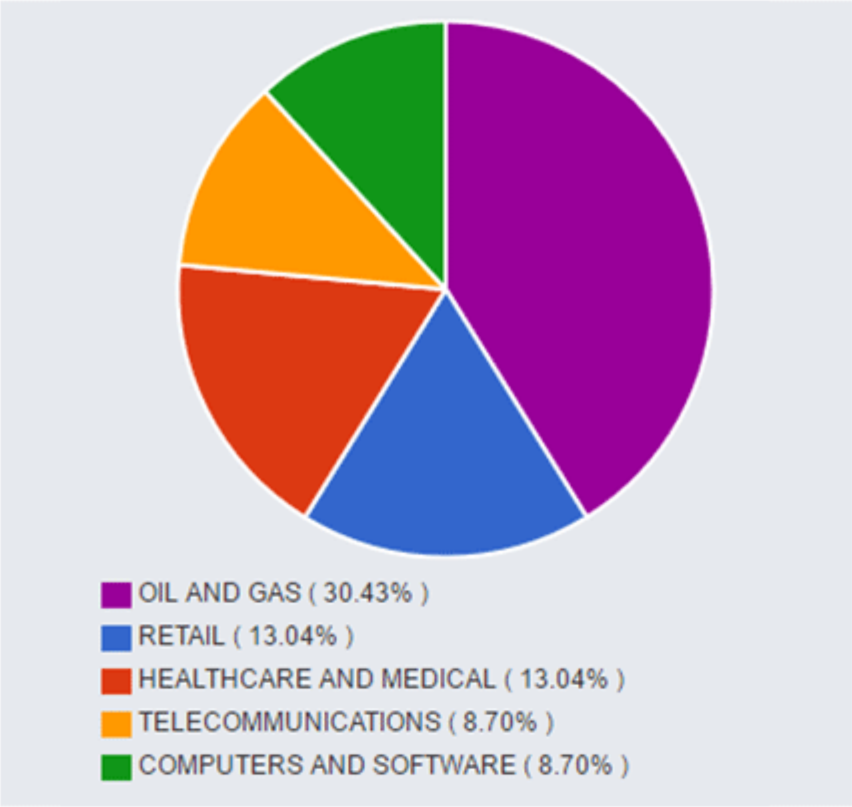
The shift in American retail habits is likely to have a significant impact on banks in the short term and, in the long term, on traditional retailers. The year 2017 could be the tipping point for brick-and-mortar retailers as e-commerce is forecast to account for approximately 10 percent of retail sales. E-commerce retailers have made great inroads into disrupting the consumer's purchasing habits at the local neighborhood brick-and-mortar retailer.

Studies by Kroll Bond Rating Agency (KBRA) and others show that customers are becoming comfortable buying a variety of goods using mobile devices. Smartphones are now the primary method by which many people engage in e-commerce. According to a survey conducted by UPS, mobile device usage in the United States is significantly higher for online shopping and in 2016 represented more than half of online purchases.

The consumer's desire to stay at home to shop is causing significant challenges for retailers burdened by the high costs of premium brick-and-mortar locations that have to adapt to the changing environment. Many well-established retailers are failing to meet the challenge. Through mid-2017, there have been multiple retailer bankruptcies and store closings. Retailers including Payless, Sports Authority, and the Limited have all filed for bankruptcy.

In 2017, more retailers have filed for bankruptcy than during the height of the financial crisis—more than 20 through May 30, 2017, according to data from S&P Global Market Intelligence. Data aggregator BankruptcyData.com reports that a fifth of the largest bankruptcies by public companies this year have been in retail; only the oil and gas sector has had more (see the chart). However, BankruptcyData.com forecasts that retail will replace energy as the most distressed sector this year. Credit Suisse predicts that more than 8,600 brick-and-mortar stores will close in 2017, four times the number in 2016.

Top Five Industries with Most Public Company Bankruptcies



Note: Data depict current year's bankruptcies.
Source: BankruptcyData.com

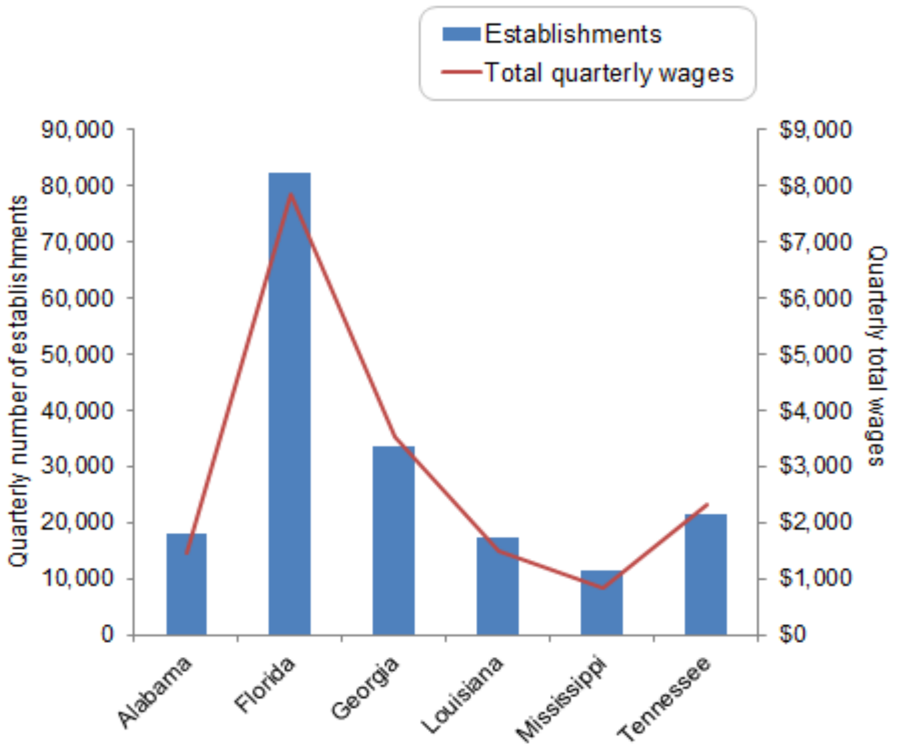
Banks' lending to the retail sector is significant

Despite assurances from some banks that the risk from the decline in brick-and-mortar retail is limited, the traditional retail sector and banks are connected. Although the level is not easily quantifiable because loan exposures are not reported by sector on banks' call reports, public disclosures indicate that many banks' direct commercial loan exposure to retailers is greater than their exposure to energy producers.

With all of the retail closures that have already taken place, delinquencies are on the rise. However, losses will likely be limited because most direct commercial exposures are typically backed by inventory or accounts receivable. Depending on the arrangements between the retailer and suppliers, banks are likely to recover a substantial portion of any outstanding loans. Struggling retailers that have not yet resorted to bankruptcy are having difficulty obtaining refinancing—and, if they can get financing, many are facing higher interest rates.

In the wake of the so-called "retail apocalypse," bank management also needs to think about reviewing loan data for any potential spillover effect. The retail industry announced 5,777 job cuts in May, the highest level in all industries, bringing year-to-date job losses to 55,910, according to Challenger, Gray & Christmas (see the chart).

Retail Trade Quarterly Establishments and Wages, 2016



Note: Data are as of 2016Q4
Source: Quarterly Census of Employment and Wages

Specifically, bank management should be aware of the potential impact of a continued retail decline on borrowers employed in the industry. In states such as Florida, where the population relies heavily on retail firms to provide employment, a large number of borrowers could struggle with loan repayment if the retail sector continues to deteriorate. The issues facing retail also raise questions about the need for new retail construction. Banks may need to consider the level of absorption in the market and the likelihood of developers' obtaining permanent financing.

The link to commercial real estate

Beyond direct exposures, banks also have indirect exposures to commercial real estate (CRE) properties that lease to retail operations. In the past five years, U.S. commercial banks have either originated or participated in more than 1,700 loans, with balances greater than $2.5 million, to regional malls, retail parks, and anchored strip malls, according to Real Capital Analytics (RCA). In addition, banks have provided loans on CRE parcels adjacent to these properties. Frederick Cannon, global director of research at the investment bank Keefe, Bruyette & Woods, estimates that banks have half of the market's $571 billion in outstanding retail-related CRE loans. CenterState Bank estimated in early 2016 that nearly a quarter of community banks' overall CRE exposure is related to retail property.

The United States has long had a much higher amount of retail space than any other country. Some properties may be anchored by major retailers—such as large department stores or national grocery stores—that generate traffic for other retailers and provide financial stability for the property owner. Some retail properties are not anchored, so the small retailer must independently drive foot traffic. Sizes of retail properties also vary, ranging from small local strip centers housing antique shops to vast regional malls. Within these various retail configurations, lease terms generally vary by retail type and tenant. Leasing is the key to the repayment of loans on the centers, so the property owners need to keep vacancy levels low.

Regardless of anchor, according to the CRE data firm REIS, vacancy rates in community shopping centers increased in 30 of 77 U.S. metro areas in 2016, up 8 percent from 2015 and 15 percent from 2014. Also, grocery-anchored properties may be entering a phase of heightened risk as e-commerce providers target the market. Malls in particular are struggling. The loss of anchor stores, such as Sears and JC Penney, has a substantial impact on foot traffic. Although restaurant expansions have helped fill some vacant space in recent years, mall owners are finding it difficult to fill the vacancies left by department stores. If they are unable to find new retail tenants, mall owners servicing their loans may face a cash squeeze. Of the regional malls, retail parks, and anchored strip malls identified by RCA, a number have been become distressed over the past 24 months (see the map).

Distressed Property Locations

Note: Data are current as of May 17, 2017.
Source: Real Capital Analytics

Not only has the lack of replacement tenants diminished cash flow, but it also hurts mall owners' ability to refinance debt, especially loans that have been securitized. Already, defaults are increasing and lenders are being forced to purchase the properties at auction. Creditors are taking haircuts on mall financing to avoid having to repo the properties that are increasingly difficult to operate at a time when so many anchor stores are closing.

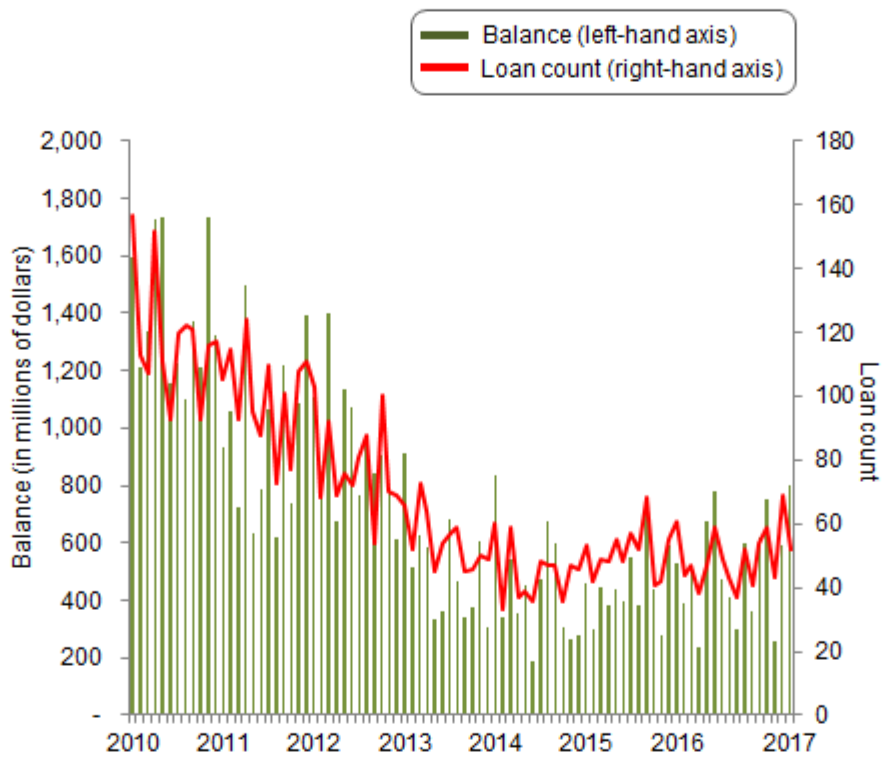
This trend is relevant to banks with credit exposure to malls or peripheral space dependent on mall traffic. KBRA data suggest that community shopping centers continue to be viewed favorably, but less productive class B and C shopping malls are struggling to replace tenants.

Delinquent loans

Struggles in the retail sector are creating a number of problems for retail CRE property lenders, which could lead to increased delinquency in banks' CRE portfolios. Because data on delinquency rates on retail CRE alone are unavailable from banks, a proxy could be data from the retail commercial mortgage-backed securities (CMBS) market. Funding for retail CRE has typically alternated between banks and the securities market, specifically CMBS. During the past 12 months, there has been $1.85 billion in losses on loans backing retail real estate, and a significant portion of all currently delinquent loans in CMBS issuances are retail loans.

Real estate tracking firm Trepp reports that, as of April 2017, the delinquency rate for retail CMBS increased to 6.30 percent, a level nearly 80 basis points higher than the overall CMBS market. Trepp's data also show that newly delinquent retail CMBS loans declined from the Great Recession through early 2014, dropping 67 percent from 2010 (see the chart). Since then, the number of loans newly delinquent has been slowly creeping upward, more than doubling through early 2017.

Retail CMBS Newly Delinquent Loans



Source: Trepp LLC

On a positive note, the loan balances that have recently become delinquent are smaller than during the Great Recession, potentially reducing the loss severity for any loans that can't be refinanced or worked out. From the banks' point of view, 0.67 percent of nonfarm nonresidential loans (which is the category reporting retail CRE data) were noncurrent in the first quarter of 2017, a significant decline from the first quarter of 2014, when the level was 1.78 percent. The struggles of the CMBS market don't appear to have touched banks yet, giving institutions time to prepare for any upturn in problem loans.

Taking action

With the increase in retail bankruptcies, it may be appropriate for banks to review their risk exposures to retail and retail-centric real estate development loans. For each commercial loan, management should ensure that a written security agreement describes the collateral as well as a signed agreement with the borrower. Management should also review the perfection process through which it secures an interest in property.

Supervisory guidance already cautions against having more than 300 percent of risk-based capital exposed to CRE. Lenders with a concentration in retail CRE should be very cautious in underwriting, as the underlying asset may experience a notable decline in value if an anchor retailer closes or a borrower defaults because of a loss of tenants.

Based on data reported in the first quarter, CoStar noted banks' indication that they were limiting their lending on a variety of retail CRE properties. Beyond tighter standards, lenders need to conduct greater due diligence. As stated in the Commercial Bank Examination Manual, close monitoring of a borrower's financial condition is a key to sound credit administration. Also, regulators see other pertinent information, such as lease/rental information for income-producing CRE credits, as necessary to properly administer CRE loans. Due diligence also incorporates an analysis of the leasing arrangements the borrower has in place with the tenants. In addition, monitoring could include stress-testing cash flows to understand potential cash flow volatility and the impact on lease structures in a shocked environment.

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