CMBS Research

Food Fight--Traditional Grocery Stores Should Benefit From Growing E-Commerce

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Authors:

Steve Jellinek | Vice President – CMBS Research | steve.jellinek@mroningstar.com | +1 267 960-6009
Edward Dittmer, CFA | Senior Vice President – CMBS Credit Risk Services | edward.dittmer@morningstar.com | +1 267 960-6043
Lea Overby | Managing Director – Head of CMBS Research and Analytics | lea.overby@morningstar.com | +1 646 560-4583

Morningstar Perspective

Thin margins, fierce competition, and a glut of space have shrunk traditional grocers' market share over the past 10 years. As a result, some lenders and investors have shied away from grocery-anchored shopping centers. As the landscape shifts, Morningstar Credit Ratings, LLC expects more industry consolidation, with large format stores getting bigger and small-format stores becoming more specialized. Meanwhile, more consumers are buying groceries online, as that segment grew 24.4% in 2016, according to Inmar Willard Bishop, LLC, a Long Grove, Illinois-based consultant, the biggest jump of all grocery formats. However, growth in e-grocery is welcome news for commercial real estate, as a key determinant of success is keeping costs down by being close to customers. As Amazon.com's purchase of Whole Foods Market Inc. suggests, the growth of grocery delivery platforms will increasingly depend on brick-and-mortar locations.

Grocery in Transition

Long thought to be immune from e-commerce and economic downturns, some traditional grocers, defined as those that offer a full line of groceries, meat, and produce with at least $2.0 million in annual sales, have been plagued by shrinking margins, competition, and oversaturation, forcing them to close stores or shut down completely. Over the past several years, A&P, which had nearly 16,000 stores at its peak in 1930, went out of business, as did several regional players such as Fresh & Easy, Marsh Supermarkets, and Bottom Dollar Food Stores.

Table 1 – 10 Largest Grocery Anchors in CMBS

MSA	$ Current Balance	% of Total Grocery Store Exposure
Ahold Delhaize	2,845,285,265	16.7
Kroger	2,446,976,079	14.4
Albertsons (including Safeway)	2,079,538,316	12.2
Whole Foods Market	1,626,875,742	9.5
Publix Super Markets	1,293,704,793	7.6
Sprouts	756,059,916	4.4
Aldi	689,729,807	4.0
Giant Eagle	675,668,000	4.0
Trader Joe's	540,885,191	3.2
Save Mart Supermarkets	521,404,442	3.1
Total	13,476,127,552	79.1

*Figures may not sum to totals because they are rounded.

Source: Morningstar Credit Ratings, LLC

Retail space devoted to food sales in the United States has hit a record high, while traditional grocers' share of the market has fallen. Square footage of food retail space at traditional grocery stores per capita in 2016 registered more than 2.5 square feet per person, from less than 1.5 square feet in 1980, according to CoStar Group, Inc. But demand hasn't kept up with store growth. Total U.S. traditional supermarket grocery sales in 2016 fell 5.9% from 2015, while industrywide average same-store sales growth has declined since 2012. Falling sales have disproportionately affected traditional supermarkets, as their market share sunk to 44.6% in 2016 from 90% in 1988, according to Inmar Willard Bishop.

Large-format stores are getting bigger, and small-format stores are becoming more specialized, further squeezing traditional grocery sales and profits. Nontraditional grocery outlets' share of sales shot up to 40% in 2016 from 2% in 1988, led by supercenters and wholesale clubs such as Walmart (AA-/Negative), Costco (AA-/Stable), Sam's Club, and SuperTarget (A/Negative). On the other end of the spectrum, limited-assortment vendors that operate stores about a third the size of a typical American grocer, such as Aldi, Lidl, Save-A-Lot, and Grocery Outlet, are fast-growing and are collectively planning to open over 1,000 new stores in the next few years. Inmar Willard Bishop Analytics reports that the limited-assortment category had the second-highest growth rate in 2016 sales, behind e-commerce. Consumers are also opening their wallets at niche grocers. For example, fresh format stores, which include Sprouts Farmers Market, Inc., saw sales grow 3.8% in 2016, while the number of stores rose by 7.5% to more than 1,500 locations, according to Inmar Willard Bishop Analytics. Growth was driven by supermarket brands, including Lunds & Byerlys, Lowes

Foods, and Mariano's, transitioning to a fresh format. Nontraditional formats such as convenience stores, drugstores, and dollar stores, have also taken a bite out of traditional grocers' sales. After supercenters, dollar stores were the top-performing nontraditional format in 2016, posting a year-over-year sales gain in food and consumables of 4.2%, according to Inmar Willard Bishop Analytics.

While online shopping for groceries continues to lag general merchandise and home and apparel, the number of households buying food online is increasing. In 2016, online grocery had the greatest increase in sales at 24.4%, fueled increasingly by millennial consumers and retailers offering the convenience of both delivery and so-called click-and-collect service, where consumers order online and pick up at the store, according to Inmar Willard Bishop Analytics. Further, the number of households in the U.S. that are using online channels to purchase food has increased about 4 percentage points since 2014, up to 23% in 2017, according to a study by FMI and Neilson, while online penetration in grocery is about 3% of the overall market. Grocery delivery services from Shipt to Instacart, Peapod, LLC, AmazonFresh, and FreshDirect are playing a major role, as fewer people have time to shop. These delivery services also benefit supermarkets, allowing them to continue selling groceries on alternative platforms and remain competitive with meal-subscription companies such as Hello Fresh and Blue Apron. This shift in shopping patterns has implications on retail space requirements. In addition to keeping grocery shopping convenient for consumers, delivery and pickup services may reduce the need for the current number of stores, while also diminishing space requirements of individual stores. Changing consumer habits will also shift demand for grocery space, as fewer households cook. According to the Harvard Business Review, the percentage of consumers who love to cook has dropped by one third in 15 years.

Shifts in CMBS Lending

The shift has implications for commercial mortgage-backed securities as the number of traditional stores is forecast to decline. The traditional format store count is expected to drop by 24.6% by 2021 with a forecast 3.5% decline in dollar share of sales, according to Inmar Willard Bishop Analytics. However, we are not overly concerned, because projected growth in nontraditional formats will buoy demand for existing grocery space as fresh format, super warehouse, and dollar formats are projected to grow store counts 48.0%, 29.7%, and 24.5% by 2021, respectively, and e-commerce is projected to grow sales 25.0%. But as grocers, retailers, and delivery services evolve, their physical needs in commercial real estate spaces will change. Grocers will see pressure to adapt to delivery and pickup models, which may necessitate smaller footprints for in-person shopping, with a focus on fresh groceries, but this will be offset by more warehouse space for pick-up and delivery of commodity and more shelf-stable items.

Investors and lenders are taking a step back, as the spread in the capitalization rate, or the required return, between different classes of grocery-anchored centers has expanded over the past several years. While the spread between Class A and B grocery-anchored centers for the first half of 2017 was consistent, the spread between Class A/B, which tend to be premium assets with strong sponsorship and superior locations, and C expanded to its widest point since 2010 and is expected to expand further in the second half of the year, according to CBRE Group Inc. Class A and B cap rates rose by roughly 10 basis points in the first half of the year from the second half of 2016. In contrast, Class C properties registered a 20-basis-point increase. Further, the difference in cap rates hit a seven-year high, widening to 176 basis points.

Lenders appear to be more selective and less tolerant of risk in grocery-anchored properties, as they have shifted to lower-leveraged, lower-balance loans. The percentage of grocery-anchored loans with balances below $20.0 million grew by 16% over 2015 levels, while the volume of loans above $50.0 million shrunk by 34.8%. The average loan-to-value ratio fell to 62.4% through the third quarter of 2017 from 69.2% in 2014.

Further, overall retail acquisition and lending volume have declined. CBRE reports that year-over-year acquisition volume for retail properties declined 32.2% in the third quarter, outpacing the total market decline of 9.2%. Further, the Mortgage Bankers Association reports that its retail lending index slid 16% for the first six months of 2017, compared with the same period in 2016.

A closer look at grocery-anchored loans with exposure to bankrupt tenants provides some context to the risk narrative. Among all A&P, Haggen, and Marsh Supermarkets brands in CMBS, representing more than $1.50 billion in unpaid principal balance, just five loans were liquidated, resulting in $7.5 million in losses. We forecast another $89.5 million in losses on specially serviced loans, resulting in a low loss severity of about 6.5%.

We found that many vacant stores were re-tenanted by other grocers. Shortly after declaring bankruptcy in September 2015, Haggen sold over half of its 164 stores to several grocery chains, including Albertsons, and in March 2016 accepted Albertson's bid to purchase 29 of its 32 remaining Haggen-branded stores. Since A&P filed for bankruptcy protection in July 2016, 15 of the 51 stores on Long Island, New York, that closed or sold are still vacant, with plans for three of them pending. Among securitized commercial mortgages, Sprouts took Haggen's space at Venice Crossroads Shopping Center in Los Angeles, which secures a $30.0 million loan in COMM 2013-LC6, and Gelson's Markets took Haggen's space at the Mercantile West Shopping Center in Ladera Ranch, California. The property secures a $39.5 million loan, which is 81.4% of BACM 2005-3.

Markets with rising retail vacancies bear watching, however. According to CoStar, 20 markets had rising retail vacancies as of the second quarter, up from eight in the third quarter of 2016. Some of the major metros with rising retail vacancies include Houston, with almost 50 new grocery stores opening in the metro area, with more under construction or planned. Inside the Houston Loop, the interstate that surrounds Houston, Whole Foods and HEB Grocery Co., LP were the most active, delivering new stores in Montrose, Memorial Drive, and Uptown. Farther away from the city center, Kroger (BBB/Stable), Aldi, and HEB had the most openings. Separately, Dallas' strong economy, the rise in population growth, and consumer spending are spurring growth in grocers including national names like HEB, Kroger, Trader Joe's, and Whole Foods.

Grocers to Watch

Industrywide average same-store sales growth has dropped since 2012. Traditional grocers have been fighting back by getting bigger, while same-store sales growth has sagged. Notable acquisitions over the past few years include Kroger purchasing Harris Teeter, Ahold's $28.0 billion purchase of Delhaize, and Albertsons' acquisition of Safeway. Despite increasing sales of 5.0% year-over-year in 2016, Kroger, the largest grocer in the nation with nearly 2,800 supermarkets and 1.0% comparable-store sales growth, is opting to invest less in its physical retail and more in digital initiatives. The company plans to expand, relocate, or open only 55 locations by the end of the year, compared with the 100 it budgeted for in 2016. Publix, which posted 1.9% 2016 comparable-store sales growth, down from a peak of 5.4% in 2014, has set aside $1.85 billion to buy more centers, build stores, and renovate existing sites. Separately, Smart & Final, Whole Foods, and Supervalu all posted negative comparable-store growth in 2016.

With an overleveraged balance sheet and negative same-store sales growth, Albertsons could be the most at risk. The Boise, Idaho, retailer, which is privately owned and operated by private-equity investors, including Cerberus Capital Management, took on debt of more than $7.60 billion to acquire Safeway in 2014. The company, which had grown through acquisitions to 2,324 stores at the end of 2016 from 1,075 in 2013, in July terminated a tender offer for $500 million of bonds, citing financing issues. Overall same-store sales turned negative in fiscal 2016 because of declining customer traffic and competitive pricing pressure. This was followed by negative same-store sales growth of 2.1% for the 16 weeks ended June 17, 2017, and a 1.8% decline for the 12 weeks ended Sept. 9, 2017. Further, the company put its plans to go public on hold shortly after Amazon's (A/Stable) deal to buy Whole Foods was made public.

Physical Storefronts Are Important

As some grocery stores pull back, fears of death by Amazon's purchase of Whole Foods may be overblown, because we believe that growth in grocery-delivery platforms will rely on existing brick-and-mortar locations. To dominate in grocery delivery, especially with perishable items, operators must be able to deliver from sites that are close to the consumers to keep costs low, according to Cushman & Wakefield. With few options existing among urban distribution facilities, Amazon purchased the roughly 460 Whole Foods scattered across the country to serve as distribution centers. These stores are in densely populated areas, averaging nearly 62,000 households within a three-mile radius versus nearly 34,000 on average for U.S. neighborhood centers, according to CoStar.

Whole Foods' share of the U.S. grocery market is just 1.7%, while Amazon has 0.8%. By comparison, Walmart has around 17% and Kroger is just under 9%. Albertsons, in third place, is around 6%, according to statistica.com. Even though Whole Foods locations aren't set up to accommodate widespread distribution, we expect to see Amazon inject its industry-leading logistics, technology, and data expertise to ramp up its e-grocery store presence.

As Amazon's strategy evolves, its purchase of Whole Foods has implications for CMBS. While the growth in fulfilling on-demand delivery is likely be in the form of brick-and-mortar locations, Amazon's ability to lower the cost of goods and its aggressive growth ambitions could be the biggest risk to CMBS. We found 229 grocery-anchored properties in CMBS (19.6% of grocery-anchored loans by balance) that are within five miles of a Whole Foods store that could be most affected. Further, over 150 of these (13.0%) are within three miles of a Whole Foods store. However, restrictive lease provisions are hampering Amazon's growth strategy. According to a GlobeSt.com article, competitors such as Target have stipulations in their leases that restrict what Amazon can do with its newly acquired stores, including pickup lockers and delivery operations.

Reason for Resiliency

Despite rising competition from nontraditional players, oversaturation, and the threat of online grocery shopping, it would be a mistake to write off traditional grocers. Such companies could even benefit from the increased acceptance of online sales, as they rethink their approach to convenience and play defense as titan Amazon enters the fray. We're already seeing evidence that both traditional and specialty grocers are looking for ways to better accommodate consumer demand for ordering groceries online, including partnering with delivery services. Given more conservative lending standards and strong demographics of more popular in-fill locations, making them desirable distribution centers, we believe that traditional grocers will prove resilient.

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To reprint, translate, or use the data or information other than as provided herein, contact Vanessa Sussman (+1 646 560-4541) or by email to: vanessa.sussman@morningstar.com.