Transcript: How Is the "Retail Apocalypse" Impacting Bond Markets?

The steady growth of e-commerce over the last 20 years has changed the retail sector and the economy. Approximately 60% of U.S. households now have an Amazon Prime subscription, and Amazon is expected to soon overtake Walmart as the largest apparel retailer, illustrating the remarkable inroads into retail that e-commerce has made.

The dramatic growth of internet retail is also affecting certain segments of the bond market, including retailer corporate bonds, commercial mortgage-backed securities (CMBS), and real estate investment trust (REIT) corporates. The most obvious effect of e-commerce has been on corporate bonds issued by retailers. E-commerce has weighed heavily on brick-and-mortar retailers' revenues and profit margins, hurting their ability to repay their debt. As a result, we have largely avoided corporate bonds in this sector.

E-commerce has had a more nuanced effect on CMBS, making detailed analysis of the properties underlying the bonds and the structure of the deal essential. The CMBS universe has meaningful exposure to enclosed malls, where e-commerce has caused an increasing number of store bankruptcies, boosting vacancy rates and lowering rents. However, higher-quality malls in strong markets with unique retailers are likely to have the resources to handle store closures, sometimes by repurposing the property.

Because CMBS are backed by a variety of collateral types with the advantage of structured cash flows, we are finding opportunities in the sector. For a defensive approach, we can focus on bonds toward the top of the capital structure to help mitigate default risk when the underlying collateral is on the lower end of the quality spectrum. For offense, we can participate in CMBS that are lower in the capital structure but have minimal exposure to retail properties. Additionally, we can invest in bonds where, after detailed credit analysis, we think pricing overstates the risk from retail exposure.

The growth of e-commerce has had similar effects on corporate bonds issued by REITs. We believe REITs that own assets like the higher-quality malls mentioned earlier and are financially able to maintain them will be long-term winners. Another segment we favor is bonds issued by industrial REITs that operate warehouses for e-commerce operators, which generally require far more warehouse space than brick-and-mortar stores.

Although e-commerce has unquestionably had a negative effect on many retail-related corporate bonds, analyzing CMBS and REIT debt can uncover areas where internet retail has created opportunities.

201910-973655 10/19