# E-commerce Disrupts Retail-Related Bonds

Detailed analysis of CMBS and retail corporates is essential.

September 2019

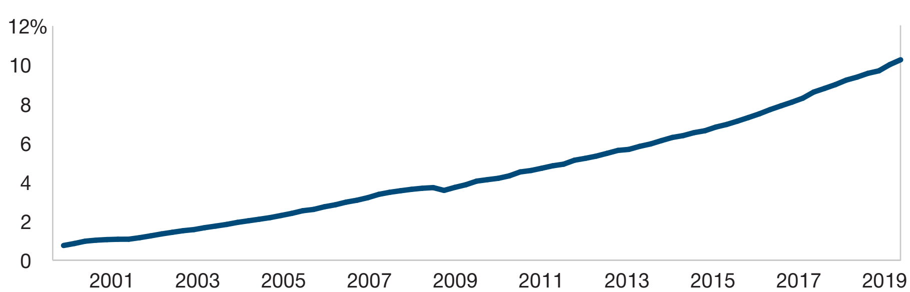
## KEY INSIGHTS

- Internet retailers are fundamentally disrupting the traditional retail industry, which is having a profound impact on some segments of the bond market.
- Commercial mortgage-backed securities (CMBS) and corporate debt from retail-related issuers are feeling the most meaningful effects of e-commerce.
- The disruption of the retail industry by e-commerce has created opportunities as well as areas to avoid in bonds.

Internet retailers are fundamentally disrupting the traditional retail industry. E-commerce has decimated brick-and-mortar retailers by offering a combination of low prices and rapid home delivery. Illustrating the remarkable inroads of internet retail, approximately 60% of U.S. households now have an Amazon Prime subscription.[1] This trend toward e-commerce is having a profound impact on some segments of the fixed income markets in addition to its well-publicized effects on various stock market sectors.

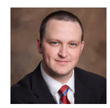
### (Fig. 1) Steady Growth of Internet Retail

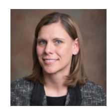
E-commerce as a share of retail sales*
As of June 30, 2019

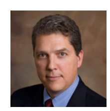


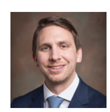

Source: U.S. Census Bureau/Haver Analytics.
*Excluding gas stations.

[1] Source: Evercore ISI.


**Carson Dickson**
*Credit Analyst, High Yield Debt*


**Jane Rivers**
*Credit Analyst, Securitized Debt*


**Ted Robson**
*Credit Analyst, Investment-Grade Corporate Debt*


**Mitchell Unger**
*Credit Analyst, Investment-Grade Corporate Debt*

**9%**

Preliminary data show that Amazon overtook Walmart as the top apparel retailer in 2018 with more than 9% of the market.

CMBS and corporate debt issued by retailers and real estate investment trusts (REITs) are feeling the most meaningful effects of e-commerce within the bond market. However, as in the stock market,[2] the disruption of the retail industry by e-commerce has created opportunities as well as areas to avoid in bonds.

These are among the key observations of four members of T. Rowe Price's global team of credit analysts. Carson Dickson covers high yield retail corporates, Mitchell Unger specializes in investment-grade retail sector credit, Jane Rivers analyzes CMBS, and Ted Robson covers investment-grade corporate debt in the financials sector, which includes REITs.

### Retail-Related High Yield Corporates Struggle

The effects of e-commerce have been almost universally negative for corporate bonds issued by retailers with below investment-grade credit ratings that reflect their already weak financial condition. "Internet retailers increasingly dominate even apparel sales, which was once one of the brick-and-mortar segments that was seen as most resilient to e-commerce because some consumers like to try on clothes before purchasing," explains Dickson. In 2006, Amazon accounted for a negligible share of the U.S. apparel market, but preliminary data show that Amazon overtook Walmart as the top apparel retailer in 2018 with more than 9% of the market.

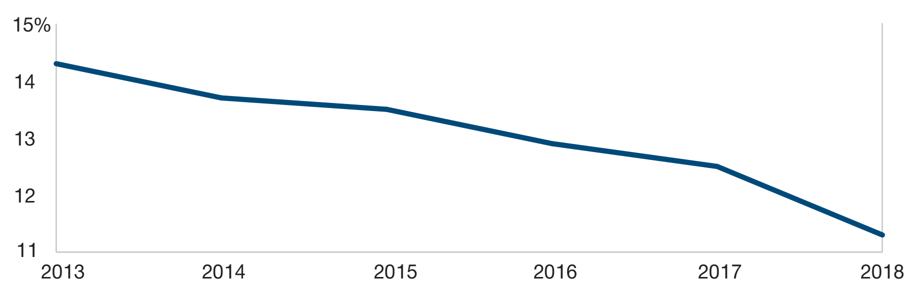
"Running down a traditional retailer's income statement, revenue has decreased as a result of e-commerce price transparency, gross margin has fallen because of the need for free and fast shipping, and the fixed costs of maintaining stores and paying staff have stayed constant," says Dickson. "All of these factors lead directly to lower profitability."

Retailers with a brick-and-mortar presence also need to invest capital to continually upgrade store appearance or risk losing customers, and they must devote additional capital to inventory in stores. T. Rowe Price analysts and portfolio managers do not see any of these trends reversing, so our fixed income strategies are either underweight retailer high yield bonds or have no exposure to the segment.

Although the same trends are impacting investment-grade retailers, T. Rowe Price analysts are somewhat more positive on corporates issued by select retailers with investment-grade credit ratings because of their stronger balance

### (Fig. 2) E-commerce Weighs on Retailer Profits

EBITDA* margin of select retailers
As of December 31, 2018




Sources: Corporate filings for 7 publicly traded and 2 privately held retailers. Data analysis by T. Rowe Price.
*Earnings before interest, taxes, depreciation, and amortization.

[2] Discussed by T. Rowe Price's equity portfolio managers and analysts in an early 2018 Insights article.

> CMBS structures provide varying degrees of credit enhancement, which can help offset elevated default risk.

sheets as well as their broader scale. "The financial resources and pure size of some retail companies in the investment-grade universe give them the ability to invest in upgrading logistics, better positioning them to compete with internet retailers," contends Unger. "We favor investment-grade corporates from 'e-tail natives' like QVC as well as home improvement and auto parts retailers that have a larger share of business-to-business sales, which insulates them to some degree from Amazon risk."

### Internet Retail's Nuanced Effects on CMBS

While e-commerce has definitely affected the CMBS market, its impacts on CMBS are more nuanced than on corporate bonds issued by retailers. CMBS are bonds backed by the cash flows from mortgages on commercial properties, including malls. As T. Rowe Price's real estate equity analysts noted in 2018, the universe of enclosed malls is bifurcating into high-quality and low-quality segments as internet retail forces many mall tenants into bankruptcy. "We think that top-quality malls in healthy markets that have financially strong sponsors and unique stores will still thrive, while low-quality malls will continue to deteriorate," explains Rivers.

The CMBS universe tends to have more exposure to mid- and low-quality malls than to their higher-quality peers. According to Rivers, "the outlook for these struggling malls is highly dependent on demographics, degree of competition, diversification of tenant type, amount of capital invested by the owner, and redevelopment potential." This makes detailed credit analysis essential for understanding which mall-backed mortgages are at greater risk of default and for quantifying the potential risk.

CMBS structures provide varying degrees of credit enhancement, which can help offset elevated default risk. AAA rated CMBS provide more credit enhancement than lower-rated bonds. "We are finding select opportunities in mall-backed CMBS that provide the right balance of default risk and credit enhancement, but detailed examination of both the deal structure and the underlying mall assets is essential for this risk/reward analysis," Rivers adds.

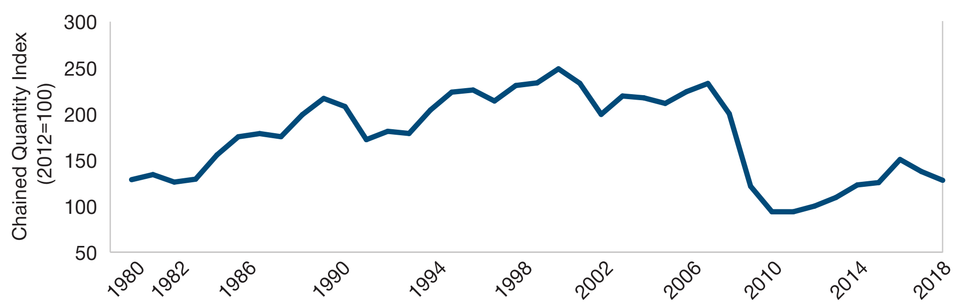
### Opportunities in Select REIT Corporates

A REIT is a company that generates income by owning, operating, or financing real estate, which can include commercial properties. REITs issue corporate bonds to fund their operations. Like CMBS, the credit quality of corporate debt issued by REITs that own malls or other retail properties is subject to the ongoing bifurcation of the mall market into high- and low-quality categories. However, unlike CMBS, REIT corporates

## (Fig. 3) Boom in Retail Investment Turned to Bust

Retail industry investment in private structures

1980 Through 2018




Source: Bureau of Economic Analysis/Haver Analytics.

However, detailed analysis of the properties underlying a particular security, whether CMBS or a REIT corporate bond, and the structure of a CMBS deal are essential.

**3x**

Internet retailers require three times the warehouse space when compared with brick-and-mortar stores.

do not have the added protection of credit enhancement. "Within the retail REIT universe, we prefer REITs with relatively stable, grocery store-oriented community shopping centers and financially strong malls," says Robson.

### Internet Retailers Need Three Times the Warehouse Space of Brick-and-Mortar Retailers

Robson thinks that another segment of the REIT universe—those focused on industrial properties—stands to benefit directly from the rapid rise of internet retail. "The boom in e-commerce sales and accompanying demand for same-day or two-day delivery are driving strong demand for warehouse space," Robson notes. "REITs that own or operate industrial warehouses are benefiting from this trend as e-commerce operators need increasing amounts of space." In fact, internet retailers require three times the volume of warehouse space as traditional retailers, according to Prologis, a REIT specializing in logistics-related properties.

### Detailed Credit Analysis Is Essential

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. Industrial REITs that can capitalize on the growing warehouse needs of e-commerce companies are a prime example. However, detailed analysis of the properties underlying a particular security, whether CMBS or a REIT corporate bond, and the structure of a CMBS deal are essential.

### WHAT WE'RE WATCHING NEXT

The trade conflict between the U.S. and China has the potential to dampen retail sales—via both e-commerce and brick-and-mortar stores—if tariffs on imported Chinese goods push prices meaningfully higher. This could shift consumer spending preferences toward lower-priced goods, potentially favoring discount retailers and affecting our analysis of the quality of traditional retailers.

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