PErspective in REAL ESTATE

A FEATURE EXAMINING THE ROLE OF PRIVATE EQUITY IN THE REAL ESTATE SECTOR.

Stay up-to-date on the latest trends

Brick & Mortar Retailer Woes Raise Concerns Despite Spiking M&A Activity

The retail model is undergoing a transformation that presents opportunities and risks for the real estate industry. Driven by changing consumer expectations about brand experience and convenience, traditional retailers are scrambling to expand their online and omnichannel offerings, while online retailers are laying down their first bricks and mortar. And despite recent headlines touting retail's demise off the back of Q1 earnings, there's been a sustained spike in e-commerce deal activity among strategic and financial buyers that suggest interest in transforming the current retail model is rapidly growing.

REITs operating in the retail industry are keeping a close eye on the sector's fiscal health—which has a direct impact on their bottom line. While the retail industry is sending investors somewhat mixed signals, the future of retail will likely be less dependent on growing brick-and-mortar footprints and more focused on developing the right balance of consumer channels. Embracing e-commerce is not synonymous with shuttering physical locations, as storefronts remain an integral element of the retail mix. Retailers that take active steps to grow their multichannel offering while right-sizing their in-store footprint look to be better positioned than competitors who have yet to take steps to address the rise of e-commerce.

The Good

General retail e-commerce M&A activity topped out at $17 billion in 2016, representing about an eightfold increase from 2014's $2.36 billion in M&A activity, according to BDO & Pitchbook's Current State of E-Commerce, which was published in May and outlines strategic and financial deal activity across the sector. Furthermore, retailers expect deal activity to continue to rise in 2017. Nearly half (46 percent) of retail CFOs surveyed in BDO's 2017 BDO Retail Compass Survey of CFOs forecast an uptick in retail M&A activity this year. More than two-thirds (38 percent) of these CFOs cite competition and consolidation as the driving factors for deals.

Strategic buyers account for the bulk of the increased deal activity in recent years. In fact, more than half of retail CFOs (56 percent) anticipate M&A activity will continue to be driven by strategic buyers in 2017, with an estimated average EBITDA multiple of 7.0, the highest in the Compass Survey's history.

That means the retail industry is likely to see more deals: first, Walmart's acquisition of Jet.com last year, then Amazon's announcement in June of a $13.1 billion bid to acquire Whole Foods. Grocery has been a retail sector arguably more insulated from e-commerce disruption than others, as customers largely still prefer grocery shopping in stores. Bloomberg reported that Amazon focused heavily on Whole Foods' distribution technology in negotiations, and experts say immediate cost reduction opportunities could be seen in warehouses. Walmart's acquisition was made to immediately bolster its e-commerce presence and to compete with Amazon. Walmart paid a premium ($3.3 billion) compared to Jet.com's valuation ($1.35 billion), but it appears to have paid off: The company's global e-commerce sales for 2016 increased 15 percent from the previous year, and its U.S. e-commerce sales gained 36 percent.

The Not So Good

At the same time, there have been recent strategic acquisitions that have delivered less clear results. Look to examples like the 2015 flash-sale startup Gilt Groupe's sale to Hudson's Bay Co. for $250 million or Bed Bath & Beyond's $100 million acquisition of One Kings Lane. Both deals enabled the buyers to enter the flash-sale space at a discounted rate, but the market ultimately slowed. Gilt Groupe's sale now seems

FUTURE PERSPECTIVES: WHAT'S NEXT FOR REAL ESTATE INVESTORS?

The real estate industry, and particularly retail U.S. REITs are bracing for a bumpy road ahead. In fact, REITs' concerns over foreclosure and bankruptcy have jumped in the last year, according to the 2017 BDO RiskFactor Report for REITs, which examines the risk factors in the most recent 10-K filings of the largest 100 publicly traded U.S. REITs. This year's report reveals that 86 percent of REITs are concerned about the risk of foreclosure and bankruptcy, up from 80 percent in 2016. Roughly the same amount (84 percent) said falling or flat real estate values are a risk in the year ahead, up from 79 percent in 2016. Meanwhile, three out of four (76 percent) retail REITs point to the growth of e-commerce, specifically as a threat.

To reposition their model in light of the rise of retail e-commerce, some REITs have already begun to take active steps to redefine the consumer in-store experience across their properties. High-end mall REITs have found some success in moving up-market to fill vacancies created when struggling retail chains have moved out, as well as by cultivating a differentiated shopper experience by incorporating more entertainment, activity and dining venues.

The implication is that, while consumers are increasingly seeking to purchase a larger share of their goods online, they remain drawn to brands that deliver a consumer experience before, during and after the transaction. While there may be some right-sizing of retail brick-and-mortar footprints still left to be done, REITs should take comfort in the fact that a new retail model—one that focuses more on brand experience—has started to take shape across the sector. That model will be dependent on a well-defined and prominent in-store component.

Read more

like a win; however, the brand was previously valued at $1 billion before losing steam as the flash-sale trend has slowed. A similar story was told for One Kings Lane. The total acquisition amount was never released, but estimates put the deal around $150 million, a far cry from the company's previous valuation of $900 million.

The Ugly

The first quarter of 2017 saw the highest number of bankruptcy declarations by retailers since 2009, during the height of the Great Recession. The number of retailers that have filed for Chapter 11 bankruptcy protection so far this year has already surpassed the total 2016 number, according to reports by *CNBC* and *USA Today*. Financial challenges seem to be hitting mall clothing chains especially hard as consumers shift their spending to more agile online sellers. Of note, roughly half of retailers that have filed for Chapter 11 protection year-to-date were previously purchased by private equity firms, according to *CNBC*. And the number of retailers on Moody's distressed list is also surpassing Great Recession levels. If this trend accelerates, REITs operating in the retail sector could be impacted by tenant loss or defaults and falling or flat lease values.

Still, surging M&A appetite and a determination by the majority of retailers to transform their business model to meet new customer preferences should provide an opportunity for evolution—for the better, ultimately—for REITs operating in the sector. Retail as we know it is rapidly changing. Just as the industry is different today from what it was 50 years ago, it will be totally transformed by 2067. And our bet is that transformation will come relatively quickly, so there is a good opportunity for disruptors and innovators in the sector to shape what the future model of retail will look like. Identifying, courting and partnering with those disruptors would be a solid strategy for REIT executives.

A version of this article first appeared in Commercial Property Executive. View it here.

Real Estate Industry Contacts:

STUART EISENBERG, New York
212-885-8431 / seisenberg@bdo.com

BRIAN BADER, New York
212-885-8203 / bbader@bdo.com

BRENT HORAK, Dallas
214-665-0661 / bhorak@bdo.com

ANTHONY LA MALFA, New York
212-885-8140 / alamalfa@bdo.com

TOM MENK, Pittsburgh
412-281-1566

IAN SHAPIRO, Miami
305-420-8052 / ishapiro@bdo.com

LOU TORRES, New York
212-885-7388 / ltorres@bdo.com

Private Equity Industry Contacts:

KAREN BAUM, Dallas
214-969-7007 / kbaum@bdo.com

FRED CAMPOS, Miami
305-420-8044 / fcampos@bdo.com

LENNY DACANAY, Chicago
312-730-1305 / ldacanay@bdo.com

JERRY DENTINGER, Chicago
312-239-9191 / jdentinger@bdo.com

LEE DURAN, San Diego
858-431-3410 / lduran@bdo.com

ERIC FAHR, McLean, VA
703-582-4293 / efahr@bdo.com

RYAN GUTHRIE, Costa Mesa
714-668-7385 / rguthrie@bdo.com

SCOTT HENDON, Dallas
214-665-0750 / shendon@bdo.com

TUAN HOANG, Los Angeles
310-557-8233 / tmhoang@bdo.com

KEVIN KADEN, New York
212-885-8000 / kkaden@bdo.com

TODD KINNEY, New York
212-885-7485 / tkinney@bdo.com

MATT SEGAL, Chicago
312-616-4630 / msegal@bdo.com

DAN SHEA, Los Angeles
310-557-8205 / dshea@bdocap.com