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RETAIL IN THE U.S.: DEPARTMENT STORE BANKRUPTCIES ARE ONLY THE TIP OF THE ICEBERG

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EXECUTIVE SUMMARY



Aurélien DUTHOIT, Sector Advisor for Retail, Technology and Household equipment

+33.1.84.11.45. 04

Aurelien.DUTHOIT@eulerhermes.com

- The Covid-19 outbreak is sending the U.S. economy into an unprecedented recession: Our central scenario anticipates a -2.7% contraction of economic activity for the year 2020, taking into account a two-month lockdown period and a U-shaped recovery starting in Q3. The impact of the crisis on the U.S. retail industry is also unprecedented and will have lasting consequences on all segments. However, we find a clear divide between food retail, which is resilient, and discretionary retail, which is cyclical, at least for the eighteen months to come.
- Food retailers will experience their best year since 2001, with annual turnover up 7%. The shift from restaurants, cafeterias, canteens, etc. to grocery and superstore aisles has provided a considerable boost to food sales under lockdown, but additional health and safety measures have a material impact on profit margins. The capacity of incumbent food retailers to capture a sizeable share of the booming online food and beverage market is good news for their top line, but detrimental to their profitability. Accounting for less than 3% of total food and beverage sales, online penetration will continue to accelerate after the crisis and become the new battleground for food retailers for good.
- E-commerce growth will accelerate to 17%. The segment has benefited from a near-monopoly on non-essential goods under lockdown and is seeing an acceleration in online grocery sales. We believe the crisis will durably transform shopping habits and further accelerate the penetration of e-commerce across segments. Despite accelerating growth, the challenge for a majority of online pure-players remains largely unchanged: will turnover growth ever turn into profits?
- If past years have been a so-called “retail apocalypse” for discretionary retailers, then 2020 will be hell, with aggregate turnover down -22% and no single sub-segment in green territory. Mandatory store closures have smashed store sales and we anticipate only a slow recovery in demand throughout the year amid high unemployment and depressed consumer confidence. The exit from lockdown will coincide with fierce price competition, with retailers rushing to clear their inventories, and the same additional costs food retailers had to bear to prevent a second wave of contamination.
- Strategies to reduce the cash burn (fire sales, freeze in rent payments, cuts in jobs – 1.7m or 29% of discretionary retail jobs have already been cut) will not be enough for many household names that were already struggling before the crisis – bankruptcies have only just begun. Announced policy measures (bridge loans, tax breaks, checks to Americans...) will provide relief in the short term, but only businesses that were sound and viable will be capable of recovering durably. We believe that 30,000 to 50,000 stores could disappear by the end of 2021, the equivalent of 6-10% of the U.S. discretionary retail footprint.

U.S. RETAILERS ARE FACED WITH A UNIQUE COMBINATION OF LOCKDOWN AND ECONOMIC RECESSION

The U.S. government declared the Covid-19 outbreak a national emergency on 13 March 2020, paving the way for statewide lockdown measures affecting the vast majority of American businesses. Retail has been no exception, with only so-called essential retailers authorized to remain open – food stores and general merchandise stores selling predominantly food, as well as pharmacies and building material retailers. The immediate impact of the Covid-19 outbreak has therefore been felt very differently across the industry. As of 18 May, restrictions on retail activities have been progressively lifted across many states. However, adding to the already challenging environment, consumer confidence has collapsed, with jobless claims soaring, the unemployment rate jumping from 4.4% in March to 14.7% in early May and, for the year 2020, an expected -2.7% contraction in U.S. GDP. The fast deterioration of the economic environment will further widen the divide between food retail, which is resilient, and discretionary retail, which is cyclical, at least for the eighteen months to come (see Figure 1).

Figure 1: Retail sales - nominal GDP growth correlation across segments (1992-2019)

Total food retailers	0.5
Food and beverage stores	0.3
Warehouse clubs and superstores	0.5
Total discretionary retailers	0.9
Furniture and home furnishings stores	0.8
Electronics and appliance stores	0.7
Building mat. and garden equip. and supplies dealers	0.8
Clothing and clothing access. stores	0.8
Sporting goods, hobby, musical instrument, and book stores	0.6
Department stores	0.7
Miscellaneous store retailers	0.7
Electronic shopping and mail-order houses	0.8
Cosmetics, beauty supplies, etc.	0.5
Electronic shopping and mail-order houses	0.8

Sources: U.S. Census Bureau, Euler Hermes, Allianz Research calculations and estimates

THE GREAT DIVIDE: DISCRETIONARY RETAIL COLLAPSES, FOOD RETAIL BOOMS, E-COMMERCE SOARS

Our [central scenario](#) for the U.S. economy assumes a two-month lockdown period followed by a progressive exit from lockdown lasting another four months, sending 2020 real GDP growth down -2.7%. We combine this macroeconomic scenario with 1) evidence of retail sales performance under lockdown collected from dominant retailers and 2) historical retail sales data at segment-level to provide an estimate of the 2020 turnover of the U.S. retail industry. Our calculations point to an unprecedented divide between the main segments of the industry (see Figure 2):

- Food retailers will clearly be winners in the short term, with annual sales up 7%. Early stockpiling and the progressive closure of eat-in restaurants, company cafeterias and school canteens has lifted demand for food to be eaten at home – prior to the crisis, Americans spent 55% of their food expenditure away from home, the highest share in the world.

Evidence from large retailers points to a surge in sales comprised between 10% and 20% of food and fast-moving consumer goods under lockdown. We anticipate growth to decelerate with the progressive reopening of restaurants throughout the year and unemployment taking a toll on the purchasing power of Americans. Additional costs and a less favorable product mix will translate into a more moderate increase in profits (see below).

- Non-essential or discretionary retailers, on the other hand, will have their worst year on record, with a 22% slump in annual revenue. A majority of stores have seen their turnover under lockdown reduced to virtually zero, with e-commerce and curbside pick-up (where allowed) providing a very limited relief to shop owners. Because they remained open under lockdown, building material and do-it-yourself retailers

have fared better until now but will see lower demand in the second half of the year. We anticipate turnover to remain somewhere between -10 to -20% under their 2019 levels throughout the year across segments.

- E-commerce growth is set to accelerate to 17% year-on-year. The segment enjoyed a near monopoly on many non-essential product lines under lockdown and has seen double- to triple-digit growth in online grocery orders. We believe the current crisis will boost the segment throughout the year, thanks to a widening customer base and increased purchase frequency among regular buyers. The most noticeable trend is an acceleration of e-commerce penetration in the grocery segment.

Figure 2: Forecast for 2020 retail sales across segments of the retail industry

Segment	2020 turnover (USD bn)	Net change (USD bn)	% change
Total food retailers	1,354	84	7%
Warehouse clubs and superstores	527	35	7%
Food and beverage stores	827	49	6%
Total discretionary retailers	994	-280	-22%
Furniture and home furnishings stores	85	-32	-27%
Electronics and appliance stores	71	-26	-27%
Building mat. and garden equip. and supplies dealers	321	-59	-16%
Clothing and clothing access. stores	194	-76	-28%
Sporting goods, hobby, musical instrument, and book	62	-16	-20%
Department stores	105	-30	-22%
Miscellaneous stores retailers	110	-25	-19%
Cosmetics, beauty supplies, etc.	47	-15	-24%
Electronic shopping and mail order houses	806	117	17%

Sources: U.S. Census Bureau, company data, Euler Hermes, Allianz Research calculations and estimates

THE EXIT FROM LOCKDOWN WILL COME AT A PRICE FOR DISCRETIONARY RETAILERS

We believe that measures taken by food retailers and e-commerce specialists to keep running under lockdown will set a blueprint for the rest of the industry once stay-at-home orders are fully lifted. A major feature of the Q1 earning narrative among retailers has been a significant increase in operating costs, falling into three main categories:

- Payroll, with costs driven both by massive job additions to answer peaks in demand and higher labor costs because of exceptional bonuses or temporary pay increases given to employees.
- In-store expenses with more regular cleaning routines, masks and gloves bought to protect store clerks, hand sanitizers for employees and customers, etc.
- Property expenses to adapt store aisles, cash desks etc. to higher standards of safety.

It is too early to provide a precise estimate of these additional costs for the entire retail industry, but available data provided by large European retailers are in the range of 0.5% of total turnover for in-store and property expenses alone. While extra costs to keep running are offset by an increase in revenue for food retailers, this will not be the case for a majority of discretionary retailers, as discussed above, and will no doubt have a material impact on profits. The race to clear inventories will impact realized margins

Risks are high that retailers will favor liquidity over realized margins when the lockdown expires. We anticipate fierce price competition as retailers will be looking to unlock capital tied up in inventories. This is particularly true for segments where seasonality is important and inventories depreciate fast, such as fashion retail. The most recently avail-

able data on retail inventories point to them oscillating between 1.5 to 2.4 months of sales (see Figure 4) across segments; because we anticipate only a progressive recovery in demand, these ratios will swell after the lockdown and consumer goods companies and wholesalers should have to endure months before orders return to normal. Retailers will have to strike the right balance between the need to preserve their cash positions and the risk of lost sales because of empty shelves. Purchased goods account for 60-70% of retail expenses across segments and are by far the largest cash outflow.

Nearly 30% of discretionary retail employment cut in two months, rent payments collapse

Large discretionary retailers have already taken bold steps to preserve their liquidity and profit margins:

- Hundreds of thousands of jobs have been temporarily or permanently cut since the beginning of the outbreak. Companies from all segments have announced measures to adapt their cost bases to a prolonged period of very limited activity: department stores (Kohl's, Macy's, JC Penney), electronics (Best Buy), clothing and accessories (Gap, Coach, Abercrombie & Fitch), beauty (Sephora), sportswear (Under Armour), home improvement (Bed, Bath and Beyond) etc. Preliminary data point to more than 1.7 million job cuts between February and April, the equivalent of 29% of the total discretionary retail workforce (see Figure 3). Labor costs typically account for between 15-20% of discretionary retail expenses.

- Commercial real estate specialist CBRE estimates that only 20% to 40% of total retail rents due for April 2020 were collected. Many large retailers have announced they have frozen rent payments to preserve their liquidity in the short term and negotiate terms with landlords. Depending on segments, rents account for about 5%-15% of discretionary retail expenses.

Public support to the industry is most welcome, but cannot prevent the inevitable

The industry's main representative body, the National Retail Federation, has given its support to two main pieces of legislation providing relief to the U.S. economy and retail industry: the CARES Act and the Main Street Lending Program. Key measures are aimed at providing liquidity (small business and corporate loan programs), support to consumer spending (one-time checks - \$1200 for adults, \$500 for children; improved unemployment insurance for retail workers) as well as tax relief (carry-back of losses, increased deductibility of interest expense, etc.). As of 18 May, the trade association was pushing for additional measures including²:

- Limitations for employer liability regarding possible Covid-19 employee litigation;
- Additional tax relief (monetization of anticipated 2020 losses, extension of measures targeting small business to larger businesses, etc.).
- A so-called "Rent Forgiveness Program" providing funds to pay upcoming rents and protecting businesses from the consequences of past missed payments.
- Greater access to the short-term funding programs.

² See [NRF Priorities For The Next Economic Stimulus Package](#) for the complete list of measures proposed.

All passed and proposed measures are obviously most welcome to support a fast recovery in sales, bridge short-term funding needs and provide temporary expense relief. They could save thousands of stores that were sound and viable prior to the outbreak. However, as evidenced in our previous paper published earlier this year, we also believe that there are deeper changes at play in the U.S. retail industry and that the reduction in the discretionary retail footprint is a structural trend that was only gathering momentum. In this respect, we cannot rule out that public support to the industry is, to some extent, about postponing the inevitable and slowing down the pace of transformation. The fact that some prominent retailers have announced that some stores will actually never reopen, even after the lockdown, has us believing that retailers themselves are anticipating a need for an acceleration in retail space cuts.

6% to 10% of all discretionary retail stores could disappear by 2021

As discussed above, we observed in a previous paper that the U.S. had lost

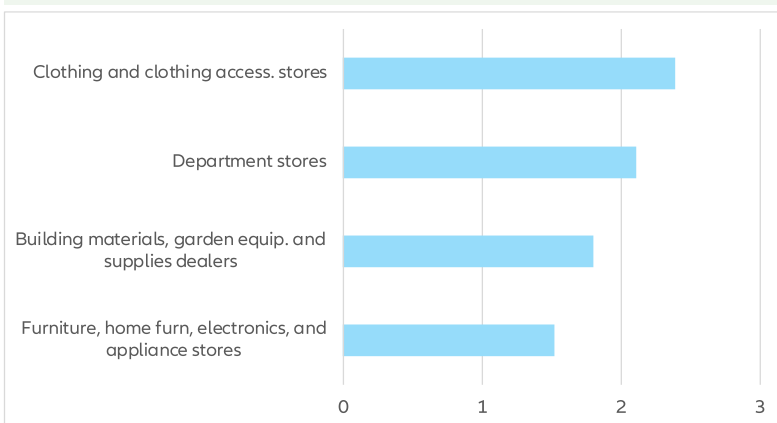
more than 56,000 stores or 10% of its discretionary retail footprint, between 2008 and 2019, on the back of growing e-commerce competition and changes in retail business models. We were anticipating another 35,000 closures by 2025 assuming a mild deceleration of the U.S. economy in 2020.

It goes without saying that the combined effect of the lockdown and a deteriorating economic environment will be a catalyzer of the trend. Looking at past retail recessions and taking into account that 1) store closures were already accelerating prior to the Covid-19 outbreak, 2) large insolvencies were also standing at exceptionally high levels and 3) we anticipate a -24% slump in discretionary retail sales for 2020 alone, we expect an unprecedented surge in store closures. The exact magnitude of closures will depend heavily on the individual fate of a few large retailers struggling for survival and possible additional support measures, but we believe that 30,000 to 50,000 stores (6% to 10% of the U.S. discretionary retail footprint) could disappear by the end of 2021.

The demise of large department store chains would be the trigger that would send store closures to the upper range of our estimates because of a domino effect. Department stores account only for a fraction of total discretionary store footprint (3% of total) but are major employers (19% of total) and, more importantly, crucial to shopping mall traffic for which they act as anchor stores. An acceleration in department store closures would have ripple effects across all other discretionary retail segments, especially on clothing specialists, which are the dominant tenants and already suffering from booming e-commerce competition. Clothing retailers alone account for more than 25% of all discretionary stores.

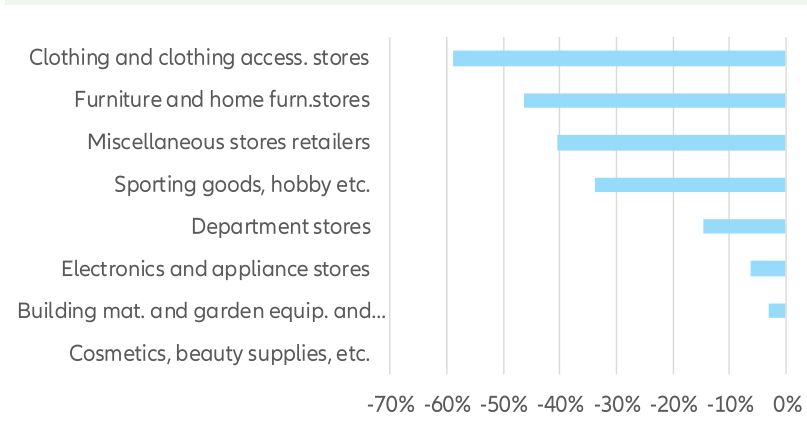
As of 18 May 2020, department store chains JC Penney and Neiman Marcus had already filed for bankruptcy.

Figure 3: sales-to-inventory ratio across segments (Feb. 2020 data)



Sources: U.S. Census, Bureau Euler Hermes, Allianz Research calculations

Figure 4: change in total retail employment across segments, Feb-April 2020



Sources: BLS, Euler Hermes, Allianz Research calculations

THE LEGACY OF THE OUTBREAK WILL SHAPE COMPETITION AND BUSINESS MODELS FOR THE COMING DECADE

Looking beyond 2020, and because the current crisis is unique in its magnitude and playing out very differently across segments, we anticipate deep and lasting implications for the years to come:

- Food retailers will emerge stronger from the crisis but will see the pace of change accelerate. In the short run, we believe the space left empty by bankrupt discretionary retailers will represent an opportunity to grow non-food sales for superstores and warehouse clubs. In the medium run, there is little doubt that e-commerce penetration in the grocery sub-segment will accelerate, thanks to first-timers becoming frequent shoppers - data from various technology companies point to a three-digit increase in online grocery purchases for the month of April 2020. Food retailers will face the same dilemma as non-food retailers did in the previous decade: either ignore e-commerce and face the risk of losing customers, or venture into e-commerce at the risk of lower margins. At an industry level, we think the trend is clearly detrimental to profitability: whether involving store pick-up or delivery at home, grocery e-commerce is structurally less profitable, if profitable at all.
- Discretionary retailers will, on the contrary, exit the lockdown with deteriorated balance sheets and squeezed margins, while their e-commerce pure-player competitors have been capturing market shares under lockdown and attracting new customers. Companies with the most advanced "omnichannel" business models (optimal physical store network + competitive online offering) have fared better than their brick-and-mortar peers and are comparatively better placed to reap the benefits of the acceleration of e-commerce growth.
- Online pure-players have definitely gained ground over their brick-and-mortar and click-and-mortar competitors, but the surge in sales has not translated into a corresponding increase in profits. Their number one challenge for the months and years to come is to retain customers acquired under lockdown and increase their purchase frequency. Notwithstanding our expectation of an acceleration of e-commerce growth, we still expect profitability among e-commerce pure-players to remain the exception, not the norm, as long as the true cost of logistics is not passed onto customers.
- Across segments, retail supply chains could suffer from renewed tensions between the U.S. administration and China that could translate into a new wave of trade restrictions or tariff increases. Retailers have already been looking for alternatives to China, but the country still accounts for an overwhelming share of consumer goods manufacturing (electronics, appliances, textiles, furniture).



APPENDIX—Scope of the report**Scope of the report**

To underline the different dynamics at play in the food, discretionary and online retail segments, we have based our calculations on segment-level information using the North American Industry Classification System (NAICS). Because they are more dependent on trends from the automotive and energy industries, automotive as well as gasoline and fuel retailers are excluded from our scope. Employment, store count and retail sales historical data and forecasts were prepared using a bottom-up approach based on the following activity codes:

Food retail:

- 445 Food and beverage stores
- 45291 Warehouse clubs and superstores

Discretionary retail:

- 442 - Furniture and home furnishings stores
- 443 - Electronics and appliance stores
- 444 - Building material and garden supply stores
- 44612 - Cosmetics, beauty supplies, and perfume stores
- 448 - Clothing and clothing accessories stores
- 451 - Sporting goods, hobby, book, and music stores
- 4521 - Department stores
- 453 - Miscellaneous store retailers

Online retail:

- 4541 - Electronic shopping and mail-order houses

Estimates of 2020 turnover and potential store closures

We have estimated 2020 sales and potential store closures taking account a mix of past data (retail sales, establishment and employment data, corporate credit metrics, company statements) at a segment level as well as assumptions on U.S. economic growth, e-commerce penetration and industry competition.

OUR TEAM

Chief Economist of Allianz and Euler Hermes



Ludovic Subran
Chief Economist
ludovic.subran@allianz.com

Head of Economic Research, Euler Hermes



Alexis Garatti
alexis.garatti@eulerhermes.com

Head of Capital Markets Research



Eric Barthalon
eric.barthalon@allianz.com

Head of Insurance, Wealth and Trend Research



Arne Holzhausen
arne.holzhausen@allianz.com

Macroeconomic Research



Ana Boata
Head of Macroeconomic
Research
ana.boata@eulerhermes.com



Katharina Utermöhl
Senior Economist for Europe
katharina.uterhoehl@allianz.com



Selin Ozyurt
Senior Economist for France
and Africa
selin.ozyurt@eulerhermes.com



Françoise Huang
Senior Economist for APAC
francoise.huang@eulerhermes.com



Manfred Stamer
Senior Economist for Middle East
and Emerging Europe
manfred.stamer@eulerhermes.com



Georges Dib
Economist for Latin America, Spain,
Portugal and Trade
georges.dib@eulerhermes.com



Dan North
Senior Economist for North
America
dan.north@eulerhermes.com

Capital Markets Research



Jordi Basco Carrera
Fixed Income Strategist
jordi.basco_carrera@allianz.com



Michaela Grimm
Senior Expert, Demographics
michaela.grimm@allianz.com



Lina Manthey
Equities Strategist
lina.manthey@allianz.com



Markus Zimmer
Senior Expert, ESG
markus.zimmer@allianz.com



Patrick Krizan
Senior Economist for Italy and
Greece, Fixed Income
patrick.krizan@allianz.com



Patricia Pelayo Romero
Expert, Insurance
patricia.pelayo-romero@allianz.com

Sector Research



Maxime Lemerle
Head of Sector Research
maxime.lemerle@eulerhermes.com



Catharina Hillenbrand-Saponar
Sector Advisor for Energy, Metals, Machinery and
Equipment
catharina.hillenbrand-saponar@eulerhermes.com



Marc Livinec
Sector Advisor for Chemicals,
Pharmaceuticals, Transportation,
Agrifood and Transport Equipment
marc.livinec@eulerhermes.com



Aurélien Duthoit
Sector Advisor for Retail, Technology and Household
Equipment
aurelien.duthoit@eulerhermes.com

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Director of Publications: Ludovic Subran, Chief Economist
Allianz and Euler Hermes
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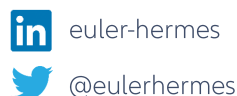
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Königinstraße 28 | 80802 Munich |
Germany
allianz.research@allianz.com



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1 Place des Saisons | 92048 Paris-La-Défense
Cedex | France
research@eulerhermes.com



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