Are Smaller-Yet-Smarter Layouts Translating to Stronger Retail Performance?

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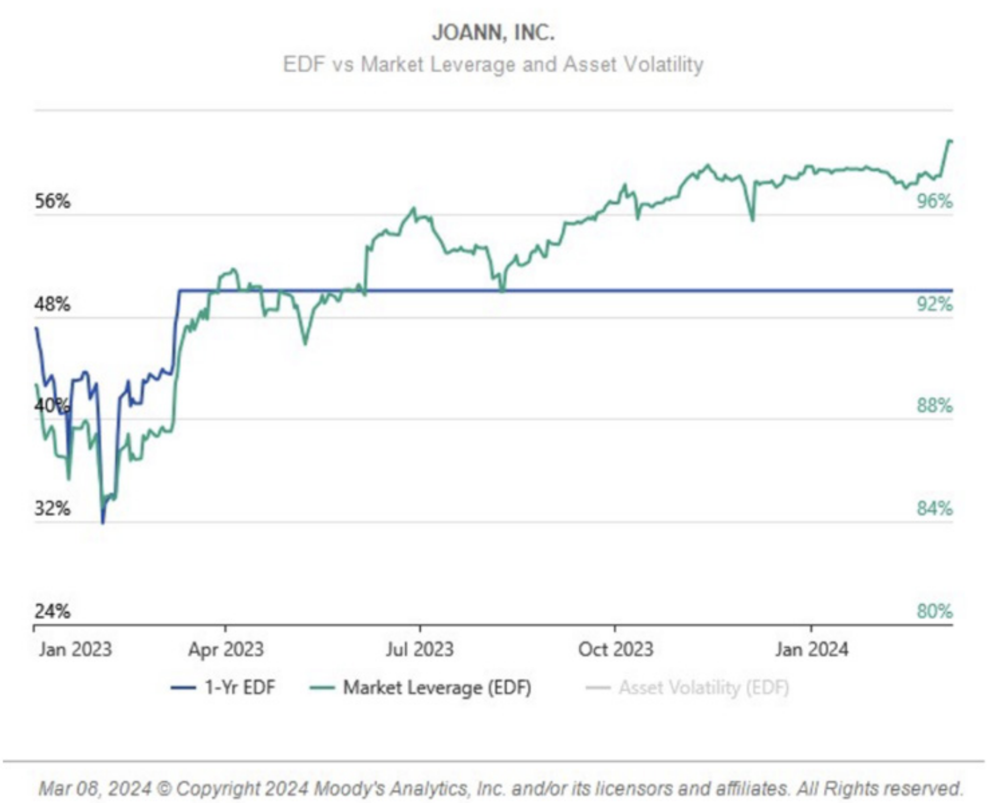
After reporting a 5.5% decline in annual sales, Macy's announced its 'Bold New Chapter' which calls for closing 150 (or 30%) "underproductive" stores by 2026, including its 77-year-old iconic flagship store in San Francisco's Union Square. As part of the plan, Macy's will open at least 30 Bluemercury stores, the company's smaller footprint luxury beauty retailer, as well as roughly 15 Bloomingdale's, a luxury retail brand that also operates in smaller stores than typical Macy's locations.[1] Macy's strategy entails not only a pivot from its middle-class target customers to its luxury brand and higher income demographics, but it's also a downscale from a massive department store format to something that can fit into a community or even neighborhood center.

This smaller-yet-smarter format experiment opened the door for Macy's and the like to explore off-mall options, increase proximity to customers, and provide curated merchants and experiences through omni-channel shopping. Whole Foods also recently announced its expansion of five Whole Foods Daily Shops in New York City, which features compact layouts ranging from 7k to 14k square feet (sqft) to tailor in-and-out needs of grocery shopping. Its downscale from full-size grocery and the elimination of a salad bar and meat counter are expected to sufficiently compensate for popular grocery delivery services like Instacart.

Figure 1: Joann Inc. EDF as Driven by Elevated Market Leverage



Source: Moody's EDF-X

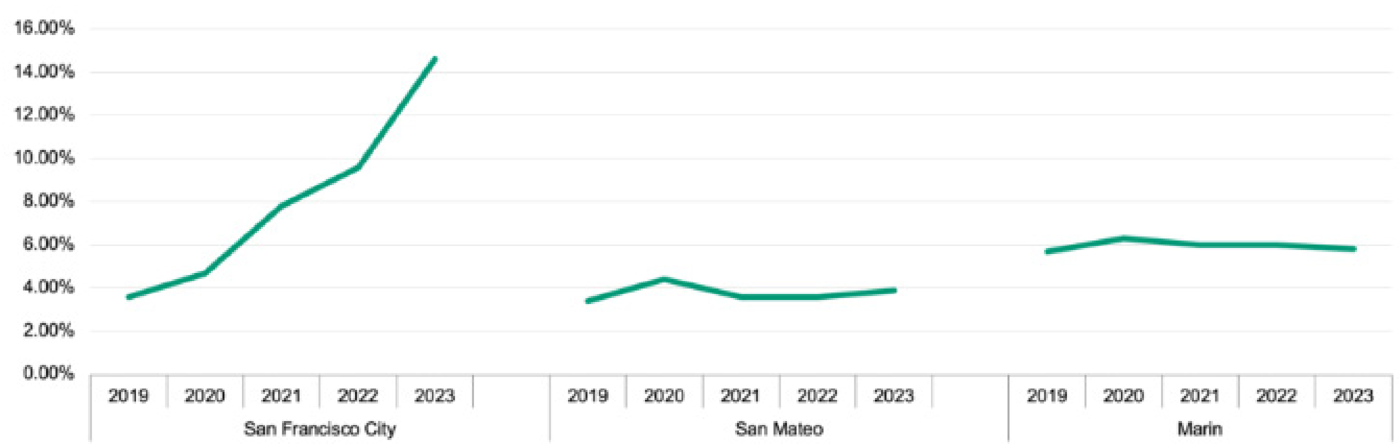
While exciting to see some retailers reinventing and readjusting, some slow to the uptake like Joann Fabric failed to sustain consumer loyalty, lower market leverage, or mitigate rising credit and operating risks are now on the blink of bankruptcy. As illustrated in the above figure, Moody's EDF-X model has been flashing red for this public company since early last year (indicated by EDF[2] reaching the highest 50%) which usually leads to significant chance of default over the next 12 to 24 months.

What does this smaller-yet-smarter trend mean to the retail sector's performance?

Stores like Macy's which used to attract middle-income customers are losing ground to stores targeting at high- or low-end consumers and the convenience of e-commerce. On the higher-end, luxury department stores that continued to offer differentiating products and desirable services to their target customers survived the competitive retail market. On the lower-end, discount stores found its place for all customers to snap deals under rising consumer debt levels. As painful failures or faulty transformations remain for old-fashioned retail behemoths, malls – especially those losing anchor retailers, further away from population centers, or slow to adapt to experiential and service-driven modern retail preferences – also struggle.

In the case of San Francisco, the Macy's Union Square closure after a slew of retailer departures in the city's downtown shopping area reflects the city's deep disintegration of live-work-play functions. San Francisco's retail landscape heavily relied on the commuting workers and travelers. Now, it suffers from stagnation in return-to-office numbers and a sluggish foot traffic recovery, still 33% behind its pre-pandemic level. Retailers that used to be embedded in San Francisco's culture now must give way to innovative retail forms such as Ikea that feature co-working spaces or high-end rooftop restaurants. With finger pointing aimed at crime and homelessness for this retail exodus, San Francisco city's retail vacancy shot up 1100 basis points (bps) since 2020 to 13.6% by the end of last year, while performance at neighboring Marin and San Mateo counties remained mostly flat during the same four-year period (Figure 2).

Figure 2: San Francisco Retail Vacancy vs. Neighboring Marin and San Mateo Counties



Source: Moody's CRE

Large department stores in urban corridors' downtown entice local and visiting consumers to come and enjoy the area while exploring other smaller retailers scattered around. The shuttering of Macy's and malls like the landmark San Francisco Centre which previously housed Nordstrom and Bloomingdale's may have a profound domino effect, driving other retailers to flee, further depress retail leasing activities, or cause deeper troubles to the downtown's foot traffic and economic recovery. Below is the map created by San Francisco Chronicle exhibiting the major retail exodus since 2023 which continued to evolve. Bay Area-based retailer, The North Face, just announced it's following in Macy's footsteps to leave Union Square. Fast fashion retailer, Zara, also decided not to renew its lease by the end of this year.

Figure 3: Major Retail Stores That Have Left San Francisco's Downtown Since The Start of 2023:

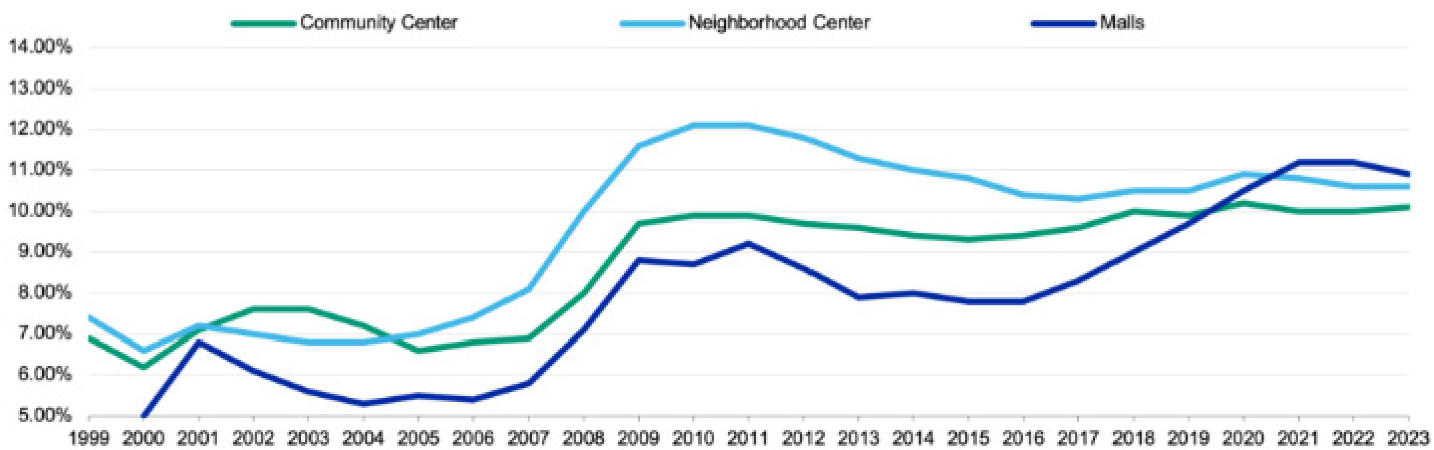
Source: San Francisco Chronicle[3]

On a positive note, while empty spaces resulted from department stores' closure are often difficult to fill, movie theaters, miniature golf courses, pickleball courts, grocery stores, or even housing can be some creative alternative uses to re-engage the customers. In the meantime, downsizing brings hope to the open-air neighborhood and community centers which have experienced rather stable performance in recent years (Figure 4).

Although it is sad to see cultural icons disappear, the retail industry will continue to reinvent, innovate, adapt, and ultimately thrive. It is important to continue monitoring public and private retailers' financial wellbeing through credit risk models like the above mentioned EDF-X platform, which allows property owners or managers to predict potential retail exodus due to credit events

12-24 months ahead of time. In the longer-term, omnichannel shopping experiences, brand differentiation, curated merchants and services, and amenities which are suitable for live-work-play community will re-write the retail legend in years to come.

Figure 4: Malls' Vacancy Stayed Elevated as Compared to Neighborhood and Community Centers



Source: Moody's CRE