

HISTORY HIDES THE PRESENT AT THE HUDSON VALLEY Mall in Kingston, N.Y., a two-hour drive north of New York City.

Walls with photos—an 1898 tugboat called Mathilda, now part of a nearby maritime museum; the Bardavon 1869 Opera House, saved from demolition in the 1970s—serve as facades that cover long stretches of vacant space engulfing scattered stores. One end is blessed with a cluster of healthy anchors: Best Buy (ticker: BBY), Target (TGT), and Dick's Sporting Goods (DKS). But these stores open to the outside and don't bring much traffic into the mall.

Across the Hudson River, a bit south, the larger and livelier Poughkeepsie Galleria has benefited from store closings at other malls, its management says. A mall's pulse can be read in its food court, and here nine of 10 spaces are occupied; Wendy's left this year but soon will be replaced by a Charleys Philly Steaks. That compares with just two of nine spaces filled at the Hudson Valley Mall food court.

Even at the Galleria, there are weak points. Anchor tenants include Best Buy, but also Sears and struggling J.C. Penney (JCP). Revenue the mall generates for its owner, Pyramid Management Group, has been gently falling for years, and occupancy, 92% in 2017, recently slipped to 87%, according to Bloomberg data.

Don't call this a retail apocalypse. U.S. sales could grow 3.5% this year to \$3.7 trillion, after rising 4.3% last year. Rarely has unemployment been lower or consumer confidence higher. The good old days for shopping? Those are happening right now. And yet, U.S. retailers have already announced 7,567 store closings this year, or 4,512 after subtracting for openings, according to industry watcher Coresight Research. That compares with 2,606 net closings for all of last year.

Investors must think carefully about how to choose among retailers. Some have too much exposure to weak malls, and others, to shifting spending patterns. Others are following new

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Randal Konik, Jeffries analyst

rules—and thriving.

Now is not the time for patience with companies showing poor results while talking about a turnaround. Think of this as the opposite of a bank stress test. Stores that are currently struggling under sunny skies could collapse during the next rain, or before it. Gymboree, Payless Shoe-Source, Shopko, and Charlotte Russe aren't the only retailers to file for bankruptcy protection this year, and they will surely not be the last.

Part of the reason for the shakeout is Amazon.com (AMZN), now 6% of U.S. retail and likely to match Walmart's (WMT) 10% within four years. And part is the broader rise of e-commerce for both online retailers and chains.

But there is also a simpler force at work: "The suburbs are overstocked and undershopped, and experts say only the top 20% of malls are thriving." That was a report from Women's Wear Daily some 22 years ago. There has been little improvement since. If Japan in the 1990s was home to zombie banks, the U.S. today is a nation of zombie stores.

There are about 1,350 enclosed malls in the U.S., but only 200 to 400 are needed, says Randal Konik, an analyst with Jefferies. At malls and beyond, the U.S. had 23 square feet of store space per person as of last year, by far the most in the world, according to the International Council of Shopping Centers. The United Kingdom had five; Spain, four; and Germany, two. Historically, urban planners in Europe carefully limited the ratio of retail space to people, whereas the U.S. took a more Darwinian approach, according to Michael Brown, a partner at consulting firm A.T. Kearney who specializes in store chains. Across much of Asia, popular store chains came up during the e-commerce age, so many are digital natives.

At the current pace of store closings, it could take 10 years to bring the U.S. near equilibrium, says J.P. Morgan analyst Matt Boss. UBS forecasts 75,000 closings by 2026, not counting food,

assuming that e-commerce rises to 25% from its current 16%.

Retail defies one-size-fits-all analysis. It isn't a single industry but many, with more than 200 publicly traded companies. To make sense of it, start with Wall Street's names for the various store and merchandise species. Supermarkets are their own category, with nearly \$1 trillion in spending. Softlines are clothing, accessories, and shoes, while hardlines include things like home-improvement products, electronics, and furniture. "If I buy something and throw it at you, and it hurts, it's probably a hardline good," says Evercore ISI analyst Greg Melich.

Broadline retailers are mass merchants such as Walmart and Target (TGT) that sell a mix of goods. Companies sometimes jump categories. "I'm old enough to remember when Macy's (M) sold televisions, but now they're mostly clothing," Melich says.

J.P. Morgan's Boss covers softlines, which includes global brand owners that sell through their own stores and retail partners. He says four factors are separating winners from losers: value, convenience, innovation, and distribution. The first two explain why off-price retailers like TJX's (TJX) T.J. Maxx and Burlington Stores' (BURL) Burlington Coat Factory, along with so-called dollar stores, are doing well. Off-price stores sell national brands at sizable discounts by scooping up closeout merchandise and overstocks from other chains. They offer better perceived value than either specialty retail or department stores, Boss says. Dollar chains use small stores to sell everyday items like milk and laundry detergent, along with specialty items like garden hoses, to customers who might otherwise have to travel to shopping centers in nearby towns. The companies leading all store openings this year are Dollar General (DG) and Dollar Tree (DLTR).

At the mall, there is more of a zero-sum game, where one gains at another's expense, but both

Shrinking Retail

A sampling of U.S. chains that have filed for bankruptcy protection and closed stores in the past two years.

TOYS 'R US

September 2018

Toys "R" Us

Largest U.S. retail bankruptcy since Kmart in 2002 until it was surpassed last year by Sears.

Maurice

November 2017

Maurice Sporting Goods

Founded in 1923. More than 90 years of profits before bankruptcy.

THE BON-TON
YOUR FASHION STORE

February 2018

Bon-Ton Stores

Emerged from bankruptcy as an online retailer with plans for bricks-and-mortar locations.

claire's

March 2018

Claire's Stores

Says it has plerced 100 million ears worldwide. Shed \$1.9 billion in debt and exited bankruptcy last year.

Southeastern Grocers

March 2018

Southeastern Grocers

More than 580 stores in seven states at time of filing, including BI-LO and Winn-Dixie.

NINE WEST

April 2018

Nine West Holdings

Sold Nine West footwear and emerged from bankruptcy in March as Premier Brands Group Holdings.

Brookstone

August 2018

Brookstone Holdings

Second bankruptcy since 2014. Plans to close all 101 mall-based stores citing "continued deterioration of traditional retail mall traffic."

face long-term pressure. For example, American Eagle Outfitters (AEO) and its Aerie brand might be taking market share from Victoria's Secret, but both must watch fast-growing upstart ThirdLove, which sells directly and isn't publicly traded. "There's a ton of almost invisible competition from boutiques," Boss says.

Investors need to tell the difference between fashion trends and more durable megatrends. The latter include the shift toward casual use of athletic clothing, which has higher levels of design innovation that customers are willing to pay for. That bodes well for Nike (NKE), Under Armour (UAA), Lululemon Athletica (LULU), and VF (VFC); owner of North Face and Vans, Boss says, and less well for Ralph Lauren (RL), Levi Strauss (LEVI), and PVH (PVH), whose brands include Calvin Klein.

Among malls we visited, even retail graveyards had a Victoria's Secret and Foot Locker (FL). Konik of Jefferies is deeply bearish on the bra seller, owned by L Brands (LB), but says sneakers benefit from relatively limited competition. "There are only five brands that matter," he says.

The retail reckoning will hit department stores especially hard, according to UBS. Sales there have fallen 33% since their 2005 peak, but the store count increased 23% over the decade ended in 2016. Recent closures by Bon-Ton and Sears, along with Macy's and J.C. Penney, haven't yet brought supply in line with demand.

UBS also sees specialty-clothing stores like Gap (GPS) and L Brands accelerating closures. In April, the bank estimated that clothing needs to shrink its store base by 17%; electronics, 22%; home furnishings, 18%; and grocery, 8%. It sees home improvement and auto parts as relatively well positioned.

For hardlines, Melich of Evercore says we are now in the golden age of multichannel retail. Stores, even ones that sell cumbersome goods like lawn mowers, must learn to excel at "bopis," or

In the years ahead, individual investors must navigate not only the continuing purge in stores and shifting tastes, but also societal trends.



Amazon Prime's growth hasn't hurt membership at Costco, where deep discounts bring in buyers.

SAMUELS JEWELERS

August 2018

Samuels Jewelers

Founded in 1891. Fourth bankruptcy since 1992. Plans to close all stores after failing to find a buyer.

MATTRESS FIRM

October 2018

Mattress Firm

Plans to close 700 stores. Has struggled to compete with e-commerce start-ups like Casper.

SEARS

October 2018

Sears Holdings

Founded in 1893. Largest U.S. retailer when passed by Walmart in 1991. About 400 profitable stores at time of filing.

DAVID'S BRIDAL

November 2018

David's Bridal

Largest bridal gown seller in the U.S. emerged from bankruptcy earlier this year.

GYMBOREE

January 2019

Gymboree Group

Second bankruptcy in two years. Lost market share to The Children's Place.

charlotte russe

February 2019

Charlotte Russe Holding

Plans to close 94 stores. Says it failed to outpace young-adult fashion trends and shifted too far toward basics.

Payless Shoe Source

February 2018

Payless Holdings

Second bankruptcy. Planned to close about 2,500 North American stores at time of filing. Will keep more than 400 international stores open.

David Paul Morris/Bloomberg

buy online, pick up in store.

"You can see it at Walmart, where they carve out thousands of square feet for click-and-collect and use store labor to load cars," he says. "Right now, they keep groceries and general merchandise separate, but they're testing stores that do both."

Among Melich's favorite stocks in hardlines are Home Depot (HD) and Sherwin-Williams (SHW), because they are digitally savvy, and although home sales are unremarkable at the moment, long-term housing fundamentals are strong. He is bearish on Bed Bath & Beyond (BBBY), whose same-store sales are expected to fall 4.5% in the fiscal year that ends in February, and whose stock he calls "almost just an option contract on how long they'll survive." Bed Bath declined to comment.

In broadlines, Melich likes both Amazon and Costco Wholesale (COST). He sees Amazon going to \$4,000 in yearly sales per Prime member by 2023 from \$2,500 today. Amazon's fast Prime growth hasn't hurt membership at Costco, which Melich says offers a "curated assortment of high-quality products at shockingly good value—not 10% cheaper, more like 60% cheaper." It does this by focusing its buying power and relying heavily on its store brand, Kirkland.

If there is one metric for investors in chain stores to watch, it's traffic, which Melich calls the mother's milk of the industry. If it is negative, companies are left with three costly paths. They must invest more capital to remodel stores or improve their technology, or change their inventory to match what customers want, or cut prices.

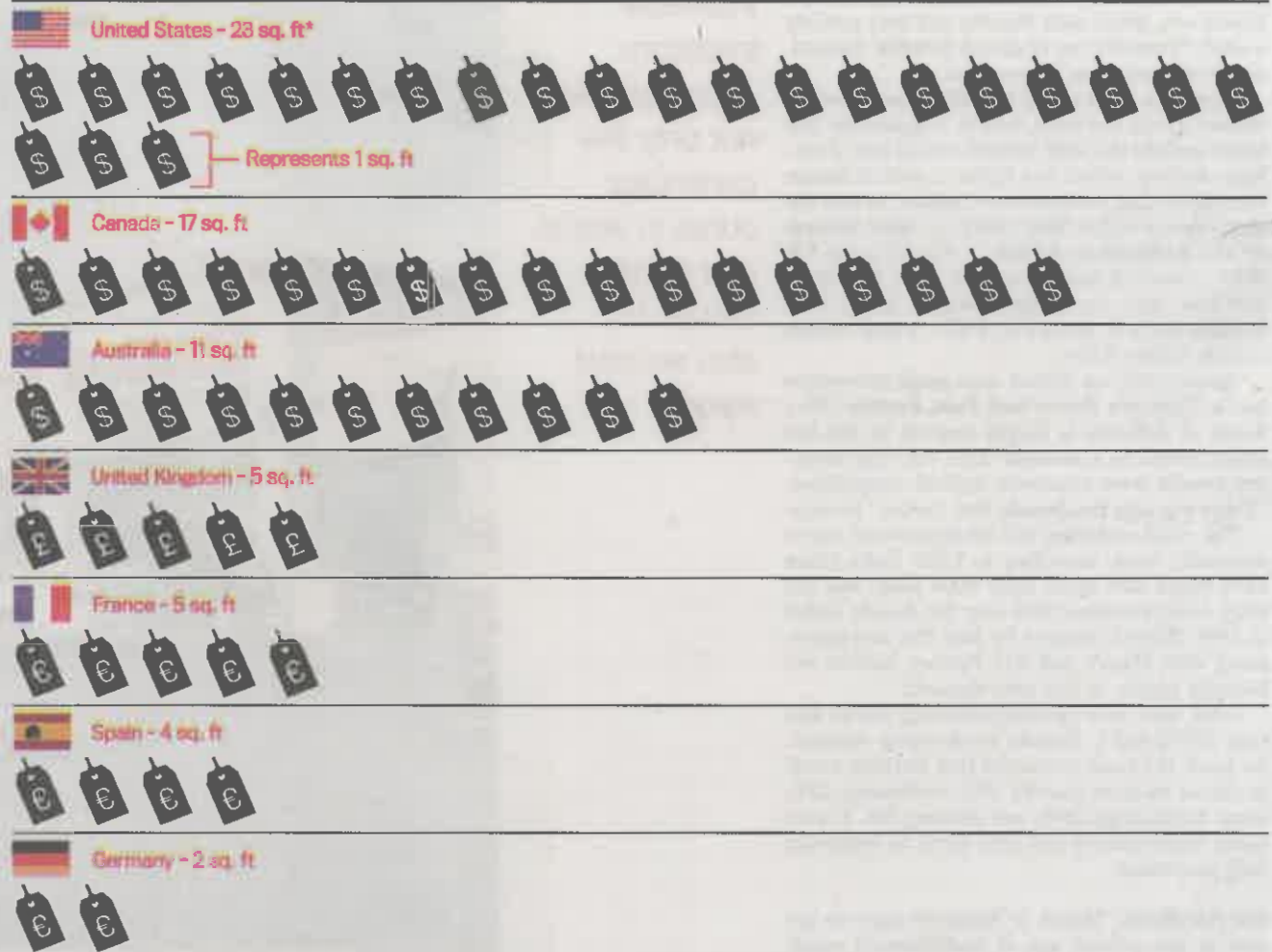
The grocery business is flooded with newcomers, from mass merchants to dollar stores. Supermarkets are a highly fragmented group with regional players that lack the financial firepower to invest in digital options, like click-and-collect. One exception is Kroger (KR), the largest pure-play grocer, which could benefit from bankruptcies of small rivals, but its shares are volatile and best bought during deep markdowns, if at all.

Growth investing and groceries might seem like odd companions, but Jefferies' Konik recently initiated coverage of Grocery Outlet Holding (GO) with a Buy rating, calling it a "retail unicorn." It isn't a start-up, however. The company dates back to World War II and is led by third-generation members of its founding family. Konik likes that the chain is growing rapidly from a small, regional base; that it has developed an off-price "treasure hunt" model for grocery that resembles that of T.J. Maxx for clothing; and that its family management reminds him of flourishing sandwich seller Chick-fil-A. Grocery Outlet went public in June at \$22 a share and has since climbed to \$38 and change, a heady 65 times this year's earnings forecast. Its earnings per share are expected to increase rapidly—by 34% next year.

In the years ahead, individual investors must navigate not only the purge of stores and shifting tastes, but also societal trends. Millennials are spending more on experiences and less on stuff than do their parents. They are comfortable in the

Overstored

The U.S. has far more retail space per person than other developed nations.



Note: Data for 2018 except Australia (2016) and Canada (2017). *Rounded to nearest foot Source: International Council of Shopping Centers

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sharing economy for things like cars and vacation-house rentals.

Will even younger shoppers expand sharing to new categories? A company called Fernish offers a subscription furniture service in Los Angeles and Seattle. Customers choose a monthly plan; select items online, where brands include Crate & Barrel; and receive delivery within a week. They can return or buy out their items, with the promise that they'll never pay more than retail. It is a tiny operation for now, and perhaps it will stay that way. But already, traditional furniture chains are feeling pressure from online sellers like Wayfair (W), not to mention Amazon, which sells its own brand of mattresses, sofas, and beds.

Back at the Hudson Valley Mall, there are clues to a path forward. It was bought in 2017 for just over \$8 million by Hull Property Group of Augusta, Ga., which is responsible for the mall's neat

appearance with those facades and photos. But that is just for short-term stabilization, and owner James Hull hasn't announced his longer-term plans. His 2012 purchase of the Liberty Fair Mall in Martinsville, Va., suggests one option. Much of the enclosed mall was demolished, leaving a smaller group of stores opening to the outside, now called Village of Martinsville.

At another faded shopping edifice along the Hudson, the Newburgh Mall, it is difficult to imagine even a scaled-down future. The only remaining anchor is Sears. Even here, however, investors bought the property in 2017 for just under \$8 million. And a Massachusetts developer this summer has been pitching the town on a plan for 122 acres across the street: a mix of stores and apartments, with medical services, a performance space, and walking trails.

Say a prayer, if you'd like, for the river's malls. Its shoppers will be just fine. ■