OCTOBER 12, 2017 | MARK HESCHMEYER

Faster Growth of Amazon Fashion Could Rock Retail Real Estate

Impact Would Likely Fan Out to Mall REITs and CMBS

Lost in the coverage of Amazon's very public search for a second, multi-billion dollar national headquarters, was the barely-noticed lease the company signed in New York City last month. Yet that lease could signal billions of dollars in losses coming for retail commercial real estate across the country.

Amazon signed a 15-year office lease for 360,000 square feet at Brookfield Properties' recently-renovated 5 Manhattan West building. Amazon will take the entire sixth and seventh floors of the 2.15 million-square-foot tower as well as part of the eighth and 10th floors in a move that is expected to bring 2,000 jobs to the Penn Plaza / Garment District submarket of Manhattan.

Amazon Fashion has also previously invested $9 million in a 40,000-square-foot fashion photo studio in Brooklyn (pictured).

"We're excited to expand our presence in New York - we have always found great talent here," said Paul Kotas, Amazon's senior vice president of worldwide advertising.

Those jobs will be coming primarily in the Amazon Fashion and advertising divisions, and that signals the online retail behemoth is getting more serious about advancing its fashion and apparel sales. In the past year alone, it has introduced seven private apparel brands to its Prime members, including Goodthreads, Amazon Essentials, Paris Sunday, Mae, Ella Moon, Buttoned Down and Lark & Ro.

A hypothetical rapid rise in Amazon's U.S. apparel market share could have significant credit implications for existing retailers, REITs and CMBS transactions, according to Fitch Ratings in a 'shock scenario report' published last month.

Worst-Case Scenario

Sharp declines in retailer revenue and margins, along with accelerated store closings, would likely drive significant cash flow erosion and weaken credit profiles for apparel-focused retailers, mall REITs and retail-heavy CMBS deals in such a scenario.

This shock would likely fan out broadly across much of the retail real estate sector, with large credit profile effects on mall REITs and retail-heavy CMBS transactions. Large-scale store closures, going well beyond previously announced cuts, would likely follow, Fitch projected.

"REITs owning regional malls with high exposure to troubled anchor stores and a less diverse tenant base would face heavy cash flow pressure," Fitch analysts said. "We estimate that as many as 400 of approximately 1,200 U.S. malls could close or be repurposed as a result of retailer liquidations and square footage reductions."

The Fitch shock scenario assumes an accelerated three-year apparel market share shift to Amazon.com as a price-competitive and convenient alternative to traditional in-store purchases. The hypothetical rapid growth in Amazon's apparel market share to 25% by 2020 could cut apparel retailer margins by around 300 basis points, pushing several retailers toward financial distress.

In addition to weaker cash flow, many mall owners would face reduced access to capital due to negative lender and investor sentiment. Attempts to re-tenant or repurpose underperforming malls with high vacancy rates would likely take considerable time and capital. Efforts by REITs to reposition mall properties in this scenario would be difficult given constraints on capital spending and liquidity in a tight financing environment.

"Widespread defaults on loans backed by malls would have a significant impact on credit quality for Fitch-rated CMBS transactions," the rating agency said. "Given the accelerated timeframe of this retail shock scenario, special servicers would be forced to sell lower tier malls at significantly distressed values rather than undertaking normal stabilizing efforts."

Assuming Amazon's share gains are concentrated in lower price points, low- to mid-tier apparel retailers, including JC Penney, Kohl's and Dillard's, would face intense competitive pressure in such a scenario, Fitch said.

Amazon's Road into Fashion Isn't Assured

The Fitch stress test does not explicitly factor in retailers' responses to a more challenging operating and financing environment. Many of these responses, including cost reduction initiatives, asset sales and secured debt issuance, could mitigate the impact of such a severe competitive shock, particularly for companies that have ample liquidity to respond to accelerated competitive threats.

And let's face it, fashion and apparel margins and sales are thin and thinning out, and could present a tough market for Amazon to break into. Competitive pressures on in-line apparel retailers have been building for at least a decade. Younger apparel consumers have demonstrated less interest in traditional department store fashion offerings, and shifted more toward 'fast fashion' and off-price retailers.

Retail real estate brokers operate in dual worlds when it comes to shopping. They are both consumers of merchandise online and brick and mortar sales people. As such, their take on Amazon is interesting.

Going into fashion is nothing new to Amazon, said Soozan Baxter, principal of Soozan Baxter Consulting, a New York-based, landlord-focused retail advisory firm. "They own Shopbop and Zappos. Shopbop is a phenomenal collection of contemporary brands with a loyal customer, while Zappos is a favorite for anyone who likes to buy shoes online."

However, shopping on Amazon is like being in an online market place without a point of view, she said. The chaotic experience doesn't resonate.

"If they can execute a bricks-and-mortar experience that is more like Shopbop and perhaps even use that name, they will be very successful," Baxter said. "If they execute more retail stores under the name Amazon, do customers get confused: is it the bookstore? Is it a Macy's? Is it an Intermix? Is it a car showroom? Is it a grocery store? The point of view gets confusing."

"The bottom line is that the margins in retail are challenging. As they want to delve further into bricks and mortar, can they create a different experience? Furthermore, Amazon has been richly rewarded by Wall Street without making a 'real profit.' As Amazon morphs into more of an omni-channel player, how will Wall Street respond to them?" Baxter asks.

Jason Polley, managing leasing director of StoneCrest Investments in Germantown, TN, says Amazon clearly has retailers scrambling to evolve and better integrate their brick and mortar stores with their online presence.

"Apparel has always seemed to be an area of retail that requires a brick and mortar presence for the customer to see, touch and try on merchandise before a purchase, as on-line purchases of apparel have a much higher return rate compared to other products sold online," Polley said.

But the problem is not all Amazon.

"Despite Amazon's clear impact, I do believe some apparel retailers have lost touch with their customer base and their core mission to deliver what their customer wants to buy," he added.

Paul Schloss, an associate broker at NAI Horizon in Tucson, also says the onus is on traditional