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What Changes, What Doesn't

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In this crisis, as in any other, it is good to spend some time thinking about what permanently changes in the economy and what does not. What is temporary and what is permanent? What is structural and what is cyclical? These are very important questions, but the answers are not always intuitive especially when one is living through a period of such transformative change.

The future may appear clear to some, but it is actually incredibly opaque. Only once events have unfolded does it seems "obvious" that the outcome was predictable. If you happened to be a citizen of ancient Rome during the reign of Caesar, does one buy or sell Roman real estate after Caesar is murdered? The tyrannical rule of a dictator is now over so that is surely good for real estate prices.

However, after the death of Caesar, you get a civil war and chaos. Extrapolate the trend of chaos too far and you are once again proved wrong because then comes the peaceful and productive reign of Augustus. This was however relatively short lived because after Augustus, you have a number of less competent and tyrannical emperors, climaxing with Nero. A few years after Nero, when all seems dire, you got to live through the golden age of Roman emperors – Nerva, Trajan, Hadrian, Pius, and Marcus Aurelius.

Every time a new Roman emperor came to power, the gods would toss a coin in the air and the citizens of ancient Rome waited with bated breath to see how it would land. The competence of different Roman emperors was obviously very important to the wealth and stability of the Roman empire, but almost impossible to predict in advance.

While predicting cyclical changes is incredibly difficult, predicting structural, permanent changes is often less difficult. When an alternative product or service is orders of magnitude cheaper or more efficient than the current choice, the cheaper and more efficient alternative almost always succeeds. Whale oil is a good example of this. Before kerosene, whale oil was widely used as a fuel in lamps, up until about 1850. The advent of cheaper and more energy dense kerosene was the beginning of the end for whale oil. There were probably a lot of investors and entrepreneurs who bet on whale oil to stage a comeback. They were all wrong. Whale oil still has its niche uses, but it will never be as widely used as it was in the past.

One area of the economy which, we believe, is experiencing a permanent structural change is the retail industry. Even before the pandemic, the retail industry was already in turmoil. Retail suffers from high fixed costs in the form of rental leases. Retail stores have to compete for space in areas with high foot traffic and pay orders of magnitude more in rent per square meter compared to their online only competition that have warehouses on the outskirts of a city. We can already see this in the headlines. House of Fraser has announced store closures, John Lewis is permanently closing its flagship Birmingham store and Marks & Spencer is laying off workers.

A similar trend can be seen across the pond. Lord & Taylor has filed for bankruptcy as has Nieman Marcus and JC Penny. These are all companies with more than 100 years of operating history. This does not of course mean all physical retail will experience ruin. Some niche stores will thrive. However, the economics are undeniable. Online-only retail enjoys a huge structural advantage through lower fixed costs. This, we believe, is a structural and permanent change that has been accelerated by the pandemic.

The closure of some physical retail stores and companies struggling to meet rent will have an impact on some commercial property funds in the UK. This asset class already suffers from poor liquidity pre-crisis and is now likely to have less reliable cashflows from distressed tenants. This is an asset class we have always avoided at Tacit mainly because of liquidity issues. The pandemic only seems to compound the problem going forward.

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