Economic Agglomeration And Bankruptcy In The Retail Sector: The Domino Effect

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The Changing Face of Retail

In the wake of a large number of recent bankruptcy filings by nationwide retailers[1], one does not have to look far to find a shuttered store front. While different theories have been advanced to explain the failure of these retail chains[2], traditional economic theory tells us that the failure of one retail store should result in its competitors having greater market share going forward, and accordingly more sales and better performance. Therefore, all other things being equal, the shuttering of a competing store should be a positive development for the store or stores that remain. As such, retail stores whose balance sheets are still relatively strong often see opportunity in the *going out of business* sales and dark store fronts of their nearby competitors. Counterintuitively, however, a statistically significant correlation has been found between the closing of one store and the performance of other stores in close geographic proximity to the closed store. By better understanding the economics of agglomeration (i.e. the benefits firms obtain by locating in close proximity to each other) and the economic relationship between stores in close physical proximity to one another, companies in the retail sector will be better prepared for what lies ahead.

As Goes Your Neighbor's Performance, So Goes Yours

A large scale empirical study of the retail sector entitled *The Agglomeration of Bankruptcy* has discovered that the closing of one retail store appears to seriously harm other retail stores in close proximity to the closed store.[3] More specifically, the researchers examined a detailed dataset of national chain store locations across the United States from 2005 to 2010 and found that the bankruptcies of retail chains impose significant negative externalities on nearby retail outlets.[4] Additionally, this direct correlation appears to be statistically significant whether or not the two stores are considered direct competitors and, in fact, is actually stronger when the stores are in the same industry.[5]

So-called "anchor stores" have long been viewed as crucial to the success of smaller retailers in the malls and shopping centers which they anchor[6], however the empirical evidence of the economics of agglomeration shows that the shuttering of a nearby non-anchor store – especially one in direct competition – can have a measurable adverse effect on the stores that remain. Because of the statistically significant correlation found by the study, savvy retail companies will certainly want to pay close attention to the financial performance of their neighboring retailers, as it may serve as a useful predictor of market headwinds.

The Potential Value of a More Collective Approach

In addition to using the performance of neighboring stores as the proverbial canary in the coal mine, the findings of the agglomeration study might also provide an empirical basis for taking a more holistic attitude towards financial success in the brick and mortar retail sector in a given geographic area. Therefore, if the results of this study are to be believed, the closing of one store will directly cause financial harm to neighboring stores, thereby creating a real and immediate economic incentive for stores sharing close geographic proximity to take actions designed to ensure that all succeed or, if the closing of a store is inevitable, that the transition to a new retail tenant is as quick and seamless as possible so the loss in business associated with the closing of the failed retail outlet is mitigated for the stores that remain. Indeed, based on the results of the study, stores sharing the

1 See e.g. Aeropostale (filed for bankruptcy in May 2016 with approximately 739 stores); American Apparel (filed for bankruptcy in October 2015 with approximately 264 stores); Deb Stores (filed for bankruptcy in December 2014 with approximately 295 stores); Delia's (filed for bankruptcy in December 2014 with approximately 92 stores); Pacific Sunwear (filed for bankruptcy in April 2016 with approximately 600 stores); Quicksilver (filed for bankruptcy in September 2015 with approximately 700 stores); Radio Shack (filed for bankruptcy in February 2015 with over 4,000 stores); Sports Authority (filed for bankruptcy in March 2016 with approximately 450 stores); and The Wet Seal (filed for bankruptcy in January 2015 with approximately 173 stores).

2 Each explanation seems to boil down to some combination of competition from online retailers and the failure of these retailers to adapt to the tastes and shopping habits of the new 'millennial' generation.

3 "The Agglomeration of Bankruptcy" by Efraim Benmelech, Nittai Bergman, Anna Milanez, and Vladimir Mukharlymov, National Bureau of Economic Research 2014.

4 Id. at p. 2.

5 Id.

6 Indeed it is common for retail leases to have opt out provisions in the event the anchor store closes or moves to a different location.

same address in a mall or shopping center, as well as the owners and landlords of these malls and shopping centers, might want to take proactive steps and recognize that the success of each individual store is tied, to some measurable degree, to the success of its neighbors. While the manner in which this holistic outlook is implemented will necessarily be specific to each particular location and situation, one could envision group promotions, advertising tie-ins, common area improvements, and other similar enhancements for the benefit of surrounding merchants to avoid the impact of a retailer's failure. This would in turn benefit landlords, competing retailers, and the vendors that sell to them.

Conclusion

While the agglomeration effect on brick and mortar retail stores will certainly benefit from further research[7], the study's findings make it clear that retail stores do not operate in a vacuum and are undeniably adversely affected by the negative performance of neighboring retailers. Accordingly, professionals working within the retail sector will want to pay close attention to the performance of neighboring stores, and consider whether or not agglomeration forces will impact their storefront, tenant or vendor.

7 The study cited above is a 'working paper' and further efforts to study and understand the agglomeration effect are expected to be forthcoming.

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