



Economic Perspectives

Emerging trends in retail real estate

Retail real estate is feeling the effects of the housing and credit crises together with a remarkable slow down in consumer spending. That combination is forcing structural changes in retailing. Retailers are aggressively closing under-performing stores, bankruptcies are surging and the effect is flowing through to retail real estate. Rents are under pressure, vacancies are rising and investors are taking a fresh and increasingly critical look at assumptions around retail real estate investment.

Shopping centers, once naively thought to be immune from downturn as a result of the extraordinary early decade residential growth have now turned into high risk assets. No longer are there growing numbers of roof tops to justify additional retail real estate development. Instead, sagging retail spending, an unsettling jobs picture, declining household wealth and housing woes have combined to destroy any semblance of economic feasibility for new development. These same factors have put existing projects at far greater risk as retailers close under-performing stores and bankruptcies surge both locally and nationally.

The retail sector has been long over due for correction after a decade long expansion. Too much space was constructed earlier this decade — much of it for reasons that did not include demand or economic feasibility. REITs, for example, one of the largest owners of retail assets were often pressured by shareholders to show growth. So they did, in the form of new and often unnecessary power centers and regional malls.

Retailers too were pressured by shareholders to grow. In a time of easy money, they created specialty spin offs that tended to locate in high end shopping centers and especially lifestyle centers. Today, in the age of contraction, tight money and sagging spending, these same retailers are pulling back, closing stores and consolidating in fewer locations. Every part of the sector is at risk but especially lower end unanchored malls and shopping centers. Today's centers need anchor tenants with strong credit which is getting increasingly difficult to find.

Big box retailers are not immune either. Electronics retailers are struggling along with department stores and others facing slow consumer spending. Large office supply "super-stores" are closing under performing stores or consolidating too as businesses contract and have less need for office supplies. Others are reducing hours. REITs are selling land once intended for near term development.

What sectors will fare best? ... and worst? Grocery anchored neighborhood centers appear best positioned to withstand the recession. Consumers will continue to spend on food and essentials even as they cut back spending on discretionary purchases. Big box discounters are likely to stay afloat and deep discounters such as Wal-Mart will do well in the current economic environment.

Lifestyle centers will likely perform the worst as tenants offer products usually regarded as discretionary. These centers became overbuilt as retailers sought to expand specialty spin off stores. Early lifestyle centers were located near fortress malls and in upscale areas. The more recent development, however, occurred in lower income areas and at suburban edges and these will be most adversely affected.

What is driving retail real estate today? The current recession has landed squarely on retailing and the retail real estate sector. Indeed, rents are no longer increasing. With few exceptions today, growth is flat or declining. At the same time, vacancy rates are rising as absorption rates slow, lease renewal levels decline and tenants seek to sub lease space. Finally, capitalization rates — the ratio between a properties net operating income and its value — are rising pushing value and prices down. Consider cap rates.

For decades, capitalization rates hovered in the 10% range. Rates were often slightly lower for new, well located investment grade properties and slightly higher for older or second tier properties. The result was the lower the rate the higher the value and vice versa. In 2002, residential development began to surge and prices rose. That fuelled additional residential development and prices continued their unprecedented rise. As retail typically supports residential development, developers followed the surging residential growth with retail real estate development. Values and prices rose in the retail real estate sector as well and that fuelled yet more development. At the same time, interest rates were at historic lows as a result of monetary policy in place following the 911 terrorist attacks

The combination of low interest rates, surging development and the apparent belief that prices would continue to rise forced capitalization rates down to levels never seen before. Rates fell below 6% and sometimes under 5%. Clearly such rates and the values they generated were unsustainable.

Today, capitalization rates are trending upward again and that is placing significant downward pressure on values. No longer are there increasing numbers of roof tops for retail real estate to follow. Moreover, investors and financial institutions alike are re-pricing risk and financing sources are extremely limited.

The CMBS (commercial mortgage backed securities) market, once the largest source of retail real estate financing is temporarily dried up and commercial banks as an industry do not have balance sheet capacity to absorb the shortfall. That has led to a record decline in transaction activity. Indeed, according to New York based Real Capital Analytics, retail real estate transaction volume fell 74% with only \$19.4 billion in transaction activity nationwide in 2008 down from nearly \$80 billion a year earlier.

All of those factors are putting upward pressure on capitalization rates. Indeed, rates rose an average of 60 basis points in 2008 and are lining up for a greater increase of 100 - 200 bps in 2009. Even the best and most desirable projects have now broken the 7.5% mark on their way back to historic norms in the mid 9% range.

Economic feasibility analysis seeks to answer the very fundamental question, *“if this project is constructed, will it be worth an amount equal to or greater than the cost to create it.”* After all, there is no rational economic reason to construct something that will be worth less than it cost to build. Today, the short answer is an almost universal and resounding no. Indeed, recent transaction data are replete with evidence of retail properties selling (or being offered for sale) at prices less than the cost to build them.

Some would argue that construction costs and land costs have declined and that should justify development. While costs have indeed declined, the argument overlooks the reality of total cost of production – the so-called “all in” cost. There is a laundry list of indirect costs in any development not the least of which are the so-called carrying costs or interest and project maintenance during a prolonged absorption period. These costs are as real as bricks and mortar and need to be covered by the project. In times like these both the amount and duration of the costs are unpredictable.

All this begs the question of what needs to happen to restore economic feasibility to retail real estate. The answer is all or some combination of the following. Rents need to increase in the range of 25% to 40%. Capitalization rates need to decline to “compression era” rates in the 5% to 6.5% range. Vacancies must decline. None of these conditions is even remotely likely. Indeed, each indicator argues strongly for the continued absence of economic feasibility.

The short term outlook for retail real estate is poor and is currently being driven by recession characteristics such as a dramatic decline in consumer spending, rising unemployment, declining home equity, declining household wealth and an absence of credit. The Federal Reserve issued its latest Flow of Funds report last week and several elements were especially noteworthy. Household net worth declined \$5.1 Trillion (17.9%) to \$51.5 Trillion from just one year ago. Since peaking in the second quarter of 2007, household wealth is down \$13 Trillion. That will likely grow to \$15 Trillion by the end of the first quarter of 2009 given the rate of decline in both home and stock prices so far this year. The nation’s wealth to income ratio for the household sector is now under 5%, the lowest since 1951. At the same time aggregate home equity has slipped to 43%, a postwar low and down from 58.5% just three years ago. One of the most obvious manifestations of these economic events is the significant and prolonged effect it has on consumer spending and how it negatively flows through to the retail real estate sector.

The longer term outlook for retail real estate. The previously described impairment is arguably the acute phase of the current recession. Many of these circumstances will correct themselves both naturally and perhaps with a boost from the various government economic stimulus programs. Nevertheless, we believe there are characteristics about retailing and retail real estate that are more structural and will have long-term effects on the industry and which will curtail future development.

First, many stores were opened and store concepts created merely to show growth and to feed an artificial boom created by unsustainable growth in residential real estate. Developers *“followed the roof tops”* and not the true economic demand. Many of those roof tops proved to be empty.

There are already clear signs that consumer spending habits are changing as a result of the prolonged recession and diminished credit availability. Savings is up demonstrably and discretionary purchasing is down — circumstances that seem likely to continue.

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