Retail Development – Ready to Turn the Corner?

Source: *CCN Retail Perspectives*

January 2013

As in recent years, those in the retail industry welcomed 2013 with cautious optimism. Calendar year 2012 turned out to be a decent year for retail developers (and retailers) with estimates that retail sales in 2012 rose approximately 5.2% over 2011. While such growth is not as robust as many had hoped, it does represent movement in the right direction, and begs the question: Can we expect to see even more improvement in 2013? Based on recent events in Washington, a slight uptick in job creation, and some positive news regarding the housing market, it appears as if there may be reason to expect better things in retail development this coming year.

One issue that likely will have an effect on the retail industry, as well as consumers in general, is the so called "fiscal cliff", which was at least partially addressed on the first day of 2013. The deal agreed to by the President and Congress made permanent the Bush-era tax cuts for roughly 98% of Americans (those individuals earning $400,000 or less, and families earning $450,000 or less). On its face, such a compromise should stimulate the economy by providing the 98% with disposable income that they would not have had if the Bush-era tax cuts had been eliminated altogether. However, another component of the compromise may work to take some of those dollars away from employees, regardless of their economic status. The expiration of the payroll tax cut, which ends a 2% discount employees received on the funding arm of Social Security, will result in less take home pay for most workers (one prediction is that approximately $125 billion will be taken out of the pockets of American workers). So, while we Americans may have avoided falling off the "fiscal cliff", it is unclear whether the compromise reached in Washington will result in more dollars available to be spent in shopping centers or other retail establishments. It should also be noted that, in reaching a compromise, the President and Congress did not resolve all of the issues that brought us to the "fiscal cliff", not the least of which involves potential spending cuts. Until final resolution of those issues occurs, it remains to be seen if the general public will be more willing to part with hard earned dollars in 2013 than they were in 2012.

A second factor which impacts retail development is the job market. Relatively high unemployment continues to plague the U.S. economy, although there are some optimistic signs. Through October 2012, there had been created approximately 1.6 million new jobs, or roughly 160,000 jobs per month. In November, the unemployment rate in California dropped below 10% for the first time since the beginning of 2009. And, according to the UCLA Anderson Forecast, employment in California is expected to increase an additional 1.3% this year, and, by 2014, the jobless rate is expected to decrease to 8.4% (from a current 9.8%). With more Californians (and Americans) employed, there should be a concomitant increase in consumer spending, much of which will likely find its way to shopping centers.

Another sector of the economy which has a major influence on retail development, and which has been relatively stagnant for the last several years, is housing. It is no great mystery that if new housing developments are built, new shopping centers will follow. And, for the first time since the beginning of the "Great Recession", it appears as if there may be some optimism in the housing market. The resolution of the myriad foreclosures, the influx of institutional investment and the force of the expanding population may all contribute to a housing turnaround in the near future. As with the economic policies in Washington, however, there is no certainty regarding the housing market, and retail developers will be likely to adopt a "wait and see" approach before taking risks on new development.

Those retail developers who are not willing to take the risk on new development will likely remain focused on the "Five Rs": renovation, rehabilitation, repositioning, releasing and refinancing. As has been the case in recent years, shopping center owners with existing product that they want to keep are spending money on renovation and rehabilitation. Such work includes common area and building improvements, in addition to upgrades to accommodate the savvy shopper who requires instant access to his or her mobile device. Other shopping center owners may work to reposition their portfolios by shedding under performing assets, while attempting to acquire Type A properties which boast higher rents and less required maintenance.

The ability to re-lease in existing product remains an important component of shopping center ownership. As in recent years, there continues to be a significant amount of second generation space hitting the market due to the downsizing of "mid-box" or "junior anchor" tenants like Old Navy and Best Buy. In addition, some analysts predict that up to 300 grocery stores in the U.S. will shutter their stores in 2013, resulting in additional space on the market. Such closures will significantly impact owners of neighborhood centers, which are commonly anchored by grocery (and drug) stores. This number does not include closures that may result from the withdrawal of Tesco from the United States market, which plan was announced toward the end of 2012.

To fill vacant space, shopping center owners are looking to those categories of tenants that have survived the past five years and are currently looking to expand. Restaurants continue to gobble up vacant space, led by quick service tenants like Subway and Five Guys Burgers. However, those tenants do not typically lease large amounts of space, which is where discount or dollar stores such as Ross, Dollar General, Family Dollar and Dollar Tree, come into play. Those tenants are often very willing to take on second generation space (with footprints varying from 5,000 square feet to 25,000 square feet), often at attractive rental rates. Indeed, some analysts have predicted that dollar stores alone will account for a minimum of 15 million square feet of occupancy growth across all retail building types in 2013. In addition, there appears to be a resurgence of "Mom and Pop" tenants willing to lease smaller space (less than 3,000 square feet). Such tenants are finding financing more readily available than in recent years. For the same sized space, retail developers are also looking to check cashing operations, shipping stores, spa concepts and hair salons.

Other retail developers are looking to re-lease vacant space to concepts not traditionally associated with shopping centers, such as go-cart tracks, trampoline facilities, day care centers, cooking schools and even swim schools for kids. Of course, the ability to add such non-traditional tenants must be balanced against the rights of other existing tenants that may have the ability to keep certain uses out of a given project. A non-traditional use may allow a retail developer to temporarily re-lease space and get some rent in return, but adding such uses may upset major or anchor tenants at a project, who may decide to aggressively fight the new uses, or to leave the project when their current term expires, rather than renew or exercise available options.

With interest rates holding steady and at historic lows, some shopping center owners are taking the opportunity to re-finance current loans. In reviewing these requests, lenders are looking at the real estate collateral and trying to make sure that vacancy levels hold steady, or are reduced, so that the income stream from rent continues unabated. Therefore, shopping center owners may be required to "re-lease" before they are able to "refinance", thereby obtaining an occupancy rate that will satisfy their lenders and allow them to obtain financing at the attractive rates the market currently offers. It is unclear how long interest rates will stay low, but the Federal Reserve recently announced that it is linking interest rate increases to job growth, and rates are expected to remain unchanged until the unemployment rate in the U.S. drops to about 6.5%.

As has been the case in recent years, retail developers (whether re-leasing existing product or leasing new, ground up development) are forced to acclimate to changes in the marketplace. For example, the Internet continues to have a profound impact on the shopping center industry. Some retailers are experimenting with so-called “click-and-collect” shopping where the customer orders online and then picks up the goods at a store nearby. Other retailers have launched opt-in mobile programs (otherwise known as “geofencing”) where promotions or other messages are sent to consumers when they are in a store, or within range of a store. For example, Best Buy plans on using eBay’s price comparison application, RedLaser, to deliver information to customers regarding in-store specials and other pertinent information. Those retailers who use “geofencing” hope that it will work to offset (at least to some extent) the damage caused by “showrooming”, where customers travel to various retailers to price goods, only to ultimately purchase them from unrelated vendors on the Internet. To accommodate such shifts in the marketplace, retail developers will be forced to provide, or strengthen, certain services (like Wi-Fi signals) in their shopping centers to attract and keep those tenants who are attempting to use the Internet to their advantage.

Retail developers who are looking to expand their portfolios may continue to experience a buyer’s market in 2012, according to some analysts, who view the market as undervalued and ripe for investors. Indeed, in just the first few days of 2013, industry giants such as Simon Property Group, Federal Realty Investment Trust and DDR Corp. all announced major transactions involving existing shopping centers. Not surprisingly, class-A product is the most attractive to buyers, but owners of that type of asset may be reluctant to sell in the current economy. Time will tell whether more shopping centers will change hands during 2013, but if the first few weeks are any indication, there may be more large scale transactions on the horizon than we have seen in recent years.

When it comes to the world of retail development, not a whole lot has changed from the end of 2011, as we move further and further away from the robust years we experienced earlier in the century. However, 2013 brings with it at least some optimism that other aspects of the economy (especially jobs and housing) may be turning around for good. If such a rebound occurs, shopping center owners may be in for a better year in 2013.