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Retail Development - Steady As She Goes

Source: *Retail Perspectives - 2016 Forecast*

1/26/2016

The retail industry welcomed 2016 with cautious optimism, a sentiment that has carried over from the previous two years. After years of relative stagnation commencing in 2008, the general consensus is that retail development continued to progress in 2015. Based on optimism regarding the gross domestic product (GDP), continued growth in the job sector (including increased wages), and the influx of foreign capital, it appears as if there may be reason to expect continued improvement in retail development this coming year.

One facet of the economy which has a major influence on the health of retail development is the GDP. The latest data indicate that the weak growth rates in the GDP of 2009–14 that stagnated around 2% may be a thing of the past, as experts forecast growth in excess of 3.0% in 2016, the first time the growth in GDP will have exceeded 3.0% since 2005.

Moreover, the unemployment rate continues to fall, further infusing cash into the pockets of many households. In fact, October's 5.0% unemployment rate is essentially the same as the traditional definition of "full employment". The economy continues to generate jobs at a rate of 200,000 per month, and, according to the *UCLA Anderson Forecast* of December 2015, the unemployment rate is expected to decline further to 4.6%. This news, coupled with wage gains, indicates that more people will have jobs, and those jobs will, on average, be paying more in the coming year. This should provide a boost to consumer spending, a critical element to retail development.

The availability of financing is another shift in the marketplace that may result in more ground-up development, and redevelopment and restructuring of existing retail assets. Since the financial crisis of 2008, banks have been somewhat wary of making loans secured by real estate projects (and not just retail). However, it appears as if commercial banks and other lending institutions are looking favorably at real estate again. In addition, many experts predict a continued resurgence in commercial mortgage-backed securities, which should result in the availability of more money for retail products. According to data from the Urban Land Institute, issuance of CMBS loans was expected to rise to at least $125 billion (and possibly as high as $135 billion) in 2016, up from less than $100 billion in 2014. The comparatively weak return from Treasuries has also made real estate a more attractive investment option.

Moreover, analysts do not expect much slowing in the influx of money from international investors seeking diversification and solid returns. With the recent instability in China, it is also possible that Chinese investors may view the U.S. market as comparatively stable, thereby directing more capital to the United States. In addition, Congress has proposed some favorable provisions that may allow foreign investors more flexibility to invest in U.S. REITs. Many predict that such an influx in capital will help drive up prices for retail properties.

While there are some positive signs, there remain potential risks to the U.S. economy in general and, by extension, to the retail industry. The Federal Reserve finally bumped up interest rates toward the end of 2015, and further increases are expected. It remains to be seen whether such increases will cause businesses (both developers and retailers) to pull back, or put any proposed expansion on hold. In addition, the impending presidential election, recent volatility in our own stock market and continued uncertainty in the global geopolitical environmental could all have a negative impact on the U.S. economy. However, these issues remain somewhat speculative in nature, and, at the current time, serve more as something for businesses to note, rather than to address imminently.

In terms of what is occurring with different types of retail projects, traditional regional malls continue to churn out solid returns for their owners, despite many predicting their demise only a few years ago. Regional malls have average annual total returns of 14.2%, according to *ULI's Emerging Trends in Real Estate 2016*, and, with limited competition because the prime sites have already been developed, returns may continue to grow. However, like other developers, owners of regional malls have had to adapt to stay relevant. For example, as the public continues the trend toward healthier food selections and different types of cuisine, mall owners have been forced to rethink their food courts through general upgrades in quality and the introduction of more "exciting" and health conscious restaurant concepts.

In fact, food uses have become one of the more attractive retail categories, not only for regional malls owners, but for developers of other types of retail product as well. Food culture is a growing trend, especially among millennials, who carry with them about $2.5 trillion in purchasing power. Partly because the experience is not replaceable by the Internet, millennials will likely continue to visit retail developments to eat, socialize and share their experiences via pictures and tweets over social media. Therefore, it behooves retail developers to create food courts and "restaurant rows" that are as attractive and inviting as possible.

Grocery-anchored neighborhood centers generally continue to provide a good return for their owners. One of the larger growth sectors in retail is specialty grocers, such as Whole Foods, Trader Joe's and Sprouts, as well as discount grocers, like Walmart Neighborhood Market, all of which operate on a smaller footprint than "traditional" grocery stores. And, although the failure of Haggen's expansion efforts into the West has created some heartburn for developers who have Haggen stores as part of their portfolios, owners of neighborhood centers continue to be able to attract retailers eager to feed off of the foot traffic generated by a tenant mix that typically includes a grocery store and drug store.

Other retail developers are being more proactive evaluating existing space by negotiating early lease terminations. These developers are seeking to strategically take back certain spaces prior to the natural expiration of the applicable leases in order to remerchandise those locations with better tenants and higher rents. Some “mid-box” or “junior anchor” tenants like Staples and Old Navy, who are looking to downsize their footprints, may be willing to give space back early to their landlords, who can look to aggregate enough square footage to attract certain “hot” retailers in an effort to revitalize their shopping centers.

In addition, as the demographic mix in the United States continues to evolve, developers are being forced to adapt their tenant mix. For example, with one-sixth of the U.S. population self-identifying as Latino, Hispanic-themed centers are popping up, with grocery stores and other amenities targeted to that ethnic group. Likewise, as Asian immigration into the U.S. continues, where appropriate, developers will need to provide shopping opportunities that meet the needs of the Asian community.

Of the types of tenants that retail developers may target, analysts predict that the “wellness” categories will continue to perform well in 2016. Retailers like Dick’s Sporting Goods that focus on athletics should continue to see their market share grow. In addition, companies like Nike and Under Armour are in a “store opening” mode as they look to get their products to the consumers more directly. Other “wellness” concepts that concentrate on health and fitness, such as gyms, yoga studios, exercise venues like Flywheel and SoulCycle, and even the vitamin category, should continue to see growth opportunities with willing developers.

As in the recent past, retail developers will continue to deal with the challenges brought about by the Internet and e-commerce. Developers are being forced to work more closely with their tenants to ensure that the space provided is not only physically desirable, but also accessible to mobile devices by improving in-store Wi-Fi capability. However, developers are starting to see somewhat of a paradigm shift as some traditional online retailers (like Amazon and Zappos) have begun leasing brick-and-mortar space for the first time. In addition, some traditional shopping center retailers plan on fostering a more cooperative relationship with online retailers by providing backroom space for products to be stored so that customers can pick up their products the same day that they are ordered. Such retailers will benefit by allowing customers access to sizes and styles in the “cloud” that are not available in the physical store, but can be delivered from off-site warehouses.

When it comes to the world of retail development, the undercurrent of optimism from 2015 continues to swell. While the heartbeat of ground-up shopping center development may still only be faint, a solid uptick in the GDP, continued growth in the job sector, and the potential for an influx of capital, both from overseas and from here in the U.S., bode well for a solid year for retail developers in 2016.