Retail Development - Riding the Tail Winds

Source: *Retail Perspectives - 2018 Forecast*

1/22/2018

As calendar year 2017 approached, many in the retail development industry felt a sense of tempered optimism, and those feelings appear to have borne out. Statistically, calendar year 2017 turned out to be a good year for retail developers (and retailers), with estimates that core retail sales in 2017 rose approximately 3.8% over sales in 2016. Although 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 2018? Based on positive news regarding the gross domestic product, continued growth in the job sector and the influx of foreign investment dollars, it appears that there may be reason to expect that retail development will continue with another steady uptick this coming year.

One facet of the economy that has a major influence on the health of retail development is the gross domestic product (GDP). The latest data indicate that the weak growth rates in the GDP of 2009-16 (which stagnated around 2% annual growth) may be a thing of the past as experts forecast growth of 3% in 2018. In addition, according to *Bloomberg Markets*, the Fed's preferred price index, which is tied to personal spending, rose at a 1.3% annualized rate in the third quarter of 2017, following a 0.9% gain in the second quarter. In addition, in-store sales gains were expected to approach 4% for 2017, and 2017 retail sales (excluding gasoline) were expected to be up roughly 4.2%.

Although housing starts continue to be lower than hoped by homebuilders, the unemployment rate continues to fall, infusing cash into the pockets of many households. According to the Bureau of Labor Statistics, non-farm payrolls expanded by 148,000 positions in November, and the unemployment rate remained unchanged at 4.1%. This news, coupled with wage gains (including increases in minimum wages), 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 driving influence for retail development.

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. Many predict that such an influx in capital will help drive up prices for retail properties.

In addition to these positive signs, one issue that will likely affect the retail industry, as well as consumers in general, is the short-term uncertainty surrounding the recently passed "Tax Cuts and Jobs Act" (the "Act"). While the Act may end up infusing many Americans with additional disposable income in the short term, it remains to be seen how other facets of the Act will impact consumers. Since consumers drive the retail industry, any lack of confidence in the ultimate benefit of the Act may result in a reluctance of consumers to part with hard-earned dollars. In addition, as the economy accelerates, the Federal Reserve may initiate a period of higher interest rates; indeed, some analysts have predicted as many as three interest rate hikes in 2018. Such increases could cause businesses (both developers and retailers) to pull back, or at least put expansion on hold, until they can better grasp the changing economic environment.

In terms of what is occurring with different types of retail projects, reports of the demise of the traditional regional mall appear to have been at least slightly exaggerated, although the strongest performing regional malls still tend to be located in more affluent trade areas. And owners of regional malls have had to adapt to stay relevant. For example, as the mores of the public continue to change, retail developers are beginning to realize that "Experiential Retail" is becoming a critical component of a viable shopping center. Such a concept places an emphasis on food, fun and fitness in an effort to not only attract customers in the first place, but also to get them to increase "dwell time", or the period they stay at the retail project -- with the hope that those customers will spend more money. Experiential Retail is seen as a sector that competes effectively with e-commerce, since transactions are more social than a mere exchange of cash for goods.

Grocery-anchored neighborhood centers generally continue to provide a good return for their owners. As in 2016, one of the larger growth sectors in retail is specialty grocers, such as Whole Foods, Trader Joe's and Sprouts; another is discount grocers like Walmart Neighborhood Market. Although there remains uncertainty over the consolidation between large-scale grocers and the effect of the acquisition of Whole Foods by Amazon, 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 a drug store.

Other retail developers are being more proactive in dealing with 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 with better tenants and higher rents. Some "mid-box" or "junior anchor" tenants like PetSmart and Staples, who are looking to downsize their footprints, may be willing to give space back early, allowing landlords to aggregate enough square footage to attract certain "hot" retailers in an effort to revitalize their shopping centers. For example, so called "fast-fashion" tenants like Forever 21, H&M and Uniqlo are actively growing and scooping up second generation space. Likewise, discount and dollar stores such as Dollar General, Family Dollar, Dollar Tree and Five Below are also in the market for residual space, often in the 5,000- to 10,000-square-foot range. For example, Dollar General, alone, recently announced plans to open 900 new stores in 2018.

Meanwhile, many retail developers have had to deal with the closures of department stores, such as Macy's and JC Penney. The deconstruction of the department stores, or "right-sizing", is seen by some as the natural progression of retail; those department stores that have elected to stay open have generally reduced product offerings to three primary product categories – apparel, housewares and cosmetics/fragrances. To combat closures, "specialty leasing" is on the rise, with retail developers looking to re-lease large vacant space to concepts not traditionally associated with shopping centers, such as go-cart tracks, trampoline facilities, escape rooms, laser tag venues, day care centers, painting studios and cooking schools, all in the category of Experiential Retail. 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.

Other retail developers continue to use "pop-up" stores to fill vacant space. Such stores are very different from the more traditional "temporary" tenants, who offer Halloween costumes and Christmas ornaments in the latter months of the year. Pop-ups sell merchandise like local art and celebrity-backed goods and can have terms ranging from a few days to a year. For retail developers, the goal of the pop-ups is to generate traffic and buzz by making under-the-radar brands available to the customer and, sometimes, bringing in start-ups linked to celebrities. And such stores allow developers to have flexibility to create change in tenant mix that is not afforded by spaces that are leased to tenants for five or 10 years. As an example, Westfield recently launched a 1,200-square foot space at Westfield Century City dedicated to unique short-term concepts, the initial concept being a month-long launderette that, in conjunction with Hermes, offered laundry services for customers with Hermes-branded clothing.

Not surprisingly, in the coming year, retail developers will continue to face the challenges brought about by the meshing of e-commerce and brick-and-mortar retail. 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, which is almost a necessity in the current climate. For example, better internet access allows customers to do research on line more easily, while already in a store, which increases the likelihood that a purchase will be made from that store. It also allows customers to take advantage of "click-and-collect" options, where the customer makes a purchase using a computer or mobile device, and then picks up the product from the physical, brick-and-mortar store. An added benefit to retailers was recently highlighted by an ICSC report which found that 90% of the holiday shoppers who entered a store to pick up an item purchased remotely ended up buying additional items while in the store.

Some regional mall owners are also using new technologies and media to better communicate with shoppers. For example, new interactive digital directories are being rolled out to provide shoppers with, among other things, information regarding the fastest routes to certain shops and services which can be sent to the shoppers' mobile devices. The directories also provide "real time" information on special offers from retailers and restaurants. Another change is the introduction of new or additional parking stalls for electric vehicles. Since research has shown that customers with electric vehicles tend to spend about 50% more time at the mall than those with traditional gas-powered cars, it may behoove the owner of a regional mall to provide additional electric parking stalls to try to keep customers at the mall as long as possible.

So while e-commerce has definitely changed the landscape of the retail industry, it has not eliminated the need for brick-and-mortar stores as some had predicted a decade ago. Retailers and retail developers have had to adapt to address changes in technology and customer needs. However, according to ULI's *Emerging Trends in Real Estate*, "Despite all the complex changes occurring in retail and retail real estate, it is hard to imagine a world in which brick-and-mortar stores will play anything other than a dominant role in the distribution of a vast majority of retail goods and services." This is a sentiment that appears to be shared by many in the retail industry.

When it comes to the world of retail development, the undercurrent of optimism from the beginning of 2017 continues to grow. While the needle on ground-up shopping center development may still not be moving, a solid uptick in the GDP, continued growth in the job sector and the influx of foreign investment bode well for continued improvement for retail developers in 2018.