2018 Research Newsletter

Retail Pricing Dislocation: Investors Must Choose Wisely

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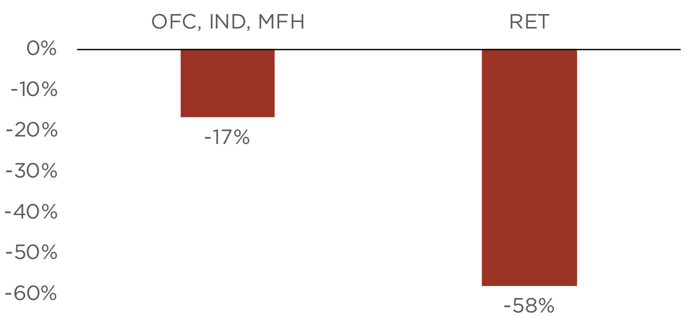
Intro

For much of the current real estate cycle, and especially over the past few years, news surrounding retailers has been consistently bearish. Nearly 7,800 store closings in 2017 including struggling former juggernauts Macy's, J.C. Penney, and Sears make for dramatic and attention getting headlines. This has spilled over into the stock market, where shares of some publicly traded retailers have been hit hard while publicly traded retail REIT's have also been caught up in the general angst surrounding the sector. For example, a recent acquisition offer from Brookfield Property Partners for U.S. mall owner General Growth Properties was priced well below what some market analysts considered fair value.

As a result, investor appetite for retail properties has significantly contracted. While the Q1 rolling four-quarter collective sales volumes for office, industrial and multi-family housing properties is 17% below the prior cycle's peak, retail remains 58% off its prior cycle peak.

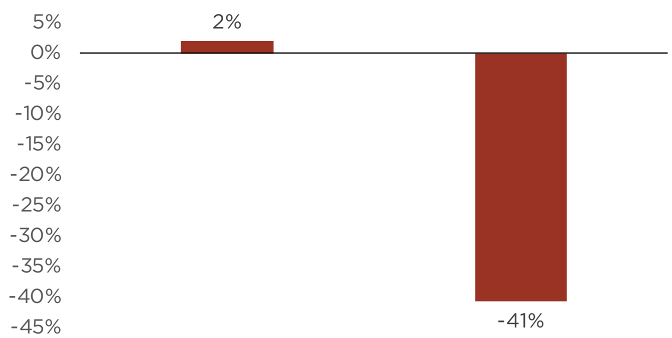
> 1Q18 vs Prior Cycle Peak



Source: Real Capital Analytics

In just the last year alone, retail property sales declined 41% on a year-over-year basis as compared to a 2% increase for the combined office, industrial, and multi-family housing sectors. In today's investment environment often characterized by crowded bid tents, this creates a rare opportunity for the savvy investor experienced in retail analysis and evaluation.

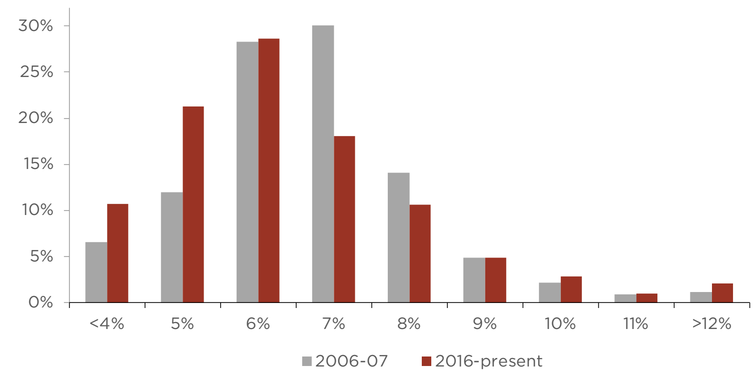
> 1Q18 vs 1Q17



Source: Real Capital Analytics

While total retail sales volume has declined, this masks a significant shift in composition of retail that is being acquired as investors selectively capitalize on the opportunity created. Investors have materially increased their preference for higher quality, lower cap rate, retail assets relative to the prior cycle as investors increasingly become aware of the bifurcation in retail performance that we outline in our 2018 property sector outlook and which has guided our acquisition strategy in recent years.

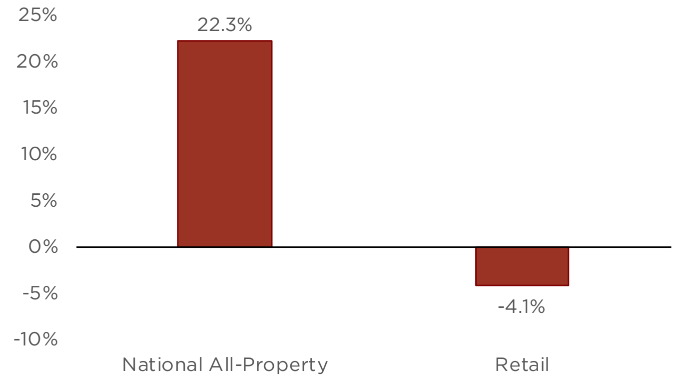
> Transaction Share by Cap Rate



Source: Neustar; BLS; CoStar

Reduced investor appetite for retail real estate has translated into weaker pricing creating select opportunities. While the Real Capital Analytics National All-Property type pricing index is more than 22% above the prior cycle peak, retail pricing remains more than 4% below its prior peak. Related to this, retail cap rates have increased nearly 50 basis points in the last 12 months alone. Do these pricing adjustments create an opportunity or merely opportunity to be left holding the bag?

> Current Pricing vs Prior Cycle Peak



Source: Real Capital Analytics

While it is a fact that ecommerce is challenging traditional brick and mortar retailers, extrapolating this into an apocalyptic view of the entire retail real estate sector is painting with too broad a brush obscuring a more nuanced picture of the sector and its investment opportunities. Rather, capitalizing on investor fear and pricing dislocation begins with examining three key elements of a potential retail acquisition: tenants, trade area, and strategic positioning within a trade area.

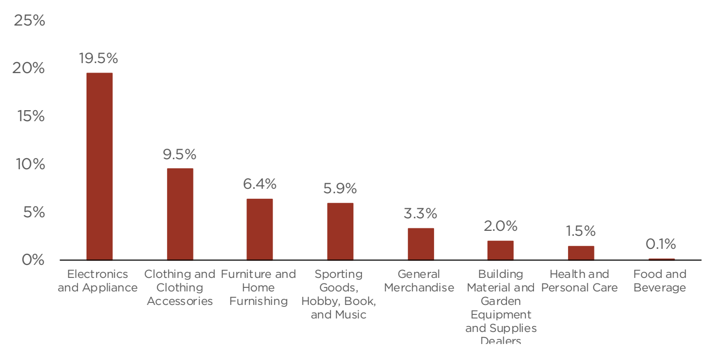
I. Tenants

Retailer struggles are often attributed to a single cause: rising ecommerce sales. While this is certainly not helping most brick and mortar retailers, it is a combination of factors that typically force retailers into closing stores – these include debt levels and increasingly value-conscious consumers collectively creating wide variation in retailer performance. Because of this, simply classifying potential acquisition opportunities into center formats such as neighborhood, power etc. is no longer sufficient, especially when one considers that center formats are converging as retailers are increasingly appearing in multiple center types. Grocery stores are now occupying centers with traditional power center tenants – so what type of center is that? Instead, an understanding of the common drivers of individual retailer success and failure is necessary.

Not Adapting to Changing Consumer Buying Patterns

Consumers buying goods online that they otherwise would have purchased at brick and mortar locations is sapping sales from traditional retailers. However, the impact varies widely by category with building material; health and personal care; and food/beverage retailers least impacted.

> E-Commerce Share of Total Retail Sales



Source: ARA Research; CoStar

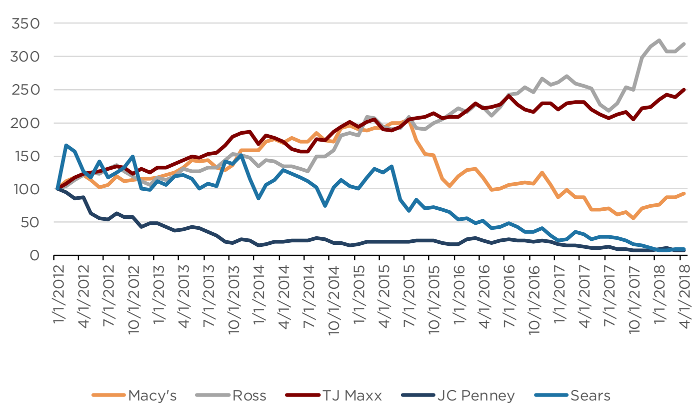
The most impacted categories not surprisingly are those filling the department stores struggling to adapt to changing consumer shopping behavior. Even within the sectors most impacted by ecommerce, there has been wide variation in retailer performance. In the electronics segment, Best Buy has figured out not only how to adapt to and compete in a world with Amazon, but also how to leverage the strengths of Amazon. Best Buy and Amazon recently announced a partnership whereby Best Buy will sell some of its televisions on Amazon expanding its customer base. Best Buy's current stock price is 63% higher than its 2007 levels, driven by a 3.5x increase in its dividend. Conversely, the regional electronics retailer H.H. Gregg filed for bankruptcy protection in 2017 succumbing to e-commerce pressures and more successful competitors like Best Buy. In the book segment, Borders Bookstores was the new kid on the block, snapping up locations in new retail centers. However, Borders didn't adapt fast enough to online sales and electronic readers and soon fell victim to new buying trends. Lumping all retailers together creates an illusion of only market carnage when in reality there are retailers decoding how to survive even in segments with significant e-commerce sales penetration.

Increasingly Value Conscious Consumers

While it is a sensitive political subject, the reality is that income inequality is an issue impacting the economy and retail in particular. As the price of education, healthcare, and shelter have outstripped household income growth, consumers looking for ways to make-up the difference are seeking out retailers offering the greatest value. This doesn't mean only the cheapest price but rather the greatest mix of what they value at the best price. Off-price retailers such as TJ Maxx, Ross and Marshalls capitalized most on this trend while department stores were slow to adapt to this reality. Department stores introduced private label goods at discounts to name brand goods while off-price retailers offered the same name brand goods found at department stores at significant discounts. In 2017 the CFO of Macy's called these off-price retailers "the bigger competitive threat for us over time."

How successful have off-price retailers been in comparison to department stores? Store activity and stock prices tell the whole story. While the shares of Ross and TJ Maxx are up 3.18x and 2.49x since 2012, shares of Macy's, Sears and JC Penneys are below their 2012 values. Not surprisingly, JCPenney, Sears and Macy's store closings seem to dominate headlines while Ross and TJ Maxx continue to open stores.

> Stock Performance for Select Retailers



Source: Yahoo Finance

Debt Burdens Exacerbate Retailer Challenges

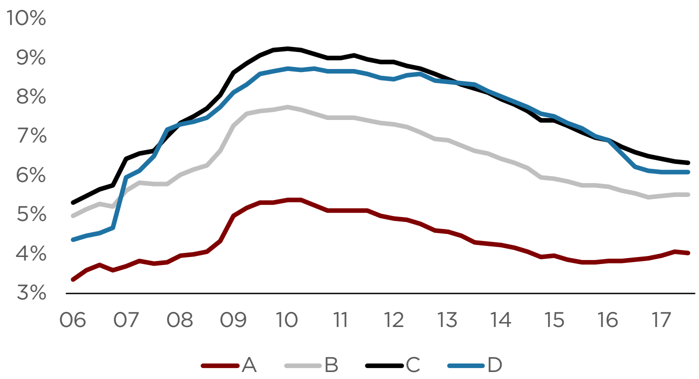
Being in a low margin business while also facing pressure from both online sales and better positioned competitors is not a good recipe for success. Add to this excessive debt burdens that exacerbate the challenges inherent in retail today and some retailers are pushed over the edge. In the case of Toys R Us increasing competition from online retailers as well as mass merchandisers like Walmart, $5.2 billion in debt and $400 million in annual debt payments became unbearable, forcing the company to seek bankruptcy. Leverage can be a key factor in determining which retailers adapt or go bust.

II. Trade Area

When analyzing a trade area, variables such as household income levels, household income growth, population, and population growth are key factors in determining a trade area's buying power. Population yields shoppers filling their bags with goods while their income levels determine how much they can afford to stuff into those bags.

Generally, trade areas with more retail offerings will capture a larger share of the trade area's potential buying power as it offers more reasons for shoppers to do most of their shopping within the trade area as opposed to frequenting surrounding retail nodes to fill their needs. We know empirically that centers located within trade areas having higher potential buying power and offering a greater concentration of retail offerings will generally have lower vacancy rates than centers in trade areas with lesser buying power and lesser concentrations of retail within the trade area relative to surrounding trade areas. Segmenting centers into different classes based on a combination of trade area buying power potential and estimated capture of the buying power creates a clear picture of center haves and have nots. While retail overall may be challenged, this masks significant variation not only in tenant performance as we saw but also center vacancy performance.

> **Vacancy by Location Quality**



Source: CoStar

II. Location, Location, Location

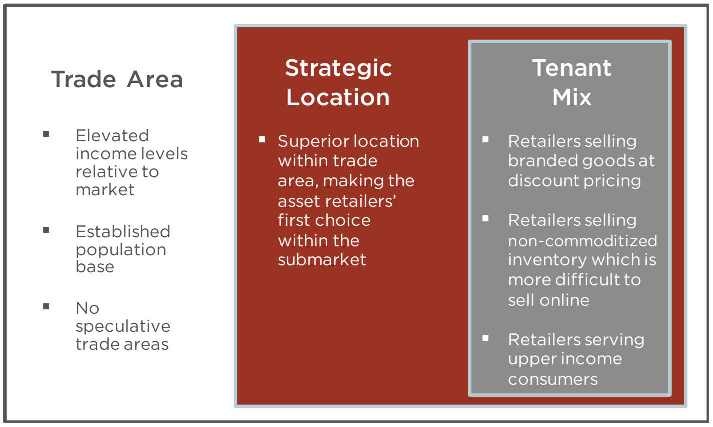
While a high income/high density trade area is a strong tailwind, an asset's strategic position within the trade area will have a material impact on its ability to capitalize on buying power. We all know the center in our local trade area where we shop that is always packed. Conversely, we also know the center which is where you go when you want to find plenty of front row parking.

How important is the strategic position of a center within a trade area? It can be the difference between achieving higher rents and occupancy or not. Retailers will come and go - Montgomery Wards used to be the king of the department store retail jungle, followed by Sears – soon supplanted by Walmart and the other big box retailers. More recently we saw the exit of multiple retailers in the electronics and book segments. The key is identifying and owning "the" center in each trade area, the center that other retailers will "trade up" to when a spot becomes available. These centers are the equivalent of first class on an airplane -- everyone wants to upgrade their location and, much like frequent flyers get first shot at first class upgrades, the strongest retailers flock to these first-class locations creating a self-reinforcing cycle of center haves and have nots.

What makes these centers so desirable? There is a retail epicenter within most trade areas determined by a variety of factors including proximity to the largest shopping center in the retail node or proximity to the center with the biggest traffic generating retailers. It can be determined by physical barriers and sometimes the epicenter is as simple as being in the center of the retail node. Even when there is no epicenter, there is typically a span of retail within which a retailer wants to be located, usually bounded by large draws at either end of the trade area. Whether a center is on the "going home" side of the road also contributes to strategic positioning as does proximity to the trade area's primary demand drivers, whether it be surrounding residential neighborhoods and/or commercial buildings. Purely physical attributes such as visibility to the primary arterial or the center's ingress and egress can contribute to the strategic position within a trade area. A center's superior strategic position within the trade area can be as important as its tenant mix.

Capitalizing on Today's Retail Pricing Adjustments

While quick and easy conclusions about the death of brick and mortar retail may be tempting, it masks a reality that is more complex as well as the opportunities within the sector. Retail is the most nuanced, complex, and dynamic of the primary property sectors due to the elevated importance of locational aspects and tenant mix. Achieving an accurate perception of the retail industry and retail property sector is a complex endeavor requiring depth of analysis and insight. Capitalizing on today's opportunities requires a skillful approach focusing first on three key pillars: Understanding the strength of a trade area, the strategic position of a center within the trade area, and tenant mix including the factors impacting retailer success and failure. These three pillars can provide a good foundation for evaluating potential center acquisitions and differentiating between the assets on sale for a good reason and the assets on sale because they have been caught up in the broader shift in investor sentiment toward all retail.



Source: American Realty Advisors

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