Breaking Out of the Deep Freeze

The U.S. economy is slowly emerging from its funk. Next year, retail real estate should begin its healing process as well.

By Elaine Misonzhnik
Illustration by Andrew Degraff

After suffering through a moribund 2009 when investment sales, lending and leasing were largely frozen, the retail real estate industry is showing signs that the long-awaited rebound may be starting.

In September, U.S. same-store sales eked out a 0.1 percent gain—the first increase in more than a year. Growth in October, at 2.2 percent, proved even more robust. Meanwhile, the volume of retail investment sales transactions increased 36 percent in the third quarter compared to the second quarter, to $2.1 billion. And the volume of retail properties in distress in October remained flat with the month prior, at $34.5 billion, according to Real Capital Analytics, a New York City–based research firm.

It's not that things are good or that a robust recovery is underway, but the situation appears to be less bad than it was for most of 2009. There are the faintest glimmers of hope. And while 2010 promises to be another tough year, many industry pros think it will mark the beginning of a slow turnaround.

The industry will get the first indicator of things to come if there is continued positive same-store sales growth during the 2009 holiday shopping season. A solid holiday sales season could put the brakes on store closures and retailer bankruptcies. That, in turn, could help stop the descent in occupancies and rents and allow property values to stop falling. It remains likely that the pace of openings will be slow and even if vacancy rates at malls and shopping centers stabilizes, they will likely remain at or near record highs for several quarters. Once the bottom has become clear, however, it may trigger the long awaited run of investment in distressed properties, which many believe will provide the foundation for the industry's recovery.

Unfortunately, a rebound in retail real estate is not entirely under the industry's control. What happens in the broader economy will dictate the strength and speed of the recovery. On the plus side, the economy does appear to be growing again. In the third quarter, U.S. GDP grew by an annualized rate of 3.5 percent, according to preliminary estimates from the Bureau of Economic Analysis, ending a string of four straight quarterly declines. And, according to the International Monetary Fund's *World Economic Outlook*, published in October, real GDP will grow by 1.3 percent in 2010.

"The economy is in recovery and it looks like we are officially out of recession, but it doesn't really [feel] like it," says David J. Lynn, managing director with ING Clarion Partners, a real estate investment management firm.

"There is not a lot of good organic growth and unemployment is still going up."

What worries Lynn about the broader economy—and should be doubly troubling for retail real estate—is the unemployment rate, which many economists predict will continue to rise well into 2010. The unemployment rate recently topped 10 percent for the first time since the early 1980s and the bleakest projections are that it could keep going past 11 percent or 12 percent. And that's just the official figure. By an alternate measure of unemployment, counting jobless, discouraged workers and part-time workers that want to work full-time, the unemployment rate is above 17 percent.

The past two economic recoveries have been marked by prolonged periods where the economy continued to hemorrhage jobs long after the recovery set in. Many economists think this could be worse. If the last cycle was the "jobless recovery," this one may turn out to be the "job-loss recovery." Add to that rising energy prices and the constricted supply of consumer credit, and the retail sector still faces daunting obstacles. The problem, then, is that growth in the economy would not be marked by a strong resurgence in consumer spending, dimming the prospects for retail real estate to rebound quickly.

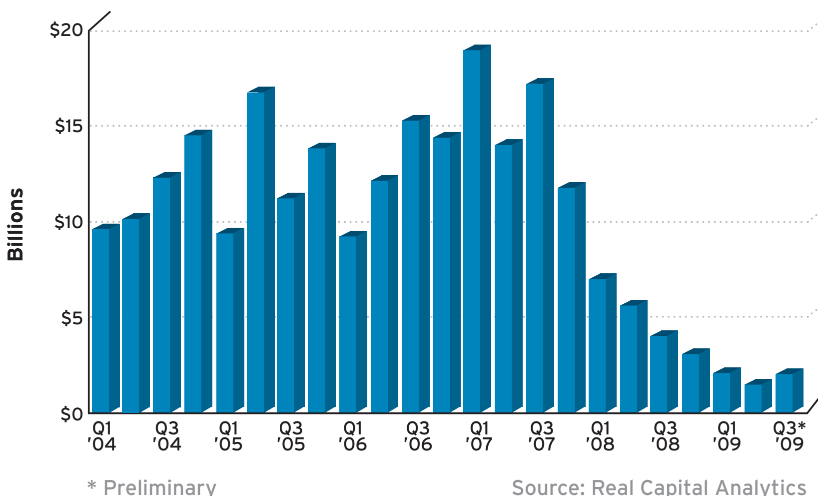
"We might be over-retailed as a country and that's okay when you have a zero percent savings rate and when even your pets get credit card offers. But that's changed," says Lynn. "There is less wealth to spend, there is less credit and more concern about the future."

Retailer outlook

In October, the Consumer Spending Index tracked by global consulting firm Deloitte rose for the fifth consecutive month. On the same-store sales front, ICSC projects the November/December period should post a small gain of about 1 percent. If that comes to pass, the stronger retailers might stop coughing up cash, leading to less pressure to close underperforming stores and fewer rent concession requests, says Sam Latone, co-CEO of the Shopping Center Group, an Atlanta–based retail real estate brokerage firm.

At the same time, if the holiday shopping season doesn't go well, there might be between 6,000 and 8,000 store closings in the first half of next year, according to Al Williams, principal with Excess Space Retail Services Inc., a Huntington Beach, Calif.–based real estate disposition and lease restructuring firm. However, the predictions were also dire coming into 2009, but that did not come to pass. Many space disposition specialists have been surprised that in 2009 store closings have stayed comparatively low. (See related story on p. 10.)

RETAIL INVESTMENT SALES VOLUME



* Preliminary

Source: Real Capital Analytics

Drastic cost-cutting measures and conservative merchandise orders helped many struggling retailers stay afloat. But Andy Graiser, co-president of DJM Realty LLC, a Melville, N.Y.–based real estate consulting firm, thinks retailers ultimately will need to do more. Cost cutting can be a temporary salve. In 2010, retailers will need to show an improvement in sales at to survive long-term. That's why many predict that the closings that didn't happen in 2009 could happen in 2010.

Indeed, the *Emerging Trends in Real Estate 2010* report produced by the Urban Land Institute and

PricewaterhouseCoopers predicts weaker retail players will continue to be weeded out. At the beginning of the recession, every retail category in the U.S. featured five to six national chains, making the field too crowded, according to Latone. With consumers' new focus on "needs, not wants," only the top two or three performers in each sector are likely to come out of this downturn, he says. What's more, we might see additional bankruptcies in the big-box sector, after the market has already absorbed the shock of the liquidations of Circuit City and Linens 'n Things.

On the upswing?

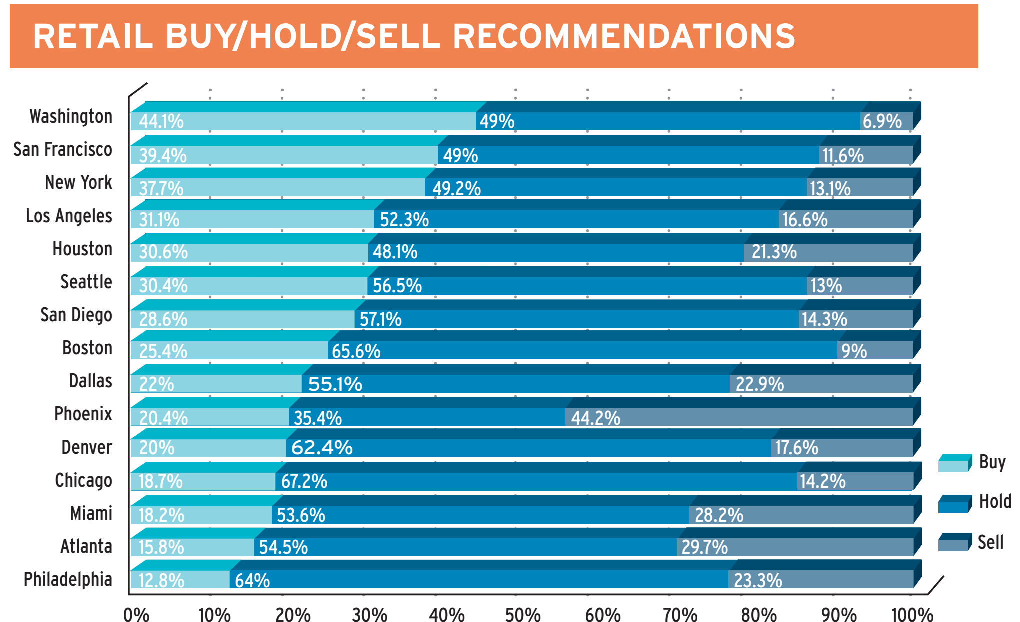
All the bankruptcies, liquidations and store closings that occurred in 2009 helped drive the vacancy rate for shopping centers to a 17-year high of 10.3 percent at the end of the third quarter, according to Reis Inc., a New York City–based research firm. The vacancy rate for regional malls reached a 10-year high of 8.6 percent. The rates jumped as the year dragged on. The vacancy rate for shopping centers hit a low point of 6.7 percent in the second quarter of 2005. From there it took 11 quarters to rise a full percentage point to 7.7 percent. In contrast, the rate jumped 2.6 percent points in the eight quarters since.

If anecdotes hold true, however, that period of rapidly rising rates may already be over. Owners and brokers are reporting that demand for new retail space has increased in the past few months as healthy chains begin to take advantage of favorable market conditions. In the big-box space, for example, which has suffered a disproportionately high number of liquidations during this recession, tenants willing to sign new leases are essentially dictating their terms, says Graiser.

The recovering leasing market was also a theme during third-quarter earnings season for shopping center REITs. For example, 66 percent, or 460,000 square feet, of new leasing deals completed by New Hyde Park, N.Y.-based Kimco Realty Corp. in the third quarter were in the big-box junior anchor category, according to COO David Lukes.

Still, things are far from normal. For example, a number of smaller, regional retailers might be crippled by the reorganization of lending giant CIT Group Inc. The bankrupt firm served as the primary source of factoring capital for these firms, which is used to pre-order merchandise. If, as a result of the reorganization, CIT drastically cuts back on its factoring business, many of these chains might have to close stores.

Taking all this into account, next year,



Source: *Emerging Trends in Real Estate 2010*

absorption of retail space will likely remain negative, dropping by 6.5 million square feet according to Reis. Though that would be a vast improvement over the 26.8-million-square-foot decline in absorption in 2009. The overall national vacancy rate might reach 11.7 percent. Non-mall retail vacancy might pass the 12.7 percent mark, predicts research from ING Clarion. Retail rents, which fell 3.8 percent this year in official estimates (and likely more if all the unofficial rent breaks are factored in), are projected to fall another 2.5 percent.

Self-inflicted wounds

Perhaps the biggest issue facing the commercial real estate industry remains the mountain of near-term debt maturities, including $320 billion in loans coming due in 2010, according to ING Clarion. The bigger institutional players, including publicly-traded REITs, have gotten a jump on competitors due to their ability to tap public markets for capital. But privately-held small and mid-size property owners still find securing refinancing extremely difficult. The commercial mortgage-backed securities (CMBS) market remains dormant.

Traditional lenders, including life insurance companies, private equity funds and mortgage REITs, are limiting lending to the best quality assets belonging to the most credit-worthy clients.

CAP RATE EXPECTATIONS

	Cap Rate Aug-09	Expected Cap Rate Dec-10	Expected Cap Rate Shift (basis points)
Full-Service Hotels	9.59%	10.08%	49
Limited-Service Hotels	9.71	10.15	45
Power Centers	8.66	9.11	45
Regional Malls	8.25	8.70	45
Suburban Office	8.85	9.28	44
Neighborhood/Community Shopping Centers	8.32	8.72	39
Apartments: High-Income	7.54	7.91	36
Central City Office	8.03	8.39	36
R&D Industrial	8.70	9.03	33
Apartments: Moderate Income	7.64	7.90	26
Warehouse Industrial	8.30	8.54	24

Source: Emerging Trends in Real Estate 2010

A collapse in property values forms the backdrop to the troubles in the debt markets. Retail property values have already fallen by more than 40 percent since the peak of the market in 2007 according to several commercial real estate price indexes. The *Emerging Trends* report predicts that commercial property values will be down 50 percent from the market's peak when the bottom finally hits.

In the absence of strong leasing demand, values might continue to fall. That will likely push more owners into default if they can't come up with additional equity to put into their centers or secure extensions from lenders.

The distress has started to spread, encompassing commercial real estate assets worth $132 billion—a 122 percent increase in distressed situations from the beginning of 2009, according to ING Clarion. That includes 1,486 properties, valued at $32 billion, in the retail sector. So far, however, lenders have been avoiding dealing with the bad loans because they fear the losses they would have to recognize will wipe out whatever capital they've managed to squirrel away in the last year.

But as the volume of distress grows in 2010, banks might be forced to start working through their commercial portfolios, according to Robert Bach, senior vice president and chief economist with Grubb & Ellis, a global commercial real estate services firm. That will include putting distressed assets up for sale. Meanwhile, the banks with healthier balance sheets might opt to take write-downs on the better assets if they think their values will increase at some point in the future and begin to dispose of less than stellar properties, according to the *Emerging Trends* report. (See p.30 for more on the financial outlook for retail real estate.)

The situation will likely create a substantial amount of pain for both real estate owners and lenders, but might also bring an end to the stalemate in the investment sales market. For most of this year, cash-rich buyers have stayed on the sidelines for fear of making acquisitions before prices bottom out. Once sales transactions start happening in any

meaningful fashion, it ought to be easier for sellers and buyers to agree on what fair prices are. Year-to-date, investment sales in the retail sector have totaled $7.7 billion, down 66 percent compared to the same period in 2008 and down 91 percent compared to the same period in 2007, according to Real Capital Analytics. In 2008, investment in retail properties totaled $19.8 billion. By contrast, at the peak of the market in 2007, the retail sector saw $60 billion in sales.

Sales transactions will likely accelerate starting in the third quarter of next year. Recovery, however, won't come all at once and it's not likely that in 2010 the avalanche of sales activity brokers had been hoping for will materialize, in Bach's view. At best, investment sales in the retail sector might increase by 20 percent compared to the abysmally low levels of 2009. The recovery process likely will stretch through 2011 and 2012.

Opportunity ahead

By the time the third quarter of 2010 comes around, the sheer volume of distress in the commercial real estate sector might force lenders to start dealing with the bad loans. So far, many banks have taken the "pretend and extend" approach to defaulting mortgages, which has helped keep the market in a state of suspended animation. In September, for example, sales of retail properties in distressed situations accounted for only 15 percent of the overall sales transaction volume, according to Real Capital. Because banks refuse to put distressed assets up for sale in the fear of incurring unmanageable losses, investors interested in purchasing real estate properties on the cheap can't start making acquisitions—they are afraid to over-value the properties.

"We are in the initial rebound phase right now and the workout phase will be in the middle part of 2010," says Lynn. "That's when you will have sellers that will finally have to sell because there is distress at the property level and they are under water, and the banks have to realize that loss and sell the property." ING Clarion estimates that in 2010, retail properties will offer total returns of approximately 3.3 percent. In 2009, total returns on retail properties declined by 11.9 percent.

Most of the prospective buyers for commercial real estate properties (and real estate debt) will likely come in the form of publicly-traded REITs, private opportunity funds and foreign investors. In the absence of readily available debt capital, whoever has cash will benefit during this market cycle.

"Values have adjusted back to [historical levels] and interest rates are still very attractive," says Anthony M. Villasenor, senior vice president of the retail division with Voit Real Estate Services, a San Diego, Calif.-based real estate services firm. "So there's never been a better time, in our opinion, to buy commercial real estate."

In many markets, cap rates on retail properties have already moved by 200 basis points to 300 basis points from the levels seen in 2007. They should continue to rise through 2010. (See chart on p. 26.)

But while 2010 might mark a turning point in the investment sales market, industry insiders predict the increase in activity will be moderate, ranging anywhere from 25 percent to 40 percent compared to what we have seen so far this year. It might take up to three years for the industry to clean up the aftermath of this down cycle.

As Bach puts it, "Commercial real estate will have to take its lumps." RT

RETAIL FUNDAMENTALS PROJECTION