

Reinventing Retail Commercial Investment Real Estate

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Developers, Owners, and Managers Are Shopping for New Ways to Keep This Property Segment Vibrant.

Across the country, the retail market is thriving as merchants ring up sales at a record-setting pace. Retail sales rose by about 7 percent last year to reach almost \$3 trillion, according to the U.S. Census Bureau. As a result, retail properties are experiencing low vacancy rates and high lease rates.

The national retail vacancy rate last year was 8 percent, down slightly from 1998, according to Marcus & Millichap Research Services. Several U.S. cities had vacancy rates well below the national average, including Seattle (3.2 percent), San Francisco (3.8 percent), Portland, Ore. (4.1 percent), and Boston (4.5 percent). Some cities are struggling with higher retail vacancy rates, including Fort Worth, Texas (17.5 percent), Houston (16.4 percent), and Greenville, S.C. (15.2 percent).

A continuous supply of new product is being added to the market. Last year, 143.9 million square feet of new retail space were constructed. An additional 113.7 million sf are slated for construction this year. Lease rates for space in anchored shopping centers have increased steadily since 1994, reaching \$16.92 per sf in 1998.

In spite of today's strong market, commercial real estate professionals know that they must continue to change with the times in order to stay successful. Strategies include addressing e-commerce competition, increasing the entertainment value of shopping centers, and reconfiguring malls so they are more shopper friendly. New opportunities exist in the industry with the rise of drugstores and the return to urban areas. Older properties also are being redeveloped to meet the needs of today's retailers.

In order to better compete in the retail market today, commercial real estate professionals should be aware of the issues and trends that are shaping it.

Bricks vs. Clicks

"I think the jury is out on what the final outcome is going to be [with e-commerce]," says Dottie Tarleton, CCIM, vice president of the commercial investment division at Stirling Properties in Baton Rouge, La. Still, property owners and managers have started taking steps to ensure that consumers are drawn to brick-and-mortar stores.

Last year, online sales totaled almost \$15 billion, which is nearly double 1998's total, according to the New York-based Jupiter Communications, an e-commerce research and consulting company. The company's 2000 projections raise the total to \$23 billion.

While the Internet may allow people the convenience of shopping from home, most commercial real estate professionals doubt it ever will replace the traditional shopping experience. "I think the potential is there [for e-commerce] to impact retail, but I still think there's a huge percentage of the population that enjoys shopping that's going to continue to go out and touch and feel the product," says Bill Oates, CCIM, a broker at Girton & McAllister in Austin, Texas.

To continue to compete with e-commerce, property owners and managers should emphasize the social aspects of shopping to attract consumers. "In the big picture, a lot of the future of the retail industry depends on our ability to enhance the quality of the human experience and continually adapt to what our consumers are telling us they want," says Rick Kuhle, senior vice president of Vestar Development Co. in Phoenix.

Vestar's roughly 35 open-air shopping centers located throughout Arizona and California always are clean, landscaped, and well-lit, Kuhle says. "We're trying to create an environment that is a pleasant and enjoyable experience so we can get people out of their houses," he says.

Stressing the entertainment component of shopping is another way to attract consumers. "You need to make your shopping center more of a leisure activity," Kuhle says. This includes having a good mix of food and beverage establishments, as well as movie theaters. The goal is to make a shopping center "a gathering place," says Susan P. Zimmerman, vice president of Kidder, Mathews, & Segner in Seattle.

Property owners are taking entertainment one step further by adding theme-park attractions similar to Camp Snoopy located in the Mall of America in Bloomington, Minn. The \$10 million American Wilderness Experience, a mini-zoo with a motion-simulator theater and restaurant, opened in 1997 at Ontario Mills in Ontario, Calif. The Sony Metreon, an \$85 million retail entertainment complex in San Francisco, opened last year with three theme parks.

Several shopping malls are battling e-commerce by clustering competing stores together, which goes against the traditional layout of a mall. RiverTown Crossings in Grandville, Mich., has an entire wing of children's clothing stores, while the Southdale Center in Edina, Minn., is renovating a wing for retailers of teen-agers' clothing. This design is intended to make the mall more convenient for shoppers looking for specific products, according to The Wall Street Journal.

Aside from the possibility of luring shoppers away from brick-and-mortar stores, e-commerce may have other financial implications for the commercial real estate industry. Kelly Bland, vice president for retail properties at Colliers International in Reno, Nev., says sales figures could be affected if an item purchased online is returned at a store and rung up as if it had been purchased in the store. This could change percentage rents or total sales psf information.

"There re] some issues that we'll have to work through," Bland says. Property owners and managers may have to start monitoring returns by insisting they be rung up as separate categories — in-store returns and online returns.

Retail properties also could be affected if retailers embrace e-commerce and look at it as another sales channel. For example, Wal-Mart plans to install Internet stations in its stores promoting products not available in the stores. "They are going to offer more than 10,000 toys [online] that they're not going to have on the shelf," Tarleton says. Banana Republic stores in New York and Santa Monica, Calif., already offer similar services.

If this trend continues, it may change the amount of space retailers need, says John A. Jackman, CCIM, president of Jackman Commercial Realty in Manchester, N.H. "You'll see a lot more retailers downsizing a bit," he says.

Some in the industry think the effects of e-commerce are positive. "[E-commerce] also seems to stimulate buying," says Matthew K. Harding, CCIM, senior vice president of Levin Management Corp. in North Plainfield, N.J. A number of consumers use the Internet to research products, then make purchases at brick-and-mortar stores. "Retailers with a presence on the Internet seem to do well," he says.

Statistics lend credibility to this theory. According to a recent survey conducted by Harris Interactive, an Internet-based market research company, consumers spend nearly \$2 off-line for every \$1 they spend online. Only book shoppers spent more online, averaging 79 cents off-line for every dollar spent on the Internet.

The rise of dot-com companies even may usher in new retail tenants. Zimmerman points out that Gateway began selling its computers only online but recently has opened brick-and-mortar stores throughout the country.

One shopping mall did launch a full-scale attack on e-commerce only to have it backfire. The Saint Louis Galleria

implemented a policy last November prohibiting its 170 tenants from advertising their Web sites to mall shoppers. After threats of legal action from at least one tenant and noncompliance from several others, owner Hycel Partners dropped the policy within a week.

While commercial real estate professionals realize that e-commerce will affect the retail market, most doubt that it will make shopping obsolete. "It's not likely that all shopping will be done over the Internet," Kuhle says.

The Drugstore Wars

"To me, the big trend ... is the drugstores all relocating [to] free-standing corners," says Matt Williams, CCIM, vice president of Grubb & Ellis/Paramount in Grand Rapids, Mich. Most are fleeing strip or power centers, where the competition from supermarkets has increased. This nationwide trend has led to hot competition for space among retailers such as Walgreens, Rite Aid, CVS Pharmacy, and Eckerd. "Everybody seems to have the same prototype," he says. "They all want the same size with a drive through."

Because many existing properties at prime corner locations are not suitable for drugstores, almost 100 percent of the free-standing stores are new construction, Williams says. About 10 to 12 stores were built last year in western Michigan ranging in size from 10,000 sf to 15,000 sf. "They're paying really big money to combine three or four parcels," he says, citing land prices that can reach up to \$30 psf in Grand Rapids.

Drugstores are buying up land in the Puget Sound area as well, Zimmerman says. The competition for key locations is driving up land prices, with some sites selling for more than \$50 psf. Typical land prices range from the high teens to the low \$20s for better locations, she says.

Other parts of the country also are seeing a rise in land prices as a result of the drugstores. "The drugstore competition really has increased the value of 1.5 acres of land," Harding says. Commercial land in New Jersey usually starts at \$200,000 per acre depending on the location, but the drugstores are paying as much as \$1.5 million per acre.

Despite the high price tag, drugstores prefer to purchase their buildings to have a fixed, one-time cost as opposed to an increasing lease rate. "If [retailers] can buy, it's much better for [them]," Zimmerman says.

Rite Aid is leading the construction frenzy with 522 projects valued at \$465 million planned for this year, according to Marcus & Millichap. Walgreens has 479 new stores valued at \$579 million that are slated for construction in 2000, while CVS has 289 projects valued at \$240 million planned.

But some brokers think the inflated prices the drugstores are paying may end up hurting the market. "I think we're getting to the point of saturation," Jackman says. "I don't know how [the drugstores] are going to be able to survive long term."

Jackman says one or two drugstores possibly could fall to the competition, leaving vacant buildings in high-traffic retail areas. If lease rates are considered too high by other retailers, the properties may sit vacant for an extended period of time.

Some areas recently have seen this occur with big-box stores. "Several years ago, the big-box retailers were falling all over each other to find new sites, but it's definitely slowing down," Tarleton says. As locations became saturated with similar big-box retailers, stores began to close or relocate. "You can only have so many sporting goods stores on the same corner," she says.

Despite the heavy competition between drugstores, Zimmerman says most retailers today are careful not to choose sites already congested with similar stores. "Retailers today are becoming more aware of market saturation," she says. "They're more aware of what the competition is doing. I wouldn't have said that a year ago; most would have gone head

to head.”

Out With the Old

Until the mid- to late 1980s, new shopping malls re-created the success of existing malls by copying their layouts and renting to the same tenants, Kuhle says. However, when new malls began changing their tenant mix and creating their own niches, the older uniform malls began to decline.

“These early malls built in the '60s and '70s have seen their volumes decrease and now are ripe for redevelopment,” Kuhle says. “They’re in good locations; it’s just they never created a niche.” Vestar Development has added several such properties to its portfolio. By partially demolishing the shopping centers, building from scratch, and focusing on a diverse tenant mix, Vestar has turned them into dominant retail centers, Kuhle says.

For example, when Vestar purchased the 40-year old College Grove Mall in San Francisco, it was only 30 percent occupied. Although it was in a great location, it couldn't attract shoppers away from the new malls. “We came in and demolished about 70 percent of it,” Kuhle says. “We ... said, ‘What’s missing in this whole trade area? What’s the tenant mix this area needs?’ ”

After doing some research, the company decided to create a value-oriented shopping center and pursued tenants such as Sam’s Club, Wal-Mart, and Staples, Kuhle says. The 700,000-sf power center was 90 percent to 95 percent leased before construction started, he says. The average annual lease rate is \$13 psf triple net for anchors and \$30 psf triple net for nonanchor tenants. Before the renovation, anchor space leased for \$5 psf to \$6 psf triple net and nonanchor space leased for \$12 psf triple net.

Kuhle admits that redevelopment of this type is costly — from buying out leases to the actual demolition — but he says it’s the best option in some cases. “There’s a point that all of a sudden makes financial sense,” he says. “There’s a right time and a right place for everything and you just have to be there.” The total cost for the College Grove Mall redevelopment was \$35 million.

Sometimes developers can modify existing space to meet the needs of specific retailers. Levin Management recently renovated a 30-year-old building in North Brunswick, N.J., whose tenant was a large discount department store. “The department store really was too small for today’s discount retailers like Target and Wal-Mart,” Harding says.

Rather than tear down the building and construct new space, the company divided the building and marketed it to specialty big-box retailers seeking about 30,000 sf of space. In addition, Harding says the company shaved 40 feet off the front of the building to add more parking. The project cost between \$2.5 and \$3 million, he says.

Levin Management did the work on spec but was confident the space would be leased because of the location, Harding says. The 81,000-sf building is now leased by Barnes & Noble, Bed, Bath, & Beyond, and Michael’s. “It’s like a brand-new shopping center,” he says. The average lease rate is \$15 psf triple net, which is typical for the area.

Urban Awakening

Urban retail areas also are experiencing a period of redevelopment. “We’re seeing a lot of movement back into the city,” Tarleton says. The trend is fueled by people’s desire for “lifestyle centers,” areas where they can shop, eat, and relax. As retailers move into urban areas, older properties are being refurbished.

In an effort to jump-start its downtown, the city of Baton Rouge hired consultants to determine what would bring retailers into the state’s capital. Tarleton says a commitment by the state to build 1.2 million sf of office space downtown should bring in stores such as Mail Boxes Etc. that are geared toward daytime shoppers.

Cities in New Hampshire are experiencing similar revivals, Jackman says. Consumers looking for an alternative to regional shopping centers recently have rediscovered quaint downtowns.

Typically, New Hampshire downtowns attract small, local merchants such as gift, antique, and clothing stores. Space requirements range from 500 sf to 1,200 sf for specialty boutiques, while clothing stores lease from 3,000 sf to 5,000 sf. Lease rates vary with most averaging from \$6 psf to \$8 psf triple net. However, rates in the more tourist-oriented Portsmouth market range from \$16 psf to \$18 psf triple net, Jackman says.

As downtown shopping districts gain momentum, they are attracting a wave of retailers that traditionally are not found in urban areas. These retailers are being forced to abandon their usual space requirements and conform to what's available, says Paul G.W. Fetscher, CCIM, president of Great American Brokerage in New York. "A lot of the big boxes found if they come to Manhattan, they have to be creative," he says.

For example, Staples usually locates along highways in 20,000- to 40,000-sf spaces. In Manhattan, though, the retailer is moving into two-level, 16,000-sf stores. "For many [big-box retailers], it's their first multilevel space," he says.

Other cities realize the potential of their downtowns and are working to bring more consumers there. Orlando, Fla., wanted to bring shoppers to its downtown by building a light-rail system that would connect it to the city's tourist corridor, says John J. D'Aloise, CCIM, an associate broker at Colliers Arnold Commercial Real Estate in Orlando. With many national retailers and six major attractions in the tourist corridor, more retail dollars are spent there than downtown, D'Aloise says. However, the light-rail plan was not approved because county administrators "didn't have a strong belief in the numbers the [train] would carry," he says.

The three-level, \$118 million Denver Pavilions has helped breathe life into downtown Denver since its late 1998 opening. The project created an 800-car underground parking garage and 350,000 sf of new retail space. Tenants include Niketown, Hard Rock Cafe, Virgin Megastore, and a 15-screen United Artists theater. The shopping center averaged between \$450 psf and \$500 psf in sales in its first five months.

The Urge to Merge

Combining two or more stores into one location has become a popular, profitable trend for certain retailers. In addition to offering a wider selection of goods, co-branding allows retailers to share the cost of better locations and properties.

Co-branding is becoming popular in Manchester, Jackman says. Mirroring other areas, co-branding predominantly occurs among fast-food chains, gas stations, and convenience stores, he says. Taco Bell and Burger King have teamed up with Mobil gas stations in his area.

Like Tricon Global Restaurants, which often combines Taco Bell, KFC, and Pizza Hut under one roof, Allied Domecq has opened triple-branded stores nationwide. The British company combines Baskin-Robbins, Dunkin' Donuts, and the submarine shop Togo's in hopes of offering a wider selection of food that will attract customers throughout the day.

Many retailers have recognized the convenience that on-site restaurants offer consumers. For instance, Old Navy, Ikea, and American Girl Place all are experimenting with in-store eateries. Ranging from cafes to full sit-down restaurants, the retailers are attempting to lengthen shoppers' average visits and increase sales.

Retail Funds

"Capital is flowing for retail quite consistently," says Marc Thompson, CCIM, CRE, vice president of First Bank of California in Concord. Lenders are backing the construction of many types of retail, including shopping centers, big-box

stores, in-fill space in downtowns, and entertainment-themed retail centers.

Lenders tend to shy away from older properties that need to be redeveloped, Thompson says. “[Those properties] are higher risk because the life cycles of retail [stores] have become shorter,” he says. The retail market can change so dramatically in a short period of time that some lenders don’t want to finance a shopping center redevelopment when the chance exists that it will have to reposition itself within the next 10 years.

Kuhle says Vestar has never had a problem obtaining financing for its redevelopment projects. “There [were] more than enough people who wanted to finance [the College Grove Mall] project,” he says. This might be due to the amount of time the company spends researching a project in order to guarantee a successful tenant mix, he says.

The major player in retail financing is commercial mortgage-backed securities, Thompson says. “CMBS have been dominant in terms of retail financing for the last three to four years,” he says. “[Retail] is the biggest asset class in the CMBS portfolio.” Collectively, CMBS distributed more than \$100 billion in financing for retail projects. He predicts this trend will continue in the near future.

However, rising interest rates may bring a halt to the strong lending period. “There’s less money available as interest rates rise,” Thompson says. “It also causes additional concern because as the economy slows, it may affect vacancies down the road.”

For now though, commercial real estate professionals are enjoying the market’s success, ready to face whatever changes the future may hold. “People are always intimidated by change unless they are a part of it,” Fetscher says, “then they embrace it.”

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