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Is Retail the Silver Lining?

Even in the face of climate change, ever-rising fuel prices, and a looming recession, there still is room for well-designed, single-tenanted retail to grow in compact, dense, healthy, urban U.S. markets.

ESCALATING FORECLOSURES, ever-increasing gas prices, inflated staples, food shortages, store closings—these have been all-too-familiar sound bites in 2008. The U.S. economic situation may appear gloomy, but for real estate, the idea of a recession is taken as a forgone conclusion. This perception is due, in part, to the subprime crisis in housing. But is the real estate industry in recession?

Better questions to ask regarding a recession are: which market, which sector, which category, which region, which stores, which households? These are productive inquires—the answers to which can help the industry build upon its strengths and conserve energy in order to rev up its weaknesses.

So far, the answers seem to be the following:

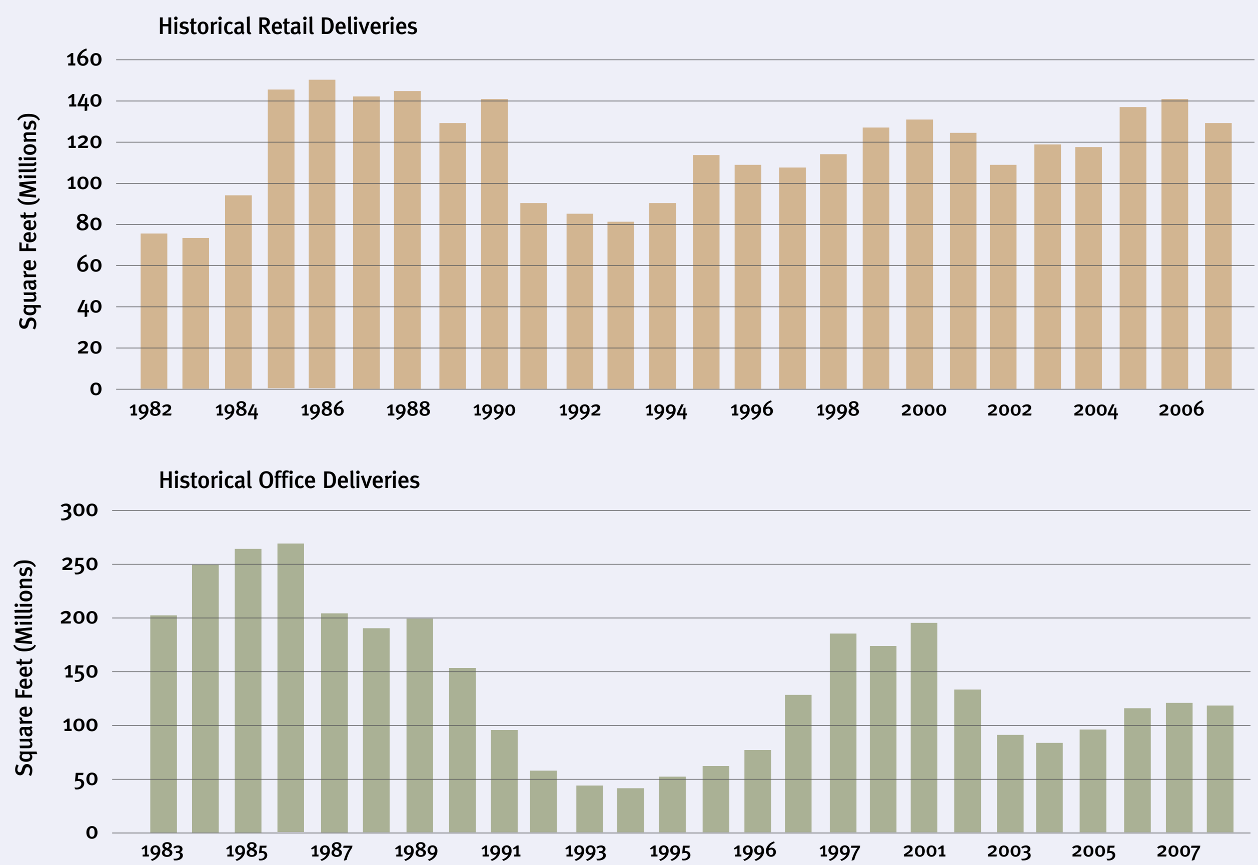
▷ The commercial market is brighter than housing.
▷ The retail sector is steadier than office.
▷ Discount and single-tenant retail is less murky than mid-range and multitenant retail.
▷ Compact, dense, walkable, urban, and quasi-urban markets are stronger than their suburban counterparts.
▷ The health of retail stores is not tied in entirely with the recession.
▷ Childless urban professionals are seeing better days than families and suburban dwellers.

These are the reasons why:

Housing. A pivotal precursor to the current economic slowdown was the subprime mortgage crisis and the ensuing bursting of the long-inflating housing bubble in mid-2007. Overextended mortgagees, no-interest loans, superfluous home improvement lines of credit, and overzealous flipping by speculators all contributed to today's high foreclosure rates and credit crunch.

Meanwhile, the oversupply of condos in markets such as Miami and Las Vegas, and single-family

FIGURE 1: RETAIL DELIVERIES HAVE REMAINED RELATIVELY MORE STABLE THAN OFFICE DELIVERIES IN THE UNITED STATES



homes in areas such as California's Inland Empire, added to the financial glut created by precarious lending practices and overeager borrowers. Overall, the housing sector has seen better days—but the details tell a more striking story:

▷ Not all housing markets are unsightly. While major markets in states such as Nevada, California, Arizona, and Florida are suffering from high foreclosure rates, other markets in states such as Minnesota, New York, Pennsylvania, and North Carolina report a much lower foreclosure rate.

▷ Some investors are capitalizing on foreclosures.

▷ The rental market continues to hold steady, with median rents rising, particularly in urban areas like San Francisco, Seattle, and Washington, D.C.

Commercial. While the housing crisis was generally taking center stage, the slumping fourth-quarter 2007 holiday season retail sales and steadily rising unemployment rates have fueled political pundits' and 24-hour news media's questions regarding a looming recession.

It is true that the credit crunch has affected the commercial real estate sector, particularly with respect to commercial mortgage–backed securities (CMBSs). Nevertheless, the commercial sector seems better off than the housing market. There are critical nuances within the commercial sectors, however, that provide a fuller picture.

▷ As with the housing market, not all commercial sectors are created equal. At present, most office markets are underperforming compared with retail. Many businesses are not expanding or are laying people off, especially those in the financial services and real estate sectors. While office oversupply is modest compared with that seen in the last downturn, overtime retail deliveries have remained relatively more stable than office deliveries, making the office market historically more volatile than the retail market (see Figure 1 on page 148).

▷ The effects of the housing crisis and the ensuing rising unemployment rate are not spread evenly across retail sectors. There are several distinct categories spread out over the retail spectrum. Currently, the health of a store depends in large part on its position within this spectrum. For example, the top luxury market is holding strong, as these retailers cater to the very wealthy who generally have not been too affected by the slowdown. While notably this represents a small percentage of the population, there is another sector that is fairing well, one that has a much larger market share. Ironically, this sector lies on the almost opposite end of the spectrum: the discount sector. These stores are still expanding, while using on-point marketing campaigns to help them survive this market. On the other hand, mid-range stores are struggling, as are trade-up luxury retailers. Consumers have not stopped shopping, however. They are just being savvier with their shallower pockets of discretionary income. Consumers who typically have shopped at mid-range stores may be scoping out brand-name discounters for the same items at a 30 to 50 percent discount. Further, there may be a lot more window shopping going on at the trade-up luxury stores these days. Consumers' waning confidence is weakening their ability to justify that "special" purchase and fewer "aspirational buyers" are actually buying.

▷ There are other ways in which tenants are not created equal—retail categories. Retailers selling goods that require high amounts of discretionary income are struggling. Home-related purchases are unlikely on the forefront of the minds of those facing foreclosures; and the numbers reflect this. Instead, consumers are focusing on fundamentals. Typically, single-tenanted discount drugstores and pharmacies are doing well. Most grocery stores are fairing well too, despite the increase in food prices. As with "soft goods," people are still shopping for essentials. Consumers are just being smarter and thriftier about their purchases, buying more generic brands and fewer more costly convenience products. Soft goods retailers are fairing somewhere between electronic goods/home furnishings and essential goods.

▷ Pay attention to what was happening before the economic downturn. There are a number of retailers that have filed for bankruptcy on the wings of this downturn or, at the very least, cut down on expansion plans. The news media have been quick to report these bankruptcies as casualties of the economic downturn. Upon closer inspection, however, some of these retailers, such as Circuit City and Shaper Image, were already falling on hard times before the bubble burst. In addition, in both of these retailers' cases, their products either were related to home goods or were ultra-discretionary items, so sales thereof were further exacerbated by the downturn. As such, not all recent bankruptcies and slowdowns are a result of the downturn.

▷ There is still room to grow—but this growth is not distributed evenly across all sectors and regions. Some international retailers, such as Zara and H&M, see the U.S. economic downturn as a great opportunity to expand, especially in their respective under-represented markets. There remain some potentially interesting opportunities in emerging, burgeoning markets. Also, established international markets, such as New York City, remain very strong; retailers still want signage on Fifth Avenue. Also, many Europeans come to Manhattan to get great deals because of the weak dollar. Again, some people are still shopping in some regions, especially those that have not been as scarred by the housing crisis (see Figure 2 for top ten and bottom ten U.S. retail markets, according to Real Capital Analytics).

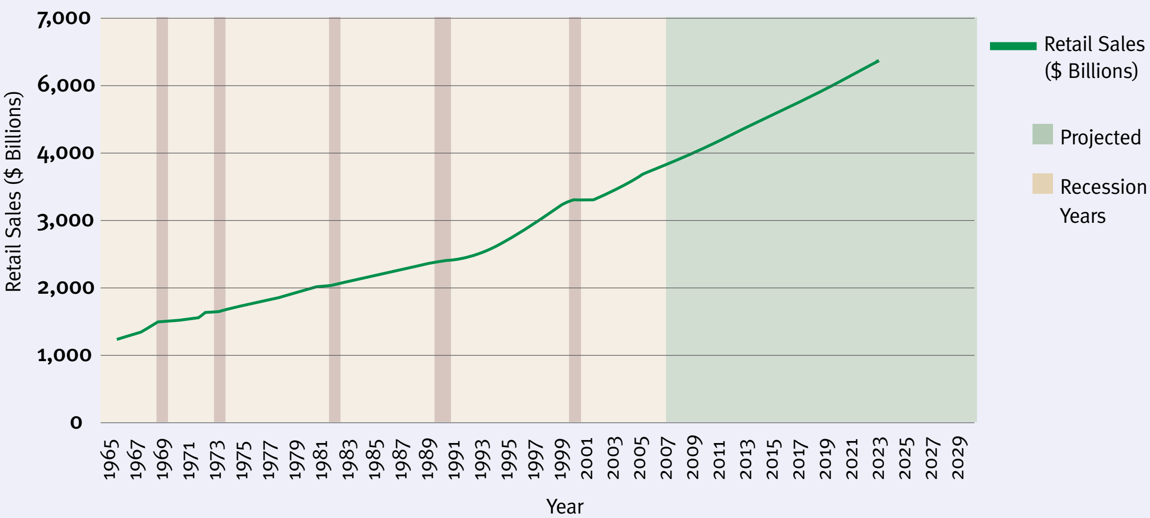
▷ Beauty is in the eye of the beholder. The news media are painting an ugly picture of this downturn.

FIGURE 2: TOP TEN AND BOTTOM TEN U.S. RETAIL MARKETS

Top Ten Retail Markets	Bottom Ten Retail Markets
San Francisco, California	Jacksonville, Florida
San Diego, California	Indianapolis, Indiana
Seattle, Washington	St. Louis, Missouri
New York City, New York	Columbus, Ohio
San Jose, California	Kansas City, Missouri
Oakland, California	New Haven, Connecticut
Las Vegas, Nevada	Cincinnati, Ohio
Orange County, California	Detroit, Michigan
Los Angeles, California	Milwaukee, Wisconsin
Portland, Oregon	Cleveland, Ohio

Source: National Retail Index, as reported by Marcus Millichap.

FIGURE 3: RETAIL SALES IN THE UNITED STATES REMAIN MOSTLY RECESSION-PROOF



It is a pretty difficult situation for many Americans: families are struggling, the middle class is being crunched, and the working poor are particularly vulnerable. Rising food and fuel prices are especially burdening the typical suburban-dwelling, 30-mile-commuting, SUV-owning, two-working-parent household—approximately one in six American households. These demographic groups have little, if any, disposable, discretionary income. The situation is significantly different, however, for double-income, no-kids professionals (DINKs), who often live in compact, walkable places. Many of them do not own cars or, if they do, walk to work anyway. They often substitute happy hour for dinner at home, or are cooking for only one. In essence, their low-carbon footprints are shielding their pocketbooks during this economic downturn. Hence, they are still shopping and eating out. Anyone walking around Dupont Circle or Georgetown in Washington, D.C.; or Soho in Manhattan; or Third Street Promenade in Santa Monica, California; or Pacific Heights in San Francisco; or Newberry Street in Boston, Massachusetts, will see evidence of this. People may not be shopping with reckless abandon, but they are still shopping and eating in restaurants.

In short, a number of urban housing and office markets are holding up; discount retailers are fairing well; single-tenanted drugstores and grocery stores are a bright spot in the retail market; retail markets that are either urban or quasi-urban, have a strong international representation, or are emerging, are thriving; and urban professionals with no children and some retirees still have some change in their pockets to spend.

These details make for a very different real estate forecast from what the media are reporting: retail may be the silver lining of this—and other—downturns. Historically, retail sales have not dipped much during previous recessions (see Figure 3). Retail growth is tied to population growth—and the United States is projected to add another 100 million residents by 2043, a faster growth rate than China's. As such, there are several key opportunities in today's retail market, if one pays attention to the details.

In particular, combining the strongest retail sector—single-tenant, essential goods retailers such as drugstores—which already ties into the robust part of the retail spectrum (i.e., discount), with the most solid regional markets (e.g., urban and quasi-urban) that have a high percentage of the most favorable demographics (e.g., single, childless professionals) can brighten up this glum market.

The irony is that, to date, single-tenanted retailers (with the exception of a few) have historically strayed away from urban markets and instead have produced one of the many iconic symbols of suburbia, the retail pod in a strip mall. Some companies, however, have already seen the advantages of locating in dense urban areas, all the while respecting the urban fabric. Moreover, some of their highest-grossing stores are located in urban cores.

So, in light of climate change, ever-rising fuel prices, and the still-looming *R*-word, there is room for well-designed, urban, form-fitting, single-tenanted retail to responsibly grow in compact, dense, healthy markets. UL

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