Reconsidering retail

Essential-service retail is well positioned in the current environment

by Robert Holuba and Uma Moriarity

Retail real estate has undergone a significant shift in investor sentiment during the past decade. From pre-pandemic pariah to emerging star, the once-shunned property sector is back on the menu for an increasing number of investors and poised for future growth. Investors who are open to looking beyond the groupthink and revisiting prior assumptions and predictions for the asset class are likely to come to the same conclusion and quickly recognize a gem hidden in plain sight.

Rather than painting the entire retail sector with a broad brush, we believe a subsector within has been positioned for this renaissance all along as a function of changing consumer behavior, demographic migration and supply constraints.

Ecommerce premonitions have not materialized

The biggest megatrend impacting the retail sector over the past decade has been ecommerce growth. Technology disrupted how consumers interacted with a physical retail location, most negatively impacting malls and department stores. At the time, many investors believed ecommerce sales growth would continue its meteoric rise and eventually disrupt all retail.

Today, a decade into this technological disruption, many of the predictions concerning the death of retail have not materialized. Ecommerce sales as a percentage of total U.S. retail sales seem to have stabilized, plateauing around 15 percent, according to Federal Reserve Economic Data. The national retail vacancy rate sits at 4.7 percent, as of mid-July, even lower than the industrial asset class, according to CoStar. Perhaps most importantly, we have now realized the "new normal" of the retail experience — an omnichannel model that allows customers to get whatever they want, whenever they want. This new omnichannel model requires the strategic deployment of both a physical and virtual presence across the customer relationship. Part of this strategy includes leveraging existing brick-and-mortar retail space as a point of distribution to meet customers' needs most efficiently.

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Robert Holuba
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Meanwhile, due to the misplaced trepidation among investors and lenders associated with ecommerce, very few shopping centers have been developed during the past decade. As a result, retail has been the least developed major asset class during the past 10 years. Compounding the supply and demand imbalance, many regions have experienced negative supply as older, obsolete centers have been redeveloped into multifamily or self-storage facilities. All the while, the population in the United States has grown, new housing communities are being built, and retail is necessary to serve those communities.

As a result of these externalities, the retail sector finds itself in an unanticipated golden era of fundamentals, boasting record-low vacancy rates, record-high rental rates and 10 quarters of positive absorption, according to CoStar. Investors who once assumed the retail sector was destined for obsolescence are best served by revisiting prior assumptions and predictions. When doing so, they will likely find new drivers are now at play.

Finding the hidden gem

With shifting trends poised to bolster the broad retail sector, certain subsectors will benefit more than others. Unanchored, neighborhood retail centers in the suburbs of non-gateway cities not only have been performing throughout the past decade despite ecommerce headwinds, but also are destined to thrive over the next major market cycle. These institutional-quality properties — which we have dubbed essential-service retail (ESR) — will be riding a number of tailwinds that have been prevalent for some time and show no signs of slowing.

If a rising tide lifts all boats, then the retail real estate sector is on its way up, with essential-service retail riding the biggest wave.

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- **Service-based tenancy.** The American consumer continues to spend more money on services and experiences than on goods. These services (i.e., food and beverage, fitness, beauty, health and medical, and business services), unlike goods, require a brick-and-mortar interface for point-of-sale consumption, making them resistant to ecommerce disruption (e.g., you have to go to the store to get a haircut). Tenants that offer these services continue to bring consumers to their physical stores.

- **Small-format footprint.** Service tenants excel at speed and convenience and do not require large amounts of space to manage their business, unlike power centers, malls or larger anchor tenants. Most service tenants operate their business in smaller, homogenous suites (1,000 square feet to 3,000 square feet) with limited improvements required. ESR properties consist exclusively of these smaller suites that cater to a wide array of various tenants, ensuring strong demand and higher occupancy rates.

- **Population and migration shifts.** We believe the suburbs are optimal locations for these centers as millennials age into a suburban lifestyle. One major demographic shift affecting this growth is the strength of the millennial generation. Born from the early 1980s to the mid-1990s, millennials represent the largest generation in the United States at 72.1 million, according to Census Bureau tabulations, and are expected to grow even further due to immigration trends. Today, millennials, who range in age from 26 to 41, are moving into their family formation years and are looking for larger spaces to live. This need often necessitates moving out of the city to the suburbs, where their consumption habits and demand for convenience persist. With urban living, a quick walk or subway ride brought them to their regular coffee shop, gym or hair salon. In suburbia, however, they need a short commute and easy parking to enjoy their services and amenities at will, fueling the demand even further for ESR properties.

- **Resilience.** Regardless of a slowing economy or global pandemic, consumers have demonstrated their resilient appetite for these services over multiple cycles. More recently, our experience has demonstrated ESR properties' ability to withstand the massive disruption that COVID-19 wrought, including lockdowns, supply-chain constraints and labor shortages. The service nature of the tenancy allowed most businesses to remain open amidst mandatory shutdowns, customers felt safe visiting the stores quickly, and both occupancy and lease payments remained among the highest in the retail industry. As the pandemic challenges have receded into history, we continue to see increasing rents and strong tenant retention, fortifying the foundation if other challenges emerge in the future.

Looking forward: increasing value and institutionalization

The "perfect storm" of market forces has enabled ESR properties to emerge as a burgeoning niche asset class. Bolstered by ongoing tailwinds, larger institutional investors have started to take notice.

- **The supply factor.** One of the often-overlooked dynamics regarding retail real estate — especially ESR properties — is the lack of new supply in the market. Given the property type's past negative sentiment, we find ourselves in an environment where new retail real estate supply has been meaningfully muted. In fact, there is only 56 basis points of retail under construction as a percentage of inventory today, and that figure has remained below 1 percent since 2009; deliveries hit a new low in 2022 for the third consecutive year, according to Green Street. These lower levels of supply coupled with the demand for tenants in these locations is resulting in record-low vacancies for this property type — under 5 percent nationally — and giving landlords the pricing power required to push rental rates to record highs.

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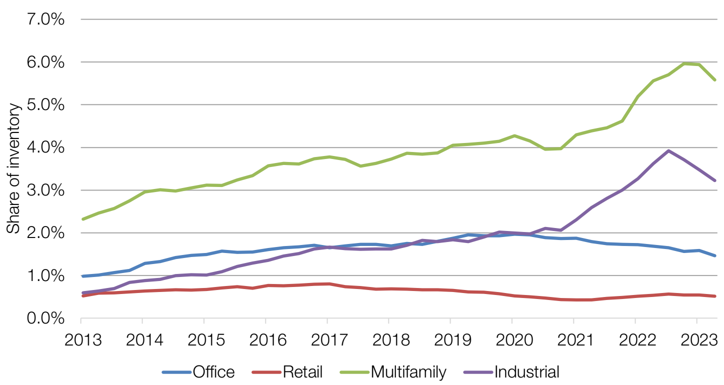
- **Price dislocation.** Negative investor sentiment for the broad retail sector created significant, unwarranted price dislocation, which is ironically serving the asset class during today's era of rising debt costs. Retail real estate finds itself in a unique position where cap rate compression did not occur to the same extent as other classes in the last few years of exuberant growth and cheap debt. Now, whereas cap rates for industrial and multifamily sectors are below the cost of debt, ESR remains attractively priced, generating positive financial leverage, while boasting strong fundamentals.

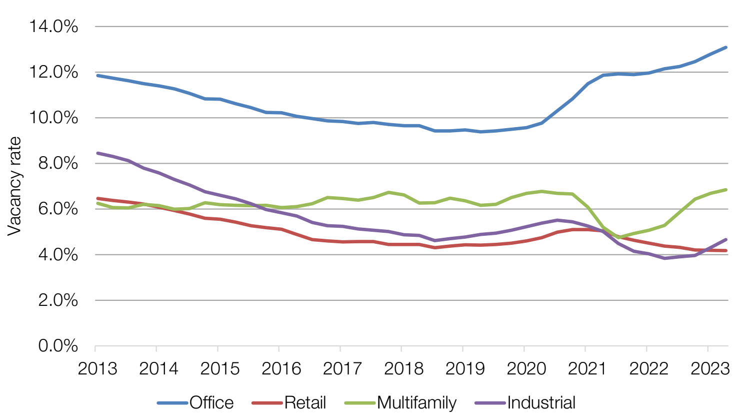
- **Consolidation.** The size and geographic dispersion of ESR properties has kept them largely off the institutional radar and in the hands of mom-and-pop operators. Yet, all the factors cited herein suggest the fragmented sector is ripe for consolidation and institutionalization. Leveraging institutional wherewithal, technology, mapping and cell phone tracking, investors can capitalize on the limited competition and acquire high-quality ESR properties at attractive cap rates with the opportunity to improve management and leasing. Those investors who can apply disciplined criteria to amass properties and generate economies of scale are in a position to benefit from stable cash flow, strong fundamentals and increased pricing power.

U.S. properties under construction, as percentage of inventory



Source: CoStar, as of July 17, 2023

U.S. vacancy rates, by property type



Source: CoStar, as of July 17, 2023

Conclusion

If a rising tide lifts all boats, then the retail real estate sector is on its way up, with essential-service retail riding the biggest wave. The well-placed optimism for sector prosperity is a welcome departure from the despondency of the last decade. Like any trend or sense of momentum, investors need to monitor demand and supply drivers carefully. As we have learned, fortunes can turn either way. Yet, for now, the future looks bright for retail as the past predictions of the sector's demise were greatly exaggerated. ❖

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