CenterSquare
REAL ASSET INVESTMENT LEADERSHIP

| Q4 2023

Revisiting Retail


Uma Moriarity, CFA
Senior Investment Strategist


Rob Holuba
Managing Director, Private Real Estate

In 2020, prior to the COVID-19 pandemic, we published a white paper on "The Quiet Mega Trend in Retail Real Estate," highlighting our observations about consumer patterns and demographic shifts that were giving way for a niche retail subsector to thrive. Since then, a global pandemic and upheaval in capital markets have only served to further strengthen our conviction. This paper, appropriately titled "Revisiting Retail" seeks to address three observations we have made at CenterSquare:

1) Institutional investors' past predictions about retail were incorrect, and e-commerce did not lead to the demise of all brick-and-mortar retail. On the contrary, brick-and-mortar retail is undergoing a golden era of fundamentals with record high occupancy and rental rates due to fifteen years with limited new supply.

2) Not all retail is created equal — seven years ago CenterSquare developed a thesis about Essential Service Retail ("ESR"), a niche retail subsector we believed would outperform other types of retail properties due to changing consumer patterns. Fast forward to today, we are one of the largest owners of ESR nationally, affirming our hypothesis with a proven track record that supports the strength of this niche sector versus the traditional sectors (power center & grocery anchored).

3) Today's capital market landscape is generating a compelling value proposition for deploying capital into the ESR subsector.

Revisiting Retail as a Sector

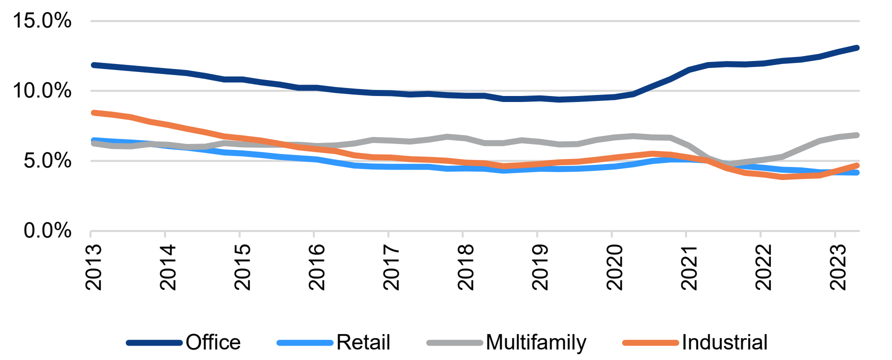
Over the past decade, the growth and evolution of technology have disrupted how consumers interact with physical retail spaces. The proliferation of e-commerce led to the thesis that online sales growth would continue its meteoric rise and eventually disrupt all retail; however, we believe this preconceived notion needs to be revisited.

Today, a decade into this technological disruption, many of the predictions concerning the death of retail real estate have not materialized. Despite e-commerce sales as a percentage of total U.S. retail sales rising past 15%[1], the national retail vacancy rate currently sits at just 4.7%, which is even lower than the industrial asset class[2] (Figure 1). 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 model requires the strategic deployment of both a virtual and a physical presence across the customer relationship. Part of this strategy includes leveraging existing brick-and-mortar retail space as a point of distribution to meet the customers' needs most efficiently.

Meanwhile, due to the trepidation associated with e-commerce, very few new retail centers have been developed over the last decade. Consequently, retail has been the least developed major asset class over the past ten years (Figure 2).

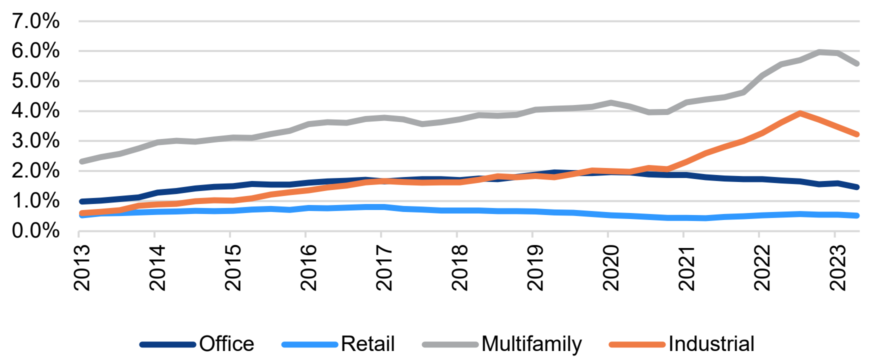
Many regions have even experienced negative supply as older, obsolete centers have been redeveloped into multifamily or self-storage facilities. During that same time, the population in the United States has grown, particularly across sunbelt markets, resulting in retail productivity increasing significantly (i.e., individual stores generating more sales) (Figure 3).

Figure 1: U.S. Vacancy Rates



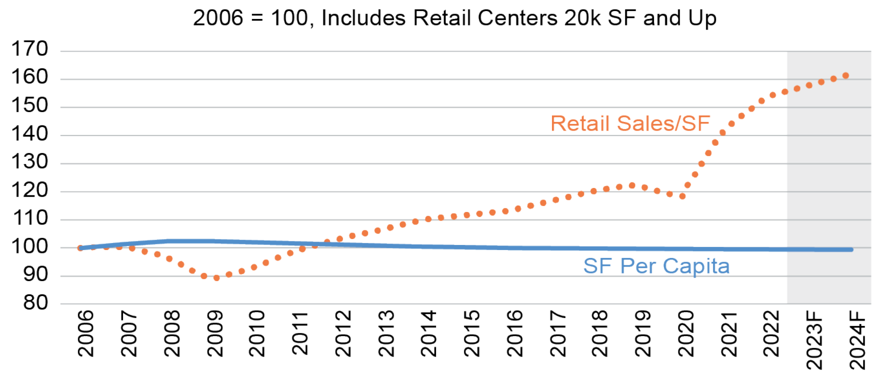
Source: CoStar, as of July 17, 2023.

Figure 2: U.S. Properties Under Construction as % of Inventory



Source: CoStar, as of July 17, 2023.

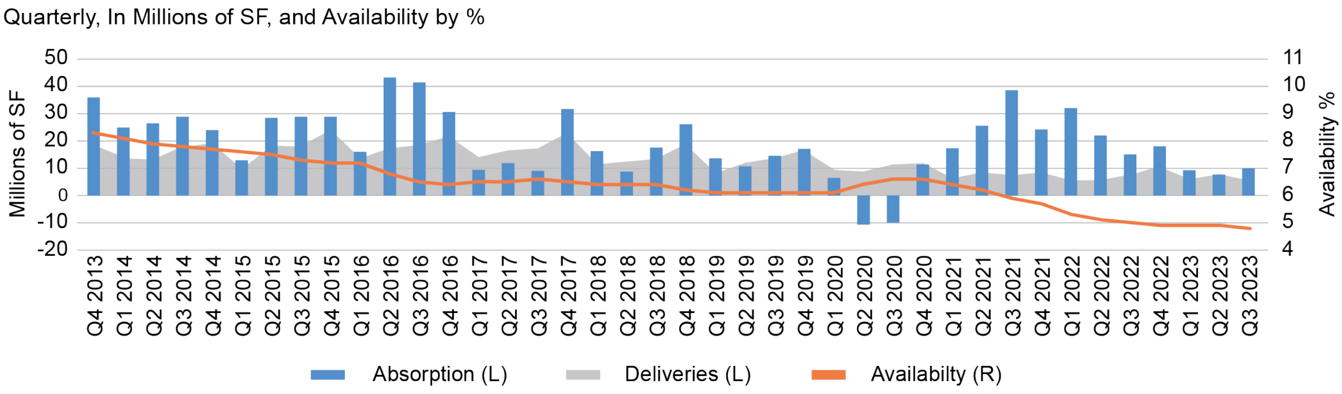
Figure 3: Annual Retail Sales/SF and SF Per Capital Index, U.S.



Source: CoStar, St. Louis FRED, CBRE Research, as of Q4 2022. The above chart includes forward looking information. Actually results may be materially different.

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 twelve quarters of positive absorption[3] (Figure 4).

Figure 4: Retail Space Absorption, Deliveries, and Availability



Source: CBRE Econometrics Advisors, as of Q3 2023.

Building a Sustainable Strategy

Neighborhood retail centers play a pivotal role in the development of community-driven initiatives and serve as the cornerstone of many diverse suburban neighborhoods. As such, sustainability and community impact considerations are a vital component of our investment philosophy across the ESR portfolio. A prime example of this consideration can be seen in Peachtree Corners Town Center (PCTC), a 57ksf unanchored ESR property located in Peachtree Corners, GA.

One of the most unique features of PCTC is the two-acre town green bordering the property that hosts free monthly events including movie showings, live music performances, festivals, fitness classes, and recycling/shredding events. These gatherings foster a spirit of camaraderie amongst tenants and visitors. Beyond serving as a communal hub, the green space increases vegetation on site, helping to mitigate the urban heat island effect. To further promote environmental stewardship, the parking deck adjacent to the center boasts 12 Tesla Superchargers that are available to the public 24/7 and provide abundant charging access to electric vehicle drivers, collectively encouraging reduced dependence on fossil fuels.

Notably, this property's accessibility and walkability is enhanced by an 11.5-mile multi-use trail system that runs through the center and crosses Peachtree parkway, a major throughway within the area. This trail provides safe and easy access to the property, creating a welcoming and inclusive space for all who visit and minimizing the necessity to use a vehicle to explore the area.

By considering sustainability principles within our portfolio, we continue to pursue the goal of maintaining an inviting, equitable, and user-friendly environment for both tenants and customers to enjoy.

Not All Retail is Created Equal

Defining Essential Service Retail

As consumer patterns have changed and technology has disrupted consumption trends, investors need to challenge not only prior assumptions about the retail sector, but also the kinds of retail in which to invest. Traditionally, most investors have targeted shopping centers with large anchor tenants. However, seven years ago, CenterSquare identified ESR – a type of unanchored shopping center largely occupied by smaller, service-based tenants – as a sector of retail poised to outperform (Figure 5). Today, ESR has emerged as a burgeoning niche sector within retail that has demonstrated a long history of strong performance and has caught the attention of institutional investors.

Figure 5: What is Service Retail?

Location

- Dense affluent suburban submarkets
- Emphasis on Sunbelt markets
- Hard corner intersections
- Highly trafficked roads

Real Estate

- 20,000 - 40,000 SF
- Built after 2000
- Small, homogenous suitesizes (avg. 2,000 SF)
- Excellent visibility and emphasis on convenience (parking & access)

Tenancy

- Unanchored (no tenant > 20% of NRA)
- E-commerce resistant
- Mostly national & regional tenants
- Below market rents

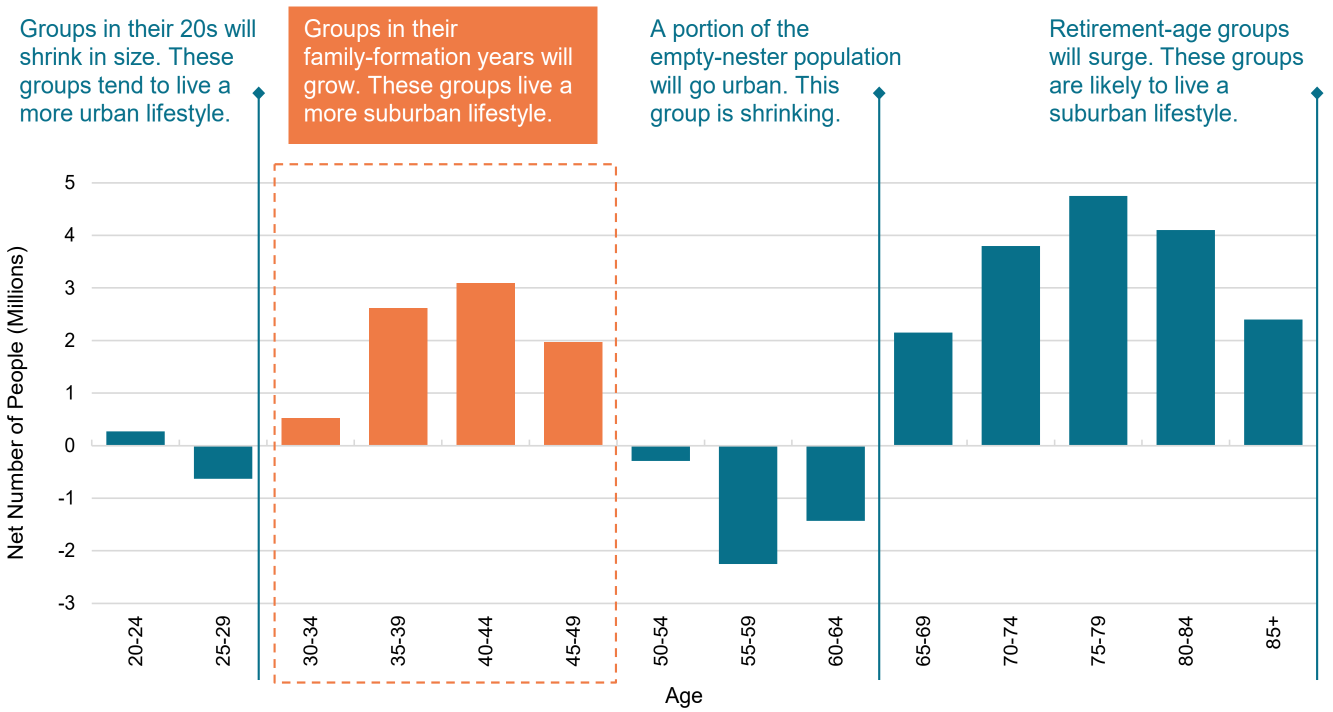
Source: CenterSquare Investment Management, as of November 30, 2023.

The Suburban Migration of Services Consumption

Two of the earliest consumer habits we saw evolving were 1) the consumers' wallet share shifting from the consumption of goods to services and 2) consumer shopping shifting increasingly online. It was this early recognition of changing consumer patterns that was the fundamental thesis for ESR — if consumers were spending more dollars online and preferred services and experiences over goods, the winning retail spaces would be comprised of e-commerce resistant tenants whose customers have to visit a physical location in order to consume the service (i.e., food and beverage, fitness, beauty, health and medical, and business services). As for the question of where the most successful retail spaces would be located, we were closely following the wave of suburbanization as the aging millennial cohort prepared to shift from urban living to a suburban lifestyle better suited for their new and growing families (Figure 6 on the following page).

Millennials, born from the early 1980s to the mid-1990s, represent the largest generation in the U.S. at 72.1 million[4]. Today they range in ages from 27-42 and are expected to grow due to immigration, retaining their influential status through the middle of the 21st century. Their suburban migration was only accelerated by COVID and the increased prevalence of hybrid work, with many millennials still working remotely several days per week. Not only has hybrid work allowed millennials to move further from their city-center offices, but it has also fundamentally increased their consumption of services in the suburban markets in which they reside and now also work.

Figure 6: Change in Adult Population by Age, 2020-2030

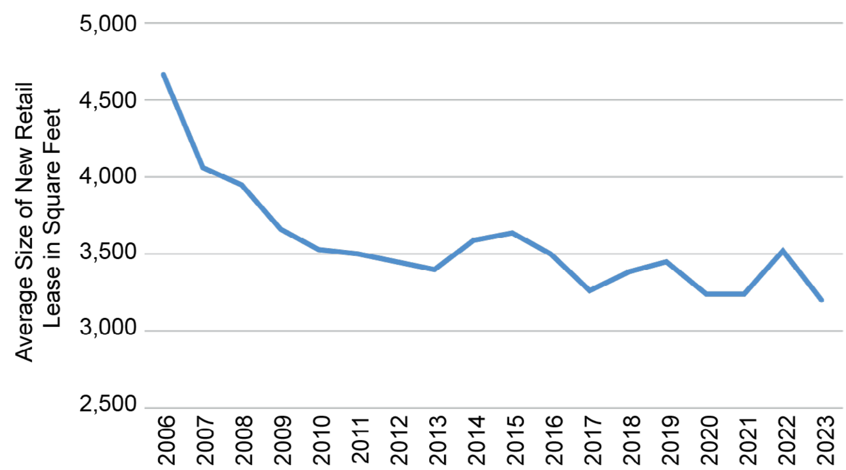


Source: John Burns Real Estate Consulting LLC, U.S. Census Bureau, as of October 2021.

ESR centers are ideally positioned to meet this demand. These compelling properties are conveniently located on frequently trafficked thoroughfares serving dense and/or affluent neighborhoods in high-growth markets. Designed to prosper without an anchor tenant, this Class A real estate functions as the “last-mile” delivery point for the services that are continuing to gain Millennials’ wallet share and represents a retail subsector that has emerged from the pandemic stronger and poised for growth.

ESR properties are not only ideal locations for retailers providing this last-mile consumption of services, but they are also gaining traction from retailers reconfiguring their brick-and-mortar footprint. Consumer preferences and expectations have changed as a function of leveraging technology to remove friction within the consumption process — resulting in a bias toward speed and efficiency. The smaller-format stores of ESR properties are built for convenience and short duration visits, and retailers are increasingly shifting toward these smaller format suites to capitalize on evolving consumer preferences. According to CoStar, the average size of retail leases executed during the first three quarters of 2023 hit a new historic low, standing at just 3,200 square feet. Notably, spaces under 5,000 square feet accounted for over half of retail leases (Figure 7).

Figure 7: New Retail Leases Average Just 3,200 Square Feet in 2023



Source: CoStar, as of November 2023. Note: Based upon new leases only

Testing the Hypothesis

CenterSquare started investing in the ESR sector in 2016 and has aggregated a national portfolio, becoming one of the largest owners of ESR in the country. We have developed a proprietary system and process to identify, filter, underwrite, and acquire these previously un-institutionalized smaller properties within an overlooked sector. The composition of the portfolio has been deliberate to ensure top-tier quality and high tenant demand and can be broken down as follows:

38
shopping centers

17
markets (primarily sunbelt)

36,088 SF
average size of the entire shopping center

2,390 SF
average tenant size

2008
average vintage

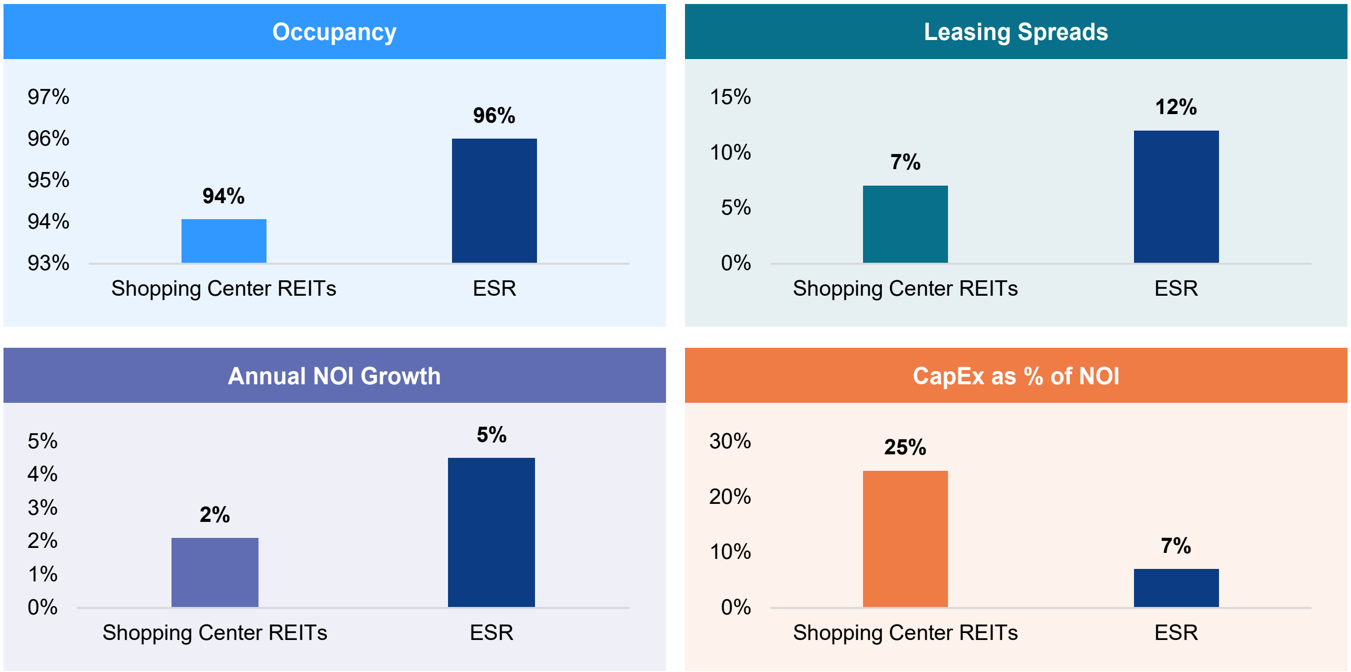
65%
national and regional tenancy

73,000/$118,000
3 mile demographics (population/income)

40,000
average vehicles per day passing by our centers

CenterSquare's ESR Platform emphasizes the following core characteristics (i) Class A quality with a high mix of national and regional tenants, (ii) efficient rectangles on highly trafficked roads, (iii) dense or affluent suburban submarkets and major MSAs. Over the last few years, retailers experienced many hardships — a global pandemic, supply chain constraints, and labor shortages to name a few — and capital markets were equally tumultuous. Despite these impacts, the ESR portfolio has remained resilient, and the subsector has emerged as the strongest within retail. The charts below compare our ESR portfolio's performance since 2016 versus public open-air shopping center REITs. It is important to note that most shopping centers owned by the public REITs are larger format, anchored centers (Figure 8). As the data shows, ESR is better accommodating tenants' needs in the face of changing consumer patterns resulting in better performance.

Figure 8: Comparison between ESR and Shopping Center REITs



Sources: Mizuho, as of November 2023. CenterSquare Investment Management, as of September 30, 2023.

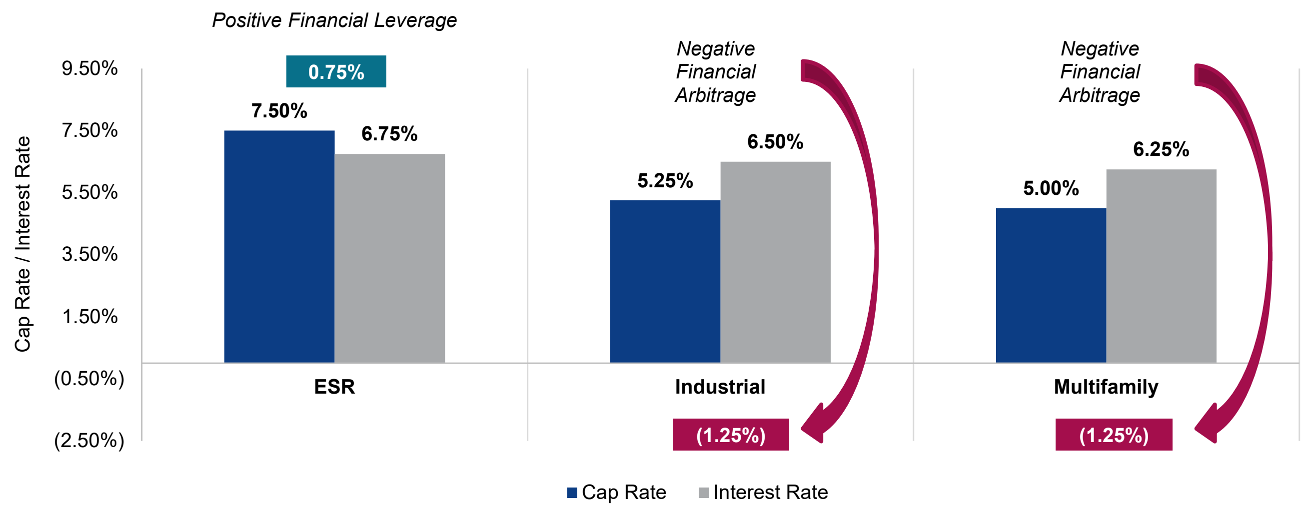
The Current Market Opportunity

Impact of Rising Debt Costs

As real estate investors, we have been navigating turbulent market dynamics over the last few years, but nothing has been as impactful as the rapidly changing cost of debt. The Federal Reserve's unprecedented rate hiking cycle to combat inflation has dramatically increased the cost of borrowing money today, and we believe the 10-year treasury yield is likely to stay closer to 4% in the foreseeable future rather than return to the near-zero rates we had grown accustomed to in the past cycle. As a function, real estate cap rates, which had found new lows, must inflect higher and settle at levels warranted for this new era of higher debt costs to avoid negative financial leverage on investments.

While this statement is true for real estate broadly, the recent negative investor sentiment toward retail meant that it did not experience cap rate compression despite the exuberant period of free money over the last few years, unlike core properties in the industrial or multifamily sector. As a result, while borrowing costs have increased to the 6-7% range, retail cap rates have not had to expand as much as other property types to adjust to this new cost of capital reality.

Figure 9: Borrowing Spread Comparison



Source: CenterSquare Investment Management as of November 30, 2023.

Today, we can deploy capital into cash-flowing ESR properties at cap rates that offer positive leverage, institutionalize operations at the property-level to drive strong net operating income growth, and generate strong cash-on-cash returns (Figure 9). The attractiveness of this investment strategy is beginning to garner attention from other institutional investors as well, as evidenced by the recent announcement of a spin-off public company, consisting exclusively of ESR properties.

Conclusion

Retail is experiencing a golden era of fundamentals due to a lack of supply. We anticipate these good times to persist as there remains no new supply on the horizon, and demand for these types of spaces remains resilient. We believe this favorable time in the capital cycle for retail will provide a backdrop for strong real estate fundamentals in this sector despite our belief in an impending economic slowdown. Furthermore, the essential nature of ESR tenancy will be less impacted (you still get your haircut in a recession, right?), especially in the high-growth markets experiencing population growth. What began as a hypothesis in 2016 has grown into a premier Service Retail operating business, and we look forward to leading the charge for the institutionalization of this niche and resilient sector of shopping centers.

Footnotes

[1] Source: FRED Economic Data (https://fred.stlouisfed.org/series/ECOMPCTSA), as of July 1, 2023.

[2] CoStar, as of September 30, 2023.

[3] CoStar, as of September 30, 2023.

[4] Pew Research Center tabulations of U.S. Census Bureau, as of April 2020.

Disclosures

Any statement of opinion constitutes only the current opinion of CenterSquare and its employees, which are subject to change and which CenterSquare does not undertake to update.

Material in this publication is for general information only and is not intended to provide specific investment advice or recommendations for any purchase or sale of any specific security or commodity. Due to, among other things, the volatile nature of the markets and the investment areas discussed herein, investments may only be suitable for certain investors. Parties should independently investigate any investment area or manager, and should consult with qualified investment, legal, and tax professionals before making any investment. Some information contained herein has been obtained from third party sources and has not been independently verified by CenterSquare Investment Management LLC ("CenterSquare"). CenterSquare makes no representations as to the accuracy or the completeness of any of the information herein. Accordingly, this material is not to be reproduced in whole or in part or used for any other purpose. Investment products (other than deposit products) referenced in this material are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by CenterSquare, and are subject to investment risk, including the loss of principal amount invested.

For marketing purposes only. Any statements and opinions expressed are as at the date of publication, are subject to change as economic and market conditions dictate, and do not necessarily represent the views of CenterSquare or any of its affiliates. The information has been provided as a general market commentary only and does not constitute legal, tax, accounting, other professional counsel or investment advice, is not predictive of future performance, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. The information has been provided without taking into account the investment objective, financial situation or needs of any particular person.

Any indication of past performance is not a guide to future performance. The value of investments can fall as well as rise, so investors may get back less than originally invested. Because the investment strategies concentrate their assets in the real estate industry, an investment is closely linked to the performance of the real estate markets. Investing in the equity securities of real estate companies entails certain risks and uncertainties. These companies experience the risks of investing in real estate directly. Real estate is a cyclical business, highly sensitive to general and local economic developments and characterized by intense competition and periodic overbuilding. Real estate income and values may also be greatly affected by demographic trends, such as population shifts or changing tastes and values. Companies in the real estate industry may be adversely affected by environmental conditions. Government actions, such as tax increases, zoning law changes or environmental regulations, may also have a major impact on real estate. Changing interest rates and credit quality requirements will also affect the cash flow of real estate companies and their ability to meet capital needs.

About the Authors

Uma Moriarity, CFA
Senior Investment Strategist and Global ESG Lead

Uma Moriarity is the Senior Investment Strategist and Global ESG Lead for CenterSquare Investment Management. She focuses on investment strategy and leads thought leadership across the Firm's public and private real estate platforms. She is part of the listed real estate investment team and serves on CenterSquare's Private Real Estate Debt Investment Committee. Uma leads the Firm's Environmental, Social, and Governance (ESG) strategy to incorporate ESG into the decision-making and management of listed and private real estate investments to create long-term value, reduce risk, and generate superior risk-adjusted investment returns. Prior to joining CenterSquare, she spent three years in corporate strategy and planning at ExxonMobil in Houston. Uma graduated from The Pennsylvania State University with Interdisciplinary Honors and High Distinction and holds a B.S. in Finance with a minor in International Business, B.S. in Accounting, and Master of Accountancy. She is a CFA charterholder and member of the CFA Institute, a LEED Green Associate, and a member of the ULI San Francisco Sustainability Committee. She currently serves on the Board of Directors for Green Building United, the Penn State Smeal Sustainability Advisory Board, and the FTSE EPRA Nareit Americas Regional Advisory Committee

Rob Holuba
Managing Director, Private Real Estate

Rob Holuba serves as a Managing Director for CenterSquare's Essential Service Retail (ESR) Strategy. In this capacity he is responsible for leading all aspects of ESR equity and debt investments including the sourcing and acquisition of new investments, implementation of business plans, leasing agents and other third-party resources, and dispositions.

Prior to joining CenterSquare, Rob worked for Lubert-Adler Real Estate Partners performing acquisitions and investment management functions on behalf of the Lubert-Adler Real Estate Funds. Rob began his career at Apartment Investment Management Company (ticker: AIV) where he worked with the development finance team.

Rob holds a B.A. in History from Princeton University and an MBA from the McDonough School of Business at Georgetown University. He is an active member of ICSC and NAIOP and currently serves on CenterSquare's Private Real Estate Equity Investment Committee, the Associate Advisory Board for the Steers Center for Global Real Estate at Georgetown University and the Board of Directors for the Princeton Football Association.

About CenterSquare

Founded in 1987, CenterSquare Investment Management is an independent, employee-owned real asset manager focused on listed real estate, private real estate equity and private real estate debt investments. As a trusted fiduciary, our success is firmly rooted in aligning our interests with those of our clients, partners and employees. CenterSquare is headquartered in suburban Philadelphia, with offices in New York, Los Angeles, London and Singapore. With approximately $12 billion in assets under management (September 30, 2023), our firm and subsidiaries are proud to manage investments on behalf of some of the world's most well-known institutional and private investors.

For more information, please contact:
CenterSquare Investment Management, LLC
630 West Germantown Pike
Suite 300
Plymouth Meeting, PA 19462
contactus@centersquare.com
www.centersquare.com

Follow us on social media:

CenterSquare
REAL ASSET INVESTMENT LEADERSHIP