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Real Estate Market Intelligence 2015

Retail Acquisition & Development in Primary Markets Quarterly Report–Q4

Table of Contents

1. Key Findings
2. Quarterly Transactions
3. REITs & Retail Centers
4. Market Overview
5. Outlook

1. Key Findings

- The retail industry is becoming more complex and changing at an ever-increasing speed. Shifting demographics, household downsizing, more educated consumers, new channel formats, among other trends, require that the industry quickly adjust and modify existing models, approaches and processes to satisfy the needs of future customers in order to be successful and profitable.
- Approximately 82 million square feet of retail space opened across the U.S. in 2015, yet the national vacancy rate stands at just 5.8%. An additional 83 million square feet is still under construction. Stand-alone retail buildings, small neighborhood centers, and grocery-anchored and power centers make up 76% of new construction.
- The top five markets, which account for 40% of the new construction, are northern New Jersey (with 3.3 million square feet); south Florida (3.2 million square feet); Houston (2.9 million square feet); Dallas–Forth Worth (2.7 million square feet); and Boston (2.6 million square feet). U.S. retail construction hit a peak of 261 million square feet in 2006 and declined thereafter; within five years it had dropped by about 77% to 59 million square feet.

2. Quarterly Transactions in Primary Markets

New York

- The Jackson Group acquired a five-story retail and commercial building at 712 Madison Avenue for $83 million in an off-market transaction from Duell Management Systems.
- The Vanbarton Group purchased a new two-building, 159,000-square-foot shopping center in the northwest Bronx, for $133 million. The 98% leased center is scheduled to open in January.
- The Kushner Cos. closed on its purchase of the retail condominium at the Times Square Building in New York for $296 million from seller Africa-Israel USA—which co-owns the 250,000-square-feet of retail space with Five Mile Capital Partners.
- HFF closed the $30.5-million sale of Linden Commons, a 115,500-square-foot, fully-leased retail center in Linden, N.J. Prestige Properties & Development purchased the asset. HFF marketed the property on behalf of the seller, Lamar Companies.
- Thor Equities purchased two Lexington Avenue retail properties for $75.5 million. The larger building, at 2082 Lexington Avenue, encompasses 59,000 square-feet, the second property located at 2080 Lexington Avenue, is a three-story, 44,000-square-foot building.
- Jamestown Properties purchased a 37-year master lease interest for a 32,400-square-foot retail condominium in Lincoln Square, N.Y., for more than $70 million.

California

- Westfield Corporation finalized a deal to sell its 1.1-million-square-foot Carlsbad shopping center in California to Rouse Properties for $170 million.
- Inland Real Estate Acquisitions facilitated the acquisitions of two shopping centers in California for undisclosed sums. Inland acquired Blossom Valley Plaza, an 111,558-square-foot, 100% leased shopping center from an unnamed seller and the Marketplace at El Paseo, a 224,683-square-foot shopping center, for an Inland-related party.
- Tanger Factory Outlet Centers sold five factory outlet centers in California, Illinois, Michigan and Maine for $150.7 million. The company sold the California property for $106.7 million and the other four properties for a combined $44 million.
- Acadia Realty Trust added an aggregate $55.2 million of street-retail investments to its Fund IV portfolio and pipeline during Q4. Acadia, in partnership with City Center Realty Partners acquired a 12,400-square foot, four-story building, located in San Francisco for $38 million.

Florida

- Prologis sold a three-property retail portfolio in Florida to a JV between Blackstone and DDR for $56.5 million.

Ohio

- Marcus & Millichap's Institutional Property Advisors (IPA) division arranged the sale of a two-property, 193,633-square-foot Giant-Eagle-anchored shopping center portfolio in Northeast Ohio for $27.7 million.
- Eidi Properties acquired four new shopping centers totaling 252,000 square feet in Northeast Ohio. Financial terms, nor the sellers were disclosed.
- Phillips Edison Grocery Center REIT II added four grocery-anchored shopping centers to its portfolio for an undisclosed amount. The properties are located in Ohio, Illinois and Georgia.

3. Retail REITs

Retail REIT's acquisition activity this year is down significantly compared to previous years. Year-to-date, retail sales transactions totaled nearly $59 billion, a 10% increase from the previous year, but not as strong as expected. As of early December, REITs accounted for only 22% of retail property acquisitions, a drop from the 33% of acquisitions REITs closed in 2014. Investors have shown a preference for urban street retail and grocery-anchored centers and represented the majority of deals in 2015. Investments in grocery-anchored assets made up 20% of total retail investment volume to date, reaching nearly $9 billion.

The following are the 10 REITs which build and manage malls and shopping centers in the U.S.:

- **CBL& Associates Properties**—CBL owns, holds interests in or manages more than 140 properties including market dominant enclosed malls and open-air centers from coast to coast. CBL is an active developer of new regional malls, open-air centers, lifestyle and community centers.
- **DDR Corp.**—DDR owns and manages 367 value-oriented shopping centers representing 115 million square feet in 38 states and Puerto Rico.
- **Federal Realty Investment Trust**—Federal Realty's portfolio of 90 properties are located in strategically selected metropolitan markets primarily in the Northeast and Mid-Atlantic regions of the U.S., California and Florida.
- **General Growth Properties**—GGP is headquartered in Chicago and focuses exclusively on owning, managing, leasing, and redeveloping high quality retail properties throughout the U.S.
- **Kimco Realty Corporation**—The company owns interests in 727 shopping centers comprising 107 million square feet of leasable space across 39 states, Puerto Rico, Canada and Chile.
- **Macerich Company**—A self-managed REIT headquartered in California, is the third-largest owner and operator of shopping centers in the U.S.
- **Regency Centers**—Regency owns, operates and developed 318 grocery-anchored retail centers, 19 regional offices and properties located in most major U.S. markets.
- **Simon Property Group**—A global leader in retail real estate ownership, management and development. The company has retail properties and investments across North America, Europe and Asia.
- **Tanger Factory Outlet Centers**—Owns the chain Tanger Outlets, an outlet mall company headquartered in North Carolina. The company offers 43 shopping outlet malls and more than 400 brand name factory outlet stores in 26 states coast to coast and in Canada.
- **Weingarten Realty Investors**—Encompasses the long-term ownership, management, acquisition, development and redevelopment of strategically located neighborhood and community shopping centers spread across major metropolitan markets in the U.S. The vast majority of its shopping centers are anchored by either a supermarket or a national value-oriented retailer.

Public REITs are selling more than they are buying. In 2015, REIT transaction volumes have dropped significantly in 2015. Year-to-date volumes totaled $13.4 billion, a 35.8 % decline from the same period in 2014. Net REIT acquisition activity has also dropped, reaching the first time in which REIT dispositions have exceeded acquisitions since 2009. This was notably evidenced across both portfolio and single-asset transactions year-to-date, having declined 45.3% and 1.6% respectively, year-to-date. In 2015, REITs focused on malls and grocery-anchored centers, which was a shift from previous years. In 2014, malls had the sixth highest volume, while freestanding retail assets saw volumes of over $8 billion.

4. Market Overview

- Buyers are plentiful but product is lacking. As the economy continues to approach pre-recession levels, sellers are less willing to part with core assets whose rents continue to rise. Many buyers are awaiting the potential onslaught of assets that are anticipated to hit the market in 2016 and 2017 as the last wave of peak-vintage CMBS debt matures.
- Private investors purchased the greatest percentage of retail assets in the second quarter of 2015, consistent with levels seen in the same period of 2014. This group focused mainly on urban and grocery-anchored retail properties. Investment by equity funds increased sharply—more than doubling their year-ago proportion of transaction volume, driven by a preponderance of mall purchases. Institutional investors also focused on mall acquisitions but saw a decline in activity relative to 2014 investment volume.

Top 10 States for Retail

Texas—A strong residential and a delayed retail construction cycle created pent-up demand in Houston. Today, 2.4 million square feet of retail is under construction, with 1 million anticipated to deliver in the first half of 2016.

California—Retailers are expanding operations and opening new locations due to a tight job market and rising median incomes in San Francisco. Builders were set to complete 53,800 square feet by year-end 2015, with surging demand for space and limited availability pushing vacancy rates down and the average asking rent expected to increase 12.4%.

New York—Brooklyn is booming, with demand for ground floor retail space spurring its dynamic growth. In Manhattan, ground floor asking rates for retail increased across the board. The Meatpacking District corridor saw a 10% increase.

Florida—New retail development is picking up considerably from Orlando to Miami, with vacancy rates hitting 3.3% in Miami and 6.5% in Orlando. Retailers are starting to adapt their store formats for ever-popular town centers.

Illinois—Restaurants and grocery stores are driving Chicago's retail market, with vacancy decreasing and rents climbing.

North Carolina—Charlotte market trends data indicates an increase of 7.4% in the median asking price per square foot for retail, compared to the prior three months.

Pennsylvania—Retailers are responding to Pittsburgh's job growth in medicine, technology and energy industries. Drugstores, grocery stores and discount retailers will push net absorption above 1 million square feet during 2015 for a third consecutive year. Vacancy will tighten further on strong net absorption this year, and quality space will become increasingly difficult to find as the pace of development slows.

Ohio—Statewide, power centers—large (250,000 to 750,000 square feet) outdoor malls with a mix of big box and small retail—performed best with a positive net absorption of 18,703 feet and an overall vacancy rate of 7.7%.

Georgia—Showed a 3.3% net absorption and dropping vacancy rates. New developments like Ponce City Market and the Braves Stadium are sparking new interest, and fresh-air grocers and big box outdoor stores are filling large spaces.

Massachusetts—There is little vacancy and lots of demand, particularly from fast casual restaurants, grocery retailers, and big box tenants who are entering urban and upscale suburban areas with smaller footprints.

5. Outlook

Trends to Watch—Retailers spinning off assets into REITs

Soaring commercial property values in the U.S. are encouraging a number of retailers to spin off their real estate assets into REITs.

- Retailers are taking advantage of the economic climate and extracting value from their real estate holdings and despite U.S. tax authorities looking to curb tax exemptions of REITs, there are still plenty of benefits for retailers. REITs can release significant sums of cash, which can be used to pay off debts, and they also release retailers from their property management duties. And while retailers must invest at least 75% of their total assets into real estate assets and cash, they consequently receive a higher return on their investments than they would if these assets remained part of their operating business. REITs also increase the financial returns for the investors, potentially giving a boost to a company's struggling stock prices.
- However, spinning off real estate assets isn't always encouraged when looking from the long term perspective. Apart from the burden of paying rent, REIT conversions can have negative credit implications for issuers. With increased investor activism, retailers are taking a hard look at where they can increase capital through renegotiating existing lease and option rates, devising strategic sale/leaseback programs or, in some cases, divesting their real estate into a REIT. With average market rents on the rise, divestiture is a truly short term solution with lasting effects as retailers may find themselves locked into market lease rates which may be well above their current lease rate.

Trends to Watch—Adapting Retail Spaces and E-Commerce

The weak bricks-and-mortar shopping climate is forcing landlords to think outside the box. Finding use for older retail space and adapting to the surge in e-commerce will be an ongoing trend to watch.

- The era of expanding American shopping centers is coming to an end as the rise of e-commerce and retailer bankruptcies force landlords to reimagine once-lucrative properties. Some owners are converting struggling malls into apartments, offices and industrial space, while others are turning big chunks of retail space into parks and playgrounds to keep shoppers interested.
- At the end of 2015 there was 48.3 square feet of retail space per person in the U.S., down from the record of 49.8 set in 2009, according to real estate data firm CoStar Group. The decline has affected most categories of retail real estate, including strip centers and convenience stores, local shopping centers and large malls.
- Online shopping has more than doubled its share of all sales, from 3.6% in Q3 2008 to 7.4% in the same period of 2015. The shrinkage could pose problems for retailers as well by pushing up rents for existing space, sparking increased competition for prime locations and forcing retailers to become more efficient about the space they use.

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5. Outlook *(continued)*

Secondary Markets and Retail Growth

- Secondary markets will be more compelling than gateway markets, according to PwC's *Emerging Trends in Real Estate 2016* report. The report states this will be particularly true for retail properties, which benefit from the lower cost of living afforded in non-gateway markets. Secondary markets such as Austin, Portland, Nashville, Charlotte and similar cities tend to boast lower costs of living and strong growth potential.
- Secondary and tertiary markets continue to be more attractive on a relative opportunity basis than some of the gateway cities. Markets such as Nashville, Charlotte, Indianapolis, Louisville, Portland, Austin, Raleigh, Durham, continue to attract lots of people.
- The potential investment for retail properties in secondary markets is nearly double that of the big six gateway markets which include New York, Boston; Washington, D.C., Seattle, the Bay Area and southern California, as pricing becomes a challenge for gateway markets. From June 2014 to June 2015, property values increased 13.5% in non-major markets, more than double the 6.5% growth in major markets. Global investors are now casting wider nets as they look at U.S. real estate markets.
- While demand for office and industrial can be thin in secondary and tertiary markets, retailers can make a good profit in smaller markets. Investing in these markets provides diversification for investors.