Retail Real Estate Quarterly Summary Report–Q1 2015

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1. National Market Trends

- As more millennials move into urban areas, a fair amount of urban retail units are being acquired by investors, according to Auction.com's EVP Rick Sharga. The firm recently reported closings on $52 million in retail properties, giving the retail sector a lead in deal volume for a second consecutive month (February and March). Because of store closings by companies like Radio Shack, Sears and Walgreens and the effect of e-tailing on these stores, more existing structures are being repurposed into multi-use facilities. Investors are picking prime locations or types of businesses likely to be more successful in today's economy, like food, entertainment, office and even residential opportunities in what had been strictly retail in the past. There has been an increase of retail conversions into other, more profitable uses. If the demand continues, there may be a strength in pricing as the year goes on.
- Shopping centers across the U.S. posted an average occupancy rate of 92.7% at the end of Q1 2014, the highest level since 2008 and shopping plaza base rents jumped by 6.5% on a year-over-year basis in 2014. The International Council of Shopping Centers partnered with the National Council of Real Estate Investment Fiduciaries to determine the property data results for retail centers in America and found strong growth in the U.S. shopping center industry with year-over-year growth in occupancy rates, tenant rents and net operating income. Net operating income in shopping centers and malls across the country saw the highest growth rate from 2013 to 2014, with a 17.5% increase in operating income which reached $28.62 per square foot.
- Mall-focused REITs and others are increasingly partnering with nonbank capital providers like pension funds for JV acquisitions—partnerships that provide real estate companies with access to cash, and capital providers with mall-management expertise. Malls in key areas that have high-quality tenants are continuing to trade at relatively high prices because investors favor such assets over smaller regional malls in secondary and tertiary markets. But with a relatively small number of such trophy malls on the market, investors are increasingly on the hunt for capital providers to go in with them on deals, and capital providers are more than happy to gain the expertise of mall companies, should the property and location be desirable. Nonbank capital providers can be as varied as pension funds, insurance companies and private equity funds

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although lawyers say pension funds in particular have been active in partnering with real estate companies on mall acquisitions. By partnering with capital providers, mall companies are able to diversify their assets and broaden their portfolio. Likewise, such partnerships provide capital providers with exposure to quality real estate assets and investment returns.

- According to Preqin, private real estate fundraising had its most successful quarter in two years, with 24 private real estate funds reaching a final close and raising $29 billion in institutional commitments. More and more though, that capital raising is becoming increasingly concentrated among the largest players, says Prequin. The 24 funds closed in the first quarter compared with an average of 52 funds closing each quarter in 2014 and an average of 62 each quarter in 2013. In addition, a big chunk of the first quarter capital raised for real estate investment was by The Blackstone Group's Blackstone Real Estate Partners VIII (BREP VIII), which at $14.5 billion became the largest private real estate fund ever raised. The Blackstone fund is expected to raise another $1.3 billion from retail investors, according to Preqin.
- Rising rents and low vacancies with lagging new supply have ignited a booming trade of industrial properties around the U.S. Despite the country's moribund economic output in Q1, overseas buyers looking for safe havens are more aggressively targeting U.S. industrial assets, which include warehouses and "flex" buildings that typically feature offices or showroom areas in addition to warehouse, research and development, or manufacturing space. Not only are buyers from Asia and Europe displacing Canada as the biggest group of foreign investors in U.S. industrial deals, but cross-border capital generally is also spreading more cash beyond primary and secondary markets, according to a recent report from JLL. With the expected completion of 171 million square-feet of new industrial space in 2015, following 142 million square-feet built in 2014, supply is still below the annual average of 184 million from 2004 through 2008.
- Investors are buying apartment properties in big numbers in smaller cities and towns. Investors bought $16.2 billion in apartment markets in secondary and tertiary markets across the country in the first quarter of 2015, according to New York City data firm Real Capital Analytics. That's a higher volume of transactions than the $12.3-billion investors bought in the six major metropolitan areas over the same period. Property prices are also rising quickly in secondary and tertiary markets, especially relative to the rents at the properties. The average price per apartment in tertiary apartment markets rose 23% to an average price of $75,344-per-unit during the year that ended in the first quarter. Detroit is the top city on the index, with a five-year average cap rate of well over 9%, followed by Cleveland, Pittsburgh and Indianapolis.

2. Leasing Trends

- Private buyers took over the retail net lease market, representing the majority of deals closed in 2014, with private investors accounting for 60% of the net lease market last year. The supply-demand imbalance is proving this is an ideal time to be a seller of net lease retail properties, as there is far more demand than supply, especially for newly constructed assets. Very few new shopping centers, power centers or malls have been constructed in the past few years, which means fewer outparcels are being developed.
- National Retail Properties primarily executes closings directly with tenants, either in the form of sale leasebacks of existing stores or development funding for new units. In 2014, the company invested $618 million in 221 retail properties. Of the 54 separate closings the REIT executed in 2014, 34 were for less than $5 million. National Retail Properties currently owns 60 properties in Ohio that have a 3.33% of Portfolio Base Rent.
- Leasing in New York is a rich niche, as fewer buildings are being raised and more spaces become empty due to rent increases, e-commerce and taxes. However, leasing is the constant that keeps SL Green busy. The company which owns 75 office and retail properties across Manhattan, Brooklyn, Westchester, Connecticut and New Jersey, offering more than 25 million square feet of space, secured 44 Manhattan office leases totaling 466,248 square-feet in the first quarter.
- Historically, PE firms focused their cost cutting on labor expenses or the cost of goods and didn't focus on lease obligations, especially occupancy costs. However, with lease obligations typically being the largest off-balance sheet liability, and in many cases in an amount even greater than loan liabilities, most PE players now see the importance and are focusing on occupancy costs and lease obligations. "When deciding whether to invest, PE firms are beginning to place a heightened emphasis on the lease cost, lease term and remodel status of the assets they are acquiring, as opposed to more traditional factors such as location or operational success," said Tom Mullaney, a principal with Huntley, Mullaney, Spargo & Sullivan, a lease and debt restructuring firm whose clients include several PE firms.

3. Major Industry Transactions

- Pennsylvania REIT and the Macerich Company are set to begin a $235-million redevelopment project to transform The Gallery mall in Center City Philadelphia, Pa. The REITs said The Gallery will be rebranded the Fashion Outlets of Philadelphia at Market East after a top-to-bottom redesign, pending approvals. The Gallery is owned 50-50 between the two REITs.
- Hudson's Bay Company is forming two new companies that are valued at a total of $3.4 billion. The companies will be positioned for an IPO and will look to purchase more real estate. The Canadian company is contributing 42 properties to a retail venture it is forming with Simon Property Group, which will be valued at $1.8 billion. The second venture, with Canadian-based RioCan REIT, will focus on growth opportunities in Canada and will be valued at $1.6 billion.
- O'Connor Mall Partners formed a JV with Washington Prime Group, helping O'Connor take a stake in five malls valued at roughly $1.62 billion. The joint venture will see O'Connor take a 49% stake in the malls, which are located across the U.S. That pegs O'Connor's investment, prior to assumption of debt, at roughly $796 million.
- Calloway Real Estate Investment Trust purchased SmartCentres for $1.16 billion and plans to change its name to SmartREIT. The deal will create one of Canada's largest retail landlords. The REIT will acquire 24 shopping centers, mainly in Ontario and Quebec, Canada. The properties are 99.7% occupied. The deal also includes nearly two million square-feet of development space.
- Westfield Corp. entered into a $925-million JV with O'Connor Capital Partners, agreeing to sell a 47.4% stake in three U.S. shopping centers. The three regional shopping centers include the Westfield Palm Desert in California, the Westfield Trumbull in Connecticut and the Westfield Wheaton in Maryland. The malls have a combined 3.7 million square feet, leased at an average of 96.6%. Westfield will continue to be the property and leasing manager and the developer of the properties. The developer expects to realize approximately $700 million in net proceeds from the deal.
- Excel Trust agreed to be acquired by Blackstone Property Partners in an all-cash deal worth $2 billion. Excel Trust mainly prefers the West Coast, East Coast and Sunbelt regions. The company's portfolio is made up of community and power centers, grocery-anchored centers and freestanding retail properties. Blackstone, which has been active in the retail sector recently secured a $600-million loan for a Florida developer turning a warehouse district in Miami into a premier luxury retail destination. Blackstone will hold a $100-million mezzanine portion of the loan with the Bank of China providing $250 million. Design District Associates are building 1.2 million square-feet of retail space across 20 buildings, where a little less than half of the neighborhood's expected 120 stores were open at end of 2014. The total value of the project, including existing equity, is $2.2 billion. The project is expected to be completed by 2016.

- Senior Housing Properties Trust closed on 37 of 38 senior living communities it acquired from CNL Lifestyle Properties for $763 million. The deal with CNL is expected to total $790 million, once the last lease community is purchased for $27 million. The portfolio consists of about 3,500 units located in 16 states.
- Blackstone Group sold more than 4,600 U.S. apartments for more than $650 million to Strata Equity Group and investors from Mexico. The company is capitalizing on strong demand for rental housing as it begins investing in a new global property fund. Strata plans to renovate most of the 12 apartment complexes, which are located in Atlanta, Denver, Houston and Austin, Texas. Blackstone has been selling assets from its 2012 fund, Blackstone Real Estate Partners VII, as it begins investing in its new fund, BREP VIII.
- QTS Realty Trust acquired Virginia-based Carpathia Hosting for $326 million. Carpathia is a colocation, cloud and managed services provider that offers security and compliance solutions to enterprise customers and federal agencies. The combined companies will service more than 1,000 customers in North America, Europe and Asia Pacific. QTS currently operates 12 data centers in eight states and owns, operates and manages approximately 4.7 million square feet of data center infrastructure.