FEATURES

Hiding in Plain Sight

How Retail's Strength Is Masked by a Relatively Few "Failed" Centers

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Abstract: *The strong and improving performance of most retail centers is masked by the extremely poor showing of a relatively few failing centers. Almost 8% of the retail stock is redundant or obsolete, as evidenced by enduring vacancies of 40% or more, while another tenth is on the cusp, with vacancies of 20% to 40% and unlikely to recover. Excluding these centers reduces the measured vacancy rate significantly, while providing a more accurate view of industry performance and showing less volatility over the business cycle.*

Introduction

For years, real-estate economists and other commentators have been decrying a purported surplus of retail space in the United States. Such claims are not new, but seemed to gain greater currency during the last real-estate expansion as the inventory of retail space mushroomed. Shopping-center space actually grew 2.5 times as much as population in the 15 years through 2008, as total gross leasable area (GLA) grew 45%, while the U.S. population rose only 18%. As a result, per capita GLA grew from under 20 square feet (sf) in 1993 to over 24 sf in 2008. By sharp contrast, the amount of shopping-center space in Europe is only 2.4 sf per capita—less than one-tenth the amount in the U.S.[1]

Overbuilding clearly has played a role; the inability or unwillingness of many owners to demolish obsolete space is perhaps even more important. Moreover, since the 2007-09 global financial crisis, the impact of two other forces has been felt: 1) the growing migration of retail sales from brick-and-mortar stores to online retailers, and 2) new locational strategies from physical retailers that call for fewer and smaller stores, further reducing the need for retail space.

But how much is too much? How much space is obsolete? One difficulty for real-estate analysts and investors is that retail space cannot be graded primarily on the basis of physical quality, whereas property in other sectors can be quickly (if imperfectly) sorted by style and quality of construction (Class A, Class B, etc.). Rather, the quality of a center depends on other, more subjective factors such as tenant roster, location and market share—factors that are difficult to quantify on a mass scale. Thus, all retail space is lumped together in standard industry data, distinguished only by type of center (e.g., power vs. community).

Just as including Class C office in a pool of office buildings would distort market data for the Class A office space, so, too, this aggregation of all shopping centers yields misleading metrics. Many obsolete centers are no longer competitive, or able to attract shoppers or tenants. However, though these centers cannot be identified by physical characteristics, a compelling alternative still exists: *market performance*.

The True Fundamentals of Shopping Centers

In fact, more than 70% of shopping centers are quite healthy, with vacancies pegged at less than 10%. These centers are succeeding—they are economically viable and rents are either stable or rising. While having almost three-fourths of the total GLA, they have less than one-fifth of the vacancies. (See Chart 1-1). Another 11% of shopping centers have vacancies between 10% and 20%. These centers are struggling; as much as one-fifth of the space cannot attract new tenants or customer traffic, severely handicapping prospects for success. Many of these struggling centers are victims of continued tenant consolidation and, more acutely, the mismatch in the size and quality of expanding vs. shrinking tenants.

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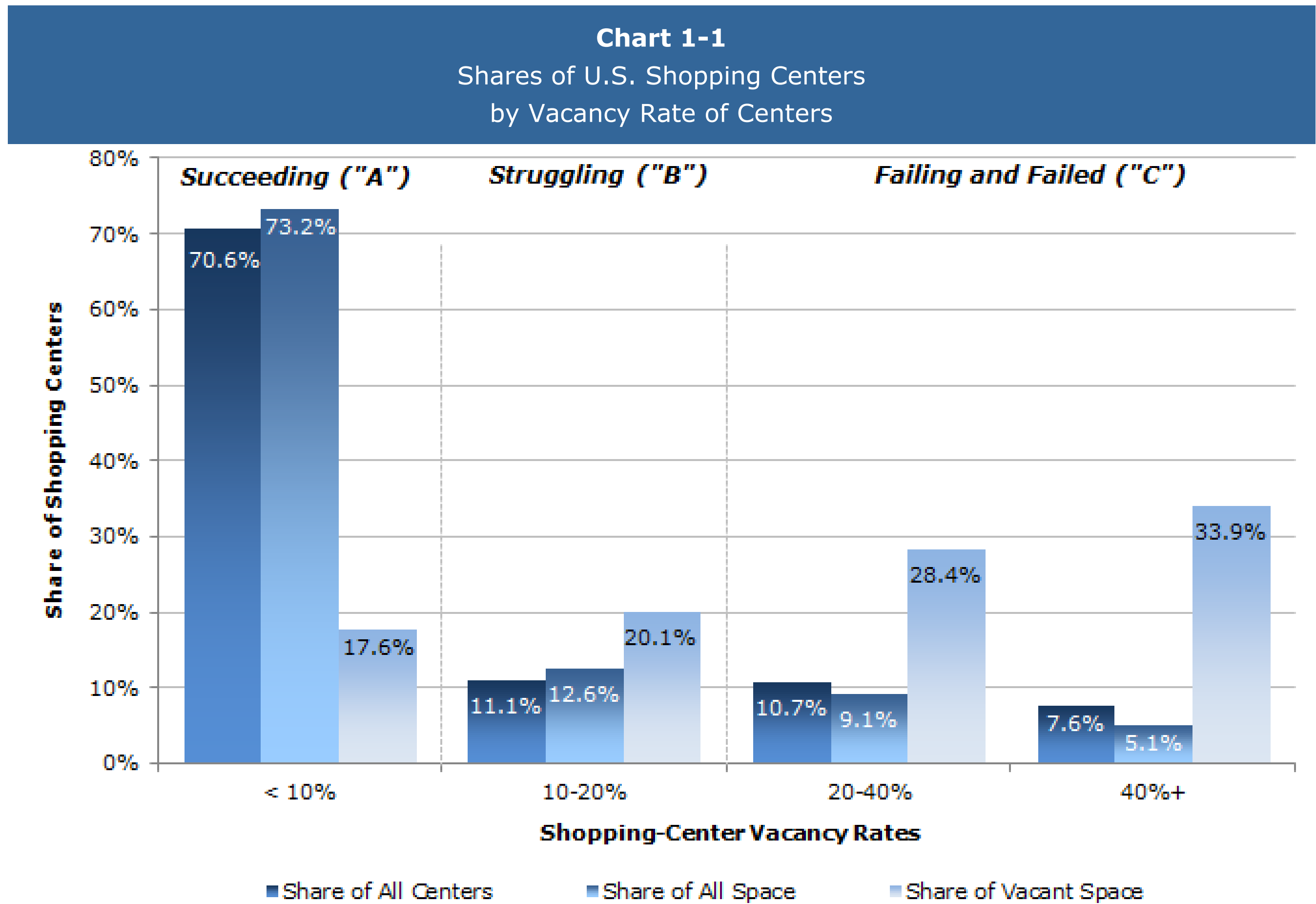
[1] U.S. figures based on data from "U.S. Retail Real Estate Industry: Size, Shape and Scope – The 2009 Industry Census," *Retail Real Estate Business Conditions*, Vol. 6 (No. 9), April 17, 2009. European data from ICSC Research, *The Importance of Shopping Centres to the European Economy*, The European Shopping Centre Trust and ICSC Europe, New York, March 2008.

Chart 1-1
Shares of U.S. Shopping Centers
by Vacancy Rate of Centers



Sources: CoStar, PPR, Deutsche Asset & Wealth Management; data as of Q4 2012

Unfortunately, this imbalance is not expected to correct soon as downsizing store counts and sizes by national tenants will persist.

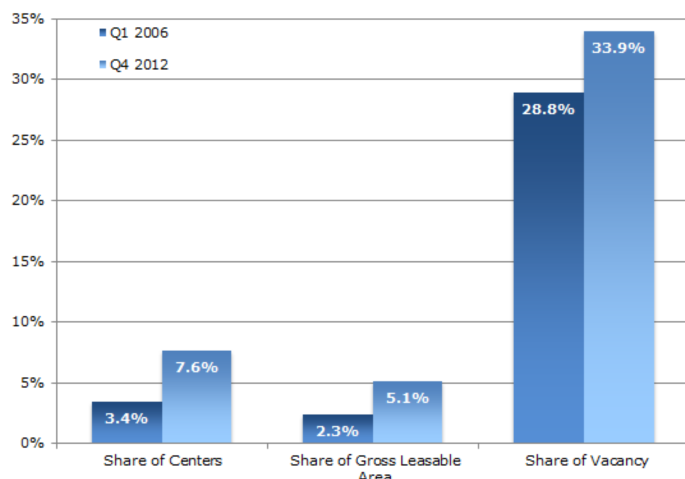
Meanwhile, 11% of centers are failing, with vacancies between 20% and 40%; their share of vacant space (28%) is three times their share of total shopping area (9%). The final 8% of centers is clearly redundant, as evidenced by enduring vacancies of 40% or more.[2] With barely 5% of the country's shopping-center space, these centers account for more than one-third of the vacant space nationwide. For all intents and purposes, these assets have failed; they are often functionally obsolete, and cannot compete for other tenants or shoppers. No one wants to shop at a half-vacant center, and no retailer wants to invest its resources or reputation in such a failure, no matter what the rent. Only a massive repositioning could bring them back into the competitive inventory. While not impossible, truly successful turnarounds are rare. More likely, the space should be razed in favor of alternative uses. But owners are usually slow to act, deterred by lack of capital, resistance from tax-hungry city governments, lease obligations, or just inertia. The unwillingness or inability to act delays the inevitable—often for years or even decades—and inflates measured vacancy rates for the sector.

The market is unforgiving to weaker tenants or shopping centers in the retail sector—constant shifts in consumer preferences and technologies cause a relentless birth/death cycle for both tenants and centers. But this process has been aggravated by the recession, over-expansion by retailers during the housing boom, and technological innovation in the way consumers shop. These three forces have accelerated the number of centers entering the failing/failed category. In fact, in 2006, less than 4% of all centers had vacancies of more than 40%; today, it is almost 8%. Similarly, in 2006, only 6% of centers were failing (vacancies between 20% and 40%) compared to 11% today.

What is so striking about the weak end of the spectrum is the disproportionate share of vacancy held there; fully one-third of all vacant space exists in the "failed" cohort. (See Chart 1-2). Excluding this space from

[2] Note that these figures include only operating centers and exclude centers under construction or renovation.

Chart 1-2
U.S. Shopping Centers
With 40% or More Vacancy



Sources: CoStar, PPR, Deutsche Asset & Wealth Management

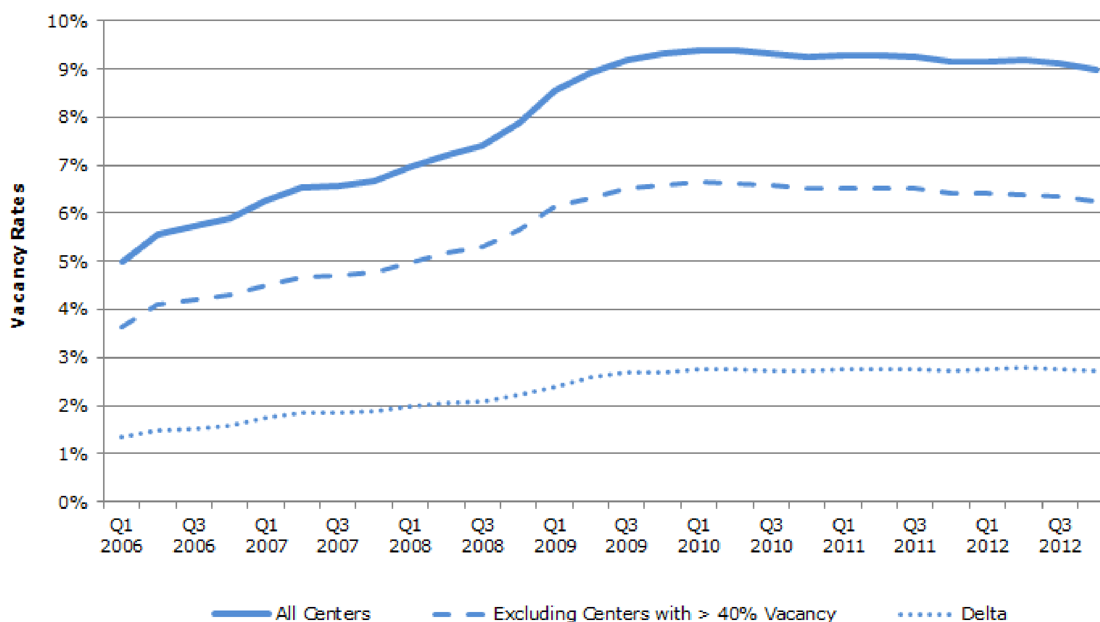
calculations of competitive vacancies reveals a far more sanguine picture in which the vacancy rate drops to 6.3% from 9.0%. (See Chart 1-3).

Similarly, the total increase experienced during the recession shrinks to less than 175 basis points (bps), compared to over 260 bps for the broader inventory. The gap between these two measures of vacancy has doubled since 2006, climbing from about 140 bps to 280 bps (it is currently 273 bps). Significantly, the gap was increasing even during the frothy years of the expansion (2006-08), suggesting that even before the recession hit, the other two forces of excessive supply and technological advancements were separating the winners from the losers. The recession only accelerated those forces, and the performance gap has endured during the early stages of the recovery. This trend helps to explain why these failed centers have not and will not come back—that oversupply and technology have forced an unprecedented retrenchment in the retail sector. The result will be structurally lower inventory per capita, reversing a 30-year upward trend.

Differences by Center Type

Often unanchored, open-air centers have been hard hit over the past six years, as over 8% of centers have "failed." This is not surprising when the "mom-and-pop" tenancy of these centers is considered. Lacking national credit tenants who could better weather the contraction, local tenants often relied on home equity lines as a source of working capital for their retail business. These lines were too often pulled by nervous banks eyeing evaporating equity, and these retailers were quickly forced out of business. With home equity lines only now (seven years on) starting to grow again, few new "mom-and-pop" retailers have emerged to take these shuttered locations.

Chart 1-3
Total and Adjusted Vacancy Rates, U.S. Shopping Centers, 2006-2012



Sources: CoStar, PPR, Deutsche Asset & Wealth Management

Table 1-1
Vacancy Rates by Shopping-Center Type (as of Q4 2012)

	All	Lifestyle	Power	Neighborhood	Community	Strip	Malls	Other*
Centers with Vacancy > 40%	7.6%	4.2%	2.1%	7.3%	5.4%	8.3%	2.9%	7.9%
Increase since 2006	+4.2pp.	+2.5pp	+1.3pp.	+3.7pp.	+2.4pp.	+4.8pp.	+2.1pp.	+4.8pp.
Share of All Centers (Count)	100.0%	0.4%	1.8%	28.5%	8.4%	59.1%	1.3%	0.5%
Share of 40%+ Vacant Centers	100.0%	0.2%	0.5%	28.2%	6.1%	64.0%	0.5%	0.5%

* Includes theme/festival and factory outlet centers, and airport retail
Sources: CoStar, PPR, Deutsche Asset & Wealth Management

Neighborhood centers similarly suffered, losing many local in-line tenants, and today, 7.3% of this segment's centers have "failed." (See Table 1-1.) The reason for this is more than the fallout from the last recession. It is largely due to competitive pressures in the grocery industry; grocery stores often anchored neighborhood centers. Groceries have emerged as the bulwark in combating declining traffic volumes due to increased online shopping. As such, there has been a rapid expansion in the amount of floor space devoted to food and personal-care items by non-traditional grocery, including aggressive unit growth by Wal-Mart and Target, in addition to specialized niche players like Trader Joe's, that have far smaller prototypes than traditional supermarkets. With the growth in the space devoted to food items far outpacing population growth, traditional grocers are getting squeezed, and 2013 will be a year of more consolidation—bad news for marginal neighborhood centers.

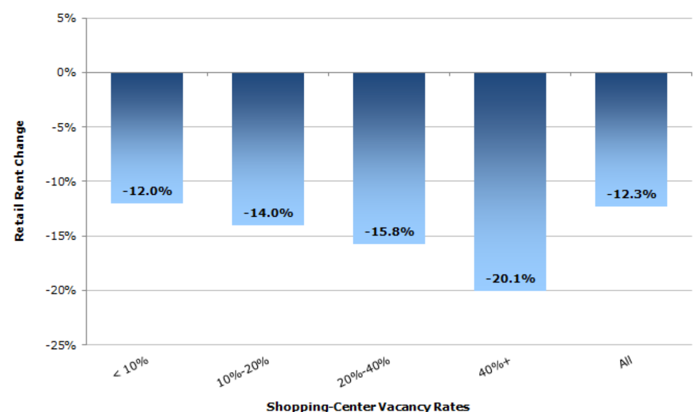
Malls, on the other hand, were only mildly hit, with under 3% of the inventory carrying vacancies of more than 40%. Surely the selling of "B" and "C" assets by the top REITs demonstrates that some malls should never have been built for the long-term. Still, the depth and quality of tenants that locate in malls predispose these centers to success and better insulates these assets from new competition.

Rent Levels and Growth

Disaggregating the retail sector data also yields new insights into rent dynamics. Both rent levels and rent changes are highly correlated with the occupancy levels of shopping centers. In short, the obsolete centers with the highest vacancies have the lowest rents and have seen the greatest rent declines in recent years, while superior centers command higher rents, experienced smaller rent declines during the recession, and now are demonstrating greater rent growth. Retail rents overall declined 12% from the peak to the trough, as observed in Chart 1-4. The declines are much greater at centers with high vacancies. Centers with at least 40% vacant space have seen asking rents decline 20% from peak, while centers less than 10% vacant saw rents drop only 12%.

This bifurcation helps explain the stubborn lack of rent growth momentum since the recession. The reality is that most centers started to see rent growth one to two years ago, but obsolete centers continue to drop rents in their unsuccessful attempts to lure new tenants and help support failing tenants. As with vacancy rates, the extremely poor showing of a relatively few failing centers is masking the improving performance of most centers.

Chart 1-4
Peak-to-Trough Retail Rent Changes by Vacancy Rate of Shopping Center, 2006-2012*



* Two-quarter moving averages
Sources: CoStar, PPR, Deutsche Asset & Wealth Management

Conclusion

The retail sector is going through a period of consolidation brought on by rapid technological change and excessive building during the housing boom. But rather than dragging all centers lower, stronger tenants are consolidating into better locations, fortifying these assets and creating a bigger gulf between the weak and the strong. With online spending growing at a double-digit pace, it is hard to see these weaker centers emerging intact. Rather, these properties should be converted into alternative uses (including heavily service-oriented centers). Absent this needed house cleaning, industry data will remain misleading and understate the performance of market fundamentals in the sector.

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