The New Urban Frontier

Technological, Demographic and Social Changes Are Refocusing Demand for Retail Space

ANDREW J. NELSON* and ALAN BILLINGSLEY**

Abstract: *Retail markets are being transformed by a confluence of new retailing technologies, dramatic shifts in the U.S. demographic profile and evolving locational preferences of more affluent and educated shoppers. The net impact of these forces over the coming decade will be an increasing concentration of retail sales in urban and inner-suburban locations, while exurban and most suburban areas will see diluted retail strength. Urban retailers will gain because more shoppers will reside, work and recreate in downtown and other urbanized locations than previously, and also because consumers will seek more specialized types of goods and services these urban stores offer relative to the more commodity-driven suburban retailers. High-street and mixed-use retail should prosper while suburban shopping centers suffer, particularly those in secondary locations or with inferior tenant rosters.*

Introduction

U.S. retail markets since World War II have been dominated by the birth and growth of suburban shopping centers, paralleling the migration of middle-income and affluent households from cities to their suburbs. The housing bubble in the past decade extended these patterns, but the subsequent housing crash beginning in 2006 revealed changes in lifestyle preferences that have been taking place. With these trends as a foundation, we are now witnessing a variety of complementary demographic, technological and sociological forces that are shifting retail back to the urban street retail[1] of metropolitan areas.

There is a promising future for urban street retail in mixed-use environments, due to shifts caused by both these technological and demographic forces. Led by the *Echo Boomers*, all generations will increasingly prefer to live close to their jobs and urban amenities, including retail, entertainment and cultural facilities. This will create pricing pressure on the more desirable urban and inner-suburban communities, thereby attracting the more successful and affluent of each generation—the very demographics most coveted by retailers and retail space owners.

Meanwhile, technology is both enabling and encouraging new retailing business models at the same time that the recent financial crisis forced households to deleverage and rethink their shopping habits. These changes are providing new opportunities for dynamic retailers and retail-property owners alike, but also raise new challenges for tired retail concepts and inferior retailing locations.

While the retail sector overall is firmly on the mend as the economy improves, there is considerable and growing variation underlying the recovery, with some segments and metros in full recovery while others suffer lingering vacancy and declining rents. While not always obvious, e-commerce and demographic changes are key drivers of these trends, to the general benefit of urban retail over suburban. The balance of this paper considers some of the key technological, demographic and socio-economic forces affecting retail in greater detail. With a focus on assessing implications for retail-space markets, it concludes with analysis of these trends on intra-urban market dynamics.

Technological Innovation

Just as retailing is finally recovering from the devastating recession, retailers and landlords are facing a new set of challenges as Internet technology is transforming both consumer behavior and retailing business models. E-commerce[2] is upending traditional retailing strategies by greatly expanding shopping convenience, selection and affordability. On top of this, mobile shopping, though in the early stages of adoption, is enhancing product and price transparency, often to the competitive disadvantage of physical retailers.

* Director, RREEF Real Estate Research

** Retired; former head, RREEF Real Estate's Research team for the Americas

[1] In this context, "urban street retail" refers to higher-density, walkable live-work-play environments, whether in downtown, neighborhoods or in older inner suburbs.

[2] E-commerce (e = electronic) refers to on-line shopping generally, especially via computers, while m-commerce (m = mobile) refers specifically to mobile shopping via smart phones and tablets.

To some extent, these issues are not new.[3] The difference now, though, is that e-commerce constitutes a much larger share of the retail sector, with little doubt that it is growing largely at the expense of traditional bricks-and-mortar retailers. Plus, the move toward online transactions is accelerating as the industry is still struggling to regain its footing after the recession. Consumers are changing where, how, when and even why they shop, forcing bricks-and-mortar retailers to rethink the role of stores in their platform and leveraging technology to reach their customers faster, easier and cheaper.

The implications for the retail sector are numerous, with deep and pervasive impacts for shopping centers and physical retailers.[4] One clear impact is the channel shift of retail sales away from traditional retailers and toward "pure-play," Internet-only retailers with no physical presence (such as Amazon and eBay) and the Internet divisions of "multi-channel" retailers with both e-commerce and physical stores (such as Best Buy and Wal-Mart).

The online share of retailing has grown steadily in the last decade, but remains low, accounting for only about 5% of non-auto sales. However, the online penetration rate varies significantly by retail segment, with the e-commerce share rising to over 10% excluding the types of goods (groceries, personal care items, etc.) that are less amenable to online shopping.

Moreover, e-commerce is on the verge of much greater growth: Capital for new shopping applications ("apps") is flooding e-commerce channels just as consumer adoption of mobile tools—smartphones and tablets—is soaring. The result will be *significantly greater rates of at-home online shopping and in-store "showrooming."* Online sales are expected to double their market share within five years.[5]

The greatest and most direct impact will be on the retailers selling merchandise. This business will quickly migrate online, particularly for stores and chains that do not have a significant, competitive e-commerce strategy of their own. This merchandise falls into two broad categories: products with a high value relative to shipping costs, and commodity items in which the products are relatively undifferentiated or easily compared online, making price the key determinant in the shopping decision. With online retailers able to offer greater convenience and more selection at lower prices, big-box retailers will be at greatest risk. In turn, *the real-estate impact will be felt in the power centers that house these big-box retailers.*

A less direct, but potentially greater, impact will be felt at the nation's marginal centers, particularly those in secondary locations. Retail chains are reducing store counts and sizes in response to financial pressures as well as the opportunities offered by emerging technologies and consumer trends. For the last generation, chains put market share ahead of profitability in hopes of reaching scale and segment dominance, but this expansion was not sustainable. Store sizes also ballooned in the belief that the greater selection of goods would disproportionately capture sales. No longer. Chains began closing stores and abandoning second-tier locations in the last recession, driving up shopping-center vacancy rates in their wake. The new mandates are now repairing balance sheets, restoring profitability and growing sales productivity.

At the same time, technology is enabling retailers to be more efficient, generating more sales per square foot by leveraging Internet and mobile applications. Retailers often find they face only small sales losses when cutting back on the amount and range of merchandise at their stores—no need to stock every color in every size—so long as they can fulfill the delivery promise, as retailers such as Nordstrom are proving. Other chains are starting to follow suit, saving on rent, staffing, utilities and other operating expenses.

As more sales migrate online, *the impact of fewer and smaller stores will be reduced demand for retail space, even once a more robust recovery economic takes root*. Chain after chain has announced plans to close underperforming locations, pushing more sales online, while still selectively opening new stores.[6]

Demographic Changes

Significant changes in the demographic composition of the United States also will alter demand for the quantity and type of retail space and its location. While the demography of the country is ever changing in ways that

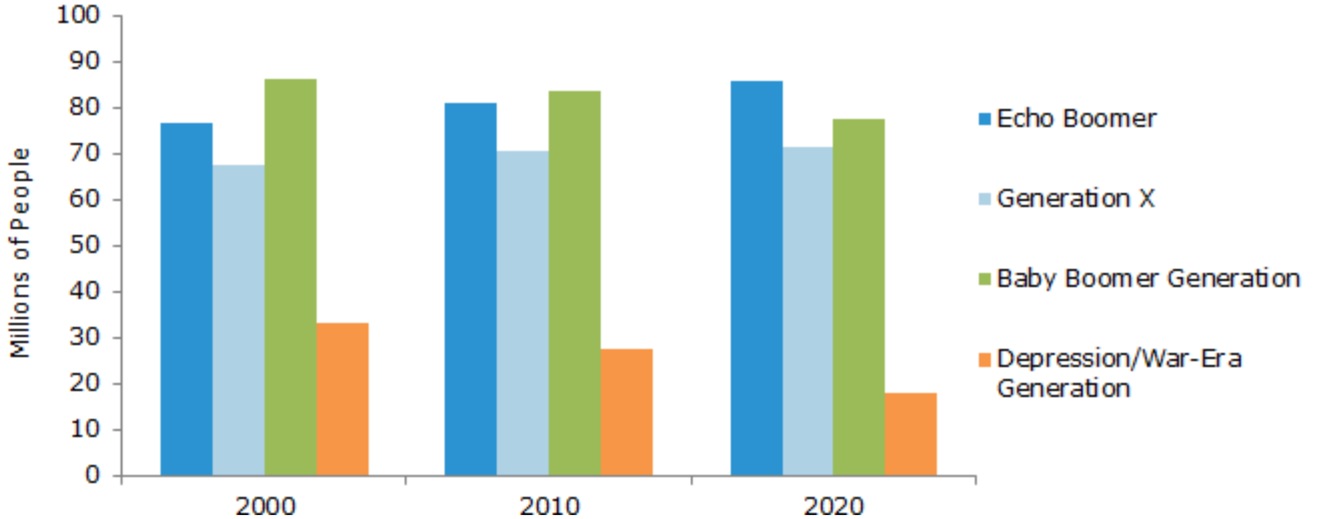
[3] Analysts have been warning about the online threat to shopping centers for over a decade. See, for instance, Chris Christensen and Mark Zandi, "Online Retailing and Its Potential Impact on Shopping Center Sales," RREEF Research, *Strategic Outlook #23*, August 1999.

[4] Conclusions in this section are drawn from a more comprehensive analysis of the Internet's impacts on retail real estate found in: Andrew J. Nelson and Ana Leon, "Bricks and Clicks: Rethinking Retail Real Estate in the E-commerce Era," RREEF Real Estate, *Strategic Outlook* #84, July 2012.

[5] Refer to Nelson and Leon for a fuller explanation of the online growth forecast.

[6] Best Buy, to take a prominent example, is closing 50 full-line stores—generally 40,000 square feet (sf) or more—at the same time they are testing new, smaller "connected" prototypes and opening many 1,000-sf Best Buy Mobile stores that focus on smartphones and tablets. Their goal is a 20% reduction in floorspace.

Chart 4-1
Generation Populations: 2000, 2010 and 2020



Source: Source: U.S. Census Bureau, 2008 National Projections

impact real-estate investment strategy, changes in the coming decade will particularly affect retailing.[7] This section will discuss these changes by major generational groups and their anticipated impacts,[8] as classified in Chart 4-1. The more affluent segments of these age cohorts all favor urban locations, although for different reasons.

The **Depression and War-Era Generation** (also known as the "Silent Generation") comprises those born in the 1930s through the mid-1940s, which was a "baby bust" resulting from a horrific economic environment in the 1930s and World War II during the first half of the 1940s, when child bearing had to be postponed to fight a war. Once past its challenging childhood and youth, however, this generation has generally been privileged, entering adulthood during the strong economic growth cycle of the 1950s and 1960s. This group benefited not only from the war rebuilding effort, but also from advances in science, technology and productivity. Given the relative small size of this generation, they were much in demand in the labor force. As a result, they saw tremendous improvements in their material quality of life.

This generation is currently aged 67 to their early 80s, and most are retired or nearly so. With childhood memories of more difficult times, this generation seeks comfort, and has generally saved and invested. Most are aging in their long-held family homes, but many have been more adventurous. Empty-nester urban or inner-suburban housing, residence clubs, condominiums associated with prestige hotels and second-home communities in mountain, desert or beachfront destinations are products that were largely invented for this generation. A portion of this generation has migrated to Sun Belt states, generally where cost of living and taxes are lower, but more importantly where the climate is more desirable. Others are choosing amenity-rich urban settings.

Though generally with the capacity to spend money, this generation also already owns most of what it wants. Therefore, spending is more targeted. They are likely to continue to support fashion retailing in stores, but also will spend generously on their grandchildren. *While the majority will age in place, a modest portion of this population will live in urban and inner-suburban environments and will contribute to retail sales in these relatively dense environments*. The remainder of this

[7] For a comprehensive assessment of the impact of demographic changes on real estate demand, please refer to Alan Billingsley and Nina Gruen, "Boomers, Echo's and X's: Generational and other Structural Shifts and Their Impacts on Future Demand for Real Estate in the Coming Decade," RREEF Research *Strategic Outlook* #81, May 2011.

[8] The generational-cycle labels are not standardized by researchers and tend to be a short-hand way of using demographics to understand different social patterns as a function of ones' era. As such, there is sometimes significant disagreement among researchers as to when these periods start and end. But all of these breakpoints for defining the periods are judgmental and some researchers, such as Jennifer Deal (*Retiring the Generation Gap: How Employees Young & Old Can Find Common Ground*, Jossey-Bass, San Francisco, 2006), suggest that these stereotypes are wrong. Deal posits from her research that "all generations have similar values; they just express them differently." Either way, these generational cycles will be used as a quick way to explore consumer impacts.

group is likely to be quite dispersed in their residential locations.

The **Baby Boomer Generation** was born immediately after World War II between 1946 and 1964, and is currently 48 to 66 years old. The oldest Baby Boomers will be in their 70s by the end of this decade. Most of this older group is likely to retire soon, producing the beginning of the largest-ever U.S. retiree cohort.

In-town living in mixed-age environments will become an even more important lifestyle for Boomers than it was for the previous generation, who largely pioneered the back-to-the-city movement for empty nesters. Still, this will be a small percentage of overall Boomers, generally some of the most affluent. *Higher-density, walkable, mixed-use suburban locations with retail, food service and entertainment activities also will attract an increasing proportion of Boomers* as they elect to trade down in size but not in amenity value, and seek a more urban setting.[9]

Generation X ("Gen X"), born immediately after the Baby Boomers, from about 1965 to 1982, is a smaller age group due to a tendency of early Boomers to postpone family formations. They are in their prime working years, 30 through 47, but grew up feeling marginalized in the shadows of the massive Boomer generation. They competed for jobs and felt stymied in advancement by the large and more senior workforce. In addition, Madison Avenue virtually ignored them, focusing on Boomers. As a result, this has been a somewhat rebellious, nontraditional generation (think "Grunge" or Rap music). However, in becoming mature adults, they will benefit from a shortage of experienced and trained labor as Baby Boomers begin to retire and as the economy adds jobs in the coming years.

A greater portion of this generation chose urban living than did previous generations, helping to expand the "urban renaissance" pioneered by Baby Boomers. While some will continue to live in urban environments, many will form households and seek more spacious quarters in the suburbs.

While Gen X will be at an age that is more interested in establishing families than the Echo Boomers in the coming generation, they are smaller in number. Gen X is also at the time in their lives when making significant retail purchases is at a high, including products for the home, automobiles, clothing for the family, etc. The volume of retail sales is expected to be restrained, however, because of the fewer number of Gen X buyers.

Members of the **Echo Boom Generation**, as noted previously, were born after 1984, and now range from their teens to 29 years old. At the mid-points of each age range, this generation (sometimes referred to as the "Millennials" or "Gen Y") is about 12% larger than the prior Gen X cohort. This demographic group began to populate colleges and universities in large numbers during the last half decade, and will continue to do so in the 2010s. At the upper end of the age range, many have entered the workforce and established independent households. The recent severe recession particularly impacted their ability to find work; many returned to their parents' homes or doubled up with friends in high-density living relationships.

The Echo Boomers will benefit cities and high-density suburban environments, as well as rental housing. With their outlook affected by the 2009 global financial crisis, this group is highly focused on career and economic growth. They are choosing to locate in cities where they believe they can best meet these goals, while also benefiting from a vibrant urban experience. Diversity of race and ethnicity is more accepted by this demographic group, particularly in large urban areas. Minorities comprise a greater share of this age cohort, and this percentage is anticipated to increase throughout the decade due to immigration.[10]

Family patterns of Echo Boomers will depend greatly on education levels. Relatively affluent professional Echo Boomers will postpone marriage to an even greater degree than their predecessors. With even more career-focused women, they also will postpone childbearing. As a result, they will have fewer children on average than did their parents.[11] This privileged subgroup of the Echo Boomer generation is expected to maintain a greater propensity to reside and work in urban environments. Given their spending power, this subgroup will have a significant impact on urban retail sales, especially for that portion of the retail market not dominated by on-line retailers.

Household composition is also evolving, across all generations. Of the household growth projected during the next decade, only around 5% will comprise traditional married couples with children. Nearly 43% of growth will come from couples without children and over 36% will be

[9] Ania Wieckowski, "Back to the City," *Harvard Business Review*, Vol. 88 (Issue 5), May 2010, p. 23.

[10] See, for instance, the Joint Center for Housing Studies, Harvard University, "The State of the Nation's Housing 2010," June 14, 2010, retrieved October 3, 2012, pp. 4-5.

[11] However, recent immigrants—particularly Hispanic immigrants—and the less educated are anticipated to have larger families into their second and third generation.

Table 4-1 Projected Share Distribution of U.S. Household Growth			
Household Status	**2011-2015**	**2016-2020**	**2021-2025**
Married + Partners, Without Children	47.7%	38.2%	28.5%
Married + Partners, With Children	2.6	8.0	11.1
Single Person	34.5	38.1	42.3
All Other Household Types	15.2	15.7	18.1

Source: Joint Center for Housing Studies, Harvard University Updated 2010-2020 Household and New Home Demand Projections

single persons. (See Table 4-1.) *With so few households involving children, demand for traditional suburban living will diminish, while urban locations will benefit.*

Indeed, the impact of these trends can be seen already. A recent study by the U.S. Census Bureau concludes that "in many of the largest cities of the most-populous metro areas, downtown is becoming a place not only to work but also to live."[12]

Socio-Economic Changes

While the changing demographic composition of the United States will have significant implications for retailing as discussed above, changing income patterns also will be determinative given the importance of income in driving retail sales. These ongoing changes are quite different among the generations, while also having impacts on each generation.

The gap in wealth between older and younger generations is widening. In a study by Pew Research, the median real net worth of heads of household 65 and older in 2009 was 42% higher than for the same age group in 1984.[13] However, for households headed by persons age 35 and younger, net worth was 68% less than in 1984.[14]

While there are many reasons for this trend, declining education relative to global competition for average Americans over the decades is a significant part of the problem.[15] And reversing long-term trends, younger Americans are much less likely than their counterparts in other countries to achieve a higher level of education than their parents. These declines in educational attainment are reflected in weak income growth. In fact, the middle class is shrinking in size.[16]

The Echo Boom Generation unquestionably includes some of the most educated and creative workers the United States has seen, yet many members of this group do not fit this profile. Still, since this cohort is quite large, even a declining percentage of economically successful workers represents a very large consumer base.

These socio-economic shifts combined with demographic changes lead to the conclusion that, while the Baby Boomers will continue to influence the retail landscape, the Echo Boomers will drive retail sales volumes during the coming decade. Though their retail needs are less than before, Baby Boomers will maintain considerable purchasing power due to their numbers and amassed wealth. Meanwhile, Echo Boomers have substantial needs, and their greater size compared to the Gen X cohort means they will disproportionately impact retail demand.

As it happens, both cohorts also favor more urbanized neighborhoods, though for different reasons. A growing share of Baby Boomers are becoming empty nesters, enabling them to downsize their living quarters and seek out more interesting living environments, without the burden of maintaining a large suburban home. At the same time, Echo Boomers are postponing marriage and

[12] "Between the 2000 and 2010 censuses, metro areas with 5 million or more people experienced double-digit population growth rates within their downtown areas (within a two-mile radius of their largest city's city hall), more than double the rate of these areas overall." See U.S. Census Bureau, "Populations Increasing in Many Downtowns, Census Bureau Reports" (September 27, 2012 press release), retrieved October 3, 2012.

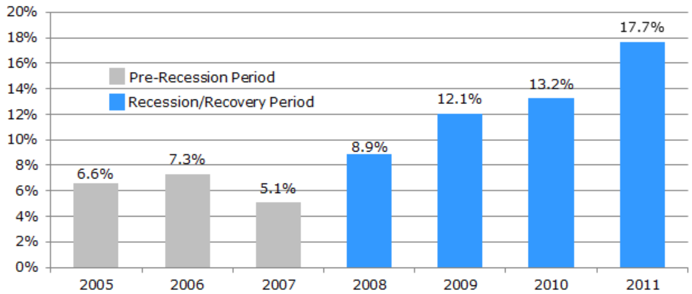
[13] Richard Fry, D'Vera Cohn, Gretchen Livingston and Paul Taylor, "The Rising Age Gap in Economic Well-Being: The Old Prosper Relative to the Young," Pew Research Center, November 7, 2011, retrieved October 4, 2012.

[14] Some of this disparity can be attributed to the disproportionate impact of the economy on the young in 2009, but Pew's research shows that this disparity has continued to rise over several decades.

[15] The United States ranked 24th out of 38 countries surveyed in the number of 15-19 year-olds enrolled in school. See "Education at a Glance 2012: OECD Indicators," Organization for Economic Cooperation and Development, September 11, 2012, Chart C1.2, p. 321.

[16] "The Lost Decade of the Middle Class: Fewer, Poorer, Gloomier," Pew Research Center, August 22, 2012, retrieved October 3, 2012. During the past decade, mean family income declined overall for the first time out of the last six decades. Defined as those with annual income between two-thirds and two times the median, middle-income households comprised 61% of total in 1971 and only 51% in 2011. Meanwhile, upper-income households (earning more than twice the median) comprised 29% of total income in 1970, but 46% in 2011.

Chart 4-2
Inner-Core Share of Metro Retail Construction, 20 Largest U.S. Metros*



* Based on 2011 standing stock
Sources: CBRE Econometrics, RREEF Real Estate

childrearing and are increasingly favoring the live/work/play environments offered by cities.

Clearly, suburban communities will not be disappearing, and will continue to house most of the population. But as the more successful and wealthy households leave the suburbs for urban centers, a growing divide can be expected in the affluence of these areas, and therefore a shift in retail sales patterns.

Prospects for Physical Retailing

The convergence of technological, demographic and social changes projected for the coming decade suggests that urban locations will capture an increasing share of bricks-and-mortar retail sales. The most successful locations will be street frontage retail in historic high-street districts or in new well-conceived mixed-use environments.

This latter change would represent a distinct reversal of the trend that existed since World War II: i.e., retailers following the migration of the nation's most affluent households into suburban and even exurban markets, while urban areas were largely ignored. The last recession revealed the excesses of that approach, as retail development often preceded the population base that could support it. Retailers also began to realize that highly-segmented land-use patterns in suburban markets limited retail demand, with shopping centers often far removed from daytime populations. At the same time, retailers began to rediscover the benefits of urban markets, which offer much higher population density as well as complementary demand from office workers, tourists, students and others. The increasing affluence of city dwellers makes urban markets all the more attractive to retailers.

These forces are already showing up in retail construction trends, as seen in an analysis of intra-urban supply trends in the county's 20 largest metropolitan areas. As shown in Chart 4-2, the urban share of metro retail construction averaged only about 6% of the 2011 standing stock in the three years prior to the real-estate downturn, but jumped to almost 9% in 2008 and has risen each year thereafter, to almost 18% in 2011, 2.8 times the pre-recession average.[17]

Closer review of this data reveals that it is not just that developers have been more enamored with urban locations; they are also retreating from the suburbs. In 2011, new annual supply as a percent of the 2005-07 average was down 80% in the suburbs but only about 45% in the cities. To be sure, much more retail space will continue to be developed in the suburbs than in urban areas—suburbs still offer less costly land, easier permitting, and continued population growth. But the development trend clearly is swinging toward urban street retail in metro areas.

Technological forces are amplifying the urban benefits. Smaller store prototypes enable retail chains to access infill locations that could not accommodate their larger, suburban prototypes. Wal-Mart's new Walmart Express format is just 15,000 square feet (sf), compared to its normal 200,000-sf prototype. Target is opening its new CityTarget format, sized at 60,000 to 100,000 sf, compared to over 130,000 sf for its typical suburban stores. Other chains are moving upscale with specialized infill prototypes, such as Petco's Unleashed urban format and Sports Authority's S.A. Elite format. Both are half the size of their typical footprint.

Consistent with this urban strategy, more retailers are recognizing the benefits of establishing large flagship stores in the best shopping districts of prominent cities. High-street retail has long been the predominant retail strategy in Europe, but in the United States such locations typically were dominated by small boutiques of the most upscale designers and jewelry stores: Tiffany, Chanel, Louis Vuitton and the like. Now Fifth Avenue in New York, Michigan Avenue in Chicago and Union Square in San Francisco are filled with a broad array of outsized flagship stores for mainstream brands such as Abercrombie & Fitch, American Eagle, H&M and Uniqlo.

[17] Analysis based on data from CBRE Econometrics. "Inner-core" determinations are based on the authors' subjective assessment of the most urbanized markets of each metropolitan area.

While these stores generate huge sales volumes that alone justify their exceptionally high rents, retailers also count on the marketing value of these stores to drive sales for the entire chain and especially online. This strategy allows for a handful of flagship stores in key markets around the globe to carry the brand, while shrinking the store fleet in less successful secondary markets. Both demographics and e-commerce are playing a role in driving these concepts and prototypes, as retailers also face market demands to serve their customers as efficiently and effectively as possible.

Conclusion

The technological evolution is both changing and reducing retailer demand for space, focusing this demand on limited categories of goods, services and entertainment. *Demographic and socio-economic trends will make physical stores even more dependent on consumers with substantial disposable income than in the past as commodity needs are filled more through Internet retailing.* Location relative to rooftops (or apartment doors!) will continue to be key, but convenience to the population's live, work and entertainment patterns will be even more important. Converging demographic and e-commerce trends signal a shift in retail space demand.

Along with dominant regional malls, which by definition are in prime affluent locations, the real winners among physical retailers will be urban and inner-suburban retail districts, reaffirming their historical role as the preferred venue for retailers and shoppers alike. In many cases, these are historic street-frontage retail districts, sometimes known as "Main Street" or "High Street" retail. In other cases, particularly where historic districts do not exist in the appropriate locations, developers are replicating them, sometimes as mixed-use environments. These retail areas serve as community crossroads, which have always been a crucial function for commercial areas, at the intersection of living and working environments. Retailers have recently been embracing these areas more, given the visibility they provide to build their brands.

Indeed, these shopping centers and districts should gain not only market share and occupancy, but also see better operating performance. If stores can maintain their sales volumes in smaller spaces, landlords should be able to charge higher rents per sf of space, while also fitting more stores into their districts and retail centers—which should enhance the shopping experience by allowing for a more diverse, exciting mix of retailers.

Andrew J. Nelson is a Director of Research at RREEF Real Estate, the global alternative real estate investment management business of Deutsche Bank's Asset and Wealth Management division. Mr. Nelson is the retail property specialist for RREEF Research, and also serves on RREEF's Sustainability Council, where he leads RREEF's global research on sustainable investment practices. Among other industry involvement, he serves on the ICSC North American Research Task Force (as Chair) and the Research Advisory Committee of the U.S. Green Building Council (USGBC). He earned a Master of City and Regional Planning Degree from the Kennedy School of Government at Harvard University and a Bachelor of Arts degree in Economics from Harpur College at the State University of New York in Binghamton. He may be reached at andrewj.nelson@rreef.com.

Prior to his recent retirement, **Alan Billingsley** headed RREEF Real Estate's Research team for the Americas. He joined RREEF in 1999 after 20 years of experience in all forms of real estate research and investment analysis. He is an active member of the Urban Land Institute serving on its local District Council as well as the national Program Committee and Commercial & Retail Development Council; is past President and member of the Executive Board of the local chapter of Lambda Alpha International; is past President of the local chapter of the Counselors of Real Estate; is a member Emeritus of the Research Task Force at the International Council of Shopping Centers; and is active in several civic and educational organizations. Mr. Billingsley holds a Master of Arts degree from the University of California, Los Angeles, and a Bachelor's degree in Architecture from North Carolina State University. He may be reached at alanbill@pacbell.net.