THE LINNEMAN LETTER

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This is an excerpt from the Spring 2018 issue of *The Linneman Letter*.

Retail Market Outlook

Most major retail tenants are quite sticky in terms of their leasing decisions. That is, you rarely see a retailer move across the street to another center to save $5 a foot in rent. In contrast, it happens all the time with industrial and office space. This stickiness derives from the repeat experience aspect of retail, which rewards retailers staying put, so customers know where the retailer is located. Thus, even if retailers sign 2-3-year leases, there is little chance they will leave upon lease expiration. Thus, the expected duration of a tenant in a given location far exceeds the lease term. In fact, the expected retail tenancy duration is basically defined by a retailer's competitive life cycle. This suggests that center owners should welcome short-term leases with a bit of a rent premium, comfortable in the fact that strong retailers will renew their leases. And equally important, weak retailers can be easily dismissed at the end of their short-term lease rather than dragging down a center's attractiveness.

A major reason retail center owners have historically focused on longer leases is that lenders focus on tenant credit. Thus, a center filled with 2-year leases receives lower leverage than one with 10-year leases. But this is a curious lending pattern, as these same lenders are excited about lending at even higher LTVs to multifamily properties, where tenants have no credit and sign 1-year leases. Center owners and lenders should, by now, realize that like multifamily, retail real estate is about location and product operation, not credit. While retail may look like a credit business, it has always been about location and operations far more than tenant credit, as today's hot retailer is tomorrow's bankruptcy.

In spite of dire headlines, NCREIF's third quarter 2017 retail vacancy rate registered a quarterly decline of 48 bps and an annual increase of 8 bps. Currently at 6.9%, the retail vacancy rate had previously been trending downward since peaking at 11.0% in 2010 until bottoming out at 6.5% in the first quarter of 2016. Retail vacancy subsequently increased from the bottom through the first quarter of 2017 to 7.5%, but most recently decreased to its current level of 6.9%.

Linneman Associates' research indicates that for every 100 bps of growth in U.S. employment, the retail vacancy rate declines by 26 bps. Assuming that 3.9 million new jobs are created from 2018 through 2022, we estimate that the retail vacancy rate will decline by about 70 bps over the next five years.

Rolling 12-month real monthly retail property sales transaction volumes stood at $5.1 billion in January 2018, or about 55% of the previous peak and up by 288% from the bottom. Real Capital Analytics data indicate the January 2018 real average private transaction value

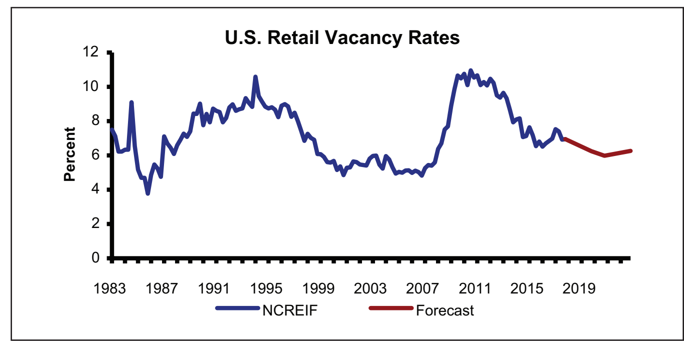

figure 1

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for retail properties was $179 per square foot, slightly short of the historic average of about $183 but well below the all-time high of $249 set in March 2015. A low of $144 per square foot was seen in 2010.

The precipitous decline in real estate values was specific to retail, as cap rates for other property sectors remained unchanged, while retail cap rates were up at least 50 bps due to concerns about online shopping. However, borrowing rates for retail are largely unchanged. This means that owning quality retail properties with long-term leverage is substantially more attractive than a year ago. Real values are currently near historic norms.

The Conference Board Consumer Confidence Index has experienced a post-election surge. The February 2018 level of 130.8 is the highest it has been since December of 2000 and is well above the long-term historical average of 92.5. The University of Michigan Consumer Sentiment Index shows a similar pattern.

Real monthly retail sales (2016 dollars) peaked at $388 billion in November 2007, dropped to $330 billion in March 2009, and have since regained lost ground, ending February 2018 at $418 billion. Monthly annualized real retail construction declined steadily from its September 2007 peak of $76.2 billion until it bottomed at $25.0 billion in early 2011. In January 2018, it stood at $40.6 billion, which is still below the historical average of $49.0 billion. The current level reflects a decline of 11.2% over the last year through January 2018, as anchor tenants seeking new stores became rare.

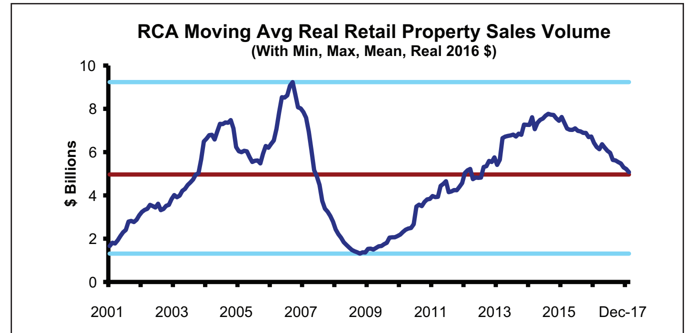

figure 3

Retail Vacancy Rates - Base Case Pipeline

Market	YE 2017 Act	YE 2018 Est	YE 2019 Est	YE 2020 Est	YE 2021 Est
Atlanta	7.7%	7.0%	6.2%	5.1%	3.7%
Austin	5.1%	3.2%	1.5%	-0.1%	-1.7%
Boston	3.3%	2.9%	2.2%	1.5%	0.7%
Charlotte	5.8%	5.3%	4.8%	4.0%	3.3%
Chicago	9.9%	9.9%	9.9%	9.8%	9.8%
Cincinnati	9.0%	9.2%	8.9%	8.5%	7.9%
Cleveland	8.3%	9.0%	8.9%	8.8%	8.6%
Columbus	5.2%	4.7%	3.9%	2.9%	1.8%
Dallas-Fort Worth	7.2%	6.0%	5.0%	4.1%	3.3%
Denver	6.8%	7.0%	6.9%	6.5%	6.0%
Detroit	8.9%	8.7%	8.3%	7.8%	7.1%
Houston	6.9%	6.3%	5.8%	5.3%	4.8%
Indianapolis	7.6%	6.6%	5.5%	4.3%	3.2%
Los Angeles	4.6%	4.3%	4.0%	3.8%	3.6%
Miami	3.7%	3.4%	3.7%	4.4%	5.1%
Minneapolis	5.3%	4.4%	3.4%	2.4%	1.3%
Nashville	4.3%	4.3%	4.1%	3.9%	3.8%
New York City	6.2%	6.8%	7.3%	7.9%	8.4%
Orlando	6.2%	5.6%	5.1%	4.8%	4.4%
Philadelphia	6.9%	7.3%	7.6%	7.8%	8.0%
Phoenix	9.8%	9.6%	9.1%	8.2%	7.1%
Portland	5.8%	4.9%	3.6%	2.3%	0.9%
St. Louis	7.4%	6.9%	6.5%	6.1%	5.7%
San Diego	4.7%	4.1%	3.4%	2.5%	1.5%
San Francisco	4.0%	3.0%	2.1%	1.1%	0.0%
San Jose	4.1%	4.6%	6.1%	7.7%	9.3%
Seattle	6.0%	4.6%	3.1%	1.5%	-0.2%
Tampa Bay	7.0%	6.4%	5.8%	5.0%	4.2%
Washington, D.C.	5.3%	5.0%	4.6%	4.1%	3.5%

Highlighted entries indicate market at supply-demand balance, or better.

Note on Negative Vacancy: In order to calculate estimated vacancy rates, we adjust beginning inventory for new construction completions and compare that to net absorption (including sublease space). If we show negative vacancy rates, it simply means that given the scheduled supply and growth in expected demand, sufficient demand pressure exists to more than absorb all available space. Of course, negative vacancies cannot occur, as in the face of such demand pressure additional development will occur and rents will increase in order to dampen demand. Therefore, forecasts of negative vacancy should be viewed as a strong excess demand indicator.

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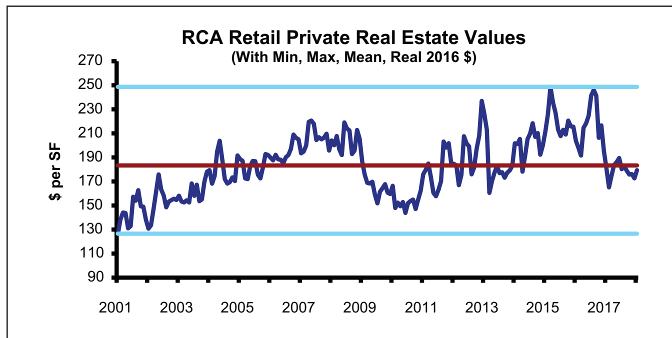

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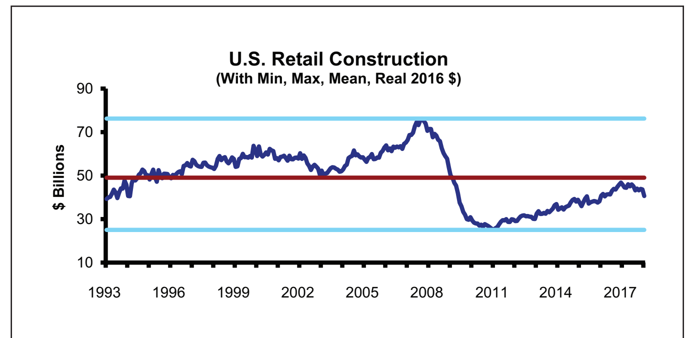

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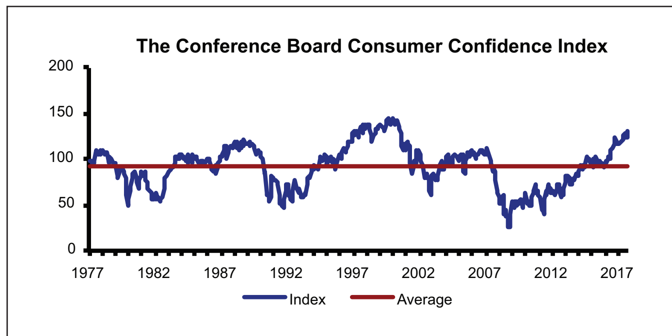

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As of the fourth quarter of 2017, the lowest retail vacancy rates were in Boston (3.3%), Miami (3.7%), San Jose (4.0%), Seattle (4.1%), and Nashville (4.3%).

In contrast, the highest vacancy rates were found in Chicago (9.9%), Phoenix (9.8%), Cincinnati (9.0%), and Detroit (8.9%).

By year-end 2019, all of our covered markets, except Seattle, New York City, Philadelphia, Cleveland, and Denver are projected to register decreasing vacancy rates compared to the fourth quarter of 2017. The greatest expected improvements from year-end 2017 through 2019 will be in Austin, St. Louis, Dallas-Fort Worth, Portland, Indianapolis, San Jose, and Minneapolis.

Using 8.5% vacancy as a benchmark for a balanced market, 25 of our 29 markets were in balance in the fourth quarter of 2017. All covered MSAs, except Chicago, Phoenix, Cleveland, and Cincinnati are projected to be in balance by year-end 2019.

About Dr. Peter Linneman

Dr. Linneman, who holds both Masters and Doctorate degrees in economics from the University of Chicago, is the Principal of Linneman Associates. For over 30 years he has provided strategic and financial advice to leading corporations. Through Linneman Associates, he provides strategic and M&A analysis, market studies, and feasibility analysis to a number of leading U.S. and international companies. In addition, he serves as an advisor to and a board member of several public and private firms.

Dr. Linneman is the author of the leading real estate finance textbook, *Real Estate Finance and Investments: Risks and Opportunities*, now in its fourth edition. His teaching and research focuses on real estate and investment strategies, mergers and acquisitions, and international markets. He has published over 100 articles during his career. He is widely recognized as one of the leading strategic thinkers in the real estate industry, and was named among the top 30 "Most Influential People in Real Estate" by Commercial Property Executive in 2013.

He also served as the Albert Sussman Professor of Real Estate, Finance, and Business and Public Policy at the Wharton School of Business at the University of Pennsylvania until his retirement in 2011. A member of Wharton's faculty since 1979, he served as the founding chairman of Wharton's Real Estate Department and the Director of Wharton's Zell-Lurie Real Estate Center for 13 years. He is the founding co-editor of *The Wharton Real Estate Review*.

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