COX CASTLE NICHOLSON

RETAIL & COMMERCIAL GROUP
2020 FORECAST

CAPITAL FOR RETAIL IN 2020 – THE ECONOMIC EXPANSION CONTINUES FOR AN UNPRECEDENTED DURATION

by Gary Glick

Gary specializes in shopping center development and retail, office and industrial leasing, generally representing shopping center, office, and industrial developers, as well as major retailers. He is nationally recognized as one of the premier retail transactional attorneys by his clients and peers. He has also been extremely involved in the International Council of Shopping Centers (ICSC), the retail industry's most prominent trade group.

The 2019 recession predicted by many economists never materialized. When an economic slowdown appeared imminent in the first quarter of 2019, in part due to President Trump's tariff war with China, the scarcity of housing, the looming Brexit crisis, the ballooning national debt and rising interest rates, the Federal Reserve stepped in and lowered the federal discount rate twice over a short period of time. The rate cuts, along with the easing of the tariff war with China, helped rally the economy in the second half of 2019, diminishing further talk of a recession. The U.S. is now experiencing the longest economic expansion in its history (approximately 10 years), as well as record highs in the stock market, a strong GDP, low unemployment, low inflation and historically low interest rates.

However, the economy is not without warning signs. The U.S. deficit is now the largest in history, and a housing shortage continues to exist (including a significant price gap between wages and the affordability of housing in much of the country). In addition, yields on 2-year treasuries are higher than yields on 10-year treasuries (a so-called "inverted yield curve"), which historically presages a recession. Despite these warnings signs, many experts expect that the economy in 2020 will be reasonably comparable to 2019, though such expectations are subject to a long list of uncertainties, including election year issues (e.g., very expensive economic proposals from some of the leading Democratic presidential candidates).

As has been the case for a number of years, the retail real estate sector is going through a significant transformative period that has made it a less than favorable class for capital investment in 2019, as compared to the industrial, multi-family and office real estate sectors. However, despite the numerous retail store closures and/or bankruptcies in 2019, retail developers and retailers have been adapting to a changing landscape where e-commerce continues to attract a larger share of dollars each year. Taking the place of many of the retailers that are not expanding or that have gone bankrupt are retailers in the food, fitness and wellness fields. In addition, despite the fact that apparel retailers have been significantly impacted by e-commerce, discount apparel stores such as Ross and Marshalls continue to thrive, along with many high-end retailers. Many retailers have continued to expand, including Target, Burlington, Ulta, Amazon, Whole Foods and Aldi.

Grocery-anchored shopping centers, regional malls in "A" locations and in-fill, lifestyle centers are all still considered a favored class by investors. Although investment sales were down slightly in 2019 from 2018, sales were still significant, especially in the second half of 2019 when interest rates were at historic lows. For grocery-anchored shopping centers in well-located areas, cap rates remained in the 5% range, maybe a slight increase from 2018. However, single-tenant leased properties with strong performing credit tenants like Chick-fil-A, In-N-Out and McDonald's continue to trade at cap rates in the 3% to 4% range. Shopping centers in B locations or with tenant mixes very susceptible to e-commerce competition were selling (if at all) at cap rates closer to 7% or 8%.

> The U.S. is now experiencing the longest economic expansion in its history, as well as record highs in the stock market, a strong GDP, low unemployment, low inflation and historically low interest rates.
>
> However, the economy is not without warning signs.

It is our expectation that investment sales will continue to remain strong again in 2020, subject to the same or similar cap rate parameters as those described above. Unless inflation becomes an issue, which has not been the case for the duration of the current economic expansion, most economists do not believe that the 10-year treasury rate will be much above 2.5% in 2020. In addition, with a softening of the economies of numerous European countries, foreign capital is expected to continue to flow into real estate developments in the United States. Furthermore, 2019 saw a reduction in capital investment from China, largely due to the trade war with the United States and policies in China constraining investment by Chinese nationals in the U.S. If the trade war ends or substantially diminishes in early 2020, there could be a significant outflow of capital from China into U.S. real estate.

Debt and equity for retail development in 2019 remained very comparable to 2018. Significant capital remained available from banks, life insurance companies, REITs, debt funds, equity funds and CMBS lenders.

Lenders continued to remain disciplined in 2019 with respect to the retail sector, although loan-to-value ratios in some instances increased. The Great Recession taught the lending industry some hard lessons, and lenders and regulators are not likely to allow a repeat of the same lax credit analysis and exuberant projections seen in loan underwriting in the mid-2000s. Among potential lenders, banks are probably most constrained by regulatory requirements. However, they still originated a significant number of loans in 2019, mostly construction loans and floating rate loans tied to LIBOR, and almost always portfolio loans.

Life insurance companies also continued to lend in 2019 at a comparable pace to 2018. These loans were usually permanent loans with terms of 10 to 20 years, at fixed rates in the 3.5 to 4.5 percent range, usually with a straight line amortization over 30 years. The mortgage portfolio of life insurers grew by about 5 percent from 2018 to 2019. As in past years, life companies continue to remain conservative in their underwriting policies and deal structuring. Like banks, life insurance companies continue to be impacted by competitive pressures from other debt sources.

In addition to permanent loans, life insurance companies also provided a significant amount of construction and mezzanine lending in 2019, continuing a trend from the past few years. However, the vast majority of this lending was linked to permanent mortgages that remain the primary debt vehicle for life companies. Because of the smaller share of riskier debt on their books, life companies are likely to be less affected by a mild recession as compared to other capital providers.

As was the case in 2018, private equity debt funds continued to proliferate. According to the research firm Preqin, private equity real estate debt funds raised more than $165 billion since 2013. It stands to reason that these fund have proliferated: capital cannot be deployed in the bond markets with the expectation of any significant returns in light of the low interest rate environment, and many investors are wary of investing in what many believe to be a bloated equities market. Fewer private equity real estate debt funds were deployed in 2019 than in 2018, largely due to the lack of new retail construction or existing projects that made economic sense.

CMBS lending increased slightly in 2019 based upon the incredibly low interest rate environment. The 10-year treasury fell to a year-to-date low of 1.47% in the third quarter of 2019, levels not seen since 2016. CMBS volume in 2019 was in the range of $90 billion, which easily exceeded the full-year 2018 level of $75 billion. Looking ahead, some observers believe that 2020 CMBS volume could rise to about $95 billion.

There was no shortage of equity capital available in 2019, but providers of equity had trouble finding retail deals that made economic sense. For the right deal, equity was plentiful. However, many providers of equity were more inclined to provide these funds to more favored asset classes, like industrial and multi-family. We expect this same trend to continue in 2020.

In summary, we expect that capital markets in 2020 likely will be very similar to 2019. For retail developers, the key to accessing this capital is to have the right product type. As was the case in 2019, grocery-anchored shopping centers (with a well performing grocer), regional malls in “A” locations and in-fill, lifestyle centers in gateway cities will attract the most capital (both debt and equity). However, other retail projects will also attract capital, just at a higher cost and/or with the requirement for more equity. All of this could change if political and economic factors change, especially if the 2020 elections result in a major political change in Washington.