COX CASTLE NICHOLSON

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RETAIL PERSPECTIVES

SPECIAL FORECAST

The Retail Group of Cox, Castle & Nicholson LLP has taken on the yeoman's task of attempting to forecast the future for the retail industry. We have digested the events that led to our current economic situation, analyzed recent developments and plans to stimulate the economy, and have certain opinions relating to four key facets of our industry. Below is the product of our thinking, in the form of four articles of interest addressing such topics as the capital markets, the health of retailing, the impact of residential development on retail, and prospects for retail developers caught in the current economic stalemate.

We hope you enjoy these articles as much as we enjoyed writing them!

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Show Me The Money: Where Did The Capital Go and When Will We See It Again?

By: Gary Glick

The economist John Kenneth Galbraith once said: "The only function of economic forecasting is to make astrology look respectable." We feel much the same way about predicting when capital will return to retail developers, real estate investors and retailers.

The retail industry (and the Country in general) are all waiting for the same thing, we are all waiting for the capital markets to become "unclogged." To understand how (and when) this will occur, one needs to understand how this mess was created. The answer is both simple and very complicated. For the most part, lending institutions over approximately the last ten years discovered the way to make a healthy profit on its lending practices. In the old days, banks lent to homeowners and either held onto the loans or sold them on the secondary market to Fannie Mae ("Fannie") or Freddie Mac ("Freddie"). With respect to the homeowner loans held by these banks, the underwriting standards were strict so as to minimize risk to the lending institution. With respect to those loans sold to Fannie or

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A Prognosis for the Health and Well Being of Retailers

By: Scott Grossfeld

The current global economic recession has certainly taken its toll on the retail business. Some blame the retraction of retail on the frozen capital markets, while others blame it on the devastating impacts of the recession on consumer confidence, the fall-out from the housing market decline, recent trends of retail over-building (and the practice of locating same category stores in very close proximity to one another, resulting in a cannibalization of the markets), the rise of unemployment and/or the collapse of the stock market. There are a myriad of other reasons that can individually, and collectively, be argued to have contributed to the current historic losses being experienced by the retail community. Whatever the reasons, few (if any) can deny that the current health of retailing in the United States is at a precedent-setting low.

California is not immune from this trend. According to statistics from the International Council of Shopping Centers, approximately 15% of the country's shopping centers (and retail square footage) is located in California. With such a large share of the nation's retailing

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When Will Housing Recover to Reinvigorate Retail Development? *By: Matt Seeberger*

It goes without saying – retail is directly dependent on housing, and new retail development is largely dependent on new housing. This was confirmed by the meltdown in the subprime credit markets, which precipitated an unprecedented implosion in the number of potential homebuyers. That drop in demand resulted in a virtual halt in residential construction (multi-family as well as single-family, although single-family has arguably been harder hit), and a similar cessation in new retail construction swiftly followed, since retailers were no longer able to justify entering new markets, because anticipated population growth clearly will not occur in the expected time frames.

The southwestern portion of the country (California, Arizona & Nevada) arguably (and unenviably) leads the nation in the slowdown in both new home construction and new retail development (although Florida is also experiencing significant problems). California may be the hardest hit due to its huge inventory of new, under construction and proposed housing, primarily in the Inland Empire (concentrated in San Bernardino and Riverside counties) and the Central Valley (chiefly along Highway 99, in and around the larger cities, such as Sacramento). Those new residential developments were forging ahead in reliance on a massive projected population increase in California over the next 20 years, continued availability of cheap credit, and the state's seemingly unending economic growth (particularly trade with Pacific Rim nations). Without those large new housing developments, and with the steep drop in home sales and sharply reduced consumer confidence, retailers have scaled back their expansion plans, leading shopping center developers to likewise scale back new construction.

The effect of the collapse of the new housing market on new retail development has been exacerbated by the dramatic rise in the number of residential foreclosures. Such foreclosures make available existing homes for first time buyers, as well as homeowners looking to trade up, at much lower prices than has been the case for a number of years. The result is a further depression in home values, sometimes below the cost of constructing a new home, making it uneconomical to undertake new home construction, and further delaying the recovery of new retail construction.

Therefore, recovery of the new retail development industry is intricately and intimately linked with recovery of the new housing markets. Unfortunately, when those markets will bounce back is unclear, because so long as the credit crunch persists, there will be no new housing due to there being no demand for new homes, and thus no new retail development. With the capital markets continuing to flounder, there appears to be no way to accurately predict how to fix the credit crisis or when it will end.

The Obama administration has put forth various programs to aid the housing industry. For example, the housing stimulus bill passed in July 2008 (the Housing and Economic Recovery Act of 2008, portions of which would have ended July 31, 2009) was extended in February 2009 (by the American Recovery and Reinvestment Act of 2009) and expanded so that first time home buyers can receive a tax credit of $8,000 (up from $7,500) if they purchase a home between January 1 and December 31, 2009; more importantly, the tax credit no longer needs to be repaid. In addition, the February legislation extended to December 31, 2009 the increases in FHA, Freddie Mac and Fannie Mae loan limits (to $217,050 for FHA and $417,000 for Fannie Mae & Freddie Mac or, if greater, 125% of the 2008 local area median home price, but not to exceed $729,750).

Other tools in the administration's arsenal include loan refinancing and restructuring, which could go a long way towards ameliorating the foreclosure problem. One such program involves getting lenders to write down principal balances to 90% of the then current appraised value in exchange for an FHA-insured loan in that amount, but the program also requires a 1.5% annual insurance fee to the FHA and gives the FHA participation rights in any profit on sale or refinance, so its usefulness may not be as great as hoped. While writing down mortgages may not be particularly desirable for lenders, in many cases it would seem preferable to the alternative of taking the property back and possibly getting even less in a foreclosure sale, or having to hold onto the property and become a landlord until the home can be sold for a reasonable amount.

Another loan program just enacted makes available $75 Billion to incentivize lenders to reduce interest payments, and in some cases temporarily reduce principal, such that payments will not exceed 31% of the borrower's income; however, the principal has to be repaid when the home is sold or refinanced, the amount of the loan that is eligible is capped at $729,750, and the loan must have been taken out before January 1, 2009. Unfortunately, this program is likely only available to homeowners who are still working, since there has to be some reasonable expectation that the homeowner can continue to make payments under the modified loan.

Yet another attempt by the Obama administration to assist the housing market is neighborhood stabilization, a program that provides $6 Billion for cities to purchase homes in bulk and then manage, repair and resell

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Retail Development - The Times They Are A-Changin' *By: Dan Villalpando*

Just a few years ago, when shopping centers were relatively easy to value and credit was easy to obtain, many retail developers were able to expand their portfolios at rapid rates, finding properties at cap rates that encouraged growth. Additionally, those developers who were not in expansion modes at the time were nonetheless able to charge high rents to shopping center tenants who were themselves expanding and interested in opening as many stores as possible.

Times have changed, however, and, so long as the credit and stock markets continue on an uncertain and, some might argue, unprecedented path, retail developers are left in a difficult position. Those developers who had recently been in an acquisition mode are finding it difficult to assess the fair market value of existing shopping centers because of a dearth of transactions. In addition, developers with existing centers who are not currently looking to expand are finding themselves scrambling to keep struggling tenants, and some are trying to fill vacant space with categories of tenants that would have been unthinkable a few years ago.

For the retail developer who views the current economic climate as an opportunity to expand its portfolio, the lack of transactions in the market place has resulted in significant uncertainty regarding property values. Neither sellers nor buyers of shopping centers have many comparable sales upon which to value existing product because transactions simply are not happening; in addition, it is arguable that the hyper liquidity in the credit markets prior to 2008 artificially drove up prices. The result is that owners of shopping centers are valuing their products at much higher prices than potential buyers, and the bid-ask spread is substantial enough to prevent most transactions from moving past initial inquiries and due diligence. Thus, while sellers may get several bids for a property, in many cases they do not get a valuation that is acceptable to them, so they elect to hold onto the property. Consequently, both sellers and buyers are left in a waiting game, with neither side currently willing to budge.

The problems for retail developers are not limited to existing centers – land development has also been severely impacted, due to the crash in the housing markets, which has resulted in retail tenants drastically scaling back their expansion plans. This retrenchment has brought the construction of new shopping centers to a grinding halt, as with no new housing, retailers cannot justify opening new stores, making it virtually impossible for many retail developers to grow their portfolios in the manner to which they had become accustomed over the past decade – buying relatively inexpensive raw land on the outskirts of cities, confident that newly constructed residential subdivisions would quickly fill up and provide customers for their new centers.

In addition, a lack of available funds to developers in need of capital has caused the market to stagnate. It is estimated that the two major sources of debt, banks and commercial mortgage backed securities (CMBS), represent a combined ownership of 80% of all commercial real estate debt. However, banks are experiencing significantly stricter regulatory oversight, making it much more difficult to lend, and the CMBS market has all but shut down. Indeed, CMBS originations, estimated to be $230 billion in 2007, dropped to a mere $12 billion in 2008. The credit market is clearly locked up, and it remains to be seen whether TARP (Toxic Asset Relief Program), TALF (Term Asset-Backed Securities Lending Facility) and the other stimulus packages making their way through the nation's capital will have much of an effect on relieving the blockage.

Another market-driven difference that may affect a potential buyer is that, just a few years ago, a buyer could acquire a shopping center with several vacancies with little worry about being able to lease it up with creditworthy tenants willing to pay high rental rates, as those tenants (particularly publicly traded ones) were also in expansion modes and eager to find spaces and open as many stores as possible. The shopping center acquisition could be underwritten with optimistic numbers for rental income, as opposed to the uncertainty that plagues the current market. Potential buyers now only view vacant space with skepticism, as deals with creditworthy tenants are currently much more difficult to find.

With cap rates on the rise, some developers who are looking to expand are shifting their focus to in-fill locations or single tenant deals where the former tenant has vacated. For example, spaces formerly occupied by Circuit City, Linens 'N' Things, Mervyn's and Home Depot Expo are hitting the market, and are attractive options for some developers with capital to spend. Such spaces can be relet to big box users or demised into smaller spaces and leased to some of the retail tenants who are currently active and looking to make deals, although even those retailers are seeking to benefit from the downturn by paying significantly lower rates than were achievable just 18 months ago.

Even developers who are not in an expansion mode likely will find themselves with plenty of issues regarding the properties in their portfolios. Of primary concern is

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Freddie, the underwriting standards of Fannie and Freddie were also strict and required minimal risk (although these standards relaxed over the past few years). Fannie and Freddie packaged the loans they bought and sold them as mortgage backed securities to investors (which proved to be a reasonably safe investment for buyers, since the underwriting standards for these loans were reasonably strict).

With respect to commercial loans, most of these loans were retained by the originating lender (with the exception of certain larger loans that had other participating lenders to share in the risk of default). The underwriting standards for these commercial loans were strict but as the economy grew and real estate became the darling of the economy, even these underwriting standards began to be relaxed.

The only thing that can be said with assurance is that the US government, through the Treasury Department, Federal Reserve and FDIC is throwing most every possible resource at the credit-crunch problem.

What changed the way financial institutions made loans was the addition of a new secondary market, a market that was in addition to that once dominated by Freddie and Fannie, one that Wall Street relished. This market did not have the strict underwriting standards of Freddie and Fannie or those of traditional banks, its main objective was "product", and as long as this product could be bundled into debt instruments that could be sold in the secondary market all around the world as securities, Wall Street was happy. These debt instruments became known as commercial mortgage-backed securities ("CMBS") and collateralized debt obligations ("CDO's") (hereinafter for simplicity collectively referred to as "CDO"). The CDO market permitted financial institutions, investment bankers, mortgage brokers, rating agencies and insurers (e.g., AIG) to generate tremendous commissions and fees by making more and more home loans and bundling them into pools and then selling them off as securities. It also permitted large financial institutions to aggressively pursue commercial loans and then sell them through the CDO market. The more home loans that were made, the more home prices appreciated. The more home prices appreciated, the less likely it became for home buyers to afford homes other than by taking advantage of lax underwriting standards. Hence, a major "bubble" was created, just waiting to burst.

And bust it did! As Warren Buffet so clearly explained in the annual report to the Shareholders of Berkshire Hathaway Inc., "As the year progressed, a series of life-threatening problems within many of the worlds' great financial institutions was unveiled. This led to a dysfunctional credit market that in important respects soon turned non-functional. The watchword throughout the county became the creed I saw on restaurant walls when I was young: 'In God we trust; all others pay cash.' By the fourth quarter, the credit crisis, coupled with tumbling home and stock prices, had produced a paralyzing fear that engulfed the country. A freefall in business activity ensued, accelerating at a pace that I have never before witnessed. The U.S. – and much of the world – became trapped in a vicious negative-feedback cycle. Fear led to business contraction, and that in turn led to even greater fear. The present housing debacle should teach home buyers, lenders, brokers and government some simple lessons that will ensure stability in the future. Home purchases should involve an honest-to-God down payment of at least 10% and monthly payments that can be comfortably handled by the borrower's income. That income should be carefully verified. Putting people in homes, though a desirable goal, shouldn't be our country's primary objective. Keeping them in their homes should be the ambition."

So what happens from here? The first government attempt to address the credit crisis (initially implemented during the Bush administration) was TARP (Troubled Asset Relief Program), a program that was initially believed to be designed to allow the United States Department of the Treasury to purchase up to $700 billion of "troubled" or toxic assets (hereinafter referred to as "Toxic Assets") (recognizing that only some of these pools of Toxic Assets contained troubled loans), allowing banks to rid themselves of these Toxic Assets and begin lending again. This program, as originally conceived, would have also created a market for these Toxic Assets, thereby creating activity in the real estate industry. Unfortunately, the government decided not to use this money to buy up Toxic Assets but to lend it to major banks without any "strings" attached, allowing these banks to utilize the cash to shore up their balance sheets. Most (if not all) of these banks did not do anything to rid themselves of their Toxic Assets. Establishing values for pools of Toxic Assets is very difficult since many of the

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underlying homes are not presently saleable. A good portion of the TARP funds were also used to shore up troubled AIG which had insured may of the CDO pools through the use of credit default swaps. The reckless underwriting utilized by AIG put it in the position of being insolvent without the addition of the government "bailout" funds provided to it.

Since the inauguration of Barack Obama, his administration has implemented numerous programs to attempt to shore up the housing industry (e.g., its Foreclosure Prevention Plan) and to provide credit for student loans, car loans and small business loans (underwritten with very rigorous standards) and packaged into securities sold on the secondary market (e.g. the Term Asset-Backed Securities Loan Facility ("TALF"). The Treasury Department and the Federal Reserve plan to spend as much as $1 trillion to provide low-cost loans and guarantees to hedge funds and private equity firms that buy securities backed by these loans. However, it should be noted that the US Government now plans to expand TALF to also provide loans to purchase Toxic Assets.

The hope is that once banks unload many of their Toxic Assets, their balance sheets will allow them to begin lending again for retail development and acquisitions.

However, the cornerstone of the Obama administration' plan to deal with Toxic Assets is the Public-Private Investment Program (the "PPIP") which was announced on March 23, 2009. The PPIP will initially draw on up to $100 billion in funds already approved by Congress under TARP, as well as additional funding from the Federal Reserve. The initiative will seek to entice private investors, including big hedge funds, to participate by offering billions of dollars in low-interest "non-recourse" loans to finance the purchases or Toxic Assets. The government plans to match private investment equity dollar-for-dollar, and the Federal Deposit Insurance Corp, will put up significant backing, up to $6 for every $1 invested, in exchange for a fee. Funding will be provided by the government or guaranteed by the FDIC for a fee. The loans are intended to be low interest "non-recourse" loans. The government will share in both the upside and downside of any investments. However, if any investment proves to be unwise, the private investor will be able to walk away from the investment at a loss only of its equity invested, but without any other loss (since the loans will be non-recourse). Observers believe that the PPIP will need at least an additional $400 billion to adequately deal with the Toxic Asset program.

The key to this program is the valuation of the Toxic Assets. The hope is that the partnership of this program with private investors will ensure that the price paid by the private-public partnership is appropriate. However, will the banks that hold (and want to sell) these Toxic Assets be willing to set a realistic price for these assets? Much remains to be seen in the coming weeks.

The only thing that can be said with assurance is that the US government, through the Treasury Department, Federal Reserve and FDIC is throwing most every possible resource at the credit-crunch problem. Will it work? Many believe that it will. However, many believe that much too much money has been utilized in connection with all of these programs, and much of it utilized unwisely. Sure, mistakes have been made. One just has to look at the initial use of the TARP funds. However, the government now seems to have finally grasped the real problem: the entire liquidity of the banking system relies upon the ability of the government to cause there to be a marketplace for the Toxic Assets. Once this is established, transactions will begin to occur and valuations will be set. At this point, transactions of any type will begin to unclog the real estate markets. In addition, the hope is that once banks unload many of their Toxic Assets, their balance sheets will allow them to begin lending again for retail development and acquisitions. When this occurs, underwriting standards will be more rigorous. Banks will not soon return to the standards applied during much of the last decade.

Will all of this really occur? Many of the pieces of the puzzle appear to be in place for this to happen. Consumer confidence has begun to reverse, if only slightly. The stock market is beginning to show signs of life. The automobile industry is in for more pain, but will hopefully see orders increase next year. Housing prices in many markets appear to have reached a low point. The wild card is impending commercial loan defaults and loan due dates. However, at this juncture, lenders appear to want to work with borrowers as opposed to becoming owners of substantial REO holdings. It appears that 2010 will likely be a better year for the real estate industry, and it will hopefully be a year in which developers and retailers begin to see the return of capital.

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business, it is not surprising that retail development in California is at its slowest in recent memory.

Unfortunately, an unhealthy retail industry negatively affects the entire retail development business. This includes retail developers, brokers, retail construction professionals and others involved in the development of shopping centers and other retail sites. Obviously, if retailers do not expand or open new stores, there will be fewer (or no) new shopping centers to build and leases to broker.

Therefore, the question on the minds of everyone involved in retail is: *When will retail recover*?

Based on recent statistics from such sources as the International Council of Shopping Centers and articles available on various industry websites (including Globestreet.com) 2008 encountered a major reversal in terms of retail growth. Through September of 2008, it was estimated that 10,600 new stores were opened in the United States. This is contrasted by an estimated 8,600 stores closing during the same time period.

The same (or similar) sources estimate that through the first half of 2009, there will be 73,000 stores that close. These sources estimate that only 2,000 new stores will open during the same time period. Such statistics, if accurate, will widen the abundance of dark stores in the nation's shopping centers and are indicative of a continuing decline in retail in the near term.

Many, inside and outside of the retail development community, are undoubtedly aware of some of the contributors to these statistics. The national news outlets spent considerable resources following the closings of many major national operators, such as Mervyns, Circuit City, Linens 'N Things, Levitz, The Sharper Image and other former shopping center stalwarts. Of course, it is not just major national brands that make up the considerable number of closures. Smaller, regional operators as well as large numbers of mom and pop stores (largely due to consumer lethargy and an inability to obtain credit for operating capital) have succumbed to the global economic downtown.

With so many retailers closing, and fewer operators expanding or opening new stores (combined with recent episodes of retail overbuilding), there will be a large supply of existing space to absorb before new development is jump-started.

Although these statistics are compelling and disheartening, there are some retailers (and retail categories) that appear to be performing well. Furthermore, there appear to be some signs that retailer decline may be slowing or changing direction.

Discount-oriented retailers and providers of necessities and staples appear to be weathering the storm better than most. According to recent news reports, Wal-Mart seems to be continuing its pattern of growth, in terms of revenue, store openings and an increasing stock price. In addition, according to recent Globestreet.com articles, retailers such as Ross and American Apparel are still growing in terms of net income and store openings. Costco, Forever 21 and Kohl's are other bright spots in terms of retailers in expansion mode. Similarly, drug stores and supermarkets seem to be less affected by the generally negative economic conditions.

In addition, some shopping center owners and commentators are reporting that a variety of retailers are resorting to the re-negotiation of leases, instead of store closings. These factors would appear to support the proposition that these retailers are attempting to wait out the economy, in lieu of throwing in the towel.

Although it is undeniable that retail has been in the worst decline in recent memory, there are some bright spots in the market. As these positive statistics grow and the root causes of the economic decline begin to be addressed, it is unquestionable that the retail industry (including retail development and associated industries) will rebound.

Yes, there are still rough days ahead for retail. And, recovery will not be immediate. However, new governmental plans to stimulate the economy by, among other things, dealing with toxic assets and increasing liquidity in the capital markets, will seemingly work to slow home foreclosures, improve the residential markets (the consumer's most critical concern) and make credit available to retailers to purchase inventory and have sufficient capital to operate their businesses. As these programs take root, many of the problems in the economy will begin to heal, leading towards a gradual but strong improvement. It is hoped that these recent governmental developments, coupled with very recent improvements in the stock market and other economic indicators evidence the start of this process and a slow (but steady) recovery. Assuming enough seeds have been planted to stimulate a recovery of the economy, it is hoped that retail will be able to show a modest improvement in 2009 fourth quarter sales, leading to a more robust 2010. This could logically result in retailers beginning the process of contemplating new store openings in 2011 – which means new leases being signed in 2010.

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properties. The goal here is to help cities exercise more control in neighborhoods that have been decimated by foreclosures, before the effect of abandonment spreads to the other homes not foreclosed upon.

Other measures may yet be enacted – for example, the House of Representatives recently passed a bill that would allow bankruptcy judges to "cram down" the principal on mortgages in Chapter 13 bankruptcies. Although this still needs to be approved by the Senate, where it is expected to face stiff opposition, the fact that there is support for such a measure could prove to be an incentive for lenders to work with homeowners and possibly prevent even larger losses.

It is still too early to tell when such measures will have an impact or how much of an impact they will have, but when combined with other stimulus packages (including other income tax benefits, efforts to relieve banks of toxic assets, and long overdue investment in the national infrastructure), they should eventually result in increased demand for new housing, which will then spur new retail development. Recent data suggests that some of the measures are having a positive effect – for example, sales of existing homes (which increases the demand for new housing by removing an alternative to homebuyers) in February 2009 were up 5.1% over January 2009, the largest monthly increase in 5 ½ years, housing starts were up 22.2% in the U.S. for February 2009, breaking a 9 month string of decreases, and housing permits being issued also increased substantially, beating estimates. While none of these alone indicates that the worst is over (and the early indicators are that there will be some retrenchment), together they provide a bright spot in what has been an otherwise dismal 18 months, leading some commentators to predict that, if such trends continue, the housing slump could well end in late 2009, although an end in 2010 still seems to be the greater consensus.

The backlog of recently constructed but unoccupied housing, along with housing under construction and permitted (and perhaps even entitled) that will probably be completed at some time (since the investment in development and infrastructure is probably too great to abandon), should allow retail developers to adjust to the new realities. However, retail developers will eventually need to learn to work not only in the traditional suburban context with 1-story buildings and surface parking, but also in a denser urban context, including accepting multi-level store buildings and parking structures, as cities require more mixed uses and intensive residential uses.

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retaining existing tenants. To do so, developers are being forced to offer rent relief or other concessions to tenants who are having a difficult time staying in business. While reducing the cash flow of a project is likely to have a negative effect on a developer's ability to refinance or obtain a take-out loan when the credit markets open up, many developers believe that it is more important to keep tenants open and shopping centers as full as possible in the short term.

In addition to keeping existing tenants open and operating, some developers are being forced to consider alternative uses to fill vacant space. Uses which up until recently had been anathema to shopping center owners are now being viewed as possibilities – discount stores, thrift stores, governmental offices, schools and churches are just some of the uses which developers are considering to "bridge the gap" until the market turns. Of course, in allowing those uses, there may be issues with existing CC&Rs or leases with major tenants that a developer needs to consider. Such documents may expressly prohibit such uses or, in the alternative, require the consent of one or more of the existing occupants of the shopping center.

Unfortunately, there is no crystal ball that definitively sets forth the date the current recession will end and retail development will begin to rebound. It is, in many ways, an unprecedented time in retail real estate, and most developers are doing their best to use techniques and information gleaned from the past to keep their heads above water and ride out the storm. The majority of analysts seem to think that it will be early 2010 before there will be a modest rebound, and that it might be early 2011 before a stronger recovery occurs. However, that storm may be clearing sooner than later, as recent reports indicate that consumer spending is trending up, housing starts have increased, the stock market has improved, and there is an expectation that 2009 holiday sales will increase over 2008 (albeit modestly).

the team

The Retail Group of Cox, Castle & Nicholson LLP has extensive experience in acquiring, developing, constructing, leasing, financing and disposing of all types of retail projects, including regional enclosed malls, lifestyle community centers, neighborhood centers, and mixed-use projects. Members of the Retail Group include attorneys who are experts in sales and acquisitions, design, engineering, and construction contracts, reciprocal easement agreements, development and management agreements, and leasing.

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