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RETAIL PERSPECTIVES

2010 FORECAST

Once again, the Retail Group of Cox, Castle & Nicholson LLP has taken on the task of attempting to forecast the future of four critical segments that affect the retail industry. As we have done in the past, we analyzed the social, political and economic events of 2009, reviewed various economic data and projections and have come to certain opinions relating to the retail industry and where it is heading in the near future. Below is the product of our thinking, in the form of four articles of interest addressing such topics as capital markets, retailing, retail development and the impacts of residential development on retail.

also in this issue

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What Will Happen To The Capital Markets In 2010 And How Will It Affect The Retail Industry?

By: Gary Glick

At the beginning of 2009, we looked at the retail industry (and the commercial real estate markets in general) and attempted to predict how they would fare over the coming year, and when traditional capital would return to the real estate industry.

On the heels of a horrible 2008 fourth quarter for the United States economy and the real estate industry, predictions for 2009 were bleak. One thing that was certain was the need for the Federal Government to take very definitive action to prevent another Great Depression. And that they did. As reported by us last year, the United States Government invested heavily in the banking system, the car industry, the insurance industry and the housing industry.

Although these Government investments were unable to spur the sale of distressed or "toxic" assets by financial institutions, and the first half of 2009 brought on the loss of jobs at an alarming rate, it appears that the "second" Great Depression has been averted. The

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Revisiting Our Retailing Forecast For 2009 And What To Expect For 2010

By: Scott Grossfeld

Our retailing forecast for 2009 projected a bleak year (with some exceptions). The gray forecast was mainly due to a combination of various negative forces collectively impacting the retail market, as well as various other markets. These factors included frozen capital markets, very negative consumer confidence, the fall-out from the housing market decline, the after effects of retail over-building, a dramatic rise in unemployment, a significant decline in the stock market and a myriad of other major, negative developments. Unfortunately, as we all now know, this generally bleak projection turned out to come true. In turn, this resulted in a very difficult year (and probably the most difficult in recent memory) for many in the retail industry.

Although 2009 was precedent-setting in terms of some of its lows, some aspects of our predictions ultimately turned out not to be as bad as we originally thought they might be. Based on then available International Council of Shopping Centers statistics and data, as

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The State Of The New Housing Market And Its Expected Impact On Retail Development In 2010 *By: Matt Seeberger*

Last spring, we tried to forecast what would happen in the new housing market, as that market directly impacts retail development. Overall, the expectations were not positive. Unfortunately, those expectations were essentially met, and although the situation is improving, recovery is not proceeding as well as had been hoped.

The meltdown in the subprime credit markets that defined 2008, which decimated the home-buying market in 2009 as well, will continue to have an impact in 2010, as many homebuyers are unable to obtain reasonably priced financing unless they have superior credit. Further, what financing is available often is primarily due to various governmental incentive programs (many of which were described in last year's article). This lack of affordable financing continues to detrimentally impact the new home-building market, as the number of housing starts, which had been on an increasing pace for six months in the middle of the year, faltered when the incentives were anticipated to expire. Although the incentives were extended to March 31, 2010, such programs will not be extended indefinitely, and may not get extended again for a variety of reasons, so it would not be prudent to expect continued governmental activity to cure what ails the housing market. In addition, homebuilders are unable to obtain favorable financing, since there are far fewer buyers for their product, due to the huge increase in foreclosures (see discussion below) and thus many alternative excellent deals to be had for well-qualified homebuyers.

Two new governmental programs that may impact new home construction were announced in mid-January 2010. First, the U.S. Department of Housing and Urban Development (HUD) announced that it would expand access to mortgage insurance issued by the Federal Housing Authority (FHA) and allow for quick resale of foreclosed properties. Current rules prevent a homeowner from obtaining FHA insurance on a home owned less than 90 days, but this restriction was lifted effective February 1, 2010 and will continue for one year (certain conditions and guidelines will have to be met). Second, HUD stated that it was allocating $2 billion in grants to communities and non-profit housing developers to combat the effects of vacant and abandoned homes on neighborhoods. While both of these actions could have the short term effect of reducing the pool of home buyers (who might otherwise look at new housing) due to easier credit for foreclosed properties, in the long run (hopefully not too long), they should help the new housing market by clearing the excess of foreclosed homes from the market and incentivizing homeowners to again look at new housing.

In any event, whatever improvement has occurred in the housing market does not appear to have been enough to jump start new residential construction, with the result that virtually no new shopping centers are currently being developed in California since there are no new rooftops to justify new retail development.

As noted last year, the southwestern portion of the country (California, Arizona and Nevada) were at the forefront of the debacle. Housing starts in California's Inland Empire and Central Valley plummeted in 2009 and the beginning of 2010, and the forecast for the rest of the year is not very good. Further illustrations of the dire condition of the new home building market include: single-family housing starts in December 2009 in the western U.S. declined 41% from December 2008, while new housing under construction in December 2009 in the western U.S. declined 32% over December 2008. And in Los Angeles County, by far the most heavily populated county in the country, residential construction in December 2009, although up 37% over November 2009, was still down 6% over December 2008. However, some housing market indicators are up, such as new housing starts in the western U.S., with a 15% increase from December 2008 to December 2009, although new housing starts in December 2009 were down 10% from November 2009. The numbers for multi-family product are not much different, at times even worse. Applications for building permits have similarly dropped.

Unfortunately, dramatic increases in home foreclosures continue to create a drag on new housing, as people are forced to leave their homes, thus opening up existing, and often more centrally located, alternatives to new home buyers. Examples of where this is occurring in California include Stockton, Modesto and Riverside-San Bernardino, which have the dubious distinctions of being the second, third and fourth most foreclosed upon regions in the U.S. in the third quarter of 2009 (Las Vegas being the first). The continuing softness in the labor market also undoubtedly contributes to the lack of interest by potential new home buyers, who are anxious about taking such a significant step (as has been noted many times, a home is often the largest single investment most families make

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Retail Development - Hold On To What You Got

By: Dan Villalpando

In last year's forecast for retail developers, the overriding theme was "change" – change in the way retail developers were valuing their portfolios from prior years, change in their approach to leasing vacant space, and change in their overall operating strategy. And while the economy appears to have improved modestly as we turn the calendar to 2010, many retail developers are clinging to the tactics that got them through a rough 2009. Indeed, in what may seem like an oxymoron, a popular strategy of retail developers at the current time is not to develop at all. Rather, the focus appears to be on trying to maintain existing occupancy levels and improving the quality of assets, to the extent existing capital is available. Also, some retail developers with debt are being forced to raise capital to pay down their loans to meet existing loan-to-value covenants as property values continue to drop.

Many of the issues that contributed to the slowing of new retail development beginning in 2008 and continuing through 2009 are still present, and may continue to serve as impediments to new development for some time. Housing starts, while up modestly in California and the western United States, are still relatively stagnant, so there are no new housing projects or residential neighborhoods for retail development to service. Unemployment continues to plod along at dangerously high levels, resulting in fewer consumer dollars being spent – both because of a lack of income from the recently unemployed, as well as trepidation from those who fear that they might soon lose their jobs and, therefore, are more prudent with their spending habits. For others with seemingly solid job security, the emphasis for the family budget has shifted from spending to debt reduction and increased savings, all of which impacts retailers. Indeed, while retail sales for December 2009 rose by 5.4% over December 2008, they were actually down 0.3% from the prior month, as some question the extent to which consumer spending is gaining traction.

Without retailers to fill new product, there is no need for retail developers to even contemplate new projects. As such, with little to no new development forecast for 2010, retail developers are left to take a lay of the (developed) land, and what they are seeing is somewhat disconcerting. A lack of consumer spending has impacted virtually all sectors of retail, forcing some retailers to close their stores, and others into bankruptcy. Not surprisingly, vacancy rates for malls and shopping centers were up in 2010, reaching an 8.3% vacancy rate in the 76 largest U.S. markets, according to The Wall Street Journal. And, for those retailers who continue to keep their doors open, many are finding the need to seek rent relief or other concessions from their landlords. While retail developers with centers in the most desirable locations may be able to reject such requests (figuring that, if a tenant leaves the center, there will be another right behind it willing to pay comparable rent), most landlords are in the position of seriously considering granting such relief or other concessions to keep tenants open and centers as vibrant as possible.

At the same time, the need to fill vacant space has resulted in some retail developers doing deals at rental rates that would have been inconceivable only a few years ago. Indeed, some analysts predict that underlying rents will continue to drop for at least another two years. This climate has resulted in good growth opportunities for retailers with capital and/or a desire to expand even in tough economic times. Since many of the "reduced rent" deals are being struck with terms in the 10 to 20 year range, these retailers will likely find themselves sitting on below market rents when the economy ultimately improves. This is good news for the retailer, but it will likely have a negative effect on a developer's ability to refinance or obtain a take-out loan when the credit markets open up, as operating income (and hence, center value) may be driven down by below-market rental rates.

As was the case in 2009, some retail developers are also being forced to consider alternative uses to fill vacant space, or are offering special events at their centers. Operators of deep discount stores, thrift stores, governmental offices, schools and churches are in some cases finding themselves with landlords willing to do deals in centers where doors would have been firmly slammed shut just a few years ago. In addition, some retail developers are introducing special events at their centers, like farmers markets and free visits with Santa Claus, in an effort to increase customer traffic.

Some retail developers have decided to use the current climate to attempt to raise capital by selling off portions of centers which are occupied by credit tenants in triple-net deals. Coupled with a trickle of increased liquidity in the

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What Will Happen To The Capital Markets In 2010 And How Will It Affect The Retail Industry? *continued from page 1*

economy is now starting to normalize. Job losses have finally stabilized (although it will take years for the economy to recover the over 8 million jobs lost), GDP has begun to grow again, retail sales are up slightly, consumer confidence is starting to return, and the stock market has recovered a significant portion of its losses from the last 18 months.

This is good news for the retail industry. However, despite this good news, the value of retail properties has dropped significantly due to retailer bankruptcies, the precipitous drop in rental rates, the lack of retailer interest in new stores, retail rent re-sets and a dearth of shop tenant demand. Investment sales were still anemic in 2009, although the bid-ask differential seemingly did start to narrow. With respect to new retail development, most retail experts do not expect any significant new development (except some rare in-fill locations and large box single store phased developments) for 3 to 5 years.

> *For the most part, banks have not wanted to acquire and sell distressed assets, determining that their balance sheets would be vastly superior by avoiding foreclosures and sales at distressed prices.*

With respect to the capital markets, over the last year, banks have chosen to work with their borrowers to avoid foreclosures. In many cases, they have either re-worked existing loans (usually in cases where cash flow continues to cover debt service) or, in the case of maturing loans, chosen the path of extending the maturity dates knowing that their borrowers could not refinance under the current stricter underwriting standards (the practice commonly referred to as "pretend and extend!"). For the most part, banks have not wanted to acquire and sell distressed assets, determining that their balance sheets would be vastly superior by avoiding foreclosures and sales at distressed prices. At the same time, most of the large banks have slowly returned to health by de-leveraging and stabilizing their portfolios, and by earning profits through investment strategies made possible by the minimal cost of funds available to them through the Federal Reserve.

However, despite the posture of banks over the last year, many real estate pundits continue to believe that the commercial real estate industry is a disaster waiting to happen. It has been reported that approximately $1.2 trillion in commercial debt is due to mature by 2013, a large percentage of which are CMBS loans. A vast number of these loans would not qualify for re-financing under today's stricter bank underwriting standards. What happens with these loans will significantly affect the capital markets, as well as the retail industry, over the coming year.

Two possible scenarios exist.

In the first scenario, banks and special servicers will work with borrowers to extend and "work-out" troubled loans as they have been doing over the last year; they may foreclose on select assets, but will only do so in limited circumstances and over a longer period of time – well beyond 2010. The banks seem to have learned some valuable lessons from the early '90s when, through the RTC, banks disposed of distressed assets at bargain prices, took significant balance sheet losses, and allowed developers and private equity groups to prosper mightily off of these assets as the economy recovered and the assets were enhanced and sold.

The second scenario is one in which the banks and special servicers become much more aggressive with problem loans. If this happens, it will be very difficult for many retail developers to survive. Some will file bankruptcy as a defensive measure to attempt to force their banks to work with them on re-structuring problem loans. However, if this scenario occurs, the investment markets will more quickly become "unclogged". Many more assets will be sold, prices will stabilize (albeit at lower values), and transaction activity will significantly increase. There is currently a tremendous amount of capital sitting on the sidelines. The public markets (and other capital sources) have provided numerous investment vehicles with money to buy these distressed assets. Will this be good for retail? For some, the answer is yes. However, for retail developers, this scenario will create a situation in which only the strong survive.

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What will most likely happen will be a hybrid of actions by financial institutions under both of the scenarios set forth above. We believe these actions will cause the retail markets to slowly recover. However, a return to fundamentals will occur for retailers, developers and banks.

Retailers will be more cautious; they will not look to locate across the street from direct competitors. Already, the number of retailers in any one category has been significantly reduced through bankruptcies or consolidations. Retailers will be less likely to locate in areas where housing is expected, as opposed to existing, and they will merchandise more prudently.

With respect to developers, they will attempt to avoid building or buying in secondary and tertiary markets. They will only buy raw land when significant pre-leasing has occurred. They will preserve capital knowing that it will take more equity to borrow.

In the lending community, underwriting standards will get tougher. Lenders will discount rents in anticipation of turnovers, they will underwrite taking into account troubled retailers, they will require 35% to 40% equity, and their loans will be recourse. However, liquidity will return, as was the case in 2009 in a very limited fashion (i.e., loans were available for high-quality assets in top markets with strong and reputable borrowers). CMBS deals will begin to slowly make some sense, if underwritten better with structures that are not as complicated and which create a better means for dealing with troubled assets. A few new CMBS deals were consummated in 2009, and more will occur in 2010.

In the lending community, underwriting standards will get tougher. Lenders will discount rents in anticipation of turnovers, they will underwrite taking into account troubled retailers, they will require 35% to 40% equity, and their loans will be recourse.

In summary, the retail industry will show incremental signs of recovery in 2010. However, we believe that a significant recovery in both the capital markets and the retail industry, although begun in 2010, will really take a more measurable hold in 2011.

Revisiting Our Retailing Forecast For 2009 And What To Expect For 2010 continued from page 1

well as various other industry commentaries, at the beginning of 2009 approximately 73,000 store closures were estimated to occur through the first half of 2009. Although 2009 experienced more store closings than anyone in the retail industry would have wanted, according to the February 5, 2010 issue of SCT Week, it appears that store closings for 2009 were less widespread than originally predicted. Some experts credit this feat due to progress on the financing front and new coping strategies adopted by both retailers and landlords. Retailers managed to adapt by offering deep discounts and tightly managing their inventories and operating expenses. Strategies such as these will only help strengthen retailers as they move forward into the future.

Although our 2009 forecast easily predicted that 2009 would be difficult, we also suggested that with new governmental plans to stimulate the economy, coupled with then recent improvements in the stock markets and other economic indicators that it was more than possible/probable that a slow and steady recovery would take root by showing a modest improvement in 2009 fourth quarter sales, leading to a more robust 2010.

We are happy to report that, based on various industry data, it appears that November to December 2009 retail sales increased by approximately 1.8% over 2008 sales for the same period, December 2009 comparable store sales increased by approximately 2.8% compared to the same month in 2008 and that overall, December holiday sales rose by 5.4% from 2008. Most analysts agree that these numbers were not phenomenal, but are significant in that they will lay a good foundation for a more robust retail industry in 2010. In fact, some analysts are anticipating that calendar year 2010 comparable-store sales will increase by 3-3½% and that there will be a 3.9% gain in 2010's shopping center sales growth, following a 2.4% drop in 2009.

The positive ripple which started in the fourth quarter of 2009 (together with the positive projections for 2010) may be taking hold and gaining some steam. Early information suggests that January sales are slightly up and some retailers are reporting and planning for more positive growth. These retailers include Ann Taylor/Ann Taylor Loft, Tiffany, Starbucks, Panera Bread and others that do not necessarily fall into the categories one would expect to be performing better in this economy, such as deep discounters and supermarkets and drug stores. In addition, according to a recent post-holiday tenant survey by Levin Management Corp. (highlighted on recent GlobeStreet.com postings), although finding mixed results, many retailers are reporting increases in sales (or sales holding steady), suggesting a retail market that is beginning to stabilize. In addition, a significant percentage of retailers reported in the Levin survey that they are looking to expand locations in 2010. According to some, this suggests a consumer/retail market that is beginning to regain traction.

Although there appear to be some positive signs in the retail market, many caution not to be too optimistic. There are commentators that strongly believe that there will be soft retail demand due to continuing high unemployment levels and lingering challenges to consumer credit and ongoing housing problems throughout 2010. High unemployment will prevent wages from rising, which is good for company labor costs, but not good for consumer spending and growth. As a result, these commentators feel that a retail recovery in 2010 may be later in the year or beyond.

There is no doubt that the retail industry is still in the midst of a correction. There are still tough times ahead. However, the situation seems to be improving. The housing market will be a big factor in improving the retail industry, and general perceptions are that it appears to be improving. Compared to 2009, the stock market is up. Unemployment is slowing, but remains uncertain. It does appear that a retail recovery has commenced and many cautiously believe that a recovery is being sustained – the retail market has now seen a few consecutive months of relatively positive performance. This will bolster consumer confidence, and, as the overall U.S. economy slowly improves, overall sentiment will begin to lift, resulting in progressive increases in consumer spending. Most analysts caution though that consumers will not quickly increase spending, but will do so slowly and selectively. Accordingly, it is expected that any retail recovery in 2010 will start/continue with growth in discount retailers such as Target, Costco, WalMart and staple providers such as supermarkets and drug stores. Hopefully, as confidence takes root, this will lead to greater and more significant activity for other retailers as the overall improvements in the economy snowball throughout 2010.

The State Of The New Housing market And Its Expected Impact On Retail Development In 2010 *continued from page 2*

in their lives) when their own employment situation may be in jeopardy.

As noted last year, there were large inventories of completed new housing and under-construction housing in the former boom areas of California when the housing market collapsed. Due to the lackluster performance of the housing market in 2009, these inventories remain, and although they will be a disincentive to additional new housing projects (those that may be entitled, and perhaps even permitted) for some time, their mere existence should eventually lead to new retail development in those former boom areas once the housing market recovers, since the investment in development and infrastructure is probably too significant to abandon, whether by the original developer, or others with available cash or who can obtain financing on favorable terms and who are able to obtain good prices for the existing finished or near finished product.

Further, one of the few bright spots throughout the downturn has been urban infill, which is expected to see continuing growth based on the push for "smarter" and "green" development, and homebuilders and retail developers would be wise to begin adapting to the denser developments that characterize this trend.

As this article shows, the statistics regarding the housing market are mixed, so it is not surprising that the "experts" are not in agreement about when the housing market will fully rebound – some think that the bottom will occur in 2010, while others think it could be somewhat later before things get markedly better. The most likely story for the remainder of 2010 is more of the same – signs of improvement, followed by small setbacks (two steps forward, one step back).

Retail Development - Hold On To What You Got *continued from page 3*

capital markets toward the end of 2009 (as some life insurance companies and commercial banks returned to the commercial real estate market), and a slight uptick in commercial mortgage backed securities, the new inventory on the market resulted in approximately $45 billion in such transactions in 2009, with some analysts predicting a total of twice as much in 2010. Some retail developers who raised money through such triple-net "pad" sales used the proceeds to pay down debt (in an attempt to stabilize loan-to-value ratios), while others were able to use the money to refurbish or otherwise renovate existing centers. By spending money on improving existing product during "down" times, these developers are hoping to be able to attract new tenants when the market turns around, and charge comparably higher rents, because of improved buildings, common areas and other shopping center amenities.

Retail developers who have raised capital and who do not need to use the proceeds to pay down debt or refurbish existing product, but instead would like to acquire existing centers, are finding a dearth of product on the market, as was the case in 2009. Indeed, those developers, including many public REITs, with capital to spend who were waiting for a flood of distressed centers to enter the market because of defaulting owners and foreclosing lenders have found the landscape relatively barren. Instead of foreclosing on problem loans, banks have been willing to extend the terms of such loans so the product is not hitting the market, at least not yet. In addition, the bid-ask spread that began in 2008 and widened in 2009 has only closed somewhat, as owners of shopping centers continue to value their assets at much higher prices than potential buyers. The lack of activity has left some retail developers flush with capital, but with little choice but to hold it until there is inventory on the market that is reasonably priced, in their opinion.

As retailer developers move into the second quarter of 2010, there appears to be a bit more optimism than was present at this time in 2009. However, the forecast of large brokerage firms and other analysts seems to indicate that there will be little recovery in retail in 2010, but that it may begin to generate momentum in 2011. For 2010 then, retail developers appear to be focusing on doing whatever possible to hold onto existing tenants (including offering rent relief and other concessions), spending some money (to the extent available) on improving existing centers, and doing what is necessary to placate lenders and make sure they are meeting the terms of existing loans.

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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