# RETAIL PERSPECTIVES

## 2012 FORECAST

As we have done for the past three years, the Retail Group of Cox, Castle & Nicholson LLP has, once again, taken on the daunting task of forecasting what to expect in the forthcoming year in four critical segments that affect the retail industry. In doing so, we analyzed the social, political and economic events of 2011, reviewed various economic data and projections and have come to certain opinions relating to the retail industry and where it is heading in 2012. 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.

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### Capital In 2012 - A Continuing Path of Slow But Incremental Growth

*By: Gary Glick*

As we have done each of the last three years, we will once again take on the daunting task of forecasting what will happen to the retail industry and, in particular, the capital markets in 2012. However, before doing so, we can not resist reciting the immortal words of Yogi Berra: "It's tough to make predictions – especially about the future."

2011 turned out to be a very volatile year for the economy. The first half of the year showed signs of recovery and increased consumer confidence. The stock market surged and job creation, although not great, showed some signs of life. This led to a small but incremental increase in retail sales, consumer spending and lending. However, by the summer, the economy faltered significantly. The fight in Congress over an increase in the U.S. debt ceiling (which ultimately led to a lowering of the credit rating of the U.S. by Standard & Poor's), a downturn in the U.S. jobs market, and the European debt crises,

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### A Preview Of The Retail Market For 2012 - Cautious Optimism

### Some More of the Same – But Better

*By: Scott Grossfeld*

The outlook for the U.S. retail market in 2012 seems to be that of cautious optimism, tempered with a bit of the unfortunate reality of likely muffled growth caused by outside forces beyond the control of the retail industry.

There are plenty of reasons to be optimistic about the retail market going into 2012. Even though retail suffered roller coaster swings through 2011 – retail started 2011 strong heading out of the 2010 holiday season, sharply dipped after the Japan earthquake, seemingly recovered only to dip again after the debt ceiling/credit downgrade debacle of August and fears of a double-dip recession, and now seems to teeter on potential Eurozone defaults – retail ultimately finished the year stronger than most commentators initially expected.

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## Retail Development – Holding On For Better Days

*By: Dan Villalpando*

As we attempt to forecast what will happen with retail developers in the coming year (and beyond), it helps to review where we were at this time last year. In January of 2011, the statistics showed relatively large growth in retail sales for December of 2010, especially with regard to department stores and the apparel industry. This news, along with other general economic indicators, gave some analysts reason to believe that the tide had turned, and that shopping center owners and retailers were in for a much better 2011. The news proved to be a bit overly optimistic, however, as 2011 ended up being only modestly better for the retail industry than 2010. And, as was the case in 2011, many forecasters believe that, while the retail market has stabilized, recovery is going to drag on for some time. So, for 2012 (and until the economy turns around), retail developers will attempt to hold on to existing assets, while creatively dealing with the square footage that is being returned to the marketplace. Opportunity may exist for those looking to expand their shopping center portfolios, but it is unclear how the current economy will impact pricing.

Unfortunately for retail developers, many of the issues that contributed to the slowing of new retail development beginning in 2008 are still present. Housing starts are still relatively stagnant, if existing at all, so there are no new housing projects or residential neighborhoods for retail development to service. Uncertainties in the global economy, as well as uneasiness regarding the upcoming Presidential election, also have contributed to the lack of new retail development. Unemployment, while having dropped slightly recently, continues to plod along at a high rate, which impacts both the developers' desire to construct new shopping centers, and the consumers' willingness to spend hard earned dollars. In fact, many analysts believe that, until more Americans are able to work, the shopping center industry will remain in a relative status quo, with little to no new development occurring.

An analysis of the data from the latter part of 2011 seems to indicate that consumers are willing to spend money at a rate at least slightly higher than in prior years. Retail sales for December 2011 rose by 6.2% over December 2010, although the numbers may be skewed a bit as an unusually harsh winter in 2010 likely hurt sales in December of that year. In addition, same-store sales for U.S. chains posted an increase of more than 3% during the November/December period, compared to the same period in the prior year. Sales were especially encouraging in the clothing and footwear industries. Again, the news is tempered by the fact that many retailers were forced to offer aggressive discounts and extreme promotions such as an early kick-off of Black Friday, which started at midnight for some retailers, even earlier than in recent years. While these numbers represent at least moderately good news for retail developers, they do not necessarily warrant the construction of new ground-up shopping centers.

Since it does not seem that retail developers are looking for new projects to develop, the focus continues to be on infill projects and the redevelopment of existing shopping centers, as was the case in 2010. As of the end of the third quarter of 2011, national retail shopping center vacancy was at 9.3%, down slightly from the 9.4% mark where it had been since the fourth quarter of 2010. Also during the third quarter, the market absorbed over 5.8 million square feet of space, which may seem high, but is much lower than the 15 to 20 million square foot amount typically seen in a pre-recession quarter. One reason for the lack of absorption of space is the returning of square footage to the marketplace due to some large scale bankruptcies which hit in 2011. For example, the Borders bankruptcy and liquidation resulted in nearly 12 million square feet of space being returned to the market, and Blockbuster, which closed approximately 1,000 locations in 2011, was not far behind, returning approximately 5 million square feet back into the market. While it is difficult to predict which, if any, large scale bankruptcy filings will occur in 2012, one cannot rule out the possibility that other prominent retailers will be forced to shutter their stores, which will give retail developers more space to lease.

Another trend that is resulting in additional square footage of second generation space hitting the market is the downsizing of "mid-box" or "junior anchor" tenants like Old Navy and Best Buy. Such tenants are often willing to "give back" space to retail developers in exchange for their exercising one or more options, giving the developer additional security that a credit worthy tenant will continue to occupy a majority of the space it originally leased for the next 10 or more years. While such second generation, moderately sized space may have been attractive to "mom-and-pop" tenants a few years ago, this category of small tenant, typically with a specific product type, has yet to rejoin the marketplace. Again, the less than favorable job market, coupled with a continuing difficulty for smaller tenants to get start-up loans, has kept the "mom-and-pop" tenant on the sidelines. Instead, discounters like 99 Cent Only, Ross and Dollar Tree, who continue to see relatively solid sales, are willing to absorb some of that excess space, often at attractive rental rates.

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# When Will It End? – The State Of New Housing In 2012

*By: Matt Seeberger*

Retail developers locally, statewide, regionally and nationally are wondering how long the new housing market doldrums will last, as there has been agonizingly little new retail development (which depends in large part on new housing) since the housing market collapsed several years ago. As in the past few years, the outlook is uncertain, as various forecasts continue to indicate that the economy, although probably having hit its low, is not improving at a pace that will promote major recovery in the retail sector.

While the subprime credit disaster may seem to be old news, it continues to affect the housing market, as evidenced by the stricter lending criteria that were imposed in response to the standards that led to the implosion, meaning that many consumers are still having more (to much more) difficulty qualifying for home ownership as compared to the mid-2000s. The expiration of the federal income tax credit for first time homebuyers has, as expected, had a negative impact on home sales, and there do not appear to be any significant governmental assistance programs coming in 2012. This represents a change from the past few years when a wide variety of efforts were put forth to stimulate housing demand and avoid foreclosures. Although the Federal Reserve Bank's ongiong adherence to low interest rates is helpful, the record so far has shown that this has not by itself been enough to increase housing purchases and sales to levels that would spur new housing development. In fact, 2011 did not bring much better results in new home sales over 2010, with the National Association of Realtors ("NAR") expecting that nationally, new home sales for 2011 will wind up at about 300,000, a record low; however the NAR does project that there will be a 20% or greater increase in 2012 in that statistic.

As in the past few years, foreclosures and short sales remain major obstacles to new housing. In 2011, over one-third of existing home sales in California were foreclosures, and another one-fifth were short sales. Thus, while the sale of new and existing homes rose 4.2%, the median price dropped 3.1%, the fifteenth straight month of year-over-year declines. This was similar to the national numbers, where purchases increased 1.7% over 2010, although prices fell slightly. Although there was some foreclosure relief in 2010 based on the sheer volume and legal challenges to lenders' foreclosure protocols, the pace has picked up again as lenders have addressed and resolved these issues. A continuing minor bright spot is that the percentage of previously owned home sales based on foreclosures decreased almost 4% from December 2011 over December 2010, to about 34%. The NAR predicts a 4 to 5 percent increase in existing home sales for 2012, which should help drive down the inventory of that product, hopefully leading to increased demand for new homes.

Employment prospects continue to plague California, and, as such, consumer confidence – a critical component of economic growth – continues to flounder. While the unemployment rate has slowly been improving, it is still at relatively high levels, both nationally and in California. Further, the uncertainty caused by global events, such as the European debt crisis, the tsunami in Japan and the continuing impact of the political upheavals in the Middle East, have undeniable, albeit difficult to quantify, effects on the overall economic picture. In addition, the continuing state and local government budget crises continue to wreak havoc on the economy around the country.

The usual suspects also continue to negatively impact the housing market, in particular the large inventory of new housing product that remained unsold when the collapse initially occurred largely remains on the market. This has made it virtually impossible to profitably build new projects in many of the areas where this inventory remains and must be absorbed before any new development can be considered.

There are also other factors that could affect the new housing market, some in unpredictable ways (such as the world events described above), but others that may be the result of new trends, such as the push toward smaller living units and more efficient use of space. For example, Santa Maria (a city of about 50,000 along U.S. 101 not far from the central coast of California) is considering allowing permanent housing units in commercial zones as small as 150 square feet, which could hurt new housing by allowing older motels to convert to apartment style living; however, it could also stimulate new housing by permitting development of more affordable housing projects.

Not much has changed over the past three years, as the new housing market continues to experience upward and downward movements on almost a monthly basis. Nonetheless, the continued historically low mortgage rates (although the NAR expects these to rise from just under 4% to around 4.5%), when coupled with, among other things, a perceived pent up demand based on population growth, lead some experts to predict that the housing market will make slow but steady gains in 2012 – not enough, perhaps, to jump start new housing to the desired level that would stimulate new retail development, but hopefully enough to create a base from which 2013 can finally start a full recovery.

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resulted in a significant loss of confidence in the U.S. economy, along with a major drop in the stock market. These events also led the media and economists to speculate about a possible "double-dip" recession. On the heels of all of this, one would have been hard pressed to predict a strong rebound in the economy in the last two months of 2011. However, that is exactly what happened.

The two main factors causing the turnaround were the European Central Bank stepping in with loans to banks in the 17 nations of the European Union and calming sovereign debt default fears in Europe (for the moment), and a reduction in the unemployment rate in the U.S. from 9.1% in August to 8.5% in December. As a result, retailers had a very respectable holiday season in 2012. To illustrate this, the 22 retailers tracked by Thomson Reuters showed a 3.4% gain in December sales at stores open at least a year.

This bodes well for some optimism entering 2012. However, the economy still remains fragile and can be easily derailed by any one of a number of events ranging from a further weakening of the global economy by more European unrest in its debt markets to political unrest in the Middle East. In addition, in the best of circumstances, economists do not expect anything other than the possibility of slow incremental growth in the U.S. economy during 2012 considering the housing foreclosure problems, the lackluster job market and local, state and federal government "belt tightening" and grid lock.

With respect to the retail industry, 2012 should continue to reflect the larger economic picture. Very little new development is expected other than in urban infill locations, and retailers continue to remain cautious about store expansions, with the possible exception of the discount-oriented retailers such as Ross, Marshalls, Family Dollar and General Dollar, grocery store chains, and fast casual restaurant chains. In addition, some larger box retailers and health clubs have shown a desire for more growth. Target, Wal-Mart, LA Fitness, 24 Hour Fitness and Dick's, to name a few, have all shown a propensity for expansion as compared to the past few years.

Turning to the capital markets, they increased slightly in 2011, as compared to 2010, notwithstanding a significant tightening during the third quarter when the U.S. economy faltered. Investor demand was strong, which resulted in slightly higher loan originations amid varied financing options. The balance sheets of most lenders strengthened during 2011 due to loan modifications and extensions and fewer write-offs, made possible through the "amend and extend" strategy. However, this strategy is gradually losing steam as lenders focus on permanent resolutions of troubled loans resulting from a pick-up in commercial real estate investment activity. 2011 also saw lower delinquency and default rates and better loan quality. In the coming years, however, the commercial real estate debt markets still remain challenging with nearly $1.8 trillion due during 2011-2015, with approximately 60.0% of this amount estimated to be "underwater."

Although CMBS originations were stronger than 2010, the market faltered along with the economy in the third quarter due to market volatility, which saw investor appetite switch to treasuries and away from the perceived risks associated with CMBS. This caused CMBS spreads to widen, which created problems for those lenders sitting on loan inventory that had yet to be securitized. As a result, CMBS originations in 2011 hovered around $20 billion, well below the predicted $40 to $50 billion. A more robust CMBS market in 2012 and beyond will be central to a more sustained commercial real estate recovery.

The volume of Bank loans continued to slowly increase in 2011, although banks continue to remain cautious about underwriting standards and sponsors. Most new loans continue to chase "core" properties in top tier geographic regions. With no secondary market, banks making larger loans will be looking to lay off some of the risk by bringing in participating banks or co-lenders. Banks are still in no rush to sell distressed assets and take losses. They will continue their preferred strategy of extending many loans with modifications rather than refinancing or disposing of them. They would rather wait for more promising opportunities and avoid balance-sheet issues until markets approve. Much like in 2011, typical loan to value ratios for both bank permanent and construction loans will range from 50% to 65%, maybe higher for recourse loans with higher reserves. Terms will be short – typically in the 3 to 5 year range, interest rates will remain low, but do not necessarily follow the historically low 10 year treasury rates, and interest rate swaps will be often required of borrowers as a hedge against significant interest rate fluctuations.

As they did in 2010 and 2011, life insurance companies will continue to lend in 2012, and with higher allocations. As with banks, the underwriting of life insurance companies will remain very strict since they have plenty of options available to them

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because of their limited allocations. They will lend to the "best-breed" borrowers who own class-A properties. They will continue to underwrite at values well below past peaks with reasonable loan-to-values in the 60% to 65% range and on projects providing good debt-service coverage and solid net operating incomes. Life company loans will continue to be predominantly permanent loans with terms between 5 and 10 years. They will be non-recourse loans with fixed interest rates between 3% and 5%, and with amortizations over 25 to 30 years. Life companies have made a significant dent in filling the void left by the collapse of the CMBS markets, but unfortunately are not able to provide the smaller loans previously available when the CMBS markets were robust.

Mezzanine debt and preferred equity are available to borrowers in need of meeting the stringent equity requirements of lenders and for refinancing or restructuring existing debt. However, this capital comes at a high cost – projected "equity-like returns" at 15% and up. These lenders orient more to preferred equity positions and desire significant control over the direction of projects to allow them exiting strategies.

We wish we could predict that 2012 will be the year when the economy and the retail markets improve significantly. However, it would be hard for anyone, other than "Pollyanna," to take this view. As we stated in last year's forecast, "[t]he profound events of 2007 and 2008 were neither bumps in the road nor an accentuated dip in the financial and business cycles we have come to expect in a free market economic system. This was a fundamental disruption – a financial upheaval, if you will – that wreaked havoc in communities and neighborhoods across this country." It is going to take years for the U.S. economy and retail and capital markets to fully recover. We are still at the very beginning of this fragile recovery. As was seen in the third quarter of 2011, many factors can derail sustained and continued recovery. As was the case in 2009, 2010 and 2011, we continue to see positive signs of recovery, but the recovery will be one of slow incremental non-linear gains. We expect 2012 to exceed the "recovery benchmarks" seen in 2011, but gains in 2012 will be a part of the longer term five to ten year recovery continuum necessary to return the retail industry to something close to the ten year real estate "boom" experienced prior to 2007.

## A Preview Of The Retail Market For 2012 - Cautious Optimism
## Some More of the Same – But Better *Continued from page 1*

According to a recent *Retail Traffic* article, the International Council of Shopping Centers (ICSC) estimates that U.S. chain store sales rose 3.5% this past December. This constitutes an improvement of 40 basis points over the increase posted in 2010. For the combined November/December 2011 period, ICSC reported a same-store sales increase of 3.3%. This figure is slightly lower than the 3.8% increase posted for November/December 2010, but still constitutes one of the best holiday shopping seasons in the past 5 years. This momentum could be an extremely positive influence going into 2012.

In addition, according to some industry analysts, including Craig Johnson (President of Customer Growth Partners, a New Canaan, Connecticut based consulting firm), the level of spending retailers saw during the 2011 holiday season is more sustainable than in years past, because shoppers have been spending money out of their current incomes, rather than relying on credit cards. This means that consumers are likely more financially stable and healthy, bolstering the concept that there is more spending money available to support the retail market on a more long term basis, resulting in a prolonged positive direction.

Furthermore, according to Frank Badillo, Senior Economist with Kantar Retail, "[s]hoppers were feeling a little better through the end of the year than they were in August and September, when there was a lot of uncertainty. . . . So we are seeing some positive signs heading into 2012, but at the same time, there are still reasons to be cautious."

According to an Associated Press survey of leading economists, the U.S. economy will grow faster in 2012, if it is not de-stabilized by such things as upheavals in Europe. This group of three dozen private, corporate and academic economists expect the economy to grow 2.4% in 2012. In comparison, the economy probably grew by less than 2% in 2011.



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Other encouraging factors for retail are that 2011 ended in an upswing in terms of unemployment. The economy generated at least 100,000 new jobs each month for the last 5 months of 2011. This is the longest such streak since 2006. In addition, as of the end of 2011, the number of people applying for unemployment benefits dropped to its lowest level since April of 2008.

Finally, according to a recent *Bloomberg* article, CBRE Econometric Advisors is forecasting that retail space available for lease in U.S. local shopping centers will decline in 2012 for the first time since 2005, as the growing economy spurs retailer expansion. According to the forecast, the availability rate of space in community and neighborhood centers was 13.2% in the third quarter of 2011 and will probably fall to 11.7% by the end of 2013. In the short term this may not impact rents, but in the long term rents may finally start to increase.

Based on all of the foregoing encouraging signs and information, it would be no surprise to expect a strong and robust retail recovery in 2012.

However, some commentators are more cautious and skeptical about outside forces and their impact on the retail market.

According to another recent *Retail Traffic* article, some seasoned real estate professionals are expecting only moderate growth in the retail sector in 2012. Much of this can be blamed on the hot and cold capital markets and the uncertainties of the upcoming U.S. elections.

Although there seems to be some increase in leasing in some of the most well-established and largest urban centers, malls and shopping centers in secondary and tertiary markets (and some primary markets) throughout the country are likely to continue to experience high vacancies and stagnant rents in 2012 because of all the space that has been freed up by bankrupt retailers and shuttered stores. Furthermore, even in the larger urban centers, many commentators do not see new development taking root in 2012, except, perhaps, with value-oriented and outlet centers. That said, although new development may not be starting much in 2012, unlike in recent prior years, many developers seem to be starting to talk about and plan new projects that will be built in the next few years.

Other factors contributing to forecasts of moderate or sluggish growth in 2012 are continued high unemployment and concerns over the vulnerability of the economy to outside shocks. Many are concerned that Europe's debt crisis could cause a global credit freeze, similar to what occurred with Wall Street in 2008. Resurgent episodes of Congressional gridlock, unforeseen global events (such as Arab Spring protests and the Japanese earthquake), rising tensions with Iran over nuclear issues and potential war (not only with Iran), further retailer bankruptcies, emerging online competition and the ongoing housing glut – coupled with volatile capital markets, the natural stagnation associated with election year politics, the European debt crises and ongoing high unemployment – could derail any retail market recovery in 2012.

Therefore, according to many cautious commentators, despite some encouraging signs, the retail sector's long-awaited rebound will not begin until there is more market certainty in the U.S. and overseas, plus sustained high levels of consumer confidence driven by higher paychecks, a stronger stock market and improved housing market. This, according to many, is unlikely to happen before the third quarter of 2012.

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The good news is that, whether one is more optimistic about the prospects for the 2012 retail market or more conservative, both views seem to agree that 2012 will include some growth. The question is how much growth will there be.

Another thing that more optimistic forecasters and more conservative forecasters seem to agree upon is that 2012 does not appear to be a "break out" year for the retail industry.

That said, especially in light of the end of year holiday season boost, declining unemployment and an expanding economy, we do believe that there is good reason to forecast a slow to modest, but incremental continuation of recovery in retail in 2012, with the possibility of volatility relating to prolonged stalemates in domestic politics, coupled with a continuing uncertain European debt crisis and continued high relative unemployment.

## Retail Development – Holding On For Better Days

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As has been the case in recent years, retail developers have been forced to acclimate to changes in the marketplace. Not surprisingly, much of the current landscape has been driven by the demands of the consumer. As the ability to shop on the Internet grows, and with the cost of gasoline holding steady at a robust $4 per gallon, retailer developers are forced to use other tactics to entice customers to visit their shopping centers. In fact, the online retail market share is now nearly 10%, according to a recent report by the Urban Land Institute. Shoppers are also able to compare prices without leaving the comfort of their homes (or by using their laptops, tablets or other similar mobile devices), which also reduces trips to retail stores for comparison shopping purposes. While it is difficult to quantify exactly how many fewer trips consumers make to shopping centers based on the information they are able to obtain over the Internet, it is pretty clear that the ease of access to such information can only have a negative effect on foot traffic in a shopping center.

To attempt to lure customers to their shopping centers, some developers are attempting to use the very same Internet to their advantage. Social media promotions, involving Facebook and similar sites, are becoming a way to offer customers a reward (such as a gift card or a preferred parking space) for logging into a center's page to learn about special promotions. Other retail developers are offering sweepstakes over the Internet, giving customers who frequent their centers a chance to win everything from free dinners to dream vacations. The goals of such promotions are to generate "buzz" among the social media savvy consumers by creating the impression that a particular shopping center is "the place to be".

Other retail developers are looking at vacant space as an opportunity to introduce new concepts, and non-traditional tenants, to their shopping centers. Such tenants include go-cart tracks, trampoline facilities, day care centers, cooking schools and even swim schools for kids. Of course, the ability to add such non-traditional tenants must be balanced against the rights of other existing tenants that may have the ability to keep certain uses out of a given project. A non-traditional use may allow a retail developer to temporarily fill space and get some rent in return, but it may also serve to upset major or anchor tenants at a project, who may decide to aggressively fight the new use, or to leave the project when their current term expires, rather than renew or exercise available options.

Retail developers who are looking to expand their portfolios may continue to experience a buyer's market in 2011, according to some analysts, who view the market as undervalued and ripe for investors. Indeed, during the third quarter of 2011, cap rates for shopping centers were among the lowest among commercial real estate product, averaging 7.2%, according to a survey published by PricewaterhouseCoopers. Not surprisingly, class-A product is the most attractive to buyers, but owners of that type of asset appear reluctant to sell in the current economy. Large scale acquisitions occurring in 2011, such as Blackstone's purchase of Centro Properties Group's 585-property U.S. shopping center portfolio, will be rare in 2012, according to some experts, with most of the deals taking place being single-asset transactions.

When it comes to the world of retail development, not a whole lot has changed from the end of 2010, as the glow of the halcyon days of the mid-2000's further dims in our rear view mirrors. In 2012, retailer developers may be forced to tighten their belt buckles another notch. Not surprisingly, it appears as if those retail developers who are able to adapt to the changing marketplace (by incorporating the benefits of social media and creatively introducing non-traditional uses into their projects) will be the best suited to weather the (now, four year old) storm and reap the benefits of what most are hoping will be a more pronounced recovery beginning in 2013.

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# *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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