RETAIL & COMMERCIAL DEVELOPMENT GROUP

2023 FORECAST

RETAIL & COMMERCIAL DEVELOPMENT GROUP:
2023 FORECAST

As we have done for the past fourteen years, the Retail & Commercial Development Group of Cox Castle has, once again, taken on the challenging task of forecasting what to expect in the forthcoming year in four critical segments that affect the retail and office industries. In doing so, we analyzed the global health, social, political and economic events of 2023, reviewed various economic data and projections and have come to certain opinions relating to the retail and office industries and where they are heading in 2023. Included here is the product of our thinking, in the form of four articles of interest addressing such topics as capital markets, retailing, retail development, and office leasing.

TABLE OF CONTENTS

DESPITE STRONG HEADWINDS, RETAIL CONTINUES TO ADAPT AND SURVIVE — Pg. 04

By: Scott Grossfeld

RETAIL DEVELOPMENT – WEATHERING CHOPPY SEAS WHILE STAYING AFLOAT — Pg. 08

By: Dan Villalpando

CAPITAL MARKETS FOR RETAIL IN 2023 – SEARCHING FOR MORE ECONOMIC CERTAINTY — Pg. 12

By: Gary Glick

OFFICE LEASING IN 2023 – CONTINUED HESITANCY IN THE RETURN TO OFFICE — Pg. 16

By: Andrew Ouvrier

KEY TAKEAWAYS

Retail in 2023

- Despite fears and talk of the economy falling into a recession for almost three quarters of 2022 and the Federal Reserve continuing to raise interest rates, the retail sector did not succumb to negative influences. In fact, even before the holiday season, according to the Orion Investment Real Estate article, "[r]etail sales rose by 1.3% in October and were 8.3% higher than last year's levels."
- Many ask how the retail sector has been able to withstand, survive, and even thrive following so many hits to the core fundamentals of the economy, and, moreover, will the retail sector continue its success in 2023? No one can completely answer the question or be sure of an answer. However, over the years, we have found that retail has been flexible, able to adapt, and change and morph in ways to enable itself to succeed.

Retail Development in 2023

- As we look toward 2023, uncertainty still exists in the retail development industry, this time in the form of supply chain issues, rising inflation, a labor shortage in retail, and general doubts about the economy, all of which will likely affect the retail sector in 2023. Despite all of these pressures and uncertainties, many in the industry remain cautiously optimistic about the coming year, while acknowledging that being able to adapt to changing times will remain key to survival.
- Many retail developers are seeking to strategically take back certain spaces prior to the natural expiration of the applicable leases in order to remerchandise with better tenants and higher rents.

Capital Markets for Retail in 2023

- In large part due to interest rate uncertainties, many retail real estate investors are viewing 2023 as a transitional year requiring changes in near-term investment tactics. A significant amount of capital likely will remain on the sidelines until there is greater clarity on pricing and future market conditions.
- Retail investors actively seeking opportunities likely will pursue the safety of top-quality retail assets that are better positioned to withstand expected headwinds due to favorable demand fundamentals or strong demographic support. Once it becomes clearer that the Fed is scaling back on its interest rate increase program, and it becomes clearer that inflation is heading in the right direction, the retail markets should once again restart.

Office Leasing in 2023

- As we move into 2023, we expect that remote working will continue to steer office users' leasing decisions. We also expect that those decisions will be affected by the availability of amenities for office workers as well as the types/locations of office buildings. These items, along with a large market of office space available for sublease, will tend to place downward pressure on rental rates and leasing activity in the office market in 2023.
- With return to office mandates falling flat, we expect that employers will need to incentivize workers to return to the office. Amenities desired by workers include things such as collaborative and socialization space, open spaces, ready access to food and coffee offerings, onsite gyms, and patio spaces, and much more.

DESPITE STRONG HEADWINDS, RETAIL CONTINUES TO ADAPT AND SURVIVE

By: Scott Grossfeld

What a difference a year makes! At the beginning of 2022, most commentators viewed the retail sector of the U.S. economy as a stabilizing, growing force, bolstered by generally strengthening core economic fundamentals. As we enter 2023, some of those core fundamentals are faltering, and retail is experiencing changes it has not seen in years (or even decades). The question now is – will retail be able to sustain its growth and resilience in the face of these challenges? We think it will.

2022 was somewhat of a rollercoaster year for the retail sector in the U.S. Although the year started with rises in COVID-19 due to the Omicron variant, thanks to large segments of the country being vaccinated and boosted, and better management of the virus and its impacts, the economy was able to remain open and operating and steer clear of resurgent recording-breaking hospitalizations and deaths.

In addition, many of the core fundamentals for a robust retail economy remained strong. Heading into 2022, the stock markets remained near all-time highs. Interest rates were low. Capital was plentiful and freely

available. The Federal Reserve was proactive in its bond purchase program. Consumer confidence was also at reasonably high levels. Unemployment was improving (and relatively low). In addition, retail sales and performance were strong coming out of the 2021 holiday period – a harbinger of positive future performance.

The general economy, and the retail segment, continued to chug along at a good pace through the first quarter.

Unfortunately, however, various factors, including world events, began to impact the economy in negative ways halfway through the first quarter of 2022. This impact was mostly manifested through the Russian invasion of Ukraine. Following the invasion, substantial sanctions were levied on Russian interests, which led to significant increases in gas prices throughout the world. Gas prices in the United States skyrocketed, and consumer prices on most all other goods increased as well.

"We see at least three major trends in retail that are helping retail manage changes in the overall economy. Traditional retail media or digitally born retailers are emerging as physical stores, tenant mixes and diversity are changing, and new store formats are taking form."

Although gas prices stabilized somewhat over time, they are still much higher than they were in 2021. In spite of stabilizing gas prices, the U.S. experienced the worst inflation it has seen in the past 30 years in the latter half of 2022. In addition to the war in the Ukraine, rises in inflation were also attributable to the zero COVID policy in China, which created significant supply chain issues. To combat inflation, the Federal Reserve instituted various rounds of interest rate increases (7 in total in 2022), to slow the economy. The stock markets waivered, had volatile swings, and are off of their all-time highs (although they are still doing reasonably well compared to long-term investment comparisons).Many believe the combination of inflation, rising interest rates and other forces have the potential to lead to higher unemployment and a recession. These factors will also likely have (as we have already seen) a negative impact on consumer confidence.

With these spiraling issues impacting the economy, many wonder how retail will fare.

Strong Retail Performance

Despite fears and talk of the economy falling into a recession for almost 3 quarters of 2022 and the Federal Reserve continuing to raise interest rates, the retail sector did not succumb to negative influences. Instead, according to a recent Orion Investment Real Estate article, "consumers appear[ed] to be resorting to some retail therapy." In fact, even before the holiday season, according to the Orion Investment Real Estate article, "[r]etail sales rose by 1.3% in October and were 8.3% higher than last year's levels."

Retail success continued into the holiday season. A number of sources issued positive predictions for retail performance during the 2022 holiday season, which is often a good indicator of upcoming retail industry performance for the ensuing year. According to a recent CoStar.com article, “Thanksgiving [2022] weekend [was] anticipated to draw a record number of shoppers, and sales for the overall holiday season [were] forecast to rise…. Consumers [were] expected to keep spending despite the economic headwinds of record inflation and potential recession….” The CoStar.com article quoted National Retail Federation President and CEO Matthew Shay, who expected to “see robust store traffic with a record number of shoppers taking advantage of value pricing.” Significant holiday season growth was forecasted in terms of both overall sales and foot traffic. CoStar.com also quoted Naveen Jaggi, President of JLL’s Retail Advisory Services, who stated “[t]o me, in light of the fact that we’ve been dealing with recessionary talk for the better part of almost three quarters now, that’s quite remarkable, which goes to show one thing: The U.S. consumer time and time again shows they’re massively resilient and will continue to spend. They may shift spending, but they continue to spend.” Other commentators had similar predictions.

It seems that the forecasts were accurate. As of the writing of this article, numerous authorities are reporting major increases in the numbers of shoppers and greater spending this past holiday season. According to a recent Forbes.com article, “[c]onsumers were back in stores on Black Friday as shopper visits increased by 2.9% compared to last year. The foot traffic to non-indoor mall locations, including lifestyle centers, open-air malls, neighborhood centers, and stand-alones, increased by 4.7%.” In addition, GlobeSt.com recently reported that “U.S. retail sales increased 7.6% year-over-year for the period running November 1 through December 24 [2022], excluding automotive.” Furthermore, according to Mastercard Spending Pulse (which measures in-store and online retail sales across all forms of payment), “in-store sales increased by 6.8% year-over-year while online sales ticked by 10.6%.” These numbers are impressive, especially while encountering gloomy macroeconomic factors, and bode well for retailers’ prospects as they likely face the same continuing challenges in 2023.

Looking Forward and Trends

Many ask how the retail sector has been able to withstand, survive, and even thrive following so many hits to the core fundamentals of the economy, and, moreover, will the retail sector continue its success in 2023?

No one can completely answer the question or be sure of an answer. However, over the years, we have found that retail has been flexible, able to adapt, and change and morph in ways to enable itself to succeed.

Currently, retail seems to still be benefitting from the after-effects of the pandemic – consumers are still tired of being cooped up at home, there is a general pent up desire to get out and spend, and a need for social interaction. Shopping addresses and satisfies those issues.

In addition, we see at least 3 major trends in retail, that are helping retail manage changes in the overall economy. Traditional retail media or digitally born retailers are emerging as physical stores, tenant mixes and diversity are changing, and new store formats are taking form.

According to a recent Placer.ai article, “[r]etail media networks, long a staple of the digital world, are becoming an increasingly important part of the brick-and-mortar environment….”

This sentiment is echoed by a recent ICSC.com article, where they find brands like "Warby Parker, Allbirds, Untuckit, Blue Nile" and others (including Amazon concepts) finding homes in physical locations.

As to tenant diversity, in its Retail Trends Forecast, Placer.ai, noted that shopping centers were "embracing new tenant types… [f]rom gyms to co-working spaces to medical practices…." The thought is that "[t]hese tenants … increase opportunities for retailers by generating new off-peak traffic and reducing competition between retail tenants. Non-retail tenants also allow shopping center visitors to have a more holistic, immersive experience which extends visit durations and gives consumers more reasons to frequent a shopping center."

Retailers are also adapting to e-commerce and fewer demands on the need for large amounts of on-site inventory by reducing the amount of space they need. As a result, retailers are taking less square footage in shopping centers and some are looking for (and landlords are permitting them to locate) so-called shop-in-shop locations within larger stores.

These (and other) shifts in retail strategies are simply some examples of evolving trends created by necessity and changing dynamics and reflect the flexibility that retail is famous for when confronted with threats to its ongoing success.

The economy constantly changes, and time and time again retail finds itself in a threatened position. However, as we have said before, consumers will always have a need to shop, eat, and experience retail services. In addition, history has also shown us that retail evolves to meet the changing times and remain a first-class asset.

SCOTT L. GROSSFELD, PARTNER

Scott's practice focuses on shopping center and other commercial development and leasing. He has comprehensive experience representing developers and property owners in all aspects of retail, office, mixed-use and industrial development, including the negotiation and drafting of leases, purchase and sale agreements, development and management agreements, reciprocal easement agreements, listing agreements and all other agreements related to the acquisition, construction, development and repositioning of commercial projects.

RETAIL DEVELOPMENT – WEATHERING CHOPPY SEAS WHILE STAYING AFLOAT

By: Dan Villalpando

As 2021 came to an end and the calendars flipped to 2022, many in the retail development industry were hopeful that better times were ahead. The country was climbing out of a crippling global pandemic, but many retailers who had been forced to close in 2020 and 2021 had re-opened, customers slowly got back to shopping and eating out, and life returned to what would pass for "normal," at least in terms of shopping preferences. However, as we look toward 2023, uncertainty still exists in the retail development industry, this time in the form of supply chain issues, rising inflation, a labor shortage in retail, and general doubts about the economy, all of which will likely affect the retail sector in 2023. Despite all of these pressures and uncertainties, many in the industry remain cautiously optimistic about the coming year, while acknowledging that being able to adapt to changing times will remain key to survival.

Any consideration of what might occur in 2023 requires us to revisit the impact of the pandemic to date. As the effects of COVID¬19 continued to linger in early 2022, millions of retailers were forced to close their businesses, and some of the smaller retailers (especially "mom-and-pop" restaurants and sundry shops) were unable to re-open and turned their keys back over to their landlords. Others reopened briefly, only to close again. As a result, despite the efforts of many retail developers (and the Federal Government) to provide financial assistance, the pandemic resulted in the shuttering of millions of square feet of retail space. However, some might argue that COVID¬19 only accelerated the inevitable for some retailers, who were struggling before the pandemic. This may actually result in a net positive for some landlords, who will be able to replace non-rent-paying tenants with new retailers to try to jump start their projects.

During calendar year 2022, many retail developers have been proactive in dealing with struggling tenants by negotiating early lease terminations. These developers are seeking to strategically take back certain spaces prior to the natural expiration of the applicable leases in order to remerchandise with better tenants and higher rents. Some “mid-box” or “junior anchor” tenants like PetSmart and Staples, who are looking to downsize their footprints, may be willing to give space back early, allowing landlords to aggregate enough square footage to attract certain “hot” retailers in an effort to revitalize their shopping centers. For example, discount and dollar stores such as Dollar General, Family Dollar, Dollar Tree, and Five Below are in the market for residual space, often in the 5,000- to 10,000-square-foot range. Dollar General, alone, recently announced plans to open more than 1,000 new stores in 2023, while Five Below is hoping to open 200 new stores. In addition, many retailers in other sectors, such as convenience stores, cosmetics, hobby stores, home furnishings, pet concepts, and shoe stores have accelerated expansion plans for 2023.

Other retail developers spent much of 2022 trying to support their tenants to help keep them open and paying rent. Some retail developers continued to organize curbside pickup programs at their properties to assist smaller retailers who lack the resources to establish their own programs. In addition, many developers are being forced to get creative with their parking lots to provide their tenants with the ability to offer buy-online-pick-up-in-store (BOPIS) capabilities, a trend that started during the pandemic, but appears to be here to stay. Since statistics show that over 80% of BOPIS consumers will shop for additional items while picking up their orders, it is no surprise that retailers are interested in offering this service, which may continue to be viable even when the pandemic subsides. Also, many retailers are requesting the right to reduce operating hours to accommodate for limited employee availability, despite contrary language in their leases. This results in instances where landlords are trying to be flexible by agreeing to allow certain stores to be open, while others are not (which is generally a situation landlords try to avoid). The common thread is landlords working with tenants to keep businesses open (and somewhat profitable) and making retail establishments feel as safe as possible to consumers, in order to keep them coming back.

In terms of what is occurring with different types of retail projects, grocery-anchored neighborhood centers appear to have weathered the storm and generally continue to provide a good return for their owners. Recent data indicates that, by mid-2022, national vacancy for neighborhood centers had fallen to 6.6%, well below the reading of 6.9% recorded in the fourth quarter of 2019. Newer market entrants like Aldi and Lidl have helped bolster the sector. In addition, specialty grocers, such as Whole Foods, Trader Joe’s, Erewhon, and Sprouts continue to open stores and provide some security to their landlords. Moreover, data indicates that fewer consumers are buying groceries online, in many cases because they think that the fees and other extra charges make it more expensive than shopping in-store. According to recent reports, e-commerce sales across the United States declined by 10% year over year in November, resulting in more trips to the local grocery store and, consequently, more foot traffic in the neighborhood center.

Another sector that seems to have rebounded is the luxury brands sector. While data indicates that luxury sales in the U.S. decreased by 14.3% in 2020, likely due in large part to the pandemic, customers in 2022 appear to have resumed spending on pricier items, and luxury good sales for 2022 are expected to be on par with 2019. Some attribute this to customers’ desire to “touch and feel” a product before spending

$3,000 on a handbag or $5,000 on a sport coat, something that was much more difficult to do during the pandemic. Luxury brands are also getting creative with pop-ups and Instagram activation to test concepts, while simultaneously attempting to appeal to a younger audience. Of course, the ability to lease to a luxury brand provider is market driven and is not a viable option to all retail property owners. However, those developers with the right real estate are finding willing partners with luxury brands like Hermes, Gucci, Channel, and Dior.

Not surprisingly, traditional enclosed regional malls have struggled, likely because shoppers have been unwilling, or unable, to brave the enclosed spaces that make up most indoor malls. As a result, owners of regional malls in non-affluent areas (mainly Class B and C malls) have had to adopt non-retail uses to stay relevant. Such uses include offices (ranging from call centers to high-tech spaces), distribution and industrial centers, movie stages, and data centers. Other "experiential" uses like pickleball courts, golf-themed spaces such as Puttshack, Puttery, and Popstroke, and bowling alleys like Stars and Strikes and Main Event are becoming viable options for retail developers with large spaces to fill. Whether such uses will still fall in the "retail" category after conversion remains to be seen, but there does seem to be an appetite for developers to repurpose underperforming enclosed malls. In addition, the ability to add such non-traditional

"When it comes to the world of retail development, many believe that the pandemic accelerated the evolution of retail, perhaps for the better. The good news is that brick-and-mortal retail has survived, exhibiting the resilience that many in the industry feel will allow it to weather new challenges in 2023 like supply chain issues, rising inflation, and a labor shortage."

tenants needs to 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 re-lease space and get some rent in return. But adding such uses may upset major or anchor tenants at a project, who may decide to aggressively fight the new uses or to leave the project when their current term expires, rather than renew or exercise available options.

Meanwhile, many retail developers continue to be affected by the closures of department stores, such as Sears, Macy's, and JC Penney. Even before COVID¬19, the deconstruction of the department stores, or "right-sizing," was seen by some as the natural progression of retail; those department stores that have elected to stay open have generally reduced product offerings to three primary product categories—apparel, housewares, and cosmetics/fragrances.

At the same time, some larger retailers are looking at less popular malls for their next store. These retailers, who may have struggled to stand out at a crowded top-tier mall, may determine that their position at a low-

er-class mall is actually elevated, giving them a stronger position within the market and an increase in sales. While this trend is not a given in 2023, it is certainly something to keep an eye on, especially for owners of Class B and C malls.

As has been the case in recent years, retailers will need to continue to adapt to the changes in their customers in order to continue to be successful. For example, the importance of being able to offer “omnichannel” marketing has been magnified by the pandemic. Recent data indicates that business that adopt omnichannel strategies achieve 91% greater year-over-year customer retention rates than business that don’t, and that consumers now use an average of almost six touchpoints when buying an item. In addition, customers are becoming increasing cognizant of “sustainable shopping,” where shoppers express curiosity about what a product is made out of, where it is made, and what they can do with it when they have finished. As a result, many retailers have been forced to improve their corporate social responsibility initiatives by selling ethically-sourced products, implementing green business practices, and being transparent with that information with their customers.

When it comes to the world of retail development, many believe that the pandemic accelerated the evolution of retail, perhaps for the better. The good news is that brick-and-mortal retail has survived, exhibiting the resilience that many in the industry feel will allow it to weather new challenges in 2023 like supply chain issues, rising inflation, and a labor shortage. To do so, retail developers will continue to be forced to adapt by working with their tenants to keep them open and transforming their projects to deal with whatever the immediate future brings.

DANIEL J. VILLALPANDO, PARTNER

For more than 25 years, Dan has specialized in commercial development and leasing. Developers and property owners look to Dan for his counsel on all aspects of shopping center development, including the acquisition and disposition of commercial real estate and the negotiation and drafting of development agreements, reciprocal easement agreements and leases with almost every national and regional retailer.

CAPITAL MARKETS FOR RETAIL IN 2023 – SEARCHING FOR MORE ECONOMIC CERTAINTY

By: Gary Glick

Inflation, the war in Ukraine and supply chain problems dominated the news for much of 2022. As a result of exceedingly high inflation (which peaked around 9%), the Federal Reserve (Fed) took unprecedented measures to curtail inflation by raising the federal funds rate seven times in 2022. Prior to that – since the Great Financial Crisis (GFC) of 2008 - the federal funds rate remained near zero, as the Fed worked to ensure that the economy would not collapse, and then to support recovery and growth. In part due to the Fed keeping rates close to zero, the economy, and the commercial real estate markets, saw unparalleled growth. When the pandemic occurred, the U.S. government then provided trillions of dollars of stimulus,

much of which was essential for economic survival and stability. However, as the economy started to recover after the COVID shutdowns, the federal funds infused into the economy contributed to inflationary pressure, even with record unemployment levels. As a result, the Fed felt compelled to impose counter-inflationary measures by raising interest rates, which they did seven times in 2022. The Fed's key lending rate stood at a range of 0% to 0.25% at the beginning of 2022 and closed the year at a range of 4.25% to 4.5%. These actions by the Fed, although not good for commercial real estate, have helped drive a significant slowdown in inflation.

"In large part due to interest rate uncertainties, many retail real estate investors are viewing 2023 as a transitional year requiring changes in near-term investment tactics. A significant amount of capital likely will remain on the sidelines until there is greater clarity on pricing and future market conditions."

Some economists believe that the U.S. economy entered a recession in the first half of 2022 in part due to the actions of the Fed, after having sustained two straight quarters of declining gross domestic product (GDP). However, if a recession did occur, other economic indices do not indicate a downturn: Unemployment claims are at their lowest levels since the 1960s and jobs are growing (although this growth seems to now be tapering off). Further, consumer spending was reasonably good throughout much of 2022.

Even though the actions of the Fed appear extreme to some, the Fed is setting interest rates closer to traditionally historical levels. Nonetheless, interest rate uncertainty over 2022 proved to be a major problem for the commercial real estate industry. When the Fed believes inflation is under control, and signals to the business community that it will no longer pursue a policy of planned interest rate increases, the commercial real estate markets should steady and begin to grow again.

In large part due to interest rate uncertainties, many retail real estate investors are viewing 2023 as a transitional year requiring changes in near-term investment tactics. A significant amount of capital likely will remain on the sidelines until there is greater clarity on pricing and future market conditions. However, retail investors actively seeking opportunities likely will pursue the safety of top-quality retail assets that are better positioned to withstand expected headwinds due to favorable demand fundamentals or strong demographic support. Once it becomes clearer that the Fed is scaling back on its interest rate increase program, and it becomes clearer that inflation is heading in the right direction, the retail markets should once again restart, possibly in a significant way.

Over the past decade, grocery-anchored assets and net lease retail opportunities have dominated the retail investment landscape. Even with interest rate challenges, many observers predict that this should

not change in 2023. As has been the case for many years now, the best opportunities in retail remain grocery-anchored community and neighborhood centers—particularly those in primary or high-population growth markets.

Net lease retail should also continue to remain in high demand at potentially historically low cap rates, particularly fast-food properties with drive-throughs, assuming that long-term leases are in place to the very best of the national credit tenants. The challenge is one of available product, because investors are all chasing this product type.

There also is momentum from institutions to allocate capital to strategies that can take advantage of re-pricing in the retail market, either because of acute distress or simply adjustment in values. There is a view common among these institutions that the next couple of years may be an excellent time to utilize their capital. However, many of these institutions are currently analyzing whether the economy is close to creating an environment for these opportunities now, or whether it will take greater interest rate stability later this year to create a more conducive environment.

Investors that are still in the market are favoring value-add retail projects, in large part because of the opportunity to take advantage of selective stress or distress in the market, such as the need for recapitalization or gap equity. Most value-add investment opportunities have income in place, offering additional defensive characteristics in the existing economic environment. However, core retail assets likely will continue to be the foundation of most retail investors' allocations. Many opportunities may exist today if investors have the patience and foresight to consider a longer time-period (say, three to five years) in assessing how a retail real estate project will perform.

As was stated by one retail institutional investor in 2023 Emerging Trends in Real Estate (published by pwc and ULI), "We anticipate an uptick in retail investment across the board in 2023. [E]veryone is chasing industrial and multifamily, and there is greater uncertainty emerging around office. Retail pricing is going to offer better returns, but you need to know what you're doing. That said, I think there is greater clarity in retail now than there has been in a long time for investors."

Since the GFC, lenders, for the most part, have been very careful in underwriting the acquisition of retail projects, or lending on new or completed retail projects. Although the recent steep rises in interest rates will impact retail development projects, lenders, for the most part, are not looking to take drastic measures such as foreclosure. Most lenders will work with their borrowers on loan modifications and extensions. However, for new developments, if the lender believes the development processes has been significantly mismanaged, it may take more drastic measures.

In terms of new loan originations for retail, lenders are in much the same position as buyers or sellers of retail projects; once they have a clearer understanding that inflation likely is under control and some certainty that the Fed will no longer aggressively raise rates, they will become more comfortable lending under the right circumstances. As in the years following the GFC, the majority of lenders likely will expect 50% to 65% loan to value ratios and well-heeled sponsors. Rates for construction loans should be between 300 to 400 basis points over SOFR with a floor, and with full to limited recourse required. For stabilized retail

projects, lenders will most likely be willing to loan at fixed rates around 200 basis points over SOFR, with terms in the 5 to 10 year range.

Even with the uncertainty surrounding interest rates, inflation and supply chains, significant capital continues to exist for strong retail projects. The big uncertainty for retail real estate developers and investors is interest rates. The fundamentals for most retail projects still remain strong, and significant capital exists in the marketplace. The expectation is that retail sales and lending for retail developments will pick up substantially in the later part of 2023 as more certainty returns to interest rates, and inflation moderates.

GARY A. GLICK, PARTNER

Gary specializes in shopping center and commercial development and retail, office and industrial leasing, generally representing developers and property owners, as well as major retailers. Gary has also represented retail and commercial developers in the acquisition and disposition of both undeveloped land and commercial projects.

OFFICE LEASING IN 2023 – CONTINUED HESITANCY IN THE RETURN TO OFFICE

By: Andrew Ouvrier

The tumultuous events over the last few years have had, and will continue to have, profound effects on all aspects of our daily lives and habits. As we move into 2023, we find that, while COVID-19 continues to affect all of us, many of the direct effects of COVID-19, such as isolationism, social distancing requirements, and the obligation to wear masks in public, either no longer affect us or have been blunted by time and familiarity.

The concerns and effects of COVID-19 on the U.S. real estate markets began to give way at the end of 2022 and have been largely replaced by concerns about the U.S. economy resulting from numerous factors, including the Federal Government increasing interest rates to the highest levels in decades, the corresponding higher cost and limited availability of capital, and the very real fear of an impending recession.

Most U.S. real estate markets, including the office leasing market, have not yet returned to their pre COVID–19 levels, and the current economic concerns have come at an especially difficult time. Fortunately for landlords, notwithstanding increased vacancies in office spaces, most existing office tenants have continued to make their rental payments, which is in part due to the long-term nature of most office leases, and the desire for tenants to have an office for their employees to return to, if and when the long hoped-for "return to office" occurs.

As we move into 2023, we expect that remote working will continue to steer office users' leasing decisions. We also expect that those decisions will be affected by the availability of amenities for office workers as well as the types/locations of office buildings. These items, along with a large market of office space available for sublease, will tend to place downward pressure on rental rates and leasing activity in the office market in 2023, creating tenant-favorable market conditions. However, there are few bright spots in the office leasing

markets such as best-in-class office properties, flex space, and medical office space, where leasing activity should continue to be robust.

The hybrid work model is likely to remain with us for the foreseeable future.
As cities went into lockdown early in the COVID-19 pandemic, there were few who could have predicted just how successful large scale remote working could be. Remote working has now become the new standard for many office employees. Remote working, especially working from home, can result in financial savings by eliminating commutes, and for many can also result in time savings that can be used for family time or to pursue other personal interests. Such additional time has, in turn, brought about a renewed emphasis on employee work-life balance and on individual autonomy. Now that office workers have lived with the benefits of remote working, few are willing to give up those benefits. What started as a necessity at the beginning of the COVID-19 pandemic has now become an expectation for many office workers.

Employers, on the other hand, have legitimate reasons to prefer that employees come back to the office. As noted in the recent PWC/ULI Emerging Trends in Real Estate 2023, some of the reasons include instilling culture, easing onboarding, and increasing productivity.

Other analysts have pointed to employee focus, increased employee productivity, maintaining corporate culture/identity, and the benefits of in person face time (especially for more junior employees).

So far, there has been no consensus on a "return to the office" by employers across the country. Some smaller companies have embraced a fully remote work environment, while many larger companies have made large scale pushes for a full time return to the office. Last Labor Day, a number of large employers made headlines by imposing strict return to work requirements for their employees, most of which fell flat. In the current economic environment, workers see themselves as having an upper hand in work relations, and unless that changes, return to work mandates will likely continue to see little traction.

Consequently, as a compromise between employer and employee needs, companies have found it necessary, and will likely continue to find it necessary on a going forward basis, to offer hybrid work arrangements whereby office workers work from home several days during the week and work in the office the other days of the week. PWC/ULI indicates that the average office worker is currently in the office 3 to 3.5 days per week. These hybrid work arrangements are viewed as necessary in the ongoing effort to attract new talent and to retain existing employees who have grown accustomed to the freedoms and flexibility that remote working offers.

From a leasing perspective, hybrid work arrangements require employers to rethink how much office space is actually needed for their employees. In its recent U.S. Real Estate Market Outlook 2023, CBRE indicated that while employers are still trying to find a balance in their hybrid work agreements (and there's no one-size-fits-all approach to hybrid work arrangements), the hybrid approach might "ultimately reduce demand for office space per employee by up to 15% from the pre-pandemic norm."

Additionally, the hybridization of office work tends to result in an underutilization of office space. Since only a portion of office workers are coming into the office on any given day, employers are forced to consider what

to do with their “excess” space. Many employers continue to hold on to their excess space, often due to a desire to retain the space for future planning needs, such as if the level of employees returns to its pre-pandemic levels, or for use as future open space/collaborative space. Other employers have elected to try to sublease their excess space. As a result, the subleasing market has exploded in the last few years, with one recent CoStar report indicating that there has been a 90% increase in the amount of sublease space available on the market as compared to the end of 2019, and we expect that trend to continue in 2023. The proliferation of available sublease space, which is often leased at rates that are lower than the typical market rates for similar space, will continue to place downward pressure on the rental rates in typical direct office leases.

“We expect the greatest leasing activity in 2023 to be in newer Class A properties, flex space properties, and medical office properties. Given their more recent construction and modern design character qualities, newer Class A office buildings are simply more likely to be able to provide the amenities desired by today’s office workers.”

Office amenities, once seen as merely desirable, are becoming necessities.

With the runaway success of remote working, workers who are able to work remotely have, in many cases, little incentive to return to the office. With return to office mandates falling flat, we expect that employers will need to incentivize workers to return to the office – if an office worker is going to give up the very real benefits of remote work, that worker will need an office environment that is conducive to a return – a place where that worker wants to be on a daily basis.

Amenities desired by workers include things such as collaborative and socialization space, open spaces, ready access to food and coffee offerings, onsite gyms, and patio spaces, as well as other less obvious but no less important items such as high ceilings, large exterior windows that allow natural lighting, highly efficient and filtered air ventilation, and touchless access technologies. As noted in CBRE’s recent U.S. Real Estate Market Outlook 2023, “[t]enants will demand more from their buildings in 2023 to better support activity-based work and increase productivity.”

Office buildings either currently have these type of amenities, or they can be added. While the idea of simply adding amenities might make sense in theory, it may be difficult to implement in practice. Many older building were originally constructed with standard ceiling heights and smaller floor plates that are not conducive to the creation of large open spaces or the addition of other amenities. For an existing owner to update those buildings to allow for such amenities would require a large influx of capital, but, as noted above, with rising interest rates and the higher cost and limited availability of capital, it may prove difficult for many landlords to make these types of updates to their buildings, which has the potential to limit the supply of amenity-rich

buildings in the market. Additionally, whereas in prior years, purchasing an older building as a “value-add” project was often an attractive option, such value-add projects are currently out of favor, and we do not expect to see many such projects being completed in the near future, further limiting the supply of amenity-rich buildings in the market. This will likely negatively affect the desirability of such buildings as targets for employers’ long term office leasing needs, leading to a glut of “obsolete” vacant office space on the market, which in turn will tend to depress rental rates and leasing activity on these types of assets.

Best in class office assets, flex space and medical office space continue to be bright spots within the office leasing market.

We expect the greatest leasing activity in 2023 to be in newer Class A properties, flex space properties, and medical office properties.

Many analysts have pointed to a consistent “flight to quality” in office space needs, where those office buildings that have the most desirable amenities are the ones most likely to capture a large share of any new demand for office space. Given their more recent construction and modern design character qualities, newer Class A office buildings are simply more likely to be able to provide the amenities desired by today’s office workers. To help illustrate the divide between newer and older buildings, a recent report by JLL Research indicated that between the beginning of COVID 19 and the second quarter of 2022, there was 86.8 million square feet of net space absorption in buildings constructed in 2015 or later, while there was 246.5 million square feet of negative net space absorption in older buildings, with the majority of such negative net space absorption occurring in buildings erected during the 1980s and earlier. As such, we expect to see the greatest amount of office leasing activity in newer Class A buildings.

Interestingly, it is not just the type and age of building at play here. Suburban offices tend to have higher leasing activity than offices in central business districts. This is consistent with the hybrid work model where office workers prefer the often-shorter commute to a suburban office location than to a downtown office location.

Flex space is office space that is operated by third party providers, such as WeWork and other traditional executive suite operators. Given the uncertainly of many companies’ space needs for the foreseeable future, flex space allows companies to supplement their existing leased spaces with flexible, often short-term leases that can be used to address short-term space needs, such as a rapid expansion or contraction of personnel. Flex space can also be used as part of a company’s hybrid work arrangement to provide satellite offices or to house specific individuals who may not be able to easily access a company’s main office. Given the desirability of flex space, we expect to see more owners partnering with experienced flex space providers, resulting in an increase in flex space leasing activity in 2023.

The demand for medical office space continues to rise. In addition to the COVID–19 pandemic, which made the need for readily available medical care all the more evident, a confluence of factors, such as the aging U.S. population and increasing lifespans, rising medical costs, new medical technologies/outpatient procedures, and insurance companies’ push for outpatient care in an effort to reduce costs, has caused an increase in demand for medical services at medical offices, rather than at more traditional hospital or surgery center settings.

The hybrid work model has less immediate impact on medical office space. While some medical officer work, such as accounting and other back-office functions, may be performed remotely, most workers, including technicians, nurses, and doctors, require “face time” with their patients and need to be in the office in order to have that level of personal interaction. Additionally, hybridization and remote working have not limited the patients’ need for waiting room space and exam rooms. As such, remote working will continue to have less of an impact on medical office space than in other office leasing sectors. Some analysts see video “telemedicine” as a factor that might diminish demand for medical office space, but telemedicine is more often seen as a means to help alleviate overcrowded waiting rooms, not as a substitute for a medical professional seeing a patient in person. In addition, following the increase in remote working, we expect that most patients will continue to prefer to have medical services available closer to home, instead of being located at or near large hospitals. As a result, we expect to see a continued steady growth in medical office demand in 2023.

Continued Uncertainty in Office Leasing.

With the current office working environment initially shaped by the COVID–19 pandemic, and continuing to be shaped by the drastic changes in interest rates and other aspects of our economy, office employees will continue to desire the ability to work primarily from home, and employers will seek ways to incentivize workers so that they will return to the office, in at least a hybrid work arrangement. While everyone is working to optimize the hybrid work environment, we expect that the general trend of slower leasing activity that we saw in 2022 will likely continue in 2023. However, with respect to certain asset classes, such as newer Class A properties, flex space properties, and medical office properties, we anticipate seeing increased leasing activity throughout 2023.

ANDREW M. OUVRIER, PARTNER

Andy’s practice focuses on the leasing and development of office, retail, medical office and mixed-use properties. He has a proven track record of structuring, negotiating and executing complicated deal transactions for a wide variety of clients, including institutional investors, entrepreneurial individuals and entities, and institutional tenants. He also regularly represents landlords in the ongoing management of office projects and retail shopping centers.

THE RETAIL & COMMERCIAL DEVELOPMENT GROUP OF COX CASTLE

The Retail & Commercial Development 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, as well as office and mixed-use projects. Members of the Retail & Commercial Development Group include attorneys who are experts in sales and acquisitions, reciprocal easement agreements, development and management agreements, and leasing, and generally represent shopping center, office, and industrial developers, as well as major retailers.

LOS ANGELES

2029 Century Park East
Suite 2100
Los Angeles, CA 90067

P: 310.284.2200
F: 310.284.2100

IRVINE

3121 Michelson Drive
Suite 200
Irvine, CA 92612

P: 949.260.4600
F: 949.260.4699

SAN FRANCISCO

50 California Street
Suite 3200
San Francisco, CA 94111

P: 415.262.5100
F: 415.262.5199

The articles contributed to the 2023 Forecast were wrtitten by the following members of the Retail & Commercial Development Group of Cox Castle:

SCOTT GROSSFELD
Partner

P: 310.284.2247
F: 310.284.2100
sgrossfeld@coxcastle.com

DANIEL VILLALPANDO
Partner

P: 310.284.2278
F: 310.284.2100
dvillalpando@coxcastle.com

GARY GLICK
Partner

P: 310.284.2256
F: 310.284.2100
gglick@coxcastle.com

ANDREW OUVRIER
Partner

P: 310.284.2189
F: 310.284.2100
aouvrier@coxcastle.com

www.coxcastle.com

© 2023 Published by the Retail & Commercial Development Group of the Law Firm of Cox, Castle & Nicholson LLP. Cox, Castle & Nicholson LLP is a full-service law firm offering comprehensive legal services to the business community and specialized services for the real estate and construction industries. Reproduction is prohibited without written permission from the publisher. The publisher is not engaged in rendering legal, investment, business or insurance counseling through this publication. No statement is to be construed as legal, investment, business or insurance advice.