

# BUSINESS BRIEFING

## US RETAIL

# RACE TO THE BOTTOM

RETAIL CONTINUES TO DEVELOP NEW STRATEGIES AS THE FINANCIAL CRISIS DEEPENS

FIRST QUARTER, JANUARY 2009 | A VALUATION ADVISORY SERVICES PUBLICATION

## CONTENTS

- 1 Introduction
- 2 Retailers feel the pain
- 3 It all comes down to housing
- 4 Race to the bottom
- 5 High vacancy stalls expansion plans
- 6 Expect more drama before recovery

Cushman & Wakefield, Inc.  
51 West 52nd Street  
New York, NY 10019-6178  
Tel (212) 841-7500  
[www.cushmanwakefield.com](http://www.cushmanwakefield.com)

## EXECUTIVE SUMMARY

For US retail, the signs of the times are: increased vacancy, lower rents, layoffs, bankruptcies, delayed expansion plans, and significantly reduced investment activity and values. At \$2.4 billion, investment volume in the fourth quarter of 2008 stood at the lowest level since 2001. Portfolio sales remain essentially non-existent. Value decreases across all retail formats have ranged from 10 percent to more than 20 percent since the start of the downturn in 2007. However, as we have stated in previous briefings, retail is unique among commercial real estate sectors in its ability to reinvent itself when consumer habits change. This reinvention can occur in products, brands, and even properties. As we begin the fast race to the bottom, more difficult times may be ahead, but retailers can still begin mapping out plans for recovery.

## INTRODUCTION

2008 was the most difficult year for the retail sector in more than four decades. As their jobs, home values, investments, and confidence eroded, American consumers embraced a renewed sense of frugality not seen in two generations. As we enter 2009, the prolonged global recession and unprecedented collapse of the credit markets have resulted in the liquidation of a growing number of retailers. Even the most resilient blue-chip companies must now resort to deep-discounting and sharp cuts in capital spending to stay afloat. For owners, illiquidity and declining consumption have caused a sharp disruption in all areas of retail investment, including transactions, financing, and macro-level property fundamentals

Retail performance is fundamentally affected by the consumer's willingness and ability to spend. Consumer sentiment in December, as measured by the Reuters/University of Michigan Surveys of Consumers, remained near historic lows. While further significant erosion is unlikely, as we have clearly entered "scream as we race to the bottom" phase of the downturn, an improvement in confidence is

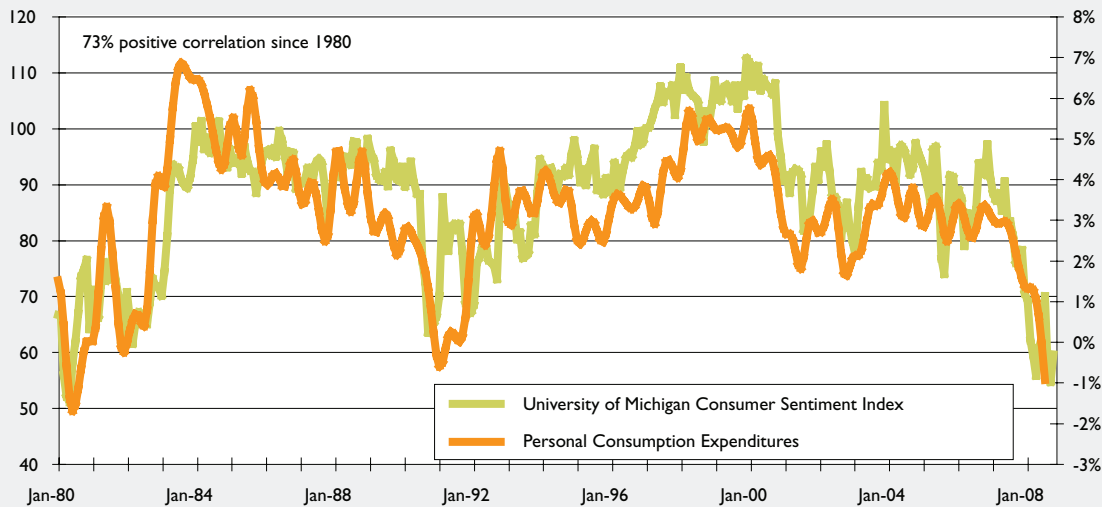


A VALUATION ADVISORY SERVICES PUBLICATION

unlikely to translate into added stimulus to retailers anytime soon. The fact is that consumers have developed a taste for deflation, brought on by the collapse of oil prices and deep discounting across the retail sector – and it will take sustained economic stability to build trust and change expectations.

For now, employment remains a major source of anxiety, as 2.6 million jobs were lost in 2008, the highest total since the end of World War II – and many more are expected before the bottom is reached. These losses pushed the unemployment rate up 230 basis points at year-end to 7.2 percent, the highest since 1993. Adding to the woes is that home equity – a significant contributor to consumer spending during the housing boom – is no longer a viable source of credit for most homeowners. Average equity in American homes fell below the 50-percent mark for the first time on record in March 2008, and continued to fall throughout the year. This trend will likely continue, as lenders and investors look to move the record inventory of foreclosed homes off of their books. Chart 1 compares consumer sentiment to consumer spending.

CHART 1: NERVOUS CONSUMERS HOLD ON TO THEIR WALLETS



Data courtesy of Moody's Economy.com, Reuters/University of Michigan Surveys of Consumers

RETAILERS FEEL THE PAIN

The sudden popularity of frugality among American consumers has had a predictable impact on the nation's retailers. After growing by 4.2 percent in 2007, retail and foodservice sales conditions weakened considerably throughout 2008, with fourth-quarter sales down 7.7 percent, the worst performance since Census Bureau records begin in 1966. Furthermore, sales in December fell by nearly 10 percent year-over-year to the lowest level in five years. This nearly unprecedented erosion of consumer demand led to a 50.1 percent increase in store closings in 2008 – to the highest level since 2001, according to the International Council of Shopping Centers (ICSC). Nearly all retailers are reversing or curtailing their expansion plans for 2009 in response to reduced demand. Retail employment also took a major hit with 522,000 jobs lost in 2008.



A VALUATION ADVISORY SERVICES PUBLICATION

The situation has become dire for many retailers that were already struggling with high debt loads or bankruptcy reorganization, as evidenced by the liquidations of Circuit City, Linens 'n Things, Mervyn's, Steve & Barry's, Value City, and Goody's. Nearly all retailers, with the notable exceptions of Wal-Mart, drugstores, and warehouse clubs, are reporting lower sales productivity. Declining tenant sales and rising vacancy will constrain owners in terms of their ability to grow effective rents, as retail tenants are very sensitive to occupancy costs. Many retailers, including Borders, Gap, Office Depot, Chico's, Pier 1 Imports, and Starbucks are pressing for rent reductions or concessions. Chart 2 compares trends in same-store sales in the last five years.

CHART 2: ICSC CHAIN STORE SALES INDEX

Format	2004	2005	Average Monthly Change		
			2006	2007	2008
Total Comp Store Sales	3.8%	3.9%	3.6%	2.1%	1.1%
<b>Total Less Wal-Mart</b>	<b>4.1%</b>	<b>4.0%</b>	<b>4.8%</b>	<b>2.6%</b>	<b>-0.9%</b>
Apparel Chain Stores	3.2%	1.9%	1.1%	-2.0%	-7.1%
Department Stores	1.6%	2.2%	4.5%	0.2%	-6.4%
Luxury Stores	9.6%	6.2%	6.7%	6.3%	-7.5%
Discount Stores	3.4%	3.4%	2.5%	1.3%	1.6%
Drug Stores	6.4%	5.6%	7.5%	4.9%	2.3%
Wholesale Clubs	7.2%	6.5%	4.6%	5.5%	5.4%

Source: ICSC

Ten percent of all residential mortgages were at least one month overdue in the third quarter; the highest level since the Mortgage Bankers Association began tracking the market in 1969.

IT ALL COMES DOWN TO HOUSING

One-in-six Americans now owe more on their mortgage than the house is worth, and 29 percent of those owners bought their homes within the last five years, according to Moody's Economy.com. Additionally, 10 percent of all residential mortgages were at least one month overdue in the third quarter, the highest level since the Mortgage Bankers Association began tracking the market in 1969. With an 85-percent positive correlation between the performance of housing and retail sectors in the last three years, the residential market is considered a lagging indicator of the health of the retail market. In previous economic cycles, retail spending has followed the variances in the housing market with a lag time of around six months. While the outlook for consumers remains undeniably negative, lower commodity prices and hints of a thaw in the credit markets are beginning to ease anxiety. Chart 3 compares growth between the median home price and core retail sales.

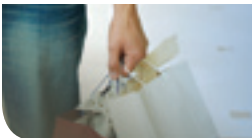
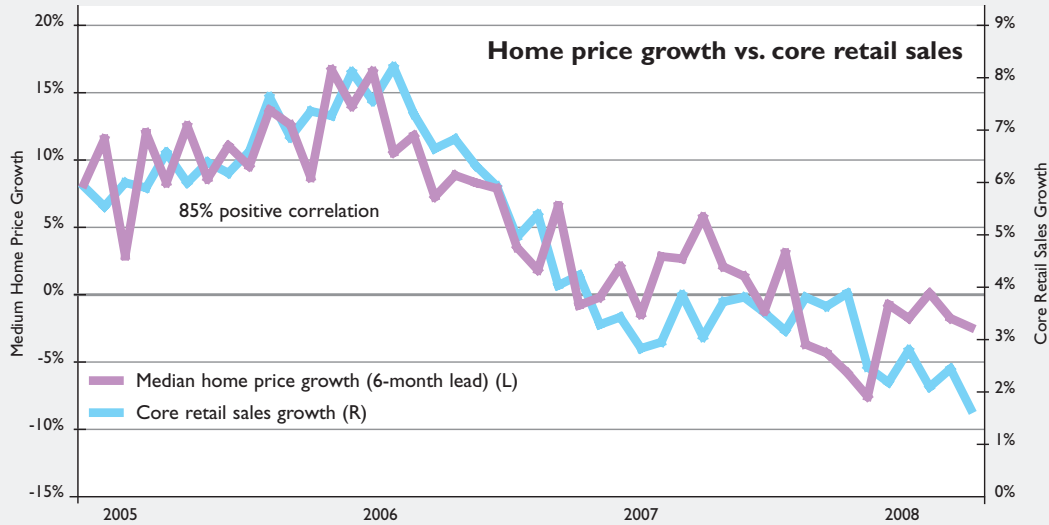


CHART 3: BUYING FOLLOWS HOME PRICES



Data courtesy of Moody's Economy.com

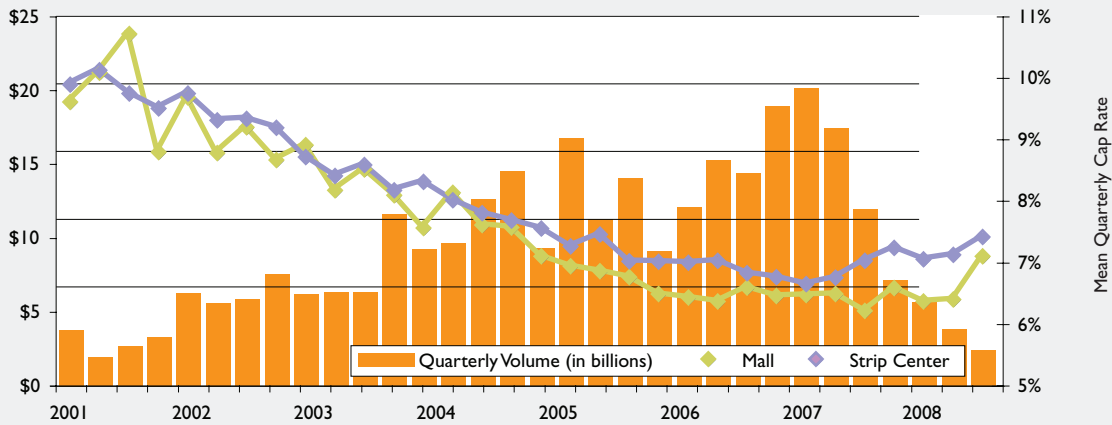
## RACE TO THE BOTTOM

Retail investment activity plunged to \$19 billion in 2008, a 72-percent decrease from 2007, according to recent estimates by Real Capital Analytics (RCA). Quarterly transaction volume fell by an average compounded rate of 29 percent from the second half of 2007 due to buyer-seller pricing disconnects and the inability to obtain financing. At \$2.4 billion, the volume in the fourth quarter of 2008 was at the lowest level since 2001. Portfolio sales, which made up the bulk of the volume in 2007, were essentially non-existent last year. For the deals that are closing, buyers are more often relying on seller financing or joint venture agreements with a better capitalized partner. De-leveraging can be a painful process for property owners and will likely contribute to a further decline in macro-level property fundamentals. However, as desperation increases there are tremendous opportunities for low-leverage and cash buyers to re-enter the market.

While the market remains opaque, there is clear evidence of upward pressure on capitalization rates. RCA reports that cap rates averaged 7.2 percent in the fourth quarter of 2008, up 70 basis points from a low of 6.5 percent in the second quarter of 2007. Strip center cap rates increased 40 basis points year-over-year in the fourth quarter to 7.4 percent. Mall cap rates gained 90 basis points over the same period to an average of 7.1 percent, with much of the increase coming in the fourth quarter. Rates are poised to continue to trend upward through the first half of 2009, although low-transaction activity obscures the magnitude of the correction. Chart 4 displays retail investment activity since 2001.



CHART 4: QUARTERLY RETAIL MARKET CONDITIONS



Source: Real Capital Analytics, Inc.

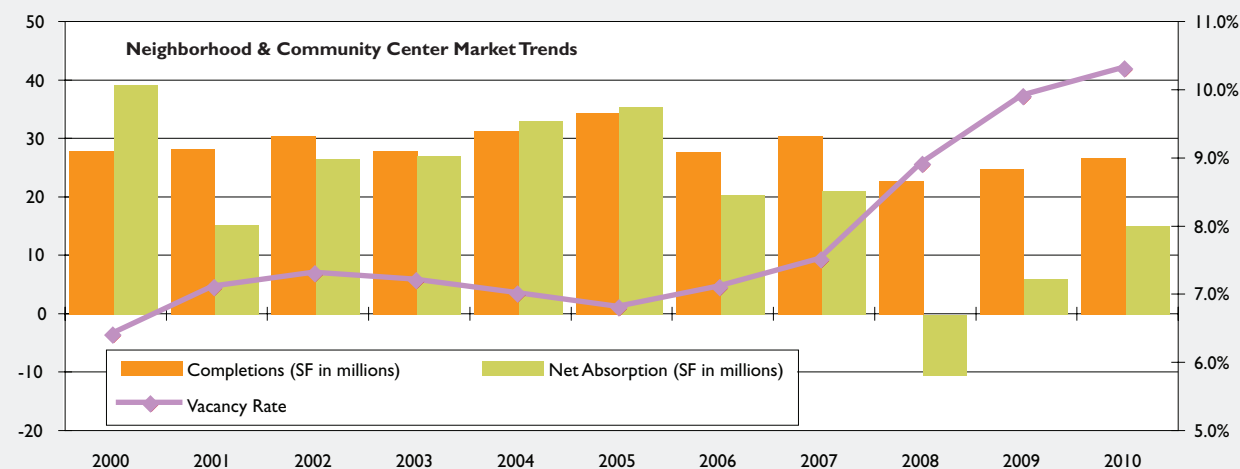
A rapid slowdown in new supply and more attractive lease terms to potential tenants will eventually help correct the supply/demand imbalance.

### HIGH VACANCY STALLS EXPANSION PLANS

Vacancy at neighborhood and community centers increased throughout 2008, as absorption fell well below the level of new supply due to store closings and stalled expansion plans. In its preliminary release of fourth-quarter market trends, Reis noted that the national average vacancy rate increased by 50 basis points for neighborhood and community shopping centers to 8.9 percent, the largest jump since Reis began tracking the market in 1999. Regional mall vacancy also increased by 50 basis points, to 7.1 percent. Total national absorption in the first quarter of 2008 was negative for the first time since the firm began tracking the market in 1980, and continued to trend downward throughout the year. Absorption fell to negative 4.1 million square feet in the fourth quarter and negative 9.4 million square feet for the year, fueling a 140-basis point rise in vacancy from 2007.

A rapid slowdown in new supply and more attractive lease terms to potential tenants will eventually help correct the supply/demand imbalance. McGraw Hill Construction recently reported that retail construction slowed by 37 percent in the year through July, 2008. Supply likely contracted at an even sharper rate in the second half of the year. Given the sharp rise in vacancy, rents will continue falling into 2009. Effective rents will be influenced by higher concessions, particularly in weaker markets. Reis reports that asking rent growth for all shopping centers inched up by 0.3 percent in 2008. Effective rents, however, fell by 1.1 percent. The decline indicates a large increase in concessions in the course of the year.

CHART 5: NEIGHBOURHOOD AND COMMUNITY CENTRE MARKET TRENDS



© 2008 Reis, Inc.  
All Rights Reserved

If there is a silver lining for property owners, it's that retailers are now more inclined to rent their space rather than build new stores to improve their balance sheets.

## EXPECT MORE DRAMA BEFORE RECOVERY

Market participants we surveyed confirm the reports of Reis and other industry analysts; that is, as we progress through the first half of 2009, we can expect higher vacancy, lower rents and weak transaction activity. We have already seen value decreases across all retail formats ranging from at least 10 percent to more than 20 percent since the start of the downturn in 2007. Consequently, capitalization rates are poised to rise further. While yield rates for virtually all commercial real estate assets are trending upward, there is evidence of a bifurcated market with Class A retail assets still in demand by all-cash or low-leverage buyers. Yield rate changes for core assets in major metro markets have not been impacted to the same degree as the lower end (B/C Class) market. This is partly driven by the fact that financing is available for credible buyers of assets that fit this investment profile. Properties falling at the lower end of the investment-risk spectrum are more vulnerable to retrenching prices, as this market has traditionally appealed to less-sophisticated buyers or opportunistic high-leverage buyers who are now priced out of a transaction. As retail sales flatten out, both current and prospective tenants will be in a much stronger position to negotiate rent reductions, higher concessions, and achieve postponements in the timing of contractual rent bumps. So, in addition to higher cap rates today, the underlying economics of the property are also driving values lower.

Despite the most challenging market conditions in nearly two decades, retail will continue to reinvent itself. If there is a silver lining for property owners, it's that retailers are now more inclined to rent their space rather than build new stores to improve their balance sheets. As property owners refocus on improving existing portfolios, this trend will help moderate vacancy losses from increased store closings. This chain of events will ultimately place many owners in a more stable competitive position once the market improves.



A VALUATION ADVISORY SERVICES PUBLICATION

**ABOUT THE CUSHMAN & WAKEFIELD VALUATION SERVICES GROUP**

The Valuation Services Group is one of the largest fully integrated real estate valuation and consulting organizations in the world. We act as the foremost valuation advisor to corporations, institutional investors, and lenders on critical debt and equity investment decisions.

We provide appraisal services, highest and best use analysis, dispute resolution and litigation support, along with specialized expertise in various industry sectors. With over 575 valuation professionals in 90 offices around the globe, we are uniquely qualified to undertake large, multi-location portfolio assignments. Thanks to our global reach and knowledge capital, we are able to analyze, evaluate and report on multiple properties dispersed over large geographic areas. We offer our clients specialized expertise in the following areas:

- Affordable Housing
- Agribusiness
- Appraisal Management
- Corporate Finance Consulting
- Dispute Analysis & Litigation Support
- Due Diligence
- Golf
- Government Affairs
- Green Building & Sustainability
- Hospitality & Gaming
- Location Incentives
- Portfolio Valuation
- Property Tax
- Residential Development
- Retail
- Self Storage
- Senior Housing/Healthcare
- Valuation for Financial Reporting

**ABOUT THE RETAIL INDUSTRY GROUP**

Cushman & Wakefield's Retail Industry Group, a Valuation Specialty Practice, offers recognized industry expertise, as evidenced by the 4,000-plus retail assignments we completed in 2007. We serve our clients through a strong network of over 40 senior retail specialists who perform valuation and consulting services in major markets throughout the United States. With an average of 18 years of valuation experience and dedicated retail expertise, we are able to deliver value-added, real-time advice to our clients on all critical retail investment decisions.

**For more information, contact:**

**Richard W. Latella, MAI, MRICS**  
Senior Managing Director  
212.841.7675  
Richard.Latella@cushwake.com

**Chris Sherland**  
Senior Market Analysis Specialist  
503.279.1797  
Chris.Sherland@cushwake.com

**James Morrissey**  
National Content Manager  
212.713.6812  
Jim.Morrissey@cushwake.com

<p><b>Cushman &amp; Wakefield</b> is known the world-over as an industry knowledge leader. Through the delivery of timely, accurate, high-quality research reports on the leading trends, markets around the world and business issues of the day, we aim to assist our clients in making property decisions that meet their objectives and enhance their competitive position.</p> <p>In addition to producing regular reports such as global rankings and local quarterly updates available on a regular basis, Cushman &amp; Wakefield also provides customized studies to meet specific information needs of owners, occupiers and investors.</p>	<p><b>Cushman &amp; Wakefield</b> is the world's largest privately held commercial real estate services firm. Founded in 1917, it has 227 offices in 59 countries and more than 15,000 employees. The firm represents a diverse customer base ranging from small businesses to Fortune 500 companies.</p> <p>It offers a complete range of services within four primary disciplines: Transaction Services, including tenant and landlord representation in office, industrial and retail real estate; Capital Markets, including property sales, investment management, valuation services, investment banking, debt and equity financing; Client Solutions, including integrated real estate strategies for large corporations and property owners; and Consulting Services, including business and real estate consulting. A recognized leader in global real estate research, the firm publishes a broad array of proprietary reports available on its online Knowledge Center at <a href="http://www.cushmanwakefield.com">www.cushmanwakefield.com</a></p>	<p><b>Published by Corporate Communications. For more market intelligence and research reports, visit Cushman &amp; Wakefield's Knowledge Center at <a href="http://www.cushmanwakefield.com">www.cushmanwakefield.com</a></b></p> <p>© 2009 Cushman &amp; Wakefield, Inc. All rights reserved. Printed in USA. Cushman &amp; Wakefield, Inc. 51 West 52nd Street New York, NY 10019-6178</p>
---	---	---

This report has been prepared solely for information purposes. It does not purport to be a complete description of the markets or developments contained in this material. The information on which this report is based has been obtained from sources we believe to be reliable, but we have not independently verified such information and we do not guarantee that the information is accurate or complete.