

# BUSINESS BRIEFING

## US RETAIL

# FRUGAL IS FASHIONABLE

THE FINANCIAL CRISIS IS TAKING A TOLL, BUT NEVER UNDERESTIMATE THE RESILIENCE OF THE US RETAIL SECTOR OR ITS ABILITY TO REINVENT ITSELF

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## EXECUTIVE SUMMARY

For now, the news about retail is not good. With the housing crisis choking consumer spending, retail is suffering the consequences. Increased vacancy, lower rents, layoffs, bankruptcies, delayed expansion plans, and significantly reduced investment activity and values are sure signs. At \$3.4 billion, investment volume in the third quarter was at the lowest level since 2001. Portfolio sales are 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, retail is unique among commercial real estate sectors in its ability to reinvent itself when consumer tastes change. This reinvention can occur in products, brands, and even properties. Being frugal has become fashionable as retailers respond to the current economic climate.

## INTRODUCTION

As the storm battering Wall Street works its way through our financial system, the US retail sector is precariously exposed to the surge of bad debt that has all but boarded up the credit markets around the world. This surge has now caused a sharp disruption in all components of the retail investment market, including transactions, financing, and macro-level property fundamentals. With consumer confidence at a record low, it's no surprise that personal consumption expenditures fell in the third quarter for the first time since 1991. The outlook for the fourth quarter is similarly challenging as spending from government stimulus efforts dries up, global growth weakens, and a stronger US dollar crimps demand from abroad.

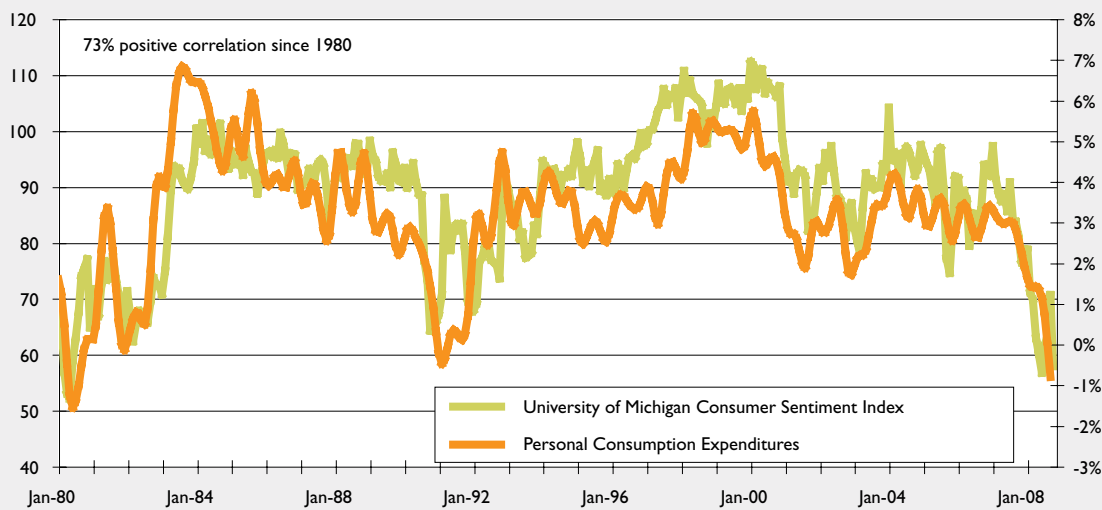
Retail performance is fundamentally affected by the consumer's willingness and ability to spend. Consumer sentiment in October was at the lowest level since 1980 and further erosion is likely as consumers react to the systematic financial strain. Employment is another major source of discontent



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with the nation's employers shedding 764,000 jobs in the year through September, pushing the unemployment rate up 110 basis points from year-end to 6.1 percent. Finally, headline inflation has nearly outpaced personal income growth throughout 2008, resulting in reduced household buying power. While the outlook for consumers is undeniably negative, low commodity prices and hints of a thaw in the credit market will eventually help ease anxiety. 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

Shrinking consumer spending is battering the nation's retailers. Personal consumption expenditures fell by 3.1 percent in the third quarter, marking the first quarterly decline in spending since 1991 and sharpest drop since 1980. A dramatic rise in bankruptcies and store closures prompted the International Council of Shopping Centers (ICSC) to suggest at least a 40 percent increase in store closings from 2007, to the highest level since 2001. Many retailers are reversing or curtailing their expansion plans for the next 18 months in response to reduced demand. Retail employment has also taken a major hit with over 250,000 jobs lost, in the 12 months through September.

The crisis has made a difficult situation dire for retailers that were already struggling with high debt loads or bankruptcy reorganization, as evidenced by the announced liquidations of Linens 'N Things, Mervyn's, and Value City. Nearly all retailers, with the notable exception of discounters and warehouse clubs, are reporting lower sales productivity. Declining tenant sales will constrain owners in terms of their ability to grow effective rents as retail tenants are very sensitive to occupancy costs. Chart 2 compares trends in same store sales over the last five years.



CHART 2: ICSC CHAIN STORE SALES INDEX

Format	2004	2005	Average Monthly Change 2006	2007	2008YTD
Total Comp Store Sales	3.8%	3.9%	3.6%	2.1%	2.3%
<b>Total Less Wal-Mart</b>	<b>4.1%</b>	<b>4.0%</b>	<b>4.8%</b>	<b>2.6%</b>	<b>1.0%</b>
Apparel Chain Stores	3.2%	1.9%	1.1%	-2.0%	-5.5%
Department Stores	1.6%	2.2%	4.5%	0.2%	-4.3%
Luxury Stores	9.6%	6.2%	6.7%	6.3%	-3.4%
Discount Stores	3.4%	3.4%	2.5%	1.3%	2.4%
Drug Stores	6.4%	5.6%	7.5%	4.9%	2.4%
Furniture Chain Stores	-2.5%	-4.7%	-7.1%	-10.3%	-6.2%
Wholesale Clubs	7.2%	6.5%	4.6%	5.5%	8.1%

Source: ICSC  
Year-to-date through September

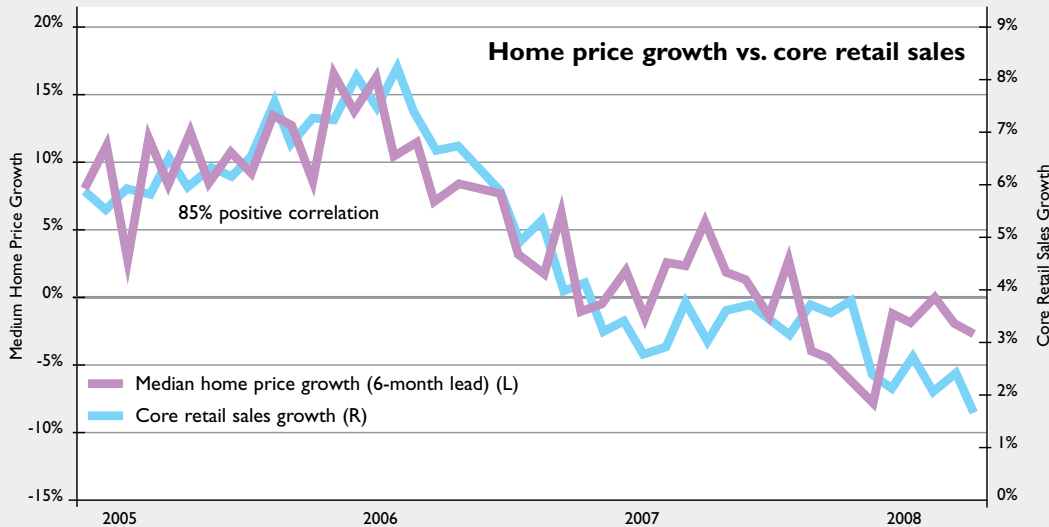
## IT ALL COMES DOWN TO HOUSING

Home equity, a significant contributor to consumer spending during the housing boom, is no longer an alternative income source for many homeowners. Americans' percentage of equity in their homes fell below 50 percent for the first time on record in March. Additionally, the National Association of Realtors reports that median single family home prices have fallen to 2005 levels. This trend will likely continue as lenders and investors look to move the record inventory of foreclosed homes. One-in-six Americans now owe more on their mortgage than the house is worth, including 29 percent of buyers within the last five years, according to recent estimates from Moody's Economy.com and Zillow. Additionally, 9.2 percent of all residential mortgages were at least one month overdue in the second quarter, the highest level since the Mortgage Bankers Association began tracking the market in 1969.

The residential housing market is a strong indicator of the health of the retail market with an 85 percent positive correlation between the two variables since 2005. In previous economic cycles, retail sales have followed the variances in the housing market with a lag time of around six months. All signs now point to a turbulent stretch for retailers until the housing market recovers. 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

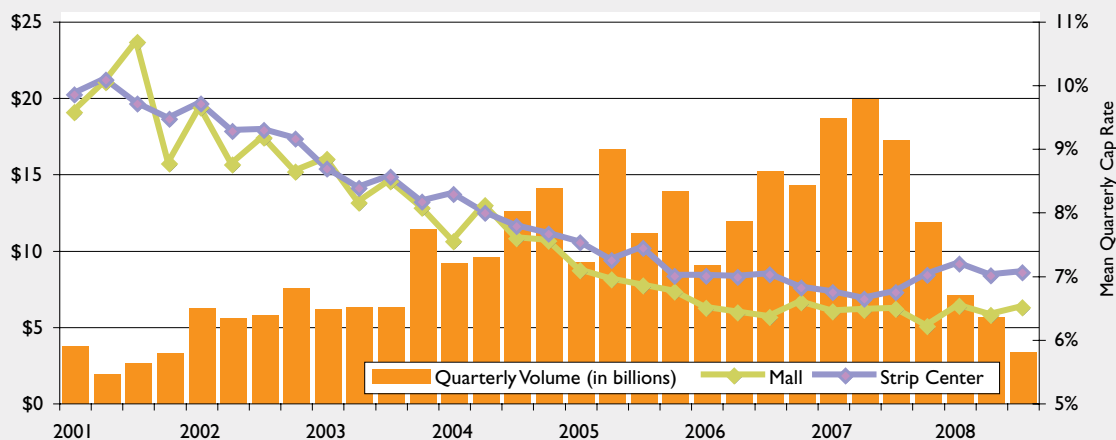
### INVESTMENT PLUMMETS

Retail investment activity reached \$75.7 billion in 2007, a 39.3 percent increase over 2006, as measured by Real Capital Analytics (RCA). Much of this increase was driven by portfolio sales and REIT privatizations during the first half year. The pace of investment fell off dramatically in the third and fourth quarters, as it became increasingly hard to close deals due to of buyer-seller pricing disconnects and the inability to obtain financing. Total volume in the second half of 2007 fell by 37.4 percent from the first half. Volume continued to plunge throughout 2008, with first-half volume down 72.5 percent from the same period last year. At \$3.4 billion, volume in the third quarter was at the lowest level since 2001. Portfolio sales, which made up the bulk of the volume in 2007, are almost non-existent this year.

### RACE FOR THE BOTTOM

The transaction market will likely remain weak in the fourth quarter as developers begin to shed assets to meet debt obligations. With financing at a standstill, property owners are being forced to seek alternative sources of capital, such as joint-venture agreements with a better capitalized partner. The recently announced \$890-million joint venture between Developers Diversified Realty (DDR) and an unidentified institutional partner provides an example of the length even blue chip developers must go to unlock capital. While the deal provided DDR with over \$200 million of capital to repay near-term debt maturities, the company was required to provided substantial seller financing to complete the transaction. Deleveraging 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, often with attractive financing from the seller. Chart 4 displays retail investment activity since 2001.

CHART 4: QUARTERLY RETAIL MARKET CONDITIONS



Source: Real Capital Analytics, Inc.

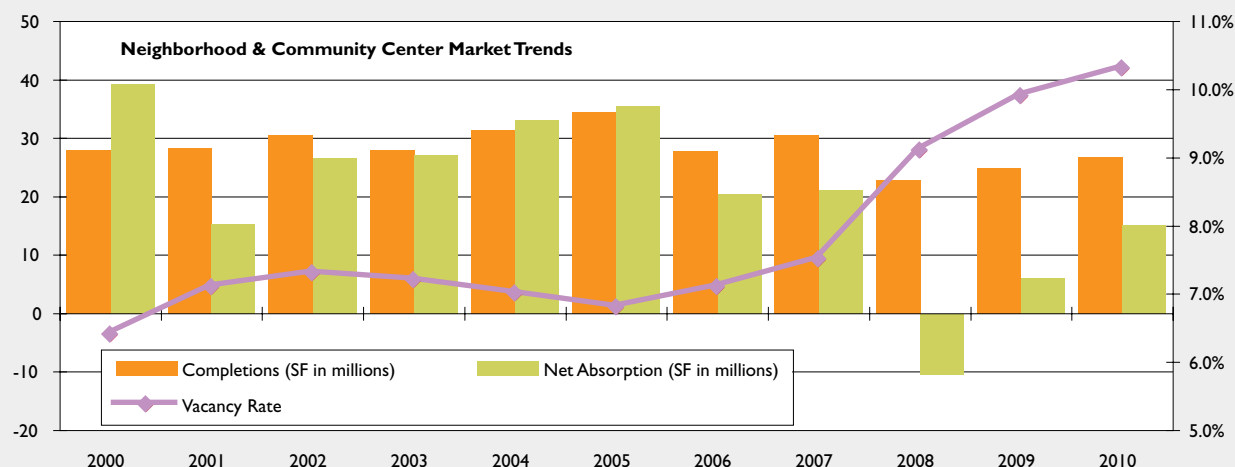
After trending downward for five years, retail cap rates are again on the rise. RCA reports that cap rates averaged 6.8 percent in the third quarter, up approximately 30 basis points from a low of 6.5 percent in the second quarter of 2007. Strip center cap rates have remained flat at around 7 percent for the last four quarters, while mall cap rates have hovered around 6.5 percent since the first quarter of 2006. Mall and strip center cap rates averaged 6.5 percent and 7 percent respectively during the third quarter of 2008. Rates are poised to trend upward at a more rapid pace over the next several quarters, although low transaction activity obscures the true direction of the market.

## HIGH VACANCY STALLS EXPANSION PLANS

Vacancy at neighborhood and community centers has increased throughout the year as absorption falls well below the level of new supply due to store closings and stalled expansion plans. In its release of third-quarter market trends, Reis noted that the national average vacancy rate increased by 30 basis points for both strip shopping centers and regional malls, to 8.4 percent and 6.6 percent respectively. Total national absorption was negative for the first time since the firm began tracking the market in 1980 in the first quarter, and continued to trend downward through the third quarter to -2.8 million square feet. For all of 2008, absorption is expected to decline by over 10 million square feet, fueling a 160-basis point rise in vacancy from 2007 to 9.1 percent by year-end.

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. Given the sharp rise in vacancy, rents are likely to continue falling into 2009. Effective rents will be influenced by higher concessions, particularly in weaker markets. Asking rent growth for all shopping centers was flat in the third quarter, while effective rents fell by 0.2 percent. Chart 5 displays neighborhood and community center market conditions since 2000.

CHART 5: NEIGHBOURHOOD AND COMMUNITY CENTRE MARKET TRENDS



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## EXPECT MORE DRAMA BEFORE RECOVERY

Market participants we surveyed confirm the reports of Reis and other industry analysts; that is, as we move into the fourth quarter of 2008, we can expect higher vacancy, lower rents and decreased 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 rates are trending upward, there is evidence of a bifurcated market with Class A assets still in demand by all-cash or low-leverage buyers. Yield rate changes at this end of the quality spectrum have not been impacted to the same degree as the lower end (the B/C class market). 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 as well as to 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 to this downturn for property owners, 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 the increased level of store closings. This chain of events will ultimately place many developers in a more stable competitive position once the market improves.



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