Retail Market Trends

Mark Robinson, CCIM - Mid-America Real Estate - Minnesota, LLC

Rob Barse, LEED AP BD+C, McShane Development
Presenter Profile

Mark Robinson, CCIM
Principal | Investment Sales
Mid-America Real Estate - MN, LLC

- Full service 3rd party management, accounting, leasing, investment sales, tenant representation firm
- Shopping center, single tenant, & retail building investment sales
- Underwrite investments
- Analyze trade area, market rents
- Perform property due diligence
- Example assignments:
Presenter Profile

Rob Barse, LEED AP BD+C
Director of Development
McShane Development

- Boutique CRE development & investment company
- Relationships 1st, Real Estate 2nd
- Single-tenant / multi-tenant retail
- Develop new or repurpose existing
- Site Identification, leasing & development execution
- Example assignments:
Presentation Outline

I. Minnesota Market Stats
II. Store Closures & Openings
III. Retailer Expansion Plans
IV. Challenges with Retailers Today
V. Amazon
VI. Grocery Wars
VII. Growth Markets
VIII. How Properties Adapt
IX. Capital Market Update
X. How to Survive in Retail
XI. Future: 2018 & Beyond
Presentation Outline Cont’d

XII. Development Challenges
XIII. Development Trends
XIV. Working with Municipalities
Minnesota Market

- 67,000,000 sq ft of retail in MSP Metro

According to CBRE Q4 2017:

- Retail vacancy at 8.0%, down from 8.3% in Q3
- Availability rose to 10.5%, attributable to growing big box vacancies
Minnesota Market

Source: CBRE Research, Q1 2018.
Retailer Closures Nationwide

- 2016 - 4,000 stores
- 2017 - 6,000 stores

Why?
- Over retailed marketplace
  - US has 23.5 sq ft of retail space per person vs 16.4 sq ft in Canada and 11.1 sq ft in Australia, the next two highest countries
- Acceleration of eCommerce
- Race to the bottom (discounters)
- Shifting consumer spending patterns
Purchasing Trends by Generation
Purchasing Trough vs Retail Supply

Purchasing Trough vs. Retail Supply
Recent Store Closures & Bankruptcies
Who’s Next?

- Sears
- Ascena Retail Group
- PetSmart

See a theme?
- Soft goods
- Junior/Big Boxes

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2016</th>
<th>2015</th>
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<tbody>
<tr>
<td>American Eagle</td>
<td>8.0%</td>
<td>3.0%</td>
<td>7.0%</td>
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<tr>
<td>Ascena Retail Group</td>
<td>-3.0%</td>
<td>-3.1%</td>
<td>-4.0%</td>
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<tr>
<td>Justice</td>
<td>4.0%</td>
<td>2.7%</td>
<td>-15.0%</td>
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<td>Lane Bryant</td>
<td>0.0%</td>
<td>5.1%</td>
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<td>Catherine’s</td>
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<td>1.6%</td>
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<tr>
<td>LOFT</td>
<td>-1.0%</td>
<td>-1.8%</td>
<td>-1.0%</td>
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<tr>
<td>Ann Taylor</td>
<td>-6.0%</td>
<td>-8.2%</td>
<td>-1.0%</td>
</tr>
<tr>
<td>maurices</td>
<td>-6.0%</td>
<td>-7.1%</td>
<td>1.0%</td>
</tr>
<tr>
<td>dressbarn</td>
<td>-13.0%</td>
<td>-4.6%</td>
<td>-3.0%</td>
</tr>
<tr>
<td>Barnes &amp; Noble</td>
<td>-6.4%</td>
<td>-9.1%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Bon Ton</td>
<td>-2.9%</td>
<td>-3.1%</td>
<td>-1.6%</td>
</tr>
</tbody>
</table>
The Good News?

- More retail stores OPENED than CLOSED in 2017
- 10,168 stores closed
- 14,248 stores opened
- Net 4,080+ new brick & m
- Consumer spending up

U.S. Consumer Spending

Source: TradingEconomics.com and U.S. Bureau of Economic Analysis
Retailer Expansion Plans

- Retailer demand still strong, but changing
- No more department stores
- Restaurants
- Fitness
- Entertainment/Experience
- Value
- Medical
- Smart growth, highly analytical
Expanding Restaurants
Expanding Fitness Concepts
Expanding Entertainment
Expanding Value Retailers
Medical in Main Stream Retail
Challenges with Retailers Today

- Co-tenancy clauses
- Sales kick-outs
- End Caps
- Drive Thru’s
- Signage
- Restricted uses
- “Any lawful use” clause
- Developers/Owners can’t finance or sell with these risks
- Makes many deals nearly impossible
- Similar issues caused trouble in 2008/2009
Amazon (and others!)

- Online sales continue to increase
- 2016 - 8% of total retail sales nationally
- 2017 - 8.9% of total retail sales nationally
- Projected continued growth thanks to eGrocery

<table>
<thead>
<tr>
<th></th>
<th>TOTAL</th>
<th>ONLINE</th>
<th>BRICK &amp; MORTAR</th>
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<tbody>
<tr>
<td>2016</td>
<td>$4.9 trillion</td>
<td>$400 billion</td>
<td>$4.5 trillion</td>
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<tr>
<td>2017</td>
<td>$5.1 trillion</td>
<td>$460 billion</td>
<td>$4.64 trillion</td>
</tr>
<tr>
<td>2025</td>
<td>$6.54 trillion</td>
<td>$1.3 trillion</td>
<td>$5.2 trillion</td>
</tr>
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</table>
Online as % of Retail Sales

Q1 2020 Forecast: 12.0%

% of Total Retail Sales

2009 Q3-09 2010 Q3-10 2011 Q3-11 2012 Q3-12 2013 Q3-13 2014 Q3-14 2015 Q3-15 2016 Q3-16 2017 Q3-17 2018 Q3-18 2019 Q3-19 2020

4.2%
Amazon Distribution Space

- **21** million square feet California facilities
- **140** million square feet U.S. logistics network
- **3.3** million square feet Amazon’s planned air cargo hub in Kentucky

Amazon’s Fulfillment Capacity vs Retail Store Footprints

- Walmart: 703 million square feet
- Target: 240.6 million square feet
- Amazon: 140 million square feet
- Costco: 75.4 million square feet

Amazon

- Not done yet!
- Whole Foods (mixed reviews)
- Continue to push grocery
- Amazon Go
- Amazon Books
- Rumors of additional acquisitions
Grocery Wars

- Grocery is still primary traffic driver for neighborhood retail
- eCommerce is still having trouble competing against grocery
  - This is changing!
- Drives daily traffic
- Higher sales per sq ft than normal retail
  - $520 per sq ft vs $300 per sq ft
- Strong grocery store is vital to a shopping area
Grocery Wars
Grocery Wars

- Unique models for each grocer
  - Price
    - Aldi, Wal-Mart, Target
  - Service
    - Hy-Vee, Lunds & Byerly’s, Kowalski’s
  - Quality
    - Whole Foods, Fresh Thyme
  - Convenience
    - Cub Foods
- ....nearly impossible to compete in more than 2 models
Growth Markets

- First/second tier development
  - Repurposing/redevelopment in first & second tier trade areas
  - Residential density, daytime population, disposable incomes, etc.
  - 3rd tier, low density markets still struggle
- Outstate markets attracting national retail interest*
  - No cannibalization
  - Limited competition
  - Less online impact
  - Red carpet reception

*A handful of concepts are seeking outstate markets, most requiring high risk landlord deals*
How Properties Adapt

- New uses (so long as not restricted?)
- Create an experience for shoppers
- Mix of entertainment, restaurant, retail, service, medical
- Add density - apartments, hotel, office
- Some spaces more valuable as retailer distribution hubs
Regional Malls Adapting

- Southdale Center
  - Lost JCPenney & Gordmans in 2017
  - Replacing JCP with 120,000 Sq Ft Life Time Fitness
  - Restoration Hardware opening 4 story 58,000 Sq Ft store on out lot
  - 146 room Hilton Hotel under construction on out lot
Regional Malls Adapting

- **Ridgedale Center**
  - New Nordstrom in 2015
  - Cheesecake Factory now open
  - 4 new retail/restaurant pad sites on out lot
  - Apartments proposed near JCPenney
  - New 6,000 sq ft entertainment space “Ridgedale Play”
Capital Markets Respond

- S&P 500 up 24% year over year
- REIT stocks down 5%
  - Rising interest rates
  - Soft goods risks
  - Not over yet
- Transaction volume peaked in 2015/2016
Capital Markets Respond

- 2017 Transaction volume down about 20%
- REITS & institutions continue to liquidate retail portfolios
  - Mostly grocery and junior box anchored
- Cap rates for junior box retail up 150 to 200 bps (big decrease in pricing from 2016!)
- Multi-tenant/neighborhood retail remains steady on pricing
  - Why? Convenience/service driven
How to Survive in Retail Today

- “Omni-channel” - blend online with bricks & mortar
- Provide an experience
- Don’t compete on price unless you’re Wal-Mart, TJ Maxx, Aldi, Total Wine
- Provide a service
- Provide convenience
- Can it be done better/easier online? Don’t do it!
Future: 2018 & Beyond

- Increased consumer spending, but mostly helps online
- More store closures & bankruptcies
- More malls will fail
- Experiential/entertainment retail thrives
- Regional malls continue to transform/adapt
Development Challenges

- More complicated today than ever before
- Each new project represents a unique combination of price, product, location & market timing
- Battle for prime real estate
- Longer & riskier entitlements
- Equity partners want higher returns
- Less leverage due to great recession
- Steep construction costs & tenant improvements
- Parking & circulation requirements
- Self development by tenants
- Rising interest rates
Development Challenges

Anchor Tenants

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<thead>
<tr>
<th>1990 - Cost PSF</th>
<th>2016 - Cost PSF</th>
<th>2018 - Cost PSF</th>
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<tbody>
<tr>
<td>$32 ($8 PSF)</td>
<td>Land</td>
<td>$48 ($12 PSF)</td>
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<tr>
<td>$16</td>
<td>Sitework</td>
<td>$26</td>
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<tr>
<td>$32</td>
<td>Building Shell</td>
<td>$60</td>
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<tr>
<td>$18</td>
<td>Tenant TI’s</td>
<td>$38</td>
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<tr>
<td>$5</td>
<td>Commissions</td>
<td>$8</td>
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<tr>
<td>$4</td>
<td>Fees</td>
<td>$10</td>
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<tr>
<td>$8</td>
<td>Miscellaneous</td>
<td>$12</td>
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<tr>
<td>$115 PSF</td>
<td>TOTAL PSF</td>
<td>$202 PSF</td>
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<table>
<thead>
<tr>
<th>2018 - Cost PSF</th>
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<tbody>
<tr>
<td>Land</td>
</tr>
<tr>
<td>Site</td>
</tr>
<tr>
<td>Shell</td>
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<tr>
<td>TI’s</td>
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<td>Comm.</td>
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<td>Fees</td>
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<tr>
<td>Finance</td>
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<td>Cont.</td>
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<tr>
<td>TOTAL PSF</td>
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Courtesy of Colliers / Welsh
Development Challenges

How borrowing costs close the gap:

<table>
<thead>
<tr>
<th>1990’s</th>
<th>2016</th>
<th>2018</th>
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<tbody>
<tr>
<td>Project Cost</td>
<td>$202 PSF</td>
<td>$453.39 PSF</td>
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<tr>
<td>Loan @ 80%</td>
<td>$162 PSF</td>
<td>$362.73 PSF</td>
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<tr>
<td>Interest Rate</td>
<td>3.5%</td>
<td>4.79%</td>
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<tr>
<td>Debt on 25 yrs.</td>
<td>$9.73 PSF</td>
<td>$24.92 PSF</td>
</tr>
<tr>
<td>Rent</td>
<td>$15.00 PSF</td>
<td>$36.50 PSF</td>
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<tr>
<td>Cash Flow after Debt</td>
<td>$5.27</td>
<td>$11.58 PSF</td>
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<tr>
<td>Cash Equity</td>
<td>$40 PSF</td>
<td>$90.68 PSF</td>
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<tr>
<td>Leveraged Yield on Equity</td>
<td>13.18%</td>
<td>12.80%</td>
</tr>
</tbody>
</table>

Courtesy of Colliers / Welsh
Development Trends

- The day of redevelopment
  - Gas stations
  - Independent restaurants
  - Banks
  - City/County/ISD-owned assets
    - Old fire stations (Eagan)
    - Municipal liquor stores (Burnsville)
    - Public works buildings (Richfield)
    - Bus garages (Edina)
Working with Municipalities

- No two Municipalities are the same
  - Fees, rules & procedures can vary greatly
- Easy to find online resources are helpful
  - Comprehensive list of potential development fees
  - List of submission deadlines, etc for varying approvals
  - Available economic development incentives
Working with Municipalities

- What we hear
  - Do your homework
  - Get to the table early
  - Engage with stakeholders, residents & constituents
Working with Municipalities

- **What we focus on**
  - Transparency & open communication
  - Establishing a strong partnership
  - Understanding if the City has goals that our development can help solve (sidewalks, streetscapes, etc)
  - Engaging community stakeholders
  - Putting ourselves in your shoes
  - Refining & improving internal processes after each project
  - Developing & maintaining a good reputation over many years
Working with Municipalities

- **Keys to success**
  - Complete & consistent information
  - Flexibility
    - “How well intentioned community guidelines for development often backfire” - Peter Hendee Brown
    - Design standards
    - Parking requirements
  - Collaborate to find balance
    - Each Developer has its “ideal” project
    - Each Municipality has its own vision
    - Work together to identify creative, practical solutions that meet needs of both
  - Patience
Case Study: Complete Information

- Initial Fee Estimate - $20,425
- Adjusted Estimated Total - $22,316.50
- Actual Total (based on previous list) - $18,823.70
- Items never identified until building permit review - $9,575
- **50% of fees to the project were missed**
- Additional onerous project burdens beyond pro forma hit
Case Study: Flexibility

- Project: medical office building
- Zoning: professional office use

<table>
<thead>
<tr>
<th>Parking Spaces</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Proposed</th>
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</thead>
<tbody>
<tr>
<td>Minimum</td>
<td>1 space / 300 SF</td>
<td>20% &gt; minimum</td>
<td>242% &gt; minimum</td>
</tr>
<tr>
<td>Maximum</td>
<td>12</td>
<td>14</td>
<td>29</td>
</tr>
<tr>
<td>Proposed</td>
<td>29</td>
<td></td>
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</table>

- Challenge: no zoning specific to medical
- Solution: provide insight on operational requirements
- Result: parking exception granted
Case Study: Collaboration

“To city planners, real estate development is a way to mesh the economic goals of private developers and their investors with a city’s larger economic and social goals” - Peter Brown, How Real Estate Developers Think
Questions & Answers (maybe)
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