Conference Insights

May 22, 2024
DJIA: **39,671** | RMZ: **1,200** | 10-Year T-Note: **4.42%**

Green Street

Retail: ICSC 2024 – The Beauty of No New Supply

Green Street's retail team recently attended the ICSC conference in Las Vegas, an event that brings together representatives of all facets of the retail industry, including investors, landlords, brokers, retailers, and other commercial real estate players. We met with numerous private and public owners across the retail property type and quality spectrum, generally outside of our REIT coverage universe, including several private owners of unanchored, convenience centers.

Similar to the past few years, **sentiment at ICSC was overwhelmingly positive on fundamentals as tenant demand across seemingly every category remains on solid footing,** despite decelerating U.S. retail sales growth and the higher-for-longer interest rate outlook. Retailer bankruptcy activity has picked up since last May, including but not limited to Express, Rue 21, Red Lobster, 99 Cents Only, and Rite Aid. Nonetheless, landlords are optimistic around re-tenanting prospects on most spaces as occupancy rates are healthy and there is effectively no competition from new supply outside of ground-floor retail beneath mixed-use developments.

These findings are consistent with recent REIT commentary and our outlook for retail coming into the conference. Green Street's retail fundamental forecasts will be updated in the upcoming Sector Update reports. Market rent growth projections will likely be revised slightly higher for strip centers while our mall outlook is unlikely to materially change. Key takeaways from the conference for real estate investors are detailed below:

Strip center fundamentals are as good as they can be, with broad-based demand across markets and store sizes. Consistent with the positive tone maintained for at least a year, strip center owners reiterated that the industry has experienced a "paradigm shift", with retailers decisively growing their brick & mortar presence and demonstrating flexibility in adapting their store sizes to match available space. The retailer bankruptcies announced year-to-date have not had a significant impact on high-quality strip center owners, nor have they dampened the enthusiasm among market participants. With REIT leased occupancy sitting at 95.5%, near all-time highs, landlord focus is on how to capitalize on the positive momentum while making sure rents are set at levels that are sustainable for retailers in the long term. As expected, landlords' pricing power has proven stronger with small shop tenants than national anchors.

Convenience centers are attracting increased interest from both institutional investors and 1031 buyers after Site Centers announced the upcoming spinoff of its convenience center portfolio, Curbline, on October 1, 2023. The focus of convenience centers on small-format stores brings with it a series of benefits, including a larger pool of potential tenants, shorter leases (a valuable trait in today's rising rent environment) and lower re-tenanting capital requirements. A point of concern lies in the traditional greater vulnerability of small shop tenants to economic cycles, which underscores the importance of striking the right balance between high and low credit tenants. Given that convenience centers often have a high concentration of food and beverage providers where the franchise model is common, it is crucial to accurately assess the risk associated with franchisees of national brands. At the same time, from a practical perspective, building a portfolio of convenience centers of large scale is challenging given the average price tag for a center is typically <$20 million. Overall, our assumptions from the initial Curbline report linked above were confirmed, including cap rates in the 6%-7% range depending on quality, cap-ex reserves of ~10% of NOI, and above-average NOI growth relative to other strip center formats.

Site Centers confirmed the sale of six power centers on May 20th to an affiliate of Pine Tree, a partnership with Utah Retirement Systems, for ~$500M at an estimated low-7% cap rate. The deal, which was reported by Real Estate Alert, a Green Street news publication, back in March, included two properties in Columbus, OH, and one each in Cincinnati, Fort Lauderdale, Portland, and Phoenix. While a direct cap rate readthrough can be difficult due to the presence of seller credits, and lag between negotiation and deal closure, the low-7% cap rate is lower than what we would've expected for these assets. This sale, combined with Kimco's dispositions of former RPT assets in the Midwest, suggest that our ascribed cap rates for power centers, particularly in secondary and tertiary markets, could be too high and are currently under review.

Strip center development remains quiet with limited new supply coming online in the coming years. In its 1Q24 earnings, Regency announced the only new REIT ground-up development this year in a master-planned community in Connecticut, anchored by Whole Foods and TJ Maxx. As part of this development, Regency is expecting a 7% stabilized yield in '27, and in general, targets a yield ~150 bps above what it thinks the property would sell for. We met with private owners with development arms that echoed the sentiment that development still does not pencil broadly but believe there are pockets of opportunity where it still makes sense, with Phoenix being referenced as an example.

Occupancy cost ratios (OCRs), the ratio of total rent to tenant sales, remain the primary metric used to assess the health of a brick & mortar store, despite the increasingly blurred lines between physical and online channels. The Express bankruptcy highlights this point given ~65% of stores in Macerich's 'A'-quality portfolio are slated to close while most other mall landlords, including 'B'-mall owners CBL and wpg, are faring significantly better with <25% of Express stores in their portfolios closing (much less in the case of Simon and Tanger). It is still not entirely clear why Macerich was hit so much harder than others, but higher OCRs are the most likely explanation. The main conclusion is that when a retailer downsizes, center quality is not the most important variable, OCRs are.

Outlets are garnering demand from non-traditional outlet concepts such as home furnishings, beauty, and food & beverage. Retailers are also opening hybrid-type stores that provide consumers a mix of full-price and value offerings under one roof. For certain categories, such as beauty, a traditional outlet store might not make sense or appeal to customers if staple products are not always in stock. This new model seems to be working well and is another source of incremental tenant demand in the outlet space. Tanger is seeking to improve its food & beverage offering, primarily through outparcel developments that offer attractive unit economics, but also within the existing center. The company is trying to move away from solely relying on food courts for F&B and is even looking to remove the food court at certain properties to boost NOI. Integrating multiple modern, quick-service concepts throughout inline space resonates better with most consumers today versus the typical food court experience. Food courts are often at the 50-yard line in the center, an area that can command premium rents. If a food court can be de-leased quickly, it could make economic sense to redevelop that space (most of which is common area that does not pay rent) to traditional shop space and integrate F&B throughout the center.

'B-Quality Malls continue to face numerous secular headwinds, but fundamentals are mostly stable for the segment as a whole. Roughly flat to slightly declining same-property NOI seems like a good betting line over the next one to two years. However, performance could deviate materially from this baseline at the asset level, primarily on the downside, due to future anchor closure risk and the impact that could have on a center's NOI due to the triggering of co-tenancy clauses – if an anchor closes, it could potentially allow many in line tenants to pay some form of reduced rents until that space is backfilled. Based on recent transaction activity and conversations with market participants, our current lower-quality mall cap rates seem to be in the right ballpark at 11.5% to 13% for 'B+', 13% to 17% for 'B', and 17% to 21% for 'B-'.

Investment recommendations are unchanged.

Vince Tibone, CFA
Paulina Rojas Schmidt
Emily Arft
Daniel Purpura