Disruptive Forces
in
Retail Real Estate

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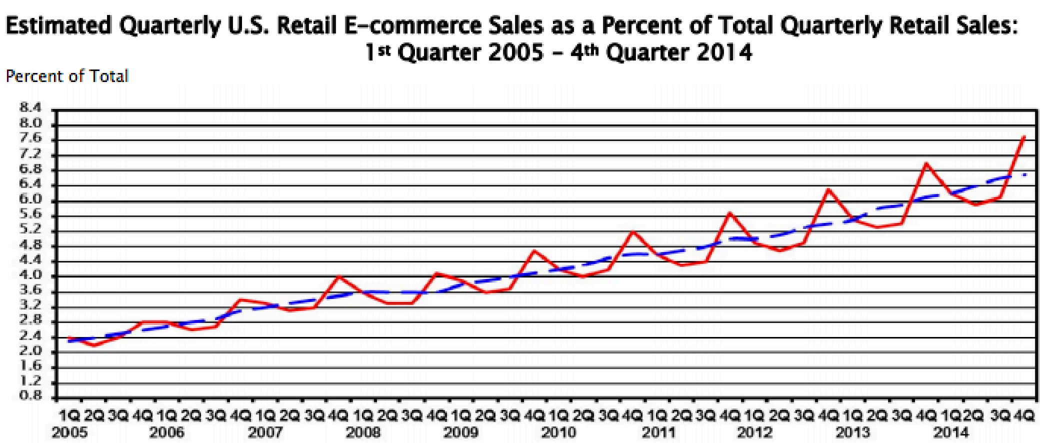
Introduction

Of all real estate sectors, retail is perhaps the most interconnected with the general public. According to the Federal Reserve Bank of St. Louis, consumer spending constituted 67% of the U.S. economy in 2013.[1] And for decades, consumers have fulfilled their needs and wants by visiting brick-and-mortar stores in urban downtowns and suburban shopping centers. The result is that the United States boasts nearly 23 square feet of retail gross leasable area per capita, the most in the world.[2]

That development has taken place over decades since World War II, as the great migration to the suburbs led to the "Malling of America" in the 1960s and 1970s, and the creation of new retail formats such as power centers in the 1980s and lifestyle centers in the 1990s. Although building came to a near-halt during the Great Recession, the U.S. economy is showing signs of recovery and retail sales have rebounded. Despite some month-to-month volatility, total retail sales in 2014 increased 4.0% over 2013 figures.[3]

Retail has become a favored sector for investors, with asset sales topping $82.6 billion in 2014, well above the previous record of $81.4 billion in 2007, according to Real Capital Analytics' (RCA) year-end review. Strip center activity rose 35% year over year, with a sales volume of $37.9 billion, according to RCA, while the combined volume of malls, single tenant assets and urban properties saw sales volume rise 28% over 2013 levels to $44.7 billion.[4] The RCA report adds that cap rates, as a result, remain compressed, falling 30 basis points to 6.7% in all sectors.[5]

Although the improving economy presents great opportunity, builders and investors in retail real estate are now facing new challenges in a landscape that differs greatly from the one that existed just a decade ago. Most notably, an ever-growing percentage of sales are being conducted online. The rise of smartphones and portable Internet access have resulted in a dramatic increase in sales through "clicks" rather than "bricks". Online sales have risen from 2.4% of overall retail revenues in the first quarter of 2005 to 6.7% in the fourth quarter of 2014.[6]



The move away from traditional stores to online sales, especially for sales of merchandise such as electronics and books, is just one factor that is disrupting retail real estate. Population shifts, the growing importance of a new generation and the different priorities of the Baby Boomers also are creating a very different retail environment that must be considered by developers, retailers and their investors. Other factors include:

- The migration of the population from suburbs to cities, which will compel retail developers to create new prototypes to accommodate older facilities and, quite likely, a consumer using public transportation rather than an automobile to arrive at the store. A new generation of young adult consumers – dubbed the Millennials (those born between the early 1980s and early 2000s), is coming to adulthood and becoming a major economic factor. This group has grown up with technology and seeks socialization and unique experiences from retail centers and districts.

[1] Economic Research, Federal Reserve Bank of St. Louis, http://research.stlouisfed.org/fred2/graph/?g=hh3.
[2] Cushman & Wakefield Global Cities Retail Guide, http://cwglobalretailguide.com/unitedstates/.
[3] U.S. Census Bureau, Advance Monthly Sales Report December 2014.
[4] Real Capital Analytics, U.S. Capital Trends Retail: Retail 2014 Year in Review (Jan. 2015).
[5] *Id.*
[6] U.S. Census Bureau, Quarterly Retail E-Commerce Sales, Fourth Quarter 2014, http://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf, U.S. Census Bureau News (Feb. 17, 2015).

- The aging of the Baby Boomer population, which has created an older generation that is more likely to seek an "experience" rather than to simply purchase merchandise at shopping districts and retail centers.

Today's retail owners and builders are adapting their facilities to meet these challenges. They are focusing more on urban downtown locations, incorporating high-speed Internet connections in their buildings to accommodate technology, and instituting flexible leasing plans to keep projects attractive to both investors and consumers.

Disruptive Forces

Urbanization

In a sense, the shifting U.S. retail real estate scene is a case of "Back to the Future." Retail, including Main Street retail, with a defined leasing plan created by a single landlord, began in city downtown districts. Most analysts cite the 1922 development of Country Club Plaza in Kansas City, Mo., as the first shopping center in the United States.[7] After World War II, however, the U.S. population began to shift to the suburbs. Retail quickly followed, creating the "mall culture" that dominated the second half of the 20th century.

Today, the suburbanization of America is reversing. The urban population of the United States rose by 12.1% between 2000 and 2010, outpacing the overall national growth rate of 9.7% for the same period, according to the U.S. Census Bureau.[8] The urban population will continue to increase, reports the United Nations, which predicts that the U.S. urban population of 263 million will rise to 350 million by 2050.[9]

Analysts cite multiple reasons for the shift:

- Rising gasoline prices early in the 2010s (now reversed) have diminished the desire for a car
- Empty nesters have returned to the city in search of services and opportunities for socialization
- Millennials have delayed household formation and home purchases
- A slow and gradual housing recovery has delayed the sale of homes, with few free to accommodate first-time buyers

According to the Environmental Protection Agency, nearly three out of four metropolitan regions saw an increased share of infill housing development between 2005 and 2009 as compared to the five years prior. In 15 regions, more than double the share of residential permits was granted in urban neighborhoods.[10]

To accommodate urban shoppers, even retailers known for their large footprint have created new prototypes designed for smaller, often multilevel spaces. Walmart's unit at H Street NW in Washington, D.C., totals 83,000 square feet, less than half the size of a Walmart typical suburban store. Parking is situated underground. Archrival Target has tried several formats, including a 20,000-square-foot TargetExpress near the University of Minnesota in Minneapolis, and plans a CityTarget shop in Brooklyn, N.Y., (joining similar units in Chicago and San Francisco) in 2016.

The resurgence of downtown living has resulted in the need for retail and services in the inner city, particularly grocery stores. Urban residents may not have the space or the car to accommodate the weekly supermarket trip common in the suburbs, but may shop more frequently for smaller items. Smaller grocers in urban areas are a tremendous opportunity for growth: Publix has joined a number of food retailers in opening smaller neighborhood stores.

Given that retail historically follows residential growth, the new retail projects being undertaken in the largely oversaturated United States are being built in, or are creating, urban downtowns in more suburban areas.

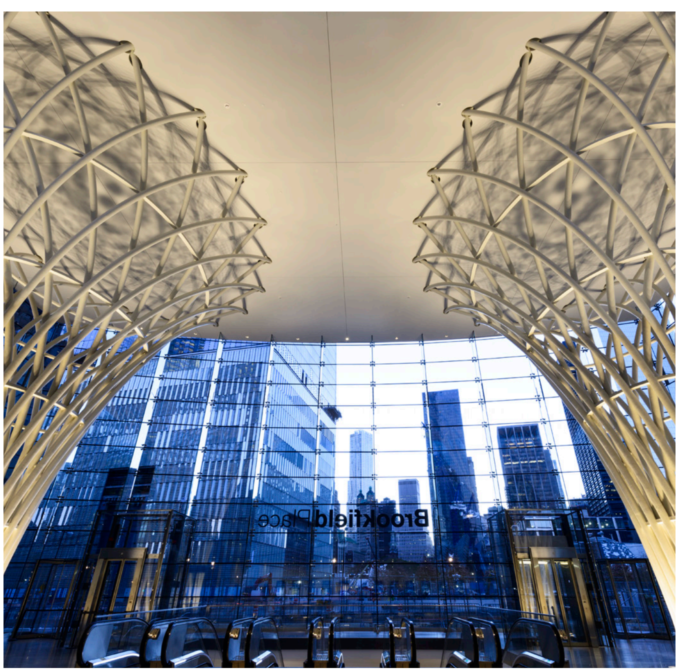
[7] One Man's Vision Shapes the City," http://countryclubplaza.com/art-history/one-mans-vision-shapes-the-city/.
[8] U.S. Census Bureau, "Growth in Urban Population Outpaces Rest of Nation, Census Bureau Reports," https://www.census.gov/newsroom/releases/archives/2010_census/cb12-50.html (March 26, 2012).
[9] United Nations Department of Economic and Social Affairs, World Urbanization Prospects: The 2014 Revision Highlights, http://esa.un.org/unpd/wup/Highlights/WUP2014-Highlights.pdf (2014).
[10] U.S. Environmental Protection Agency, Residential Construction Trends in America's Metropolitan Regions, http://www.epa.gov/smartgrowth/construction_trends.htm#2012Report.

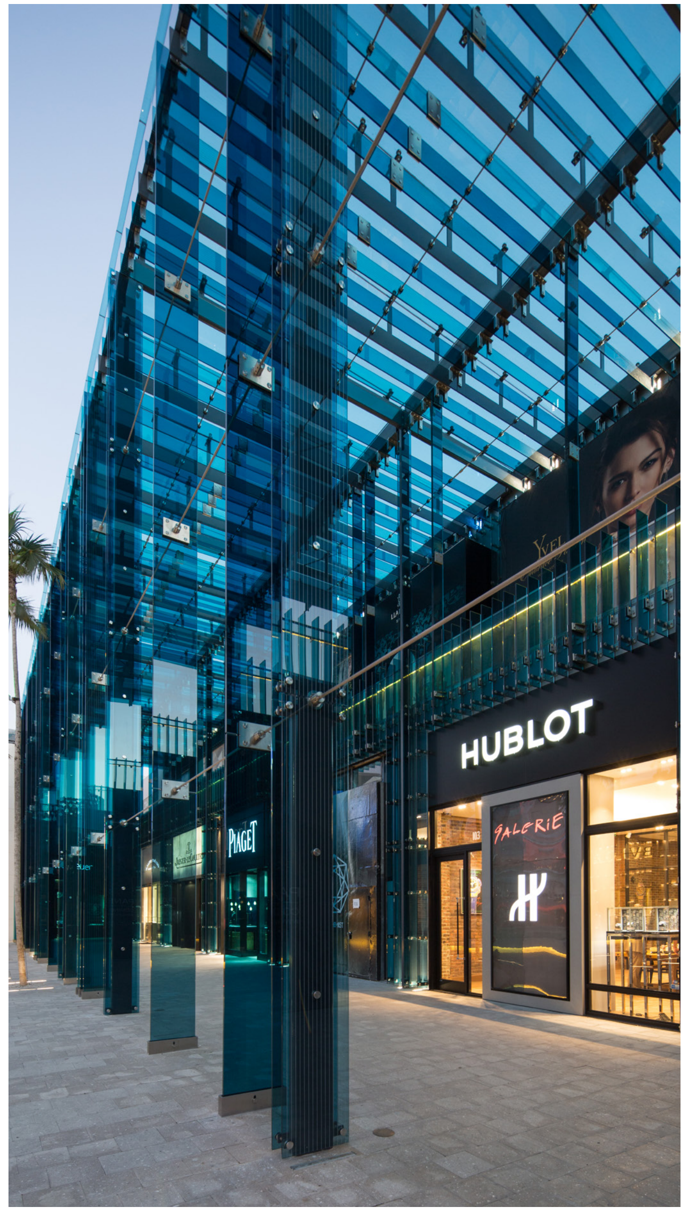
Examples include:

Brookfield Place and Westfield World Trade Center, New York City: The redevelopments of these separate projects by different developers (though literally across the street from each other) are creating an entirely new retail and dining district in Lower Manhattan even before their planned phased openings throughout 2015 and 2016. Interconnected by world-class transportation hubs, including 13 different subway lines and a PATH train, these two projects symbolize the epitome of new retail construction, ultimately transforming shopping and dining to destination experiences. Westfield World Trade Center will feature 350,000 square feet of new retail, seamlessly integrated with the World Trade Center Site in lower Manhattan. The two projects will offer complementary shopping experiences, with Brookfield focused more on luxury brands and Westfield including a mix that addresses the needs of a diverse and dynamic audience. The critical mass is already drawing global brands and international retailers such as Zara to surrounding streets.

Brookfield Place, New York (Above and Below Left)

Westfield World Trade Center, New York (Below Right)





Shops at Midtown, Miami

Shops at Midtown Miami/Design District/et al.: Perhaps no other city is benefiting more from urbanization than Miami. The Shops at Midtown Miami has situated some of the major “big box” retailers, such as Target and Marshalls, more typically found in the suburbs into a redeveloping neighborhood that was formerly dominated by a rail yard. Nearby, the Design District, long a headquarters for home furnishings showrooms, is seeing an influx of designer apparel boutiques and restaurants to accommodate the influx of residents. Just as the below-mentioned Grove has created a downtown retail experience in Los Angeles, CocoWalk has created a core for Coconut Grove, Florida.

The Grove, Los Angeles: Opened in 2002 on the former site of an orchard (and adjacent to the famed Farmer’s Market, the 575,000-square-foot Grove has created an urban downtown district by offering a central park/plaza with an animated fountain and performance space surrounded by retail, entertainment and dining establishments.

City Creek Center, Salt Lake City: Opened in March 2012, this 626,000-square-foot center in the heart of downtown Salt Lake City is the core of a mixed-use downtown redevelopment. A retractable glass roof enables management to provide a climate-controlled environment, when necessary, or to offer a typical open-air urban experience.

Hudson Yards, New York City

Hudson Yards, New York City: This may well be considered one of the largest private real estate developments in the history of the United States, and the largest in New York City since Rockefeller Center was built. Now under construction on the far west side of Midtown Manhattan, the retail portion of the Hudson Yards mixed-use complex will feature more than 100 retail stores anchored by the first full-price Neiman Marcus in the city. More than 24 million people are expected to visit Hudson Yards annually.[11] It will also include dining and the highest open-air observation platform in New York. Located just off the Hudson River, the project is helping to draw street retail west along 34th Street from Herald Square.

Customization and Other Technology

Perhaps due to the constant connection and instant research technology permits, the Millennial shopper is knowledgeable about products, more comfortable with diversity than previous generations, and far more insistent on customizing the products they purchase.

Personalization has become the new luxury for a generation psychologically affected by the Great Recession and quite likely burdened by high student loan debt. Two-thirds of recent bachelor's degree recipients report outstanding loans, with an average balance of $27,000.[12] Bain & Company research reported that 25% to 30% of online shoppers polled were interested in purchasing items customized to their own taste.

Fortunately for consumers, but possibly threatening to retailers, technology is developing rapidly that will enable products to be completely customized to customer needs and tastes. New 3D printers are creating customized goods from jewelry to automobiles, quickly and affordably, enabling shoppers to pick up precisely tailored items, and relieving retailers of the need for extensive backroom storage. Stores can be reduced in size as they become portals for ordering customized merchandise to be printed and collected, or delivered, later.

Not only are technological advances making manufacturing possible, but they are also affecting the overall shopping experience. Accessory designer Rebecca Minkoff's New York City flagship store (a collaboration with eBay) greets shoppers with a touchscreen that allows them to order a beverage and arrange for merchandise to be delivered to a fitting room. High-tech mirrors can scan the items and depict alternative colors and sizes to be delivered by associates.

[11] http://www.hudsonyardsnewyork.com/the-story.
[12] Pew Research Center, "Millennials in Adulthood: Detached from Institutions, Networked with Friends," http://www.pewsocialtrends.org/2014/03/07/millennials-in-adulthood/ (Mar. 7, 2014).

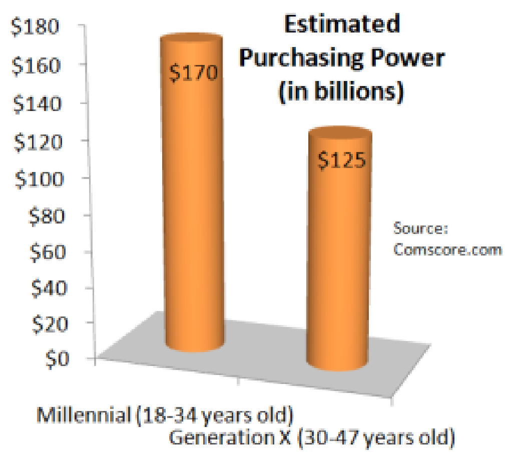
Los Angeles' Left Shoe Company uses 3D scanners to produce precise measurements of its (male) customers' feet, then permits its shoppers to select materials and styles to create bespoke footwear at vastly more affordable prices. Hointer, a Seattle haberdasher, displays a single unit of each item, bearing a QR code scanned by the shopper. Robots deliver the items to a specified dressing room. Goods are purchased by credit card on a tablet. Sears' online store is partnering with 3DLT, a Cincinnati-area printing company, to sell items ranging from jewelry to home furnishings made on a 3D printer.[13] These combinations of traditional experience and technology may, however, require landlords to invest in the bandwidth and other infrastructure needed to accommodate retailers utilizing these new methods to enhance the shopping experience.

Socialization

Perhaps because they are the most digitally connected generation in history, Millennials highly value socialization. However, they want to socialize on their own terms. Their desires regarding communication must be accommodated as this generation's spending potential increases. In its report, "The Reciprocity Principle: How Millennials Are Changing the Face of Marketing Forever," Boston Consulting Group notes that as of 2013, Millennials account for some $1.3 trillion in direct annual spending, of which $430 million is discretionary.[14] The group already has more estimated purchasing power than Generation X, and this should increase as this generation enters its peak earning years.

Income/Retail Sales Potential of Millennials

Courtesy of Fung Business Intelligence Group



Yet these globally connected customers primarily use digital information for research, according to The Intelligence Group.[15] They then go to stores and restaurants in search of physical interactions. Even so, these stores and eating establishments must be interactive as well, using the latest technology to fulfill consumer desires for the customized experiences and goods.

It is important to remember that socialization is not just limited to Millennials. The members of older generations, who have already purchased enough merchandise for a lifetime, increasingly are seeking to spend money on communal experiences such as dining and entertainment. Food courts brought in $792 per square foot in 2010, up 5% from the year before, according to the International Council of Shopping Centers; restaurants brought in $459 per square foot, up 4% from 2009.[16] The National Restaurant Association recently predicted that 2015 U.S. restaurant sales will rise 3.8% over 2014 figures.[17]

In response, many shopping centers have increased the proportion of eating establishments in their mix, adding everything from fast casual to fine dining.

[13] Brownfield, Andy, "Major U.S. retailer partnering with Cincinnati 3-D printing startup," http://www.bizjournals.com/cincinnati/news/2015/01/28/major-u-s-retailer-partnering-with-cincinnati-3-d.html (Jan. 28, 2015).
[14] Barton, Christine, Koslow, Lara and Beauchamp, Christine, "How Millennials Are Changing the Face of Marketing Forever: The Reciprocity Principle," https://www.bcgperspectives.com/content/articles/marketing_center_consumer_customer_insight_how_millennials_changing_marketing_forever/ (Boston Consulting Group Jan. 15, 2014).
[15] The Intelligence Group, Fall/Winter 2014 Cassandra Report.
[16] *Id.*
[17] Restaurant Industry Sales Expected to Increase 3.8 Percent in 2015," http://www.fesmag.com/home-highlights/12320-restaurant-industry-sales-expected-to-increase-3-8-percent-in-2015 (Jan. 27, 2015).

The Impact on Real Estate

In some respects, retail real estate owners and managers have more opportunities for success than ever before. The Internet has given rise to global consumers as knowledge of international brands is merely a click away. Retailers such as Uniqlo, Topshop, Zara and H&M have opened in the United States, with shoppers literally lined up around the block. Thus, the potential tenant pool has risen. At the same time, e-commerce has created an omnichannel experience that benefits the shopper, but can drastically affect store counts, expansion strategy, square footage, and lease terms for landlords.

Store closures in the United States have not just been limited to failing retailers such as the now-defunct Circuit City, Coldwater Creek and Borders Group. With shoppers able to order merchandise from brick-and-mortar stores' websites, downsizing the number of units is now a given for chains that have blanketed the country. Staples, Barnes & Noble and GameStop are among the national retailers that have reduced their overall store count as more merchandise is ordered online. Omnichannel retailers planning to expand may no longer need to open hundreds of stores to create a national presence. Instead they are finding physical locations in major markets and then supplementing with an online presence.

In the stores themselves, vast amounts of inventory are no longer needed. Large boxes may sublease space for other uses or convert part of their showroom space to store items ordered online and picked up on site (called "click and collect"). Instead of renewing its lease, a 5,000-square-foot retailer may opt to take a smaller location of 3,000 square feet.

Getting this space back is an opportunity for real estate owners. Services such as spas, fitness centers and restaurants are taking some of the vacated big-box space. None of these uses can be provided online, and each fills the socialization needs not just of Millennials, but those of all consumers.

Internet retailers themselves have become a source of new brick-and-mortar stores, including Boston Proper, Bonobos and Warby Parker. Even Amazon is testing a physical store, on West 34th Street in Manhattan, a sure sign that e-tailers recognize the benefits of enabling customers to touch merchandise and having goods available for immediate delivery.

Finding these retailers can require flexibility – many e-tailers turned retailers test the brick-and-mortar format by opening pop-up shops on "Main Street" or in shopping centers. A necessity during the recession to fill vacant spaces, pop-up stores have become an expansion strategy for new and established retailers, as well as a viable income stream for landlords. Fung Business Intelligence reports that pop-up stores, festivals, crafts and classes now account for some $5 billion to $10 billion in retail sales.

The creative reuse of obsolete malls is also very much a current topic among developers today. The former Echelon mall in Voorhees, N.J., has been redeveloped into Voorhees Town Center, a neighborhood that includes residential space, restaurants, services and a smaller enclosed retail center. Other proposed uses have included call centers, warehouses and even medical facilities.

Developers and owners should be prepared to negotiate flexible spaces and lease terms to accommodate an ever-changing roster of tenants, as Internet-founded pop-ups are subject to the same competitive forces as traditional retail. Piperlime, Gap's e-commerce line that later expanded to brick-and-mortar retail, recently was shuttered. However, among the benefits of leasing to e-tailers can be the creation of new superstar retailers and a constantly changing and thus exciting environment to attract the increasingly time-pressed and distracted consumer.

Conclusion

Retail real estate is in the midst of a cataclysmic shift as it strives to accommodate a new generation of shoppers comfortable from childhood with the conveniences of technology and more inclined to live in the city than move to the suburbs.

By changing its focus from the suburbs to more urban and urban-style developments — creating experiences that will draw people together, continually renewing tenant mix, and building the infrastructure today's high-tech stores will require — the retail real estate sector can continue to evolve and thrive for generations to come.

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