

# Real Estate **Forum**

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## **Retail and the Recession: Navigating the Aisles In a Tough Market**



From Left: **Shecky Schechner**, Barclays Capital  
**Bernard J. Haddigan**, Marcus & Millichap Real Estate Investment Services Inc.  
**David Henry**, Kimco Realty Corp. • **Andy Graiser**, DJM Realty  
(Moderator) **Ian Ritter**, GlobeSt.com (not pictured)

In many ways, the plight of retail is the most visible of commercial real estate sectors. When an office building or plant closes, that is a local story, impacting a particular community. But when chains like Circuit City and Linens 'n Things liquidate and shut about 1,400 stores, the reverberations are felt across the country. These are the places America shops every day.

REAL ESTATE FORUM recently hosted a roundtable discussion to address the issue of store closures and other ways the recession is afflicting the retail real estate industry. A panel of experts weighed in on the current state of the retail market, the opportunities presented to retailers and investors and where they believe the sector is headed. An edited version of that discussion follows.

The entire session is available via [GlobeSt.com](http://GlobeSt.com)'s webinar series.

Visit [www.incisivemediarealestategroup.com/webinars/retail](http://www.incisivemediarealestategroup.com/webinars/retail).

**IAN RITTER: Is this the worst retail market you've seen in your careers? Is it worse than it was in the early '90s?**

**SCHECKY SCHECHNER:** This is the worst retail market that I've seen in my 25 years in the business, and it feels more prolonged given the impact and the depth. In short, this is worse than the days of the early '90s. It's actually supposedly worse than what it was in the early '70s, so it's pretty bad.

**BERNARD J. HADDIGAN:** It depends on what side of the market you're on. I would argue there are quite a few investors who are excited about the opportunities that will present themselves over the next two or three years. From a brokerage and finance point of view, it's by far the most difficult stretch I've been through in 28 years in the business. The disconnect between buyer and seller expectations and the lack of capital in the marketplace has really created a situation of broad paralysis.

**RITTER: Is it difficult because properties aren't trading, or because retailer performance is low? Or both?**

**ANDY GRAISER:** There's a perfect storm right now. Consumers just aren't out there buying because it's not cool to shop anymore. The operations side is incredibly difficult. Inventory appraisers are coming in and valuing inventory, and appraisals are coming down. The asset-based lenders that are lending against the inventory are taking their liquidity down. At a time when retailers need liquidity most, they are actually getting squeezed by all the stakeholders. At this point, everyone is just ratcheting back and being incredibly conservative. Whether it's the vendors or lenders, they are more concerned about their jobs than actually conducting good business.

**DAVID HENRY:** This is a lot different than the downturn of the '90s, which was also pretty severe. It was a scary time. But in the early '90s, there was a huge oversupply of retail real estate, along with office and industrial. Now it's more tied to the general economic maelstrom. Our sector hasn't really gotten too far ahead of itself in terms of development. The issue is on the demand side; our tenants are all retrenching. They have stopped expanding to any significant degree, which has put a lot of strain on the existing inventory. We're rapidly becoming oversupplied in retail real estate, but I don't think development is driving it.

**RITTER: When we have a chain like Circuit City or Linens 'n Things completely shut down, does that mean we're over-stored?**

**HENRY:** What you certainly have is a situation where fewer tenants are willing to go into that vacancy, so by definition you are oversupplied—or you're beginning to be—as these stores hit the market and stay vacant for a sustained period of time.

**SCHECHNER:** But we are seeing situations where the vacant Mervyn's and Circuit City stores are being backfilled by other tenants. So while we might think we are over-stored and that all the space isn't being absorbed, a surprisingly large amount of single-tenant boxes are being retenanting.

**RITTER: By whom?**

**HENRY:** We've signed leases with HHGREG, Nordstrom Rack and Ross Stores for vacant Linens 'n Things in the US. In Canada, Bed Bath & Beyond took four of the six vacant Linens 'n Things we were left with.

**GRAISER:** We're involved with the disposition of the Linens 'n Things and Circuit City leases, and retailers are absorbing those. The more challenging issue is with the vacant Circuit City properties; there were leases done with Best Buy and PC Richard and others, but this round of vacancies is going to take longer to absorb than the Linens 'n Things.

**RITTER: Will the Treasury's actions make any difference in the retail sector?**

**SCHECHNER:** You'd think that having more capital come into commercial real estate would help relieve some of the pressure. Whether it's the Term Asset-Backed Securities Loan Facility, which is the program for new loan origination, or the Public-Private Investment Program, which is for legacy loans and securities—if they are successful and add more capital to the system, it should also put a floor on valuation. If an owner can borrow 40% with partial support from the government, that 40% loan and the resultant 60% equity means you have a floor for the capital structure of the asset. That should help with a lot of the valuations going forward—no more assumptions that there is no available debt. While not perfect, it is a start. Now, while the government programs create a baseline capital structure—40% LTV loans—the other large issue is whether you can come up with an NOI for underwriting purposes. It's one thing to have a lot of capital, but the question is, what are you underwriting to?

**HENRY:** Anything the government can do to stimulate lending and capital into the sector is going to be good. I agree that the real question for investors is, how low is this going to go? You don't want to use that oft-repeated expression, "Catch a falling knife," and jump in too early. Most investors would rather wait to see definitive signs that things are improving, and if they miss the bottom by a little bit, that's okay. You've still got a market filled with fear rather than greed, and greed works a lot better in the real estate market.

**HADDIGAN:** History has shown we run in cycles. The question is how long and how deep this one is going to be. There's just so much uncertainty and investor activity remains virtually frozen. Let's assume consumer spending started accelerating today. From the transaction side, things aren't going to start trading until people can more accurately assess risk and feel comfortable with what they're doing. That goes to the heart of all this.

When underwriting a deal today, how do you assess risk? In general, rents are certainly not moving up. There's pressure on the expense side across the entire US. Whether the expenses are encumbered by the tenant or the landlord, it doesn't seem like we've got an environment in which you're going to see any significant NOI growth. There will certainly be exceptions, but as a general statement, there's pressure on NOIs and lenders are very reluctant to take any aggressive positions. Deals that are getting financed in today's market are situations where the lenders are underwriting the borrower as much as they are underwriting the real estate.

Treasury Secretary Timothy Geithner's actions are certainly positive, but anything we do to try to create some relief and start some activity and movement with distress is going to be a positive thing.

**RITTER: Is this tied in any way to consumer confidence? Do you think the Treasury's actions will impact consumer behavior?**

**SCHECHNER:** Consumer confidence is a very big part of it. Right now, people are watching family, friends and neighbors losing their jobs. There's a lot of anxiety. Until that turns around, whether through a stimulus package or restoring stability to the banking system, a return of consumer confidence and spending—at rational, long-term patterns, not even aggressively—would give a sense to all retailers that they should put a lot of inventory in the stores. That will probably signal to landlords that there will be more activity in the centers, which would certainly give more confidence and stability to the operating incomes and cash flows of the underlying assets.

Otherwise, you wonder how far NOIs will fall. Different public companies are expecting incomes to be down 3.5% or 5%, but no one really knows. The visibility is extremely low.

**RITTER: Speaking of spending, there aren't many transactions taking place, and those that do occur are very small deals. Have you seen this shift?**

**HADDIGAN:** The investment sales market has been a developing story over the past 24 months. With the capital markets seizing in the summer of '07, we saw a bit of a lag time in terms of the transactions that were being done. But when all was said and done, in calendar year 2008 versus 2007, the \$20-million plus market was probably off by 95%.

Approximately 97% of the retail market has historically consisted of deals under \$15 million. As 2009 progresses, transaction velocity will continue to decelerate. However, properties priced under \$10 million are still trading. If the institutional side of the market was off 95% or more in 2008 compared to 2007, the market in general was probably off by well over 50%. The bright spot in the retail sector is the net lease business, which is off by 35% to 45%. But the market is much more careful in how it's assessing transactions.

**HENRY:** There's a huge disparity between the bid and ask today. If you assume for the moment that we're following the residential market, it took a while to see severe decreases in home prices. It's like when you put your house up for sale in a soft market, you don't reduce your price right away. It isn't until the traffic slows down and your broker moans and groans for three or four months that you finally get a little more realistic. We're in the early stages of that with commercial real estate. The sellers really haven't been willing to take the big discounts that may be necessary to move their real estate.

**GRAISER:** Dave, do you think that with these balloon mortgages coming up, it's going to start forcing these sellers to start getting more realistic with their pricing? The interest reserves on those mortgages are coming due and they've got to refinance, but have no place to go.

**HENRY:** That's the slow-motion train wreck we're all worried about. There's a huge wave of commercial real estate loan maturities facing us. There has been some anecdotal evidence that special servicers and others are getting realistic, and if they have a performing loan, they'll consider extending it for 12 months or even 18 months—

with, of course, a higher interest rate and fees. But why take a performing loan and force it into foreclosure or a non-earning status? We're still very worried about all of these maturities, but perhaps some sanity will come into the securitization market and it won't just be full of bankruptcies and foreclosures.

**SCHECHNER:** With all the maturities, I think the special servicers—because there isn't a robust investment sales market—do not want to take back the assets and manage the properties. That's not what they're set up to do. If the borrower has been performing and not stealing the cash and is a decent operator, why wouldn't the special servicers extend the loan for 12 months at a higher rate and/or fees, and potentially a small pay down if available? We anticipate you're going to see a lot of these type of extensions until the markets recover in some way.

**GRAISER:** One of the other things I'm seeing is that some of the retailers, certainly the healthier ones, are getting more realistic that this might be a really good opportunity for them to buy back some of their own real estate, especially when you've got some of these free-standers whose leases are coming due in the next couple of years. Instead of trying to renegotiate a rent reduction, they're now spending time with the landlord trying to buy the real estate.

**RITTER: Are there any retailers out there that you can trust as a tenant?**

**HENRY:** The safest place to be as a landlord is in a ground lease position, where the retailer has actually built his building on top of your land and you're receiving ground rent. If you have a good credit tenant and a ground lease, that's a pretty good combination.

**GRAISER:** The category killers that no longer have competition. Those tenants are safe bets because there are not a lot of places to go outside of those categories. Whether it's in electronics or linens, they're safe bets.

**RITTER: Are there more regional or local tenants in shopping centers than there were before? It seems like this market is opening the door to opportunities for smaller, regional names.**

**GRAISER:** What we're seeing, because we're out marketing a lot of these leases in non-bankruptcy and bankruptcy settings, is local retailers stepping up and taking over some of the vacated space, though not, obviously, at the rate that any of us would like. A good example is when you saw PC Richard take some Circuit City stores in the New York area. We're seeing a lot of landlords who previously would never have accepted certain local or regional tenants in their shopping malls, but now have to fill the space and drive traffic. They are now willing to go that route, so it creates a great opportunity for the local guy to start expanding.

**HENRY:** I agree. Some of the privately owned regional players are stepping up and trying to take advantage of the situation. Publix, for instance, bought a lot of the Albertsons that we acquired. Wegman's is a good, strong local retailer that's looking at ways to take advantage of this situation. Ross Stores is another one that's growing right now.

**GRAISER:** A company like Big Lots, which is expanding, has done a good job of being very patient. Now the market has come to them whereas before, in some cases, landlords wouldn't give them the time of day because of their type of merchandise. Some of these tenants now have the opportunity to go into centers at really good rates.

**RITTER: What's your forecast in terms of recovery? What needs to happen for the market to improve?**

**SCHECHNER:** We need to reach stability, which leads to consumer confidence. We need two quarters during which the banks around the globe stop announcing losses. That will help lead to a change, though that's at least six months away. But given that real estate is a lagging indicator, the real estate universe is not going to turn around until 2010 at the earliest. In terms of transaction velocity, we won't see normal activity levels until the second half of 2010.

**HADDIGAN:** From a transaction and capital point of view, there is just so much uncertainty and perceived risk out there that investors are only targeting best-of-class, infill locations. It will be very interesting to see how things play out with the FDIC and the Treasury in terms of trying to bring some liquidity into the system. Once we start to see some motion and the market starts getting some direction, you're going to see a lot of capital come back in on the equity side. It's going to be a number of years before we get back to the froth of the old days. At a very macro level, the investment sales business will start picking up later this year, and 2010 to 2012 will be a very busy time in the business, simply in terms of bringing order back to all the disconnect that we've seen.

**GRAISER:** Unemployment really has to start going in the other direction. It's in the papers every single day. It's a reminder of how bad things are. Once that starts stabilizing, it will start taking some of the fear out of the market. Until that changes, we're going to see this for a while; I'm going to say toward the second half to the end of 2010.

**HENRY:** I agree. Even though the economists will tell you that unemployment is a lagging indicator, I'm not so sure in the state of the world today. Every company is looking at ways to cut costs right now, and that includes people. If the US is going to continue losing jobs at 500,000 or 600,000 a month, that is a horrible thing for real estate fundamentals. As long as real estate fundamentals are under attack in terms of rents and cap rates and so forth, it's hard for the market to find its feet. I look towards the employment. ♦