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A LOOK BACK: 2009 Retail Real Estate…

And A Glimpse At What May Be in Store for 2010

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For retailers, landlords and developers, the punch line to the old joke about the light at the end of the tunnel being a train is hitting a bit too close to home these days. As tough as 2009 has been on retailers, a strong recovery might not be quite as close at hand as some have predicted. While some retail real estate analysts see brighter things ahead for 2010–there is some data to support that prediction–the bottom line is that most retailers' bottom lines are likely to look less impressive in the near future, and retail real estate markets will continue to remain soft well into 2010.

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It would not be accurate to characterize 2009 as a wholesale collapse, but retail real estate values have certainly gone down dramatically. Some figures place the decline as high as 36% nationally. Some of the biggest names in retail have declared bankruptcy within the last year, including such familiar and iconic stalwarts as Linens 'N Things, Circuit City and Mervyn's. Some of the real estate has been redeployed, but a great deal of it is still sitting vacant out there, exerting significant drag on the marketplace.

The reality is that there are both big and small names in the industry barely hanging in there, and unless things change dramatically in the months ahead, the bankruptcy rolls are likely to swell. Because so many retailers have struggled throughout 2009, the always important holiday shopping season looms larger than ever this year. Unfortunately, in what will be for many retailers a make-or-break year-end push, there is little reason for optimism that the current dynamics will yield anything more than a modest boost at best.

Because so many current landlords received loans and purchased properties based on a certain set of rosier rent assumptions, many existing retail and mixed-use developments are not going to be sustainable; many of those pro forma balance sheets no longer add up.

Consumer confidence remains shaky, and with real unemployment hovering at over 10% nationally–up from 7% last year at this time–the daunting combination of fewer employed consumers, smaller paychecks and tighter credit points to a less-than-robust holiday season. Retailers are already taking proactive and strategic measures to prepare for a lean holiday and ensure that no mercantile stone is left unturned, including price-cutting, implementing and promoting layaway programs, and opening temporary pop-up stores to take advantage of affordable, vacant commercial real estate.

The degree to which retailers are embracing these measures is an indicator that the industry recognizes the importance and the likely mediocrity of this holiday season. The 2009 holiday season will ultimately have a disproportionately large impact on retail real estate over the next 24 to 36 months. Unfortunately, while many forecasters are predicting that retailer stockings might not exactly be filled with a lump of coal, a dramatic, momentum-generating turnaround seems very unlikely.

The upshot, of course, is that a recessionary cycle, high unemployment and sagging consumer confidence continues to exert significant pressure on retailers, resulting in a correspondingly bleak effect on retail real estate sales and rental rates. The cyclical nature of the industry demands consumer spending to ultimately fuel the retail engine, and with that engine running on fumes, retail real estate sales and rental rates have been suffering. With consumers not spending, retailers cannot afford current rents.

From a retail perspective, it is always possible to adjust labor costs and calibrate inventory to demand, but existing lease agreements are relatively fixed, absent a mechanism for renegotiation. And because so many current landlords received loans and purchased properties based on a certain set of rosier rent assumptions, many existing retail and mixed-use developments are not going to be sustainable; many of those pro forma balance sheets no longer add up. That disconnect between landlords and banks has had a chilling effect on the industry's ability to adapt thus far. Banks are essentially blocking many landlords' abilities to restructure the value of their real estate based on what retailers can afford right now, limiting landlords and possibly slowing the recovery process for the industry as a whole.

Of the retail properties completed this year, 30% opened half-empty or worse, according to Reis data. Unfortunately, with a few other large bankruptcies looming on the horizon, the near-term outlook is not likely to improve quickly. There is a very real possibility that the landlords sending keys back to the banks will be the only way we will see a reset of true rent values. Once the banks gain control of these assets and sell them at a number that reflects a more realistic assessment of current rent values, we are more likely to see some stabilization.

Contrary to what more optimistic predictions may outline, a realistic perspective on substantive recovery would look more at the 24- to 36-month time frame… largely determined by how many retailers are able to keep their heads above water in the months ahead.

Ironically, the state of the marketplace is such that retailers *could* make some great deals right now. But with landlords fighting to hang onto every dollar and understandably reluctant to give that relief, many retailers remain locked into their existing lease. In fact, while a handful of aggressive retailers are making moves, relatively few are in a financial or contractual position to take advantage of what are actually some historic deals right now. Prices have dipped as low as $10-$11 per square foot for retail space in some major markets. What has gone on in 2009 and will likely continue in 2010 is retailers are working to restructure instead of expand, and are working to "clean up" portfolios in an attempt to pare down and optimize efficiency.

Looking ahead to 2010, retail real estate prospects seem likely to remain mixed at best. As we have seen in 2009, some cash will be out there, but the question is, who will be in a position to take advantage of it? Retailers, landlords, developers and investors are in a holding pattern, with everyone waiting for the bottom. Investors seem to be waiting for a clearer sign that the decline is reversing, and in the meantime, movement of properties remains slow. Lenders are correspondingly hesitant, a dynamic that only gums things up further.

Unemployment is still a big factor nationally, and with the job market predicted to recover slowly, if at all, in 2010, that is likely to have a suppressive influence on retail real estate. As always, the issue becomes: how will we know when the bottom has been reached? While it certainly feels like the bottom in states like Michigan, Florida and California, where overexpansion and too-high prices created both a bubble and an inevitable deflating "pop," the real sign that things are on the upswing will be investors starting to buy again.

The Moody's/REAL Commercial Property Price Index (CCPI) is more than 30% lower than the same time last year, and nearly 40% lower than its October 2007 peak. The last time the industry experienced a situation this dire, during the S&L crisis of the 1980s, the Resolution Trust Corporation (RTC) was created to liquidate devalued assets, essentially flushing the dead weight out of the market in a remarkably efficient manner. Absent a similar market-clearing mechanism today, the recovery is destined to be a slower process.

Contrary to what more optimistic predictions may outline, a realistic perspective on substantive recovery would look more at the 24- to 36-month time frame. The timing of the recovery will be largely determined by how many retailers are able to keep their heads above water in the months ahead. To the surprise of some industry insiders, many troubled retailers are trying to hang on through the holidays. But, in keeping with recent patterns, discount brands will likely perform well during this challenging holiday season, and those hanging on by the skin of their teeth are not likely to see a drastic turnaround, if at all.

Despite the grim near-term outlook however, it is worth maintaining some perspective. For all the doom and gloom about our fiscal circumstances, the American economy is still the largest in the world; Americans produced approximately $15 trillion worth of goods and services in 2008, the fourth largest per-person output in the world and 25% larger than the nearest competitor (China). The potential is there. The world's most powerful economic engine has been sputtering a bit since 2007, but, while it may need a tune-up, we are far from running out of gas. As a slow but steady consumer-fueled recovery breathes life into retail in the years ahead, the retail real estate market will once again regain its robust status as a dynamic and thriving marketplace. abfj

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