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SPACING OUT

A sharp increase in store closings in 2008 will force landlords to consider new kinds of tenants

By Elaine Misonzhnik

In February 2007, Dillard's closed a 150,000-square-foot store at the 206,000-square-foot Shively Shopping Center in Louisville, Ky. During a normal economic period, that wouldn't have been a major hardship. The center's owners, Shively Center LLC, could have sought out a replacement anchor. Or, short of that, the center's owners could have chopped up that space and leased it to several smaller retailers. But the past 12 months have been far from normal.

A credit crunch combined with an economic slowdown have created a daunting environment for retailers. Many are closing stores. Others are slowing expansion plans. That has made it increasingly difficult for properties in positions like Shively Shopping Center to find retailers to fill vacant space.

That's when Shively Center LLC got creative. Rather than turning to a retailer, the company is bringing in Norton Healthcare Inc. to take a 16,500-square-foot chunk of the property to house an immediate care practice, a primary care center and an obstetric and gynecologic practice. Another 12,000-square-foot spot at the center houses a branch of Spencerian College, a local vocational school.

Elsewhere, a 43,000-square-foot former Wal-Mart in Seward, Neb., for example, will soon become home to the 300-member Hillcrest Evangelical Free Church, reports the Lincoln Journal Star. And at the 380,632-square-foot Colonial Promenade at Hoover in Hoover, Ala., the Armed Forces Career Center has just moved into 4,000 square feet of space at a vacant storefront on the property's west end.

Welcome to the new normal.

Increasingly, expect to drive up to your local shopping center and find next to the dry cleaner and deli day care centers, trade schools, bingo parlors, libraries, doctor's offices and even small churches.

The situation is being driven by the rash of new bankruptcies and store closings that have swept through the industry after last year's rough holiday shopping season. Since January, furniture seller Domain, Inc., high-end jeweler Fortunoff Inc. and electronics merchant Sharper Image entered bankruptcy proceedings. During the same period, women's apparel chain operator Charming Shoppes, Inc. said it will close 150 stores, discount retailer Fred's Inc. announced plans to shutter 75 locations and Wilsons The Leather Experts Inc. promised to cut its store fleet by 160 units.

To deal with a more challenging playing field, both landlords and space disposition specialists have had to become more flexible, says Alvin Williams, principal of Excess Space Retail Services, Inc.

And the flexibility has come at a time when the workloads of space disposition specialists are already rising. Excess Space, a Huntington Beach, Calif.-based real estate disposition and lease restructuring firm, for example, experienced a 20 percent jump in the amount of space in its portfolio in February compared to the same month a year ago. The firm is currently working on the disposition of 220 locations belonging to Rent-A-Center, Inc., a rent-to-own chain of consumer electronics, appliances and computers. It was also recently retained by Whole Foods Market, Inc. to dispose of 21 stores in 11 states totalling 511,161 square feet.

CB Richard Ellis Portfolio Services Group, which focuses on dispositions through single-asset sales, portfolio offerings and sale-leaseback, also expects a 20 percent in-

crease this year, says Donna Kolius, senior vice president with the group. Her team is now handling the disposition of 28 locations belonging to restaurant operator Yum! Brands, Inc., and is working with the Inland Real Estate Group on selling a number of Wal-Mart leases.

Executives at DJM Realty, LLC, a New York-based diversified real estate consulting and advisory firm, also say their numbers are about 20 percent ahead of last year's. Since November, DJM has been holding the contract for 335 leases and five distribution centers belonging to furniture retailer Bombay Company and in January, apparel seller Pacific Sunwear chose it to dispose of its 154-store Demo division.

But this year it will take longer than usual to find replacement tenants, according to Matthew Bordwin, managing director of KPMG Corporate Finance LLC, a Melville, N.Y.-based middle-market investment bank.

"Every day it seems a retailer is either filing bankruptcy or announcing store closures, and even healthy retailers are pulling back on growth and expansion plans," he says. "It is common to hear an announcement from any type of retailer that previously said it will open 100 stores that now it is going to open 50."

In fact, the Deloitte Research Leading Index of Consumer Spending, which tracks consumer cash flow as an indicator of future consumer spending, turned from positive to negative in January 2008. With the economy appearing on the brink of a recession, the ICSC estimates that the industry will see 5,770 store closings in 2008—up 25 percent compared to 4,603 closings in 2007. Some observers place the estimate even higher—up to 7,000 closings. The last time the figure surpassed the 5,000 mark was in 2004, when 6,303 locations closed.

Under normal circumstances, an increase in surplus space is no big deal, say the experts—if CompUSA (which was acquired by an affiliate of restructuring firm Gordon

Brothers Group in December 2007) leaves its 100-plus locations, landlords can count on office supplies stores or big-box discounters to take its place. But in the current economic climate, retailers that have traditionally made use of surplus space are scaling back their expansion plans. In February, Office Depot announced that it will open only 75 new locations in 2008, half of its original target of 150. Lowe's shrunk its opening plans to 120 new stores this year, down from 150. And J.C. Penney Corp., which opened 50 stores in 2007, is slowing down a bit this year and planning to open only 36 stores.

With healthy retailers pulling back, empty stores will sit on the market longer than in 2006 or 2007, says Ivan L. Friedman, president and CEO of RCS Real Estate Advisors, a New York City-based investment advisor and restructuring and portfolio optimization firm. Whereas in the past few years owners only had to deal with a dark store for a few months, this year they may have to live with vacancies for 12 months or more.

But if the situation in the retail industry doesn't improve by the end of the year, landlords might have to resort to the most painful measure of all, says Bordwin—lowering rental rates and offering concessions.

What are the options?

How a retailer who's cutting its real estate inventory disposes of surplus properties depends on if the spaces are owned or leased and whether they are located in a mall or a shopping center.

When it comes to stand-alone properties that are owned by the tenant, it's often possible to find a buyer not only among fellow retailers, but among developers who specialize in repositioning, such as Chicago-based Klaff Realty L.P. and New Hyde, N.Y.-based Kimco Realty Corp., and speculative investors. Redevelopers currently purchase approximately 58 percent of store-owned surplus real estate on a national basis, while retailers purchase 27 percent and opportunistic investors 15 percent, respectively, according to Kolius.

When the new owner is another retail operator, the strategy tends to be straightforward—they renovate the space as needed, refit it to their specifications and start operating their own business.

When the buyer is a professional developer, the new owner will often spruce up the facade and divide the property into smaller units, which together bring in a higher rental stream than a single large operator. Smaller tenants also tend to be easier to find because there are more of them than behemoths like Wal-Mart and Target. At one 49,754-square-foot former Wal-Mart location CB Richard Ellis worked on in Fitzgerald, Ga., for example, Fred's, Beall's Outlet and Farmer's Furniture now share the space.

U.S. STORE ANNOUNCED CLOSINGS	
2001	7,041
2002	5,950
2003	4,973
2004	6,303
2005	4,269
2006	4,730
2007	4,603
2008	est. 5,770

Source: ICSC

At another, in Georgetown, Texas, Hobby Lobby, Tuesday Morning and a salon currently occupy the former big-box discounter's 72,605-square-foot home. "It's rare to see second-generation retail box space being leased to a single tenant. It is normally divided to multiple tenants," Kolius says. If finding a substitute retailer proves impossible, those kinds of properties can also be turned into other uses, such as storage facilities, call centers, auto dealerships or medical facilities, as happened with a 94,401-square-foot Wal-Mart in Ankeny, Iowa. That space now serves as home to Mercy Hospital.

Meanwhile, if the buyer is a speculative investor, he or she will try to resell the building at a higher price to another retailer, with which the investor often has a pre-existing relationship.

By and large, retailer-owned properties will retain their retail use through the current downturn, says Kolius, by the virtue of their location and zoning. It's just that instead of mid-market and upscale chains, we will see more of them gobbled up by discount operators.

Tenants who lease their real estate, on the other hand, will have a harder time finding replacements, especially if they are mall-based. Mall landlords tend to be very particular about substitute uses, so space disposition experts have to work with them on an extensive basis to find new tenants as creditworthy and appropriate for the property as the ones leaving, says Andy Graiser, co-CEO of DJM Realty. Owners of shopping centers don't feel the same kind of pressure to maintain a uniform retailer mix, so they are more open to new operators and non-retail uses such as doctor's offices.

On the move

Fortunately for the renters, the market still has some national chains with good credit that will be expanding this year and might be willing to take secondhand space. Discount retailers and grocers seem to be handling the slowdown well so far and have been upping their expansion plans for 2008. In February, for example, TJX Companies, Inc. president and CEO Carol Meyrowitz told analysts the firm had the capacity to grow its TJ Maxx and Marshalls division by 400 stores, up from the previous estimate of 200. Meanwhile, wholesale club operator Costco Wholesale Corp. has been using former department store spaces to open new locations for at least four years, and has plans to open two such stores in 2008 and another four or five before the end of 2009. Altogether, the retailer plans to open up to 30 new North American locations this year.

Bright spots remain in the electronics and high-end retail sectors. Nordstrom will open eight new stores this year, compared to two in 2007. And big-box electronics chain Best Buy will open 85 to 100 new U.S. stores in 2008, on target with its previous plans.

STORE CLOSURES BY SECTOR IN 2007

Merchandise Group	Number	Share of Total
Home furniture	1,228	26.70%
Home entertainment	1,087	23.60
Apparel	542	11.80
Drugstores	398	8.60
Footwear	395	8.60
Bookstores	286	6.20
Grocery stores	161	3.50
Miscellaneous retail	125	2.70
Toys/Hobby/Educational	122	2.70
Stationery	85	1.80
Variety	60	1.30
Department stores	42	0.90
Personal care	23	0.50
Other	49	1.10
Total	4,603	100
Source: ICSC		

"In the luxury sector, in the discount sector, people are still continuing to expand," says John Bemis, executive vice president and director of leasing and development with Jones Lang LaSalle Retail, an Atlanta-based third-party retail management firm. "The section that seems to be impacted the most to date has been the mid-price point section."

But, he admits, new store openings among national chains will not be enough to fill 5,770 empty storefronts. As an alternative, landlords will have to turn to local and regional chains, which are normally considered too high-risk. To mitigate the risk, they will use short-term leases—lasting two to three years, as opposed to the standard seven to ten years, Bemis says.

Other options will include international retailers and new concept spin-offs from national chains, according to Williams. Urban Outfitters and Abercrombie & Fitch are coming out with new concepts this year, while Aeropostale and American Eagle revealed plans to launch concepts in 2009.

Meanwhile, a good example of an international retailer with its sights on U.S. real estate is the Italian footwear seller Geox, says Williams. The chain, which had planned to open 10 new stores in the U.S. in 2007, will open 776 stores worldwide in the next two years (Geox takes spaces measur-

ing 1,000 square feet to 1,400 square feet).

“Many retailers are able to take advantage of the opportunities created by surplus space as it can allow them to quickly enter new markets, often at very competitive rental rates,” says Williams. “This current marketplace may actually prove to be advantageous to retailers that are out there looking to aggressively expand.”

But the current conditions will also make it easier for non-retail users to get into malls and shopping centers. Over the past several years, tenants as varied as pediatric dentists’ offices and driving schools have taken occasional empty storefronts. Now, the trend is becoming more widespread, according to Graiser. At one property located in Florida, he brought in a technical college to take over space vacated by General Cinemas. The college uses the screening rooms as lecture halls. He also recalls a case from a few years past, when a church bought several locations from the now defunct furniture chain Heilig-Meyers. In 2008, we will start seeing those kinds of deals again, Graiser says.

Last resort

If consumer sentiment doesn’t improve by the end of this year, landlords might be forced to start lowering rents and offering concessions to retailers to stay in place, something they haven’t had to do for several years, says Bordwin. As a result of shrinking demand for space, retail vacancies will rise 50 basis points on a national basis in 2008, to 10.2 percent, slowing effective rent growth to 2 percent, estimates the national brokerage firm Marcus & Millichap Real Estate Investment Services.

In fact, in class-B and class-C malls, landlords are starting to be more flexible with leasing terms, according to

Friedman. Aware of how long it might take to find a replacement tenant and anxious to avoid leasing to a non-retail user, they can go up to 20 percent to 30 percent under the market rent to secure a respectable name, he says.

Plus, offering an existing tenant better lease terms to keep it at the property may be a more sensible solution for a landlord than trying a variety of second-best choices, some of which come with a much higher risk factor, according to Bordwin.

“If we go through another holiday season like the last one, I think it will definitely force landlords to offer up more concessions,” he says. “What happens in markets like these is that everyone gets scared, and even if retailers start doing more transactions, they will do their due diligence and only open stores in good locations.”

For the moment, however, most industry experts, including Bemis and Kolius, expect the downturn to be brief. Consumers are waiting for the 2008 presidential election to take place before they start purchasing at the same rate as in the past few years, according to Bemis. Once the White House has a new occupant and fears of a recession subside, things will return to business as usual. Meanwhile, retailers will have dealt with most of their excess real estate by the fourth quarter of the year, which will mean fewer store closings in 2009, says Kolius.

“In my opinion, 2008 is going to be a challenging year and we as developers and leasing people will have to work that much harder to make deals in our centers,” Bemis says. “But I do believe that post-election, we will see a dramatic improvement in the tone and tenor of the attitude in the press, which in turn will lead to consumer confidence and a very early 2009 recovery.” **RT**