

# abfjournal

FOR THE COMMERCIAL FINANCE PROFESSIONAL | WWW.ABFJOURNAL.COM

## Retail Real Estate— Scary in the Short-Term, Long-Term Opportunities Exist

NOV/DEC 2008

BY SPENCE MEHL AND EDMUND TERRY

**While the subprime mortgage crisis** may have been the first rock to start sliding, the avalanche of bad news that has been making headlines this fall is the result of a number of complex structural concerns that have radiated out to virtually every corner of the national economy. Unfortunately, retail real estate has been no exception.



**SPENCE MEHL**  
Senior Vice President,  
RCS Real Estate Advisors



**EDMUND TERRY**  
Managing Director,  
Crystal Capital

**T**he year 2008 is not over yet, but for many parties in retail real estate, this is already a year they would like to forget. As 2008 winds down and the industry begins to look ahead to 2009 and beyond, what factors will play a significant role in determining where we go from here? How are the current dynamics within the national and international financial markets and the real estate industry changing the ways in which commercial developers, landlords and retail tenants operate? Is there a light at the end of the tunnel?

### Market Overview

The industry arc over the past year and a half has been a reflection of the national economy. Since the summer of 2007, subprime concerns have been the obvious driving factor. While industrial and office development tends to be driven by the business market, retail and multifamily is more connected to the residential market. As liquidity issues began to mount over the pinching of credit and the inability to get home equity loans, the retail market started to feel the squeeze.

The combination of liquidity issues and spreading uncertainty is a potent and troubling combination, and while some markets and products have held up better than others and regional differences have been noticeable, the general impact across the industry has been significant—and it is still growing. The softness we have seen in real estate markets around the country is both a reflection of, and increasingly, an influential factor that is in turn driving the changes taking place in the larger context of the national economic landscape.

**The current challenges are all the more striking when compared to what had been an extraordinary period of real estate growth and prosperity over the previous decade.**

Reactions throughout the industry have spanned the full spectrum, from calm equanimity to wholesale panic. As it has become increasingly clear that this is not a passing trend, industry professionals have had to come to grips with the fact that developments over the past year and a half likely constitute the beginnings of some profound changes across not only the financial landscape, but

throughout the retail real estate market. For commercial banks, investors, developers, landlords and retailers, it has begun to sink in that these events are significant, and may present a substantive challenge to even the most established names in the industry.

The current challenges are all the more striking when compared to what had been an extraordinary period of real estate growth and prosperity over the previous decade. But the boom times that began in the 1990s and continued well into 2006 and 2007 were, in retrospect, clearly unsustainable. As recent events have made only too clear, while that prosperity was not all a house of cards, retail real estate markets were playing a string of great hands into what would prove to be an unsustainable winning streak. We were perhaps due for a reality check.

Initial hopes that commercial real estate lending would remain relatively immune to the residential mortgage crisis seemed, for a time, like they might pan out. But, inevitably, consumer credit difficulties will lead to corresponding difficulties in commercial credit as well. It may be no coincidence that Lehman Brothers, whose failure made headlines in September, was the Wall Street bank with the largest exposure to commercial mortgage-backed securities.

While commercial real estate loans have long been considered among the most secure, the worsening economic outlook has more and more lenders and investors worried about the status of these loans. Over the last year, several large banks have had to take write-downs on commercial loans, and while the overall stability of commercial real estate loans still far exceeds those in the residential sector, more banks are reassessing the status of their commercial lending strategies with an eye toward reducing their exposure.

And while many experts have, until recently, considered overly aggressive underwriting to be a more significant factor than any kind of fundamental structural weaknesses in the market, that conclusion is becoming more difficult to justify. Because it is certainly fair to say that, with a few exceptions, retail performance is looking somewhat less than robust at the moment.

We are seeing shrinking GDP growth, a credit crunch and poor retail sales numbers. The consumer is retail's lagging indicator with sales growth numbers the canary in the coal mine that expires long after the atmosphere is unsafe. And what have those sales growth numbers been recently? From 6.1% in 2005 and 4.7% in 2006, to 3.9% in 2007, the trend line is clear. We are seeing forecasts for

the fourth quarter of 2008 ranging from 1.5% to 2.2%. The National Retail Federation (NRF) predicts retail sales will rise 2.2% (to \$470.4 billion) this year. If that pans out, it would be the slowest growth in sales since 2002, and a figure that is well below the ten-year average of 4.4%.

The impact on the construction side has been profound. Money for leveraging construction/development projects has been drying up, and judging by the square footage numbers, no one is building and retail real estate growth has essentially come to a screeching halt. Life insurance companies are pulling back, lending very little or not at all. With larger banks still absorbing the subprime hit, their lending has also dried up. With little or no leverage, it is very difficult for anyone to buy anything right now, with the exception of all-cash buyers. The result of all this turmoil has been some significant struggles for prominent industry leaders. In addition to the collapse and imminent downfall of a couple of big names, there has also been a changing of the guard, with new leadership at some of the big national retailers.

If these economic trends continue and the markets continue to exhibit a high degree of volatility and instability, the concern going forward is that any extended downturn would lead to more financial struggles for commercial property owners. And if those owners continue to struggle to meet their mortgage obligations, the forecast for retail real estate grows a bit cloudier. Whether or not prosperity trickles down, adversity undeniably filters up. And while the overall *long-term* economic outlook remains strong, there is concern about the ramifications of what can happen in the commercial real estate market once the loans that are already out there come due in the next few years. If commercial real estate pricing continues to reflect the tightening in commercial lending, refinancing those loans will be extraordinarily difficult.

### Landlords, Tenants, and the Way Forward

So how has this instability and uncertainty in the marketplace played out on a day-to-day basis? How have tenant relationships been impacted, and what strategies can landlords and retail tenants pursue to mitigate the impact of these challenging circumstances? As cost structures and vacancies rise, there is good reason on both sides of the landlord-tenant equation to find common ground. But leaner times can take a significant toll.

Larger discount stores such as Wal-Mart and Costco are reaping some benefits from an overall national belt-tightening, but many consumers are just sitting on their hands—and wallets—and playing the waiting game hesitant to spend in an uncertain economic climate. Conventional wisdom is taking a bit of a pummeling, as even some formerly reliable retail sectors are now more vulnerable. Electronics used to be considered by many analysts to be relatively “recession proof” (the “everyone needs a TV” mentality and the perception that a home electronics purchase was a popular alternative to an expensive vacation or other luxury during a downturn both driving this perspective), but with margins so slim, the safe bet can seem much less invulnerable.

While a number of retailers came into the fall season with strategically lighter-than-usual inventories, adjusting to a rapidly evolving marketplace can be a challenge for even the most savvy. Some have actually taken a hit by not having *enough* clearance and discount merchandise available. It is certainly no risky prediction to suggest that this holiday season might be somewhat less than memorable for retailers.

There have been a very large number of retail bankruptcies this year, with a disconcerting number of noteworthy industry stalwarts appearing on that list. Store closings for 2008 are estimated to be approaching 6,000, a number that is up at least 25%-30% from last year and is unprecedented in recent memory. And yes, there are more bankruptcies on the horizon. Part of the problem, especially with bigger, less nimble retailers, is that there is significant lag time between strategic decision making and subsequent deal making, construction, and opening of a new location.

The cumbersome momentum of a large retail operation is a poor fit when trying to steer through the turbulence of a rapidly evolving marketplace. When it can take as long as a year and a half to get a new site up and running, and market conditions are changing daily—even hourly—that momentum is hard to stop; and can be a real lia-

bility. Once a lease is signed, the retailer's options are constrained, and deciding what kind of adjustments to make in response to negative circumstances can seem like choosing between “bad” and “worse.” Do you open your doors and try to make a go of it? Do you not open and hunker down and hope things improve quickly? Do you try and get out of your lease?

Increasingly, retailers and landlords alike are realizing that being willing and able to come to the negotiating table and reach a mutually beneficial solution is the best way for all parties to make the best of a tough situation. From a retail perspective, we are seeing that those retailers that are able to move quickly and aggressively are faring better than those that are passively sitting and taking a wait-and-see attitude. In the current marketplace, retailers need to be not just responsive, but proactive; taking an aggressive approach to everything from deal making and restructuring to strategic decision making and consolidation.

Given the difficulties of a retailer successfully emerging from Chapter 11 under the new bankruptcy laws, struggling retailers need to be assertive and proactive in negotiating rent concessions, while landlords need to be open to that process and willing to embrace more out-of-court deal making. In today's climate, leverage points are in the retailers' favor. There are so few out there doing deals, and those that *are* looking are generally unwilling to settle for anything less than a “slam dunk” opportunity. Some landlords are stuck in denial. But it's not 2004 anymore, and landlords and tenants alike are both realizing that sometimes half a loaf is better than no loaf at all.

It is not all about putting out fires, however. There are opportunities to be realized, even in the most difficult markets. For those retailers that *are* looking to grow, this is actually a great time, with landlords in need of warm bodies. Because retailers need to be ready and able to pounce on quality opportunities, it is more important than ever that they make sure to establish relationships with trusted real estate professionals. While the over-the-counter merchandise is always important, real estate is looming ever larger as a critical factor in the retail equation.

As for 2009 and beyond? Things seem unlikely to turn around too quickly. It remains to be seen whether the recent series of government initiatives, from the \$700 billion rescue plan, to loan guarantees and support for struggling banks, will bear fruit, but with a market-wide liquidity crunch and a residential growth curve that has turned into a nosedive, the structural challenges are still significant. Retail real estate is still connected in many fundamental and inescapable ways to the residential real estate market, and long-term success in one is virtually impossible without prosperity in the other.

Despite these obstacles however, a reasonable big-picture perspective confirms that there is reason for long-term optimism. The roller coaster always seems scarier on the way down, and while the ride can set heads spinning and leave some people feeling a little queasy, ups and downs are an integral and unavoidable part of the commercial marketplace. And, for all of the challenges out there, there is a Darwinian imperative that rewards quality and creativity, and elevates the assertive and the visionary to new heights. For those retail real estate professionals who are able to transform challenges and liabilities into opportunities, and who can use temporary adversity as a springboard for long-term stability, today's obstacles are simply the next step on the road to lasting success. [abfj](#)

---

**SPENCE MEHL** is senior vice president of RCS Real Estate Advisors, a retail real estate advisory firm with three specialist practice areas: Growth and Development, Restructuring and Portfolio Optimization, and Investment Advisory and Participation. Mehl can be reached at 212.239.1100 x221 or at [smehl@rcsrealestate.com](mailto:smehl@rcsrealestate.com).

**EDMUND TERRY** is a managing director of Crystal Capital in the real estate debt investment business. Crystal Capital is an investment firm that provides capital for middle-market companies across all industries in the U.S. and abroad. Terry can be reached at 617.428.8778 or at [eterry@crystalcapital.com](mailto:eterry@crystalcapital.com).