United States | Q2 2018

JLL Research Report

Retail Outlook

Out with the old: closures present opportunities for new retail and new uses

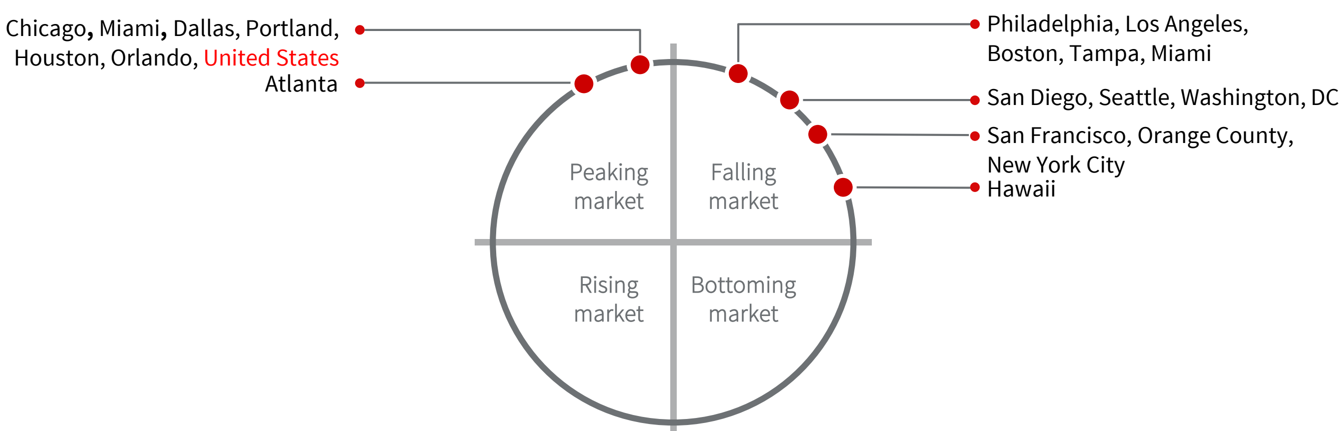
Contents

Retail closures are only half the story

Total U.S.

Type	Total s.f.	Total Vacancy	YTD Net Absorption	Q2 2018 Avg rent	QOQ% Chg	YOY% Chg
General Retail	5,759,886,838	2.9%	5,458,297	$20.07	1.9%	8.1%
Malls	924,780,987	4.0%	(2,141,193)	$18.51	-4.6%	-7.1%
Power Centers	794,420,164	4.7%	(909,054)	$17.90	1.6%	2.7%
Shopping Centers	3,691,682,351	7.2%	5,002,255	$15.74	1.4%	3.5%
Specialty Centers	91,024,969	5.2%	214,322	$15.31	1.8%	-4.1%
Total Retail	11,261,795,309	4.6%	7,624,627	$17.41	**1.6%**	**5.4%**

Retail subtype	Definition	Examples
General Retail	Consists of single-tenant, freestanding, general-purpose commercial buildings with parking	Drugstores, some groceries, street-front urban retail stores
Malls	Includes Lifestyle Centers, Regional Malls and Super-regional Malls	Primarily anchored by mass merchants, fashion and department stores
Power Centers	Consists of several freestanding anchors with minimal small tenants, 250,000–600,000 s.f.	Primarily anchored by big-box tenants and discount supercenters
Shopping Centers	Includes Community Centers, Neighborhood Centers and Strip Centers	Primarily anchored by groceries and local services
Specialty Centers	Consists of the combined retail center types of Airport Retail, Outlet Center and Theme/Festival Center	Primarily anchored by manufacturers' and retailers' outlets
Total Retail	All retail building types in both single-tenant and multi-tenant buildings, including owner-occupied buildings	All retail



Reading the clock

The JLL retail property clock demonstrates where each market sits within its real estate cycle. Markets generally move clockwise around the clock, with markets on the left side of the clock generally landlord-favorable and markets on the right side generally tenant-favorable. Most of the major metros, including Hawaii, San Francisco and Seattle, have moved to a falling market as demand softens and vacancy rises.

Source: CoStar, JLL Research

Retail vacancy inches upward as stores close

The closure announcements that have filled the headlines for months are now taking effect. Over 2,500 locations closed during the first half of this year. Another 573 specified locations are expected to close by year-end according to Creditntell. As anchors like Sears and Bon-Ton and big boxes like Toys 'R' Us closed their doors in the second quarter, fundamentals are now notably softening, as expected. Net absorption in the second quarter totaled 8.7 million square feet—a slowdown from both the last quarter and the last year, with declines of 45.2 percent and 59.4 percent, respectively. Malls and power centers, in particular, saw negative net absorption. Major metros move from a cyclical peak to a falling market, as vacancy has bottomed and inched up 10 basis points in the last quarter. Fortunately, construction remains relatively restrained and rents, in general, are still heading upward. In fact, they are now more than 3.5 percent above their pre-recession peak in the first quarter of 2008. Boston, Miami and Manhattan showed particularly strong, double-digit rent increases, year-over-year.

Investors cherry-pick prize retail assets to avoid risk

Retail's softening fundamentals are having an effect on investment activity. Although both investor and consumer sentiment have been more positive in 2018, transaction activity remains cautious thanks to stricter acquisition criteria and increased sensitivity to risk. The number of transactions have fallen from year-ago levels, but volume has been boosted by large portfolio deals and entity-level transactions like Unibail-Rodamco's acquisition of Westfield Corp.

Essentially, star assets in top markets are still highly sought after by investors. Smaller secondary and tertiary markets, in contrast, are seeing fewer deals. With more risk present in the retail sector and few Core assets on the market, institutional and REIT investors are shying away from retail purchases—due, in large part, to lack of opportunity. However, private investors are jumping at the chance to acquire quality retail, with high-net-worth transaction volume increasing by 35.0 percent year-over-year. While grocery-anchored centers are still at the top of the list for retail investors, pricing has softened except for best-of-the-best assets.

The three outcomes for vacant space

Retail closures are not the end of the story for retail. As the retail industry moves toward an experiential, service-driven entity, we are seeing radical changes in the use and layout of space.

There are three main outcomes for vacant retail space:

1. Re-leasing by other retailers
2. Re-leasing by non-retail or service tenants
3. Repurposing or demolishment

1. Re-leasing by other retailers

Just as some retailers are struggling and shuttering their stores, others are flourishing and expanding. Value and discount retailers like supercenters, off-price retailers and dollar stores remain popular with consumers and are pushing into new locations and markets. Food and beverage concepts, including fast-casual and chef-driven models, are expanding. Formerly pure-play online retailers are moving to bricks and mortar to more effectively reach consumers:

- Mattress retailer Casper plans to open 200 physical stores in the next three years
- Adore Me, a women's intimate apparel seller, is planning 200–300 locations in the next five years
- Untuckit, a men's apparel store, is opening 100 new locations by 2022

Spaces vacated by department stores and big-box retailers in malls and shopping centers in many cases are being backfilled by expansion-minded retail types, including grocery stores, off-price retailers and craft/hobby stores. Department store spaces, in particular, are being taken by a wide range of tenants including At Home, Whole Foods and H&M.

While the Toys "R" Us closures hit retail centers with millions of square feet of vacant space, there has been a flurry of demand from retailers to take over the erstwhile retailer's vacant spaces. Topping the list of retailers are off-price retailers like Big Lots and Ollie's. Home furnishing retailers like Scandinavian Designs and Ashley Furniture are also eager to take space. Other retailers bidding for Toys "R" Us space include Aldi, Golf & Tennis Pro Shop and Hobby Lobby.

2. Re-leasing by non-retail or service tenants

The growing focus on experience has led to a rising share in non-retail tenants, including food and beverage (F&B), salons, movie theaters, fitness centers and medical clinics.

According to a recent study by ICSC, non-retail and non-restaurant space in shopping centers increased from 19.2 percent to 23.1 percent from 2012 to 2018. Shoppers who patronize these service-oriented tenants visit shopping centers more frequently (38 percent) and spend more time when they come (45 percent). Shoppers also say these service tenants make visits more enjoyable and efficient. In fact, 44 percent prefer to visit shopping centers that have a wide variety of non-retail tenants. Especially in demand by consumers are F&B tenants, entertainment venues and personal care services.

Who's filling vacant department stores?

Off-price retail and fitness centers rush to fill vacant department store space

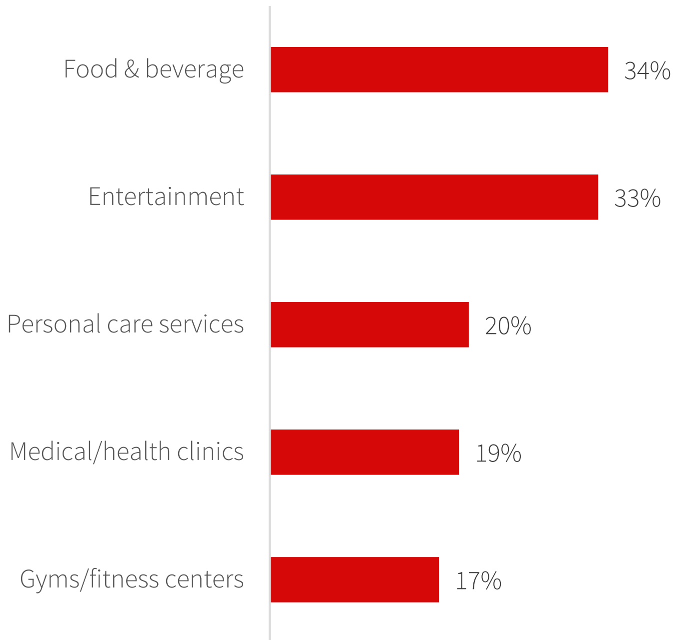
Macy's	Sears	JC Penney	Bon-Ton
Lifetime Fitness	Planet Fitness	Marshalls	Target
Home Sense	AMC Theatres	H&M	Shoprite
Whole Foods	Burlington	At Home	
Hobby Lobby	Mariano's	Hobby Lobby	
Home Goods	Best Buy		
	Dick's Sporting Goods		

Source: PNC, JLL Research

**sample of 62 backfilled space announcements from Q4 2017 to present*

Consumers want more F&B and entertainment tenants

Non-retail tenant consumers want to see more of



Source: ICSC, JLL Research

In 10 years, the share of F&B space at malls will jump 12 percentage points to 26 percent, while other services will grow 11 percentage points to 24 percent of mall GLA (ICSC). Similarly, in open-air centers, traditional retail tenants will take up less space, with more space being devoted to F&B and other services. It's important to note that services will not overtake traditional retail. The majority of shopping center space will still consist of retail stores. However, these service tenants complement traditional retail and allow centers to become more experiential. The growth in these tenants is already boosting shopper visits and dwell time.

3. Repurposing or demolishment

Some retail centers are poorly situated and do not have the demographics or infrastructure to continue in their current form. Enthusiastic overbuilding in pre-recession years led to a glut of retail locations in certain areas. U.S. GLA per capita—at 23.6 square feet—is more than twice as high as Australia's (11.2 square feet per capita), the runner-up country. Fortunately, developers have pulled hard on the construction reins and current development activity is still much lower than it was prior to the Great Recession. In some cases, old and defunct retail space is being redeveloped into mixed-use developments with multifamily, office and hospitality components.

Retail construction is building people into projects

Retail space under construction totaled 71.2 million square feet at the end of the second quarter, down 14.8 percent from year-ago levels. Total retail deliveries also fell to 11.6 million square feet—a 42.9 percent decrease, year-over-year. Developers are focusing on general/freestanding retail buildings, urban locations and mixed-use developments. The Texas markets—Houston and Dallas—lead in construction activity. Houston, in particular, is going gangbusters with new developments. The metro's retail inventory jumped 1.8 percent, thanks to new retail properties last year.

Developers are going where the people are—or, rather, ensuring that shoppers are already part of new projects. A good portion of construction projects are located in high-urban-density areas or include a multifamily component. Of the 105 top-tier (4- and 5-star rated) retail properties with over 100,000 square feet under construction, 53.3 percent are part of a mixed-use development.

Notable mixed-use projects with a multifamily component:

Project name	Market	Retail SF	Completion year
Hudson Yards	New York	1,000,000	2018
Steelpointe Harbor	Westchester/S. Connecticut	750,000	2022
La Vista City Centre	Omaha	575,000	2018
New City DC	Washington, DC	550,000	2019
Essex Crossing	New York	489,000	2018
Miami Worldcenter	Miami	450,000	2019

Source: ICSC, JLL Research

Retailers are joining forces and adding core tech competencies to remain competitive

Retailers are investing, acquiring and partnering with technology firms to become more profitable. The consumer and retail industry made the most purchases of tech companies this year, accounting for 32 percent of cross-sector acquisitions (PwC).

- Walmart acquired a majority stake of Indian e-commerce giant Flipkart for $16 billion. The retail giant has been steadily acquiring online companies, including Bonobos, ModCloth, Jet.com, JD.com and Parcel.
- Macy's acquired a minority stake in b8ta, a retail concept that allows shoppers to try new tech products before they buy. Macy's will use b8ta to enhance its experiential concept, Market.
- Nordstrom acquired two digital retail startups earlier this year: BevyUp and MessageYes, both of which will bolster its e-commerce platform.

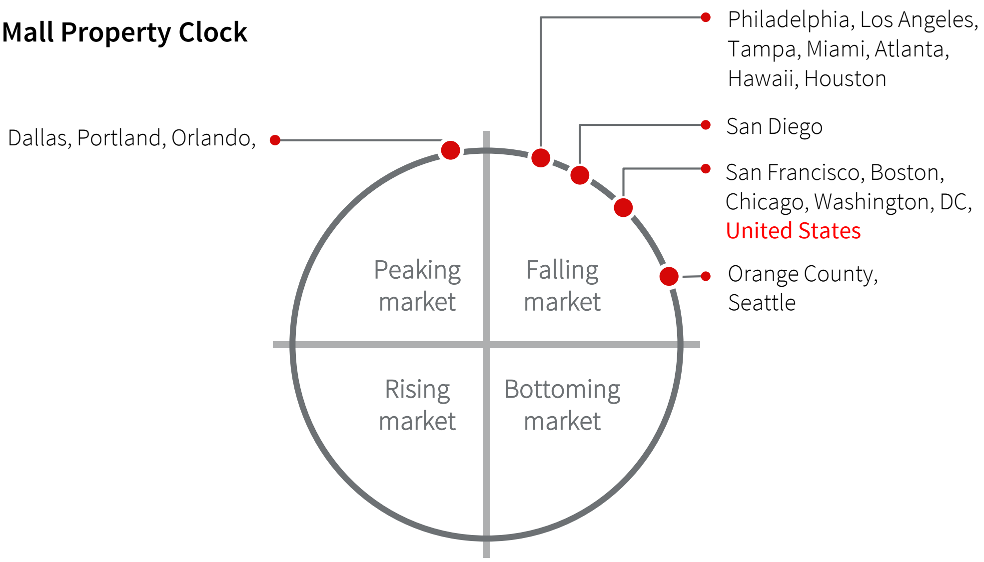
Retail sales are strong

Retail sales grew by 6.6 percent, year-over-year, in June 2018 and should remain healthy in coming quarters. The uptick in saving this year—currently at 6.8 percent—is also a positive for the economic outlook.

Well-situated malls scoop up strong replacement tenants

For malls, most of the major markets have now peaked or are approaching peak. Dallas, Portland and Orlando are still showing strong performance in the mall segment.

Mall Property Clock



It's all about location

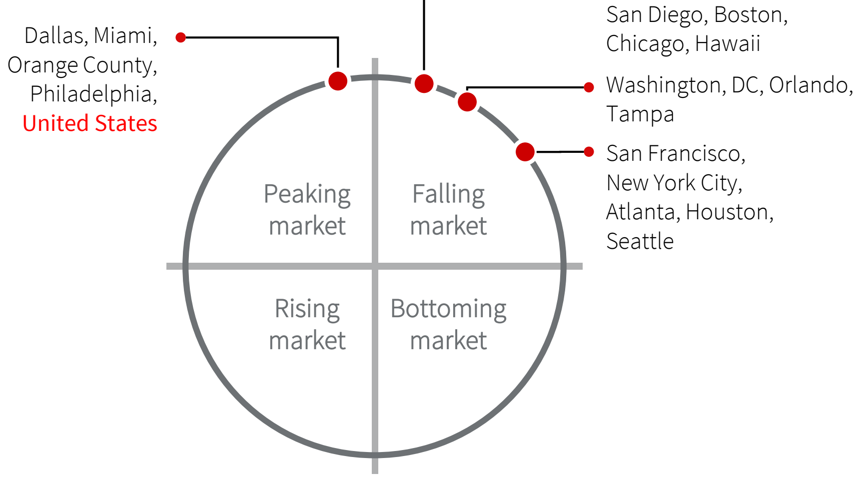
Strong malls in top locations not only have less exposure to closing retailers, but fill vacant space much faster and more profitably than average properties. Closures hit hard during the second quarter, pushing mall net absorption into the red at negative 2.1 million square feet. Vacancy jumped from 3.7 percent in the first quarter to 4.0 percent. This is in line with expectations, given the fact that 130 department stores—mostly Sears and Bon-Ton—as well as over 90 Claire's stores shut their doors in this last quarter. Mall move-outs totaled 7.8 million square feet. The lion's share of these move-outs took place in low- to mid-rated malls, which comprised 4.8 million square feet—or 61.2 percent of vacated space. Top-rated malls (having a 5-star rating in CoStar) had negligible move-outs of less than 100,000 square feet—a little over 1 percent of mall space closed. Regional malls saw a high percentage of tenant move-outs in relation to its inventory (compared to lifestyle centers and super-regional malls), totaling 0.9 percent.

The ease at which properties find tenants to fill these vacant spaces is dependent on the quality of the location. CoStar found that approximately 70 percent of the best locations had vacant space re-leased within a year. In contrast, properties in average locations re-leased within a year 20 percent of the time. Additionally, those with strong locations were able to nab high-productivity tenants like Whole Foods, Wegmans and Nordstrom. Those in fairly good locations were leased by tenants like Dick's, Belk and At Home. Those with only an average location had a harder time finding a replacement tenant, and when they did it was usually a lower-performing non-retail tenant.

While many major markets posted negative net absorption during the quarter, Philadelphia was a standout. The market had approximately 390,000 square feet of positive net absorption for the quarter, thanks to strong demand in King of Prussia and Horsham/Willow Grove.

Toys “R” Us closures push up power center vacancy

Power Center Property Clock



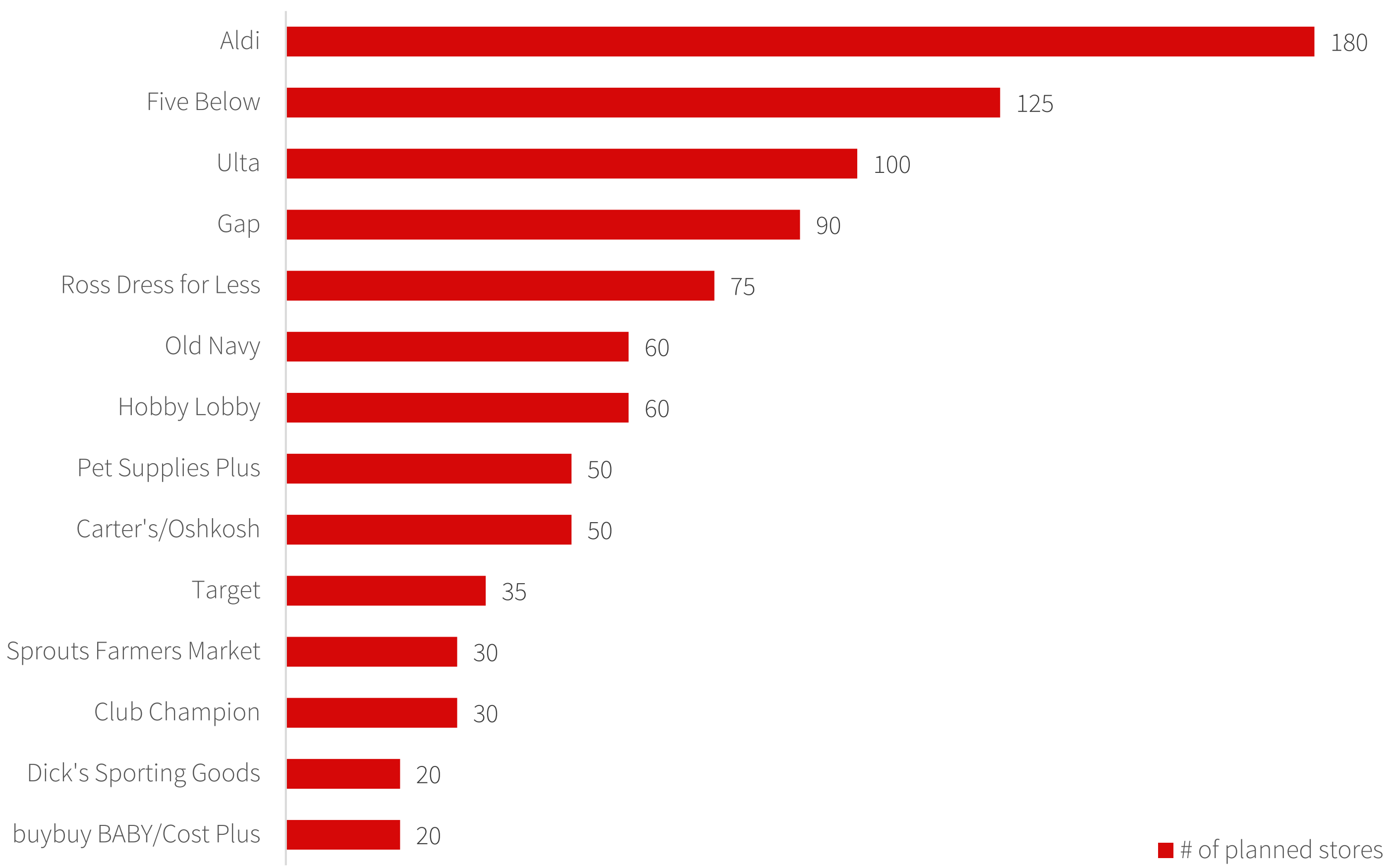
Power centers in most major metros are now in the falling market segment of the property clock, characterized by rising vacancy and falling rents. However, some metros like Dallas and Miami are still approaching their peak as they continue to see strong performance.

Big boxes are being filled by value and entertainment tenants

Vacated Toys “R” Us stores had a sizable impact on power centers during the second quarter. Power center net absorption was negative 900,000 square feet and vacancy rose 20 basis points. Despite gross absorption comparable with previous quarters, move-outs totaled 7.6 million square feet, plunging absorption into the red. Power center rents, however, are still on the rise, increasing 1.6 percent from the first quarter and growing 2.6 percent from year-ago levels.

Retail openings during the second quarter showed interesting trends including home furnishing retailers like At Home and HomeSense and entertainment tenants like Escape Room, Urban Air Trampoline Park and Jump!Zone. Future expansion plans for power centers include value tenants, groceries and sporting goods retailers.

Big-box expansion plans include power centers

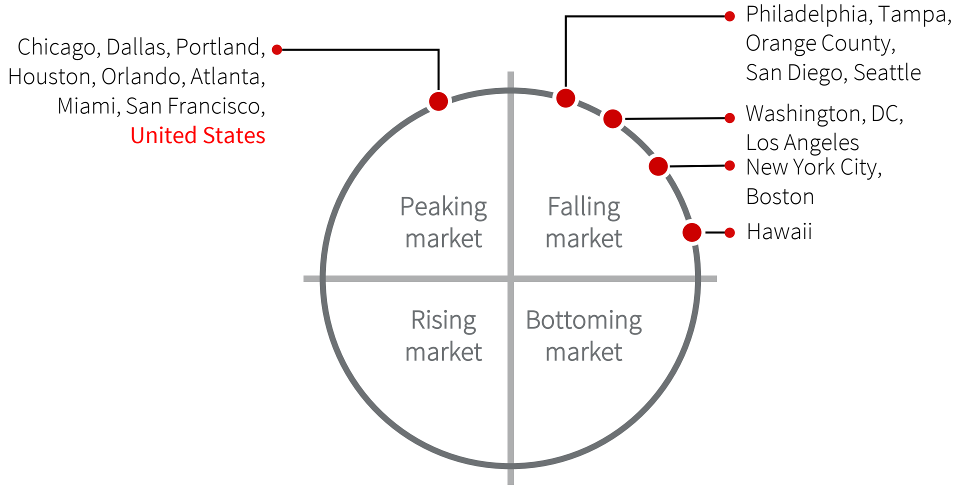


Source: PNC, Coresight Research, JLL Research

Community, neighborhood and strip centers remain healthy

For shopping centers, the markets on the clock are concentrated in the peaking and falling segments, as significant improvement is still apparent for some metros. As conditions continue to soften, more markets should gradually move past midnight.

Community, Neighborhood & Strip Center Property Clock



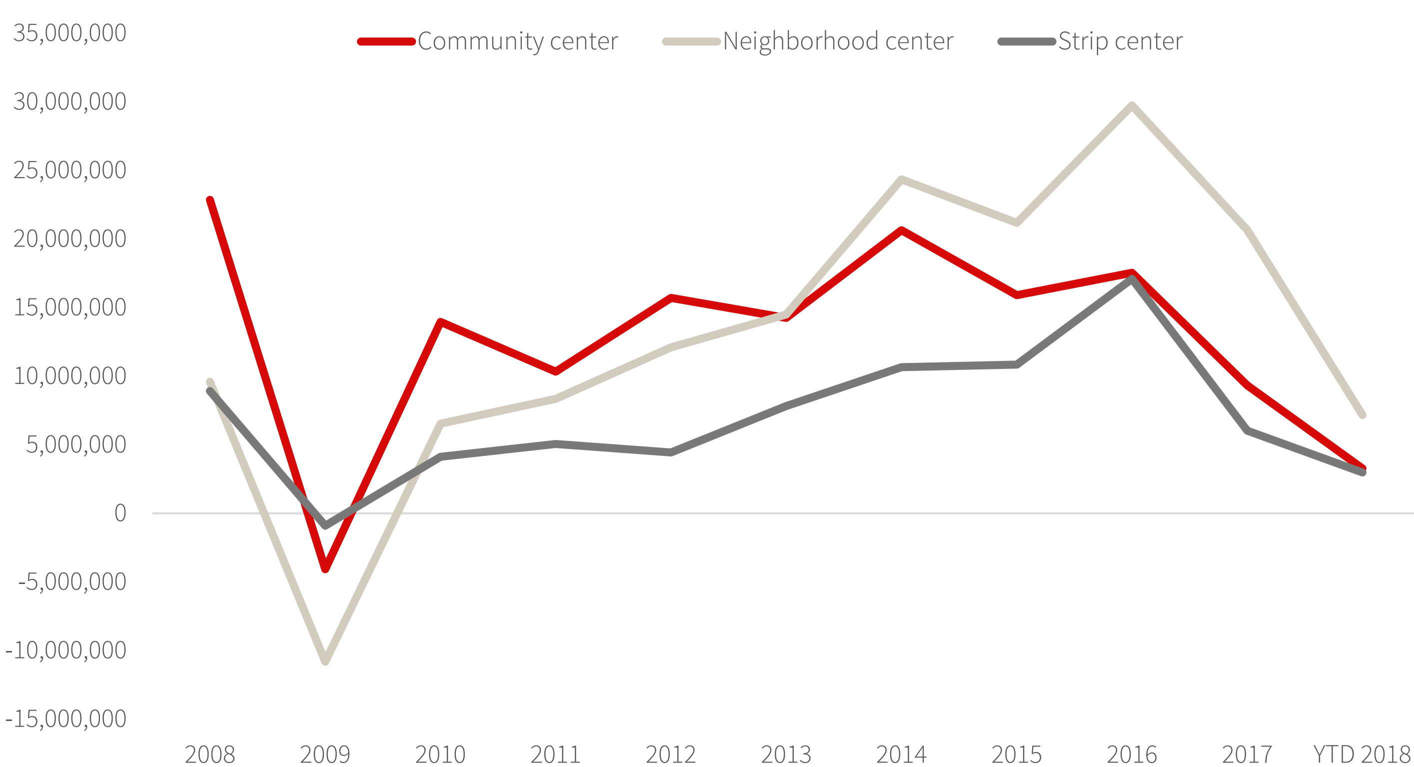
Daily needs and entertainment tenants are a boon for shopping centers

Absorption continues to be positive for shopping centers. While move-outs from consolidating retailers affect this group as well, demand is high enough to surpass vacated space and net absorption stood at just over 5.0 million square feet in the second quarter. These centers have seen a vacancy decline of 40 basis points in the last year, as deliveries stayed comfortably below demand. Shopping centers have also seen the second-highest year-over-year rent gains, next to general/freestanding retail—where urban rents push up growth. Strip centers have seen the highest rent growth among the shopping center subtype, with gains of 6.1 percent, year over year.

Dallas and Chicago both had strong shopping center net absorption of over half a million square feet each in the second quarter. Dallas's strong economy and population growth have boosted demand for supermarkets. National grocers like H-E-B, Whole Foods and Trader Joe's are opening new stores in both suburban and urban locations in the metro. Other tenants opening in the metro's shopping centers include Airborne Sports (trampoline arena), Rebel Fit and Mega Dollar.

Chicago's shopping center fundamentals have been steadily improving, with vacancy falling 110 basis points and rents rising 4.1 percent in the last year. As big boxes like Bon-Ton and Toys "R" Us close, a multitude of fitness models including Core Martial Arts, XSport Fitness, OrangeTheory Fitness and Anytime Fitness are opening up. Non-traditional tenants like The Second City (improv comedy venue) and Chicago Curling are also leasing space.

Neighborhood centers have highest demand among shopping center subtypes



Source: CoStar, JLL Research

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