Retail e-Volution: Predictions for 2025

By CCIM Institute Chief Economist K.C. Conway, MAI, CRE
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It’s no secret within the commercial lending and investment community that retail is often the property type more institutional capital sources underweight for allocation of investment capital. While retail is notorious for tipping the scales regarding undesirable metrics like loan delinquency (the highest among core property types at 4.29 percent versus 2.98 percent for office) and value decline, retail real estate is arguably the property type with the most opportunity.

Many vacated malls, shopping centers, and big-box stores have desirable location attributes – frontage along primary commercial arterials and public transit routes, proximity to employment centers, and site configuration or building design that’s well-suited for adaptive reuse. Conversion of these buildings is ideal in meeting the ongoing demand for affordable housing, industrial warehouse utilization, off-campus medical use, and even coworking office space. The central question now, however, for legacy storefronts is one of highest and best use to unlock the market value of the real estate for retail use. Both retailers and communities have a vested interest in putting these real estate assets back to productive use to recapture lost property value and return vacant buildings to new uses accretive to property and local tax revenues.

This report is not another examination of retail’s demise, because in the immortal words of Mark Twain, “The reports of [its] death are greatly exaggerated.” Nor is it another foretelling of how the use of retail stores is morphing from a place to shop to something experiential. Retail has always been experiential – dating as far back as centuries-old seaport trading centers to the more modern development of shopping malls.

Moreover, according to a recent report by the International Council of Shopping Centers, “The Halo Effect II,” online and brick-and-mortar retail have a symbiotic relationship that produces impressive synergistic results on the bottom line. This halo effect increases not just overall spending by the consumer, but also the propensity to visit online and brick-and-mortar locations when a purchase occurs. For example, when a consumer spends $100 online and subsequently visits a physical store within 15 days of that purchase, the person spends an additional $131. If they start out with that same $100 purchase in-store and head online within 15 days, the average additional spend is even greater, at $167. Additionally, the consumer is more likely to visit both online and brick-and-mortar storefronts as a result of a purchase. ICSC’s research indicates that customers complete an average of 2.1 in-store transactions within 15 days following an online purchase, and 1.3 online transactions within 15 days of an in-store purchase.
Retail success in its next iteration will be defined by alignment with services – services like hospitality, transportation centers, health care, and education. This report peels back the misconceptions behind retail bankruptcies and store closings (no, Amazon isn’t the primary culprit) and proffers where the next generation of retail is headed. Could it be that mall retail stores re-emerge in hotel lobbies, airports/transportation centers, and medical centers? Could the halo effect accelerate with retail aligned with these service offerings?

Additionally, will the next generation of real estate curriculum at university real estate centers like the Alabama Center for Real Estate or professional industry organizations such as CCIM Institute modify the long-standing axiom that all real estate is location, location, location with all retail real estate is logistics, logistics, logistics?

While this report tackles several myths, one is most germane to the predictions that follow – that Amazon and online retail have been the primary cause of store closings. The truth is, the real villain behind what many industry analysts have coined as the “Retail Apocalypse” is overleverage. Furthermore, online retail sales are still a relatively small portion of total retail sales that have yet to take a real bite out of retail store activity. Amazon merely tapped into technology to reinject growth into retail, enabling the company to dominate book and music sales and, more recently, generate a similar disruption into grocery retail.

Here are five predictions for the future of retail that debunk several primary myths behind the plethora of retail bankruptcies and store closings that occurred in the past decade.
Myth #1: Retail Bankruptcies and Store Closings Are Due to Less Consumer Spending

The fact is, total retail sales have increased at an average annual rate in excess of 4.35 percent since 1993, according to Trading Economics. Additionally, most retailer quarterly earnings statements – whether from Walmart, Target, Home Depot, or major grocers – report increased physical same-store and online sales (with a few exceptions identified in this report). While online sales have yet to reach 10 percent of total retail sales, the growth is on track to make a material impact by 2025, with 20 to 25 percent of total retail sales projected.

If it’s not the loss of in-store sales to online consumption or recessed consumption post-Great Recession, what’s the real culprit behind the bankruptcies and closures? Overleverage. It started in the 1980s, with a string of leveraged buyouts by private equity firms like KKR, and peaked in 2006, when CMBS debt issued for mall properties exceeded $15 billion with peak loan-to-value (LTV) ratios surpassing 70 percent. Retailers felt the acute pain of being overleveraged when growth slowed, the Great Recession hit, and the cost to service debt overtook revenue growth. Assets of the company were typically sold off to pay the debt when the carrying cost of the debt exceeded the leveraged company’s cash flow to service debt or when growth faltered. Moody’s retail analyst Charlie O’Shea best characterized the impact of overleverage by saying, “You can’t outrun debt.”

Myth #2: After Years of Bankruptcies and Thousands of Store Closings, Both Will Abate in Coming Years

The simple fact is that the U.S. is “over-retailed.” Research by ICSC and CoStar shows the U.S. has more than 115,000 shopping centers totaling over 7.5 billion square feet. According to PwC, there is approximately 24 sf of retail space per person in the U.S. – 50 percent more than second-ranked Canada, twice that of No. 3-ranked Australia, and nearly six times that of the U.K. PwC forecasts that U.S retail space will need to shrink toward that of Australia to rebalance – a contraction of more than 50 percent.

Future closings will be determined first by leverage and then by technology gaffes. Look for one in four malls to close by 2022, according to research from Credit Suisse. Currently, malls are closing at an annualized rate of 75 per year. The 11 regions that will see the most mall closings and contraction in per capita retail by 2025 based on mall inventory and deteriorating performance metrics will be California, Florida, Texas, Pennsylvania, New York, Ohio, Georgia, Illinois, Michigan, the Mid-Atlantic (Virginia and Maryland), and Tennessee.
Myth #3: Online Retail Is Expanding Because It Is More Cost Effective

Alix Partners, crunching the numbers for CNBC in 2017, found that apparel retailers’ net margin from merchandise sold at brick-and-mortar stores was 32 percent, compared to 30 percent for online apparel sales. The cost to build omnichannel systems, operate last-mile delivery reliant upon the current inefficient infrastructure, and process the volume of returned online merchandise (now an estimated 30 percent of all merchandise sold online) are much more capital intensive than leasing, stocking, and staffing brick-and-mortar retail stores. Keep this in mind as some iconic luxury retailers like Macy’s and Lord & Taylor experiment with rental apparel models. If managing 30 percent returns today is a nightmare, wait until the logistics of dry cleaning, alterations, and repairs for rental clothing are layered in. These logistics challenges, though, are not enough to reverse course and go back to shop-and-take-home retailing. A report by ICSC illustrates how online and brick-and-mortar retail feed the activity of the other. The trick is making logistics and last-mile delivery more cost effective. Look to retail prediction #3 for more details on that tricky endeavor.

Where do apparel retailers make the largest profit?

- **In Store**: 32%
- **Online**: 30%
- **Online In-Store Pickup**: 23%
- **Online Ship From Store**: 12%
*Percentages are profit margins*

Myth #4: Malls Are Obsolete, and No More Will Be Built

The mall is not dead. In 4Q2019, one of the 10 largest malls in America will open in New Jersey. TruAmerica Triple Five Group, the Canadian developer that previously built two of the three largest malls in North America including Mall of America, will open its 3-msf American Dream Meadowlands. The final design and offering will be a mix of 55 percent entertainment and 45 percent retail with 500 stores. The mega-mall will offer every imaginable experience to lure traffic and generate revenue beyond rent from stores, including the first-ever indoor snow park and largest indoor water park in North America; a Nickelodeon Universe theme park; an NHL-sized hockey rink, with promotional deals in place with the New York Rangers, New York Islanders, and New Jersey Devils; and more. The mall is not obsolete – it is just going over the top on entertainment offerings.
As Online Continues to Grow, Retail Reimagines Itself

Online consumption is here to stay and expanding to everything. Online retail sales will double by 2025. Hard to believe? Look no further than the Rule of 72 for validation. U.S. Commerce Department figures show online retail sales are growing at an annual clip of 10 to 15 percent (and more at-large retailers like Walmart that recently reported a 35 percent annual growth in online sales). Dividing 72 by 10 translates to a doubling of current level of online retail sales in roughly seven years. In reality, this prediction is conservative when considering the expansion of online retail into more categories like grocery and automobiles.

Retail Prediction #1

While Amazon is formidable, it is not invincible. The online giant has stumbled recently and is pulling back from online food delivery after losing out to Uber Eats, Grubhub, and DoorDash, who collectively own more than 75 percent of market share of the U.S. food delivery market. The closure of Amazon Restaurants in 2020 after investing considerable time and money is a rare retreat for the e-commerce behemoth. Amazon Restaurants first launched in Seattle in 2015 and expanded to more than 20 U.S. cities and London. The service gave Prime members a way to have meals delivered to their door, using the Amazon Restaurants website or through the Prime Now shopping app. Amazon also shut down Daily Dish, a workplace lunch delivery service that launched in 2016.
Online Takes a Bite Out of Grocery

No longer is online just for merchandise once consumed at the mall. Amazon’s acquisition of Whole Foods in 2017 foretold the next move into grocery. According to global market research firm Forrester, the $5 trillion (yes, trillion and not billion as in other retail segments) grocery industry is in the early stages of a global battle between offline and online retailers.

In two short years, this trend has progressed quickly in the U.S. with Target’s acquisition of Shipt for its online grocery platform and Kroger partnering with Walgreens. Walmart is also succeeding with online grocery, realizing a reported 37 percent year-over-year increase in 2Q2019, although the adoption of online grocery shopping in America has lagged other parts of the world. While online shopping is just 2 to 4.3 percent of the total $641 billion U.S. grocery market, a study by the Food Marketing Institute conducted by Nielsen predicts that online grocery sales will make up 20 percent of total grocery retail sales, or $100 billion, by 2025.

While the technology enabling more online purchases is reducing the need for physical store space, it is not eliminating the need for retail real estate. Global customer data science company Dunhumby noted, however, that grocery stores are shrinking – not in number, but in size. The average sales area has contracted by 15 percent since 2010. Looking ahead, the grocery stores of the future will be a third to a half the size they are today, with a more limited, locally curated assortment of products designed to fit the neighborhood. That is exactly the model currently used by Aldi, a German-based grocer.

Additionally, physical stores and e-commerce will become an increasingly connected omnichannel experience, and the role of the store itself will become more experiential. One future model attaches a “dark store” to a smaller footprint store with 5,000 items (a typical grocery store currently has 45,000 items) from which basic commodity products will be picked and staged for pickup or delivery. This model is along the lines of what Kroger is experimenting with its partnership with Walgreens in its online fulfillment model.

When you look at the online growth in retail, think beyond material goods and merchandise to consumption of services. Online consumption of services for home or business needs are already being undertaken by the likes of Angie’s List, HomeAdvisor, and Takl.
More Co-Retailing Pops Up in Hospitality

Technology is rearranging the chairs where retail activity will be seated, rather than eliminating the need to seat retail in real estate space. As ICSC’s “The Halo Effect II” report details, there is a definitive need for physical retail real estate space. Online-enabling technology of goods and services is shifting the space utilization from a traditional retail store format to either a warehouse or an emerging convergence model. This co-retailing with other property types is a more integrated approach affording some distinct benefits. The property types run the gamut from hospitality, medical, and auto dealerships to transportation centers like airports and high-traffic transit stations.

According to GlobalData, a U.K.-based data analytics and consulting company, retail in airports is now a bright spot in the market sector. GlobalData’s latest report, “Global Airport Retailing 2016-2021,” reveals that spending in airports hit $38 billion globally in 2016 and is set to grow by 27 percent, to $49 billion, by 2021. Asia-Pacific airports generate the most spending, at more than $15 billion annually. Europe ranks second, with spending exceeding $10 billion annually. The U.S., which has traditionally offered a poor shopping experience at airports, is finally discovering this retail opportunity; many large airports such as New York’s LaGuardia, Atlanta, and Denver are planning more retail space as part of major overhaul and expansion projects. The new Kansas City International Airport, for instance, will increase retail, food, and entertainment space by a factor of 10 over the existing airport.

An even greater opportunity for retail lies in hotels. Popular brands like Restoration Hardware and West Elm have already jumped aboard this retail train with strategic moves into hotels and resorts. The Washington Post’s travel section recently covered this trend in a June 2019 story titled, “Your Favorite Retail Brand May Be Coming to a Hotel Near You.”

“They will join a smattering of hotels already operating around the world under names more associated with fashion, jewelry, crystal or home goods, including Armani, Versace, Bulgari, Baccarat, Ikea, Muji, and Shinola.

Hotels are the new showrooms for retail,” said Chekitan Dev, a professor of marketing and branding at Cornell University’s School of Hotel Administration. “It’s a dynamic, interactive, profitable showroom.”

The attractiveness of leveraging hotels is strong. The hotel real estate option provides brand exposure, offers product interaction in high traffic areas, and requires less physical real estate space and labor, which can improve margins to mitigate the rising costs for fulfillment.
Service Offering as Important as Experience

Looking ahead to 2025, the retail brick-and-mortar sector most at risk is apparel-centric shops and department stores. Retailers burdened by debt that also lack a service offering to accompany their products are merely commodities that can be moved to a warehouse and marketed exclusively online. A recent casualty example of this phenomena is A’gaci, a Texas-based women’s apparel retailer that just entered bankruptcy for the second time in two years. Expect more retail closures for both debt and non-debt burdened retailers that do not integrate service offerings with their products. A recent report by Trepp details the apparel-centric shops and department stores most at risk based on being overleveraged via CMBS debt, which represents 13.5 percent of the total CRE debt in the U.S., according to REIS.

Then there’s Nike, a retailer recognizing this sea change and adapting accordingly. Its mega fulfillment center in Memphis, Tenn., integrates 3D/additive manufacturing and order fulfillment into a single facility, eliminating the need for many stores or shelf space in sporting goods stores. This concept melds manufacturing, retail sales, and order fulfillment all into a warehouse box – all at the same expense of retail store floor space, be it their own store or shelf space in a sporting goods store.

Auto dealerships have figured out this recipe as well by adding concierge services, in-dealership cafes, and branded merchandise stores to showrooms and former service bays. Representatives at BMW, Mercedes, Toyota, and Honda confirmed that all new dealerships are including floor space for both limited food and beverage services (beyond vending machines) and up to 1,000 square feet of retail merchandise space for everything from logo apparel and merchandise like key chains and replacement fobs to bike and ski racks.

Two other examples of retailers that recognize the synergistic pairing of services with a product are Build-A-Bear and the PGA Superstore. Build-A-Bear is about the experience and process of creating an almost lifelike stuffed animal by children complemented by year-round special events and birthday party experiences. The company is discovering how to migrate into the hospitality space and out of the mall to extend its unique offering into a destination hospitality concept like Great Wolf Lodges across the country. On the other end of the spectrum is the PGA Superstore created by Home Depot founder Arthur Blank. This retail concept is not overleveraged and offers myriad services to complement its golf and tennis products, such as lessons and custom on-site club and racquet fitting, to transform buying golf gear as a commodity into an experience in much the same way tailoring used to be commonplace in clothing.

RETAILERS WITH LARGEST CMBS EXPOSURES

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<tr>
<th>TENANT/ANCHOR</th>
<th>TOTAL LOAN BALANCE</th>
<th>TOTAL EXPOSURE BALANCE</th>
<th># OF DEALS</th>
<th># OF LOANS</th>
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<tr>
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<td>$19.53 Billion</td>
<td>$991.5 Million</td>
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<td>187</td>
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<td>Macy’s</td>
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<td>$4.18 Billion</td>
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<td>H&amp;M</td>
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<td>Burlington Coat Factory</td>
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<td>$1.01 Billion</td>
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<td>178</td>
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Source: Trepp (www.trepp.com)

*Total Loan Balance = Total loan balance backed by retailer

*Exposure Balance = (current loan balance) *(Percent occupied by retailer)* (allocated percentage of the loan backed by the property)
stores. The PGA Superstore also embraces another element cogent to the millennial and Gen Z workforce in determining which retailers to patronize – good ESG (environmental and social governance). The PGA Superstore leads all its social media and marketing with these core values.

Retail in hospitality is an incredibly virtuous cycle for both the hotelier and retailer. The hotelier reduces operating costs by turning over management and staffing of retail services to various retailers while still receiving a slice of the revenue. The hotel company is also able to provide a broader offering to its patrons – as in the case of the Great Wolf Lodge. Consultants to and developers for both Hilton and Marriott hotel brands have revealed that adding retail to hotels enables the properties to attract more meeting and even coworking business to the hotel. (Proximity to or access within a hotel to coworking space is one of the most frequently asked booking questions now by business travelers.) The retailer, in turn, gets use of a high traffic space with lower occupancy costs. Both the retailer and hotelier also benefit by dovetailing loyalty programs and tapping into what airlines and car rental companies figured out decades ago – there are synergies in bundling services.

One risk to monitor in this growing trend is parking. Will increased retail traffic result in a need for more parking at hotels? The jury is still out.
Retail Prediction #3

E-Commerce Goes the Extra Last-Mile

According to Verizon’s 2018 Holiday Retail Index, average e-commerce retail traffic for the Monday, Tuesday, and Wednesday before Thanksgiving was 32.6 percent over the same period in 2017. Black Friday saw a similar year-over-year increase of 31.2 percent. Needless to say, the demands on supply-chain infrastructure from a rapidly growing e-commerce economy will only increase over the next decade.¹

Compounding the issue, the search for a cost-effective, last-mile fulfillment solution remains elusive. Amazon, FedEx, Walmart, eBay, and much smaller Shopify are all engaged at different levels to dominate land, sea, and air logistics to deliver online commerce while making a profit. Thus far, the goal of cost-effective, same-day order fulfillment while making a profit is a unicorn even Amazon can’t lasso.

The expansion of e-commerce into every product category is limited only by logistics and the fulfillment network. Amazon demonstrated that fulfillment of any product is possible as long as profitability is not an immediate priority. Even big and bulky items like large appliances are now ordered online and fulfilled via warehouse. This relatively recent advancement can be attributed to a large CapEx investment by companies such as XPO Logistics and FedEx to revamp their conveyor systems and warehouses to handle larger and heavier packages. This upgrade impacts developers, too. As a result, contractor visitation is declining as large-scale shipments for building materials can be processed just-in-time and as-needed at the job site.

FedEx has spent billions over decades perfecting overnight delivery and evolving logistics to process virtually any size, shape, or weight package on a global scale while making a profit. Now, Amazon, after its FedEx divorce, aims to do it all with same-day delivery with its own fulfillment strategy without regard to profitability.

As Amazon enters more areas of commerce, retailers from Lego to Walmart worry about the threat Amazon poses should it succeed at global fulfillment. The good news is that this fear is driving new strategies for fulfillment by FedEx and much smaller Shopify. This battle over logistics is “Retail War Games.” One example of the evolving strategies is FedEx’s recent decision to partner with Dollar General for package fulfillment following its divorce from Amazon. FedEx will offer secure in-store parcel pickup and drop-off in 8,000 Dollar General stores by 2020, increasing FedEx’s retail presence to 62,000 stores in the U.S. – meaning that “90 percent of Americans will ultimately live within five miles of a FedEx hold retail location.”²

As explored in “Logistics Infrastructure: Transformational Opportunities” by ACRE, the current logistics infrastructure in the U.S. cannot support a modern e-commerce supply chain that is growing 25 to 30 percent a year.³ The battle to conquer last-mile must include a massive CapEx investment to overhaul every aspect of infrastructure from connectivity advancing to 5G and faster, roads with embedded technology to facilitate autonomous transportation, and cybersecurity to protect the data being gathered from consumers via their online activity. No part of this solution comes cheaply or without a lot of public and private CapEx spend.
The Role of Autonomous Vehicles

If you are still of the mindset that driverless trucks are aspirational, a technology that will not be realized in your lifetime, think again. Autonomous trucking is no longer a piece of the puzzle to be solved in the battle for last-mile — it is the kind of innovation that can bring down the cost of last-mile fulfillment to make e-commerce profitable.

Autonomous vehicles are already deployed by Walmart along our horizontal U.S. interstates, UPS is testing them out between Phoenix and Dallas, and Florida just hit the accelerator on this technology. In June 2019, the state passed legislation allowing driverless trucks to proceed on Florida highways by 2020.14 With autonomous trucking technology being deployed a decade ahead of most experts’ forecasts, changes to logistics and e-commerce warehouse design are needed ASAP.

Key design changes include:

- Larger land-to-building ratios to accommodate more truck pad parking and larger truck courtyards for dual trailers (the ratio is now 7:1, up from 3:1 or 4:1).
- Different flooring systems, like Ductilcrete, to reduce expansion joints and cracks that interfere with electronic robotic forklifts.
- Higher ceilings, measuring 40-foot clear and higher, to handle the larger package conveyor systems within the warehouses.

In high density MSAs where land is scarce and cost prohibitive, innovative warehouse design is essential to maximize utility and profitability. One such example can be found at 640 Columbia St., a three-story logistics facility in Brooklyn’s Red Hook neighborhood. Costar reported that when the 336,500-sf facility, a joint venture by Goldman Sachs Asset Management and DH Property Holdings, is completed later this year, it will not only be the tallest distribution center on the East Coast, but it will offer the fastest last-mile fulfillment in the largest city in the U.S.15
What the OTIF? On Time In Full is a new metric in the logistics industry being used by retailers like Walmart and Kraft Heinz to measure logistics performance. It will play into warehouse and e-commerce fulfillment site selection, serving as the measure of success in the online retail battle. OTIF went mainstream as a supply chain metric in August 2017, when Walmart began evaluating suppliers by their score and penalizing those that couldn’t comply by assessing fines up to 3 percent of the value of the shipment. In 2018, Walmart started imposing this 3 percent penalty if an OTIF measure of 85 percent or greater wasn’t achieved. In 2019, that benchmark increased to 87 percent. OTIF will be an embedded variable in all warehouse site selection for e-commerce and logistics companies within two years. And don’t be surprised if you see an OTIF of 90 percent as the standard among large retailers by 2025.

Retailers and e-commerce fulfillment companies are developing the OTIF standard that will be as common to retail and logistics real estate by 2025 as clear-ceiling height is today. Retailers need to be factoring in how an OTIF penalty structure might eventually flow back through the economics of shipping costs and even store or warehouse rent, much the same way percentage rent worked as a rent enhancement in retail decades ago.

Bottom line: Some legacy metrics like same-store sales are becoming less relevant, and online sales figures like order-online-and-pickup versus order-online-and-delivered are evolving. How we measure retail activity and profitability is changing, and new metrics like OTIF are emerging to illuminate how to make online more profitable.
Many of these retail center assets benefit from great locations ideally suited for adaptive reuse, especially with the benefit from the 2017 Tax Act pertaining to opportunity zone programs, which mitigates the adverse impact from overbuilding and overleverage. Adaptive reuse of retail centers and malls will be the most impactful, powerful trend for retail between now and 2025. Numerous examples illustrate the clear benefits of repurposing larger vacant retail spaces like malls.

Ford Motor Company is reinvigorating its home city with its acquisition of the vacant Michigan Central Station in Detroit’s Corktown neighborhood, a designated opportunity zone. Ford shared with Fortune magazine that they “plan to use the building as an ‘innovation hub’ which will house teams working on the future of mobility — think self-driving cars, ride sharing, etc.” This property represents just half of the 1.2-msf campus the company is planning for the area. Ford and its partners will occupy 900,000 sf, leaving the remainder for the community and visitors.

Just outside Washington, D.C., The Howard Hughes Corp. plans to redevelop the Landmark Mall located in an opportunity zone in Alexandria, Va. The company revealed a 1.5-msf to 2-msf Phase 1 plan that features a mixed-use project involving residential, retail, hotel, office, and other public facilities. The long-term vision of the area includes 5.6 msf of development across the 51-acre site. Howard Hughes Senior Vice President Mark Bulmash shared with Bisnow, “We want to make this a vital place that satisfies the needs of the community. Fundamentally, we want this to be a center of the community. We want people to come here once a week, or maybe it’s multiple times a week if you exercise or use the supermarket, as opposed to a mall model of once a month.”

While capital and debt markets are pulling back from retail due to overleverage and record-setting loss severities, this revenue could be replaced by deferred capital gains via qualified opportunity zone funds. CCIM Institute’s 3Q18 Commercial Real Estate Insights report, titled “Adaptive Reuse: Turning Blight into Bright,” offers a comprehensive report on the ever-growing trend of adaptive reuse in commercial real estate.
Changes in property tax legislation combined with big court wins for retail will have governments looking elsewhere in the retail food chain to fund education in their states.

At both the state and federal level, this topic has matured parallel to the closing of so many retail stores, raising questions around the market value of empty big-box buildings and shopping centers. The discord around property tax stems from the disparity in how they are determined and applied. It is of particular concern in states without an income tax where property taxes are more onerous (e.g., Texas and Florida), in high-tax regions where state and local taxes have become motivation for people and businesses to leave, and in retail where store closings continue. The value of department and big-box stores are nowhere near what they once were, but local government jurisdictions can’t afford to take the revenue losses in property tax appeals.

The U.S. Supreme Court’s recent 5-4 decision in *Knick v. Township of Scott* now allows private property owners to bring a Fifth Amendment Takings Clause claim in federal court without first seeking compensation in state court. Property owners can bypass state courts to seek relief in matters of unfair property tax and unreasonable denial of adaptive reuse for a vacant big-box retail store or mall. This case comes on the heels of another watershed case in Florida involving Disney and the double taxation of intangibles in hospitality real estate. This 2018 ruling underscores the need for a multi-disciplinary approach for accurate valuation of commercial real estate. In other words, as retail is repurposed, property tax issues become more complex and material.\(^{\text{xx}}\)

At the retail property level, a major case involving Walmart was decided in Johnson City, Kan., in June, with the headline, "Johnson County Overcharged Walmart Millions in Property Taxes, Board Rules."\(^{\text{xx}}\) This case is a wake-up call regarding the declining market values of retail real estate for an industry undergoing massive disruption. It is just the latest in an ongoing legal battle between local taxing authorities and large retail stores to determine the proper way to measure the value of commercial real estate. Numerous other cases are being filed by retailers like Target, Home Depot, and other big-box stores across the U.S.

Because the largest portion of revenue for local government and school districts is property taxes – and commercial properties like shopping centers, malls, and big-box stores represent annual property taxes that can equate to as much as an entire residential subdivision – the dollars at stake are quite substantial. And more reform legislation is coming to address issues ranging from a lack of uniformity – such as in Kansas, Florida, and Pennsylvania – to distinguishing between market value of the real estate and intangibles used by a business operating within a real estate building. What local taxing authorities lose in revenue from tax appeals on vacant retail stores they may seek to find in e-commerce warehouses. Property tax is a sleeper issue in retail that will get more litigious by 2025.
What does this mean for commercial real estate professionals? First, their local communities will be impacted by the declining values from closed retail, producing a large funding hole that will deepen for local governments across the country. Second, CCIMs are in a unique position to advise investors on the financial feasibility and returns on commercial real estate. Property taxes are one of the biggest expenses in owning property after the mortgage and maintenance. CRE professionals must understand that a former retail property converting to an adaptive reuse may be over-assessed in its value and take corrective actions to properly serve investors and clients. In states like Texas, where property tax statues are being addressed for the first time in decades, those who are proactive in understanding the property tax implications will be a trusted resource for property owners and investors alike.

Retail has followed the rooftops from the get-go and will continue to do so. To begin with, it is important to recognize that the shopping center and shopping mall are essentially the mid-20th century adaptation of the historical marketplace. The 21st century version is Amazon and the virtual e-commerce marketplace. Each iteration disrupts the prior format, which is what is occurring today. Those who adapt will survive this extinction event. Those who don’t will go the way of the dodo bird, rotary phones, and Blockbuster.

National Inline Stores as Metric for Retail

The health of a mall or retail center’s net operating income (NOI) is more dependent on inline tenants (the smaller stores connecting the anchor department stores) because department stores provide only a small portion of a mall or shopping center’s NOI. These inline tenants account for 90 percent of an anchored retail center’s NOI, according to the 2019 Green Street Advisors’ Mall Tenant Analysis. Inline tenants, therefore, have an outsized impact on mall NOI, and their performance offers a preferred indicator of a mall/anchored center’s health.

Another way to look at which retailers are likely to survive is to analyze the top 25 expanding and contracting national inline stores. Green Street Advisors’ 2017 Mall Tenant Turnover Analysis clearly illustrates which national inline retailers will continue to thrive.
Note that the net-closing of national inline retailers (nearly 2,500 stores in 2017) outnumber the net-opening retailers (just shy of 800 stores in 2017) by a ratio of 3 to 1. More of this contraction among national inline retailers is ahead based on all the points detailed in this Commercial Real Estate Insights report.

The best inline tenants to track when gauging a mall’s health are the approximately 300 national tenants who have at least 50 mall locations nationwide. Loss of these tenants means something is systemically wrong. Although occupancy may be backfilled, suggesting all is copacetic, the NOI paid and collected will likely be less and from a weaker credit retailer. The 2017 Green Street Advisors report shared its analysis on national inline tenants and found that regardless of mall quality (A, B, or C), at least two-thirds of the malls observed a net-negative change in the composition of national inline retailers. It was over 80 percent for lesser C-grade malls located in secondary and tertiary markets.

CRE professionals should look to this powerful data to inform decisions on two fronts: mall site selection for inline stores and inline store selection for mall property owners.
Footnotes

i. Trepp CMBS Delinquency Report, May 2019: https://info.trepp.com/hubs/May%202019%20CMBS%20Delinquency%20Report.pdf?hsCtaTracking=38eb6365-3afe-433f-925f-e1bc69bee4b4%7C5f97876a-3958-446c-b0de-be6d9b7359ed


iii. Trading Economics Retail Sales History Chart 2009-2019: https://tradingeconomics.com/united-states/retail-sales-annual

iv. Trepp’s “Is the Retail Apocalypse’s Effect on Mall Loans Hype or Reality?”: https://info.trepp.com/treptalk/retail-apocalypse-effect-mall-loans-cmbs-cre

v. “America’s vast swaths of retail space have become a burden in the age of e-commerce”: https://qz.com/1032723/theres-much-more-empty-retail-space-in-the-us-than-in-other-countries-on-a-per-capita-level/


xiii. Logistics Infrastructure: Transformational Opportunities: http://www.acre.culverhouse.ua.edu/explore/stories/logistics-infrastructure-unprepared-for-e-commerce


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