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## US Retail Market – Investment Opportunities at the Peak of the Market

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### Introduction

Investing in any asset class at the peak of the market bears risk. RREEF Research believes that retail relative to the other property markets has peaked, rendering this a riskier time for investing. The office, industrial and apartment markets were severely impacted by the economic downturn in 2001 and recovered slowly afterwards. Retail markets were only moderately impacted during this period, and continued to see healthy rent growth. National retail vacancy rates increased by less than 100 basis points between the peak in 2000 and the trough in the following year, and have since recovered 30 basis points. The office, industrial and apartment markets were far more volatile, but are having their turn with strong absorption and above-inflation rent growth projected over the next three years. By contrast, the retail market is not expected to see rent growth exceeding inflation. In some markets, retail rent growth may actually lag the pace of inflation.

### Fundamentals

Retail markets have been exceedingly strong during the past few years. Retail sales growth slowed significantly during the recession in 2001 and then quickly rebounded (see Exhibit 1). In 2004 through the second quarter 2006, retail sales (excluding automobiles) grew at an annual rate of between 7% and 8%. Unlike previous cycles, consumers bounced back quickly during this period of economic recovery, their confidence fueled by low interest rates, modest inflation, rising home values (the wealth effect) and income tax reductions and rebates.

During this same period, when the equity markets were recovering from a major fall in 2000 and 2001, retailers were restrained in their expansion plans. In fact, most publicly owned retail companies used this period to firm up their balance sheets. By 2005, the retail property market was in the enviable position of having the support of an enthusiastic consumer, propped up by healthy retail tenants, but facing only modest risk from new supply. During the past few years, retail rents in better quality properties have increased at a rate exceeding inflation. For the historically flat retail markets, this has been strong growth (see Exhibit 2).

### Prospects for Retail

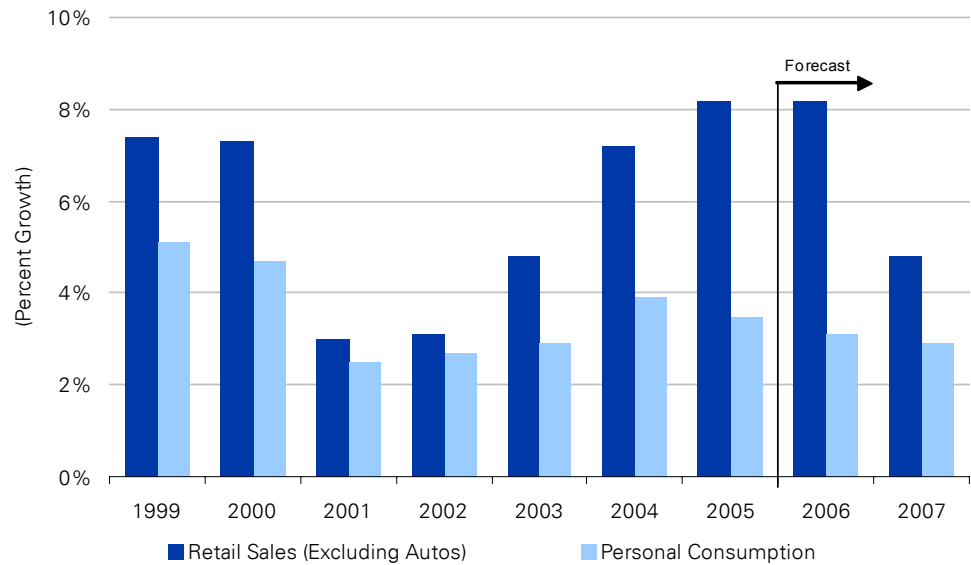
Going forward, retail sales growth is expected to slow. Rising interest rates are placing pressures on home values, thereby moderating the wealth effect, and making it more difficult for households to take equity out of their home through refinancing and home equity loans. While job markets remain strong, economic growth is leveling off. High oil prices are likely here to stay, and detract from purchasing power. And the beneficial effects of tax cuts have fully been absorbed by retail growth in the past few years. We are not expecting a total retrenchment by consumers, but we are expecting moderate growth in spending in line with trends in disposable income.

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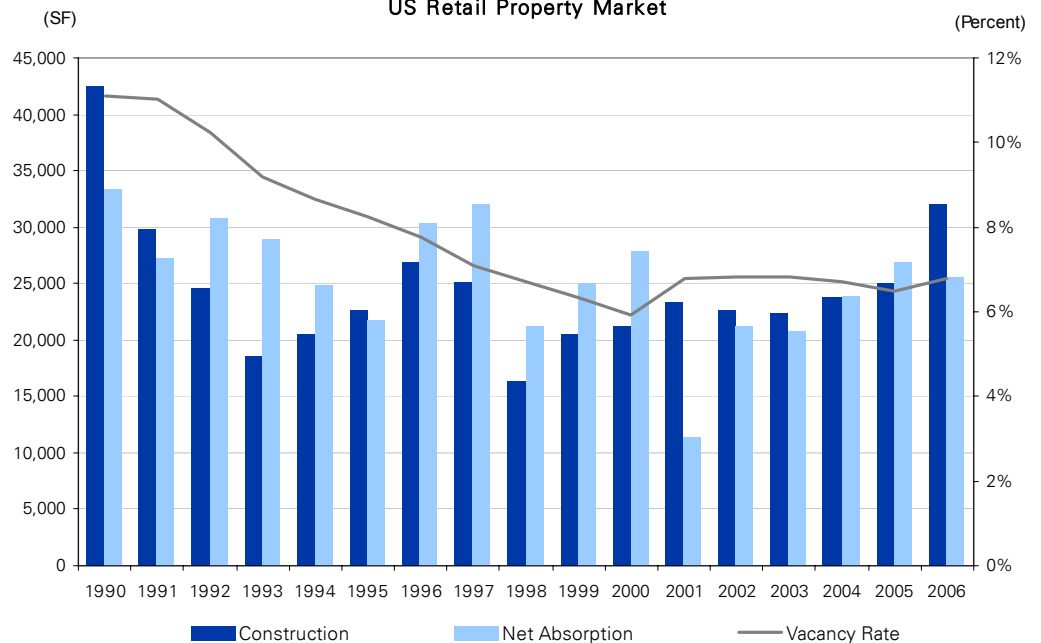
Retail sales growth should average between 4% and 5% annually for the next several years. As a result, rent growth at high quality retail properties is expected to be in line with inflation, generally between 3% and 4% annually.

**Exhibit 1**  
**Growth in Retail Sales and Personal Consumption**  
**1998–2007**



Source: Economy.com and RREEF Research

**Exhibit 2**  
**Supply Demand and Vacancy Rates**  
**US Retail Property Market**



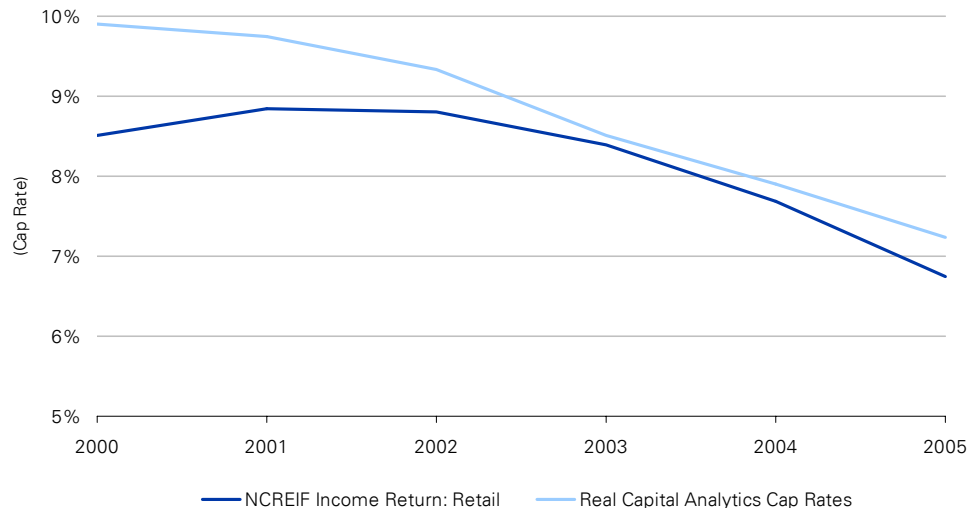
Source: RREEF Research

## Capital Markets

Of the major property types, retail was the most out of favor during the late 1990s, when its stable but slow growth performance was viewed as a negative in an economy that was seeing significant rent growth (and therefore value growth) in office, industrial and apartments, not to mention the high returns from the booming equity markets. Retail received renewed respect from the capital markets during the economic downturn and recovery from 2001 through 2005. During this period, retail's relative stability was embraced as a virtue. Unlike previous economic downturns, the down cycle which began in the early 2000s resulted mostly from a business retrenchment, rather than a collapse in consumer spending. Not surprisingly, the corporate side of the real estate markets, office and industrial, felt the brunt of the negative economic shock.

Industrial and office markets were closely tied to the overall economy and its weak employment market, and were therefore struggling. Apartment markets suffered as a result of historically strong for-sale housing markets, which were fueled by low interest rates. Retail property pricing, as a result, was bid dramatically upwards, far exceeding the performance of other property types. Between 2002 and 2004, the NCREIF total annual return for retail properties averaged 17.9%, compared to 10.1% for all properties, an incredible 780 basis point spread. According to Real Capital Analytics, average cap rates for strip retail centers declined from approximately 10% in the first quarter 2001 to below 8% by fourth quarter 2004, a 200 basis points decline (see Exhibit 3).

**Exhibit 3**  
**Cap Rate Trends for Retail Property Acquisitions**  
**2000–2005**



Source: NCREIF, Real Capital Analytics and RREEF Research

During 2005, however, retail lost its top billing status. Total return for retail during the year was approximately 20.0%, with a slightly higher 20.1% return for the overall property index. Apartments and industrial properties moved ahead of retail returns, while office continued to lag modestly. Retail cap rates continued their decline but at a much slower rate, losing approximately 50 additional basis points. Similarly, in the first quarter of 2006, retail produced a 3.4% total return, compared with 3.6% for all properties. Office and apartments moved ahead of retail, while industrial lagged. Cap rates for strip centers remained flat during this period, indicating that retail property returns were primarily from income, with little appreciation.

These trends imply that the retail property market has peaked in terms of both NOI growth and value. Apartments, industrial and office, still in the growth phases of their market cycles, have more room to grow, and are now outpacing retail properties.

## Acquisition Strategies in Core Retail

Historically, RREEF Research has recommended the acquisition of core retail properties, including the best retail assets in the best markets. These are typically newer properties in excellent infill submarkets within strong metros with some operating history. Targeted acquisitions are anchored by national or regional retailers that are top performers in their respective categories. Such properties tend to be the most desired by investors and achieve the most attention and highest prices (i.e., lowest cap rates).

At the peak of the market, however, such core acquisitions are a riskier strategy for several reasons:

- Low cap rates leave little room for a strong total return, when future growth is expected to be moderate.
- At this market peak, inflation is on the increase. Since anchor tenants within retail centers typically have long term leases at fixed rates that do not adjust for accelerating inflation, real NOI growth would be limited, and would likely be lower than inflation
- Non-anchor retailers, who typically have shorter terms, are better prepared to keep up with inflation. However, forecast rent growth of 3% to 4% limits their ability to produce healthy NOI growth.
- As interest rates and inflation move upwards, cap rates are also expected to move upwards modestly. Underwriting a higher “going out” cap rate relative to the first year projected cap rate hurts the projected total return.
- Recent enthusiasm by retailers to open new stores places modest pressure on occupancy. Increased supply and higher vacancy rates, although not alarming, will make it harder for owners to push rents upward.

## Recommended Strategies

In this current market environment, it will be important to either buy at a favorable cap rate or achieve healthy NOI growth in retail property investments in order to offset anticipated rises in cap rates over the hold period. Since rental rates are expected to increase at a moderate rate at best, this NOI growth will have to come by other means.

The following are prototypical deals that are potentially profitable given the current phase in the retail market cycle:

### **New Properties**

High quality, core properties can sometimes be acquired at a discount while they are still in the construction and lease-up stage, including community, power, lifestyle and hybrid retail centers. Ideally, these properties can be acquired off-market through developer partner relationships. This pricing discount is intended to compensate for the risk of acquiring a center with no sales/performance history. To be successful in minimizing this risk, the investor needs excellent research to assess locations, anchors, retail concepts and market support, and to

determine whether the center is defensible from potential future competition. In addition, intelligence from a strong property leasing group on the center's anchor tenant performance, with their outlook for the property, can mitigate anchor risk. While these deals are similarly flat like the "core" assets described above, the strategy is to buy at a favorable going in cap rate, thereby still providing a relatively strong total return.

### **Old Properties**

Properties that are 30 to 50 years old, in excellent supplied constrained infill locations, can sometimes be acquired at cap rates similar to those for newer properties, but have upside potential from expiring below market anchor leases. Often these leases are reaching the end of their below market rent options during the projected hold period. Given the strong location, these anchors will either renew at market, or more likely, newer and more dynamic anchors can be attracted to the center. These centers are often unattractive, with dysfunctional or obsolete layouts, so require renovation and some repositioning. As anchors are replaced, returns can be magnified by replacing smaller tenants subject to below market rents upon turnover. Acquiring, retreating and repositioning such centers can add substantial value, and hence provide potentially attractive total returns. Strong development expertise is required in such transactions to help mitigate potential construction risks in such a project.

Some older properties in similarly strong locations maintain high vacancy rates. This weakness may be the result of under-investment in a deteriorating property, tenant mix that does not meet the market, weak or vacant anchors, and/or poor management of the center. With some renovation and strong marketing, the investor can substantially increase NOI through lease-up and higher lease rates that would emerge from a property with better tenants. Value can be further improved by a lower cap rate that reflects the improved quality of the center.

### **Redevelopment**

Some centers, similar to the older property described above, are located on valuable land and are ripe for redevelopment. These are typically properties in affluent residential areas within major cities or in inner suburban locations where the underlying land value is supported by potentially high retail rents, multifamily residential, office, and/or hotel demand. These infill locations are typically supply constrained with significant barriers to entry. In some markets, the underlying land value might be \$40 per square foot or higher on a property that is being utilized by a 25% coverage surface parking shopping center. Clearly, additional value can be extracted by adding to the center's density. Densification can be created through simply adding parking structures, developing multi-level retail, and/or by demolishing portions or the total center for mixed-use development.

Such redevelopment deals require considerable management of leases and intricate phasing. Expertise in office and residential markets is essential to undertake mixed-use development. Considerable value and total returns can be generated by a redevelopment strategy for the right properties.

The redevelopment of failed malls could also provide an excellent opportunity. An abundance of such malls exist across the country, but opportunities should be limited to those in outstanding locations and where a significant portion of the center is vacant or with expiring leases. Such redevelopment is quite complex, requiring management of leases, tenant relocations, phasing, and strong development expertise.

### **Development**

New development of retail or mixed use properties is also an excellent opportunity at this point in the market cycle. As a lot of capital is pursuing the better projects, relationships are

key to consummating these deals. Otherwise, normal market fundamentals apply. Particular emphasis should be placed on pursuing mixed use projects in high value infill markets, as the market opportunities for such projects are outstanding, given demographic trends and consumer preferences.

## Conclusion

At the present time, at a point near the peak of the market cycle, investors should exercise extra caution investing in retail properties. Traditional core property acquisitions are currently aggressively priced, particularly in view of limitations on their potential for income growth in a market that is not expected to accelerate further. On the other hand, cessation of acquisitions of this product type would be an inadvisable over-reaction, as retail sales growth is expected to continue, but at a more muted pace than in recent years. Retail properties that have strong potential for reasonable NOI growth over their hold periods should be targeted. We have identified six typical acquisition targets:

1. New properties that can be acquired directly from the developer, and therefore have no performance history, can sometimes be purchased at an attractive yield.
2. Older properties, where anchor retailers paying substantially below-market rents are nearing the end of the lease term, can offer attractive total return over the hold period. These older properties often also offer opportunities for increasing rents on below-market small shop leases.
3. Older properties in strong infill locations, but due to history, condition or management, have substantial vacancy, could provide opportunities for strong NOI growth.
4. Redevelopment of older retail properties located on valuable sites can offer significant returns. This redevelopment might be a higher density retail center, or a mixed-use project. In high value locations, a mixed-use strategy afford particular potential for value creation.
5. Redevelopment of older failing malls in excellent infill location and with expiring leases or substantial vacancy offer opportunities for good returns.
6. New development of retail or retail in a mixed-use development offers considerable potential for attractive total yields.

#### ANALYST CERTIFICATION

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