RETAIL FUNDAMENTALS REMAIN STEADY WHILE FORECASTS SHOW MIXED RESULTS

- **KEY INDICATORS:** Key retail market indicators showed mixed results with respect to economic growth. Real gross domestic product increased by 0.8 percent in the first quarter of 2016, according to the “second” estimate. The University of Michigan’s consumer sentiment index fell 0.7 points to 91.0 in March (its third straight monthly decline) and a 2.2 percent decline YOY. However, retail sales increased by 2.7 percent year-over-year totaling $850.3 billion.

- **VACANCY:** Overall, vacancy rate declines have tapered, ranging between 10.0 percent and 11 percent during the first quarter of 2016. Vacancy rates are expected to decline modestly over the next couple of years. When compared to the previous quarter, Malls and Shopping Centers showed vacancy rates declined by 10 basis points to 5.5 percent and 8.7 percent, respectively. Power Center vacancy rates inclined by 10 basis points to 4.5 percent.

- **SUPPLY:** New construction starts and deliveries remained at very low levels, both decreasing by approximately 39 percent when compared to last quarter. New construction totaled 9.9 msf this quarter. The last time construction starts were reported below 10 msf by CoStar was during the fourth quarter of 2011. Meanwhile, deliveries for the sector are the lowest they have been since mid-2013, decreasing last quarter by 3.8 msf to 12.7 msf.

- **DEMAND:** According to CoStar, U.S. net retail absorption in the first quarter of 2016 was reported at approximately 18.6 msf, down from 31.8 msf last quarter, but up by 20.7 percent over the same timeframe last year. While absorption rates have trended downward compared to the 2015 quarterly average, the 20 top U.S. retail markets (by total gross leasable area), however, experienced positive absorption over the last twelve months and twelve of the top markets experienced even greater absorption rates when compared to the same timeframe last year (see chart on page five).

- **RENTAL RATES:** CBRE and Reis reported that effective annual rent growth slowed YOY, with approximately 0.5 percent to 1.0 percent rent growth in the first quarter of 2016. Over the next couple of years, effective rent growth is expected to continue to increase at a pace exceeding 2 percent annually. Beyond 2018, however, forecasts vary greatly projecting rent growth between 0.5 percent and 4.0 percent (see chart on page six).

- **CAPITALIZATION RATES:** During the first quarter of 2016 retail investment totaled $15.7B, a 23.5% decrease from last quarter and a 29.0% decrease YOY. Mall properties led the retail segment volume this quarter at $8.3B, a 24.3% decrease from last quarter, and 43.1% lower from a year ago. Volume for strip properties worsened 22.7% this quarter to $7.4B and was down 2.3% YOY.
KEY RETAIL INDICATORS

According to the Bureau of Economic Analysis “second” estimate released, real gross domestic product (GDP) increased by 0.8 percent in the first quarter of 2016. PNC’s National Economic Outlook for March forecasted real GDP growth of about 2 percent for the remainder of 2016, a slight slowing from the 2015 pace. As illustrated in the “U.S. Retail Sales” chart, retail sales (excluding motor vehicles and parts) in the first quarter of 2016 were down 13.6 percent when compared to last quarter. Retail sales totaled $850.3 billion for this quarter and increased 2.7 percent YOY.

The University of Michigan’s consumer sentiment index fell 0.7 points to 91.0 in March, the third straight monthly decline and a 2.2 percent decline YOY. According to the University of Michigan’s Survey of Consumers, consumer sentiment continued its slow decline due to weakening expectations for future economic growth. Although consumers’ views of their current finances remained positive. The top concerns of consumers involve whether the anticipated slowdown in economic growth will lead to slower income and job gains and the rise in uncertainty about future economic policies depending on the outcome of the presidential election. Overall, the data indicate that real consumption will grow by 2.5% in 2016.

The University of Michigan’s Chief Economist stated in the Survey of Consumers report that “the retreat from the 2015 peaks was evident across a wide range of expectations about prospects for the national economy. The size of the decline, while troublesome, is still far short of indicating an impending recession. The decline is all the more remarkable given that consumers’ assessments of current economic conditions, including their personal finances, have remained largely unchanged at very positive levels during the past year. This divergence may reflect the strength of the consumer relative to the business sectors, and exacerbated by growing uncertainty about the economic policies advocated by various presidential candidates.”
RETAIL MARKET TRENDS

VACANCY

According to CBRE and Reis, vacancy rate declines have tapered off, remaining within the 10.0 percent and 11.0 percent range respectively, during the first quarter of 2016. Vacancy rates are, however, expected to further decline at a modest rate over the next couple of years (see adjacent chart).

Shopping Centers, Power Centers, and Malls, vacancy rate declines have also slowed with each segment reporting only slight changes during the first quarter when compared to the fourth quarter of 2015. Malls and Shopping Centers showed vacancy rates declined by 10 basis points to 5.5 percent and 8.7 percent, respectively. Power Center vacancy rates increased by 10 basis points to 4.5 percent. Although vacancy rates have risen modestly for Power Centers, this segment is still the only one to report vacancy rates below pre-recession levels.

The strategy for filling retail space is ever-changing. According to the 2016 Emerging Trends in Real Estate published by PWC and ULI, retail tenant mix continues to evolve. What’s not replaceable by the internet is moving to the fore. For example, food culture is now a trend. Along with restaurants and bars there are other lifestyle oriented concepts making their way into centers, including yoga studios, fitness centers, massage, dental, and entertainment.

According to CoStar, the fifteen “Leading Markets” continued to experience vacancy rate declines, with all Leading Markets reporting lower vacancy rates, except San Francisco, which is already at the top of the list. Just like “Leading” markets, most “Lagging” markets continued to experience vacancy rate declines, with the exception of Milwaukee and Inland Empire. Las Vegas and Phoenix continued to report the highest vacancy rates at 9.5 percent and 9.0 percent, respectively. One of the notable deliveries in Las Vegas during the first quarter of 2016 includes a Desert 215 Superstore (69,859 sf) that is 100.0 percent occupied. Phoenix’s notable deliveries include RideNow Motorsports (97,000 sf) and Main Event (58,229 sf), both developments are 100.0 percent occupied as well. Newcomers to the “Lagging” list this first quarter of 2016 included St. Louis and Milwaukee.
SUPPLY
For the first quarter of 2016, new construction starts and deliveries remained very low. Furthermore, both decreased by approximately 39 percent when compared to last quarter (see Construction Starts & Deliveries chart). New construction totaled 9.9 msf this quarter. The last time construction starts were reported below 10 msf by CoStar was in 4Q2011. Meanwhile, deliveries are the lowest they have been since mid-2013, decreasing last quarter by 3.8 msf to 12.7 msf. According to Marcus & Millichap’s Retail 2016 Investment Forecast, “Restrained retail-property development has characterized the post-recession period and supported a steady drop in vacancy, a trend that likely will persist in 2016. This year, developers are scheduled to complete 46 msf, representing a modest decline from last year’s total, but the pipeline of (national) planned projects is increasing. Nearly 30 percent of this year’s projected square footage will come online in five markets: Houston, NYC, Dallas/Ft. Worth, Chicago and Orlando.”

MARKETS
Represented in the “Construction Activity – Top Construction Markets” chart are the 15 markets with the greatest amount of square footage under construction. New construction in the most active markets during the first quarter of 2016 totaled 34.4 msf, a 12.8 percent increase over last quarter. Together, these 15 markets make up 49.0 percent of total construction currently underway. As a percentage of existing supply, NYC continued to surpass all “Top Construction Markets” for having the most space under construction at 5.1 percent or approximately 2.6 msf in total. However, Texas tops the list in terms of square feet under construction with Dallas/Ft. Worth having 4.0 msf under construction and Houston trailing behind at 3.8 msf. According to Marcus & Millichap’s 2016 U.S Retail Investment Forecast, the Houston metro stands to face significant headwinds, as the energy sector remains a concern while growth in other industries, such as the medical and downstream oil-and-gas operators propel the market. Several large projects are underway, including Valley Ranch Town Center which is 98.0 percent preleased and comprised of more than 1.0 msf in northeast Houston as well as the 450,000-sf Shoppes at Parkwest in Katy which is 83.0 preleased. Both projects are expected to deliver later this year, and as a result vacancy should remain flat this year, hovering near historic lows. There are also newcomers to make the list and they include Seattle/Puget Sound (1.3 msf U/C), Denver (1.3 msf U/C), Atlanta (1.7 msf U/C), and Nashville (1.3 msf U/C).

Overall, nine of the fifteen “Top Construction Markets” (by GLA) are at least 76.5 percent pre-leased. The Miami-Dade market is the only market to remain on the list that has continued to have considerably weak preleasing at 29.1 percent. What’s more alarming is that Miami-Dade continued to add new construction with very little preleasing. During the first quarter of 2016, CoStar reported Miami-Dade having 2.3 msf under construction with only 29.1 percent preleasing, while last quarter they reported approximately 1.7 msf under construction with 52.9 percent preleasing.
DEMAND
According to CoStar, the U.S. quarterly net retail absorption during the first quarter of 2016 was reported at 18.6 msf. That was down from 31.8 msf last quarter, but up by 20.7 percent over the same timeframe last year. While absorption rates have trended downward compared to the 2015 quarterly average, the 20 top U.S. retail markets (by total GLA), however, experienced positive absorption over the last twelve months, and twelve of the top markets experienced even greater absorption rates when compared to the same timeframe last year (see bottom chart).

MARKETS
Once again, the Chicago and Dallas-Fort Worth markets saw the highest level of retail absorption over a trailing twelve month period. When compared to a year ago, Philadelphia saw the highest increase in absorption, rising nearly 2.2 msf. According to Marcus & Millichap’s 2016 U.S. Retail Investment Forecast, Philly’s job gains in healthcare and education, as well as the strong trade sector, helped push the metro’s unemployment rate to its lowest level since the recession. The report also stated:

“Philadelphia has seen outsized growth in median household income, which now sits at more than 20 percent above the national level. As the metro population’s disposable income increases, annual retail sales growth will reach the highest point since 2006. Although new development will post a slight decline from last year’s pace, builders will remain active with annual completions staying well above the five-year average. Uptown Worthington in Malvern is the marquee retail development of the year. Once completed, the mixed-use project will have allocations for Class A office space, luxury apartments and 725,000 square feet of gross lease area retail. Despite another year of consistent construction, overwhelming tenant demand will push vacancy rates to unprecedented levels, spurring a sizable rent hike.”

The other eight retail markets reported similar or weaker levels of retail absorption in 2015, compared to a year ago. Two market in particular, Las Vegas and Charlotte, showed absorption decreased by more than 1.0 msf over a trailing twelve month period when compared to the same timeframe last year. Although Charlotte showed a slowdown in retail absorption, it reported a healthy market vacancy rate of 5.6 percent as well as a 6.0 percent increase in rental rates when compared to the same timeframe last year. Las Vegas, however, is more concerning with market vacancy rates much higher at 9.5 percent. Despite high market vacancy, however, Las Vegas still posted a 6.3 percent increase in rental rates over the same timeframe last year.
RENTAL RATES
As illustrated in the adjacent chart, effective annualized rent growth slowed to approximately 0.5 percent to 1.0 percent during the first quarter. Over the next couple of years, effective rent growth is expected to continue increasing at a pace exceeding 2.0 percent annually. Beyond 2017, however, forecasts vary greatly projecting rent growth between 0.5 percent and 4.0 percent.

In the first quarter, the average Power Center asking rental rate was $16.71 psf, up by 2.2 percent sequentially and 4.3 percent YOY, the greatest increase when compared to the other segments. Mall asking rates declined by 0.5 percent to $16.74 psf compared to last quarter, but still increased by 5.2 percent YOY. The Shopping Center segment, which has consistently posted the highest vacancy rate and the lowest rental rate averages, posted a 0.6 percent increase over last quarter to $14.39 psf and a 1.1 percent increase YOY.

MARKETS
Nashville made the top of the “Leading Markets” list this quarter with a 13.7 percent increase in rental rates YOY. According to Marcus & Millichap’s 2016 U.S. Retail Investment Forecast, Nashville’s healthy demographics and property performance are at a 10-year high. A slowdown in new development amid robust demand should encourage metro wide tightening with vacancy reaching its lowest point since the downturn and rent growth should follow suit, as operators lift rents past the prior cycle’s peak. The greatest decreases in retail asking rates ranged from -1.0 percent to -5.0 percent. “Lagging Markets” this quarter have shown wide distribution throughout the U.S. The Memphis market saw the greatest decline in average retail rental rates by 5.0 percent YOY. Most “Lagging” markets on the list have recurred throughout 2015; however, markets new to the list include, Westchester/S Connecticut, Chicago, Harford, Jacksonville, and San Antonio.
CAP RATES
Overall, during the first quarter of 2016 retail investment totaled $15.7B, a 23.5% decrease from last quarter and a 29.0% decrease YOY. Mall properties led the retail segment volume this quarter at $8.3B, a 24.3% decrease from last quarter, and 43.1% lower from a year ago. Volume for strip properties worsened 22.7% this quarter to $7.4B and was down 2.3% YOY. Despite the declining volume, RCA noted that a slowdown in portfolio and entity-level transactions contributed to this slowdown in volume. However, the slowdown in sales volume is not indicative of investor sentiment for the rest of 2016. In JLL’s 1Q16 Retail Outlook, they note that the current retail pipeline is strong and investment activity in this sector may improve going forward.

The Moody’s/RCA CPPI index indicated that prices are up 7.8% YOY, but are still 2.4% off peak levels reached in 2007. There were two notable California transactions this quarter. One involved a partnership between Pacific Retail Capital Partners and Silverpeak Real Estate Partners, which acquired a 1.4 million SF, super-regional mall in San Jose for $225 million ($286 PSF). Blackstone purchased a portfolio of 12 retail properties totaling 259,400 SF for $201 million ($771 PSF). These properties are part of the One Colorado shopping center in Pasadena’s historic Old Pasadena neighborhood.

Cap rates across the retail sector continued to post slight improvements or show signs of moderation. Both PwC and RCA noted that mall cap rates are the only subtype to post quarterly and annual improvements. Power centers and strip center cap rates are flat on a quarterly basis, but have improved on an annual basis according to PwC.

Urban retail has seen a flurry of activity in 2015 per RCA, resulting in lower cap rates. RCA noted that this subtype is typically located in markets that have some of the highest prices in the USA. However, luxury shopping is declining on a global basis, impacting the desirability of urban retail product in select markets. Given the changing shopping patterns of today’s consumer and decline in travel and tourism expenditure (a major facet of luxury shopping), upscale brands are experiencing difficulty maintaining storefront properties in prime urban retail corridors per JLL. These larger macro concerns coupled with high primary market pricing have led to an increase in secondary market activity, as the cheaper pricing is attractive to investors who favor this asset type.