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CONCRETE THOUGHTS
ICSC SPECIAL REPORT

Connecting the Dots on Retail, Mixed-Use Investment Sales

Yes, recession stymied consumer spending, yet sales activity strong in '10; what to watch going forward

EXECUTIVE SUMMARY:
- → Retail, mixed-use investment sales sectors have seen strong activity in 2010.
- → Retail values have slid in 2010; mixed-use values, however, have increased.
- → Consumer skittishness continues to impact the retail and mixed-use investment-sales sectors.
- → Well-located prime spots continue to move—recent examples abound!
- → As the economy improves, relatively under-retailed New York will recover significantly.

Given the ICSC convention in New York this week, we will take a look at the investment-sales market for properties where retail stores are the primary drivers of revenue.

In 2010, the retail and mixed-use property sectors have seen strong activity. The retail sector has seen sales-volume increases, both in terms of the number of properties sold and the dollar volume; this is not surprising given the extraordinarily low levels of activity seen in 2009. Within the mixed-use sector (mixed-use properties are those where retail tenants occupy at least 25 percent of their gross square footage, with residential apartments above), we have seen similar increases in the number of buildings sold and in the dollar volume of sales over 2009 levels.

Robert Knakal
Columnist

In 2009, there were 143 retail properties sold in New York City, having an aggregate dollar volume of approximately $445 million. Through Nov. 15, there have been 160 retail properties sold, having a market value of approximately $760 million. These figures reflect increases of 12 percent in the number of properties sold and 71 percent in the dollar volume of sales, without taking into consideration transactions that will close in the last six weeks of the year. Within the mixed-use sector, in 2009 there were 238 properties sold, having a market value of approximately $416 million. Through Nov. 15, there were 286 mixed-use properties sold, having a market value of approximately $525 million. The increases here are 20 percent and 26 percent, respectively, without annualizing these figures.

Whether these percentage increases, and optimistic numbers, are reflective of positive fundamental developments within the retail sector, or simply a result of the expected increases from anemic 2009 levels can be determined by analyzing value trends within these sectors.

On a price-per-square-foot basis, within the retail sector, values have continued to slide in 2010 from 2009 levels. In the mixed-use sector, values, on a price-per-square-foot basis, have increased in 2010 in all submarkets over 2009 levels, with the exception of one. The residential component of mixed-use properties has clearly helped value within this sector.

If we take a step backward and look at how the retail and mixed-use sectors have performed over time, we see that they have been adversely affected in a tangible way by the recent recession. The erosion of consumer confidence and the evaporation of consumer spending drove value in these two sectors down significantly from their 2007 peaks. Mixed-use properties saw average price-per-square foot values drop by 46 percent in 2009 from their 2007 highs. Properties within the retail sector saw values decline by 49 percent from their peak.

It is not difficult to understand how these two sectors took such a beating if we consider how the recession has impacted consumer behavior. The Bureau of Labor Statistics shows that in 2008, consumer spending had increased 1.7 percent versus 2007. However, BLS statistics show that, in 2009, consumer spending was down by 2.8 percent from 2008 levels.

The United States has also experienced a significant shift in savings patterns. In early 2007, the savings rate in the U.S. had reached minus 4 percent. In October of 2010, the savings rate reached 5.7 percent. This nearly 10 percent shift in savings habits

has had a significant impact on our gross domestic product.

Consider that the U.S. has a G.D.P. of approximately $14 trillion and approximately 70 percent of that total is consumer driven. This means that roughly $10 trillion of output in America is the result of consumer spending. The 10 percent swing in the savings rate extracts about $1 trillion from our economy annually. That is a significant amount of consumption to do without.

Consumers are indeed saving more and are cautious about increasing discretionary spending based upon many factors that they are concerned about in our economy. For the average American, a home is their largest asset, and the level of equity in that home provides a "wealth effect" that has significant psychological implications for spending habits. In the bubble-inflating years of 2005 through 2007, financing terms were easy, and many homeowners used home-equity withdrawal to fuel retail purchases. As home prices declined, the use of houses as ATM machines was all but eliminated. Today, home sales remain sluggish, leaving consumers on edge.

Unemployment remains stubbornly high as job creation was far below expectations in November, with only 39,000 jobs being created and the unemployment rate increasing to 9.8 percent. Additionally, all the headlines and news reports about the massive U.S. deficit and deficit-reduction potions have Americans more aware than ever about the impact of debt on financial solvency. Consumers are less likely today to exploit credit cards than they were years ago.

As consumers feel more confident, they will spend more, leading to higher rents in the retail sector. As rents increase, upward pressure on value will be exerted, moving the market in the right direction.

Notwithstanding the facts mentioned previously, the National Retail Federation has projected consumer spending will increase by 2.3 percent in November and December 2010, versus the same period last year. This is due, in part, to the surge in retail store reward-bonus programs and store-loyalty incentives. Credit card companies have also aggressively increased their cash-back rates, and some have even initiated premium return-protection services to entice shoppers. An analysis of these programs shows that they are truly only beneficial if consumers pay off 100 percent of their balances each month and don't carry outstanding debt.

To the extent consumer spending does increase in line with the NRF's projections, it will enhance property value within the retail and mixed-use segments. Values within these sectors have been interesting to follow. Within the retail sector, value is surprisingly down on a price-per-square-foot basis from 2009 to 2010 (all data compares 2009 totals versus 2010 results through Nov. 15) in all five submarkets that we analyze. The submarket that has performed best is northern Manhattan, which has experienced just a 4 percent reduction in value on a price-per-square-foot basis, moving from a $324 average in 2009 to a $312 average in 2010. The most adversely affected submarket has been

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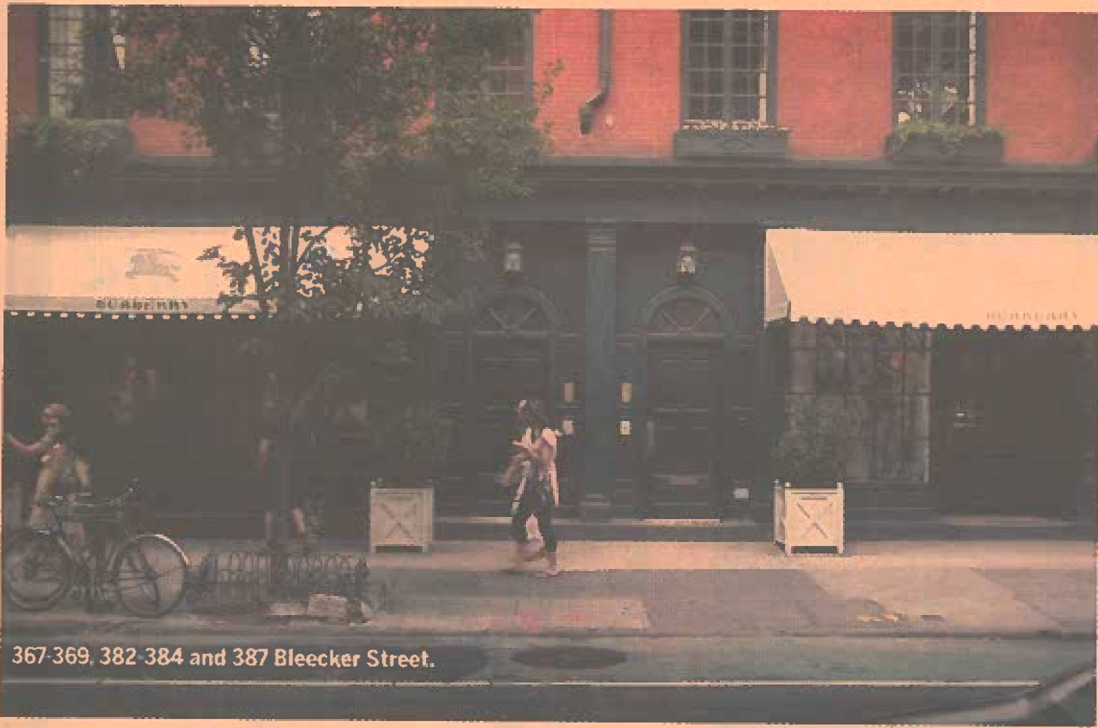
367-369, 382-384 and 387 Bleecker Street.

the Bronx, where value has dropped from an average of $341 per square foot in 2009, to $200 per square foot in 2010, a 41 percent decline.

Capitalization rates within the retail sector have been on a roller-coaster ride since 2007. For example, in Manhattan in 2007, almost any retail property or retail condominium could be sold at a 5 percent cap rate regardless of the creditworthiness of the tenants. The average cap rate in the first half of 2009 in the retail sector increased to nearly 7.5 percent; since then, cap rates within the sector have continued to decline, now averaging just over 6 percent. It is counterintuitive to see that the value per square foot continues to fall even though cap-rate compression is occurring. This is due to the fact that retail rents have seen sharp declines and are only beginning to stabilize.

Notwithstanding these general trends, well-located prime retail properties continued to be highly sought after by investors in the marketplace. The supply-demand imbalance that the invest-ment-sales market is currently experiencing and the extraordinarily low-interest-rate environment that we are operating in have created circumstances under which some outstanding transactions are occurring.

Recently, James Nelson, a partner at Massey Knakal, and I represented the seller of six retail condominiums at 367-369, 382-384 and 387 Bleecker Street, located on the prime luxury retail corridor in Manhattan's West Village. The retail condominiums were fully leased to established, high-quality tenants, including Michael Kors, Marc Jacobs, Burberry, A.P.C. and Mulberry. These units contained a total of approximately 5,100 square feet and were sold for $34 million, or approximately $6,700 per square foot, one of the highest prices paid for retail properties in the United States. Even at this high price per square foot, the cap rate was approximately 6.3 percent based on the high rents commanded on this stretch of Bleecker Street

"New York City retail condos with credit tenants are rarely offered in this market," Mr. Nelson said. "As a result, institutional, foreign and local investors competed aggressively for this offering. After receiving multiple preemptive offers near the ultimate sales price, the contract was signed within three weeks of bringing this offering back to the market."

In another recent retail property transaction, Guthrie Garvin and I represented the seller of a 27,700-square-foot retail condominium at the base of Trump Palace on Third Avenue between 68th and 69th streets. This space was completely net-leased to Great Atlantic & Pacific Tea Company on a very long-term basis, at a rent well below today's current market. Given the tremendous amount of upside in this property, notwithstanding the exceptionally long duration of the lease, the buyer paid $21 million for this asset, yielding a 5 percent cap rate. This property was purchased by shopping mall developer Equity One.

In another noteworthy retail transaction, James Nelson and Clint Olsen, Massey Knakal's first vice president of sales, represented the seller of a 3,750-square-foot retail condo at the southwest corner of 49th Street and Second Avenue in the new Alexander Condominium. The space was recently net-leased to TD Bank and was sold for $11.1 million. At that price, the cap rate achieved on this transaction was about 6.5 percent. The buyer was a high-net-worth South American investor.

Many other retail transactions are occurring at a very healthy pace, although location and, more importantly, the relationship between existing rent level and today's market is driving capitalization-rate fluctuations on these transactions. Clearly, the supply-demand dynamics and interest rates will significantly impact the value of retail and mixed-use properties moving forward.

Additionally, the state of the U.S. housing market and the overall performance of our economy will impact the behavior of consumers. As consumers feel more confident, they will spend more, leading to higher rents in the retail sector. As rents increase, upward pressure on value will be exerted, moving the market in the right direction. New York City is under-retailed by a wide margin relative to other major U.S. cities and is, therefore, poised for a significant comeback as economic conditions improve.

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Robert Knakal is the chairman and founding partner of Massey Knakal Realty services and in his career has brokered the sale of more than 1,100 properties, having a market value in excess of $6.8 billion.

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