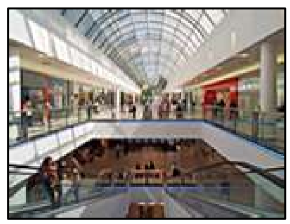
Supply and Demand of Retail Real Estate: A History of Repositioning

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I. Executive Summary

The supply and demand of retail real estate has evolved in response to the shifting demographics of the U.S. population, suburbanization, economic booms and busts, and the changing technologies available in the marketplace. The current recession is severely constricting consumer spending, causing vacancies to rise and properties to become distressed. Coupled with other factors, such as the growth of online shopping, functional obsolescence, the presence of value-oriented retail behemoths like Walmart, and restrictive grocery store anchors, the retail real estate industry is over-supplied.

The economic impact of these vacancies has a rippling effect through owners, lenders, tenants, governments, and communities. When demand for retail exists, these properties can be repositioned through renovations, re-development, or a mixed-use approach. When demand is lacking, change of use, donation, or build-to-suit are effective alternatives. During any market conditions, cost reduction strategies through energy efficiency programs, sustainability retrofit, and negotiations with tenants are valuable tools to incorporate into proactive asset management.

Opportunities exist for well-positioned companies to purchase distressed or automobile dealership properties at prices which will likely be well below recent market values. While the government is attempting to stimulate economic recovery through changes in accounting rules, depreciation, and cancellation of debt, recovery for retail is not anticipated until at least 2010. Useful conclusions can be drawn from the historical context of retail real estate which can be translated into guiding principles. They are:

-Real estate values and construction have peaked one to two years before a depression and have stayed at peak levels until the onset of the downturn.

-Know where you are in the real estate business cycle: recovery, expansion, over-supply, or recession.

-Preserve capital, avoid over-leveraging properties, and arrange alternative sources of capital prior to its need for deployment.

-Don’t oversupply the market with speculative building.

-Conduct due diligence in a thoughtful, thorough, and disciplined way.

-Review barriers to entry in the proposed market.

-Understand local supply, demand, and market conditions.

-Renovate properties every 10 years.

-Be acquainted with your impact on and connectivity to the community, tenants, lenders, state and local government, property management, and vendors.

-Keep apprised of new legislation, population and market trends, new building methods, and changes to accounting rules.

II. Introduction

The retail real estate industry is currently facing one of the most severe downturns in its history and the challenges it faces will likely persist, if not worsen. Changes in consumer spending ability and behavior coupled with overbuilding, functional obsolescence, constricted lending, and population changes have caused many to re-evaluate retail real estate fundamentals. The wave of suburban shopping center development over the past decade has outpaced the population growth leaving too much supply and not enough demand. As the suburbs expanded beyond the first tier of cities into secondary and tertiary markets, poorly conceived shopping centers followed with grocery-anchors that limited potential in-line tenants with restrictions and exclusions. The emergence of new product types like power centers and big boxes brought in national chains that began consuming smaller tenant's market share and services. Newer centers offered space, but small local tenants couldn't afford the base rent plus triple net required of square footage constructed at higher costs.

As the housing crisis triggered widespread economic distress, consumer spending declined, job losses soared, lending seized, and retail sales started to decline. As the downward spiral continued, retailers declared bankruptcy at record rates in 2008 and store closings are projected to double for 2009. Retail vacancies skyrocketed and tenants began seeking rent concessions; exacerbating the cash position of retail real estate owners. The instability of property fundamentals has caused cap rates to rise, resulting in fewer sales and up to 40% decreases in asset values. Delinquent loans are on the rise and banks are offering little by way of new lending to help owners refinance the loans that are coming due. Instead, they are increasing underwriting standards and lowering loan-to-value ratios to impede the psychology of overleveraging that plagues current owners now. Even the stalwart REITs are experiencing unfamiliar volatility that is approaching the general market level. The impact of these changes not only has an effect on the financial market, but on communities as well. Loss of tax revenue is forcing unsavory budget cuts to local services while city and county planners are perplexed about what to do with these as well as auto dealership vacant properties.

When this recession is over and the markets begin to recover, there will be opportunities for the survivors who managed themselves well during the downturn. New market realities are emerging that suggest fundamental and lasting changes to consumer shopping habits. Many believe that the new focus on value and reduced consumption will become permanent in the marketplace for this latest recession/depression generation. Multi-channeled retail that seeks consumers in stores, on-line, and in catalogs will continue to reshape the retail landscape. As retail adapts to the changing preferences of its consumers, owners of retail space will reinvent their shopping centers to meet these rising trends. Whether or not the market rebounds enough to absorb the enormous supply of retail space remains to be seen as recovery for retail is not anticipated until 2012.

The focus of this paper is to study the evolution of the retail real estate industry and the factors that brought us to this place of crisis. A review of the historical context is critical to understanding the causes of expansion and contraction in the market so that the appropriate framework for the current market conditions is set. The next step is to conduct a comprehensive review of the implications for the real estate sector and the industries and individuals that it supports. This review reveals a set of challenges for the retail market based upon evolution, demand, changing demographics, and obsolescence. Where demand is anticipated to exist in the future, there are both traditional and alternative methods that owners can employ to redevelop their shopping centers. There are also opportunities for owners who preserved capital and avoided over-leveraging their properties to purchase distressed properties with the potential for reuse. Although the face of the retail real estate marketplace will continue to evolve, there are lessons to be learned from predecessors who have survived the previous booms and busts. As the country endures this period of reset, perhaps it is time for retail real estate to return to its fundamentals as well.

III. The Historical Context - Suburbanization and the Evolution of Shopping Centers

Overview

Over the centuries, marketplaces have been established in a haphazard way wherever people have settled into communities. As these societies changed, so did the markets, arcades, agoras, and bazaars that brought them their goods and services. Although our modern day shopping centers have roots in these historic markets, they are unique because they are generally planned, developed, owned, and operated as a single business entity. Retailers in these centers are carefully designed to have complementary roles that present a unified image to the communities they serve.

These malls and open-air strip centers are a unique result of the American culture that promoted suburbanization, mass-market consumerism, and widespread use of the automobile after World War II. As they matured in response to the changing needs of American consumers, they have become intricately woven in to the fabric of our retail and social landscape. Not only are they places where consumers meet their daily needs, but they often represent the small-town lifestyle that fosters a sense of community, security, and predictability for so many Americans.

Independence Through the Industrial Period

The trend toward suburbanization is a philosophy set forth by Thomas Jefferson through his policies and public opinions about cities. "I think our governments will remain virtuous for many centuries as long as they are chiefly agricultural; and this will be as long as there shall be vacant lands in any part of America. When they get plied upon one another in large cities, as in Europe, they will become corrupt as in Europe," Jefferson said.[1] Before the Constitution, Jefferson pushed his anti-urban policy in the Land Ordinance of 1785.[2] This is the classic land policy that divided land in what is now the Midwest into six square mile townships, divided into 640 acre sections that would primarily be used for farming.[3] The ordinance was in opposition to the English government custom of promoting cities through the use of charters to create towns. Although he is not to blame for suburban sprawl, his policies encouraged the idea that land meant equality and freedom for Americans, who were beckoned with large tracts of open land to claim their independence from the cities.

Largely because of the promotion of expansion into the countryside, the majority of Americans were scattered on farmsteads that preferred mail-order catalogs to the long, difficult trips to the trading posts or dry goods store through the first half of the nineteenth century.[4] During this time, Baltimore was established as a tobacco port. The town then rapidly developed into a flour-milling and shipbuilding center, with a flourishing trade with Europe and the Caribbean.[5] A second phase of growth began in 1828, when America's first railroad, the Baltimore and Ohio, was built to compete for the western trade created by New York's Erie Canal.[6] As the city grew, Baltimore was influenced by the trend of cities towards annexation to capture the wealth in the "precincts" adjoining the city. By the early 1800's one-third of Baltimore County's residents lived in these precincts and their land accounted for over forty percent of the county's total property value.[7] These areas were serviced by an omnibus and builders, such as James and Samuel Canby, were promoting large-scale middle-class housing developments like Franklin Square.[8]

Beginning in the nineteenth century, the industrial revolution drew people back into the cities for manufacturing jobs and the need for managers, business services and governmental agencies swelled. Dry goods stores were expanded into emporiums, like The Wanamaker Store in Philadelphia, to serve the growing populations.[9] The electrification of the streetcar in the 1880's prompted a number of rail lines to expand radially outward from cities to their suburban enclaves. Along the streetcar lines were residential neighborhood developments that still relied upon the city as a commercial and cultural center, but had small shops to service their daily needs.

For Baltimore, an area called "the Belt" had developed as a result of electrified streetcar lines, "encircling the city on three sides with industrial and residential settlements like Pikesville and Catonsville."[10] The city also boasted a large ethnic population spurred by European immigration and the migration of former slaves from the south. As African-Americans began to occupy a larger portion of the city, the Jewish population that lived in the northwest of the city continued to move outward into the suburbs.[11] Developers supported the planned community designs of Fredrick Law

Olmstead, Jr. and created Roland Park, which was a 100 acre site that included housing, fire and police protection, a country club, parks, school and church sites, and a shopping center.[12] The shopping center, six shops located in a Tudor-style building, may have been the first to provide parking in the rear for the automobile.

Roaring Twenties, The Great Depression and World War II

The introduction of the automobile was revolutionary in its ability to connect farmsteads and suburbs to the city. Moderately priced and available to the masses, the automobile gave people freedom of movement. It also laid the foundation for the age of mass-manufacturing techniques which caused prices of goods to drop and promoted mass consumerism. Much of the retail was located in the central business districts (CBD's) at this time, and automobiles began to clog the streets of emporiums and shops. In response, small strip centers, usually anchored by a supermarket or drug store, were cropping up on the fringes of the city.[13] At the same time, discretionary spending increased from 20% to 35% and domestic appliances were becoming commonplace in American homes. In response, chain stores began to appear in the market and catalog companies like Sears realized the need to open freestanding stores accessible to the newly mobile and affluent customers. [14] Department store companies located in the CBD were less likely to expand in the suburbs for fear of cannibalizing their downtown business.

The Great Depression in 1929 brought an ending to the free-spending of the Roaring Twenties. Development was stifled for over a decade, even with the massive government spending on World War II. When the war ended, the nation was starved for housing and consumer goods. The government supported the rapid development of inexpensive housing in the suburbs through Federal Housing Administration (FHA) programs and the 1944 Serviceman's Readjustment Act (GI Bill). Nancy Cohen wrote in America's Marketplace, "Federal housing converged with the urgent demand, the now ubiquitous automobile and the wartime development of fast and cheap construction techniques to orchestrate a massive exodus of young families to the new suburbs." In some instances, the FHA insisted that developers build a shopping center and even provided free building plans as part of the loan agreements.[15]

To offset the costs for supermarkets, developers soon realized that a conglomeration of tenants that offered a variety of goods and services would attract more customers to their centers. As the shopping centers grew, the industry struggled with how to accommodate automobiles while segregating them from the shopping experience. Many found that a return to the downtown street of shops like James Douglas's Northgate in Seattle, with two lines of shops facing each other across a walkway, would be critical to success.[16] This focus on pedestrianism would pave the way for the prototype of the modern shopping mall. Opened in Edina, Minnesota in 1956, the mall named Southdale was the country's first fully enclosed, climate-controlled shopping center.[17]

The federal government also contributed to urban flight by redlining, or creating maps to indicate the level of security for real-estate investments in each surveyed city. Many minority neighborhoods were within the "red lines" indicating that the residents there were ineligible to receive financing.[18] This paralyzed the city housing market, lowered property values and further encouraged landlord abandonment. Customers in these areas also found themselves vulnerable to retail redlining, a similar process of not serving certain areas because of their ethnic-minority composition.[19]

Baltimore and the surrounding counties were experiencing much broader national trends. Maryland experienced great prosperity from World War II as research and testing complexes like Aberdeen Proving Ground and Edgewood Arsenal brought in thousands of new residents to work in war-related activities.[20] Companies like Glenn L. Martin Aircraft Company were bringing in so many new workers that a severe housing shortage ensued. The company agreed to build one house for every two that the government built and government contractors were booming from the nearly 38% growth during the 1930's.[21] By 1947, the economy stabilized enough to support private construction. During the five year period from 1947 to 1952, more new houses were constructed in Anne Arundel, Baltimore, Montgomery, and Prince George's counties than had been built there in all of the preceding centuries. [22]

By the mid 1940's large-scale supermarkets and shopping centers were being developed in the suburbs to serve these new communities. The first fully-enclosed shopping center in Maryland, Edmonson Village, was opened in 1947 and the first enclosed mall was built at Harundale and opened in 1958.[23] These centers were instrumental in transforming the suburbs from urban bedroom communities into self-contained living and working areas that were a downtown-away-from-town.

The 50's and 60's

New business opportunities were rising in the wake of major demographic shifts. From the 1940's through 1960's, public and private interest in commercial properties almost equaled the investment in housing.[24] All of this activity was fueled by the Interstate Highway Act of 1956 that financed 41,000 miles of interstate highway construction and changes to tax code in 1954 that provided incentives for new construction rather than renovations to older downtown districts.[25] Developers took advantage of the highly visible site located along the highways and constructed many roadside shopping sites.

Large centralized farming also became the dominate agriculture, with goods easily dispersed by hauling trucks, and small farms began their slow conversion to other uses. As the cities emptied out into cheaper land in the suburbs, merchants followed their customers' urban flight and left downtown stores for newer sites with less expensive rent and more traffic. "The regional mall is the child of the interstate highway system," said R. Dean Wolfe, an executive with the May Department Stores Company, "When Eisenhower put the highway in place, he didn't realize he was destroying the downtown."[26]

Developers during this time began to face new issues surrounding site design, leasing standards, and property management so they formed a trade association, the International Council of Shopping Centers (ICSC) in 1957.[27] The association helped to educate developers on successful industry practices, conduct research in areas such as parking ratios, and develop uniform tools like the Reciprocal Easement Agreement (REA).[28] The financiers of the centers were predominantly insurance companies whose pensions liabilities were a good match for the long-term commercial loans. They were also a primary source of residential loans during the postwar boom and were looking for new ways to diversify as savings-and-loans were taking over the residential market. These lenders helped to shape the tenancies and retail for decades through their desire to minimize risk. They would typically require that the entire debt service be covered by triple-A tenants and this led to many centers being filled with up to 85% of national chains.[29] These underwriting requirements encouraged chains and left little room for independent shopkeepers.

During the 50's and 60's, the balance of power shifted to these large chains and since they controlled negotiations, they positioned themselves for expansion and consolidation. Many large department stores began buying up family-owned emporiums to expand their market share. In addition, department store credit cards became one of the only forms of retail credit for customers and were a creative way to ensure customer loyalty. As powerhouses like Allied and May Department Stores grew, the Federal Trade Commission (FTC) began to scrutinize the industry and intervened to ban mergers and acquisitions without their consent.[30] As a result, instead of promoting horizontal growth, the department stores focused on expansion plans for major divisions that created the boom of shopping centers to avoid FTC rules.

Between 1950 and 1980, the population of the suburbs nearly tripled with the addition of more than 60 million people.[31] Coupled with the new tools like zip code analysis, historical performance data, and other marketing techniques, this allowed retailers to cater to the changing preferences of the Baby Boomers, the 76 million children born between 1946 and 1964.[32] These new customers rejected the mass marketed products of their parents' generation and demanded differentiated products that created new niches in the marketplace. Once bank credit cards became available in the mid-1960's, the department store powerhouses began to experience an erosion of their consumer base to specialty stores.[33] Pioneered by E.J Korvette in 1948, discount stores such as Woolworth's, Target, J.C. Penney, Walton's and K-Mart were increasing in popularity as well.[34] Expansion of these stores was spurred by the repeal of trade laws prohibiting the sale of goods below the manufacturer's fixed price. By 1970, their sales of $24.2 billion overtook the $16 billion annual sales of the department stores.[35]

In Baltimore, the 1950's was a period when the character of construction in the suburbs changed. By 1951, construction of inexpensive housing and garden apartments came to a halt and a second post-war boom occurred that built larger and more expensive homes.[36] One major reason for the expansion of the suburbs was the constructions of 15 major highways in Maryland that serviced all of the major suburban areas.

The highways gave suburbanites easier access to jobs in the city and increased land values, but “ripped through the hearts of downtown areas, displacing thousands of city dwellers”.[37] During the 1950’s and 1960’s the city was also the site of civil rights demonstrations for integration in schools and public places. In 1968, after the assassination of Martin Luther King, Jr., Baltimore was the site of race riots. By the late 1960s, Baltimore's inner city was as financially depressed as it had been during the Depression because of a ‘suburban flight’ out of the inner city.[38]

The 1970’s

The 1970’s brought about more changes to the retail shopping center. Many of the retail concepts were refined over the years since and developers responded to the new expectations of consumers. Consumers were demanding a greater attention to design, landscaping, barriers and fencing, and improved roadway access. Developers responded to these requests and invented new concepts, like the food court, to keep customers shopping for longer periods of time. A study by Centermation Systems showed that of shoppers in malls with food courts, the mean level of expenditure was 22% higher than those without food courts.[39]

As the suburbs contended with the effects of its rapid growth, all types of development came under increased scrutiny and regulation by local and state governments. Many governments that would have previously funded road improvements, water or sewage infrastructure, or traffic signals were now assessing impact fees on the developers. Broader economic conditions, such as the energy crisis of 1973 that necessitated increased insulation and automated HVAC systems, also increased the cost of development. Other changes, like the Employee Retirement and Income Security Act of 1973 which mandated that pension funds diversify their holding beyond stocks and bonds, provided new conduits for capital.[40] With an underwriting record over 20 years long now, lenders themselves started to take up to 50% ownership stakes in their investment properties.[41] It was a pivotal point in the industry’s evolution where ownership had passed from entrepreneurial to institutional.

The 1980's

The 1980's saw a proliferation of growth in neighborhood shopping centers less than 100,000 square feet. By the end of the decade, the number of centers grew 65% from 22,100 to 36,500 and represented 85% of new construction in the industry.[42] The growth was largely due the 1981 Economic Recovery Tax Act of the Reagan Administration that liberalized depreciation rules and offered tax benefits to outside investors.[43] Investors with no prior experienced flooded the market and the rate of new development began to outpace demand. New entrants still perceived shopping centers as a prime investment and savings and loans (S&L's) poured capital into the market after their industry was deregulated. Underwriting standards were lowered and lender requirements were waived which paved the way for overbuilding and the S&L crisis. The Tax Act of 1986, which took away the favorable tax benefits of commercial real estate also contributed to the S&L crisis.

One benefit of the boom was refocused efforts on redeveloping downtown shopping centers. Local governments invited developers to join them as partners in bringing retail back to urban sites since financial obstacles such as expensive parking structures and higher security costs made projects less attractive. Some centers were built from scratch and others, like the Union Station in Washington, DC, took old properties and adapted their use into a unique retail experience.

As many shopping centers were trying to distinguish themselves in an increasingly price-oriented market, the department store stalwarts were faltering. New competition from outlet stores, or mills, was reshaping consumer perception of value. Department stores tried to rely on sales and promotions that eroded the credibility of their pricing.[44] Specialty stores with product development departments could bring the newest fashions to the market at a cheaper price. More women were entering the workforce and that meant less spending time from the primary shopper. In response, department stores fell back into their traditional role of selling apparel and lost their appeal when they abandoned whole categories of goods like white, brown, and yard goods. With department stores' power diminished, the FTC did not object to their mergers anymore. Department store bankruptcy and consolidation escalated in the1980's.[45] Many developers were left with large spaces of empty retail, during a time of decreased spending, and a shrinking number of retailers to fill the vacuum.

In the 1970's and 1980's people continued to move to the suburbs surrounding Baltimore. From 1960 to 1980 the city's population dropped by 16 percent.[46] In response, the city started redevelopment projects to revitalize areas such as the Inner Harbor. The Inner Harbor became home to Harborplace, an area of shops and restaurants, developed by the Rouse Company in 1980 and to the National Aquarium the following year. In 1992 the Oriole Park at Camden Yards, where the Baltimore Orioles professional baseball team plays, opened in downtown Baltimore.

The 1990's

The United States started the 1990's in a recession after a collapse of the savings and loan associations. Lenders tightened their underwriting requirements and new center development dropped 70% between 1989 and 1993, from 1,510 construction starts to 451.[47] Many lenders were demanding 25% equity, when they had typically financed 100% of the deal. Many developers converted their firms into real estate investment trusts (REITS) to access the public market as a new source of capital.[48] Developers were also realizing that the market was saturated and "recognized that is was no longer going to be a market of development, but of acquisition, and they needed large pools of capital to participate in the acquisition process," remarked John Bucksbaum, the former CEO of General Growth.[49] Mergers and acquisitions were the hallmark of the 90's for the industry and changed it from a group of pioneering private developers into a handful of large public companies. Some charge that is has made the industry more risk adverse and too reliant on earnings to allow for reinvestment into properties and communities.[50]

Greater access to capital has allowed more centers to be renovated to avoid obsolescence. Many developers began to renovate, remodel, and reposition their mature shopping centers. They understood that retail is a changing business and shopping centers must continuously refine themselves to adapt to the changes in retail trends, consumer base, the market, and competition. Re-use was also a new strategy because according to historian James Hughes, "Old forms become obsolete and are replaced by new ones that are generally more efficient, but the land is very valuable and is usually re-used in some fashion. Abandoned retail facilities ultimately are reinvented."[51]

The 90's also saw a shift in consumer buying trends from purchasing things to purchasing experiences. The industry also saw the emergence of "cocooning", a trend that sees individuals socializing less and retreating into their home more.[52] Revenue was up in stores like Crate & Barrel, Pottery Barn, and the Body Shop. Consumers were also spending less time shopping and wanted faster, more convenient trips to the mall, so physical layouts were changed to cluster store selling similar goods. Malls also tried a new strategy by offering amenities like valet parking, parcel drop-off sites, family rest rooms, nursing lounges, and free strollers to attract customers.

For mission-oriented shoppers in a hurry, the mall still could not compete with the curbside parking that streamlined shopping trips and there was a comeback for smaller spaces closer to buyers' neighborhoods. Many shopping centers responded with attempts to re-create the atmosphere of an old-town Main Street, with varying levels of success. Power centers with category-killers, like Kohl's, BJ's, Best Buy and Home Depot emerged onto the scene and in the early 1990's their growth eclipsed the regional malls.[53] They often clustered around regional malls to capture the largest share of the market and began draining mall sales.

Modern Period

As developers were still repositioning themselves to meet the divergent needs of consumers, e-commerce provided a new, more flexible shopping experience. Although lacking in its ability to provide a sensory experience, internet shopping provided more convenience and allowed customers to price-shop from their homes. Interestingly enough, internet shopping and retail stores have become complementary to one another, primarily due to multi-channel shoppers.[54] Multi-channel shoppers use a variety of methods such as catalogs, brick and mortar stores, and the internet to purchase items. According to a 2000 study by the National Retail Federation, J.C. Williams Group, and BizRate.com, almost 60% of online shoppers and more than two-thirds of catalog shoppers have also purchased items from the merchant's store.[55] Now a new type of consumer, the multi-channel, is being marketed in addition to the traditional single-channel.

The success or failure of a center depends upon its ability to reinvent the retail mix in response to an ever accelerating retail lifecycle. Trends and fashion are changing at warp speeds and many retail stalwarts and retail chains, unable to adjust rapidly to change, filed for bankruptcy in the 1990's and early 2000's.[56] Examples include Zayre, Ames, Bradlees, Hechinger, McCrory's and a number of large chains operating smaller format stores, such as Merry-Go-Round, Pic-N-Pay Shoes and Kinney Shoes. The process of attrition and renewal is an integral part of retail, so developers began to lease to service-oriented tenant and redefined their ideas of tenants to include medical facilities, fitness center, postal branches, libraries, and museums. They also tried to create a shopping experience and sought distinction through entertainment attractions and architecture. Two alfresco types emerged as well: the lifestyle center, with upscale specialty tenants, targeting high-income shoppers; and the hybrid center, a combination of a mall and strip center.[57]

One of the newest ways for an old shopping site to remake itself is the mixed-use center. A combination of office, retail, and residential, the mixed use concept sits well with those who are concerned about sprawl, energy conservation, and traffic congestion. The marriage of diversity and high-density living makes sense to developers, city planners, and the community. It offers yet another way to meet the varied and multi-faceted needs of a continuously changing consumer base.

Shopping centers have traditionally served as the point of connection between people and their communities, as they come together to meet basic daily needs. The current economic downturn is reminding us of our interconnectedness and our dependence upon one another for survival. Just as individuals adapt to the currents of change that are sweeping through their lives, so too will shopping centers continue to adapt and reshape themselves to this new environment. Cohen astutely remarks, "Growing together, lenders, developers, and retailers wove an intricate web of working relationships, each strand depending upon but also strengthening the other."

Conclusions

The growth of our modern-day suburbs was facilitated by the development of zoning laws, redlining, and various innovations in transport. Advances in methods of transportation such as automobiles, electric railways, and the Interstate Highway System allowed for greater distances between people's home and work. The economic boom following World War II caused rapid growth in the suburbs as relatively inexpensive housing was needed for returning veterans and baby boomers. The government encouraged movement out of the cities by making it cheaper to construct homes in the suburbs through FHA programs. As cities grew and expanded into suburbia, the need to deliver goods and services to new communities followed. Simply put, retail follows the population.

Most vital to the retail industry now is the financial health of consumers and there is a confluence of negative factors impacting purchasing power. Consumers have been on a buying binge but have curtailed shopping because of the US housing slump, tightened credit markets, increased rates of unemployment, and loss of financial security in the their investment portfolios. Debt-to-disposable income levels have risen from 70% in the early 90's to 140% in 2008.[58] As home price depreciation is nearly 30% and mortgage equity withdraw is collapsing, consumers cannot obtain equity from their homes anymore.[59] The unemployment rate is at its highest level since 1984 and job losses are accelerating.[60] Real wage growth and real income growth have been stagnant and consumer confidence has plunged to a record low of 25.[61] The U.S. economy's contraction in the fourth quarter was the biggest since 1982, according to the Commerce Department. Consumer spending for the fourth quarter dropped at a 4.3 percent rate, the most since 1980.[62] Economists are forecasting that the current recession could be the worst in seven decades and the rippling effects on global economies are staggering. This is one byproduct of globalization that is causing many companies to retreat to their homelands.[63] When the economy does emerge from this recession, there will be fundamental and lasting changes to consumer buying and the retail industry.

IV. Current Conditions of the Retail Real Estate Market

Overview

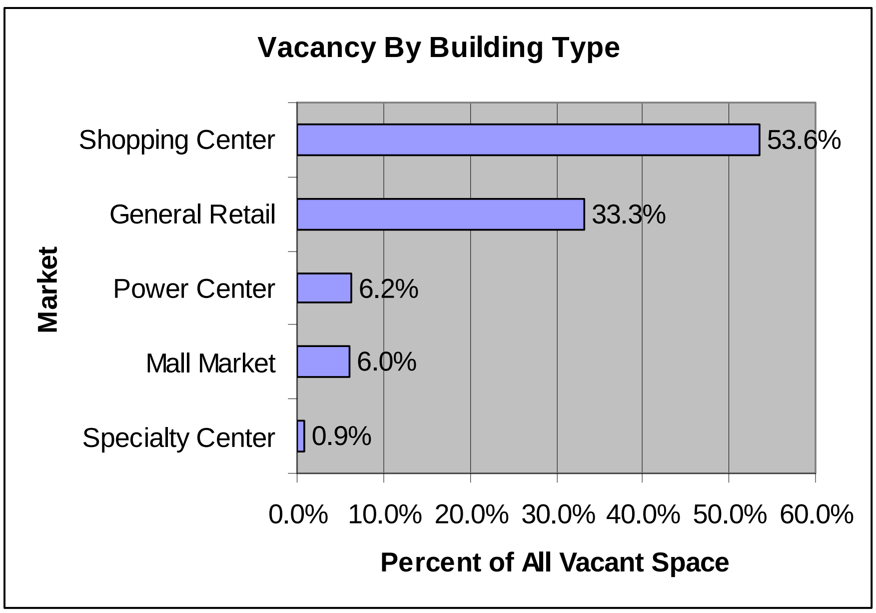
All of these market conditions will undoubtedly produce distressed retail real estate. As tenants close stores from lack of sales, vacancy rates spike and owners cannot remain solvent if their net operating income (NOI) erodes, while cap rates are rising to the point that debt obligations cannot be covered. Those owners with newer centers, in designated growth areas with higher visibility and healthier markets, are better poised to survive the downturn. Conversely, those with aging centers, already experiencing higher vacancy rates during more affluent times, may become insolvent. The values of these assets are plummeting as investors are showing little interest at previous market cap rates for acquisition when the underlying property fundamentals are weakening. Property values are already down 20% to 30% from their peaks and property sales activity has stalled as buyers and sellers are entrenched in their negotiating positions.[64] The scope of the problem is wide and could result in another financial crisis for an already ailing economy. An evaluation of current national and local trends is needed to determine the starting point for further evaluation of the retail market.

National Trends

According to The CoStar Year-End 2008 National Retail Market Report, the condition of the U.S. retail market deteriorated slightly in the fourth quarter of 2008. The report covers 63 major markets and encompasses all property types; general retail, power centers, specialty centers, shopping centers, and malls. The average total vacancy for all markets was 6.7%, up 50 basis points from the 2007 year end with increases in each quarter of 2008. Net absorption was slightly positive in the fourth quarter bringing the total for 2008 to 68.9 million square feet. This figure is 52% less than the square footage absorbed in 2007. There was 8,535,094,837 square feet of retail inventory in 530,649 buildings and 70,824 centers at the end of 2008. The square footage at year end 2008 for projects under construction, 87,029,865 was also down by 28% over the previous year end. Asking rents also dropped 0.2% from $17.73 in the third quarter to $17.69 in the fourth, but the year end was still up 1.6% from the end of

2007. Sales activity has also diminished for 2008 when compared to the previous year. For the first three quarters, there were 1,255 retail property sales transactions with a total volume of over $10 billion and an average price per square foot of $156.36. The previous year, there were 1,962 transactions with a total volume of over $19 million and a price per square foot of $166.12. Cap rates are lowering, down to 6.48% in 2008 from 6.82% in 2007, but are anticipated to rise between 50 and 150 basis points during 2009-2010.

With the number of store closings outpacing new store openings in 2008, some statistics, such as vacancy rate, seem surprisingly low. This data, however, aggregates all retail building types and it is important to segment the information by type. Following is a chart from the CoStar report showing the vacancies across building types, shopping center, general retail, power center, mall market, and specialty center, as a percentage of all vacant space.

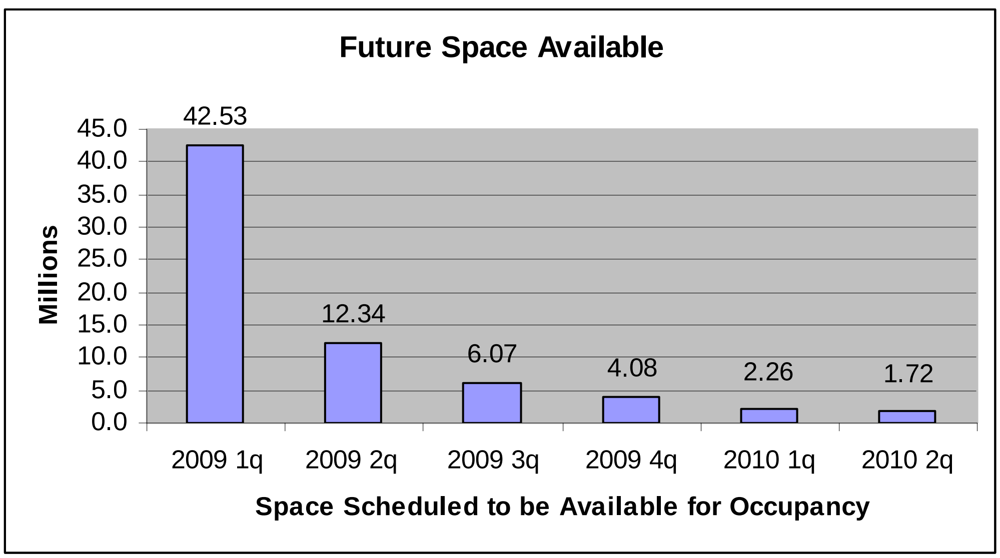


Power centers, for big box tenants, experienced the most significant deterioration in 2008. Although vacancy rates were 6.4% at the end of 2008, the rate is up 120 basis points over the previous year and average asking rents were down 10% over year-end 2007 to $20.65. Developers also reduced new construction for the year by 12% and had 24% less square footage under construction at year end.

Shopping centers are also feeling the effects of the downturn with the vacancy rate ending up 110 basis points over year-end 2007 at 9.7%. The asking rental rate increased during the first three quarters of 2008, but dipped slightly in the fourth quarter. While 54.8 million square feet of shopping center space was delivered in 2008, it is down 16% over the previous year and space under construction at year end was down about 50%.

Although not immune to the bankruptcies and closure of anchors and small shop tenants, malls and lifestyle centers ended the year with a vacancy rate of 4%, an 80 basis point increase over 2007. The average asking rental rate rose from $21.85 in the first quarter to $22.29 in the fourth quarter of 2008. Deliveries were up in 2008 by 18%, primarily due to lifestyle center construction, but signs of cancellation and delays are evident since projects under construction are down 23% over 2007 year-end.

Net absorption for 2008 was 52% less than 2007, with absorption in the fourth quarter of 10,114,222 square feet. The following table shows the amount of space available for occupancy, including space under construction. Holding vacancy rates constant, the first quarter of 2009 shows 42,53 million square feet available. With net absorption trending downward and vacancy rates on the rise, it is not inconceivable that space could be available for 12 months or longer.



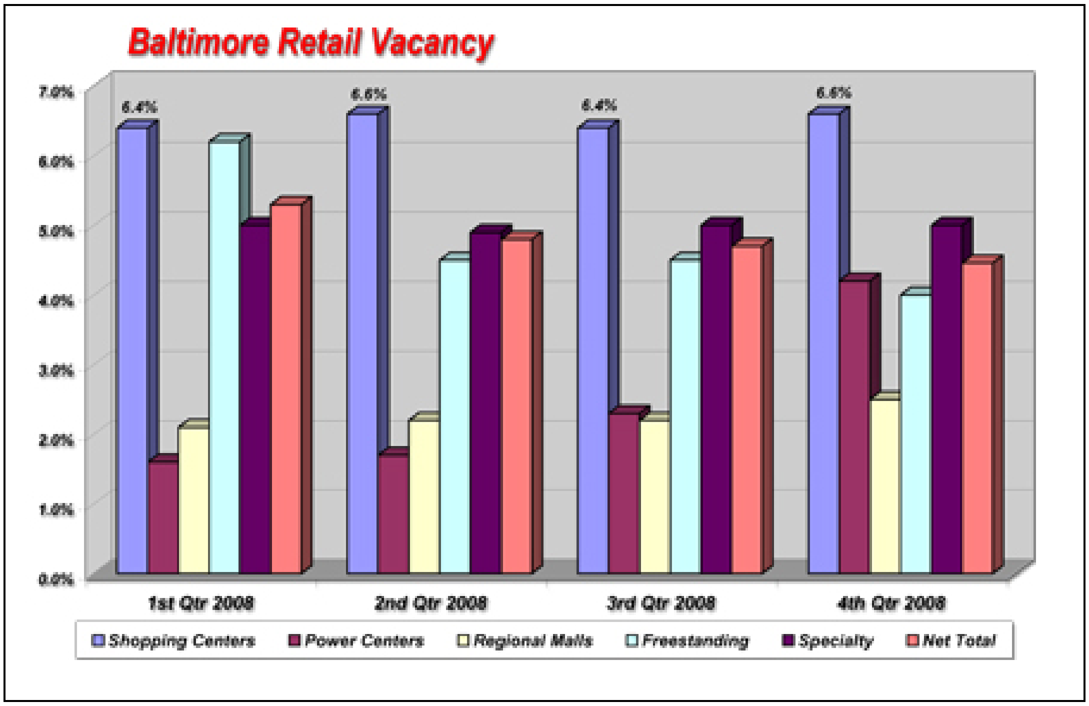
Baltimore Market Trends

Information from the CoStar Year-End 2008 Baltimore Retail Market Report shows that Baltimore has one of the lowest vacancy rates in the country and experienced strong net absorption in 2008. Vacancy remained flat over the previous quarter at 4.8% and represents a decrease from the first quarter 2008 level of 5.3%. Vacant sublease space, however, trended upward over the four quarters by 10.2%. Asking rental rates of $20.26 were up 3.55% over year-end 2007 and 0.6% over the previous quarter. Net absorption was strong with over 1.5 million square feet in 2008. New construction brought 34 new building to the market with 1,353,460 square feet of new retail space. Another 1,014,444 was under construction at the end of the year.

The shopping center market saw a slight increase in vacancy over the four quarters of 2008 starting at 6.4% and ending at 6.6%. Rental rates trended upwards, but net absorption totaled (16,262) square feet for the year.

The vacancy rates at power centers increased 220 basis points from the first quarter 2008 at 2% to the fourth quarter at 4.2%. Power centers also experienced negative absorption of (153,952) square feet and vacant sublease has increased from 4,129 square feet to 34,106 square feet for 2008. There were no new centers under construction in the fourth quarter 2008 and rental rates for this segment remained relatively flat.

General retail vacancy rates dropped from 6.5% at year-end 2007 to 4% to end 2008. Mall vacancy remained relatively flat at 2.5% and specialty centers rate improved by 20% over 2007 rates to end 2008 at 5%. Quoted rental rates for each of these sectors increased over their previous year end. Net absorption was positive for general retail and malls, while absorption for specialty centers was nil. Following is a chart of vacancy rates for all Baltimore retail segments during the four quarters in 2008.

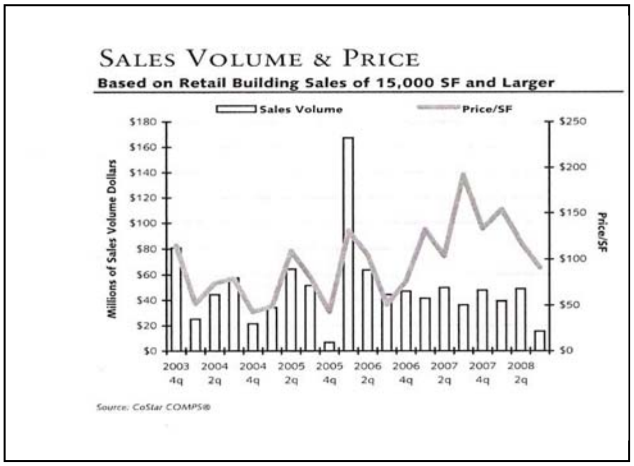


Sales Activity

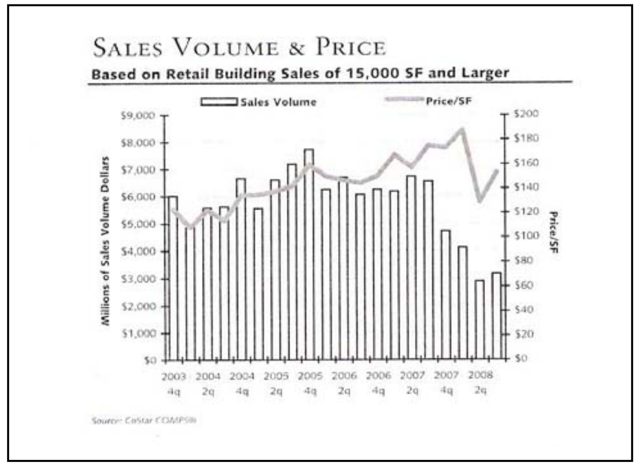
National retail center sales activity and price per square foot were down for year end 2008. During the first three quarters of 2008, there were 1,255 transactions with a total volume of $10,169,939,154 and a price per square foot average of $156.36. For the same three quarters in 2007, there were 1,962 transactions totaling $19,496,822,752 and an average price per square foot of $166.12. These figures represent a transaction reduction of 36%, volume reduction of 47.8%, and price per square foot reduction of 5.9% over the previous year. Cap rates were lower for 2008, averaging 6.48% compared to the 2007 rate of 6.82%.

Baltimore retail center sales activity and price per square foot are also down for year end 2008. During the first three quarters of 2008, there were 19 transactions with a total volume of $103,976,135 and a price per square foot average of $123.51. For the same three quarters in 2007, there were 23 transactions totaling $127,839,008 and an average price per square foot of $129.37. These figures represent a transaction reduction of 17.4%, volume reduction of 18.7%, and price per square foot reduction of 4.5% over the previous year. Cap rates were lower for 2008, averaging 4.3% compared to the 2007 rate of 7.43%. Again, this trend in the reduction of cap rates will likely be reversing in 2009 and beyond.

Baltimore



National



Future Trends and Forecasts for 2009

For 2009, over 700 commercial real estate experts surveyed by the Urban Land Institute believe that the situation will get worse before it gets better.[65] They anticipate the sector to bottom in 2009, remain at the bottom for 2010, and begin recovery in 2011.[66] Retail sales are down, consumer confidence is falling, unemployment is rising, and tightening credit markets are some of the major impediments to the markets health. The National Retail Federation is predicting sales volume to be down 2.5% during the first half of 2009 alone, as many previously stable properties may fall into distress.[67] Grubb & Ellis is also predicting that asking rental rates will decline by as much as 10% during 2009 and effective rent, which includes concessions, will continue to fall at a pronounced rate. [68] In addition, Marcus and Millichap anticipate vacancy rates for the retail sector to increase to 10.2 percent in 2009.[69]

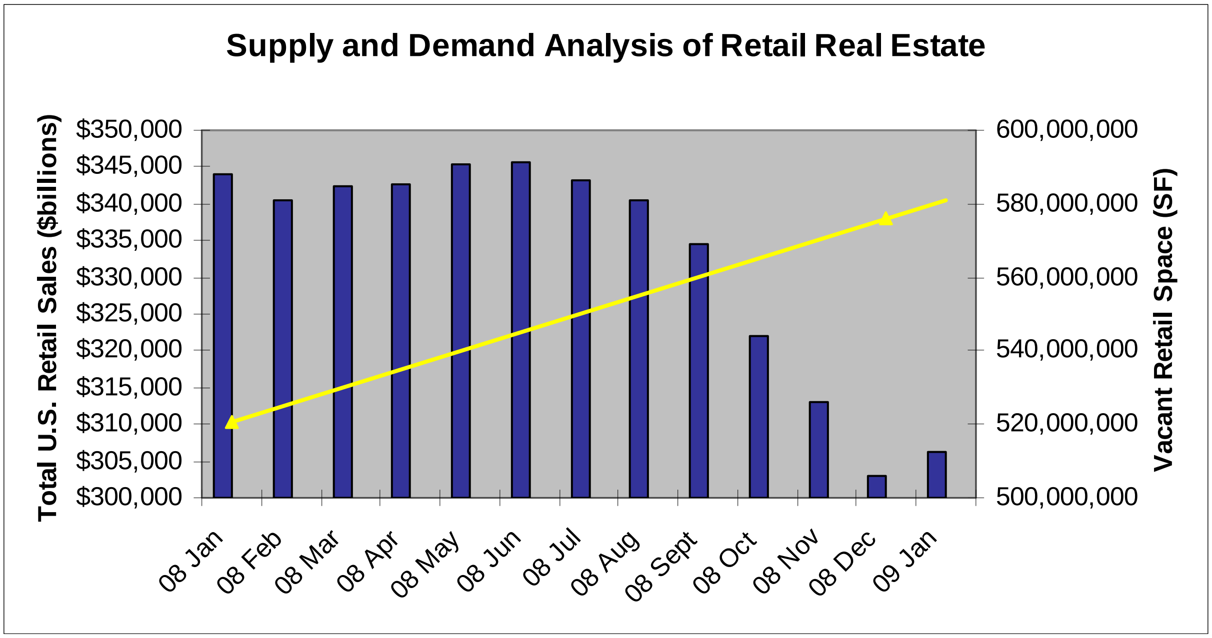
Sales activity is also expected to drag as capital constraints are impeding investment and a gap remains between bid and ask prices. Sellers are reluctant to lower their prices as buyers feel that prices are over-inflated in this deteriorating market. According to a report by Retail Traffic, cap rates are expected to increase at least 50 basis points for quality properties and 150 basis points for lesser quality properties.[70] They continued that buyers are avoiding the “middle market” properties and pursuing stressed properties where the owner is forced to sell at a discount, or “A” quality sites in top-tier locations with high-credit tenants.[71] Many aging properties that are becoming functionally obsolete are potential bargains if capital can be raised. The excess supply of retail real estate will become one of the greatest challenges over the next few years.

The Baltimore market will not be immune to the downturn, but may perform better than other regions because of it's proximity to Washington, DC and Base Realignment and Closure (BRAC) plans. Both serve as powerful stimulants to the area through the creation of new, high-income jobs that will need supporting infrastructure, housing, schools, and retail. In addition, developers did not oversupply the market and it was not until tenants like Linens 'N Things and Circuit City went bankrupt that vacancy rates began to rise, according to Thomas Maddux, principal with KLNB Retail.[72] Edward Goldmeier, vice president for retail Baltimore's Grubb & Ellis, predicts that expansion will occur in the value-oriented sector and as long as the tenants are well capitalized, they will have access to retail spaces that they previously couldn't afford.[73] The Baltimore/Washington market is not over-supplied because its barriers to entry are high. Zoned land for commercial development is scare and much of the new retail construction is actually redevelopment, rather than new GLA being added to the market. Functionally obsolete properties such as Reisterstown Road Plaza, Golden Ring Mall, Harundale Mall, have been redeveloped and are recycling GLA rather than adding to it.

V. Challenges Impacting the Supply & Demand of Retail Real Estate

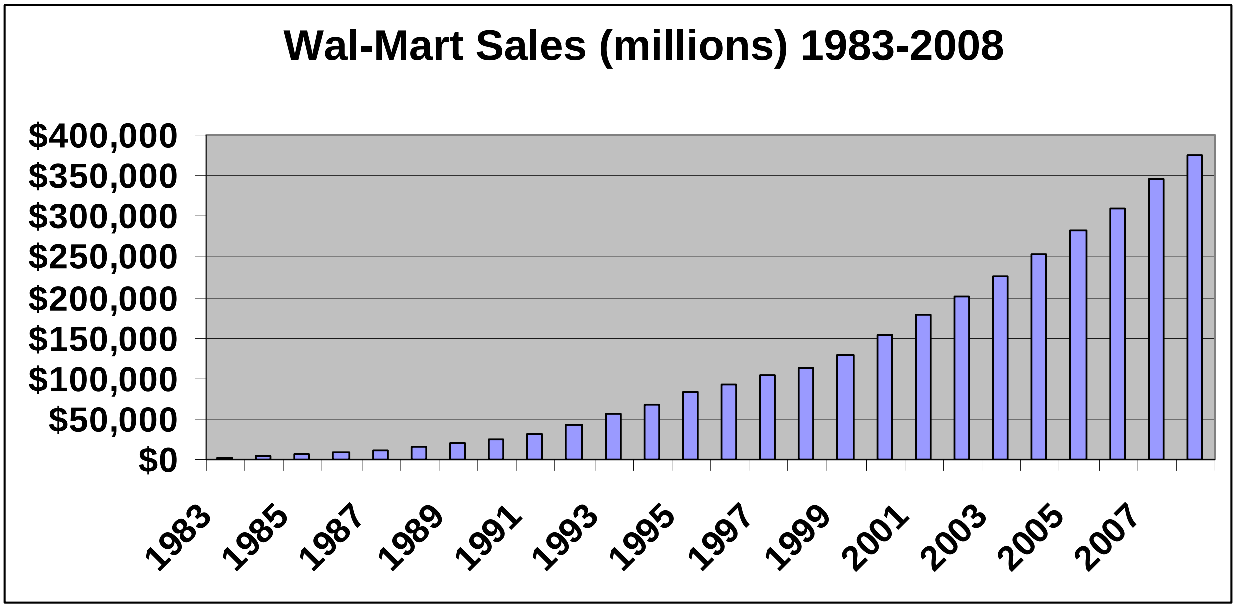
Overview

Although the current recession is the catalyst for the reduced consumers spending that has ultimately led to increased vacancy rates, reduced asking rents, and less tenants to capture, there are other challenges facing the retail real estate industry that should be explored. As discussed in the historical context section, the modern period has brought drastic changes to the primary ways in which consumers receive their goods. The increase in on-line shopping, the proliferation of mega stores like Walmart, and the expansion of grocery stores into new market segments have fundamentally changed the retail industry. Not only do these changes impact the size and type of tenants that can be secured, but they have a profound effect on supply and demand fundamentals. Following is chart that compares the amount of available supply or vacant space in square feet from Costar Year End Reports to the demand for U.S. retail sales based upon monthly Department of Commerce data. This chart clearly indicates the gap between the supply and demand of retail space that is occurring in the market. Some of this gap can be attributed to the depressed economic conditions, but there are other factors that industry professionals must consider when evaluating the causes of oversupply.

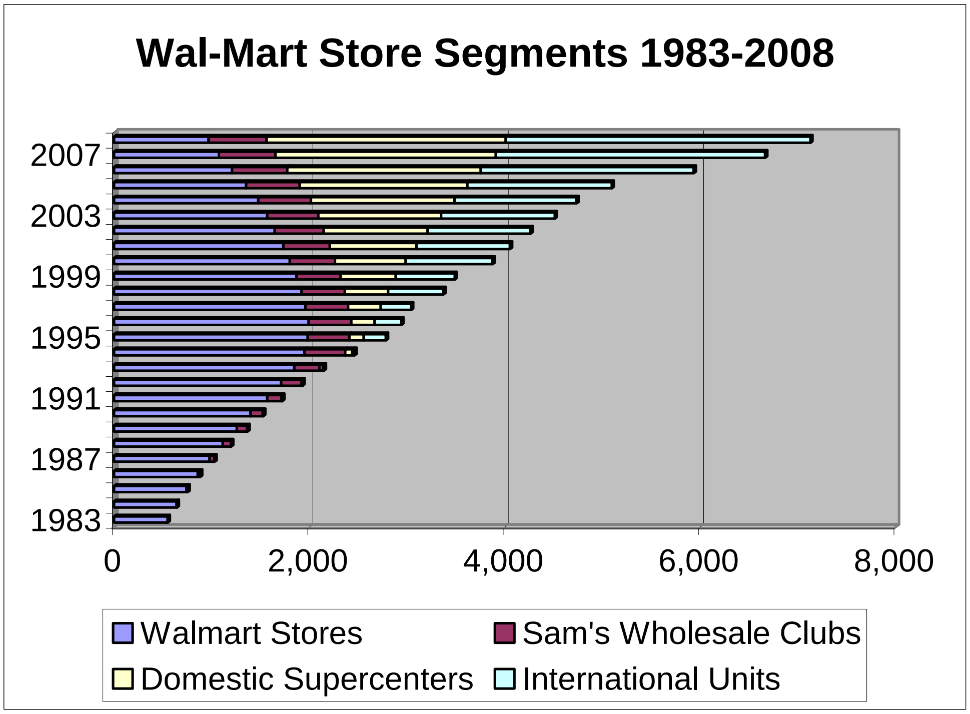


Growth of Wal-Mart

Wal-Mart has ranked at the top of the Fortune 500 list of America's largest corporations for six of the last seven years.[74] Annual revenues of Wal-Mart exceed those of behemoths like Exxon Mobil, Chevron, General Motors, General Electric, and Citigroup. If Wal-Mart was a country, its revenues would push Saudi Arabia out of the top 25 in the world.[75] Managing Wal-Mart is not unlike running a small country; it employs over two million people, more than the population of Philadelphia. It is the world's largest retailer and grocery chain by sales; accounting for 7.5% of consumers' total annual expenditures on retail goods and 21% on groceries.[76] This means that for every dollar spent on retail and groceries, 7.5 cents and 21 cents is earned by Wal-Mart, respectively. Their enormous buying power allows them to purchase products at lower prices which are passed onto consumers. Wal-Mart's annual sales have never decreased since the company's inception in 1968. The following chart shows Wal-Mart's annual sales revenue in millions for the past 25 years. (Data taken from Annual Reports from 1983 through 2008)



Over time, Wal-Mart has expanded its business segments from stores to wholesale clubs, domestic centers and international units. The following chart tracks the trend of these store segments over the past 25 years. The data shows the contraction of the traditional Wal-Mart stores, the growth and relative plateau of Sam's Wholesale Clubs, the growth of Supercenters as a replacement for traditional stores, and the expansion of its international presence. Whereas 25 years ago, Wal-Mart was solely a U.S. based company, the company now has 56% of its stores in the U.S. and 44% overseas. Both the domestic and international units have increased every year with no breaks in expansion. (Data taken from Annual Reports from 1983 through 2008)



Since Wal-Mart stores or clubs are in every major market in the U.S., they compete with a wide variety of other specialized retailers, such as grocers, toy stores, consumer electronics, sporting goods, apparel, and home décor. While they are competing for overall market share, their focus on price differentiation puts them in competition for a different consumer base. In times of economic turmoil, when markets are price-sensitive, Wal-Mart is able to capture a larger consumer base. A recent study by the Interbrand Design, a New York branding agency, names Wal-Mart as the top retail brand over Dell, Home Depot, CVS, and Coach.[77] Department stores were not on the list and this reflects the changing attitudes of consumers towards lower priced products and brand loyalty.

Some have suggested that Wal-Mart is a reverse indicator of overall GDP. In a downturn, it attracts huge numbers of people who are bargain shopping. In fact, revenue for the first quarter of fiscal year 2009 was approximately $94.1 billion, an increase of 10.2% over $85.4 billion for the first quarter of fiscal year 2008.[78] As consumer spending contracts and every dollar is critical to retailers' survival, Wal-Mart can not post such huge increases in revenue without taking market share from other retailers. Wal-Mart is careful not to over saturate U.S. markets so 78% of their growth is planned for new international stores during 2009**.**[79] They are, however, opening new

Hispanic-focused supermarkets called Super Mercado de Wal-Mart's in Phoenix and Houston to better serve these diverse communities.[80]

Due to their size, Wal-Marts impact a retail trade area significantly. They capture a large portion of the total trade area demand for general merchandise, toys, electronics, groceries, and pharmaceuticals. Smaller stores in shopping centers, malls, and strip centers cannot compete on price so they must compete based upon product differentiation, brand, or marketing. As consumers continue to reject conspicuous spending in favor of lower prices and value, Wal-Mart revenue will continue to increase and force smaller retailers out of the marketplace. This will contribute towards a greater supply of retail space. In addition, as Wal-Mart continues the trend of replacing traditional stores with supercenters, the space vacated by traditional stores will become available as well.

Growth of Internet Shopping

Forrester Research indicates that the majority of the 11% growth in online spending projected for 2009 will come at the expense of physical stores.[81] Web-based retailers like Amazon.com will be the primary beneficiaries of the $156 billion in online sales anticipated for 2009.[82] This market, which makes comparison shopping and receiving goods easier, should make up about 7% of total retail sales in 2009.[83] The growth of online shopping centers is due to the increasing use of high-speed internet connection and marketing from savvy online giants like Amazon.com. Over 100 million businesses and homes have high-speed internet which makes online shopping faster and more interactive, particularly for the growing number of U.S. workers that purchase online during work breaks.[84] Amazon.com is also a driving force in online retailing with sales revenue growing dramatically when compared to total U.S. retail sales and retail e-commerce sales (See Chart Next Page).[85] One of the

strategies that Amazon.com has so successfully deployed is e-mail marketing. The company sends e-mails to customers that offer products for every facet of a holiday or event so customers never need to leave their homes or offices to prepare for an occasion.

Online growth is expected to continue to grow and this puts pressure on the brick and mortar retail stores. The multi-channel merchants, who have both a physical and online presence, account for 48% of online purchases.[86] This suggests a complementary relationship between these two competitors but does not diminish the fact that demand for physical stores is being consumed by e-commerce. If online shopping continues to capture greater percentages of the overall retail market, expect to see an increase in supply of retail real estate. One demographic that will impact the growth of online sales is the time-stressed baby boomers that like shopping online and having items delivered to their homes.

Technology is also contributing to changes in the way that traditional goods like books, music, and movies are delivered to the marketplace. The advent of the mp3 music player, handheld video devices, and electronic books are replacing consumer trips to the book, music, and video stores. With iPods and Kindles, consumers can download their desired product online without ever leaving their home or office. This highly efficient delivery method may eventually lead to the partial obsolescence of traditional stores. Therefore, the supply of retail space in these categories can be expected to increase as well.

Changing Nature of Grocery Stores

During economic downturns, grocery stores remain relatively stable because the demand for food is not highly sensitive to these changes. In fact, food accounts for less than one tenth of a family's disposable income, so cutbacks during downturns are usually taken from discretionary spending instead.[87] Thus, their impact on the supply side of retail real estate is derived from different sources. Grocery stores have traditionally sold produce, fresh meats, canned or packaged goods, and some non-perishables. Over the years, they have added health and beauty sections, seafood, and bakery departments. More recently, they have broadened the scope of their services not usually performed by grocery stores such as pharmacies, postal service areas, film processing, video rentals, banks, coffee shops, and catering services. Over the past few decades, stores have grown is size from approximately 30,000 square feet in the 1970's to about 85,000 square feet in recent years.[88] They have also served as anchors for shopping centers for decades and have acquired considerable advantages when structuring lease deals. Because of their larger size and ability to sign long term leases, they seek protective risk management terms that limit owners' ability to tenant in-line space. To support the sales per square foot, grocery stores seek extensive use clauses, radius restrictions, and non-compete language. Since these terms are rarely negotiable, they present a challenge to owners by way of reducing the tenant pool that can lease smaller spaces adjacent to the grocery store.

Another challenge facing owners with grocery store anchors is the increasing competition from warehouse club stores, supercenters, like Walmart, and niche food stores. Supercenters are becoming some of the largest food sellers and Walmart outsells its nearest competitor in the grocery category by almost 2 to 1.[89] Consumers are increasingly attracted to the one-stop shopping experience combined with lower priced merchandise. The niche food stores, catering to certain ethnicities or food-growing methods like organic, are growing at a rapid pace.[90] These competitors are reflective of the shifting demands from consumers that can impact traditional grocery store anchors. As a result, after 20 years of steady growth, the median size of a grocery store dropped slightly in 2007 to 47,500 square feet.[91] This upends a long-running trend in the grocery business and could signal a desire for smaller stores in the future.

Due to restrictive leasing terms from expanding in-store services and competition from supercenters and niche stores, grocery stores can cause increases in retail real estate supply. The increase is currently caused by a smaller in-line tenant pool and potentially from larger grocery stores seeking to downsize.

VI. Economic Impact of Failing Retail Sites – Ripple Effect

Overview

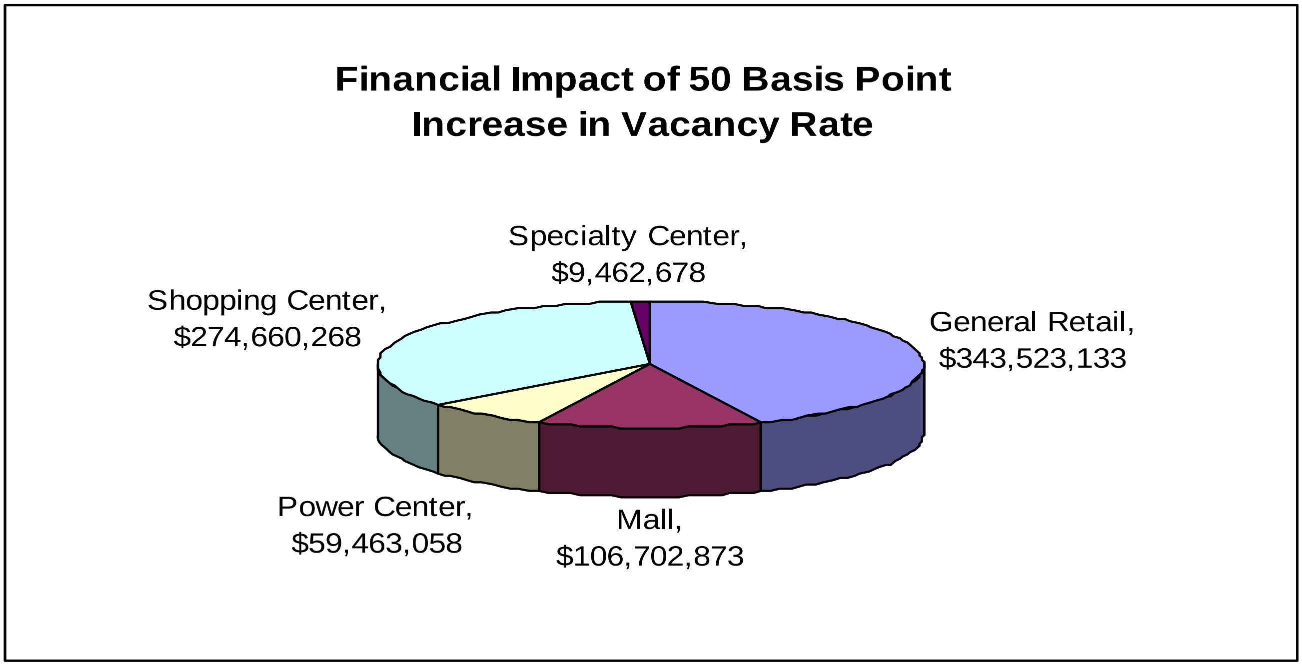
Data from a recent research study by Madison Marquette, in conjunction with CoStar, reported that of the 8.5 billion square feet of retail real estate assets in US markets, over 576 million square feet of space is currently vacant.[92] The velocity at which vacancies have increased over the past year in certain markets is cause for concern and all projections indicate further erosion of the retail sector. This downturn impacts everyone from the owner, lender, tenant, community, state and local government, and the capital markets.

Property owners, finding it difficult to refinance existing properties, are trying to maximize their investments by strengthening occupancy, but tenants are leaving the marketplace. Owners are experiencing lower rental rates, loss of percentage rent, higher vacancies, risk of loan default, lower property valuation, inability to access capital, and possibly exposure to bankruptcy. Lenders, which are operating under stricter underwriting standards are not releasing debt and this is exacerbating the situation. When owners default, lenders are subject to bankruptcy court “cram downs”, or court-ordered reduction of the balance due, and they run the risk of becoming unwilling property owners. From the tenants’ side, vacancies cause less traffic in shopping centers and they cannot access small business loans or commit equity towards tenant improvements. The community also begins to feel the impact as centers become blighted and they respond by changing their shopping habits, which perpetuates the cycle. State and local government stand to lose sales and property tax revenues. Finally, because of a loss of confidence in collateralized debt obligation (CDO) rating agencies, investors have drastically reduced investment in commercial mortgage-backed securities (CMBS). CMBS valves have dropped amid concern that defaults on office and retail properties will continue to rise. The significance of the problem is immense and has ramifications for many within and beyond the real estate industry.

Owner

The most significant impact to owners from the economic downturn is the loss of base and percentage rent from vacancies. Higher vacancy rates are now shifting power to tenants who are looking for concessions and lower rental rates. Forced to have some revenue stream for their properties, deals are struck which cause fundamental changes to NOI predictions and property value. For distressed or over-leveraged properties, the inability to access capital to restructure debt is life-threatening. A recent example is General Growth Properties, the second-biggest owner of US shopping malls. They have missed several deadlines to repay its debts and have declared bankruptcy due to a lack of borrowing capacity and poor cash flows.[93] Combined with lower property valuation and reduced sales activity, owners may not be able get out from under distressed properties through their sale.

As noted in the future trends section, vacancy rates are anticipated to rise by a minimum of 50 basis points. Across all retail categories – general retail, mall, power center, shopping center, and specialty center – each basis point increase equates to over 42 million square feet of vacancy and a financial loss of nearly $800 million, on a monthly basis. Data was taken from the CoStar Year-End 2008 National Retail Report using total gross leasable area (GLA), vacancy percentage, and average quoted rental rates for each retail category. The vacancy rates were increased by 50 basis points and the change in square footage vacancy and, holding rental rates constant, total dollar impact to the sector. These are generalizations, though, applied to the entire national market. Certain parts of the country may experience results that could be much worse or better performing than the national average.



In addition to these known losses based upon vacancy, there is additional financial loss that is not reported in any market. Nowhere are cash losses from lost collections, forgiven rent, or rental rate reductions indicated since income statement don't show receivables. There is a difference between the loss of asset value and loss of cash flow when compared to the asset gross potential that is not quantified in the industry but is, nevertheless, a very real loss. Also, many tenants are not paying, so receivables are piling up on developers balance sheets, hurting property values. Again, this does not show as vacancy, though it may turn to that at some point. While increases in vacancy are reported, the true loss of vacancy, concession, and collection losses could all be rising and masking the true depth of the loss for a property. This represents a true challenge to owners and investors when evaluating the value of an asset, its potential, and its current operating performance.

Real Estate Investment Trusts (REIT)

Although the occupancy rates of retail REIT portfolios outperformed the national average for 2008, their operating results for year-end 2008 were down.[94] Cancellations or delay of projects, lease terminations, declining rental income, and lower property values contributed to a 17% reduction in the funds from operations (FFO) over the previous year end.[95] "The fundamental earnings of REITs are less volatile than those of other companies. However, the volatility of their stock prices has risen to being very close to that of the general market," says Glenn Mueller, a professor at the University of Denver and a real estate investment strategist with Dividend Capital Group.[96] "While REITs have not been as volatile as the general stock market historically, the introduction of derivatives and hedging of REIT stocks has increased their price volatility in the past few years, just as they have done to the rest of the stock market."[97]

REITs are also being affected by impairment charges for development-related abandonment and severance activities. If increased impairment charges reduce equity to levels that trigger technical loan defaults, this could severely impact a REIT's ability to obtain additional financing. Moreover, the weighted average cost of capital for REITs will increase by an average by 100-200 basis points, to 7-8% all-in, according to Goldman Sachs.[98] Since REITs depend upon leverage, increases to the cost of capital lower asset values and reduce their ability to refinance their own debt.

To recapitalize their balance sheets and conserve cash, many REITs are paying 2009 in stock rather than dividends.[99] REITs have an obligation to distribute at least 90% of taxable income to shareholders. As REIT stock values continue to decline, expect them to use this strategy more as the downturn progresses. By issuing stock dividends, share value is being diluted and the volatility of this traditionally low-risk investment vehicle is increasing to general market levels. It is uncertain whether this change in volatility is permanent or transitory.

Lender

The situation for lenders is already dire from the residential mortgage crisis and defaults on commercial mortgages are trending upwards as well. Delinquency rates in all commercial mortgages sectors, including office, industrial, hotels, retail, and multifamily have spiked dramatically in the third and fourth quarters of 2008 and are likely to soar through 2010.[100] The following chart, by istockanalyst.com on 01/15/09, shows the delinquency rates for each sector in comparison to the overall rate for commercial property.

When owners default and bankruptcy looms, a process now being considered for residential loans, called a cram-down often occurs. A cram-down is when a judge modifies a loan by reducing the principal to a level of affordability for the borrower. Lenders do not have a choice and must absorb the loss or run the risk of becoming unwilling property owners. If cram-downs increase and bank losses mount, new projects or refinances would bring additional risk and could possibly result in fewer and more expensive loans.

Lenders are also tightening their underwriting standards in reaction to growing defaults and adverse market trends. Cash flow is paramount to underwriting commercial loans and if owners cannot meet the debt coverage ratio (DCR) requirements, then loans cannot be made. Falling property values and loan to value amounts convert into smaller loans. With borrowers personal and business credit worthiness deteriorating and coming under increased scrutiny, lenders will have a difficult time writing the loans that the market needs to maintain its health.

Tenant

The theme threaded throughout this discussion is drop in consumer spending and the impact on retailers. With store closings projected at staggering rates, the current economic downturn will produce a Darwinian “survival of the fittest” in retail. Most assuredly, some tenants will fail and if unable to sublease, they may be subject to financial penalties to break their leases. For those few who are expanding or repositioning themselves, they don’t have the cash to afford the tenant improvements.

In addition, for shopping centers based upon complementary stores, less consumer traffic is deadly and will perpetuate the downturn.

Conversely, tenants are now in a position to negotiate more favorable leasing deals as property owners scramble to fill vacancies. Previously unattainable locations are becoming available and may allow these tenants to have higher visibility, newer space, and lower rents.

Property Management/Vendors

The services that support shopping centers, mainly provided by property management will be impacted by owner loss of revenue. The main source of income for property management companies is a fixed percentage per month from property owners. The economic situation has dwindled this income considerably as rents and property values fall and foreclosures are hitting investors at every level. Many owners have also started managing their properties themselves as a cost cutting measure, sidelining the services of the property management company.

These property management companies, in turn, pay landscaping, waste removal, cleaning, snow removal, and maintenance companies to service their properties. If budgets are contracting, these companies may see their services reduced or eliminated. On the other hand, these companies could see an increase in work as centers try to undergo cosmetic renovations to differentiate themselves in an effort to entice customers.

State/Local Government

With the continued erosion of consumer confidence and spending levels, the immensity of the current downturn is dire for retail. Over 150,000 stores are expected to close this year that will result in a steep decline of state and local sales tax revenue.[101] For example, the average mall can sell $300 million which when taxed at the national average of 6%, yields significant revenue to state and local budgets.[102] With the reduction in revenue come difficult decisions to cut funding for schools, police, fire, public transportation, and infrastructure.

Real estate taxes may also contribute to a reduction in taxes. As property values fall, many owners may file petitions for reassessment of their taxable base to reduce their overall tax burden. With sales activity stagnant, counties and cities will lose on transfer and recordation taxes. In Maryland, real estate taxation – property tax, transfer tax, and recordation tax generates nearly half of county and city budgets. The real estate industry, which includes real estate, finance, construction, and insurance sectors, contributes 23% of the state's gross state product and represents 18% of total state jobs.[103]

Community

Communities will also suffer from the boom of retail as centers become vacant and can begin to feel blighted. Many cities and counties had their dreams pinned to areas of revitalization or new town center plans. These plans must be put on hold until budgets stabilize and capital is flowing again. Consumers will respond to vacant centers with changes in their shopping habits and will continue to search out value-oriented stores. Again, a decline in county or city revenue will also translate into funding reductions for schools, police, fire, and other services that communities depend upon.

Capital Markets

Rising default rates and declining property values have moved from the housing market to the commercial real estate market, hammering the value of bonds backed by loans made to office buildings, shopping centers, and apartment complexes. With the slowing economy threatening the health of commercial borrowers, investors are wary of buying the bonds, even though some cash-strapped banks, hedge funds and money managers are willing to sell them at steep discounts. As a result, the market for commercial-mortgage-backed securities (CMBS) has been sent into a tailspin by the combination of forced selling and bleak economic forecasts.

Until recently, investors had presumed that commercial-mortgage bonds were relatively safe. They avoided taking a direct hit from the sub-prime meltdown, which derailed the market for bonds backed by residential mortgages, and the bonds' default rate, while climbing, has stayed below 1 percent.[104]

Reports about delinquent payments on high-profile loans stirred fears about whether an era of rosy business projections and loose lending standards will, like the residential market, give way to missed mortgage payments and a tough refinancing environment. "A lot of very foolish loans were originated between 2005 and 2007, and many of those loans begin to mature in 2010," said Mike Kirby, director of research at Green Street Advisors, a commercial real estate research firm. "You have a significant amount of debt maturing at that time and yet you don't have a market to replace that debt."[105] Adding to the panic is a spate of recent bankruptcy filings by high-profile merchants such as Circuit City. Dimming prospects for consumer spending in a slowing economy has stirred concern about the value of commercial-mortgage bonds tied to properties dependent on retail tenants.

VII. Methods to Reposition or Improve Properties

Overview

The causes are varied: absentee landlords, shifting demographics, bankruptcies, and the passage of time. Whatever the reason, obsolete shopping centers can be found in many first tier suburbs. According to the National League of Cities, these centers with old facades, high vacancies, and crumbling blacktop are just beyond central cities but still within the developing suburbs. Much of this real estate, built decades ago, are underperforming as development has spread beyond this first tier, anchors have vacated, and newer centers make stiff competitors. According to the ICSC, by 2006, over 45% of small neighborhood and community centers were at least 20 years old.[106] The current rule of thumb is that a center needs to be refurbished every 10 years, but many of these centers are sold when their marginal utility has peaked. Re-development, renovations, change of use, and leasing terms are all traditional methods that developers can use to reposition their retail centers. Some of the alternatives, such as renovation, re-development, or a mixed-use approach assume that there is demand in the market for this retail space. Other options, such as change of use, donations, and build-to-suit are effective when demand is lacking. Finally, cost reduction strategies through energy efficiency programs, sustainability retrofit, and negotiations with tenants are valuable tools to incorporate into management during any market conditions.

When Demand For Retail Exists: Renovate, Re-Develop, or Try Mixed-Use

Renovation and Re-development of Center

It is a constant in the industry that traditional shopping centers and malls are renovated or re-developed to either accommodate the changing needs of consumers or to breathe new life into functionally obsolete properties. These centers are focusing on reconfiguring the number and sizes of tenant spaces that support the highest and best use of the site when demand is present. The typical guidelines for the general operating characteristics of shopping centers are listed below as defined by the International Council of Shopping Centers. The information on site size, number of anchors, anchor rations, and merchandizing concepts serve as guides for renovation and re-development of older properties that do not fit into one of these generally defined categories.

International Council of Shopping Centers SHOPPING CENTER DEFINITIONS - U.S.

Type of Shopping Center	Concept	Square Feet (Including Anchors)	Acreage	Typical Anchor(s) Number	Typical Anchor(s) Type	Anchor Ratio	Primary Trade Area
MALLS							
Regional Center	General merchandise; fashion (mall typically enclosed)	400,000-800,000	40-100	2 or more	Full-line department store; jr department store; mass merchant; discount department store; fashion apparel	50-70%	5-15 miles
Superregional Center	Similar to regional cener but has more variety and assortment	800,000+	60-120	3 or more	Full-line department store; jr department store; mass merchant; fashion apparel	50-70%	5-25 miles
OPEN-AIR CENTERS							
Neighborhood Center	Convenience	30,000-150,000	3-15	1 or more	Supermarket	30-50%	3 miles
Community Center	General merchandise; convenience	100,000-350,000	10-40	2 or more	Discount department store; supermarket; drug; home improvement; large specialty/discount apparel	40-60%	3-6 miles
Lifestyle Center	Upscale national chain specialty stores; dining and entertainment in outdoor setting	Typically 150,000-500,000 but can be smaller or larger	10-40	0-2	Not usually anchored in the traditional sense but may include book store; other large-format specialty retailers; multi-plex cinema; small department store	0-50%	8-12 miles
Power Center	Category-dominant anchors; few small tenants	250,000-600,000	25-80	3 or more	Category-killer; home improvement; discount department store; warehouse club; off-price	75-90%	5-10 miles
Theme/Festival Center	Leisure; tourist-oriented; retail and service	80,000-250,000	5-20	N/A	Restaurants; entertainment	N/A	N/A
Outlet Center	Manufacturer's outlet stores	50,000-400,000	10-50	N/A	Manufacturers' outlet stores	N/A	25-75 miles

New categories of shopping centers will continue to emerge and some, like malls, are attempting a hybrid approach that combines the best of enclosed and open-air centers. After 50 years of building malls across the country, older, low-performing malls began failing in the 1990's and new construction peaked in 2000.[107] Not only are malls bringing in entertainment, offering more restaurants, and providing new outdoor plazas, some are considering upgrading to cost intensive retractable roofs. Retractable roofs offer the open-air shopping experience that many customers now prefer while providing the option of protection from bad weather elements like heat, rain, or snow. These roofs fit well with projects designed to conform to Leadership in energy and Environmental Design (LEED) standards since heating and cooling costs are reduced when the climate is temperate and the roof is open.

Cosmetic or Phased Renovations

Another option is to invest in cosmetic renovations, such as new lighting, signage, landscaping features, and façade upgrades to attract tenants to the center. Due to equity constraints, development plans can be phased on larger sites and no speculative renovation should occur. These changes are only temporary, and can mask the fundamental deficits of a property. Their value, however, is in improving the short term environment as a low-cost method for site renovation that creates new energy and focuses fresh attention on the center until additional capital for major renovations can be secured at a future date.

Mixed Use Approach

A mixed-use approach of offering any combination of retail, office, residential is another re-development option that can maximize the full economic fall of the underlying land. After working on several mixed-use projects across the country, Yaromir Steiner, CEO of Steiner & Associates told Shopping Centers Today (SCT) that "Mixed-use development is as old as the history of urban settlement. Thus, America's 70-year pursuit of the single-use, zoned development that is responsible for sprawl should be viewed as an aberration from a model that is thousands of years old."[108] These projects are complicated, however, and require public-private partnerships that present new challenges that usually delay the development process.

When Demand For Retail Is Lacking: Change Use, Donate, or Build-To-Suit

Change of Use

Sometimes the best option for an obsolete property is a complete change of use. These require intensive due diligence and market research to determine the highest and best use for the site. If demographic research indicates a significant population over 55 and few independent living, hospice care, or assisted living units, then senior housing or age-restricted communities may be an option. Residential, such as apartments or owner-occupied single family, town homes, or condominiums are possible when communities are growing at a rate where the housing supply can't meet the demand. Data showing an increase in job creation, business expansion, and income growth could be signs that an office park with mid-rise or flex space is viable. Restaurant parks or recreation and entertainment centers, like ice rinks, bowling alleys, or rock climbing facilities are opportunities for areas with growing families and disposable income. Some municipalities are looking to take over sites to convert them into community centers, but the lack of financing and tax revenue is hampering their efforts, at least in the short term. Other options include self or public storage, auto theme park with car washes and auto parts and repair shops, or banquet and/or catering facilities.

Real Estate Donation

The donation of real estate, either the entire property or an easement, is another option for a non-producing property in a portfolio. Donation to a non-profit entity, such as a charity or church is one alternative. For corporate donors who have held a property for more than one year, the donated property is valued at fair market value less the accumulated depreciation, not purchase price. If donated to a private foundation, the deduction is limited to the property's cost basis. Up to 10% of the net profit of the corporation can be deducted and excess contribution amounts can be carried for up to 5 years.[109] Most of the time the donor is responsible for the acquisition expenses such as title insurance, property insurance, environmental testing, probate or other costs.

Another alternative is to donate a conservation easement to the state or local government, such as the Maryland Environmental Trust. These donations result in a state and federal tax savings and property tax credits. State income tax credits vary from state to state, but in Maryland, a credit of $5,000 per year may be taken for up to $80,000 for 15 years.[110] In addition, a federal income tax deduction can be taken for appraised value of the donation up to 50% of adjusted gross income over 16 years.[111] Finally, land donated to the Trust will be exempt from property taxes for 15 years from the date of donation.[112]

Charitable donations of real estate are a good option for companies with certain financial and philanthropic goals, such as those who need for a tax write-off, have incurred uninsured catastrophes, own abandoned or fully depreciated properties, or want to avoid capital gains tax on highly appreciated property. They can also be used creatively to fund corporate personnel packages for executive incentives, severance, or retirement. Under this method, a trust is created where the property is donated to a charity, but the donor continues to use the property and/or receive income from it for a specified period of time.[113] At the termination date of the trust, the charity receives the corpus of the trust. The donor avoids any capital gains tax on the donated property and gets an income tax deduction for the fair market value of the remainder interest that the trust earned.[114] By donating a non-producing real estate asset into charitable remainder trusts, a company can timely dispose of a property, reap tax benefits, and alternatively fund an employee benefit program.

Built-To-Suit

Although difficult to find, sometimes an opportunity presents itself where a prospective tenant is looking for a large site to expand, consolidate, or relocate its operations. Such tenants, like the State, County, or Federal Government, usually sign long term leases for the buildings and possibly the land. There are other prospective tenants such as churches, college campuses opening satellite locations, or corporations looking to consolidate onto a campus. This option is favorable to tenants that wish to preserve their corporate equity to finance business operations, research departments, or other investment opportunities available to the tenant.

Management During Any Market Conditions: Negotiations with Tenants, Sustainability Focus, Energy Efficiency Programs

Negotiations with Tenants

Negotiations with tenants are always ongoing, but several steps can be taken in the current economic environment to offer a “boon” to struggling tenants so that higher vacancy rates can be mitigated. One method is to temporarily offer rent reductions or abatement of percentage rent for some or all tenants for a specific period of time, at which rents would increase on a graduated scale back to their previous amounts. There are some pitfalls, mainly legal ramifications if the terms of the agreement are not clear, particularly with regard to default of the new agreement. A decision also needs to be made about whether or not the difference in rent will be repaid. The tenant can be permanently forgiven for the rent differential or agree to repay the amount over time at an agreed interest rate. Any agreement should contain a waiver enabling the landlord to forfeit for breach of the concession agreement. A concession agreement alters the lease agreement and must be approved by the guarantors or they could be released from liability if the tenant becomes insolvent. Lease agreements are used to transfer right through contractual means from the owner to the tenant and any provisions that may be in voided or breached from a concession agreement need to be carefully reviewed with a contract lawyer.

Focus on Sustainability

Focusing on sustainability is more recent trend that serves as a marketing tool as well as provides tax credits, where available. Owners say they can sell their green core-and-shell developments on a litany of practical benefits, including lower utility and operating costs, a healthier work atmosphere, an opportunity for market leadership and a better return on investment.[115] Some suggest that if your building isn't green, either through new construction or retrofit, then it's already obsolete. At USGBC's Greenbuild convention in November 2008, the focus was less on new development and more on green retrofits, energy management and streamlined efficiencies, according to Mark Peternell, vice president of sustainability at Regency Centers. The real footprint of retail is the 6 billion square feet of space already on the U.S. market, not new construction, USGBC pointed out.[116] Van Jones, author of the Green Collar Economy, mirrors those sentiments. The first weapon in a national retrofitting movement "is the caulk gun," he told the gathering. Such an effort would "power us through the recession," providing thousands of jobs and saving energy, he insisted.[117]

Energy Efficiency Programs

If there is a silver lining to the economic downturn, perhaps it is a renewed focus on improving the performance of the existing building stock, which consumes enormous amounts of energy when compared to new LEED and Energy Star buildings. According to James Bodman, Secretary of Energy, "More than 75 percent of the nation's five million commercial, industrial and institutional buildings were built prior to the many groundbreaking energy-efficient technologies currently available today. These buildings annually consume nearly 900 billion kilowatt-hours of electricity costing over $40 billion each year."[118] By pursuing low cost or no cost energy efficiency opportunities, owners receive a direct economic payout that is realized almost immediately. Improvements can be easily retrofitted to the building envelope as well as lighting, HVAC and hot water systems that result in reduced energy cost and increased NOI and asset value.

- Empirical data from various case studies show that lighting energy savings of more than 50 percent can be achieved by installing the latest energy efficient technology in fixtures, lamps, ballasts and controls that maximize the use of natural light.[119] The primary causes of higher energy cost from lighting are inefficient light sources, transmission losses from dirt or other light obstruction, over lighting when daylight is available, and excessive 'on' hours.[120] 'No costs' solutions to reduce energy consumption include removing unneeded fluorescent fixtures and disconnecting their ballasts, using partial lighting before and after public hours, turning off lights near windows, using automatic lighting controls, and by cleaning any dirty lighting fixtures that can reduce light output by up to 30%.[121] 'Low cost' options include retrofitting fixtures with high efficiency ballasts that use less electricity, replacing old lamps with efficient lamps that have more lumens per watt, using reflector lamps in recessed down lights, purchasing halogen lamps where dramatic lighting is needed, and replacing incandescent light bulbs with compact fluorescent bulbs or light-emitting diodes (LEDs).[122] Current information from utility company BGE shows that replacing one incandescent light bulb with a fluorescent bulb saves $37 for every 10,000 hours of use.[123] Another low cost option is to install occupancy sensors in areas like private offices, restrooms, or storage areas that detect motion and turn lights on or off automatically.

More substantial investment involves rewiring and installing more efficient controls that allow an owner to control lights in different areas. While these changes can be expensive and complicated, they yield immediate results that increase NOI and property value. Following is an example of the payback, return on investment and impact to asset value after the installation of an automatic lighting control system.

Payback, ROI and Increased Asset Value	
The following cost/benefit analysis shows the payback, return on investment and increased asset value of the installation of an automatic lighting control system. The financial gains are the result of energy consumption reduction. Data was taken from a report prepared for the National Electrical Manufacturers Association	
Building Size	1,000,000 Square Feet
Lighting Watts per Square Foot	1.5
Annual Lighting Hours	3,500
Annual Kilowatt Hours	5,250,000
Annual Lighting Cost @ $0.10 KWH	$525,000
Percent Savings	30%
Annual Savings	$157,500
Savings per Square Foot	$0.16
Installed Cost of Equipment	$400,000
Payback	2.5 Years
Annual Return on Investment	43.90%
Five Year Net Savings	$387,500

Notes

1. Nonresidential KWH rate supplied by Edison Electric Institute.

2. Return on investment calculation is based on the annual savings plus the tax benefit of depreciation. A 34 percent tax rate is assumed. Cost is depreciated over 7 years using a modified accelerated cost recovery system. Product life is 12 years.

Building Asset Value Increase Calculation
To determine the increased asset value due to the savings generated by the reduction in lighting expense, the key pieces of information to use are the annual savings, the installed cost of the equipment and the capitalization rate.
Increase In NOI ($157,500)/Cap Rate (7%) = $2,250,000 Increase In Value

More methods to improve energy efficiency involve changes to the building envelope, HVAC systems, and machinery. The goal with the building envelope is to stop infiltration, reduce heat transfer, control humidity, and control sunlight. Tightening doors and windows, using shades, covering window air conditioners, and sealing cracks with caulk, foam, or insulation are all low cost ways to improve energy efficiency. By insulating distribution pipes and hot water storage tanks, stand-by heat loss is reduced and it is possible to reduce water temperature by 10-degrees, saving 3-5% in energy costs.[124] For water, installation of aerators, occupancy sensing controls, and automatic shut-off valves can reduce consumption as well. As always, ongoing maintenance of equipment, machine parts, and the building also play an integral part in controlling energy costs. One commercial real estate company, Transwestern Commercial Services, invested more than $12 million in efficiency upgrades in 2006 and realized reduced energy costs of 25 percent.[125] Those savings led to higher net operating income and when capitalized, a $344 million increase in the company's portfolio value.[126]

Alternative Energy Programs

Alternative energy programs are also emerging that actually generate revenue for owners. Developers like Developers Diversified Realty Corporation have partnered with solar power companies such as SunEdison Solar Energy Services to develop solar-power initiatives. In this scenario, the solar power company leases roof space above a shopping center to install solar-heat panels. The power can then be purchased at a cost below market utility rates and it has been so effective for companies like Developers Diversified, that they are deploying the program throughout 30 centers by the end of 2009. The reduction of greenhouse gases is also significant and according to Marc Feldman, vice president of Developer's new business development, "at just one center alone, we will avoid an estimated 10 million pounds of carbon dioxide pollution." [127]Important to the viability of the plan, however, are the available state and local solar-energy tax credits that make the program more cost efficient. Such programs are highly attractive because they are clean, renewable, and environmentally-friendly while generating revenue and reducing utility costs.

Strategic Energy Procurement Plan

Another method to consider is joining an energy buying group and developing a strategic energy procurement plan. As an independent energy consultant, like ECNG Energy, LP in Canada, these companies work on behalf of their client to obtain the lowest energy rates and the most favorable contracts. These companies can also achieve lower pricing because they purchase from a group of suppliers and can select the best pricing among competitors. They also develop an energy supply strategy by auditing energy demands and practices in an existing portfolio to minimize cost fluctuations. These companies monitor market conditions, set up layered purchasing structures based upon risk profile and commodity prices, and provide expertise for companies that aren't familiar with energy buying practices.

VIII. Opportunities

Overview

In this new financial environment, where fundamentals are deteriorating and the bottom is unknown, creative strategies can be deployed and opportunities can be seized during this period of economic reset. Opportunities exist for state and local planning departments to control the supply of retail space through zoning and land use while investors with equity on hand can purchase distressed assets at discounted prices. New data is showing that local owners with older properties are experiencing better performance than REIT-owned properties and they may be the first to recover from the downturn. There is also a remarkable development opportunity in the increasing number of automobile dealership lots that are closing. Finally, demographic changes present opportunities for retail properties to reposition themselves to meet the needs of an aging population.

State and Local Planning Departments

A recent study by Madison Marquette combined data from CoStar about vacancy rates, square footage, and deliveries to determine a distress index for retail real estate assets. These markets are considered fertile ground for distressed assets when their index rating is above 95%, indicating less than 80-85% occupancy, time on the market greater than 6 months, and increasing velocity of vacancy.[128] The markets with the least amount of distressed share common factors that contribute to their stability, including high barriers to entry, a median retail square feet per capita of less than 50.2, unemployment rates less than 7.2%, and lower foreclosure rates than markets with the potential for distress.[129]

Such an index is a valuable tool for state and local planning departments not only for what it reveals as contributing to a stable market, but for the opportunities it presents. High barriers to entry, such as land use and zoning restrictions, contribute to increasing the price and reducing the supply of commercial real estate. By reviewing per capita statistics, planning departments can also mitigate their potential for real estate distress by subverting overbuilding. As more assets fall into the distressed category, eager investors with equity on hand will purchase them at discounted prices. Planning departments must carefully consider changes to the underlying zoning as developers try to redevelop the properties to ensure that they are not positioning their market for future distress.

Purchase of Distressed Property

There is approximately $11 billion of distressed commercial property currently for sale, but transactions are minimal in the current market.[130] This is primarily due to lack of certainty about demand fundamentals in markets. Developers tend to make decisions based upon recent sales and retail trends. If the data is almost non-existent, as is the case for sales activity, or current growth in retail demand is unknown, then developers cannot make accurate forecasts about the profitability of a site. For examples, many sites that were constructed in secondary or tertiary markets, where housing growth was not sustained and foreclosures skyrocketed, are extremely risky. Unless the price drops low enough to account for the extreme risk, investors aren't ready to deploy their capital. When demand exists and price points are attractive enough, companies who have preserved there capital can purchase distressed assets at below market levels. When the economy eventually recovers, these properties may rebound and become productive, income-producing assets once again.

Local Ownership and Older Properties

According to retail experts like Sam Kartalis, President and COO of Henry S. Miller Brokerage, owners of "older centers that are more likely to experience the silver lining of this market" because "their ability to charge lower rents and still make a profit is working in their favor."[131] These owners have the luxury of offering lower rentals rates because they have less debt, if any, on their properties which results in lower costs per square foot. Kartalis believes that these properties will be among the first to experience a rebound when the recession is over. This is because other owners, like REITSs, cannot make the same deals as local owners because they own newer properties with higher costs and property values. REITs also must meet their internal rate of return targets and have to turn away tenants who can't afford their rental rates. In addition, they take longer to deliver lease agreements since corporate offices are not likely to be in the immediate area of the property.

Evidence of this can be found by looking at a small section of the Baltimore retail market: the Reisterstown Road Corridor. Within this corridor, CoStar indicates there are 209 properties with 106 being older than 30 years and 103 newer than 30 years. Six properties are owned by REITs and account for almost 25% of the total rentable building area (RBA) for newer properties. These properties have vacancy rates of 5%, time on market of 17.5 months, and average rental rates of $19.58/yr/sf. In comparison, the properties older than 30 years have the same vacancy rate of 5%, but time on market is significantly lower at 6.8 months, and the average rental rate is lower at $17.45/yr/sf. This data highlights the flexibility and advantage that local owners with older properties have when making decisions about whether or not to lease to a tenant.

Redevelopment Opportunities for Empty Auto Lots

Automobile dealership lots situated in high-density locations are already commercially zoned and present great opportunities for reuse and redevelopment. Plummeting car sales have forced many dealerships to close and a 2009 report from Grant Thornton predicts that over 5,000 more new car dealerships will shut down.[132] These properties equate to more than 20 percent of the industry's real estate footprint and will result in over 1 billion square feet of retail or mixed-use land for sale.[133] Companies who have preserved equity and are focusing on a buy-hold strategy can purchase these properties at discounted prices and take the time to develop careful and comprehensive development plans that can be executed when the economy begins to grow. If the automobile industry recovers, the land can also be leased back to dealerships through ground rents.

Repositioning to Meet Shifting Demographics

Between now and 2030, the number of Americans aged 65 or older will double to more than 70 million.[134] Most shopping centers and malls have been created for people who are fully functioning and are able to drive to their destinations. Jenneke Foottit from Queensland University of Technology 's Dementia Research and Training Centre conducted a study and found that "Older women use shopping centers as a way of connecting with society. They go there for social activity, to see people, they use it for safe exercise and, sometimes, they mention doing the shopping. This has implications for the building and refurbishment of shopping centers. As our population ages, we must make sure they stay mobile by creating social environments that are safe for them to move around in."[135]

As the population ages, they will be ready to move out of their oversized houses into homes and apartments that are wheelchair and walker friendly with close proximity to shops and doctors offices. They will need access with ramps, handrails, wider doorways, and wider crosswalks with slower signal calibrations. Rest areas with benches or seating with shade trees or awnings is important as well. As mobility is decreased, transportation is vital and being in close proximity to public transportation or offering shuttle services for larger lots may give a shopping center an advantage over its competitors. Changes to signage that provide high contrast signs with larger print should be considered. Another area where opportunities exist is in the service sector of malls and shopping centers where services like personal car escort, baggage carrying and loading, personal shopping, and security will be important to providing a customer-friendly experience for the elderly. They are, however, technological savvy and coupled with decreased mobility, they may have changing needs for traditional brick-and-mortar formats.

Baby Boomers aren't the only shifting demographic. Generation Yers, people born between 1980 and 1994, will begin to purchase homes and start their families over the next few years. They, however, are not as affluent because many are faced with paying off huge student loans. "Forced to market to an overall audience that is both older and younger, richer and more cash strapped, and tech-savvy and decidedly not, retailers must adapt their approaches, layout and store sizes to accommodate an ever-growing dichotomy," said Al Meyers, senior vice president of business development of TNS Retail Forward.[136] "Retailing will change dramatically over the coming years, and by 2015, you won't recognize the retail industry," Meyers said.

IX. Legislation Impacting the Industry

Overview

Government has always played a major role in impacting the real estate industry through tax and accounting policies, zoning and land use regulations, and other legislation that either directly or indirectly affects the industry. It is important for real estate investors to keep apprised of these changes and study their intricacies to develop strategies that take their intent into consideration. Recently, there are several new pieces of legislation, both approved and being debated, which will affect commercial real estate.

Troubled Asset Relief Program (TARP)

As part of the Troubled Asset Relief Program (TARP), the U.S. Treasury Department will create a Public Private Partnership Investment Program to purchase toxic assets of banks. The program will use $75 billion to $100 billion from the TARP enacted last year, giving the government $500 billion of purchasing power to buy legacy assets.[137] Legacy assets are real estate loans owned by banks and securities backed by loan portfolios. As a result of the housing crisis, poor underwriting standards, and complex securitization products that were not fully understood, losses were generated which led to investors existing these markets. This caused further decline in market liquidity and the value of these assets. The government is hoping that this partnership with private sector investors will stop this negative economic cycle and bring stability back to the financial system. For the commercial real estate industry, this legislation will hopefully restore liquidity to banks so they will release more loans, increase investor confidence so they return to purchasing securitized mortgage pools, and offer investment opportunities for companies that may want purchase these assets. The most optimistic result of the legislation is that it ebbs the tide of increasing defaults that could worsen the economic crisis and affords lending institutions the ability to meet the demand for credit to refinance maturing commercial real estate loans.

American Recovery and Reinvestment Act (ARRA)

Small businesses are extremely important to the vitality of the economy and are the drivers of new ideas, employment, and economic growth. SBA's flagship 7(a) loan guarantee program declined in volume by 30 percent last year.[138] Stephen Wilson, Chairman and CEO of LCNB National Bank, suggested that Congress could reverse this trend by reducing program fees, making the application process easier and cheaper for small businesses and banks, and temporarily increasing the federal guarantee provided on SBA loans.[139] The American Recovery and Reinvestment Act (ARRA) contains a package of loan fee reductions, higher guarantees, new SBA programs, secondary market incentives, and enhancements to current SBA programs that will help unlock credit markets and begin economic recovery for the nation's small business sector.[140] The bill provides $730 million to SBA and makes changes to the agency's lending and investment programs so that they can reach more small businesses that need help.[141] By making credit available to small businesses, the commercial real estate market will reap the benefits of new tenant prospects as well as increased financial stability from existing tenants.

Mark to Market Accounting Rules

The mark to market accounting rule set by the Financial Accounting Standards Board (FASB) was recently loosened to give more flexibility to assign value when no market exists. Under the ARRA, the government has given the authority to the Securities and Exchange Commission (SEC) to relax mark to marketing standards. This type of accounting arose in response to the US Savings and Loan Crisis in the 1980's when financial institutions inflated the book values of their assets. Balance sheets were being valued at their purchase price rather than their fair market value. The mark to market rule forces financial institutions to mark the value of their assets to market prices and take the gain or loss through income statements and onto their balance sheets. In

2007, the FASB released Statement No. 157 which many see as a contributing factor to the international financial crisis.[142] The statement introduced an asset hierarchy based on the market available for the asset with level 1 assets being the easiest to price and most liquid and level 3 being completely illiquid and nearly impossible to price.[143] As the CMBS and CDO markets seized, financial firms holding billions in securities with no market began writing down assets which triggered huge losses.

"By relaxing the US financial system's mark to market accounting standards, the US government is effectively deactivating the financial 'early warning system' that let investors know that a global credit crisis was brewing," Money Morning reported.[144] Many feel that changing the accounting rules will increase distrust in short-term credit markets, deprive investors in critical information, and make financial institutions more risk adverse as transparency decreases. On the other side of the argument, proponents of changing the rules argue that mark to market, or fair value accounting, existed in the 1930's during the Great Depression and President Roosevelt suspended the rules in 1938 and they remained that way until 2007. Edward Yingling, president of the American Bankers Association, feels that "the mark to market rules have exacerbated the financial crisis as institutions have been forced to report market losses rather than economic loses, resulting in a continuous downward spiral of market prices and further losses." [145] Regardless of one's side to the argument, the message for commercial real estate investors is that the accounting rule is pro-cyclical, or tied to the business cycle. When the market is up, bank capital increases and loans flow. Conversely, when the market is down, mark to marketing rules cause banks to devalue assets, which reduces their capital and lending capacity.

Recovery and Reinvestment Act – COD income

The ARRA enacted a new section 108(i) of the cancellation of debt tax code that benefits commercial real estate companies who have cancelled, reacquired, or exchanged debt at a discount during 2009 or 2010.[146] If any portion of the debt from a commercial lender is cancelled or forgiven, the amount cancelled may need to be reported as income and is taxable, unless the loan was non-recourse or the company is bankrupt. Under old law, the income was reported in the tax year that it was generated and taxed at the ordinary income rate. Under the new ARRA laws, the resulting income may be deferred for up to five years and amortized equally over five years. For commercial real estate companies that restructure debt in 2009 and through a workout with their lenders they can defer claiming the cancellation of debt income to between 2014 and 2018.[147] The legislation will make it easier for lenders to workout loans with borrowers, but it is important to understand the full tax implications before agreeing to any terms.

Recovery and Reinvestment Act – Depreciation

The ARRA also allows 50 percent bonus depreciation for certain depreciable property placed in service in 2008, including qualified leasehold improvements to commercial real estate.[148] Recently, the bonus depreciation allowance has been extended through the end of 2009. Before this bonus depreciation, a landlord who spent $3 million on the cost of tenant improvements could deduct $200,000 a year for 15 years on his taxes. Under the new temporary rule, the landlord can deduct $1.5 million upfront while the other $1.5 million takes the form of a $100,000 deduction annually over the next 15 years.

X. Projections for Recovery

Overview

As the government focuses on new policies and methods for stimulating the economy, predictions are being made about economic recovery. Although no one can definitively predict the conclusion of this recession, many suggest that the economy will rebound by the end of 2009 or early 2010. When this recession is over and the markets begin to recover, there will be opportunities for the survivors who managed themselves well during the downturn. New market realities are emerging that suggest fundamental and lasting changes to consumer shopping habits. Many believe that the new focus on value and reduced consumption will become permanent in the marketplace for this latest recession/depression generation. Multi-channeled retail that seeks consumers in stores, on-line, and in catalogs will continue to reshape the retail landscape. As retail adapts to the changing preferences of its consumers, owners of retail space will reinvent their shopping centers to meet these rising trends. Traditionally a lagging economic indicator, retail is not expected to recover until late 2010 or 2011.

Projection for Demand and Post-Recession Consumer

In recent years, consumer spending has accounted for 72 percent of the Gross Domestic Product (GDP), compared to the long-term mean of 65 percent. [149] American consumers have been addicted to spending and utilized home equity loans, cash out refinancing, and credit card debt to finance their consumption. This led to retail expansion plans based on extrapolation of false demand. As this pseudo-wealth created has unraveled during the current recession, a permanent psychological change has occurred in consumers. Many believe that no amount of fiscal stimulation will reverse the trauma that has caused consumers to retrench and reevaluate their personal spending habits. Consumer assumptions that homes values were buoyant and financial assets would grow over the long term have been shattered. As a result, most Americans, in several surveys, feel that we will continue to experience a downturn for the next five to seven years and may never again enjoy the economic growth we were once accustomed to.[150]

Once the economy begins to recover, the question is whether consumers will remain permanent spendthrifts or return to their old spending habits. A new study by the National Foundation for Credit Counseling shows that many Americans are spending less because they have to, not because they feel an urgency to save.[151] "Of those spending less, about 45% said they saw their newfound thrift as temporary and planned to recapture their old lifestyles once the economy improved." [152] There will be more consumers, however, who return to living within their means and continue to reject conspicuous consumption. The uncertainty about consumer demand and consumption will continue to challenge retail real estate investors and reshape old assumptions about property types and their performance. As we move out of this recession, it is important for investors to evaluate these demand fundamentals and interpret their implications.

Projection for Absorption of Vacant Space

Whether or not the market rebounds enough to absorb the enormous supply of retail space remains to be seen. The following table calculates the projected years needed to absorb vacant retail space based upon data in the CoStar Retail Report Year End FY08 for the National Retail Market. Based upon FY08 net absorption, with the current year end 2008 vacancy rate of 6.7%, it will take 1.7 years to absorb the vacant space back to pre-recession levels of 6.2%. When vacancy rates are raised to the projected levels for 2009, absorption of the current oversupply of space will take over 4.8 years. The figures are sobering and represent the true challenge that faces retail real estate owners in the current market.

Projections for Absorption of Vacant Space

Absorption With:	Vacancy Rate	Total to Be Absorbed (Inc Proj New Deliveries)	Average Net Absorption FY06-FY08 (SF)	Years to Absorb Vacant Space to 6.2% Average
FY08 Year End Vacancy Rate	6.7%	168,675,474	96,747,922	**1.7**
FY09 Projected Vacancy Rate	10.2%	467,403,793	96,747,922	**4.8**

These figures, however, are conjecture since the historical absorption rates are not a guarantee of future absorption trends. In fact, the CoStar First Quarter 2009 National Retail Market Report recorded negative net absorption of -23.77 million square feet, compared to positive net absorption of 22.91 million square feet during the first quarter of 2008.[153] This high level of negative absorption is a result of retail store closings and new deliveries that remain un-leased.

With demand fundamentals clouded by ambiguity, it is nearly impossible to accurately predict when the surplus of retail space will be absorbed. Much of this space may need to be converted to alternative use, such as the vacant auto dealerships, obsolete enclosed malls, and the growing inventory of empty big-box stores. The increase in on-line shopping, the proliferation of mega stores like Wal-Mart, changing demographics, and the expansion of grocery stores into new market segments have also fundamentally changed the retail industry. The full impact of these shifts in demand may be unknown, but the fact that they will surely increase the supply of retail space is no mystery.

XI. Lessons Learned & Conclusions

The cycles of boom and bust in the real estate industry will undoubtedly continue and while each cycle brings unique challenges, experience from prior downturns can provide valuable guidance on how to survive and capitalize on opportunities. While there is no magic bullet, there are some useful conclusions that can be drawn from history. These conclusions can be translated into guiding principles that keep companies rooted in the basics while preserving adaptability in the real estate environment.

Real estate is a major component of the economy, and has historically been subject to large and widespread fluctuations. Economist Fred Foldvary has reviewed historical data from the U.S. and concluded that real estate booms have preceded major depressions. The construction industry plays a major role in the creation of the boom/bust cycle and his work shows that **real estate values and construction have peaked one to two years before a depression** and have stayed at peak levels until the onset of the downturn. Whereas the smaller and more frequent business cycles may be due to random shocks or non-real-estate causes, the larger real estate cycles exhibit a pattern that tends to work in 18-year cycles. There are usually 14 years of rising prices followed by 4 years of recession across the broader economy.

As an owner or investor, **knowing where you are in the real estate business cycle, recovery, expansion, over-supply, and recession, is vital to survival**. There is always a peak to the expansion phase and there are warning signs that the precipice is approaching like low cap rates, loosening underwriting standards, appraised values that can be manipulated, and an abundant supply of lending. When cap rates fall to the point where no real return exists above the risk free rate of a treasury bond, it’s time to formulate a re-trenchment plan, reduce costs, and lock in rate terms even when faced with refinancing penalties. Only after early and late correction periods, when time on market grows, investors flee the market, vacancy rises, and sales volumes fall, will the bottom finally arrive.

To survive the correction period, you should have **preserved capital, avoided over-leveraging properties, and arranged alternative sources of capital prior to its need for deployment**. Capital reserve assumptions should be reviewed for adequacy under the best, likely, and worst case scenarios of cash flows and alternative sources of capital, such as lines of credit, should be secured prior to a downturn. In addition, the desire for higher return-on-equity (ROE) by leveraging properties works well during an appreciating market, but also amplifies the potential loss when properties are devalued, so over-leveraging should be avoided. Manage debt well and compare debt per square foot across properties to identify properties that may be over-leveraged. When cash flows contract, property values decrease, and lending sources become restrictive, following these recommendations will ensure that your company is well-positioned for the impending recovery period.

Evidence of the boom/bust cycle also highlights one of the most important lessons for commercial retail real estate: **don't oversupply the market with speculative building**. While most retail real estate markets avoided the overbuilding that exacerbated the previous downturn in the early 1990's, the Marcus and Millichap distress index showed that over 35 markets did not heed this fundamental concept and are facing extreme financial difficulties. Aggregate demand for retail property within a market depends on consumption patterns and retail purchases across the different product lines. The quantity of sales depends upon market size, household structure, household income, credit conditions, consumer expectations, relative prices, and tax policies. Although rudimentary, this data serves as an important foundation for evaluating markets and, when ignored, can lead to distressed markets.

Conducting due diligence in a thoughtful, thorough, and disciplined way is another lesson learned by many real estate professionals. When a particular market increases in momentum and you begin over-paying on purchases, over-leveraging properties, and aren't able to understand the fundamentals of highly complex financial instruments being sold, intuition should tell you that the market is over-heated and you have lost discipline. Exuberance over a project or market can sometimes lead to irrational behavior and requires an immediate correction and return to rational and careful review of market, property, and financial conditions.

One essential component of due diligence is to **conduct a review of the barriers to entry in the proposed market**. Based upon evidence in this paper, the conclusion has been drawn that **properties in markets with high barriers to entry tend to be better performing**. These areas exhibit stronger knowledge of real estate fundamentals and tend to have market indicators, like vacancy and rental rates, that are more positive than those with low barriers to entry. These mature markets are better able to control supply and have weathered economic downturns more successfully.

Interpreting these markets requires an **understanding of local conditions**. Each property is a living entity that must be operated, financed, and managed differently to create the highest operation efficiency and value. The key to unlocking value is having local expertise that can make decisions at a local instead of a national level. This is where local ownership from smaller niche companies focusing on long term holds may have a performance advantage over REITs as they can adapt more quickly to the changing demographics and needs of communities. The long-term hold strategy also minimizes the impact of temporary market fluctuations, which in turn helps secure favorable financing.

Whether you are a long-term property owner or have newly acquired the site, **follow the industry rule of thumb that properties must be renovated every 10 years**. The strategies are varied and include renovating functionally obsolete sites to conform to property type standards, focusing on sustainability, changing use, or offering a mixed-use approach. Regardless of the refurbishment choice made, the necessity for capital investment to keep a property current in the market is not negotiable. The case study conducted here has shown that when the proper investments are made to aging properties, they can perform as well, if not better than newer properties.

Within your market, it is important to **be acquainted with your impact on and connectivity to tenants, lenders, state and local government, property management, and vendors.** By understanding the impact of a distressed retail real estate industry on these partners, one can have more cogent discussions when working collaboratively towards solutions to the problems that economic downturns present.

Finally, **stay ahead of the curve by keeping apprised of new legislation, population and market trends, new building methods, and changes to accounting rules**. Subscribe to trade magazines, review industry websites, attend conferences and seminars, and stay connected to the current events of the real estate industry, even if they aren't occurring in your particular sector. Use resources the publish information based upon historical research, such as the ISCS guidelines for the general operating characteristics of shopping centers. Know the history of your sector to glean lessons learned from those who tell of their experiences. Continuously absorbing new knowledge can lead to dynamic and paradigmatic shifts in the way that one views challenges and creates solutions.

The key to the future of shopping centers is its ability to remake and reinvent themselves to the changing demands of the marketplaces they serve. This assured their success in the past and will fuel their survival in the future. Whatever form they take, be it mall, shopping center, or power center, they serve as financial engines, as places of employment, as satisfiers of our daily needs, and as the place where communities come together. In this current economic downturn, we have been reminded of our interconnectedness and the vulnerabilities that we share collectively as a community and country. As we endure this time of reset, we use the lessons learned from our past to guide us in making better choices and changes in the future to ensure our survival. Because according to Charles Darwin, "It is not the strongest of the species that survives, nor the most intelligent, but the one most responsive to change."

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