NATIONAL REAL ESTATE Investor®

Catching Up

After several years of lagging the market, retail properties gain favor with investors.

Elaine Misonzhnik

April was marked by a sudden flurry of activity among U.S. retail REITs. On April 11, Vornado Realty Trust, a diversified publicly traded REIT, announced it filed paperwork with the SEC to spin off a new entity, another publicly traded REIT devoted solely to 85 of its shopping centers.

The same day, Kimco Realty Corp. revealed it was buying out its joint venture partner in 12 shopping centers in the Mid-Atlantic and the Northeast in a $408.2 million transaction. A day later, CBL & Associates Properties, a regional mall REIT, followed by announcing plans to sell 21 of its properties, or about a quarter of its portfolio, within a three-year timeframe.

What's to account for all these moves? Retail assets, which have lagged the multifamily and office sectors in recovering from the downturn, have gradually gained favor with investors and retail REITs are taking advantage of the timing by either putting non-core centers on the market or snapping up value-add opportunities.

In 2013, the most recent period for which data has been released, sales of all retail properties rose 8 percent, to $60.8 billion, according to Real Capital Analytics (RCA), a New York City–based research firm. That still put retail behind sales of apartment buildings, which totaled $103.5 billion, and office properties, which totaled $101.5 billion. Prices for apartment buildings are now 5 percent higher than they were during the peak reached in the last real estate cycle, according to RCA's Commercial Property Price Index (CPPI). The prices on office buildings nationwide are still 11 percent below their previous peak and on retail 15 percent below the previous high.

However, sales of strip centers and unanchored retail centers both shot up 26 percent in 2013, to $27.3 billion and $5.3 billion respectively. Sales of strip centers outside of major metros climbed 33 percent, more than any other property type.

"Retail as a property sector was a laggard in this recovery over the last few years," says Dan Fasulo, managing director with RCA. "A massive spread opened up between offices in central business districts and multifamily, which were the top-performing property sectors, and retail—a spread in values, a spread in capital available, in interest from lenders. However, everything changed over the last 12 months and capital is now pouring into almost every segment of the retail sector. It was the best performing segment of the market last year, as far as increases in transactions and values. It's almost trying to catch up with the other sectors and the capital markets are trying to get ahead of the recovery in fundamentals."

Long climb back

The retail sector took longer to bounce back in part because so much new construction came on-line during the boom years, notes Fasulo. But with the development pipeline remaining virtually frozen since 2009 (only 650,000 sq. ft. of new space came online in the first quarter of 2014, according to Reis Inc., a New York City–based research firm), supply and demand had been brought back into equilibrium, says Michael Carroll, CEO of Brixmor Property Group, a shopping center REIT that went public last year.

"Certainly on the opportunistic investor side, private equity came into the retail space seeing a big opportunity in 2010 and 2011," says Carroll. For its part, Carroll's firm was purchased by the Blackstone Group's for $9 billion in 2011 and raised $825 million in its IPO last October.

"It's taken the rest of the investor base [longer] because it's been more dependent on capital flows back into the market," Carroll says. "Certainly, multifamily has garnered a lion's share of capital on a macro basis. Now, the same investors see that there are no [new] shopping centers being built, occupancies have recovered and there is still retailer demand out there. And that, ultimately, is going to drive NOI levels higher."

For instance, Olshan Properties, a New York City–based real estate owner and developer, has begun putting renewed energy into retail acquisitions over the last nine to 12 months, as the economy has shown consistent improvement, rents have spiked up and there is cash to be disposed of. Alison Lies, director of real estate with the company, notes she wishes Olshan had added retail assets as far back as 2010, but the firm had to finish some existing projects first. "I'd say we have a year or two more for [acquisition] opportunities, but I can already see pricing being pushed to very high levels."

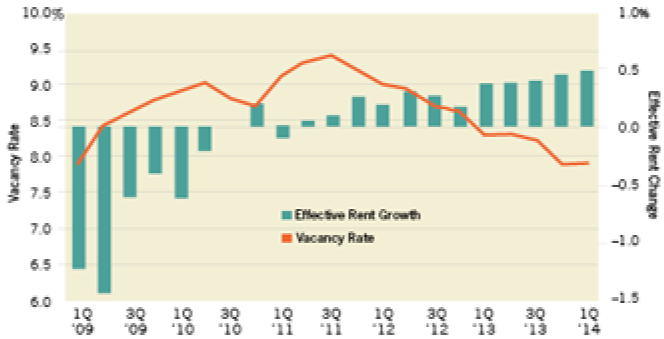
Irvine, Calif.–based Passco Co. LLC tends to be an opportunistic investor that buys various types of commercial real estate assets depending on the market environment. For the past few years, the company focused its attention on multifamily properties, according to Gary Goodman, senior vice president with the firm. Passco executives saw the opportunities for good returns on investment in value-add retail centers as far back as 2009, just as private equity buyers did, but "the risk with those kinds of situations was that if the recession would have lasted longer, you would end up with an empty center for a lot longer," Goodman says. "So we decided to wait for more of a recovery in the economy."

On the mend

By now, retail property fundamentals have shown enough of an improvement to give buyers like Passco confidence. The average vacancy rate for shopping centers currently stands 70 basis points below its peak of 11.1 percent in the third quarter of 2011, according to Reis data. In the first quarter of this year, effective rents at shopping centers rose 1.6 percent compared to the same period in 2013, Reis reports.

Holding Steady

The vacancy rate at regional malls remained flat in the first quarter at 7.9 percent. Vacancy is down 150 basis points from the historical high reached during the third quarter of 2011. Asking rents grew by 0.5 percent in the first quarter and 1.7 percent during the last twelve months.



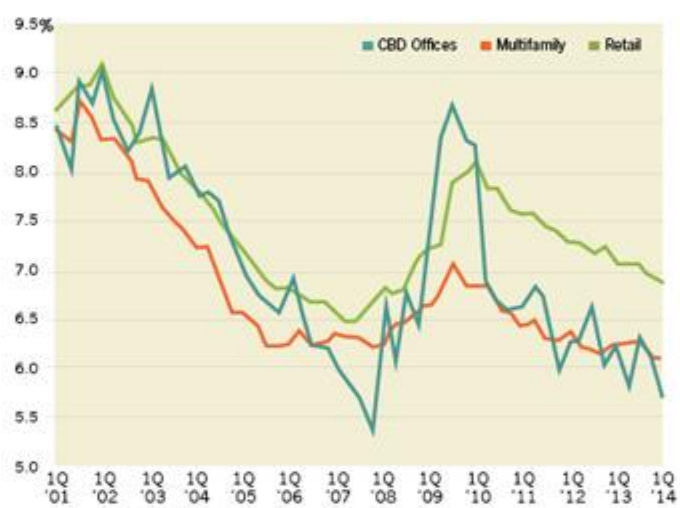
Source: Reis Inc.

"The recovery in fundamentals is still early, so as the economy continues to recover, fundamental improvement will translate into NOI growth and increases in value and investor interest," says Ryan Severino, senior economist with Reis. "The key to investors is going to be figuring out which properties are currently imperiled by something cyclical (declining population, loss of jobs, income stagnation, etc.) versus the ones suffering from structural problems that are more permanent. The ones that are having cyclical issues will recover with the economy."

At the same time, real estate investors have seen enough of a discount on retail centers compared to multifamily properties and class-A office buildings that the former are beginning to look more and more attractive. At year-end, cap rates on all retail transactions averaged 7.0 percent, according to RCA. Cap rates on sales of strip centers averaged 7.4 percent, and cap rates on sales of strip centers outside major metro areas averaged 7.6 percent.

Bargain Pricing

As cap rates for multifamily and office properties in CBDs have fallen, retail began to look more attractive.



Source: Real Capital Analytics

In comparison, cap rates on sales of office buildings averaged 6.9 percent during the same time period, while cap rates on multifamily transactions averaged 6.2 percent. Valuations are higher still when it comes to core markets. Apartment buildings in New York City, for instance, have appreciated in value by 52 percent compared to the peak of the market in the fourth quarter of 2007, according to RCA CPPI. Apartment assets in San Francisco gained 47 percent in valuation. Even properties in Tampa, Fla., have appreciated in value by 1 percent compared to the peak.

In secondary markets, newer apartment buildings are trading at cap rates of approximately 6 percent, according to Passco's Goodman. In that kind of an environment, shopping centers, which in those same markets trade in the 7.5 percent to 8.0 percent range, offer greater relative yields. That is why Passco is now actively buying retail assets, including value-add centers. In the past two years, it has bought six retail properties. Goodman says the firm's management has set a goal of approximately $100 million in retail acquisitions for 2014. As an example of the kinds of deals Passco finds attractive, he brings up a 28,000-sq.-ft. center in Victorville, Calif., that the company bought in late 2013. The center came with a 5 percent vacancy rate.

An added benefit of bidding for smaller centers (priced at $10 million and under) is that the competition tends to be less sophisticated than among mall and power center buyers, Goodman adds.

"That market is a lot less perfect in terms of transactions," he notes. "For smaller centers that are not particularly well marketed, there may only be a few offers."

Olshan Properties also has an appetite for value-add centers, but it prefers larger assets in top 150 MSAs. Alison Lies estimates that depending on the size of the market, returns on such properties can range from 5 percent to 10 percent.

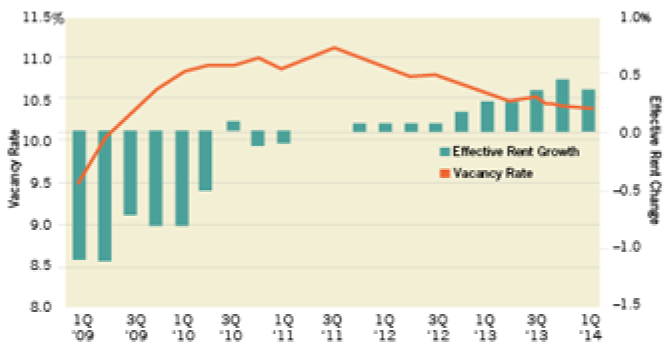
Brixmor, on the other hand, wants to concentrate on its existing portfolio for the time being, but "as we move into 2015 and beyond, we'll probably be more of an external player," says Carroll. "I see fundamentals remaining strong for a period of time—certainly the next five years look pretty good to us."

Smart moves

The challenge facing investors looking to buy today is figuring out which retail properties offer the best risk/return combination. Dan Fasulo, of RCA, points out that fortress malls and retail assets in core markets—up till now investors' favorite bets—have been fully priced. "Those are the assets that have the most risk associated with them if interest rates do rise," he notes.

Looking for More

Asking and effective rents at shopping centers grew by 0.4 percent in the first quarter while the vacancy rate held steady. That was made possible, in part, by low amounts of construction and absorption. But the pace of rental growth is not as robust as it was in the years prior to the recession.



Source: Reis Inc.

According to RCA research, malls and other retail properties in major metro areas traded at an average cap rate of 5.9 percent in 2013, and an average price of $399 per sq. ft. Given that rents at those types of properties have limited growth prospects and that interest rates are likely to rise in the near-term, that kind of valuation makes sense for either a short-term investor or someone who plans to hold the assets forever, says Spencer Levy, executive managing director of capital markets with real estate services firm CBRE. For investors looking at five- to seven-year return horizons, he recommends going after value-add centers and/or centers in secondary markets that are valued roughly 200 basis points above core retail.

RCA reports that at year-end, cap rates on all retail transactions outside major metro areas averaged 7.3 percent. Unanchored shopping centers traded at an average cap rate of 7.5 percent.

“One of the things I suggest to a lot of investors is ‘know what your flexibility is for an extended period of time,’” Levy says. “If you have the ability to hold, a lot of the secondary markets look attractive. If you don’t have a liquidity risk because of the strong cash on cash return you are getting upfront, you are getting a very attractive investment.”

That’s in large part why the REITs, including CBL, Vornado and Simon Property Group (which has created a new firm called Washington Prime Group for 98 of its smaller malls and strip centers this winter), are either putting non-core assets up for sale or spinning them off into separate public companies. Shareholders in pure-play mall REITs like CBL and Simon want them to concentrate on their main business lines and top-tier properties, notes Rich Moore, a REIT analyst with RBC Capital Markets. The more non-core holdings they have, they more their share price suffers.

But if they create a separate REIT holding only the value-add centers or put those same assets on the market, there will be plenty of buyers, especially in the private sector, who’ll be happy to pick them up.

“There are a lot of guys out there looking at assets,” Moore says. “Middle market kind of guys like PREIT and the Rouse Companies, and then of course you’ve got Starwood Retail Partners, and you’ve got [private equity firm] KKR. And you also have local buyers.”

Meanwhile, shopping centers boast the advantage that unlike apartment buildings or office towers, their success is less dependent on the size of the market they are in than on the precise location of the asset within that market, says Passco's Goodman. He notes that shopping centers positioned at the right intersection in even tertiary markets can do extremely well.

Christopher Maling, senior vice president in the Los Angeles office of real estate services firm Colliers International, also advises clients to think about what kinds of tenants a center features. Given how many retailers have been destroyed or severely challenged by online competition over the past few years, the best bets would be centers filled with chains that drive daily traffic—grocery stores, pharmacies, gyms.

Whichever retail assets investors are planning to purchase, Fasulo advises them to buy sooner rather than later. Whereas a few years ago the acquisition market for retail was limited to private investors, the field is now getting more and more crowded with REITs, pension funds, life insurance companies and foreign buyers.

"The capital moves a lot faster than it used to," Fasulo says. "Cap rates have already fallen significantly in the retail sector, but there is still a nice premium versus multifamily. The window is going to close very quickly for some opportunistic type investments; and for value-add stuff I'd be surprised if those assets don't start getting fully priced again by 2015."

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