THE OUTLOOK

Marcus & Millichap

RETAIL

MIDYEAR 2019

Increasing Appetite for Experiential Retail Transforms Sector; Investors Adopt Strategies to Capitalize

Fed takes action to extend economic growth cycle. Sturdy underlying fundamentals continue to support domestic growth, expanding the economy by 2.1 percent in the second quarter, but headwinds are emerging. Growth has moderated over the past several months and some international forces are weighing on momentum, prompting the Fed to cut the overnight rate by 25 basis points at the end of July, seeking to extend the economic runway. This modest cut may have fallen short of what was needed to offset the escalating trade war and financial market turbulence as the 10-year/two-year yield curve recently inverted. This commonly perceived signal of an impending recession has the potential to increase uncertainty and work against the positive economic forces such as steady job creation, low inflation, sound wage growth and elevated consumer confidence. In addition, sustained recruiting demand has resulted in a 22 percent surplus of job openings relative to job seekers, enabling many people with weaker skills and education to find work. Reflective of this, organizations are becoming increasingly competitive in their recruiting efforts, opening additional locations to tap new labor pools and boosting compensation packages to attract new staff members and retain existing workers. This has provided a bump to household and disposable income levels nationwide.

Uncertainty restraining some growth drivers. Though economic optimism remains elevated, consumption and corporate investment have tapered relative to 2018. Unresolved trade talks, slowing international economies and the hangover from elevated interest rates last year continue to pressure domestic markets, prompting some consumers and businesses to act more cautiously until additional clarity emerges. These factors have restrained leasing activity for some property types in several markets during the first half of this year, but a recovery could be sparked by lower interest rates. Still, the recently inverted yield curve and uncertainty surrounding trade will weigh on the outlook.

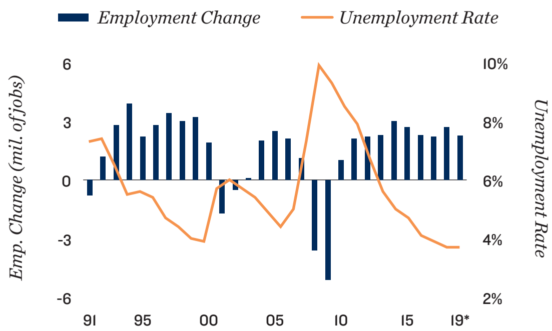
Retail platforms converging from different angles. Retail has witnessed dramatic change over the past several years, but the transition is still ongoing. Companies are finding ways to mesh brick-and-mortar locations with strengthening online capabilities to produce seamless omnichannel experiences for consumers. Walmart and Target embraced this strategy, taking their prominent physical footprints and adding enhanced digital and logistical systems to better compete with internet retailers. This has resulted in more online sales and faster delivery times. Digitally native companies including Bonobos and Warby Parker came from the other direction, building internet-only platforms then opening physical stores to heighten brand awareness and customer engagement. The confluence of these factors is reinventing retail, helping companies realize the importance of a combined physical and online presence. The retail sector continues to refine the nuances of the new, broader platform.

Experience-oriented retailers spearhead positive consumption trends. Several retail categories have a positive outlook as the cycle progresses and the retail sector transforms. Bars and restaurants will remain highly sought after tenants as consumers continue to increase spending at these establishments — surpassing consumption as grocery stores, which have exhibited solid growth over the past few years. These places provide experiential settings and drive foot traffic, making them key to healthy tenant blends. Gyms are also expanding quickly, particularly as an increasing number of big-box vacancies can accommodate these types of businesses. Fitness tenant space in shopping centers has almost tripled in the past 10 years, as these retailers try to keep pace with the nearly 72 million consumers nationwide using health clubs. Entertainment retailers, like esports venues and dine-in movie theaters, are using vacant big-box locations to support growth strategies as well. As some retail concepts falter in the face of sector transformation, many owners are surveying options to fill empty space, giving other retailers opportunities to expand their footprint.

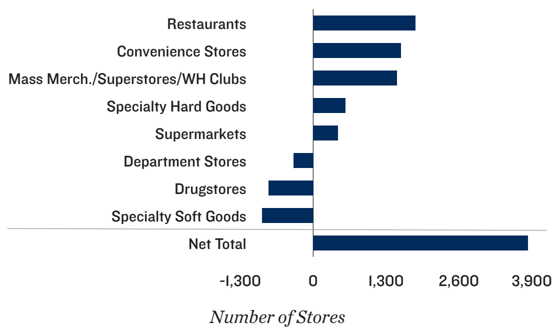
Executive Summary

- The tight labor market remains a key driver of the economy as continued job growth is helping those secure employment who typically have difficulty finding work. This is pushing more money through the economy, supporting domestic growth and retail sales.
- Transitioning to an omnichannel model remains key for retailers as they keep stride with evolving consumer preferences. Improving online capabilities and widening distribution networks allow physical retailers to better compete against their online counterparts.
- Food, fitness and fun remain cornerstones to the retail sector's performance. Many investors are modifying their tenant compositions to include some of these retailers as consumers gravitate toward experiential destinations.
- The extended business cycle and ongoing trade negotiations are causing many retailers to stay conservative, putting a hold on expansion plans and softening space absorption levels nationally.
- The sector's transformative nature makes retail assets a viable value-add opportunity for many investors. These properties can also be suitable portfolio diversification tools as the current cycle extends.

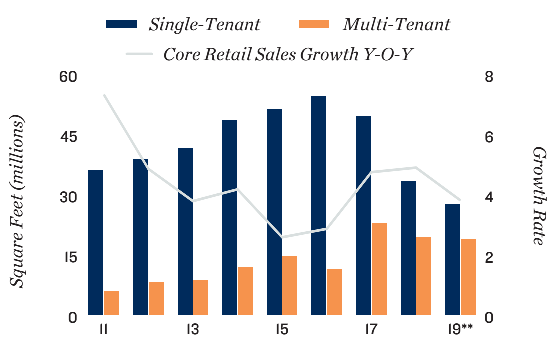
Employment vs. Unemployment



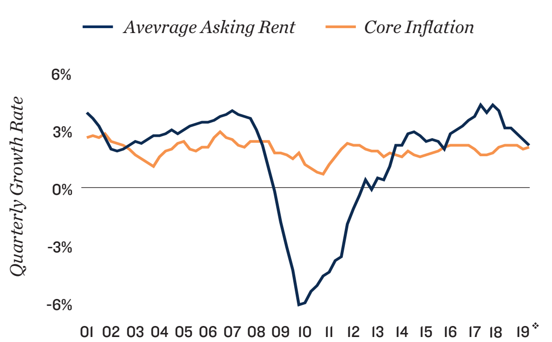
2018 Net Store Growth



Retail Completions



Rent Growth Remains Above Inflation



* *Employment change trailing 12 months through July; Unemployment rate as of July*
** *Trailing 12 months through 2Q*
⁺ *Through 2Q*
Source: CoStar Group, Inc.

Millennials Key to Retail Outlook

Suburban real estate may be biggest winner of evolving millennial lifestyles. The millennial cohort will have a transformative impact on real estate markets as this generation approaches a new life stage. Many millennials are beginning to form families after delaying marriage until their late 20s or early 30s. Family formation will increase the appeal of suburban neighborhoods as more affordable housing costs and proximity to quality schools becomes increasingly important. Suburban housing demand will be bolstered in the coming years amid this lifestyle shift, putting further pressure on apartment vacancy rates and producing even stronger demand for entry-level single-family homes. Corporations are taking note of this, setting up campuses in suburban employment hubs, bringing jobs to the growing talent pools. This is bringing more retail space to the suburbs as retailers seek to get their products closer to growing consumer bases. New retail developments are molded around sustainable tenant blends as these emerging trade areas are composed of many modern consumers who favor omnichannel retail platforms.

Late-Cycle Dynamics Keep Expansion Plans in Check

Development highlighted by southern markets. Retail construction will remain limited this year, totaling just 50 million square feet. While stricter lending practices will weigh on the pipeline, development is further restrained by rising labor and materials costs. Nearly half of this year's completions will be confined to 10 major metros, with New York leading the way by adding roughly 5 million square feet of retail space. Quickly growing Sunbelt markets including Houston, Dallas/Fort Worth, San Antonio and Charlotte will also generate increased development as builders are attracted by robust employment growth and household formation. In higher-density areas like Northern New Jersey and Miami, a rising number of mixed-use projects will fuel supply growth. Conversely, construction will be relatively sparse in the vast majority of Midwestern markets, keeping space supply and demand in balance.

Evolving retail sector benefiting investors. Retail vacancy nudged higher in the second quarter for the first time this cycle as space absorption retracted. Absorption was slowed by two factors: Retailers have become more cautious in their expansion plans as they weigh the risks of rising tariffs, in addition to low vacancy rates in premium locations inhibiting expansion options. The pace of single-tenant absorption has retreated in 2019, with many expanding retailers pausing to evaluate the market. Shopping center absorption has been comparatively stronger but has still posted declines each of the past three quarters. Despite this, increasingly refined retail business models continue to support demand, giving retail investors a range of high-quality tenants to choose from to fill vacancies. Adding internet-resistant concepts will boost the long-term viability of retail properties, elevating foot traffic and asset performance. The repurposing and redevelopment of existing retail assets will also contribute to decreasing vacancy as investors get creative with outdated shopping centers. While this may include redesigning an asset's layout to accommodate desired retail tenants, it could also mean converting the space to another use such as self-storage, last-mile fulfillment or office space.

Income growth outpacing inflation. The nation's average asking rent will rise steadily this year, driving the figure to roughly $1 above its pre-recession peak. The vast majority of major metros will witness growth levels above the current 2 percent core inflation measure, offering retail owners stable revenue growth. Tight coastal cities and Sunbelt markets will headline rental gains this year, producing 5-plus percent growth rates. Muted construction nationwide should continue to bolster asking rents as retailers vie for the limited remaining available space.

Investors Gaining Stronger Grip on Sector Nuances

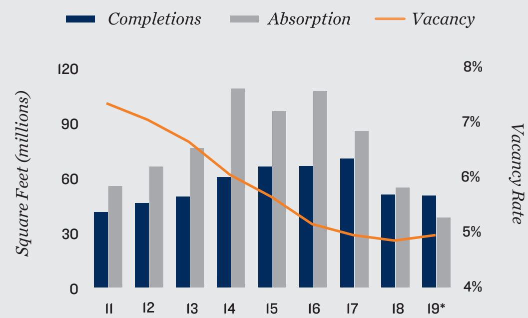
2019 Forecast

U.S. CONSTRUCTION:

50 million square feet completed Y-O-Y

- Development will reach its lowest level since 2013 as retailers rein in expansion plans and lenders maintain conservative underwriting. Sunbelt markets will headline this year's construction trends.

Retail Supply and Demand



U.S. RENT:

3.3% increase in average asking rent Y-O-Y

- The nation's average asking rent edges up to $20.49 per square foot as growth remains stable this year. Shrinking space availability in the multi-tenant segment will play key role in the sector's rental growth moving forward.

U.S. VACANCY:

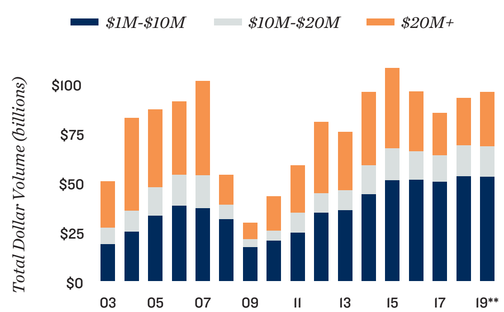
10 basis-point increase Y-O-Y

- With net absorption on track to hit 38 million square feet in 2019, the national vacancy rate is forecast to increase for the first time this cycle, inching up to 4.9 percent. Last year, more than 56 million square feet was absorbed.

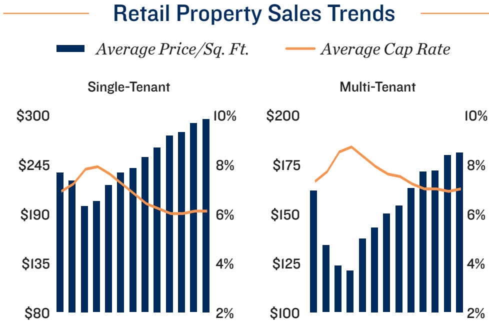
2019 INVESTMENT OUTLOOK

- **Yield-driven investors find opportunities.** Multi-tenant retail continues to serve as a viable value-add option for many investors, providing an avenue for portfolio diversification in a maturing cycle. Midwestern metros have seen increased activity as investors seek returns up to 200 basis points higher for multi-tenant assets than in coastal markets. High-growth Sunbelt cities have also produced strong demand as buyers focus on population expansion, netting yields above the national average cap rate of 7 percent for value-add properties.
- **Investors explore ways to enhance retail assets.** The mixed-use trend is gaining more traction with investors as they adapt to modern consumers. Adding a housing or office component proximate to an existing retail center can deliver significant value, better positioning it for long-term growth.
- **Grocery stores bring additional dimension to owners.** Retail investors continue to target grocery-anchored strip centers, generating competitive bidding environments for these assets and producing cap rates typically between 7 and 8 percent. Grocers' ability to drive foot traffic can provide a jolt to overall property performance, making them highly desired shopping center tenants.
- **STNL sector sustains steady performance**. Over the past year, the national average single-tenant cap rate remained flat at 6.1 percent after rising 10 basis points one year earlier. Investors favor the stability and hand-off nature of single-tenant assets, maintaining strong bidding climates and pushing the average price per square foot up 5 percent year over year.

Retail Sales Volume by Price

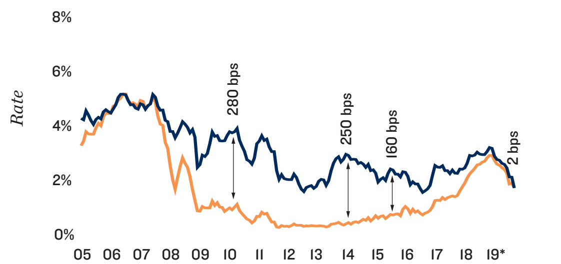


Retail Property Sales Trends

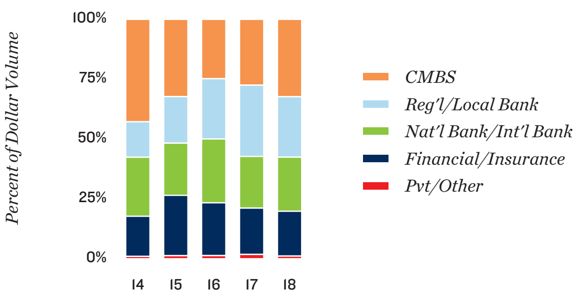


* Forecast
** Trailing 12 months through 2Q
Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Real Capital Analytics

10-Year Treasury vs. 2-Year Treasury Yield Spread Tightens



Retail Mortgage Originations By Lender



** Through Aug. 14*
Include sales $2.5 million and greater
Sources: CoStar Group, Inc.; Real Capital Analytics

Fed Breathes More Life Into Economy; Plenty of Capital Available for the Right Deal

Fed efforts to extend economic runway facing increased headwinds. The Federal Reserve's decisive action, including their rate drop in July, will support the economic growth cycle, but may be outweighed by the escalating trade war. Uncertainty and caution increased following the August 1 announcement that additional tariffs would be levied, sparking a flight to safety and the recent inversion of the 10-year and two-year Treasurys. Though the Fed's 25-basis-point reduction of the overnight rate and early end to quantitative tightening could pose some inflationary risk, the Fed has communicated a willingness to let the economy "run hot" in an effort to spur growth. Should core inflation rise above 2 percent, it will not be seen as an immediate risk. Falling interest rates, a byproduct of the trade war and the Fed's efforts to boost the economy, will bolster leveraged yields for investors. With the yield on the 10-year Treasury now down 70 basis points from the cycle peak last October and at their lowest level since the record-low set in 2016, investment options that may not have penciled even 30 days ago have been reinvigorated. This should help moderate the buyer/seller expectation gap that widened earlier in the year.

Lenders focus on tenant composition. The evolving nature of the retail sector is providing opportunities for investors, giving underwriters more confidence in the long-term outlook of retail. Lending habits remain relatively conservative; however, a wide range of financing is available for strong proposals. Underwriters are beginning to focus more on tenant mixes, heavily emphasizing the inclusion of tenants with sustainable business models before they sponsor a deal. Active lenders include local, regional and national banks, and insurance companies, with a primary lender focus on net-leased assets and premier mixed-use structures being highly desirable. Meanwhile, outlying malls and non-credit tenants will undergo much more scrutiny. This has produced loan-to-value (LTV) ratios in the 60 to 70 percent range and typical debt service coverage (DSC) ratios above 1.3 depending on borrower, asset and location factors. Mezzanine and bridge loan structures have been more frequently used in this environment, with owners undertaking capital improvements at higher leverage ratios on the short-term debt before seeking long-term financing options once their operations have been proved.

National Retail Group

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Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Experian; IHL Group; International Health, Racquet & Sportsclub Association; Moody's Analytics; Real Capital Analytics; TWR/Dodge Pipeline; U.S. Census Bureau