Market Update

Despite economic realities, retail remains attractive

Real estate transactions have slowed but not halted, excess capital continues to propel buyers and sellers to transact, albeit in a slower and more cautious manner. Retail's stable cash flow has kept investor appetite steadfast. Lack of new development, especially in the shopping center space, has led to reduced vacancy and rising rental rates. Tax incentives and accelerated depreciation that benefit from fee-simple retail real estate also sustain demand. While transaction velocity currently is reduced, this is primarily driven by turmoil in the capital markets, as the Fed has rapidly increased interest rates. Property fundamentals of retail real estate are strong and improving providing compelling reasons to invest.

When this article is released, the 10-year Treasury yield will be over 4%, Fed rates will have reached a target range of 3.75%-4% and year-over-year inflation remains over 8%. 2022 has seen a 375 basis-point Fed rate increase and a sustained 40-year high of inflation. Michael Gapen, chief U.S. economist for Bank of America, anticipates Fed rates to peak at a target range of 4.75 -5% by the spring. Wall Street equities markets remain volatile. Real estate is less volatile seeing an average +/- 1.8% quarter-quarter value change compared with the S&P's +/- 6.6% over the last two decades (Marcus & Millichap).

Not all economic conditions are somber. Employment is firm, with

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unemployment claims holding at 60-year lows, and consumer spending is proving resilient. Spending grew by 0.6% in August and September (Commerce Department). While headwinds are worrisome, real estate remains the preferred long-term investment vehicle of 29% of Americans (Bankrate July 2022).

A sustained period of heightened interest rates is inevitable as the Fed attempts to ease inflation. In reaction, real estate buyers are strengthening their liquidity positions. Leverage is further restricted in the near term because of lenders tightening their debt coverage covenants. As such, cash buyers have led the pack for deals transacted in the second half of the year. Retail in the $1 million-$10 million range has stayed sturdy when priced correctly. Deals debuted in the second quarter have become stale and require price reductions to stay competitive. Anticipated further price adjustments have resulted in lower deal volume. Sellers have become more selective as year-end nears, vetting buyers by the highest probability of close. Due to this, liquid buyers will continue to dominate the market.

Retail real estate should be viewed

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as a stable investment. In face of the current conditions, retail's annual cash flow remains a part of investor criteria. Retail lease's rent structure provides a hedge against inflation via annual or midterm rent increases. In the single-tenant net leased space, 2% annual – or 10% every five years – rent increases are common. Leases that encumber investment-grade tenants are secure as payments are backed by stable corporate entities. Accelerated depreciation is utilized in single-tenant retail real estate, predominately in auto and service station properties, to reduce income tax burdens. Trade fixtures can be depreciated by investors at a quicker pace than the building itself. During the first five to seven years of ownership, investors can employ the double-declining balance accounting methodology. This 100% bonus depreciation allowed via Section 179 of the IRC is declining by 20% each year through 2027, when it expires.

In turbulent economic conditions, buyers and sellers a like must remind themselves of the fundamentals of retail real estate. Cash flow, depreciation, appreciation, diversification, pride of ownership, hedging inflation, etc., are all reasons to utilize retail real estate as an investment vehicle.

"Why should I buy retail real estate when I can get a Treasury bond with similar yield or invest in the stock market?" asks a friend. The answer to your friend would be the following:

Retail real estate offers long-term management-free leases and appreciating value that differentiate it from stocks and bonds. Over the last 20 years, real estate outpaced S&P returns, with real estate seeing compounded annual growth of 7.8% (Marcus & Millichap), while the S&P 500 saw 5.3% during that period. The quantitative and qualitative aspects of a real estate transaction outweigh a Treasury bond or a 10-year investment in the S&P 500. Stocks and bonds do not have qualitative properties. Given good property location, it is likely to see land value appreciation and redevelopment potential, magnifying future returns over the return from rental income. Should the tenant vacate, backfilling probability by another operator is strong. As interest rates continue to rise, a bond's value decreases, and S&P is likely to remain in limbo. The tenant's good credit standing provides guarantees of rental payments. Stock and bond payments are stagnant with their given coupon rates and dividends.▲

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