

SUMMER 2010

The Big Box Dilemma

PART 1: SECOND GENERATION BIG BOX RETAIL



The recent economic downturn has presented retailers in the United States with one of the most challenging operating environments they have faced in decades.

As of first quarter 2010, Colliers International reported an overall retail shopping center vacancy rate of 11.0 percent across the markets that it tracks. This number is up considerably from January 2008, when the rate was 7.4 percent.

While vacancy has indeed increased for every retail shopping center type in virtually every U.S. market, occupancy losses for big box retail buildings have been especially pronounced.



WHAT IS A BIG BOX?

The traditional definition of a “big box” retail building is a single-story, freestanding retail property of at least 50,000 square feet. For the purposes of this report, we have expanded our definition to retail buildings of at least 20,000 square feet. These buildings are often called “junior boxes” or “junior anchors” and have been hit especially hard by the big box vacancy trend. For example, the collapse of Linens ‘n Things and Circuit City resulted in more than 1,150 “junior box” vacancies combined.

Consider: The U.S. had a total retail inventory of just over 11.6 billion square feet at the end of first quarter 2010, according to the CoStar Group. Of that space, 870.7 million square feet was vacant. We estimate that just under 300 million square feet of that total is in the form of vacant big box space. In other words, the total amount of vacant, large-format retail stores in the U.S. currently accounts for more than 34 percent of all retail vacancy.

In fact, approximately 120 million square feet of big box retail space has been vacated since January 2008 alone. That figure is roughly the equivalent of the entire shopping center inventories of Baltimore, Cincinnati and Kansas City combined.

HOW TO EMPTY 85 MILLION SQUARE FEET

Beginning in 2008, multiple retail bankruptcies quickly translated into dropping big box occupancies. The collapse and subsequent liquidation of chains such as Linens ‘n Things, Circuit City, Steve & Barry’s, Mervyns, Goody’s, Gottschalks and Sportsman’s Warehouse resulted in the return of nearly 85 million square feet of big-box retail space to the marketplace over a period of just over one year.

But bankrupt retailers weren’t the only ones returning big box space to the market. In the face of declining sales, most chains sought to cut costs and close underperforming locations. Since 2008, roughly 50 Sears locations nationwide have closed or been slated for closure. Between underperforming namesake stores and its now defunct Expo Design Center locations, The Home Depot, Inc. has also shut down roughly 50 stores over the same period. Dozens of regional furniture store chains, such as Wickes Furniture, have also shuttered large format stores.

MAJOR BIG BOX CLOSINGS, 2006-2010*		
Retailer	Units Closed	Approximate SF Vacated (millions)
Linens ‘n Things	589	18.2
Circuit City	567	17.1
Steve & Barry’s	276	15.1
Mervyns	149	11.1
Goody’s	282	6.3
Gottschalks	61	4.8
Home Depot Expo Design	34	3.7
Sportsman’s Warehouse	38	2.4
Boscov’s	10	2.0
Joe’s Sports & Outdoor	36	1.9
Wickes Furniture	43	1.8

(*through end of June 2010)

Regional department store chain *Boscov's* returned roughly 2 million square feet of space to the market with the closure of ten stores. *Dillard's*, *Macy's* and *Saks Fifth Avenue* have all closed underperforming locations and may still close more.

Grocery chains have not been immune. Arizona-based *Bashas'* closed ten stores as part of its Chapter 11 reorganization. South Carolina-based *BI-LO* cancelled 31 of its leases and closed 17 stores as part of its bankruptcy. Alabama-based *Bruno's* has closed ten stores as part of its bankruptcy. Even warehouse club giant *Sam's Club* recently closed ten stores, adding roughly another 1.2 million square feet to the market.

EMPTY STORES IMPACT RENTS

Just how many big boxes have suffered nationwide? More than 50 stores closed in Las Vegas alone since 2007. The Charlotte market has seen more than 25 individual big boxes go dark since 2008. As this report went to press, the Chicago market had approximately 175 vacant big boxes on the market, accounting for nearly 9.5 million square feet of inventory. Minneapolis reported roughly 80 empty big boxes and Sacramento showed 65.

The impact on rental rates has also been severe. While we can report that big box leasing activity has picked up considerably over the first six months of 2010, most of these leases have been executed at rates from 30 to 40 percent below the peak levels of just a few years ago. For tenants with the cash to pay for their own improvements, we have seen rental rates discounted by as much as 50 percent or more. In many markets, big box space that previously rented from \$13 to \$16 per square foot (on an annual triple net basis) is now being leased for approximately \$10 per square foot if the landlord contributes tenant improvements. In cases where tenants are paying for their own improvements, we have seen deals go for as low as \$5 per square foot, though this has largely taken place at weaker suburban or rural locations.

Hard bargains are not the only challenge landlords face. In the past, 20-year leases were commonplace, but today's deals are typically for 10 years. Tenants are also demanding more early-exit options.

EMPTY BOXES, LOW SALE PRICES

The impact of vacancies on property values has been severe. A *Kmart* store in the Greater Los Angeles suburb of Highland, California, sold for \$64 per square foot in November of 2005. When *Kmart* shuttered this location, the landlord defaulted and the property became bank-owned. It sold again in December 2009, but the vacant property traded at \$17.26 per square foot — approximately 75 percent off its peak value.

In 2006, a developer built a 50,000-square-foot build-to-suit store for *Sportsman's Warehouse* in Memphis. *Sportsman's Warehouse* occupied the space with an annual rent of \$11.00 per square foot (triple net). In 2007, the developer sold the building to an investor for \$7.8



This former *Kmart* in Highland, CA, sold for \$64 per square foot in 2005 when it was occupied. Now vacant, it traded in December 2009 for just over \$17 per square foot.

This former Sportsman's Warehouse in Memphis found a new tenant in Ashley Furniture, but at a rental rate nearly half of that which the previous tenant had been paying.



million (\$156 per square foot). Sportsman's Warehouse filed for bankruptcy in March of 2009. Rent payments stopped, the lease was rejected and the space went dark. In early 2010, an Ashley Furniture franchisee signed a ten-year deal on the space at \$6.00 per square foot (triple net). The property is now on the market for sale, where it is expected to fetch \$3.2 million, or roughly 41 percent lower than its peak 2007 value.

CIRCUIT CITY, HERE WE COME!

Reduced rents are now playing a major role in bringing users back to the marketplace. We have seen a surge of big box leasing activity over the past few months, driven largely by discounters, off-price apparel retailers and grocery concepts looking to lock in low rental rates on vacant second-generation space.

Electronics chain HHGregg has opened more than 30 stores in the past 18 months, with plans to open 45 more in 2011. The majority of these new stores will occupy former Circuit City locations. The Indianapolis-based electronics retailer is on track to single-handedly absorb more than 2.5 million square feet of vacant big box space through the end of next year.

HHGregg is not the only player to actively pick up vacated Circuit City stores. Best Buy has leased or is in negotiations to lease 25 former Circuit City stores. Two organic concepts, Henry's Farmers Markets and Sprouts, have both been signing deals for former Circuit City space.

Of the roughly 17 million square feet of space vacated by Circuit City, we are aware of roughly 4 million square feet that has been or will be backfilled by the end of 2010.

Sprouts Farmers Market took this former Circuit City in Greeley, Colorado. The fifteen-year deal was noteworthy for the fact that the lease was transacted at a rental rate 15 percent higher than the rent that Circuit City had paid. The quality of the space, along with a substantial tenant improvement allowance, proved to be major motivating factors for Sprouts.



FORMER MERVYNS FIND NEW TENANTS

Several retailers took the opportunity to adapt many of the 149 former Mervyns locations to their own purposes. In fact, we expect roughly half of the vacated Mervyns locations — totaling approximately 5.5 million square feet — to be backfilled within the next year.

Kohl's took a total of 32 vacant locations on the West Coast, comprising roughly 2.4 million square feet of space. Fashion retailer Forever 21 took 15 Mervyns locations, leasing up 1.1 million square feet. Burlington Coat Factory, Osh Sporting Goods, Hobby Lobby, TJ Maxx and Jo-Ann's Fabrics and Crafts have all either signed leases or are in negotiations for former Mervyns space. Walmart recently purchased a store in San Diego and has made offers on at least one Northern California site.

Grocers have also been active in backfilling Mervyns sites. Asian chain Seafood City and traditional grocery operator Safeway, Inc. have each taken locations. Safeway purchased a 70,000-square-foot former Mervyns in Palm Desert, California, for \$12 million. This move is

notable for the fact that Safeway has no plans to occupy the building. Rather, it purchased the property in order to block other grocers from picking up market share. The company plans to lease the space to a non-grocery retailer.

LEASES 'N THINGS

With typical footprints from 30,000 to 40,000 square feet, former Linens 'n Things sites have proved attractive targets for backfilling retailers. HHGregg has signed a number of leases in former Linens 'n Things spaces. TJX Companies has plans to open roughly 130 stores under its TJ Maxx and Marshall's brands in 2010; former Linens 'n Things sites fit their site preferences perfectly.

ROSS RAMPS UP

Ross Dress for Less is on pace to add 35 stores this year and is ramping up expansion plans for 2011. The chain wants to add as many as 550 new stores over the next several years by expanding both in its existing trade areas and into new markets in the Midwest and Northeastern U.S. Nearly 80 percent of the leases that we have seen from off-price apparel retailers in the last 12 months have been for vacant, second-generation big box space.

ADAPTING TO THE OPPORTUNITY

One retail chain reinvented itself to take advantage of new opportunities. Two years ago, Forever 21 was a mall player with a typical footprint of 20,000 square feet or less. Now, the chain has become a department store player with a mix of new concepts, including XXI Forever, Faith21, Love21 and 21Men, acquiring department store space as large as 200,000 square feet.

Both Walmart and Target also appear willing to tweak typical footprints in order to take advantage of deals offered by second-generation big box space. But both are using this strategy to find space in congested urban markets where new development for larger stores is difficult.

EXPANDING INTO 2011

Though most backfilling of vacant big boxes has been driven by discounters, there is reason to believe that deal activity will continue to increase. Colliers International tracks the expansion plans of more than 500 major retailers. Between January and May of this year, nearly one third of those retailers increased their growth plans for 2011 and beyond. Strong store sales until May of this year likely played a factor in retailers becoming more bullish on 2011. However, it is entirely possible that some retailers may scale back growth plans should sales continue to slump or if the recession hits another dip, as some speculate will happen.

RETAILERS ACTIVELY LEASING SECOND GENERATION BOX SPACE

The following is a list of retailers that have either signed deals for vacated second-generation big box space or would consider these types of properties:

99 Cents Only	Fresh & Easy	Rooms To Go
A.C. Moore	Golfsmith	Ross Dress for Less
A.J. Wright	Goodwill	Roundy's
Academy Sports	Goody's (Stage Stores is reviving the concept)	Saks Off Fifth
Aldi	Grocery Outlet	Salvation Army
Ashley Furniture	H-E-B	Save Mart
Bass Pro Shops	H&M	Savers
Bed, Bath & Beyond	Henry's Farmers Markets	Schnuck's
Best Buy	HHGregg	Seafood City
Big 5 Sporting Goods	Hobby Lobby	Shoe Show
Big Lots!	Home Goods	ShopRite Supermarkets
BJ's Wholesale Club	JCPenney	SmartCo Foods
Bloom	Jewel-Osco	Smart & Final Extra
Bloomingdale's Outlet	Jo-Ann Stores	Sports Authority
Bottom Dollar Food	Kohl's	Sprouts
Burlington Coat Factory	Lord & Taylor Outlet Store	Staples
buybuyBaby	Marshall's	Stater Brothers
Cabela's	Meijer	Sunflower Farmers Market
Christmas Tree Shops by BB&B	Michael's	Target
Costco	Newflower Farmer's Market	TJ Maxx
Dave & Buster's	Nieman Marcus Last Call	Top's Friendly Markets
Dick's Sporting Goods	Nordstrom Rack	Toys R Us
Dollar Tree	Ocean State Job Lots	Tractor Supply
DSW	Ollie's Bargain Outlets	Trader Joe's
Family Farm & Home	OSH	Vons
Famous Labels	Petco	Walmart
Food Lion	PetSmart	Winco Foods
Food Maxx	Price Chopper	Wonder! Stores
Forever 21	PriceRite	
Fred Meyer	Publix/Publix Sabor	

INVESTMENT OUTLOOK

Sale prices in most markets are off by 40 percent or more from the peak values recorded in 2006 and 2007. In hindsight, we now know that these peak values were unrealistic and unsustainable, and do not expect values to return to such levels any time soon. A new “normal” must now be established, with both buyers and sellers adjusting to new market realities.

The key factor for a reasonable return in value, of course, is occupancy. We have seen vacant boxes consistently sell at prices that are often half that of occupied big box space. We expect a continued schism in pricing between stabilized core assets and distressed properties for years to come.

The average price of big box space sold over the past year nationwide has been \$97 per square foot, with an average cap rate of 7.8 percent, according to Real Capital Analytics. However, we have seen big boxes in urban areas with long-term leases from national credit tenants sell for twice the national average at cap rates as low as 6.5 percent. We have also seen vacant rural box space sell below \$20 per square foot.

SELECT 2010 BIG BOX RETAIL SALE TRANSACTIONS

Sale Date	Property Name	City, State	Price	Square Feet	Price PSF
05/10	BJs Wholesale Club (occupied—ground lease sale)	Falls Church, VA	\$25,000,000	87,708	\$285
05/10	Petsmart (occupied)	Milford, OH	\$5,178,388	27,442	\$189
05/10	Lowe’s (occupied—ground lease sale)	Geneva, NY	\$5,000,000	139,410	\$36
04/10	Former Walmart	Victorville, CA	\$4,040,000	125,000	\$32
04/10	BJs Wholesale Club (occupied)	Franklin, MA	\$13,667,000	108,510	\$126
04/10	Former Circuit City	Independence, MO	\$1,400,000	32,770	\$43
04/10	BJs Wholesale Club (occupied)	Canton, OH	\$7,700,000	108,532	\$71
04/10	Dick’s Sporting Goods (occupied)	Eugene, OR	\$11,625,000	60,122	\$193
03/10	Borders Books & Music	Santa Barbara, CA	\$9,800,000	38,015	\$258
03/10	Former Furniture Express	Clinton Township, MI	\$750,000	58,443	\$13
03/10	Former Best Buy	Westland, MI	\$854,000	36,336	\$24
03/10	Kohl’s	McAllen, TX	\$7,300,000	88,248	\$83
03/10	Garden Ridge (occupied)	Round Rock, TX	\$8,500,000	152,496	\$56
02/10	LA Fitness (occupied)	Highland, CA	\$9,215,000	45,000	\$205
02/10	Home Depot	Passaic, NJ	\$7,700,000	117,827	\$65
02/10	Barnes & Noble	Cary, NC	\$5,350,000	40,000	\$134
02/10	Former Dillard’s (redevelopment play)	Akron, OH	\$80,500	125,821	\$1
02/10	Former Carpet & Tile Liquidators	Youngstown, OH	\$780,000	26,550	\$29
02/10	Former PathMark	Philadelphia, PA	\$6,200,000	57,288	\$108
01/10	Target	Riverside, CA	\$8,000,000	191,484	\$42
01/10	Former Kmart	Colton, CA	\$2,900,000	108,000	\$27
01/10	Former Circuit City	Cincinnati, OH	\$2,150,000	33,401	\$64
01/10	Former Kmart	Defiance, OH	\$825,000	177,775	\$5
01/10	Academy Sports (sale-leaseback)	San Marcos, TX	\$7,700,000	78,000	\$99

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**LOOKING AHEAD**

While the worst of the hemorrhaging is over, we do expect additional big box vacancies to occur over the next two years. Consolidation within the grocery industry will intensify. The good news is that many discount and specialty grocery chains are actively seeking big box space and have been locking in deals. Walmart alone is expected to add as many as 300 new stores in 2011, the majority of which are expected to be grocery stores sized around 20,000 square feet. Many other similarly-sized chains are on the move as well, including Aldi, Trader Joe's, Grocery Outlet, Henry's Farmer's Markets and Sprouts.

In addition to the challenges they will face from expanding discount and specialty grocers, traditional grocery store players like SUPERVALU, Kroger and Safeway will see additional competition coming from other retail sectors. Target is adding more than 300 grocery components to existing stores this year. Both Walgreens and CVS are beefing up their grocery and fresh food offerings. Even a number of dollar store chains and 7-Eleven are increasing fresh food offerings. Smaller regional grocery chains — most of which are unionized — will struggle to compete with discounter prices.

We expect a number of smaller grocery chains to fail in the months ahead and for many of the larger mid-range price-point players to shutter underperforming stores. The biggest damage will likely be in suburban markets that are already over-saturated.

But even with further consolidation within the grocery sector, the amount of space being returned to the market will be outpaced by the number of users backfilling vacant big boxes.

Top-tier big box locations — those within busy shopping centers or situated on prime intersections — are already moving quickly. We expect that most of these will be backfilled within the next 12 to 24 months. But it will still take years to work through the current glut of big box vacancy. Those within weaker shopping centers or on less popular intersections will face longer lease-up times. It could take three or four years for some of these buildings to be occupied again.

Landlords of big boxes larger than 50,000 square feet may find that demising their properties to accommodate multiple smaller tenants is a necessity. Unfortunately, this process is far more complex and expensive than merely putting up drywall. Plumbing, heating, air conditioning and ventilation systems need to be adapted and can cost \$4 to \$6 per square foot.

For the weakest big box product there simply may not be any relief coming in the form of new retail tenants. Creative adaptation to non-retail uses or even demolition may be the only option.

In Part 2 of this report, we'll examine some creative ways that landlords have adapted their retail big box space for reuse.