The retail sector’s uneven recovery equates well to stop-and-go driving: Ultimately, you get where you want to go, but it takes longer and can be incredibly frustrating. Despite recent surges in consumer spending, the pace of retail’s rebalancing lags other property types. Many factors have contributed to retail’s struggles, among them high debt levels for households and businesses, high structural unemployment, and slow (or negative) after-tax income growth. Each of these has constrained consumer spending, particularly on discretionary items. The primary impediment to a more rapid recovery, however, has been the oversupply created by the retail industry’s misreading of housing demand during 2004-2007. Building too much retail in locations where population growth did not materialize has left many properties scrambling to backfill vacant spaces and their owners struggling to cover their debt service.

Retail’s dependence on a healthy economy and a fickle consumer makes it vulnerable, but as an investment category retail real estate presents attractive opportunities. For property owners, municipalities, and investors committed to the sector, opportunistic investments can materialize by thinking differently from the herd. This type of forward-thinking analysis involves digging beneath the top-line numbers to understand the factors and conditions necessary for asset performance and values to recover further, and how those elements will favor certain retailers and markets. This white paper aims to identify and analyze successful investment and branding strategies, and the retailers ahead of their peers in executing them. We’ll also look at evolving macroeconomic conditions and infrastructure networks to recognize U.S. states and metropolitan areas that are poised to outperform.
FACTORS DRIVING RETAILER SUCCESS

Much has already been made of the Great Recession’s effect on consumer preferences and resulting outperformance by both discounters and luxury brands. Low-price chains such as Ross, T.J. Maxx, and the dollar stores benefited from shoppers’ newly frugal mindsets dictated by personal debt levels and employment concerns. On the high end, luxury goods shoppers led a “flight to quality” that spiked revenues at Burberry, Hermes, and Chanel, to name a few. Yet, while this bifurcation trend highlights the troubles for brands caught in the middle, it doesn’t explain why some high-end retailers and some discounters have struggled. Looking ahead to suggest which retailers are poised to outperform, we argue that corporate success now hinges far less on absolute price than it does on corporate strategies for reinvesting in technology, elevating the in-store experience, and refining the service aspects of the retailer’s offering.

ABILITY AND WILLINGNESS TO REINVEST IN THEIR BUSINESS

When the recession hit, many companies—not just those in retail—had weak balance sheets and subsequently spent the last couple of years rebuilding their reserves. Moody’s Investor Service recently reported that U.S. nonfinancial corporate cash holdings were $1.24 trillion at the end of 2011, matching what they were in 2010, up from $1.11 trillion at end of 2009. As their competitors operated in “survival mode,” retail companies with more liquidity seized the opportunity to invest in corporate infrastructure. Nordstrom and Macy’s, two prominent examples, focused real estate expansion on their off-price store concepts (Nordstrom Rack and Bloomingdale’s Outlet, respectively), expanded their programs to promote customer loyalty and enhance in-store fulfillment, and established multichannel inventory systems.

Effective cost containment and revenue optimization have generated enough executive confidence to loosen the purse strings on capital expenditures (CapEx) for both technology and real estate. Technology investment takes the form of channel diversification: improving and integrating brick-and-mortar, online, mobile, and catalog operations. Real estate investments include opening new stores, experimenting with smaller prototypes, and upgrading...
remodeling existing locations. Unfortunately, relatively few companies disclosed specific dollar amounts allocated to each category, so we can’t yet make any comparisons between programs or draw additional conclusions.

Within Colliers’ 105-retailer sample set, 78 companies (74% of the total) increased their CapEx budgets in 2012. Nine companies estimate that they will spend more than $1 billion, including the leaders in each merchandise category: big boxes Walmart, Costco, and Home Depot; drugstores CVS and Walgreens; Kroger and Safeway in grocery, and McDonald’s and Yum! Brands in quick-serve restaurants (QSRs). Building on their strong 2011 performance, 16 companies have increased their 2012 CapEx budgets by more than 50% over last year. This group includes The Buckle (+132%), Cost Plus (+91%), Family Dollar (+74%), Brinker International (+71%), Starbucks (+69%), and Williams-Sonoma (+61%). As these companies effectively demonstrate, having the means to reinvest in their businesses is the result of being good at what they do, which leads directly into the next success strategy: reworking physical locations to better showcase the brand.

**ENHANCING THE IN-STORE EXPERIENCE**

As e-commerce has expanded in the past decade, it exposed the vulnerabilities of certain brick-and-mortar retail chains: those selling products that were content-related (and could be digitized) and those that relied on volume sales rather than margin (competing on price) to generate revenues. Doing business in a commodity-driven marketplace relegates the physical store to merely a distribution facility versus a place that plays up brand identity and creates a space where customers can interact with it. The dizzying pace of technology advancement, combined with the sticky process by which retailers and landlords allocate remodeling capital, means that most existing brick-and-mortar stores don’t yet offer the experiential components sought by today’s shoppers.

Retailers “ahead of the curve” in reinventing their physical spaces elevate the shopping experience to focus on every aspect of their business that matters to their customer. They seek to create spaces that are not only integrated with their online business but offer something special that on-line can’t deliver: a multisensory marketing blitz plus a personal touch. Apple distributes its product through multiple retail channels, none more successful than its 300+ company stores worldwide. There, shoppers have unrestricted access to create their own experience; to try out anything in the product line, conduct their own research in-store, flag down an iPad-toting sales associate or chat with other customers to answer questions, and check out quickly. All this takes place within a physical space that perfectly reflects Apple’s corporate branding.

It’s a safe bet that much of the 2012 technology CapEx mentioned earlier will be spent by retailers trying to apply Apple’s execution to their own platforms. Looking ahead, it will be interesting to see how other successful retailers with a less specialized product line (e.g., CVS, Safeway, Staples) evolve their branding programs. By offering time-pressed customers a shopping option that’s more than just shopping, outperforming retailers will cement the value of their brick-and-mortar locations and maintain the vibrancy of their brand.

**THE RISE OF THE SERVICE COMPONENT**

Recent improvements, however slight, in the U.S. economy have allowed retailers that adapted promotional programs during the recession to return to their core pricing strategies.
While a certain segment of consumers remains extremely price-sensitive, many more are becoming comfortable spending again so long as they know that the price they pay—whether for a Happy Meal, a haircut, or a Birkin bag—aligns with the value they expect to receive. Very often these days, value is measured in time saved. Retail is becoming more about service and less about "stuff."

Looking at the accompanying chart at left, a large number of expanding retailers offer a service component. Automotive and QSR are two examples. The automotive sector is growing not only because the average vehicle is the oldest on record (10.8 years), but because people who want to save money maintaining their out-of-warranty cars need advice on products to buy and how to use them. QSR operators can also be thought of as service providers: You’re paying for speed of delivery over product quality (usually). QSR has a built-in advantage in the e-commerce age because the nature of customer demand doesn’t translate into anything except at brick-and-mortar locations. In contrast to these fast movers, we project that future store closings are far more likely to impact businesses that sell goods than those focused on services, which are more difficult (if not impossible) to transact over the Web.

The property valuation process changes as more service businesses open and as existing retailers generate more revenue from services. Within the past 12-18 months, landlords around the country have signed on more service providers to backfill vacancies. A higher percentage of service uses forces lenders to rethink how they finance real estate projects. Pro forma construction costs increase: Service-driven uses such as spas and physicians’ offices typically cost more to build, and the resulting property ownership structure will become more capital-intensive (as is already the case for high-end malls with more expensive finishes). Cash flow assumptions must also change, for many service retailers are too small to have received a credit rating. Because institutional capital isn’t as familiar with these retailers, property appraisers must rethink what the appropriate cap rate should be in the absence of a corporate debt rating, and adjust default rates and turnover ratios to model risk more accurately.

Winning retailers will both leverage the value of multichannel to drive their brand, and neutralize the pricing / convenience factor of e-commerce by offering better product and more comprehensive service.

### FACTORS DRIVING LANDLORD / PROPERTY SUCCESS

“Location, location, location” may be the age-old mantra for real estate success, but “tenants, tenants, tenants” are ultimately what drive traffic to a retail project, generate revenues, and separate it from its competitors. Constraints on new development have aided retail’s recovery, allowing even the smallest increases in consumer demand to benefit properties with tenant mixes well-tailored to their shopper base.

A February Wall Street Journal article on “The Malaise Affecting America’s Malls” highlighted the success achieved by market-dominant “fortress” malls at the expense of their weaker competitors. It has since prompted many chains to reassess their real estate strategy. As one example, Abercrombie & Fitch announced plans to focus both only on stores in high-performing locations and new stores overseas. Colliers also knows of at least two national restaurant chains that are planning similar portfolio refocusing.
Where are these dominant retail assets and who owns them? The map above plots the locations of the 158 regional malls (excluding outlets) estimated to generate in-line sales of more than $400 (PSF) as of January 2012, the ICSC average was $398/PSF. More than 90% are owned fully or in part by a publicly traded real estate investment trust (REIT). REITs’ large, diversified portfolios enable them to extract concessions, leverage co-tenancies, and not only refinance debt on the property but do so at more attractive terms than smaller competitors can negotiate. Market size matters too: Nearly two-thirds (64%) of these assets are located in one of the country’s largest 20 metro areas, and all but ten of them in the largest 100 metros. As they continue to gain market share, these malls drive higher sales tax revenue and benefit* municipalities in which they are located. Forty-one percent (41%) are located in metro areas adding population at a 5-year Compound Annual Growth Rate greater than 5%.

While “A” centers in Core markets are well-positioned for future success, the majority of owners and investors possess more modest portfolios. Their issue becomes how to reposition “B” and “C” centers in non-Core markets. Differentiation and creativity are essential to maintaining a competitive advantage. Successful landlords will be those that remain focused on maintaining a unique tenant mix and be willing, if necessary, to accept lower rents short-term to achieve the long-term payoff of owning a commercially viable property with stable (or rising!) occupancy rates and cash flows. Another option is to develop tenants internally: incubating new retail concepts that will eventually take space. And, landlords and owners (and their lenders) have to be willing to demolish vacant or under-utilized spaces, foregoing short-term cash flow, to create new retail zones.

*The increasing use of mobile devices to purchase retail goods complicates the process of allocating sales among distribution channels if customers use more than one (for instance, make a purchase using a tablet while in a store, but request merchandise be shipped to them from a warehouse). Multiple channels make it difficult to allocate sales to a specific location, which impacts sales taxes paid to the corresponding municipality. In the future, retailers and landlords will have to agree on changes to lease language to deal with percentage rent.
FACTORS DRIVING STATE/METRO AREA SUCCESS

Retail investors’ third opportunity lies with the allocation of funds and resources to U.S. regions and metropolitan areas with high growth potential. Effective investment timing requires an understanding of the trends that most benefit retail and where major markets are in the economic cycle, for the recovery is playing out unevenly across the country. Successful retail corridors of the future will be those where supply is aligned with demand. Not surprisingly, areas currently out of balance are experiencing slower rates of recovery.

Metro markets poised to outperform in the next decade exhibit one or more of the following attributes: an improving housing market (even if improvement is occurring from a very depressed level); potential for favorable demographic shifts; ability to cultivate job growth and a skilled labor force in energy- and knowledge-based industries; and proximity to intermodal infrastructure. We will examine each of these in turn.

AN IMPROVING HOUSING MARKET

The improving housing market is boosting some secondary markets that may not yet appear on investors’ radar screens. Although many housing metrics remain in recession territory, recent readings from the National Association of Homebuilders (NAHB) First American Improving Markets Index demonstrate “measurable improvement” in both housing supply and demand measures. The index correlates home price appreciation, job growth, and permit activity rates for all U.S. Metropolitan Statistical Areas (MSAs). In April, for the first time since 2007, more than 100 housing markets—concentrated in the “Rust Belt” Midwest and Southeast—made the Improved Markets list, with a nearly identical total this month. For May, the five states with the highest number of improved markets are Texas (11), Florida (10), Michigan (8), and Pennsylvania/North Carolina/Iowa (6). The NAHB data support the argument that housing has bottomed and is recovering in interior and secondary MSAs where neither home price appreciation nor new supply overheated prior to 2008.

Metro areas’ ability to emerge from the housing crash is also highly dependent on their states’ foreclosure status as either judicial or non-judicial. Courts in each of the 23 judicial foreclosure states are backlogged with cases, delaying the process by which properties are returned to investors. Non-judicial states move through their foreclosure inventory more quickly, allowing residential properties to be recycled into productive housing: One-third of existing home sales are now being made to investors, who most often chose to convert them into rental properties.

FAVORABLE DEMOGRAPHIC TRENDS

Household formation, whether in rental or owned residences, is a significant driver of retail expenditures. Retail sales took a hit beginning in 2007 when the homeownership rate began to decline from its all-time peak of 69% as households began doubling up with multiple generations. Short-term, this population transfer benefits higher-income neighborhoods and metro areas—where Mom & Dad are more likely to live—at the expense of the areas vacated by the children returning home. It also boosts certain discretionary (and service) retail expenditure categories such as pet products, entertainment, salons/hair care, and restaurant dining as extended families incur less housing cost per capita.

What will be the tipping point for these doubled-up households? Tight lending standards currently prevent many borrowers from qualifying for a loan, even with long-term financing.
rates at historic lows. Credit score reform will eventually allow potential borrowers with blemished histories to improve their rating and qualify for a loan. The big shift will likely be demographic, as the 78 million Millennials move into their prime household formation years and find a way to move out of their parents’ basements. There is already anecdotal evidence that household formation is increasing: recent quarterly comparable year-over-year sales growth from Pier 1 (+10.3%), Bed Bath & Beyond (+6.8%), and Williams-Sonoma (+7.0%) illustrated a broader improving trend in the housewares sector.

**KNOWLEDGE-BASED JOB GROWTH AND A SKILLED LABOR FORCE**

Job growth is occurring in areas dominated by industry sectors that either were more resistant to the recession or began to improve earlier in the recovery. The strength of energy, an example of the former, extends beyond the powerhouse Texas cities of Houston and Dallas to include Colorado, Oklahoma, North Dakota, Kentucky, and Wyoming (a real “sleeper,” in our opinion, because of new intermodal facilities in Cheyenne and Casper constructed to keep pace with Denver). North Carolina, the second-highest energy jobs-producing state behind Texas, is redeploying laid-off investment bankers from Wachovia and Bank of America into energy trading programs.

Manufacturing, which had struggled since 9/11 and China’s entrance into the World Trade Organization, turned up ahead of the broader economy beginning early last year. Despite a slight activity pullback in March 2012, it is still growing at a healthy clip. Indices measuring factory activity in Texas, the Midwest, and South point to expansion. Texas is particularly strong, with the Dallas Fed’s diffusion index showing growth in production and factory employment. Recovering Midwest manufacturing hubs such as Detroit and Flint (MI) made the May NAHB Improved Markets list discussed earlier in this paper.

The current manufacturing rebound differs from previous recoveries in the type of worker being sought by growing firms: highly skilled but not necessarily whitecollar. This corporate demand for trained labor will benefit education center and knowledge-based gateway cities such as Austin, Boston, Chicago, Denver, and Raleigh. In the past decade Michigan has also emerged as a center for technology development; although the state lost hundreds of thousands of manufacturing jobs (which generated huge headlines), it was simultane-
ously adding back higher-paying technology jobs, albeit in smaller numbers, in automotive and medical device research and development. As job and wage growth fuels consumer spending, retail properties benefit as revenues rise, and increased tenant demand leads to lower vacancy rates and higher rents.

PROXIMITY TO INTERMODAL TRANSPORT INFRASTRUCTURE

Big changes are coming for metro areas proximate to intermodal infrastructure, such as deep-water ports and rail lines, as macroeconomic dynamics shift import/export demand and the Panama Canal expansion nears its scheduled 2014 completion. Even as West Coast ports retain the largest overall market share (49.1%) in U.S. container trade, current growth trends favor East Coast and Gulf ports. East Coast traffic is anticipated to increase at double-digit rates as emerging markets trade grows and Asian/European trade declines. Post-2014, port authority directors along the East and Gulf coasts expect that the warehouse demand will surge in the rush to accommodate larger vessels. Port expansion projects underway to dredge deeper channels (Savannah and Charleston), upgrade crane equipment (Miami), enhance “roll-on, roll-off” (RoRo) rail service, and automate activities in right-to-work states will also contribute to increased warehouse demand.

Long-term, these trends completely flip the orientation of the container industry. Instead of most container traffic coming in from Los Angeles/Long Beach/Oakland/Portland/Seattle and heading east, it will likely enter from Charleston, Savannah, and Miami and head west. This shift impacts every aspect of the supply chain, including the labor market and overall economic health of every city in the distribution network. Other examples of the linkage between skilled labor, manufacturing, and intermodal infrastructure include: 1) Highly skilled labor in Midwest manufacturing facilities creates product that can then easily be transported by with rail cars loaded to Southeast port cities such as Charleston, Savannah, New Orleans, or Port Everglades; 2) Denver, which benefits from its proximity to light rail and the airport; and 3) Houston, where growth is more focused on medical and port than its traditional strength in energy.

CONCLUSION

It doesn’t take a crystal ball to realize that retail’s gradual recovery continues be both nuanced and marked with ups and downs as it tracks shifts in consumers’ confidence and ability to spend. For potential investors, though, it is that unevenness that generates opportunities for outsized returns, particularly when they understand what successful retail companies are doing correctly and how the evolving U.S. job market will reshape economic activity and spending. We never underestimate the power of U.S. consumers, both households and businesses, to dictate how those events unfold.