Sperry Van Ness
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RETAIL
Market Outlook

The recovery phase in the current real estate cycle has been like no other for the retail sector, which is dealing with profound shifts in consumer habits related to e-commerce. More than a new source of competition for bricks and mortar stores, the online world is now an entrenched component of the shopping experience; hence, omni-channel marketing by retailers incorporates the internet and social media as tools to engage customers and generate traffic to conventional stores as well as to drive online sales. As in the office sector, tenants' pursuit of greater efficiency has reduced space requirements for many retailers, particularly those that have introduced scaled-down formats to better suit the tight, inner-city neighborhoods to which young, highly-paid professionals are migrating in droves. Unequal retailer performance across the price spectrum reflects bifurcation of incomes in the United States, which has created a retail divide in which necessity- and value-oriented retailers are enjoying brisk sales and are embarking on nationwide expansion programs, while high-end retailers serve a clientele that was largely unaffected by the recession and has continued to spend freely through the downturn. Cautious spending has hampered sales at mid-tier stores, however, and most of the national chains in this bracket have curtailed any plans for multi-city rollouts, depriving power center developers and those landlords with vacant big box spaces of their main source of anchor tenants. Grocers and entertainment venues, such as theaters and the occasional bowling alley, have proven to be a good substitute to fill some of those needs, and provide an added source of foot traffic for retailer tenants. REITs, which control more than 80 percent of U.S. malls, have been unloading mid-tier shopping centers and weak malls in order to redeploy capital in acquisitions and expansions of their most profitable properties, which could create acquisition opportunities for investors with the skills to reposition assets for greater value. Thanks to a conservative construction pipeline in most markets, retail vacancy rates are headed down at the national level and particularly in markets with strong energy, high tech, tourism, financial services, health care or other growth industries that promise to fuel continued increases in retail demand.

FLORIDA TECH CORRIDOR ORLANDO TO TAMPA FLORIDA

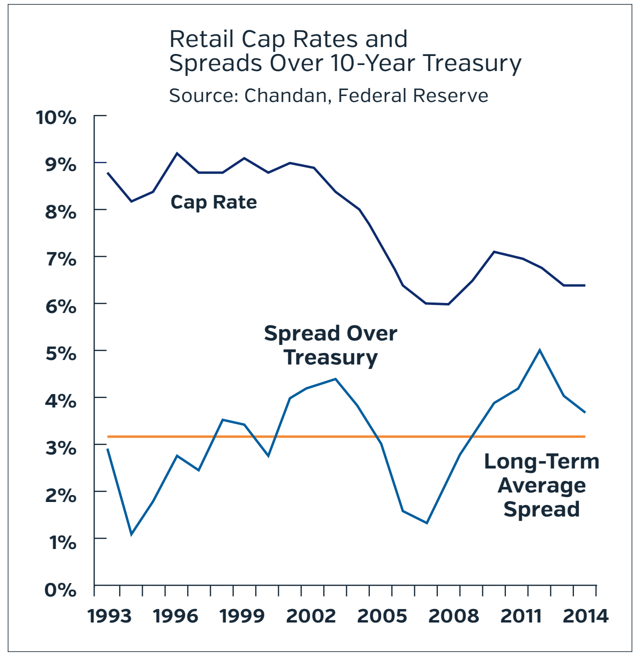
In addition to boasting some of the top tourist destinations in the United States, Central Florida has cultivated a thriving technology cluster in a 23-county region spanning the breadth of the state. Joint programs by regional universities and community colleges cover a wide range of technology fields, from microelectronics to biotechnology, modeling and robotics, aerospace, wireless technology and digital media. The growing workforce of highly skilled, young professionals is attracting tech employers and fostering startups, adding a significant and expanding source of well-paid residents to help drive retail sales. Tampa and Orlando share a similar overall retail vacancy rate of about 9.5 percent, but Tampa's malls have outperformed with a vacancy rate below 4 percent and average mall rents of $25 or more per square foot. In Orlando, mall vacancy is 200 basis points higher and average rent is closer to $15. Tampa's weak spot since the recession has been excess vacancy at strip and neighborhood centers, but falling rents in those subsets showed signs of flattening in late 2013. Orlando in particular has benefited from resurgent tourism that will increase as the economic recovery takes a firmer hold in U.S. markets this year. Investor confidence in Central Florida's outlook has driven strong demand for net-leased retail since 2011, and would-be buyers are now showing greater interest in multi-tenant properties with below-market rents that offer good upside potential.

10 RETAIL MARKETS TO WATCH

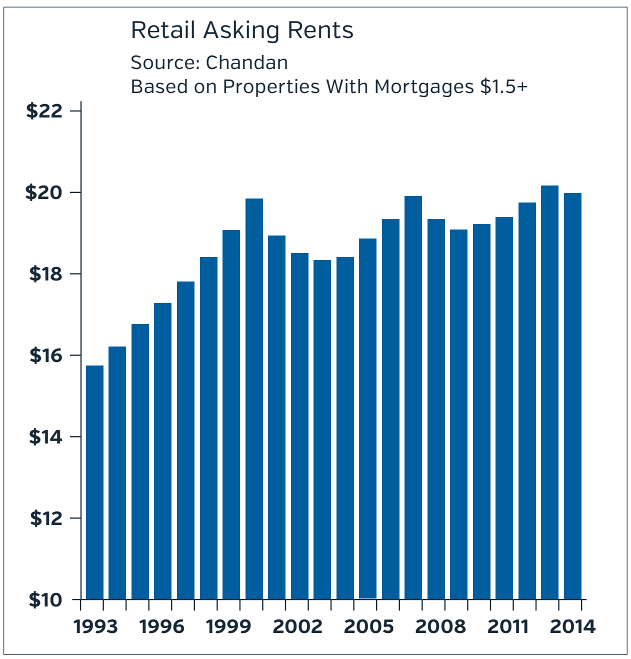
- FLORIDA TECH CORRIDOR: ORLANDO TO TAMPA
- HOUSTON
- LOUISVILLE
- NEW YORK CITY
- OKLAHOMA CITY
- ORANGE COUNTY
- PHOENIX
- NASHVILLE
- SAN FRANCISCO

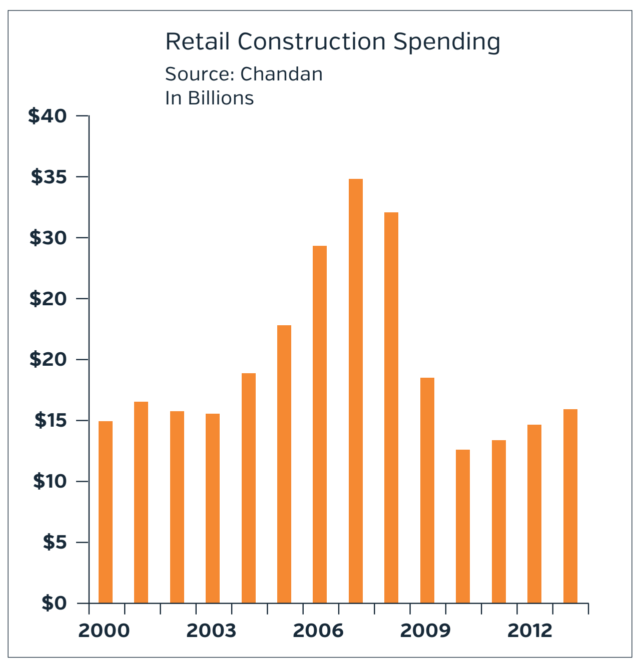
Key Retail Market Trends in 2014

Trending higher than other property types, cap rates in the retail sector absorbed increasing interest rates into spreads last year. Urban retail, triple-net single-tenant assets, and dominant regional malls were the best performers. However, the price recovery is still incomplete for smaller and more suburban neighborhood and community shopping centers.



Retail rents and occupancy rates avoided the sharp declines seen for other property types but are now struggling to build momentum. In major tourist corridors and at dominant regional malls, rents are higher. For many other retail product types, the slow recovery of household income and the encroachment of online sales are significant drags on performance.





Retail occupancy trends are benefiting significantly from a drop off in development. In suburban areas in particular, banks and other sources of construction financing have been wary of engaging with prospective borrowers. With development still in check, investors have a further reprieve to raise occupancy rates and grow income.

HOUSTON, TEXAS

The Energy City added more than 82,000 jobs in 2013, pushing down unemployment to 5.5 percent in December and fueling strong retail sales and demand for retail space. Citywide retail vacancy rates near historic lows continue to fall despite active development. With less than 1 million square feet in the construction pipeline following the absorption of some 3 million square feet in 2013, rental rates should continue to climb. As the poster child for urban sprawl, however, Houston experiences wildly divergent occupancy and rental rates. Properties in the metro's hottest locations command as much as $70 per square foot, while other landlords are barely able to garner double-digit rents. In a city that prides itself on a lack of zoning, site-specific due diligence is therefore of paramount importance before attempting any retail investment or development project.

LOUISVILLE, KENTUCKY

The retail hub for a 16-county region, Louisville is slowly recovering from the downturn with employment growth that exceeds Kentucky's overall performance but lags the national average. The market's year-end unemployment rate was 7.5 percent, down from a peak of 10.5 percent in January 2010. In 2013, Cabela's opened an 88,000 square foot store in the Old Brownsboro Crossing development, alongside Norton Brownsboro Hospital, Lowe's and Costco. This year, Horizon Group Properties and CBL & Associates will open The Outlet Shoppes of the Bluegrass, an outlet mall in Simpsonville on the eastern edge of the Louisville metro. Downtown Louisville welcomed six new retail shops last year and will soon join in the renaissance of mixed-use development taking shape across the nation: a $261 million development in the CBD will bring a 600-room Omni convention hotel, 200 apartments, retail shop space and an upscale grocery. Across the market, healthy absorption at neighborhood retail centers has offset negative absorption in most other retail property types. Completion of new projects in 2013 increased overall vacancy slightly, but the vacancy rate remained in the single digits at year-end, with no major space in the pipeline other than CBL's outlet project. The slow pace of absorption may not call for large-scale retail construction in the near term, but Louisville offers numerous opportunities to meet existing pockets of unmet demand with infill, value-add plays. Louisville will get a new four-diamond hotel " along with a much-anticipated downtown grocery, retail shops and 200 apartments" under a $261 million downtown development plan announced by Mayor Greg Fischer and Governor Steve Beshear.

NEW YORK, NEW YORK

The retail recovery is old news in the Big Daddy of U.S. core markets. In New York City, the retail talk in 2014 is about new stores, strong sales, and intensive investment. Massive increases in tourism are a big part of the retail story, with more than 50 million visitors annually in each of the past three years. In 2013, tourists spent $8 billion at local retailers, excluding what they spent on dining and accommodations in the city. Fifth Avenue department stores and other high-end retailers aren't the only shopping destinations with strong retail sales–the metro area's dense population and high income demographic has supported more uniform demand across retail classes than in most other U.S. markets. More than 900,000 square feet of absorption, chiefly in the metro area's neighborhood shopping centers, drove the vacancy rate below 5 percent in 2013. Developers added roughly 400,000 square feet to the local inventory, almost entirely in that same category of neighborhood centers. Outside the core areas and in the broader metro, strip centers have generally fallen behind other product types and experienced a 70,000-square-foot demand contraction last year. Competition to acquire well-located properties is intense, and cap rates compressed through competitive bidding are squeezing out even heavily leveraged investors.

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OKLAHOMA CITY, OKLAHOMA

Oklahoma City's retail real estate fundamentals are curiously fragile for a market with strong job growth. The metro area has created jobs in numbers well in excess of those lost during the downturn, and although the jobless rate showed volatility in 2013, the rate stood at 4.8 percent in December, one of the lowest in the nation. Retail space absorption is improving, registering stronger results in 2013 than in 2012. That annual gain masked a poor third quarter in which retailers gave back more than 100,000 square feet in neighborhood shopping centers. Mall vacancies have come down from more than 30 percent in 2012, but roughly a quarter of mall space remains dark, and single-digit lease rates at those properties are the lowest of any retail product type in the city. A drawback to the city's low unemployment rate is a limited labor pool that has hampered corporate growth and recruitment of new employers, contributing to the slow recovery in retail. Job growth should top 2.2 percent in 2014, however, and with above-trend annual population growth of 1.6 percent, the metro has good prospects for increasing retail demand.

ORANGE COUNTY, CALIFORNIA

Retail sales in Orange County are gaining momentum as a recovering housing market adds increased consumption by local residents to the tourism-related dollars already flowing into this resilient West Coast market. The county's retail vacancy rate is among the lowest in the nation, on par with those in Oakland/East Bay and San Diego, and could fall as low as 5 percent in 2014. Some segments of the market continue to struggle, however. In particular, construction in 2014 will exacerbate double-digit vacancy among specialty retail properties. Overall rental rates should continue to climb, however, as retailers compete for space in a market that promises increasing retail sales volumes in step with robust tourism, driven by recovering employment in California and around the nation.

PHOENIX, ARIZONA

Phoenix's jobless rate fell to 6.2 percent at the end of 2013 from 6.8 percent a year earlier, driven by gains in financial services, construction, insurance and healthcare jobs. Already one of the fastest-growing cities in the nation, Phoenix will see its population expand by more than 2.4 percent in 2014, with a commensurate rise in retail sales and even greater demand for retail space. Overall vacancy fell to near 10 percent in late 2013 in a year when retailers absorbed approximately 3.5 million square feet of new retail space, far outpacing construction that added roughly 1.5 million square feet to the market in that period. Three years of positive absorption will likely bring rental rates to an inflection point in 2014, ending a protracted decline as landlords gain greater pricing control. Already a strong market for discount and necessity retailers, Phoenix's growth in high-paying professions will fuel sales for middle- and high-end retailers in the years ahead.

MARKETS TO WATCH

NOT THE LARGEST or the most actively contested markets, the 2014 Retail Markets to Watch are each at an important juncture that presents unique opportunities for investment. Together, they reflect the diversity of trends that is driving the economy and commercial real estate performance in markets across the country.

NASHVILLE, TENNESSEE

A state capital with a skilled workforce and diverse economy, Nashville is staging a strong comeback in its retail fundamentals. The vacancy rate dropped by 100 basis points year-over-year in 2013 and is poised to enter single-digit territory this year. Absorption has been positive across all retail subsectors and has been most pronounced in the city's malls, which accounted for nearly a third of net absorption. Mall fundamentals have firmed up markedly in the past 18 months, reining in vacancies from a rate in the mid-teens to more closely match the citywide rate near 10 percent. With little new space delivered in 2013 and a scant supply in the pipeline, fundamentals are on track for further improvement this year. As Nashville enters the radar screens of more investors at the national level, competition could help to preserve and enhance value as interest rates rise.

SAN FRANCISCO, CALIFORNIA

Consumers are prospering in San Francisco, and that gives retailers and retail landlords something to celebrate. As one of the U.S. gateway markets that have drawn an outsized share of retailer expansions since the recession, however, San Francisco has essentially filled its inventory of Class A space and offers only limited availability in B properties. The barriers to entry that help to place a premium on existing space are also keeping the construction pipeline in check, forcing some retailers to delay expansions pending an improvement in the availability of suitable space. Cap rate compression and intensive competition for acquisitions have inspired many investors to turn their attentions from this top tier market to cities offering opportunities for larger annual returns. Yet for core retail investors, it's hard to find a more attractive market than San Francisco.