

Retail Market Trends United States

Grubb & Ellis Research

Summer 2009



GRUBB & ELLIS

From Insight to Results

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Retail Market Trends

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The Bottom Line

Hitting the Reset Button

The current recession, already the longest of the 11 post-war downturns, is also among the unkindest to consumers and, by extension, retail tenants and shopping center landlords. That is because it began with the bursting of a housing bubble that led to the bursting of a credit bubble that extended into all corners of the global econ-

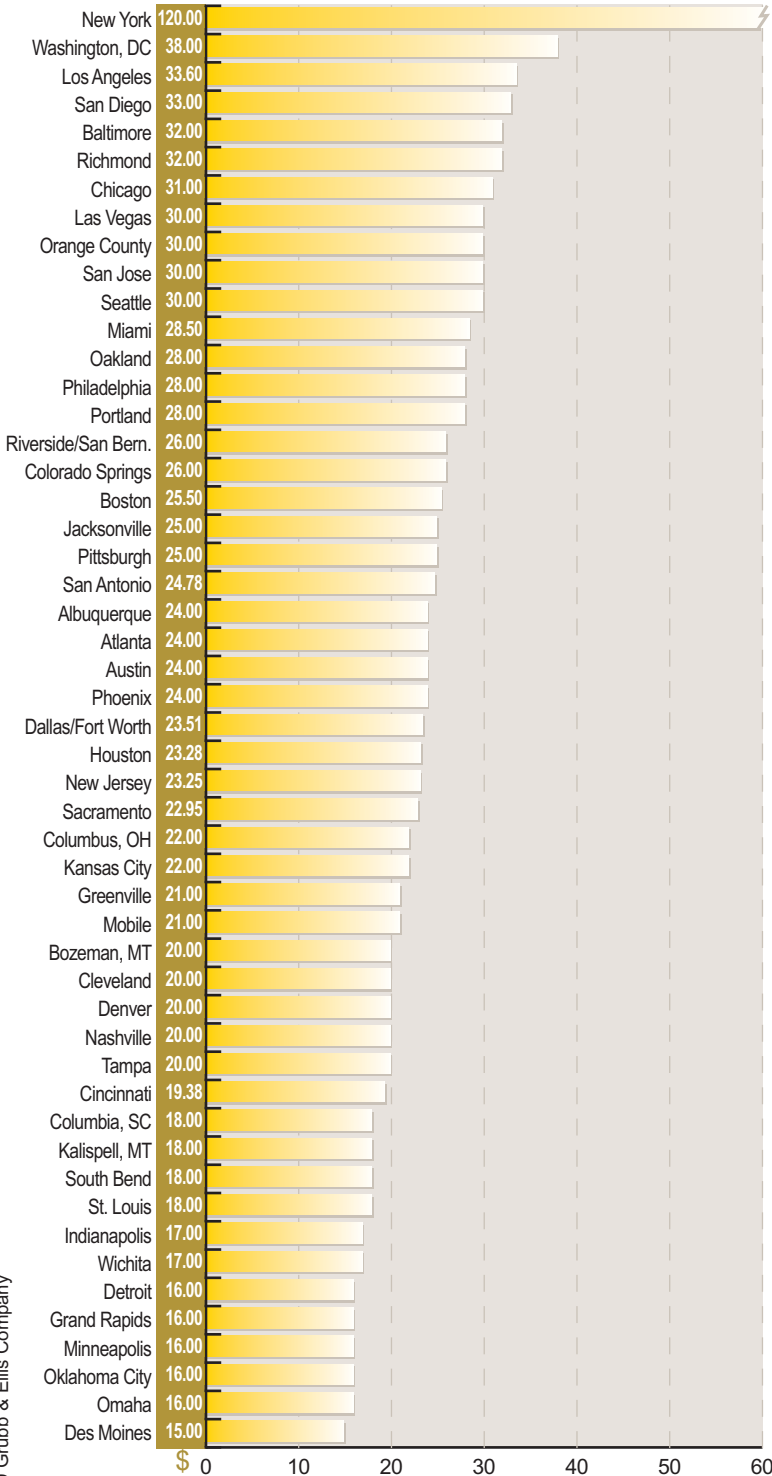
This process likely will have long-term consequences...

omy. Housing and credit are important drivers of retail sales. This is in sharp contrast to the 2001 recession and 2002-03 jobless recovery, a period when the retail sector outperformed thanks to artificially low interest rates and a vigorous housing market that eventually inflated into a bubble. Fortunately, the current recession appears to be nearing a bottom, and a slow recovery may take root as early as the fourth quarter. Many observers have referred to this period as a "reset," by which they seem to mean a recalibration of personal, corporate and civic values. Part of this recalibration is an increase in the personal savings rate and perhaps a rethinking of the meaning of value in the goods and services that we consume. This process likely will have long-term consequences for retailers, developers, investors and consumers that will endure beyond the recession.

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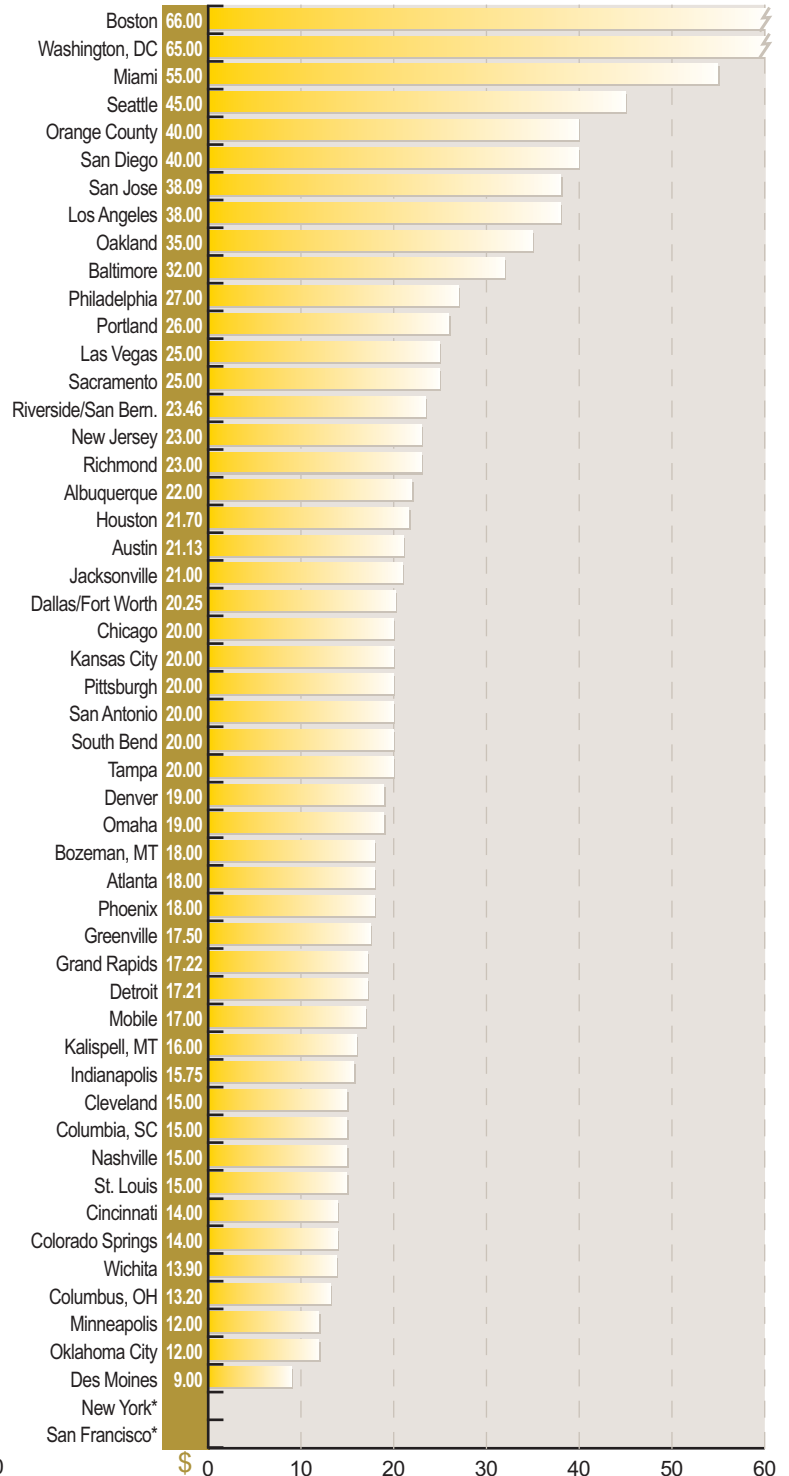
Rental Rates, In-line Shop Space

Note: Rental rate data refer to in-line shop space in grocery-anchored center, 3,000-square-foot national credit tenant, newly developing suburban trade area, first generation space, white-box build-out. Rates are per square foot, quoted on an annual, triple net basis.



Pad Site Prices

Note: Sales price data refer to 1-acre pad site (vacant land) suitable for a bank, restaurant, drug store, etc.; mall-adjacent, newly developing suburban trade area. Sales prices are per square foot.



* Few such properties available

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State of the Market

Recessions are never good for any category of commercial real estate, and this one has been especially tough on retail properties and their landlords.

How We Got Here

Of the four core property types—office, industrial, retail and multi-family, retail has some unique attributes that affect its performance in real estate cycles. Shopping centers have suffered from the perception, if not the reality, of chronic overbuilding for at least a couple of decades, ever since category killers like Toys “R” Us, Home Depot, Staples, PetSmart, Barnes & Noble and others began siphoning market share from mom-and-pop retailers and small regional chains. In the mid- and late 1990s, shopping centers were viewed as vulnerable to the Internet. Shopping center owners watched nervously as consultants laid out plans for retailers to ladder their lease terms so they could gradually reduce space commitments and migrate their operations to the Web. While Internet sales have grown rapidly, they account for only 3.4 percent of total retail sales according to the Census Bureau. Nevertheless, the perception of risk drove down returns from retail properties well below other property types from 1995 through 2000 according to the National Council of Real Estate Investment Fiduciaries (NCREIF).

Then shopping center landlords caught a break as they rode record low interest rates and the housing boom in the early part of this decade. Shopping center vacancy rates tightened, rental rates increased and new construction exploded. From 2002 through 2004, retail property returns surged well ahead of returns for

other property types. But the out-performance was not destined to last. Home prices began their decline in late 2006, the credit markets seized up in August 2007, the economy slid into a recession in December 2007 that worsened in the fall of 2008, and consumer spending plunged.

Where We Are

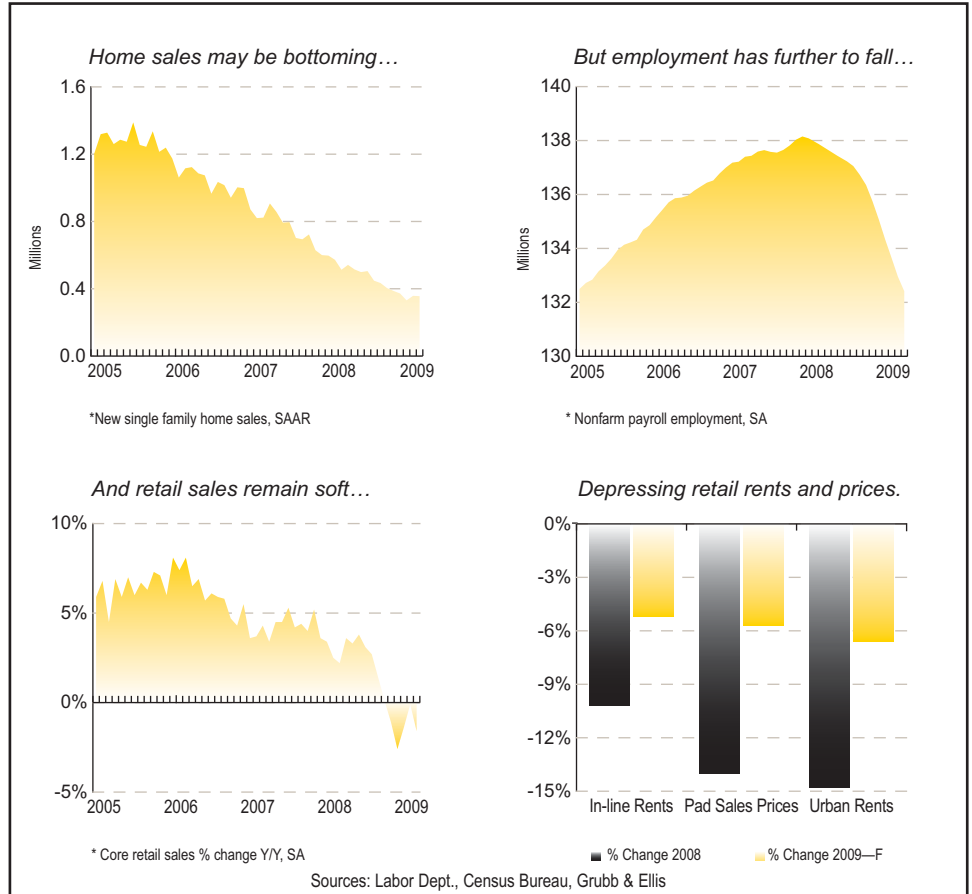
As of spring 2009, there are signs that the recession is nearing a bottom, though the strength of the recovery is in question. Federal Reserve Chairman Ben Bernanke and a majority of private economists expect a slow, “jobless” recovery of the kind that followed the 2001 recession,

though dissenters point out that deep recessions such as this one usually are followed by vigorous recoveries.

For shopping centers, there are several hopeful signs:

- Home sales appear to be at or close to a bottom, with prices having fallen low enough to attract investors and first-time buyers, particularly in hard-hit markets such as California. Prices, however, remain under downward pressure with pessimists forecasting a further decline of 10 to 15 percent in the U.S. average.
- Personal consumption expenditures increased unexpectedly by 2.2 percent in the first quarter, its highest rate of

The Economic Story: The Struggle Continues



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State of the Market (continued)

increase in two years. Because this category accounts for 70 percent of total gross domestic product, the hope is that consumers will lead businesses, which have sliced inventories mercilessly, to resume production and restocking and to curtail staff layoffs.

- Consumer confidence appears to be bouncing off a bottom as measured by both the Conference Board and the University of Michigan. The New York Times/CBS News poll and The Washington Post/ABC News poll both suggest a renewed sense of optimism, which could support increased spending.

The recession is making itself felt in real estate leasing market fundamentals. Reis reported negative net absorption in neighborhood and community centers of 8.2 million square feet in the first quarter of 2009, the largest quarterly decline in the history of its survey. Asking and effective rental rates also posted record declines in the first quarter of 0.6 and 1.8 percent, respectively, as tenants downsized and in many cases renegotiated with landlords for lower rents, sometimes in return for extending the terms of their leases. The vacancy rate for neighborhood and community centers ended the quarter at 9.5 percent, an increase of 60 basis points from year-end 2008. The vacancy rate in malls ended the quarter at 7.9 percent, its highest level of the decade.

Not all retailers are struggling. Wal-Mart, dollar stores and other discounters are doing quite well in this environment and capturing market share from upscale competitors. Fitness centers continue to expand, tailoring their facilities and programs to different market segments. Auto repair shops and parts stores are taking advantage of the low level of new car

sales as drivers are more inclined to fix than trade in their vehicles. McDonald's is thriving.

Upscale retailers, which have been resilient in prior downturns, are not so lucky this time. Aspirational consumers are pulling back, slicing sales at Nordstrom, Saks and Neiman Marcus. Saks tried deep discounts during the holiday season with limited success. On the other hand, some non-luxury retailers that refused to discount, such as Abercrombie & Fitch, saw their sales plummet compared with their competitors.

How individual shopping centers are performing depends on their tenant mix and trade areas. Typically in recessions, grocery-anchored centers outperform because grocery stores generate frequent visits. This is particularly true in the current recession because grocery stores are capitalizing on a decline in restaurant sales. Grocery-anchored centers in mature trade areas have out-performed those on the urban fringe where housing construction has been halted. Power and lifestyle centers have seen some of their anchors go dark including Circuit City, Linens 'n Things and Mervyn's. Malls, too, are struggling, although the bankruptcy of General Growth Properties, the nation's second largest mall REIT, resulted more from imprudent levels of debt than from weakening performance of its properties.

The investment market is suffering from a lack of debt capital to refinance maturing loans and the reluctance of investors to act until prices fall further. Retail property sales totaled \$1.9 billion in the first quarter, a drop of 39 percent from the prior quarter and 73 percent from the first quarter of 2008. The increase in distressed retail properties is

outpacing other property types.

Capitalization rates are on the rise.

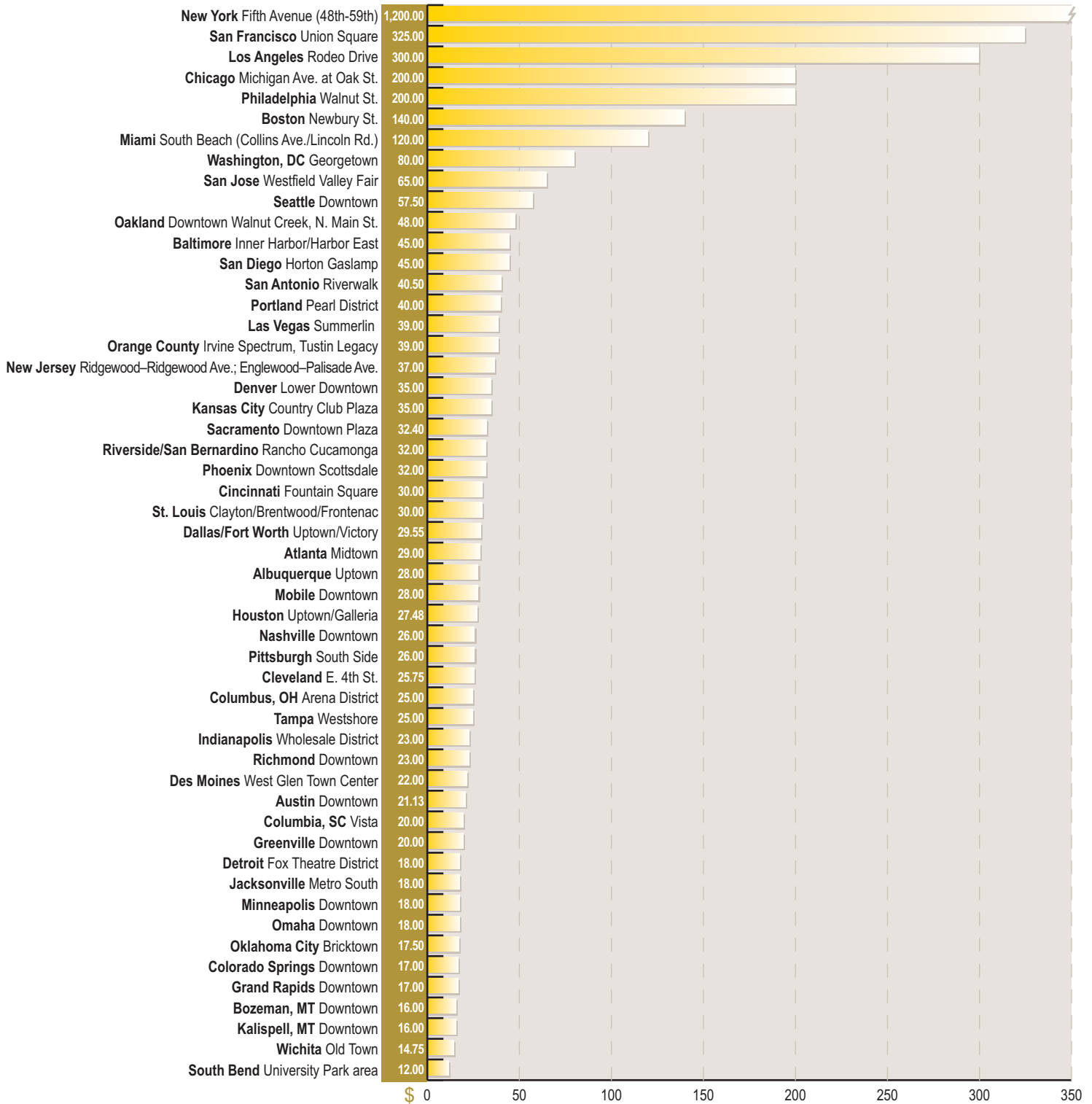
Outlook

The crystal ball is cloudier than usual. Is this just another cyclical downturn, or are there secular forces at work that will permanently alter the retail market landscape? Is this recession indeed a "reset" as some observers have suggested? Most likely some of the recession-inspired changes will outlive the recession. Spending in the last few years has been supercharged by unsustainable housing prices and a flood of credit, neither of which are likely to bounce back quickly. Consumers have been shaken by the loss of housing and stock market wealth totaling some \$15 trillion, while some analysts suggest that a generation of children will be permanently affected, much as children growing up during the Great Depression remained frugal throughout their lives. Perhaps that is too much of a stretch, but it does seem like some of this newfound conservatism and attention to value will be permanent, particularly the increase in the savings rate from near zero in recent years back to around 10 percent, the level of the early 1980s. These changes may be part of the wallpaper in a couple of years after the recession has ended, that is, part of the "new normal" operating environment for retailers and their customers.

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Rental Rates, Premier Urban Shop Space

Note: Rental rate data refer to premier retail space located in or near downtown except in predominantly suburban markets, 3,000-square-foot national credit tenant, white-box build-out. Rates are per square foot, quoted on an annual, triple net basis.



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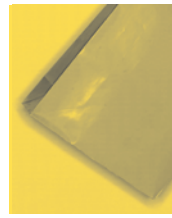
NORTHERN CALIFORNIA/ PACIFIC NORTHWEST

Fresno: Retailers remain cautious at the close of a stagnant quarter. There is a glimpse of activity on the horizon as retailers looking to capitalize on the availability of built-out and fully equipped spaces begin to emerge from the bunkers... **Oakland/East Bay:** Neiman Marcus plans to build a store in Downtown Walnut Creek, which has fared much better than the outlying submarkets in the East Bay... **Portland:** A Pacific Northwest fixture, Joe's Sports, Outdoor & More, declared bankruptcy, shutting down more than 30 stores across the Northwest... **Sacramento:** Large store vacancies continue to push on the region's retail vacancy rate. In one established corridor, Gottschalks, Linens 'n Things, Mervyn's and Circuit City were all within walking distance of one another and are now shells... **San Francisco:** Desire for premier retail space held strong even through the economic turmoil. However, rental rates will soften compared with the healthy increases of the past few years... **San Jose/Silicon Valley:** Major retailers and department stores were closed or filed for bankruptcy. Few retail transactions are expected until consumer spending begins to improve... **Seattle:** Moderate drops in asking rates, generous tenant improvement allowances and free rent have dramatically lowered effective rates. Vacancies in suburban areas have trended higher, reflecting the closings of Circuit City, Mervyn's and Joe's Sports, and down-sizings of others retailers.



SOUTHERN CALIFORNIA/ PACIFIC SOUTHWEST

Los Angeles: The retail market has cooled dramatically over the past 18 months. Low consumer confidence mixed with a large drop in spending has driven vacancy up and asking rates down... **Orange County:** Asking rents have dipped slightly, but effective lease rates are down significantly—15 to 20 percent lower. Anchor space rents have declined more than inline rents... **Riverside/San Bernardino:** The retail sector has been hit hard by the severe local housing slump and elevated rate of foreclosures. Local taxable retail sales were 40.7 billion in 2008, down 4.4 percent from 2007 as consumers confined their spending to necessities... **San Diego:** The countywide vacancy rate remains under 5 percent and is expected to stay in single digits through 2009. Net absorption was negative, and vacant sublease space increased slightly.



MOUNTAIN/SOUTHWEST

Albuquerque: The market showed symptoms of weakness as vacancy soared to its highest level since 2002. The sharp increase was propelled by a storm of bankruptcies and closings by national and regional retailers. This is providing opportunities for some tenants to upgrade spaces at attractive rates. The recent closings of the Zangara Dodge dealership and Enchantment RV are unlikely to be the last upheavals in the automotive sector... **Bozeman:** The retail market was not overbuilt prior to the recession. Rental rates have declined, but the decrease is commensurate with the decrease in building costs... **Colorado Springs:** Although growth has slowed dramatically, the market remains stable due to the four local military bases. Other activity is limited to national big box closures and lease renegotiation for shorter terms to maintain occupancy... **Denver:** Big box space and large strip centers are suffering the most following a wave of closures. Grocery-anchored centers have lost smaller ancillary tenants. Gart Properties is moving forward with its \$25 million renovation of the Denver Pavilions and intends to capitalize on the departure of Virgin Records to anchor the center with a new tenant. Park Meadows has been attracting tenants to The Vista... **Kalispell:** Absorption will be slow... **Las Vegas:** Although there are great deals to be had, tenants don't necessarily have the confidence to take advantage... **Phoenix:** Asking rental rates will continue to decline while concessions increase. Owners will focus on maintaining occupancy levels. Vacancies have been rising since 2004.



TEXAS/GREAT PLAINS

Austin: Occupancy remains high among all shopping center types. A slowdown in construction activity will funnel demand into existing centers, helping landlords fill their empty spaces... **Dallas/Fort Worth:** Rather than lowering asking rents, landlords are offering more free rent and fewer tenant improvement dollars to preserve cash flow. Cash is an issue right now for tenants also with most looking for turn-key deals or needing a significant amount of the finish-out done by the landlord... **Des Moines:** Steve & Barry's 35,000-square-foot store closing was the single largest hit to the market. Kohl's opened a new 88,000-square-foot store in West Des Moines... **Houston:** The outlook remains cloudy as landlords and owners deal with retailers going into bankruptcy, closing stores and scaling back expansion plans... **Kansas City:** While retail sales are down and leasing activity has slowed, development has continued in some areas. Three separate sites near I-35 are under development in Liberty, Mo. On the

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Kansas side, there is still activity in southern Johnson County...

Oklahoma City: Many operators are scaling back their expansion plans, but not value-oriented retailers, who are actively growing operations... **Omaha:** Developers have already responded to the changing retail landscape by slowing the pace of planned development, particularly for small shops... **San Antonio:** Retailers have taken a hit, and newly constructed centers are not leasing up. Part of the issue is that asking rates remain high for these newly developed centers as many are required by loan terms to achieve a certain level... **St. Louis:** Rents have dropped, but vacancies have not risen sharply. Although retailers are showing no sense of urgency in signing leases or committing to deals, they are touring available sites and planning to open and expand in 2010...

Wichita: A majority of the recent pad site sales have gone to restaurants or banks rather than strip center developers, which has kept pad site prices strong. Lease rates, however, have suffered from less demand and oversupply.



GREAT LAKES/OHIO VALLEY

Chicago: Many newly constructed retail centers on the urban fringe stand empty as the focus shifts to the redevelopment of existing centers in mature trade areas... **Cincinnati:** Expanding retailers include grocery stores and fitness related

concepts along with specialty hamburger and sandwich shops. New grocery-anchored centers and strips in premier locations are filling inline space, but B and C locations will struggle... **Cleveland:** Plans have been stopped for any new major developments. The only activity is with smaller users, 3,000 square feet and below, and a select few outparcel or smaller restaurant users... **Columbus:** Lease rates continue to fall as leasing activity subsides. Vacancies are increasing... **Detroit:** Very little retail construction is occurring. Walgreens and CVS are holding their own thanks to their focus on pharmaceuticals and medical supplies, which are recession-resistant if not recession-proof... **Grand Rapids/West Michigan:** Leasing transaction volume was down at least 60 percent in the first quarter... **Indianapolis:** Market activity has bounced back with deals driven by price reductions, a flight to quality and/or redevelopment opportunities. Liquidity is still critical to every deal... **Minneapolis:** Dunkin' Donuts, Smashburger and Five Guys Burgers and Fries are all slated to open their first local locations this year and have plans for multiple locations over the next few years. Sonic is looking to open several new locations this year... **South Bend:** After overbuilding, the market became stagnant with many big box spaces left empty and small shops closing their doors. The market is likely to stagnate at least until the second half of the year.



NORTHEAST/MID-ATLANTIC

Baltimore: Service-oriented, grocery-anchored strips remain strong as households continue to shop for the essentials. Developers are extremely cautious and are typically not breaking ground on new projects unless they are more than 80 percent pre-leased... **Boston:** Small retail suites are still in demand, and community bank financing is available. Vacancies are steadily rising in urban and suburban locations... **New Jersey:** Retailers are closing underperforming stores while taking advantage of rising vacancies to open new stores in more desirable locations. Strong demographics, including high per capita income and a dense population base, will keep the state on the radar screen of expanding retail chains... **New York City:** Expect more retailers to ask their landlords for rent reductions to offset the drop in revenues... **Philadelphia:** Landlords are increasingly aggressive in backfilling vacancies, applying further downward pressure on asking rents... **Pittsburgh:** Despite sluggish conditions, a number of retailers are expanding while better properties are selling and leasing... **Washington, DC:** Recently completed centers built in newer subdivisions are struggling to fill remaining space and have had to backfill a few shuttered spaces. Certain key categories such as food service remain underserved.



SOUTHEAST

Atlanta: For a reliable tenant, landlords are willing to drop asking rates \$3-4 for the first year followed by aggressive bumps of almost \$1 a year to make up for the initial discount... **Columbia:** Most landlords have been successful hanging onto their smaller shop tenants, but new tenants are waiting on the fence... **Greenville/Spartanburg:** Several large retail projects are on hold. When the market improves, a significant amount of pent-up development is expected... **Jacksonville:** Landlords are making concessions on rents in order to fill vacancies... **Miami:** Even the famed South Beach district is showing signs of the recession due in part to the decline in international tourism... **Mobile:** Wal-Mart is putting pressure on grocery stores. Other retailers are just hanging on... **Nashville:** While space might take a little longer to lease, landlords of newly constructed centers are achieving rates near the bottom of their pro formas... **Orlando:** Retail investment sales are down 50 percent from the first quarter of 2008, but investors have been showing more interest in recent months... **Richmond:** Landlords are willing to negotiate. Centers under construction with low occupancies are the most likely to fail as construction loans come due... **Tampa:** Landlords are offering heavy concessions and incentives.

Grubb & Ellis Office Locations



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