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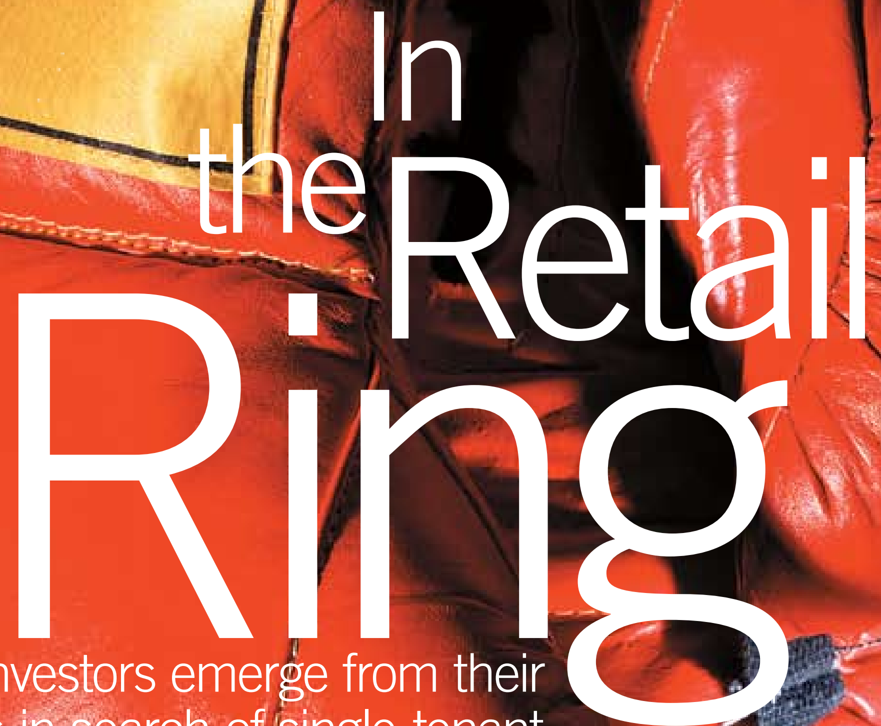
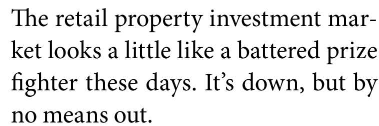


In the Retail Ring

Investors emerge from their corners in search of single-tenant opportunities.

by Beth Mattson-Teig



The retail property investment market looks a little like a battered prize fighter these days. It's down, but by no means out.

Given the one-two punch of the credit crisis and the tepid economic recovery, retail investment sales are well off the 2007 peak of $78 billion. Transaction volume tumbled to $32 billion in 2008 and fell almost by half again in 2009 to around $17 billion, according to Marcus & Millichap.

But slowly investors are moving off the ropes, drawn partly by opportunities in the single-tenant niche. Buyers are fighting for well-located properties in major markets and strong in-fill locations that are leased to national credit tenants such as CVS, Walgreens, Burger King, and McDonald's. "When you look at properties priced below $5 million or even $3 million, there is still a lot of money on the acquisitions side," says Bernard Haddigan, a Marcus & Millichap managing director in Atlanta.

In fact, retail properties priced between $1 million and $10 million represented the lion's share of 2009's retail property sales — 94.5 percent of the 4,554 individual transactions in total retail sales. In comparison, properties priced between $10 million and $20 million accounted for 3.5 percent of transactions, and those properties priced above $20 million represented just 2 percent, according to Marcus & Millichap.

One key factor propping up the single-tenant sector is that many of those buyers are not looking for leverage. "They are looking for stability and cash flow, so they don't mind putting more equity into the deal to get their monthly cash flow checks," Haddigan says.

Returning to the Ring

Overall retail investment activity increased during the early part of 2010 with a rise in both the supply of properties on the market and more interest from buyers. "What is surprising me is that I have been busier in the last 45 days than I was during the last six months of last year," says Cynthia Shelton, CCIM, CRE, director of investment sales at Colliers International in Orlando, Fla. "If that continues we could have, perhaps not a great year, but a good year — certainly better than 2009."

The majority of action is on two fronts. One segment of the market is small investors looking for safety: single-tenant properties structured with triple-net leases. The other group is comprised of opportunistic buyers shopping for value-add deals among distressed assets.

One reason for increased activity among net-lease properties is that 1031 buyers have started to return. Over the past two years, it didn't make sense for owners to sell property such as apartments and land, which is what drives the majority of 1031 deals. "Today, those owners are starting to sell again for one reason or another — not a tremendous amount, but enough to keep cap rates stable," says Deborah K. Vannelli, CCIM, director of net-lease sales at Minneapolis-based Upland Real Estate Group.

Single-Tenant Players

RETAILER	2010 NEW U.S. STORE ROLLOUT	AVERAGE CAP RATE FOR RETAIL CATEGORY
Walgreens	250	7.5%
Dollar General	600	8.5 – 8.9%
7-Eleven	250	7.0 – 7.5%
McDonald's	150	7.5 – 8.0%

Source: Marcus & Millichap, CNNMoney.com

Another explanation for the bump in activity is that people simply are tired of sitting on the sidelines. "A lot of people mentally buried 2009, and now they are more optimistic," says Jerry A. Williams Jr., CCIM, a vice president at Grubb & Ellis in San Antonio.

Part of the buyer interest has resulted from the narrowing bid/ask gap in pricing, Williams believes, as well as the fact that some lenders are returning. "In 2009, almost no one was lending, but now we're starting to see regional banks and credit unions opening up lending for the right asset," he says.

Last year was a learning curve for lenders and the commercial real estate industry as a whole, notes Mike Milano, CCIM, MAI, managing director of retail investment sales at Colliers International in Clearwater, Fla. "As the mountain of distressed properties started to build, lenders were not sure what to do with them," Milano says. "Now lenders are going to start moving properties out, and I expect distressed sales to start picking up around the second and third quarters."

Prizefighter Strategies

Single-tenant properties structured with triple-net leases are actively trading, and there has been a definite flight to quality as buyers gravitate toward solid credit tenants and top locations in a still-shaky economy. "Most buyers are acquiring investment-grade-rated tenants only," Vannelli says. That appetite has helped keep pricing strong for top tenants in good locations.

For example, McDonald's ground leases are being snapped up quickly even though capitalization rates have remained near historic lows around 5.5 percent to 5.7 percent. The problem is that those premium properties remain in short supply. "We recently sold a McDonald's ground lease in Florida at full price with seven more full-price, all-cash offers waiting in case the initial transaction fell through," Vannelli says.

U.S. Retail Snapshot

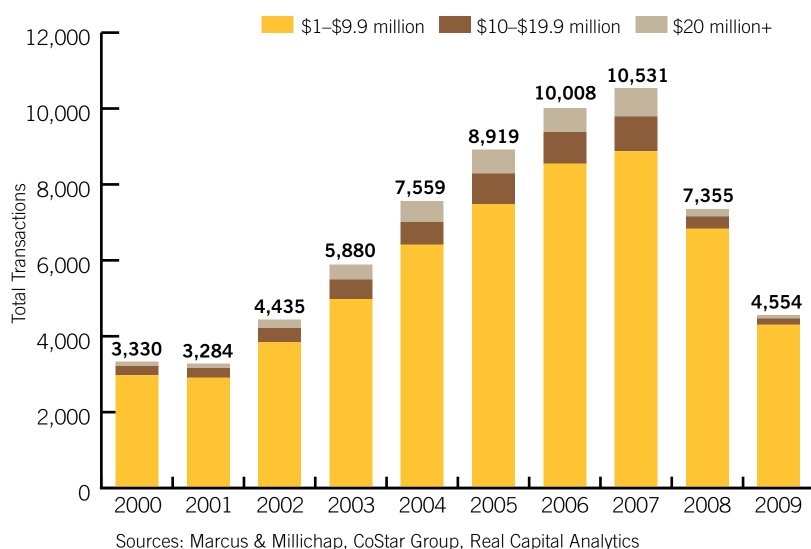
	COMPLETIONS (SF)	VACANCY RATE
2006	215,845,210	6.9%
2007	189,974,323	7.1%
2008	207,553,748	8.3%
2009	97,483,903	9.9%
2010*	70,000,000	10.4%

* Forecast
Sources: Marcus & Millichap, CoStar Group

McDonald's is one of the few exceptions that are still commanding cap rates below 6.0 percent. The bulk of the net-lease investment market has seen cap rates increase 150 to 200 basis points amid tougher underwriting standards and economic uncertainty. Three years ago, Walgreens stores were trading at cap rates between 5.7 percent and 6.3 percent. Today, Walgreens are up about 200 basis points to between 7.7 percent and 8.4 percent. "That would be considered the baseline of the easiest to sell and even on those deals the prices have gone down and cap rates have gone up," Haddigan says.

Investors are being very cautious in underwriting both the credit and the location. Most buyers today only are looking at solid urban locations or in-fill locations in first- or second-ring suburbs with good demographics. They are attracted to core markets such as Washington, D.C., New York, Houston, San Francisco, and Chicago. At the same time, most remain wary of investing in secondary and tertiary markets: Even double-digit cap rates are not enticing them. "Almost every investor I've closed a deal with over the past 12 months either used to live where the property is located, currently lives there, has family nearby, or vacations there," Vannelli says. "This gives them additional comfort that even if the tenant fails they know the market will survive."

The return to conservative underwriting is having a big impact on pricing. Colliers International currently is marketing a single-tenant property occupied by a national book and game retailer in Orlando. The store is likely to sell for a 14 percent cap rate because the operator only has six years left on the lease. "With everyone skeptical of the retail market, buyers are wondering if the tenant will make it through for the six years, and if they do, will they renew?" Shelton says.



Sources: Marcus & Millichap, CoStar Group, Real Capital Analytics

The Battered and Bruised

The volume of distressed properties continues to pile up on lender balance sheets. Banks alone reported $41.7 billion in commercial mortgages that were in default at the end of 4Q09, according to Real Capital Analytics. That default rate represents 3.8 percent of all outstanding loan balances on commercial properties, which is a 16-year high for the nation's bank lenders. However, banks have been slow to write down those troubled assets and push them out into the sale market.

As a result, the distressed deals have yet to materialize as

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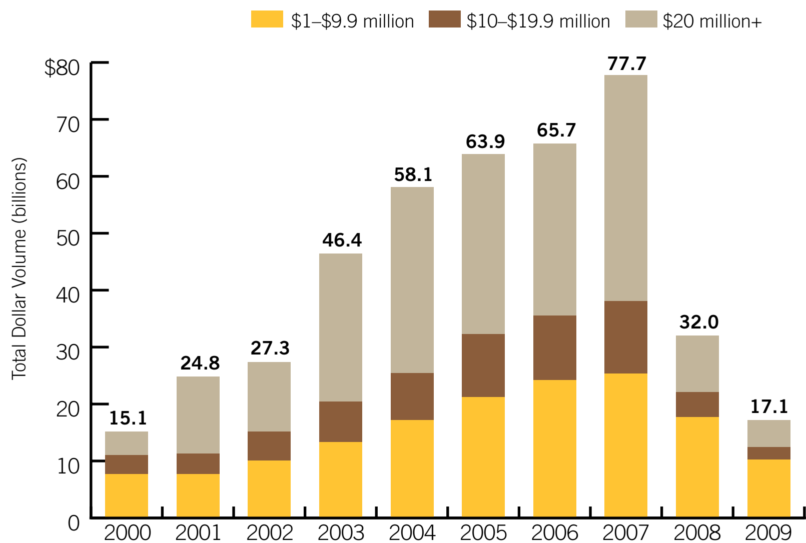
many bargain hunters had hoped. "There is a lot of paralysis on the bank side, because they can't afford to take the losses," Haddigan says. The banks don't want to take the write down, because they don't have the reserves to make sure they have their depositors' balances covered. "As distress continues to accumulate, it will force some people to act," Haddigan says. "So I think the second half of 2010 is going to be a more active acquisition market."

Florida is a big retail market hit hard by the recession. Many in the commercial real estate industry are watching to see how that market deals with its heavy load of distressed properties. "Banks and owners are just starting to realize that they will have to take a hit in order to dispose of assets that are now worth less than the debt in most cases," Shelton says. "The income-producing assets are starting to have offers generated, but at values that shock many."

U.S. Retail Dollar Volume by Price Category



Sources: Marcus & Millichap, CoStar Group, Real Capital Analytics

Is Retail Leasing Down for the Count?

Shaky consumer confidence and a national unemployment rate hovering around 10 percent continue to pummel the retail industry. Yet the rate of decline appears to be slowing as the economy gains steam.

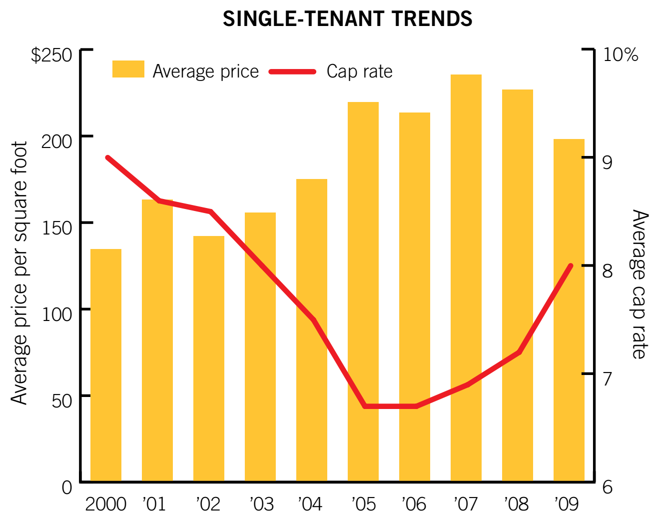
"Leasing activity had begun to pick up at the end of third quarter 2009 but trailed off significantly in the fourth quarter," says Jerry A. Williams Jr., CCIM, a vice president at Grubb & Ellis Co. in San Antonio. "The new year has brought a new influx of activity, and we hope the trend follows through the summer months in order to sustain the momentum."

The retail vacancy rate reached 9.9 percent at the end of 2009, the highest level in more than a decade, and vacancies may inch higher to 10.6 percent by year-end, according to Marcus & Millichap. The vacancies along with rising concessions have caused effective rents to drop 7 percent in 2009 with effective rents projected to fall another 4.2 percent this year.

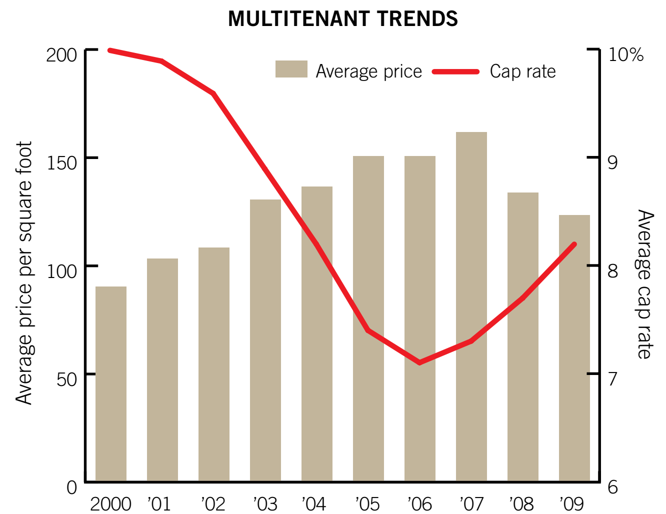
Even though national statistics paint a struggling retail market, local and regional retailers as well as quick-service restaurants are fueling leasing activity in many parts of the country. "We are seeing very little new deal activity from national retailers," says Jordan M. Spiegel, CCIM, president of Sunburst Advisors in New York. "A good portion of the national tenants that are already saturated in the New York marketplace have allowed their leases on older, unprofitable stores to expire." Major retailers such as Starbucks, Ann Taylor, The Gap, and Foot Locker are among those that have vacated locations throughout New York in recent months. In comparison, regional and local retailers such as Crumbs Bake Shop, Planet Fitness, and BonChon Chicken have remained fairly active, leasing new stores throughout Manhattan and the outer boroughs, Spiegel adds.

The retail industry is still struggling under the weight of 6,600 retail store closings in 2008 and another 6,200 closings in 2009, according to data from Marcus & Millichap and the International Council of Shopping Centers. Although the tide of store closings has likely peaked, the volume of vacant big-box space continues to be an issue for landlords because there are not enough large-format retailers to absorb the big blocks of empty space. "Unless that space is filled with creative re-uses, such as medical use, churches, and skating rinks, a lot of that space needs to be knocked down," says Bernard Haddigan, a managing director at Marcus & Millichap in Atlanta.

U.S. Retail Price and Cap Rate Trends



Note: Includes sales $1 million and above
Sources: Marcus & Millichap, CoStar Group



Note: Includes sales $1 million and above
Sources: Marcus & Millichap, CoStar Group

For example, Colliers International is listing a 45,000-sf non-grocery-anchored neighborhood center in Fort Myers, Fla., being sold at the request of the lender through a court-appointed receiver. The property sold for $3.8 million in 2003, $8.8 million in 2006, and now will likely fetch a price of around $3 million.

"We anticipate seeing a lot more product coming to the market," Milano says. "Lenders now are more attuned to the fact that the best way to get out of their problem is to take the write-down and sell it."

As of Feb. 1, 2010
Total troubled retail assets:
$43 billion
Amount resolved:
$1.1 billion
Source: Real Capital Analytics

Knock-Out Opportunities

Persistence is paying off for investors who have access to capital. Commercial Alliance traditionally works as a developer of single-tenant properties for restaurants and drugstore tenants. The firm currently is pursuing prime corner locations with the potential to redevelop or reposition real estate.

"We're seeing a lot of opportunities to buy good sites that we wouldn't even have been able to bid on before," says Kristian Cotta, CCIM, director of acquisitions at Commercial Alliance in Scottsdale, Ariz. Two to three years ago, the overheated investment market had produced bidding wars for well-located corner sites. Today, Commercial Alliance is finding itself in more situations where it is the sole bidder. "Now small to midsize companies can compete on a level playing field," he adds.

For example, Commercial Alliance was poised to purchase a vacant grocery store in Corpus Christi, Texas, at the onset of the credit crisis in November 2008. The lender backed out two weeks prior to closing. Commercial Alliance was able to find equity from a small group of investors that enabled it to purchase the property all cash. The firm has since leased the vacant grocer to a charter school and re-platted the 9-acre site to include four pad sites. The developer has sold one pad site to Jack-in-the-Box, has another site under contract to a national quick-service restaurant chain, and is working on additional deals. In the end, Commercial Alliance expects to deliver about a 30 percent return to investors. "That is an example of how you have to be creative to make deals in this market," Cotta says.

Ultimately, 2010 likely will be a year of transition as the retail industry as a whole stems the tide of deteriorating occupancies and rents and searches for solid footing before it can start to recover. "I see the retail market trending sideways for the next 12 months, not getting much better but not worse either," Cotta says. "Once those first deals start going through and we can gauge the success of those transactions," he adds, "then the activity will pick up as everyone else will want to take advantage of the opportunities that are hiding."

Beth Mattson-Teig is a freelance writer in Minneapolis, Minn.

Only @ Where is retail investment headed in the next six months? Marcus & Millichap's Bernard Haddigan tells us in a follow-up podcast at **www.ciremagazine.com**.