

STATE OF THE INDUSTRY 2008 “DON’T PANIC”

By Nicholas Hamner

The same questions are being asked at every shopping center event since the first round of subprime mortgage foreclosures. Familiar greetings are now quickly followed with a barrage of questions like, “Where do you think the market is headed,” “Is this going to hurt as much as the last one did” and “How’s business?” The answers are always interesting, so we thought it would be a good idea to nail down our readers’ stances on the key issues.

The Dealmakers surveyed our readers with a barrage of questions of our own. We asked, at length, how the local and national markets were, how everyone’s finances and prospects looked, how the current market conditions compared to the 1990s and where the market was headed. We were careful to avoid using the “r” word, as is the media trend of late, though many respondents were quick to call the current economic climate a recession.

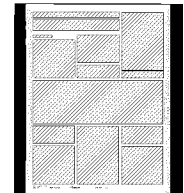
An overwhelming majority of respondents felt that growth would be slow and steady for primary markets and many felt that secondary markets would hold steady with a select few seeing some growth. Very few respondents saw any positive prospects for tertiary markets over the next 18 months. As evidence, respondents from primary markets did not indicate any major difficulties in their businesses while those in secondary markets indicated a number of delays and difficulties in attracting new tenants and getting projects off the ground. Katherine Roberson, president of Combined Properties, Inc., sympathized with the smaller markets, writing, “We have great centers in great markets and are still feeling the impact. I can only imagine what others are experiencing in more secondary and tertiary locations.”

Cap rates were another point of agreement as few saw them holding or sinking during the next 18 months. While most agreed the Fed was right in lowering interest rates during the past six months, they also agreed that interest rates would begin to slowly rise sometime during the next year and a half.

While many respondents felt that consumer spending would recover during the next 18 months, the reasoning was of two camps. One group felt that existing government-backed economic stimuli would do its job and that consumer spending would increase as a result. The others felt that no real recovery would be seen at least until after the November presidential election.

Regardless of how they felt about stable or slightly-growing markets, many respondents felt that retail bankruptcies, store closings and slowed expansion would be inevitable. Ken Simon, of Lerner Heidenberg Simon Properties, remarked that he had seen several anchor tenants reevaluating future deals and renegotiating where they could. As of press time, 84 Lumber, Friedman’s, Hollywood Video, Big Dollar/Big Value, Sunny’s Surplus, Dillard’s, The Sharper Image, Ann Taylor, Talbot’s, Linens ‘N Things and Pacific Sunwear have announced plans to close stores while Fresh & Easy, Wal*Mart and Home Depot have trimmed initial expansion plans for 2008. Few respondents chose to make a guess as to which retailers would file for bankruptcy, but those that did pegged non-essential retailers, such as trendy apparel and video rental chains as those most likely to file this year. Several respondents detected a silver lining to the current economic setbacks, at least for investors. Ben Kogut, a retail investment associate with Grubb & Ellis, wrote that the increase in store closings would result in landlords selling their properties, thereby providing good investment opportunities. Barry Dotson, chairman of Phoenix Ventures, LLC/Red Realty, noted that it is a good time to buy.

Respondents were more inclined to discuss which retailers would succeed, with many noting discount chains and supermarkets as the retail forerunners during the coming 18 months. A consensus of respondents predicted that “maintenance” retailers—those stores focused on selling goods that help prolong the life of other products like cars or electronics—would do well. Chains that sell basics at low prices are also expected to weather the economic storm. While growth in these sectors may be



expected, profitability is not necessarily a given. Michael Reisman, director of communications for Metro Commercial Real Estate, wrote, "Large retailers are seeing their product mix shift to lower margin – more basic goods" which hurts their profitability. Roberson noted that "Profitability will likely be down across the board for most retail," citing the credit crunch, the housing crisis and inflation as reasons for the decline.

All agreed, without exception, that the leasing market had changed and terms that were acceptable one year ago are not acceptable today. Many wrote that landlords either had become more flexible or were going to have to if they didn't want empty space. Crystal C. Hanley, vice president of retail services for Realty Capital Advisors, Inc., noted, "Landlords are giving more concessions in TI, free rent and lower annual increases to secure [tenants]" but that "landlords are still needing to be informed of market conditions to give incentives." Peggy M. Israel, an attorney based in Baltimore, Md., wrote that developers and

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landlords are conceding more to tenants to keep a tenant from changing their mind in this nervous market. However, landlords are not universally flexible, as Edward A. Freeman, of Freeman Commercial Development, Inc. in Carmel, Ind., reported a landlord of mid-30s space refusing to budge \$1.70 psf, resulting in an impasse over \$9.92 per day. He then added that the current market "is making my stomach more pained each day wondering when this deal or that deal will close or die."

Tenants are taking advantage of the current situation, as both James E. Harpool, of Harpool Morgan Haney, LLC, and Dotson reported big boxes looking for a lot of freebies in the deals. Bill Smith, of Real Property Specialists, Inc. located in Florida, wrote about a tenant looking to add another year of free rent to a signed lease.

Based on the survey results, there were three strong undercurrents thought to be influencing the economic market at present: The first, and most mentioned, influence was oil, specifically, the price of crude oil. Anthony Sabatino, a broker with Realty USA Commercial Division, pointed out that "the trickle-down is enormous" when it comes to the effect of oil prices on the economy. Respondents listed the price of oil as a direct influence on tightened consumer spending, retailers' profitability and growth due to higher inventory distribution and utility costs in addition to it being more expensive building from the ground up due to increased construction material and transportation costs. It was also considered to be indirectly influential on retailer site selection. Harpool explained "Due to high construction costs driven primarily by fuel costs...some retailers will start reconsidering older properties in denser neighborhoods as a means of survival."

Several respondents listed job growth as an influence. Harpool noted that job growth would prove a big challenge for many communities, and stagnation would lead to trouble. Dotson wrote that major corporate cut backs and the unemployment rate will have profound impact. Nicholas Miner, associate broker of Eagle Commercial Realty Services, AMO, correlated the potential success of tertiary markets during the coming 18 months to the size of their job base.

The third influence is foreign business and investment. Several respondents mentioned the influence of foreign investors assisting in the market's stabilization. The available investment opportunities along with the continued fall of the dollar's value led several respondents to predict further foreign investment during the coming 18 months. Foreign investment may come in the form of retailers, as Deborah Foehr, of Star Commercial Real Estate, LLC in Connecticut, predicted that specialty centers tenanted by European chains might be the "next big thing."

Opinions started to split in answers to the survey's tougher questions, such as who or what caused the current financial situation. The responses were largely divided along "push" and "pull" lines. Some believed that the investment banks pushed the limits of legal business practices. Others argued that the banks were pulled by recent changes to federal statutes and guidelines. The harshest indictment came against the banks and it came from a property investor. To him, the investment market fell due to "the singular lack of foresight

and incredible greed shown by the investment banking industry." A few respondents argued that market conditions, as a whole, were not bad. They argued that individual segments, like the subprime housing market, fell but that the economy itself was strong. They contended that retail growth slowed as smaller retailers have grown cautious in response to the media hype. As Wilbur F. Breslin, president of Breslin Realty Development Corp in New York wrote, "Perception is worse than reality."

Though everyone agreed that the market is in a "down" cycle, just as many respondents predicted a recovery by the end of this year as did the number of respondents who that predicted recoveries by the end of 2009. A select few argued that the market has not truly hit bottom yet and that it is impossible at this stage to predict a recovery period. All agreed that the market would definitely be different five years from now, in light of current events, though few agreed on how. Some suggested tighter regulation would be in place, others argued that current events would encourage better business practices in the future. One or two worried about the short attention span that has developed within the industry.

When asked how they were handling the current financial situation, responses varied again. Some said they were cutting back in every aspect of business. One retailer mentioned improving their efficiency, eliminating meetings at shows in favor of generating deals by walking around. Most landlords and brokers mentioned renewed efforts in lease creativity and proactive marketing measures. As Smith wrote, "The days of placing a sign on the property and taking orders are gone."

Many respondents compared the current situation with the recession of the late 1980s/


early 1990s. Some argued that the market is better prepared this time around, as the Fed seems content to buoy the failing banks and there is no over-building. Breslin pointed out that "capital and construction loans dried up in the '90s" and that, at the present, "there are still sources of funding [for] good projects." Others argued that there is some evidence of over-building in certain markets and that developers, while the pace has slowed down, are still building.

Many across the country reported difficulty finding empty big box space in primary markets and even more difficulty in finding large parcels suitable for developing power centers. Sabatino wrote that, at least in the Northeast, cities and residents have developed a strong "not-in-my-backyard" complex that makes it difficult for power and big box developments to gain approvals.

Small, medium and large banks and private equity sources were all listed as having funds available, though it depended on the region and the project. The consensus opinion was that funding was available for strong projects but banks had grown much more cautious and underwriting criteria was much stricter now than 12 months ago. A Midwestern developer wrote, "We are seeing capital constraints in the debt markets...and certainly the retailers are slowing expansion and closing underperforming stores." A retailer wrote of the wariness that accompanies opening stores in planned developments or projects under construction as new delays in getting financing result in more late openings.

Overall, despite the dire predictions for developers, tertiary markets and smaller retailers, the 18-month outlook was predominantly positive among most respondents. The consensus is that the sky is not falling, but there are some storm clouds.



Keep that in mind as you walk the floor of the ICSC's annual convention this year. 

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Electronics

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