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Family Office Insights

"Death of Retail" Rumors Overblown, Opportunities for Returns Still Exist

While family office investments in retail real estate are facing a number of challenges, opportunities for returns remain in brick-and-mortar stores.

Real estate remains the third largest asset class in the average family office portfolio. This makes sense, as returns on commercial real estate tend to be stable and their correlation to equities is low. Investments in retail real estate can provide family offices with agreeable income streams and long-term appreciation.

Last year was a difficult one for the retail sector. There were a reported 662 retail bankruptcies in 2017, up 30% from the previous year. Store closings tripled, with nearly 7,000 locations shutting their doors. Some of the largest "big box" retailers have begun retrenching, impacting already struggling regional malls. With recent high-profile retail bankruptcies, including brand names like Toys 'R' Us, Claire's and Nine West, many real estate investors are scrutinizing their investments in the retail sector.

While it is true that the retail industry is facing a number of challenges, those challenges come with opportunities as well. From shifting shopping preferences of Millennials to experiential services, tightening of disposable income and the rapid rise of e-commerce, there are a lot of factors that retailers are working to contend with and forecast. The US retail space is also high compared with its peers, with 40% more space per capita than northern neighbors in Canada. However, with consumer confidence increasing and promising prospects of rising wages, combined with the new tax bill that reduces the corporate tax rate and interest rates still being relatively low, there is reason for investors in the retail commercial real estate space to be optimistic.

Signs of Strength

The reality is that the retail sector remains strong, but is evolving in its use of real estate and engagement with customers. Despite calls of a "retail apocalypse," and the aforementioned bankruptcies, occupancy rates at US malls remain at about 93%. Moody's has predicted that US retail operating income will increase a full percentage point this year, with sales jumping 4.5%. Retail bankruptcies are expected to slow this year as well, and M&A activity is likely to increase. Not all the headlines are doom and gloom either: Best Buy has opened its first US store in seven years, while losing their mall-based phone stores; Nordstrom is bucking the trend by opening a Manhattan store; outdoor retailer REI celebrated its 80th year with record sales and opened four new stores in 2017; and long-time catalog and online retailer LL Bean has announced plans to add 100 new stores to its current 26 by 2020.

Two brands in particular can give family offices insight into the shifts taking place in the commercial real estate space. The first is Walmart, which is closing 63 Sam's Club locations, 12 of which are being converted into e-commerce distribution centers. The shift to industrial real estate warehouses and distribution centers is indeed taking place and will have important consequences for retailers and family office investors alike. Walmart is adapting to this shift to e-commerce, recently acquiring two e-commerce-driven companies, Jet.com and Bonobos. According to CBRE, momentum for additional construction of US warehouse space continues to climb. Likewise, the data center industry has increasing need for space. Repurposing retail stores into these alternate uses is only set to rise.

Another brand that is shifting its retail to better reflect consumer demand is the Gap. Though they are closing a reported 200 Gap and Banana Republic stores, they are set to open 270 Old Navy and Athleta stores over the next three years. With stagnating wages in recent years, discount retailers have been the beneficiaries and "athleisure" wear has benefited from Millennial shoppers' preferences. As retailers continue to refine their inventories and fulfillment models, we are likely to see other retail refocusing of this kind. Given increased scrutiny over retail leases, they may also be able to negotiate more beneficial terms than they could 10 years ago.

Opportunities Abound

Apart from apparel, food retail is booming. Despite high failure rates, restaurant space continues to do well in urban areas, especially multi-unit food halls and pop-up spaces. There are now 33,000 coffee shops across the country, and that number is expected to increase by 2% this year. Grocery-anchored malls are also remaining steady, even though some grocery stores themselves have become concerned about their footprint. CoStar has found that commercial square footage of retail food space per capita is hitting record highs, with 4.15 square feet of food retail per person. Many grocers have taken note and are increasingly opting for "boutique-style" markets with a smaller footprint and specialty offerings. Indeed, in the era of e-commerce, family office investors should generally be looking at smaller-format retailers. Many former big-box locations such as K-Marts are being subdivided and filled with specialty retailers and more service-oriented offerings (such as gyms, salons, indoor play space and healthcare services).

Family office investors can also look for opportunities in secondary markets. While JLL found that New York remains the retail hub of the country in its recent *Destination Retail* report, many secondary markets are offering exciting prospects. Texas makes a strong showing in the top 140 retail cities, with Houston, Dallas and Austin all in the top 40. Orlando, Tampa and Washington DC are also in the top 60. Marcus & Millichap's 2018 *Retail Investment Forecast* also reported that Dallas/Fort Worth made the largest jump in its National Retail Index this year, followed by Denver and Atlanta.

While family office investors in retail commercial real estate are facing various risks and challenges, there certainly remains opportunity within the sector for favorable returns. With traditional e-commerce merchants now opening up brick-and-mortar stores and many retail niches doing better than ever, the traditional retail store is certainly not disappearing anytime soon.

Please contact your principal firm lawyer or the lawyer listed in this publication for additional information, or for help on these matters from our global Family Office team.

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