Marcus & Millichap

The Retail Outlook

Midyear 2018

Retail Reinvention in Progress; New Retail Concepts Gain Traction, Improving Sector Fundamentals

Economy gets a boost from tax reform. Economic growth surpassed 4 percent in the second quarter, lifted by strengthened consumption and business investment. The new tax law has stimulated the economy by increasing after-tax earnings and pushing consumer and business confidence to near-record levels. This combination has sparked elevated spending and accelerated job creation. Through the first half of 2018, the economy added over 1.3 million jobs, driving unemployment below 4 percent and boosting wage growth to 2.7 percent, its highest level since the onset of the recession. As a result, personal disposable income has grown by 5.4 percent over the last year, dramatically outpacing the 3.5 percent average growth rate over the past 10 years. The combination of low unemployment and more disposable income has translated into particularly strong consumption. Through the summer, core retail sales growth surged to 5.6 percent, well ahead of the 10-year average of 3.1 percent.

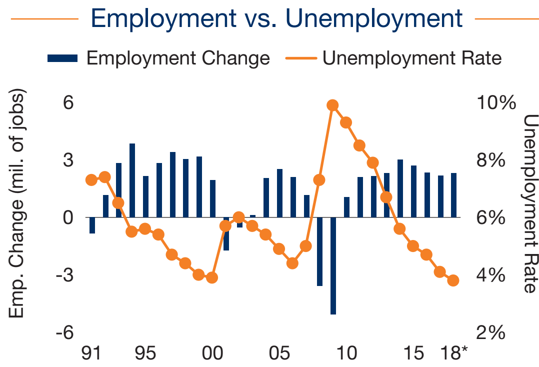
Rising inflation and higher interest rates could cool momentum. Accelerated growth brings with it some new challenges. Core inflation has nudged upward to 2.3 percent, raising caution at the Federal Reserve. To rein in inflationary pressure, the Fed has already signaled that it will tighten monetary policy by raising the overnight rate a total of four times in 2018; this will push up short-term interest rates. The challenge for the Fed is that long-term interest rates have been range bound, with the 10-year rate hovering near 3 percent for the last six months. Unless the Fed can push long-term rates up, its monetary tightening policies could invert the yield curve, raising short-term Treasury yields above long-term Treasuries. An inverted yield curve is a commonly perceived sign of an impending recession, raising the risk of a slowing economic outlook.

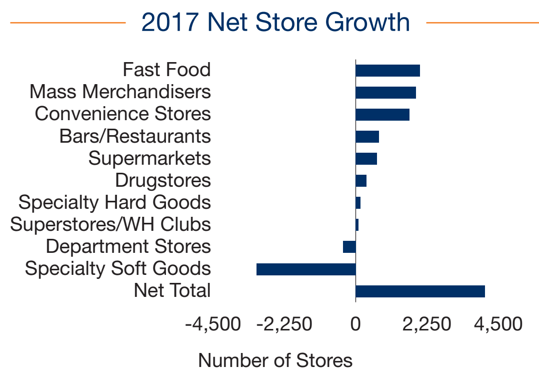
Retailers use variety of methods to adapt to evolving sector. Even with the Fed looking to further tighten monetary policies, a still prosperous economy is supporting heightened business investment. While some retailers are investing capital into accelerated expansion efforts, others are reinvesting into existing locations. For a number of retailers, such as grocery stores, this means altering store layouts and adding amenities to accommodate current consumer preferences. Conversely, other retailers make improvements by way of reduction. For example, decreased inventory has become an increasingly popular theme as some retailers shift to a more showroom-style layout. Though with this design, the merging of physical and online retail is often times necessary as customers use this newly modified space to test products before a purchase decision is made.

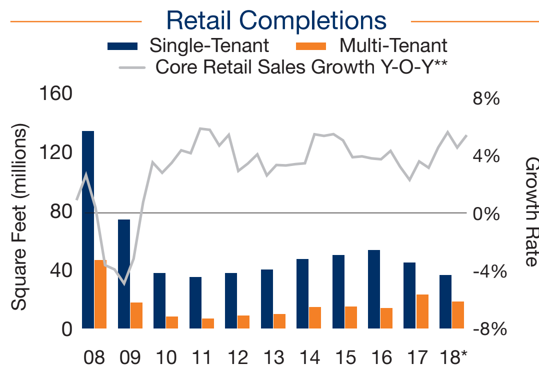
Omnichannel platforms crucial to retailers' success. Although several bankruptcies involving high-profile retailers have captured headlines, the sector's performance continues to improve as physical retailers explore omnichannel concepts to combat e-commerce. Additionally, online retailers are entering the brick-and-mortar space to broaden their reach as they realize the importance of a physical presence. Online retailers like Casper and Untuckit have adopted this strategy and are expanding at rapid rates as they plan to open 200 and 100 brick-and-mortar stores over the next several years, respectively. The inclusion of physical locations comes with several advantages such as a potential reduction in advertising expenses and the avoidance of some shipping costs, which are rising rapidly. Even e-commerce giant Amazon decided to forge a physical footprint through last year's Whole Foods acquisition. In addition, Amazon Books continues to expand in many major markets around the country.

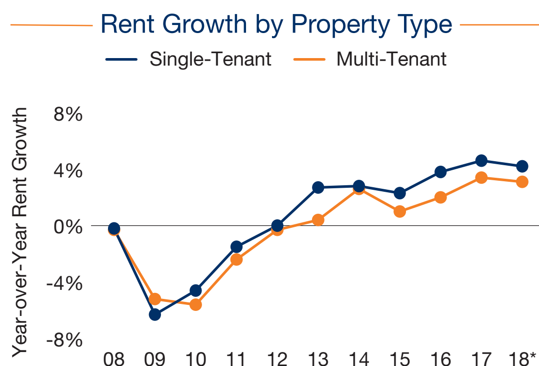
Executive Summary

- Boosted consumption has lifted core retail sales growth markedly, increasing by an average of 5.6 percent in the past three months ending in June. This growth has well exceeded long-term averages.
- Vacancy continues to drop as construction slows and landlords find more stable tenants. Since the recessionary trough in early 2010, national retail vacancy has fallen nearly 300 basis points.
- This year's retail construction activity will remain restricted a by still-tight retail lending environment. Additionally, space vacated by big-box retailers has been cut to smaller footprints suitable for expanding retailers.
- As the amount of available retail space decreased, rents have risen at a solid pace, climbing by an average of 2.9 percent each of the past five years. This year's rent gains should stay on a similar trajectory.
- With the retail sector evolving, some investors are using a wait-and-see approach, while others are staying away from large deals and focusing more heavily on smaller deals. This has led to decreased dollar volume nationwide for the past two years.









* Forecast
** Through second quarter

Tax Reform Brings Significant Changes For Real Estate Investment

Retention of key real estate tax provisions just scratches the surface. The new tax law kept three important rules for investors: tax deferred exchanges, real estate depreciation and the mortgage interest deduction. Beyond this, the new rules deliver a host of important changes that could reshape investor strategies. Three important changes investors should consult their accountants about include:

- **20 percent pass-through deduction:** For active investors using a pass-through entity such as an LLC, the new 20 percent pass-through deduction will boost after-tax yields. This new deduction has a variety of restrictions based on income and asset base but offers substantive upside for those who qualify.

- **Bonus depreciation:** This temporary provision will phase out after 2023, but it enables investors to immediately expense personal property in real estate assets acquired after Sept. 27, 2017, boosting immediate cash flow. A Cost Segregation Study enables investors to identify the deductible components.

- **Restrictions on business interest deductions:** Companies that have loans on purchased locations they operate from have historically been able to deduct the interest on their real estate. Under the new rules, companies with average annual gross receipts of $25 million or more face limits on their overall interest deductions. The new rule can make the sale-leaseback of locations more beneficial for companies from a tax standpoint because leases remain a deductible expense.

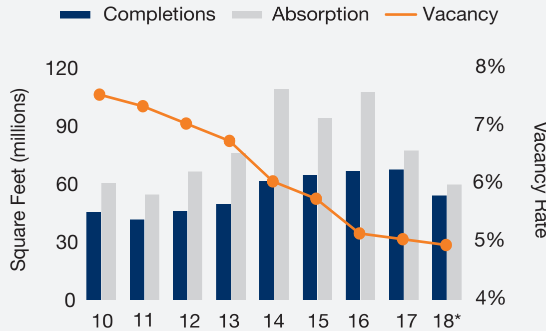
Slowed Construction Intensifies Demand

Vacancy slides as landlords explore new ways to fill space. Over the past year ending in June, vacancy continued to decline, receding 10 basis points to 5.0 percent. Landlords have contributed to this descent by fine-tuning their tenant mix to match the evolving retail climate. Today's mix may include off-price retailers, health clubs and several other relatively e-commerce-resistant concepts. Bringing in these generally more stable tenants, along with the plethora expanding retailers, will support net absorption of about 60 million square feet this year.

Tightened lending tempers retail construction pipeline. This year, construction posts its lowest completion total since 2013 as roughly 54 million square feet will be delivered. The slowed pace of development can be partially attributed to stricter lending practices as loan originators remain relatively cautious while they watch the retail sector evolve. This cycle's lending behavior is vastly different that the previous one in which originators' practices were quite liberal. Despite this, several markets will witness significant increases in construction activity this year due to strong employment and household growth supporting an influx of new retailers. However, development will stay subdued in most markets moving forward as more disciplined lending persists. This year's completions are further restrained by a number of retailers sidestepping new construction by occupying space left behind by companies who failed to evolve with the rest of the sector.

Limited development helps preserve healthy rent gains. With conditions in the retail sector tightening, rent growth has maintained a strong rate, increasing 2.9 percent over the past year ending in June. Moving forward, marketed rents will continue to advance at a similar clip as tenants vie for the limited amount of available space, due in part to reduced construction.

Rents Make Steady Gains Amid Tight Vacancy Trends



U.S. VACANCY:

10 basis point decrease Y-O-Y

Vacancy at level unseen in nearly two decades. Strong retail sales growth supported by elevated consumer confidence has prompted many retailers to ramp up expansion efforts. This will continue to place downward pressure on vacancy, helping push the national rate down to a forecast of 4.9 percent in 2018, the lowest point on record since early 2001.

U.S. CONSTRUCTION:

54 million square feet completed Y-O-Y

Development pipeline remains compressed. Construction decreases in 2018 following last year's delivery of 67 million square feet. This cycle's pace of retail development is much slower than the previous one, which logged nine straight years of 120 million square feet or more completed.

U.S. RENT:

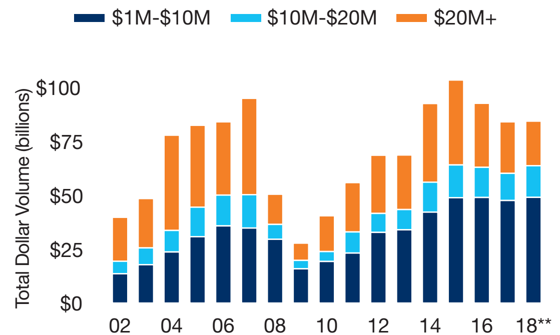
3.2% increase in the average asking rent Y-O-Y

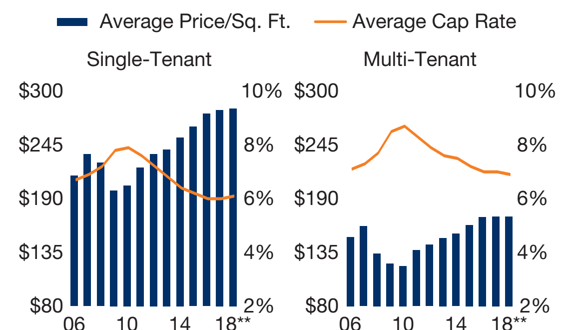
Rents edge higher as conditions tighten. With limited construction and strong tenant growth this year, the average asking rent is forecast to rise in 2018 to $19.89 per square foot as tenants vie for the limited amount of space left in the market.

* Forecast

2018 Investment Outlook

- **Large deals slow as investors watch sector transform.** With retail in the midst of transition phase, investors will remain somewhat tentative, refraining from large deals and targeting more assets in the $1 million to $10 million range. Nationwide, dollar volume has decreased each of the past three years, with 2018 projected to be no exception. Though investor caution exists, supply and demand fundamentals remain strong.
- **Pharmacy yields hold steady despite Amazon's recent purchase.** Amazon's acquisition of PillPack has yet to impact drugstore cap rates as the e-commerce heavyweight will have to add more pieces to truly disrupt the pharmaceutical industry. This move into the prescription-drug sector presents no immediate threat to traditional drugstores like CVS and Walgreens, thus keeping investor sentiment toward these assets positive.
- **Grocers preserve appeal through experiential changes.** In a time when tenant mix is of the utmost importance, institutions are focusing heavily on grocery-anchored centers. With recently integrated features like dine-in options, wine bars and more quality products, these assets have become relatively resistant to e-commerce.
- **Stability drives single-tenant net leased deal flow.** Investors continue to acquire STNL properties as they swap out management-intensive assets for those that involve a more passive approach. The low-maintenance nature of these investments keeps STNL retail segment attractive to commercial real estate investors.

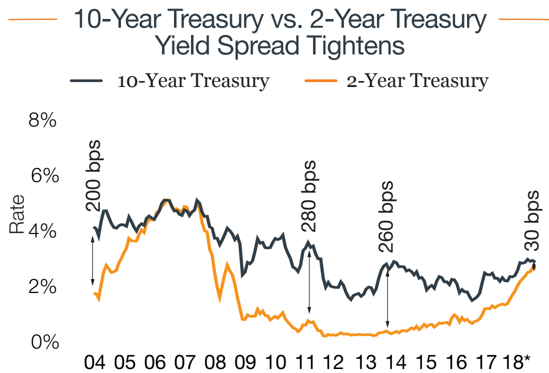


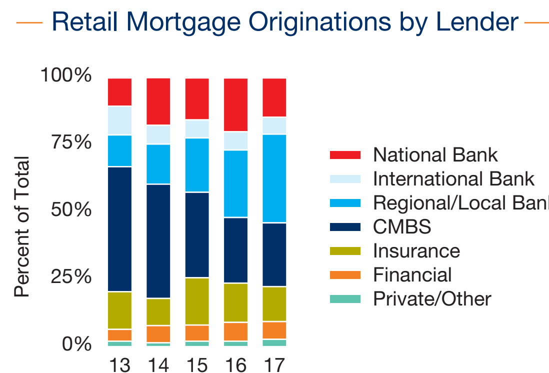


** Trailing 12 months through second quarter

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Real Capital Analytics

U.S. Capital Markets





* As of Aug. 17

Lenders Pursue Deals as Capital Plentiful; Caution Enforcing Underwriting

Fed watchful as economic surge raises inflationary pressure. Strengthened hiring amid exceptionally low unemployment levels has boosted wage growth, placing upward pressure on inflation. Amid this trend coupled with rising trade protectionism and tariffs, the Federal Reserve appears determined to head off inflation risk by continuing its quarterly increases of the overnight rate. These actions are lifting short-term interest rates while the 10-year Treasury rate remains range bound near 3.0 percent. Should the 10-year remain steadfast, Fed tightening could create an inverted yield curve in which short-term rates rise above long-term rates. Although this event has preceded every recession of the past 50 years, many economists suggest such an inversion this year could be an exception to the rule. Because of distortions caused by regulatory changes and quantitative easing, this inversion could be different. Nonetheless, the Fed's stated path does raise recessionary risk levels because it could weigh on confidence levels and restrain spending by consumers and businesses, thus slowing economic growth.

2018 Capital Markets Outlook

- **10-Year Treasury still "sticky" at 3 percent.** After surging at the beginning of the year, the 10-year Treasury has been range-bound near 3.0 percent. To create some headroom for its escalation of short-term rates, the Fed has tried to exert upward pressure on long-term interest rates by unwinding its balance sheet. This quantitative tightening has had little influence, particularly as foreign investors have enjoyed a yield premium relative to their native 10-year rates.
- **Potential rapid interest rate escalation a downside risk.** Although capital remains plentiful, lending could tighten quickly for a short period if interest rates rise rapidly. As experienced in late 2016 when the 10-year rose by more than 80 basis points in 60 days, and again at the beginning of 2018 when there was a 60-basis-point surge, market liquidity could tighten if rates jump. Considering this has happened twice in the last two years, borrowers will likely benefit by taking a cautious approach with their lenders and lock in financing quickly.

National Retail Group

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Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Experian; Moody's Analytics; Real Capital Analytics; U.S. Census Bureau