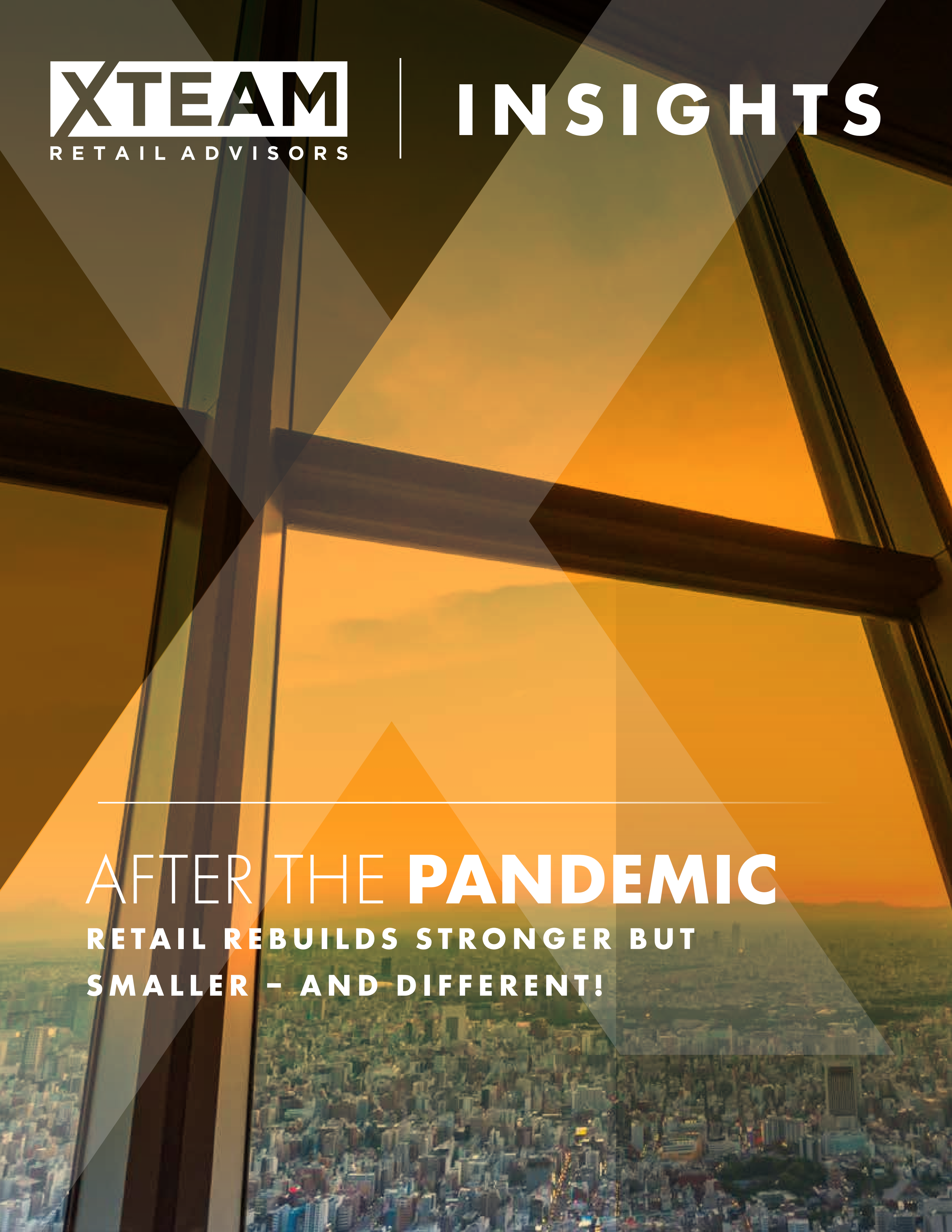


XTEAM
RETAIL ADVISORS

INSIGHTS

AFTER THE PANDEMIC

RETAIL REBUILDS STRONGER BUT SMALLER – AND DIFFERENT!

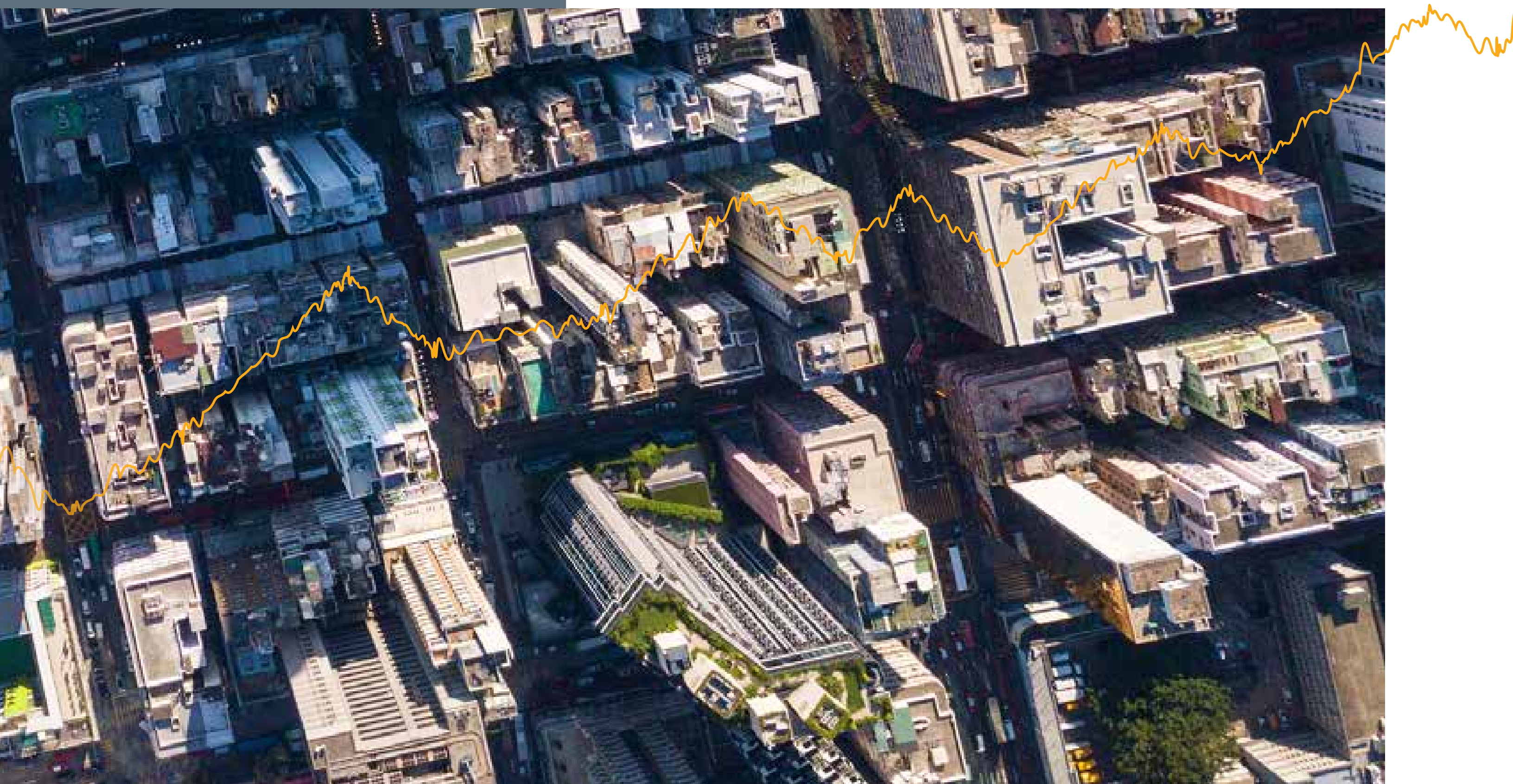
XTEAM
RETAIL ADVISORS

CONTACT

www.xteamretail.com

602.682.8145

info@xtreamretail.com



T **THERE WERE A HOST OF HEAVY CONSIDERATIONS WEIGHING ON THE MINDS OF U.S. CONSUMERS AS THE FIRST FEW MONTHS OF 2022 UNFURLED. INFLATION HAD RAISED ITS UGLY HEAD.** The Fed began raising interest rates. The economy and political environment was volatile and uncertain. Labor was tight and a war between Ukraine and Russia played out in vivid color on newscasts. And it all came just as the world was emerging from an unfathomable two-year hiatus caused by the Covid-19 pandemic. Making sense of everything going on around the world was vexing and posed new questions for a retail sector that had survived the pandemic, and surprisingly, was emerging with new life and promise.

If demand continues to increase unabated and supply can't keep pace, then economists expect inflation will persist. To be sure, consumers may be confused about which way the world is headed, but despite those uncertainties, spending remained strong through the first quarter of 2022. The Commerce Department reported U.S. consumer spending, which accounts for more than two-thirds of U.S. economic activity, surged 1.1% in March 2022, reflecting strong demand for services. Spending rose more than expected and its strength as Q2 2022 began may allay fears of a recession after the economy unexpectedly contracted in the first three months of the year.

"The recurring theme over the last few months is INFLATION," said X Team's Steve Edwards (The Edwards Company). "Though consumer confidence and spending continue to remain robust, inflation will likely dampen the enthusiasm in the not too distant future. The hope is the Fed can get inflation under control and eventually lower interest rates so the consumer can get back to doing what they do best, which is spending money and keeping the economy growing. If not, the bad news will turn worse, and the dreaded "R' word (recession) will dominate the headlines."

Impact of **Soaring Inflation**

The U.S. Labor Department reported that U.S. inflation in March rose to a new 40-year high of 8.5%, compared to the same month a year ago. That surge was being driven by high energy and food costs, supply constraints and strong consumer demand. In March 2022, the consumer-price index, or CPI, rose at its fastest annual pace since December 1981. The annual rate had stood at 7.9% in February 2022 and inflation continues in a string of six straight months sitting above 6%.

Looking a bit deeper into the numbers reveals an interesting trend. In March 2022, the core price index, excluding the often-volatile categories of food and energy, increased 6.5% from a year earlier. That was the sharpest 12-month rise since August 1982. Gro-

cery bills rose significantly in March. For example, meat prices were up 14.8% in March from a year ago, as consumers saw prices for hot dogs and lunch meats rise at the fastest clip since 1979. Breakfast cereal prices climbed 9.2% over 12 months, which was the sharpest increase since 1989. Continued rising housing costs added to the pressures of inflation and experts point out this category accounts for nearly 1/3 of the CPI.

The low interest rate environment and government stimulus, coupled with pent up demand as the country emerged from COVID-19 restrictions, worked to push the economy into overdrive. But with booming growth comes a downside, higher inflation. The surge in inflation actually began to show up in early 2021 and has economists and investors wondering when it will peak. Economists fear that rising prices could trigger a consumer pullback. And although consumer spending decelerated in February, it remains strong, up 13.7% from the same month in 2021.

But it is not just the cost of goods and services that are driving inflation. Supply-chain constraints also continue to push prices up. Throughout the pandemic consumers shifted to remote work situations, traveled less, went out to restaurants and bars less, though found other ways to spend. That was largely reflected in online shopping habits. E-commerce had begun to emerge before the pandemic, but it has been fully embraced over the past two years. X Team's Dave Cheatham points out that retail has shifted and will continue to adjust to accommodate CPI-based leases rather than fixed-bump deals. Demographic shifts to less urban environments means there will be "urban-ization" opportunities in suburban markets with multiple-use, higher density projects, while volatility and uncertainty drive consumers to seek value in retail.

The biggest changes that have transpired so far in

"THE INTEREST RATE INCREASES EFFECT ALL NEW REAL ESTATE TRANSACTIONS. CAP RATES WILL RISE, NEW PROJECTS WILL REQUIRE NEW PROFORMAS, AND REFINANCING WILL SLOW..."

Jim Bieri, Stokas Bieri

2022 that bear watching are higher interest rates, inflation increases and supply chain disruption. X Team's Jim Bieri notes, "The interest rate increases effect all new real estate transactions. Cap rates will rise, new projects will require new proformas, and refinancing will slow. Inflation has been driven by the government over stimulating the economy while disruption in the supply chains have given companies license to raise prices."

Retail **Survives**

Remarkably, the retail sector survived the coronavirus pandemic and emerged much stronger than anyone could have reasonably foreseen when Covid-19 first struck. The pandemic inflicted much damage to the retail sector, and the pain and adjustments are not nearly over. But to the surprise of almost everyone, retail sales recovered to pre-pandemic levels almost as soon as the economy began to reopen in the summer of 2020 and have continued rising ever since.

This extraordinary performance was based on many factors, but none more important than the massive $6 trillion infusion of stimulus by the federal government, bolstered by the Federal Reserve Bank's aggressive expansionary monetary policies. Together these programs helped minimize the economic downturn, as the pandemic recession technically lasted only two months – the shortest recession in U.S. economic history.

The retail sector benefited in several ways. First, stimulus checks and extra unemployment benefits kept households solvent and spending. Moreover, retailers benefited from the federal and state housing programs that provided rent relief and mortgage forbearance to households, so consumers redirected spending from housing expenses to retail goods. Finally, the retail sector was helped more directly by the financial and regulatory assistance for small businesses that kept many retailers financially afloat.

But beyond these government programs, much credit for the retail sector's incredible success can be attributed to its adaptability both during the pandemic and since. The retail sector had to overhaul – almost instantly – the entire shopping ecosystem: how to deliver products to consumers for anything that could be shipped, and how to enable consumers to shop safely in stores when onsite shopping was essential.

The resilience of individual retailers was no less remarkable. Defying expectations, millions of retailers – many thinly-capitalized mom-and-pop operations – somehow managed to survive waves of lockdowns, crushing regulations, shifting consumer demand, and unending uncertainty. And all this at great risk to their own personal safety and their finances. Certainly, many did not last. Stores shuttered and bankruptcies soared, though not to the levels suffered during the Great Financial Crisis ("GFC"), and many store closings proved to be temporary.

Overall, the retail sector is much healthier than would have seemed possible at the depths of the national lockdown last spring. But neither the pandemic pain nor subsequent recovery have been equally distributed, and much has changed throughout the retail landscape. As always in this dynamic sector, retailers will be challenged to keep innovating to meet evolving consumer expectations and shopping patterns.

Favorable **Economic Tailwinds**

When the economy abruptly shut down at the beginning of the pandemic, economists and consumers alike fully expected economic output and jobs to take years to get back to pre-COVID levels. But the recovery has been much faster than projected. Jobs have been slower to recover, but we have already regained 80% of the jobs lost during the pandemic.

Real gross national product (GDP) had surged back to pre-COVID figures by mid-2021, only a year after the recession began, and Q3 stood 1.4% higher than the prior peak. Gross domestic product fell by an annualized rate of 1.4 percent in the first quarter of 2022, a drop that was predominantly driven by a widening trade deficit, as import volumes rapidly climbed, and exports declined. Many experts believe the conclusion of government stimulus programs and less government spending contributed to the lower GDP. Still, positive metrics underpin the economic foundations of the U.S. personal consumption and private investment both added to GDP last quarter, and domestic purchasing, adjusted for inflation, also increased by 2.6 percent.

The economic outlook is exceptionally strong, primarily due to the financial strength of consumers. Households accumulated nearly $4 trillion in savings during the pandemic as the personal saving rate rose to its highest level ever recorded in 2020. The reasons were three-fold: the massive government payments, generous rent relief programs, and the inability for consumers to spend on services like dining and travel. The savings rate has fallen back this year, but households are still sitting on a huge savings reserve.

Households are also much wealthier. The economic recovery and the Fed's stimulative monetary policy helped fuel a tremendous buildup in household wealth as stock prices and home values soared. With a solid job recovery on top of the savings and wealth gains, consumers have ample resources to keep spending long after Covid relief programs expire. And spend they will. After months of sheltering-in-place followed by limited opportunities for socializing and entertainment, consumers have an immense pent-up demand for resuming normal activities.

Finally, fundamentals in the business and financial sectors were strong on the eve of the recession making rebuilding easier. All these factors together set the stage for robust growth. The International Monetary Fund forecasts real GDP will grow 6.0% this year and 5.2% in 2022, the highest rates in decades and an extraordinarily positive foundation for the retail sector.

Ongoing **Challenges**

Not everything is copacetic, however. The economy faces some daunting risks. The greatest near-term threat to continued economic growth is the intractable coronavirus. Indeed, the "delta variant" slowed the recovery during the third quarter and the Omicron variant that emerged in early 2022, have worked to worsen global supply chain problems and dampen consumer demand.

Epidemiologists are now starting to call Covid-19 an "endemic"—a disease that will be a constant presence that ebbs and flows. Nonetheless, it seems that the worst may finally be behind us. Moreover, we have learned to carry on despite the periodic infection spikes, which should mitigate its economic impacts.

Beyond the pandemic, other downside risks loom that could derail, or at least slow, economic growth and hit tenant or investor demand for retail real estate, despite the solid economic tailwinds heading into 2022. Of gravest concern are the large and growing disruptions along the global supply chain as well as an exceptionally tight domestic labor market.

The overall economy remained strong despite higher prices and a tight labor market. Companies' voracious appetite for more workers was reflected in the fact that U.S. employers added 431,000 jobs in March 2022. That number was the 11th consecutive month with job gains above 400,000, and it marked the longest such stretch since 1939. But there still is a massive labor void to fill.

Shortages of critical inputs and labor are straining production and slowing deliveries. The production bottlenecks largely originate in Asia, where Covid outbreaks have closed factories that make semiconductor chips and other critical inputs. But there are also problems closer to home, as a backlog of cargo ships waits to be unloaded. Shortages of warehouse space and truck drivers compound the port challenges as importers cannot store the goods onshore or distribute them quickly to retailers and consumers.

The labor shortages extend much further than just truck drivers and port workers, of course. Firms in every industry are reporting difficulties hiring for all types of workers. Many workers retired early or otherwise left the labor force. Generous government benefits discouraged some laid-off workers from seeking new jobs, but the bigger issues are obligations at home (like caring for a child) and health concerns. The pandemic also seemed to invite many people to reassess their work and lifestyle choices, aggravating shortages in lower-paid sectors like retail. A record number of workers are quitting their jobs.

There are now more job openings than unemployed workers to fill them. These labor shortages are slowing not only the job recovery but economic growth generally. However, there is ample reason to believe this tight labor market will ease over time. Firms are raising wages to attract workers. Meanwhile, pandemic savings are declining, as are concerns about workplace safety as Covid infection rates fall.

Nonetheless, strong consumer demand is intensifying the supply chain issues and labor shortages, increasing inflationary pressures throughout the economy.

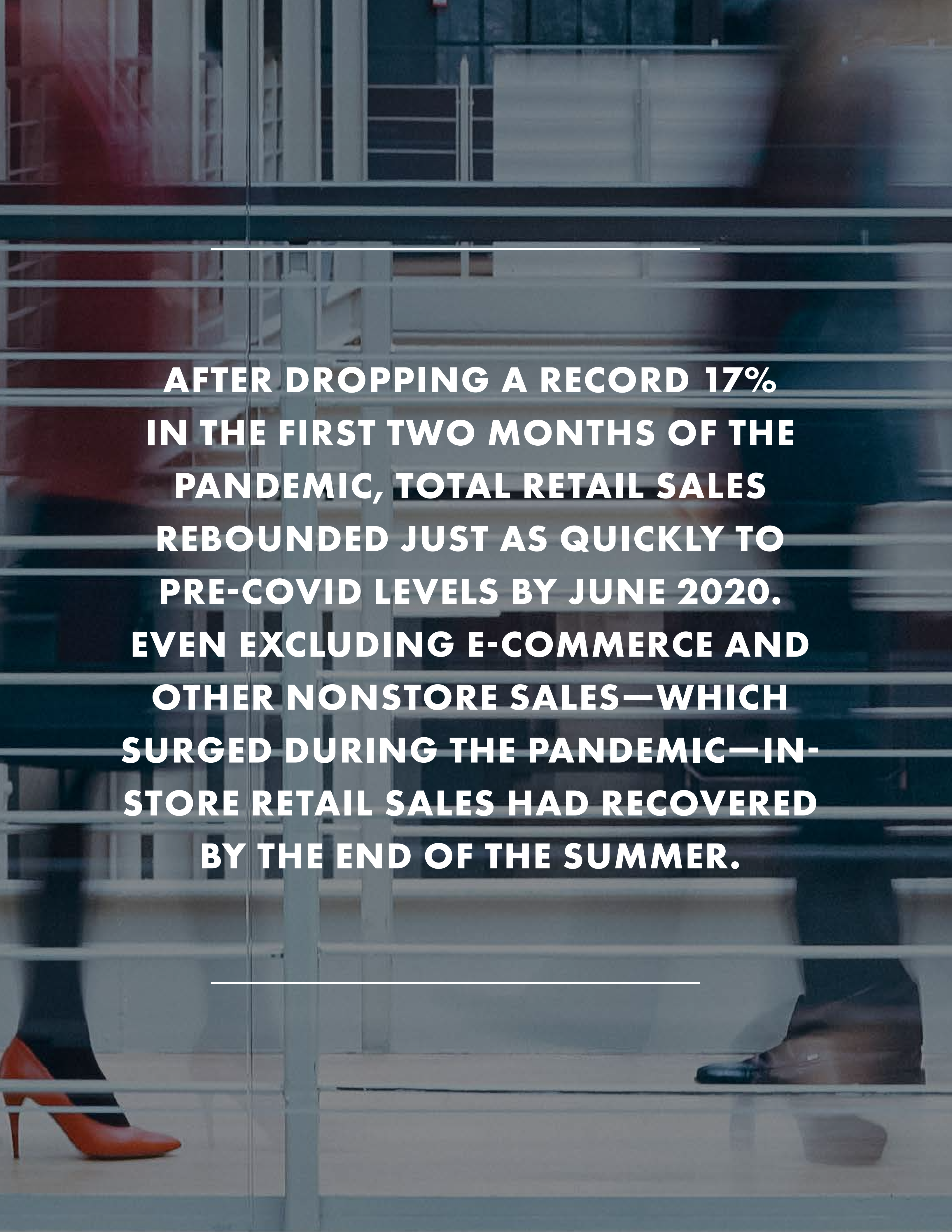
THE OVERALL ECONOMY REMAINED STRONG DESPITE HIGHER PRICES AND A TIGHT LABOR MARKET.

Initially widely believed to be transitory, elevated inflation increasingly looks to be more enduring. The risk here is of an overreaction from the Fed, which is raising interest rates and otherwise working to slow growth to tame inflation. Initially, the Fed appeared to be patient and willing to let the economy run hot for a while longer to ensure a continuing economic recovery. But, since the Federal Reserve must strive to keep inflation to an average target of 2%, the Fed's Open Market Committee raised rates in March 2022 for the first time since 2018. In early May the group is expected to raise the federal funds rate by up to 50 basis points. It is too early to tell if efforts by money policy makers to curb inflation by raising interest rates will work. The Federal Reserve's tightening monetary policy is intended to keep inflation in check by dampening price gains without throwing a wet blanket on growth.

Another global challenge that is playing havoc on people's minds and disrupting supply chains is war. In February 2022 a war erupted between Russia and Ukraine, marking a steep escalation of the Russo-Ukrainian War, which began in 2014. Many real estate experts, like X Team's Cheatham, believe the ongoing battle between Russia and the Ukraine will largely be contained in Eastern Europe, thus likely will not have a significant impact in the United States. Should the conflict expand to other parts of Europe or continue for a longer period of time, the impact could spread wider.

A final risk for continued economic growth would be federal government disfunction and policy misfires. Washington remains highly polarized, jeopardizing the ability to accomplish even basic government functions like passing a budget and funding the government. Potential outcomes like a government shutdown or debt default could be devastating for the economy.

Despite these significant risks, the economic outlook is probably more positive now than it has been in decades.



AFTER DROPPING A RECORD 17% IN THE FIRST TWO MONTHS OF THE PANDEMIC, TOTAL RETAIL SALES REBOUNDED JUST AS QUICKLY TO PRE-COVID LEVELS BY JUNE 2020. EVEN EXCLUDING E-COMMERCE AND OTHER NONSTORE SALES—WHICH SURGED DURING THE PANDEMIC—IN-STORE RETAIL SALES HAD RECOVERED BY THE END OF THE SUMMER.

Impacts and Implications **for Retail**

This expected economic growth is especially favorable for the retail sector and should support continued improvement in retail market conditions for at least two years. Consumers are financially strong and have plenty of pent-up demand for goods and services, which should drive robust retail spending in the nation's shopping centers and malls. X Team's Richard Chichester notes, "The economy has shown itself to be highly resilient, with strong consumer demand, though there is a growing change in demand from services to goods.

The risks to the sector essentially mirror those to the broader economy but magnified in some key respects. The supply bottlenecks present special challenges for retailers trying to keep their stores stocked. Empty shelves are an increasingly common sight and are sinking sales for many chains. Retailers and distributors are revamping their supply chains, moving to a new "just in case" inventory strategy that prioritizes supply reliability and redundancy, replacing the prevailing philosophy of "just in time" inventory that stresses minimizing costs. But these adjustments will take time.

Most analysts believe the shortages will be relatively short-lived as the bottlenecks are relieved. However, the backlog on orders threatens to undercut traditional strong shopping seasons. Though it seems holiday shopping starts earlier every year, retailers are especially insistent now in advising their customers to shop early or risk losing out on desired items. X Team's David Larson pointed out, "The first quarter of 2022 reflected the pent-up demand that returned to the market, after retailers had been in some degree of limbo for the last two years. Active tenants are furiously working to meet new store growth numbers at a frantic pace."

Inflation represents another risk to retailers. So far, consumers have been resilient, enabling retailers to pass on their cost increases. Indeed, strong consumer demand has been a primary driver of the product shortages. But demand could sag over time if inflation rates climb above wage gains, hitting retailer sales volumes and profits.

The Search for **Workers**

Labor shortages are widespread throughout the economy but are especially acute for retailers. Along with hospitality, no sector has lost more workers—or had such problems attracting them back. Many former workers found better work elsewhere when restaurants and retailers were closed during the lockdown, often at higher wages. Many others were simply burned out from the hard work, health concerns, and often low wages. Retailers and restaurants face higher labor quit rates and more difficulty recruiting new workers than other industries.

In response, retailers are trying to attract new workers with higher pay. They are also investing in robotics and other forms of automation to reduce their labor needs—a theme we return to in our discussion of changing retailer strategies. These costs can test the bottom line of almost any retailer, but are especially tough on smaller independent retailers, who are less able to afford wage increases to attract more workers or make capital investments to replace workers.

However, even with these pay raises and capital investments, many retailers and restaurants have been unable to maintain operating hours to meet strong customer demand. Lacking enough workers, stores are closing early and missing out on sales, while some chains are delaying new store openings.


R ISLAND
H&M
Superdry
Levi's

Retail Sector **Conditions**

Retail Sales and Consumer Spending

After dropping a record 17% in the first two months of the pandemic, total retail sales (dashed black line) rebounded just as quickly to pre-COVID levels by June 2020. Even excluding e-commerce and other nonstore sales (blue line)—which surged during the pandemic—in-store retail sales had recovered by the end of the summer (green line). Sales in mall-focused categories like department stores and apparel were slower to recover but still reached pre-COVID levels in January of this year (red line).

The recovery began as soon as the lockdowns eased and the economy reopened. In-store sales in the fourth quarter of 2020 managed to slightly beat the pre-Covid peak registered in the fourth quarter of 2019, the last full quarter prior to the pandemic. By the end of September 2021, in-store sales during the third quarter were 16% higher than in 4Q 19. Perhaps even better news is that sales in every major retail segment are now above their pre-Covid peaks, even the hard-hit restaurant sector.

But there has been significant variation in how different retail segments fared during and since the lockdowns. The pandemic triggered tremendous changes in how and where we spend our time and money. Forced to shelter more at home, consumers abruptly increased their spending sales on groceries and home improvement items while cutting back sharply on apparel, restaurants, entertainment, and personal services like haircuts and manicures.

Apparel took the hardest hit initially, down more than half in 2Q 20 relative to 4Q 19, while department store sales—which depend heavily on apparel—fell by a quarter. Restaurant spending fell almost 40% as takeout and delivery sales were not nearly enough to offset the significant decline in onsite dining. On the other hand, grocers and home improvement stores gained about 12% in 2Q 20 relative to six months earlier, before the pandemic. Discount store sales also thrived as consumers moved to economize during the downturn.

Sales recovered across most sectors by the end of 2020 as the nation slowly resumed more normal activities. Though apparel, department stores, and restaurants were all well off their levels from a year earlier, all significantly improved from earlier in the year. Grocery stores slipped back a bit as households felt more comfortable dining out again, but grocers still have outpaced overall retail sales gains, along with discount and home improvement stores. All three have increased their share of retail spending.

However, the biggest and most enduring shift was the dramatic rise in the scale and scope of e-commerce during the pandemic as we became more comfortable shopping for more types of goods online more often. Online sales soared more than 20% in the quarter after the lockdown as the nonstore share of sales jumped from 15.5% to 20.8%, effectively achieving five years of e-commerce growth in just one quarter. As with grocers, the e-commerce share has fallen some as life is returning to normal, but there is no doubt that some of the channel shift online will endure. In sum, nonstore sales have increased twice as much as physical retailers since the end of 2019.

Retail Real Estate **Market Conditions**

Despite challenges from e-commerce retailers and a chronic oversupply of store space, the retail sector made steady progress in reducing the inventory of vacant space after the GFC. The vacancy rate steadily declined from 7.0% in 2011 to a low of 4.4% in late 2018. Absorption increased during the economic expansion, particularly in 2014-16, but occupancy also rose due to the historically low levels of construction. Annual net additions to inventory averaged less than 60 million square feet nationally in the decade preceding the pandemic, well below the rate in prior expansions.

Vacancies started to rise in 2019, a year before Covid hit, and then accelerated during the pandemic. CoStar estimates that about 4.8% of retail space was vacant as of the fourth quarter of 2021, down from its peak of 5.1% at the beginning of the year. Vacancies are far lower than during the prior recession, demonstrating the resilience of the retailers during the pandemic as well as the willingness of landlords to work with distressed tenants to find common ground with their tenants.

Conditions vary by type of retail space, reflecting sales trends in the stores themselves. While occupancy for all retail space fell by 0.6 percentage points ("pps") between 2018 and 2020, occupancy in "general retail" (much of which is freestanding big box stores) fell just 0.2 pps while mall occupancy fell 2.5 pps. In between are the shopping centers that house many of the nation's grocers and home improvement stores, which together saw an occupancy decline of 0.9 pps.

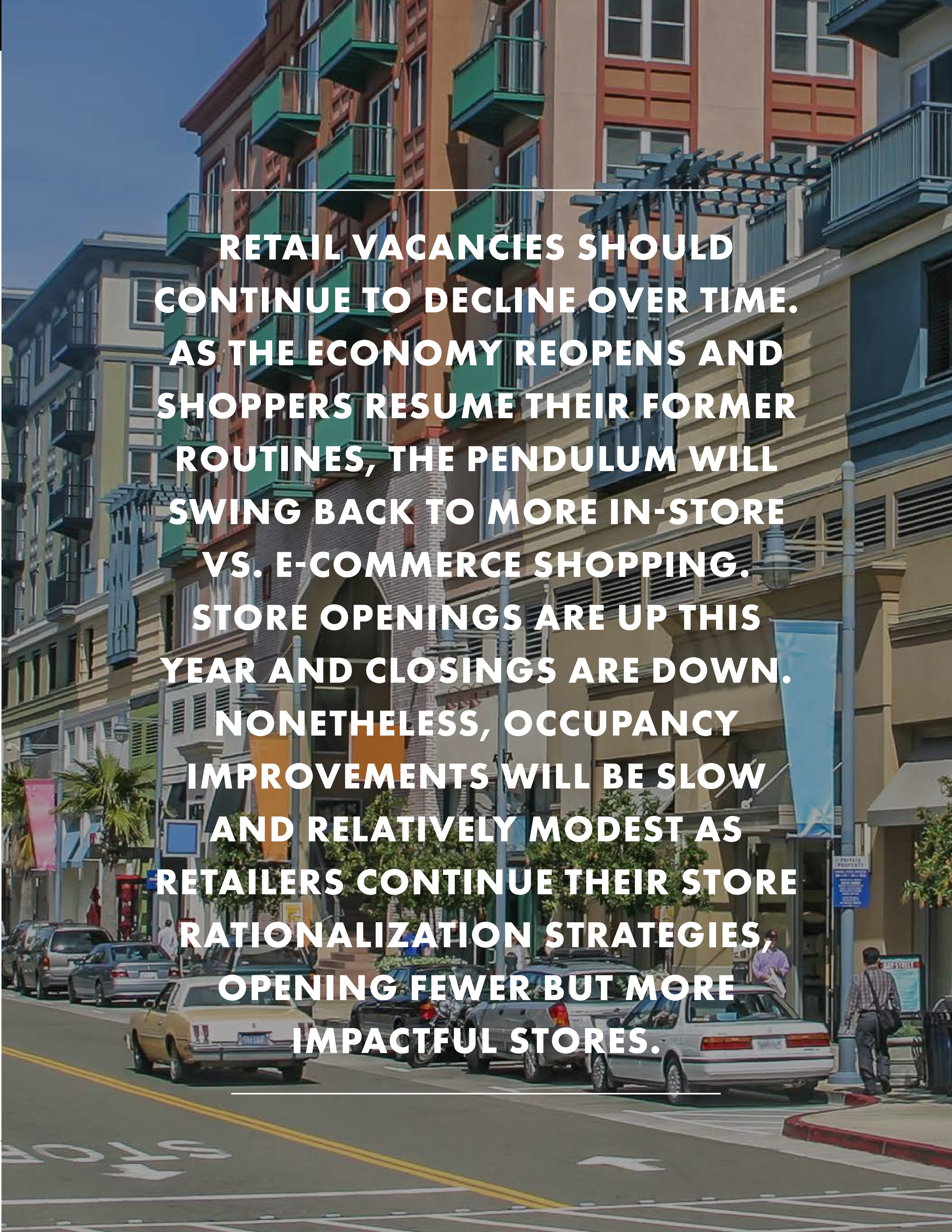
Retail vacancies should continue to decline over time. As the economy reopens and shoppers resume their former routines, the pendulum will swing back to more in-store vs. e-commerce shopping. Store openings are up this year and closings are down. Nonetheless, occupancy improvements will be slow and relatively modest as retailers continue their store rationalization strategies, opening fewer but more impactful stores. CoStar forecasts that overall, the retail sector will get back to its pre-pandemic vacancy level in late 2023. However, malls and power centers are likely to lag the more robust advances in neighborhood and community centers.

Retail Property Trends **and Segments**

New Concepts and Adaptations

Retailers are experimenting with a wide variety of new store concepts. The retail sector had been undergoing a period of intense reinvention even before Covid, as more shopping was moving online and away from traditional malls. Retailers sought to enhance the shopping experience to differentiate themselves while landlords looked to create more interesting tenant mixes.

But the pandemic—and resulting shifts in shopping patterns—encouraged retailers to be even more bold. More than ever, the retail sector is splitting into two camps, with value and convenience essential for com-



RETAIL VACANCIES SHOULD CONTINUE TO DECLINE OVER TIME. AS THE ECONOMY REOPENS AND SHOPPERS RESUME THEIR FORMER ROUTINES, THE PENDULUM WILL SWING BACK TO MORE IN-STORE VS. E-COMMERCE SHOPPING. STORE OPENINGS ARE UP THIS YEAR AND CLOSINGS ARE DOWN. NONETHELESS, OCCUPANCY IMPROVEMENTS WILL BE SLOW AND RELATIVELY MODEST AS RETAILERS CONTINUE THEIR STORE RATIONALIZATION STRATEGIES, OPENING FEWER BUT MORE IMPACTFUL STORES.

THIS MOST TRADITIONAL OF RETAIL PROPERTY TYPES IS EXPERIENCING SOME OF THE BOLDEST INNOVATIONS. GROCERY STORES BENEFITED GREATLY DURING THE PANDEMIC AS CONSUMERS SHIFTED FROM RESTAURANT MEALS TO HOME COOKING, BUT THESE GAINS CAME AT A COST. GROCERS WERE FORCED TO ADAPT AND INVEST IN ORDER TO ACCOMMODATE AND EXPAND THEIR DELIVERY SERVICES AND "CLICK-AND-COLLECT" SHOPPING, NOW OFTEN REFERRED TO AS BOPIS (BUY ONLINE, PICKUP IN STORE).

modity shopping while experience is vital for the luxury retailing, leaving little middle ground. Retailers are also trying more formats to be more flexible and adapt their concepts for different markets.

Retailers are opening smaller format stores. Some chains are looking to expand into new markets that could not support their full-size stores, such as Bloomingdale's with their 22,000-square-foot Bloomie's concept. Others seek access to dense urban markets, such as Target with their small-format stores. Walgreens has opened more than 30 small-format pharmacies as part of its "Cooper" pilot for underserved markets. Many grocers are piloting new store sizes and concepts, as will be discussed later. Beyond accessing new markets, the smaller stores can allow for more localized marketing and lower overhead for more competitive pricing.

A growing number of niche retailers are opening "shop-in-shops" in department stores and large-format retailers. The brands get access to high-traffic space at a lower cost than opening a new freestanding store, while the department store attracts more shoppers to their store. Ulta Beauty is opening 1,000-square-foot stores in Target stores while competitor Sephora is opening 2,500 square foot stores in Kohl's. Target is also home to new Apple stores. Other examples include Casper (mattresses) opening shop at Bed Bath & Beyond and Indochino (men's suits) and Tonal (fitness) setting up shop in Nordstrom's.

Also, important to note are the many brands and digitally-native retailers opening brick-and-mortar stores as a way of expanding their brand and providing a more compelling shopping experience for their customers. Among other names expanding their store portfolios are Suitsupply (men's suits), Warby Parker (glasses), Kendra Scott (jewelry), Peloton (fitness), Untuckit (men's clothes), Bonobos (men's clothes). Wilson's sporting goods is opening its own stores after being a supplier for generations. And Amazon is expanding its footprint, using its physical locations to support last-mile distribution.

In the following sections, we discuss trends in some of the most dynamic retail segments.

GROCERY STORES

This most traditional of retail property types is experiencing some of the boldest innovations. Grocery stores benefited greatly during the pandemic as consumers shifted from restaurant meals to home cooking, but these gains came at a cost. Grocers were forced to adapt and invest in order to accommodate and expand their delivery services and "click-and-collect" shopping, now often referred to as BOPIS (buy online, pickup in store). These services existed before the pandemic, but grocers had to scale up their operations quickly.

Some of the sales gains ultimately will revert to restaurants and prepared foods as the pandemic recedes, but some of the shift is permanent. Grocers cannot afford to rest on their laurels, however. They will need to continue investing heavily in offsite fulfillment centers, store adaptations for BOPIS, and improved inventory control systems to retain their edge.

Physical stores are fulfilling an increasing share of online sale as delivery services are growing faster than e-commerce. While independent grocers might use delivery platforms like DoorDash, Peapod, and Instacart, larger chains are increasingly turning to partnerships with more sophisticated services like Fabric that combine robotics and logistics to automate fulfillment. Many rely on micro-fulfillment centers based in dark grocery stores, giving new life to shuttered stores while saving on construction costs.

A more radical trend is 15-minute grocery-delivery services. Several firms have already entered this market, including Gorillas, Jokr, and 1520. These services target dense urban markets for their hyper-local, ultra-

fast delivery of a relatively limited selection of grocery items. It remains to be seen how widely these services will spread, but these firms are already attracting a lot of capital—and customers.

Altogether, eMarketer projects that online grocery sales will exceed $100 billion this year, making up 12.4% of all e-commerce sales. Though growth will slow as shoppers feel safer shopping in stores again and dining in restaurants, there is no going back. Customers introduced to online grocery shopping during the pandemic will continue to rely on the convenience of this service.

What else are retailers trying? Pretty much anything and everything. Take Hy-Vee. The conventional grocery chain has introduced five separate concepts, including a convenience store, a dollar-store format, and an alcohol outlet. As with other retail segments, grocery chains like Hy-Vee are experimenting with smaller footprints to access more markets, especially dense urban areas, where a typical grocery store is not feasible. The smaller grocery store sizes can also enhance profitability by reducing overhead and allowing for more targeted marketing and merchandising.

The smaller grocery formats typically range in size from 12,000 to 25,000 square feet, according to Progressive Grocer, compared to the average grocery store of almost 40,000 square feet. Stores in urban markets can be even smaller. But these new prototypes are not without risks due to their more limited inventory. Trader Joe's reportedly lost market share during the pandemic as many shoppers consolidated their shopping trips, preferring larger stores for one-stop shopping. Social distancing can also be more difficult in smaller stores, but these may be temporary issues.

RESTAURANTS

Restaurants were the hardest hit of all retail segments. Over 110,000 eating establishments closed in 2020 alone, according to the National Restaurant Association, equal to about 17% of all restaurants. However, some of these closures were only temporary, and new eateries replaced others.

Restaurants are recovering as the economy reopens and people resume their former routines. Restaurant sales are 10% above pre-pandemic levels. Nonetheless, the recovery is not nearly complete. Consumers have changed their spending patterns in several key respects:

- **By restaurant type:** Consumers have moved downscale and toward faster meals. Quick service restaurants (QSR or "fast food," like McDonald's and Subway) and fast casual (e.g., Panera Bread and Chipotle Mexican Grill) are gaining at the expense of full-service restaurants.
- **By location type:** Suburban markets were quicker to recover than their downtown counterparts, in part because of outmigration from central business districts (CBDs) and the slower return to

the workplace for CBD offices. These trends favor the larger fast casual chains that predominate in more suburban markets, while downtown restaurants that cater to office workers and business travelers have suffered.

- **By food delivery method:** Along with the shift to faster, less expensive meals, demand has shifted to delivery, drive-thru, and pick up. This change also favors QSRs and fast casual restaurants, whose meals are more amenable to offsite consumption.
- **By seating area:** When patrons do dine at restaurants, they are much more likely to eat outside. Alfresco dining is now common on urban streets and suburban sidewalks, even in markets not used to this option.

As with the grocers, adapting to these new trends often requires making significant new capital investments, such as for new drive-through lanes. With restaurants facing even more acute labor shortages than stores selling goods, many QSRs and coffee shops are reducing their in-store seating and expanding their pick-up options.

Related to the expansion of meal delivery has been the dramatic expansion of ghost kitchens during and since the pandemic. Ghost kitchens existed before Covid. World Wide Waiter, now known as waiter.com, pioneered the concept of online restaurant delivery in 1995, and other offline models existed well before that. But with consumers stuck at home during the lockdown and restaurants unable to hire waitstaff even when they reopened, many restaurants turned to ghost kitchens to prepare their meals for delivery.

With no need for customer-facing space, these kitchens typically are located in less expensive industrial space, saving on occupancy costs. The innovations don't stop there. Some chains are using ghost kitchens to enter new markets before opening restaurants. For example, Cracker Barrel Kitchen is using ghost kitchens to prepare meals in the Los Angeles market and using delivery platforms like DoorDash to deliver the food.

Perhaps the greatest physical change for restauranters has been the widespread move to outdoor dining. With people eager to return to the full-service dining experience but unable or unwilling to dine indoors with strangers, restaurants responded with an unprecedented expansion of outdoor seating, transforming many U.S. cities to look more like European sidewalks. Outdoor dining became a critical lifeline for struggling restaurants, and the capital investments were typically relatively modest, with less expensive furniture and fit-out costs than for indoor space.

In a marked departure from 20th-century urban planning norms that increasingly favored vehicular access and parking over pedestrians, local governments waved restrictions and reallocated precious curb space and sidewalks for restaurant use. Though the loss of parking is contentious in some retail districts, most residents seem to welcome the change. Alfresco dining seems likely to become a permanent fixture on the urban landscape.

MALLS

Malls have suffered the greatest fall in occupancy and rents of any shopping center type, accelerating a trend that began long before the recession as consumers shift to online shopping and big-box discounters. Enclosed malls, especially, have seen sales decline as shoppers migrate to more mixed-use centers, outdoor lifestyle centers, and "neighborhood-centric" retailing.

The pandemic also reinforced trends away from enclosed malls to more outdoor shopping. Cell phone tracking data from Placer.ai shows a persistent gap in the recovery between indoor and outdoor malls. As of September 2021, visits to outdoor malls were down 5.2% relative to two years ago, but visits to indoor malls were down 6.5%, based on the proprietary index of 200 leading malls and outdoor centers. Though visitation levels are up significantly over last winter, visits have since retreated from early summer as the "delta variant" spread.

Malls are recovering some of their lost sales as shoppers resume more normal routines and the pendulum swings back away from online shopping to physical retailing. But no one expects a complete reversion to pre-COVID conditions. The revival in apparel, a key driver of mall performance, is unlikely to be sustained for much longer. Sales at apparel boutiques and department stores surged this summer as shoppers rushed to replace ill-fitting and outdated clothing, but the rise of remote working bodes poorly for continued growth.

Not all malls are suffering, however. Indeed, the best malls are fully occupied and commanding record rents. But there is a clear bifurcation between these 100 or so A+ malls and everything else, especially the B- and C malls in secondary locations. Retail dynamics are increasingly driven by a "barbell of prosperity" in which luxury and discount stores thrive while the middle continues to wither, to the detriment of secondary malls.

The retail sector will be hard-pressed to figure out how to repurpose all the excess space at the ailing and failing malls. The immediate challenge will be to work out what to do with all the vacant department stores for the malls that have a future. Strategies include densifying, converting space to other uses, and adding complementary land uses like office, hotels, and multifamily residential.

The choices will be more difficult for the half of all malls that are obsolete or dead. Many are centrally located and might have a future as a last-mile distribution center. After years of decline, the old Silver City Galleria mall was finally demolished, and its land turned over for industrial uses. Such conversions often face daunting hurdles, however, not least because communities are reluctant to lose their retail tax base and to give up on what had been a local gathering place.

But even the best malls and retailers cannot stand still. The demise of the department store means malls must use distinctive tenant mixes—with unique, local retailers—to bring in shoppers, while the retailers themselves need to keep innovating and provide compelling experiences to attract shoppers. Both retailers and shopping center owners will be challenged to provide the seamless experience from online to store that customers expect.

CAPITAL MARKETS

Investor demand for U.S. commercial property is stronger than ever. Real Capital Analytics (RCA) reported that U.S. commercial property sales climbed at double-digit rates from a year ago in Q1 2022 despite the uncertainty around war, interest rates and inflation. Sales activity in the first quarter increased 56% on the same period a year ago and in March 2022 activity

MALLS ARE RECOVERING SOME OF THEIR LOST SALES AS SHOPPERS RESUME MORE NORMAL ROUTINES AND THE PENDULUM SWINGS BACK AWAY FROM ONLINE SHOPPING TO PHYSICAL RETAILING. BUT NO ONE EXPECTS A COMPLETE REVERSION TO PRE-COVID CONDITIONS. THE REVIVAL IN APPAREL, A KEY DRIVER OF MALL PERFORMANCE, IS UNLIKELY TO BE SUSTAINED FOR MUCH LONGER.

increased 47% from a year prior. While deal activity climbed, the pace of price growth did decelerate from the recent record highs, reported RCA. In 2021, global sales of commercial real estate surpassed $1.3 trillion, powered by the U.S. market's surge and growth in Asia Pacific and Europe. All three global zones posted record trading volume, RCA reported. In the Americas, 2021's sales of income-producing property were double 2020's subdued total, propelled by a leap in U.S. apartment trading.

Deal volumes are sure to increase further as investors sitting on an enormous pool of dry power of capital eager to be placed. Investor interest in U.S. property markets is strong from both domestic and offshore capital due to attractive yields relative to alternative investments including domestic bonds and commercial property in other countries.

However, recovery in the retail sector has been more tepid. The retail sector ranks last among the major property types in ULI's annual Emerging Trends investor survey for both development and investment prospects, as it has for the last several years. Transaction volumes for retail property fell 43% last year compared to 25% for all other property types. Retail property sales are coming back this year, but not nearly as strong as for other property types. Excluding some high-profile deals, like Kimco's acquisition of Weingarten Realty this past summer, sales of individual shopping centers have been much more limited.

There are some key exceptions, however. Demand for single tenant retail is hot and "the absolute strongest part of the market," according to X Team's Chichester. Investment in single tenant retail is becoming more mainstream. Sophisticated investors are replacing some of their shopping center investments and moving into single tenants to rebalance their portfolios and reduce risk.

The capital for this niche product still primarily comes from smaller private investors, but interest is increasing from institutional investors, especially for portfolio deals. Some analysts expect deal volumes to hit record levels in 2021 due to strong market dynamics and consistent rent growth. Low interest rates are also driving demand, reducing the cost of acquisition debt and making yields on bonds and other interest-sensitive investments less attractive.

Among shopping centers, demand remains strong for grocery-anchored neighborhood and community centers. However, institutional interest in malls has faded. Instead, there is greater interest from opportunistic investors looking to reposition malls and other out-of-favor retail. ■

A SPECIAL **THANK YOU** TO...

Dave Cheatham
Connie Niessink
Justin Baker
Bryan Cornelius
Rick Chichester
Steve Edwards
Jim Bieri
David Larson
Andrew Nelson
Evan Albert

CONTACT

www.xteamretail.com
602.682.8145
info@xtreamretail.com

X TEAM RETAIL ADVISORS
2415 E CAMELBACK ROAD, #400
PHOENIX, AZ 85016
WWW.XTEAMRETAIL.COM