XTEAM
RETAIL ADVISORS

INSIGHTS 2023

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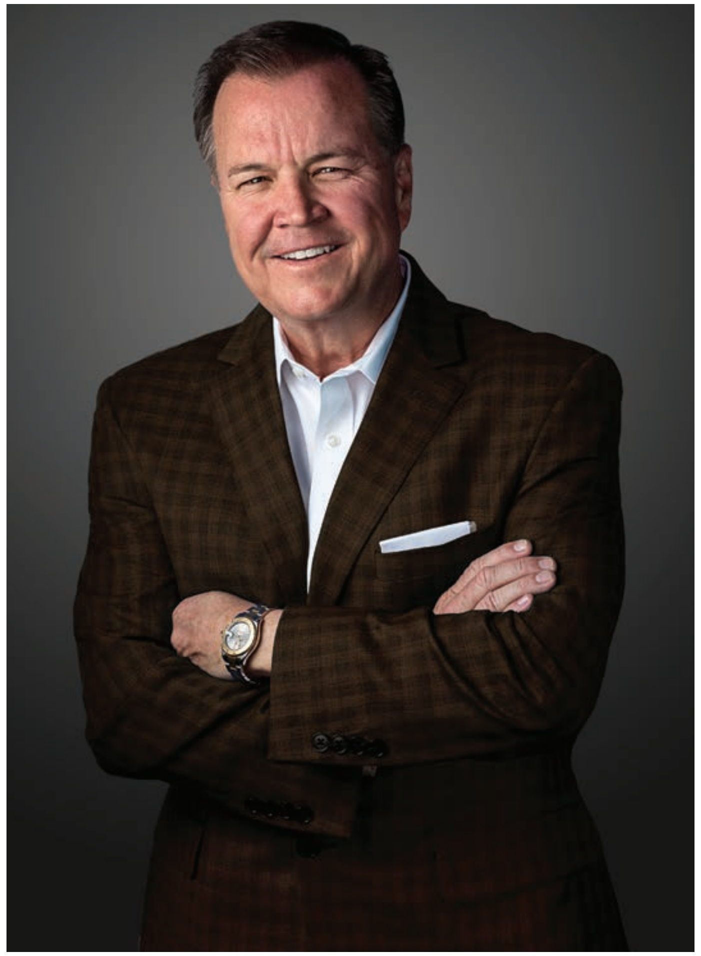


Welcome to the 2023 edition of X Team *Insights*. We are excited to present our annual publication to you. We hope it provides you with compelling content, thought-provoking topics contributed by X Team's retail real estate advisors, and inspiration for your company's continuing strategies.

Our X Team *Insights* is the result of a collaboration between our organization's partnership of boutique advisory offices located in major markets across the United States and Western Canada. This type of collaboration is the cornerstone of what makes X Team unique.

Our members communicate and work seamlessly, pooling their market intelligence and extensive resources to form a strong and cohesive platform of retail real estate experts. Our connectivity allows X Team to provide our clients with local knowledge and real-time data with a national scope.

Consumer behavior has changed post-pandemic, evolving retail store strategies and methods to reach shoppers where they are, whether at home, in-store, or on their smartphones. On a daily basis, our members monitor the trends in the industry, conduct extensive research, and provide solutions for clients. It became clear that this valuable information was meant to be shared.

In this edition of X Team *Insights*, we will look at the role that technology is playing—and will increasingly play—in the retail experience, including grocery stores, QSRs, and industrial and operational applications.

While the commercial real estate industry faces various challenges in 2023 that are making the market more complicated, the outlook for retail real estate is cautiously optimistic. Low historical unemployment and record capital levels are helping the sector grow. Many in the industry are considering the long-term, aiming to ride out this downcycle and reposition their strategies for a coming period of sustained growth and strong returns. As the Fed works to lower inflation closer to its 2% target, we anticipate a gradual decline in rates in the fourth quarter of 2023 and early 2024, enabling investors to secure debt more easily. Pricing is readjusting sooner than expected, as buyers and sellers negotiate to transact deals quickly with surety of close. While transaction volume and investment sales are down, there are market opportunities unseen these past 24 months.

Our feature story examines retail real estate construction, the lack of new supply this past decade, and how this plays out in 2023 and beyond. The economy's higher interest rates, rising materials and labor costs, and increasing cap rates have tempered market activity. The pricing on many deals no longer makes sense. We expect to see more action in the market once interest rates reverse their gains these past 14 months. That said, investment activity continues for more modest retail projects, such as single-tenant properties and neighborhood centers receiving financing through established banking relationships.

2023's postscript will note how we continued to pivot and adjust to a variety of disruptive forces that challenged our industry. While it is evident that the commercial real estate market continues to modify toward pre-COVID normalcy, there have been undeniable societal changes, workplace shifts, and permanently altered consumer behaviors. Since the pandemic, retail has faced cyclical headwinds, supply chain issues, and labor shortages and quickly pivoted to at-home delivery, innovative omnichannel strategies, and new bricks-and-mortar models that prioritize nimbleness and efficiency. Despite doom-and-gloom forecasts, industry fundamentals are solid and resilient. Retail sales remain healthy and upbeat, consumers are still purchasing, and retailers want to expand.

We believe the retail industry is well-equipped to face uncertainties with lessons hard won during the pandemic. Our professionals are creative masterminds, flexible and innovative, proving that we can come up with solutions to manage a rapidly changing world.

Enjoy this issue of X Team *Insights*, and let us know your thoughts. We welcome your feedback so we can meet and exceed your expectations. I want to take a moment to thank the X Team contributors who gave their time and expertise to publish this magazine. As you read through the issue, we sincerely hope the ideas presented will inspire you to share them with your clients and colleagues.

Dave Cheatham
President
X Team Retail Advisors

RETAIL RESILIENCE

Retail adaptability is proving itself in the way brands are continually evolving to meet consumers' ever-shifting expectations.

Every so often, an apocalyptic headline pops up announcing the demise of retail, specifically brick-and-mortar retail. Much of this occurs in response to the latest news about a retailer's bankruptcy, the most recent being Bed Bath & Beyond. Then there have been the "retail-is-dead" topics over the past few years. Specifically, e-commerce is killing brick-and-mortar. And more recently, questions arose about whether the pandemic meant an end to physical retail.

While the headlines create a "sky-is-falling" scenario, physical numbers explain the opposite. The National Association of Realtors reports that thanks to a lack of new supply, vacancy in the U.S. retail sector has been falling consistently in recent quarters, ending 2022 at 4.2%. Average asking rents and net absorption also increased.

So, what's going on? The simple answer is that brick-and-mortar isn't going away. Nor is retail in danger of extinction. What it is doing is changing, as it always has, to meet the needs of consumers. In other words, it's evolving to survive shifting market conditions.

This is nothing new; simply look at how the sector has transitioned over the past several decades. What began as mostly mom-and-pops and corner shops morphed into department stores in downtown locations. Suburban spread then drove retailers outside of CBDs, and things took off from there.

These days, said Providence Group Partner Melissa McDonald, "retail hasn't returned to the business districts in most mid-sized markets." There has, however, been an increase in urban infill development. "The suburbs have continued to expand, adding more retailers that would have typically been located in more interior neighborhoods."

Another "today" trend? Retailers are eyeing former office and industrial space for their brick-and-mortar locations. Part of this is an aesthetic move. A different look is a branding strategy, one that allows a retailer to stand out from the competition. "This is much more prevalent in markets with infill, urban locations where there are minimal options for traditional retail product," McDonald said.

MALLS FACE SHRINKING ATTENTION SPANS

The "mall is dead" theme is an unfortunate generalization; not all malls are going belly-up. Many are in the process of changing as they respond to consumer demand.

Whereas teens of the 1990s would hang out all weekend in malls, things are different today. The teenage mall rats of the late 20th Century have been replaced by tech-savvy youth who "have other things to do than hang around a food court," said Tim Miller, a Principal with GreatStreet Realty. "This generation is more in and out. They don't like to spend the day at the mall. Attention spans are shorter."

80%

Of absorption in 2022 was driven by general retail and neighborhood centers

Successful malls are evolving, as they offer convenience, ideal co-tenants, restaurants and entertainment, he said. This, in turn, leads to the need for a sense of place. As a result, newer construction (and mall renovations) is determined by demographics as well as psychographics, versus simply putting a bunch of national chain stores together and hoping for the best. Or, as Miller said: "The malls that are thriving today have resolved anchor issues and kept the interior small shops fresh."

McDonald noted that the more unsuccessful—typically older Class B or C properties—are undergoing their own change. Many are being re-purposed into office or medical uses. Still others are being incorporated into mixed-use centers, complete with residential components. "The more viable malls that are not performing have done some redevelopment and added promotional retailers to the mix to create more a more stable tenant mix and, in turn, a more stable asset," she added.

BIG BOXES GET SMALLER

The headlines also proclaim the demise of the big-box footprint; this was "news" even before the pandemic. In reality, the big-box format isn't going away as much as it's being re-imagined.

Bryan Cornelius, Principal with RetailUnion Partners, pointed out that the larger-format space is becoming home to entertainment, especially if that big-box space is part of a larger center. "Restaurant and entertainment are becoming the anchors here, rather than department stores," he said.

Then there are the large-format retailers that refuse to budge. They're staying the course by offering buy-online-pickup-in-store (BOPIS) or buy-on-line-pickup-at-curbside (BOPAC) services. This isn't necessarily new; BOPIS and BOPAC were offered before the COVID-19 pandemic. And as consumers return to in-person shopping, retailers continue offering this as a convenience. "Large retail stores have capitalized on having great real estate near rooftops by operating a retail store with more sophisticated e-commerce and BOPIS programs," Miller said.

As such, big-box retailers are repositioning their space as both a destination to visit and as a fulfillment center for online orders. For example, Target has announced that beginning this year, it's going even larger with its store layout, in part to allow more efficient BOPIS/BOPAC order fulfillment.

And in some situations, the big-box format does well for smaller retailers, especially with a decline in retail construction. "With the lack of vacancy, there are multiple users for each box," Providence Group's McDonald commented. "Some of the boxes in excess of 100,000 square feet are being subdivided, given that most box users are in the 22,000- to 55,000-square-foot range now."

TECH TOOLS ADD TO RETAIL'S RESOURCES

Despite all the predictions to the contrary, most consumer sales transactions are taking place in person. According to the U.S. Census Bureau, e-commerce sales in 2022 accounted for 14.6% of total retail sales, but that figure has remained flat since the prior year.

Supporting this finding is a Bain & Company survey among shoppers, which reported that people of all age groups like setting foot, and shopping in, physical stores. Notably, this was the case with tech-savvy Millennials and Gen Z. The survey indicated that young adults accounted for 38% of all retail spending during the latter part of 2022 and early 2023.

If anything, retailers are recognizing that technology can boost their sales and help with other areas. Target, for instance, relies heavily on tech to further its business decisions. Before launching its newer, larger stores, the retailer built and tested the model using virtual reality. Target's store design team created a fully virtual, life-size representation of the re-imagined store, allowing them to analyze and redesign features in real time while virtually "walking" the store to ensure the enhancements would work for both customers and team members.

Before the age of predictive analytics, choosing where to place a store involved extensive field analysis based on complementary or competitive retailers. Today, more sophisticated market approaches synthesizing data on lifestyle segmentation, visitor analytics and consumer psychographics help retailers better pinpoint locations that will best serve their target markets. The result is an increase in both sales dollars and foot traffic.

Furthermore, retail is undergoing an integration between e-commerce and brick-and-mortar. Most brands these days require a digital presence to survive since the majority of shopping trips start with a visit to a search engine. Without a digital presence, retailers also won't show up in internet searches.

But the integration of retail and tech isn't new; it's just taken a few steps forward. GreatStreet Realty's Miller said that e-commerce changed the perspective of retailers, while the pandemic forced innovation in the field. "One of the best improvements is the ability to go online to see if something is in stock at a store, click it, buy it, and pick it up," he observed. "To me, that is the most effective strategy that has emerged in the past five years."

THREAT IS DOWN, BUT COVID'S IMPACT REMAINS

The pandemic impacted retail immensely. Shorter store hours, partly due to labor shortages, are one lasting result. Restaurants beefed up their mobile and online ordering processes, while focusing more resources on drive-thru and take-out options versus on-site dining. Those restaurants in warmer climates expanded their outdoor seating areas.

In fact, more attention is being paid to the outside of brick-and-mortar properties, in general. "People want to be outdoors more, even with the pandemic in the rear-view mirror," said Cornelius with RetailUnion. "This has led to more outside facilities and attractive landscaping, as well as more open pedestrian areas."

Another trend involves the blending of products and services to improve branding, stand out from the competition and lure consumers back to the stores. Swedish meatballs at Ikea have always been a thing. But these days, home furnishing stores and apparel stores are adding food and drink areas "to bring customers in, enhance the overall experience and take less 'Main and Main' locations in absence of that space being available," McDonald said.

Interestingly, consumer preference has also shifted toward smaller retailers and shopping closer to home. You can thank the pandemic for that one, Miller said. "When everything was forced to close, customers realized that supporting bricks-and-mortar in all categories was vital to their community," he concluded.

Indeed, today's consumers still like the experience of in-person shopping—it's just that now, they also want to be engaged enough so the experience is worth the effort. *X*

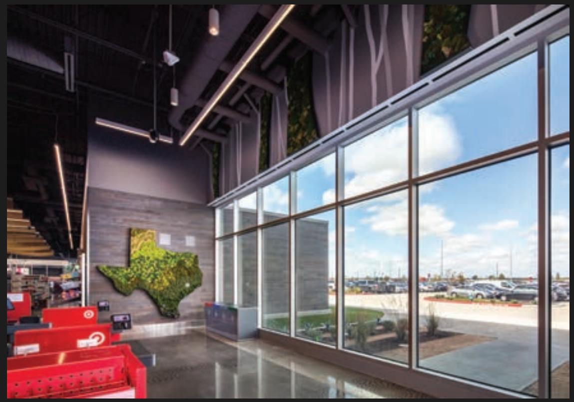
75.8MSF YOY NET ABSORPTION

4% YOY RENT GROWTH

4.2% YEAR-END VACANCY

6.7% YEAR-END CAP RATE

Source: National Association of Realtors' 2023 CRE Insights Report



After thoroughly testing it in virtual reality, Target launched a new larger-format store concept earlier this year. The bigger facilities feature more merchandising options and expanded backrooms with updated fulfillment areas that will also support the retailer's growing same-day services and stores-as-hubs strategy. The new format also includes natural design elements, open layouts, sustainable features and comfortable, flexible team spaces.

CONSTRAINTS SHADOW SCARCITY'S SILVER LINING

After a decade of low construction activity, retailers are doing their best to find innovative and creative solutions with the options they have available.

The past decade has been challenging for retail and commercial real estate, losing ground to the 2008 recession, the e-commerce revolution, and a sluggish economic recovery. The troubled era threw cold water on most retail development. Malls also took a hit, with many low occupancy or abandoned properties labeled "dead malls." Consolidation and over-expansion of department stores took another toll on retail as they were met with demographic declines of the middle class and the need to dress for work or special occasions.

But the industry is regaining some footing and has rebounded after a long period of stagnation. The availability of spaces larger than 10,000 square feet have precipitously dropped in several south and southwest markets, and inventory is tight. Large format users of the market have been growing, with big-box chains such as Target, Costco and Walmart stepping up their construction budgets.

For the first time since 1995, more stores opened than closed in 2022, according to Morgan Stanley. With minimal development, larger spec projects are on pause for the most part. Inventory scarcity also makes existing assets more attractive to investors.

THE SILVER LINING

On the supply side, though new retail construction remains below pre-recession levels, 2022 proved to be a strong year for growth. Retail construction starts hit $19.4 billion last year, a 31% increase from 2021, according to Dodge Construction Network. Retail construction starts, which lag housing construction by roughly one year, have benefited from solid residential growth over the past few years.

> **"There's insufficient momentum to roll out new projects. The margins needed are just not there."**
>
> Jason Baker
> *Baker Katz*

Lack of inventory is great news for landlords. With occupancy rates at all-time highs and near-record rental rates in many markets, it's a good time to be a property owner, shared Jason Baker, Executive Director of X Team Retail Advisors and Principal of Baker Katz, a Houston-based retail tenant brokerage firm.

Overall vacancies have continued to fall since 2021, ending Q1 2023 at between 4% and 4.5% nationally. That's led to substantial rent growth—rates increased 10% or more in many areas and are projected to rise by another 3.3% this year. Tenants shopping for Class A space may even find themselves priced out.

These conditions have created a supply-demand imbalance keenly felt in hot retail markets like Las Vegas, Phoenix, Denver, and Houston, among other Sunbelt cities. It's also driven retailers to look at innovative ways to accommodate their growth plans, such as revamping older properties, leveraging technology and implementing smart and sustainable building systems.

Baker confirmed that some retailers opt for vacant spaces in older, yet well-located neighborhood centers to meet their needs. "What I tell my clients trying to manage sticker shock and high rental rates is that as a rule of thumb, a landlord will have a portion of their portfolio, 5% to 15%, sitting vacant," he explained. "We've seen much of that previously overlooked space getting leased."

While Baker stated he is "encouraged by what I see in terms of expansion plans" by many retailers and developers, he remained concerned about how the recession will delay or scuttle those plans.

STORM CLOUDS AHEAD

While the supply constraints have contributed to the retail sector's healthy performance, they've also created a challenging climate that may become even harder to navigate when compounded with rising costs, higher interest rates, and a looming recession.

For one, construction is not immune to the labor shortage plaguing all corners of the economy. The Associated Builders and Contractors (ABC) reports that the construction industry will need to attract 546,000 additional workers on top of the average hiring pace in 2023 to meet the labor demand. Hiring will be more challenging, with workforce shortages forcing contractors to increase compensation and benefits. By all accounts, qualified, skilled trade professionals are desperately needed to backfill the industry.

Further, most non-residential development of late has centered around industrial. Industrial construction spending increased by nearly 20% last year as more businesses began to home-shore their production after global supply chains crippled distribution and sales. The high demand for industrial space has fueled development, and the sector is performing well enough to afford higher construction costs.

Supply chain concerns persist, according to the Associated General Contractors of America. Takeaways from their 2023 Construction Outlook National Survey indicate that supply chains are still broken, with project delays, price hikes for materials, and logistical headaches as top concerns.

The inflationary environment doesn't necessarily translate into more groundbreaking events even if workers are available. Baker noted that Houston has some contractors and subcontractors looking for work and coming up empty. Adding to that is the cost of materials. "Where we do not see movement currently is in the pricing," he shared. "While some items like lumber have come down, other materials like steel and concrete are still at all-time highs. New development costs in this market are at least 40% to 50% higher than before COVID hit."

Ambitious government-led initiatives to spur economic development might also work against retail development. The Biden Administration's Infrastructure Investment and Jobs Act, CHIPS and Science Act of 2022, and Inflation Reduction Act will direct $2 trillion toward public investment in infrastructure, clean energy, semiconductor manufacturing, and more. These programs, which will begin to roll out over the next several years, are expected to transform the country and direct most of the talent and focus to the public sector.

Even retail's relative health isn't enough to spur development when there are still plenty of reasons for caution. While Baker has been encouraged by the number of projects on paper, he is less enthusiastic about construction timetables. "Unfortunately, there's insufficient momentum to roll projects out," he said. "The margins needed are just not there for contractors, labor, or materials."

"Everybody is waiting on the sidelines and ready to get things done, from contractors and GCs to title companies and lenders," said Baker. "While there is appetite for more retail space, I don't see much more product being delivered anytime soon."

CAN LESSONS LEARNED BE SWIFTLY FORGOTTEN?

During every cycle in the US economy and real estate market, there are ebbs and flows to development activity. One professional that's seen his share of up and down markets is Baker Katz Principal Jason Baker, who also serves as an Executive Director with X Team Retail Advisors. Having joined the brokerage business in the late 1990s, he has witnessed both booms and busts in his hometown of Houston.

At the turn of the millennium, the city experienced significant population growth. This was swiftly followed by a proliferation of new retail to service the growing populace. Houston saw between five and seven million square feet of new retail deliveries in the early 2000s. "We had more retail per capita than any other major market in the U.S.," Baker recalled. "Things were great during those haymaking years."

Perhaps too great, depending on whom you ask. "The last time we saw vitality like that was in 2015. I understand that retail follows rooftops, but we had too much," he shared.

Activity has decelerated in the past three to four years, which Baker assigned to a handful of contributing factors. For one, retailers started declaring bankruptcy in higher numbers. "Retailers got smarter, realizing that they didn't necessarily need as many stores to accommodate a population area."

Today, post-pandemic migration patterns have made Sunbelt cities attractive for households looking to relocate from other, more expensive markets. Labor and state politics, cost of living, and climate are all factors in the decision to relocate, and Texas and Arizona have become desirable targets for businesses and individuals alike. According to Census figures, Houston has become the second-fastest growing metro in the US. If this growth continues, Baker is concerned that the number of planned projects he's seen so far can lead to oversupply, repeating mistakes from the past. Lessons learned potentially will be forgotten.

Baker added that the saving grace is high prices on construction materials, land, and labor, which have forced developers to remain disciplined. "I sense that high costs will likely delay a meaningful amount of retail being built in Houston anytime within the next year." X

WITH CAPITAL SIDELINED, DEALS GET TRICKY

Despite a tighter lending climate and widening bid-ask gap, savvy retailers and their advisors are finding ways to find funding for their CRE plays.

The rapid normalization of interest rates and the speed of that trajectory has created a pricing dislocation in the market that has impacted all commercial real estate lending, and retail is no exception. Challenging valuations are the steep run-up in the cost of debt, which has risen more than 500 basis points since March 2022, the ninth increase in a year.

With traditional sources of capital constricting and borrowers struggling to meet tighter lending standards, the real estate capital markets are facing ample headwinds. Lenders' risk mitigation strategies require investors to contribute a more significant proportion of equity to the deal. In many cases, deals are no longer making sense, and the gap between sellers' price expectations and what buyers are willing to pay is too wide to breach.

Lately, though, Partners Ryan McArdle and Steve Collins of The Palomar Group have noticed an inflection point as buyers and sellers adjust to the new reality and bring their expectations in line. And this is happening faster than expected.

"At the start of the year, we anticipated that buyers would ease up on their pricing in the second half of 2023," McArdle explained. "The adjustment happened much sooner than anticipated, in the early part of the first quarter. Sellers who had no desire to negotiate have been willing to shift their expectations."

As a result, he added, the bid-ask gap is also widening faster than expected—a trend that will likely continue. Collins agreed with his colleague, stating, "The biggest challenge facing the market right now is that sellers are unable to reach pricing levels attained during the first half of 2022."

Psychology and confidence influence market behavior, and aggressive interest rate increases have fomented shockwaves that cooled the trading environment. Math is critical when underwriting a commercial real estate asset because a significant difference in valuation impacts a buyer's expected return.

SOURCING OPPORTUNITIES

Unlike the Great Financial Crisis (GFC), experts agree that this is a liquid real estate recession with plenty of capital waiting in the wings. Investment activity will increase as inflation indicators decrease and the Fed's aggressive stance eases.

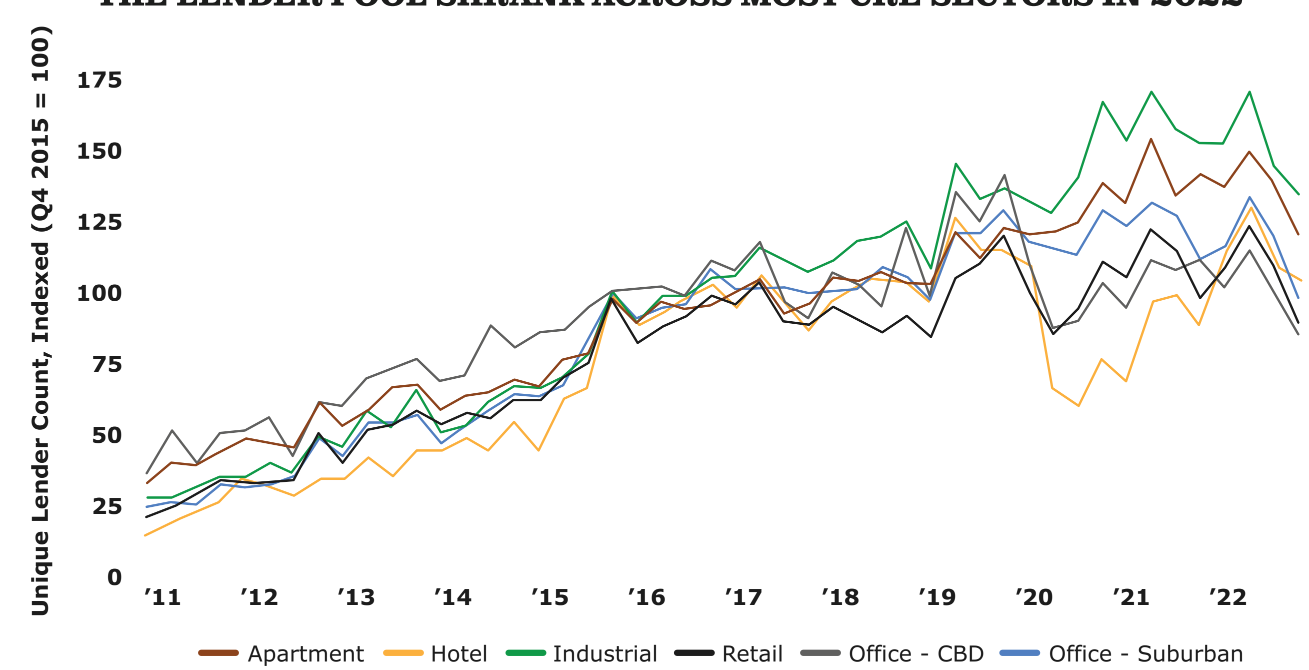
There is continued demand in the retail sector, and McArdle related that fresh inventory has been starting to come on line within the past six months. "Opportunities are presenting themselves in the market," he confirmed, "and deals can be had if buyers can figure out their debt financing."

Over the past 24 to 36 months, McArdle said Palomar has been helping clients source financing to help to move their plans forward, though debt financing is a challenge. The shift is evident in the latest sales figures, which show that year-over-year sales transaction volume is significantly down across the retail spectrum, from single-tenant assets to shopping and neighborhood centers.

Still, middle market transactions are having a better time securing financing based on relationship banking and the availability of equity in the deal. "Most current assets in our sales pipeline are single-tenant properties or smaller strip centers, which are less reliant on debt constraints," McArdle revealed. "Larger deals are more challenging since there are fewer cash buyers."

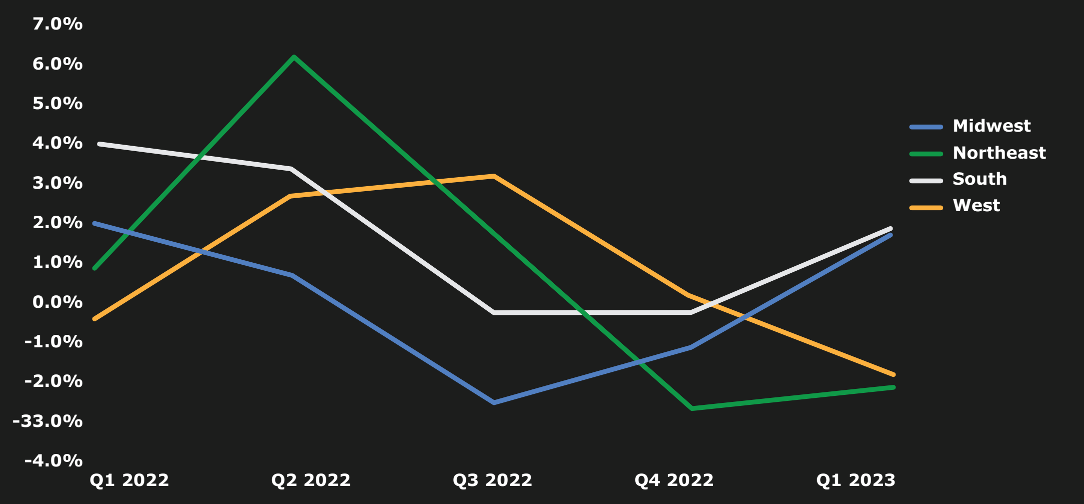
Pricing levels can move even when an assured closing is on the table, he added. "Sellers don't know what the future debt market will look like, so we find they are more willing to be flexible on their asking price as long as there is reasonable due diligence and a guaranteed close," McArdle said. "In this environment, cash is king, and quick closings count."

THE LENDER POOL SHRANK ACROSS MOST CRE SECTORS IN 2022



SOURCE: MSCI RCA Commercial Property Data

QUARTERLY CHANGE IN RETAIL PROPERTY PRICES, BY REGION



While prices for retail properties fell across the country, some regions saw more drastic declines over the past year. Pricing is recovering somewhat nationally, though the West continues to lag.

NOTE: Data through 03/2023
SOURCE: CoStar Commercial Repeat-Sale Indices

What's more, Collins noted, retail investors in general have been able to refinance their debt, unlike other sectors like multifamily or office. "Over the past two to three years, cap rates and the spread between debt and capital have been large, and the leasing environment has been strong enough to generate sufficient NOI," he explained. "Investors have been able to cover their debt service ratio and refinance debt, even with changes in interest rates this past year."

But, Collins stressed, it's somewhat based on the depth of the borrower's relationships with capital sources in the industry. "On smaller unanchored deals, those investors with relationship banking can access funds and get their deals closed," he related. "We don't too see many deals getting financed among investors who don't have those established relationships."

For the first time since rate hikes began, CMBS loans have returned to the market. "These loans are among the few alternatives to access non-recourse debt," stated McArdle. "We have seen CMBS loans that offer a five-year term, with interest only for the first year, at 7.9%."

McArdle has noticed that in the past year, credit unions and credit union funds have also stepped in to provide funding on a larger scale outside their markets. According to data from the National Credit Union Administration, these lenders had $129.1 billion in commercial loans outstanding in the fourth quarter of 2022, an increase of 24.5% from the prior year.

Construction lending is happening, but like other aspects of CRE financing, it's getting more complicated. The pool of available capital "is shrinking with the uncertainty of the economy," Collins related. "Compounding matters are construction costs, which are also rising. Developers are finding themselves in an untenable situation, with spreads that are no longer attainable. So unlike 12 months ago, many construction deals are just not making sense for lenders right now."

Retail real estate has proven itself healthy, and there is a rebirth and repositioning underway that investors are noticing. Despite current headwinds buffering the sector, the horizon looks promising. The industry has absorbed lessons learned, and innovations tested during the pandemic, while adjusting and repositioning itself for growth. *X*

CUSTOMERS & BRANDS SEEK A BALANCE OF HUMAN-DIGITAL TOUCH

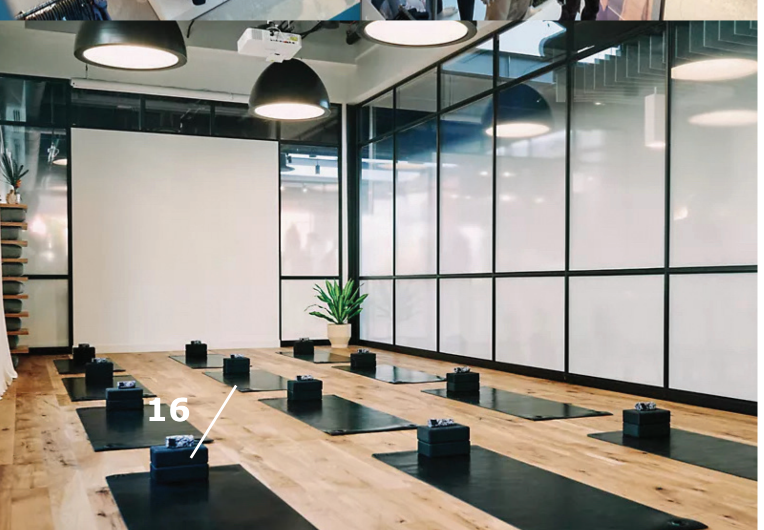
To satisfy today's shoppers, retailers must pay as much attention to making in-person connections as they do to enhancing their online offerings.

By Melissa McDonald and Tim Miller

The Covid-19 pandemic and social distancing mandates impacted the retail business in ways once thought unimaginable. Even as conditions gradually improve since restrictions were lifted and the industry returns to some semblance of normal, retail is still dealing with the repercussions.

In 2020, unemployment was at its highest level since the late 1940s and consumer spending was down nearly 10% from the prior year. By the second quarter of 2021, comp store sales increased close to 16% in what was purely consumers' response to easing restrictions. The obvious categories showing





the largest increases were in the sale of home furnishings, alcohol, fitness equipment and some casual/fitness apparel. And who can forget the panic buying of household and pantry items that occurred with consumers effectively creating a scarcity of those items by buying in bulk?

Three years after the worst of it, it's clear that while consumer behavior is reverting to business as usual, some of the changes adopted during the pandemic are here to stay. The remote working environment is still in place for some employees, be it full or hybrid; this shift in work habits has resulted in a significant change to the restaurant and retail business in urban environments that were once dependent on foot traffic from workers. Tourism in many major cities including NYC, Chicago, and San Francisco has still not rebounded to pre-pandemic levels. Costs and staffing are issues for both restaurants and retail as they try to meet consumer demand within a labor shortage.

As the industry collectively tries to do more with less, customers have returned to the stores with a pent-up demand that is still evident during the first quarter of 2023. That's not surprising, given that 92% of consumers polled by Raydiant said they missed in-person shopping during the pandemic. At the same time, retailers and consumers alike have come to embrace and even expect the convenience and efficiency e-commerce has afforded in recent years. Let's take a closer look at the ways in which consumer habits and expectations have shifted.

E-COMMERCE'S EFFICIENCY

The explosive growth of e-commerce activity sent sales skyrocketing in many industries. Purchases made online or via mobile app accounted for nearly 16% of the $5.6 billion in total retail sales recorded for 2020, with the channel experiencing a 43% growth, according to DigitalCommerce360's analysis of U.S. Department of Commerce figures.

Even after pandemic precautions were lifted, the trend toward e-commerce continued as consumers got used to the efficiency and convenience it offers. The pace of that growth is slowing as consumers have the option to go inside stores; e-commerce sales growth came in at 17.8% in 2021 and fell to just 7.7% by year-end 2022. As a share of retail sales, though, the Fed has e-commerce consistently accounting for between 14% and 15% of all retail sales each quarter since its 2020 peak, coming in at 14.6% in Q4 2022.

In dollar figures, U.S. e-commerce sales topped the $1-trillion mark for the first time ever in 2022 at $1.03 million, while overall retail sales came in at $7 billion. By 2027, it's expected that retail e-commerce revenue will reach $1.5 billion or more. While it's not going to overshadow brick-and-mortar shopping, offering omnichannel options has become a vital component of retailers' business.

Retailers with an eye on growth have come to understand digital and in-person shopping aren't warring options but rather, complementary parts of a broad strategy. Those who have adopted an omnichannel strategy are able to provide a more personalized experience for consumers, as well as offering greater flexibility in how and where consumers can shop.

An omnichannel strategy allows retailers to leverage the strengths of both online and offline channels to provide for a seamless experience, which many consumers have come to expect. For example, a consumer may browse products online but prefer to make their purchase in-store. By integrating the online and offline channels, retailers can provide a seamless experience for consumers, allowing them to complete their purchase in the most convenient way.

Even brands that built their business models on in-store experiences realized the need to embrace digital in recent years. For Build-A-Bear—which itself was viewed as a category disruptor when it emerged 25 years ago—the pandemic upended its entire concept. "As a brand known for providing in-person, one-on-one experiences, establishing a meaningful and growing e-commerce channel required a complete strategic shift by Build-A-Bear, and diversification into digital was necessary to prosper through the disruptive macroeconomic environment," the company said. It's been implementing a plan to turn its business into a "multi-channel, diversified, site-based entertainment and experience company."

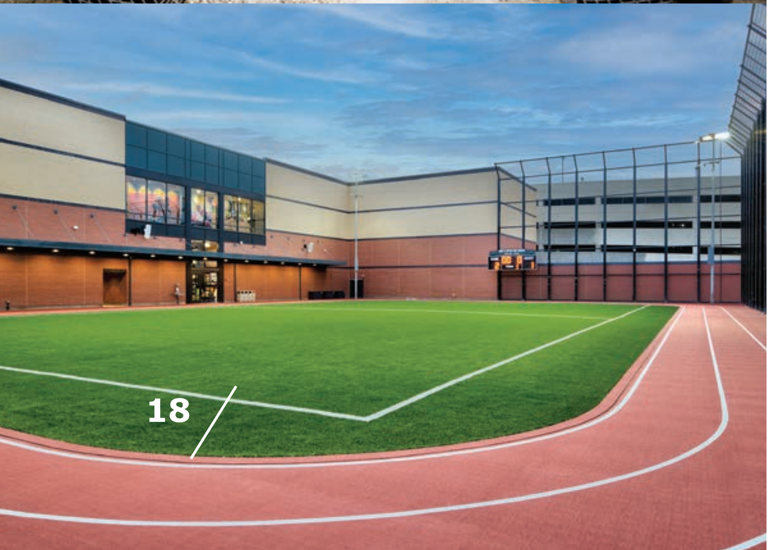
As malls have weakened, Build-a-Bear started building workshops in tourist and destination locations—particularly family-centric ones like amusement parks, cruise ships and resorts where its customers will want to create memories. These locations now account for over a third of its workshops.

The company is also working to expand and diversify into digital channels by taking initiatives to drive e-commerce demand and updating its mobile offerings with a revamped website, digital collectibles and an online Build- A-Bear Tycoon game on Roblox. Further, the addition of capabilities like BOPIS, ship-from- store and same-day delivery with Shipt have been instrumental in efficiently supporting its growth in digital demand, which was up 180% for the first half of 2022 compared to the same period in 2019.

Virtually every retailer has stepped its game up with the consumer experience, e-commerce and most importantly the ease of BOPIS and curbside pickup. Many have their own proprietary mobile apps and loyalty programs. What's more, retailers can use data derived from both online and offline channels to gain insights into consumer behavior, which can be used to improve the overall shopping experience by providing features like personalized recommendations.

Growth-minded retailers are even using the information gained from customer interactions to make broader business decisions, including whether, how and where to launch new products or concepts. The key to success is knowing how to use all this information. Retailers need to be able to "connect the dots" between online and offline interactions, as well as data from other sources such as loyalty programs, transaction histories and purchase frequency. This allows them to create a more accurate picture of their customers, and thus offer them better experiences.

Lululemon opened its largest truly experiential store in 2019 in Chicago's upscale Lincoln Park neighborhood. The two-level, 20,000-plus-square-foot location offers three exercise studios that offer up to 10 classes a day, locker rooms with showers, a restaurant, and dedicated space to spotlight local businesses and events.



IN-PERSON SHOPPERS FAVOR LOCAL, INTERACTIVE OPTIONS

It sounds counter-intuitive given the efforts put into avoiding human contact in recent years, but post-pandemic trends indicate that consumers prefer shopping closer to home, as well as opportunities to socialize. Some may have been driven to this decision by the sight of empty storefronts as neighborhood mom-and-pops were forced to close shop. For others, perhaps the massive supply shortages pushed them toward smaller, local retailers that have better control over their inventory. Either way, it's given sort of a reality check to the public of the importance of local business to the fabric of their communities, local economies and tax base.

With national chains reporting increases in brick-and-mortar comp store sales, there's no telling how long consumers' proclivity for supporting small business will last. If new retail business is any indication, demand remains for original concepts. In 2021, the growth rate for "emerging" brands exceeded retail's average four-year CAGR by more than 50%.

A major benefit for the timing of these new businesses is that they were forced to embrace multi-channel options from the get-go. Many digitally native and direct-to-consumer brands offer online sales in specific markets to test and determine where to place physical locations. The number of digitally native brands offering in-person shopping is steadily increasing as these businesses recognize that both a digital and physical presence are requirements for growth and brand awareness.

Some of the stronger big-box retailers are working on improving the in-store experience by adding promotions and in-store events to differentiate themselves, and incorporating emerging brands within in- store pop-up-shops. Piggybacking off the popularity of "retailtainment" concepts like axe throwing, indoor golf, bounce zones and the like, retailers are also working harder to create more interesting, experiential store environments.

Among the new ventures Dick's Sporting Goods has launched in recent years is House of Sport, focused on "multi-sport experiences" and more community engagement. The experiential store features activities like rock-climbing walls, turf fields and track, batting cage, golf simulator and putting green.

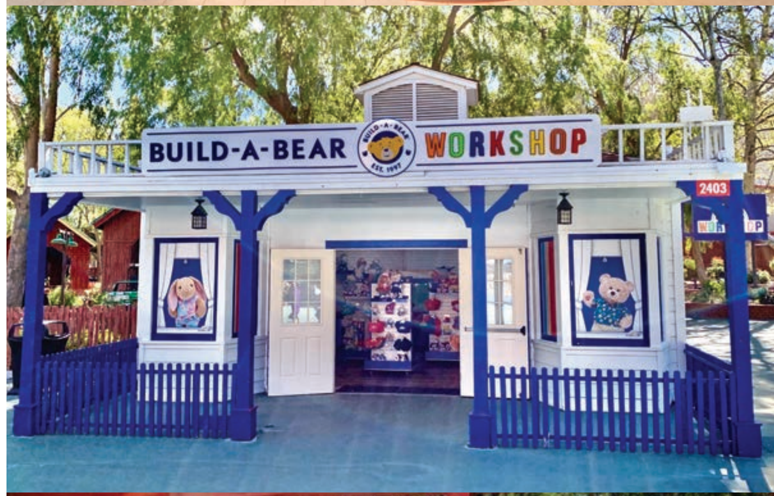
The reasoning is that these immersive, interactive atmospheres will not just lure shoppers inside stores, but will also get them to stay and engage for longer periods. After all, Build-a-Bear showed that kids might love a stuffed animal more if they had a hand in making it. Doesn't buying new cleats sound a lot more appealing when you can try them out on actual turf before leaving the store? You can do that, and squeeze in a rock-climbing session, at Dick's Sporting Goods' House of Sport. All Lululemon stores sell workout clothes, but many offer free yoga classes as well and its flagship even lets you take workout clothes for a spin while you take an in-store class. And the decision on which new mattress to buy becomes a whole lot easier when you can try it out overnight, like some shoppers were able to do during an in-store sleepover promotion by Ikea.

This goes to show that as convenient as e-commerce is, consumers are still looking for the social component of shopping. Retailers understand offering interactive, memorable brand experiences is an investment in building brand loyalty necessary for growth. According to Fundera data, 43% of customers spend more on brands to which they're loyal, and 54% will consider dropping a brand if it's not doing enough to engage customers. More telling is one of the findings of a HubSpot survey, which reported that 93% of customers will most likely come back for another purchase with a brand if their previous experience was excellent.

A CONSTANT BALANCING ACT

In a competitive, fast-paced retail environment like the current one, retailers have leaned into the omnichannel concept to create a bond with their customers. That means it's imperative that they pay as much attention to making in-person connections as they do to enhancing their online offerings. Today's consumers have come to expect convenience and choices along with an enhanced, personalized shopping experience. Retailers and related businesses that can find a balance between the human and digital touch will be the ones to succeed in the coming years. X

Build-a-Bear is implementing an strategy to become a multi-channel entertainment and experience company. In addition to branching out to non-traditional locations like amusement parks (Six Flags Magic Mountain) and resorts (Great Wolf Lodge), it expanded its digital presence with a revamped website and an online game on Roblox.



FLIGHT TO QUALITY REACHES NEW HEIGHTS

Making the most of the uncertain economic outlook and post-pandemic market weakness, retailers are fleeing to better-quality properties and stronger markets.

By Darren Pitts

Surviving in the retail sector has always been a battle between the unpredictable buying preferences of consumers and the size of their wallets pitted against a wide spectrum of retail strategies, sales pitches and neon signs. Retail brands have had their gloves off for decades proclaiming their products were better than the competition. Shoppers pondered how to get the best deal for their most coveted purchases. E-commerce supercharged the playing field, giving consumers the power to help drive retailers' expansion decisions.

Typically, when the term "flight to quality" found its way into commercial real estate conversations, it meant capital was in pursuit of higher-quality markets and better assets. In a retail context, flight to quality today tends to relate to a brands' expansion strategies. Given the turmoil and rapid market changes, retailers are keenly focused on opening and operating the best stores in a market while being cognizant of costs. Meanwhile, tenants and consumers alike are developing their own definitions of quality.

Retail remains a bifurcated story in 2023 and one in which consumers are continuing to follow their post-pandemic return to the high street. They have, howeverm become notably discerning in their search of experiential, as well as high-quality, retail therapy.

Retail sales volumes are reflecting the broader flight to quality, with modern, well-performing, well-located assets rising in favor among investors. Meanwhile, older, poorly located and technologically obsolete assets remain challenged by headwinds and likely face the real prospect of being repurposed in an effort to breathe new life into the property.

Investment in retail remains a value play in the eyes of some investors simply because the sector has weathered storms and often is overlooked today. During the pandemic, physical retail proved its place as an essential part of Americans' daily lives. Post lockdowns, e-commerce had not sent brick-and-mortar stores crumbling. In fact, sales growth at physical stores outpaced e-commerce over the past year, accounting for more than 85% of all retail sales. Now, a promising post-pandemic era is emerging in the retail sector.

The National Retail Federation's (NRF) annual forecast anticipates that retail sales will grow between 4% and 6% in 2023. In total, the organization projects that retail sales will reach between $5.13 trillion and $5.23 trillion this year.

"In just the past three years, the retail industry has experienced growth that would normally take almost a decade by pre-pandemic standards," said NRF President and CEO Matthew Shay. "While we expect growth to moderate in the year ahead, it will remain positive as retail sales stabilize to more historical levels. Retailers are prepared to serve consumers in the current environment by offering a range of products at affordable prices with great shopping experiences."

In-store sales outpaced e-commerce by more than **85%**

> **"In just the past three years, the retail industry has experienced growth that would take almost a decade by pre-pandemic standards."**
>
> Matthew Shay,
> *National Retail Federation*

The 2023 forecast compares with 7% annual growth to $4.9 trillion in 2022. The 2023 NRF forecast is above the pre-pandemic, average annual retail sales growth rate of 3.6%. Non-store and online sales, which are included in the total figure, are expected to grow between 10% and 12% year-over-year to a range of $1.41 trillion to $1.43 trillion.

While many consumers continue to utilize the conveniences offered by online shopping, much of that growth is driven by multichannel sales, where the physical store is still an important component in the fulfillment process. Brick-and-mortar stores remain the primary point of purchase for consumers.

FASHIONABLE PERFORMANCE ADVANCED PREPARATIONS

The retail sector is no stranger to change. In fact, it is accustomed to taking on new challenges just about as often as Fashion Week in NY or LA. The latest ensemble has retailers keenly focused on opening and operating the best stores in a market. Today, brands waste little time on weaker-performing stores. Strategies are now more frequently attuned to the locations that have the best projections. Retailers are also focused on fine-tuning stores that already exhibit top performance.

Retailers are also homing in on core trade areas rather than taking a riskier chance on a bleeding edge site. Whereas a retailer may have taken a flier on location in an emerging trade area, those approaches are being passed over in favor of proven locations. For one, they simply can't risk making an investment faux pas in a new store and secondly, they don't have the luxury of time to wait for a market to develop around a store. Retailers are simply flocking to quality retail locations in markets where they believe stores will benefit from high levels of co-tenancy and foot traffic.

Two retail trade areas in New York, Union Square and SoHo, reflect the ways brands are adjusting to appeal to consumers. SoHo, which squarely took on the challenges faced during the pandemic, is now on solid footing. The same could not be said of Union Square, which continues to struggle. SoHo has attracted dozens of new tenants and shoppers flock to an area that is considered a tourist destination.

Persevering through the pandemic required SoHo's luxury and mid-range brands to reinvent themselves. Retailers such as Coach, Dior, Louis Vuitton, Tiffany & Co., Forever 21 and Uniqlo undertook store redesigns. They were joined in 2021 by new tenants such as Aritzia, Valentino, and even Petco's Reddy premium lifestyle concept for dogs. In 2022, a string of new retailers came to SoHo including Armani Exchange, Athleta, Arc'teryx, Balenciaga, Eataly, Glossier, Timberland and popular athleisure brand Vuori. Even under-the-radar tenants are attracted to SoHo—as is the case with the House of Cannabis, a museum planning a 2023 opening. The shift has revealed a retail bright spot amidst chaos.

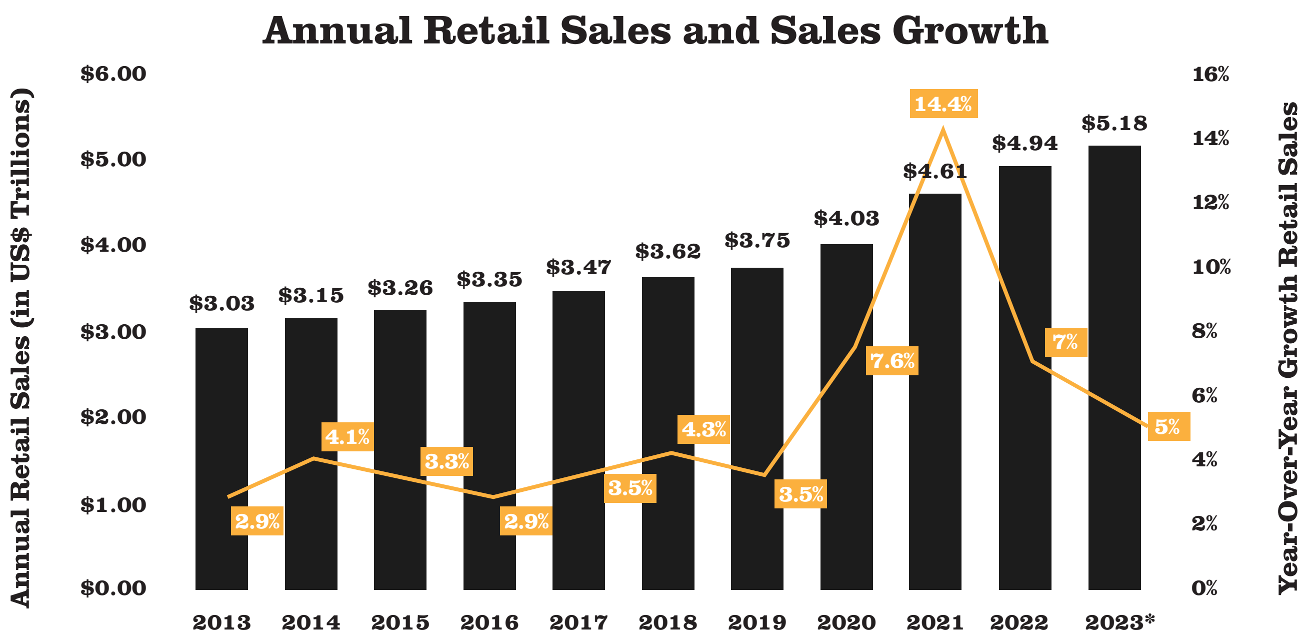
RETAIL RESET: RETRACING FOOTPRINTS

Rising costs are curtailing retailers' enthusiasm and ability to take chances in 2023, yet there are glimmers of promise through the austerity. Rising land prices are causing retailers to rethink 2023 expansion plans as they weigh the viability of opening a new store amidst new market realities, while soaring labor costs are making them reconsider operational budgets.

Among several new retail-tainment concepts popping up is The House of Cannabis, a first-of-its-kind immersive experience in New York City's SoHo. Housed in a historic, five-story cast iron building that spans over 30,000 square feet, the cultural institution offers a café and store, private lounge and gathering space for community events, live glassblowing and other features.

The volatility and uncertainty in the market are leading several retailers to quickly adjust their expansion plans, as well as their existing footprints. Walmart Inc. said it would close four of its eight Chicago stores this spring, largely due to performance issues and theft. They're the latest in a wave of urban-area closures Walmart plans involving 19 stores in 11 states. Walmart hopes a smaller footprint will help drive demand for its remaining locations.

A cloudy economic forecast is making the future less clear for retailers. Many, if not all,



*Preliminary as of March 15, 2023

Source: National Retail Federation 2023 Outlook

retailers have pared back or reconsidered expansion plans for 2023. More often their growth strategies focus on what they consider their core markets. But that doesn't mean they aren't exploring their options.

In fact, not all brands are pulling back. Up to 30% of retailers today are moving ahead with their expansion plans. Flight to quality for this segment is likely to encompass close-in core locations as retailers acutely focus on sites that are perceived as safer simply because they have already proven their performance. Instead of waiting for an emerging market to mature or grow into a top performer, they're favoring established locations with built-in customer bases.

CUSTOMERS SEEK QUALITY, TOO

The shopper perspective is another aspect to consider in the flight to quality trend. Consumers spending reflects this shift as shoppers seek out their own versions of quality. They're making choices with their wallets from a cost standpoint, whether that be for goods or services. This is creating an environment where inefficiencies are being squeezed out of the system, and retailers are competing more fiercely with online options or warehouse grocery options like Costco.

This commoditization of purchases reflects consumers' quest to find options that match their view of quality. A way this may play out today is a shopper choosing to buy garbage bags online or at a warehouse retailer since they are more acutely focused on price. But if they are hosting a party, the same consumer may buy products that more closely reflect the quality level they wish to present to guests.

Today's retail environment may still be best characterized by the words of Peter Drucker, an influential business visionary. He asserted the purpose of a business is to create a customer, but achieving that goal requires a true understanding of what "value" is to a customer. Retailers that discover what the customer defines as value and focus their efforts on building relationships with their customers today, will likely appeal to a growing consumer sentiment toward a flight to quality. And that may well prove to be the best retail survival strategy. *X*

RETA.I.L INTELLIGENCE

Retailers that embrace AI tools can unlock the vast potential in their physical locations while driving cross-channel growth.

Artificial intelligence has long been a topic topic in business and other circles. Seeking Alpha's Damon Judd dubbed AI as "the new IT Megatrend." PwC anticipates that AI could contribute $15.7 trillion to the global economy by 2030, with an up to 26% boost in GDP for local economies by the same time. This, in turn, prompted the Bank of America Institute to announce that "we are at a defining moment…where Artificial Intelligence is moving toward mass adoption."

Can the power of AI be harnessed to help drive consumers and their shopping behaviors? The answer is: Yes. The additional answer? AI is already driving consumer shopping behaviors by providing in-depth information to retailers. This might bring to mind blank-faced people following the will of their shopping machine overlord and master. But the truth is less science fiction and more fact.

WHAT EXACTLY IS AI?

Artificial intelligence is a technology that's generated both excitement and concern, but it's important to strip down the hype to the basics. According to IBM, AI involves the use of computers and data to assist in decision-making and problem-solving. BofA takes this one step further, pointing out that AI leverages large data sets and uses algorithms to improve predictive decision-making while potentially driving better business outcomes. Why and how it handles and processes the data depends on specific prompts programmed by humans, but basically, it's AI's job to do the work. It's also important to remember that while AI is a tool that relies on data to learn and make predictions, the quality and quantity of the data it is fed are crucial to its effectiveness.

"The idea behind AI is to process vast amounts of data very quickly so they provide benefit," said Ethan Chernofsky, senior vice president with location analytics platform Placer.ai. "There's a lot of reasons to talk about it, in terms of better data processing and better identifying anomalies and security systems."

Chernofsky went on to say that, when it comes to organizing and processing, AI isn't as front-and-center or "out there" as articles would have us believe. "It's a technology that happens mainly in the background, which makes everything we do much more effective."

Jyotika Singh, Director of Data Science with tech-enabled hospitality platform Placemakr agreed with this assessment. "Machines today are able to analyze much more data than humans can process," she added. "This creates insights at a large scale and personalization at a much more granular level."

And personalization, countless studies have found, goes a long way. Brands that create personalized experiences by integrating advanced digital technologies and proprietary data for customers are seeing revenue increase by 6% to 10%, according to Boston Consulting Group. Retail brands are using customer data like search and purchase history, engagement, sales data and other information to provide personalized product recommendations and promotional offers to consumers.

Personalization is helping consumers find products that match their preferences and increase engagement and the likelihood of a purchase. Many brands are also offering virtual try-on features for products, thereby reducing the costs and resources it takes for product returns and disappointment. Snapchat parent company Snap's AR Enterprise Services (ARES) allows retailers to integrate its technology into their own apps, websites and physical locations. Brands that have partnered with ARES include Cartier, Prada and Nike, which used Snapchat's AR Mirror at its Williamsburg, Brooklyn store for customers to virtually try on products and unlock discounts.

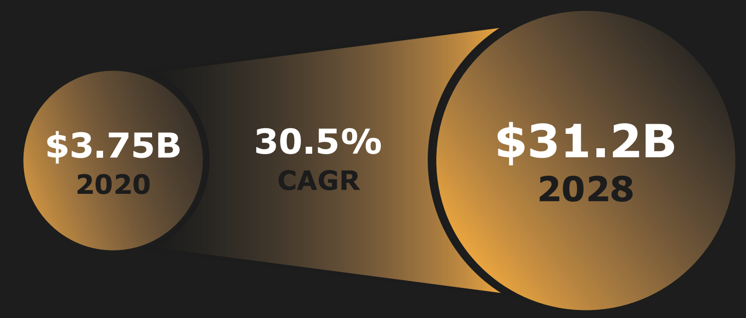
Further, AI components like Machine Learning and Natural Language Processing enhance the quality of interactive chatbots, which learn to speak and respond like a human in real time—all while collecting valuable customer data.

IT'S NOT A NOVEL CONCEPT

Though artificial intelligence is lately being touted as "The Next Great Thing," it's been with us for a while. AI got its start in the 1950s, and made its way into retail a couple decades later. "In the 1970s, retailers began using bar codes, a technology that utilizes optical character recognition, or OCR," Singh said. "It's a type of AI that's used to recognize those bar codes."

With the rise of e-commerce, AI turned to enhancing the experience of online shoppers, which it continues to do today. The push notification from shopping app Zulily alerting you about a sale on a specific item you've been watching? AI. The pop-ups on Amazon.com that encourage you to "keep shopping" or "buy again" whenever you log on? Again, AI.

Examined from this standpoint, AI collects your shopping data, which the retailers spit back to you. "Most people these days own smart phones," said Bryan Cornelius, principal with the commercial real estate firm RetailUnion Partners. "And most people shop on those smart phones. By extension, those smart phones collect that data, and then retailers turn around and use it for recommendations."



The global market size of retail-related AI is expected to grow from **$3.75** billion to **$31.2** billion between in 2020 and 2028, at a CAGR of **30.5%** during that period.

Jehan Hamedi, founder and CEO of visual analytics company Vizit, said that AI has been very useful for online shopping. But there's a disconnect between e-commerce and the in-store experience. "Right now, AI application is restricted to elements driving online customer loyalty and reducing cart abandonment," he said. "These are worthwhile endeavors, but only scratch the capabilities of modern AI."

On the other hand, Singh suggested some connections are starting to occur between online and brick-and-mortar activity. AI influences online marketing, she said, in the form of targeted ads on social media and even influencer brand recommendations on Instagram. "This transfers to in-store purchases," she explained. "AI utilizes consumer browsing data to shape shopping decisions, both online and offline."

DRIVING CONSUMER BEHAVIOR

Unlike cynical depictions, AI doesn't convert consumers into programmable automatons. It merely provides consumer shopping data to retailers that then make decisions on strategies to help drive consumer purchases and engagement. It all operates on a predictive model, and such data is only effective if it's repetitive. "That data attempts to figure out your shopping patterns and where you're most likely to shop," Cornelius elaborated.

Essentially, noted Chernofsky, "AI empowers digital assets to engage with us in a more personal way." This can take many forms. For example, there is in-store computer vision for digital signage. With help from artificial intelligence applications, this type of point-of-sale digital signage helps detect people's faces, their behavior and their demographics.

"This type of signage collects data beyond what can be captured through a traditional POS system," said Ryan Weller, Principal and Studio Director at Nadel Architecture and Planning. "It captures what types of customers are shopping, when and what they're shopping for. This provides deeper insights into shoppers that retailers can use to tailor experiences specific to their customers."

The proper use of AI can also help retailers determine the right geographic location to best serve an audience. "Data coming out of AI can tell the retailer where a customer is based, where they live, and how many customers are likely to be in a certain trade area," Cornelius said.

He explained that this is especially helpful for e-commerce companies thinking about brick-and-mortar set-ups. "You already understand who your best customers are, where to ship the product, and where the highest concentration of customers might be," Cornelius said.

And once that location is determined, AI is helpful when it comes to the store design itself. For instance, customer purchase data can impact shelving decisions "that increase the likelihood of additional product purchases," Singh said. "Earlier, these processes were done manually, and thus only had an influence at a low scale."

One example she used was Target's placement of $5 items near its store entrance, a decision based on consumer behavior information. "Even if customers don't need those items, they're encouraged to explore them, and often end up buying a few, due to the low-price appeal," Singh explained. "Enhancing the visibility of products significantly impacts their purchase numbers, and layout decisions are analyzed using AI to understand customer purchase behavior."

Since launching a decade ago, Lowe's Innovation Labs has unveiled several concepts, such as the Lowebot. The NAVii robot roams the store and answers customer questions, helps find products and continuously scans shelves to monitor inventory. A newer test product is Lowe's Digital Twin, which fuses spatial with other proprietary data into a virtual replica of the store that can be accessed on a range of devices. The ability to interact with a store's digital data gives associates "superpowers" to optimize operations and plans.

AI can also be helpful when it comes to telling shoppers what products are available at a certain location remotely via email or texts. "Machine-learning algorithms can be used to identify what products are popular in specific locations, and then inventory tools can alert consumers that their favorite items are available," Hamedi said.

Meanwhile, location services can direct coupons to consumers via email or push notifications on sales or discounts while they are in the store. "Artificial intelligence can make shopping much easier," he explained, "whether it's through product recommendations, faster in-store checkout, or providing multiple customer service options for returns and exchanges."

As such, "retailers are able to strategically develop stores to cater to their target customer," Weller said. "This results in a better customer experience and increased sales."

EYEING THE FUTURE

Despite all the hype surrounding it, AI is simply another tool to help provide consumers with a better shopping experience. "This helps build a stronger, more consistent customer relationship," Cornelius pointed out.

In other words, AI won't step in and start making decisions for consumers without their knowledge or will. "We have a tendency to view AI as if it knows our thoughts and therefore, we will predict what it's going to do next," said Placer.ai's Chernofsky. Right now, AI involves improving the experience for the shopper by providing data to the retailers. "They're the ones who are trying to build things to improve the shopper experience," Chernofsky said. "That won't change."

If forecasts are any indication, that's a good assumption. According to Fortune Business Insights, the global market size of retail-related AI is expected to grow from $3.75 billion in 2020 to $31.2 billion in 2028, at a CAGR of 30.5% during that period. Further, research firm Fact. MR estimated that the global retail AI market will reach a valuation of $85 billion by 2033, representing a 30.3% CAGR over the next decade.

As such, the future of AI is that it will keep doing what it's doing now—but better. "Again, we're talking about handling massive amounts of information really quickly to enable better processes," Chernofsky explained. The data can be used to find efficiencies for everything from protecting credit card information to determining the next

Shoppers at Sephora (top) can use the brand's app or in-store kiosks to find their best matches and virtually try on products. Taking customer data one step further, Uniqlo's UMood kiosks use neurotransmitters to measure customers' reactions to various images, and then recommends products based on the viewers' feelings.

store location. It has also enabled retailers to offer customers "a more personalized experience, both online and inside the store."

In fact, companies worried about the upfront costs associated with implementing AI tools should be comforted by the potential value it can unleash. Analysts at Accenture discovered that the use of AI has the potential to boost profitability by an average of 38% across major industries by 2035, leading to a $14-trillion economic boost in 12 countries.

The firm measured forecasted gross value-added (GVA) growth—considered an approximation of an industry's contribution toward overall GDP—for a variety of global industries, with and without AI integration. In terms of industries that would see the most benefit, retail rounded out the top three, after manufacturing and professional services. Widespread AI adoption within the retail and wholesale industries could result in 59% more GVA growth by 2035, adding another $2.23 trillion to the $6.18-trillion estimated baseline.

Delving into specifics, Weller said this could generate useful data for formulating front-of-store and back-of-store square-foot allocations. This could spill over into other metrics. Specifically, determining the right number of fitting rooms for an apparel store. Figuring out lighting levels during specific times of day. This could also encompass determining how much in-store branding would be effective and where it would be placed. "AI could even dictate the exact number of employees that would be necessary for each shift," Weller said.

And while retailers are already using occupancy sensors—like the aforementioned digital signage—to identify highly populated and trafficked areas of stores, Vizit's Hamedi said this could go one step further. "Feeding that data into advanced systems could reveal how to strategically place products to spread out traffic in a location," he said. "This could also help determine what products make for great endcaps and other information."

To put it into perspective, AI takes shopper data and uses algorithms to find behavior patterns to make predictions. There's little to suggest that "driving consumer behavior" is anything more than using past experience to determine future retail strategies.

Still, as AI improves, it will likely help retailers better meet the needs of their shoppers. Said Weller: "It will be interesting to see how AI processes information and informs store layouts, square footages dedicated to certain products, and geographical location selection."

In fact, many retailers hope to utilize AI to do exactly that, and more. McKinsey advisor John Straw proclaimed that the future of retail belongs to brands that boldly invest in cutting-edge technology without "worrying about how it affects P&L, but about how it's going to affect the value of the business to the consumer.

"The technology will just get better and better going forward," he noted, pointing out the potential for using robots in shops or holographic virtual assistants for customer service queries.

And since about 85% of retail transactions are made in person, where else will all this transformation happen if not brick-and-mortar stores? Brands that adopt and implement AI can improve customer satisfaction, realize operational efficiencies and differentiate themselves in today's crowded market. *X*

RETAIL HAD A LINE PROBLEM. GOING ONLINE HELPED FIX IT.

There is pressure on retailers to resolve the workforce shortage and speed up transactions. Technological solutions may make checkout lines a relic of the past.

By Darren Pitts

The retail transaction experience has always rested on two foundational concepts: increased efficiency and decreased friction. Customers expect convenience and a seamless journey purchasing from the businesses they choose, so personalization and knowing your customer has always been a crucial part of the buying experience.

In the age of Mom and Pops, the shopkeeper would retreat to the back stock room and pull out a sack of flour or whatever merchandise their customer was picking up. Most of the labor in getting the product into the customer's hands relied on the shopkeeper. In time, retail systems evolved, partially transferring that work to the customer, making them active participants, and—paving the way for the buyer's journey. The invention of the cash register, shopping basket, and checkout lane were game changers. Evolving efficiencies accelerated with the development of warehouse science. Satellites incorporating location intelligence utilizing indoor positioning were introduced to speed restocking and picking merchandise, and now robotics, drones, and AI are at play.

Amazon brought convenience to the forefront when it introduced Just Walk Out and Amazon One at its Amazon Fresh, Amazon Go and Whole Foods stores. The e-commerce giant has recently started to license its proprietary technology to other retailers. Ubiquitous airport convenience store Hudson News has started using Amazon's tech at an increasing number of its 1,000-plus stores nationally.

Walmart recently announced that it will have 65% of its stores fully automated by the end of the fiscal year 2026. Other retail businesses are expected to look to Walmart's example to harness technology to streamline operations and cut costs. Walmart, which operates more than 5,000 U.S. stores, has a long history of focusing on and developing inventory-control technology because it understood that this was the key to efficiency. During COVID, Walmart spent a lot of effort and resources improving its online commerce to compete with Amazon. To a large extent, it's succeeded; the company is now pivoting to physical store efficiencies to increase profits and enhance its larger omnichannel strategy.

After a 10-year pause in building new stores and construction, retailers are focusing again on expansion—both physically and on digital platforms. Several large brands are purchasing or developing proprietary technology they can monetize by licensing the software to other retailers. As retailers invest in technology, they must ensure that the solutions they choose are scalable and can adapt to changing needs and expectations. If not, they risk frustrating and alienating the customer.

Every retailer's challenge is friction and providing seamless touchpoints throughout the transaction. Research has shown that friction makes the average business lose about 10% to 30% of its customers annually. A study from NewStore found that physical retail locations lose nearly $40 billion in potential sales each year from customers who don't want to wait for more than a few minutes in a checkout line. Despite this, only 16% of brands have rolled out a way to shore up those potential dollars with mobile checkout.

Reducing friction can save brands from losing their best customers and maintain a competitive edge. The pandemic changed how Americans consumed, and there are now multiple touchpoints in the retail experience. Business Insider Intelligence reports that 68% of consumers use BOPIS and curbside pickup. Online shopping is standard practice and most customers report using multiple channels throughout the shopping experience, and three-quarters check online for price comparison before they enter the store. Offering your customer a great experience from that first touchpoint to the final purchase and delivery increases the chance that they will become loyal customers.

The ability to provide a flawless omnichannel experience is the next step in the progression of efficiency and the new benchmark in retail. Amazon began as a bookseller

In a move that was well received by the public, American Express opened a checkout-free store in the Barclays Center arena in Brooklyn, exclusive to Amex cardholders. Integrated technology allows event attendees to buy concessions and merchandise faster, with visits averaging two minutes versus 15 minutes at a typical outlet.

that catered to customers who wanted their books directly delivered to their reading chairs. Amazon's understanding of that customer cost Barnes & Noble tremendous market share and put Border's Books out of business. Now Amazon offers consumers almost anything they want—and Amazon Prime can deliver it in hours.

Amazon succeeded because it knew its customer and could offer them convenience, safety and speed of delivery. Customers price-shopped online from the comfort of their homes versus driving to several stores to find the desired item. Their back-end efficiency built their success and business.

There is pressure for retailers to resolve the workforce shortage and speed up transactions, and technology can provide a solution to reduce pain points and drive customer engagement. Kiosks, Walk Out technology, touchless QR codes, and endless aisles, also known as click and collect, make the shopping experience smoother.

In-store kiosks enable customers to build virtual carts and add products that are out of stock in a store that can then be delivered to their homes or picked up in the store. The result is an engaged and satisfied customer. The retailer has eliminated a pain point and avoided the customer taking its business elsewhere if an item is unavailable in their correct size on the sales floor.

Endless aisles allow retailers to extend their products and services online without relying on additional inventory. The result is a more engaged customer that can browse, search, compare orders, and pay for items.

Walk out technology is an out-of-the-box, low-cost solution that retrofits a grocer's existing carts, using cameras, computer vision, and machine learning to identify when items are added or removed from the cart. Cameras are positioned at different angles to distinguish between products. Amazon's Just Walk Out and FLOW's autonomous checkout technology are licensing their proprietary knowledge to other retailers, such as Hudson Nonstop, at select major airports. This technology assists with operational efficiency because airports operate from 5:00 am to midnight, requiring two or three shifts of employees. Walk out technology is a time and staff saver, and we will see more adoption in stores requiring a time-efficient, low-service experience.

Resolving a customer's concern is the most crucial factor. The importance of the retail transaction isn't necessarily the store environment where the customer purchases the item but the successful completion of the sale. Retailers doing a great job fulfilling their customer's needs will be successful. Those who discount the importance of increased efficiency and providing the customer with the best buying experience will suffer the consequences in a highly competitive, evolving playing field. X

THE FUTURE OF FAST FOOD IS FRICTION FREE

Customers are eagerly embracing the efficiency and convenience of mobile apps and contactless ordering and pickup options. Innovative quick-service restaurants are reaping the rewards.

By Kyle Underwood

Driven by skyrocketing demand during the pandemic, the rise of contactless ordering for quick-service restaurants (QSRs) in the U.S. has been remarkable. Pivoting quickly to meet changing demands became vital to keeping doors open, so operational models had to be quickly adapted to keep diners and staff safe while also conducting business.

Yet even after the safety precautions were lifted, contactless or frictionless ordering didn't lose traction. Rather, consumers continued to lean into the convenience and efficiency of the concept and eventually the trend transformed into standard business practice. In response, QSRs adapted their offerings to meet this demand by implementing and leveraging technologies that allow customers to seamlessly check in, log into their loyalty program, place orders, obtain their meals and pay—all with little to no direct contact with staff or other customers in the restaurant.

The benefits to the restaurant, meanwhile, are ample. These systems allow them to collect more robust data on their customers, allowing for further personalization and a customized loyalty program. By eliminating or reducing front-of-house customer service, restaurants can also free up their employees to do more important tasks, increasing efficiency as well as speed of service. The added security features built into these technologies can also drive additional revenue by reducing potential human errors or credit card fraud.

HUMBLE BEGINNINGS

It's not the first time a trend has changed the way in which QSRs operate. When the first drive-thru was unveiled in 1947, it received little fanfare outside of Springfield, MO, where the owner of Red's Giant Hamburg thought it would help cut costs by eliminating carhop service. A year later, In-N-Out Burger opened its first drive-through in California, complete with lap mats to protect drivers' clothes.

When Jack-in-the-Box restaurants debuted with their drive-thru-only concept in 1951, the only way to place an order was through a two-way speaker. The concept of contactless ordering was so novel that customers had to be warned that a disembodied voice would be speaking to them.

Imagine how those customers would react to the myriad ways in which technology and foodservice has evolved. Yet just like drive-through has become engrained as a part of American culture, frictionless experiences are gradually becoming the norm for QSRs, and all indicators show that customers increasingly expect contactless options to order, check in, manage loyalty, receive and pay for their food.

AN INEVITABILITY ON FAST FORWARD

To be fair, technological innovations were moving restaurants in this direction before COVID-19 hit; the pandemic simply sped up the adoption timeline, and some behaviors are here to stay.

One of the biggest complaints from retailers, and especially QSRs, since the pandemic has the phenomenon of "line balking"—where would-be customers do a 180 upon seeing a long line. This remains prevalent even after social distancing rules were relaxed, thanks to labor shortages severely impacting the food industry. Compared to pre-pandemic levels, the restaurant industry is still down by a quarter-million jobs, and more than 30% of eateries have been short-staffed for two years or more. Online ordering, paired with contactless pickup or delivery, helps to alleviate long wait times while reducing labor requirements.

ONLINE FOOD ORDERING HAS GROWN

300%

FASTER THAN DINE-IN SINCE 2014.

Adding to that is consumers' increasing reliance on tech; more than 50 million smartphone owners use food delivery apps, and that number is growing significantly. Deloitte reports that 25% of customers prefer a digital or contactless

Chipotle's investments in innovation have paid off—its mobile app has more than 30 million users and its "Chipotlanes" concept, which features dedicated windows for mobile app orders, boasts an average wait time of just 12 seconds at around 570 locations. The company also unveiled a line of Chipotlane Digital Kitchens, a digital-only prototype that has no inside guest access, bur rather, a Chipotlane and walk-up window for digital order pickup. Next year, the company plans to open between 255 to 285 new restaurants, with at least 80% including a Chipotlane.

payment method to a physical one, while 43% of Millennials and Gen Z customers opt for contactless payment when dining out. More than half of all respondents—with 72% of millennial respondents—to a 2022 National Restaurant Association survey said that online ordering, takeout and delivery apps are "essential to their way of life."

It's no wonder, then, that three-quarters of restaurants are integrating technology platforms. *QSR Magazine* reports that online food ordering has grown 300% faster than dine-in since 2014, demonstrating annual growth of 15% to 20%, versus 3.7% growth for the broader restaurant industry. That growth is expected to exceed $220 billion by 2025, accounting for about 40% of all restaurant sales, per Zippia.

In addition to boosting customers' experience and operating efficiency, adopting this trend can also boost profits. A report by MadMobile found that restaurants with an online ordering system can raise their takeout profits by 30% more than those who do not. That's supported by a recent PYMNTS/Paytronix study, where 45% of consumers said the ability to order online would encourage them to spend more on food. Another 31% said the same for curbside pickup, which is now offered by most QSRs. According to eMarketer, curbside is projected to account for over $140 billion in sales in 2024, compared to $35 billion in 2019.

It's worth noting these trends don't only encompass online or mobile ordering. A Deloitte study reported that 64% of consumers prefer to order digitally on premises. Square's Future of Restaurants study reports that 66% of consumers said they prefer automation over live staff in at least one aspect of their experience at their favorite restaurants.

Many QSRs have installed self-order kiosks where customers can walk inside, browse the menu, place orders, customize meals, make payments and earn loyalty points—all without the need for staff assistance. Four out of five respondents to Square's survey agreed that kiosks, QR codes and biometric platforms inside restaurants help provide an easier experience.

A study conducted by tech company Vita Mojo, in partnership with KAM, found that QSRs are an ideal place for kiosks. Three in four diners said they are likely to use them, compared to 66% for supermarkets (also a high figure). Among the reasons: 63% prefer viewing menus in a kiosk vs menu board and 83% say it's quicker than placing an order with a person. Specifically, over 80% of Gen Z and Millennials would choose a restaurant with self-serve kiosks over one without.

RESTAURANTS' RESPONSE

Chipotle has invested significant resources into innovation in the past three years, and its mobile loyalty program now exceeds 30 million members. It quickly realized the benefits; by the end of 2022, Chipotle's digital business had surpassed $3 billion, accounting for 39% of food and beverage sales.

In addition to advancing the features of its app, the Fresh-Mex chain is focusing on expanding its Chipotlanes concept, which features dedicated windows for orders placed through its app. The 570-plus Chipotlanes that were in operation by year-end 2022 outperformed stores without one, boasting an average wait time of just 12 seconds.

Another major name embracing contactless ordering is McDonald's, which has invested heavily in technology as part of its "Accelerating the Arches" strategy, unveiled in late 2020. To transform its digital offerings across drive-through, takeaway, delivery, curbside pick-up and dine-in, the company launched a new digital growth engine. The MyMcDonald's platform provides customers with tailored offers, a new loyalty program and the ability to order, pay and receive their food through multiple channels.

McDonald's has also been investing in other forms of technology, such as self-order kiosks and digital menu boards. By the end of 2021, digital sales (via app, kiosks and delivery) exceeded $18 billion, accounting for more than 30% of systemwide sales in its top six markets and representing 60% year-over-year growth. Stateside, the MyMcDonald's app has been downloaded more than 40 million times and digital sales exceeded $2 billion in the first quarter of 2022 alone.

Most recently, McDonald's has started testing a new restaurant prototype focused entirely on digital ordering and a contactless experience. Located in Fort Worth, TX, the pilot location is about half the size of a traditional McDonald's and features a conveyor belt for picking up orders placed digitally, a shelving area for delivery couriers to pick up orders, and kiosks with screens for those who want to order to go.

Panera's "NextGen" model debuted in 2021 and offers several options for customers. In addition to the traditional line, diners can use the store's kiosk, pick up their order-ahead takeout meal, pull up for curbside delivery, or go straight to a table and use Panera's app to order a contactless dine-in meal.

Yum! Brands, which operates KFC, Taco Bell, Pizza Hut and Habit Burger Grill, is also reaping the rewards of its investment in innovation. Taco Bell's Go Mobile and KFC's Next Gen concepts include several features tailored to contactless and order-ahead dining, such as drive-through lanes dedicated to online orders, pickup shelves inside and curbside pickup. More recently, Taco Bell unveiled another concept, Defy, featuring a two-story design with a proprietary vertical lift to transport orders directly from the kitchen to customers.

Despite the return of in-person dining, YUM's digital sales surged to a record $22 billion by year-end 2021. Management attributed the gains to several factors, including increasing the percentage of its stores with delivery to 85% and the launch of KFC's U.S. e-commerce website and delivery channel, which has led to a 70% growth in the region over the year. By the start of this year, Yum! Brands' digital business hit a new high of $24 billion, double that of 2019, with both KFC and Taco Bell seeing upticks of more than 40%.

Of course, these developments are becoming the norm at QSRs as customers have come to expect the ease and convenience of low- and no-contact experiences. What's interesting now, though, is seeing the ways in which digital innovation and new concepts are paying off for these brands. Whereas these concepts once stoked worry about the death of brick-and-mortar, many QSRs are reinvesting their recent gains into growing their footprints.


Yum! Brands, which operates KFC, Taco Bell and Pizza Hut, has introduced several innovative concepts at its restaurants that include features tailored for contactless and order-ahead dining. Its latest concept, Taco Bell Defy, features a two-story design with a proprietary vertical lift to transport orders directly from the kitchen to customers. The design also offers digital check-in screens to scan mobile order customers' unique QR codes and two-way audio and video technology service for customers to talk to team members on the second floor.

Yum! Brands, for instance, anticipates opening 4,560 new locations this year, the most in its history. Chipotle, too, plans to open 255 to 285 restaurants in 2023, with over 80% including a Chipotlane. And in unveiling their Accelerating the Arches 2.0 roadmap earlier this year, McDonald's said it was adding development as a priority of its M-C-D campaign, in addition to delivery, digital and drive-through. Specifically, the company plans to open 400 new locations in the U.S. and other internationally operated markets, marking a reversal of nearly a decade of contraction—despite its size, McDonald's has consistently closed more locations than it's opened since 2014.

THE FUTURE OF FRICTIONLESS

As we've seen, contactless commerce is here to stay as restaurants not only embrace the trend, but also use it as an engine for growth and profitability. The immediate impact—new store concepts and configurations, improved apps and loyalty programs, adaptions to store layouts, biometric payment platforms, visual AI—is clear to see in most U.S. restaurants today. Now, QSRs are taking advantage of another byproduct of the trend, which is access to valuable customer insights.

As the food and beverage industry continues its digital transformation, restaurateurs need to prepare to take advantage of a tidal wave of data that these interactions create. Collecting data on consumer ordering, spending and payment patterns can help QSRs to better meet their customers' needs. It's related to the growing "Internet of Behaviors" trend, where companies seek to capture, analyze, understand and monetize the physical and digital representations of behavior, ultimately enhancing customer experience via increased personalization.

An even better advantage, however, is the opportunity to collect valuable data insights of consumers on a mass level and plan accordingly. For instance, a QSR specializing in pizza & wings can take transaction data, combine it with weather reports, sports schedules and inventory menu items to better predict and prepare for game-day sales.

The future of the restaurant space depends largely on how quickly businesses can adapt to the world's increasing reliance on technology and contactless models. It will be interesting to see how today's brands continue their innovation and stay competitive as the idea of a frictionless experience evolves. X

FAST FOOD SLIMS UP TO BULK UP

With consumers' growing focus on wellness and sustainability, restaurants are in an arms race to outfit their menus with healthier, ethically sourced alternatives.

Once upon a time, fast-food restaurants were best known for selling hamburgers, fried chicken or pizza. The food was plentiful, relatively inexpensive and served quickly. On the downside, fast food wasn't particularly healthy.

Eventually, this led to a bevy of criticisms against the quick-service restaurant (QSR) sector. The food was bad for you. The lack of nutritional value and assembly-line preparation methods translated into poor health and chronic disease. The ingredients weren't always responsibly sourced. And from an environmental perspective, the methods used to process meats, chicken and potatoes could be unsound.

In response, the QSR sector started to offer healthier or "cleaner" offerings. This means both a change in menu and, in many cases, a change in the restaurants themselves. "The healthy trend among QSRs has been going on for about two decades, with the rise of fast-casual restaurants such as Chipotle, Panera and Sweetgreen," said Boyd Rudy, Team Leader and Associate Broker with MiReloTeam

Demand for healthy fast casual alternatives has resulted in several new brands emerging on the market with ambitious expansion plans that would rival traditional QSR behemoths. Steele Brands, which operates a few healthy QSRs including Crisp & Green, has a pipeline of 250 new locations. WOWorks, which runs brands including Saladworks and Frutta Bowls, has more than 360 sites across the country. Another growing vegan concept is Veggie Grill, which operates 35 locations in California, Oregon, Washington, Illinois, Massachusetts and New York City.

Keller Williams Realty Living. "Consumers' growing awareness of nutrition and health, as well as their desire for quality, fresh ingredients and higher-end menu items, drove this trend, and continues to do so."

There have been noticeable changes at major QSR brands over the past several years. Leading fast food chains like McDonald's and Taco Bell pledged to use more natural products such as antibiotic-free meat, cage-free eggs and lower-calorie options like salads, grilled chicken and fresh vegetables.

Increased attention to health and wellness coming out of the pandemic might have given an extra lift to the healthy foods sector. In the aftermath of COVID-19, said Bryan Cornelius, principal with RetailUnion, "More people started hitting the gym; we've seen an explosion of fitness clubs in the market." This, consequently, has brought with it a general desire for healthier food choices.

Restaurants are bulking up their existing menus with healthier alternatives to provide consumers with what they want while helping to improve sales margins. "Some are adding healthier options to their existing menus, such as salads, grilled chicken sandwiches, veggie/fish burgers and sweet potato fries," said Eran Mizrahi, Co-Founder and CEO of restaurant supplier Ingredient Brothers. "Others are introducing entirely new menus focusing on options like smoothie and juice bars or vegetarian and vegan fast-food restaurants."

These offerings accomplish two things. First, they give the consumers what they want. Second, it means more health-conscious consumers might be willing to buy food from previously avoided QSRs.

Velocity Group President Dave Cheatham explained that established chains like Panera Bread and Chipotle started to source their ingredients locally, and more responsibly. "Panera, Chipotle and the other health-conscious restaurants are catering to people that really want quality food," he said.

In other words, the restaurant chain is taking responsibility for a healthy food supply chain. This appeals to customers that want better, more ethical fast-food options. "The younger generation is driving this trend," Cheatham explained. "They're the Whole Food shoppers. They care about sourcing."

Demand for these alternatives has also driven the growth of the "healthy fast casual" niche—eateries that have made the trend a part of their identity and used it to differentiate themselves from competitors. These emerging players, saw a chance to push forward with expansion plans as they sought to fill diners' growing appetite for clean eating.

Several new brands have emerged on the scene and have launched major expansion plans. Take Steele Brands, for instance, run by fitness industry veteran Steele Smiley. Operating under the notion that "people shouldn't have to choose between a quick meal and a healthy one," he opened his first Crisp & Green healthy fast-casual restaurant in Minnesota in 2016. By 2023, Smiley had grown Steele Brands to include two additional concepts—vegan eatery Stalk & Spade and Paco & Lime, a modern Mexican concept. The platform currently has a pipeline of 250 new locations, most of which will be Crisp & Green stores, in about 25 states.

Salad and Go, a self-described "emerging QSR industry disruptor committed to revolutionizing fast food," is also expanding at a rapid clip. The quick-service, drive-thru-only concept has more than 80 locations spread throughout Arizona, Texas, Oklahoma and Nevada. The company is now focused on expanding its presence nationally with the goal of having more than 125 locations by the end of this year.

Then there's WOWorks, which has been aggressively expanding its better-for-you restaurant concepts since its formation in 2020. The umbrella company oversees several brands, including Saladworks, Frutta Bowls, Garbanzo Mediterranean Freshand Zoup! Eatery, among others. Between its brands, WOWorks has more than 360 U.S. locations.

Another concept is Veggie Grill, which operates a chain of vegan fast casual eateries in 35 locations in California, Oregon, Washington, Illinois, Massachusetts and New York City. Launched in 2006, the family of brands also includes plant-based burger concept Stand-Up Burgers, vegan Mexican eatery Más Veggies Vegan Taqueria, and health-focused, Vegan Bowls for All.

Demographics and psychographics play a huge role in determining where restaurants are placed, given socioeconomic and cultural differences between various regions of the country. In addition to cost factors, the types of cuisine matter, too. "Some regions have specific preferences for certain types of healthy QSRs," explained Keller Williams' Rudy. "This might include a Mediterranean cuisine, which tends to be more popular along the West Coast and in the Southwest."

As long as the demand continues, healthier options aren't going anywhere. "Young people continue to be more conscious of their diets and food additives," explained RetailUnion's Cornelius. "They're not automatically going to go to the regular fast-food options they might have previously chosen."

Additionally, the increasing use of food delivery services—think DoorDash, Uber Eats and Grubhub—is making it easier than ever for consumers to order healthy options. This, in turn, will further drive the trend toward healthy food demand in fast-food locales.

Meanwhile, on the restaurant side, Ingredient Brothers' Mizrahi explained that ongoing consumer demand, cultural preferences—and even government regulations—will all help provide the impetus for a move toward healthier fast-food options.

Restaurants will want to meet consumer demand while attracting new customers, he said. "As more people become interested in healthy eating," Mizrahi commented, "QSRs that fail to offer healthy options risk losing market share to competitors who do." X

GYMS GET FIT WITH HVLP CONCEPTS

As post-pandemic consumers seek more bang for their collective bucks, will high-value, low-price gyms provide enough juice to fuel the segment's rebound?

By Jason Baker

The high-value, low-price (HVLP) fitness category occupies a booming industry segment, offering customers a compelling value proposition at a palatable price point. The category appeared in the 1990s when operators provided basic clubs with circuit equipment, mats, free weights, and little else beyond four walls.

The sector has evolved to become more sophisticated and competitive over time. HVLP 2.0 brands (e.g., Planet Fitness, YouFit Health Clubs, EōS Fitness) still offer inexpensive memberships—typically in the $10- to $20-per-month range with a menu of elevated features, including streaming classes, digital wellness tracking, personal training, and workout recovery.

Best-in-class operators are experiencing robust growth and giving luxury and boutique gyms a run for the money. In fact, the HVLP category is a case study of perseverance, reinvention and success.

Today's achievements in the HVLP sector weren't achieved without pain, though. The fitness industry was one of the hardest hit during the COVID-19 shutdowns. After a decade of consistent revenue growth, the fitness industry lost $29.2 billion in revenue, a decline of 58%, between March 2020 and June 2021, according to IHRSA, the Global Health & Fitness Association. In 2020 alone, the fitness industry lost $20.2 billion in revenue, down from $35 billion in 2019. Nearly half of industry employees, or 1.5 million, lost their jobs, and 17% of clubs permanently closed.

Slightly more than three years have passed since the crisis began. President Biden announced the end to COVID-19 emergency declarations at the start of 2023. Still, club owners have yet to recover to 2019 high-watermark levels. By the numbers, the number of fitness facilities in the U.S. went from 41,370 in 2019 to 31,028 by the beginning of 2022.

While the industry is not where it once was, research indicates that fitness centers' customer visits have risen by a third since 2021. Owners have shared that they are at 60% to 70% capacity. It is not unusual to head into the gym for a workout and see other members still wearing face masks occasionally as COVID variants spike—even in Texas. However, this differs from state to state. It is evident that an industry comeback is on the horizon, but its form will look different than before the pandemic shifted the landscape.

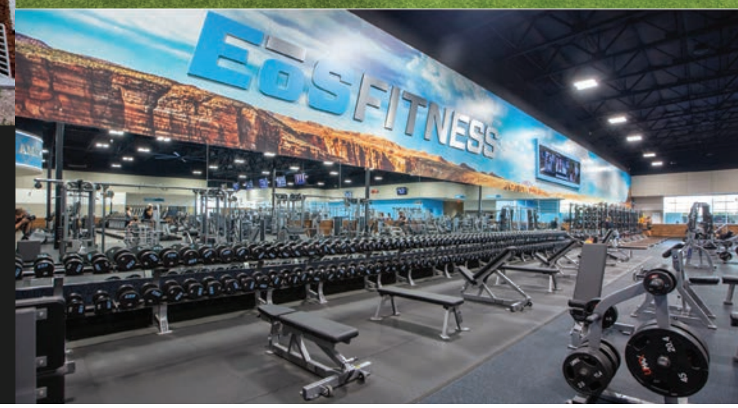
Although the past three years were profoundly traumatic and disruptive, they offered an unexpected silver lining: people focused inward to improve their health, emotional well-being, and fitness. People turned to technology and online fitness to work out, defining the phrase "alone together." While traditional gym memberships have declined, digital fitness has taken off. In 2023, more than 25% of adults report using fitness apps, a 38% jump since 2018. Members venturing back into the gym now demonstrate a commitment to wellness—not just breaking a sweat. That said, there is still an opportunity to get people moving again and back on the treadmill as a return to the office and perhaps public life continues to emerge.

PREFERENCE CHANGE

Consumers' tastes, habits, and demands have changed, and most industry insiders feel that this will permanently alter how people approach their fitness routines. After months of spinning at home and downloading on-demand workouts, customers fully adapted to high-touch tech and turned their smartphones into lifestyle devices. Their taste for flexibility and an à la carte experience has forced the industry to meet their needs.

For example, EōS Fitness, a brand Baker Katz has represented, offers a low-priced membership that includes group classes, the latest equipment, amenities, and a mobile app with a vast library of on-demand workouts. The company's locations are in Florida, California, and the Southwest, and it recently moved its headquarters to Dallas. EōS plans to open sixty new locations in Greater Houston alone in the coming year.

HVLP gyms will continue to improve support and value by integrating technology into a vertically integrated portal that gives their members access 360-degree wellness. The fitness industry is evolving and utilizing technologies to meet consumer preferences for a higher level of service, regardless of price point. Enhancing performance and focusing on workout recovery is changing the fitness experience. AR/VR and gamification are becoming part of the workout. An award-winning instructor can lead a class on the other side of the country that's simulcast in a

After months of spinning at home and downloading on-demand workouts, customers have come to expect flexibility and an à la carte fitness, forcing the industry to adjust. One rapidly growing club is EōS Fitness, which offers a low-priced membership with multiple perks including a mobile app with a vast library of on-demand workouts.

local studio. Winners in the industry will offer integrated services in their clubs, including gym-based physical therapy, sports medicine, nutrition, and other synergistic offerings.

Baker Katz' experience with EōS taught it that there is a growing expectation of cleanliness and hygiene, lighting, and other dialed-in details necessary to the customer experience. The firm sees this as a growing industry trend that will differentiate brands in this competitive middle market and narrow the gap between low-cost providers and luxury clubs. There is a customer expectation that they want more than they are getting. That is why Baker Katz believes there is room in the industry for an in-between player. HVLP fitness clubs increasingly offer features expected at a much more expensive gym at a lower price, which is a critical point.

SWEATING THE SMALL (OR BIG) STUFF

Gym closures mandated by COVID-19 impacted many fitness providers, who could not pay their rent. Commonly, landlords agreed to provide concessions in deferred or abated rent for the right to recapture space. Many landlords are committed to having some fitness experience in their shopping centers. They reasoned that this "plug-and-play" strategy could replace one gym operator with another without harming their retail center foot traffic. Baker Katz has seen this happen before, with major chains like 24 Hour Fitness closing locations and other HVLP operators stepping in to acquire the space.

HVLP tenants and shopping center owners debate the advantages of having a large club on the property. The HVLP tenant will claim they bring increased foot traffic and that shoppers benefit other tenants. The property owner may be skeptical and wonder how many gym members want to hit the stores after a sweaty workout. While they may love the higher rents these gyms pay and perhaps the foot traffic, they question whether having a big HVLP player may hurt or help long-term leases, future vacancies, and the effect on parking.

A balanced view and understanding of this evolving industry are crucial. The sector will continue flourishing and expanding as people lose their anxieties about working out in large gyms. Also true, customers will continue to integrate the physical gym at home and include outdoor experiences. Great HVLP brands and operators who stay competitive and on top of technology and trends will always find opportunities and willing customers in the fitness marketplace. *X*