Intelligent Investment

Retail sector provides strong value-add investment opportunity

VIEWPOINT

Changing fundamentals, a shifting population and stable cash flow lead the retail sector to once again catch investors' attention.

CBRE EA
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Executive Summary

- Investors should reconsider their allocations to benefit from misvalued retail.
- In recent years, retail's share of overall investment transaction activity in the U.S. dropped to an historical low of 9% in 2021.
- Retail has the highest cap rate (6.4%) among the four major sectors (office, industrial, apartment and retail).
- However, the retail sector has been recovering as evidenced by discounts to net asset value (NAV) for the decline in public REITs for shopping centers (-2.3%) and regional malls (-8.3%) by more than 40% in May 2020.
- Grocery-anchored retail properties are out-performers in the retail sector, a trend which is expected to continue.
- Sunbelt markets are expected to produce higher internal rates of return (IRRs) benefitting from continued strong market fundamentals.

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High retail cap rates are beginning to compress.

6.4%

Grocery transaction price per sq. ft. growth compared to Q1 2020.

15%

Expected rate of return over the next 10 years.

5.5%

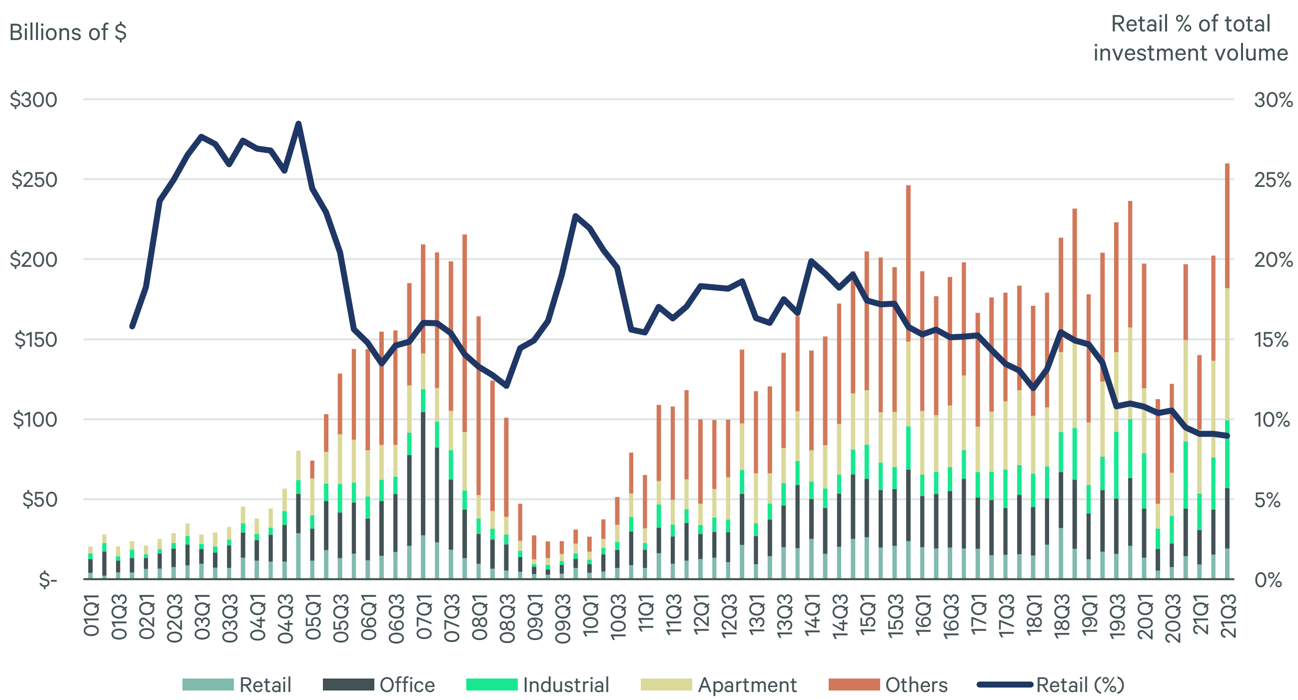
Time for Retail's Comeback?

Is it time for investors to reconsider allocations toward retail? Data from RCA (figure 1) show that historically retail has been at or above 15% of total investment volume, reaching its high in 2004 at 28%. Over the last decade retail investment has been trending lower at shares closer to 10% despite seeing historically steady investment levels. The falling retail investment percentage began prior to the pandemic while the growing share of both industrial and apartment investments accelerated during the pandemic. We outline why investors could benefit from misvalued retail over the next years.

The robust fundamentals of industrial and logistics and apartments comes largely from high demand. The large consumer demand in these sectors increases their value and investors see them as future-proof. Further, the short supply of these properties along with the attraction of many investors further raises the prices of industrial and apartment real estate. The subsequent raised prices lead to lower cap rates and the increased market share of industrial and apartment properties.

Though retail itself is an attractive sector for new investment, its potential for multi-use increases its appeal as other sectors' prices rise. Unfortunately, multi-use in the retail sector remains mysterious as data is sparse and unreliable.

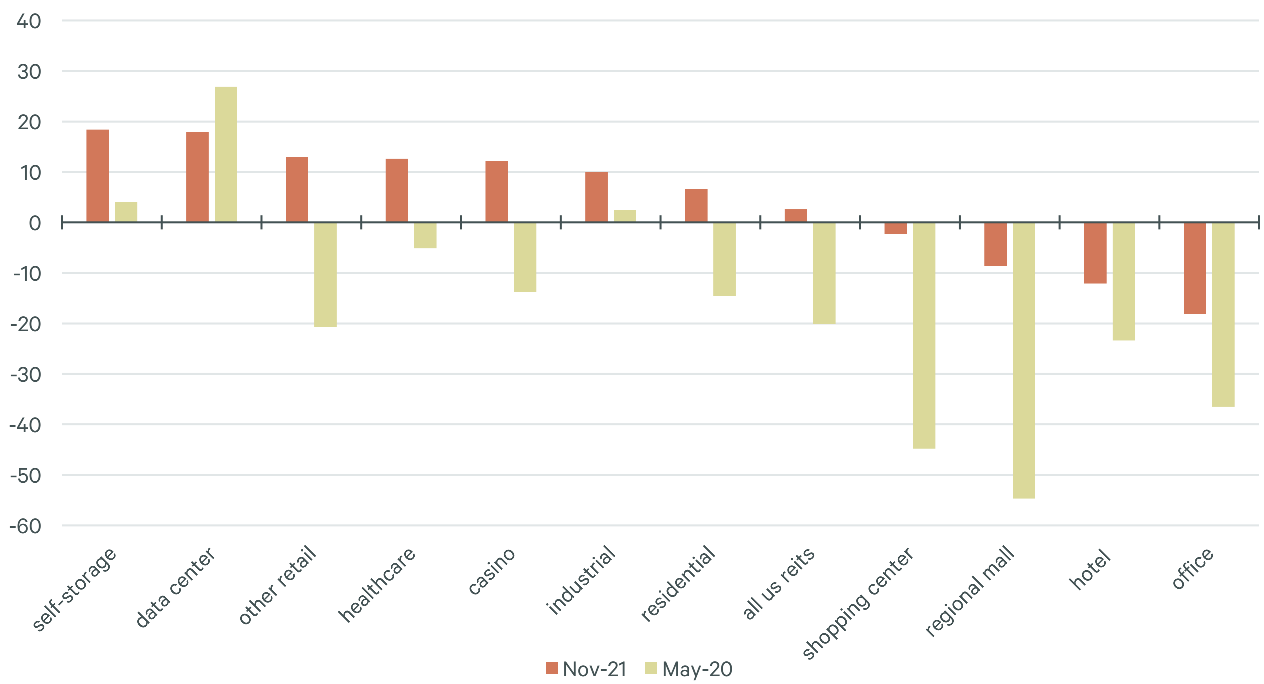
Figure 1: Billions of Total Investment Volume and Retail Share



Source: RCA, CBRE EA 2021

According to data from S&P Global Market Intelligence (figure 2), in May 2020 shopping center and regional mall REITs were valued at 40% discounts to NAV due to the havoc the pandemic wreaked upon retail and the economy in general. As of November 2021, the discount rate for shopping centers is at a mere -2.3% while regional mall discounts are at -8.3%. In comparison, the hotel (-12.1%) and office (-18.1%) sectors now have higher discounts to NAV than retail. The improvement in the discount ratio to NAV shows investors' growing confidence in the retail sector. Stock prices for major retail REITs have bounced back since early 2021. Rising stock prices reflects investors' optimistic expectation for the performance of retail properties going forward.

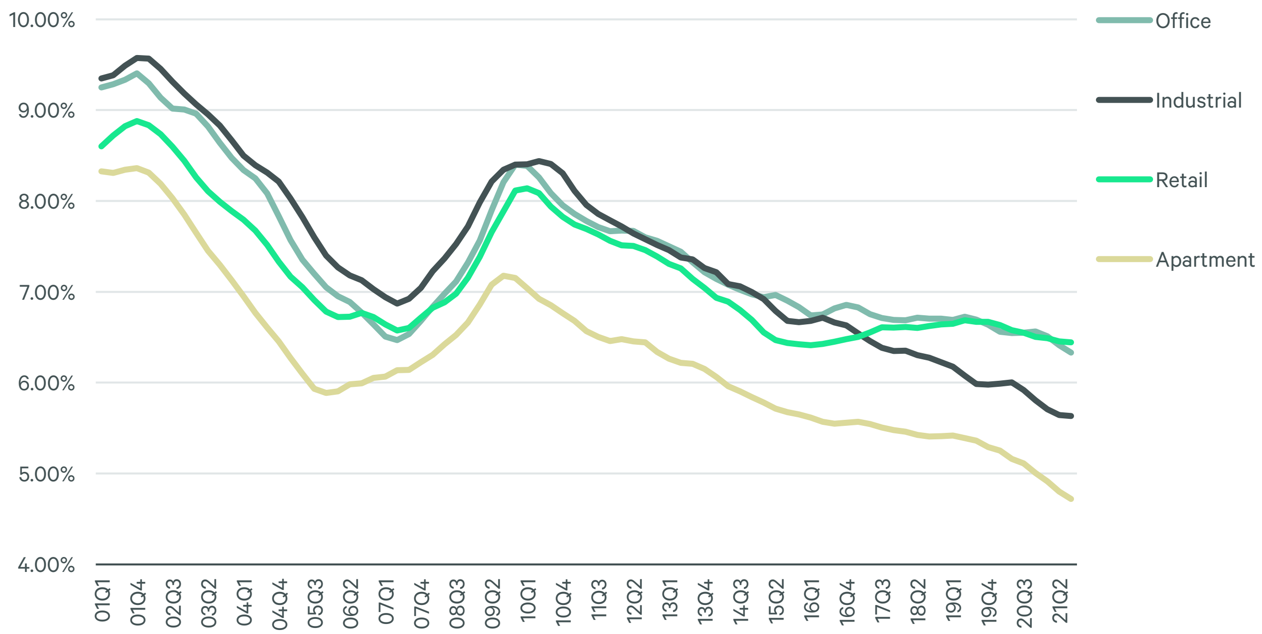
Figure 2: Medium Discount to NAV (%)



Source: S&P Global Market Intelligence, CBRE EA 2021

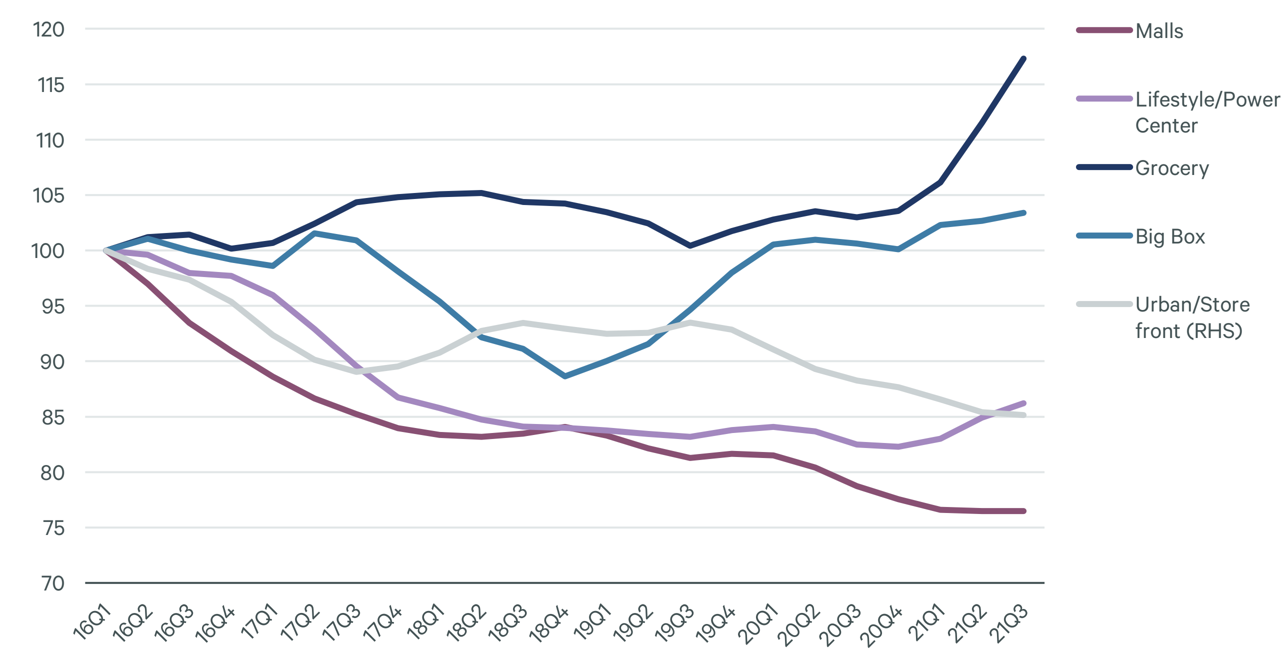
Based on RCA data (figure 3), retail cap rates are currently higher than the three other traditional property sectors, though they remain neck and neck with office. Over the last 24 months, retail cap rates have compressed slightly, driven by strong appetite for grocery-anchored properties as investors are attracted to their stable cash flow opportunity. Grocery stores create foot traffic for other in-line tenants, bolstering demand for these assets. We see this manifest through the 15% increase in transaction price per sq. ft. for grocery (figure 4), since Q1 2020. By comparison, price per sq. ft. dropped 8% for urban/store front and 6% for malls. Investors with more risk tolerance and an appetite for higher premiums will find some retail assets more attractive than others.

Figure 3: Commercial Real Estate Cap Rates



Source: RCA, CBRE EA 2021

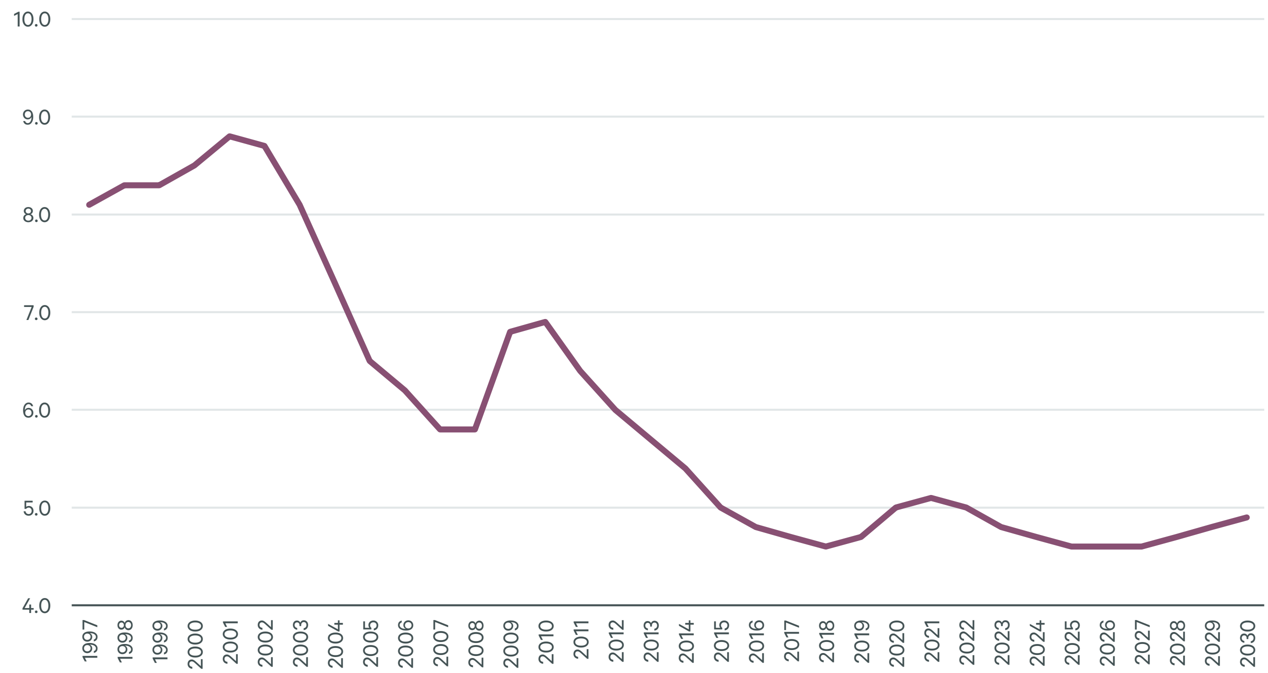
Figure 4: Transaction Price per Square Foot (Indexed to Q1 2016 = 100)



Source: RCA, CBRE EA 2021

Forecasting Neighborhood, Community, and Strip Centers Cap Rates

Figure 5: EA Cap Rate Forecasts for Neighborhood, Community, and Strip Centers



Source: CBRE EA 2021

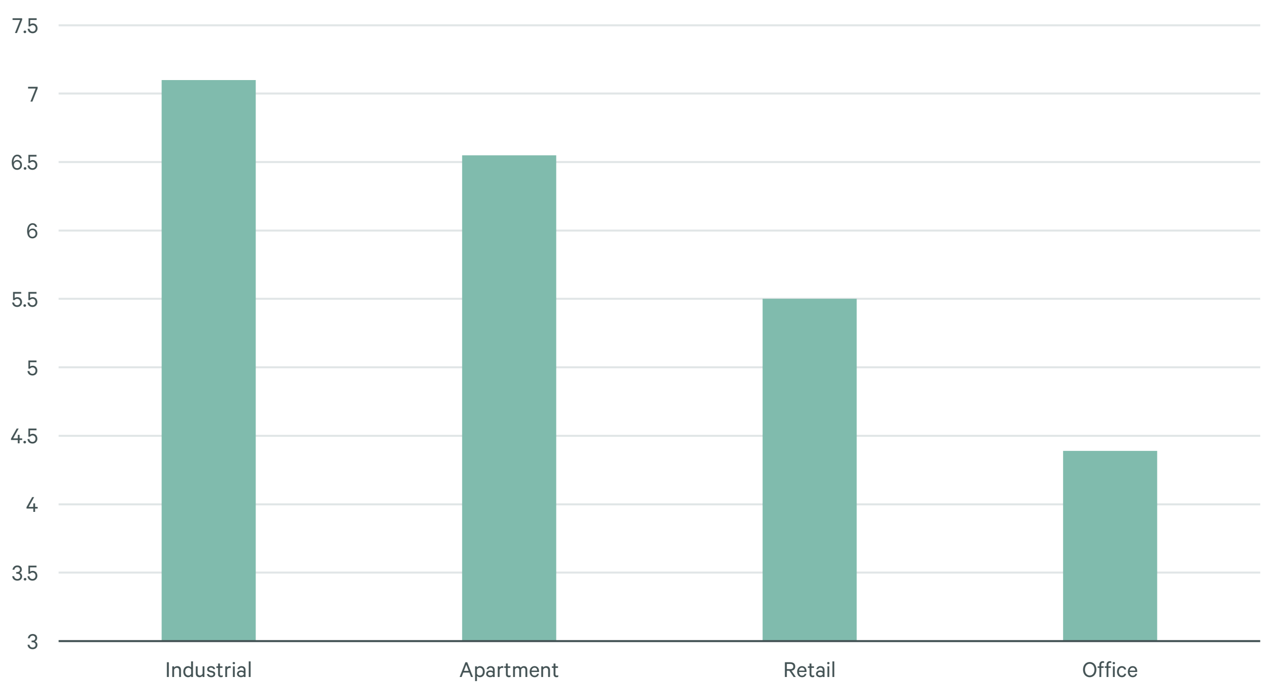
Looking at the EA cap rate forecasts for the Neighborhood, Community, and Strip Centers (NCS), in figure 5, keeping in mind many are anchored by a grocery store or a big box retailer, we expect a compression in cap rates in the next five years as demand stabilizes and rents continue to rise. As more people moved to suburban and urban adjacent core markets during the pandemic, we saw NCS centers grow. With these growing populations, we expect NCS to maintain steady performance because the presence of grocery stores will continue to generate foot traffic at these centers. In turn, this will lead to higher property values and cap rate compression.

Further, the available land at retail centers may generate mixed-use opportunities. As mentioned previously, the data on mixed-use facilities of retail are sparse, but retail typically has a larger lot-to-square-footage ratio. With the increasing productivity of retail spaces, the need for additional square footage to make retail complexes highly profitable is no longer needed and thus some portion of many centers can be repurposed into other use types. These other uses, such as mixed retail/logistics use and apartment with ground-floor retail, improve foot traffic and expose the property to new customers through the tenants and visitors.

Market Opportunities in NCS Centers

To put retail markets in perspective, we look at EA forecasts. On average across the U.S., the retail IRR is forecast to be 5.5% over the next 10 years, higher than office but more than 100 basis points (bps) lower than apartment and industrial (see figure 6). Though the NCS sector has a lower IRR than the apartment or industrial sectors, there are still attractive markets to be found. Many markets can generate returns on par with or even above average industrial returns. Many out-performing markets are Sunbelt cities with warmer weather, growing populations, and robust economies. Looking at the graph of forecasted rental growth and IRR (figure 7), we see most markets with strong rental growth also have a high IRR. Notably Atlanta, Las Vegas and Orlando have strong population growth to support higher rents and value appreciation. These markets had positive demand momentum before the pandemic, and we expect them to resume their growth trajectory after the pandemic.

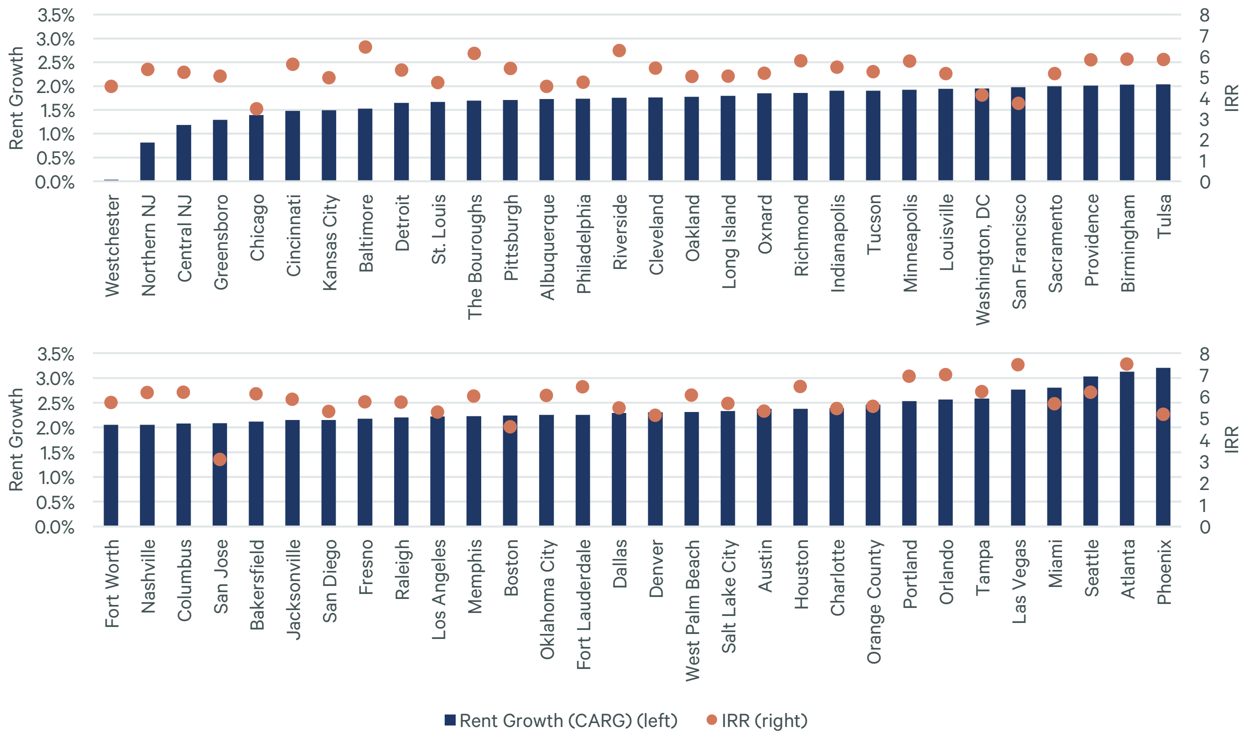
Figure 6: 10 Year (Q3 2031) IRR % by Property Type



Source: CBRE EA 2021

Notes: forecasted IRR is a national average for 10 years past Q3 2021, including cap rate forecasts and forecast of NOI. The IRR is the discount rate that makes the net present value (NPV) of all cash flows from a particular investment property equal to zero.

Figure 7: Commercial Real Estate Rent Growth and 10-year IRR



Investors should strongly consider retail as an investment strategy over the upcoming years. Investor demand is down, and attractive opportunities will be easier to identify than alternative sectors with growing buyer pools. Investor confidence is up reflected in stabilizing retail REIT pricing. Yields (cap rates) are still relatively higher and on par with office. Relatively strong future rent growth, combined with stable cap rates, will drive solid returns and value growth, particularly for well-located assets in high-growth Sunbelt markets.

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