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GROWTH OF OUTLET CENTERS IS IN FULL BLOOM

From Iowa to Michigan, the pipeline of new and expanding centers remains quite robust.

By Danielle Everson

Shoppers love a good deal, particularly when the U.S. economy is soft. That's why outlet shopping centers, which specialize in offering designer labels at affordable prices, thrived during the aftermath of the Great Recession. Developers in the Midwest capitalized on the strong consumer demand by opening new outlet centers or expanding existing ones.

But now that the economy is growing modestly and consumer confidence has ticked up, will outlet centers retain their immense popularity or will shoppers choose instead to spend more of their discretionary dollars at full-price stores?

Michael Barelli, vice president of

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New England Development is partnering with Paragon Outlet Partners to develop the 365,000-square-foot Outlets of Michigan in Romulus, Mich. The project, which is slated for completion in 2016, is targeting shoppers in Southeast Michigan and Northwest Ohio.

NET LEASE DEMAND CONTINUES UNABATED

Despite compressed cap rates, many experts believe NNN activity in 2015 could surpass 2014.

By Joe Gose

Buyers and sellers are trading net lease properties at a vigorous pace in an environment marked by an abundance of low-cost capital, lofty property values and a lack of alternative income-producing investments.

Industry professionals say that the activity simply prolongs the net lease market's banner year in 2014. Most anticipate that 2015 could even top 2014 as long as no economic, interest rate or geopolitical surprises intimidate investors. Like other bullish prognosticators, Calabasas, Calif.-based Marcus & Millichap anticipates that lower gasoline prices will allow consumers to boost retail spending, which will further enhance the appeal of retail net lease properties.

Institutional and foreign investors continue to have a strong appetite for drugstores, auto parts stores, quick-service restaurants, fitness facilities, convenience stores and other retailers. More recently, private buyers such as high-net-worth individuals and family offices have increased their net lease property acquisition activity, says Jonathan Hipp, president and CEO of Washington, D.C.-based Calkain Cos.

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FRESH COMPETITION FOR SUPERMARKETS

Growing crop of specialty stores puts added pressure on major grocery chains to adapt.

By Danielle Everson

Traditional supermarkets are being forced to adapt to a shifting grocery landscape. On one side are the growing number of "fresh format" stores like Whole Foods Market and Fresh Thyme Farmers Market that offer natural and organic items to shoppers focused on healthy eating. On the other side are giants like Walmart and Target, which leverage their size to offer a wide variety of goods while targeting price-conscious shoppers. Even drugstores, convenience stores and dollar stores are vying for consumers' grocery dollars.

"The grocery store market is extremely competitive," says Grant Mechlin, senior associate of retail and tenant representation for St. Louis-based brokerage firm the Sansone Group. "The emergence of specialty grocers has led more traditional grocers to focus on and add new elements to their stores."

Fresh Thyme announced in 2014 that it would open more than 60 new stores, 23 in the Midwest, through 2019. And Colorado-based Lucky's Market, a natural and organic grocery store chain, is also opening several new stores, including three Midwest locations in Traverse City, Mich.; Bloomington, Ind.; and

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it can't be."

Freely flowing capital certainly has allowed private investors such as 1031 exchange buyers to become more active in the market, suggests Jim Shipman, a partner and senior vice president of net lease investments for PECO Real Estate Partners in Salt Lake City.

Indeed, private investors accounted for 60 percent of net lease transactions in 2014, up substantially from 42 percent in 2013, according to the Boulder Group. Meanwhile, Marcus & Millichap predicted in its Net-Leased Outlook report for the first half 2015 that 1031 exchange buyers would dominate the net lease market in 2015.

In particular, Marcus & Millichap predicted that apartment-owning retirees would take advantage of investment demand for multifamily properties to exit the sector and plow the proceeds into retail net lease deals.

"The landscape has been changing over the last 18 months or so as more private investors have gotten involved in the net lease market," says Shipman, who has overseen some $50 million in property investments since PECO launched its Real Estate Income Fund in 2012. "Generally that's a signal that the economy is healthier because banks are back to lending to private investors at rates that only larger institutional investors could take advantage of during the down cycle."

But affordable financing and compressed cap rates are convincing some buyers to take on renewal, location or refinancing risk, says O'Shea. That's especially true of a growing number of private investors without real estate experience. They largely see net lease properties as commodities or bonds that generate stable income in the short term, but they may not be prepared for a vacancy or other setback, particularly if a tenant only has a few years remaining on the lease, he maintains.

Stan Johnson represented the individual seller and REIT buyer of a Walgreen's in Kilgore, Texas, in July 2014. The drugstore chain has leased the property for 25 years, and it has 50 one-year renewal options.

Even tenants considered virtually bulletproof can throw net lease landlords a curve. Walgreens in early April announced that it would close 200 stores — about 2 percent of its locations in the U.S., Puerto Rico and U.S. Virgin Islands — as part of a measure to cut $1.5 billion in costs by 2017.

Dedicated real estate investors typically enter transactions with long-term goals and ideas about other users in case of difficulty, notes O'Shea.

Additionally, while many private investors are squeezing out more yield by tapping five-year debt, which typically carries a lower interest rate than loans with longer terms, smarter investors continue to take out mortgages for 10 years, O'Shea explains.

"I always ask people, 'If you're buying something at a 6 percent or 6.5 percent cap rate with an interest rate in the mid-4 percent range (and a five-year term), do you think interest rates are going to go up 200 basis points over the next five years?'" he says. "Nobody really knows, but experienced practitioners say it could easily go up 200 basis points."

Private buyers also are moving up the price curve, Fritz adds. Private investors have historically showed most interest in net lease properties priced around $10 million or less, while deals of around $20 million were largely the exclusive domain of real estate investment trusts and institutional investors, he says.

But recently he marketed a $40 million property and was surprised to see an equal amount of interest from private and institutional investors.

"I would have never expected that a couple of years ago," says Fritz. "I think a lot of it is being driven by debt — more and more lenders are willing to take on risk because they have to get money out the door."

On the institutional side, investment managers also need to put a crush of capital to work, which is leading to questionable deals, warns Paul Domb, asset manager and vice president of Miami-based United Trust Fund.

He sees history repeating itself only six years after the financial meltdown and says the Federal Reserve's money printing policy and artificially low interest rates are the "only things driving this market."

"The trend is billions of dollars of other peoples' money will be placed in substandard deals because there is way more money on the sidelines earning nothing, and fee-generated institutional 'investors' with discretion need to spend that money to make themselves money," he explains. "With the supply of 'good' economic deals virtually unavailable, prudent due diligence takes a back seat."

Rate Hike Uncertainty

Volatile economic growth and the mystery surrounding whether interest rates will begin to rise this year are among primary contributors to bearish views.

U.S. GDP growth of 4.7 percent in the third quarter of 2014 and more consistent job growth over several months served a strong indication that the economy was on the verge of booming.

But fourth-quarter GDP growth of 2.2 percent coupled with estimates that first-quarter 2015 GDP will fall below 1 percent have tempered optimism.

Economists and other market analysts largely anticipate that the Federal Reserve will tighten monetary policy to push up interest rates later in the year as the economy approaches "full employment."

However, similar expectations over the last few years have gone unfulfilled.

Even if interest rates do rise, industry professionals maintain that they will have minimal influence on net lease property buying and selling so long as the rates move up in a measured manner. They also expect an eventual increase in cap rates to lag any interest rate hike by three to six months.

"While interest rates have been somewhat uncertain, cap rates have continued to compress on a year-over-year basis," says Fritz. "That speaks to demand."

Some observers also downplay worries about an overheating net lease property market. Shipman notes that net lease tenants tend to renew at a high rate at proven locations.

Kyle Matthews, an executive vice president for Colliers International in El Segundo, Calif., argues that most investors in the sector remain risk averse and are often proactive in approaching tenants to renew leases.

"There is some frothiness, but nothing like in 2007," says Matthews. "In 2007, all of the market fundamentals were screwed up — you had tenants signing leases at rents that were unsustainable based on their sales or projected sales." n

WILL CONSOLIDATION AFFECT THE NET LEASE MARKET?

Although net lease investors continue to display strong demand for most retail categories, professionals predict that they will become more reticent about investing in office supply and dollar stores in the months ahead. The proposed $6.3 billion merger between Staples and Office Depot and the shareholder-approved $8.5 billion merger between Family Dollar Stores and Dollar Tree guarantee store closures. In fact, the Federal Trade Commission is expected to require the merged dollar stores to divest themselves of around 300 locations.

Still, investors willing to navigate the uncertainty and to accept the typically lower credit ratings associated with dollar stores compared with Walgreens or CVS should see new opportunities in the dollar store category. In light of the Family Dollar and Dollar Tree deal, Dollar General in March announced plans to bolster its position in the industry by opening 730 stores in 2015. The company opened 700 stores last year.

Investment demand for dollar stores remained strong in 2014 as investors pushed up the average property sales price 5 percent to $159 per square foot, according to Marcus & Millichap. Plus, buyers already were beginning to move their attention toward dollar stores in reaction to the slowing expansion of Walgreens and CVS, says Jim Shipman, a partner and senior vice president of net lease investments for PECO Real Estate Partners.

"I think investors will look to see how this all plays out," he says. "But I still think the dollar stores will be popular. The bigger shift is that buyers are willing to take a little more risk on the credit side of a tenant."

— Joe Gose

FRESH COMPETITION FOR SUPERMARKETS

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Rock Hill, Mo.

"The consumer demand for organic and healthy foods as well as a natural and aesthetically pleasing shopping environment have pushed this industry into new store prototypes," says Jacqueline Haynes, senior vice president of DTZ in Indianapolis, who has been working in the shopping center business for 30 years.

Fresh Thyme Farmers Market's 28,000-square-foot stores offer customers an abundance of produce, including locally sourced and organic fruits and vegetables; more than 400 bins of natural and organic bulk items; small batch locally roasted premium coffee beans; a butcher shop; gluten-free and dairy-free products; and a full dairy section that sources local Midwest items.

Fresh Thyme Farmers Market's 28,000-square-foot stores offer an abundance of produce, including locally sourced and organic fruits and vegetables and more than 400 bins of natural and organic bulk items.

Some other features of the markets include Fresh Thyme Kitchen, which offers healthy prepared salads and meals as well as a full salad bar, made-to-order sandwiches and a bakery; a Hops & Grapes department with a selection of wine and local craft beers; and more than 7,000 varieties of vitamins, supplements and natural body care products.

Lucky's Market, another player in the fresh-concept niche market, recently opened its first Michigan location in February in the Burns Park neighborhood of Ann Arbor, Mich. Chefs Trish Sharon and Bo Sharon founded Lucky's Market in 2003 in Boulder, Colo.

The natural and organic grocery store, similar to Fresh Thyme, offers its customers a selection of organic, specialty and gluten-free items at its stores.

The market also features house-made deli items, in-house cured and smoked bacon, local produce, fresh meats and seafood, and a bakery. The store also includes a fresh juice bar; coffee bar; beer, wine and spirits section; salad bar; and a community room.

Phoenix, Ariz.-based Sprouts Farmers Market, another grocer attentive to offering fresh goods, is also making its way into the Midwest market. The company successfully opened 24 stores across the country in 2014, including two in Kansas and one in Missouri, according to its fourth-quarter 2014 earnings report. As of February 2015, the grocer operated a total of 198 stores.

The Kroger Co., which posted fiscal 2014 sales of $108.5 billion, continues to gradually roll out the Kroger Marketplace concept. These big-box stores span 100,000 to 125,000 square feet, twice the size of the supermarket chain's typical grocery stores. In Indiana, two of the stores are already open in Fort Wayne and two stores are planned for Indianapolis and one each in Fishers and Columbus.

The stores include a full-service grocery and pharmacy and a wide range of merchandise including electronics, toys and furniture. Other features of the store include wine tasting events, cooking classes, a jewelry store, Starbucks and a clothing department.

A Changing Market

Haynes says over the last two to five years, grocery store chains have been somewhat cyclical as they have either built ahead of residential growth or have been replacing stores whose designs are obsolete.

"Grocery-anchored centers have always been a neighborhood staple," says Haynes. "However, now we are seeing grocery stores opening in community and lifestyle centers, further enhancing tenant mix and offering more services to the consumer."

One of those lifestyle centers is Simon Property Group's Clay Terrace Mall, which is located in Carmel, Ind. The 577,000-square-foot shopping center features 80 retail stores and restaurants. Anchor tenants include Whole Foods Market, Dick's Sporting Goods and DSW.

Haynes says grocers want customers to have a more enjoyable shopping experience when they visit a shopping center. Grocery stores now offer cafés and eating areas, salad bars and fresh prepared foods for grab-and-go, says Haynes.

"They are becoming more of a lunch destination than in years past, and they are expanding other merchandise categories to include soft goods, home goods and medical services," says Haynes.

She adds this change in the shopping experience is even incorporated into the design of each of these stores. "The current trend is to create a very open concept with a lot of natural light and repurposed, sustainable architectural elements in the design," says Haynes.

One Midwestern state where the grocery business is fiercely competitive is Indiana. In addition to Kroger, Fresh Thyme Farmers Market and Giant Eagle opening stores, Meijer has new units planned and Aldi has also

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been opening locations in the region, according to Haynes.

"Some of the growth is an offensive position, or market expansion; and some growth is defensive, protecting market share of trade areas," says Haynes.

Vacancies in Chicagoland

Sansone says that while grocers such as Fresh Thyme and Lucky's Market are building new stores, other grocers are occupying stores left vacant by competitors in many cases.

In the Windy City, Safeway Inc.'s closing of its 72 Dominick's stores in Chicago in 2013 led to a return of 4.5 million square feet of space to the market, according to JLL.

Grocery chains such as Mariano's Fresh Market, Whole Foods, Jewel-Osco, Fresh Thyme and others have filled many of those formerly dark spaces, says Dan Tausk, retail tenant specialist for Mid-America Real Estate Corp. in Chicago.

"None of those boxes were split up, reused or turned into new uses. They were all very valuable and snatched up quickly," says Tausk. "It's indicative of the supply and demand dynamics of Urban Chicago's grocery market. Certainly Whole Foods, Mariano's and Jewel-Osco recognize these were unique opportunities that don't come around very often."

Mariano's, part of the Roundy's Inc. grocery chain, took over many of Safeway Inc.'s Dominick's stores in the Chicago area. Mariano's 30th store opened in February in Evergreen Park, Ill.

Catering to the shopper experience concept, the newest location features live piano music, a variety of made-to-order foods, an in-store grill, fresh-roasted coffee, handmade gelato, a smoothie and juice bar, and a full-service pharmacy.

> The lenders are aggressive and actively seeking this kind of product.
>
> *— Dan Rosenberg, Managing Director of Capital Markets, Cohen Financial*

"In large metropolitan areas such as Chicago, there are dozens of specialty grocers competing for market share," explains Nick Sansone, a principal at Sansone Group. "Markets like St. Louis, with strong, local traditional grocers, are also experiencing an aggressive influx of new specialty grocers competing for the food dollar."

As stores filled vacant grocery properties, Tausk says Fresh Thyme is one grocer that has resonated well with shoppers and continues to expand in the Chicago market.

"There was the entry of a lot of new grocers in the last two years, mainly gourmet concepts that seemed to put their toe in the water and pulled back out," says Tausk. "However, Fresh Thyme seems to be a success and is clearly making new deals."

Finance and The Future

Property and portfolio sales in the grocery-anchored retail sector totaled $2.1 billion in 2014 across the 10 Midwestern states covered by this magazine versus $1.2 billion during 2013, according to Real Capital Analytics. (The data is based on transactions $2.5 million and higher.) The increased volume has created plenty of financing opportunities for lenders.

Dan Rosenberg, partner and managing director of capital markets at Cohen Financial in Chicago, describes grocery stores as necessity-based retail, which is ideal for lenders.

Rosenberg believes the sector's resilience to the growing impact of the Internet is a major reason grocery-anchored retail is popular with lenders. While customers can buy goods such as bread and milk online, they are more likely to go a brick-and-mortar store to purchase them. Conversely, with apparel or electronics, consumers may be just as likely to buy the items online as they would in person, he adds.

"The lenders are aggressive and actively seeking this kind of product," says Rosenberg. "On the grocery side, we are doing acquisitions as well as refinancings. If the borrower wants long-term money, the financing is being done through either life insurance companies or CMBS lenders."

Rosenberg says when it comes to acquisition financing and refinancing for grocery-anchored deals, the loans typically are for a 10-year period, with a 75 percent loan-to-value ratio at a 4 percent rate.

Cohen Financial recently closed on a $9 million acquisition loan for The Shops at Flint Creek, an upscale retail shopping center located at 500 N. Hough St. in Barrington, Ill., a northwest Chicago suburb. A Heinen's grocery store anchors the property, which is fully leased. Rosenberg secured the CMBS loan with Citigroup Global Markets Inc. The borrower is a venture of Next Realty, a national owner of retail properties.

The grocery-anchored sector has rebounded well after the Great Recession, says Mechlin of the Sansone Group.

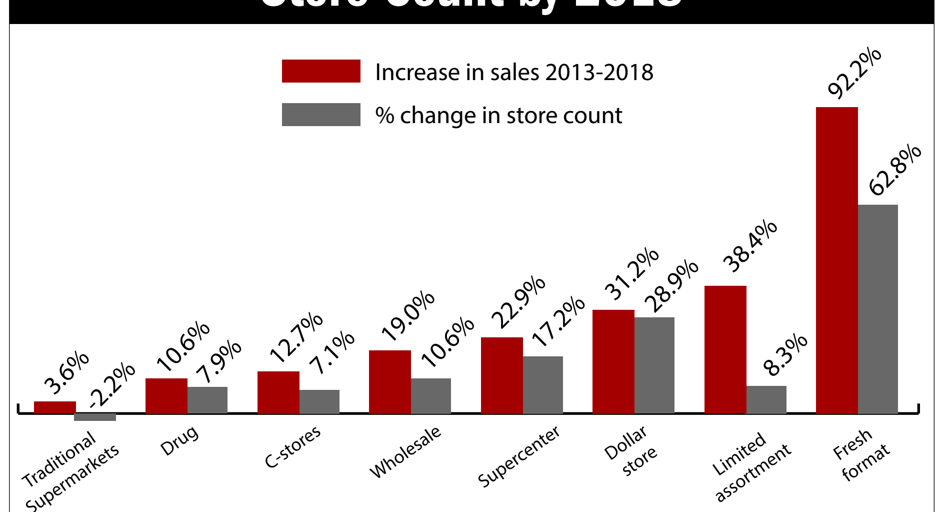
"There is significant pent-up demand in the shopping center sector and development has lagged until recently. Class A shopping centers currently have very strong occupancy levels," he says.

The vacancy rate in grocery-anchored space is lower than that of neighborhood and community centers because of the non-discretionary income associated with goods sold in grocery store, according to New York-based real estate research firm Reis.

"It seems like these types of centers and the higher-end Class A malls that cater to luxury customers (whose discretionary spending is less volatile than other sectors of the economy) are tending to outperform," says Michael Steinberg, an economic analyst with Reis.

As of fourth-quarter 2014, the vacancy rate for grocery-anchored space stood at 6.6 percent nationally compared with 10.2 percent for neighborhood and community centers, reports Reis, which tracks 77 markets. n

Fresh Format Stores to Increase Store Count by 2018



Source: JLL, Willard Bishop