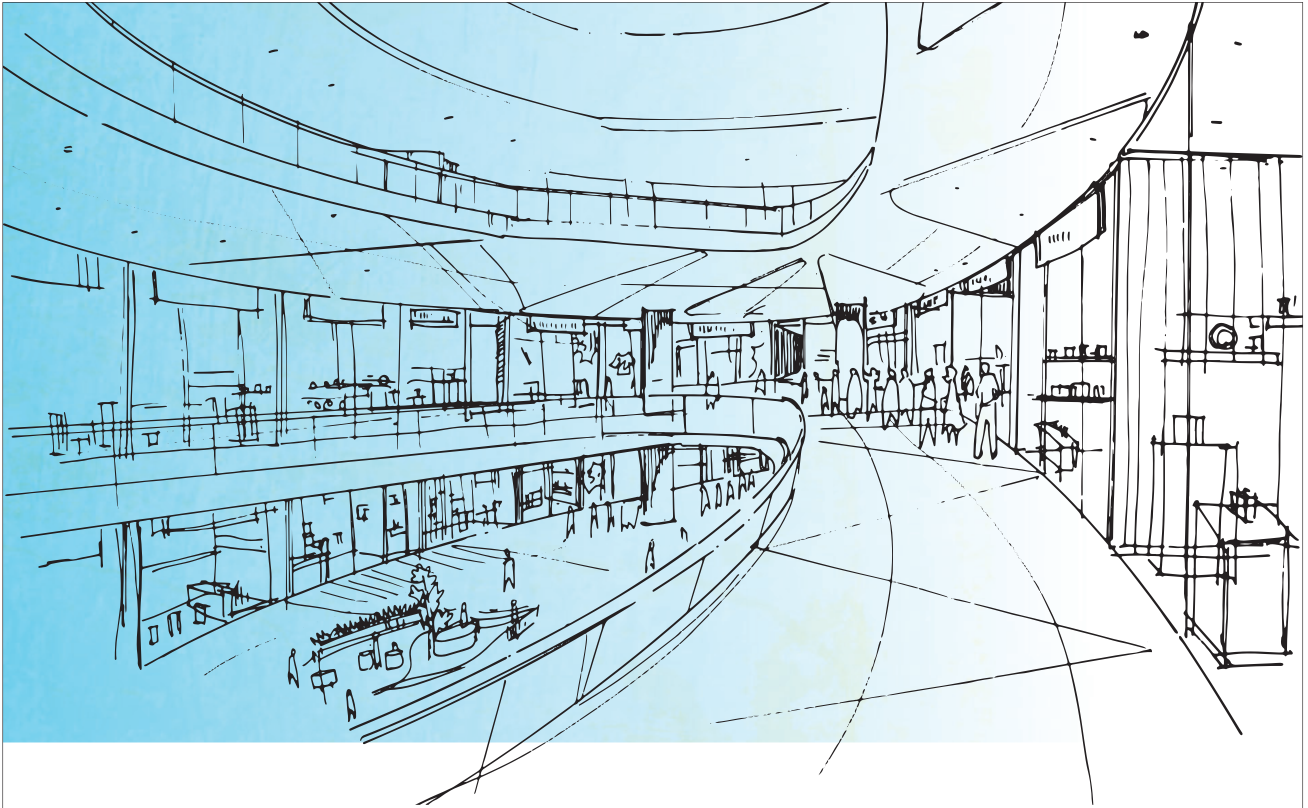
Real Estate Capital USA



Minding the shop

Subdued levels of new retail supply over the past decade means lenders have one eye on the sector – and one eye on a potential recession, Randy Plavajka writes

Commercial real estate lenders are looking more closely at originating retail loans, a significant turnaround for a sector that has long been a poster child for the impact of overbuilding and aggressive pricing. While there is a growing sense that the worst of the sector's troubles are behind it, lenders are wary of the potential impact of a near-term recession.

There are two significant metrics causing lenders to consider retail lending opportunities more seriously: supply and demand and relative pricing.

"New construction in retail has been remarkably subdued over the last decade, so vacancy rates should remain relatively low barring a severe economic recession," says James Bohnaker, senior economist at Chicago-based advisory Cushman & Wakefield. "Additionally, recent pricing increases for retail assets during 2020 and 2021 were not as aggressive as other sectors."

Price increases in the industrial and multifamily sectors translated into cap rates in the low-4 percent range. By comparison, cap rates are in the mid-5 percent range for retail. "There remains potentially more opportunity for investors to yield positive returns given the retail pricing relative to other assets," Bohnaker says.

Shopping centers are presenting a particularly interesting opportunity as vacancies dropped 20 basis points to 5.9 percent from the second to the third quarter – the lowest level since 2007. Additionally, average asking rents rose by 1.4 percent quarter over quarter to $22.77 per square foot, according to Cushman data. These metrics will allow potential investors and

© PEI Group. All rights reserved. Content on this site may not be reproduced, distributed, transmitted, displayed, published or broadcast without the prior written permission of PEI Group or in the case of third party content, the owner of that content. You may not alter or remove any trademark, copyright or other notice from copies of the content. You may download material from this site (one machine readable copy and one print copy per page) for your personal, non-commercial use only.

lenders to have a positive outlook for ongoing income growth over the next several years, Bohnaker says.

While retail is not immune to rising rates or a recession, these metrics will allow potential investors and lenders to be optimistic about ongoing income growth over the next several years, Bohnaker says.

There is a growing sense among sponsors that the sector has weathered the worst of a storm that began long before the covid-19 pandemic.

Tingting Zhang, founder and CEO at Los Angeles-based commercial real estate lender and investor TerraCotta Group, is actively looking at potential lending opportunities in the sector. Demand for brick-and-mortar retail assets has been underestimated, especially with the relatively slow pace of new stock coming online following the Global Financial Crisis, she explains.

TerraCotta's view on retail heading into any oncoming recession continues to be optimistic because of the multiple cycles the sector has gone through in the last 20 years. As a lender, Zhang believes the most favorable retail assets will be recession-proof concepts and services, including grocery stores, hair stylists and a tenant base that has outlasted previous e-commerce waves alongside pandemic volatility.

Chris Coiley, first senior vice-president and head of commercial real estate lending at Wayne, New Jersey-based Valley Bank, says retail notably does not sit at the bottom of the sector priority deck when it comes to participating in deals to keep a given lending book active.

Jason Hernandez, managing director and head of US debt at New York-based Nuveen Real Estate, notes that in today's market a significant portion of new originations are being directed toward multifamily assets and other similar, stable property types. Nuveen is also seeing viable opportunities in the retail space, particularly in needs-based portfolios.

From a lender's perspective, Hernandez says sponsor quality and general liquidity top the needs list when Nuveen is considering a new opportunity. "We want to be in larger liquid markets," he says. "If it feels like you are taking liquidity risk in retail, we don't want to compound that with business plan risk."

TerraCotta Group follows a similar strategy. "We don't lend to retail centers unless the property is in the top quartile in terms of its location score, which is a proprietary methodology we use to force-rank the subject property's location factors against the peer group in the sub-market," Zhang says.

Performance benchmarks

While the retail sector has changed substantially over the past 10 years, the way lenders evaluate potential opportunities has not.

"Retail fundamentals really haven't changed a whole lot, especially the neighborhood centers," Zhang says. "It's by and large dependent upon the consumer behaviors of the local residents, and we tend to benchmark against the retail asset performance during the Global Financial Crisis."

Greg Michaud, head of real estate finance at Atlanta-based Voya Investment Management, says one of the key metrics for assessing a viable retail lending opportunity is diving into tenant issues and seeing how much rent relief was given and then seeing how much the borrower received during periods of volatility. In situations where nothing or next to nothing was given, such assets are more likely to be stable in the future.

Michaud notes past tenant bankruptcies are another factor, particularly looking at how quickly an asset was able to re-tenant a space after losing a major tenant. As one example, Michaud says Voya is looking at one deal in Atlanta right now where a major grocery anchor is seeking a new 10-year lease with two years remaining on its current contract. Even with anticipated recessionary signals present, Voya is willing to take the risk with the brand because he knows one of its many grocery peers would take the lot if it turned over simply because it is well-located and highly trafficked.

Bohnaker says the biggest risks for retail lenders are more tied to the broader macro and interest rate environment. "Once there is more clarity on where the Fed is taking rates, that should allow for stabilization in debt markets and more clarity on market clearing prices, both of which are needed for transactions to ramp back up," he says.

One more thing to note: store openings by retailers this year are outpacing closures for the first time since 2017, he adds.

As the US moves into what is widely expected to be a period of distress, Bohnaker notes that buyer profiles also change and shift considerably during periods of market disruption. "We've seen institutional investment managers and public buyers take to the sidelines, while private buyers have grown relatively more active, attracted to yield with a long-term investment perspective – many of these buyers are able to buy either all cash or with low leverage," he says.

As retail continues to evolve, Bohnaker says the sector is becoming less about traditional anchors and more about consumer experiences ranging from fitness to social activities to unique entertainment options. Retailers have gotten smarter – and will continue to do so – about store locations and design, and consumers seem to be re-enthused about the in-person shopping experience.

At this point, the retail tenant profile is still healthy compared to previous recessions where there were waves of store closures and bankruptcies. "There are a handful of troubled retailers out there, but not enough that would warrant severe disruption in tenant demand," Bohnaker says. "This should allow the retail fundamentals to remain relatively healthy despite a period of weaker corporate earnings." ■

© PEI Group. All rights reserved. Content on this site may not be reproduced, distributed, transmitted, displayed, published or broadcast without the prior written permission of PEI Group or in the case of third party content, the owner of that content. You may not alter or remove any trademark, copyright or other notice from copies of the content. You may download material from this site (one machine readable copy and one print copy per page) for your personal, non-commercial use only.