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The Brick-and-Mortar Retail Evolution

What's Old is New

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Executive Briefing

Retail real estate may not be the current darling of the industry, but the negative rhetoric surrounding brick-and-mortar over the last few years has been too strong. Humans are social beings – they tend to enjoy vibrant atmospheres. Retail has and will continue to provide that atmosphere.

While the proliferation of e-commerce is causing upheaval, the continued desire for human interaction is prompting a new style of retail development; a style that is rooted firmly in the fundamentals of urban life.

Developers are finding that a well-organized mix of property types including housing, offices, as well as both experiential and goods retail has the ability to provide a consistent level of vibrancy and foot traffic that all involved desire. This "new" model of development is finding footing throughout the country and is not only helping to preserve brick-and-mortar retail, but is also having the effect of transforming auto-centric suburban areas into walkable communities. As land becomes increasingly scarce, this relatively high-density approach to development is likely to be a permanent fixture of our society.

In Summary

Retail real estate has hardly collapsed and is not even on life-support. Instead, the commercial real estate sector evolves much like nature. Consumer preference – how people tend to spend their time and money – will continue to change as it has for much of contemporary human history. But the common thread through these changes is that human beings are social; human beings tend to seek out vibrant spaces – spaces with other human beings. Historically, retail real estate has provided much of that space. Strolling the retail corridor of a bustling downtown, spending a rainy day shopping in an indoor mall, or joining your neighbors at the local pub to get a pint after work, have all long been considered an enjoyable part of our modern human experience. But what happens when no one else is on those streets, or in that mall or pub?

With the proliferation of e-commerce in our society, many have prognosticated the end of this necessary vibrancy, at least within a retail context. We contend this view is both naïve and shortsighted. As Kevin Fagan, et al. describes in a recent Moody's Analytics paper, The Mall of the Future, there is an emerging blueprint for maintaining vibrancy, or a critical mass within these spaces, which would ultimately lead to brick-and-mortar retail success. **Fagan concludes that a greater diversity of tenants, including tenants from other sectors (office, industrial, medical, multifamily, etc.) may now be needed, particularly for struggling regional malls. Quite interestingly, this is how many cities organically evolved prior to the automobile becoming readily available to the masses. We now use the term "mixed-use" to designate multiple real estate sectors in the same building, but if we expand that to nearby buildings, these pre-auto cities were always mixed-use. Retail was always located within a short walk of where people lived and worked. So, is the new model for retail success actually just a modern copy of pre-auto urban life?**

It turns out that many developers tend to think so, but of course, with a hint of nuance. In this follow-up paper to "The Mall of the Future", we explore recent trends in new development, and redevelopment, to determine the extent of this return to mixed-use spaces.

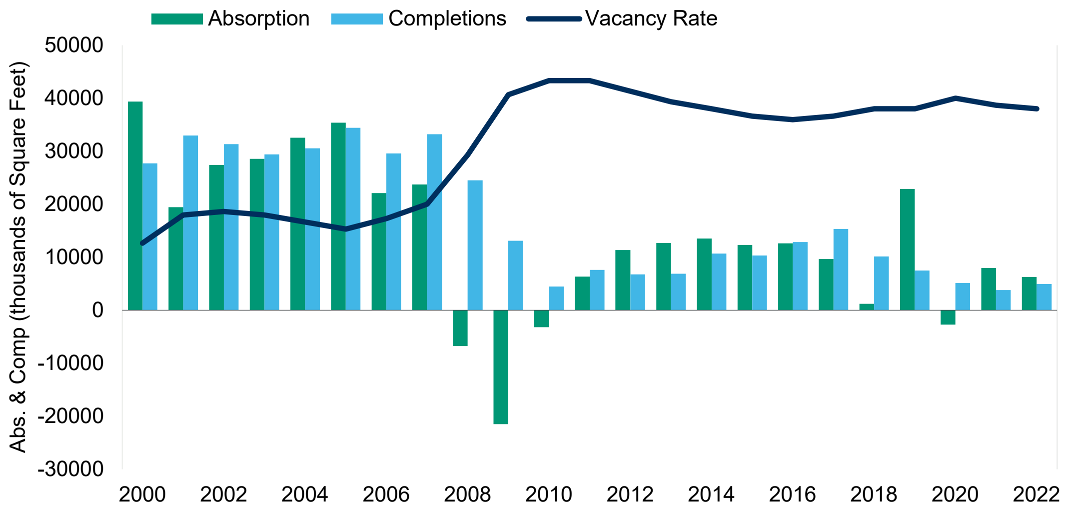
Retail Update: Performance is Weak but Steady

Recent rent and vacancy figures paint a less than stellar picture for retail, but certainly not an apocalypse. Figure 1 plots the vacancy rate and its underlying supply (completions) and demand (net absorption) drivers for neighborhood and community shopping centers. The starting data on the chart is the year 2000, which reasonably approximates the start of e-commerce becoming a significant factor within retail.

To best understand the current state of retail, it is valuable to break up this chart's timeline into three distinct phases, all in relation to the 2008 Great Financial Crisis (GFC): Pre-GFC, GFC, and Post-GFC. The Pre-GFC period in the early 2000s was marked by the growth of big-box retail and the beginning of suffering for regional malls. Many new open air and large shopping centers (sometimes referred to as power centers) were developed and proved to be quite successful during this time. Concurrently, indoor mall construction ground to a halt. The new power centers were pervasive throughout suburban areas within the entire country; very related to the blossoming of single-family housing, which came on the back of cheap money and faulty underwriting during the early part of the century.

Retail suffered when the GFC hit in 2008, as shown in the chart by three straight years of negative net absorption. Due to the inability to predict this crisis, developers had many projects that already “left the station”, causing supply to continue to grow at an inopportune time. This combination led to a spike in the vacancy rate from its long-term average of 6 to 7%, up to a record 11%.

Figure 1: Neighborhood and Community Shopping Center Performance

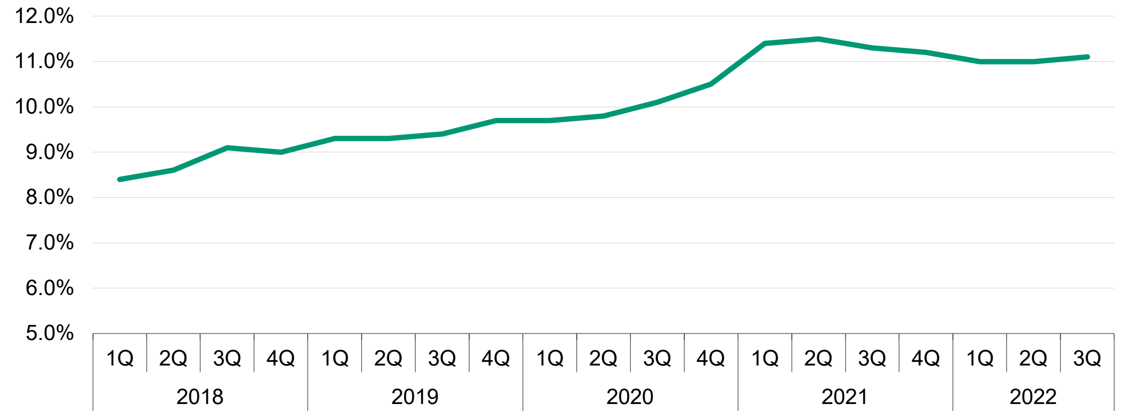


Source: Moody's Analytics CRE

As the economy began to sluggishly rebound from the GFC, retail followed suit. The vacancy rate inched toward 10% in the past decade, but never again close to its previous averages. This is when retail enters another chapter of its evolution. Developers began to take a more cautious approach to building as retailers adjusted their footprints, causing supply growth to considerable weaken. **Fast forward to the COVID-19 pandemic, and while the health crisis brought on an overnight need for a greater presence of e-commerce, the retail vacancy data shows little additional stress. In fact, it is more of a continuation of the Post-GFC trend rather than a seismic shift. Yes, new construction activity and leasing have slowed even further as uncertainty and evolution occur within the sector, but it would be difficult to argue that this is an apocalypse.**

Some may contend that grocery stores, home improvement stores, and pharmacies are what kept neighborhood and community shopping centers afloat during this period. But even if we turn attention specifically to indoor shopping malls, performance is surprisingly similar. Yes, there are a good many of the current 1,000 or so malls that are struggling, but in aggregate, the current 11.1% vacancy rate (Figure 2) isn't far from its pre-pandemic trend. Even the traditional indoor mall isn't quite dead, although we concede that the distribution of property-level performance, especially in the left-tail, has widened.

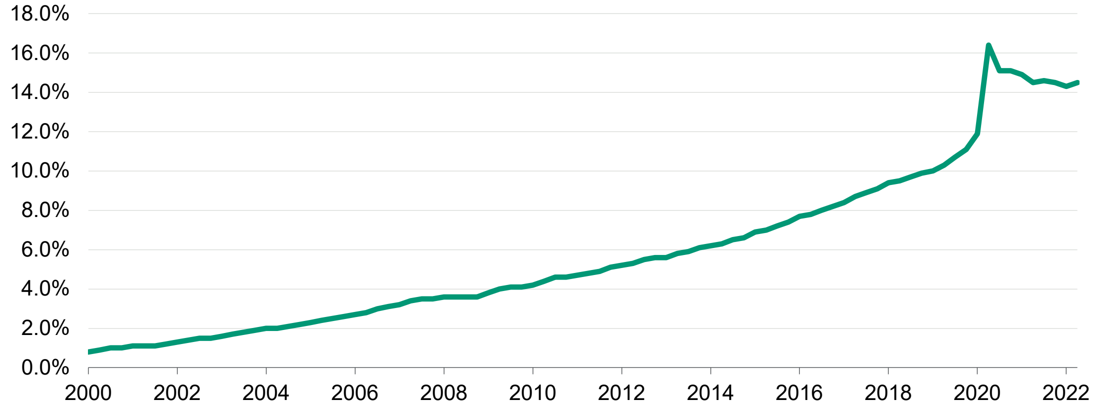
Figure 2: Regional Mall Vacancy Rate



Source: Moody's Analytics CRE

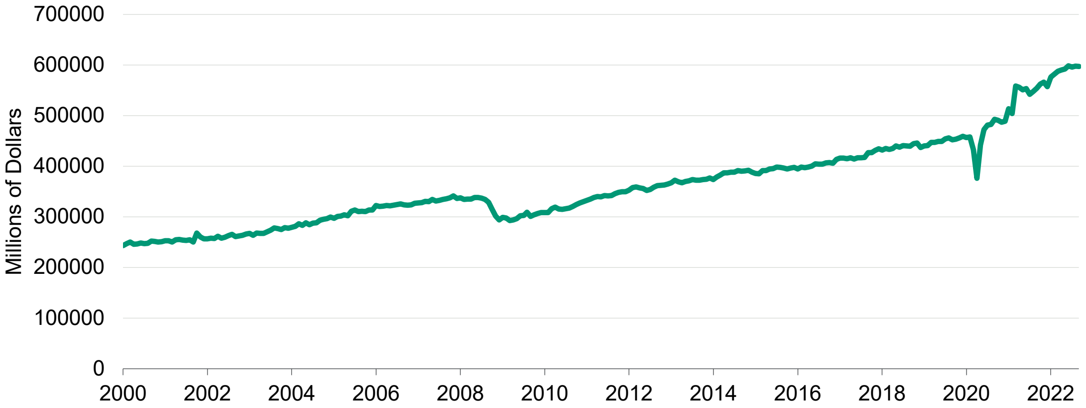
As further evidence of brick-and-mortar's resilience, Figure 3 shows the e-commerce share of retail sales. Note how after the 2020 peak of 16.4%, the share retreated to 14.5%, arguably below its pre-pandemic course. Given this and how retail sales have spiked in the last two years (Figure 4), brick-and-mortar maintains a strong foothold on retail.

Figure 3: E-Commerce Share of Retail Sales



Source: Moody's Analytics CRE, St. Louis Fed

Figure 4: Retail Sales



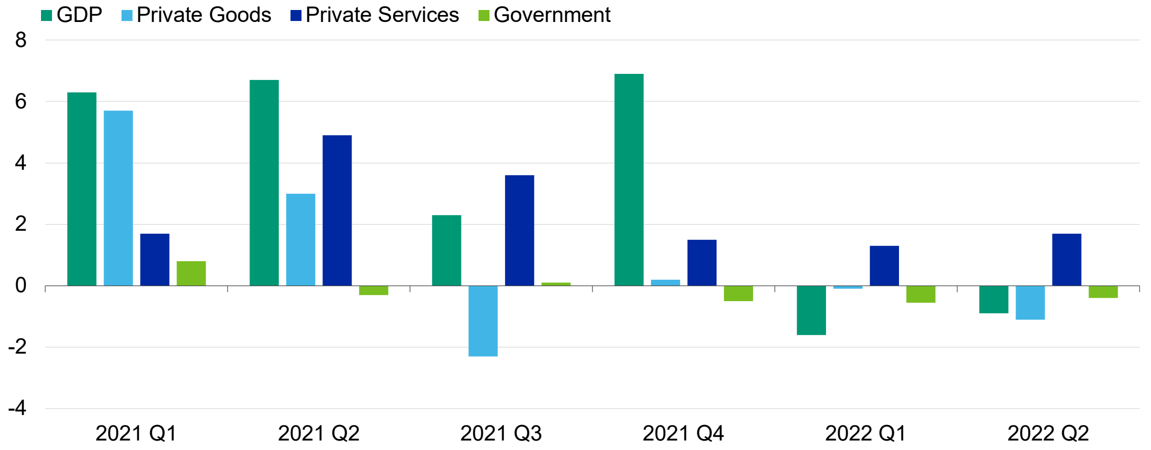
Source: Moody's Analytics CRE, St. Louis Fed

What are consumers buying? And why it matters for the future of brick-and-mortar success

After a surge in private goods spending early in the pandemic (household and home improvement goods), consumer preference pivoted (as shown in Figure 5). **Private services spending growth has outpaced goods spending in every quarter since COVID restrictions began to ease in the spring of 2021**. Yes, some of this may prove to be temporary as "revenge" spending ebbs, but a more permanent shift is on the table. The long period of forced isolation gave consumers a new appreciation for social interactions. Consequently, spending in restaurants and pubs, indoor rock climbing, aquariums, live music performances, etc. may remain elevated well into the future.

This shift in spending habits, along with e-commerce's decades long growth, sends a clear message to current retail center owners, operators, and developers – **a consistent level of activity within a given shopping center will likely need a greater proportion of these "social" tenants in order to attract enough foot traffic to support all tenants.**

Figure 5



Source: Moody's Analytics CRE, BEA

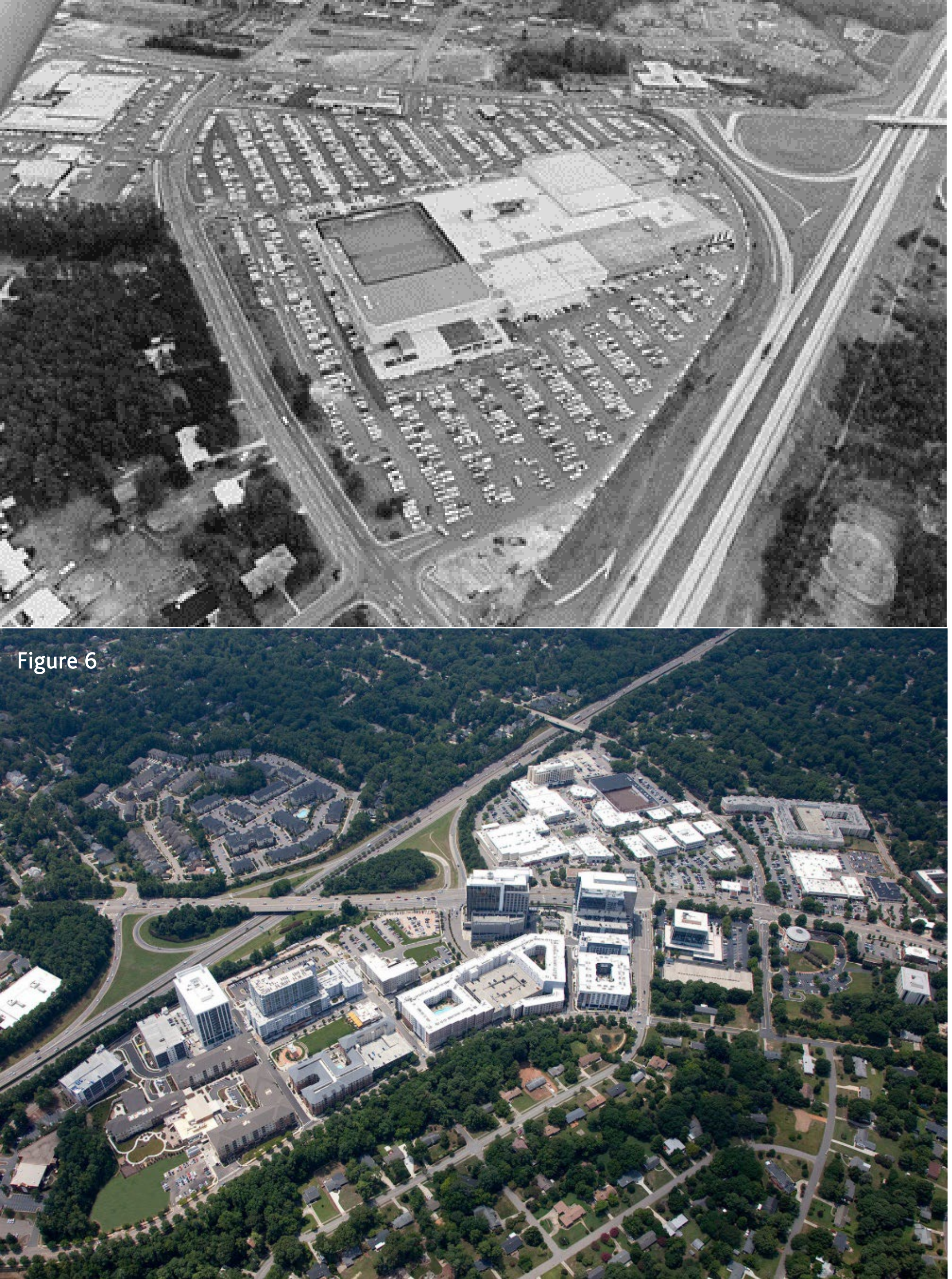


Figure 6

Are Retail Stakeholders Getting the Message?

A resounding “yes”, and many are expanding beyond the diversification approach of service or experiential retail towards other less conventional property types. One of the largest and most ambitious examples of this is the $3 billion Legacy West “lifestyle” development built in 2017. Being a bit ahead of the curve, the Plano, Texas project was built in a “live, work, play” style with a mix of office buildings, townhouse and apartment style housing, and both experiential and goods retail. The development boomed, attracting the US headquarters of Toyota, and even catalyzed further development.[1] Interestingly, or perhaps ironically, JCPenney’s was an original partner in the development of this new “downtown”, which is adjacent to the struggling retailer’s headquarters.[2]

The above model has also been used across the country to transform older, sprawling retail properties into modern lifestyle centers. In fact, early in the 21st century, well before Legacy West, the struggling North Hills Mall in Raleigh, NC was turned into a “urban” style mixed-use neighborhood. This repurposing of the original 1960 strip center is one of the oldest and most successful examples of this repurposing trend. Figure 6 shows the startling transformation.[3]

[1] See “New 18-story residential building being proposed at Legacy West in Plano,” 2 May 2022.
[2] See “Office campus, shops and high-rise hotel in the works for big Plano development,” 14 March 2014.
[3] See “Vision: The Evolution of North Hills”.

North Hills and Legacy West provided a roadmap for others to follow, and retail's evolution during these past 20 years or so has finally led to this model gaining traction. As an example, the Oakdale Mall in Johnson City, NY, built in 1975 and located just outside of Binghamton, was for years anchored by a large Sears and a two-story Macy's. The greater than 500,000-square-foot mall fell on hard times about a decade ago and both large anchors closed their doors. With both large anchors now shuttered, the property became ripe for redevelopment. In the past few years, the Sears has become a thriving brewery; and in August, Dick's Sporting Goods, which has its origins in Binghamton, announced plans for a "destination" store complete with a turf field, ice skating rick, batting cages, and rock-climbing wall in the old Macy's.[4]

Retailers will likely respond well to this intriguing omnichannel approach: a combination of experiential retail within a traditional retail store complemented by a strong online presence. And the disruption to anchor tenancy is just the tip of the iceberg for the above property. The mall was recently rebranded as Oakdale Commons, to express the "community" aspect of the recent changes. Further, a local health care provider introduced a wellness center, and there are discussions regarding further medical, light industrial, and even potentially residential to the location. **This diversified tenant mix will likely sustain foot traffic throughout any given day, a challenge for many shopping centers previously reliant on weekend customers, or evening patrons without much activity in between.**

These are only a couple examples of the nationwide movement. The Atlanta area's oldest mall, The North DeKalb Mall, was just approved for a repurposing into a walkable mixed-use development in an otherwise traditional suburban setting. In Los Angeles, the 75-year-old Panorama Mall in the San Fernando Valley-East submarket was recently purchased and is planned to be renovated into a substantial mixed-use project and is located directly across the street from another planned mixed-use development in a former Montgomery Wards store.[5]

As a final example, Figure 7 is a depiction of the proposed new development to replace the 45-year-old, 1.5 million-square-foot Lakeside Mall in Sterling Heights, MI outside of Detroit. Like the LA and Atlanta proposals, this development will be a walkable mixed-use neighborhood with retail. The city of Sterling Heights describes the development as a "game changer" and will have "over 2,800 multi-family apartments which includes 750 for senior housing, nearly 150,000 square feet of retail and dining (in addition to the existing 400,000), 60,000 square feet of office space and a 120-room hotel".[6] Moody's Analytics Commercial Location Score gives this location high marks for low vacancy rates, good safety, business vitality, and local amenities. Not enough to support the old mall, given the saturation of malls in the local market, but a strong enough location for the developer to be bullish on the future prospects of this new city center.

Figure 7

Source: City of Sterling Heights

[4] See "Dick's Sporting Goods to build its largest store at Johnson City's Oakdale Commons," 18 August 2022
[5] See "Primestor Converting L.A.'s Panorama Mall Into Mixed-Use Project," 19 May 2022
and "Redevelopment to Turn Panorama Mall into Housing and Hotel," 6 May 2022
[6] See "Out of the Box Ventures Announces $1Billion Redevelopment Plan for Lakeside Mall," 28 October 2022

As Legacy West's development illustrated, renovations of existing properties are not the only outlet for this trend. Mixed-use or "lifestyle" is a model for new development as well. Our Moody's Analytics new construction database is chock full these projects. At 4.7 million SF, the largest of these is The River Mile in Denver, CO. The master planned, walkable mixed-use neighborhood will include office, retail, multifamily, as well as education and cultural facilities. The first residential units are expected to be completed by 2024, but the developments "completion" timeline is estimated to be 25 years – **a new neighborhood is being born, and traditional ground floor retail among other uses is a key component.**

More near term, Phase Two of the successful Lake Nona Town Center in Orlando, FL, is currently under construction with more retail, hotels, housing, and office are all underway or planned.

The Evolution of Retail is Intertwined with the Evolution of Human Preference

How we as humans choose to live, work, and play is continually evolving, but the one constant is we are social beings. **While plenty of households will choose a rural or traditional suburban setting, the option for many of a walkable "urbanesque" setting is proving very attractive and developers are responding.** As evident of many recent developments and leasing activity, many people are showing a desire to walk to the coffee shop or grocery store within their own neighborhood. Walkability has certainly become a buzzword, but households, retailers, office firms, and developers are all recognizing its value, even in traditional suburbia. A standalone corporate park along a highway is likely going the way of the dinosaur, as the ability to walk or bike to work, or at a minimum walk to lunch or grab a coffee with colleagues is becoming a necessary amenity to attract labor back to the office. And while isolated residential or retail developments are not "finished", more and more developments will be mixed, with retail as an important centerpiece.

The critical mass of foot traffic has always been crucial for retail, but how to achieve that critical mass is now evolving alongside our consumer spending habits. Retail development is reverting to the way it was originally conceived.

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