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The Mall of the Future

How Regional Malls Will Survive a Rapidly Changing Retail Industry

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Summary

Roughly two decades ago, the US retail sector began a transformation that has ramped up in recent years, where the best retailers thrive by dynamically serving consumers of the digital age. The pandemic further jolted the growth of online shopping and shook out retailers that didn't have the agility or resources to reach consumers in diverse ways.

Brick-and-mortar stores will continue to be a critical part of retailers' strategies, but like the best companies in retail, property owners will evolve to survive. That is particularly true for regional malls, since among brick-and-mortar property types, the traditional mall is most directly disintermediated by e-commerce. This also compels an evolution in mall underwriting by investors and lenders.

Regional malls will continue to exist (many experts estimate that roughly **one in five of the over 1,000 US malls will remain as malls**), but the "mall of the future" will have a diverse set of draws beyond conventional department store anchors. Operators will also have to be more attuned to the shifts in retailing strategies, and in many cases take on more of the risks that retailers face than in the usual landlord-tenant relationship.

» **For most retailers, implementing an "omnichannel" strategy is now critical not optional.** Online sales as a share of total US sales will grow further, likely eclipsing the 30% mark in the next five years, when that share will likely plateau for various practical reasons. The large majority of retail sales will still occur in physical stores, and even where online sales do supplant in-store sales, e-commerce is becoming less cannibalistic and more intertwined in a holistic approach to retailing.

While most brands' will selectively thin-out their portfolio of stores, most successful retailers will invest in **both** digital platforms and brick-and-mortar stores as they strive for an "omnichannel" approach to retailing. This involves integrating the traditionally siloed tasks of sales, marketing, customer service, and inventory management across all digital and physical channels to form efficiencies and connect with customers by every means possible. In addition to researching and buying online, shoppers will continue to use stores for convenience, service, tactile research, social, and other experiential reasons, often affording retailers with well-positioned physical locations a competitive edge.

» **Metrics of mall quality shift as landlords revise the regional mall business model.** Successful mall operators will diversify the drivers of rent and foot traffic beyond the traditional model of department store anchors. The limited number of traditional retailers available to backfill mall vacancies, especially large anchor spaces, means landlords must be willing to use the space differently and look to certain national big box retailers, entertainment businesses, sporting goods, high-volume restaurants, or some mix of alternative uses such as logistics, residential, medical office, or service-based retail. Targeting and supporting omnichannel retail tenants will be of growing importance. Evolving characteristics of leases, like shorter term lengths and mall performance contingency provisions, will force landlords to share more in the risks of their tenants. Some malls will fail because operators will not have (or choose not to deploy) the capital to do necessary reformatting. All of this makes it ever more important to have a sophisticated, well-capitalized mall operator to survive the rapidly changing retail world.


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For most retailers, implementing "omnichannel" strategy is now critical, not optional

Major retailers that thrive over the next decade are fast-tracking their efficiencies across their value chain with a clear goal: to capture and retain today's increasingly savvy, mercurial customers who have many tools to seek the best prices for the best products, where and when they choose to get them.

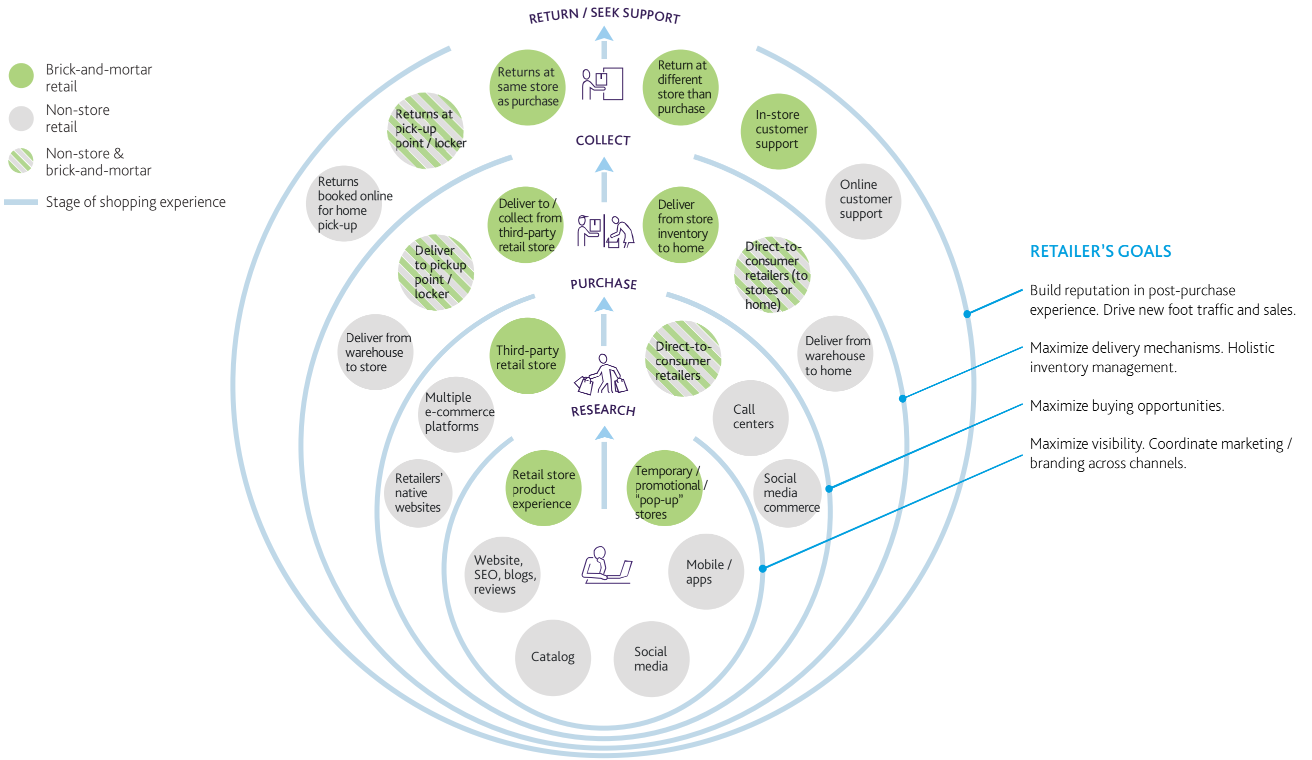
This strategy has long been referred to as omnichannel retailing. Hardly a new idea, omnichannel is the attempt to seamlessly integrate sales, marketing, and logistics through both online and physical operations. While the shift to this strategy began in earnest back in the early 2000s, the retail industry's implementation of this has been broadly rocky and gradual since it involves a complex integration of operational layers of retailing that are traditionally siloed.

Exhibit 1 shows how retailers holistically look to create efficiencies across the stages of retailing to improve customer capture and retention. This includes all channels of customer acquisition, selling, delivery, and post-sale customer service. Although many elements of the shopping process have gone digital, a successfully omnichannel strategy retains brick-and-mortar stores (shown as the green circles in Exhibit 1) as a common thread across the layers of shopping experience.

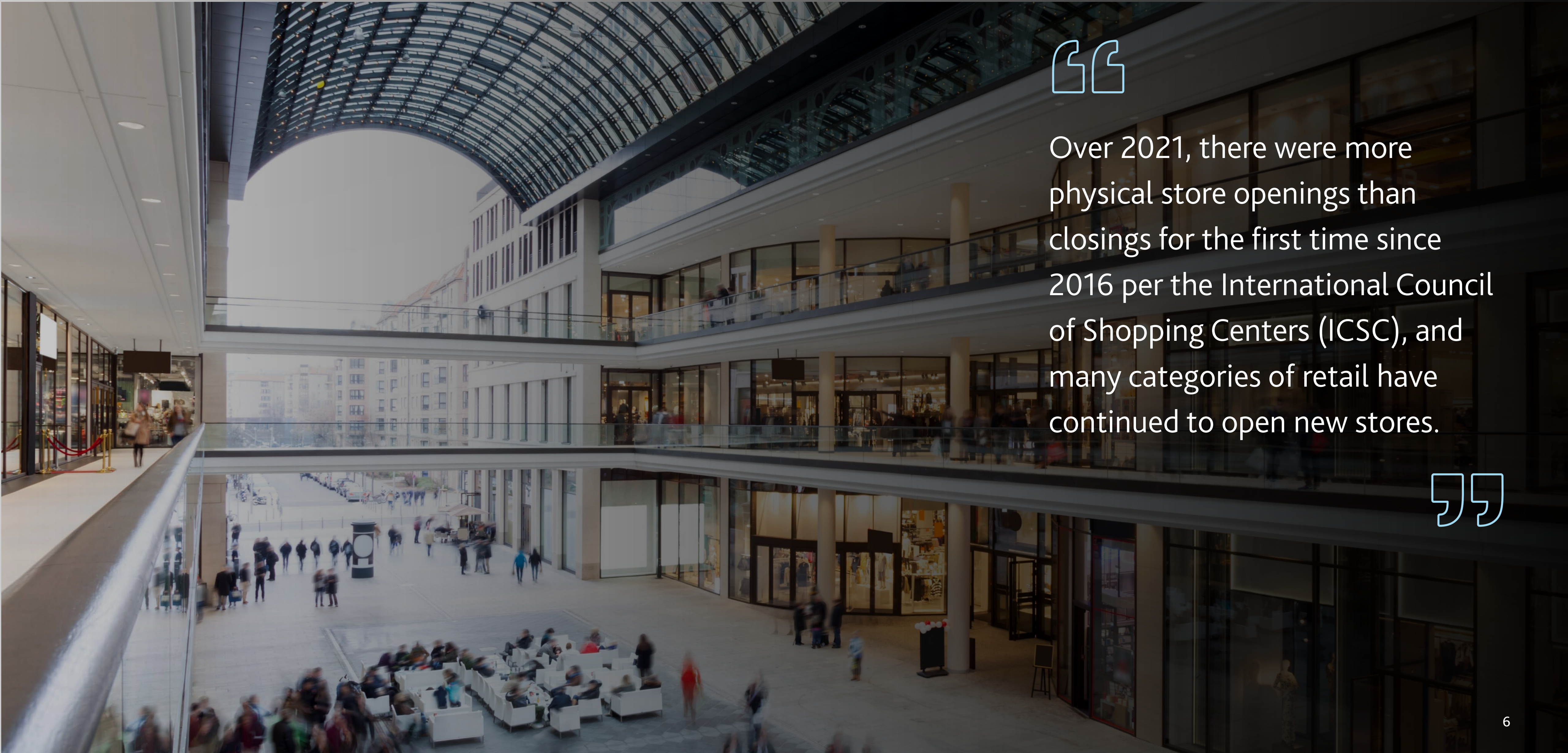
A brick-and-mortar presence remains a major component of retailers' strategy, but **omnichannel retailing is as much about operations as it is selling**. Over 2021, despite the pandemic surge in e-commerce, there were more physical store openings than closings for the first time since 2016 per the International Council of Shopping Centers (ICSC), and many categories of retail have since continued to open new stores in 2022, [despite headwinds].

But stores are often used for more than just selling goods. Omnichannel retailing, as opposed to "multichannel" retailing, is not about providing multiple channels for selling only. Integrating the different layers of retailing online and in-store helps create efficiencies and better experiences for customers.

EXHIBIT 1: Conceptual business model for an omnichannel retailer



Source: Moody's



> Over 2021, there were more physical store openings than closings for the first time since 2016 per the International Council of Shopping Centers (ICSC), and many categories of retail have continued to open new stores.

Omnichannel for cross-selling, maximizing visibility, showcasing, streamlining inventory management

Many retailers use stores to enhance delivery options, such as ship-to-store, ship-from-store, or pick-up at store. Walmart, now one of the world's largest online retailers, adopted such tactics only a few years ago[1], eyeing their existing stores as a potential competitive advantage for supply chain management. Subsequently, Walmart greatly improved their delivery times and costs to customers[2], with more improvements to come by using technology to effectively leverage stores as distribution hubs[3]. Amazon has made similar moves, with their acquisition of Whole Foods and their experimentation with different store formats, which is still evolving despite closures of certain concepts in 2022.

Approximately **two-thirds of customers purchasing online used a physical store before and after the transaction**, according to a report by consulting firm A.T. Kearney[4]. That reinforces that a store often significantly contributes to generating a sale, even though a transaction may be eventually registered online.

More retailers are distributing their e-commerce orders from stores, the pace of which accelerated further during the pandemic. We expect physical locations as fulfillment nodes to enable faster delivery to be a permanent trend after the pandemic. Things like this will make it necessary for brands to change how they measure a store's performance and value to their company. Some are already attributing e-commerce sales in a region partially to the stores within that area. But how a given store's utility is measured will evolve in the coming years. This also complicates things for landlords, which we will discuss more later.

Omnichannel for brand management, customer retention, and new sales generation

The post-purchase phase of retailing is another way that omnichannel retailing helps brands build their reputation. Post-sale support and returns are a major part of retailing that determine whether customers will become repeat customers, not to mention leave reviews of products. An online and physical support system has worked well for many brands.

One particularly crucial part of the omnichannel strategy is customer recapture and cost recouping during the returns process. According to the National Retail Foundation[5], nearly 17% of total US retail sales in 2021 were returned. The return rate is always much higher for online purchases, stemming mostly from poor fit for apparel or items not having expected qualities. Costs of these returns is very high (handling, fraud, lower resale, et al). To mitigate these costs and drive new sales, having a physical store to return items not only provides convenience for customers and curbs fraud, it also encourages new purchases during the return visit, a strategy many retailers have taken, including two of the largest online retailers, Amazon (in returns to Whole Foods) and Walmart.

[1] See "Ship From Store Technology Could Be Walmart's Edge in eCommerce Battle," 14 November 2017.
[2] See "Walmart drops the $35 order minimum on its 2-hour 'Express' delivery service," 1 March 2021.
[3] See "Walmart adding automated warehouses with robots to stores to help fulfill pickup, delivery orders," 27 January 2021.
[4] To read the Omnichannel Shopping Preferences Study Report "On Solid Ground: Brick-and-Mortar is the Foundation of Omnichannel Retailing," visit www.atkearney.com.
[5] See "Consumer Returns in the Retail Industry 2021," January 2022.

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CASE STUDY: Best Buy is an example of using stores for an omnichannel distribution strategy

Because of the rapid expansion and success of e-commerce, traditional brick-and-mortar “rack” retailing is increasingly difficult. Traditional retailers are forced to pivot to this changing environment. One retailer that has had success adapting, despite numerous obstacles, is Best Buy Co.

For most shoppers, electronics is a large purchase, and they want to physically see and feel the product before buying. However, major online retailers often sell products at lower prices than brick-and-mortar stores. Best Buy was one of the first to embrace price matching, while also developing a strong online presence to update how they use their physical space.

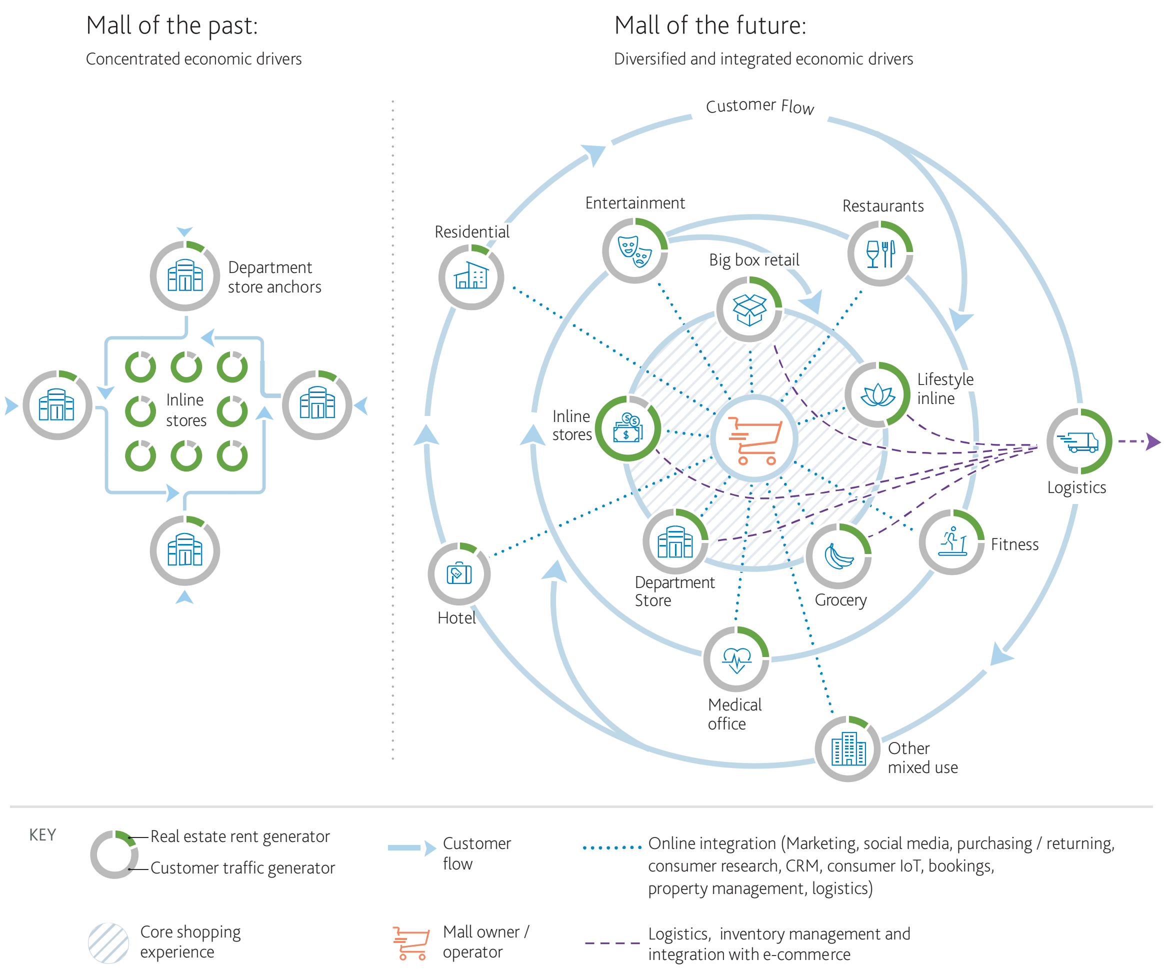
Best Buy has invested millions to develop its website and this has helped fuel the company to be one of the largest electronic stores in the country. Additionally, the company found new ways to better utilize their space in this new online era of retail. They converted half of the store's retail space to industrial distribution aimed at fulfilling online orders much faster, a concept Amazon has also embraced within Whole Foods. Best Buy also trained existing staff to fulfill multiple roles, working with customers in the retail portion of the store some days and in the backroom fulfilling orders other days.

It was also one of the first retailers to successfully execute in-store pickup. An online retailer’s greatest challenge is the lack of instant gratification, with consumers waiting days or even weeks to receive an item. But most Americans are within 15-20 miles of a Best Buy store, so the company invested in systems to ensure customers can pick up merchandise at the store within minutes. Additionally, Best Buy found that in-store pickup often resulted in purchases of additional items once inside the physical store.

Metrics of mall quality shift as landlords revise the regional mall business model

The accelerated changes underway in the retail industry have expedited the need for mall operators to fundamentally change their business model. Exhibit 2 illustrates the economic drivers of the "mall of the past" versus the "mall of the future".

EXHIBIT 2: Regional mall business models are evolving toward more diverse revenue drivers



Source: Moody's

The previous model of the mall was relatively simple, where large department stores would be a destination for shoppers looking for a variety of goods they may find in one place. The department store anchors at the ends of the mall drove traffic among the smaller “in-line” stores situated between them. Anchors would take up roughly a third of a mall’s net rentable area (NRA) but pay a fraction of the total rent at the mall. Rent from in-line tenants would generate the vast majority of a mall’s rent, paying for the privilege to benefit from the shoppers that the department stores would draw.

However, department stores have been the major category of retail most disrupted by e-commerce. The bankruptcy filings of department stores Bon Ton and Sears began to create vacant wings in malls, and COVID-19 led additional anchor tenants including Lord & Taylor and J.C. Penney into bankruptcy. If a landlord cannot replace vacated anchors, the business model of the property is in jeopardy. If the highest and best use of a mall is no longer a mall, the high cost to reposition such a large property with a specific use can reduce property value to near zero. To wit, failed malls have the highest loan losses in commercial real estate, often exceeding 100% loss severity (meaning there was effectively no recovery value).

This has forced a rethinking of the fundamental mall business model. With the disruption of the traditional anchors and the shifts in retail strategy and consumer expectations of physical retail spaces, the mall economics have become more complex. Similar to how a store is becoming more than just a place for a retailer to sell goods, malls are increasingly more than a place to shop in stores.

In some ways, **malls are evolving to fill the gap left by the traditional mixed-use “Main Street”, which was once a bustling epicenter of American communities**. They will generate foot traffic and rental income from other means, such as restaurants, theaters and other entertainment, service-oriented retail, lifestyle and wellness retail, groceries, fitness facilities, medical offices, and other types of commercial real estate uses.

A strong example of this is **The Domain in Austin, Texas**, which is a massive mixed-use center with an open-air mall nestled within a diverse array of retail, experiential draws, housing, and office, making it both a community and destination. Apartment rents within the center are some of the highest in the metro area.

Mall operators will also have to take retailers’ omnichannel strategies in mind. They’ll need to help providing tech infrastructure for omnichannel selling and marketing and support for distribution center-like usage of space for more dynamic logistics. In terms of the contractual relationship between mall landlords and tenants, leases will become more favorable and flexible for tenants, **increasing the retail industry risks landlords have traditionally managed.**

> Failed malls have the highest loan losses in commercial real estate, often exceeding 100% loss severity (meaning there was effectively no recovery value).

How does this change assessment of mall quality?

The change in the mall business model illustrated in Exhibit 2 drives a shift in what determines quality and resiliency of malls going forward. Exhibit 3 illustrates some key metrics and factors for mall survival over the next decade of rapid change.

EXHIBIT 3 – Key Indicators of Regional Mall Viability

Mall Characteristic	Long-term Viability as Regional Mall		
	High Potential	Some Potential	Questionable Potential
Mall Format / Tenancy	» Formats that fuse live, work, and play; diverse demand drivers » National / high volume core retail tenants » Strong entertainment, restaurant, grocer and lifestyle tenants » Limited clothing in-line tenants (<45% in-line NRA)	» Some diversification of mall demand drivers » Some national tenants » Some entertainment and restaurants	» More traditional anchor / in-line mall format » Limited national tenants » Predominantly clothing in-line tenancy
Omnichannel Considerations	» Omnichannel tenancy; some with use of stores as distribution » High-tech infrastructure; wifi and companion shopping tech tools » Website / app to support shopping / ordering / marketing services	» Some omni tenants » Some tech enablement	» Limited online or tech integration
Lease Structure / NOI Margin	» Triple Net Leases » Longer lease terms, average 5-10+ years » Few percentage of sales in-lieu of base rent (PIL) leases or performance kick-out clauses » NOI margin 70% - 80%	» Triple Net Leases » Medium lease terms, average 5 years » Some percentage of sales in-lieu of base rent (PIL) leases or performance kick-out clauses » NOI margin 65% - 70%	» Gross Leases » Short lease terms, average <5 years » Some percentage of sales in-lieu of base rent (PIL) leases or performance kick-out clauses » NOI margin <65%
Sales / Occupancy Cost / Store Profitability	» Inline sales over $520+ PSF » Occupancy cost over 13% » Several tenants with profitability well above the chain average	» Inline sales $400-525 PSF » Occupancy cost 10% - 13%	» Inline sales below $400 PSF » Occupancy cost below 10% » Several tenants with profitability below the chain average
Trade Area Demographics and Competitive Position	» Dominant mall in trade area » Above national and regional average population and household income demographics	» Only mall in smaller but healthy trade area » Top mall in major metro (strategic location)	» Faces superior competition from similar size and quality mall » Relatively weak demographics
Sponsorship	» Elite, well-capitalized, national mall owner	» National mall owner	» Regional / local owner

Source: Moody's

Mall Format and Tenancy

Malls with national and high-volume retailers following an omnichannel strategy will likely be more resilient. Mall store counts have fallen in the past decade, and we expect the pandemic will ultimately accelerate the obsolescence of many retailers. As discussed in the previous section, retailers with a robust omnichannel strategy will have the most draw and survivability as tenants.

Mall operators must more shrewdly differentiate between winners and losers among potential tenants as retailing evolves, particularly for large tenants. Many malls successfully replaced their mid-priced department store anchor tenants (or offset their diminished appeal) with tenants that more effectively attract customers. These primarily consist of big box and sporting goods stores (e.g., Dick's), entertainment, as well as high-volume restaurants. Repurposing these large spaces in malls for different uses or multiple uses will become more common.

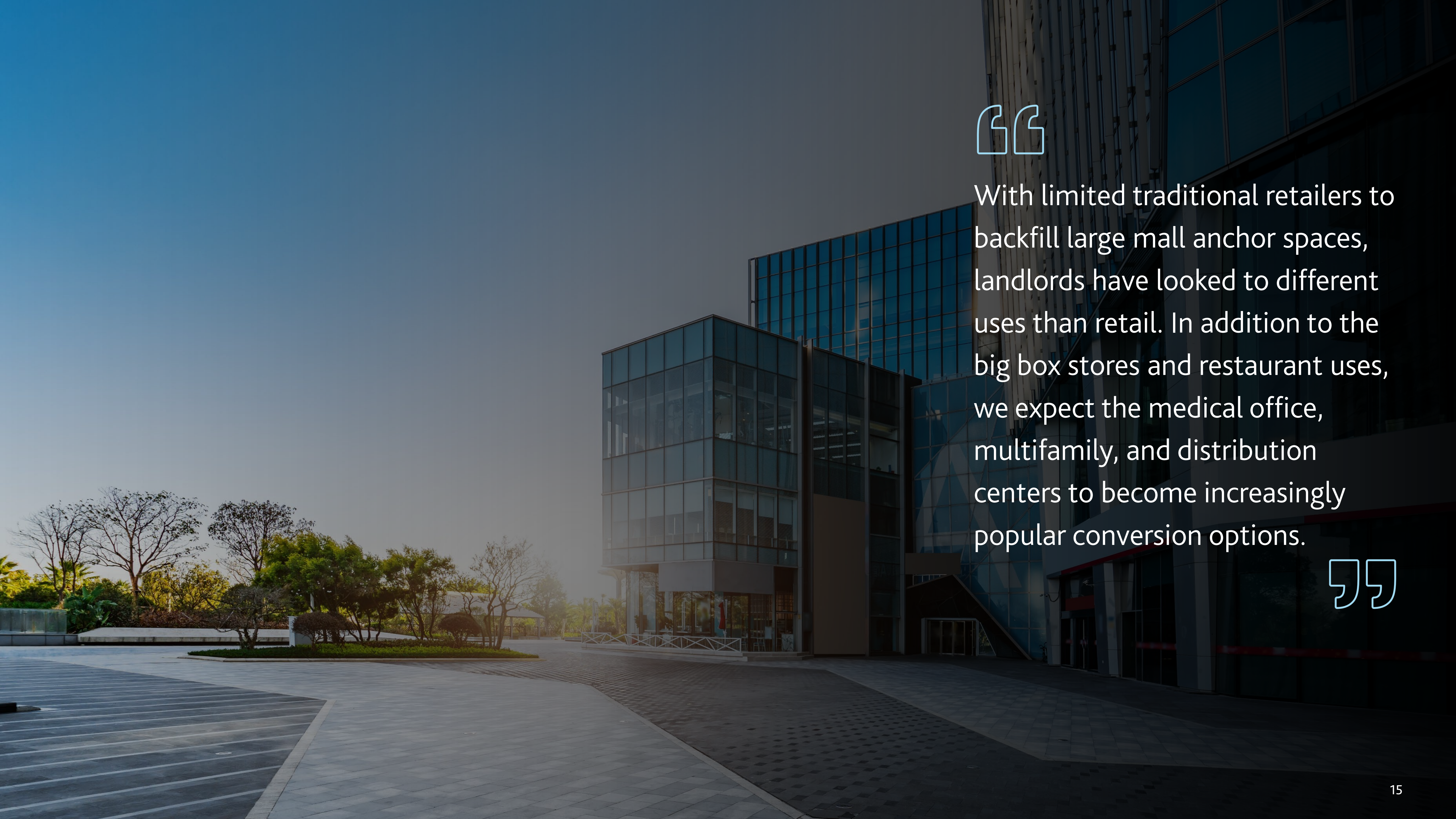
Changing consumer preferences has always forced landlords to constantly rethink their rent rolls and to some degree their overall format. Now with the business model at risk of becoming obsolete, reformatting has become more common or in some cases necessary.

With limited traditional retailers to backfill large mall anchor spaces, landlords have looked to different uses than retail. In addition to the big box stores and restaurant uses, we expect the medical office, multifamily, and distribution centers to become increasingly popular conversion options. These elements may be added to the center as outparcels rather than within anchor spaces, but they still serve to be generators of traffic.

The redevelopment of a portion of the mall as multifamily housing means on-site residents help replace lost foot traffic, and brings the site closer to the mixed-use, walkable development concept. One benefit of this strategy is that if the multifamily is successful, the landlord has a greater opportunity to fill space at the property with other supportive uses, such as medical offices and entertainment options.

Another alternative use of space would be logistics, whether partially as in the Best Buy example mentioned previously, or full distribution center-like usage. Fulfillment centers do not attract customers and would do little to attract other retail uses in the mall. However, they would relieve pressure on mall owners by filling large retail spaces that are eyesores. Additionally, it opens the possibility of a fulfillment tenant using the retailers' inventory at the mall to complete online orders — creating the highly effective omnichannel experience for shoppers, retailers, and mall owners.

Converting vacant mall space to fulfillment centers or multifamily housing has potential zoning hurdles. Fulfillment centers are often classified as industrial so, to the extent the mall is zoned commercial, a comprehensive rezoning plan amendment may be necessary. If the mall was developed in accordance with a master development plan that identified specific uses, that master development plan would likely have to be amended. Obstacles aside, some mall owners are beginning to successfully navigate these types of conversions.



> With limited traditional retailers to backfill large mall anchor spaces, landlords have looked to different uses than retail. In addition to the big box stores and restaurant uses, we expect the medical office, multifamily, and distribution centers to become increasingly popular conversion options.

CASE STUDY: Repurposing anchor spaces as logistic/fulfillment operations

As the era of the large 200,000 square foot (SF) department store comes to an end, many mall owners have explored the idea of leasing the space to companies as fulfillment and logistic centers. The reasons are clear: The vacant anchor space is large enough to accommodate the needs for “spoke distribution”, while malls are located close to a high density of consumers and can fill the undersupplied “last mile” distribution space needs of companies. Additionally, large mall box space is typically cheap, ranging between $2-4 per square foot (PSF).

Morgantown Mall is a regional mall located in Morgantown, West Virginia. In late 2018, Sears said it would close the approximately 80,000 SF store at the property. The owner of the mall, broke traditional retail thinking and began to explore logistic companies as replacement tenants. In June 2020, it was announced the vacated space will be leased to WVU Medicine Group as the company's logistic, distribution, and fulfillment center to service their clients in the region.

Although there are few examples of such logistic conversions, over time landlords will overcome the obstacles of replacing department stores with distribution operations. Once a successful formula is developed and repeated, it will lead to logistic centers not only backfilling space, but interacting with mall tenants. If an online retailer had a logistic facility in the mall and sold goods of an on-site store, the online retailer and traditional mall retailer could potentially create fulfillment arrangements using store inventory and the logistics operation to complete customers' orders much faster and at lower cost. Such strategic business potential makes this a likely first evolution in what will ultimately be a common characteristic of malls of the future.

Omnichannel

Aside from targeting tenants with strong omnichannel businesses, mall owners can take some measures to help their tenants implement their strategies. Use of logistics in-store for inventory management is one we've already mentioned, but other tenant goals are increasing the delivery options, cross-channel marketing and promotions, and providing technical solutions to shoppers

Mall owners are likely to invest in additional technology to promote tenants' omnichannel offerings including high-speed wireless Internet at the property. Malls should have an online platform (including website and app) that supports customer research and notifications of sales and events. It may also support developing "Internet-of-things" (IoT) technology, the best example of which recently is mall-sponsored body scanners that tell customers the correct clothing size by brand within the mall. The mall online infrastructure could also eventually be able to cross-promote services among stores or be incorporated into the delivery and inventory management needs of tenants.

Mall owners that view online shopping as a synergy, as opposed to an obstacle, will target tenants well developed in e-commerce and invest in technological infrastructure within the mall to better connect customers' physical and digital shopping experiences. This will maximize profit for the tenants and, in turn, increase the value of the shopping center. Mall owners that resist technology, and concepts of omnichannel, run the risk of obsolescence.

Lease Structure

Mall vacancies continue to be elevated post-pandemic, shifting lease negotiating leverage to tenants. Generally, except perhaps for the very strongest performing malls, landlords will be drawn into sharing more the risk of retailing with tenants. This comes predominantly in the form of shorter leases, leases based on a percentage of sales in lieu of a fixed rent, and provisions that allow tenants to terminate leases early.

Leases for retail are generally trending shorter. For all retail (not just malls), lease terms declined steadily from about 8.3 years in 2017 to about 6.4 years in 2021. That was driven in part by an increase in short-term tenants. Short-term tenants, sometimes referred to as "specialty leasing" or more commonly "pop-ups", often include new brands, startups, and even established retailers testing new products. In some cases, these enable merchants a bridge to a permanent store. But while this does backfill space for landlords, shorter leases add volatility and risk and often cause financing issues with lenders.

Tenants are also likely to look for more flexibility in lease provisions. Many will try to negotiate "percentage in lieu" (PIL) rent, which is rent based on a percentage of their sales in lieu of a base rent. This could also be negotiated to start at a base rent but switch to PIL at some point during the lease term, which would generally result in a rent reduction.

Further, tenants will frequently seek performance-based "kick-out" clauses based on a performance of the mall or the store, which allows a tenant to terminate their lease early if certain (typically sales based) thresholds are not met. These would be in addition to common co-tenancy clauses, which are usually based on the continued presence of certain anchor tenants.

Both PIL and kick-out clauses can shift significant retail business risk to landlords. In the case landlords accept such negotiated provisions (and overcome such issues with their lenders), they will need to invest in more active management of their properties than under the traditional mall model, particularly when sales are distinctly declining and store footprints are shrinking for many brick-and-mortar retail categories.

Sales and Store Profitability

For several years, operating performance figures for brick-and-mortar retail has been tightening and the need for efficiency is paramount for retailers. Retailers' profit margins are very tight, generally ranging from 2%-6%. As a result, it becomes very important for stores to have either a strategic advantage or high sales volumes. Therefore, the number of stores for most brands have fallen substantially and higher productivity levels should now expected of in-line tenants in healthy malls. So while $400 PSF of sales per year may have been acceptable five or 10 years ago, with fewer stores a retailer will generally expect north of $500 PSF in a store now to remain in a given mall.

We expect a mall with high long-term viability to produce in-line sales of $520 PSF or greater, while malls with questionable long-term viability to generate sales productivity of less than $400 PSF (this is excluding unique high-volume lifestyle tenants like Apple or Lululemon that skew the overall mall average sales figures). Occupancy cost (the ratio between a tenant's gross sales and real estate cost) is also a key consideration for tenants and landlords. While tenants will likely try to request lower rents to lower their occupancy cost, the better malls will be able to command better rent and higher occupancy cost ratios (the best tend to have >13% ratios as Exhibit 3 shows).

While store sales will remain an important metric, measuring a physical location's performance will become an increasingly complicated matter for mall operators. As we mentioned earlier, many online sales originate with an in-store visit as a means of shopper research. Also, the trend of stores as partial fulfillment centers will likely last. This makes the total value of stores for retailers more than the in-store sales alone. Some brands are beginning to attribute all, or at least a portion of, online sales within a region to stores in those markets. While this gets closer to recognizing the value of a store, this still fails to tell the whole story about a store's profitability and its contribution to the retailer's overall performance. As metrics for this evolve, mall landlords will need to track store health beyond in-store sales.

Trade Area

Malls will still be largely driven by the value of their location for retailers, and that means position in a market with strong demographics, with population density and above average household incomes. However, with less retail demand to go around, demographics alone will not save malls in a poor competitive position. It is increasingly important to be the dominant mall in a "trade area", which is roughly a 30-45 minute drivetime radius. For many markets, that means only one or two large format regional malls will get the lion's share of customer foot traffic and therefore survive going forward.

Sponsorship

Strong sponsorship is more important than ever for a malls' ongoing success. These sponsors will be well capitalized, have more efficient operations, and deeper tenant connections. Capital investment will be needed to increase foot traffic and adapt the mall to evolving consumer trends after the pandemic subsides. Like for retailers, some of that capital investment will be allocated toward a useful online platform. Some will be allocated toward full-scale renovations. Other capital investment will be deployed in the form of landlord monetary contributions towards tenants' build-outs of their stores to their desired specifications (also known as tenant improvements or TI's), which will be required to create new store formats and further expand experiential retail at malls.

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