Chilton
Capital
Management

1177 West Loop South, Suite 1310
Houston, Texas 77027

TELEPHONE: 713 650 1995
FACSIMILE: 713 650 1739
TOLL FREE: 800 919 1995

A Brief History of Grocery-Anchored Shopping Centers | August 2015

Shopping centers have played a major role in the US REIT industry since the early 1960's when President Eisenhower signed legislation approving the REIT structure. Some of the early entrants to the space included Federal Realty (NYSE: FRT), NewPlan Realty (now part of Brixmor (NYSE: BRX)) and Pennsylvania REIT (NYSE: PEI). Most observers use the Fall 1991 IPO of Kimco Realty (NYSE: KIM), now one of the largest in the sector, as the start of the Modern REIT Era. As of June 30, 2015, shopping center REITs only equate to 8%, or $63 billion, of the market capitalization of all traded equity REITs in the US.

A shopping center usually is comprised of one or more anchor tenants and complemented by smaller, 'inline' tenants. One of the most prevalent and coveted anchors for shopping centers is a successful grocer. Investors are attracted to grocery-anchored shopping centers for the stability that its unique tenant mix provides. The right grocer can sometimes attract a customer two to three times a week, which also benefits the other inline tenants at the center. The 'everyday necessity' nature of the tenant mix provides stability to the rent roll and lowers sales volatility by driving traffic to the property in both good and bad times. Also, though Amazon (NASDAQ: AMZN) and a few other companies have tried online grocery services, grocery-anchored centers should be one of the most internet-resistant retail properties.

A History of Competition

The grocer industry has a deep history of very strong competition. Currently there are over 37,500 supermarkets in the United States which sell over $638 billion worth of products annually taking up 5.6% of the average consumer's disposable income. If a grocer doesn't have the vision and ability to adapt to the changing dynamics, there is a competitor ready to take market share.

The first instance of innovation within the grocery industry came in the 1930's with the creation of what we think of as the 'traditional' supermarket today—grocers with annual sales of at least $2 million that offer a full line of groceries, meat, and produce across 15,000 to 60,000 SKUs (Stock Keeping Units). Prior to the creation of supermarkets, a shopper would have to make multiple stops at separate vendors to pick up meat, bread, produce, and other groceries. Sometimes vendors would even locate next to each other for convenience, causing consumers to often mistake them for being under the same ownership.

In August of 1930, Michael Cullen opened King Kullen Grocery Company in Queens, NY, which is often cited as the first supermarket. Mr. Cullen chose low rent locations, often abandoned factories and warehouses, on the border of populated areas as the sites for his supermarkets. These locations allowed for the rare luxury of ample free parking, which not only encouraged more people to come, but it also permitted them to buy more groceries because they would no longer have to carry them home. King Kullen supermarkets concentrated on volume by bringing multiple vendors under one roof, which added convenience for the consumer and lowered prices substantially. As a result, 'old-style' grocers (e.g. Kroger (NYSE: KR), A&P, Safeway) had to adapt to survive. In 1932, there were approximately 300 supermarkets generating nearly $150 million in sales. By 1936, over 1,200 supermarkets existed across 32 states with annual sales of $500 million, and just three years later the number grew to 4,500 supermarkets.

New Name, Same Game

The supermarket model worked extremely well for over 50 years, eventually growing its market share to 90% by the late 1980s. However, new concepts and competition have brought the

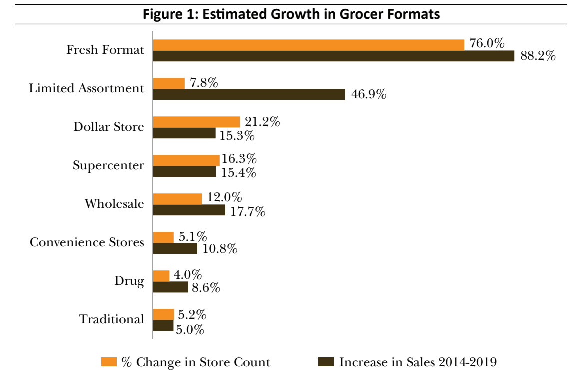
market share below 50% today. One of the main causes of the decline has been the introduction of full-line grocery service in Wal-Mart (NYSE: WMT) and other supercenters and warehouse stores across the country. As an example, Wal-Mart used the traditional grocers' strategy against them at an even larger scale. Wal-Mart's focus on a lean business model and the company's negotiating power enabled them to offer goods at even lower prices. Now, Wal-Mart is the largest U.S. grocery retailer and has been cited as the cause in over 25 grocery chain bankruptcy proceedings, the most recent being the 156-year-old, Northeast-focused Great Atlantic & Pacific Tea Company (better known as A&P).

Supermarkets have had to adapt in order to survive and contend with the new competition. With thin profit margins, supermarket participants have had to consolidate to gain scale and pass cost savings on to the consumer. Earlier this year, the owners of Albertson's bought Safeway for $9.2 billion, and in 2014 Kroger acquired Harris-Teeter, a regional grocer, for $2.5 billion. The REITs see the consolidation in the industry as an opportunity. Consolidation usually generates redevelopment prospects for landlords because the consolidator often decides to give space back due to low store performance or market overlap with an existing store. Though tenants still have to pay rent on vacated space until the end of the lease term, REITs often jump at the chance to substitute a lower performing grocer with a newer concept. Re-tenanting not only increases the productivity of the anchor space but also provides a boost to the entire center through an increase in consumer traffic. This underscores one of the main axioms in real estate: the importance of 'location, location, location'. The most successful REITs are savvy with this critical aspect of the business.

The Introduction of 'Fresh' Ideas

According to research by University of Rochester professor Paul Ellickson, Wal-Mart's grocery expansion coincides with an approximate one for one reduction in supermarket stores. However, it is also connected to a one-and-a-half for one expansion in 'fresh format' and 'limited assortment' stores. To separate themselves from the Wal-Marts of the world, many grocers have taken on differentiated strategies focused on the quality and freshness of produce along with service. The fresh format strategy, best illustrated by Whole Foods Market (NYSE: WFM), has a heavy focus on perishables and they tend to offer local, ethnic, natural, and organic items. Companies like ALDI and Trader Joe's have taken a different approach using limited assortment, defined by low prices and a limited selection of goods with a high level of private label items.

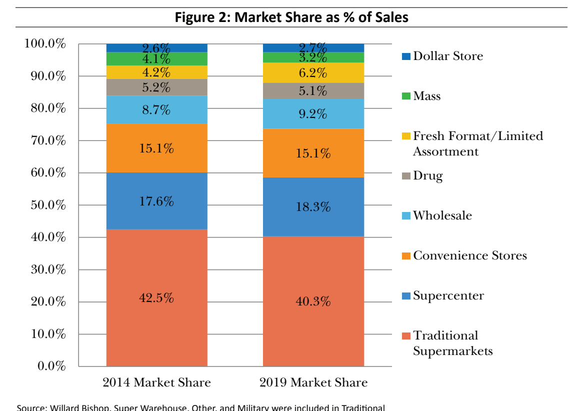
Figure 1: Estimated Growth in Grocer Formats



Source: Willard Bishop. Super Warehouse, Other, and Military were included in Traditional

Between 2014 and 2019, the limited assortment and fresh format markets are projected to have the highest growth in sales with increases of 46.9% and 88.2% (Figure 1), respectively. The fresh format grocers are also expected to experience the highest percent increase in store count at +76.0%. Though the limited assortment/fresh format grocer segments have a small market share compared to traditional grocers (Figure 2), they are expected to be one of the top gainers in market share (an increase of 200 basis points), while traditional grocers are expected to lose 220 basis points.

Figure 2: Market Share as % of Sales



Source: Willard Bishop. Super Warehouse, Other, and Military were included in Traditional

Individually, the differentiation strategy has been a success, especially for Whole Foods which has one of the highest sales per square foot among its peers (see Figure 3). With both Baby Boomers and Millennials having a new focus on healthy eating and prepared foods, Whole Foods' success should come as no surprise, and it is expected to keep the momentum going with plans to open another 83 stores by year end 2017. However, Whole Foods' success has not gone unnoticed. Not only is competition increasing with Sprouts Farmers

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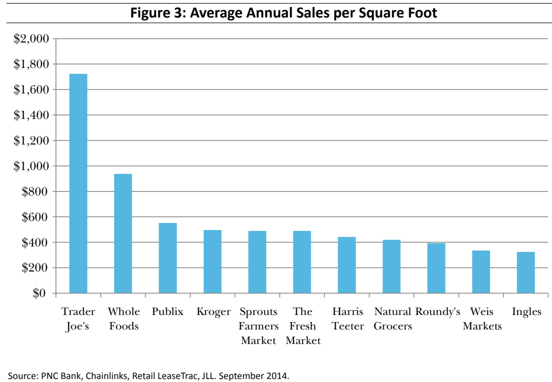
Market (NASDAQ: SFM) and The Fresh Market (NASDAQ: TFM) within the fresh format concept, but supercenters and traditional grocers like Wal-Mart and Kroger are also entering the space by offering organic brands with a focus on value.

Figure 3: Average Annual Sales per Square Foot

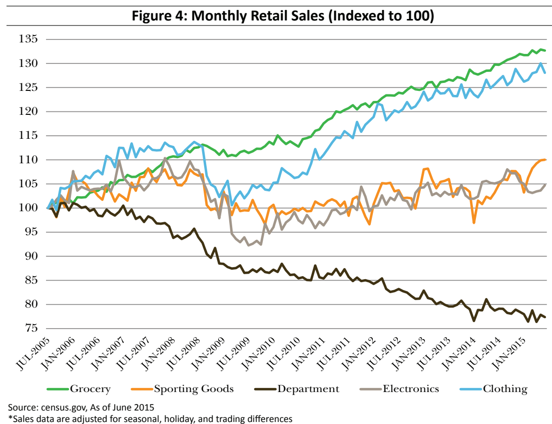


Source: PNC Bank, Chainlinks, Retail LeaseTrac, JLL. September 2014.

Why Grocers?

Because REITs are infinite-life vehicles and therefore must think about investing for the long term, they are attracted to the durability and low risk nature of grocery-anchored centers. Figure 4 shows grocery sales growth has far outpaced other retail segments since 2005, and has also been the most consistent performer taking less than two years to recover during the downturn. Other retail segments such as department stores, electronics, and sporting goods have still not fully regained their pre-2008 strength. A more stable anchor increases the predictability of future cash flows from a property by maintaining productivity and occupancy.

Figure 4: Monthly Retail Sales (Indexed to 100)



Source: census.gov, As of June 2015
*Sales data are adjusted for seasonal, holiday, and trading differences

In the case of an unexpected vacancy, the hypercompetitive grocer environment ensures productivity does not stay down for long. The top grocers are constantly fighting for market share and looking to expand in locations with high visibility, population densities, and income levels. However, finding quality space can be difficult due to very limited new retail development (~0.75% of existing supply as of June 2015 according to CBRE) that is struggling to keep up with obsolescence (generally one percent of supply). Because REITs tend to own space in the most desirable locations, available anchor space is quickly absorbed by new grocers, resulting in higher rental rates and valuations for REITs focused on this property type. Some examples of REITs with significant exposure to grocery-anchored centers are shown in Figure 5.

Figure 5: Grocery-Anchored Center Exposure

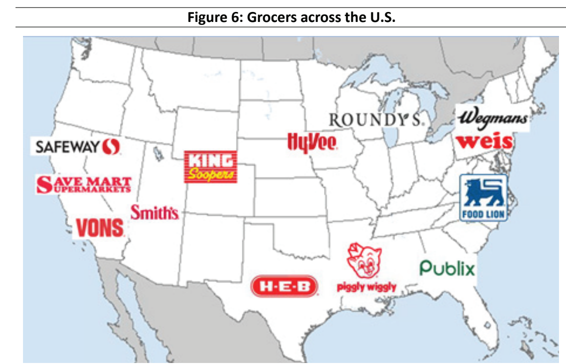
	% of Assets
Retail Opportunity Investments Corp	98%
Regency Centers	86%
Weingarten Realty	75%
Brixmor Property Group	71%
Equity One	59%

Source: Company Investor Relations and Financial Documents, as of 6/30/2015.

The Grocer Makes a Difference

With over 60% of grocery sales coming from the top 20 grocers, the national, brand-name supermarkets are common anchors at REIT properties. However, there are also regional operators across the country who are well known and successful within their respective markets (Figure 6). Regional grocers have the ability to tailor each store's assortment and merchandising specifically to the individual neighborhood it serves. Publix is a dominant regional grocer in the Southeast and is especially strong in Florida where it has up to 50% market share in some of the state's largest markets. Publix has been able to undercut its competition and has built a strong following with its loyalty and price matching programs. H-E-B is the dominant grocer in Texas with about 340 stores across 155 communities. The company even has other brands such as Central Market, which competes with Whole Foods, and Joe V's Smart Shop, which competes with Trader Joe's and ALDI's.

Figure 6: Grocers across the U.S.



Source: Chilton Capital Management. Von's is owned by Safeway; Smith's Food and Drug is owned by Kroger; Roundy's includes Copps Food Center, Mariano's Fresh Market, Metro Market, and Pick 'n Save

The redevelopment of the Westchase Shopping

Center in Houston, Texas is an excellent case study on the value that can be created by substituting a top grocer for an underperformer. Owned and redeveloped by Weingarten Realty Investors (NYSE: WRI), the property has high quality demographics with three mile population density of over 190,000 and average three mile household income of almost $83,000, which compares to the average Houston REIT-owned grocery-anchored center population density of 125,000 and income of $70,700.

The center was originally anchored by Randalls, a Houston-based grocer. At its prime, Randalls was a market leader with sales per square foot over $500. In 1999, Safeway purchased Randalls when it was the number two grocer in Houston with 20% market share. Since the Safeway purchase, Randalls has declined to a number five ranking among Houston grocers, which made Safeway unwilling to reinvest in the space.

However, given the high desirability of the site, WRI was able to re-lease the space to Whole Foods Market at a rental rate 45% higher than Randalls. Once completed in 2016, the Whole Foods is projected to achieve sales of $700 per square foot and double foot traffic to the center. Rents at the small shop space are now expected to increase more than 20% as the leases expire. Additionally, as a result of the new anchor, the property should see an approximate 100 basis point reduction in its cap rate. After completion, WRI believes they will have created $10 million in Net Asset Value (NAV), an approximate 17% increase over the pre-development valuation.

The strength of the grocer is of utmost importance when considering grocery-anchored shopping centers. A top-of-the-line anchor will help a center weather the ups and downs of the real estate cycle and add value to the property through a reduction in cap rate. The offerings of Whole Foods Market, Sprouts, and Trader Joe's seem to be the current trend among grocers, but rest assured, if history has any say, this trend will too fade. As long as the REITs continue to own in-demand properties, they can only welcome the competition.

Blane T. Cheatham
bcheatham@chiltoncapital.com
(713) 243-3266

Matthew R. Werner, CFA
mwerner@chiltoncapital.com
(713) 243-3234

Bruce G. Garrison, CFA
bgarrison@chiltoncapital.com
(713) 243-3233

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