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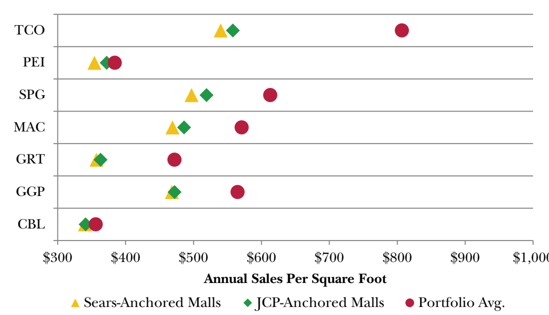
# You Can't Spell Retail without R-E-I-T | December 2014

Sears (NYSE: SHLD) and JCPenney (NYSE: JCP) are giving retail and retail real estate a bad name. Twenty years ago, the catalogue business was supposedly changing the role of physical retail. Then it was on-TV purchases (ex. QVC); now it's the Internet. Of course, Borders, Circuit City, and Blockbuster were disintermediated and forced to close stores. But, every change also created an opportunity. Retailers that embraced the change not only survived, but thrived. While Sears and JCPenney have been struggling to adapt to the new environment of retail, companies like Lululemon (NASDAQ: LULU), Restoration Hardware (NYSE: RH), and Starbucks (NYSE: SBUX) have been growing stores and profits. By aligning with best-in-class retailers, retail landlords can ensure their centers will attract sufficient traffic to charge premium rents.

Retail centers are an interesting animal. Though the 'location, location, location' saying works for the owner, poor retailers can fail at even the best locations. Conversely, successful retailers can succeed at marginal locations, and even transform a marginal location into a 'destination' for shoppers. For example, a successful restaurant or unique local designer could drive traffic to the point where other retailers desire to be close to them, which increases rents. Therefore, tenant selection, or 'tenant mix', can sometimes be almost as important as 'location, location, location'.

**Lump of Coal Retailers**
Successful transitions to the new model of retailing are often over-shadowed by the collapse of former retail stalwarts. Prime examples are JCPenney and Sears. Once giants of retail, a failure to invest in technology, location, and experience has caused their sales to steadily decline. Originally, these department store anchors drove traffic to malls and shopping centers, which increased occupancy and rents for surrounding inline stores; now these same stores are holding back malls and shopping centers from moving on, as shown in Figure 1.

**Figure 1: Sears and JCP Malls Less Productive Than Avg. REIT Mall**




Source: Company Reports as of 9/30/2014. Green Street Advisors.
NOTE: Many malls are included in JCP-Anchored and Sears-Anchored Avgs. Portfolio avg includes JCP and Sears Anchored malls

To buy time while they figure out how to right the ship, Sears is exploring a sale-leaseback of 200-300 owned locations to a new REIT, which could generate $1.4-1.9 billion in estimated cash proceeds. As a side note, we believe the REIT investing public would not be receptive to a single-tenant REIT, especially one with such poor credit quality. It has already spun-off its Land's End clothing brand, sold Sears Canada, and secured a $400 million loan from the CEO's investment company. However, Sears is projected to burn through $1.5 billion in cash per year in 2014 and 2015, so their time is running thin.

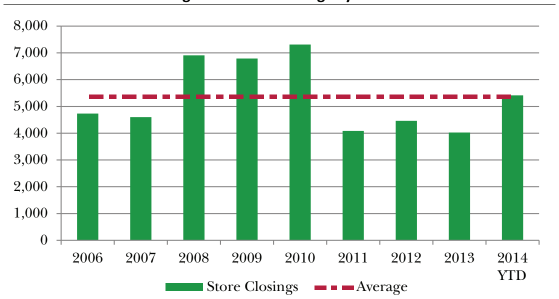
JCP does not have the same asset base to monetize, and therefore must attempt to transition to a modern retailer. After hiring and firing Ron Johnson (the former Apple retail chief), JCP's sales declines have somewhat stabilized, though at a much lower level. Ultimately, JCP and Sears will have to reduce their footprint. Sears has already closed 209 stores in 2014 as of 9/30, and they plan to close another 77 by year end. JCP closed 33 stores this year, and will likely close more after the Christmas season. Their failure is a gain for many REITs.

For 'A' quality mall owners, closures would be the best possible outcome. Though it would take time to re-tenant or redevelop each of the locations, the returns on investment could be outstanding.

For example, General Growth Properties (NYSE: GGP) purchased a Sears box adjacent to their Ala Moana mall in Honolulu, HI in mid-2013 for roughly $200 million. Now, GGP is spending an additional $375 million to redevelop the space. All in, GGP expects to produce an unlevered 9-10% annual return on a $575 million investment. Using Green Street Advisors' cap rate of 4% for Ala Moana, this one redevelopment is projected to create almost $800 million in value for GGP, or approximately $0.85/share. The project is expected to deliver in 4Q 2015.

The truth is that there will always be store closings. As shown in Figure 2, 2014 store closings are near the 8 year average as of September 30. Note that the fourth quarter traditionally is the lowest quarter for closings due to the strength of sales during the holiday season. Even the best REITs are going to do deals with retailers that can't quite figure out the formula. The retail landlords will be ready to fill the empty space with a new tenant if and when that day comes. According to the International Council of Shopping Centers (ICSC), retailers plan to open 40,000 stores in the next 12 months and 77,000 stores in the next 24 months, which will more than make up for an above average year of store closings in 2014.

**Figure 2: Store Closings by Year**




Source: Source: BofA Merrill Lynch Global Research. As of 9/30/2014

**A Diss to Disintermediation**

Nowadays, the story of the demise of a retailer focuses on disruption from Amazon (NYSE: AMZN) or other e-tailers. E-commerce sales growth of 17.0% compared with only 3.5% for in-store sales in 2013 fits nicely for authors touting the demise of the physical shopping experience. However, due to the fact that in-store sales account for 90% of all retail sales, the 3.5% growth actually represented a $144 billion increase, while the e-commerce growth was only $38 billion. Furthermore, of the 10% of retail sales that were done online, half were done through retailers that have a physical store presence. In fact, retailers find their online sales increase by 3-5 times in a market when a *physical* store opens nearby.

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As such, there are many examples of previously 'online-only' retailers opening up physical stores to drive sales, both online and in-store: Athleta (owned by Gap (NYSE: GPS), Microsoft (NASDAQ: MSFT), Warby Parker, Bonobos, and Boston Proper, just to name a few. Even AMZN is opening a physical store. Just ask Apple (NASDAQ: AAPL) how much a physical location can lift sales. With sales per square foot consistently double their nearest competition since opening up their first store at Macerich's (NYSE: MAC) Tyson's Corner mall in 2001, AAPL will likely be remembered as the best physical store retailer of all-time. Today, AAPL has over 250 retail locations compared to 65 only ten years ago.

**Embracing the Change**

One recent example of an adapter to the shifting retail landscape is Restoration Hardware, a company known for its thick catalogues and expensive furniture. At a time when many large format stores are considering shrinking their footprint and lowering expenses on mailing campaigns, Restoration Hardware is growing their average store footprint and printing thicker catalogues. RH has been able to achieve sales per square foot over $850 at its five 'design galleries' by pivoting from selling furniture and home decorations to selling a luxury experience, a trend that many retailers are now attempting to duplicate.

By understanding that a purchase online is equal to a purchase in-store, RH attempted to differentiate themselves by investing heavily in the design and technology of their stores. RH did away with cash registers and checkout lines; instead, they moved to iPad-based sales, which provides access to the entire inventory and allows RH sales representatives to walk freely around the store. They even started selling beverages and including common space to encourage longer customer dwell times. If a customer is going to browse online for a purchase, why not have them do it in their own store? In the words of RH CEO Gary Friedman, “We’re willing to destroy today’s reality to create tomorrow’s future.”

The willingness to cannibalize some of the old to make way for new revenue streams is a characteristic that is common among forward-thinking, adaptive retailers. Even though AAPL is in the laptop business, they have been the leader in tablet sales. Similarly, if a customer is going to use a physical store as a showcase to make an online purchase, at least the retailer can capture that customer if they offer multiple channels for purchase. Figure 3 shows a few of the ways that the customer needs have changed, and how the retailers have adapted to address them.

**Omni-Customer Grab**

Using multiple channels for retailing is often called ‘omni-channel’. The definition is rather broad, but essentially ‘omni-channel’ starts with seamlessly integrating full price, outlet, and online sales. The term applies to both the customer and the retailer experience so that pricing, costs, and inventory are managed efficiently; for example, a discount at a full price store on an item should not price below the outlet as the company would be giving up profit and a customer may be deterred from visiting the outlet. Furthermore, the practice of looking online prior to entering a store necessitates that in-store prices match customer expectations. According to a study by IDC Retail Insights, omni-channel shoppers spend up to 3.5 times more than single-channel shoppers, and shop 3 times more frequently.

A retailer’s ability to conduct coherent omni-channel marketing and sales is critical to staying ahead and being able to afford rents at ‘A’ malls or high quality street retail locations. It may sound like an obvious and somewhat logical process, but it requires significant capital and time. There are companies that sell software that ties a retailer’s online, mobile, and store operations together to provide a view of where and how their customers are shopping – essentially, real-time ‘big data’ analysis. As previously mentioned, Restoration Hardware is excelling, but there are others at different stages of adoption making the shift. Lululemon, Coach (NYSE: COH), and Chipotle (NYSE: CMG) have been cited by the software providers as embracing the change and successfully delivering solutions.

Increasingly, consumers want to determine when, where, and how the item is purchased, shipped, and received. In many cases, retailers are struggling to adjust to these demands because their initial roll-outs of e-commerce platforms were entirely separate from their in-store retailing. Instead of integrating the two platforms together, it often requires starting from scratch to create the holistic picture necessary to make decisions to ship, discount, or move an item to an outlet.

As an example, imagine ordering a jacket online. With a working omni-channel setup, the software assists in determining where to ship the item from (warehouse, store nearby, store in an area that is warm) and how to best get it to the consumer. The ability to choose which jacket is sold at which price can drive margins substantially higher than single-channel sales.

**Figure 3: Consumer Shifts and Retailer Responses**

| CONSUMER SHIFTS FROM: | TO: | RETAILER RESPONSE FROM: | TO: |
|---|---|---|---|
| Needing Stuff | Unique Experiences | Limited Focus on E-Commerce | E-commerce as a Major Growth Driver |
| Conformity | Customization | Mass Marketing | Omnichannel Integration |
| Plutocracy | Democracy | Channels Managed Independently | Personalized Marketing & Brand Engagement |
| New | New And Now | Supply Chain as Cost Center | Supply Chain as Potential Differentiator (Value Chain) |
| Self | Community | Assets Dictate Business Cadence | Speed as an Imperative |
| | | Retail Real Estate Dictates Where & When Consumers Shop | Consumer Dictates Where & When They Shop |

Source: Macerich Investor Day Presentation

By providing a physical location for pickups and returns, revenues can increase by 30%. According to AT Kearney, the net sale for online-only retailers is 77% after factoring in an average 23% return rate. However, a physical store can add 12% from in-store pickups, and an additional 18% from in-store purchases when making a return, resulting in a net sale of 107%. The capture of the additional 30% explains Amazon’s decision to open up its first physical store this year (in a property owned by Vornado (NYSE: VNO) coincidentally). Macy’s (NYSE: M) CFO Karen Hoguet summarizes the benefits of omni-channel as follows: “We find that people shop more [online] when we have a store in their neighborhood. So, if we were to close this store, we not only lose the store sales, we also often lose [online sales] and we’re also finding customers like the convenience to come into the store, look at it, make returns. So, interestingly the Internet is actually making some stores stronger than they might have been otherwise, and also as stores become fulfillment centers, we’re able to put more fashion in some stores that might not otherwise have gotten it, because if it doesn’t sell there, we're able to ship it out to satisfy Internet demand".

**Role of REITs in Retail**

Similar to their tenants, REITs are using technology to their advantage. Mall REITs GGP, Simon Property Group (NYSE: SPG), and Macerich have announced a partnership with Deliv, a crowdsourcing company that will deliver goods same day to a customer's destination of choice, thereby alleviating any bulkiness of carrying bags or large items. MAC has created a 'digital concierge' that will respond to text messages for any questions about the mall or stores within the mall (ex. sales on shoes). They have even incorporated parking inventory capabilities into their mall apps so that a customer can see where the most convenient open parking spot is located before getting to the mall.

Locations at strip centers, outlets, and street retail serve as yet another opportunity to provide convenience and experience to a customer. SPG and Tanger (NYSE: SKT) have been the leaders in the revolution of the outlet, though MAC, Taubman Centers (NYSE: TCO), and Glimcher Realty Trust (NYSE: GRT) have also made forays into the industry. Of special note is the reemergence of downtown retail, or 'street retail', and the trend toward 'flagship' stores that promote the brand and experience. Federal Realty Trust (NYSE: FRT), GGP, and Vornado (NYSE: VNO) are at the forefront of this revival.

Importantly, the retail REITs are ensuring the future of their product by finding tenants that will add value to their portfolio. Both the retailers and the retail landlords are responding to customers' current and future needs by investing in technology and embracing change, which is differentiating them from competition. Those that fail to adapt will only make the leaders stronger.

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