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Buckle Up! Retail REITs are Traffic Drivers | December 2015

Time is money. Each and every one on the planet should agree with this statement. The question is who benefits from this equation? The answer: retailers and retail real estate owners. Consumers who stay longer in stores and malls tend to spend more. Thus, it is every retailer's (and landlord's) mission to maximize traffic and the length of a customer's visit to the store or mall. All parties that stand to benefit from the customer's time and money have been investing heavily in innovative ideas to enhance the merchandising mix with this goal in mind.

The Consumer Landscape

Tenant bankruptcies and resulting occupancy loss among the mall REITs was elevated in 2015 as compared to the prior 4 years. American Apparel (OTC: APPCQ), Jones New York, and Forever 21 are just a few of the retailers that are shrinking their footprint, adding to last year's high profile declining retailers including Coldwater Creek (OTC: CWTRQ), RadioShack, and Wet Seal. In the case of RadioShack, it found itself trapped in an undifferentiated space, essentially selling goods that were commodities and easier to purchase online. Coldwater Creek and Wet Seal joined the long list of apparel retailers who discovered how difficult it can be to chase fashion trends. These failures tell part of the story about shifts in customer dollars, but they certainly don't represent all retailers. In fact, retail sales are actually up 2.1% (0.8% ex-auto) over 2014 using the comparable period of January through October.

The consumer is relatively healthy, helped by low gas prices and upward pressure (finally) in wages. The stock market and housing prices have cooled off in terms of growth, but they are still positive, which is helping at the high end. At the lower end, sales from dollar stores seem to be shifting to Walmart (NYSE: WMT), Target (NYSE: TGT), and similar stores higher up on the expense ladder, indicating that the consumer is feeling a bit wealthier. Restaurant sales are up 8.2%, which is a positive indicator for consumer confidence and future spending.

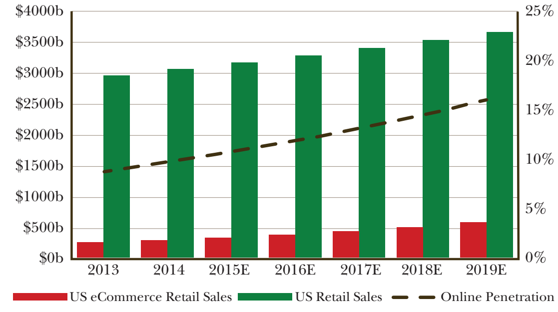
Hours worked have increased along with total employment, up 2.06 million jobs from December 2014 to October 2015, as adjusted for seasonality.

The National Retail Federation (or NRF) predicts that holiday shopping will be 3.7% higher than last year, which was up 4.1% from the year before. The personal savings rate is now at 4.8%, which compares to 4.6% from last year, and household debt service is down to multi-decade lows at 10% of disposable income, down from 13% before the Great Recession. In other words, the retail spending potential is there for the retailers that can figure out how to get customers in their stores or on their websites - or both!

Mutually Exclusive or Symbiotic?

Online retail sales have been growing at a much faster clip than sales in physical stores, as shown in Figure 1. While total retail sales (excluding food services) grew by 4.0% annualized from 2011-2014, online retail sales have grown by 14.2% per year over the same period. Though it is on a smaller base as online retail sales only grew by $98.6 billion versus physical store sales growth of $424.0 billion, it is fair to say that online retail sales growth is eating into physical stores' retail sales growth. Assuming a 14.5% growth rate (source: UBS) for the next five years, e-commerce will lower the physical store retail sales growth rate by about 140 basis points per

Figure 1: Online and Total Retail Sales Trends



Source: US Census Bureau, UBS

year (14.5% growth X 9.7% e-commerce share of 2014 overall retail sales). It is a trend that is not going away, and therefore must be discussed for all stakeholders. Thus far, the class "A" malls, outlets, and "street retail" in major cities such as New York are proving to be the most resilient, and we think this will continue to be the case.

We've discussed many times in this publication the changing retail environment and how it is creating winners and losers. The move to e-commerce has marginalized some physical store locations, while strengthening others. In fact, according to a UBS survey, e-commerce has actually increased traffic to physical store locations. Returning the favor, it's been shown in many different ways how online purchases increase in a trade area after opening up a physical location. Thus, a retailer *can* use the internet to their advantage if they have an omni-channel strategy – a strategy that *needs* a physical store presence that integrates with the website.

"...e-commerce has actually increased traffic to physical store locations."

We have seen this play out with the continuing bifurcation of dominant malls and the 'garden variety' regional malls. In our property tours over the past several decades, we have seen what changing demographics can do to a mall. Millennials spend *more* time at the mall than the previous generation, so it appears the 'death of the mall' is going to have to wait another generation. However, millennials do show different shopping patterns, mostly incorporating the use of the internet, than their parents, which will continue to displace retailers and retail locations that are not adapting to the new generation. Therefore, the internet itself is not a physical store killer; it is merely a new tool available to a new generation. And, similar to other historical demographic shifts, retailers need to innovate to survive, which includes reevaluating their space needs, and retail real estate owners need to show the benefits of locating at their property.

Retailers are ultimately responsible for their own sales as their profits are most directly affected by an increase (or decrease) in sales at a particular location. However, they are merely lessees; if the sales don't justify the rent, they can decide not to renew the lease (or terminate for a price) and wipe their hands clean. In contrast, retail real estate owners may not be as affected by the volatility of sales of a particular tenant, but a widespread decline in sales at a property would lead to lower demand and thus lower rent growth. And, as an owner, there is no option to 'walk away' without significant financial consequences. Therefore, retail real estate owners have to be at least as innovative as their retail tenants to ensure that their centers remain an essential part of a customer's shopping plans.

Yellow Pages and Clipping Coupons

The children of millennials will likely only learn about clipping coupons and yellow pages on their tablet textbooks. These ancient incentives were every company's recipe for success. Obviously, disruptive technology has made them essentially obsolete, but there are some lessons learned from the companies behind such campaigns that are now bankrupt or pursuing a different business plan. With established methods that 'worked', a retailer could be successful merely by providing a desirable product and finding the cheapest way to get it to the end user. It is much more difficult today.

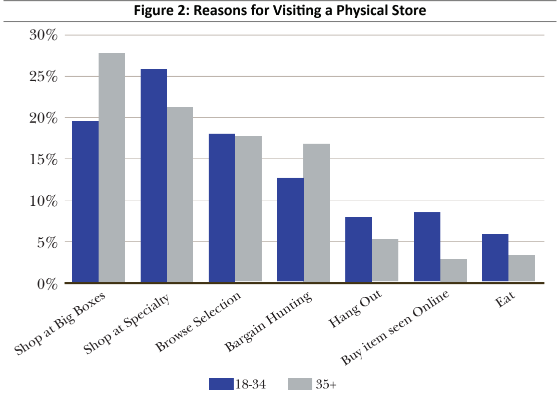
The current retail environment has shifted advertising dollars to social media, online video, and webpages. Of course, television is still important, but even that is changing as the advent of digital video recording (or DVR) has enabled many viewers to fast forward through commercials, thus negating the desired effect. Sporting events have increased in advertising value as they are less likely to be recorded and watched at a later time, and now companies are figuring out how they can advertise in 'on-demand' videos. Facebook (NASDAQ: FB) and Twitter (NYSE: TWTR) are gaining traction as the go to advertising platforms for businesses using likes and preferences to determine who is most probable to engage with a retailer. In short, the disruptive changes we are witnessing are making retailers get smarter – and those that are failing to adapt are getting left behind very quickly.

Black Friday has been a somewhat new advertising innovation by retailers that has driven customers to stores in order to take advantage of deeply discounted items, and has benefited retail real estate owners. Clever media campaigns, loyalty cards, product innovation, and other promotions can drive traffic to centers, driving sales and hopefully future rents. However, retailers are mostly focused on building the brand with their advertising dollars instead of driving traffic to specific locations.

Own Your Sales
Everyone has seen a Santa Claus at the mall during Christmas season, a tradition that is synonymous with Christmas shopping. However, this is only one month of the year and is prevalent in all malls. Retail real estate owners have had to become more creative in drawing traffic - and dollars - to their centers.

Anchors Away!
First, they have been rethinking traditional anchor space. Historically, department stores were the principal drivers of traffic to a mall, and small shop tenants could reap the benefits of the massive growth of the traditional anchors. However, millennials do not share the same affinity for big box department stores. According to Figure 2, only 20% of respondents in a UBS survey under the age of 35 went to a shopping center due to the big box or department store, which compares to almost 30% for respondents over 35. After many bankruptcies and mergers, and now headlines for fear of more department store issues, retail real estate owners are finding new 'anchors' that can draw traffic to their properties. Health clubs, 'flagship' stores, restaurants, furniture stores, movie theaters, grocery stores, and other concepts with items that need to be 'experienced' are replacing dwindling department stores and other 'Amazoned' concepts.

Figure 2: Reasons for Visiting a Physical Store



Source: UBS Evidence Lab

Apple (NASDAQ: AAPL) and Tesla (NASDAQ: TSLA) are superb examples of tenants with products that need to be seen and felt by a customer before being bought. They also happen to have the highest sales per square foot among retailers today, and whose presence is a very good indicator of the strength of a center.

One issue historically has been the difficulty to upgrade an underperforming anchor, especially at a strong center. Anchor leases are extremely favorable to the tenant, both in rate and duration. The low rent means that the sales threshold to close an anchor store to hand it back to the landlord is much lower than at a small shop store. Thus, most of the anchor closings announced by department stores have been at extremely weak centers, while retailers such as JCPenney (NYSE: JCP) and Sears (NYSE: SHLD) continue to profit from stores at strong centers despite declining traffic and sales.

However, Sears' recent real estate transaction will enable landlords to access this valuable real estate. Called Seritage Properties (NYSE: SRG), the company owns 266 Sears and Kmart locations, 31 of which are in joint ventures with leading mall owners including Simon Property Group (NYSE: SPG), Macerich (NYSE: MAC), and General Growth Properties (NYSE: GGP). The 50/50 joint ventures will allow for redevelopment of up to 50% of each box, which could result in excellent value creation opportunities and, of course, new drivers of traffic to the centers. Many of the mall owners involved have suggested completely eliminating the Sears presence could also be an option provided it has a good chance of monetizing the real estate from Sears' perspective and enhancing value of the mall.

A Santa Every Week
Secondly, expanding upon the 'Santa Claus' experience provides consumers another reason to spend minutes, and dollars, at the mall (or center). Retail real estate owners now have begun using coupons that are only applicable at their properties. In addition, retailer coupons may only be pushed to user smart phones when they are driving or walking by. Social media, email distribution lists, and old-fashioned mailings keep regular customers apprised of upcoming sales or events at the center. Some examples of events include concerts, celebrity appearances, competitions, fashion shows, loyalty cards, ice skating rinks, cook-offs, movie and sporting event showings, cultural celebrations, product demonstrations, food truck gatherings, giveaways, and farmers markets. As an example of how much focus mall owners put on such events, Macerich (NYSE: MAC) does 3,200 events annually at its 50 properties, or more than one per week per property!

Applications Welcome
Third, retail landlords are using technology to make it easier and more enjoyable to shop at their locations. Instead of crowding around the few-and-far-between mall directories, shoppers can now access interactive shopping

directories on their mobile smart phones. Mobile applications can use GPS to navigate the shopper to the desired location, while informing him or her of sales on the way. Instead of walking all the way to the one concierge, shoppers can text a concierge to learn where to go for the best deals or most desirable fashion trends. And, instead of carrying around heavy bags to their cars or on public transit, shoppers can have purchased items delivered to their doors later that day. Speaking of cars, there are also applications that will show shoppers where to find a parking spot!

Additionally, Simon Property Group has a subsidiary called Simon Venture Group, headquartered in Silicon Valley, that is investing in a wide range of start-ups that are at the forefront of retail tech innovation that include both brick-and-mortar as well as online-related tech. The group was created with the sole purpose to connect with the consumer, which will result in: 1) a better shopping experience for the customer; 2) higher retail sales at Simon centers; and 3) identifying new retailers or concepts that can proliferate in the Simon portfolio.

Invest in the Long Term Winners

Ideally, both the tenant and the owner will 'get it' and embrace consumer trends so that they work together to maintain or increase sales throughout changing retail environments. The reality is that there are thousands of store closings each year because one or both of the two have failed to adapt. For real estate owners, location can usually trump vacancies and allow for second and third chances to get it right. In addition, retail construction across the country has been close to all-time lows for the past 6 years, making it a landlord's market for high quality retail real estate. Retailers aren't always so lucky, given their highly competitive arena. It is for this reason that we believe well-located class A malls, outlets, and street retail offer excellent risk-adjusted return potential, *especially* with the increase in e-commerce, for the foreseeable future.

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