

The COMEBACK **kid:** *Brick-and-mortar retail*

Far from dead, retail stores are transforming and evolving as they are joined by online compatriots in search of customer loyalty and retention.

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Since mid-2017, headlines have been screaming reports of the retail apocalypse. Major news outlets competed to see who could more rapidly detail the imminent demise of brick-and-mortar stores in the advent of the e-commerce and Amazon era. This story became so ingrained in the U.S. that it has received the distinction of its own Wikipedia entry.

So how do we explain the following headlines:

It's the Golden Age of Traditional Retail, Not its End Days,
TechCrunch (Jan 2019)

The Return of the Brick-and-Mortar Store,
Bloomberg (May 2018)

The Future of Brick and Mortar:
Enhancing the Customer Experience,
Forbes (Jan 2018)

U.S. Holiday Retail Sales Are
Strongest in Years,
The Wall Street Journal (Dec 2018)

Retail Apocalypse Becomes Retail
Euphoria, *Seeking Alpha (Dec 2017)*

While the retail apocalypse story has been told time and again, the resurgence of retail came on the back of robust financial conditions, growth in retail sales, high consumer confidence, and a sudden rush in household net. Retailers also benefited from the Tax Cuts and Jobs Act, which reduced tax rates for businesses and individuals for the 2018 fiscal year and hence boosted profits (Exhibit 1).

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However, in order to thrive in the digital age and grow while digital disruption is at its peak, the industry needs to keep reinventing itself.

Evolving retail

The evolution process has begun. The fundamental truth that bankruptcies have been plaguing specific sectors within the industry, so much so that the retail sector is expected to die, has been

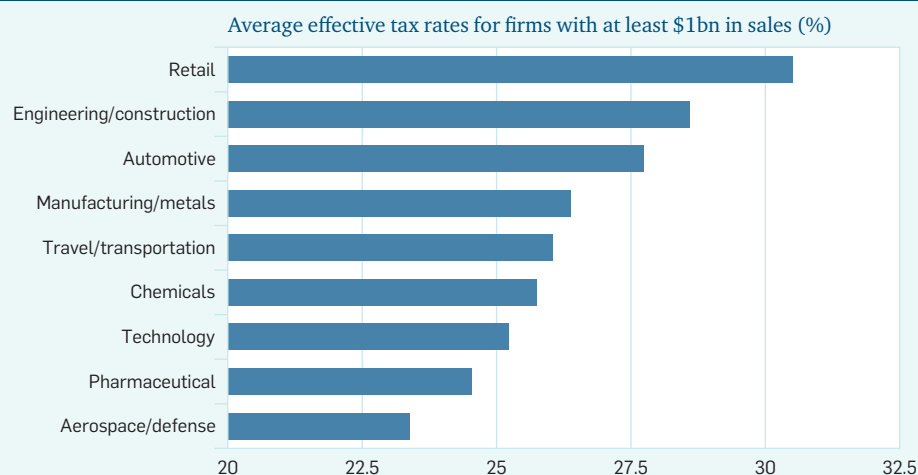
conclusively refuted. Research conducted by the IHL Group showed that retailers had plans to open over 5,500 more stores in 2018. The report, *Debunking the Retail Apocalypse*, laid a viable foundation to the claim that the above-mentioned obituary was actually “fake news.”

While U.S. retail sales continued their long-term annual growth rate of 5%, the industry is undergoing some fundamental changes. The common

belief is that e-commerce is the catalyst, but retailers and market participants know there are other factors that have added to this instability. The main issues are the changing tastes and expectations of consumers, a trend toward off-price retail, and the downfall of the department stores. E-commerce is growing at a steady pace, but only 5% of all sales come from pure-play e-commerce vendors (Exhibit 2).

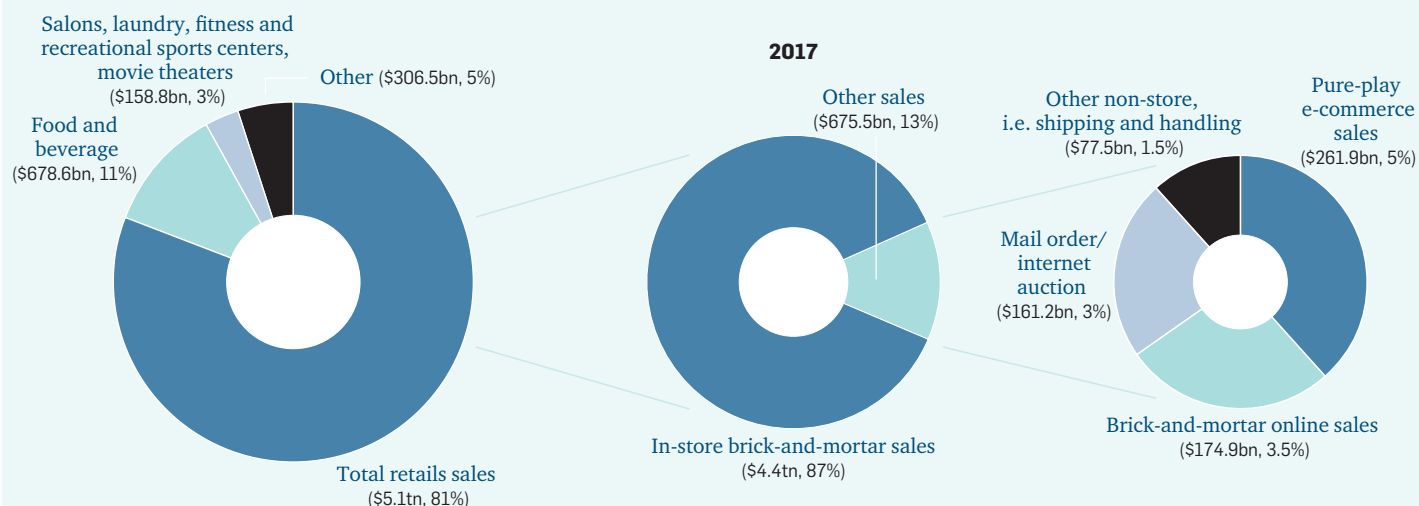
Not all brick-and-mortar retail is the same. Enclosed malls in non-prime locations may have trouble replacing vacating tenants, but shopping centers and malls in prime locations are still considered healthy, evident by net positive absorption and rent growth. For the former, repositioning opportunities will materialize, thanks to an abundance of capital available at historically low costs seeking opportunistic investment returns. As the retail world continues to evolve, brick-and-mortar stores will play an increasingly dominant role in the distribution of retail goods and services. Physical stores remain the most efficient and profitable distribution channel.

Exhibit 1: Tax rates by industry



Source: PwC, The Wall Street Journal.

Exhibit 2: Retail real estate is becoming consumer real estate



	In-store brick-and-mortar retail sales	Food and beverage	Pure-play e-commerce
2017 sales (bn)	\$4,393.1	\$678.6	\$261.9
Growth since 2013 (bn)	\$409.2	\$135.3	\$125.3
% growth	10.3%	24.9%	91.8%

Source: ICSC Research, U.S. Census.

The mall

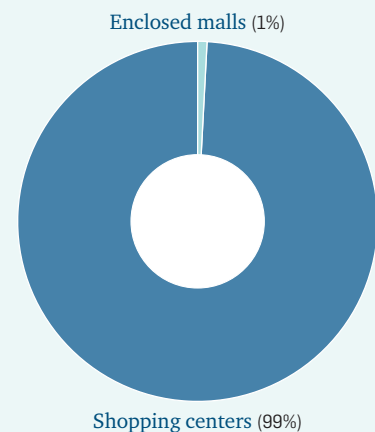
When asked about retail shopping, people often think of malls. Contrary to the prevailing perception, there are currently only about 1,040 malls operating in the U.S., compared to approximately 115,000 open-air shopping centers (Exhibit 3). While in the “old days” the mall offered the ultimate convenient shopping experience, in 2019, it is difficult to argue against the convenience of e-commerce. Consumers, no matter their location, via the smartphone can compare countless brands and chains, choose the products they need, make a purchase at the click of a button,

and speedily receive them right at their doorstep.

A key strength of malls was the department store which helped generate traffic and attracted consumers and visitors to the smaller inline shops within the mall. A combination of factors, including compressed margins, poor service, and high leverage, have wreaked havoc among department store operators. The downfall of this industry and its major players such as Sears and J.C. Penney has only intensified the damage caused to malls.

The way back to a profitable bottom line for malls requires them to adjust to the latest retail reality and create an

Exhibit 3: Shopping centers and enclosed malls in the U.S.



Source: ICSC Research and CoStar Realty Information, Inc.

attractive alternative for consumers vis-à-vis the e-commerce websites.

Modifying the tenant mix by adding restaurants, fitness centers, and family fun zones gives consumers a reason to get off the couch and visit the mall not only to shop, but for an experience. Inspiration for the required change can be found in the open-air shopping center model and its premise.

The open-air shopping mall or lifestyle center attempts to marry the familiar mall model with open retail centers scattered across the U.S. to withstand Amazon and its kind. Essentially, open-air malls house a mix of tenants, in contrast to the unlimited shopping opportunities online, that prioritizes services and activities over products.

Compared to traditional shopping malls, open-air malls have a lower cost of construction and a leaner maintenance cost structure. The two are possible due to the lack of an overarching roof, thus rendering powerful central lighting and air conditioning systems obsolete. This also has the effect of creating a more “live” shopping experience that is entertaining whether on one’s own or with family and friends. This also creates a clear distinction between the anti-social and boring shopping experience of making a purchase in front of a screen, and the creation of a more organic integration of the mall into its surrounding environment.

Exploring new formats and commercial real estate opportunities

Although location remains the key consideration for all retail, having a differentiated design and structure is

E-commerce proof retailers

Many landlords are strategically placing more service providers than ever to make their properties “e-commerce proof.” The basic premise is that services cannot be migrated online and are irreplaceable, such as salons, medical clinics, movie theatres, fitness centers, and spas.

Other retailers that find ways to deliver value to the new breed of customers are:

- 1. Restaurants:** People like restaurants not only for the food, but also for the overall experience. This fact is expected to help protect brick-and-mortar restaurants from losing traffic and sales to takeout and delivery services. In addition, as food service delivery is expected to grow significantly, restaurants are capitalizing on the opportunity to increase revenue, which will only benefit their existing locations and operations.
- 2. Off-price retailers:** The heavily discounted prices offered by stores like T.J. Maxx, Marshalls, Ross, and Burlington are difficult for e-commerce players to replicate, especially considering the costs associated with delivering products to consumers in a short span of time.
- 3. Dollar stores:** Similar to off-price retailers, dollar stores like Dollar General, Dollar Tree, and Five Below focus on cost savings. A few dollar stores are even attempting to penetrate the online marketplace at this time, but their aggressive store expansion plans suggest their e-commerce efforts are merely complementary.
- 4. Furniture stores:** E-commerce infiltration sits at around 20% in this segment but is expected to stay relatively low as people prefer to physically test out furniture before committing to a purchase. In addition, shipping costs associated with bulky items such as furniture make returns extremely costly and inefficient.
- 5. Grocery stores:** While there has been an influx of companies pursuing online grocery services, JLL has found that most people still prefer to inspect their food personally before buying. High costs and logistics challenges surrounding the online-to-door delivery of fresh food may also prevent companies from pursuing an online model.
- 6. Service-oriented retailers:** Dry cleaners, hair dressers, and fitness centers “guarantee” heavy return traffic by customers and thus ensure unique value-proposition while promising irreplaceable benefits to their clients.

increasingly important. Open-air shopping centers provide an additional benefit of creating an atmosphere of a town center, especially when they incorporate mixed-use real estate. Many

of these centers being built in urban areas are open and fully integrated with the landscape and community. An example of a successful and profitable open-air shopping mall model

implementation is the Ala Moana Mall located in Honolulu, Hawaii. The seventh largest mall in the U.S., the Ala Moana Mall has more than 350 stores that are a mix of luxury brands, inexpensive off-price chains, about 100 restaurants, a weekly farmers' market, and other entertainment attractions.

To win customers/foot traffic in the e-commerce era, it is critical that shopping centers are much more than just stores. The mix of tenant/public space is moving from the current 70/30 ratio to 60/40, or even 50/50. When this happens, expanded public spaces will need to be planned and programmed over the year, much like an exhibition. They will need to be managed more like content and media, instead of traditional real estate.

Mixed-use developments like Kimco Realty's Pentagon Centre in Arlington, Virginia offer consumers an attractive and integrated community in which to live, work, and shop. Kimco is redeveloping a 329,000 square foot Costco-anchored shopping center, by adding a 26-story residential tower with 440 luxury apartment units and 7,000 square feet of retail on the ground floor. In addition, Kimco has secured entitlements to add a hotel and an office tower. Redevelopments like this enhance traditional retail by bringing more people to the site on a daily basis.

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From clicks to bricks

Despite the convenience and lure of e-commerce, retailers understand that in-person customer experiences are key to customer acquisition and retention. As a result, retailers are expanding direct-to-consumer physical locations, as well as developing their online presence.

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Furthermore, leading digitally native retailers such as Warby Parker, Athleta, Casper, and Bonobos, to name a few, have opened 400+ locations over the past 24 months.

For evidence that brick-and-mortar locations are necessary, look no further than e-commerce giant Amazon which has opened numerous physical stores. With their acquisition and integration of Whole Foods in 2017, the planned expansion of 3,000 new Amazon Go locations, and Amazon 4-Star stores, Amazon is clearly committed to reaching their customers face to face.

Research by UBS suggests that the majority of store closures have

impacted the apparel category, which is a much bigger concern for enclosed malls as opposed to shopping centers. Neighborhood shopping centers face less pressure from e-commerce growth than department store-anchored regional malls, largely due to the department store's dependency on apparel sales.

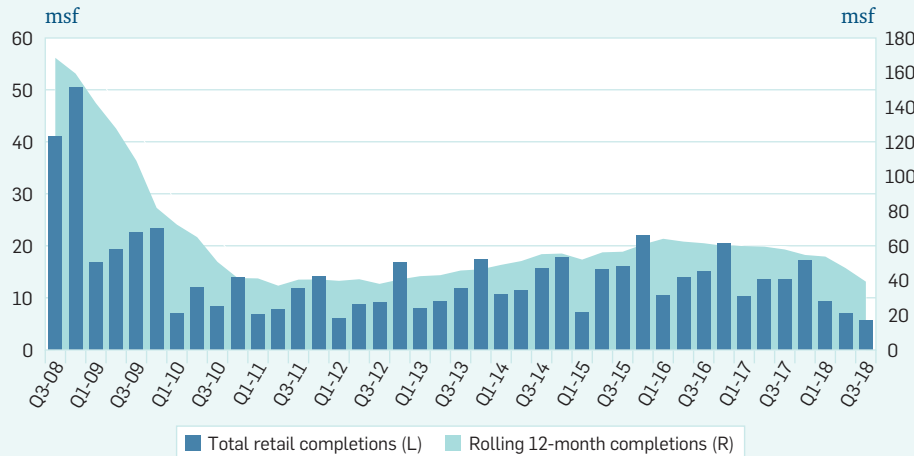
Certain soft-line stores are failing to resonate with customers, while others (e.g., fast fashion, discount, athleisure) continue to perform well. Over the next three years, Gap will be closing 200 Gap and Banana Republic stores, but is also opening Athleta stores and spinning out Old Navy into a separate company.

Fundamentally speaking

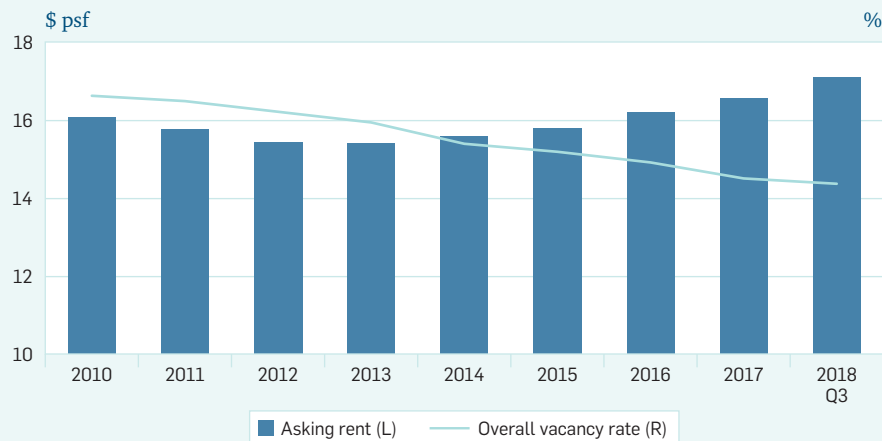
Since 2009, the U.S. retail market has seen low levels of new retail supply (Exhibit 4). While there is shadow supply from store closures from the likes of Toys 'R' Us and others, demand simply outpaces the increase in supply. This has resulted in a downward trend in vacancy rates. As all real estate is impacted by the traditional supply and demand balance, retail properties have posted increased asking rents due to continued tenant demand and low levels of supply (Exhibit 5).

The future of brick-and-mortar retail

Modern retail store operators are adapting and integrating technology to enhance the in-store experience. App checkout, 3D scanning, and touchscreens will become common throughout major retail stores. Mobile apps, for both online and in-store retail, are becoming increasingly critical to long-term retail success.

Exhibit 4: Total retail completions

Source: CBRE Econometric Advisors, Q3 2018.

Exhibit 5: Rents and occupancy are going up

Source: Cushman & Wakefield, Marketbeat: U.S. Shopping Center Q3 2018.
This exhibit includes: community/neighborhood, power/regional, lifestyle, and strip centers.

The shopping experience must be more interactive to retain customers and to keep them coming back. James Giglio, CEO of MVP Interactive says, “Retailers will be experimenting or implementing features such as mobile rich checkout, virtual aisles, in-store gamification, augmented commerce, etc.” A good example and implementation of these principles can be found in Glossier. The

five-year old skincare company has taken the millennial beauty market by storm with its approach to makeup and use of social media.

Millennials and Generation Z are the future customers of retail. According to CBRE, over 77% of Gen Z consumers born after the mid-1990s and early 2000s prefer brick-and-mortar stores. Younger millennials have a strong desire

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for immediate gratification. The in-store experience satisfies this desire where they can purchase and own an item the same day, rather than waiting for an item to be processed and shipped to their home.

Consumers expect retailers to provide them easy, entertaining, and efficient experience for their money. It is evident that physical locations will be a prominent part of every national retailers’ strategy to meet those expectations. In addition, there are numerous categories of tenants that thrive in retail properties providing goods, services, and experiences (gyms, restaurants, entertainment, etc.) that are not easily duplicated on a mobile device or computer. For all of these reasons and more, brick-and-mortar retail locations are the comeback kids of real estate. ♦

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