THE OUTLOOK

Marcus & Millichap

RETAIL

MIDYEAR 2021

Retail Market Recovering More Quickly Than Expected; Investors Selective But Actively Acquiring Properties

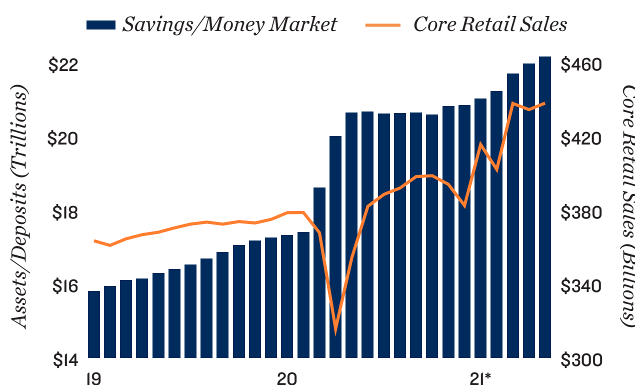
Retail sector poised for growth. Following the upheaval caused by the health crisis, retail property performance is expected to begin realigning with the new realities of space demand. A partial shift to online shopping, the resumption of experience-based retailing, and the reopening will be the primary drivers of property performance. Traffic-generating tenants will remain as a dominate factor for in-line space demand in the coming months as smaller retailers reopen and relocate. Many retail spaces that failed to return to pre-recession strength are expected to be repurposed. A rise in the need for medical office facilities could fill some locations, while other spots may be utilized in the education sector. Larger, outdated retail centers, such as some malls, will be repositioned as distribution centers or razed and redeveloped. Many of these properties are in core locations or near thoroughfares, which will help accelerate reuse.

Consumer spending surge to remain during second half. Since February of 2020, core retail sales have soared by 16.8 percent, largely supported by government stimulus. Enhanced federal unemployment benefits helped maintain the foundation of retail spending among workers still on the sidelines. Employed people, meanwhile, often enjoyed a reduction in costs associated with commuting and shuttered entertainment options, allocating spending toward traditional retail sectors. As professional sports arenas, concert venues and other experience-based locations continue to increase occupancy, and thereby compete for a larger share of consumers' wallets, the pace of retail sales growth will normalize. Sales should continue to grow as Americans have accumulated more than $4 trillion in easily accessible capital relative to pre-pandemic levels. Consumer confidence also reached a 16-month high in June as COVID-19 deaths remain relatively low due to vaccine distribution, despite a recent rise in positive tests.

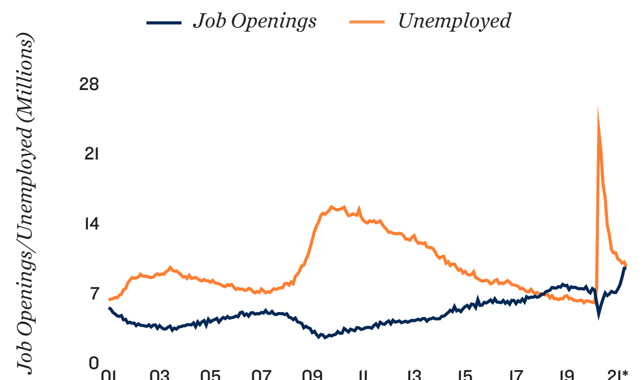
Job creation potential at record levels. Employers are having a challenging time finding and onboarding workers as the economy transitions out of the health crisis. In May, the number of job openings reached 9.2 million spots, the highest level since record keeping began in 2002. During the same month, approximately 9.3 million workers were searching for positions, according to the household survey from the Bureau of Labor Statistics. Strong employment growth in June is an indication that the job market is gaining traction, and further gains are anticipated as incentives to remain on the sidelines dwindle. Approximately half of states are ending federal unemployment benefits before the September 6 deadline, while the CDC eviction moratorium currently sunsets at the end of July. That could begin to fill the 1 million retail trade and 1.3 million accommodation and food services open positions.

Bevy of light headwinds persist for retail. Most indicators point toward a better-than-expected recovery for the retail market, though some concerns exist that could impact brick-and-mortar locations. Inflation is one of the largest issues mounting on the horizon. Nearly one-quarter of the cash and easily-converted-to-cash money supply has been created since the onset of the pandemic, applying upward pressure on the cost of goods and services. Core inflation soared 4.5 percent during the past year, and additional spending near $6 trillion is being considered in Congress, which could put further upward pressure on prices. Although the Fed believes inflation is transitory, the increase in wages that occurs during the labor crunch is unlikely to be surrendered. Elevated housing prices are an additional challenge as recent homebuyers will spend a greater share of their income on mortgages, reducing discretionary income.

Consumers Cash Reserves Positive for Retail



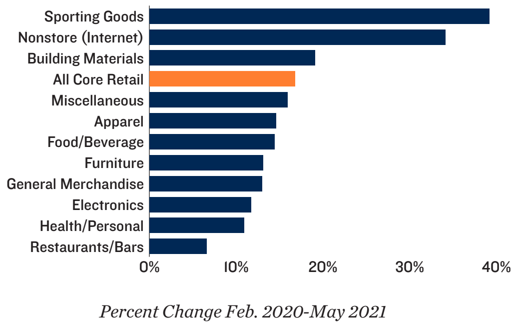
Job Openings at Record High



* Through May

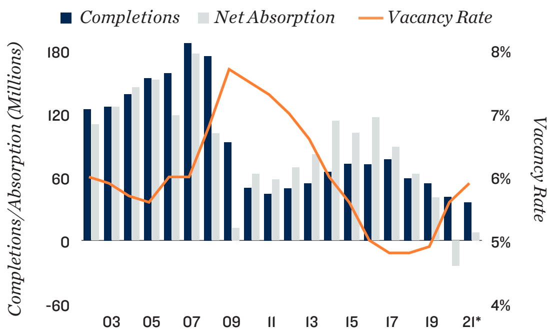
Sources: BLS; Federal Reserve; Office of Financial Research; U.S. Census Bureau

Retail Sales Soar Above Pre-Pandemic Levels

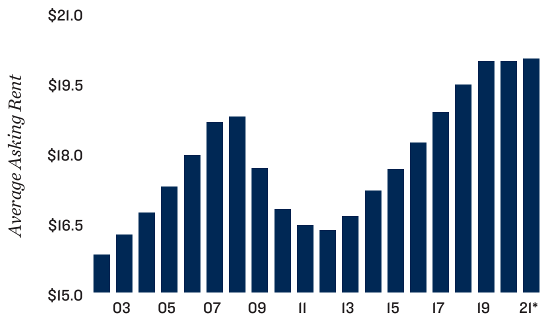


Percent Change Feb. 2020-May 2021

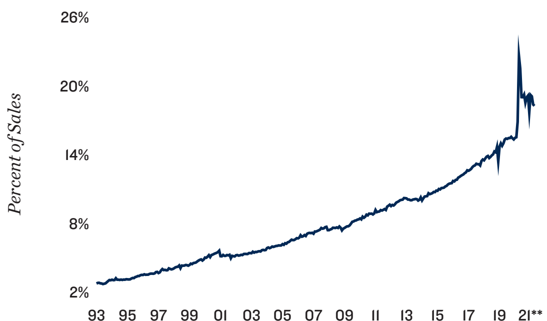
Supply and Demand



Rent Trends



E-Commerce Share of Core Retail Sales



** Forecast*
*** Through April*
Sources: CoStar Group, Inc; U.S. Census Bureau

Retail Outlook Brightens as Economy Accelerates

Most pandemic spending gives way to traditional trends. Nowhere is the return to normalcy more prevalent than in the relationship between dining out or at home. In April of 2015, spending at restaurants and bars surpassed grocery sales for the first time on record. The pandemic reversed that trend due to fewer options and safety precautions. However, dining out has already re-eclipsed grocery sales due to stimulus, pent-up demand, and reopening. Another contributing factor is the rise of delivery services such as DoorDash, Uber Eats and others. These firms provide a convenient option to receive takeout orders, which are credited to restaurants in the Census' figures. Sales at gas stations also reflect an economy returning to normal. Spending at these locations advanced 11 percent between February 2020 and May of this year. Monthly gasoline deliveries in April 2021 were only 2 percent below February of last year, indicating that most of the rise can be attributed to an increase in gas prices.

Vacancy and rent outlook better than early fears. As the health crisis winds down, the worst-case scenario for brick-and-mortar retail fundamentals is becoming significantly less likely. Much of the space that will see the largest impact from the downturn was already on life support and the pandemic accelerated the inevitable in most cases. The potential rise in vacancy across the sector will be mitigated by the removal of outdated or unnecessary stock, limiting pressure on asking rents. In fact, marketed rent for available space is anticipated to inch up 0.5 percent this year as mid- to high-end retail buildings remain online and some bottom-tier space is razed and redeveloped. Single-tenant availability is expected to rise 30 basis points to 5.6 percent, while multi-tenant vacancy climbs 60 basis points to 7.1 percent. Both measures could begin to improve in 2022 as tenants reshuffle and buildings are repurposed.

Forward momentum contingent on myriad of factors. Several characteristics will merge to determine the pace of the retail recovery through year end. Reopening schedules are the largest component, but a market's reliance on tourism and supply-side pressure may also temper the pace of retail growth. Among major markets, five of the 11 largest increases in vacancy year over year are in California. As the state lifts COVID-19 restrictions, the upward pressure on availability should abate, particularly in San Diego, which will benefit from a surge in domestic tourism. Asking rents for available space also provide a gauge on the retail outlook. New York posted the largest annual decrease in rents between the first quarters of 2020 and 2021. The return to densely populated cities will play a critical role in the hardest-hit retail markets. San Francisco's significant exodus, dependence on international travel, and remote-work-open tech companies may delay the retail recovery in some areas of the city.

Online spending here to stay. Although shoppers are returning to physical locations, the upward shift in e-commerce sales from the health crisis is expected to remain. From February of last year through March of 2021, nonstore retail sales surged by more than 35 percent. In the following two months, these sales dipped 1 percent due to reopening. The pace that e-commerce cuts into total retail sales is expected to return to the pre-pandemic trend in the second half of this year. On the high end, online shopping will make up an additional 1 percent of consumer spending annually over the next few years, barring a significant shakeup in the sector. Not all projects can be replicated digitally, however, and some trends like the 54 percent surge in online grocery sales should level off.

Buyers Widen Focus in Wake of Reopening

2021 Forecast

U.S. EMPLOYMENT

4.6% increase Y-O-Y

- Firms continue to replace positions lost to the pandemic as 6.5 million jobs are added in 2021. The termination of the eviction moratorium and sunsetting of federal unemployment benefits could push that forecast higher.

U.S. CONSTRUCTION

36 million square feet completed

- Developers grapple with elevated construction costs and lower demand. Through 2021, builders are expected to increase supply by 0.4 percent. However, a significant jump in removals could decrease that level.

U.S. VACANCY

50 basis point increase Y-O-Y

- Additional space will become available during the next several months, though most of the tenants have already succumbed to lockdowns. Vacancy rises to 6.1 percent by the end of this year.

U.S. RENT

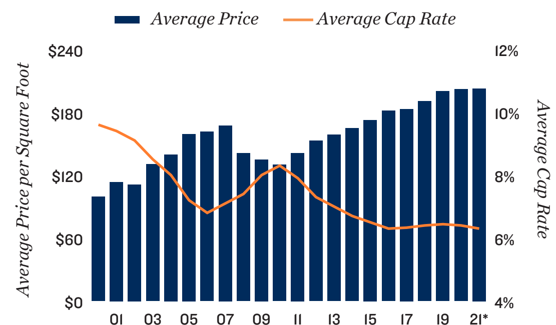
0.5 percent increase Y-O-Y

- The removal of antiquated stock from the market will limit pressure on rents, though significant gains are not projected. By year end, the average asking rent for available space is anticipated to reach $20.06 per square foot.

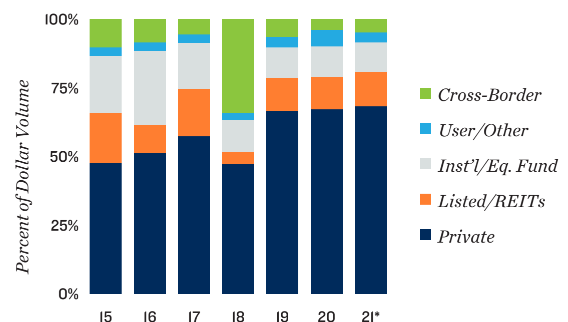
2021 INVESTMENT OUTLOOK

- **Retail investment activity overcomes pandemic conditions.** On the multi-tenant side, investors continue to retain heightened due diligence when considering a purchase. That should begin to loosen as tenant roster strength becomes more apparent upon full reopening. Single-tenant velocity remained strong throughout the health crisis, especially for national credit tenants. Overall, deal volume surpassed $18 billion during the fourth quarter of 2020 and 2021 sales were approaching $30 billion at midyear.
- **Prices sturdy despite performance challenges.** Both multi-tenant and single-tenant valuations have held relatively firm through the health crisis despite pressure on rent collections. Owners are now receiving more than 91 percent of rents, surpassing 90 percent for the first time since March 2020. As a result, average single-tenant prices inched up 1 percent to $306 per square foot in the 12-month period ending in March. The multi-tenant average price increased 4 percent to $199 per square foot during the same period.
- **First-year returns compressing.** Lower interest rates have offset softening operating fundamentals, putting modest downward pressure on cap rates. Single-tenant yields dipped 10 basis points to 6.1 percent in the yearlong period ending in March, relative to the prior year. In the multi-tenant arena, the average cap rate held steady at 7.0 percent. Although valuations have not suffered as much as feared, some of the sturdiness in first-year returns can be attributed to the elevated quality of assets changing hands.

Sales Trends



Buyer Composition Trends



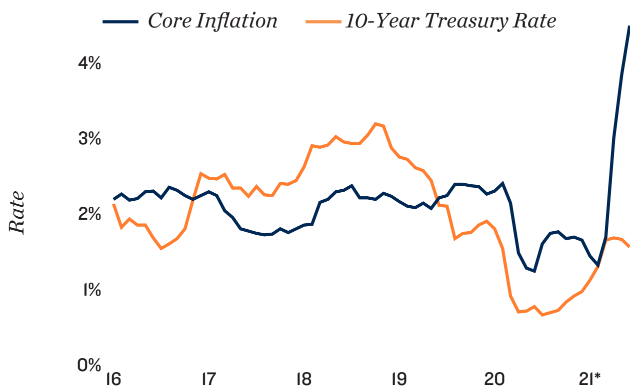
** Trailing 12 months through 1Q*
Buyer composition for sales $2.5 million and greater.
Sources: CoStar Group, Inc.; Real Capital Analytics

Capital Market Operations Largely Resume; Inflation Concerns Becoming More Apparent

Fed positions for temporary higher-inflation period. Applying lessons learned from the global financial crisis, Congress and the Federal Reserve acted swiftly to preserve market liquidity and support borrowers amid the pandemic last year. As U.S. infections recede and the economy reopens, attention is shifting to the potential longer-term ramifications of these actions. The rapid increase in money supply from multiple stimulus provisions paired with low interest rates and disrupted supply chains has led to higher inflation, with core CPI climbing 4.5 percent annually in June. While above earlier expectations, the Federal Open Market Committee (FOMC) still considers this a transitory concern and intends to allow inflation to stay above the traditional 2 percent growth target for longer than it has in the past. The Fed also expects to keep the overnight lending rate low for the near future, citing still-high unemployment as one reason to hold off. More committee members are now open to the prospect of raising rates in 2023, however. Current quantitative easing practices will also remain in effect for the time being. The FOMC will wait for more substantial economic progress before tapering asset purchases, although some pandemic period programs have already expired.

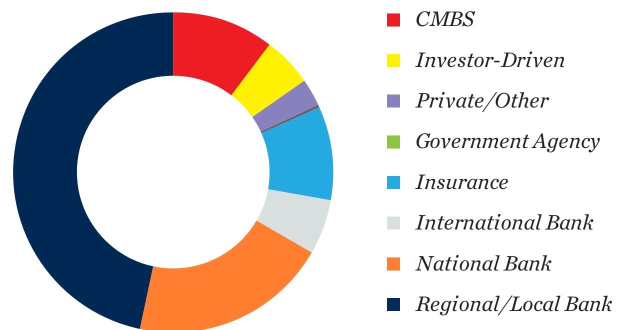
Lenders, like the economy, are opening back up, with financing available for quality properties. Following significant disruptions last year, the majority of lenders are now active and anticipating larger volume after 2020's slowdown. Sentiment is improving, aided by greater population mobility that will help properties in commercial and travel hubs that were disproportionately affected by lockdowns. Lenders are nevertheless favoring borrowers with whom they have an established and positive relationship. A borrower's credit worthiness and track record bear considerable weight when accessing capital, as does recent property performance, including rent collections. More opportunities are available for assets that demonstrated durability during the pandemic or are now in a strong recovery position. Banks and credit unions are offering competitive lending rates at generally pre-pandemic levels of leverage for a range of high-quality properties. Life insurance companies are modestly more selective by comparison, while CMBS securitizations are now underway. For more challenged assets, bridge financing may be available from debt funds and other sources, at correspondingly higher lending rates. Overall, while lending volume is not anticipated to recover to 2019 levels, the impact of the health crisis on capital availability is expected to be less severe than that of the global financial crisis. The external nature of the health problem and critical efforts taken by Congress and the Federal Reserve have maintained and are improving liquidity in the market.

Inflation and Interest Rate Trends



* Through June
Sources: BLS; Federal Reserve; Real Capital Analytics

2020 Retail Lender Composition



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Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; eMarketer; Federal Reserve; Real Capital Analytics; The Conference Board, U.S. Census Bureau