

# REAL INSIGHT

April 2018

## The Evolving Demand for Retail Space

By Dain Fedora

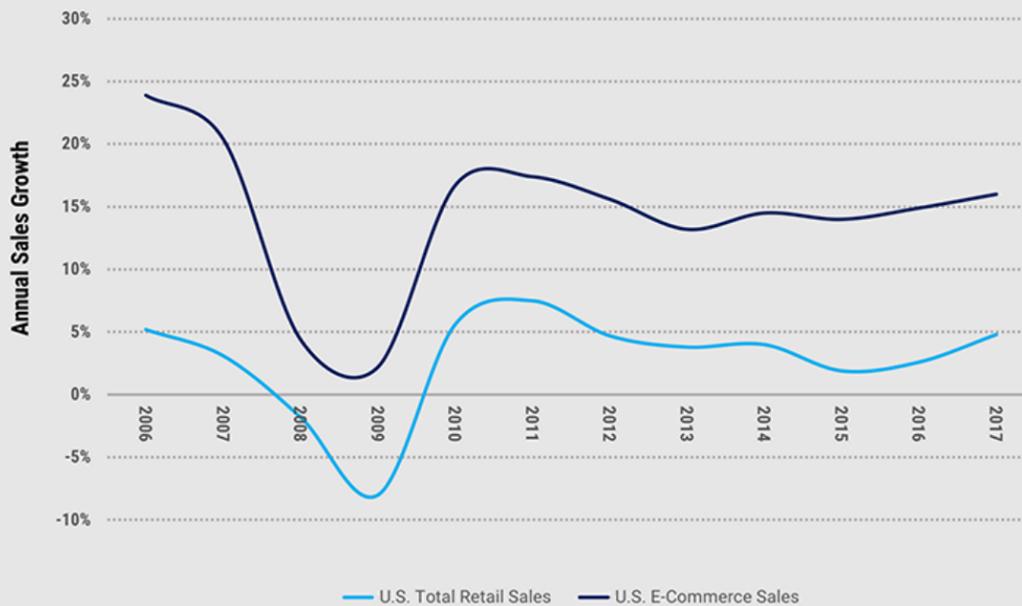
### The National Trend: Brick-and-Mortar Retail Remains Essential But is Being Transformed

For several years, real estate headlines have barked that brick-and-mortar retail is dead – an easily disproved notion, based on the facts that in-person sales still constitute 91% of America's \$5.1 trillion retail market and approximately 4,000 more stores opened than closed during 2017. However, brick-and-mortar retail is undergoing a transformation. The U.S. has the most retail space in the world at 23.6 square feet per capita, roughly five times that of the U.K. and other European countries. The landscape has been challenging for department stores in particular, with the Macy's CEO once describing the situation as "ridiculous" before announcing the closure of 100 underperforming stores out of the company's 728 locations. Most of the planned closures were in regional shopping malls, many of which have been victims of changing consumer tastes, a widening wealth gap and growth in online shopping. The list of recent store openings is heavily weighted toward discount merchandisers and convenience, and many require a different format than the real estate footprint of the stores that are closing.

The challenges facing brick-and-mortar retail often are pinned on e-commerce giant Amazon. Yes, web sales in 2017 were up 16.0% from 2016, compared with total retail sales increasing 4.8% over the same period (see the adjacent graph). Further, e-commerce is on track to have a 17% market share by 2022. However, many large chains, the malls they typically took space in, and even flagship urban stores have failed to adapt to today's consumer, who wants a unique experience. This experience can run the gamut from excellent customer service to value-buys. Apple, for instance, generates more in-person retail revenue than any other company in the world, at \$5,546 per square foot; consumers can purchase the same items on Amazon, Best Buy or even Apple's website, but most choose to visit Apple's stores. The interactivity of an Apple store – the ability to touch and try its devices – makes visiting the store a social experience worth investing in. Among discounters, Ross Stores gives shoppers the "thrill of the hunt" by offering name-brand fashion at up to 70% off. The company had strong earnings in 2017, and does not focus on e-tailing.

### U.S. E-COMMERCE SALES GROWTH VS. TOTAL RETAIL SALES GROWTH

E-Commerce annual sales growth exceeds that of total retail sales, but brick-and-mortar sales still represent 91% of the U.S. retail market



Source: U.S. Census Bureau, NKF Research

Additionally, shipping costs can be steep for an e-tailer: Nearly two-thirds of consumers returned at least one item this past holiday season and 27% bought items specifically with the intention to return them later. E-commerce represents powerful convenience for consumers, but it is not a natural fit for all retail categories, especially those with high return rates. Online shopping for toys makes sense, but fashion purchases (where return rates are high) are a less efficient proposition for retailers. Similarly, brick-and-mortar retailers that are adapting their customer engagement – such as through the use of technology – are advantaged in the marketplace. This includes smart phone integration to alert shoppers of flash sales and smart mirrors to try on clothes virtually.

### Featured Market: Southern California

The Southern California retail market highlights how new opportunities may emerge when retailers shed space. The Paseo, an upscale outdoor mall in Pasadena, California, that covers three city blocks with office space, shops, restaurants, a movie theater, and 391 loft-style condominiums, had a big setback when Macy's and Gelson's Markets left in 2013. Fast-forward to the present and a 186-room Hyatt Place hotel is under construction on Macy's former site, while the Rose, a concert and dinner venue, replaced Gelson's. The Rose has a capacity of 1,300 and features a mix of dinner seating and standing room, with two full bars and a raised VIP area. It also houses Los Angeles's first CaliBurger franchise (recently featured in global media outlets for its use of a burger-flipping robot), and a restaurant concept called the Chef's Gallery, where diners can sample food from a rotating cast of up-and-coming local chefs at various serving stations. Artists including Stone Temple Pilots, Berlin and the Psychedelic Furs have performed at the venue.

The Paseo is undergoing a \$70 million renovation and has attracted new restaurants and retailers, including H&M. It serves as an example of how retail real estate can be repurposed into mixed-use facilities that better fit consumers' lifestyles.

### What Are the Implications for Our Clients?

The changing tastes of consumers represent opportunity for investors in commercial real estate. Those investors who create the right format for expanding retailers – or who have the capital to transform older centers into a modern format suitable for experiential retail – can achieve strong returns. While some department stores and electronics retailers are closing, those spaces are being backfilled by fitness centers, coffee shops, bowling alleys, trampoline parks, climbing gyms, and other retail niches that offer experiences to consumers. Destination lifestyle centers, with a healthy mix of dining, entertainment and shopping options, are better suited to capture foot traffic than traditional malls.

Several prominent brands known for their online presence are establishing a larger physical presence – most notably Amazon through its brick-and-mortar bookstores and its purchase of Whole Foods. Amazon also was considering buying Toys 'R' Us locations at the time this study was written. In addition, some online startups are opening showroom space for three reasons: 1) consumers get a memorable in-store experience, 2) the retailer can better establish brand awareness and customer relationships; and 3) the company can simplify logistics. Indochino, which sells customized apparel, is taking this brick-and-mortar route after starting online. Some traditional retailers are adapting accordingly. For instance, Nordstrom customers can reserve clothes online and try them on in-store before purchasing while they also meet with a personal stylist. The result of this "showrooming" effect helps unify a traditional retailer's online and physical marketplaces, and leads to demand for well-located retail space among firms that previously had no physical retail presence.

Investors in retail real estate are finding other creative ways to transform the utility of their properties. Vacant retail buildings in densely populated markets can serve as last-mile distribution hubs or return centers for e-tailers. Having more last-mile centers lowers an e-tailer's transportation costs and expedites shipping times to consumers. Other investors are converting aging centers to medical offices, self-storage facilities, and even schools.

### Research

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