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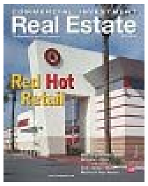

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Editorial Calendar
Media Planner
Reprints
Issue/Article Orders
Issue Index
Current Advertisers
Contact

Cover Story

Red Hot Retail

National chains fire up expansion plans in secondary and tertiary markets.
By Beth Mattson-Teig

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Retail real estate is hot. Large retailers continue to drive new development and investor demand remains near record highs. As competition heats up for prime space in major U.S. metropolitan areas, retailers are expanding into secondary markets and even far-flung rural communities to get in while the mercury is rising.

“Secondary markets are getting a lot of attention because primary markets are so picked over; there is so much competition for deals that people are considering markets that they perhaps wouldn't have in the past,” says Bernard J. Haddigan, managing director of Marcus & Millichap's national retail group.

Strong Fundamentals Fuel the Fire

Dodging the economic woes that have plagued other real estate sectors, retail's fundamentals remain solid with steady rent growth, stable vacancies, and a strong pipeline of new development. During the past four years, overall retail vacancy hovered around 10.3 percent, and no major changes are expected this year, according to Marcus & Millichap. Rents rose 2.5 percent in 2004, and a similar increase is anticipated this year. Neighborhood and community center construction is forecast to rise moderately to 27 million square feet this year, up from 25 million sf built last year, according to Marcus & Millichap.

Retail sales are expected to increase only by 3.5 percent this year, significantly off the 6.7 percent growth experienced in 2004, according to the National Retail Federation. However, slower sales predictions don't appear to be derailing many retailers' expansion plans. In fact, a modest sales increase actually may entice retailers to tap new markets as a means to boost revenues.

Another factor that may fuel retail expansion in the coming months is retailers' and developers' ready access to inexpensive capital. Although the Federal Reserve Board increased interest rates 125 basis points in 2004, the 10-year U.S. Treasury only rose 10 points during the same period to 4.25 percent at year-end.

Solid fundamentals and historically low interest rates are boosting investor demand for retail properties in both large and small markets. “[Last year] was a record year for almost everyone in the retail business,” Haddigan says. “There is a lot of money chasing deals, and buyers really came alive in a big way in late 2004 and into 2005.” The industry in general is seeing more velocity, and as long as interest rates remain fairly stable, deal flow this year will equal or exceed that of last year, he adds.

Secondary Markets Sizzle

As retailers continue to roll out new stores across the country, secondary and tertiary markets are clearly on their radar screens. “Every retailer has criteria that they want to use in the market placement of stores,” says Robin J. Muir, CCIM, director of real estate for Hastings Entertainment in Amarillo , Texas .

For example, some retailers might only look at towns of 150,000 or more people. Yet many retailers recognize that, if they want to expand their brand, they may have to consider towns of less than 50,000 to 100,000 people, he adds.

Secondary markets offer benefits such as more available land and lower land and redevelopment costs when compared with major urban locations such as Boston and Chicago . In addition, retailers that have saturated larger markets may move into secondary markets because they lay in the path of growth.

Some secondary markets gain from their close proximity to larger cities. Lincoln , Neb. , has a population of about 250,000, and is located about 60 miles from Omaha , which has a population of 735,000. “Retailers will look at both markets and put several stores in Omaha and one in Lincoln,” says Robin S. Eschliman, CCIM, an associate broker with NAI FMA Realty in Lincoln . “Even though they are two very different markets, there is a little bit of a trickle-down effect,” she says. New additions to the Lincoln market include Bennigan's, HuHot Mongolian Grill, Starbucks Coffee, Big Lots, and Steve & Barry's discount clothing store.

Wal-Mart Recycles

Wal-Mart has more than 3,700 U.S. stores and expects to open another 335 to 365 this year. But along with an aggressive expansion program comes the task of disposing of its vacant real estate.

The retail giant has taken on the responsibility of filling the property voids it creates. In fact, Wal-Mart Realty leased or sold almost 16 million square feet of space in fiscal year 2005, which ended Jan. 31. The company expects transactions to reach a similar level this year.

One of the reasons behind the excess space is Wal-Mart's larger Supercenter format. Wal-Mart plans to open 240 to 250 new Supercenters this year, around 120 of which will be relocations. The real estate disposition is primarily focused on subleasing vacancies, since about 90 percent of Wal-Mart's inventory is comprised of leased real estate. Although stores range in size from 29,000 sf to 145,000 sf, vacancies typically average about 85,000 sf.

In most cases, the key to finding the best tenant mix, best value for the real estate, and best use for the community involves splitting up the large boxes to accommodate smaller tenants. “There are not a whole lot of 50,000-sf to 100,000-sf tenants out there -– particularly in smaller markets,” says Scott Greear, director of building development at Wal-Mart Realty in Bentonville , Ark. Wal-Mart has its own tenant construction team that assists with the design and manages the buildout. “What helps us in particular is that we are already there — zoned, entitled, and the infrastructure is there for retail,” Greear says.

Another point in Wal-Mart's favor is that the space surrounding a store often is considered prime real estate by other retailers and restaurant tenants. “If Wal-Mart moves to a new Supercenter, we try to follow that. But the old Wal-Mart might be a pretty good location, so we might take part of their old store,” says Robin J. Muir, CCIM, director of real estate for Hastings Entertainment in Amarillo, Texas. A classic example is the Hastings store that opened in Manhattan , Kan. , in September 2004. When Wal-Mart built a new Supercenter next to its existing store, Hastings seized the opportunity to move into a portion of the vacant store. “The old Wal-Mart is pretty much in the front door of the new center,” Muir says. It has proved to be a tremendous location with sales up 40 percent since the store opened, he adds.

Wal-Mart stores in rural markets often are re-tenanted by dollar stores or farm-supply businesses, while large secondary markets often attract tenants such as Hobby Lobby, Gander Mountain, Ashley Furniture, and Goody's. Wal-Mart also has been successful in recycling vacant stores as alternative and community uses ranging from schools and churches to fitness centers and call centers, Greear notes. “Sometimes we have to be

Retailers are recognizing that many secondary markets possess strong demographics on a smaller scale. Big boxes are proliferating in markets such as Dayton , Ohio , where Wal-Mart, Target, and Home Depot are expanding. Restaurants also have embarked on aggressive expansion campaigns. “Restaurants are doing so well in large cities that people in smaller towns are saying, ‘Hey, I want to do a franchise,'” says Robert L. Zavakos, CCIM, broker/owner at Re/Max Commercial Dayton.

Though small, some markets such as Dayton contain pockets where the demographics are as impressive as Chicago or Los Angeles . “Even smaller towns have home-run locations, they just don't have as many,” Zavakos says. For example, while a chain can open 30 restaurants in Los Angeles , they probably can open three or four in Dayton . Panera Bread, Chipotle, Nothing But Noodles, and Starbucks are just a few of the new concepts to enter the Dayton market in the past year.

Small market expansion also is part of some retailers' regional strategies. For example, Huntsville , Ala. , lies between the larger markets of Birmingham , Ala. , and Nashville , Tenn. Retailers with stores in the larger cities also can locate in Huntsville and take advantage of their existing marketing and distribution systems. “The issue is getting on the radar screen of the particular retailer or user that you are soliciting,” says D. Scott McLain, CCIM, managing broker at Coldwell Banker Commercial McLain Real Estate in Huntsville .

Huntsville has been aggressive in promoting itself through various economic development efforts. However, it is still a more challenging job to gain the attention of retailers who might not be as familiar with Huntsville as they are with Atlanta . “You have to sell your market better, which requires conversations about the demographics of your community and what makes it special,” McLain says.

Niche Players

While secondary and tertiary markets represent an attractive alternative for some retailers, others see these smaller markets as their first choice. Hastings Entertainment, a multimedia retailer active in 20 states, targets cities that are at least 50 miles from major metro areas. “We want to be the big fish in the little pond,” Muir says. Hastings , which sells books, videos, games, music, and software, wants to attract shoppers in those smaller markets who might otherwise travel longer distances to urban centers where there are more shopping options.

Typically, Hastings looks for 15,000-sf to 25,000-sf free-standing stores or end-cap locations that can accommodate their drive-through coffee bar windows. “In these small towns, the biggest hurdle is that there isn't a tremendous inventory of real estate,” Muir says. The upside is fewer site-selection dilemmas: Often Hastings has only one or two sites to examine. In addition, small towns often have “build it and they will come” phenomena — both from shoppers' and tenants' perspectives, he adds.

That philosophy has helped spur developers to move into smaller markets and build 100,000-sf to 150,000-sf mini power centers. “We're seeing developers from bigger cities building small power centers and attracting tenants who want to go to these smaller markets and change shopping patterns,” Muir says.

A number of retailers are expanding into smaller markets with scaled-down versions of their prototype. For example, Best Buy has different prototypes that range in size from 20,000 sf to 45,000 sf that it uses to expand into both smaller and urban markets where space is limited. Applebee's also has a scaled-down version of its restaurant for towns with less than 50,000 people.

Hastings modifies its prototype to fit the market size. In a town of 150,000 people it might open a 30,000-sf store, whereas a population of 50,000 typically would support a 15,000-sf store. In some cases, Hastings enters even smaller markets: The chain operates an 8,500-sf store in Dumas, Texas , population, 13,000.

Slow Going in Rural Markets

Rural market retail activity remains fairly static, in large part because most small towns don't possess the demographics to generate retailer interest. Nevertheless, rural markets can represent a desirable niche for national retailers such as dollar stores and video rental chains.

creative and have some perseverance in the smaller markets,” he adds.

Big Lots and other discount chains often lease vacany Wal-Mart stores in rural markets such as Durant, Okla., population 13,000.

Photo: Wal-Mart Realty

Multimedia retailer Hastings Entertainment actively seeks locations in small markets hoping to be the "big fish in the little pond."

Photo: Hastings Entertainment

Grubb & Ellis-Paramount has represented Movie Gallery in more than 40 deals in rural Michigan in recent years. “They love the smaller towns. That's their bread and butter,” says Matthew J. Williams, CCIM, MAI, vice president of retail at Grubb & Ellis-Paramount in Grand Rapids , Mich. They favor small markets because there is less competition, and they view rural towns as more insulated from technology. “So they see a longer opportunity to survive changes in their market,” Williams says.

Rural markets also are enjoying some activity thanks in large part to aggressive expansion among the dollar-store chains. Dollar chains can be major retailers in rural towns with stores as small as 7,000 sf. They are often the second-largest retailer behind the local grocer, and they fill a much-needed merchandise gap, similar to the old five-and-dime stores, Williams notes.

Most dollar stores can adapt to existing buildings as long as the rents are low. For example, Dollar General recently signed a lease in Cedar Springs , Mich. , for space in an upgraded pole building — a metal building with a concrete foundation. “The key is keeping rents low, which is not hard in a small market like that,” Williams says. Triple-net rents in rural Michigan run between $4 and $6 per square foot.

On the other hand, developers sometimes have trouble securing rents high enough to justify new construction. For example, Jeff Roberts, CCIM, president of Roberts Properties in Muskogee , Okla. , is able to get between $2 and $3 psf net in rural Texas markets — less than half the rent he can collect in larger cities. The upside is very little competition and low land prices. “The land opportunities are good in the smaller rural markets, and you typically have an easier process dealing with municipalities,” Roberts says.

In the last five years, Roberts has completed 76 build-to-suits for Dollar General in both metro and rural markets across Oklahoma , Texas , Kansas , and Arkansas . The markets range in size from 2,000 to 40,000 people with stores between 7,500 sf and 9,100 sf. “The rural markets are small enough where the big boxes are not going in, so if you put in a 9,100-sf Dollar General, they love it because this is their Wal-Mart,” he says.

Redevelopment Potential

Savvier small markets are taking advantage of retailer interest to spark local revitalization efforts. Huntsville has redeveloped four older mall properties in the past several years, and its fifth redevelopment is poised to start. The city is planning to redevelop the 18-acre MarketSquare at the Heart of Huntsville site as an urban entertainment-retail destination. The 1960s-era mall separates downtown Huntsville from a principal north/south corridor.

Recent improvements surrounding the parcel include a new 300-room Embassy Suites and a flood mitigation project that will result in a new river promenade, making the property more attractive to developers, McLain notes. Redevelopment projects appeal to municipalities because they utilize existing infrastructure, boost the tax base, and bring needed goods and services into mature trade areas.

“I think we are seeing a lot more mixed-use development for a lengthy list of reasons,” says James W. Tucker, CCIM, a senior adviser with Sperry Van Ness – Land Strategies LLC in Williamsburg , Va. A top reason is the new urbanism trend — a desire for a more pedestrian-friendly lifestyle. “People don't want to be a slave to that auto every time they want to get a cup of coffee or sit at a café and read the newspaper,” Tucker says. People want to live in areas where they can walk to shopping, eating, and retail-entertainment destinations.

Williamsburg is moving forward with the redevelopment of nearly 60 acres near its center. Such large tracts of land are rare, especially so close to the heart of the city. The site is in close proximity to the historic Old Colonial Village commercial corridor and the College of William and Mary. Major project components include more than 450 residential units and 250,000 sf of retail including a 14-screen theater, restaurants, and shops. Site work is scheduled to begin this spring.

Rural market retailers adapt their format to available local product, including a pole building in Cedar Springs, Mich., which now houses a Dollar General.

Photo: Grubb & Ellis-Paramount

Buying Boom

Investors' insatiable appetite for retail properties does not appear to be dampened by small market size. Retailers moving into rural markets are generating tremendous investor interest. National chains such as Movie Gallery and Dollar General have strong credit. “Those deals are very, very hot on the backside,” Williams says. “They are selling as investment properties as fast as you can get them on the market.” Such investment properties are selling at low capitalization rates in the mid-7 percent range, Williams adds.

“Cap rates for well-located retail properties are the lowest they have been in 30 years,” agrees Neil B. Goodhue, CCIM, a partner at Goodhue Investments in Piedmont , Calif. Cap rates in his market are hovering at about 6 percent, and there are very few properties available. Typically, Goodhue pursues new investments that range in price between $2 million and $6 million. The company owns about 500,000 sf of retail properties ranging from 5,000 sf to 20,000 sf in Northern California 's Alameda , Contra Costa, and Tuolumne Counties .

Buyers flush with capital from 1031 exchanges are driving up prices as they seek to avoid capital gains taxes and reinvest in other real estate. Retail has been a favorite alternative among 1031 exchange investors because many deals are structured with low maintenance and triple-net leases. “I have never experienced a market so driven by 1031 activity,” Goodhue says.

Some investors have been less active in the past year because prices have been driven higher by increased demand. However, there may be some relief in sight if interest rates continue to rise this year. “I personally expect the prime rate at the end of 2005 to close at 7 percent,” Goodhue says. “I think cap rates will follow that, which may lead to more buying opportunities.”