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SHOPPING CENTER BUSINESS

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PLACEMAKING BRINGS RETAIL CLOSER TO COMMUNITIES

In California and on the East Coast, retail owners are focusing on community needs and wants.

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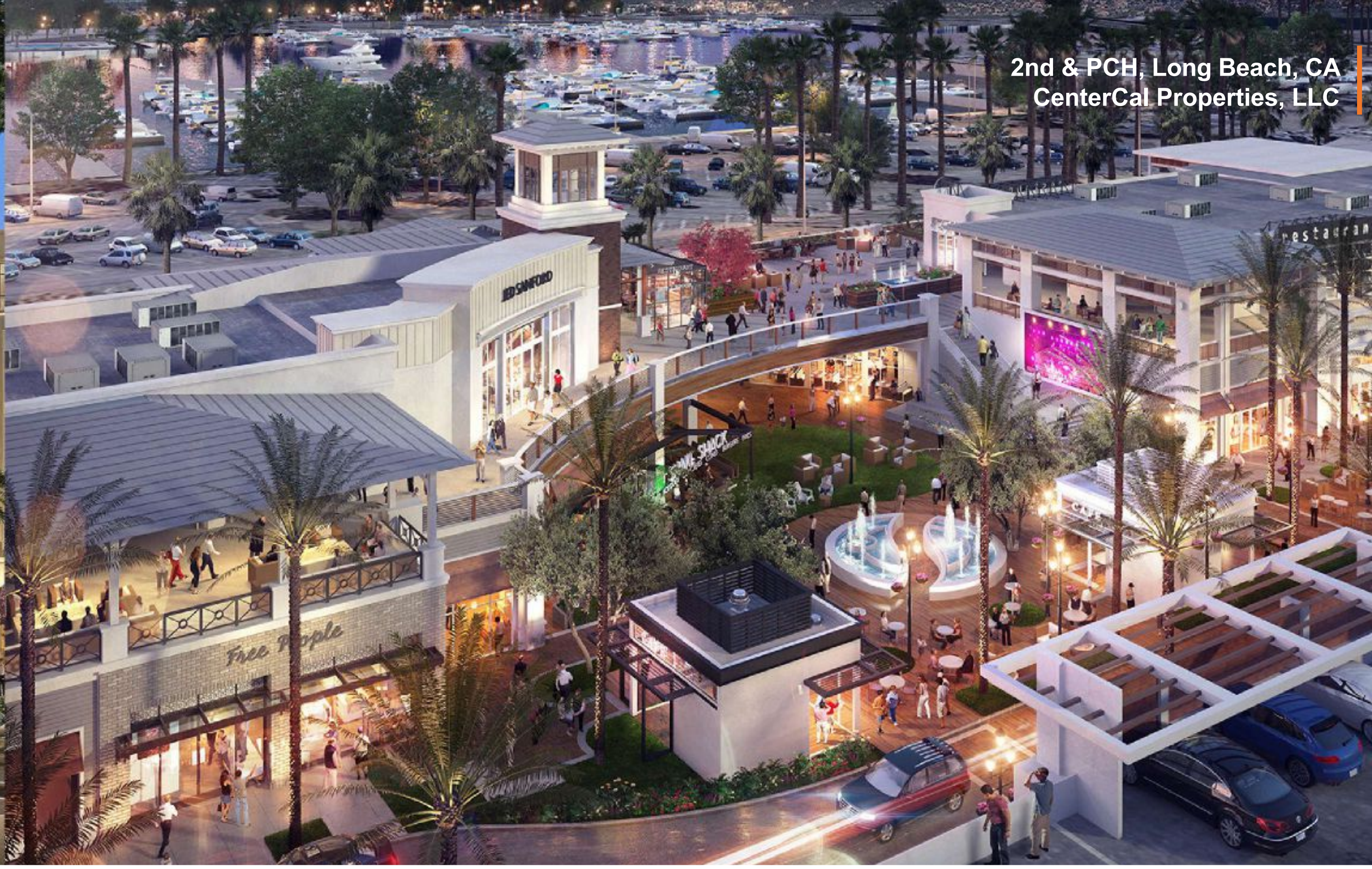

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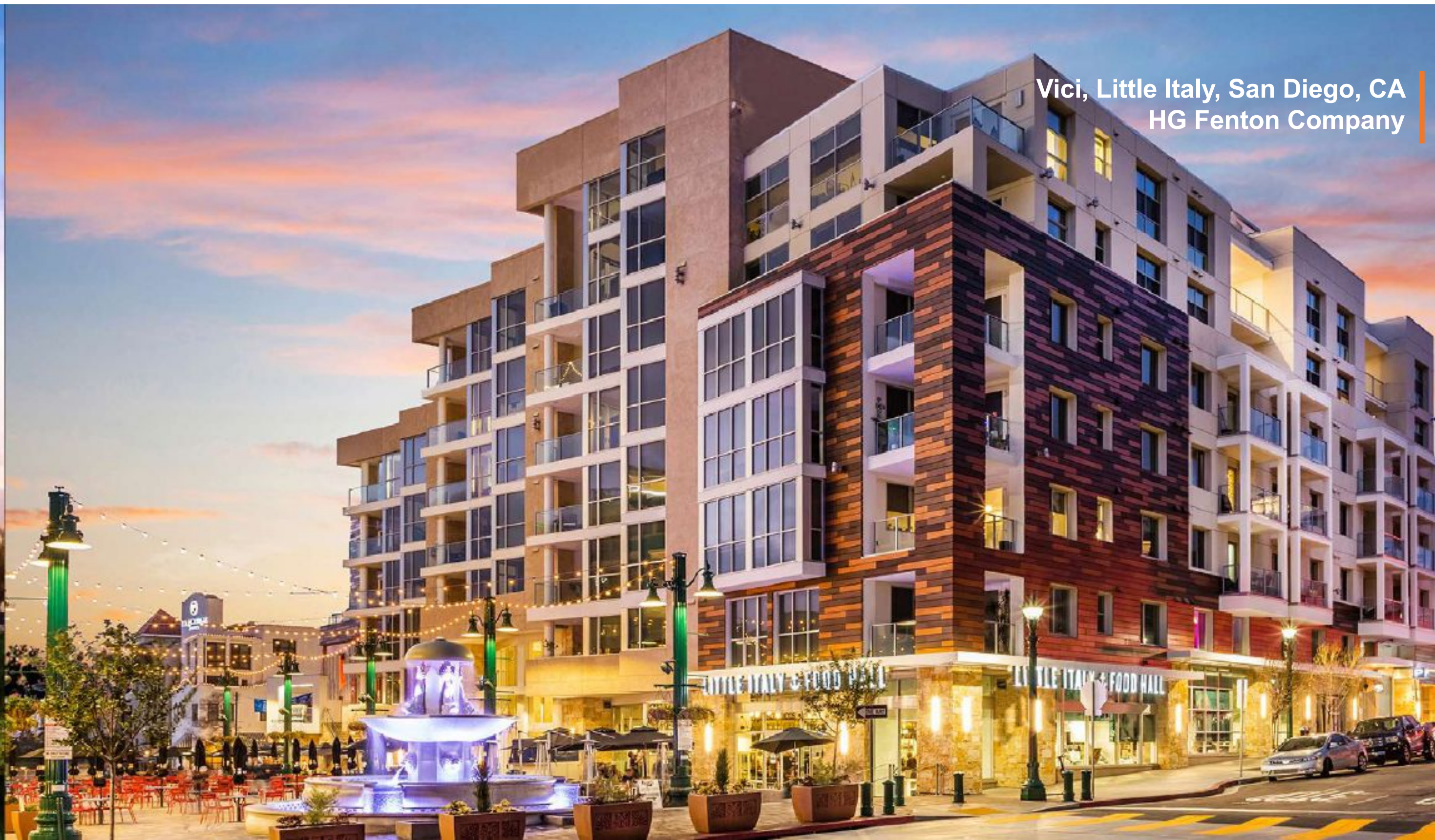

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California Retail Puts Emphasis On Placemaking

California's leading retail experts weigh in on what's holding the state down, and what's lifting the state up.

Nellie Day

2nd & PCH is a 220,000-square-foot urban lifestyle center designed to be the new living room for the Long Beach community. It also features picture-worthy views as the center overlooks the Long Beach marina.

In many ways, California isn't all that different from the nation's other retail markets. Food, fun, fitness and fashion are resonating with patrons. Department stores and many big box retailers are receiving the same cold shoulder they are throughout much of the country. Consumers are sharing their opinions about what's hot and what's not via social media. However, one of the biggest attractions for many is, ironically, the very thing you can't buy.

"We are seeing a key trend emerge in the California market," says Robert Budetti, partner at Architects Orange in Orange, California. "Many of our new retail centers place heavy emphasis on placemaking and creating the new 'living room' for the community, complete with activated gathering areas, open spaces, pocket parks and engaging landscaping. Developers are catering to what really draws people in and encourages them to hang out."

GETTING THEM OUT OF THEIR LIVING ROOMS, INTO YOUR LIVING ROOM

California certainly doesn't have a lock on the open-space concept. It's a widely known and used strategy for many of today's savvy shopping center developers. This emphasis on placemaking, comfort and community, however, tends to be on a different level in California. There are a few reasons for this. For one, literal living rooms and backyards can be small, cramped or non-existent for many of the state's residents, as housing is expensive and the population is explosive.

Add to this a generally hospitable climate for all 12 months, as well as the leisurely lifestyle Californians tend to embrace, and you have a recipe — or a requirement, rather — to create an ideal gathering hub.

"The biggest 'a-ha' moment for retail today is the importance of developing a place," says Jeff Kreshek, senior vice president of leasing for the West Coast in Federal Realty Investment Trust's Los Angeles office. "The customer wants something that's comfortable."

Kreshek and his team internalized this trend and how it fits into the California lifestyle four years ago when they opened The Point in El Segundo. It was one of the first projects of its kind to be anchor-less — at least in the sense of a traditional shopping center. Rather than a Macy's or Kohl's, a 45,000-square-foot outdoor plaza headlined the project, along with a slew of local and artisanal restaurants. Kreshek notes this was Federal's response to a bifurcation within the retail environment.

"We always talk about experiential shopping versus transactional shopping," he says. "Experiential shopping gives customers the option to do whatever they want on their terms. They can shop a little, they might not shop at all. But consumers often gravitate to places that make them feel good. If they enjoy going somewhere,

Swedish outdoor clothing and equipment company Fjallraven is one of the compelling brands that Kreshek believes will keep fashion interesting in today's shopping centers. Pictured above is the store at Santana Row in San Jose.

commerce will come out of that. When I walk by The Point, sometimes I see a father and son playing soccer in our plaza. That's great. Did they buy something? I don't know. Maybe not this trip. But perhaps the next one. Or the one after that."

David Senden, principal at KTGY Architecture + Planning, believes it's prudent to create a collective living room of sorts if shopping center owners hope to stave off online competition.

"It's critical that we are providing something in retail that the consumer can't get by clicking a mouse from his couch," he says. "It is our firm belief that humans are, by nature, social creatures. It is not their goal to sequester themselves as hermits, peaking their heads out only when absolutely necessary, but technology has allowed them to be selective about the things they are leaving the house for. Shopping is done for fun, not out of necessity these days. So, if retailers are going to entice shoppers to fight traffic across town, struggle with parking and give up their valuable time, there better be something interesting on the other end."

One of the increasingly popular points of interest are Instagrammable backdrops, as Budetti can attest.

"Another key trend is designing spaces to specifically capture the Instagram moment," he adds. "Clients are becoming very creative and strategic in creating spaces that emphasize their brand and provide the perfect photo backdrop. Developers are catering to what really draws people in

Unibail Rodamco Westfield has a major renovation project underway at its Valley Fair center near San Jose that will add to the center's mix of retail, restaurants and entertainment.

and encourages them to hang out."

The beauty of these Instagram-friendly backdrops is that they can be both organic and manufactured. Architects Orange is working on CenterCal Properties' 220,000-square-foot 2nd & PCH project in Long Beach, which will take advantage of the area's natural backdrop to draw people to its second-story restaurant and food pavilion.

"2nd & PCH is a great example of an urban lifestyle center that is anticipated to become the new living room for the local community," Budetti notes. "The entire project overlooks the Long Beach marina and takes advantage of the SoCal climate. What sets this development apart is how they respond to the retail trends, tenant demands and developer agendas, while balancing a high level of thoughtful design and placemaking to create community environments where people want to be."

On the manufactured side, an Instagram-worthy spot can be as simple as the pink-painted wall outside Paul Smith's Melrose Avenue store in Los Angeles, or a decorative piano encouraging consumers of all ages to tickle its ivories at Protea Properties' Flower Hill Promenade in Del Mar.

"Fun is critically important," Senden adds. "The goal for any shopping center should be to be the living room for the community. Then you become the go-to spot for entertainment, dining and fun. Creating an environment that leads to habit, enabling diners and shoppers to pick their spot without even thinking, while they're on autopilot, is the goal."

WHICH OF THE FOUR F'S IS NUMBER ONE?

The second story of 2nd & PCH will feature a restaurant and food pavilion. Eateries will include Shake Shack, Mixt Greens, The Bungalow, Tocaya, Ola Mexican Kitchen and Caffe Luxxe.

The secret to a center's success — the famous Four Fs of fun, food, fitness and fashion — aren't much of a secret anymore. Interestingly enough, just which F reigns supreme depends on who you ask, which depends on the shopping center and demographics.

"It depends who you want to be popular with," Kreshek clarifies. "From a popularity standpoint, we're still most excited about fashion. Fashion tends to be an outlier right now. The retail brands coming out now are interesting, engaging and fun."

He lists Native Shoes, Gorjana, Warby Parker, and Swedish outdoor clothing and equipment company Fjallraven as a few of his favorites. He has found a place for all four at Federal Realty's Santana Row in San Jose.

"Shopping had become very antiseptic and very uncool," Kreshek continues. "Going to the mall had become a chore and the shopping experience was full of friction. It was brands doing the exact same thing the same way for all your life. Is it really that much of a surprise that a 50-year-old retail brand went away? These new brands have made the shopping environment cool again and they've made it fun."

Fun is the F that Allen Lyda, executive vice president and COO of Tejon Ranch Co. just south of Bakersfield, had in mind when his team crafted its lifestyle experiences program for the 60-plus-store Outlets at Tejon.

"The most popular category is lifestyle products," he says. "Given this is the case, lifestyle experiences are being developed for successful centers to grow. Since 2015, we have had a Style Ambassador who hosts fun events like a back-to-school fashion show and holiday tree lighting at the Outlets. She has also appeared on local TV and local media, representing our tenant's clothing and accessories, promoting events and sales, and helping increase our brand."

For Floyd Shaheen, an investment associate in Marcus & Millichap's Encino office, he sees fitness as the category of choice for many of his investor clients.

"I have seen an explosion of health-conscious-related businesses occupying more retail space than they did 10 years ago," he says. "Gyms have helped stabilize the retail rental market, especially after I've seen so many retailers who were unwilling to adapt their businesses eventually close their doors. This health trend has also spilled into the food sector as companies such as Sweet Greens are capitalizing on people's appetite for healthy dining."

Shaheen also believes these types of retailers can help foster the sense of community and placemaking that shopping center owners are hoping to achieve — whether their centers have large, open spaces, or not.

"Within many of LA's trending submarkets, such as Silver Lake, Echo Park, Boyle Heights and West Adams, Millennials are gravitating toward neighborhoods that have more of a home-grown community feel, that transform the fabric of a neighborhood," he continues. "These smaller businesses, such as yoga studios, cafes and coffee shops, are what end up giving these neighborhoods their identities."

Bill Asher, executive vice president of Hanley Investment Group in Corona del Mar, is also particularly bullish on food, especially from an investor standpoint.

"Popular, new single-tenant, net-leased developments in today's market are fast-food and quick-serve restaurants like Chick-fil-A, Chipotle, Raising Cane's Chicken Fingers, Panera Bread and Starbucks," he says. "These tenants continue to be market leaders and the most aggressive regarding expansion plans and new store developments."

Drive-thrus, particularly in California, have also picked up steam, according to Asher.

"Certain retailers with drive-thrus in stand-alone buildings or endcaps to multi-tenant pads have a high level of interest due to increased sales volumes generated via the drive-thru and intrinsic value for reuse or repurpose in the future," he continues. "Double drive-thru formats for tenants like Chick-fil-A and drive-thru-only formats for tenants like Starbucks are becoming more prevalent. Meanwhile, new to the California market, Dutch Bros. uses a combination of both via a double drive-thru-only format based on their previous successes in numerous locations across the country. Collectively, these types of single-tenant net-leased assets will continue to be some of the most highly sought-after retail asset types in today's market."

While Kreshek appreciates the four Fs,

Unibail Rodamco Westfield has opened new retailers, entertainment facilities and restaurants at its Westfield Century City center in Los Angeles as part of a major renovation.

he has some concerns that landlords have grasped onto these internet-resistant tenants a little too tightly.

"I do worry on the food-fitness-fun angle that every landlord right now that has a vacant space will rely on one of those three categories to fill it," he explains. "With fitness, I'm excited about some brands but if you've got four to five players in each category with Pilates, cycling, running and rowing, it's hard to see where two or more will survive long-term."

Asher believes the max capacity for fitness may be approaching the finish line, though many concepts are still in expansion mode.

"LA Fitness, 24 Hour Fitness and Planet Fitness continue to expand," he says. "However, we are starting to see the heavy saturation of private operators and personal training in some markets. There are approximately 4,326 health clubs in California with nearly 8.9 million residents visiting health clubs. Last year, four LA Fitness, four 24 Hour Fitness and one Planet Fitness location changed hands in California, according to CoStar Group."

California also holds the record for the lowest cap rate for a single-tenant health club so far in 2019. That deal involved an LA Fitness in Irvine, which sold for $18.5 million at a 5.39 percent cap, according to CoStar. The fitness company recently remodeled its Riverside and Upland locations, and opened its doors on a new outpost in Newbury Park this past July. 24 Hour Fitness opened its 150th club in Southern California in San Juan Capistrano this past January, while Planet Fitness continues to target new-store locations in former Toys 'R' Us and Sears spots. This is in addition to the company's partnership with Kohl's, which will bring 10 Planet Fitness locations ranging from 20,000 square feet to 25,000 square feet adjacent to Kohl's stores.

"In today's evolving retail landscape, our differentiated approach to fitness continues to drive traffic to shopping centers across the country," says Chris Rondeau, CEO of Planet Fitness. "We are excited to announce this initial expansion and partner with Kohl's to drive new and complementary traffic to these locations, while introducing shoppers to our high-quality, judgement-free, fitness experience at a great value."

The Point's plaza is lined with local and artisanal restaurants, such as Hopdoddy Burger Bar, Lil'Simmzy's, Mendocino Farms, True Food Kitchen and Umi by Hamasaku. These outposts also contain their own patio areas, thereby adding to the project's abundant outdoor spaces.

TOO MUCH DEMAND, NOT ENOUGH SUPPLY

Shopping center landlords might continue to invest in the four Fs, and many of the four F tenants continue to invest in their spaces, but there is a category of investors who aren't spending a dime. Namely, shopping center investors. And it's not for lack of desire.

"The single biggest head-scratcher we have witnessed is the sheer lack of quality of product being offered for sale," notes Glenn Rudy, senior managing director in Newmark Knight Frank's Newport Beach office.

Rudy says this is even more unfortunate, as today's fundamentals can offer an ideal acquisition environment.

"While many are skeptical about what our collective macroeconomic future looks like in the near term, interest rates remain at a historic low with an abundance of capital seeking quality opportunities in this region," he continues. "If there was a time to execute on a core offering, there may be no better time in recent history."

Philip D. Voorhees, vice chairman of National Retail Partners-West in CBRE's Newport Beach office, shares the same sentiments…and frustrations.

"Specifically in Southern California, there is essentially no core retail investment real estate assets for sale," he says. "As a REIT, pension fund or advisor, if you cannot buy core due to scarcity, then you will not sell core, perpetuating the lack of inventory."

Voorhees also notes that retail development remains at historically low levels for the ninth consecutive year since the bottom of this cycle. Given the drop in the 10-Year Treasury (10YT) since early November — from 3.27 percent to its current mark around 1.50 percent — CBRE expects 20 to 35 basis points (bps) of cap rate compression between now and the end of the year. CBRE also expects 25 bps of cap rate compression on quality pad and strip retail assets in the Western U.S. as cap rates track interest rates.

"As goes the 10-Year Treasury, over time, so go cap rates on higher-quality assets," Voorhees explains. "The lack of core retail properties for sale has caused institutional capital to consider retail types previously not acquired, like high-quality strip and pad retail centers in the better, primary markets around the Western U.S. Frankly, the only thing holding institutional capital back from acquiring these centers is the small transaction size and lack of scale from an asset management perspective."

Don MacLellan, senior managing partner at Faris Lee Investments in Irvine, believes we'll continue to see more California investors prioritize capital preservation over profits.

"Quality and preservation of capital are the biggest investment sales trends I'm seeing," he says. "A lot of investors experienced the Great Recession. Right now, they're not necessarily focused on the return of capital, but on preservation."

This has led many investors to focus on infill assets with quality, long-term leases, low management obligations and aggressive yields. For those who can take on more risk, however, MacLellan thinks the rewards can be there.

"Professionals buying larger power centers are fairly sophisticated investors who are willing to take on more risk, buy at attractive yields and finance at historically low rates," he asserts.

Voorhees believes these latest conditions may just have produced the best acquisition opportunity environment he has ever witnessed.

"In my 20-plus years of doing this, there has never been a better time to buy than right now for lower-leverage investors focused on equity preservation, cash flow and security, particularly in Southern California," he says. "The result of the correction in 2017 and 2018 is an extreme 'risk-off' approach to retail investing. This, combined with the precipitous drop in the 10-Year Treasury and effective debt/interest rates, have produced the widest ever cap rate to 10YT spread in history, even more so than at the bottom of the Great Recession."

This, Voorhees contends, has caused better than average and average retail properties to price at cap rates 500 to 600 basis points over the 10YT, producing the best-leveraged cash-on-cash returns he's ever seen in retail investing.

"In CBRE's view, the market is not accurately pricing risk on most retail investments, creating a career acquisition opportunity!" he exclaims. "As Warren Buffet famously said, 'be fearful when others are greedy, and greedy when others are fearful.' Buy now with long-term, fixed-rate debt. You won't be disappointed, especially considering your investment alternatives!"

Some of those alternatives might involve seeking higher yields outside the state. MacLellan, for one, hasn't seen investors have a lot of luck with this.

"A lot of people prior to the recession went outside the state chasing higher yields in areas that weren't as strong as

The Point might have been ahead of its time when it debuted in El Segundo in 2015. It was one of the first projects of its kind to shirk department stores and big box retailers in favor of a 45,000-square-foot outdoor plaza and restaurant row.

California economically and got hit quite a bit," he says. "This time around they're saying, 'no, we're not going to get delusional chasing higher yields outside California.' This time, they really want to focus on California. They're willing to take lower yields to preserve capital and the impact from any down cycle that occurs. They feel more comfortable that California will weather it."

J.D. Blashaw, vice president of MetroGroup Realty Finance in Newport Beach, says it is precisely California's strong and diverse attributes that keep lenders confident in times of uncertainty. He notes that Southern California is partially driven by media and aerospace, while Northern California is powered by technology. The Central Valley, meanwhile, is the most productive agricultural region in the world. That's to say nothing of the state's several large ports, which contribute to its significant trade region.

"California is fortunate to have a very diverse economy, which softens the impact of many trends," he says. "In all, the diversity and resources of the California economy, coupled with record-low unemployment, increased consumer spending and the adaptation of retail product to meet consumer preferences, has pushed vacancy down and asking lease rates above pre-recession levels in our region."

The true impact of "trends" like interest rates, trade wars, the upcoming election, an impending (or is it?) recession may not be known for some time. While it's helpful to prepare and, in some cases, preserve, Kreshek believes it's more strategic to view this market from a macro perspective, rather than honing in on one micro element. Kreshek likens this to another trend he believes retailers and shopping center owners spend way too much time focusing on.

"Black Friday," he asserts. "I don't care about Black Friday. You say things like that and people raise an eyebrow. Everyday matters. I have to win your birthday, next Tuesday, lunch. In my opinion, those are the times when you have to have a relationship built with the customer. It's every day. It's not one day a year because there's a line out the door with people thinking we're giving away something for nothing. I need the other 364 days to be relevant in their lives or I don't stand a chance." **SCB**