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Retail REITs Successfully Adapting to New Shopping Environment

New Tenants, Improved Shopping Experience Boost Operating Performance Fundamentals

CALVIN SCHNURE*

Abstract: *Despite the challenges posed by e-commerce, the operational performance of U.S. retail real estate investment trusts (REITs) remains sound. Landlords in REIT-owned malls have kept occupancy rates high by bringing in new tenants and, while largely retaining the same top retailers, have become less dependent on them. Owners have also diversified their tenant mix away from the department stores and fashion retailers that dominated in the past. This article also analyzes the effectiveness of the retail REIT sector by comparing it with the REIT performance of other sectors, including infrastructure, industrial, and data centers.*

E-commerce, Retail Properties and REITs

Changing consumer shopping patterns are driving broad changes in the retail landscape. E-commerce has captured a rising share of total retail sales, although most sales still take place in stores. Competition from online sales has forced traditional retailers to change their business models, often scaling back their physical presence while working to integrate their bricks-and-mortar and online distribution channels. Several major retailers have been forced out of business by the changes, while others have expanded as they have taken advantage of innovative strategies and new niche markets.

Commercial real estate markets have felt the impact of e-commerce as the relationship between retail shopping and physical store locations continues to evolve. Yet the fundamental operating performance of retail REITs, which own a large share of the malls, shopping centers and free-standing retail in the United States, has held up surprisingly well considering the magnitude of the changes over the past half-decade.

REITs tend to own properties located in higher-income areas, and have little exposure to the malls and shopping centers that have suffered the greatest impact from store closures. As such, they own many of the high-productivity malls and open-air shopping centers that have adopted successful strategies for dealing with the changing retail environment. (See Chart 1.)

REITs publish detailed information on operating and financial performance through their filings with the Securities and Exchange Commission (SEC). These reports show that the occupancy rate of REIT-owned malls and shopping centers rose from 92 percent in 2010, to 95 percent or higher in recent years, as detailed in Chart 2. The increase in occupancy rates among retail REITs

Lessons Learned

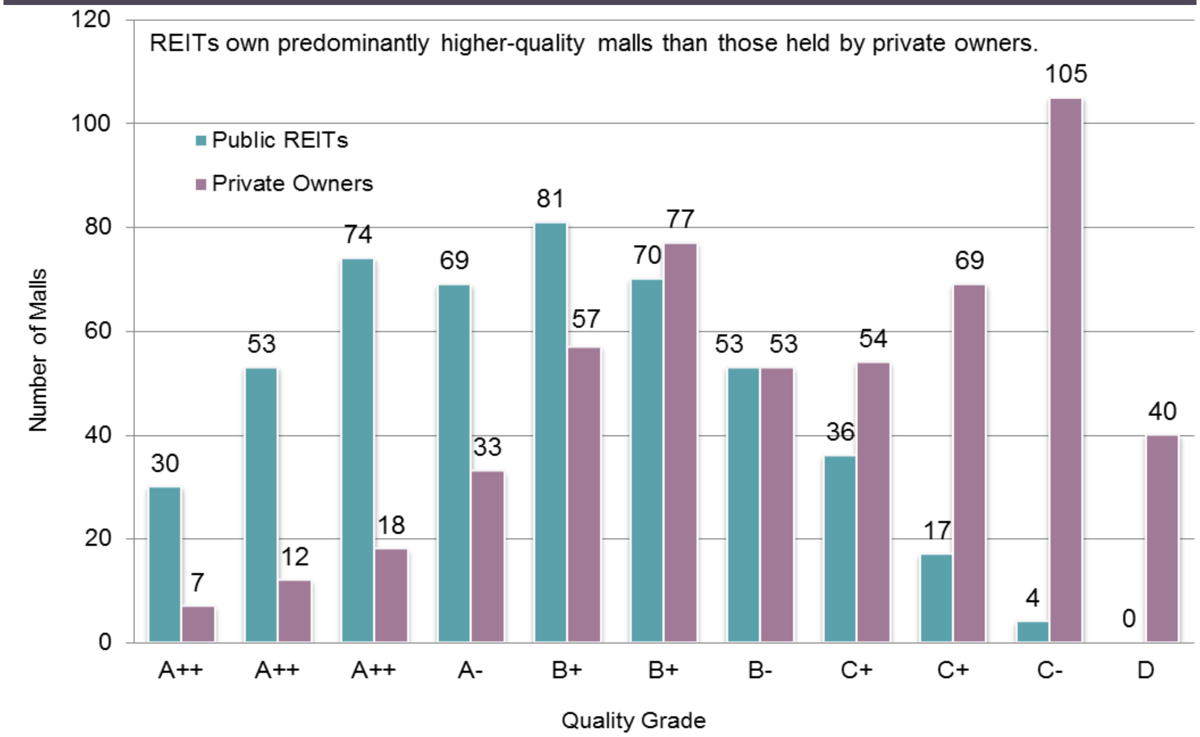
Even as e-commerce alters the relationship between shopping and physical locations, an analysis of retail REIT data over the last several years underscores continuing sound fundamentals in the sector:

- Retail REITs tend to own properties located in higher-income areas, and thus have little exposure to the properties that have suffered the greatest impact from store closures.
- Increased occupancy rates among retail REITs exceeded those in other sectors except industrial REITs.
- Retail REITs have also posted steady gains in funds from operations (FFO), net operating income (NOI), and same-store sales.
- Tenant mix changes at mall REITs demonstrate that retail is not going away but evolving, with many tenants not even being present in 2011.
- New tenants offering services rather than goods represent another means of diversification away from the department stores and apparel retailers that dominated mall lineups.

As older business models fade, retail REITs are benefiting from new, more successful models used by their tenants as well as other landlords.

* Senior Vice President, Research & Economic Analysis, Nareit.

Chart 1
Mall Ownership by Quality Grade

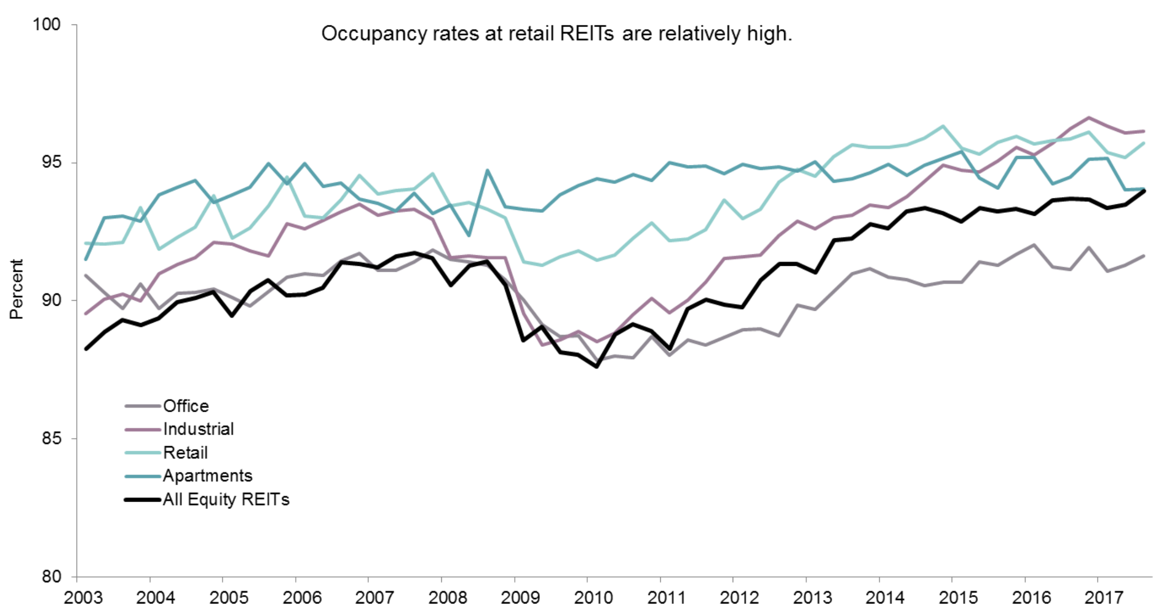


Sources: Green Street Advisors, Brookfield, Nareit.

surpassed those in other sectors except industrial REITs, which were boosted by the demand for logistics facilities needed to ship goods purchased online.

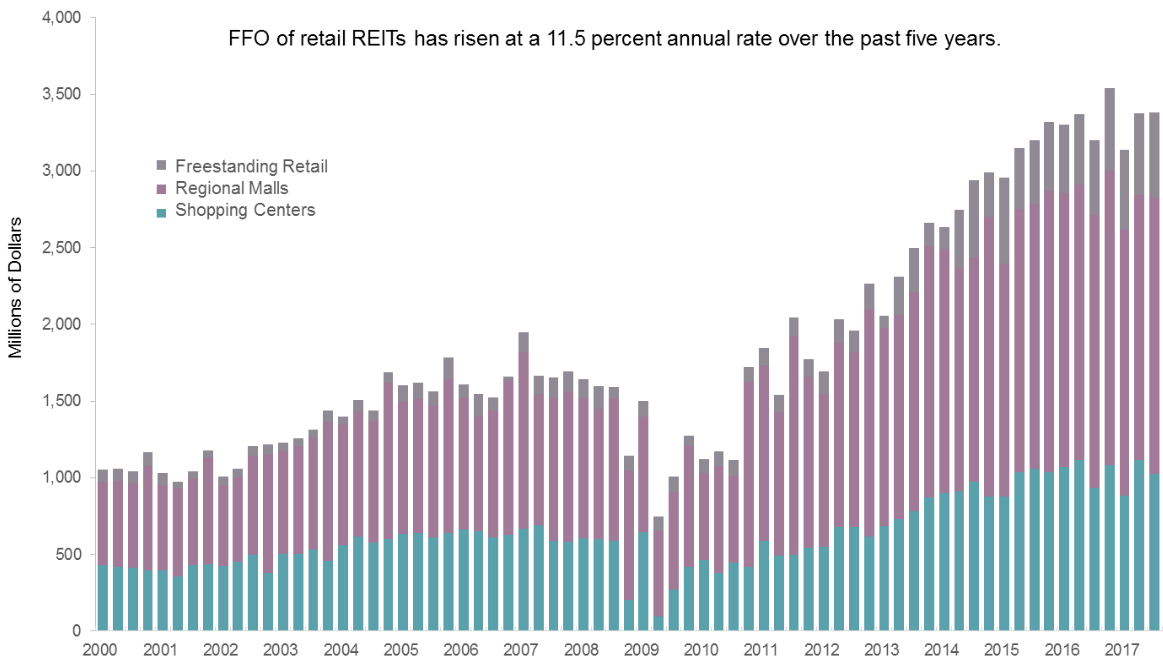
Retail REITs have posted steady gains in earnings as well. FFO, a supplemental non-GAAP earnings metric widely used to gauge the operating performance of REITs, has risen at more than a 10 percent rate over the past five years, although it has flattened out

Chart 2
Occupancy Rates For Different Sectors, 2003-2017



Sources: S&P Global Market Intelligence, Nareit T-Tracker®

Chart 3
Funds From Operations (FFO) of Retail REITs, 2000-2017

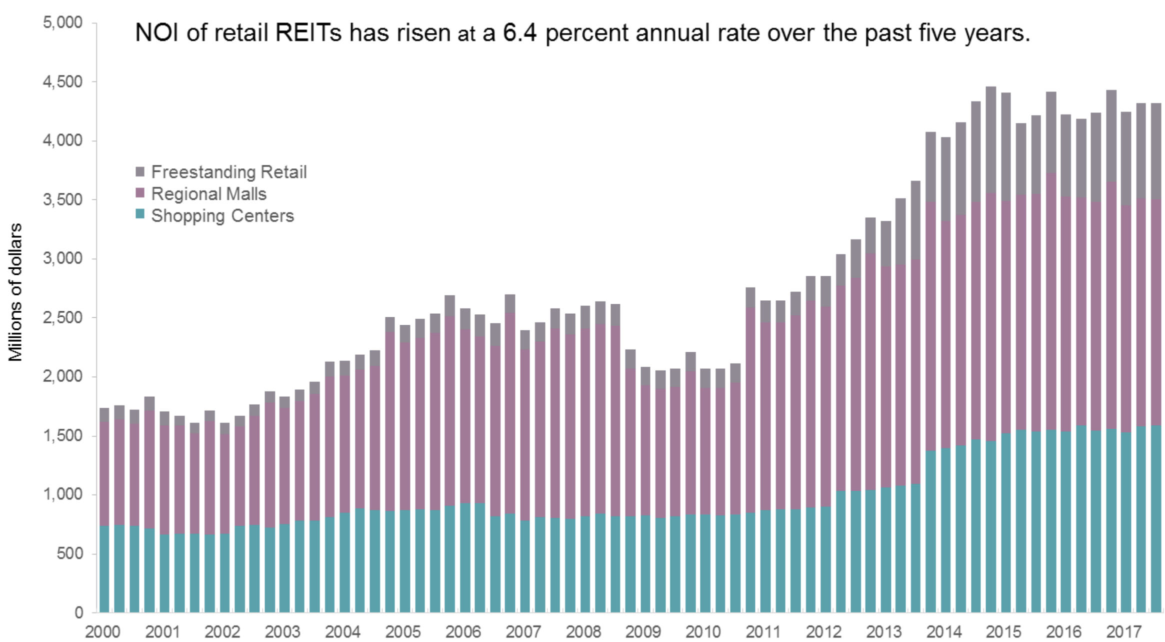


Sources: S&P Global Market Intelligence, Nareit T-Tracker®

recently, as seen in Chart 3.[1] NOI has posted similar gains over this period. (See Chart 4.) Retail REITs paid nearly $10 billion in dividends to shareholders over the four quarters ended Q3 2017, representing an 11.3 percent annual growth rate over the past five years. (See Chart 5).

Some of the growth in FFO and NOI is due to acquisitions and consolidation within the industry, but results on a same-store basis (which report only the NOI for properties held for one year or longer) also show continued growth. Same-store NOI of retail REITs has grown at a 2 percent to 4 percent pace since 2011.

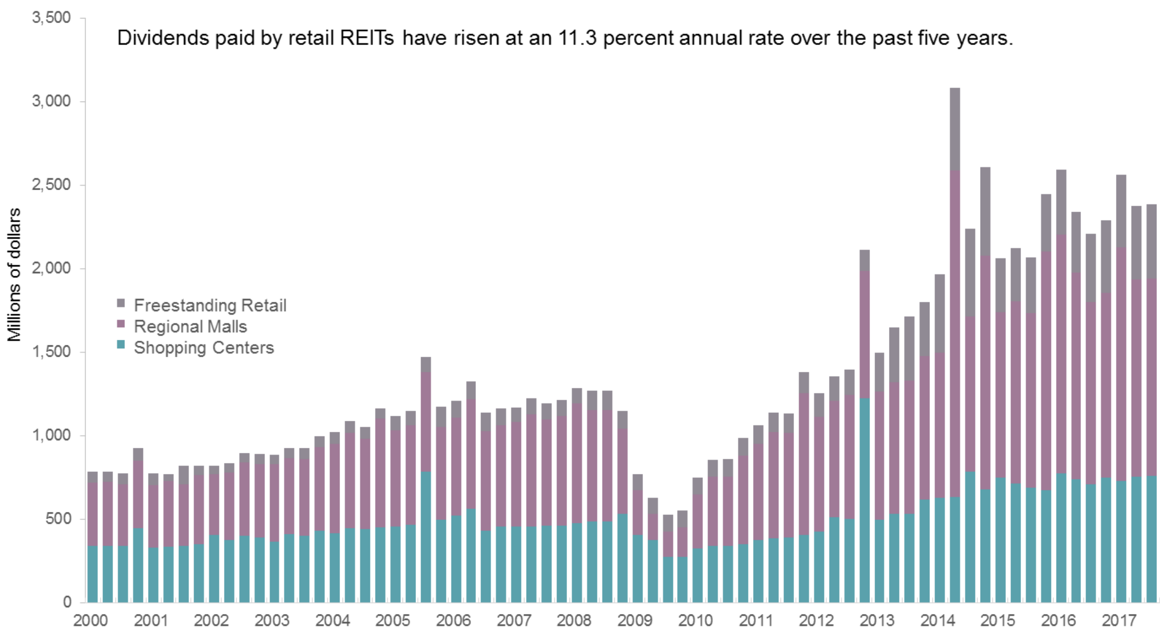
Chart 4
Net Operating Income (NOI) of Retail REITs, 2000-2017



Sources: S&P Global Market Intelligence, Nareit T-Tracker®

[1] For a discussion of FFO and other measures of REIT performance, see "How to Invest in REITs," *www.reit.com* [undated], and "White Paper on Funds From Operations," *www.reit.com*, April 2002.

Chart 5
Dividends Paid by Retail REITs, 2000-2017



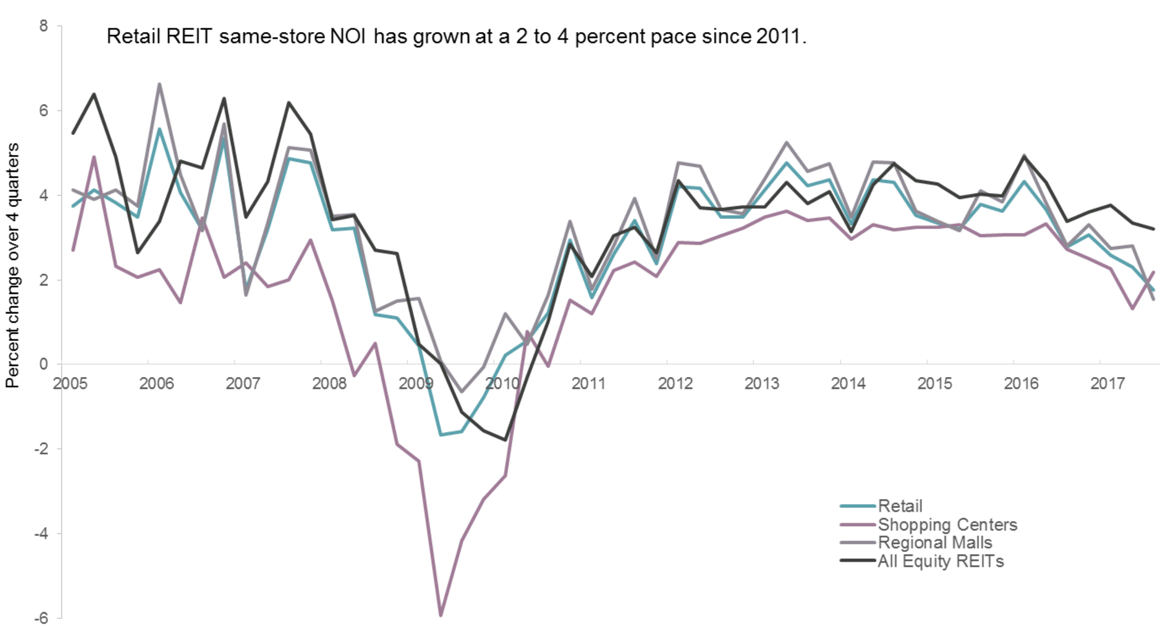
Sources: S&P Global Market Intelligence, Nareit T-Tracker®

There has been some slowing of SS NOI growth since early 2016, but trends for retail REITs have generally been in line with, and have at times exceeded, those of other property sectors. (See Chart 6).

The share prices of retail REITs have frequently traded at a discount to their net asset value (NAV) since mid-2015. This indicates that the total market capitalization of these firms is less than the current value of the properties that they own. To a certain extent this may reflect investor concerns about the outlook for the retail property sector, but it should also be noted that the shares of REITs in other property sectors have recently traded at discounts to NAV as well. Changes in a discount (or premium) to NAV may also reflect changes in a general equity market premium that is common to all listed stocks.

As usual, past performance is no guarantee of future results, but today's stock price discount to NAV, like dividend yield spreads, is

Chart 6
Retail REIT Same-Store NOI, 2005-2017



Sources: S&P Global Market Intelligence, Nareit T-Tracker®

in a bullish part of its historic range. That is, the discount currently seen is on the higher side, and there is some significant upside potential for REITs.

At the end of 2016, Green Street Advisors estimated that exchange-traded equity REIT stock prices averaged about 9 percent less than NAV, which is in the top one-fifth of discounts seen during the modern REIT era.

Tenants at REIT-Owned Malls

To dig deeper into how the retail REITs have adapted in the changing retail environment requires examining the major tenants and anchor stores at REIT-owned malls. REITs make available the lists of anchor stores and major tenants in their annual filings with the SEC. This high degree of transparency about their operations allows an analysis of how the composition and types of tenants have changed over time, how the REITs have dealt with store closings and, importantly, how they have brought in new tenants to maintain high occupancy rates and give their properties an environment for a more enjoyable shopping experience.

The present report starts with an examination of the top 10 anchor stores at mall REITs in 2006, 2011 and 2016. This list is based on the number of locations listed in the total property portfolio. The list does not reflect square footage—some tenants have larger or smaller stores than others, and there have been changes in store sizes over time—but it nevertheless reveals several interesting facts, as seen in Table 1:

- **The top four tenants at mall REITs were the same in 2006, in 2011 and in 2016.** There have been changes in the relative ordering of the retailers, but Macy's, JCPenney, Sears and Dillard's were among the top four in each of these years. These retailers were also the only ones with more than 100 store locations in mall REIT properties in any of these years.
- **There are six retailers that were in the top 10 in each of these years.** Nordstrom and Dick's Sporting Goods moved up in the ranking from 2006 to 2016.
- **The list has become less top-heavy.** The top four retailers saw their store counts in malls decline 37 percent from 2006 to 2016. Nordstrom, in contrast, had a 21 percent increase in store count, while store count rose 57 percent for Dick's Sporting Goods. The top four accounted for 81 percent of store locations among the top 10 retailers in 2006; their share had slipped to 67 percent by 2016.

Next let's look at the retailers that had the largest decreases in the number of store locations between 2011 and 2016, as well as those with the greatest increases. This includes those among the top 10 in each year, but also the increases and decreases of other retailers. The top four retailers examined above are also at the head of the list in the decline in total store locations (Table 2). Other names here are not a surprise, including several department stores and other home goods retailers selling the type of standard goods that are easily purchased online.

The retailers that opened more stores in 2016 compared with 2011 cover a different segment of the retail universe than those that posted declines. Sporting goods and outdoor equipment stores are well represented, with Under Armour topping the list, and also The North Face, Dick's Sporting Goods, Nike and Adidas. The rest of the list of largest increases is rounded out with fashion and clothing, including H&M, Michael Kors, Kate Spade New York, American Eagle and Armani Outlet. All of these stores sell goods where the size, fit and appearance matter more than for

Table 1
Top 10 Anchor Stores at Mall REITs

Retailer	Number of Stores, 2006	Retailer	Number of Stores, 2011	Retailer	Number of Stores, 2016
Sears	408	Macy's	364	Macy's	275
JCPenney	401	Sears	359	JCPenney	254
Macy's	380	JCPenney	355	Sears	229
Dillard's	245	Dillard's	210	Dillard's	147
Belk	71	Nordstrom	87	Nordstrom	85
Nordstrom	70	Belk	70	Nike	79
Target	62	Nike	60	Dick's Sporting Goods	77
Dick's Sporting Goods	49	Dick's Sporting Goods	58	Coach	70
Old Navy	46	Coach	56	Saks Fifth Avenue	66
Mervyn's	39	Saks Fifth Avenue	55	Banana Republic	60

Sources: Company reports, Nareit 2017.

Table 2
Largest Declines and Increases in REIT-Owned Malls' Anchors, 2011-2016

The tenants with increases in the number of store locations, in malls owned by REITs, look quite different from those with decreases.

Retailer	Change, 2011 – 2016	Retailer	Change, 2011 – 2016
Sears	-130	Under Armour	39
JCPenney	-101	H&M	30
Macy's	-89	Michael Kors	28
Dillard's	-63	Kate Spade New York	27
Belk	-24	American Eagle	25
Target	-22	The North Face	21
Best Buy	-22	Dick's Sporting Goods	19
Bed, Bath & Beyond	-22	Nike	19
Kohl's	-20	Adidas	17
Burlington	-19	Armani Outlet	14

Sources: Company reports, Nareit 2017.

the goods typically sold at the retailers that reduced their physical presence in mall locations.[2]

The changes in the composition among tenants at mall REITs indicates that retail is not going away; it is evolving. While many of the headlines have picked up the store closings and bankruptcies among the types of retailers whose products can be most easily bought online, there are other retailers who are thriving in the current environment.

All the tenants that have shown up in the lists so far fall into fairly traditional categories of department stores, athletic and outdoor gear, and clothing and fashion. For a look at some of the more novel players in the retail universe, we next turn our attention to those that did not have any stores listed in mall REIT properties in 2011 but had one or more locations in 2016. Out of 329 separate tenants reported in mall REIT properties in 2016, there were 112 new anchor stores located in mall REITs that did not have a presence in 2011. One mark of the success that mall REITs have achieved in increasing their occupancy rates in the current retail environment is that fully one-third of the tenants were new retailers that did not have a presence in malls in 2011.

The new entrants in 2016 do include several selling fashion and clothing. Some of them, however, tend to be newer or niche retailers, including Uniqlo, Lululemon, Primark and All Saints. There were also several restaurants, another traditional type of mall tenant, that opened mall locations in 2016. Several cinemas that did not have a reported presence in malls in 2011 had one or more theaters open in mall REIT properties in 2016.

Other new tenants, however, represent a diversification in the tenant base away from the department stores and clothing and fashion. Many of these offered services rather than goods. Several banks had leased space in the mall REITs in 2016. Four-year colleges, community colleges and universities also showed up for the first time in 2016, including Des Moines Community College, Kaplan College and Liberty University. Several fitness centers opened locations in the mall REITs, including Crunch Fitness, Fieldhouse USA, King's Bowl and Lifetime Athletic. Grocery stores have been in the news for their growing presence in malls, as opposed to the neighborhood and community shopping centers where they have long been common, and the mall REITs reported several such new grocery stores in their properties as well. There were also offices listed among the tenants, including a location for *The Indianapolis Star*.

Among the new tenants were also several offering experiences not found in malls a decade or two ago. There were two indoor trampoline parks (Vertical Trampoline Park, Jump Street indoor trampoline park), Madame Tussauds, and Punch Bowl, a food-and-entertainment location that hosts parties and karaoke events.

E-commerce Impacts the Use of Other Types of Real Estate

Retail real estate is not the only property type that has been affected by e-commerce. Several other property sectors help

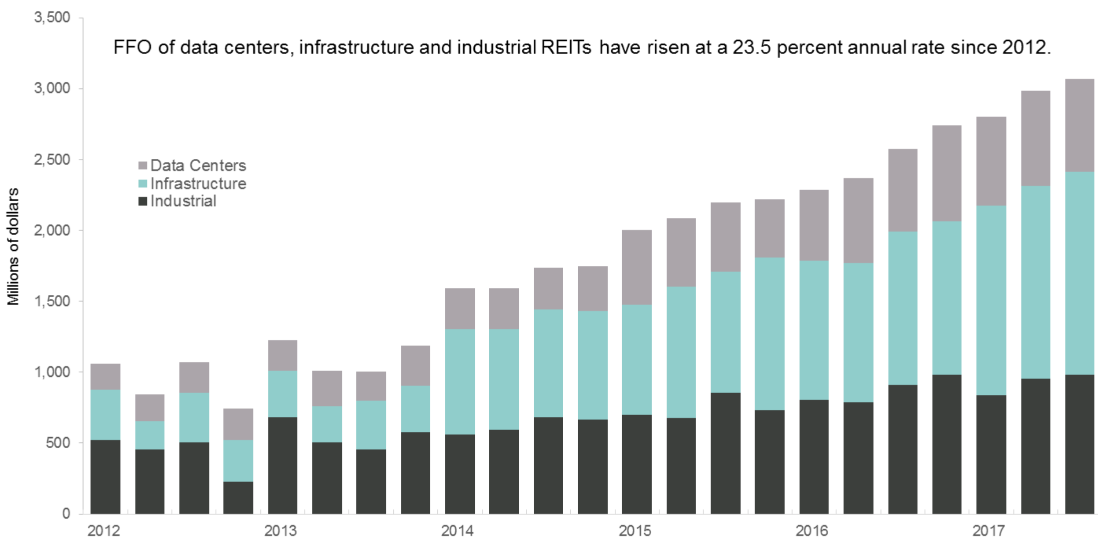
[2] There were many other retailers with significant increases in store locations in mall REITs that did not make this top 10 list, including Vera Bradley, Loft Outlet, Apple, Planet Fitness, Pottery Barn, Restoration Hardware, Brooks Brothers, J. Crew, Polo Ralph Lauren, Coach, Tommy Hilfiger, Calvin Klein, Saks Fifth Avenue, and Banana Republic. Like the top 10, however, this list is dominated by fashion and clothing where size, fit and appearance matter.

facilitate the communications and logistics needs of Internet purchases. While there is a degree of competition between these new channels and traditional retail, they also support the more traditional retail sector by allowing retailers to integrate their brick-and-mortar delivery systems with purchases completed on the Internet.

These growing sectors reflect the way e-commerce is changing how all types of real estate are used, including the growing need for communications and transmission capacity for Internet and electronic communication, data processing and storage of these communications, and distribution and shipment of goods purchased on the Internet. Each of these activities relies on commercial real estate, and REITs are industry leaders in all these areas. There are seven infrastructure REITs that operate cell towers and transmission equipment; these REITs have a combined market capitalization of $119.8 billion. There are five data center REITs that own and operate ultra-modern facilities with secure air conditioning, power (and back-up power) to ensure continuous operation of the Internet for both businesses and consumers; their combined market cap is $70.5 billion. In addition, there are 12 industrial REITs operating the logistics facilities that help deliver goods directly from the seller to the buyer, with a combined market cap of $73.2 billion.

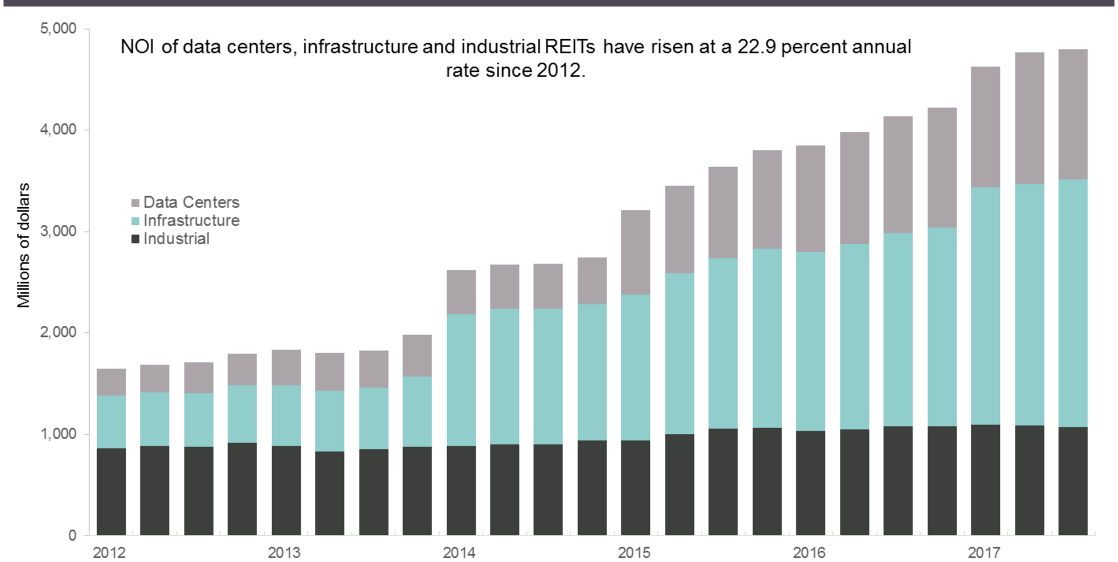
The infrastructure, data center and industrial REIT sectors have expanded rapidly, with FFO, NOI and dividends paid to shareholders all growing at 20 percent to 25 percent annual rates over the past five years, as shown in Charts 7, 8, and 9. It is important to keep in mind that these growing sectors help support

Chart 7
FFO of Data Center, Infrastructure and Industrial REITs, 2012-2017



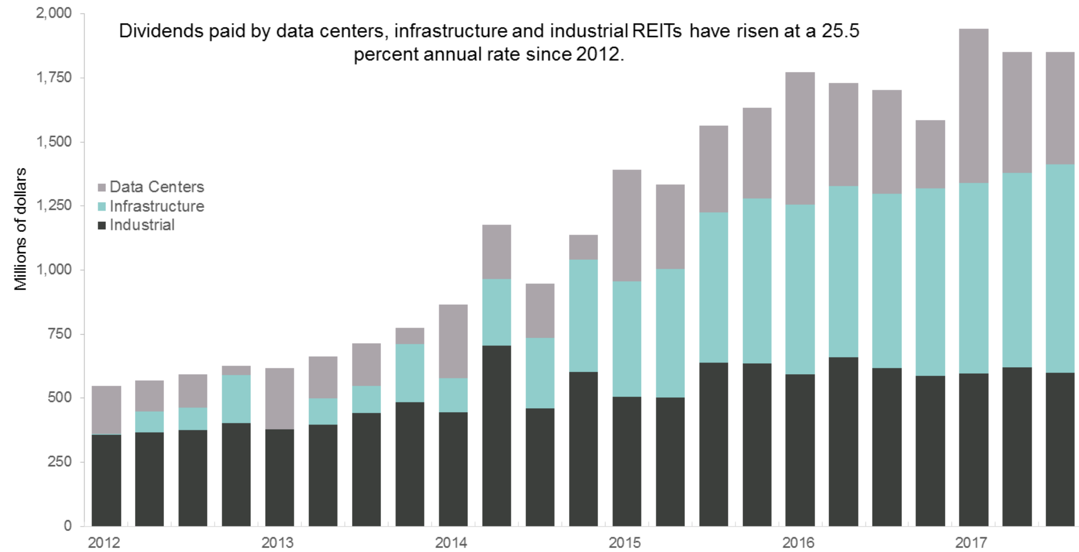
Sources: S&P Global Market Intelligence, Nareit T-Tracker®

Chart 8
NOI of Data Center, Infrastructure and Industrial REITs, 2012-2017



Sources: Company reports, Nareit 2017.

Chart 9
Dividends Paid by Data Center, Infrastructure and Industrial REITs, 2012-2017



Sources: Company reports, Nareit 2017.

the more traditional retail sectors by allowing them to integrate their brick-and-mortar delivery systems with purchases completed on the Internet.

Conclusion

The impact of e-commerce varies across the range of retail stores and the retail property sector. While some retailers that are most threatened by e-commerce have gathered the most headlines, others are thriving. In addition, the challenges facing the retail property sector are different from those facing retail stores.

The major retail stores from several years ago have adopted various strategies. Many of these center on the omni-channel approach, where a customer can shop and compare, purchase and return items either in store or online. While there has been some consolidation of space requirements, including store closures and retailer bankruptcies, most retailers do find a need for physical store locations.

The preceding analysis of the major tenants at malls owned by REITs shows how these REITs have responded to the changing retail environment. Mall owners have found new tenants ready to lease space in productive malls, which has helped keep occupancy rates high and same-store NOI growing.

Owners of retail properties have worked to improve the shopping experience. This includes modern updated facilities, as well as both long-standing types of tenants offering "experiences" including food and beverage and movie theaters, as well as more recent entrants like fitness centers, banks, health care services, higher education, indoor trampoline parks and others.

E-commerce is reshaping the way real estate is used by businesses and consumers. As older business models fade, new and more successful models for retailers and property owners are rising to take their place.

Calvin Schnure, Senior Vice President, Research & Economic Analysis joined Nareit in March 2011. He analyzes developments in the macro economy and their impact on REITs and commercial property markets, and on financial returns to REITs. He monitors performance of mortgage REITs and conditions in the U.S. mortgage market. He also conducts original research on REITs' stock market returns and economic fundamentals.

Calvin began his professional career in the early 1990s as Economist at the Federal Reserve Board. While at the Fed he analyzed the non-bank financial sectors for the flow of funds accounts, corporate profits and commercial paper markets in the Capital Markets group, and also analyzed business fixed investment, including capital spending on nonresidential structures, for the Fed's economic forecast. Subsequently he was Vice President for U.S. Economics at JPMorgan Chase, where he analyzed and forecast economic and financial market conditions, and advised senior management and clients. He was Senior Economist at the International Monetary Fund from 2002 through 2006, and Director of Economic Analysis at Freddie Mac from 2006 through 2011.

Calvin earned a B.A. in Economics from Williams College, a Master of Arts in Law and Diplomacy from the Fletcher School at Tufts University, and a Ph.D. in Economics from the University of California, Berkeley.

For further information related to this article, Dr. Schnure can be reached at: CSchnure@nareit.com.

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