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Chicago

Retail State of the Market

This is a summary of the September 26, 2019 meeting of the ULI Chicago District Council, which gathered at the Union League Club in Chicago to hear from leading retail experts about where the retail sector is heading. In the ever-changing brick-and-mortar environment, they discussed where investments are being made, as well as the companies that are sticking around through the change.

The moderator was **Matt Hendy**, *Vice President, Market Officer,* Regency Centers. Joining him on the panel were Patrick Anderson, *Vice President*, Crow Holdings; Marc Panzer, *Senior Vice President, Real Estate,* Williams-Sonoma, Inc.; and Tim Phair, *Co-Founder and Principal,* L3 Capital

Moderator Matt Hendy set the stage for the discussion by noting the dichotomy of American consumer confidence being near an all-time high even as “storm clouds” are forming amid a looming global economic slowdown.

Panelists delivered regional and national perspectives from the realms of retail (Marc Panzer), traditional shopping centers (Patrick Anderson) and urban real estate (Tim Phair).

For L3 Capital, said Phair, the focus is on the top seven markets across the country: Miami, Washington, D.C., New York, Boston, Chicago, San Francisco and Los Angeles—and aiming for “optionality” in those markets.

“What we’ve seen in every market is it’s very binary,” he noted. “…there is heavy, heavy demand to get smaller and be in more neighborhood, lower-cost submarkets within these larger cities.”

He offered a tale of two neighborhoods in Miami. One, an upscale area called Lincoln Road, has seen rents that were upwards of $400 per square foot around 2016 drop to $115 to $160 net—a 60- to 70-percent plunge. Meanwhile, in the city’s Coconut Grove neighborhood, there has been a 5- to 10-percent increase in rent.

“We have smaller spaces (in Coconut Grove),“ said Phair. “There’s a live-work-play demand, there’s a demand for office space, and for residential, whereas the beach traditionally has been driven by tourism.”

Those contrasts exist in all the cities where L3 does business, and "we have to be granular and get the information to really figure out who the retailers are, who is going to expand, and where do they want to be?"

Taking up the theme of polar-opposite experiences, Hendy said that since 2017 there have been 10,000 store closures in the apparel and department store categories, but that has been offset by more than 18,000 net store openings across all other retail segments.

Panzer noted that Williams-Sonoma, Inc., whose brands include Pottery Barn, West Elm and Rejuvenation, generates about half of its revenue from online sales, and the other half from brick-and-mortar locations that double as "customer experience centers."

"We see them as continuing to drive brand awareness," said Panzer. "How do we make sure that we show up in the best locations to make it as easy as possible on our customer? How do we make sure that we drive low-friction experiences for our customers?"

Williams-Sonoma is enjoying success, he said, in lifestyle centers and power centers, with a focus on being in people's everyday path and providing an "experience."

"For example, for all of our furniture brands, we have design centers in all of our stores and this has become a great part of our business where a customer can come in and meet with the design consultant for free," Panzer continued. "They'll come to your house, they'll help you to choose a product, help you to decorate."

Starting in 2014, Crow Holdings developed a strategy that sought to be "e-commerce and recession-resistant," as the firm focused on the top 30 metro areas by population, said Anderson.

At the time, a statistic cited by Starbucks CEO Howard Schultz made an impression on Crow Holdings: one-third of Starbucks' stores had a drive-thru, but those locations were driving two-thirds of the company's profits.

"We started to see this shift in retailers wanting to be more convenient—drive-thru being an example," said Anderson. "So our strategy really is, how can we buy shopping centers that are small-format of 10- to 40,000 square feet (tenants) that are your food, service, daily-needs tenancy, and are in areas with high buying power and disposable income."

“Perpetual demand drivers” are also crucial, he said, such as office workers, medical employees if a hospital is nearby, or universities with large student demand.

“We’ve always geared toward ‘what is the long-term play, what sort of trends are we seeing?’ And we’re seeing tenants shrink their footprint to be more convenient to the customer,” Anderson continued.

On the subject of projects that reflect some of the booming trends in the retail marketplace, Panzer said one prime example is Regency Centers’ Mellody Farm development in Vernon Hills, where West Elm is among the original tenants for an early-2020 opening.

“It was a great opportunity for us to see a project that was really about serving that customer with all their daily needs,” said Panzer.

He pointed to Whole Foods Market as an attractive anchor tenant at Mellody Farm; the grocery category is resistant to the negative effects of the e-commerce trend while also sparking frequent shopping that spurs foot traffic for nearby stores.

“He was able to pull in a bunch of value-oriented tenants, which while we know our brands are a little more high-end, we also know that the customer isn’t shopping strictly within some sort of band,” Panzer continued. “Your customer can be shopping Whole Foods, shopping at Nordstrom Rack, shopping at Home Goods, shopping at West Elm.”

The presence of local food establishments was also attractive, because shoppers prefer a “local feel” over national chains, he added. “It’s all about finding that right balance, about bringing activation.”

Other strong shopping centers include Mosaic in Washington, D.C., Ponce City Market in Atlanta, and University Village in Seattle, which Panzer described as one of the top lifestyle projects around. Its assets include proximity to a university, in an area with high-income households, and a convenient location with major names like Apple as well as a “community center” feel.

For Crow Holdings, said Anderson, one of its core strengths is in the scale of its assets across the country—over 1,400 tenants in 150 shopping centers. That includes multiple Chipotle restaurants, a client that Crow Holdings can help in identifying new locations, among other services.

Panelists also discussed the synergy between retail, residential and office uses, as they help create a more attractive overall package for investors as well as tenants and residents.

According to Phair, an "absolute must-see" destination for anyone looking for a cutting-edge example of hot e-commerce brands rolling out their brick-and-mortar presence is a section of San Francisco known as Hayes Valley. Because of a local regulation that prohibits the expansion of any chain beyond 11 stores without neighborhood approval, the area "has become almost an incubator for the direct-to-consumer brands," said Phair.

"If you've got nine or 10 stores and have one of these experiential direct-to-consumer brands, you're putting your ninth, 10th or 11th store on Hayes Street because you want to go into one of the San Francisco neighborhoods," Phair explained. "…they want access to the San Francisco demographics, and they know they can't get it if they don't do it before the 11th store."

Panelists talked about technological transformations in collecting customer data, transaction data, and psychographic profiling of customers, all of which help drive business decisions.

"Data analytics is helping us understand where our customers live, where they work, and how often they are going in to a project—we can also compare projects using these tools—so (there is) a lot of data-driven decision-making happening in a way that we never had access to in the past," said Panzer. "It's really transforming the way that we think about our real estate and allows us to be as much on the cusp of the customer's path as possible, and as convenient as possible."

An emerging technology that Anderson cited is one that helps "forecast the zoning designations for different parcels," which helps his company gauge the potential for an area.

Phair talked about the "Instagram effect" that has occurred in some pockets, such as a rundown Coral Gables, Florida street whose popularity boomed as [fluorescent umbrellas lining the street captured people's imagination](). In the process, rents tripled along the street, said Phair.

"It was purely the Instagram effect," he said. "That's one thing we do—check the hashtags. There's not a lot of science to it…to really get granular, you have to look at the individual hashtag and the street and the market, and that's something we've started to use."

Other advances, are resulting in companies having access to "cleaner" data that is more targeted and updated so they can make more informed decisions, said Hendy.

"The data is incredible. It's almost like the baseball reference from scouts (who used little quantitative data) to sabermetrics (and its extensive use of data)," Hendy added. "I've seen it in my career over 15 years. The way we pitched sites to retailers 15 years ago is not the way we pitch to retailers today. Because there's so much data out there, there are so many points, it's ever-evolving."

During a question-and-answer period, panelists fielded inquiries on various scenarios and topics, including distribution channels, trends in tenant improvement packages, the potential retail growth around Esports (video game competition), the availability of retail options near lower-income areas, and the interplay between retail and office space.

On the retail / office topic, Phair touched on a development for his firm in the Downtown Crossing section of Boston. Office rents there have "sky-rocketed," providing more flexibility in developing one particular retail-driven project, he said. Whereas it had been envisioned as 80 percent retail, it is evolving into roughly half-retail and half-office space, he estimated.

"I think in the markets we play in, whether it's Manhattan or Boston or Chicago, Fulton Market—office rents have gotten to a point where it makes underwriting second- and third-floor space a lot easier," said Phair.

The audience's final question was about the relative importance of retail sales—from the standpoint of a tenant's leverage with the landlord—versus e-commerce sales.

"While e-com is factored in in some way, you still want to make sure you're driving a profitable four-wall box," said Panzer. "That stays of the utmost importance. Obviously the more productive you are…the more you have leverage with your landlord to negotiate because they're not going to want to lose somebody who's driving up the value of their center."

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