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RESEARCH NOTE

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RETAIL PROPERTY UPDATE

Refreshing the Business - Many Retailers Announce New Plans Involving Changes to Property Usage

OVERVIEW

- Substantive seasonal news-flow from the retail REIT sector
- Real estate prominent in many retailer business plans
- Muted macro environment - consumer spending growth remains rather subdued, notwithstanding lower energy prices
- Omni-channel/e-commerce evolution continues
- Divergence of performance/prospects for retail property dependent on type/geography
- We believe investors need to look for adaptable REIT management and asset quality

The early months of a new year are usually a plentiful time for news from the retail sector. Public retail companies report their Q4/FY 2014 earnings, which include the critical holiday period, and many provide initial earnings guidance for the forthcoming year, together with comment on the current state of the business and plans for future positioning. There is typically news from many private companies as well. This year is no different. Against a backdrop of a positive but still subdued consumer, and in light of the transformational changes being wrought by e-commerce, some retailers continue to expand their physical presence and add new stores, while others are seeking to reduce store counts and otherwise rationalize their businesses.

While the current nature and pace of change in retailing may seem unusual, change is a fact of life within the sector. The rise and fall of retail tenants is an ongoing occurrence, as are changes in the economic vibrancy of different geographies, meaning some locations thrive while others perform poorly. Another recurring theme is change in consumer tastes that favor certain types of retailers over others (for example, the relatively recent rise of home improvement and pet stores, compared to the decline of book and record stores). Most retail landlords who have survived a business cycle or two have learned by necessity to adapt to change. **We are of the view that retail property investors need to look carefully at the underlying quality of the assets they are buying into and, in particular, for management that is capable of responding to the changing needs of the retail tenants.**

It does appear to be appropriate for retail property investors to focus most heavily on fundamental demand. At present, overall new retail property supply remains relatively in check with activity limited by largely conservative development funding requiring high pre-leasing.

NEWS FROM THE TRADED REITS

The traded retail REITs produced positive Q4/FY14 earnings and forward earnings guidance. Most companies reported historically high year-end occupancy in excess of 95%, lease renewal spreads in the high single digits or higher, NOI growth of 3% or better, healthy dividend increases and earnings guidance for further FFO growth in 2015. Many traded companies are focused on high-end retail properties, which have generally been outperforming the overall retail property market. REIT stocks included in the shopping center and mall sub-sectors have performed in line with the overall REIT sector in 2014 and YTD'15, when measured by the FTSE NAREIT Index.

There has been a recent trend among the traded REITs to spin-out sizeable portfolios of properties. Simon Property (SPG) spun-out Washington Prime (WPG) as an owner of less productive malls and shopping centers. WPG subsequently announced a merger with mall company Glimcher Realty, which closed earlier this year. Vornado (VNO), principally an owner of office properties in New York and Washington DC, spun-out its retail properties with Urban Edge (UE). Investors have generally been positive on the post-split parent owning a more focused portfolio, but less enthusiastic about the new company spin-outs. Most recently, SPG has made an offer for large fellow mall REIT, Macerich (MAC). Should the deal go through it would mark further consolidation of the ownership of up-scale malls in the US; however, MAC has rejected the bid and the board has made governance changes in an effort to make a takeover more difficult.

CONSUMER SPENDING SUBDUED, OUTLOOK POSITIVE

We believe that growth in the economy, improvement in the job market and the benefits of lower energy prices should combine to support a positive outlook for consumer spending, which we think should bolster retail space demand. There is little in the most recent data to support the idea of additional spending related to energy savings, though the price of crude oil has halved and the price at the pump has declined by about 40% since mid-2014. If energy prices stay low, however, we do think over time, there is likely to be some pick-up in consumer spending.

Q4'14 GDP of +2.2% was revised down from 2.6% on the first read. Business spending and the trade deficit were drags while consumer spending was a robust +4.2%. Market expectations are for GDP growth of around 3% for FY'15.

Jobs are being added at a fair clip, with 295k added in February after 3mm/246k per month in 2014.

Consumer spending declined 0.2% m/m in January, while incomes rose 0.3%. Headline spending data included gas sales, which would have reflected lower prices.

Retail sales in February were down 0.6% m/m (+1.7% y/y). Excluding autos, sales were -0.1% m/m (+0.8% y/y). Nonstore (e-commerce) sales were +2.2% m/m (8.6% y/y). It is likely the severe weather impacting much of the country in February suppressed overall sales.

The Consumer Confidence Index was 96.4 in February, down from 103.8 in January.

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OMNI-CHANNEL / E-COMMERCE

Most large retailers have adopted omni-channel strategies. This can be described as multiple ways of selling goods and satisfying the consumer, which include mobile devices, computers, TV, catalog and bricks and mortar. Critical to successful implementation is the maintenance of data and flexibility of the supply chain. Most attention has been paid to traditional retail business models bolting to e-commerce; however, there are now examples of e-commerce businesses adding physical stores (such as Amazon and Rent the Runway – see below).

According to the Department of Commerce, e-commerce sales in 2014 grew at 15.4% and amounted to 6.5% of total sales. Total sales grew at 3.8% in 2014, a quarter of the pace of e-commerce growth. E-commerce as a percentage of total sales has roughly doubled since the late-2000s and appears likely to continue to take market share.

There are implications for the use and demand of property associated with the rise of e-commerce. Some retailers may reduce the amount of space they utilize as they move towards more efficient and responsive supply chains and have less need for inventory. The development of 'buy-online/pick-up-in-store' programs adds a function to physical stores and will work best in locations with superior access. For high-end retailers, the desire to have a physical store to showcase their goods in the best locations is supporting robust demand in upscale malls, places of high tourism and prestigious retail street addresses.

Some retailers are less vulnerable to tech related disruption. Consumers still appear to be happy to visit a physical store to purchase goods from home improvement and pet stores, for example. More generally, some landlords have leased more space to service tenants such as health care providers, sports clubs and professional services, which has helped maintain shopping center occupancy and relevance.

Some retailers have announced larger scale business rationalization plans that have included a focus on opening smaller stores, store closings, and in some cases, corporate mergers that feature cost reductions that are likely to involve future store closings.

For many established retail businesses, the physical store does remain the principal means of contact with their customers. We have few doubts that traditional 'bricks and mortar' retail properties will continue to have an important role for most retailers for the foreseeable future.

SELECTED RECENT RETAIL COMPANY ANNOUNCEMENTS

Department stores continue to rationalize their property use and ownership.

Sears (SHLD) plans to sell 200-300 of its best stores for around $2bn to a new REIT that would be spun-off to SHLD shareholders. The stores would then be leased back to SHLD. SHLD closed about 234 stores in 2014 to shrink its store count to 1,725.

J. C. Penney (JCP) is to close 40 stores in 2015. The company will then operate about 1,020 stores.

Macy's (M) is to close 14 of its 790 stores in 2015.

Discounters are actively adapting their businesses and property needs.

Target (TGT) is to cut several thousand jobs over the next two years and plans to invest $2.2bn in the current year on remerchandising and catching up with on-line rivals. The company has 1,790 discount stores in the US. The new CityTarget stores are ~25% smaller than traditional stores of 90-125,000sq. ft. TargetExpress, the company's smallest format, is a food focused local/urban store concept that launched in 2014.

WalMart (WMT) plans to open 200-220 new stores in 2015 with a focus on smaller, discount stores of 106,000sq. ft. (compared to the Superstores of 186,000sq. ft.).

Family Dollar (FDO) shareholders approved the $8.5bn bid from Dollar Tree (DLTR) to acquire their company. Assuming the FDO/DLTR deal closes, it is expected that there could be about 300 store closings, along the lines indicated by the Federal Trade Commission on competition grounds.

Other Retail News Includes:

News has featured mergers and rationalizations among some well-established names and from several 'teen' retailers.

Office Depot and **Staples** announced a planned merger, which would likely result in store closings. The merger of Office Depot and OfficeMax in November 2013 resulted in plans to close at least 400 store closures (~20% of the combined total) by end 2016.

RadioShack (RSH) has filed for Chapter 11 bankruptcy after agreeing to sell 1,500-2,400 stores to Standard General, an investment company. Standard General intends to partner with Sprint Corporation to operate up to 1,750 stores. The bankruptcy court is being asked to consider closing the balance of the 4,000 stores (1,600-3,500) not sold to Standard General.

Young women's retailer **Wet Seal (WTSL)** has closed 338 stores (two-thirds of the total) and filed for Chapter 11 bankruptcy.

Cache, the women's dress and formal wear retailer, is liquidating its business, impacting over 200 stores.

Delia's, the teen retailer, is liquidating its business, impacting over 100 stores.

Deb Shops, another teen retailer, is liquidating its business, impacting 300 stores.

Aeropostale (ARO) is looking to close 50-75 stores in 2015 and 175 over the next few years, after closing +100 stores in 2014.

Abercrombie & Fitch is planning to close 180 (~20%) of its US stores in 2015.

Also adding to the supply of space, **JP Morgan (JPM)** is to close 300 bank branches (~5% of its total count) as customers move online and the bank seeks to reduce costs.

SPACE TAKEN UP BY NEW RETAILERS

Out with the Old, In with the New

Rent the Runway, the online designer dress rental business, is expanding into physical space. It currently has stores in New York (two), Las Vegas and Washington. Successful European fashion retailers including **Primark** (taking space from Sears), **H&M** and **Top Shop** continue to expand their store counts in the US. And, in a much publicized move, **Amazon (AMZN)** is set to open a store on 34th St., Manhattan, later this year.

Good quality, well-located retail property has historically proved to be an adaptable asset. Operated well by good management with appropriate and timely capital investment, retail properties can have long and productive lives.

OPEN NTRS WITH RETAIL PROPERTY INTERESTS

- American Realty Capital Global Trust II, Inc.
- Cole Credit Property Trust V, Inc.
- Corporate Property Associates 18 – Global Incorporated
- Hartman Short Term Income Properties XX, Inc.
- Inland Real Estate Income Trust, Inc.
- Phillips Edison Grocery Center REIT II, Inc.

DAILY NAV REITS WITH RETAIL PROPERTY INTERESTS

- Cole Real Estate Income Strategy (Daily NAV), Inc.
- Dividend Capital Diversified Property Fund Inc.
- Jones Lang LaSalle Income Property Trust, Inc.
- RREEF Property Trust, Inc.