



Trouble in the Retail Sector: What's in Store for Communities?

By Michael Stumpf, January 2009

Retail is struggling. The past few months have produced an unrelenting stream of bad news for the industry, with declining sales and a record numbers of store closings. Early hopes that the upscale segment of the market would weather the storm soon proved to be baseless. Nobody is immune.

Recent data along with analyst predictions give some idea of the scale of the problem.

- The U.S. Census Bureau reported that December 2008 sales were down 2.7 percent, and total sales in 2008 declined 0.1 percent from 2007 levels.
- More than 500,000 retail jobs were eliminated in 2008 with further losses expected in 2009. These jobs are not all in stores. They include call center, distribution, and headquarters operations.
- An estimated 148,000 US retail closed in 2008. The International Council of Shopping Centers predicts that as many as 73,000 retailers may close during the first half of 2009. The total number of closings may hit 200,000 stores.
- According to Reis, Inc., vacancies at regional malls reached 7.1 percent in the fourth quarter of 2008, while the vacancy rate rose to 8.9 percent at neighborhood and community centers. The overall retail vacancy rate ended the year at 8.3 percent.
- Grubb & Ellis expects net retail space absorption to end 2009 at negative 12 million square feet. This will result in a vacancy rate of 9.9 percent. Alterna-

tively, Property & Portfolio Research, Inc., has predicted a vacancy rate soaring to 17.3 percent for centers sized 30,000 square feet or larger. These centers house the mid-box, department store, and specialty retailers most susceptible to the economic downturn.

- Regardless of who may be more accurate in their estimates of the vacancy rate, all analysts agree, and data supports the claim that asking rents will be declining in 2009. This will put further pressure on landlords with vacant space and cash flow concerns.
- The CoStar Group has analyzed commercial mortgages on properties throughout the country to predict a 300 percent increase in the number of delinquencies in 2009.
- Goldman Sachs is predicting that commercial property values will drop between 21 and 26 percent in the next few years as the market seeks a bottom.

In short, 2009 – and likely 2010 as well – will bring further declines in sales, an escalating number of store closings, a high rate of retail vacancy, and a substantial increase in the number of distressed commercial properties. For communities, this translates into a loss of jobs and businesses, decreased shopping opportunities for residents, struggling business districts, additional policing and code enforcement needs, and declining sales and property tax revenues.





Retailers feeling the pain

Don't look for any group of stores to perform well. Instead, it seems like some within each sector may perform better, based more on their business strategy rather than the market they serve. While the electronics sector may not be doing well overall, for example, a handful of electronics retailers are still seeing sales growth as a result of service and their product mix. The same is true of apparel.

Department stores, which have struggled for many years to retain market share, are among the hardest-hit retailers. December sales at Neiman-Marcus were down more than 25 percent from one year ago. This has implications for malls that rely on their drawing power to feed customers to specialty tenants. An increasing number of malls may ultimately go dark as the few remaining department store chains close underperforming stores.

Apparel stores are particularly vulnerable to closing when a mall loses its drawing power. This sector is already struggling with declining sales, and most analysts predict continued declines as consumers forego clothing purchases.

Furniture and home furnishings stores have made up about a quarter of recent store closings. This sector expanded rapidly with the housing boom in the late 1990's and early 2000's, helping to fuel the rejuvenation of many specialty shopping districts. The struggles of this sector may now be a factor in derailing downtown programs in small and large communities alike.

Add gas stations to the list of suffering retailers. High prices initially, and now the faltering economy have combined to finally get Americans to drive less. We are spending less on gas, and making fewer trips into the convenience store as well.

Closures and Retail Center Formats

It is difficult at present to foresee whether malls, strip centers, or traditional business districts will fare differently over the coming years. A case can certainly be made that the closure of many mall anchors will lead to decreased customer traffic and the departure of smaller tenants. Is this any different for strip centers?

Over the past decade or so a majority of the new retail space constructed in the United States has been in power centers and strip malls anchored by discounters and mid-box retailers. Prominent among these are a large number of the retailers that already have, or are expected to close stores, such as Gap (85 stores), Fashion Bug (100 stores), Office Depot (126 stores), Footlocker (140 stores), Mervyn's (149 stores), Rite Aid (181 stores), Bennigan's Restaurants (220 locations), Goody's Family Clothing (282 stores), Movie Gallery (378 stores), Circuit City (567 stores), Linens 'N Things (589 stores), Starbucks (600 stores), and many more. Expect more announcements from chains including Borders, Kmart/Sears, Pier 1, and Staples, to name just a few. Add to these a coming wave of bank branch closings as a result of consolidation and cost-cutting. All of these closings are bound to create vacancies that will be hard to fill, especially in markets where retail space was already overbuilt. Community shopping centers will be hit hardest, while neighborhood centers anchored by grocery stores and drug stores may be less affected.

Traditional business districts often have relatively few chain retail businesses, and may therefore be spared some of the effects when a national retailer goes under. But independently owned businesses are also impacted by diminished spending and may have less available cash to carry them through until sales again begin to rise. Few statistics are available to document current trends in independent business closings, yet anecdotal evidence suggests a rising number of vacancies on Main Street.

The geography of retail distress

What parts of the country are going to be hit the hardest? Analysts have noted a consistent correlation between the severity of decline in the local housing market and the performance of retail stores and retail real estate. Foreclosures, underwater mortgages, and eroding home values are leading us from an era of asset-funded consumerism to a cash flow economy, with the result that households are spending less.

Another likely scenario is that newly developing areas on the suburban fringe will be among those hardest hit. Stores in these areas have not had sufficient time to establish themselves. Often, their decision to locate in these areas is based on an assumption that an adequate market will grow around the store. With new housing construction all but stalled in most markets, the needed customers have not materialized. Stores in these areas tend to be among the weak locations pared by chains as they seek to improve their bottom line.

Rural communities may be among those least affected. Initially, these places were benefited by the rapid escalation of fuel prices that made lengthy travel to larger market centers costly. This made local shopping (but also Internet purchases) more attractive. Although gas prices have now dropped, people continue to be reluctant to travel for shopping unless it is necessary. The trick for rural retailers will be to find ways to offer the service, selection, and competitive pricing that are needed to sustain local shopping over the long term.

The future demand

It may be helpful to consider possible short- and long-term trends. These would include changes within the retail industry and also in the way in which we develop.

To start with, many people are looking for the economy segment, including discount stores, dollar stores, and others, to do well during the recession. A variety of factors suggest otherwise. Discount stores, including Walmart, did not fare particularly well during the past Christmas season. Furthermore, product costs that rose sharply in the second half of 2008 put a squeeze on profits. Still, chains like Aldi and Family

Dollar are opening new stores in 2009, which is more than can be said for other retailers.

At least for the moment, it appears that there are four strategies that hold promise for retailers.

- **Discount.** Just about everybody is cutting back on spending and looking for bargains. Customers who frequented department stores may turn to Target, and Walmart customers who never ventured into a dollar store may now do so. In the coming months, bargains will be the driving force in retail. Walmart, Target, Ross, Kohl's, TJX, Family Dollar, Aldi, and Big Lots are some names you may see attached to this strategy.

- **Provide a premium product at an affordable price.** The market for high-quality or status goods will not go away, although it will shrink. The stores that capture it are those that can maintain a reputation for quality while also providing merchandise at an accessible price. Many independent retailers will fit this model. Among bigger retail chains, this approach may be adopted by niche chains like Bass Pro or Coach.

- **Cater to the new homebodies.** Americans will be staying home more regularly as they hesitate to spend money on restaurants, travel, and entertain-



ment. Instead, they will spend money on activities for their homes. GameStop, for instance, saw its holiday sales increase ten percent over the previous year. Besides electronics, activities such as home remodeling and gardening may see stronger sales as a result of people staying home.

- **Provide a unique experience.** This has always been a strategy for some stores and business districts. Ap-

ple and Cabela's come to mind, as well as many downtowns that host concerts, farmer's markets, and other events. The entertainment factor is a draw for customers, and perhaps more so when people are more reluctant to pay for entertainment.

The successful chains are going to have their pick of sites for new stores or to relocate existing ones to better real estate. There will be a substantial number of retail properties available to lease on favorable terms. There will be more available space than potential tenants, however, and less desirable locations are likely to have a hard time leasing storefronts.



This oversupply of retail space will have two more outcomes. First, there is unlikely to be a great deal of new retail construction during the next several years. Second, as the economy returns to health we may see a desire to redevelop poorly performing retail centers with different uses. Fringe locations with new buildings will be the most challenging, both because of the economics of redevelopment and the scarcity of viable alternative uses. Sites in inner-ring and established suburban locations will hold the most promise.

This market for redevelopment is shaped by three trends developers anticipate on the other side of the current crisis: 1) the ascendancy of Generation X and Generation Y homebuyers and renters, who already show an inclination to prefer active urban environments; 2) an expectation that people will choose to live closer to the urban core, partly for improved access to a greater selection of jobs, and partly due to

rising commuting costs; and 3) financial conditions that make higher-density and multifamily housing a more appealing option. Under this scenario, secondary retail locations may be ideal for conversion to residential or mixed uses.

A last trend to watch for is a rise in retail entrepreneurship. The departure of large competitors will leave a void in many markets at the same time that experienced retail professionals will find themselves out of work. This is a natural environment for entrepreneurship.

Community responses

It is this last trend that has, perhaps, the greatest potential for communities as they seek to restore vitality in their commercial districts. After all, there will be fewer chains, and even if they do not have a presence in the trade area, few of them are opening any new stores now. Besides, new stores will create *unique* shopping experiences, and that is one of the best ways to draw customers.

Few economic development programs have very good programs for developing retail entrepreneurs. This stems from our long-time bias to working with manufacturers. But in an age where quality of place is critical to attracting the talent needed by businesses, retail start-ups need to be given a greater priority. An effective program for retail entrepreneurship should include training, technical assistance (especially with creating a web presence), and targeted financial incentives for uses such as inventory, interior tenant improvement, fixtures, and working capital.

Attraction – and more importantly – retention should be another area on which to focus in the near term. Customer traffic is already declining in most places. Where anchor tenants depart, whether in a regional mall, strip center, or downtown business district, customer visits may drop off precipitously, leading to a further wave of store closings. Downtown programs that already host traffic-generating events and promotions may need to step up their efforts, while malls and commercial strips may need to give some thought to this practice.

Rather than wait for conditions to deteriorate, now is the time for economic developers to work proactively with property owners. With financing unavailable,

space going dark, and declining rents, many of these owners will not be in a position to renovate their property, or perhaps even continue to maintain it.

Redevelopment may be the ultimate fate for many commercial properties, as we are unlikely to see the same level of demand as existed prior to the economic slump. Marginal locations may not find new or from the community's standpoint, desirable uses. Redevelopment may be possible with other uses replacing retail space.

Standard approaches may not be available in this economic climate. Tax increment financing, for example, is hard to support when property values are declining and there are no apparent prospects for development to generate value increments. Similarly, general fund revenue based on sales and property taxes is not likely going to be available. We may yet see a return of grant programs such as those available in the recession of the early 1980's, but so far, the options are limited.

Where to begin? The answer is to conduct a realistic assessment of the threats and potential opportunities both now and in the long run. What businesses and properties are in danger? What are the possible issues and costs associated with rising vacancies and declining values? What is the current market and how may it be evolving during the next few years?

Knowing answers to these questions, communities can begin to prioritize concerns and devise strategies that minimize risks and position it to capture prospects once the economy improves.

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