



# nerej

## **Buyers should assess the upside potential and the downside risk associated with each property**

March 24, 2010 - Spotlights

It's now reasonably safe to conclude that the retail cycle found a bottom somewhere around the end of Q3 last year. Comp-store sales for many retailers have been trending in the black since that time, albeit modestly, and financial results, after trimming inventories, are showing very encouraging year-end profit gains. Although bankruptcies and store closings continue, including Blockbuster, Hollywood Video, Ski Market, Bernie's Appliance and others, we have seen retailers take advantage of favorable rents, absorbing a number of larger format retail spaces such as the former Circuit City and Linens 'n Things boxes. To date, there are commitments for 16 of these boxes in our territory coming from retailers such as Ocean State Job Lot, Savers, REI and a newcomer to the region, Ultimate Electronics.

A bottom that cannot be confirmed yet, however, is the bottom in commercial real estate prices. Billions of potential investment dollars raised by shopping center REITs, institutional investors, and private equity firms are sitting on the sidelines. Although we are beginning to see signs that price declines are subsiding, it is apparent that they haven't yet hit the floor. Lender workouts and loan extensions are delaying the inevitable write-downs in real estate values, but most prognosticators forecast that buying activity will improve later this year. Simon Property Group's \$10 billion bid for General Growth may suggest that some confidence has been restored to the markets. This could arguably act as a catalyst to close the current price gap between buyers and sellers. When investors decide that fair market pricing is returning, it is imperative that they diligently assess not only the upside potential but also the downside risk associated with each property.

Between 2005 and 2007 we witnessed a commercial real estate buying frenzy, in which properties were grossly overvalued but buyers were still willing to write the checks. It seemed investors couldn't find a property they could say no to, and that lenders couldn't place money fast enough. Whether overly aggressive assumptions regarding value-added scenarios were made, or the vulnerabilities of shopping centers and/or existing tenant mixes were simply underestimated, one thing is sure...buyers overpaid. So this time around, let the buyer beware!

Some of the salient considerations to which buyers should pay close attention include the following: What is the financial health of the anchor stores? A buyer needs to consider the historic sales and profit trends of key tenants as well as their competitive ranking within respective merchandise categories.

What does the competitive alignment look like? What is the potential of a retail competitor relocating or expanding and ultimately improving its competitive position in the trade area? For example, a nearby Walmart expanding from a traditional store prototype to its Supercenter format or relocating to a new Supercenter development could have a detrimental effect on a supermarket anchored shopping center.

Is the property appraiser using relevant shopping center comp sales in assessing a center's market value? Just because a property of similar size and with similar tenant mix sold for \$X, it doesn't necessarily mean that the property under evaluation should also. If one of these shopping centers is located within a very productive retail concentration while the other is located in a secondary market with an inferior demographic profile, the appraisal could be significantly distorted.

Speaking of demographics, what is the population trend within the trade area? Are demographic changes in the market going to impact a shopping center's tenant mix? Is the tenant mix appropriate based on the income and taste levels within the trade area? Should the crime rate be a consideration in assessing a shopping center's longer term viability? A thorough examination of demographic shifts within the trade area should not be overlooked.

Is the local economy diversified enough for the shopping center to withstand an economic downturn, or is it a one-industry town? In communities impacted by GM plant closings, high unemployment likely had an adverse impact on local shopping centers. Without job opportunities in other sectors of the economy creating jobs, high unemployment rates may be prolonged, affecting long term viability of the acquisition.

If the shopping center has expansion capability, does the valuation of the shopping center include future rental income even before the expansion potential is determined? Perhaps the shopping center is competing with competitive space on the market that can offer better lease terms, diminishing the potential of the assumed expansion.

For the most part, cash flow, rental rates, and lease term expirations tend to be on the front burner when shopping center acquisitions are evaluated. But buyers should never ignore the factors noted above, particularly in relation to buy-and-hold strategies. A-rated properties have a premium attached. The reasons should be obvious: buyers, be well informed when you buy!

Bob Sheehan is vice president of research for KeyPoint Partners, Burlington, Mass.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540