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Investors in retail-oriented commercial real estate should remain aware of a few key topics - by Chris McDaniel

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It will come as no surprise to any retail real estate investor that the sector remains fundamentally altered and challenged by on-line retailing. The volumes of articles on dead malls and retail location closures are further testament to what we already know and what Warren Buffett was quoted as saying in a CNBC interview, “Retailing is very tough, and I think the online thing is hard to figure out.” In December of 2017, Moody’s Investors Service released a “stable” retail outlook for 2018, with retail sector operating income expected to grow from between 3.5%-4.5%. Also, Moody’s further expects speculative grade retail defaults rates to peak and then decline to 4.9% in October of 2018. Despite a “stable outlook,” investors in retail-oriented commercial real estate should remain aware of a few key topics outlined below, especially if they are seeking debt to buy, or refinance their commercial real estate debt.

First, interest rates are rising. The fed raised interest rates in December 2017 and according to Reuters’ December 13th article “Fed raises interest rates, keeps 2018 policy outlook unchanged,” the forecast of three rates increases in 2018 and 2019 remain. Additionally, the 10-year Treasury on 1-19-18 is 2.62%, up from 2.45% last month and well off the recent nadir of sub-2.1% in September of 2017. For owners that are seeking long-term fixed rate debt, locking in a low interest rate will likely become increasingly important. My firm A10 Capital, for example, is a provider of 7-20 year fixed rate debt on its non-recourse permanent loan platform. These are loans that A10 keeps on its own balance sheet and does not sell, so there is no B-piece buyer risk, like in CMBS. Additionally, for non-stabilized assets, where a borrower typically obtains floating rate mortgage debt, 30-day LIBOR is 1.56% (1-19-2018), up from 1.29% two months ago and up from sub 1% in May of 2017. A10 also provides non-recourse bridge debt for owners of assets that are not yet stabilized and moreover can offer fixed rate bridge loans, in the event a borrower wants to hedge floating interest rate risk.

Second, a January 2, 2018 WSJ article, “Peak Commercial Real Estate Prices Force Investors to Get Creative,” is instructive in its analysis of what may be coming for real estate generally, as well as for retail in 2018. If asset pricing is at, or near peak levels, lenders are going to be especially cognizant of potential valuation re-sets. This could very well affect commercial mortgage loan proceeds. Particularly in the retail sector, owners should be very prepared to articulate their business plan and their asset's competitive advantage, whether bridge, or permanent financing is needed. Having the right lending relationships are going to continue to be key, as each retail asset will face heightened scrutiny in the lending market. A10 Capital is a relationship lender that is committed to understanding its client's needs and to providing non-recourse debt, that it holds on its balance sheet and services in-house.

Finally, the brick and mortar retail sector is not "dead." However, consumer preferences have changed and 2018 will see more re-imagining of brick and mortar space. According to Steve Patterson, CEO of Related, "[t]he single biggest challenge is walkability." (WSJ Property Report) Patterson's comments are reflective of today's consumer demand for instant gratification. Whereas on-line shopping is supplanting the pre-internet's inconvenient 30-minute drive to the suburban mall, it is not replacing the consumer's desire to enjoy attractive brick and mortar retail locations, close to home and work. For example, retail owners are constructing multi-family buildings, or offices near retail locations to bolster walkable traffic. In some cases, they are even building new retail locations like GGP's SoNo Collection in more dense and wealthy suburban markets. This 700,000 s/f new development in Norwalk, CT, although an anomaly, is representative of the quest to re-imagine retail. This strategy is more likely to work where retail is proximate to a growing and walkable market like Norwalk, where 1,500 multifamily units have been built in the last 5 years. Moreover, the location is purpose-built to deemphasize the traditional transaction focused brick and mortar retail experience, by adding outdoor/indoor space that encourages the type of community gathering that you can't get on the Internet.

Make sure to reach out to relationship lenders like A10 Capital in 2018. Understanding your market options for debt today will be key to obtaining a great execution.

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