the RETAIL BRIEF

SOUTHEAST RETAIL INVESTMENT ADVISORS

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5 Five Questions With...

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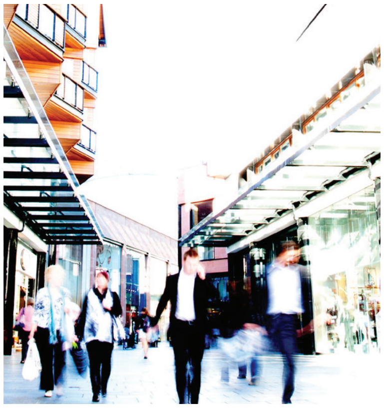
Q&A

1: What is the Overall U.S. Capital Markets Outlook for the remainder of 2019 and 2020?

A: 2018 was the third strongest year for transaction activity on record, with volumes coming in just a hair below 2015 levels. M&A activity exploded in 2018 – much of it involving consolidation and/or privatization in the retail sector. This drove the outsize increase in volumes, but core single asset sales also continued to increase at a 6% pace, as has been more or less the case in recent years.

Meanwhile, the economy grew as fast as it has at any point in this cycle while inflation has remained moderate. This is the context as we think about 2019 and 2020. Overall transaction activity is going to moderate in 2019 since we are unlikely to repeat 2018's outsized M&A activity, but single asset sales volumes will continue to increase to the tune of 3% to 6%, driven predominantly by private capital (a group of investors that has more flexibility in respect of deal sizes, risk profiles and market selection than either institutions), REITs or cross-border capital. Institutional investors, specifically value-add and opportunistic vehicles, have tremendous amounts of dry powder pushing on them to deploy.



I don't think this translates to a dramatic increase in deals because we are in a market where pricing is effectively in equilibrium; however, it creates a floor under transaction volumes and pricing. The debt markets also continue to be incredibly supportive amid elevated competition among different lender groups (banks, life companies, CMBS and debt funds) for deal flow. Earlier in the cycle, these different groups segmented out the market by asset quality and leverage, but we are seeing increased overlap among these groups to the benefit of borrowers. Debt spreads meanwhile remain historically healthy and underwriting is conservative, so I don't see this as a red flag. Which brings me to the economy – this outlook is predicated on the U.S. economy continuing to grow albeit at a moderating pace over the next several years. This is my (and Cushman & Wakefield's) base case, and I'm more confident in that case now because 1) the Fed has turned more dovish, 2) the prospect of a China trade deal seems to have improved and 3) public – though not private – tech company valuations have corrected.

2: The Southeast's economic growth and expansion has been largely fueled by Sunbelt migration and corporate relocations. Do you foresee this trend changing and how much more gas is left in the tank?

A: I do not see this slowing down. If anything the most recent data we have seems to indicate that this trend is accelerating. Reaccelerating would be a more appropriate word as what's happening as the shift in bodies and businesses to the Sunbelt has been ongoing for decades – more or less since the invention of air conditioning (not kidding). The attractive climate, lower cost of living, better business environment and resulting dynamic economies all continue to attract population flows to the Sunbelt from high cost regions in the west and northeast as well Midwestern metros that have struggled with economic transition to the services and technology economy. Broader demographic forces seem only to support this continued migration with the baby boomers entering their retirement years and millennials forming families, both of which increase the attractiveness of metros with more affordable cost of living, notably housing.

3: There continues to be significant levels of capital formation for real estate investment. Can you provide a historical context?

A: I refer to this more obliquely earlier, but to put a fine point on it, there was $223 billion dollars in dry powder at close-end funds targeting North American real estate in February – up from $194 billion in December. That means that new fundraising has been particularly robust so far this year, making up for some weakness in the fourth quarter amid the financial market stress. At the peak of the last cycle, these funds had only $96 billion. The situation is a bit less flush for the open-ended core funds, and anecdotally, we hear some funds face queues for new investors while others face them for redemptions.

Overall however, net cash flows have turned positive and contributions are at or near all-time highs. REIT capital raising meanwhile has decelerated strongly recently amid stressed valuations, but with REIT stocks recently performing strongly relative to the market – if not necessarily relative to NAVs – we could see an uptick in 2019. The biggest bucket of capital and the least transparent, however, is private capital. If we judge from their acquisition and disposition activity, they are still generating attractive returns and in position to continue to recycle capital.

4: What are the economic threats that keep you up at night?

A: There are things that still keep me up at night, including 1) economic slowdown throughout much of the world 2) political instability in Europe (UK, Italy, France) and 3) the necessary transition of the U.S. growth engine from job growth to earnings growth, which was apparent in the most recent jobs and wages report.

The good news is that none of these risk factors require a recession as opposed to slowing growth, but the more that growth slows, the more susceptible the economy is to shocks as Germany's near technical recession in 2018 demonstrates. Regardless, I think the central consideration for investors is that the next economic correction – whenever it should occur – will not be a repeat of the financial crisis and though I'm all for prudence, they should not manage their portfolios on the expectation that it will be.

5: Do you foresee opportunity zones having a significant impact on retail investment and development?

A: I think opportunity zones are extremely exciting for specific geographies and the overall amount of capital that will be deployed over the course of the program will be meaningful – potentially in the range of $100 billion. Most the capital is likely to focus on housing assets, but I also see opportunity for other product types, including retail. The program supports development and heavy repositioning of existing assets. If I were a retail opportunity zone fund investor, then I would be looking for Class B and C malls that are under distress and are in an opportunity zone that either has some existing economic momentum or is adjacent to areas that have this momentum.

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This situation provides a fundamental case for redeveloping/repositioning the mall into a mixed-use format with a housing and/or office component and has the vacancy to support shift in the tenant mix towards more experiential retail. That is a formula that could work and where the tax benefits would turbocharge the upside return. More broadly, many of the opportunity zones are retail deserts, which contributes to a vicious circle in which businesses and people don't want to move there because it lacks amenities. The opportunity zone program could be the spark that jump starts investment or accelerates it thereby attracting tenants and supporting existing property values or justifies the case for modernizing existing space.

Bonus Question: What is your favorite retailer and why?

A: I am stereotypically millennial in most of my discretionary dollars go to experiential retail. In particular, I'm a dedicated patron of restaurants and gyms (symbiotic relationship there).