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## To Buy or Not To Buy: Retail Strategies in Today's Consumer Market

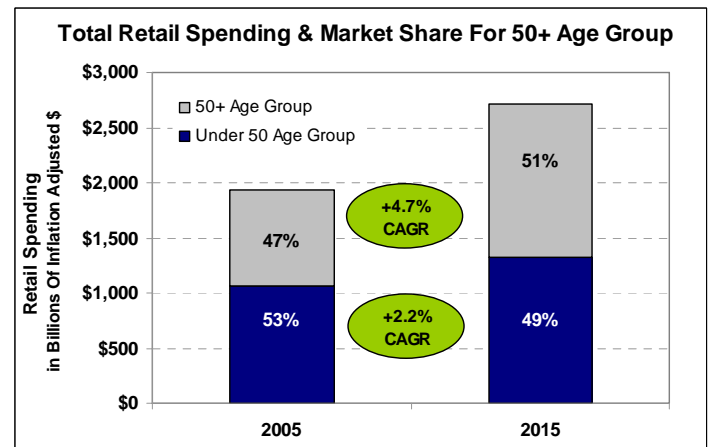
### Spring 2010 Newsletter

The retail sector is undergoing changes that are likely to have a significant effect on private real estate investment strategies. In this newsletter, we will cover the dominant changes in retail trends that are occurring or are expected to occur over the next few years including those driven by demographics, competition, consumer preferences and technology. By making informed investment strategy decisions regarding these significant trends, investors can select the types of retail assets and tenant strategies that are most likely to earn above-average investment returns in the years ahead.

### Demographic Changes

The aging of the Baby Boomers generation (population born between 1946 and 1964) and to a lesser degree the graduation of the Baby Boomers' children from college are likely to be key demographic factors that drive changes in retail real estate demand in the years ahead. In particular, the 50+ age group represents a wave of retail spending that is likely to grow at a 4.7% annual rate or more than double that of the remaining portion of the

population. The wave of retail spending from the 50+ age group is likely to be so strong that it is forecasted to account for 51% of total retail spending by 2015, compared to 47% in 2005. In total, 66% of the growth in retail spending is likely to be focused to the 50+ age group. Contributing to the growth of retail spending by the 50+ age group is the likelihood that this generation will work more years than past retirees, which will help support income and retail spending levels that are forecasted to increase by more than 20% between 2005 and 2015. Like the 50+ age group, the 25 to 40 year old age group, or Generation Y, is also expected to be a key driver of retail demand, since this group accounts for the majority of new households, although the growth is not likely to be as dramatic.



**Baby Boomer Strategy:** For real estate investors, this wave of Baby Boomers entering the 50+ age group means that demand for retail space from leisure, health care and financial service retail tenants should be strong. Retailers who focus on the specific needs of this cohort will tend to do



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better in this environment. For example, as household size in the 50+ age group tends to be smaller, grocery stores are likely to find that smaller packages of fresh food are going to sell better than the super sized packaging of the late 1990's, which would be good for a Trader Joe's or a Fresh & Easy relative to a Sam's Club or Costco.

**Generation Y Strategy:** As young adults entering the workforce and building their careers begin to set up new households, the smaller, yet significant Generation Y (population born between 1970 and 1985) population is expected to grow in consuming importance until 2020. From a retailer's perspective, these consumers should help firm up the weakness in furniture and household product categories, with electronic goods capturing greater demand from this growth segment and retail centers occupied by tenants in this category should benefit.

### Competitive Changes Impacting Retail

**Expanding Retailers:** At any point in the retail cycle, some firms are expanding, many are holding constant and some are contracting. For retail centers needing to lease space, the adjacent list of expanding retailers should provide a good starting point for targeting new tenants. Looking at this list, it is interesting to note that Wal-Mart and Best Buy, normally seen as the archetype for retail expansion in the past, are missing from the top 40 retailers in terms of expansion. Stores such as Kohl's and Target are still expanding but, compared to prior years, the current pace of 50 stores or less is far below the more specialized convenience/restaurant retailers shown in the list and suggests that these traditional diversified retailers are not going to be the growth drivers that they were in past years.

Ownership of retail centers with contracting retailers could pose a challenge. To help minimize this risk, we recommend an investment/tenancy strategy focused on the market share leader of each retail category, and then selecting properties occupied by these tenants whose stores are ranked in the upper quartile of stores for that particular retailer. By doing this, retailers who have little incentive to move allow the landlord the ability to capture higher rental rates upon lease renewal.

**Big Box Retailers:** One response to the shift in consumer preferences has been the movement of big box retailers offering grocery items including Target, Costco, Meijer, Wal-

Mart and others. In particular, Wal-Mart now has over a 20% grocery market share in 15 metros and is clearly focused on expanding into large cities.

For investors in traditional retail assets, a strategy for dealing with these big box retailers tends to follow a "use them to our

advantage" or a "hide and duck" strategy. Under the "use them to our advantage" strategy, investors use the big box retailer as an anchor to help drive traffic to the area, typically by owning synergistic retail, which might include a sporting goods store, restaurants, entertainment, electronics, office supplies and soft goods stores that provide a higher level of product or service quality than the big box retailer. In contrast, under a "hide and duck" strategy, the location of current big box retailers and potential new centers needs to be considered, with the goal of minimizing likely competition from these big box retailers.

**Increasing Importance of Retail Synergy:** A successful retail strategy has always included some form of retail synergy, as one retailer by themselves will not do as well as a cluster of retailers together. This recession has clearly highlighted the type of retail synergies that work and those that don't. For example, we have found that when the cluster of retailers reaches a critical mass of over 300,000 sf retail centers tend to do better, as shoppers are more likely to combine multiple stops into an overall shopping trip. In particular, retail clusters need to include at least one grocery store, a drug store, local service firms, banking and several restaurants. Clusters with retailers that draw customers from a larger trade area than a grocery store are important to have in the retail cluster, including at

| Top Expanding Retailers in 2010  |      |                      |    |
|----------------------------------|------|----------------------|----|
| Number of planned stores opening |      |                      |    |
| McDonald's (global)              | 1000 | Five Below           | 98 |
| Go Green Station                 | 900  | Panera               | 90 |
| Dollar General                   | 600  | Big Lots             | 80 |
| Zara                             | 450  | Tractor Supply       | 80 |
| GameStop                         | 400  | Pizza Fusion         | 75 |
| Walgreens                        | 350  | Sephora              | 75 |
| Ashley Furniture                 | 300  | Wing Stop            | 69 |
| Burger King                      | 300  | Bridgestone          | 68 |
| Muscle Maker Grill               | 200  | Foot Locker          | 60 |
| Advance Auto Parts               | 150  | Papa John's          | 60 |
| Popeye's                         | 130  | Tim Horton's         | 60 |
| Chipotle                         | 130  | Darden Restaurants   | 55 |
| Target                           | 128  | Scooter Store        | 51 |
| Sonic                            | 125  | Boost Mobile         | 50 |
| Gymboree                         | 100  | Kohl's               | 50 |
| Edible Arrangements              | 100  | Ulta                 | 46 |
| Einstein Bros. Bagels            | 100  | Lowe's               | 45 |
| rue21                            | 100  | Urban Outfitters     | 45 |
| Save-a-Lot                       | 100  | Marshall's / TJ Maxx | 43 |
| Starbucks                        | 100  | Foot Locker          | 40 |

Source: About.com, ARA Research

| Wal-Mart Grocery Share Over 20% |
|---------------------------------|
| Atlanta                         |
| Austin                          |
| Charlotte                       |
| Dallas                          |
| Houston                         |
| Indianapolis                    |
| Kansas City                     |
| Las Vegas                       |
| Nashville                       |
| Orlando                         |
| Phoenix                         |
| Pittsburgh                      |
| St. Louis                       |
| Salt Lake City                  |
| San Antonio                     |

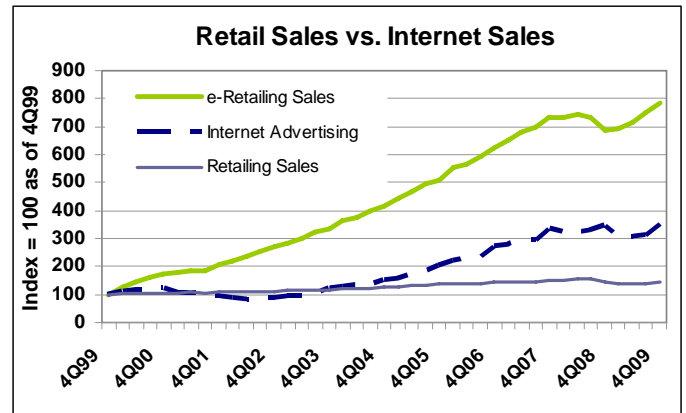
Source: Nielson Co, ARA Research

least one or two category killer retailers, such as a Best Buy or Bed Bath & Beyond. By investing in these cluster locations, the need to make a single large bet on a property is eliminated, which reduces investment risk while allowing investors to gain from the traffic generated by the overall retail cluster.

In contrast, retail clusters that lack the 300,000 sf of critical mass or have retailers that tend to only have a fairly limited trade area, are likely to underperform, unless they are located in a highly supply constrained monopoly control area, such as within a large master planned community. Additionally, we have found that the inclusion of some durable goods, such as furniture stores and car dealers, generally does not have a significant positive impact upon retail synergy, as these retailers do not tend to participate in multiple stop shopping that is important to creating retail synergy. As is true of all real estate, exceptions to these trends will and do exist, with investors needing to conduct significant customized research to understand how retail synergy impacts a particular retail center.

**Technological Changes to the Retail Environment**

**Growth Of e-Retailers:** Technology is greatly influencing how retail products are delivered to consumers. Take for example, online retailers who are gaining market share from traditional brick and mortar retailers. Since 1999, e-Retailing has grown seven fold, while the retail sector as a whole has only experienced a 44% rise in sales. This means that of the non-auto retail sales, e-Retailing grew from 2.5% of sales in late 1999 to over 14% in 2009. Clearly companies such as New Egg, Amazon and Dell Computers have been able to use the internet to drive retail sales, keep overhead costs down and to provide excellent service. This growing strength of e-Retailers is one of the primary reasons why brick and mortar retailers are using the internet to drive sales for both online and traditional stores. As the internet becomes more dominant, investors are likely to be well served to increase exposure to national retailers over local retailers, as these firms have the resources to effectively compete for consumer spending. Additionally, products that need a tangible environment such as dress clothes, and products that are less subject to bargain hunting, such as many needs-based products/retailers, are likely to effectively compete with the growing share of e-Retailers.



Source: Economy.com, Internet Advertising Bureau, Dept. of Commerce, ARA Research

**Book, Music and Video Stores:** The technology of the internet is increasingly having a negative impact on sales of print and video media, which for real estate investors means book, music and video rental stores. In particular, tenants in these retail segments are likely to downsize or not renew when their lease term is up, which poses a significant risk to many retail properties. In replacement, many of these retail spaces are being converted to service uses, with health care uses for urgent care being one of the fastest growth segments, as health care providers are working to improve the ease of accessing these health care services.

**Consumer Taste Changes**

Predicting trends in consumer preferences is difficult. For example, is the demand for dress clothes likely to increase or decrease? Will the shift to healthy food choices actually occur? Are consumers likely to eat out more or less in the future? To help understand and address these questions, we have conducted research on retail trends of companies opening and closing stores, as in the end, this is the move by retailers that can have a large impact upon retail real estate investors.

| Top Contracting Retailers in 2009 |     |                   |    |
|-----------------------------------|-----|-------------------|----|
| Closing All Stores                |     |                   |    |
| Linens 'n Things                  |     | 371               |    |
| Bombay                            |     | 384               |    |
| KB Toys                           |     | 356               |    |
| Movie Gallery                     |     | 378               |    |
| Sharper Image                     |     | 184               |    |
| Friedmans                         |     | 120               |    |
| Scaling Back                      |     |                   |    |
| Rite Aid                          | 181 | Disney            | 98 |
| Wilson Leather                    | 160 | Gap               | 85 |
| Dell                              | 140 | Talbots Kids/Mens | 78 |
| Footlocker                        | 140 | Lane Bryant       | 40 |
| Office Depot                      | 126 | Eddie Bauer       | 29 |
| Sprint/Nextel                     | 125 | Dillard's         | 26 |
| Ann Taylor                        | 117 | Pier 1            | 25 |
| Zales                             | 105 | Home Depot        | 15 |
| Fashion Bug                       | 100 | Macy's            | 11 |

Source: About.com, ARA Research

From that analysis the following trends in consumer tastes appear evident:

- Many fashion oriented retailers have experienced a significant decline, as companies like Gap, Talbots, Lane Bryant, Eddie Bauer, Dillard's, Macy's, Fashion Bug, and Ann Taylor all closed stores in 2009. In fact, nationwide clothing sales have declined by 8% in the most recent recession, which clearly shows that the clothing industry is not a recession resistant needs-based retail category.
- While the restaurant business has risks, 15 out of the 40 expanding national retailers represent some aspect of the food/entertainment sector. Additionally, during the recession, the food and drink service business only experienced a 1% decline in sales nationally. In short, this means a retail strategy focused on attracting high volume restaurants tends to be good for retail centers. In particular, Chipotle, Panera Bread and even an upgraded McDonalds are likely to do well. But to attract these tenants, the quality of tenant improvements needs to be high.

## Conclusion

While the consumer is under stress from the recession, retail investors need to adapt to a changing environment that is likely to include:

- demographic changes with retail sales growth from the 50+ age group
- an increasing focus on restaurants and services at retail centers
- the continued move toward national retailers
- the growing dominance of big box stores in the grocery business
- growing competition from e-Retailing

To adapt to these changes, we are recommending investment strategies that target leading market share anchor retailers, while shifting shop space to national retailers and focusing the tenant base on needs-based retailers that benefit from a tangible environment so as to minimize the risk from expanding e-Retailers.

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