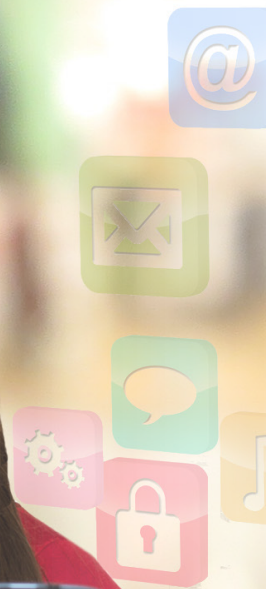


The new retail


Online shopping is having far-reaching impacts on retail and industrial property

by Denise DeChaine



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Imagine Holly Golightly, heroine of *Breakfast at Tiffany's*. She's wearing her iconic black dress and gloves with pearls, tiara and sunglasses, coffee and pastry in hand. She jumps into a cab to seek the calm refuge of the windows at Tiffany & Co., because nothing bad could happen to her at that temple dedicated to order and shopping.

But wait. What's this? The Tiffany & Co. flagship store isn't there anymore? It has become an online retailer instead?

This scenario may be unlikely, as Tiffany & Co. continues to operate brick-and-mortar locations even as it rolls out its online component, but it is happening to shops worldwide. E-commerce is taking over.

Shoppers go online

"The popularity of e-commerce has grown rapidly over the years, and it is not showing signs of slowing down," says Sebastien Nadeau, senior analyst, global real estate securities, at Presima. "While physical store retail sales are barely growing, e-commerce sales are growing at a mid-double digit rate and are taking market share from typical retail locations."

But the question many people have been trying to answer is why e-commerce has been growing so rapidly. One explanation is the millennial generation. A recent report by MetLife Investment Management, *The Age of Experience-Based Retail*, explains the central role millennials will play in our culture and economy during the next half century has made them a frequent topic of commentary and analysis. The millennial generation's preference for experiences, their rising spending power, and the changing consumption patterns of baby boomers will all play a major role in determining which retail formats outperform in the future.

The report also explains the key to grasping the impact millennials will have on the retail sector is a clear understanding of who they are. Born between 1983 and 2001, the generation has a population of about 83 million; the oldest millennials are in their early 30s. Of those millennials over the age of 25, 35 percent have attained a bachelor's degree or higher, which does not come without a price and is one of several factors weighing on their finances.

This financial burden might explain the shift, compared with previous generations, in the mode and amount of millennials' consumption: more purchases through e-commerce,

yet less in total. Where past generations were concerned primarily with the acquisition of material goods well into middle age, millennials are more concerned with the acquisition of experiences and memories, and are expected to remain so in the future.

Another reason e-commerce is taking over may be the boom in mobile- and app-based purchasing. According to the Marcus & Millichap report *The Retail Outlook: Summer 2016*, as more sales move to the digital realm, mobile devices are emerging as a vast new frontier for retailers. Currently, nearly 30 percent of all Internet-based sales are conducted on mobile devices. Millennials are leading this trend, collectively harnessing \$2.5 trillion of spending power.

"Technology has become a significant component of American shopping habits," says Scott Crowe, chief investment strategist at CenterSquare. "E-commerce is supplanting traditional brick-and-mortar stores as the go-to retail experience."

That leaves some asking what retail types are most at-risk from the Internet.

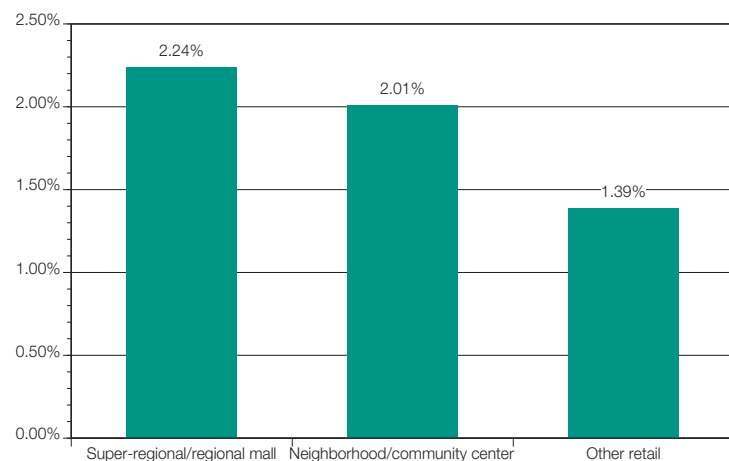
"Every retail sector is impacted to some extent by e-commerce, with all types of shopping centers in peripheral locations particularly at risk," says Lee Meniffee, head of Americas investment research at PGIM Real Estate. "The deepest potential impact initially is likely to be on power centers, which specialize in the sale of non-everyday purchases of commodity products. Retailers are only just beginning the process of 'right-sizing' that will ultimately entail not just reducing overall store count, but also in many cases reformatting their stores to a smaller footprint. The retail centers that will best withstand the e-commerce challenge will be those that serve a broader function than just utility or convenience by incorporating a larger share of service-retailers and serving as places for entertainment and leisure."

So what can retailers and retail investors do to e-commerce-proof their businesses?

First, consider some of the trends in retail. The biggest trend right now is the "omni-channel" strategy, combining physical presence and online presence.

Nadeau explains retailers with a well-established omni-channel strategy can leverage their physical store presence to generate higher net sales from e-commerce when a physical store is involved in a "buy online, pickup and return in store" or "buy online and return in store" strategy. Returns represent 23

Retail property subsector total returns in NPI by type, as of Q3 2016



Source: NCREIF

percent of online purchase and are much more expensive when not done in store.

Another trend is online grocery shopping. With more supermarkets, along with Amazon Fresh, promising same-day food delivery, the online grocery service is booming. Today, 41 percent of U.S. consumers have bought groceries online — and half of those also have done so in the past 30 days, according to a study by Brick Meets Click titled “How consumers are using online grocery and what it means for retailers in 2016.” Many consumers view online grocery as a better alternative for at least some of their shopping, and it has moved into the mainstream set of alternatives that they consider for grocery purchases.

“Same-day delivery remains a significant advantage for Amazon that should spur major retailers to improve relationships with the third-party delivery services that Amazon is already cozy with,” says Adam Ruggiero, associate director at MetLife.

A final trend worth mentioning is the emergence of nontraditional uses in shopping centers, allowing retail property owners to continue to attract and retain tenants even as more shopping activities move online.

“Healthcare providers, particularly in dental and urgent care, are leaving the traditional medical office spaces in favor of occupancy in retail centers,”

says Jay Matthes, senior asset manager, retail, at American Realty Advisors. “While the significant buildouts are costly and of limited reuse value, the rents these type of tenants can pay make them attractive. Also, we have found that they actually provide a synergistic benefit to the other retailers of the center.”

So, considering these trends, what can be done to e-commerce-proof the retail property business?

“Retail investors can curate their merchandise mix and create community gathering places to provide a social experience that is not available on the Internet,” says John Ragland, U.S. head of retail and portfolio manager for the U.S. Cities Retail Fund at TH Real Estate, a unit of TIAA Global Asset Management. “The provision of a wide range of food offerings is an important part of this experience. Options include full-service restaurants, fast-casual concepts and fast-food operators. Community gathering places can be created through the creative use of common areas, whether in regional malls and open-air centers and through retailers that provide some form of in-store activities, such as yoga at Lululemon and cooking classes at Williams-Sonoma.”

Crowe adds retail investors need to cycle out of lower-quality assets into higher-quality retail mixed with service components, such as movie theaters, nail salons and restaurants. He also adds, as traditional retailers close stores, online retailers such as Amazon Inc., eyeglass designer Warby Parker Retail, and menswear retailer Bonobos Inc. are opening physical locations in high-quality assets.

“While this does add to demand for brick-and-mortar retail locations, this omni-channel strategy is expected to also benefit high-quality, well-located mall properties specifically,” says Crowe.

Retail impact on the industrial market

Another consideration for investors is how all of this affects the industrial market. The advance of information technology, and the resulting global interconnectedness, affects logistics real estate on different levels, according to the *THINK Global: Logistics* report by TH Real Estate. The most obvious factor is the rise of e-commerce transforming the supply chain in the retail sector. It has been widely documented that e-commerce is creating occupier demand for large fulfillment centers, often with mezzanine space and increasingly automated. E-commerce logistics in urban areas also requires smaller, more-local distribution



centers and parcel hubs. The trend toward ever-shorter delivery times and the need to handle returns efficiently means e-commerce increases the overall footprint of logistics space servicing retail.

“Demand for industrial space has increased substantially as a result of the rise of e-commerce,” says Chris Caton, head of global research with Prologis. “Rapidly growing online sales have prompted retailers to prioritize investment in dedicated e-fulfillment supply chains, growing the amount of inventory held in logistics facilities rather than on store shelves. Rapid online sales growth is only part of the story, however. E-commerce customers also use logistics space differently than traditional industrial users. A broader product variety, higher inventory levels, direct business-to-consumer shipping operations, and returns processing all contribute to a higher intensity of use in e-fulfillment facilities. This intensity requires three times the logistics space per unit of sales than a traditional distribution operation.”

“With each \$1 billion of e-commerce sales translating into approximately 100 million square feet of industrial demand, industrial real estate is affected more by the growth in e-commerce sales than any other real estate sector,” adds Brad Simpkins, portfolio manager for the U.S. Cities Industrial Fund at TH Real Estate.

With this boom in demand for industrial space, investors are focusing on specific types of properties.

“Speaking for ourselves, we have a bias for both newly built and close-in warehouse,” says Ruggiero. “Our research suggests that newer

facilities dramatically outperform in NOI growth due to their ability to accommodate the latest distribution strategies, and close-in warehouses are best positioned to take advantage of the trend toward same-day delivery.”

To benefit from the e-commerce boom, Nadeau explains, real estate investors in the industrial sector need to target buildings with certain structural requirements, to attract tenants and drive rents higher. Some of the requirements are:

- High ceilings to accommodate several racks to store more inventory
- Extensive parking places available nearby to accommodate a large number of employees
- A large number of doors to allow for faster and on-time loading and unloading for arrival trucks

That emphasis on faster times brings us back to same-day delivery, an option that has an impact on the industrial side.

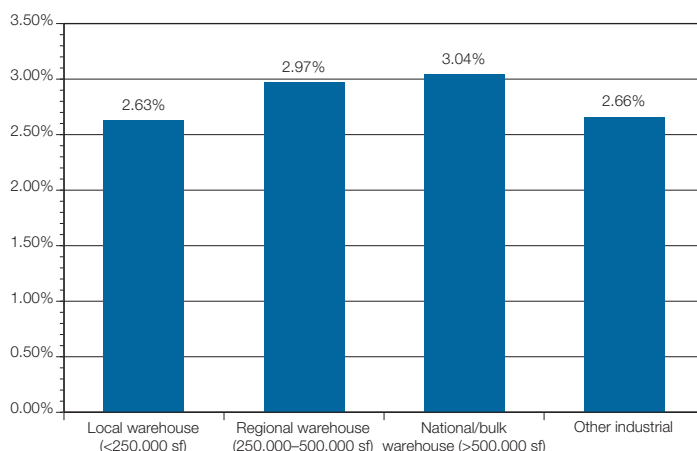
Crowe explains same- or next-day delivery, which is used to lure customers online, is creating a reversal from singular bulk distribution centers; many industrial developers are now building or buying smaller warehouses closer to larger markets, such as San Francisco or New York City, where products can be quickly dispatched to a larger population.

“Supply chain models are shifting to accommodate shorter delivery times, with a greater focus on the last mile,” explains Meniffee. “This includes tenants preferring logistics buildings in locations conveniently situated between larger fulfillment centers on metro fringes and key population centers. Tenants prioritize location and major roadway accessibility over building quality in these infill locations.”

Certain building features also are changing to meet the demands of e-commerce tenants, elaborates Meniffee. E-commerce tenants require ramps in last-mile locations — as opposed to truck docks — to accommodate cargo vans, and cross-dock design to increase throughput. In addition, there is a push for



Industrial property subsector total returns in NPI by size/type, as of Q3 2016



Source: NCREIF



In 2012, Amazon bought Kiva Systems (now Amazon Robotics), which designed these robots specifically for warehouses

taller clear heights in larger fulfillment centers to provide sufficient space for materials-handling equipment.

“The last mile is defined as a location that is utilized to deliver to the end customer in as little as a few hours from when an order was placed,” explains TH Real Estate’s Simpkins. “While it would be preferable to have a state-of-the-art building that is also located in a ‘close-in’ location, very few are available. As a result, we are seeing last-mile users being flexible in their loading and clear-height requirements. Companies such as Amazon are developing innovative means to deal with the constraints of older, lower-clear-height locations but still have the ability to turn a tremendous amount of product in an efficient way. With e-commerce sales growing at a rate of approximately 20 percent per year, I anticipate that we will see more logistics innovations with last-mile users that will allow them to utilize close-in locations in as efficient a manner as possible.”

While newer is ultimately better, it seems all types of warehouse spaces are in demand, as long as the property is well located. Essentially, quick product turnover is key for retailers and consumers alike. The faster, the better.

What about *Breakfast at Tiffany’s*?

Online retail is on the rise, with twin impacts on the retail and industrial property sectors. Retail property owners are facing down the threat of e-commerce by making their assets irresistible to shoppers — adding experiential components, such as restaurants and movie theaters; attracting nontraditional tenants, such as medical service providers; and promoting omni-channel retailing, such as click-and-collect or in-store returns. And industrial property owners are taking advantage of the promise of e-commerce by providing a wider array of warehousing and distribution options, including smaller, close-in warehouses that support same-day delivery options in major markets.

Perhaps you can imagine Holly Golightly in her sweatpants (and tiara), her cat beside her, ordering all her jewels (as well as clothes and groceries) online and having them delivered to her by the next day?

If only her landlord would carry the boxes up the stairs for her. ♦

Denise DeChaine is special projects editor of **Institutional Real Estate, Inc.**
