

Consumer Focus on Necessity Goods and Experiences Drives Tenants to Available Space, Extending a Stretch of Historically Strong Property Performance

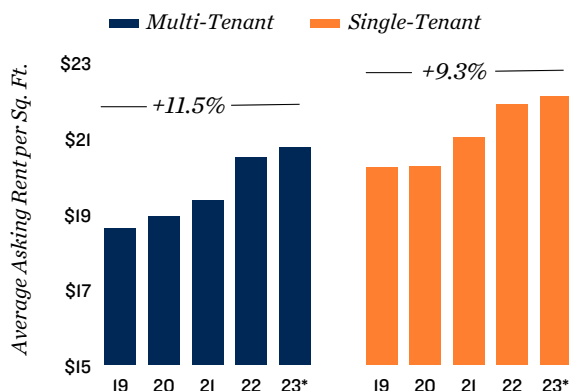
Consumers' priorities reinforce positive outlook. One of the nation's least-vacant commercial real estate segments, the retail sector entered the second half in a favorable position. Labor market resiliency, wage growth and easing inflationary pressures are aiding consumers' purchasing power, with households concentrating more of their spending on groceries, personal care items, dining and experiential retail. These consumption trends are motivating a collection of retailers to broaden their footprints and product offerings to capture market share. By executing expansion initiatives, these companies will generate demand for vacant and sublet space of various sizes. The positive leasing momentum that results will preserve historically limited single-tenant vacancy and enable multi-tenant availability to remain on par with immediate pre-pandemic levels.

Store closures provide an avenue for expansion. The retail sector is on solid footing, yet a wave of store closures could impact fundamentals. As of mid-May, 2,600 locations had been shuttered during 2023, outpacing last year's total. Additional closures by Party City, Bed Bath & Beyond, Tuesday Morning and a group of regional shops will elevate this tally. Fortunately, a host of vendors are in expansionary mode and construction activity is slowing, indicating these properties, and floor plans up for sublease, will be backfilled over the near-term. Recent leasing activity suggests dollar stores, off-price retailers and grocers are most likely to fill these spaces; however, experiential retailers, including trampoline parks and pickleball courts, will also play a role.

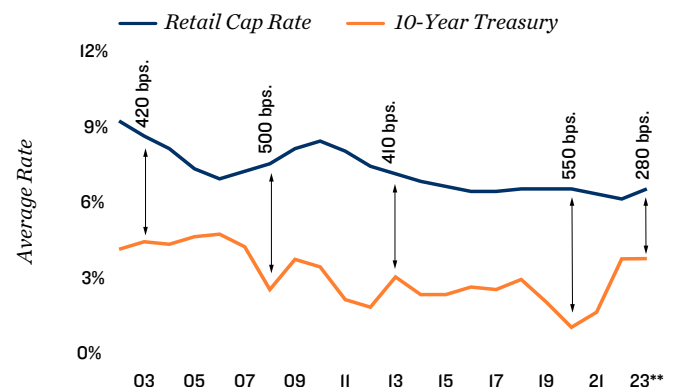
Boost in seasonal travel on the horizon. While some consumers' budgets are being tested, resulting in a greater reliance on credit, an estimated 45 percent of Americans are planning to travel more this summer than they did last year. With gas prices down notably from mid-2022, when the national mean exceeded \$4 per gallon, travelers are likely to have more money to spend on necessities and food while on the road. This dynamic represents a boon for growing convenience stores, drive-thrus and fast casual restaurants — including Buc-ee's, Dutch Bros. and Chipotle. More broadly, international tourism is expected to improve, as the Centers for Disease Control and Prevention has lifted the COVID-19 vaccine requirement for inbound travel.

Retail marketplace proves more resilient. Capital costs elevated by tightening Federal Reserve policies and regional bank failures have constrained investment sales across property types. This has reduced the flow of 1031 exchange capital into net-leased assets and shopping centers that command sub-\$10 million commitments. Specifically, during the six-month period ending in March, deal flow declined by 31 percent when compared to the prior two-quarter stretch. This fluctuation, however, was less exaggerated than what was recorded across the multifamily and office sectors, reflecting the attractiveness of the retail sector to active investors. Moving forward, historically low vacancy, record asking rents and consumers' encouraging spending habits are likely to attract other buyers to single-tenant assets and well-leased centers, a potential motivator for owners mulling a sale.

Retail Rent Trends



Retail Cap Rate Trends

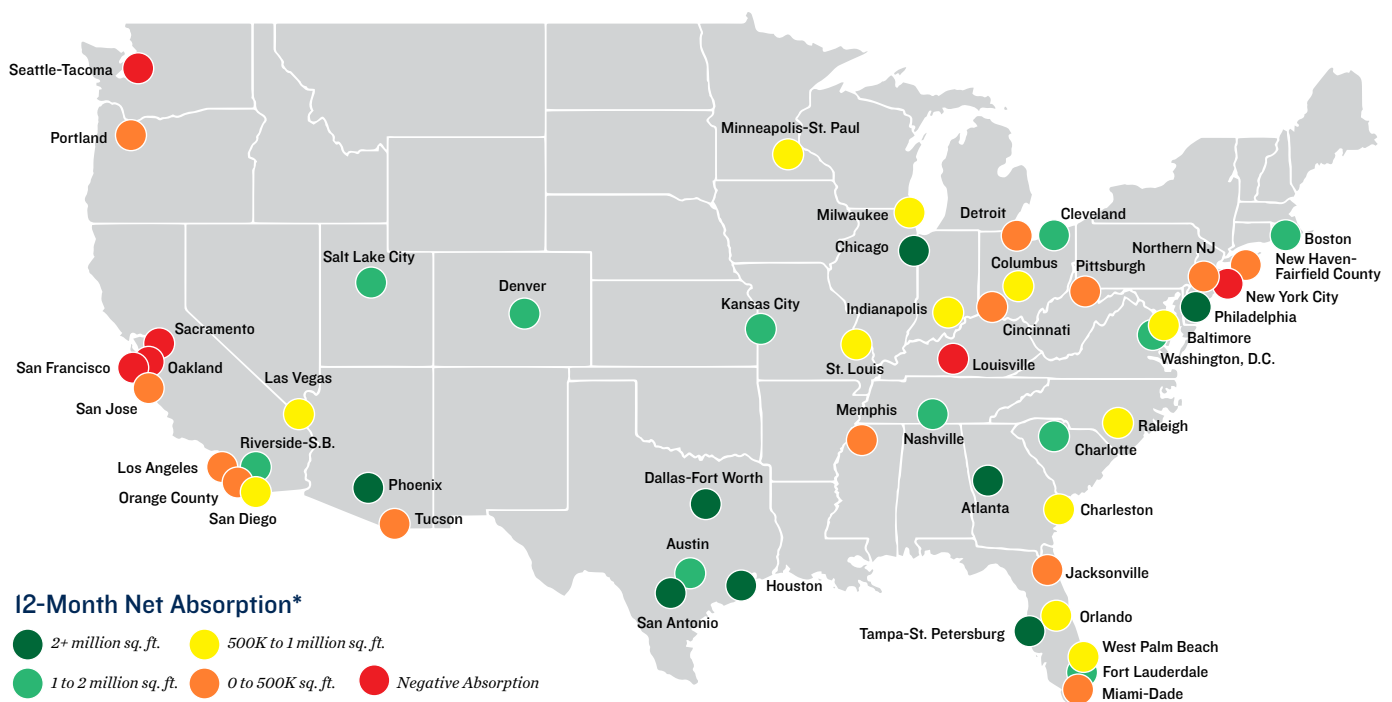


* As of 1Q

** 10-Year Treasury as of May 31; Trailing 12 months through 1Q for cap rate

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Federal Reserve, Real Capital Analytics

Noteworthy Demand for Available Space Evident Across the Sun Belt



Regional Vacancy Well Below Pre-Pandemic Mark

Texas space coveted. Retailers continue to follow population growth, translating to the absorption of more than 34 million square feet across the Sun Belt during the yearlong stretch ended in March. This activity lowered regional vacancy 40 basis points to 4.7 percent, while also boosting the average asking rent by nearly 5 percent. Major Texas metros played a vital role in this performance, with retailers in the four markets accounting for 20 percent of all space absorbed on net nationwide over the past year. Strong demand for available retail floor plans should continue here, as the collective population of the four metros is expected to rise by 1.4 million over the next five years.

Above-average vacancy distracts from strong performance.

Three Sun Belt markets are registering encouraging demand from a historical standpoint, despite local availability that exceeds both the national and regional mean. Phoenix entered April with a vacancy rate 60 basis points above the U.S. mark, but 210 basis points below its pre-pandemic measure, the largest disparity among Sun Belt metros. Nearby, Las Vegas holds claim to a similar-sized gap, with Riverside-San Bernardino home to a 140-basis-point spread despite its 6.7 percent rate. Moving forward, sizable population growth projections for each market suggest retailers will fortify their local presence via renewals or prioritize expansion into these areas over the near-term.

Gains Noted Across Property and Market Spectrum

Retail hiring a reflection of leasing activity. Widespread demand for available single-tenant space translated to the net absorption of 43 million square feet over the past year ending March, nearly doubling supply additions. This leasing velocity compressed vacancy 30 basis points to a historic low of 4.3 percent, with 29 major metros home to tighter conditions. The multi-tenant segment noted an identical decline during the 12-month interval, placing vacancy at 5.6 percent — a figure 20 basis points above the record low. Recent job growth reinforces the overall strength of both sectors, with the number of U.S. retail trade positions in May exceeding the immediate pre-pandemic mark by 31,000 roles.

Widespread demand evident. Spanning market types, overall vacancy compressed 30 to 40 basis points over the past year, indicating retailers are expanding across a diverse collection of major metros and smaller cities. At 4.1 percent in April, tertiary vacancy was at an all-time low, as was secondary availability, at 4.7 percent. While the primary market rate is slightly higher, the segment's average asking rent is at a historically elevated mark, surpassing the national mean by nearly \$5 per square foot. With the U.S. retail stock slated to expand by 0.5 percent or less for a third consecutive year during 2023, near-term supply-side pressure should be minimal across most large metros and more rural areas.

* Trailing 12 months through 1Q

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.

Investment Landscape Poised for a Period of Realignment

2023 Forecast

U.S. EMPLOYMENT

1.2% increase Y-O-Y

- By the end of 2023, total employment will be nearly 4 million jobs higher than the immediate pre-pandemic mark. Despite unemployment entering the year at a multi-decade low, 1.8 million positions will be added.

U.S. CONSTRUCTION

42 million square feet completed

- Supply additions will surpass last year's 38.9 million-square-foot completion total. However, inventory will expand slower than the long-term average of 1.2 percent, at only 0.5 percent year-over-year.

U.S. VACANCY

30 basis point increase Y-O-Y

- Vacancy will rise for the first time in the past three years, elevating to a still-tight 5.0 percent. Despite the uptick, positive leasing velocity is expected, with tenants absorbing a net of 8.6 million square feet.

U.S. ASKING RENT

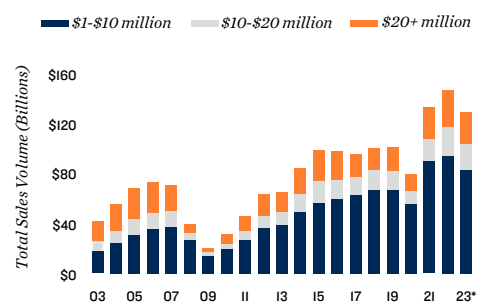
3.0% increase Y-O-Y

- The retail sector notches an 11th consecutive year of rent growth, pushing the average asking rate to \$22.20 per square foot. Sun Belt metros are expected to record some of the most pronounced annual gains.

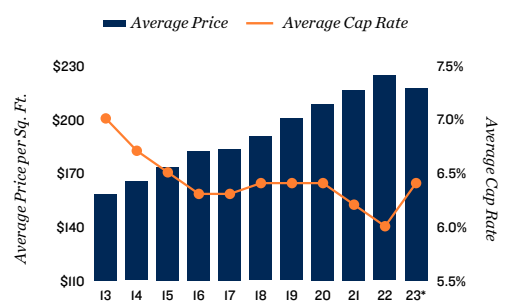
2023 INVESTMENT OUTLOOK

- Positive dining trends elicit investment.** Recent sales data suggests retail asset pricing will face downward pressure in the second half as buyer-seller expectations fall closer in line. Preliminary findings from the first half reveal an investor preference for restaurants, fast-food properties and smaller shopping centers at low-6 to low-7 percent first-year returns.
- Grocery listings warrant buyers' attention.** Cost-pressured consumers' prioritization of groceries is influencing supermarkets to grow their market share in metros of various sizes. Leasing activity reflects this, with tenants absorbing a net of more than 5 million square feet over the yearlong window ending in March. Moving forward, a historically small construction pipeline will drive demand for the limited volume of available space that remains. These dynamics and above-average rent growth should foster a healthy level of buyer competition for supermarket-anchored centers.
- Northeast bucks broader trend.** The potential for additional budget tightening on the part of U.S. consumers may influence some retail investors to target more affluent markets comprised of households typically less impacted by inflationary pressures and economic volatility. This trend may already be playing out. During the first three months of 2023, a collection of Northeast markets — including Boston, New Haven-Fairfield County, Long Island and Central New Jersey — each noted quarter-over-quarter gains in deal flow.

Retail Sales Volume By Price Tranche



Investment Sales Trends



* Trailing 12 months through 1Q for sales volume, average price and average cap rate

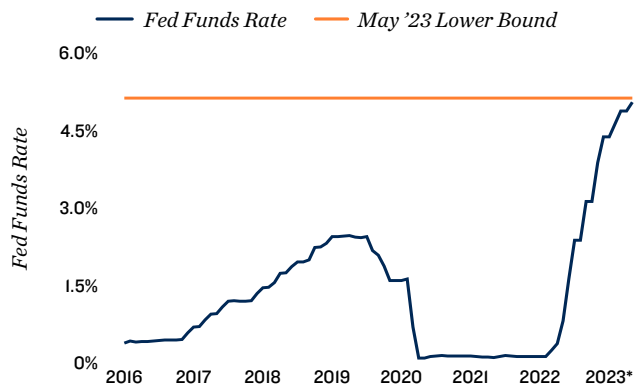
Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Real Capital Analytics

Rate Stability Catalyzes Sales Activity; Lenders Favor Net-Leased Assets and Grocery-Anchored Centers

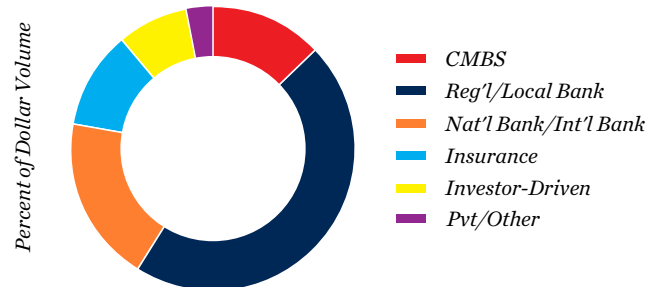
Fed’s reactive stance aids retail investment landscape. It appears that the most robust and rapid phase of the Federal Reserve’s current tightening cycle is in the rear-view mirror. At its May meeting, the FOMC announced a data-dependent approach to further monetary policy adjustments, after lifting the lending rate’s lower bound to 5.00 percent. While recent bank closures have spurred tighter underwriting over the short-term, an overall reduction in rate uncertainty, together with recent downward pressure on the 10-year Treasury, could deliver modestly lower interest rates to commercial real estate borrowers in the second half. This stability will help buyers and sellers more closely align on expectations, as capital providers will more readily set terms and determine property valuations. Together, these dynamics, along with historically low single-tenant vacancy and muted pricing pressure, could fuel a pick-up in transaction activity during the second half of this year.

Capital remains readily available, albeit at lower leverage. Net-leased assets and well-located shopping centers with high-credit anchors continue to represent some of the more approachable property types for many lenders. The retail sector’s tight vacancy, restrained development and record asking rents should prolong this trend. Local and regional banks, who took on a larger share of lending over the past year, are providing single-tenant financing at 55 to 70 percent loan-to-value (LTV) ratios, while also teaming on multi-tenant deals in tertiary markets. These sources, however, may tighten their standards as they build reserves. Investors seeking loans under \$10 million will be most impacted, as these banks accounted for nearly half of all lending in the space during 2022. Buyers of institutional-grade assets will be less affected, with CMBS active and life company funds available for grocery-anchored centers. Additionally, private debt has returned for properties with a value-add component. These sources are overall providing loans at leverage up to 65 percent, requiring borrowers to layer the capital stack with additional sources — including private equity and mezzanine debt. Some distress could arise as higher-leverage loans obtained over the past five years come due amid today’s elevated capital costs and lower LTVs.

Federal Funds Rate Over Time



Retail Mortgage Originations By Lender**



* As of May 3

** As of 2022; Properties and portfolios \$2.5 million and greater

Sources: Marcus & Millichap Research Services; Real Capital Analytics; Federal Reserve

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Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Real Capital Analytics; Bureau of Labor Statistics; Federal Reserve; Coresight Research; Prodege