SPECIAL REPORT

Marcus & Millichap

UNANCHORED STRIP CENTERS

APRIL 2024

Strip Centers' Unique Service Offerings Stand Out in Current Retail Landscape

Eye catching supply-demand dynamic at play. Typically located closer to consumers than larger centers and featuring a diverse mix of tenants, unanchored strip centers are in a position of strength amid a period of household budget tightening and big-box closures. Over the past three years, demand in the subsector more than quadrupled new space delivery, compressing vacancy to 4.7 percent — the lowest recording since 2003. During this same window, an average of 10,000 new leases were executed annually for 1,000- to 5,000-square-foot spaces at strip centers, reflecting steadfast tenant demand for these storefronts. Moving forward, consumers' preference for more convenient shopping options and those that can't be easily replicated online is likely to rise, if gas prices remain elevated and hybrid work schedules become fully ingrained into the corporate workweek. As such, unanchored strip center owners with diverse tenant bases stand to benefit, with conditions in the subsector poised to remain tight. This dynamic will positively impact overall retail vacancy, as strip centers — despite their relatively small size — collectively account for a large share of the sector's total inventory.

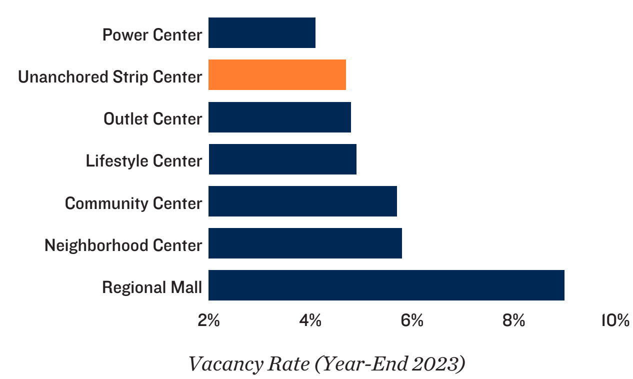
Strong demand warrants supply additions. Recent consumer spending trends also bode well for the future performance of strip centers with a mix of tenants. This February, spending across the restaurants and bars, electronics and appliance, and apparel categories all rose in real terms, even after factoring in inflation. Sales at miscellaneous retailers — a segment that includes florists, pet shops and used merchandise stores — also climbed 3.2 percent year-over-year, prior to accounting for inflation. Should this momentum continue, competition for strip center space should remain robust, with most retailers required to comb existing properties amid a pullback in development. As of March, the subsector's active national construction pipeline comprised less than 1 million square feet, with half of this space located in Texas and Florida. This activity will translate to the lowest annual delivery total since at least 2000.

Institutions and larger tenants attracted to strip centers. Consumers' habits and the strong performance of strip centers are catching the attention of some parties that have previously avoided the subsector. Bath & Body Works and Foot Locker are among a group of vendors that are exiting their mall space in favor of storefronts at these outdoor properties, with discounted operating costs and encouraging foot traffic likely being motivating factors. The property type is also becoming more attractive to certain institutions, REITs and investment funds. A handful have recently sold their larger shopping center holdings or recapitalized a sizable portfolio with plans to reinvest funds into collections of strip centers.

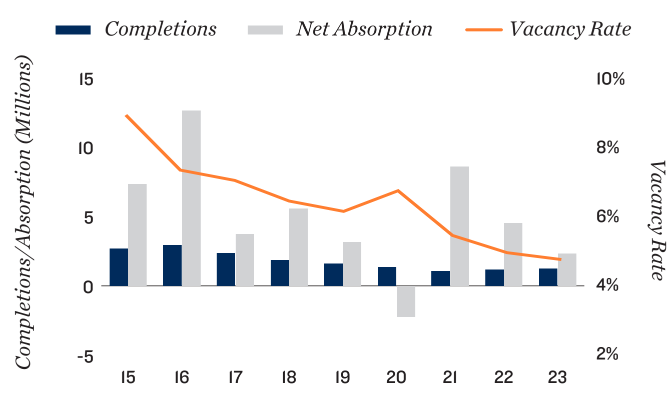
Unanchored Strip Center Traits

- A 10,000- to 50,000-square-foot center featuring a row of stores occupied by multiple retailers, none of which are anchor tenants. Many properties feature fewer than 10 tenants and are located along major thoroughfares or near freeways.
- Common tenants include: quick-service, casual and sit-down restaurants; hair and nail salons; liquor stores and bars; hobby shops and other niche retailers; laundromats and dry cleaners.
- Across major metros and smaller markets, most of these properties can be acquired for less than $5 million.

A Top-Performing Retail Property Type



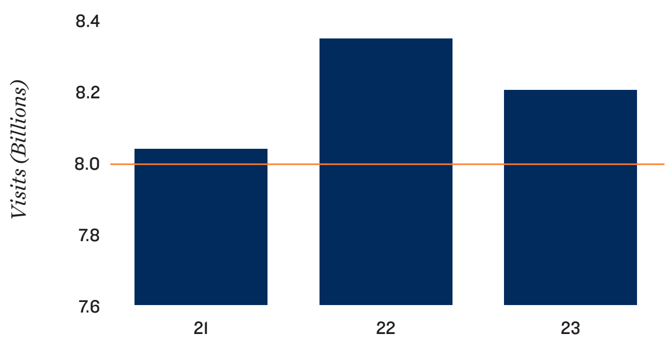
Supply and Demand*



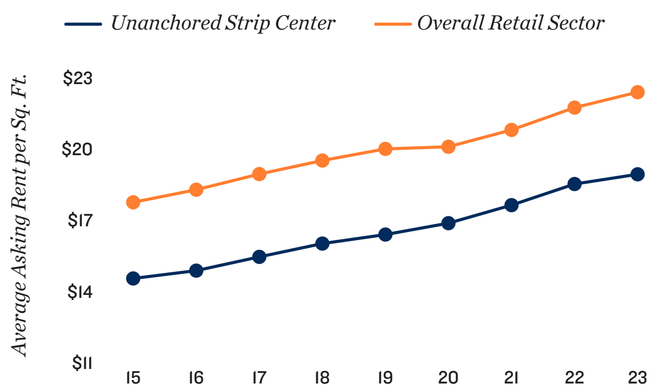
* Unanchored strip centers

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

Visitations Hold Above Threshold*



Favorable Rent Discount Continues



** Holding above 8-billion visitations has allowed the average weekly foot traffic per year at shopping centers to be consistent, ranging from 155 to 160 million.*

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

Investment Outlook Positive

Investors favor potential leasing value creation. In addition to some institutional-level interest of late, the subsector will also remain a quintessential target for a host of private investors in 2024, preserving what is a fragmented ownership pool. The segment's tight vacancy, minimal construction pipeline and possibility of 7 percent-plus first-year returns should generate notable competition for well-located listings in both major markets and smaller cities. Also stoking buyer interest, the average asking rent for unanchored strip center space rose by more than 12 percent over the past three years; yet, the subsector still offers tenants a $3.50 per square foot discount to the retail sector's overall mean marketed rate. This disparity, amid strong segment rent growth and encouraging foot traffic, suggests private investors can capture value by re-tenanting vacated spaces and obtaining lease renewals. Opportunities to do so are likely to be more frequent for strip center owners as most of the leases executed for 1,000- to 5,000-square-foot spaces over the past 14 months ending this February had terms of one to three years.

Discounted pricing amid standout fundamentals elicits acquisitions. Further enhancing the appeal of strip center investment, sub-$200 per square foot pricing is available for these assets across both larger markets and tertiary areas. Buyers targeting larger metros are likely to be most active in high-growth Sun Belt markets including Phoenix, which recorded the third-highest strip center transaction total nationally in 2023. Private investors that favor smaller areas may focus on properties in college towns within walking distance of campuses and proximate to clusters of student-occupied housing. Regardless of strategy, financing hurdles are expected to somewhat ease this year. The Federal Open Market Committee is widely expected to cut interest rates at some point in 2024, and regional/local banks are expected to actively finance unanchored strip center acquisitions. Lending rates from these sources are likely to start at 6.5 percent, with leverage ranging from 50 percent to a maximum of 65 percent. Some investors may bypass this route, instead executing all-cash transactions, potentially with proceeds from 1031 exchanges.

Retail Division

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Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Placer.ai; U.S. Census Bureau