Introduction

Since the economic downturn of 2007-2009, occupancy and rental rate gains in the open-air shopping center sector have been aided by a lack of new construction. Annual deliveries of new retail space have been a small fraction of the historical averages, and show no signs of material acceleration. This limited amount of new construction has been a tailwind that has helped stabilize the market in spite of other factors that would seem to threaten retail occupancy and rents. Rents, occupancy and Net Operating Income (NOI) in institutional quality open-air shopping centers have been on an upward path for the past few years. This article explores factors behind the continuing lack of new retail space delivery, and suggests some reasons why the factors restricting new supply are likely to continue to act as a brake on new construction, providing support for future NOI growth.

Solid Fundamentals

As the last economic cycle came to its end, occupancy and NOI in the U.S. open air shopping center market fell. Green Street Advisors’ Strip Center REIT occupancy index, representing higher quality open-air shopping centers, dropped from 95.4% in 2007 to 91.5% in 2009.1 Not surprisingly, income fell within Green Street Advisors’ REIT sector as well, with same-property NOI decreasing by 3.5% in 2009.2 However, starting in 2010, the market began to rebound and has now generated positive total occupancy growth for six and a half straight years. By the second quarter of 2016, Green Street Advisors’ Strip Center occupancy index had climbed 350 basis points to 95.0% and was near a ten year high.3 The improvement in the shopping center market was fairly broad based. Over 60% of the 62 metro areas tracked by CBRE Econometric Advisors experienced increased occupancy during the twelve months ending June 2016, including such cities as Atlanta, Denver, and Austin.4 Occupancy gains have in turn helped propel income growth, with Green Street Advisors’ Strip Center sector registering average annual NOI growth of nearly 3.6% between 2012 and 2015.5
Given sluggish economic growth, the impact of e-commerce and other headwinds, why do we find good news on shopping center occupancy? One key factor is that delivery of newly constructed space has been at historic lows. Between 2000 and 2008, the new supply of open air shopping centers (neighborhood, community, and strip centers) delivered nationally averaged just over 62.3 million square feet per year. In 2005, at the height of the previous development cycle, more than 72.6 million square feet was added to the market. This amounted to approximately 2.7% of the total existing shopping center inventory in that one year.
When the economic downturn began in 2007, the retail industry was materially impacted. Between 2007 and 2009, retail and food services sales, adjusted for inflation, decreased by 11%. Retailer demand for new space turned negative in some sectors, and vacancy rates rose significantly. Developers and lenders cut back on new starts. Some were caught with projects already under construction. From 2007 to 2009, over 163 million square feet of new shopping centers were completed. Development fell to less than 13 million square feet per year in 2010 and 2011, and fell even further to 11.0 million square feet in 2012. The pace of new deliveries of shopping center space had dropped 85% from its 2005 peak. Development picked up slightly in 2014 and 2015, but stayed far below the 2000 to 2008 annual average.

### U.S. Shopping Centers - Annual Completions (square feet)

Source: CBRE Econometric Advisors, Q2, 2016; reflects completions of neighborhood, community, and strip retail centers; 2016 is a forecast.
As retailers closed stores and cut back on new openings, annual growth in occupied retail space dropped from an average of 2.4% between 2003 and 2006 to well below 1.0% from 2008 through 2012. Though the increase in aggregate occupied retail square footage accelerated to an annual average of nearly 1% between 2013 and 2015, new demand was still half of its previous peak.

With lackluster demand and a supply overhang, asking rents fell beginning in 2008, and were 13.8% below the historical peak by the end of 2013. While average rents in the necessity driven sector have been recovering at a healthy pace, increasing by 1.3% in 2015 alone, overall demand in this typically stable market segment has not fully recovered. Even with the recent tightening of the market, rents in the neighborhood, community, and strip center retail market were still 11.9% below peak at the end of last year. While there appears to be room for rents to keep growing, rents in many locations still linger below the level that would support new construction. As a result, new development of shopping centers will likely remain limited in the coming years. Existing centers should continue to benefit from this trend.

Lenders, under the careful scrutiny of their regulators, have been stingy with capital for new retail development. Lower loan-to-value ratios and higher pre-leasing requirements than in prior cycles have shifted what little retail development there is toward single tenant assets and away from speculative multi-tenant construction. With regulators recently even more focused on commercial real estate risks, this trend should continue.

Development Under Pressure

Since the 2007-2008 recession new shopping center development has been historically low for a number of reasons.

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• The anchor tenants that have been expanding have been very demanding in lease negotiations. Even tenants in a position to pay new development rents have sought to negotiate terms such as termination rights (also known as “sales kick-outs”) if the new store does not meet its revenue targets. These options shift the risk of the store’s success onto the landlord, making an already skeptical financing market practically impossible for the developer to navigate.

• Americans have been shifting their attention toward urban living. “In 2011, for the first time in nearly one hundred years, the rate of urban population growth outpaced the suburbs. Today it is America’s cities that entice younger workers with better options for their careers and lifestyles.” The trend toward urbanization can also be seen in new home delivery statistics, historically a major contributor to suburban retail growth. The completion of new privately owned housing units fell from an average of 1.7 million for the ten year period ending in 2006, and a high of 1.98 million in 2006, to 585,000 in 2011. By June 2016, the annualized rate of completions had only recovered to 1.1 million, still 33% less than the 1997-2006 average. The consequent demand for retail space has grown slowly, if at all, in many suburban markets. With the trend toward city living, demand for retail space has grown in more expensive urban locations. Finding affordable urban land for retail development has proven difficult and is likely to remain so, continuing to hold back the pace of new construction.

• On the consumer behavior front, since the recovery began a meaningful portion of new retail demand has been siphoned off by e-commerce. The e-commerce share of total retail sales increased from approximately 3.5% in 2007 to 8.1% by the second quarter of 2016. While the growth rate of e-commerce has begun to level off, it is still growing faster (though off a much smaller base) than traditional “brick and mortar” retail sales. This re-orientation of demand has led retailers to shift their investment priorities away from stores and toward technology and distribution. This trend now appears to be coming full circle, as growing recognition of the synergies between “clicks and bricks” leads formerly “e-only” retailers such as Amazon, Warby-Parker, Bonobos and others to open physical stores. While e-commerce is expected to take an increasing share of overall retail growth for the next several years, it has not completely offset the overall need for more retail space. The result has been steady but slow improvement in existing shopping center fundamentals, but not to the extent that would lead to excessive building.
Future Development and Market Conditions

Retail development ground to a virtual halt during and following the recession, but select projects were still built and supply grew as the economy and market slowly improved. Certain markets such as Houston, Dallas/Fort Worth, Orlando, and Washington DC are helping to lead an emerging retail development cycle. Through the first three quarters of 2016, both Dallas and Houston are on pace to add nearly 1% to their respective shopping center inventory. Nonetheless, from a national perspective, many experts do not foresee development reaching its former peak levels anytime soon. In a Q3 2016 report on the retail market, Cushman & Wakefield indicated that “virtually no new projects are moving forward without anchor commitments in place and, in most cases, significant preleasing of inline and pad space as well.” Furthermore, according to CBRE Econometric Advisors’ forecast for shopping centers, annual new supply for 2016 is expected to be 16.5 million square feet or 75% less than the 2004-2008 average. As a result, CBRE Econometric Advisors projects that the overall retail market (all quality levels) will approach ninety percent occupancy by the end of the year and generate a 2.6% year-over-year increase in rental rates. The tailwind created by very limited new construction, combined with slow but steady growth in demand for retail space, appears to have stabilized the market and set the stage for further gains in occupancy, rents, and NOI.

![U.S Retail Market Rent Growth](image)

Source: CBRE Econometric Advisors, Q2 2016; rent inflation based on CBRE’s TW Rent Index; 2004 to 2015 represent actual results; 2016 is a forecast.
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For over 45 years, Inland’s primary mission has been to serve its investors. This long tradition of investor focus is manifest in a corporate infrastructure that emphasizes dedication and service to Inland’s individual and institutional investors. Its commitment to investor satisfaction is one of the key reasons why Inland has been successful in creating hundreds of real estate ventures and REITs over many decades. As of September 2016, Inland had raised more than $21 billion in capital from investment securities sales.

Since 2005, ICAP has facilitated the completion of over $5.0 billion of institutional investment vehicles (gross asset value) for Inland, including numerous closed-end funds and joint ventures with domestic and international pension funds. Institutional investors have included several of the world’s largest pension funds and other private domestic and international institutions, including a joint venture with a foreign publicly traded real estate investment trust. ICAP believes that Inland’s extensive experience with regulatory compliance and governance standards in the public company sector has facilitated its attractiveness to institutional investor.

\begin{footnotes}
\item[1] Data from Green Street Advisors, Inc.’s (“GSA”) Strip Center Sector Update, August 26, 2016. Occupancy statistics reflect GSA’s U.S. Strip Center REIT Weighted Average Occupancy index.
\item[2] Ibid.
\item[3] Ibid.
\item[4] Ibid.
\item[5] CBRE Econometric Advisors, Q2 2016 (published October 2016). Data only reflect neighborhood, community, and strip centers (thus excluding power centers, lifestyle centers, enclosed malls, and stand-alone retail).
\item[6] Ibid.
\item[7] Ibid.
\item[8] U.S. Census Bureau.
\item[9] CBRE Econometric Advisors, Q2 2016 (published October 2016).
\item[10] Ibid.
\item[11] Ibid.
\item[12] Ibid.
\item[13] CBRE Econometric Advisors, Q2 2016 (published October 2016).
\item[14] Ibid.
\item[15] Ibid.
\item[16] Ibid.
\item[17] Ibid.
\item[18] CBRE; “U.S. Urbanization Trends: Investment Implications For Commercial Real Estate”; 2015.
\item[19] U.S. Census Bureau.
\item[20] Ibid.
\item[21] Ibid.
\item[22] U.S. Census Bureau; statistics based on seasonally adjusted totals.
\item[23] CBRE.
\item[24] Cushman & Wakefield, Marketbeat, U.S. Shopping Center, Q3 2016.
\item[25] CBRE Econometric Advisors, Q2 2016 (published October 2016).
\item[26] Ibid.
\item[27] Data as of September 2016; representing multiple property types.
\end{footnotes}
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