Big City Retail
A Good Time to Invest?

How retail trends are affecting Manhattan real estate and its quality as an investment (October 2017).

There are big shifts taking place in the retail sector. While simply interesting to better understand these changes, it is specifically so to the property investor. Sometimes change offers great investment opportunities, but is this a good time and where to invest?

To understand retail trends—start at home

Changes in retail behavior are a nationwide phenomenon driven heavily by the shift to on-line purchasing. This is having a huge impact on the use of physical retail space, even in a dense, pedestrian city like New York.

To understand a complex topic, there is logic to starting at home, in my case on Riverside Drive, where all of us spend more and more money on-line. My neighbors' habits are clear from the number of boxes delivered daily to the lobby.

On-line shopping has grown because it is hassle-free. Dense and crowded, sometimes unbearable, moving around the city can involve a lot of time. On-line, I don't travel looking for unfindable things, and I avoid waiting in lines, unattractive stores, higher Manhattan prices and frequently indifferent service. While the city offers many fabulous places, daily shopping in Manhattan is not always a special or an elevating experience.

I still shop on the street, for fresh food at the green market, the local supermarket, Zabars or Fairway, and from time to time, the bookstores, which are some of the best in Manhattan. There are some good bakeries and coffee places where I can take things out or sit outside. I am a devotee of Mondels, a long-surviving specialty chocolatier at 114th and Broadway. And I buy a lot of things while out of town.

A younger neighbor, Sheila Parekh, has somewhat different habits. On-line, she buys bulk household goods—laundry detergent, several at a time, where they are better priced—some specialty goods that are hard to find, gifts (which are shipped directly) and stamps. On the street, she looks for specialty stores, such as the local Book Culture, or a very nice, small store with kids' things, on Broadway, between 111 and 112th. She likes the small health food store around the corner; the owner is knowledgeable and helped with a vitamin mix for her dogs. The West End Market, at 110th Street and Broadway, and the local wine store are for when she is in a hurry. Otherwise she uses better wine shops that deliver. And for food she prefers Whole Foods, at 98th Street and Columbus Avenue, where the selection and prices are better, and where there is a specialist to talk to in every department.

In Chelsea, where she lived previously, she did nearly all of her shopping on or between 9 and 10th Avenues. There were lots of specialty shops and florists, and she was near to the Chelsea market. The stores are staffed with people who know what they were doing. But the

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neighborhood got too busy and too touristy. The Chelsea Market, as we all know, is now so crowded that it is unusable.

We are only two people in a city of millions, but from our changing habits two underlying lessons can be derived:

--Internet shopping is more convenient, particularly for commodified or hard-to-find goods. Day to day shopping in the city is often a hassle, and it is now avoidable.

--Shopping is still a pleasure, but it focuses on food—that is either grocers, bakeries, café's or restaurants—or on special places, where there are special things to buy, even clothes, which many of us want to see and touch, and helpful personal interaction. Yet even these experiences can be adversely affected. I met a young French wine distributor, a few months ago, who told me that it is not possible sell good wines in many New York restaurants. The rents are too high, and the restaurants need to mark-up cheaper bottles. Frequently our experiences are unreasonably expensive, noisy or mediocre.

And many stores are vacant. You have seen them on upper Broadway, even up near Columbia University. Empty spaces, for months, even a year or more. Some of these appear to filling up now, slowly—there is a new Shake Shack across from the Columbia gates, and an Asian food market opening in the old D'Agostinos space at 110th Street and Broadway. Take a walk on the most luxurious stretch of Madison Avenue, in the 60's or the 70's, to see the numerous vacancies, and there are others. . .

Beginning Research
My first conversation, on this issue, was with George van der Ploeg, an old friend and Douglas Elliman townhouse broker who has listed some retail property. (I ran into him in a little café off of Madison, on 68th Street). Retail landlords on Madison Avenue, he said, have deep pockets and often own multiple buildings. They hold to their rents for up to two or three years, because they are locking their property into long-term, often 20-year leases, which in-turn dictate the value of the property, a function of capitalized income, for either sale or refinance. I asked whether the long vacancies might not affect the vacancy factor used to calculate to a realistic net income. He suggested that the prior vacancy no longer mattered, once the sought-after long-term lease is signed.

So many vacancies are the function of an asset value strategy, and indeed, the *Wall Street Journal* recently reported that "While some owners of New York retail properties are reluctant to offer drastic rent cuts, they have become much more generous with other entitlements such as free rental periods and contributions towards the costs of building out a store, incentives that were rare a few years ago."[1] Expect asking rents to drop slowly in these circumstances.

[1] Retail Slump Pounds Manhattan Landlords, Keiko Morris, *The Wall Street Journal,* April 30, 2017

Changing Trends
There have been a number of articles on retail trends in the press. These report growing retail sales nationwide, with a shift to faster-growing on-line purchasing, now accounting for about 10% of retail sales. This has translated into store closings for old-time mainstream retailers, such as Sears or even Macy's, closing of outdated malls, and a shift to value and experience-oriented stores. Most recently, Amazon has purchased Whole Foods, while Walmart has expanded its on-line businesses, including the purchase of Bonobos, a men's clothing retailer. The interaction between the physical and on-line experience is driving much of the new retailing.

According to one retail/investment broker I met, most major brands are cutting down on the number of stores they operate, opting instead for larger "display" stores in prominent, high traffic, locations. These stores are meant to support their brand, more so than to make actual sales. Yet this observation, presumably nationwide, does not fully explain the loss of demand in the Manhattan retail market. Years ago, I was told that Madison Avenue rents did not make sense, yet in those years the luxury retailers chose to be seen there.

In the same conversation, I learned that gyms, restaurants, athletic stores, walk-in medical offices and fast food are doing well. But in many parts of Manhattan, the new tenants are not taking up all of the available space. Of course, this is location and store specific. Lower Madison Avenue is now very hot, I was told, all the way up to 34th Street. The restaurants want to be there.

New Places to Shop
So, in addition to vacancies in Manhattan, we are seeing new types of places to shop. One of the most obvious is Amazon's two new bookstores, the first at Columbus Circle and a second which opened this summer at 7 West 34th Street, across from the Empire State Building.

On a Saturday afternoon in early June, I visited the Amazon bookstore at the Time Warner Center on Columbus circle. It is on the third level, as was the now-closed Borders bookstore, but in a smaller space, at the front of the building, and strategically placed next to the Bouchon Bakery's café seating. There was lots of room for Kindle stuff and a relatively limited selection of books, each posted behind a highly-starred customer review, similar to what one sees on Amazon.com. My interest was drawn to a new history of the Holy Roman Empire and an English-language reprint of Salvador Dali's gorgeous cookbook, *Les Diners de Gala.* The store was very crowded, as was the café. Were the crowds a reflection of the novel marketing approach, or perhaps simply the location and a typically crowded Manhattan Saturday?

According to Jill Lovatt, a retail broker at Cushman & Wakefield, younger consumers are much less interested in things than they are in experiences, and so even when buying things, they are looking for an experience that gives a unique context to the object. The firms that cater to these tastes are often smaller, growing, firms—started as on-line businesses. These firms already know their customers and choose their store locations based on where their customers live.

According to *Crains (*September 21, *Retail's new niche, Airbnb for pop-ups),* Vancouver based Thisopenspace, which specializes in short-term retail rentals, is expanding into Manhattan, joining not only Jill Lovatt but also other firms such as Storefront and Appear Here. Thisopenspace focuses on Etsy and Shopify merchants, helping them “become the next Warby Parker” (the hip glasses outlet) by connecting them to landlords, as temporary tenants.

I followed Jill’s advice, and visited a few retailers, including the Trunk Club, an affiliate of Nordstrom. This is not exactly an Etsy retailer, as it is housed in a huge, prestigious space, one of the Villard Houses on Madison Avenue, and for years the offices of the Municipal Art Society. However, the service and experience were certainly there.

I met by a chirpy young blond woman, named Andrea Plachter, who started my visit with a tour of the store’s grand rooms, each decorated by a different clothing brand, and then settled me into an extraordinary high-ceilinged space on the first floor with San Pellegrino water, where she started to show me clothes. She pushed my limits, with appealing clothing that I would never have had the courage to try. This was a level of service that I had not experienced since our mother helped us choose back-to-school clothing in the locally-owned Chrislow’s department store (in Los Gatos, California) in the late 1950’s and early 1960’s. And at the Trunk Club, the prices were far lower than I had expected, a $700 sport jacket, $200 shirts. . . my respect for Andrea grew, and I walked out, after a wonderful time, with two Bonobos slacks at $95 each (including alterations). Across the street, at the Bonobos store, I found the same at $105.

There are more new places to shop, even as old ones lose their luster. Here is Santiago Calatrava's new oculus transportation center, photographed during a recent visit. The architecture is exceptional, although catering to the current preference for overwhelming whiteness. The pedestrian connections to the Fulton transit center and the Word Financial Center are impressive. The retail mix is "international" chain stores, a bit sterile, "high end" and predictable. There were certainly a lot of tourists; perhaps they are now more frequently downtown than on upper Madison Avenue.

And there are much more interesting developments. Turnstyle, a newish collection of shops and cafés, occupies a wide subway pedestrian passage, under Columbus Circle, from 57 to 59th Streets, just outside the fare zone for the southbound #1 and A, B, C and D lines. Although it is underground, it is quirky, unusual and appealing, and I stop in frequently to watch its world with a cup of coffee.

Turnstyle is a collection of café's, jewelry and specialty shops, some common, like a Starbucks, but most quite unique, like Blossom du jour, 100% vegan fast food or Doughnuttery. Susan Fine, known for her work creating the retail mix at Grand Central Station, met me at Café Toscano, a Turnstyle specialty pizzeria. She led a group of investors who signed a 30-year lease for the space, with the MTA and, in turn, has created and subleased the stores to retailers; many are food sellers, putting special effort into unique offerings. Her tea store followed a list she developed of 20 tea sellers, whom she interviewed until she found the right one. The passage has attractive, colorful center tables, some inspired by tappas tables she saw in Barcelona, but narrowed due to space constraints and modified for handicap access. Manhattan's above-ground streets used to be more like Turnstyle she said; now they have banks and drugstores. Yet Turnstyle can still profit from the subway station traffic, and adjacency to the Time Warner Center and the southwest corner of Central Park. Turnstyle is a changing shopping street, with new stores, every year, like in shopping centers. She and the store owners are in a constant experiment to test what works. Rents are in the range of $250 to $300 per square foot, far lower than at street level.

According to Cushman & Wakefield's second quarter *Marketbeat Manhattan* report, the food hall trend is indeed expanding, with one of the largest commitments being Cipriani's announcement of a new 28,000 square foot specialty food market, at the base of a new building at about 60th Street, between Riverside Blvd. and West End Avenue.

Differing Neighborhood Impacts
Two serious surveys address the Manhattan retail landscape in some statistical detail. One is the above-indicated Cushman & Wakefield report, the other is by the Real Estate Board of New York.

According to Cushman & Wakefield [2], rising availability and declining rental rates continued as second quarter retail asking rents dropped, with the biggest annual declines in Soho (-13.6%), Herald Square/34th Street (-10.1%) and Fifth Avenue, 42nd to 49th Streets (-7.2%). However some sub-markets had asking rent increases including Fifth Avenue, 49-60th Streets (2.6%, 10.6% for direct space) and Flatiron/Union Square (5%).

Vacancy rates are high in all of the markets reported, with the highest vacancies on Fifth Avenue, 42nd to 49th Streets (32.8%) and Madison Avenue (23.5%).

According to the Real Estate Board of New York (REBNY) Spring 2017 report [3], average asking rents also declined in most of the markets surveyed. The largest decline was on Bleecker Street (in the West Village) which dropped 27% and is currently at $373/SF. Other locations with significant declines are Broadway, 14th to 23rd Streets (-22% to $348) and West 34th Street, 5th to 7th Avenues (-18% to $734/SF). Increases were noted on 5th Avenue, 14th to 23rd Street (18% to $456) and lower Broadway, Battery to Chambers Street (11% to $362).

[2] MarketBeat Manhattan, Retail Q2 2017, Cushman & Wakefield
[3] Manhattan Retail Report, Spring 2017, The Real Estate Board of New York

In the Spring of 2017, asking rents on Bleecker ranged from \$200 to \$495 and on Madison Avenue, 57th to 72nd, from \$520 to \$2,100. The quality and placement of space and the expectations of individual landlords can have a significant impact on asking and obtainable rents.

How and whether to invest in retail

All of these changes and variances can make it very difficult for building investors to gage the potential and security of retail real estate as a source of income. So, in late September my good friend, Charles Goldberg of Colliers, organized a group of his investment broker friends to teach me their views of the retail investment market.

High credit tenants

Their most simple but powerful assertion is that the quality of retail income depends on the credit worthiness of the retail tenant. From a highly-rated credit tenant, the payment of rent is secure, so the quality of the income is high, the capitalization rate low and the pricing high. In the present low-interest rate environment, even with the considerable uncertainties in the retail market, the demand for this type of real estate has been stronger, driving prices up further, and reflecting both an emphasis on quality and even lower yields elsewhere.

Buyers of real estate, with top quality tenants, are buying something akin to a high-quality bond, and will therefore accept a relatively low yield. The quality of the real estate per se, is relatively unimportant if a high-quality tenant is in place with a relatively long lease. These properties are actually valued as financial instruments, with capitalization rates in the five percent range.

However, the number of retail tenants, at the highest credit ratings, is relatively limited. According to various web sites, S&P ratings for Apple are AA+, for Chase, A-, and for Starbucks A. Most of the retail space we see is not occupied by tenants at this credit level, yet in understanding the motivations of the landlord-investor, we begin to understand why we see so many of the "generic" banks and chain stores on Manhattan streets.

Other properties

This is not true of most properties, which have shorter remaining lease terms or with lesser quality tenants who can be adversely affected by the changing nature of retail. Retail rents have declined in many neighborhoods, and investors are much more careful, even if the potential sellers are not realistic. These are purchases/sales where the real estate fundamentals should dictate pricing. Cap rates for these properties are higher, if they sell, in the 7-9% range, somewhat higher than a few years ago.

Many of these buildings, however, are controlled by investors who follow the motivations that George van der Ploeg earlier described and which the Chuck Goldberg's friends confirmed. Retail property owners may be opportunistic investors who purchased two or three years ago, anticipating a continued rise in retail rents and in partnership deals that were structured to pay them only if their property income reached targeted levels. These owners have strong incentives to negotiate to keep their rents up, offering tenants up-front payments, tenant improvements (previously unheard of in the retail market), or some months of free rent.

This was discussed extensively in an article in *The Real Deal* in September 2017. [4] Among other examples, the article cites the sale of a 27-story office building at 650 Madison Avenue, where the major retail tenant, Crate & Barrel, had only six years left on its 62,000 square foot lease, at a below market rent. The building owners and the brokers marketing the property got Crate & Barrel to agree to pay a higher rent, in exchange for an amendment to the lease that provided for a cash payment if the owners sold the building. The building could then be marketed with the higher income. Indeed in June 2013, the building was sold for $1.3 billion, although the lease amendment was not exercised, the store was vacated, and four-years-later has not been entirely re-leased.

For an opportunistic investor, the goal is to get the income as high as possible, to meet the demands of equity partners or bank lenders, or to push up the eventual sale price. For less sophisticated investors, the fatal flaw is to overlook what the seller spent to achieve the retail rent roll, and/or to expect that a high paying tenant is available to fill vacated space. [5] Sellers buying through a 1031 exchange, have a limited time frame within which to identify rollover property. They cannot wait-out the sellers, and this serves to keep the market afloat. All of this, of course, may not have much impact, if retail rents are only a small component of a building's overall income.

So where are the 7-9% cap rate deals, perhaps with some upside? In this, I have not yet gotten too far. These deals may be carefully cherished by those who have access to them, unless you have ready cash in hand. A review of retail listings on websites of Sinvin and Cushman & Wakefield indicated just a few available properties, with a variety of tenants, and with both asking price and net income estimates indicated. These offerings were at capitalization rates of 4-5%.

For investors, taking advantage of the weakness in Manhattan's retail market may be premature, or it may simply require patience and the right advisors.

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[4] "*NYC's great retail façade, As more building owners employ quiet tricks to increase retail rents, some say they're establishing a false perception of the market.*" The Real Deal, September 1, 2017
[5] Ibid.