COVER STORY, SEPTEMBER 2010

RETAIL REAL ESTATE RALLY IN CALI?

While the number of retail properties trading is low, what is trading is going for top dollar. Retailers, meanwhile, are infilling better locations in the Golden State. Randall Shearin

While activity is down overall in California retail real estate, the climate itself is vibrant and poised for a comeback. Although the volume of leases getting done is less than it was 3 or 4 years ago, there are a number of large, healthy tenants who have realized now is the time to get into California's wealthy infill markets that used to have big barriers to entry.

"From a tenant perspective, some of the national corporate tenants, as well as the regional tenants are considering jumping back into certain markets," says Robert Pinon, vice president of corporate retail solutions at Jones Lang LaSalle. "Los Angeles is one of the big ones. Tenants are trying to upgrade some of their real estate or penetrate those markets of L.A. that they weren't able to get into before due to the real estate opportunities or expense."

While not every tenant is in the market for space, some are looking for deals where they can dictate good terms and good location.

"Tenants are being a lot more methodical," says Pinon. "It has to be the site for the number. Otherwise, tenants are walking."

For landlords, this means paying closer attention to properties, keeping their eyes on existing tenants and future possibilities.

"The current climate almost requires the landlords to hyper-manage their own leasing efforts to make sure that attention is paid to the properties," says Steve Jaffe, executive vice president of Los Angeles-based BH Properties.

That said, there are many retailers who have stepped up activity in recent months.

"There has been a marked increase in the past 6 months over the previous 12 months," says Robert Champion, president of Los Angeles-based Champion Real Estate Companies.

Linda Hagelis of Ventura County-based retail brokerage Hagelis Group, notes that activity among tenants has also picked up in recent months.

"We haven't had a lot vacancies in our centers, but the tenants wanted the best deal they could get from the landlord," she says. "Some deals, we would get good tenants but the economics wouldn't make sense to the landlord. Things have become a little healthier now."

Owners like NewMark Merrill Companies are seeing a lot of activity among tenants who want to improve locations.

"We are seeing competition for space, which is great," says Sandy Sigal, president and CEO of NewMark Merrill. "Our sign calls are up significantly from last year. That said, tenants are still asking for substantial TI allowances and low rents. The good news is that there are transactions."

Sigal reports a lot of activity among discount tenants and big boxes like Staples, Petco, Ross Dress For Less, A.J. Wright and Marshall's. Goodwill has also continued to backfill larger vacant space. Quick service restaurants like Qdoba, Chipotle and Panera Bread have also been active. Pinon of JLL reports that tenants like Ashley Furniture, Burlington Coat Factory and TJX are picking up empty box space in Southern California. Pinon also reports supermarkets like Sprouts and Sunflower Market are expanding in California. The Coffee Bean & Tea Leaf and Starbucks are also reviewing options in Southern California, in some cases looking to upgrade real estate.

"Some of the larger big box retailers are using the decline in value to try and lock up opportunities that they would not have been able to afford a few years ago," says Champion. "There's no doubt that the consumer is retracted and is more value conscious than they were. The value retailers have been very aggressive. They are definitely out there trying to take advantage of the low end to lock up and improve their position in the market."

One retailer who has done this in California is Costco. The warehouse retailer is creating a 154,000-square-foot location at Bella Terra in Huntington Beach that will open in 2011 by using the site of a former Mervyn's location. Costco selected the property, which is owned by DJM Development Partners, after doing a thorough analysis of the Orange County market. Costco also has signed deals to anchor two Westfield.

Across the board, retail leasing agents like Hagelis Group are seeing more value oriented tenants as a whole.

"We are seeing a reemergence of family oriented tenants, like value-oriented restaurants," says Bill Hagelis of Hagelis Group. "The mom-and-pops and other tenants who were priced out of Southern California in the good times can now afford space."

Tenants at malls and lifestyle centers are making deals if the center is established and has proven strong sales.

Caruso Affiliated's Americana at Brand in Glendale has seen several tenants join in 2010, including American Eagle Outfitters, Deluca's Deli, and Trattoria Amici. The largest mall owners in California — Westfield and Macerich — continue to report strong occupancy rates in their portfolios. As well, smaller tenants are finding spaces that fit their needs as well, evidenced by the recent openings of Crocs and Varga at CIM Group's The Strand in Huntington Beach.

"Everybody is really stepping in if it is the right deal," says Jones Lang LaSalle's Pinon.

Other categories that Hagelis Group sees active along the South Central Coast include banks and small grocery stores, like Fresh & Easy. Hagelis also sees the resurgence of local chains. The company is working with Islands Restaurants, a 57-unit chain that is seeking more locations in the Central Coast. New development is rare and only happens today when land costs and tenant interest meet. Many smaller projects are being developed with cash.

"New development occurs when land costs are reasonable and the numbers make sense," says Hagelis. "The realistic owners are making deals; the ones who are waiting for the market, who knows when they will move."

For those tenants considering expanding or jumping into the market, Pinon says they should act now.

"There is definitely still opportunity out there, if the tenants are willing to stick to their analytical data and not be worried about the overall economy," he says. "There is still buying power in Los Angeles and people are still making deals at good numbers. Those numbers will increase the moment construction starts to come back online."

Investment Climate

Don MacLellan, a director with Faris Lee Investments, reports that there are a number of assets in California on the market between $10 million and $40 million. On the distressed side, there are some bank default retail developments between $40 million and $90 million that have traded.

"The single-tenant market has continued to be very active," says MacLellan. "On the distressed side, we are seeing tremendous offer activity from the $5 million deal to the $90 million deal. With stabilized assets, we are seeing more scrutiny but there is interest in infill sites in Southern California."

Los Angeles-based Champion Real Estate Company has liquidated a number of assets in recent years to create a co-investment pool. The company has aligned itself with four opportunity funds to leverage its investment to about $500 million in value-added properties.

"We are not looking strictly for rent arbitrage or cap rate arbitrage; we're looking for properties where our past development expertise can help create additional value," says Robert Champion.

Thus far, Champion has not closed on any properties, but does have one center and some property for future development — both in Southern California — in escrow. The company currently has about 12 assets in retail and multifamily that it has held in its portfolio. While his fund has been seeking centers, like other buyers, Champion is surprised at the low number of properties on the market, and the pricing of those that are.

"There hasn't been that much that has traded," says Champion. "What has traded has done so at surprisingly low cap rates."

"There is a big dichotomy between the A properties and the C properties," explains Bill Hagelis. "With the C properties, you having a tough time leasing them and a tough time commanding the value that we once saw in these properties. With an A property, you can get multiple offers and you can get your value."

As Bill Hagelis and Robert Champion state — that the top properties that go on the market sell for top dollar — the current investment climate has created a quickly closing timeframe for potential buyers to react to a listing.

"The investment climate is ridiculously hot," says Sigal. "There is very little product on the market. For every product that is listed, there is a crazy amount of offers. For top product, there has been little movement on cap rates; deals that would have traded at a 6.5 cap rate in good times are now trading at 7, for instance."

For lower performing properties, this isn't the case. Many of our interviewees reported several centers they knew that had been on the market for a long time with little interest because of their condition or pricing.

"The junk assets aren't trading," says Sigal. "The good assets are trading at the cap levels where they used to trade."

A number of larger deals that we researched pointed to a trend of taking partners out of deals, such as Forest City selling its 50 percent stake in San Francisco's Metreon in July to the center's other owner, Westfield.

Other centers that have traded include the $11.75 million sale of The Town Center Ontario, a 128,330-square-foot center that was 85 percent vacant at the time of sale. The center, which was in receivership, was sold to Oxylane Groupe-Decathlon, a French investor. Faris Lee represented the seller, while Epsteen & Associates/Samuels Company represented the buyer.

Many owners counted on having a large selection of distressed assets to buy at this point in time, and that hasn't materialized.

"Everybody has been waiting for this onslaught of properties to be dumped on the market," says Jaffe. "We haven't seen that. That's a challenge to those of us looking to acquire, because there are not a lot of properties flooding the market to press prices down."

That refrain is common among owners who have lines of credit or value-add funds and partners assembled. Many simply can't find the properties that fit their needs in the acquisition market.

"We're ready to go," says Jaffe. "Many people are realizing this is the way it is, so let's get back in business."

Development and Redevelopment

The slow economy has also made many owners realize that, if they can't acquire, now is the time to invest in assets they already own and make them better. As a result, many properties in California have received facelifts and redevelopments over the past 2 years.

Mall owners have concentrated heavily on redevelopment and repositioning over the past few years, and the evidence has begun to open in California. Macerich opened the newly renovated and repositioned Santa Monica Place in August. The redevelopment of the center brings more than 60 new retailers to the 550,000-square-foot center, which is anchored by Nordstrom and Bloomingdale's. Tenants at the center include Tiffany & Co., Tory Burch, True Religion, kitson, Louis Vuitton, Hugo Boss, The Disney Store, CB2 and Burberry.

Westfield has recently expanded two centers in Southern California, and has a third expansion underway. The company opened a new wing of shops at Westfield Valencia Town Center in Santa Clarita in November 2009; it opened an expansion at Westfield Santa Anita in Arcadia in May; and it has an expansion project underway at Westfield Topanga in Woodland Hills. In November 2009, the company held a grand opening of Westfield Culver City, which underwent a $180 million redevelopment. New retailers at the center include Target, Best Buy, H&M, XXI Forever, Coach, The Disney Store and Hollister. Other anchors include Macy's and JC Penney.

One large development deal will help change the face of the Central Coast. Lee & Associates closed a 10-acre land sale in August to Target in San Luis Obispo at the Prefumo Creek Commons power center. Target will build a 140,000-square-foot store, while Madonna Enterprises will build and own the remainder of the center, which will total 191,025 square feet. The center is expected to be complete in 2011. The $32 million project is one of the larger in the state, and speaks to the strength of the Central Coast market, says Clint Pierce, president of Madonna Enterprises, LLC.

Shea Properties is developing The Collection at RiverPark in West Ventura County.

"The San Luis Obispo market had high barriers to entry," says Pierce. "Target has been working on getting into the area for over 15 years, and the partnership between the city of San Luis Obispo, Target Corp., and Madonna Enterprises produced a successful project."

Shea Properties is under construction with The Collection at RiverPark in West Ventura County. The 650,000-square-foot mixed-use project is anticipated to open in late 2011. Designed by Altoon + Porter to be LEED certified, anchors include Target, Whole Foods, Century Theatres and REI. In addition to retail, it will contain 60,000 square feet of office space.

Shea also has a mixed-use project in San Diego scheduled to break ground in 2011. The 85,000-square-foot Mercado del Barrio is located in the Barrio Logan neighborhood near downtown. The project will be anchored by a Gonzalez Northgate market and an additional 48,000 square feet of street level retail, with 92 affordable housing units above one of the retail buildings.

Watt Commercial is redeveloping Palo Woods Shopping Center in Harbor City, opening in December. The 110,000-square-foot center, designed by Nadel Architects, will be anchored by Ross Dress for Less and LA Fitness. The project is the redevelopment a 44-year-old Kmart building, with most of the existing structure being utilized.

Watt Commercial's Palo Woods Shopping Center redevelopment in Harbor City

Watt is also redeveloping Alicia Towne Center in Mission Viejo, a project that will commence construction next month. The company plans a $7.6 million redevelopment of the 149,350-square-foot center. The major component of the redevelopment is the conversion of a former Mervyn's location into a two-story LA Fitness unit.

In Orange County, Craig Realty Group is underway with sitework on Plaza San Clemente, the first upscale outlet center in the county. Craig Realty Group's Brenda Benter, senior leasing executive, is working with Peter Spragg of Grubb & Ellis's Retail Services Group and Jim Clarkson of Strategic Retail Advisors to lease the center. So far, signed tenants include Under Armour, Vans, Levi's, Hanes, Puma, Carter's, Osh Kosh, Pearl Izumi, Bass, Van Heusen and many others. As the first outlet center in the area, Plaza San Clemente holds an advantage for retailers.

"Most outlet malls are doing better this year than they were last year, and they fared better than the regional malls," says Benter. "Retailers are viewing outlets as a way to expand their business during recessionary times."

Donahue Schriber is renovating its 273,298-square-foot Del Mar Highlands Town Center in San Diego County. The $20 million renovation will add new paint, signage, storefronts and landscaping to the center, as well as 8,000 square feet. Tenants at the center are Ralphs Fresh Fare, Rite Aid, Ultra Star Cinemas, Barnes & Noble and Tilly's. Donahue Schriber's leasing team is negotiating to bring more restaurants to the center as part of the redevelopment, which is expected to be complete in summer 2011.

Donahue Schriber's Del Mar Highlands Town Center

In Northern California, Cassidy Turley is leasing @First, a mixed-use project in San Jose, for Cupertino-based Hunter Properties. Target is under construction and will open next month, while other retailers who have signed leases or are under negotiations are Chick-fil-A, Chipotle, Sweet Tomatoes, Five Guys, Union Bank, CVS/pharmacy and Panera Bread.

NewMark Merrill recently completed redevelopments of centers it owns in Riverside and El Cajon. In Riverside County, it repositioned Arlington Square, adding a Fresh & Easy and remodeled tenants like Ross Dress For Less, Big Lots, and Dollar Tree to the 85,000-square-foot center. It also removed an older bank building on an outparcel and added a Chase branch and a T-Mobile.

“The center is now 97 percent leased and it has won awards by the city for the work we did there,” says Sigal.

In El Cajon, the company remodeled El Cajon Town & Country, adding Fresh & Easy, Chase, a restaurant and other tenants, as well as remodeling the Rite Aid and Bank of America stores at the center.

NewMark Merrill, a preferred developer for CVS/pharmacy, has a few deals going for that tenant in select locations.

“They are developing only when they can make deals that are very good relative to the market,” says Sigal.

There is also still development going in tertiary markets in California. As reported in Western Real Estate Business, Los Angeles-based Rothbart Development is underway with Walmart-anchored projects in Victorville and Lancaster.