Food & service retail

Small retail has big potential

by Sterling Hillman

For thousands of years, the marketplace has been a fixture of our daily lives — places where people buy and sell goods and services. While the nature of retail real estate has evolved over time, a certain mantra has remained: "Keep it simple."

The current environment seems to be another inflection point in the retail space. Outside observers assume that ecommerce has decimated the sector — finishing off what the pandemic started in terms of consumers' buying patterns. Others may have read headlines about the "over-retailing" of the United States and jumped to the conclusion that current total square footage is out of step with demand. But the data tell a different story.

Amid all the noise and distortion, the fundamentals of retail — location, convenience and enduring demand — ring true and shine through. Small-format, convenience-oriented, open-air, food and service shopping centers are proving to be a thriving, internet-resistant segment of the sector and a compelling investment opportunity.

Developing story of retail development

The retail property sector's renaissance has been anything but sudden. The foundation of the shift has been unfolding for more than a decade, largely driven by the principle of supply and demand. The former has decreased, leading to an increase in the latter.

The total amount of retail space under construction in the United States has declined for three consecutive quarters and remains near the lowest levels of the past decade. Just under 12 million square feet of retail projects were started during first quarter 2023, the lowest total recorded since CoStar started aggregating national retail figures in 2005. In addition, retail construction starts appeared set to hit a record low in the third quarter, as a mere 7.1 million square feet of new retail projects were started through the first 75 days of the second quarter. Furthermore, more than 62 million square feet of retail space was under construction at the end of June, down 4 percent since the end of the first quarter and nearly 15 percent below the prior 10-year average of 73 million square feet.

On the demand side, per Cushman & Wakefield, the first quarter national vacancy rate measured at 5.6 percent, the lowest since at least 2007, when the firm's data tracking began. That rate was essentially unchanged from the fourth quarter of last year. This first quarter marked the U.S. retail property's eighth consecutive quarter of positive net absorption, meaning the square footage of stores that opened is higher than the square footage of stores that closed, reported Cushman & Wakefield. In total, retailers moved into approximately 2.5 million square feet of space during the quarter.

Current tendency of tenancy

Where is all the demand coming from? According to CoStar, restaurants, fitness centers, discounters and grocers account for most of the demand for retail space across the United States, responsible for more than 51 percent of the total amount of retail space leased in 2021 and 2022. Restaurants and fitness centers alone contributed more than 31 percent of all leasing in 2022. Per a recent retail sales report for April 2023, Americans spent $88.1 billion at restaurants and bars during the month, more than 30 percent higher than the monthly average spent in restaurants and bars during the 12 months preceding the pandemic.

Another evolving trend in retail is the consumerization of medical care, often called "medtail." This evolution of medically focused and specialized tenancy has led to more healthcare providers seeking physical locations outside of the traditional hospital, or medical office system, and into more visible and consumer-facing retail space. Education- and healthcare-focused tenants accounted for 7.6 percent of all retail leasing activity in 2022.

Convenience is key

The U.S. consumer economy is increasingly rooted in convenience, and a segment of retail that appears the best positioned to accommodate this closer-to-consumer demand is "lifestyle retail," also known as "essential," or "food and service" retail. This brand of retail can be unanchored or shadow-anchored, and features an open-air construction, promotes accessibility, provides convenient parking, and appeals to what may be the deepest pool of tenancy in retail today. According to CoStar, during the first three quarters of 2021, the average size of a retail lease fell to an all-time low of more than 3,000 square feet. This continued a multidecade trend in the retail sector, with the average lease size falling by more than 30 percent during the past 15 years.

Featuring lower-ticket check averages and internet-resistant business models, this food and service–oriented tenancy has proved surprisingly resilient during the pandemic and appeals to a growing share of consumer spending — shifting from goods to services. Even as the country grapples with recessionary concerns throughout 2023, this daily needs–oriented tenancy is still poised to capture a large share of consumer spending that remains accountable for more than two-thirds of GDP. In addition, during the global financial crisis recessionary period of 2007–2009, real personal consumption expenditure only fell 2.3 percent, while durable goods spending declined 14.5 percent from peak to trough.

Innovation of institutionalization

The favorable supply-demand dynamics of food and service retail centers provide for promising investment conditions at the property level. The investment thesis on a portfolio level is even more compelling, given the largely fractured and private ownership profile that currently exists. The noninstitutional owner contingent benefits from the consistent cash flow and low capital expenditure attributes of the asset class, but they often neglect pursuing the income gain that can be realized from providing tenant improvement allowances and incorporating professional leasing and management teams. This under-investment leaves value-creation opportunity on the table for the institutional owner. The smaller format retail segment experienced more than $21 billion, reported CoStar, of real estate trades under $20 million in asset value across 2021, presenting an attractive opportunity for future scalability.

Storefront names will change over the years, but well-located properties, positioned in closest-to-consumer formats, possess an enduring appeal to a broad pool of tenancy. Investors who recognize the secular trends of domestic migration, limited supply and consumer behavior can be well-positioned to capitalize on this simple concept: Small-format, internet-resistant retail is essential, everyday retail. ❖

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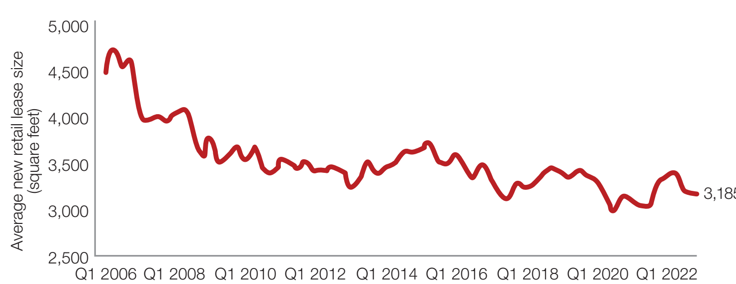
Average new lease size dipped 3.0% year-over-year



Sources: CoStar Advisory Services, JLL Research