The Retail Outlook

Summer 2016

Marcus & Millichap

Retail Property Sector Riding Economic Momentum As New Concepts Grip and Shake Up Retail Industry

Steady job creation in 2016 has driven U.S. employment well above the pre-recession peak and is providing momentum for consumer spending, the primary engine for economic growth. Core retail sales, which exclude auto sales and price-sensitive gasoline, also continue to reach new highs monthly, and specific retail segments are growing notably. Consumer staples have performed well, while receipts at bars and restaurants have risen to surpass grocery store sales as dining habits change.

Nonstore spending drives a larger share of total retail sales each month, prompting a widespread reconsideration among retailers of traditional strategies. Thus far in 2016, retailers without an omnichannel strategy that combines physical stores with a digital presence have proved susceptible to incursions by more technologically nimble competitors. Increasingly, retailers who cannot differentiate their services, particularly big-box stores, face the most serious competition from online retail.

As more sales move to the digital realm, mobile devices are emerging as a vast new frontier for retailers. Currently, nearly 30 percent of all Internet-based sales are conducted on mobile devices. More than 80 million millennials are leading this trend, collectively harnessing $2.5 trillion worth of spending power.

Against the backdrop of the sweeping changes buffeting the retail industry, the space market continues to perform well. Restrained completions and growing space demand are maintaining tight vacancy on a national level, while the delivery of thousands of urban apartments continues to open new trade areas and augment property operations in many metros. Rents also continue to grow, albeit modestly, and will become a larger driver of property valuations.

The lines between e-commerce and traditional retail will become more indistinct in the coming years, creating new challenges for retail property owners and potentially opening up new revenue streams. As store-based retailers fortify their online presence and re-assess store counts, nonstore merchants will continue to open physical locations, a trend exemplified by Amazon's recent gambit of opening its own bookstores.

Retail 2016 Outlook

46 million sq. ft
will be completed

Construction:
Developers will place in service 46 million square feet of space. Dallas/Fort Worth, Houston and New York City will each receive a substantial amount of new space.

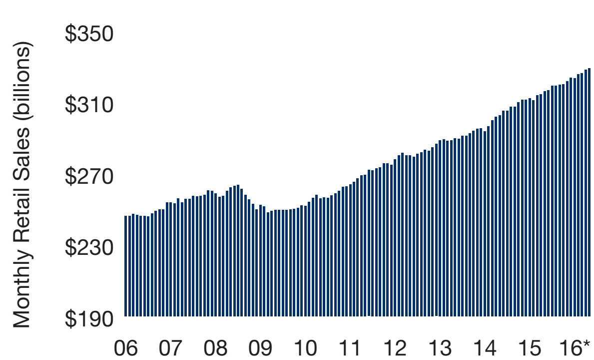
30 basis point
decrease in vacancy

Vacancy:
U.S. retailers will occupy an additional 67 million square feet of space during 2016 to drive down the nationwide vacancy rate 30 basis points to 5.8 percent.

2.8% increase
in effective rents

Rents:
After a gain in the first quarter, the average rent remains on track to climb 2.8 percent this year, exceeding last year's 1.9 percent increase.

Core Retail Sales Soaring



* Through May

Economy

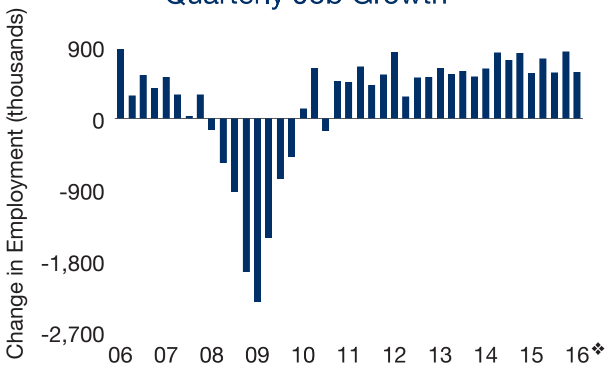
Growth in service-sector industries continues to underpin a strong labor market and provide the fuel for greater consumption of goods and services. With an average of nearly 200,000 positions added monthly over the past five years, U.S. payrolls currently sit nearly 5.5 million jobs above the pre-recession peak. Contributions to total employment have been broad-based, with growth in healthcare, and leisure and hospitality making up for losses in oil-and-gas industries. Reflecting the steady growth in retail spending, retail trades have also chipped in, accounting for one in five of all jobs created this year. Nearly all of the gain has occurred at store-based merchants, but payrolls of nonstore retailers continue to demonstrate an accelerated growth pace.

Consumers' spending power continues to improve behind low gas prices and steady income growth. Disposable income per capita adjusted for inflation has increased by more than 2 percent over the last year, supporting more sales of retail goods. While core retail sales are increasing at approximately 4 percent annually, in line with long-term trends, the outperformance of several segments of the retail universe highlights changing consumer habits and preferences. E-commerce is capturing a greater percentage of sales each month, offering new opportunities for retailers to engage customers. Nonstore retail spending rose more than 60 percent over the past six years, exceeding growth in all other categories over the period. Additionally, increases in sales at bars and restaurants are outpacing growth at grocery stores as new rental households are formed in urbanized areas that offer numerous dining options. While grocery anchors remain highly valued among retail property owners, restaurants are increasingly coveted for their ability to draw traffic and because of their insulation from online competition.

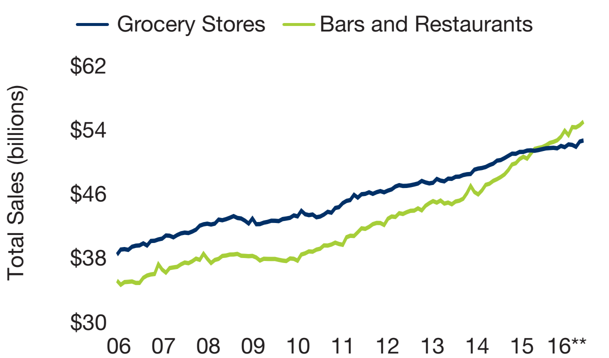
Shifting demographic trends drive demand for an array of retail goods sold. The millennial generation comprises more than 80 million Americans and wield spending power in excess of $2.5 trillion, commanding the attention of retailers, and bars and restaurants. The vast scale of this segment of the population has prompted changes across the economic landscape, forcing retailers to merge traditional methods of reaching customers with new technologies to capture more customers and sales. The comfort and agility with digital products displayed by the millennial generation, in particular, continues to encourage retailers to reinvent how they engage potential shoppers and prod them to visit stores.

Outlook: Employers will hire roughly 2.1 million workers in 2016. The stable labor market will support GDP growth in the 2 percent range.

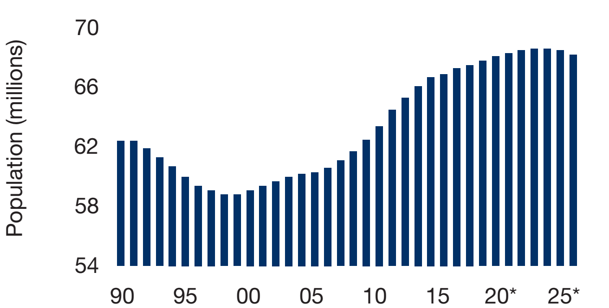
Quarterly Job Growth



Dining Out Spending Exceeds Groceries



U.S. Population 20-34 Years Old



❖ Through 1Q ** Through May * Forecast
Sources: CoStar Group, Inc.; BLS, Census Bureau

Performance Trends

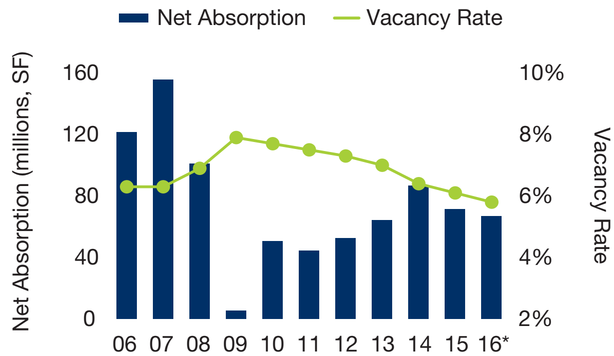
Minimal completions and rising space demand continue to sustain a low vacancy rate at U.S. retail properties. Tenants occupied an additional 10.1 million square feet of space in the first quarter, holding the vacancy rate steady at 6.1 percent and matching the lowest level during the current economic cycle. Among the trends that continue to find traction in the first quarter were demand for space to house e-commerce showrooms and customer service functions. Brick-and-mortar concepts that keep expanding include off-price multiline merchants, fitness, quick-service restaurants, hobby stores, organic grocery offerings and fast fashion. At the metro level, only a few markets recorded a decline in occupancy during the first quarter. These markets include San Jose and Bay Area neighbor Oakland, where the vacancy rate nonetheless remained tight at less than 4 percent. Several top-performing metros include those where rental housing stock is growing substantially, opening new trade areas for retailers. Dallas/Fort Worth and San Antonio each registered a sizable influx of new apartments during the first quarter, which likely contributed to elevated demand growth.

Nearly seven years after the end of the recession, only a trickle of new retail properties are coming out of the construction pipeline. In the first quarter, developers completed 8.5 million square feet nationwide, with the vast majority in single-tenant formats. In general, retailers remain highly selective, locating in areas with the strongest demographic profiles, at the exclusion of secondary or marginal locations that would have been built out during the last growth cycle. The shift in retailers' focus continues to restrain quarterly completions to roughly one-third of the level recorded in the years prior to the recession. A sudden upturn toward the historical trend is not likely imminent, either, as retailers adapt an omnichannel approach to merchandising that rethinks the store experience and integrates an online presence. A trend toward mixed-use properties is also underway, especially in highly urbanized areas with growing residential populations.

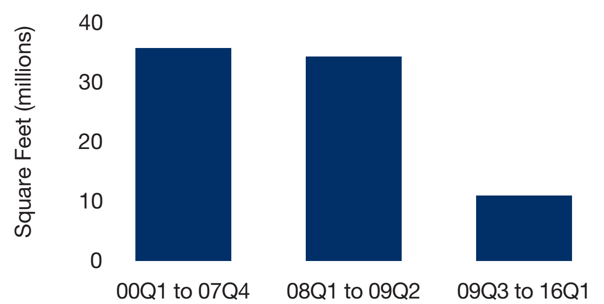
Tight vacancy and limited competition from new supply are exerting upward pressure on rents. The average rent on space marketed for lease nationwide advanced to $18.52 per square foot in the first three months of 2016, marking a respectable 2.3 percent gain from the first quarter last year. Overall, the average rent on space on the market remains below the quarterly levels posted preceding the recession, likely reflecting a preponderance of lower-quality or marginally located space for lease.

Outlook: Rising incomes will support growth in retail spending and generate new demand for retail space nationwide. The vacancy rate will decline 30 basis points to 5.8 percent and the average rent will rise 2.8 percent.

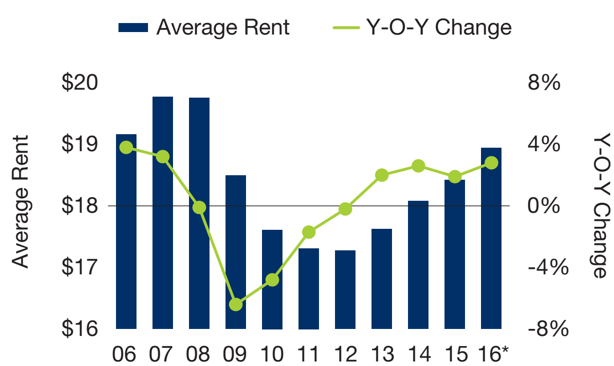
Annual Vacancy Rate



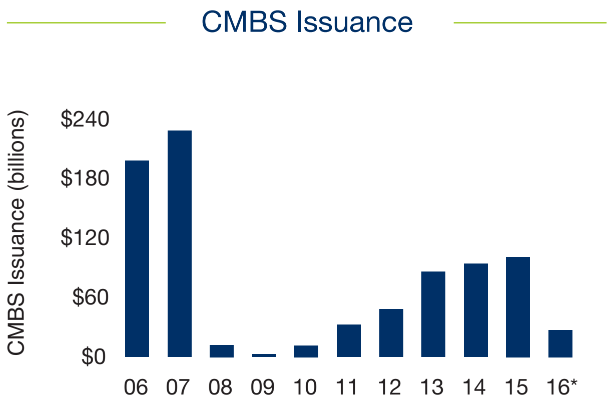
Average Quarterly Completions Drop

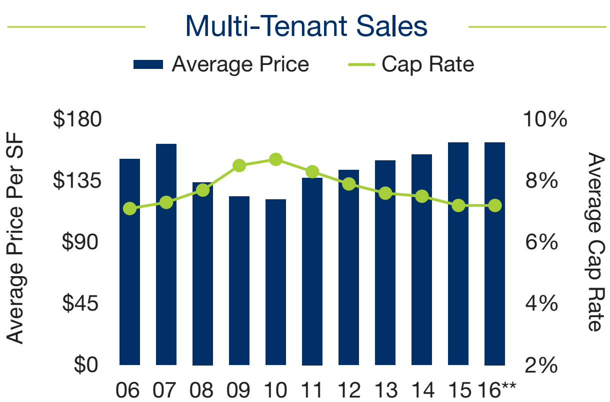


Annual Rents



* Forecast





* Through 1Q
** Trailing 12 months through 1Q

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Capital Markets

By WILLIAM E. HUGHES, Senior Vice President Marcus & Millichap Capital Corporation

The U.S. economy maintained an uneven pattern of growth in the first half of 2016. Recent data showing a slower rate of job growth and subdued increases in wages will likely encourage the Federal Reserve to adopt a more measured approach to monetary policy and extend its timeline for raising its benchmark rate.

CMBS issuance declined in the first quarter from the corresponding period in 2015. Spreads on the highest-rated bonds compressed but remain wider than one year ago. Banks remain capitalized to compete for market share, offering leverage in the 65 percent range and terms up to 10 years. Spreads vary depending on asset location and quality but generally start in the low- to mid-200-basis-point range above corresponding swap rates.

Outlook: Foreign economic trends and events could potentially create temporary volatility in global markets during the second half of 2016. As markets absorb these actions, a migration of capital into the safe haven of U.S. government bonds will maintain the yield on the 10-year U.S. Treasury within a tight range.

Sales Trends

Multi-tenant property sales invigorated, pushing prices above pre-recession peak. Solid growth in space demand and limited competition for tenants from new properties continue to support investments in stabilized anchored shopping centers as well as assets where turning over tenant mixes can unlock greater value. Transaction velocity rose at a modest but steady pace from one year ago, led by capital flows into Class B/C assets.

Rebounding demand at the beginning of the year for multi-tenant properties advanced pricing above levels witnessed in 2015. Cap rates edged down slightly in the mid-6 percentage range, showing the strength of investor interest for all types of retail property types with primary and secondary markets garnering the majority of attention.

Single-tenant net lease transaction activity flattened from last year, reflecting the limited inventory of listings available to investors. Highly rated drugstore tenants and franchise quick-service restaurants remain highly sought after. However, several states are considering more stringent definitions of like-kind exchanges. If implemented, the changes could potentially limit interstate capital flows.