

2008 Retail Leasing Forecast

A Special Research Report

Contents:

- 2 Survey's Key Findings
- 2 Retail Sales Forecast
- 4 Retail Leasing Demand
- 6 Retail Development Trends
- 7 Tougher Lease Terms
- 8 Occupancy Costs Increase

Survey Methodology

Between September 12, 2007, and September 14, 2007, 207 people responded to an online survey that was sent to *Retail Traffic* print and e-newsletter subscribers. The survey was conducted by Penton Research, the independent research unit of Penton Media, the parent company of *Retail Traffic Magazine*, and sponsored by PlainVanillaShell, the online portal of Trade Dimensions, a Westport, Conn.-based research firm.

Objectives of this study effort include:

1. Investigate current trends and concerns in the retail leasing process.
2. Compare the opinions of retailers and developers.
3. Examine how industry trends have changed in the past two years.

BUSINESS AS USUAL

Retailers keep one eye on the economy, while the other seeks expansion opportunities

Stalled economic growth, diminished consumer confidence and forecasts of weak retail sales haven't managed to paralyze American retailers. Instead, they're still expanding, signing leases for 2008 openings and scouting locations for 2009.

But, the expansion isn't willy-nilly – retailers are being smart about their new locations, choosing the best sites and demanding leases with plenty of perks and flexibility in case the economy and consumer spending head south. Developers and owners are submitting to leases with exclusivity agreements and co-tenancy provisions that give retailers the ability to delay store openings or terminate their leases.

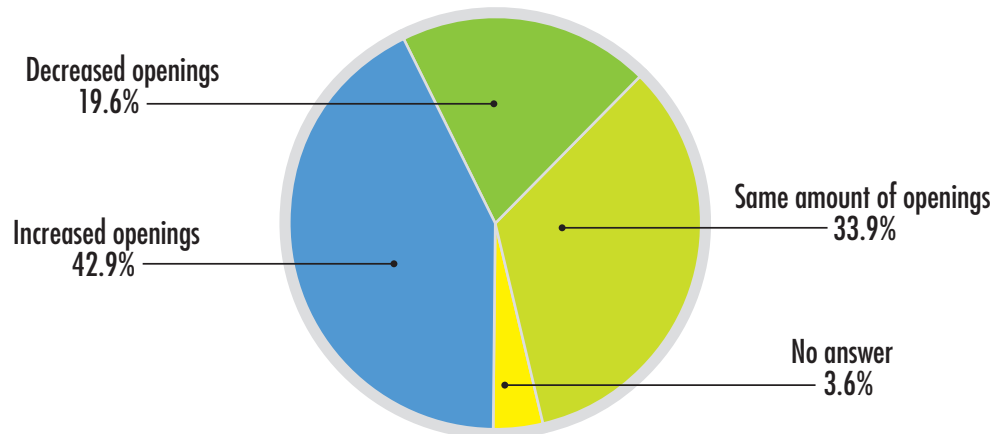
Roughly 77 percent of retailers say they will open more stores or the same

amount of stores in 2008 and 2009 as they did in 2007, according to a survey conducted by Penton Research, the independent research unit of Penton Media, the parent company of *Retail Traffic Magazine*, and sponsored by PlainVanillaShell, the online portal of Trade Dimensions, a Westport, Conn.-based research firm. Less than 20 percent of retailers say they'll open fewer stores in the coming future. (see figure 1, page 1)

"There's still a lot of demand from retailers, from big and junior boxes to smaller national and regional chains," says Brett Hutchens, partner in charge of retail at Casto, a Columbus, Ohio-based owner and developer of grocery-anchored, power and lifestyle centers. "There's no question that retailers want to develop more stores

Figure 1: A majority of respondents plan to open the same or a larger number of stores in 2008 and 2009.

• How does your store opening schedule for 2008 and 2009 compare to 2007?



around their existing base of stores, as well as enter new markets.”

Hutchens notes that many retailers have already completed their expansion plans for 2008 and have started to work on 2009, while some are deep into 2010 expansion plans. “Retailers expect occasional economic corrections and know they can’t put their heads in the sand until the economy is strong again,” he says. “If they do that, they wouldn’t have any store expansions or openings during the good times.”

In order to gain an in-depth understanding of the current retail development and leasing environment, *Retail Traffic* and PlainVanillaShell collected data from 207 retail industry experts from September 12, 2007, to September 25, 2007. Retailers accounted for roughly one-fourth of the survey respondents, while retail developers and owners accounted for the remaining portion.

Nearly seven out of 10 retailer survey participants are executive-level professionals with roughly 38 percent serving as CEO or president of their organizations. They have an average of 47 stores, which average 15,446 square feet.

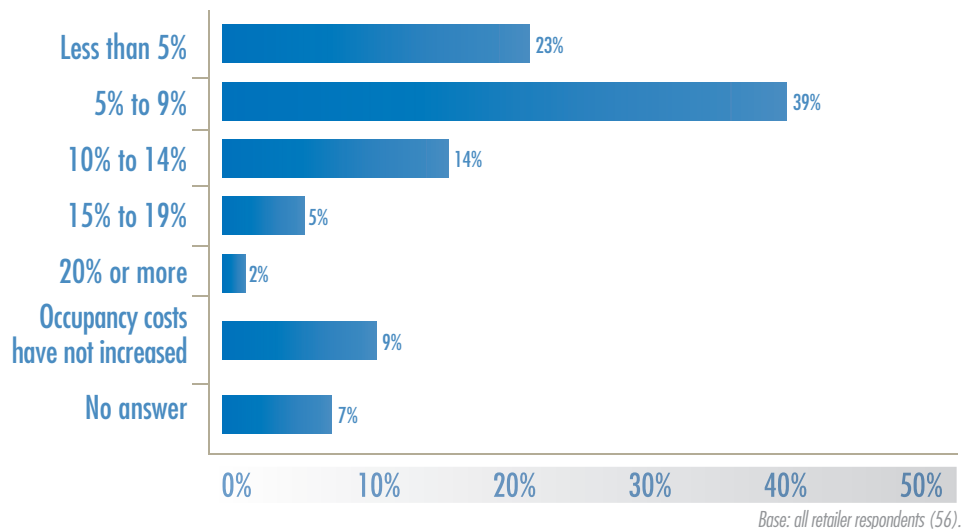
Developer/owner respondents own or manage an average of 21 centers with an average gross leaseable area (GLA) of 323,793 square feet and have an average of 399,296 square feet of retail space under development. In fact, one-fourth of developers have 500,000 square feet or more of retail space under development.

Among the survey’s key findings:

- Eighty-three percent of retailers report occupancy costs have increased over the past two years; specifically they estimate occupancy costs have jumped an average of seven percent. Respondents point to the rising costs of construction, utilities and insurance as reasons for the increase, as well as higher common area maintenance (CAM) charges. (see figure 2, page 2)
- Nearly eight out of 10 respondents, both retailers and developers, have leases with exclusivity agreements. In fact, roughly 40 percent of retail leases have exclusivity

Figure 2: Faced with rising outlays for construction, utilities, insurance and maintenance, respondents saw an average rise in occupancy costs of seven percent in the past two years.

• If occupancy costs have increased in the past two years, by what percentage?



agreements. Thirty-one percent of developers say they’re giving more exclusivity agreements, while another 53 percent report no change in the preponderance of exclusivity agreements. (see figure 3, page 3)

- Nearly three out of four developers have leases with co-tenancy provisions including early lease terminations, delayed store openings and go-dark clauses. In the past two years, only 16 percent of retailers have enforced a co-tenancy provision, while 23 percent of developers say a retailer has enforced a co-tenancy provision at one of their centers. (see figure 4, page 3)
- Terrorism insurance did not seem to be a concern for the retailers and developers in our survey. In fact, 50 percent of retailers say terrorism is not at all important, while only four percent say it is extremely important. Surprisingly, nearly half of developers have no terrorism insurance for any of their centers. Overall, 21 percent of properties have terrorism insurance. (see figure 5, page 4)
- Although 20 percent of developer respondents have no idea when the turmoil in the

capital markets will subside, the majority (60 percent) thinks the CMBS market will calm down in 2008. Unsurprisingly, 72 percent of respondents prefer to obtain debt financing from a portfolio lender rather than any other source while 19 percent say they still prefer conduit lenders. (see figure 6, page 5)

SHOP TILL THEY DROP

Americans are shoppers, and our propensity to shop has been evident over the past several years. In fact, consumer spending kept the U.S. economy afloat during the most recent 2001 recession. During that recession, consumer spending did not decline in any quarter, even though employment shrank by 2.7 million workers, according to Diane Kutyla, an economist with Deloitte’s retail services group.

This year, however, consumer spending has slowed. Consumers, whose spending represents about 70 percent of all U.S. economic activity, are becoming even more cautious. They’re increasingly worried about falling home prices, as well as higher food and fuel prices.

While retail sales have remained positive, posting year-over-year increases in 38 out of 40 weeks in 2007, total foot traffic

has slumped eight out of nine months, according to ShopperTrak RCT, provider of the National Retail Sales Estimate (NRSE) and ShopperTrak Retail Traffic Index. (The NRSE provides a nationwide benchmark of retail sales and is derived from U.S. Commerce Department data, as well as ShopperTrak's proprietary research on shopper traffic and sales statistics.)

From January to September 2007, foot traffic declined. March was the only month that saw positive growth due to the Easter holiday. This downward traffic trend represents the lengthiest period ShopperTrak has seen since the company began collecting traffic data nearly 10 years ago.

Bill Martin, co-founder of ShopperTrak, says a traffic decline eventually shows up in retail sales and warns that if the slowing traffic trend does not reverse, retail sales could decline in the first quarter of 2008.

While total U.S. foot traffic for the month of September decreased 4.9 percent as compared to the same month in 2006, NRSE showed retail sales increased 3.4 percent for the same period, highlighting the continued resiliency of the American consumer.

Annualized growth in real personal consumption expenditures, which includes spending on goods and services, increased three percent in the third quarter, compared with an increase of 1.4 percent in the second quarter, according to the U.S. Bureau of Economic Analysis. But, the pace of growth in real personal consumption is expected to slow to two percent over the next four quarters, with the weakest quarterly growth rate of about one percent at the turn of the year.

Even worse, consumers are losing confidence: the Conference Board Consumer Confidence Index, which has been declining since August 2007, fell further in October. The Index now stands at 95.6, down from 99.5 in September, which dropped six points from August. These declines are significant because the Index is now at a level not seen since November 2005 when consumers were traumatized by hurricanes and sharply higher gas prices.

Figure 3: Eight out of 10 retailer and developer respondents say they have leases with exclusivity agreements.

• *What percentage of your leases include exclusivity agreements?*

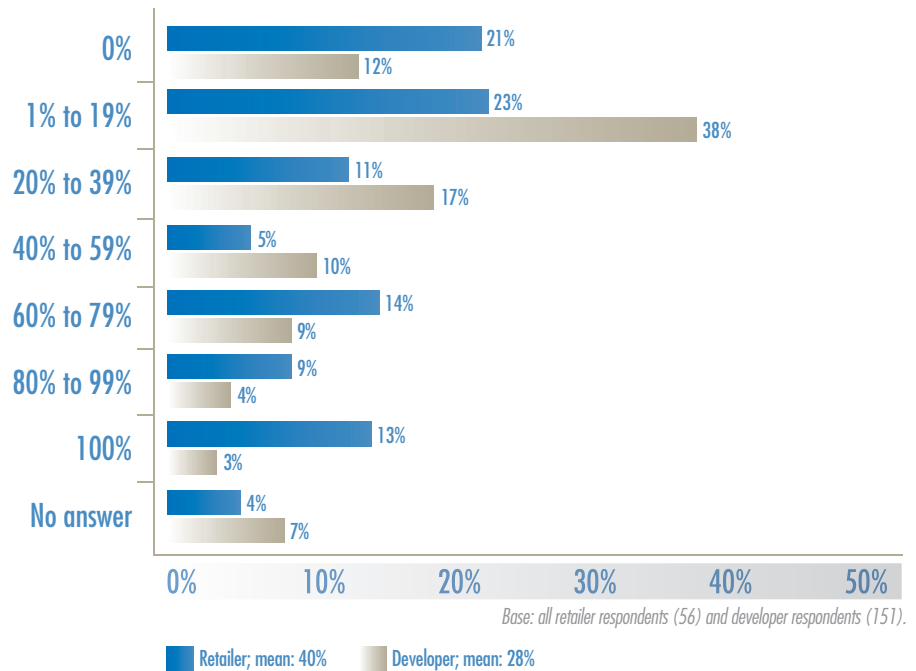
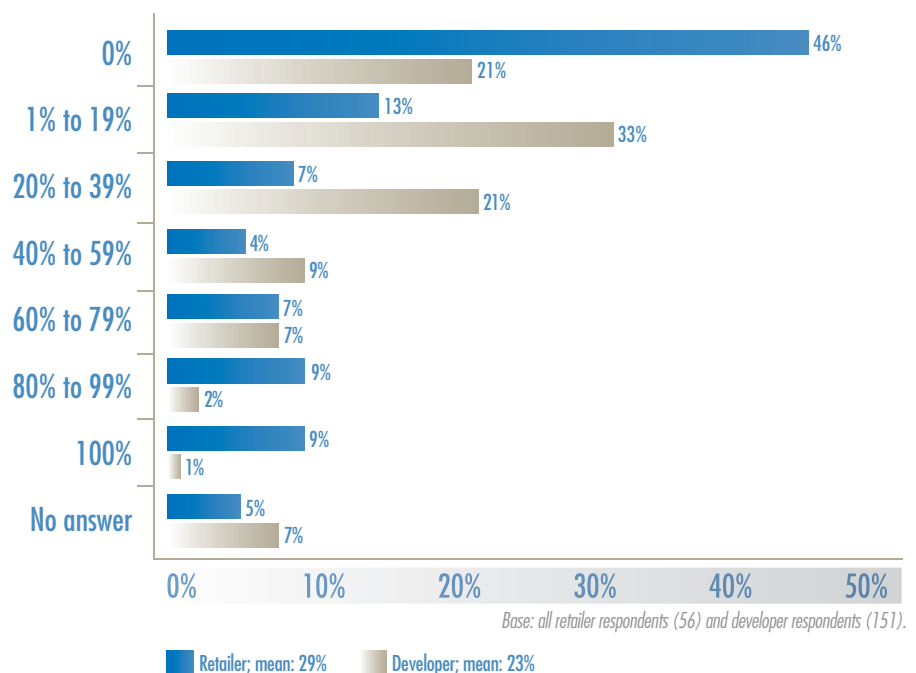


Figure 4: Three out of four developers issue leases with co-tenancy provisions, including early terminations, delayed openings and go-dark clauses.

• *What percentage of your leases include co-tenancy provisions?*



The Conference Board Index isn't the only harbinger of bad news, either. The Reuters/University of Michigan Index of Consumer Sentiment was 80.9 for October 2007, down from 83.4 in the August and September surveys, and significantly below the 93.6 recorded in October 2006.

While overall confidence levels are still well above the point that signals an impending recession, according to Richard Curtin, director of the Index, each downward step in confidence increases the probability of recession. All of the October loss was related to consumers' assessments of future economic prospects. They did not judge overall economic prospects favorably, either for the year ahead or over the next five years.

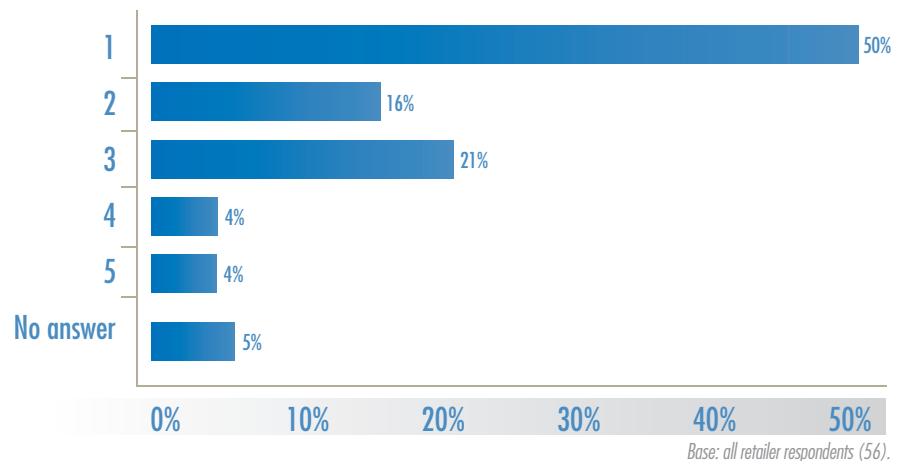
At the same time consumer confidence is waning, overall consumer net worth is rising – it increased 7.8 percent during the third quarter over the prior year, representing the strongest increase in the last four quarters. Growth in real disposable income continues to hold up and has been slightly better than 2006's 3.1 percent gain.

Nonetheless, industry experts are predicting a grim 2008 for retailers. Morgan Stanley's key retail analyst Gregory Melich cut his forecast from 4.5 percent to three percent for 2008, marking the slowest annual growth in retail sales since 2003. He contends that U.S. consumer spending will be restricted by declining home values, tighter credit standards and more modest job growth, and his forecast assumes average home prices will fall about six percent from where they are now, resulting in roughly \$100 billion less in total consumer spending.

"Retailers are really watching the economy and consumers very closely because they're concerned about holiday sales," notes Roger Burghdorf, senior vice president of growth and development for RCS Real Estate Advisors, a Santa Monica, Calif.-based consultant firm for retailers including Forever 21 and The Container Store. "But, all the retailers I am working with are in a very aggressive expansion mode and looking for good real estate."

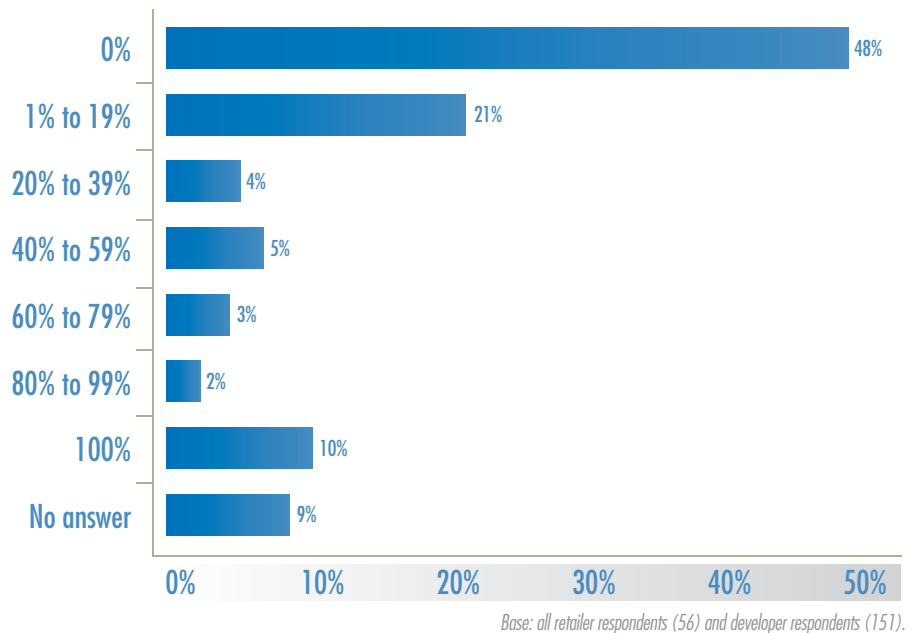
Figure 5: Fifty percent of retailers say terrorism insurance is not at all important.

- How important is it that the owner have terrorism insurance on the properties in which you're located?
1 = Not At All Important, 5 = Extremely Important



Nearly half of developers do not have terrorism insurance for their retail properties.

- For what percentage of properties do you have terrorism insurance?



DEMAND SOFTENS SLIGHTLY

By 2011, the country's leading retailers will open more than 94,000 new locations, or the equivalent of 53 locations a day for the next five years, according to Thomas Donato, director of research operations for Trade Dimensions.

Supercenters have the largest space requirements. Big boxes like Wal-Mart,

Target and Meijer will need between 48.7 and 111.9 million square feet over the next five years as supercenter chains plan to open 576 stores. Similarly, department stores including Kohl's and J.C. Penney will see almost 700 new units over the same time frame and will occupy between 40.8 and 87.4 million new square feet. All figures are based on Trade Dimensions re-

search and estimates, as published in the Retail Tenant Directory.

Despite Wal-Mart's decision to pull back on its expansion plans, the discount giant will add the most square feet over the next five years – roughly 67.5 million square feet in 568 stores. Lowe's, Kohl's, Walgreens and The Home Depot round out the top five list of retailers with the biggest expansion plans.

While the big box chains do plan to open a sizable portion of new locations, much of the growth comes from smaller, regional chains, particularly food-related operators. Denver-based Chipotle, for example, is on track to open about 100 new locations in fiscal year 2007. The chain, which serves giant burritos in a hip environment, has similar growth plans for 2008.

Apparel retailers and off-price outlet stores also have robust expansion plans, according to Trade Dimensions. Consider CHICO's FAS – the Fort Myers, Fla.-based apparel retailer plans to open 135 to 145 stores this year, followed by 105 to 115 stores in 2008 under three different brand concepts: Chico's, Soma and White House/Black Market.

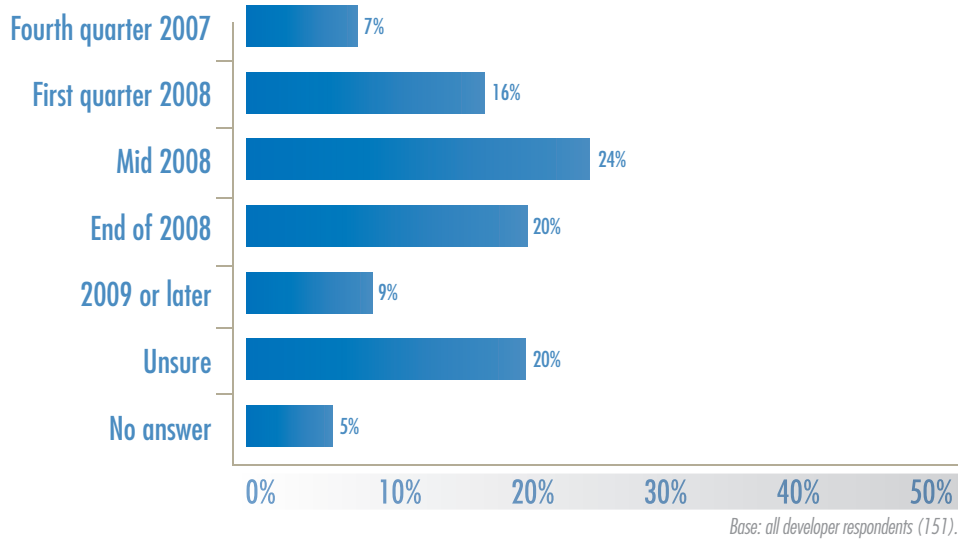
Similarly, Bradenton, Fla.-based Beall's Outlet Stores expects to open nearly 240 new locations by 2010, a move that would increase its store base of nearly 500 stores by 50 percent.

Service-oriented retail also is booming, or at least it is for Cartridge World, Palm Beach Tan and Fantastic Sams. All three chains are aggressively expanding. Cartridge World, for example, has developed 600 stores across the U.S. since 2003, according to vice president of real estate Bob Moglia. The chain, which refills and sells recycled printer cartridges, is actively working with a number of retail real estate owners from large companies like Centro Properties to REITs like Regency Centers Corp. This year, Cartridge World will open 200 stores and next year it hopes to exceed that number.

But, both retailers and developers are sensing a slight softening in demand, especially when it comes to iffy projects. "The slam-dunk properties are not having a problem with tenant interest," says Mike Jaffe, president of The Jaffe Companies,

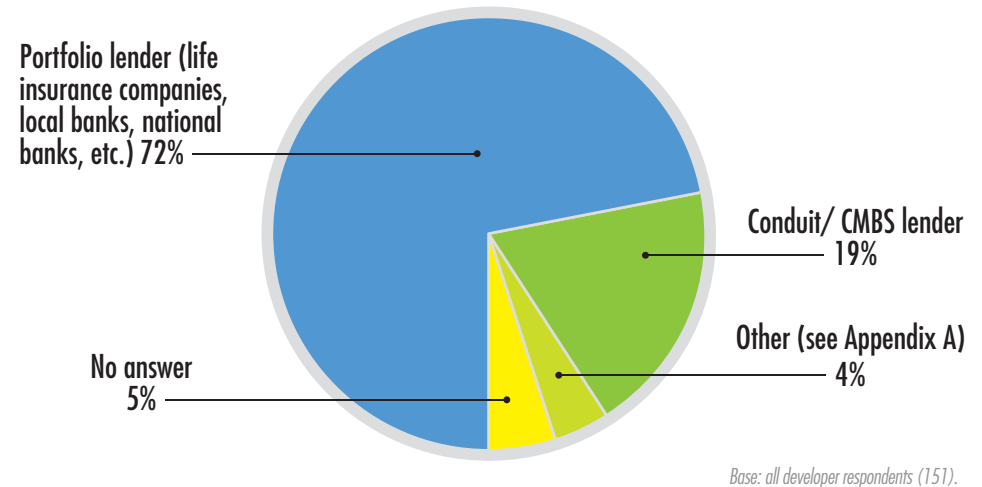
Figure 6: Most developers expect the CMBS market to calm down in 2008, although seven percent believe things will settle down by the end of 2007.

• *When do you expect the turmoil in the CMBS market will begin to subside?*



With the current upheaval in the CMBS market, more than seven out of 10 developers prefer to obtain debt financing from a portfolio lender.

• *Given today's lending environment, from which funding source would you prefer to obtain debt financing?*



a Northbrook, Ill.-based firm that is developing a 600,000-square-foot, open-air project in suburban Chicago. "But, tenants are pulling their horns in on the projects they can live without – the projects that are sponsored by marginal developers or those in second and third tier markets."

Fortunately, retailers consider Jaffe's Arboretum of South Barrington a qual-

ity center – it's scheduled to open in 2008 and already is more than 70 percent leased with rental rates in the mid to high-\$20 range. Chico's, White House/Black Market, Aveda, DSW and Panera Bread have committed to space there.

"Well designed and well located developments are fine, but I think there is a slowdown because we're not seeing the

same leasing velocity that we did two years ago," says G. Peter Jacob, president of Weaver Davis & Jacob Realty Group, a Houston-based firm that develops unanchored retail centers.

In fact, the vacancy rate for neighborhood and community shopping centers increased by 10 basis points to 7.4 percent during the third quarter 2007, according to REIS Inc., a New York City-based research firm. This increase marks the 10th consecutive quarter of flat or deteriorating retail occupancy at the national level, and the vacancy rate is predicted to increase to 7.5 percent by the end of the fourth quarter – its highest level since 1996.

The slowdown is obvious to Cartridge World's Moglia, who says the brokerage community has started to pursue his chain more aggressively over the past 30 days. "In the past, there were times when we were interested in specific locations and we never received a call back from the broker," he recalls. "Today, brokers are not only calling back, but they're cold calling us to see what kind of expansion plans we have. That's a sign that business is turning."

Specifically, Moglia points to a small community near the Bay Area in Northern California where the vacancy rate had been almost zero. "We're seeing some businesses close. Tenants are defaulting on their leases so there are opportunities that weren't there for us even a few months ago," he says.

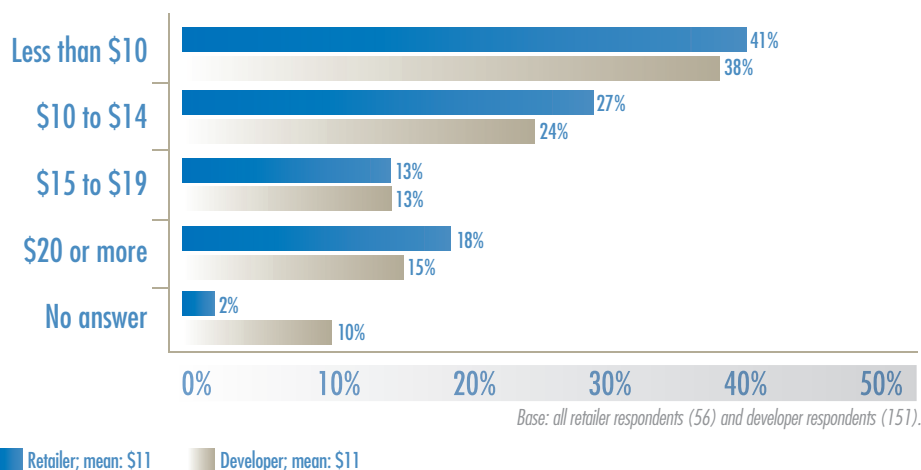
NOT QUITE OVERBUILT

Given the number of new projects that are either under construction or have opened recently, retailers have plenty of choices and can afford to be picky, says Gar Herring, president of The MG Herring Group, a Dallas-based developer with several retail projects under construction throughout North Texas. Its biggest project, dubbed the Villages at Fairview and Allen, is a mixed-use town center with retail, hotel and office uses situated around an events venue.

"Because of the amount of competition in the market, retailers are in the driver's seat," Herring says. "When you have developers competing in the same trade areas,

Figure 7: The average amount of tenant improvement dollars offered is \$11 per square foot, although more than 30 percent of retailers say they receive more than \$15 per square foot.

- On average, how many tenant improvement dollars do you receive per square foot?
- On average, how many tenant improvement dollars do you offer to big box tenants on a per square foot basis? (Asked of both retailers and developers)



tenants can pick and choose and are making incredible demands." He says it's not unusual to hear a retailer say that it plans to open 100 stores but has 500 projects from which to choose.

Total retail square footage under construction has been steadily on the rise over the past seven quarters, while the pre-leased rate of these retail projects under construction is down slightly, according to CoStar. At the end of the third quarter, 221 million square feet of retail space was under construction, an increase of 4.2 percent, or 8.9 million square feet, over the second quarter 2007.

Compared to third quarter 2006, the current level of construction has increased a whopping 44 percent, or 67.3 million square feet, and an increase of 79 percent, or 97.6 million square feet, over first quarter 2006, according to CoStar. Dallas-Fort Worth, Southern California's Inland Empire, Phoenix, San Antonio and Chicago rank as the top five markets for new construction.

Roughly 61.3 percent of the new construction was pre-leased at the end of the third quarter, slightly lower than the rate at the end of the first quarter. To put this in

perspective, Orange County has the highest pre-leased rate at 84.7 percent.

During third quarter, 33 million square feet of retail space broke ground while 24 million square feet of retail space was completed. Both of these figures are the lowest quarterly amounts recorded since CoStar started publishing the data in first quarter 2006. Third quarter retail construction starts were down 4.8 million square feet, or 12.6 percent, over the same time last year.

But, completions of neighborhood and community shopping centers are projected to rise significantly in the fourth quarter 2007. During the third quarter, developers finished and delivered 6.2 million square feet of new retail space to the market, which outpaced net absorption of 4.5 million square feet, according to REIS.

Industry experts stop short of describing the current level of retail construction as overbuilding, but it's clear that many feel there are a fair number of retail projects in development that should have never made their way out of the ground.

"Every developer feels they have the prettiest baby, but it seems that there are major projects being built in every town with

more than 10,000 people,” Herring notes. “It definitely makes you curious if some of the developments are really warranted.”

With vacancy rates on the rise, developers should be taking steps to ensure they’re making good long-term tenant decisions, says Trade Dimensions’ Donato. “If you’re thinking a supermarket anchor is the way to go for your neighborhood center, then do your research on the competition,” he suggests. “If there are already 25 supermarkets in a 10-mile radius of your property and half of them are underperforming stores, saturation may be an issue. It may be time to think about your second choice.”

DRIVING A TOUGH BARGAIN

The abundance of retail space is one of the reasons why rental rates are decreasing and concessions are increasing. “Smart retailers are driving a tougher bargain than they were last year,” says Mark Schurgin, president of Festival Development Inc., a Los Angeles-based company that owns and manages a portfolio of 13 million square feet of retail space.

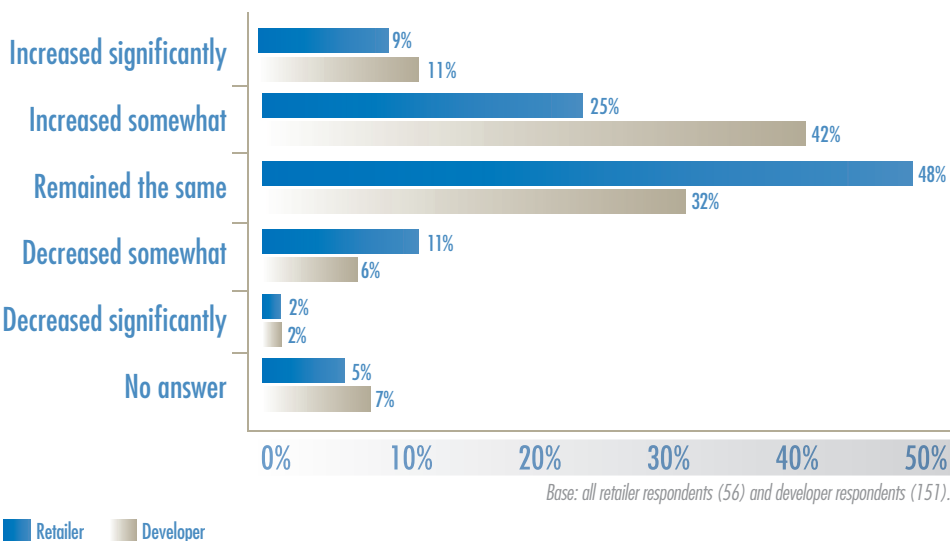
Schurgin expects concessions and Tenant Improvement Dollars will increase in 2008. “I wish they wouldn’t, but they will,” he laments, adding that retailers are going to be able to pit developers and owners against each other to get the best terms. “I can’t say it’s totally a tenants’ market, but it’s more of one now than it was last year and it will become more of one next year.”

In fact, REIS reports that non-anchor rent growth for the third quarter slowed for the fourth consecutive period to just 0.6 percent. At \$19.32 per square foot, the national average asking rent is 3.3 percent higher than a year ago. For 2007 overall, the research firm projects rents to rise by 3.1 percent.

The third quarter was the 13th consecutive quarter that concession levels, which have grown to a record-high of 9.5 percent of the current asking rent, have resisted narrowing, REIS says. *Retail Traffic* and PlainVanillaShell’s survey supports REIS’ data – the survey found that half of retailer respondents received concessions for leases signed in 2007. Moreover, almost 10

Figure 8: More than half of developers say they’ve increased their tenant improvement budgets and are offering more tenant improvement dollars today than they did two years ago.

• How has the amount of tenant improvement dollars you receive changed in the past two years?



percent of respondents say they received concessions for every lease they signed.

Today, retailers expect to receive more TI dollars today than they did in the past, says Casto’s Hutchens. “Given the popularity of lifestyle projects and how hard we have to fight to get tenants, TIs have increased from \$50 per square foot two years ago to \$110 per square foot,” he notes.

Survey participants say the average amount of TI dollars offered is \$11 per square foot. However, it’s worth noting that more than 30 percent of retailers report their TI allowances exceed \$15 per square foot. (see figure 7, page 6)

More than half of developers say they’ve increased their TI allowances over the past two years. Only eight percent report they’ve decreased their TI allowances during the same time frame. (see figure 8, page 7)

And, developers and owners aren’t only on the hook for concessions and TI dollars – retailers are increasingly demanding exclusivity agreements and co-tenancy provisions, according to the *Retail Traffic* and PlainVanillaShell survey.

Exclusivity is a critical point of every lease

negotiation for Palm Beach Tan, a Dallas-based chain with more than 200 locations. “We always go for exclusivity and out of all the locations we’ve opened, fewer than five don’t have exclusivity [clauses],” says Steve Berkman, vice president of franchise services for Palm Beach Tan, adding that he would not lease space in a center that didn’t offer exclusivity unless it had some kind of “wow factor” with co-tenancy.

Jaffe says it’s getting to the point where it’s hard to find a center that isn’t tied up with co-tenancy and exclusivity provisions. Even worse, some retailers are putting additional limitations on developers and owners – demanding ways out of the deal if the center doesn’t lease up by a certain date or if the co-tenants don’t open at a specific time.

“Retailers are really digging their heels in and getting more strident in their demands,” Jaffe notes, adding that it takes more time and energy to work through these issues than ever before. “It takes a lot to stand toe to toe with retailers today and say no to exclusivity and co-tenancy. Most of the landlords are rolling over on this stuff.”

The MG Herring Group is one owner

that isn't rolling over when it comes to exclusives. "We have a 'give none, get none' policy at our newest project," Herring says. "We're not giving exclusives to any retailers, and they're not going to get exclusives. We've turned down deals because of it."

Herring says his firm just didn't want to deal with exclusives. "They can be so onerous and complex, and if you can stick with 'give none, get none' it's easier for everyone - the tenants, the developer and especially the lender," he contends. However, the retailers make sure that MG Herring can't violate their agreement by adding penalties to their lease.

But, MG Herring accedes to retailers' co-tenancy requirements. "Owners kick and scream and fight against co-tenancy, but there is some sort of silver lining," Herring says, explaining that co-tenancy agreements make leasing and financing more difficult, but they also protect the developers and owners who can make the co-tenancy work. "It keeps competition at bay."

Herring and other industry experts don't expect retailers to ease up on their exclusivity and co-tenancy requirements. Even developers and owners with signed leases may find their centers in jeopardy. "A lot of retailers still have contingencies on the leases they've signed and they may have the ability to push openings out or never open at all," says Festival's Schurgin.

Experts don't expect the leasing environment to become more favorable to developers and owners, especially if the economy softens even more. They acknowledge there is a danger that retailers will severely curtail their expansion. If that happens, a lot of retail projects will have trouble finding tenants and could even fall into financial difficulties.

"I think retailers are going to become pickier and pickier about their locations and take fewer chances on the risky projects," Herring says. ■

OCCUPANCY COSTS GROW

Retailers may be demanding more and more from developers and owners, but they're suffering too as their occupancy costs increase.

A survey conducted by *Retail Traffic* and PlainVanillaShell found that 90 percent of retailers report occupancy costs have increased over the past two years. The average occupancy cost for retailers is 10 percent of sales, and retailer respondents estimate occupancy costs have jumped an average of seven percent. Respondents point to the rising costs of construction, utilities and insurance as reasons for the increase, as well as higher common area maintenance (CAM) charges.

The survey also found that 50 percent of retailer respondents say their occupancy costs exceed 10 percent of sales. One in 10 retailers report their occupancy costs have risen above 15 percent of sales. (see chart)

Steve Berkman, vice president of franchise services for Palm Beach Tan, estimates the chain's occupancy costs have jumped 30 percent over the past five years. "Previously, we were paying \$20 per square foot, this year we're at \$26 to \$28 per square foot in those same markets," he says. From his perspective, the good news

is occupancy costs aren't growing at the same rapid pace that they were.

Experts say occupancy costs are increasing because owners are passing along their increased operating expenses to their tenants. For example, Dallas-based developer and owner MG Herring Group has seen its property taxes and insurance costs increase substantially, but has found that many retailers are balking at absorbing those expenses.

"Tenants are increasingly trying to cap their occupancy costs by doing gross leases or by capping the expenses or the annual increases in the expenses," explains Gar Herring, president of the MG Herring Group. "Not all developers are willing to accept such terms but retailers are getting stubborn."

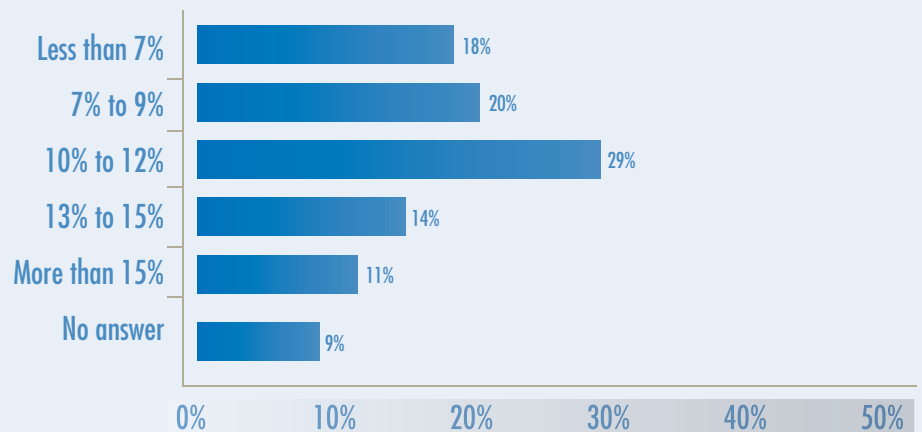
Jeff Sturgis, vice president of development for Fantastic Sams, says rents have also been rising at the same time owners are passing along operating expenses. This year, the hair salon chain plans to open about 90 locations and is shooting for 100 openings in 2008.

"That's put a lot of pressure on retailers, and that's why we're fighting as hard as we can to get reasonable terms," Sturgis says.

Occupancy Costs

Fifty percent of retailers say their occupancy costs exceed 10 percent of sales. One in 10 retailers indicates their occupancy costs have risen above 15 percent of sales.

• *What is your occupancy cost as a percentage of sales?*



Base: all retailer respondents (56).

PlainVanillaShell.com, a product of Trade Dimensions, is an information hub for the retail and development industry. The site features continually-updated news, hand-selected for relevance and value to its members. The site even provides a venue for members of the community to make deals - or simply make contacts - on its Marketplace page. Perhaps most importantly, PlainVanillaShell.com offers online access to the invaluable data in The Retail Tenant Directory (RTD). For over 30 years, brokers, leasing agents, suppliers and innumerable others have depended on the detailed and painstakingly-accurate data that makes up the RTD. Visit the industry's leading online community: PlainVanillaShell.com.