

Robust consumer spending prior to the recession brought on a significant expansion of retail space in the Southeast. Absorbing the postrecession surplus development into the marketplace remains a challenge.



tattered awning flapping in a spring breeze is the only sound at a shopping complex just north of Atlanta. Abandoned CompUSA and Marshalls stores stand surrounded by acres of cracking, empty asphalt. At an intersection two miles away, a strip shopping center once anchored by a Publix supermarket is more than half empty. A sign in the window of a baby products store welcomes shoppers on public assistance. At a larger retail complex across the street, a cavernous empty space squats at one end.

These shopping complexes are hollow shells despite plenty of bustle around them. About a mile away from those vacant centers, 7,500 cars fly past every hour, on average, on the Georgia 400 expressway. The surrounding Roswell-Alpharetta area is home to roughly a quarter million people, with a median annual household income of more than \$90,000, far higher than Fulton County's five other census subdivisions, according to the U.S. Census Bureau.

A picture repeated all over

This slice of north metro Atlanta mirrors a nationwide retail real estate slump brought on by a mixture of economic and demographic factors. Some of these factors are straightforward: recession and slow income growth lowered consumer spending, forcing many stores out of business after a development boom had added vast supplies of new retail space. Fueled by abundant financing, development was particularly intense and vacancy rates high in certain Southeast markets such as Atlanta, Nashville, and Birmingham, according to statistics from F.W. Dodge Pipeline, which tracks commercial real estate development.

Other factors are more subtle. Shopping patterns are fluid in high-growth areas such as Atlanta's north Fulton County. A decade ago, for instance, the intersection in Roswell, Ga., vacated by Publix was a regional retail nexus, said Ruth Coan, principal with The Shopping Center Group, a real estate services firm with 23 offices across the Southeast. However, along with high-end residential development, north Fulton's shopping hub has migrated several miles up Georgia 400 to the Northpoint Mall area. Consumer tastes have also shifted away from traditional enclosed malls and neighborhood strip centers and toward lifestyle centers designed to resemble traditional downtowns.

At the root of the retail space glut, though, is a fundamental imbalance of supply and demand, experts said. During the past couple of decades, the nation's retail space per capita has more than doubled, according to the International Council of Shopping Centers and the National Research Bureau. In three years, 2007 through 2009, developers across the country added nearly 700 million square feet of retail space, according to F.W. Dodge.

"We built an awful lot of retail space in the past three years, and now half of it is unleased," said K.C. Conway, subject matter expert in the Atlanta Fed's Center for Real Estate Analytics. In that recent period, metro Atlanta added 20.9 million square feet of shopping space, roughly equivalent to about 17 super-regional malls. Only Phoenix and Chicago added more retail real estate during the past three years. In 2009, developers finished more retail space in Atlanta than in any other metro area in the country, according to F.W. Dodge.

As the supply of space has mushroomed, Atlanta's retail vacancy rate has risen each year since 2004. It reached 15.5 percent

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in the fourth quarter of 2009, according to data compiled by the Atlanta Fed's Center for Real Estate Analytics. (Another measure, by the real estate firm CB Richard Ellis, put the vacancy rate as high as 25 percent at the end of 2009.) Likewise, store spaces are emptying across the Southeast. In the fourth quarter of 2009, 26 of the region's 28 largest markets saw retail vacancy rates climb from the year before, REIS Inc., a New York-based real estate research firm, reported.

It's happening here, there, and everywhere

The Southeast's high vacancy rates aren't unique. Nationwide, vacancies at the larger malls reached a record high in the fourth quarter of 2009, while neighborhood and community shopping centers were their emptiest since 1991, according to REIS. Atlanta



and Los Angeles at the end of 2009 had more excess retail space than any other U.S. market, reported the CoStar Group, another commercial real estate information service.

"New space is cannibalizing older space," said Julian Diaz, professor and chair of the Real Estate Department at Georgia State University's J. Mack Robinson College of Business in Atlanta. Explaining the highly visible problem of vacant retail space is more complicated than simply saying developers built too much space and then recession hit. For example, Coan said, changing traffic and shopping patterns helped the Roswell, Ga., strip center vacated by Publix devolve from a choice retail location a decade ago into a property with traffic, access, and visibility problems.

That sort of change is not unusual. Major retail real estate development is a fluid business. Retail chains and their landlords do not view a lease agreement as a lifetime arrangement. Major anchor tenants typically sign a 10-year lease when they move into a center, according to Coan and other real estate experts. Arthur C. Nelson, a well-known urban planner and director of the University of Utah's Metropolitan Research Center, has calculated that the average life span of a retail structure in the United States is only about 25 years, as opposed to more than 150 years for a home and 60 years for office buildings.

Changing consumer preferences have also affected development as developers in recent years have built few, if any, enclosed malls. According to various news reports, no indoor mall has opened in the United States since 2006, after about 140 opened every year on average in the mid-1990s.



As retailers settle into the new centers, they leave behind empty spaces. Malls, meanwhile, are falling victim to impatience. A major reason enclosed malls have fallen out of fashion is that hurried shoppers don't want to walk too far, said Harold Hunt, a research economist in Texas A&M University's Real Estate Center. Rather than browsing, today's "more driven, purposeful shopper" wants to park near the destination to save time, Hunt said, adding that developers have turned increasingly to U-shaped centers, where shoppers can park in the middle and walk a similar distance to most stores. His research focuses on retail centers in Texas. Nevertheless, he figures that the state's intense heat, similar to the summer weather in much of the Southeast, will keep existing indoor malls around for many years to come.

Sizzling summertime temperatures didn't save Palm Beach Mall. The South Florida retail center that opened in 1968 as the largest enclosed mall in the Southeast closed in February. Similarly steamy Orlando's oldest mall has also fallen victim to recession and fickle shoppers. Opened in 1973, Orlando Fashion Square early this year had about 40 empty storefronts out of about 130, according to the Orlando Sentinel.

Developers develop, property owners adjust

As property owners' plans shift in response to changing consumer behavior, this change of plans can, in some cases, lead to intentional retail vacancies. A couple of largely vacant retail centers near the 25-year-old Gwinnett Place Mall outside Atlanta, for

instance, are empty primarily because the owners are considering a major redevelopment with different types of tenants and thus have structured leases to essentially clear out the space, Coan said. "There are different motivations creating vacancies in different space," she said. "And some of it is just overbuilding."

Recession can also force retail property owners to agree to enter into less conventional arrangements with their tenants. Under a co-tenancy agreement, for example, if a new anchor or set of tenants does not move into a center as planned, or if they leave a center, then the rest of the tenants are free to leave or get concessions such as lower rent. As many major retailers are closing stores and scaling back expansion plans, these clauses are kicking in more often, Conway said. "It devastates cash flow in a retail property and is unique to retail," he said. "Other commercial real estate does not have this feature in their leases."

Co-tenancy deals become problematic for landlords because there is more space than the market demands. Why does that sort of surplus happen? Classroom theory holds that developers are like any other entrepreneurs: they see an unmet need and they fill it, Georgia State University's Diaz said. In practice, though, that's not always the case. "What developers actually respond to is supply of money," Diaz said. "As long as a developer has money, they are going to develop. That's their business."

Until the recession's full force hit in 2008, money was plentiful. Among Georgia-based commercial banks, for example, commercial real estate loans—including retail and other types of properties—climbed from \$8.5 billion in 1999 to a peak of

Retail Property Owners, Lenders Face Refi Crunch

Commercial real estate owners and their lenders face an approaching wave of commercial loan refinancings at a time when retail properties have been losing value.

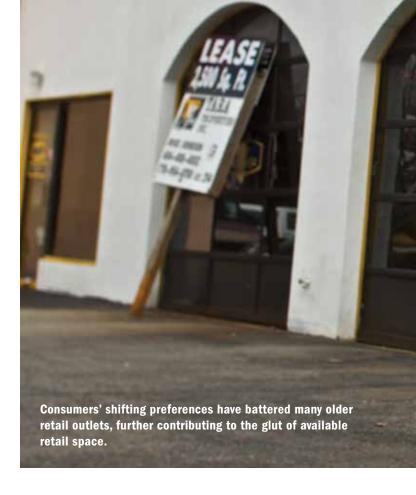
Commercial real estate (CRE) loans made during the past decade across the United States totaling \$1.4 trillion will require refinancing in 2011 through 2014, according to a February report from the Congressional Oversight Panel on the Troubled Asset Relief Program (TARP). Those loans include money to finance retail properties along with office space, industrial buildings, hotels and apartments. The concern: Nearly half of the loans are underwater, according to the report, meaning the borrower owes more on the loan than the underlying property is worth, making it hard for a lender to justify a new loan.

Commercial property values in general have fallen more than 40 percent since the beginning of 2007, according to the Congressional Oversight Panel's report. At the same time, retail rents have declined 33 percent, depressing the value of retail properties.

Many CRE loans have three- to 10-year terms that will soon expire. They require refinancing because the monthly loan payments are not designed to repay the loan during the original term. Thus, at the end of the term, the entire balance of the loan comes due, meaning the borrower must take out a new loan to finance continued ownership of the asset. If not, the lender can move to foreclose on the property.

The report says "a wave of commercial real estate loan losses over the next four years could jeopardize the stability of many banks, particularly community banks." Community banks hold a large share of CRE loans relative to their size. At the end of 2009, the 1,026 commercial banks based in the Southeast with assets less than \$1 billion carried \$56 billion in CRE loans, according to FDIC data.

As K.C. Conway of the Atlanta Fed's Center for Real Estate Analytics pointed out, it is difficult to refinance a loan on a retail center with large vacancies because the owner's cash flow is low. This concern is widespread, Conway said, because half of the roughly 700 million square feet of retail space built in the nation from 2007 through 2009 is vacant.



\$35.2 billion in 2008, according to the Federal Deposit Insurance Corporation (FDIC).

Simple timing also complicates the dynamic that leads to an oversupply of retail space. There is, of course, a lag between the planning of a retail center and its opening. "Developers nevertheless make decisions based on projections weighted heavily toward recent sales and rental trends," says a FDIC report on commercial real estate. "If the market in question is experiencing unsustainable growth (a 'boom' period for example), then such projections are likely to lead to an overly optimistic outlook for future demand."

Diaz described a "spiral" that in his view operates outside the bounds of a natural real estate business cycle. It works like this: a region like metro Atlanta experiences huge population growth, creating a clear need for shopping centers. Developers rush in to fill the demand, with abundant financing at their disposal. Because the new space does not open for a few years, demand for retail space intensifies, driving up rental rates and spurring still more development, ultimately leading to an excess of space relative to the original demand, Diaz said. Eventually, as new space opens, it takes tenants away from older retail centers.

Banks' woes put the brakes on development

Capital for commercial real estate development, including retail, has become scarcer in the wake of widespread real estate-related problems at Southeastern banks (see the sidebar). Federal Reserve lender surveys in late 2009 found that large numbers of banks



had tightened their standards on commercial real estate lending. The Shopping Center Group's Coan said she has seen even solid retail projects stalled recently because developers could not secure financing.

It appears that many retail projects have been shelved. The volume of retail development that has been abandoned or deferred over the previous four quarters is a telling barometer. As of the end of 2009, according to data compiled by F.W. Dodge, those numbers were substantial in many Southeastern markets: 17 million square feet in metro Atlanta, 6.8 million square feet in Birmingham, 5.3 million square feet in Miami, 6.3 million square feet in Nashville, and 5.6 million square feet in Tampa. Nationwide, F.W. Dodge reported that 68 million square feet of retail space was under construction in January, a sharp reduction from the 166.2 million square feet completed in 2009 and the nearly 700 million square feet built in the past three years. For industry watchers, that reduction is good news. The last thing an overbuilt market needs is more supply.

In another positive sign for retailing, consumer spending has been inching upward again after a plunge, rising in March for a sixth straight month, according to the U.S. Department of Commerce. And the U.S. Department of Labor reported in May that the nation added 290,000 jobs in April, the biggest monthly gain in four years. According to the Atlanta Fed's Regional Economic Information Network, the employment situation in the Southeast in March 2010 continued to improve on a year-overyear basis as the rate of job losses slowed. On the downside,

however, business bankruptcies-which many analysts consider a leading indicator for retail real estate—continued climbing early in 2010 in the Southeast's biggest markets.

A healthier economy, of course, will be the strongest tonic for retail real estate. For now, plenty of empty stores remain, unsightly and disheartening reminders of recession and overbuilding. And while signs of improvement are emerging, the forlorn parking lots and hollow retail shells appear likely to be with us for some time. \blacksquare

This article was written by Charles Davidson, a staff writer for EconSouth.