BEYOND THE GLOBAL HEALTH CRISIS

Marcus & Millichap

SPECIAL REPORT RETAIL & NET LEASE SUMMER 2020

Discretionary and Experiential Retail Face Seismic Shift, But Transformation Has Already Begun

Store reopenings brighten retail center outlook. As shelter-in-place orders abate across the nation, more retailers are opening their doors. Segments hit hard by sequestration including apparel, home goods and sit-down restaurants all posted an increase in foot traffic since the beginning of April. Customer volume at outperforming sectors — including grocers, dollar and drugstores, and mass merchandisers — have returned to more normal levels. Businesses with an omnichannel presence also fared better as shelter-in-place households conducted a greater portion of their shopping online, boosting e-commerce sales. Many households placed orders online and picked up at local stores. After the coronavirus threat eases, this trend will likely stay and may require a redesign of parking lots and center layouts to facilitate pickup capacity.

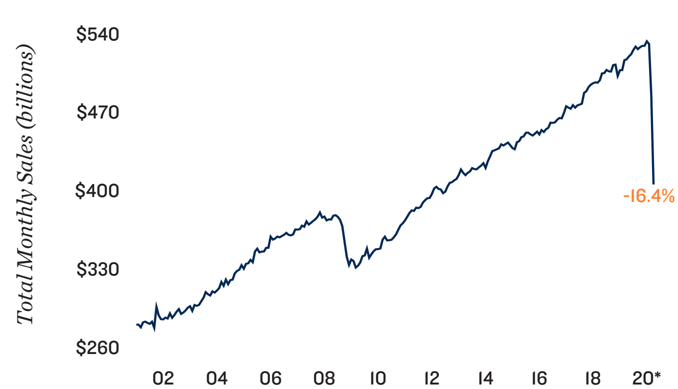
New regulations more difficult for some retail sectors. As states begin to open nonessential stores, retailers in some segments will have a harder time adapting to new regulations. Experiential businesses, in particular, will face the difficult task of recalibrating to comply with social distancing and increased sanitation. Already a variety of stores, including the buffet-style Souplantation and Sweet Tomatoes restaurants, have announced they will not be reopening due to difficulties adhering to the changing reality. Several other retailers that had financial difficulty before sequestration have filed for bankruptcy protection in recent weeks and face an uncertain future. As more companies reassess their position in the marketplace, additional store closures are expected. Although an increasing number of storefronts have darkened, some leases are still in place, creating a widening gap between physical and economic occupancy.

Owners can take proactive stance to preserve assets' value. Shopping center performance this year will be highly dependent on tenant mix. Operators are most likely to receive rent payments from necessity-based tenants, many of which have prospered during sequestration. It may be in the owners' best interest, however, to help quality tenants who were in good standing before the pandemic come through this difficult economic situation rather than having to retenant under less-conducive market conditions next year.

Changing Retail Landscape

- More households ordering online will continue to boost retailers with an omnichannel presence. Brick-and-mortar will benefit from an increase in curbside pickup services. Some operators are establishing an online site for the centers with a designated pickup spot for all tenants.
- Enhanced safety and sanitation standards will be needed to entice people back into stores. The increased cost for signage and supplies amid shorter store hours and limiting customers for social distancing weigh on margins.
- It may be in the best interest of many retail center owners to assist valued tenants through the short-term hardship in ways that are beneficial to both parties. A number of retailers will not survive these economic disruptions, resulting in higher vacancy rates. Quality tenants may be more difficult to find a year from now.
- Retailers still in position to expand will take advantage of rising vacancy to lease higher-quality locations.

Monthly Retail Sales Plunge



* Through April

Retail Outlook for 2020 Depends on Duration of Economic Downturn And Pace of Future Recovery; Health Crisis Resolution Critical Component

Shorter — Economic Downturn — *Longer*

Stronger — Economic Recovery — *Weaker*

Short Downturn/Strong Recovery

- V-shaped economic recovery
- Retailers fully open by summer, some bankruptcies
- Pent-up demand brings customers back
- Supply-chain disruptions ease, inventory recovers quickly
- Minimal disruption to construction pipeline
- Investors resume activity after pause

Extended Downturn/Strong Recovery

- Extended U-shaped economic recovery
- Online sales and curbside pickup increase
- Many local retailers close, raising in-line vacancy
- Strongest retailers expand into premium locations
- Construction pipeline thins
- Investors scrutinize tenant mix

Short Downturn/Weak Recovery

- ✓-shaped economic recovery
- Malls, stores and restaurants open in stages
- Consumer spending slow to gain traction
- Retailer bankruptcies push vacancy higher
- Construction delays, planned projects reevaluated
- Investors focus on centers with essential retailers

Extended Downturn/Weak Recovery

- L-shaped economic recovery
- Essential and discount retailers outperform
- Reduced retail spending results in more defaults
- Sizable rise in vacancy, decline in rent
- Many stores transition emphasis to online fulfillment
- Opportunistic buyers increasingly active

Short Downturn/Strong Recovery

Rapid economic recovery brings customers back to brick-and mortar. If stay-at-home orders quickly abate and retailers open their doors by summer, the sector will still face a disruption as a variety of retailers go dark. Housebound residents will want to get out and enjoy the summer with family and friends, boosting sales at restaurants, garden centers and experiential retailers. People heading back to the office will boost spending at apparel providers. Some stores and shopping centers that were struggling before the economic downturn will shutter, however, as could a number of small local retailers, moving vacancy up nominally.

Short Downturn/Weak Recovery

A short downturn amid a slow expansion delivers increased closures. Under this scenario essential retailers and discount stores outperform as consumers closely manage expenses. The slowed growth cycle will weigh on hiring, reducing disposable household income and slowing retail sales. More nonessential and experiential retailers will not be able to survive the downturn into 2021, increasing in-line vacancy. Inventory additions will decline as some projects are delayed and others reevaluated. Investors will focus on properties with credit-worthy tenants.

Extended Downturn/Strong Recovery

Tenant mix gains in priority. If the duration of nonessential store closures extends into the fourth quarter, a second round of stimulus will be necessary to prevent a large number of retailers from going out of business. Many local stores will not be able to hold on through the prolonged downturn, increasing in-line vacancy. The rising supply of available storefronts will allow surviving retailers with the means to expand to move into premium locations. Tenant mix will become even more important to an growing number of opportunistic buyers.

Extended Downturn/Weak Recovery

Essential retailers fare best amid a slow recovery and prolonged downturn. An extended lockdown period will have a dramatic affect on the retail sector. Elevated unemployment will keep budgets tight and slow spending into the holiday buying season, causing a major disruption to many in-line retailers. Shopping will be largely confined to businesses deemed essential and those with an online presence. Online sales will result in more retailers using closed locations for expanded pickup and delivery services. Additional tenants that cannot open stores will stop paying rent, resulting in significant distress.

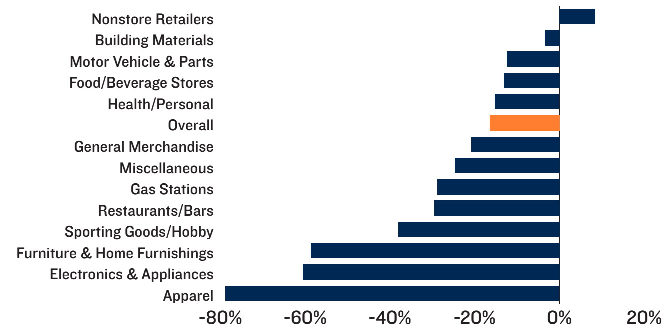
Establishments Open to a Changed Economy and Retail Climate

Businesses will need to lure customers back. As stay-at-home orders abate in more areas of the nation, nonessential retailers and dining places are in the process of reopening. New sanitation standards and social distancing protocols will need be enacted by retailers to make shoppers feel safe enough to venture into their facilities. Employees donning masks and gloves will become more common and store layouts may need to be changed to promote one-way flow. Hours of operation may also be adjusted to accommodate lower customer volumes. Center owners may need to increase budgeting for sanitation and maintenance. The higher operating costs amid less throughput, however, will equate to lower margins for many retailers and some will opt not to open.

Stores reopen to vastly different buying atmosphere. Nonessential businesses are reopening to a much different economic outlook since being temporarily shuttered in March. Nearly 40 million people filed first-time unemployment claims in the first nine weeks of the pandemic and many of the employed are working from home instead of commuting into offices. These factors will likely change spending patterns in the near term as those without jobs reduce discretionary consumption. In addition, some retail segments including apparel may need to change their inventory offerings to align with working from home. The opening of retailers in office buildings, near transit hubs or entertainment venues may be delayed until foot traffic in these areas picks up. Changing regulations are also impacting retailers differently. Eliminating the shared use of utensils has grocery stores packaging bulk items and closing buffet offerings. Some buffet-style restaurants are converting to cafeteria-style and others such as Sweet Tomatoes have opted to close.

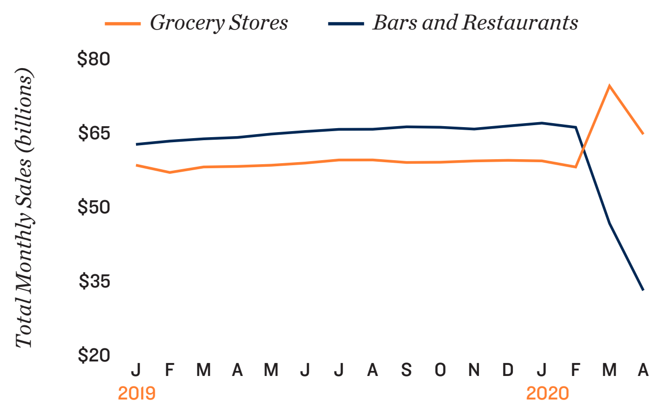
Structural change to retail world as e-commerce momentum accelerates. Shelter-in-place restrictions fueled Internet shopping as more people who were once reluctant to place orders online found it more convenient or safer than visiting local stores, boosting retailers with an omnichannel presence. The surge in ordering overwhelmed just-in-time supply chains and delivery capacity, requiring Amazon and Walmart to each hire more than 100,000 workers. The convenience of online ordering also contributed to more people using pickup services at local retailers. Grocers in particular benefited as many firms already had this service in place with a varying degree of success. Other retailers such as Best Buy have been able to keep stores open for pickup-only service. As the recovery expands these trends are likely to remain, which may require adjustments to store and shopping center layouts to accommodate smoother pickup capability.

Retail Sales Drop in Most Sectors

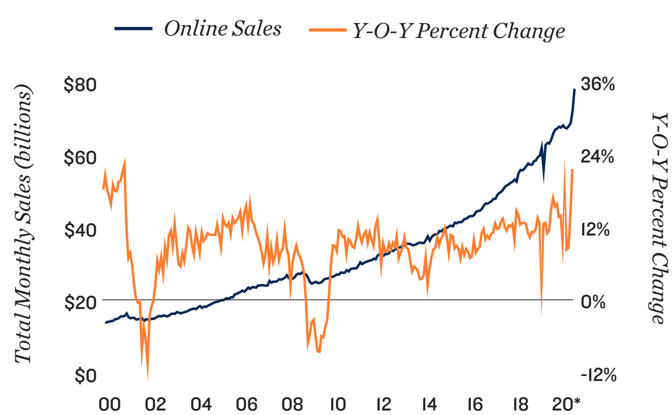


March-April Percent Change

After Surge, Grocery Sales Dip

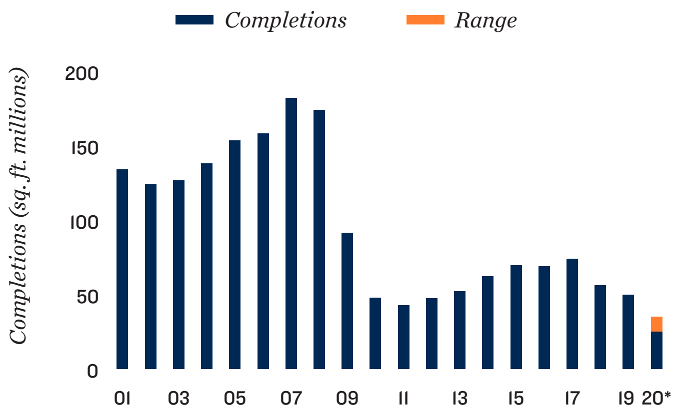


Online Sales Gain Momentum

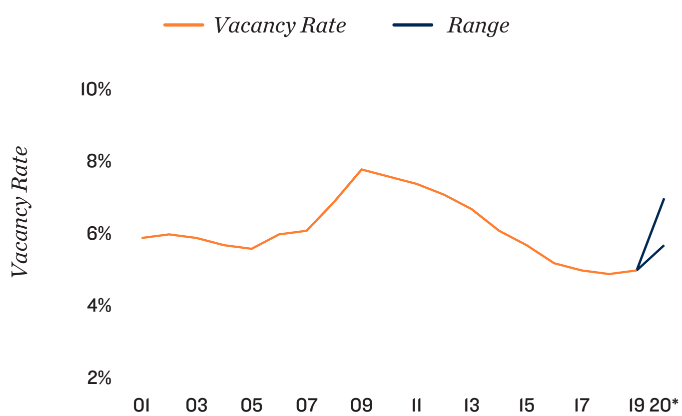


* *Through April*

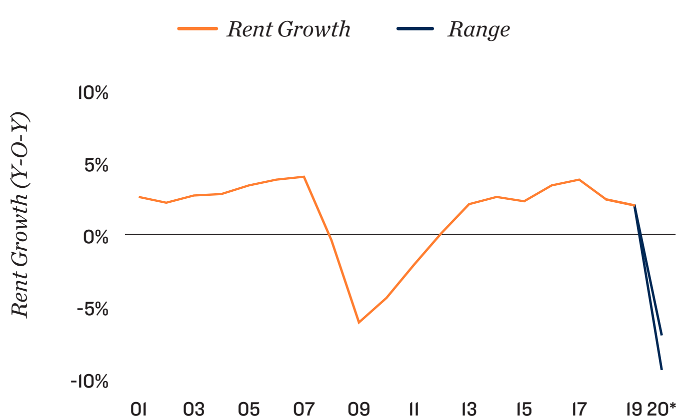
Completions Fall to 20-Year Low



Store Closures Weigh on Vacancy



Eight-Year Run of Rent Gains Ends



** Forecast*

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.

Slackening Construction Lessens Impact On Vacancy; Rents Expected to Fall

Construction pace falls sharply. Completions during the first three months of this year dropped to 8.3 million square feet, the lowest quarter level since the year following the global financial crisis. During 2020, inventory additions are expected to decrease to the least amount since 2000 as between 25 million to 35 million square feet is finalized depending on the length and severity of the economic downturn. This is down from nearly 50 million square feet last year as the recent economic upheaval along with construction sites being closed due to the coronavirus spread have pushed the delivery of some projects into 2021. Single-tenant space will account for the largest portion of this year's total at nearly 17 million square feet.

Differential between physical and economic vacancy grows. The temporary shuttering of brick-and-mortar locations has been difficult on many nonessential retailers and some will not survive. Although storefronts are being vacated, a number of leases still remain in effect, which is expanding the gap between physical and economic vacancy. By the end of 2020, the average physical vacancy rate will jump to a range between 5.6 and 6.8 percent, up 60 to 210 basis points on an annual basis, but economic vacancy will likely be much higher. How many retailers survive through the turmoil will largely depend on their cash reserves, the length of time each location is required to remain closed and whether the retailer can obtain financial assistance. The rate of closures will vary by retail segment and from state to state. Shopping centers with a higher portion of local tenants, experiential retailers or departments stores are the most vulnerable.

Rising vacancy puts a damper on rents. Heading into sequestration, asking rent climbed an annual 2.2 percent to an average of $20.50 per square foot in the first quarter. This growth is expected to bring closure to an eight-year string of gains that pushed rent up roughly 20 percent during the period. The severity of the pandemic's effect on vacancy will have a major impact on rent going forward as shuttered spaces become more difficult to retenant. Big-box space will especially drag down rent gains as more department stores succumb to the economic downturn. By the end of 2020, the average asking rent is forecast to fall between 7.0 and 9.4 percent.

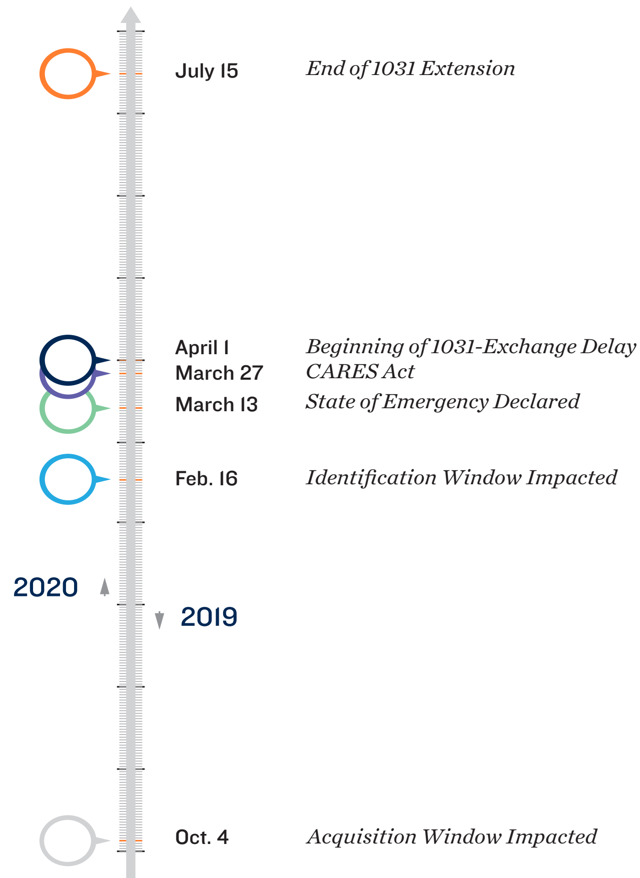
STORE OPENINGS BOOST FOOT TRAFFIC AT NONESSENTIAL RETAILERS

Retailer	Retailer % change Jan-Mar	Jan-Apr	Sector Performance	Apr-May 10	Retailer % change Apr-May 10	Retailer
Kohl's	-98%	-97%	APPAREL	+109%	84%	Kohl's
Macy's	-99%				246%	Macy's
T.J. Maxx	-97%				99%	T.J. Maxx
Marshalls	-96%				51%	Marshalls
Panera Bread	-83%	-89%	DINING	+69%	33%	Panera Bread
Applebee's	-92%				83%	Applebee's
Chili's Grill & Bar	-89%				105%	Chili's Grill & Bar
The Cheesecake Factory	-94%				-23%	The Cheesecake Factory
H-E-B	5%	-4%	GROCERY	-22%	-23%	H-E-B
Whole Foods Market	-32%				-21%	Whole Foods Market
Walmart Neighborhood Market	20%				-30%	Walmart Neighborhood Market
Trader Joe's	-20%				-14%	Trader Joe's
The Home Depot	41%	+32%	HOME GOODS	+7%	8%	The Home Depot
Lowe's Home Improvement	80%				3%	Lowe's Home Improvement
Bed Bath & Beyond	-94%				30%	Bed Bath & Beyond
At Home	-95%				821%	At Home
Walgreens	-3%	-2%	DRUGSTORES	-8%	-4%	Walgreens
CVS/pharmacy	1%				-15%	CVS/pharmacy
Rite Aid	-2%				-10%	Rite Aid
Dollar Tree	-11%	+27%	DOLLAR STORES	-9%	36%	Dollar Tree
Dollar General	52%				-19%	Dollar General
Family Dollar	42%				-16%	Family Dollar
99 Cents Only Stores	1%				-8%	99 Cents Only Stores
Walmart Supercenter	4%	-6%	SUPERSTORES	-10%	-18%	Walmart Supercenter
Target	-28%				11%	Target
Costco Wholesale	-4%				-17%	Costco Wholesale
Sam's Club	21%				-13%	Sam's Club

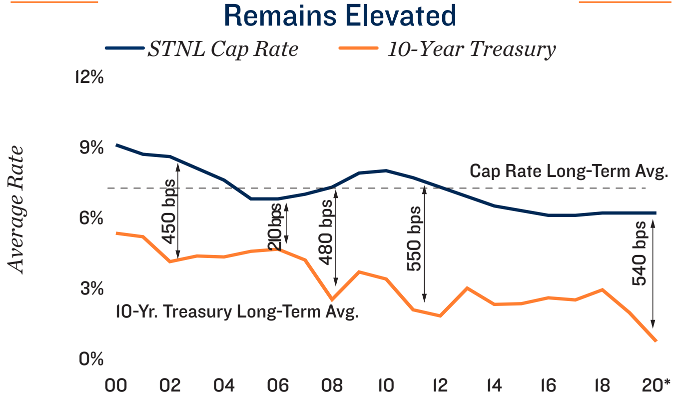
Sources: Marcus & Millichap Research Services; Placer.ai

1031 TAX-DEFERRED TIMELINE EXTENDED

(October 2019 to August 2020)



Avg. Single-Tenant Yields Premium Remains Elevated



* *Through first quarter*

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.

Buyers Searching for Safety Target Single-Tenant Net Lease Assets

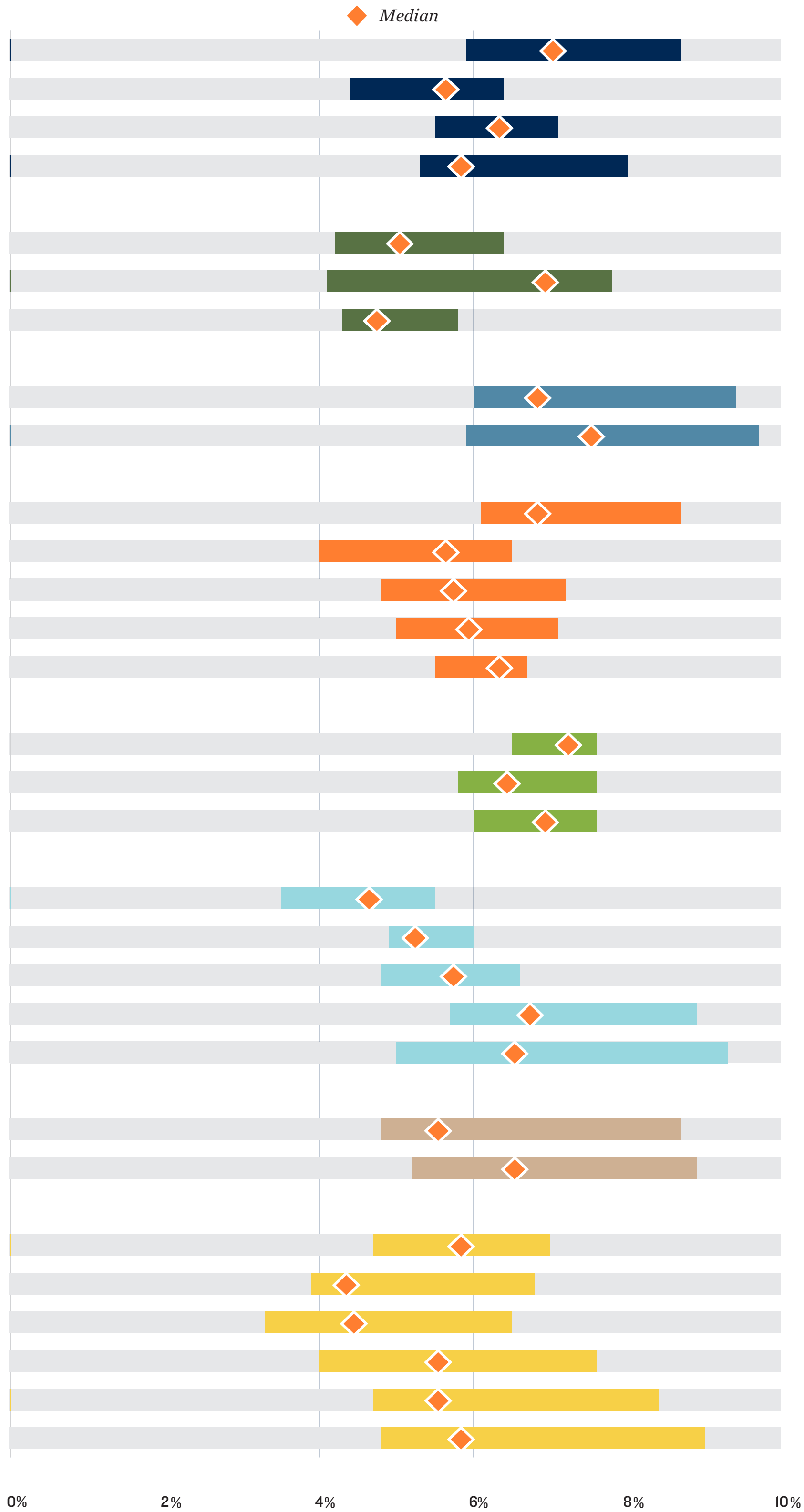
Investors target properties housing essential retailers. The long-term security and the less-management-intensive aspect of single-tenant net-leased (STNL) properties attract a wide range of investors. Buildings with retailers deemed essential remain especially strong during the pandemic. Dollar stores, drugstores and auto parts stores in particular can receive multiple offers, keeping pricing stable. Cap rates have averaged in the 5 to mid-6 percent range. Quick service restaurants (QSRs) are also being targeted as those with drive-throughs have remained open and have generated 60 to 75 percent of pre-coronavirus sales. Initial yields for these assets can start in the 3 percent range for prominent tenants such as McDonald's or Chick-fil-A in strong locations. Buyers have paused on nonessential categories including fitness centers, department stores, and sit-down restaurants as many of these tenant have asked for some form of rent relief that can complicate transactions. Coming out of sequestration, assets in these segments that are able to draw customers back are likely to regain attention from investors at cap rates that were in the 6 to 7 percent span before the downturn.

Exchange buyers receive extension. A portion of the capital chasing single-tenant assets is coming from other asset classes, especially apartment owners executing 1031-exchange deals. Transactions that had a deadline to find and/or acquire replacement properties on or after April 1, 2020, were given an extension until July 15. Due to shelter-in-place requirements, however, many of these trades are taking longer to close. Following the deadline, transaction activity will likely wane due to slower exchange activity initiated during the pandemic. In addition, some expansion plans have been put on hold, limiting new for-sale inventory in the months ahead.

Store closures will provide buying opportunities. Sequestration is taking a toll on a number of single-tenant net-leased properties. Already Steak 'n Shake has plans to close 57 locations and the owner of buffet-style restaurants Souplantation and Sweet Tomatoes restaurants has announced that it does not intend to reopen; whether they dispose of properties is uncertain. Additional shuttered locations will provide retailers in expansion mode an opportunity to seek better locations. Buildings with a drive-through will especially be desired by tenants and investors. As more companies run into financial difficulty, buyers may be presented with a wider array of prospects for portfolio expansions this year.

Brand	Locations*
Auto Parts	
Advance Auto Parts	4,276
AutoZone	5,815
Caliber Collision**	1,062
O'Reilly Auto Parts	5,477
Convenience Stores	
7-Eleven	8,707
Circle K	6,250
Wawa	815
Dollar Stores	
Dollar General	16,278
Dollar Tree/Family Dollar	15,288
Fast Casual Restaurants	
Applebee's	1,682
Bloomin' Brands	1,214
Chili's	1,238
Darden Restaurants	1,812
Red Lobster	749
Fitness Centers	
24 Hour Fitness	448
LA Fitness	709
Planet Fitness	2,001
Grocery & General Retail	
Aldi	1,987
Safeway	895
Sherwin-Williams	4,415
Verizon Wireless	1,703
Walmart	5,078
Pharmacies	
CVS	8,131
Walgreens	8,916
Quick Service Restaurants	
Burger King	7,566
Chick-fil-A	2,497
McDonald's	15,338
Starbucks	16,752
Wendy's	6,289
Yum! Brands	18,841

STNL CAP RATE RANGE BY BRAND**



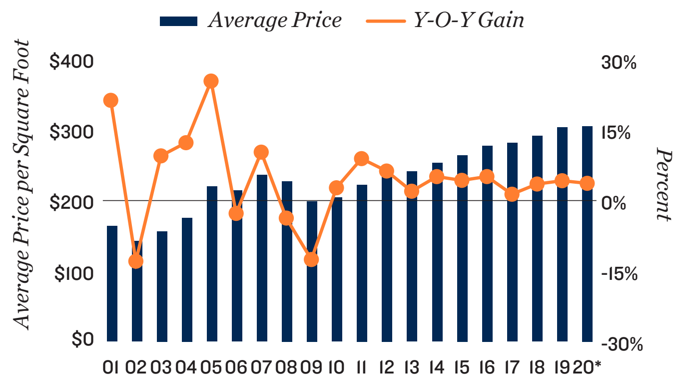
Cap rates shown above are representative of transactions that closed in the trailing 12 months ending in March. Actual yields will vary by locations, tenant, lease terms and other considerations.
Locations sourced from Creditntell for public companies and company websites for private companies.
** U.S. and Canadian locations ** For transactions closed in the trailing 12 months ending in March*
Sources: Marcus & Millichap MNET; CoStar Group, Inc.; Creditntell

More Investors Move to Sidelines During Covid-19; Active Buyers Focus on Assets With Essential Retailers

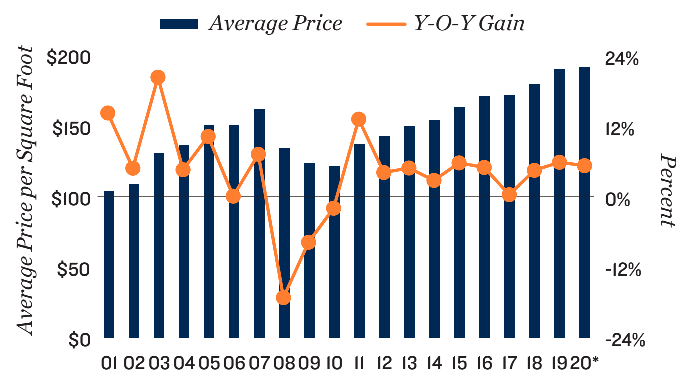
Vacated properties provide owners with options. The list of retailers filing for Chapter 11 is expanding. Whether these companies liquidate or emerge from bankruptcy protection has yet to play out, but the implication for operators can be substantial. While some retailers may come out from under bankruptcy in better standing and prove to be a quality tenant, the financial difficulties of others may not be over. Establishments that do not survive will leave owners with shuttered storefronts that need to retenant at a time of increasing vacancy. This can provide an opportunity for owners with the financial backing to upgrade facilities to make the assets more attractive to tenants. Strategies including ways to social distance or expanding pickup capacity. Owners with assets in desirable locations, meanwhile, may have an easier time attracting higher-quality tenants.

Many investors paused as coronavirus spread. As stay-at-home orders went in effect and prevented many buyers from touring properties, transaction volume slid. Deal flow declined 14 percent for assets in the $1 million and above price tranche year over year in the first quarter. Trading activity for multi-tenant centers is especially sparse as financing becomes difficult to obtain. Moving forward, tenant mix will be a key factor that buyers and lenders scrutinize as more retailers announce plans to seek bankruptcy protection. Single-tenant properties fared better. In a flight to safety, demand rose 7 percent for high-quality single-tenant buildings. Assets with retailers deemed essential were especially desired. Trading activity for these properties in primary and secondary markets registered double-digit increases. Some optimism appeared in April as the decline in transactions for single-tenant properties lessened.

Single-Tenant Price Outlook Varies by Subtype



Multi-Tenant Pricing Faces Increased Pressure



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Price: $1,500

Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Creditntell; Experian; Federal Reserve; Global Financial Data; Moody's Analytics; Placer.ai; Real Capital Analytics; Standard & Poor's; U.S. Census Bureau