After a strong run of solid performance, the tough outlook for landlords, tenants, investors and developers is forcing creativity back into the sector

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RETAIL
ROUNDTABLE

PARTICIPANTS

Alex Czopek | Henry D. Finkelstein | Tom Gast | Jack Kyser | Fred C. Sands

Retail rode the economic wave that flooded commercial real estate with capital to become a favored real estate investment product type. As credit markets and consumer spending dried up, retail has become one of the most at-risk property sectors.

About $30 billion in retail real estate — more than 1,500 properties — is in some state of distress nationally, making retail the No. 1 distressed property type, according to Real Capital Analytics. More retail distress is bound to come due to limited refinancing options, a stalled transactional market and ongoing fundamental challenges as more household-name retailers go bankrupt.

Yet today's market conditions may represent one of the most opportunistic times in years for retail. Formerly untouchable properties will become available in the distressed market. The shake-up among national credit tenants has opened up opportunities for growing tenants. Retail anchors being redefined as empty big boxes present new redevelopment opportunities. Developers can look beyond the lifestyle center and ground-floor retail under residential as the cutting edge of retail development. Retail is poised to go out of the box as today's challenges will force new creative thinking in a sector that constantly must reinvent itself.

The California Real Estate Journal gathered five retail experts to discuss the latest trends in the sector. Moderated by Editor Michael Gottlieb, the Roundtable included:

ALEX CZOPEK, southwest division real estate manager, 7-Eleven Inc.
HENRY D. FINKELSTEIN, partner, Greenberg Glusker
TOM GAST, prinicipal, Gast Retail Group
JACK KYSER, founding economist, Kyser Center for Economic Research, Los Angeles Economic Development Corp.
FRED C. SANDS, chairman, Vintage Real Estate LLC

Retail's Rise and Fall

CREJ: Retail performed well during the last economic downturn and helped buoy the whole real estate market as it emerged as a top-tier investment class. How does this recession differ from that?

JACK KYSER: We've been through what we call the Great Recession, and we do feel that the economy is starting to turn up. There are enough positive indicators. But it is going to be a very, very slow recovery.

You have a changed consumer out there. It's very difficult to get credit cards. Consumers aren't going to be able to get a second mortgage on their homes. It's going to be what we call a "jobless recovery," with job losses continuing into 2010 and the unemployment rate going up until then. Consumer spending power is constrained and consumers are quite scared.

The retail industry itself is in chaos. You hear a lot of scary stories out there. The fate of mid-range and higher-end stores is in question because the hiring market is destabilized.

In Southern California, retail sales declined year-to-year in both Orange County and the Inland Empire. Everybody fell off the table in 2008, with further losses in 2009. People don't realize how troubled retail real estate is overall because there's no comprehensive retail vacancy rate out there.

There's a 16 percent retail vacancy rate in downtown Los Angeles. That gives you an idea of the problems that we have.

CREJ: Did retail's relative strength during the last downturn exacerbate the severity of the downturn today?

KYSER: You had too much retail. Think of the dictum from former GE CEO Jack Welch, "If you're not No. 1 or No. 2 in your market segment, forget about it." Look at all the pet stores out there or the office supply stores or middle-range general merchandise stores. There were a lot of players and way too much capacity.

CREJ: Have there been any surprises in terms of which retailers have gone by the wayside?

KYSER: No. A lot of people expected Mervyns to go because it lost its way. For the regional malls, Kohl's and Forever 21 were godsends. Then you wonder if Forever 21 is getting overly ambitious, because they're expanding.

FRED C. SANDS: They're changing their business model into a big box model. They should do a pilot program in two stores, not across the country.

KYSER: There are probably going to be more store closings among the larger chains, some pruning of underperforming locations. For example, Macy's in Pasadena, where they have one on Lake Avenue and another in the Paseo Colorado mall. Do you need two so close together? That's a lot of exposure.

ALEX CZOPEK: It's been my experience that this downturn in the Inland Empire differs from the downturn in Los Angeles, Orange County or San Diego. The recovery is going to be that way also.

KYSER: I agree. It's going to be a very uneven recovery.

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The Inland Empire's driving force was international trade and that crashed. Then you had a lot of office development that was supposed to serve the residential real estate market. Retailers chased rooftops and a lot of those rooftops turned out to be empty. It will probably be 2013, 2014 before that region gets back to where it was in 2006.

San Diego is going to pull through this thing sooner because of investment by the military. The downtown condominium market is distressed, but tourism will come through this first. Then I'd say L.A. probably will come along, and then Orange County. Riverside and San Bernardino and all the inland areas will be the laggers. Even San Jose took a hit this time around.

'People don't realize how troubled retail real estate is overall because there's no comprehensive retail vacancy rate out there.

There's a 16 percent retail vacancy rate in downtown Los Angeles. That gives you an idea of the problems that we have.'

— **JACK KYSER, Los Angeles Economic Development Corp.**

CZOPEK: Housing in the Inland Empire has been a considerable driver of business activity there, on many levels, and it's nearly zero at this point. It changes the whole economic model for the region.

KYSER: The good news is that housing is affordable in Riverside and San Bernardino again.

SANDS: This happens in every recession. The outlying areas get hit the hardest.

In 1992, I had a real estate auction company. We'd sell 100 lender-owned houses on a Saturday. We sold homes in Moreno Valley for as little as $20,000. Pretty soon, many developers were buying cheap land and building hundreds of houses. People left South Central because of the crime and bought a house in San Bernardino County with no downpayment. They may even have kept their job downtown.

Gasoline prices went up, they were laid off, and now you have vacant houses. The same thing happened in Palmdale and Lancaster. Those are the first areas to be hit and the last to come back. The Inland Empire got ahead of itself.

Consumer Spending Trends

CREJ: Would you say the changes in consumer spending are cyclical or are we looking at a longer-term impact? Can people return to their previous spending patterns quickly once the economy stabilizes or have their market losses taken away their retirement money for good?

SANDS: The wealth effect is gone for the baby boomers. The value of their houses went down and their 401(k) has been knocked down 40 percent. They're scared. It's like the people that lived through the Great Depression — they missed out on a lot of opportunities because were just too afraid to act.

We've got Americans saving for the first time. While the Japanese are great savers, they've had a terrible economy for a long time. If we don't get people spending, we're not going to get out of this for decades.

KYSER: There's a real challenge for the higher-end stores. Saks Fifth Avenue threw the fat in the fire last Christmas when they started discounting on current high-end merchandise.

SANDS: There were fist fights in the stores.

CZOPEK: Electronic commerce and information platforms are making for a generational shift among consumers. Pricing information is so much more easily available to people, they can comparison shop online for almost anything they buy.

We're in the convenience store business. People don't check their 401(k) when they're hungry; they just want to eat. They may buy coffee from us instead of one of the brand-name coffee houses because it's a better value.

This is a huge piece of our strategy today. People's taste in beer has changed, for example. It's such a pedestrian item. The name beers are not as important as the budget beer category. That's what's kept us healthy and moving forward lately.

CREJ: If adaptability is the key factor, then the high end, which we had thought of as being somewhat insulated, now seems much more vulnerable since its branding is attached to higher-cost merchandise.

SANDS: No one is insulated. Every retailer at every level and in every category has to employ different strategies.

There was a misperception on the part of high-end retailers. Half the people who were buying at Saks and Neiman Marcus may have seemed wealthy, but they were actually aspirational buyers. They were living on credit cards. The value of their house and their 401(k) went down, and now they can't continue as they did in the past.

Now the smart high-end retailer is moving the price point on their goods to match today's buyers' wallets. The retailer is going back to the manufacturer and saying, "Look, people don't want to buy $2,000 suits any more. We need your brand to produce lesser-priced goods." The manufacturers are not stupid. They will do it. You'll have the same brand but it won't be the same quality suit.

HENRY D. FINKELSTEIN: I have an integrated manufacturer boutique that's a high-end operator. He made the move you just described, Fred, but he told me that he can never sell enough jeans to make up for losing out on those $3,000 handbag sales. Some boutique operators just can't push enough volume at the lower price points to keep their doors open.

SANDS: Unless they change, the mom-and-pops and many of the small, high-end boutiques are going away and they won't come back for years. The chain stores will hang on. They may hammer on their landlord, but the tough landlord will not budge. The frightened landlord might. The publicly owned chain stores are under pressure to grow their earnings. Even though sales are down, they're expanding. That's what we like to deal with.

KYSER: And you've got a lot of landlords of smaller retail spaces that haven't heard about the severe retail downturn and still holding the rental rates steady or trying to boost them.

SANDS: It depends on who blinks. A lot of retailers are going to their landlord and saying, "We can't pay the rent." The weak landlords will cave. In my opinion the smart landlords are going to hang tough.

Tough Tenant Negotiations

CREJ: Isn't it fair to assume that every retail landlord has been contacted by every tenant by now to ask for a rent reduction?

SANDS: If they know the answer is no, they stop asking. We turn down 95 out of a 100, and we haven't lost anybody.

KYSER: But they ask.

SANDS: You don't ask, you don't get. Look, it's an opportunity. These are not stupid people, especially the chain stores. And if word gets out you're doing it, everybody is going to come to you. But the Westfields and Simons of the world are not going to give the store away.

We bought a mall and the tenant said that the former owner had sent them a letter saying, "I know you're having trouble. Do you need any help?" When we took over, we said, "We're different. You're not getting any rent relief. We'll help you build the sales of the mall, but you pay rent on the first of the month, period." So we set the standard.

FINKELSTEIN: That's effective for the first-class-location properties. For the secondary locations, where you don't have a balance sheet credit behind the tenant, perhaps some more flexibility is in order.

SANDS: I agree. If the guy is going out of business and he shows you his financials and you work with him — unless you have somebody better to put in.

KYSER: There are fewer stores out there. A lot of the chains have disappeared, and they're being very careful.

SANDS: We're seeing a lot of new ideas. The teens and tweens concepts are hot; they're expanding. We're putting them into locations, and somehow if dad's sport coat is worn out, he lives with it, but the kid's got to have new clothes for school. We're seeing a lot of retail chains, like Hollister and Rue 21, expand.

TOM GAST: You have to look at the type of property owner involved. Some investors own fewer and maybe lesser-quality properties, and they are finding themselves struggling to keep their properties stable. It's not a matter of being strong and telling their tenant, "No." It's, "Gee, my loan is coming due next year. Everyone is asking me for a rent reduction. If I play chicken with this tenant and lose, there's a very good chance that I'm going to lose my property."

SANDS: Does the tenant have a lease?

GAST: Yes.

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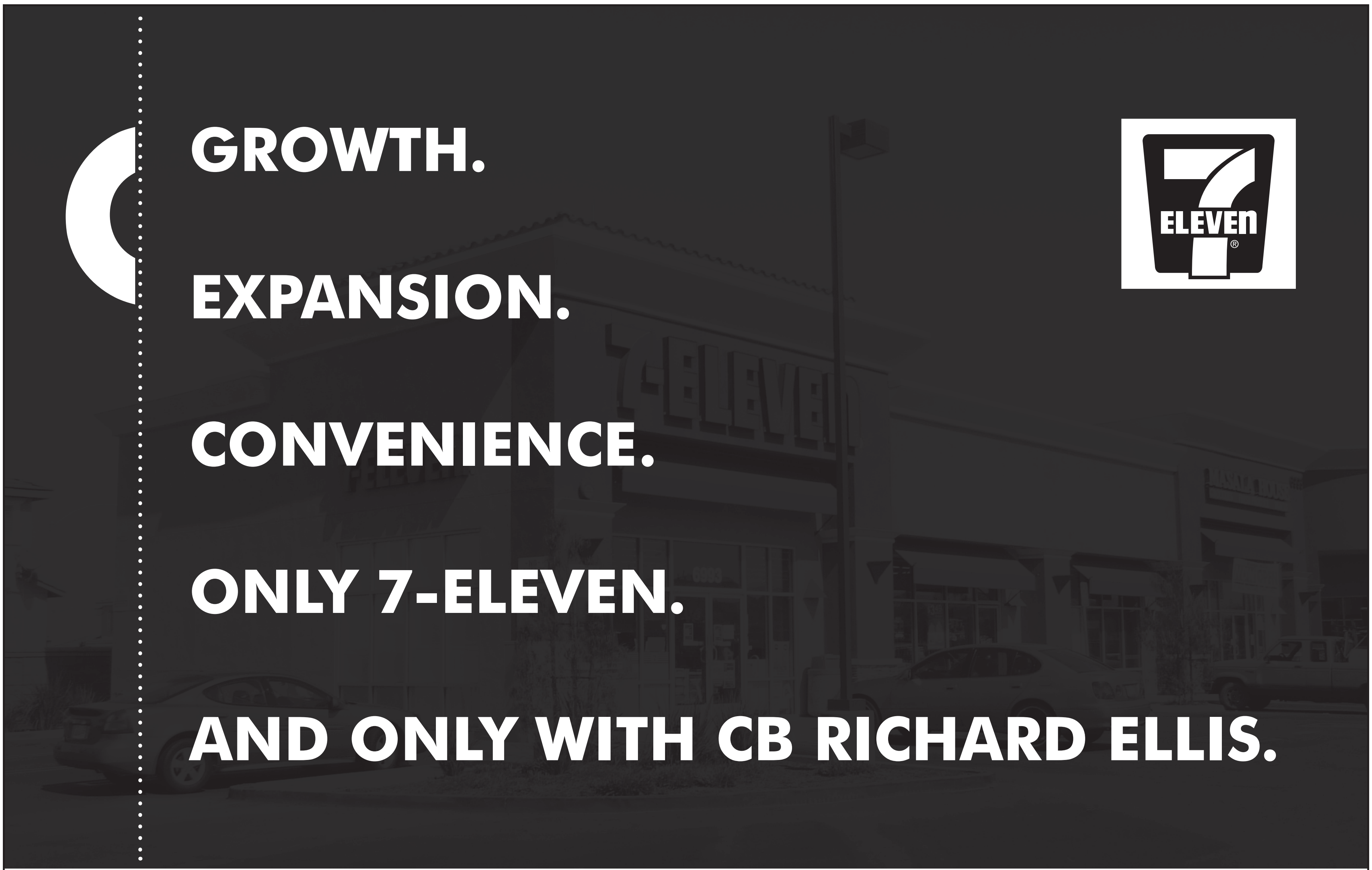

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SANDS: We get personal guarantees from all the tenants. So my people would say, "OK, you could lose everything. You better pay your rent."

GAST: But in many cases that's shielded behind another entity, such as an LP or LLC.

SANDS: We don't sign tenants up with their little, single-purpose LLC. You have to be stupid to do that.

'Unless they change, the mom-and-pops and many of the small, high-end boutiques are going away and they won't come back for years. The chain stores will hang on. They may hammer on their landlord, but the tough landlord will not budge. The frightened landlord might.'

— FRED C. SANDS, Vintage Real Estate LLC

GAST: Well, many owners don't get that.

SANDS: You're right.

GAST: Many tenants won't give personal guarantees and therein lies the quandary for the owner: Do I give the rent concession and keep some stability in my property or play hardball and risk imminent foreclosure?

SANDS: If you don't have the personal guarantee, then you have to do what you have to do.

GAST: Right.

SANDS: In my mind, that's weak landlording.

GAST: A lot of these smaller-shop tenants asking for rent reductions are folks that historically have taken second mortgages on their homes to finance their businesses. Now that they have mortgages that exceed the value of their homes, that source of capital is no longer there.

SANDS: The landlord didn't do his due diligence. We don't accept tenants that can't afford to pay their rent, that don't have reasonable assets. A lot of real estate people are not good at evaluating operating businesses. They don't understand them. We have people who look at margins and capital expenditures. We do detailed, comprehensive credit evaluations of tenant businesses.

GAST: Those are very sound practices, but in the real world, Fred, there are a lot of landlords who have fallen into a very deep and expensive trap. They got caught up in the real estate frenzy at the height of the market a few years ago, made a lot of money from the sale of a property, got into a 1031 exchange and overextended themselves. Now they find that their property is no longer worth what they paid for it. In the meantime, their tenants want rent reductions and they're faced with having to make the decision to either put additional equity into their investment and recapitalize their debt, try to convince their lender to discount the note or give it back to the bank.

SANDS: Maybe they should have had a good asset manager in the first place if they're making decisions they don't understand.

CZOPEK: From a retailer standpoint, you're almost talking about apples and oranges. Your property, Fred, is a mall — a 100,000-, 200,000-, 300,000-square-foot property. It's a whole different mindset than when you're dealing with small strip shopping centers of eight-, 10-, 12-, 15,000 square feet. That owner is different than yours.

SANDS: You're correct.

CZOPEK: In our situation, we are fighting hard to reduce our fixed occupancy expenses. We are successful at it and we will continue to do that in the marketplace. It's good business.

SANDS: Sure.

CZOPEK: As leases come up for renewal, or out a year or two, we have significant leverage to go talk to those people because we have alternatives in the market. The huge vacancy rate in almost every marketplace gives us alternatives to move from a B-plus corner to an A corner and possibly lower our rent expense in a better facility.

We're fighting hard and we're having some terrific success. When you're the credit tenant in a small shopping center, you have a lot of leverage. We are intending to continue to work that leverage, no doubt about it.

GAST: In light of the state of the economy in our industry, the passive investor is now forced to have a better understanding of how their property is positioned, its strength and quality and who the likely replacement tenants are if they should lose their anchor.

SANDS: What they're learning now, they should have known before they bought the property.

CZOPEK: The trading of small retail properties is a whole different level. In a typical 12,000-square-foot center, you'll have us, a dry cleaners, a hair salon, a sandwich shop. We're the only credit they have to anchor that whole center.

SANDS: They can refinance their property based on your credit.

CZOPEK: No doubt. If we go away, is a landlord going to replace us with a mom-and-pop convenience store with paper-thin capital? That doesn't make any sense. The rent from those tenants is worth a whole lot less to any bank. It's just the way it is.

GAST: You can't fault the retailers. They're being smart and leveraging the strength of their position by capitalizing on very weak and tentative economic times. They should be aggressive. Whether a rent reduction is warranted or not, they should ask for it and they are.

FINKELSTEIN: They're putting the same squeeze on all their vendors. A real estate location provider is not really that different from any other supplier.

CZOPEK: We are looking for rent reductions wherever we can. It's just good business.

Adaptive Retail

CREJ: How is vacancy impacting rents?

KYSER: If you walk through a regional mall today, you'll see a lot of blank storefronts.

SANDS: Some. Our occupancy is the 90's.

CZOPEK: How do you replace a Circuit City or those other people that went away?

SANDS: You re-tenant the property as an opportunity. Put in a Forever 21, or the spinoff of Forever 21, which is Love Culture. People are always trying new things.

Maybe you have too many anchors. You then re-tenant with many small in-line stores, which pay a much higher rent. I use Westfield as my business model. They've done things very well.

CZOPEK: From a small-box perspective, we are now having the opportunity to consider corners and spaces that weren't available two and three years ago at prices that we can afford within our business model. People were trading rents at ridiculous numbers just to grab corners. Many retailers now are stuck with unworkable operating expense platforms that do not make sense.

FINKELSTEIN: Did the real estate owners get to be too greedy when rents on Robertson Boulevard in L.A. were $10 a foot a month? Is that sustainable?

SANDS: It's a free marketplace. You go with what the market is at the time. Now, what's on Robertson Boulevard? Pilates studios that are not paying high rents.

CZOPEK: Nothing is being built now so we're looking at second-use tenancies. When you have a set of dark windows and no revenues coming in, it changes your business model. We aim to take advantage of that. We're going to be very aggressive as to our dollars.

SANDS: Are you in the real estate business? It would seem to me, if I own 7-Eleven and I stole a corner and I sold a franchise, I would do a lease to that franchisee and I would put it at fair market value.

CZOPEK: That's not how 7-Eleven works. 7-Eleven corporate controls the property. We lease the site, typically a 10-year term and then we'll franchise it out for a fee. We have an alternative model called our "business conversion program."

SANDS: Do you charge a franchise fee?

CZOPEK: No. It's a gross-margin profit model split. As far as the landlord is concerned, we at corporate are the credit tenant. We do all the build-out, and all the planning and fixturing of the store. The franchisee operates the store.

FINKELSTEIN: It's remarkable that Forever 21 and some of the new apparel concepts are able to creatively use existing spaces. We've all admired Dave Gold for being able to put a 99 Cents Only store in practically any space and make it work. But my perception is that, for most of your better national retailers, there's a very tough cost-benefit analysis in reusing an existing space.

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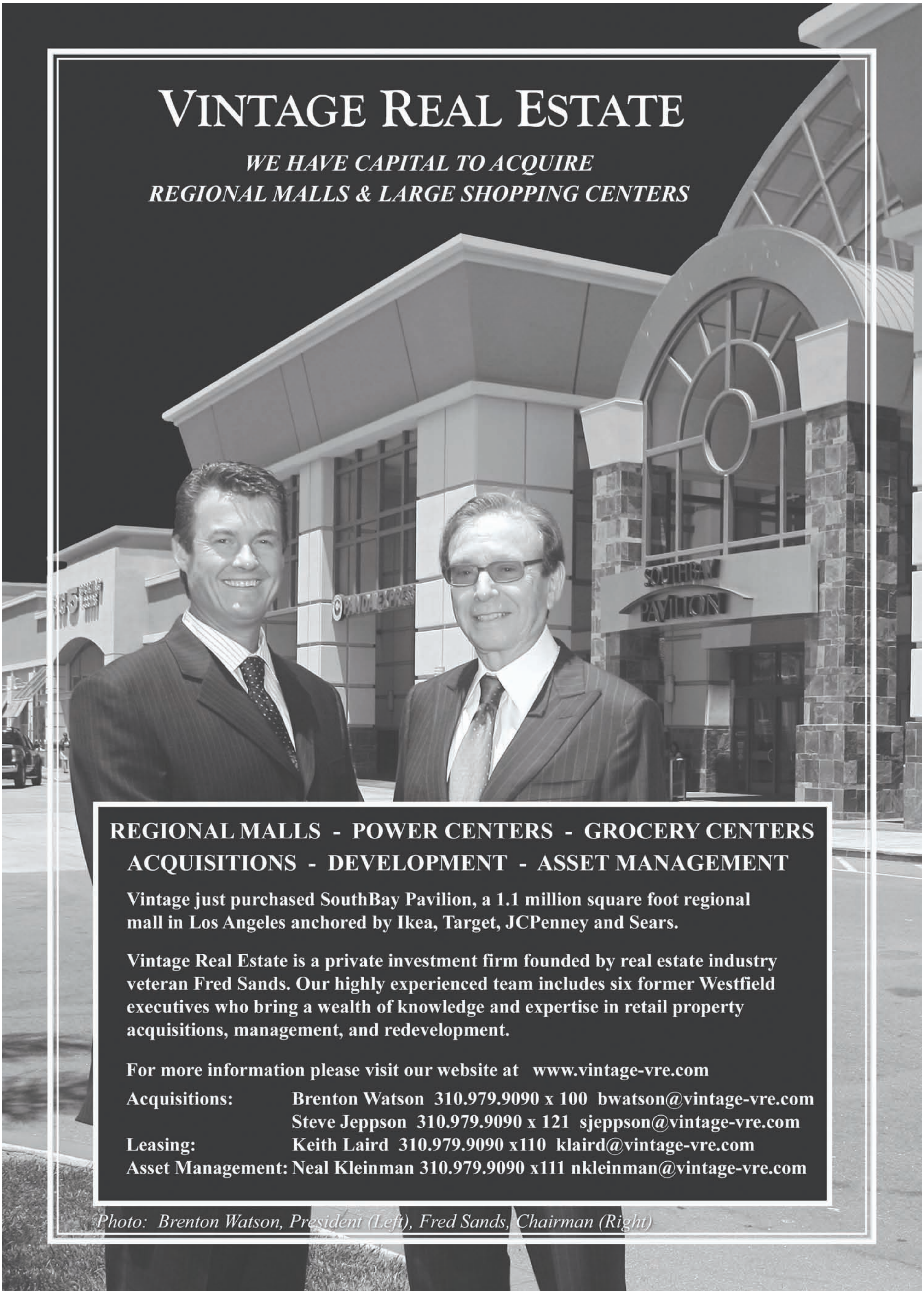
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Photo: Brenton Watson, President (Left), Fred Sands, Chairman (Right)

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SANDS: They'd better all be doing that or they're going to be toast.

FINKELSTEIN: There's some very real costs for the retailers in getting away from their prototypes and real risks that the property owners don't necessarily understand or respect. You want to replicate the success you have elsewhere. If your image and operating process changes, you might not replicate the same success. Your ROI projections might not be as accurate.

'As leases come up for renewal, or out a year or two, we have significant leverage to go talk to those people because we have alternatives in the market. The huge vacancy rate in almost every marketplace gives us alternatives to move from a B-plus corner to an A corner and possibly lower our rent expense in a better facility.

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— ALEX CZOPEK, 7-Eleven Inc.

An individual boutique's got the creative person right there on the spot, doing the merchandising, layout and buying. That allows them to be more flexible. The whole idea of a big company is to centralize those functions up at corporate, to be efficient and to have the benefit of the best specialists. They can't afford to have too many people in the field or to take unnecessary chances.

SANDS: You have to micromanage your markets. You can't do the same thing in one location as you do in another.

We bought a mall in Wenatchee, Wash. and found from our credit card tracking that Ralph Lauren was being purchased by people in Wenatchee and our anchor tenant wasn't carrying it. We quickly talked to them, and their sales went up. They needed our input to become aware of this.

Macy's just came up with the concept of My Macy's, a store within a store. They ask, "What do you really want? What are you not getting?" They create a whole boutique within the store and present to the customers exactly the things they ask for. The consumer feels that they bought into it, they suggested it, they better buy it.

FINKELSTEIN: Yes, but the low-margin operators succeed *because* they have a central system.

SANDS: But it's price-driven.

FINKELSTEIN: Part of their ability to have that lower cost of goods sold is the efficiencies of not customizing and doing stores off the beaten path.

Let me offer one more aside on operating costs. There's a surprising amount of extra labor if the loading dock is an elevator away, or on the wrong side, or if there are no skylights in the building and you have to pay for more lights, or if the parking lot is beaten-up and your triple-net charges are going to have to include repairs. Well-run retailers are taking all of these considerations into their imputed occupancy cost when they do this analysis.

My architect friends also tell me that the cost of a pre-engineered building shell isn't very much of the total project cost and that the cost of renovating a space oftentimes isn't very different from scrapping and starting all over.

CREJ: If I go from a 7-Eleven in one community to one in the next, will they be different in response to local demand?

CZOPEK: Yes and no. We're a franchise company. We have the benefit of an involved owner-operator at the stores. While the fixturing and the look of the stores is the same — we want the customer to have a similar experience whether they're in a store in Los Angeles, San Diego or Seattle — the merchandise is key for the community. Our franchisees have the ability within the store, in an organized, systematic way, to vary their merchandise.

For instance, in a Latino community, we'll have a lot of merchandise serving those customers. In a Korean community, the merchandise will absolutely be different. If the store is on the beach, we'll specialize in beach merchandise. We have field consultants on staff to work with the stores, specifically to help customize them and meet the market.

Every 7-Eleven is going to have a coffee bar and coffee. They're going to have Slurpees. They're going to participate in national promotions for the hot dogs and all those things. But within that store there is that ability to personalize, to be reactive to the local community. That's a piece of what makes us successful.

SANDS: Do you ever find where a smart franchisee brings in something you never thought of selling in a store, and it's so good you want to replicate it in other stores?

CZOPEK: That's happened, yes, absolutely. We have both a local merchandising staff at the division level here in California and a national merchandising staff back in Dallas that serve the needs of the marketplace.

Closing the Gap

CREJ: Let's look at the investment side. Are buyer and seller expectations coming into equilibrium with reality? If not, what do you think it will take for investor expectations to realign?

SANDS: There's always a big disparity between buyer and seller, but now more than ever. It depends on the motivation of the seller. Many sellers say this is not the time to sell. My property is performing well. Maybe I have a few more vacancies. I'm going to wait. If somebody has a CMBS loan coming due, they're going to have to do something. Those are the circumstances. Capitalization rates have expanded and might continue to expand.

GAST: There's still quite a disparity. Rising cap. rates, fair market comp. sales, a noticeably weaker retail market and tighter lending practices all will contribute, over time, to narrowing that gap. Hopefully, over time, owners will be more realistic in terms of their expectations and property values will reflect that.

CZOPEK: As a tenant, we see there is still that gap between 2006 and 2009. We're trading in 2009, 2010. We have not seen the full erosion of asking rents to reflect where the market has gone.

SANDS: If the store has been vacant for a year, you're not going to be bashful about your offer.

FINKELSTEIN: It also doesn't hurt to remind the owner that he's running some real entitlement risk if he leaves the space vacant. What a nightmare it would be to discover that you couldn't claim credit for the trips from the old Circuit City story because it had been sitting empty so long that the "existing condition" was treated as vacant land.

CZOPEK: We're not bashful in any circumstance, I can promise you that. We see the opportunity to be aggressive in a market because we're a credit tenant and very few credit tenants are expanding. If we're going to spend large capital dollars to open up a new store, we want to make sure that its economic platform is sound.

We do buy some of our properties. We will often acquire a gas station and convert the convenience store and gas pumps to 7-Eleven branding. We're finding huge erosion in those prices right now, where gas stations traded at numbers that made no sense back in 2005 and 2006, so we can buy at significant discounts. We expect to see even more of that.

CREJ: Do you think closing that gap is going to require some of the things that we've been seeing in the hospitality sector, where keys are being handed back to the lenders?

CZOPEK: Absolutely.

FINKELSTEIN: Sometimes the gap is not immediately apparent from the listing price. When our retailers look at a parcel, they are working toward their imputed occupancy cost. The land price is just one piece. Very often there are major costs for site-improvement costs, changes in the site utilities, landscaping and code upgrades and on and on.

Sometimes, if you run a residual land value analysis on building a new building, even with a great credit tenant — one that Fred would raise his hands and say, "That's the kind of tenant I want" — the property's worth a lot less than calling up our friends at 99 Cents Only.

Investor Expectations

CREJ: Are investment dollars looking for retail opportunities? Where is that money and what expectations do those investors bring?

SANDS: We are buyers. We just recently closed on a 1 million-square-foot mall in the South Bay area. But sellers have to be realistic. They have to really want to surrender and say, "We're afraid it's going to get worse." In retail, you have to have money for capital improvements.

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Eighteen months ago we bought a mall in Washington state from a TIC. Now, what in the world was a tenant in common doing with retail center tenants? They don't have money for tenant improvements. We knew we were going to have to put serious money into capital improvements to find tenants. It had 35,000 square feet of vacant space.

We leased it all to national tenants — a lot of the teen and tween. Aeropostale, Casual Clothing, Children's Place, Hollister, Rue 21, they're expanding. It seems like the teens have all the money. Where is this coming from? It's from mom and dad because they love their kids.

'In light of the state of the economy in our industry, the passive investor is now forced to have a better understanding of how their property is positioned, its strength and quality and who the likely replacement tenants are if they should lose their anchor.'

— TOM GAST, Gast Retail Group

KYSER: What about Buckle? You have Buckle?

SANDS: We're negotiating with Buckle right now.

KYSER: Who would have heard of Buckle a couple years ago? They came out of nowhere, out of Nebraska.

Reinventing for the Next Cycle

CREJ: Retail as a sector is constantly reinventing itself because it has to appeal to consumer tastes and trends. For the past few years, it's been hard to find much new creativity. Are you seeing any real innovation in retail real estate, and in the basic mall format?

SANDS: I'm a believer in conventional malls. You look at companies like Simon and Westfield, they haven't changed much. They have good locations and they don't have many vacancies, despite high rents. There's more publicity for demalling malls, but the traditional mall is not going away.

FINKELSTEIN: There's a much less of a bright line between a regional mall and a power center, a neighborhood center and a lifestyle center. A lot of the users are crossing over into the different categories of properties. The operators are having to take out a clean sheet of paper on how navigating a big shopping cart can be compatible with carrying a little blue bag.

SANDS: A mall is an operating business. It's not like having a 7-Eleven store. You collect the rent checks and put them in the bank.

Look at what's going on right here in Los Angeles. The former Fox Hills Mall is now the Culver City Mall and Westfield is putting in a Target. Target used to be the category killer. Well, guess what? Nordstrom likes to be next door to a Target. Things are changing. Even with the dearth of capital, they are reinventing the mall model.

KYSER: Remember, Target is Le Tar-zhay.

FINKELSTEIN: It's surprising oftentimes to government officials, for example, how the demographics at Costco and Nordstrom are almost exactly the same. Target is way up there, too.

SANDS: Target does well in low-end areas as well as high-end areas. When I had my real estate company, the managers in the Valley used to all go to what they called "Tar-zhay."

CREJ: Where is the next wave of retail anchors and tenants coming from?

SANDS: Let's see how Forever 21 evolves. They'll either expand and be a power player, or they'll have issues if they're not smart enough. It looks like they are.

CZOPEK: What about Wal-Mart expanding?

SANDS: The labor unions are keeping them out. Inglewood needed a Wal-Mart, but a campaign by the labor unions put it on the ballot and Wal-Mart lost. The people lost.

KYSER: In Rosemead they were expanding the Wal-Mart to include groceries because they had no real grocery in town and then you had all kinds of political conniptions.

SANDS: They turned it down.

KYSER: Not immediately. They expanded the store, but the city is going to try to make them un-expand it. It's very strange, but the unions are death on Wal-Mart.

GAST: It will be very interesting to see if the general thinking of cities toward Wal-Mart will change, especially when they are losing significant sales tax dollars from closed car dealerships and other failing retailers. Maybe big box sales tax generators, who also create new employment opportunities like Wal-Mart aren't such a bad idea for their communities after all, especially in such dire economic times that may take years to fully recover.

Building Retail

CREJ: Is the entitlement environment in California getting easier for retail?

SANDS: It depends on how smart the municipalities are. If they're smart, they want to help their community.

KYSER: Communities in the Inland Empire have offered assistance to auto dealers just to try to keep their doors open.

GAST: It's going to be an interesting balancing act with the fiscal situation between the state and many of California's municipalities. First, the state is now getting into the pockets of the cities, taking away precious reserves for self-serving "loans" in order to meet their own budget shortfalls. Secondly, a lot of these larger regional counties and communities, such as in the Inland Empire, have imposed huge Transportation Uniform Mitigation Fees that are being passed on to the developer and retailer in order to pay for improvements in infrastructure.

For example, a few years ago, when I was working for Ralphs Grocery Co., we did some developments in Riverside County. The TUMFs were on an increment-graduated basis and when they eventually reached their ceiling it added half a million dollars to the cost of building a brand-new Ralphs store. That is significant and a major consideration in developing a strategic store development plan, particularly in those areas where the cost of construction is much higher.

So I am curious to see how this will sort out now and how that will impact new construction and development in these areas over time.

SANDS: The smart retailers say, "Let me show you the sales tax dollars that we generate. We will now show you what we need in dollars." We have outside companies that do studies for municipalities that says, if we do this we have to expand, put in a 16-screen theater; if we do that, here's what the gross receipts are and how that impacts you. Write us a check or float some bonds.

GAST: In the Inland Empire, probably the single hardest-hit mortgage foreclosure market in California, retail demand has slowed appreciably and as mentioned before, entitlement costs have gone up significantly. Retail development in those areas is going to be very difficult for the retailer to justify in light of other alternative areas being considering, especially with limited capital available. The additional housing needed before retailers will commit is just not there for the immediate future and those that are there are rapidly becoming vacant.

KYSER: They also tried to move upscale a little bit too rapidly. That hurt them.

Another problem is that cities that are struggling financially have laid people off, making it harder to get anything processed.

FINKELSTEIN: I did a project in Riverside that slipped barely under the wire in avoiding that regional traffic fee by having a statutory development agreement in place before it became effective. The city knew the project couldn't sustain the cost.

I'm finding that cities are bending over backwards to use whatever block grants or other monies they have doing traffic improvements and trying to mitigate the CEQA impacts of retail uses without burdening the center. Retail is a general-fund additive use. The agencies properly impose the fees and infrastructure conditions on residential projects instead because they are a net revenue drain.

GAST: They have a similar system in San Diego, with TUMFs discouraging new development in many respects. It makes the second-generation product more attractive to retailers. For investors, the value-added part looks a lot better than new development right now, not to mention that construction lending is virtually non-existent.

CREJ: Southern California is absorbing its first generation of mixed use. Are we seeing new uses for the street-level retail beyond serving the condos above, when that wasn't successfully delivered?

KYSER: Driving around, you see a lot of vacant street-front retail under condos and apartments, no matter where you are. There's skepticism.

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SANDS: What's upstairs is not sufficient to service the retail.

FINKELSTEIN: I just helped buy a luxury condo in Reno. The condos are almost sold-out, but there's 30,000 feet of retail and a 2,000-foot coffee shop, which is rumored to be about to close. It is just sitting empty.

CZOPEK: We have a number of those types of properties in San Diego. Obviously it fits our business model. But we look for other dynamics to drive a project — proximity to a trolley stop, occupancy of adjoining buildings. They can't be 90 percent vacant.

We did one very successfully in Little Italy, San Diego, and the store has done very well. Less so in Orange County — we're really not doing very many of those. We just weren't comfortable that it would be a good investment.

'There's some very real costs for the retailers in getting away from their prototypes and real risks that the property owners don't necessarily understand or respect. You want to replicate the success you have elsewhere. If your image and operating process changes, you might not replicate the same success. Your ROI projections might not be as accurate.'

— HENRY D. FINKELSTEIN, Greenberg Glusker

CREJ: Your focus isn't just on servicing the residents, is it?

CZOPEK: You can't just service the occupants because they go away. We need workers in the area, a hotel across the street, a trolley stop.

KYSER: Which means you need parking, don't you?

CZOPEK: Not necessarily. We have some very successful walk-ups. The key is people — using the trolley, walking by our doorstep — and converting them to shoppers who will come in and buy a bottle of water, a Slurpee, a sandwich or a slice of pizza.

CREJ: Do you foresee integration for retail and office, rather than the retail-residential connection that has been so popular with cities?

SANDS: You'll see this in some retail centers in tertiary markets that are not growing.

KYSER: They're doing that in the Carousel Mall out in San Bernardino, which is an ongoing failed mall.

SANDS: Even in good times that's a tough market.

KYSER: In bad times it's even worse.

FINKELSTEIN: It may not be that easy to get from here to there. Recorded covenants make it difficult to do. Cities are desperate for general fund revenues. Partnerships with the other occupants may be required.

GAST: Mixed use is attractive to the retailer because it generally allows them to get into more densely populated, under-served urban areas that typically are associated with high land costs — not so much to serve just the limited number of units integrated with them.

I use as an example the Ralphs at Ninth and Flower in downtown L.A. Although there are some 200 units as part of that integrated development, the real opportunity comes from the overall growth and transformation of the area basically from office to residential and retail. You're seeing the same type of projects in Seattle, South of Market in San Francisco with Whole Foods and Safeway, and San Diego's greater downtown area — the new Albertson's at Market and 14th would be a good example. Will that phenomenon continue? It will, with time, when housing starts expanding again. These areas have been sorely lacking significant retail for many years.

SANDS: Wherever you have high-end residential with limited retail, the retail is a pot of gold. Pacific Palisades, or Montana Avenue in Santa Monica, now there is an abundance of vacancies, but those are good areas with affluent consumers and not a lot of places to shop. You think that would be the case with Palos Verdes but it doesn't seem to work.

KYSER: They really struggle.

GAST: That's why I don't think that concept is ready for Orange County yet. There's just too much sprawl and too many areas available for expansion, redevelopment and new growth.

SANDS: That's the trouble. That's what's wrong with Phoenix, Scottsdale and Las Vegas. They just keep building.

GAST: Why compromise your prototype when you can do your conventional format in a more traditional, suburban neighborhood shopping center and get an equal or better return on your investment?

FINKELSTEIN: With the bottom dropping out of per-door prices for condos, land that would be good for retail, but got priced out may well end up with retail uses again. They may end up being transitional uses until 20 years from now. They may get developed with mixed-use projects.

CREJ: What are some strategic recommendations you can make for retaining value in retail properties today?

SANDS: Any business, whether it's real estate or retail, has to reinvent itself at least every five to seven years. Look at your property and say, "Do we need a new façade? What kind of tenant would revitalize this?" We always go to the people.

CZOPEK: If you wait five to seven years to reinvent yourself, you're out of business. It has to be constant, on a continuous basis.

FINKELSTEIN: There was a German company that had the idea that their store had a lifespan of 18 months. No matter how well it did, 18 months later they were going to close that prototype and build something completely different, just to keep it fresh.

SANDS: Capital improvements are going to take them down.

KYSER: Watch the cleanliness, what's going on with the crowds, security …

Final Thoughts

CREJ: Where do you see the best opportunities in retail real estate today?

GAST: There will be a lot more product available in the next year or two especially for those fortunate enough to survive and who are looking to grow their business. For a lot of retailers, the opportunity is going to be in waiting for the weak to fall by the wayside, to reevaluate where the best market opportunities are and to seize those opportunities that will offer the greatest upside potential in business and real estate value over time. Expect retailers to continue to take advantage of the weak economy and undervalued assets and be aggressive in approaching new opportunities and renegotiating existing terms. Also, more flexibility may follow with physical prototype criteria in order to procure in-fill locations that historically have been difficult areas to penetrate.

KYSER: The next two years are going to be very, very difficult in retail. This will present opportunities. There will be poorer-performing malls and you may see somebody come up with bright new ideas — the next Forever 21.

CZOPEK: We see the next two years as a great opportunity. We are being offered locations that weren't available to us two years ago.

As a credit tenant, we're just what the doctor ordered for some of these small property owners. It allows them to keep their property. We're going to leverage that. We're going to pay prices that make sense for us, based on our business model. Sometimes it's difficult medicine. It can make for hard conversations. But a lot more people will say yes.

SANDS: There's no alternative. There is a time to buy and a time to sell. We were selling things in 2006. I couldn't understand the cap rates we were getting, but we didn't complain. Now, 2009, 2010 — this is a time to buy. We're buying malls — 300,000 to a million square feet — from operators that don't own other malls. We're being very selective.

Cap rates will expand further, but you can't pick the bottom of the market. If it's a good enough deal, it will make sense, and we buy on cap rates on existing income. We don't pay for a vacant space.

It's tough getting financing today. It's back to the old days of seller financing, but that's where we see opportunity.

FINKELSTEIN: From the retailer's side, this is an ideal opportunity to upgrade locations, penetrate difficult markets that would not otherwise be available, consolidate to the best locations and, like the car dealerships, eliminate the poor locations and the cannibalization they're causing to your good locations.

CREJ: The retail marketplace has been pretty dark this past year, but it's clear that the opportunity is out there for the real estate industry to do some very creative work and perhaps create out-of-the-box retail projects that help redefine the next wave of growth for the industry.

Thank you very much for your time.

Sponsor Biographies

ALEX CZOPEK

Alex Czopek is the southwest division real estate manager for **7-ELEVEN INC.** Czopek is responsible for new store development for 7-Eleven in Southern California along with a portfolio of 850 existing retail properties (and surplus). His duties also include entitlements (ABC licenses and permits) for new store projects.

Czopek joined 7-Eleven in early 2008. His prior experience includes national real estate manager for PPG Industries, national real estate manager for True Value Hardware Inc. and western/Canadian real estate manager for General Electric (Penske Truck Leasing).

Czopek has served on the boards of retailers and industry research groups, including the HIRI.

HENRY D. FINKELSTEIN

Henry D. Finkelstein is a partner with **GREENBERG GLUSKER**. He has more than 20 years of experience in real estate and business transactions. He has represented developers, investors, lenders and end-users. He also has acted as outside counsel to the Los Angeles Coliseum Commission.

Matters Finkelstein has handled include development, joint ventures, financing, leasing and sales of office buildings, hotels, industrial buildings, apartments and a wide range of retail projects. He has expertise in the acquisition, entitlements, leasing and pad sales of shopping centers on behalf of developers and anchor tenants. These engagements include the acquisition and development, or build-to-suit leasing, of approximately 10 million square feet of space on behalf of a major retailer.

Finkelstein's engagements have ranged from center city redevelopment to the repositioning of early suburban shopping centers to green fields. He has a affinity for both complex financial transactions and working with other stakeholders in the development process.

TOM GAST

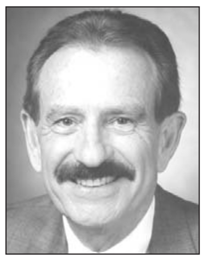
Tom Gast is a principal of **GAST RETAIL GROUP** located in Tustin, specializing in retail brokerage and consulting services for property owners, retailers and supermarket operators. Other areas his firm handles include dispositions, investment sales, retail development and project management.

Prior to joining Gast Retail Group, Gast was president of De Rito Partners West Inc. where he was responsible for all new development and acquisition activities in California and Nevada. He was formerly senior vice president of real estate for Ralphs Grocery Co.

Gast was responsible for overseeing new and existing store development for Ralphs supermarkets and Food 4 Less stores in California and Nevada, including property management and surplus property dispositions, as well as supporting backside warehousing and distribution facilities for both supermarkets. He has more than 30 years of retail experience, 24 of which were in real estate.

JACK KYSER

Jack Kyser is the senior vice president and chief economist of the **LOS ANGELES COUNTY ECONOMIC DEVELOPMENT CORP**. He is responsible for interpreting and forecasting economic trends in the five-county Los Angeles area and for analyzing the major industries of the region. Utilizing this information, he helps develop job-retention and job-creation strategies for Los Angeles County. Kyser's advice is frequently sought by business, government and the media.



Kyser's analytical research work and knowledge of the regional economy has helped to elevate the LAEDC to recognition as the preeminent source of economic information and forecasts on Southern California.

FRED C. SANDS

Fred C. Sands is the chairman of **VINTAGE REAL ESTATE**, which acquires and redevelops underperforming regional malls and large shopping centers. He is also the chairman of Vintage Fund Management LLC, a private equity fund that invests in growth companies.

Sands is the former chairman and sole shareholder of the second-largest real estate and financial services company in California, including owned and operated entities in title insurance, home warranty, mortgage banking and escrow. The essentially debt-free company was sold to Coldwell Banker in December 2000.

Sands was honored as the recipient of the American Academy of Achievement Award.