The Allure of the Shopping Center

Distressed retail assets offer opportunities for careful investors

By Gary D. Rappaport

Anyone watching the financial markets during the past year would know that high interest rates are slowing the economy and putting the squeeze on many commercial real estate owners, who are struggling to repay their mortgages. Some owners with adjustable-rate mortgages or maturing loans are dealing with reduced cash flows and other issues.

These factors may force them to unload their properties at bargain prices in the near future if they are unable to restructure their mortgages. While these circumstances have proven difficult for some property owners, they have also provided opportunities for investors who have the capital and the expertise to buy distressed properties.

The question for commercial mortgage brokers whose clients want to buy real estate then becomes, which of these distressed property types is the most favorable to their needs? One category not to be overlooked is retail — specifically, open-air community and neighborhood shopping centers.

Resilient properties

Shopping centers that are anchored by grocery stores or big-box retailers, such as The Home Depot, were quite resilient during the COVID-19 pandemic and continue to be strong real estate investments. In recent years, in fact, restaurant and retail chains that traditionally stayed in urban markets have suffered from diminishing foot traffic in the urban core due to office workers embracing remote work. As a result, they have been drawn to the well-located, suburban shopping center for greater access to consumers.

Not all centers are flourishing. When one of these properties is considered distressed, it is typically due to one of the anchor tenants going dark or because high interest rates are preventing the owner from servicing the debt. And not every distressed property is equal. Experienced investors often prefer to buy a shopping center with characteristics that the new owner can enhance.

One important characteristic, naturally, is location. Acquiring an existing retail property on a busy thoroughfare allows the new owner to focus on ways to create added value through renovation or expansion. Another technique is remerchandising, which involves the landlord rethinking the shopping center to bring in the most popular retail uses to fill vacancies and replace tenants as leases expire. This may include leasing to health care storefront providers, educational uses and even fast casual restaurant concepts.

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Prospective buyers often seek short-term loans from regional banks to cover the costs of acquisition and renovation. Within a year or two, they'll typically seek permanent financing from a CMBS source or an institutional lender, a trend to watch today as interest rates return to more reasonable levels in the second half of 2024 or in 2025.

Getting started

Before a buyer invests in an existing retail center, it is important to know every aspect of the property and analyze how best to enhance the project to increase value. One of the first factors to consider is how to raise the equity needed to buy the asset.

The best place to start is with the potential owner's circle of friends, family members and other high net worth individuals in their local community. The buyer can sell this group of investors an equity stake in the new venture. This way, the partners can share the profits of the acquisition and benefit from joint ownership.

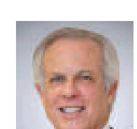
Another challenge to overcome is raising the debt capital. A mortgage broker can help the potential buyer understand all the nuances relating to the availability of capital, the interest rate environment for the type of acquisition and how to structure the loan.

It's also crucial to know the market in question. Brokers should advise borrowers to invest in properties near where they and their business partners live. This way, the owners can easily visit and assess the performance of both the property and individual stores.

Know the property

Three aspects of a property that potential owners need to pay attention to include the site's layout, location and accessibility. How a shopping center is laid out — including which side of the road it's on, and how easy it is to enter and exit — make a major difference. Shopping centers that run parallel rather than perpendicular to a main road are much more viable in attracting shoppers. They offer tenants more visibility to potential customers driving by.

Continued on Page 52 ▶



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◀ Allure continued from Page 50

Also, it's usually best to be on what's sometimes referred to as the "going-home" side of the road. Many people like to shop after work and prefer to take a right turn into a shopping center, rather than a left turn against traffic. Of course, other businesses, such as Starbucks or Dunkin', fare better on the "going-to-work" side of the road since they offer what morning commuters crave.

The size of the project is another key factor. Potential owners and their investor partners won't have an endless supply of money, so the size of a shopping center they want to purchase makes a big difference. A general rule is that a retail asset of 10,000 to 50,000 square feet is a good starting point for first-time investors. These are considered strip convenience centers. Novices should stay away from projects of 100,000 square feet or more until they are more established and experienced.

Potential buyers should examine all existing leases. Each tenant in the retail center has a lease, so investors should read and understand these agreements prior to their purchase. Also, read any correspondence in the tenant files that would indicate promises made outside of the lease. If most tenants have relatively long lease terms, or they hold options for renewal at preset, below-market rental rates, there is little owners can do to grow revenue and show added returns to their investors.

Look for growth

Investors should look for properties that offer the potential for improvement and expansion. This might be counterintuitive, but shy away from stable, successful properties. They aren't likely to give the new owners and investors the opportunity to add enough value to provide the investment returns they desire.

Instead, prospective buyers should look for a fixer-upper property that can be upgraded. They might create additional value with new landscaping or signage, repainting or other measures. Also, determine whether the center can be expanded. Increasing the size of the shopping center is one tried-and-true method used to increase cash flow and asset appreciation. An expansion project doesn't have to be big. It can be as simple as adding a fast-food restaurant in the parking lot facing the road.

As with any real estate investors in learning situations, commercial mortgage brokers should caution clients about doing their homework before plunging into a shopping center investment. The retail landscape is changing constantly. To succeed, you must be prepared to change with it. Time does not stand still, not even for a day. ●

KEY POINTS

Factors for shopping center buyers to consider

- Study the market where the property is located.
- Examine the layout of the center to see if it allows for easy access.
- Novice investors should look to acquire smaller properties that are easier to handle.
- Examine all tenant leases and be aware of any written promises that are off lease.