December 2024

ORG Research Thought Piece

Retail Real Estate – Understanding the Changing Shopping Preferences of Americans

Contents

Introduction 3

Understanding the Demographic Picture 3

Demographic-Driven Retail Subsector Opportunities 4

Conclusion 5

ORG Research Team

Stephen Stuckwisch, CFA, CAIA
Principal & Investment Committee Member
SStuckwisch@orgpm.com

Kevin Stone
Vice President
KStone@orgpm.com

Lucas Tiberi
Associate
LTiberi@orgpm.com

Maddie Mittler
Investment Analyst
MMittler@orgpm.com

All ORG Research Thought Pieces can be found on our website at the following link:

https://orgpm.com/news-and-insights.php

Introduction

Throughout the 21st century, retail real estate has undergone significant changes due to the evolution of how consumers purchase goods and investors access the sector. Since the Global Financial Crisis ("GFC"), the retail sector has experienced stress as the period of high unemployment materially impacted consumer spending and the demand for retail space, as well as essentially shutting down the capital markets to fund new transactions. Subsequently, the mid-2010s brought about the rise of e-commerce in retail, which rendered many regional malls obsolete as consumers valued the speed and convenience of e-commerce over the experience of shopping at traditional retail centers.

Most recently, the COVID-19 Pandemic once again hurt the retail real estate sector as government mandated lockdowns prevented many Americans from leaving their homes through mid-2020. The habits of remote work and education meant that less consumers left their homes and further accelerated the demand for e-commerce services to deliver goods directly to the home.

Despite the adversity that the sector has experienced, ORG believes that there are segments within the retail sector that have proven to be resilient and continue to grow in popularity. This will be the first of a two-part series that outlines ORG's thesis on the open-air retail sector. In this paper, ORG will explore the fundamental demographic and consumption-based trends that have led us to develop a favorable position on open-air retail real estate as an investment theme.

Understanding the Demographic Picture

ORG believes that much of the future growth in retail real estate will be tied to the ability to cater to the Millennial generation and Generation Z ("Gen Z"). Millennials, born between 1981 and 1996, and Gen Zs, born between 1997 and 2012, currently make up approximately 63% of the prime working age population, defined as individuals aged 25 to 54 years old. Over the next decade, this will increase to nearly 97% as only the tail end of Generation X workers (those born between 1965 and 1980) will remain in their prime years. Not only will the amount of purchasing power for Gen Z and Millennials increase significantly as they continue to reach prime earning years in the workforce, they are also likely to inherit massive amounts of purchasing power as a result of the wealth transfer from the Baby Boomer generation (those born between 1946 and 1964), which were estimated to hold 52% of the total wealth in the United States as of 1Q 2024[1].

The discretionary purchasing habits of these younger generations have changed due to the wide adoption of e-commerce, which was further accelerated during the COVID-19 Pandemic. Many young consumers have developed the habit of ordering goods and services from smartphone apps with social media becoming the main source of product discovery for Millennials and Gen Z[2]. This trend has led to a shake out of retail assets into three main groups: 1.) assets which continue to have high shopper volume, 2.) assets which serve as hybrid stores and fulfillment centers and 3.) those that have been significantly disrupted by e-commerce and need to be re-imagined. ORG believes that open-air retail centers with the right tenant mix will be able to satisfy the needs of retailers who are looking for space with high foot traffic and the ability to fulfill sales that are converted online.

---

1 August 26, 2024, "Wealth distribution in the United States from the first quarter of 1990 to the first quarter of 2024, by generation," Statista, https://www.statista.com/statistics/1376622/wealth-distribution-for-the-us-generation/
2 2024, "Consumer Trends Report Exploring what makes buyers click, tap and buy.," HubSpot and Glimpse

In order to be viable in a world that is dominated by working Millennials and Gen Zs, retail assets should possess the following two characteristics. The first is that the shopping experience should be convenient and enjoyable. This will require assets to be in strong locations such as walkable neighborhoods, near high amounts of working age individuals and situated in live-work-play environments that attract active consumers. These assets should also be inviting, not only in physical appearance, but in layout and tenant selection and should cater to the needs and desires of young professionals. Secondly, retail assets and their tenants need to provide a strong value proposition to their customers that entices them to venture out of their homes. Some of the most successful retail companies since 2020 have been those who are able to make young consumers feel that they are getting excellent value with the money they spend. Providing such value has become increasingly important as inflation over the past four years has diminished the purchasing power of consumers. Many suburban open-air retail centers have the ability to embody both of these characteristics as their tenants are able to provide value to their consumer base and are located in environments that provide an enjoyable and convenient shopping experience for young families and professionals.

Demographic-Driven Retail Subsector Opportunities

The NCREIF Property Index ("NPI") defines and tracks the following subsectors as part of the retail index.

Subsector	Size	Description
Neighborhood Center	30,000 to 150,000 square feet	Sale of daily living needs to the immediate area, typically anchored by one tenant.
Community Center	100,000 to 350,000 square feet	Convienience goods and some apparel and furniture anchored by one to two tenants.
Regional Mall	400,000 to 800,000 square feet	Variety of goods including general merchandise, apparel, home furnishings, services and recreational activities.
Super Regional Mall	800,000 or more square feet	Extensive variety of goods with three or more full line department stores.
Fashion/Specialty Center	80,000 to 250 000 square feet	Mainly consistent of high-end fashion tenants with no dominant anchors.
Power Center	250,000 to 600,000 square feet	Centers with three or more tenantsthat occupy 75% to 90% of the total area. Tenants are typically home improvement, discount department stores, warehouse clubs and off price stores.
Single-Tenant Retail	N/A	Freestanding structure with no anchor stores. Tenants can consist of restaurants or drugstores.

Source: NCREIF Property Index Detail Report

Today, the strongest performing subsector has been the power center sector, producing a 4.11% total return for the year ending 3Q 2024, as well as the highest income return out of all retail subtypes of 6.04%[3] (compared with the broader NPI producing a -3.47% total return and 4.72% income return for the year ended 3Q 2024). This reflects the popularity of many big box stores which have made a resurgence due to their value propositions for their consumers both in the beauty and apparel and grocery sectors. Club grocery retailers such as Costco and Sam's Club, as well as beauty and apparel retailers such as TJ Maxx, Ulta Beauty, Marshalls, HomeGoods and Ross, have been areas of particular interest for Millennial and

3 July 25, 2024,"2Q2024 NCREIF Property Index – Quarterly Detail Report," NCREIF

Gen Z shoppers[4]. ORG believes that retail assets with these types of tenants could continue to perform well due to their ability to provide value to Millennial and Gen Z consumers as well as their demonstrated resilience against e-commerce competition. Power centers have also been increasingly acting as fulfillment centers for grocery and for non-grocery related retail sales made online or via cell phone applications[5].

The community and neighborhood center subsectors have also generated strong total returns of 3.42% and 2.13%, and strong income returns of 5.68% and 5.39%, respectively, for the year ended 3Q 2024[6] (compared with the broader NPI producing a -3.47% total return and 4.72% income return for the year ended 3Q 2024). These centers have experienced strong performance likely due to their central location making them easy to commute to from suburban homes, apartments and offices. Community and neighborhood centers, especially those which are either unanchored or grocery anchored and positioned to act as the hub of a live-work-play environment, appear to be attractive areas of investment for the future. They could continue to have resilience against e-commerce due to their proximity to rental housing units and tenant mix which can often consist of food service retail and entertainment venues or bars. Additionally, the co-location of synergistic tenants can make the in-person shopping experience feel more enjoyable and productive for younger shoppers.

Open-air centers not only appeal to retail tenants because of high foot traffic and positioning to satisfy the shopping habits of the younger generations, they also have structurally lower common area maintenance charges ("CAM"). Unlike enclosed malls, open-air retail centers require less capital expenditure to maintain, which leads to lower charge backs to tenants through CAM and improves the tenants' bottom line. For landlords, the current environment is far more conducive for re-leasing space if a tenant were to leave. In many cases, new tenant leases are showing to be of higher credit than the prior tenants with investment grade companies replacing locally run stores[7] and big box occupiers such as Bed, Bath & Beyond that are struggling with obsolescence and/or bankruptcy[8].

Conclusion

Despite the challenges posed by e-commerce, many retail asset types have performed well due to the strength of retail tenants and steady foot traffic. ORG believes that open-air retail centers, including power centers, neighborhood centers and community centers offering convenience and value to Millennial and Gen Z consumers will be particularly well-positioned for the future. As the tenants of these open-air centers continuing to appeal to the preferences of younger consumers, they will be the beneficiaries of the increasing buying power of Millennials and Gen Zs generated from both their prime working years and transfers of wealth. Additionally, younger Americans enjoy utilizing these centers since they offer consumers with value-oriented goods and can act as fulfillment centers for sales that are converted online. Open-air centers present a value proposition to the retailer, who can access strong locations with lower CAM, and the landlord, who has more optionality in tenant selection due to a healthier

4 Kate King, November 25,2024, "These Bricks-and-Mortar Stores Thrive in an Online World," Wall Street Journal, https://www.wsj.com/business/retail/these-bricks-and-mortar-stores-thrive-in-an-online-world-2d666308

5 Brin Snelling, April 5, 2022, "Why Retailers are Converting Stores Into Fulfillment Centers," Forbes, https://www.forbes.com/sites/brinsnelling/2022/04/04/why-retailers-are-converting-stores-into-fulfillment-centers/

6 July 25, 2024,"2Q2024 NCREIF Property Index – Quarterly Detail Report," NCREIF

7 Kate King, October 21, 2024, "Retail Space is Going Fast and Pushing Out Local Shops," Wall Street Journal, https://www.wsj.com/real-estate/commercial/retail-space-is-going-fast-and-pushing-out-local-shops-1b83b867

8 Mark Gilman, April 27, 2024, "Retail Space Is At A Premium, And A Slew of Companies Are Lining Up To Take Bed Bath & Beyond's Soon-To-Be Vacant Locations," Bezinga, https://www.benzinga.com/real-estate/23/04/31996284/retail-space-is-at-a-premium-and-a-slew-of-companies-are-lining-up-to-take-bed-bath-beyonds-soon-to demand environment from higher quality tenants. ORG believes that investors must carefully consider the supply and demand dynamics of retail space and recognize that not all retail sectors are alike. In a future thought piece, ORG will explore additional factors and trends that make certain areas of the retail sector attractive including acquisition cap rates, income returns, occupancy, absorption and supply.