The State Of California Retail Amidst The Lingering Pandemic

The pandemic has accelerated trends that were already afoot in retail real estate. Here's how those are playing out in California.

Elliot M. Shirwo

COVID-19 remains a humanitarian challenge that will have lasting effects on how people live, work, and play.

While the pandemic has presented, and continues to present, unique challenges for all real estate asset classes, the headwinds were and continue to be much more pronounced for some. Retail and hospitality — two sectors especially reliant on in-person experiences — were most adversely affected during the pandemic and, in certain ways, during the continued recovery.

Retail vacancy has climbed sharply, as businesses re-evaluated their footprints in response to reducing in-person demand. Many California landlords implemented rent deferral or abatement programs with retail tenants in response to challenging economics; the state government implemented an eviction moratorium; and delinquencies of retail CMBS products increased dramatically.

Despite the challenging environment, the state of retail during the pandemic's recovery portends signs of hope and opportunity, as the sector adapts and many retailers expand into a new, reimagined retail landscape.

PRE-COVID CALIFORNIA RETAIL REAL ESTATE

Even pre-COVID, retail property owners had been responding to the pressure on brick-and-mortar businesses by finding experiential tenants like restaurants, bars, gyms and spas, where consumers' need to visit in-person could provide protection against online competition. But these are exactly the sorts of businesses whose models are most seriously disrupted by the pandemic — and in some cases, such as gyms, consumers are shifting toward at-home versions of these experiences out of necessity, as we have seen with the rise of Peloton. If some of those shifts become permanent, and clearly many will, then some experiential retail businesses will turn out to have been more exposed to online competition than they thought.

During the peak of the pandemic, the outlook seemed diciest for retail real estate. Retail landlords reported the highest rates at which their tenants failed to pay rent, with nearly half of retail rents going unpaid, as tenants faced dire financial straits. Landlords have little recourse when tenants don't pay — can they evict a restaurateur and find a new tenant to sign a lease for the space in this economy?

Since the shift toward online retail already had been reducing demand for physical retail space, the coronavirus crisis turned this gradual decline into a steep drop: Many department stores that might have closed gradually over the next decade already have closed, which, in turn, have reduced foot traffic at the malls they anchor, casting deep shadows on the stores that do reopen.

Overall, the level of new retail property construction is expected to decline significantly through 2023. Some existing space, lacking sufficient demand, will be converted to other uses. In a recent survey conducted by Allen Matkins and UCLA Anderson, 62 percent of commercial real estate respondents indicated that they will not develop any new properties in the coming 12 months.

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The current COVID-induced recession has tripled down on the struggles retail already faced during the previous economic downturn. First, household loss of income and shelter-in-place policies continue to lower demand for brick-and-mortar retail. Second, the inability to physically frequent many retail establishments continues to create a new set of online shoppers. Third, increases in the savings rates on the part of households in response to the recession has further aggravated and continues to foster less consumption. To be sure, some activities will return, particularly personal services and experiential retail. However, marginal properties will not find tenants willing to pay sufficient rent to keep the properties in the retail space. This reality has resonated with some malls that are closing or downsizing as they never evolved well enough and there are just too many.

POST COVID

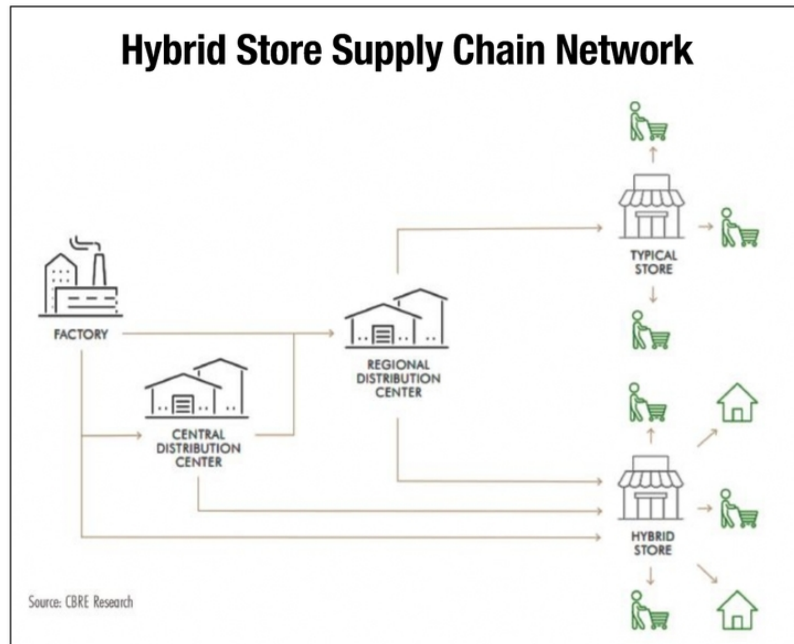
The COVID-19 experience could permanently change habits that may affect demand for other real estate assets, such as hospitality properties and short-term leases. Even a short

moratorium on business travel could have lasting impact when alternatives such as video conferences prove sufficient or even preferable. Near-shoring of supply chains may further reduce demand for cross-border business travel, and consumers who are afraid of traveling overseas may shift leisure travel to local destinations.

Consumers forced to shop online because of closed malls and shuttered shopping centers may permanently adjust their buying habits for certain categories toward e-commerce. This long-term trend may accelerate even faster after the crisis — especially as many previously struggling brands are tipped over the edge into bankruptcy or forced to radically reduce their footprints. Early evidence from China shows some staying power in the coronavirus-driven shift to e-commerce. Within certain product categories where supermarkets or mainstream retailers competed with online retailers, substantial market share could transfer to online players. The shift to e-commerce may also further boost already high demand for industrial space.

The most glaring distress is in the $529 billion market for bonds backed by commercial real estate loans. The delinquency rate about mid-year 2021 on commercial mortgage-backed securities (CMBS) was 20 percent for hotels and 14 percent for retail, according to Trepp. Those obligations will become more difficult to repay as they fall further behind.

Northern California's leasing volume fared better in the suburbs compared to core central business areas, which have been hit hard with loss of foot traffic during stay-in-place orders. Overall retail leasing volume in the region has picked up since early September 2020 but will likely remain challenging well into 2021 as various regions around Northern California slowly reopen. Year-over-year total availability in Northern California increased 43 basis points at the end of the 2020 third quarter. As to be expected, overall vacancy also grew, which translated into nearly 183,000 square feet of negative net absorption across Northern California. The Peninsula market accounted for 62 percent of the negative net absorption during the third quarter, posting more than 113,000 square feet of negative net absorption. Overall rents for the region softened to $24.35 per square foot. As the pandemic continues, there will be more retailers shuttering, especially in urban locations around the region. As well, rents will continue to continue to soften, with tenants looking for concessions such as free rent or short-term leases.



At the same time, necessity based tenants, such as grocers, pharmacies, dollar stores, auto parts sellers, and farm suppliers, will continue to have a secure place in an ever-evolving retail market where consumers require physical proximity to such essential retail providers. Evidence of this continued development is the expansion of dollar stores and discount grocery stores.

Retail's reinvention in Southern California predates COVID-19, but the pandemic has magnified the importance of adapting the region's retail footprint to meet changing consumer demand. With the Delta variant accelerating, it now appears as if the sector will continue to be buffeted by social distancing and mask regulations, both volunteered and mandated. CBRE anticipates that the eventual path forward will be one in which retailers embrace hybrid spaces. For properties that are underperforming, a wave of conversions is likely to materialize.

The surge in adoption of e-commerce has fundamentally, and perhaps permanently, changed the role of brick-and-mortar stores for consumers. Increasingly, retailers are embracing the omnichannel in which the physical store is only one of many channels for reaching the customer. Indeed, brick-and-mortar retailers with a strong omnichannel presence have benefited the most during the pandemic. Examples include Best Buy and Target, the latter of which reported a 242 percent uptick in online ordering year-over-year. As regional retail evolves in the coming years, stores are also going to become an increasingly dynamic node in the supply chain network. The embrace of distribution approaches such as buy online pick-up in store (BOPIS) has reinforced the store as the element of the supply chain that is frequently closest to the end consumer. As a result, the line between logistics and retail will become increasingly blurred as hybrid stores emerge with dual functionality.

Even before the pandemic, in response to the shifting retail landscape, regional landowners were pursuing adaptive reuse strategies. These projects ranged from full-scale redevelopment of retail properties to creative reuses of existing structures for non-traditional tenants such as industrial users.

The disruption by the pandemic has been a catalyst for the accelerated adaptive reuse of regional retail space, and this is certain to continue in the second half 2021 and beyond. The advantages to upcycling recently vacated retail space are numerous — chief among them is the opportunity to create desperately sought-after space in high-density submarkets. There are 55 malls with more than 500,000 square feet in the Greater Los Angeles/Orange County/Inland Empire region, with an average of 167,000 people living within a 3-mile radius of each site — putting potential last-mile fulfilment centers within striking distance of major population centers.

Of particular interest in the coming years are retail-to-industrial conversions. With a small number of these projects completed, this mode of reuse is especially attractive for retailers that are looking to solve distribution challenges with their existing footprints. CBRE Research has identified 59 retail-to-industrial conversions that have been proposed, broken ground, or have been completed since 2017 in the U.S., including two projects in Southern California.

Retailers are also seeing a broader and changing mix of tenants pursuing space. In particular, the medical sector has embraced retail sites as a means to bring the provision of care directly into communities. The proliferation of ambulatory care facilities in traditional retail complexes represents another example that is foundational to the growth strategy for most regional health care providers. These tenants are likely to become more even commonplace as the pandemic has reinforced the need for decentralized healthcare services.

RETAIL MARKET OUTLOOK

The state of retail in California continues to evolve through the cycles of the economy, global anomalies like the pandemic, and the advancement of human innovation and imagination.

The following variables will continue to challenge the retail real estate sector in the near term:

While consumer spending has rebounded, sales in retail segments reliant on in-person experiences (namely apparel stores and food & beverage) remain well-below pre-COVID levels.

Vacancy rates are forecast to rise sharply through 2021, reaching levels slightly above the peaks sustained in the Great Recession. Correspondingly, rents are projected to decrease sharply, returning to levels seen earlier in the decade.

At the same time, there is great hope

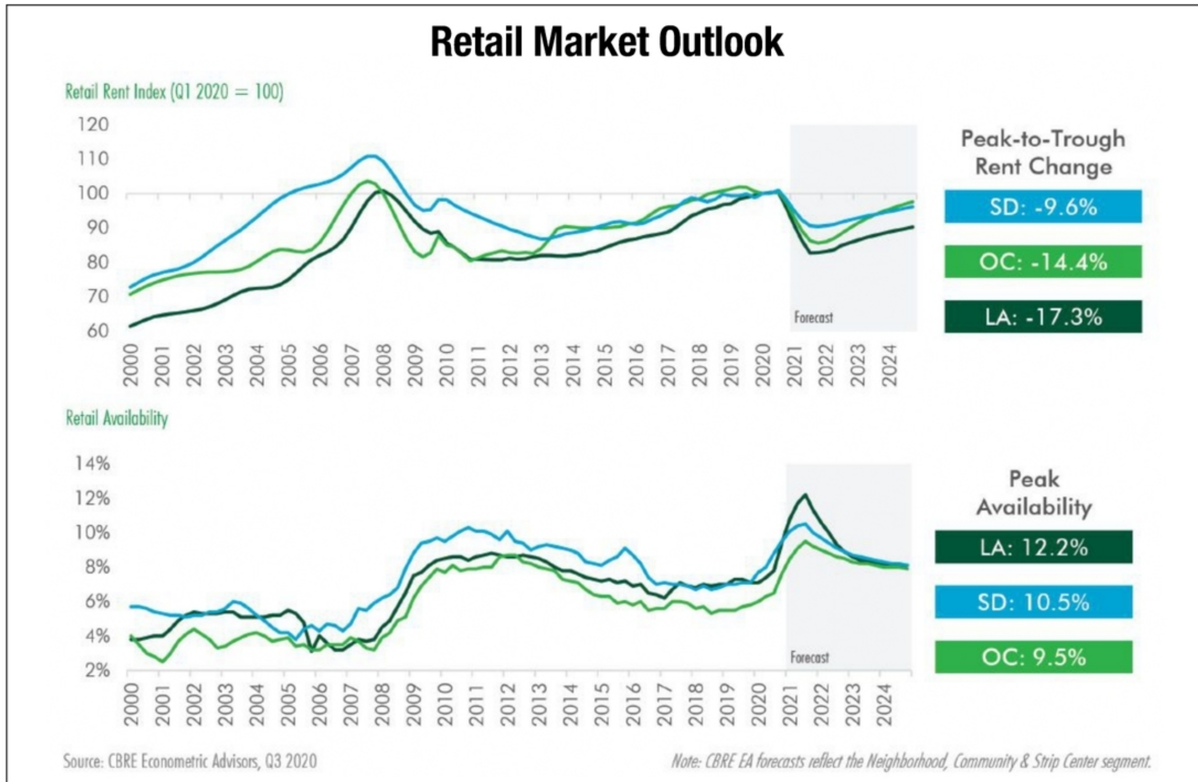
Retail to Industry Conversions

- Former 584,000 sq. ft. "Westside Pavilion" regional mall in Los Angeles.
- $360 million renovation into creative office space.
- Leased entirely to a prominent tech company. 14-year lease.
- Due to complete renovations by 2022.

- Former 108,000 sq. ft. free-standing big box retail space in Stanton.
- In use by former retail tenant but converted into warehouse distribution center for company's e-commerce fulfillment.

- Former "IKEA" and "Office Max" buildings in Burbank.
- $350 million dollar renovation into multifamily/retail mixed-use property.
- 1,000 housing units and over 200 hotel rooms.
- Due to complete renovations by end of 2020.

Source: CBRE Research



that the human spirit will overcome the challenges we have experienced. We have seen this hope breathe new life in our state of retail with the widespread adoption of vaccines, causing a rapid bounce-back of commercial activity, including with the full re-opening of restaurants in 2021; the expansion of essential-based retailers in a market that requires both a brick-and-mortar and online presence; retailers' discovery how their local stores can act as hub-and-spoke for distribution; and adaptive, re-use transformations of vacant, retail spaces into reimagined, operating businesses that meet the daily needs of consumers, such as urgent care centers.

Landlords in collaborations with their tenants who provide the most value to the local consumer will continue to survive and thrive in the unprecedented new state of retail in California. **SCB**

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