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Hidden value in U.S. open-air shopping centers

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At this stage in the cycle, with an abundance of capital chasing a limited number of properties, where do investors of open-air shopping centers[1] uncover value?

General sentiment holds that the most expensive gateway markets have become richly priced.

Does the data support such sentiment, and if so, should investors stay the course? Or do better opportunities lie elsewhere?

1) Open-air shopping center data includes the sale of anchored, unanchored, and power centers and portfolios of $2.5 million and greater, and was obtained from Real Capital Analytics.

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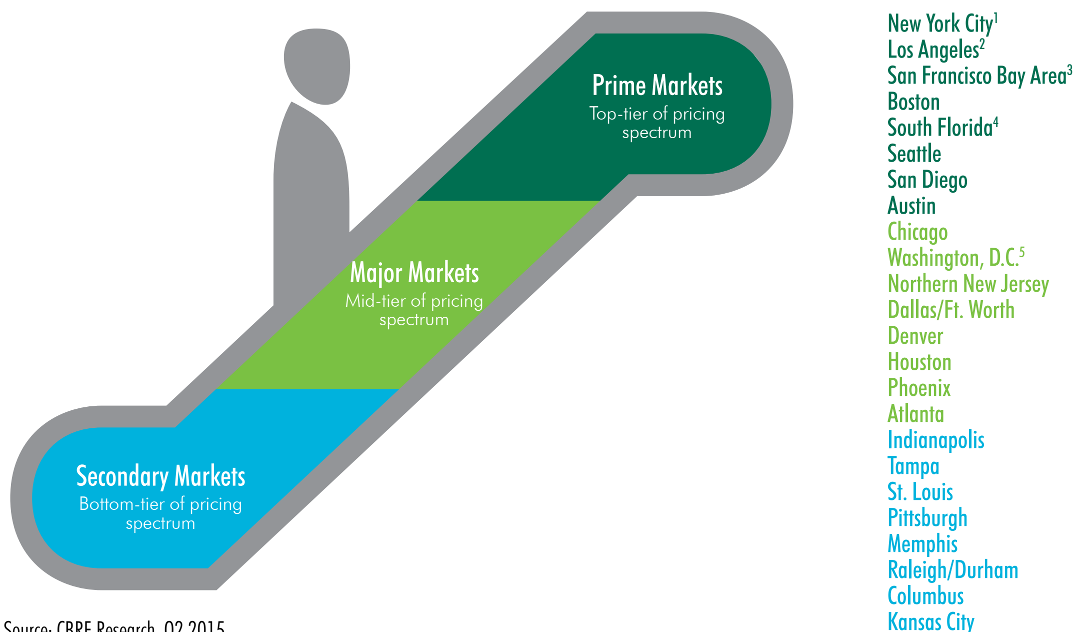
This report reveals significant, relative value exists in open-air shopping centers in major markets within the middle of the pricing spectrum. In markets such as Dallas/Ft. Worth, Northern Virginia and Phoenix, open-air shopping centers have scarcely been cheaper relative to the nation's priciest markets such as New York and San Francisco. Indeed our analysis discovered the most expensive open-air shopping center markets are richly priced. Furthermore, our analysis shows mid-priced major markets offer relative value even against secondary, lower-priced markets.

This paper examines three tiers of open-air shopping center markets categorized by their average cap rate in 2014: a high-priced tier of "Prime" markets, a mid-priced tier of "Major" markets, and a low-priced tier of "Secondary" markets. These markets—partially selected for their geographical diversity—are located within the top 50 U.S. metro areas in population.

In order to discover what value lies among these pricing tiers, we compared not only cap rate levels[2], but cap rate spreads between each tier. We also examined pricing by deal size: over and under $20 million. Finally, we evaluated two important drivers behind the pricing differentials: liquidity and the outlook for fundamentals. More often than not, no matter how many ways a tier was analyzed, our conclusion remained the same: value today in open-air shopping centers is found in mid-priced "Major" markets.

Figure 1: Open-air Shopping Center Market Tiers



Source: CBRE Research, Q2 2015.

Figure Note: 1) Includes Westchester County and Long Island. 2) Includes Orange County. 3) Includes San Francisco, Oakland, and San Jose metro areas. 4) Includes Miami, Fort Lauderdale, and Palm Beach. 5) Includes Northern Virginia and Suburban Maryland.

2) A six-quarter moving average of each tier's cap rate was used.

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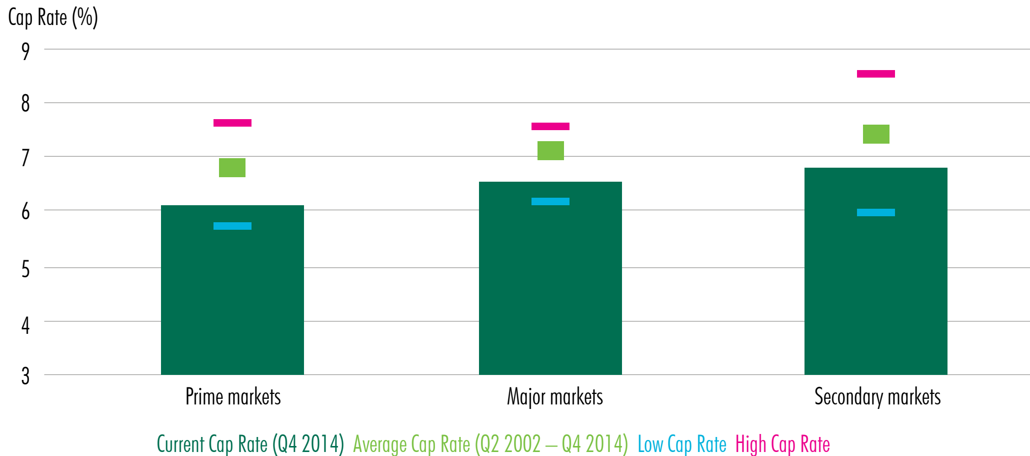
CAP RATE LEVELS

Cap rates for open-air shopping centers are low by historical standards, regardless of the tier of pricing (for properties over $20 million). However, cap rates in prime markets appear to have fallen further below their long-term average, compared to other market tiers. The average cap rate for our sample set of the nation's most expensive, prime open-air shopping center markets was 6.1% in Q4 2014, not far above the record-low of 5.8% reached in Q4 2007.

Major markets, on the other hand, stood approximately 50 basis points (bps) higher than prime markets at the end of 2014, averaging 6.6%. This level compares to a record-low of 6.2% reached in 2007. Meanwhile, the nation's lower-priced, secondary open-air shopping center markets had an average cap rate of 6.8% in Q4 2014. Perhaps indicative of the widening recovery and greater comfort on the part of investors, cap rates for secondary markets dropped significantly over the past five quarters.

Figure 2: Open-air Shopping Center Cap Rates (Q2 2002 – Q4 2014) Transactions over $20 million



Source: Real Capital Analytics, CBRE Research, Q1 2015.

Cap rates for each market tier currently hover well below their long-term averages from Q2 2002 to Q4 2014. Nonetheless, cap rates of major markets have deviated the least, currently measuring 0.8 standard deviation below their long-term average. In contrast, prime market cap rates are 0.9 standard deviation below their long-term average. Our data shows the average cap rate for secondary markets are only 0.6 standard deviation below their long-term average, but attribute this small deviation to a lack of data available between Q2 2008 and Q2 2010, when cap rates were likely their highest.

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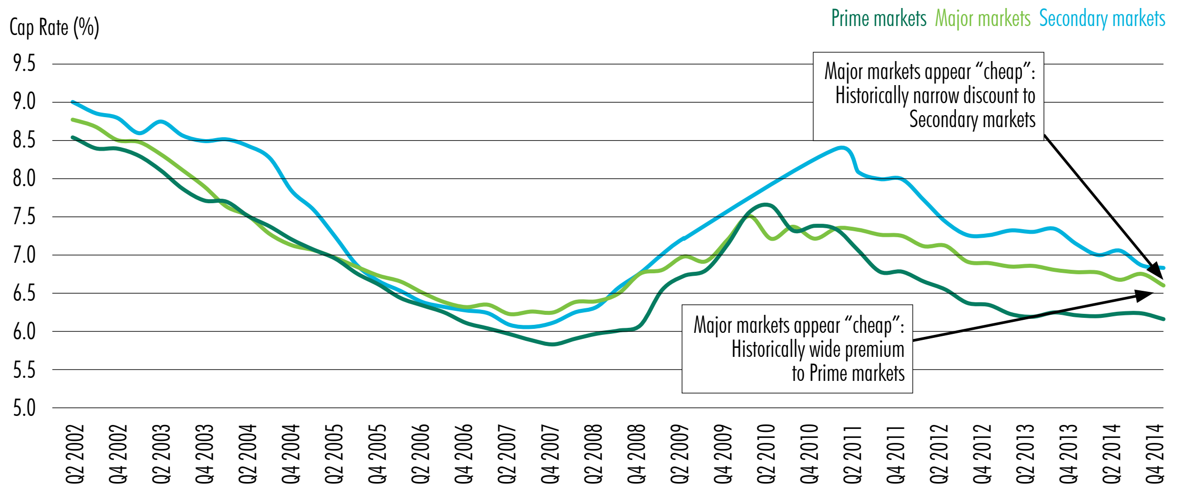
CAP RATE SPREADS

The most intriguing data that uncovers value between market tiers comes from an analysis of spreads between cap rates (for properties over $20 million). In particular, the current spread between cap rates in major and prime markets has rarely been as high as it stands now. As such, investors in major markets are being unusually well-compensated relative to investors in the nation's prime markets. The Q4 2014 spread premium offered by major markets against prime markets was 44 bps, compared to the long-term average of 26 bps.

Figure 3: Cap Rate Trends among Market Tiers
Transaction of Properties $20 million and above



Source: Real Capital Analytics, Q1 2015.

The current wide spread between major and prime markets is all the more remarkable since little, if any, premium existed prior to 2006. Indeed, the only instance a measurable spread between these market tiers developed was as commercial real estate markets unraveled entering the last recession. Considering the heightened uncertainty plaguing markets in 2008, we might assert such a spread had been warranted. However, the existence of a similarly wide spread against today's favorable economic outlook appears particularly attractive.

At the same time, major markets appear attractively valued against the smaller, secondary markets based upon a historically low spread. At the current 23 bps spread, the premium to invest in secondary markets versus major markets is essentially as low as it has been since the peak of the last cycle. In short, investors are being compensated for their risk virtually the same in secondary markets as they are in major markets.

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WHAT'S DRIVING THE PRICING DIFFERENTIAL BETWEEN MARKET TIERS?

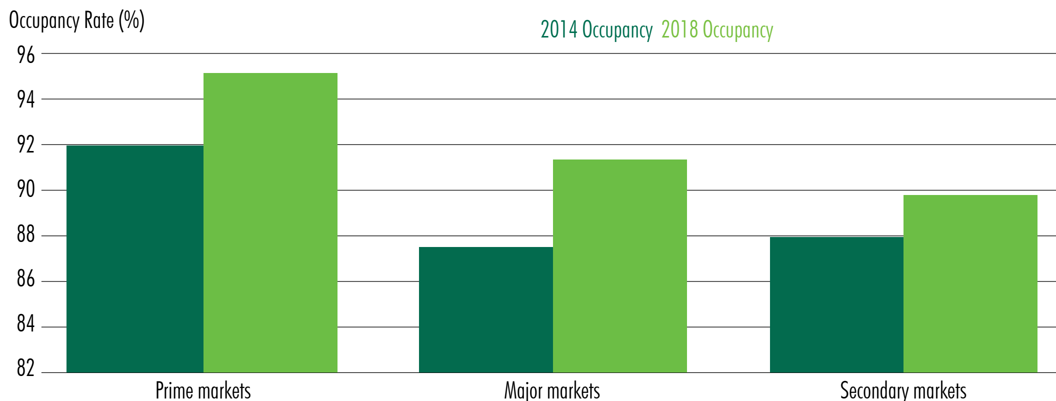
Although two major trends add rationale behind the relatively expensive opportunities for open-air shopping centers in prime markets, these trends also support the relative value in the major markets. One trend is the recent performance in fundamentals and the outlook through 2018. The other trend is liquidity, so often cited as an attractive investment characteristic in the nation's prime markets.

Favorable trends in supply and demand fundamentals help support the rationale for historically low cap rates in prime open-air shopping center markets. Indeed, the average occupancy rate for neighborhood, community and strip centers in prime markets is the highest (92%, 2014) among the three market tiers. Furthermore, the forecast calls for occupancy to increase through 2018 to a level of 95%, an attractive 320 bps jump.

In contrast, the average occupancy rate for neighborhood, community and strip centers in major markets was only 88% in 2014, nearly 400 bps lower than prime markets. This may explain some of the wide premium in cap rates for major markets. However, our analysis also shows both market tiers have experienced similar improving fundamentals; the forecast for the occupancy rate in major markets is projected to grow 380 bps through 2018 to a level of 91%. If the pricing differential between the two market tiers is based upon fundamentals, we would assert the spread remains disproportionately wide after evaluating these trends.

For the secondary markets, the 2014 occupancy rate of 88% was the same as the major markets. However, occupancy in secondary markets is only forecasted to rise to 90% in 2018. In short, supply and demand trends in secondary markets seem to argue for a wider spread than what they are currently being priced, relative to major markets.

Figure 4: Occupancy Rates



Source: CBRE Econometric Advisors, Q1 2015.

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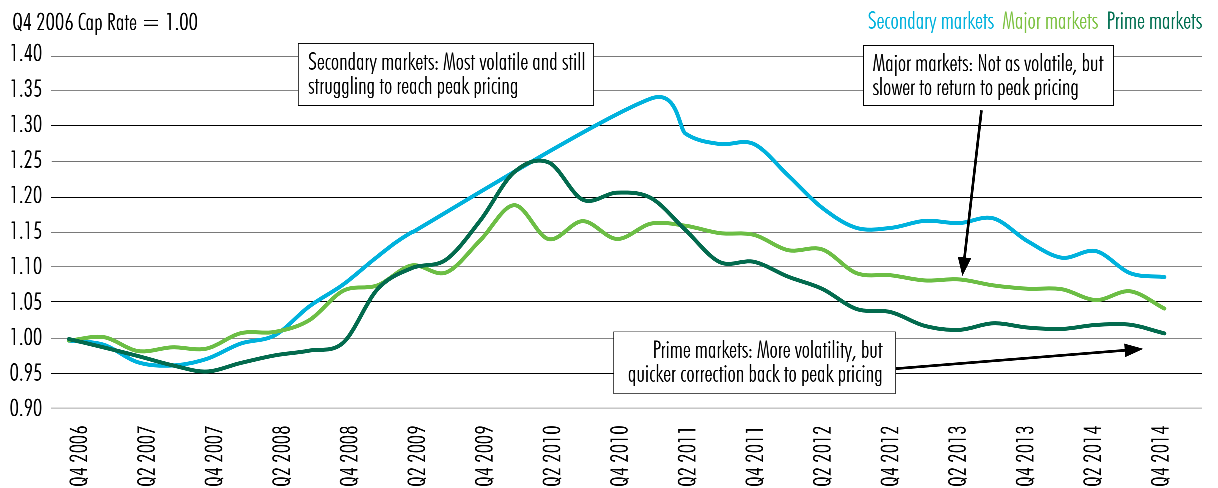
Liquidity is another reason often cited for disproportionately high pricing in prime markets. Analysts frequently use the historic transaction volume of a market as a proxy for liquidity. However, there are two problems with this method. One is that, in this analysis, our prime and major markets have nearly identical transaction volumes and activity. As such, do we assume liquidity is the same in these market tiers? Two, we assert a market's liquidity might be better understood by how steep a reduction in price a seller may have to accept if it becomes necessary to sell, rather than solely the number of buyers.

Figure 5: Cap Rate Trends (Indexed to Q4 2006)



Source: Real Capital Analytics, CBRE Research, Q1 2015.

Based upon this reasoning, if we reference 2006 and 2007 as the years when most investors bought open-air retail shopping centers, we discover that the average cap rate in prime markets during that period was 6.1%. Assuming a "going-in" cap rate at this level, if investors in these prime markets were forced to sell during the market bottom in 2009 to 2010, cap rates would have jumped 120 bps to an average of 7.3%.

In comparison, investors in major markets would have purchased at a "going in" cap rate between 2006 and 2007 at 6.4%. If they were forced to sell in 2009 and 2010, the average cap rate would have increased 80 bps to 7.2%—a much less severe increase in cap rates. Therefore, faced with the same historic transaction levels and activity in prime and major markets, we conclude that an investor in prime open-air shopping center markets would have had to accept a steeper reduction in price at the nadir of the market cycle than an investor in major markets. One could then arguably assert "liquidity" is more favorable in major markets.

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However, if the prime markets investor was able to hold off selling for just a few more years, he or she may have fared much better. By 2013, the average cap rate for prime markets had rebounded to 6.2%. By the end of 2014, the average cap rate in prime markets was 6.1%, likely equaling the investor's original purchase price.

In contrast, though the investor in major markets may have avoided a less severe price cut at the market's bottom, the same investor was experiencing a much more sluggish rebound in pricing. By 2013, the average cap rate had fallen, but only to 6.8%—a fair bit higher than the original cap rate of 6.4% in 2006 and 2007. By the end of 2014, the average cap rate for major markets had fallen slightly more to 6.6%.

So what do the prime markets offer open-air shopping center investors? One answer is more volatility, but if an investor can last through the market bottom, it appears prices adjust more rapidly. On the other hand, though pricing appears to adjust more sluggishly in the major markets, there is less volatility and less probability of suffering as steep a price decline as the prime markets during a market correction. Ultimately, the benefit from liquidity may change for each investor's situation, but is not something exclusive to the prime markets. Comparing market tiers, it is possible that "liquidity" is overvalued for the prime markets.

OPPORTUNITIES IN OPEN-AIR SHOPPING CENTERS UNDER $20 MILLION

As we examine the transaction market for open-air shopping centers under $20 million, the divergence in pricing between prime markets and others is even more extreme. The average cap rate in prime markets for open air shopping centers under $20 million reached a post-recession low of 6.3%. This level is one standard deviation below its long-term average of 7.1%, and a record 123 bps lower than the average cap rate for major markets. A similarly historic wide spread exists between the cap rates for prime and secondary markets. As a result, both major and secondary markets are inexpensively priced compared to the prime markets on a relative basis.

Liquidity trends in the under $20 million transaction market are interesting. Not only did the prime markets return to their peak pricing by the end of 2014, but they experienced less volatility than the major and secondary markets. Furthermore, prime markets have experienced much stronger transaction activity, reaching their pre-recession peak in volume, compared to more sluggish activity in major and secondary markets.

Despite the robust transaction activity and pricing in the prime markets for properties under $20 million, the value still appears to lie in the major markets. Relative spreads are at record-highs and the favorable outlook for fundamentals doesn't support such divergent pricing.

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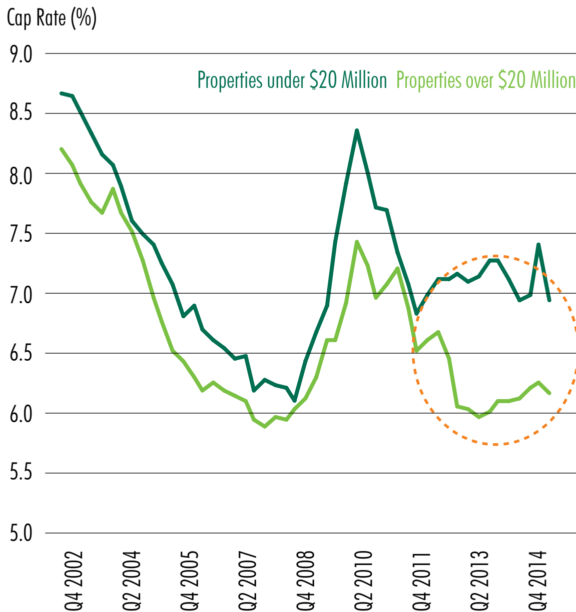
GROCERY–ANCHORED SHOPPING CENTERS

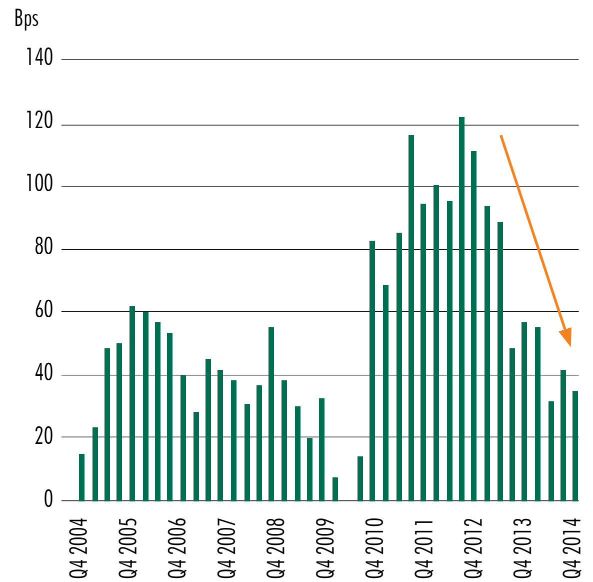
Being one of the most sought-after segments in retail, we narrowed our analysis to grocery-anchored shopping centers. In this segment, we uncovered less pricing differential among market tiers, and as a result, less clear opportunities for investors today. However, in the prime markets, while prices have noticeably flattened over the past two years, a strong divergence in pricing exists between the over $20 million market and the under $20 million market. In fact, the cap rate spread between these markets persists at historically high levels. Part of divergence in pricing might be attributed to not only the effect of e-commerce on smaller grocers, but also the effect on their businesses by non-traditional grocers (Wal-mart, Target, etc.). On the other hand, prime markets were very expensive on a relative basis to major and secondary markets since the recession, however that gap has begun to close.

Figure 6: Grocery-anchored Cap Rates in Prime Markets



Sources: Real Capital Analytics, Q1 2015.

Figure 7: Grocery-anchored Cap Rate Spreads Between Prime and Major Markets



Source: Real Capital Analytics, Q1 2015

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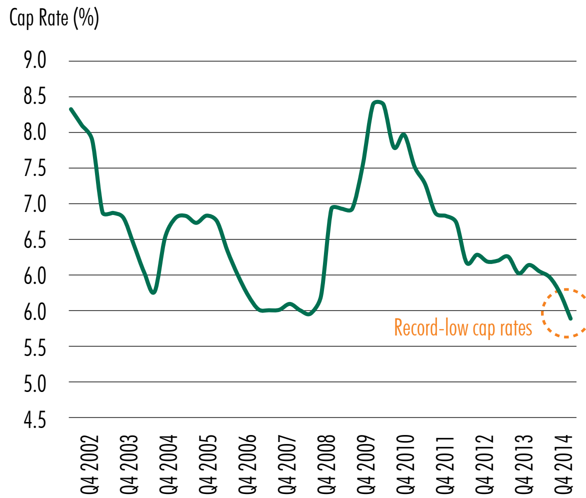
POWER CENTERS

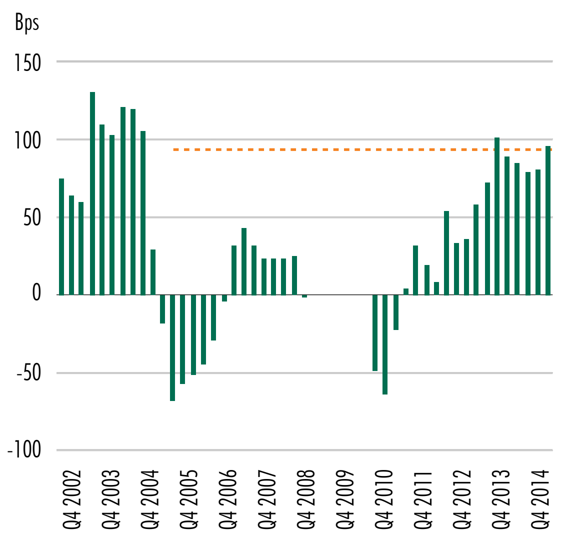
Among power centers, relative value is more apparent across market tiers. Specifically, cap rates for power centers in prime markets just reached a new record-low of 5.9% in Q4 2014. The occurrence of record-breaking cap rates is not only unusual across retail segments, but especially so for a segment that has been challenged by economic conditions and exposure to e-commerce. Nonetheless, as prime markets reach record levels, the cap rate spreads between prime markets, major and secondary markets are at cyclical highs, offering investors a value proposition in these other markets. However, the historically wide difference in pricing could be a result of the lack of overbuilding in prime markets going into the last recession.

Figure 8: Power Center Cap Rates in Prime Markets



Source: Real Capital Analytics, Q1 2015.

Figure 9: Power Center Cap Rate Spreads between Prime and Major Markets



Source: Real Capital Analytics, Q1 2015.

CONCLUSION

As a favorable outlook for the economy boosts commercial real estate fundamentals, investment opportunities for open-air shopping center investors appears to be shifting decidedly to many of the nation's mid-priced, major markets. Our analysis shows the nation's priciest prime markets—most of which are considered gateways—appear to have the fewest options to discover value at this stage in the cycle. Indeed, on a relative basis, major markets, in particular, offer a clear value proposition to investors of open-air shopping centers: considerable risk premiums, liquidity and improving fundamentals.

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