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retail market analysis

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The previous Quarterly article left off with a high level of uncertainty regarding the future of commercial real estate in the wake of Covid-19. The impacts have begun to become clearer as the months have progressed and the market has continued to crawl through the pandemic. The question is no longer how long will it take for retail to make money again. It is now, how much longer will retailers, landlords, and lenders be able to remain solvent through this recession.

The effects of the virus have now made their way through the real estate chain to all involved in commercial real estate. Unfortunately, this has been nowhere truer than in the retail market. Last quarter, sales had dropped off a cliff and were still bottoming out. Now, in the second quarter, sales are mixed, but are showing signs of rebounding. In fact, according to the US Census Bureau, retail sales were actually higher in June this year than in June 2019. The Bureau reported about $12 billion in increased sales year over year with June of 2020 have $530 billion in sales. This as compared to April's sales in 2020 which totaled at $410 billion marks an almost 30% sales increase.

Although this overall increase indicates very positive sales numbers and a very encouraging trend, it is important to specify and indicate which sectors are thriving and which are still struggling. For instance, when the pandemic hit its sales trough in April, clothing and accessories stores were one of the submarkets that were hit the hardest. They reported only $2.9 billion in sales. In June, this number had skyrocketed almost 450% to $15.8 billion from their April lows! Some of these numbers may be partially due to a reduced base or deferred purchases. But primarily, it is likely that this sales boom indicates a strengthening market that is adapting to the virus. Similarly, sporting goods, hobby, and bookstores increased sales by almost 200% between April and June. These and other submarkets such as building material and garden stores and food and beverage stores have actually had their June sales actually show growth year over year. And of course, nonstore retailers that work through online shopping have sales that are substantially more than what they were last year.

The market trends seem to be positive in most aspects for retail as it continues to come back from its early losses. It should be mentioned though, that everything is not back to normal. Many retail stores are still closed and show no signs of opening up for a while. Additionally, although the path of growth is a strong one, many retail submarkets such as furniture and décor, electronics and appliances, gas stations, and food services and drinking places all still have decreased year over year sales. And, due to the many governmental restrictions that prohibit or deter individuals from going to such places, their sales are likely to continue to be damaged as the virus continues to take its toll. R. Christopher Whalen, head of Whalen Global Advisors, attributed social distancing to a sort of "financial Armageddon for commercial real estate and municipalities"

RENT

Despite the continuing growth in retail sales, the retail real estate market is still having a difficult time. Evidenced by the dismal rent collection in this past quarter, retail has been struggling to stay on its feet during this trying time. Portland historically has been a strong retail market due to its constant influx of new residents, high median income, and lack of sales tax. This contributed to consistent rental rate growth for almost ten years. But, in the second quarter of 2020 rental growth had essentially stopped, and according to projections, is likely to report a 6% decrease. This is no surprise as many people predicted that June would be when the full effect of the virus would reach retail markets. In fact, according to a study by Datex Property Solutions, "nearly half of retail rents were not paid in April or May." In fact, between April and May, only about 56% of rents were paid. This has been a major blow to all involved in the industry, especially when landlords were relying on historical rent payments like that of March 2020 which were just above 90%.

This variation between the growing and increased sales recognized by the Census Bureau and the lack of rent being paid is likely due to a few contributing factors. The first and most obvious is that the rental payments will always trail the sales. It will take a while for retailers to build back their sales and infrastructure in order to be fully recovered from the pandemic. The president of NewMark Merrill Cos. pointed out that, although some tenants are now better able to pay rent, many are still not there. He said, "Our tenants are still hurting. They need time to build back clientele. It really doesn't matter. So even if my rent collection is 100%, we still have a long way to go." In other words, tenants being able to pay rent is not the only indicator of that tenant's ability to make it through the pandemic. The second reason for the lack of rental payments is that many of the large retailers, especially restaurants, are still not paying rents. For instance, some of the large national chain restaurants within the Portland metro area have simply said that they will not be paying rent during this time. This makes it incredibly difficult for a landlord to collect a large portion of rent when an anchor tenant simply says that they will not be paying rent. The last major reason that there is a discrepancy between increased sales and rental payments is Oregon's legislation banning evictions for not paying rent that lasts through the end of September 2020. With the extension of the Oregon Eviction ban, tenants now do not have to worry about any repercussions if they do not pay rent. This is likely to cause some, especially large national chains who have already said that they will not pay full rent, to continue to not pay rent.

Overall rental rates in Portland are likely to continue to decline into the third quarter of 2020 as the pandemic and governmental regulations have come together to create the perfect storm for tenants, landlords, and lenders. And although Portland rents still are about $.90 per square foot above the national average of $21.73, this number is declining for all. As the pandemic drags on, so too will the retail stores struggle to generate sales and increase revenue in order to meet rental payments and all the other associated bills.

LEASING

The Portland retail real estate market has been dealt a major blow in terms of leasing. Although Portland has historically been a strong retail leasing market, the pandemic has caused that to all but stop. In fact, this quarter has reported the highest negative net absorption for Portland in the last ten years at -276,000 square feet. This has been the third negative absorption quarter in the past four quarters with the fourth quarter of 2019 only being slightly positive at 59,000 square feet. This negative trend is likely to continue over the next few quarters as retailers try to build their infrastructure back in order to begin to expand once more. One of the most notable leases that did occur this quarter was Ashley Homestore's lease of 24,000 square feet in Tigard. This is one of the few positives in a quarter that has been dominated by leasing difficulty. For instance, Lloyd Center, a shopping mall that has had a difficult time since losing both Nordstrom and Sears in the past five years, was set to get these vacant spaces leased up with a concert venue and a movie theater. These plans have been put on hold due to the pandemic. All of these things contribute to the rising vacancy within the overall and Portland market. In the second quarter of 2020, vacancy is at 3.64%, up almost 75 basis points from its low in 2019 quarter one. More specifically, vacancy rates specifically in the neighborhood and strip center submarkets are averaging 5.7%. These numbers are all expected to go up in the next couple quarters as markets continue to adjust to the pandemic and its effects begin to sink into the real estate market. While the vacancy rates still reflect a robust market, the high level of collection loss and eviction restrictions are hiding significant weakness. It is important to note though, that in terms of the national retail real estate market as a whole, Portland still outperforms. Despite increasing vacancy and decreasing rental rates, the Portland market still has vacancy at 1.2% less than the national average of 4.9% and has rent that is still slightly above the average.

NEW DEVELOPMENT AND SALES

New development and construction within the Portland market for retail is still occurring, albeit at a slower pace than before. This may be due simply to the construction industry lag that often occurs in situations such as this Covid-19 pandemic. Many of these construction projects had already been in the pipeline and were established prior to the pandemic but are now in the process of being constructed. This is the case with the small retail development in Fairview right off of Interstate 84. Another project that was supposed to begin construction this quarter was the Riverwalk near Willamette Falls at the old Blue Heron Paper mill, but it has been postponed and will need to pick up at a later date due to the pandemic. Because of this, there were only about 55,000 square feet of retail construction started in the second quarter of 2020 in the Portland metro area. This is less than half of that started in the first quarter.

Thus, in a sector such as retail which had already been experiencing declining new deliveries since 2014, the pandemic has only expedited that decline. Additionally, the pandemic has shifted both the consumer's and developer's mindsets in terms of where the future of retail is going. Prior to the pandemic, there was an influx of experiential based retail development such as the 125,000 square foot Sherwood development that was anchored by Langers, a family fun center. Places such as Bridgeport Village in Tualatin were being hailed as the new transition for malls and centers. But now with the pandemic in mind, developers and consumers have begun to shift toward less involved shopping and activities in favor of online shopping and touchless delivery. Although this pandemic is not likely to stop the move to experiential based retail, it is likely to slow it and cause developers to assess their plans in order to assuage people's fears about interaction. The full effects of this are yet to be seen, but it will be an interesting story to follow as retail development begins to pick back up slowly.

CONCLUSION

The retail real estate market for Portland in the second quarter of 2020 has shown slow but consistent growth as attempts to begin to come back from the major dip that was created by the Covid-19 pandemic. As the pandemic continues, there are indications that retail has reached its bottom and is now on the way up. One of the biggest signs of this is the increase in retail sales that have happened between April and June. Every retail submarket's sales have increased in that time, with some submarkets having increased by 200% or more. And, although this is not the case with many of the retail submarkets, in June some of the submarkets have actually grown in the year over year sales at that time. With this being said, the pandemic is far from over, and many retailers are still having difficulty paying their rent. This is likely to continue due to several factors such as the case that even though sales are increasing, there is no security in the retail market because no one knows what will happen next in regard to the pandemic. Additionally, government intervention has had mixed results in its effects on the retail market. Granted, the government is explicitly trying to stop the spread of the virus. Unfortunately, some of the byproducts of these decisions have created more difficulty for retailers and their sales generation.

Because of this decline in the retail market, there has been a parallel decline in terms of leasing with very few leases occurring in the second quarter. And with the decrease in rent collection and leases, there has also been a decrease in square footage of retail space under construction as developers and contractors wait to see what happens next before they put their money and time into new retail space.

With all this being said, it does seem that the retail market is beginning to rebound from its April trough. There is still a long way to go before things get anywhere close to where they had been pre-Covid, but the steps are being made to progress, and it is likely that in the coming months, there will continue to be slow and steady growth in the retail sector.

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