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# retail market analysis


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**With capital markets shying away, and stories of bankruptcies, closures and the rise of e-commerce circling, it is tempting to paint a damning portrait of the retail sector in Portland. Yet through a deeper look at both the successes and failures occurring amidst the pandemic, one notices that the underlying demand for storefront retail has not disappeared, rather it is undergoing an evolution expedited by a black swan event. Creative developers and forward thinkers are being rewarded, and those companies who failed to upscale or integrate online prior to the pandemic, have had the fragility of their demand exposed. Additionally, the unexpected set of variables and rules introduced by the pandemic is favoring certain retail types whilst adversely impacting others.**

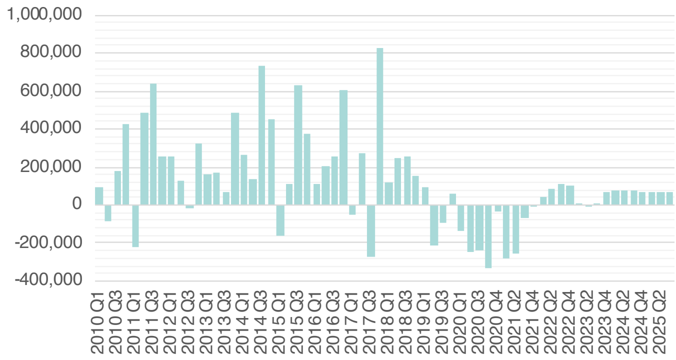
Well capitalized companies who understood that e-commerce and storefront retail were symbiotic prior to the pandemic, and were already tailoring a seamless end-user omnichannel experience - Warby Parker or Peloton - have performed solidly. These types of companies will be eying expansion when primely located distressed assets soon become available. Indeed, brick and mortar stores have multiple purposes for a well-integrated company in the year 2020. Lululemon CEO Calvin McDonald captured this sentiment when reflecting upon Q2 2020's earnings, stating that "we continue to believe physical stores are and always will be an extremely important part of our ecosystem. Our stores are our local hubs and communities across the globe, gathering spots for our ambassadors and our connection to local studios. They facilitate e-commerce transactions via our ship-from-store and buy online, pick up in-store capabilities, and are a portal to bring new guests into our brand". The fact that E-Commerce heavyweight Amazon continues to expand their storefront presence with Amazon 4-star, Whole Foods, also points to the vital role that a physical presence plays in "customer acquisition, brand engagement, and awareness building".

Conversely, private retailers with poor financial leverage, no online presence or means to acquire new online customers have either closed or are limping to Christmas to capture final sales before pulling down their shutters. Perhaps some of these closures will be what the market was calling for prior to Covid - the U.S. possesses 50% more GLA per capita than the second largest national market, despite only generating 33% more retail sales - perhaps suggesting a glut of underperforming assets and will likely be replaced by smaller store footprints, a stronger online presence, overall better tenant mix and a curated end-user experience.

Then there are mixed accounts of retailers who have been lucky or unlucky due to the unique variables introduced by COVID; classification as an essential business, population density being a shortfall, and the short term skewing of consumption patterns. Executive Order 20-12 closed all malls, fitness centers, grooming, and entertainment businesses directly impacting revenues for multiple product types including malls, community centers, and strip centers. Civil unrest, closed offices, the freezing of tourism and hospitality industries has completely undercut the demand for retail in downtown Portland. The 80,000 people daily that previously frequented Downtown Portland have largely disappeared. With increased space, safety, and a residential demand base, suburban retail has picked up the slack. As people are stuck at home with excess time on their hands, home improvement trends have spiked with a 23% increase in revenue for Home Depot between May and July, giving a boost to power centers. Childcare, and doggy daycare have experienced strong growth as parents contend with a new work-life balance and the realities of impulse pet purchases. Stand-alone grocery stores, and grocery anchored neighborhood centers are performing well with people forced to cook at home. Other success stories include Cannabis, liquor, drug and hardware stores. Some regional malls that were struggling before the pandemic are really suffering now. However, certain outdoor malls and gallerias have been finding ways to appeal to customers by offering everything from drive through coronavirus testing, to increased sanitation and ventilation, social distancing practices, curbside pickup, spot holding and newfound attempts to insert themselves as an important part of the social equation.

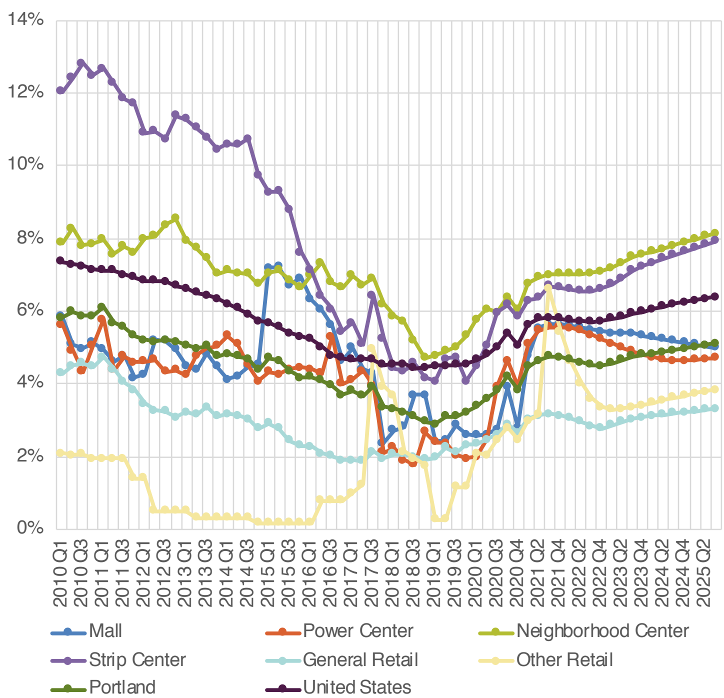
When surveying the Q3 brokerage reports and CoStar data below, some of these above dynamics are evident, yet a lot of the difficulty being experienced is not so obvious. For instance, market rents have remained stable as landlords opt for rental concessions and abatements over lowering market rental rates per square foot, drastically reducing effective rents and revenues. Vacancy rates have seen upward movement, but the eviction memorandum muted any sizable shift in vacancy over the last few quarters. Low new supply of inventory over the past year has kept the negative absorption patterns under control. And as new variables align in Q4 - eviction memorandum expired on the 30th of September, the holiday period arriving shortly, Coronavirus cases on the increase – many retailers will face uncertainty.

### TABLE ONE
### PORTLAND MSA RETAIL NET ABSORPTION




*Source data from CoStar*

### TABLE TWO
### VACANCY RATE BY PRODUCT



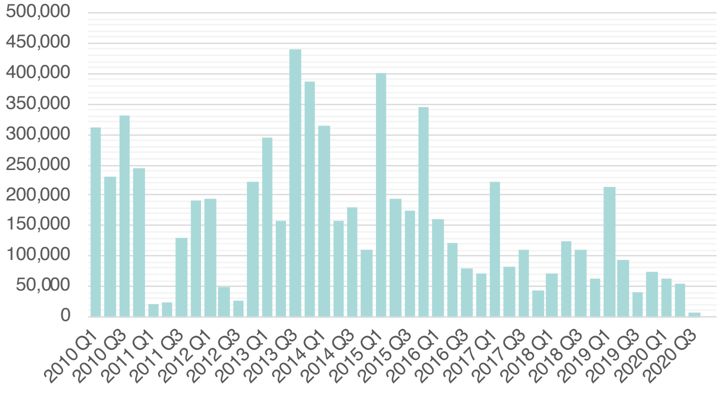

*Source data from CoStar*

## DEMAND / ABSORPTION

Portland's strong economic and population expansion had driven an eight year run of vacancy rate compression and positive absorption, which eventually came to a halt in Q2 2019. Potential causes for the softening demand were changes in consumer patterns, the growth of e-commerce, and an oversaturation of retail space. And as is widely discussed, COVID has acted as an accelerator for trends that were occurring across commercial real estate. This was evident in Q3 2020, with negative absorption of 237,000 square feet, adding onto the approximately 400,000 square feet of negative absorption during Q1 and Q2 (Table One). CoStar's base case forecast predicts this trend to continue with negative absorption to occur through mid 2022. The impact of this metric is heightened due to no significant new supply of space being added during the timeframe.

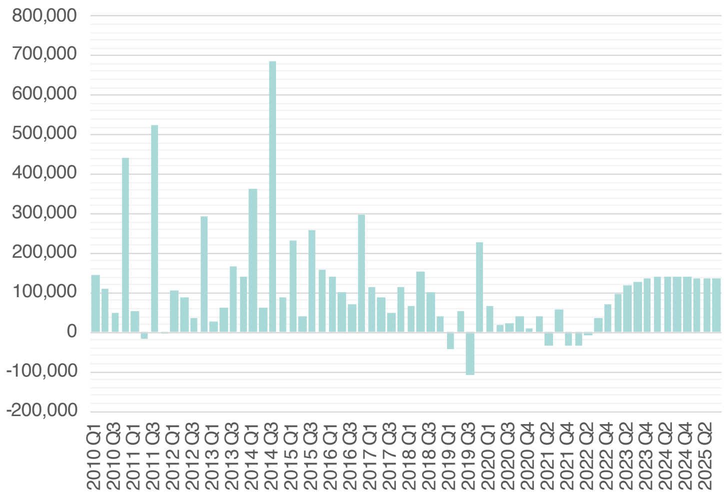
Product specific vacancy rates shed some more light on the different dynamics at play. Strip centers have seen a sharp rise in vacancies which have increased 90bps to 6% in Q3, with an overall 1.5% increase during 2020 as seen in Table Two. Power centers have been impacted with a 140bps uptick during Q3 reaching 3.9%. The vacancies and economic damage happening in malls have not yet been registered as a metric with a mild 20bps increase in vacancy over 2020. With the eviction memorandum expiring at the end of Q3, and Christmas around the corner, Mall's performance over Q4 2020 and Q1 2021 will be telling. CoStar predicts a jump in vacancy after the Holiday period jumping from 2.8% in Q3 2020 to 5.5% in Q2 2021. The availability rate has jumped in strip centers 200bps since Q1, with Q3 at 5.7%. Neighborhood centers seem to be holding steady with a 20bps uptick since the start of 2020 to the end of Q3. That said, neighborhood centers are becoming more reliant on their grocery anchors, and "essential in-line stores".

### TABLE THREE
### PORTLAND MSA RETAIL CONSTRUCTION STARTS




*Source data from CoStar*

### TABLE FOUR
### PORTLAND MSA RETAIL NET DELIVERIES



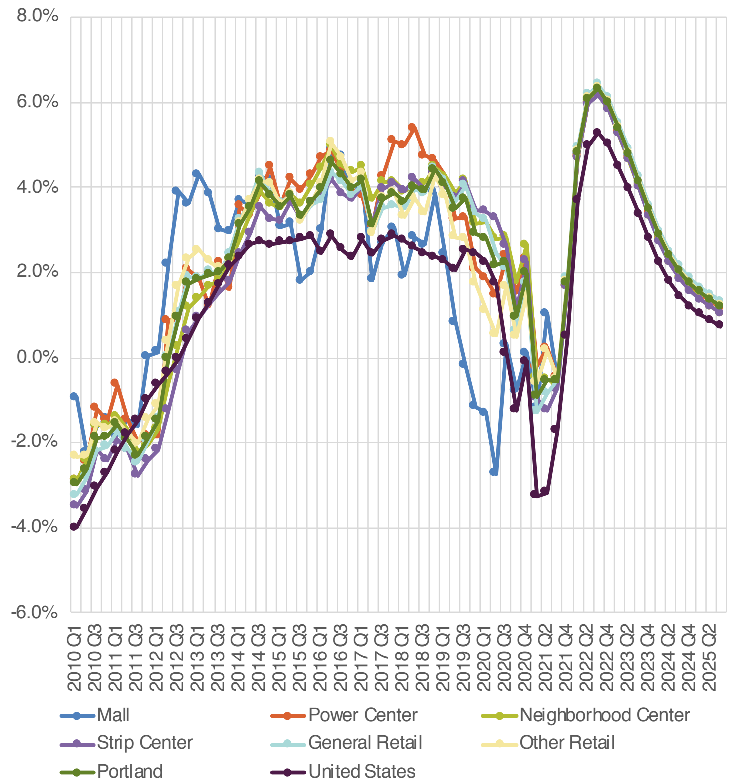

*Source data from CoStar*

## SUPPLY

The low vacancy rates and solid rent growth is partially attributable to the modest amount of inventory added during this real estate cycle compared to other expansionary periods. This delivery of new space has further tightened due to the pandemic, with virtually all new construction coming to a standstill. In terms of construction starts, Q3 2020 reported only 7,413 square feet of new construction starts, the lowest on record since the Great Financial Crisis (Table Three). In terms of deliveries, 23,500 square feet of new space was added during Q3, with another 40,000 square feet of new space expected during Q4 (Table Four). This leaves the tally of under-construction space at 315,581 square feet, and a lot of that space could potentially fall through due to financing issues.

Suburban and outlying markets remain the focus, with the Kruse Way, Clark County Outlying, North Beaverton and East Columbia Corridor submarkets all representing the bulk of construction activity. However, no submarket surpasses 100,000 square feet of new construction in the pipeline. In Clark County, Ridgefield Pioneer Village is a new proposal in the works which will be a mixed-use development with apartments and a retail section. The Willamette Falls Legacy Project is an opportunity for retail developers with a plan to develop the area into a commercial zone with restaurants, shops and other commercial buildings.

### TABLE FIVE
### PORTLAND MSA RETAIL MARKET RENT GROWTH (YOY)




*Source data from CoStar*

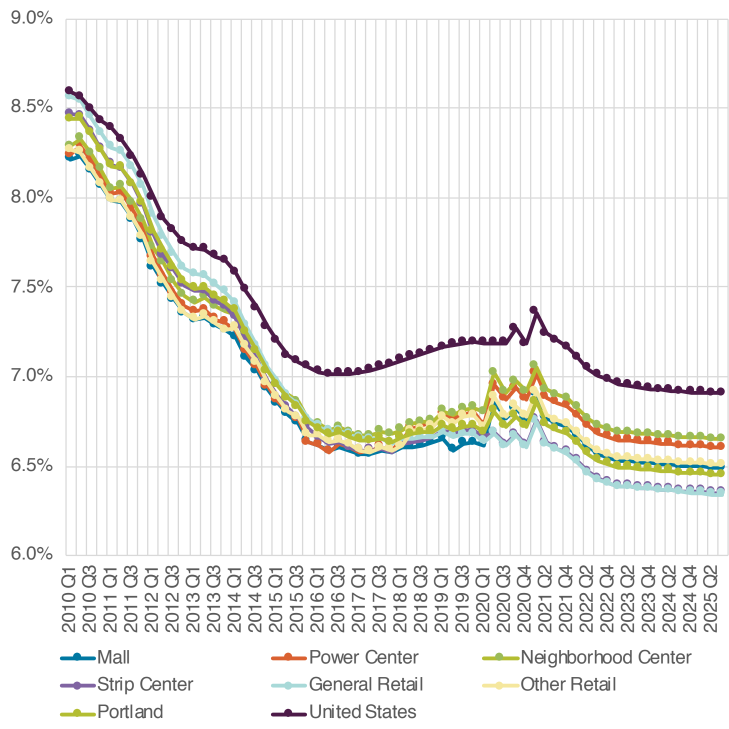
## RENTAL / CONSTRUCTION RATES

Q3 saw a slight improvement on rental rates from Q2 across all retail types (Table Five). Neighborhood centers increased $0.41 to $24.90 per square foot, and malls jumped $0.64 to $23.88 per square foot. CoStar is predicting another dip in rental rates post the Holidays, perhaps forecasting the effect of post-Christmas closures and softened demand for new leases. After plateauing in mid-2021, rents are expected to rise slowly. Stabilizing the rents are landlords preferring concessions and abatement over lowering prices. And feedback from brokers is that some tenants will have a 50% rent reduction with the balance being amortized back into the lease. Some tenants are simply paying a lump sum at the end of the lease. For new leasing activity, landlords are offering concessions in the first year with 3-5 months of free rent, and 3 to 4 months of half rent the following year, then full rents in the third year onwards.

With regard to YOY Market rent growth, there were mixed performances across product types. Strip centers had a 70bps drop, whereas Neighborhood centers remained static. Power centers jumped 90 bps to 2.4% YOY rent growth, with general retail dropping 40bps to 2.1%. All product types rental growth remained positive during Q3 but are predicted by CoStar's base case forecast to turn negative in Q1 2021 and remain that way until Q4 2021, when the Christmas 2021 period will cause a rapid recovery in rental prices.

Construction costs remained relatively stable from Q2 2020 to Q3 2020. Demand for better ventilation saw HVAC costs increase 2.4%, and plumbing systems also saw a 1.9% cost hike. Across 2020, demand for contractors and suppliers has dropped due to less construction activity signaling lower costs, yet disruption of supply chains has meant many materials have come with a premium. The Mortenson Construction index is predicting "overall project costs remaining flat with some continued volatility in pricing as the market adjusts to ongoing events".

### TABLE SIX
### PORTLAND MSA RETAIL MARKET CAP RATE




*Source data from CoStar*

Albertson's in Lake Oswego. Source CoStar

## SALES / LEASING

Given the current economic environment, it is no surprise that sales volume has sharply contracted in the Portland retail market. Institutional investors, REITs and Private Equity shifted their focus away from retail in mid 2019, a telling sign that detailed analysis was revealing retail's weakening fundamentals. In turn, portfolio sales dissipated in mid 2019, and of the few transactions completed in Q3, the majority were by singular purchases by private investors. Q3 exceeded Q2's sales volume crossing the $100M threshold, but similar to Q2 represents a quarterly low unseen since 2012 (Table Six). Price per square foot has remained relatively stable, which perhaps implies that potential sellers are holding out for a turn in the market recognizing the strong intrinsic value of Portland land and location. Similarly, institutional capital is presumably waiting for the market to get more distressed before attempting any value-add strategies. CoStar base forecast has not anticipated any great movement in price per square foot in the coming quarters.

After eight years of cap rate compression, the pandemic instantly caused a 17bps jump in cap rates in Q2 2020. Rates settled back down slightly during Q3 back to 6.7% - a rate that has prevailed since 2016 - but are expected to worsen after the Holidays. Tellingly, all of 2020's $10M plus sales have been triple net leased grocery stores. Major transactions include a 40,000 square foot Albertsons in Lake Oswego (Pictured) that sold for $16.8M at a 5% cap rate. The lease had 2% annual rent escalations with a long horizon of 14.4 years left on the lease. The purchaser was Florida based Benderson Development Company, and the seller was REIT Spirit Realty Capital from Dallas Texas. August also saw a Walgreens sale in Sandy for $6.6 million, at a 6.3% cap rate. Buyer G&S Family LP picked up the Tanasbourne Town Center in the Sunset Corridor / Hillsboro Submarket for $6.3 million. The asset was 100% leased at the time and is 25,000 square feet. Other sales include a Mall on SE 122nd Ave, and McMinnville Toyota in the Yamhill County Submarket. Large leases include a 25,000 square foot space at Evergreen Plaza in Vancouver.

## REFERANCE

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