

## Love For Strip Centers

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By Marc Blum

Is a strip center a sexy investment? Not always in fact, most of us take them for granted, even if we visit one almost every day. Neighborhood shopping centers, or strip centers, have become such a fixture in the American landscape that they are almost invisible. Ranging from well-kept smaller retail centers to lower-end, less attractive properties, these unglamorous shopping destinations don't grab many headlines the way high-profile, glitzy regional centers do, but investors can find them quite rewarding. A neighborhood shopping center can thrive even in a weak economy or an overbuilt market -- if its owners and managers have the skill, patience, and business savvy.

While we think of strip malls as a contemporary invention, the concept first emerged in 1896 with the development of Roland Park Shopping Center in Baltimore, Md. Today, the term strip mall generally applies to both small neighborhood centers, often grocery-anchored centers, from 30,000 to 200,000 sf in size; the larger "power" centers with one or more big-box tenants such as Home Depot or Target; or "lifestyle" centers offering the same retailers that dominate regional malls. Some strip malls are hybrids, with features of both small neighborhood centers and power or lifestyle centers.

With long-term leases, a thriving trade area and a high proportion of land value to building value as mandated by parking requirements, a strip center offers all the ingredients of a promising investment. Such properties can provide a predictable income stream and appreciation if managed properly.

Many individual and institutional investors have taken notice, undeterred by the low cap rates of recent years. According to data from Real Capital Analytics, approximately \$21 billion in strip centers changed hands in 2005 as the real estate investment market continued to operate in overdrive.

That is not to say the strip mall sector is without its risks. In fact, the present environment may very well separate the amateurs from the professionals. Given today's uncertainty about interest rates, energy prices and other unpredictable forces, strip mall owners and investors now would be wise to focus on maximizing property cash flows rather than counting on the cap rate compression and the resulting soaring property valuations to generate return on investment.

New development adds another question mark to strip center profitability. Retail sales growth is projected at 6% in 2006, down from 9% in 2005, but nonetheless a positive sign for this sector. However, Reis Inc. forecasts some 21.5 million square feet of community shopping center development in 2006, with 15.4 million square feet allotted to smaller neighborhood strip centers. That volume of new development is expected to exceed absorption, a situation that will make professional management of such properties even more important than it already is.

It's difficult to assess how much of the pending new development will include grocery-anchored centers. We generally choose not to acquire these properties, although a grocery-anchored strip center used to be a property investor's sure bet. That's no longer the case, now that Wal-Mart has become the leading grocery seller in the United States.

Wall Street pressures have made national chain stores more willing than ever before to close locations that aren't meeting profit goals. Whether a potential

tenant is a well-known national brand or a local entrepreneurial business, a landlord must take a close look at retail trends and retailer credit ratings to determine whether a tenant presents an acceptable level of risk.

Of course, these trends play to the strengths of some owners and managers. Next Realty property managers, for example, are among those inclined to buy and hold older strip centers and other retail properties. While we selectively engage in new development through our development arm, we also have found meaningful investment opportunities in existing properties that we can reposition to better serve the needs of the community. This approach meets the needs of our investors and creates increased economic value from underutilized properties.

On the acquisition side, our firm has focused on neighborhood shopping centers in the 25,000- to 40,000-square-foot range, as well as land sites for strip center development and joint ventures with residential developers. Our development arm, on the other hand, is building larger centers ranging from 250,000 to 400,000 square feet of space in underserved markets on the East Coast and Colorado.

We have often found that the best way to add value to a strip center is to acquire one that hasn't been properly managed. For example, an older center in a gentrifying neighborhood may have long-term tenants that are not paying market rents or that are not appropriate for neighborhood shoppers. While some tenants will be willing to pay higher rents to avoid relocation, others invariably will choose to leave. To attract desirable new tenants at market rates, the landlord may need to make property improvements such as a new facade and more elaborate landscaping, requiring a degree of capital investment.

It's not uncommon to see a less experienced strip mall investor cope with declining or stagnant below-market rents or a large vacancy by deferring maintenance and not making the property improvements that would boost cash flow. After a certain point, these owners often find themselves unable to secure financing to salvage their investment and therefore must sell. Naturally, that unfortunate situation creates an opportunity for firms like ours that have the skill and the financial wherewithal to undertake a long-term repositioning program for a floundering property.

Another scenario with potential upside is to acquire a strip mall with a significant vacancy from the departure of an anchor tenant. Even if the vacated tenant is still paying rent or paid a lease termination fee, a large dark space can create a drag on financial results as in-line tenants experience reduced traffic and depart the premises. Lenders sometimes are leery of such properties, leaving potential buyers to either pay cash or accept less than ideal financing terms. A savvy real estate investor can realize gains from such an investment if they are able to secure a replacement anchor or to creatively repurpose the facility.

Successful strip mall investors are those who have the financial structure to withstand cash flow variations resulting from retailer consolidation, a weak economic environment or the natural tenant turnover that occurs during a repositioning program. An owner may need several years to stabilize a property with a strong tenant roster, and not all investors can afford that kind of patience.

The good news is that, in the right hands, a neighborhood center can generate attractive returns for investors while meeting the shopping needs of its community. Glamorous? Not really, but the returns can be pretty sexy. Marc Blum, CPM, is principal and chief operating officer of Northbrook, IL-based

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