

Owners and Developers Apply Today's Lessons to Future Projects Landlords filling short-term retail vacancies keep long-term profit potential in mind when selecting tenants

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Shopping center owners and developers are taking lessons from the highs and lows of the current real estate cycle and applying them to the future.

What they have learned will inform future projects, from retenanting existing properties to building new centers. And as they look at strategies to fill vacancies today, they're making short-term decisions with an eye on long-term profits.

Colton Sudberry, president and chief financial officer of San Diego-based **Sudberry Properties Inc.**, said the development company is getting back to normal underwriting standards for new projects.

"We've got to get back to basics and stop trying to push the envelope in order to get the deal," Sudberry said.

The biggest lesson that his company has learned during the last few years is that it should not plan as much shop space alongside larger retail tenants, because those tenants are more likely to fail when the economy sours.

"We were trying to site plan more shop space, because shop space gets higher rents," Sudberry said. "That's great when the economy's doing well."

In addition to planning for fewer smaller storefronts, Sudberry Properties also will look more closely at the strength of the tenants the company considers for its centers.

"There were tenants willing to pay the right rent and you were willing to build a center for them," Sudberry said. "[You shouldn't] build more square footage just because you can get a tenant, but build enough square footage for the right tenants."

Of course, the right tenants now might be the wrong tenants later. He noted that no one anticipated 20 years ago when they built large stores for Mervyns that the department store chain would close its doors last year, but many landlords now are hurting because of vacant big boxes at their properties.

Walter Limburg of Newport Beach-based **Strategic Retail Advisors** said it's likely that power centers will be smaller in future development because the risk associated with that retail format is rising as certain big box categories are whittled down to fewer players.

"We now have one linens player and one electronics retailer - Bed, Bath & Beyond and Best Buy - and today those tenants have the upper hand if you want that category in your center," Limburg said. "Now these landlords that dictated those high rents won't be able to achieve that in the future, at least not with these tenants."

He said one lesson that shopping center developers now should understand is the importance of buying land at prices that support realistic rent growth for the long term.

"We have had an exuberance to develop and too many people chasing too few pieces of property," Limburg said. "They had to achieve pretty fancy rents to make projects pencil and once the cap rates changed, the values weren't there. "

Repurpose or Retenant?

While builders may price land in the future based on lower rent expectations instead of competition for the property, landlords and developers are still trying to determine what market rents should be now based on what tenants can afford and the deals that they can get in an environment with rising vacancy.

Limburg said landlords do make short-term decisions with the future of their centers in mind, but property owners facing the prospect of doing deals today with tenants that might not be ideal versus letting space sit vacant with no income for an unknown length of time might have a hard time taking a long-term view.

"If that tenant has another option in that marketplace, you might not be able to do that deal again," he said. "And if you get that anchor filled, the new traffic helps the other tenants."

William B. Tate II, partner in the Irvine office of **Bryan Cave LLP**, said there are a lot of issues that landlords have to think about as they consider creative ideas to generate income at vacant or partially vacant properties.

"A lot of what you can do with the space has to do with the integration of what you have in the immediate area," Tate said. "If it's in a mall or shopping center, you can't change the space dramatically."

If vacant space or a stand-alone building might be converted to another retail use or a different property type, landlords need to think about whether or not all of those uses can work well together rather than jumping on the first credit-worthy tenant that submits a letter of intent.

For example, it might be possible to repurpose a stand-alone retail building that is not part of a shopping center for office, storage, warehouse or light manufacturing use to the extent that the land-use plan for the area allows it.

However, Tate said landlords have to consider the land-use approvals they already have in place. An urban retail building may have been approved by the city to provide parking at four spaces per 1,000 square feet of space. But when the owner converts from retail to storage and tries to go back to retail to get higher rents after the economy recovers, there could be new standards for retail parking at five spaces per 1,000 square feet.

Without the appropriate accounting, legal or brokerage advice, the landlord might not be aware of the change in parking requirements and the property may not be grandfathered in under the new guidelines, Tate said.

"Right now I haven't seen a substantial surge in repurposing these retail spaces, primarily because of the unavailability of financing and also because most tenants have taken a wait-and-see strategy," Tate said. "I don't see a huge wave of this occurring at the moment, but

that's not to say landlords don't need to consider a wide range of uses to assure they're obtaining what business is out there for the assets they have."

Peter Kay, a retail specialist with Los Angeles-based **Wilson Commercial Real Estate**, recently represented the owner of Downey Landing, a 370,000-square-foot shopping center in Downey, in leasing 5,000 square feet for two years in the retail property to an office tenant, **Syfab Inc.**, a mortgage and real estate investment firm.

Syfab's offices will share the shopping center with Ross Dress For Less, PetSmart, Best Buy, Marshalls, Michaels, Old Navy, Staples and Bed Bath & Beyond.

"The building was an office building that was leased out to a mortgage company before," Kay said. "It could have been a retail space, but the likelihood was that it would not."

Tax specialists, medical offices and dentists frequently lease retail space because they like the foot traffic that comes by their businesses in shopping centers that they wouldn't get in a traditional office building. Kay said some of those tenants may be paying reduced rents on busy streets at certain retail properties. However, it does not appear to be a trend across all shopping center sites.

He has seen new tenants with similar uses that are coming in to replace national tenants, many of which are now idle. He recently replaced a hair salon at one property with a tenant that specializes in eyebrow threading. In other instances, a vacant H&R Block site might be filled by a mom-and-pop tax office or a Starbucks might be replaced by a new regional coffee shop chain.

"Overall rents have come down, so some of these national tenants are now being replaced with mom-and-pop local tenants that do the same kind of business," Kay said.

Formulating a "Recession Plan"

Generally, landlords signing leases with local or regional tenants are locking in short-term deals with agreements to increase rents to fair market value when the two- or three-year term ends.

"You give them a short-term deal for three years, assuming they have the financials to support it, then you look for it to go up at the end of the three-year term," Kay said.

Tony Villasenor, senior vice president in the San Diego office of **Voit Real Estate Services**, said many landlords have instituted across-the-board cuts in rents for certain distressed tenants, including rental abatement and partial deferral of rent.

Villasenor said most creditworthy tenants have been successful in securing some variation of a "recession plan," but small mom-and-pops that have invested their life savings in their stores have not fared as well.

Credit tenants are able to sit down with a landlord and make a commitment to staying in their space for 10 more years if they can get rents reduced by up to 30 percent for a certain amount of time while they wait for the economy to rebound.

"As the recession takes its toll on property values across the board, clients have begun to work together [with tenants] to find new ways to boost sales, expedite business, trim

overhead and avoid further shortfalls," Villasenor said.

Investors are making every effort to buy retail properties at the right price so that they can focus on making the best leasing deals they can and work together with the tenants to find ways to boost sales and cut overhead costs.

"As landlords, we look at the property as a blank stage," Villasenor said. "The tenant's job is to put the production on. We're a team and when everybody realizes and understands we're a team, the process works better."

One way that landlords and tenants can work together is to lobby local government for more flexibility on sign ordinances to increase visibility for retailers in a shopping center, Villasenor said. They can also work with local officials on access issues, asking them to address needed turn signals or other infrastructure that helps customers get to stores.

"The way to get through these tough times is to understand the team approach for the landlord and the tenant," Villasenor said. "Landlords need to be able to collect their rent to pay their banker. The banks are already on board working with the landlords. They're all on the same team. The city's on the same team as well."

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