Focus on U.S. grocery-anchored shopping centers

David "Mac" McWhorter, executive director, and **Randall Zisler,** chief investment strategist and research director, of the Institute for Real Estate Operating Companies (iREOC), recently spoke with **John Roche** and **Bob Dake** of ShopOne Centers REIT about the role of retail real estate in today's unsettled environment. An excerpt of their conversation follows.

CONTRIBUTORS

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CEO & CFO

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Let's start with a brief overview of ShopOne REIT.

John Roche: ShopOne was started by Davidson Kempner in 2017 as an opportunistic acquisition of a distressed shopping center company. Since then, the business has focused on the importance of the platform and operating infrastructure when accessing opportunities in the neighborhood shopping center space. One of the lessons that has been continually validated is the importance of asset management in creating value in shopping centers. In some property types, a third-party property manager or leasing agent is a viable alternative, but managing a shopping center portfolio requires an ownership mentality. Success in the shopping center space is largely dictated by an intimate understanding of the tenancy and their performance, lease mechanics and market dynamics, which is difficult to do without the appropriate infrastructure.

What makes shopping center asset management so different from that of other real estate classes?

Roche: Community and neighborhood shopping centers require active asset management that monitors tenant sales and health ratios, merchandising mix, lease mechanics — including guarantees, prohibited uses and co-tenancy clauses — and market dynamics, and how those factors affect occupancy and cash flow. A shopping center is not formulaic. It requires experience and understanding of how those factors respond to the local demographics. Successfully creating a healthy ecosystem and curating different tenant uses that resonate and serve the local community is a critical part of being a successful operator in the space.

How exactly does asset management increase value?

Roche: Knowing each tenant and what they do means we can diversify our tenant mix to not only reduce risk, but help drive traffic from one tenant to another. For example, if we had an organic grocer in the center, we might actively look for a fitness center, juice press or a physical therapist. Being aware of how the tenants complement each other — as well as making sure each tenant is appropriate for the surrounding neighborhood demographics — stabilizes the property and results in long-term tenancy. Tenancy isn't forever, and we understand that, but being an experienced operator enables us to understand and manage risk as it relates to potential move-outs and proactively identify potential replacement tenants prior to vacancies occurring. A strong relationship with our tenants, mixed with a thorough understanding of each tenant's sales and health, enables us to make informed decisions, thus creating lasting value within the center. Having these relationships and analytic expertise to evaluate tenants in properties we might want to acquire helps us more accurately value the property, assess risk, and create value almost immediately through proactive actions, such as lease extensions. If I were a less-sophisticated buyer and I lacked access to that information, I might very well overpay and end up with rents rolling down or vacant stores.

Even before the pandemic, retail real estate was struggling in the face of e-commerce. Will COVID-19 accelerate this trend?

Bob Dake: Investors should not paint all retail with the same, broad brush. It's true that retail, as an asset class, has been struggling for some time, but the grocery-anchored neighborhood centers that we own have been and are doing very well. They provide essential goods and services in good times and bad and are, thus, more resilient to outside forces than most other retail sectors. However, I think the current climate will significantly accelerate the demise of certain classes of retail, such as B- and C-quality malls. The unfortunate decline of the department store and increasingly high costs of operating an enclosed mall will likely drive additional tenants to the open-air shopping center space. When looking at e-commerce, some have wondered if grocery delivery services are a threat to the brick-and-mortar groceries. I think these past few months have demonstrated the opposite — they are an added benefit instead of a threat. The tenants who embrace and perfect their omnichannel functions will continue to thrive. It is no secret that a retailer who opens a physical store in a market sees an improvement in their e-commerce business, whereas when a retailer closes a physical location in a market, they see a correlating decline in their e-commerce business. The grocery-anchored neighborhood center is a significant part of that last-mile equation and, whether it is micro-fulfillment or click-and-pick, they have been a stabilizing factor. In addition, service-oriented tenants, such as hair stylists, medical providers, banks and others, had already been migrating to shopping centers. I would anticipate that continuing.

What other trends do you see?

Dake: There will be a continued migration of these assets into the hands of more-sophisticated owners because of the benefits of having a platform in which you can standardize the management of retailers. For example, a form lease that can be utilized across a portfolio will reduce the time required to negotiate a lease, resulting in us collecting rent sooner. Neighborhood shopping center ownership is highly fragmented. A significant portion of these assets are owned by private investors without the financial resources or infrastructure to maintain the properties, or fund tenant improvements to enhance the tenant mix and increase occupancy. Over the years, we have had grocers come to us and ask us to buy their center. They may have a strong store, but they don't want to renew with the current owner because the owner is not maintaining the center to its fullest potential, thus limiting the grocer's ability to improve performance. Good retailers want to work with strong owners who understand that achieving success is dependent on creating the right environment.

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Roche: Tenant relationships were already important; they are even more so now. While the neighborhood center is likely to weather the storm better than other retail sectors, the restrictions and justifiable fear around COVID-19 have put pressure on some of our tenants, so we are reaching out to make sure they have the support they need to survive. Having the benefit of an infrastructure that we believe is best-in-class has allowed us to successfully manage through this crisis and outperform most of our peers. In the long run, we will probably come out of this with an even stronger tenant base and mix than we have now, as strong tenants migrate from poorly managed centers to ours.

iREOC research indicates that pre-COVID neighborhood shopping center returns exhibited bond-like characteristics. Do you expect these characteristics to survive?

Roche: This is not an easy sector to generalize. I am a firm believer that the same center in the hands of two different owners can have significantly different outcomes, as a function of access to capital, relationships, understanding the tenant mix, and what you should and should not be doing.

Dake: Historically, neighborhood shopping centers have been a superior risk-adjusted return opportunity. Grocery leases average about 1 percent to 2 percent growth, but they are long-term and stable. We can build the rest of the tenant base around that stability. Property expenses in an open-air center are a fraction of those of a large mall. In addition, the grocery store is a superior traffic driver. People go to the grocery multiple times a week and are more likely to stop in and get their hair cut, buy a slice of pizza, or visit some other retailer in that center, as opposed to a department store–anchored mall in which there is less traffic. In the current environment, on a risk-adjusted basis, we think the sector will continue to be a winner, and one where we will outperform.

Where are the opportunities today?

Roche: I believe that, in the current environment, we will see great assets currently in the hands of less well-capitalized, less-sophisticated owners change hands. It will be an opportunity for those who have the capital, infrastructure and the ability to then execute on the value-creation opportunity. Many of the investors who aggressively acquired shopping centers over the last few years are now struggling with legacy challenges. We liquidated a portfolio in 2019, and so we have the capital and bandwidth to focus on new opportunities, as opposed to trying to resolve problems within our existing portfolios, which puts us in a very enviable position. In addition, we have a supportive bank group with whom we have done business for decades over multiple opportunities. Having this financial support is a real competitive advantage. We are continually in contact with virtually all of the major brokers, and we will be listening and prepared to act whenever appropriate.

Post-1986 and post-2009 were generational acquisition opportunities. Is the current period another one of those generational opportunities?

Roche: I think so, having participated in both of those. Each one reemphasized the importance not only of having capital, but having the ability to understand what to acquire and where the business was going. That meant having relationships with both lenders and tenants, and a platform that enables you to execute. We are positioned as a function of all we have done before, as well as at ShopOne, and we are looking forward to it.

Bottom line: Why should an investor invest with you?

Roche: Investing with ShopOne is an opportunity to access a vertically integrated operating company, whose team expected at the outset to be an institutional-quality platform, with the reporting and transparency that entails. Our team's average tenure in the shopping center space is over 20 years, all REIT veterans with a history of creating value in difficult environments. We are focused more on tomorrow and less on yesterday. We don't have legacy issues. We are like the high-performance automobile with a tank full of gas or the battery fully charged. We are ready to go, and I think that is unique in the current environment.

OVERVIEW

ShopOne Centers REIT owns and manages market-dominant, grocery-anchored and necessity-based shopping centers across the country. Our properties benefit from a diversified mix of high-quality national and regional tenants. The company has a self-managed, fully integrated operating platform led by an experienced management team. ShopOne leverages its best-in-class platform, local market knowledge and operational expertise to maximize the value of the portfolio and support the growth of its retailers.

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