Aegon Asset Management

Real Assets
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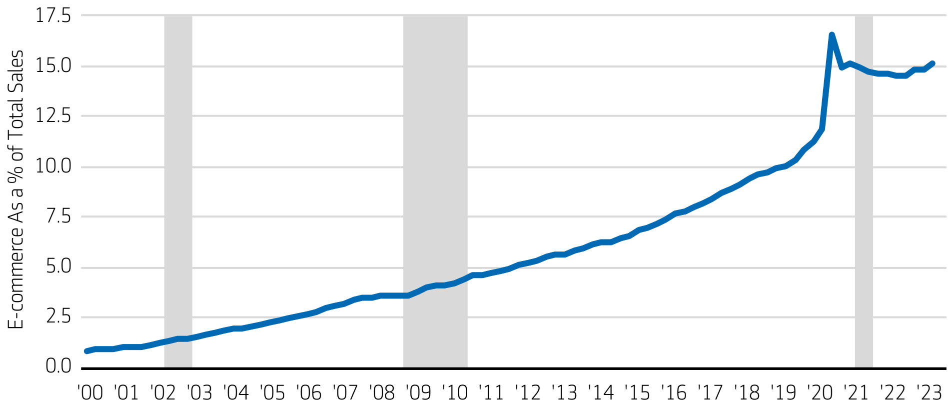
AEGON **INSIGHTS**

Identifying resilient retail segments for US commercial mortgage lending

Commercial Mortgage Loan Production Team

The retail sector has received a lot of attention in recent years given the Covid-19 pandemic, decline of the regional mall, wary shoppers, and subsequent government-mandated restrictions, leading some to doubt the need for physical retail establishments in the future. Predictably, e-commerce sales spiked in 2020, but as pandemic restrictions have receded, e-commerce as a percentage of total sales has stabilized in line with the prior trend (exhibit 1).

Exhibit 1: E-Commerce sales revert back to trend post pandemic



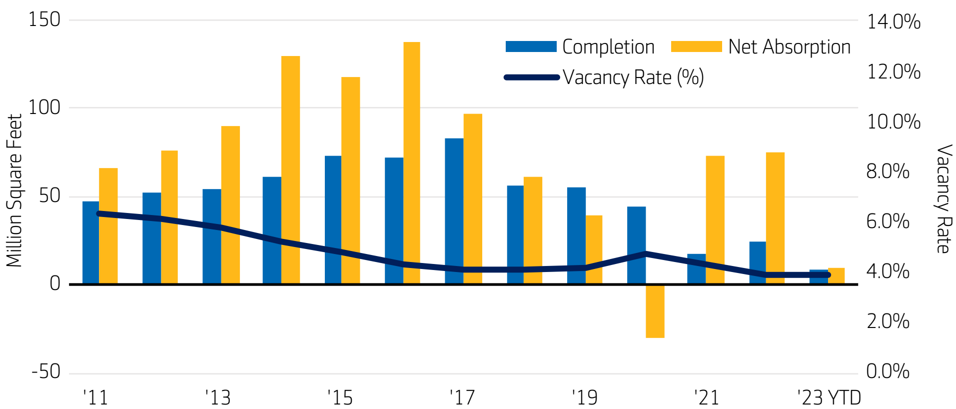
Shaded areas indicate US recessions. Source: US Census Bureau. May 19, 2023

The availability of retail space is near historic lows. There has been a significant decline in retail completions since the Great Financial Crisis as the sector was overbuilt coupled with the secular shift towards online shopping. In addition, the rise in construction costs has helped limit the threat of new supply across retail subtypes and geographies. As a result, we believe the retail sector is in a good position to weather a mild recession.

Despite the prominent news articles of retail tenants defaulting, the national retail vacancy rate was 4.2%, a 30-basis point decline over the past 12 months ending March 31, 2023.[1] In addition, many power/neighborhood centers that tend to be the victims of these tenant bankruptcies are well-located in fundamentally strong markets, which limits the amount of downtime should space become available.

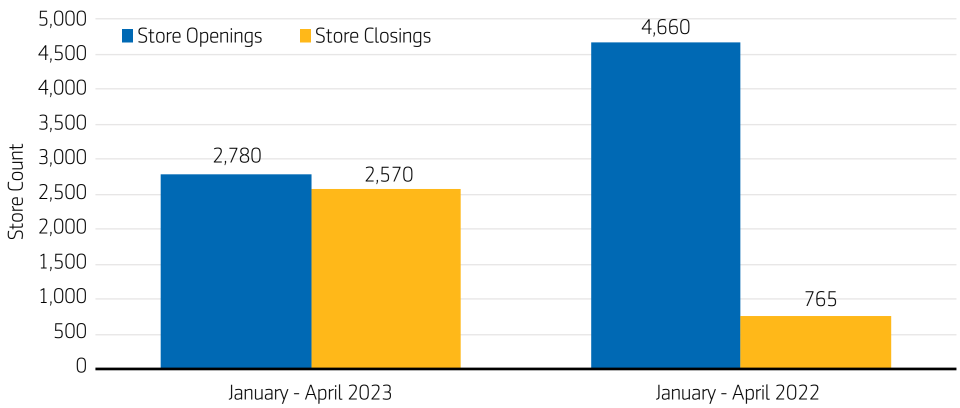
Nearly all major retail types, including fitness chains, cosmetic retailers and dollar-store chains, have experienced higher foot traffic when compared to 2019.[2] Moreover, annual net absorption since 2011 has remained positive with the exception of 2020 (exhibit 2).[1] Although store openings have slowed, during the first four months of 2023 there were more store openings than closings, specifically in the discounter segment, which has responded well during and after the pandemic (exhibit 3).

Exhibit 2: Minimal new supply has kept retail fundamentals largely balanced



Source: CoStar 1Q 2023 US Retail Report

Exhibit 3: Announced store openings still exceed closings



Source: Daily on Retail, May 2023

Finding lending opportunities

Grocery-anchored retail

One segment that has consistently demonstrated strength is grocery-anchored retail, in particular centers occupied by grocery stores with dominant market positions[3] or smaller chains that fit a niche market and exhibit strong local market demand. In our underwriting, we prefer grocer tenants with a proven track record of sales growth and low occupancy costs. We believe these factors help to mitigate the risk associated with grocers prematurely exiting the market or at the end of their lease term.

For centers that contain junior anchor(s) and other in-line tenants, it is important to be mindful of co-tenancy clauses[4] and to minimize in-line tenant space. Our preference

One segment that has consistently demonstrated strength is grocery-anchored retail, in particular centers occupied by grocery stores with dominant market positions or smaller chains that fit a niche market and exhibit strong local market demand.

is for centers located in well-established markets, supported by robust population counts that extend the trade area several miles and have median incomes within 1-, 3-, and 5-mile radii exceeding the national average. Additionally, we favor high-traffic areas with convenient access to major roads, ensuring optimal exposure and convenience for consumers.

Needs-based strip & unanchored retail

We believe there are promising prospects within the needs-based strip and unanchored retail segment. Properties in this segment typically include centers with a strong occupancy history, staggered lease expiration schedules, and a tenant mix that includes e-commerce resistant businesses. However, a heightened level of selectivity and careful evaluation throughout the underwriting process is warranted. We place a strong emphasis on in-fill locations within larger, densely populated markets that already have well-established customer bases. In addition, high land values also serve as a reinforcing factor, further solidifying viability of properties.

Recent examples

During the fourth quarter of 2022, Aegon AM Real Assets originated a loan secured by a grocery-anchored center situated in the Washington DC metropolitan statistical area (MSA). This center consists of a diverse mix of tenants, including a neighborhood grocery anchor, junior anchors, and in-line tenants. The anchor tenant's lease rollover is set for 2029, with multiple renewal options available and the loan is structured to reflect this upcoming event. The transaction featured a loan-to-value (LTV) ratio of less than 55% and a debt service coverage ratio (DSCR) of over 2.5x. The loan is set to mature in 2030 with a 30-year amortization schedule.

In the second quarter of 2023, we originated a loan secured by an unanchored retail center located within the Baltimore MSA. This center comprises several reputable junior anchors and in-line spaces, and benefits from staggered lease expirations. The property exhibits a high land-to-loan value ratio and a track record of long-term tenant occupancy. The transaction included an LTV ratio below 40% and a DSCR of over 3x. The loan is set to mature in 2030 with a 30-year amortization schedule, accompanied by a 36-month period of interest-only payments.

While price discovery is still an ongoing issue as retail transaction activity remains subdued, this is the case across all major commercial real estate sectors. By closely analyzing these types of retail properties, we feel there will continue to be opportunities to underwrite resilient investments in a rapidly evolving market.

[1]CoStar Realty Information, Inc. March 31, 2023
[2]Placer.AI. January 2023
[3]National and regional chains ranking among the top three in their respective markets.
[4]A co-tenancy clause allows a tenant to reduce their respective rent or potentially terminate their lease if a key tenant(s) (i.e., grocer, large anchor retailers) or a certain number of tenants leave the overall center, as specified in a lease.

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