PREMISES
The Retail Issue

Brooklyn's Farmers' Market

SCHACK INSTITUTE OF REAL ESTATE
SAVE THE DATE

FALL 2014
Wednesday, November 19
47th Annual Conference on Capital Markets in Real Estate
sps.nyu.edu/capital
The Pierre, Grand Ballroom
New York, New York

SPRING 2015
Thursday, February 26
5th Annual Conference on Sustainable Real Estate
NYU Kimmel Center

Wednesday, April 15
20th Annual REIT Symposium
sps.nyu.edu/reit
The Pierre, Grand Ballroom
New York, New York

Thursday, June 11
45th Annual Urban Leadership Award Dinner
sps.nyu.edu/urbanleadership
Waldorf Astoria New York, Grand Ballroom
New York, New York

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Investment in Retail Real Estate Will Accelerate
Glenn Rufrano

Lower Manhattan’s Retail Revolution
Jessica Lappin

An Interview with Faith Hope Consolo

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Adina David

Downtown Brooklyn’s Retail Thrives on Borough’s Diversity
Alan Washington

The Internet & Retail Real Estate...the Real Story
Gary Ralston
MESSAGE FROM DIVISIONAL DEAN AND
CLINICAL ASSOCIATE PROFESSOR ROSEMARY SCANLON

COLLEAGUES AND FRIENDS:
The Fall Semester is in full swing at the Schack Institute of Real Estate

We welcomed 176 new graduate students entering the three Master’s programs, for a total of 660 at our Midtown Center. Our B.S. degree in Real Estate program, now in its second year, welcomed 26 freshmen, who join the 17 sophomores of the class of 2017, all taking their core courses and first introductions to real estate at NYU’s main campus at Washington Square.

ALL OF OUR STUDENTS HAVE THE FORTUNATE EXPERIENCE OF STUDYING REAL ESTATE AT A TIME OF STRONG ACTIVITY IN THE INDUSTRY.

New York City’s strong economic recovery has generated 402,000 jobs since that low point in September 2009.

All of our students, graduate and undergraduate, have the fortunate experience of studying real estate at a time of strong activity in the industry and in the New York City economy. Substantial volumes of capital are now available to buyers and builders of real estate as the local market has recovered from the worst years of the global financial crisis and as money is pouring into New York City real estate from other countries. Major new development projects are underway at the World Trade Center and at Hudson Yards, and new or renovated housing developments are in construction in all five boroughs.

The city’s economy has been on a strong growth trajectory since the low point of the city’s recession in September 2009. Two years later, total employment in the city had recovered to match the peak in employment in August 2008, well ahead of the employment recovery for all of the United States, which did not reach this similar mark until May of this year.

New York City’s strong economic recovery has generated 402,000 jobs since that low point in September 2009. This is an annual growth rate of just over 2 percent, and it has lifted the city’s job totals above 4 million. Growth has been led by the city’s largest industries: education and medical services,
BOTH OUR GRADUATE AND UNDERGRADUATE STUDENTS CURRENTLY AT SCHACK WILL WITNESS THE MAJOR REVOLUTION IN RETAIL DEVELOPMENT AND RETAIL OFFERINGS.

which did not exhibit any downturn in employment through the recession, and professional business services, leisure, and hospitality. The city’s hotels and restaurants also benefited from the 55 million business and tourist visitors this year, as did the city’s many cultural attractions and theaters. In the diverse information sector, job levels in motion picture production and sound recording have now reached a level of 55,000 on the strength of 5.5 percent growth per year during the past decade, while employment levels in the publishing industry have stabilized after several years of sharp declines. The tech sector has caught much attention with new start-up firms, although jobs are difficult to classify as a separate industry or sector.

However, neither employment levels nor average wages in the city’s powerful finance and insurance industries have yet to recover from the damage of the financial crisis, although profit levels and bonus payments in the major banks and insurance companies are improving. At peak in 2007, wages and bonuses in this sector accounted for one-third of all wages earned in the city, although job levels were 9.3 percent. At year-end 2013, the average wage of $266,000 was down 7 percent from the 2007 peak and accounted for just under 27 percent of all wages and salaries earned in the city and 8 percent of all jobs.

Finally, a tip of the hat to strong business activity in the retail sector throughout the city, where employment over the last five years has been growing at over 4 percent per year. Retail trade now provides over 350,000 jobs. That sector is the centerpiece of this issue of Premises, with articles by industry leaders Glenn Rufrano and Gary Ralston, and an extensive interview with Faith Hope Consolo. We also have a review of the burgeoning Downtown Brooklyn market by Alan Washington, a Spring 2012 Schack alumnus, and a presentation of the equally exciting changes in Lower Manhattan by Jessica Lappin, of the Alliance for Downtown New York.

Both our graduate and undergraduate students at Schack will witness a major revolution in retail development and retail offerings, not only in Brooklyn but also at the World Trade Center, where Westfield has over 500,000 square feet of new space nearing completion. Also exciting is the major renovation of retail space underway at Brookfield Place as well as the rejuvenation of retail throughout the five boroughs, especially at Hudson Yards, where a huge volume of retail space is being planned.

The recovery in the city’s retail sector is a product of the strong employment figures, the influx of visitors, and the steady growth in population, all of which impact the city’s real estate market and make this issue of Premises a must-read.

Rosemary Scanlon
Divisional Dean and Clinical Associate Professor
NYU School of Professional Studies
Schack Institute of Real Estate
INVESTMENT IN RETAIL REAL ESTATE WILL ACCELERATE

By Glenn Rufrano

Glenn Rufrano
Chairman and CEO
O’Connor Capital Partners

Glenn J. Rufrano is chairman and CEO of O’Connor Capital Partners, rejoining that firm in November 2013. He was formerly CEO at Cushman & Wakefield, and before that, CEO at Centro Retail Trust. Glenn is a member of the Schack Institute of Real Estate Advisory Board.
The Great Recession (2007–2009) has caused changes in demand patterns for all forms of real estate. Perhaps it was not only this dramatic period, since real estate, which houses our residential and business functions, is always changing with time. But those of us living through that period may say it had the most dramatic effect on our real estate thinking. Some, of course, didn’t make it through.

This article will not discuss the full spectrum of property change from 2009. It will focus on retail real estate. Further, it will focus on investors’ attitudes and demand for retail product over the last few years, concluding with a view that we will see greater investment in the near term. Near term will be defined as the next 12 months. Looking beyond a year is a task fraught with its own risks. The conclusion will be drawn from the data we know as of the summer of 2014, buttressed with some basic common sense.

The “common sense” argument simplifies all the elements that go into a retail real estate investment into three basic buckets: consumption, forms of retail distribution, and retail fundamentals. All three have to be understood before the “why” question can be answered in support of the thesis that investment in retail real estate will accelerate.

Consumption

We all know the US is a nation of consumers. Two-thirds of our household budgets are still devoted to spending on goods and services, the most important fundamental underlying the purpose of shopping centers. Unless the nation’s propensity to consume is understood, we will not grasp the key to how and why real estate is demanded by the retailers themselves. Table 1 shows that consumption, although interrupted by the Great Recession, is back on track in the US. Not only are we spending more, but our confidence in the continued ability to spend is increasing (see Table 2). There are a number of factors causing consumption growth: better employment trends, increasing personal income, lower personal debt burdens, rising home prices, and a projected increase in population of between 2 and 3 million people per year. We can see our long-term pattern of consumption is back, a positive indicator for anyone connected to the retail business.
A likely outcome will include both online and bricks-and-mortar retailing for most tenants. This is now termed “omni-channel retailing.”

**Forms of Retail Distribution**

Retailers know the dollars are out there. The challenge is to find ways to capture consumer spending and provide value. The industry calls this “distribution.” The Gap, for instance, can distribute its products and services in a mall, open-air community or neighborhood shopping center, lifestyle center, outlet center, urban main street or online. Retailers and investors in retail real estate have absorbed the fundamentals and risk differentials in the “bricks-and-mortar” forms of distribution just mentioned. The real issue here is online retailing and its impact on the bricks-and-mortar formats.

The negative position taken for the battle of online retailing versus bricks-and-mortar retailing centers around the greater percentage expansion (the growth rate) of e-commerce and in-store retail tenants reflecting weak results. Perhaps it takes some age in the business to have perspective, but similar arguments were used as we transitioned across the spectrum of bricks-and-mortar formats mentioned above. This time we are in the middle of the online transition, with tenants themselves determining what ratio of service distribution — online versus bricks and mortar — provides optimal value to the consumer and optimal value to the enterprise.

The higher growth rate in e-commerce versus total retail sales in Table 3 is illustrated against the low base on which this growth is predicated. The growth does impact store sales, but more importantly should be viewed as providing an additional arrow in the quiver of the retailer as it distributes to the market.

Bricks-and-mortar tenants are investing in building e-commerce channels and have been doing so for more than a decade. There are also companies such as Apple, Microsoft, JUSTFAB, Althleta, and Bonobos — which have relied predominantly on Internet sales — migrating to some percentage of bricks and mortar. The industry is in transition and finding ways to meet changing consumer needs and patterns. Pop-up stores sometimes are targeted experiments by e-merchants seeking experience in reaching customers face to face. A likely outcome will include both online and bricks-and-mortar retailing for most tenants. This is now termed “omni-channel retailing.”

Although the retail investing market is still absorbing the impact of omni-channel retailing, there has been very good market information since the recession to provide risk assessment for investors. As uncertainty diminishes, the price of risk comes down and so do barriers to investment.

**Retail Fundamentals**

Risk assessment in real estate investing is always a function of current market fundamentals and expectations. Table 3 illustrates the dramatic negative impact of the Great Recession, directly affecting retail tenant viability. Coupled with growth in e-commerce, the investor in retail real estate needs to understand the fundamentals of retail real estate value before pricing can be established.

Start with retail sales growth. Table 4 illustrates a generally healthy market expanding at 7.8 percent. Sales slumped in
the first quarter of this year (mostly due to temporary factors caused by last winter’s extreme weather), but came roaring back in the second quarter to the highest level in the last three years. This is the result of increasing consumption and confidence, economic fundamentals for the stores sector.

An even more important factor to investors is supply. Up until 2008, supply in the 2000s averaged around 2.6 percent of the 6.5 billion square feet of gross retail leasable area. Table 5 shows the sharp reduction in 2010 through the first quarter of this year. We are now experiencing net new retail space additions at 0.5 percent. When we couple supply with population growth, the square-foot-per-person ratio has dropped from 24.2 in 2009 to 23.7 in early 2014. These are good results from an investor’s standpoint, because the impact on online retailing may not be fully understood, but it surely means we require less square footage.

Occupancy levels for malls and open-air community and neighborhood shopping centers have been gaining. Public

mall company occupancies have risen from 91 percent in 2009 to 95 percent. Small stores in open-air centers jumped from 80 percent occupancy to just over 90 percent during the same period. Rents have also been on the rise. Retail real estate net operating income is once again matching its 2000 high of 26 percent of all property types as tracked by NCREIF’s database as well as matching NOI growth for all NCREIF property types (see Table 6).

Lastly, let’s look at the retail real estate returns for NAREIT and NCREIF (see Table 7) that are the result of these trends
in consumption, distribution formats, and fundamentals. As usual, we find the NAREIT numbers more accentuated and time sensitive to NCREIF, but the post-recession results in both are quite positive. The first half 2014 numbers indicate the potential for a record year. That could surprise a lot of people.

**TABLE 7**

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* Year-to-date numbers  
Source: NAREIT, NCREIF

**Investment in Retail Real Estate Will Accelerate**

This article paints a positive portrait, drawing on a review of consumption, retail distribution and the online effect, and retail fundamentals. Opposing views could argue that specific retail categories and certain department stores are in jeopardy. Retail sales may be up, that argument goes, but understand that certain retail categories are experiencing sluggish growth, functionality of certain shopping centers is in question, and regardless of reduced supply certain geographic locations have too much retail product. These are all good thoughts, but the real question is, given the positives and negatives, can retail real estate be priced and traded?

Here there is no question — the answer is yes, and at an accelerated pace. That trend has held from 2011 to 2013, with 2014 approaching the highest volume since the banner year in real estate capital markets of 2007.

Table 8 reflects the US historical investment sales volume, retail historical sales volume, and the percentage of retail to total. 2007 is a standout year with over $514 billion in total investment sales, of which $75 million was in retail. The total investment sales estimate for 2014 is $348 billion.

Retail investment sales totaled $21.3 billion in the first quarter of 2014, up 158 percent year over year. If we take the last six years of retail investment sales as a percentage of total investment sales, approximately 20 percent, and apply it to the total sale estimate of $348 billion for 2014, we find 2014 may be as high as $70-$75 billion, very close to the retail peak year of 2007.

The capital markets should support this volume with the abundance of debt capital matched against product availability. We do have potential headwinds with increasing interest rates, but barring dramatic shifts, the accelerating trend of 2014 should extend into 2015.
LOWER MANHATTAN’S RETAIL REVOLUTION

By Jessica Lappin
Jessica Lappin, President, Alliance for Downtown New York
Jessica Lappin is a Lower Manhattan business and civic leader. The Alliance for Downtown New York is the City’s largest Business Improvement District. She was a member of the New York City Council from 2006 to 2013.

If you are looking for a good spot to view the ongoing transformation of Lower Manhattan, try the bustling intersection of Fulton Street and Broadway. To the west, the gleaming, tapered tower at One World Trade Center soars 104 stories into the sky. To its immediate north stands the sleek, 741-foot 7 World Trade Center. Peeking into view are the ribbed-steel wings of Santiago Calatrava’s World Trade Center Transportation Hub. On the southeast corner looms the MTA’s much-anticipated Fulton Center, its glossy, glass-paneled exterior perfectly reflecting the commotion of pedestrians, cabs, and buses. To the northeast, a big, bold sign portends an upcoming new arrival to the neighborhood: “Zara... opening 2015.”

This busy downtown juncture has seen many other recent changes. Major commercial tenants have taken up residence in office buildings at both 195 Broadway and 222 Broadway. A new Pace University dorm opened at 182 Broadway last year, and another one is on the way at 33 Beekman Street. A flurry of storefronts has also changed hands over the last few years. Once dominated by a medley of fast-food restaurants, shoe stores, and bodegas, the Fulton/Broadway area has become a dynamic hub for a host of new and reimagined shops. It is one of many such hubs sprouting throughout downtown, as a wide-ranging constellation of new stores, restaurants, bars and coffee shops emerges south of Chambers Street.

Lower Manhattan is in the midst of a retail revolution. As $30 billion of public and private investment come to fruition downtown, the neighborhood is evolving in many ways. But there is nothing — with the exception of the revitalized World Trade Center site — that is redefining the area as radically as the new stores opening up.

The changes are part of a larger story that began before the attacks of September 11. Then, the area was known as a place of off-price merchandise and limited shopping options. In 2001, Lower Manhattan was home to just 23,000 residents. Now, nearly three times as many people live there, and that number is expected to grow. Pre-9/11, there were 2,300 hotel rooms in the district; by 2016, there will be 7,700 rooms. These are among a confluence of shifts reshaping Lower Manhattan is seeing its greatest transformation in retailing in generations as a result of office and residential investments that have created a true 24/7 community.
the retail landscape. Other trends include growing tourism, rising student enrollment, enhanced spending power, an expanding transit network, and an increasing and varied array of office tenants. By 2016, a total of 1.55 million square feet of new or repositioned retail will have come online.

There will not only be more stores, but a greater breadth of options. Already, downtown shoppers can find Tiffany’s, Sephora, Tumi, and Urban Outfitters. A Zara and a Gap are opening soon, and rumors have swirled of a Saks Fifth Avenue department store. In some places, the neighborhood’s commercial complexion is unrecognizable from just a few years ago. The new arrivals — which will include high-end stores, boutiques, and popular chains — are complementing the existing ones and helping to answer a surging swell of demand.

Most New Yorkers are, of course, familiar with downtown’s Century 21 department store, a legendary city institution that opened in 1961 and became famous for its vast array of discounted designer merchandise. Still a popular draw for residents, tourists, and workers alike, it has recently expanded and upgraded its store. In anticipation of a new cross-section of customers, it has added 60,000 square feet over three levels. Century 21 is one of several existing retailers that have responded to the changing demographics and office tenancy in Lower Manhattan. Another is the flagship McDonald’s at 160 Broadway, which has reinvented itself to appeal to the growing community of tech and media companies downtown. In addition to a new customized store design, the restaurant also replaced a grand piano above the entrance with a live DJ.

Altogether, there are now 997 retail shops in Lower Manhattan. Several significant developments currently underway will move that number upward. The MTA’s $1.4 billion Fulton Center, opening soon, will introduce 65,000 square feet of new retail space being leased by the Westfield Group.

A block away, Westfield will also unveil 150 new shops and restaurants at the World Trade Center. Those are expected to open in late 2015. At Brookfield Place (formerly known as the World Financial Center), a major reinvention is unveiling a host of local and international retailers and a diverse bounty of new eateries. On the East Side, the Howard Hughes Corporation is giving Pier 17 a complete makeover, with a new glass-clad building that will house a mix of shopping and dining outlets, expected to open in 2016.

Lower Manhattan’s annual spending power tops $5.2 billion. The area’s residents are generally well educated and affluent; the average household income is $204,000. New residential developments are driving the growth in population. The pipeline of upcoming residential projects includes 2,200 new units in 10 buildings currently under construction. Retailers are, of course, taking note of all these changes.
Century 21’s recently expanded store, sits right in the middle of the bloom of retail in Lower Manhattan.

CENTURY 21 DEPARTMENT STORE, A LEGENDARY CITY INSTITUTION FAMOUS FOR ITS VAST ARRAY OF DISCOUNTED DESIGNER MERCHANDISE, HAS RECENTLY EXPANDED AND UPGRADED ITS STORE.

Robust tourism has also drawn their interest, as a number of new attractions have opened. In 2013, 9.6 million tourists visited Lower Manhattan, and the hotel industry is racing to keep pace. The roster of upcoming hotel projects now makes up 20 percent of New York City’s total hotel pipeline. They span a variety of service types — from luxury to boutique to budget. The impact on foot traffic for current and upcoming retailers will be significant.

There are 310,000 workers in Lower Manhattan with an eclectic appetite for shopping and dining choices. The workforce is become bigger and more diverse as companies continue migrating downtown. Time Inc. recently signed an office lease for 670,000 square feet at Brookfield Place; the company will relocate from its global headquarters at the Time & Life Building in Midtown. Condé Nast is fitting out its space at One World Trade Center and will begin moving its employees in November 2014. The area has become a magnet for media and technology companies, and a new creative cluster is taking shape south of Chambers Street. The number of technology companies grew by 24 percent in the space of one year, to 600 or so in 2013. Many of these companies were lured downtown by a combination of affordable rents, a reliable broadband infrastructure, a robust transit network, and tech-friendly buildings with adaptable floor plates.

In anticipation of the influx of new workers from Condé Nast and other companies, many other retailers are now eyeing Lower Manhattan, according to a recent New York Times article. But if more workers means more retailers, the inverse can also be true: More companies will likely be attracted to Lower Manhattan by the abundance of shopping and dining options.

Momentum is building and the boom extends beyond shopping into dining and fitness. A flourishing food culture is taking root south of Chambers Street, and it has drawn

The number of technology companies grew by 24 percent in the space of one year, to 600 or so in 2013.
Downtown retailing’s expansion and revival is catapulting this market into the top tier of urban shopping venues worldwide. Between the major upgrading at Brookfield Place, the opening of the Westfield retail at World Trade Center, and the Fulton Transportation retail hub, workers, residents, and tourists will enjoy exceptional shopping and restaurant opportunities in Lower Manhattan.

A FLOURISHING FOOD CULTURE IS TAKING ROOT SOUTH OF CHAMBERS STREET, AND IT HAS DRAWN THE ATTENTION OF NAME-BRAND RESTAURATEURS LIKE STEPHEN STARR, TOM COLICCHIO, AND KEITH MCNALLY.

the attention of name-brand restaurateurs like Stephen Starr, Tom Colicchio, and Keith McNally. The Institute of Culinary Education is moving from the Flatiron District to a 71,000-square-foot space at Brookfield Place. The recently opened 600-seat Hudson Eats dining terrace is a pioneer in the growing trend of upscale food courts in New York City. The site offers 14 curated gourmet eateries and sets out to provide a higher-end, fast-casual dining experience. A reflection of the growing residential population and wide-ranging mix of new office tenants, a number of fitness chains have also sprouted downtown facilities; among them are Equinox, Retro Fitness, Blink Fitness, and Soul Cycle.

The rich range of new arrivals on the Lower Manhattan retail scene has reached a tipping point – a neighborhood once known solely as the domain of Wall Street and a largely 9-to-5 business district is poised to become one of the city’s major retail destinations, a fully serviced 24-hour urban center.

Over its 400 years, Lower Manhattan has mastered the art of reinvention. In the neighborhood where George Washington took the presidential oath, where millions of immigrants entered the United States, where one of our greatest national tragedies revealed our city’s unique resilience – a new chapter is unfolding.
**Interview With Faith Hope Consolo**
*Chairman, Retail Leasing, Marketing and Sales Division
Douglas Elliman Real Estate*

Faith Hope Consolo, the “Queen of Retail,” is the most renowned retail broker and consultant in the country, not only for her knowledge, reputation, and taste, but also for her key role in revitalizing and sculpting retail corridors across the nation and beyond. As Chairman of Prudential Douglas Elliman’s Retail Leasing and Sales Division, a position created especially for her, she is responsible for providing comprehensive retail counsel to an array of tenants and landlords, both nationally and internationally.

**Premises:** Thanks for taking the time to share your thoughts on “high-street retailing.”

**FHC:** I’m really glad to! You know, at the start of my career, I took classes at NYU’s Real Estate Institute, before it had a master’s degree program and was called “NYU/Schack.” I learned a lot and met really important industry people. I’ve enjoyed the times I have been able to come back for lecture and panels. I hope to be able to do that again.

**Premises:** We’ll be sure to make that happen!

**Premises:** There’s no one better than you, Faith, to give us perspective on Manhattan’s signature retail locations on the world-renowned avenues in Midtown.

**FHC:** For merchants, it is all about foot traffic on the street. You find this on the Champs-Élysée in Paris, Bond Street in London, and on Fifth Avenue in New York. Throughout the year, people are out walking on these street. Retailers love it.

**Premises:** People with lots of money to spend.

**FHC:** Don’t jump to conclusions. Yes, “high street” used to mean “luxury,” and you still see Tiffany’s, Harry Winston, Cartier, Armani, and such on Fifth Avenue. But more and more, high-street retailing is about the mix. There’s a place for all kinds of brands and flagship stores catering to many different kinds of shoppers. The foot traffic is very diverse and so are the stores. There’s H&M, Uniqlo, and the Gap. Just take a look at what’s actually there and you’ll see there’s no stereotype. Don’t assume you are shut out if you are not in the “1 percent.”

**Premises:** What’s the reason for such a diverse mix?
FHC: You know, for the high streets, I believe you have to start with the tourists. Again, look at who makes up all that foot traffic. It is so diverse, but so many of the shoppers come to New York from around the country and from around the world. Fifth Avenue is a destination. Successful retailing is complicated in some ways, simple in others. One thing you absolutely need is energy, and the tourists bring that. There are 54 million or so tourists coming to New York each year. They are excited to be here and love seeing the windows, then walking into the stores.

Then you have the merchants themselves. They are positioning themselves in the marketplace. Yes, locally, but the Fifth Avenue address becomes the face of the brand. Look at H&M. It already had hundreds of stores, but they were small stores. It needed to have a big space in Midtown to say that it was to be reckoned with; that it belonged. And the company designed a very welcoming space — lots of light, very open, drawing the customers in. It is a strategic move for the whole business, not just another store opening.

TO SERVE THE CLIENTS YOU HAVE TO KNOW WHAT WORKS. YOU HAVE TO KNOW WHAT SELLS. THAT’S WHAT’S DEEP ABOUT RETAILING. IT IS ALL ABOUT EDUCATING YOURSELF ABOUT THE CULTURE OF THE CITY.

A bronze statue of Atlas in Rockefeller Center, at the center of Fifth Avenue’s retail row. Marco Rubino/Shutterstock.com.
And don’t forget you need a landlord who is attuned to what retail can do for his whole building. Again, it is about the mix. Does the marketability of office space increase because of the retail energy of the high street? I think it does. And landlords can make a huge difference, not just for the retailer, but also for the whole urban quality. Think of how much all of New York benefited when Tishman Speyer upgraded the retail frontage at Rockefeller Center. That suddenly tied Fifth Avenue north of 51st Street to Fifth Avenue south of 48th. It seems so natural now, we take it for granted. But it took a decision, and an investment. I think it’s paid off.

Premises: What do think is behind a decision like that?

FHC: Retail is the sexy side of real estate. Stores give buildings identity and throw off value. It raises the bar for a building, too. Owners are motivated to put their best foot forward. Of course, the merchant feels a responsibility too. Look at how much time, talent, and money go into window displays. No one wants to be seen as “less than” to a shopper walking down the avenue. They want to feel like they are in the club, even if they aren’t selling luxury goods.

Premises: Why is that?

FHC: Again, you are talking about very sophisticated merchants here, even if their target markets differ by income. Think about that traffic: It’s everybody – denim to diamonds. Do you present yourself to the lowest common denominator or do you elevate your game to the highest standard? By being on Fifth Avenue you’ve right away made a commitment to quality. That’s what you are saying to yourself: This is Fifth Avenue, and I belong here.

Premises: There’s a real international flavor, isn’t there? Not just the tourists, but the signs that tell us that a merchant is in “New York, Paris, Geneva, London, Milan, Tokyo,” and so on.

FHC: Well, of course retailers are extremely competitive. It is really interesting to me to see that big cities around the world – I’m speaking about the retail streets here – aren’t changing as swiftly as in New York. Paris and London are seeing much less change. There’s a great opportunity to be a first mover in Paris and London. New York is by far the fastest changing: We shift “in a New York minute.”

Premises: Does that make a big difference?

FHC: It absolutely does. Retailers have to reinvent themselves constantly. Nobody is ahead of the curve.

Premises: Is the same true for other US cities?

FHC: Retailing is local, perhaps to a surprising degree. Global retailers need to understand this in their real estate searches. What works in New York doesn’t necessarily fly in Philadelphia or

THE E-TAILING IMPACT IS MUCH, MUCH LESS THAN PEOPLE THINK. SHOPPERS RESEARCH ONLINE, BUT USE STORES AS THEIR PRIMARY CHOICE FOR EVERYTHING BUT BOOKS, MUSIC, AND ELECTRONICS. SHOPPING IS ABOUT “THE EXPERIENCE.”
Boston, or even in the big California markets. We sell lots of expensive dark wool suits here. Try doing that on Lincoln Road in Miami Beach.

Across the US I look for cities with great art and great sports. It’s not a perfect guide, but a good one. Atlanta is a terrific shopping town, but look what Asheville has become. Look at the retailing near the sports arena and convention center in D.C. All different, all successful in their own way.

There is no “pure shopper” out there – just a wide variety of taste, behaviors, pocketbooks. Everyone involved in retail real estate needs to address their own learning curve. Consumers have gotten so knowledgeable.

**Premises:** Some of that is the Internet, isn’t it? How does the high street function in an e-commerce world?

**FHC:** The e-tailing impact is much, much less than people think. Shoppers research online, but use stores as their primary choice for everything but books, music, and electronics. Shopping is about “the experience.”

**Premises:** Meaning?

**FHC:** It starts with understanding your customers. The whole array of them. The best retailers are always engaging their customers in talk. This isn’t just chitchat – it’s learning. Understand the mix: tourists, locals, buyers, and browsers. Offer services as well as “stuff.” Above all, make it fun. Be creative.

**Premises:** Does that really pay off?

**FHC:** It builds on itself. What’s the test? Do investors want to put their money into high-street retailing? There seems to be demand from all over the world to own a piece of Fifth Avenue. Canadians. Australians and New Zealanders. Asians. The Greeks have been here a long time – all the Europeans, in fact. It is like the United Nations. I love to walk to work, to hear all the languages. Does it pay off? Yes, some of the impact of being on Fifth Avenue is selling the brand worldwide, but these stores do tremendous business, too.

**Premises:** Your enthusiasm is contagious. You love what you do.

**FHC:** Well, yes. I have a saying, “Fashion is my passion.” Do you know that I still do canvassing? Personally? Just to stay in touch with the market. To serve the clients you have to know what works. You have to know what sells. That’s what’s deep about retailing. It is all about educating yourself about the culture of the city, about constantly adapting, about marrying product to market. Do you know what’s hot right now? Menswear! Why? Metrosexuals! How could you not be enthusiastic?

**Premises:** So what’s the takeaway for our readers?

**FHC:** Address your own learning curve. Work harder, travel more, and keep studying your field. Here’s the truth: Only the smart survive.
WINNERS!
NYU/SCHACK—COLUMBIA U TEAM PLACE IN HUD COMPETITION
RUNNERS-UP FOR AFFORDABLE HOUSING STUDENT DESIGN AND PLANNING

By Adina David

Adina David is completing her master’s degree in real estate finance and Investment at the Schack Institute of Real Estate at NYU. She is currently working as an Acquisition and Asset Management Specialist at the Dermot Company, a firm with approximately $2 billion of real estate assets under management and development.

What could be more exciting than being on the cutting edge of a field that is both socially important and financially challenging? A team of five students, three from NYU/Schack and two from neighboring Columbia University, tested their mettle in a national competition during the Spring 2014 semester and came away with second-place honors in the first annual “innovation in affordable housing design” program, organized by the US Department of Housing and Urban Development (HUD). The competing teams were asked to show their imagination and skill sets on a historic site in Bergen County, New Jersey.

The Peter DeBaun House was built in 1770 and is located at 324 Main Street in Emerson, New Jersey, a borough in Bergen County. Emerson is considered a suburb of the New York metropolitan area, with easy access into Manhattan, approximately 18 miles to the east. The 3,100-square-foot DeBaun building sits on roughly 1.5 acres and has housed the American Legion Post 269 since the 1970s. The HUD challenge sought to provide a compatible development for the veterans served for decades by this American Legion post.

Designing affordable housing is a challenging task for real estate professionals. We want to maximize the returns on investments while creating something that has purpose for our communities. In a free, competitive market, we like to assume that if the latter is true and demand exists, then the former will also materialize. However, building affordable housing in an expensive market is a tough proposition. To do so requires a combination of...
disciplines to find a practical, feasible, and smart solution to the affordable-housing problem that fits optimally into the natural and built environment. In the process, this particular competition sought to save a property with deep history for Northern New Jersey.

HUD competition guidelines allowed for groups of up to five graduate students, with a minimum of three disciplines represented in each group. Team 57 included three students from New York University’s Schack Institute of Real Estate – Adina David (MS RE Finance and Investment), Jason Fleisig (MS RE Development), and Matthew Meskill (MS RE Finance and Investment) – and two students from Columbia University – Anna Oursler (MS Urban Planning and MS Architecture) and Eric Blair-Joannou (MS Urban Planning and Business Administration). We competed in two phases: an online submission of a proposal in February from all teams and an in-person presentation of all four finalists’ projects. The latter was held at HUD’s headquarters in Washington, D.C. in May.

Market and Demographics: Understanding the Client

Phase I of the competition required a thorough understanding of the subject property and the target clients. As with market rate development, quantitative and qualitative research of both Emerson and the greater Bergen County area was paramount in understanding how supply and demand shape the feasibility of this affordable-housing development. In addition, the team sought to address equally important issues regarding veterans’ integration into the community and how to avoid marginalization of said residents in an affordable-housing development.

The total population of Emerson, according to the 2010 census, was 7,401 people in roughly 2,480 households. The median household income was $99,292, which is high when compared to the rest of the United States. Consequently, the cost of living index in Bergen County is 123.2, compared to the US average of 100. According to the Census Bureau, 9,125 veterans live in Bergen County, with 386 living in Emerson itself. Numbers could not be found at the local or county level for homelessness, but at the state level, New Jersey’s unsheltered homeless population has increased by 22 percent between 2011 and 2012. Thankfully, the homeless veteran population decreased by 27 percent during the same period, from 811 to 592 veterans.

The community surrounding the subject property is primarily residential, with one main commercial center 0.4 miles to the north of the property. This area has a high concentration of medical offices, clinics, and a hospital, providing the necessary facilities to disabled or aging veterans.

This area has a high concentration of medical offices, clinics, and a hospital, providing the necessary facilities to disabled or aging veterans.
The Fair Market Rent (FMR) standard for Bergen County for 2014 is at $1,230, which may actually be low for properties within Emerson. For the purposes of this development, our analysis averaged one- and two-person household incomes and set a rental rate of 30 percent of that amount, or $853 per month.

The Target Community

Having spoken with local community leaders during our site visit, Team 57 envisioned a beautiful space taking shape around a restored DeBaun House. Target marketing requires a very specific sense of who is to be served. In our view, the client best served by this rehabilitation and development project was a veteran recently returned from war abroad, perhaps dealing with readjusting to life at home, suffering from post-traumatic stress disorder or trying to overcome a physical disability. Such a client would have access not only to services, transportation, education, and employment, but also to rehabilitation facilities, with respect for personal privacy.

The team found excellent statistical support for a plan to develop purpose-built veterans housing. The current housing supply is limited: The average vacancy rate within a five-mile radius of the DeBaun site is approximately 3 percent. With 386 veterans living in Emerson, 24 one-bedroom units would lessen the difficult search for those seeking affordable housing.

Aside from the client demand for affordable housing, there is wider benefit. Local communities across the United States have a shortage of renewed, rehabbed, expanded, or newly accessible spaces. Our interdisciplinary team identified several focal points for innovation to be addressed in our plan, namely:

- Communities need to be linked with each other and within;
- Rehabilitating an older building can restore a piece of history, and harnessing the natural environment to enhance that building can organically lead to rehabilitating people as well as property;
- Readily available green building technology can improve quality of life and environment without necessarily making it cost-prohibitive;
- Understanding and deploying available sources of financing can optimize the capital available to affordable-housing developments, potentially freeing excess funds for community projects.

The proposed design of DeBaun Village

Team 57 proposed a three-building layout, which included 24 apartment units at 650 square feet per unit, with 44 parking spaces. The buildings would be situated behind the existing DeBaun House, with access in a loop from the property’s existing driveway. Taking advantage of the natural topography of the site, we designed paths and semipublic outdoor spaces that integrated organically with our setting. An indoor/outdoor gazebo was added near a pathway; vegetable gardens were placed on the south side of the lot, where exposure to sunlight was best; a graywater system and a compost facility were included within the site; and the pathways themselves were designed with different purposes in mind, specifically for helping veterans undergoing physical rehabilitation. Additionally, Team 57 thought that the project would be very well served by not only refurbishing the DeBaun House, but also by including a small café on the south side, which would cater to the local community, commuters, or cyclists to the area.

Some of the green building components are illustrated in the accompanying diagrams.
Financing

Team 57’s financial model for this development accounted for the aforementioned innovative design amenities, green technology, and other special features. These may increase initial costs, but over the lifetime of the building, will reduce operating expenses. The sources of financing considered require that the general contractor be paid Davis-Bacon wage rates.

Thus, Team 57’s construction budget reached a total cost of $6 million, with hard costs priced at $165 per square feet for the entire project, including the new units and the rehabilitated DeBaun House. Since this proposal would be presented to the Housing Authority of Bergen County, land costs were kept at $0.

Based on market research, Team 57 identified two sources of financing most appropriate for this project – 4 percent Low Income Housing Tax Credits (LIHTC) and the HUD 221 (d) 4 mortgage program. We also considered 9 percent tax credits, but concluded that those would be difficult to obtain. Developers compete keenly for the more generous 9 percent LIHTC funds. The LIHTC program is an indirect federal subsidy used to finance the development of affordable rental housing for low-income households. The 4 percent credits are awarded on a noncompete basis. The credits are syndicated to investors, raising equity capital and reducing the need to borrow funds. Such a capital structure made it financially feasible for Team 57 to redevelop the Peter DeBaun House while remaining in compliance with the rent rates for low-income housing.

As a Project-Based Section 8 development, tenants pay 30 percent of their monthly adjusted income toward rent, while Section 8 vouchers cover the difference. Team 57’s assumptions were based on a Fair Market Rent for 2014 in Bergen County of $1,230 per month, per unit, and utility reimbursements of $117.

Securing the project-based vouchers would enable us to obtain an FHA loan at more favorable terms, with a lower debt service coverage ratio and greater loan-to-cost level. The HUD 221 (d) 4 mortgage is the largest nonrecourse construction and permanent type of debt available, with advantageous rates and loan proceeds of up to 90 percent of the total development cost. Its 40-year amortization feature keeps debt service low. Additionally, commercial use is allowed for up to 10 percent of the total rentable area and 15 percent of the gross income, which we took into account with Woods Café, alluded to above as an amenity on the south side of the site.

If Section 8 project-based vouchers were unavailable, the subsequent changes in underwriting would decrease the eligible loan amount. In this case Team 57 suggested alternatives. The first option would be to try to obtain project-based HUD – Veterans Affairs Supportive Housing (or VASH) vouchers as well as equity or soft-debt sources to fill our capital stack gap. Some sources identified for this additional capital are HOME funds, Community Development Block Grants (CDBG), and the New Jersey Economic Development Program (ERG), which are all applicable to the project as proposed by our team. The property will also benefit from a Payment in Lieu of Taxes (PILOT) agreement that will equate to 6.25 percent of effective gross income, less utilities, over the 40-year term of the loan.

Team 57’s development proposal includes structuring a joint-venture partnership with a private developer who would receive half of the total developer fee underwritten, or $410,000. The remaining proceeds would be directed back into community program funds at the Peter DeBaun Village. Additional revenue can be generated for these funds from building operations, as the cash flow after debt service would be approximately $28,000 per year.

Conclusion

Team 57 was the runner-up in the competition, receiving an award of $5,000. The Bergen County Housing Authority has continued the process of saving the DeBaun House, using outside consultants for the site. Team 57 was very grateful to be involved. Beyond the cash prize, our reward was in working together to fashion a creative and feasible solution for the Peter DeBaun House.

The team would like to thank Schack Institute professors Dr. Hugh Kelly and Michael Zukerman for their guidance throughout the competition.
Alan Washington is the director of Real Estate and Planning at the Downtown Brooklyn Partnership. He is responsible for this Local Development Corporation’s planning, commercial attraction, and real estate services. Alan is a Schack Institute alumnus, having earned his master’s degree in real estate in 2012.
Downtown Brooklyn has had a long and vibrant history as a premier retail destination in New York City. As Brooklyn's primary central business district, Downtown Brooklyn has a diverse economy supported by residents, traditional private-sector businesses, tech and innovation firms, government agencies, college students, and tourists who visit the area every day. Downtown Brooklyn also benefits from tremendous transportation infrastructure.

Eleven subways and 13 MTA bus lines provide connections to Downtown Brooklyn for all New Yorkers. The Long Island Railroad terminal is at Atlantic and Flatbush Avenues, the location of the Barclay Center.

The neighborhood is home to five different retail corridors, each with easy access to transportation and its own distinct style, making Downtown Brooklyn one of the most diverse retail destinations in the city. There have been setbacks over the borough's history, each of which has altered local retailing. The Great Depression of the 1930s and the Fiscal Crisis years of the 1970s saw business fail and new merchants arrive. Events such as the opening of the Verrazano Bridge connecting Bay Ridge to Staten Island; the closing of the Brooklyn Navy Yard, the borough's largest employer; and the coming containerization to the New York port — major changes occurring in the 1960s and 1970s — shifted the market for Downtown Brooklyn retailers, altering demographics and the employment basis. Differing urban revitalization strategies were attempted over the years, and the reshaping of the area took form with the development of Metro Tech in the 1990s. Through it all, retail has remained resilient in Downtown Brooklyn, thanks to the borough's population base of more than 2 million and its pivotal location. This has secured the neighborhood's status as a major business hub, now claiming recognition on a national and global scale.
**Districts and Corridors**

Perhaps the most famous Downtown Brooklyn retail corridor is a stretch of Fulton Street between Adams Street and Flatbush Avenue, often referred to as “The Fulton Mall.” This streetscape has defined the epicenter of the neighborhood since the 19th century. Here are the roots of Brooklyn commerce. In the late 1800s, Fulton Street was home to family-owned businesses operated by merchants who lived in the neighborhood or in immediately adjacent areas like Brooklyn Heights or Clinton Hill. Patrons of the theaters that once lined the streets in the area supported many of these businesses. By the early to mid-1900s, the Fulton Mall was often referred to as Fashion Avenue. Department stores like Abraham & Straus (later acquired and rebranded by Macy’s), J.W. Mays, Martin’s, and E.J. Korvette lined both sides of the street. For more than a century, from 1892 to 2004, the iconic restaurant Gage and Tollner drew diners to its location on Fulton, near Smith Street.

ASKING RENTS ALONG FULTON STREET ARE NOW UPWARDS OF $300 PSF, A SIGNIFICANT INCREASE IN JUST THE LAST FEW YEARS, TESTIMONY TO THE ECONOMIC VITALITY AND DESIRABILITY OF THE FULTON MALL.

Today, the mix has changed and the pace of flux is accelerating. While most of the large department stores have closed, with the exception of Macy’s, new merchants such as DrJays stepped into their place as shopping patterns and consumer preferences changed. Many new national name-brand stores have recently opened, including the Gap, T.J. Maxx, Aeropostale, and Armani Exchange.

The largest, and perhaps the most noteworthy, development along the Fulton Mall right now is the 1.8 million-square-foot City Point project. City Point will add 675,000 square feet of retail space once it is completed in 2015. Century 21 will be the department-store anchor, joined by retailers and venues like City Target, Alamo Drafthouse Cinema, and a food market hall. Asking rents along Fulton Street are now upwards of $300 PSF, a significant increase in just the last few years, testimony to the economic vitality and desirability of the Fulton Mall for retailers and their customers.
The Fulton Mall is not the only noteworthy retail corridor in Downtown Brooklyn. The Adams Street, Jay Street, and MetroTech retail zone has seen an increase in leasing activity in the last year as well. Several new eateries have opened, catering mostly to the daytime office population at MetroTech Center, local courthouses, and nearby Brooklyn Heights. Fast-casual dining establishments such as Chipotle, Au Bon Pain, Panera Bread, Orange Leaf, and Shake Shack are examples of the type of establishments opening in the zone; Downtown Brooklyn’s newest full-service restaurant, Hill Country BBQ, opened in December. Asking rents along this corridor are approximately $100–$125 PSF.

Each Saturday, the plaza at Brooklyn’s Civic Center near Borough Hall sees one of the city’s most popular farmers’ markets. Open from 8 AM to 6 PM, this is just one of six year-round green markets in Brooklyn offering farm-fresh local produce to our dense urban population.

Downtown Brooklyn’s newest full-service restaurant, Hill Country BBQ, opened in December. Asking rents along this corridor are approximately $100–$125 PSF.

The area around Borough Hall along Court Street between Atlantic Avenue and Joralemon Street is reemerging as a strong retail destination. The ground floor of the Municipal Building at 210 Joralemon Street was recently leased to a developer who is reconfiguring the space. The new shops will enhance the street presence, provide more retail options to the neighborhood, and generate additional revenue for the City as the landlord. Meanwhile, tenants such as Yoga Works, Sephora, and It’s Sugar have moved into three of the retail spaces in the building.

Like several new retail establishments in Downtown Brooklyn, Sephora and It’s Sugar have exceeded their sales goals since opening. Sephora had lines wrapped around the block on opening day, and It’s Sugar had a successful launch as well. In fact, out of the 27 It’s Sugar candy stores opened in 2014, the Downtown Brooklyn store had the highest-grossing sales volume. Asking rents along the Court Street corridor are approximately $100–$125 PSF.

For those unfamiliar with Downtown Brooklyn, two lesser known but equally interesting retail corridors in the neighborhood are worth exploring. The Livingston-Schermerhorn area, bounded by Court Street to the west and Flatbush Avenue to the east, is a local gem. Storefronts in this corridor are smaller and often quaintly retro, offering flexibility for independently owned retail stores and a distinctive change of pace from the national brands now filling the Fulton Mall. Spaces along the main thoroughfares and side streets have been popular with clothing, hair, and other specialty shops. The antiques stores, sit-down restaurants, and boutiques along Atlantic Avenue west of Flatbush add to the mix. Asking rents in this area range from $65–$100 PSF, depending on proximity to Fulton Street, representing a value alternative to those looking for more
affordable space. Not surprisingly, real estate brokerages have set up shop in this area as well.

The second less familiar retail area is part of a world-class arts nucleus, the Brooklyn Cultural District. The area bounded by Fulton Street, Flatbush Avenue, Fort Greene Place, and Hanson Place is home to BAM (the Brooklyn Academy of Music), the Mark Morris Dance Group, and MoCADA (the Museum of Contemporary African Diaspora Arts). BAM offered its first performance in its grand hall on Lafayette Avenue in 1908. MoCADA closed out the 20th century with its establishment in 1999. Recently, new homes for Theatre for a New Audience, BRIC Arts | Media, and UrbanGlass have added to the already artistically diverse district. Recognizing the potential to serve the growing number of patrons visiting the Brooklyn Cultural District, several new development projects will add over 100,000 SF of new retail in the next two years. Much of the new retail

Recognizing the potential that a thriving business, cultural, retail, residential, and educational mixed-use district could bring to the City’s economy, New York rezoned the core Downtown Brooklyn area for denser development. Today, much of this vision has been realized.

will be in the base of Two Tree’s development at 286 Ashland Place, Gotham’s development at 250 Ashland, and Jonathan Rose’s development at 280 Ashland Place.

Of course, the Barclays Center has its own draw. The arena is now the No. 1 concert venue in the country based on ticket sales. The Atlantic Center is adjacent to Barclays, with several well-known fashion retailers, including DSW (Designer Shoe Warehouse), Men’s Wearhouse, Victoria’s Secret, Marshalls, and others. Across Flatbush Avenue are P.C. Richard & Son and Modell’s.

Much of the recent success of retail can be attributed to the rezoning of Downtown Brooklyn in 2004. Recognizing the potential that a thriving business, cultural, retail, residential, and educational mixed-use district could bring to the City’s economy, New York rezoned the core Downtown Brooklyn area for denser development. Today, much of this vision has been realized, thanks in large part to an initial $400 million of public investment in infrastructure like roads, parks, cultural venues, and public spaces. As a result, nearly $6 billion of private-sector funds across 122 projects have been invested in Downtown Brooklyn since the 2004 rezoning. With another $4.2 billion in the pipeline, Downtown Brooklyn is poised to benefit further from a development cycle that, once complete, will bring the total amount invested close to $10.5 billion over 170 new construction projects.

Even with this influx of new development, Downtown Brooklyn is still vastly underserved from a food and beverage retail standpoint. There are simply not enough venues serving Downtown Brooklyn’s population. In a recent resident and worker survey conducted by the Downtown Brooklyn Partnership, 59 percent of participants said they would spend more time visiting restaurants in Downtown Brooklyn if the
restaurant scene improved. Specifically, the community is interested in seeing more versatile and higher-quality retail, particularly full-service restaurants that stay open later.

A new wave of residential construction is expected to bring over 8,000 new apartments online in the next two to three years. This combines with a growing college student population of 60,000 (more than Cambridge, Massachusetts), studying at 11 colleges and universities. Tech-sector jobs are expected to double to nearly 20,000, occupying nearly 4 million square feet of office space.

Market fundamentals already present attractive opportunities for restaurateurs. Downtown Brooklyn experienced an impressive 211 percent increase in food and beverage sales between 2001 and 2011, according to city and state data sources. Buying power for dining out increased 298 percent, from $5.3 million to $21.3 million during that same 10-year period, as reported in US Bureau of Labor Statistics studies. A tremendous opportunity exists to capture millions of additional dollars being “left on the table” by the restaurant industry at present.

Downtown Brooklyn is very much a growing retail hub. The retail offerings have evolved as changes in the economy, demographics, urban development policies, and consumer preferences have forced retailers in the neighborhood to remain dynamic. What is perhaps most noteworthy today, however, is that the retail demand in Downtown Brooklyn will only get stronger as more investment is made in the neighborhood. The new wave of residential construction is expected to bring over 8,000 new apartments online in the next two to three years, adding to the 5,000-plus units built since 2004. Three new hotels are in the pipeline, adding to the six hotels that have been built in Downtown Brooklyn, which will significantly increase the number of overnight travelers to the neighborhood.

This confluence of new residents, students, office workers, and visitors highlight the need for additional retail options, making Downtown Brooklyn a prime location for retail investment.
Let’s look first at a few interesting facts to set the stage for a discussion of the retail sector in general and retail real estate in particular. First, consider the concentration of market share in the leading retail chains. The top 100 retailers\(^1\) occupy less than 15 percent of the total number of stores around the country but account for nearly 50 percent of total retail sales.

Consider also the general misunderstanding of the impact of the Internet (“e-commerce”) on retail real estate. In my experience, when the question of what percentage of retail sales does Internet sales represent is posed, almost without exception the response is not just incorrect — it is incorrect by a large margin.

Retail is defined as NAICS (the North American Industrial Classification System)\(^2\) codes 44 – 45, although most analysts include Food Services and Drinking Places (NAICS 722) and exclude the motor vehicle sales sector. In 2013, retail sales

\(^{1}\)National Retail Federation, https://nrf.com/2010top100-table

\(^{2}\)http://www.census.gov/eos/www/naics/index.html
E-COMMERCE IS GROWING AT A FASTER RATE THAN TOTAL RETAIL SALES, BUT MANY ANALYSTS BELIEVE THE SHARE WILL NEVER GET TO DOUBLE DIGITS.

were about $4.1 trillion, and e-commerce sales were $262 billion. Internet sales, then, has only a 6.4 percent share of retail sales. E-commerce is growing at a faster rate than total retail sales, but many analysts believe the share will never get to double digits. No one knows for sure what the limit might be, but the history of product introductions teach a lesson of limits — new products find their market saturation level, and then the growth curve flattens.

Why is this the case? Dr. Carl Steidtmann, former chief economist at Deloitte, has defined retailing as the final step in the distribution of merchandise for consumption by end users. In other words, retail is a logistics-based business. For the most part, goods are transported to stores in bulk, using semis with (typically) a 53-foot cargo trailer. Experienced retail developers are keenly aware of the need to design parking lots and traffic circulation to accommodate such rigs. Walmart has been an industry leader in retail logistics, popularizing cross-docking in the 1980s. Cross-docking breaks down bulk deliveries by transferring goods directly to smaller trucks, doing away with the need to keep inventory in warehouse storage. It is one way that leading retailers aim to make distribution more efficient. Today, Walmart links point-of-sale data directly to headquarters, distribution centers, and even vendors. Logistics is a core strategic competency.

In the retail logistics model, “the last mile” is the most inefficient. For store-based retailers, the last mile (from the store to the consumer’s home) is efficiently outsourced to the consumer. The consumer (at no additional cost to the retailer) transports goods from the store to their car and then to their home. That means the “cost of the last mile” is not included in the price paid at the cash register.

We can illustrate this store-based competitive advantage by an examination of the leading Internet retailer, Amazon. Based on Amazon’s annual report (Form 10-K), its sales in North America for 2013 were $44.5 billion. Approximately one-third, or $14.5 billion of sales, consisted of products (media and other) purchased and delivered when the consumer pushed “enter” on their computer. Thus Amazon’s sales of goods that would otherwise be on the shelves of store-based retailers was about $30 billion. In other words, Amazon’s retail merchandise sales are about the same as Dollar General’s and Family Dollar’s combined, and less than 9 percent of Walmart’s sales.

In Amazon’s model, the cost of the last mile is part of the price. Amazon’s shipping costs in 2013 were 8.9 percent of sales. Considering that one-third of its sales were products that did not need to be shipped, shipping costs are about 12 percent of sales of goods directly competing with store-based retailers. Retail store occupancy costs, as a percent of sales, are in the range of 5 percent to 15 percent, and analysts might consider 8 percent or so to be a reasonable median estimate. Applying this metric to the cost problem

3 https://www.census.gov/retail/
4 http://en.wikipedia.org/wiki/Cross-docking
5 www.amazon.com/investor relations
leads to the conclusion that Amazon suffers a 4 percent or so logistics-based cost disadvantage when compared to store-based retailers.

Again, the data is revealing. Amazon no longer enjoys a competitive price advantage. Amazon's gross margin in 2013 was 27.2 percent, up from 22.4 percent in 2011. For comparison, Walmart's 2013 (fiscal year 2014) gross margin was 24.3 percent. Overall, Walmart now has lower prices than Amazon.

Then there is the question of sales tax. According to a recent study by Ohio State University, when Amazon is required to collect and send on sales tax, as in-store retailers have always done, its sales decline about 9.5 percent. The percentage of decline is substantially higher, 24 percent for items priced above $300.

More than anything else, the Internet has created informed consumers in the retail sector. In effect, power has shifted from the retailer to the consumer. Consumers can not only search for comparative pricing from their computer at their home or office, they can easily use their mobile device while in the store to research products and search for the lowest price. This forces the retailer to “price match.” The result is that the consumer gets the lowest available price and the retailer immediately captures the sale.

For sure, price matching puts pressure on the retailer's gross margin. That initiates a fascinating dynamic. Retail real estate operators appreciate that financially feasible rent is a function of sales at the specific location (effectively, demand at the point of local supply) coupled with the retailer's gross margin. As the retailer's gross margin declines, it seeks lower rent for store space. Retailers can also offset the gross margin pressure by seeking to increase sales per SF. Merchants use technology tools to create more efficient inventories, eliminating products that account for lower sales, a practical application of the Pareto principle, often referred to as the 80/20 rule. Reducing inventories means that companies can reduce store size. Smaller stores that generate higher sales per SF offset the financial impact of lower gross margins when considering occupancy cost.

Retailers also seek to capitalize on “the last mile” inefficiency by promoting in-store pick-up of goods that are ordered online. The increased “inventory turn” from this strategy will help to offset the negative impact of lower gross margins. It can also stimulate added in-store sales simply by bringing the customer to the goods.

But, some would object, hasn't the Internet driven a bunch of electronic retailers (for instance) out of business? It is worth asking if that story is accurate. Circuit City didn't

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6 Walmart 10-K  http://stock.walmart.com/financial-reporting/

7 “The Amazon Tax”: Empirical Evidence from Amazon and Main Street Retailers; Brian Baugh, Izhak Ben-David and Hoonsuk Park; Fisher College of Business, Ohio State University; NBER Working Paper No. 20052; April 2014
Many sector analysts believe that Walmart may be a bigger threat to retail real estate than the Internet. Walmart’s 4,838 US stores (as of February 2014) contain almost 750 million square feet. That is about three times the size of the portfolio of the largest US retail real estate company. Walmart’s over 1.3 million employees are almost 1 percent of US nonfarm employment. Those are powerful figures.

The real estate industry is heavily influenced by trends in the retail sector itself, that is, what is going on with the tenants. Retailing is, somewhat, in a stage of stagnation. According to Steidtmann, this sector has a four-stage life cycle: introduction/innovation, growth/expansion, maturity, and decline.

Currently, most retail formats are mature or in decline. Even giant Walmart is struggling to post same-store sales gains, an indication that they are in the maturity phase. A reduced level of new and expanding retailing means there is reduced demand for retail real estate. This is further exacerbated by the above-noted trend toward smaller stores.

One of the activities in the maturity phase is consolidation. Retail business lines have, for the most part, consolidated into two or so market leaders, except for supermarkets. Home improvement sees Home Depot and Lowe’s, discount department stores are dominated by Walmart and Target, and warehouse clubs see Costco and Sam’s with a lion’s share of the market.

Opportunity does exist. There are a few growing geographies that are generating expanding consumer demand and thus retail development. But for the most part, new development is attributable to factors such as exclusive-use clauses in leases of existing anchor tenants. There may be existing supply that could meet the needs of an expanding or relocating retailer, but, due to the exclusive-use provisions, such space may not be available to them. They are then driven to new, often freestanding, locations.

Here is another trend to note: The occupancy composition of retail real estate has changed over the past decade.
Today, over 25 percent of shopping center space is occupied by non-retail businesses (i.e., tenants not classified in NAICS categories 44-45 and 722). This trend will expand in the future.

Astute retail landlords are already focusing on new business categories, such as healthcare. Healthcare businesses are seeking convenient locations closer to their customers. Retail real estate is a perfect fit. Such tenants may be small medical groups or urgent care centers. But direct care is only one element, and the presence of a health facility might engender demand for a fitness center, a health-food and vitamins store, a juice bar, even a specialty sports apparel or sports shoe outlet.

Retail real estate can also become the “location of choice” for many start-up service businesses. The attributes of a good retail site — convenient to customers/clients, with adequate parking and flexible operating choices, fit such services businesses well. The tenant can put its name on the door... often including a sign visible from a thoroughfare, and choose its own hours of operation. There is not a common lobby that closes at 6 PM, as so often happens in suburban office buildings. And since the space is typically served by package HVAC units, businesses can adjust the climate controls to their specific taste, mitigating the most common complaint in typical office buildings: temperature. Retail space is easily provided in increments of 1,000 SF or so, very attractive and scaleable unit sizes for small start-up businesses. Remember that small businesses account for about two-thirds of all new jobs. Providing space for them is a good business opportunity.

Many baby boomers are leaving traditional employment and instead of retiring, are starting a business. As a result, franchises are expanding and proliferating. Franchises provide a platform for start-ups to compete effectively, since they bring the entrepreneur a business plan and operating model, networking, and brand identity. Franchisees are good tenants for retail real estate.

From an investment and accounting perspective, retail real estate is also quite attractive. The improvements to real estate do suffer real economic depreciation. However, land does not depreciate. Therefore, an asset class, such as retail real estate, in which buildings are less intensive (typically single-story) and in which land is a greater percentage of value, would tend to enjoy more appreciation.

It is, I suppose, fashionable to decry false assumptions as they creep into conventional wisdom. But maybe it is not all bad. The misinformation in retail real estate creates opportunities for well-informed, astute investors and operators to outperform the overall real estate market in the future. For the careful property professional, that could be a very good thing.