

TEXAS RETAIL ROUNDTABLE

Retail real estate professionals from across the state discuss the industry's performance in 2011 compared to last year, and what they foresee for 2012.

Texas Real Estate Business recently spoke with several retail real estate executives in the state to get their impressions of the market. Participants included: Jason Baker, co-founder and principal, Baker Katz; Gerald Crump, vice president and director of Central Region, Weingarten Realty; Jerry Goldstein, senior director — National Retail Group, Marcus & Millichap; Jeff Read, principal, Read King Commercial Real Estate; R. Carson Wilson IV, marketing director, Fidelis Realty Partners; Jason Claunch, principal, Catalyst Commercial, Inc.; Tim McNutt, director of leasing and sales, Bright Realty; Jean Smith, COO, UCR Realty; Keith McRee, vice president, NAI REOC — San Antonio; David Simmonds, principal, Retail Solutions; Ramiro Aleman, manager of business development, Harlingen Economic Development Corp. ; Bob Ayoub, President, MIMCO — El Paso; Michael Blum, Partner and Managing Broker, NAI RIO Grand Valley; Max Prestridge, broker, Huntington Group; Randy Summers, Vice President, Davis Equity Realty and Jason Clanton, broker associate, Curt Green & Co. Commercial Real Estate.

Houston

From Houston, the following professionals participated in the roundtable discussion: Jason Baker, Co-Founder and Principal, Baker Katz; Gerald Crump, Vice President and Director of Central Region, Weingarten Realty; Jerry Goldstein, Senior Director — National Retail Group, Marcus & Millichap; Jeff Read, Principal, Read King Commercial Real Estate; and R. Carson Wilson IV, Marketing Director, Fidelis Realty Partners.

TREB: What is the current state of retail activity in Houston?

Baker: Retail activity is high in Houston, unlike anything we've seen in the last 3 years. What vacancy has been created through the fallout is all but gone. We're hearing retailers reference the market activity as reminiscent of 2005-06. Retailers who struggled with a backlog of inventory 2 years ago are flowing products off the shelves

now and activity is very positive.

Crump: The Houston and Texas market in general has performed remarkably well compared to other parts of the country and the retailers have taken note. We are seeing fairly strong activity from the national and regional retailers and retail service providers. The mom-and-pop startups are still struggling to get financing so we are seeing fewer deals from them; however we are seeing good small shop franchise activity. We have released the vast majority of our big box vacancies in the Houston market and at the state level with overall occupancy above 92 percent. Small shop leasing has been strong in the dominant grocery and soft goods anchored centers within the various trade areas. Second tier centers or unanchored strips are the laggards in the marketplace unless the landlords are willing to drop rents to maintain occupancy.

Goldstein: The sale of retail properties, which is the area I'm involved in, has improved in 2011. It's not just for the reason that investors got sick of low interest rates being paid by banks on their sidelined cash, but more that some sellers have met the market with where they are selling their properties. There has also been an acceleration of lenders (banks and special servicers) discounting notes and retail centers to reduce their REOs and defaulted loans.

Read: Although still not near pre recession levels, 2011 has been a breath of fresh air for developers, brokers and investors. Grocery store anchored retail continues to be the most active segment of the market followed closely by restaurants, service users, and medical. Big box retailers are being very selective and opportunistic and are opening a reduced number of stores. Medical clinics and hospitals have branched out into neighborhoods in an effort to be convenient to patients and are now focused on the same real estate characteristics as retailers — location, visibility, access, and co-tenancy.

Wilson: Driven by the health care and the oil and gas business sectors, Houston's economy is amongst the most

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robust of any major metropolitan area in the country. The Houston Business Journal listed Houston as the No. 2 city in the U.S. in terms of job growth, adding an estimated 51,000 non-farm jobs from April 2010 through April 2011. As a direct result, suburban Houston communities are amongst the fastest growing in the U.S., with Katy being listed by many publications as the single fastest growing community in the country. The Houston retail market is significantly more active than at any time since the onset of the recession in 2008. After several years of dormancy, many retailers are starting to expand in order to meet the growth demands of Wall Street. Given Houston's thriving local economy relative to the rest of major markets in the U.S., it has become an obvious destination for these expanding retailers. This excitement is significantly tempered somewhat by the overregulation, debt and fiscal problems created by the federal government.

TREB: What retail leasing/development trends have surfaced during the economic downturn? Have any major developments come online this year? Are any planned?

Baker: The sites with the most activity are those properties landowners have been sitting on throughout the recession the last 3 to 4 years, like the Whole Foods development at Cinco Ranch. We're also seeing new projects on existing tracks of land, and even more commonly, activity igniting the second or third phase of an existing project that had been postponed while landowners let the market catch up. A good example of this is the Phase II and III development of LaCenterra at Cinco Ranch. There is a continued increase in non-traditional users backfilling retail space left vacant by traditional retailers. The banking category, once known for overpaying in rents during the boom of 2005-06, has slowed to a crawl in activity.

Crump: Deals have become much more difficult to get done especially where approvals are needed from other tenants. Approvals that were once easy to obtain have increasingly become more difficult due to retailers

looking for any leverage to negotiate economic incentives or a change in lease terms. We are also seeing many of the big box tenants downsizing / rightsizing stores by up to 25 percent of their previous sizes. We are also seeing tenants take second generation spaces that they would not have considered in the past or that are not according to their typical prototype. We continue to see tenants that were historically mall tenants coming out into the power centers and also many medical office uses coming out of office buildings into grocery anchored centers. Most of the developments you are seeing around the city that have come out of the ground over the last 18 months have either been on the drawing board before the recession or are additional phases to centers that were put on hold previously based on market conditions. We are seeing some new projects being announced by the supermarkets, smaller specialty grocers and large discounters but in much smaller developments than before. Many of the proposed deals in this market are freestanding big box deals or deals with very little small shop space. Much of the activity has been in the more urban infill locations or in suburban areas where density already exists.

Goldstein: Very few new developments have come online this year and that is a welcome trend allowing the market to absorb the supply of space already built. Downsizing by anchors like Best Buy adds to the additional inventory of vacant space.

Read: Power center development has slowed significantly and we don't see any new projects coming out of the ground in 2012. Grocery store development continues to be the golden ring with HEB, Kroger, and Walmart competing for market share. HEB has been aggressive on strategic land acquisition in the Greater Houston Area and has several future developments in land inventory. Though online retail only currently accounts for 10 percent of all retail sales, it is growing at a rate of 10 to 15 percent per year and has created a focus with the bricks and sticks retailers on downsizing prototypes. This trend in online sales also puts a value premium on grocery store anchored retail that traditionally has a tenant mix of daily

needs retailers, service users and restaurants that are not significantly impacted by online retail. The urban core has several mixed-use developments and redevelopment projects currently under construction, with additional projects planned to break ground within the next 12 months. The demand for “close in” new apartment units is driving the mixed-use development which benefits from a retail component that increases apartment rental rates, accelerates lease up and contributes to the return on high priced land. West Ave, a mixed-use project at Westheimer and Kirby streets that features a good mix of restaurants, soft goods retail, and service/office tenants, has been successful with effective apartment occupancy above 92 percent and good velocity on the retail lease up. At least four other projects will break ground inside the loop within the next 6 months.

Wilson: As for trends, one of the great lessons we learned from an economic downturn is that we need to return to the fundamentals of retail development — building anchored shopping centers with credit tenants and a limited amount of spec space. Prior to the downturn, it was fairly common to see unanchored strip centers being built mid-block at inferior intersections. This trend has ceased to simply because lenders won’t finance these types of properties and they have proven to be too challenging to lease in down economies. As times improve, it is important to remember these lessons to prevent repeating the same mistakes in the future. There are a few major developments that have come online this year or are being planned for next year. Speaking specifically for Fidelis Realty Partners, we recently completed development on a 200,000-square-foot center anchored by Academy Sports and Burlington Coat Factory in Humble. We are also currently working on a 125,000-square-foot power center in Cinco Ranch. We are also beginning to work on an 18-acre redevelopment of an existing multifamily site located at San Felipe and Fountain View, which will be mixed-use but predominantly feature retail.

TREB: What submarkets are performing best? What types

of retail product?

Baker: The markets undoubtedly shining in Houston are on the west side, Katy and Cinco Ranch. These areas are looking to sustain the most growth and retailers are showing consistent interest as a result. Additionally, retailers in The Woodlands are doing very well. Grocers and restaurants are large categories of high performing retail in this extremely competitive market. We’re consistently seeing in most categories of retail that those who have traded down in market and those who have maintained performance as luxury are doing best, which explains why Tiffany’s and the outlets are doing so well. It’s those with price points in the middle who are struggling.

Crump: The dominate grocer and/or soft goods-anchored centers in the various submarkets have performed much better than the smaller unanchored strips. We have also seen that the centers and strips located in the more dense population bases have fared better as the retailer is no longer chasing the new center on the edge of the trade area. We have also seen well-located big box vacancies and small shop space release quicker and has remained in high demand from retailer looking to expand or enter these tighter centers/submarkets. Demand seems stronger near the core of the city.

Goldstein: The Woodlands, West Houston/Cinco Ranch/Grand Parkway and the Inner Loop/River Oaks/West University/Bellaire areas are the most desirable. Restaurants are leading the way — international concepts and healthy fare are popular startups. Medical users are more prevalent in retail spaces (emergency clinics, cosmetic practices, schools, etc.).

Read: The submarkets performing best in the overall Houston market are the Inner Loop, Katy-Grand Parkway Corridor, Cypress — 290 Corridor, and The Woodlands. The demand inside the loop is driven by strong incomes, strong densities of both population and employment, and lack of available real estate. In addition to the proposed

mixed-use retail, “inside the loopers” will see Walmart open their first store in the urban core at the intersection of Interstate 10 and Yale in the Washington Heights submarket. The retail development in the Katy/Cypress/Woodlands markets is driven by continued home growth and high demand for daily needs shopping, service retail and medical. Grocery store anchored retail and medical development are the most active product types in these suburban markets. Continued home growth has created new store opportunities for grocers such as HEB, Kroger, Walmart and Whole Foods. Cinco Ranch in Katy was the No. 1 master-planned community in the country for new home sales in 2010. As a result, Cinco Ranch will add a Randall’s, Kroger and Whole Foods in 2012. The Woodlands will benefit from the biggest employment shift in Houston with the recent announcement of Exxon moving their corporate headquarters to the south side of the master-planned community. This employment gain is another example of why The Woodlands is defined as the as the most complete master-planned community in the greater Houston area and has become the model for developers around the country.

Wilson: Class A retail product is clearly performing the best, and all product classes below that have proven difficult to lease, finance, and sell. Suburban markets such as Katy, The Woodlands, Sugar Land and Baybrook are very active as well as are infill locations inside the loop and in the Galleria. In general, retail that is located around mid-to-high income demographics in established trade area is thriving.

TREB: What, if any, major retailers have entered/exited Houston?

Baker: Nordstrom Rack has come into the market to open a 30,000-square-foot store at Post Oak Boulevard and Westheimer Road, and a 35,000-square-foot store at Highway 6 and Highway 59 in Sugarland, and are planning to continue expansion in Houston. The retailer is doing very well with its lower pricing structure. Additionally, Ross Dress For Less is expanding its dd’s

concept in the market. They’ve signed four leases at about 20,000-25,000 square feet each, which opened September 24th. CompUSA, who left the market during the downturn is now coming back, and major discount grocers like Aldi and Trader Joe’s are showing interest. open their first store in the urban core at the intersection of Interstate 10 and Yale in the Washington Heights submarket. The retail development in the Katy/Cypress/Woodlands markets is driven by continued home growth and high demand for daily needs shopping, service retail and medical. Grocery store anchored retail and medical development are the most active product types in these suburban markets. Continued home growth has created new store opportunities for grocers such as HEB, Kroger, Walmart and Whole Foods. Cinco Ranch in Katy was the No. 1 master-planned community in the country for new home sales in 2010. As a result, Cinco Ranch will add a Randall’s, Kroger and Whole Foods in 2012. The Woodlands will benefit from the biggest employment shift in Houston with the recent announcement of Exxon moving their corporate headquarters to the south side of the master-planned community. This employment gain is another example of why The Woodlands is defined as the as the most complete master-planned community in the greater Houston area and has become the model for developers around the country.

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Crump: On the niche grocer side we have seen new tenants to the Houston market like Sprouts and Trader Joes looking for space. We continue to see HEB, Kroger and Walmart selectively looking for infill locations and holes in their market coverage. Yogurt, dental and burgers have been the hottest concepts filling space on the small shop side. Restaurants, beauty and medical related uses seem to be the more prevalent uses doing deals. Luckily we have not seen many retailers leaving the Houston market other than those like Borders who have filed bankruptcy in recent years. Generally speaking retailers are doing well in Texas.

Goldstein: Few major retailers have completely exited the Houston market. However, there are a few: Krispy Kreme Donuts finally bit the dust as well as Spence Diamonds. Restaurants have been the primary driver in retail expansion. Two majors, one retailer and the other a restaurant chain, are entering/re-entering the market: Trader Joe's and Bennigan's.

Read: Several specialty grocers have committed to new stores in the Houston Market – Mi Tienda (HEB Hispanic grocery concept), Joe V's (HEB warehouse foods concept), Aldi (discount small venue warehouse concept), and Sprouts. Trader Joe's has also appeared on several site plans, but has yet to commit to their first store. Other retailers entering the market include Neiman Marcus Last Call, American Girl, H&M, Santikos Theater, Equinox and Foundry. Many big box retailers are downsizing

existing stores, creating excess space to sublease. In the Houston market, Office Depot, Ashley Furniture, Best Buy, Old Navy, Sears, and Sports Authority are examples of big box chains planning to scale back. In an increasingly competitive environment where the consumer can cross-shop pricing from inside the store with the use of mobile devices, retailers are looking for ways to reduce operating costs and to improve efficiency in store design in an effort to maintain profit margins.

Wilson: Nordstrom Rack, Trader Joe's and Aldi are all retailers entering the Houston market. The most notable exit from the market is Borders, which has declared Chapter 7 bankruptcy and is currently liquidating.

TREB: What is vacancy like? Are rental rates holding steady?

Baker: Vacancy in Houston is about 10 to 11 percent and decreasing. Houston, on a per capita basis, has about 30 to 40 percent more retail than most markets similar in size. If you discount those ill-conceived projects from the 1980s that every market has, our vacancy rate is even lower. There is a delta as it relates to rental rates. Where there is a strong co-tenancy, we're seeing an increase in rental rates. There's a flat to downward slide in rental rates where co-tenancy is poor or properties are unanchored or poorly anchored.

Crump: As mentioned before, rental rates and vacancy on well positioned and anchored centers remain strong. We are seeing more growth in our renewal rates than in our new lease deals. As occupancy increases landlords should begin to see rental rates increase as well for good space. We have seen occupancy for our Houston portfolio increase about 140 bps since third quarter of last year.

Goldstein: Market occupancy is hanging in the high 80s percentage-wise. Rates have stabilized with less concessions/reductions with existing tenants. There is still stress in some suburban markets where rates are trending down in un-anchored strips.

Read: Overall occupancy is increasing due to very little new product being developed. Most of the big box space vacated by bankrupt chains such as Linens ‘N Things, Circuit City, and Borders has been absorbed by direct competitors and/or multiple tenants as the space is quite often being subdivided. Rental rates are also benefitting from a lack of new product and in some cases are increasing where demand exists from several competitors in the same category competing for the same space. Generally landlords are finding themselves funding higher tenant improvement dollars to achieve the same rental rates. The Class B and C centers have seen the most significant increase in vacancy mostly due to a tenant mix made up of under-capitalized mom and pop shops.

Wilson: Rental rates for non big box spaces in Class A product are on the rise, in some instances surpassing the pre-recession levels due to a lack of supply on the market. One of the most common statements we hear from tenant rep brokers is there is very little available Class A space on the market, and there is a high level of demand from retailers looking to expand which in turn causes rents to rise. Rental rates for available big boxes in the market have risen somewhat but not to the same extent as the smaller players, mainly due to the availability of big boxes in other parts of the country.

TREB: How is the second half of the year performing compared to the first half? Is there more activity/optimism?

Baker: By the second quarter, we were seeing a major uptick in optimism, and for the second half of the year we’re seeing activity increase significantly. There is renewed tenant interest in the market that should point toward a strong finish in 2011 and a special 2012.

Crump: Activity and optimism seems to fluctuate with the global economic concerns, both good and bad. The brokers we work closely with in the marketplace seem to be optimistic and busy with retailer tours so we view this

as a positive sign for deals to come. Much of our business the second half of the year has been national, regional and franchised deals with very few startups. This is a trend we are seeing across the country the second half of the year versus last year and into the first part of this year. Financing and overall economic worries affect smaller business much more than the larger well capitalized business. We have very good assets, a strong platform coupled with seasoned dealmakers who remain focused on finding opportunities for both types of users within the portfolio and marketplace.

Goldstein: The second half should be improving because of advanced economic growth. Undo caution is still dominating certain investors outlook because of unwillingness to recognize the progress Houston is making. However, the second half should be productive.

Read: 2011 has been a rebound year for our brokerage business and our projects. Our brokers did more gross volume in the first six months of 2011 than they did for the entire year in 2010. We have seen a similar increase in volume of new leases in our own portfolio. However, a significant amount of our leasing activity has been from non-traditional retail tenants — medical users (emergency care, physician’s clinics, dialysis, diagnostic, and dentist) and more traditional office tenants looking for a street front presence.

Wilson: While performance is roughly the same, there is significantly less optimism than there was several months ago due to the uncertainty of our national monetary and fiscal policies, the lack of leadership coming out of Washington and the great amount of uncertainty in Europe. Our goals, as always are to develop fundamentally sound shopping centers and to keep our existing shopping centers leased with quality merchants and increasing vacancy where possible.

TREB: What are your goals for the remainder of the year?

Baker: We want to continue to think long term. We're looking at every part of our business, from technology to people. We hope to continue to increase our market knowledge and strengthen our client relationships. We're encouraged and looking forward to 2012.

Crump: We are focused on getting as many of our tenants under construction today open for the holidays. We have several larger retailers including Kohl's, Marshalls, Nordstrom Rack and Saks opening in the fourth quarter in the Houston market. We are already focused on our 2012 pipeline, which is already shaping up to be quite strong. We remain focused on our acquisition and disposition goals for the year and remain committed to our new development program within each market.

Goldstein: Doing more of what I've done so far working for lenders, special services and private clients to deliver properties to that market with investor appeal and demand.

Read: A direct benefit of the contraction in our industry has been our ability to increase our market share and make several strategic hires of seasoned professionals. In the last 2 years we have doubled our third party management and leasing contracts and significantly increased our tenant representation business.

Wilson: Our goals through the end of this year are to continue to pursue strategic user driven development, broaden our third party management and leasing platform, increase our tenant rep accounts and add several key employees and brokers.

TREB: Do you believe things will turn around in your market in 2012? Why or why not?

Baker: The Houston market isn't in need of a drastic turnaround. We experienced a slight downward tick and

slowdown in new construction, which allowed us to catch up. The next wave of activity should reflect the beginning of new construction and an increase in new projects.

Crump: It is hard to tell what will happen next year as much of our deal volume will depend on how the retailers do this holiday season and their open to buy for the coming year. We have signed a good number of deals this year that will open next year. If the economic pulse stays the same or improves somewhat I think we will have a good 2012/2013. Retailers who are public need to expand / grow and those that have been on the sidelines have missed some good opportunity for lower rent deals the past couple of years. Today there is little new development of any significance coming out of the ground and will continue to be light for several years so good existing product type should see an increase in occupancy and cash flow. If we can avoid a double dip recession and more bankruptcies things could be quite good for 2012 and beyond. Our grocery-anchored product type has performed well over the past couple of years given it is made up of tenants who for the most part provide basic goods and services. Much of our success in the coming years will depend on the consumer.

Goldstein: Things have already turned in Houston. 2012 should be a continuation of that trend.

Read: While there is continued talk of a double dip, it is imprudent to keep waiting for an upswing. It is time to invest and to "expand out" of current circumstances. Texas is undoubtedly going to be in the spotlight between now and November 2012. On the upside, Texas has fared relatively well since the economic downturn. According to the president of The Federal Reserve Bank of Dallas, 37 percent of new jobs since June 2009 were created in Texas. Additionally, Houston is credited with creating one out of every 20 U.S. jobs. Though challenges remain, Houston persistently outperforms the rest of the country and the outlook remains optimistic.

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Job growth is fundamental to Texas' recovery. Overall, retail jobs in Texas are up 1.9 percent while nationally the retail sector is experiencing a downturn of 7.2 percent. Houston is also adding new retail-trade jobs, posting an increase of 5,900 jobs since July 2010. Although the consumer is cautious, Houston is benefiting from a resurgence of inner loop development. The city is also home to four of the nation's upper income, top-selling, master-planned communities, indicating that Houston is positioned for recovery.

Wilson: While there is a great amount of uncertainty, much more than existed 6 months ago, I think the economy in Houston will continue to improve which will make development in Houston viable.
