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Features

Retail Resurgence Headlining Current CRE State

Not everyone is thriving in the environment.

By **Anthony Russo** | July 30, 2024 at 03:51 PM

Not all segments of commercial real estate are created equal. Some right now are thriving, while others are struggling to see demand.

Since the onset of the pandemic, life has changed. More Americans are employed remotely or have hybrid schedules to improve their work/life balance. Interestingly, this has resulted in fascinating trends recently.

The retail boom

The improved work/life balance has resulted in more time spent shopping, even with a mass amount of malls and brick-and-mortar stores closing over the past couple of decades. The issue was supply not meeting demand in the space–but now that has reversed with construction and development becoming more scarce, according to Alex Zikakis, CEO and president of Capstone Advisors.

"The best thing for retail reputation and appreciation was people's understanding of just how valuable and necessary it is, especially having gone through a pandemic and that you still pretty much need physical retail," he told GlobeSt.

"People need to drive and get their groceries."

This year, there have been encouraging trends in retail. In March, vacancies were at an **all-time low**, according to a national report from Marcus & Millichap. Convenience stores and fast food establishments led the way with the lowest inoccupancy rates.

Plus, supermarkets, restaurants, discount stores, and fitness centers all saw significant gains in traffic in the first five months of 2024. The spike ranged from 5.7 percent to 8.9 percent, with discount retailers seeing the highest gains in customers. This is all thanks to consumer's appetite to spend. Asking rents are expected to jump 2.2 percent in 2024 compared with last year, according to Marcus & Millichap.

'Rent growth has been solid. Tenant resilience has been high, and you can still buy retail and get positive leverage with debt," Zikakis said.

He added low cap rates, especially in the near-zero interest rate environment, have not only benefited retail – but the multifamily and industrial sectors as well.

"When debt got super cheap, there was a lot of development in those two asset classes, and what we see by and large is that all new development of big, multifamily and institutional class industrial [properties] has stopped," Zikakis said.

He added, that "fundamental demand is still, is still solid," even with an excess of construction in those segments of CRE.

Office sector headlines struggles

But then there's the office market, which is a different story. The work-from-home trend hasn't been too kind to the asset class. That has led to a dip in the need for office space. In fact, tenants now need 18 percent less space, which comes out to less than 160 square feet, a Moody's report found.
Zikakis said that offices with "a lot of difficult commute patterns, high cost of parking and streetscapes that don't make it conducive to wanting to walk around the streets in some cities, because of homelessness or crime, vagrancy and high vacancies," are doing the worst.

Also, he said companies that focused on the "burn cash to grow model" are probably having a tough time generally right now operating in the environment. This applies to firms that haven't generated a profit yet, without positive cash flow.

"That's been a very difficult space," Zikakis noted.

"They burn cash until you can hopefully have some big binary event where to get to a big exit, either through an IPO or something, or a strategic sale, but you're going to burn a lot of money to get there. That's more attractive for investors when there aren't a lot of good sort of current income options. When interest rates went up, there became a lot of good current income options."

Investment strategy for CRE

As an owner and developer in CRE, Zikakis follows whatever the hottest market is. Right now, that's the Sunbelt area, which includes 18 states such as Florida, Texas, Utah, California, and Arizona.

Zikakis' philosophy is picking two or three markets and staying put in them.

"We pick two, or three markets for diversification purposes, and then hopefully pick good, durable markets [that] have good demographic attributes to them and good political and regulatory environments," he said.

"We stay in those markets, and we don't go jump to a new market that we're not operating in, simply because we think that, we can find, one or two deals in a hot market."

He also added that the other important factors when pinpointing an area are the labor market and population. Is there a growing number of Americans migrating to a particular region? And what's the quality of talent like when it comes to workers?

Going forward, Zikakis said that the office market has some uncertainty. His concern is the recovery will be slow because of the long-term lease commitments, coupled with the lack of renewals, with tenants trying to reduce their footprint.

"You're on this slow decline of facing issue after issue because your leases slowly roll over right into the building," he noted.

Zikakis added that it could be a "painful process" to go through, and the office sector could take years to rebound.

No outlook was provided for retail – but he revealed that "improvement allowances are higher than they have ever been."

"To get to a good, high-quality tenant with a really good concept, you gotta keep your asset current. We are writing bigger checks for those tenants, Zikakis concluded.

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