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Retail-to-Industrial Transformation: As the Retail Landscape Changes, Can Outdated Mall Anchors Be Reborn as Fulfillment Centers?

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NEWMARK

TABLE OF CONTENTS

Key Findings

Regional malls have experienced an evolution over the past 50 years, as the once-celebrated destinations face increasing competition for shoppers and their discretionary spending. Consumer demand for more open-air shopping areas has led to a decrease in the number of new malls constructed and many retailers leaving enclosed malls for these newer centers.

Department stores have been anchors wherever they were located, whether it was a downtown city block or a suburban regional mall. The dwindling number of these stores creates new challenges when space is vacated and owners look to find new tenants. The challenges in the U.S. retail market were exacerbated by the pandemic in 2020, resulting in further softening of fundamentals throughout the country, prompting mall owners to more aggressively consider alternative uses for their assets.

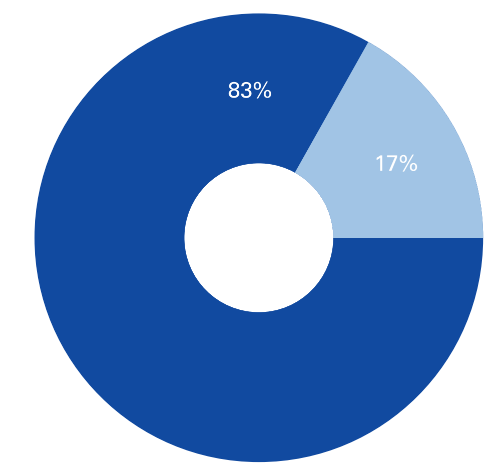
Converting vacant anchor spaces at shopping malls into distribution or fulfillment centers in service of e-commerce offers considerable upside as a redevelopment play. In some cases, a full property conversion may be the highest and best use of the property, although the conversion process can be expensive and complex.

The Regional Mall: From Convenient Destination to Often Outmoded Retail Experience

Take a look at photos of U.S. shopping malls from 20 years ago and one sees a starkly different retail environment than today's. The role of the large, regional shopping mall in a consumer's life has changed dramatically as more retail choices emerged. The usually smaller open-air town centers and outlet malls became much more desirable destinations, as evidenced by their prevalence among retail construction activity since 2000 (see the adjacent exhibit). Consumers' preferences changed toward natural air and light. Creating an enticing environment to cultivate an experience became the norm—a trend that was well underway even before the arrival of COVID-19 and the acceleration of e-commerce.

Foot traffic at enclosed malls has declined dramatically over the past 20 years, forcing retailers to reconsider store locations. Department stores typically have a major impact on attracting customers to a mall, so their absence has a domino effect on patronage at other stores. The anchors are the dominating presence on the mall property, and the lower number of potential companies to fill the space leads to new questions about the viability of the space and the mall overall. The rise of the omni-channel retail experience places further strain on large anchor spaces.

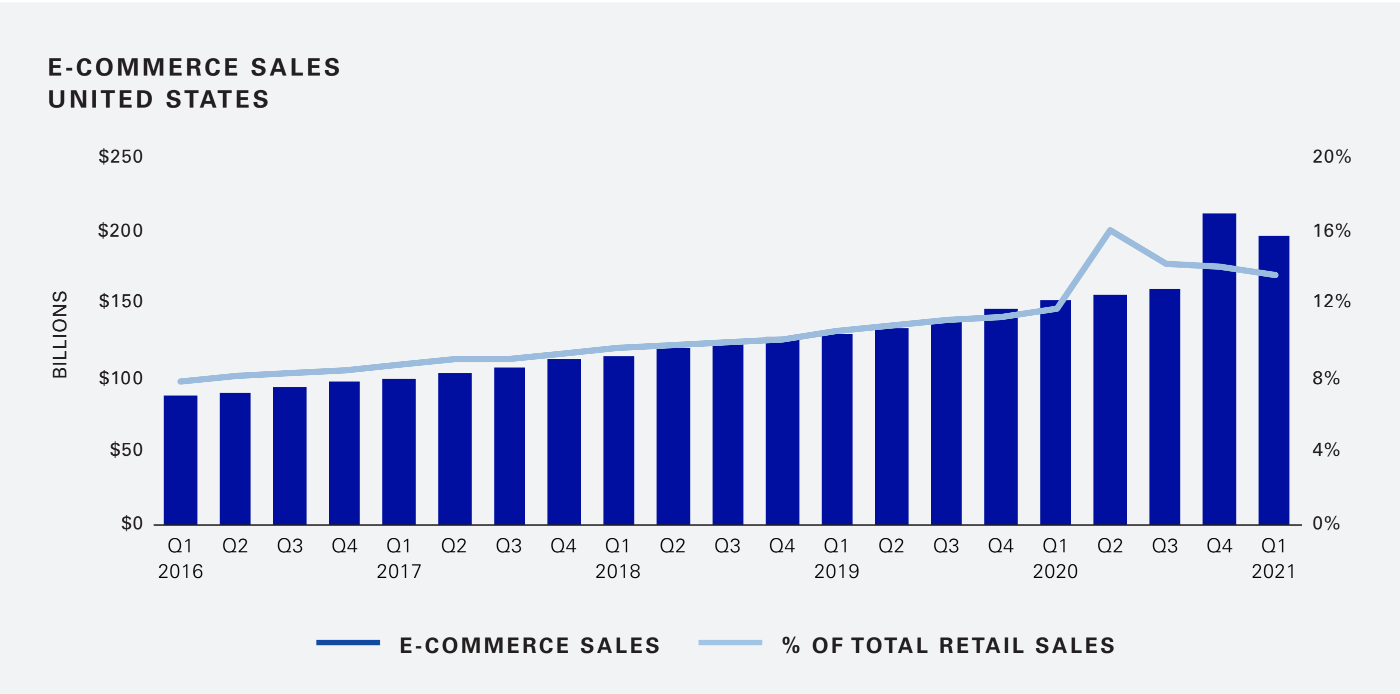
REGIONAL MALL CONSTRUCTION UNITED STATES



BUILT PRIOR TO 2000 — **BUILT 2000-2020**

Note: Includes super-regional mall properties over 500,000 SF
Sources: Newmark Research, REIS

Newer open-air malls have differentiated themselves from enclosed malls with a greater mix of apparel, entertainment, grocery, fitness and restaurants. The average size of the stores is smaller, which helps limit the impact of vacancy on the property's revenue. In fact, in 2017 mall operator General Growth Properties had reduced apparel from 50 to 41 percent of its portfolio over



Sources: Newmark Research, U.S. Census Bureau

the previous five years. Coinciding with the emphasis on the shopper experience was the increased access and ability to shop online. Once consumers had more spending options, retailers had to shift their focus, reducing the number of stores in many cases and potentially relocating to more central locations. In addition, strengthening their online platforms led successful retailers to put more effort into their distribution networks as online orders surged.

E-commerce sales as a share of overall retail sales has slowly grown over the past decade. At the end of 2019, online sales were 11.3% of total retail sales. However, the pandemic spurred an explosive jump to 16.1% in the second quarter of 2020 (see the above exhibit). While the relaxing of restrictions around the country and the increased access to the new vaccines saw that figure decline to 13.6% in the first quarter of 2021, some of the new shopping habits catalyzed by the pandemic likely are here to stay.

E-commerce sales more than doubled in the past five years, increasing 138.8% over that period to peak at $211.6 billion in the fourth quarter of 2020. This growth was a direct result of the increasing number of retailers growing their online presence and capabilities, including via the rise of "buy online, pick up in-store" (BOPIS). At the same time as this growth, several online retailers, such as Warby Parker, Joybird and Untuckit, have opened new brick-and-mortar locations. Those retailers believe in the value of a physical store in strengthening and building their brand, which in turn can increase sales.

The change in consumer preferences, the shifting retailer landscape and the proliferation of omnichannel retail has encouraged property owners to consider their mall assets differently. The major holes left by departed anchor tenants may require a new approach to maximizing the value of those assets. Let's examine the chain of events from the closing of anchor stores to the action steps mall owners may wish to consider in response to the rise of e-commerce.

Gone But Not Forgotten: The Loss of Department Stores

Department stores generally are the biggest tenants in a shopping mall, taking prominence on peninsulas and commanding prime signage along nearby roadways and in marketing materials. Yet, over the past 35 years, many of those iconic companies have faded into history as consumer habits and tastes changed and the retailer either could not or would not keep up (see the adjacent exhibit).

Sample of Department Stores Closed or Downsized Since 1985

- Barney's New York
- Bonwit Teller
- F.W. Woolworth Company
- Garfinckel's
- Gayfers
- Gimbels
- Hecht's
- Hill's
- Jacobson's
- Kaufmann's
- Lord & Taylor
- Montgomery Ward
- Rich's
- Sears, Roebuck and Co.
- Woodward & Lothrop
- W.T. Grant Co.

Sources: CNBC, Newsday, *Good Housekeeping*, *Business Insider*

The closing of these stores resulted in empty anchor spaces, most of them more than 200,000 square feet in size. Many anchors own their portions of the building, adding another wrinkle to the departure. With the options for re-tenanting such large spaces by one store limited, many mall owners and local municipalities became concerned about their malls' ongoing viability.

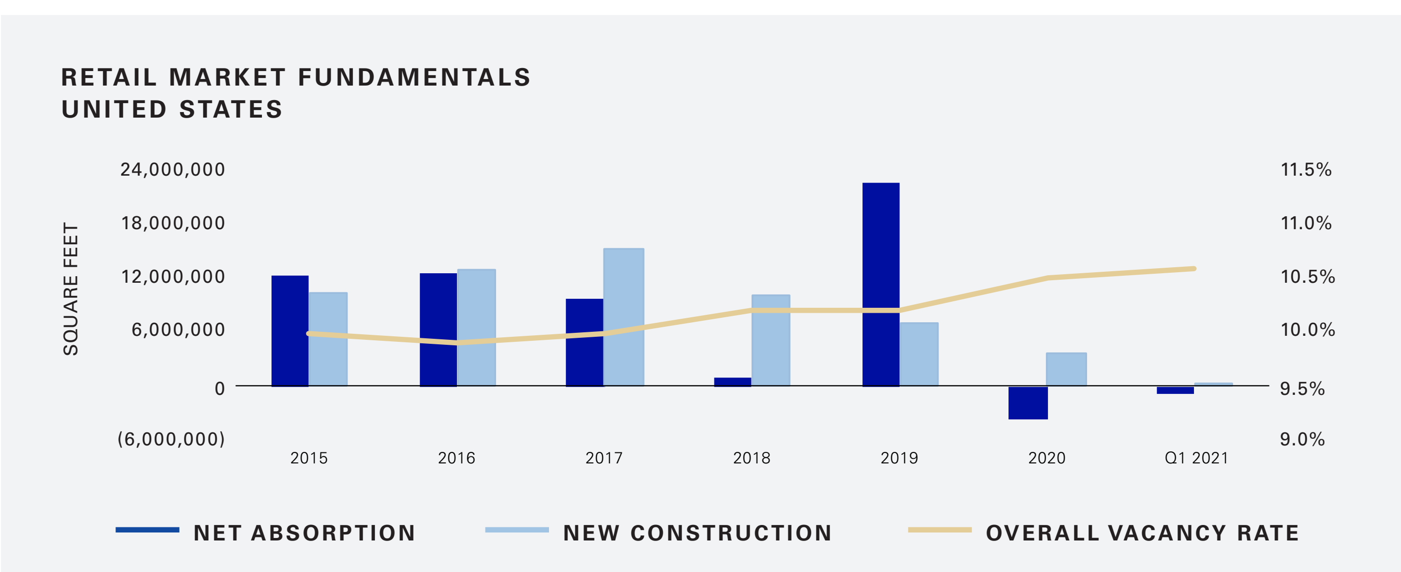
The limited number of potential retailers to backfill empty anchor spaces results in the question: What is a mall's next option? Many of the stores are owned by the retailer, which could result in a conflict with the mall owner if the retailer wants to change how it operates or decides to sell its property.

Pandemic-Related Challenges for Retail Real Estate

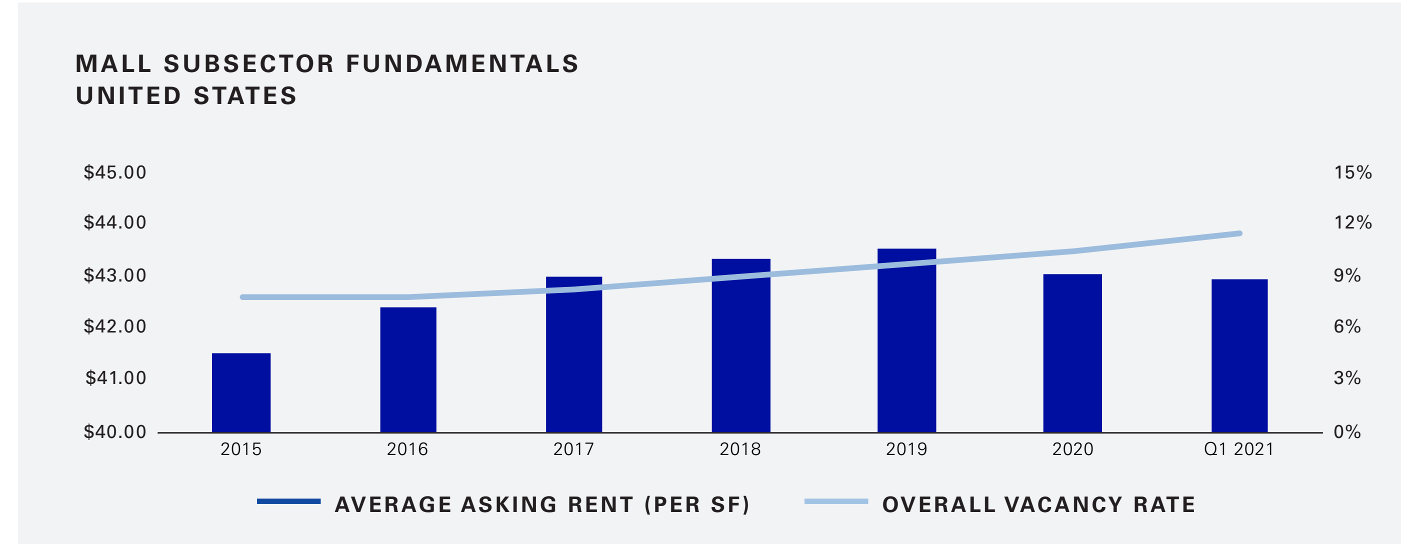
During 2020, retail real estate performance suffered as a result of the COVID-19 pandemic. A sector struggling with oversupply saw a significant increase in vacancy throughout 2020 of most space types, including the permanent closure of more than 110,000 restaurants. This resulted in a significant amount of empty space added to an already oversupplied product type. The United States, when compared to countries around the world, has the highest amount of retail space per capita by a wide margin. The 23.5 square feet per capita in the U.S. is almost 40% higher than the next-highest rate of 16.8 square feet in Canada and also more than double the 11.2 square feet in Australia. By contrast, the United Kingdom, Japan and the Netherlands average around 4.4 square feet per capita, while Italy, Germany and Thailand average less than 3.0 square feet per capita.

During 2020, at least 30 prominent retailers and restaurant chains filed for bankruptcy. These included big box and anchor retailers such as Pier 1 Imports, Neiman Marcus, Tuesday Morning, Lord & Taylor and JCPenney. Six more large retailers declared bankruptcy during the first quarter of 2021. While several retailers filed for the protection in order to regroup due to prolonged closures, others had to close permanently. These became much larger holes to fill in the shopping centers and malls within which they occupied prominent locations.

Store closings throughout 2020 put downward pressure on the retail fundamentals in the U.S. The nation's vacancy rate for all types of retail product rose to 10.6% at the end of first-quarter 2021, up 40 basis points from the end of 2019. This is the highest vacancy rate since 2013. More than 3.6 million square feet of occupied space was returned to the market during 2020, with 800,000 square feet returned in the first quarter of 2021. This was quite different than the 22.6 million square feet of occupancy gains in 2019, the last non-pandemic-affected year. In addition, 2020 represented the fourth year over the past six in which new supply outpaced demand, further driving vacancy upward and amplifying concerns among retail asset owners.



Sources: Newmark Research, REIS



Sources: Newmark Research, REIS

Malls have experienced more significant declines in performance over the past several years, a trend that was clearly underway before the pandemic arrived. Their 11.4% vacancy rate at the end of first-quarter 2021 was the highest in 10 years. (Most department store anchors of regional malls own their buildings, so they are not accounted for in these statistics.) While some of the spaces were leased to experiential operators or converted into another use, most vacancies of anchor spaces are underreported metrics. This further creates concern for backfilling vacancies on a larger scale.

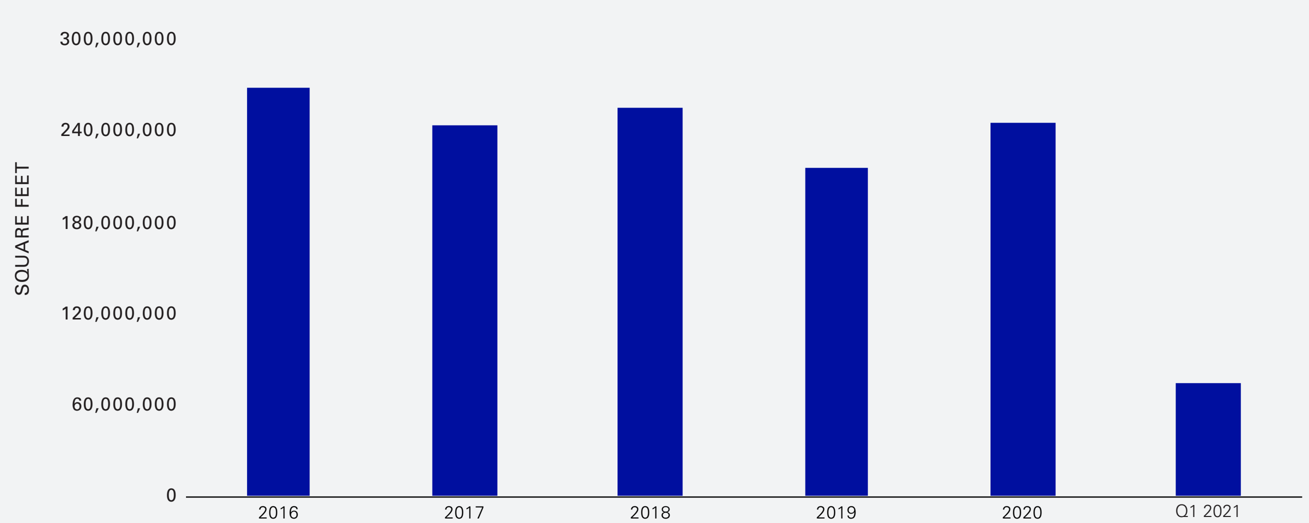
Behind these trends are retailers' decisions to downsize their store footprints as part of efforts to cut costs and better meet customers' needs. This has contributed to rising vacancy across retail subtypes. For example, Kohl's recently opened more than a dozen locations of approximately 35,000 square feet, roughly half the size of its typical 80,000-square-foot stores. Target created a small-format store and opened 100 across the country, serving college campuses and urban neighborhoods. In October 2020, IKEA announced it had plans to open 50 stores during the following 12 months, catering to smaller locations in urban centers. Macy's and JCPenney are testing smaller formats as part of their efforts to evolve.

Shifting Retail Habits Driving Growth of Demand for Industrial Space

The increase in online sales, whether for delivery directly to the consumer or through BOPIS, has resulted in unprecedented demand for warehouse and distribution space throughout the country. Many retailers have reduced the selection of goods in their stores in order to promote their full inventory online. This need to have product ready and available to ship has reshaped the U.S. industrial warehouse/distribution network. The pandemic also forced many retailers to reexamine their supply chains, as the disruptions caused by manufacturing delays in other countries and congestion at U.S. ports impacted retail sales. A direct result has been retailers needing more warehouse space, in direct contrast to store closings and generally reduced retail footprints.

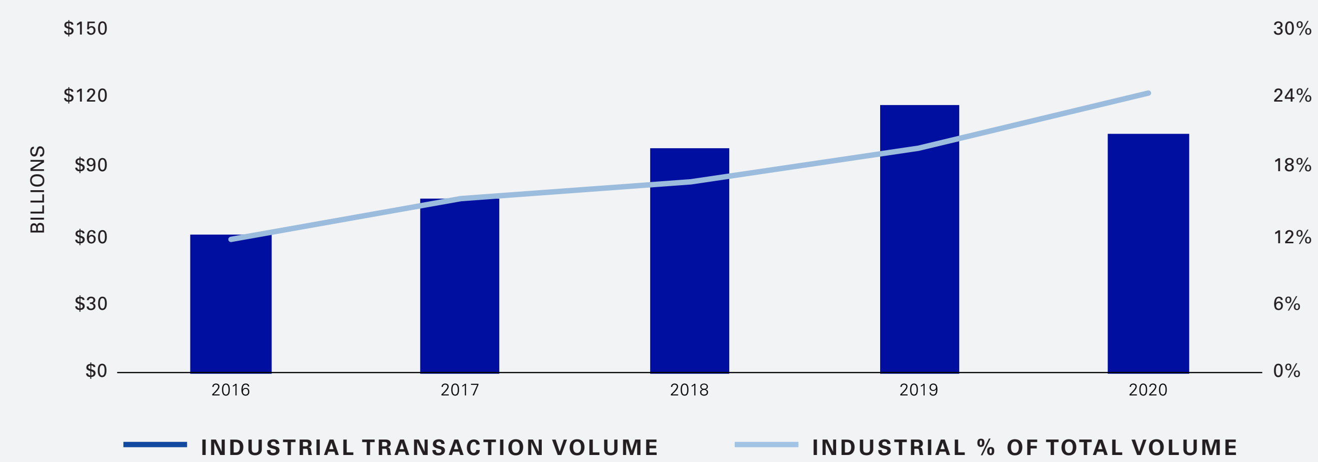
The U.S. industrial market absorbed 1.3 billion square feet of space since the beginning of 2016, according to Newmark Research. This demand led to 1.4 billion square feet being built during this time and 371.2 million square feet of new space in the construction pipeline at the end of first-quarter 2021. The bulk of this demand was for warehouse and distribution properties. As one example, Atlanta's warehouse/distribution inventory experienced 71.6 million square feet of net absorption (occupancy increase) from 2016 to first-quarter 2021, almost three-quarters of the market's total industrial net absorption during this period.

INDUSTRIAL NET ABSORPTION
UNITED STATES



Source: Newmark Research

INVESTOR ALLOCATION TO INDUSTRIAL PRODUCT
UNITED STATES



Sources: Newmark Research, Real Capital Analytics

Increased demand has resulted in industrial rental rates reaching all-time highs in many markets around the country. Annual rent growth since 2015 has averaged more than 5.0%, leading to heightened investment volume. In 2020, 24.5% of commercial real estate investment activity was dedicated to industrial properties, a substantial increase from the 11.8% of total commercial real estate sales volume in 2016.

Shipping goods directly to consumers requires more space than shipping goods to brick-and-mortar storefronts. The distribution centers must add shipping and packaging operation space. Retailers have been forced to reexamine their real estate to analyze how it operates and where it is located, as a large component of the battle for consumer spending is the ability to deliver goods quickly. As the shift to omnichannel continues and demand for distribution and fulfillment centers continues to eclipse demand for retail space, some owners will find that the highest and best use for some well-situated retail properties is a conversion to industrial use.

What Comes Next for Underutilized Retail Spaces?

The growth of e-commerce sales has led to the potential transformation of anchor stores or entire mall properties to distribution or fulfillment centers. The pandemic accelerated the consideration of such possibilities, as consumers flocked to online shopping during the spring 2020 lockdowns. Retailers were quick to adapt to increased online traffic, and many shifted operations to facilitate a more seamless integration of in-person and online shopping—the omnichannel experience. The "buy online, pick up in store" (BOPIS) option became much more prevalent among retailers across all segments. Successful BOPIS entices consumers with a quick turnaround for pick-up and easy in-store or online returns. This put pressure on retailers to find additional warehouse space to hold greater inventory close to brick-and-mortar stores. The goal became quicker servicing, enhanced by larger shipping and packaging operations.

With distribution/fulfillment space needed due to the growth of online shopping, and an oversupply of mall space making conversions a possibility, what determines whether a mall is an attractive option as a distribution or fulfillment center? Proximity to population centers and connectivity to utilities remove some of the barriers that would otherwise drive industrial users to other sites. The large surface parking lots allow trucks to access the buildings and maneuver around the properties. Loading docks are already in place to unload inventory that had previously been delivered to a mall's stores.

The vacant mall anchor spaces are leading many owners to look at other uses for the anchors or the site overall. Examples include:

- In **Alexandria, Virginia**, INOVA Health System will be constructing a new hospital campus as an anchor to a new mixed-use development at the former Landmark Mall.
- Simon Property Group is transforming **Seattle's** Northgate Mall into a mixed-use development that will include the training facility and headquarters for the National Hockey League's newest team, the Seattle Kraken.
- In **Tucker, Georgia**, Emory Healthcare leased the 224,000-square-foot former Sears at Northlake Mall for its back-office operations.
- **Lakewood, Colorado** gained a defined downtown when Continuum Partners built Belmar. The old enclosed mall was converted into a large mixed-use development anchored by nine acres of parks and plazas. The site is now home to 2,000 residents.
- Before turning the loan over to a special servicer in January 2021, Brookfield Properties announced plans to convert the ailing North Point Mall in **Alpharetta, Georgia** to a mixed-use development with green space, office towers and apartments.
- In **Charlotte, North Carolina**, Eastland Mall was expected to become the stadium site for the city's new Major League Soccer team, but those plans were derailed due to the pandemic.
- Neiman Marcus, after filing for bankruptcy, put its Hudson Yards store in **Manhattan** on the market as office space.

Macy's announced in the fall of 2020 that two of the stores it had closed earlier in the year would become fulfillment centers. Its CEO pointed to the chain's efforts to promote BOPIS and curbside pick-up as they are cheaper than typical shipping to the consumer. Macy's converted its stores in Dover, Delaware and at Southwest Plaza in the Denver suburbs to omni-service centers. While customers could still pick up in person and make returns, the bulk of the interior use is as a fulfillment center. Walmart, to address increased online demand and remain competitive in the e-commerce space, is testing the conversion of part of its stores into fulfillment centers. The large floor plan of its stores lends itself to the typical shopping capacity in the front half of the building, while the back half would be converted into a warehouse and fulfillment center.

Randall Park Mall, Ohio

Case Studies: Randall Park Mall and Euclid Square Mall in Cleveland, OH and Greendale Mall in Worcester, MA

The Randall Park Mall and Euclid Square Mall combined to total 2.5 million square feet of once-thriving retail space. Randall Park opened in 1976 to the fanfare typically seen for a movie premiere. Over the next 30 years, shopping habits changed, and the mall closed in 2009. After opening in 1977, Euclid Square fell out of favor with customers, tenanted by churches and small businesses in its final years. Euclid Square was closed in 2016, and demolition occurred in 2017 and 2018. The closure of these malls led to an increase in unemployment in the surrounding areas. In the mid-2010s, Amazon needed to expand its Ohio warehousing operations. It found the site of the Randall Park Mall a good fit for its infrastructure needs, and the Amazon fulfillment center opened in 2019, creating 2,000 jobs. Amazon also opened its fulfillment center at the former Euclid Square Mall site in 2019, creating an additional 1,000 new jobs.

At the end of 2020, the Worcester, Massachusetts Planning Board approved the proposed redevelopment of Greendale Mall into a last-mile distribution and fulfillment center for Amazon. This would be the first such conversion in New England. The mall had one tenant remaining after struggling for years. The current owner, having owned the property for one year, had originally planned for a mixed-use development to replace the mall but switched course after the rise in e-commerce sales during the pandemic.

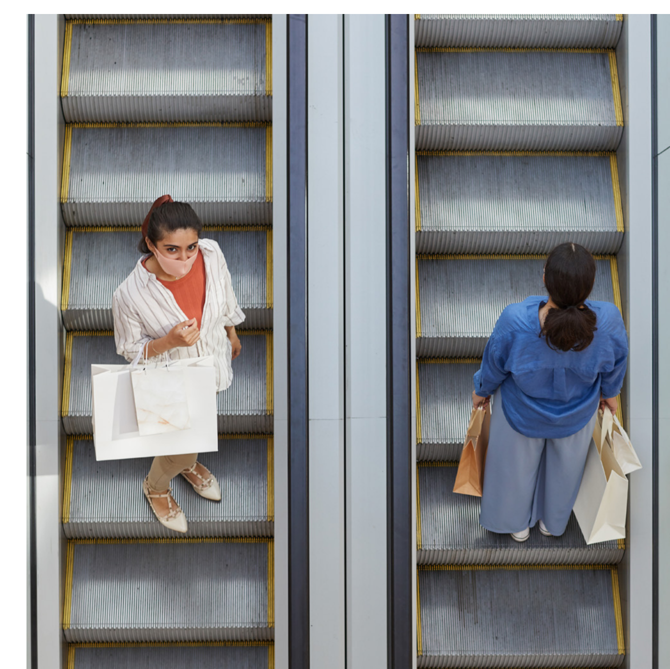
Challenges and Action Steps of the Retail-to-Fulfillment Conversion Process

As the country's population grows and shifts, properties in secondary and tertiary markets with declining populations are facing challenging headwinds. This will likely require a reimagination of the sites' future, whether as a retail destination or something else.

Converting an asset from a retail use to an industrial use is not a simple undertaking. One reason is that retail stores usually have one set of delivery bays, while a distribution or fulfillment center will have both inbound and outbound bays for higher capacity. Multi-floor department stores provide an additional challenge: adapting to the different layouts needed for automation or machinery. Conversion of in-fill stores may generate retailer opposition to transforming an anchor space, as doing so likely would reduce foot traffic throughout the mall. If the mall has multiple property owners, that can create additional headaches for a partial or full conversion to a fulfillment function. Co-tenancy clauses in leases can create challenges for landlords when considering how to backfill vacant space.

Local zoning laws also may create a barrier to conversion. Truck access to the facility may be restricted. In some scenarios, the existing building does not work for conversion and the property is razed and rebuilt to meet the specific requirements of a distribution center. Communities may resist such a transformation due to the increase in truck activity in their neighborhood. A municipality may also be hesitant to approve a change in use if the site has been one of the biggest tax generators for the community.

Transforming underutilized or poorly performing retail assets into an industrial use such as a fulfillment center provides an opportunity for owners to revitalize their revenue streams. Particularly important is that the owner ensure it has a detailed understanding of the facility's adaptability and that it is partnering with the most appropriate tenant. To date, the number of mall sites around the country that have been converted to industrial use is limited, and many required a full demolition of the old structure to make way for a new building. As noted earlier, some smaller, non-mall retail assets may work as partial fulfillment centers, particularly for large chain retailers. Not every obsolete mall site will work as a fulfillment center but repurposing these sites—and sometimes existing buildings—to their highest and best use can be a win for the asset owners and the local community as the retail landscape evolves.



Glossary of Terms

Anchor Tenant: The primary and usually the largest tenant in a shopping center. Larger shopping centers may have more than one anchor tenant. Rent for anchor tenants is often significantly lower than rent for other tenants in a shopping center because the anchor tenants draw consumers to the center.

Co-tenancy: A clause in a retail tenant's lease that provides remedies to a tenant in the event that another tenant, typically an anchor or major tenant, ceases its operations at the property.

Distribution Center: A type of warehouse facility designed to accommodate efficient movement of goods.

E-commerce: Electronic commerce is the buying and selling of products or services mostly through the Internet. Typically, transactions are carried out via desktop and laptop computers as well as on mobile devices such as smartphones and smart tablets.

Fulfillment Center: An industrial property type that enables goods to be efficiently moved or transported from a warehouse directly to a consumer.

Loading Dock: An elevated platform at the shipping or delivery door of a building; it is usually situated at the same height as the floor of a shipping container on a truck or railroad car to facilitate loading and unloading.

Omnichannel Retail: A fully integrated approach to commerce, providing shoppers a unified experience across all channels or touchpoints.

Vacancy Rate: A measurement expressed as a percentage of the total amount of vacant space divided by the total amount of inventory. This measurement is typically applied to a building, a submarket or a market.

Warehouse: A facility primarily used for the storage or distribution or both of materials, goods and merchandise.

Glossary Sources: NAIOP Research Foundation, Newmark Research, ShopifyPlus

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