Necessity Retail

The Battle-Tested Retail Niche

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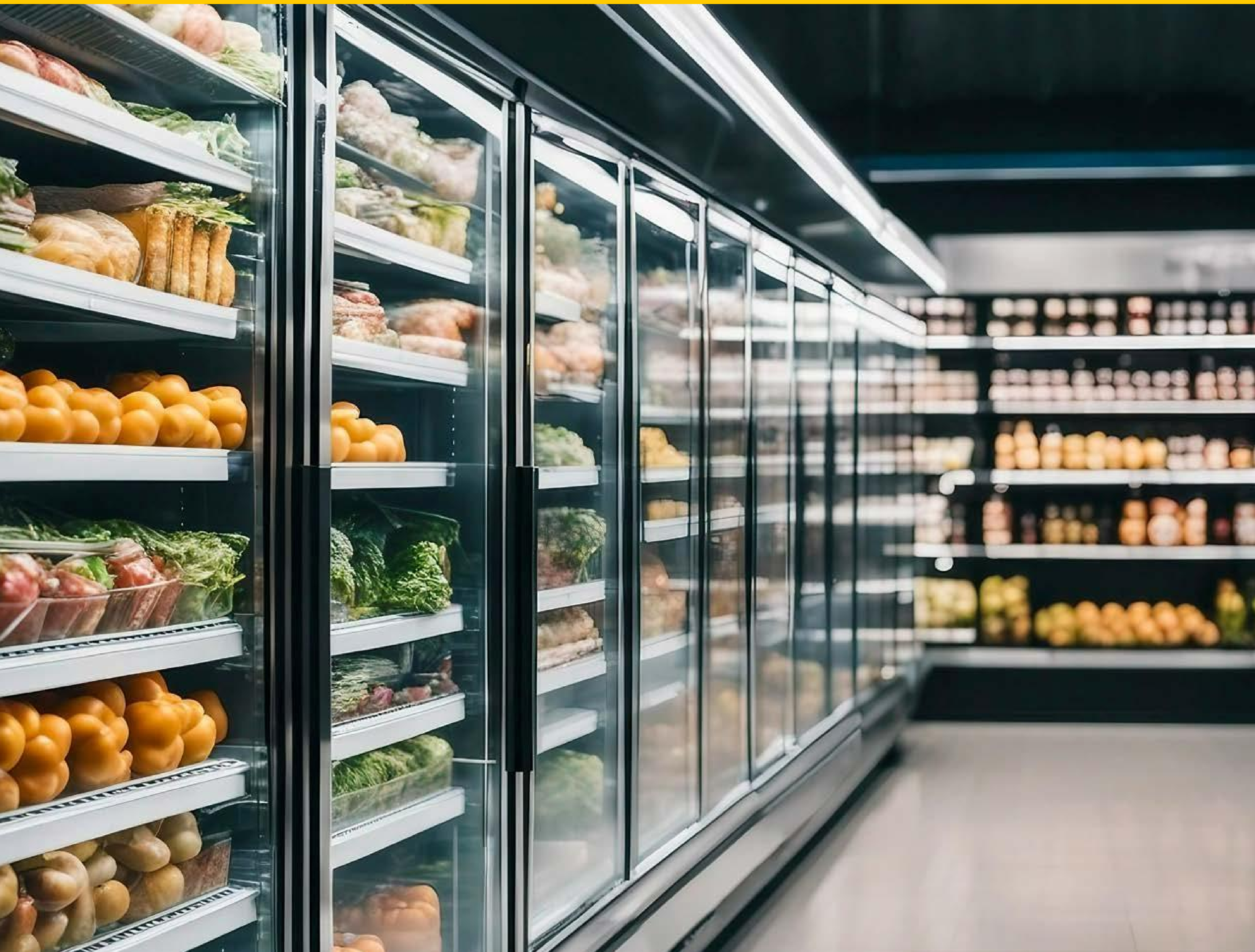
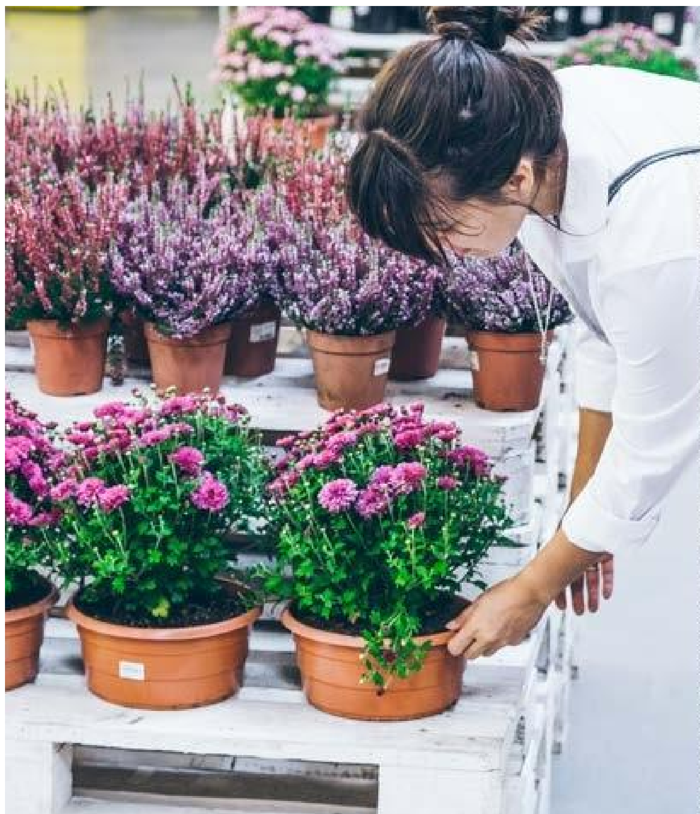
Jim Dillavou
National Head of Retail Investments

Lincoln



Introduction

Following the Great Financial Crisis (GFC) of 2007-2008, "retail" became synonymous with "mall". This misleading equation grew out of private capital's shorthand for various shopping center formats, including neighborhood centers, power centers, lifestyle centers, single tenant retail, and yes, malls, among others. By lumping them together, they failed to differentiate retail into its component parts, which have proven historically to perform very differently. This paper focuses on the retail subsector with the strongest and most consistent track record—necessity retail.



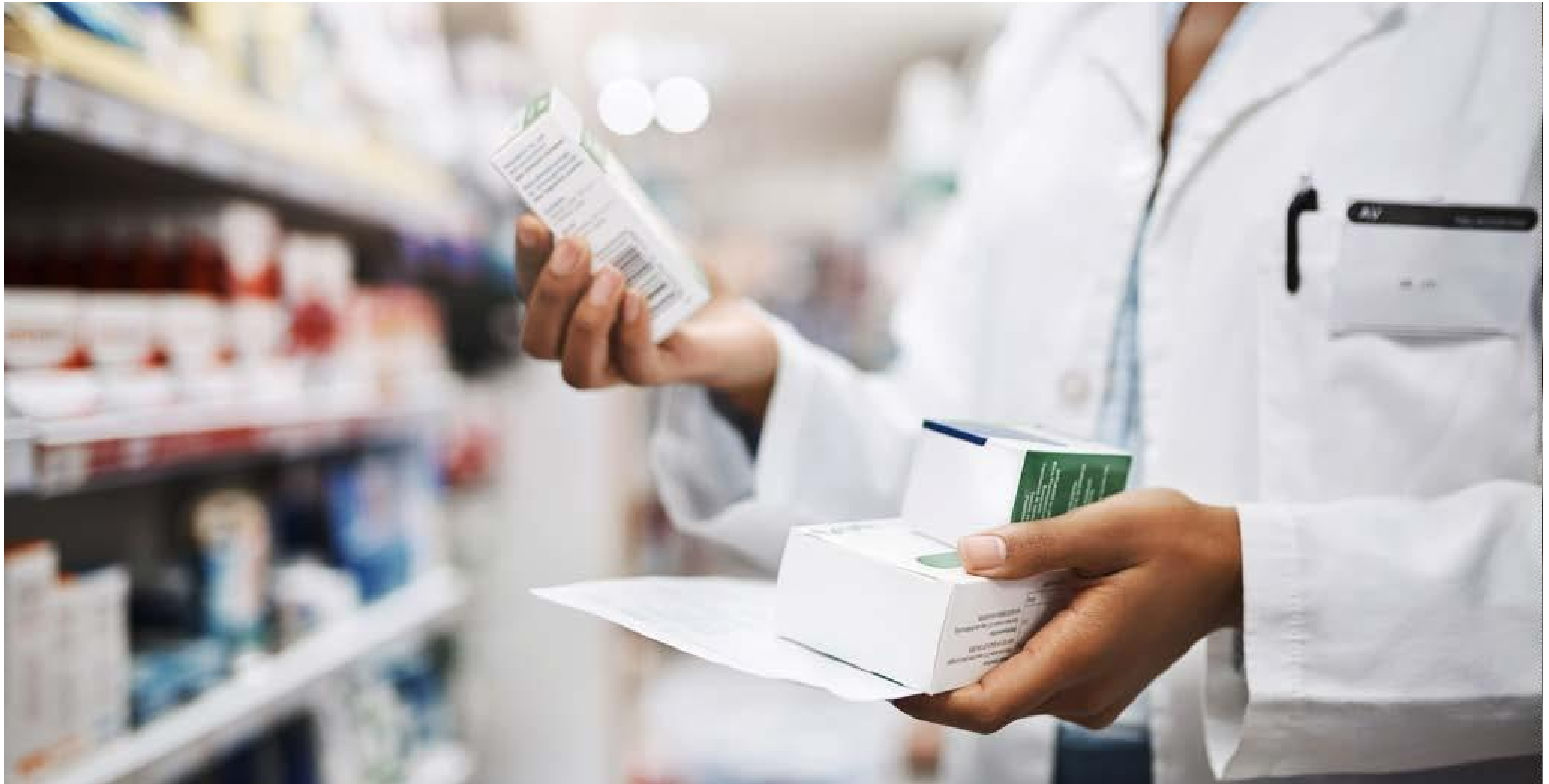
"In 2017, when debating with a room full of investors about the so-called "Retail Apocalypse", I urged them to consider distinguishing necessity-based retail from the rest of the retail sector. But this was a tough crowd. They had suffered losses from the retail sector; and even with strong supporting data, it was difficult to convince them that this niche was different."

- **Jim Dillavou**

The next five years further tested the thesis that necessity retail can outperform the broader retail sector, as it was impacted by escalating e-commerce pressures, mandatory government shutdowns during the COVID-19 pandemic, and the largest capital markets adjustment since the GFC. Yet, even with these powerful headwinds, necessity retail continued to outperform all other retail categories[1].

Today, necessity retail is finally being recognized for its characteristics of income durability, high barriers to entry, under-supply, and the pivotal and growing role it plays within our last-mile fulfillment and distribution ecosystem.

[1] NCREIF Private Market Total Return, 2Q23.



What Sets Necessity Retail Apart from the Sector?

Necessity retail businesses provide goods and services that are necessary to daily life, such as food, healthcare, and household essentials. Several characteristics of this niche contribute to its ongoing durability and track record of outperforming all other retail subsectors[1]. This includes:

1. Predictability during economic downturns as consumers prioritize spending on necessities;
2. Accessible locations near established neighborhoods support daily/weekly in-person visits;
3. Lowest health ratio ranges among all retail categories can predict higher lease renewal rates; and
4. Expanding role in the "last-mile" or "final fifty-feet" distribution system provides additional reasons for in-person visits, increasing the likelihood of in-store shopping while picking up online purchases.

[1] NCREIF Private Market Total Return, 2Q23.

Income Durability

Investment fundamentals matter. Current yield matters. Contractual growth matters. Cash flow matters. Operational expertise matters. These investment characteristics are timeless—they value discipline and data over chasing yield. Financial engineering and aggregation validate necessity retail's resilience against cyclical, systemic, and unpredictable economic challenges.

Throughout the rise of e-commerce, the challenges of the pandemic, and the recent dramatic increases in capital costs, necessity retail centers generally continue to generate healthy tenant sales, sustainable retailer occupancy costs, low vacancy rates, and durable income streams.

Multiple Retail REITS with large necessity retail allocations demonstrated these themes on Q3 2023 earnings calls, including the following highlights.

1. Philips Edison & Co.

(PECO)—Owns and operates 275 neighborhood centers totaling 31.4 million SF, with prominent grocery anchors such as Walmart, Sprouts, and Safeway.

- Portfolio continues to perform well with year-over-year (YoY) occupancy up 70 bps to 97.8% in Q3 2023. Anchor occupancy hit 99.3%, up from 98.9% a year ago, with inline occupancy rising 130 bps YoY to 94.9%.
- Same-store NOI is up 3.2% YoY, and dividend distributions increased 4.5%. Year to date, PECO has executed 779 leases totaling 3.6 million SF. Comparable rent spreads in Q3 2023 were 26.3% for new leases, 16.9% for renewal leases, and 19.6% combined.
- The portfolio generates 97% of its annualized base rent from omnichannel grocery stores, with a 93% retention rate. PECO's grocers on average generate $670 in sales PSF with a 2.3% grocer tenant health ratio.

2. Brixmor

Owns and operates 364 open-air retail centers totaling 65 million SF, with prominent anchor tenants such as TJ Maxx, Burlington Coat Factory, and Whole Foods.

- Averaged 93.9% occupancy portfolio-wide in Q3 2023, with anchors like Whole Foods at 95.7%.
- Same-store NOI growth of 4.8% YoY. Year to date, 1.7 million SF of new and renewal leases were executed, with rent spreads on comparable space of 22.3%. New lease spreads of 76% on recaptured, 2023 bankrupt tenant space.
- Recently signed tenants include Trader Joe's, BJ's Wholesale Club, TJX, Ross Dress for Less, Burlington, Barnes & Noble, Five Below, Ulta, and Lululemon, with small shop first-additions of Cava, Torchy's Tacos, and Urban Plates.
- Signed but not yet occupied leases total 2.8 million SF, with a record $62.1 million of annualized base rent. Reinvestment pipeline includes 55 capital projects with an aggregate net estimated cost of ~$491 million.

3. SITE Centers

Owns and operates 119 open-air shopping centers totaling 22.3 million SF, with prominent anchor tenants such as Publix, Target, and Kroger.

- Same-store NOI up 2.9% for 2023, with portfolio leased rates of 94.6%.
- Generated new leasing spreads of 37.7% and renewal leasing spreads of 7.3%, on a pro rata basis, for the trailing 12-month period ended September 30, 2023. New leasing spreads of 58.2% and renewal leasing spreads of 6.6%, on a pro rata basis, for the third quarter of 2023.
- Plan to spin off their convenience portfolio into a focused growth company called Curbline Properties, initially seeded with 61 wholly owned convenience properties that they began investing in five years ago.
- Analytics show that convenience properties, which can be considered necessity retail, generate 3.5x the customer traffic than other retail properties. Additionally, the average shopper is in and out in under seven minutes, which has increased by almost 40% in the past five years, illustrating the cross-shopping advantage of necessity retail centers.

High Barriers to Entry

Warren Buffet explains that the most important factor in evaluating a business is determining the size of its moat, which represents a company's ability to protect long-term profits and market share with competitive advantages that others can't easily replicate. Necessity retail has a wide economic moat, due in part to the sector's high barriers to entry. Other factors include operations, capital inefficiency, and the historical retail narrative.

The operational moat around necessity retail is the result of deep tenant relationships; highly localized market knowledge, design, and placemaking; rigorous asset management; knowledge of ever-evolving consumer sentiment and habits; and a thorough understanding of retailer prototypes, operations, business plans, and balance sheets.

Necessity retail's capital moat results from the need for flexible capital and comparatively small equity checks. This combination makes it extremely difficult to scale, and therefore may be inefficient from an institutional capital deployment standpoint. In contrast to multifamily, office, and industrial properties, the typical necessity retail investment size makes it difficult to efficiently deploy capital at scale, while maintaining institutional-quality infrastructure.

Lastly, the narrative moat refers to the "Retail Apocalypse" storyline that has persisted in defining retail for nearly a decade. This fear-inducing narrative instilled a belief that e-commerce was swallowing all forms of physical retail, which would soon become functionally obsolete. While non-necessity retail was certainly adversely impacted by the growth of e-commerce, the narrative proved largely inapplicable to the cash flows and cap rates of centers anchored by essential retail that meets customers' daily needs.

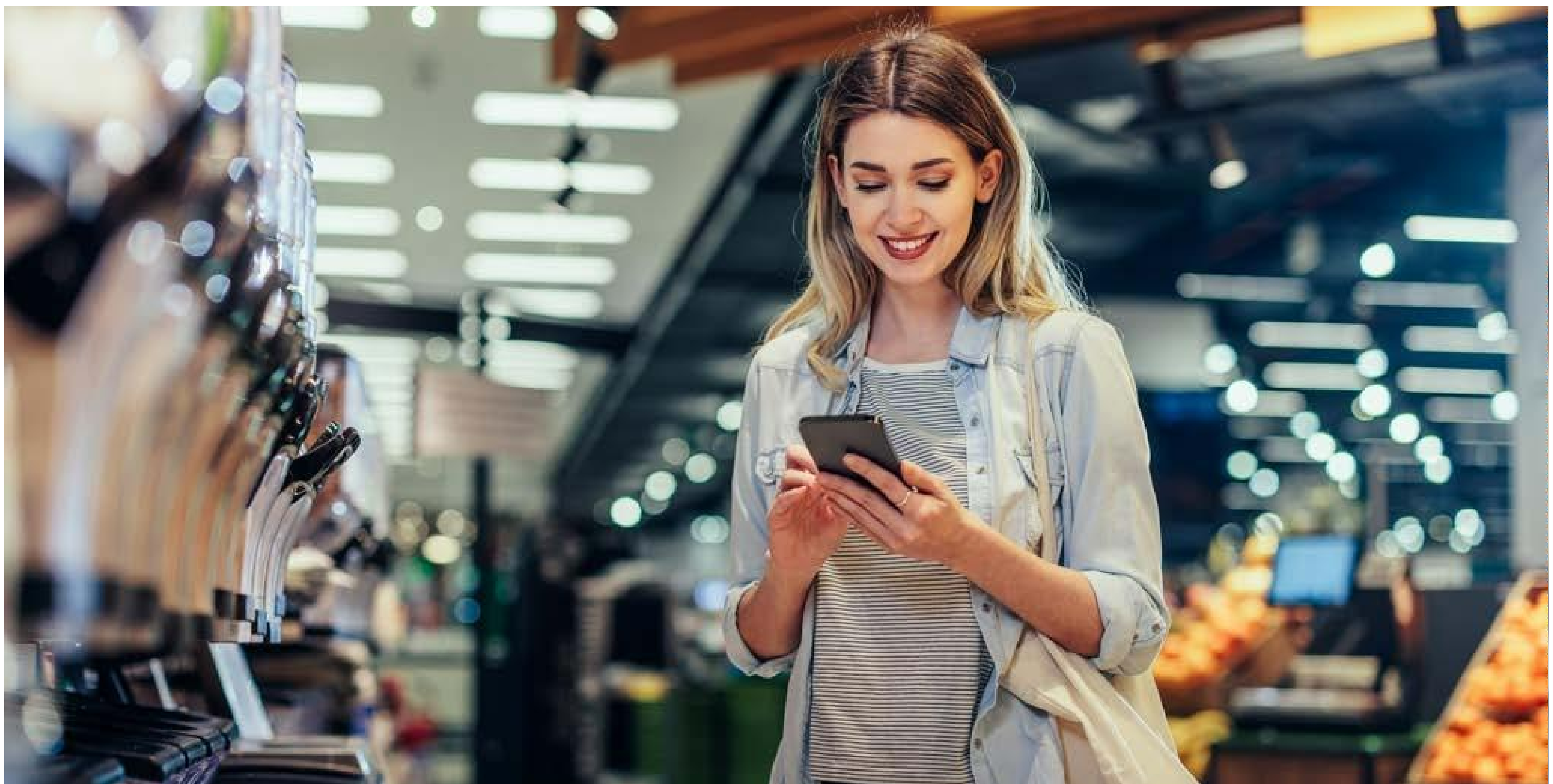
Although digital channels, last-mile distribution, and direct-to-consumer innovations impacted the retail ecosystem—they have not replaced the efficiency, customer engagement, and brand loyalty that is the hallmark of necessity-based retail and its continued success.

A recent Forrester Research report showed that nearly all retail sectors experienced a decrease in profit margins in 2022 due to rising supply chain costs. Pure-play e-commerce retailers saw the largest YoY decrease from 2021 to 2022 at 10.2%.

Supermarkets—the largest subset of necessity retail—were the only sector that did not demonstrate margin compression, thanks to continued demand for everyday essentials and consumers' strong preference to purchase these items in-store.

The term "omnichannel" refers to the multiple consumer touchpoints beyond the physical store location. An effective omnichannel sales and marketing approach provides consistent buying experiences across all operational channels, including in-store, online, mobile, SMS, and social media. Major necessity retail stores such as Whole Foods, Target, and Walmart have deployed successful omnichannel strategies to adapt to the changing retail landscape.

Perhaps more than any other retail sector, the success of necessity retail proves that e-commerce and bricks-and-mortar can be mutually beneficial when the physical store remains at the center of an essential retailer's operational network, and at the heart of the retail omnichannel ecosystem.



Under-Supply

Demand for neighborhood retail space has exceeded the available supply. Today's domestic retail market is experiencing the tightest conditions on record, with over 95% occupancy and less space available for lease than at any time since before the 2008 recession. Availability has decreased 50 bps over the past year and is nearly 200 bps lower than the 6.8% historical average.

Occupancy rates among major Retail REITS—many of whom have a substantial allocation to necessity retail centers— are currently at unprecedented highs.

- **SITE Centers Portfolio: 22.3 million SF; 95% Leased**
- **Tanger Factory Outlets: 14.5 million SF; 98% Occupied**
- **Philips Edison Portfolio: 31.4 million SF; 98% Occupied (anchor occupancy: 99%)**
- **Acadia Portfolio: 13.9 million SF; 95% Occupied**
- **Brixmor Portfolio: 65 million SF; 94% Occupied**
- **Kite Realty Portfolio: 28 million SF; 93% Occupied**
- **Macerich Portfolio: 47 million SF; 93.4% Occupied**

Grocery store vacancy is even more constrained than the broader market at only 2.2% (as of June 2023)—the lowest it's been in 20 years. Many grocery chains reported positive growth and expansion plans during their Q3 2023 earnings calls. Select examples are highlighted below. The strong performance of this sector is expected to put continued pressure on supply, resulting in ongoing low vacancy rates.

Publix

Publix reported a 7.2% increase in sales for Q3 2023. Their privately traded stock was up to $15.10 per share, from $14.75 in the previous quarter. Expansion plans include entering Kentucky, their eighth state, in early 2024. Year-to-date they've opened 33 supermarkets, including nine replacement stores, closed four locations, and remodeled 79 stores. Scheduled openings include Dacula, GA; Winston-Salem, NC; Ooltewah, TN; and Lakeland, FL before year-end. They ended Q3 with 1,351 supermarkets across seven Southeastern states.

Natural Grocers

Natural Grocers is a growing regional player, operating about 165 stores in 21 states. They announced new store openings in Loveland, CO, which will expand their Colorado store count to 45. Recent openings also include a store in Kennewick, WA, and a remodeled location in Norman, OK. On average, their locations are 16,000 SF and generate about $410/SF in sales.

Gelson's

Gelson's, an upscale local grocer, opened their 28th Southern California store this year, with their first supermarket. The 33,000-SF anchor store in West Los Angeles follows modern grocery store structure, featuring a sushi/tapas bar, build-your-own pizza bar with an adjacent café and bakery, self-serve salad bar, a hot-food and soup bar, a Poké Bar, and a wine and cheese section. On average, their stores generate about $35 million in annual revenue.

Walmart

Q3 2023 revenue hit $160.8 billion, up 5.2% YoY. E-commerce saw very solid growth of 24% in the U.S., with Sam's Club seeing a boost of 16%. Their supply chain infrastructure continues to be a focal point of investment, with automated fulfillment centers in seven of their stores by the end of November, following their store renovation program. This makes sense as their e-commerce success has been driven heavily by click-and-collect and same-day delivery sales.

Aldi

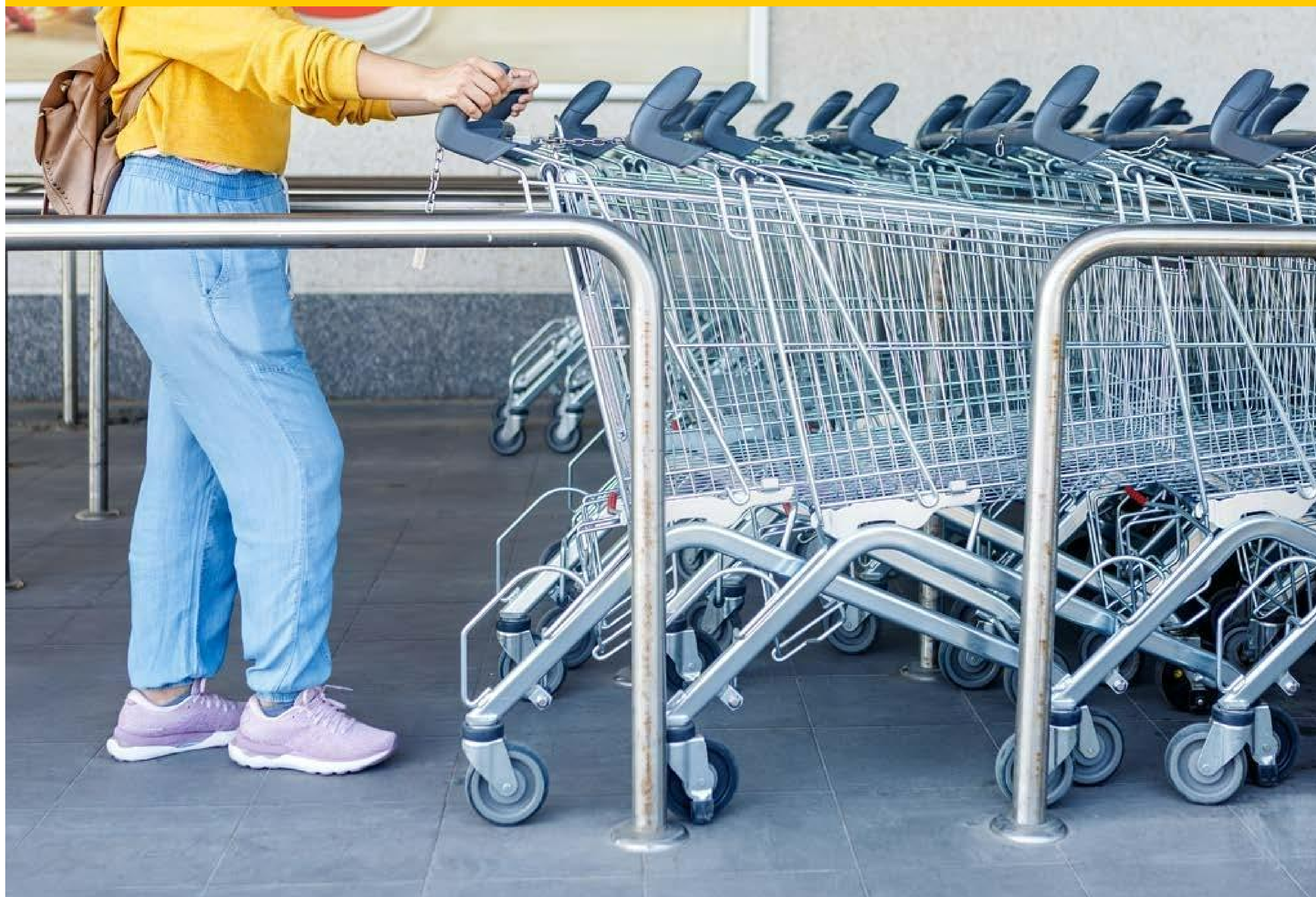
The German-owned discount chain is one of America's fastest-growing grocers, with plans to open 120 new U.S. stores in 2024[1]. The retailer opened seven stores this past June and at least three more in July. Aldi is now expanding in the Midwest, with three new stores opening in Ohio.

WAWA

Announced expansion plans into eastern North Carolina. The initial phase includes 80 stores over the next 10 years, with eight opening in 2024. The first stores to open will be in Wilson (2), Goldsboro (2), Greenville (1), Rocky Mount (1), Kill Devil Hills (1), and Elizabeth City (1). Wawa has more than 30 other sites under contract going through local approval processes, with plans to open 15 stores in 2025, and 10 more in 2026.

On the supply side, only 11.9 million SF of retail construction commenced over the past year—the lowest since 2005—and only 50 million SF of retail was delivered to the market. This marks a 35% decrease from the 10-year average. The lack of supply was also exacerbated by the removal of obsolete retail from the overall inventory, with over 150 million SF of retail space removed from the market since 2017, including 16 million SF in the past year.

This supply-demand imbalance has resulted in the steady growth of retail same-store sales and strengthening retailer health ratios—resulting in upward pressure on rents. As obsolete space continues to be removed from the market, and construction of new product is challenged by high borrowing costs, existing retail properties will continue to increase in scarcity and value.



Distribution & Fulfillment Ecosystem

The pandemic caused a temporary surge in demand for online purchases, and quickly revealed the shortcomings of existing retail infrastructure, and the immediate need for retailers to enhance their omnichannel capabilities. The need for smaller infill stores to double as logistical "last-mile" distribution centers grew beyond the capabilities of traditional industrial properties.

Consequently, necessity retail centers—particularly those anchored by tenants with strong omnichannel capabilities—became an integral component of the hub-and-spoke model of supply chain connectivity.

Necessity retailers optimized last-mile logistics by utilizing their existing network of local brick-and-mortar locations to (1) reduce the need for excessive inventory storage, (2) facilitate immediate customer needs, (3) reduce shipping times, (4) expedite exchanges and returns, and (5) grow brand and customer loyalty.

The "Buy Online, Pickup In-Store" concept (BOPIS) is another key component of a successful omnichannel network and has been adopted by a number of major stores across categories. A recent Forrester report highlighted BOPIS as one of the best solutions for retailers with deteriorating margins as it gives consumers the convenience of online shopping while also meeting their need for same-day pick-up. Data by Adobe, which tracks online digital retail spending, shows that BOPIS spending rose 6% to $6.4 billion from 2021 to 2022.

Additionally, brick-and-mortar sales during the same period were boosted an average of 11% due to BOPIS, as physical retail locations served as last-mile distribution centers benefiting from their e-commerce presence[2].

[2] CBRE

Successful omnichannel retailing requires a balance between e-commerce and physical retail. After several years of annual sales growth in excess of 20%, e-commerce growth has moderated following the pandemic, falling from a high of 26.7% down to 7.1% in 2022. It is projected to stabilize through 2026. Physical retail sales declined 2.6% during the pandemic low of 2020. However, as consumers returned to in-person visits, physical retail sales returned to positive growth in 2021, and are projected to remain positive through 2026.

E-commerce and physical retail appear to have found equilibrium in their relative growth rates, as the in-person experience proved necessary and symbiotic with online retail sales.[3]

Conclusion

Capital markets fluctuations, overly simplistic narratives, and emotion are always a part of any investment landscape. Necessity retail is no exception. Like many before it, the trajectory of the post-GFC real estate investment cycle encouraged risk-on underwriting in pursuit of engineered, outsized returns as real estate competed for capital against other growth industries. However, the market and the mentality have changed. Risk is once again weighed against reward; and fundamental underwriting is the new normal as investors are searching for sustainable, dependable yield.

Lincoln believes necessity retail has been battle-tested for decades—and the results speak for themselves. With its moats intact and fundamentals strong, necessity retail has once again become a darling of the real estate investment community, and is well-positioned for the foreseeable future.

[3] eMarketer, December 2022

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Lincoln Property Company
8111 Douglas Avenue, Suite 600
Dallas, TX 75225

***.lpc.com

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