2022 LBX RETAIL OUTLOOK: LOOKING TO STAY AHEAD OF THE HERD

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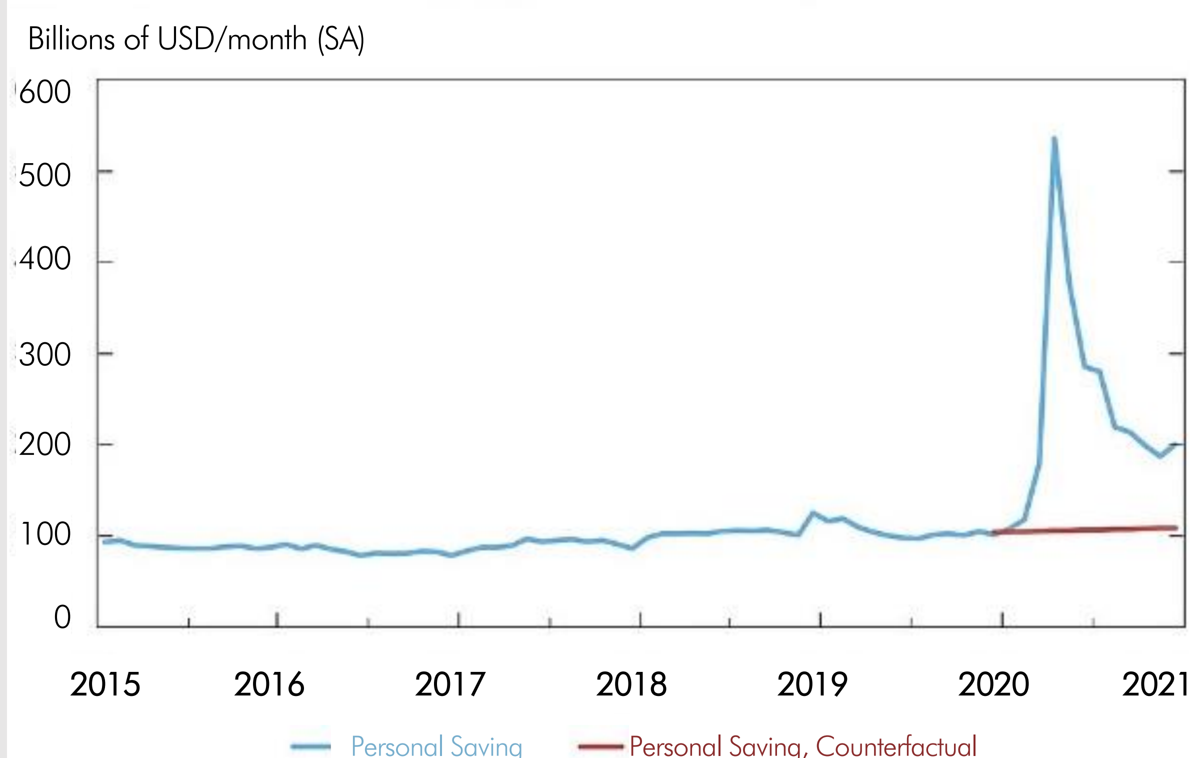
Our Retail Investment Thesis Remains Unchanged, Despite COVID's Societal Impacts

But Pricing Has Grown Tighter, Creating Both Risk and Opportunity

OMICRON HAS MANY CONCERNED BUT DON'T EXPECT A RETURN TO THE PAST

As we begin 2022 with inflation fears growing, interest rates on the rise, and COVID-19 case numbers at record highs, the Omicron variant's potential impact on the economy and financial markets is top of mind and evoking some unpleasant memories from March 2020. **Our house view is that we will not see a return to the past.** The pandemic continues to impact the retail sector in a myriad of ways (both on the supply and demand side), but we do not expect widespread retailer shutdowns in the coming months, as was experienced back in 2020. This is especially the case in the Sunbelt markets in which we have predominantly operated, where the political and consumer will for shutdowns is almost nonexistent. Certain segments of retail may be impacted in the near-term (e.g., restaurants, entertainment), as shoppers are showing signs of cutting back on public gatherings to some degree. But, these same shoppers have also accumulated savings throughout the pandemic, which, in our view, should continue to support retail sales and buoy the economy. Today's consumer may shift their dollars away from experiential retail and towards physical items like apparel and electronics in the very near-term, but overall retail sales forecasts continue to be high, reflecting the underlying strength of the American consumer (consumer spending equals ~70% of the GDP) and US economy.

EXCESS SAVINGS REMAIN ELEVATED, PROPPING CONSUMERS



Source: Bureau of Economic Analysis

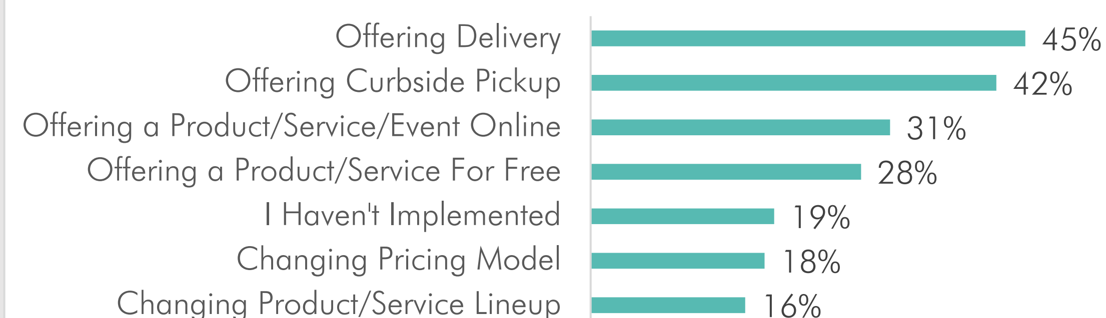
Our investment thesis, meanwhile, has not changed. If anything, it has strengthened based on the performance of our portfolio since early 2020. We remain bullish on well-located open air shopping centers with the right tenant mixes, demographics, traffic counts, and other characteristics, and believe these properties will continue to provide investors with attractive risk-return opportunities. This is particularly the case in comparison to other real estate asset classes such as multifamily and industrial, where cap rates have in most instances fallen into the very low single-digits and rely on projections of significant rent growth in order to achieve targeted IRRs. Shopping center pricing has grown more aggressive as well over the past six months, reflecting increased capital availability and a lack of supply, but remains nowhere near as heated as competing sectors. For example, we are currently evaluating several value-add opportunities of solid real estate at cap rates at or above 7.5%.

In this year's outlook, we highlight a handful of themes we believe retail real estate investors should be eyeing in 2022:

#1: COVID-19 was "The Great Accelerator" of existing trends that were exerting downward pressure on retail. It also sparked innovation and improvements that are ongoing, to the benefit of the top retail companies and the consumer.

The pandemic's impact on the retail sector is known in industry circles as "The Great Accelerator," because trends that had been building momentum for years hit a tipping point in 2020. The headline story is that once people were forced indoors, e-commerce spiked and many struggling retailers were killed off. Shoppers returned to traditional bricks and mortar as COVID waves subsided but, importantly, the pandemic has forced retailers – in particular, national players – to reimagine the customer experience. Business models had already been incorporating BOPIS (buy online, pick up in store), curbside, dark kitchens and other innovations, but the onset of COVID significantly accelerated the incorporation of these models into traditional retailer's businesses. As a consumer, you now have more choices than ever and – as Steve Dennis, a retail influencer we respect, says – "If you are anything less than remarkable today, more and more, you might as well be invisible." As an example, quick-service restaurants like Shake Shack and Chipotle are now investing heavily in drive-thru locations. Chipotle's "Chipotlane" will be cashless and fully integrated with mobile ordering. **There is arguably more innovation occurring in retail today than ever.**

BUSINESS MODEL CHANGES RETAILERS MADE IN RESPONSE TO COVID-19



Source: Software Advice COVID-19 Retail Digital Transformation Survey 2020
Q: Have you considered or implemented any of the following changes to your business model because of COVID-19?

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#2: Do not assume that e-commerce and bricks and mortar retail are in conflict, or that bricks and mortar is dying. On the contrary, the strongest retailers will continue to figure out how these "channels" can co-exist in harmony (and actually feed off one another), and e-commerce-only retailers will continue to struggle to reach profitability. Many "pure" e-commerce companies are now opening stores in order to enhance their customer experience and to drive sales and profitability.

The pandemic boosted e-commerce adoption, yes, but **investors should not expect physical retail to disappear.** Besides the fact that consumers returned to stores in droves once they reopened, numerous retailers have continued to open physical stores in order to build customer loyalty and increase their exposure to new shoppers. Stores also enable retailers to educate consumers, create unique shopping experiences and minimize return costs. The most successful retailers realize they need to be with us at all times and have developed fully integrated business models that incorporate brick-and-mortar locations, mobile phone browsing, e-commerce, social media channels, and digital experiences that dovetail with the physical world. Therefore, the key for us, as investors in retail, is to acquire the assets that are in the best position in any submarket, because that is where the top retailers and e-commerce companies are going to want to be to support their brands and drive customer experiences.

There are certainly exceptions to the rule of fully integrated retail. Some of the strongest retailers – TJX, Ross, Trader Joes, and Dollar General, for instance – rely almost entirely on their network of brick-and-mortar locations for growth and have very little online presence. On the other hand, retailers that pursue an e-commerce only strategy will continue to struggle for profitability because online businesses are very expensive to operate, especially as shipping costs continue to climb. Operating margins are typically thin to begin with in retail, and every step of their supply chain, from the beginning (user acquisition) to the end (item returns) adds a layer of cost. As a result of the high costs of operating online-only businesses, numerous digital retailers – including Amazon – have been opening brick-and-mortar stores and this trend will continue.

Source: LBX Investments

#3: Inflation and supply chain disruptions may be a challenge for consumers and many retailers, but the best retail companies are using inflation to their advantage and driving profitability. From a landlord perspective, we expect to see continued rent growth at well-located, high-quality open air shopping centers as stronger retailers continue to expand, and as new entrants demand space. Meanwhile, expect "mom-and-pops" – who have far less financial muscle than national retailers – to focus more acutely on quality site selection, as they leverage the foot traffic driven by the top national brands.

There have been plenty of headlines about the pandemic's impact on consumers and retailers. If you have set foot in a store or a restaurant recently you have probably experienced rising prices, limited staffing and/or items being out of stock. Consumers are dealing with the highest level of inflation in three decades and retailers are working through a litany of supply chain disruptions ranging from higher shipping costs to truck driver shortages. As landlords, we also continue to see rising expenses, as well, with taxes, insurance and tenant buildout costs continuing to rise.

Despite these COVID-driven issues, the neighborhood, community and strip center segment of the retail sector has experienced dynamic net absorption last year (more than 11 million square feet, per CBRE). This reflects increased demand for open-air centers, which stems from a combination of retailers' multi-channel strategies and consumers' demand for high quality retail options, pick-up and delivery convenience and health considerations. Rent growth has helped our open-air portfolio, as we have been able to push topline across our portfolio while we maintain fixed financing costs.

OPERATING METRICS FOR STRONGEST RETAILERS REFLECT THEIR DOMINANCE AND MITIGATE INFLATION CONCERNS

	WALMART	ROSS	TARGET	TJX	ULTA
Period	3Q FY22	3Q21	3Q21	3Q FY22	3Q21
Two-Year Stacked Comps	15.6%	14%	33.4%	14.0%	14.3%
Interest Coverage	19.1x	32.6x	25.8x	44.0x	892.3x
Gross Margin	24.4%	27.8%	28.0%	29.0%	39.6%
Δ in EBITDA Margin TTM	6.3% vs. 6.1%	14.3% vs. 7.7%	11.1% vs. 9.8%	11.4% vs. 5.8%	18.4% vs. 11.5%

Source: Creditntell

The strongest retailers continue to open up new stores outside of the enclosed regional mall and have the financial capacity to navigate through today's havoc. They are benefiting from higher revenues, can pass through higher expenses to consumers and squeeze suppliers in order to maintain or even enhance profitability (see chart to the right). Smaller "mom-and-pop" retailers, however, lack pricing power and are not as well-positioned to weather inflation. For instance, triple net reimbursements – which are typically comprised of taxes, insurance and common area maintenance ("CAM") charges – are rising and factor into all retailers' total occupancy cost equation. Mom-and-pops are more sensitive to these increases and the underlying quality of a site needs to pencil for them. If they are based in a marginal location, they will likely have less capacity to carry elevated operating costs into a lease extension.

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#4: More supply of prospective investments should hit the market in 2022 but we expect pricing to continue to be very competitive as more capital is chasing fewer deals. Wall Street is increasingly favoring REITs that sell their non-core assets (e.g., non-Sunbelt states) and invest into the Sunbelt, which means we should see interesting value-add opportunities in some new markets.

We believe investors should pay attention to two key investment trends in 2022. First, pricing continues to tighten across all sectors, but retail generally continues to offer relative value across most metrics, with compelling cash yields and risk-adjusted total returns as well as favorable supply-demand characteristics. Industrial and multifamily remain the most favored sectors among investors but – **with going-in cap rates for these property types dropping below 4% in some markets** – will rely more on continued asset appreciation than current yield to achieve targeted IRRs.

Second, while a limited supply of shopping centers hit the market in 2021, we expect to see a robust pipeline of value-add and core plus opportunities in 2022. Halfway through January, for example, we are already evaluating more than 20 different potential investments in markets across the country.

SECTOR COMPARISONS ARE VERY FAVORABLE FOR RETAIL VS. MULTIFAMILY, INDUSTRIAL AND OFFICE

	MULTIFAMILY		INDUSTRIAL		OFFICE		RETAIL	
Characteristics	CORE	VALUE-ADD	CORE	VALUE-ADD	CORE	VALUE-ADD	CORE	VALUE-ADD
Cap Rate	4.25%	4.94%	4.09%	4.75%	6.47%	7.69%	6.59%	NA
New Supply	Very High		Very High		Low		Very Low	
Supply Sensitivity	Very High		Low		High		Low	
Operational Requirements	Moderate		Very Low		Low		Low	
Lease Term	Annual		Long-Term		Long-Term		Long-Term	

Source: CBRE Cap Rate Survey (1H21) and LBX Investments

What is surprising to note is that some of the most interesting opportunities we are seeing fall outside of our typical Sunbelt markets. **We have been seeing more REITs and other institutional sellers looking to divest of their holdings in markets they believe are less desirable – e.g. the Midwest – as they look to capitalize on the Sunbelt growth story.**

This trend was illustrated in a Globe Street article in December, which highlighted a specific REIT's recent push into grocery-anchored centers in Sunbelt markets:

"The top guns of retail investing have a need for needs-based assets, especially grocery-anchored shopping centers. [This REIT] is riding that unwavering demand, which is further fueled by increased Sun Belt job and population growth, **to more than $300 million in retail asset additions in the next two years** [because] the region has fundamentals for sustained retail growth … [and] demand coming from local, regional and national tenants."

REITs and other institutions tend to follow each other, often in response to what they believe Wall Street wants. For example, Sunbelt markets like Austin, Nashville and Raleigh have become institutional mainstays. REITs and other institutional sellers looking to trade the Midwest for the Southeast are effectively looking to "recycle" their capital from existing assets in less favorable markets into redevelopments and acquisitions in hotter markets. We are happy to stay a step ahead of the herd and acquire their mismanaged, excellent properties in less popular markets.

This is leading to some very interesting investment opportunities in places we have not traditionally looked for deals. For example, we are currently underwriting an investment in suburban Detroit that has an exceptional tenant roster, strong sales numbers, with very attractive demographics. It will likely trade in the 7.5% cap range and – with conservative leverage – offer a double-digit going-in yield and excellent debt service coverage. This same deal would trade at least 100 – 150 bps tighter in the Atlanta or Austin markets. **Investors should expect to see more opportunities like this in 2022.**