Market Analysis for Simsbury Commons Shopping Center

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Version: 4/15/12

Step 6: Measure the Sources of Cash Flows in Local Markets: Subject Capture and Scenario Analysis

Overall objective: As a commercial real estate appraisal assignment, this study performs market analysis for a property: Simsbury Commons, an open air community shopping mall located at 498-540 Bushy Hill Road, Simsbury, CT 06070 (Subject Site, SS). This appraisal is undertaken for investment analysis (purchase of the SS) and for evaluation of collateral for a mortgage loan.

Functional Skills:
• apply pro rata share techniques and related techniques to evaluate market capture
• use trend analysis to estimate market growth
• evaluate risks using scenario analysis
• apply the six step method and develop a market defining story for your subject site (your project)

Overall: the ability to create an estimate, and a range of possible projections of sales revenue (gross cash flow) and net operating income (NOI) generated by the real estate site.

Initial Thesis: The 35,000 sf of available and vacant space at SC pose a difficult problem for investors and lenders—see supporting details in Step6Scenarios.xls, discussed below.

• Fanning’s “fundamental analysis”\(^1\) indicates that there is enough demand for SC to fill its vacant space
  o But, examination of the underlying parameters and assumptions suggest considerable risk: i.e., a range of outcomes are possible
  o Similarly, market capture analysis based on Fanning, Chapter 12, indicates that SC’s capture of new demand might range from 20% to 30%.
• Fanning’s analysis is only a starting point because the key issue is the ability to lease the large empty or available spaces: 7,700 sf vacated by EMS and about 24,000 sf available where Border’s is now.
• We consider the following strategies:
  o Aggressively pursue tenants. Build on the remaining strong retailers.
    ▪ Aggressively seek tenants that fit with the existing SC tenants: see Step 5.
    ▪ This may involve bidding tenants away from nearby competitors.
  o Seek clearance outlets of some of the better quality stores: Nordstrom Rack, Saks Off 5th, etc.
  o Seek an electronics store.
    ▪ Some might be attracted by lower rent into the 24,000sf vacancy
    ▪ PC Richards is one
    ▪ If Best Buy is having trouble across the street, they might move.
  o Improve the tenant mix for apparel, especially discounted women’s clothing.
    ▪ Try to attract Dress Barn or similar retailer
  o Look for “emerging retail concepts” as defined below.
  o As a last resort, after a considerable period of vacancy, go to a value/discount approach such as a $ store or Ocean State Job lot.
    ▪ However, this will substantially reduce the rent per sf
    ▪ There is a risk that this will not play well in this high income market
• Cash flow analysis
  o A wide range of outcomes are possible based on the success of the above strategies.

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\(^1\) The buying power and ratio analyses are the main components of fundamental techniques.
We examine rental rate and vacancy based on our strategies and informed by Fanning’s fundamental analysis.

**Fanning’s Fundamental Analysis: capture analysis and scenarios on absorption of sf/year**

- See the workbook entitled Step6Scenarios.xls.
  - The first sheet is a simple pro-rata capture estimate of 21.1% based on the 257,500 sf in Simsbury Commons divided by CoStar’s estimate of 1,215,941 sf of competitive space in the polygon trade area.
  - The second sheet displays results from Fanning’s competitive rating
    - A list of center characteristics is given in column B.
    - The rank (relative importance) of each characteristic is given in column I.
    - A numerical score ranging from 0 to 3 (best) is given to the SS in column C and to each major competitor in columns E and G.
    - The total score, row 24, for each competitor is the sum of scores times ranks.
    - A 30% capture based on Fanning’s marketability rating of SC compared to the two most competitive centers.

**Most likely, pessimistic and optimistic scenario: Cash flow estimates, the bottom line of market analysis**

- All make different assumptions about future growth in the number of households and household income. See Table 1 for the assumptions behind the analysis.
- All revise the assumptions of Fanning’s Buying Power analysis.
- E.g., the capture rate and the 40%, 48.3% and 1.32 parameters on the Buying Power sheet are all subjected to review and revision
  - Step 3 and 5 analysis indicates that expenditure on retail at similar types of shopping centers might be as low as 40% instead of 48.3%.
  - A higher percentage might be justified based on 2010 BLS consumer expenditure survey, but we omit this in order to produce conservative estimates.
  - Step 3 analysis(revised) shows that the retention/leakage parameter might be as low as .8 based on Hartford county expenditures.
- An advantage of basing scenarios on Step 1 to Step 5 is that the analyst knows where there are weaknesses in 1) household assumptions; 2) capture assumptions; and 3) buying power assumptions.
- Specifically, the five year forecasts in Step5Marketability.xls are based on CoStar forecasts
  - But CoStar has not revealed its forecasting method – it is a black box
  - The forecasts look unrealistic – too optimistic based on the anemic recovery so far from the current recession
  - We update with *ChainLinks Retail Advisor, Spring 2011; with The Outlook for Retail Rent Growth in 2011* by CBRE-EA and with data from the National Bureau of Economic Research. Also, LoopNet shows declining rental rates and rising vacancy rates for the region.
LoopNet (http://www.loopnet.com/local/?linkcode=30260) indicates declining retail lease rates and rising vacancy in the Hartford area.

These sources suggest the possibility of slow household growth: between 1% and 1.5% total growth over five years in the Hartford area.

Income may grow only at the rate of inflation, about 2.5% to 3% per year.

The percent of income spent on retail might be constrained by high household debt and foreclosure as well as high unemployment.

This provided the basis for the following assumptions for scenario analysis

Table 1: Assumptions behind scenario analysis and cash flow estimates

<table>
<thead>
<tr>
<th>Assumption</th>
<th>Pessimistic</th>
<th>Most Likely</th>
<th>Optimistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Households grow by a total of __% in 5 years</td>
<td>1.0%</td>
<td>1.5%</td>
<td>2.4%</td>
</tr>
<tr>
<td>Average household income grows by __ per year</td>
<td>0.0%</td>
<td>2.5%</td>
<td>5.0%</td>
</tr>
<tr>
<td>% of income spent on similar types of shopping centers</td>
<td>40.0%</td>
<td>44.0%</td>
<td>48.3%</td>
</tr>
<tr>
<td>Retention within trade area</td>
<td>0.80</td>
<td>0.90</td>
<td>1.32</td>
</tr>
<tr>
<td>Simsbury Commons capture</td>
<td>20.0%</td>
<td>21.1%</td>
<td>28.0%</td>
</tr>
<tr>
<td>Average rent psf</td>
<td>$15.30</td>
<td>$18.48</td>
<td>$21.65</td>
</tr>
<tr>
<td>Common area maintenance (CAM), taxes and other operating costs psf</td>
<td>$7.46</td>
<td>$7.51</td>
<td>$7.56</td>
</tr>
</tbody>
</table>

The Bottom Line on Market Analysis: Scenarios for Net Operating Income

Conclusion from pessimistic absorption analysis: SC will be unable to fill the vacant and available space over a 5 year period. Dollar assumptions supported by CoStar, $ and Cents of Shopping Centers, LoopNet and the analysis in Steps 1 through 6. Net operating income will be about $1.6M per year in 5 years.

Conclusion of most likely absorption: This is an average of pessimistic and optimistic scenarios. Net operating income will be about $3.2M per year in 5 years.

Conclusion of optimistic absorption: it will take 2 years to fill the vacant and available space at SC and rents will quickly increase because SC enhances its tenant mix with new tenants. Net operating income will be about $4.7M per year in 5 years.

For details on how we arrived at these conclusions: see notes on pessimistic, most likely and optimistic spreadsheets in the Step6Scenarios.xls workbook and discussion above. An important outcome of market analysis is leasing strategies: see the attachment for detail.
Attachment: Strategies for leasing vacant and available space

- Fanning’s analysis only provides background for leasing strategies
  - The reason is that SC needs general strategies for attracting categories of retail (e.g., consumer electronics, women’s apparel) that might fill the Border’s space.
  - SC must identify specific tenants (e.g., PC Richard & Sons) that might be attracted
  - No matter how strong the market, long term vacancy at Borders is a possibility that poses serious risks for investment and lending related to SC

Strategy #1: better management and aggressive leasing

- Retail occupancy tends to be more dynamic than office or industrial
  - Retail business productivity (sales psf.) is directly tied to location, so we tend to see more jockeying for position when good spaces open up.
  - The cost of a move can be offset by a resulting incremental increase in business volume.
- Tenants might move when an engaged local owner is competing against the absentee management of a distant investor.
  - If the local owner has talented leasing people and is flexible on lease terms, they often can capture available leasing opportunities before the broader market is aware they exist.\(^2\)
- The departure of EMS from SC, together with in-line vacancy, suggests that SC will not be able to draw the luxury component of retail expenditures.
- Conclusions: SC benefits from an aggressive, locally-engaged leasing agent and property manager

Strategy #2: build a leasing strategy on Simsbury Common’s strengths

- Although suffering from the loss of Borders, the center continues to have a very strong position in the market.
  - Stop & Shop, Walgreen’s, Bed Bath & Beyond, Bob’s and the theater are solid, performing tenants.
  - Experts think that Stop and Shop is the highest volume grocery store in the Valley.
  - These tenants are generating a lot of daily traffic to the site.
- Conclusion from Step 5: The first leasing call might go to PC Richards & Sons
  - They might go head to head with Best Buy which is located across the street from SC
  - Or, if Best Buy is having trouble with their Big Box concept, they might move to a smaller store at SC
- Next, a more aggressive marketing strategies will be presented

\(^2\) We tend to see this lack of attention in properties where the owner/lead investor has a transaction-driven culture, as opposed to one focused on leasing and operations. We’re seeing more of this in recent years as the result of the flood of money into retail properties during 2002-2006.
Strategy #3: Emerging retail concepts strategy

- Emerging retail concepts usually come out of one of the big retail industry MSA’s (NYC, Chicago, Minneapolis, Dallas, San Francisco, etc.) and then, if successful, expand their outlets
  - They often expand to the next highest population MSA’s
  - Boston is typically their initial focus in this region and they’ll get to Hartford once they have the coverage they want in the Boston MSA.
- Conclusion: SC’s leasing agents should be paying attention to emerging retail concepts on the national scene, focusing on which of those is opening in Boston and/or NYC
  - Then make a pitch to them to look at Simsbury Commons.
  - The household income around SC (median is $92,661 in the 5 mile trade area, mean is $116,500, according to CoStar) gives a good story to tell.

Strategy #4: A value/discount merchant format

- If “discount” plays out as “cheap”, it won’t fly in affluent markets.
  - High income customers respond well to a high style presentation of quality merchandise at a value price, but will avoid a poor style presentation of low quality merchandise, even where the price is low.
  - This reasoning suggests that Ocean State Job Lots or $ stores will not do well in the Farmington Valley submarket.
- Some history of value retail in the Farmington Valley submarket:
  - Bob’s Furniture failed, 99 Pub failed, Caldor was doing poorly but Wal-Mart does great in the same location.
  - Shows the importance of presentation and style of operation.
- Rents for discounters are much lower than for other retailers
- Typically one can’t attract factory or manufacturer’s outlet retailers to this type of location since it’s too close to their retail dealers/merchants who sell at full price. Means that value/discount retailers would be the focus.
- Conclusion #1: Analysis in Step 5 supports discount apparel such as Dress Barn.
- Conclusion #2: Need to carefully examine the financial feasibility of moving to a value/discount format.
  - If rents go from an average of mid-$20’s to ⅓ of that, the value of the center falls off dramatically.

Strategy #5: Lease to clearance outlets for some of the better quality stores

- Might be worth pursuing a strategy of leasing to: Nordstrom Rack, Saks Off 5th, etc.
  - The big hurdle with these tenants will be the low population numbers within a reasonable drive time trade area.
  - These types of retailers typically want one or more of the following three criteria: regional location near an interstate; or, a major concentration of similar operations; or, 250,000 population within 5 miles