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When Retail Space Goes Bad

Ronald B. Bruder

Many shopping centers are obsolete and have little chance of regaining their competitiveness—it's time to apply adaptive reuse more aggressively to retail property.

Adaptive reuse has been associated primarily with the conversion of light industrial property to office or multi-family uses. Today, this approach is beginning to find useful application in the retail sector, where the roster of obsolete and superfluous properties is rapidly growing.

As an aspect of redevelopment, adaptive reuse often is both a socially and economically desirable alternative to new development. Without contributing to urban or suburban sprawl, it revitalizes vacant or soon-to-be-vacant property that might otherwise blight communities, while minimizing damage to architectural history. Most important perhaps, adaptive reuse helps communities apply resources efficiently, filling real needs and creating stable employment opportunities.

Ronald Bruder is chairman of the Brookhill Group, a New York City-based redeveloper of retail property, which he founded in 1979; and chairman of Brookhill Redevelopment LLC, which specializes in purchasing environmentally impacted properties.

This article focuses on a compelling example of the adaptive reuse of retail property: the conversion of a vacant enclosed mini-mall into a fully occupied state-of-the-art call center where more than 1,000 persons are employed.

Sycamore Mall

Sycamore Mall, an obsolete 120,000-square-foot enclosed shopping mall in Memphis, Tennessee, stood little chance of being utilized. All of the small store space and a former 60,000-square-foot furniture store were vacant, with the exception of a church, that, out of fear of divine retribution, was allowed to remain until the last possible moment. The property was too small to attract a new anchor; its layout was outdated and visibility from the street was blocked by four restaurants located between the mall and the highway. The property had been fully vacated and suffered from significant deferred maintenance. Finally, there was extensive groundwater and soil contamination from the operation of a gas station adjacent to the site.

In 1996, the Brookhill Group determined that the property had little chance of surviving as a retail location. Market research indicated that a major shift in retailing was in progress toward a new regional mall under construction less than 10 miles away. There also was sizable competition from larger and newer shopping centers. Sycamore could not be competitive as a shopping center.

Therefore, if this property were to become a performing asset, it would have to be redeveloped for a different use. Since the local commercial real estate market was gathering strength, Brookhill purchased the first mortgage from the FDIC and developed a marketing plan to orient the Sycamore property for office use. Brookhill believed its chances for success were highly promising.

to its portion of the building that were comparable to SITEL's. While it is unusual for two call center tenants to occupy the same facility, the second tenant saw SITEL's presence as confirmation of Sycamore's suitability as a call center location. It also recognized that the first tenant's presence had helped to attract a qualified labor pool.

Refinancing

With two credit-worthy tenants in place on long-term leases, the property was ready for refinancing and Brookhill negotiated a $13.1 million first mortgage. The new mortgage covered the redevelopment expenses and allowed Brookhill to realize a profit on the property while still retaining the asset.

Other Conversion Opportunities

The conversion opportunity created by Brookhill at Sycamore is by no means unique. The retail market in the United States contains many older properties that have been eclipsed by newer properties. As the country that invented the mall concept, the United States contains significant numbers of malls that date back to the 1950s and 1960s, when suburban population growth brought shopping centers to prominence. Furthermore, the revitalization of central-city shopping over the past 10 years or so has provided potent competition for suburban malls. With virtually all major markets saturated with malls and/or downtown retail, the growth in demand for retail facilities has waned.

This decline in demand, however, has done little to deter developers from building new retail facilities. Each new generation of consumers expects a shopping experience superior to that afforded to a previous generation. The amenities that have been added to malls include such features as food courts and the addition of entertainment options, best typified by the multiplex cinema.

Development, Not Redevelopment

Rather than renovating old malls to include these amenities, most developers have chosen to build new malls. Development has proven to be a financially superior option to redevelopment for a number of reasons. The cost of new retail development often is comparable to a significant renovation of existing product, so cost is not an issue. As growth patterns have changed, many malls that were well situated when they were built are now in low-growth areas, and many have experienced a drop in store sales as income levels of nearby residents declined or stagnated. Furthermore, as a result of a combination of changing demographics and the consumer's increasing demand for the convenience of having many shopping options in the same facility, yesterday's malls are too small and poorly located to provide the expected shopping experience.

In-Line vs. Anchor Tenants

The drive to improve a mall to be the best in its market can be severe. The owner of a mall is constantly threatened by "winner take all" marketing strategies. The tenants of a mall are classified as either in-line or anchor tenants. In-line tenants occupy smaller spaces, while anchor tenants--typically national, credit-rated chains--occupy the larger stores that "anchor" the property by attracting shoppers. The financing of a mall is underwritten based largely on the strength of a mall's anchor tenants. Without an anchor tenant, malls cannot be financed. This leads to situations where new malls systematically take anchor tenants from older malls, thereby crippling the older malls' ability to draw traffic and maintain financial viability. The process is degenerative and once a mall falls from its status as a destination location with strong anchors, it is difficult, if not impossible, to win tenants back. Because of this competition, a significant number of underperforming malls litter the landscape.

Shopping Patterns

Mail order and e-commerce have changed shopping patterns and adversely affected the demand for retail real estate overall. These formats encompass some of the traditional mainstays of malls, such as recorded music, books, and gifts, and their growth shows no sign of abating. The financial markets reflect this trend, as retail REITs sell at higher yields than their office and industrial cousins do.

Conclusions

In summary, there is an excess of retail product in the United States and much of it is old, poorly located, lacking in amenities, and financially troubled both in the short and long term. Redevelopment of this product for retail use is problematic because of both capital and location issues. This scenario is likely to continue to produce significant changes in the landscape of suburban commercial real estate, as redevelopers create new uses for obsolete shopping facilities. ■