

PROPERTY INCOME RISK & PERFORMANCE

FOCUS ON RETAIL AS OF JUNE 2017

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NATIONAL MARKET

USA

SECTOR FOCUS

RETAIL

As of Q2 2017, just over half of U.S. commercial leases tracked by MSCI were set to expire within five years. The underlying contracts were concentrated heavily by property type (nearly 60% were tied to office assets) and geographically (more than half the value was weighted to California and the Northeast corridor from Boston to Washington, DC). The timing of expiration schedules and the level of open market rents matter, especially in these areas of concentrated investments. In this report, we examine the structure of U.S. retail leases, which account for one-fifth of institutional investment in U.S. real estate. The analysis covers the four primary dimensions of income risk – concentration, lease length, market conditions and tenant credit – as captured by IRIS, MSCI's flagship product for property income risk.

The retail sector has faced headwinds in recent years with changes in consumer spending patterns and structural challenges, including the growth of online sales, obsolescent physical formats and an evolving landscape of major retailers. Despite the negative headlines, retail remains a sizable and important part of the investment landscape, accounting for nearly 22 cents of every dollar in contracted rent. An analysis of MSCI's IRIS database shows that at a high level, U.S. retail leases appeared well positioned at mid-year, with potential gains on lease renewals averaging over 16%, a level far ahead of suburban offices or industrial properties. Nevertheless, at a more granular level it is clear that the risks are not evenly distributed across metropolitan markets and tenant types.

USA: NATIONAL OVERVIEW AS OF JUNE 2017

THE FOUR MAJOR COMPONENTS OF REAL ESTATE INCOME RISK*

		CONCENTRATION	TERM	MARKET	CREDIT
		CONTRACTED RENT % of national market	REMAINING LEASE TERM years (weighted)	% GAIN / LOSS TO LEASES market vs contract rent	TENANT RISK
					LOW MED HIGH
ALL PROPERTY		100.0%	5.1	14.3%	
BY EXPIRATION	2017	6.0%	—	11.5%	
	2018	10.6%	—	9.8%	
	2019	10.6%	—	6.8%	
	2020	11.1%	—	10.6%	
	2021	12.5%	—	11.1%	
	2022 and beyond	49.1%	—	9.4%	
BY LOCATION	LA/OC/Riverside	12.9%	4.7	17.4%	
	SF Bay Area	12.8%	4.7	26.9%	
	NY/NNJ/LI	10.8%	6.1	21.3%	
	Chicago	9.6%	6.1	10.9%	
	Boston	8.0%	6.0	16.3%	
	Washington DC	6.9%	5.3	-1.6%	
	Seattle	4.4%	5.0	18.4%	
	South Florida	4.2%	4.4	13.3%	
	Atlanta	3.3%	6.0	5.3%	
	Houston	3.3%	4.7	11.6%	
BY SECTOR	CBD Office	40.4%	5.6	17.7%	
	Retail	21.8%	5.8	16.4%	
	Industrial	20.2%	4.2	7.0%	
	Suburban Office	17.6%	4.2	12.1%	
BY TENANT INDUSTRY	Banks/insurance (OFF)	11.0%	4.6	17.0%	
	IT/R&D/consulting (OFF)	6.5%	5.0	13.6%	
	Legal services (OFF)	5.9%	6.7	12.8%	
	Manufacturers (IND)	4.5%	4.4	9.8%	
	Mfg ex-pharma/med (OFF)	3.9%	4.7	28.0%	
	Software & media (OFF)	3.8%	4.4	16.8%	
	Clothing/fashion (RET)	3.7%	4.8	10.5%	
	Wholesale traders (IND)	3.5%	3.9	8.9%	
	Retailers (OFF)	3.5%	6.5	13.5%	
	Transport/logistics (IND)	2.9%	3.8	8.2%	

Source: MSCI (IRIS)

*based on the current status and expiration schedules of actual lease contracts held by institutional owners. This is not a forecast.

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		CONCENTRATION RISK	
		ALL SECTORS	RETAIL
		CONTRACTED RENT % of national market	CONTRACTED RENT % of property sector
USA		100.0%	100.0%
BY EXPIRATION	2017	6.0%	5.3%
	2018	10.6%	9.8%
	2019	10.6%	10.4%
	2020	11.1%	12.1%
	2021	12.5%	10.7%
	2022 and beyond	49.1%	51.7%
BY LOCATION	LA/OC/Riverside	12.9%	12.9%
	SF Bay Area	12.8%	10.8%
	South Florida	4.2%	8.9%
	Chicago	9.6%	8.7%
	NY/NNJ/LI	10.8%	7.5%
	Washington DC	6.9%	7.1%
	Denver	2.6%	4.6%
	Boston	8.0%	3.7%
BY TENANT INDUSTRY	Clothing/fashion (RET)	—	16.9%
	Groceries (RET)	—	11.7%
	Full-service dining (RET)	—	7.0%
	Furniture/home (RET)	—	6.9%
	Misc merchandise (RET)	—	4.8%
	Fast-food dining (RET)	—	4.7%
	Sports/toy/hobbies (RET)	—	4.4%
	Financial storefronts (RET)	—	4.2%
	Pharmacy/optical (RET)	—	3.3%
	Bulk merchants (RET)	—	3.2%

KEY POINTS

- As of Q2 2017, expiring U.S. leases were slightly more front-loaded overall than the retail sector. About 51% of all U.S. commercial leases were set to expire before 2022 versus 48% of U.S. retail leases in the same period.
- Institutional retail portfolios also differed geographically from property investments overall. Major outliers at Q2 2017 included New York and Boston, where investors were less weighted to retail than to other property types, and South Florida, where the opposite was true.
- The highest tenant industry exposure was clothing/fashion, which accounted for 17% of contracted retail rents, followed by groceries at 12% of contracted rents.

		TERM RISK	
		ALL SECTORS	RETAIL
		REMAINING LEASE TERM years (weighted)	REMAINING LEASE TERM years (weighted)
USA		5.1	5.8
BY LOCATION	LA/OC/Riverside	4.7	5.9
	SF Bay Area	4.7	6.4
	South Florida	4.4	5.3
	Chicago	6.1	7.2
	NY/NNJ/LI	6.1	5.0
	Washington DC	5.3	5.0
	Denver	4.9	4.4
	Boston	6.0	8.8
BY TENANT INDUSTRY	Clothing/fashion (RET)	—	4.8
	Groceries (RET)	—	10.1
	Full-service dining (RET)	—	5.4
	Furniture/home (RET)	—	5.9
	Misc merchandise (RET)	—	4.7
	Fast-food dining (RET)	—	5.3
	Sports/toy/hobbies (RET)	—	4.5
	Financial storefronts (RET)	—	5.2
	Pharmacy/optical (RET)	—	7.5
	Bulk merchants (RET)	—	4.4

KEY POINTS

- As of Q2 2017, about 5.8 years remained on the average U.S. retail lease, compared to 5.1 years for all U.S. leases.
- In major metropolitan areas of California, Boston and Florida, retail leases were notably longer than the local averages at mid-year. This contrasted with New York, Denver and Washington DC where retail leases were set to expire ahead of the all-sector average.
- A typical grocery tenant at Q2 2017 remained a decade away from renewal, well beyond other tenant types like fast-food and apparel.

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		MARKET RISK			
		ALL SECTORS		RETAIL	
		% GAIN / LOSS TO LEASES contract rent vs market rate		% GAIN / LOSS TO LEASES contract rent vs market rate	
USA		14.3%		16.4%	
BY EXPIRATION	2017	11.5%		8.8%	
	2018	9.8%		6.7%	
	2019	6.8%		5.2%	
	2020	10.6%		12.3%	
	2021	11.1%		14.3%	
	2022 and beyond	9.4%		11.3%	
BY LOCATION	LA/OC/Riverside	17.4%		28.4%	
	SF Bay Area	26.9%		7.6%	
	South Florida	13.3%		11.5%	
	Chicago	10.9%		23.9%	
	NY/NNJ/LI	21.3%		23.9%	
	Washington DC	-1.6%		1.7%	
	Denver	24.3%		32.1%	
	Boston	16.3%		22.3%	
BY TENANT INDUSTRY	Clothing/fashion (RET)	—		10.5%	
	Groceries (RET)	—		38.1%	
	Full-service dining (RET)	—		-5.3%	
	Furniture/home (RET)	—		18.2%	
	Misc merchandise (RET)	—		8.8%	
	Fast-food dining (RET)	—		-19.1%	
	Sports/toy/hobbies (RET)	—		28.7%	
	Financial storefronts (RET)	—		-14.4%	
	Pharmacy/optical (RET)	—		-7.1%	
	Bulk merchants (RET)	—		24.7%	

KEY POINTS

- If expiring leases were renewed at market rents, the average U.S. lease contract would rise by 14% compared to nearly 16% for retail properties.

- Potential retail gains are not evenly distributed across metropolitan markets with the SF Bay Area, South Florida and Washington DC lagging the aggregate retail measure. In the former two, potential retail gains also lag the all sector comparison.

- Across tenant types, reversionary potential also varies considerably. Grocery leases are positioned for average mark-ups of 38% but fast-food dining and financial storefront leases are facing potential negative reversion of 19% and 14%, respectively.

		CREDIT RISK									
		ALL SECTORS					RETAIL				
		TENANT RISK					TENANT RISK				
		LOW	MED	HIGH			LOW	MED	HIGH		
USA											
BY LOCATION	LA/OC/Riverside										
	SF Bay Area										
	South Florida										
	Chicago										
	NY/NNJ/LI										
	Washington DC										
	Denver										
	Boston										
BY TENANT INDUSTRY	Clothing/fashion (RET)										
	Groceries (RET)										
	Full-service dining (RET)										
	Furniture/home (RET)										
	Misc merchandise (RET)										
	Fast-food dining (RET)										
	Sports/toy/hobbies (RET)										
	Financial storefronts (RET)										
	Pharmacy/optical (RET)										
	Bulk merchants (RET)										

KEY POINTS

- Credit risks at the tenant level can be weighted and rolled up to identify discernible differences when aggregated across time, geography or tenant industry.

- Among U.S. retail tenant types, lower-than-average credit risks could be identified in consumer staples such as groceries, pharmacy/optical and homewares. Risks were slightly higher among tenants with more elastic demand such as full-service dining.

- From a credit standpoint, the amount of high risk income for retail (0.3%) is below office (0.5%), and the average tenant risk score is below industrial (3.4 and 3.5, respectively).

Source: MSCI (IRIS) and Dun & Bradstreet

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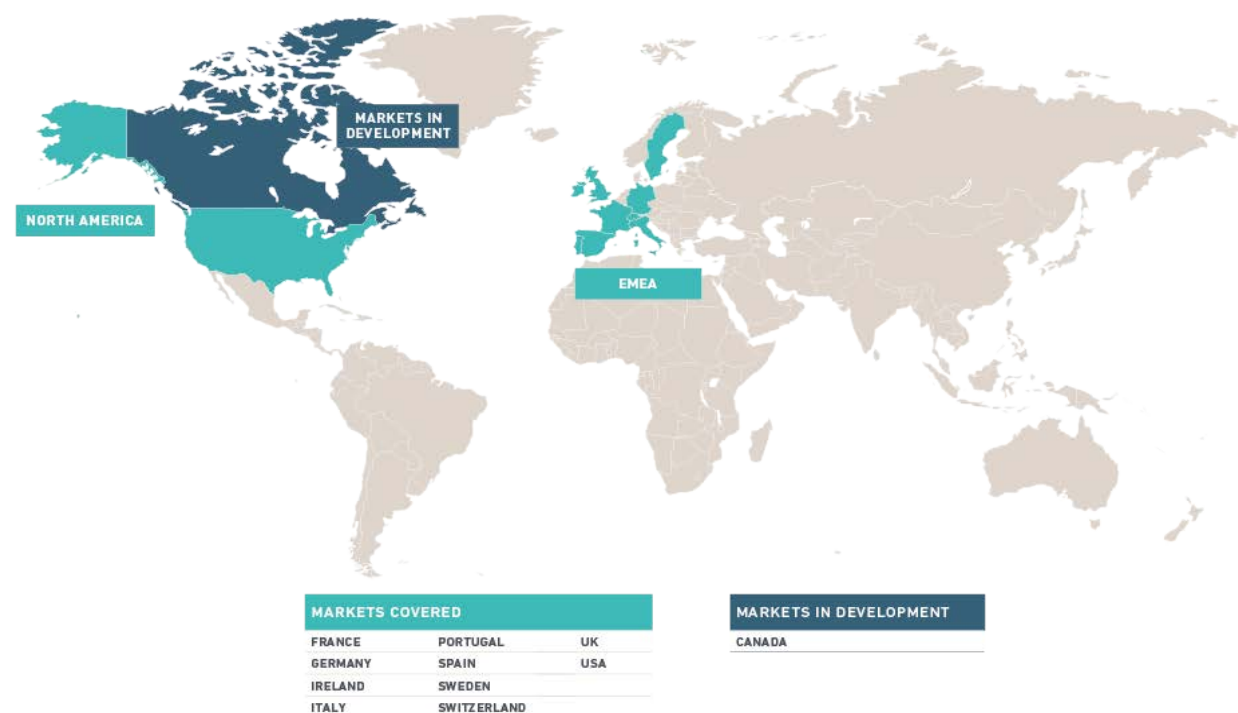
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KEY BENEFITS

- Reduced performance volatility through active management of opportunities and risks to changes in value.
- Optimized duration of income through more informed leasing strategies in business plans for individual assets within your portfolio.
- Improved communications with current investors, prospective investors, and consultants.



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