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DEMAND FOR RETAIL SPACE SURGES IN BOSTON

Although development continues unabated inside the Route 128 loop, strong job and population growth have fueled absorption, keeping vacancy in check.

Boston's urban core is seeing a healthy volume of new development, such as Arsenal Yards, a mixed-use project in Watertown that will ultimately feature 250,000 square feet of retail space. But with healthy demand from new retailers and restaurants, the market appears to be balanced.

By Taylor Williams

Bolstered by strong growth in its millennial population and high-paying jobs, Boston's urban core continues to boast one of the lowest retail vacancy rates in the country, despite fielding waves of new development over the past several years.

But this trend has also led to a wave of new development that could temper that good news for Boston retail owners.

According to data from Marcus & Millichap, metro Boston's retail vacancy rate is expected to rise by 40 basis points from 3.2 percent to 3.6 percent in 2019, a year in which 1.3 million square feet of new projects are slated for completion. By comparison, the national vacancy rate stood at 10.2 percent at the end of the first quarter, reports Reis. Marcus & Millichap predicts that the uptick in metro Boston's retail vacancy will slow the pace of annual rent growth to 3.3 percent.

Population growth is fueling demand for housing, which in turn spurs demand for retail to serve those new residents. Metro Boston's population has grown by more than 112,000

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DISCIPLINE TEMPERS DEBT MARKET FLUSH WITH CAPITAL

Lenders are undeterred by a long-running cycle and slowing investment sales, but they are becoming more selective in granting loans.

By Joe Gose

When the current economic expansion hit the 10-year mark in June, it matched the longest growth cycle in U.S. history and is poised to eclipse that mark in July. Still, mixed messages continue to plague the economic outlook.

Arguments for optimism include the rising trajectory of GDP growth, which hit a three-year high of 2.9 percent for all of 2018 and was followed by a 3.1 percent reading in the first quarter of 2019. Unemployment is at a 50-year low, and interest rates remain near historical lows.

On June 19, the 10-year Treasury yield briefly fell below 2 percent for the first time since 2016 before closing that same

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Earlier this year, Thorofare Capital provided a $17.75 million bridge loan to a New York real estate developer for the acquisition, renovation and rebranding of a 200-room Mainstay Hotel in Newport, Rhode Island. The non-recourse financing included a 33-month term and interest-only payments.

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lichap, and the area boasts a median household income in excess of $90,000.

While the local rate of population growth mirrors that of the United States as a whole, average household income is nearly 33 percent higher in Boston than in the rest of the country. In addition, the market added 23,560 new jobs during the 12-month period that ended March 31. That figure represents a decline from the previous 12-month period, but a healthy indicator nonetheless given that the bulk of those jobs were in the business and professional services sector.

In markets where the population is growing, retail developers and operators often look to the suburbs for new spaces and customers. But Boston's urban core is experiencing inward migration, due not only to the aforementioned job and population growth, but also to the presence of vibrant new destinations.

As such, retail real estate professionals see little cause for concern in terms of oversupply. They expect key retail categories like food, fitness and entertainment to continue to drive positive absorption, particularly in submarkets located within the 128 loop.

Mixed-Use Projects Abound

Similar to the United States as a whole, the Boston retail market is over-retailed in the big box segment. But much like other primary markets, well-located properties with authentic, creditworthy tenants continue to perform well and attract strong demand from investors.

In addition, redevelopment projects that feature a mix of uses have brought elevated demand for retail space to growing submarkets. Such projects include Arsenal Yards, a mall redevelopment project in Watertown, and the Seaport District, located near South Boston.

At the same time, neighborhoods like Somerville and Brighton, which have traditionally been strong retail markets anchored by nearby college populations, are also seeing retail development within mixed-use settings. Assembly Row in Somerville offers several entertainment destinations — an AMC theater, Legoland and Lucky Strike Social — in addition to boutique dining and shopping options. In Brighton, the new Boston Landing development, which houses the world headquarters and flagship store of New Balance, is also seeing its retail and dining components come on line.

"The densification of Boston's urban core is happening with high-rise residential and office projects," says Manny Steiner, vice president of leasing at New England Development, a firm known locally for projects like CambridgeSide, which fronts the Charles River in East Cambridge and Chestnut Hill Square in Chestnut Hill. "With those projects, retail is often required by government authorities, and many developers see that component as an amenity that sets the tone for the rest of the building."

Steiner also says that taking a mixed-use approach to retail development will be integral to balancing future supply in Boston's suburbs, where much of the existing product is pure-play retail space. Big boxes and single-tenant properties have been hit by both slacking absorption and investor demand in the age of online shopping.

"The needs of retail in today's urban core are more pedestrian, modest and transit-oriented than they were in the past," says Steiner. "Today's consumers want convenience above all else and are approaching retail from an omni-channel perspective. Much of the older retail space in the suburbs will need to be repurposed or reinvented."

Corey Bialow, president and CEO of full-service brokerage firm Bialow Real Estate, notes that the emergence of new destinations is prompting retailers and restaurants that are new to the area to rethink their site selection strategies. This holds true in both neighborhoods that have high densities of retail space and which have always been hotbeds of pedestrian traffic, as well as in submarkets that lack those qualities.

In many cases, first-to-market concepts that have historically gone to neighborhoods close to downtown, like Fenway-Kenmore or Back Bay, are considering other submarkets that are experiencing population growth but which are more affordable.

"Historically, Boston has been a very difficult market for new tenants to enter. This is due in part to a large supply of older buildings, properties that carry restrictions that often limit landlords' ability to meet the needs of tenants," says Bialow. "But new projects have many modern amenities, such as larger floor plates, upgraded mechanical systems and parking garages that traditional retail hotbeds like Newbury Street can't offer."

Fighting E-Commerce

The steady growth among Boston's internet-resistant retail categories has been a defining point of this cycle. Boutique fitness concepts that focus on specific workout routines, as well as quick-service restaurants that offer healthy menu options, are among the new users beefing up their footprints in the state capital.

"We're seeing many e-commerce brands realize that having a physical presence is important to building their brand and forming a better connection to their customers," says Bialow. "This has helped backfill many of the voids created by traditional brick-and-mortar retailers closing their stores, though the city of Boston has fared much better than the suburbs in terms of [minimizing] closures."

Companies that built their brands with e-commerce are also drawn to brick-and-mortar locations in Boston due to the metro's demographic advantages, including a growing cohort of millennials. According to a recent report by the Boston Chamber of Commerce, more than a third of the city's population was classified as millennials, persons roughly between the ages of 20 and 34.

And with more than 30 colleges and universities located throughout the Boston metro area, the market has a high proportion of millennials that have college degrees — almost 60 percent, according to recent data. These demographic traits make Boston an appealing market for companies seeking young talent, which in turn is drawn to workplace settings with strong retail and restaurant amenities.

Kenneth Fries, vice president of leasing, development and acquisitions at Needham, Mass.-based RK Centers, also cites grocery-anchored product as one of the market's strongest-performing sectors. Established grocers like Wegmans, Whole Foods Market and Market Basket are among the users that have expanded their store counts during this cycle, unlocking additional value in the underlying real estate in the process.

"The draw of legacy grocers allows developers to charge rents that are higher than current market rates for ancillary, small-shop spaces," says Fries. "But for smaller grocers that are faced with operating stores with declining sales, it often makes more sense to work with the landlord to permit and redevelop the land for a high-density residential use."

While some small-shop spaces in more affluent neighborhoods command above-market rents, there is a shortage of affordable small-shop space across the market as a whole. According to Fries, this is one of the biggest concerns currently facing the Boston retail market, as it creates a major barrier to entry for up-and-coming retail concepts that lack the credit or capital to take space in a prime Boston location.

"The lack of availability of affordable small-shop space for budding new retail concepts is a problem," says Fries. "It's not a new problem, but in the past it always seemed like there were incubator locations for cool new tenants."

In addition to hurting merchandisers, the dearth of quality retail space that won't break the bank is also problematic for new restaurant users. These users, if not backed by a larger operating group, often have higher costs of occupancy — mainly in the form of tenant improvements — and take longer to turn a profit.

The market is experiencing ample demand for space from both nationally branded and chef-driven concepts. But restaurants that want to develop their own spaces face high construction costs and property taxes, and some users that are looking for turnkey spaces are being priced out by the market's strong pace of rent growth.

The suburban markets of Eastern Massachusetts are also seeing absorption from certain national tenants, some of which have backfilled big box vacancies. According to a report from KeyPoint Partners, a full-service firm with offices throughout the region, Hobby Lobby led the way in terms of large-format store openings, recently adding two new locations in Braintree and Attleboro. Target has opened three new stores in Burlington, Medford and Cambridge; and At Home is opening a second regional store in Dedham.

Smaller-format retailers that have also boosted their presence in metro Boston include Xfinity (nine new stores), Verizon Wireless (seven new stores) and Richfield Convenience Express (seven new stores). According to KeyPoint Partners, this activity has brought the vacancy rate for all of Eastern Massachusetts, which has a market inventory of about 196 million square feet, to 9.4 percent.

Investment Outlook

Similar to retailers adjusting their sales and marketing strategies to adapt to e-commerce, landlords are retooling their tenant rosters to promote cross-shopping, longer visit times and socialization and recreation within their centers.

Retail investors are already drawn to Boston's demographic and economic fundamentals. As retailers and developers continue to make the aforementioned changes, the confidence of retail investors in the operating strategies of these groups is coming back. This is perhaps best captured by a slight uptick in recent investment activity from institutional capital sources, the activity of which has largely been confined to shedding non-core assets over the last several years.

Based on property and portfolio sales of $2.5 million and above, private investors accounted for about 47 percent of all retail acquisitions in the Boston market during the first quarter of 2019 on a trailing 12-month basis, according to Real Capital Analytics (RCA) and CoStar Group. Publicly traded REITs comprised just 3.7 percent of buying activity, while equity funds and other sources of institutional capital accounted for 12 percent of purchases.

"Having in-house operating, development and leasing resources allows us to get granular in our valuation," says Shelley Anderson, managing director at KPR Centers. "Being able to cite key tenant relationships in the underwriting and due diligence phases gives confidence in a successful transaction."

Investors in Boston and beyond still face hurdles, however, such as accurately analyzing online sales data to determine a store's overall health or finding value-add opportunities that aren't overly capital-intensive. But according to Anderson, capital sources are still allocating funds for retail deals. Combined with Boston's strong retail fundamentals — population

Transit-served projects like Boston Landing that also offer retail and restaurant options within a mixed-use environment are fielding strong demand from users.

growth, residential development and traffic counts — this mandate has elevated the competition among buyers in the marketplace.

"Competition continues to be tight within the [State Route] 128 and [Interstate] 495 rings, where demographics are especially robust," says Anderson. "However, redevelopment costs incurred and rent adjustments are causing a shift in how we underwrite and evaluate risk for retail investments."

Landlords are also being aggressive when it comes to pursuing tenant renewals and extensions, she adds. "As landlords seek to fill vacancies and fight for the new and thriving tenants, maintaining lease term and strong cotenancy will distinguish winners from losers on residual sales of assets."

The influx of millennials and high-paying jobs aside, Boston's retail investment market also benefits from high barriers to entry, says Bob Horvath, executive vice president at Horvath & Tremblay, which specializes in net-lease and multi-tenant retail deals.

"Boston is still a desirable market for investors due to the complexity of zoning in New England, which serves as a barrier to entry for new development," he says. "In addition, cap rates in this area tend to hold fairly steady relative to other parts of the country. The capital flow is sticky and tends to stay in New England, as local investors tend to focus on local assets."

According to CoStar and RCA, as of the first quarter of 2019, the average cap rate for multi-tenant retail assets in the Boston area was about 6.5 percent. Single-tenant properties tended to trade at an average cap rate of 7.3 percent. The average sales prices for these asset classes clocked in at $322 per square foot and $374 per square foot, respectively.

Across the board, however, investors are paying close attention to the term and credit of tenants, as well as the residual risk component — whether the rent is replaceable with a new tenant or if it's significantly above or below the market rate.

"The market on a national level is a little softer in terms of cap rates, and there's been some upward movement on certain assets," says Horvath. "But much of that is driven by macroeconomic factors — interest rates, uncertainty in the larger economy. This is still a top market with excellent fundamentals: population, income, traffic counts — all the things you look for in retail, Boston has them." ■