

RETAIL TRAFFIC Magazine, Oct 1, 2006

## OUT OF THE SHADOWS

By Jennifer Popovec



**In April, Schostak Bros. & Co. Inc.** spent \$100 million to acquire a portfolio of 28 properties from Memphis-based Spectra Group Inc. While there have been plenty of more expensive deals this year, Schostak Bros' transaction stands out.

The reason?

Not one of the properties in the deal have anchors. All sit next to Wal-Mart Supercenters that Southfield, Mich.-based Schostak Bros. has absolutely no control over. The firm instead is building a portfolio entirely based on the concept of shadow anchors. It is consciously looking to buy centers adjacent to stores owned and operated by the world's largest retailer. But it has no interest in being Wal-Mart's landlord. Its strategy is to capitalize on all the benefits of having Wal-Mart as a traffic generator without having the headaches (and meager rents) that come from being a big-box landlord.

This is a 180-degree turn for Schostak Bros. For decades it owned and operated a collection of regional malls in the Midwest. But it decided it couldn't compete in that format and opted to sell all of those properties and instead build the largest portfolio comprised entirely of shadow-anchored properties.

"We feel that the regional mall business is best left to the REITs," says Robert Schostak, co-president of Schostak Bros., which was founded in the 1920s. "We thought that we would be better off focusing on shadow-anchored centers."

In all, Schostak Bros. now owns 36 shadow-anchored shopping centers totaling more than one million square feet. Over the next two to three years, the firm plans to invest another \$300 to \$400 million for Wal-Mart shadow-anchored centers, says Patrick K. Windley, a vice president with Schostak Bros. who put the first deal together. The firm also has established a leasing and management division dedicated completely to shadow-anchored properties.

"We see ourselves getting into this product segment in a big way," Schostak says. "We're focused on becoming the largest owner of shadow-anchored properties."

Shadow-anchored properties aren't a brand new idea. In some form or another they have been around since the inception of the shopping center 50 years ago. But they've historically been viewed as second-class assets and you wouldn't find such properties in the portfolios of the industry's leading players. In the last few years, however, there has been a sea-change in how shadow-anchored properties are perceived.

Once seen as risky endeavors because of the lack of control inherent in the property, today they are viewed in a more positive light. For one, they pay out higher average rents because owners are only collecting from in-line tenants, who pay much more than anchors. According to ICSC research, median anchor rents at open-air centers in 2004, the most recent year for which data is available, was \$8.04 per square foot. Meanwhile, median rent on in-line stores was \$14.07 per square foot and median rent on out-parcels was \$16.25 per square foot.

Also, shadow anchors have become more attractive in an era when what defines an anchor is in flux. It's not just the department stores and grocers any longer. It's big boxes. It's collections of restaurants. Or, in the case of shadow-anchors, it's your next-door neighbor whether that be a

Home Depot, a Wal-Mart, a larger grocer or another shopping center. Moreover, investors are deciding that it's better to cede control to be next to a retailer you know is strong rather than have an anchor that may have trouble competing. "A Wal-Mart shadow-anchored center is going to be worth more than a Winn-Dixie-anchored center," says Chris Tokarski, managing director of Countrywide Commercial.

Today you'll find shadow-anchored properties in portfolios of any investor that looks at neighborhood or community shopping centers. REITs like Kimco Realty Corp. (which partnered with Schostak Bros. on the April deal), Kite Realty, Cedar Shopping Centers, Equity One and Urstadt Biddle all have shadow-anchored centers in their portfolios. Big private players like Inland Real Estate Group of Companies, Phillips Edison and Westwood Financial Corp. have them as well.

And more shadow-anchored portfolios, like the one Schostak Bros. acquired, are popping up. In May, Irvine, Calif. — based SilverCreek Properties acquired 48 Wal-Mart shadow-anchored centers spread over 20 states for just under \$100 million. Meanwhile, Houston — based Henry S. Miller Commercial is currently marketing a portfolio of nine Wal-Mart shadow-anchored properties in five states for \$31.8 million.

"They've become very popular with developers and investors," says Barry Brown, a managing director with Holliday Fenoglio Fowler L.P.'s Dallas office.

In fact, demand is so strong that shadow-anchored properties are now commanding prices typical of traditionally anchored centers. Today, shadow-anchored properties are trading at lower cap rates than anchored centers — 6.8 percent versus 7.1 percent — according to data compiled by Real Capital Analytics Inc. Five years ago, investment activity was reversed — anchored properties traded at cap rates of 9.3 percent while shadow-anchored deals moved at 9.8 percent.

In all this year, investors have spent \$1.5 billion on shadow-anchored deals — roughly 8 percent of all multi-tenant retail acquisitions. The volume of sales puts 2006 on pace to be the fourth straight year of \$2 billion in investment in shadow-anchored centers.

"Even with a shadow-anchored property, the pricing is still based on the credit of the tenants," says Jason Weissman, principal of Boston Realty Advisors, a Boston-based real estate investment and management firm.

And, although shadow-anchored properties remain a risky asset class — pilot fish that will likely die if their whale leaves town — the outlook for shadow-anchored centers is solid because big boxes like Wal-Mart and Home Depot continue to expand and retailers want to be close to them.

"With our shadow-anchored centers, 50 to 75 percent of our tenants are national credit because they want to be close to a Wal-Mart," Windley points out, adding that Schostak Bros.' shadow-anchored portfolio, which is sprinkled throughout the nation in markets like Radcliff, Ken. and Tell City, Ind., boasts an occupancy rate in the mid to high 90 percent range.

Even lenders that previously favored anchored centers over shadow-anchored centers are concluding that the differences between them are "overblown." In addition, the competitive lending environment is forcing lenders to look more closely at shadow-anchored centers.

Countrywide Commercial, for example, has financed several shadow-anchored deals in the past several months, with debt priced at roughly the same for these properties as for anchored retail centers.

"The bias is gone," Tokarski affirms. "While we would rather our borrowers control the anchor, it's not that big of a deal if they don't."

### **The "big awakening"**

Wal-Mart is by far the most common and desirable shadow anchor, says Jim Fielder, a vice president of Birmingham, Mich. — based Robert B. Aikens & Associates. In fact, the Bentonville, Ark. — based behemoth can be credited with "big awakening" for shadow-anchored

centers, which are now accepted within the development, leasing and financing communities and clearly distinguishable from unanchored retail space and anchored centers.

All shadow-anchored properties are close enough to a big retailer to benefit from the traffic it generates, but there are many variations of this asset class. For example, some centers that appear anchored may, in fact, be shadow-anchored if the anchor tenant (or tenants) owns its space and the developer only controls in the in line shop space. This kind of setup is fairly common with grocery-anchored centers.

Other shadow-anchored centers sit beside or behind a Wal-Mart or Home Depot. In these cases, the big box and the smaller center aren't owned by the same investors.

Larger power centers can also be shadow-anchored, according to Jim Koury, senior vice president with Jones Lang LaSalle's Boston office. He recently brokered RREEF's acquisition of Taunton Crossing, an 84,000-square-foot center in Taunton, Mass. The center, which is leased to retailers such as Michael's, Office Depot and Pier 1, sits right next to a Home Depot and Target.

### **Back to the future**

The concept of shadow anchors can be traced back to the early years of regional malls. Local developers were so desperate to nail down department store anchors that they were more than willing to allow these retailers to own their own space. All too often, they would give away land and buildings in return for lengthy operating covenants.

As department stores lost luster and owners gained more power within the industry, such relationships fell out of favor.

The turn back to shadow anchors began about 10 years ago, when Wal-Mart was just beginning to emerge from the pack. In its pre-Supercenter days, Wal-Mart leased the majority of its space in strip centers. But as it began to change formats — which necessitated the closing of smaller stores in favor of opening larger ones nearby — the company determined the process could be expedited if it owned its own space and didn't have to deal with penalties in breaking leases early.

That process was the genesis of Wal-Mart Realty Corp., a subsidiary that deals with selling or subleasing excess space in addition to unused parcels around stores it has built.

Today, Wal-Mart, along with retailers such as Target, The Home Depot, Lowe's and Kohl's, have become powerful enough to revive the ability to “control their own destiny.” Even some grocery store chains have taken cues from these retailers and are buying more space from developers and owners rather than leasing.

### **Tolerance for risk**

Developers, investors and lenders who get involved with shadow-anchored retail must have a rather high tolerance for risk. Shadow-anchored owners have no control over the anchor, no idea how the store is performing and no insight on whether they will stay open for years or close tomorrow. And if they do leave, owners have no input on how that space will be redeveloped or released, all of which can leave the property without the big traffic draw.

“We all feel that the probability of something happening to most of these anchors is very remote,” says John Riser, a senior director in Marcus & Millichap's National Retail Group who has negotiated many shadow-anchored deals. But he admits there are no assurances. “It's such a scary thought that we don't even like to think about it and no one wants to talk about it.”

A shadow-anchored center owner has no formal relationship with the shadow anchor when it comes to the right to go dark including any re-tenanting choices, Brown says. That means that no legal recourse exists.

“If I own a retail center and the shadow anchor goes dark, you don't know if the owner will put in bowling alley or a paint ball park,” he explains.

“With traditional anchors, you have the credit and the control,” notes Andrew Oliver, managing director with New York — based Sonnenblick-Goldman. “But, if the anchors own their own store and they go dark, they have no real incentive to fill the store and it could really hurt the center.”

Schostak Bros. is attempting to temper that risk by only acquiring centers shadow-anchored by Wal-Mart Supercenters, which it believes are more stable than other big box tenants that are used as shadow anchors.

“We have aligned ourselves with Wal-Mart, and we consider them to be the world's biggest and smartest retailer,” Schostak says. “They are doing a great job of penetrating the U.S., and taking advantage of them is a sound strategy. We wouldn't be doing this with Kmart today for obvious reasons.”

Moreover, Schostak says the company is able to minimize the potential impact of losing one anchor by building a large and geographically-diverse portfolio of small centers, which average about 25,000 square feet.

Schostak Bros. sees plenty of leasing upside in shadow-anchored centers, Windley says. In fact, the company hopes to bring several mall-based retailers to its shadow-anchored centers. “We believe there's a whole other group of retailers that may be traditionally part of the mall concept that can take space in shadow-anchored centers at a lower cost factor,” he explained.

And, many owners feel that the risks get slightly overblown. “We feel like there's a misperception about Wal-Mart going dark,” Schostak says. He points out that stores Wal-Mart closes have smaller floor-prints. The discount giant has never closed a Supercenter.

“Our shadow-anchored centers were built because of Wal-Mart, but they are also in the best location within their markets,” Windley says. “We're very careful in our due diligence to make sure that there is demand.”

Oliver though, says he has witnessed several shadow anchor closings that seriously damaged the performance and valuation of a center. Home Depot, for example, has been guilty of closing a store only to open up a similar store on an empty lot just to keep Lowe's out of the market.

The long-term viability of the shadow anchor, along with its credit quality, is key to valuing a shadow-anchored center, Tokarski says. Countrywide Commercial, for example, refused to provide a permanent loan on a Las Vegas Valley retail center that lost its shadow anchor. “We want to see the Albertson's re-tenanted before we agree to a perm loan, but our borrower doesn't own the anchor,” Tokarski says. “We don't know what the lease provisions are so it hinders the value for our borrower.” The lender ended up providing a \$13.3 million bridge loan for the property.

Patrick Pauken, partner in the Cleveland office of law firm Baker Hostetler LLP, suggests that investors and lenders find out everything they can about the shadow anchor, paying special attention to any co-tenancy provisions that allow tenants to close or reduce their rent if the shadow anchor closes.

And, experts also advise developers take a proactive approach by negotiating for repurchase rights if an anchor vacates its space. Since they already have a relationship with the shadow anchor, there's a good chance that they may be able to reclaim the shadow-anchor space through the “buy-back” option. “If you're a developer, it behooves you to try to get some type of assurances from the shadow anchor so you can control your destiny,” contends Gary Glick, a partner in the Los Angeles office of Cox, Castle & Nicholson LLP.

Woolbright Development Inc. had some of the same considerations when it acquired Springs Plaza, a 62,500-square-foot center in Orlando, Fla., for \$10 million. The property is shadow-anchored by Albertson's and occupied by national and local tenants such as Starbucks, Quizno's and AmSouth Bank.

“We felt that the small shop space would not only survive without the shadow anchor, but it would thrive,” says executive vice president Mike Fimiani. “It always helps to have a nice anchor tenant, but we weren't concerned that we didn't own the anchor space.”

## Little choice

Pros and cons aside, the fact of the matter is that with so many big-box retailers adamant about owning their stores, developers and investors have little choice but to get used to shadow anchors, says Leslie Lundin, senior vice president and national director of originations for Inland Mortgage Capital Corp. "It would be preferable to control everything, but if you want to do business in this market, you have to accept it," she says. The lender has financed several shadow-anchored centers that are selling at cap rates similar to those achieved for anchored centers.

Steven Lowery, a senior vice president in Wells Fargo's Chicago office, agrees: "These retailers are very powerful and these are the types of deals that they want to do. We see more shadow-anchored deals today than we ever have."

Wells Fargo has provided construction financing for four shadow-anchored deals in the past two months. "We tend to take a look at the whole project and if we know that the shadow anchor is a strong draw, we're very comfortable providing the construction financing," Lowery says.

"Lenders are used to shadow-anchored properties now," Aikens & Associates' Fielder says. And, Inland Mortgage's Lundin concurs: "If the shadow anchor is dominant and plans to stay for a while, there's good money to be made."

Overall, most real estate professionals are convinced that the benefits of shadow-anchored retail outweigh the risks. "Shadow-anchored centers are a more risky endeavor," says Jason Weissman, principal of Boston Realty Advisors, a Boston-based real estate investment and management firm. "But they're still great investment opportunities because they pull on the coat tails of big boxes."

<b>2006 DEAL COMPARISON</b>			
	<b>ANCHORED</b>	<b>UNANCHORED</b>	<b>SHADOW ANCHORED</b>
<b>No. of Deals</b>	759	387	74
<b>Total \$ Value</b>	\$12,750,214,458	\$4,006,522,807	\$1,497,989,362
<b>Square Footage</b>	81,680,403	23,427,660	9,656,038
<b>Avg. Cap Rate</b>	7.1%	6.9%	6.8%
Source: Real Capital Analytics			