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## Shifting Sands in Retail Sector Require Careful, Calculated Steps

By Tom Garesché



Shopping centers have enjoyed a great run of ever-increasing valuations. Their success and popularity comes not only from contractual net operating income (NOI) growth, but also because of steadily declining cap rates driven by low interest rates, interest-only loans and a flood of both domestic and foreign equity capital that has identified open-air retail real estate as an institutional grade asset class. Five years ago, who would have believed that cap rates, which hovered around 10 percent, would drop to the levels that we have seen recently? During the last couple of years the questions has been, "How low can cap rates go?" Now we know.

Except for the most premier A-class assets with irreplaceable locations in major coastal markets, strong tenancy with high sales levels and potential for above average NOI growth (or all or a combination), capitalization rates are rising. This is especially true for B- and C-class assets in secondary and tertiary markets, and for properties with little potential for future NOI growth. Valuation of those "leverage-sensitive" properties has been negatively affected by the

tumult in the commercial mortgage-backed securities market, which has resulted in higher spreads over the benchmark 10-year Treasury and tighter lender underwriting standards. The upshot is lowered loan proceeds and raised borrowing costs from just a few months ago.

Six to nine months ago, lenders' spreads on loans for grocery-anchored shopping centers ranged from 90 basis points to 120 basis points above the 10-year Treasury. Now, we're beginning to see quoted spreads of 150 basis points to 200 basis points above the 10-year Treasury yield. Only a portion of this dramatic increase in spreads has been offset by an aggressive Treasury rate.

Underwriting standards have tightened too, and, with a lack of conduit lender competition to push rate and proceeds, balance sheet lenders are in the driver's seat and equity requirements are up significantly. Active lenders are able to cherry-pick deals.

Reputation and experience as a qualified and well-funded buyer is paramount for owners looking to sell their properties, eliminating the potential for repeating a lengthy due diligence process. For example, an institution like Federal Realty Investment Trust, which has been in business for 45 years, offers ready access to capital through public capital markets and has the ability to complete tax deferred structures. That goes a long way for owners looking to ensure execution.

### Smart Growth

Federal Realty's Assembly Square project in Somerville includes the redevelopment of an industrial building, an enclosed mall and vacant land to a transit-oriented, mixed-use environment, creating a 24/7 community that

benefits the entire region as well as the city of Somerville. Acquired by Federal Realty in 2005, the former Assembly Square Mall has been turned inside out and serves as a catalyst for a true mixed-use development that epitomizes smart growth. It is the type of redevelopment previously unseen in metropolitan Boston. The first phase of the project has been completed, and the company is working toward completing the entitlement process for another 400,000 square feet of retail; 2,100 residential units; and 1.75 million square feet of office space supported by a new Orange Line T stop.

Grocery-anchored shopping centers or mixed-use projects with at least 100,000 square feet of retail, supported by strong demographics and high barriers to entry, remain the most appealing investment opportunity for potential buyers.

Linden Square, Federal Realty's 18.4-acre redevelopment in Wellesley, will be turned into 275,000 square feet of retail (including an upscale local grocery anchor), restaurants and office space. In addition, Linden Square will include the most energy-efficient affordable housing units in metro Boston. It will be one of the first projects of its type to achieve a LEED Platinum rating. Federal Realty acquired the project last year.

Who knows what tomorrow will bring, but today, valuations remain extremely competitive for properties with the right mix of location and opportunity. For owners of this high-quality retail real estate today, it is important to find reputable, experienced buyers with a good track record that can creatively identify and uncover value. There is no shortage of companies with the resources to acquire the right property at the right time – for the right price. ■



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