What’s Ahead for Retail Landlords?

Despite an improving economy, retail property owners are contending with a fundamental shift in consumer behavior that could challenge the sector for years to come. We remain underweight retail REITs due to what we believe are long-term risks, focusing instead on sectors that appear to be more attractive, such as apartments, offices and data centers.

Highlights

• Just a few months into 2017, U.S. retail store closures and announcements have accelerated to levels not seen since the Great Recession, putting even more pressure on landlords that are already dealing with an over-retailed consumer, rising e-commerce sales and changing consumer priorities.

• Retailer demand for physical space will remain weak in the near term, in our opinion, especially for low productivity or commodity space, but we believe high-quality retail owners stand to become more dominant and gain market share over the long term.

• We believe that better opportunities exist in other property types, where demand is strong and is outstripping supply, leaving landlords in a stronger position to raise rents and occupancy. REITs overall are attractive, in our view, but we would underscore the importance of active management in delivering absolute and relative returns.

Even as overall consumer spending in the U.S. has remained relatively healthy, brick-and-mortar retailers have had a tough time this year, particularly department and apparel stores. Changing consumer spending patterns have led to dismal sales figures for the industry, widespread store closings and numerous bankruptcies. These trends are hardly new, but recently the impact has been felt by retail landlords as well.

For regional mall and shopping center REITs, the threat of increased vacancies and rising costs for redevelopment and re-tenanting caused declines of 14.6% and 11.5%, respectively, in the 12 months ended March 31, 2017. Excluding these sectors, the FTSE NAREIT Equity REIT Index produced a healthy 8.2% total return in that period.

We expect the paradigm shift taking place to dramatically alter the retail landscape, with potentially significant implications for real estate investors. At the core are four primary issues:

• The U.S. is “over-retailed,” with 24 square feet of retail space per capita—one half more than Canada and nearly five times the square footage per person in the U.K. (Exhibit 1).

• Electronic and mobile commerce is growing at a double-digit annual rate, far outpacing the low-single-digit growth of brick-and-mortar retail, with companies increasingly transitioning to omni-channel distribution, reducing the need for physical locations.

• Consumer spending habits are changing, with more being spent on experiences, such as restaurants, travel and entertainment rather than clothes and other consumer goods.

• There is mounting evidence that the department store distribution channel has been impaired. Whether this is a secular or cyclical issue remains a subject for debate, but either way the solution is for retailers to close stores.

Exhibit 1: The U.S. is Over-Retailed

See back page for additional disclosures.
In a bid to stabilize profitability, department stores such as Macy’s, Sears and JCPenney have all announced significant closings, with more likely to come. Many tenants that occupy the middles of malls—including Abercrombie & Fitch, Payless Shoes, BCBG, Wet Seal and Ascena brands (Dress Barn, Loft, and Ann Taylor, among others)—are also closing stores. About half of the companies with widespread closings have either filed for bankruptcy or are expected to. We see this retail weakness, which is occurring despite a relatively healthy economy, as part of a permanent evolution in how and where Americans spend their money.

Target’s Canada Expedition Could Be a Harbinger

For a sense of what may be in store for U.S. retail REITs, a case study can be made of Target’s 2013 foray into Canada. The department store chain opened 133 stores at an initial cost of $4.4 billion, but with little apparent thought given to location, renovation costs, inventory planning or distribution challenges. It was the company’s first international expansion, and it was a colossal flop. Within two years, the Canadian operation had filed for creditor protection, fired more than 17,000 employees and written off billions in losses. Four years later, Canadian retail property owners continue to feel the impact of Target’s departure in high vacancies and rent pressures across the country. We believe the impact of U.S. store closings could similarly affect retail owners for years to come.

First-quarter performance generally corresponded to company asset quality.

In This Environment, Quality Is Key

We expect that store closings in malls and retail spaces near malls will drive fierce competition to attract and retain tenants. Different property types are likely to contend with these issues in different ways:

- **Class A malls**—the most prestigious and profitable in the sector—are positioned to attract new tenants, in our view, and should continue to draw in shoppers, widening their lead over Class B and C malls. Vacated anchor stores may actually benefit some properties, as owners can redevelop the space and charge higher rents. But in the near term they may still face downward pressure on rents and increased vacancies due to higher competition from increasing store closings.

- **Class B and C malls** may have a tougher time replacing tenants. Generally speaking, their future is much cloudier and we expect to see loss of market share. We believe much of the efforts to refurbish properties may do little to create actual value.

- **Shopping centers** could also feel the pinch of vacancies and rent pressures due to retailers downsizing. But we believe those with grocery stores as anchor tenants should be somewhat cushioned, as everyone needs to eat.

- **Outlet centers** should remain more shielded from store closings. They don’t have department store tenants, and their occupancy rates are typically high since they have been a highly profitable distribution channel for retailers.

The type of properties a REIT owns can have a meaningful impact on performance. As shown in Exhibit 2, owners of higher-quality (Class A) malls broadly outperformed Class B/C mall owners in the first quarter of 2017. In our view, this underscores the importance of active management in limiting exposure to riskier markets and selecting potentially well-positioned companies.

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**Exhibit 2: Cohen & Steers is Underweight Regional Malls**

<table>
<thead>
<tr>
<th>REITs in the Regional Mall Sector</th>
<th>FTSE NAREIT Equity REIT Index Weight</th>
<th>Cohen &amp; Steers U.S. Realty Total Return Composite Weight</th>
<th>Q1 2017 Total Return</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simon Property Group</td>
<td>6.7%</td>
<td>5.5%</td>
<td>-2.2%</td>
<td>Class A malls, outlet centers</td>
</tr>
<tr>
<td>GGP</td>
<td>1.4%</td>
<td></td>
<td>-7.2%</td>
<td>Class A malls</td>
</tr>
<tr>
<td>The Macerich Company</td>
<td>1.1%</td>
<td></td>
<td>-8.1%</td>
<td>Class A malls</td>
</tr>
<tr>
<td>Taubman Centers</td>
<td>0.5%</td>
<td></td>
<td>-9.8%</td>
<td>Class A malls</td>
</tr>
<tr>
<td>CBL &amp; Associates Properties</td>
<td>0.2%</td>
<td></td>
<td>-14.6%</td>
<td>Class B/C malls</td>
</tr>
<tr>
<td>Washington Prime Group</td>
<td>0.2%</td>
<td></td>
<td>-14.1%</td>
<td>Class B/C malls</td>
</tr>
<tr>
<td>Pennsylvania REIT</td>
<td>0.1%</td>
<td></td>
<td>-19.2%</td>
<td>Class B/C malls</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>10.2%</strong></td>
<td><strong>5.5%</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

At March 31, 2017. Source: Bloomberg and Cohen & Steers. Data quoted represents past performance, which is no guarantee of future results. The mention of specific securities is not a recommendation or solicitation for any person to buy, sell or hold any particular security and should not be relied upon as investment advice. Holdings are subject to change without notice. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin. See back page for index definitions and additional disclosures.
Better Opportunities in Other Property Markets

Malls and shopping centers represent 18% of the REIT market (Exhibit 3). Index-following exchange-traded funds leave investors fully exposed to the potential long-term risks in these sectors. We believe the ongoing challenges in the retail sector represent an opportunity to add value through active management.

While we expect the mall “experience” to remain relevant for Class A properties—at the expense of lower-tiered, less productive malls—we nevertheless remain somewhat cautious toward even the best names in the category. Further, we find more attractive values in other parts of the REIT market.

**Exhibit 3: Retail Weights in Real Estate Benchmarks**

<table>
<thead>
<tr>
<th>Index</th>
<th>Regional Mall</th>
<th>Shopping Center</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dow Jones U.S. Real Estate Index</td>
<td>13.2%</td>
<td>9.2%</td>
<td>22.4%</td>
</tr>
<tr>
<td>FTSE NAREIT Equity REIT Index</td>
<td>10.2%</td>
<td>7.6%</td>
<td>17.8%</td>
</tr>
<tr>
<td>MSCI U.S. REIT Index</td>
<td>10.2%</td>
<td>7.5%</td>
<td>17.7%</td>
</tr>
</tbody>
</table>

At March 31, 2017. Source: FactSet.
See back page for index definitions and additional disclosures.

Overall, we anticipate that demand for commercial properties in the U.S. will outstrip new supply in 2017, and we believe many sectors offer attractive relative valuations and improving growth prospects. Some of the more compelling sectors, in our opinion, include:

- **Apartments** and other residential sectors, with accelerating household formation and jobs benefiting demand
- **Offices**, particularly those focused on central business districts in coastal cities, where demand is expected to remain high
- **Data centers**, with the migration of data to cloud computing and the outsourcing of IT infrastructure creating demand tailwinds.

Cohen & Steers has helped investors access opportunities in REITs for more than 30 years, through multiple economic and real estate cycles. This specialized expertise, along with our disciplined investment process, has produced superior returns over multiple time periods. To learn how REITs may help you achieve your investment goals, contact your financial advisor.

Active portfolio managers can seek to minimize exposure to riskier sectors and stocks, which index funds must own as part of their broad market allocation.
Index Definitions. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. The Cohen & Steers U.S. Realty Total Return Composite represents the investment performance records of fully discretionary U.S. Realty Total Return accounts, which invest in U.S. real estate securities, primarily REITs. The Dow Jones U.S. Real Estate Index is designed to track the performance of real estate investment trusts (REIT) and other companies that invest directly or indirectly in real estate through development, management, or ownership, including property agencies. FTSE NAREIT Equity REIT Index is an unmanaged, market-capitalization-weighted index of all publicly traded U.S. REITs that invest predominantly in the equity ownership of real estate, not including timber or infrastructure. The MSCI U.S. REIT Index is a free-float-adjusted market-capitalization-weighted index that is comprised of U.S. equity REITs excluding mortgage REITs and specialized REITs.

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