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Developers: Small centers are getting more difficult

By Jennifer LeClaire
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These days, small retail centers require strong pre-leasing, a strong site and a proven developer, according to Bob Spratt, president of Hill Partners Inc., developer of The Streets of Mayfair in Coconut Grove.

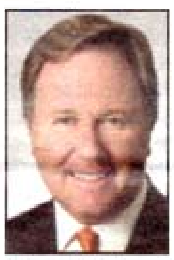
Developing retail shopping centers is never easy, but it's becoming more and more difficult in today's economy to bring a small, unanchored center from concept to completion at a profit.

There are several factors in play.

Since lenders have tightened up the pre-leasing requirements on shopping centers, developers are being forced to ante up significant equity dollars to get the property built.

What's more, small shopping centers, by nature of a tenant mix that may include mom and pop operations, don't always make the best credit tenants.

Then there's the red tape. Even with smaller retail shopping centers, retail developers still have to wade through the entitlement process and zoning. Developers still need public subsidies to defray some of the cost. And they still need credibility with the local community to garner support for the project.



Ross Glickman

Developers agree it's challenging to get any retail shopping center done - even in the best of times. But getting a small center done in an economic downturn can be nearly impossible.

"Developing unanchored centers is difficult. The anchor situation today is dramatically diminished because there aren't as many traditional anchors anymore," said Ross Glickman, chairman and CEO of Urban Retail Properties LLC in Chicago. The company developed Shoppes of Boynton, Miami Lakes Town Center and Beach Place in Miami, among other South Florida retail shopping centers.

The department store roster has declined substantially over the years, Glickman continued, and even grocery-anchored centers aren't as common as they once were.

"If you have the better location and the better tenant mix around a grocery store, then maybe you've built a better mousetrap," Glickman said. "But it's very competitive and difficult to get these developments out of the ground and returning the kind of leveraged cash on cash return your expectations show."

So the question, then, becomes: How can you get small centers done?

The short answer is strong pre-leasing, a proven track record and a

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SMALL CENTERS

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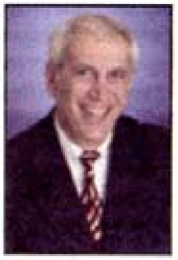
strong site to execute a development, according to Bob Spratt, president of Charlotte, N.C.-based Hill Partners Inc., a commercial real estate developer specializing in shopping centers. Hill Partners developed The Streets of Mayfair in Coconut Grove and Lochmann's Fashion Island in North Miami. Even then, he said, you can expect development to take longer.

Abe Schear, a partner at the law firm of Arnall Golden Gregory LLC in Atlanta, and chair of its Commercial Real Estate/Leasing Practice Team, has some additional takes. Just because you don't have a traditional anchor, he said, doesn't mean you can't attract a well-known retailer to your center and build around it.

"A good example would be a tenant like Starbucks - or another tenant that is iconic that would allow you to both predictably borrow the money and predictably generate enough traffic that other tenants would be happy with the results," Schear said.

In today's market, though, that may be easier said than done. Lenders are requiring more pre-leasing, and tenants are moving more slowly. Developers are charged with assuring potential tenants that they will be able to open their stores on time.



Abe Schear

Some developments that were scheduled for completion in 2008 are sliding out beyond 2010, Schear noted. Properties that have shorter lead times, then, have an advantage in the current market. Especially if tenants are public companies, delays are problematic from a shareholder expectation perspective.

Beyond the obstacles, there are the hidden challenges; challenges that could cause unwanted delays in the construction phase or unwanted terminations in the leasing phase.

"A lot of risk can be encountered in the site work stage of the development," Spratt said. "Undiscovered environmental conditions, rock or other objects can add tremendously to the overall site costs." If construction costs rise more than 10% from the original perspective, it could kill the deal.

From a leasing perspective, the proverbial ducks could be aligned, but there is still no guarantee. The tenant's committee could approve the lease - but the developer discovers the lease is laden with tenant requirements and clauses that kill the deal.

Glickman likened the pricing process to "coordinating a ballet" with tenants in terms of the timing.

With economic uncertainty in the air, tenants could decide to kill the deal despite a signed lease. Developers should partner early with attorneys who can structure deals with a sense of urgency.

"It's important for landlords to work toward documenting their deals as fast as they possibly can because you don't want deals that are ready for a signature to go unsigned," Schear said. "Too often today, leases are getting dragged out, and it gives tenants a greater opportunity to walk away from the deal."

The message is clear: Getting small centers done relies on pre-leasing more than ever before. Pre-leasing helps control timing and risk for all parties, Spratt said, and it can also help create momentum. "One must be careful," he added, "to construct enough to create a critical mass of retailers."

Developers understand the realities of getting small centers done. Glickman, for one, doesn't see the hurdles lowering until sometime in 2009. The credit crunch cannot be underestimated.

With so many hurdles and so many unknowns up in the air, how can a developer determine if the investment is worth the risk?

There are a number of positive signs up front that give an indication of the investment, but no one is 100% sure until they are complete with construction and lease up.

"Positive up front signs are a low vacancy in the area, strong sales, pre-leasing success and favorable land value to name a few," Spratt said. "Red flags in one area include high vacancy, low sales or generally unfavorable economic factors."

In today's market, getting small centers done means getting back to basics.

Specifically, that means doing a market feasibility study. It may sound pedestrian, but it's more important than ever to determine whom you are building for.

"You need insight demographically into your customer base and how to shape and even design your center," Glickman said. "That whole thrust is the parameter - initially - on how to plan on building and leasing your property. There are no secrets. There are no tricks. It's just smart planning and perseverance."

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