Cool vs Credit

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There exists an unprecedented dichotomy in today's retail environment. Many shopping centers are at or near all-time highs in both occupancy levels and rents, while others struggle to garner any significant tenant interest at all. Some trade areas are targeted by seemingly every active retailer, restaurant and service provider while others are either over served for retail or do not have a demographic profile strong enough to attractive active tenants. In similar contrast, some retailers and restaurants have experienced explosive growth leading to surging profitability and, in some cases, high stock valuations while others struggle to compete with the internet. Increasing employment costs, food costs, tariffs and occupancy costs are also at the forefront of concerns for all retail tenants, especially in California.
In today's world of "haves" and "have nots" a question that many of my more fortunate landlord clients are asking themselves is, what is more important when selecting a tenant, cool or credit?

Many shopping center owners are not faced with this question because in an unusually shallow tenant pool they may not have the desire to pass on a qualified tenant in hopes of attracting a more attractive user. However, owners of core retail or mixed-use real estate assets sometimes have to choose whether to go with the security of a national or regional user with a solid financial statement, or a local, exciting brand that provides the tenant mix with a "wow factor." The latter usually requires a higher tenant improvement package, a more creative rent structure which offers substantially less

security, but it could also help drive traffic which, in turn, could drive demand for the balance of the project. While the owner certainly needs to weigh the impact on parking, merchandising, traffic, etc., the answer really comes down to a simple analysis of what is driving the value of the asset.

In a typical shopping center environment, the answer is simple...rent. Traditional shopping centers are designed, built and leased to maximize the net operating income (NOI) and compress the cap rate to achieve the highest overall value. Whether looking to sell the asset or secure financing, the reliability of the income stream is paramount to maximizing value. In this case, going with a national tenant with a healthy balance sheet and operating history is almost always the right move because it takes the guess work out of the underwriting. It also limits the exposure of a vacancy in the near term. There are certainly exceptions, but unless you have the critical mass to make up for the lack of credit on a particular space by leasing space around it at higher rents, going with the safe play is usually the right call, even if it's not the "cool" one.

On the other hand, particularly in specialty centers and urban mixed-use projects, the "cool" retail component may be used to serve as an amenity to the rest of the project. Having a really cutting-edge restaurant on the ground floor of a high-rise may help you achieve higher occupancy levels and higher rents from the residents or office tenants in the balance of the asset. People may not want to live or work above a bank or a mattress store, no matter how good their credit is. In this case, achieving a better credit tenant or even a higher rent might ultimately have a negative impact on the value of the project if it hurts the desirability of the office or residential component, which is likely what is driving the NOI and value. Or, if a retail developer is trying to create a special retail experience and a trendy restaurant or aspirational retailer could begin to form the nucleus for a desired theme or help attract other desirable tenants, then it very well may be worth taking that approach.

Like any real estate transaction, a decision cannot be made in a vacuum. Each deal is unique and each decision complex. It is important, however, to understand the endgame. Some projects require the risk associated with leasing to the really attractive local operator, while others are better off going with the security of a national credit tenant. In a world of ever-increasing dichotomy the decision is, more than ever, more art than science.

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