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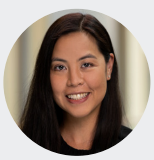
REAL ESTATE

U.S. Retail is shaping up to outperform in 2024

Why now may be a good time to consider investment



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KEY TAKEAWAYS

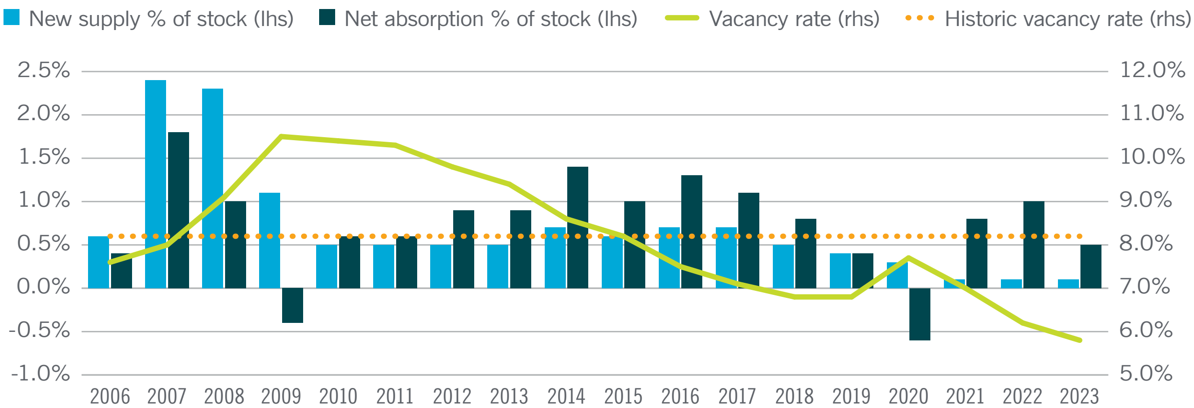
- Retail property markets ended 2023 in a position of strength. Property fundamentals are healthy, particularly across open-air and necessity retail segments with vacancy rates below their long-term average across most markets.
- Healthy and well capitalized retailers are continuing with expansion plans, targeting growth areas in the suburbs and non-costal markets. The combination of low availability and the dearth of new construction will keep conditions favorable for landlords in the near term.
- We believe the best opportunities for investment are grocery-anchored centers and open-air centers that fulfil daily needs consumers visit multiple times a week. At the asset level, there is an opportunity to update tenancy with more productive and relevant retailers, roll rents to market and grow NOI.

Essential retail is one of Nuveen Real Estate Research's top counter-consensus investment picks in 2024. We maintain high conviction in this segment of the retail market, and believe the sector is poised to outperform given its healthy fundamentals. As consumers continue to require essential goods and services, trade down, seek convenience and stay local due to hybrid work, we remain focused on retail formats which will benefit from these trends.

Retail is arguably one of the most repriced sectors since 2019. Years of negative sentiment drove down values, creating attractive entry points for new investors. We see several strategic investment themes and retail property attributes aligning which could make for an attractive entry point in the coming years. (Figure 1)

Figure 1: Vacancy rates at neighborhood shopping centers hit a new low in 2023

U.S. retail neighborhood centers — supply and demand trends



Source: Costar, Neighborhood retail, data as of December 2023.

THE STRATEGIC THEMES

Necessity retail is defensive by nature

Investor sentiment is shifting favorably towards retail given its relative value and potential for stable, long-term income. The property type generates consistent traffic and captures frequent in-store visits with most services consumed on premise, making it more resistant to e-commerce penetration. According to NCREIF, the retail sector has historically outperformed coming out of downturns due to its ability to produce income. As of the fourth quarter 2023, total returns for retail amounted to -0.9% and outperformed the NFI-ODCE benchmark and other core property sectors. At 5.3%, the sector produced the highest income returns.

Flight to quality is expected to persist and deepen

Customers are increasingly relying on close-to-home centers to fulfil multiple needs, and may gravitate towards shopping centers that offer convenience, a better experience, and the most relevant collection of retailers, restaurants, healthcare and service providers. Consequently, retailers are leveraging data to select sites located along their customers' daily path and are increasingly moving into open-air formats. With urban and top-tier mall store strategies mostly satisfied, retailers see the value that open-air centers can provide such as consumer convenience, ability to enable Buy Online, Pick-up In Store (BOPIS) and lower operating costs compared to traditional enclosed malls. In turn, the most dominant, class A assets should continue to garner an outsized share of consumer, tenant and investor demand.

Retail property fundamentals are strong

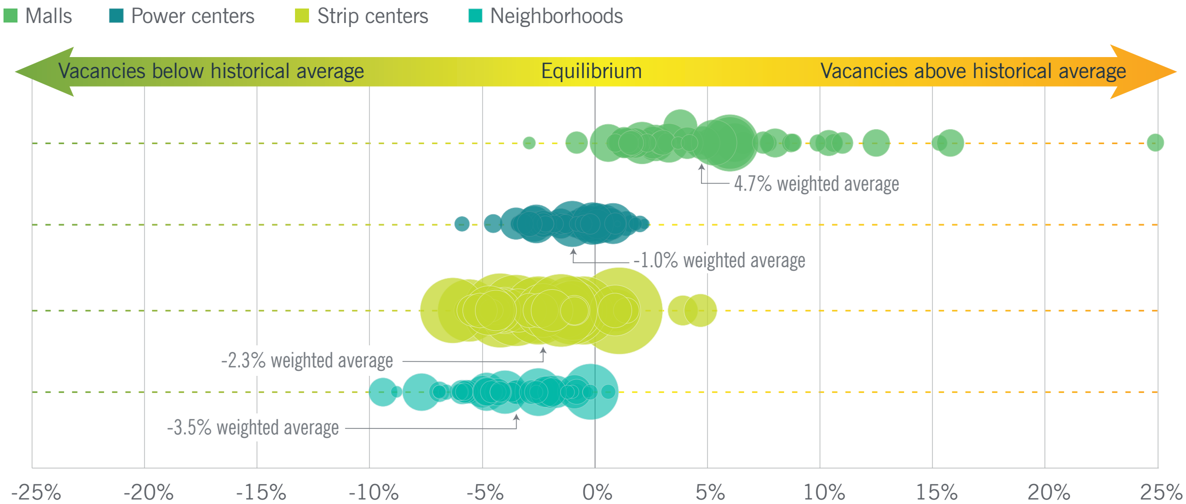
The sector has been stress tested and fundamentals are in a much better position today compared to recent history. The purge of unhealthy and less relevant retail tenants has been positive for the sector and has made room for tenants that are better suited to compete in today's retail landscape. Vacancy rates for open air-shopping centers continue to tighten on the back of steady tenant demand. (Figure 2)

According to Costar data, net absorption at neighborhood centers remained in positive territory for the third consecutive year totaling 16.4 million sq. ft. (MSF) (0.4% of inventory). Demand for the sector outpaced new supply by almost four times during 2023. Construction activity has been depressed, which has helped occupancies recover in many markets. With market rents still 40% below levels that justify new construction, we anticipate a quiet pipeline going forward.

Deliveries during 2023 totaled 4.2 MSF (0.1% of inventory). As a result, the vacancy rate fell to a

Figure 2: Year-end 2023 retail vacancies are below their long-term average in most markets

Current (23Q4) market vacancies of top 50 cities relative to long-term pre-pandemic averages



Source: Costar, Neighborhood retail, data as of December 2023.

historic low of 5.8% and sits 195 basis points (bps) below the peak reached during the pandemic and 470 bps below the prior peak in 2009. Lastly, with vacancies continuing to tighten rent growth remains healthy and reached 4.4% over the year — well above the five-year average annual average of 3.3%. Prospects for future rent growth remain favorable and may surprise to the upside with vacancies remaining below historical average.

Store opening announcements continued to outplace closures, despite a handful of retailer bankruptcies that the market had anticipated. According to Coresight Research, retailers announced 5,559 openings compared to 4,669 closures in 2023. (Figure 3) The most noteworthy was a list of retailers closing stores in malls and opening in open-air centers, including Foot Locker, Signet and Bath & Body Works.

DEMAND CONTINUES TO SURPRISE TO THE UPSIDE

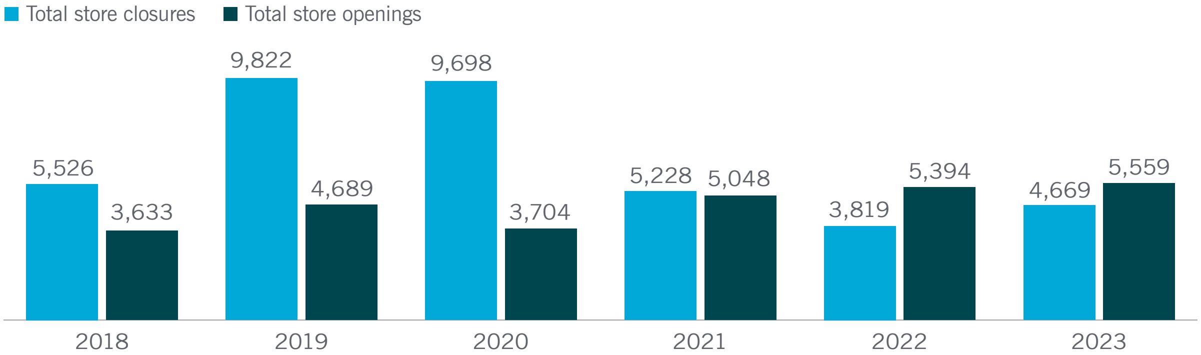
Well capitalized, healthy retailers are moving forward with conservative growth plans to reach a larger or untapped audience by following customers close to where they live. Migration to Sun Belt and growth of suburban markets has been positive for retailers and expanded growth prospects beyond top-tier regional malls and lifestyle centers, urban neighborhoods and coastal markets. Retailers have needed to be more flexible when considering new locations given the tight supply of available space, turning to suburban shopping centers that attract daily foot traffic to meet growth targets. The upside for tenants has been lower rents and occupancy costs compared to urban retail or malls.

2023 WAS THE YEAR OF THE RESILIENT U.S. CONSUMER

Marked by steadfast spending in the face of inflation, higher interest rates and rising costs of living, the consumer continued to propel economic growth to 3.3% in the fourth quarter and 2.3% for all of 2023, according to the U.S. Bureau of Economic Analysis.

Consumers have been exhibiting recessionary behaviors for some time by trading down to lower priced commodity items and reverting to spending on services and experiences such as travel from goods but have continued to spend on discretionary items. Consumers closed out 2023 with another robust holiday season. In December 2023, retail sales increased 5.6% year-year, according to

Figure 3: Store openings and closure announcements



Source: Coresight Research (store openings and closure announcements), data as of December 2023.

the U.S. Census Bureau, well ahead of the 3.4% consumer price index reading over the same period, according to the U.S. Bureau of Labor Statistics.

Confidence has been bolstered by a sturdy labor market, low unemployment, and earnings growth. This momentum could be a signal that the consumer will continue to drive growth through the first half of 2024. Even as the winddown from the pandemic plays out, shoppers will continue to focus on necessities, rotate from goods to services and rely on local centers to fulfil daily needs..

THE GREAT VALUATION GAP

Property transaction markets remain subdued despite the recent reversal of the 10-year U.S. Treasury, more favorable economic data than forecast and greater optimism that the U.S. Federal Reserve (Fed) could maneuver a soft landing next year.

At year-end 2023, retail strip center values already endured a correction in the early quarters of the covid-19 pandemic, with the Commercial Property Price Index (CPPI) falling over 15% from pre-pandemic highs in late 2020 according to Green Street Advisors. As a result, the current correction in pricing has been less severe than in other core property sectors, with the CPPI falling 3.2% year-over-year as of Q4 2023. Data from MSCI Real Capital Analytics indicate transaction volumes for U.S. retail properties fell to $57.3 billion in 2023, representing a 38% decline from 2022 annual levels. To compare, volumes for all property types tracked by MSCI Real Capital Analytics) fell a collective 51% over the same period with apartment (-61%), office (-56%), and industrial (-44%) sectors experiencing the most impactful year-over-year decline since the Global Financial Crisis.

OUTLOOK FOR 2024 — THE RISKS AND WILD CARDS

The transaction market may take more time to recover than investors hope — even with the prospect of lower rates in the coming year(s). There is some evidence that cap rate expansion in the U.S. has abated for high-quality, grocery-anchored centers in prime markets, particularly in high-growth areas with strengthening buying power. Overall, buyer's and seller's expectations were too far apart in 2023 and will need to see stable interest rates and pricing alignment for increased activity.

We anticipate new entrants coming into retail in 2024, attracted by relative yields, positive leverage and increasingly strong fundamentals. Investors who may have underweighted retail allocations are looking again as demand and pricing headwinds take shape in other sectors.

We expect to see continued demand for income driven returns that core, grocery-anchored retail produces given durable demand drivers, limited new supply and a liquid market for smaller deal sizes. New capital formation is gathering momentum in the value-add and opportunistic space with growing appetite for higher yielding assets. However, value-add players are struggling with high debt costs and are exploring tertiary or smaller markets to meet required returns.

The most salient risk for retail is the connection of the economy, consumer behavior and retail demand. Retailers could potentially pump the breaks on ambitious expansion plans and slow new leasing activity due to emerging supply chain risks, economic uncertainty, higher costs and the threat of a subdued consumer. Additionally, a housing market slowdown or higher-for-longer interest rates may challenge the U.S. consumer and constrict discretionary spending. Small businesses may also be impacted disproportionately compared to well capitalized national brands due to availability of financing, cost of debt or declining in-store sales.

However, with little new construction underway, there is little visibility as to what will be available in the future. Retailers, for the first time in over 20 years, are making decisions in a higher interest rate environment, with a greater focus on profitability. With rents still well below replacement cost, new supply will remain constrained and will not be able to keep up with near-term demand from growing retailers looking to meet store opening targets. Nevertheless, some concepts in high-growth mode are leasing space for openings in 2026 and beyond. Even if the consumer pulls back, vacancy is likely to remain below historical levels in the near term.

FOLLOW THE CONSUMER IN 2024 AND BEYOND

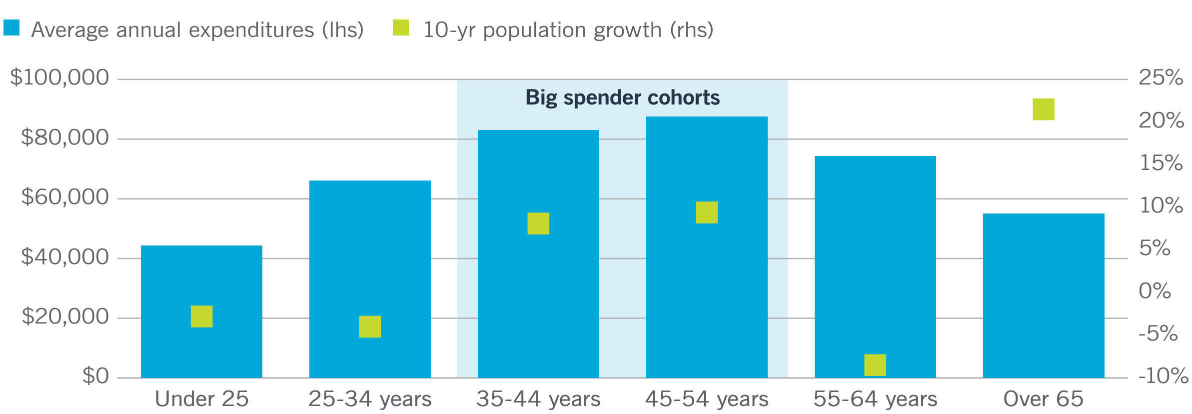
The macro-backdrop is mostly constructive and supportive of consumer spending. Tolerable inflation levels, a more optimistic view of the economy and a steady employment picture have allowed consumer spending to continue and could provide the runway for a soft landing. Above-average spending could be opposed by rising credit card balances at high interest rates, the resumption of student loan payments and a weakening employment picture. As consumers become more critical of discretionary purchases as the cycle matures, they will continue to consume essentials, services and focus on value.

WE REMAIN FOCUSED ON THE DEMOGRAPHIC DRIVERS

Improving mobility as the housing market gets back on track with the prospect of lower mortgage rates, continued migration to the suburbs, and the growth of the "big spender cohorts" as Millennials step into their highest earning, spending and homebuying years. The retail sector could be driven by demographic waves of spending and present a significant opportunity to capture the spending power of this growing population set over the next decade. (Figure 4)

Figure 4: Average annual expenditures and population growth forecast

Average annual expenditures vs. 10-yr population growth



Source: U.S. Bureau of Labor Statistics, Consumer Expenditure Surveys, Data as of September 2023 and Population growth forecast, economy.com, data as December 2023.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

THE BEST IS YET TO COME

In summary, we continue to have strong convictions in neighborhood retail formats due to the fundamentals, relative pricing, improved retailer outlooks and demographic drivers.

The strategic themes coalescing around the sector are aligning. Value declines for high-quality retail real estate have abated. We are seeing investor sentiment slowly starting to shift towards what we expect to be a strong opportunity. The inefficiency of the capital markets, lack of dry powder or onerous investment queues are keeping several high-profile investors on the sidelines. In our view, this is setting the stage for compelling investment conditions and a better vintage year. We feel the best prospects will be in the grocery-anchored and lifestyle space. There is an ample supply of centers in top trade areas in need of a creative update to better align with the needs and wants of a growing community.

For more information, please visit nuveen.com/realestate.

Endnotes

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