



Mixed-Use Centers, Part I: The Economics of Place-Making

How to Blend Residential Uses Into the Retail and Services Mix

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Abstract: This report, the first of two on the subject, discusses how to transform smaller regional malls that may be struggling into viable mixed-use centers. It analyzes how residential uses work particularly well with the current retail-and-services model in shopping centers. It concludes with a redevelopment master plan or “toolkit” that addresses property ownership issues and interests in the context of a site-specific reciprocal easement agreement (REA), as well as tenant lease terms and conditions.

Changing Landscapes: The Role of Place-Making

Although unique cultural-social-commercial experiences can be found around the world (e.g., Atlanta’s Ponce City Market, Quebec City’s Public Market, or Athens’ Monastiraki Square), even a look around one’s own neighborhood or city shows where the market is evolving beyond the original use of buildings and locations:

- The warehouse district of the late 1800’s that is morphing into a place for entrepreneurs and start-up businesses with new apartments, condominiums and a vibrant local food scene;

- The beef-packing plant of the early 1900’s that is being converted into a food hall;
- The shopping mall of the 1960’s or 1970’s that served as the center of department store shopping that is changing into a new urban village.

These property re-uses are part of a process that can be thought of as *place-making*—a synergy involving how people live, work, shop, socialize and visit. That process is natural, even in a

Lessons Learned

Underperforming regional malls can achieve greater commercial viability through conversion to mixed-use projects that enhance community place-making:

- As a result of the digital revolution, *technological advances are opening up commercial space for specialization* and transforming the retail real estate landscape.
- The transformation of retail space is having *an asymmetrical impact on malls*, with upscale super-regional centers performing well while some smaller regional centers may face greater risks when an anchor leaves.
- A mixed-use redevelopment of a struggling mall can become a *dynamic mix of selected specialty retail, restaurant and entertainment uses* that attract and support viable non-retail uses, such as a limited-service hotel, medical office and residential housing.
- *Mixed-use redevelopments can capitalize, through their residential components*, on young singles, couples and families priced out of homeownership, as well as aging Baby Boomers who desire amenity-rich communities that cater to their need for healthier, more active lifestyles.
- In transitioning a site from regional mall to mixed-use, it is essential to take account of *the dynamics of the local marketplace*, including instances where an appropriate tenant mix will keep the daytime population in the area longer after work.
- Converting from a regional mall to a mixed-use center requires market intelligence, strategic planning and patient capital—which is why *such conversions are not happening as quickly as anchor store closings*.
- Conversion plans need to address issues arising from *reciprocal easement agreements and tenant lease terms*.
- In a *redevelopment master plan*, a highest-and-best-uses feasibility analysis should consider such factors as the viability, use and market timing for the retail, restaurant, entertainment and residential components of a mixed-use center.
- *Highest-and-best-uses feasibility analysis* may also involve a conceptual set of site plans, a strategic and executable leasing plan, marketing and presentation materials, and additional pro forma analysis and financial due diligence.

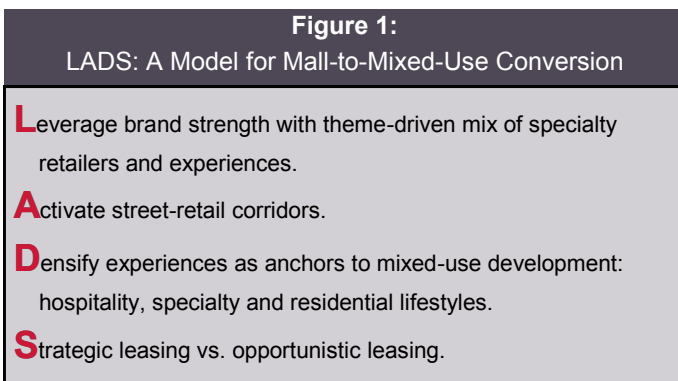
Conversion to mixed-use projects is part of a synergy essential to *place-making*—the evolving nature of the places where people live, work, shop, socialize and visit.

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retail environment such as the current one where change is so rapid.

With 2017 often marked by closure announcements by traditional mall anchors, as well as inline retailers filing for Chapter 11 bankruptcy and/or reducing store locations, headlines screamed about a coming “retail apocalypse.” Quite simply, this is an exaggeration, even though these changes are transformative, structural, and, in the case of some smaller regional malls (i.e., traditionally enclosed, department store-anchored shopping centers with 400,000 square feet to 800,000 square feet), possibly disruptive.

But regional malls that are underperforming can transform into dynamic mixed-use centers in order to remain viable long-term. The steps in this process, as seen in Figure 1, can be summarized by the acronym LADS. In so doing, the property would provide accretive value for the owner, and evolve into the kind of vibrant community hub that is so essential to place-making.



Specifically, this article focuses on the market viability for residential uses. This use works particularly well with the current retail-and-services center combination in creating the live-work-play synergy crucial for place-making.

But the conversion of regional malls to mixed-use centers does not happen quickly. This article will explain why, then conclude with a redevelopment “toolkit” that draws on the experience of Hoffman Strategy Group with clients in markets of all sizes across the United States.

Digitization: Breaking Down Geography, Ushering in Specialization

Technology is profoundly reshaping the economics of shopping, of malls and, by extension, the once geographically static commercial marketplace. Travel time to the nearest mall has been reduced to just the mouse click on a desk at home or work—and even more so, by tapping the one-click payment options on a smartphone, no matter if one is in Anaheim or Amsterdam.¹ The package often arrives courtesy of free shipping or the shipping is subsidized.

In the current digital revolution, advances in technology, such as the smartphone, break down geography and open up commercial space for specialization. The economic factors behind this shift

explain why owners of super-regional and regional malls can differentiate the marketplace.

Specialization has given rise to Bonobos and Amazon Books; to the preference for artisanal beers and distilleries; and to the increasingly sophisticated MX4D and 4DX technology that makes you feel and smell the scenes of a movie or video-gaming system.² Specialization and differentiation result in an increasingly closer integration of the marketplace, the workplace and one’s sense of place in a broader community sense.

This economic disruption in the retail space is having an asymmetrical impact on malls. The long-term viability of traditional smaller regional malls has become less tenable, as the closing of one 120,000-square-foot department store may leave another as the remaining anchor. This is exposure to further downside risk.

In contrast, upscale super-regional malls, such as Westfield’s University Town Center (UTC), are performing well. Even though Sears closed at UTC in July 2017, the center is undergoing a \$500 million phased expansion that includes an expanded Nordstrom; as well as an outdoor dining area called The Pointe that features farm-to-table and celebrity chef-driven restaurants.³ Online retailers like Amazon Books and Bonobos have stores at UTC. And a 23-story, 300-unit residential tower is now under construction and scheduled to open in 2019.

Some of the larger shopping center REITs have exemplary super-regional malls that are concentrated mainly in strong markets. Magnets for retailers, restaurants and entertainment venues, these malls reflect the new economics of shopping and of commerce.

So, if a struggling department store closes, the mall remains viable because there is a well-curated and diverse tenant mix. The property also remains viable long term, and produces above-industry returns, because surplus parking space is converted to revenue-producing non-retail uses such as residential, limited service hotels, and transit-oriented stations.

Markets are not created equal. And, as the polarization just discussed illustrates, the impact from this current economic disruption is uneven across the regional mall landscape—a landscape that includes major cities, suburban and exurban areas and rural towns.

Where the Traditional Mall Model is Changing—Rapidly or Slowly

The traditional U.S. mall model (i.e., a retail center anchored by a department store, largely focused on apparel and surrounded by parking) is coming under pressure from overstoreing in some markets, increasing e-commerce sales and changing consumer preferences. A number of shopping malls, therefore, will depend on redevelopment and repurposing to ensure future success and viability.

The conversion of regional malls to mixed-use projects occurs slowly, however, for two key reasons:

¹ Laura Stevens, “Amazon With Pumpkin Pie? Holiday Shopping Starts on Your Phone After Dinner,” *Wall Street Journal*, Nov. 24, 2017.

² Ryan Faughnder, “Rumbling Seats, Virtual Reality, Booze, How Cinemas Are Adapting to Uncertain Future,” *Los Angeles Times*, June 2, 2017.

³ Roger Showley, “UTC Launches \$500M Expansion,” *The San Diego Union-Tribune*, July 14, 2015.

1) REAs and Property Ownership

The Reciprocal Easement Agreement (REA) as a legal and operating document presents several issues related to covenants, restrictions and obligations between the mall owner, outparcel landowner(s), anchor department stores and others. A general objective of the REA is to ensure long-term success of the mall and of the anchor stores. Issues in an REA range from parking and signage to mall design, size of buildings, and operating covenants.

REAs differ in terms of how they specifically address and resolve issues. Site-specific facts and history are as material as the specific language of an REA. For example, if a traditional department store has been allowed over time to change its use and operate as a college outreach location, a mall owner may be limited in its ability to object to the store's desire to change to a residential use (e.g., a Sears box becoming a residential-above-restaurant building).

In short, the starting point for an REA party is to understand what it can and cannot do at a site. Alterations may require approval by the mall owner and other REA parties.

In some instances, the local government or community recognizes that a mall needs to be redeveloped because of changes in the market. A mayor, urban or community development department or an economic development agency may prefer, redevelopment of property that is no longer viable as a mall. Redevelopment to market-viable uses, such as a mixed-use center with residential housing, is better than a blighted property. Owners may then seek modification, arguing that the document is out of date and does not serve the overall public interest.

The ability of mall owners and department store anchors to redevelop the property in ways that introduce non-retail uses in a site controlled by an REA depends largely on the specifics of the document, the site's operational and financial performance, and community interest and demand.

2) Tenant Lease Terms

The terms and conditions of tenant leases must also be addressed as part of a plan to redevelop a regional mall into a mixed-use center. For example, such a plan should cover the number of suites, net rentable square feet expiring, and cumulative square feet expiring on existing leases over a 10-year hold.

It is also important to evaluate the rent roll particulars over that same 10-year hold period. This analysis focuses on issues such as:

- Co-tenancy requirements;
- Tenant lease terms and re-leasing assumptions;
- Covenants, protected use clauses and exclusivity rights regarding retail competitors and sales of specific merchandise (e.g., shoes or other footwear, cosmetics, appliances, etc.);
- Radius restrictions; and
- Kick-out clauses.

Property ownership issues and interests in the context of a site-specific REA, and tenant lease terms and conditions, are fundamental to address as part of a broader redevelopment master plan, which is described in Exhibit 1.

New Maps for Different Landscapes

Regional malls have served as a retail amenity to many communities across the United States for well over 50 years. Department store anchors were once central to the viability of these centers. While the narrative around the retail apocalypse is vastly exaggerated, the conversion of a number of regional malls to mixed-use centers will ensure the long-term viability of such consumer centers. Part II of this report will offer case studies in which this process can be seen in action.

Exhibit 1:

A Redevelopment Master Plan: A "Toolkit"

A redevelopment master plan begins with a *highest-and-best-uses feasibility analysis*. This addresses issues such as the viability, use and product type, and market timing for the retail, restaurant, entertainment and residential components for a mixed-use center. Of course, office, hotel and other uses may be explored in this market-and-feasibility analysis.

Part of the highest-and-best uses analysis is the modeling of potential sales and revenues generated from new uses that are viable on the property. This includes developing an optimal tenant mix for retail, restaurants and entertainment; curating the viable residential housing product type(s) and amenities; and evaluating how to create a synergistic interaction among the mixed uses.

A *conceptual set of site plans* flows from this extensive market viability analysis. This part of the redevelopment master planning process should include existing department store anchors and tenants. There may also be outreach to the city and other community stakeholder groups in this process. One form of this is the design charrette, an intensive planning session involving collaboration among cities, designers, and others.

The optimal tenant mix and estimated sales forecasts from the highest-and-best uses analysis becomes part of a strategic and executable leasing plan, and incorporated in necessary *marketing and presentation materials*.

An overall redevelopment master plan that includes estimated sales and revenue forecasts for the mixed-use components is also part of *additional project pro forma analysis and financial due diligence*. Part of this due diligence is a conversation with city and county officials regarding available public finance incentives.

In brief, the highest-and-best uses analysis produces a practical redevelopment master plan that is used by the property owner, the development/redevelopment team, the investment or finance team, the marketing and communications team and the leasing team.



Jerry Hoffman, Owner and President of Hoffman Strategy Group, is an economist with over 25 years of extensive experience in economic and market analysis that provides insights for all pieces of mixed-use projects. Core project specialties include urban retail corridors, infill, and suburban mixed-use, as well as shopping center re-purposing and redevelopment, entertainment district development, university-led development, and adaptive reuse of property. Previously, he wrote for ICSC the article “Retail in Urban Mixed-Use,” *Retail Property Insights* (Vol. 22, Issue 3), 2015-2016. For additional information, visit hoffmanstrategygroup.com or contact Mr. Hoffman at jerry@hoffmanstrategy.com.

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