Holiday Retail Outlook
December 2016

AEW

Where Do We Stand Heading into 2017?

- Consumer confidence now back to pre-crisis levels
  - U.S. has added 15 million jobs since 2010
  - Unemployment rate now well below 5%
  - New claims for unemployment insurance at lowest levels since early 1970s
  - Number of open jobs at highest level ever recorded
  - Wage growth accelerating
  - Stock market at record highs
- Markets now pricing in higher growth and inflation ahead
- Federal Reserve has more room to normalize policy

The First 100 Days?

". . . and will to the best of my ability, which is terrific ability, by the way. Everyone agrees, I have fantastic ability. So there's no problem with my ability, believe me. . . ."

- **Renegotiate NAFTA or Withdraw**
- **Leave the Trans-Pacific Partnership**
- **Declare China a Currency Manipulator**
- **Lift Restrictions on Domestic Energy Production**
- **Repeal and Replace the Affordable Care Act**
- **Begin Deportation of Two Million Illegal Aliens**
- **Fund Construction of Southern Border Wall**
- **Overhaul U.S. Tax Rates**
- **Pass Infrastructure Spending Bill**

Who Benefits from Lower Corporate Tax Rates?

Retailers among the groups likely to benefit the most from lower corporate tax rates

Ticker	Company	Tax Rate
PHM	Pulte	40%
CVS	CVS	40
WFM	Whole Foods	39
BBY	Best Buy	38
CAH	Cardinal Health	38
TWC	Time Warner	38
CMG	Chipotle	38
GPS	GAP	38
CSX	CSX	37
WMT	Walmart	30

Ticker	Company	Tax Rate
EBAY	eBay	19%
PCLN	Priceline	18
ABT	Abbott Laboratories	18
MRK	Merck	17
GOOGL	Alphabet	17
GILD	Gilead Sciences	16
VRX	Valeant	17
NFLX	Netflix	14
LLY	Eli Lilly	14
AMGN	Amgen	13

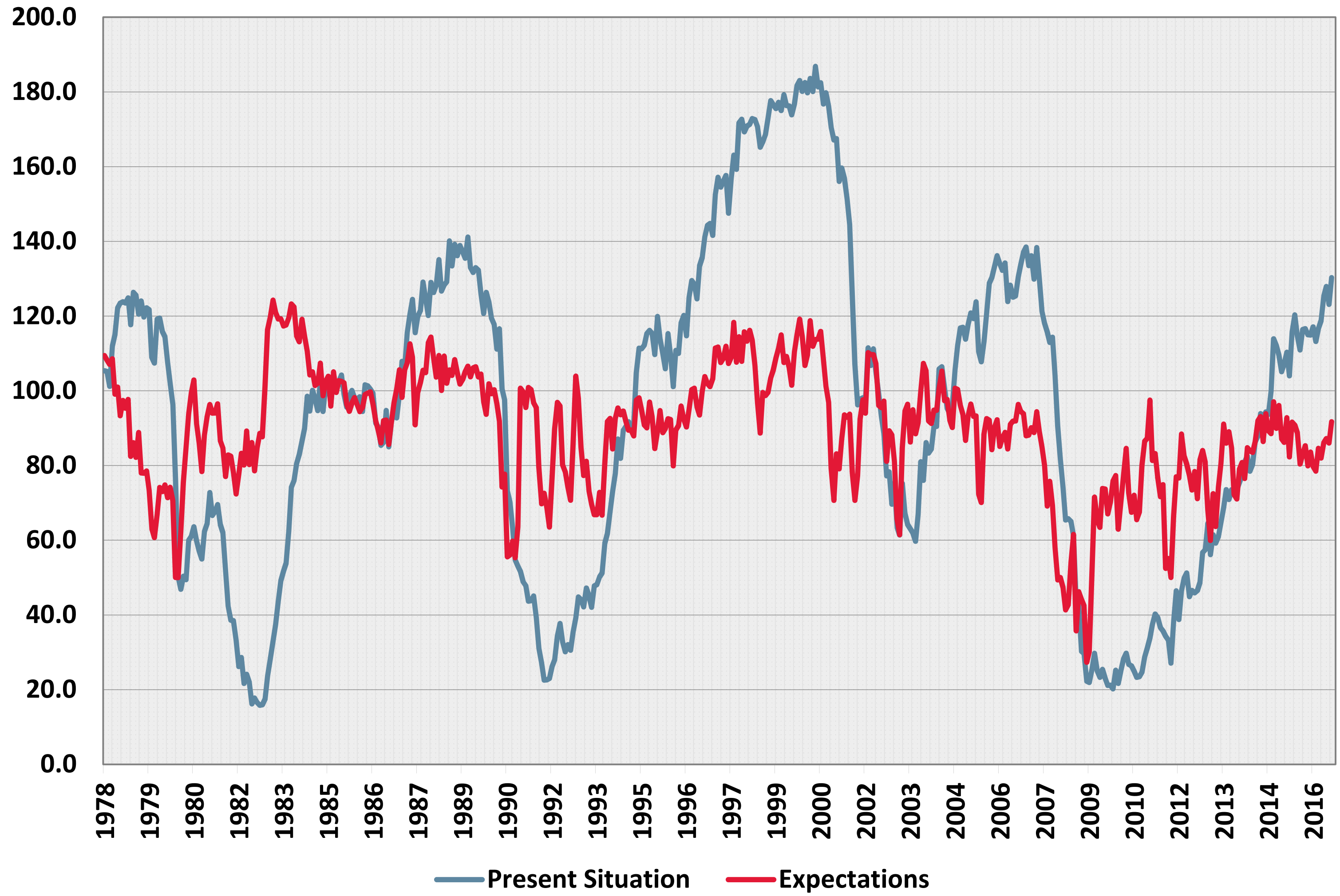
Source: Cornerstone Macro

Consumer Confidence Returns to Pre-Crisis Levels

Consumer confidence began rising over the summer and has surged post election

Expectations about the future also moving up in recent months

CONSUMER CONFIDENCE INDEX



Source: Conference Board

Retail Sales Growth (Year-Over-Year through November)

	2009	2010	2011	2012	2013	2014	2015	2016
Retail Sales - Total	1.8%	6.7%	6.6%	3.9%	3.1%	4.7%	1.0%	3.6%
Retail Sales - Total excl. Motor Vehicles and Parts	1.2%	5.0%	6.5%	2.8%	1.8%	4.1%	-0.4%	3.7%
Motor Vehicles and Parts	4.4%	14.1%	7.1%	8.2%	8.0%	6.9%	5.7%	3.3%
Furniture and Home Furnishings Stores	-8.2%	1.6%	3.7%	3.5%	7.4%	3.3%	4.7%	4.1%
Electronics and Appliance Stores	-5.0%	-1.2%	6.7%	0.9%	-0.4%	5.4%	-4.5%	-3.8%
Building Material and Garden Equipment/Supplies	-10.1%	4.3%	4.8%	4.8%	4.8%	8.4%	4.4%	4.3%
Grocery Stores	0.8%	2.9%	4.8%	2.3%	2.2%	5.2%	1.9%	2.6%
Gasoline Stations	14.9%	7.1%	16.1%	2.4%	-5.8%	-3.8%	-19.9%	4.0%
Sporting Goods/Hobby/Book/Music Stores	-3.1%	5.0%	-2.9%	1.9%	4.6%	4.6%	5.4%	-1.4%
General Merchandise Stores	-0.9%	4.5%	2.5%	1.6%	2.2%	2.5%	0.3%	-1.3%
Department Stores	-5.5%	1.5%	-3.5%	-4.7%	-2.6%	-1.0%	-2.5%	-6.4%
Food Services and Drinking Places	-0.8%	5.2%	6.2%	5.1%	5.6%	6.1%	6.9%	4.9%

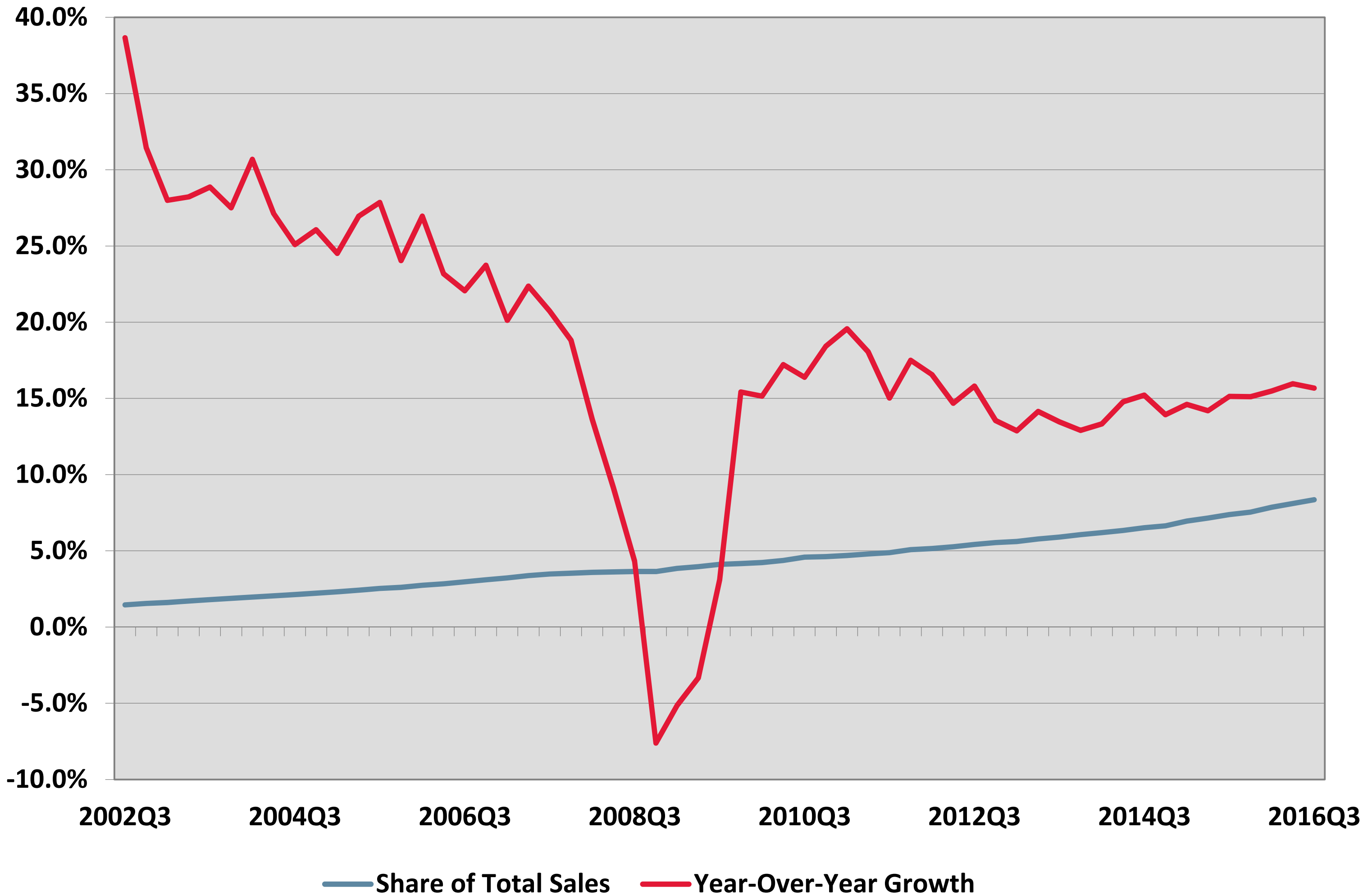
Source: Commerce Dept.

E-Commerce Sales

Growth in e-commerce sales has stabilized at roughly 15% per year over the past six years

Total e-commerce sales now account for nearly 10% of total retail sales

SHARE OF TOTAL SALES AND YEAR-OVER-YEAR GROWTH

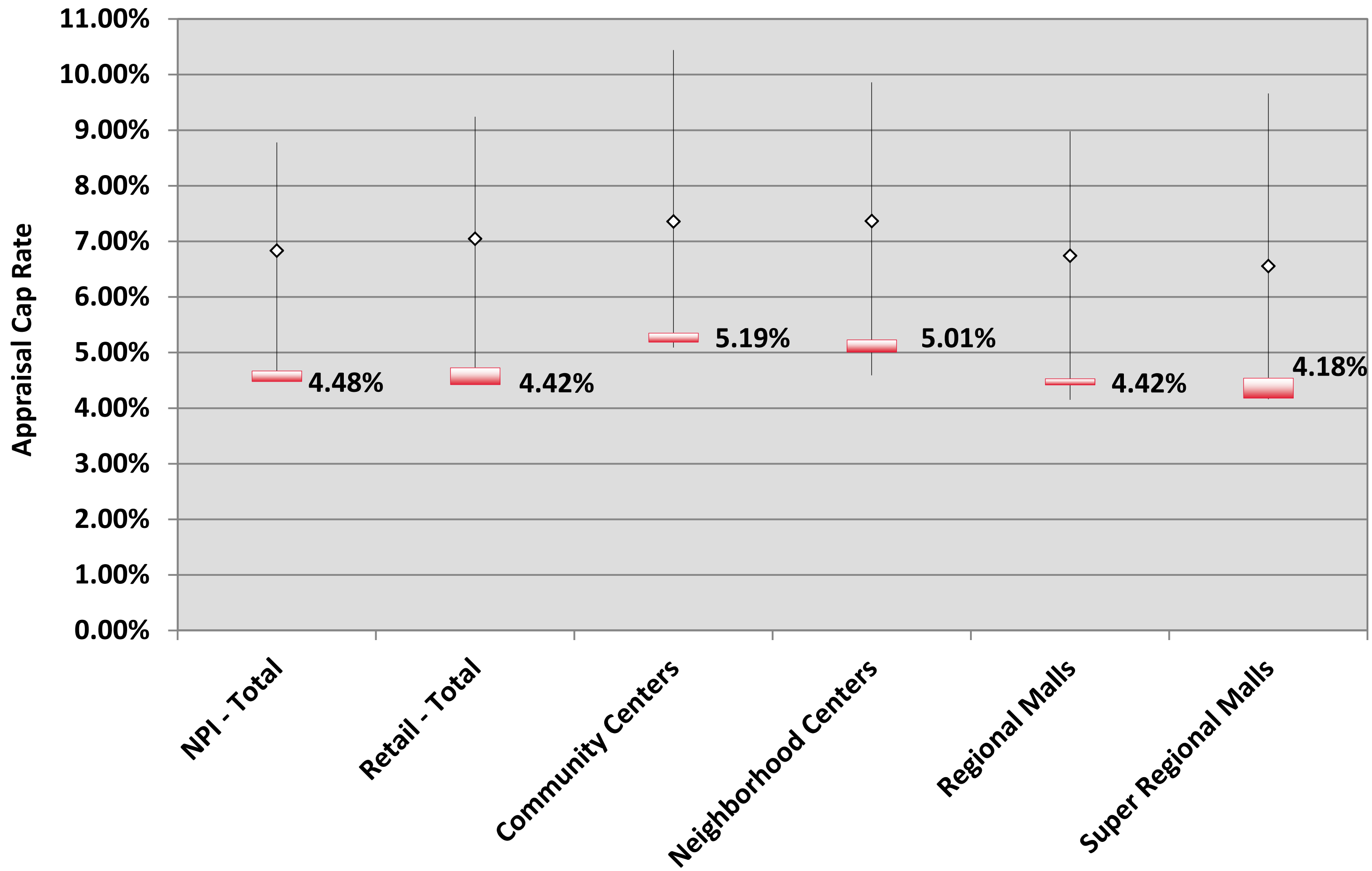


Source: Commerce Department

Property Yields Near All-Time Lows

Property yield spreads expected to compress through 2017 as Treasury yields rise

HISTORICAL CAP RATE RANGE (%)



Source: AEW Research, NCREIF

Holiday Retail Outlook 2016

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Estimated U.S. Retail Sales by Kind of Business - YTD November 2016

	Sales $MM	% Total Sales	% Total Sales Ex. - Auto	% Change vs. 2015
Retail & Food Total	**4,962,592**	**100.0%**		**3.1%**
Autos	1,029,804	20.8%		3.5%
Retail ex. Auto	**3,932,788**	**79.2%**	**100.0%**	**3.0%**
Furniture & Home Furnishings	**98,306**	**2.0%**	**2.5%**	**3.9%**
Electronics & Appliances	**88,534**	**-3.3%**	**2.3%**	**-1.8%**
Building Materials	324,800	6.3%	8.3%	3.9%
Food & Beverage Stores	642,140	12.9%	16.3%	2.3%
Health & Personal care	303,601	6.1%	7.7%	7.5%
Gasoline Stations	371,131	7.5%	9.4%	-7.3%
Clothing & Accessories	**222,823**	**4.5%**	**5.7%**	**0.5%**
Sporting, Hobby, Book & Music	**80,374**	**1.6%**	**2.0%**	**3.7%**
General Merchandise	**593,226**	**12.0%**	**15.1%**	**-0.7%**
– Department Stores	133,919	2.7%	3.4%	-5.2%
Non-Store Retailers	491,972	9.9%	12.5%	11.5%
Restaurants & Bars	601,045	12.1%	15.3%	6.0%
GAFO	**1,083,263**	**21.8%**	**27.5%**	**0.2%**

Source: U.S. Census Bureau

Retail Real Estate 2016 – The Big Picture

- **With notable exceptions, retailers have reported mildly disappointing sales and profits in 2016 and in the absence of sustained industry-wide sales growth are clearly focused on protecting profit margins, reducing inventories, regaining market share and limiting new store growth**
  - Unseasonably warm weather, continued economic stress for the middle class, and the elections all played a role; colder recent weather could spur a late season surge in winter apparel after sales sagged noticeably – in stores and online - in the two weeks leading up to the election
  - Retailers now familiar "hunker down"/"control what we can control" management mindset continues with laser focus on methodically reducing inventories, managing SG&A leverage points down to maintain operating margins without topline growth, and carefully balancing their more profitable store channel with their less profitable online businesses
  - Regardless, after years of cutting costs, investing in more efficient inventory management systems, reducing debt, selectively implementing proven omni-channel tools, and rationalizing, renovating and selectively expanding their store fleets , U.S. retailers collectively are far more efficient and resilient than they were at the dawn of the Great Recession
    - Over-riding emphasis industry wide is regaining profit margins without the benefit of sustained topline growth
  - Exceptions to these more dour results were recorded by off-price retailers and Dollar Stores, who continue to grow sales and profit margins as American shoppers continue to trade down to more value-oriented options
- **Dramatic reduction in new center development continues**
  - Total U.S. Shopping Center GLA grew at annual rate of 0.4% over the last six years; substantially below the 4.2% annual growth rate recorded in the '80s and the 2.3% annual growth rate experienced from 1990 to 2010
  - In a user driven business – where substantial pre-leasing is the rule – lack of new supply reflects sub-par sales growth, retailers balancing CAPEX between omni-channel investments and selective store additions, and unblinking focus on profitability and operational efficiency

U.S. Shopping Center Industry Growth by Center Type 1980-2016

	1980	1985	1990	1995	2000	2005	2010	2016*
Total Shopping Center GLA (SF, MM)	3,087	3,717	4,650	5,224	5,939	6,740	7,412	7,582
Trailing 5-Year CAGR	4.8%	3.8%	4.6%	2.4%	2.6%	2.6%	1.9%	0.4%
Regional Malls (number)	713	839	972	1,032	1,102	1,166	1,205	1,222
% Retail GLA	21.8%	21.0%	19.3%	18.2%	17.2%	16.1%	15.2%	14.9%
Total GLA (SF, Million)	672	778	894	950	1,020	1,085	1,124	1,133
Trailing 5-Year CAGR	6.2%	3.0%	2.8%	1.2%	1.4%	1.2%	0.7%	0.1%
N'Hood/Community (number)	18,625	22,822	28,586	31,369	34,789	38,455	41,508	42,318
% Retail GLA	57.7%	58.7%	60.1%	59.7%	58.7%	57.6%	56.3%	56.3%
Total GLA (SF, Million)	1,780	2,184	2,793	3,120	3,488	3,881	4,175	4,266
Trailing 5-Year CAGR	4.8%	4.2%	5.0%	2.2%	2.3%	2.2%	1.5%	0.4%
Power Centers (number)	394	460	647	933	1,360	1,810	2,190	2,252
% Retail GLA	5.4%	5.2%	5.8%	7.7%	9.9%	11.7%	13.0%	13.0%
Total GLA (SF, Million)	166	194	271	400	588	791	961	986
Trailing 5-Year CAGR	2.7%	3.1%	6.9%	8.1%	8.0%	6.1%	4.0%	0.4%
Lifestyle Centers (number)	80	100	132	145	184	277	435	485
% Retail GLA	0.9%	0.9%	0.9%	0.9%	1.0%	1.4%	2.0%	2.1%
Total GLA (SF, Million)	27	32	41	45	59	94	147	163
Trailing 5-Year CAGR	2.7%	3.8%	5.0%	2.1%	5.5%	9.7%	9.3%	1.7%
Outlet Centers (number)	44	73	150	233	271	290	323	363
% Retail GLA	0.9%	1.6%	3.1%	5.1%	5.9%	6.0%	6.7%	7.5%
Total GLA (SF, Million)	6	12	28	48	61	66	75	86
Trailing 5-Year CAGR	4.1%	15.2%	17.4%	11.7%	4.7%	1.6%	2.8%	2.1%

*Trailing growth rates for 6-year period ended 2016
*Source: ICSC, CoStar

Retail Real Estate 2016 – The Big Picture

    - Relatively mature business – some weaker sectors are arguably "under demolished" relative to foreseeable demand growth, notably older, underperforming department store locations that are no longer relevant or competitive in their markets
    - None of the larger national anchors have new store plans sufficient to drive substantial new center development, and the recent store closings announced by Macy's, and ultimately planned by Sears, should free up sites with good re-use potential, further reducing demand for new centers
    - Wall Street rewarding margin recovery and efficiency – battle-tested business models that stand the test of time - not e-commerce or unit growth plans without demonstrated, and closely monitored, profitability
  - Omni-channel retailers completing investments in new distribution facilities and inventory management systems to support the "cross channel fulfillment capabilities" necessary to deliver a seamless, convenient shopping experience to demanding customers; at same time continuously investing in mobile apps to capture and serve rapidly growing mobile traffic
    - With more experience comes the growing realization that online sales are less profitable than store sales, and therefore many are explicitly seeking to more carefully balance their online and traditional bricks-and-mortar channels
    - Retail margins are threatened by Amazon, which is creating a parallel retail universe with the benefit of unlimited funding that has yet to produce, much less forecast, meaningful profits
- **New development limited to a handful of outlet centers, dwindling number of in-fill projects driven by specialty grocers, mid-market chain restaurants, off-price apparel stores, sporting goods, and beauty concepts, focused primarily on established retail nodes or shopping centers**
  - Market remains bifurcated/bar-belled – off-price and discount retailers cater to growing pool of income constrained/value-oriented consumers while higher-end specialty retailers feel the pain from reduced tourism and brand integrity issues

Retail Real Estate 2016 – The Big Picture

- Mass merchants in the shrinking middle focused on improving profitability, developing omni-channel capabilities to compete with Amazon – while buying back stock – with modest new store plans testing smaller urban in-fill concepts; most expect to grow sales with existing store base

- **Lack of new center development focuses redevelopment and repositioning activity on the department store locations that are expected to be freed up by Sears and Macy's over the next several years**
  - Sears and Macy's actively pursuing strategies to close unprofitable stores and unlock the value of the underlying real estate
  - Case in point is Seritage Growth Properties, a portfolio of 265 owned stores that Sears spun out into a public REIT in 2015 in a sale-leaseback transaction that positions these stores for eventual redevelopment
    - The leases allow Seritage to recapture and redevelop significant portions of these stores while allowing Sears to downsize or exit these locations
    - Roughly 30 Seritage locations are in 50-50 joint ventures with GGP, Simon and Macerich, giving these landlords a key role in directing the future re-use of these stores while bringing their redevelopment skills and tenant relationships to the table
    - Initial activity has been tepid, given the higher than expected cost to redevelop and reconfigure many of these locations
  - Macy's announced plans to close 100 underperforming locations in June 2016 and subsequently announced it had entered into a pre-development JV with Brookfield Asset Management for 50 of the stores not located in centers owned by major mall owners
    - While market reacted by bidding down mall REIT shares, Macy's move is long overdue and closures could free up locations with more attractive and updated re-use options

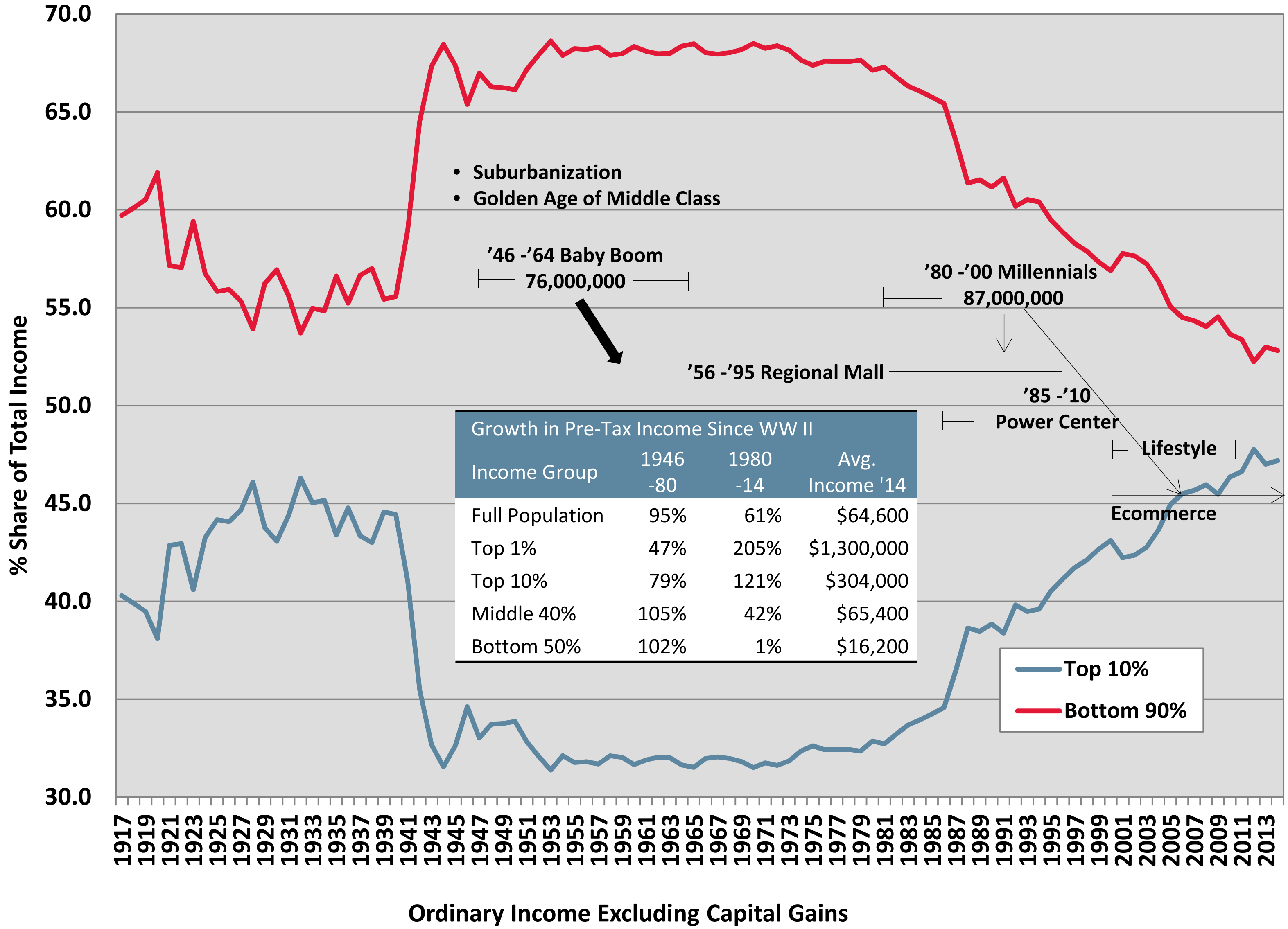
- **While net operating income from better quality centers continues to increase, market observers are less optimistic about the scale of future gains, due both to higher occupancies, slowing sales growth and tepid tenant demand**

Retail Real Estate 2016 – The Big Picture

- **As demonstrated by the recent elections in Britain and the U.S., retailers, landlords, market observers, and pundits are more keenly aware of the significant issues posed by the effects of growing income inequality and wage stagnation on the fortunes – and spending habits – of the vast majority of shoppers**
  - While past research identified the issue years ago, these studies were hampered by poor, survey-based data that only hinted at the extent and depth of the issue – in the last several years, a number of studies have been conducted using more robust and accurate tax data that indicate a major shift in income from the vast majority of Americans to the upper 10% of income earners has occurred since 1980, real incomes for 50% of the population have not grown in 35 years, and the incomes for those at the top have more than doubled
  - These findings are consistent with recent U.S. retail development and tenant sales trends, with value-oriented retailers and mass merchants outpacing the market as their customers increasingly rely on cheaper goods to make ends meet in the absence of real income gains; they also portend the slow growth sales scenarios that most retailers have been preparing for post-recession
- **The big question for the near term future is whether Millennials will spend the same way as their Baby Boomer forbearers did**
  - The "leading edge" of the Millennial generation, now in their mid-30s, are entering their prime household formation, home buying and family raising years – activities that generate strong retail sales and also lay the foundation for future wealth accumulation and spending
  - While more numerous, better-educated and more diverse than Boomers, Millennials came of age during the worst recession since the great depression, entering a difficult job market with over $1.3 trillion of collective student debt; recent studies indicate more Millennials are living at home with parents than ever before and continuing to delay marriage, home ownership and children
  - The spending patterns of Millennials over the next ten years will have a pronounced effect on retail – if more similar to the Baby Boomers, the effects would be extremely positive

U.S. Income Distribution 1917-2014

Shopping Center Development Trends 1946-2014

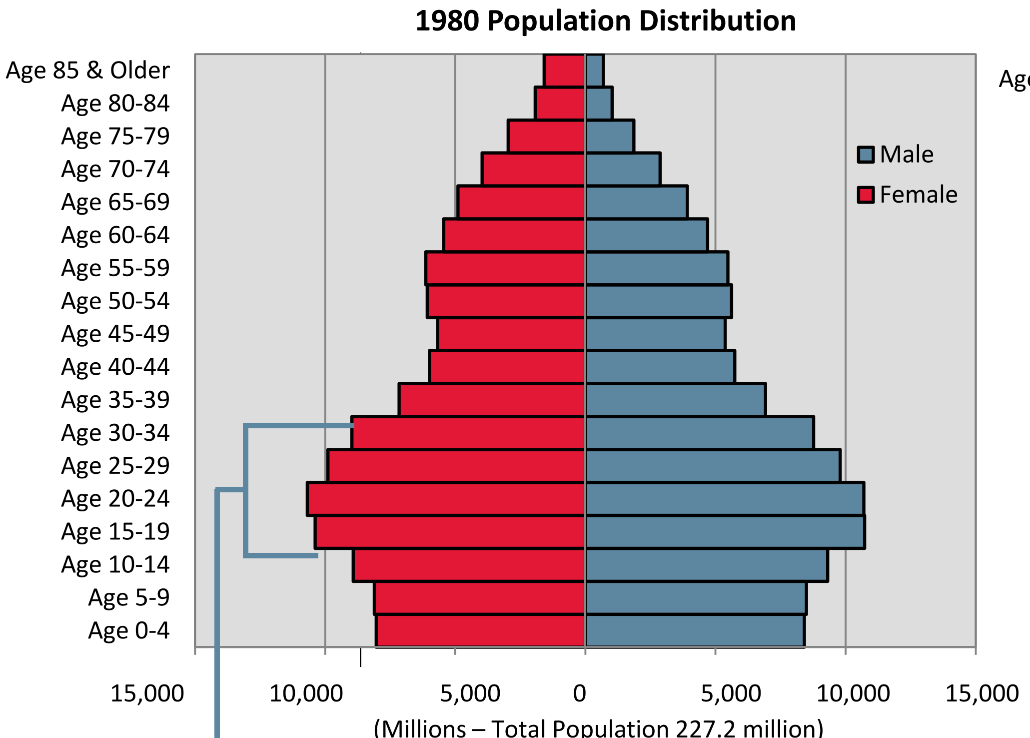


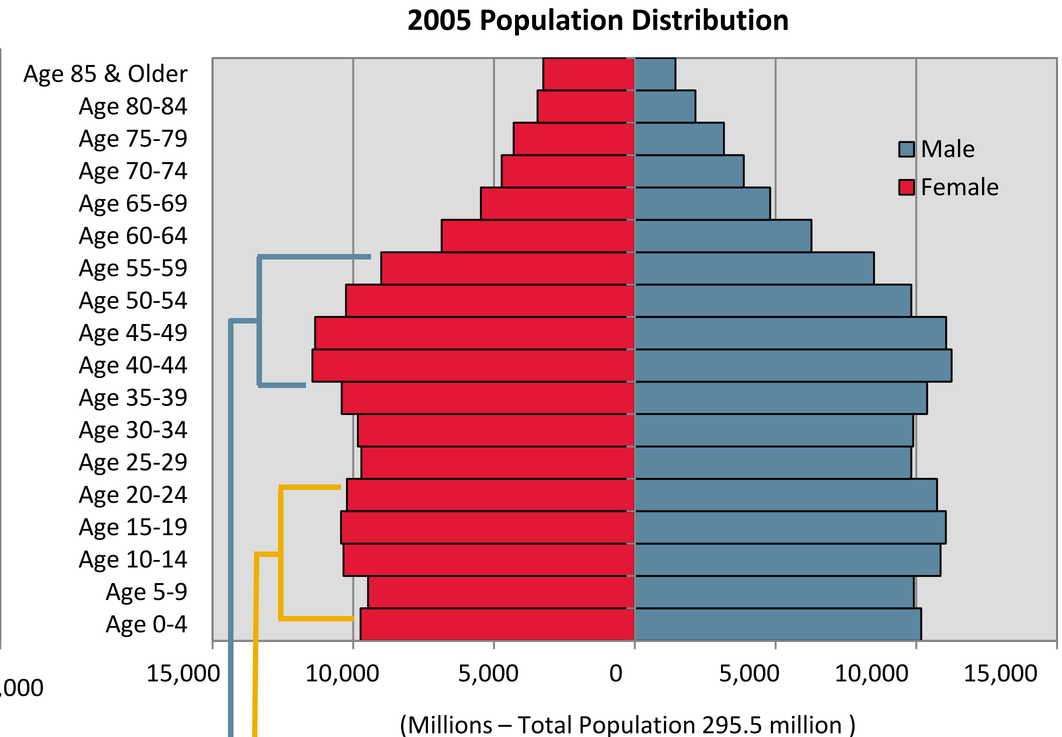
Growth in Pre-Tax Income Since WW II

Income Group	1946 -80	1980 -14	Avg. Income '14
Full Population	95%	61%	$64,600
Top 1%	47%	205%	$1,300,000
Top 10%	79%	121%	$304,000
Middle 40%	105%	42%	$65,400
Bottom 50%	102%	1%	$16,200

Source: The World Wealth and Income Database

Population Cohort Pyramid





Baby Boomers – 79.9 million; 15-34 yrs. old; 35% of population

- Front edge (late 20's/early 30's) early career, buying homes & starting families
  - Entering prime spending years
- Back edge (late teens/early 20's) finishing school, living at home
  - 15% +/- taking on student debt
  - Younger group hanging out at the mall

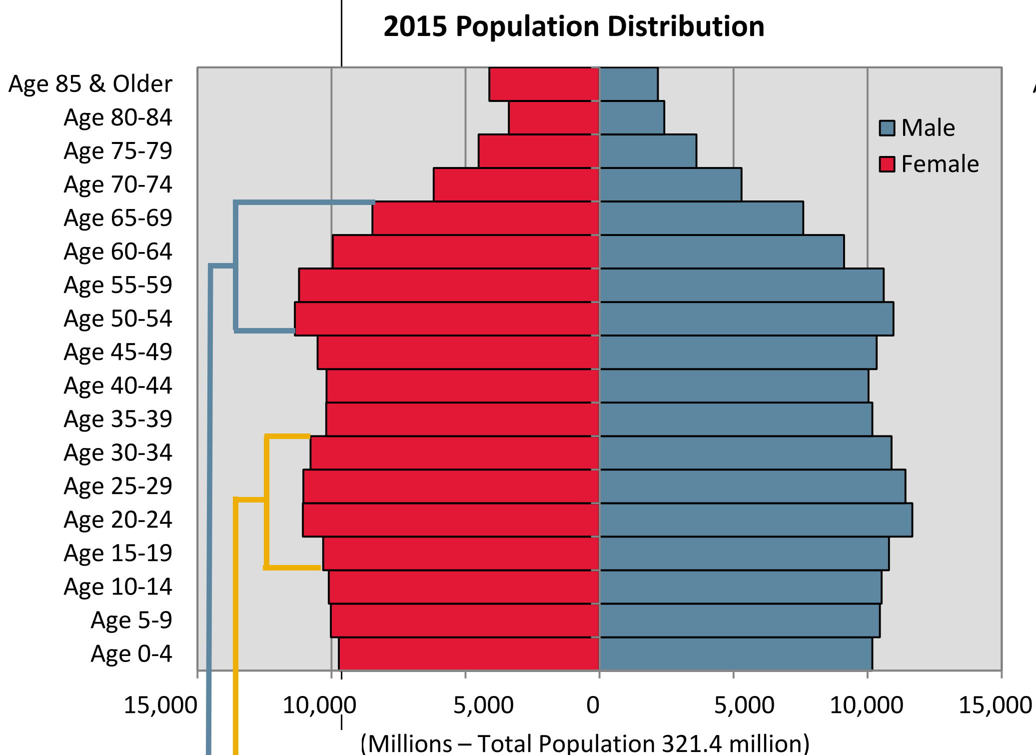
Baby Boomers – 84.7 million; 40-59 yrs. old; 28% of population

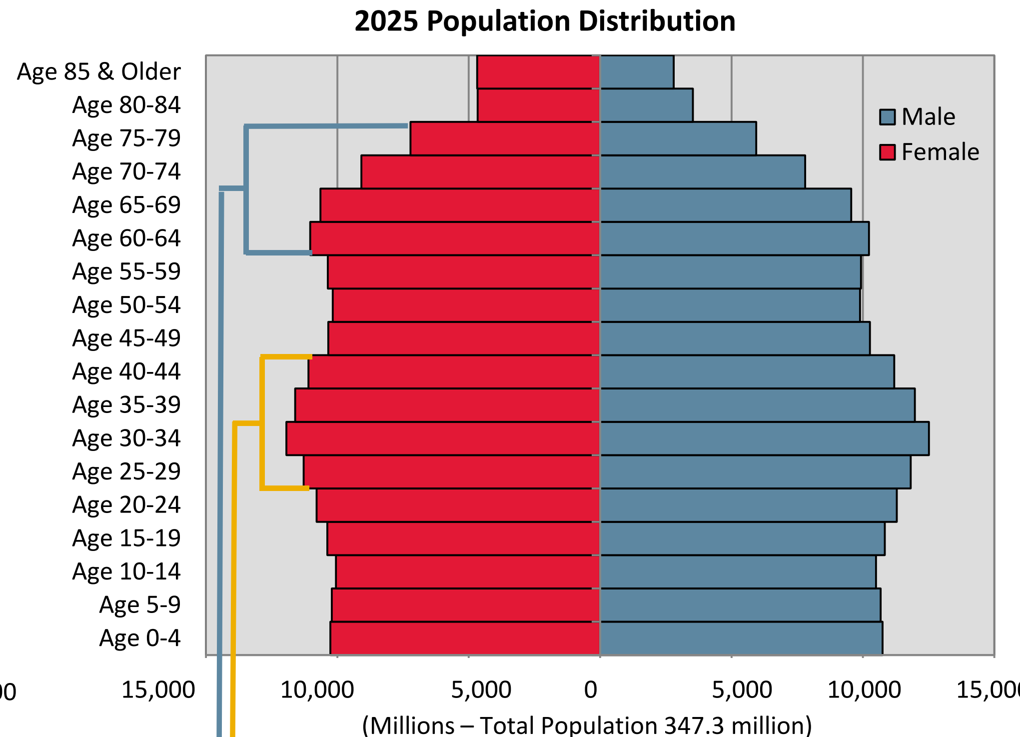
- Peak earning, spending & savings years
- Established households

Millennials – 83 million; 5-24 yrs. old; 28% of population

- Front edge finishing school, taking on student debt
- Back-end at the mall driving teen apparel sales

Population Cohort Pyramid





Baby Boomers – 79.3 million; 50-69 yrs. old; 25% of population

- Major hurt from recession for vast majority
- Front edge – working retirement?
- Back-end – should be peak earning years - rebuild incomes, support families, looming retirement

Millennials – 88 million; 15-35 yrs. old; 27.5% of population

- Front edge – early careers, home ownership & household formation slowed by economic circumstances; 42% with student loan debt - $1.3 trillion in total
- Back end – finishing school, buying iPhones and taking on debt

Baby Boomers – 71.5 million; 60-79 yrs. old; 20.5% of population

- Retirement – working or otherwise for front edge, looming for back-end

Millennials – 93.4 million; 25-44 yrs. old; 27% of population

- Front edge – entering peak earning, spending & savings years; home ownership if student debt paid off and successful career
- Back end – finishing school, early careers, student loan debt

Retail Real Estate – Center by Center

Grocery-Anchored

- **As in other sectors, growth of new grocery-anchored neighborhood centers has slowed dramatically**
  - While benefits of limited new supply continue to favor higher quality centers, higher occupancies limit their near term NOI growth
  - Grocery-anchored centers are far and away the most abundant retail product type with a substantial inventory of older, arguably obsolete centers; new center development follows rooftops so muted new housing construction further limits center growth
  - Grocers face stiff profit and sales headwinds from significant food price deflation – only the third deflationary cycle in last 30 years – that has shifted their strategic focus to cost-cutting and efficiency measures
- **Occupancy levels increasing steadily at better centers – in excess of 95% - while lower quality centers gradually recover with some concern that department store consolidation will create new mall-based competition for traditional neighborhood center tenants**
- **Despite margin pressure from deflation, major supermarket chains continue to invest in store upgrades – expanding selection of organic and natural foods, improving quality of take-home meals and expanding their fresh meat and seafood offerings to defend themselves from Costco, Target and Walmart, at the low-end, and Whole Foods and Fresh Market at the upper-end, while leveraging increasingly efficient supply chains and distribution systems to protect margins and "invest" in price**
  - Along with price, organics have become a key market share battle ground, with mass merchants and warehouse clubs, notably Costco, using targeted value-priced organic offerings to drive overall traffic to their stores

Retail Real Estate – Center by Center

  - Increasingly accurate consumer analytics show that customers shop more frequently, purchase fewer items and buy higher-margin prepared foods – less stocking-up and more buying meal-by-meal places competitive premium on convenience and quality
    - As shoppers buy meal-by-meal, growing concern that meal kit operators, along with traditional competition from fast casual restaurants and take-out options will increasingly compete for market share – particularly at the higher-end
- **The growth of specialty grocers such as Whole Foods, The Fresh Market and Trader Joe's has slowed as the sector faces increasing competition from traditional supermarkets, over-saturation and cannibalization in several major markets and more frugal customers than expected in smaller new markets**
  - All rethinking pricing, profitability and operations to regain margins while slowing expansion plans
  - Whole Foods has tested several value oriented "365 Foods" stores in smaller markets and in-fill locations with mixed results
  - As the "foodie revolution" explodes (how many more celebrity chef reality TV shows can we take???), customers cherry pick specialty grocers for quality produce and proteins while shopping updated supermarkets for "center of the store" items
- **Walmart threat remains, but at reduced level – limited supercenter growth, comparative weakness in organics and prepared foods, and competitive responses by regional grocers, specialty grocers and even low-end dollar stores have maintained balance**
  - Sold 42 of their smaller format Walmart Express locations to Dollar General
- **Dollar Stores continue to be one of the fastest growing segments in retail – growing store counts and maintaining solid profitability as struggling families trade down, expanding selections of convenience and frozen foods, and acting as mini-anchors for centers in more moderate rural trade areas**

Retail Real Estate – Center by Center

Power Centers

- **The major retail growth engine of the 1990s, new power center development has slowed dramatically as mass merchants and Big Box retailers have established solidly profitable store fleets serving the majority of the U.S.**
  - The industry has consolidated dramatically since the early 90s as multiple players in each category (home improvement, electronics, books, warehouse clubs, crafts and off-price retailers) were gradually winnowed down to the two strongest national companies
  - The recent bankruptcy of The Sports Authority and the on-going demise of K-Mart could mark final stages in this process
  - Expanding larger format power center additions are primarily off-price retailers such as Burlington Coat Factory, TJMaxx, Ross and Nordstrom Rack
- **Higher quality centers benefit substantially from the cyclical shift to home improvement (Home Depot/Lowe's), continued success and expansion of off-price apparel concepts (TJMaxx, Ross and Nordstrom Rack), stabilization of books, home and electronics, and the addition of new traffic generating uses, such as moderate sit-down restaurants, specialty grocers and entertainment**
  - Occupancy levels at historic highs – boxes vacated by failed concepts quickly converted to new uses as value-oriented junior box users continue to expand
  - The "Power Village" trend continues at a somewhat slower pace, driven by the moderating growth of fast causal and moderate sit-down restaurants, selective expansions by specialty grocers, and the more recent advent of destination grocers, such as Wegmans, that require easily accessible regional locations – the addition of food uses expands customer draw and generates more frequent visits
  - Some concern that redevelopment of unproductive department stores will increase competition for box retailers from malls

Retail Real Estate – Center by Center

- **Target and Walmart fighting back against Amazon for the limited wallets of income constrained customers with enhanced omni-channel capabilities, significantly improved in-stock positions, wage increases and measured improvements in food quality and selection – new store development muted as both focus on re-establishing sales and profit growth while aggressively buying back shares (after repurchasing a total of over $11B last year, these two retailers are on track to repurchase a total of over $10B of their shares this year)**
- **Likewise, Big Box retailers, most notably Lowe's, Home Depot and Best Buy, have tested and adopted key omni-channel features – notably order online/pick up in store/ship from store – that have proven popular with customers, driving store traffic and generating add-on sales**
  - In its initial roll-out, 40% of Home Depot online sales picked up in store, while Best Buy has used in store pick-up to provide system set-up and technical advice – both approaches generate significant add-on sales
  - Conversely, off-price apparel retailers have only a modest online presence, with frequent arrivals of new brand name goods at low prices driving traffic

"A" Malls

- **True "A" malls typically serve densely-populated, high-income trade areas with strong barriers to entry, first rate anchors and a steadily growing and improving mix of better merchants and restaurants – better retailers, laser-focused on the best centers**
- **While high-quality regional malls have delivered several years of strong sales and improving fundamentals, sales slowed more quickly than expected in 2016, raising concerns about the impact of eCommerce, continued department store consolidation and a pronounced drop-off in tourism in key gateway cities – share prices for the major mall REITs, which control the vast majority of high-quality malls, have meaningfully underperformed the overall REIT market and trade at sizable discounts to private market valuations**

Retail Real Estate – Center by Center

  - Few new regional malls have been built in years, and this lack of new supply in the face of steady, albeit measured, demand from highly-selective retailers, has driven up occupancies to record levels, increased rents as leases roll and spurred significant redevelopment, renovation and repositioning investments – in short, high quality regional malls have steadily improved their competitive positioning and relevance as the recovery has progressed
  - Recent sales declines have been largely driven by tepid apparel sales, with historically warm weather, anxious consumers, and uncertainty surrounding the recent election keeping shoppers on the side lines, and forcing some retailers into early promotions
    - Retailers with traffic counters recorded a significant drop in overall traffic – mall and non-mall - in the first two weeks of November, after lackluster September and October results as cold weather apparel did not sell; notably, however, traffic improved considerably after the election and into the Thanksgiving holiday
  - While the brunt of the decline occurred in 2015, "A" malls in popular tourist destinations and gateway cities continue to feel the negative effects of a significantly stronger dollar
- **With no meaningful supply – either from malls or lifestyle centers – on the horizon, stable rents and lack of competition enable landlords to consider redevelopments, including department store replacements, that previously did not pencil, allowing established malls to add compelling new uses, expand market reach and further reinforce their market dominance**
  - Seritage JVs, a potential opportunity to add larger format mini-anchors, fast fashion and additional restaurant offerings to fully-leased centers – key challenge is managing redevelopment and reconfiguration costs, which currently appear high
  - Macy's closures could also free-up potentially valuable re-use opportunities

Retail Real Estate – Center by Center

- **Underperforming retailers in "A" malls are typically replaced with stronger retailers as leases expire; department stores, on the other hand, either own their stores or benefit from favorable long-term leases, making anchor replacement far more difficult – combined with REA rights (mall equivalent of a condo association), an obsolete, underperforming department store can linger for years, blocking its replacement with more productive new uses**
  - The recent underperformance of mall REITs followed Macy's August announcement that it planned to close 100 stores starting in early 2017 – while Macy's announcement was long overdue, and viewed within the industry as a positive step for Macy's and an encouraging sign that long-standing hopes to free-up and convert underperforming Macy's locations to more productive new uses could finally move forward, the news nonetheless put a cloud over the entire mall sector
    - Macy's recently announced it had retained Brookfield Asset Management to devise pre-development plans for 50 of the stores slated for closure – notably Macy's pointed out that the list did not include any stores in properties owned by major mall landlords
- **The recent uptick in mall renovations, store remodels and new store prototypes has updated and refreshed the look and feel of most better malls following the "hunker down" years of the recession – store remodels align their online image with their in store experience while mall renovations aim to update the look, feel and function of the overall center, including flooring, entries, signage, lighting, the addition of expanded dining options and popular new customer amenities, such as WiFi and charging stations**
  - The better retailers - and department stores, Nordstrom in particular – in top tier malls continue to add omni-channel retail capabilities, ranging from reserve/buy online and pick-up in store to buy in-store or on-line and ship from shore, ensuring that these centers will feature the most updated store concepts making full use of the most current retail technology

Retail Real Estate – Center by Center

  - The advent of mobile has changed the mall shopping trip dramatically – while mall sales have grown steadily during the recovery, mall traffic has declined as customers increasingly start their shopping trips online, browsing and checking availability at their convenience on their smart phone, and then visiting the store to inspect and ultimately buy, driving up in-store conversion rates, average ticket and sales - despite lower traffic

- **Current leasing faces headwinds of tepid demand from struggling teen and family apparel retailers, with lower price point (and lower rent) larger format fast fashion concepts expanding their presence in better centers; on the other hand, innovative new concepts focused on health & beauty, "athleisure" and updated apparel continue to expand their mall footprint**
- **Mall REITs have aggressively sold or spun off their lower productivity centers, boosting portfolio-level operating metrics and focusing their leasing and redevelopment efforts on smaller, higher quality portfolios**

"B" Malls

- **Investor interest in "B/C" malls has moderated as higher quality mall REITs have sold or spun-off their lower quality mall holdings to new owner-operators**
  - "B/C" mall pricing in both public and private markets has softened in light of comparatively higher debt burdens, relatively flat sales, declining traffic and the on-going challenges faced by more moderate retailers and anchors - notably Sears, JC Penney and, most recently, Macy's – all reflective of the economic headwinds effecting middle America
  - Regardless, new owners are aggressively upgrading and improving higher quality B centers with repositioning strategies that include extensive renovations, new mini-anchors and restaurants, and refocused leasing, while capitalizing on opportunities to recapture and redevelop unproductive anchor stores – the renewed focus and energy is notable with numerous projects underway

Retail Real Estate – Center by Center

    - "B" and "C" mall operators arguably have more experience repurposing department stores – with a clear role as a town center capable of offering a broader array of goods and services than a dominant, fashion-oriented "A" center, the menu of possible re-use options is often broader and more flexible

- **While "A" malls typically dominate larger, higher income trade areas, "B" malls typically serve submarkets within those trade areas or smaller, middle markets where they are the "only game in town"**
  - "B" malls typically anchored by JC Penney, Sears and one-to-two smaller regional chains, and a moderate mix of national, regional and local specialty tenants
  - "B" malls experienced greater sales and occupancy declines during the Great Recession than the "A" malls and have been slower to recover given more tepid demand from moderate retailers – effects of recent tenant bankruptcies more pronounced in "B" centers
  - Class "C" malls out-of-favor – those in good locations are prime candidates for redevelopment and repurposing, often to non-retail uses
- **Successful turnarounds by JC Penney and a rationalization of Sears' extensive footprint would be significant positives for "B" centers**
  - JC Penney has made significant progress on its turnaround, and now appears to be on the mend and heading back to profitability
  - Sears continues to face competition from all sides and is accelerating its downsizing – the Seritage transaction is an important step towards rationalizing its store base and freeing up unproductive stores for redevelopment
  - Macy's closure impact remains to be seen – while most "B" mall landlords have long track records of successfully redeveloping vacated anchors, the lack of specifics cloud the upside potential for the moment

Retail Real Estate – Center by Center

Lifestyle Centers

- **Development of new centers has all but ceased**
- **Well-located, well-conceived centers in strong in-fill locations with solid specialty tenant rosters and complimentary dining and food uses have performed well and command competitive pricing in the marketplace – many of those that fall short of these characteristics continue to "run in place" in light of stagnant sales and modest leasing demand**
  - "A" lifestyle centers pursuing similar expansion strategies as "A" Malls and Power Villages, adding new dining options and organic groceries to increase traffic
- **While interest remains in converting more challenged lifestyle centers to outlet uses or adding new restaurant and specialty grocers, outlet business is dominated by handful of operators and tenants that prefer more standard outlet concepts**

Outlet Centers

- **Outlet center business has changed dramatically since the first wave of centers was developed in the early 90s**
  - The outlet store model has largely transitioned from the traditional clearance, out-of-season and irregulars business to predominantly branded made for outlet product
  - Ownership of the new generation outlet centers is highly-concentrated among established outlet center developers partnered with, or owned by, one of the major mall REITs – over 70% of outlet centers are owned by Simon or Tanger
  - Far more outlet center projects are announced than actually built, partly reflecting the influence of a handful of key outlet center tenants that do not want to cannibalize their full-price stores or dilute their brand image with cheaper, made for outlet, products

Retail Real Estate – Center by Center

  - Like malls, outlet center traffic has been erratic, with many relying on "day trips" from outlying areas, and tourists, for a considerable portion of their business – as a result, restaurants have had a checkered experience in outlet centers due to the difficulty generating repeat business from more local customers

- **As a result, outlet centers now offer complete assortments of value-priced fashion merchandise, basics and accessories – less of a treasure hunt than in the early days – which reflects full price retailers aiming to serve a more value conscious consumer with branded outlet product**
- **Renewed investment in larger outlet centers serving major tourist markets – particular interest from higher end retailers looking to clear out-of-season product – has slowed during the recent decline in international tourism caused by the strong dollar**

Reported Same Store Sales ($ per square foot)
Regional Mall REITs

	2007	2008	2009	2010	2011	2012	2013	2014	2015	Rolling 12-month 2016
General Growth*	$462	$438	$406	$446	$505	$545	$564	$570	$588	$583
Macerich	$467	$441	$407	$433	$489	$517	$562	$587	$635	$626
Simon**	$491	$470	$433	$494	$536	$568	$582	$619	$620	$604
Taubman***	$555	$533	$498	$564	$641	$688	$721	$809	$800	$790
CBL	$346	$331	$313	$322	$336	$360	$356	$360	$374	$377
PREIT	$358	$342	$334	$350	$365	$378	$380	$394	$429	$457

Green=Prior Peak Sales Year

*GGP Sales post 2011 reflect Rouse spin-off
**Simon Sales after 2010 include outlet centers
***Taubman Sales after 2013 reflect Starwood sale

Quotes from the Front – Retail Real Estate

- "…we've taken a large chunk out of stores. As you know we're taking a more refined view of the store fleet, projects are going forward only when they clear a significantly higher hurdle rate that's heavily risk assessed. And we've just been able to dial that back based on the challenging store trends that we've seen…" (Ascena)
- "We opened 42 stores in the third quarter on our way to exceeding our 2016 program of 100 net new stores, ending the quarter with 949 stores…[N]ew store productivity remains very strong, with the class of 2016 performing well above budget, and far above sales hurdles established to meet our internal rate of return thresholds. We've already approved all of the 100 stores planned for 2017…" (Ulta Salon Cosmetics)
- "…we've actually seen pretty consistent results over the last number of years across our real estate in general…we're not seeing any weird spikes by region, we're not seeing any weird spikes by location. Obviously, where we have put investments into the new real estate strategy, or rather, the remodel strategy, we continue to see very healthy lifts in that business…" (L Brands)
- "…there's going to be some continued rationalization by certain retailers, but we're also seeing growth by others in categories such as beauty, cosmetics and athletic footwear, and the L Brands are still strong. So we're seeing good demand. And there's just a shift in the tenant mix of the properties…I don't really have anything new to say about Sears…They've been much more focused on Kmart in terms of where their losses are." (CBL)
- "In 2016, we continue to expect to open 25 net-new stores with an average square footage of 51,000 square feet. Our store pipeline is on track to open approximately 30 net new stores in 2017…our market planning and real estate underwriting processes give us confidence that we can reach 1,000 stores over the long-term…We've added a lot more analytics behind how we're picking sites over the last two-to-three years, and there is a nice supply also of sites out there that we can chose from." (Burlington Coat Factory)

Quotes from the Front – Retail Real Estate

- "Our goal with all of these investments, whether physical or digital, is to strike a balance between market presence and demand such that we open the right number of stores in any given trade area and not one more than needed to serve our customers." (Zumiez)
- "…we have one of the leanest store fleets in the industry and I don't think there is any way we can consider ourselves overstored. And we've been extremely cautious about opening more stores in recent years…I really don't think it is a problem with stores per se. I think the real problem is that there are just too many stores in North America. And I think what you see day in and day out are reports of people either reducing their store count or going out of business altogether, which I believe over the long-term will reduce the store count and bring the supply and demand back into line." (Urban Outfitters)
- "…we continue to be cautious on square footage expansion overall. We would expect that teen Journeys and Lids stores, which…are pretty close to being built out in the U.S., will see little to no new growth, even reduced square footage in the next few years in the C malls…our square footage growth on a percentage basis is going to be a lot, lot less in the next five years than it was in the past five years." (Genesco)
- "We remain focused on improving the results of our existing stores for the time being rather than opening a significant number of new stores." (Tilly's)
- "Our real estate model is the foundation of driving strong returns. We continue to see new store productivity at around 80% to 85% of our comp base, all while driving returns over 20%. For 2016 we are on track to open 900 new stores and relocate or remodel a combined 900 stores." (Dollar General)
- "…we're in a lot of malls. And the malls that we're in are all of the higher A to A+ malls…when we chose a site we look at many factors; parking, exterior, we look at all the demographics, and malls are great places for us to be." (Cheesecake Factory)

Quotes from the Front – Retail Real Estate

- **"Only once before in my career have I seen such incongruity between perception and reality…[R]egional malls, especially those in the secondary markets, are currently being underwritten in a de facto liquidating trust fashion with little reversionary value. It's just plain silly. Our results continue to demonstrate the stability of our cash flow. Our assets serve as town centers and its incumbent we improve upon our dominant position…we're working our behinds off to actually accomplish this goal." (Washington Prime Group)**
- **"…the best thing we can do is invest in our product…unfortunately what I've seen with a number of retailers that they've not invested in their product…or they chased the holy grail of internet sales to the detriment of what they should be doing with their physical product. Still, people want to go physical shopping, and when they go physical shopping, you know then you got to have a nice physical environment…the number one job I should be doing is investing and making my product better… (SPG)**

Key Themes in Retail 2016

- **While overall economic fundamentals continue to improve, with steady job growth, the first notable wage increase in years, recovering housing markets, lower gas prices and the Fed raising short term interest rates for the second time, 2016 is proving to be one of the most challenging years for top line retail sales and bottom-line operating profits in recent memory**
- **In a repeat of 2015, unseasonably warm weather in the early fall cut into sales of high margin winter apparel, and many retailers reacted by postponing deliveries, cutting inventories and starting promotions earlier than planned**
- **The Presidential election also was a net negative for retail, especially restaurants that saw a noticeable drop-off in traffic during the debates**
  - The largely negative messages reinforced the customer anxiety that has characterized much of U.S. retail since the great recession
  - Store traffic and online traffic fell dramatically in the weeks leading up to the election, with some encouraging indications that they have recovered somewhat in the weeks since with the recent return turn of cold weather
- **Retail earnings disappointment was widespread in the 3rd quarter, with upper end retailers continuing to feel the effects of reduced tourism due to the strong dollar, despite the post-election market rally, while mass merchants and specialty retailers continued to report lower traffic across channels amid continuing signs of shopper anxiety**
  - Notably, off-price apparel retailers, a handful of health & beauty concepts, and several niche apparel retailers recorded favorable results
  - After a few years of gradual improvement, retail sales and operating margins took a significant step back in 2016, with most management teams focused on operational efficiency, reduced inventories, and “stress-tested” business models that can generate reliable profits without meaningful or sustained sales growth – most retailers are now pursuing business models that lower their SG&A leverage points to 1-3% comp sales growth – a far cry from the 3-5% gains assumed pre-recession

Key Themes in Retail 2016

  - The emphasis on leaner inventories and greater supply chain efficiencies was eerily reflected in the Hanjin Shipping bankruptcy, both as a leading cause of the filing and due to the fact that this loss of a major shipping operator had no meaningful effect on U.S. retailers…that would not have been the case four to five years ago
  - The food industry is experiencing a significant deflationary cycle – the third in 30 years – that reflects both record grain harvests and poor global demand, which has further pressured their margins and operating results
  - In short, there is widespread concern in the retail industry that margin pressure and erratic sales patterns with little growth are likely to persist for the near future – the industry mantra is “control what we can and don’t expect sales to revive anytime soon”
- **Major macro culprit continues to be long-standing wage stagnation for the vast majority of consumers, constrained household budgets, and growing sense of a slow growth “new normal” with a shrinking middle class facing more of the same in the future; the biggest uncertainty – and hope – continues to center around the future impact of 87 million Millennials will have when they leave home, get jobs, get married, have kids…and hopefully start spending like the Boomers did before them**
  - Retail bifurcation or bar-belling continues between upper-end specialty retailers catering to upper income customers, on one end, and the long term growth of off-price retailers serving everyone else, on the other; this leaves traditional mass merchants like Target and Walmart in the middle to fight it out with Amazon
  - While overall industry has gradually shifted towards lower margin, value-oriented formats over the last 30+ years, the trend has picked up steam since the recession with upper end chains like Nordstrom rolling out Nordstrom Rack stores, Burlington Coat Factory, Ross and TJX enjoying record growth and specialty retailers steadily expanding their outlet presence with branded “made for outlet” product that caters to less affluent, value-conscious consumers
  - At the very low end, Dollar General and Dollar Tree have been two of the fastest growing retailers in America over the last ten years

Key Themes in Retail 2016

- **The repeat of record warm weather in September and October again cut dramatically into cold weather - higher margin – apparel sales, but this year most retailers delayed major shipments of goods to protect against a repeat of 2015, and have aggressively reduced inventories and delayed or canceled shipments of fresh goods as they carefully tracked the weather and erratic traffic patterns**
  - The return of colder weather in December could be a late boost for retail sales and overall margins – while retailers kept inventories low, they have improved their ability to “chase” inventory to quickly replenish goods that do sell
  - Off-price players continue to mine the supply chains for surplus first quality branded merchandise and are packing away like crazy
- **As expected, the teen apparel business struggled in 2016, with Aeropostale emerging from bankruptcy with three new owners – GGP, Simon and Authentic Brands – and a much reduced store base, Pac Sun entering and exiting bankruptcy largely intact, and Abercrombie & Fitch continuing to struggle with declining sales and margins**
  - Teen population and spending power has declined from its 2007 peak, smartphones and dining out now capture a larger share of their limited spend, and the overall teen sector remains overstored for the near future
- **Department stores continued to face challenging apparel dynamics with no fashion excitement or “must haves” again in 2016 – instead the big news is Macy’s announcement of its plans to close up to 100 stores in the coming years and the continued decline of Sears, most notably its K-Mart division**
  - JC Penney, on the other hand, remains a relative bright spot as it executes a solid turn around by returning to its value- and fashion- oriented roots
  - Several notable retailers, including Coach, Ralph Lauren and Michael Kors, have cut back on their department store business, citing a desire to elevate their brands and reduce their presence in more promotional channels

Key Themes in Retail 2016

- **Mobile traffic continues to grow as larger, easy-to-read screens and user-friendly retailer apps with improved graphics have dramatically increased the speed, reliability and convenience of mobile web searches**
  - While total mobile website traffic again increased over 15% compared to last year over the Thanksgiving holiday, the share of online sales made via a mobile device also increased over 25%
  - Smartphones have effectively replaced tablets as the mobile device of choice
- **Comparatively strong performers remain off-price branded apparel merchants (TJMaxx and Ross), home improvement chains (Lowe's and Home Depot) and health and beauty concepts (Ulta)**
- **The persistently stronger dollar continues to hamper retailers with a strong international presence and concentrations in key tourist and border markets – this issue crept into the results reported by several of the major mall REITs with significant assets in gateway markets**
- **Despite the headwinds, retailers continue to investment in their business models, with notably increased focus on improving supply chain speed and efficiency, improving inventory management while editing down assortments and dropping less profitable lines, and continuing to selectively invest in proven omni-channel capabilities that drive store traffic**
  - Outside of off-price retail, dollar stores and a handful of niche specialty retailers, new store growth has been downplayed as retailers adopt a "wait and see" posture and focus on improving operational efficiency and profitability of their existing stores
  - Retailers continue to selectively renovate their existing stores, adding the "back of house" IT and shipping capabilities they need to become part of their integrated omni-channel networks – store remodels aim to align online image with in-store reality
  - Retailer balance sheets on average have improved dramatically since the Great Recession – significantly reduced debt and strong cash flows with many aggressively buying back shares (Home Depot and Lowe's - $8.1B combined to date in 2016; Target and Walmart – nearly $10B combined in '16; and Dollar General - $4.3B in '16)

Key Themes in Retail 2016

- The growth concepts of the past few years – specialty grocers, moderate sit-down restaurants and a handful of mini-anchors, have all reduced their growth plans as new units have not met internal performance hurdles and management teams preserve capital as they wait out the current deflationary cycle
- The major chains that continue to steadily expand in the U.S. – H&M, Zara, and Primark – are all value-oriented apparel retailers with long histories serving income constrained consumers overseas…

- **The retail industries' continuing focus on operating margins, increased ROIC and striking the most profitable balance between their bricks-and-mortar, outlet, online and catalogue channels has only intensified since 2015**
  - Safe to say, return to unit growth and footprint expansion not happening, which will continue to limit new supply growth
- **Heading into 2017, the overall retail industry is less profitable overall but certainly more resilient and better prepared to weather continued volatility than it was prior to the Great Recession – while all stand to benefit significantly if and when economic prospects improve for middle income consumers – Millennials in particular – no retailers are expecting any such rebound and are managing their businesses accordingly**

Quotes from the Front – The New Reality 2016

- "…the market, as you can all see, has been very challenging both in the macro and retail. I think this is probably one of the toughest years we have seen besides 2008." (Li & Fung)
- "…we see consumers' increased focus on value continuing for the foreseeable future." (Ross Stores)
- "The glass is always half full when you're…in our spot." (Footlocker)
- "Over the last year, we have been addressing not only the challenges of top line trends, but the longer term impacts of operating a fast growing e-commerce business." (Nordstrom)
- "Clearly, the political calendar, debates in particular, Olympics and general uncertainty on behalf of the consumer combined to produce a generally weak retail environment and the softest industry-wide restaurant performance we've seen in some time…the tone of this years' political season, regardless of where your allegiances may lie, has generated what some would call a nearly unprecedented level of negativity and doubt in the minds of everyday American citizens…many preferred to stay home versus going out." (BJ's Restaurants)
- "…market conditions are challenging. And at this time, we believe it is prudent to assume that they will remain so. We're focused on the areas of business that we can control. We expect to drive down inventories, inventory levels, execute cost controls, and build a more flexible and responsible organization in general." (Ascena Retail)
- "…we've been informed that September has been the warmest September in 55 years since we've started to measure…if the heat wave continues, the window of selling autumn garments, winter garments is narrowing, of course this leads to an increased risk of mark downs...[a]nd…it's not just…an H&M specific issue, this is for the whole industry. And we already have seen…competitors…getting panicked and starting their mid-season sales before this season even started. So, that puts pressure on us and the industry." (H&M)

Quotes from the Front – The New Reality 2016

- "This is the second year that we've had a deflationary environment...driven by overcapacity, commodity prices, and weak consumer demand. The whole retail environment is almost permanently promotional…[g]one are the days when promotion is a few times a year…[s]o this is leading to a lot of margin squeeze for the retailers and through the supply chain. Shipment continues to get delayed…because people are buying closer to market, and they're trying to reduce their inventory level, based on a poor season before and also as a percentage of total sales." (Li & Fung)
- "…while our store traffic is slightly negative, it is consistent with the trend that we've seen throughout the year…the traffic that is out there today tends to be more serious about making purchases and not just window shopping, so we are still seeing healthy traffic from these guests." (Lululemon Athletica)
- "..deflation persisted through the third quarter and, as we've said before, transition periods create a difficult operating environment. This is the third time we've had deflation in 30 years and in previous instances deflation has lasted from three-to-five quarters in a row. We're in the middle of the cycle now, and it's not fun…[A] silver lining of deflationary environments is that it reveals to us how we can run our business better by shining a light on areas we can improve." (Kroger)
- "In terms of availability, it's pretty broad-based and spread throughout all the markets. There's been…a lot of availability despite the fact that department stores have kept their inventory basis in line, there is definitely more goods out in the market…it all depends on what sales those department stores…do and the inventories they have bought…into…we see no problem with supply." (Ross Stores)

Quotes from the Front – The New Reality 2016

- **"…as we moved into October and November, traffic was down pretty significantly in our stores. And the fact of the matter was that customers just weren't looking for cold weather products and weren't coming into our stores. Conversion, interestingly, was up in October and mostly flat for November." (Genesco)**
- **"We still think the number one driver that's out there is continued appreciation in homes but it has moderated some. It's still a healthy industry but not to the extent that we would've seen the numbers supporting a year ago." (Lowe's)**

Quotes from the Front – The Evolving Retail Business Model

- "We have been buying too much inventory, letting that overflow to value channels, buying too much in the product tail, buying too early before the customers have bought, not created room to chase in season and distributed too much in the low-volume shops, and promoted too deep and too frequently." (Ralph Lauren)
- "…you really have to pressure-test a business for this new environment. And to just sort of wish that the sales are going to come back to the levels that we enjoyed many years ago…isn't the way you want to run a business going forward…we're going to pressure-test and prepare the business for a different kind of retail environment, one where the power is in the hands of the consumer and they have multiple avenues in which to meet their needs…" (Chico's FAS)
- "…we're in a tough environment. It's hard, I can't predict how long that's going to run. But we see a lot of positive forces in our business. Our margins are strong, we're not giving away our goods, our inventories are clean – our inventories have never been cleaner thank you to ship from store. And we see ourselves as a share taker. As the environment improves, we love our positioning to continue to benefit…over time." (Tailored Brands)
- "A big part of what you've seen in terms of our improved results have to do purely with the fact that our sales are growing faster than inventory and the benefit of all that is what we're seeing…in our results." (Nordstrom)
- "…inventory is one of the most difficult things retailers do…we've reduced our overstock substantially versus last year, and that's allowed us to better serve our customer because we can more quickly, efficiently get to what we've purchased versus carrying and storing a bunch of things that aren't selling, and that's been really positive…But it's not just about taking inventory down; it's also about being in stock" (Williams-Sonoma)

Quotes from the Front – The Evolving Retail Business Model

- "…fundamental to our model is trying to create that scarcity in our store…we don't want our customer to come in and see stacks of 12 or 18 of everything and think they can wait us out 'til we take it into clearance." (Francesca's)
- "…our e-com business in total is only a little over 1% of our total business…[We] like the traffic we're getting. We like the sales the way it is going. And on the flip side as you know with e-com, you have to be very careful on your cost structure…we have taken a hard look at the cost structure and making sure that we keep our investment at a very appropriate level. And in fact, a leveling off level, I guess would be the best way to describe it." (TJX)
- "Demand-based buying is a critical piece, and…we…traditionally bought the year one season…at a time. And that means making large commitments well in advance of when the product is going to be in the store and…what the customer really wants. So we have been building the responsive supply-chain capabilities…re-engineering the front-end of the business so that we can buy on a much more continuous basis…we'll remain open as we get closer to the season and can pivot the buy to the most meaningful trends…[I]t's more about the front-end of the business than…the back-end of the business right now." (GAP)
- "So I think brands are very smart about how they think about distribution, about how they want to play it out…they're thinking about their longevity as a brand…probably more clearly than ever understanding that controlled distribution…allows them to control pricing and margins more effectively as a brand...and I think we're going to see over the next few years that there's going to be very, very controlled, limited broadening of distribution for a lot of these brand partners." (Zumiez)
- "The fact that our inventory is in great shape – you saw our inventory grow at half the rate of our sales…we think…will mitigate some markdown exposure in the back end." (Dick's Sporting Goods)

Quotes from the Front – The Evolving Retail Business Model

- "…we believe that based on where we are today and going into the next year, even if sales don't change…even with some store closings, you can get…flat sales year-over-year, we can cut those costs and put us in a positive operating income range before any impacts of increasing sales." (Christopher & Banks)
- "Just as a rule of thumb, I would think of a leverage point of…low end of the mid-single digits for leveraging SG&A expenses in 2017." (Express)
- "Typically it is a strong 3% that you need to leverage your buying and occupancy cost." (TJX)
- "We've always said that we believe margins over time will continue to decline from a gross margin standpoint, and that's the reason why we worked so hard to get costs out… partnering with our technology teams to fundamentally change the way we do work to get costs out." (Kroger)
- "…we're trying to get back 50 basis points a year of merchandise margin improvement through inventory initiatives…[b]ut that's going to be offset by about 30 basis points of pressure from e-commerce…" (Kohl's)
- "…we continue to make progress on gross margin, but it continues to be offset with increased shipping expenses as we continue to drive dot-com." (J.C.Penney)
- "For most of the categories, the dot.com channel is overwhelmingly a promotional one, with most of our competitors having perpetual sale shops available. As you're aware, we have a clear strategic direction to limit our promotional stance on-line, given the negative impact on long-term brand health…we have a very clear strategy to limit our promotional stance online" (Coach)

Quotes from the Front – Rationalizing Department Stores

- "We are strategically reducing our sell into department stores in order to protect our brand and margins in this channel through disciplined inventory control and reduced promotional activity." (Michael Kors)
- "Actions towards our commitment for restoring profitability include the following: reducing unprofitable stores, reducing space in stores we continue to operate, reducing or eliminating specific categories we operate in where performance and return on investment is poor, and improving our gross profit performance and SG&A relative to sales." (Sears Holding Corp.)
- "We are now also in the process of rationalizing our North American department store distribution, taking our door count down by about 25% or by over 250 locations over the fiscal year as well as reducing promotional events in the channel." (Coach)
- "We have been talking for several years about cleaning up wholesale. We still have much to do…we talked in May about the flip of our business over the past years from predominantly wholesale to retail…it will be about continuing to elevate the brand." (Burberry)
- "Macy's has real estate assets with significant value creation opportunities. But we recognize that realizing these opportunities will often require alternative uses for the property and some amount of related development…To help us with this component of our strategy…we're giving Brookfield an exclusive right for up to 24 months to create a pre-development plan on each of approximately 50 assets that are initially included in this agreement…and in most cases, the assets that we have initially selected are not in malls with the major mall owners." (Macy's)

Quotes from the Front – Rationalizing Department Stores

- "Once a plan for a particular asset is developed, Macy's will have the ability to proceed or not to redevelop this asset. If we choose to redevelop the asset, the property will then be contributed into the redevelopment joint venture. Macy's can at that point decide to take a cash settlement or contribute and participate in the redevelopment joint venture…we believe that having a single significant partnership will align interests and improve both communication and execution as opposed to working with separate developers for each opportunity." (Macy's)
- "…let's talk about department stores and their store rationalization, a topic we think is an unnecessary dark cloud…over our industry…something our industry has been successfully dealing with for decades…[that] provides us with the chance to bring in what consumers crave, ranging from entertainment, dining, fitness, salons, big box offerings, off price merchants as well as full-line department stores…[T]he end result is replacing department stores who have average product assortments and below average store experiences with new and exciting destinations." (Penn REIT)
- "With the consolidation of Macy's and the May Company going back eleven years ago, many of the brands that really make up the excitement within a department store began to look at the balance of power that they had in the negotiations with department stores and decided they wanted to add another channel of distribution to their omni-channel approach. Albeit eleven years ago, I doubt that word was literally used that much, but many of the great brands…relied predominantly on…wholesale distribution through the department stores. And over a period of time, those brands have decided to open up full price retail stores and in many cases flagship stores. And they comprise many of the best names that we have in the mall today…." (Macerich)

The Mobile "Tipping Point" and the Role of the Store in the Omni-Channel Balancing Act

- **Omni-channel – brick-and-mortar's response to Amazon, the proliferation of ever more powerful mobile devices with user-friendly shopping apps, and the demands of time-sensitive, value-oriented customer; combining an integrated inventory and supply channel with a website or app that allows customers to shop whenever, wherever and however they want using the fulfillment channel – bricks-and-mortar, mobile app or website - they find most convenient**
  - Contrast this broader definition with one found on Google: a "multichannel approach to sales that seeks to provide the customer with a seamless shopping experience whether the customer is shopping online from a desktop or mobile device, by telephone or in a bricks and mortar store"
  - While this definitions' focus is correctly on the customer – who is driving this transformation – the broader definition recognizes the "back-of-house" adjustments retailers must make to transition from siloed legacy "push" inventory systems to the unified "pull" inventory systems they need to consistently deliver a seamless shopping experience across sourcing and distribution channels while preserving profit margins
  - Often lost in the discussion is the reality that Amazon is building a massive "parallel retail universe" based on basic strengths in commodity sales, backed by seemingly unlimited funding, that has yet to deliver, much less forecast, meaningful operating profits – a business model retailers can't replicate and investors can't tolerate
- **Customers expect a seamless omni-channel experience – no longer a "coming feature" for most retailers – and are armed with new mobile devices featuring larger screens with better graphics that can quickly download massive amounts of data; at the same time retailers are developing user-friendly apps and robust websites that allow shoppers to access and "pull" product from their entire inventory regardless of where the product resides (store, warehouse, in transit), select from a variety of payment and delivery options, and maintain a record of the transaction for future recommendations or special offers**

The Mobile "Tipping Point" and the Role of the Store in the Omni-Channel Balancing Act

- Retailers have found that customers that shop via multiple channels (store, web, mobile) tend to be their most loyal and productive customers, often outspending those who shop via a single channel by 2-3 times
- Shoppers prefer retailers with physical stores for fashion or big-ticket purchase – validate quality and fit, assistance and advice from trained sales associates, and the ability to return merchandise or have items serviced
  - Retailers note that online sales are higher in areas where they have physical stores

- **Mobile phones now drive the majority of online search traffic – overtaking tablets and desktop – and while they are far from becoming the preferred vehicle for actual sales, the tipping point on search has powerful implications, most notably enabling impulse shopping around the clock**
- **While online sales continue to grow at a double digit pace – albeit from a small base - retailers are clearly using their omni-channel capabilities to drive store traffic after the initial browsing session, redefining the stores' role in subtle but important ways**
  - The buying process for many discretionary purchases now often starts with browsing on a mobile device – searching for product, comparing prices, and availability - with subsequent steps executed online, in-store or increasingly through some combination of the two
  - Moving product, inventory through stores is the retailers' most profitable avenue for nearly all purchases, except deep clearance - over 90% of retail sales are made in traditional bricks and mortar stores with well-established profit metrics backed up by efficient supply chains and inventory management systems
    - Utilizing stores as mini-fulfillment centers for online orders reduces shipping costs, moves inventory and drives customer traffic, which in turn generates add-on sales opportunities

The Mobile "Tipping Point" and the Role of the Store in the Omni-Channel Balancing Act

  - Aside from search, mobile apps and customized e-mail blasts also encourage shoppers to visit stores by keeping them up-to-date on new products, special offers and in-store events

- **Retailers have invested significantly in store upgrades that support enhanced omni-channel capabilities while freshening appearances to be more consistent with their online images – the most common omni-channel capabilities include:**
  - Buy/reserve online, try-on and pick-up in store (and try-on and hopefully buy lots of other stuff)
  - Buy online, ship to store, pick-up in store (move inventory through established store distribution channel and encourage customer to buy a bunch of other things while they're there…)
  - Buy online, ship from nearest store inventory (move inventory gathering dust in store stockrooms)
  - Buy special item or size online from store, ship to home (make the sale even if you don't have the item in stock)
  - All of these services allow sourcing across inventory platforms, enabling the retailer to find the closest product – whether it be in a nearby store, distribution center or central warehouse – and ship it to customer's preferred pick-up point; this helps keep inventory from going stale, increases inventory turns, and lowers shipping costs

- **As such, the new omni-channel shopping trip can take many different paths through and between the retailers' various supply, distribution and fulfillment channels, allowing the customer to special order individual items from the retailers' total inventory no matter where it is located – which has significant logistical and profitability implications for retailers**
  - The traditional "push" distribution systems – regular bulk shipments of replenishment goods from a central warehouse to an established store network in anticipation of demand – are the most efficient and profitable

The Mobile "Tipping Point" and the Role of the Store in the Omni-Channel Balancing Act

- In omni-channel, however, every order is a special order, and special orders are more costly to fulfill – "pulling" individual items from the retailers' inventory, requires the retailer to locate and pack each item separately and then ship to an endless list of addresses, increasing inventory management, picking, shipping and personnel costs
- Split orders and returns are especially costly challenges in omni-channel – approximately 15-30% of all online orders shipped to homes are returned; while profitable for UPS and Fedex, these "reverse logistics" are costly management challenges to retailers; returns to stores require additional staff time but generate additional store traffic and potential add-on sales

- **As such, quickly and efficiently fulfilling online sales through the store channel, regardless of where, when or how the original order is made, is critical to retailer profitability – finding the right balance between more profitable store sales and less profitable pure online sales will be a major challenge for the foreseeable future.**
- **Bottom-line … a well-designed, well-executed customer-centric omni-channel retail capability that generates profitable sales and drives store traffic is a critical component of a successful bricks and mortar retail business model**

E-Commerce - Black Friday/Cyber Monday
E-Commerce Metrics - 2015/2014
U.S. Sales[1]

	Thanksgiving 2015	Black Friday 2015	Black Friday 2015 vs. 2014	Cyber Monday 2015	Cyber Monday 2015 VS. 2014
Total U.S. Sales Increase Year Over Year	26.0%		21.5%		17.8%
Transaction Metrics:					
Items/Order	4.20	4.08	2.77%	3.97	(2.7%)
Average Order Value	$123.45	$127.84	(1.18%)	$123.43	(0.63%)
Conversion Metrics:					
Conversion Rate	3.65%	4.20%	6.33%	5.37%	4.27%
New Visitor Conversion Rate	2.70%	3.26%	2.69%	4.39%	6.04%
Shopping Cart Sessions	14.63%	15.36%	14.63%	17.17%	14.09%
Shopping Cart Abandonment Rate	75.18%	72.81%	0.52%	68.95%	(0.83%)
Session Traffic Metrics:					
Average Session Length	8:26	8:44	3.56%	8:39	2.17%
Bounce Rate	32.40%	31.26%	(0.35%)	30.41%	(1.39%)
Browsing Sessions	49.52%	50.60%	6.19%	52.60%	6.59%
Page Views Per Session	8.64	8.76	4.66%	8.71%	3.69%
Mobile Metrics:					
Mobile % of Sales	40.03%	36.16%	27.56%	27.64%	25.67%
Mobile % of Site Traffic	59.81%	57.19%	15.23%	47.94%	16.33%
Mobile Bounce Rate	34.18%	33.57%	(3.48%)	33.63%	(4.08%)
Mobile Conversion Rate	2.82%	2.97%	12.08%	3.56%	9.54%
Smartphone Traffic	NA	44.7%	28.8%	36.8%	29.1%
Tablet Traffic	NA	12.5%	(14.4%)	11.1%	(11.2%)

[1]Sales from 800 U.S. Retail websites
Source: IBM Watson Trend

Quotes from the Front – Role of the Store in Ecommerce and Omni-Channel Retail

- **"Everyone is focused on e-commerce development. What we're seeing now is that…e-commerce probably contributes to about 10% of retail sales…and a lot of this growth actually is coming at the expense of profits, a lot of e-commerce…is still growing the top-line but may not be profitable, but the market is actually tolerating that. And that really creates an unlevel playing field for a lot of brick and mortar companies with a different business model and different financial model, but that's the reality they have to face at the moment." (Li & Fung)**
- **"We'll continue to invest in video content. We'll continue to invest in fulfillment space to handle higher and higher paid unit volumes and shipped unit volumes…[W]e'll continue to invest in getting faster and faster shipping methods for our customers. We believe that's working… As far as long long-term operating margins, I can't forecast that right now." (Amazon)**
- **"…you're going to see us be very thoughtful and mindful of how we grow e-commerce and make sure that whatever we do is accretive and isn't destructive…we'll…always be having an eye towards, as we ramp that penetration up, is it cannibalizing our existing store base? So far, it's hard to say it has, but certainly there's a break even point in there somewhere." (Francesca's)**
- **"…we really run the business agnostic to those channels…because it's how our customers shop…full-line stores and e-commerce, there's so much overlap between those businesses, and that is increasing…one example…, the store reserve,…is a very...seamless experience that connects a shopping journey that starts online and ends up in a store. We know that's how lots of our customers have been shopping, but they start online and when they go in the store and want to actually touch it, feel it, try it on, they have to start over. This allows them not to start over. So a lot of our initiatives are around continuing to take out friction between the channels…." (Nordstrom)**

Quotes from the Front – Role of the Store in Ecommerce and Omni-Channel Retail

- “So, first, the teenagers tell us they still like to go to stores. And that is confirmed by the independent research and it’s confirmed by our mix of sales between stores and online. They will do, no surprise, a lot more research online. So when you see a decline in traffic, we have always assumed over the last several years a lot of that is the window shopping aspect, the first step of shopping. And the fact we have been comping up on lower traffic with better conversion is a good fit with that.” (Genesco)
- “…where we have a bricks and mortar presence or have established a new bricks and mortar presence, it drives increased demand on digital. So having the brand awareness within the marketplace represented by a bricks and mortar store is driving an entire omni-channel experience that’s driving incremental sales within that marketplace.” (American Eagle)
- “We offer reserve online, pick-up in-stores in 100 stores…[C]urrently we are experiencing a 3 to 1 attachment rate to the units being reserved online. Our next omni-channel capability, buy online, pick-up in store is scheduled to be launched in the second quarter of 2017.” (The Children’s Place)
- “..we are seeing a lot of returns from DTC coming into the stores and we’re clearing some of those returns through pick, pack and ship…so we have some markdown pressure…[T]he reality is if the customer wants to return a DTC purchase to the store, there…can be an incremental benefit for us because not only does it drive traffic, it gives her another opportunity to…interact with the brand, and oftentimes we’re able to convert her.” (Urban Outfitters)
- “This quarter, online sales grew over 17% and represented 5.6% of overall sales. Over 40% of our online orders are picked up in the store which we view as a positive sign of our physical stores’ continued relevance with our customers.” (Home Depot)

Quotes from the Front – Role of the Store in Ecommerce and Omni-Channel Retail

- **"We've learned, as I hope you have, guests still like physical stores. And year-to-date still almost 90% of all retail shopping is taking place in a physical store. So we've got to make sure we've got a great experience, we've got great service, we continue to elevate that experience and service…but we're also continuing to make investments online and we want to make sure we continue to give guests the choice of shopping anyway they want…leveraging our stores as flexible fulfillment centers…to deliver the last mile." (Target)**
- **"…well over 1,000 of our stores are shipping directly to our guests…accounting for a third of our digital volume during the peak period from Thanksgiving through Cyber Monday…this capability reduces shipping times given the proximity of these stores to the vast majority of the U.S. population. With that proximity to guests we also save on shipping, helping to relieve pressure from shipping growth on our P&L. It also allows us to balance inventory across our store network, maintaining in-stocks while reducing mark-downs and store locations with heavy inventory." (Target)**
- **"…when you look at the ecommerce market, it could be one in five or one out of every six packages that are shipped to a consumer get returned…[T]hose packages are highly profitable. First of all, many of those packages get dropped off and don't have to be picked up because the consumer finds it more convenient to drop them off at UPS stores…or hand them to a UPS driver. So there's little cost when it comes to pick-up. And then, obviously the deliveries are going back to businesses, and we could be delivering tens or hundreds of packages back to these businesses. So it's a highly profitable B2B delivery with very little pick-up cost." (UPS)**

The Millennials – Will They, Can They, Spend Like the Boomers?

- **While definitions vary widely, and the census has yet to issue an "official" definition, Millennials are generally considered to be the age cohort born between 1980 and the early-mid 2000s – 15-35 year olds**
- **Millennials are the largest, most diverse generation in the U.S. population, numbering over 87 million and representing one-third of the total population**
  - Compared to the 76 million member Baby Boom generation, Millennials are more diverse, more highly- educated and have come of age in one of the difficult economic situations since the 1930s – as the Council of Economic Advisers noted in an October 2014 report, "…perhaps the most important marker for Millennials is that many of them came of age during a very difficult time in our economy, as the oldest Millennials were just 27 years old when the recession began…while the economy is well into its recovery, the recession still affects lives of Millennials and will likely continue to do so…Millennials are…the generation that will shape our economy for decades to come…"
  - As such, Millennials faced substantial challenges entering the labor force and establishing careers – while they have experienced a substantial recovery in employment, the early challenges have forced many to delay home ownership, families and the spending that comes along with those life phases – unlike their Baby Boom predecessors who entered a world of relative opportunity
- **At same time, Millennials have come-of-age during the information revolution and have lived with computers, the internet and smartphones much of their lives – a world in which the "frontiers" of technology appear unlimited**
  - Millennials use social media more frequently, and are more likely to sleep near their smartphones
- **Recent analysis by the Pew Research Center found that for the first time since 1880, the share of 18- to 34- year olds living at home with their parents – 32.1% - was greater than most common historic living arrangement – living with a spouse or partner in their own household – 31.6%**
  - Living with a spouse or partner peaked in 1960 when over 60% of 18- to 34-year olds lived in this setting, since that time 18- to 34- year olds have gotten married later (20.1 years for women and 22.5 years for men versus 27.1 years for women and 29.2 years for men today)

The Millennials – Will They, Can They, Spend Like the Boomers?

  - Living at home with parents has been the dominant living arrangement for 18- to 34-year old men, particularly unemployed young men, since 2009
  - These findings demonstrate that Millennials are forming fewer households, form them later than Boomers, and delay the expenditures that accompany household formation
- **While Millennials are highly educated, they have borrowed heavily for their educations, with 42 million students owing over $1.3 trillion in total student loans with an average balance in excess of $30,000 – in recent research, Fitch Ratings found that homeownership rates for those under 35 years old have declined from 41% in 2000 to 34% in 2016, noting that stagnant incomes, increasing home prices, and student debt burdens "could be key factors constraining home ownership and may weigh on long term consumption growth"**
- **Observers continue to assert that Millennials prefer online shopping and avoid the malls – points which ignore two key issues:**
  - Having come of age and entered the work force in the wake of the Great Recession, with higher student debt burdens, lower incomes and limited growth prospects, Millennials are clearly more budget constrained and money conscious than previous generations, and they readily use technology to save time and money
  - By delaying families and home ownership, Millennials favor cities and metropolitan areas away from the major shopping venues found in more suburban, bedroom communities – likewise spending more on rent and less on goods needed to furnish their own home and raise kids
- **Survey data prepared by the UBS Evidence Lab indicate that Millennials spend more on clothing, shop more online and also visit malls more frequently than non-Millennials, making them the preferred current, and potentially lucrative future, customers for omni-channel retailers**
  - Millennials spend an average of $126 on clothing per month, 30% more than the average consumer, and visit the mall 1.7 times per month (which has been increasing), well above the 0.8 trip frequency for non-Millennials – while Millennials buy 50% more of their apparel purchases online, the fact they purchase both online and in-store makes them a retailers' most desired customer

What's on Your Millennial's Holiday List?

2016 Holiday Preferred

iPhone 7 with regular display 128GB	$750
One Year data plan ($70/mth)	$840
Total (One Gift!)	$1,590

2016 Holiday - Guys' Wardrobe from A&F	
Classic Parka	$180
4 Heathered Oxford Shirt ($48/shirt)	$192
4 Plaid Mix Shirts ($34.80/shirt)	$138
4 Iconic V-Neck Sweaters ($29/sweater)	$116
4 Jersey Knot Henleys ($38/shirt)	$232
4 Classic Straight Jeans ($39.00/pair)	$156
2 Pair Eastland High Fidelity Cap Toe Boots	$240
2 Pair Converse All Star High Top Sneakers	$170
6 Pair Boxer Briefs ($12/pair)	$72
6 Pair Casual Crew Socks ($6/pair)	$36
2 Pair Classic Sleep Pants ($28.80/pair)	$58
1 Starbucks Tall Dark Roast Coffee	$2
Total - 41 Items	$1,592

2016 Holiday - Gals' Wardrobe from H&M	
2 Wool-Blend Coats ($149/coat)	$298
5 Denim Shirts ($34.99/Shirt)	$175
4 Plaid Flannel Shirts ($24.99/shirt)	$100
5 Cable-Knit Sweaters ($49.99/Sweater)	$250
4 Classic Sweatshirts ($24.99/Shirt)	$100
5 Straight Regular Jeans ($39.99/pair)	$200
2 Pair Lace-Up Boots ($39.99/boot)	$80
1 Pair Premium Suede Boots	$99
5 - 3 packs Hipster Briefs ($14.99/pack)	$75
8 Pair Jacquari Knit Socks ($9.99/pair)	$80
4 Pair Fleece Pajamas ($29.90/pair)	$120
2 Starbucks Vente Lattes ($7/cup)	$14
Total - 47 Items	$1,590

Quotes from the Front – Millennials and Boomers

- "Millennials are the driving force behind digital adoption and…our core customer is a Millennial Mom. They are digitally savvy and have grown up with technology resulting in a high comfort level with digital and social engagement…We know that our customers spend significantly more when using digital devices, so ensuring a seamless brand experience is more important than ever." (The Children's Place)
- "For the first time in more than 130 years, adults aged 18-34 were slightly more likely to be living in their parents' home than they were to be living with a spouse or partner in their own household. This turn of events is fueled primarily by the dramatic drop in the share of young Americans who are choosing to settle down romantically before age 35." (Pew Research Center)
- "Dating back to 1880, the most common living arrangement among young adults has been living with a romantic partner…[T]his type of arrangement peaked around 1960, when 62% of the nation's 18- to 34-year olds were living with a spouse or partner in their own household, and only one-in-five were living with their parents. By 2014, 31.6% of young adults were living with a spouse or partner in their own household, below the share living in the home of their parents – 32.1%." (Pew Research Center)
- "For men ages 18-34, living at home with mom and/or dad has been the dominant living arrangement since 2009…Employed young men are much less likely to live at home than young men without a job, and employment among young men has fallen significantly in recent decades. The share of young men with jobs peaked around 1960 at 84%. In 2014, only 71% of 18- to 34- year-old men were employed. Similarly, with earnings, young men's wages (after adjusting for inflation) have been on a downward trajectory since 1970 and fell significantly from 2000 to 2010." (Pew Research Center)
- "Young adults never married as young as they did around 1960 and they have not married as young ever since…the median age at first marriage reached a record low in 1956 at 20.1 years for women and 22.5 years for men…[T]oday the typical age at first marriage is 27.1 years for women and 29.2 years for men." (Pew Research Center)

Holiday 2016 Retail Tour – The Retailers Report

- **Four dimensional tour – venue, retail segment, performance since 2007, and customer base**
  - Venue and retail segment
    - Apparel in the mall – teen, family, women's and department store
    - Power center across the street – mass merchant, off-price apparel, home improvement and electronics
    - Warehouse clubs and dollar stores
  - Summary performance metrics
    - Net sales, gross margin and operating income
    - Number of stores, comparable sales and percent of sales from DTC channel
  - Historic performance through three retail "eras" since 2007
    - 2007 – end of the "Go-Go" years – high margins, sales and unit growth fueled by home appreciation induced debt
    - 2008-2010 – the "OMG" years – bottom falls out of housing market, debt crisis ensues, massive unemployment and the Great Recession is on – retailers hoard cash and watch profit margins plummet as they cut prices to clear bloated inventories amidst a massive pull-back in consumer spending
    - 2011-Present – "hunker down"/"control what we can" mindset – re-engineer business model and supply chain systems to carefully manage size, content, accuracy and flow of inventory; lower SG&A comp leverage point to maintain profits in light of tepid, erratic sales trends; test, invest, and implement new technology to catch-up with consumers' adaptation of rapidly improving mobile search and online purchase capabilities; create a seamless shopping experience across all channels (store, online, outlet) that reduces "channel friction" while protecting profitability; rationalize and re-think store network and role as both fulfillment and return centers; bolster balance sheet, shed debt and buy back shares; and wait/hope for sales growth to resume – someday – but don't count on it!!!

Holiday 2016 Retail Tour – The Retailers Report

- Customer Base…and the cars in the parking lot
  - Mall – middle-to-upper income Boomers, Millennials and their kids – newer cars
  - Power Center – lower-to-middle income families, increasingly older Millennials – newer cars, old cars and trucks
  - Warehouse/Dollar Store – lower-to-middle with many receiving some form of government assistance – old cars and trucks

- **Key Takeaways**
  - While commentators and the press are obsessed with mobile, ecommerce and online sales, the retailers that generate the vast majority of sales in the U.S. obsess about operating margins, inventories and profitable sales.
  - Retail profit margins fell dramatically as top line sales plummeted during the recession, and while most have engineered gradual recoveries, operating margins for specialty retailers, with notable exceptions, appear to have ratcheted down permanently
    - While specialty retailers routinely generated high teen to low twenties operating margins before 2008, they are now laser- focused on achieving sustainable upper single digit to mid-teens operating margins, without the benefit of sales growth
    - Aside from off-price, value retail, and a handful of emerging specialty concepts, net new store growth has slowed dramatically as retailers rationalize their fleets, focus on renovations that incorporate new omni-channel capabilities (order/reserve online, pick-up or ship from store) that deliver a seamless shopping experience, and balance their more profitable in-store channel with their less profitable online channel
    - In contrast, larger, more established mass merchants have regained and maintained relatively stable operating margins, while off-price retailers, including Ross, TJX and the dollar stores, have steadily grown margins

Holiday 2016 Retail Tour – The Retailers Report

- The two major margin challenges are, first and foremost, income constrained, value-oriented consumers that, through sheer necessity, honed by years of shopping promotions – and now armed with powerful mobile search apps – “wait out” the bargains and never pay “full price”; and second, Amazon, the standalone online retailer that, with seemingly unlimited funding, is building a massive “parallel retail universe” that has yet to produce, much less forecast, meaningful or sustainable operating profits - a business model retailers can’t replicate and their investors won’t tolerate
  - Online – DTC, or “Direct to Customer” – sales generate lower profit margins due to shipping costs (both fulfilling purchases and processing the 15%-30% of purchases that are returned), price matching the ensures a “race to the bottom” on price for commodity product, and their use as a clearance channel, and also require significant investments in the rapidly changing, often unproven technology needed to operate more complex supply and distribution systems – as a result, retailers with significant online operations (Nordstrom for example) face growing margin headwinds, while those with minimal online businesses (Ross, Costco and Dollar General) have maintained solid profit margins
- With notable exceptions, total sales for retailers serving middle- and upper-income consumers (everyone from American Eagle and the GAP to Target and Walmart) have barely budged since 2007, with the vast majority of sales growth going to branded off-price retailers (Ross, TJ Maxx), dollar stores, warehouse clubs, and most recently home improvement chains – with improving margins
  - The shift in sales to lower margin, value and off-price retailers clearly reflects stagnant incomes and constrained household budgets for the majority of American consumers
  - Notably, much of Nordstrom’s growth has come from its roll-out of Nordstrom Rack while the major driver behind JC Penney’s recovery has been returning to its roots serving value oriented middle and lower income consumers

Holiday 2016 Retail Tour – The Retailers Report

- Masked in the margin and sales challenges are the strong cash flows that mature, well-established retailers generate, reflecting more operational efficiency, "right-sized" profitable store networks, restrained capital spending, reduced debt burdens, and, most importantly, leaner, higher quality inventories with improved flow and edited assortments
  - Retail capital spending has generally been divided between systems and infrastructure improvements – inventory tracking, distribution facilities and supply chain – store upgrades, and stock buybacks, with "back of the house" efficiency improvements taking precedence over new stores, which were the primary pre-recession growth drivers
  - Stock buyback activity for these retailers continues to be significant – in the third quarter, Lowe's, Home Depot, Target, Walmart and TJX collectively repurchased over $5.3 billion of their respective shares, and are well on their way to completing nearly $24 billion of share repurchases in the current fiscal year
- Many full-price teen, family and moderate women's apparel stores – traditional mainstays of the mall sector – have seen their operating margins cut by as much as half, with the consolidating teen retail sector experiencing a second wave of margin compression as it faces a smaller, income-constrained customer base with little cash left after buying smart phones and sneakers for new clothes, while the women's business faces similar challenges compounded by a prolonged absence of new "must have" fashion
  - Stronger performers, such as L Brands (Victoria's Secret, Bath & Body Works), Lululemon and Footlocker, have bucked the trend with solid margins and steady sales growth, based on fresh, innovative fashion, carefully managed store growth that delivers a curated in-store experience, and steadfast emphasis on brand integrity
- In the department store sector, JC Penney is methodically engineering a solid comeback after a disastrous attempt to upscale its offering that alienated its traditional value oriented customer in favor of an elusive, upper moderate customer that never showed up

Holiday 2016 Retail Tour – The Retailers Report

  - Nordstrom, widely considered a leader in customer-centric omni-channel retailing, has moved aggressively into the value business with Nordstrom Rack (their version of TJMaxx), measures that have created margin headwinds as the company balances its more profitable full-price store base with its less profitable online and value sales
  - Sears remains mired in a long overdue downsizing, complicated by serious, deep rooted problems at its K-Mart division
  - Macy's recently announced 100 store closure plan is healthy and long overdue - the company has been over-stored since its merger with the May Company, and many of its older stores cannot compete with off-price retailers
- Big Box margins have stabilized at slightly lower levels – again with modest net new store growth – with mass merchants Target and Walmart steadily regaining their footing in the face of Amazon, anxious customers, pullbacks from ill-fated forays into Canada and small market grocery concepts, and execution errors – notably out-of-stocks on basics as they reduced inventories; meanwhile, Home Depot and Lowe's have benefited from slowly recovering home sales and values, while Best Buy's significant investments in customer service and omni-channel capabilities have begun to offset continued deflationary pressure and intense online competition in electronics and appliances
- Off-price apparel retailers – TJMaxx, Ross, Burlington Coat Factory and Nordstrom Rack – continue to profit from excess inventories in the branded apparel channel, utilizing "pack away" to buy steeply discounted name-brand apparel and then gradually flowing these goods back out to stores as warranted by customer demand – with no compelling need for an online presence, solid customer demand and growing sales at solid margins, off-price is achieving the profit margins that specialty retailers are working to regain

Holiday 2016 Retail Tour – The Retailers Report

- Net sales, profit margins and store counts for dollar stores and warehouse clubs continue to grow at an unprecedented pace – Dollar General sales have doubled since the advent of the Great Recession – to nearly $22 billion – making it one of the fastest growing retailers in the U.S., while Costco's sales have increased by over $54 billion over that time, nearly double the combined 2016 sales of Nordstrom and JC Penney; notably, neither Costco or Dollar General have a meaningful online presence
- Many retailers no longer report DTC sales separately – opting instead to include online sales in "comparable store sales" to reflect their omni-channel strategies
  - DTC sales for off-price, mass merchants, and warehouse stores considerably lower in comparison to specialty retail – while reporting is spotty, most report DTC sales of less the 3% of total sales

Holiday 2016 Retail Tour: Specialty Retailers – Teens

American Eagle Outfitters	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$3.055	$2,989	$2,967	$2,968	$3,120	$3,476	$3,306	$3,283	$3,522	$3,641
Gross Margin %	46.6%	39.3%	39.3%	39.5%	36.7%	40.0%	34.6%	35.2%	37.0%	37.9%
Operating Income %	19.6%	10.1%	9.6%	10.7%	9.4%	12.4%	7.1%	6.3%	9.1%	9.8%
Number of Stores	987	1,098	1,103	1,086	1,090	1,044	1,066	1,056	1,047	1,058
% Comp Sales	1.0%	(10.3%)	(3.6%)	(1.0%)	3.0%	7.0%	(7.0%)	(6.0%)	7.0%	1.5%
% Sales DTC	8.0%	10.3%	11.6%	11.3%	12.3%	13.4%	N/A*	N/A*	N/A*	N/A*

Abercrombie & Fitch	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$3,750	$3,540	$2,962	$3,469	$4,158	$4,511	$4,117	$3,744	$3,519	$3,352
Gross Margin %	67.0%	66.7%	64.6%	63.8%	61.3%	62.4%	62.6%	61.8%	61.9%	61.3%
Operating Income %	19.7%	12.4%	5.1%	8.3%	5.3%	8.3%	5.4%	5.1%	3.9%	0.7%
Number of Stores	1,035	1,125	1,096	1,069	1,045	1,051	1,066	969	932	937
% Comp Sales	(1.4%)	(13.3%)	(22.9%)	7.3%	5.0%	(1.4%)	(11.3%)	(8.0%)	(2.7%)	(4.9%)
% Sales DTC	7.9%	8.6%	9.7%	11.7%	13.3%	15.5%	18.9%	22.2%	24.0%	25.0%

Tilly's	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$246	$255	$ 283	$333	$401	$467	$496	$518	$551	$573
Gross Margin %	37.2%	32.5%	30.9%	30.9%	32.2%	32.1%	30.4%	30.0%	30.4%	29.9%
Operating Income %	16.0%	9.3%	7.6%	7.5%	8.7%	8.3%	6.0%	4.5%	3.5%	3.4%
Number of Stores	73	99	111	125	140	168	195	212	224	225
% Comp Sales	8.7%	(12.5%)	(3.1%)	6.7%	10.7%	2.3%	(1.9%)	(2.8%)	0.7%	1.0%
% Sales DTC	5.0%	6.0%	8.0%	9.9%	10.9%	11.3%	12.0%	11.3%	10.9%	10.8%

*Sales from online channels included in store sales

Holiday 2016 Retail Tour: Specialty Retailers – Family Apparel

The Gap	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$15,772	$14,526	$14,197	$14,664	$14,549	$15,651	$16,148	$16,435	$15,757	$15,450
Gross Margin %	36.1%	37.5%	40.3%	40.2%	36.2%	39.4%	39.0%	38.3%	36.3%	35.9%
Operating Income %	8.3%	10.7%	12.8%	13.4%	9.9%	12.4%	13.3%	12.4%	10.3%	8.6%
Number of Stores	3,167	3,149	3,095	3,068	3,038	3,095	3,164	3,280	3,275	3,296
% Comp Sales	(4.0%)	(11.5%)	(3.0%)	1.0%	(4.0%)	4.8%	2.2%	0.0%	(4.0%)	(3.0%)
% Sales DTC	5.8%	7.1%	7.9%	8.9%	10.7%	12.0%	14.0%	15.2%	N/A*	N/A*

Urban Outfitters	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$1,508	$1,835	$1,938	$2,274	$2,474	$2,795	$3,087	$3,323	$3,446	$3,576
Gross Margin %	38.3%	38.9%	40.6%	41.2%	34.8%	36.9%	37.6%	35.4%	34.9%	35.4%
Operating Income %	14.9%	16.3%	17.5%	18.2%	11.5%	13.4%	13.8%	11.0%	10.3%	9.9%
Number of Stores	245	293	326	371	427	472	507	544	572	598
% Comp Sales	5.5%	8.0%	(3.4%)	4.3%	(3.8%)	(0.8%)	6.0%	2.0%	2.0%	1.0%
% Sales DTC	13.6%	14.9%	16.7%	19.1%	20.4%	23.7%	24.0%	N/A*	N/A*	N/A*

*Sales from online channels included in store sales

Holiday 2016 Retail Tour: Specialty Retailers – Women's Apparel

Ann Taylor**	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$2,397	$2,195	$1,829	$1,980	$2,212	$2,376	$2,493	$2,533	$2,455	$2,362
Gross Margin %	52.2%	48.1%	54.4%	55.8%	54.6%	54.8%	53.9%	51.0%	52.5%	N/A**
Operating Income %	6.5%	(16.9%)	1.5%	6.3%	6.8%	7.0%	6.8%	5.3%	7.3%	7.2%
Number of Stores	929	935	907	896	953	984	1,025	1,030	1,022	1,010
% Comp Sales	(3.3%)	(14.8%)	(17.4%)	10.7%	6.8%	3.3%	2.3%	(1.9%)	(3.0%)	(3.0%)
% Sales DTC	5.0%	6.0%	6.6%	9.6%	11.2%	12.4%	12.8%	N/A*	N/A*	N/A*

L Brands	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$10,134	$9,043	$8,632	$9,613	$10,364	$10,459	$10,773	$11,454	$12,154	$12,552
Gross Margin %	34.6%	33.2%	35.1%	37.8%	39.1%	41.9%	41.1%	42.0%	42.8%	41.3%
Operating Income %	11.0%	6.5%	9.9%	13.4%	11.9%	15.0%	16.2%	17.1%	18.0%	16.5%
Number of Stores	2,926	3,014	2,971	2,968	2,941	2,876	2,923	2,969	3,005	3,073
% Comp Sales	(2.0%)	(9.0%)	(5.0%)	9.0%	10.0%	6.0%	2.0%	4.0%	5.0%	2.0%
% Sales DTC	13.8%	16.8%	16.1%	15.6%	15.0%	17.3%	16.4%	15.8%	15.8%	16.4%

*Sales from online channels included in store sales
**Ann Taylor acquired by Ascena Retail Group August 2015

Holiday 2016 Retail Tour: Department Stores

J.C. Penney	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$19,860	$18,486	$17,556	$17,759	$17,260	$12,985	$11,859	$12,257	$12,625	$12,703
Gross Margin %	38.6%	37.4%	39.4%	39.2%	36.0%	31.3%	29.4%	34.8%	36.0%	36.0%
Operating Income %	9.5%	6.1%	3.8%	4.7%	0.0%	(10.1%)	(12.0%)	(2.5%)	0.3%	3.0%
Number of Stores	1,067	1,093	1,108	1,106	1,112	1,117	1,094	1,062	1,024	1,024
% Comp Sales	0.0%	(8.5%)	(6.3%)	2.5%	0.2%	(25.2%)	(7.4%)	4.4%	4.5%	1.2%
% Sales DTC	N/A	N/A	N/A	8.6%	8.8%	7.9%	9.1%	10.0%	11.2%	11.9%

Nordstrom	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$8,828	$8,272	$8,258	$9,310	$10,497	$11,762	$12,166	$13,110	$14,095	$14,582
Gross Margin %	37.4%	34.5%	35.5%	36.7%	37.2%	36.8%	36.4%	35.9%	35.0%	34.5%
Operating Income %	13.7%	9.1%	9.7%	11.5%	11.5%	11.0%	10.8%	9.8%	7.8%	6.4%
Number of Stores	156	169	184	204	225	240	260	292	323	349
% Comp Sales	3.9%	(12.4%)	(3.6%)	8.1%	7.2%	7.3%	2.5%	4.0%	2.7%	0.1%
% Sales DTC	5.1%	5.8%	6.8%	7.6%	8.7%	10.8%	13.3%	15.2%	18.0%	20.0%

Holiday 2016 Retail Tour: Big Box Stores

Target (US Segment)	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$63,368	$64,948	$65,357	$65,787	$68,466	$71,960	$71,279	$72,618	$73,785	$69,964
Gross Margin %	30.2%	29.8%	30.5%	30.5%	30.1%	29.7%	29.8%	29.4%	29.5%	30.0%
Operating Income %	8.3%	6.8%	7.1%	8.0%	7.8%	7.3%	5.7%	6.2%	6.7%	7.4%
Number of Stores	1,591	1,682	1,740	1,750	1,763	1,778	1,793	1,790	1,792	1,795
% Comp Sales	3.0%	(2.9%)	(2.5%)	2.1%	3.0%	2.7%	(0.4%)	1.3%	2.1%	0.0%
% Sales DTC	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Ross Stores	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$5,975	$6,486	$7,184	$7,866	$8,608	$9,721	$10,230	$11,042	$11,940	$12,813
Gross Margin %	22.7%	23.6%	25.8%	27.2%	27.5%	27.9%	28.0%	28.1%	28.2%	28.6%
Operating Income %	7.0%	7.6%	10.1%	11.5%	12.4%	13.1%	13.1%	13.5%	13.6%	13.9%
Number of Stores	890	945	995	1,042	1,103	1,181	1,276	1,362	1,446	1,530
% Comp Sales	1.0%	2.0%	6.0%	5.0%	5.0%	6.0%	3.0%	3.3%	4.0%	3.6%
% Sales DTC*	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM

*Online sales not meaningful – less than 1%

Holiday 2016 Retail Tour: Big Box Stores

Home Depot	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$77,349	$71,288	$66,176	$67,997	$70,395	$74,754	$78,812	$83,176	$88,519	$94,015
Gross Margin %	33.6%	33.7%	33.9%	34.3%	34.5%	34.6%	34.8%	34.1%	34.2%	34.2%
Operating Income %	9.4%	6.2%	7.3%	8.6%	9.5%	10.4%	11.6%	12.6%	13.4%	14.1%
Number of Stores	2,234	2,274	2,244	2,248	2,252	2,246	2,263	2,269	2,274	2,277
% Comp Sales	(6.7%)	(8.7%)	(6.6%)	2.9%	3.4%	4.6%	6.9%	5.4%	5.6%	4.9%
% Sales DTC	N/A	N/A	N/A	N/A	1.8%	2.4%	3.5%	4.5%	5.0%	5.0%

Best Buy - Domestic	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$31,031	$33,328	$35,070	$37,314	$37,070	$37,615	$35,831	$36,055	$36,365	$36,476
Gross Margin %	24.5%	24.5%	24.6%	24.2%	25.1%	24.4%	22.5%	22.4%	23.0%	23.2%
Operating Income %	6.0%	6.0%	5.0%	5.6%	5.5%	4.9%	2.92%	3.7%	4.0%	4.2%
Number of Stores	873	971	1,107	1,192	1,317	1,503	1,495	1,448	1,416	1,395
% Comp Sales	4.1%	1.9%	(1.3%)	1.7%	(3.0%)	(1.6%)	(0.4%)	1.0%	0.5%	0.0%
% Sales DTC	N/A	N/A	N/A	N/A	N/A	7.2%	8.5%	9.8%	N/A	N/A

Holiday 2016 Retail Tour: Warehouse/Dollar Stores

Costco	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$70,977	$69,892	$76,255	$87,048	$97,062	$102,870	$110,212	$113,666	$116,073	$124,674
Gross Margin %	10.5%	10.8%	10.8%	10.7%	10.6%	10.6%	10.7%	11.1%	11.3%	11.3%
Operating Income %	2.7%	2.6%	2.7%	2.7%	2.8%	2.9%	2.9%	3.1%	3.1%	3.1%
Number of Stores	543	558	572	592	608	634	663	686	715	745
% Comp Sales	8.2%	(3.7%)	6.9%	9.8%	6.8%	5.5%	4.2%	1.0%	0.0%	3.1%
% Sales DTC*	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM

Dollar General	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Net Sales ($MM)	$9,495	$10,458	$11,796	$13,035	$14,807	$16,022	$17,504	$18,910	$20,369	$21,937
Gross Margin %	27.8%	29.3%	31.3%	32.0%	31.7%	31.7%	31.1%	30.7%	31.0%	30.8%
Operating Income %	2.7%	5.6%	8.1%	9.8%	10.1%	10.3%	10.0%	9.4%	9.6%	9.4%
Number of Stores	8,194	8,362	8,828	9,372	9,837	10,506	11,132	11,789	12,483	13,335
% Comp Sales	2.1%	9.0%	9.5%	4.9%	6.0%	4.7%	3.3%	2.9%	2.7%	0.7%
% Sales DTC*	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM

*Online sales not meaningful – less than 1%

U.S. Income Distribution

- **Income inequality in the U.S. has been growing steadily since the mid 70s, effectively transferring a 15% share of national income from the lower 90% of the income distribution to the top 10% over the last 35 years**
  - Within the top 10% of the income distribution, 2/3rds of the 15% share transfer went to the top 1%, effectively shifting 10% of national income from 90% of the population, which routinely spends all of its income on goods and services, to the very top of the income distribution, which spends comparatively little – recent research, based on more accurate and extensive data, show that the lost multiplier effect of this income shift has hampered overall economic growth and well-being
- **Following a brief pause during the depths of the Great Recession, income equality has accelerated to the point where Janet Yellen, Chair of the Federal Reserve Bank, noted in October 2014 that "income and wealth inequality are near their highest levels in the past hundred years" and that the "past few decades of widening inequality can be summed up as significant income and wealth gains for those at the very top and stagnant living standards for the majority"**
- **From 1944 to 1980, roughly 2/3rds of annual income (excluding capital gains) accrued to the bottom 90% of taxpayers while the remaining 1/3 accrued to the top 10% - this distribution allocated an historically high share of income to the bottom 90%, which, given this group's higher propensity to spend, set off an unprecedented era of prosperity and growth that became the essence of the "American Dream"**
  - While overall pre-tax income grew 95% for the population as a whole in the 35 years from 1946 to 1980, incomes grew 102% for bottom 50% and 105% for the middle 40% - while the top 10% received a much lower 79% increase in income
  - In the 35 years since 1980, however, the income share accruing to the bottom 90% has dropped to just over 50% while the share accruing to the top 10% has increased to nearly 50%; over that same time period, income has become even further concentrated in the top 1%, increasing from 8.2% of income in 1980 to over 19% in 2012

U.S. Income Distribution

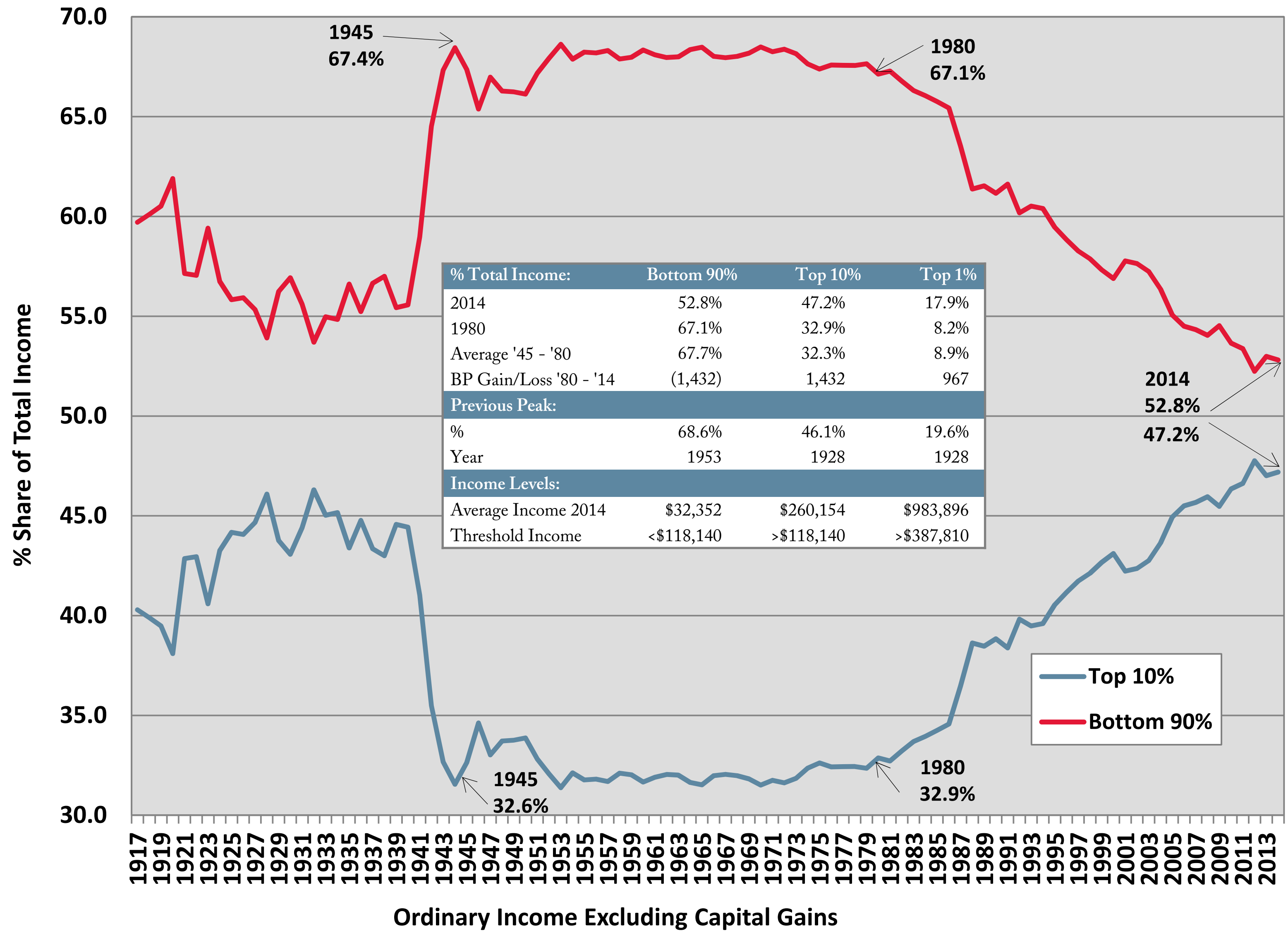
- From 1980 to 2014, overall pre-tax income growth grew at a much slower 61% rate and was far more unequally shared, with pre-tax incomes growing 1% for the bottom 50% of the income distribution, 42% for the middle 40% and an astounding 121% for the top 10%
- ***As such, the bottom half of the adult population – over 110 million wage earners – have been shut out of economic growth for the last 40 years, while the top 1% - just over 2.3 million workers – have seen their incomes double***
- Recent analysis by Piketty and Saez indicates that while post tax transfer payments improved income growth for the bottom 50% since 1980 from 1% to 21%, a closer analysis reveals that the majority of the transfer was health care benefits to older people in this income group, not disposable income

- **Recent analysis by the Federal Reserve found that families in the middle-to-upper income brackets (between 40% and 90%) saw little change in average real incomes since the end of the recession in 2010 and thus had failed to recover the losses suffered between 2007 and 2010 – at the same time families at the very top of the income distribution saw widespread gains**
- **Improving average household income and net worth is masking the effects of substantial income disparity as the vast majority of American shoppers are not benefitting from the recovery – not a new event as their fortunes have been in decline for quite sometime**
  - To make matters worse, the bottom 90% of the income distribution owes 73% of outstanding debt – the 90% effectively borrowed to compensate for stagnating wages, effectively “de-saving” in the years leading to the Great Recession, magnifying the effects of the downturn, dampening any recovery and clearly effecting retail sales and the retail landscape
- **Finally, recent research indicates that a key pillar of the American Dream – children having brighter futures and higher incomes than their parents – apparently is no longer true for 50% of the children born since the late 70s – where children born in 1940 had a 90% probability of earning more than their parents, by 1964 – the end of the Baby Boom generation - that probability had fallen to just over 50%**

U.S. Income Distribution

- **In this context, the slowdown in retail sales and lack of new shopping center construction, after a prolonged period of expansion up to 1990 driven primarily by the double income Boomer households, reflects what many retailers have known and reacted to for over 25 years: lower and middle income consumers – 90% of the U.S. population - are budget constrained with limited "wallet" for discretionary purchases and non-essentials**
  - Not surprisingly the "Golden Age" of mall development took place in the midst of the 1945-1980 time period when the middle class enjoyed a significant share of national income and steadily increasing wages – with the Baby Boom and suburbanization magnifying the multiplier effect
  - The next wave of retail development – Big Box, lower margin power centers - followed in the 90s as income disparity grew, income growth for the bottom 50% ended and grew only modestly for the middle 40% and the need for value to make ends meet became a necessity – most department stores adopted a heavily promotional strategy to drive sales
- **Given income disparity, the average household budget is extremely constrained and poorly understood – the widespread notion that savings from lower gas prices in 2015 would result in strong retail sales (they did not), reflects how poorly understood the average household budget is; bottom line there is not much left over for discretionary retail after the bills are paid**
  - According the BLS, the average "consumer unit" has an annual income of $69,630 – once taxes, housing costs, food, transportation and healthcare costs are accounted for, the average consumer unit has $154/month to spend on apparel and services
  - The median U.S. income is simply not adequate to sustain a "decent yet modest" standard of living for a family of four in most U.S. metros – to achieve a "decent yet modest" standard of living in New York, Milwaukee, Houston or even Grand Rapids requires annual incomes 15% to 40% higher than the local median income level
- **Retailers are well aware of this dynamic – they see more of America at the cash register in a day than most people see in a lifetime – and as such, without meaningful middle class wage growth, we should not expect a "break-out" in retail sales or new center construction outside of Dollar Stores or more affluent markets for the foreseeable future**

U.S. Income Distribution 1917-2014

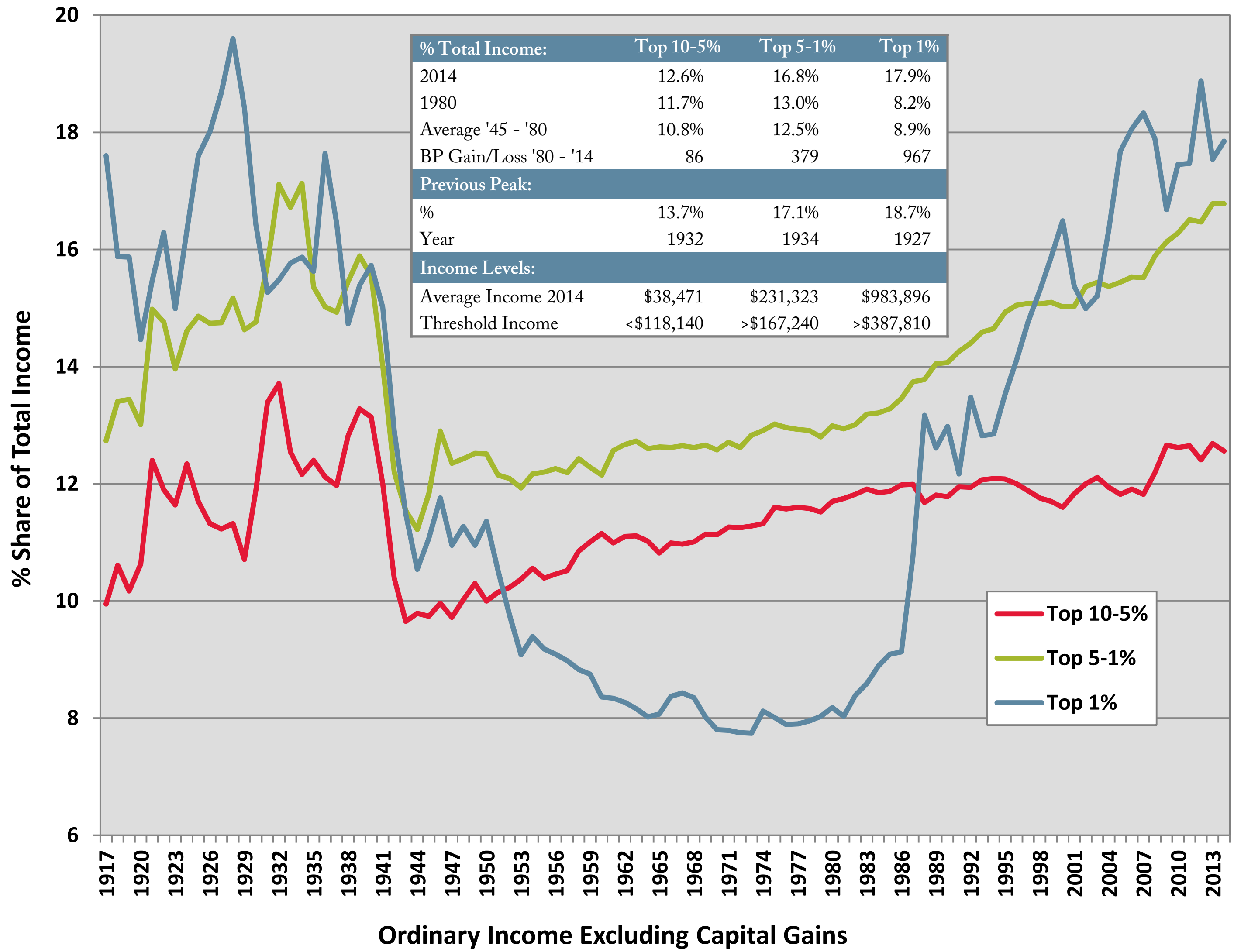


% Total Income:	Bottom 90%	Top 10%	Top 1%
2014	52.8%	47.2%	17.9%
1980	67.1%	32.9%	8.2%
Average '45 - '80	67.7%	32.3%	8.9%
BP Gain/Loss '80 - '14	(1,432)	1,432	967
Previous Peak:			
%	68.6%	46.1%	19.6%
Year	1953	1928	1928
Income Levels:			
Average Income 2014	$32,352	$260,154	$983,896
Threshold Income	<$118,140	>$118,140	>$387,810

Source: The World Wealth and Income Database

AEW

U.S. Income Distribution - The Top 10%



% Total Income:	Top 10-5%	Top 5-1%	Top 1%
2014	12.6%	16.8%	17.9%
1980	11.7%	13.0%	8.2%
Average '45 - '80	10.8%	12.5%	8.9%
BP Gain/Loss '80 - '14	86	379	967
Previous Peak:			
%	13.7%	17.1%	18.7%
Year	1932	1934	1927
Income Levels:			
Average Income 2014	$38,471	$231,323	$983,896
Threshold Income	<$118,140	>$167,240	>$387,810

Source: The World Wealth and Income Database

National Income

DISTRIBUTION OF NATIONAL INCOME IN THE U.S. IN 2014

Income Group	Number of Adults ('000)	Pre-Tax Income Average Income	Pre-Tax Income Income Share	Post-Tax Income Average Income	Post-Tax Income Income Share
Full Population	234,400.0	$64,600	100.0%	$64,600	100.0%
Bottom 50%	117,200.0	$16,200	12.5%	$25,000	19.3%
Middle 40%	93,760.0	$65,400	40.5%	$67,200	41.6%
Top 10%	23,440.0	$304,000	47.1%	$252,000	39.0%
Top 1%	2,344.0	$1,300,000	20.1%	$1,010,000	15.6%
Top 0.1%	234.4	$6,000,000	9.3%	$4,400,000	6.8%

GROWTH OF NATIONAL INCOME IN THE U.S. SINCE WWII

	Pre-Tax Income Growth		Post-Tax Income Growth	
Income Group	1946-1980	1980-2014	1946-1980	1980-2014
Full Population	95%	61%	95%	61%
Bottom 50%	102%	1%	130%	21%
Middle 40%	105%	42%	98%	49%
Top 10%	79%	121%	69%	113%
Top 1%	47%	205%	58%	194%
Top 0.1%	54%	321%	104%	299%

Source: Piketty/Saez/Zucman - Distributional National Accounts: Methods and Estimates for the United States - December 2, 2016

Average Expenditures and Income of All Consumer Units - 2015

INCOME

Item	Annual	Monthly	% Of Pre-Tax Income
Pre-tax Income	$69,629	$5,802	
Taxes	$13,651	$1,138	19.6%
After-tax Income	$55,978	$4,665	80.4%

EXPENSES

Item	Annual	Monthly	% Of Pre-Tax Income
Food	**$7,023**	**$585**	**10.1%**
Housing	**$18,409**	**$1,534**	**26.4%**
- Shelter	$10,742	$895	15.4%
- Utilities	$3,885	$324	5.6%
- Furnishings & Equipment	$1,818	$152	2.6%
Apparel & Services	**$1,846**	**$154**	**2.7%**
Transportation	**$9,503**	**$792**	**13.6%**
Healthcare	$4,342	$362	6.2%
- Health Insurance	$2,977	$248	4.3%
Entertainment	$2,842	$237	4.1%
Cash Contributions	$1,819	$152	2.6%
Insurance & Pensions	$6,349	$529	9.1%
All Other	$2,530	$211	3.6%
Food, Housing, Transport, HC & Insurance		**65.5%**	**81.5%**

Source: Bureau of Labor Statistics - August 2016

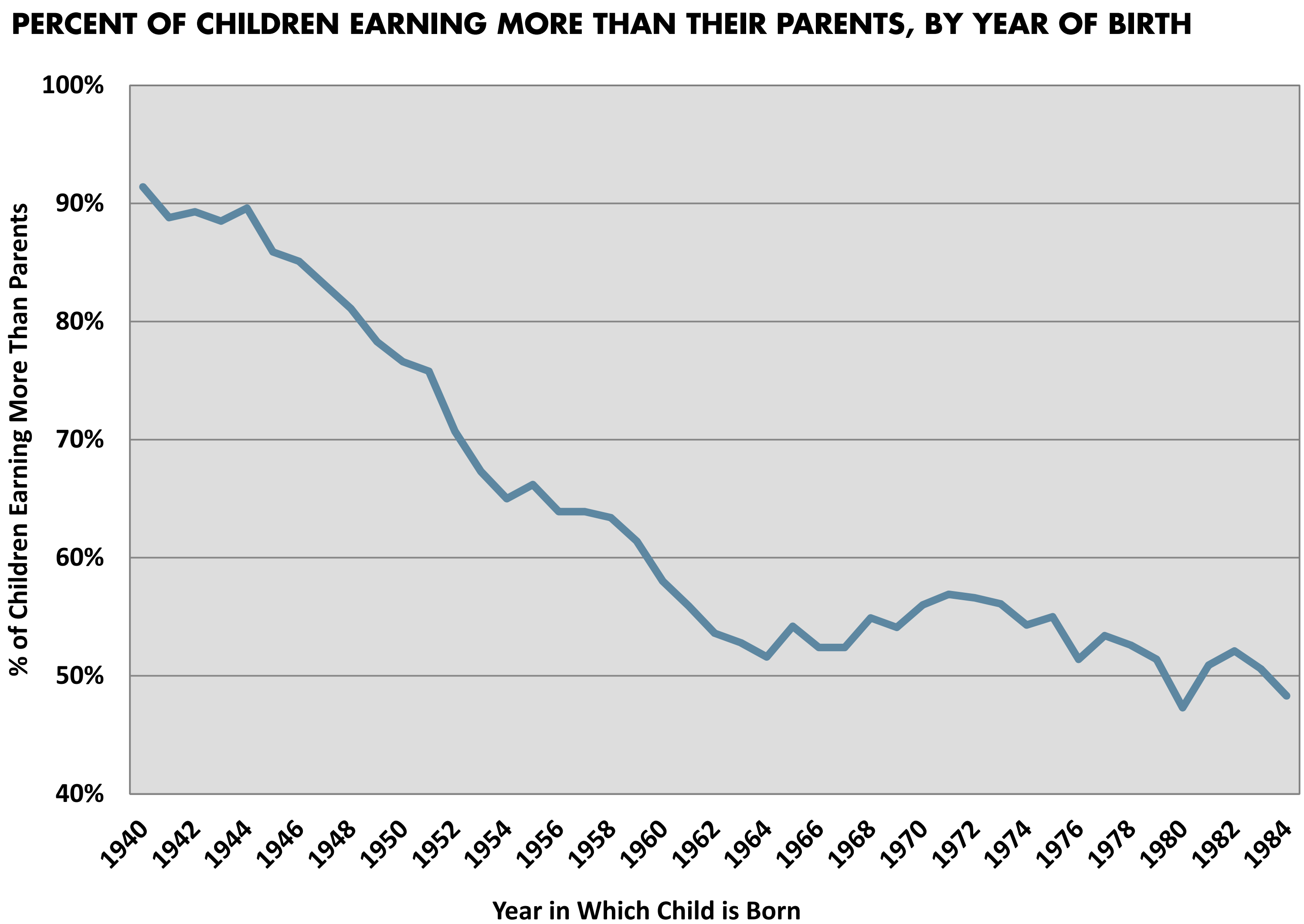
The Family Budget*

What Does a "Decent Yet Modest" Standard of Living Cost?

	New York		Milwaukee		Houston		Grand Rapids	
	$/Month	% Income	$/Month	% Income	$/Month	% Income	$/Month	% Income
Housing	$1,440	17.5%	$812	12.8%	$926	18.3%	$740	14.2%
Food	$782	9.5%	$782	12.3%	$782	15.5%	$782	15.0%
Child Care	$2,011	24.4%	$1,530	24.1%	$835	16.5%	$1,029	19.8%
Transportation	$583	7.1%	$608	9.6%	$583	11.5%	$620	11.9%
Health Care	$1,061	12.9%	$990	15.6%	$694	13.7%	$726	13.9%
Other Necessities**	$1,073	13.0%	$770	12.1%	$825	16.3%	$735	14.1%
Taxes	$1,277	15.5%	$850	13.4%	$407	8.1%	$577	11.1%
Monthly Budget	$8,227	100.0%	$6,342	100.0%	$5,052	100.0%	$5,209	100.0%
Annual Income	$98,724		$76,104		$60,624		$62,508	
Median Family Income	$63,740		$63,740		$63,740		$63,740	
Median - Decent SOL Gap	-35.4%		-16.2%		5.1%		2.0%	
SMSA Median Family Income	$59,265		$56,157		$51,046		$49,728	
Median - Decent SOL Gap	-40.0%		-26.2%		-15.8%		-20.4%	

*Assumes Two Parent, Two Child Family
**Necessities - apparel, entertainment, personal care expenses and household supplies & furnishings
Source: Economic Policy Institute - Family Budget Calculator
BLS - Consumer Expenditure Survey

Percent of Children Earning More Than Their Parents



Source - The Equality of Economic Opportunity Project

Quotes from the Front – U.S. Consumer

- **“The bottom half of the adult population has been shut off from economic growth for over 40 years, and the paltry increase in their disposable income has been absorbed by increased health spending.” (Piketty/Saez – “Distributional National Accounts: Methods and Estimates for the United States” December 2016)**
- **“The Economic Policy Institute has found that the Walton wealth was larger than the wealth of the bottom 40 percent of all American families combined in 2010.” (Joseph Stiglitz)**
- **“…we talk to our consumers each and every quarter…and as late as mid third quarter they were telling us that their sentiment, feeling is even more dire than it was in the previous quarter…[A]nd what they are citing…is the rising healthcare costs that they are facing…[A]nd then, rental costs continue and they call that out second…because most or our…core customers rent, don’t own, and those rents are going up across the nation at a pretty high rate.” (Dollar General)**
- **“The share of national income accruing to upper income groups has increased sharply in recent decades, particularly in the U.S. The top decile (10%) income share has risen from less than 35 percent during the 1970s to about 50 percent in recent years. The top percentile (1%) income share itself has more than doubled, from less than 10 percent in the 1970s to over 20 percent in recent years. As a consequence, low and middle incomes have grown much less than what aggregate GDP growth statistics would suggest.” (Piketty/Saez – “Top Incomes and the Great Recession: Recent Evolutions and Policy Implications”)**
- **“The Fed asked respondents how they would pay for a $400 emergency. The answer: 47 *percent* of respondents said that either they would cover the expense by borrowing or selling something, or they would not be able to come up with the $400 at all. Four hundred dollars! Who knew? Well, I knew because I am in that 47 percent…[M]any of us, it turns out, are living in a more or less continual state of financial peril. So if you really want to know why there is such deep economic discontent in America today, even when many indicators say the country is headed in the right direction, as a member of that 47 percent, ask me.” (Neal Gabler in The Atlantic)**

Quotes from the Front – U.S. Consumer

- “The average pre-tax income of the bottom 50% has stagnated since 1980 at about $16,000 per adult (…in constant 2014 dollars…) while the national average income has grown by 60% to $64,500 in 2014. As a result, the bottom 50% income share has collapsed from about 20% in 1980 to 12% in 2014. In the meantime, the average pre-tax income of top 1% adults rose from $420,000 to about $1.3 million, and their income share has increased from about 12% in the early 1980s to 20% in 2014…The top 1% income share is now almost twice as large as the bottom 50% share, a group by definition 50 times more numerous.” (Piketty/Saez – “Distributional National Accounts: Methods and Estimates for the United States” December 2016)
- “So it is true that rich people can spend more money than middle class people, but there’s this upper limit on what they can spend…My family can afford to go out to eat more than most American families, but not more than three times a day. We can’t go out 3,000 times a day…My family…owns a pillow company, and the pillow business is tougher because fewer and fewer people can afford to buy pillows. I earn a thousand times the minimum wage, but I can’t sleep on a thousand pillars. We need everyone to succeed to be able to afford a pillow every year…to have a successful pillow business, and concentrating wealth at the top essentially creates a death spiral of falling demand.” (Nick Hanauer)

Quotes from the Front – U.S. Consumer

- "People want to feel, need to feel, that they are advancing in the world. It is what sustains them. They need to feel that their lives will improve, and, even more, that the lives of their children will be better than theirs, just as they believed that their own lives would be better than their parents'. But people increasingly do not feel that way." (Neal Gabler in The Atlantic)
- "…children's prospects of earning more than their parents have faded over the past half century in the U.S. The fraction of children earning more than their parents fell from approximately 90% for children born in 1940 to around 50% for children entering the labor market today. Absolute income mobility has fallen across the entire income distribution, with the largest declines in the middle class…[M]ost of the decline in absolute mobility is driven by the more unequal distribution of economic growth in recent decades rather than the slowdown in GDP growth rates…[I]f one wants to revive the "American Dream" of high rates of absolute mobility, then one must have an interest in growth that is spread more broadly across the income distribution." (Chetty, Grusky et al – "The Fading American Dream: Trends in Absolute Income Mobility Since 1940 – December 2016)

Biographical Information

MICHAEL J. ACTON, CFA, *Managing Director, AEW Research*

Michael J. Acton, CFA, is Director of Research for AEW Capital Management, L.P. with responsibility for directing the activities of AEW Research, the firm's highly regarded in-house research group. Mike joined the firm in 1990 and has more than 30 years of experience as an economic analyst and forecaster and is a standing member of the firm's Investment Committee and Management Committee. The resources of AEW Research are an integral part of AEW's investment process and Mike works closely with senior professionals in all areas of the firm to develop investment strategies that match clients' risk/reward objectives with market opportunities. Mike is also a member of the firm's Compliance Committee and Risk Management Committee. Prior to joining AEW, he was with DRI/McGraw-Hill where he managed the Metropolitan Area Forecasting Service. He is a graduate of Bates College (B.A.) and a CFA charter holder.

RONALD M. PASTORE, *Director, AEW Direct Investment Group*

Ronald M. Pastore is the Senior Retail Portfolio Manager in AEW's Direct Investment Group. In this capacity he oversees AEW's retail portfolio with particular emphasis on super regional malls, urban specialty centers and retail-oriented mixed-use projects. Ron brings to his position over 30 years of real estate experience, including extensive experience managing joint ventures, complex redevelopment projects, financings and dispositions at both the asset and portfolio level. Ron served as managing partner for separate ventures that owned historic Union Station in Washington D.C. and Woodfield Mall in Chicago, and currently serves in a similar capacity for Arden Fair Mall in Sacramento, California. He previously served on the partnership committee of the Taubman Realty Group and was a key player in the restructuring of the Taubman UPREIT in 1998. Ron recently advised an AEW client on the redevelopment of a downtown property holding in Salt Lake City into City Creek Center - a 20-acre, open-air mixed use project anchored by Nordstrom and Macy's, featuring 300,000 square feet of specialty retail and 450 housing units. City Creek Center opened in March 2012 and received the International Property Award for "Best Retail Development, USA". Ron joined AEW in 1993 from Himmel/MKDG, where he was responsible for retail asset management, development planning and joint venture structuring. Prior to Himmel/MKDG, Ron was a consulting city planner responsible for financing and managing infrastructure improvement and downtown revitalization projects in New England. He is a member of the International Council of Shopping Centers (ICSC). Ron is a graduate of Bowdoin College (B.A.), Harvard University's Kennedy School of Government (Masters in City and Regional Planning) and MIT's Sloan School (M.B.A.).

Please feel free to contact Mike or Ron regarding any of the information contained herein

macton@aew.com
or 617-261-9577

rpastore@aew.com
or 617-261-9336