

RETAIL DESIGN AND DEVELOPMENT STANDARDS

Large Format Retail Vacancy Issues and Opportunities

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Impacts of Vacancy:

Vacant large format retail storefronts can have negative impacts on the surrounding areas, both aesthetically and economically. The Federal Reserve Bank of Atlanta's Journal Partners¹ detailed many of the issues associated with the closure of these stores. The journal stated:

Abandoned buildings and empty parking lots are not only unsightly, but they also become targets for vandals and attract other undesirable activities. The empty space also becomes a visible sign of economic decline and disinvestment.

In addition to the visual impacts, departure of a large retailer may strain other area businesses. Surrounding businesses often rely on traffic generated by larger retailers, so when the retailer departs or relocates, the dependent businesses may be in jeopardy as well. Smaller retailers in shopping centers may hold leases that allow them to vacate if the anchor tenant departs. Loss of a big-box retailer can thus trigger the decline of an entire shopping center.

While the article did not elaborate on the specific size of the retail causing these impacts, it generally discussed vacancy of discount stores, such as Walmart, Target and Kmart, department stores including Sears, JC Penney's and Montgomery Ward, as well as grocery stores. While vacancy of mid-size retail and smaller retail spaces can also have negative impacts, most of the vacancy literature reviewed focuses on the larger scale structures, generally occupying 60,000 square feet or greater.

The result of these highly visible vacant large format retail spaces is the perception of disinvestment and blight. The empty structures have the potential to trigger further decline within a multi-tenant commercial development.

Nationally, the primary causes of vacancy in large format retail spaces include:

- Poor economic performance (lower than expected sales)
- Development of a newer store nearby
- Large nationwide closures due to acquisition, consolidation or a retailer going out of business

¹ Partners Volume 15, Number 2 (2005)

With the first two causes, the retailer can often hold onto the lease, paying rent in order to prevent a competitor from occupying the space.² This creates difficulties in reoccupying the space, as there may be no motivation from the building owner if rent is still being received. The third cause results in viable retail space being vacated as a result of forces outside local control.

Quantifying the Issue:

A comparison between the Portland metro area retail vacancy rate (7.4%, q4, 2009)³ and the national retail vacancy rate (12.6%)⁴ illustrates several key issues. First, it shows the potential impact that the urban growth boundary has on containing development and limiting the amount of unnecessary retail development. This is likely a cause of the Portland metro area's lower rate, which historically has been one third lower than the national average. However, the statistics also show the Portland metro area is not immune from retail vacancy, and half of the vacant space, or 1.5 million square feet, is attributed to large-format retail⁵ defined by brokers as spaces 20,000 square feet or larger.

The Portland metro area also has a documented history of successfully renting vacated spaces to new tenants or redeveloping the site. One local example of this is the former QFC space at Gresham Station which is currently a Best Buy. Recent data is indicating that the metro area's vacant large format retail spaces are beginning to be re-absorbed, which is being attributed to lowered lease rates.⁶

Gresham currently has four retail spaces over 20,000 square feet which are vacant, totaling about 154,000 square feet. These include the Food for Less space (60,000 square feet), the vacant QFC building (42,000 square feet); the former Wild Oats space (28,000 square feet) and the former Goodwill (24,000 square feet).⁷

The timeframe required to release and reoccupy a large format space (typical) could be expected to last between six months and two years. While most vacant large format spaces in the Portland metro area will be released, some properties have significant site issues which may limit any potential re-occupancy by retail tenants.⁸

Given the history of releasing these spaces or redeveloping the property, the most appropriate question is how aggressive does Gresham want to be in expediting the releasing/redevelopment process?

Addressing Future Large Format Retail Vacancy:

The following approaches have been utilized by other communities to address potential vacancy of large format retail buildings developed in the future. The first two approaches deal with releasing and reutilization of the structure. While releasing large format retail space may be

² Final Report on Research for Big Box Retail/Superstore Ordinance (City of Los Angeles); Rodino Associates, Oct. 2003.

³ NAI Norris, Beggs & Simpson, Retail Report, Portland Metro Area, Fourth Quarter 2009

⁴ ICSC

⁵ New & Neville Real Estate Services

⁶ Conversation with Mark New, New and Neville Real Estate

⁷ Conversation with Sue O'Hallaran

⁸ Conversation with Mark New, New and Neville Real Estate

difficult, it can be an effective tool to combat commercial vacancies. This approach encourages the reutilization of a structure, the continued use of existing municipal infrastructure and the continuation of existing shopping travel patterns. The third approach below can include actions as significant as demolition in response to a long-term ongoing vacancy.

A table detailing the ordinances evaluated is included as an attachment at the end of this document. This table includes pertinent information about each community, applicability and specific code language.

I. Eliminate Detrimental Lease Restrictions:

Many retailers insert clauses in to their leases allowing them to vacate the space under certain conditions, such as low volume of sale or profit margin, while continuing to pay on the lease. This allows the retailer to prevent a competitor from occupying the space and capture the market share in the areas. Some communities have responded by creating regulations whose purpose is to speed re-occupancy of the space by prohibiting such leasing language. Certain ordinances prohibit retailers from maintaining a lease if the property is vacated and allow or require the building to be marketed once vacated. Others prohibit competition clauses or restrictive covenants if the building is vacated.

Peachtree City, GA, a small community of 35,000 people on the outskirts of Atlanta's metro area, established a large format retail ordinance, which includes a requirement that leases for spaces over 10,000 square feet allow the building owner to release the property if the retailer voluntarily vacates the structure. Additionally, a copy of the lease shall be provided to the city attorney.

Forsyth County, GA, a rapidly growing county in suburban Atlanta, prohibits the use of lease restrictions which prevent the building owner from marketing the property in the event of voluntary vacancy in spaces over 75,000 square feet. It also allows the space to be occupied by any use permitted in the zoning code, disallowing competition clauses after vacancy. The ordinance also requires a plan for building removal or a adaptive reuse (including release or sale of property) within 24 months of vacancy. The owner must also provide security patrols on the site to deter vandalism or other crime.

Reno, NV, requires leases of spaces with footprints larger than 50,000 square feet to allow the building owner to immediately market the building and eliminate any competition clauses upon the large format retailer vacating the building. This ordinance is also relatively new and has been used only once. The development community was originally resistant to the requirement but has accepted it and the ordinance has not faced legal challenges. Reno's major isue currently is vacant large format retail spaces that were developed prior to the adoption of the ordinance. In response, Reno is applying the same ordinance to reoccupied spaces that require tenant improvements.

Evanston, WY, a rural mountain town of 15,000 people, took a different approach and negotiated a memorandum of understanding directly with Wal mart. This document, an adopted ordinance, required the large format retailer to assist in finding the city a new tenant if the space is vacated.

There can be legal issues when ordinances attempt to regulate contracts between two private entities. The Contracts Clause⁹ would generally prohibit this; however, research and precedents suggest and reveal this is not an absolute bar to legality. In preliminary discussions with the City Attorney's office, this approach may represent a legal methodology to address vacancy. However, a full legal opinion has not been established and will ultimately depend of the final ordinance language.

This approach has no upfront or ongoing cost to Gresham, the developer or the building owner and eliminates potential encumbrances to reoccupying the space. In discussions with local real estate brokers, lease restrictions would likely be perceived as unnecessary and detrimental since developers and brokers are reluctant to give exclusivity clauses, but they may be required to make the deal work. In discussions with The City of Reno's planning office, staff indicated there was resistance from the development community to this approach, but they did not feel it would prohibit development. They did indicate that the City did educational outreach to get the development community on-board with the approach.

The approach has other limitations and may be ineffective if the building owner has no interest in filling the space. This may occur with a stand-alone project, in which the large retailer is not acting as an anchor. The retailer may continue to pay rent to prevent a competitor from occupying the space, in which case there is little motivation for the landlord to seek a new tenant.

2. Design for Future Occupancy:

Because there are fewer potential tenants for large format retail spaces, certain communities are requiring new retail proposals to show how the building could be reutilized if vacated, including potential compartmentalization for occupancy by multiple users. This common strategy, which is often included within design standards, is frequently used in conjunction with lease restrictions or bonds/fees.

Bozeman, MT (small isolated city of 28,000), **Olympia, WA** (city of 48,000 in small metro area), and **Reno, NV** (large city of 220,000) have similar ordinances which requires proposals to be accompanied by documents that show the development could accommodate multiple future tenants. Bozeman's regulations are applicable to spaces of 40,000 square feet, Olympia's depend on the zoning district and take effect between 25,000 and 60,000 square feet, and Reno's ordinance is applicable to buildings with a 50,000 square foot footprint. These ordinances require documentation of a potential arrangement of a subdivided building interior, the compartmentalization of mechanical, electrical and other building systems, how the façade could be modified to accommodate multiple entries and how the parking area and walkways would serve the tenants.

These ordinances focused on reducing the scale of the space to be accommodated by smaller tenants, not re-occupancy by tenants of similar size. While reoccupation of the structure with smaller tenants would address many of the issues associated with vacancy, it would not address all of them. If there are other small businesses on the site, the replacement of an anchor and its associated traffic generation with small retail tenants without major drawing power may do little to support the existing businesses.

⁹ The Contracts Clause, found within the United States Constitution, forbids any state (and therefore local government) from passing a law that retroactively impairs the obligation of contracts.

Staff has been unable to locate any information addressing the costs associated with this type of requirement from the subject communities. For most elements of these ordinances, the applicant is required only to detail how improvement could be made, rather than make actual changes in the construction strategy. Compartmentalizing the mechanical systems, which is one of the elements of the ordinances, would likely increase the development cost; however, the magnitude of this change is unknown. Renovations of a large format retail building for new occupancy has tremendous variability depending on the new use and scale of improvements, from \$5 to over \$90 per square foot.¹⁰

3. Bonds and Fees:

Several municipalities require developers to post bonds or pay fees as part of the approval process to be utilized for a variety of activities if the building becomes vacant. The most well known is the demolition bond, which would be executed to fund demolition of the structure if it remains vacant for a specified period of time. Other types of bonds are less aggressive and focus on maintenance of the site and structure.

Oakdale, CA, a city of 20,000 15 miles from Modesto, CA, reserves the right to require demolition bonds for buildings over 100,000 square feet. The bonds would be carried for the life of the building (or a length of time specified in a developers agreement) and would be executed after 12 consecutive months of vacancy. These bonds would cover the cost of demolition as well as costs associated with maintaining vacant sites. Oakdale has never had to utilize this ordinance since no large format retail has been developed since adoption. Buckingham Township, PA, requires a similar bond.

Newberg, OR, a small city of 21,000 within the Portland metro area, requires a surety bond equal to 1% of the improvement value of the proposed development if greater than 40,000 square feet. If the building is vacant for one year, the bond may be executed to fund property maintenance; Newberg also may execute the bond early if the building or site is neglected. The bond may also be used as an incentive for future tenants, funding application and permit fees, landscaping and façade improvements. Newberg has also not utilized this ordinance.

Wauwatosa, WI, a first tier urban suburb of Milwaukee, WI, requires retail development over 50,000 square feet to contribute \$.20 per square foot to the City's Land Conservation Fund. If vacated, the building owner must submit a plan to reuse or demolish the building. The Planning Commission may extend the amount of time required for re-occupancy or if unsatisfied with the reutilization plan, may use the funds to raze the structure.

Bonds and fees have positive and negative attributes that should be understood prior to any adoption of a requirement. In order to utilize bonds or fees to address vacancy, Gresham would need to identify what specifically should be paid, when to utilize the funds (period of vacancy) and how long to maintain the bond.

The long-term nature of these bonds and their significant costs will likely make them difficult for developers to obtain, and potentially more difficult to execute. In discussions with multiple

¹⁰ Big Box Reuse; Julia Christensen, 2008. Information gathered from multiple case studies in the book. In these cases, the large format spaces were converted to a primary use other than retail.

bonding firms¹¹, staff learned there is little existing knowledge of these types of bonds in Oregon and due to the on-going nature and the probability of execution, the costs would likely be very high. The rates, while based on the credit worthiness of the bond holder, would likely be between 3 and 5% annually, and the bonding company may require a significant initial deposit (one company quoted up to a 100% deposit). For example, a demolition bond for a 100,000 square foot building would likely be around \$1,000,000, with an annual cost of \$30,000 to \$50,000.

These bonds would also likely be structured with a one-year term with annual renewals. This provides the bonding company an annual evaluation of the property and potentially a method to get out of what they perceive to be a bad investment. This raises another issue with bonds; what is the City's recourse if a property is unable to renew their bond?

Since bonds also establish a finite and potentially brief period to release the property, building owners may be less discriminating about tenant selection, which can result in the introduction of marginal or inappropriate tenants into otherwise successful retail environments. The relatively short time period typically found in these bonds may be inappropriate if requiring demolition. A re-occupancy time period of two to three years for a large format retail space is not atypical in the Portland metro area.

Demolition bonds could potentially have several other issues. For example, lenders may be reluctant to provide capital to projects which could be demolished in a brief period of time if vacated. Additionally, the current economic climate has caused a dramatic increase in large format retail vacancy, resulting from decreased consumer spending. While many argue the nation is over-retailed, one would anticipate the re-occupancy of many of these buildings as the economy improves. The short timeline of these bonds could have resulted in the demolition of many buildings which still had significant life and economic value left in the structures.

Because of these complications with bonds, Wauwatosa, WI, elected to require a simple fee of \$.20 per square foot which would be paid to the City's Land Preservation Fund.

These bonds or fees could also be used to fund additional police patrols, limiting the potential for vandalism and other crimes which give the perception of disinvestment.

¹¹ Phone discussions with Assurety NW, Inco Dico May 2010;