Real Estate Roundtable:
The Future of Urban Retail

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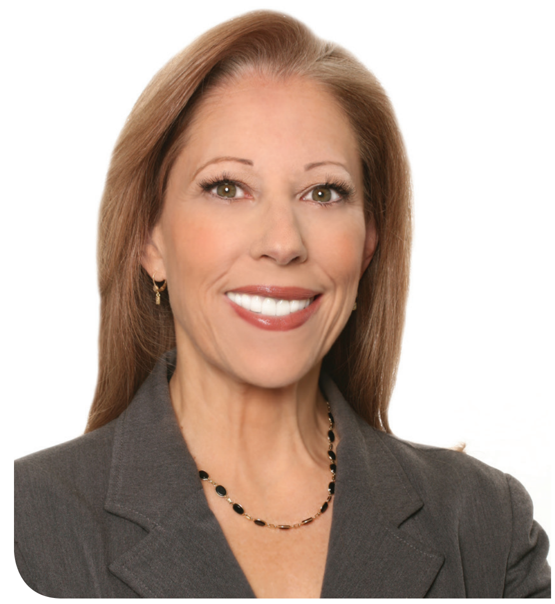

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It's a challenging time to run retail stores in New York City, as e-commerce poses increasing competition. In one unfortunate sign of the trend, many chains with a presence in the area announced store closings in the early part of 2017.

Nonetheless, challenges like this have sparked the creativity of retailers, especially on the luxury front. Many of the most successful brands are attracting shoppers to their stores with innovative approaches, from pop-up stores to experiential retail, that make the shopping experience fun.

"In New York City, you have an extremely large and dense population, as well as millions of tourists visiting annually from all over the world. This results in a consistent customer base that is ready and willing to spend money," said attorney David Rabinowitz, a director in the real estate practice group at Goulston & Storrs. Rabinowitz is a member of the International Council of Shopping Centers' U.S. Law Conference Program Committee, and a member of the Real Estate Board of New York (REBNY).

And most consumers are not ready to abandon the pleasures of shopping in person, anytime soon, say experts.

"People shop online for convenience, but most consumers still enjoy the experience of shopping: touching, feeling and trying on apparel, shoes and accessories, sitting on sofas and in chairs and testing out electronics before making purchase decisions," said Robin Abrams, executive vice president and one of the principals of The Lansco Corp., a New York-based full-service real estate firm and a member firm of REBNY. Abrams serves on REBNY's Manhattan Retail Report Advisory Group and Commercial Brokerage Board of Directors, Retail Committee and Brooklyn Committee.

For insight into how retailers can make the most of today's environment and thrive, Crain's Custom recently spoke with Rabinowitz and Abrams.

Crain's Custom: What are your clients most concerned about at the moment?

Robin Abrams: Retail clients are concerned about being relevant. In today's competitive market, retailers must establish their brand message and tell their story through their product and the environment in which they showcase and sell their merchandise. Most retailers utilize both brick-and-mortar stores and e-commerce sites, which ideally work in tandem and support one another.

With today's challenges, a retailer that is supporting brick-and-mortar stores must draw ample foot traffic. The signage and storefront must be eye-catching with an effective store layout and merchandise displays. The store also needs to be in an appropriate location. The ideal site can include being near neighboring retailers that are strong co-tenants, proximity to public transportation, being within a destination location that has an unusual physical space or is near a great anchor tenant that attracts the retailer's target customer.

Retailers are challenged with securing and maintaining a retail location, while also servicing and growing online sales. A retailer's online sales should be bolstered by a physical store that can best set the tone for the retailer, which is why there are evolving trends of e-commerce retailers opening stores and retailers opening fewer stores and/or smaller stores. Brand consistency across platforms is essential for instant identification to create a connection with the customer through every brand touch point.

David Rabinowitz: Many of our retailer clients are concerned about rising occupancy costs and their ability to continue to generate and grow revenue in the face of those costs. Our brick-and-mortar clients continue to be particularly concerned about the competitive challenges posed by e-commerce and online retailers.

While we are seeing many of these e-commerce and online retailers scale their businesses quite easily, we are also seeing many notable retailers that have been traditionally based online look to launch brick-and-mortar stores in order to realize what they believe is their full business potential.

The challenge for those retailers is structuring their lease agreements for their new stores with economic terms and operational flexibility that work for the business as a whole. Their goal is to be able to offer customers a seamless way shop across different channels, whether at the physical store, online or a combination of both.

We also work with many international retailers looking to expand into the United States, and the challenges and concerns are the same. It is essential for the retailer to engage the right professionals to help with understanding the vast U.S. market, site location, and structuring and negotiating the economics and the critical aspects of the lease to maximize the chance for success. Because occupancy costs in major urban markets are so high, we are seeing some of our foreign retailer clients looking to open in secondary and even tertiary markets, and in some cases using a mall-based strategy.

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Crain's: How do you view the current retail real estate market in New York City, particularly for luxury retail?

Rabinowitz: While there is talk of rents moderating in New York City, the rents remain high, and it all comes down to whether a business can generate and grow revenue in the face of these high occupancy costs. Unfortunately, some retailers are having to make difficult decisions about their businesses, including the viability of their physical stores. One recent example is Ralph Lauren's decision to close its iconic store on Fifth Avenue.

Luxury retailers face the same challenges as any business, and we are likely to see an evolving re-emergence of some of these luxury retailers as they adapt to the current economic landscape and find new ways to maintain their brick-and-mortar presence and attract customers. For example, we may see an increased presence by luxury retailers through pop-up stores or "flash retail," which has proven an attractive and successful option for retailers as diverse as Kanye West and Uniqlo.

Landlords might also begin to realize that short-term occupancies and a "lights on" presence are better than dark stores, and the vacancies on luxury retail mainstays such as Fifth Avenue that are becoming more prevalent may cause landlords to take action to ensure long-term financial stability and marketability of their properties.

Abrams: There is a lot of activity now in the retail market as retailers who may have been on the sidelines are now prepared to commit to leasing space. The market was very competitive and aggressively priced the past several years. Many retailers paid record rents to secure space on the high profile corridors in various market areas like the Plaza District (Madison Avenue, Fifth Avenue and 57th Street); SoHo, and the Meatpacking District.

Over the past six months, rents have leveled off, as part of a natural correction, and landlords are offering more creative concessions, which have led to more deal-making. Many retailers that paid record-level rents over the past few years, have vacated space, or put their space on the sublet market. Other space has sat empty with unrealistic asking rents. More deals are now being made at rents that are keeping pace with market conditions several years ago, during which rents were 20-30% less.

Based on this, we are seeing many international luxury and fashion brands like Elie Saab, Bottega Venetta, Tom Ford and Coach open large flagship stores to showcase their brands in New York City, while mainstays Victoria's Secret, Nike, Asics, Under Armor, American Girl and Apple continue to hold strong with new [stores] or expand prominent flagship locations. Restoration Hardware is opening its largest store in conjunction with its hotel in the Meatpacking District. The White Company, based in the United Kingdom, is opening its first store in the United States in the Flatiron District. Brookfield Place, The World Trade Center, and the South Street Seaport have changed the face of retail downtown in the Financial District, while Hudson Yards has announced multiple retail deals.

Crain's: Where do you see the most exciting opportunities for New York City retailers to differentiate themselves—and are any new issues related to intellectual property emerging as they carve out a unique presence?

Abrams: Expectations are greater than ever before for retailers to lease a unique space, create a compelling environment and provide an experience. Many do it by creating unique intellectual properties like the Nike store, which has its basketball court, and the American Girl store, which has its café where patrons can dine with their dolls.

Rabinowitz: Consumers will always be attracted to the "shiny new thing" in retail. Pop-up stores and experiential retail are growing in popularity, and many consumers are demanding the new and different in their retail shopping experiences.

Retail can change the landscape of neighborhoods, and we see examples of this every day in New York. For example, did anyone ever think an outlet mall would factor into the New York City retail market? Empire Outlets in Staten Island is category-changing for that very reason, and retailers who are flexible enough to consider an outlet model – or another innovative approach – in a market like this will be those who have a place in New York's retail landscape for years to come.

With this creativity, however, comes new challenges. For example, retailers that want to develop store designs and promotions that incorporate the products and intellectual property of others need to assess whether they may need or already have permission from the IP rights holder to do so.

Further, manufacturers and resellers of products in the fashion industry need to consider the implications of a March 2017 Supreme Court decision that clarified the scope of copyright protection for the artistic features of apparel designs. The potential for designers to claim copyright protection, and not just design patent or trade dress protection, may result in more aggressive enforcement efforts that could affect competing designers and their sales channels.

Crain's: How important is the experiential retail trend – and what are some of the most interesting examples you've seen in New York City?

Rabinowitz: E-commerce is changing the retail landscape. This is challenging developers/landlords and retailers to rethink the critical question: What will get people to visit our property and stores?

The answer is creating a retail environment with customer friendly amenities and a multitude of experiences. Retailers are focusing on forming a destination with memorable spaces and places. Many of these projects not only open up to the neighborhood around them, but they often serve as their civic hubs and gathering places.

Brick-and-mortar stores can stay relevant by blending online and in-store shopping, providing in-store experiences that cannot be replicated online and being flexible enough to provide different types of amenities their target customer might want on a given day.

Among the interesting projects across the city are Club Monaco's downtown café and bookstore and Fair Folks & a Goat's two Manhattan outlets, which blur the lines between coffee shop, bookstore and apparel boutique. These locations offer consumers the opportunity to grab a coffee, browse for a book and even do both – all while remaining at the store – lengthening the visit and increasing the chances that the consumers might also purchase their apparel and accessories.

The largest challenge and consideration for retailers looking to move to experiential is making sure that they can monetize the experience. Of course, they must also ensure that their lease agreements permit the experiential ideas they are implementing and that the ideas are synergistic with the rest of the store.

Abrams: In a market like New York City, where many international brands jockey for attention, the retailer must make a significant impression on the consumer: thus the evolution of experiential retail.

The store's exterior—inclusive of storefront, signage and window display—is of prime importance to draw the customer in. The interior fixtures and finishes that display and showcase the product should be in sync with the brand ethos. The lighting, music and sales staff should all contribute to creating a cohesive environment.

In touristic locations, in particular, many stores have an interactive environment. They range from the Pirch home store in SoHo — where you can go in your swimsuit to try out the shower — to Lululemon, where you can attend a free community yoga class. Soon to come in the Meatpacking District is Restoration Hardware's flagship store connected to a hotel featuring its furnishings, as well as Starbucks' 20,000-square-foot roasting plant.

Customization and personalization trends are linked to experiential retail. Many retailers are inviting customers to put their stamp on their product and share their feedback on social media. Some stores incorporate technology to assist the customer with choosing products. Shoppers can even build an outfit on an iPad as they look at different items in different colors—while inside the store.

Food and flea markets, food halls and other multi-tenant venues like the Brooklyn Flea, Chelsea Market and TurnStyle are an added layer to experiential retail, bringing a diversity of options in one-stop locations that have turned the shopping experience into an outing.

Crain's: What are the greatest challenges facing retailers in New York when it comes to leasing, accounting and contractual issues — and how can these be overcome?

Abrams: It is of utmost importance for a retailer to do the appropriate due diligence in order to best mitigate risks as they go through the leasing process. In negotiating the lease agreement, tenants need be guided by an attorney and all business terms should be carefully negotiated. Tenants need to make certain the physical space is in good condition, zoned for their anticipated use and possesses the appropriate Certificate of Occupancy. If it is in a landmark district or is a landmark building, the retailer should be aware of how it will affect their ability to brand the store. Landmarked status may affect the storefront design and could limit signage.

The retailer should also understand the timeline for their design/planning phase, filing and obtaining building permits, and the build-out of their premises.

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Real estate taxes should be addressed, with attention given to the proposed base year and tenant's proportionate share. The tenant should review a history of real estate tax increases and any estimated projections as to how they may increase. The tenant should also be aware of the potential need to pay New York City commercial occupancy tax, based on the amount of their annual rent.

Rabinowitz: The name of the game is finding a balance between controlling occupancy costs and maintaining the ability to generate and grow revenue. Contracts with the most flexibility in use clauses are essential these days for tenants, as this permits evolution as needed. Landlords should be mindful of this need, and in return will certainly demand flexibility on different uses that will be permitted on their property.

Exit strategies on both sides of the negotiation also require strategic thought and consideration. For retail tenants and landlords, last year's changes to the Financial Accounting Standards Board rules related to lease accounting are potentially significant.

Under the new accounting rules, the former distinction between capitalized or financing leases, which generally are reported as assets and liabilities on the tenant's balance sheet and operating leases, which have not historically been treated as such, will be eliminated. After these new rules become effective, a tenant under a real estate lease must now include the lease on its balance sheet, even where the lease was treated as an operating lease under prior generally accepted accounting principles (GAAP) rules. The most significant FASB change would require all tenants to include any lease greater than one year as a liability and an asset on their balance sheet.

There may be some unexpected consequences as the new rules are fully implemented. Retailers and landlords should review carefully and begin to plan for all of these changes.