AS 2023'S DUST SETTLES, UNCERTAINTY REIGNS DESPITE RETAIL'S STRENGTH

MARKET COMMENTARY — MARCH 19TH, 2024

Open Air Retail's Performance Has Improved Sentiment Towards The Sector

Commercial Real Estate Deal Flow Remains Challenging Through 1Q24, However

Last year LBX had its most acquisitive year to date. Despite broadly negative investor sentiment, which worsened as inflation soared and the Fed aggressively hiked short-term interest rates, we acquired five assets comprising 750,000+ SF and ~$130 million in purchase price. What was notable about the year for us, however, was not just our acquisition activity in an environment in which deal volume was extremely muted. For the first time since launching the LBX Retail platform in 2018, we saw a marked shift in investor appetite and interest towards open-air retail from both institutional and accredited investors despite widespread concern about the state of the economy. Most people we spoke with consistently echoed some (or all) of these themes:

- They were seeing too many capital calls and distribution cuts in other sectors (primarily multifamily)
- They were overallocated to other sectors and were looking to diversify and increase their exposure to retail
- They were seeking day-one cash flow, and liked that retail was still offering positive leverage, even in an elevated interest rate environment

Additionally, retail's resilience has helped attract new investors and capital to the sector. Operating metrics have held up. Amazon did not destroy brick and mortar, as many over the past few years speculated would occur. For the first time in years, retail received positive press coverage. Shopping centers bounced back strong from COVID-19 and store openings outnumbered closings again in 2023 for the second year in a row. Per JLL, overall US retail vacancy hit a record-low 4.0% at year-end 2023, with the neighborhood, community and strip center segments in which we operate tightening sharply. As we will discuss further, the supply-demand imbalance in retail remains very meaningful. There was only 40.9 million SF of new retail delivered last year nationwide (0.3% of total inventory), which has contributed to pronounced occupancy gains and rent growth for stronger, well-located centers.

ADDITIONS TO NEW RETAIL SUPPLY ARE WAY DOWN FROM THE GREAT FINANCIAL CRISIS ...

DELIVERIES	GENERAL	MALL	POWER	NEIGHBORHOOD	STRIP	OTHER	ALL
2008	64,654,992	22,723,179	40,163,324	62,302,660	16,738,606	4,930,255	211,693,606
2023	33,249,292	(225,826)	750,466	4,109,738	2,295,777	522,015	40,938,515
Change (Abs)	(31,405,700)	(22,949,005)	(39,412,858)	(58,192,922)	(14,442,829)	(4,408,240)	(170,755,091)
Change (%)	-48.6%	-101.0%	-98.1%	-93.4%	-86.3%	-89.4%	-80.7%

... MEANWHILE, EXCLUDING MALLS, RETAIL VACANCY RATES ARE HISTORICALLY TIGHT ACROSS SEGMENTS

VACANCY	GENERAL	MALL	POWER	NEIGHBORHOOD	STRIP	OTHER	ALL
2008	5.0%	3.8%	6.2%	9.1%	10.0%	5.3%	6.3%
2023	2.5%	8.5%	4.2%	5.8%	4.6%	4.9%	4.0%
Change (%)	2.5%	-4.7%	2.0%	3.3%	5.4%	0.4%	2.3%

Source: JLL

A few primary factors have contributed to the strength of the very best located open-air shopping centers: (1) the lack of new construction since the Great Financial Crisis, largely due to increased construction costs; (2) the desire of better-positioned retailers to continue to grow and expand their footprints; and (3) the growth in markets with stronger demographics and economic trends.

What We Saw in 2023: Our Primary Value-Add Strategies Are Holding Up, Though Outparcel Sales Have Slowed, Construction Costs Have Risen, and We Remain Wary of Some Retailer Credit

Despite the positive sentiment surrounding the sector, suburban value-add open-air shopping centers with a discount-oriented tenant profile tend to trade at attractive valuations relative to other property types. Grocery-anchored centers tend to trade at tighter cap rates due to their perceived safety and larger buyer pool. Cap rates for our last several deals – which have generally not been grocery-anchored – have hovered in the 8-9% range, with going-in per square foot pricing falling well below replacement cost. While a low-cost basis is helpful, in that we are not forced to generate outsized rents to make deals pencil, and that we are more protected against supply additions, we commonly apply one or both of the following strategies to generate outsized returns for the perceived risks we are taking: (1) outparcel arbitrage and (2) targeted shop space (sub-10,000 SF) leasing.

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Outparcel Arbitrage

Where feasible, we look to acquire retail centers where we own or have the opportunity to develop, single- and multi-tenant parcels and then sell them to net lease and 1031 exchange investors at accretive cap rates in order to deleverage, de-risk, reduce our basis and return capital to our limited partners. **Since 2019, we have returned almost $17 million in equity to investors and paid down close to 3x that amount in debt in our transactions** by selling off 152,582 SF of parcels and outparcels across our portfolio. 2023 was a difficult year for this strategy, as the economic climate and interest rate increases slowed transaction volume considerably and impacted cap rates on NNN deals. With the outlook for interest rates finally showing signs of improvement, we are beginning to see more activity in the outparcel market. In 1Q24 alone, we have received strong offers for two outparcels in our portfolio and we are planning to place additional outparcels on the market later this year to take advantage of this enhanced liquidity.

Shop Space Leasing

We specialize in driving value through leasing up small (<10,000 SF) spaces. We tend to buy our centers from larger platforms (public REITs or larger private equity) who tend to not focus on the small leasing opportunities as we do. Since 2021, we have executed 36 new leases for 112,955 SF across our portfolio, and 2023 was our busiest year on record. As of 4Q23, for example, our leasing team was working on 35 renewals and more than 60 active deals. Per the table below, spreads on new leases vs. shop rents at acquisition are wide, even though we typically underwrite just 1% market rent growth per year. In some cases – often after targeted capital investment – we are executing leases at spreads that are $10/SF or higher than original shop average base rent ("ABR"). This speaks to the supply – demand dynamic noted above that is helping to drive this opportunistic and profitable leasing activity.

SHOP LEASING REMAINS A KEY VALUE DRIVER FOR LBX

YEAR ACQ	SHOPPING CENTER	SHOP ABR AT ACQ	SHOP ABR 2023	SPREAD
2018	Oakwood	$15.95/SF	$17-26.50/SF	$1.05-10.55/SF
	Alafaya	$19.18/SF	$24-26/SF	$4.82-6.82/SF
	Harbison	$17.59/SF	$28-$42.50/SF	$10.41-24.91/SF
2019	Terraces	$17.74/SF	$24-28.75/SF	$6.26-11.01/SF
	Oakbrook	$16.40/SF	$28-28.50/SF	$11.60-12.10/SF
2021	Ridgeway	$27.95/SF	$35-37/SF	$7.05-9.05/SF
	Evergreen	$24.18/SF	$32/SF	$7.82/SF
2022	Four Corners	$22.26/SF	$41.50/SF (LOI)	$19.24/SF
	Orchard Crossing	$17.48/SF	$25/SF	$7.52/SF
	The Court at Deptford	$19.25/SF	$21.50-30/SF	$2.25-10.75/SF

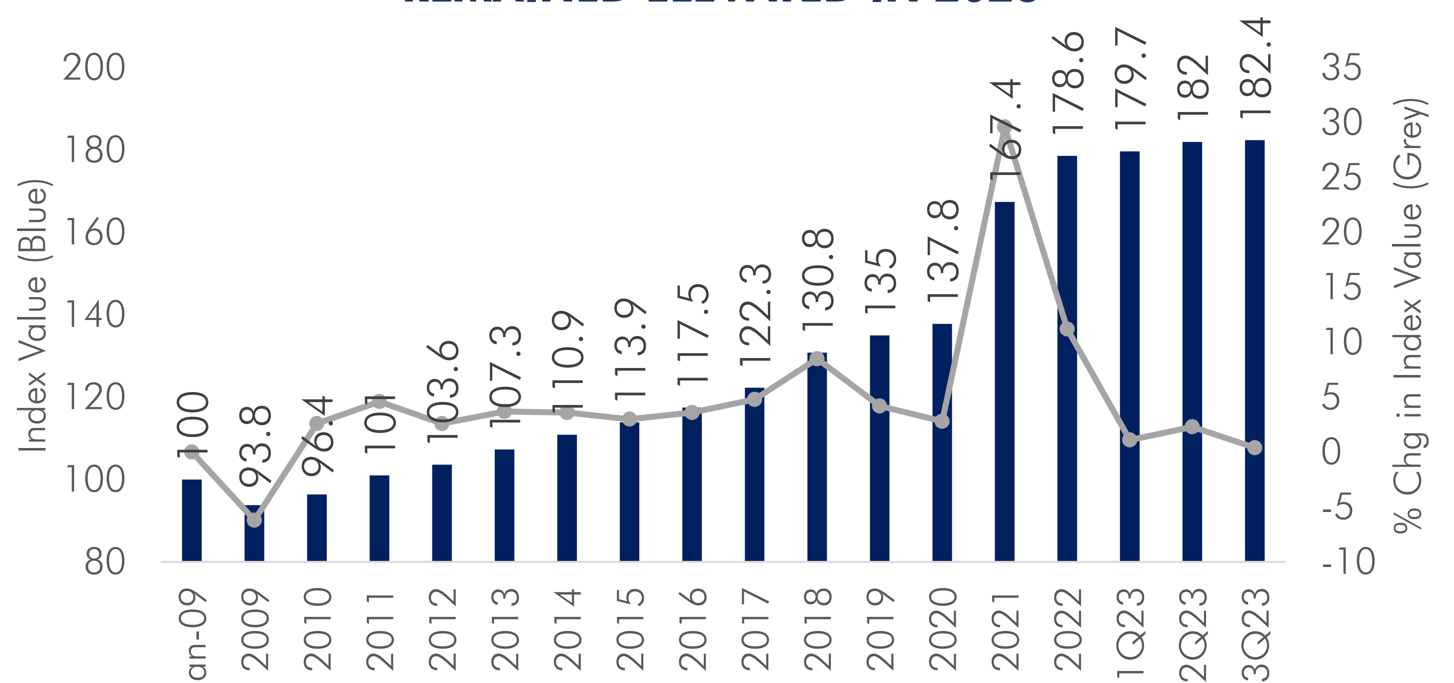
Source: LBX

Construction Costs Remain An Issue, Offset by Higher Rents

Open-air retail is healthy. **That said, rising construction costs have presented both positives and negatives for the sector.** First, the major positive: elevated construction costs have made new development almost impossible to pencil, except in the highest rent markets and in certain mixed-use cases. This is very protective for existing high-quality centers. Additionally, as most retail leases are NNN, other costs that have plagued other property types (such as insurance impacting multifamily) get passed through to tenants. Provided we own one of the best centers in a submarket (a key focus for our value-add strategy), this has also been protective, as retailers want to be in the strongest locations and can generally weather rising operating costs to a degree. However, we have seen the cost to fund high volume leasing activity rise significantly. This – coupled with less funding availability from lenders – has to some extent offset the strong rent growth that well-located retail has enjoyed.

For example, in 3Q23 we sold Alafaya Commons, a community center in Orlando, FL. We significantly grew rents at the asset **(shop rents were in the mid-$20s/SF at sale vs. $19.18/SF at acquisition)** and generated a very attractive return **(deal-level 24.6% IRR/2.27x equity multiple)**, but we underperformed on our cost assumptions. This was partially due to operating in a highly inflationary environment, and partially because we outperformed our leasing expectations (leases cost money). To an extent, we were victims of our own success at the center: we saw an opportunity to spend on the façade and tenant improvements to drive rents and value beyond what we had initially underwritten. After we committed to moving forward with large-scale renovations, costs continued to push to higher than anticipated levels. **We ended up exceeding our underwritten cost targets by close to $1 million over the life of the deal.**

U.S. CONSTRUCTION COSTS SPIKED 30% FROM 2020-22 AND REMAINED ELEVATED IN 2023



Source: Mortensen

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RETAIL APOCALYPSE? HARDLY. BUT SOME CREDIT ISSUES ARE LINGERING IN THE SECTOR

While open-air retail has seen more store openings than closings for the past couple of years, credit concerns still linger in certain pockets of the sector. For example, in the hobby/crafts segment, Hobby Lobby is a very strong credit, but Michael's (which is ironically opening stores) and JoAnn Fabrics, which filed for Chapter 11 bankruptcy this week, have struggled. In segments featuring larger, discretionary purchases such as furniture, Kirkland's and Conn's appear to be wobbling, following bankruptcies by Mitchell Gold + Bob Williams and Z Gallerie in 2023. Big Lots! is another retailer that – despite offering off-price goods that tend to be more defensive in challenging economic climates – has seen its financial performance deteriorate. LBX has minimal exposure to the weakest of today's retailers (with just two Kirkland's in our entire portfolio), however there could be a handful of upcoming retail bankruptcies in 2024. These typically create vacancies and can lead to value-add opportunities.

2024 DEAL FLOW HAS THUS FAR LOOKED DIFFERENT FROM WHAT WE SAW IN 2023

We have historically averaged 4-6 value-add open-air retail investments per year (excluding 2020) and expect opportunities to emerge in this sector again this year. We remain selective, however, and our value-add deal volume may be somewhat muted in comparison to 2023 for several reasons. First, as we entered 2023, we were already engaged on a large portfolio acquisition that accounted for four of our investments last year. We are currently bidding on interesting opportunities as they arise, but there have been fewer attractive value-add opportunities in the sector to start 2024. This has created a supply-demand imbalance between capital and deal flow, and the few attractive value-add opportunities we have seen in the first quarter have been bid up excessively, in our view. This situation is exacerbated by challenges in other sectors: equity investors have adopted a wait-and-see stance on multifamily, fled the office sector, struggled to find yield on industrial, and are generally nervous around lodging. Retail's consistent performance over the past several years, coupled with its relatively attractive yield profile, has increased competition in the value-add segment of the market.

We should also note that some of what has hit the market thus far in 2024 offers more of a core-plus profile because many of the best retail centers have already been enhanced and are operating at robust levels. We believe investors that want to own the highest quality retail real estate will appreciate the risk-return profile in the core plus space, though we have seen more institutional than high net worth interest in this segment thus far in 2024.

The financing market also does remain challenging, particularly for middle-market value-add deals, and we expect – as with every deal we have done since December 2022 (see to the right) – to find sellers who are forced to transact for some reason. End of fund life, forced liquidations, and shifts in corporate strategy should continue to create buying opportunities in 2024. To what extent deal flow will emerge, however, is an open question. In a difficult fundraising environment last year, we were able to syndicate more than $50 million in equity, and we are well-positioned to capitalize on attractive opportunities should they arise. To what extent that will happen this year, we still do not know.

WE LOOK FOR ASSETS THAT ARE FORCED TO TRADE

CENTER	REASON FOR SALE	TIME OF SALE
The Court at Deptford	End of Fund Life	4Q22
Seritage Portfolio (4 Assets)	Forced Liquidation	2Q23
Poplar Prairie	End of Fund Life	4Q23

We know that we do not expect to see many distressed retail opportunities, however. In contrast to other real estate asset classes, where investors are gearing up for deals to fail, well-located open-air retail – as noted above – has generally performed well. There were some high-profile corporate bankruptcies last year like Bed, Bath & Beyond (whose better, more well-located leases were quickly snapped up by Burlington and other national tenants), but the best centers have consistently shrugged off issues with weaker retailers and maintained high occupancy levels. The general rule of thumb in our space has been if an asset is distressed, it probably (not always, but probably) was not worth owning in the first place.

WE EXPECT TO CONTINUE PURSUING OPPORTUNITIES IN LESS GLAMOROUS MARKETS

When we first began acquiring open air centers, we were solely focused on markets in the Southeastern United States due to their favorable population growth and economic profiles. From 2018-2019 we acquired assets in the Nashville, Orlando, Atlanta, Charlotte, and Charleston metro areas – some of the country's hottest markets. When the COVID-19 pandemic arrived, these markets attracted people from gateway cities, and significant institutional investment and cap rate compression followed. As a result, and due to our contrarian nature, we began to expand our footprint into Midwestern and Northeastern markets where REITs and other institutions were selling high quality properties in a herd mentality. This was a contrarian approach at the time, as these markets are less glamorous than Sunbelt markets, but it has borne fruit. They are now home to some of our strongest performing centers. Absorption metrics support our recent investment activity. Per the chart on the right, Chicago (where we acquired in 2021, 2022 and 2023), Philadelphia (2022) and Central New Jersey (where we just saw a deal fall through) saw very strong net absorption in 2023, along with Phoenix, Orlando (where we also acquired in 2023) and the five primary Texas markets. Unlike the Sunbelt markets, which also ranked in the top 10 for new completions, these markets saw far fewer new additions to new supply. Strong absorption with limited new completions has led to robust rent growth.