Research

US Investment Update

ICSC Retail Report

Corporate Overview

Rockwood is a full-service real estate investment banking firm headquartered in New York with additional offices throughout the United States. Formed in 1991, the firm provides a broad range of research-driven real estate investment banking services and business solutions to institutional and private investor clients on a national and global basis.

As of May 2011, Rockwood is a wholly owned subsidiary of CW Financial Services and handles all distribution for CW Financial's REO and loan sales.

Over the past 12 months, Rockwood's Capital Markets group has undergone a dramatic expansion with the addition of 14 Managing Directors. The new hires bring deep industry experience with an average of 25 years of banking/investment sales/credit experience.

Rockwood's Hospitality Team, led by Andrew Kern, formed in mid September 2011, has 4 offices (Washington, DC, New York, Atlanta and Cincinnati). The team got off to a quick start with 8 deals closing or under contract in the 4th quarter. During 2012, the Hospitality Team has been retained and will bring to market a multitude of assignments exceeding $300 million in value. Engagements include investment sales, raising debt and equity, and asset management services.

Offices and practice leaders are listed on the back cover, or you can visit our website, www.rockwoodrea.com, for more information about our services and 2012 pipeline.

Rockwood Research

Rockwood Research, in conjunction with Maximus Advisors, produces both regular reports and tailored reports specific to our clients' investments, portfolios or strategic planning. Our weekly Capital Markets Update provides key market metrics, commentary on market activity and highlights current transactions that Rockwood is marketing.

Regular research reports that are available by subscription include our Metro Economy & Property Ratings, which provides our analysis and outlook of the property segments of each of the 50 major US markets. Our Monthly Employment Monitor, which reports recent dynamics in job growth across the 52 largest US metro areas and our Monthly Employment Sectors Report, which gauges the breadth and acceleration/deceleration of US economic activity.

For clients who desire analysis of specific markets, trends or opportunities, customized research and reporting is available. The research team can work to identify the appropriate set of criteria to be analyzed, and/or has the ability to customize existing surveillance and analytics to address the specific investment opportunity under review. We provide regional economic and real estate market/submarket analysis and proprietary forecasts on a transactional basis. The research coverage includes:

- All North American markets and submarkets, including secondary and tertiary markets
- All real estate segments (office, warehouse/industrial, retail, hospitality/gaming, and multifamily, single-family)

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ICSC Retail Report

US Retail Market

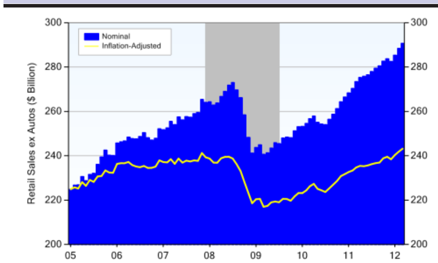
Cyclical Outlook

The US economic recovery has been noteworthy for its stop-start nature and overall languid growth. Consumer spending, which is not only the most important driver of overall economic growth, but also the key to retail market fundamentals has followed this pattern closely.

US consumer spending showed surprising strength in the latter part of 2011 in the aftermath of the summer's turmoil. This carried into the early months of 2012 before more recent data has begun to show some signs of flagging spending. Monthly non-auto retail sales have continued to grow. However this partially reflects sales of gasoline at significantly higher prices, though even accounting for this impact, sales are still good. While sales through March have been healthy, the weekly April ICSC chain store index has been weak, with declines in three of the four weeks. This could reflect the early Easter this year, so it is too early to worry about a fullscale consumer retreat.

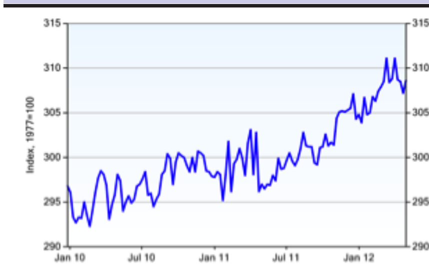
Continued cyclical improvement is fundamentally important to generating future retail absorption. Similarly, retailers have continued to hire workers, meaning that they remain expansion oriented and this too presages future expansion and absorption.

Non-Auto Retail Sales Are Up …



Sources: Census, Maximus Advisors

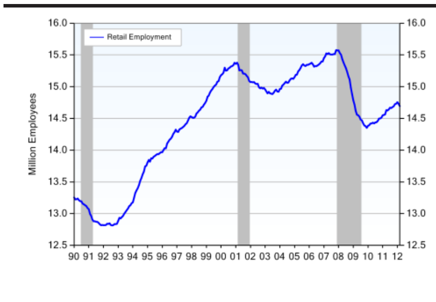
… However Weekly Chain Store Index Hints at Renewed Hesitancy



Sources: BLS, Maximus Advisors

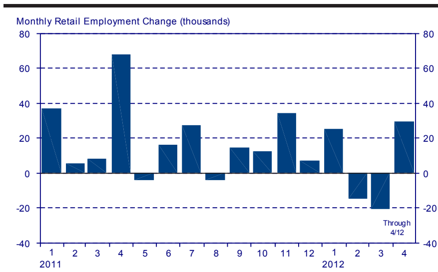
Continued cyclical improvement is fundamentally important to generating profitable retail absorption. Increasing or decreasing payrolls is one of the indicators that provide guidance on how healthy expansion oriented retailers are. Retailers added to payrolls through most of 2011. More recently however, we have seen two monthly increases followed by two decreases through April. Total US retail employment now stands 0.8% above last year's level, but the recent wobbling leaves this figure down from over 1.5% toward the end of 2011.

Retailers Had Been Hiring, Pushing Employment Up Over the Past Year, Indicating Expansion Orientation



Sources: Census, Maximus Advisors

However Retail Payrolls Have Wobbled So Far This Year

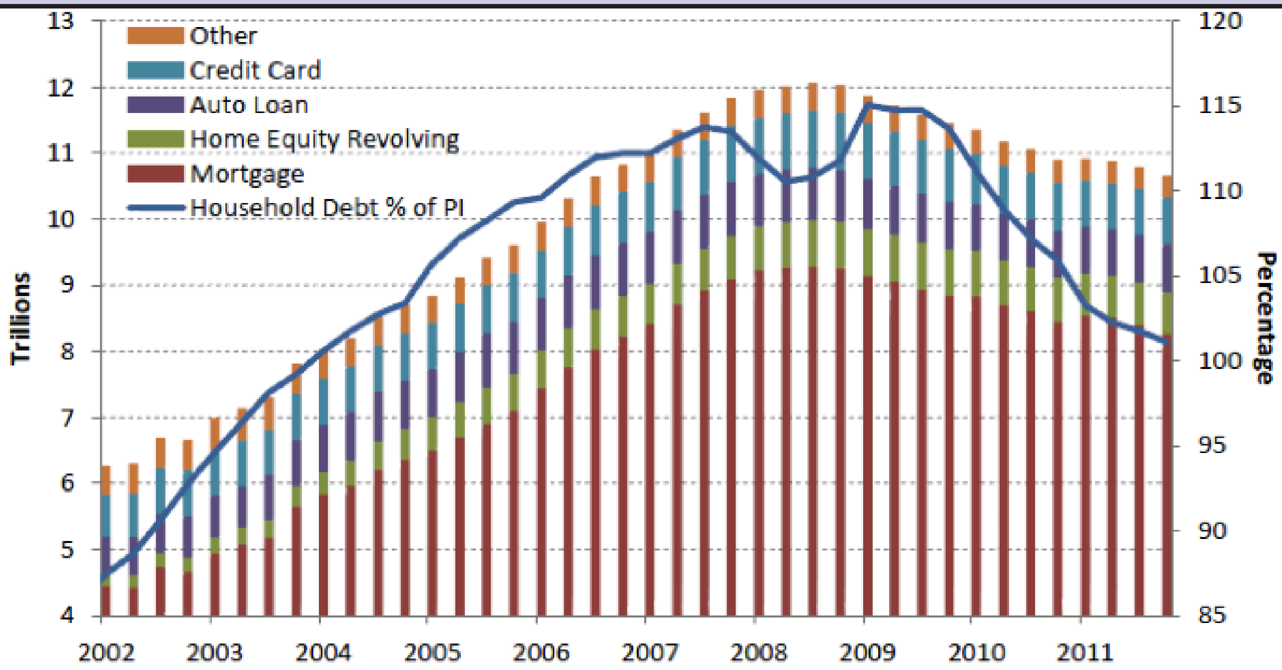


Sources: BLS, Maximus Advisors

US households have made significant progress in deleveraging, even if much of this has been through walking away from debt. Nevertheless, the percentage of debt to household income, which is still above 100%, remaining above the 90% level, which is generally considered to be sustainable. This deleveraging progress that consumers have made brings them closer to being able to sustain current spending levels, especially if we continue to see improved job gains.

The drawn out housing downturn has been a key element in the disappointing overall US economic recovery. Retail has also been a victim of the long single-family housing bust. Many types of consumer spending, including furniture, home textiles, home improvement goods and appliances, are tied into the sale or purchase of a home. The low velocity of home sales has been an ongoing drag for many retailers, as evident in the sales figures for both furniture stores and home improvement outlets in the chart below. More recently, home sales appear to finally be recovering from their prolonged depression, although many of these sales are of foreclosed properties to investors.

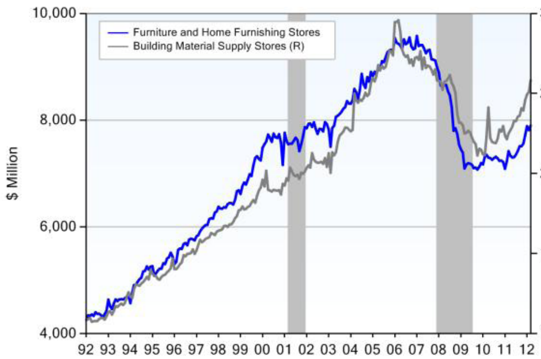
Household Debt Has Declined but Not Yet at Sustainable Level



Sources: Bloomberg, Maximus Advisors

Furthermore, we have also seen large jumps recently in new household formations, which could presage sales of homes to individuals. Either way, increased home turnover appears to already be boosting sales at these types of stores in concert. If the nascent home sales recovery is sustained, this will add another dimension of the cyclical economic recovery, as well as renewed vibrancy to retail formats that have suffered in conjunction with housing.

The Long Housing Downturn Has Hurt Key Retail Segments; Nascent Recovery Would Boost Them



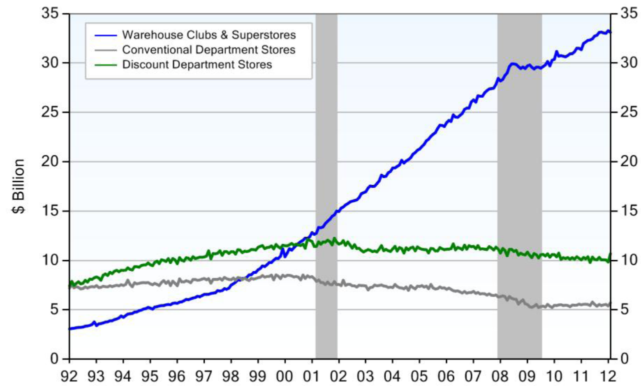
Sources: Census, Maximus Advisors

Structural Retail Shifts

Finally, retail has also been a segment with ongoing shifts in winners and losers, which means that beneath the overall retail spending currents there is churn among formats and individual retailers. As the following chart shows, debt strapped consumers facing high food and gas prices have accelerated the market share gains of warehouse clubs and superstores in recent years. On the other end of the spectrum, high-end retailers have outperformed, as upper end households have been more resilient during this downturn.

Indeed, the strength of high-end retail, the consumer focus on discount retailers, along with the shift toward e-retail is evident in the bifurcation between successful malls that are maintaining high per-square-foot sales and a larger group of sub-par malls with high vacancies, low foot traffic and weaker sales totals. Malls in the latter category have been forced to shift to leasing to non-traditional retail tenants and reaching out to more local retailers. Meanwhile, some national retailers are retreating from weaker malls and concentrating on high-end ones, to reinforce brand image as well as the higher sales potential. While cyclical consumer recovery would ease these pressures, we do not expect them to disappear.

Long Standing Market Share Gains by Warehouse Clubs and Superstores Has Accelerated at Expense of Conventional Department Stores and Discounters

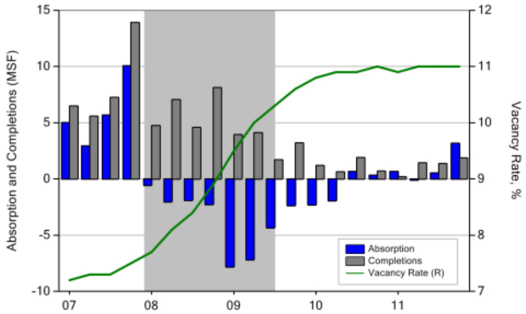


Sources: Census, Maximus Advisors

Retail Fundamentals

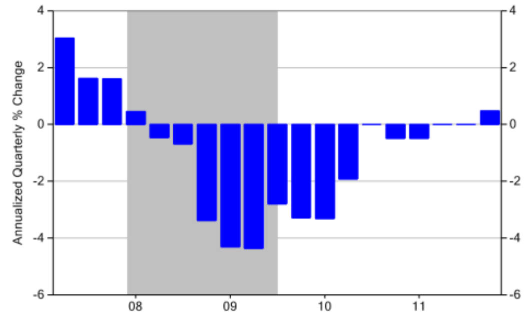
US neighborhood/strip retail vacancies have held steady around the 11% mark since early 2010. This has been a result of minimal supply and demand. Effective rents have been static in response, hovering around the $16.50 psf mark, with the $16.51 level at the end of 2011 even with the level at the end of 2010.

Retail Vacancies Are Flat at Peak Level



Sources: Reis, Maximus Advisors

Rents Have Stabilized

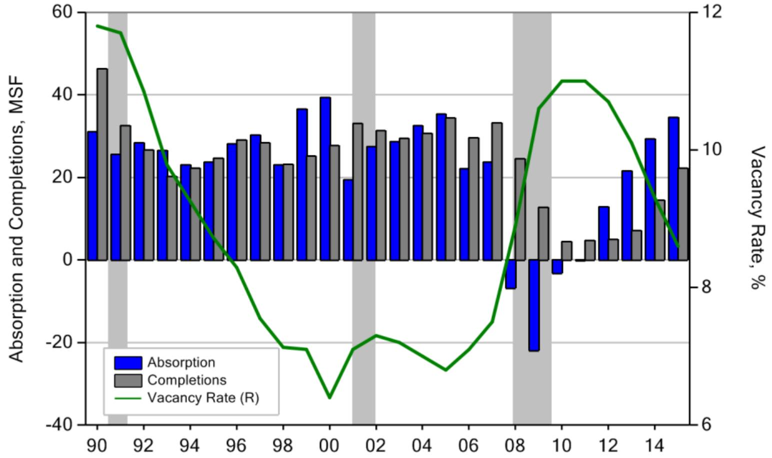


Sources: Reis, Maximus Advisors

2011 was the year of stabilization of retail fundamentals and we expect 2012 to be the transition year to recovery. However, the initial progress is likely to be slow. While supply is now not an issue for the retail sector for the next few years, demand is likely to be slow to reemerge since we have not yet seen enough of a spending boost to initiate significant retail expansion plans in the immediate term. Nevertheless, we project that vacancies will edge down from the 11% mark, improving by about 30 bps and for effective rents to increase about 0.5%, still leaving them at a low level.

Once demand gains momentum, reduction in vacancies should accelerate, coupled with rent gains. Project vacancies should fall to the mid-8% range by 2015, which would still represent a fairly high vacancy level for this property segment.

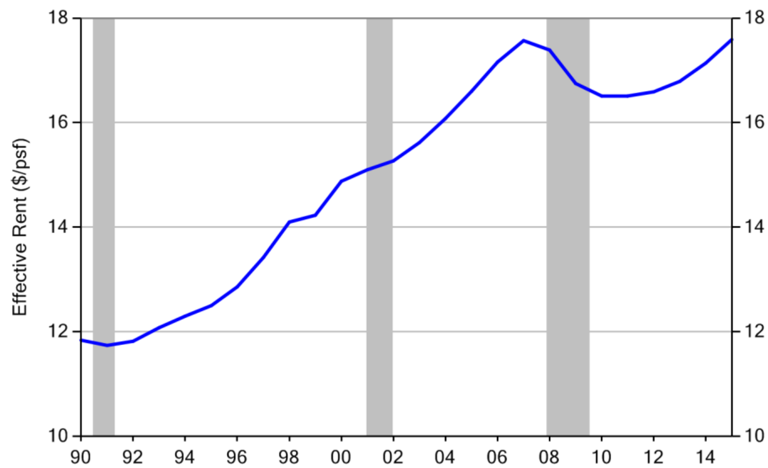
Retail Vacancies Will Hover at High Level Before Demand Begins to Pull Them Down in Coming Years



Sources: Reis, Maximus Advisors forecasts

With vacancies still elevated, effective rents will not see significant growth until 2013 and beyond. We expect modest effective rent growth of 0.5% in 2012, with growth then registering a still-modest 1.2% in 2013 and then improving to 2.1% in 2014 and 2.6% in 2015. This would leave effective rent levels on a nationwide basis in 2015 about even with the previous peak in 2007.

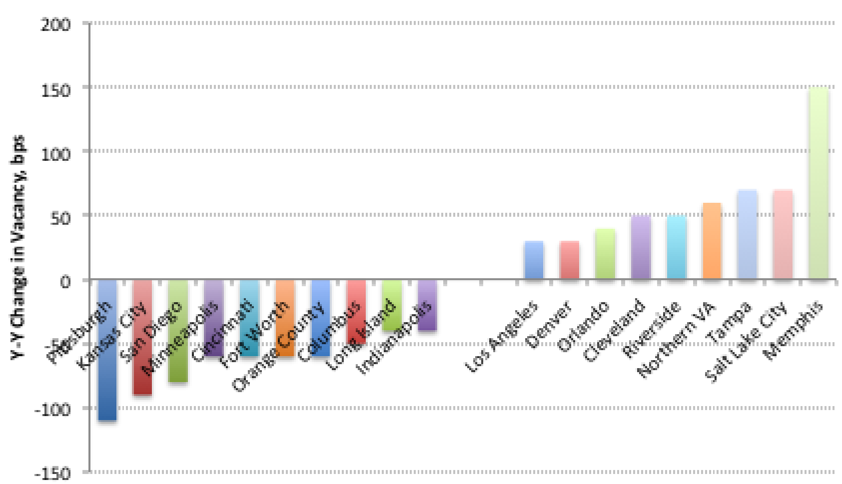
Effective Retail Rents Will Recover Slowly Over the Next Few Years, Reaching the Previous Peak in 2015



Sources: Reis, Maximus Advisors forecasts

The stasis of the broader retail segment continues to be reflected at the market level, as 21 metro's en-joyed improved vacancies in 2011, four were flat and 24 posted increases. However, most metros saw only nominal vacancy shifts, with the average movement across the 49 major markets a mere 1.6 bps over the

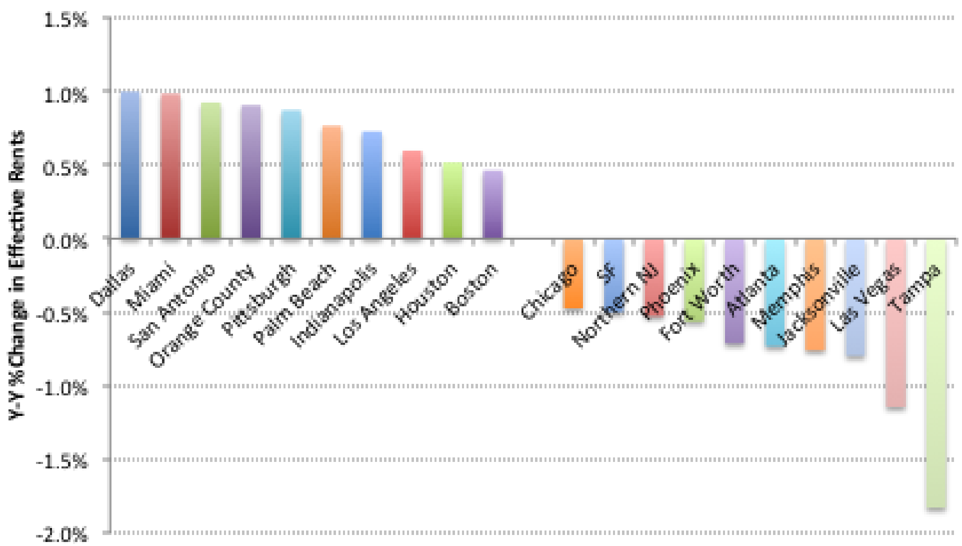
The 2011 Stabilization of National Retail Vacancies Was Reflected in Minimal Moves Up and Down in Most Markets



Sources: Reis, Maximus Advisors

Like vacancies, retail rent movements across the major US markets were generally minimal in 2011, with 22 markets with increases balancing out 23 with decreases, with four showing rents unchanged. The biggest rental gains were in Dallas and Miami, which each increases 1% over the year, while Tampa (-1.8%) and Las Vegas (-1.1%) had the worst declines in 2011.

Few Retail Markets Showed Big Rental Movements in 2011, with Losers Balancing Out Gainers



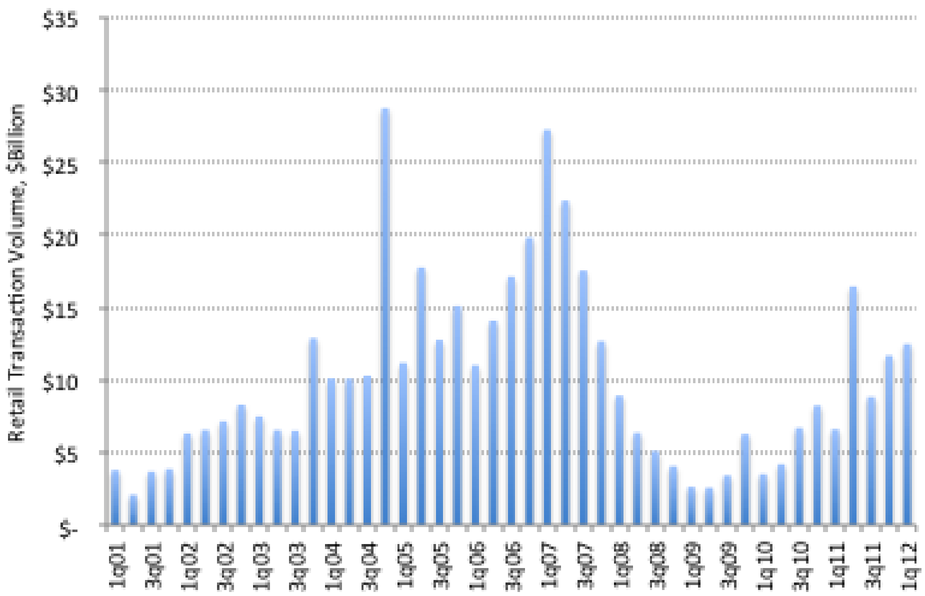
Sources: Reis, Maximus Advisors

Retail Capital Markets

US retail valuations took a modest step back in the fourth quarter, as capital market upsets took their toll. Retail pricing fell 9.2% in the fourth quarter from the third according to Real Capital Analytics, though it is still 17.3% higher than a year ago. Deal volume has continued to improve, rising 35% from the quarter prior and 43% from a year ago. Deal volume is now more than 350% higher than its trough in 2009 but is still 29% below its bubble levels in 2007. Retail cap rates have continued to improve as well, measuring 7.5% in the fourth quarter according to Real Capital Analytics, 10 bps lower than the quarter prior and off their peak of 8.1%. We expect that valuations will continue to improve in the coming years, as interest rates remain low, and will gain strength as the improvement in fundamentals accelerates.

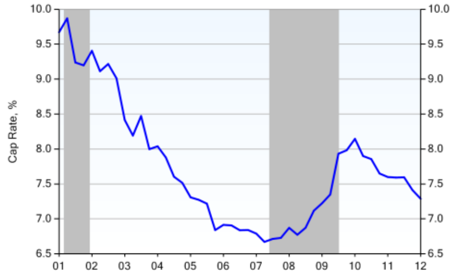
Source: Real Capital Analytics, Rockwood Research

Retail Deal Volume Has Returned to Normalized Levels, Ahead of Recovery in Fundamentals



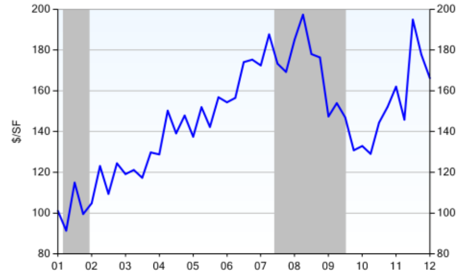
Sources: RCA, Maximus Advisors

Retail Cap Rates Are Declining



Sources: RCA, Maximus Advisors

Retail Values Are Up from Downturn Trough



Sources: RCA, Maximus Advisors

RETAIL SECTOR TREND

Retail Darwinism: Is E-Retailing the Better Mousetrap?

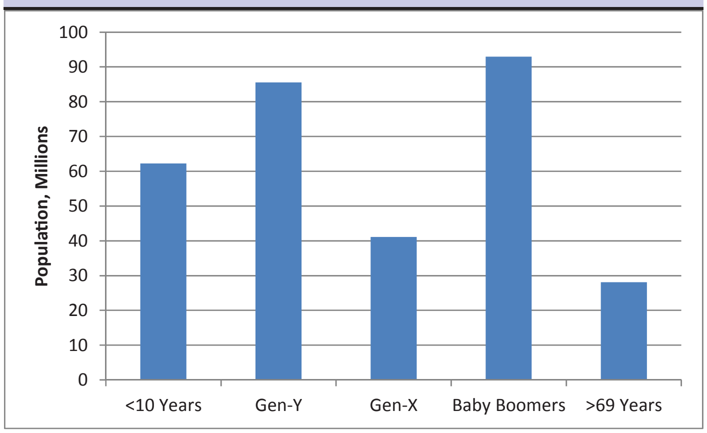
"If there is one constant in retail, it is change." And that remains true today, and will continue to be true as store-centric retailers (traditional retailers) face the growing challenge from on-line e-retailing, related to:

- Generation Y's growth and economic influence
- A technology savvy generation with above average spending habits
- Growing reliance on e-retailing that is transforming the retailing landscape
- The need for traditional retailers to respond

Fastest Growing Segment of Today's Workforce – Generation Y

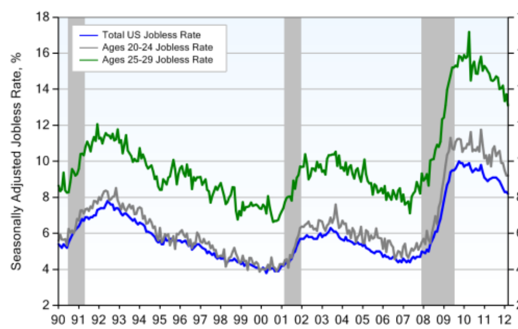
Structural change related to future retailing is being driven by demographics – specifically Generation Y ("Gen-Y") with its sizable young population base that could potentially rival the influence the Baby Boomer generation (current population of over 80 million) had on US society over the last 30 years. Gen-Y, with a population also over 80 million and a median age of 26 years, is on the cusp of exerting its economic influence (and disposable dollars) as the fastest-growing segment entering the workforce, and retailers are targeting this growing population segment.

Gen-Y and Baby Boomers Make Up Majority of US Population



Gen-Y is the most technologically savvy generation, embracing technology and incorporating it into all aspects of their lifestyle, including how they socialize, communicate and work, along with its many forms of entertainment. One favorable characteristic noted by retailers is Gen Y's propensity to spend more on average for goods/services than both the Generation X and the Baby Boomer generations. This liberal spending habit reflects Gen-Y's experience of not having lived through a serious economic downturn, until the most recent recession. Unfortunately, the recession had a much more pronounced effect on Gen-Y cohort, as the chart below highlights a higher unemployment rate for both 20-25 age and 26-30 age segments.

Young Adult Unemployment Rate Finally Retreating from Post-Recession Peaks and Will Also Boost Demand



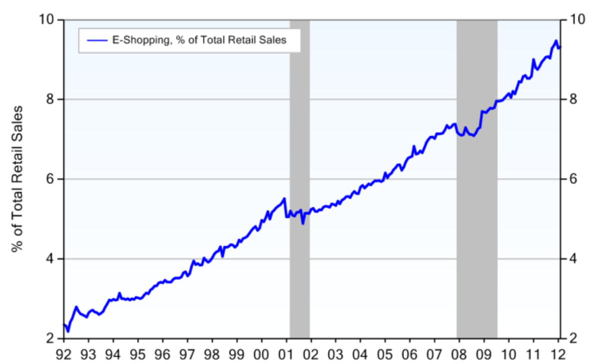
Sources: BLS, Maximus Advisors

During the recession, many Gen-Ys graduated college with sizable student loans to repay, moved back with parents or hibernated in graduate school. However, as the economy strengthens and the employment picture improves, this generation will gain economic traction and influence. The combination of being technology savvy, along with their characteristic of spending more on retail goods, will lead Gen-Y to flex its economic muscle and further place its stamp on how retailing will evolve.

E-Retailing Becomes the 800 Pound Gorilla

There will always be an important place for “bricks and mortar” retail stores, however, the demand for space will continue to be kinked by the accelerating growth of online sales. As the chart below shows, the market share gains of e-retail are accelerating - the time for a two percentage point gain generally halving from 10 years to 5 years to about 2 years most recently. This has important implications for space demand, not just in the obvious way that certain types of retail outlets are nearly completely displaced by e-retail distributors, such as Amazon, Buy.com, Zappos, Wayfair.com and Overstock.com. We have already seen this with book stores and record stores, and the potential for other sorts of retail exists.

E-Retail Market Share Gains Are Accelerating



Sources: Census, Maximus Advisors

E-retail distributors have demonstrated a clear pricing advantage over traditional retailers, with no overhead in terms of leasing physical stores along with the associated operating costs (although warehouse/fulfillment center investment is clearly required for e-retailers). In addition, online retailers have not been required to collect sales tax on products they sell; the onus was on the consumer to self-report and pay sales tax on online purchases, and that rarely happened. This combination of reduced real estate overhead cost and no tax collection has provided online retailers a significant pricing advantage over “brick and mortar” retailers, although “brick and mortar” retailers can take some comfort that online retailers may soon be subject to collecting sales tax on the products they sell. Nevertheless, this pricing advantage has manifested itself through technology for what is termed “scan and scram” – for example, a consumer visits a retail store and, using a mobile device, can take a picture (or scan a bar code) on a product of interest; the device can then list competitive product prices by different online vendors for the same product. If the price is less, the consumer can purchase the product from an online competitor, even while in the retail store.

The loss of sales to e-retailing distributors is known as online leakage, and this began in the mid-90s. Since then, online sales have grown by double-digits every year through the present, with the exception of 2009, which saw single digit growth during the recent recession. Note that during the recession aggregate sales by “brick & mortar” retailers were negative. Since 2009, e-retail sales have continued their double-digit ascent and for 2011, e-retail sales represented 9.5% of total retail sales. Not surprisingly, this trend is expected to continue with an improving economic outlook for Gen-Y, along with technology advances in mobile devices, tablets and the continued improvement in network speeds to facilitate online/mobile shopping.

Bricks and Mortars: “If You Can’t Beat Them, Join Them.”

The growth in e-retailing sales has traditional retailers taking notice, and they are evolving by making major e-commerce investments. Per Carol Meyrowitz, CEO of TJX Cos Inc (TJ Maxx, Marshalls, and HomeGoods stores), “E-commerce is clearly in our future.” Other traditional retailers concur, and are investing in e-Commerce to complement their existing store formats, including:

- **Nordstrom** investing approximately $1 billion over five years to develop its e-retailing strategy/infrastructure.
- **Walgreens**’ acquisition of Drugstore.com in 2011.

- **Kohl's** has focused its capital spending on e-Commerce, which includes the construction of a 950,000 sf warehouse supporting its Kohls.com operation.
- **Walmart** has a think-tank platform based in Silicon Valley known as "@WalmartLabs," focused on social and mobile commerce to support Walmart's global strategy of integrating the shopping experience between its physical stores and e-commerce.
- Similar to @WalMartLabs' investment, **Staples** will build an e-Commerce Innovation Center in Cambridge, Mass., to remain competitive and be at the forefront of emerging online technologies and strategies.

What Does this Mean for Retail Space Demands?

E-retail distributors are likely to have a more subtle impact on retail space demand. The size of some retail stores could shrink from current dimensions as they become more like showrooms, where shoppers can see, test and analyze the product but the delivery is done directly to the home and the need for large inventory space is diminished. Traditional retailers continue to address the following "strategy points":

1. Competitive product pricing (and ability to match pricing).
2. Provide an entertainment component and/or a knowledgeable sales staff that can readily assist. Apple Stores get high marks for this.
3. If product or inventory is unavailable within the store, then the ability to order from the store and have it delivered to the customer's home address is favorable. Coming back to the store to pick up a back-ordered item is not viewed as favorable.
4. "Digitail" is a term used to describe the blending of the digital and traditional retail formats in one physical locale. We anticipate this combination format of an online component within a retail store to grow. In addition, the convenience of returning an online product to a physical store cannot be understated.

So Which Retail Formats are the Most Vulnerable?

Recent performance provides some evidence as to the potential effect on traditional retailers from online distributors, ranging from marginal erosion to going-out-of-business. The following highlight the potential influence of e-retailing on several real estate formats:

- Fortress Class "A" malls have performed well from a fundamental and valuation perspective, because they are destination properties that typically have an entertainment component which cannot be replicated online. Although some of the individual mall stores (both inline and anchor) are vulnerable to online retail sales, the emergence of physical stores with an online e-commerce component should limit online leakage from e-retailing competitors. However, many B and C malls without an entertainment component or the demographics to support an entertainment component have not performed well recently, and are susceptible to sales per square foot erosion from online e-retailers. Many of these properties may be susceptible to being valued for a different "highest and best use."
- Necessity-based retail has done well because of its "necessity based" nature, and grocery anchored centers have done well in terms of fundamentals and valuations. These properties remain somewhat insulated from online sales because consumers still prefer the ability to evaluate their produce, fruits, meats and fish. Some commodity-like products in boxes and cans remain candidates for online retailers. However, pricing margin for grocery items is notoriously narrow and it is difficult for e-retailers to win on pricing against store grocers. In NYC, online grocer "Fresh Direct" has had modest success, but this may be attributed to convenience.
- The tenants most vulnerable to online leakage are retailers offering commodity-like products, such as books, movies, video games, and electronics, combined with the inability to compete on price. Several retailers have met their demise due to the inability to offer competitive pricing and prevent online leakage. Such names include, Circuit City, Borders, Blockbuster, and Hollywood Video. Some have pointed to Best Buy as the next on that list

with their announced closing of 50 stores, but within the same announcement, Best Buy touts the opening of 100 smaller mobile store formats - consistent with the future view on retailing.

Online E-Retailer Effect on the Retail Store Competitive Landscape

Online e-retail sales growth continues to drain sales from the traditional stores, making an already competitive real estate landscape even more competitive. Retail stores that were marginally competitive before the erosion from online retail sales are now further challenged. The retail space formats most susceptible to e-retailing sales intrusion would be in-line, anchor, and big box space with tenants that sell commodity-like goods and are vulnerable to online pricing pressure and sales erosion.

For real estate owners, it comes back to basic fundamentals of real estate property ownership, and that speaks primarily to the defensive quality of the commercial real estate - does the property have a good location, strong traffic, prime visibility and accessibility, good demographics and growing household incomes, and potentially an entertainment component? Regardless of the retail tenant, it becomes a question of whether the property can compete in the market as e-retailing sales erosion heightens the leasing and re-tenanting risk of a property. If the property cannot compete, then it becomes a question of economic obsolescence.

Future Retail Store Demand?

This report has highlighted the need of store tenants (and retail property owners) to evolve and meet the challenge of a growing demographic base and an expansive technology-driven shopping experience, but we can also envision the need for online "only" e-retailers having to evolve. That is, to expand their retail distribution network to include physical stores or showrooms. Apple has demonstrated this successfully, and it is possible that Amazon may one day require a physical store presence in malls and urban retail areas - potentially adding another element to the demand for real estate properties.

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