MEMO

Date: 7.19.21

From: Corinna Cole, Executive Director, Lisle Economic Development Partnership

To: Village Trustees

cc: LEDP Board

Subject: Commercial Real Estate Trends

The purpose of this memo is to inform the Village Board of current trends in the commercial real estate sector.

Analysis of changing real estate market trends

Commercial real estate is undergoing a seismic shift corresponding to drastic changes in the American economy. Whether retail, restaurant, or office, businesses are opting to occupy smaller footprints or eschew brick and mortar altogether. These changes, which were first noted around 2010[1], have largely been driven by the rise of online retailing and shifting demographic trends. The pandemic, of course, has thrown gas on the proverbial fire, accelerating these trends far faster than would have otherwise occurred had the market stayed on the same trajectory as it was on in early 2020.

Demographics, technology, and the emphasis on experience

Millennials are the largest generation alive in America. Often called digital natives, Millennials and Gen Z view technology as intrinsic to their lived experience, including how they choose to spend their money, interact with their environments, work and live. As such, they often choose online retailing for its convenience and cost savings. These generations also prefer to spend their money on experiences, such as restaurant dining or travel, over purchasing physical goods.

To coax digital natives away from the convenience of online buying, the shopping experience cannot just be characterized by good service or a pleasant environment, but instead must be a compelling reason to venture out, such as spending time with friends or interacting with a product in a unique fashion (e.g., having a personalized make-up session at Sephora). In fact, due to the large shift towards work from home during the pandemic, people feel the same way now about the office environment. In an article addressing how law firms are currently leasing offices, one expert said "the office will become more of a destination. People on the same client teams, for instance, might come in several times a month specifically to brainstorm(...) Firms

[1] https://en.wikipedia.org/wiki/Retail_apocalypse

that are not able to adapt enough will lose their talent,[2]" Effectively, these digital natives do not want to interact with physical real estate in a transactional way that can be accomplished online; rather, they want to enjoy the experience or destination of shopping or going to the office.

How these changes impact physical space

Retail:

Since 2016, news outlets and business publications have given top billing to the widespread trend of the commercial real estate 'shrinking footprint.' Until the pandemic, most airtime was spent on the changing nature of retail, sometimes dramatically referring to the numerous store closures as the 'retail apocalypse.' In fact, in April of this year, Business Insider ran an article entitled "Roughly 80,000 stores are doomed to close in the next 5 years as the retail apocalypse continues to rip through America." The impacts of this ongoing, decade-long trend are obvious: many once familiar brands are no longer present. Vacant big box stores are a common site along once thriving retail corridors. Malls are struggling to survive or reinvent themselves.

Correspondingly, retailers have seen diminishing returns on maintaining their costly brick-and-mortar locations. With a dramatic rise in online retailing, there is simply no need for huge stores that require high labor and overhead costs. Many retailers have shifted to a smaller format store. Prominent examples include Target, Aldi, Ikea, Nike, BestBuy, Dollar General, Dollar Tree, Burlington, Ralph Lauren, Express, Nordstrom, Kohl's, Macy's, Whole Foods, 7-Eleven, Fresh Thyme (backed by Meijer), Levi's, Mariano's, Sprout's, Walgreens and Bloomingdales.

The combination of declining retail sales and the shift to smaller stores can deeply hurt a community: when a big box retailer closes, there are no new retailers that want to occupy a 50,000 square foot store, nor pay for the costs to divide it into the correct size. The big box remains vacant, reducing needed traffic to the strip center, perhaps even triggering a co-tenancy clause that allows other stores or franchises to flee.[3] Without an anchor tenant, the strip center cannot attract other lucrative tenants for the in-line spaces and then enters a vacancy spiral where the center does not generate cashflow. Consequently, the landlord may not maintain the center and/or it goes vacant entirely.

Grocery and other necessity retailers, such as pharmacies, are not immune to this trend. As stated above, many brands are moving to smaller footprints. Also accelerated by the pandemic, people have realized that necessities are easily delivered to their homes. When they want to visit a grocery store, they are more likely than in past years to be willing to travel to one that offers an

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[2] https://www.law.com/dailyreportonline/2021/03/19/law-firms-are-planning-major-office-changes-for-post-pandemic-era/

[3] Co-tenancy clauses are language included in a commercial lease that allows one tenant to leave alongside another which may attract a demographic of shoppers critical to the tenant's business model.

experience, such as Trader Joe's or Mariano's. In turn, necessity stores no longer locate in every town, but can opt for fewer (and smaller footprint) locations in highly trafficked areas with prime retail stock.[4]

While it is easy to understand why the pandemic would accelerate these changes – one study showed that online commerce grew ten years in three months during 2020[5]- it may be tempting to conclude that consumers will surge back into brick-and-mortar stores now that the pandemic is over, reversing the trend for those retailers that came through intact.

However, for eighteen months consumers were forced to adopt online retailing through all sorts of omnichannel methods[6] and are unlikely to abandon those habits. Large footprint stores are still costly to develop and operate and some businesses experienced a deep hit to their financial well-being. In short, while retail is enjoying the benefits of the pent-up consumer demand, experts say that the fundamentals have not changed and the same market forces that caused the retail apocalypse and smaller store footprints will continue to play out.

Office:

Office space has also been trending smaller for the last decade, particularly as the large suburban office complex fell out of vogue and millennials preferred transit oriented, walkable, urban locations with a mix of amenities[7]. By relocating to cities to which multiple mass transit lines connect, employers could access a much larger talent pool, drawing both from millennial city dwellers, but also from mass transit commuters living throughout adjacent suburbs. Likewise, the traditional, space-taking cubical farm and private office layout became less popular in favor of open, flexible, collaborative workspaces. Employers came to view office amenities as an important recruitment tool[8]. Technological innovations made remote work a viable option for many. Collectively, these changes resulted in a smaller office footprint. From a 2016 article concerning office space: "Many firms are encouraging remote working because it does help to reduce overall office costs (…) The changing workplace has dramatically reduced the square

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[4] https://www.iedconline.org/index.php?src=blog&srctype=detail&refno=2613&category=Real%20Estate%20and%20Revitalization

[5] https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/five-fifty-the-quickening

[6] Omni-channeling refers to the practice of unifying the types of contact consumers have with a retailer's various 'channels,' or ways of communicating and selling. Wikipedia notes that a consumer may use "mobile devices, the mobile web, mobile apps, contextual help, augmented reality, virtual reality, and chatbots (…) in addition to traditional physical and human interaction channels."

[7] https://www.iedconline.org/index.php?src=blog&srctype=detail&refno=1095&category=Archive

[8] https://www.ccim.com/cire-magazine/articles/2017/03/shrinking-footprint/

footage per employee during the past decade (…) CoreNet Global predicted that the average space per office employee would decline from an average of 176 sf in 2012 to 151 sf by 2017."[9]

It is obvious by now that the pandemic forced most office employers to positively reconsider the efficiency of a remote workforce. Companies have the option to drastically reduce overhead by limiting the amount of physical office space and also access a talent pool unconstrained by geography.[10] A Bisnow article published in April of 2020 headlined "Survey: 69% of Companies Plan to Shrink Office Footprint, Increase Remote Work."[11] While some in-office work is necessary, companies can pick and choose which functions remain remote and efficiently make use of physical space only when it adds a net benefit. A March CNBC article summarized it this way "(employers) have learned over the past 12 months that their employees can work from just about anywhere. So that means the office must serve a much more compelling purpose: A hub for collaboration that can't be accomplished virtually."[12]

In short, employers and employees are looking for a desirable office "experience," one where they can connect with colleagues and collaborate more effectively than virtually. In keeping with the trend identified in 2016, high quality office space is a recruiting tool both for office building landlords and the employers that tenant them. From an article published by WSP Global, managerial consultant specializing in in property management: "(the pandemic) is probably going to accelerate the need for modern, flexible office space with lots of services (…) The buildings that suffer will be the older ones that tenants just don't want any more. They're just the wrong product."[13] The article goes on to say that successful office buildings will be located adjacent or within cities and will prioritize 'home comforts' and wellness initiatives that 'increase the feelgood factor and ultimately raise productivity and creativity." Other articles have stated that area amenities, such as walkable or bikeable trails, restaurants and bars, and entertainment opportunities can improve an office building's competitive position.

Another interesting development caused by the pandemic is the exodus of city dwellers in search of more living space in the suburbs. The Deloitte Global 2021 Millennial and Gen Z Survey noted: "The acceleration of flexible workplaces could eventually affect where people choose to

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[9] https://www.ccim.com/cire-magazine/articles/2017/03/shrinking-footprint/

[10] https://www.forbes.com/sites/ashiraprossack1/2021/04/25/office-not-required--why-remote-work-is-here-to-stay/?sh=3cc21bde6ab4

[11] https://www.bisnow.com/new-york/news/commercial-real-estate/new-surveys-show-that-work-from-home-is-expected-to-be-more-permanent-104187?utm_source=outbound_pub_2&utm_campaign=outbound_issue_38334&utm_content=outbound_link_4&utm_medium=email

[12] https://www.cnbc.com/2021/03/10/1-year-into-covid-employers-rethink-offices-and-function-matters-most.html

[13] https://www.wsp.com/en-GL/insights/how-will-covid-19-change-demand-for-office-space

live. During the pandemic, nearly 10% of millennials and Gen Zs surveyed said they temporarily (5%) or permanently (4%) moved out of a city. That is a fraction of the 56% who said in last year's survey that, if given the opportunity to work remotely in the future, they would choose to live outside of a major city. But it represents notable movement given the short time frame and will be an interesting trend to watch in the future.[14]" While remote work lessens the need for office space, it also may increase the number of millennials and Gen Zs interested in such a centrally located community with transit access to Chicago. In turn, office tenants may be attracted to Lisle for similar reasons, but also because they can benefit from cheaper rent than is available in the city and still attract talent.

[14] https://www2.deloitte.com/content/dam/Deloitte/global/Documents/2021-deloitte-global-millennial-survey-report.pdf