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Structural Changes in the US Retailing Industry and Legal, Economic and Strategy Implications for the US Real Estate Sector

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Abstract

The US retailing industry has been experiencing substantial decline over the last few years. This has been manifested in layoffs, changes in management, inventory write-downs, discontinuation and streamlining of online marketing efforts, bankruptcy, reduced capital expenditures, store closings and cost cutting. In many companies in this industry, real estate accounts for a substantial portion of fixed assets (land, buildings/fixtures and lease interests), capital expenditures and operating costs (maintainance, insurance, taxes, rents and depreciation). This article analyses the economic, legal and strategic impact of the Internet and ongoing industry restructuring on the US retail real estate sector. Appropriate strategies for developers, investors and retailing companies are explained. The article's contributions to management theory, law and economics is in: a) improving the understanding of the analysis of structural long-term changes in large industries, b) showing the relationships and dependencies among strategy, change management and regulation, c) raising questions about the standard models of industry competition in which forward-integration and backward-integration are deemed absolutely necessary and natural in certain conditions (in this instance, the opposite applies), and in which competition is based primarily on price or product differentiation (in this instance, competition is based on other factors), d) showing why the standard method of analysis of antitrust and competition for regulatory purposes (industry concentration) may not be accurate in certain circumstances, e) analyzing the strategic use of real estate - this has not been covered adequately in many management articles even though real estate constitutes a substantial portion of assets and expenses in many industries such as retailing, healthcare, power, manufacturing, and hospitality, f) introducing new models/theories of competition, change and industry structure, g) explaining the effect of regulatory structures on change, industry dynamics and firm performance.

Keywords: Industry restructuring, strategy, change management, law and economics, real estate, healthcare facilities, retailing, hospitality.

1. Summary Of The US Retailing Industry

A. The Retailing Industry – Product Segments

The retailing industry is highly fragmented and consists of companies from many different industries selling a wide variety of goods. The industry has more than 1.6 million establishments, and employed more than twenty million people (S&P; Moodys; trade journals). Competition is assumed to be based primarily on price and to a lesser extent brand loyalty, depending on the nature of the product. Most retailers segment their customers by location,

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age and household income, and tend to focus on households with annual incomes of $20,000-85,000. Inventory controls, supply chain management, logistics, and CRM are key to profitability. From a real estate and product perspective, the retailing industry consists of five segments – a) gasoline, general merchandise, b) Internet grocery, c) Ready meals, d) financial services, and e) healthcare facilities.

Gasoline/Convenience Stores

The gasoline segment has a market size of about $260 billion (Merrill Lynch; S&P; Moodys; trade journals), and supermarkets account for about 20% of sales. Ownership in this segment is highly concentrated among oil companies (Exxon, Shell, Mobil, Elf, etc.) and large supermarket chains. Gasoline remains a daily necessity for most families. Many oil companies who produce oil have been developing their own gas stations and leasing gas stations as opposed to selling fuel to middlemen. In addition, supermarket chains (Albertson's, Kroger, BJs, Costco, Safeway and Walmart) have been adding fuel stations to their existing stores, and are cross-selling and cross-promoting fuel and other goods, and this has typically increased sales at these stores by up to 20% annually. These trends have increased the demand for locations for gas stations. The barriers to entry include obtaining zoning variances and permits, locating suitable land and environmental problems. Convenience stores typically make a profit of $0.09-0.14 per gallon of fuel, while supermarket chains make a profit of $0.04-0.07 per gallon (Merrill Lynch, 2001/2002). Convenience stores do about 750,000 gallons or $1 million in sales annually, while the large retailers do about $1.35 million in sales per store annually (Merrill Lynch, 2001/2002; S&P; trade journals). Given that UK retailers now own about 25% of the UK gasoline market, US retailers are positioned to gain about $45-50 billion of gasoline sales over the next ten years, by adding new fuel stations to existing stores.

General Merchandise. The general merchandise segment has a market size of about $528 billion (Merrill Lynch, 2001/2002; S&P; trade journals), and supermarket chains account for at least 10% of the sales. This segment includes all general merchandise other than food – such as pharmacy, household durables, books, footwear, toys, apparel, health & beauty, CDs, videos, etc. General merchandise constitutes 7-30% of the total annual sales of many large US and European retailers. The dominant companies in this segment include ASDA, Royal Ahold, Casino, C.C. Carrefour, Delhaize, Iceland Group, Metro, Safeway, Kroger, Food Lion, Albertson's, Winn Dixie, Target, Kmart, etc. This segment has relatively low inventory turns, has massive seasonal peaks and goods often have to be marked down. Many retailing chains are introducing pharmacies into existing stores.

Internet Grocery. The Internet grocery segment is dominated by large retailing chains, and has annual sales of about $5 billion (Merrill Lynch, 2001/2002; S&P; industry journals). Industry sources think that this segment will account for only about 5% of total grocery sales, and will cater mostly to the rich, and house-bound shoppers. Consumer acceptance of the Internet continues to grow, and Internet shopping in general will follow similar trends. However, many solutions and retailing formats have not succeeded because of the perishable nature of goods, wide range of products, tight delivery schedules, and

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price sensitivity. Systems developed by Tesco, Ahold and Safeway have achieved break-even.

Ready Meals. The ready-meals segment has annual sales of about $60 billion (Merrill Lynch, 2001/2002; industry journals). The products consist mostly of prepared foods that are packaged for sale. Competition is based on perceived quality. This segment has not taken off in the US due to inadequate retailer investment in food service, technology, personnel and research; inadequate scale in the case of small retailers, brands which are not strong enough to generate consumer loyalty and trust required for new product introductions, inability and or unwillingness to commit capital to partner with local food manufacturers, and lack of good manufacturers capable of producing time and quality sensitive chilled food. Ready meals account for 5-10% of full line supermarket sales.

The convenience-store/gas-station sector is characterized by the following (First Research, 2001/2002; trade journals; Moodys):

- Sells gasoline, which represents over half of sales, and tobacco, fast food, beer, soft drinks, and other products.
- Location is key to successful sales.
- Stores must be small enough to control costs and large enough to offer a variety of merchandise.
- Wholesale merchandise is an important revenue source due to favorable gross margins.
- Specialized product lines are being introduced for market growth.
- Technological enhancements, such as pay-at-the-pump options, POs systems, e-commerce, Internet access terminals, and ATMs.
- Mergers, acquisitions, and joint ventures increasing.
- New technology and automation improve security.
- Hypermarket locations compete directly with gasoline retail stores for business.
- Potential for UST liability has increased insurance costs.
- Quality, training, and turnover make labor an ongoing challenge.
- Gross margins on gas cannot be controlled as they are determined by competition and not necessarily by location.

Drug stores have the following characteristics and issues (First Research, 2001/2002; trade journals; Moodys; S&P):

- Can be independent or belong to chains, supermarkets, and mass merchants.

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- Average drugstore has annual sales of about $2.5 million and fills 1,000 prescriptions per week.
- More than 80% of prescription sales are paid for by managed care plans.
- There is rapid inventory turnover, usually financed from cash flow.
- There are two main types of products: prescription drugs, and "front-store" products.
- There has been increased prescription drug use in recent years.
- Internet sales of prescription drugs is a rapidly growing business that threatens the current drugstore business model.
- Companies are using automatic drug dispensing and pharmacy technicians to increase prescription volume.
- Chains, including supermarkets and mass merchandisers, hold 60% market share and continue to expand.
- Selection and marketing of non-prescription items is crucial for profitability.
- Improved computer information systems and new electronic prescriptions have increased efficiency.
- Independents band together in buying groups and cooperatives to gain purchasing leverage.
- Shortage of pharmacists remains an issue.
- Low-cost pharmacies like mail order or online pharmacies, are encouraged by HMOs and are a low cost threat.
- Sourcing (from manufacturers or from wholesale distributors) is key to profitability.
- Institutional pharmacies (located in hospitals, etc.) have had increasingly negative impact on drug store revenues.

Grocery Stores and Supermarkets (First Research, 2001/2002; industry journals; Moodys):

- Large national chains generally lead the industry, although small chains and independent grocers still dominate some markets.
- Inventory management, information systems, logistics, storage and good management practices are key to profitability.
- Detail-oriented and very labor-intensive business.
- Small chains and independent stores buy from wholesale distributors; big chains buy directly from manufacturers.

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- There is continuing consolidation which should create economies of scale and more efficiency.
- The percentage of food bought at supermarkets for home-cooked meals has been declining.
- Companies are changing store layout to capitalize on highest gross margin items and new high margin services such as takeout, film processing, videotape rentals, and flowers.
- Margins are low and companies are prone to frequent failure.
- There is increasing competition from warehouse stores, mass merchandisers, and wholesale clubs.
- Companies are focusing on protecting market share by opening new store locations, while preserving profitability.
- Specialty food stores and warehouse clubs are gaining market share.
- New technology can be increasingly used to boost customer loyalty.

Footwear Manufacturing/Wholesale/Retail sector (First Research, 2002; industry journals; S&P; Moodys):

- Mature and seasonal industry, with annual sales of about 1.2 billion pairs of shoes.
- Retail shoe market is heavily segmented by type of consumer and by price level.
- Some US companies own foreign factories, but most contract with independent footwear manufacturers (mostly abroad).
- Shoe prices have been flat for many years.
- Domestic manufacture of shoes has been rapidly declining and now has sales of less than $3 billion annually.
- Demand for dress shoes continues to decline as more causal dress styles are now common in business.
- Retail chains that sell multiple brands are rapidly gaining market share from single-brand stores.
- Companies have high labor costs, because shoes are still assembled mainly by hand (and are sold mostly in stores).
- Inventory management is a major concern for producers and retailers.
- Many companies have consumer Internet sites that allow online shopping.
- Some retailers have increased buyer loyalty through frequent buyer programs.

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- Technology is being used increase sales and customer loyalty, and to reduce labor costs.
- US trade policy (quotas and tariffs on footwear imports) affect the profitability of many US companies.

The childcare facilities sector (First Research, 2002; industry journals):

- Highly fragmented industry sector - the top 50 chains represent only 10% of licensed capacity.
- Few barriers to entry, low margins, no proprietary technology, few economies of scale, weak brand distinctions, and heavy regulatory oversight.
- Labor is the biggest cost and management challenge.
- Location is more important than cost in determining demand for services.
- Demand has increased rapidly in the past decade as more women enter the workforce.
- For-profit childcare faces heavy competition from home-based daycare and non-profit organizations.
- Major national employers offer onsite childcare for employees.
- Increasing consolidation by a few industry giants buying smaller chains.
- Liability is an inherent risk.
- National accreditation by an independent agency improves marketing and sets standards.
- High quality teaching is gaining importance.
- There are substantial differences among states in price, quality, and availability of childcare.
- Security and providing facilities for children with disabilities are now important.
- Mix of revenues (state vs. federal vs. private-pay) is key to liquidity.

B. The Restaurant Industry – Fastfood And Casual Dinning Summary.

The US restaurant industry is highly fragmented, very competitive (price, service, location, and food quality type), fragmented, management intensive and had annual sales of about $379.2 billion in 2000 (National Restaurant Association, 2002; Standard & Poors, 2002). The fast food segment consists of sandwich chains, Pizza stores and stores that focus on chicken. The casual dining segments consist of full service restaurants, grill/buffet restaurants and family restaurants – Denny's, Cracker barrel, Golden Corral, etc. The restaurant industry is generally mature, but sales growth has been slow recently, and there is intense

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competition. Same store average sales for restaurant chains increased by about 0.2-1.50% in 2000 due to increases in both the number of transactions and the average check amount per transaction. Annual growth in the number of restaurant chain stores is estimated to be more than 1.5% during the next five years. Most restaurants are small; over two-thirds of them have less than $500,000 in revenue. A typical restaurant location has one general manager, 3 or 4 assistant managers, and 40-60 hourly employees. Labor costs are increasing due to competition, labor shortage, high turnover, and minimum wage increases. The prices of raw materials have remained steady, are not likely to increase substantially in the next few years, and cheaper supplies of meat and diary products from Latin America may lower costs. Labor prices have remained stable, but proposals to increase the minimum wage may affect labor costs. However, increases in labor costs can be passed on to customer.

The $345+ billion US restaurant industry and its $110+ billion fast food segment are highly competitive and are very sensitive to increases in labor costs and food prices. In 2000, the industry's top 100 companies controlled 50.3% of total chain restaurant sales ($129.7 billion); while the second 100 companies controlled only 5.4% of sales. Companies in the fast food segment include Advantica Restaurant, Wendy's, Tricon, Applebees International, and Taco Cabana. Although competition is based on perceived quality and service, companies are adding the new dimensions of variety, value, quality drive-through service and access, all of which are unique competitive advantages. Companies such as Burger King, McDonald's and Wendy's have variously used discounting and promotions to increase the number of customer visits, but this has affected margins. The Hamburger segment is dominated by MacDonald's, Wendy's and Burger King, which account for over 72% of market share. Ownership in the fast-food segment is quite concentrated, and it is dominated by a few companies such as Macdonald's, Burger King and Wendy's. While the general restaurant industry is highly fragmented and has been experiencing low growth, the fast food sector is characterized by high fixed costs (real estate, equipment and some labor costs), and slightly higher growth rates. Intense competition has forced players such as Macdonald's and Burger King to close under-performing units, to focus on cost reduction efforts, to reduce expansion of number of units, and to renovate existing units and upgrade equipment, often at large costs. Appropriate location is now more important than ever, and fast-food chains are seeking out unusual sites such as hospitals, gas stations and airports, and are trying "dual branding" (combining operations with other fast-food chains at the same sites). These domestic trends have compelled US fast-food and casual dining chains to look abroad where the number of units has been growing at an average annual rate of 5-7.5% compared to about 1.5% in the US. The fast food segment is poised to grow as more customers allocate more of their spending to fast food. Customers presently spend over 52% (up from 43% four years ago) of their total food expenses on fast food, thus such expenses may not be considered discretionary, and should not be evaluated on the basis of disposable income, but indicate a new pattern of lifestyle. The advent of the Internet will make it easier and faster for customers to order fast food, particularly for drive-through customers who account for over 70% of restaurant revenues. Each fast food restaurants has annual stores sales of $600,000-$1.6 million. Most fast-food chains operate about 30% of the restaurants and the rest are operated by franchisees. The growth of the number of working-age persons with two or more jobs, entertainment overload, relatively high di-

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vorce rates, growth of double income families, and increased female participation in the workforce, will increase revenues of fast food chains.

Real estate constitutes a substantial portion of the fixed costs and fixed assets of restaurant companies. Some restaurant chains only lease buildings/spaces, while others commit capital to lease land, construct restaurants and then enter into sale-leaseback transactions. Obviously, this alternative ties up much needed capital, requires substantial cash and human capital, and diverts companys' resources from improving existing restaurants. It costs between $1-1.8 million to build a restaurant (including ground-lease payments ad other carrying costs). Ownership involves high capital requirements, and potential high debt levels in a cash-based and highly competitive industry. The upside of ownership is in buying properties at low prices, and the appreciation in the value of the real estate or land, and the depreciation tax shields provided by such ownership. Thus, the advantages of ownership greatly depends on location, and fast-food chains are actively seeking out unusual sites in order to maximize market penetration. On the contrary, leasing involves substantially lower capital requirements, can replicate the depreciation benefits of ownership (use of capital leases), provides the company with more financial flexibility and operational flexibility in terms of relocating under-performing units, but creates exposure to lease termination and increased rental rates. Leasing allows companies to grow faster by eliminating capital requirements and delays associated with new construction. Restaurant chains also have to decide whether to use operating leases or capital leases, and this has significant accounting implications in terms of costs, cash flows and asset base. Use of capital leases allows the lessee to carry the assets on its balance sheet (thus increasing total assets, and reducing ROA), to record the present value of minimum lease payments as long-term debt (thus increasing Debt/Equity ratios and reducing perceived financial stability), and to use depreciation tax shields associated which such property. With operating leases, the assets and the associated liabilities are not reported on the lessee's balance sheet, lessee does not depreciate the property, and the lessee merely expenses lease payments.

Restaurant chains are facing key issues such as: a) development risks, b) financial stability of franchisees, and the ability of franchises to operate restaurants in line with company policies and procedures, c) seasonality, d) changes in labor and food costs; employee retention and turnover problems; proposals to increase the minimum wage; unionization; highly labor intensive business, e) regulation by local and state agencies, f) high leverage and negative working capital – some large companies in the industry seem to be highly leveraged, primarily due to construction activity, g) high fixed costs and low barriers to entry, h) changes in customer tastes and preferences, location, demographic trends, pedestrian and motor traffic, consumer income, family structure, quality of food service and value of food service. However, several trends are transforming the restaurant sector, some of which will improve credit quality and profitability:

- Information systems will improve real time control of operations, financial management, inventory management and storage of products.
- The increasing popularity of franchising will stabilize operations – failing franchise stores are turned over to franchisors rather than being closed; and franchisors can often provide lease guarantees.

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- Changes in demographics and consumer behavior favor restaurants.
- Although most firms have negative working capital, industry debt levels are relatively low.
- Increased advertising for name recognition, brand image and product differentiation.
- Increasing use of leasing as opposed to ownership of restaurant buildings/spaces.
- Regional consolidation, and international expansion by some chains.
- Better recruitment and training of franchisees and staff.
- Segments: full-service, quickserve or "fast food", away-from-home managed institutions for schools and hospitals, and other food businesses such as hotels, and catering.
- Franchising is integral to the industry, but there is overabundance of supply in some markets.
- Casual dining restaurants has had higher growth than the rest of the industry.
- Finding qualified labor at reasonable prices remains a problem.
- Supermarkets and convenience stores are increasing competition by offering "ready meals".
- Advertising partnerships, customer complaint resolution, faster payment transactions, and reduction of credit card fraud and transaction fees are important for profitability.

C. Healthcare Facilities: Assisted Living And Surgical Center Summary.

This sector includes assisted-living facilities, independent living facilities and freestanding out-patient surgery centers. Most of these segments of the healthcare industry are positioned to benefit by the aging of the US population and the increasing percentage of senior citizens in the US population. Nursing homes and assisted living operations account for approximately $100 billion of the almost $900 billion expended for healthcare in the US (First Research, 2001/2002; Moodys, S&P; trade journals). Although nursing homes and assisted living facilities are designed for dependent senior persons, they also admit dependent people of all ages that need rehabilitative and sub-acute care, which is goal oriented short-term rehabilitative services like surgery recovery. Medicaid/Medicare do not cover independent living accommodation.

Assisted-living and independent-living sectors:

- Assisted living residences typically provide or coordinate 24-hour supervision; three meals a day in a group dining room; and a range of services that promote resident quality of life and independence, including: personal care services (help with

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eating, bathing, dressing, etc.); various health care services; social services; food service; supervision of persons with cognitive disabilities; social and religious activities; exercise and educational activities; arrangements for transportation; laundry and linen service; and housekeeping and maintenance.

- About 60% of the facilities are operated by for-profit firms. Maintaining bed occupancy above 90% is key.
- Assisted living homes have fewer regulatory barriers than nursing homes.
- Substantial barriers to entry (government approvals, capital, and knowledge), relatively good margins, large chains achieve economies of scale, increasing brand distinctions (Marriott, Sunrise, ManorCare, etc.), and risk of more heavy regulatory oversight.
- Four service rate models: all-inclusive, basic/enhanced, a la carte/fee-for-service, and service levels.
- Due to oversupply and operational problems the number of assisted living facilities recently declined.
- Assisted living offers a cheaper alternative to nursing homes, and assisted living operators are more likely to recover their actual costs (of providing services) than nursing home operators who are more dependent on Medicaid/Medicare that limits revenues.
- Type of assisted living home residents has changed to a more disabled, and more medically dependent population. Assisted living facilities are expanding services offered to include post-surgical recovery services, rehabilitative and wellness classes to help cross-sell services and increases revenues.
- Assisted living sector faces increased regulation from federal and state governments.
- Assisted living and independent living businesses are labor and capital intensive; but are highly fragmented.
- Net-leasing is not yet prevalent in this sector, but companies will be looking to raise capital through ground-leases and sale-leaseback transactions. Some companies such as Sunrise are focusing on sale/manage-backs as a means of expansion.
- ALFs differ widely in ownership, auspice, size, services, staffing, accommodations, and price.
- The median price of the facilities is $1,800 per month; there was a wide variation in which services were covered by the base rate. The most common monthly basic price was between $1,300 and $3,010 for both facilities with a single rate (i.e., 45% were in this range) and facilities with multiple rates (i.e., the range covered the most common rate for 52% of the ALFs). In many ALFs, these rates do not cover all serv-

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ices, and residents often pay extra for such services as medication administration, transportation, and any assistance with ADLs or nursing care above the minimum covered by the basic rate in a facility.

- The average high service ALF or the average high privacy ALF are unaffordable for the majority of older persons, particularly since they must also pay for other basic needs (e.g., supplemental insurance, out-of pocket spending on health care and medications, clothing). However, Medicaid is increasing available for assisted-living in some states, and this will increase the potential market for ALFs.

- The assisted living and independent sectors are going through a major shakeout primarily due to management problems and oversupply in some markets. Although some investors see these as growing sectors, capital has withdrawn from the industry and development activity has slowed.

- Assisted living revenues are expected to reach $56.7 billion by 2003.

- As the average resident age has increased from 70s-80s years, there has been rising levels of illness among residents - and thus, unexpected "cost creep" or fast-rising healthcare and service expenses not anticipated by operators.

- One-half of the residents are aged 85 or older; most are educated and relatively affluent. Nearly one-fourth of the residents have significant cognitive impairment. Residents of assisted-living facilities are less disabled than residents of nursing homes.

- The majority of ALFs (55%) are free-standing, while 45% are located on a campus housing multiple facilities or residential settings offering different levels of care. ALFs on a multi-level campus have higher occupancy rates, higher monthly prices than free-standing ALFs, are more likely to have private units and apartments and to arrange more services for residents, and have higher levels of nurse staffing than free-standing ALFs. In addition, they were more likely to admit residents who needed nursing care or use wheelchairs.

- The conventional model of Medicaid reimbursement will probably not be suitable for assisted living, and thus, new means of payment are needed, especially vouchers that elders and their families can spend as they desire, thus giving assisted living facilities a competitive edge against nursing homes. (First Research).

- Requirements by several states prohibit assisted living facilities from providing full services to clients. Rules in some states, for example, bar them from caring for those with Alzheimer's disease at even its early stages.

- Local building and fire codes for nursing homes are commonly applied wholesale to assisted living facilities and frequently impede their development.

- Many operators expect 40% or more gross operating margins for private-pay-only buildings, and 20% to 30% margins for Medicaid buildings.

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- Increases in the country's elderly population has resulted in a rising demand for less costly, more appealing residential options for seniors who need some daily assistance but don't require full-time, skilled nursing-home care.
- The U.S. Census Bureau predicts that the number of people aged 65-years and over will increase to 19 million by 2020, and that 20% of the American population will be age 65 or older by 2030. The 85-and-over population, the fastest-growing segment of the U.S. populace, will nearly double by 2020 after having grown by 40% between 1990 and the year 2000.
- Analysts project that nursing home operators, unable to keep up with demand and faced with cost-containment pressures, will increasingly funnel lower-acuity residents to assisted living facilities.

Freestanding Outpatient Surgery Centers:

- Highly fragmented and ripe for consolidation. In 2000 there were 2,075 freestanding surgery centers in the US. 44% are owned by for-profit companies, 16.4 % are owned by sole proprietorships, 13.1% are owned by physician partnerships, and 9.4% are owned by limited partnerships.
- Companies will be seeking sale-leasebacks and ground-leases as a way to raise capital and to expand.
- Surgical centers offer better cost advantages compared to in-hospital surgery units.
- Volume growth is increasing due to demographics (The increasing percentage of senior citizens in the US will increase demand for surgical procedures), consumerism and advances in technology (minimally invasive surgery).
- New and ancillary services such as imaging are being added to increase profits. About 60% of surgical centers now have imaging services. Imaging is becoming a more important primary diagnostic tool in most phases of care.
- 20% of all surgeries are performed in freestanding surgical centers (SMG Marketing Group, 2000). Delays and scheduling problems at acute care hospitals, patient preference for the un-institutional setting of surgery centers, higher flexibility of freestanding surgery centers, location of surgery centers in suburban areas, and increased control by physicians will result in more demand for surgical centers.
- Fees are partly paid by Medicaid/Medicare, private insurance and personal funds.
- Most of the procedures are Opthalmology (26%), Gastroenterology (19%), and Orthopedic (9%). (SMG Marketing, 2000).
- Public companies include Healthsouth, AmSurg, United Surgical Partners, Surgicare, Dynacq, Symbion Healthcare, ASC Group, and Surgery Centers Of America.

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3. Market Participants In The US Retail Real Estate Sector.

A. Private Real Estate Entities:

These are new and experienced real estate development and investment companies, and can be categorized as follows:

a) The first category includes the newer and small companies that are active in certain cities. They typically use a combination of bank financing and their own equity.

b) The second category of companies consists of older, larger and well capitalized REITs, LLPs and LLCs that specialize in acquiring and managing strip malls, community centers, regional malls and super-malls. They are active in new construction and acquisition of larger multi-tenanted retail buildings. These companies rarely get involved in acquisitions or renovations of mid-sized mid-priced or single-tenant free-standing properties, and are not active in moderate-income neighborhoods, and do not buy or sell net-leases. These companies typically focus on buildings that contain more than 25,000SF of leasable space and are multi-tenanted. These companies rely on their own equity and on bank financing. This second category includes Developer's Diversified Realty, Heritage Properties Investment Trust, Pan Pacific Retail Properties, First Washington Realty Trust, Westfield America Trust, Equity One, Prime Retail, and Center Trust.

c) The third category consists of private and publicly-traded "triple-net-lease" REITs and companies such as Franchise Finance Corporation of America (GE Capital), Captec NetLease Realty, NLPoNet Lease Properties, US Restaurant properties, Commercial Net Lease Realty, Realty Income Corporation, Lexington Property Trust, and Capital Automotive REIT. These companies are well-capitalized, but they are not active in moderate-income neighborhoods, and do not buy or sell net-leases.

d) The fourth category consists of companies that develop their own properties. These companies often choose to build their own stores, but typically lease the land and then build the stores. However, the trend is that companies are leasing stores and land for development. Many of these companies are limited by lack of capital, and risk of excess debt. This group includes companies like Jack-In-The-Box and McDonalds and assisted-living companies.

e) The fifth group consists of regional and national development companies.

f) The sixth category consists of private investors who seek net-lease deals. Most of these private investors seek Section-1031 (US Tax Code) exchange transactions, and tend to do mostly below-investment-grade credit transactions.

B. Individual Developers

Many local developers in the New York City Metro Area are buying land for development for retailers. Those that are buying buildings as investments tend to use bank loans, options

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and their own equity and they typically contribute 0-25% as equity. These individuals are limited by lack of capital, insufficient real estate knowledge and a tendency to buy only properties in their neighborhoods and cities.

C. Credit Guarantee Companies.

These are private agencies that provide fee-based credit insurance and third-party guarantees for loans and bonds that are used to finance the development and acquisition of retail property. They include Financial Security Assurance, MBIA, AMBAC, Financial Guarantee Insurance Company and GMAC. These companies provided much needed credit enhancement. However, given the recession of the last few years, they have generally tightened their standards, and credit enhancement has become more expensive. They are selective in terms of property types, property quality and locations.

D. Credit rating Agencies.

The credit rating agencies are private companies that provide credit ratings to bonds, preferred stock and loans that are used to finance development, renovation and acquisition. They also rate development companies, state governments and local governments. The three major agencies are Standard & Poors, Moody's Investors Service and Fitch/IBCA. They quantify risk and provide a basis for pricing debt used in the development, renovation and acquisition process.

E. Banks

There are several categories of banks that are actively involved in the retail real estate sector

1) Investment banks typically act as intermediaries in raising capital to finance acquisition, development and mergers. On occasion, some investment banks manage investment funds that buy and own retail real estate. Investment banks also operate loan conduits that provide mortgage and mezzanine capital for real estate transactions.

2) Commercial banks provide commercial loans for development, acquisition and mergers. Most commercial banks lend regionally. Due to CRA requirements, most commercial banks now have community development subsidiaries that lend in low-income and moderate income neighborhoods.

3) Community banks are local, and provide residential and commercial mortgages for acquisition, renovation and development.

F. Insurance Companies.

Insurance companies provide medium term (5-7 years) and long term debt capital for acquisitions and development. Insurance companies also own and manage real estate for their portfolios. Insurance companys' investment decisions are limited by NAIC rules. Insurance companies are active nationally and some invest in international real estate funds.

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G. Pension Funds.

Pension funds provide medium term (5-7 years) and long-term debt capital for acquisitions and development. Pension funds are limited by ERISA rules, generally conservative investment guidelines and decision-making patterns of executives who may underfund or overfund pension funds.

H. Mortgage Brokers.

Mortgage brokers act an intermediaries to link residential and commercial borrowers with lenders. Mortgage brokers provide debt capital and on occasion, mezzanine funds for residential and commercial acquisitions, renovations and development. The mortgage brokerage industry is highly competitive, has low margins, is increasing automated and is national. Mortgage brokers often work with lenders and federal agencies to provide loans to borrowers that have impaired credit.

4. Structural Changes In The US Retailing Industry And Impact On Real Estate Sector

The following summarizes trends in the US retailing industry (which for the purposes of this analysis, consists of retailing, restaurant and healthcare facilities sectors):

- There will be an increasing emphasis on analysis of concentrations of consumer buying power and high-income neighborhoods, highest household income per capita, and the highest "demand densities" and population densities. (*Sales & Marketing Management*, Sept.2001). This will enable retailers to obtain maximum demand and sales per square foot, and consequently, the maximum percentage sales.

- Retailing remains the largest industries in the US. Total US retail sales in 2000 was about $3.23 trillion (Standard & Poors). In 2001, approximately 31% of US GDP was from retail sales. In 2001, retail sales (for personal and household use) was $3.2 trillion (US Dept. Of Commerce). In 2001, US personal consumption expenditure was $6.4 trillion (63% of US GDP). In 2001, the US retail industry had more than 1.6 million establishments, and employed more than 20 million people (17% of the US workforce). (Standard & Poors).

- According to Standard & Poors, as of 2001, 80% of all US retail businesses employed less than twenty people each, and many companies in this group operated one or two stores. However, 'size' in the US retail industry can no longer be measured accurately by the number of employees due to: a) mail-order operations, b) internet sales, c) automation of many processes which reduces the need for employees, d) outsourcing of many functions, e) buying-clubs, f) 'network effects'.

- Walmart ('WMT') remains a substantial presence in the industry – WMT had $245 billion in revenues in 2002, and is the world's largest company, and has 138 million shoppers per week at its 4,750 stores (1,309 in ten foreign countries). In 2002, 82% of American households made at least one purchase at WMT. See *BusinessWeek Online*, October 6, 2003. Economists often refer to a 'Wal-Mart effect" that has sup-

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pressed inflation due to cost controls. WMT is not anti-union and many of WMT's sales's clerks earned an average of $13,861 in 2001 (when the federal poverty line for a family of three was $14,630), and its employee turnover declined to below 45% from 70% in 1999. WMT accounts for 30% of the US market in household staples such as toothpaste, shampoo, and paper towels; WMT accounts for 15% to 20% of all sales of CDs, videos, and DVDs; and WMT now makes 15% of all single-copy magazine sales in the U.S. WMT controls a substantial portion of sales of major consumer products companies - 28% of Dial (DL) total sales, 24% of Del Monte Foods (DLM), 23% of Clorox', and 23% of Revlon (REV)'s sales. In 2003, WMT hopes to open 335 new stores in the U.S. (55 discount stores, 210 supercenters, and 45 Sam's Clubs and 25 Neighborhood markets), and 130 new stores in foreign markets. Wal-Mart operates 1,386 super-centers (79% share of 'super-centers') and is the US's largest grocer (19% market share), and the third-largest pharmacy (16% market share). (*BusinessWeek Online*, October 6, 2003). If WMT maintains its current 15% growth rate, it will double its revenues over the next five years and top $600 billion in 2011. According to WMT, about 44% of its 1.4 million employees will leave in 2003, and WMT will need to hire 616,000 workers. From 2004 to 2008, the company wants to add 800,000 new positions, including 47,000 management slots. The United Food & Commercial Workers Union is increasing its attempts to unionize WMT stores, and has current campaigns in forty-five locations. WMT is now seeking sites in urban areas and looking to diversify its locations away from the south and mid-west US. (*BusinessWeek Online*, October 6, 2003). Wal-Mart plans to open 1,000 more super-centers in the U.S. during the next five years, and this is projected to increase WMT's grocery sales and related revenues to $162 billion, and increase it share to over 35% of U.S. food sales and 25% of US drugstore sales (*Retail Forward*) – WMT will be cannibalizing sales from unionized competitors that pay their workers 30% more on average than WMT does (UFCW); and for every new supercenter that Wal-Mart opens, two supermarkets will close (*Retail Forward*). Although supercenters offer price discounts (14% average), their increasing growth will mean longer travel times to supercenters, restricted choice of goods and layoffs at competing stores. Unlike many retailers, WMT does not charge "slotting fees" for access to its shelves and unusually shares sales data with manufacturers; but dictates delivery schedules and influences product specifications. WMT's focus on cost reduction affects product quality, and results in movement of US jobs to low-wage countries - the $12 billion of Chinese goods purchased by Wal-Mart in 2002 was 10% of all U.S. imports from China (*BusinessWeek Online*, 10/6/2003). WMT's focus on cost reduction affects product quality and has resulted in movement of jobs to foreign countries.

- Many of the national, international and regional retailing chains are now choosing to reorganize their operations rather than merge. Mergers among such companies are quite difficult due to antitrust concerns, difficulty in obtaining financing and existing problems in the industry. Since many retailers have operations in the same markets, many combinations will result in substantially higher concentration and thus, trigger antitrust violations. This trend will result in a continued proliferation of retail

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brands and "retailing formats" which in turn will result in a wide range of site selection criteria and continued demand for retail space.

- The wide variety of retailing concepts in any one "basic'" industry ensures demand for existing retail stores – eg. a Taco-Bell restaurant may do well where a Burger King may not, and a discount apparel chain may do well where a mid-price apparel chain fails.

- The problems in the industry, and the resulting financial difficulties and ratings downgrades has led to a credit crunch for many medium and large chain store retailers. These firms will be looking to reduce expenses and close non-performing stores. Such credit problems will require that such retailers obtain credit enhancement and lease guarantees for operating and capital leases. Financial intermediaries that want to securitize cash flows from retail properties will also need more credit enhancement primarily in the form of guarantees and credit insurance as opposed to senior/junior structures. Furthermore, it may be more difficult to obtain reasonable mezzanine debt for assets backed by the credit of many retailers.

- Many retailers are consolidating their warehouses, improving their inventory management systems and their logistics. This will generally lead to low growth on demand for warehouse space. However, many retailers depend on foreign manufacturers and will continue to require storage space for merchandise.

- There has been a shift of sales revenues and market shares from most classes of retail stores to discounters. Many of the discounters and department stores are owned by a few international and national chains. Smaller companies have responded with 'everyday low prices' and other promotions.

- Cost control and technology improvement have become more important and subjects of management focus. Companies are reducing inventory levels, closing stores, laying off employees and consolidating warehouses. Retailers are also implementing automated inventory systems, bar code systems, automated billing systems, supply chain management systems and automated financial management systems, all of which help in reducing costs.

- Many large retailers are expanding internationally. Walmart, Costco, Sears and JC Penny have opened stores abroad and have invested in foreign retailing companies. Most of their foreign operations are in South America, Europe and Japan.

- The advent of the Internet, increasing use of credit cards, and the use of automated billing systems has provided opportunities for retailers to obtain more information about their customers and to develop one-to-one relationships with their customers. This has resulted in the development and implementation of Customer Relationship Management (CRM) systems.

- Demographic changes have also affected the US retailing industry:

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- Baby boomers (borne between 1946 and 1964) constitute about 30% of the US population (78 million people). They are now focusing on retirement savings and tuition (S&P, 2002).

- The 'baby-bust' generation were born between 1965-1976 and number 45 million people (17% of US population). Their transition to marriage and family life will provide some opportunities for retailers.

- There is an increasing number of senior citizens (aged more than 55 years). This group controls a substantial portion of the wealth and disposable income in the US.

- The 'Echo Boom' generation are those who were borne between 1977 and 1997. This group consists of 71 million people (25% of the US population).

- According to a 1999 US HUD report titled "*New Markets: The Untapped Retail Buying Power In America's Inner Cities*", America's inner-city neighborhoods have substantial buying power which was estimated to be $331 billion in 1999, or one-third of the $1.1 trillion total for the central cities in which those neighborhoods are located. However, this HUD report contradicts some Community Board reports (which disclose welfare statistics), and it seems to lump together both moderate-income and low-income inner-city neighborhoods. Some retailers are slowly opening stores in low-income neighborhoods. The highest inner-city retail purchasing power is in New York City – an estimated $118.7 billion annually in 1999.
- Many small and mid-sized US cities have surprisingly substantial consumer buying power – ie. Trenton, NJ had $880 million (1999), and Schenectady, NY, had $700.9 million (1999). In some larger cities, the Retail Gap (difference between households' retail buying power and total retail sales) is substantial – for example, in New York City, the 1999 "Retail Gap" was $37.1 billion, or almost one-third (31.2%) of total retail purchasing power.
- The mobility of moderate-income tenants among the residential sub-markets in many regions is limited because the public transportation systems are not linked to form one affordable transportation system that will fuse the retail sub-markets in such regions, and thus some areas are under-served by retailers.
- Many developers and property owners seek liquidity; particularly owners of community malls and lessors to non-investment-grade tenants. Thus, they are willing to sell specific leases at below-market values, in order to raise cash and reduce their exposure to certain tenants. As the recession ends and interest rates begin to rise, owners will become more interested in selling triple-net-leases.
- The economic recession that began around March 2001 will result in more lease defaults, mortgage defaults and foreclosures, and opportunities to acquire land and triple-net-leased single-tenant properties at low prices. (*Chain Store Age*, 2001).
- Decreasing levels of consumer household wealth due to losses in stock portfolios, consumers with record high debt levels, volatility in global markets, the increasing

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number of temporary workers, and significant continued layoffs at larger corporations will collectively result in job migration and thus store closings and store openings.

- The family structure is changing, divorce rates are relatively high, more women are choosing to be single, more senior citizens are living in senior housing, there are more adopted children and more pets, more women are in the work force, and more middle-aged people and heads of households are commuting to work and spending less time with their families, and these trends will increase the demand for certain basic goods and services such as restaurants, convenience stores, child-care centers, etc.

- The structural changes in the US retailing industry have been in the form of:

  - Increasing automation (billing, inventory management, customer service, production, etc.)

  - Increasing demand for sales people and technical/systems staff.

  - Re-distribution of market share among industry participants – the retail chains have gained market share at the expense of non-franchised and non-chain stores. The department stores have lost substantial market share to discounters.

  - Introduction of new technologies and online retailing – CRM, MRP, automated billing, supply-chain management systems, inventory management systems, automated financial management systems, bar-coding, etc..

  - Jobs are being re-allocated from smaller local/regional companies to national/international retailing chains.

  - More manufacturing and sourcing are done abroad.

  - Competition is now multi-faceted, and not loner based on just price or product differentiation.

- Consumer behavior and decision-making in the US is changing:

- Women purchase or influence the purchase of 80% of all consumer goods, including stocks, computers and automobiles.

- Women earn more than half of all accounting degrees, four of every ten law degrees, and almost that many medical degrees.

- According to Jupiter Media Metrix, more than half (55%) of all new Web users are women.

- The solo woman's market (never-married women aged 25-44) will be $200 billion by 2006 (Packaged Facts/MarketResearch.com).

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- One recent study of Generation-X and boomer moms found the mothers very dissimilar when grouped by age (Marketing to Women). The most useful segmentation was by similar parenting styles, occupations, interests and identities than by gender.

- Baby-boomers (30% of US population; 78 million people born between 1946-1964) are focusing their spending on tuition payments for children, mortgages and savings for retirement.

- Generation-Y (born between 1979-1994; consists of 71 million people or 25% of the US population) do a substantial portion of the physical household shopping and are more likely to be influenced by the Internet and retailers' product differentiation efforts.

- The population of seniors is increasing as baby boomers age, and this may affect demand for certain goods such as apparel, leisure and healthcare.

- Purchasing habits are changing - more sales are being done with credit cards, and outside the customers' neighborhoods.

- More consumers are cross-shopping across a wide range of store types and price points.

- Consumers are focusing on convenience and efficient shopping, and they are apt to use the Internet to locate products.

- The increasing number of children between the ages of five and twelve (as a percentage of total population), and commuters will create more demand for "drive-through" convenience stores and restaurants, and household necessities. (Restaurants And Institutions, Feb. 2001). More than 70% of restaurant customers are drive-through customers. Many large drug store chains have added drive-through windows to existing stores, and are converting older stores to the "free-standing" format. There will be continued demand for the "free-standing" store format as more customers seek prompt service. (Restaurants And Institutions).

- Retailing stores are doing better in corner locations and "free-standing" sites, than in strip malls, regional/community malls and power malls. (Shopping Centers Today). Free-standing sites typically involve much less land, and much less problems to lease. About 500 of the existing 2,500 shopping malls in the US need to be closed during the next few years. (Urban Land Institute, 2001; Business Week, 2001).

- Leasing can reduce retailers' debt loads if structured as operating leases, and this gives retailers more flexibility to change locations, and facilitates for faster expansion, and allows capital to be used in other areas such as merchandising, and marketing.

- The increasing number of franchises and franchisees, and the "turnover" of failed franchise stores to franchisors (as opposed to closure of failed stores), will result in continued demand for the "free-standing" store/restaurant format. The US franchis-

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ing sector has about 316,000 franchised units created by about 1,500 franchise systems (International Franchise Association, 2002, 2001). According to the IFA, franchised businesses have a failure rate of less than 5%, compared to 60-90% for new non-franchised businesses. Thus, landlords must consider this difference in credit quality, and should obtain guarantees and credit enhancement when leasing to non-franchised retail businesses.

- Many people "out-shop" outside their neighborhoods and by mail-order or Internet, because most of the retailing outlets are located in sub-urban "clusters" (such as Paramus, NJ, and parts of Long Island, NY) or are located in downtown areas. Thus, many neighborhoods are under-served by retailers. This implies an increased focus on site selection and analysis of transportation systems in selected markets.

- Leasing stores reduces retailers' capital requirements, facilitates rapid expansion and enhances their flexibility (in terms of re-locating stores). Real estate constitutes a substantial portion of the fixed operating costs and fixed assets of retailers.

- Corporations now own more than $1.7 trillion of private US real estate; and net-leasing is a good source of financing for below-investment-grade companies, and thus, there will be substantial demand for net-leases as companies try to unlock capital. (*National Real Estate Investor*, July 2000). Many retailers will continue to do sale-leaseback transactions in order to raise capital, reduce fixed costs and improve their risk profiles.

- Consolidation in the retailing business, direct selling through online retailers and catalogs and home shopping television channels, consumers with record high debt levels, decreasing levels of consumer household wealth due to losses in stock portfolios and 401k plans, volatility in global markets, intense price-based competition, high corporate debt levels, and expansion into smaller markets, has put pressure on retailers to reduce costs and debt, and thus, retailers are now more likely to lease stores. (*Business Week*, Dec. 2001).

- In spite the economic recession, certain retailers still intend to expand in the US, particularly those in “basic” industries. Real estate owners will need to consider the differences in consumer demand for goods in different industries, since credit ratings, availability of financing and store performance depend on such differences.

- The growing numbers of store closings, the continued decline of the mom-and-pop stores, and repositioning of full-price/multi-line department stores, changes in product mixes and supremacy of the discount store chains, and very selective opening of new stores by national retail chains will create demand for more new stores, with an emphasis on location. About 500 of the 2,500 malls in the US need to be closed in the next few years – mostly misplaced and old centers. (Urban Land Institute, May 2001). (Dragun & Howard, 2003).

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- Continuous changes in demographics, tastes and fashions, and the dwindling appeal of the major mall will create continuing demand for new store locations and free-standing single-tenant properties. (*Urban Land*, Feb. 2001).

- The integration of Internet marketing strategies into traditional marketing means that retailers will still need new brick-and-mortar store locations, and they will likely expand in tandem with the penetration of broadband, wireless Internet and wireless services. (Miller, 2000). Internet retail sales account for only about 0.7% of total US retail sales excluding automobiles (US Department of Commerce, 2001; *Shopping Centers Today*, January 2001). However, Internet sales are like to grow as Internet penetration increases, broadband penetration increases, online transactions become more secure, and retailers integrate online marketing into their overall marketing efforts. (Feinberg, Kadam, Hokama & Kim, 2002). (Fenech, 2002). (Evans, Swartz & Martin-Keating, 2002). (Gibler, Black & Moon, 2002).

- Retail real estate had an average annual total return of 7.7% in 2000 (NCREIF) compared to 12.03% for the NCREIF Index, but this performance was solely attributable to the decline in values of retail real estate – this fact combined with fear of tenant bankruptcies, layoffs, and higher investor return requirements, has reduced liquidity and selling prices of retail properties, and thus presents unique buying opportunities. (Urban Land Institute, May 2001).

- The re-positioning of wholesale distributors and the advent of Internet-based wholesale distribution/ordering systems will probably force companies to close stores, open new store locations and to change site selection criteria. (Gibler, Black & Moon, 2002).

- Advances in management information systems will lead to improved real-time control of regional operations, quicker and better decision-making, and prompt decisions about store performance, store closings and re-location. Many retailers are implementing and revising automated supply-chain improvement programs. (Miller, 2000). (Feinberg, Kadam, Hokama & Kim, 2002). (Howgego, 2002). (Knee, 2002).

- Due to the information revolution, companies are increasingly mobile, and can reach their customers from strategic rural locations that offer cheap land and lower labor costs. (Worzala & McCarthy, 2001). The advent of the Internet will not have a substantial impact on demand for store space at excellent locations. (Howgego, 2002). (Knee, 2002). (Fenech, 2002).

- Many full-price retail chain stores (and even some discount chain stores) recently had, and continue to have financial and operational difficulties. This will lead to more store closings and re-location of warehouses, and thus, more demand for new store locations. (Ernst & Young, Special Report, Fall 2001). (Gibson & Barkham, 2001). (Hertzel, Smith, Kiholm & Smith, 2001). (Manning, Rodriguez & Ghosh, 1999). (Mejia & Benjamin, 2002). *(Nation's Restaurant News,*Page 6.32). (Gibler, Black & Moon, 2002).

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- Most of the completed sale-leaseback and synthetic-lease transactions have not succeeded in providing efficient financing for retailers and developers. (Graff, 2001). (Carn, Black & Rabianski, 1999). (Gibson & Barkham, 2001). Glascock & Wachter, 1995). (Pretorius, Walker & Chau, 2003). Thus, there is demand for new financial structures that will reduce long-term liabilities and the incremental cost of capital.

- Demand for land for retail development remains strong and somewhat inelastic. Supply of land is often limited by zoning, taxation, impact fees, land conservation programs, environmental protection measures, difficulty in obtaining permits and variances, substantial land preparation costs, and retailers' selection criteria.

- The volume of construction of retail space will decline in 2002 and 2003 due to an abundance of retail space in many markets, slow growth of retail sales in some markets, and wary lenders and investors (McGraw-Hill Construction Information Group, ULI and PPR).

- Many nursing home companies are emerging from a period of financial and operational problems, bankruptcies, lower reimbursements and increasing regulation, and are seeking capital, and thus, will be looking to lease properties to in order to expand and to conserve capital (as opposed to building facilities).

- The assisted living industry is facing increased regulation by state governments. Some states have passed laws to regulate assisted living facilities and to provide government reimbursement for such services. Such regulation includes building codes, pre-development approvals, employee qualifications and training, sanitation, Medicaid/Medicare reimbursement, etc. In some of these states, assisted living facilities can accept Medicaid/Medicare payments. The net effect of such regulations will be increased operating costs and compliance costs, higher costs to residents, perhaps improved quality, and limitations on construction and renovation of assisted living facilities. Many assisted living companies are experimenting with various forms of pricing – bundling vs. one-price vs. equity interest, etc. (Doctrow, Mueller & Craig, 1999). (*Health & Medicine Week*, Sept. 2001, p.15). (*Marketing Healthcare Services*, Winter 2000, Page 30). (Anikeeff, 1999).

- The drug-store chains sector is facing increased competition from, and losing market share to alternative marketing channels such as online stores, mail-order companies, buying clubs, and in-house pharmacies. Drug stores are changing and broadening the mix of products (adding photographic services, ATMs, copying services, food, etc.) they carry, implementing MIS systems and emphasizing location analysis. (*Chain Store Age*, March 2001, Page 154). (*Drug Store News*, December 17, 2001). (Gibson & Barkham, 2001). (Knee, 2002).

- Franchising now accounts for at least one third of retail industry in many developed countries. Franchising is growing and may become the dominant form of business enterprise in the retailing sector, primarily because of the cost and efficiency advantages its offers. Franchised business are generally gaining market share from non-franchised retailing firms, and in many retail sectors, labor is generally moving from

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non-franchised to franchised companies. (Athanassopoulos, 2003). (*Drug Store News*, December 17, 2001). (Watson, Kirby & Egan, 2002). (Colla, 2003). (Dant & Kaufman, 2003).

- Some local governments are gravitating towards favorable land taxation for certain land uses, and the easing of the approval process for variances and permits, in order to spur economic development. (Needham, 2000).
- Several trends in retailing will improve the profitability and credit quality of certain retailers and restaurant companies, and lead to higher Percentage Rents:
- Consolidation will eliminate smaller companies, reduce competition and result in economies of scale.
- Only large retailers can achieve substantial economies of scale, which just began to occur during the last two years.
- Operating leverage from centralization is now becoming available through better technology.
- Technology will continue reducing labor, customer acquisition and inventory costs – for example, in 2001/2002, Kroger recently achieved cost savings of $500 million, and reduced its working capital by another $500 million.
- Wage growth is likely to remain higher than the inflation rate, and thus more consumption dollars will become available.
- Retailers tend to perform better in times of low inflation.
- The percentage of US families that earn more than $75,000 annually has increased to 22.5% in 1999.
- According to the National Restaurant Association (2002), total restaurant industry sales will be more than $577 billion by 2010; and consumers will spend 53% of every food dollar on food prepared outside the home.
- Many restaurants are managing multiple brands to stabilize and increase their revenues – eg. McDonalds, Darden, Tricon, etc.
- Over 41% of US retail sales is from franchised businesses. About 70% of restaurants are operated by franchisees.
- Consumer spending in the "basic" industries is typically not affected by the level of consumer discretionary income.
- US retailing is a fragmented business, and thus, there is low probability of long-term national or regional price wars.
- Continued population growth in certain states (ie. TX, CA, IL, WA, NY, NJ, PA and CT) will probably increase same-store sales.

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- Addition of new departments in chain stores (fuel, pharmacies, groceries etc.) will improve customer traffic and sales.
- Convenience stores have broadened convenience food and food-service offerings.
- The size of the average drug store has grown from 7,000SF to about 11,000SF.
- Currently, retailers lease 50% of their stores and own 50% of their stores, and thus, there can be more sale-leaseback transactions.
- About 3% of existing capacity is added annually as new retail space (Walmart accounts for 1%).
- Annual sales are about $494 billion for the groceries segment, $528 billion for general merchandise, $260 billion for gas/fuel, and $60 billion for ready-meals (Merrill Lynch, January 2002), and 20-60% of these items are sold through large retail chains.
- There is minimal substantial non-US retailing competition - only Delhaize Group (3% market share) and Ahold (4.5% share).
- During the last few years, low interest rates resulted in substantial mortgage refinancings which created and will create more disposable income ($85 million of additional cash in 2001, $128 billion in 2000/2001, and $77.8 billion in 1998/1999 (Merrill Lynch, December 2001). This additional cash will help reduce any effect of higher unemployment.
- The retailing and restaurant sectors have many concepts and formats, and highest-and-best use analysis (appraisal/feasibility technique) does not yield the optimum decisions, some location attributes are not valued properly, and these factors lead to mis-pricing of land, that can be exploited.
- In the US economy, there are free trade barriers in the form of restrictive class of trade pricing which results in different cost-of-goods for different retailers that sell the same types of goods (Merrill Lynch, 2001/2002) - and subsequently, different "Percentage Rents". This is relevant to valuing and acquiring triple-net-leases.
- Triple-net-leased properties require little or no property management, and are typically easy to finance, and are amenable to credit enhancement techniques. The same applies to triple-net leases that are acquired.
- Many retailers and assisted-living facilities have developed site selection criteria. (*Chain Store Age*, 2001). The typical site selection criteria applied by retailers for a gas station and convenience store ground-leases are as follows:
- More than 20,000 SF+ of land.
- Located at a corner and at a traffic light, and near demand generators.

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- High traffic counts of at least 25,000 cars per day.

- Favorable Phase-I environmental tests, and no history of environmental problems.

- Manufacturing or commercial zoning (eg. M2 or C8 in New York City); and where feasible, land with multiple uses.

- 20-year ground-leases with four five-year renewal options and 10% to 15% rent increments every five years.

The typical site selection criteria applied by retailers for a free-standing restaurant ground-lease are as follows:

- More than 25,000 SF of land.

- Located at a corner, and or at a traffic light, on a major road, and near demand generators.

- High traffic counts of at least 25,000 cars per day.

- "Mixed use", "commercial" or "residential" zoning; and where feasible, land with multiple uses.

- Favorable Phase-I environmental tests, and no history of environmental problems.

- 15-20 year ground-leases, with four five-year renewal options; and 10%-15% rent increments every five years or CPI-linked rent increments every five years.

- Annual sales of more than $200 per Square Foot (SF) at existing restaurants in the Secondary Trade Area.

- Median annual household income of more than $18,000 in the Secondary Trade Area. Average annual household disposable income greater than $6,000 in the Secondary Trade Area.

- Combined "Lunch-time Population" and "Dinner-time Population" of more than 50,000 people in the Secondary Trade Area.

The typical site-selection criteria applied by retailers for a single-tenant free-standing apparel store or drug store ground-lease are as follows:

- More than 90,000 SF of land.

- Located at an intersection of major inter-state roads, or at a corner on a major inter-community road, and near demand generators (such as entertainment complexes, offices, hotels, schools, etc..

- High traffic counts of more than 50,000 cars per day.

- "Commercial" or "mixed use" zoning; and where feasible, land with multiple uses.

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- 10-20 year ground leases with two five-year renewal options; and 10% to 15% rent increments every five years or CPI-linked rent increments every five years.

- Good visibility from all directions, for vehicular and pedestrian traffic.

- Favorable Phase-I environmental tests, and no history of environmental problems.

- Population of more than 60,000 people within the Primary Trade Area (within a five-mile radius) and 100,000+ people within the Secondary Trade Area (within a ten-mile radius).

- Median annual household income of more than $30,000 in the Secondary Trade Area.

- A maximum of 15SF of existing retail space per "potential retail customer" (persons aged 11-80 years) in the Secondary Trade Area.

- Annual sales of more than $250 per Square Foot (SF) at existing stores in the Secondary Trade Area.

- Average annual household disposable income greater than $8,000 in the Secondary Trade Area.

4. Opportunities And Strategies For Real Estate Companies:

There seems to be substantial opportunities in the acquisition and re-positioning of land, acquisition of triple-net leases, and the acquisition of triple-net-leased retail properties in the US northeast, California, Illinois, Missouri, Texas and Georgia. (Lee, 2001; Fickes, 2001; Leitz, 2001).

Investors, developers and companies seeking to acquire retail properties should seek out situations where:

- There is financial distress (and to a lesser extent, physical distress), and or the owner has abandoned the property.

- Improved land can be purchased cheaply, and or existing structures can be demolished cheaply.

- Zoning is favorable and high floor-area-ratio land parcels can be acquired relatively quickly and at low prices.

- Land can be re-zoned and re-positioned.

- Future development, zoning, traffic, demographics and other factors will increase the values of land and development rights.

- Distressed retail properties can be purchased, particularly where the land is underpriced.

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- There is an opportunity to acquire land and building, and then create and sell the ground-lease, and rent the building.
- Portfolios of non-performing ground-leases and or land/buildings can be acquired, and companies can negotiate for title.
- Local land taxation is favorable, and land taxes can be passed onto tenants.
- The land is near existing utility lines and sources of cheap labor; and relevant utility lines can be installed at low costs.
- Owners of community and regional malls may subdivide them or create "condominium" ownership structures.
- Companies stand to benefit from leasing land to companies that sell household necessities and acquiring buildings net-leased to these companies (ie. "basic" industries – groceries, fast food, gasoline, healthcare, household items, child-care, apparel, etc), which are typically more resistant to recessions than all other industries. This will eliminate the fluctuations associated with consumer discretionary spending.
- The triple-net-leases and triple-net-leased properties will appreciate in value substantially after 2-3years, as the above-mentioned trends occur, and as credit ratings of retailers improve – values of single-tenant freestanding properties depend on the credit quality of tenants. The values of single-tenant triple-net-leased properties and triple-net-leases are more sensitive to changes in credit quality than the values of regional-malls, community malls, power malls and strip-malls. Thus, non-investment-grade tenants with improving credit profiles are the better prospects for acquisitions and returns.
- By acquiring and leasing land, developers and investors will create and benefit from the price differentials arising from:
- Mis-priced land, and mis-pricing arising from improper "uses", and mis-pricing of "Percentage Rents".
- The difference between the cost of capital used to purchase the land (0-12%) and the implied discount rate in the ground leases,
- The reversion and mis-pricing of residual values of improvements.

Companies that sell ground-leases in the secondary market can:

- Eliminate capital gains taxes.
- Eliminate credit risk.
- Obtain cash while retaining rights to the ownership and value of the improvements at the end of the lease term.

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- Benefit from the mis-pricing of land, and from improper "uses", and mis-pricing of "Percentage Rents",
- Earn the spread between the cost of capital used to purchase the land (0-12%) and the implied rate of return from the ground-leases.
- By acquiring triple-net-leases, and triple-net-leased free-standing single-tenant properties, real estate companies will:
- Avoid all burdens and risks associated with ownership and management.
- Achieve more diversification per dollar invested, and have more flexibility to adjust the portfolio.
- Benefit from mis-pricing of costs implicit in the lease, "Percentage Rents" and the residual/terminal values of the improvements.
- Eliminate lease-up risk and earn immediate revenues.
- Retain depreciation tax deductions.
- Earn the spread between the cost of capital used to purchase the net-leases and the implied rate of return from the net-leases (most of the leases were signed when interest rates were much higher that today's rates).
- Earn returns from mis-pricing of land – companies can also create ground-leases from owned properties.
- Gain from possibly re-negotiating the leases to increase their value.
- Gain from changes in lease value arising from actual and perceived changes in the credit ratings of the tenants.
- Gain from opportunities to lease the space (controlled by the net-lease) at higher rents to other tenants.
- By focusing only on large retailers, restaurant chains and healthcare companies that have BB to AA+ credit ratings, and by focusing on single-tenant properties, and using full-credit triple-net-leases structured to qualify as operating leases to retailers for accounting and tax purposes, real estate companies can eliminate economic risks and management burdens associated with small tenants, and landlords will effectively shift all risks and costs of ownership to tenants, while retaining depreciation deductions and lease payments.
- By requiring guarantors for leases, real estate investors will eliminate development risk, operating risk, and the substantial upfront capital required for leasing commissions and tenant improvements.
- The use of leaseholds and or estate-for-years interests will reduce risks and capital requirements. (Graff, 1999).

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- Publicly-traded net-lease REITs do not typically sell ground-leases and do not focus on moderate-income and non-downtown areas. (Graff, 2001). This provides opportunities for private real estate investors and funds to participate in these areas.

- Compared to public markets, private real estate markets offer more opportunities to acquire assets at substantial discounts to fair market value, and to obtain only real estate market exposure. (Clayton & MacKinnon, 2000).

- The performance of publicly traded REITs had only a 0.25 correlation with the S&P 500 in 2000, compared with a 0.65 correlation with the S&P 500 during the 1980s (Ibbotson Associates, 2001).

- Real estate companies can provide the equivalent of an investment in "residual equity" of mortgage-backed securities and CMBS because: 1) the underlying assets are real estate, 2) investors get regular cash-flow before the ground-leases are sold, and "residual equity" after the ground leases are sold and the remaining price of the land is paid, 3) credit enhancement can be obtained to secure the dividends paid to investors. Most real estate entities do not have prepayment and volatility risks that are characteristic of MBS/CMBS.

- Publicly-traded REIT shares are more volatile, react more to non-real-estate factors, are more sensitive to other sectors than private-market real estate. Private-market real estate provides more stable values and more direct real estate exposure. (Howton, Howton & Friday, 2000; Stoesser & Hess, 2000).

- Since REITs typically have higher management fees than real estate investment companies and real estate hedge funds, REITs are more likely to impose excessive agency costs on investors than management of real estate hedge funds and investment companies. (Graff, 2001).

- The durations of real estate triple-net leases are much shorter than the durations of bonds. When a leases agreement is purchased at a below-market price or includes overage clauses, the duration is even shorter. Leases are less sensitive to changes in general economic conditions than bonds, primarily because leases include built-in rent escalation clauses and overage clauses. (Graff, 1999). Given the reduced and declining volume of long-term (15-30 years) US corporate bonds and government bonds, triple-net leases meet investors' need for long-term fixed income instruments, but with less sensitivity to inflation, interest rates and economic conditions.

- Real estate triple-net leases will have higher effective-yields than corporate bonds partly because:

- Triple-net-leases pay cash monthly while corporate bonds pay cash semi-annually, and as US interest rates rise, reinvestment of lease proceeds will provide higher effective yields.

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- The basic yields from triple-net leases are typically much higher than bond yields; and unlike most bonds, triple-net-leases can be structured or re-negotiated to pay cash annually, and thus, reduce reinvestment risk.

- Triple-net-leases are less sensitive to inflation than corporate bonds and government bonds, because triple-net-lease typically have rent escalation clauses and annual CPI rent adjustments.

- In ground-leases, the terminal value of the improvements typically revert to the lessor at lease expiration, and thus, is similar to a zero-coupon bond, with built-in automatic reinvestment at rates that are typically higher than corporate bond yields.

- Real estate companies can essentially replicate an investment in a portfolio of "defensive" stocks because of the long-term triple-net-leases to large "credit" companies in different "basic" industries, and in sites located growing retail sub-markets, where many neighborhoods are socially and economically unique, and thus will provide adequate diversification. States in the US became 50% more diverse between 1970 and 1996. (*Shopping Center World*, February 2001; Wolverton & Cheng & Hardin, 2000; Lee, 2001).

- Companies will be able to replicate an investment in a portfolio of "high-yield AA-rated" and "high-yield AAA-rated" fixed-income securities of companies in many "basic" industries because: i) the implied yields from the ground-leases and triple-net leases are typically much higher than the yields (and in some cases, the total returns) from the equity and debt securities of these companies, and ii) the use of third-party lease guarantors (full credit leases) will improve the credit risk, c) assets will be leased to these companies for 10-20 year terms. (Graff, 1999).

5. Legal Issues

Most of the legal issues raised by the restructuring of the US retail industry revolve around anti-trust, labor issues, regulation of consumer finance and the treatment of leases in financial distress and bankruptcy:

1. Many of the medium and large retailing chains have stores in the same locations and in most major markets. (Saltzman, Levy & Hilke, 1999). (Poole, Clarke & Clarke, 2003). (Wrigley, 2001). (Burt & Sparks, 2001). Thus, any mergers among these companies is likely to raise substantial antitrust issues. One key issue is whether ownership or leasing of physical stores increases the likelihood that a merger/acquisition will be deemed anti-competitive – if ownership is deemed to increase the probability of anti-competitive sanctions, then retailing chains will be more likely to lease stores. (Seiler, Chatrath & Webb, 2001). (Roulac, 2001). Ownership sometimes involves the same or similar legal filings as long-term leases because major leases are sometimes recorded at municipal offices. Similarly, mortgages that are used to finance certain leases are also recorded. In the case of capital leases, lessors often have the same economic rights and risks as owners. There are major differences in the accounting treatment of capital leases and operating leases, which should affect the level of antitrust liability in mergers/acquisitions. However, a retailer's owner-

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ship of a retail store generally indicates a longer-term commitment to a geographical market, compared to leasing.

Furthermore, pricing strategies and contractual issues (joint ventures and alliances) in the industry are quite susceptible to antitrust review. These limitations tend to restrict profitability of retailing companies.

The advent of the Internet has changed the reach and penetration of retailers and buying patterns of consumers. This has made the traditional measures of market concentration less accurate. (Poole, Clarke & Clarke, 2003). (Wrigley, 2001). (Burt & Sparks, 2001). Market dominance is less determined by physical store location, store size and population of the primary trade areas, because the buying decision and associated transaction processing can be done via the Internet, and the customer can pick up the purchased goods at more than one location. Furthermore, many items sold by retailers are somewhat commoditized, and for each category of good/service, there are several potential suppliers. The growth in the use of alternative retail channels (other than the retail store), such as buying clubs, mail order sales, concessions, in-house stores, garage sales, minim-markets, newspaper ads, door-to-door sales, and coops, have reduced the dominance of the typical retail chain store as the main channel. (Williams, 2003). Thus, traditional measures of retail industry concentration such as retail chain floor space (relative to population) and store sales volume are becoming irrelevant. (Myron, Kwast, Starr-McCluer & Wolken, 1997). (Rubinfeld & Baker, 1999).

The consolidation of the retailing sector may result in mergers and acquisitions that may be deemed anti-competitive. In such cases, the combining retailing firm s will be required to divest specific retail stores. This may be done through outright property sales or cancellation of leases. Forces sales in specific regions will probably affect property prices. In the case of lease cancellations due to a government agency order, what are the rights and remedies of the lessor ? (Poole, Clarke & Clarke, 2003). (Wrigley, 2001).

2. Real estate leases are complex long-term contracts requiring simultaneous, continuous and phased performance, and different types of monetary and non-monetary performance by sometimes unrelated parties. The lessee's propensity to comply with lease terms at specific times is greatly influenced by economic conditions, lessee's resources, and the various costs that may be incurred by the lessee and lessor upon breach of the lease agreement. (Benjamin, Jud & Winkler, 2000). (McNally, Klein & Abrams, 2001). (Pretorius, Walker & Chau, 2003). (Triantis & LoPucki, 1994). (Triantis, 1993). (Hylton, 1993). (Stanley & Coursey, 1990). The typical lease provides the lessor with periodic (quarterly or semi-annual) property inspection rights in order to monitor property conditions. The landlord incurs other 'monitoring costs' (M) (for appraisals, reviews of filings, etc.) in order to ensure compliance with lease terms. In some instances, minor defaults occur because the lease terms are so many and onerous. There are post-default 'cure costs' ('C_T') incurred by the lessee, and 'cure costs' incurred by landlord ('C_L') if lessor does not seek other remedies and is willing to negotiate. There are post-dispute pre-litigation costs ('PD_T') that the lessee incurs and costs that the landlord incurs ('PD_L') to comply with lease terms in other to avoid further litigation or to settle a dispute – these costs are incurred before there is resolu-

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tion activity (ie. arbitration, court litigation or mediation) and include negotiation costs, attorney fees, transaction costs, etc. There are post-default 'remedy costs' ('R_T') which the lessee and 'remedy costs' which the landlord incurs ('R_L') typically to cure prolonged defaults of leases terms – these costs are incurred when there is some dispute resolution activitiy (arbitration, court litigation, or mediation) and include litigation costs, accrued rent and interest, engineering and consultants' costs, payment of necessary fees/expenses such as insurance and taxes, etc. The landlord gets 'remedy' benefits ('B_L') upon settlement or termination of the dispute – such benefits include accrued rent, costs of assigning the lease or subletting the space to another tenant, reimbursement of litigation expenses, and other accrued expenses such as utilities, maintainance and taxes. The landlord gets 'damages benefits' ('DB_L') if it wins in court or arbitration proceedings. The lessee gets 'damages benefits' ('DB_T') if lessee wins in court or arbitration proceedings. The lessee incurs 'performance costs' ('P') in order to perform entire terms of the lease. While most retailing firms typically treat each store as an operating entity in terms of performance evaluation and capital allocation, the retailer typically incurs 'supervisory/rationalization costs' (SR) to ensure compliance with all lease terms and to determine where or not to close or relocate stores. The landlord obtains economic value ('L') from lessee's performance of all lease terms.

Specifically, the lessee will always comply with lease terms so long as:

$$R_T + P + PD_T \quad P + SR + C_T \qquad (1)$$

The landlord will be willing to negotiate instead of litigating lease defaults if:

$$[L - M - PD_L \quad L - R_L - PD_L + B_L - M]_T + P + PD_T = P + SR + C_T] \qquad (2)$$

Note that in (1) and (2), the decision to litigate or settle is almost completely independent of either party's estimates of probability of prevailing in court/arbitration proceedings and expected damage awards.This approach is somewhat different from existing models of litigation, for several reasons. Each party's decisions can be made based on existing information because performance is clearly defined. Most contract breaches are not tortuous and thus, do not involve the award of large damages other than contractual damages. It is reasonable to state that the adjudicator's remedy can be predicted with some measure of accuracy because lease terms are relatively straightforward. On the other hand judges and juries may not follow expected patterns of decisions, and damage awards vary depending on the circumstances of each case.

In this instance, the issue of asymmetric information has several dimensions: a) the lessee has more information about its prospects and its ability to perform lease terms – in such information has minimal value primarily because of the validity of lease agreements, expectations of contractual performance, and established remedies and possible existence of credit enhancement such as letters of credit; b) either party may have more information about real estate market conditions and the possibility of finding another tenant for the space at the same or higher rent – in this instance, such information also has minimal or no value because of existence of established remedies for default, variations in rents in real estate markets, and the typical difficulty in confirming potential tenants, c) either party may

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have different opinions and or more information about the outcome of any prospective litigation.

3. Some retailers have relied on the securitization of their receivables as a source of funding, and this raises the issue of bankruptcy remoteness of credit card securitization SPVs. Such transactions typically involve the use of 'bankruptcy-remote' special-purpose vehicles ('SPVs'). The bankruptcy-remoteness is based on making the transaction a 'true sale' without any (or with minimal) residual interest in the SPV. Some financially distressed retailers may have 'assigned' receivables to such SPVs, or provided guarantees to such SPVs or retained residual interests in such SPVs, and any of these conditions may implicate the SPVs in the retailer's bankruptcy proceedings. The receivables may not be paid, and holders of the SPV's securities may have recourse against the retailer. In these instances, holders of the SPV's securities may have claims that are senior to those of landlords/lessors, and these holders may be able to substantially influence the development of the pre-petition or post-petition reorganization plan.

Many retailing chains are offering their own credit cards to customers. An increasing number of retail purchases are being financed with credit card debt. Many customers have defaulted on such credit card debt due to economic conditions, and this has resulted in declining credit quality of retailers. Various laws have been passed to regulate consumer finance and predatory lending, but these have proved to be insufficient. The issue is that mortgages secured by retail stores typically require security interests in accounts receivables and related proceeds generated in the retail store that secures the mortgage. When such receivables are securitized, there could be conflicts of priority of claims. Pledging of such receivables as security for securitizations may constitute an event of default of the mortgage.

4. Due to declining economic conditions in some sectors of the retail industry and the resulting declined in credit ratings of companies, many retailers may seek to consummate sale-leaseback transactions in order to: a) obtain capital, b) reduce asset base, c) reduce reported liabilities, d) improve their credit ratings. Thus, it is very likely that such retailers will be looking at tax/legal/accounting driven transactions. To achieve the objectives mentioned, retailers will probably try to structure such leases as operating leases for financial reporting purposes (and perhaps as capital leases for tax purposes). The main legal issues are: a) ensuring the existence of a true sale transaction – as opposed to a financing lease, b) ensuring the existence of an operating lease – there are at least four conditions that must be met in order for leases to qualify as operating leases for financial reporting purposes, c) the treatment and timing of lessee's option to purchase the property, if any, d) the treatment of the reversionary interest at lease expiration.

5. There is the issue of the validity of security/collateral for short-term loans and conflicts of security filings (UCC filings versus municipal filings). Most retailers are funded with a variety of debt – accounts payables, taxes payables, short-term debt, medium-term debt, leases and mortgages. In most cases, short-term debt convenants require a security interest in the company's accounts receivables, cash, furniture, equipment and other assets. At the same time, many mortgages require the granting of security interests in the borrower/retail-

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er's receivables (generated from business in the mortgaged property), cash, furniture/fixtures/goods/equipment attached to, or located in the mortgaged property. Mortgages are typically filed in municipal offices, and associated UCC statements are sometimes filed at local/state offices. The key issues are conflicts in priority of security interests in the borrower's assets, and the validity of such security interests. Sometimes, UCC and municipal lien searches do not provide clear answers because: a) some state laws do not require UCC filing for perfection of security interests, b) some security agreements grant security interests and priority of claims without the need for filing UCC statements.

6. Another key legal issue is the determination of solvency of retailers who are current or prospective tenants. Retailers are somewhat unique in that values of their assets fluctuate substantially compared to other industries:

a) The values of retailers' accounts receivables are highly sensitive to local and national economic conditions.

b) The values of retailers' inventories are typically affected by obsolence, theft, shrinkage, and inflation.

c) Retailers' furnitures and fixtures typically have low resale values because such property are fixed to the building and cannot be re-used.

d) Retailers are constantly facing the problem of training and retaining store staff, and staff turnover is relatively high in some retailing segments – thus, the value of retailers' human capital also fluctuates substantially depending on retention efforts and the quality of training provided by retailers.

e) Due to changes in mobility of residents, Internet shopping, seasonality and other factors, the value of retailers' 'Trade Area Rights' changes frequently.

Many of such fluctuations in asset value are not reflected in retailers' audited financial statements. On the hand, retailers' liabilities are relatively difficult to calculate:

a) Many US retailers buy goods from foreign manufacturers, and thus, are exposed to substantial foreign exchange risk.

b) Many retailers engage in transactions that give rise to deferred taxes that are difficult to measure.

c) Retailers use floating rate debt.

d) Retailer's property leases typically include overage clauses and overage rents can vary substantially.

e) Retailing is labor intensive, and the associated pension liabilities are highly sensitive to changes in assumptions used in calculating the present values of such liabilities and the required payments by retailers.

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Furthermore, advisers such as accountants and lawyers have vested interests in not reporting retailer insolvency, and lenders are sometimes willing to re-schedule debt, or to ignore default, primarily because of the transaction costs and resolution costs associated with debt re-negotiation and bankruptcy. hese issues make it somewhat difficult for landlords to assess prospective retailer-tenants, and to anticipate retailer financial distress or bankruptcy.

7. Many retailers who close stores often have outstanding lease liabilities, and thus, the choice of subletting the space, assigning the lease, re-negotiating lease terms, not performing the lease terms or filing for bankruptcy. This raises several issues in terms of creditor rights, the treatment of valid leases in bankruptcy, and the impact of pre-bankruptcy waivers of stay clauses in leases. (Butler & Steiner 2002). (McNally, Klein & Abrams, 2001). (Kratzer & Kuntz, 2002). (Bernfeld, 2002). (LoPucki, 1993). (Markides, 1995). (McNally, Klein & Abrams, 2001). (Bartell, 1998). See: *Eastover Bank For Savings v. Sowashee Venture* (In Re Austin Dev. Co.), 19 F3d 1077, 1080, 1083-4 (5th Cir., 1994)(holding that the rejection of a real estate lease was only a breach but not a termination of the lease). In many cases, retail leases are either nullified upon filing of bankruptcy by the retailer, or the landlord joins a diverse class of creditors in the bankruptcy process (and will often file an administrative claim). Often the landlord has to incur additional marketing, tenant improvement, leasing and professional services costs to re-lease the space. The relevant issues include:

- Continuous credit analysis and review of tenant payment patterns.
- Section 362 of the US Bankruptcy Code provides an automatic stay. Under Section 365, the landlord has a specific period of time to accept or reject the lease.
- Section 502(b)(6) of the US Bankruptcy Code limits landlords damages from lease terminations.
- Landlord's responsibility to mitigate damages arising from lease defaults and lease terminations.
- Prepaid rents and security deposits are part of the debtor's bankruptcy estate unless the lease states otherwise.
- The landlord can file an administrative claim for pre-petition lease defaults.
- Assignment and assumption of leases - a) financial condition of prospective tenant (assignee), b) curing existing lease defaults.
- The third-party lease guarantees.
- Terms of Letters Of Credit, and conditions under which Letters of Credit may be invalid.
- Lender's security interests in lease proceeds.

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Whether the bankruptcy court accepts the rejection of the lease as valid depends on several factors including the terms of the lease, stated remedies for default, presence of forum selection clauses in the lease, etc..

8. The lease is the key defining document that states the relationship between the retailer and the landlord. Many retail leases are triple net leases – taxes, insurance and maintainance costs are paid by the tenant. Some lease terms such as assignments, sub-letting, rights of inspection, reversion of capital improvements paid for by tenant, calculation and payment of percentage rents (overage rents) including sales partly completed via Internet, third-party lease guarantees, letters of credit, events of default, grace period for curing defaults, etc., are negotiable and can affect the economics of leases.

- Assignments and sub-letting – landlords will be more willing to include assignment and sub-letting clauses in leases (so long as landlord's permission is required before such assignment) in order to reduce credit risks.

- Lease guarantees and Letters of Credit (LOCs) – landlords will probably require more third-party credit enhancement. LOCs are more popular and

- Events of default – definitions of what constitutes events of default and the period of time allowed to cure such defaults. Most existing leases contain rather onerous terms.

- Landlords must be careful about the lease terms covering pass-throughs such as utilities, taxes, insurance and maintainance. The lease can be structured such that there is 'lock-box' account for such pass-throughs, and payments to such lock-box accounts should be secured under a waiver of the automatic stay provisions of the US Bankruptcy Code.

Many existing leases are 'incomplete contracts" in the sense that they are triple-net leases with overage clauses. Due to financial difficulties, it is expected that many tenants will seek to reduce the fixed portions of rents, and to increase the 'overage' or variable portions of rents. The effect of such 'incompleteness' can be substantial and depends on location, brand name, tenant marketing efforts and transaction costs (costs of re-leasing the space, litigation costs, lost sales revenues, etc.).

9. Given the current industry conditions, standards of due diligence (for investing in retail real estate and retailing companies) are likely to be higher.

10. The ongoing changes in the retailing sector seem to be permanent changes, and will affect zoning and land use patterns, and the ease of obtaining variances. Mixed-use projects that contain retail space are like to become more common. As a result, much less land will be needed for retail uses and this trend may affect land use patterns. More areas zoned for retail/commercial uses can now be re-zoned for other uses, and it may become easier to obtain zoning variances. Given the increasing popularity and growth of 'super-centers', it is also likely that the scope of zoning laws will be expanded to include more specific details about activities that can be conducted in sites (typically covered in building codes) and on reducing the impact of development (requiring impact studies, etc.). Zoning laws are cre-

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ated and enforced at the local government level, and litigated at both state and federal courts. The restructuring in the retail sector is likely to increase the involvement of state governments (and federal agencies) in amending or promulgating zoning laws and land use patterns.

11. Purchase/sale agreements are likely to contain 'sale as-is' clauses.

12. Retailers will be more likely to lease stores than to buy stores in order to reduce capital commitments and perceived leverage. There will be more focus on the retailers' lease interests, and on recording of leases at local county clerks' offices. Security interest in leases will probably become more popular as financing instruments. Most existing mortgage documents include a formal 'assignment of leases and rents' which is typically filed at the county clerk's office with the mortgage. However, some states require UCC filings for such security. It is likely that more transactions will involve UCC-1 and UCC-3 filings covering leases and rents.

13. Retailers' expansion into urban markets and focus on site selection will likely result in more organized anti-development activist groups, revisions to zoning laws, negotiations for tax subsidies and. Walmart now has about one hundred formal challenges to its proposed site development projects in the US. Such opposition has been supported by some academic studies that have repudiated the proposition that new big-box stores boost employment and property-tax receipts – the net increases are minimal because the new big-box stores merely capture sales from existing businesses in their trade areas. These challenges often evolve into public hearings and litigation, and the outcomes are determined by a mix of local politics, perceived costs-benefits, capabilities of lawyers and developers' ability to make concessions in project scope.

14. The immediately preceding discussion has substantial implications for antitrust criteria. A retailer's true market dominance cannot be measured by sales alone. Walmart's activities in the US retail industry may raise issues of antitrust violations. Many of the existing US antitrust statutes (eg. The Robinson-Patman Act of 1936) were designed for an economy and modes of trade that are very different from what exists today. Walmart's 'market dominance' is illusory because: a) WMT is merely an 'displacing aggregator' of retail sales and does not have true market power, b) behind Walmart, is a wide variety of suppliers who can sell the same goods to other retailers at the same price, c) Walmart's relationship with its suppliers has evolved into a 'virtual aggregator' company because Walmart's strategy is heavily dependent on controlling its costs and suppliers' costs, c) another retailer can conceivably choose to execute Walmart's low-cost strategy and dominate markets, d) Walmart cannibalizes sales of existing stores, and if Walmart did not exist, other retailers will absorb the sales, e) customer loyalty varies substantially among different products. Thus, within the retailing industry, antitrust market power criteria should include customer loyalty, and retailer commitment to markets (form of presence - mail order vs. leasing vs. owned stores). The more interesting question is why no other company has been able to replicate Walmart's model in the US – these companies can conceivably buy the same goods from Walmart's suppliers, advertise in the same media as Walmart, and offer

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the same promotions as Walmart. Thus, the primary source of antitrust liability for Walmart is likely to be its relationships with suppliers, and advertising media.

15. Many local governments have or have recently promulgated regulations that limit the size of retail stores, the geographical breadth of retail development, the scope of retail activity, and the types of goods retailers can sell. For example, in June 2003, county supervisors in Contra Costa County (near San Francisco, USA) enacted an ordinance that prohibits any retail outlet larger than 90,000 square feet from devoting more than 5% of its floor space to food or other nontaxable goods. (*BusinessWeek Online*, October 6, 2003), and Wal-Mart gathered enough signatures to force a referendum scheduled for March 2004. Some of these local ordinances can be deemed unconstitutional and improper restrictions on trade, particularly the ones that restrict the scope of goods sold in stores.

16. Franchising accounts for a substantial and growing portion of the US retail industry. Thus, the franchising agreement will become increasingly vital in operations and financing of retailing companies and associates real estate:

- Franchisors may increasingly guarantee franchisees' real estate leases.
- Franchisors may build stoires and then sell/lease them back to franchisees (franchisros typically have better credit and borrowing capacity than franchisees.

c) The Franchise agreement may contain restrictions on types and duration of leases that franchisee may execute. The Franchise agreement may specify site selection criteria, site development procedures, and the types of activities that can be done in stores.

d) The definition of royalties in Franchise Agreements may contradict Overage Rent clauses in lease agreements.

e) The franchisor can be held partially liable for events that occurred on the franchisee's premises, or for franchisee's misconduct where it can be shown that the franchisor exerted such substantial influence on franchisee's operations, that the franchisee was essentially functioning as a subsidiary of the franchisor. Such 'undue influence' may be inferred from standard policies and procedures, supplying franchisees with products (with or without credit), regular site inspections, participation in internal budgeting and hiring decisions, participation on the board of directors of franchisees, etc..

f) There is issue of seniority of Lease Agreements and Franchising Agreements. Some franchisors may expressly or impliedly subordinate real estate agreements to Franchisee Agreements. ie. validity of the lease agreement could be contingent on the existence of the Franchise Agreement and performance of terms therein. On the other hand, most lease estate lease agreements expressly state that they are subordinate only to the existing and future indebtedness (loans) of the lessee.

g) Location is crucial to franchise stores. Franchise rights are granted for specific geographic areas. In some instances, franchise rights are granted to operate busi-

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nesses only at a specific location or locations. Real estate leases convey lease interests (and implicitly, 'location' interests to franchisee). Since the value of the franchise right is so heavily dependent on location, the issue is whether such lease interests are part of the franchise rights or separable.

The Franchise Agreement is a complicated incomplete agreement and is explained in: Agrawal & Lal (1995); Arrunada (2000); Brickley (1998); Dnes (1996); Arrunada, Garciano & Vasquez (2001); Gompers & Lerner (1996); Lafontaine & Slade (1998); Matthewson & Winter (1985); Williamson (1979); Bhattacharya & Lafontaine (1995); Kaplan & Stromberg (1999).

6. Future Sources Of Financing

A. Sources Of Financing For Retailers

1. Inventory Financing: a) short term loans secured by their inventory – revolving loans, lines of credit, etc., b) goods sold on consignment, c) delays in payment, d) extension of payment terms.

2. Receivables Financing: a) short term loans secured by their accounts receivables – revolving loans, lines of credit, etc., b) sales of accounts receivables to factors and finance companies, typically at a discount to face value, c) securitization of accounts receivables.

3. Sale-leasebacks – retailers can sell their retail stores and then enter into long-term leases of such properties. This provides capital, reduces asset base and reported liabilities, and does not disrupt operations.

4. Consignment of goods – retailers can obtain goods on consignment for sale (primarily from manufacturers).

5. Insurance – given the uncertainty in the retailing sector, many retailers are likely to enter into insurance contracts to hedge their exposure to various types of risk – business interruption risk, risk of obsolence of goods, risk of theft, risk of inventory shrinkage, risk of labor problems, etc..

6. Derivatives and hedging:

> a) Many retailers now purchase goods abroad, and thus have to hedge against currency fluctuations. Such hedging is done using derivatives such as swaps, captions, caps, and involve hedging both currency risk and counter-party credit risk. Retailers can reduce their cost of capital using such hedging techniques.
>
> b) Retailers can enter into forward contracts, futures contracts, and options agreements for the purchase of goods.

7. Seller financing: some manufacturers and distributors provide short-term and medium-term financing for goods on favorable terms.

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8. Leasing: retailers can lease equipment (computers, software, and furniture, etc.) used in day-to-day operations. Leasing eliminates the need for capital to purchase such items. Retailers can also lease store space used for sales.

9. Joint Ventures. Retailers can enter into joint venture agreements and strategic partnerships with distributors and manufacturers to finance their purchase of goods. In such instances, the JV partners will like get a share of sales in addition to their typical margins.

10. Government-Sponsored Economic Development Programs. Some local and state governments provide low-cost loans for companies that relocate to, or open stores in specific geographical areas.

11. Excess pension funds: retailers can draw on excess pension funds – in excess of expected pension obligations.

12. Labor concessions – most sectors of the retail industry depend on unionized labor. Labor concessions such as reduction of overtime pay, extended work hours, and reduction of benefits can reduce require capital.

13. Bulk purchasing and bidding. The implementation of bulk purchasing and supplier bidding programs will help in achieving economies of scale and efficiency in the purchasing process.

14. Retailers can obtain extensions of payment periods from suppliers.

B. Sources Of Financing For Retail Real Estate Companies

1. Commercial Loans – developers and investors typically obtain various types of fixed-rate and floating-rate loans from banks, insurance companies, pension funds and finance companies.

2. Joint Ventures. Developers enter into JVs among themselves and with retailers. In such JVs with retailers, the retailer typically commits top lease the property upon completion, and the financing is based on such commitment. Investors typically enter into JVs with each other primarily to obtain equity and mezzanine capital to fund acquisitions.

3. Special Loans. These include convertible mortgages, participating mortgages, currency-linked bonds, debt/warrant units,

4. Government Subsidized Loans. Some local and state governments provide low-cost loans for companies that relocate to, or open stores in specific geographical areas.

5. Lease financing. Developers and investors can obtain loans and mezzanine capital based solely on the quality of triple-net leases.

6. Options on land.

7. Securitization. Developers and investors can obtain capital by securitization of present and future interests in real estate, leases and proceeds of leases.

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8. Sale of specific leases. Owners of shopping centers can elect to sell their interests in specific leases in shopping centers - primarily through an assignment of their interest in proceeds of the lease. This enables the property owner to retain ownership interest in the property, reduce exposure to certain tenants and raise capital.

9. Purchase of estate-for years interests in land and property.

7. **A New Model Of Organizational Change.**

- In the present and future business environment, the primary change agents are and will be: a) the customers' and the employee's interaction with the company's Information Systems ('IS') – Information Systems in this context is much broader than the company's physical software/hardware/telecomm systems and includes customer surveys, competitive analysis and other processes used in monitoring customer interactions with the company; b) the cognition of customers and employees – this implies feedback mechanisms, continuous employee training/development, customer education, and emphasis on hiring and promoting employees with multiple and cross-functional skills; c) the firm's knowledge management and quality management capabilities, and d) a culture of innovation that encourages feedback and continuous evaluation in which the firm is constantly in transition. In this new model, change is constant, management becomes a facilitator of change rather than a change catalyst, and the emphasis is on less-visible and sub-conscious elements of humans and the organization, that can be influenced but are less susceptible to manipulation in obvious ways. (Whitley, 2002). (Sterman, 1994). (Smith, 1993). (Saltzman, Levy & Hilke, 1999). (Robey & Boudreau, 1999). (Markides, 1995). (LoPucki, 1993). (Kaniovski & Peneder, 2002). (Hawawini, Subramanian & Verdin, 2003). (Feldman, 2000). (Armenakis & Bedeian, 1999). (Brown & Eisenhardt, 1997). (Gibler, Black & Moon, 2002). (Lichtenstein, 1995). (Filatochev & Toms, 2003). (Dant & Kaufman, 2003). (Athanassopoulos, 2003).

- 'Reinforcement' techniques implemented by management to institutionalize change are somewhat secondary, visible and thus can be manipulated for individual gains - they include written communication, contracts, changes in reward systems (for both employees and customers), changes in employee performance measurement criteria, implementation of feedback systems, changes in organization structure, use of cross-functional teams and changes in the company's Information Systems.

- Government regulation is a given externality. It does not change very often and thus is less relevant in change management.

- 'Process' and 'content' of change are two distinct issues, and whether content determines process or vice versa, depends on context, industry-specific conditions and company-specific conditions.

- Organizational change is neither 'internal' or 'external' but is constant and permeates very aspect of company and industry operations. Change originates from the company's interactions with various constituencies (such as customers, suppliers, the

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government, labor unions, special interest groups, competitors and shareholders), and the resulting review and planning processes defined by management and performed by employees.

- Management of change and response to change depends on the company's Information Systems, communications within the firm and relations with customers, and the ways in which the company's strategic objectives are incorporated into the change management processes. The interaction of corporate strategy and change management is vital to the growth of companies. This requires that the strategic planning process, quality management processes and the development of change management processes be done together and at various levels of the organizational structure, and that there be a system of rapid feedback from employees and customers. This integrated approach that combines corporate strategy, change management and quality management ensures consistency of objectives, optimal and rapid responses to external factors and external constituencies.

- Other change agents include asset utilization, organizational culture, and quality of management.

- The process of change also depends on time factors, managements' capabilities, government regulation, labor (unions versus non-union labor), structure of the firm's capital (human capital, intellectual capital, fixed assets, liquid assets).

8. A New Model Of Intra-Industry Competition

- As illustrated in the foregoing analysis, the retail industry does not fit into any of the traditional models of competition. Neither the Porter model or the traditional economic models of competition (oligopoly, monopoly, pure competition) are applicable to the US retail industry.(Andersson, Gustafsson & Lundberg, 2002). (Hawawini, Subramanian & Verdin, 2003). (Hertzel, Smith, Kiholm & Smith, 2001). (Kaniovski & Peneder, 2002). (Porter, 1998). (Saltzman, Levy & Hilke, 1999). (Markides, 1995). (Filatochev & Toms, 2003). (Athanassopoulos, 2003). (Hardesty & Bearden, 2003). (Dant & Kaufman, 2003). (Suri & Monroe, 2003). (Lee & O'Connor, 2003). (Arnold & Reynolds, 2003).

- An alternative model of competition is the "Customer Preferences" model of competition which has the following characteristics:

* The number and sizes of companies in an industry do not matter. The Internet, modern communications and globalization provide small companies with the global reach that was once possible only for large companies. Geographical location is less relevant.

* Competition is not based primarily on price or product differentiation or first-mover advantage, but on various factors that must be simultaneously considered. (Arnold & Reynolds, 2003). (Suri & Monroe, 2003).

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* "Competitive advantages" do not matter since its mostly not sustainable even in the short run, and it largely depends on customer perceptions and preferences. In situations where competitive advantage is not clearly defined by government regulations, it can be an ambiguous term.

* “Competitive advantages” do not matter since its mostly not sustainable even in the short run, and it largely depends on customer perceptions and preferences. In situations where competitive advantage is not clearly defined by government regulations, it can be an ambiguous term.

* Similarly, the term ‘product differentiation’ does not matter so much because it matters only in the short run, and is mostly not sustainable in the short run. Furthermore, its subject to customers’ perceptions and cognition, and the conditions that exist at the point- of-sale and at the customer-interface.

* Thus, ‘customer Point-Of-Sale’ and ‘customer interface’ are a key competition factors, because they are where the customer makes buying decisions and can override previous conceptions/influences, and they affect how much information can be obtained about the customers’ preferences.

* With the advent of the Internet and increasing global trade and global sourcing, suppliers are much less of a factor.

* Switching costs are less important due to standardization in many industries.‘Customer acquisition costs’ and ‘customer retention costs’ become more important since companies are willing to cover some or all of traditional ‘switching costs’. In this instance, tenants can sub-lease space or the prospective landlord can takeover the space.

* The terms ‘price-takers’ and ‘price-setters’ are effectively moot given the increasing use of dynamic pricing and profit optimization systems. Unless prices are established by government regulators, prices are fluid and depend on the customer’s preferences and negotiating abilities. Thus, ‘price’ is not fixed number but rather, is a distribution. (Docters, Reopel, Sun & Tanny, 2003). (Lee & O’Connor, 2003).

* Competition is based on understanding and taking advantage of customer preferences in various dimensions within the context of government regulations, labor considerations, and the firm’s resources (human capital, Information Systems, CRM, intellectual capital, fixed assets, tax losses, liquidity, etc.).

9. A New Theory Of Industry Structure

- Based on the foregoing analysis, a new theory of industrial change and strategy termed the "Inter-dependency Theory" is explained in this section. (Andersson, Gustafsson & Lundberg, 2002). (Hawawini, Subramanian & Verdin, 2003). (Hertzel, Smith, Kiholm & Smith, 2001). (Kaniovski & Peneder, 2002). (Porter, 1998). (Saltzman, Levy & Hilke, 1999). This theory describes an unusual phenome-

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non in which two industries are dependent on each other, but do not evolve through certain rational expected processes. The Inter-dependency Theory is defined as:

* Strong positive correlation between activities in two industries - sales, capital expenditures, employment, capacity utilization, cash flows, etc.
* No or minimal forward-integration and backward-integration.
* No or minimal spin-offs/divestitures.
* No meaningful economies of scale can be achieved by a merger of any two companies in these two industries.
* The credit quality of any company in any of the two industries depends on conditions in both industries.
* Switching costs are typically high in one industry.
* Product differentiation is high in both industries.
* There is movement of labor between the two industries.
* Competition in either industry can be based on different factors including price, quality and product differentiation.
* Technology cannot substantially change the nature of the relationship and dependencies between the two industries and between any two pairs companies in both industries.

The Inter-dependency Theory is evident in several pairs of industries such as Real Estate/Retailing, Real Estate/Lodging, Automobiles/Steel, Lodging/Travel/Transportation, Retailing/Household Products.

10. A New Theory Of Value Creation

The foregoing discussion illustrates several issues about value creation in the modern company in large industries. (Andrade & Kaplan, 1998). (Baker, 1992). (Carn, Black & Rabianski, 1999). (Dennis, 1994). (Dial & Murphy, 1995). (Evans, Swartz & Martin-Keating, 2002). (Gibler, Black & Moon, 2002). (Horn, 2000). (Joroff et al., 1993). (Markides, 1995). (Whitley, 2002). A new theory of value creation is explained as follows.

- Value creation is defined as enhancement of perceived positive knowledge about products/services and an increase in cash gains by the company - with an emphasis on cash gains.
- Value is largely defined by the customers and shareholders who are the primary constituencies to whom management is accountable. The concept of competitive advantages is practically moot because they are rarely truly sustainable and are subject to customers' cognition, preferences and whims.

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- The government, customers, investors, employees, suppliers and society typically have different views of value and value creation, because they have different objectives, criteria, resources, time horizons and management styles. This sometimes results in sub-optimal decisions because it forces management to prioritize 'value attributes' based on which constituency that has to be appeased most within a time frame. Differences in perceptions of value (among customers, investors, employees, etc.) affects customer preferences, and customers' willingness to provide feedback or experiment with alternatives, because such differences negate the firm's advertising and promotion efforts, makes its hard for employees to interact with customers and determine relationships between customer profiles and product/service attributes, makes it more difficult for customers to communicate their preferences. Unfortunately, such differences in perceptions of value are sometimes built into the company's Information Systems and CRM systems. Furthermore, in many industries today (ie. real estate, television, radio, healthcare, etc.), products and services are still being forced on customers without regard to individual preferences and without any organized efforts to determine customer needs. These issues reduce the firm's ability to develop and implement value-creating changes. Differences in perceptions of 'value' also cause shareholders/investors to react in ways that affect stock prices and credit ratings, and thus, managements' decisions.

- The traditional sources of value creation include human capital, knowledge management, technology, competitive positioning, relationships (alliances, joint ventures, long term sales contracts), organizational culture, Information Systems, etc. However, the common issue among these sources is 'conversion capability', measurement and perception of value. Conversion capability refers to management's ability to convert such sources of value into free cash flow and dividends within a reasonable time frame. Perception and measurement refers to the ability of customers, investors, suppliers, competitors, government and employees to recognize and assign monetary worth to such sources of value.

- In today's environment, firms' values resides mostly in employees, the firm's Information Systems (IS), its relationships (customers, strategic alliances, joint ventures and long-terms sales/service contracts) and its knowledge management capabilities. The global economy is shifting towards a knowledge-based economy in which the ability to manage specific information produces value. The ability of employees to function effectively as groups is also crucial to value creation. In the case of the retail industry, many of the value-creating strategies discussed above are based on the firms' knowledge management capabilities.

- The firm's workforce becomes a sustainable source of new value when it is trained to: a) extract customer preferences, industry trends and competitor data, b) communicate effectively and seamlessly across different functions and levels of authority, c) develop cross-functional skills.

- Value in companies is best protected by organizational culture, knowledge management, adequate employee training and development, use of cross-functional teams,

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efficient and inclusive decision-making processes, and effective use of Information Systems.

- The market for new value creation has largely evolved from efficient-use-of-assets initiatives to employee-empowerment/development initiatives; to initiatives that explored the employee-Information System interaction and to initiatives that explore the employee-Information System-customer-competition interactions.

- Organizational culture facilitates value-creation when its informal, fosters communication and encourages innovation and feedback.

- Some types of sources of value tend to last longer than others. Knowledge management capabilities, organizational culture and some government regulations are much easier to sustain than technological advantages, competitive positioning, client relationships and Information Systems.

11. Conclusion

The US Retailing industry and the US healthcare facilities industry are experiencing substantial and fundamental long-term changes that continue to affect the real estate industry. However, retailing companies that implement appropriate strategies, recognize that treat real estate is a strategic asset, and adopt a comprehensive approach to financing and operational strategy, will prosper. Real estate developers and investors will need to re-assess their investment and development strategies given the changes in the retailing and healthcare sectors.

With the advent of technology and automation, and the growth of the service sector, the nature of competition and organizational change has radically evolved in many industries. Most existing theories of competition and organizational change cannot explain some trends and phenomena in business today.

Value creation remains the primary goal of all corporate entities. Value is determined by customers, investors and employees. The primary sources of value are the firm's employees, Information Systems, relationships (strategic alliances and joint ventures) and its knowledge management capabilities.

Real estate constitutes a substantial portion of fixed assets (land, buildings/fixtures and lease interests), capital expenditures, loan assets and operating costs (maintainance, insurance, taxes, rents and depreciation) in many industries such as retailing, healthcare, transportation, technology, banking, oil & gas, food processing, agriculture, insurance, and lodging. However, many companies do not use real estate strategically and do not incorporate real estate strategies into their overall corporate strategy and change management processes.

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