OUTPARCELS REMAIN ATTRACTIVE, EXPENSIVE

Convenience and popular uses have kept California's outparcel spaces in demand, despite in-line center vacancies.

By Nellie Day

7-Eleven is utilizing technology to its brick-and-mortar advantage by developing the 7Rewards loyalty program. Membership in the app-based platform has almost tripled from 9 million to 25 million members who earn rewards during their convenience shopping.

Urgent cares, coffee shops, fitness studios, car washes, convenience stores, quick-service restaurants. What do they all have in common? They're some of the most sought-out retail categories as shopping centers look to become as internet-proof as possible. What else do they have in common? These tenants are often found in outparcels, the convenient, detached commercial spaces within a broader shopping center.

No longer the "outliers" of shopping centers, these now-coveted spaces are particularly popular in California, given the supply-demand imbalance, thanks to high barriers to entry and a lack of developable land.

"While there's an abundance of in-line retail vacancy, outparcel and pad opportunities in California are scarce," says Bruce Milton, a restaurant leasing and investment specialist with Lee & Associates' LA North/Ventura office. "As a result, sale prices and ground lease rental rates have escalated considerably over the past three to five years. Of course, the coastal areas and highly dense trade areas of California command the most interest — in some cases even despite the traffic congestion we have."

The average cap rate for single-tenant net lease (STNL) sales in California has outpaced the national average by about 100 basis points, according to Hanley Investment Group (HIG) Real Estate Advisors. The average cap rate in California has ranged between 5.7 percent and 5.8 percent over the past five years, with the exception of 2016 when the cap rate was 5.5 percent. The average cap rate for nationwide STNL sales over that same period has ranged from 6.7 percent to 6.8 percent, according to CoStar.

STNL sales volume also reached a five-year record high in California in 2019, coming in at more than $4.8 billion. This was an interesting figure, considering 2019 represented the lowest transaction velocity during that same period, with only 1,279 deals throughout the state.

"Outparcels in California are performing well and continue to be the most highly sought-after investments based on the location and overall real estate fundamentals," says Bill Asher, executive vice president of Hanley Investment Group in Corona del Mar. "Both national and franchise tenants remain in high demand by investors, especially assets priced $3 million and less."

THE SHOPPING CENTER SPECIAL

Though some of the attractiveness to outparcels is due to their service-oriented tenants, this product type isn't completely immune to the impact of ecommerce on shopping centers.

"There are indirect impacts in the sense that incremental vacancy among anchors due to ecommerce reduces traffic to the outparcels," explains Chris Lomuto, associate director in Stan Johnson Company's Walnut Creek office. "In terms of direct impact, retail banking is certainly evolving in a way that would seem to reduce the need for outparcel dirt, as is merchandise-type retail to some degree."

Ryan Shea, managing partner at CalBay Retail Properties in Manhattan Beach, has seen the ecommerce impact on outparcels for more than a decade now.

"Undoubtedly outparcels have been affected by technology and ecommerce," he says. "One of the most obvious and original outparcel casualties of ecommerce was Blockbuster Video, which was one of the most desired outparcel tenants of the '90s and

Chipotle outposts, such as the one at Zinfandel Crossings in Rancho Cordova, have experienced great success, but that comes with great demand. The QSR is attempting to combat wait times by rolling out "Chipotlanes," a drive-thru option where those who have pre-paid via mobile app can receive their food in about 12 seconds.

2000s. Another case in point is small shoe stores, as in the recent demise of Famous Footwear. Cell phone stores are also not expanding nearly as fast anymore."

All this, he says, is due to online platforms like Netflix, Zappos, and the customer's comfort and ability to order their phones from their preferred providers with help from online tech support. Though these industries are changing, a few others are expanding at warp speed, proving that outparcels may just have a few lives left yet.

"Overall, the ecommerce impact has been similar between in-line and outparcels in that there is a shrinking set of tenants in expansion mode to fill space, but outparcels are much better positioned than in-line space to capture interest from those tenant categories that are still in expansion mode, namely, restaurants, coffee/cafes, convenience stores and service uses," Shea adds. "Many retail developers are focused on planning projects with as much restaurant outparcel space as possible because it's perceived to offer the largest universe of expanding tenants to lease to — and oftentimes at the highest rents."

In fact, technology and online platforms can actually bolster traffic and sales at many of these popular outparcel locations, according to Asher. This occurs when the tenant — say, Starbucks, 7 Eleven or Chipotle — offers a mobile payment or loyalty program app. HIG cites that Starbucks had about 25.2 million app users in 2019, representing 39.4 percent of proximity mobile payment users. This placed the coffee retailer second only to Apple Pay in the mobile payment department. 7 Eleven introduced its 7Rewards loyalty program two years ago and has since seen its membership in the app-based platform almost triple from 9 million to 25 million members.

Then, there's Chipotle.

"Chipotle is planning to put 'Chipotlanes' in half of its restaurants currently under construction, a drive-thru concept that takes an estimated 12 seconds to get your food when you pull up in your car with a mobile order paid in advance," Asher notes. "The chain plans to open between 150 to 165 new locations in 2020, with more than half including a Chipotlane."

CALIFORNIA PROS, CONS

Chipotlanes brings us to the first pain point about outparcels in many areas of California. Well, the first pain point behind price and supply, anyway.

"Technology and the gig economy

In-n-Out Burger locations, such as the one at Brixmor's Bristol Plaza in Santa Ana, are outparcel darlings for many investors. However, the chain's significant drive-thru requirements can be met with pushback in some California cities that have banned this fast food convenience staple.

have increased the need for pick-up windows and drive-thrus for local and national fast-casual and full-serve restaurants," says Matt Berger, president of the Western Region in Brixmor Property Group's Carlsbad office. "California has more stringent zoning conditions than other markets. For example, the same trendy restaurants that enhance streetscapes with patios and gathering spaces require delivery capabilities, such as drive-thru lanes and pick-up windows that local zoning laws restrict. Communities that are not open to creative designs that fall outside of their current zoning conditions will miss out on these concepts."


Regional players like Amy's Drive-Thru may have difficulty competing for outparcel space, particularly where drive-thrus are concerned, but some cities have made exceptions for the vegan-friendly burger chain in an attempt to diversify a center's offerings. Pictured above is the Amy's Drive-Thru in Rohnert Park.

California cities like San Luis Obispo, Long Beach, Santa Monica, Burbank, Baldwin Park, Corte Madera and Walnut Creek all have varying restrictions on drive-thrus. These can range from a nearly 40-year ban to a six-month moratorium on new construction and even an occasional exception, as was the case when Amy's Drive Thru, a vegan-friendly burger joint, received approval for its concept at Hall Equities Group's 2nd Avenue and North Main Street development in Walnut Creek. It is worth noting that both Starbucks and In-N-Out were denied drive-thru approval at this spot, thanks to the neighborhood coalition Larkey Park Neighbors United.

Of course, these sorts of bans simply make the value of existing drive-thrus skyrocket.

"Certain California towns seem to be at the forefront of trying to discourage fast food development in areas that are deemed oversaturated with fast food restaurants," Shea explains. "This typically leads to difficulties in getting drive-thrus approved for new construction — in some cases making it impossible. When you combine that with the general lack of developable land in SoCal — and the difficulty and high cost of all new development — you have a situation where the existing drive-thrus are very valuable when a re-tenanting situation arises. This has driven outparcel rents, especially those with drive-thru land, much higher than most everywhere else in the country."

This, in turn, gives those tenants with the deepest pockets the biggest advantages — and the best spots.

"Due to the incredible densities in SoCal, many of the top quick-service restaurant brands do their highest nationwide sales volumes in California, which allows these high rents to be paid and for the stores to be very profitable," Shea continues. "Going forward, it can be expected that the top food and beverage tenants, such as Chick-fil-a, Starbucks, In-n-Out Burger and Raising Cane's, will continue to see their California locations perform at a high level and, therefore, there will be continued competition and higher rents for the best outparcels."

Unfortunately, this powerhouse competition is often too much for the smaller players, which may explain why the cities of Walnut Creek and Corte Madera made exceptions for Amy's Drive Thru.

"Smaller operators work under a business plan that typically allows them only $1.2 million to $1.5 million all-in for the parcel and ground rent, so they can't match what a national chain can afford," Milton notes. "In California, the outparcel values remain in the control of landlords, and that's even become more evident in the past three to five years. A lot of operators and investors are chasing a limited amount of product, especially in the most desirable trade areas, and that is driving increases in sale prices and ground lease rents."

EXPANSIONS, CONTRACTIONS

Raising Cane's, for example, has been one of the most active fast food tenants, with an eye specifically on California expansion. There were about 18 Raising Cane's locations in California as of October 2019, with two more under construction in Ontario and Redlands.

"Raising Cane's has strategically selected regional, dense infill locations where it is positioned as an outparcel with a drive-thru," Asher says. "Preferably, the company selects pad sites shadow-anchored by a national tenant like Target or Sprouts, along with freeway visibility or pylon signage, providing additional exposure and identity to the site."

Shea knows this firsthand, as he and his firm recently developed an outparcel for the chicken chain in front of a Target store at 101 Euclid in Anaheim.

"This location, which was previously a little-used portion of Target's parking lot, was ideal due to its prominent visibly on Euclid Street, high traffic counts and direct adjacency to the main driveway entrance to the Target store project," he notes. "Plus, the access driveway was at a traffic light, allowing for all turning movements into and out of the outparcel."

Though much of the outparcel focus remains on fast food and QSRs, sit-down restaurants in well-located centers are also strong performers. This is because, as much as the outparcels can draw traffic into a center, the strength of the center, its location and visibility can also call attention to the outparcels. Such is the case at Ontario Mills Mall in Ontario.

"Some of the highest restaurant volumes in the entire Inland Empire are being achieved at Ontario Mills Mall," Shea continues. "BJ's Brewhouse, Olive Garden, Red Lobster and Lazy Dog are all achieving way above average sales. That can be attributed to the incredible regional draw that Ontario Mills offers. It sits at the intersection of two freeways, meaning it pulls customers from a much farther distance than a typical mall."

Raising Cane's found an ideal location for its California expansion at 101 Euclid in Anaheim, as the chicken chain prefers to be in front of large retailers like Target.

Lomuto has also found success when the demographics — and tenants — have fallen into place.

"A few of us in San Francisco recently partnered with some of our Stan Johnson brokers in Chicago on a casual dining outparcel and two 'big four' bank outparcels in San Jose," he says. "In all three cases, we found clear outliers in terms of performance. Both banks had exceptionally high deposits, and the casual dining user was way over the system-wide average in terms of sales and bottom line. And it was obvious why — incredibly healthy retail fundamentals. Very high household income in the area, very densely populated, conveniently located on the periphery of a shopping center that had everything the surrounding community could need. So, while no one was surprised that the tenants were doing well, we were pleasantly surprised at just how well they were actually doing."

Still, for every tenant and investor doing well in California, there seems to be an equal share that wonder whether the Golden State is worth it.

"Traffic, NIMBYism, the growing resistance to drive-thru retail — these things are all major factors," Lomuto adds. "Some of our single-tenant retail developer clients have been telling us for years, 'we would love to be more active in California, but it's just really hard to make it work sometimes. The dirt can be very, very expensive, it's difficult to get things approved and, even in California, the tenants can only afford so much rent. At some point you just can't make the numbers work.'"

Other markets can seem particularly attractive if you're a smaller player trying to compete with national and even global companies, as Milton points out.

"California isn't the only attractive market for these operators and investors," he says. "In truth, a great intersection in another city or suburb can be just as productive, and it won't cost what the same product in California commands."

For all the trouble, however, many operators still find it worth it to maintain a presence in the state. This is perhaps much in the same way residents will scrape and save and tolerate the taxes and bureaucracy all for the chance to call this over-populated paradise home.

"We've seen plenty of instances where even a legacy brand that is struggling at all but the best-of-the-best sites can make it work in California," Lomuto says. "So as usual, we're in a world where location is everything." **CC**