Investing in Shadow-Anchored Retail Development Deals

Q. I have heard about "shadow-anchored" real estate development investment programs. This is supposed to be a low-risk, high-return strategy. How does this work? How does it differ from other types of real estate development? Are there any unique risks I should be aware of?

A. The concept of a shadow anchor is nothing new. Big-box stores, such as Target, Home Depot, Wal-Mart, Lowe's and Costco, to name a few, like to own their own real estate. They have their own task force to acquire the land and permits. Because they draw in so much foot traffic, these stores are magnets for small-shop tenants next to the same land base. The shadow-anchored developers spend years building relationships with one or more of the big boxes, and "follow them around" by buying sites adjacent to their newer stores. Most shadow developers have a regional footprint and have been able to develop strong relationships with dozens of small-shop tenants as well as with the anchors. In addition, they are usually developing a very similar project each time. This allows them to streamline the design, entitlement and construction process.

Q. What are the advantages of a shadow-anchored development?
A. There are several advantages to shadow-anchored retail development. First, the development is virtually guaranteed to retain a strong anchor for years to come. Before buying the land, the anchor companies thoroughly weigh the property location, the demographics of the area, the view of the local townships on keeping up or revitalizing the communities in the area, and how the local population views their products and stores. The shadow-anchored developers do not have to worry about re-tenanting a big, deep space when the lease is up on the anchor in 10 years. Next, tenant demand is very strong because dozens of regional and national small-shop tenants review the success of big box locations and base their strategy on the past success or failure of those sites. In addition, the small-shop companies review the products they will offer in that location for competition from other nearby, non-anchored stores. So, it is possible for the shadow-anchored developers to substantially pre-lease these deals. Third, because each project they develop is similar in design and size, they have found ways to get costs down, streamline the schedule and build on budget every time. Fourth, because the buildings are both standard and simple and in established commercial areas, they can be designed, entitled and constructed often in under one year, providing a much quicker turnaround than many other types of real estate.

Q. What are the risks of shadow-anchored developments?
A. While the risks are considered to be minor by some, the investor has to carefully weigh additional items. The biggest risk is paying too much for the land. Due to the attractiveness of the anchor, you can be sure the shadow developers will be lined up to bid on nearby leftover land whenever a new big box goes in or plans on it. If the land is not "leftover", will there be high demolition costs? This is where having a relationship with a big box and getting early leads is critical. Check on whether the shadow developer has done a number of projects with the anchor. Another risk is if the anchor itself were to go dark, the shadow development might be all but destroyed if another anchor could not be found.

However, this is highly unlikely since a new anchor has done a great deal of due diligence and is probably not going to build a store that closes very soon. In addition, most of the big boxes are publicly traded companies and news of their problems is readily available. A careening economy usually has a greater impact on smaller stores than on anchor-sized ones, which can better sustain themselves over a rough patch.

Not given as much play is the name and number of stores in the shadow-anchored area. Although shadows have less well-know names, there should be name recognition in the local area of at least one of the intended stores. We have seen offerings where the largest store sold electric guitars; in another, an unknown store name sold running shoes. Neither of these holds a broad enough customer base. Location always applies. For instance, a shadow strip backed on its anchor in such a way that prospective customers had to leave the anchor and deal with two busy stoplights to get into the shadow mall. Sometimes there is a fast-food restaurant in a shadow space. Many large anchors rent space inside their stores to fast-food restaurants so as to retain the customer there if they should get hungry. Even if the restaurant has good food, it may not be found by anchor shoppers anxious to get home or who are out of money after visiting the anchor. Ask for a highlighted aerial view of the whole layout. Don't forget to research the financials of the shadow stores.

Q. Please talk about Shadow-Anchored Development Funds.
A. Shadow-anchored developments are smaller, usually averaging $2 to $7 million in total cost. This is because the anchor owns its own real estate, so all that is left for completion are the small shops. Because of this, some securities firms are raising money for funds (sort of like REITs) that focus on investing in several shadow-anchored development projects. These funds allow for more investors and higher individual investments than a one-off shadow-anchored deal would. In addition, because funds from projects completed and sold can be rolled over into new projects, investors can keep their money in longer than the typical 9-to-12 month duration of an individual project. Also, because projects usually roll on a staggered basis, after the first 9-to-12 months it is possible for investors to receive a more regular cash flow (such as on a quarterly basis). Be sure to understand when returns will start and if that method meets your financial needs. All the shadow plans offered in the fund should look solid to you.

Q. What should I know about the developers?
A. As much as possible. Shadow-anchored investments and funds rely on experienced developers who have strong track records and solid relationships with one or more big boxes. These developers are often still small-to-mid size, and hence need investor capital to grow and take their businesses to the next level. Hence, the investors supply the developers with the capital they need, and the developer delivers the high returns that investors are seeking. Ask to see that strong track record. Question any missing time in the record.

Q. What about Off-Shore developments? I understand that a lot of commercial construction is going on in Mexico and Puerto Rico.
A. First, if you are thinking of a 1031 exchange, real estate inside the U.S. and real estate outside the U.S. is not considered a “like-kind” exchange, and that holds for U.S. protectorates like Puerto Rico. Next, if it is not a 1031 exchange, how much do you know about investing in foreign countries? Despite the current real estate situation, the U.S. still has some of the most investor-protective laws. It would be wise to have had some experience with a company that has done non-U.S. offerings – that is, a good experience. Question them in detail about what happens in case of failure, ask if the political situation is solid, and if the investment is insured. Remember, it is not only the return **on** your investment, but the return **of** your investment.

Conclusion

Shadow-anchored retail development offers several advantages over some other types of real estate. The shorter return cycle with comparatively less construction and lease-up risk may better suit investors. The keys to making it work are finding a good site next to a new (or newer) big box in an area with good demographics that is reasonably priced. A solid review of the items above can put the investor’s mind at ease.

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