



As the Pandemic Fuels E-commerce Explosion, Will Retail be Converted to Industrial?

Converting failing malls and struggling big box stores into warehouse/distribution facilities is hardly a new concept, but in the wake of the pandemic's crippling impact on retail, finding ways to re-purpose properties has been gaining traction. According to the oft-cited CBRE Research survey released in July, 59 retail-to-industrial conversions had either been completed, proposed, or are underway since 2017, a figure more than double the 24 projects CBRE first reported in January of 2019.

Nearly all of those conversions were conceived pre-COVID, and while the 15.5 million square feet of new industrial space gained represents just a tiny

fraction of the 14 billion square feet of warehouse/industrial inventory in the U.S., the strategy has proven successful in some markets. So when the pandemic hit and lockdowns devastated traditional retail models—propelling U.S. e-commerce sales to a 44.5% surge year-over-year—the idea of ramping up conversions seemed to many to be a logical solution. But while the idea makes sense on the surface, the practicality of conversions is much more complicated, according to CRE and logistics experts.

“Simplistically, we hear people saying, ‘Why don’t you just turn that store into a last mile?’” says Craig Meyer, SIOR, president and head of JLL’s Industrial

THE INDUSTRIAL CONVERSION

By Michael Hoban

Properties Group for the Americas in El Segundo, Calif. “What they don’t understand is that it’s a far more complex issue than that and it’s got to be worked out over time. So the answer to the question of whether that’s possible would be the classic, ‘It depends.’ Some stores can be easily converted, but others will not be. That’s the trick and that’s going to be the challenge for the real estate industry as we go through this metamorphosis.”

The appeal of the malls and standalone big box stores is obvious. The key to reducing last mile delivery costs is to be as close to consumers as possible, and

retail centers are typically located off main thoroughfares with easy access to urban or suburban population centers. However, there are a number of other considerations that complicate straight-up retail-to-industrial conversions.

First, there are the physical challenges. As Prologis points out in its recent report, “Logistics Real Estate – Sizing the Retail Conversion Opportunity,” not all retail sites are viable for logistics. Minimum sizes for distribution centers are typically 8-10 acres, which eliminates strip malls and most neighborhood centers. Mall conversions are workable, but in most

cases that means demolition and full redevelopment, as the design of the mall structures (multiple floors, lack of dock doors and truck bays, inadequate floor loads and ceiling heights, etc.) do not lend themselves to industrial repurposing.

Amazon has had some success with the knockdown model, as exemplified by two recent conversions of dead malls just outside of Cleveland. The Randall Park Mall and the Euclid Square Mall were leveled and replaced with Amazon fulfillment centers, transforming 2.5 million square feet of retail space into 3 million square feet of warehouse/

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distribution space. Freestanding big box stores make far better candidates for conversion, because in addition to offering ample parking, the buildings usually feature the dock doors and clear heights needed for warehouse/distribution facilities. Sam's Club Stores have successfully converted several of their shuttered stores into regional distributional centers to fulfill online purchases.

But pure retail-to-industrial conversions are not likely to be widespread, says John Morris, who heads up CBRE's industrial, logistics, and retail divisions as America's leader and executive managing director. "It will happen sometimes, where there isn't cheaper warehouse capacity available nearby, where the retail fundamentals have just gone downhill, and where there's enough e-commerce households within a good delivery route map to make good sense as a fulfillment center, but there will only be so many of those."

Conversions currently face a myriad of other challenges, including potential legal issues involving equity and debt holders in the property, or lease provisions like REAs (Reciprocal Easement Agreement) and co-tenancy clauses that give rights to existing users that can derail the necessary rezoning. There's also the question of the community response to repurposing the retail center, which means zoning changes. The emotional

and financial impact on a community can't be underestimated, as retail centers provide jobs and tax income to the municipalities involved.

"Most communities are still holding out hope that the mall that has gone dark is going to come back one day. It's not really a strategy, it's more of a hope," says Morris. "Those realizations by municipalities will happen gradually over time, and that will be one of the mitigating factors in terms of how much conversion gets done, because the downzoning is going to be hard to accomplish."

With the end of the COVID-19 pandemic nowhere in sight, economic conditions are not likely to return to "normal" anytime soon, which may help to accelerate those decisions. Coresight Research¹ predicted that as many as 25,000 U.S. retailers will permanently close their doors by the end of 2020, with 55% to 60% of those situated in America's malls.

Those conditions may be creating a willingness on the part of municipalities to re-think their positions, opines Geoff Kasselmann, SIOR, partner and senior vice president of workplace strategy at CRG | Clayco, a firm that is working on large-scale retail conversions in multiple states. "Most municipalities have been financially devastated by COVID...so how are they going to make

up that unanticipated but significant shortfall? Since the jobs seem to be in the industrial sector, if they want to see their community's citizens go back to work, then considering a zoning variance from retail to industrial suddenly becomes viable on some agendas," he observes. "Little by little we are seeing industrial being allowed to take root in some former retail properties where just a year ago it was unthinkable."

Kasselmann emphasizes that while there is no definitive "best practice" on a national scale at this juncture, and such conversions are typically very local in nature, "Everybody everywhere is having these conversations right now."

He adds that there is sincere interest from large-scale e-commerce operators—Amazon, Walmart, Target, Lowe's, Home Depot, etc.—to be where their consumers are, for same day or next day fulfillment and ease of returns. "So these older megamalls that are dead, without much if any income and lacking in prospective retail tenants, are really ideally located as infill mega-development properties. Large last-mile operations could never assemble that kind of land in such an 'in-fill' location without it having been done for the mall. Utilities are in place and consumers are nearby. It's potentially irresistible."

Curt Bimschleger, a supply chain leader and managing director at Deloitte, also

thinks that the winds may be shifting in terms of converting retail to industrial, but not necessarily as tear downs. “I think there are a lot of companies looking at taking these anchor malls and stores and turning them into localized fulfillment centers or dark kitchens (delivery-only restaurants).” Much of the space in the big malls is becoming relatively inexpensive to lease, he says, adding that the actual lease costs associated with the rental of the building or the warehouse is usually less than 10% of the total cost of delivering that item to the consumer. And while there are drawbacks to using retail space for fulfillment (much less space than a warehouse, no loading docks, no restrooms or break rooms for employees), the converted retail space provides additional fulfillment nodes that are cost effective because they are that much closer to the consumer.

“During COVID, some companies were using their retail stores to fulfill product, so in a sense they were acting as a warehouse during that time, fulfilling product when some stores weren’t allowed to have consumers in the building,” he notes. “There’s a point where using a retail store as both, to fulfill from the store as well as the curbsiding and pickup, is going to continue to accelerate. And the demand for fulfillment space is going to continue to thrive as the consumer has shifted their buying focus to online.”

The retail chain Best Buy reports that 60% of their online orders are now either picked up at stores or by curbside, or shipped from them², so at the start of the fourth quarter, they began testing a ship-from-store hub model in about 250 stores—about a quarter of its approximately 1,000 stores.

As the retail model transitions to this omnichannel approach, the roles of industrial and retail CRE advisors have had to adapt accordingly. “The acceleration of e-commerce made it clear for us at CBRE that it was time to work more deliberately on the integration of retail and industrial, because the channels are connected, and retail needs the supply chain behind it,” says Morris.

In September, JLL responded to the challenge by rolling out a blended service model, the Retail Industrial Task Force (RITF), to advise retail owners, occupiers, and investors using a single team approach, to solve both real estate and supply chain distribution needs.

JLL’s Meyer cautions that the issues in this evolving retail environment are complex and that there is no one-size-fits-all solution. He advises on-the-ground brokers to broaden their view to think about uses within the context of the revised supply chain. “The pressure today on brokers to have good technical real estate skills is extremely

important,” says Meyer. “These clients are going to come to us asking, ‘What do I do with my dark store? Is my city primed for last mile logistics facilities?’ And they’re going to expect brokers to understand all that and come up with solutions. More than ever, they need expertise.” ▼

1. <https://coresight.com/press/as-many-as-25000-u-s-stores-may-close-in-2020-mostly-in-malls/>

2. <https://www.cnn.com/2020/08/25/best-buy-experiments-with-stores-as-it-bets-on-online-shopping-shift.html>

MEET THE AUTHOR

Michael Hoban is a Boston-based commercial real estate and construction writer and founder of Hoban Communications, which provides media advisory services to CRE and AEC firms. Contact him at michaelhoban@comcast.net

CONTRIBUTING SIORS



Geoff Kasselmann,
SIOR



Craig Meyer,
SIOR