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Dark Retail and Property Tax Assessments, Explained

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Dark Retail and Property Tax Assessments, Explained

The evolution of the retail industry and of basic commerce has major, systemic ramifications for property tax managers at companies that have significant real estate holdings.

The face of commerce has, during the past decade, unquestionably changed. The traditional, enclosed shopping mall is on its way out, giving way to the open-air communal spaces with no traditional anchor tenants that draws most of the foot traffic. Consumers today prefer independent merchants, craft coffee, and curated experiences over brand familiarity. Online shopping is ubiquitous.

These shifts have made redundant many physical retail locations. Store closures, and the resulting stagnation and rot associated with commercial real estate in some areas, are what we refer to when we talk about "dark retail."

Dark retail is coming into focus as a considerable risk to the property sector. On the same day in early 2017, three large retailers — Sears, Macy's, and The Limited — announced plans to shut down a significant number of physical locations. "This is all happening in an overall reasonably good economy, with an unemployment rate below 5% and accelerating wage growth," Bloomberg stated[1] at the time. "The next recession, whenever it comes, is likely to produce a 'shock and awe' moment for malls and physical retail."

In other words, dark retail could be the next real estate bubble — which begs a comparison to the last real estate bubble, the subprime mortgage crisis that began in 2007.

Around 2006, property investors began walking away from underwater mortgages in what was the beginning stages of the housing bubble's infamous burst. Because the national banks that took possession of the property had no interest in caring for abandoned suburban homes, many devolved into dilapidated eyesores. In cities, developers stopped work on high-profile, costly development projects because demand or funding went dry, leaving half-built condos and apartments standing in the wake.

The byproducts of the housing bubble had profound, nuanced effects on the real estate sector as a whole. Abandoned homes drove downward the property values of their neighbors. Failed construction projects depressed previously stable neighborhoods. For several reasons, the housing bubble led to higher demand for rentals, which has pushed young people into cities, driven up rents there, displaced longtime residents, and contributed to urban sprawl.

The results are still being felt: longer commutes, brittle infrastructure, more traffic. Ironically, greater urban population density creates demand for the very type of commerce that has created dark retail in the first place. City dwellers don't need lawn mowers from Sears, and they're not travelling to the suburbs to eat dinner at the Applebee's next to the mall.

Since all real estate is intrinsically linked, the housing bubble accelerated the difficulties brick-and-mortar retail was bound to face as a natural consequence of the changing face of commerce.

The practical impact on property tax managers

First, there is a brewing debate about how tax authorities should value real estate assets that do not produce ongoing income for their owners, either in the form of rents or as the physical location of a business. Property tax assessors tend to make valuation assessments of a property based on its location, and the fact of the matter is that many dark retail spaces are located in prime areas. In Manhattan's Upper West Side, for example, 12% of storefronts are unoccupied, according to research done by a city councilmember which was recently cited[2] in a New York Times editorial.

Making a balanced assessment on the tax liability of dark retail in areas where real estate prices are growing, not contracting, is challenging as a matter of policy. Reflexively lowering the taxable valuation of these properties could cause owners to keep the properties vacant because of the reduced tax liability hold out for higher rents, which is common in gentrifying areas.

Proposed legislation in Indiana, Wisconsin, and Michigan would allow active, fully operational (and ostensibly profitable) stores to value their real estate holdings in line with dark stores that are vacant and sit unused. In practical terms, these proposals are property tax cuts for owners of commercial space dressed up as relief for owners of dark retail, and this proposed approach should unquestionably be on the radar of property tax managers as well as senior management at companies that own significant amounts of commercial space for its potential implications on overall taxability. Another occasionally floated policy option is an additional tax on commercial space that sits, in the view of lawmakers, vacant for too long. It is fair to say that no one policy fix would work well across all tax jurisdictions.

For now, owners of commercial space are absorbing market risk through, for example, "going dark" provisions included in many commercial leases. Thomson Reuters Westlaw explains:

> The tenant's right to cease operations at its leased space while the tenant continues to pay rent. A go dark clause is commonly negotiated in retail leases.
>
> The right to go dark provides tenants with maximum flexibility, which is especially important for large national retail tenants. For example, a national retailer that is able to cease its operations at a particular location may have a significant cost savings, even if rent is still being paid.
>
> The use of a go dark provision can seriously upset the tenant-mix of a shopping center. Most landlords do not grant tenants the right to go dark without including certain protective measures in the lease for its own protection.
>
> For example, a landlord will typically include in the provision its right to take back the tenant's space if the tenant exercises its right to go dark. The landlord's recapture right in a retail lease allows the landlord to terminate the lease after the tenant has gone dark, without either party being in default. However, a landlord typically exercises its recapture right only after it has secured a new tenant for the space.

Large retailers with vast real estate holdings do have some options.

In 2015, for instance, Sears spun off its dark retail, properties that it owned, into a real estate investment trust called Seritage Growth Properties. The primary business model of Seritage is to renovate dark retail from Sears and Kmart into modern commercial real estate that appeals to new tenants such as chain restaurants, grocery stores, and entertainment options.

The strategy is working: the average cost per square foot of Seritage real estate has grown from \$4.40 to \$12.74, stated[3] a CNBC report, quoting an industry analyst.

Sears, however, is the exception that proves the rule. Many occupants of dark retail don't own the land or the structures, which minimizes the role they can play in turning an empty store into an accretive asset.

Most brick-and-mortar retail spaces are built to suit, and retrofitting these spaces for another occupant or owner can be capital-intensive and risky. For every failing mall that has found new life as a hospital, high school, corporate office, or modern apartment complex, there are hundreds of pieces of dark retail that still sit empty.

One solution many property tax managers are coming to terms with is to contest the assessed value of dark real estate more frequently, and to vie for lower valuations with stronger data. Property tax valuation is typically almost entirely subjective and relies in part on the assessor's judgment and experience — but data can help make a persuasive case. Owners of commercial properties can make their case for a lower assessed value that will lead to lower property tax liabilities, and there are platforms available that can arm them with the right research and content information by jurisdiction and track their appeals in real time.

Four lingering questions, answered

The mortgage bubble burst, and now the mortgage market is strong again. Will brick-and-mortar retail bounce back to create new demand for dark retail locations?

The retail sector will probably not revert back to being dominated by brick-and-mortar stores that customers drive to, shop in, and carry goods away from. Digital commerce is too entrenched in the buying habits of today's consumers, and it is quite frankly a better customer experience. To generalize a bit, Amazon, et al, are winning at retail because they should be.

Dark retail is not an episodic phenomenon. It is a systemic change.

Who owns the 'dark store' properties?

It varies.

- Traditional department stores often own not only their stores but also the parking lots around them. They're pretty significant commercial real estate owners with complex real estate holdings.
- Other stores lease their retail space from owners like shopping mall operators, real estate investment trusts, and commercial property investors. But these leases typically last many years — 10- and 20-year commercial leases are common — and are made at fixed prices, so commercial leases in high-growth areas can be valuable.
- Some retailers, typically franchise operations, create entities to hold real estate that they then lease back to franchisees. This technique, called a sale-leaseback deal[4], allows the company to reduce the risks created by owning real estate while generating steady capital flows through rents.

So, in essence, the subject of ownership seems to depend on a company's specific business strategy and their strategic approach to property investing.

Obviously, businesses can change their underlying business models and potentially even restructure their operations, but those changes happen slowly and methodically. It doesn't do much to fix the problem of an abandoned building just sitting there right now, losing value, and taking up space.

What is most likely to happen with that real estate capacity?

During the next few decades, much of this capacity is likely to be used for other purposes.

As online commerce continues to grow, there should be strong demand for warehouses and distribution centers, particularly in urban and suburban areas. If the rental market continues to grow, some dark retail locations would make for excellent apartment stock, similar to what old factories have become in cities like New York, Chicago, and Boston. As the Boomer generation continues to age, dark retail capacity could find new life as elder care centers or assisted living facilities. All of these transformations would have positive economic effects and, on the surface, seem like sensible business decisions.

Mall operators in many cities have simply turned enclosed malls into open-air, mixed-use space that includes smaller retail stores that sit among restaurants, breweries, entertainment options, and green public space, and I expect this to continue to happen.

What will the bottom-line impact be for companies?

The risk of a commercial real estate bubble is real, and the next downturn is likely to drive more retail closures.

Companies that own a large volume of commercial real estate that has heavy exposure to the retail sector should be looking closely at their approach for tracking and contesting property valuations and the corresponding tax liability. They should also be monitoring policy regarding commercial space valuation, which is typically made locally, and opportunistically acting to influence that policy.

As with most any other systemic change that affects an asset class companies have heavily invested in, there are likely to be winners and losers here moving forward, and the companies that win are those that have the tools, processes, and people in place to develop strategic short- and long-term plans and execute them quickly and effectively.

Andrew Graham is founding partner of Clear, a media agency in New York City, and advises Thomson Reuters ONESOURCE™.

1 Sen, Conor (2017, January). Your Local Mall Is Dying. Unless You Are Rich. https://www.bloomberg.com
2 The New York Times (2017, November). Why Is New York Full of Empty Stores? https://www.nytimes.com
3 Gustafson, Krystina (2017, April). It's not Armageddon for all malls, some are turning store closures into higher rents. https://www.cnbc.com
4 Chichester, Richard. Mousavi, Matthew. (2014, October). Sale-leasebacks turn favorable for operators. www.franchisetimes.com

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