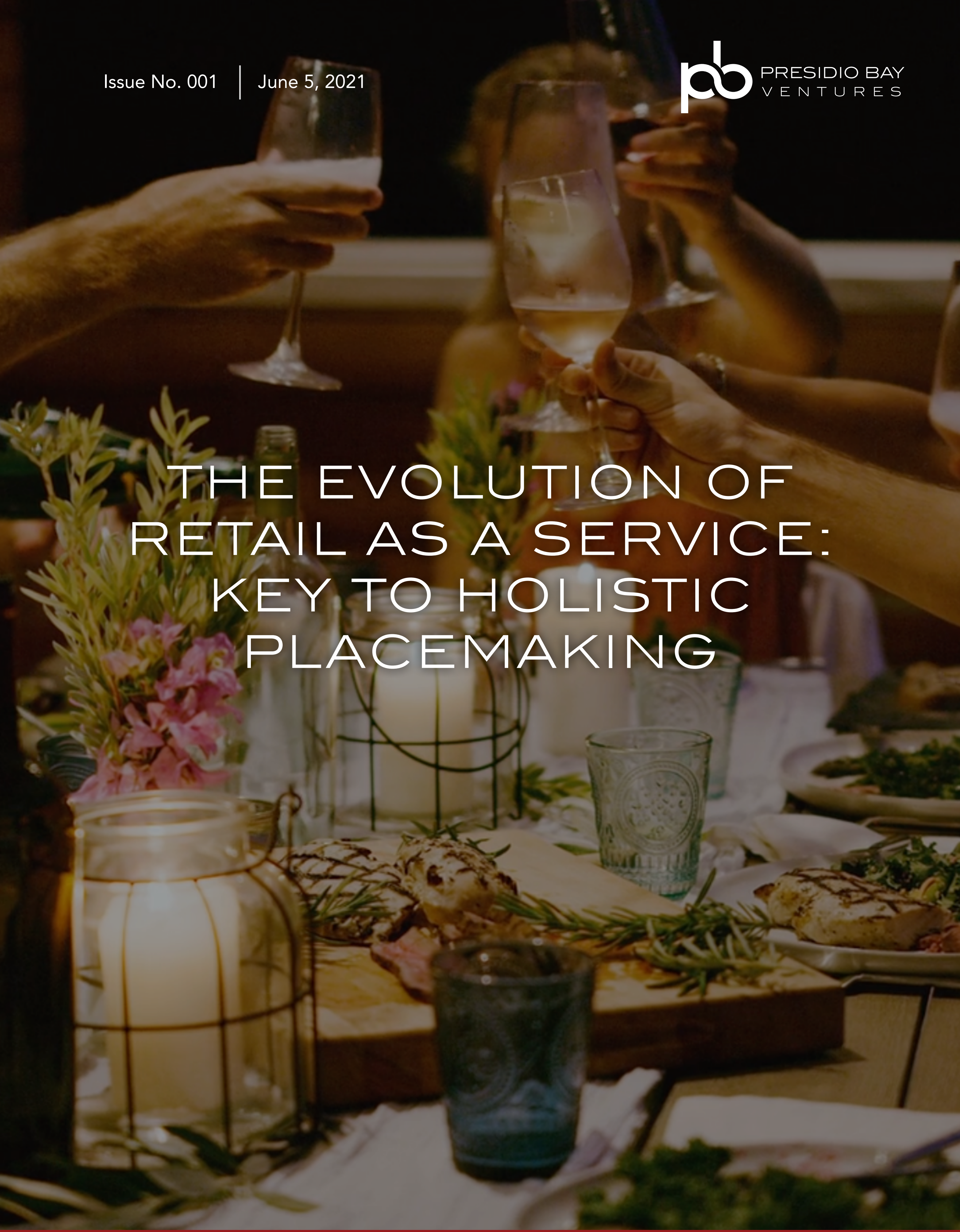
Issue No. 001 | June 5, 2021

PRESIDIO BAY VENTURES



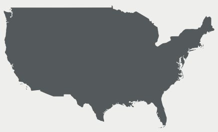
THE EVOLUTION OF RETAIL AS A SERVICE: KEY TO HOLISTIC PLACEMAKING

Retail, at its essence, boils down to a relationship between consumers and the purveyors of goods and services. For centuries, that connection occurred primarily in brick-and-mortar retail establishments – from the family-owned shops of the 1700s, to downtown department stores in the late 1800s, to shopping malls, discount chains and superstores that saturated the landscape in the 20th century. With the advent of e-commerce in the 1990s, and the near-total adoption of cellphones over the last decade, digital, mobile and cross-channel retail has become the norm.

The rapid and disruptive growth of e-commerce and subsidized shipping, defined by its unmatched convenience and choice, quickly outpaced a poorly-timed surge of new store construction. Between 1970 and 2015, the number of malls expanded twice as fast as the U.S. population, as Wall Street investors put a premium on sales growth. This coincided with the rise of big-box "category killers" that offered wide assortments in a single segment such as electronics, sporting goods and housewares, and a surge in dollar and off-price stores riding a wave of growing income inequality – both of which severely fragmented the department store customer base. By the time the shopping mall boom was complete, the Internet had already captured the eyeballs and wallets of many would-be in-person shoppers. Today, the U.S. has the world's highest retail square footage per capita, but it produces the lowest level of proportionate sales: 56 square feet per person generating only about $338 per square foot, according to CBRE. The U.K. has only 13 square feet of retail per person generating an average of $708 per square foot; and China is even more efficient with only 4 square feet of retail per capita generating $1,935 per square foot. China also has the highest online sales of these countries, so if those figures were backed out of the calculation, the gap would be even more extreme.

RETAIL SQUARE FOOTAGE VS PROPORTIONAL SALES

UNITED STATES



56

SQURE FEET PER PERSON

$338

PER SQUARE FOOT

UNITED KINGDOM

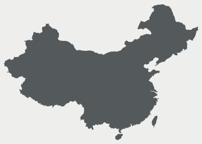
13

SQURE FEET PER PERSON

$708

PER SQUARE FOOT

CHINA



4

SQURE FEET PER PERSON

$1,935

PER SQUARE FOOT

Amid structural oversupply, massive shifts in consumer habits and preferences, and initially significantly low barriers to entry for e-commerce players, incumbent retailers have had to radically rethink the structure of the customer journey to maintain their relevance. The COVID-19 pandemic dealt a final blow to many of those who failed to adapt. Estimates suggest lockdowns and health and safety concerns accelerated e-commerce adoption by five to ten years, with people over age 65 comprising the fastest-growing cohort. "Shopping is largely habit-driven and there are very few times in one's life when you have an opportunity to reshape their habits," said Josh Silverman, CEO of the online marketplace Etsy in an earnings call. "The classic three are when you get married, when you move (into a) home, and when you have a baby. And otherwise, your habits are pretty cemented. And you're not really open to forming new habits. And so … this is a moment when everyone's habits are up for grabs."

Analysts suggest some digital behaviors are likely to prove sticky, especially online grocery shopping, telehealth and streaming entertainment. The investment firm UBS predicts e-commerce will vault to 26 percent of total sales by 2026, and more than 80,000 U.S. stores – roughly 9 percent of the total – will shut their doors. "Covid-19 has set fire to the old-growth forest that was pre-pandemic retail," writes retail consultant and author Doug Stephens. "While devastating on a human and economic level, the effects of the pandemic will also clear out decades of rotting industry underbrush. Only the healthiest and genetically soundest species of retail business will remain."

Retail health is driven by sales volumes and margins, which help drive rent appetite. Post-COVID, what will the strongest brick-and-mortar merchants look like? What function will they play in communities, and how should landlords reconsider the way in which retail deals should be structured? This white paper examines the emerging role of retailers as experience designers that facilitate social interactions, emotional experiences, and hands-on interaction, and the critical placemaking roles that they can serve when mixed appropriately with each other and the public realm. We discuss the near-term outlook, and prospects for a recurrence of the "Roaring 20s," a period of cultural and financial exuberance similar to the decade following World War I. Finally we look at how the new retail paradigm both challenges and is challenged by development decisions, space design, public policy and investment underwriting.

> The investment firm UBS predicts e-commerce will vault to 26 percent of total sales by 2026, and more than 80,000 U.S. stores – roughly 9 percent of the total – will shut their doors.

IMMERSIVE AND SOCIAL EXPERIENCES

Post-COVID, successful retailers will utilize physical locations as destinations where consumers can engage with brands and see, touch, feel, and try on products; or immerse themselves in an experience, whether dining, entertainment, socializing, fitness or personal care. Physical stores are crucial to brand-building and marketing, and more profitable than e-commerce, which must contend with hefty shipping costs and reverse logistics. "Stores are a demand-generation machine," said William McComb, former CEO of Fifth & Pacific Cos., which owned Kate Spade, Juicy Couture and Lucky Brand Jeans during his tenure. "Consumers don't automatically go to your website. It's very expensive to get the eyeballs."

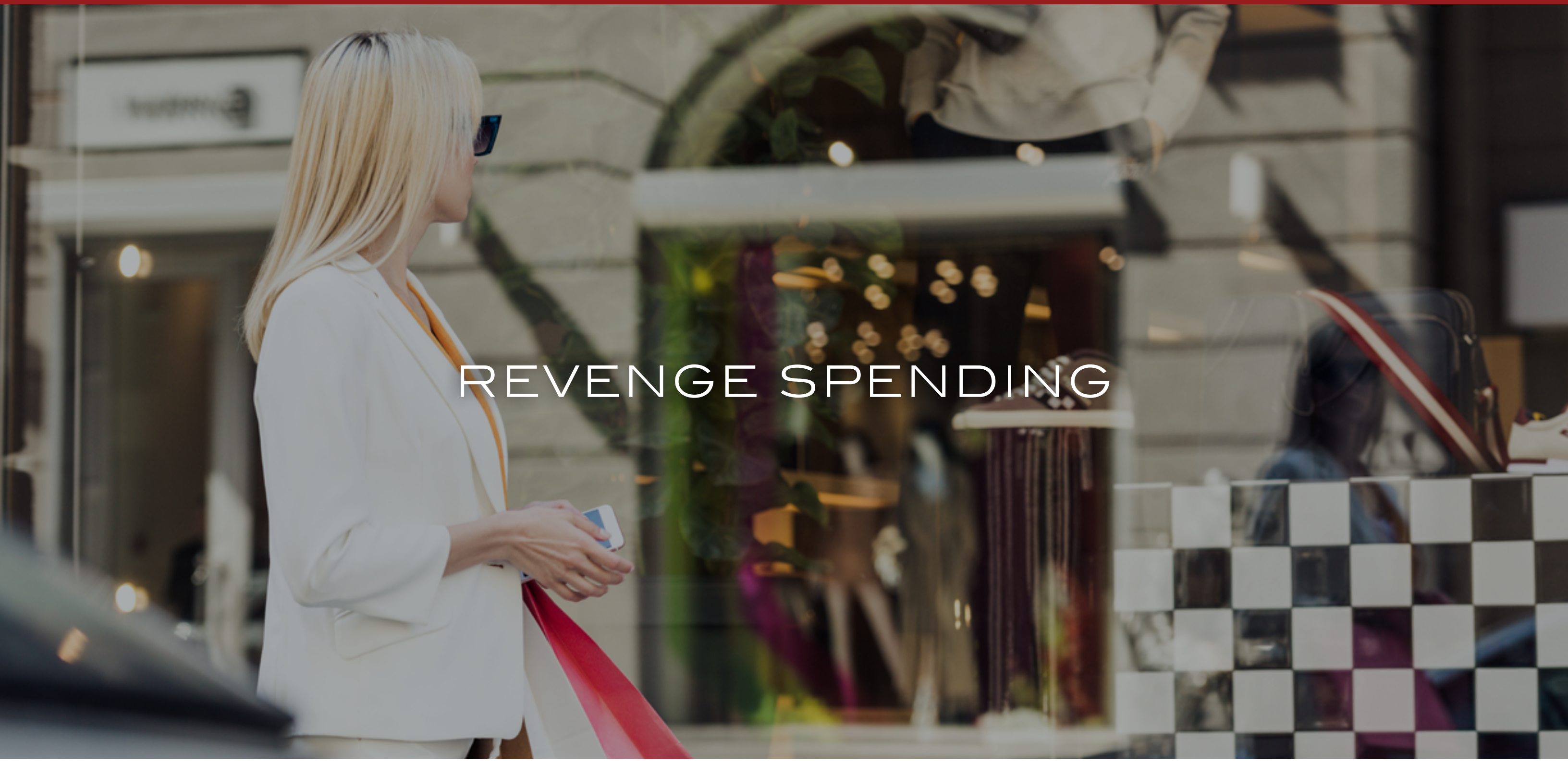
Even Amazon, which garners $5 of every $100 spent online, subscribes to this theory. Indeed, the e-commerce giant debuted its first "4-Star" concept store in Manhattan in 2018 to showcase electronics, toys and household goods rated four stars or above, and within three years expanded to more than 30 stores in 17 states. "We are entering the world of "phygital"—physical and digital at the same time, where there is not a physical world or digital world in retail, but rather a completely connected one," said Eric Hazan, a partner at the consulting firm McKinsey.

> "We are entering the world of "phygital"— physical and digital at the same time, where there is not a physical world or digital world in retail, but rather a completely connected one."
>
> — Eric Hazan, McKinsey

According to a recent McKinsey report, the future of shopping is connected. New virtual and augmented technologies are empowering customers to interact digitally within the physical store environment to address immediate needs and preferences. Brands like Uniqlo, Topshop, IKEA and Converse have offered virtual reality product suggestions for several years now, and retailers may eventually employ game or spatial-computing designers to up the ante, said Brian Solis, global innovation evangelist for Salesforce.com. "By 2030, 5G will have given way to 6G," he noted. "We'll have sensors, computer vision, artificial intelligence, augmented reality, immersive and spatial computing. How can these worlds play together in a way that is almost fantasy-like? Figuring that out takes imagination. It takes experience architecture—a new type of discipline and expertise. It's about creating magic. Great retailers, in the future, will make you feel like you're in a special place, designed especially for you, so that you take time out of your life to go to that place because it feels like the right place to be. It's aspirational."

Aside from enhancing individual brand loyalty through technology, retail can play a critical role in the social fabric of communities by providing a common meeting ground for shared and collective experiences. As department stores and shopping malls declined in recent years, owners and investors focused on creating social experiences to drive traffic, filling vacancies with restaurants, bars, movie theaters, "eatertainment," fitness centers, family activity parks and exclusive pop-up stores. Nevertheless, the pandemic dealt a lethal blow despite best intentions and sound strategies. Many of them – particularly restaurants – innovated quickly, adding take-out menus and incorporating flexible indoor-outdoor spaces. More than 10 percent of U.S. restaurants closed permanently, according to one report, the movie chain Alamo Drafthouse filed for bankruptcy in March 2021, and the full extent of the fallout may not be known for some time. The lucky survivors were based in geographies with less stringent lockdowns, received Payroll Protection Program (PPP) funds, had business models that accommodated delivery or extensive outdoor dining, or had flexible landlords who recognized the intangible value of retail for activation. Even flexibility, including 100 percent rent abatement, wasn't enough to keep some food and beverage operators alive, exposing the fragility of the industry, and a need to rethink financial structures. Post-pandemic, these same businesses might benefit from a repeat of the "Roaring 20s" from consumers chomping at the bit to spend their disposable income and make up for lost time with family and friends.

> "Great retailers, in the future, will make you feel like you're in a special place, designed especially for you, so that you take time out of your life to go to that place because it feels like the right place to be. It's aspirational."
>
> — Brian Solis, Salesforce



REVENGE SPENDING

Following the devastating loss of life and businesses throughout 2020, the U.S. economy is on track for its strongest growth since 1983. Economists expect 6.7 percent GDP inflation-adjusted growth in the fourth quarter of 2021 over the year-earlier period, according to a survey by IHS Markit. Covid-19 related restrictions on shopping, traveling and dining out, combined with government stimulus checks, led to sky-high personal savings rates, and an estimated $1.7 trillion in pent-up spending power – at least among those who were fortunate enough to have jobs that allowed them to work remotely. Historians have found that after periods of significant non-financial disruption, such as war and pandemics, economic growth does rebound. “Crises encourage people and businesses to try new ways of doing things, upending the structure of the economy,” The Economist noted. Others point out that the 1920s boom was primarily focused on the upper class, and driven by a myriad of factors – including the migration from farms to cities and new technologies such as the automobile and the radio – that don’t relate to the current environment.

> ”The eagerness isn’t from a place where you can’t wait to part with your money, but rather from a sense where you’re ready to get back to your normal lifestyle.”
>
> — Lauren Anastasio, Certified Financial Planner, SoFi

There are already indications that revenge spending is ramping up. “Revenge spending in our response to the pandemic has so much to do with pent-up anxiety or frustration that came from not being able to do what we enjoy,” said Lauren Anastasio, a Certified Financial Planner at SoFi. “And in many ways, the things we enjoyed had to do with spending money. The eagerness isn’t from a place where you can’t wait to part with your money, but rather from a sense where you’re ready to get back to your normal lifestyle.”

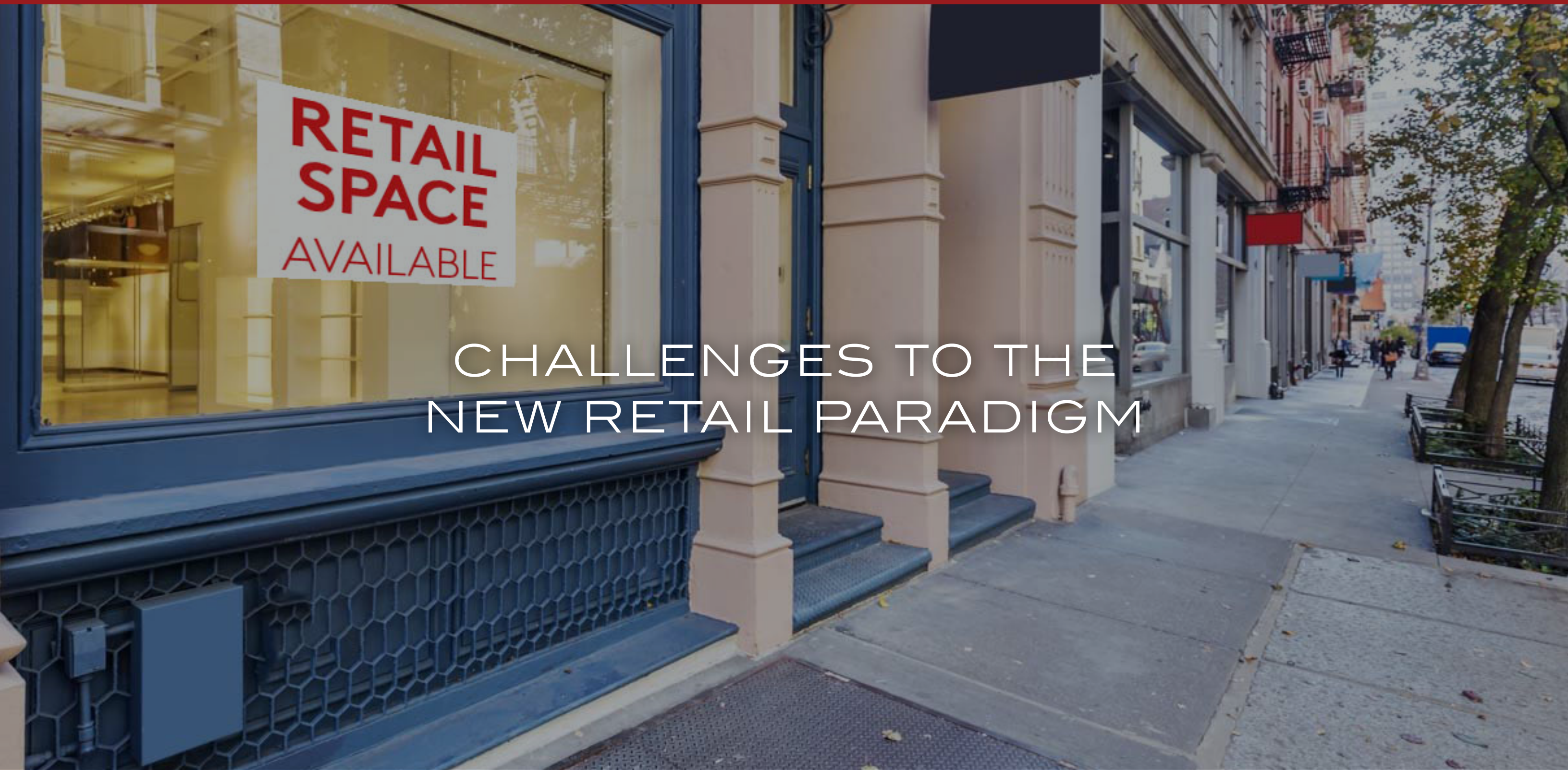
Revenge spending had already begun in 2020, as a dearth of travel and dining opportunities was rechanneled into luxury "milestone" gifts purchased online for anniversaries, birthdays, baby showers and the like. For example, Farfetch, an online marketplace offering access to Fendi, Gucci, Prada and other high-end brands, added 900,000 customers in the second half of 2020, with an average shopping cart of $600.

The desire to spend time and money in the public realm is a natural reaction to 15 months of social isolation. Nearly half of consumers surveyed in the first quarter of 2021 said they plan to "immediately" start shopping at retail stores once COVID-19 restrictions are lifted, according to a report by S&P Global Market Intelligence. Another 22.7% said they will start spending in stores within three months. Retail spending rose 10.7 percent in March 2021, fueled by government stimulus checks, and the National Retail Federation is forecasting a jump of 6.5 to 8.2 percent in 2021 to more than $4.33 trillion.

Early on in the pandemic, we had a glimpse of just how strong the brick-and-mortar shopping rebound can be, particularly in the luxury markets. After just two months of lockdown, the Hermès Guangzhou flagship store, the second largest store in China, took in $2.7 million dollars on its reopening day in April 2020. Shoppers posted their buys – from crocodile skin Birkin bags to furniture and tableware – on China's social media channels. "Renewed consumer confidence coupled with stimulus and a rapid vaccine rollout has meant that luxury consumption returned at surprisingly fast pace," noted The Bain & Company Luxury Study 2021 Spring Update, released in May. "The rebound in the US has exceeded expectations; improved macroeconomic conditions, a buoyant stock market, increasing consumer confidence and a fast vaccine rollout are contributing factors to a strong recovery."

> "Renewed consumer confidence coupled with stimulus and a rapid vaccine rollout has meant that luxury consumption returned at surprisingly fast pace."
>
> — The Bain & Company Luxury Study May 2021 Update

Experiential operators are also poised to benefit. For instance, perennial hotspots that hold either institutional or distinctive appeal, such as House of Prime Rib in San Francisco, immediately sold out of indoor tables in March 2021 as the city reopened. "In the near term, just going to a bar or a place with a variety of people to interact with will be entertainment," said Leslie Lundin, co-founder and managing partner at Los Angeles-based LBG Real Estate Companies. "Given the newfound desire for direct interaction with other real people, places and things, in the near term, entertainment venues won't need to work hard to draw crowds."



CHALLENGES TO THE NEW RETAIL PARADIGM

Scenes of large multifamily buildings lining city streets with vacant storefronts became ubiquitous during the pandemic. They served as painful reminders of the crucial role physical retail plays in neighborhood activation and placemaking. Humans are fundamentally social beings, yearning for interaction and unique experiences. Retail can facilitate organic, meaningful and memorable interactions and provide the space for programming that ignites a community. Retail must push the envelope of design and operational innovation if it is to play a role in reviving downtowns and neighborhoods. Yet even before the pandemic, retail vacancies were on the rise, due in large part to rapid changes in physical infrastructure requirements and increasing government regulation and costs, particularly in urban centers. The pace of innovation in retail has outpaced that of development and certainly of regulation.

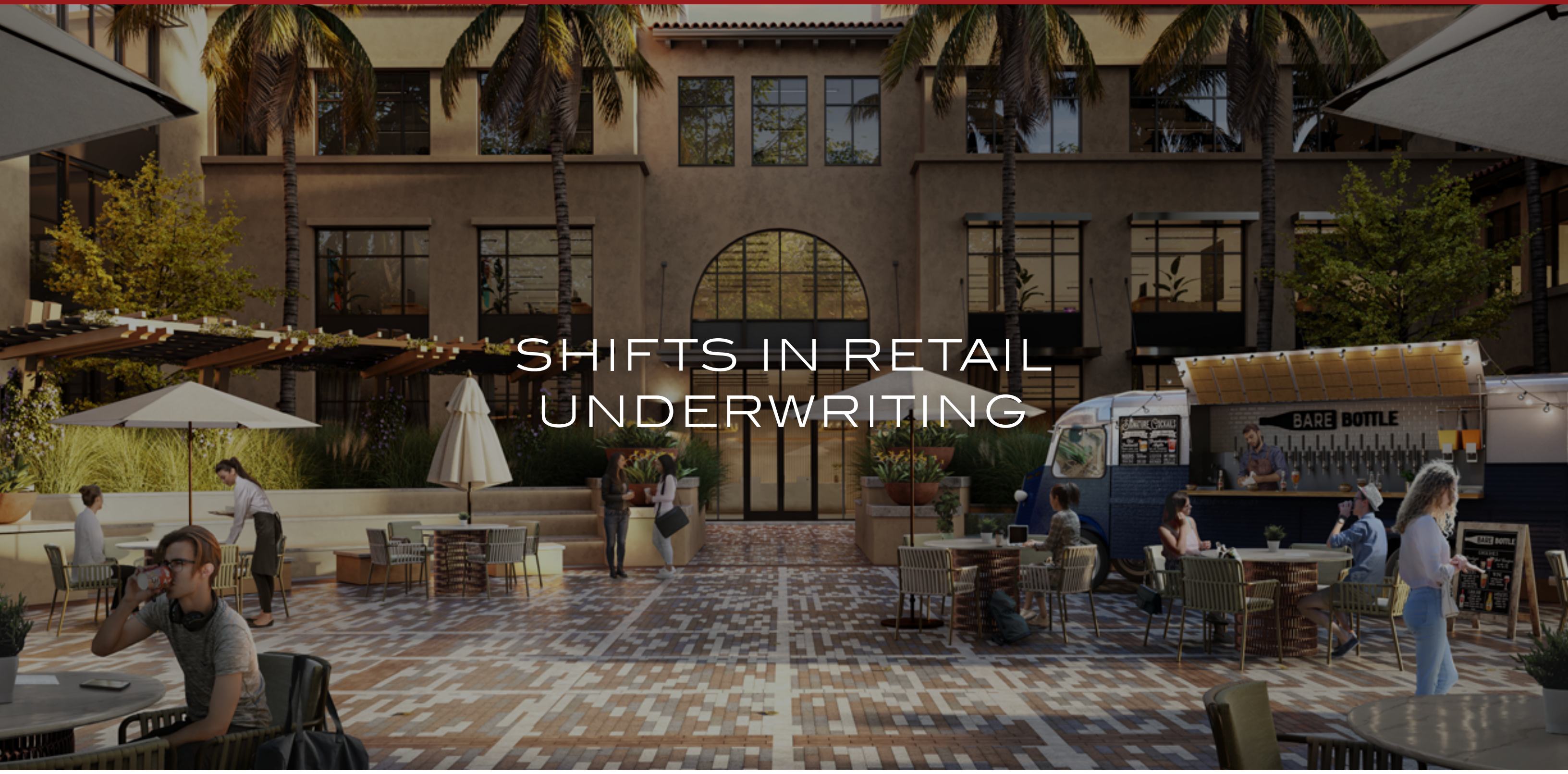
As the customer journey has changed, physical space must keep pace. For example, brick-and-mortar retailers are being forced to navigate the surge in demand for fulfillment and last-mile distribution centers. They handled 10 percent of online orders in 2020, a figure expected to rise to 20 percent by 2026, UBS estimates. This shift demands better back-of-house functionality and efficient loading space. Power is another crucial consideration. A 7,000-square-foot restaurant typically requires up to six times more amps of electrical service to run appliances, coolers and lighting than comparable non-restaurant space. But building owners and developers are failing to adapt to changing operational needs. Retail spaces are often afterthoughts in mixed-use projects, forcibly occupying ground-floor spaces more as a function of local planning ordinances than a true desire for placemaking. Without the appropriate physical characteristics designed to support modern uses, businesses cannot operate efficiently. In an already tight-margin business, these spaces make or break a retailer's viability. For the sponsor, these dynamics not only impact the immediate lease-up or sale of whatever is upstairs, but can diminish the long-term value of the asset. Everyone wants to work, live and play in a cool neighborhood, but few investors or developers have wanted to take responsibility for ensuring that "cool" in their buildings. While the upfront investment is arguably greater, the outcome of thoughtful placemaking with the right retail clearly enhances long-term value.

In addition, a myopic approach to permitting and zoning has thwarted innovation. Cities are struggling to deal with changing use categories, including a fusion of uses. This prevents exciting new concepts from getting permitted at all, or creates major delays and inefficiencies. Meanwhile, municipalities adopt ordinances that sabotage success stories and frustrate citizens. Consider San Francisco's formula retail rules, which ban chain stores and restaurants in Chinatown, North Beach, and Hayes Valley and require a six-month (or longer) approval process with public comment in most other districts. A popular Japanese curry restaurant that opened in the Marina to long lines was forced to close temporarily and file for a special permit, because it has more than 10 locations worldwide. As one neighborhood resident noted on Twitter: "It's one thing to make things harder for the McDonald's and Starbucks of the world, it's another thing to create a bunch of extra hoops for places opening their first US spot, in a long vacant storefront, and with a cuisine unavailable in at least a mile and a half radius." (It's worth noting that the space has turned over three times in the past few years, and has been vacant more than it has been activated.)

In March 2020 San Francisco voters authorized a vacant property tax on ground-floor retail space.

The hurried and haphazard implementation of politically urgent regulations, such as those focused on energy efficiency and carbon emissions, have also had a chilling effect on the flexibility of both new and existing retail spaces. Costly upgrades and renovations required of landlords who are unable or unwilling to invest the required capital has led to the continued dilapidation and obsolescence of otherwise high-potential retail space. By the same token, the design, engineering and budgeting for newer developments almost always precede the implementation of policy by several years, resulting in pushback and frustration from the development community when budgets and schedules are unexpectedly impacted. In both cases, a common sense approach to grandfathering both existing and new developments, along with a financial commitment from municipalities to assist qualified landlords and owners, would result in a broader embrace of ambitious public policies.

Unfortunately, certain jurisdictions appear to be acting contrary to the long-term interests of retailers and ultimately the public realm. Rather than passing legislation that encourages owners to fill these vacancies, in March 2020 San Francisco voters authorized a vacant property tax on ground-floor retail space. The reasoning for the tax was that landlords were supposedly to blame for the prohibitively high rents that drove 'mom-and-pop' retailers out of business, a line of logic that is seemingly contradictory to regular market forces. While there are certainly a few bad actors, the reality, as described by Reuben, Junius & Rose, a leading San Francisco land use advisory firm, lies within the city's high costs of employment (minimum wage, health insurance), onerous permitting processes and other headwinds discussed previously.



SHIFTS IN RETAIL UNDERWRITING

The future of retail flips the notion that tenants should be treated as arms-length entities positioned "on the other side of the table" and who are viewed simply as a direct source of net operating income. For retail to succeed, it must be deliberately woven into its physical surroundings and the wider community. The more deeply connected retail is to the other product types – the more it actually aligns with the way human beings use space and is integrated with the operational priorities of landlords– the more successful it will be. The winning strategy is not about bringing in a few "check the box" amenities, but consciously selecting the ideal uses helmed by the right operators who are then positioned into the right spaces. The goal is to curate an experience that people want by mirroring the way people actually interact with their communities. Situating retail within an overall placemaking strategy will create a competitive advantage that results in higher rates of absorption and price elasticity among prospective tenants, while also driving demand for other nearby uses such as housing and offices. At Presidio Bay, we are seeing this thesis play out first-hand at our Springline development, where we successfully leased 100% of the retail space by Summer 2021, during arguably one of the worst environments for retail since 2008. As noted earlier, retail health is driven by sales volume – and approaching the space in the context of a larger placemaking strategy results in stronger operators and higher rents long-term.

In a market rife with vacancies, retail must be viewed as a service, an amenity, and a central element to activation and placemaking. Consider the vibrancy in mixed-use, historic redevelopments, which already have an established sense of place: the Fulton Market warehouse district in Chicago; the Wynwood Arts district in Miami; the High Line and the Meatpacking district in New York; and The Wharf in Washington, D.C. "If you can offer a

For retail to succeed, it must be deliberately woven into its physical surroundings and the wider community.

historic destination, a place that people have been coming to and want to come – if you can offer authenticity and building and design and, create the right merchandising in that district, it's just a much easier task than brand new, ground-up creative space," said Terry Brown, managing partner of Asana Partners, a private equity platform headquartered in Charlotte, North Carolina, that has invested in roughly 30 mixed-use projects in 13 states over the past six years. "And it just works. Both in person and with a digital experience, the authenticity of that experience and the emotional connection of space and place to the consumer just gets to be more and more important every day."

To generate long-term value, sponsors need to structure smarter deals and take on more risk. Sponsors often chase the highest upfront rent and zero tenant improvement dollars without a recognition of how retail is evolving, which results in high turnover. Institutional investors and lenders support these types of decisions being made by their borrowers by looking at comps, which are rearwards facing by definition and not reflective of our proposed recipe for future success in retail activation. The results of this short-term thinking are the lifeless retail corridors experienced in stretches of Manhattan's Fifth Avenue, areas of downtown Los Angeles and so many other geographies. Indeed, many investors and lenders have simply stopped ascribing any value to retail suites below a certain size when contained within a broader housing or commercial development, as though acknowledging that current structures are untenable but stopping short of evaluating any other approach or considering appropriate capital requirements. If given the option, landlords will simply avoid building retail altogether, unless otherwise mandated by local zoning.

THE RESIDENCES AT SPRINGLINE IN MENLO PARK

The private residential entrance, and the public lobby and co-work lounge are open-air and connected to Canteen Cafe, the fountain plaza, and residential amenity spaces to encourage chance encounters and social interaction.

CREATING ALIGNMENT

In the post-pandemic era, with so much investment wiped out, landlords need to create alignment with retailers, and consider investing capital in top-tier operators who can revitalize neighborhoods and bolster their investments. Underwriting retail property is about underwriting the occupant brand more than the balance sheet. Landlords have always taken the primary risk in the capital structure with retail tenants. We now must recognize that, in the new retail paradigm, they, along with their investors and lenders, should consider underwriting these costs, and participating in the upside through pure revenue-share models.

Landlords willing to take on more of the permitting, building and capital risks are more likely to attract top operators who wouldn't otherwise consider traditional market deals. Removing the barriers for amazing operators to focus on their business plan and execution helps them to flourish. This in turn drives greater demand for a project. Investing in unique, innovative concepts helps to activate the neighborhood, enhance prestige, evoke exclusivity, and create a sense of place that attracts and engages people – ultimately generating higher sales long-term and promoting sustainable outcomes.

Landlords need to take on more risk in order to attract top operators, including things like:

1. PERMITTING
2. CONSTRUCTION
3. INVESTING CAPITAL

CONCLUSION

What is the future of brick-and-mortar retail? The most successful companies will be omnichannel experience designers, offering physical venues for shared and collective experiences, while integrating key technologies to serve consumers' needs and preferences. Successful retailers will flourish in communities that take a thoughtful approach to permitting, zoning, taxation and regulations to ensure spaces are quickly activated and enrich the quality of neighborhoods. Prosperous retailers will partner with landlords who understand the unique demand drivers of their communities, and provide smartly designed spaces with up-to-date systems to support the occupiers' operational goals.

Most importantly, the future success of physical retail depends on a new alignment between landlords and retailers, from purely short-term, transactional relationships to longer-term partnerships. Sponsors and investors must be willing to shoulder more underwriting risk in exchange for higher long-term value. This scenario is already playing out across the globe. A decade ago, a British government commission declared that high-street shopping districts, which had once formed "the hearts and towns" of communities, were in crisis. Vacancies soared, foot traffic evaporated and local economies declined – a death spiral exacerbated by the pandemic. "The best returns on investment will come from maximum collaboration based on local partnership," the report stated. "Crucially, we need everyone collaborating and compromising at a local level to develop and deliver a vision which works."
The New York Times recently profiled the coastal town of Poole in the southwest, where investors, local government and retailers accepted the challenge to maximize collaboration. Property owner Legal & General Investment Management, a unit of the country's largest corporate pension manager, offered two years' of free rent to new retail businesses, and in other cases, flexible leases as short as three months, with rents based on the tenant's earnings. Local authorities agree to waive some taxes. The landlord targeted local boutiques rather than national chains, looking for curated offerings and experiences. Ten new businesses opened in six months – from a coffee shop/record store to design studio to a seafood market – while other vacant spaces will be used by the town for adult learning courses. Poole's Old Town, a protected heritage area, received £1 million in funding to renovate its historic buildings and leverage the community's unique and authentic history in attracting visitors.

This kind of alignment represents the best hope for retail to thrive in the future. By approaching opportunities with a unified vision, developers, government and retailers can foster the authentic, memorable and differentiated experiences that form the basis of intelligent placemaking that engages consumers, builds a loyal following and establishes the foundation for long-term success.