Vol. 4 -FOURTH Quarter - 2017

dpd-report

Denver Planning and Development Report

Curating the topics driving Denver's growth

The IMPACT OF AMAZON

Fall 2017 EDITION

This issue of Denver Planning and Development Report looks at three aspects of the Amazon Effect. First, what is it that we know or might conjecture about Amazon's search for a second headquarters location? Secondly, how is e-commerce affecting retail investment and development from the perspective of a thought leading retail fund manager and developer? Thirdly, how is Amazon's supply chain and logistics strategy affecting the strategies of brick and mortar and e-commerce retailers of all sizes? Fourthly, where would Amazon locate in Denver?

Thoughts on the Amazon HQ 2 Search

Jeffrey B. Samet, Editor in Chief

The Amazon HQ2 RFP has touched off a fevered competition around the country to land the $5 billion investment and promise of 50,000 new jobs. Economic development consultants editorialize on which site selection criteria will be decisive, and knowledgeable pundits speculate that Denver is either the likely winner or not even a top 10 contender. Each bidder is undoubtedly convinced that its composite attributes of a deep, diverse pool of software engineering talent, supportive infrastructure, international air connections, and lifestyle appeal make it a short list candidate. The reality is probably no one outside of the Amazon site selection team knows the real drivers and implicit biases in the process. What then might we guardedly speculate?

• Amazon's cost leadership is its generic competitive strategy. Minimization of operating costs through its computing and networking technology is integral to this strategy. This has obvious implications for site location- the availability of a pool of software programmers, big data analysts, networking engineers, artificial intelligence developers, etc. is the armature of this strategy. Along with talent, the presence of universities with well regarded computer science and engineering departments attracting top students and faculty is an obvious plus.

All other operating costs, ie, real estate, utilities, etc., must be as cost effective as possible. Finally, incentives that reduce operating and capital costs will be a factor, all other things being equal. Incentives can't make up for a deficit of talent or thedesirability of a location for that talent.
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• Amazon is committed to market development, already operating 11 on-line market places- 3 in North America (U.S Canada, and Mexico), 5 in Europe (U.K. Germany, France, Italy, and Spain), and 3 in Asia (Japan, China, and India). International growth is an important piece of Amazon's growth strategy. DIA does not have to have the most international flights but direct service to these markets, in particular, is important.

• Amazon CEO, Jeff Bezos, speaks about a relentless focus on the customer. He calls it a Day 1 strategy. In his words, 'customers are always beautifully, wonderfully dissatisfied, even when they report being happy and business is great. Even when they don't yet know it, customers want something better, and your desire to delight customers will drive you to invent on their behalf.' That thinking led to the creation of services such as Amazon Prime, but also envisioning the elimination of check out lines in their stores using machine vision. This, of course, has everything to do with corporate culture and strategy, independent of site location.

It does raise the question how is this ethos replicated in a second headquarters location? Whereas Amazon did not specify in its RFP which functions or divisions would be housed in the second location, or how many employees would initially and incrementally be added, would it not be reasonable to speculate that there would be a sufficient number of transplants from established locations to carry on and propagate the Amazon culture? It would also seem likely that Amazon would talk to existing CEO's of high growth

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companies in each of its short listed locations about their experience with recruiting, training, and retaining top notch technical talent.

No doubt each bidder is scouring the press and social media for leaks about who is really in the running, sleuthing whether anyone is surreptitiously gathering information in their city, and second-guessing whether they neglected something in their submittal.

Irrespective of Amazon's decision, Denver will continue to grow its economy through new startups, expansion of existing companies, and relocation of outside corporations. Everything that has made Denver a contender will continue to make it ~~so for new and existing businesses~~.

Jeffrey Samet, Editor in Chief

Brad Hutensky, CEO Hutensky Capital Partners

Amazon's Impact on Retail Real Estate

Amazon has an unbroken, 20-year streak of posting revenue growth in the double digits. Its technological prowess, domination of e-commerce in the U.S., diversification into media and consumer electronics, and recent entry into the grocery business is transforming the retail sector. Whereas Amazon will continue to be insistently innovative and disruptive, it is well to remember that e-commerce only accounts for about 8% of retail sales.

To get a perspective on how this is affecting retail real estate, the Denver Planning and Development Report interviewed retail real estate investor Brad Hutensky, CEO of Hutensky Capital Partners. Brad has extensive experience in the acquisition and repositioning of shopping centers around the country and serves on the Board of Trustees of the International Council of Shopping Centers. He was its 53rd Worldwide Chairman in 2012-13.

DP&DR: Is the internet going to be the death of brick and mortar stores?

Hutensky: The media loves writing that story but, the death of store-based retailing has been greatly exaggerated. In fact, 92% of retail sales still occurs in retail stores, according the U.S. Department of Labor. Today, virtually every top retailer uses both the physical store and online channels to maximize sales. After Amazon, the next four largest e-commerce retailers are Walmart, Apple, Staples, and Macy's. Further, retailers who began as pure play internet players such as Warby Parker, Bonobo's, and Amazon have all been aggressively opening physical stores. Hard to understand why these retailers would open stores if the store is "dead." Amazon's recent purchase of the 460 store Whole Foods chain is clear validation of the importance of linking brick and mortar locations with a strong internet presence.

DP&DR: What about all of the recent retailer failures?

Hutensky: Retailing has always been a Darwinian business with great retailers growing and poor ones closing . This is nothing new. Most tenants who have failed do not offer the customer a quality experience (bad service, uncompetitive pricing or unimaginative merchandise} or have poor capital structures (usually too much debt). Any business with these characteristics deserves to fail.

DP&DR: And all those store closings?

Hutensky: While store closings make for salacious headlines, the number of closings is not by itself an indicator of the industry's health. First, it is important to note that while some 10,000 stores are expected to close in 2017, there are

more than 14,000 store openings projected over the same period, according to industry analyst, IHI Group. Second, numbers can be misleading. Two retailers- Radio Shack and Payless Shoes- together closed 1,700 stores or 17% of the closings. While that seems a lot, both operate small stores whose closings will not have a major impact in most shopping centers. In other instances, retailers like Staples are recognizing that as their online sales increase as a percentage of total sales, a smaller store size or decreased number of stores is optimal.

DP&DR: But haven't the closings and downsizings negatively impacted the retail real estate sector?

Hutensky: On the contrary, the sector has performed quite well, in part because of the new store openings. CoStar reports that the vacancy of power centers is currently about 5% (about equal to pre-crash levels in 2006) and down from 1Q 2009 high of 8%. Broker JLL reports that over the past 12 months during a time of many store closings, vacancy rates have fallen 20 basis points and rents have grown 5%. Rising rental rates and shrinking vacancies certainly suggest a retail real estate industry that is healthy and well able to absorb store closings.

DP&DR: Can you sum up what we will see going forward?

Hutensky: As retailing changes, there will be winners and losers in terms of retailers and shopping centers. While change is never easy, the best quality shopping centers and retailers that are managed well will continue to prosper and we should not be confused when we simultaneously see retailers and shopping centers experience failure. That's how it has always been.

DP&DR: Brad, that is a valuable perspective. Hutensky Capital Partners' recent acquisition of Northglenn Marketplace makes all the more sense in this broader retail context.

Amazon Footprint Closely Followed by Competitors

Jeffrey B. Samet, Editor in Chief

Amazon's logistical footprint has rapidly grown in the Denver area. Starting with its 452,00 square foot sortation facility in Aurora that opened in 2016, the company subsequently opened its first fulfillment center in Aurora. That is now to be followed by a second fulfillment center in Thornton scheduled to open in 2018. This second facility will be a 3 story, 2.4 million square foot building that will deploy robotics for pick operations.

Amazon's rapid expansion here is being replicated around the country. The role of its sortation and fulfillment centers reflects how the company continues to refine its supply chain and logistics model to be able to compress customer delivery from 2 days to a matter of hours. Amazon is forcing the entire e-commerce industry to follow its lead.

Robert Lieb, professor of supply chain management at Northeastern University who has surveyed 3PL CEOs for nearly 25 years, said in Supply Management 24/7, " Just about everybody in retail is being dragged along by what Amazon does. They are trying to respond with an omnichannel solution to maintain brick-and-mortar stores, but also be competitive in e-commerce. Because a lot of retailers - particularly small ones - can't afford to put together their own stand-alone e-commerce business with the geographic and inventory positioning capability to meet same-day/next-day delivery expectations, they're asking 3PLs (third party logistics providers) to help."

This was the subject of one of the panels at ULI's Fall meeting in Los Angeles. Panel moderator, Benjamin Conwell, who heads Cushman & Wakefield's E-commerce and Electronic Fulfillment Specialty Practice group for the Americas, said that with e-commerce growing at a 15% annual pace and reaching $400 billion in revenue in the U.S., it now accounts for one quarter of total U.S. industrial leasing. That figure is even higher, 30%, for buildings over 700,000 square feet.

Other panel members commented on the demand for last mile distribution centers where vans and smaller vehicles pick up and deliver packages to consumers' homes. Richard Kolpa, a ProLogis vice president in Seattle, said that five years ago, there were no institutions interested in this product. Now there are close to a half dozen developers who compete with Pro Logis for this business.

Panelist Patrick Ryan with Cabot Properties said it's not just Amazon and Wal-Mart competing for this product. He cited the example of an entrepreneur in Chicago who is leasing 50,000 square feet to manufacture mattresses, which are only sold on-line to a global market. He located next to a Fed Ex Ground facility to facilitate delivery. Timur Tecimer, CEO of Los Angeles based Overton Moore Properties, described 3PL's role not only in distribution, but in managing returns because up to 30% of apparel goods ordered on-line end up being returned.

The take away is that the Denver warehouse industrial market will continue to respond to this convergence of retail and distribution, driven by the big players like Amazon and the smaller players forced to follow in its wake.

Denver Planning and Development Report is a quarterly publication highlighting noteworthy real estate development and regulatory trends in the Denver market. Market makers, economic development, and regulatory officials will be consulted to provide a more in-depth understanding of what is affecting this high growth market. Comments, criticism, and topical suggestions are welcome so that the publication can be relevant, accurate, and insightful.

- **Jeffrey Samet, Chief Editor: Jeffreysamet940@gmail.com**
- **Steven Ferris, Contributor: sferris@realestategarage.net**

In the Know:

Where Might Amazon Locate in Denver?

Steve Ferris, founder of Real Estate Garage and former director of Development Services for the City of Denver, recently published an article in the Colorado Real Estate Journal,(link: https://crej.com/news/amazon-hq2-comes-denver-might-go/) identifying prospective sites that he felt met Amazon's site criteria. Excerpted below is his assessment. It will be interesting to compare it to the site listing submitted by the State Office of Economic Development as part of their response to the HQ2 RFP.

Amazon's stated criteria.

"HQ2" could be, but does not have to be:

– An urban or downtown campus
– A similar layout to Amazon's Seattle campus
– A development-prepped site

The company would consider existing or new buildings, shovel-ready green field sites, or infill opportunities, all with the ability to meet the project's timelines. It requires that a half-million sf of building be available in 2019. A site should be mass transit served, be within 30 miles of a population center, 45 minutes of an international airport, and within 1 to 2 miles of a major highway.

Given these criteria, Ferris has qualified the following sites.

pictured at right Steve Ferris

POTENTIAL DENVER AREA AMAZON HQ2 SITES: QUANTITATIVE COMPARISON

SITE	CURRENT SIZE (approx. acres)	POTENTIAL SIZE (approx. acres)	POTENTIAL SQUARE FOOTAGE	OCCUPIABLE SPACE 2019
Ridgegate Lone Tree City Center, Lone Tree	125	146	8-9 million	500,000 at Sky Ridge Station
Downtown West-miniter, Westminister	105	TBD	8 million	TBD
Upper Fox, Denver	41	99	8 million	500,000
Penn Station, Denver	200+	200+	TBD	TBD
Broadway Station with Denver Design District Denver	110	130	8 million +	500,000
38th & Blake North RiNo, Denver	136	166	8 million +	500,000
Elich Gardens/Pepsi Center Parking/Water Street, Denver	62	78	8-10 million	0
Stapleton North, Denver	100	100	13.5 million	500,000