Publications: Stale myths fall as new shopping center rises

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It's a grueling challenge for many foreigners to navigate congested, narrow roads and sardine can parking lots to visit Japan's shopping centers. And then there is Seth Sulkin, a foreigner hailing from Chicago, who takes on bigger challenges. His Tokyo-based company, Pacifica Malls, is the first foreigner-led development firm to conceive, plan, finance, and actually start building a shopping center in Japan without a Japanese partner. In an industry dominated by large, domestic firms, Sulkin is bringing an American model of retail development and a much-needed dose of creativity to the Japanese mall scene.

"This is not rocket science or magic, just common sense and a few new ideas," Sulkin said. His project is Vivit Square, a 560,000 square foot shopping center that will open just outside Tokyo in Funabashi on December 1, 2004.

Finding even 350,000 square feet of open land on the outskirts of Tokyo is no small feat. But Sulkin's background makes him ideally suited for his current task. After starting as a Wall Street Journal reporter, he worked for many years in the planning and construction of Third World infrastructure projects, many financed by Japanese lenders. He followed that with several years doing outsourced buying of American merchandise for Japanese department stores that could not afford their own U.S.-based buyers.

It helps that changes have shaken the status quo in Japan's real estate sector and that land once hoarded by large companies has hit the market. Vivit Square is being built on the former leisure grounds of Yamaichi Securities. Once one of Japan's leading financial institutions, the company went belly-up in 1997, a sudden bankruptcy that shocked Japan into the realization that its "old guard" was no longer infallible.

"Land has traditionally been viewed differently in Asia than in the West," says Sulkin, whose insights into Japanese culture serve him well as he tries to drive changes in old habits and traditions. "There is a kind of emotional attachment to ownership of land--any land--in Asia. In the United States this is sometimes seen in farm country, but rarely would selling land in, say, a suburban retail development, be seen as an emotional matter. It's just a business."

Because Japanese banks lacked the expertise to judge businesses on the basis of the operation itself, there was a fixation on using hard-asset collateral as the main lending criteria. Land was the collateral of choice--scarce enough to be valuable, easy to define, and seemingly stable. Companies bought and held extraneous land simply to have collateral for financing and to gain status in a culture where owning land symbolized power and success.

But banks in Japan are now far less willing to loan to companies with poorly performing businesses, even if they own land. Meanwhile land prices, while still high by world standards, have plummeted over the past ten years. So companies, denied access to further bank credit, are being forced to sell unproductive land to raise capital. Others are selling land under pressure from new accounting rules to clean up their balance sheets and to please shareholders demanding improved returns on assets.

Flows of new ideas and business models are starting to thaw Japan's rigid habits and to move the economy. In this new environment, people like Sulkin have the specialized expertise and individual initiative needed to create land uses that fit the times. Backed by foreign banks, such as the newly public Shinsei, their impact will be large, as will their profits.

Meanwhile, the sorry state of the Japanese retail development industry makes it ripe for profitable innovations.

"About 85% of Japanese shopping centers have zero or one anchor store, which makes for a very dull shopping experience," Sulkin said. "In many cases the mall is owned and run by a subsidiary of the same company that owns the anchor store, so nobody is thinking about the other stores, about the overall shopping experience of customers, or about maximizing the profitability of the mall operation itself."

Malls not run by the anchor stores are instead often owned and operated by huge diversified real estate companies or by trading companies that also develop office buildings, residential homes and condominiums, industrial parks, theme parks and everything else involving land, Sulkin added.

Diversified Japanese companies typically rotate employees between divisions every few years, they have few people who develop the deep, specialized knowledge needed to do innovative and profitable retail development. The result: mediocre replications of boring malls.

Like U.S. mall developers, Sulkin's model and inspiration, Pacifica Malls focuses on its chosen sector, retail, leaving office towers, homes, and other endeavors for someone else's plate. Companies such as Simon and Rouse had founders of the same name who pursued a vision of a specific type of retail environment and the benefits and profits it could bring. They executed their ideas as merchant developers by employing their own teams of retail development specialists and by working with outside specialist firms.

True to this concept of specialization, Pacifica is the first developer to engage Gensler, the top U.S. specialist in retail mall design, for work on a stand-alone Japanese shopping center.

Specialization also offers Sulkin the key economic advantages he needs to create a winning business model. Pacifica Malls makes the bold claim that Vivit Square will simultaneously offer a superior shopping experience, favorable rents to tenant stores, and superior returns on investment.

To pull this off, Sulkin has to get much more than his Japanese competitors can out of his land and his people. Vivit Square will have four stories of retail space rather than the one or two common at most Japanese malls, and all parking will be in a huge multilevel indoor garage or on the roof of the retail facilities, saving space often wasted in Japan's suburban malls by uncovered parking lots. This allows Vivit to house five anchor stores as well as specialty mini-anchors offering expanded versions of their usual smaller stores. All of the stores will have convenient, barrier-free access directly from one of the four levels of parking; an innovation Sulkin says is a first in Japan.

The popular conception is that the Japanese are second-to-none when it comes to using tight spaces in ingenious ways, but that tale needn't intimidate would-be entrepreneurs, Sulkin says. Surprisingly, malls in Japan often lack basic consumer amenities such as public benches to rest on, drinking fountains and easily accessible restrooms. There are few trashcans, and the indoor trees that grace U.S. malls are largely absent.

Poor consumer appeal and resulting low operating income of most Japanese malls shows that the myth of the Japanese as masters of packing a lot into a small space doesn't apply to their shopping centers, says Sulkin. Japanese mall operators often lack the incentive and skills to maximize the use of space in suburban malls.

Pacifica looks to achieve superior economy of space with much lower personnel costs than its Japanese counterparts. In doing so it exposes yet another of Japan's business fables.

"It looks like the big Japanese developers keep costs down by outsourcing so many functions, but actually their total costs are much, much higher than they need to be," Sulkin said. "The main reason they outsource is that they lack knowledge of retail development, so they pay others a fee, which includes a profit margin, to do things they should do themselves. They tend to pick well-known companies as contractors because they seem to be a more safe choice, but the big-name contractors are often the most expensive and least innovative. And Japanese developers often outsource the wrong things. In particular, they frequently outsource a big chunk of tenant leasing and mall promotion, the very functions that make or break the profitability of a retail development. Pacifica does these things primarily in-house. Even if we wanted to outsource these functions, which we don't, nobody matches our expertise in these areas. We get better results and more control at much lower cost."

Vivit's aims are attracting a better mix of high-quality stores than a typical Japanese mall would, Sulkin says. "We are able to offer a lot to our store tenants. First of all is shopper traffic. Vivit is adjacent to a mall called Lalaport, which is twice the size of Vivit and attracted 25 million people last year. I use the word 'attracted' because it is run more like a theme park than a shopping center. People go there on average once a month or less and are not buying much while there. Both of Lalaport's two anchor stores have closed. What's left is literally hundreds of small stores each offering a very limited selection for daily needs."

Sulkin has recruited appealing tenants and convinced them to build large format stores by offering lower rents, lower fees, and better loading dock facilities than malls like Lalaport. "From my years selling goods to Japanese stores, I know their needs, how their cash flow works, what they can afford and what they can't," he said. "Despite a somewhat slow economy, we have been able to get popular stores to sign up." Sulkin is counting on Vivit's mix of retailers to drive actual sales, not just visits.

Much of the focus in Japanese retailing until now has targeted young women in urban centers. Sulkin sees huge opportunities in applying American expertise toward developing shopping centers in Japan that appeal to families and older people. In addition to the Vivit project, Pacifica's current agenda includes buying and revitalizing ailing malls to quickly achieve big turnarounds.

Vivit's neighbor Lalaport appears to have been based on the old Japanese model of "just build it and they will come." This may have worked for Kevin Costner and even for Japanese retail developers from the 1960s through the 1980s, when people had plenty of money, still lacked many basic household goods, and had few choices of where to buy them. But the previously passive Japanese middle class is now walking and talking with its wallet, seeking a shopping experience focused more on their comfort and needs. Shoppers want amenities most

Japanese malls lack; they want nice places to sit down, they want to enjoy good food and drink--in short, they seek a pleasant outing whether they buy goods or not. Malls slow to realize this are faring poorly.

Vivit will have an attractive atrium and offer a "daily errands zone" with a full service bank branch--rare in Japanese shopping centers--along with other conveniences. Shimamura, Japan's leading musical instrument retailer, will have a large store with practice rooms, which many amateur musicians rent because Japanese houses are too thin-walled and close together for people to practice without bothering their neighbors.

Tellingly, the bank that jumped first at the opportunity to put a branch in Vivit Square was Tokyo Star, one of the new breed of banks in Japan controlled by U.S. interests. Shinsei Bank, another such bank, took the lead in the overall financing of the Vivit project, being more flexible about applying an innovative form of real estate finance called a non- recourse loan, which is common in the United States but traditionally much less so in Japan for a newly developed property.

A non-recourse loan is a debt for which the borrower is not personally liable. In the case of a shopping center, it means the lender can't look beyond the property itself for recourse should the loan fail. That allows a developer to be more aggressive because its assets are protected from the risk of any single project failing. In the last few years Japanese banks have finally caught up with their overseas counterparts in terms of offering non-recourse loans on established properties, but are still unresponsive when asked to make such loans on new developments like Vivit. Unlike counterparts such as Shinsei and Tokyo Star, most Japanese banks lack the skill and confidence to evaluate the business prospects of a new project such as Vivit.

Foreign businesspeople often believe that even if they bring a superior business concept to Japan, the life of a new venture is doomed to slow death by excessive business regulations. Yet in retail development, Sulkin has found that this is another myth.

"Vivit is going from idea to opening in under three years; in the United States and Europe, new malls can take ten years and tens of millions of dollars invested just in the permitting process," he said. "Most of the laws governing retail development here in Japan are just guidelines. If we meet or exceed them, things move along briskly. We are consulting extensively with the authorities and neighbors and doing our best to meet their concerns, but we can't and don't do everything they ask."

Sulkin sees as indispensable his own role as the leader of the project's vision and goals. "If you want to get a good outcome, you can't plan by committee something as complex as Vivit, with all its different interested parties. Somebody has to champion the original vision, focus on profitability and at the same time balance the legitimate needs of shoppers, store tenants and neighbors." His ability to do this is one of Pacifica's advantages over its large competitors, he says. "The way large companies rotate staff, it's not clear they have people who know the business deeply enough to develop the judgment needed to play such a leadership role. Given how such companies diffuse responsibility away from a single point, I am not sure they would let one person play the role I do, even if they had someone who could."