

SHOPPING CENTER BUSINESS™

Distressed Retail Real Estate, Investment And Management

The investment sales market is being impacted by the availability of capital and the lack of distressed properties on the market. Meanwhile, managers are also stunned at the low number of properties that are being placed into receivership by lenders.

— Randall Shearin

Many people *Shopping Center Business* interviewed were quick to admit that the number of distressed properties hitting the market is less than they anticipated. That could be because a large number of distressed investment deals are being done through note sales and off-market transactions (see related article “Capital Availability In 2010” in this issue for more). What is certain, though, is that the investment market has been impacted by the availability of capital, and that has led to a distressed market for investment sales. As well, retailers have been impacted by poor consumer performance leading them to make decisions on closing stores. Management firms, meanwhile, are working on distressed properties, often through receivership.

INVESTMENT MARKET

Since the end of 2008, the retail transaction market has experienced a severe slowdown in volume. It is what Bernard Haddigan, senior vice president and managing director of Marcus & Millichap’s National Retail Group calls a state of “broad paralysis.” By that, he says, it is difficult for a buyer or a lender to assess risk in today’s market. Two exceptions to the paralysis are premium grocery-anchored centers and smaller, triple-net properties, says Haddigan. For many in the market, though, there is little upside to buying or selling a property because of its current value.

“Many of the deals we are pricing today are not worth the debt on the property,” says Haddigan. “If a property traded in 2005 through 2007, many are worth equal to or less than the debt. You have an owner who has no equity, and they have no motivation other than to remove a liability from their portfolio.”

That owes mainly to the low-cost financing of the mid-2000s that drove up property values. Those values have now plummeted. When you couple that with the equity that lenders are now requiring, it is impossible to refinance many deals, leading to a distressed asset.

“On a 2007 loan that was funded for \$10 million, you are only going to get [a loan for] 60 to 70 cents on the dollar for a healthy property,” says Haddigan. “If you’ve got vacancies and other issues, a lot of this stuff is not financeable.”

While many centers that were financed from 2004 to 2007 may find themselves in this boat, banks haven’t been aggressively foreclosing on properties with overdue loans.

“In general, the banks do not have the reserves to aggressively foreclose on properties,” says Haddigan. “Banks have to have reserves to cover their deposits.”

Nelson Wheeler, a principal with Newport Beach, California-based Strategic Retail Advisors, a member of X-Team International, says distressed properties are slow to make it to the traditional investment sales market.

“There is a lot of conversation about the

distressed market,” he says. “Unfortunately, there isn’t as much activity as we would like to see right now.”

Instead, distressed sellers, who often wish to remain off the market so they don’t draw attention to themselves, are often selling assets off market through private parties, or they are working with their lenders to sell their loans to another party as part of a workout strategy. But some banks won’t be able to hold all the real estate they have on their books.

“It doesn’t seem like the FDIC is forcing banks to resolve issues [with distressed properties],” says Haddigan. “With CMBS, it is everywhere. Healthy properties are being foreclosed on because of issues with the loan.”

“There are big players going after pools of distressed assets,” says Wheeler. “There are a lot of community banks that can hardly stomach any non-performing assets. Those are the ones who are being quicker to react.”

Also complicating matters is that the pricing of distressed assets heat up when they hit the market. There have been so many venture funds formed to acquire distressed properties that they often show enough interest that a bidding war can erupt on a distressed asset.

“Some people think that assets may not fall in price as they should because of the supply of capital that is lining up to acquire distressed properties,” says Wheeler. “Capital can’t find a rate at a decent rate of return so it is going into riskier

OPTIMIZING A PORTFOLIO

For many retailers, the challenge in this economy has been to pare down and right-size the number of stores they are operating. With the remaining locations, they have to make sure that every store is operating profitably at a rent that sales can support.

“Today, long term operators know that rents need to correlate to store sales,” says Bernard Haddigan, senior vice president and managing director of Marcus & Millichap’s National Retail Group. “With the development run-up between 2002 and 2007, rents really correlated to construction costs and the capitalized yield that developers were looking for. The rent burden typically had nothing to do with store sales. We’re going through a correction right now.”

According to Ivan Friedman, president and CEO of RCS Real Estate Advisors, retailers only close doors when the operation of the store becomes unbearable. That generally happens, he says, when the cost of operations outweighs what the retailer is paying in rent.

“In most strip centers, the tenant has the right to go dark, meaning the retailer can close and stop operating,” says Friedman. “Sometimes that makes more sense—if they can’t buyout the lease—to close up and leave the store dark. It costs them less. They will actually save money by doing that and paying the rent.”

Friedman sees the trend of retailers asking for rent relief continuing in 2010. RCS Real Estate Advisors, who has a specialized practice for restructuring and portfolio optimization, helps retailers cut their occupancy costs through lease terminations and renegotiations with landlords. The area is RCS’s largest practice.

“If a retailer’s sales are down in a specific location, they do go to the landlord, who will ask for financials on a specific store, not only from the sales perspective, but a profitability perspective. The retailers have been pretty forthcoming with the financial data,” says Friedman.

The feedback RCS is hearing from retailers generally revolves around the fact that occupancy costs are too high for the lower volumes of sales that the store is doing. The retailer, says Friedman, can usually make the store profitable if the rent is lowered to a level that enables that.

The loss of rental revenue, while a concern for shopping center owners, is only part of the worry.

“The strip center landlords are under a lot of pressure under co-tenancy clauses,” says Friedman. “If a certain amount of the shopping center is empty, the other retailers can reduce their rents to a very low number. It is very stressful for the landlord.”

Landlords are not just letting retailers walk away with reductions in rent, says Jeff Green, president of Jeff Green Partners, a retail project consulting firm based in Mill Valley, California.

“The larger retailers have more leverage in lease renegotiations than smaller retailers,” says Green. “There are many retailers who are going through their entire portfolio to renegotiate. The pushback from landlords has been surprisingly strong.”

Retailers are also auditing leases closely to make sure the landlord is adhering to every clause, says Green. He reports many large retailers are hiring firms to go through every lease and look closely at every center to make sure all covenants are being followed by the landlord. Any oversight could be an open door for negotiation on the existing lease, says Friedman.

“Landlords have their threshold of pain,” says Friedman. “In a strip center of 100,000 or 300,000 square feet, if they have two empty big boxes, the landlord has a problem. The retailer also has a problem in that they may have a claim on its co-tenancy cause.”

While consumers have cut back on spending in recent years, much of their woes are burdened on overexpansion at a time when rents were based on new construction costs.

“Retailers in general have found that their stores that opened in 2008 and 2009 didn’t open to their expectations and cannibalized their existing stores more than expected,” says Green.

To fix that situation, many retailers are closing locations or finding better locations in a time when rents have fallen drastically. In some cases they are opening new locations and closing surrounding older stores.

“Retailers need to figure out what the right size is for their chain,” says Green. “I don’t think a lot of them know. If they are going to look at store closings, they may just look at the financials instead of trying to understand the performance and the potential for the location. There could be issues with operations, merchandising, pricing or promotion for that store.”

Friedman, who sits on the retailer’s side of the table, says he sees a lot of cooperation going on in the industry right now between landlords, who want to avoid a dark center, and tenants, who need help to survive.

“I think everybody is trying to help each other, but everyone has their financial limitations,” he says.

— Randall Shearin

ventures. Those risky ventures become the itchy fingers for those funds to pull the trigger.”

Marcus & Millichap took a number of retail listings to market on behalf of Capmark that were in special servicing for the FDIC. The properties generated hundreds of offers, says Haddigan, because people heard the word “foreclosure.”

THE NEXT STEP—RECEIVERSHIP

When a distressed asset sits in the middle of the relationship between borrower and lender, things can get tough quickly. When a borrower stops paying on a loan, at some point in time, the workout process will begin. That’s either a renegotiation of the terms of the loan, an equity payout by the borrower, a sale of the loan to a third party, foreclosure or any number of other

creative options. Usually, when a borrower falls behind, the lender will ask a broker for what’s known in the industry as a “broker’s opinion of value”—a fair market value of what the center is worth today.

“Once a broker gives its opinion of value, that’s when everything starts in the lender or servicer’s mind,” says Greg Maloney, president of Jones Lang LaSalle’s retail division. “They look at the loan amount and compare that to the value. That’s when the decision is made to work something out with the borrower, place it in receivership or foreclose. That’s where they earn their money. They have to gamble in receivership by putting money into the property and hope that they get the value back.”

If lender and borrower do not agree on how

the property should be handled, the lender will generally file a motion to place the property in receivership.

“Under receivership, your basic duties are to get control of the asset, including taking control of it physically and financially,” says Maloney. “The receiver appoints a manager and leasing agent to fulfill those duties.”

The receiver then determines the next steps for the center with the lender. The next steps can include foreclosing on the asset or selling the center while its in receivership. Dealing with centers can mean that the receiver has to deal with multiple parties. One mall Jones Lang LaSalle is managing under receivership has a separate landowner, who is not in trouble, to whom it must relay every decision regarding the center.

RECEIVERSHIP PRIMER

A receiver is appointed when there are concerns brought to a court of law, generally by the lender or special servicer. These parties may realize that the owner is not properly maintaining the property or maintaining funds that the asset may be generating. A receiver is appointed when it becomes apparent to the court that the owner should not be in control of the property. The receiver has a fiduciary responsibility for the property. The receiver selects a management and leasing company for the property and ensures the asset is maintained while the foreclosure case wades its way through the court. Technically, receivers represent the court, not the lender or borrower.

“Every property has its own unique set of circumstances,” says Maloney.

Lenders choose more and more to keep properties operating in receivership rather than sell them, mainly because of today’s lower property values.

“The borrower remains liable for the asset under receivership,” says Maloney. “The loan amount also stays where it is, whereas if you sell, you are going to take the write-down.”

Most properties, Maloney says, enter receivership as a mutual decision of the borrower and the lender. There are exceptions to this, of course, when the lender places the property in receivership against the borrower’s wishes. The most public case of this in the last year was Chicago’s Block 37, which was placed in receivership by Bank of America in November 2009 after the developer defaulted on a \$128.5 million debt from its construction loan.

Receivership isn’t just a business being entered by large players like Jones Lang LaSalle. A number of healthy real estate companies who can afford to post the bonding needed and have the staffing necessary to handle receivership duties are getting into the act. In some states, an individual can act as receiver, while in others, a

company can be named. John McKay, a Florida developer who has been through several real estate recessions, is making the most of the economy. McKay has founded Riverside Real Estate, a company that is making workouts and turn-arounds its business. McKay, who is a receiver, is working on several projects where the bank has taken back a property. When you takeover properties as receiver, says McKay, you find all sorts of issues. At one property, a condominium tower, the developer had never created any documents for the condominiums. The same project had physical problems with the building that had to be addressed.

Like Maloney, McKay says the key to being successful in the receivership market is to have a lot of capabilities under one roof.

“There are a lot of very qualified people out there who want to do the leasing, marketing and sales of a distressed property, but there aren’t many who have the capability of also being the receiver,” says McKay. “You need the ability to preserve and retain entitlements on projects where the developers did not finish acquiring those, you need full accounting capabilities, construction abilities, as well as leasing and marketing skills.”

McKay believes distressed properties are

beginning to trickle in from the commercial banks and that the stream will continue to build. He sees the CMBS wave hitting second. Third, he sees some distressed assets coming from insurance companies, who were more conservative with their underwriting.

“Life companies were aggressive in their pricing,” says McKay. “They were not as aggressive as the conduits. As a property owner, we liked the life companies’ structure because it gave us more flexibility with our cashflow than the conduits.”

Jones Lang LaSalle is also surprised at the relatively low number of properties placed in receivership. With 63 centers currently being managed by JLL in receivership, the company says it had expected several hundred by this point in time.

“On 90 percent of [distressed] properties, there are workouts going on,” says Maloney. “The lender wants the borrower to honor their contract. If the loan covenants have been breached and there is additional equity that’s needed, they want the borrower to step forward. However, if they can’t, I think you will see more action in 2010 to get the property away from the borrower if they are not going to cooperate with the lender. The lender doesn’t want the property, but if the borrower is not willing to step up and accept some responsibility, I think you will see foreclosures happen.”

In 2010, Maloney sees two directions that lenders could take distressed properties.

“Workouts are happening at this point,” says Maloney. “By mid-year, lenders will have determinations on what they are going to do. Either we are going to see a lot of extensions in the second half of the year or we are going to see a lot of foreclosures.” **SCB**
