

# Spending ebb puts store space at risk

## *Casts a pall on resale values for this year and next*

By Frank Byrt

**W**ith prospects of a sharp decline in consumer spending after a disappointing holiday sales season, retailers are announcing store closings at an alarming rate, casting a pall over the resale value of retail commercial real estate for this year and beyond.

The National Retail Federation has predicted that retail sales in 2008 will grow at the weakest pace in six years, and retailers are already responding by closing underperforming stores.

For example, Pacific Sunwear of California, a retailer of apparel and footwear, said it is disposing of 173 primarily non-core-brand stores; Zale's, the biggest U.S. jewelry chain, with 2,200 stores, said it will close 60 stores in the next 90 days; Talbot's, a women's clothing retailer, said it is closing 78 stores; and Sprint Nextel is closing 125.

Ivan Friedman, a retail industry veteran and CEO of RCS Real Estate Advisors in New York, said the cyclical retail industry faces recession-level business prospects for at least six to nine months.

"I see certain pockets within retail being very weak, with a lot of failures and a lot of store closures," Mr. Friedman said. He was referring in particular to second-tier retailers that face "category killers" such as Best Buy, Wal-Mart and Target.

Indicative of that, Mr. Friedman said his firm recently agreed to do dispositions for a major retailer that wants to liquidate rather than file for Chapter 11 bankruptcy.

Even traditional mall anchor-store tenants are consolidating. In December, Macy's announced that it plans to close nine underperforming stores this year.

Two weeks ago, Sears Holdings, parent of the Sears and Kmart chains, owner of 766 stores and lessor of 2,032 more, announced

a reorganization of its management structure, including the creation of a separate real estate holding unit. That move has experts speculating that its purpose is to sell some store sites as it downsizes.

Any large-scale shuttering by a national anchor sends tremors through the industry because it makes it tough for mall owners to find a new tenant of equal size, while a big empty space makes it harder to recruit new tenants or raise rates for existing ones, which typically count on luring in customers drawn to the anchor.

In the fourth quarter of 2007, the vacancy rate at regional malls, which have traditionally been retail real estate's most stable performers, since they attract the national chains and lock them in with seven- to 10-year leases, rose to 5.8%, the highest level since 2004, according to the real estate research firm Reis. The vacancy rate at neighborhood and community shopping centers rose to 7.5%, the highest level since 1996.

As a result, rents are softening. Lease rates were virtually flat compared with those of the third quarter and are expected to rise by about 2% for 2008, Reis said.

Commercial property values are typically based on capitalization rates—projected cash flow from leases as a percentage of the cost of the property. Since many malls have leases that include a base rate plus a percentage of sales, lower sales translate into lower mall-owner income—and, subsequently, lower resale values.

In addition to worrying about falling rents and rising vacancies, prospective retail property investors face much higher financing costs and tougher underwriting standards thanks to the credit crunch.

If all that's not enough, there is a glut of new space coming to market. About 145 million square feet of retail space was built in the largest 54 markets in 2007, with another 123

million square feet on the drawing boards, according to Property & Portfolio Research, a Boston-based firm. Consumer spending will be able to support only 43% of that space over the next two years, the firm estimates.

A wild card in the game is what will happen to Melbourne, Australia-based Centro Properties, the fifth-largest shopping mall owner in the U.S., with about 700 properties. It is struggling to refinance a \$3.9 billion short-term debt payment due Feb. 15. Its new CEO has said he's not considering a piecemeal fire sale of its malls, failing an infusion of cash from new investors, but even a quick sale of its portfolio en masse to, say, a private equity firm, is likely to depress mall resale values for some time to come as that new owner could be expected to sell individual malls to raise cash.

In Chicago, executives of shopping mall developer and owner General Growth Properties have rushed to the defense of their company—the largest U.S.-based publicly traded real estate investment trust—after news reports surfaced that it could face a refinancing shortfall involving up to \$6 billion in debt that comes due over the next two years.

GGP's chief financial officer, Bernie Freibaum, told Financial Week that it's wrong to compare his company's situation to that of Centro. "We don't have any bridge loans," Mr. Freibaum said. "We have used mortgage loans as our principal source of capital as long as we've been in the business, 15 years," he said, adding that that is "a very conservative form of financing" for the industry.

"We have over 200 properties, and we probably have 150 mortgages, and a total of \$26 billion of debt, and every year we have \$2 or \$3 billion coming due," Mr. Freibaum said. "So if we needed liquidity, we could do a joint venture, get additional mortgages or [make property] sales to get additional financing." **FW**