

# NATIONAL REAL ESTATE Investor®

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## SPECIAL RETAIL REPORT

# Survival of the Fittest

Amid thousands of store closures, shopping center owners take bold steps to retain tenants. **By Joe Gose**

For years, economists warned that the annual rise in consumer spending wasn't a permanent condition, but those concerns largely fell on deaf ears. Retailers continued to ring up sales at a healthy clip. In fact, in 2005 and 2006, total retail sales grew 6.6% and 6.2%, respectively, according to the International Council of Shopping Centers (ICSC).

But a series of economic setbacks has put a damper on the retail party. A spike

in home foreclosures tied to the subprime mortgage meltdown in 2007 has led to a crisis of confidence in the bond markets and slowed lending activity. Foreclosure filings on nearly 234,700 properties in March showed a 57% increase over the prior year. Meanwhile, the combination of rising gas and food prices and lost jobs has taken its toll on the American consumer's psyche and wallet. The average price of gasoline nationwide rose nearly 20 cents over two weeks in April to \$3.50

a gallon. The cost of food was expected to rise up to 4.5% this year after increasing 4% in 2007, while workers' wages generally aren't keeping pace.

Battle-fatigued consumers are being forced to curtail their spending. Retailers have responded by closing stores, reversing ambitious expansion plans and, in some cases, filing for bankruptcy. That in turn puts stress on retail real estate landlords. While owners of best-in-class properties have seen an opportunity to replace weak stores with stronger tenants at higher rents, virtually all landlords are worried about rising vacancies and falling income.

Retail sales growth slipped to 4% in 2007 after two relatively robust years. And sales are expected to grow only 3.6% in 2008. Meanwhile, major retailers announced closures of more than 2,100 stores in the first quarter, on top of 4,603 closings in all of 2007. Several retailers have declared bankruptcy in the last seven months, including Sharper Image, Wickes Furniture and Children's Place.

"The climate has really shifted since last November, which is when retailers saw their world start to collapse," says Ivan Friedman, president and CEO of New York-based RCS Real Estate Advisors, a retail consultant that buys leasehold interests from bankrupt retailers. "You're talking about hundreds and hundreds of stores going back to landlords."

### APPAREL RETAILERS GET SOCKED

The apparel segment accounted for nearly 38% of all store-closing announcements in the first quarter of 2008. Women's ready-to-wear retailers were particularly hard hit.



Source: International Council of Shopping Centers

## Hands-on strategy

Some shopping center owners are taking aggressive steps to limit their exposure to vacant space. Stephen Ifshin, chairman of DLC Management Corp., is attacking potential tenant problems in an effort to keep rent delinquencies at about 1.5% of his rent roll. The Tarrytown, N.Y.-based developer and acquirer of neighborhood and community shopping centers owns and manages some 16.5 million sq. ft., mainly in the eastern half of the U.S.

In some cases, the job requires investigating the credit of struggling mom-and-pop stores to determine if a temporary rent cut would help them stay in business or simply delay inevitable failure. In other cases, it means finding replacements for national women's apparel tenants that are closing non-productive stores.

The tasks are doubly demanding given the fact that some of DLC Management's properties are located within difficult trade areas. "I'm a player who looks to do deals in places that other large developers may not—in fringe locations and ethnic urban areas," he says. "But we have a track record of making those work. Now whether in this economy I can make them work is still to be determined."

So far Ifshin is optimistic about weathering the storm. On balance, DLC Management's aggressive leasing agents have helped keep leasing velocity ahead of closures. That has kept the company's overall occupancy consistent at about 93.5% over the past few years, he says.

Plus, he adds, as the credit crunch and soft economy douse new development in coming months, successful retailers that typically open stores in new projects need to keep expanding to increase sales. "They'll have to look to existing centers, so it could be a help to us," says Ifshin, who identifies Bed Bath & Beyond and Michael's as prime examples.

## Vital signs sour

The floundering economy has heightened uncertainty within the shopping center investment and development community. The national vacancy rate for community and neighborhood centers ticked up 20 basis points in the first quarter to 7.7%, while asking rents grew 0.4%, reports commercial real estate

research firm Reis Inc. The researcher projects vacancies to rise to 8% by the end of 2008.

Meanwhile regional mall vacancies rose by 10 basis points over the prior quarter to reach 5.9%, and asking rents increased 0.4%. One major sign of trouble: absorption of retail space plunged from 8.5 million sq. ft. in the fourth quarter of 2007 to negative 1.2 million sq. ft. in the first quarter. That marks the first time retail developers have experienced negative absorption since Reis started tracking the sector in 1980.

"Retailers are definitely more focused on cutting the fat as opposed to the growth that went on pretty much unabated for the past few years," says David Solomon, president and CEO of NAI ReStore in Princeton, N.J. The division of brokerage NAI Global focuses on retail leasing, sales and acquisitions. The ICSC anticipates 5,770 chain store closings this year, a 25% increase over last year. Plus, analysts anticipate more Chapter 11 filings by retailers hit hard by the housing slump.

In mid-April, for example, home-goods retailer Linens 'n' Things announced that it would miss a \$1.6 million interest payment and that it was discussing a possible capital restructuring with debt holders. The company, which was acquired by

Apollo Management in 2006 for \$1.3 billion, reported a \$62 million loss in the fourth quarter last year.

Such an environment is forcing landlords to become more flexible, says Friedman of retail consultant RCS Real Estate, which represents tenants in lease negotiations. Over the last few months, shopping center owners have started to chip in more tenant-improvement money than in the past, for example, and have less of a take-it-or-leave-it attitude when pricing lease renewals.

"Landlords have been expecting [bankruptcies and closings]," Friedman adds. "For three years they've not seen bankruptcies, and they've been getting good rents and good increases."

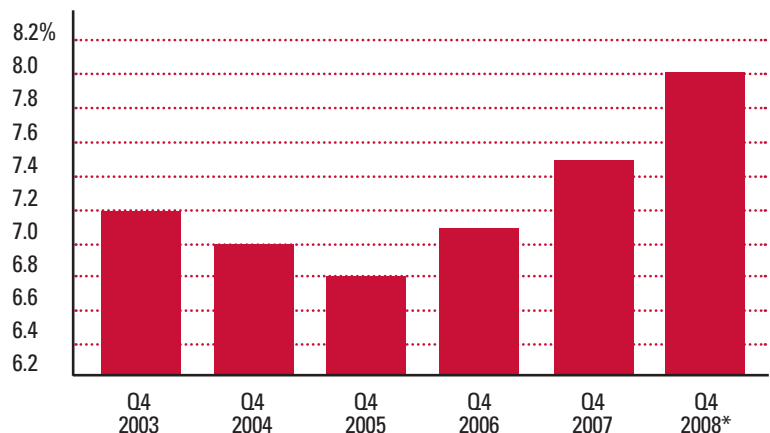
## Choosier tenants

Some experts say that the concerns over store closures are overblown, pointing out that shopping center landlords routinely face a rash of closings and bankruptcy announcements after the Christmas shopping season. Many think the lion's share of retailer Chapter 11 filings in 2008 have already occurred.

Executives at General Growth Properties, the Chicago-based REIT that manages or has an ownership interest in some 200 regional shopping malls totaling 180 million sq. ft. in 45 states, main-

### RISING RETAIL VACANCIES, GROWING CONCERNS

Due to a slowing economy, by the end of this year the retail vacancy rate at community and neighborhood shopping centers is projected to reach 8%, up from 6.8% in 2005.



\* preliminary projection

Source: Reis

tain that successful retailers continue to open new stores and introduce new concepts: Abercrombie & Fitch is rolling out Gilly Hicks, for example, while Neiman Marcus is launching Crewcuts.

REIT executives concede that they're operating in a much more uncertain economy than even just a year ago. Merchants that continue to expand are much more finicky about location and landlords than in the recent past, and some retailers want to push back openings from 2008 to 2009, they say.

"So much of what's going on is the result of overexpansion by many retailers and the resulting cannibalization," says Jeff Green, principal of Jeff Green Partners, a San Francisco-based retail real estate consultant. "They didn't have a good handle on the net new sales that any given new store would give them."

Retail experts suggest that landlords may have to be even more accommodating and offer free rent or other incentives to lure tenants. Most landlords, however, say they're far from offering concessions. DLC Management's Ifshin, for example, says he's fighting requests for five-year leases from new tenants as opposed to his standard 10-year deals. "For the moment we seem to be getting the rents we're asking for," he says. "But you'd have to be a nut job to build in any rent growth."

### Seizing the advantage

Many shopping center owners, particularly REITs, are executing a two-pronged strategy to become lean and mean. On the operations side, they're cutting costs, aggressively re-signing tenants well before leases end, selling assets, and shoring up balance sheets (see sidebar, p. 35), among other measures.

General Growth executives, for example, mapped out a series of measures for REIT analysts during its 2007 earnings call earlier this year. The company has reduced energy demand, for example, and is evaluating all internal departments to wring out efficiency. The REIT is also exploring the possibility of utilizing excess department store space for either residential or hotel uses.

But landlords are prospecting for opportunities to boost earnings, too, from re-tenanting vacated spaces for

higher rents to swooping in on distressed private developers. In the latter case, the REITs would generally partner with the distressed developers, buy their debt or acquire their projects. In fact, Cleveland-based Developers Diversified Realty, a REIT that owns and manages some 163 million sq. ft. of retail space in the U.S., South America, Russia, Puerto Rico and Canada, has created a department to specifically hunt for troubled developers.

Developers Diversified executives characterize potential candidates as developers who typically received 85% to 100% in debt to fund a \$50 million to \$100 million lifestyle center during the capital market's heyday. But now that same developer must pony up 30% in equity to build the same project and will need additional capital partners.

Daniel Hurwitz, president and COO of the REIT, told analysts during a recent fourth-quarter earnings call that the company would likely fund distressed opportunities using proceeds from asset sales. "We believe the greatest risk-adjusted returns are available in development as we capitalize on the distress that many private developers are experiencing in funding and leasing projects," Hurwitz said during the call.

### Mounting misery

Executives with Simon Property Group in Indianapolis, the nation's largest owner of shopping malls, have made similar statements concerning the pursuit of distressed assets. While REIT officials have yet to identify specific opportunities, one of the first big collapses has already played out in the Midwest at Premier Properties USA, an Indianapolis developer of roughly 2 million sq. ft. in Indiana, Ohio and Pennsylvania.

Premier tapped into plentiful debt and used little if any equity to fund its projects over the past couple of years—so-called "power villages" with retailers such as Target and J.C. Penney anchoring a variety of users. Premier's principals, which established separate limited liability companies (LLCs) to own the properties, wagered that rising rents and property appreciation would cover the mortgage and future refinancing.

But the LLCs defaulted on loans amid

the credit crunch. In mid-April, mezzanine debt provider Dominion Capital in Atlanta assumed majority interests in LLCs that owned 10 properties, including the 650,000 sq. ft. Plainfield Commons near Indianapolis and the 635,000 sq. ft. Bridgewater Falls near Cincinnati. Dominion provided some \$28 million in mezz debt to fund those projects and \$55 million to finance five others.

Retail real estate experts predict that similar opportunities will emerge so long as the credit crisis makes it next to impossible for highly-leveraged developers to permanently finance newly built projects or refinance existing centers.

### A silver lining for Simon?

Opportunities to re-lease space struggling retailers have vacated is a growth business. Not only do landlords typically receive termination fees when a store leaves before its lease ends, but the rents they can charge new tenants are often higher than what the old tenant paid.

Simon Property's regional malls, for example, have 27 million sq. ft. of leases that expire over the next five years at an average base rent of about \$36 a sq. ft., according to Simon CFO Stephen Sterrett, who spoke at Credit Suisse Group's Real Estate Conference in early April. New leases are \$45 a sq. ft.

The question becomes whether enough expansion-minded merchants exist to fill those vacancies. The answer's a "yes" for top-tier centers in Class-A locations, says Friedman. Landlords of lesser properties should be sweating.

"In many cases landlords of the best malls in the best locations are very happy to get space back," Friedman says. "They'll be the quickest to rent the space, and as you go down to Class B, C and D malls, they're not going to rent the spaces out. It's just like life—the rich get richer and the poor get poorer." ■