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Why Lenders Must Account For Mall Trends

The rise of smartphones and online retailers such as Amazon and Ebay has obvious implications for retailers because technology has changed the way people shop. However, changing trends in shopping also have significant implications for the institutions that finance retail properties.

As consumers increasingly shop online, malls and retail outlets have taken a major hit in revenue and traffic. That has not only led to the bankruptcy of retailers such as Sports Authority, RadioShack, and Aeropostale, it has reduced the impact of anchor stores such as Macy's and Sears on regional malls. The result, according to a study released last week by Moody's Investors Service, is that performance of malls that serve as collateral in CMBS pools is growing much more bifurcated. Malls have a tendency for steeper losses in the event of failure or default, therefore staying relevant and profitable is even more important than other real estate sectors.

In order to keep malls afloat, owners have to adapt to new demands of the consumer. Rather than going to a mall primarily to shop, consumers today seek experience based shopping. Fast casual and upscale restaurants have replaced chain style food courts as the main dining options at many malls. Movie theatres are becoming part of the mall landscape as landlords look to fill vacant space with entertainment and socialization as a way to attract visitors.

The Moody's study—"Separating Winners From Losers in the Emerging Mall Landscape"—found that the loss severity on malls within CMBS portfolios is often much higher than other

types of loan liquidations. The average loss severity on CMBS held malls that have been liquidated in the past eight years has exceeded 75%, while the loss severity for all CMBS loan liquidations averaged 45%, according to Moody's.

In other words, when malls fail and are forced into liquidation, the value of the property is significantly less relative to the outstanding loan, compared to other types of real estate. That is because retail, unlike other real estate sectors, is highly dependent on key tenants. Occupancy and revenue in an office building generally does not depend on one or two tenants, and neighbors moving in or out of an apartment typically doesn't result in the entire tenancy turning over. However, occupancy in malls is tied to the presence and performance of an anchor retailer, historically large department stores such as Macy's, Nordstrom, JCPenney and Sears. Shoppers were drawn to the mall for the convenience of the department store, then stayed and shopped at in-line retailers occupying smaller storefronts.

So how can a mall remain solvent and profitable through the ever-changing retail environment? When assessing the potential for long term solvency for retail locations, the Moody's study noted that a few factors generally predict success:

Given the uncertainty of occupancy and revenue, it is becoming harder for individual mall owners to secure the financing needed to keep their property in operation. For the smaller players in the retail real estate industry, the risk of losing anchor tenants becomes even greater. Not only do landlords lose revenue when anchor locations leave, but many in-line retailers have leases tied to anchor stores. Co-tenancy clauses are common and allow smaller tenants to reduce their rent or terminate their lease in the event of a key tenant vacating the property.


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Demographic make-up of the mall's location. Unlike other forms of real estate, malls carry additional risk because they cannot be easily repurposed like offices and apartments. As a result, location becomes an important factor that will help determine its profitability and solvency. Similar to other forms of real estate, malls are experiencing demographic changes as shoppers are interested in urban and public transit accessible retail locations. There is a shift away from suburban areas with sprawling parking lots, and shopping centers are popping up in densely populated neighborhoods with high discretionary income residents. Multi-use areas that provide patrons access to shopping, dining and entertainment, gain a competitive edge over malls with one specific focus, located far from urban cores.

Sales per square foot of in-line retailers. The strength of in-line tenants however is also a key influence on a mall's overall performance. If in-line tenants can routinely produce sales of $300-400/sf, then the mall will have a better chance of keeping its doors open. As sales dip below $275 per square foot for in-line retailers however, the mall will likely struggle to stay profitable. As anchor tenants leave and revenues at in-line retailers decline, a cascading effect can occur in a very short time period, leaving a mall with high vacancy, reduced profitability, and the inability to service its debt.

Prevalence of national sponsors rather than local owners. Size and financial strength of ownership and tenants also play a significant role in a mall's overall ability to

remain profitable. National sponsors have sufficient capital to continuously repurpose their properties to meet shopper demands, while local owners may not be able to turn over their storefronts fast enough to compete. Large REITs and national mall owners also have more flexibility to obtain financing and maintain an operating budget as a struggling mall with weak revenues can be offset by a stronger mall in the sponsor's portfolio.

National, as opposed to local tenants. Similar to national sponsors, large national brands improve the sustainability of malls. Brands like Dick's Sporting Goods, REI, and Bass Pro Shops offer experiential shopping in the form of indoor driving ranges, rock climbing walls and fishing ponds. Not only can shoppers try out merchandise in authentic settings, but the amenities provide an exciting reason for consumers to come to the store. In addition to the higher foot traffic, national brands can increase a mall's strength and viability because of the deep resources and balance sheets of their parent companies. If a national brand is seeing weak performance from one location, the parent may choose to invest capital in the store, in hopes of boosting sales. A local brand may be forced to close because it does not have the funds to improve a given location.

Beneficial lease structure. Finally, the leasing structure of a mall can be a good indicator of the mall's future profitability prospects. Malls with the best chances for long term operations will maintain a strong majority of their leases as triple net leases, under which the tenants are responsible for taxes, insurance and maintenance of their stores. Triple net leases shift the variable costs of the property to the tenant and allows the mall owner to better understand and forecast its cash flows. On the contrary, a mall with many gross leases may indicate a weaker tenant pool that does not have the financial ability to fulfill the terms of the lease. Without having to pay insurance, taxes and maintenance it is easier for a tenant to close its doors and fall delinquent on its lease obligations.

There is likely no turning back from the online oriented trajectory of retail, however malls and their owners can stay competitive by adapting and embracing the change. Attracting national brand tenants and a strong diverse group of in-line tenants will boost revenue. Negotiating lease agreements that work in the mall owner's favor will increase the likelihood of steady and high occupancy. Adding experienced based tenants rather than only catering to consumption based tenants will attract higher foot traffic, and positioning malls in key demographic areas will transform them from the big box shopping centers of the past into a new in-demand social setting of the future.

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