
Payden & Rygel

POINT *of* VIEW

FALL 2017

Our Perspective on Issues Affecting Global Financial Markets

MALLRATS: THE PAST, PRESENT, AND FUTURE OF THE SHOPPING MALL

In the mid-1990s, a distinct species infested the suburban world: the mallrat. Fast becoming extinct, these once-great bipeds wasted hours of their lives looking for love, piercing ears, and scooping up compact discs in the great halls of commerce known as malls. Today's world of online shopping appears to spell the end for mallrats. However, lost in the foreboding headlines are pockets of opportunity.

Mallrats: The Past, Present, and Future of the Shopping Mall



We limit our comments along two axes. First, the discussion below relates to shopping centers (including both malls and lifestyle centers), not strip centers or other kinds of collected retail. Second, we base our arguments and analysis largely on the shopping center properties

Mallrats were everywhere. These strange creatures, found in suburban shopping malls, would creep from Hot Topic to Sam Goody in search of trendy shirts or hit CDs, or even pranks to pull. The bane of serious shoppers' existence through most of the 1990s and early 2000s, mallrats are now on the brink of extinction.

From the first shopping centers built after World War II until their heyday in the 1990s, malls and their memories are known to Americans across generations. The latest news on enclosed shopping malls, and the mallrats which call them home, is bad news. Not a day goes by without breathless journalists heralding (altogether too gleefully, we think) the death of the shopping mall.

In what follows we sketch the problems and opportunities with which shopping malls and their owners must contend. We start with a brief history of the shopping center craze in the U.S. With the background established, we analyze the two main problems facing shopping centers today: an oversupply of mall space and changing consumer preferences. Hope, not hate, takes us to the finish line as we meditate on the aspects of shopping centers—operational flexibility and valuable land—which we believe ensure their place in the future of American retail.

owned by publicly-traded real estate investment trusts (REIT). In general, these REITs own stronger shopping centers and so do not represent the full spectrum of mall shopping in the United States.

«WE ANALYZE THE TWO MAIN PROBLEMS FACING SHOPPING CENTERS TODAY: AN OVERSUPPLY OF MALL SPACE AND CHANGING CONSUMER PREFERENCES.»

MALLS, ARE A HISTORY

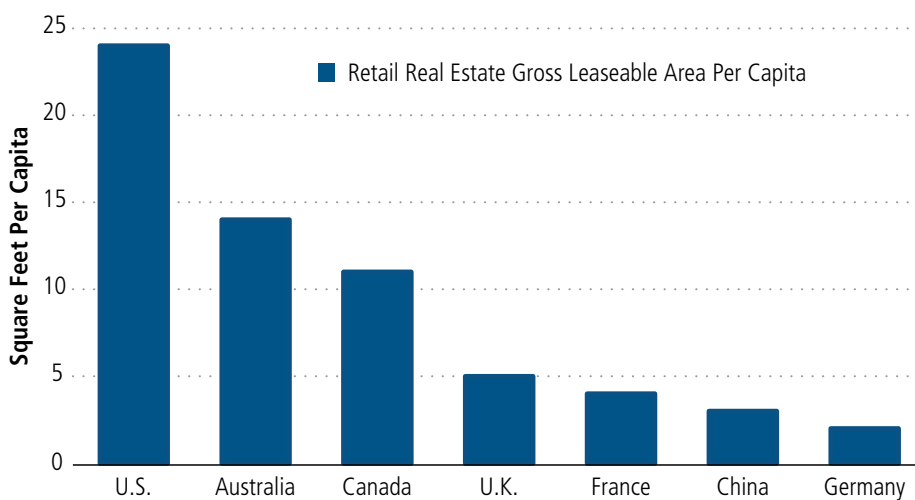
Since the first shopping mall, Southdale Center, opened in Edina, Minnesota, in 1956, the appeal of bundling retailers together in a climate controlled environment accessible only by automobile has maintained a special place in the American imagination.

The popularity of the shopping mall retail format traced the trajectory of America's mid-20th-century development more broadly. Pre-World War I shopping in the United States revolved around a centrally located "Main Street," which housed hardware stores, produce markets and even an occasional department store.

Demographic shifts, wrought in part by World War II, altered American retailing. The explosion of family life and the ensuing exodus to suburbia meant that the prime consumer unit, the family, was no longer near a traditional "Main Street." Sarah Shindler, a land use legal scholar, notes, "Although stores initially remained in city centers, their proprietors eventually realized that they needed to follow their customer base, and thus many moved their shops out of traditional downtowns and to the suburbs."¹

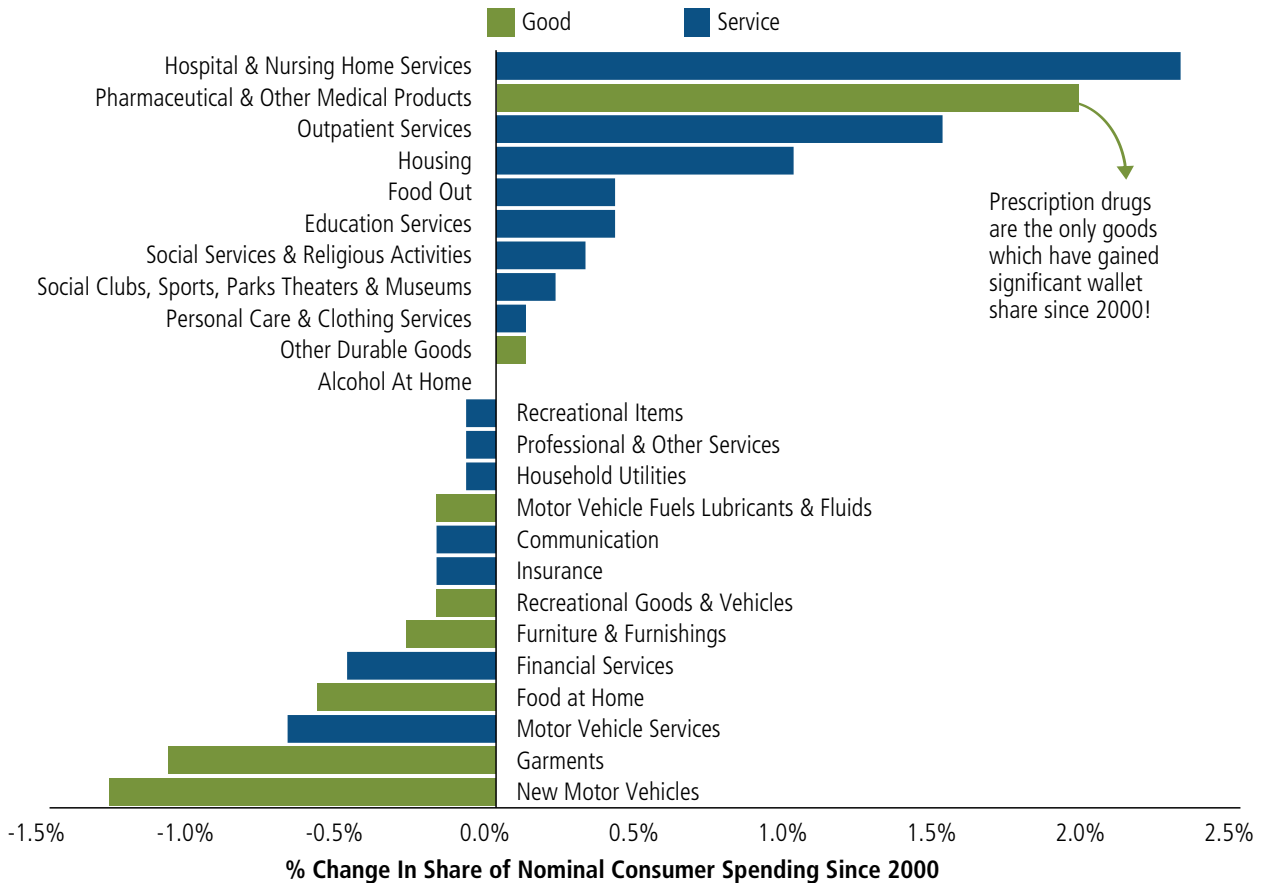
Federal tax legislation in 1954 was the match that lit the demographic gasoline for mall construction. Congress wrote changes into

fig. 1 SHOP 'TIL YOU DROP, AT LEAST IN THE U.S., WHERE THERE IS 12X MORE RETAIL REAL ESTATE PER CAPITA THAN IN GERMANY



Source: Wells Fargo Research, ICSC

fig. 2 UP TO NO GOOD: THE CHANGE IN CONSUMER SPENDING SHARE SINCE 2000 FAVORS SERVICES



Source: U.S. Census Bureau

the tax code that provided the owners of income-producing real estate the opportunity to take accelerated depreciation.

In many instances, operating expenses and the large depreciation charges more than covered gross income from the property and so allowed owners to shelter nearly all their income (from their real estate ventures and elsewhere!): “accelerated depreciation...suddenly transformed real-estate development into a lucrative tax-shelter.”²

Tax and demographic changes allowed the U.S. suburban mall to catch fire. Only two years after the tax code change, “developers completed twenty-five regional plazas...more than doubling the total previously in existence.”³

UN-SUITED SUPPLY: TOO MANY FOR TOO LONG

Even after the initial tax boom, shopping center growth continued unabated. According to data from the International Council of Shopping Centers (ICSC), from 1970 to 2016, shopping center gross leasable area grew at a compound annual growth rate of 3.2%. The overall retail sector saw gross leasable space ratchet up at an average annual rate of just 1.9% over the same time.

The shopping center boom scars the United States to this day. In 1970 there were 8.7 square feet of leasable mall space per U.S.

citizen. By 2016, the ratio registered at 23.6 square feet per person, nearly three times more saturation. Contrast the shopping center supply in the United States with the rest of the world: American boasts two times more retail real estate per capita than Australia and twelve times (12x!) more than Germany (see Figure 1 on previous page).

«TAX AND DEMOGRAPHIC CHANGES ALLOWED THE U.S. SUBURBAN MALL TO CATCH FIRE.»

DEMAND: REDIRECTED NOT REFUNDED

Creditors in search of missed coupon payments and visitors to empty malls intimately understand the oversupply of mall space in the United States. These same shoppers and investors—when the latter group acts as shoppers—know that their buying habits have changed, too. Here is where the headlines are true. Yes, popular shopping mall tenants of yore are going bust, and yes, the internet has changed the way we shop.

fig. 3 WHO'S AFRAID OF CHANGE? TOP 10 SIMON PROPERTY GROUP
TENANTS AS OF 1993 IPO AND CURRENT STATUS

Tenant	% of 1993 Rent	Current Status
The Limited	7.3%	Now in existence as L Brands, 2.1% of SPG rents
F.W. Woolworth	4.7%	Out of business in original form
Melville Corp.	2.9%	Various retail divisions split off, pharmacies renamed to CVS in 1996
U.S. Shoe Corporation	2.4%	Acquired by Luxottica in 1995, 1.2% of SPG rents
The Musicland Group	1.5%	Purchased by Best Buy in 2001
Edison Brothers Stores	1.5%	Bankrupt
Zale Corporation	1.4%	Purchased by Signet in 2014, 1.6% of SPG rents
Petrie Stores	1.3%	Bankrupt
Kmart Corporation	1.3%	Merged with Sears in 2005, 0.5% of SPG rents
Payless Shoe Stores	1.3%	Bankrupt

Source: SPG Company Data, Goldman Sachs

A key problem for malls is that their customers stopped shopping at their most popular (or most prevalent) tenants' stores. In 2016 alone, the mall mainstays of the 1990s and early 2000s completed far-reaching store closures: Aeropostale (-117 stores), Wolverine World Wide (-100 stores), Macy's (-66 stores), and Abercrombie and Fitch (-54 stores) all shrank their brick and mortar footprint.

Why the store closures? Consumer spending patterns in 2017 are very different than they were in 2000. We know, of course, that consumers purchase more goods and services online than ever before—e-commerce purchases rose to 8.5% of all retail sales in Q1 2017, their highest level ever, and up from 3.2% only one decade ago.

Not only have consumers' shifted some of their purchases across media (from brick and mortar to online), the composition of purchases has changed as well. Services have made broad gains in the hearts and wallets of American consumers. Goods, on the other hand, have fallen as a share of total U.S. consumer purchases since 2000 (see Figure 2 on previous page). For malls depending on the traditional vendors of goods (looking at you, apparel retailers!), the secular trend is not a friend.

The shrinking of the consumer demand for these once-great mall tenants relates to the rise of e-commerce and the share of purchases increasingly made online. In April 2017, the *Wall Street Journal* reported, "Retail margins on average fell to 9% last year from 10.5% in 2012."⁴

Corroboration for the growing share of e-commerce sales appears in the foot traffic at malls. Data from Thasos Group, a research service which tracks mall foot traffic from smartphone location data, show year-over-year foot traffic fell roughly 3% at "A" malls, 5% at "B" malls, and 6% in the second quarter of 2017.

RESILIENT MALLS RIDE THE TIDE

Problems abound on both the supply (too much) and demand side (online and the shift toward services) of the mall equation. However, we now direct your attention to possible remedies for the retail maladies discussed above. The underlying principle behind the ensuing possible solutions to the mall malaise is dynamism. While malls may live in our imagination as a fixed concept (think, "Mallrats"), we ought never to forget that these spaces evolve and morph in surprising and successful ways.

The 7.8 billion square feet of leasable shopping center space in the United States may currently play home to certain retail concepts, but it neither needs to host the same retailers nor does it need to stay retail space forever.

Our first example comes from a high-quality mall REIT, Simon Property Group. The largest mall REIT in the world, Simon's shopping mall properties run an occupancy rate of 95.2%, higher than the national average of 90.5%. How can they manage so much shopping center space so successfully? They change with the times. If we think of malls as the wrapping and the underlying tenants/experiences as the present, Simon has demonstrated shrewdness in repositioning its assets over the years.

Consider the tenant mix the mall operator boasted in 1993 at the time of its initial public offering. The ten largest renters—brands like The Limited, F.W. Woolworth, and Melville Corp.—accounted for ¼ of Simon's total rental revenue. Of those top ten retailers, today, three are bankrupt, six operate under new parent companies, and one is no longer in existence (see Figure 3). During this period, Simon has grown its core earnings from USD 78.4 million to USD 3.8 billion and its market capitalization from USD 854 million to USD 56 billion—an increase of nearly 70x!

To be sure, mall REITs still have large exposure to apparel and other goods sales. That said, they have been able to ride mergers, acquisitions, and bankruptcies among their tenants adroitly.

«INVESTORS OUGHT TO REMEMBER A MALL OPERATOR OFTEN GETS ONLY USD 3-4/SQ. FT. IN RENT FROM A TRADITIONAL DEPARTMENT STORE BUT CAN GET 4-5X THAT DEPENDING ON THE REPLACEMENT TENANT.»

You might be wondering, “Sure, the mall operators can handle changes to in-line tenants, but what about all the big-box stores? Surely these tenants occupy plenty of retail space.” Regarding square footage, big-box retailers do dominate. However, as it affects the bottom line of the mall operator, investors ought to remember “a mall operator often gets only USD 3-4/sq. ft. in rent from a traditional department store but can get 4-5x that depending on the replacement tenant.”⁵ In total these cash square-footage hogs not only sometimes own their real estate, but they also account for only 15-20% of a given mall’s cash flows.

Historically, department stores negotiated low rents with their landlords in exchange for the traffic they generated. As mall traffic falls and department stores shutter, re-leasing to smaller retail tenants could generate opportunities for the malls and their owners—whether that means new in-line tenants (e.g., H&M, Zara, Yard House) or other bigger box tenants (Dick’s Sporting Goods, Ulta Beauty, TJ Maxx).

Even in this apparently troubled environment, the best-in-class mall operators still expect same-store net operating income to grow between 2-4%.⁶ The growth is coming not only from reduced expenses but also landlords’ ability to raise rents for new tenants (the re-leasing spread) at 10% or slightly higher. Measured by their ability to generate operating income, regional malls are in a king’s condition (see Figure 4).

RESILIENT MALLS SEE THEIR LAND TURNED TO GOLD AND SEND THE DROSS BACK TO LENDERS

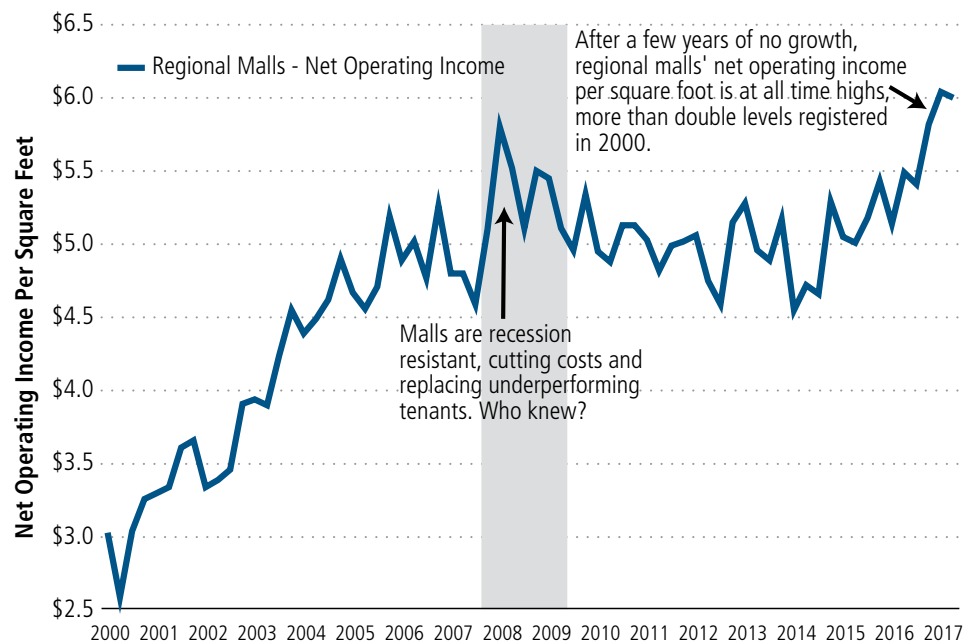
Strong mall operators evolve their tenant mix to better suit their customers. In cases where customers will not materialize even for an optimal tenant mix, and where land values are low enough, redeveloping some or all of the mall into new uses can be a lucrative route for the developer and a benefit to the surrounding community, especially for the weakest of mall properties. Adaptive reuse of the buildings and land is the second reason to envision a relatively bright future for shopping center owners.

Take the Fiesta Mall in Mesa, Arizona, as an example.⁷ After opening in 1979 and running for many years, the Fiesta mall lost its four major anchor tenants and sank to 10% occupancy. In the intervening time, a developer has since acquired the once vacant Macy’s and Best Buy anchor stores and has plans to transform the old space into mixed-use, office, and residential property. As for the main mall, a group spearheaded by a neighboring landowner purchased the mall and intends to invest USD 30 million into the property (nearly 4.5x the multiple of their USD 6.7 million purchase) to create an education and health-care campus.

There are also cases where existing owners can default on the debt backing their underperforming malls and re-enter the same positions at a more attractive price. How is this possible? Lenders are less interested than mall operators in running a shopping mall.

In one representative example, the mall REIT Washington Prime Group (WPG) defaulted on an USD 87.3 million loan collateralized

fig. 4 DESPITE THE HEADLINES, MALL FINANCIALS LOOK AS GOOD AS THEY EVER HAVE



Source: ICSC

by the group's Mesa Mall in Grand Junction, CO. Creditors soon resold the property for USD 63 million. The catch: the new buyer was Washington Prime Group. Lenders lost USD 24.3 million but avoided having to run the mall themselves.⁸ WPG, meanwhile, reduced the asset's leverage profile. The stronger balance sheet may provide needed flexibility for the mall to run a while longer.

«OF THE 72 MALLS THAT CLOSED IN THE PAST DECADE, 41 HAD BEEN REPURPOSED. TWENTY-THREE OF THOSE 41 MALLS WERE REDEVELOPED INTO OTHER RETAIL FORMATS, BUT 18 WERE REUSED OR RE-PURPOSED »

More generally, the trend is for underutilized mall space to change. Research conducted by Wells Fargo analysts concluded that of the 72 malls that closed in the past decade, 41 had been repurposed. Twenty-three of those 41 malls were redeveloped into other retail formats, but 18 were reused or re-purposed as civic centers, museums, county offices, residential towers, or office space. Of the 31 malls which had not been repurposed, only eight remain vacant in place.⁹

The conversion of malls into industrial, warehouse space has begun in earnest. From Union City, Georgia, to Mesquite, Texas, developers are turning old mall space into new distribution facilities, transforming 360,000-765,000 square feet of empty into plenty. Hamid Moghadam, CEO of Prologis, an industrial real estate REIT, recently remarked, "before too long you will see some two-anchor, Class B malls converted into logistic buildings, that is not too far-fetched at all. But, we're definitely looking at some of them."¹⁰


In short, mall landlords have many levers to pull to keep the value of their holdings at more attractive levels than headlines would suggest. Evolving their tenant mix—both in-line and anchor—as well as creative redevelopment, means that even if some malls must die, most will morph and live on.

NOT SO MALL-EFFICIENT

Our survey of the U.S. mall REIT landscape revealed a picture more nuanced than headlines proclaiming the "death of the mall" would have you believe. We are not blind to the risks ahead for enclosed shopping

malls. Oversupply, caused by decades of tax advantages (especially before the Tax Reform Act of 1986) and optimistic growth projections, as well as changing consumer preferences will not soon disappear.

However, malls are more dynamic entities than most casual commentary suggests. Strong operators who adapt their tenant mix appropriately, control speculative capital spending and consistently prune individual properties, as well as their entire portfolios of poor performers, are here to stay.

The fickleness of Mr. Market in 2017 has meant that many mall properties and related securities are on sale. Attractive entry prices as well as cool-headed (though unexciting) appraisals of future occupancy might not repopulate the earth with mallrats, but it will ensure they may remain in their natural habitat for just a while longer. 

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