

Tight Squeeze

Ben Johnson, Editor-in-Chief and Joel Groover, Associate Editor

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Spend some time with the elite money managers of the real estate industry and you quickly sense a distinct attitude about retail properties. Compared with office, multifamily, hotels and even industrial, the retail sector is often treated as the ugly child of the family.

It's too volatile, too dependent on fashion whims. There are too many cowboy capitalists doing unpredictable things in the market. So, when the big money looks for the best returns, retail often drops to the bottom of the list.

But why? Are there rational explanations for such oversight? The answers, not surprisingly, depend on who you talk to, because there are at least as many different types of investors as there are retail property types.

"I would say that there is capital available to retail but not as much as some other property types," says Scott A. Wolstein, CEO and chairman of the board of Cleveland-based Developers Diversified Realty Corp. "Unfortunately in retail you get a lot of people who invest in it that don't understand it and make ill-advised capital commitments to projects that aren't well conceived. Probably that happens in other sectors as well but it can be a little more so in retail. I don't know that the misconceptions cause problems. I think retail's a very good business. It's been a very profitable business for us and one in which we've outperformed other sectors in a very stable, consistent way. But we understand the business."

Some of the perceptions about risk in retail are well founded, of course. With returns from retail properties so closely tied to store performance, it's clear that malls and other retail properties thrive and starve according to consumer spending. So, when the economy softens, valuations of retail equities and investments drop faster than they do for other property types. And the flow of new investment dries up.

That's what happened last year, according to figures compiled by the Mortgage Bankers Association of America. Investment in retail followed both multifamily and office in volume of commercial real estate funding. The biggest annual increase was for multifamily lending, which saw a 33% increase in 2001 over 2000. And while lending for office buildings dropped by almost \$400 million, lending for retail properties was \$1.2 billion higher in 2001 than in 2000.

A year-end report by Chicago-based Real Estate Research Corp. notes that retail real estate investments in general turned in a weak performance in 2001 and more weakness is expected through 2002. According to RERC analysts, "diversification is key to this property sector; economies of scale and scope are critical to being a successful retail real estate investor."

Yet, for all the predictions of disaster that led to the capital drought, the performance of retailers and the retail property owners that depend on them has been surprisingly strong. Discounters Wal-Mart and Target reported strong results for 2001, while other top-performers included Kohl's, J.C. Penney and Ross stores.

2001 wasn't all that bad for property owners, either. The nation's largest mall REIT, Simon Property Group, reported a 7% increase in its 2001 funds from operations (a recognized performance benchmark). Developers Diversified Realty posted an 8.7% increase in its FFO for the year.

That news, however, apparently does not erase the concerns over retail real estate, most notably the belief that the sector is now overbuilt. "The problem is that the retailer expansions of 1999 and 2000 are now slowing and tenants that are going out of business do not have as many new retail concepts behind them to consume the space they will be

vacating,” says Glenn R. Mueller of Philadelphia-based Legg Mason equity research.

According to the National Council of Real Estate Investment Fiduciaries (NCREIF), the retail property sector finished third in 2001 average total returns with 9.12%, versus apartments (9.48%) and industrial (9.41%). Office came in dead last with only a 6.35% annual return.

On top of these reports, the general perception that more retailers are going bankrupt (witness the demise of Montgomery Ward, Kmart and other recent failures) and that consumer spending could still falter contributes to a “piling on” effect, giving retail in general a black eye. This negative news almost totally ignores the good news coming out of stronger retailers.

“The so-called ‘death of retail’ is more of a prediction that keeps not coming true,” says Allen O'Brien, managing director of Atlanta-based NetFunding.com. “There is still low vacancy and the default rate is miniscule. Look at how sales performed late last year. They did better than anyone expected.”

Witness the 2002 edition of *Emerging Trends in Real Estate*, the authoritative annual survey of leading real estate experts around the country by Lend Lease Real Estate Investments and PricewaterhouseCoopers. A few of the kinder cuts from the report are included here: “Interviewees are uniformly gloomy about retail real estate and grope for positives.” “America is over-stored — too many formats cannibalize each other.” “The pickings are slim.” “A weak economy promises to exacerbate retailer troubles and bleed returns from shopping centers.” “For the present, retail is being taken off a lot of radar screens.”

Peter Harned, a Lend Lease principal and head of finance in New York, strongly disagrees with the notion that sophisticated investors don't know how to look at the many property segments within retailing to find the best opportunities. “For the most part, good-quality centers with good rent rolls that are leased are very financable. It's not a question of preference for asset type in today's market, particularly with the office market taking it on the chin from the standpoint of heavier vacancies across all markets and bigger sublease space.”

The message is clear, he says: Investors who do their homework will find the opportunities to make money. “It depends on the type of center and the credit,” says Harned. “All of the underwriting fundamentals are the same for retail as they are for the other asset classes.”

Flight to quality

Those underwriting criteria have gotten a lot tighter in down times, which makes it tougher on marginal borrowers. That means more dollars are finding their way to safe havens, or the proverbial “flight to quality.”

“We have the same preference as most equity investors — fortress malls in good locations are very easily financable. Unanchored community centers or power centers with spotty credit are obviously more difficult,” says Harned.

In real estate parlance, an investment-grade rating (meaning a Standard & Poor's credit rating of BBB- or better) is still king to many investors. Non-investment-grade projects face tougher scrutiny, and have less financing options in a risk-averse climate.

But given the reliance on credit ratings, Michael K. Houge, principal with Minneapolis-based Upland Real Estate Group, which specializes in single-tenant retail net lease transactions, worries that many lenders will not do the due diligence it takes to understand retail. “The tendency for lenders to all follow the same piper — a ‘lemming effect’ — is likely to create difficulties in financing all but the best, ‘bullet proof,’ retail projects.”

Houge points to increased competition between general investors and those involved in 1031 tax-deferred exchanges. These exchanges are named after Internal Revenue Code Section 1031 (a)(1), which allows properties that are held for investment to be exchanged for any other property that is being held for investment. In return, the investor will be allowed to defer paying capital gains taxes.

“Previously, most of the drugstore transactions, and other properties leased to investment-grade tenants, were really

only purchased as replacement properties in 1031 exchanges.”

In this environment, however, fewer investors are willing to chance making above-market returns on below-investment-grade properties. “Where we used to find significant opportunities for investors in less than investment-grade-quality tenants, that avenue appears to be drying up,” says Houge. “Lenders are gun shy over all of the bad news in the retail sector. The recent demise of Kmart, coupled with the hangover effect of the Rite-Aid debacle, continues to worsen this effect. Enron, although not a retailer, just increases the jitters already quite apparent with lenders.”

The bottom line may be more demands for lower leverage and more recourse loans to satisfy the concerns of the lenders.

Houge's partner, Keith A. Sturm, says investment-grade tenants aren't having funding problems at all. “We are currently seeing a plethora of financing options available for properties leased to investment-grade tenants. Conduits, life companies and pension funds are competing heavily for these deals.” In fact, he says they're offering non-recourse loans, amortized up to 30 years, with as little as 10%-20% down.”

On the flip side are properties with non-investment grade tenants, which are not favored by these same investors. “This trend is forcing investors to finance their properties with traditional banks. In most cases, the banks are located in the community where the development is sited. Also, many times a ‘banking relationship’ is needed to entice the bank to make the loan,” says Sturm. These loans typically have personal recourse and require 25%-35% down, and most have a balloon payment due five years from inception.

During these safe-haven times, it's understandable why institutional investors still tend to focus on the credit quality of both retail tenants and their property owners when making their funding allocations. But there are hints that if the economy improves in the second half of 2002 as many expect, investors may start paying equal attention to more bottom line-oriented factors like cashflows and profitability.

O'Brien of Netfunding.com says some lenders are already seeing the light. “Lenders are getting more into profitability instead of just relying on a credit rating. They're getting a little more comfortable. Today, lenders are looking closely at performance trends and rental rate. If a tenant has been recently downgraded, has been put on negative watch, or has a falling market share, lenders will apply conservative loan underwriting or decline the transaction.”

For their part, tenants are trying to improve their overall profitability by weeding out their marginal stores. “This trend has resulted in lenders underwriting market rents below the contract amount, regardless of the credit quality of the tenant,” says O'Brien. “In the case of existing properties, lenders are looking for profitable locations. Grocery stores need to have an all-in occupancy cost of between 3% and 5% of sales. Drug stores need to fall in the 6%-8% range. Strong sales will overcome even a short-term lease maturity, when seeking to refinance.”

Could bigger be better?

One retail segment that has attracted Wall Street's influential attention is the retail real estate investment trusts (REITs). In the past six months alone, they have closed some astounding financing deals. Chicago-based General Growth Properties (GGP), for example, successfully sold \$2.55 billion of commercial mortgage pass-through securities in December 2001. Recently it used some of the proceeds to acquire Salt Lake City-based JP Realty for \$1.1 billion. GGP also filed a shelf registration in February 2002 to issue up to \$2 billion in new securities.

Respect for retail REITs could come quickly if persistent rumors that Indianapolis-based Simon Property Group could soon join the S&P 500 are true. It would be the first retail REIT to join the two other REITs already on the benchmark — Equity Office Properties Trust and Equity Residential Property Trust, both out of Sam Zell's real estate stable in Chicago.

To maximize their credibility, most major retail REITs have been honing their portfolios, steering them toward Class-A status, which is the preferred retail asset class for investors.

“We've had a formally announced strategy from early in the '90s to push the quality of our portfolio to the highest

possible level, to get as many Class-A properties as we could get and to have as few Cs as possible, and we've been very successful at that," says Jeffrey H. Donahue, executive vice president and CFO of Columbia, Md.-based The Rouse Co. "Those are the types of properties the lenders are dying to lend on. So whoever they're talking with, to the degree that the company has those higher-quality properties, there's no problem financing them. There's no problem finding, if you wanted to, equity partners to come into them."

Joel Simmons, partner with Chicago-based Cohen Financial, says many capital providers are looking for lower-leveraged deals and that plays into the REITs' hands. "Let's face it, a lot of the investments in retail have been by the REITs in the last couple of years and their appetite for capital is for lower-leveraged capital and financing has been very aggressive for that type of financing. We've been doing many low-leveraged deals for REITs and institutional owners at extremely aggressive spreads both on floating and fixed rates."

But according to some observers, even the mighty retail REITs aren't without their challenges in the months ahead.

"The retail REIT sector will face significant challenges this year, including the constant need for fresh concepts, updated buildings and the continued, but reduced, threat of e-commerce," says Merrie Frankel, senior analyst with Moody's Investors Service in New York. "The negative outlook for the retail property sector varies by the sub-sector, with community centers being comparatively better off. The gap between the strong and the weak properties is widening, and contributes to the negative outlook, in addition to the continued slide in consumer confidence."

Grocery anchors weigh!

Those investors who have decided to plunk down their cash for retail properties have tended to focus most heavily on one sector — grocery-anchored community shopping centers.

"I think that the institutional equity capital that's been investing in retail in recent months and maybe even years has been primarily dedicated to a narrow sliver of the business, which is the grocery-anchored neighborhood shopping center business," says Wolstein of Developers Diversified Realty. "I think if you read most publications that speak about pension fund investing and real estate the mantra is almost universal that the preferred property type is grocery-anchored neighborhood centers."

Simmons agrees the segment has been hot, but is not sure how long it will last. "Of course, everyone loves grocery-anchored centers, just like everyone loves multi-tenant industrial and apartments. There are just so many food-anchored centers out there. The problem is, the negative effects of capital in the industry have more been towards the boxes that don't have credit, or the smaller single-tenant boxes. They've taken the greatest hit because really, as we all know, there are very few investment-grade retailers anymore, and even the ones that are investment grade are being scrutinized."

Rebound in fortunes?

If the much-predicted economic rebound actually happens later in 2002, retail will most certainly benefit, both in terms of investor perception and in reality with increased sales numbers. The big questions are when will the uptick occur and how far behind will retail lag?

Like most investors, O'Brien expects the economy to begin recovering by third-quarter 2002. "However, the real estate industry typically lags the economy by 12 months. This will create a bottom for occupancies in the second to third quarter 2003. The retail industry has weathered the storm nicely, supported by an active consumer. 2001 holiday sales fell from double-digit growth to 1-2% growth, at a time when negative growth could have been the case. The retailers who are failing already had fiscal problems. The economic slowdown has served to clean out weak operators."

Chris Marabella, CEO of Escondido, Calif.-based Marabella Commercial Finance, says enough signs are in place for a turnaround to occur. "The lower interest rates orchestrated by the Fed under Alan Greenspan should have a positive effect on the economy. With fixed rates as low as 6.75% in December 2001 for investment grade tenants such as Walgreens, CVS and others, we have seen an increase in borrowings from 1031 exchange buyers, owners of existing net lease properties, and developers."

But Simmons worries that any economic rebound will take time to impact properties on the ground. "I think it's lagging and we haven't yet seen the full washout as far as how the economy has affected these retailers. There's still some washout and I think that the lenders are watching that and scrutinizing that."

Until a "pretty definitive" turnaround occurs, loan underwriting standards will continue to be tight, says Harned of Lend Lease. "We've seen that trend consistent over the last two years. Most lenders are going to be conservative lending into a down economy. With a more rosy picture going forward, you're going to see an improvement, particularly in the amount of capital that's sitting on the sidelines right now waiting to invest. We're being very selective on the types of assets that we buy."

Will retail get its fair share of the money that's ready to invest? Donahue of The Rouse Co. says the silver lining in retailing's recent troubles could help it in the long run.

"Nobody likes a recession but we're not altogether sorry to see the industry mature a bit. People are saying, 'Gee, there are differences between property types. There are differences in quality levels within property types.' Because we were on a quality mission for a fair part of the '90s when quality really didn't count for that much, that strategy actually looks better when times are tough."

Investors favor apartments...

MBA Commercial Mortgage Banker Origination Survey, Quarterly Results

4th Quarter, 2001 Originations by property type

	(\$ millions)	
Multifamily	10,680	47.4%
Office Building	4,854	21.5%
Retail	3,412	15.1%
Industrial	1,472	6.5%
Hotel/motel	530	2.4%
Health Care	341	1.5%
Other	1,236	2.2%
TOTAL	22,523	100.0%

Source: Mortgage Bankers Association of America

while retail racks up the returns

NAREIT Investment Performance Index*

Property Sector	Total Returns		# of REITs	Dividend Yield
	2001	January 2002		
Equity REIT Index	13.93%	0.20%	150	6.79
<i>Retail</i>	<i>30.42%</i>	<i>1.51%</i>	<i>41</i>	<i>7.05</i>
• Shopping Centers	29.89%	-0.13%	26	7.18%
• Regional Malls	31.88%	2.90%	10	6.87%
• Free Standing	23.95%	3.83%	5	7.27%
<i>Residential</i>	<i>9.04%</i>	<i>-4.62%</i>	<i>23</i>	<i>6.95</i>
• Apartments	8.66%	-5.12%	18	7.00%
• Manufactured	13.72%	1.71%	5	6.38%
<i>Industrial/Office</i>	<i>7.09%</i>	<i>-1.68%</i>	<i>34</i>	<i>7.13</i>
• Office	6.65%	-1.98%	19	7.18%
• Industrial	7.42%	0.10%	7	6.67%
• Mixed	8.15%	-2.50%	8	7.42%

Source: National Association of Real Estate Investment Trusts

* All figures represent percent change except where noted.

Fewer players, bigger deals

This year's ranking of the top direct lenders and intermediaries to the retail real estate industry sees many a familiar face, but overall fewer players.

Familiar names like Morgan Stanley (which tops our Direct Lenders ranking) and Holliday Fenoglio Fowler (tops on our Intermediaries ranking) are still in the hunt, but other firms did not respond to our repeated inquiries for information. It is important to note that this is by no means a definitive ranking of every top lender or intermediary. Individual companies were responsible for supplying information to *Shopping Center World* for these rankings.

This year, our rankings were compiled by PK Data Inc., an Atlanta-based marketing research firm specializing in the retail sector. The company provides custom market research, including customer surveys, competitive analysis and site selection evaluations. For more information, please contact PK Data at 770.931.9677.

Top Lenders Survey

1. Morgan Stanley

1585 Broadway

New York, NY 10036

Phone: 212-761-4000

E-mail: james.flaum@morganstanley.com

- *Total retail dollars financed: \$2,500,000,000*
- *Officers: John E. Westerfield, Managing Director; James E. Flaum, Managing Director; Steven S. Stern, Managing Director; Steven Holmes, Executive Director; Fred Harmeyer, Executive Director*
- *Locations: New York, NY; London; Tokyo*
- *2001 major projects: Sawgrass Mills, Sunrise, Broward Co., FL, \$335,000,000; Woodfield Mall, Schaumburg, IL, \$300,000,000; Potomac Mills, Dale City, Prince William Co., VA, \$200,000,000; Freehold Raceway Mall, Monmouth County, NJ, \$178,000,000; Danbury Fair Mall, Danbury, CT, \$175,000,000*
- *Total dollars of refinancing: \$2,500,000,000*
- *2002 direct lending goal: \$5,000,000,000*

2. TIAA-CREF

730 Third Avenue

New York, NY 10017

Phone: 212-498-9000

Fax: 212-916-6005

- *Total retail dollars financed: \$946,000,000*
- *Officers: John H. Biggs, Chairman, President & CEO; Martin L. Leibowitz, Vice Chairman & Chief Investment Officer; John A. Somers, Executive Vice President, TIAA Investment; Joseph W. Luik, Senior Managing Director, Mortgage & Real Estate*
- *Locations: New York, NY*
- *2001 major projects: Tacoma Mall, Tacoma, WA, \$135,000,000; Northbrook Court, Northbrook, IL, \$98,000,000; Fayette Mall, Lexington, KY, \$98,000,000; Arrowhead Towne Center, Glendale, AZ, \$85,000,000; Galleria At Sunset, Henderson, NV, \$92,000,000*
- *Total dollars of refinancing: \$120,000,000*
- *Dollars financed by region:*
 - Northeast: \$85,000,000*
 - Southeast: \$204,000,000*
 - Midwest: \$197,000,000*
 - Southwest: \$125,000,000*
 - West: \$335,000,000*

- o 2002 direct lending goal: \$3,300,000,000

3. **Bear, Stearns & Co. Inc.**

383 Madison Avenue

New York, NY 10179

Phone: 212-272-7918

Fax: 212-272-7047

Website: www.bearstearns.com

E-mail: choeffel@bear.com

- o Total retail dollars financed: \$648,000,000
- o Officers: J. Christopher Hoeffel, Senior Managing Director; Jeff Taschler, Managing Director
- o Locations: Boston, MA; Chicago, IL; Los Angeles, CA;
- o 2001 major projects: Overton Plaza, MacArthur Park & Cascade Plaza, Various Locations TX & WA, \$43,010,000; Eastgate Square Phases I,II,III,IV,Vi, Mount Laurel, NJ, \$81,000,000; Tyson's Square, Tyson's Corner, VA, \$18,200,000; Southgate Plaza, Sacramento, CA, \$17,850,000; Randall Square Shopping Center, Geneva, IL, \$13,530,000
- o Total dollars of refinancing: \$538,000,000
- o Dollars financed by region:
 - Northeast: \$254,000,000
 - Southeast: \$116,000,000
 - Midwest: \$80,000,000
 - Southwest: \$59,000,000
 - West: \$139,000,000
- o 2002 direct lending goal: \$1,000,000,000

4. **Capital Lease Funding**

110 Maiden Lane, Floor 36

New York, NY 10005

Phone: 212-217-6300

Fax: 212-217-6301

Website: www.caplease.com

E-mail: bill@caplease.com

- o Total retail dollars financed: \$426,000,000
- o Officers: Paul H. McDowell, CEO/Sr. Managing Director; William R. Pollert, President; Edwin J. Glickman, Executive Vice President; Shawn P. Seale, CFO/Sr. Vice President; William F. Paylor, Vice President, National Accounts
- o Locations: New York, NY
- o Total dollars of refinancing: \$21,300,000
- o Total dollars for new construction: \$404,700,000
- o Dollars financed by region:
 - Northeast: \$110,760,000
 - Southeast: \$123,540,000
 - Midwest: \$89,460,000
 - Southwest: \$59,640,000
 - West: \$42,600,000
- o 2002 direct lending goal: \$800,000,000

5. **Wells Fargo Commercial Mortgage Group**

45 Fremont Street, 9th Floor

San Francisco, CA 94163

Phone: 415-396-6616

Fax: 415-975-7813

Website: www.wellsfargo.com

- *Total retail dollars financed:* \$270,285,500
- *Officers:* Ed Blakey, Executive VP, Managing Director; Jim McDevitt, Senior VP, Origination Manager
- *Locations:* San Francisco, CA; Los Angeles, CA; Irvine, CA; Dallas, TX; Houston, TX; Phoenix, AZ; Chicago, IL; Minneapolis, MN
- *Dollars financed by region:*
Midwest: \$43,700,000
- *2002 direct lending goal:* \$2,000,000,000

6. **Archon Financial, L.P.**

600 E. Las Colinas Blvd, Suite 800

Irving, TX 75039

Phone: 800-710-7616

Fax: 972-830-7698

Website: www.archonfinancial.com

E-mail: ben.glatzer@archonfinancial.com

- *Total retail dollars financed:* \$250,000,000
- *Officers:* Robby O'Neal, Co-Chief Executive Officer; Jim Conway, Co-Chief Executive Officer; Joseph M. Osborne, Chief Operating Officer/General Counsel; Kevin Streufert, Vice President-Securitizations; Benjamin Glatzer, Marketing Director
- *Locations:* Irving, TX; Los Angeles, CA
- *2001 major projects:* Southlake Town Square, Southlake, TX, \$40,750,000; Mesa Grand, Mesa Grand, AZ, \$29,000,000; Presidential Marketcenter, Snellville, GA, \$28,000,000; Rancho San Diego, San Diego, CA, \$17,000,000; Hong Kong Mall, Houston, TX, \$16,750,000
- *Total dollars of refinancing:* \$250,000,000
- *Dollars financed by region:*
Northeast: \$31,000,000
Southeast: \$46,000,000
Midwest: \$27,000,000
Southwest: \$81,000,000
West: \$65,000,000
- *2002 direct lending goal:* \$1,200,000,000

7. **USA Capital**

4484 South Pecos

Las Vegas, NV 89121

Phone: 702-734-2400

Fax: 702-734-0163

Website: www.usacapitalender.com