

Factory Outlet Centers: Implications for Development and Investment

by

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Submitted to the Department of Architecture in Partial Fulfillment Of The Requirements
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Roger Mann

Submitted to the Department of Architecture on August 11, 1995, in partial fulfillment of the requirements for the Degree of Master of Science in Real Estate Development.

Abstract:

The factory outlet center development industry has boomed over the past decade, despite the fact that factory outlet stores originated in the last century. The traditional format for a factory outlet was a small store located near a factory, used as a vehicle to distribute lower quality or out of date merchandise at deeply discounted prices. The factory outlet center concept arose during the past 25 years, with a number of manufacturers locating in a shopping center format. Factory outlet centers have represented a minute portion of the retailing landscape, of interest primarily to local or regional real estate developers. Outlet centers have recently evolved into a new retailing concept composed almost exclusively of “value-oriented” merchandise.¹ They have been significant profit centers for manufacturers that have experimented with retailing, and they have transformed some manufacturers into full-scale retailers. They have also transformed the development approach for some companies from a traditional limited partnership format on individual projects to multiple large scale developments undertaken by public market real estate investment trusts (REITs). The explosive growth of the outlet center industry initially attracted investors in the public markets. As the frontier nature of factory outlet center development has given way to a more slowly expanding, mature industry, questions have been raised about future growth prospects for retailers, developers and real estate investors. This thesis explores the dynamic growth of the industry, the questions that have arisen in the process, and the implications for future factory outlet center development and investment.

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¹ W. Thomas Anderson, *Retailing in the Year 2000: Quixotic consumers? Exotic Markets? Neurotic Retailers? in The Future of U.S. Retailing: An Agenda for the 21st Century* (New York: Quorum Books), pp. 53-54.

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Introduction

Factory outlet centers can trace their origin to the manufacturers in the 1800s that sold overruns, outdated products and flawed items at deep discounts in stores next to their plants. Today, some manufacturers still sell lower-grade merchandise in their outlets, but most offer first-quality stock, and most are located in some type of open-air shopping center with other manufacturer's outlets. Hence, the factory outlet as a means to manage excess inventory has become an experiment for manufacturers to enter the retailing business and take advantage of the latest manifestation of consumer demands. As I will discuss in Chapter 1, this experiment has, in turn, manifested itself such that factory outlet centers have become an increasingly important, though small, component of the retailing landscape. They have attracted significant attention in the retailing and real estate development industries such that hundreds of manufacturers have entered the market, prompting a movement in the real estate development community to respond with specialized product.

Chapter 2 will discuss how developers have responded to the demand for factory outlet centers by manufacturers. A number of developers have altered traditional ownership formats and development strategies to exploit this new level of demand. But with this new retailing format have come new risks, rewards and management challenges for developers.

As will be discussed in Chapter 3, this new retailing format has presented new vehicles for investors to participate in its growth. Like the developers, investors have been presented with new risks and rewards to analyze. The investment community has struggled to understand the industry and its growth prospects, amidst an initial surge of development. After a brief period of unrealized investor expectations, the factory outlet sub-sector is now even witnessing some consolidation.

The industry is now at a point where retailers, developers and investors are looking to the national economy and consumer spending levels and preferences to signal

what direction to take. In the meantime, however, manufacturers disguised as retailers, along with profit-seeking developers, are continuing to expand the development of factory outlet centers.

Finally, in Chapter 4, this thesis will explore various arguments concerning the future of factory outlet centers, and the critical factors for future success in the industry.

Chapter 1 -- The Factory Outlet Center in the Context of the Retail Industry

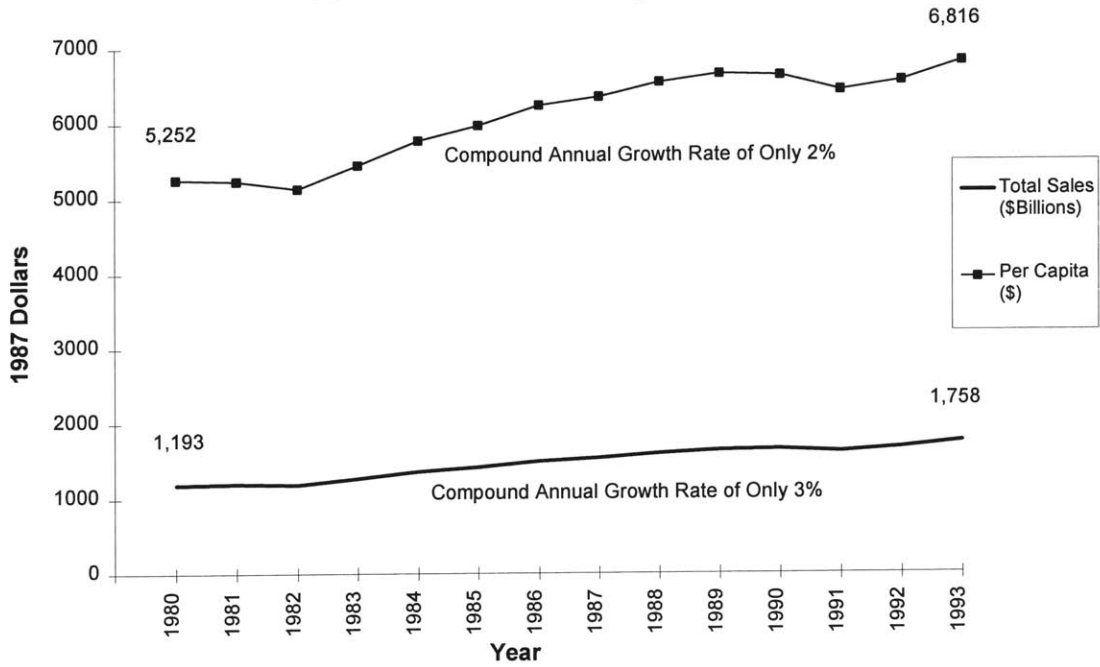
In the late 1980s and early 1990s, the market was fairly stagnant for U.S. retailers. Retail spending had not grown as it had in prior years as shown in Chart 1.1. With slow growth in consumer spending, traditional retailers struggled for market share amid changes in both demographics and preferences for consumer merchandise. For example, in the U.S., the percentage of adults aged 35 to 54 was predicted to grow substantially as seen in Chart 1.2 and continue to grow faster than the population as a whole.² Traditional retailers of apparel and home furnishings, typically located in shopping centers, could expect to benefit from this cohort's growth, because it tends to outspend younger consumers for such goods. However, the age 64+ cohort was also expected to grow. These older consumers tend to spend less than younger adult consumers on traditional retail goods like apparel and home furnishings.³

² U.S. Bureau of the Census Projections.

³ "A Decade of Change," *Chain Store Age Executive* (November 1988), pp. 55-77.

Chart 1.1

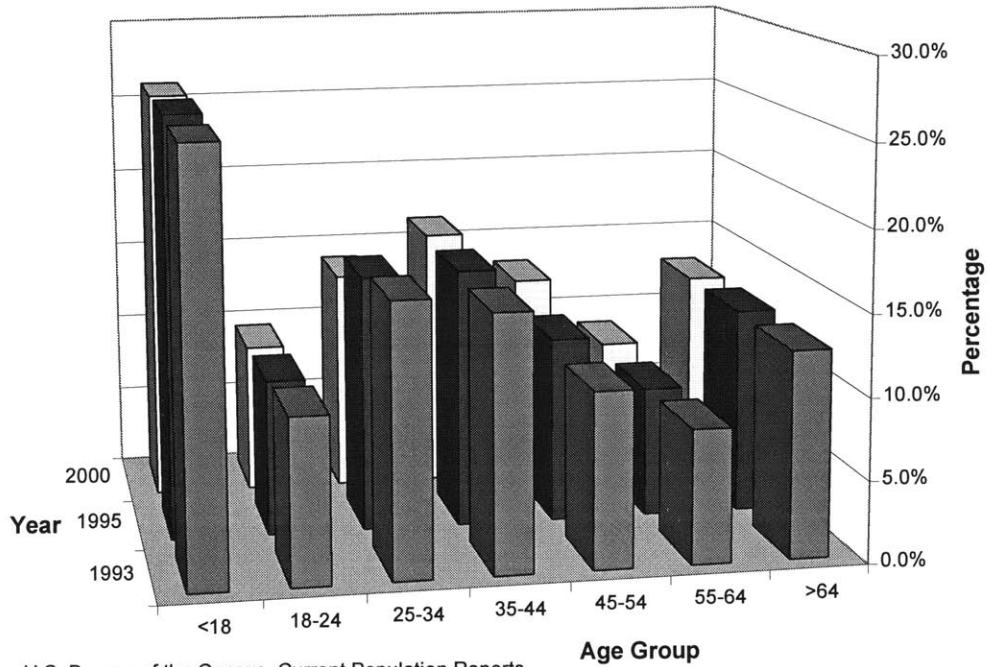
Retail Trade Sales -- Summary: 1980 to 1993



Source: U.S. Bureau of Economic Analysis, Survey of Current Business, monthly; and unpublished data.

Chart 1.2

Past & Future Population Age Distribution



Source: U.S. Bureau of the Census, Current Population Reports.

The net effect was that all types of retailers in the late 1980s were trying new strategies to retain market share. One such strategy was to create a strong sense of value for consumers; instead of periodic sales, some retailers began offering every day low prices (EDLP). Off-price retailers, primarily of apparel, such as TJ Maxx and Marshall's, began to gain in market share. By year-end 1992, there were 620 off-price chains, operating more than 48,779 stores. Total sales for off-price retail that year were about \$321 billion.⁴ By 1995, off-price retail sales made up 22% of all U.S. "Value Apparel".⁵

Other retailing strategies included streamlining the distribution process, and in some cases, eliminating the traditional retailer. Factory outlet stores allowed manufacturers to sell outdated or second-quality merchandise to consumers at discounts of 30% to 70% since the traditional retailer was not involved. Grouping individual factory stores into factory outlet centers provided more merchandise depth to attract customers consistently. In addition, factory outlet centers provided manufacturers with an opportunity to maintain brand integrity at full-price department stores and malls. Through the traditional retailers, consumers could be conditioned to pay a premium for a particular brand's in-season merchandise. With a factory outlet center, a consumer could be conditioned to expect "bargains" for branded merchandise that was in some way less than first quality -- either last season's merchandise, an unpopular style or color, or second quality merchandise. About half of all factory outlet center retailers (manufacturers), like traditional department store and mall retailers, have been apparel retailers, although a significant number of hard-goods manufacturers comprise the factory

⁴Terry Dunham, Publisher, *The Art & Science of Outlet and Off-price Retailing and Development: Answers to Value Retailing's Most Asked Questions* (Clearwater, FL, 1993) p. 7.

⁵ NPD Research, *The Topline Report*, Jan.-Mar. 1995. Value Apparel refers to apparel sold at either discount department stores, off-price stores, warehouses, or factory outlet centers.

outlet center industry.⁶ In 1993, apparel sales made up about half of total factory outlet center sales.⁷

In 1981 there were only 26 factory outlet centers in the U.S. By 1993, there were 275 as shown in Figure 1.3. By year end 1994, there were 311 factory outlet centers in the nation, and the number of manufacturer tenants has increased just as dramatically. Prior to 1986, there were only a handful of manufacturers that had a significant presence in more than one factory outlet center. By 1994, there were 500 manufacturers operating outlet stores, led by Phillips-Van Heusen with over 275 stores and The Brown Group (shoes) with 545.⁸

⁶ Perry Grueber, Horizon Outlets, Inc., July 5, 1995, interview. Hard goods retailers with a significant factory outlet presence include Black & Decker, Corning/Revere, Oneida, American Tourister, Pfaltzgraff, and others.

⁷ Calculations -- Value Retail News reported 1993 Total Industry Sales of \$9.9 billion. NPD Research 1993 estimates of apparel sales of \$4.649 billion.

⁸ Lee Schalop and Christopher Hartung, J.P. Morgan Securities, Inc., Equity Research, "Factory Outlet Center Industry Overview", New York, June 21, 1994.

Chart 1.3

Outlet Centers Open and Manufacturing Retail Chains, 1988-1995

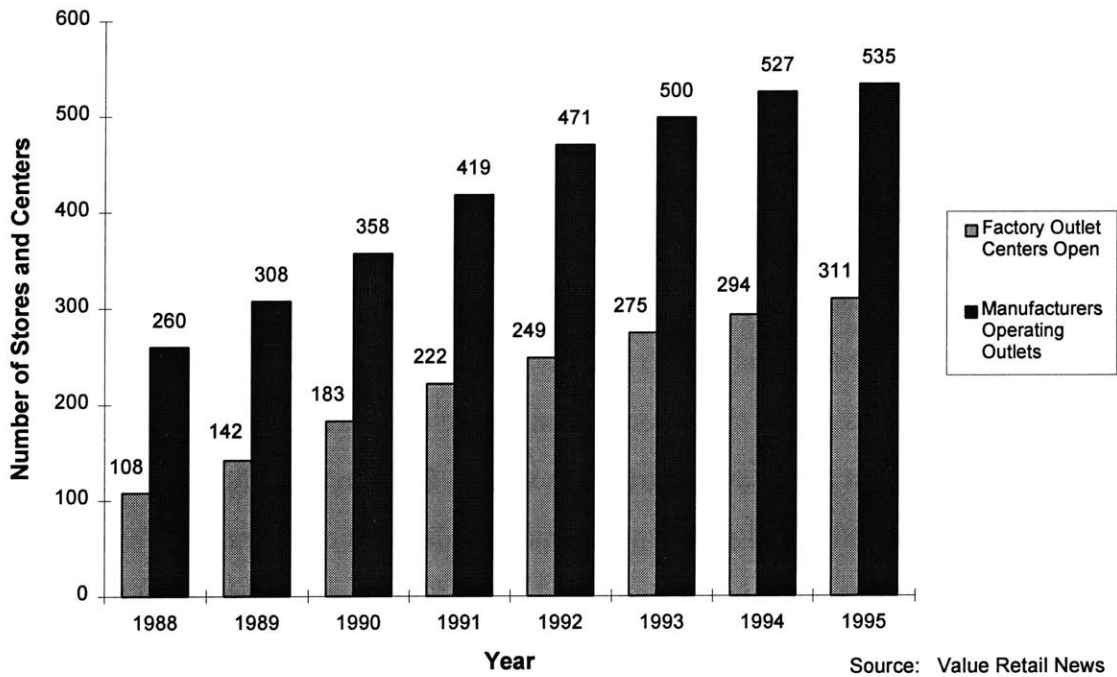
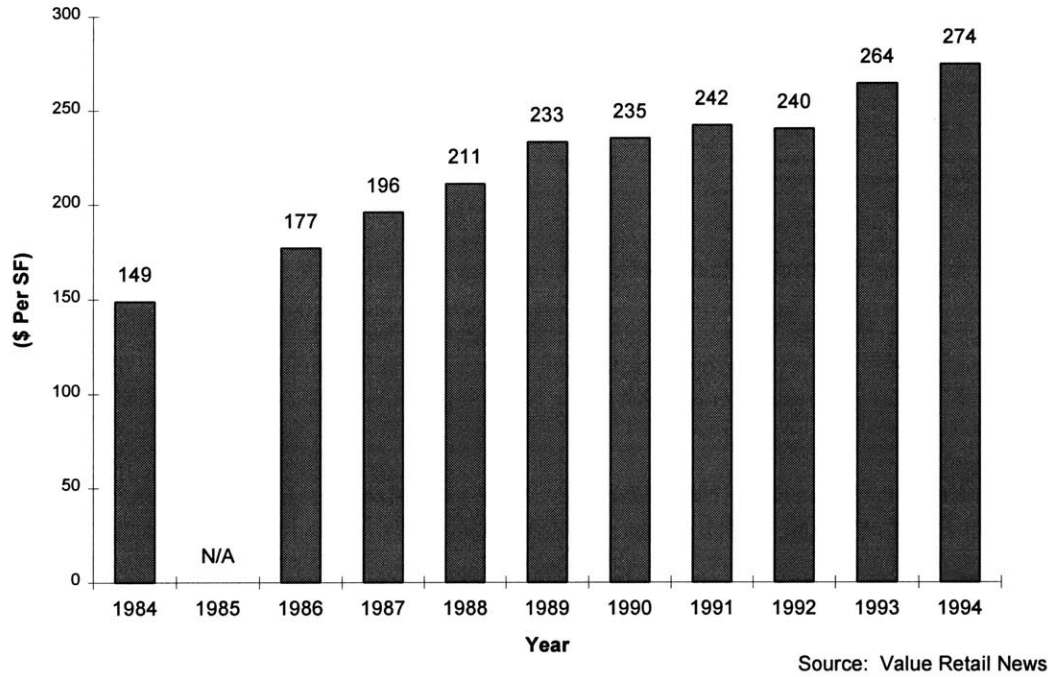


Chart 1.4

Average Sales Per Square Foot for Outlet Retailers, 1984-1994



At the same time, sales of these newly-minted retailers grew from \$149 per square foot in 1984 to \$264 per square foot in 1994 (Chart 1.4). As a point of reference, a 1994 sample showed that outlet store tenants averaged sales of \$259 per square foot, compared to \$250 for regional mall tenants⁹.

The 1993 outlet retail sales level of \$9.9 billion was small compared to regional and super-regional mall annual sales of about \$246 billion, and catalog and mail order sales of \$29 billion¹⁰. Still, nearly \$10 billion has been significant enough to attract the attention of the real estate development and investment communities. This rapid growth in both sales and stores points to the conclusion that retailers were, and are, no longer using the factory outlet center as a distribution vehicle for second quality merchandise, but rather as an alternative and supplement to normal distribution channels. For example, the largest outlet chains noted in a Value Retail News Survey at year end 1994 had over 200 stores, and the fastest growing chains were expanding by about 50 stores in 1995.¹¹ Other retailers that have brought their outlet retailing into the mainstream of operations are the Gap and Ann Taylor. Both manufacturers have established separate sourcing bases and merchandise teams for their factory outlet divisions, Old Navy (Gap) and the Loft (Ann Taylor).¹² A survey by Value Retail News demonstrated that manufacturing

⁹ Therese Byrne, "Factory Outlets Reach Turning Point in Growth," *ICSC Research Quarterly* (Spring 1995), p. 18.

¹⁰ Sales compiled from reports by the following organizations: International Council of Shopping Centers, National Research Bureau, Monitor Magazine, Shopping Center World Magazine, U.S. Statistical Abstracts, 1994.

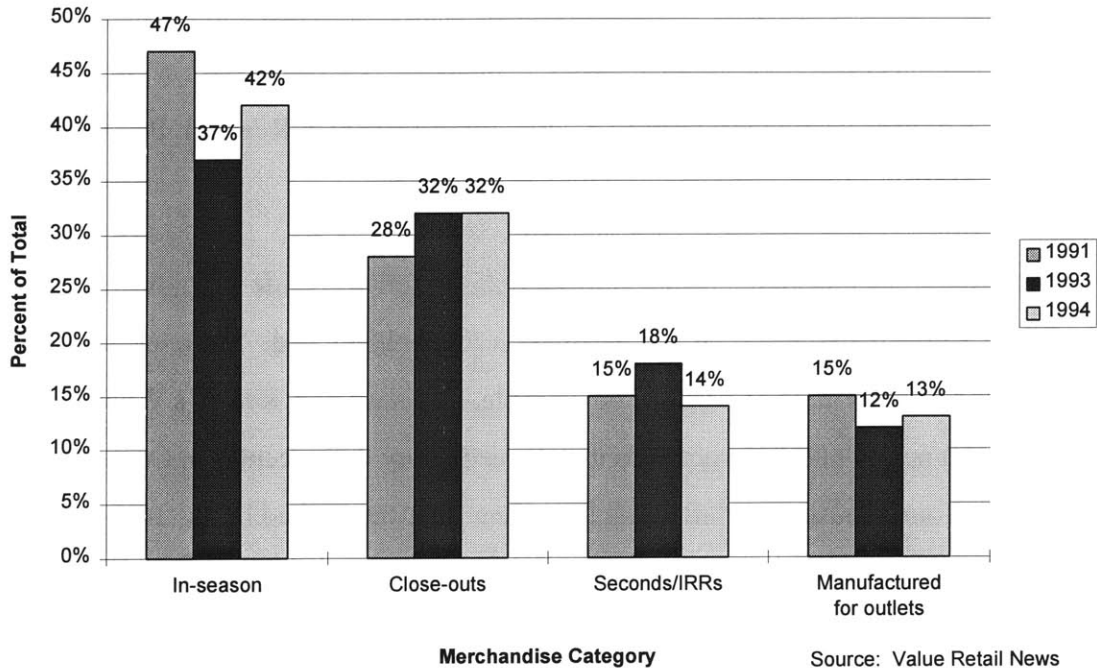
¹¹ Tom Kirwan, "Value Retail News Pinpoints '94's Fastest Growing, Largest Chains," *Value Retail News*, (June 1995, Volume 13, No. 4), pp. 40B-40C. Interviews with industry participants have confirmed that some manufacturers have focused on factory outlet retailing. Retail industry consultant Hank Hershey (July 14, 1995) and company reports confirm that nearly half of Van Heusen's 1994 sales came from factory outlet stores. This was also noted by Barry Vinocur, in a June 14, 1993, *Barron's* article, "Outlet Centers: Good Bargains For Investors?", p. 56.

¹² Sharon Edelson, "Once A Poor Relation, Outlets Go Legit -- And Trouble Looms", *Women's Wear Daily*, April 4, 1995, pp. 1,8,9.

retailers sold some seconds and close-outs in their stores, but over half of the sales came from in-season merchandise and goods made specifically for the outlets (Chart 1.5).¹³

Chart 1.5

Outlet Center Merchandise Inventory



Because larger scale (over 200,000 square feet) factory outlet centers are a recent phenomenon, the factory outlet center profile varies somewhat, but is frequently patterned after a regional shopping center format, with good highway access and plenty of parking. Some are larger, some are located closer to metropolitan areas. Some have a village type design, others are more like strip centers or open air malls.

Phillips Van Heusen, (one of the industry’s most prolific manufacturer tenants) categorizes factory outlet center locations as follows¹⁴:

¹³ Kris Hundley, “Sourcing Strategies,” *Value Retail News* (November 1994), p. 26.

¹⁴ Linda Humphers, “Defining the Center: A Roadmap to Outlet Development,” *Value Retail News* (April 1995, Vol. 13, No. 4), p. 74

- ◆ Between two metropolitan areas on a major highway (e.g., Castle Rock Factory Stores, between Denver and Colorado Springs)
- ◆ In a tourist destination or on the way to a tourist destination (e.g., Desert Hills, at Cabazon, California, outside of Palm Springs, or any factory outlet center in Florida or Hawaii)
- ◆ A tourist destination itself (e.g., VF Outlet Village in Reading, PA, Branson, MO)

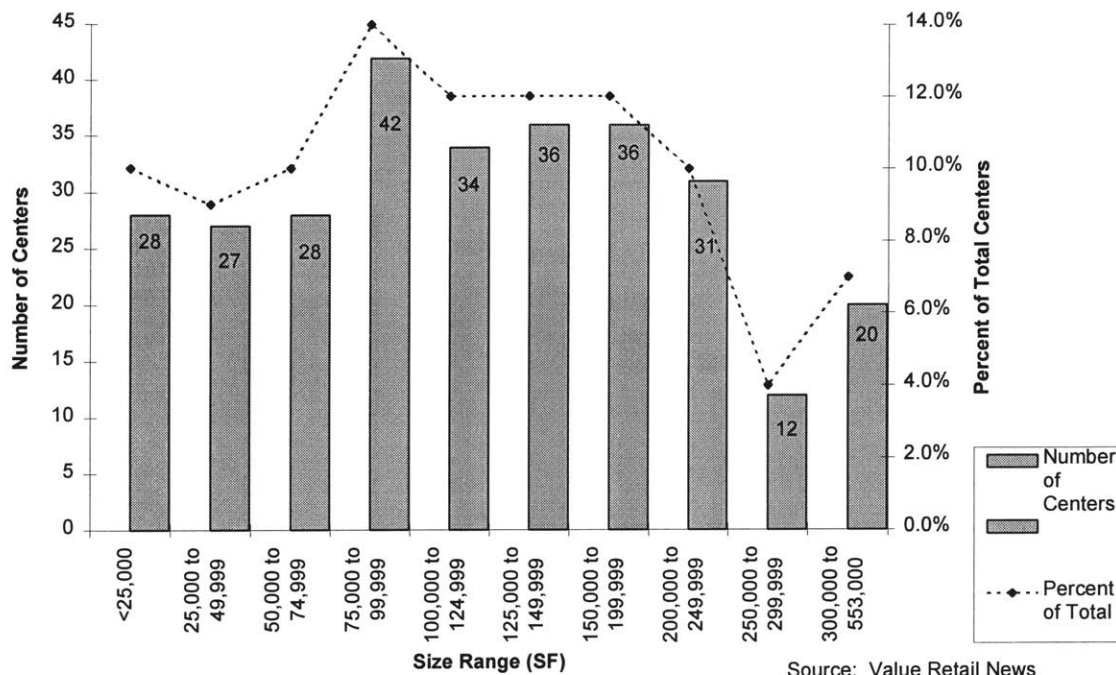
A typical factory outlet center is located 25-50 miles outside a major metropolitan area near a highway exit ramp. It is a destination for sophisticated, “value-oriented” shoppers and tourists in some cases. For example, Chelsea GCA Realty’s Woodbury Common, is a nearly 600,000 square foot open air factory outlet center in Central Valley, New York. Tourist buses regularly visit the center on a year-round basis. In the late 1980s and early 1990s, most factory outlet centers were developed with an initial phase of 150,000 square feet and with at least 70% pre-leasing.¹⁵ Within two years, a second phase was added of at least 100,000 square feet. Today, existing factory outlet centers range in size from under 50,000 square feet to almost 600,000 square feet (see Chart 1.6).¹⁶

¹⁵ Barry Vinocur, “Outlet Centers: Good Bargains for Investors?”, *Barron’s*, June 14, 1993, p. 56.

¹⁶ Taken from interviews with Hank Hershey, retail industry consultant (July 14, 1995) Perry Grueber, Director of Marketing, Horizon Outlet Centers, Inc. (July 5, 14, 1995). Also Value Retail News research department, Cher Russell, (June 9, 1995).

Chart 1.6

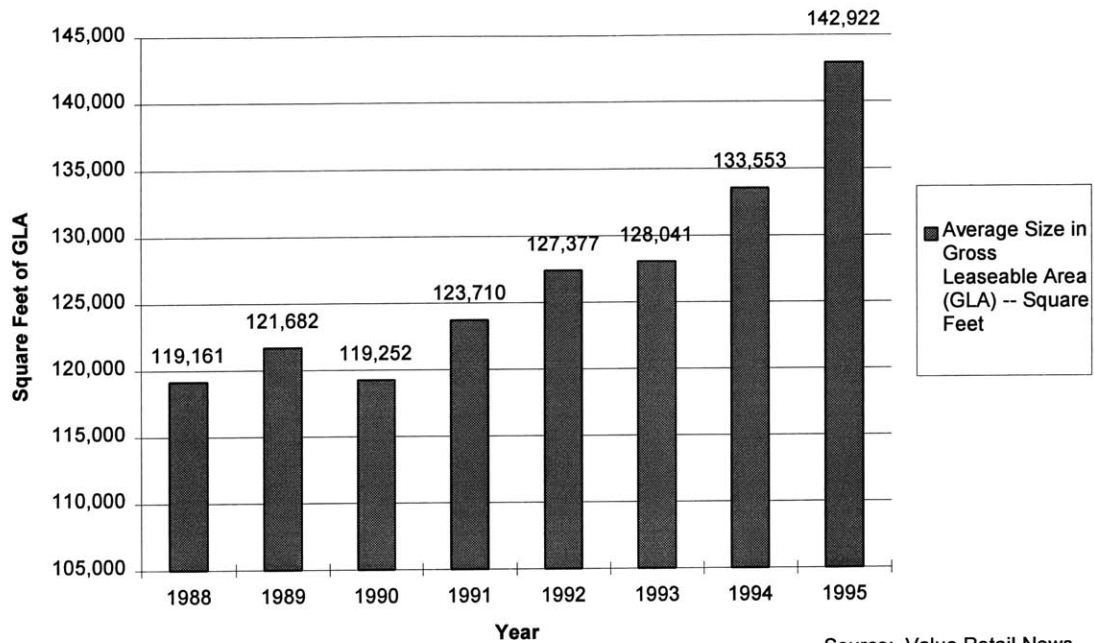
U.S. Outlet Centers By Size (SF), As of 1993



There is a slight trend toward building larger centers, as more manufacturers enter the retailing industry. The average size of a factory outlet center scheduled to open in 1995 is about 140,000 square feet. The average size of factory outlet center that opened in 1994 is about 130,000 square feet.. As shown in Chart 1.7, there has been growth in the average size of center construction.

Chart 1.7

Average Center Size [Square Feet of Gross Leaseable Area (GLA)], 1988-1995



Source: Value Retail News

There have recently been incidences of developing factory outlet centers closer to metropolitan areas. Some industry analysts have declared this a trend. They cite examples like the Citadel Factory Stores, a 150,000 square foot outlet center in Los Angeles, built in 1990. However, the average distance from a metropolitan area has not changed much in recent years. In 1991 a survey by Value Retail News showed 23.2 miles, as reported by retailers. A 1994 survey showed the average at 25 miles. Yet another survey of retailers showed that 6.7% of retailers said their location criteria was the same, 31% said it was less and 2.1% said it was more.¹⁷ Tenants of earlier factory outlet centers were concerned about competing with traditional retailers that carried their brands. The traditional retailers could retaliate by not carrying the manufacturers brands if they felt that the manufacturer was competing with them. In fact, advertising in factory outlet centers was typically muted so as not to appear to be competing with other retail

¹⁷ Interview -- Research Department (July 20, 1995) *Value Retail News Magazine*, Clearwater Florida, (Research Department).

distribution channels. In certain instances, manufacturer retailers would not display a sign outside their store, and would not allow the center to advertise its name.¹⁸ The movement of factory outlet centers closer to traditional retailers suggests that the factory outlet retailing strategy is growing more refined than its original goal of dumping the excess inventory of traditional stores. There is no universally accepted sensitivity measure, however, in terms of mileage from traditional centers. Manufacturers identify their target customers. If they feel that a particular location will steal business from a traditional retailer selling their goods, then they will not locate there. This type of case-by-case site analysis allows some factory outlet centers to locate closer to traditional retail centers.¹⁹ As of yet, moving closer to more densely populated metro areas is not a widespread trend.

Factory outlet centers have no single anchors, unlike traditional shopping centers. Initial lease terms to tenants are typically less than 10 years, as compared to regional malls that often lease space to anchor tenants for terms of 20 to 25 years. Tenant spaces in factory outlet centers range from 1,500 to nearly 10,000 square feet. Industry analysts and participants indicate an average size of about 4,000 square feet.²⁰

In summary, the change in consumer demographics and recent changes in the U.S. economy have caused changes in shopping behavior patterns that allowed factory outlet

¹⁸ From June 14, 1995, interview with Kevin K. Nunnink, MAI, Nunnink & Co., Westwood, Kansas. At the Desert Hills outlet center, Cabazon, California, one of the retailers would not put up its brand sign because the owner of Dillard's department store was known to travel past the center on his way to vacation in Palm Springs. The manufacturer did not wish to appear to be competing with the Dillard's store in Palm Springs.

¹⁹ International Council of Shopping Centers "Proximity not a taboo in Las Vegas", *Shopping Centers Today: Special Supplement* (September 1994), p. S10.

²⁰ REIT analysts Lee Schalop and Christopher Hartung of JP Morgan in their June 1995 industry review estimate 4,000 square feet per average store. An average of Chelsea GCA Realty's store sizes taken from a December 31, 1993, 10-K Report was 3,459 square feet. Aggregate square footage estimates of centers (Schalop & Hartung) and numbers of stores operating (Value Retail News) indicate an average size of about 3,800 square feet.

centers to grow within the retail industry. The increased demand for value-oriented brand-name goods among consumers, combined with manufacturers' desire to protect eroding margins associated with traditional retail distribution channels, created an opportunity for shopping center developers to capitalize on satisfying two unsatisfied clienteles.

Chapter 2 -- The Factory Outlet Center in the Context of the Real Estate Development Industry

As noted in Chapter 1, the shift in consumer demands, and the desire for manufacturers to keep open distribution channels for merchandise, provided a unique opportunity for retail real estate developers. Manufacturers needed store space to sell goods, but did not want to compete directly with traditional department store and mall retailers. Real estate developers had to provide an appropriate product to satisfy those needs. This chapter discusses the unique characteristics of factory outlet center development as contrasted with that of conventional shopping centers. This chapter will examine aspects of development strategy, including ownership form & financing, land acquisition, leasing, marketing, operating and property disposition.

Development Process -- Traditional Ownership Entity -- Ltd. Partnership

In a traditional retail real estate development, a developer forms a limited partnership to raise equity capital. The developer's corporation is commonly the general partner and actively manages the project. The limited partners are often high-net worth individuals or institutional investors who provide the capital, receive partnership units for their investment, and exercise no control over the development operations. The return on their investment takes the form of property cash flows and/or proceeds of sale or refinancing, depending on the tax status of the investor and the particular partnership agreement. This form of ownership has been predominant in the retail real estate development business for a few decades, with varying degrees of tax incentive for investors. The limited partners typically deferred taxes through partnership allocations of tax (non-cash) depreciation deductions stemming from the developed improvements.

The general partner contributes management expertise, usually has tenant relationships, negotiation or "deal-making" skills, and contributes a relatively small amount of equity, typically in the form of cash and/or land. In addition, the general

partner usually assumes the financial risk on the construction loan. After a successful construction phase, the general partner often will receive on-going management fees from the project, in addition to a portion of the project's cash flow. If a project is sold or refinanced, the general partner often shares significantly in such proceeds.

The limited partners share a significant amount of financial risk during the construction phase and beyond. In return for assuming the risks, the investors expect a commensurate return on their investment. It is difficult to generalize accurately about the risk premium paid to retail real estate limited partner investors, but a minimum of 200 basis points over a Grade B corporate bond would not be unreasonable as a starting point.

However, limited partnerships have certain drawbacks. First, the limited partnership units are not liquid. Partnership agreements are not standardized, and consequently, there is a thin after-market for limited partnership units. Investors who need liquidity often have to sell their partnership units at steep discount, often to other limited partners or the developer/general partner.

In addition to illiquidity, limited partners tend to receive uneven flows of information with respect to their investment. While the general partner is required to report financial and development progress to the limited partners, the reporting requirement is defined in the partnership agreements and is difficult to enforce. Bad news tends to travel slowly, if at all, from the general to the limited partners. Naturally, this makes it difficult for investors to make informed decisions.

As mentioned earlier, a major appeal of a limited partnership investment was the tax deferral component. However, in recent years, the IRS has curtailed tax deferrals by lengthening depreciation schedules and restricting the type of income that can be sheltered. Hence, real estate investments that can produce a satisfactory return primarily through current income have become more desirable to investors. As the next section will illustrate, REITs of the late 1980s and early 1990s have provided a vehicle that emphasizes current income to investors. The following two sections will briefly describe

the nature of REIT ownership and why many believe it is appropriate for factory outlet center developers.

REIT Ownership

REIT ownership of real estate has been available since the 1960s. REITs were created by the U.S. tax code to provide smaller investors the opportunity to participate in real estate investment. Although there are debt, equity and hybrid REITs, public REITs are essentially publicly-traded real estate corporations. Equity REITs in particular (REITs that primarily own and manage property), have been used by factory outlet center developers to raise capital for growth. Equity REITs must have at least 100 shareholders and no more than 50% in value of its shares or units may be owned by five or fewer individuals. From a strict tax compliance perspective, however, a large financial institution can own more than 10% of total value, since the institution's many shareholders (or beneficiaries, in the case of a pension fund) are considered individual holders of its stock under the current tax attribution rules. Specifically, if a REIT distributes at least 95% of its taxable income to its shareholders, then such dividend distributions will be deductible for tax purposes.²¹ To the extent that a REIT distributes more than it earns, the excess is treated as a tax-free return of capital to its shareholders.²²

In the equity REIT format, management assumes the role of developer, and the shareholders the role of investors. With the limitations on tax incentives for real estate investment, equity REITs, with an emphasis on distributing current cash flow from its properties, became more appealing to real estate investors in the late 1980s and early 1990s. Factory outlet center developers accessed the public capital markets by converting their ownership entities from a collection of limited partnerships, joint

²¹ Internal Revenue Code: Sec. 857(a)(1)(A)(i).

²² Taken from Reprint of "REITs and UPREITs: Characteristics, Requirements and Taxation", by Lawrence S. Kaplan and Craig S. Stern, Kenneth Leventhal & Company, New York, 1994, pp. 2-3)

ventures and S corporations into REITs. In order to avoid large taxable transactions, some factory outlet center developers contributed (on a tax-deferred basis) their existing properties and partnership interests into another, larger partnership, known as an “Umbrella Partnership”. Essentially, this allowed the owners of existing factory outlet centers to contribute such partnership units to another partnership controlled by a REIT, without incurring a tax liability until they converted their partnership units to more liquid REIT shares. Partners that needed to liquidate their interest could do so without disturbing an operating portfolio of properties, simply by taking back REIT shares, on a taxable basis that could then be sold in the public markets. The next section discusses reasons a factory outlet center developer would find REIT ownership beneficial as part of a factory outlet center development strategy.

Why Become A REIT?

Electing the REIT format instead of limited partnership format could provide a factory outlet center development company with a number of benefits. The benefits frequently noted in the initial public offering prospectuses indicate that recapitalization into a REIT would allow the company greater access to public and private capital markets to continue development.²³ In the rapidly growing factory outlet center development business, access to capital would provide a competitive edge in controlling and developing sites, and expanding existing ones. In 1993 and 1994, when a number of factory outlet center development companies formed REITs, there was a general condition in the U.S. economy, commonly referred to as a “credit crunch.” That is, traditional collateralized real estate lending sources, such as commercial banks, insurance companies, and pension funds greatly reduced or ceased lending, due to regulatory edicts

²³ Horizon Outlet Centers, Inc. IPO Prospectus, November 1, 1993, pp. 5-6; Factory Stores of America, Inc. IPO Prospectus, June 3, 1993, pp. 5-6; Prime Retail, Inc., IPO Prospectus, March 15, 1994, pp. 8, 10.

or internal policies that arose from losses the lenders were incurring on bad credits.²⁴ Although the factory outlet center industry appeared healthy, there was little private capital available. As shown in Chart 2.1, the level of construction and development loans by commercial banks dropped significantly from June 1990 to December 1992.

Chart 2.1 Construction & Development Loans: Insured Commercial Banks with Assets > \$100 Million



In summary, the factory outlet center development companies needed additional capital to grow, and REITs were a vehicle to provide it.

In addition to raising capital for expansion needs, a number of developers had significant amounts of existing debt coming due that could not be conventionally refinanced. Even though a company was solvent, the lenders were requiring repayment in full, with no option to refinance. With so many lenders curtailing their lending, factory

²⁴ James T. Fergus and John L. Goodman, Jr., *The 1989-92 Credit Crunch for Real Estate* (Washington DC: Board of Governors of the Federal Reserve System, 1993).

outlet center developers were in a dilemma. As an illustration, Horizon Outlet Centers, Inc., a developer, owner and manager of factory outlet centers owned over 1.3 million square feet of space in five states in 1992, prior to its REIT IPO. It had shown net income of \$708,000 on total revenues of \$17.4 million. It owed about \$90 million in mortgage loans, was paying an average of 7.4% in interest, and about \$61 million (70%) was maturing in the next two years. Without the ability to refinance these obligations, the company could be forced to liquidate. Raising capital through a REIT would allow the company to pay down most of its debt. The projected dividend payment would be equivalent to about 7%, so the annual dividend component of the equity capital would be nominally less expensive than the traditional debt.

The debt problem for the factory outlet center developers had an additional facet. Again using Horizon as an example, of the \$90 million of mortgage debt, about \$32.6 million (36%) was recourse to the borrower (the company's owner). By going public and raising predominantly equity capital, the recourse debt would be retired, and the owner would receive about 1.3 million shares and/or exchangeable partnership units, at \$24 per share. Clearly, the removal of recourse liability would be an added benefit for any owner wishing to form a REIT. Similarly, when Chelsea GCA Realty went public in 1993, its vice-chairman relieved himself of \$52 million in personally guaranteed bank loans.²⁵ In summary, the needs for growth in development capacity as well as the need to clean up company balance sheets and senior management recourse liabilities were significant factors in selecting the REIT format to go public and own and develop factory outlet centers.²⁶

²⁵ Kris Hundley, "Penchant for Penny-pinching Led Ginsburg to Outlet Career", *Value Retail News* (April 1994), p. 120.

²⁶ Horizon Outlet Centers, Inc. IPO Prospectus, November 1, 1993.

Land & Construction Strategy -- Traditional Retail v. Factory Outlet Center

In the traditional retail real estate development process, developers initially try to control a site by optioning the land. Typically, the site has a desirable location, with easy access from a heavily traveled road, and close proximity to a residential population that has disposable income sufficient to be inclined to make discretionary purchases of retail goods. Specifically, a site may have a traffic count of 30,000 vehicles daily. There might be a critical population of households (20,000) within five miles with average household incomes of \$35,000. Purchasing surveys might show that the population spent a certain amount of money for apparel, groceries, etc. The specific parameters would vary depending on the site, but the developer and its prospective tenants would analyze these and other locational attributes. Because the site is desirable, it would demand a premium price. For example, in an area where residential lots cost \$50,000 per acre, retail development sites could cost a few times that. Because of the relatively higher land cost, a traditional developer would build the maximum amount of retail space possible in the first phase. Carrying costs of the land typically prohibit longer-term, phased retail developments.

During the site location process, the developer would solicit interest from so-called anchor tenants. An anchor tenant is a retailer that has strong name recognition that will draw shoppers to the center. In a regional mall, an anchor tenant would normally be a fashion-oriented department store, like Bloomingdale's. In a neighborhood center, an anchor could be a supermarket. An anchor tenant would often own its store and underlying land on the site, or enter into other joint agreements with a developer.²⁷ In any case, the anchor usually comprises less than 50% of the total center space. By obtaining a leasing commitment from an anchor tenant, a developer could increase chances of obtaining construction and permanent financing from traditional sources, like

²⁷ Editors, *Chain Store Age Executive*, "A Decade of Change: 1978-1987", (November 1988), p. 58.

banks, insurance companies, or pension funds. A key aspect to the land strategy in traditional retail development is that once a desirable site is controlled, the competition factor is often reduced. A desirable site is desirable in part because it is unique. Controlling a unique site can pre-empt a competing developer that is vying for the same anchor tenants.

In contrast, the land strategy of a factory outlet center developer begins with controlling a site that is not ordinarily unique or scarce. As noted in Chapter 1, factory outlet center locations are often 25-50 miles from major metropolitan areas, or a few miles outside of tourist destinations, at or near highway exits. Although there are examples of “closer-in” centers, the surrounding land is commonly available, and since its immediate surroundings are not usually urbanized, the land is relatively inexpensive. The primary trade area of a factory outlet center is often up to 200 miles. In this case, it is difficult to benchmark demographics as with a traditional center. In general, the land cost is not as great a consideration with a factory outlet center development as with traditional center development. Accordingly, once a factory outlet center site is controlled, there is still a large competition risk for a developer, since another developer could gain control of a nearby site with similar attributes. In this sense, it is often a factory outlet center developer’s existing relationship with tenants that is a competitive advantage in completing successful projects. If there are a number of developers with undifferentiated locations, a tenant could enter into agreements with any of them. In the industry this is often referred to as “exit-ramp” or “cut-off” risk. That is, the theory is that a developer could build an outlet center away from a metropolitan area, only to be “cut-off” by a subsequent development, closer in to the city. The fear is that sales could be diluted, or worse, eliminated by the newer center. This lack of differentiation in factory outlet center locations is a factor in obtaining traditional financing, as well. Lenders are reluctant to lend to a development that could be easily duplicated. However, a lender is often more comfortable lending to a developer with proven relationships with successful outlet tenants.

Due to the unique land aspects of the factory outlet center, the developer participates in on-going dialogue with a number of well-recognized brand manufacturers that can, and must, form a nucleus of the center. In that way, a developer can control a site and solicit interest from the critical tenants and financing sources.²⁸ While a traditional center developer could obtain financing with only an anchor tenant commitment, a factory outlet center developer usually has pre-leasing commitments for 70%-90% of the center's space, before it commences construction.²⁹

Because the land is relatively inexpensive in a factory outlet center development, and due to the competitive aspects noted earlier, a factory outlet center developer will often purchase more land than is initially necessary for a first phase of development. This provides for future expansion and can shield against competing developers. In addition, because customers travel longer distances to shop, they are inclined to stay longer.

Construction of the traditional center is designed to maximize the visibility of all stores. This helps to entice shoppers that are not familiar with the center. In contrast, because the factory outlet center is more of a destination, street visibility, while important, is not paramount. In addition, the so-called "sensitivity" issues regarding competition with traditional retailers mentioned in Chapter 1, make manufacturing retailers reluctant to use as much signage as traditional retailers. That is, a manufacturing retailer does not want to appear to be competing directly with traditional retailers in department stores or mall retailers. Therefore, construction of the factory outlet center is designed to create a pleasant shopping experience for the shopper that has traveled a longer than normal distance to shop. The factory outlet center itself is promoted as a value-oriented, brand-name shopping experience. As mentioned earlier, many factory outlet centers are located at, near, or on the way to tourist destinations. There is often a

²⁸ Interview with Perry Grueber, Horizon Outlet Centers, Inc., July 5, 1995.

²⁹ Interview with Perry Grueber, Horizon Outlet Centers, Inc., July 5, 1995.

theme to a center that shoppers can easily identify. For example, there is a factory outlet center in Medford, New Jersey, that is patterned after an old English country village, with ivy covered brick-face and cobblestone streets. Other centers have desert Western or Spanish villas themes, etc. While traditional centers can have themes, it is a characteristic more associated with outlet centers. Industry analysts have estimated costs of construction for the six factory outlet center REITs that range from \$60 to \$110 per square foot (including land), depending on the design prototype.³⁰ Because traditional centers are more often built on expensive sites, their costs are generally higher (\$100 to \$120 per square foot, including land). Thus, the land strategy for factory outlet centers has more risks associated with it in terms of competition, but it is less expensive, and can provide for more creative opportunities with design.

The next section on leasing and marketing discusses the opportunities and risks associated with factory outlet center developers' ability to create low-cost retail space.

Leasing and Marketing

As mentioned in the previous section, a traditional developer would obtain a commitment from an anchor (or anchors, depending on the center's size). Because the anchor tenant is a magnet for shoppers, it often would share in the equity of the property, pay a reduced rent, or obtain concessions from the developer in the form of store construction, or common-area maintenance reimbursements. Because an anchor tenant must invest significantly in a new location, it usually agrees to lease space for a relatively long period (up to 25 years). This provides the developer with a reliable, long-term income stream that can be pledged to a lender as security for financing. The remaining tenants, ("satellite", or "in-fill" tenants) are typically smaller in size and pay a larger

³⁰ Lee Schalop and Christopher J. Hartung, J.P. Morgan Securities, Inc., New York, Equity Research, Industry Update, "Outlet Center REITs: FFO up, Stocks Down in '94; Outlook Better in '95", February 13, 1995, p. 23.

proportional rent, sign shorter leases (anywhere from 2 to 10 years, with 5 years being most common).³¹ Often the developer negotiates future rent increases in a lease to provide some internal growth to the development to offset expected inflation, and to satisfy investors' expectations. Developers also try to obtain percentage rent agreements in leases that provide for increased rents if tenant sales exceeded a pre-determined "break point". This strategy allows developers to create a tenant mix that maximizes the sales of all tenants in the center, thus bringing additional percentage rent to the investors. In order to optimize the sales of the center, the developer often requires tenants to join merchant associations that provide regular collaborative promotions and advertising.

The marketing and leasing strategy for factory outlet centers is different in a number of respects. Leasing commitments are initially obtained from a number of high-profile brand-name manufacturers. If the perceived customer base is more upscale and fashion oriented, then tenants like Ann Taylor, Liz Claiborne, or other higher end manufacturers are recruited. Accordingly, if the customer base is less inclined to demand higher fashion items, manufacturers that produce so-called "100 year brands", like Levi's or Phillips Van Heusen will be solicited for leasing. Similarly, the proportion of apparel manufacturers to hard goods manufacturers varies by location. In many cases, the apparel and footwear tenants comprise at least 50% of the total factory outlet center.³² Ultimately, the successful factory outlet center developer must actively manage the leasing process to create a tenant mix that will maximize sales and then rental income. Because there is no anchor tenant, the factory outlet center developer must carefully

³¹ Averages of lease term lengths are notoriously difficult to obtain. Industry participants and analysts usually concur that five-year leases predominate.

³² Interviews with Jim Sullivan, Senior REIT Analyst, Prudential Securities, June 8, 1995, and Perry Grueber, Horizon Outlets, Inc., Director of Marketing, July 5, 1995. While there are not formal survey data available to confirm this, I have surveyed centers in the *Outlet Project Directory 1995*. I assumed each tenant space was equal in size and identified that the factory outlet centers allocate about 50% to 60% of their space to apparel manufacturers (not including footwear).

monitor its tenant mix to provide the critical merchandise mix that will consistently attract shoppers.

Because factory outlet centers frequently have lower land costs, the rents charged to manufacturer tenants can often be lower than those at traditional shopping centers. This also allows outlet tenants to sell their goods at discounts while maintaining adequate margins. Tenants in traditional shopping center venues pay between 15%-18% of gross sales in occupancy costs.³³ Tenants in factory outlet centers customarily pay less than 10% of gross sales.³⁴ As will be discussed later in the paper, those who tout the bright future for the industry cite the low occupancy cost as an indication of potential growth.³⁵

Like all retail center developers, factory outlet center developers must consider the credit quality of the tenant signing the lease. Factory outlet center developers must be certain that the entity that signs the lease is not simply a meagerly capitalized shell corporation with no assets, using the brand name of the larger, more financially secure manufacturing corporation. While this is a concern unique to factory outlet center developers, it has not been a problem yet.³⁶ Another concern are the “kick-out” clauses that appear in some leases; some manufacturer tenants reserve a right to terminate their lease or revert to paying percentage rent only if certain sales goals are not reached. Since the industry is generally on an upswing, this has not been a problem yet. Once a factory outlet center is fully leased and operating, there are a few issues that a developer must be concerned with that are unique to the factory outlet center REITs. The next section introduces and discusses these unique issues.

³³ Therese Byrne, “Factory Outlets Reach Turning Point in Growth,” *ICSC Research Quarterly* (Spring 1995), p. 18.

³⁴ Interview with Perry Grueber, Horizon Outlets, Inc., July 5, 1995.

³⁵ Therese Byrne, “Factory Outlets Reach Turning Point in Growth,” *ICSC Research Quarterly* (Spring 1995), p. 18.

³⁶ July 14, 1995, interview with Perry Grueber, Horizon Outlets, Inc.

Property Operation & Management

Traditional shopping center developers will either manage the property directly, or contract with a third-party management company. The factory outlet center developers organized as public REITs are so concerned with managing the growth of their centers' earnings that they manage all properties exclusively. Both traditional and factory outlet center developers are concerned with maximizing sales per square foot. A factory outlet center developer, lacking anchors that could provide a rich merchandise mix, must closely monitor tenant sales to make sure the tenant mix is appropriate for the current shopping trends. As mentioned earlier, while a conventional shopping center developer can rely to a certain extent on the anchor(s) to do this, the factory outlet center developer can not.

As traditional retailers have begun competing with factory outlet centers on pricing in the last couple of years, some factory outlet center developers have implemented price monitoring programs and produced consumer surveys, auditing tenant stores for appropriate pricing. Center managers will monitor price levels in stores and notify the tenants when their prices are deemed too high.³⁷ Clearly, factory outlet centers present additional operating challenges to management compared to conventional centers; they require the developers to become more involved in the merchandising and pricing policies of the tenants than traditional retail landlords.

Exit Strategy

Exit strategies for a traditional retail center would include selling the property to a pension fund, insurance company, or other investor that had a long-term investment requirement, possibly with a need for tax shelter. When deciding whether to sell, the tax effects on all the partners need to be considered. That is, the developer might be

³⁷ Linda Humphers, "Policing Pricing: Outlet Developers Try to Guard the Industry's Value Edge", *Value Retail News* (February 1995), pp. 14-20.

restricted by the limited partners' desire to avoid taking a taxable gain. The REITs that develop factory outlet centers, however, normally keep developed properties in their portfolio and try to increase the earnings of each property, through future expansions, or rent increases after initial lease expirations. To qualify as a REIT and enjoy its tax benefits, IRS rules encourage a REIT to hold properties for at least four years (a REIT must derive no more than 30% of its gross income from the sale or disposition of real property held for less than four years -- other than foreclosed property).³⁸ As noted in the discussion of land strategy and construction, acquiring and developing properties provides the earnings growth demanded by REIT investors. Selling properties thus far has not been the key to growth, partly due to the tax incentives to hold property and the current superior returns on development costs.

In summary, the planning and execution of factory outlet center development has its own unique risks and rewards that differ from conventional shopping center development. Because the factory outlet center developers that became REITs are such a significant part of the industry, the next chapter focuses on their role in the retail real estate investment landscape.

³⁸ National Association of Real Estate Investment Trusts, *REIT Fact Book: The REIT Concept* (Washington, DC, 1989), p. 36.

Chapter 3 -- The Factory Outlet Center in the Context of Real Estate Investment

Retail real estate investment capital traditionally came from a variety of sources prior to the recent surge in REITs and factory outlet center development. Among the investors for the highest quality properties were high net worth individuals, life insurance companies, mutual funds and pension funds. Investors understood that retail real estate was a relatively long term investment; that is, it could take a few years for a new shopping center to be built, lease-up, and begin producing a stabilized, distributable cash flow. High net worth individuals usually invested to receive cash flow from the investment, and/or shelter other income from current taxation by using non-cash depreciation deductions available under the U.S. Tax Code. After the Tax Reform Act of 1986, the IRS restricted passive investors' ability to offset other income with real estate investment losses. Therefore, real estate investments which emphasized current income became more appealing. In addition to the 1986 Act, the Clinton Administration in 1993 made some changes that enhanced investor interest in REITs. Among the changes was a rule that reduced the taxable gain on a portion of a REIT's annual dividend, effectively converting it from income to capital gain, significantly decreasing an investor's tax liability.³⁹ For example, if a REIT pays out dividends that exceed its net income (after non-cash depreciation and amortization deductions), which is common, then the portion of the dividend that exceeds the net income is treated as a return of capital to the investor. Instead of being taxed at a marginal income tax rate as high as 39.6%, the investor will be taxed when the stock is sold at the lower capital gains rate of 28% for that portion of the dividend that exceeds the net income. Effectively, the investor is able to defer taxation and then convert ordinary income into capital gain.

³⁹ Barry Vinocur, "Clinton Tax Boost Serves as Boon to REIT Salesmen", *Barron's* February 28, 1994, p. 60.

Insurance companies and pension funds traditionally were not as concerned with reducing their tax liabilities in real estate investments. Insurance companies and pension funds that invested in real estate were typically tax-exempt. They typically had long-term liabilities like life insurance policy payouts and future retirement benefits that required matching with long-term assets. In addition, these investors believed that shopping center income could provide some protection from inflation. Non-anchor tenant leases were often less than ten years long, and included rent increases to coincide with the Consumer Price Index (CPI). Therefore, the lease income could increase with inflation, either during the lease or at rollover.

In the 1970s and 1980s, investors did not traditionally rank liquidity as a primary investment objective. However, during the late 1980s and early 1990s, when financial institutions were being forced out of business and lenders nearly everywhere were compelled to cease lending, liquidity became a prominent concern with real estate investors. Limited partners holding partnership units, including life insurance companies and pension funds, could not sell their positions because many potential buyers needed financing. In addition, as mentioned earlier, the Tax Reform Act of 1986 limited the tax shields provided by real estate investment.

Investors then who wanted liquidity, current income and risks characteristic of retail real estate could theoretically invest in shares of a REIT that developed shopping centers or other retail product types. Since factory outlet centers represented a rapidly growing sector within the retail industry, investors could participate in that growth through investing in development-oriented factory outlet center REITs. Such investors could expect increasing dividends and significant share appreciation. In addition to these benefits, a REIT could potentially provide even a small investor with “geographic diversification”. By purchasing REIT shares in a few companies that owned properties focused in particular regions, an investor could spread geographic risk across economic regions. With the regional recessions in real estate in the late 1980s and early 1990s, geographic risk was an investor concern. Since the factory outlet center REIT portfolios

were initially concentrated in particular regions in the U.S., theoretically, an investor could reduce his return's volatility by investing in a few factory outlet center portfolios with different geographic concentrations.

The most compelling reason for investing in factory outlet center REITs, however, was their growth potential. In 1989, there were only 142 factory outlet centers in the U.S. By 1992, there were 249, representing a 20% annual increase over the three years. In that same period, the number of manufacturers in this rising industry went from 308 to 471, a 15% annual compound increase for the three years.

Factory Outlet Center REIT Growth

There are a number of measures that REIT managers, investors, and analysts use to benchmark performance and growth of the factory outlet center REITs. One of the most common is funds flow from operations (FFO). Because of the unique nature of a REIT's assets (almost all of which are depreciable), FFO is the analog of earnings per share for a typical corporation's stock. The technical definition of FFO according to the National Association of Real Estate Investment Trusts is as follows:

The National Association of Real Estate Investment Trusts defines FFO as net income (computed in accordance with generally accepted accounting principles), excluding gains (or losses) from debt restructurings and sales of property, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures. Adjustments for unconsolidated partnerships and joint ventures [are] calculated to reflect funds from operations on the same basis. The NAREIT White Paper dated March 1995 recommends that only depreciation and amortization uniquely significant to the real estate industry should be added back to net income to compute FFO, and notes that amortization of deferred financing costs is

specifically excluded from the category uniquely significant to the real estate industry.⁴⁰

As industry analysts have become more familiar with the new industry and the new generation of REITs as investment vehicles, there have been modifications to FFO as performance measure: FAD, or CAD, standing for “Funds, or Cash Available for Distribution”. Due to differing accounting policies among factory outlet center REITs, FAD is an attempt to identify the actual operating cash flow of the different REITs. For example, some factory outlet center REITs account for rents on a straight-line basis. That is, they consistently report in accordance with to GAAP, the average annual rents expected from the leases. For lease payments that increase over time, straight-lining rents overstates the current income and understates future income. FAD attempts to report the actual operating cash flows associated with such a lease (i.e., “unwind” GAAP reporting conventions), and to adjust for different policies regarding the accounting of capital expenditures such as tenant improvements, leasing commissions, replacement items, and some amortized financing costs. In order to determine FAD accurately, an analyst would require more detailed financial information than is generally available in annual reports and 10-Ks. Therefore, FFO is still the most widely used measure of performance for the factory outlet center REITs. In this discussion then, FFO is used as a comparative measure of performance.

Factory outlet center REIT developers can meet investor growth expectations primarily by increasing FFO per share. Put simply, there are two ways that the FFO per share can increase -- either via internal growth or external growth. These two methods of increasing FFO are described in the next section.

⁴⁰ Lee Schalop and Christopher J. Hartung, J.P. Morgan Securities, Inc., New York, Equity Research, Industry Analysis, “Still Driving an Hour to Shop: Outlet REITs Continue to Achieve Strong Growth”, June 13, 1995, p. 21.

Internal Growth

The typical factory outlet center REIT can generate growth in FFO by increasing rents at the time of lease renewals and/or including contractual rent increases within new leases. Frequently, the REITs have been able to obtain some cash flow growth in new leases. For example, average base rents for factory outlet chains have regularly increased since 1986. The factory outlet center REITs were largely responsible for the industry average increases. Tanger Factory Outlet Center noted that in 1992 average base rents for existing space increased about 13% over the expiring rate. Similarly, Chelsea GCA Realty noted in the first half of 1993, it re-leased space at an average base rent 28% higher than its previous year's average. Nonetheless, the large increases have tended to dissipate in the last two years. In 1993, industry average base rents increased 7% from 1992 to 1993, and only 4% from 1993 to 1994. However, this is not usually sufficient to satisfy the appetite of most Wall Street investors. Many of the institutional investors consider factory outlet center development risky and want to be rewarded commensurately (i.e., dramatically) for their investment.⁴¹ Following is an example (Table 3.1) of how a factory outlet center REIT could grow FFO internally. As will be seen in the next section, the growth is much less than that provided by new development.

⁴¹ Linda Humphers, "Retail Investor Finds the Outlet Industry Positively Charged", *Value Retail News* (April 1995, Vol. 13, No. 4), p. 44-46.

Table 3.1	
Internal Growth: Increasing Base Rents at Existing Center	
Prior to Rent Increase	
Share Price	\$20.00
# Shares Outstanding	10,000,000
Dividend Yield	8.00%
Dividend Yield Per Share	\$1.60
FFO	\$19,000,000
FFO per Share	\$1.90
Existing Center Size (S. F.)	150,000
Avg. Base Rent/Square Foot	\$17.00
Total Rent From Existing Center	\$2,550,000
Rent Increase on Existing 150,000 Square Foot Center	
Assume Annual 5% Increase on All Base Rents	
Amount of Rent Increase	\$127,500
Post-Rent Increase	
FFO	\$19,127,500
FFO Per Share	\$1.91
% increase in FFO/Share	0.67%

External Growth

The most effective way a factory outlet center REIT can increase its earnings is through new or expanded developments of centers. The six major factory outlet center REITs increased the total size (square footage) of their portfolios 30% from 1993 to 1994. As a group, they expect to increase another 26% and 19% in the next two years. Since the number of manufacturer tenants in the industry is expected to expand, the developers believe the new space will continue with a high occupancy rate.⁴² Combined with the growth associated with improvements in operating performance from existing centers, the rents generated from the new space provides the earnings growth that the Wall Street investors expect. Following is a prototypical example (Table 3.2) of how a factory outlet center REIT can increase its FFO through development of a new 150,000

⁴² Interviews with industry participants and analysts indicate that pre-leasing is still at least 70% for new and expanding centers (July 5 and 14, 1995 interviews with Perry Grueber, Horizon Outlets, Inc., and July 4, 1995, interview with Jim Sullivan, Prudential Securities)

square foot center. The cash on cost return figures (initial cash yields from new development), noted earlier, were chosen from industry analyst reports. The share price and FFO information were selected to be a rough composite of the factory outlet center REITs.

Table 3.2	
External Growth: 1st Phase Ctr. Development Accretive to FFO	
Prior to Development	
Share Price	\$20.00
# Shares Outstanding	10,000,000
Dividend Yield	8.00%
Dividend Yield Per Share	\$1.60
FFO	\$19,000,000
FFO per Share	\$1.90
Development	
Construction Cost/SF of Bldg. Including Land	\$100
Size of Development (Bldg. SF)	150,000
Total Dev. Cost	\$15,000,000
Cash on Cost Return for Development (%)	15.00%
Cash on Cost Return (\$)	\$2,250,000
Assume Finance Development Cost by Issuing New Shares at Market Price w/ 8% Dividend Yield	
# of New Shares Issued	750,000
New Equity Cost @ 8% Div. Yield	\$1,200,000
Post-Development	
Total # of Shs. After Development	10,750,000
FFO	\$21,250,000
FFO Per Share	\$1.98
% increase in FFO/Share	4.04%
Excess Cash After Paying Dividend to New Shares	\$1,050,000

Clearly, if this type of development were completed a number of times, the FFO growth would be substantial. As a REIT becomes larger, the development must increase commensurately to satisfy the growth expectations of REIT investors. As will be noted in Chapter 4, the question of diminishing growth prospects is hotly debated now in the industry.

The Fundamentals and Brief History

After the growth surge in 1993 and 1994 by the factory outlet center industry, and especially the REITs, investors obviously want to know how long such growth can be sustained, and whether the factory outlet center REITs warrant continued interest as high growth stocks. In order to understand the question more fully, one must review the recent history of the new REITs. Following is a table (Table 3.3) showing share prices and offering sizes of the six factory outlet center REITs that had their initial public offerings in 1993 and 1994. They are the focus of this chapter since they own and operate (in the U.S.) about 40% of the estimated 44.4 million square feet in the industry.⁴³

Table 3.3 **Outlet Center REIT IPOs**

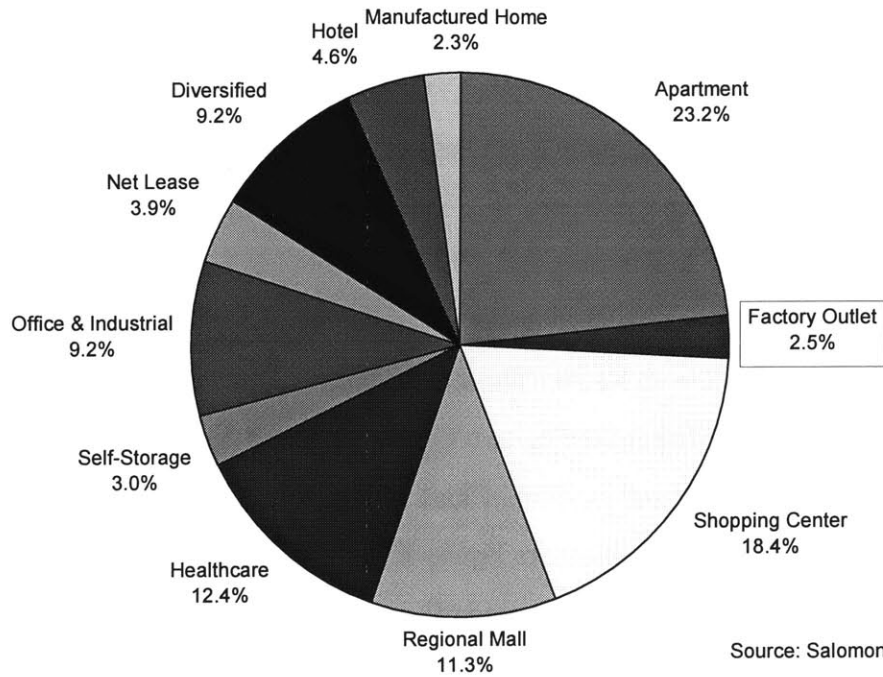
Outlet Centers	Offer Date	Amt. (\$ Mill.)	Offer Price Per Share (\$)	IPO Yield	Price 4/13/95 (\$)	Yield 4/13/95	% Price Change	Y-T-D Total Rtn.	Trail. 1 Yr. Total Rtn.
Tanger Factory Outlet Ctrs.	5/27/93	92.3	22.50	7.47%	23.25	8.60%	3.30%	0.89%	-24.26%
Factory Stores of America	6/2/93	140.2	23.00	7.83%	19.88	10.26%	-13.60%	-3.51%	-16.86%
McArthur/Glen Realty Corp.	10/13/93	212.1	21.50	6.74%	13.25	10.94%	-38.40%	-15.33%	-39.73%
Chelsea GCA Realty	10/27/93	254.1	27.50	6.69%	23.25	8.95%	-15.50%	-12.77%	-13.07%
Horizon Outlet Centers	11/1/93	201.6	24.00	6.96%	21.50	9.40%	-10.40%	-15.77%	-5.21%
Prime Retail	3/15/94	54.6	19.00	6.21%	12.50	9.44%	-34.20%	-3.43%	-31.19%
Average (Offering Thru 3/31/95)				6.98%	18.94	9.60%	-18.13%	-8.32%	-21.72%
Average Offering Size		\$159.2							
Total (\$) Raised (4/27/93-3/31/95)		\$954.9							

Source: Realty Stock Review April 24, 1995 Equity REIT IPOs: Sector Performance Survey

⁴³ Lee Schalop and Christopher J. Hartung, J.P. Morgan Securities, Inc., New York, Equity Research, Industry Analysis, "Still Driving an Hour to Shop: Outlet REITs Continue to Achieve Strong Growth", June 13, 1995, p.4.

Chart 3.4

Equity R.E. Securities - Public Equity Mkt. Capitalization by Property Type, 31 May 1995



Source: Salomon Brothers, Inc.

Together, the factory outlet center REITs at \$1 billion represent about 2.5% of the \$43 billion in total market capitalization for equity REITs in 1995 (Figure 3.4). As can be seen from the table, the new factory outlet center REITs promised a dividend yield of about 6%-8%. Analysts were predicting FFO per share ranging from about \$1.50 to \$2.40. The factory outlet center REITs ordinarily met their FFO projections and dividends. According to a recent analysis by J.P. Morgan, the factory outlet center REITs either met or surpassed estimates for the third quarter 1994. However, all the REITs suffered share price declines in 1994, partly due to a glut of IPO offerings, and partly due to their sensitivity to interest rates. Interest rates dropped during 1993. The 10-year Treasury note had dropped from 7.01% in December of 1992 to 5.87% in December 1993. During 1994, however, interest rates on the 10-year U.S. Treasury Note increased from 5.75% in January to 7.96% in November.⁴⁴ In addition to the general fall in share

⁴⁴ Federal Reserve Bulletin, Board of Governors of Federal Reserve System, Washington, DC.

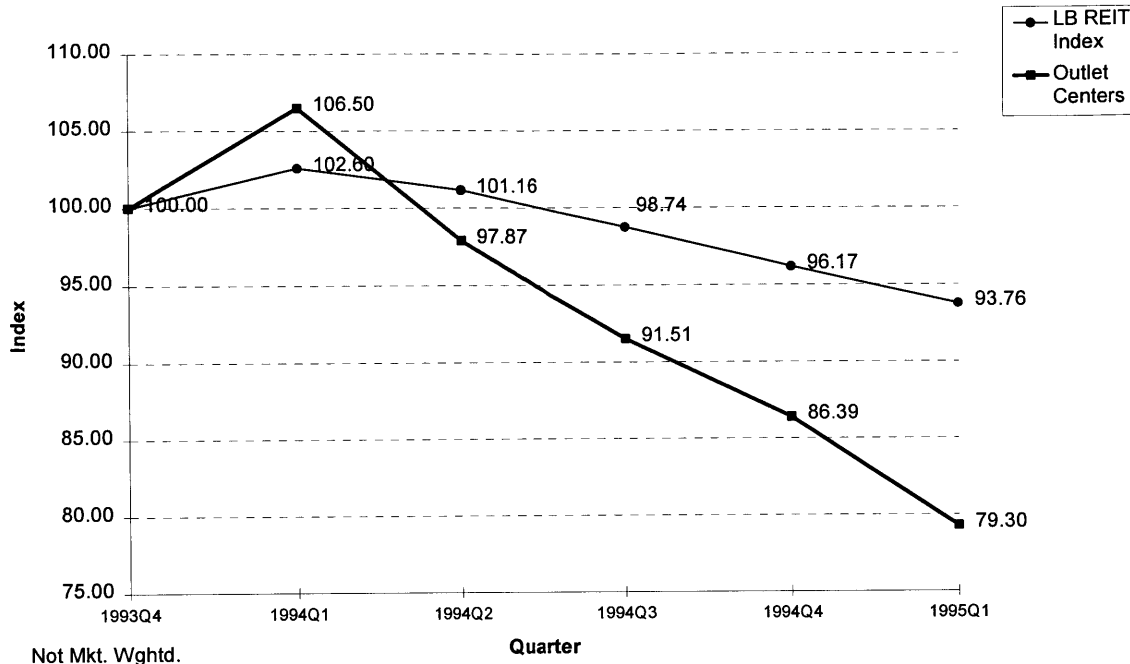
prices for all REITs, the factory outlet center REITs were negatively affected by one company's performance. McArthur/Glen Realty had its initial public offering in the Fall of 1993. Its share price was \$21.50. Its price had increased to \$28.25 by March of 1994. However, the company missed its pro forma FFO projection for the fourth quarter of 1993. The occupancy in the company's centers dropped from 96% to 93%. In the second quarter of 1994, management announced that instead of delivering one million square feet of space in 1994, it would deliver only 175,000 feet. 1994 FFO estimates were dropped from \$1.60 to \$1.52 per share by REIT analyst Lee Schalop of J.P. Morgan. He dropped his 1995 estimate to \$1.80 from \$2.10. The share prices dropped to about \$17 by the second quarter of 1994.⁴⁵ The following two figures (Charts 3.5 and 3.6) show how factory outlet center REITs fared in 1994. Chart 3.5 shows the factory outlet center REITs compared to the Lehman Brothers Equity REIT Share Price Index. While the equity REITs as an investment class dropped 6% in share price, the factory outlet center REITs fared even worse, dropping nearly 20% (on an indexed basis). Chart 3.6 shows indexed monthly total returns of the equity REITs, the S & P 500 and the factory outlet center REITs. While the S & P 500 and all equity REITs showed a slight increase during 1994, the factory outlet center REITs clearly did not perform for investors. As a sub-sector, factory outlet center REITs averaged a -6.58% total return in calendar year 1994.⁴⁶

⁴⁵ Peter C. DuBois, "Bargain Mall? Price of Outlet REIT Takes a Big Markdown", *Barron's*, June 27, 1994, p. 15.

⁴⁶ Jim Sullivan, Senior REIT Analyst, Prudential Securities research, included in an article by Kris Hundley, "Outlet REITs' FFO Growth Expected to Beat Other Retail Sectors in 1995", *Value Retail News* (March 1995), p. 63.

Chart 3.5

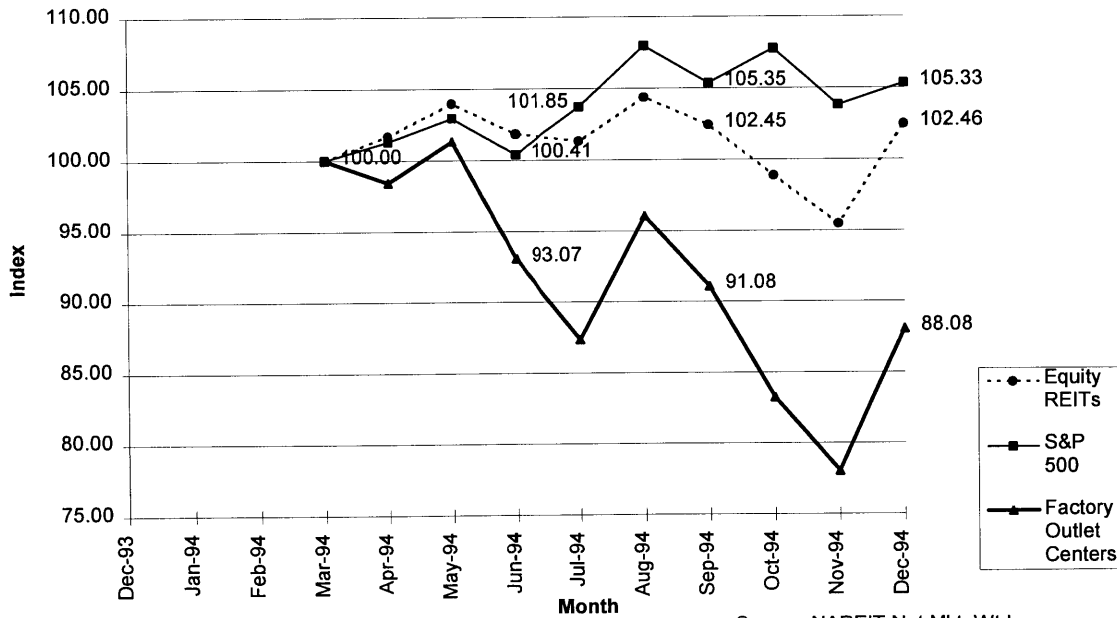
Factory Outlet Index (Share Price): 12/30/93 = 100



Healthcare REITs are not included in LB REIT Index Source: Lehman Bros. Equity Research, and SNL Securities, Inc.

Chart 3.6

Total Monthly Return Index, Apr.-Dec. 1994: All Equity REITs, S & P 500, Factory Outlet Ctr. REITs



Chapter 4 -- The Future of Factory Outlet Center REITs

Despite the poor performance of the shares in 1994, many investors project a bright future for the industry and, hence, their investment in factory outlet center REITs. The future of the factory outlet center REITs, however, is the subject of constant debate. While it is impossible to predict the future, this section will explore the various arguments advanced on both sides of the growth issue. Some predict that the factory outlet REITs have already “hit a wall” with respect to their growth. Others see a termination of growth in two to five years. This section will summarize certain long-term predictions regarding when the growth will stop. Finally, I will list critical factors for the future success of the factory outlet center REITs and the factory outlet center industry. Without these factors, the industry could become a passing fad for consumers, developers and investors. With these factors, the industry will remain a viable part of the retail, development and investment communities.

Two seminal questions facing factory outlet REIT investors today are:

- 1). Are factory outlet center REITs trading at an “unfair discount”, or are investors accurately assessing the risk and growth prospects of this new, unproven industry?
- 2). Where will it all end? When will saturation occur, and abnormal growth cease?.

I will review the arguments on both sides of the questions. First I will review the arguments projecting a positive outlook for investment. Then I will summarize arguments that have arisen to suggest a more negative viewpoint.

Those who feel that factory outlet center REITs trade at an unfair discount basically argue that FFO per share has grown in the past, and will continue to grow, based

on the developer's expansion plans in 1995 and 1996. They argue that investors are currently misperceiving the long-term strength of outlet centers. For the factory outlet center REIT sector, First Call estimates of FFO per share show projected increases of about 18% from 1994 to 1995, and 13% from 1995 to 1996⁴⁷ (Table 4.1). More bullish estimates from Prudential Securities project nearly 23% in FFO growth from 1994 to 1995 (Table 4.2), compared with about 9% for the more mature regional shopping center and strip center sectors.

Table 4.1 **FFO Per Share Growth Estimates**

Company	(\$) 1994 FFO/Share	(\$) 1995 FFO/Share	Growth Est.	(\$) 1996 FFO/Share	Growth Est.
Tanger Outlet Centers	2.23	2.80	25.56%	3.13	11.79%
Horizon Outlets	2.12	2.62	23.58%	3.02	15.27%
Prime Retail	0.69	1.44	N/A	N/A	N/A
Chelsea GCA Realty	2.04	2.52	23.53%	2.96	17.46%
McArthur/Glen Realty	1.52	1.72	13.16%	1.89	9.88%
Factory Stores of America	2.36	2.44	3.39%	2.66	9.02%
Mean	2.05	2.42	17.82%	2.73	12.89%

Source: First Call Consensus Estimates, As of June 1995

⁴⁷ First Call Consensus Estimates, June 1995.

Table 4.2**1995 Projected Growth for Outlet Center REITs**

Company	Price a/o 12/31/94	1995 Price/FFO Multiple	Multiple-To- Growth Ratio	FFO Current Yield	Growth 1994-1995
Tanger Outlet Centers	\$23.50	8.0	0.23	7.83%	34.1%
Horizon Outlets	\$26.13	9.9	0.38	7.04%	26.2%
Prime Retail, Inc.	\$13.25	9.2	0.36	8.91%	25.2%
Chelsea GCA Realty	\$27.25	11.0	0.46	6.75%	24.0%
McArthur/Glen Realty	\$16.50	9.5	0.62	8.73%	15.2%
Factory Stores of America	\$21.63	7.9	0.65	8.88%	12.2%
Mean (Not Mkt. Wghtd.)	\$21.38	9.3	0.45	8.02%	22.8%

Source: FFO estimates from Prudential Securities, Inc., where available; otherwise First Call consensus estimates.

Those predicting continued growth for the industry cite the expansion plans for the six REITs. In 1995, the entire industry expects to expand its 44.4 million square foot inventory by 11.6 million square feet, or 26%. In 1996 there are plans for another 23.1 million square feet, or an additional 41%.⁴⁸ The REITs account for 11% of the industry's growth in 1995 and 8% in 1996. They expect to increase their own existing inventory by 26% in 1995 and 19% in 1996.⁴⁹ The FFO growth is expected to come from the rents on the new space to be built. The pro-industry argument is that the increasing number of manufacturer tenants joining the factory outlet center retailing business (as noted in Chapter 1) combined with the increasing rents on new space observed recently (as seen in Chart 4.3 below), will fuel the earnings growth. Industry analysts have noted that the new planned expansions for 1995 are at least 70% pre-leased.⁵⁰

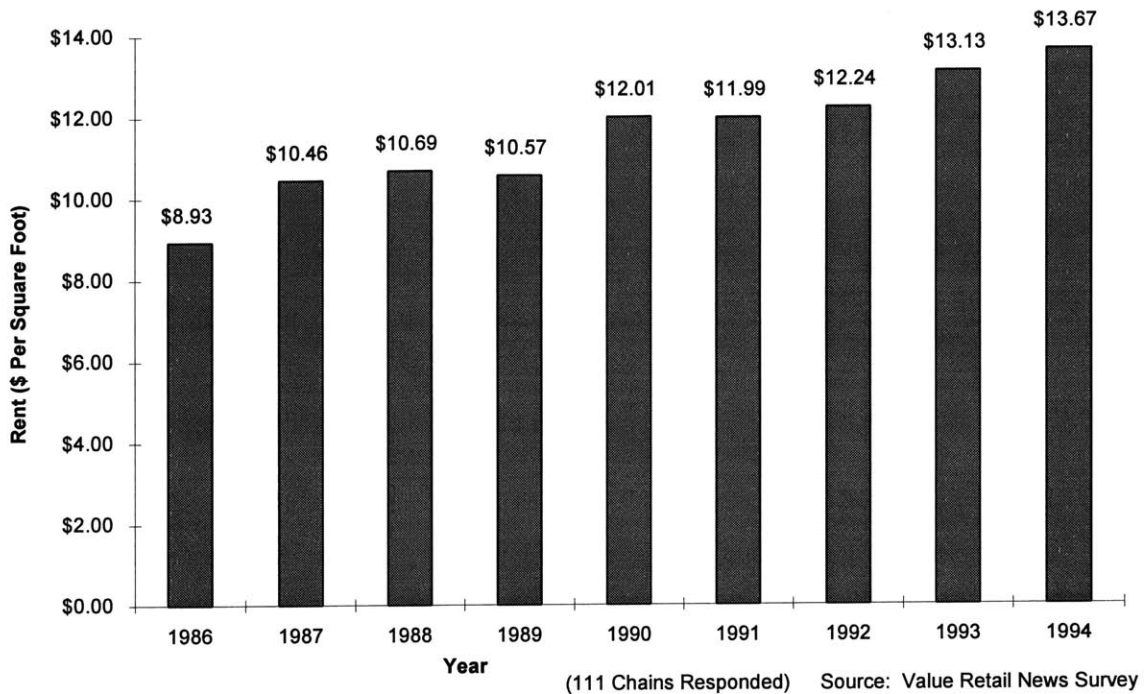
⁴⁸ Kris Hundley, et al., *Outlet Project Directory*, (Clearwater, Florida: Value Retail News, 1995).

⁴⁹ Inventories and growth projections provided by Lee Schalop and Christopher J. Hartung, J.P. Morgan Securities, Inc., New York, Equity Research, Industry Analysis, "Still Driving an Hour to Shop: Outlet REITs Continue to Achieve Strong Growth", June 13, 1995.

⁵⁰ July 4, 1995, interview with Jim Sullivan, Senior REIT Analyst, Prudential Securities.

Chart 4.3

Average Base Rents Per Square Foot For Outlet Chains, 1986-1994



Another branch of the pro-growth argument is that the factory outlet centers account for such a small portion of the retailing market share that they have plenty of room to grow before they reach a plateau. For example, factory outlet retail sales in 1994 represented only 12% of total apparel value retail, and only 4% of total U.S. apparel retail.⁵¹

The retailing strategy of providing branded merchandise at deep discounts via factory outlets is considered a winning one by those promoting the growth argument. In contrast, they consider the off-price retailing channel (Marshall's, TJ Maxx) as confusing to consumers. The clear delineation of in-season, branded merchandise in department stores and traditional mall stores, combined with out-of-season, or less popular inventory in factory outlets is easier for consumers to understand. In off-price outlets, because

⁵¹ NPD Research Topline Report, January-March 1995, Consumer Research Surveys, NPD Research, New York.

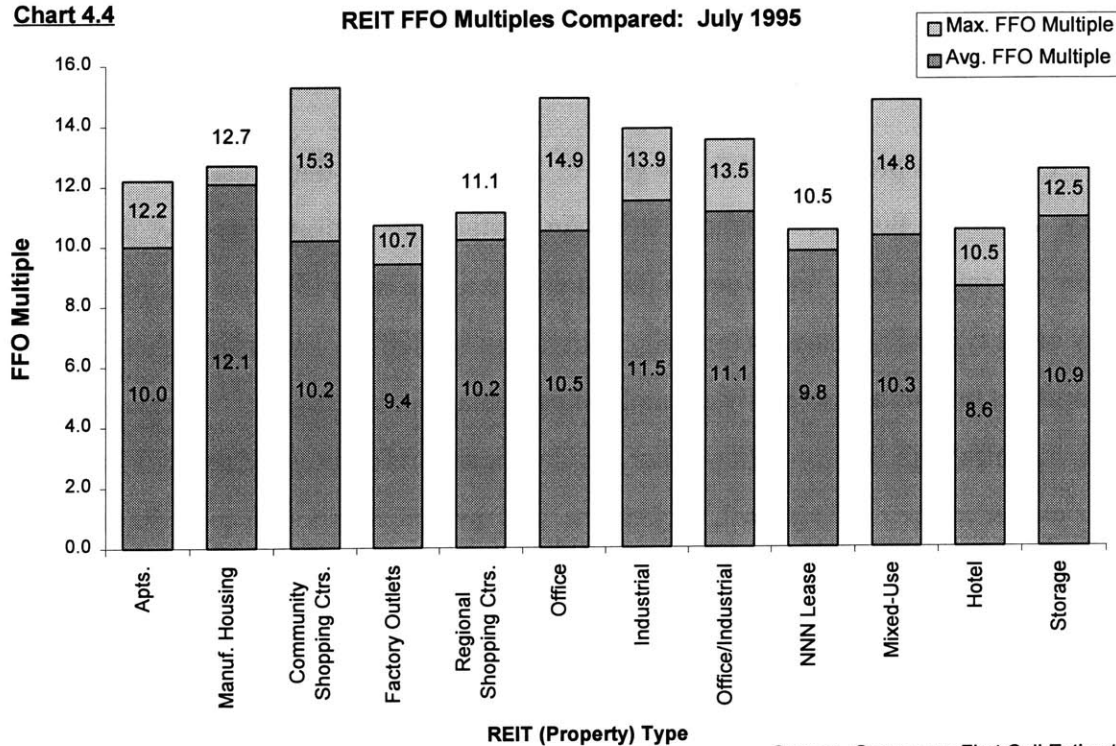
many brands are inconsistently presented together, the consumer does not clearly perceive the value of the branded merchandise.

Finally, the promoters of future growth do acknowledge that outlet development is risky. Although the data is difficult to obtain, participants and analysts have noted that cash on cost returns from initial development phases range from 13% to 15%, higher than on any other type of investment typically undertaken by REITs. Expansion phase development returns are normally a couple of percentage points higher.⁵² The argument here is that although factory outlet center development is risky, most of the REITs have met or exceeded their FFO growth projections, and their shares should, accordingly, trade at a higher multiple (“multiple expansion”) than they currently do. As of June 1995, the factory outlet center REIT sub-sector shares had the lowest FFO multiples of all other types of REITs, except hotels. Their FFO multiple averaged 9.4, while most other types of REITs traded at multiples averaging 10 or more (See Chart 4.4).

⁵² July 14, 1995, interview with Perry Grueber, Horizon Outlets, Inc. Also, Lee Schalop and Christopher J. Hartung, J.P. Morgan Securities, Inc. June 13, 1995 Industry Analysis, “Still Driving an Hour to Shop: Outlet REITs Continue to Achieve Strong Growth”; and Green Street Advisors, Inc., January 1994, “The Factory Outlet Center REITs”.

Chart 4.4

REIT FFO Multiples Compared: July 1995



Source: Consensus First Call Estimates

In summary, those predicting a bright future for the factory outlet center REITs expect that development of successful sites will continue, bringing the manufacturer tenants increased sales and the developers more rent. In the next section, a number of arguments are offered to suggest that the growth in factory outlet center REITs has already peaked. The arguments presenting a negative outlook for the factory outlet center REITs focus on a number of indicators projected to weaken the growth story.

The negative arguments presented largely in “street” research are not in the form of a coherent hypothesis, but are a list of negative signs that, taken together, could convince investors to view factory outlet center REITs as a limited investment opportunity for the future. They can be loosely grouped into three categories: Outlet Retailing Economics, Development Strategy Issues, and Financial/Capital Market Issues.

Outlet Retailing Economics

Retail Sales Down

A point most frequently encountered is that retail sales in the U.S. are either decreasing or growing only slowly in a number of merchandise areas, but especially in the all-important apparel category. In fact, growth in apparel retail sales, which comprise about half of factory outlet center sales (Chapter 1) has been down (see Table 4.5).

Table 4.5				
Estimated Retail Sales 1993-1994, by Major Store Type				
	Sales in \$millions			
	1994 Sales	Share of 1994 Sales	1993 Sales	% Change, 1993-1994
GAFO Stores				
General Merchandise	284,950	12.7%	265,400	7.4%
Apparel & Accessories	107,990	4.8%	107,040	0.9%
Furniture & Furnishings	128,720	5.7%	117,340	9.7%
Other GAFO	87,040	3.9%	81,620	6.6%
GAFO Subtotal	608,700	27.2%	571,400	6.5%
Convenience Stores:				
Grocery	381,900	17.1%	369,545	3.3%
Other Food	23,470	1.0%	24,410	-3.9%
Food Subtotal	405,370	18.1%	393,955	2.9%
Drug	83,040	3.7%	79,920	3.9%
Convenience Subtotal	488,410	21.8%	473,875	3.1%
Home Improvmt. & Bldg. Supplies				
	129,430	5.8%	113,595	13.9%
Home Improvmt. & Bldg. Supplies Subtotal				
	129,430	5.8%	113,595	13.9%
Shopping Center-inclined Total				
	1,226,540	54.8%	1,158,870	5.8%
Automobile Dealers	522,250	23.3%	448,090	16.6%
Gas Stations	136,870	6.1%	134,240	2.0%
Eating & Drinking Places	224,400	10.0%	212,740	5.5%
All Other	129,340	5.8%	132,430	-2.3%
Total Retail Sales	2,239,400	100.0%	2,086,370	7.3%

GAFO: General Merchandise, Apparel, Furniture & Home Furnishings,
and All Other Merchandise Related to Retail Classification
Source: U.S. Dept. of Commerce and ICSC.
Taken from ICSC Research Quarterly, Volume 2, No. 1, Spring 1995, p.6

However while retail sales in all sectors have been flat in recent years, there is evidence that factory outlet centers are outperforming other types of retailers for apparel sales. Information from NPD Research's consumer survey suggests that while sales increases have been weak overall for apparel (dollar volume increases of 5.3% and 4.9% for 1993 and 1994), factory outlet center apparel sales have grown more rapidly, at 22.6% and 8.7%. (See Table 4.6)

	Table 4.6 U.S. Apparel Sales Volume (\$Millions)				
	Jan.-Dec.			% Chg. 93/92	% Chg. 94/93
	1992	1993	1994		
Total	122,447.0	128,974.0	135,256.0	5.3%	4.9%
Dept Stores	28,802.0	29,246.0	30,686.0	1.5%	4.9%
Top 50	22,808.0	23,394.0	25,429.0	2.6%	8.7%
Other Dept.	5,994.0	5,852.0	5,257.0	-2.4%	-10.2%
Spec Stores	22,682.0	23,255.0	23,813.0	2.5%	2.4%
Specialty Chains	11,212.0	11,898.0	13,485.0	6.1%	13.3%
Other Spec	11,450.0	11,356.0	10,327.0	-0.8%	-9.1%
Major Chains	18,826.0	19,657.0	20,684.0	4.4%	5.2%
Disc Stores	24,315.0	26,329.0	28,363.0	8.3%	7.7%
Off-price Retail	8,158.0	8,650.0	9,473.0	6.0%	9.5%
Factory Outlets	3,791.0	4,649.0	5,052.0	22.6%	8.7%
Direct Mail	6,890.0	7,697.0	7,662.0	11.7%	-0.5%
Other Outlets	9,003.0	9,481.0	9,520.0	5.3%	0.4%
Warehouse Clubs	1,016.0	1,057.0	1,028.0	4.0%	-2.7%
Food and Drug	1,202.0	1,154.0	1,108.0	-4.0%	-4.0%
Other Misc.	6,785.0	7,270.0	7,384.0	7.1%	1.6%

According to data from NPD Research, 900 West Shore Road, Port Washington, NY 10050
Categories: Accessories, men's, women's, children's, infant's, tops, bottoms, outer & swimwr., lingerie, men's undergmnts, women's suits, men's & women's tailored clothes

Price Advantage Eroding

Another argument against growth is that the price advantage over traditional retailers has eroded for the outlet retailers. While it is not rigorously documented, industry experts have agreed that the focus of many traditional retailers has shifted more toward price.⁵³ This could, in turn, squeeze the margins that outlet retailers now enjoy. On the other hand, the current average occupancy cost for factory outlet center retailers versus a traditional regional mall retailer is shown in Table 4.7. Industry participants and analysts have noted that there is considerable room for this margin to erode before the

⁵³ July 14, 1995, interview with Hank Hershey, retail consultant. Also, Tom Kirwan, Value Retail News interview of Ed Johnson, of Johnson Redbook, "Retail guru Ed Johnson Sees Brighter Apparel Days Ahead This Year", *Value Retail News*, (April 1995), p. 62. Also, Value Retail News interview with Kurt Barnard, publisher of Barnard's Retail Marketing Report, "Barnard: Dept. Store Consolidation Puts Pressure On Outlet Retail Industry", *Value Retail News* (March 1994), p. 39.

FFO growth in factory outlet center REITs is affected.⁵⁴ Even Barry Ginsburg, vice-chairman of Chelsea GCA Realty acknowledges that price deflation is an issue, but the manufacturer retailers will have to cut their margins before the factory outlet center developers do: “If price deflation continues, the outlet retailers are going to have to sharpen their pencils. They’re going to have to take lower margins to stay competitive.”⁵⁵

Table 4.7

Occupancy Costs Compared		
Outlet Tenant Costs	Factory Outlet Store	Regional Mall Store
Avg. Sales/Square Foot	\$259	\$250
Gross Margin	35%-45%	30%-40%
Occupancy Costs	5%-7%	12%-18%
Operating Margins	10%-12%	5%-7%
ROI for Store Openings	25%-36%	15%-25%

Source: T. Byrne, in ICSC Research Quarterly, Spring 1995

Development & Occupancy Costs Rising

Another argument that growth is slowing in the industry is that occupancy costs are rising for manufacturer tenants. With traditional mall tenants and department stores consolidating and competing on price, outlet retailers’ margins will be squeezed (especially if occupancy costs continue to rise, as mentioned in the prior section), ultimately reducing rental income and FFO growth for the factory outlet center REITs. The limited survey results show that average gross rents, (base rent plus CAM, Marketing, Insurance, Taxes and Percentage Rent) for retailers has increased slightly in the past few years from \$16.59 per square foot in 1991 to \$19.80 in 1994 (See Chart 4.8).

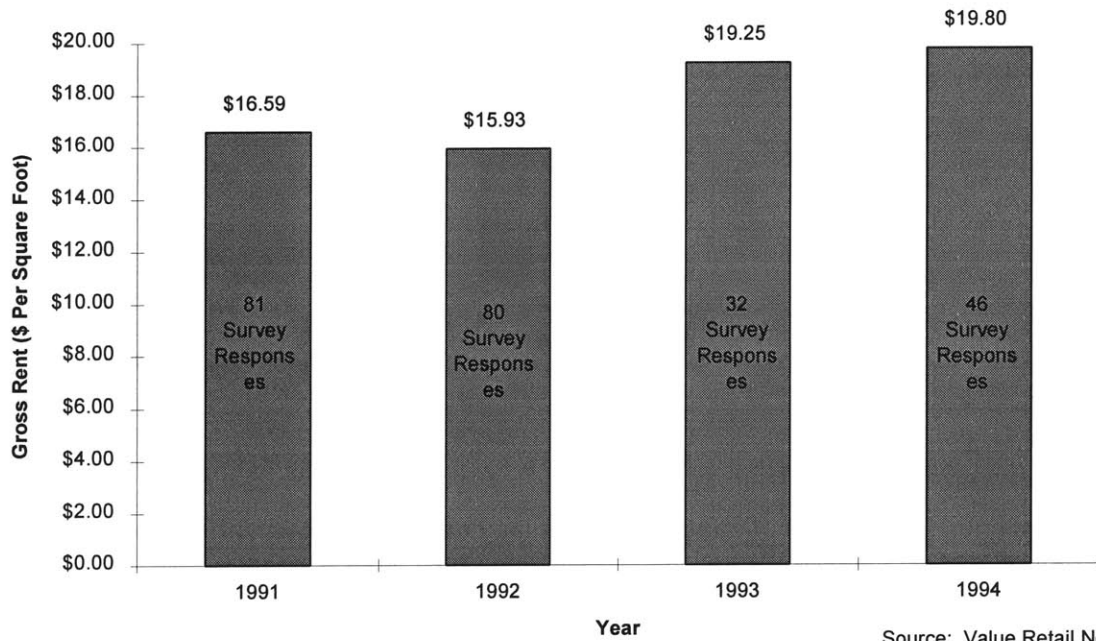
⁵⁴ July 5, 1995, interview with Perry Grueber, Horizon Outlets, Inc., and July 4, 1995, interview with Jim Sullivan, Senior REIT Analyst, Prudential Securities, Inc.

⁵⁵ Sharon Edelson, “Once a Poor Relation, Outlets Go Legit -- And Trouble Looms”, *Women’s Wear Daily*, April 4, 1994, p. 8.

However, since gross rent includes percentage rent, stores with higher rent may be performing better. Another survey by Value Retail News indicates that tenant occupancy costs as a percentage of sales has not increased in the past few years, but has maintained a level close to 9%. (See Chart 4.9).

Chart 4.8

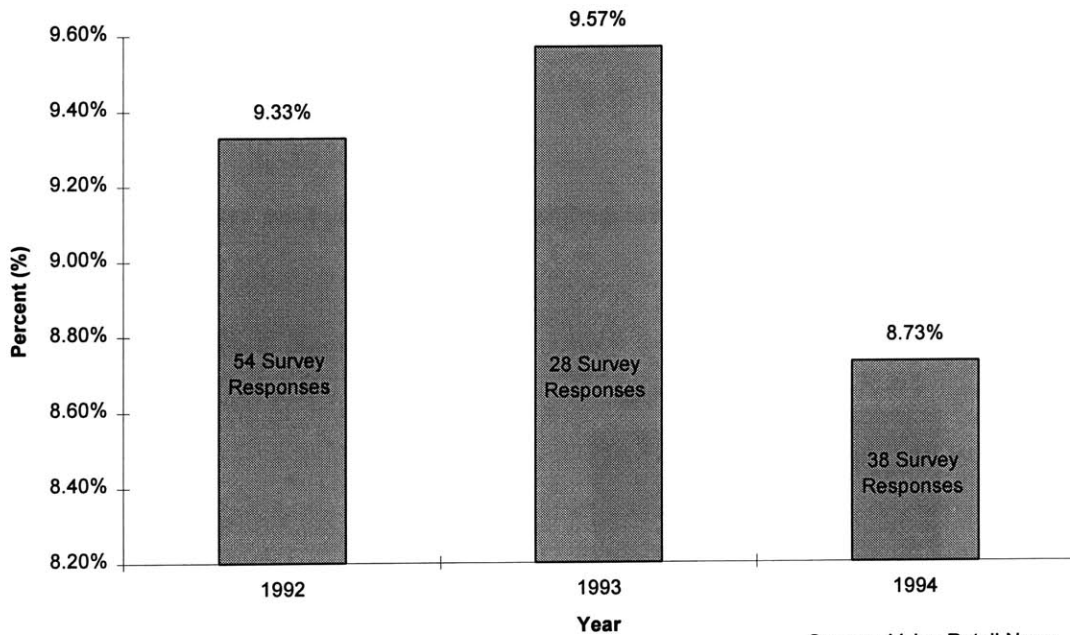
Outlet Retailers Average Gross Rent Per Square Foot, 1991-1994



Source: Value Retail News

Chart 4.9

Factory Outlet Center Tenant Occupancy Costs as Percent of Sales, 1992-1994



Source: Value Retail News

A related argument is that cost structure is on the rise for the factory outlet center REIT developers. Examples of increasing costs are land costs and tenant improvement costs. There is little formal research to indicate this, but if true, then developers would have to either pass those costs on to the tenants, or reduce their cash on cost returns. As noted in the prior section, an opposing view suggested there is room for occupancy costs to increase before REIT FFO growth is negatively affected.

Customer Boredom On The Rise

Industry analysts have noted that customer boredom is on the rise. As the traditional retailers compete more aggressively on a price basis, consumers can be tired of driving an hour to find that factory outlet discounts are not sufficient. If shoppers stop frequenting the factory outlet centers, then sales will stop growing. Eventually, growth in rent and FFO would stop. There is anecdotal evidence and inconclusive survey data on both sides of the customer boredom issue. Defining what constitutes sufficient discount

and customer boredom is problematic. Sales, however, are a good proxy for determining customer boredom. Sales have continually increased, as noted in Chapter 1. Potential customer boredom is a constant problem for any industry. It is not unique to factory outlet centers, but the investment community is wise to follow the issue.

New Tenants Are Not Credit Tenants & Other Tenants Are Exiting Market

Another negative argument offered is that the new manufacturers entering the factory outlet center retailing arena are not “credit” tenants (i.e., they do not have an investment grade rating on their debt or equity securities). There has been, however, no formal study compiled to verify this. There have been increasing numbers of manufacturers participating in the market. If they are in fact, not credit tenants, then this could affect the risk profile of the factory outlet center REITs. However, it may not necessarily affect growth. Related to this argument is the assertion that some tenants are leaving the market. While it is true that some retailers have closed certain stores, or merged with other manufacturing retailers, it is not clear that this will affect growth. Industry participants have noted that after a particular store leaves, the space can occasionally be rented to a new tenant at a higher rate than the departing one.⁵⁶

First Term Leases -- Rollover Risk

Much of the existing inventory in the industry has been built in the past five years. Of the 311 factory outlet centers open as of January 1995, nearly one-third have opened in the past four years. Therefore, a good portion of the leases in place now are first term leases. When these leases come up for renewal, if sales are still low, or if tenants perceive a dilution of the outlet retailing market, then they will negotiate for lower rents, or rents growing at a slower rate. A worst-case scenario for investors would be if tenants

⁵⁶ Kris Hundley “Outlet Centers Shine at Lease-Renewal Time,” *Value Retail News*, March 1993, pp. 14, 16-18. Also, Company annual reports.

did not renew. Vacant factory outlet centers are worth very little. As explained in Chapter 2, the land under many of these centers is not worth much unless it is producing growing rents. This would clearly affect the FFO growth prospects for the REITs. However, rents have been increasing up to this point, as noted earlier in Charts 4.3 and 4.8.

Development Strategy Issues

Only 2nd Tier Sites Remain

A third indicator of slow growth is presented as follows: The best sites for factory outlet center development have been taken, and only second tier sites remain. Presumably, the second tier sites are less profitable or not profitable at all. This argument has not been presented in a detailed format. It is not clear where the first tier sites are, or what makes a first tier site a first tier site. In fact, of the sites that have been developed, there are many expansions planned. Industry participants and analysts agree that expansion phases are often more profitable, in part because infrastructure investments have been sunk and also tenants are willing to pay more in rent for a proven location.

Exit Ramp Risk

Supporters of the negative arguments point to the “exit ramp”, or “cut-off” risk, mentioned in Chapter 2. One example of this risk was presented by Green Street Advisors in its January 1994 research “The Factory Outlet REITs”.⁵⁷ In New Braunfels, Texas, a 250,000 square foot center opened in 1988 between San Antonio and Austin on route I-38. In 1990, another developer opened a center within a few exits on the same route and expanded it to 362,000 square feet. Also in 1990, another developer opened a

⁵⁷ John Lutzius et al., “The Factory Outlet Center REITs”, Green Street Advisors, Inc., Newport Beach, California (January 1994).

140,000 square foot center nearby. According to Green Street Advisors, the area has a strong tenant mix. Although they did not have access to sales results, their hypothesis is that profit margins have been diluted. This is a reasonable argument. It is somewhat unique to factory outlet centers due to their location. However, it is not clear that it will slow the entire industry's growth to an unacceptable level.

Planned Expansions of Existing Space Outpaces New Development

Some have pointed to the current focus on expanding existing centers, rather than building new as a sign of weakness in the industry. In fact, for the six factory outlet center REITs, 1995 projection for new space (2.7 million square feet) is slightly more than for planned expansions (2.3 million square feet). For 1996, the planned new construction and expansions are about the same at 2.3 million square feet. Nonetheless, as noted earlier in this chapter, first phase development can be less profitable than expansion of existing centers. Therefore, to promote growth for shareholders, one could argue that developers are undertaking the most optimal development at this time when they choose to expand centers.

Incidence of Closer-in Centers A Sign of Weakness

Another argument is that the incidence of "closer-in" centers is a sign of weakness in the industry. The thrust of this argument is that weak factory store sales have compelled outlet retailers to move closer to population bases to increase their share of the market. As mentioned in Chapter 1, while there are incidences of new centers closer to traditional centers, it is not an industry wide trend. In fact, analysts and industry participants have suggested that closer-in centers are an efficient way to optimize retailing for manufacturers. As mentioned earlier, the consumer can be conditioned to shop for full price, in-season goods at the traditional, more convenient, malls and department stores. For a slightly less convenient, but bargain-filled opportunity, the consumer can shop at a factory outlet for less popular or trendy goods that still bear the

favorable brand name. It is difficult to quantify the value of these arguments, but they should be considered.

International Development Is A Sign of Weakness

Some industry analysts have pointed to the recent international developments as a sign of weakness in the U.S. markets. The amount of international development has by no means supplanted domestic development. According to the 1995 Outlet Project Directory, existing international projects listed amount to a total area of 1 million square feet. There are plans for another 3 million square feet by 1997. The REITs are responsible for less than 1 million square feet or 22% of the expected 4 million square feet by 1997. This represents less than 2% of the existing factory outlet center space in the U.S. today, and even less by 1997.⁵⁸ It is possible that international development is currently more profitable than domestic development. Another reason developers may be entering the international market (mostly European), is that they are taking a long term view. European zoning regulations are generally more onerous than those in the U.S., slowing the development period. The move to European markets may be simply good long-range planning. In any case, the U.S. factory outlet center REITs are often entering into joint ventures with only nominal investments, and not betting the future of their companies on the international markets.⁵⁹

Financial/Capital Market Issues

Capital Market Pressure to Overbuild

The next point encountered is that capital market pressure to continue growing will force the REITs to overbuild, creating losing projects. This is difficult to analyze,

⁵⁸ Kris Hundley et al., *Outlet Project Directory* (Clearwater, Florida: Value Retail News, 1995).

⁵⁹ Chelsea GCA Realty, Inc., 1994 Annual Report, p. 4.

because it is a hypothetical argument. However, the successful REIT developers have built track records of developing with 70%-90% pre-leasing. If the locations become weaker, presumably, outlet retailers will signal this by refusing a forward commitment. This would be a signal of overbuilding. If the industry reaches a point of saturation, presumably, investors would realize the situation and reward the companies that have successful income records. That is, the successful factory outlet center REITs could be viewed as less risky and trade at higher multiples. At this point, it is premature to speculate, but while overbuilding does not appear to be a problem yet, investors alert to its signs could avoid losses.

Not Enough Capital to Develop -- Threatening Debt to Equity Ratios

Another potential signal of the end of the growth story has been the conclusion that the factory outlet center REITs do not have enough capital to finance future expansion, causing debt risk (i.e., over-leveraging). That is, using average costs of development, Lee Schalop and Christopher Hartung have calculated that the REITs have only enough capital available to finance their planned growth for 1995. They argue that 1996 expansion must be financed with debt. The argument continues that this would increase the debt to market capitalization ratio to potentially unacceptable levels for Wall Street investors. When the factory outlet center REITs went public, there was an unofficial consensus among industry analysts that a 40% debt to market capitalization ratio would be a threshold to stay below. Most of the six factory outlet center REITs are well below this now. For the six REITs, estimated debt to market capitalization ratios for year end 1995 range from 15% to 44%, according to J. P. Morgan Securities, Inc.⁶⁰ An important element in this argument is that the 40% debt level is meaningful. It has not been explicitly agreed upon, nor is there any precedent for it. In fact, many non-factory outlet center REITs have debt levels higher than this and suffer not ill consequences.

⁶⁰ Lee Schalop and Christopher J. Hartung, J.P. Morgan Securities, Inc., Equity Research, "Industry Update: Outlet Center REITs" June 13, 1995, p. 1.

Assuming the projected debt estimates are accurate, and investors react negatively to debt higher than 40%, then this could stall the growth of the REITs. However, the 40% debt threshold is not based on formal criteria. It is possible that investors will not react negatively to this. Predicting capital levels for the new REITs is difficult, since they are so young. However, a lack of capital would certainly slow the growth.

Summary

In summary, there are a number of issues that bear monitoring both on the positive and negative side of forecasting factory outlet center REIT performance. Predicting the future is especially problematic in the factory outlet center industry, since it has such a short track record. The potential sources of weakness must be closely followed in order to provide any meaningful forecast. Thus far, the industry has enjoyed explosive growth and does not seem to exhibit appreciable slowing, despite the investment community's cautiousness about the REITs. In the next section, I will review a few predictions of saturation for the industry (especially the REITs).

The BIG PICTURE: At What Point Saturation?

There is no final word on the growth predictions. Industry analysts have attempted to forecast growth in development and FFO. Much of the argument on both sides is anecdotal, because the industry is relatively new and small; and few sources have been consistently gathering information. Often it is difficult to obtain information from REITs. Industry experts and participants contacted are reluctant to put hard numbers on "saturation" levels. I will summarize a few of the available predictions.

The Value Retail News has polled major factory outlet center developers and retailers to determine the major challenges in the coming year. For 1995,

overdevelopment is considered the greatest challenge to both developers and retailers.⁶¹ In another Value Retail News survey, prominent developers were asked how long before the market reached saturation of centers. Predictions ranged from 2 to 12 years with an average of 5 years.⁶²

Therese Byrne, a prominent retail real estate consultant has predicted that the growth in the factory outlet center will slow over the next 5 or 6 years. There will be about 450 factory outlet centers in the year 2000. She provided no rigorous model to come up with her estimates, but discussed several issues noted above. The main focus of her arguments are that development will outpace demand for space.

Another point of view on future predictions was offered by Perry Grueber, Director of Marketing, Horizon Outlets, Inc. He noted that asking how many centers is too many is not the appropriate question. Grueber focused on market share, and suggested that the current factory outlet prototype may evolve into something new in the future. He gave examples of factory outlets in non-traditional retail locations, like casinos, entertainment centers, etc. While he was not espousing any particular location, he emphasized that the industry had responded to the desire for low cost retail space that would not compete with existing brand retailers. Just as the current outlet center prototype has changed from a remote factory building to more of a regional shopping center, the future could bring yet another manifestation of outlets. When the current prototype reaches a peak, Grueber suggested other prototypes could arise to meet the demand.

While this type of prediction has certain appeal, the investment community focuses on numbers, and growth of the current prototype. While there is no clear

⁶¹ Kris Hundley, "Overdevelopment Tops Lists of Industry's 1995 Challenges", *Value Retail News* (January 1995), pp. 32-33.

⁶² Kris Hundley, "Overdevelopment Tops Lists of Industry's 1995 Challenges", *Value Retail News*, (January 1995), pp. 32-33.

consensus on the future of the industry as an investment, there are certain events that must occur in order for factory outlet centers to continue as a viable industry and viable investment.

The industry growth has been for the most part consumer-driven. The REITs have maintained occupancies above 90%. While same-store sales for centers have not increased significantly, this is true for all retail, and there are indications that outlet retailers have outperformed other retailers. Consumers must continue to desire brand name goods at perceived bargains.

Retail margins must be preserved. Low cost of development must be maintained to a certain extent. There is room in the factory outlet center retailers margin for some increase as noted by Byrne, but this will be limited eventually. In order to maintain the appropriate margins, developers may have to consolidate. The market has witnessed this already to a certain extent. In 1995, Horizon Outlets, Inc. has merged with McArthur/Glen Realty, and Factory Stores of America has purchased a major privately held outlet center developer, Charter Oak Group.

The successful REITs must continue to post successful track records in order to convince investors that factory outlet center REITs are a worthy investment. In order to post a successful track record, the REIT must create new fully leased space, that will increase FFO per share. The REITs that can successfully do this will continue to grow and attract investor interest. Those that can not will lose share value and have insufficient capital to continue. They may be absorbed by the successful REITs, as has occurred with Horizon and McArthur/Glen. After McArthur/Glen failed to meet pre-leasing goals, its construction schedules lagged. Investors saw this as a sign of weakness in the industry's growth potential, dumped their REIT shares, and effectively kept McArthur/Glen from growing.

Eventually, even the successful factory outlet center REITs will grow more slowly. As their portfolios increase, it will take more and more expansion to produce

consistently large percentage growth. At that point, however, the investment community may begin viewing them as less risky, and will reward the shares with a higher FFO multiple than the 9 that they currently have. At this point, the developers will have to focus more on effective management of the existing portfolio, to extract marginal internal growth. Strong management skills and internal growth strategies within the factory outlet center REITs will take the place of strong development skills and external growth strategies.

Conclusion -- Critical Factors for Success

Factory outlet center REIT growth has been driven by consumer demand, as evidenced by surging sales, and the ability of developers to provide a low cost product to manufacturer retailers, who can maintain their margins while selling goods at deep discounts, evidenced by the occupancy costs of less than 10% of sales. Consequently, predictions about the future of the industry must focus on future demand for manufacturer retailers' goods, and development costs. Factory outlet center REITs have only about a two-year track record. With such a short history, and evolving consumer attitudes and demographics, rigorous long-term predictions are meaningless. REIT management must continue to develop viable sites that have strong pre-leasing. The REITs that can successfully open and expand pre-leased centers will in the short-term, survive and prosper. As these REITs grow, however, their growth must proceed apace to satisfy public equity investors. A larger REIT must expand more rapidly to effect similar percentage increases in FFO. At the same time that a successful REIT developer is growing, it must also promote its management skills to ensure that existing center performance can add to the REIT's growth. This will entail continued close monitoring of the retail industry as a whole, and local markets, to maximize outlet center sales. The REITs that do not continually improve their site selection and development skills will lose the confidence of manufacturer retailers and eventually investors. Similarly, the REITs that do not constantly monitor merchandise and tenant mix in existing centers will lose earnings growth internally. Again, investors will lose confidence and punish the

REITs via share price drops. The successful factory outlet center REIT developer will maximize all skills necessary to continue growth. The successful investor will choose the REIT management that does this better than others.

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