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Abstract

Executive Summary

• The most compelling B-mall investment strategy is to acquire B-2 malls that have the potential to move up to the B-I level.
• High barriers to entry and population demographics in their suburban locations make B-malls attractive.
• Secondary malls typically price at below replacement cost.

B-grade shopping malls have evolved into an extremely attractive real estate investment product. A B-mall is a regional shopping center that, relative to an A-mall, suffers from advanced age, a secondary or tertiary location, and/or mismanagement. The positive attributes of most B-malls, however, include strong and consistent cash flow production, high leasing demand, exceptional locations, functional and fungible physical plants, and trading values that are below replacement cost. Understanding the attributes that make B-malls successful and then realizing their intrinsic value by designing and executing proper rehabilitation, retenanting or expansion plans will increase cash flow and value for the savvy owner/manager.

Keywords

Cornell, real estate, retail, malls, retail investment, B-class malls, retail underwriting

Shopping for B-Malls: Investing for Stable Cash Flows and Value Creation

Jeff Giller and Steven Plenge[1]

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Resolving Underwriting Challenges

To price B-malls appropriately and execute a successful value-added business plan, investors must identify the positive and negative attributes of their acquisition targets. In the past, the trading volume for B-malls was limited because it was difficult to understand the appropriate price, risk and cash flow characteristics of an asset in a class with such a wide range in quality.

From an operational perspective, B-malls at the high-quality end of the spectrum can compete effectively with A-malls, while B-malls that are functionally obsolete or mismanaged may be failing and performing more akin to C-malls. Despite wide ranges in B-mall attributes, valuation and operating metrics typically are compiled for the B-mall sectors as a whole.

Identifying measures within a more detailed B-mall classification system allows investors and lenders to assess value and risk more accurately and establish better underwriting standards for B-malls. To better manage investment risk, a ratable classification system for B-malls was developed. This system divides the sector into three subclasses and differentiates the assets within each class by measures of productivity and value (See Table 1, "B-Mall Productivity Metrics", and Table 2, "B-Mall Value Metrics").

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Table 1: B-Mall Productivity Metrics

Subclass	Percentage of Total B-Mall Supply	Center Sales PSF	Anchor Tenant Sales PSF	Occupancy Costs	5-Mile Trade-Area Population (thousands)	Middle-Class Household Percentage	Mall Supply Per Capita
B-1	18%-22%	$300-$390	$180-$230	10%-11%	80-100	65%-85%	10.0-19.0
B-2	58%-67%	$250-$299	$150-$225	12%-14%	90-250	60%-72%	8.5-15.0
B-3	15%-20%	$190-$249	$120-$180	13%-16%	150-290	50%-60%	15.0-20.0

Sources: Pantheon LLC, National Research Bureau, U.S. Census Bureau

Table 2: B-Mall Value Metrics

Subclass	Capitalization Rates	IRRs	Relative Value 2003, bps*	Value Spread 1998, bps*	Gross Rental Rates	NOI Margins	NOI PSF	NOI 5-Yr. CAGR
Average	8.0%-12.0%	11.50%	609	459	$25.98	6.30%	$21.59	2.00%
B-1	8.0%-8.5%	10.50%	459	304	$26.93	8.30%	$28.02	3.80%
B-2	9.0-10.3%	11.50%	609	424	$26.25	6.70%	$18.86	2.50%
B-3	11.0%-12.0%	12.50%	759	649	$24.77	3.40%	$16.05	-1.50%

* Capitalization rate relative to 10-year Treasuries as of May 2003; Sources: Eastdil, Real Capital Analytics, Pantheon LLC

Malls that fall into the B-1 classification are the investment-grade assets of the B-mall sector. B-1 malls have been found either to compete effectively or to coexist profitably with A-malls. B-2 malls possess physical, operational or location challenges that may cause them to move on the sub classification scale. B-3 malls are the junk asset class of the B-mall sector and have the highest level of risk and the lowest probability of turnaround.

The most compelling B-mall investment strategy is to acquire B-2 malls that have the potential to move up to the B-1 level through appropriate repositioning strategies. The successful repositioning of a B-2 mall to the B-1 level can result in a net operating income increase of up to 200 basis points and capitalization rate compression of 100 basis points to 200 basis points. Success depends on understanding and identifying the attributes that define a strong B-1 mall and ensuring they are present, at least intrinsically, for the targeted B-2 mall investment.

Attributes of a Strong B-1 Mall

Valuable Infill Locations

The regional shopping mall was conceived in the booming economy of the post-World War II era. Following consumer demand, regional shopping malls were developed during the 1960s, 1970s and 1980s in the centers of the United State's expanding suburbs. Today, these properties fall into the B-mall class because of their advanced age. As the suburban areas around these B-malls continued to expand during the 1990s and into the new millennium, they have benefited from what have become dense suburban infill locations.

The positive impact of these trends is evident in looking at the population density in B-mall markets. While the nation's shopping mall supply averages 12.5 square feet per resident for all mall types, for B-1 and B-2 malls located in suburban markets the supply is much more constrained, averaging about 9 square feet per resident.

Barriers to Entry

High barriers to entry to develop large retail assets in suburban markets have begun to create supply/demand imbalances that favor the owners of existing B-malls. According to the International Council of Shopping Centers, 45 regional malls totaling 53 million square feet will have opened between 2001 and 2004. Although the velocity of this new construction demonstrates the viability of the mall, the actual growth rate of mall supply additions has slowed from about 5 percent of existing supply over the past four decades to less than 2 percent in the current decade. This decelerating trend in supply additions ensures against the creation of unhealthy future supply excesses and bolsters the value of existing B-malls.

One significant barrier to entry is the high land value that characterizes the suburban infill locations that B-malls typically occupy. The high cost to purchase land and build competing centers in these locations would cause the overall occupancy costs of prospective shopping centers to be too high to compete with already established B-malls.

Political barriers to entry are also a strong factor favoring B-mall owners. Local residents tend to be adverse to the development of new regional malls and to the development of indirect competitive properties such as power centers. This limitation on power center supply additions has begun to push traditional power center retailers, such as Wal-mart and Target, into B-malls.

Community Centers

In American suburbs that lack a 'Main Street", the regional shopping mall often serves as the center of the community. Residents and city planners are calling for more human-scale projects where the community can congregate. As a result, hyper-scale fortress malls are becoming less popular than more intimate, community lifestyle-oriented B-malls. B-malls that are well-located, well-managed, have an appealing lifestyle orientation, and where the owners have included a mix of strong local and regional tenants have been highly successful.

Positive Demographic Trends

A distinct advantage of a B-mall over the larger A, or fortress malls, is that they are typically smaller and thrive in a much smaller trade area. The primary trade area for B-malls is usually a five-mile radius. The optimum demographic characteristics of B-mall trade areas include a wide income range within a strong middle class population base, population growth and cultural diversity.

A study conducted by Pantheon LLC of the 2000 U.S. Census indicates a majority of B-malls are located in suburban markets dominated by diverse middle-class populations.

Cultural, composition and income diversity in middle-class households results in a diversity in demand for consumer products and therefore, higher levels of consistent consumer traffic. Sales and productivity at regional malls tend to increase commensurately with the incomes and lifestyles of upwardly mobile middle-class residents.

Increased Demand for B-Malls Space

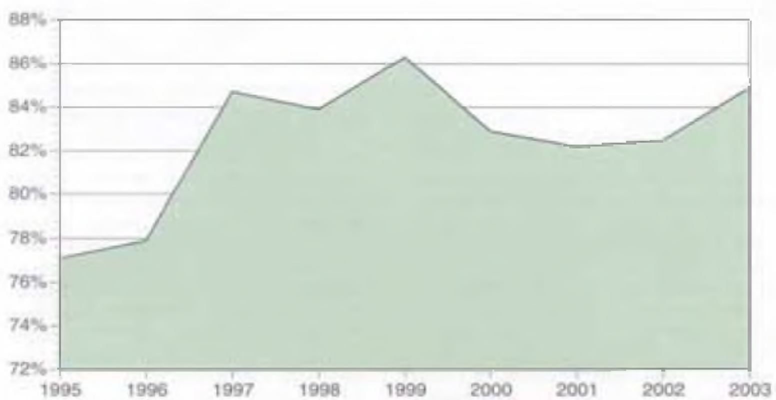
Many national and regional chain stores that relocated from malls to power centers during the 1990s are now returning to malls. Similarly, many of the value retailers that have traditionally occupied power centers have begun to recognize the value of the mall's high traffic channel and are beginning to relocate to malls. For example, 25 percent of the approximately 100 B-mall sites that Montgomery Ward recently vacated were re-leased to Target stores.

Also driving this trend is the anti-development climate that exists in a number of suburban markets, which has restricted the construction of new shopping centers. This absence of developable sites has made B-malls, with their strong locations, flexible structures and relatively low occupancy costs, an attractive alternative to traditional shopping centers for power-center tenants. According to the MAX-SI Spatial Index, new store openings among mall-oriented chain stores have been averaging 8.8 percent annually over the past five years compared to power center-oriented stores, which have been increasing openings at a rate of 8.5 percent per year. As value retailers continue to convert to the mall channel, new mall store openings could increase to 11 percent per annum.

Pricing and Investment Characteristics

A compelling attribute of B-malls as an investment product is that they typically trade at prices below replacement costs. A nine-year survey of B-mall sales conducted by Pantheon LLC revealed that B-malls located in infill locations have traded at prices ranging from 77 percent to 85 percent of replacement costs (see Figure 1, "Average Purchase Price to Replacement Cost Ratio for B-Malls").

Figure 1: Average Purchase Price to Replacement Cost Ratio for B-Malls



Sources: Real Capital Analytics, Pantheon LLC

Cap rates for B-malls range from 8 percent for the best B-1 malls to 12 percent for struggling B-3 malls. The availability of debt capital for B-mall investments has increased and the cost of debt has decreased as the CMBS market has come to accept B-malls as a viable asset. The combination of high cap rates, low interest rates and pricing below replacement costs of B-mall investments has transformed them into annuity-like investments with value-enhancement characteristics.

Unlike A-malls, which experienced a significant run-up in pricing over the past two decades, B-mall pricing has remained relatively stable. According to Pantheon LLC, cap rates for A-malls dropped to as low as 5 percent during this period, while B-mall capitalization rates held steady at 10 percent to 12 percent.

While A-mall values are maxed out with significantly lower cost bases, B-malls — whose capitalization rates have recently fallen by about 200 basis points — still have the flexibility to add improvement dollars to enhance their values. B-mall yield spreads over 10-year Treasuries have been considerably more attractive than spreads for A-malls and other relevant investment benchmarks (see Table 3, "Relative Valuations").

Table 3: Relative Valuations

Mall Spreads*	1997	1998	1999	2000	2001	2002	2003	6-Yr. Trend
A	165	274	205	197	309	299	236	236
B	368	459	475	467	644	609	505	505
B-1	225	304	325	337	534	459	360	360
B-2	335	424	435	467	614	609	485	485
B-3	545	649	665	597	784	759	670	670
Retail Bond Spreads								
A	135	161	142	197	202	205	205	183
B (average)	296	366	364	504	435	483	483	413
BBB	133	174	176	281	284	331	331	242
BB	321	418	374	467	417	433	433	405
B (high-yield)	434	506	541	764	605	685	685	592
Junk	771	1506	2,194	2,994	2,663	1,854	1,854	2,042
CMBS Spreads								
A	93	270	183	188	171	106	106	173
B (average)	402	523	553	541	612	486	486	527
BBB	125	195	285	243	287	172	172	224
BB	480	585	525	540	580	435	435	531
B (high-yield)	600	790	850	840	970	850	850	825

* Going-in yields relative to 10-year Treasuries; Sources: Pantheon LLC, Standard & Poor's, JP Morgan

A Value-Added Proposition

B-malls are attractive investment assets for two main reasons: They are usually located in suburban infill locations with high barriers to entry and growing population, and so benefit from favorable supply/demand imbalances; and they can be acquired at prices below their replacement costs and, thus, have upside potential and enjoy insulation from competitive supply additions.

The level of cash flow generated by B-malls is typically attractive and stable. With an understanding of the intrinsic value-enhancing attributes of B-malls, experienced investor/managers can reposition B-2 malls to B-1 levels of performance, drive cash flow even higher and, upon sale, reap the financial benefit of lower B-1 cap rates. Repositioning strategies that enhance cash flow and add value to B-malls range from making light cosmetic renovations to adding anchor, in-line or out-parcel space and changing tenant mixes to make the mall more community-oriented.