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PLRA Daily REIT Note

September 28th, 2023

Retailer Earnings Review

I was in Milwaukee last weekend, which is the kind of market that I'm always tweaking REITs for running away from. If institutional investors are serious about themes like industrial onshoring, housing affordability and climate change, wouldn't this be a better place to get ahead of them than some of these other metro areas that they're crowding into?

But I do appreciate why it's hard to allocate capital to the Rust Belt at a public REIT scale, especially in multitenant retail. In fact, I searched my own notes for Milwaukee, and the last time I wrote about it was in 2018, making fun of "redevelopment yields" at declining malls:

> CBL announced the first phase of their redevelopment at **Brookfield Square** in Milwaukee, and it's very entertainment-oriented; [they] bought this Sears a year ago and got $9M from the city for this project to replace it. A few miles away, GGP's **Mayfair Mall** is seeking subsidies for a new hotel in an empty office tower. At Simon's **Southridge**, they're talking to the town about their own mixed-use plans, and Seritage is converting the Sears into a Round One and Dick's.
>
> The former Bayshore mall was already redeveloped in 2006 into a mostly open-air mixed-use format, and they're currently replacing their Sears with a Nordstrom Rack. And a new lifestyle center, The Corners of Brookfield, is just opening next to CBL's center.
>
> How do you value all this? Well, they're checking all the right boxes — live/work/play, mixed use, Dick's, Nordstrom Rack… you could go around the map assigning letter grades and cap rates, and I'm sure all these owners would quote strong initial yields on the incremental capital. You could take your theoretical cap rate on the center (and it's never been more theoretical) and assign it to that incremental income, without asking what it's doing to the existing tenant base.
>
> But maybe it makes sense to take a step back and say "wait, how many malls does Milwaukee actually need? And how badly do any of these tenants need to be in any given one?" Because even with the various subsidies… collectively, **retail landlords are throwing good money after bad**, and the leverage for tenants is only growing…

What a jerk, right? But to be fair, I was writing the same way about mall redevelopments in coastal and Sun Belt markets, and I was right about most of those too. And ultimately, this is more than a format question or a market question. It's about how REITs are allocating capital, how investors should be valuing them, and why my thematic, tenant-first, outside-in approach has been more predictive in retail than the standard real estate toolkit. So rather than just summarizing my key retailer notes, this quarter I'll try using a single market to tie them into on-the-ground examples…

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1. MALLS, LIFESTYLE CENTERS, STREET RETAIL

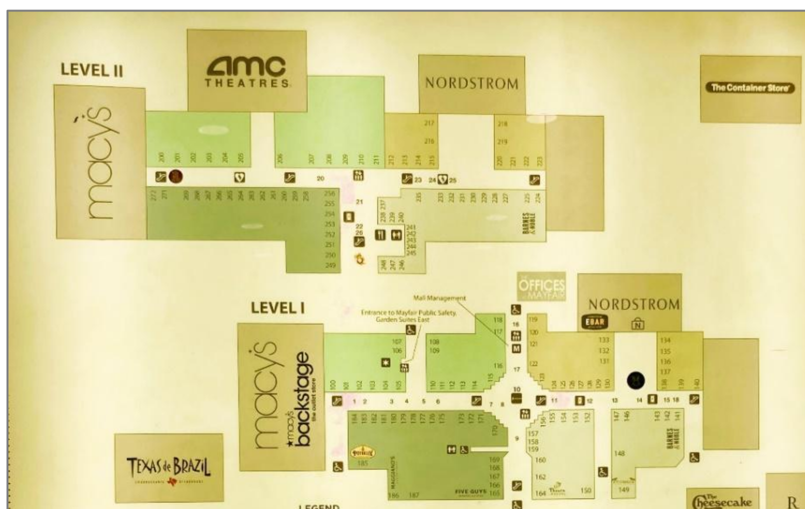
Let's start by taking all five centers that I mentioned in that 2018 note, and looking for every tenant that I mentioned in **last week's note on mall leasing**:

	Enclosed Malls			Lifestyle / Mixed Use		Street Retail	
	Brk. Square	*Southridge*	**Mayfair**	**Bayshore**	**Corners**	**Third Ward**	East Side BID
Urban Outfitters			X				X
Free People					X		
Anthropologie					X	X	
Warby Parker						X	
Carter's		*	*				
Lululemon			X		X	X	
Apple			X	X			

*adjacent open-air center

We won't dwell on the first two malls, which both look pretty far gone. Mayfair was already the "A" back then, and it's the only one I visited this time. But before I tell you anything about Mayfair, you can already see a problem, right? These are the kinds of tenants that want to cluster, and none of these four clusters has quite enough of them. And if you've read that note last week, you can also see it in terms of their individual preferences that we discussed — e.g. street retail is the first choice for WRBY, strips for CRI, and none of these centers is dominant enough to lure them in.

OK, here's Mayfair:



This was a two-anchor mall when GGP bought it in the late '90s, with Macy's and the Boston Store (on the right). They expanded it to add the movie theater and Barnes & Noble, as well as more in-line space. Nordstrom was a ground-up addition they delivered in 2015, spending $70M and

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quoting an 8% return — and this is the kind of redevelopment math I was criticizing in that note, so let's take a moment to think about why.

First, that Container Store outparcel also delivered in 2015, along with the neighboring open-air Mayfair Collection — two good examples of the A mall overexpansion/diffusion problem, tugging the center of gravity away from the interior space. Second, it was already clear that Boston Store parent Bon-Ton was potentially in trouble. Third, the "yield" on this kind of project is a complex and partly subjective estimate, and REITs have never given us much disclosure about it.

So when REIT investors underwrote "value creation" of $70M x 8% / 5% — or whatever A mall cap rate — you can see how that was smuggling in other optimistic assumptions. And when I criticized that approach, I was not saying that anyone in 2016 or 2017 had a crystal ball, and knew *for sure* that Bon-Ton (for example) wouldn't make it. I was just suggesting that we should have been raising our risk premium and widening the cap rate.

Anyway, by the time I was writing that Milwaukee mall rundown in early 2018, Bon-Ton was already in liquidation or close to it, and this store at Mayfair closed shortly afterward. It was crossed with other BONT stores in a separate CMBS loan, and it would take five years and three auction attempts before it was finally acquired by the town this summer, for just $4M.

And how did the mall feel this past weekend? Look, it felt like a lot of these other A malls that I write about, with a core of healthy tenants that's been shrinking a bit every year. Two years ago I called Natick a great 800k SF mall that was "rattling around" in a 2M SF shell, and if I went back there now I might say 600-700k. And even at Mayfair, which is no Natick — if you could lop off the theater and the whole second floor, and move a third of those tenants downstairs, then you might have the kind of environment that some spreadsheet A mall bulls are still envisioning.

But that's not how it works, is it? You still have all that other space to fill. And to understand how some of it is now being filled, you can read my **recent note on Express**, which has a nice big store here across from Apple. Then you can look at the directory and count the other tenants like this: Forever 21, Eddie Bauer, Lids, Banana… all on some version of this same licensing treadmill.

And then if you think about the *best* concepts who are really bringing shoppers back, like Apple or Lululemon or Aerie… you can read **my 9/1 LULU note** to see what that really takes, in terms of capital and risk-taking, and it will be clear why that first group can't do it… and why this growing imbalance will keep weighing on traffic, and eventually push the successful retailers to relocate.

So if not the mall, which of those other three clusters is the best bet? I like the Third Ward, but if this was a fashion retailer asking where to put their first store in Milwaukee, it would depend at least somewhat on their target demographics — and again, none of them has that critical mass of cotenancy that would make it a no brainer, as some dominant A malls did in their heyday. And from the REIT side, it's more about what we *can* get exposure to, right? It's not easy for REITs to accumulate material street retail exposure in a secondary market, or to execute ground-up developments like the Corners… or a redevelopment like Bayshore that takes the whole mall apart.

And ultimately, the problem with partial redevelopments at a mall like Mayfair is that you're taking almost as much development risk, without resolving the core problem of excess space, or the tensions between these very different cohorts of in line tenants. So I'm not disputing that Brookfield and the town planners *could* still wind up with new apartments and a nice mixed-use result here, and I hope they do. What I'm questioning is whether it can really be done without taking the roof off, and what the true annualized investor returns will look like.

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2. STRIPS

Here’s an example of that point from the beginning: when KIM announced their acquisition of RPT a month ago, they talked about selling some of the Midwest assets, and I wrote that maybe they should keep them — “or at least some other modest strategic pivot” in the direction of higher risk and more accretion. Easier said than done, right?

OK, two of those assets are in the Milwaukee metro area. One is a fully occupied community center in what looks like a wealthy third ring suburb, and the other is a 15% vacant power center in the industrial inner ring suburb of West Allis. So it’s that **tougher one** that I wanted to see…

…and having seen it, I can understand why it may not be on Kimco’s keeper list. But let’s try to make the case either way.

This was a minor redevelopment from the prior RPT management team, replacing K-Mart (or part of it) with that Hobby Lobby, which is a reliable anchor. And I’ve been positive on most of this other value-oriented lineup — like BURL and ROST, in **this off-price check-in** a month ago…

But I could also point to my note **a day earlier** on HD, WMT, and TGT, which are even better positioned to keep taking share. There’s a neighborhood Walmart just a few blocks away, and all three are at other centers within a few miles… and you might be competing against future tenant fallout at those centers, in addition to this direct exposure to Party City.

So for KIM, maybe this looks like either a heavier redevelopment or a punt — and maybe the first option would not seem like enough of a needle-mover at their scale, or the highest return on their finite development bandwidth.

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On the other hand, West Allis felt like exactly the kind of older manufacturing area that should benefit from onshoring demand, and might support a creative redevelopment with non-retail components. And if KIM sells this center, they're down to a single asset in a market that they've already exited before, and it may be tempting to sell that too… and then they're back to this same "flight to quality" dynamic, where too many of their peers are buying in the same hot markets… and the yields are just not enough to drive sustained earnings growth, especially if we have another couple of PRTYs going away every year.

So this is the basic strip REIT tension that I'm always writing about, and I don't think there's ever a single answer. It doesn't have to be Milwaukee, and geography is not the only axis — but I do think KIM is a good example of a REIT that needs to go further out on the risk/return spectrum than their current strategy is contemplating.

3. RECREATION

I was quite negative on "eat and play" tenants this quarter, but the best summary of my bear case is actually in last quarter's notes **on Dave & Buster's** and **Bowlero** — which each have standalone locations near Mayfair Mall. And now we're in net lease territory. The BOWL store is a former AMF, and I'm guessing it's still in the old AMF portfolios that iStar just renewed and sold to Carlyle. The D&B was built in 2010 with **NNN**, and is presumably still part of their ~3% exposure to D&B/Main Event today.

So this is an interesting D&B to think about. It was one of their larger formats at the time (34k SF) and may be a little oversized today… but it's also an old investment where NNN has already had a pretty good payback. And it's not right in the bullseye of new supply; there's still no Topgolf in Wisconsin, for example.

On the other hand, this stuff is everywhere. From a quick Google search, here's another Milwaukee **bowling/arcade concept** that expanded in 2013, and a **Topgolf clone** that opened last year. Topgolf itself has their small-format Swing Suite in **this new food hall** downtown. We've already mentioned the 2018 **CBL project** at Brookfield Square, and that box filler recreation subsidy is similar to the shadow vacancy risk at West Allis. So this D&B is not the worst example — but when you add on the operating challenges that I laid out in those prior notes, hopefully it's clear why I still see recreation exposure as a rapidly growing risk.

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