

## SAMPLE NOTE

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# PLRA Daily REIT Note December 14<sup>th</sup>, 2023 What is a Mall?



After a brief post-Covid hiatus, the mall-and-department store soap opera is now back on the air. And I'm covering it with the same approach that was so effective in the pre-Covid years — which begins with a complete rejection of the standard real estate framework.

In other words, I'm not just an "A" mall bear in the sense of applying higher cap rates. I've argued that the entire approach of *assigning* cap rates and letter grades is no longer useful for valuing enclosed malls, much less anchor space. I've written that we should look at the entire mall as a "permanent rolling redevelopment" until the roof comes off, and underwriting *any* kind of interim stabilization is a "capital trap."

That's still a bear case for public mall REITs, but at this point it's not necessarily a bear case for the "real estate value" at department stores... in any case, I know I'm still losing some readers at the first step. The standard valuation approach is an increasingly tenuous mark-to-model exercise, but it can still be hard to give it up without a new mental model to replace it.

So I'll try to give you one now, and I'll tie in a visit to **SPG's** King of Prussia mall (above) as well as yesterday's call at **Zara**. This is a framework that underlies many of my other mall notes, but I've never spelled it out all at once.

It starts by replacing the "anchor" metaphor with a "battery," which captures much of what's different about malls from the anchor/landlord dynamic in other retail settings. So think of the original mall format as a battery-powered device — where the developer purchased the batteries by subsidizing the department stores, then plugged them into each end of the in-line space, and sold the electric current (foot traffic) to the small shop tenants.

During the postwar heyday of mall development, suburban population shifts were another ambient source of power, and the best-designed and best-run "machines" were drawing in more of it, as others gradually drained their batteries and shut down. But even the best malls are not perpetual motion machines... and there have also been new external drains on their power, like when the big box category killers started opening across the street.

(You can think of that as taking your neighbor's power with an extension cord, if you're still with me on the electricity metaphor. But I also think of an old quote that I once read from a department store exec: "once we lost hard goods, it was the beginning of the end.")

Then there are internal decisions that can drain the battery faster, and the most common one is to expand the shop space without a commensurate increase in traffic. So now you can see how this framework diverges from the standard one, and why it's been so much more predictive. If you think of dominant fortress malls as a permanent compounder, you'll see their dying anchors as an "opportunity" to buy back the box, replace it with a luxury wing or more junior anchors, and value the incremental NOI at the same cap rate as the mall.

But from our new perspective, the cap rate for the whole mall should now be higher, because you're getting closer to a reckoning with the remaining anchors. Even if you're not draining those batteries faster — that is, even if the traffic in your new wing is entirely incremental — you're still one step closer to maxing out the potential traffic in the trade area. (And in practice, we've looked at cases where even the project-level redevelopment yields appear much lower in retrospect.)

In any framework, we can also agree that e-commerce has become a universal drain on retail traffic. But remember that US department store sales peaked over a decade before e-commerce started moving the needle. They've been shrinking ever since we stopped building new malls, and that shouldn't be a surprise. Batteries don't last forever.

Now, this is not yet a bear case for any individual A mall. This life cycle might still take fifty or a hundred years, and generate lots of excess value along the way. The point is just to let go of this linear mental model in which "the best malls get better" and compound indefinitely... and replace it with a cyclical model in which the end is built into the beginning.

Because then you can fit malls into the same investing intuitions that you'd apply to any business, not just real estate or retail. After all, if I can sell you a perpetual motion machine, I can sell you anything. Even the most explosive-growth products like the iPhone will eventually saturate their market — and again, the maximum value creation at any given mall has a much lower cap, just as a function of geography.

So when someone tries to sell you a "fortress" mall... rather than debating whether it's an A+ or an A, now your first instinct will be to figure out where it sits in this life cycle. If it's too far along, then it may still feel like a "survivor" from a shopper's perspective, but it's becoming a diminishing-return capital trap for the landlord.

I'd say that the vast majority of enclosed A malls in the US are well into that phase, largely because of overexpansion... which in turn was a rational response to REIT and CMBS investors (and not a few LPs) who wanted to apply the letter grades, accept the initial redevelopment yields, and treat that as pure "value creation" without widening the cap rate.

In my view, *this* is the valuation bubble that was finally collapsing in 2018-19, not some tipping point with traffic or e-commerce. And the blow-off top was structures like SRG or the Hudson Bay CMBS package... structures I described at the time as "being sold the same mall twice."

We've looked at a dozen different ways to measure a mall's life cycle, and the easiest one is just to focus on traffic, rather than lagging indicators like sales or NOI. You can also start from the point of view of the department stores and test the batteries directly, which we'll come back to shortly. But even as a shopper, you can see this creeping "soft around the edges" effect that I've been writing about at one A+ mall after another. King of Prussia this weekend was no exception...

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To be clear, a certain amount of this is just frictional. But once it gets above a certain level, and there's no longer a long waiting list for new tenants... at some point, you won't have enough competition to drive market rent growth for the best space, either.

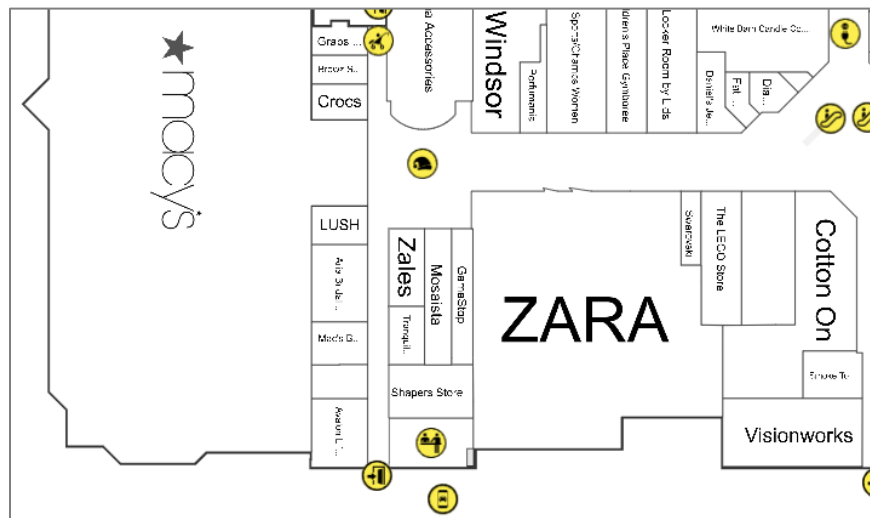
To be even more clear: I'm not saying that Simon has made any mistakes here in terms of leasing or operations, and I don't think they have. I'm not disputing that it's still a valuable asset with lots of traffic, or that it's a "survivor" or that it's successfully "evolving." I'm not even questioning any of the past expansions; as I just wrote, they may have been completely rational, and in any case, what's done is done. What matters now is where it is this long-term mall life cycle, and what the returns will look like from here.

Another rough life cycle indicator is the "locust" dynamic that I've written about with junior anchors, which is another kind of power drain on the rest of the center. Here's Zara yesterday:

**Q:** Could I ask about your performance in the Americas, and if there's anything to call out [given] a softer consumer environment in the US?

A: ...the US remains our second most important market, [and] we continue to see significant opportunities for our selective growth there. During this quarter, some of the projects that we announced during our annual results presentation became a reality — such as the relocation of our store at Dadeland in Miami, or the opening of our store in Baton Rouge, or our new store in San Antonio. And additional exciting projects in the coming weeks, including the reopening of our store in Roosevelt Field...

Those are four heavyweight malls where Macy's owns their store. I'll use Brookfield's North Star Mall in San Antonio as an example, since some readers may have followed their recent CMBS refi. **Take a look** at this big new Zara store in the Macy's wing:



And notice how Zara's new, larger prototypes are sounding a bit more like a department store...

The design integrates attractiveness and functionality into sections, like digital fitting rooms, self-checkout areas, click and collect points, in-store silos and stockrooms... dedicated spaces for lingerie, shoes and handbags, the Origins collection...

You might also notice how even the specialty stores in malls seem to be getting larger in inverse proportion to their credit, like the huge Express off to the right of that map, while some of the stronger legacy mall tenants are shrinking at renewal...

But I won't beat this to death with more examples; I think you can see the dynamics I'm trying to describe. And obviously I'm not implying anything devious on the part of any of these companies; we're just trying to look clearly at everyone's incentive structures, and how they're interacting. So how does this traffic/electricity model look from a department store's perspective?

Well, instead of seeing your owned stores at A malls as an "underperforming" or defective piece of the center that's somehow your fault... where it's your job to either close that gap operationally, or give up and redevelop the space for others who can... you might think of them as a collection of dying batteries on the edge of 15-acre lots, plugged into an oversized appliance next door, which will keep draining the battery *whatever you do*.

You've already invested heavily in e-commerce, just like all the specialty stores ... again, we might think of that as mall tenants plugging in their own extension cords from the store to the website, and siphoning off traffic while it's still flowing.

After that, it gets tricky. One approach is to "become the mall" as the mall dies around you, by leaning into concessions, subtenants and services... somewhat like JCPenney's 2019 prototype. As the rest of the mall is eventually redeveloped into a live/work/play town center, it may still need a retail hub.

You could also take a market-level "ecosystem" approach, like what Nordstrom tried to do with their Rack and "Local" stores, and siphon more of the remaining power into off-mall settings.

Neither of these strategies seems to work all that well. And Macy's has experimented with both of them, but they've also found another one that I've been more impressed by, namely the off-price Backstage floors. Maybe they were inspired by the mall expansions from the prior Burlington management team, which BURL is now unwinding; in a sense, they overcommitted on box size, and undercommitted to the off-price model.

But for Macy's, injecting an off-price store into the mall seems like the perfect response to more shiny new fast fashion right outside your door. It's fighting locusts with locusts, and drawing some power back into the battery, rather than just slowing the leakage. And it's also building up a new banner (and sourcing function) in a hot open-air category, which could transition and grow into its own off-mall / post-mall business.

(I know the stated goals also include customer acquisition for the full-price business, and I wish them luck with that too... but as I've argued extensively with Rack and Nordstrom, you don't actually need that for the off-price business to be valuable on its own.)

I won't go any further here in connecting this to my Macy's LBO comments in Tuesday's note, because I'm trying not to make it about any particular anchor, mall, or REIT. As I wrote at the beginning, it feels like the whole show is back on the air — including the Saks/Neiman merger talks, the second PREIT bankruptcy, and probably a lot more drama to come. The point of this note was to lay out a neutral framework for analyzing all of it... for investors who are wary of dusting off the A/B "cap rate" framework that failed so badly in the last cycle.

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