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Is the Retail Reckoning for Regional Malls at an End?

After a turbulent decade, the U.S. mall industry seems to have come out of the pandemic in decently good health.

Jenn Elliot | Nov 28, 2022

The past few quarters brought an unexpected trend in the U.S. mall sector—operating results reported by some of the nation’s biggest mall owners seemed to show a marked return to normal.

For example, for the third quarter of 2022, Simon Property Group, the publicly-traded REIT that owns the nation’s largest mall portfolio, reported that its property NOI increased 2.3 percent , and that its occupancy averaged 94.5 percent, an increase of 170 basis points compared to the prior year and an increase of 60 basis points compared to the second quarter.

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Simon’s FFO grew by 4.7 percent year-over-year, to $8.71 per diluted share.

Meanwhile, The Macerich Company has also experienced improving occupancy and increased NOI throughout 2022. It posted same-center NOI growth of 2.1 percent in the third quarter compared to the same period in 2021, which was a “very strong quarter,” according to Scott Kingsmore, senior executive vice president and CFO.

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Occupancy for Macerich’s portfolio averaged 92.1 percent, a 180-basis-point improvement from the third quarter 2021 and a 30-basis-point sequential quarterly improvement over the second quarter 2022.

The REIT's FFO grew by 2.2 percent year-over-year, to $0.46 per share.

"With the pickup in occupancy, we'd started to think we could start to push on rates, and that seems to be the case," Kingmore said during the REIT's third quarter earnings calls. "We got to 92 percent occupancy, which creates that tension between supply and demand. As we review deals again every other week, it seems like we're getting more and more pricing power."

PREIT reported that its NOI, excluding lease termination fees, rose by 3.3 percent in the third quarter, while its occupancy rose by 480 basis points year-over-year, to 94.4 percent. The company did report what it called a marginal decline in its FFO, at a negative $1.13 per diluted share, which it attributed to lower NOI from a sale of an interest in an outlet center property and higher interest expenses.

At the same time, CBL Properties, a REIT which has historically focused on somewhat lower quality malls than Simon and Macerich, reported that its NOI for the third quarter declined by 7.0 percent compared to the same period the year before, though its year-to-date NOI rose by 1.8 percent. CBL's portfolio occupancy reached 90.5 percent in the third quarter, up from 88.4 percent the year before. The company also raised the guidance for both its full-year FFO to a range of $7.40-$7.67 per diluted share, and its same-property NOI. CBL went through a bankruptcy filing in the fall of 2020.

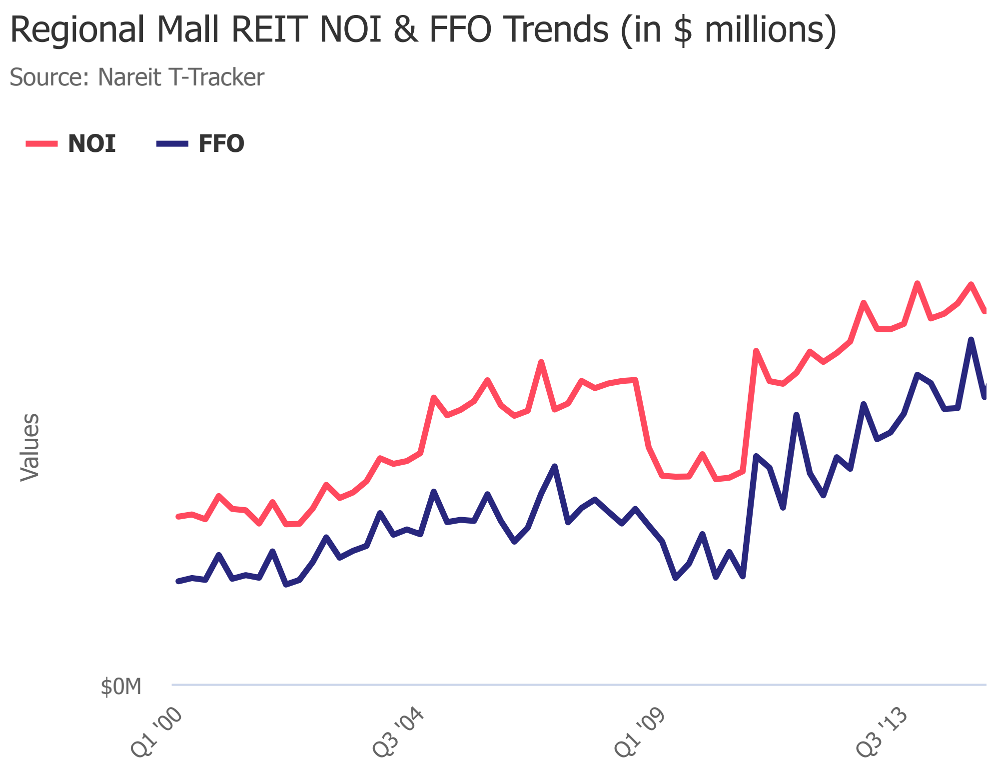
Strong tenant demand and sales per sq. ft.

Tenant demand and tenant sales have been and continue to be strong for mall space. In fact, many mall REITs have broken their own sales per sq. ft. records this year.

Simon reported another record for sales per sq. ft. in the third quarter at $749 per sq. ft., which was an increase of 14 percent year-over-year. Sales at its portfolio of Mills properties ended up at $677 per sq. ft., a 15 percent increase.

During the first three quarters of 2022, Simon signed more than 3,100 leases totaling an excess of 10 million sq. ft. It has a “significant number of leases” in its pipeline too, according to statements by president, chairman and CEO David Simon.

The REIT’s average base minimum rent increased for the fourth quarter in a row, reaching $54.80—an increase of 1.7 percent year-over-year. The opening rate on new leases increased 10 percent since last year, roughly $6 per lease.



Likewise, Macerich is also enjoying a high level of leasing activity. “We continue to see strong leasing volumes, which, for the year, are in excess of 2021 levels,” notes Kingmore, adding that the REIT executed 219 leases for 1.1 million sq. ft. during the most recent quarter. “The quarter continued to reflect retailer demand that is at a level we have not seen since 2015.”

Macerich’s sales per sq. ft. reached a record of $877 for tenants under 10,000 sq. ft.

Similarly, CBL’s sales per sq. ft. have increased, albeit at lower levels than Simon’s and Macerich’s. CBL’s same-center tenant sales per sq. ft. for the trailing 12-months ended Sept. 30 was $440, an increase of 2.1 percent year-over-year.

The REIT signed new leases and renewals at average rents that were 5.2 percent higher vs. prior leases, which marks a “notable reversal in trends,” according to CBL’s CEO Stephen D. Lebovitz. “We are pleased with our operating results in the third quarter, including 210-basis-point growth in quarter-over-quarter portfolio occupancy and our first quarter of overall positive lease spreads in several years, driving an increase in our full-year expectations for same-center NOI,” he said during the company’s third quarter earnings calls.

What came before

These encouraging results come after the mall sector has suffered a years-long reckoning , as weaker malls have been forced to close due to competition from e-commerce, struggling anchor department stores and shifting consumer expectations.

Many of the mall REITs that existed 20 years ago are now just a memory. Likewise, hundreds of malls across the U.S. have gone dark or have been scraped to make room for more in-demand property types. However, the pace of mall closures has decreased, and many mall owners are now making significant investments in their properties through redevelopment and bringing in new tenants.

Publicly-Traded Regional Mall REIT Snapshot

Sources: Nareit T-Tracker and REITWatch, October 2022 and 2012 editions.

Category	2012	2022
Regional Mall REITs	8	3
Average Share Price	$45.92	$31.55
FFO Per Share	$2.83	$6.82
Equity Market Cap	$83.63B	$31.60B

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Since malls have reopened following pandemic-related shutdowns, fundamentals have been trending in the right direction , according to Vince Tibone, a senior analyst at independent research and advisory firm Green Street who leads the firm's retail research team. Occupancy is up, as are rent rates and sales per sq. ft.

Yet all this positive momentum could be derailed so easily. "It's going to be a difficult 12 to 18 months for retailers and possibly for mall owners too," says Thuy Nguyen, vice president and senior analyst in Moody's Investors Services' corporate finance group.

Lower income consumers have had to pull back on discretionary spending due to higher energy costs and inflation. And now, middle- and higher-income consumers are closing their wallets, thanks to losses in both the stock market and the job market.

“Middle and higher-income consumers are the mall customers,” Nguyen notes.

Will ongoing inflation, rising interest rates and the looming threat of a deeper recession in 2023 spur another wave of mall closures, consolidation and market exits?

More consolidation or exits?

Consolidation and exits have been major themes in the mall sector over the past decade. Examples of consolidation include Brookfield Property Trust absorbing General Growth Properties assets out of bankruptcy, and Simon Property Group acquiring smaller rival The Taubman Group.

According to an ICSC U.S. Shopping Center Classification and Characteristics factsheet published in 2012 and sourced from CoStar data, there were 1,505 regional and super regional malls in the U.S. with an aggregate 1.32 billion sq. ft. of GLA. Today, according to ICSC U.S. Marketplace Count and Gross Leasable Area by Type factsheet, there are 1,148 regional and super regional malls with an aggregate of 1.06 billion sq. ft. of

GLA. Based on those figures, that's a 23.7 percent decline in properties and a 19.5 percent decline in mall GLA.

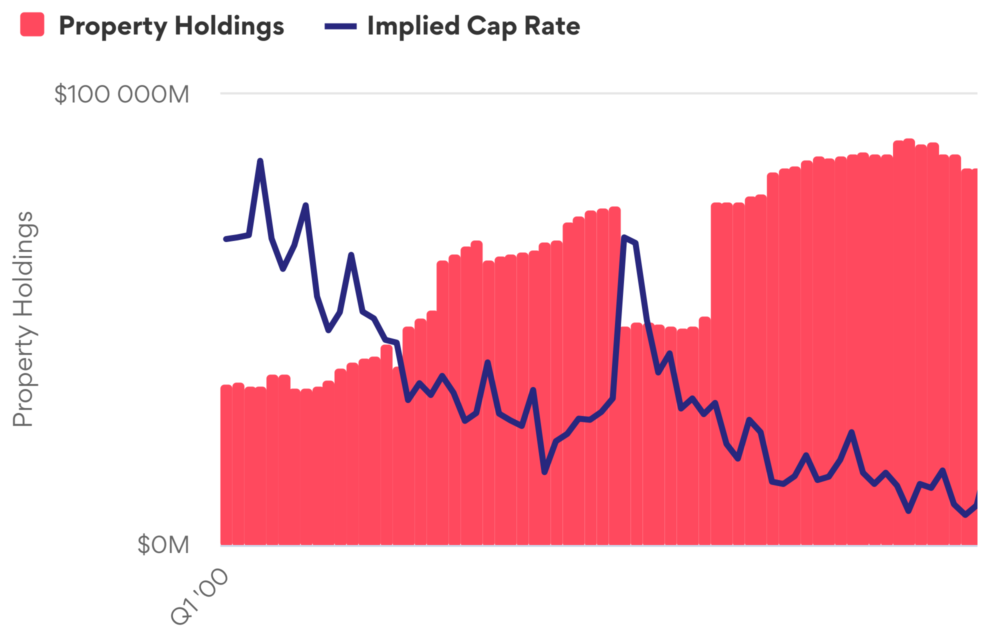
However, Green Street's Tibone doesn't expect additional REIT consolidation in the coming years. "We've reached a point where we're pretty stable—I don't think we're going to see any new ones emerge, nor do I think we're going to see any go away," he notes.

Likewise, industry experts don't anticipate any large-scale exists from the market similar to French company Unibail-Rodamco-Westfield (URW) . The company's announcement earlier this year that it planned to sell all its mall properties in the U.S.—24 malls over the next 18 to 24 months—came as a surprise to some, but an equal number of industry observers anticipated such a move.

URW was (and continues to be) overleveraged, so its decision to dispose of its U.S. mall portfolio and concentrate on its European assets makes sense from a financial perspective, industry experts say. "URW's situation is unique," says Tibone. "I think the motivation of selling is driven by desire to raise capital and improve leverage metrics more than anything else."

Regional Mall Holdings and Implied Cap Rates

Source: Nareit T-Tracker



URW has already taken the first step toward achieving its goal: in August 2022, it completed the sale of 1.5-million-sq.-ft. Westfield Santa Anita in Arcadia, Calif., for $537.5 million. Though URW declined to identify the buyer, property records identify Riderwood USA as the owner of the mall. The deal represented the largest mall sale since 2018, according to CoStar.

Dealing with debt

Decreasing property values, tighter lending standards and fewer sources of debt have created a challenging situation for mall owners—even mall REITs with strong balance sheets.

“Many malls are dealing with difficult debt structures—loans that were made seven years ago when the market was vastly different,” Tibone notes. “They have debt on them that needs to be refinanced sooner rather than later, and the reality is that mall asset values are down a lot. That means it will be a challenge for mall owners to refi without putting in a lot more money.”

Macerich, for example, has refinanced or extended $580 million of debt at a weighted average closing rate of just over 5.0 percent, according to Kingsmore. The REIT expects to extend its $500 million loan for Washington Square in Portland, Ore. for four years until late 2026, as well as its $300 million loan Santa Monica Place loan for three years until late 2025.

In the case of malls that are mortgaged for more than they’re currently worth, mall owners might decide that it’s smarter to let go of the property. For example, in August CBL conveyed Asheville Mall in Asheville, N.C. to the lender in exchange for cancellation of the $62.1 million loan secured by the property.

CBL also surrendered the keys to four additional malls in Ohio, Virginia, North Carolina, and South Carolina, which resulted in a total of roughly $132.9 million of debt that will be removed from CBL’s pro rata share of total debt.

“We don’t view handing back the keys as a negative,” Tibone says. “To us, defaulting on a loan that is underwater and transferring the property back to the lender is the right decision.”

Even though there’s a perception that owners are only willing to let poorly performing malls go back to the lender, that’s not always the case (although the bulk of relinquished malls have been B and C quality).

“Just because a mall has a problematic debt structure, doesn’t mean it’s bad mall,” Tibone points out. “It’s not always a reflection of the mall.”

Tibone anticipates that most malls that go back to the lenders in the next 12 months will generate interest from traditional mall investors and operators, not just investors who seek to redevelop.

Is e-commerce still a threat?

A recent Shopping Centers Marketbeat report from real estate services firm Cushman & Wakefield states that the e-commerce disruption has already peaked. Most shoppers still value the in-person experience of browsing through merchandise and discovering surprises. In fact, a plethora of consumer research has found that 60 percent to 80 percent of consumers prefer to visit a store than shop online.

Smart retailers are no longer operating under the assumption that their customers prefer to buy their products online. They've realized that having a physical presence is still an important part of their business strategy. To that end, retailers are investing in bricks-and-mortar locations, adding new features such as interactive displays and in-store cafes and using technology to enhance the shopping experience.

"The flight toward bricks-and-mortar is real," said Simon during the REIT's third quarter earnings calls. "It's going to be sustained. If they're in the retail business, and they want to grow, they're going to open stores. It's that simple because the returns on e-commerce just aren't quite what everybody talks about."

Will recession stall improving fundamentals?

Today, mall REITs are in better financial shape than they've been in years, in part because two of the most financially-challenged REITs—CBL and Washington Prime Group emerged from bankruptcy in 2021 with stronger balance sheets. (WPG voluntarily de-listed from the NYSE in late 2021).

CBL, for example, completed over $1.1 billion in financing activity during the first three quarters of 2022. During the REIT's recent earnings call, CEO Stephen D. Lebovitz said that locking in financing at "favorable rates" significantly de-risked the balance sheet, reduced interest costs and increased cash flow. He added that

CBL now benefits from a “simplified capital structure primarily comprised of non-recourse loans, a strong cash position, a pool of unencumbered assets and significant free cash flow.”

Though mall owners saw foot traffic rebound from COVID-related declines though early 2022, by mid-year, inflation and higher gas prices began to take a toll, according to Placer.ai. October 2022 represented the third consecutive month that the year-over-year visit gap widened, by 5.7 percent.

However, it’s important to put this in context—given the economic headwinds, the actual decrease was fairly limited, especially considering the comparison to the unique strength shown in October 2021.

“Frankly, I think we’ve done an unbelievable job in increasing our occupancy and increasing our cash flow since the shutdowns,” said Simon. “Hopefully, in ‘23, we’ll get back to pre-COVID levels.”

Of course, the health of retailers continues to a topic of conversation within the mall industry. In response to recent deepening of economic challenges, Moody’s downgraded its outlook for U.S. retail and apparel from stable to negative. The ratings agency lowered its 2022 operating income forecast to a decline of 12 percent from a previous forecast of 1 to 3 percent drop. And, while Moody’s predicts sales growth of 6.0 percent, that is primarily due to inflation.

"Retailers are being hit with too much inventory just as demand is falling, not only with lower income consumers, but also middle- and higher-income consumers," Moody's Nguyen says, adding that the inventory glut has caused operating margins to compress more than 100 basis points.

However, fewer retailers are on the "tenant watchlist" than previously . Tibone notes that it seems to be a lot shorter, with fewer tenants on the brink of bankruptcy. "Even with a mild recession, I don't think the tenant bankruptcy situation will be too bad for malls," he says.

Mall REIT executives agree. "The question I get asked all the time—given what's going on in the macroeconomic environment out there and the looming recession is, are the retailers pulling back—and the short answer is they're just not," said Doug Healey, senior executive vice president of leasing for Macerich, during the REIT's third quarter earnings call. "We have a very, very healthy retailer environment right now."

According to Kingsmore, "I would say our renewal conversations with our retailers are still very strong. Generally, they've rightsized their fleets in the United States, and they're in expansion mode for the most part."

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