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Shaky retail real estate imperiled by mortgage-backed securities

The International Council of Shopping Centers president likens the retail market to the fires in Los Angeles County.

"They are getting under control but they are still burning and there's a lot more work to do," said Michael Kercheval, during the recent ICSC Western Division Conference at the San Diego Convention Center.

Kercheval, who conceded that it could take many months to fill vacant spaces, said the biggest problem facing his industry is an estimated \$1.7 trillion in commercial mortgage-backed securities (CMBS) set to mature within the next three to four years.

"If we don't fix that nothing else matters," Kercheval said suggesting that he does believe legislation is coming at the federal level that will allow these instruments to be renegotiated.

Landlords, who may have lost **Circuit City** or other retailers, still have to find a way to fill these spaces.

Kohl's (NYSE: KSS) has taken several Mervyn's here, including stores in Carmel Mountain Ranch and Marketplace at the Grove, and **Best Buy** (NYSE: BBY) is going into a Linens 'N Things in Carmel Mountain Ranch.

Still, many more spaces need to be filled, and companies such as Rite-Aid (NYSE: RAD) continue to build stores despite some ugly balance sheets.

Susan Harris, Los Angeles-based Charles Dunn Co., Inc. senior director, said the good news is that for the most part, there hasn't been a dramatic slide in retail as in residential.

The bad news is she believes more chain failures are on the way resulting in more empty space.

Harris said this problem is being made more acute by the fact that many retail leases today are governed by co-tenancy clauses allowing neighboring tenants to leave when a major retailer leaves a center.

Other co-tenancy clauses may allow significant rent reductions that could also make it harder for a landlord to manage its debt service.

"This is killing shopping center owners," Harris said.

Bruce Pomeroy, president of Glendale-based **Evergreen Development**, cited a Real Capital Analytics statistic claiming that some \$31 billion worth of the nation's retail properties are "in some state of foreclosure."

The news may be bad for landlords, but Harris said there are "vulture" funds poised on the sidelines that are ready to rush in if and when these properties go into foreclosure.

"Sam Zell (who founded Equity Office Properties and sold it last year) has put together a fund for this very time," Harris said.

As for when the market will be strong enough for developers to start building speculative retail again, there is no clear consensus.

Harris suggested mid-2011 might be a likely time.

Douglas Exworthy, company manager of Seattle-based TRF Pacific LLC said it certainly doesn't make sense today.

"The sentiment is, 'We're not ready to take a project to market. There's too much vacancy right now,'" Exworthy said.

Mary Lou Fiala, ICSC past chairwoman and Jacksonville-based **Regency Centers** (NYSE: REG) chief operating officer, said the good news here is that tenants who had been waiting for space in formerly leased up centers, now have some options they didn't have before.

Don Provost, ICSC vice president and Colorado-based Alberta Development Partners principal, said it will be four or five years "before the mega projects come back."

It may well take discounted rents to keep tenants in their spaces, but Timothy Wright senior managing director of Holliday Fenoglio and Fowler in San Diego, said that can be a slippery slope.

"Say you roll a rent back \$30 to \$40 per-square-foot per year; do you roll everybody's back?" Wright wondered aloud.

"This is much more an art than a science," said Susan Pickrell, senior investment office of John Hancock Financial in Walnut Creek. "If it's above market rates it'll be written down."

Exworthy said he won't do it.

"Our response is no," Exworthy said adding that his firm is willing to negotiate the level of rent increases in future years.

Karine Clark-Foreman, a **U.S. Bank** vice president, said retailers are much less likely to question the rates in newer properties.

On the sales side, Clark-Foreman had another concern _ the accuracy of appraisals in a market where there are few retail sales transactions at all.

"We've seen appraisals come in that decimate the value of a property," Clark-Foreman said.