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REIT Bricks and Retail Clicks | October 2013

Back to school shopping proved profitable for REIT buyers, as the MSCI US REIT Index (RMS) produced a total return of +3.3% for the month, which brings the year to date total to +3.2%. Comparatively, the S&P 500 was up 3.1% for the month, and still has a comfortable lead on the REITs with a +19.8% total return for the year.

"Intelligence is the ability to adapt to change." -Stephen Hawking

Though the RMS has surpassed and fallen back below its 2007 peak in 2013 (Chilton REIT investors did so in December 2010), the share price for the average REIT is still 25% below its all-time high. Though simplistic, a look at share prices today versus prior peaks can be instructive on who were the best stewards of investor capital over the 6.5 year time period.

FIGURE 1: SHARE PRICE COMPARISON - 2007 VS SEPTEMBER 2013

Company Name	Ticker	Sector	2007 High	9/30/2013
Simon Property Group	SPG	HQ Malls & Outlets	$123.78	$148.23
General Growth Properties	GGP	HQ Malls	$67.00	$19.29
Glimcher Realty Trust	GRT	HQ Malls	$29.28	$9.75
Macerich Co.	MAC	HQ Malls	$103.32	$56.44
Taubman Centers	TCO	HQ Malls	$63.22	$67.31
Pennsylvania REIT	PEI	LQ Malls	$48.95	$18.70
CBL & Associates	CBL	LQ Malls	$49.98	$19.10
Tanger Factory Outlet Centers	SKT	Outlets	$22.02	$32.65
JC Penny	JCP	Department Store	$86.35	$8.81
Macy's	M	Department Store	$46.51	$43.27
Nordstrom's	JWN	Department Store	$59.66	$56.20
Amazon	AMZN	E-Commerce	$100.82	$312.64

NOTE: LQ= Low Quality; HQ= High Quality

Figure 1 shows the share prices of the mall REITs, a few department stores, and Amazon (NYSE: AMZN) compared to their 2007 highs. Noticeably, the winners are 2 high quality mall REITs, an outlet center REIT, and AMZN, while the losers are low quality mall REITs, department stores, and, curiously, 3 high quality mall REITs. Just as the retailers were tested over the past 6.5 years, the retail real estate owners have had to share in the threats of the growth of e-commerce, changes in consumer spending, and the ever-changing landscape for what makes a successful retailer/tenant. The REITs that have been the most successful are those who were the most flexible and willing to adapt. Today, the market is once again questioning the flexibility and adaptability of mall and outlet REITs, which has created an investment opportunity that rivals any other REIT sector.

2007 in Heaven

Looking back, the valuation metrics that were reflected by the new highs in share prices reached by so many companies appeared expensive, but the sentiment at the time was at a similar high. Going into 2007, US Total Compensation had risen 28.2% since 2002, or 5.1% annualized. Similarly, disposable income was up 14.7% for the same period, or 2.8% annualized. Higher incomes led to more discretionary purchases, much of them at malls and local shopping centers. Retail sales, ex-food, had been on a tear, rising 26.7% since 2002, or 4.8% per year. Retail stocks were hitting new highs, and the market was affirming the anticipated flow-through in rents to the REITs by similarly rewarding them with new share price highs.

With shoppers' wages and total compensation rising and their employers feeling confident about the future, consumers were comfortable lowering their savings rate down to 3.0% for 2007, the second lowest full year average on record (after 2005's 2.6% savings rate), and a far cry from 4.4% in July 2013 and the 8.5% average since 1960. However, rising consumer debt levels (total credit card debt grew 38% from 2001-2007) were signaling that the consumer was stretching beyond his or her means and leaving little for protection in case of an economic downturn.

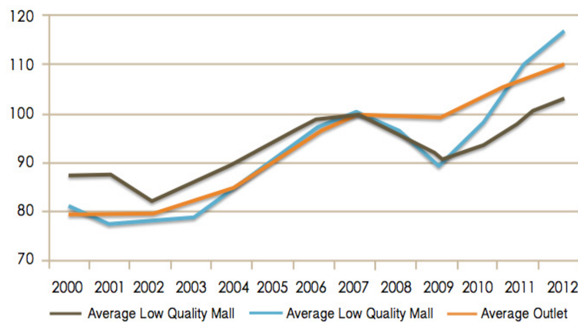
Who Didn't Hate 2008?

When the music stopped in late 2008, there were a lot less chairs than consumers, retailers, retail real estate owners, and even economists had anticipated. The nationwide de-levering caused lenders to ask for loans to be repaid at the same time that borrowers had their lowest savings and were experiencing wage compression. Wages were down 4.7% and credit card debt decreased by 11.0%, which resulted in retail sales declining by $100 billion, or 2.8%. Another $200 billion

decline in retail sales headlined 2009, but the real story was the shift in how Americans were spending their $3.6 trillion that year.

Two trends emerged from the crunch: thriftiness was okay or necessary, and quality malls were king. Outlet centers and dollar stores benefited as a result of the new thrifty nature of shoppers, and quality malls got stronger at the expense of weak centers and malls. While Sears (NASDAQ: SHLD), JC Penney (NYSE: JCP), Barnes and Noble (NYSE: BKS), and Circuit City were blaming Amazon (NYSE: AMZN) or eroding margins as they tried to keep prices low, some retailers embraced the new 'threats' and turned them into advantages.

FIGURE 2: MALL & OUTLET SALES, INDEXED TO 100 IN 2007



SOURCE: Company Documents, SNL. HQ Malls represented by GRT, MAC, SPG, TCO, GGP. LQ Malls represented by PEI, CBL. Outlets represented by SKT and SPG Outlets.

Figure 2 shows the sales growth of the high quality malls, low quality malls, and outlet centers for the period of 2000 to 2012, indexed to 100 in 2007. Impressively, each of them has recovered to above prior peak, although some were able to regain footing faster than others. Notably, outlet centers were down less than 1% in 2008 and 2009, and Simon Property Group's (NYSE:SPG) outlet centers actually had higher sales in 2008 than they did in 2007.

Bricks and Clicks

At Chilton, we are proud to have analyst capabilities across the spectrum. Sam Rines is our Consumer Discretionary analyst, and he closely follows retailers that are tenants of REITs. It is his opinion that utilizing the internet and outlet centers is a necessity for successful retailing in today's world.

"Malls and outlets are tied together by the e-commerce channel, and many retailers have developed differentiated e-commerce experiences to compliment the bricks and mortar, a strategy some have referred to as 'bricks and clicks'. Successful retailers have tied the entire piece together to cast the widest net, drive higher foot-traffic, and maintain a wide range of price points."

ANN INC (NYSE: ANN), owner of the Ann Taylor and Ann Taylor LOFT brands, stated in its 2012 Letter to Shareholders: "ANN INC's financial results have also improved, fueled by business diversification into growth channels like e-commerce and factory outlet.... We have improved both the in-store experience and our bottom line through more productive real estate, as well as diversifying our business mix into higher return channels...." The maximization of productivity of real estate is a theme for both the REITs and retailers alike, as sales per square foot is the driver of higher rents.

Don't Doubt the Outlet

Thus, the 'three-legged stool' of mall, outlet, and internet became the model for retailers, and the REITs were quick to pick up on it. SPG, the world's largest publicly traded commercial real estate owner, acquired Chelsea Property Group, an outlet center REIT, in 2004 for $4.8 billion, and invested another $2.3 billion to buy Prime Outlets in 2009. SPG has expanded into Asia and Mexico with their Premium Outlets brand, and recently entered Europe with the announcement of a joint venture with McArthurGlen in June 2013. SPG and Tanger Factory Outlet Centers (NYSE: SKT) are the two largest owners of outlet centers in the country, and SKT CEO Steve Tanger estimates that REITs own 80% of the quality outlet market. In the past 15 years, mall REITs Glimcher Realty Trust (NYSE: GRT), CBL & Associates (NYSE: CBL), Macerich (NYSE: MAC), and Taubman Centers (NYSE: TCO) have also diversified their portfolios by developing or acquiring outlet centers.

This summer, we visited two A+ outlet centers: the Fashion Outlets of Chicago (owned by MAC) and The Outlet Collection|Jersey Gardens (owned by GRT). Both are enclosed centers by airports (O'Hare and Newark, respectively), and are projected to have over $700/sqft in tenant sales for the next 12 months, which compares to SKT's portfolio average of $376/sqft in 2012. With quasi-anchors, shuttle service, close proximity to metropolitan centers, and numerous dining options, these 'outlet centers' share a surprising amount of qualities with luxury malls. Jersey Gardens receives over 18 million visitors per year, and the average international shopper spends $650 over almost 7 hours!

We also attended a tour of two outlet centers in St. Louis, previously the largest US city without a quality outlet center. When TCO's Prestige Outlets Chesterfield opened on August 2 for tax free weekend, 2,000 shoppers were waiting in line by 9:15am and 10,000 visitors had been through the center by 1pm. SPG's St. Louis Premium Outlets opened on August 22 to similar fanfare. The success of outlet centers has cemented the channel as one that retailers cannot ignore. SKT and SPG derive 100% and 35% of their NOI from outlet centers, respectively, which helps to explain why their sales were among the first to recover from 2008.

Luxury Bounces Too

TCO's portfolio boasts the highest tenant sales per square foot in the mall REIT sector, and serves as a proxy for the luxury mall segment. Luxury consumers were similarly affected by the downturn, as evidenced by TCO's 4.0% and 5.8% decline in tenant sales in 2008 and 2009, respectively. However, luxury shoppers rebounded extremely fast because the wealthy own a disproportionate amount of public stocks and bonds. The 'wealth effect' from the rebound of the stock market in 2009-2010 encouraged high end shoppers to return to their 2007 ways quicker than most expected. TCO's tenant sales surged 12.4% in 2010, leading the mall sector and bringing tenant sales to a new record high at the time.

Meanwhile, Penn REIT (NYSE: PEI) surpassed 2007 sales in 2011, and CBL did not surpass 2007 tenant sales numbers until 2012. While the luxury consumers hold a majority of their net worth in stocks and bonds, the middle and lower class consumers derive most of their net worth from net equity in their home. The collapse of the housing market in 2008 hit all consumers alike, but the lack of a significant bounce back to peak prices has had a 'reverse' wealth effect on middle income consumers without a large stock and bond portfolio. Research suggests that the B and C mall consumer is still 20% below their peak net equity despite the rebound in housing prices.

REIT E-Tailing

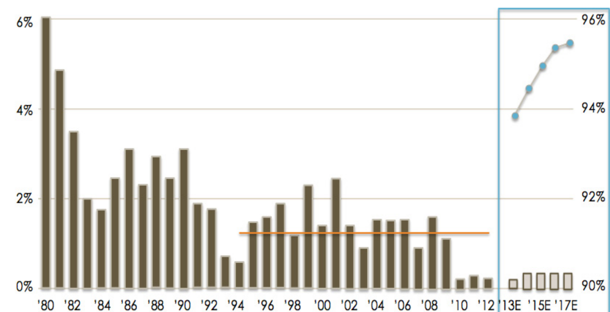
Mall owners have had to adapt to the 73% growth in e-tailing over the past 5 years that has decreased department store sales by 10% over the same period. As a result, mall owners are targeting tenants that are "experiential", which means they necessitate the consumer to physically be in the store. GRT has made a concerted effort to bring in tenants that specifically drive traffic. GRT CEO Michael Glimcher has stated, "We want to be a place that people go to frequently, more than one time a week," as they have targeted tenants that specifically drive traffic. Movie theaters, restaurants, salons, and membership-driven concepts have become coveted mall tenants whereas they used to be reserved for strip centers.

Despite efforts to drive traffic in the internet age, overall foot traffic is still below 2007 peak levels. Malls simply cannot provide the convenience of a click without dealing with parking and lines. However, as we stated earlier, mall sales are well above 2007 levels. Adaptive retailers and mall owners have used the internet, specifically social media, to their advantage to drive more sales from fewer shoppers.

Surprisingly, social media drives about the same amount of in-store purchases as it does for online purchases. The strategy focuses on both increasing the likelihood that a visitor will buy something, and increasing the amount that the visitor spends. Pinterest, Facebook (NASDAQ: FB), Twitter, and Instagram are the most popular methods that are being used today. According to a survey from Crowdtap, nearly 65% of shoppers use social media to find the perfect gift. By garnering 'followers' on social media, retailers and mall owners can generate 'earned advertising' as opposed to 'paid advertising', as followers recommend products or stores to their followers. According to the same Crowdtap survey, 92% of consumers trust earned advertising over paid advertising. As a result, shoppers develop loyalty to brands and locations that have made well-received recommendations, and will be more inclined to decide to go shopping or make an unplanned purchase when they check their mobile device while running errands or walking into the mall.

The combination of successful retailing efforts and a lack of competition from new malls (see Figure 3) is driving mall occupancy and rents

FIGURE 3: MALL SUPPLY GROWTH AND PROJECTED OCCUPANCY



SOURCE: ICSC, Green Street Advisors (2012-2017)

to new highs, on average. TCO has been renewing expiring leases at rates 20% above the prior leases, and its portfolio occupancy cost (rent/tenant sales) still is at a recent low of 13.9% as of June 30, 2013, which indicates that TCO can continue to push rents higher. Similarly, SKT had an occupancy rate of 98.3% as of the same date and an extremely low occupancy cost of 8.4% as of December 31, 2012, which drove re-leasing spreads approaching 30% for the second quarter of 2013.

Adjusting for Risk

Returning to Figure 1, it now may be apparent why some REITs have recovered to levels above 2007, while others have not. GGP, GRT, and MAC stick out as underperforming anomalies to their high-quality peers despite their success in restoring tenant sales numbers. The stories of GGP, GRT, and MAC are testaments once again to the importance of the balance sheet and capital allocation decisions by management teams. Leverage, equity dilution, and dividend cuts can outweigh even the best operational successes when it comes to total returns for shareholders.

Through the deep experience on the Chilton REIT Team, we have refined risk management to maximize risk-adjusted returns for our clients. Leverage, management track record, and dividend policy are just a few of the criteria we use to classify each REIT into Core (lowest risk), Value-Add, or Opportunistic (highest risk) categories. Each category has a required return to justify investment, with the Core REITs requiring the lowest total return and the Opportunistic REITs requiring the highest. We attribute our historical outperformance to our unique process of assessing risk, establishing price targets through proprietary earnings models, and prudent portfolio management. Accordingly, our careful analysis of the high quality mall and outlet REIT sector gives us confidence that they will be able to adapt to the ever-changing retail environment and produce outsized returns for shareholders going forward.

Indexes are unmanaged and have no fees or expenses. An investment cannot be made directly in an index. The funds consist of securities which vary significantly from those in the benchmark indexes listed above and performance calculation methods may not be entirely comparable. Accordingly, comparing results shown to those of such indexes may be of limited use.

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RMS: 1321 (9.30.2013) vs. 1280 (12.31.2012) vs. 1087 (12.31.2011) vs. 1000 (12.31.2010) vs. 792 (12.29.2009) vs. 933 (9.30.2008) and 1330 (2.7.2007)

Please feel free to forward this publication to interested parties and make introductions where appropriate.

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