Cortlandt Town Center

Introduction

In April 1998, Stephen Lebovitz reflected on the meeting that would be held the next day. The owners of the Westchester Mall, the Tutaks, were flying to CBL & Associates Properties' corporate headquarters in Tennessee to take part in a "renegotiation" of the terms of the sale of the property. The costs on the project had escalated significantly over the original pro-forma, and the original timetable was not adequate to allow for the completion of the permitting necessary for CBL to redevelop and expand the project to a 790,000-square-foot power center.

Lebovitz needed to be fully prepared for the meeting. How much of a price reduction did he need? How would the Tutaks, who were especially difficult sellers, react? Were there other ways to approach the renegotiation other than a straight price reduction? Would it be possible to negotiate further concessions down the road if necessary?

Adding more complexity to the issue would be the meeting next week of CBL's board of directors. They were aware of the project's problems and would expect an update. Lebovitz would need to evaluate the impact of the renegotiation and justify continuing to pursue the project to the board, if appropriate. Strategically, why is CBL, a developer of regional malls and strip centers, building a power center? Is it likely to be a major money maker for the company?

CBL had gone public in October 1993 as a self-managed and self-administered real estate investment trust (REIT). It had a portfolio of 117 owned and managed properties totaling 22.8 million square feet. The properties are located primarily in mid-sized markets in the growing Southeast and in select markets in the Northeast.

Background

The Westchester Mall was originally constructed on 40 acres in 1974 by a New York area developer. Located in the Town of Cortlandt, it appealed to the growing affluent trade area in northern Westchester County. The property was anchored by a Waldbaum's Supermarket, a Two Guys discount department store, and included a strip of shops, several freestanding buildings, and a small enclosed mall area.

The original plan contemplated an expansion on the adjacent 80 acres to develop a larger regional mall as the trade area population expanded. However, in the late 1970s, Jefferson Valley

Adjunct Professor William J. Poorvu and Senior Lecturer Arthur I. Segel prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

Mall was developed only three miles away at a nearby interchange off of the Taconic Parkway. Jefferson Valley Mall was a conventional enclosed regional mall with Sears and A&S (now Macy's) as its anchors. Its development precluded the expansion of the Westchester Mall due to its superior access and the lack of need for two conventional regional malls serving the same trade area. As a result, Westchester Mall became more of a "discount" mall serving the lower-income population in the trade area.

CBL's Initial Involvement

In 1988, Stephen Lebovitz, recently graduated from HBS, set up a regional office in Boston for CBL & Associates, Inc., a developer and owner of shopping centers primarily in the southeast. The strategy for the office was to leverage off of CBL's excellent relationships with expanding retailers like Wal-Mart, Home Depot, and others to develop community shopping centers in the northeast. One of the first market opportunities that he was pointed to was the northern part of Westchester County. While the population had grown considerably in recent years, the stringent zoning and limited supply of developable land had kept new shopping centers from being developed.

CBL investigated several prospective projects in the trade area. One of these that looked promising was the Westchester Mall. CBL was first introduced to the Westchester Mall in 1993 by A&P, parent company of Waldbaum's. A&P had been working with the owners of the mall, the Tutaks, who had bought the mall from the original developer several years before, to expand its store into a state-of-the-art 50,000-60,000 sq. ft. supermarket. A&P called CBL because it was frustrated by the Tutaks' lack of development expertise and inability to proceed with the redevelopment for financial and other reasons. While the Tutaks were successful business people, they had never owned or developed a shopping center of this size. A&P asked CBL to come in, try to purchase the existing center from the Tutaks, and proceed with the redevelopment and expansion.

In recent years, the Westchester Mall had deteriorated to a major degree. After the original Two Guys discount anchor store had gone out of business, that building was sub-divided and occupied by Jamesway, a discount department store, and Pergament, a discount home improvement center. Both of these stores were weak from an operational and financial point of view. Also, no capital whatsoever had been invested in the property since it was built, which was readily apparent in the decrepit condition of the parking lot (i.e., huge potholes) and buildings. The enclosed mall portion of approximately 100,000 square feet was less than 50% occupied, and most of the stores were local operators. The center also had a horrible reputation in the community due to its consistent deterioration over the years.

At the same time, CBL viewed the Westchester Mall as a terrific redevelopment and repositioning opportunity. The search for a piece of raw land to develop in the area had been fruitless due to most of the local communities' opposition to new shopping center development. While the existing property was in terrible condition, immediately adjacent to it were 80 acres of vacant land correctly zoned for a shopping center development. About half of the property was not developable due to wetlands; however, CBL estimated that it could add in the range of 440,000 square feet of rentable space, although the design would have to accommodate a 40-foot grade change between the two parcels. This expansion, coupled with the redevelopment of the existing 350,000-square-foot property, would allow CBL to reposition the project into a new "power center" and accommodate many of the retailers who had expressed an interest in locating in the northern Westchester County market.

CBL made the decision that this was an opportunity worth pursuing. However, this project would be breaking new ground for the company. Most of its properties consisted of either conventional enclosed regional malls or strip shopping centers containing less than 250,000 square feet and anchored by a supermarket and a discounter. This project would contain in the range of

790,000 square feet and would include multiple anchors. It would be CBL's first true "power center" development.

A "power center" was a relatively new classification of shopping center originated in the early 1980s. "Power centers" were larger than conventional community or neighborhood strip shopping centers and were anchored by stores known as "big boxes." "Big boxes" were superstores which were designed to dominate a specific retail category, such as Toys R Us for toys, Staples for office supplies, and The Home Depot for do-it-yourself home improvement work. "Big boxes" ranged in size from 20,000 to 100,000 square feet and required a regional trade area of at least 250,000 people to support a store. They typically were located around regional malls and had created a whole new competitive landscape for traditional mall tenants not accustomed to the aggressive pricing of the "big boxes." A number of shopping center developers had focused their energies on the development of "power centers," and CBL had begun to buy more land around its regional malls so it could accommodate these types of users who expected to achieve average annual sales levels of $300 per square foot v. $225 per square foot for the average mall store.

From a landlord's perspective, the downside of power centers is that the big box retailers as part of their effort to cut prices aggressively try to cut occupancy costs. While in a regional mall, the average mall tenant was accustomed to paying about 15% of sales for base and percentage rent and common area maintenance charges, these retailers tried to limit their occupancy costs to 5%-6% of sales.[1] Furthermore, it was this market, at least in theory, which might be vulnerable to E-tailing or E-commerce-based retailers since most products power centers sold were price-sensitive and "commodity-like".

In approaching the Tutaks, CBL knew that the redevelopment of the Westchester Mall would require several years. CBL was not willing to buy the property "as is." Instead, it needed to put the various pieces in place to allow for the successful redevelopment of the project before making the commitment to acquire the existing center and adjacent land. CBL's first approach to the Tutaks was rejected because the Tutaks were not willing to give CBL the two to three years estimated to accomplish this redevelopment. However, six months later the Tutaks re-approached CBL because the developer they had been dealing with was faltering. CBL was successful in structuring an option to purchase the property that allowed for an acceptable time frame (3 years) and a "market" price of $30.5 million, for both the existing shopping center and the vacant land. CBL's standard policy is to develop a project pro forma for any new project before it executes an option agreement. The initial pro forma in May 1997 (**Exhibit 1**) showed a projected free and clear return (i.e., unleveraged) of 11%, which was CBL's minimum return criteria for proceeding with a new development project.

Development Challenges

With the property under "control," CBL began the development process. In order to move forward, CBL invested considerable money in the due diligence and approval process. As it got deeper into the project, CBL began to understand that the project would be even more complicated and expensive than was originally thought. Some of the issues it faced were the following:

Leasing environment CBL was not the only developer pursuing a power center project in northern Westchester County. Two other companies were actively pitching competitive projects. While CBL's site had the advantage of being the only properly zoned property, it also had two fairly major drawbacks. First, the location was 3 miles off of the closest highway. This was a negative since for the most part, power center retailers prefer interstate visibility and accessibility. Second, CBL had to overcome the "baggage" associated with the stigma attached to the existing, failed center that was

[1] Common area maintenance charges for enclosed regional malls might run about $12 per sq. ft. compared with $3.50 per sq. ft. in power centers.

proposed for redevelopment. Despite its marketing efforts, it took quite a bit of imagination to see how such a distressed center could be turned around. As a result, CBL had to be more aggressive by offering better economics to secure the initial anchor tenants for the project.

Trade area While Westchester County offered a growing and affluent trade area, northern Westchester County was still "thin" in the eyes of many retailers. As set forth in Exhibit 3, CBL's market study showed a trade area population in 1997 for a 10-mile ring of 187,109 people or 63,871 households with an average household income of $79,972. Approximately 20% of average household income is spent annually on retail goods and services. While the population and income levels showed good growth, many retailers questioned whether the trade area could support the existing stock of shopping centers plus what had been proposed. CBL thought that given the strength of their retail tenants, customers would come to the center from outside the 10-mile ring. The target population could well be 300,000.

Approval issues In order to obtain the necessary approvals for the project, CBL would need to spend considerably more funds than initially estimated. These included an estimated $2.0 million for off-road and traffic improvements such as widenings, signals, and sidewalks. Also, the Town of Cortlandt insisted on an amenity package including a community room, a park, and several plazas to create a "streetscape" feel to the project, which added in the range of $1.0 million in costs to the project.

Site conditions For the existing center, the more CBL learned, the worse the news it received. For the most part, the existing buildings and parking lot were a liability with roofs that needed to be replaced, utilities that were in disrepair, and a failed parking lot. While many of these factors had been anticipated, some had not and put further pressure on the numbers.

Tenant buy-outs In order to successfully implement its plan of development, CBL needed to buy out a number of existing stores. The initial budget of $1.5 million had to be increased to over $3.0 million for this category.

The Renegotiation

By April 1998, a revised pro forma showed that project costs had risen from $71.2 million to $83.6 million. On the other hand, income after operating expenses had risen from $8.2 million to $8.8 million and interest rates had dropped substantially.

CBL's free and clear pro-forma return had decreased to approximately 10%, below the minimum criteria. While the Tutaks had been kept informed of the problems and the higher costs encountered, and knew that CBL needed a price reduction, they had resisted any renegotiation to this point. However, after much back and forth, they agreed to the meeting in CBL's Tennessee headquarters to discuss the situation.

Even though CBL would be forced to write off over $500,000 in costs invested to date, Lebovitz knew it was not wise to continue to pursue the project without a restructuring of the agreement. The trend on the project had been for the costs to be higher than anticipated.

The Meeting

In preparing for the meeting, Lebovitz listed the following positives and negatives of where the project currently stood.

POSITIVES

1. Deals had been struck with anchor tenants, including Home Depot, Nobody Beats the Wiz (a large NY metro area consumer electronics store), A&P, United Artists Theaters, Modell's Sporting Goods, Home Place, and Office Max, eliminating the two competitive projects. Leasing momentum was building and rents were improving. Tenant prospects felt that sales of $300/SF were achievable. Most of the leases were relatively long term—10 to 20 years, compared with leases in the malls which generally were from 3 to 10 years.

2. CBL had done considerable due diligence on the physical condition of the existing center and the vacant land, which should minimize the "surprises" going forward.

3. There was good momentum with the Town of Cortlandt in securing the necessary approvals. Most of the key issues that affect cost had been negotiated.

4. Even at a lower return, the project would generate an attractive return to the company, given low interest rates and a favorable market for financing.

5. Jamesway, one of the anchors, had filed Chapter 7 and was expected to liquidate. This would provide an opportunity to bring in Wal-Mart or Target and further strengthen the anchor tenant lineup.

6. The project would be relatively high profile, given its size and location, and would provide CBL, a NYSE traded REIT, with good publicity in the shopping center industry as well as the New York metropolitan area, where many REIT analysts and investors reside.

NEGATIVES

1. The project would need to be built with union labor, not a factor CBL typically dealt with. Construction costs in the budget were estimates and not "hard bid" numbers.

2. The financing market for "power centers" had softened. A number of sectors were experiencing shakeout, and the financial markets had become less enthusiastic about financing this type of project especially with the recent advent of web-based retailing on the internet.

3. The layout of the center was such that the new construction on the vacant land was most attractive to tenants. Since this area had been the first to fill up, the more challenging locations were left.

4. Over $500,000 would need to be spent over the next several months in order to prepare the final application to the State of New York and the Town of Cortlandt to move the approval process forward. This would bring CBL's investment to over $1.0 million.

5. Rents for the larger tenants were relatively flat over their lease terms.

6. Given the difficulties encountered on the project to date, there was always a nagging doubt in Lebovitz's mind of "what else could go wrong."

As he prepared to go into the meeting, Lebovitz was somewhat apprehensive given how hard he had worked on the project over the course of the past year. The Tutaks had terminated the previous developer involved and could very well do the same to CBL. While over the course of the past year, they had worked together closely, the Tutaks were slow to "trust" CBL. What could Lebovitz do to get the Tutaks comfortable that CBL really had its back to the wall and needed a major concession to go forward? The time pressure of the pending board meeting weighed on Lebovitz as well. The Tutaks did not like to be pressured. The more he thought about the meeting, the more nervous he became. Lebovitz closely reviewed his latest pro forma (**Exhibit 2**) which incorporated the latest leasing, financing estimates, cost budgets, as well as the potential Wal-Mart or Target deal. He had several ideas that he thought would work with the Tutaks. He just hoped he was right.

From a broad standpoint, CBL was in a relatively strong position. Total revenues in 1998 were expected to be $150 million, with earnings before interest, taxes, depreciation, and amortization (EBITDA) of approximately $112 million. Funds from operations (FFO) after interest charges and certain other minor adjustments were estimated at $63 million. With a number of regional malls under development and a new acquisition program of existing malls under way, growth of both revenues and earnings were expected to be 20% per year over the next two years. CBL's total market capitalization of about $1.3 billion was divided approximately 50% debt and 50% equity.

With the number of changes going on in the retail world and the perception that America was overstored, there was concern that future growth of regional malls would be much slower. There was talk that the Internet would also be a negative. As a result, CBL's stock which had come out in October 1993 at $19.50 had only risen to $22 by mid-1998. With an expected 1998 FFO of $2.05 per share and a distribution rate of $1.68 per share, Lebovitz tried to assess how Cortlandt fit with the company's future. The board meeting would be interesting, but first, the Tutaks.

Exhibit 1 Original Pro Forma, Income Statement & Development Budget

Project Name:	Cortlandt Town Center	Acres:	120.0
City & State:	Cortlandt, NY	Purchase Price Land:	$30,500,000
Date:	03-May-97	Redevelopment Costs:	$40,663,448
Prepared by:	Stephen Lebovitz	Project Cost (net of tenant reimbursements):	$71,163,448

		Total
Rental income		$8,228,000
Percentage Rent		50,000
Less Management—5.0% of Gross Rentals		(413,900)
Less Vacancy—5.0% of Small Shop Income		(32,198)
Income after Expenses		$7,831,902
Less Debt Service		
$54.000,000		
9.0% interest	20-year schedule	
10.8% constant	10-year term	5,830,224
Net Cash Flow		$2,001,678
Free and Clear Yield		11.0%
Return on Equity		11.7%

Exhibit 1 (continued)

Original Development Budget (May 1997)				Total
Land				$30,500,000
Site				12,633,836
Buildings				17,266,400
Contractors OH&P 5% of site and building cost only				1,495,012
Insurance/Construction Bonds/State taxes				150,000
Off-Site Traffic Improvements/Other Impact Fees				500,000
Architectural			$1.00 psf	785,547
Engineering, Traffic, Geotechnical, etc.			$1.00 psf	785,547
Marketing				300,000
Interim Finance				
Land (assumes 100% outstanding)	$26,900,000	9.0%	12 mos.	2,421,000
Project (assumes 50% outstanding)	$44,250,000	9.0%	12 mos.	1,991,250
Mortgage Fee		1.0% of total financing		540,000
Mortgage Broker's Fee		0.5% of total financing		270,000
Equity Fee	$17,150,000	4.0%		686,000
Real Estate Broker's Fee				395,000
Legal Fee				500,000
Closing Costs		0.5% of total financing		270,000
Taxes during Construction				400,000
Contingency				627,905
Other Costs - Existing Tenant Buyout/Relocations				1,500,000
Other Costs - Theater Contribution		$80.00 psf		3,200,000
Other Costs - Leasing Commissions				1,361,179
Other Costs Non-Applicable Project Costs				100,000
Project Management				750,000
Corporate Overhead, Travel, Expenses, etc.				1,034,773
Total Project Cost before Selloffs and Reimbursements				80,463,448
Less Sale of Pad/Site Work Reimbursement to Home Depot				(7,200,000)
Less Income (Deficits) during Construction Period				(1,100,000)
Less Renovation Costs to be Recaptured from Existing Tenants				(1,000,000)
Net Project cost				$71,163,448
Less Loan				54,000,000
Equity				$17,163,448

Exhibit 2 Revised Pro Forma, Income Statement and Development Budget

Project Name:	Cortlandt Town Center
City & State:	Cortlandt, NY
Date:	12-Apr-98
Prepared by:	Stephen Lebovitz

Acres:	120.0
Purchase Price Land:	$30,500,000
Redevelopment Costs:	$53,104,134
Project Cost (net of tenant reimbursements):	$83,604,134

Revised Income Statement (April 1998)		**Total**
Rental Income		$8,850,000
Percentage Rent		50,000
Less Management—5.0% of Gross Rentals		(445,000)
Less Vacancy—5.0% of Small Shop Income		(36,440)
Income after Expenses		$8,418,560
Less Debt Service		
$54,000,000		
6.9% interest	25-year schedule	
8.4% constant	10-year term	4,538,675
Net Cash Flow		$3,879,885
Free and Clear Yield		10.1%
Return on Equity		13.1%

Exhibit 2 (continued)

Revised Development Budget (April 1998)				**Total**
Land				$30,500,000
Site				13,720,000
Buildings				23,880,370
Contractors OH&P 5.0% of site and building cost only				1,852,619
Insurance/Construction Bonds/State taxes				150,000
Off-Site Traffic Improvements/Other Impact Fees				3,000,000
Architectural			$1.00 psf	785,547
Engineering, Traffic, Geotechnical, Etc.			$1.00 psf	785,547
Marketing				300,000
Interim Finance				
Land (assumes 100% outstanding)	$26,900,000	8.0%	12 mos.	2,152,000
Project (assumes 50% outstanding)	$56,700,000	8.0%	12 mos.	2,268,000
Mortgage Fee		1.0% of total financing		540,000
Mortgage Broker's Fee		0.5% of total financing		270,000
Equity Fee	$29,600,000	4.0%		1,184,000
Real Estate Broker's Fee				395,000
Legal Fee				500,000
Closing Costs		0.5% of total financing		270,000
Taxes during Construction				400,000
Contingency		2.0% of construction cost		778,100
Other Costs - Existing Tenant Buyout/Relocations				3,275,000
Other Costs - Theater Contribution		$80.00 psf		3,200,000
Other Costs - Leasing Commissions				1,361,179
Other Costs Non-Applicable Project Costs				100,000
Project Management				750,000
Corporate Overhead, Travel, Expenses, etc.				1,034,773
Total Project Cost before Selloffs and Reimbursements				$93,452,135
Less Sale of Pad/Site Work Reimbursement to Home Depot				(7,200,000)
Less Income (Deficits) during Construction Period				(1,100,000)
Less Renovation Costs to be Recaptured from Existing Tenants				(1,000,000)
Net Project Cost				$84,152,135
Less Loan				54,000,000
Equity				$30,152,135

Exhibit 3 Shopping Center Market Analysis

SHOPPING CENTER MARKET ANALYSIS
Cortlandt Town Center
10 Mile Ring

Urban Decision Systems, Inc.
03/23/97

POPULATION		**HOUSEHOLDS**		**INCOME**	
2000 Projection	193,681	Number (1997)	63,871	Per Capita	$27,556
1997 Estimate	187,109	Average Size	2.80	Agg Income ($Mil)	5,156.0
1990 Census	179,554			$0-$14,999	5,650
		FAMILIES		$15,000-$24,999	4,500
% 90-95 Change	4.2%	Number (1997)	49,172	$25,000-$34,999	5,156
		Average Size	3.22	$35,000-$49,999	8,297
RACE				$50,000-$74,999	12,706
White	169,235	**AGE**		$75,000-$99,999	10,530
Black	10,430	0-13	34,575	$100,000-$149,999	11,054
American Indian	269	14-20	16,684	$150,000+	5,967
Asian	5,213	21-34	38,262	Median Household	$66,103
Other	1,962	35-54	58,717	Average Household	$79,972
Hispanic	9,311	55-64	17,114	Median Family	$76,215
		65+	21,757	Average Family	$91,173

SHOPPING CENTERS	27	**TOTAL GROSS LEASABLE AREA (GLA)**			2,852
Neighborhood	10	Centers Reporting			21
Community	9	Centers Reporting Anchor GLA			4
Regional	2	Total Anchors GLA			440
Super Regional	0	Total GLA Excluding Anchors			2,412
GLA/Pop Ratio	15.2	Enclosed Centers	3	GLA	1,160
GLA/HH Ratio	44.7	Strip Centers	13	GLA	1,210

SIZE OF CENTER	**Neighborhood**	**Community**	**Regional**	**Super-Regional**
Number Reporting GLA	10	9	2	0
Total GLA	369	1,543	940	0
GLA Excluding Anchors	322	1,543	547	0
Average Total GLA	37	171	470	
Number of Stores	96	135	171	0

AGE AND STATUS	**Number**	**GLA**
Under 5 Years Old	1	256
5-10 Years Old	3	262
11-15 Years Old	1	585
15-20 Years Old	6	377
Over 20 Years Old	8	1,018
Planned Centers	2	0
Under Construction	0	0

Source: 1980, 1990 Census, March 15, 1995 UDS Estimates.

Urban Decision Systems Inc./3975 Fair Ridge Drive, Suite 200N/Fairfax, VA 22033/(800) 364-4837

Note: All GLA statistics are in 000s of square feet.

Exhibit 4 Mall Highlights

CORTLANDT • TOWN • CENTER

MALL HIGHLIGHTS

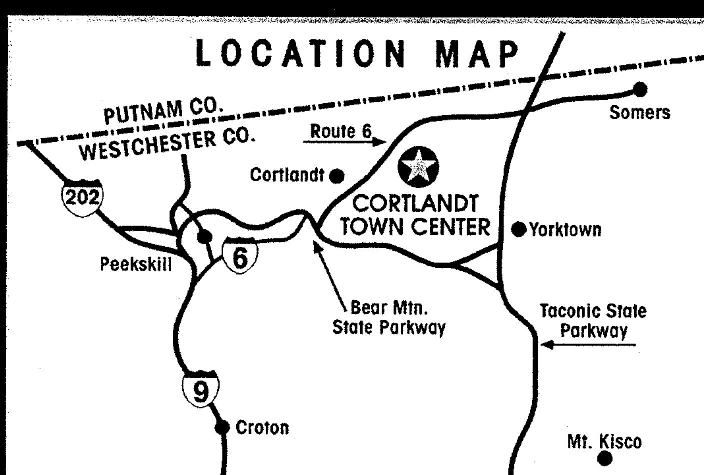
Size:	766,000 sq. ft. Power Center
Major Stores:	Home Depot (133,000 sq. ft.) Wal★Mart (130,000 sq. ft.) A&P Supermarket (65,000 sq. ft.) HomePlace (53,000 sq.ft.) Nobody Beats The Wiz (55,000 sq. ft.) United Artists Theaters (11 screens) Barnes & Noble (25,000 sq. ft.) Old Navy Clothing Co. (15,000 sq. ft.) 5 Additional Major Tenants
Acreage:	120 acres
Total Stores:	40
Parking:	3,800
Opening:	Fall 1999
Location:	Route 6, three miles west of the Taconic State Parkway, in the town of Cortlandt, New York.

GENERAL INFORMATION

- Primary trade area population is 300,000 in affluent Westchester and Putnam Counties.
- Average household income of $77,000.
- Cortlandt Town Center will become the largest shopping center in northern Westchester County.
- Easily accessible from the Taconic State Parkway and the Bear Mountain State Parkway.

CORTLANDT, NEW YORK
WESTCHESTER COUNTY

NOW UNDER CONSTRUCTION!



CBL & ASSOCIATES PROPERTIES, INC.

Exhibit 5 Site Plan