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The only game

In general, if a parking spot on a Manhattan street appears to be unoccupied, it isn't a legitimate parking spot. So, by analogy, on Wall Street if a company appears to be cheap in the sixth year of a bull market, it probably isn't a legitimate company, and it probably isn't cheap.

An exception to prove the rule is the subject at hand. CBL & Associates Properties Inc. (CBL on the Big Board), a $3 billion market cap, 5.9% yielding real estate investment trust, is that exception. Shopping malls and outlet centers are its stock in trade. It owns 76 of the former and five of the latter, as well as dozens of other retail and office properties. Sears and J.C. Penney figure among its largest tenants. Amazon breathes down its neck. Still—with a codicil—we're bullish.

Read the biography of Jeff Bezos the next time you feel an urge to invest in a retailer, Bill Ackman, CEO of Pershing Square Capital Management, advised ticket holders at the 2014 Fall *Grant's* Conference: "After you are done reading it and you still want to invest in retail, you should have your head examined."

The recent bankruptcies of Deb Shops, Wet Seal, RadioShack, Cache and Body Central do nothing to disprove that dictum. Then, again, neither do they prove it—at least, they do not prove the bearish case on retail bricks and mortar.

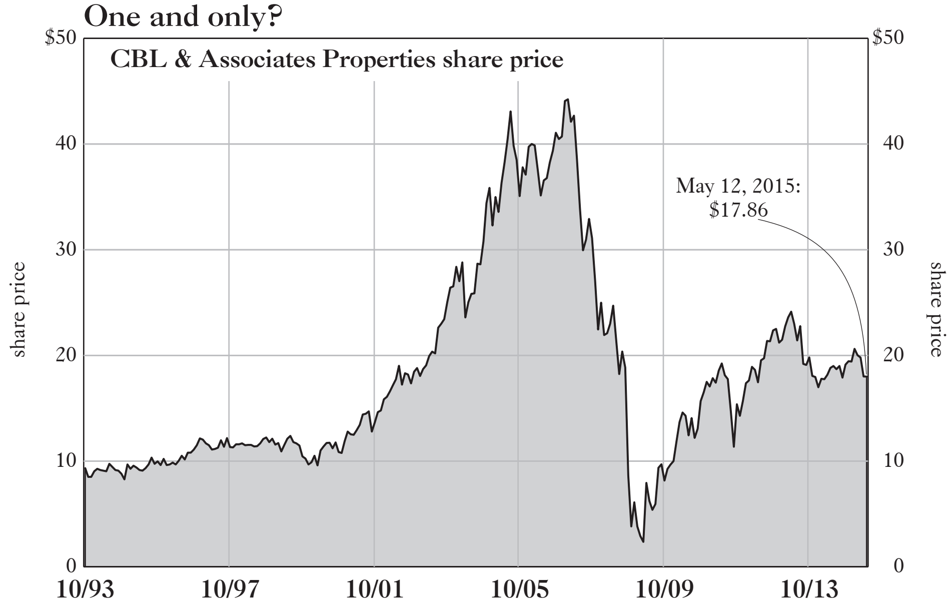
We write with a small store of hard-won knowledge. In the issue of *Grant's* dated March 22, 2013, we presented the bearish case on Pennsylvania Real Estate Investment Trust (PEI on the NYSE), a shopping-center owner that, like CBL, was heavily exposed to Penney and Sears. Did the price of a share of PEI obediently decline? It did not. Management proceeded to off-load marginal properties. An activist investor, Land & Buildings Investment Management, took an interest. From publication date to the present, Penn REIT has returned 29.2% with dividends reinvested. Over the same span, CBL has cost its holders 14.8%, also with dividends reinvested. What the management of Penn REIT did, CBL hasn't done. That it one day may emulate Penn REIT is at the heart of the bullish case on CBL.

Founder Charles B. Lebovitz is the CBL eponym. The company he founded in 1978 has interests in 29 "associated" centers (that is, retail properties adjacent to malls), 11 community centers, and 13 office buildings, as well as the aforementioned malls and outlets: 84 million square feet in all. The Southeast and Midwest is CBL's stomping grounds; it has properties in 30 states. The "B" mall type predominates; in the 12 months ended March 31, CBL's tenants produced an average of $365 in sales per square foot. Such "A" mall operators as Simon Property Group and General Growth Properties generate sales per square foot in the neighborhood of $600 a square foot.

Cheap stocks are cheap for a reason; it falls to the value-seeking analyst to judge the validity of that reason. In the case of CBL, we think we can identify three reasons, or pretexts: e-commerce is laying waste to bricks-and-mortar retailing; Penney and Sears, major CBL tenants, are not long for this life; and to judge by its deeds, not even CBL management is very bullish on CBL.

We judge knock No. 1—a seeming

One and only?



source: The Bloomberg

self-evident truth in this Age of Amazon—to be wide of the mark. Virtually no new malls have been built since the Great Recession, as Green Street analysts D.J. Busch and Spenser Allaway observe in a March report. "Non-anchor occupancy continues to move higher to all-time highs," they relate. "Portfolios are generally only left with frictional vacancy," or a slightly higher-than-frictional vacancy rate owing to the afore-noted burst of bankruptcies. Online retailers have discovered that people want to see and touch the merchandise. Too, they want to have a place (besides the post office) to return it in exchange for the correct size.

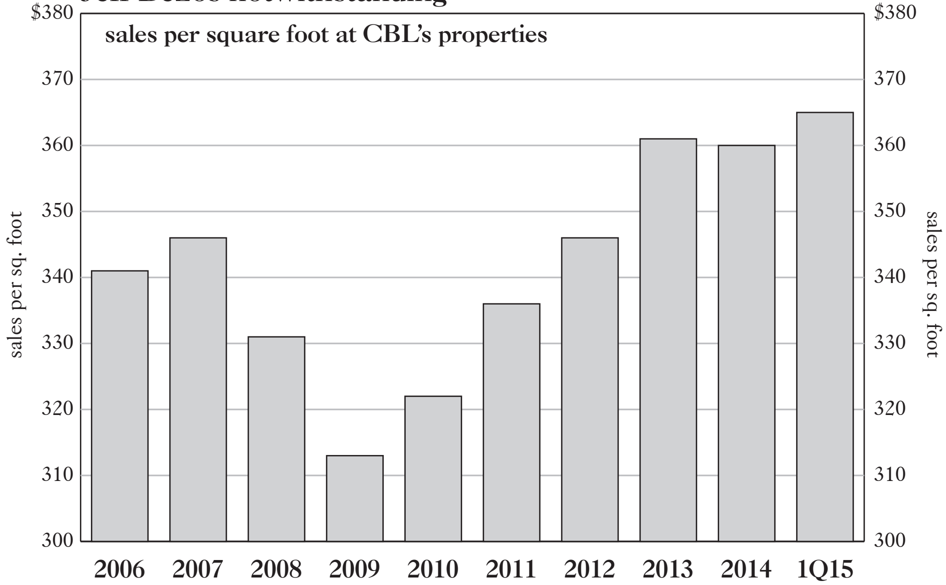
CBL's results largely conform to the Green Street industry overview. Occupancy declined to 90.9% in the first quarter of 2015 from 92.5% in the first quarter of 2014. In partial compensation, gross rent per square foot on re-leasing activity jumped by 10.6%. Gains on lease renewals increased by 3.4% and new leases by 35.1%—which is to say that CBL can charge substantially more when struggling tenants leave. (Eight to 10 years is the typical length of a CBL lease, though an anchor tenant can run for much longer.)

Knock No. 2, the one about Sears and Penney, is no more persuasive than the first, we think. There are 62 Penneys and 55 Sears at CBL's malls. It would be better if they weren't there. "Rather than a drag on results," colleague Evan Lorenz relates, "the slow death of these retailers constitutes a significant source of potential growth for CBL. Penney and Sears either own their stores in CBL malls or lease them at extra-long terms and at below-market rates. They contribute little to the CBL top line, less to the bottom line. In 2014, Penney generated just 1.27% of CBL's revenue; Sears didn't even make it into CBL's top 25 list of tenants by revenue."

"CBL is earning either zero or maybe $2 per square foot of rent in those locations," an anonymity-seeking investor in CBL tells Lorenz. "When they get the keys back, they can flip that space to an Ulta, a Dick's, or a Whole Foods and they will get $10 per foot. It is instantly accretive to them when a Sears or J.C. Penney leaves a property for them to flip it and turn it into something else."

Long gone are the days when Penney or Sears were pulling shoppers into the malls. At the CBL-owned Fayette mall in Lexington, Ky., for instance, "the Sears is at the center of the mall so you have to walk through Sears to get to one side or the other," Katie Reinsmidt, a CBL investor-relations contact, tells Lorenz. Good things happened after CBL bought out Sears and redeveloped the vacant space: "We opened it late last year and it has an H&M, a Cheesecake Factory, a tremendous amount of high-end retail was added to that center as a result. Fayette Mall is the only mall in Lexington, and it does $560 or so per square foot; it is tremendously productive. It has been 99% to 100% leased every year. We had a strong amount of retail demand to come into that center so it was a phenomenal project for us. We actually view anchor redevelopments as one of the best investments/best uses of capital that we have today. It is a tremendous opportunity for us."

Jeff Bezos notwithstanding



source: The Bloomberg, company reports

The Sears and Penney concern is related to another. That is the suspicion that CBL's properties are marginal entrants in Bezo-ed and oversupplied markets. From which it would follow that CBL would belong where many investors seem automatically to consign it, namely in the mediocre company of Rouse Properties Inc., WP Glimcher Inc., and the previously named Penn REIT. The fact is, according to Green Street's D.J. Busch, that 60% of CBL's properties are functional monopolies, i.e., "the-only-game-in-town" kind of malls (as REIT people put it), compared to 40% for Rouse, 30% for WP Glimcher, and 25% for Penn REIT. (For its part, CBL claims that 90% of its properties are either the only game in town or "market dominant.") On average, the company says, the typical CBL shopping center is plunked down 26 miles from the nearest competition. Only-game-in-town examples include the aforementioned Fayette Mall, which is the one-and-only mall in Lexington; The Outlet Shoppes at Oklahoma City, which is the only outlet center in the Sooner state; and the Dakota Square Mall, the only mall in Minot, N.D.

For now, Mr. Market dissents from the cheerful notion that Penney and Sears constitute sources of opportunity for CBL and not a clear and present danger. As our investor-informant puts it, "Every time Sears or Penney announces they are closing 40 stores and CBL has two of them, the stock gets hit." With its 5.9% dividend yield, CBL is not an inexpensive stock to short. It is, however, on an all-in basis, including the cost of securing borrowed shares, a cheaper, less crowded short than either Sears or Penney (measured by short interest as a percentage of float, CBL stands at 5.1% vs. 37.7% for Sears and 33.5% for Penney).

Credit weighs heavily in the CBL valuation scales, of course. Is the tenant thriving or otherwise? Is it paying its rent (and, in some cases, a premium linked to retail sales), or not? "Most of our watch list [of troubled tenants] has been cleared out as a result of the bankruptcies that have occurred in the first quarter and the fourth quarter of last year," Reinsmidt tells Lorenz. "We always have a few mom and pops that go in and out, but as we look at the rest of the list, we

CBL vs. the field

	share price	NAV/ share	div. yield	P/2015 AFFO	implied cap rate	net debt/ ebitda
CBL & Associates Properties Inc.	$17.86	$27.25	5.9%	10.7x	8.6%	7.0x
Rouse Properties Inc.	17.04	15.75	4.2	14.5	7.0	10.8
WP Glimcher Inc.	14.46	19.50	6.9	9.4	8.6	6.0
Pennsylvania Real Estate Investment Trust	22.92	28.25	3.7	22.3	7.2	7.6
Simon Property Group Inc.	184.44	185.75	3.3	21.5	4.7	5.7
General Growth Properties Inc.	27.38	29.50	2.5	23.1	4.2	8.0

sources: The Bloomberg, Green Street Advisors

have a very small watch list relative to where we were before."

CBL's tenants performed well enough during the Great Recession. Between 2007 and 2009, they suffered an average 10% decline in sales per square foot to $313. Toplofty Simon Properties did little better; its tenants bore a 12% average sales decline, to $433 per square foot, in traversing the same cyclical obstacle course. Both sets of tenants returned to growth in 2010.

"If only CBL's management had done as well as its tenants," Lorenz reflects. "In 2007, the company was buying back stock at prices in the 30s. It entered the recession with too much debt and a wall of near-term maturities. In 2008, net debt footed to 8.6 times EBITDA (that is earnings before interest, taxes, depreciation and amortization), while operating income covered interest expenses by just 1.2 times. To right size its balance sheet, management issued 58.4 million shares in June 2009 at $6 per share, effectively—disastrously—doubling the share count. Today's price: $17.86."

Dilution to the contrary notwithstanding, CBL has delivered a total return—fat dividends included—of 145% since the close of 2009 vs. 112% for the S&P 500. Dividends do matter. Since coming public in 1993, share price appreciation plus reinvested dividend income have combined to produce a 706% gain for the persevering CBL investor. Over the same 22 years, share-price return plus reinvested dividend income in the S&P 500 has served up a 576% return.

CBL's balance sheet is on the mend even if it is not yet Great Recession-proof. At last report, net debt amounted to seven times trailing EBITDA while operating income covered interest expenses by 1.6 times. Other public "B"-mall operators carry an average ratio of net debt to EBITDA of 8.1 times; "A" mall operators do business at an average of 6.8 times. In the first quarter of 2015, CBL's debt carried a weighted average interest rate of 4.83%, close to the average for the "B" mall group as a whole.

Reinsmidt, the IR person, says the company is pointing to a ratio of net debt to trailing EBITDA in the low sixes. "We will do that through a combination of things," she tells Lorenz. "One is investing our free cash flow into our redevelopment pipeline and existing assets which contributes to the growth in EBITDA. If we are not growing debt and we are adding EBITDA, it is a great way to improve that metric. Our coverage ratios are very strong, but we will continue through that natural progression of growing EBITDA to improve it. As we swap out secured debt for unsecured bonds, we are making tremendous moves in improving our interest rates. Our weighted average cost of capital is coming down as a result."

A curious feature of present-day real estate finance is that a company like CBL can borrow more cheaply on an unsecured basis than it can on a secured basis. It's easier to talk about property-level financing than it is to actually obtain it. Mortgage providers, once burned in 2007-09, tend to be fastidious dotters of "I's" and crossers of "T's" nowadays; you need to get their approval for things like extra-long leases and redevelopments, and their approval usually entails the payment of a fee. While a mortgage loan against a thriving mall might come cheaper than the average unsecured loan, the company—in the aggregate—is finding more advantageous terms in the unsecured bond market (thank you, Janet Yellen).

As Green Street does the arithmetic, net asset value per share of CBL amounts to $27.25, which implies that the stock changes hands at a 34% discount to liquidation value. Applying the same analytical methods, the Green Street analysts find that WP Glimcher and Penn REIT trade at 26% and 19% discounts to their respective NAVs; Rouse trades at an 8% premium, while Simon and General Growth are quoted at a 1% discount and 7% discount, respectively.

"In fact," as Lorenz points out, "CBL looks cheap relative to the mall REIT sector based on any relevant metric. Implied cap rate is one. On the basis of net operating income per share divided by the share price, CBL is valued at 8.6%, the highest cap rate in the mall sector. 'B'-mall REITs more typically trade at a 7.6% implied cap rate, the 'A'-mall REITs trade at a 4.5% implied cap rate.

"The ratio of price to adjusted funds from operations (AFFO) is another conventional REIT valuation metric," Lorenz continues. "It's defined as income from properties minus the sum of expenses, normalized capital expenditures and one-time gains or losses. CBL trades at 10.7 times the estimated 2015 AFFO vs. 15.4 times for the other 'B' mall REITs and 22.3 times for the 'A'mall segment."

Knock No. 3 on CBL, unlike the first two, has more than a little substance, we judge. The complaint is that the company gives the share price, therefore the shareholders, short shrift. The insiders, including the founder and chairman, Charles Lebovitz, and his son and successor, Stephen D. Lebovitz, together own 2.2% of the outstanding shares. They have bought not one additional share since 2013 (none of the other insiders has either; as far as that goes, neither has any been sold). Then, too, management, which was all too happy to buy at the top in 2007, has repurchased not one share since then.

"A stock buyback is a tremendous investment today given where our stock is trading now," says Reinsmidt. Still, the company has no plans to buy any. When pressed, Reinsmidt says that CBL must be "mindful of the credit metrics." Or perhaps the front office, not much liking the Fed-induced inflation of nearly every tradable asset, is simply bearish. We wouldn't blame them in the least if that is what they're thinking. We're a little bit of the same mind.

How else might management move the deeply discounted CBL share price off the dime? Why by off-loading low-potential assets. In April 2014, the company identified 25 such properties for sale. "We've sold two, one last year and one this year," Reinsmidt relates. "We also had, as part of that, identified about four assets that were overleveraged or highly leveraged that we intended to talk to the lender about in lieu of a sale, or to facilitate a sale on behalf of the lender. We've given back two of those properties. We also have a property that is a mall currently under contract where due diligence has expired and escrow is firm and we have some additional transactions that are in various stages but not to the point where we can announce them yet."

The deliberate pace of the asset disposal program has Wall Street pulling its hair. The analysts—and the investors, too—want fast dispositions and good prices, both at the same time. Then, again, our unnamed investor adds, the market gives the company no credit for its marginal assets; the discount to NAV is proof of that supposition. "I get that they are not selling them fast enough, but you are giving a zero value and maybe even a negative value. All these malls have property level debt so I am not so worried. If you give them a zero value, they can just hand back the keys to the lenders."

At the beginning of this essay, we mentioned a codicil. We are bullish on CBL so long as the interest-rate subsidized levitation in real estate values continues (a would-be seller of property needs bidders after all). If it's curtains for the bond market, the best that can probably be said for CBL is that, possessing a margin of safety, it likely won't fall as far as its value-starved comps. There are worse things to be said for an investment.

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