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Just looking

It's nobody's idea of news that Sears Holdings Co. and J.C. Penney Co. are on their uppers or that smart phones facilitate price comparisons or that you don't have to go to the mall to go shopping. Yet, since the stock market took off four years ago, the Bloomberg REIT Regional Mall Index has out-returned the S&P 500 by 568% to 121%, counting reinvested dividends. To this anomaly we now bearishly turn.

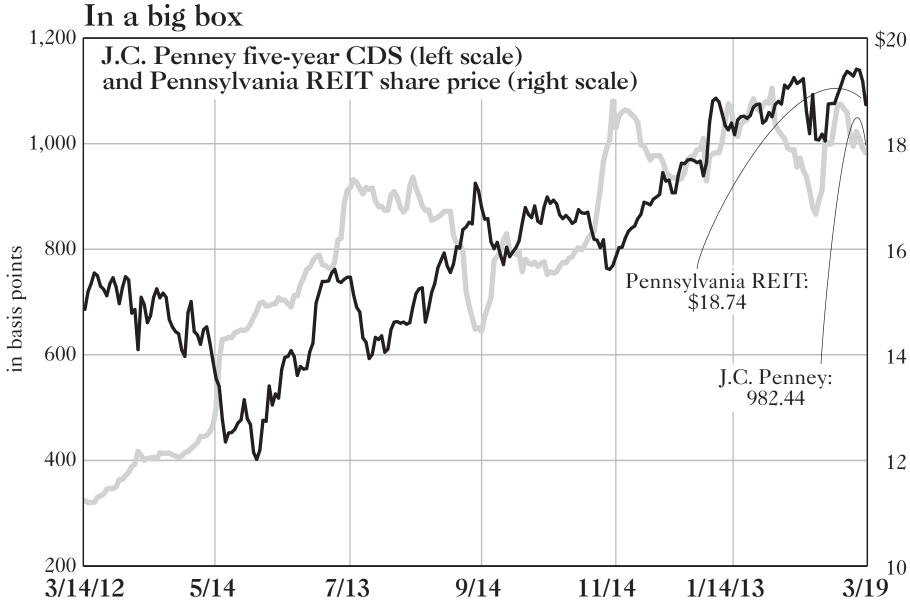
But not before we make our confession. Realty Income Co. (O on the Big Board) is 34% higher since the publication of "Without shopping bags" (*Grant's*, Aug. 6, 2010), a piece about the then emerging trend of people entering a shopping mall with their cell phones and making a purchase—but leaving without any merchandise. "Spotting an object that tickles their fancy," we wrote, "they drop their gaze to a handheld electronic device. A slight movement of the fingers, and the sale is consummated"—but at Amazon or Bluefly instead of at the mall. If the trend was then emerging, it has subsequently taken flight. But Realty Income, with its movie theaters, convenience stores and drug stores, has thrived just the same.

Pennsylvania Real Estate Investment Trust (PEI on the Big Board), owner of malls and centers with Sears and Penneys on the premises, is our new candidate not to thrive. Founded in 1960, PREIT, as the company styles itself, owns interests in 42 operating properties, of which 36 are malls and six are strip centers or so-called power centers (i.e., a shopping emporium dominated by one or more big anchors), mainly in New Jersey, Pennsylvania and Maryland. Just the other day, the stock scored a 52-week high, $19.47 a share, though—in our opinion—it shouldn't have.

If the front office had picked up the phone when colleague Charley Grant called to ask how's business, it could have spun a passably bullish story. For instance, under the new CEO, Joseph Coradino, PREIT has begun paying down debt and raising preferred equity while upgrading the quality of the portfolio (disposing of three unproductive malls so far this year). The shares trade at a reasonably low multiple of price to 2013 funds from operations (just under 10 times) and at a significant discount from NAV (24.8%, according to Green Street Advisors). Could PREIT be a takeover target? Insiders own just 9% of the shares, compared to an industry average of 21%, and the board of directors, unusually for a REIT, is elected in staggered terms, thus complicating a possible takeover defense at the board level. The shares yield 3.8%.

Management might have been a little less eager to discuss the way Amazon upended the retailing business with its offer of a 5% discount to any who used the Amazon Price Check mobile app. This was as long ago as December 2011. You think back to the academic notion of perfect competition, and you wonder if that Jubilee has not, to a degree, arived at the mall. Thus, Best Buy on March 3 disclosed that, like Target, it will make permanent its holiday season policy of matching the best price—i.e., best to the consumer, if not to the bricks-and-mor-

In a big box



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tar retailer. Analyst Grant, making a tour of some Long Island malls, stopped to chat with a merchant at a Sunglass Hut kiosk. "Our stuff is way overpriced," the company representative confessed, "and people use their phones a lot"—though not to make phone calls.

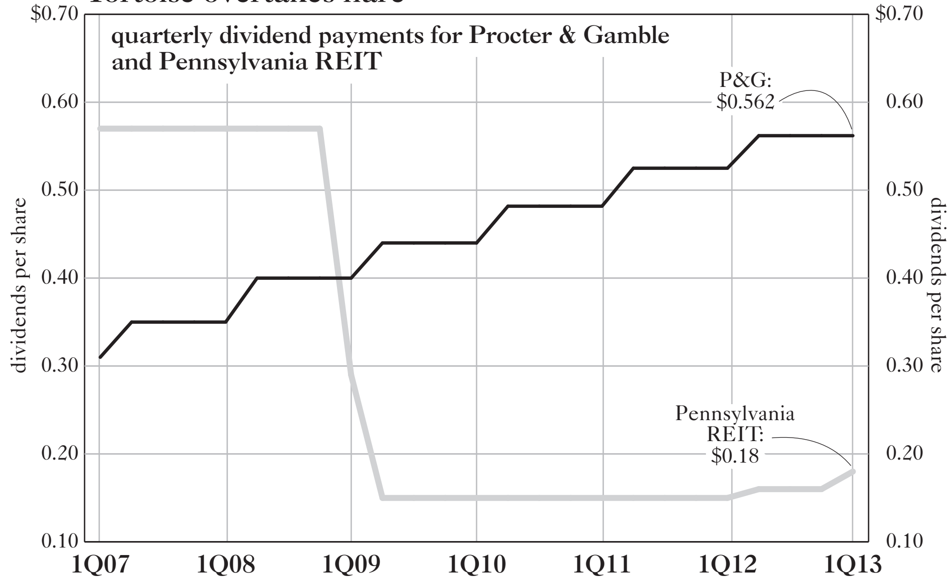
Grant's does not here contend that every mall is struggling, let alone dying. "The reality," says Cedrik Lachance, a Green Street managing director, "is that high-end malls are actually wonderful real estate investments. We'd argue they're probably the best of all major real estate sectors in which to invest. It's true at current prices and we consider it to be true for the longer term as well. The reason is because a lot of the high-end malls are in very good competitive positions within their market. Very often population has grown around the malls, so you have properties that are in relatively infilled positions. . . . " Besides, Lachance, adds, the rising stock market has raised the net worth, therefore the spirits, therefore the spending, of the high-end customer.

The mark of a mall, according to Green Street, is how much it sells per square foot of retailing space. PREIT, by this criterion, rates a Green Street grade of "B." Of the company's 36 malls, 29 have a Penney Store, 26 a Sears. On a July 31 conference call, PREIT's CEO fielded a question about Penney. "We've not seen sales decrease in malls or wings of Penney stores at this point and hopefully don't anticipate it," Coradino said, "but to go beyond the question you asked, I would say that we feel good about the J.C. Penney transformation." As Coradino spoke, Penney's five-year credit default swaps were quoted at 874 basis points; on Tuesday, they traded at 982 basis points.

"Let me acknowledge," says Grant, "that Penney has its fans. On Monday, the stock jumped 6% after an analyst suggested that the retailer could turn its best 300 locations into a REIT. A creative idea, no doubt, but one that Vornado Realty Trust chairman Steven Roth—a Penney director and a heavy seller of Penney shares—has likely already considered."

"You can think of J.C. Penney and Sears in two ways," Lachance says. "On the way down they can shed real estate, and there's a lot of value in the very high quality malls, because the operators themselves can purchase these boxes, re-engineer that wing of the mall and usually create substantial profits for themselves in doing so. The flip side is once you start to go down the mall quality stream, it can get really difficult to replace an anchor—there you have to be a little more creative."

Tortoise overtakes hare



source: The Bloomberg

In the context of losing an anchor, the difference between a high-quality mall and a low-quality mall is literally the difference between night and day. You could see it in a February 2012 transaction in which Sears agreed to sell six of its stores and vacate five anchor locations in consideration of $270 million from General Growth Properties, the nation's second largest mall REIT. "No less than $250 million of this price," Grant relates, "was attributable to a Sears at Ala Moana in Honolulu, the fifth largest mall—and one of the best malls—in America. Such a price tag implies a value of $730 a square foot for the Ala Moana property—and just $14 a square foot for the 10 other locations."

Or, to quote from PREIT's 10-K: "We cannot assure you that there will not be store closings by Sears, Kmart, J.C. Penney, or any other anchor tenant in the future, which could affect the results of our operations, cash flows and ability to make cash distributions. The closure of one or more anchor stores would have a negative effect on the affected properties, on our portfolio and on our results of operations, particularly if the affected properties are not classified as Class A malls."

PREIT is at risk, as well, in the article of leverage; the company's every asset is encumbered by mortgage debt or bank credit.

The clustering of lease expirations presents another point of vulnerability. In 2013, leases written to tenants accounting for 11.8% of total gross rent fall due. In 2014, the figure is 12.4%; in 2015, 11.8%; in 2016, 13.1%; and in 2017, 10.4%.

"Then, too," Grant winds up, "there's a question of reaching for yield in an economically sensitive industry. PREIT paid a 57-cent-per-share dividend throughout 2008. It paid 29 cents in the first quarter of 2009 and 15 cents per quarter thereafter. (Only last month did it bump up the rate to 18 cents). As a counterexample, the steady-eddy nondiscretionary consumer products giant Procter & Gamble, currently yielding 2.9%, was able to maintain its dividend rate throughout the slump. Maybe the PREIT executive suite has been musing along the same lines. Just disclosed is a flurry of insider selling at around 19 ¼. We commend their judgment."

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