Thursday, October 24, 2024
2:45 PM to 3:45 PM

Workshops 16

Determining the Valuation of a Retail Project: Are We Just Throwing Darts?

Presented to

2024 ICSC+U.S. LAW
JW Marriott Orlando Grande Lakes, Orlando, Florida
October 23-25, 2024

by:

Matthew Cohen
Mesa West Capital
1585 Broadway, 33th Floor
New York, NY 10036
212-871-8907
mcohen@mesawestcapital.com

Domingo Cruz
Pacific Life Insurance Company
700 Newport Center Drive
Newport Beach, CA 92660
949-539-5948
Domingo.Cruz@PacificLife.com

Introduction:

When drafting contracts for the purchase of a real estate, arguably the most essential business term is the purchase price. As lawyers, we accept the negotiated purchase price as a non-negotiable item, but have you ever paused to ask: "how or why did this price get established"? This interactive workshop will take you behind the curtain in understanding (a) how a purchase price/valuation of shopping centers and other real estate is established, and (b) what variable factors can cause a purchase price to adjust, even after a letter of intent is executed.

Hypothetical: Consider 2 different term sheets:

1) Description: Newly-developed grocer-anchored shopping center with 200,000 sf of retail space in ten buildings with 1000 parking spaces. Major Lease threshold of 10,000 sf (Trader Joe's – 25,000 sf and 4 other tenants including a pharmacy and a bank).

   PP: $100,000,000

   Due Diligence Period: 30 days

   Closing: 30 days after end of the Due Diligence Period

2) Description: Mature mixed-use project with 500,000 sf of retail space and 100,000 sf of office space in twenty buildings with 3000 parking spaces (including surface parking and a parking structure) and tenants including an aging movie theater, a new fitness club and an upscale grocer. Major Lease threshold of 20,000 sf.

   PP: $200,000,000

   Due Diligence Period: 60 days

   Closing: 30 days after the end of the Due Diligence Period

Valuation Considerations:

There are many factors that are considered in determining the value of a parcel of real estate. We will go through several of them below. It's important to remember that the real estate is ultimately only worth what a buyer is willing to pay. There is no "right answer". In this case, when positioning the shopping center for sale, it's important to ensure it's being marketed to the right buyer pool. For example, a grocer-anchored shopping center with a grocer with robust sales and long remaining lease term along with high overall occupancy and sales trends will be marketed differently than that same center about to go through a repositioning plan. In order to maximize the value of the asset, the seller will want to clearly identify the factors that they believe will drive the price.

Macro Trends:

Before determining the appropriate risk rate(s) to apply to the subject, a review of recent market conditions, particularly in the financial markets, is warranted. The Commercial Real Estate (CRE) market is driven by investor demand and strong liquidity. Investors are monitoring the impacts on both factors from the Federal Reserve's interest rate policy, inflation, and other macroeconomic factors, which have increased uncertainty in the financial and CRE markets. In addition to the macroeconomic factors, a buyer is going to consider the demographics of the local area, the financial performance at the center as well as the physical attributes of the center.

Demographics:

- Population of the 1/3/5-mile rings around the shopping center
- Median age
- Average and median annual household income
- Education levels
- Population growth/decline
- Employment distribution – how stable are the jobs in the market? Are the major employers growing or shrinking?

Property financials:

- **Anchor Tenants**: On a percentage basis, anchor tenants often lease the highest percentage of square feet in the shopping center. The anchor tenants also drive the demand for the non-anchor tenants. For this reason, a greater property value is assigned to shopping centers who are anchored by tenants with significant financial strength versus those that are not. Retailers are often required to report their on-location sales to their landlords, which allows for the calculation of the health ratio, or occupancy cost (tenant sales/rent). With the increase in internet sales, there is robust debate about what makes a good occupancy cost today for traditional retailers. However, it is still a metric that a long-term holder of real estate would want to evaluate. In our first situation, occupancy cost will be a major factor for a buyer to determine the likelihood that Trader Joe's and the pharmacy tenant are likely to renew at lease expiration. In our second situation, contrast the theater space.

- **Non-anchor Tenants**: Occupancy cost, where available, will be important again. We will also be focused on the layout of the shopping center, the amount of non-anchor square footage, the weighted average remaining lease terms, tenant credit considerations and depth of non-anchor space, among other things. For both anchor and non-anchor tenants, the buyer's determination of market rental rates will drive their view of the stabilized net operation income ("NOI") of the asset.

- **Net Operating Income**: The durability, or strength, of the NOI will affect the capitalization rate and ultimately be a key factor in determining the value of the asset.

- **Capitalization Rates**: The capitalization, or cap, rate of the asset is determined by dividing the property's NOI by the purchase price. Since each buyer will be doing their own analysis to come up with what they believe to be the in-place NOI, the cap rates can be different even for buyers getting to the same price. Since cap rates reflect the unleveraged cash on cash return, it's a good metric to compare a real estate investment to a non-real estate investment. The cap rates typically trade to a premium to the risk-free rates in the market.

Property Conditions:

- **Location**: The answer to the age-old real estate question of the three most important factors in determining a property's value: location, location and location. This is especially true for a shopping center. Once again, there are several factors to consider regarding the location.

    - What are the traffic counts driving by the center?
    - Where are the competing shopping centers?
    - How likely will a new competitive center be built in the area?
    - In our first example, how close is the nearest Trader Joe's?

- **Site Conditions**: The layout of a center is a key factor in the long-term success of the retailers.

    - How efficient is the ingress/egress?
    - How visible is the signage?
    - Is there ample parking?
    - Is it convenient to access the different sections of the shopping center?
    - Is there any non-ground floor space included in the square footage?
    - How deep are the anchor spaces? How deep are the non-anchor spaces?
    - Is the property located in a flood zone?

Financial Factors:

Debt: Most commercial real estate in the United States is owned by leveraged buyers. The availability and cost of this leverage will be determined by the factors above, as well as the Loan to Value, Loan to Cost, in place debt yield (loan amount/NOI) and stabilized debt yield among other things. Essentially, the lender will be evaluating the long-term health of the center, while also investigating the borrower's ability to execute on their business plan.

Return profile: Commercial real estate investments are typically analyzed based on their expected IRRs over the life of the investment. The IRR will be impacted by both the current return and the return on exit. Shopping centers,

like other types of commercial real estate, go through several life cycles as an asset. Examples include the pre-development, development, lease-up, stabilization, re-positioning and re-development. Generally, there are different types of owners, with differentiated capital structures, well-situated for each of these stages. While the IRRs may be similar for the different periods of ownership, how those returns are generated can differ greatly. As a result, there are different types of owners and lenders providing liquidity during each of these periods as well.

Ownership Structure: There are many types of groups/individuals who own real estate. Some ownership structures – such as ownership through tenancy-in-common – will affect the ability to finance as lenders will want extra protection in connection with a TIC structure. However, the vast majority of structures are conforming to a new SPE entity being established to own and operate. For purposes of this discussion, we are going to consider whether this opportunity will appeal more to core/stabilized owners or opportunistic/transitional owners. For the former, the stability and consistency of the in-place cash flow should lead to long term fixed rate debt. They will be focused on the cash on cash return for their investment on an ongoing basis. For the value add/opportunistic owner, the focus will be on transforming the asset to improve the cash flow profile in hopes of attracting a core/stabilized buyer. Their goal will be to create value at the asset, with all of their return coming in the sale of the asset. In our second example, the aging movie theater space represents the kind of challenge and opportunity a value add/opportunistic owner seeks out.

Due Diligence Process Considerations:

Due Diligence will include items such as: leases, estoppels (80% of rsf) and SNDAs (for "Major Leases"), service contracts, REAs, rent roll, operating statements for the last 3 years, inspection reports, tax bills, litigation files, permits and COs, warranties, tenants' financial statements, if any, delinquency reports, a personal property schedule, CAM budgets, appraisal(s), surveys and environmental audits and a title commitment.

- On price, drivers would seem to fall into 2 categories: (i) the items underlying the valuation in the appraisal (e.g., the items reviewed above in connection with "Property Level Considerations") and (ii) the items that impact price during the due diligence process.

- **Estoppels**: These are not complicated legal documents. However, the value is the opportunity to have direct communication with the tenants and issues are raised (maintenance, co-tenancy violations, CAM/audit reimbursements) that have a direct impact on the economics of the property (e.g., immediate required HVAC or roof repairs).

    - Deducts for immediate repairs or hold-backs? What do you want? What will your lender require (e.g., are the issues life-safety issues)?

- **SNDAs**: Three-party agreement between the lender, tenant and owner/borrower. The SNDA will address a number of matters: the priority of the lien of lender's security interest in the mortgaged property, the parties' rights and obligations if the owner/borrower defaults under the loan or the lease and what happens if lender commences foreclosure. Note that the effect of foreclosure (and whether foreclosure is judicial or non-judicial) on leases is different by state. In California, a trustee's sale will terminate all subordinate leases unless there is a non-disturbance and attornment agreement with the tenant. Note, however, that if a judicial foreclosure is pursued in the case of a deficiency against the borrower being sought, subordinate leases must be named in order for the leases to terminate. Lenders may avoid termination by not naming lessees in the foreclosure action. By contrast, New Jersey, is a judicial foreclosure state and, unless named in the foreclosure action, subordinate leases remain in effect and a successful bidder takes subject to all existing leases. All of this highlights the importance of thinking ahead about options if a property is undergoing stress.

  There are key aspects to subordination – e.g., casualty and condemnation proceeds. However, for present purposes, let's focus on the intersection where legal issues have an effect on valuation in this context. Why does a lender want an SNDA at all and what's the corresponding effect (even if indirect) on the asset?

    - Leaving aside extraneous facets to the asset that can yield value (e.g., the ability to develop an outparcel), the value of a retail asset boils down to the value of the rent roll.
    - An SNDA entails tenant's agreement that, in the event of a foreclosure, it will attorn to (recognize) the ability of the lender to step into the shoes of the borrower under the lease. In other words, the value of the lease will stay in place. The tenant will keep paying rent and performing its obligations under the lease.
    - Question: Should that lead to the question as to the present value of the lease in place and whether there is more value in an alternative tenanting strategy or potential use of the leased premises (e.g, redevelopment)?

- Is it too often assumed that every major lease in intrinsically valuable and worth the time, effort and transactional costs (time and money) associated with obtaining an SNDA?
- Should there be a more explicit calculation of the value of the lease so that the legal mechanism of attornment is triggered when the value is accretive (from a pure market-rent perspective, co-tenancy requirements or any other ways in which we can substantiate that a lease is valuable)?