Retail & REIT Takeaways: Silver Lining for Retailers…Peaking Rents for Landlords?

Summary

We recently hosted a meeting with retail REIT expert Josh Podell of Podell Real Estate Advisors (PREA) to discuss trends (positive and negative) facing retailers and their retail REIT landlords. With declining traffic/retail sales, and the growing prevalence of online shopping with Millennials, Mr. Podell envisions: 1) mall closures ("at a 20% decline," but mostly in lower productivity cohort we believe) and emergence of new mall formats; 2) decreasing gross occupancy rates; 3) more favorable renewals (slowing pace of rent growth for landlords); and 4) online retailers increasingly testing "pop up" spaces.

Key Points

- Following our discussion and Mr. Podell's analysis, we continue to view retailers such as KATE (high eCommerce penetration), PLCE (portfolio rationalization benefits) and TIF (superior strategic position) as better positioned and accordingly maintain our Buy ratings.

- On the landlord side, we continue to prefer 'A' mall REITs given their superior risk-adjusted growth profiles in the current environment of slowing retail sales, eCommerce cannibalization and ongoing store closures and maintain our Buy ratings on GGP, SPG and TCO.

Company	Symbol	Price (5/10)	Rating Prior	Rating Curr	PT
Kate Spade & Co	KATE	$24.07	–	Buy	$30.00
Simon Property Group, Inc	SPG	$213.92	–	Buy	$233.00
Taubman Centers, Inc.	TCO	$73.58	–	Buy	$86.00
The Children's Place	PLCE	$71.09	–	Buy	$85.00
The Macerich Company	MAC	$81.42	–	Neutral	$87.00
Tiffany & Co.	TIF	$70.72	–	Buy	$80.00

Source: Bloomberg and Mizuho Securities USA

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Retail REIT Meeting Takeaways: Silver Lining for Retailers…Peaking Rents for Landlords?

We recently hosted a meeting with retail REIT expert Josh Podell of Podell Real Estate Advisors (PREA) to discuss notable trends (positive and negative) facing retailers and their retail REIT landlords. In the face of declining traffic (both mall and Outlets) and overall retail sales, and the growing prevalence of online shopping with Millennial lifestyle preferences, Mr. Podell envisions: 1) mall closures ("at least a 20% decline," but mostly in lower productivity cohort we believe) and the emergence of new mall formats (more hybrid "PowerMalls"); 2) decreasing gross occupancy rates; 3) more favorable renewals (slowing pace of rent growth for landlords); and 4) online retailers increasingly testing brick-and-mortar "pop up" spaces in malls. Given this backdrop, we prefer KATE (high eCommerce penetration), PLCE (rationalizing fleet by 18% FY13-FY17), and TIF (strategic store plans) within the specialty retail coverage. On the landlord side, in the face of these factors we continue to prefer 'A' mall REITs (GGP, SPG, TCO) as we believe they are best positioned given their superior risk profile - better customer demographics, pricing power and n/t cash flow growth prospects, as well as "stickier" asset values.

Exhibit 1: Number of Malls Declining

	Currently	Future	% Change
Regional Malls	1200	800	-33%
Outlet Centers	200	150	-25%
"Lifestyle" Centers	400	200	-50%
Strip/Power Centers	1000s	TBD	TBD
Hybrid Centers	NA	100s	TBD

Source: PREA, Mizuho Securities USA, Inc.

Although the retail backdrop has been deteriorating in recent years on negative traffic trends, PREA estimates mall sales productivity has remained relatively stable at $475 per square foot from 2013-2015. We believe the figures are partially boosted by the inclusion of Apple and Tesla stores in select malls; according to industry sources, Apple stores have provided sales per square boosts of approximately $75-100 in select instances.

Exhibit 2: Sales Productivity by Mall Types

	Sales/SF	% of Mall Mix	
A Malls	$550	20%	
B Malls	$400-550	55%	
C Malls	$3252-400	25%	*
D Malls	<$325		

* Both C/D represent 25% of total mall mix.

Source: PREA, Mizuho Securities USA, Inc.

From a mall REIT, or landlord, perspective, Mr. Podell's comments were generally in-line with our view that 'A' mall (higher productivity) landlords are best positioned, though not immune, to retail industry market forces such as growing eCommerce share, slowing retail sales and ongoing store closures. Despite these industry headwinds, 'A' mall REITs have been able to generate meaningful portfolio sales psf growth since 2010 (see Exhibit 3) via tenant repositioning and the culling of lower tier assets. While not providing full immunity, the result is that mall REIT portfolios are in a better position to not only implement omni-channel strategies, but to also provide a bit of "defense" from e-Commerce market share gains; implicit assumption here being that higher productivity assets (marked by higher immediate household incomes and density) should be better positioned as that is where retailers most want to be and the ability for these centers to provide a more complete "experience". We expect this structural shift to continue to pressure the long-term viability of lower-quality malls…though "only game in town" centers as well as those with a less discretionary spending focus should continue to play a role in this environment.

Exhibit 3: Historical Sales psf Productivity by Mall REIT

	FY2010	FY2015	% chg
CBL	$325	$374	**15%**
GGP[1]	$446	$588	**32%**
MAC	$433	$635	**47%**
TCO	$564	$800	**42%**
SPG[2]	$494	$620	**26%**

1. GGP - combined mall sales psf
2. SPG - US operations only

Source: Company documents, Mizuho Securities USA, Inc.

As a result of declining foot traffic and flattening sales per square foot, gross occupancy as a percentage of sales has also declined across most mall formats. We view this as a positive development for retailers able to strategically prune their store fleet while simultaneously obtaining more favorable occupancy rates that should aid gross margins. It is encouraging that in select C/D malls, retailers can perhaps negotiate for more favorable lease terms that are 10-20% below prior levels.

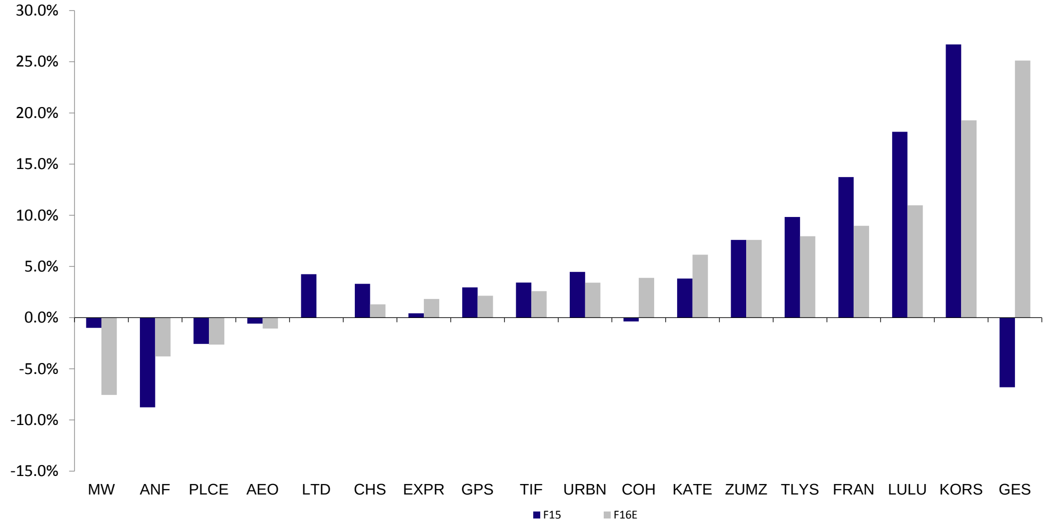
Exhibit 4: Gross Occupancy Decreasing

	2014	2015	2004	2005
A Malls	17-20%	15-20%	12-15%	12-15%
B Malls	10-15%	8-15%	8-12%	8-12%
C/D Malls	6-10%	5-8%	5-8%	5-8%
A Outlets	15%	15-17%	8-10%	8-10%
B Outlets	10%	6-10%	8%	6-8%

Source: PREA, Mizuho Securities USA, Inc.
*Gross occupancy is inclusive of minimum rent, CAM, r/e taxes, insurance, marketing

Despite some favorable occupancy concessions, retailers have gradually moderated square footage growth since FY07. From the peak of FY07 when the group posted an average square footage growth of ~15%, we forecast ~4% growth for FY16. Square footage growth in our coverage universe primarily stems for higher growth areas such athletics/athleisure and modern luxury concepts. Going forward, Mr. Podell suggested spin offs (such as ivivva from LULU) combined with online retailers (Warby Parker, Birchbox, Bonobos) may help propel further brick and mortar store openings, partially offset by strategic pruning of existing retail fleet. In addition, while Mr. Podell was not in complete harmony with MAC's recently expressed view (on its recent 1Q16 earnings call) that e-tailer store openings would offset the store closures of existing retailers, he did acknowledge that the pace of e-tailer store openings ("pop-up" / temporary space) would likely pick up in coming years, providing some offset (and more benefit to 'A' malls).

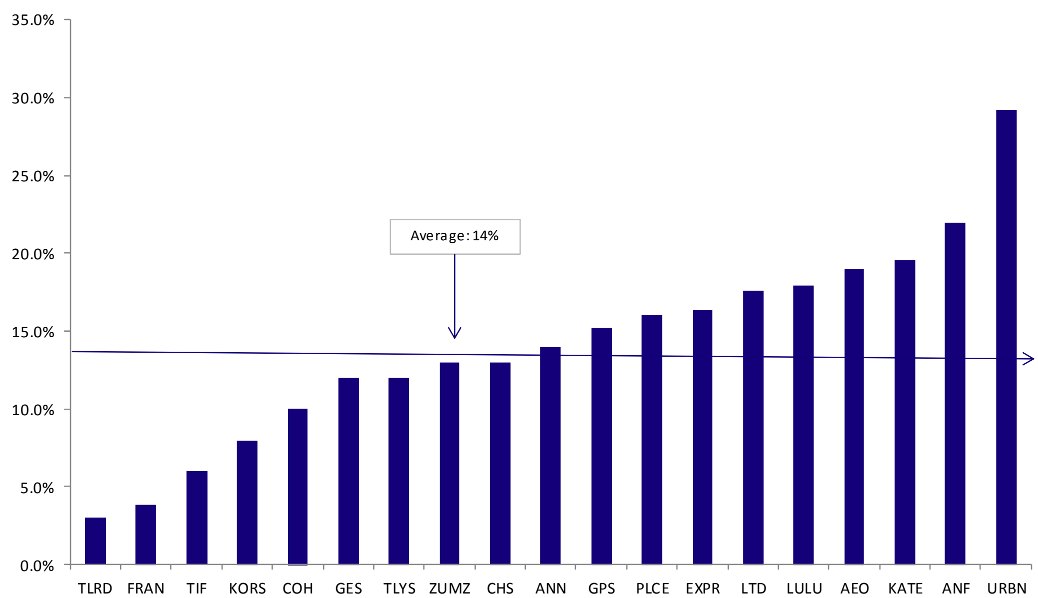
Exhibit 5: Specialty Retail Square Footage Growth



Source: Company Reports, Mizuho Securities USA, Inc.

Unsurprisingly, growing eCommerce sales penetration is a crucial driver of the declining store presence. In FY15, our coverage universe averaged 14% in sales from the online channel, up from 13% in FY14. We believe omni-channel and online sales growth will continue to outpace brick and mortar sales and increase in overall revenue penetration.

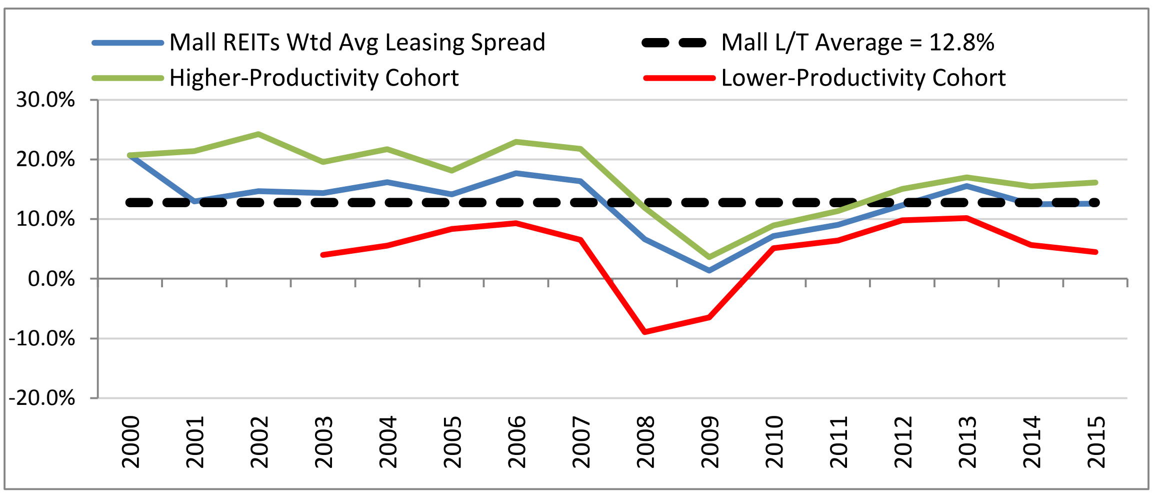
Exhibit 6: Rising eCommerce Penetration



Source: Company Reports, Mizuho Securities USA, Inc.

Looking ahead, we believe 'A' mall REIT landlords (GGP, MAC, SPG, TCO) will continue to generate solid, above-trend rent and ssNOI growth (4%+), well ahead of B/C landlords (CBL, PEI, WPG) for the next few years, given increasingly discerning tenants, still low occupancy cost ratios and tight supply. However, the pace of mall REITs' portfolio rent growth is expected to slow in coming years (as seen by the pace of re-leasing spreads slowing from high teens to low teens in recent years after peaking in 3Q14). In fact, Mr. Podell mentioned that inline retailer tenants are able to get leases done today at better terms (ranging from lower rent growth rates and at times shorter durations) than they would have secured one year ago and that shorter term leases are becoming more prevalent. Another factor worth considering is that leases signed in recent years were signed off of easy comps (during the recession period) and upcoming expirations are set to face tougher comps. Against this backdrop, we maintain our bias towards 'A' mall REITs and our Buy ratings on GGP, SPG and TCO.

Exhibit 7: Historical Re-Leasing Spreads by Mall REIT

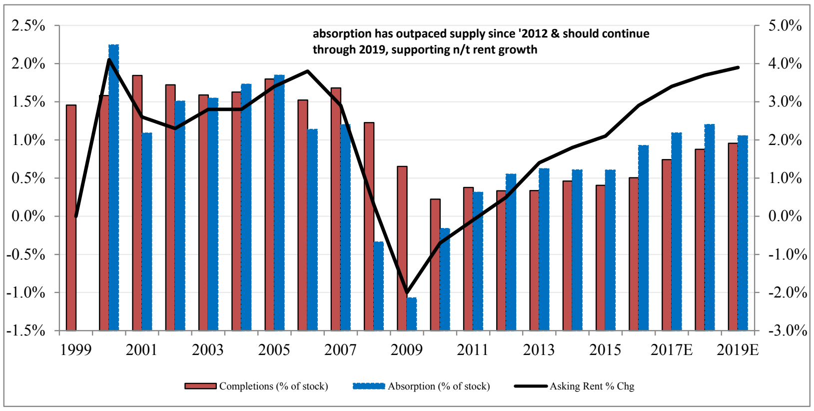


Notes:

1. Higher-Productivity Cohort: GGP, MAC, SPG and TCO; Lower-Productivity Cohort: CBL, PEI and WPG.
2. 2001-2003 numbers only represent GGP, SPG and TCO.
3. WPG's leasing spreads are only available for 2015 and 1Q16.
4. TCO (2004-2007): consolidated property only. PEI (2006): consolidated property only.

Source: Company documents, Mizuho Securities USA, Inc.

Exhibit 8: Demand should outpace supply through 2019



Source: REIS, Mizuho Securities USA, Inc.

Note: The Reis data set includes neighborhood, and community retail properties in complexes with >10,000 square feet. Although the database also may contain selected free-standing, mixed-use, outlet center, power center, and regional properties, these are excluded from inventory, completions, and all other Reis competitive retail statistics.

Price Target Calculation and Key Risks

Kate Spade & Co

We derive our 12-month price target of $30 by applying ~32x (above group average given earnings growth) to our FY17 EPS forecast of $0.95.

Risks to attainment of our share price target include heightened competitive environment, consumer receptivity to merchandising changes, poor inventory management, deterioration in macroeconomic conditions, volatility of supply chain, and changes to import tariffs/quotas.

Simon Property Group, Inc

Our price target of $233.00/sh equates to our NAV estimate of $212.00 (with a 10% premium due to SPG's aforementioned advantages). Risks to our views include increased fears of a near-term U.S. recession, widening CMBS spreads and slowing retail sales, all of which are disproportionately negative for lower productivity landlords.

Taubman Centers, Inc.

Our price target of $86.00/sh equates to our NAV estimate of $95 with a 10% discount (given aforementioned acquisition proof corporate by-laws, spotty development track record and higher leverage ahead). Risks to our views include increased fears of a near-term U.S. recession, widening CMBS spreads and slowing retail sales, all of which are disproportionately negative for lower productivity landlords.

The Children's Place

Our $85 PT is derived by applying ~21x (premium to the peer group average given early strong momentum and signs of multi-year turnaround) to our FY16 EPS estimate of $4.05.

Risks to attainment of our share price target include heightened competitive environment, consumer receptivity to merchandising changes, poor inventory management, deterioration in macroeconomic conditions, volatility of supply chain, and changes to import tariffs/quotas.

The Macerich Company

Our price target of $88.00/sh equates to our NAV estimate of $93.00 (with an applied 5% discount applied due to lower M&A probability, despite similar overall asset productivity to GGP and SPG). Risks to our views include increased fears of a near-term U.S. recession, widening CMBS spreads and slowing retail sales, all of which are disproportionately negative for lower productivity landlords.

Tiffany & Co.

We derive our $80 PT for TIF by applying ~22x to our FY16 EPS estimate of $3.65. The premium to the group average of ~20x reflects the company's strong margin profile and domestic & international expansion opportunities.

Risks to attainment of our share price target include heightened competitive environment, consumer receptivity to merchandising changes, poor inventory management, deterioration in global macroeconomic conditions, slowdown in Chinese spending, volatility of supply chain, changes to import tariffs/quotas, and changes to foreign exchange rates.

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(As of 5/10)	**% of coverage**	**IB service past 12 mo**
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