What the CEO of America's Largest Mall REIT, Simon Property Group, Just Said about the Brick & Mortar Meltdown and How it's Trying to Manage It

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"I prefer not to scare you at this point, okay. But it's something that we've been able to withstand": CEO David Simon.

Mall-landlord Simon Property Group – as it says, the largest real estate investment trust "in the world" by market capitalization, with 234 "destinations" for shopping, dining, entertainment, and mixed-use in America and elsewhere – has its finger deeply in American brick-and-mortar retail. And when its CEO talks about how the company is dealing with these malls, as e-commerce and too much debt are shrinking or toppling its tenants, such as Sears, it gets interesting.

On Friday, when the company reported fourth-quarter earnings, the "redevelopment" of its malls dominated the earnings call. It started out with these points in the press release:

- In 2018, the company "delivered **five significant property transformations** and expansions; started construction on several redevelopments of former department store spaces."

- "Construction also continues on **other significant redevelopment** and expansion projects including The Shops at Riverside (Hackensack, NJ), Southdale Center (Edina (Minneapolis), MN), Northshore Mall (Peabody (Boston), MA)...."
- "Construction also started on **five significant redevelopment projects of former department store spaces** at Broadway Square, Cape Cod Mall, Midland Park Mall, Ocean County Mall and Phipps Plaza."

This topic dominated the earnings call because the brick-and-mortar meltdown is real, and retailers are closing stores and filing for bankruptcy in large numbers, and Simon has to work with them, and it has to manage the process and develop alternatives. Chairman and CEO David Simon even threw out a number: The company's president is sitting on "his 200th unsecured creditors committee." That's how many bankruptcies and restructurings its tenants have gone through so far.

"There are points in time where it's painful as we go through that with them," David Simon said.

So here is how the largest mall landlord in America is dealing with the historic transformation of the retail industry, as explained by Mr. Simon during the earnings call (transcript via Seeking Alpha).

The first question on the topic was about the impact from the "repurposing" of the 25 Sears anchor stores, "like sales disruption or any kind of compensation you might have to give tenants while you're working on the Sears space...."

Mr. Simon said essentially that Simon Property Group is big and diversified and can handle it, with only "48% of our business in the mall business," down from 95% early on.

Many of the anchor stores at Simon Property Group's malls have made the news with store closings. Sears is in bankruptcy. J.C. Penney may be heading that way. Neiman Marcus was subject to a leveraged buyout, precisely the process whose consequences are now pushing so many retailers into bankruptcy. Simon Property's top anchors, in order of square footage (number of anchor stores):

- Macy's (117)
- C. Penney (66)
- Dillard's (38)
- Nordstrom (28)
- What's left of Sears Holdings (25)
- Dick's Sporting Goods (31)
- Hudson's Bay Company (16)
- Belk (9)
- Neiman Marcus (12)
- Target (6)
- Von Maur (6)

Mr. Simon:

"So, there's always disruption in our industry. Department store spaces that we reclaim either through lease termination or acquisition, we think will be beneficial in the long run. There are down-times associated with that, and that's all kind of manageable for a company like ours."

"I do think on the retail front, the strong are getting stronger. But as you've seen by the numbers throughout the retail community, a rising tide doesn't lift all retail boats."

"There are some retailers out there that we're nervous about. So far in the first quarter [this is just January], bankruptcies are trending lower than they were in 2017 and 2018. However, there are some rumored names out there. And [2019] could ultimately end up being similar to 2017 and 2018."

"It's a little bit out of our control when we get the space, and then to do a lease takes time.... So I mean, we have our work cut out. We are concerned about a few retailers. That should shake out in Q1. But I think the retailers that are investing in their product, in their store experience, in their branding were having decent results."

"And obviously, as you know, we've had a number of retailers. The list is long, the landscape is littered of leveraged buyouts in our industry that we continue to sort through."

"Leveraged buyouts were not ultimately beneficial, by and large, to our business. That's kind of working its way out of the system."

"Actually, I think we've never been busier on the alternative uses. We got a list in the 8-K that shows you what's been approved, but that pales in comparison to the future activity."

Here is the list from the 8-K filing:

Malls – Redevelopments	The future
Auburn Mall – Auburn, MA	Redevelopment of the former Macy's F
King of Prussia – King of Prussia (Philadelphia), PA	Redevelopment
Burlington Mall – Burlington (Boston), MA	Redevelopment of the former Sears TE
Roosevelt Field – Garden City (New York), NY	163 room Residence Inn by Marriott
Columbia Center – Kennewick, WA	Dick's Sporting Goods
Orland Square – Orland Park, IL	Redevelopment of the former Carson's
Shops at Riverside, The – Hackensack (New York), NJ	Redevelopment
Southdale Center – Edina (Minneapolis), MN	Redevelopment of the former JCPenne
Broadway Square – Tyler, TX	Redevelopment of the former Sears bu

Midland Park Mall – Midland, TX	Redevelopment of the former Sears bu
Ocean County Mall – Toms River, NJ	Redevelopment of the former Sears bu retailers
Cape Cod Mall – Hyannis, MA	Redevelopment of the former Sears bu
Dadeland Mall – Miami, FL	Kendall West expansion including the
Northshore Mall – Peabody, MA	Redevelopment of the former Sears bu
Phipps Plaza – Atlanta, GA	Mixed use redevelopment of the forme Life Time Work, Office, and retail
Other Properties	Redevelopment projects at various prc

"Three off the top of my head, that are massive mixed-use projects," and that "aren't even on our list [above]," Mr. Simon said:

- "Northgate, which we have made a deal with the NHL franchise in Seattle, to do their corporate office as well as their practice facility and ice facilities for the general public."
- "We have Brea [Brea Mall, Orange County, California] which we have a reclaimed department store space that is in the process of permitting to do a massive amount of residential.
- "Same thing with Stonebridge in [Pleasanton] California."

"We obviously had a significant redevelopment. We're feeling the pressure what we're going through in our portfolio. So I would say by and large, when we're looking at these spaces, they're much more focused on changing the mix, adding additional elements… wellness, fitness, restaurants, residential, hotels – to kind of make it a standard statement of live, work, play, et cetera. So rarely is it just small shops."

President and COO Rick Sokolov chimed in:

"To echo David's point, this trend is accelerating. This time last year in our 8-K, we listed 11 projects for 2018 and beyond. This year, we have 19. And as David said, we have many more that are in the pipeline that are going to be coming in here. So we have a dedicated team."

David Simon, in response to a question of how the troubled retailers, disappearing anchor stores, and redevelopment activity impact net operating income (NOI):

"The reality of how leasing works is that it takes time to lease space, right?... So if you look at the comp NOI growth, it's being affected by some of these retailers that are going through this significant change. And we tend to work with them because at the end of the day, we tend to do it on a shorter-term basis, because we know, ultimately, we have to re-lease the space to someone."

"When it comes to a good property and a good space with a good retailer, we're making strides. But we're working with some of the ones that are going through their various restructurings, and that ultimately has some impact, certainly, in the short run."

And to another question about the impact on income, Mr. Simon said:

"The pressure that we have is that we are still dealing with a handful of retailers that, for whatever reason, have to go through their various restructurings. Because we can't lease every space every minute, we tend to work with them.... I do think the cycle of the levered retailers is working its way through the system. And I think, at the end of the day, we just like cleanse. I mean, we're suffering the pain. I mean, 2% comp NOI – we're not ecstatic about it, but the primary factor in that is the retailers that are going through the various restructurings that we had."

"I think, though, as that is cleansed, we'll get to that number. But retailers are very focused on their cost and their operating model. Stores continue to be their best investment and their best return. Obviously, there's a lot to talk about how profitable the Internet is and e-commerce and who's bearing the brunt of the investment and all that.... The reality is, because of a lot of investments they're making, they're looking at every expense category. And we are having those discussions. They're not easy."

"We have a long list of retailers that have struggled. 80% to 90% of that list have been over-levered, so they couldn't turn left or right. You just can't have too much leverage in any industry and any business. When you run into an economic difficulty, or if you need to make investments, you just have nowhere to go."

"If I read you the list [of those retailers], you would – it comforts me in one sense because we withstood this pretty successfully. On the other hand, I might scare you. So, I prefer not to scare you at this point, okay. But it's something that we've been able to withstand."

"The retailers that have a vision, whether they're starting from the internet or just been around, and that have invested in their business and their product, we're seeing pretty good results. Let's look at the higher end luxury category; they don't have a lot of internet sales, they invest unbelievably in the store experience, and then the product. And guess what, they had great results."

"So, not overly complicated. The technology and some of the new concepts that we've seen out there that have been successful. Usually it's a visionary leader. It's a visionary group that's dedicated to the business. They may have a little bit different angle on something that exist today. And they just execute it better than the next person."

"I think the power of our industry is that we can withstand the ups and downs of a retailer – or retailers. There are points in time where it's painful as we go through that with them. But ultimately, whether they turn it around or not, if we get the space back, historically, we've been able to lease it to a better person.

"Now I will give you a number that I probably shouldn't, but we tend to be on most retailers' unsecured creditors' committees. We have somebody internally [Rick Sokolov, President and COO]…. He is currently on his 200th, 200th unsecured creditors' committee. Now okay, yes, that might say, holy cow, that makes you a little nervous."

"On the other hand, I mean, we did earn $4.3 billion…. So, I think more importantly, it speaks to the resilience of our industry, our product, and what the consumer really wants."

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