VALUE RETAIL NEWS

THE JOURNAL OF VALUE-ORIENTED RETAILING & DEVELOPMENT

Volume VIII, Number 8 August 1990

FINANCING:

Chase complicated by credit crunch

Industry pioneers look at past, present, future

The trouble with factory outlet expansion

Despite growing public acceptance of factory outlet retailing, it has never been harder to develop an outlet center.

Sadly, notwithstanding the scarcity of new opportunities and all of the effort it takes to make a deal, a large percentage of planned outlet projects will die before the shovel ever pierces the ground.

Why?

Financing a factory outlet shopping center is a painfully difficult feat.

Permanent mortgage lenders (such as life insurance companies, pension trusts, savings banks and S&Ls) tend to shy away from factory outlet shopping centers despite their longstanding attraction to conventional shopping center loans. This is happening despite the fact that financial institutions have had materially

COMMENTARY by Emanuel B. Halper and Andrew Smith

fewer problems with permanent shopping center loans than with multi-family housing loans or the now legendary junk bonds. (Permanent loans are long-term loans disbursed on or after the substantial completion of construction.)

If you want to understand why institutions resist loan proposals to finance factory outlet shopping centers, you need to know a bit about the way the institutions evaluate permanent shopping center loans in general.

Institution lenders have developed many criteria by which to judge applications for permanent loans. One such criterion is the credit or security offered as assurance for repayment. Shopping center landlord-developers aren't quick to offer their personal credit to permanent lenders; they customarily ask permanent shopping center lenders to look solely to the security for the loan for repayment. That means that, if the landlord-developer-borrower fails to repay the debt, all the lender can hope to do is to foreclose its mortgage and thus become the owner of the shopping center. It can't go after the landlord-developer-borrower's piggy bank, race horses, or football teams.

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Consequently, the landlord-developer-borrower's credit is usually irrelevant to an application for a permanent mortgage loan. However, that doesn't mean that the lenders aren't interested in credit. They certainly are interested in credit -- the credit of the tenants.

For the most part, the American shopping center industry did not rise and grow on the field of the landlords' credit. Retail tenants took the basic risks and made the ultimate commitments that spurred the growth of the conventional shopping center industry. The risks and commitments were embodied in the leases they executed.

What about these leases made conventional shopping centers such an attractive investment that the membership rolls of the International Council of Shopping Centers now exceeds 28,600 and approximately 2,000 new conventional shopping centers (malls and strips combined) were developed last year?

The tenants usually agree to pay a fixed minimum rent; a percentage rent based on the amount, if any, by which their gross sales exceed an agreed sales base; and a pro rata share of real estate taxes, insurance premiums and common area maintenance expenses.

The percentage rent (when it comes) is a delicious dessert for the landlord. However, the minimum rent is allocated first to the discharge of the mortgage debt. (The balance is kept by the landlord.) In essence, the mortgage debt repayments come from the minimum rent.

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Even the amount of the mortgage debt is determined, in part, by the amount of minimum rent. As the annual rate of minimum rent increases, a landlord-developer-borrower is able to pay the lender bigger monthly installments of interest and principal. It's easy to see that, when you can repay more money every month, you stand a good chance of borrowing more money in the first place.

The lease term is another critical factor in determining how much money a developer is able to borrow to finance a center and the length of the term of the loan. It's obvious that, if the lender looks principally to the tenants' rent commitments for repayment of the loan, it is vitally concerned about how long the tenants' rent commitments last. Lenders are willing to lend more money and for longer periods of time

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against the security of long-term leases than they are willing to lend in the case of short-term leases. In fact, many lenders won't lend you anything at all in the case of a short-term lease.

How does all of this threaten the growth of factory outlet shopping centers?

In a most direct way.

The amount of rent factory outlet tenants pay is not the problem. The manufacturers have been tough but fair in this respect. Annual rates of minimum rent in factory outlet shopping centers are generally lower than rental rates on conventional malls and strips, but they are high enough to do the job.

The difficulty is the term of factory outlet leases. A mysterious force impels tenants to insist on very short-term leases when they negotiate for space in a factory outlet shopping center. Although tenants routinely sign leases for 10, 15, 20 and even 30 years when a conventional shopping center is involved, they become ultra-conservative and overwhelmed with a fear of a long relationship in the context of factory outlets.

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Similarly, even an extremely diplomatic suggestion that the term of a factory outlet lease be for 10 or 15 years is prone to cause outrage, self-pity, athlete's foot and palpitations of the heart. Given this medical insecurity, developers have settled for five-year leases and agree (in some cases) to kickout clauses providing for still earlier cancelation.

How has this custom affected the growth of the outlet industry? It has had a dramatic effect to date and will continue to have a dramatic effect in the future. Unfortunately, dramatic effects are not always beneficial, and this dramatic effect certainly has not been beneficial.

What factory outlet tenants have won with their negotiations as to the length of the term is many fewer opportunities for profit. A prospective permanent lender, enticed at first by this new and efficient means of distributing merchandise, recoils when he reads the leases and sees that the tenants have the theoretical right to discontinue rent payments and leave the shopping center after only five years. This concern is exacerbated by tenants whose executives confuse a lease with a very brief flirtation and insist on the right to cancel unless they reach a predetermined threshold of sales volume within two years.

Ultimately, we must all cope with reality. In shopping center development, as well as in personal loving relationships, short-term commitments are a shaky foundation. It takes money and lots of it to buy shopping center land, construct site improvements and buildings, negotiate leases, and arrange financing. Although the initial source of funds may be an institutional mortgage loan and equity investment, the loan and investment must be amortized, and the ultimate source of amortization is the minimum rent.

Naturally, you can't expect to fully

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amortize the cost of development with the minimum rent paid during the first year or two or even the first five years. We customarily figure on amortizing the cost of development over more than 30 years.

That's why the underpinning of the conventional shopping center industry is the 25-year lease. The 25-year period became customary because it's almost 30 years.

That's not to say that all conventional shopping center tenants sign 25-year leases. Most of them don't. However, the anchor tenants and the tenants who take larger blocks of space in conventional shopping centers tend to commit themselves for approximately 25-year periods without much fuss.

Since they occupy huge portions of the project and are expected to attract smaller tenants, the landlord and the lender are encouraged to invest in the project.

The commitment derived by long-term leases executed by anchor tenants gives the lender and landlord the confidence to assume that the shopping center will be occupied by rent-paying tenants for a long enough period to fully amortize the cost of development.

The result is that conventional shopping centers become a natural investment vehicle. You put up your money in the reasonable expectation that someone will pay you enough to make your investment worthwhile.

Contrast this to the proposition factory outlet tenants offer their landlords and that we as an industry offer to institutional lenders.

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