Trepp®
CRE Research

March 2015

Shifting Retail Landscape Poses Big Questions for CMBS Borrowers and Lenders

Trends

Online shopping has placed brick and mortar retailers in a unique position. The convenience of straight-to-your-door services and a nearly infinite selection has curbed the appetite for physical stores, but the demand to see, feel, and touch a product is still at the core of the retail experience. Tech integration, on top of the overall transition to sustainability, has put pressure on retailers and property owners to upgrade and redesign facilities with integrated technology to draw customers away from their screens and into stores. Rather than use stores like small inventory warehouses, retailers are shifting more toward the showroom and omni-channel models.

Retail stores are now just one part of the purchase process, which has grown to include online connectivity, brand engagement through social media, and experiential flagship stores. Landlords are increasingly redeveloping retail properties to cater to the expanded technological needs of tenants and, in many cases, their lower square footage requirements as a result of having less inventory on premises. Retailers themselves are grappling with performance measurements of brick and mortar stores under this new model, which often drives business online despite the purchase decision being made in a physical store.

A barbell effect seems to have taken hold in retail property investment, as large retail REITS are shedding underperforming assets and pumping money into high-end luxury malls and storefronts in urban "high street" retail areas. On the other end, grocery stores, pharmacies, discount retailers, and other consumer essentials tenants that anchor smaller retail properties are performing fairly well. Second tier regional malls, the power centers built more than thirty years ago that are anchored by beleaguered big box tenants like JC Penney, Sears, and Best Buy, are the properties suffering the most. It is these properties that are causing the most damage to legacy CMBS loans, as large parcels slowly become vacant.

Historical Performance

For the most part, delinquency rates have settled down since the wild effects of the financial crisis hit the market. Trepp's rate for retail loan delinquencies in February was 5.38%, down

22 basis points from January's rate and 286 basis points from its peak in March 2012. Retail delinquencies recovered more rapidly than other major property types, as special servicers were faster to cut their losses and foreclose on distressed retail properties, as opposed to the 'extend and pretend' approach taken with a lot of large office and multifamily loans during the slow recovery. The office delinquency rate, by comparison, was 6.15% in February.

This year is the first of the oncoming 'wave of maturities,' which is the more than $300 billion of 2005 through 2007 vintage 10-year loans due to mature over the next three years. Nearly 30% of the maturing balance will come from loans backed by retail properties. Loans that are current now may end up defaulting as they near maturity and borrowers assess their sale or refinance options.

When the maturing retail loans are broken down by the underlying properties' reported occupancy rates, a quarter of the loans provide cause for concern with regards to their tenancy. Higher vacancy rates lead to lower income and ultimately lower valuations, possibly causing trouble for these loans when it comes time to refinance.

Figure 1. Retail Delinquencies

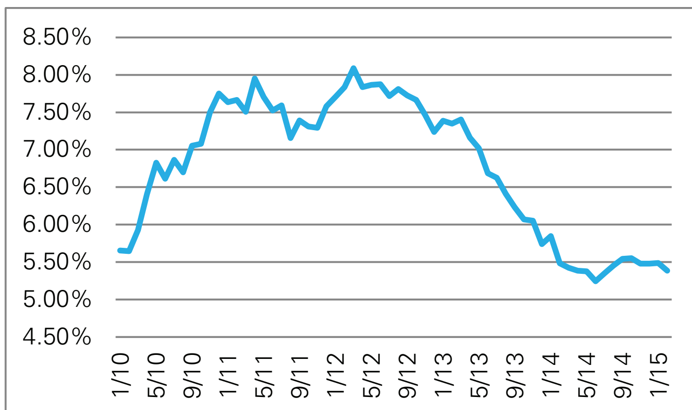


Figure 2. Volume of Loans Maturing

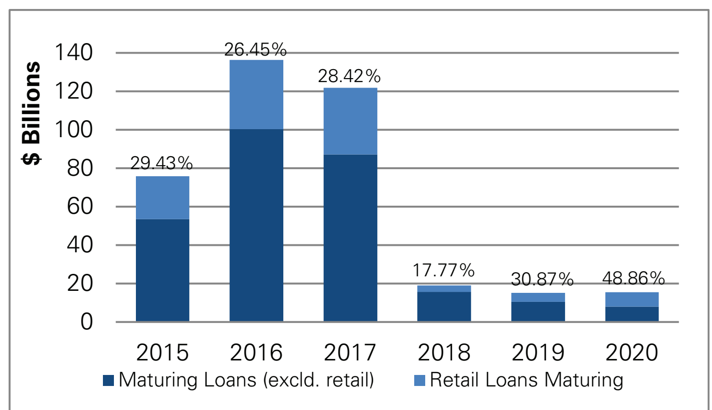
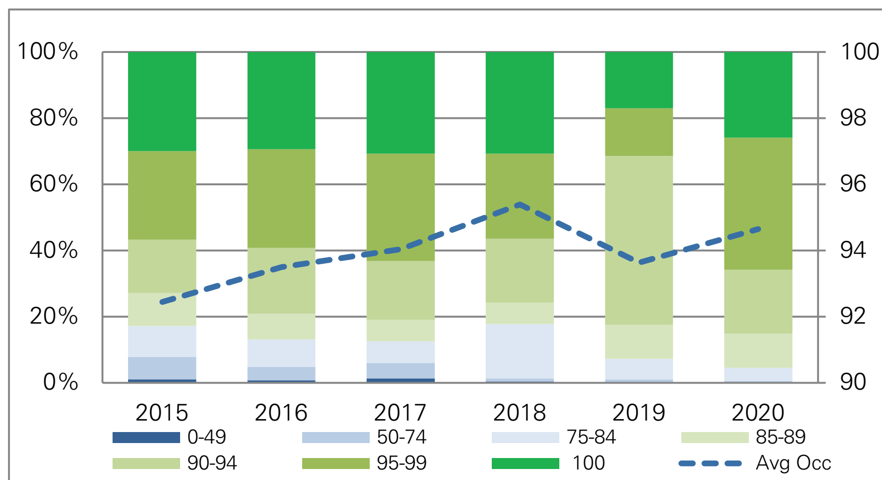


Figure 3. Occupancy of Maturing Retail Loans



To get a clearer picture of what losses may look like as the wave of maturities hits, we look to the status of the loans coming due from now until 2017. Of the maturing retail loans, 7.93% are current but have been assigned appraisal reduction amounts (ARAs), while 7.68% are delinquent with an ARA. ARAs can serve as both a warning and estimate on the level of losses that may result based on the borrower's missed principal and interest payments. Looking at 2015 retail maturities alone, over 14% were reported as delinquent in February. The majority of the delinquencies are either REO or in the process of foreclosure, so it is highly likely that these properties will report losses upon disposition. An additional 2% of 2015 maturities are currently with the special servicer. Another 7% and 7.7% of 2016 and 2017 retail maturities are already delinquent, respectively.

Historically, average loss severity on retail dispositions has been volatile due to varying maturities, prepayments, foreclosures, and the overall state of the commercial real estate market. Over the last ten years, 19% of retail loan dispositions resulted in a loss, with an average loss severity of 51.55%.

Figure 4. Wave of Retail Maturities

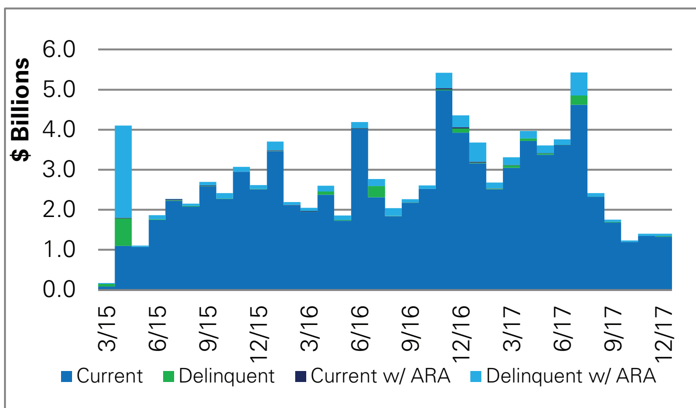


Figure 5. Losses on Disposed Retail Loans

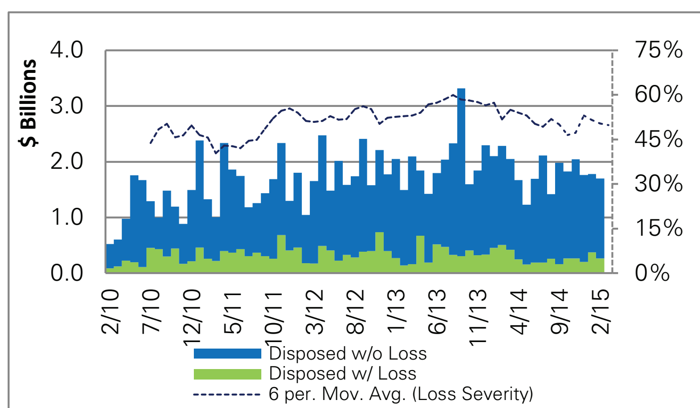
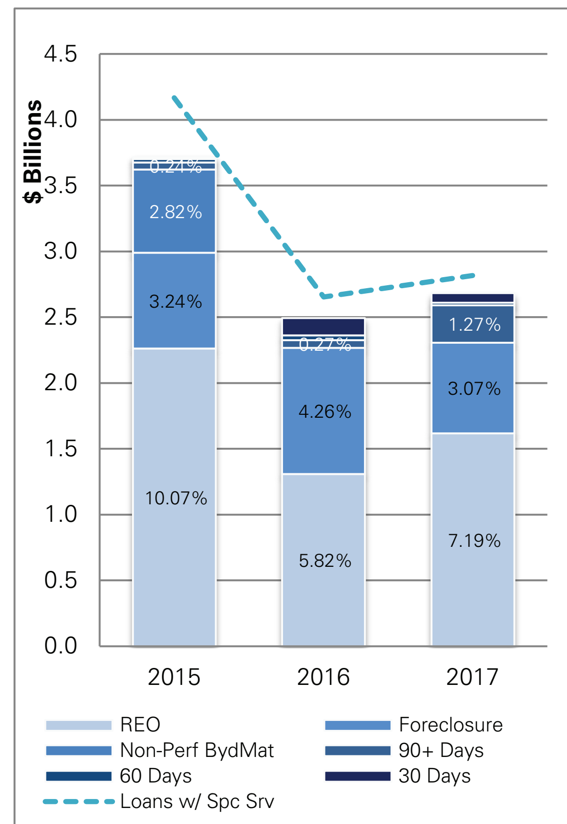


Figure 6. Maturing Retail Delinquencies



New Issuance

Issuance of retail loans in CMBS has been trending upward since the recession despite a slight drop in 2014. Beginning in 2012, single asset/single borrower deals accounted for a growing proportion of annual issuance. The large trophy type assets or portfolios financed by these deals, paired with their relatively easy-to-analyze structure, made them more appealing to wary CMBS investors. Growing use of this deal type also supports the theory that the capital markets are shifting their assets toward high-end, luxury, prime-location retail properties.

As more capital enters the market and lenders compete harder for lending assignments, underwriting standards are on the radar of investors and ratings agencies. One measure of underwriting standards is the percentage of interest-only (IO) loans being originated in CMBS.

Interest-only loans have made up a growing proportion of new retail origination over the last year. In general, IO terms are considered riskier than amortizing loans that that pay down principal over their term.

The loan-to-value ratios on loans being issued also serve as a good measure of where underwriting standards are in the market. In the case of retail loans, weighted average LTVs don't give much away, but it does appear that lenders are originating loans at slightly higher leverage points so far in 2015. One reason LTVs may be staying fairly flat is a coinciding drop in capitalization rates. Cap rates measure net operating income (NOI) in relation to property value, so the downward trend in cap rates implies that property values are increasing for the same amount of NOI.

Figure 7. Retail Issuance by Deal Type

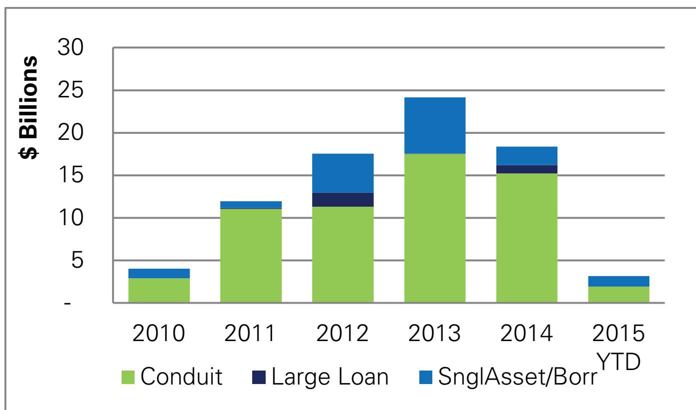


Figure 8. Retail Amortization Types

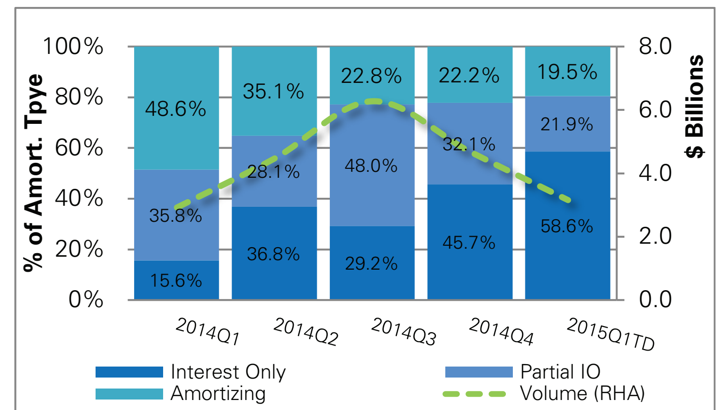
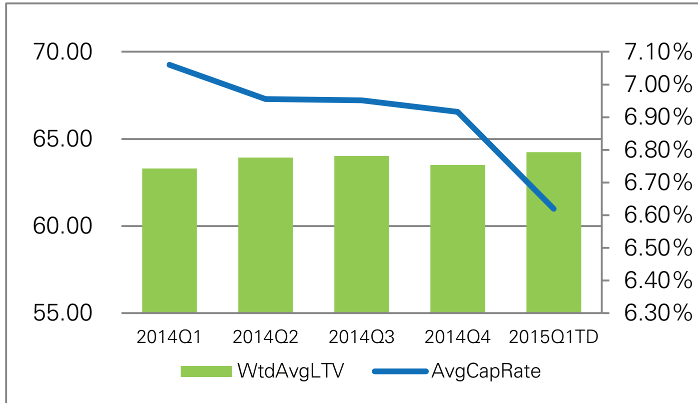


Figure 9. Weighted Average LTV & Cap Rates



Outlook

Rents in urban markets soared last year and will remain competitive as the move toward urbanization continues and millennials stay unmarried and live in cities longer than the generation before them. Large anchors in malls continue to struggle to stay relevant, and many staples in the industry have either faded, like Sears, or fallen, like RadioShack. Now, both companies are trying out the store-within-a-store model, with Sears carving up parcels to sublease unnecessary space, and RadioShack teaming up with Sprint to lower expenses and better utilize their existing square footage.

Many middle-of-the-market malls continue to underperform, some of which have gone completely dark, while high-end shopping centers benefit from access to capital and higher foot traffic. Simon Property Group's recent bids for Macerich may point to a trend toward consolidation in the retail REIT market that could advance the process of culling underperforming assets and investing in high performing properties. Ultimately, owners and tenants will have to revitalize space by integrating technology to enhance consumer engagement and compete with online outlets with less overhead.

The high volume of retail loans coming due over the next three years will lead to increasing new CMBS origination in this space. However, many of the properties up for refinancing will be reappraised in a retail environment very different from what it was ten years ago. Depending on the landscape in the next five years, this could put pressure on borrowers to contribute more capital or sell properties at discounted values. ■

For inquiries about the data analysis conducted in this research, contact press@trepp.com or call 212-754-1010.
For more information about Trepp's commercial real estate data, contact info@trepp.com.

About Trepp

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