ASSESSING RENEWAL PROBABILITIES DURING AN ACQUISITION

LBX investments

MARKET COMMENTARY | AUGUST 9, 2021

Should They Stay Or Should They Go?

Assessing Renewal Probability With Large Retail Tenants Is A Complex Endeavor

OVERVIEW

By the end of the summer, LBX will own two shopping centers that have significant concentrations of large national retailers. At Ridgeway Trace ("Ridgeway") in Memphis (which is shadow-anchored by a Super Target), Best Buy, REI and PetSmart comprise 42% of the center's square footage and 40% of its annual rents. At Evergreen Plaza ("Evergreen") in Chicago, national tenants including Whole Foods, TJ Maxx and Ulta comprise 91% of the square footage and close to 95% of its annual rents. At each center, large leases coming up for renewal during our expected holding period present multiple potential threats. Should any major tenants opt to leave, it would most likely be expensive to backfill their space, and distributions could be impacted.

We are not naïve to these risks and are very careful underwriters. We spend a considerable amount of time analyzing these situations during due diligence. Generally speaking, if a retailer is performing well at a dominant center, is in the right size and shape box, has strong corporate fundamentals, and the store is profitable, they are highly likely to stay. That said, we conduct far deeper analysis when evaluating renewal probabilities, so that we can make as educated an assessment as possible. Factors we consider include tenant sales and health ratios (and broader occupancy costs), the corporate health of the retailer, evidence of commitment to the center, location data, market and box characteristics, the competitive position of the underlying real estate and legal language in the leases.

SEVERAL FACTORS WE CONSIDER WHEN EVALUATING RETAIL LEASES

TERM
• Tenant Sales and Health Ratios (and Broader Occupancy Costs) • Corporate Health of the Retailer • Tenant Interviews and Evidence of Commitment to the Center • Location Data (Demographics, Traffic Counts, Number of Visitors, etc.) • Market Rents and Box Characteristics • Competitive Positioning of Underlying Real Estate • Sales Kickouts and Co-Tenancy Clauses

Source: LBX Investments

PRIMARY FACTORS CONSIDERED

Tenant Sales and Health Ratios (and Broader Occupancy Costs)

Tenant sales are an important indicator of a retailer's health at a location. Retailers look closely at their occupancy costs and one simple metric to help evaluate performance is a "health ratio" (rent /sales). Per the terms of their leases, retailers are not always required to report sales, but we can usually get solid anecdotal information about performance at specific locations through our network of corporate and industry contacts. Different retail categories have different target occupancy costs – for example, an established grocery store typically aims for a health ratio of no greater than 3-4% because the operating margins in the supermarket business are relatively thin, while quick service food retailers can operate with significantly higher costs as a percent of sales. When we are considering a tenant's strength at a location, we first look to tenant sales numbers. A good health ratio does not guarantee that a tenant will remain at a center, but it obviously increases the probability.

TYPICAL HEALTH RATIO RANGES

RETAILER	TARGET RANGE
Grocery	Below 5%
Restaurant	5-8%
Apparel	5-10%
Gym	15-25%

Source: LBX Investments

Investors should also note that while the health ratio is a pure rent/sales metric, we also consider triple nets reimbursements (NNNs) in a retailer's total occupancy cost equation. NNNs – which are typically comprised of taxes, insurance and common area maintenance ("CAM") charges – vary from market to market and tend to be highest in dense, high-tax, urban markets and in lifestyle centers with expensive shared services.

Corporate Health of the Retailer

Much has been made of pressures faced by retailers – particularly during the COVID-19 pandemic – but many are performing very well. National retailers like Ross, Ulta, and Target have been opening locations and growing their businesses for several years. When we evaluate tenants for a prospective acquisition, we look beyond sales and assess the strength of their business models. We run full credit analyses, placing particular emphasis on their strategies vis-à-vis their surrounding demographics, their leverage and liquidity profiles, and the general risk profile of their industry segment. We generally view leading discounters, for example, as strong tenants and are wary of many department stores.

If we see excessive risk tied to a retailer's long-term outlook, we will ratchet down our renewal probability accordingly. For example, at Ridgeway Trace we cut Lane Bryant's renewal probability to 25% in our underwriting because they have been struggling at a corporate level and are closing stores. Low renewal probabilities from an underwriting perspective means that we have assumed in our models that we will have lower occupancy (and lower revenue) as well as dollars set aside for re-tenanting, when a particular retailer rolls. This provides a buffer in our underwriting to ensure that we can hit our underwritten returns, even when negative events occur.

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THE PRIMARY FACTORS WE CONSIDER (CONTINEUD)

Corporate Health of the Retailer (Continued)

For some good quick indicators of a retailer's strength, we advise investors to consider metrics such as debt/EBITDA, interest coverage ratios, debt maturity walls, and same store sales. Additionally, investors can often look to the number of new stores the company is opening as an indicator of its growth prospects. There are notable exceptions to this – Best Buy, for example, has been closing its larger format stores for years despite its increasingly dominant market positioning – but retailers that are expanding are typically a good bet to remain at a productive shopping center.

LOCATIONS OPENING IN 2021

WHOLE FOODS	TJ MAXX	ULTA	BURLINGTON	FIVE BELOW	PLANET FITNESS
40	76	40	100	180	100

Source: LBX Investments and Creditntell

Tenant Interviews and Evidence of Commitment to the Center

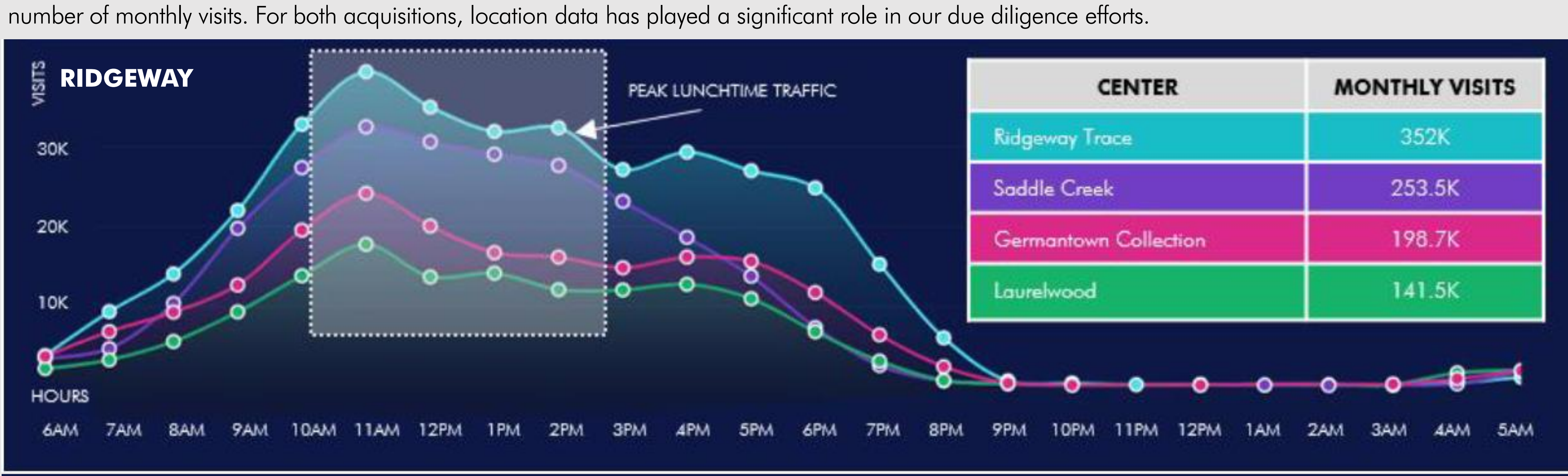
When we acquire a center, we attempt to meet with local, regional and national (where applicable) representatives from every retailer in order to better understand their performance and happiness at a particular location. For larger tenants, we generally seek to learn where a specific store ranks chain-wide, how it performs compared to others in its market, whether the footprint fits their current prototype, and whether the store has been trending positively or negatively. For example, at Ridgeway, one of the national tenants has multiple additional stores in the market. We learned that the Ridgeway location is slightly above chain average nationally, does very well relative to its peers in the market, is right-sized for its current prototype, and that sales are trending positively. Based on that interview alone, we are confident the retailer will extend its option to remain at the center.

Location Data

Mobile location analytics is a relatively new field that has quickly become indispensable in shopping center analysis. Over the past few years, companies that use technology to track tens of millions of cell phones (not individually) have been providing information to landlords, brokers and retailers about pedestrian traffic at shopping centers. These companies help shed light on where shoppers are coming from, how often they are shopping in certain locations and how that compares to other locations. Increasingly retailers are using this information to make strategic decisions, shifting from the more traditional and now outdated 1-3-5-mile demographic rings, in order to determine where to open and close stores. We subscribe to a service called Creditntell to conduct location data analyses; Placer.ai is another leader in the space. Both offer data that was unavailable until just recently.

LOCATION DATA EXAMPLES

Ridgeway (top) attracts a high amount of daytime traffic, which is key to our investment thesis. Evergreen (bottom) ranks #25 nationally out of 4,785 centers for number of monthly visits. For both acquisitions, location data has played a significant role in our due diligence efforts.



EVERGREEN

	LOCATION SF	NAT'L RANK	STATE RANK	COUNTY RANK	MSA RANK	ZIP RANK	20 MILES RADIUS	TOTAL VISITS	2020 %	AVG FREQ
River Forest Town Center 7261 Lake Street River Forest, IL 60305-2238	203.7K	13 of 4785	1 of 215	N/A	N/A	1 of 1	N/A	689.4K	137.4%	2.91
Evergreen Plaza 95th St & S Western Ave Evergreen Park, IL 60805	355.5K	34 of 4785	2 of 215	N/A	1 of 137	1 of 1	N/A	587K	106.8%	2.87
Pointe Plaza Touhy Avenue Niles, IL 60714	332.4K	39 of 4785	3 of 215	1 of 30	2 of 137	1 of 4	N/A	571.7K	21.25%	2.65
Commons of Chicago Ridge 9900 S. Ridgeland Avenue Chicago Ridge, IL 60415	346.3K	42 of 4785	4 of 215	2 of 30	3 of 137	1 of 1	N/A	568.6K	137.5%	3.06
Oak Lawn Shopping Center 4060w 95th Street Oak Lawn, IL 60453	290.9K	97 of 4785	5 of 215	N/A	5 of 137	1 of 1	N/A	515.4K	2.39%	2.86

Source: LBX Investments and Creditntell

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THE PRIMARY FACTORS WE CONSIDER (CONTINUED)

Market Rents and Box Characteristics

During due diligence, we evaluate the physical attributes of a tenant's space and whether the tenant is paying a market rate. Retail business models are rapidly evolving, and retailers are being far more efficient with the space they lease today than they were 20 years ago. Store footprints have been shrinking and frontage requirements changing. If a retailer is occupying too much space for its present-day needs and its sales numbers do not justify the rent spend, then the economics of this space may change over the life of the holding period. If market rent for a particular space declines during our holding period, and costs to convert a vacancy are much higher than anticipated, then an investment can easily miss its return projections.

Competitive Positioning of Underlying Real Estate

We often advise investors that demand exists even in soft markets. Well-positioned real estate still attracts proven concepts that are positioned to grow in the most challenging economic conditions. For example, our shopping center portfolio saw 24,922 SF in positive net absorption last year, a 3.2% increase in average base rent, and a 2% increase in same store occupancy, despite the impact of COVID-19.

LBX RETAIL PERFORMANCE IN 2020

	12/31/2019	12/31/2020	YoY Change
Same-Store Occupancy	94.2%	96.1%	2.0%
Same-Store Average Base Rent	$11.84	$12.22	$0.38 (+3.2%)
Same-Store SF Leased	1,236,389 SF	1,261,311 SF	24,922 SF (Net Absorption)

Source: LBX Investments

Retailers tend to follow strong demographics because population and income growth (and/or high density) provide a steady flow of shoppers. Even in a downturn, centers that sit at high-quality locations in thriving retail nodes are more likely to attract demand than centers with weaker positioning.

Sales Kickouts and Co-Tenancy Clauses

On a final note, larger tenants often negotiate sales kickout clauses and co-tenancy agreements. When acquiring a center, these provisions will be contained within the leases and must be fully evaluated. Accordingly, we spend significant time analyzing and understanding leases during the due diligence phase.

Sales kickout clauses provide retailers (and occasionally, landlords) with flexibility and negotiating leverage in the future if tenant sales are weaker than anticipated and/or occupancy costs rise too much. Put bluntly, a retailer that is performing below its sales targets is often a risk to leave a center (or renegotiate their lease).

A co-tenancy clause is a lease provision that specifies a minimum co-tenancy requirement that the landlord must maintain. If the required tenancy is not met, the retailer will have the right to reduce rent until an appropriate replacement tenant is found by the landlord. For example, Evergreen Plaza has a Whole Foods on a long-term lease. Should Whole Foods ever leave the center, it would trip co-tenancy provisions for some neighboring tenants and they would have the right to reduce their rent until we remedy the vacancy.