Hilco Global
Asset Smarter

SMARTER PERSPECTIVE: REAL ESTATE INDUSTRY

The Evolution of the New Mall Lease

By Dan O'Brien

A shifting dynamic has developed between tenants and landlords in the negotiation of shopping center leases. In this article we outline key considerations that can aid tenants in obtaining the most equitable lease terms in today's evolving real estate landscape.

In 1956 the first regional, enclosed mall was built in Edina, MN. As suburban population growth exploded, there have been nearly 120,000 shopping centers built in the years since. Many of these are grocery-anchored or local in nature, but 1,300 of those properties are classified as regional or super-regional shopping "malls," offering 50+ small-shop tenants, with three or morelarge-format department store anchors,and a cohesive floorplan to coordinateall these operators in a retail-centric appeal to shoppers, one and all.

With consumer-friendly amenities and climate-controlled environments, malls became the popular place to gather, shop and eat. Main street shopping districts located in towns across America were the primary casualties of these malls' ability to generate immense foot traffic and associated sales for their tenants' stores. With that advantage, landlords garnered an acute understanding of the supply and demand for their real estate, and retailers looking for a captive audience of consumer shoppers knew that the mall was the best opportunity in town.

As a result, a relatively small number of developers went to great effort to build and/or buy most of these regional and super-regional malls, as these owners/operators knew – to a great extent – they could set their own terms with both new and renewing tenants, particularly when no competitive malls were in proximity. This was based, in large part, on an assumption of how traffic levels in those malls could potentially enable stores to achieve optimal levels of performance.

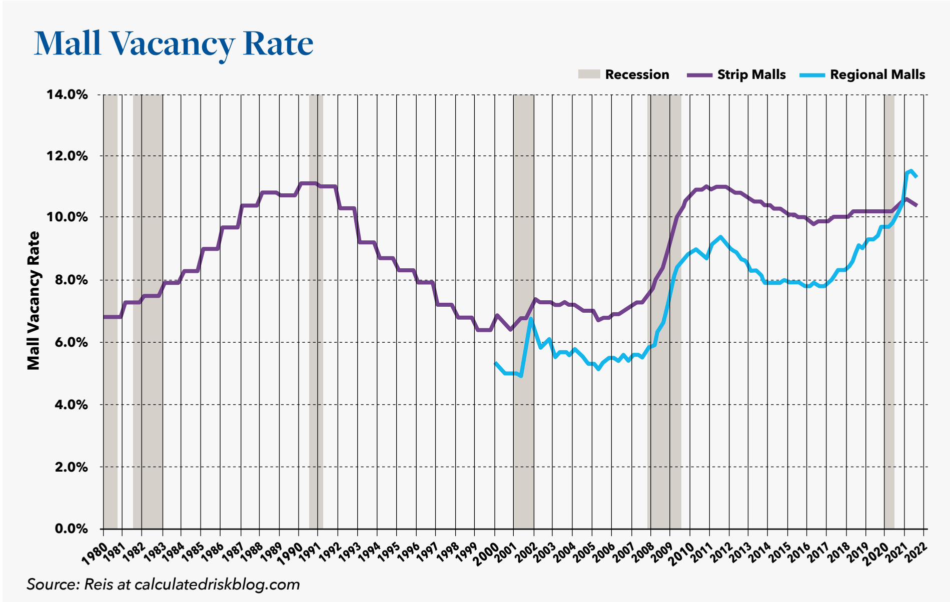
Most landlords then required payment of fixed 'base or minimum' rents plus additional common area maintenance (CAM), real estate taxes, marketing, and other fees. Annual increases of 3-5%, expensive buildouts and 10-year terms were also the norm.

As the ability of malls to drive immense amounts of foot traffic was solidified in geographies across the country throughout the 1990s, tenants clamored to sign these types of leases and grab their share of consumers' wallets. While anchor tenants typically held most negotiating power at the malls during this time, many of the popular brands those department stores carried saw an opportunity to establish their own brick-

and-mortar presence within the highly trafficked corridors of those community shopping epicenters. As a result, they opened independent units outside the walls of the department stores, creating even more demand for this premier real estate.

The growth of this property class peaked around 2007, just as use of the internet was gaining momentum and Amazon's impact was accelerating, but still well before the widespread proliferation of eCommerce. As more consumers began shopping online or at value-driven off-mall stores, foot traffic within these shopping centers began to decline. In turn, many mall tenants experienced flat or declining sales yet continued to see costs associated with their long-term leases increase. As technology advanced and the omni-channel approach to retail became more prevalent, traditional brick-and-mortar retailers became less reliant on malls. Retail tenants who were slow to adapt to the shift in consumer shopping behavior were among the first to experience distress, and many of those sought renegotiation of their lease terms. As a lease negotiation expert at Hilco Real Estate, I have led those discussions and repositioned leased store locations for dozens of valued retail clients.

The financial crisis beginning in 2008 had an amplifying impact on retail distress and corresponding bankruptcy filings. The more widespread eCommerce became in the ensuing years, the less dependent these small shop brick-and-mortar tenants were on the malls and the in-person foot traffic they had come to expect. The COVID pandemic, of course, greatly accelerated direct-to-consumer (DTC) shopping while further adding to the woes of mall operators and brick-and-mortar retailers. In the past dozen years more than 200 malls have closed or have been repurposed, and some industry experts expect that by 2030 more than



According to Reis, the regional mall vacancy rate was 11.2% in Q3, 2021 down from 11.5% in Q2, and up from 10.1% in Q3 2020. Neighborhood and Community mall (strip mall) vacancies were 10.4% in Q3, down from 10.5% in Q2, and unchanged from 10.4% in Q3 2020. Mall effective rents increased slightly in Q3, after stabilizing in Q2. This followed five consecutive quarters will declining rents.

35% of the remaining properties will follow suit. Understandably, this and the overall retail environment have changed the nature of the mall landlord/tenant relationship, delivering greater leverage to tenants to drive more equitable lease deals.

Today, benefiting from that institutional knowledge and market expertise, Hilco professionals are able to negotiate favorable mall leases on behalf of tenant clients with far greater protections, flexibility, and efficiency than at any point over the past 20+ years.

NEW DEAL COMPONENT #1: EQUITY = DOWNSIDE PROTECTION WITH UPSIDE SHARING

When negotiating a new lease, it was, and still is, standard operating procedure for a landlord and tenant to review sales potential. A percentage of sales that the tenant can afford to pay the landlord to generate such sales, while still yielding a reasonable profit to the tenant, is then assigned. During the apex of the property-class and the incredible demand that existed from a multitude of tenants, landlords often had an ability to push tenants to higher sales targets and greater percentages to finalize deals. Those rates would then be fixed over a ten-year NNN lease, with annual increases on the rent and extra charges.

Unfortunately, as referenced earlier, those long-term fixed-rate deals typically benefit landlords more than tenants, as the cost of real estate has tended to far out-pace the sales being generated by most tenants at these malls. As a result, tenants are often desperate to renegotiate at the expiration of a lease or, potentially, within the context of a bankruptcy, when a debtor has the legal right to assume or reject a lease at its discretion. In the current market, tenants should be entering lease negotiations with a different mindset, as they have greater leverage than before based on the unknowns associated with the future of malls, the traffic within their walls and the lighter consumer dollars being spent at these properties.

Tenants Have Gained an Edge

In the current environment, well-represented mall tenants have the leverage to negotiate leases with far greater protections, flexibility, and efficiency than at any point over the past 20+ years.

At Hilco we advocate for tenants to secure more variable rent deals, including lease structures with rent paid via a straight percentage of sales (i.e.: 15% on a projected $1 million in sales for $150,000), with the landlord apportioning that overall dollar amount to their varying charges as they see fit. In some cases, the tenant may include a guaranteed minimum floor and pay that amount versus the greater of a percent of their sales. That guaranteed minimum, as well as the percent of sales, are not based on a 'best case' or 'worst case', but often on a median sales expectation that will allow the tenant to make a minimum amount of profitability with conservative estimates. Then, if sales exceed estimates, both landlord and tenant can share in greater upside. Oftentimes, those gross deals come with lower annualized increases as well (more in the range of 1.5% - 3% per annum), to better mirror CPI.

So, while landlords and tenants are still negotiating today based on sales expectation and a fair percent of revenues as they did with traditional deals in the past, guaranteed rents are more 'base case' versus 'best case.' This means mall landlords must consider a more variable rate framework, as valuable tenants are working to protect their downside, cognizant of the omni-channel and on-line impacts to brick-and-mortar retail.

NEW DEAL COMPONENT #2: FLEXIBILITY + SHORTER TERM COMMITMENTS

With so many changes now occurring across the real estate and retail landscape, it is that much more important for tenants to remain nimble and flexible in their ability to pivot and adjust to changing circumstances. Commercial real estate markets have always been prone to shift, requiring tenants to be proactive to stay where their customers shopped. In today's omni-channel world, however, with evermore fickle consumers, brick-and-mortar retail is often seen as a more cost-laden channel, with growing risk factors as compared to eCommerce, wholesale, or other distribution opportunities.

As a result, at Hilco Real Estate we typically advise our clients to commit to more deals for shorter periods of time. Additionally, we actively push for tenant kick-outs or tenant termination rights. In some cases, these actions can be tied to sales performance. This enables a tenant to commit to a five-year lease but terminate without penalty within a 30-day window if, after a certain numberof years, sales are not exceeding a pre-determined threshold.

Landlords, understandably, are not big fans of these kick-outs as they often generate optimal value by locking in longer lease deals and some publicly traded landlords resist this approach because they can only account for rent during the term up to the kick-out. Yet, more and more, these shorter-term commitments are being viewed by landlords as a decent compromise to get tenants into a vacant space on a shorter-term initial commitment with the potential to renegotiate a deal that is more in their favor down the road, once more bullish sales are proven. In that scenario, a tenant benefits from greater flexibility and less risk associated with the old standard 10-year fixed term. The landlord, in turn, also stands to benefit by not being locked into a less-than-optimal deal for an inordinate period of time with a tenant that ultimately may not be able to afford the cost of the real estate the landlord is looking to support.

NEW DEAL COMPONENT #3: EFFICIENCY = LESSER BUILD OUT COSTS

In today's environment, the need to remain nimble also requires that tenants, and landlords, proactively work to value-engineer both their upfront and fixed, on-going costs. Along with a variable rate rental structure and shorter negotiated lease commitments, a more cost-sensitive, compact P/L and amortization schedule may be considered. Exploring lower build-out costs not only benefits everyone's margin but can potentially limit losses in the event of an early store closure or a tenant's need/desire to relocate.

Lower cost buildouts have gained momentum in recent years as numerous retailers have shifted from very elaborate layouts to much more simplified stores that still show well. Whereas malls were once built as ornate meccas of commerce, today's Millennial and Gen-Z shoppers are more focused on the product and its value, rather than the package (meaning the store) from which it is sold. Minimizing unnecessary investment by both landlord and tenant eases the burden on the ledgers of both parties, allowing for a better chance at success.

THE RESULT: GREATER PARTNERSHIP = SHARING OF RISK AND REWARD BY LANDLORD AND TENANT

The outgrowth of the mall's evolution in recent years and the associated shift in lease leverage generates a much more equitable and beneficial partnership between landlord and tenant, balancing the risk and reward of the relationship. This significant movement toward a true alignment of interests allows both parties to be more motivated and committed to work together toward driving traffic, increasing revenues, and maximizing upside profits.

While landlords create a welcoming environment and assemble the right tenant mix to generate interest among consumers, tenants pull traffic into their stores and convert those browsers to dollars. Traffic turns into revenue, revenue becomes rent, and anything beyond rent and associated costs becomes profit for the tenant. When a deal does not work or either party is dissatisfied with traffic, sales, or other performance measures, neither side is satisfied or committed.

CONCLUSIONS

To quote the famous English proverb adapted from Plato's 'Republic', "Necessity is the mother of invention." Leasing space in a traditional, regional shopping mall 20 or 30 years ago was an absolute necessity for many brick-and-mortar retailers. Today, that is no longer the case. While the necessity for any landlord is, and always has been, to maximize the value of its real estate, the tenant's necessity in today's market is to be where customers want and need them to be, whether online, as a stand-alone or part of a bigger store, as a pop-up, in a street location or a strip center. That fundamental strategy must be a highly varied and fluid prospect, as consumer shopping habits continue to shift along with the development and adoption of new ecommerce technologies.

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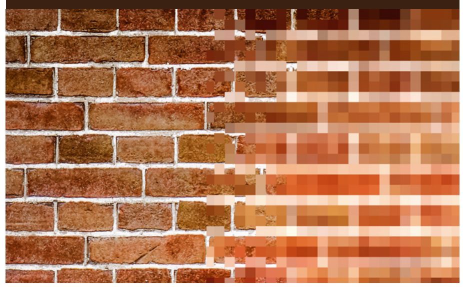

As the framework of most mall leases continue to evolve, it is perhaps more essential than ever to gain an up-to-date understanding of the nature of the deals that landlords are now willing to make. These can vary greatly based on factors unique to a mall owner, its recent transactions, market conditions or even a specific time frame.

Hilco Real Estate actively handles lease transactions on behalf of all types of tenants across the country and has gained significant insight regarding mall properties, owners, leasing strategies, recent lease transactions and market conditions that can be of significant value in both new lease and renewal negotiations. Our team of experts help equalize the playing field for tenants by negotiating more equitable deals reflective of the shifting landscape that requires much more of a landmark partnership with flexibility for all – including upside share with downside protections. Reach out to our experienced team for a conversation. We are here to help.

Hilco Real Estate is the one of the industry's most respected and accomplished authorities on real estate repositioning and disposition, advising and executing strategies to help both healthy and distressed clients maximize the value of their real estate assets. Hilco Real Estate's lease restructuring program is a unique and targeted approach to optimizing leased real estate assets. Engaging Hilco produces significant benefits not only to companies in transition but also for those who simply want to reduce their occupancy expense structure. Lease repositioning and advisory solutions target all forms of leasehold obligations, including rent reduction, lease renewal, assignment/sublease, or lease termination. Our team has successfully mitigated lease-related financial obligations on over 50,000 leases, resulting in billions of dollars in savings for our clients.

DAN O'BRIEN IS SENIOR VICE PRESIDENT AT HILCO REAL ESTATE

He joined Hilco Real Estate in 2008 and provides clients more than twenty years of expertise in the commercial real estate industry, focusing on strategic planning, asset analysis, and the optimization of brick-and-mortar positioning within varying marketplaces.

Dan works with clients across the U.S. and Canada to manage leasehold portfolios, inside and outside of the bankruptcy process, for distressed and healthy operators. He has extensive experience with many small-shop and large format retailers, along with a host of quick service and sit-down restaurateurs, as well as tenants at industrial/flex properties; all to devise strategies that maximize asset value.

Dan received his Juris Doctor degree from Loyola University's School of Law in Chicago and passed the Illinois state bar in 2015.