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BH PROPERTIES

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Capital infusions needed: The real picture for retail properties that need some help

There's a retail development in the works in El Monte, California, with a 50,000-square-foot gym, a 100,000-square-foot movie theater and a hotel. It's not shocking the developer is seeking some extra capital to stay alive: Those uses combined into a "perfect storm" of bad news, says BH Properties senior managing director of investments Andrew Van Tuyle, whose company is working on a deal to provide capital to the developer. BH Properties has seen an uptick in demand for capital over the past three months, he says, notably for retail developments that are struggling.

Last year, lenders granted some forbearance on loans to retail property owners, but those periods are expiring while the pandemic lingers. Now, cash-strapped owners are searching for alternative sources of capital to avoid giving the keys back to their lenders. Such "rescue capital" comes in a variety of forms, including mezzanine and bridge loans, preferred equity, joint-venture partners or even lines of credit. One indicator of owners' financial pain is commercial mortgage-backed securities delinquencies. At the end of January, 12.7 percent of the $131 billion in retail CMBS loans in the U.S., or $16.6 billion, were more than 30 days past due, according to Trepp.

Traditional lenders today are looking at projects like the one BH is working on and thinking, "I don't know if I want to provide construction financing or continue to throw good money after bad if we're going to develop it and movie theaters and gyms are not going to be allowed to open or if these tenants are just going to go away," said Van Tuyle. That's where his firm's special situations division can step in to provide added capital, such as through a preferred equity or JV investment. A lot of borrowers are just doing whatever they can to hold off the lender, pay their property taxes and pay their utilities to keep the lights on, he says.

Less capital for retail

The pool of rescue capital targeting retail properties is smaller than for other types of distressed assets. While a significant amount of rescue capital has been raised in general, much of it is targeted for hospitality and select multifamily, notes Marcus & Millichap senior vice president and national director of retail Daniel Taub. There are definitely funds that have been raised around retail dislocation and market and tenant distress, but much of it appears to be focused on note purchases and lender-owner property, he says. "With that said, there appears to be capital available and investing in transactions deemed to have great distress/upside," he adds.

Class B and C malls and shopping centers that are anchored by department stores or other struggling big-box anchors will face the biggest challenges in securing rescue capital unless the path to convert to another use is clear. Meanwhile, the appetite is greater to provide capital to grocery and credit-tenant, big-box-anchored centers, shadow-anchored centers and neighborhood strip centers occupied by tenants like local bagel and pizza shops.

"The abundance of rescue capital today is from owner operators already in the space and often with internal management and leasing capabilities that understand the product, tenancy, market dynamics and ultimately the value proposition," said Marcus & Millichap Capital Corp. executive vice president and head of business Evan Denner. In addition, private equity and other funds, both foreign and domestic, have dedicated capital to the sector or are interested in select segments, markets and levels of distress, he adds.

Alternative asset management company Slate launched a special situations investment fund this year to provide liquidity to owners impacted by COVID-19. The $450 million fund is investing in retail, hotels and office in the U.S., Canada and Europe. "There is a lot of capital available for safety or perceived core assets, but if you go into sectors that have been significantly impacted because of COVID, there is not as much capital," said founding partner Blair Welch. "That does not mean they are not great assets or great sponsors; they just need a little bit of help to get them through."

Rescue capital is moving cautiously

Capital sources are moving carefully and being selective because of the uncertain outlook for retail and the challenges that existed pre-pandemic. Many distressed retail properties will need to be repositioned, and there are still a lot of questions about which retailers will remain and what traffic counts might look like post-pandemic, says Welch. "There is less money looking at retail because of that uncertainty, but that also creates opportunity," he says.

For Slate, how that rescue capital is structured depends on the situation. A well-located property may call for less retail and just need added capital to reconfigure, says Welch. "You have to look at the quality of the asset, its location and real estate fundamentals, the sponsor who owns it, and the strategy and plan for coming out of the situation," he said.

Most rescue deals are structured as participating preferred equity above an existing senior loan. That is a defined interest rate and an economic interest in the value created, notes Denner. If the asset is truly underwater and overleveraged, a "hope note" structure, essentially a structured sale with some back-end participation from the existing owner, is more likely, he says.

Some owners may be limited in the types of rescue capital they can layer on top of their existing debt. For example, the terms on an existing loan may not allow a borrower to take on additional subordinate debt. If mezzanine financing isn't allowed, a borrower may have to get more creative and do a private equity infusion or joint-venture capital structure, notes Van Tuyle.

For those who can access rescue capital, it's going to be more expensive than traditional capital sources. On the low end, rates are in the high-single digits depending on the collateral, leverage and borrower history. On the high end, subordinate debt can range between 20 to 22 percent. A lot of times, already cash flow-constrained borrowers don't want to put financing in place that immediately raises their debt service further, notes Van Tuyle. "So what they are really looking for is an accrual of interest on the back end that will allow them to live and fight another day."