TCW

INSIGHT

VIEWPOINT

REIT Adverse Selection

SAGAR PARIKH | FEBRUARY 27, 2018

In 2011, retail REIT GGP started a trend that has had some present and future implications for the CMBS market. GGP decided to spin off Rouse, once a subsidiary, into a separate, publicly traded REIT and along with it, 30 lesser-tier malls that Rouse would absorb as a new entity. Understanding the growing divergence between trophy and non-trophy assets in the retail space, GGP knew it wanted to reinvest into its higher quality properties while keeping cash on hand for potential accretive acquisitions. GGP's spinoff was the beginning of a strategy by larger retail REITs disposing and walking away from lower quality retail properties in their portfolios either by locking in non-recourse long term CMBS financing or spinning them off into separate entities. Due to the non-recourse nature of traditional CMBS loans, the CMBS market has essentially given the sponsors a low-cost option to walk away from the lower quality assets without having to put any further equity into the properties or risk their corporate balance sheets. As CMBS investors, we at TCW pay very close attention to sponsors' long-term commitment to their properties.

As GGP was emerging from bankruptcy it broke down its regional mall portfolio into broad categories based on each property's characteristics, market size and competitive positioning: (A significant number of Rouse properties were securitized through the CMBS market.)

GGP vs. Rouse Portfolio Distribution

Mall Tiering	GGP	Rouse
Tier 1 Malls	44	0
Tier 2 Malls	53	1
Other Malls*	27	26
Special Consideration**	0	3

Source: Deutsche Bank Research

* Other malls included regional malls with lower sales per square foot, those that were located in areas impacted by high subprime defaults / high unemployment rates or those that needed repositioning.

** Special consideration properties consisted of three properties that the company felt had high enough debt that it was not justified retaining ownership in them without further concessions from the lenders.

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After GGP spun off Rouse, other REITs such as Simon Property Group, Vornado, and DDR spun off portions of their portfolios into new public REITs. These new REITs, marketing themselves as turnaround specialists, were often able to finance the newly spun-off assets through the CMBS market and to use the proceeds from those loans to reinvest money into their higher quality assets. For the CMBS market, these loans (often underwritten with high debt yields and DSCR's) were incorporated to allow conduit issuers to improve the collateral metrics of their deals. The quickly changing evolution of the retail sector, however, over the last couple of years has only accelerated the continuing push by REITs to reinvest and reposition their top quality assets. For the lower quality properties backed by CMBS loans, the REITs have chosen to invest as little as possible and simply carry the excess cash-flow while the longer term securitized financing (often full interest-only) is outstanding.

The table below illustrates the adverse selection of properties within the CMBS market versus the broader REIT portfolios. This snapshot shows GGP's and Simon's sales/ft at issuance versus their overall sales/ft for the REIT portfolios going back to 2012.

Sales/ft for SPG and GGP vs. Their Spun-Off Entities:

Sales/FT (2012-2016)	GGP	SIMON
CMBX Loans	418	426
REIT Portfolio	559	605

Source: Deutsche Bank Research

A look back at Simon Property Group, the largest mall REIT, gives insight into how larger sponsors view the CMBS market. In 2013, Simon Property decided to spin off 54 strip centers and 44 lower-tier malls into a new entity called Washington Prime Group. SPG no longer wanted to invest any money into those properties and knew that many were locked into attractive long term financing through the CMBS market (making it accretive for a equity spin-off). The investors who suffered were the CMBS bondholders who were left with assets owned by Washington Prime Group, which didn't have the same balance sheet as SPG to help re-develop the underperforming assets. As a result, many of these assets ended up defaulting on their balloon date, and as you can see below, the difference in sales performance points to the adverse selection that CMBS bondholders were left with in their exposure to the WPG portfolio. (Generally, the higher the sales, the higher the asset's quality.)

Sales/ft for SPG and GGP vs. Their Spun-Off Entities:

Enitity	Company	Pre-Spin Off	Post Spin-Off
MainCo	Simon Property Group*	$582	$621
Spinoff	Washington Prime		$358
MainCo	General Growth Prop.**	$471	$525
Spinoff	Rouse Properties		$287

Source: Intex

* SPG announced the spinoff on Dec 13, 2013 (Using Q4 2013 financials) - / Spinoff was finalized and results published in Q2 2015

** GGP announced on Aug, 2011 (using Q3 2011 financials)- / Spinoff was finalized and results published in Q1 2012

Larger REITs like SPG have strong access to unsecured financing, which has fewer restrictions in terms of redevelopment versus CMBS financing. Further, unsecured financing provides the flexibility to reposition assets in a quickly changing retail environment. Simon currently has nearly $17BN in unsecured financing lined-up as far out as 2046 at a weighted average cost of financing of 3.0%, giving it a significant advantage over its competitors. SPG's CMBS portfolio, meanwhile, is typically secured by longer-term, non-recourse financing and gives it a low-cost option to walk away from lower quality assets. Simon's CEO, David Simon, has been very vocal about the company's desire to continually dispose of underperforming assets.

"Look, I think it's a question of your assets that don't fit with our portfolio, we generally have been a seller or spinner-offer of assets. The market is not great. On the other hand, I think we'll have at least a sale potentially by year end or early next year. But it's a very simple – there's no asset here that we lose sleep over or that we have consternation over. And it's a function of – if we get the right price, we'll sell."
-- **David Simon**, Q4 2017 earnings call

Despite Simon's candor regarding the quality of its weaker assets, WPG post the spin off was very quickly able to finance seven of the properties in the portfolio through the CMBS market. As displayed below, these properties were previously performing at the lower end of Simon's portfolio and WPG's long-term financing through CMBS allowed SPG to raise equity without having to reinvest into the assets. For smaller REITs like Washington Prime, the CMBS market is typically one of their few avenues of financing. (As you can see at the very bottom, WPG's portfolio has the lowest sales/ft of the retail REITs) When assessing sponsors of CMBS loans, we at TCW are very focused on the liquidity profile of the sponsor and its ability to access financing outside of the CMBS market.

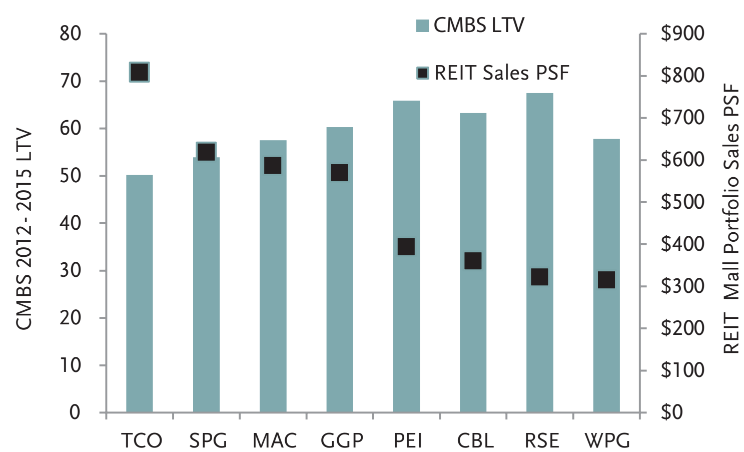
WPG Previously Unencumbered Malls That Were Subsequently Financed in CMBS 2.0

Loan	City	Built/ Renovated	Occupancy	In-Line Sales PSF	In-Line Occ. Cost
West Ridge Plaza	Topeka	2013	97%	$200	9.20%
Muncie Mall	Muncie	1971/1997	99%	$301	12.70%
Cottonwood Mall	Albuquerque	1996/2003	96%	$330	14.50%
Lincolnwood Town Center	Lincolnwood	1990/N/A	93%	$313	15.90%
Westminster Mall	Westminster	1974/2008	92%	$304	16.60%

Source: Offering Documents, Morgan Stanley Research as of July 8, 2014.

CMBS LTV vs Sales PSF

Loans Securitized Since 2012



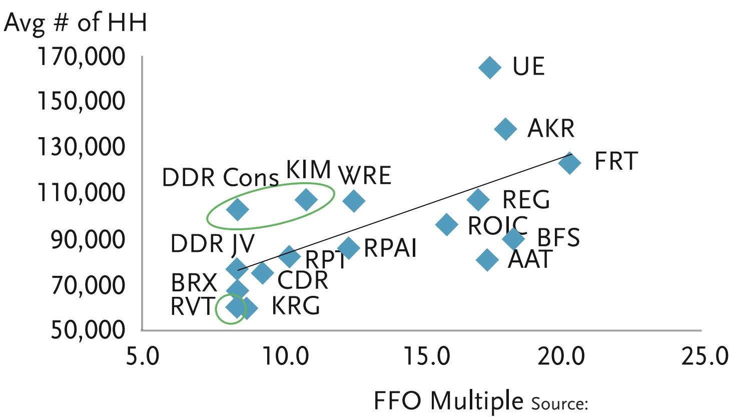
Source: SEC Filings, Trepp, Nomura

While GGP and SPG have had mall retail spinoffs, both DDR and Vornado have spun off portions of their strip center portfolios that have also appeared in CMBS trusts. Vornado's Urban Edge was created in 2014 with 79 strip centers and three malls that Vornado no longer wanted to hold on its balance sheet. DDR, meanwhile, is currently expected to spin off 50 assets, including 12 in Puerto Rico, into a new REIT (RVT - Retail Value Trust) and is expected to encumber those assets through the CMBS market. Vornado was able to improve its overall portfolio metrics post the spinoff and other REITs could look to do the same in the future if DDR is successful with its spin-off of Retail Value Trust. Vornado, in particular, has been very open in the past about its desire to reduce its lower-quality retail exposure and its spinoff, Urban Edge, is a very large CMBS borrower.

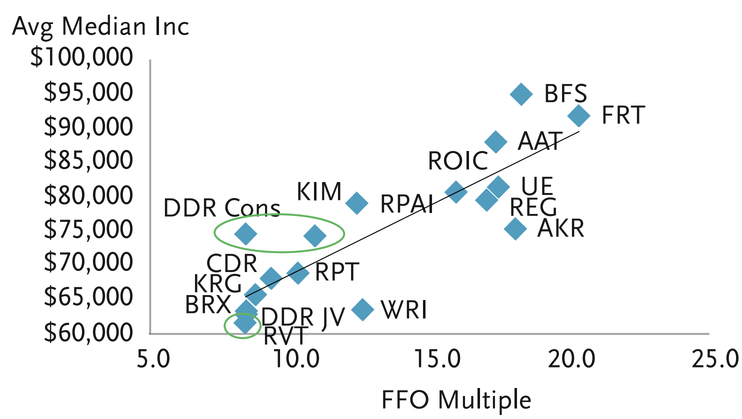
"We made the prescient call four years ago that retail was in secular decline and acted on that by selling our malls, spinning our strips into Urban Edge Properties, while retaining and even growing our flagship street retail in Manhattan," **Steven Roth** (chairman of Vornado) wrote.

DDR's $1.35BN Retail Value Trust CMBS spinoff (expected to close in the first half of 2018) is going to be floating-rate and most importantly, non-recourse to RVT. The assets will compromise 100% of DDR's 12 Puerto Rico assets and 38 lower-quality assets out of DDR's U.S. portfolio. RVT's portfolio will be comprised of assets mostly in tertiary markets; MSAs with lower median household income and where residents have less discretionary spending. While Retail Value Trust is expected to liquidate most assets within 12-24 months and pay back a dividend to DDR, the Retail Value Trust portfolio will be adversely selected and if the liquidation strategy doesn't work, the CMBS bondholders will be exposed to the remaining assets. As CMBS investors, we at TCW feel it is important to stay in front of sponsors' behavior and focus on which assets they are reinvesting cap-ex into.

New DDR's Average Number of Household (5 Mile Radius) is considerably higher than RVT



New DDR's Median Household Income (5 Mile Radius) is considerably higher than RVT



Source: Company Data, SNL Financial, AlphaWise, Morgan Stanley Research

If the past-spinoffs of GGP and SPG are an indication of the potential adverse selection rolled into the new entity, Retail Value Trust will be a test to see if CMBS bondholders have structured provisions to protect them against the lower quality collateral in the pool. Historical evidence has shown that the non-core assets of REITs can have a significant deterioration in value if the sponsors don't choose to reinvest in the assets. The CMBS assets below were all held by GGP or SPG prior to the asset being handed over to the special servicer and the high severities are an indication of the downside possibilities within a spun-off portfolio. We are continuing to monitor the developments of the RVT transaction and to follow public REITs as their desire to reinvest in certain parts of their portfolios can change over time.

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Historical CMBS Loss Severities by Select SPG/GGP Malls

Loan Name	%Loss Severity	Original Sponsor	Sales PSF
Palm Beach Mall	101%	SPG	420
Simon - DeSoto Square Mall	92%	SPG	125
Simon - Upper Valley Mall	88%	SPG	180
Steeplegate Mall	82%	GGP/Homart, Inc	180
Vista Ridge Mall	77%	GGP/Homwart	350
Simon - Washington Square Mall	77%	SPG	180
Indian River Mall & Commons	76%	SPG	275
Moreno Valley Mall	58%	GGP	420
Southern Hills Mall	48%	SPG/Macerich	315
Mesa Mall	24%	SPG/Macerich	374

Source: Bank of America

In terms of our investing process at TCW, we try to look beyond just loan financials and lease maturities, to focus on sponsors' long-term commitments to their properties. We continually screen earnings calls from REITs and take a proactive approach with the data provided by the public markets to study capital expenditures and observe sponsors' ability to raise unsecured and portfolio financing outside the CMBS market. The non-recourse nature of CMBS loans gives larger sponsors like SPG and GGP the option to walk away from underperforming properties and it is vital to understand how public investors view certain assets (as they may be disposition targets). Also, just as the unsecured REIT market prices in the difference between SPG's and WPG's portfolios, it is important to understand the relative value between both sponsors on the CMBS side as well.

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