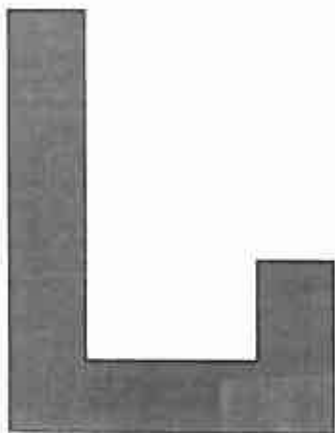


STEVE & BARRY'S



INCENTIVE ENOUGH?

LANDLORDS ARE DEBATING THE USE OF TI PAYMENTS TO SWEETEN LEASES
By Steve McLinden



LANDLORDS HAVE LONG USED THE TENANT IMPROVEMENT allowance to help retailers cope with the costs of opening stores. These TI payments have, in fact, amounted to a deal-making tool for landlords, one they typically used with little fanfare. At least, this is the way it was until this past July, when apparel discounter Steve & Barry's Chapter 11 filing brought TI payments into the spotlight and revealed just how vital such incentives have been to the sustenance of the chain's unconventional business model.

The payments dried up in the aftermath of the credit crunch, and Steve & Barry's cash flow dried up with them. (New York City-based Bay Harbour Management and York Capital Management took over Steve & Barry's in August [story, page 52]). Court docu-

ments show that the brunt of the earnings of Steve & Barry's, which sells most items for under \$10 at razor-thin profit margins, came in the form of landlord TI payments, some of which were estimated to be as high as \$7 million to \$8 million, in the larger stores.

Landlords grant these and other monetary inducements routinely to help fill empty spaces and generate foot traffic. Typically, a landlord will give a tenant a set amount of money per square foot up front for improvement or opening expenses, then roll over some or all that into the length of the lease. The arrangement is akin to buying a house and simultaneously adding a pool to it, then consolidating everything into the same note, says Joseph Brady, managing director of retail outsourcing services at Jones Lang LaSalle.

TI payments can be an ideal way for a retailer to gain access to capital that the landlord gets at cheaper rates, says Brady. "They are a standard deal generator and

have been a perfectly acceptable practice through the entire retail food chain," Brady said. But the somewhat unusual structure of the Steve & Barry's deals, where the company received up to \$80 per square foot, constituted a highly aggressive use of the TI allowance and even demonstrated a willingness on the part of some landlords to act as a bank, he says.

Shopping center owners, including several large retail REITs, could lose some if not all of those improvement dollars as unsecured creditors, says Howard Davidowitz, chairman of Davidowitz & Associates, a New York City-based retail consulting and investment banking firm. Even the commercial lending unit of General Electric Co., a major Steve & Barry's lender and a secured creditor in the bankruptcy, will get nowhere near a dollar-for-dollar recovery on investment, he says. "So where does that leave landlords as unsecured creditors?" Where indeed — under Bay Harbour-York Capital, Steve & Barry's has asked landlords of surviving stores to renegotiate leases for at least 25 percent less than what was previously paid, Davidowitz says.

With some exceptions, most major shopping center REITs pay out far less in tenant allowances than Steve & Barry's received, usually between \$10 and \$20 per square foot, sources say. This is consistent with what Taubman Centers has given out in mall tenant allowances over the past five years. Taubman paid out \$18.47 per square foot in 2007, \$19.05 in 2006, \$19.84 in 2005, \$19.02 in 2004 and \$13.37 in 2003.

In Steve & Barry's case, landlords essentially bought the traffic-generating retailer with those overly generous tenant improvement allowances, and they did so with eyes wide open, says Davidowitz. "They had to weigh that against the risk of not having an anchor store and the problems that would create with other tenants," Davidowitz said. "That's what they were most worried about, in my view."

Even in the wake of the Steve & Barry's debacle, such payments are going to become more prevalent, not less, especially with current market realities being what they are, says Davidowitz. "Everybody has read what Steve & Barry's got," he said. "Now they know what they can ask for. Landlords are going to be forced to make some business decisions that are based on the lesser of two evils."

Because Steve & Barry's became so popular so fast, some landlords neglected to do their financial homework before disbursing such large tenant allowances, says Mez R. Birdie, director of NAI Realvest's Retail Investment Services, of Maitland, Fla. Though tenant improvement allowances remain a good investment in most instances, "if you have a retailer with flat or declining comp-store sales and you still continue to give out big concessions, you're traveling on a slippery road," Birdie said. "Free rent and concessions are meaningless if the retailer isn't able to generate sales." Even though the current market demands more anchor concessions, "you simply can't give the farm away, and that's what happened in the case of Steve & Barry's," Birdie said. "No matter how attractive the rent is, [tenants] still need to have some skin in the game, some kind of risk factor. The tenant has to have a respectable balance sheet to make it worthwhile for the landlord." Most privately held retailers will

divulge their financials "but the landlord really has to push for them sometimes," Birdie said.

The retail REITs concerned were unwilling to discuss their TI policies or the specifics of their Steve & Barry's deals. But in a November 2006 SCT story on tenant creditworthiness, Robert Williams, senior vice president of development and leasing at Macerich, said teams of its asset managers typically grade tenants on a risk scale of 1 to 10 but then factor in the importance of that retailer to the center's merchandising plan.

Usually, the TI numbers balance out and make sense for both landlords and tenants, Brady says. "In a typical transaction, the capital that the tenant gets will not make or break that retailer," he said. That these allowances have taken such a prominent place in trade news is further indication that the Steve & Barry's situation is an anomaly, says Brady, who was a regional vice president of development at Hollywood Entertainment. "Even with that situation, I don't think lenders are going to raise a red flag and say, 'No more big tenant allowances.'"

A Merrill Lynch report issued in June says that CBL & Associates Properties, Feldman Mall Properties, Glimcher Realty Trust and Westfield Group had the greatest physical exposure to Steve & Barry's, which at the time was a tenant at roughly a quarter of their malls, or more. In dollar terms, Steve & Barry's revealed that it owed \$2.2 million to Simon Property Group, \$1.2 million to General Growth Properties, \$1.2 million to CBL & Associates and \$812,000 to Westfield.

In a second-quarter filing, Glimcher laid out a worst-case scenario in which a rejection of all its Steve & Barry's leases and closure of all the retailer's stores in the portfolio would cost the landlord \$1.5 million in base rent and an additional \$1 million in nonliquid write-offs associated with lease inducements.

Birdie says center owners are likely to vet privately held anchor tenants more carefully now, no matter how "hot" they might seem to be. "If you have a second-generation space that is not revenue-producing, you certainly want to have it occupied and generating income, so the temptation is always there," he said. "But you can't give financial incentive to tenants where the economics don't make sense."