

THE \$1.8-Billion Question

What will become of Southern California's distressed retail assets?

By Ian Ritter
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When it opened in 1952, the former Robinsons-May department store at 9900 W. Wilshire Blvd. in Beverly Hills generated a great amount of buzz. According to the *Los Angeles Times*, it was a modern-shopping miracle, with “striking architecture and sophisticated smartness.”

Robinsons-May closed in 2006 as part of the former Federated Department Stores (now Macy’s Inc.) acquisition of May Department Stores. The following year, high-end British developer Candy and Candy bought the property for \$500 million, and planned a grand redevelopment, with two 12-story condo towers and two four-story loft buildings.

Fast forward to 2009, ladies and gentlemen, and we now have a vacated 220,000-square-foot building with no certain future. Most important, it’s the most significant distressed asset in Southern California, with its debt clocking in at \$365 million after a Candy and Candy affiliate defaulted on its loan last fall. (A representative for the firm did not return a request for comment.)

Though the situation on Wilshire is extreme, hundreds of other properties in the region are going through similar scenarios. The credit crisis, housing crash, major dips in consumer spending and double-digit unemployment all contributed to the demise, or near collapse, of plenty of properties. Contributing to the mess is the slew of retail cutbacks, from the disappearance of Linens ‘n Things

and Circuit City, to the paring back by Starbucks, Ann Taylor and others.

In all, Southern California has \$1.8 billion in distressed retail assets, according to New York City-based Real Capital Analytics. Los Angeles has the most, with \$951 million worth of distress; followed by the Inland Empire (\$479 million); San Diego (\$272 million); and Orange County (\$85 million).

“Southern California has been hit much worse than anyone else,” says Josh Poag, president and chief executive officer of Memphis-based Poag & McEwen Lifestyle Centers, an owner of seven lifestyle centers across the country.

He should know. According to RCA and distress-tracker Trepp, Poag & McEwen’s Promenade Shops at Dos Lagos, a 350,000-square-foot lifestyle center that opened in 2006 in the Inland Empire’s Corona, is the second-largest retail default in Southern California, at \$125.2 million.

Poag says that his firm is working to come to an agreement with loan servicer CWCapital on the asset’s fate, but the process is complicated because it used CMBS financing. The firm even has potential equity partners interested in investing in the property, though it’s uncertain under accounting rules whether they are allowed to partake in the venture.

“We have the lender and the tenants at the table, and we’re trying to figure out how to get from point A to point B,” Poag says. “In the long term, we believe the Inland Empire will be back and growing.”

We might not see many more workout situations like what is happening at Dos Lagos in the near future, though. “We’re coming to the sunset of the workout stage of the game,” says Tom Lagos, senior vice president of retail investments at Colliers International in Los Angeles.

The next phase, he contends, will be borrowers that can’t make good on their compromises with banks. Those centers will likely get taken back by financial institutions that hire firms to stabilize them for sale. That means the industry is headed to the hardcore phase of distress.

That’s also why too many major retail sales haven’t been done so far, Lagos says. “There are a lot of people still waiting on the sidelines,” he maintains. “Lenders are going to be forced to sell no matter what, so why not wait it out?”

Mark Schurgin, principal and president of the Los Angeles-based Festival Cos., is one of those players on the sidelines. Festival, which owns several shopping centers in Southern California, started making offers in May, but at that time executives weren’t able to close any deals.

“While we haven’t been successful, we haven’t been turned down yet,” Schurgin explains. “The bid and the asking prices still have to get closer.”

Edward Hanley, president of Irvine-based Hanley Investment agrees. So far it’s too “early in the cycle” for a lot of transactions to take place. In some cases banks are valuing assets using appraisals from six months to a year ago that overvalue an asset in potential buyers’ eyes. “The lenders still tend to want more than the distressed buyer is willing to pay,” Hanley says. “In this marketplace, the buyers of distressed assets are somewhat risk adverse. They’ll take the risk, but they’ll discount the price heavily.”

In this market, all Hanley regularly sees right now are \$5-million deals by private individuals acquiring stabilized assets.

The distressed situation in the region hasn’t stalled transactions only. Lease-ups are also becoming more difficult.

Though Beachwood Hills, OH-based REIT Developers Diversified Realty doesn’t have any distressed assets in Southern



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California, its centers in the area are dealing with issues related to Mervyns—a former tenant that was certainly distressed and filed for bankruptcy last year, ultimately closing all 149 of its stores.

DDR’s Southern California portfolio has 13 former Mervyns totaling one million square feet. The firm is finding that tenants want to go into the empty spaces but are negotiating harder than ever to get cheap rates, says Bryan Zabell, DDR’s vice president of leasing and anchor redevelopment.

“But we’re losing out on a lot of deals to our competition,” Zabell says. “The negotiations are just going longer than we would prefer them to.”

So far DDR has sold two former Mervyns to Kohl’s and leased one to clothing retailer Forever 21. Zabell says he sees interest from niche grocers, off-priced apparel retailers and fitness clubs in the spaces, which average about 80,000 square feet.

“There are certainly tenants with an appetite to open new stores,” he says, noting that DDR should make “significant progress” on the spaces in the next 18 to 24 months. “The challenge is finding deals that are acceptable.” In more extreme cases than what is happening in DDR’s portfolio, shopping centers that have lost a lot of distressed

tenants might need a complete overhaul, sometimes with uses other than retail.

Retail services firm Transwestern is dealing with such a center in the Los Angeles, two-thirds of which is getting re-tenanted with non-retail users, such as medical and municipal offices. The outfit is also trying to carve large, vacant anchor spaces of the 500,000-square-foot mall into sections that a number of tenants can use.

“It’s all about cash flow,” says George Garfield, director of Transwestern’s Western region. “The key is to triage the asset and identify the value issues that need to be attacked immediately.”

Garfield doesn’t see the distressed situation in Southern California as unique. Communities across the country are dealing with similar issues, and in the extreme case of the Inland Empire, he sees an eventual return to growth once the job market improves.

Tony Villasenor, a broker at Voit Commercial Brokerage in San Diego, agrees. “Southern California is where the path of growth is, and that will continue,” he says. “The population isn’t decreasing. We’re out of room in greater LA. It will come back, and it will be fine.”

He says that at the International Council of Shopping Centers RECon convention held in May in Las Vegas, he met with investors representing an aggregate of about \$1 billion in capital who are “waiting to pounce. I’m excited about the prospect of doing business in this market.”

Hanley says that investors with investors with financial wherewithal should see a lot of opportunities on tap. “There will be a great deal of wealth created in the next three years,” he predicts.

That’s the plan of Festivals’ Schurgin, who says he will keep looking in Southern California and thinks others would be served well doing the same. For example, to a lender in New York City, Schurgin contends, the local region is going to prove more attractive than most other areas of the country when credit improves.

“Southern California, long term, has more desirability and cache,” he concludes.—SOCAL