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Malls May Be Dying, But Bets Against Their Debt Haven't Paid Off

Despite store closures, mall owners have scrambled to refinance debt and find new tenants for vacated spaces

Customers browsing through discounted merchandise on Sept. 5 at a Sears store in Provo, Utah, that was slated for closure. PHOTO: GEORGE FREY/GETTY IMAGES

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A rash of store closures and bankruptcies last year prompted some investors to bet against debt tied to the retail property sector.

So far, at least, the bets haven't paid off.

The wager against commercial mortgage-backed securities largely has focused on the CMBX 6, a little-known credit default swap index that tracks the values of bonds backed by mortgages on malls as well as office buildings and other commercial properties.

While a few slices of the index have slumped due to the perceived greater exposure to struggling mall properties and retail bankruptcies, more mall mortgage defaults would have to occur before investors will get a windfall.

"Has the bet paid off? Not quite," real-estate data provider Trepp Inc. said in a recent report. So far, Trepp said, only four loans tied to the CMBX 6 incurred losses, totaling just $4.3 million.

Some landlords have refinanced their debt or found new tenants to take up space vacated by departing retailers. At the same time, some retailers have worked out deals with landlords that allowed the owners to keep up their mortgage payments. A positive holiday sales season also took some shine off the trade.

The owner of Holiday Village Mall in Great Falls, Mont., refinanced its loan on the property when it reached maturity last month. The landlord was able to secure new leases with Hobby Lobby and PetSmart last year after Sears Holdings in 2014 closed its Sears store and auto center at the two-story mall.

Overall, the delinquency rate for CMBS loans made after the financial crisis is 0.52%, while the delinquency rate for the CMBX 6 constituency is 0.96%, according to Kroll Bond Rating Agency.

"It is higher, but a delinquency rate of less than 1% is not devastating," said Steve Kuritz, managing director at Kroll Bond Rating Agency.

Some short sellers anticipated that Sears Holdings would be in bankruptcy proceedings by now, which would result in a wave of store closures in malls across the country that would be tough to backfill quickly. While Sears said on Thursday it is closing an additional 103 Sears and Kmart stores in March and April on top of 63 other stores it said in November it would close, it still has more than 900 Sears and Kmart stores in business.

Some short sellers did make money from the decline in weaker slices of the CMBX 6 last year. The portions of the index rated BB and BBB- declined 12.1% and 9.5%, respectively, in 2017.

Steve Pei, founder and chief investment officer at Los Angeles-based hedge fund Gratia Capital, said the magnitude of the declines more than offset the 3% coupon cost of the trade, so it was profitable for his firm.

"There will be a lot more closures in the next few years in our view—the trend is pretty clear-cut even though the pace may fluctuate," Mr. Pei said. He added that his firm has taken both long and short positions in individual retail stocks.

Investment firm Alder Hill Management, which issued a 58-page report last year that described its bet on lower-quality malls and how malls would struggle with mortgage repayment, remains in the trade, according to people familiar with the matter.

The report, issued last January, said 26 out of roughly 40 mall loans in the index were expected to default before maturity or in 2022.

Some analysts said they are expecting more store closures to be announced in the coming weeks.

"The number of distressed retail mortgages will likely increase as they inch closer to their scheduled maturity dates and collateral performance continues to deteriorate," according to the report from Trepp, the real-estate data provider.

The question is when. Landlords say they remain positive about their ability to get new tenants, pointing to retailers and entertainment operators that are still expanding.

At the Newgate Mall in Ogden, Utah, a 141,000-square-foot Sears store is scheduled to close in the coming months. The mortgage loan backing Newgate Mall is linked to the CMBX 6 index.

Last year, the landlord signed leases with retailer DownEast Home & Clothing, which took up space vacated by Sports Authority. It also leased a lot on the outer edge of the mall to Fly High, a trampoline park operator. It is currently searching for a replacement for Sears.

"I'm optimistic about the leasing potential," said Ami Ziff, director of national retail at Time Equities Inc., a real-estate developer and investor that owns Newgate Mall.

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