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Dividends at risk

In the past half-decade, the estimated value of the "most valuable retail building in the world" has plunged by 57%. If it can happen to 611 Fifth Ave., the Manhattan Taj Mahal of Saks Fifth Avenue, it (or something not unlike it) can happen to other top-flight retail assets, including the investments held by Brookfield Property Partners, L.P. (BPY) and its fraternal twin, Brookfield Property REIT, Inc. (BPR; both on the Nasdaq). Skipping down to the bottom line, *Grant's* is bearish on them.

You may have no interest in either company, long or short, but there are other good reasons to keep on reading. Nowadays, everyone's looking for income, and our picks-not-to-click yield upwards of 7%. And many, not least the noble readers of *Grant's*, are concerned about the sedative power of radical monetary policy, the Janus-faced blessing of technological progress and the kind of investment risk that hides in plain sight.

The first order of business is to clarify the cast of corporate characters. Brookfield Property Partners is the flagship real-estate vehicle of Brookfield Asset Management. Brookfield Property REIT is a subsidiary of Property Partners. With assets of $85.2 billion, Property Partners is much the larger of our two featured tickers. It is likewise the more diversified, its portfolio comprising office properties (42%), retail (41%) and investments in other Brookfield-managed real-estate funds (17%).

But retail property—shopping malls for the most part—is our principal focus, since that asset category contributes 46% of the net operating income of Property Partners and 100% of the NOI of Brookfield Property REIT.

Few critics would quarrel with the proposition that Brookfield is a high-quality operator. Whether it be office, retail or other kinds, Property Partners is a trophy collector. S&P Global Ratings director Mike Souers tells colleague Evan Lorenz that, from the brick-and-mortar point of view, Simon Property Group, Inc. is Property Partners' one and only peer among S&P-rated real-estate companies.

As to the character ("all gentlemen") and competence ("they know real estate") of Brookfield's operating personnel, Lorenz heard plaudits from a Manhattan real-estate building owner who recently happened to have lost a tenant to the gracious Canadians.

And from another real-estate investor (who, like the one just quoted, asks to go nameless), Lorenz heard this about Property Partners: "They've tended to shift to more value-oriented sides of the market while still maintaining the types of class-A buildings that people expect to see in a REIT. For example, they were huge in downtown Manhattan when everyone was flooding Midtown with capital. They own class-A high-rises in large Midwestern cities vs. exclusively being in the big gateway cities."

But even the finest assets are susceptible to commercial obsolescence and, if overleveraged, to financial risk. In the Age of Bezos, overleveraged shopping malls are vulnerable on each count.

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Brookfield Property REIT came into the world in August 2018 on the occasion of Property Partners' purchase of A-class mall operator GGP, Inc., for a consideration of $9.3 billion, payable in cash or stock.

Property Partners is no plain-vanilla investment. Incorporated in Bermuda, it's a publicly traded limited partnership. It files a 20-F instead of a 10-K and conforms to International Financial Reporting Standards rather than to American GAAP.

To the fractional owner of such a limited partnership falls the irksome duty of annually filing form K-1 with the IRS. To sweeten its acquisition offer, Brookfield created a tax-time workaround in Brookfield Property REIT. BPR, which began trading in August 2018 and reports in GAAP rather than IFRS, is as American as the Fourth of July. No K-1 required.

Brookfield Property and Brookfield REIT share equal rights to dividend income, and their shares may be exchanged even-up, one for the other, at the request of the holder. The share prices, hovering at $19 and change, and dividend yields, within a few basis points of 6.80%, are nearly identical.

Not quite identical, though, are the shareholders' claims and interests. For

one thing, BPR's assets consist of the former GGP malls alone—thus, the REIT is a pure play on yesteryear's troubled retailing business model. And it carries $5.7 billion in recourse debt—meaning claims on the going concern, not on individual mortgaged properties. S&P appraises BPR triple-B-minus, a notch below BPY.

BPY's market cap is $19.5 billion, BPR's just $1.3 billion. Bears on Brookfield have swarmed the mall-centric REIT, in which short interest amounts to 21% of the float, compared with 1.2% for Brookfield Property. We wonder why. At the first sign of trouble, an alert BPR holder could simply swap out into BPY.

Striving to produce annual 5%–8% dividend growth, Property Partners says it aims for a 10%–12% total return on its office and retail portfolios and a 20% total return on its investments in Brookfield-sponsored funds.

Like all externally managed public investment companies, BPY pays a quarterly fee to its manager, in this case Brookfield Asset Management. However, that fee is derived from nothing so simple as the change in BPY's book value. Instead, on top of a minimum quarterly charge of $13.8 million, there's a 1.25% annual levy on the change in BPY's total capitalization, i.e., the sum of market cap plus recourse debt, starting in 2013, the year Property Partners started its independent existence as a Brookfield Asset Management spin-out.

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For the basic bull case on BPY, look no further than the dividend yield: Compared with the payouts on offer from A-class mall REIT Simon (5.6%), U.S. office REITs (3.8%) and sub-investment-grade bonds (5.8%), 6.80% is princely.

When asked why investors should consider BPY, CEO Brian Kingston, speaking at the Citi Global Property CEO Conference in March, just repeated himself: "It's cheap. It's cheap. It's cheap." He was alluding to the calculated discount of the share price to net asset value. And at press time, the $19.37 share price was pitched 32% below the $28.61 estimate of the Sept. 30 NAV.

To close the discount—of which more below—Property Partners is buying back shares, more than $500 million's worth in the year to date compared to a combined BPY-BPR market cap of $20.7 billion.

Nor do bulls forget to assert that BPY is a beneficiary of low interest rates. "Over the last 12 months, while we've seen a dramatic decline in interest rates in both the U.S. and in Europe, this is yet to be reflected in the valuation of our assets," said Kingston on the Nov. 6 earnings call. "To put this into perspective, a 100 basis-point reduction in cap rates adds almost $20 to our net asset value per unit. The continued low-interest-rate environment should translate into higher demand for real assets, which will increase the value of our portfolio of properties."

Even as mall anchors stumble (third-quarter same-store sales at Macy's, Inc. showed a 3.5% decline), Property Partners reports that its portfolio is almost fully leased and that net operating income is still growing, albeit slowly. Thus, as of Sept. 30, BPY's office portfolio was 92.4% occupied (down 50 basis points year-over-year) and same-store NOI grew by 0.4% year-over-year. Occupancy for the retail portfolio totaled 95% (down 60 basis points from the prior year) at quarter end and same-store NOI expanded by 0.2% year-over-year.

The Street, at least, accepts and approves, with all five analysts on the case saying "buy." As expressed in deeds, not words, the insiders are noncommittal.

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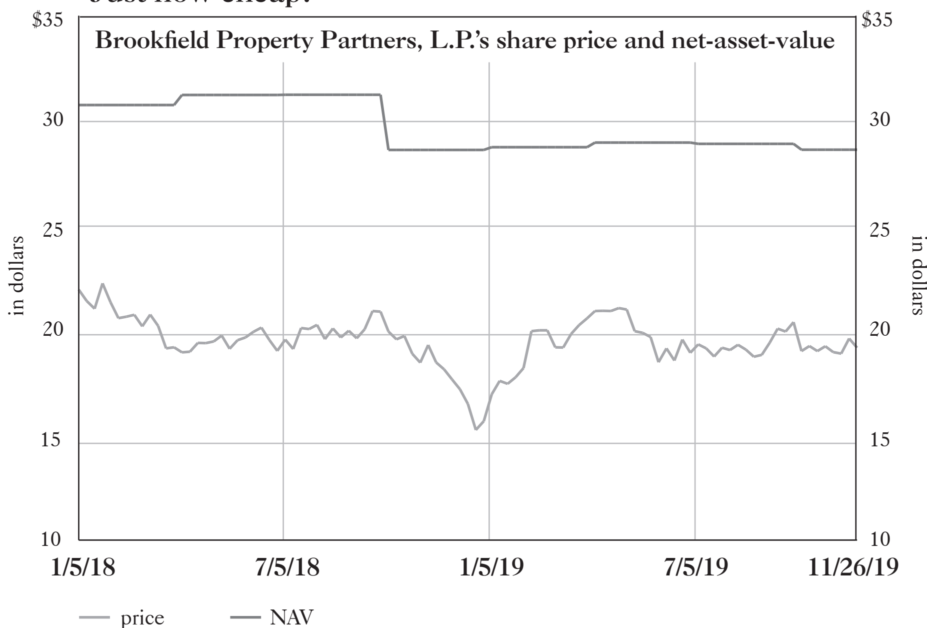
Carl Icahn, to judge by *his* deeds, is bearish. *The Wall Street Journal* last week broke the news that Icahn has purchased credit-default swaps on the CMBX 6, an index of commercial mortgage-backed securities issued in 2012. According to an October AllianceBernstein report, 11 of the 37 malls that constitute the CMBX 6 belong to Brookfield.

It's a fair guess that Icahn notices how old-school retail is struggling. From the origination of the mall concept until five or 10 years ago, commercial dynamics took the form of a virtuous cycle: Anchor tenants—department stores—paid low rent in return for pulling in traffic, not only to their stores but also to smaller, "inline" tenants, who willingly paid rents at a higher per-square-foot rate than the anchors. The crisis of physical retailing in general, and of the department stores in particular, has turned things upside down.

A virtue in a virtuous cycle, debt is a vice in a vicious one. As mentioned, Brookfield Property boasts a triple-B debt rating, bottom rung of the investment-grade scale, though it carried $44.3 billion in debt at the end of the third quarter, equivalent to just under 13 times trailing earnings before interest, taxes, depreciation

Just how cheap?



sources: company reports, the Bloomberg

and amortization. That isn't the full picture, S&P tells Lorenz: Adjust for items such as the straight-lining of rents and operating leases, and leverage is slightly higher than 14 times. Ebitda did cover interest expense in the third period but only at a ratio of 1.5 times. S&P calls Property Partners the most heavily leveraged of the 80 or so American real-estate companies on its analytical radar.

In conversation with Lorenz, Ana Lai, a colleague of the aforequoted Souers, acknowledges that BPY's "financing strategy is rather aggressive." But mitigating that fact, she says, is (a) the presumed credit support available from A-minus-rated Brookfield Asset Management, (b) the secured, asset-specific nature of most of Property Partners' debt and (c) the expectation that that encumbrance will sooner or later be relieved through asset sales, though scaring up a bid these days for even the better malls is no easy matter.

"Reading the documents and listening to Souers and Lai," says Lorenz, "I judge that Brookfield Property Partners is on the cusp of a downgrade to triple-B-minus. And whatever S&P does or doesn't do, management has little room to maneuver. In the past 12 months, BPY earned $3.51 billion in Ebitda. In the same 12 months, it paid $3.45 billion in interest and dividends. The residual, a scant $56 million, is all that's left to make new investments and to refresh aging properties.

"In the year ended Sept. 30, Property Partners spent $112 million keeping up with the retailing vicious cycle," Lorenz goes on—"for instance, tearing down an empty Sears box and building a new mixed-use retail/office/condo to replace it. In the same 12 months, outlays on what appears to be maintenance capital spending totaled $1.5 billion. The source of those funds? Property Partners issued $2.3 billion in debt net of repayments."

Commercial relevance in the retailing industry doesn't come cheap nowadays, and Brookfield is redeveloping nine of its 123 malls at a cost of $2.5 billion to generate an expected payoff of $150 million in incremental net operating income. "When it's done," said Kingston in a Sept. 26 investor-day presentation, "it should add about $775 million of value to these nine malls." Which leads us to wonder: What will it cost to secure the viability of the other 114 malls?

Brookfield Property Partners at a glance

proportionate financials in $ millions unless otherwise indicated

	2014	2015	2016	2017	2018	TTM*
revenue	$3,726	$4,444	$4,703	$4,782	$5,431	$5,948
net operating income	2,166	2,594	2,737	2,788	3,302	3,780
net income	3,734	2,915	1,793	357	1,978	1,468
office occupancy (in %)	92.5	92.3	92.3	92.6	93.5	92.4
retail occupancy (in %)	95.8	95.6	96.5	96.2	96.5	95.0
total assets	58,935	65,543	64,547	67,975	86,578	85,159
cash	955	1,077	1,227	1,290	2,057	1,714
debt	27,145	31,163	30,173	32,875	46,700	46,009
net asset value	20,208	21,958	22,358	22,186	28,284	27,518
Ebitda	1,846	2,222	2,342	2,431	2,954	3,508
interest expense	1,148	1,428	1,423	1,490	1,826	2,192

* For the period ended Sept. 30, 2019.
source: company reports

Lots of money, suggests Vince Tibone, who leads the retail-analysis effort at Green Street Advisors, in a new comment on the mall-capex question: "The headwinds affecting the mall industry are not new but far from over. The stream of small-shop closures is likely to continue, and many department stores will eventually shut down and impose heavy capital burdens on landlords. In this context, Simon was recently upgraded to 'buy' from 'hold' as it is the only mall REIT [in Green Street's coverage universe, which excludes the Brookfield names] with the balance sheet to face the difficulties that lie ahead."

In the 12 months ended Sept. 30, Simon generated $4.2 billion in Ebitda, which covered not only interest expense ($804 million) and dividends ($2.5 billion), but also—critically—capital expenditures ($819 million). In this regard, it can't hurt that Simon's leverage, as measured by the ratio of debt to Ebitda, is less than half of Brookfield Property Partners' (5.8 times vs. S&P's all-in calculation of 14 times).

"I want the balance sheet that allows us to invest," Simon CEO David Simon said on the company's Oct. 30 earnings call. (He is son of eponym and founder Melvin Simon.) Lorenz called the company and asked: What does that mean? Leverage of around five times Ebitda, CFO Brian McDade answered. "You have to make the necessary long-term investments to improve your balance sheet because you can't do it overnight," McDade explained. "When you need it, you need it. You don't have the opportunity to correct it when you need to do it."

"For us, we simply look at our business and we produce funds from operation of approximately $4.4–$4.5 billion per year," McDade continued. "We are a REIT, so we have a requirement to pay out our taxable income to maintain that status. To do so, for us that is approximately $3 billion per year. After we deduct our dividends we generate approximately $1.4 billion in free cash flow to reinvest in our own assets. If you look at the vast majority of our peers, they have, if not none, very limited amounts of free cash flow after their dividends to reinvest in their assets."

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The quality of Brookfield's mall portfolio is another item on the list of bearish complaints. Yes, on average, BPY's properties are class-A, but class averages can obscure problem students. "They have a wider dispersion of mall quality than a Simon, Macerich or a Taubman [i.e., other class-A mall operators]," Tibone tells Lorenz. "One thing we noticed when we dove into GGP's portfolio [now the Brookfield Property REIT portfolio] is they generally have more department stores or more anchors per mall than the other A-mall REITs, which, depending on your view of redevelopment, is both an opportunity and a risk. It's an opportunity at your good malls and you can

probably still get good returns there, but, in your middle to lower-quality malls, those department-store upcoming vacancies are probably more of a headache than an opportunity."

To put this into numbers, as of May 2018, Green Street graded 17% of GGP's malls "B." Twelve months later, it designated 8% of Simon's malls "B."

Which brings us to net asset value, the calculation of which is critical to the bullish contention that the Brookfield Property twins are "cheap, cheap, cheap." An arithmetic operation it might be, but it's also an artful one, the quality of the art depending on the assumptions you make.

BPY assumes that it will sell a property after a certain period of time, generally 10 years. It uses a discount rate to translate into present dollars the value of the estimated future cash flows attributable to that property. It hazards a guess about the value of the assumed future sale by assigning a future price, expressed as a cap rate; this is the terminal value.

As of Sept. 30, key assumptions include these: a 6.3% discount rate, and a 5.3% terminal cap rate, for the office portfolio; a 6.6% discount rate, and a 5.2% terminal cap rate, for the retail properties.

Actual transactions being few and far between, Tibone said he assumes cap rates in the high 4% to low 5% range to value "A-double-plus" malls, i.e., the best of the best. He uses a 6.5% cap rate for class-A malls and rates between 10% and 14% for the class-B ones.

"In other words," Lorenz comments, "BPY's assumptions could be in the right ballpark, depending on how generously you read their portfolio and how you assess their rosy view of the future of physical retailing. But, whatever you think, management's analysis misses the fees that BPY and BPR pay to Brookfield Asset Management.

"It's a critical omission," Lorenz proceeds. "Over the past 12 months, those fees summed to $101 million, and they're set to grow. Take BPR alone. Immediately following the 2018 organization and launch, Brookfield Asset Management granted its fledgling a kind of fee holiday. But the holiday's over, and BPR, with a stock-market capitalization of $1.3 billion and recourse debt of $5.7 billion, may boost the total fee for both entities to $155 million a year."

In its third-quarter results, Brookfield Asset Management, the recipient of BPY's fees, gave its own estimate of net asset value. In that calculation, BAM values its fee income (some of which comes from BPY) at a 25 multiple. Using the same multiple to capitalize $155 million in prospective fees gives a $3.9 billion value. Subtracting that from BPY's self-declared NAV yields $23.6 billion in adjusted net value instead of $27.5 billion. The new—and, we judge, improved—arithmetic lowers the discount to NAV to 12.3% from 32%. If BPY is cheap, it's hardly cheap-times-three.

For us, we deny that even one "cheap" is defensible after you delve into the occupancy rates of the Brookfield shopping malls. The question partly hinges on the definition of "occupancy."

"We are seeing an increased reliance on temp tenants in the mall today, which are shorter-term lease deals, at the rule of thumb one-third of full price of a normal mall tenant," Tibone tells Lorenz. "Mall full-time occupancy is probably trending worse than the inline occupancy reported by the REITs. You need to be in the weeds to see it."

But the reported facts, too, are contestable. A short-seller we know hired a real-estate advisory firm to walk through 21 of Property Partners' 123 malls to calculate vacancies, assess the health of the malls and to come up with appraised values. The consultant calculated non-anchor occupancy at 87.1%. It calculated "BPY-owned occupancy," i.e., including vacancies in anchor spaces that BPY itself owns, at 82.7%.

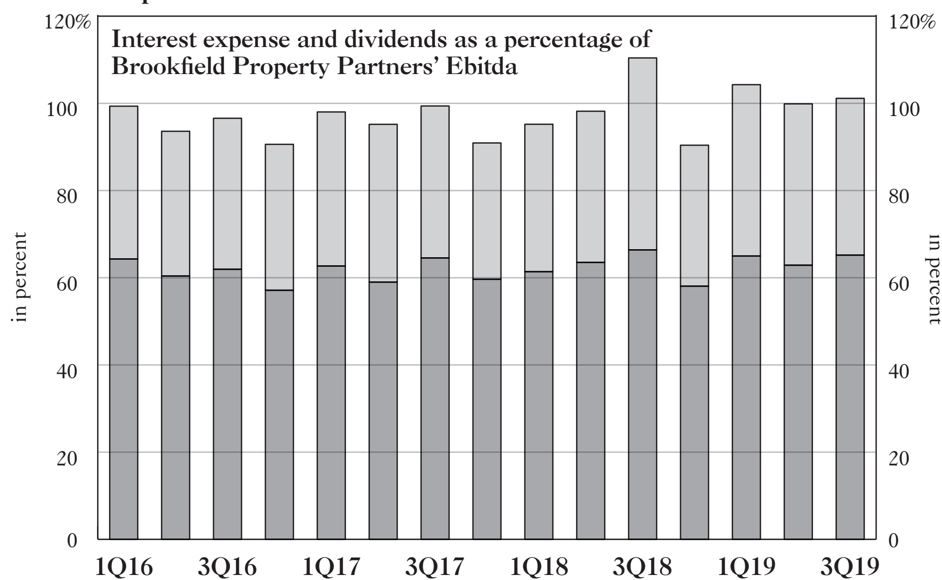
Compare and contrast BPY's own reckoning. In the third quarter, said management, those 21 malls were 95.6% occupied.

Commercial mortgage-backed securities figure in the financing of at least 46 of BPY's malls. As we go to press, the managers of 40 of the 46 have disclosed second-quarter occupancy levels. On average, BPY's reported occupancy is four percentage points higher than what the loan documents show. And in 27 out of the 40, lenders reported an average occupancy 6.8 percentage points below the corresponding BPY figure.

Pronounced discrepancies between CMBS and BPY reports for the second quarter include Carolina Place Mall in Pineville, N.C. (74% occupancy according to CMBS reports, 96.2% according to BPY); Providence Place Mall in Providence, R.I. (75% vs. 97.5%) and Greenwood Mall in Bowling Green, Ken. (78.1% vs. 91.2%).

Politics poses a risk to asset owners of blue and red stripe alike. In June, the New York State Senate passed sweeping new rent-control measures for apartments state-wide. And the New York City administration of Bill de Blasio is reported to be weighing the regulation of commercial rents for tenants with 10,000 square feet of space; the stated purpose is to curb retail va-

Capex can wait



source: company reports

cancies. For good measure, the city is also mulling the regulation of industrial rents (up to 25,000 sq. ft.) and office rents (up to 10,000 sq. ft.), too.

"You are talking about a city that is about to kill the golden goose," a Manhattan building owner complains to Lorenz. "They can't get the dot-com people. They can't get the hedge-fund people. They will get who they can get, and I can't move a building."

"Of course," Lorenz observes, "we all need yield, and you may or may not be willing to toss the dice on shopping malls. For ourselves, we'd toss with Simon Property Group, which is capitalized to seize such opportunity as the death throes of the department store may surface."

The aforequoted Simon CFO, Brian McDade, describes the potential upside thus: "Sears was the marquee department store. If you look at where the Sears locations are and the quality of the real estate they're attached to, it is really unprecedented. They had access to the very best retail-mall assets in America. After they filed for bankruptcy, we had the opportunity to go in and recapture those department stores.

"We talk about the recapture of the department store," McDade goes on. "It's not the physical store that is the most important part. It is sitting on 12–20 acres of land that is a part of a 200-acre tract that is the dominant regional asset in the marketplace. We are basically getting 12–20 acres of land that we can reimagine in new use for what is relevant to today's consumer, not what was relevant 40 years ago. We are investing heavily in those opportunities with our free cash flow, that $1.4 billion that I talked about, and really driving the future of the mall and all that it offers the communities in which it operates."

"Simon," Lorenz winds up, "is priced to deliver a 5.6% dividend yield. While that's 120 basis points less than BPY's yield, BPY's leverage is more than twice Simon's. In fact, you earn only 15 basis points for each additional turn of leverage at Property Partners."

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