Simon Property Group: 8% Yield, Discounted Price, Real Risks

Retail REITs have been among the hardest hit stocks during COVID19 lockdowns, and blue-chip Simon Property Group (SPG) has not been spared. Its dividend has been reduced significantly and its share price has fallen dramatically. Furthermore, its former Taubman Centers (TCO) deal, recent retailer buying spree and rumors of a deal with Amazon (AMZN), complicate matters further. In this article, we review the health of the business, valuation, risks, dividend safety, and conclude with our opinion about whether SPG is worth considering if you are a long-term income-focused investor.

Key Takeaways:

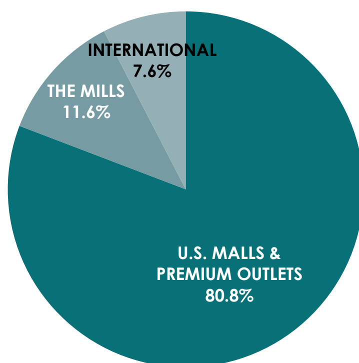
- Dividend reduced, but safe and sustainable.
- Well positioned financially to navigate through the COVID-19 impact.
- High leverage, but backed by high-quality assets

Overview:

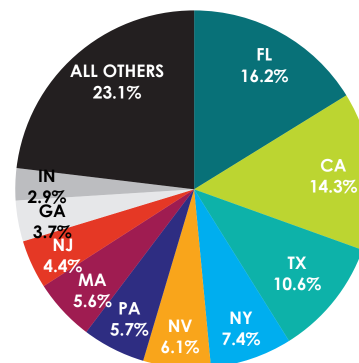
Simon Property Group, Inc. (SPG) is a premium mall-focused retail REIT that owns, develops and manages premier shopping, dining, entertainment and mixed-use destinations. The company's portfolio is geographically diversified across North America, Asia and Europe and consists of 235 properties comprising 191 million square feet. SPG is the largest premium mall owner in the USA with 204 properties (99 malls, 69 premium outlets, 14 Mills, 4 lifestyle centers, and 18 other retail properties). Internationally, the company owns 31 Premium Outlets and Designer Outlet properties located in Asia, Europe, and Canada. SPG also owns a 22.4% equity stake in Klépierre SA, a Paris-based real estate company that owns shopping centers in 15 European countries.

Net Operating Income Composition *(For the six months ended June 30, 2020)*

NOI BY ASSET TYPE



U.S. PORTFOLIO NOI BY STATE



Source: Q220 Supplemental Data

SPG's tenant base is also highly diversified with no single tenant accounting for more than 3.5% of its base minimum rent for US properties. The Gap, Inc. is SPG's single largest inline tenant accounting for 2.1% of total square footage and 3.5% of total base rent revenue.

U.S. Malls and Premium Outlets Top Tenants

Top Inline Store Tenants

TENANT	NUMBER OF STORES	SQUARE FEET (000's)	PERCENT OF TOTAL SQ. FT. IN U.S. PROPERTIES	PERCENT OF TOTAL BASE MINIMUM RENT FOR U.S. PROPERTIES
The Gap, Inc.	403	3,752	2.1%	3.5%
L Brands, Inc.	287	1,786	1.0%	2.2%
PVH Corporation	234	1,464	0.8%	1.7%
Tapestry, Inc.	248	1,013	0.6%	1.5%
Ascena Retail Group Inc	350	1,898	1.1%	1.5%
Signet Jewelers, Ltd.	337	491	0.3%	1.4%
Capri Holdings Limited	139	536	0.3%	1.2%
American Eagle Outfitters, Inc	199	1,278	0.7%	1.2%
Foot Locker, Inc.	206	956	0.5%	1.2%
Luxottica Group SPA	375	663	0.4%	1.2%

Top Anchors

TENANT	NUMBER OF STORES	SQUARE FEET (000's)	PERCENT OF TOTAL SQ. FT. IN U.S. PROPERTIES	PERCENT OF TOTAL BASE MINIMUM RENT FOR U.S. PROPERTIES
Macy's Inc.	103	19,935	11.0%	0.3%
J.C. Penney Co., Inc.	57	9,372	5.2%	0.3%
Dillard's, Inc.	36	6,532	3.6%	*
Nordstrom, Inc.	27	4,556	2.5%	0.1%
Dick's Sporting Goods, Inc.	34	2,309	1.3%	0.5%
Hudson's Bay Company	17	2,174	1.2%	0.1%
Sears	8	1,608	0.9%	*
The Neiman Marcus Group, Inc.	12	1,458	0.8%	0.1%
Belk, Inc.	7	1,194	0.7%	*
Target Corporation	6	831	0.5%	0.1%
Von Maur, Inc.	6	768	0.4%	*

* Less than one-tenth of one percent.

Source: Q220 Supplemental Data

Retail Recovery – Encouraging Early Signs

Despite all the COVID19 related headwinds, including the loss of nearly 10,500 shopping days in Q220 (according to the Q220 Supplemental Data), the resiliency in the company's premium retail portfolio helped it manage the situation well and generate profits. Q220 revenue saw a 24% decline to $1.1 billion, FFO was down ~30% from the previous year to $746.5 million or $2.12 per share, and NOI decreased by ~$315 million from the previous year comparable quarter to ~$1.2 billion. NOI was significantly impacted because of a $215 million hit the company took during Q220 on account of reduced lease income, rent abatements, tenant bankruptcies and write-offs.

Mall and premium outlet occupancy were impacted by tenant bankruptcies and lower specialty leasing activity and stood at 92.9% at the end of Q220, which is not too far-off from SPG's historical occupancy rates. The

average base minimum rent increased 2.8% to $56.02, while leasing spreads were flat for the TTM June 2020 period.

As state economies started reopening, the percentage of tenants open across SPG's US retail properties accelerated to 91% as of 7 August 2020 (from ~50% in mid-May). More than half of the remaining 9% remained shut due to government restrictions. Encouragingly, a number of SPG's retailer tenants said that consumers are coming back more quickly than they expected, and sales volumes are more than 80% of prior-year levels. Internationally, all of SPG's designer and premium outlets have opened and are operating with volumes of ~90% of prior-year levels.

With the reopening, cash rent collection also accelerated from ~51% of contractual rent billed in April and May combined, to ~69% in June, and ~73% in July. We note that ~15%-20% of Q220 rents were either not collected, or were written-off or reserved for, and ~28%-30% of rent payments are still being negotiated or are under litigation, including ~$66 million in rent being pursued from its biggest tenant, The Gap, Inc., under litigation. A negative outcome of the negotiations or litigation could put a dent on the company's cash flows, but the company remains confident of reaching a deal on most of them. According to the company:

"The deferrals in July were de minimis. Deferrals in June were less than April and May. So, it's all moving in the right direction, and the collections are – we haven't given up on April-May as Q2 collections. We expect to – other than what we abated and wrote off through bankruptcy, we expect to reach a deal on the vast majority of it."

Source: Q220 Earnings Call

Nonetheless, with the reopening, SPG's mall tenants are on the path to recovery as suggested by the decreasing rent deferral requests, which implies that there will be less intense headwinds from rent deferrals in the coming months. Going forward, we believe rent collections should further accelerate to track at +85%, provided any additional rounds of lockdown are not imposed.

Balance Sheet – On Solid Footing

Higher-quality REIT balance sheets such as SPG's typically tend to be backed by higher-quality properties. SPG has ~$23.6 billion in geographically diversified, high quality, at cost investment properties (net of depreciation) on its balance sheet.

Moreover, the company's balance sheet is rated highly amid a negative outlook due to the pandemic. A higher rating, along with its significant debt compliance cushion provides SPG with major benefits through which it can maintain a strong liquidity position despite uncertainty and bankruptcies in the retail sector.

CREDIT RATINGS

Standard & Poor's			Moody's		
Corporate	A	(Negative Outlook)	Senior Unsecured	A2	(Negative Outlook)
Senior Unsecured	A	(Negative Outlook)	Commercial Paper	P1	(Negative Outlook)
Commercial Paper	A1	(Negative Outlook)	Preferred Stock	A3	(Negative Outlook)
Preferred Stock	BBB+	(Negative Outlook)			

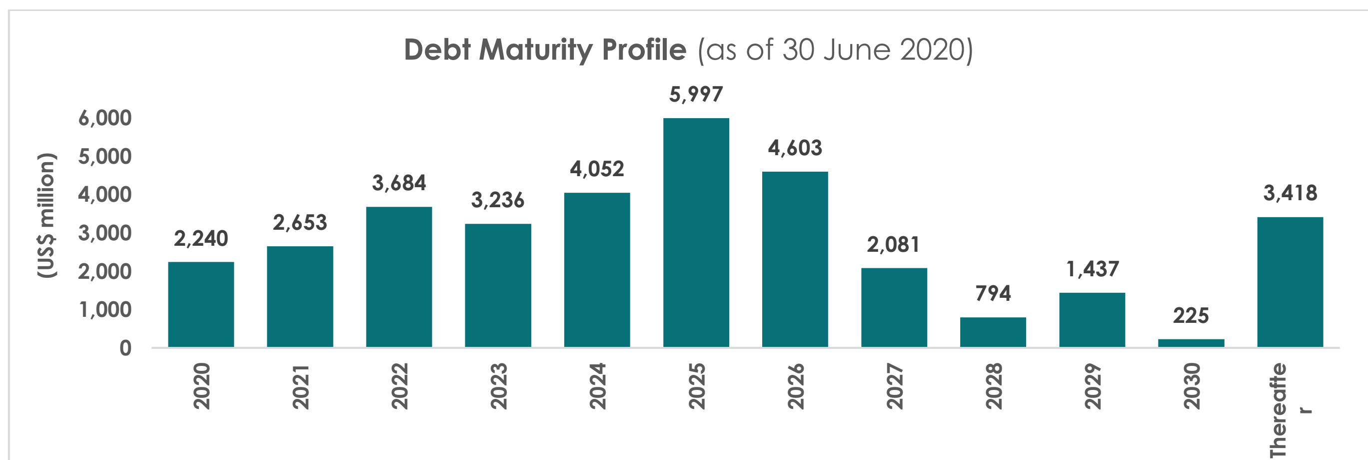
SENIOR UNSECURED DEBT COVENANTS (1)

	Required	Actual	Compliance
Total Debt to Total Assets (1)	≤65%	44%	Yes
Total Secured Debt to Total Assets (1)	≤50%	19%	Yes
Fixed Charge Coverage Ratio	>1.5X	4.8X	Yes
Total Unencumbered Assets to Unsecured Debt	≥125%	244%	Yes

Source: Q220 Supplemental Data

SPG's liquidity position remains strong with $8.5 billion at its disposal as of 30 June 2020, considting of $3.6 in cash (including a share of joint venture cash) and $4.9 billion of available credit facility and borrowing capacity. SPG also has $1.5 billion in net tenant receivables and accrued revenue on its balance sheet, a major chunk of which, we believe, should convert into cash as the company pushes for collection of deferred rents either through negotiations or through litigations, in the coming months.

Subsequent to Q220, on 7 July 2020, SPG raised $2 billion from the sale of senior notes, part of which was used to pay down certain debts maturing later this year. The company's ability to tap the low interest-rate environment to raise debt amid these uncertain times reflects on its balance sheet strength. Additional debt on the balance sheet does raise some concerns, but SPG has managed its balance sheet well by structuring its debt maturity profile favorably.



Source: Q220 Supplemental Data

Overall, we are confident that with a solid balance sheet and available capital resources, SPG will efficiently navigate through the current uncertainties and capitalize on opportunities stemming from market dislocation due to the current operating environment.

Dividend Safety – Management's Reassurances are Believable

Income-oriented investors typically own REITs because their operating structure requires them to pay at least 90% of their taxable income to shareholders as dividends. Amid the uncertainties caused by the pandemic, many retail REITs have reduced or suspended their dividend payouts. However, SPG has assured its shareholders of its intent to continue with regular dividend payments. The following is a statement by the company's Chairman and CEO, David Simon, during Q120 earnings conference call:

"We expect to pay out at least 100% of our taxable income in 2020 in cash. As a point of reference, there have been over 175 public companies who have either suspended or reduced their common stock dividend by 50% or more. ***We will not be one of those companies****."*

As with other retail REITs, the pandemic took a bite out of SPG's latest quarterly dividend as well. SPG cut its dividend by ~38% from $2.10 in Q120 to $1.30 per share during Q220, implying a payout ratio of 61% of its FFO of $2.12 per share. Comparing this to the 2019 dividend payout ratio of 69%, it seems that the company is being a little conservative, given the macro circumstances. However, SPG again assured investors of regular dividend payments for the rest of 2020. Here is a statement by Mr. Simon from Q220 earnings conference call:

"The board will declare a third-quarter dividend by September 30th and we expect in total for 2020 to pay at least $6 per share in cash for dividends."

Considering the overall retail REIT universe dividend payment scenario, we think a $6 yearly dividend for 2020 is still extremely good from a yield perspective, which works out to +9% at the current share price. Some digging into SPG's historical dividend yield before the onset of the pandemic reveals that the company exhibited a much lower dividend yield, and at a +9% yield the company's stock is attractive.

Source: Yahoo Charts

Bankrupt Retailer Acquisitions – Generating Sideline Value

SPG and its acquisition partner Authentic Brands Group, through their 50-50 joint venture, SPARC Group, have snapped many struggling retailers on the verge of bankruptcy or during bankruptcy auctions, including Aéropostale, Forever 21, and most recently Lucky Brand Jeans and Brooks Brothers. There is a wide circulating belief that SPG buys out these struggling retailers to ensure its rent payments. But SPG says that it does these investments because it sees value in them and expects them to payback within a very short duration. Here is what Mr. Simon had to say on this during the Q220 earnings conference call:

"It's a sideline business. And I do see the narrative that -- and I don't buy into this, that we're buying into these retailers to pay us rent. We're doing it because we -- for one reason only, we believe in the brand and we think we can make money.

These investments are expected to generate positive EBITDA soon after their integration into Sparc. We expect any equity investments should be returned within a year after integration of operations."

We think of these acquisitions of bankrupt retailers as profitable investments done at extremely cheap valuations, which, of course, is enabling the viable retailers to survive and keep paying the rents. SPG may as well generate large capital gains from selling out these investments once their operations become stabilized and they are past the "valley of death."

Brief Round-up of SPG in the News

Taubman Centers Acquisition Deal: SPG has been legally trying to pull itself out of the $3.6 billion deal to acquire Taubman Centers (TCO), accusing TCO of doing little to mitigate the financial impact of the pandemic. As per the latest reports, the court has ordered both companies to be ready for a jury trial in the mid of November this year. There are rumors that with the litigation, SPG is trying to get a better acquisition price. Whether SPG gets a better deal price or not is a different matter, it will be a long drawn out legal battle where both the companies will have some financial implications.

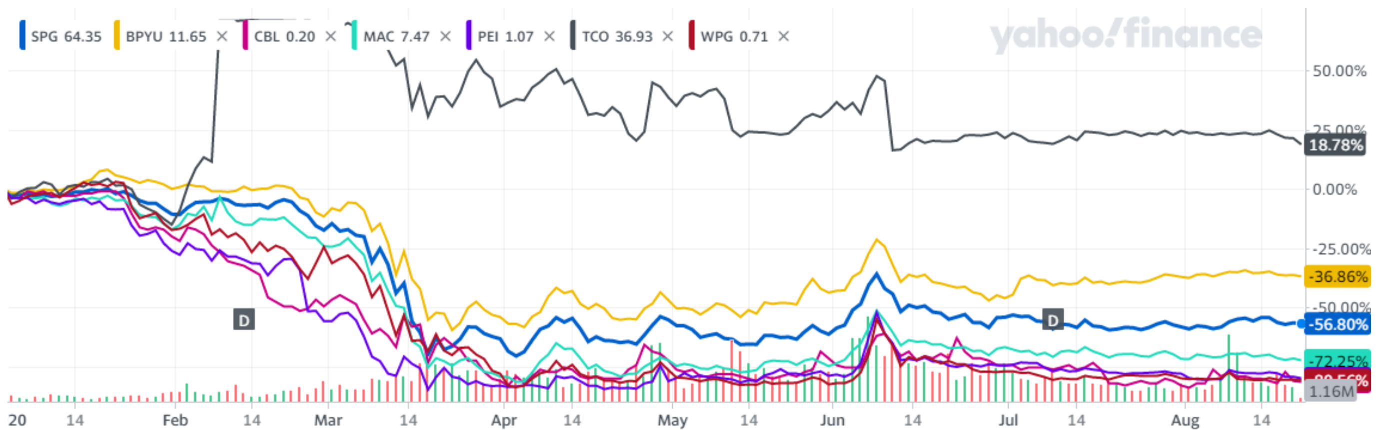
Talks with Amazon: As per a recent WSJ article, SPG has been in talks with Amazon (AMZN) to explore the possibility of turning some of its anchor department stores (possibly the shuttered J.C. Penney and Sears stores) into Amazon distribution hubs. Although it is too early to comment, in case a deal with Amazon happens, it will mark the entry of SPG into one of the least volatile industrial REIT business. However, the company is likely to face hurdles in converting the stores to warehouses.

Interest in J.C. Penney: As per several news reports, SPG is reportedly interested in buying the bankrupt J.C. Penney in alliance with Brookfield Property Partners (BPY). While SPG's management termed it as speculation and declined to comment on the possibility of buying out the retailer, we think there can be no smoke without the fire. Considering that J.C. Penney stores account for just over 5% of SPG's leased square footage in the US, buying out the retailer would not be such a

bad option, given that SPG would also get to keep up with its rent from the J.C. Penney stores.

Valuation:

As with the sell-off witnessed across the retail REIT sector since the imposition of lockdown in March because of coronavirus, SPG's stock has also taken a big hit. YTD the company has lost ~57% of its market value. However, with the reopening and the positive data so far on retail sales trend, we believe SPG will soon make up some of its lost ground. The share price going back to pre-COVID levels will take a long time, given the financial costs of restarting and rebuilding amid a still uncertain environment.



Source: Yahoo Finance

At its current price of $65, the stock is trading at 6.2x its 2020E FFO, which is much lower than the Price to FFO multiple of ~16x it was trading at just a year ago. While comparing SPG with the other mall focused retail REITs, as classified by NAREIT, yields that SPG is trading at a relative premium to its peer group, none of its peers compare to SPG on its underlying fundamentals. Despite a ~$27 billion debt load on its balance sheet, its Net/Debt to NOI ratio is lower than its peers; it maintains an extremely healthy interest coverage ratio; and its balance sheet is backed by high-quality real estate assets. The company also continues to pay healthy dividends in an environment where many of its competitors have suspended dividends altogether.

Name	Ticker	Market Cap ($ bn)	2020E Price/FFO (x)	Div. Yield (%)	Net Debt / NOI (x)	Interest Coverage Ratio (TTM)
Brookfield Property REIT	BPYU	0.65	na	11.31%	na	1.0
CBL & Associates Properties, Inc.	CBL	0.04	0.2	na	7.1	2.4
The Macerich Company	MAC	1.15	2.8	7.81%	6.4	3.9
Pennsylvania Real Estate Investment Trust	PEI	0.09	2.2	na	8.9	2.4
Taubman Centers, Inc.	TCO	2.33	13.4	na	4.7	4.9
Washington Prime Group Inc.	WPG	0.13	1.0	na	7.9	2.5
Simon Property Goup, Inc.	**SPG**	**19.84**	**6.2**	**8.02%**	**5.8**	**6.1**
Average			**4.3**	**9.05%**	**6.8**	**3.3**

Source: Blue Harbinger Research, Yahoo Finance, Company data

Although the coronavirus turmoil is likely to affect SPG as well in the near to mid-term, we believe it is well-positioned to weather the storm. We recommend income-focused investors, as well long-term investors looking for wealth creation opportunities, consider a position in SPG, as its current share price presents an attractive opportunity to invest in an industry-leading business at a historically low price level.

Risks:

Litigation with Taubman Centers: After SPG backed out of the acquisition of Taubman, both companies are involved in a legal fight. In case the court gives out a decision in favor of Taubman, SPG might have several financial implications, including fines.

Tenant Bankruptcies: SPG is exposed to the risk of tenants not being able to meet their rental obligations owing to the difficult operating environment. However, SPG's diversification, both across geographies and across tenants, is a key mitigant. Further, with the dividends being backed by high-quality assets, it seems highly unlikely that tenant bankruptcies will threaten its dividend safety. Nonetheless, should some of these tenants face financial trouble, it could lead to future cash flow interruption.

Further government-imposed lockdowns: Because most of SPG's tenants operate in the non-essential retail category, any further lockdowns imposed by the government in case of a dramatic rise in the number of COVID19 cases, might cause business closures and adversely impact the company's cash flows.

Interest rate risk: The US Federal Reserve has cut interest rates to essentially zero and even though we expect interest rates to remain relatively tame, dramatically rising rates could create challenges. As REITs are often seen as an alternative to bonds, higher interest rates could mean decreased demand for REITs, thereby causing a decline in their share price.

Sensitivity to Consumer Spending: With projections from renowned institutions such as the IMF pointing to a global recession, we think consumer spending and confidence will be hit and in general will be negative for retail-focused REITs. However, the resilient nature of SPG's business should help it weather any downturn. Although the company is much better placed, a global recession is likely to hurt its earnings.

Conclusion:

SPG's scale, geographic diversification, and focus on a high-quality portfolio at some of the most desired locations, offer much value to retailers, enabling SPG to consistently attract high-quality tenants. With the reopening, the early retail trends are encouraging, which should help SPG in accelerating on its rent collections. Also, the dividend is backed by a balance sheet that has high-quality real estate assets, and management's reassurance gives us confidence that SPG's dividends are among the safest in the REIT industry. At the current price, SPG looks extremely attractive from an income-generating perspective as well as from a longer-term wealth creation perspective. We are currently long shares of Simon Property Group in our Blue Harbinger Income Equity Portfolio.