# FACTORY OUTLET CENTERS: PUBLIC VS. PRIVATE PRICING

by Howard C. Gelbtuch, CRE

From the late 1980s until just recently, the regional mall was the most preferred property type for direct investment. The change occurred because most consumer preferences shifted from mall-driven conspicuous consumption of designer jeans and the like, to more value-oriented shopping. When retailers and shopping center developers realized that it was more fashionable to buy goods at bargain prices than to flaunt one's wealth, various value-oriented formats evolved such as

- **Factory outlet stores**, owned and operated by manufacturers, sell directly to the consumer and eliminate interim markups in pricing. Among the manufacturers choosing this route are Van Heusen, Levi Strauss & Co., Nike and London Fog.
- **Catalog outlets**, retail stores operated by the major catalog merchandisers such as Lands' End and L.L. Bean, offer discounts from standard pricing.
- **Specialty outlet stores**, operated by the specialty chains, are increasingly found in outlet shopping centers—neighborhood or community sized-centers tenanted exclusively with value-oriented stores. These centers frequently include Nine West, Ann Taylor, VF Corp., Levi Strauss & Co. and Nike.

The number of factory outlet centers in the U.S. nearly tripled between 1988 and 1994, from 108 to 311. Their meteoric growth coincided with an early 1990's structural change in traditional large investor attitudes toward direct investment in real estate. Mortgage loan portfolios at commercial banks were coming under increasing regulatory scrutiny as foreclosures increased; excessive imprudent lending by many savings and loan associations lead to their eventual insolvency or demise; and insurance companies faced intense examination by both rating agencies and state regulatory authorities. In addition, many tax-oriented limited partnerships became increasingly insolvent because of the confluence of the Tax Reform Act of 1986, a weak economy and severe overbuilding. Also, corporations came under pressure from stockholders to better deploy their capital, including funds tied up in real estate, and foreign investors became disenchanted with the performance of their U.S. real estate acquisitions. Lastly, pension fund investors began to question the wisdom of real estate investment as their expectations for real estate liquidity and theoretical performance evaporated. The result was a shedding of real estate assets and, more important, a shortage of traditional

*Howard C. Gelbtuch, CRE, MAI, a principal with Greenwich Realty Advisors, Incorporated in New York City, frequently writes on retailing topics.*

private sector capital available for direct investment in real estate.

**Public Vs. Private Investor Attitudes**

With private investors rethinking their real estate asset allocations, the time was ripe to tap the public markets for capital. Public equity markets traditionally had been frowned upon by real estate developers because of the abundance of institutional capital available in private market transactions, the perceived higher cost of public capital, the nuisance of dealing with numerous individual (rather than institutional) investors and the risk of losing privacy and control.

The negative change in institutional attitudes toward real estate also coincided with an increasingly positive attitude by smaller investors. Individuals were attracted to the enhanced liquidity available through the stock market compared to private ownership of real estate. They were encouraged by a small but growing precedent of publicly-held real estate companies, e.g., Rouse, Federal Realty Investment Trust and Weingarten Realty Investors. The transition from private to public ownership was further facilitated by the increasing number of institutional managers focusing on real estate, including Fidelity Investments and Cohen & Steers Capital Management Inc. With a lack of institutional financing, the surge in factory outlet centers was financed largely with the sale stock in new, publicly-traded companies such as Chelsea GCA Properties, HGI Realty, Tanger Factory Outlet Centers and Factory Stores of America.

*Location, Location, Location*

Most outlet centers are situated away from large metropolitan areas in order not to compete with the manufacturer's larger customer base at department stores and mass merchandisers. While the public became enamored with the concept of outlet shopping, many direct real estate investors have resisted because of store locations in small towns like Boaz, Alabama; North Bend, Washington; or Mineral Wells, Texas. While these may be pleasant places to live, institutions that invest directly in real estate through mortgages or equity typically prefer the larger, more dominant neighboring cities such as Huntsville, Seattle and Fort Worth where replacement tenants are easier to find if the outlet concept fails. Many outlet center companies compensate for a small local populace by locating properties in tourist-dominated cites such as Branson, Missouri; Lake George, New York; and Conway, New Hampshire. Mortgage financing in small towns often is available from locally based banks or thrifts.

However, not all factory outlet center REITs include poorly located real estate. Woodbury Commons, north of New York City and operated by Chelsea GCA Realty, is among the most successful outlet center in the country because of its outstanding highway access and relative proximity to the New York metropolitan area. Similarly, the Secaucus area of New Jersey and many tourist-dominated towns of New England draw large crowds of shoppers because of their outlet centers. Although many direct real estate investors are unwilling to invest in traditional outlet center locations, the public's favorable response to the concept is largely responsible for the infusion of funds into outlet center companies.

**The Arbitrage Opportunity**

From a company perspective, current dividend yields of about 8 percent on many factory outlet stocks are favorable since they are far less than the capitalization rates the property would command if sold individually in the open market. (A capitalization rate which is derived by dividing a property's income over its value, is akin to a dividend rate. However, a REIT does not pay all of its cash flow as dividends to investors.) The demand for higher cap rates is primarily a function of the location and the limited re-use potential of most outlet centers. The lower dividend rate accorded the factory outlet shares indicates that investors are willing to pay a premium (accept a lower return) for the increased liquidity available through stock ownership, as well as for professional management.

This disparity in pricing has resulted in owners of outlet center companies seeking public rather than private financing, even if the latter is more available, since it is far less expensive to offer stock with an 8 percent dividend than to sell or finance an outlet center based upon a capitalization rate several hundred basis points higher. This is true even after adding the costs of going public.

For the investor, this has led to interesting opportunities in investment arbitrage. For example, The Mills Corporation's value-oriented, super regional malls often house 15 to 20 anchor stores, such as Bed, Bath & Beyond, Filene's Basement and Marshall's, along with up to 200 smaller stores. These have become destinations unto themselves. Yet the dividend yield on The Mills Corporation stock is currently about 10.5%, probably less than the capitalization rate otherwise assigned to its properties by real estate buyers and sellers. Therefore, sophisticated investors can arbitrage investments in REITs with direct real estate investments by analyzing each risk/reward ratio. If the dividend rate on a given stock exceeds the capitalization rate for a similar alternative real estate investment, the stock should be purchased.

Reflective of real estate markets overall, REITs trailed the admittedly sizzling performance of the Dow Jones Industrial Average in 1995; the NAREIT Equity Index was up 15.3 percent last year

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**Mary Jo Thomas, SRA**

*1201 West Freeway*
*Fort Worth, TX 76102-6074*
*telephone 817.332.7872*
*fax 817.332.2940*


TABLE 1

Price Performance Of REITs During 1995

| Sector | 1995 Price Change |
|---|---|
| Office | 24.8% |
| Hotel | 17.6% |
| Industrial | 12.8% |
| Apartment | 4.0% |
| Regional Malls | ( 6.8%) |
| Shopping Centers | ( 8.6%) |
| Factory Outlets | (10.2%) |

Source: 1996-Annual Review and Outlook For REITs, Lehman Brothers

compared to 37.6 percent for the S&P 500. Shopping center stocks generally did not perform as well and outlet center REITs were even worse.

Based upon the performance of outlet center stocks through 1995, direct real estate investors have proven themselves to be more astute than the public by steering clear of real estate that is locationally challenged. It is uncertain whether this was a conscious decision to avoid outlet centers, due to other perceived opportunities for better capital deployment, or because of a general aversion to real estate. Perhaps time will prove that factory outlet companies, at their current pricing, are an attractive investment. If so, it will not be because the quality of their underlying real estate is high.

### Looking Forward

The stock market is usually an excellent prognosticator of returns as shown in Table 1. Many Wall Street brokerage firms are projecting an overall return of 15 percent from REITs in 1996. As this is based on the sum of both an annual dividend and expected price appreciation, it is similar to an IRR in real estate parlance. Investors who concur with this scenario but cannot buy real estate directly at a 15 percent IRR may be better off investing in REITs. Within the REIT universe, some stocks are expected to outperform the average (office companies for example) while others with shopping centers are expected to underperform. Counter-cyclical investors, or those with the capacity to add value to their acquisitions, may continue to prefer investing in real estate. REITs themselves also will begin to arbitrage capital costs by taking advantage of the current low interest rate environment to borrow money for acquisitions.

As the REIT market continues to expand, real estate counselors will need to reconcile real estate terminology with that used by stock analysts and to recognize that stocks and real estate compete with each other for capital. The distinction between owning bricks and mortar and share certificates is blurring, and real estate counselors who want to remain on the leading edge of their profession have to speak both languages.