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REITs

PREIT Preferred Shares: Strong Q2 Results Offer Hope

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Summary

- PREIT's NOI came roaring back last quarter, nearly reaching pre-pandemic levels.
- June sales per square foot for PREIT's small-shop tenants surged 16% relative to June 2019.
- With shoppers returning in droves, tenants are signing leases at the fastest pace in years. This will allow PREIT to quickly rebuild occupancy and grow NOI.
- PREIT still needs to raise capital through asset sales, JVs, and/or an equity offering in order to refinance its extremely expensive term loans.
- PREIT's preferred shares offer a better risk-reward tradeoff than the common stock.

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Pennsylvania Real Estate Investment Trust's (PEI) (PEI.PB) (PEI.PC) (PEI.PD) Q1 results showed glimmers of hope for its post-pandemic (and post-bankruptcy) recovery. In a great sign for shareholders, the long-suffering REIT's Q2 earnings report showed far more tangible signs of progress.

Notwithstanding its recent momentum, PREIT continues to be weighed down by an unsustainable debt load. It has a number of options for addressing its weak balance sheet, but none are a slam dunk. As a result, both the common and preferred shares remain highly speculative. However, at their current prices, both have ample upside to compensate for their risk: especially the preferred shares.

NOI comes roaring back

In the first quarter, PREIT was still suffering from rent abatements, credit losses, high vacancy rates, and weak tenant sales. As a result, same-store NOI (excluding lease termination revenue) plunged 21.2% year over year to $37.7 million, on top of a 9.6% drop a year earlier.

By contrast, in Q2, PREIT generated same-store NOI (excluding lease termination revenue) of $50.7 million: up 34.3% sequentially and 53.9% year over year. Including lease termination revenue and non-same-store properties, total NOI surged 63.8% year over year to $54.4 million.

Even more remarkably, PREIT's Q2 NOI excluding lease termination revenue was down just 0.6% from $51.0 million in Q2 2019, while total NOI slipped just 0.2%.

To be fair, same-store NOI benefited from $3 million of credit recoveries last quarter, while total NOI benefited to the tune of $3.4 million. That's obviously not a sustainable source of NOI: it merely offsets credit losses booked last year. Still, PREIT's Q2 performance shows that it's on the way to matching if not surpassing its pre-pandemic NOI as soon as next year.

While the speed of the recovery is surprising, there were very good reasons to expect PREIT's NOI to surpass 2019 levels within a few years. First, the vast majority of PREIT's remaining malls have strong competitive advantages, making them desirable locations for prospective tenants. Indeed, properties like Capital City Mall and Dartmouth Mall are thriving thanks to the collapse or outright closure of competing malls.

(Image source: PREIT)

Second, in late 2019, PREIT began opening a series of redevelopments across its portfolio that together cost roughly $400 million. Many of these projects look suspect from an ROI perspective (most notably the Fashion District Philadelphia redevelopment, which cost over $200 million at PREIT's share), but they will likely provide a cumulative NOI lift of about 10% by 2023.

Leasing activity accelerates

During 2021, PREIT has capitalized on a remarkable rebound in demand for retail space. Most notably, it signed leases for about 196,000 square feet of small-shop space in the first six months of the year, at an average initial rent of $41.42 per square foot. During the same period in 2019, it signed leases for approximately 172,000 square feet of small-shop space at a similar average rent of $41.86 per square foot.

Including renewals and larger non-anchor boxes, PREIT signed leases for over 1.1 million square feet in the first half of 2021, up from 623,000 square feet in the first half of 2019.

PREIT's leasing success will help keep its properties vibrant. Notably, it recently signed a lease with Phoenix Theatres for an upscale movie theater at Woodland Mall: a dramatic upgrade over the second-run theater that closed last year. PREIT will also add a high-traffic Aldi grocery store in part of the space formerly occupied by Sears at Dartmouth Mall this fall. Moreover, it has found replacements for nearly all of the anchors that have closed in its portfolio since the beginning of 2020.

The surge in leasing activity will also help PREIT quickly address its biggest near-term NOI growth opportunity: boosting occupancy. PREIT ended Q1 with non-anchor occupancy of 87.0% and leased occupancy of 88.2% for its core malls. For comparison, non-anchor occupancy stood at 91.1% at the end of Q1 2018.

By the end of Q2, non-anchor occupancy for PREIT's 18 core malls had improved to 87.8% and leased occupancy had reached 90.4%. In its earnings report, the REIT said it had 500,000 square feet of leases signed for future openings, worth $10.8 million in annual gross rent.

Pennsylvania Real Estate Investment Trust

Summarized Sales and Rent Per Square Foot and Occupancy Percentages

	June 30, 2021[3]				Actual Occupancy		Leased Occupancy		June 30, 2020				Actual Occupancy	
	% Rolling 12 Mo. NOI	Average Comp Sales[1]	Average Gross Rent[2,3]	Occupancy Cost	Total	Non-Anchor	Total	Non-Anchor	% Rolling 12 Mo. NOI	Average Comp Sales[1]	Average Gross Rent[2,3]	Occupancy Cost[4]	Total	Non-Anchor
Malls	89.4%	n/a	$ 56.36	n/a	90.2%	87.8%	92.6%	90.4%	90.8%	n/a	$ 59.66	n/a	92.4%	89.5%
Non- Same Store Mall			$ 54.23		72.7%	65.5%	78.8%	73.2%			$ 56.27		72.1%	64.3%
Non-Core Malls	0.3%	n/a	$ 30.16	n/a	68.2%	46.4%	68.2%	46.4%	1.5%	n/a	$ 44.29	n/a	61.8%	55.3%
Malls Total	**89.6%**	**n/a**	**$ 55.67**	**n/a**	**87.8%**	**84.3%**	**90.3%**	**87.2%**	**92.2%**	**n/a**	**$ 59.09**	**n/a**	**89.4%**	**86.1%**
Other Retail Properties	5.9%	n/a	$ 23.67	n/a	88.8%	87.8%	90.9%	90.1%	7.1%	n/a	$ 25.73	n/a	89.4%	88.6%
Total Retail Properties	**95.5%**	**n/a**	**$ 46.72**	**n/a**	**87.9%**	**84.8%**	**90.4%**	**87.6%**	**99.3%**	**n/a**	**$ 50.27**	**n/a**	**89.4%**	**86.5%**
Sold Properties	0.0%	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0.1%	n/a	$ 40.64	n/a	64.5%	78.9%
Other Properties	4.4%	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0.6%	n/a	n/a	n/a	n/a	n/a
Total Portfolio	**100.0%**	**n/a**	**$ 46.72**	**n/a**	**87.9%**	**84.8%**	**90.4%**	**87.6%**	**100.0%**	**n/a**	**$ 50.08**	**n/a**	**88.5%**	**86.3%**

(1) Average comp sales are not reported for 2021 or 2020 due to COVID-19 related mall closures and operational limitations impacting 2020 activity. As a result of these closures and related limitations, comparisons are not meaningful.
(2) Average gross rent for malls includes all non-anchor space owned by the Company and leased to tenants that occupy individual spaces of less than 10,000 square feet. Average gross rent for other retail properties includes all non-anchor space owned by the Company regardless of size.
(3) Average gross rent for mall tenants greater than 10,000 sf was $21.37 per square foot as of June 30, 2021 and $21.52 per square foot as of June 30, 2020.
(4) Occupancy Cost is not included in either 2021 or 2020 due to Average Comp Sales not being presented.

(Source: PREIT Q2 2021 supplemental, p. 19)

There's more upside here. Given the improved quality of PREIT's portfolio and its lack of anchor vacancies, I expect non-anchor occupancy to eventually stabilize in the 92%-93% range, excluding Plymouth Meeting Mall, where management is marketing most of the mall interior for non-retail uses (particularly life sciences). That translates to a lot of incremental NOI.

Another good sign: strong tenant sales

While traffic to PREIT's malls plummeted last year, shoppers have returned in droves recently. In fact, management says that sales per square foot at its 18 core malls surged 16% above 2019 levels in the month of June. That boosted trailing-12-month sales per square foot to a new all-time high.

In the near term, strong tenant sales will boost NOI via percentage rent payments. Small shops in malls typically pay a fixed base rent and then a percentage of sales beyond a certain level, but PREIT has also signed a significant number of short-term leases since 2019 where tenants pay a percentage of sales, with no fixed rent.

Longer term, high sales productivity makes malls more desirable for tenants. So while PREIT currently must balance its desire to maximize rents with the need to rebuild occupancy as quickly as possible, it should be able to raise rents as leases come up for renewal in the future.

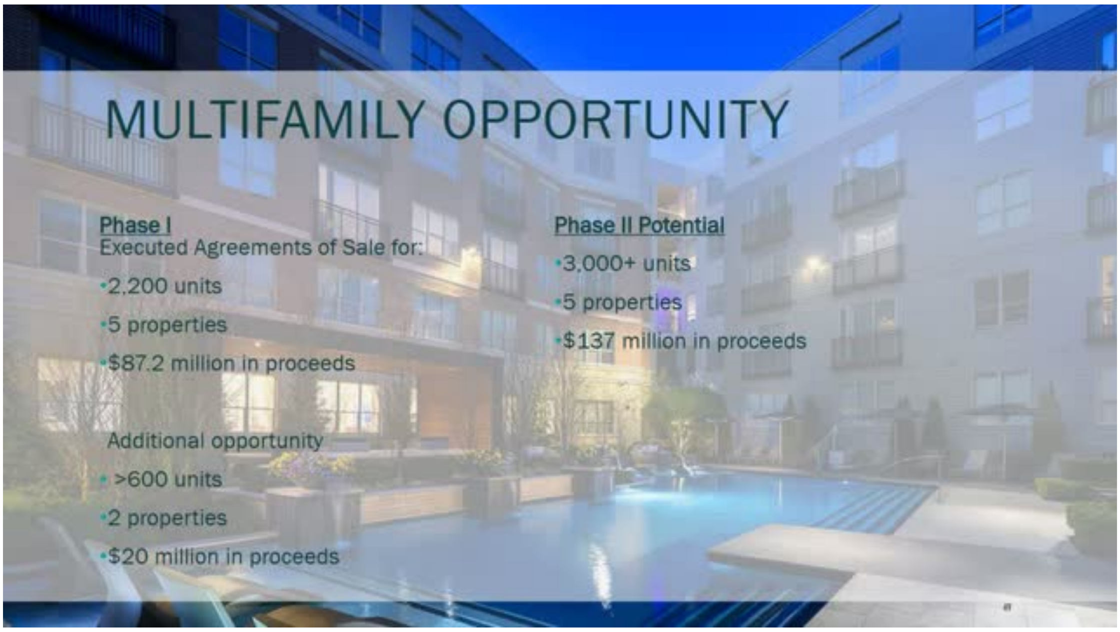
What about the balance sheet?

The balance sheet remains the big question mark for PREIT. The REIT ended last quarter with $2.24 billion of debt: essentially unchanged from a quarter earlier. Even with strong operational performance, organic debt reduction is nearly impossible because PREIT's debt now carries a weighted average interest rate of 6.25% (excluding the amortization of deferred financing fees). A year ago, that figure stood at 3.61%.

PREIT's debt load currently stands at nearly 10 times its 2019 NOI and almost 12 times its 2019 EBITDA. Even if NOI modestly exceeds 2019 levels by 2023, PREIT won't be able to refinance its debt on reasonable terms with this much leverage. That makes it crucial to raise capital one way or another to pay down debt.

Management has provided more insight into its thinking recently. Land sales (primarily for multifamily development) remain the top priority. PREIT has firm contracts for $90 million of land sales, covering multifamily developments at five properties and a hotel at Moorestown Mall. It also has a near-term opportunity to rebid the multifamily opportunities at two more sites, which could bring in another $20 million or so.

Longer term, PREIT sees room to add another 3,000-plus units in "Phase II" of its densification initiative. Management values that opportunity at $137 million.



(Source: PREIT June 2021 Investor Update, slide 49)

That said, PREIT needs to get entitlements or anchor consents to complete these transactions. The timeline has slipped repeatedly. Two years ago, management hoped to close a substantial number of land sales in 2019 or, at worst, Q1 2020! Furthermore, the Ch. 11 plan created last fall assumed that PREIT would close two land parcel sales for about $28 million in the first half of 2021 and three more for $34 million in Q3. So far, it hasn't completed any of those deals.

This doesn't mean the land sale opportunity doesn't exist. However, investors should recognize that the need for third-party approvals makes the timing inherently uncertain. It's still reasonable to estimate that most of PREIT's Phase I land sales will close before its term loans' final maturity date in late 2023, but PREIT is unlikely to realize any proceeds from Phase II land sales by then.

Selling $100 million of non-income-producing land would certainly improve PREIT's balance sheet, but it's nowhere near a complete fix. Fortunately, PREIT also intends to explore other asset sales or JVs. It could have several worthwhile opportunities in this vein.

First, as it demonstrates the rapid recovery of its top-tier properties, it may be possible to sell JV stakes at attractive cap rates to pay down debt. (As I noted earlier this year, Cherry Hill Mall alone could quite reasonably merit a $550 million valuation.)

Second, while Plymouth Meeting Mall and Exton Square Mall have the lowest sales per square foot and non-anchor occupancy in PREIT's portfolio, both have strong alternative use potential. PREIT lacks the financial resources to fully redevelop those malls, but it could monetize that opportunity either through JVs or outright sales. Selling these properties would have the secondary benefit of improving PREIT's overall portfolio quality.

The one capital-raising tool management hasn't discussed publicly is an equity raise. However, if progress on other fronts lifts PREIT's share price to $4 or higher, selling equity to reduce leverage would become very attractive.

Why I prefer the preferreds

With NOI likely to reach or surpass the 2019 figure of $228 million as soon as 2022, there's little doubt that PREIT's real estate is worth significantly more than its $2.24 billion of debt. At a 7.5% cap rate on 2019 NOI, the preferred shares are easily covered, and NAV for the common shares would be $5. This valuation might even prove conservative in light of PREIT's long-term multifamily land sale opportunities and the alternative use potential at Exton Square and Plymouth Meeting.

PREIT's preferred shares currently trade at a roughly 60% discount to their liquidation preference and accumulated dividends. In theory, at least, that gives them 150% upside if PREIT can repair its balance sheet enough to rule out a second bankruptcy filing.

The common shares could have even greater upside if PREIT completes numerous asset sales in the next two years and mall cap rates improve significantly. Nevertheless, the preferreds offer a better risk-reward tradeoff. If nothing else, the more the common shares rise, the more enticing it will be for management to fix the balance sheet via an equity offering. That would simultaneously improve coverage for the preferreds while capping the common's upside due to dilution.

Even PREIT preferred shares remain highly speculative at this point. While PREIT has multiple potential paths to fix its balance sheet, it hasn't made meaningful progress yet, leaving substantial refinancing risk in place. But for investors who can tolerate that risk and have a 3-5 year time horizon, PREIT preferred shares continue to look quite attractive.

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Additional disclosure: I am also short Jan. 2022 $3 calls on PEI.

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