Markets/ Finance

March 20 — March 26, 2017

PHOTO ILLUSTRATION BY KURT WOERPEL; PHOTOS: ALAMY (2); GETTY IMAGES (28)

Short the Food Court

▶ **The struggles of retailers such as Macy's could lead to shopping center mortgage defaults**

▶ **"These malls are dying, and we see very limited prospect of a turnaround"**

It's no secret that many shopping malls have been struggling as Americans buy more stuff online. Now some malls are catching the eye of Wall Street speculators who think they've found a way to profit from such woes.

In a strategy reminiscent of Michael Burry and Steve Eisman's famous "Big Short" wager, which made money on the collapse of the housing market before the financial crisis, a small but growing group of investment firms is betting against loans taken out by U.S. mall and shopping center operators. The loans were packaged into bonds—commercial mortgage-backed securities (CMBS)—and so far their prices haven't fallen as much as the stocks of beaten-down retailers.

The speculators think this will change. By one measure, bets against some of the most vulnerable CMBS surged to $5.3 billion last month, a jump of more than 50 percent from a year earlier. Among the firms lining up against mall debt is **Alder Hill Management**, started by protégés of hedge fund billionaire David Tepper.

The investors are buying credit protection contracts, which pay for CMBS losses that occur when shopping centers fall behind on their loans. In return, buyers pay monthly premiums to the seller—usually a bank—for as long as they hold the position. So far this year, traders bought a net $985 million of contracts that target risky portions of CMBS, according to the Depository Trust & Clearing Corp. That's more than five times the purchases in the prior three months.

Nobody is suggesting there's a bubble in retail-backed mortgages that's anywhere as big as the one in home loans in the 2000s or that the potential fallout is comparable. The bearish bets are just a tiny fraction of the $365 billion CMBS market. They're costly to maintain and may not pay off. Many malls could limp along, earning just enough from tenants to stay current on their loans.

Still, bears are convinced that the trouble in brick-and-mortar retail will lead to a pileup of loan defaults. After a poor Christmas season, **J.C. Penney Co.** said in February that it plans to shutter as many as 140 stores out of 1,000. That echoed **Macy's Inc.**'s decision last year to close some 100 outlets and **Sears Holdings Corp.**'s move to shut about 150 locations. Delinquencies on retail loans are at 6.5 percent, a percentage point higher than those for CMBS as a whole, according to Wells Fargo & Co.

The extent of losses on mall loans has been "meaningfully higher than other areas," says Michael Yannell, head of research at Gapstow Capital Partners, which invests in hedge funds that specialize in trading complex debt-based securities. Investors are focused on bonds sold in 2012 that are backed by a lot of loans to regional malls and shopping centers. "These malls are dying, and we see very limited prospect of a turnaround in performance," said a January report from Alder Hill. "We expect 2017 to be a tipping point." And they favor the portions of CMBS rated BBB- and BB, which suffer losses first when the underlying loans default.

Prices on portions of CMBS rated BBB- slumped to 87.1¢ on the dollar in mid-March, from about 96¢ in late January, index data compiled by Markit show. Many of the malls are anchored by the same struggling chains, and a wave of closures could be "disastrous" for mortgage-backed securities, according to Alder Hill. In the worst-case scenario, the money manager says, the bonds rated BBB- could incur losses of as much as 50 percent, while the BB portion might lose 70 percent.

Some think it's the mall bond bears that are headed for a bath. Credit Suisse Group AG said last month that non-CMBS specialists are helping to drive the recent runup in demand for credit protection. That raises concern that too many people are chasing the same trade. "The short feels crowded to us," says Matthew Weinstein, principal at Axonic Capital, a hedge fund. "If these defaults start happening soon, the short will work." And if they don't? Because of the way the contracts are constructed, the first big investor to back out of the bearish trade could trigger losses for those who move more slowly.

It costs about 3 percent a year of the amount invested to short securities rated BBB- and 5 percent to bet against BB notes, plus an upfront fee to put on the trade. The wager is "more speculative" than the short on housing was, according to Sorin Capital Management's Tom Digan.

Hudson Valley Mall in Kingston, N.Y., offers a glimpse of the grim prospects for some shopping centers. It used to house a J.C. Penney and a Macy's, but both left. In January the mall was sold for less than 20 percent of its original $50 million loan. "When a mall starts to falter, the end result is typically binary in nature," says Matt Tortorello, a senior analyst at Kroll Bond Rating Agency Inc. "It's either the mall is going to survive or it's going take a substantial loss." *—Rachel Evans and Matt Scully*

The bottom line Speculators are buying contracts that will pay off when malls can't pay back their loans. But the trade has risks.