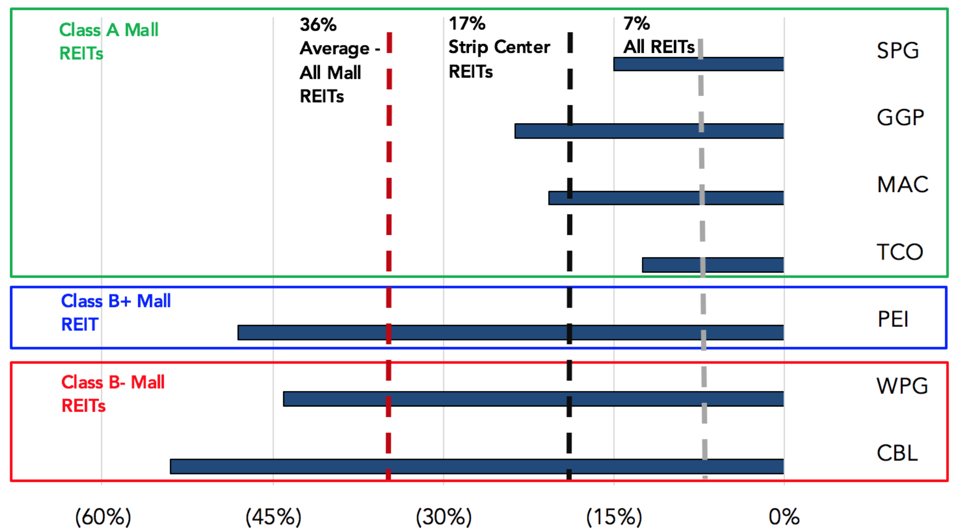
Class A Mall Real Estate Investment Trusts ("REITs"): Misunderstood and Mispriced

Mall REITs have suffered from a steady drumbeat of negative news for several years now given the shift toward e-commerce at the expense of 'bricks and mortar' real estate. Recently announced plans to close additional stores at Macy's (NYSE: M) and Sears (NASDAQ: SHLD) have added fuel to the fire and pushed mall REITs further out of favor than ever before. Their recent performance, especially when compared to industrial REITs, implies that e-commerce has already made the mall obsolete.

Industrial REITs, the primary beneficiaries of e-commerce, led all REIT sectors in 2016, outperforming the MSCI US REIT Index ("MSCI") by 2,200 basis points ("bps"), as measured by the FTSE NAREIT Industrial Index. The FTSE NAREIT Regional Mall Index, by contrast, was one of only two REIT sectors with a negative total return in 2016. Mall REITs finished the year 3,600 bps behind industrial REITs, the largest underperformance since 1997.

Figure 1: Mall REITs Trading at Large NAV Discount



Source: Evercore ISI, Consensus estimates as of March 31, 2017. Bloomberg
Simon Property Group Inc ("SPG"), GGP Inc. ("GGP"), Macerich Co ("MAC"), Taubman Centers, Inc. ("TCO"), Pennsylvania R.E.I.T ("PEI"), Washington Prime Group Inc ("WPG"), CBL & Associates Properties, Inc. ("CBL")

We believe that high quality Class A mall REITs offer the best risk-adjusted returns currently available to investors in US real estate, public or private (as shown in Figure 1, Class A malls are trading at a significant discount to net asset value ("NAV"). This is a result of several years of underperformance driven by the public market's fundamental misunderstanding of department store and e-commerce risks, which we believe to be actually massive opportunities for high quality, well-capitalized Class A mall REITs. While we concede that these risks will adversely affect Class B-minus or lower mall owners, the shuttering of these properties and the minimal planned construction of new Class A properties will cause the mall sector to be the only type of real estate where existing supply will actually decline over the next decade.

Mall REITs were trading at an average discount to NAV of 36% as of March 31, 2017, as shown in Figure 1. This discount is particularly unwarranted for Class A mall REITs, who are also benefiting from an environment of growing retail sales, which should result in strong same store cash flow growth and attractive reinvestment opportunities for them. If discounts continue, it may also attract the interest of real estate private equity and buyout funds, who are sitting on record amounts of dry cash.

Department Stores Out of Style

Few retailers have lost as much in-store sales to e-commerce as middle-market department stores. Since 2013, Macy's, JCPenney (NYSE: JCP), Dillard's (NYSE: DDS), Sears, and Kohl's (NYSE: KSS) have closed over 20% of their US locations, vacating their lowest sales/square foot ("sqft") stores, which tend to anchor Class B-minus or lower malls. Many of these malls are no longer viable without demand from replacement tenants. Invariably, the business press has focused on Class B-minus and lower malls in its narrative of the death of the American mall. However, that is not the full story.

Unlike Class B-minus and lower malls, Class A malls boast record high rents and occupancy levels, which have translated into all-time high private market values. Similarly, Class A malls are actually excited when a weak department store wants to get out of its lease or sell its box, as these have become exponentially more valuable real estate since the mall was originally opened.

For most mall owners, department stores were initially viewed as a traffic generator, gaining them favorable occupancy terms in exchange for providing an ecosystem that creates demand for higher priced small shop space. Despite occupying 60-70% of mall sqft, anchors contribute 10% or less to a mall's net operating income ("NOI")!

No Class B-Minus or C, No Problem

Class A malls have not suffered from department store vacancies because their ecosystems, locations, and tenant rosters cause them to have a waiting list of new tenants wanting to lease space in them. When malls were first developed, department stores negotiated from a position of strength. Today,

Class A mall landlords have the negotiating advantage as such malls' ecosystems are less dependent upon department store anchors. Many of the malls are now surrounded by high-end residential, hotel, and office properties that further enhance the mall experience. With such strong demand, the landlord can replace the tenant with a higher performing anchor at a higher rent, which can generate more traffic for the other retailers. Additionally, if they can subdivide the anchor's space and re-lease it to multiple tenants at a higher rental rate, it is incredibly profitable.

Seritage Growth Properties (NYSE: SRG), into which Sears spun off 254 of its owned and leased stores in June 2015, was formed with this specific purpose. Seritage set out to close its underperforming Sears and Kmart properties, sub-divide them, and re-lease them to higher paying tenants. SRG's disclosures of recent developments give investors an insight into just how profitable this strategy can be. Through December 31, 2016, SRG has repurposed and re-leased 2 million sqft of Sears space at an average rental rate of $18.62/sqft, over 4.4 times the $4.20/sqft average rate Sears was paying previously. The company estimates an unlevered yield of 12% on $400 million of redevelopment thus far, which would grow NAV by $7/share assuming an exit cap rate of 6.0%.

The Class A mall REIT that has most aggressively pursued this strategy is GGP Inc. (NYSE: GGP). Since 2011, GGP has re-leased or redeveloped 91 of the 95 department stores or big box anchors that have vacated their spaces at a total cost of $1.1 billion. These projects generated an 11% yield, almost twice GGP's 6.1% implied cap rate on March 31, 2017.[1] The replacement tenants include 18 new department store anchors, 14 entertainment venues, 10 sporting goods stores, 5 grocery stores, 3 fitness centers, and hundreds of new small store tenants. In addition to the extremely profitable direct results from the redevelopment of anchors, GGP has benefited from the enhanced ecosystem provided by the new traffic drivers.

Figure 2. America's Highest Sales/SF Sales

Mall Rank and Name	MSA	Sales/SF	Owner
1. Bal Harbour Shops	Miami	$3,185	Private
2. The Grove	Los Angeles	$2,200	Private
3. The Mall at Rockingham Park	Salem, NH	$2,170	SPG
4. Forum Shops at Caesars	Las Vegas	$1,615	SPG
5. Aventura Mall	Miami	$1,595	SPG
6. Pheasant Lane Mall	Nashua, NH	$1,595	SPG
7. The Village at Corte Madera	San Francisco	$1,475	MAC
8. Century City	Los Angeles	$1,457	Westfield
9. Ala Moana Center	Honolulu	$1,440	GGP
10. The Mall at Millenia	Orlando	$1,345	TCO

Source: CNBC, company filings

GGP's biggest redevelopment program has been at Ala Moana Center in Honolulu. Ala Moana is a huge 2.4 million sqft mall that is widely considered to be the most valuable mall in the US, generating the ninth highest sales/sqft in 2016 (see Figure 2). It is the main hub of Honolulu's mass transit system, its Centerstage is one of Hawaii's most popular public venues, and it is adjacent to Ala Moana Beach Park, all of which make the center a must-see destination for tourists, and even locals.

In 2013, GGP bought Sears out of a 300,000 sqft lease at Ala Moana for $200 million, then spent an additional $300 million to redevelop the space by replacing Sears with Bloomingdales and dozens of small stores. GGP estimates this increased the value of Ala Moana by over $1 billion, assuming a 4% cap rate for the property. The mall has made the area so attractive that GGP is building its second condominium tower adjacent to the property, and GGP spinout Howard Hughes Corporation (NYSE: HHC) has pre-sold four condo towers next door, with plans for an additional 12 towers. A strong ecosystem indeed!

Who's Closing?

Reports of closing malls and subsequent underperformance by Simon Property Group (NYSE: SPG), GGP, and Macerich (NYSE: MAC) suggests that such REITs hold similar properties that will also close. In fact, that could not be further from the truth. SPG, GGP, and MAC have only 1.5%, 2%, and 4% of their portfolios in Class B-minus or lower malls, respectively. While it is undeniable that many Class B-minus or lower malls have been given back to lenders as their values declined to less than the property-level debt, there has not been enough media coverage of the record values and rents being attained by Class A malls. Figure 3 breaks out gross asset value by class for the US mall universe and each of the mall REITs.

Class A mall owners have been proactive in improving the shopping experience by investing large sums to enhance the physical layout, diversifying the tenant mix, and enhancing the retail experience with more dining and entertainment options. Typically, Class A malls are located in high income and high population density trade areas or tourist destinations. Ecosystems at these malls create a positive reinforcement loop, as the best retailers want to have a presence there. This allows such

1: Source: Evercore ISI

tenants to stay relevant to consumers and increases overall mall traffic, which in turn makes it more attractive to other high quality retailers, and encourages the landlord to reinvest in the property. It is not a coincidence that Apple (NASDAQ: AAPL) or Tesla (NASDAQ: TSLA), the two highest sales/sqft tenants today, happen to occupy space in 78 of the top 100 malls and 67% of all US REIT-owned Class A malls.

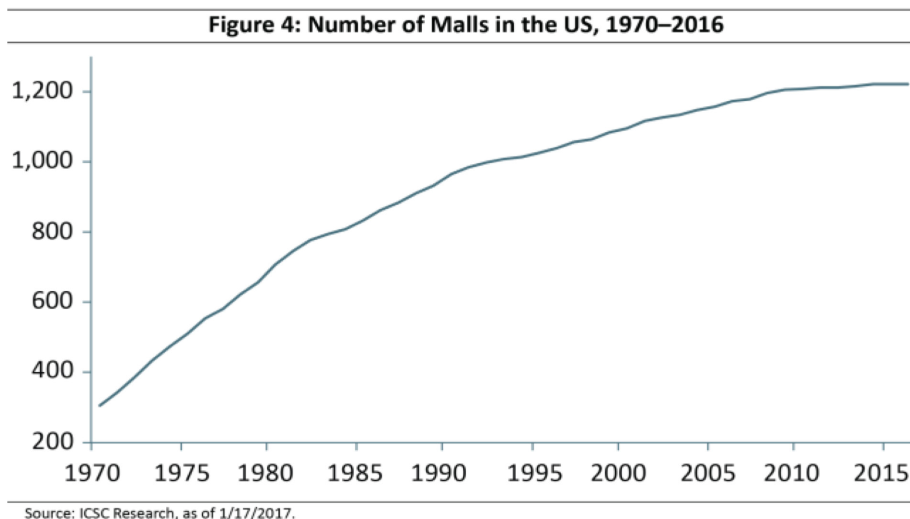
Figure 3: Class A Mall REITs Have Little Risk of Closures

Mall REIT Portfolios	Small Store Sales/ Sqft	Small Store Rent/ Sqft	% of Malls by Gross Asset Value			
			All US Public & Private	Public Mall REITs		
				Class A	Class B+	Class B-
Class A	>$485	>$45	77%	89.3%	58.0%	26.4%
Class B+, B	$385-485	$35-45	16%	8.9%	34.2%	37.1%
Class B-	$320-385	$25-35	3%	1.3%	5.1%	22.3%
Class C or lower	<$320	<$25	4%	0.5%	2.7%	14.3%

*Class A includes SPG, GGP, TCO, and MAC. Class B+ includes PEI. Class B- includes WPG, CBL.
Sources: Chilton research, Green Street Advisors, and 3Q16 company filings.

We estimate that continued growth in e-commerce market share will force 10-15% of existing US malls to close or be repurposed over the next decade. The vast majority of these are expected to be Class C or lower malls, with some Class B-minus mall closures likely. We are unaware of any Class A malls that have ever closed, and we remain confident that this will be true for the next decade. With closings and little new development on the horizon, the total supply of malls has peaked, as shown in Figure 4. The surviving malls stand to benefit from lower competition, especially in an environment of growing retail sales.

Figure 4: Number of Malls in the US, 1970–2016



Source: ICSC Research, as of 1/17/2017.

One prominent example of this is Valley View Center in Dallas. First developed in 1973, the one million sqft Class B mall initially thrived as an affordable alternative to nearby NorthPark Center, Dallas's most high end and oldest mall. In the 1980's, the upscale Galleria Dallas mall was built less than half a mile away from Valley View. Over the next 20 years, it gradually lost most of its customers, small tenants, and even large anchors to the Galleria and NorthPark. The mall effectively closed in 2013 when JC Penney vacated its space, leaving only Sears and a movie theatre as semi-freestanding 'anchors' to the property. In late 2016, Valley View's owner began demolishing the property and plans to replace it with a large mixed-used development.

Mismarked Inventory

Current valuations of Class A mall REITs also provide a large margin of safety and an excellent risk/reward ratio. As Figure 1 shows, all mall REITs trade much further below their NAV than they have on average since 2011 (post Financial Crisis, gray bar) and over the long term (since 2000 excluding the Financial Crisis, black bar).

Class B-minus and lower mall REITs may deserve significant NAV discounts as recent private market transactions have surprised most analysts to the downside, indicating cap rates could be higher than those used in current NAV estimates. However, the dramatic deviations from historical aver-ages seen in Class A mall REITs are entirely un-warranted. As shown in Figure 3, even if we assume that all Class B and C malls for Taubman Centers (NYSE: TCO), SPG, MAC, and GGP are worthless and there is no debt on the properties, they would still be trading at significant discounts to NAV.

The Class A mall REIT discount is unwarranted based on where individual assets are trading on the private market. For example, as far back as January 2014 TCO sold a 49% interest in International Plaza in Tampa for a 4.2% cap rate. In 2015, an Australian pension fund paid a 3.8% cap rate for a 25% interest in Ala Moana Center. Most recently, TIAA-CREF paid GGP a 3.7% cap rate for a 50% interest in Fashion Show Mall in Las Vegas in 2016.

The NAV discount is even more unwarranted when looking at future NAV growth. For the next three years, we project Class A mall REITs to produce same store NOI growth of more than 3% per year. By combining the same store NOI growth with value creation from redevelopment programs of 1% of the portfolio per year, we estimate each company will grow NAV/

share at 5% or more annually over the next three years. Therefore, even if we assume that NAV discounts remain at today's unreasonable levels, Class A mall REIT prices would still be 16% higher than they are to-day. This is one of the largest margins of safety available to US real estate investors, public or private.

Public investors have thrown the baby out with the bath water and are pricing in a doomsday scenario for Class A mall REITs that own great properties and are led by proven management teams. Retailing is a constantly evolving industry and we are currently witnessing a welcome reduction in retail space in the United States, in part due to e-commerce but also due to changes in consumer tastes and buying habits.

The owners of Class A malls have been the most proactive in responding to these changes by investing significant dollars to keep the malls vital to retailers in an "omni-channel" world. The future looks even brighter as Class A mall REITs stand to benefit from the decline of the department store, both from redevelopment and less competition as a result of mall closures. Finally, a deep buyer pool has been consistently paying record-low cap rates for Class A malls given their scarcity and historically strong cash flow growth. As REITs own over 70% of all US Class A malls, these companies should continue to be undervalued until the public market recognizes their present margins of safety and bright futures.

Q1 2017 Performance and Attribution

For Q1 2017, the West Loop Realty Fund ("the Fund"), as measured by the institutional share, produced a total return of 0.21% versus the MSCI US REIT Index (RMS) return of 0.99%. For the quarter, the largest detractors to relative performance included an overweight allocation to regional malls, and underweight allocations to healthcare and triple net[2] REITs. An overweight allocation to the data center/tech sector, stock selection within the strip center sector, and an underweight allocation to industrial REITs contributed to relative performance.

An overweight allocation to the data center/tech sector contributed to the fund's relative performance. Tower REITs look to be the beneficiaries of carriers deploying recently acquired spectrum, the major growth of mobile usage, and the expansion of small cell sites which are helping carriers meet insatiable demand in urban areas. Data center REITs will continue to benefit from increased corporate data outsourcing, the growth of the 'cloud', and the need for speedy delivery of data. Owning Retail Opportunity Investments Corporation (NASDAQ: ROIC) contributed to our relative performance within the strip center sector. ROIC primarily owns grocery-anchored strips centers across the major markets on the West Coast. ROIC's tenants are more focused around necessities and everyday services that are less impacted by competition from e-commerce. An underweight allocation to the industrial sector contributed to the fund's relative performance. Growth in e-commerce has been a driver of demand for industrial space; however, we believe that the current pricing of most industrial REITs implies a growth profile that will be difficult to achieve given high current occupancies, which negates the potential for growth from lease-up.

An overweight allocation to the regional mall sector detracted from the Fund's relative performance. The first quarter was marred with negative headlines from retailers. Notably, JCPenney announced store closings, which adds to the previously announced closings by Sears and Macy's. In addition, a disclosure in Sears' 10-K revealed doubt about the company as a 'going concern'. We continue to favor Class A mall REITs over Class B mall REITs, as they stand to benefit from the shakeup in retailing that will disproportionately affect lower quality real estate. An underweight allocation to the healthcare sector (0% allocation) detracted from the composite's relative performance. Healthcare REITs continue to be the most correlated to interest rates due to its similarity to fixed income. We continue to favor sectors with more attractive growth profiles. An underweight allocation to the triple net sector (0% allocation) detracted from the composite's relative performance. However, similar to healthcare, triple net REITs are highly correlated to changes in long term interest rates. We continue to prefer sectors with higher organic growth and better-located properties.

PERFORMANCE - Through 3/31/17

	Q1 2017	YTD	1 Year	3 Year	Ann ITD*
REIAX	0.15%	0.15%	1.98%	10.72%	12.55%
REIAX w/Load	-5.61%	-5.61%	-3.89%	8.54%	10.51%
REICX	-0.05%	-0.05%	1.19%	9.85%	11.70%
REIIX	0.21%	0.21%	2.21%	10.94%	12.80%
MSCI US REIT Index	0.99%	0.99%	3.17%	10.05%	12.51%

2: Triple net REITs are those that invest in properties that are solely comprised of triple net leases. A triple net lease is a lease agreement that designates the lessee, which is the tenant, as being solely responsible for all the costs relating to the asset being leased, in addition to the rent fee applied under the lease.

Performance data quoted represents past performance and is no guarantee of future results. *Total return figures include the reinvestment of dividends and capital gains. Current performance may be lower or higher than the performance data quoted. Investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than original cost. For the most recent month end performance, please call (800) 207-7108. Returns showing less than one year are cumulative. *ITD represents inception-to-date data. The Fund's inception date was 12/31/2013. The gross operating expense ratio for the Class A, C, and Institutional Shares are 1.82%, 2.57% and 1.57%, respectively. The net operating expenses after fee waiver and/or expense reimbursements are 1.50%, 2.25% and 1.25% for the Class A, C, and Institutional Shares, respectively. The contractual agreement between the Fund and the Advisor for fee waiver and/or expense reimbursement is in effect until April 30, 2017. Without the contractual agreement, performance would have been lower. Performance results with load reflect the deduction for Class A Shares of the 5.75% maximum front end sales charge. Class C Shares are subject to a contingent deferred sales charge of 1.00% when redeemed within 12 months of purchase. Performance presented without the load would be lower if this charge was reflected.* ***Fund performance may be subject to substantial short-term changes.***

As of March 31, 2017, the Fund's Top 10 holdings were as follows: Simon Property Group (SPG): 8.60%, Boston Properties (BXP) 5.88%, Life Storage (LSI) 5.70%, GGP Inc. (GGP) 5.67%, American Tower Corporation (AMT) 4.96%, Essex Property Trust (ESS) 4.72%, AvalonBay Communities (AVB) 4.68%, Crown Castle International Corp (CCI) 4.24%, Cyrus One Inc. (CONE) 4.20%, Vornado Realty Trust (VNO) 3.89%.

RISK AND OTHER DISCLOSURES:

Before investing you should carefully consider the West Loop Realty Fund's investment objectives, risks, charges and expenses. This and other information about the Fund is in the prospectus and summary prospectus, a copy of which may be obtained by calling 800-207-7108 or by visiting the Fund's website at www.libertystreetfunds.com. Please read the Fund's prospectus or summary prospectus carefully before investing.

An investment in the West Loop Realty Fund is subject to risk, including the possible loss of principal amount invested and including, but not limited to, the following risks, which are more fully described in the prospectus:

- The Fund invests in Real Estate Investment Trusts (REITs), which involve additional risks compared to those from investments in common stock. REITs are dependent upon management skills; generally may not be diversified; and are subject to heavy cash flow dependency, defaults by borrowers, self-liquidation, and tax risks.
- Investments in REITs involve risks including, but not limited to, market risk, interest rate risk, equity risk and risks related to the real estate market.
- The Fund will be closely linked to the performance of the real estate markets. The Real Estate industry is subject to certain market risks such as property revaluations, interest rate fluctuations, rental rate fluctuations and operating expenses, increasing vacancies, rising construction costs and potential modifications to government regulations.
- REITs are subject to declines in the value of real estate as it relates to general and local economic conditions and decreases in property revenues. Continued disruptions in the financial markets and deteriorating economic conditions could adversely affect the value of the Fund's investments.
- As a non-diversified fund, the Fund may focus its assets in the securities of fewer issuers, which exposes the Fund to greater market risk than if its assets were diversified among a greater number of issuers.
- The Fund's investments will be concentrated in the real estate sector. The focus of the Fund's portfolio on a specific sector may present more risks than if the portfolio were broadly diversified over numerous sectors.
- Foreign investment risk. These risks include currency fluctuations, economic or financial instability, lack of timely or reliable financial information or unfavorable political or legal developments. Foreign companies are generally subject to different legal and accounting standards than U.S. companies.
- The Fund invests in small and mid-cap real estate companies, which may involve less trading and, therefore, a larger impact on a stock's price than customarily associated with larger, more established company stocks.
- In order to qualify for the favorable tax treatment generally available to regulated investment companies, the Fund must satisfy certain diversification requirements. The Fund's strategy of investing in a relatively small number of securities may cause it inadvertently to fail to satisfy the diversification requirements. If the Fund were to fail to qualify as a regulated investment company, it would be taxed in the same manner as an ordinary corporation, and distributions to its shareholders would not be deductible by the Fund in computing its taxable income.

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The Fund may not be suitable for all investors. We encourage you to consult with appropriate financial professionals before considering an investment in the Fund.

The MSCI US REIT Index is a free float-adjusted market capitalization index that is comprised of equity REITs. With 148 constituents, it represents about 99% of the US REIT universe and securities are classified in the Equity REITs Industry (under the Real Estate sector) according to the Global Industry Classification Standard (GICS®). It however excludes Mortgage REIT and selected Specialized REITs. The RMZ index symbol refers to the price-return basis of the MSCI US REIT Index while the RMS index symbol refers to the total-return basis. The FTSE NAREIT All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. Equity REITs. Constituents of the Index include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property. The Index is subdivided into 13 sub-indices, including the FTSE NAREIT Industrial Index and the FTSE NAREIT Regional Mall Index. Basis Point: one basis point is equal to 1/100th of 1%, or 0.01% (0.0001), and is used to denote the percentage change in a financial instrument.

One cannot invest directly in an invest.

The views in this material are intended to assist readers in understanding certain investment methodology and do not constitute investment advice. The views in this material were those of the Fund's Sub-advisor as of the date written and may not reflect its views on the date this material is first disseminated or any time thereafter.

Liberty Street Advisors, Inc. is the advisor to the Fund. The Fund is part of the Liberty Street family of funds within the series of Investment Managers Series Trust.