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Research Update:

CBL & Associates Properties Inc. Downgraded To 'BB+' As Rent Concessions Pressure Performance; Outlook Stable

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Overview

- CBL reported weaker-than-expected operating results in the third quarter ended Sept. 30, 2017, and lowered guidance for the full year, driven by additional tenant bankruptcies, store closures, and rent concessions. CBL also announced an approximately 25% dividend cut to preserve liquidity that it will use largely toward redevelopment.
- We lowered our corporate credit rating on CBL & Associates Properties Inc. to 'BB+' from 'BBB-' based on our expectations that debt leverage will remain elevated at about 7.9x over the next year because of continued pressure on NOI growth.
- We affirmed the 'BBB-' rating on CBL & Associates Limited Partnership's senior unsecured notes. We assigned a '2' recovery rating to CBL & Associates Limited Partnership's existing senior unsecured note debt as a result of the lowered corporate credit rating.
- We based the stable outlook on our expectations that same-store NOI will continue to decline over the next year, with continued rent concessions needed to stem occupancy declines. However, we think CBL's efforts to reposition and redevelop its portfolio of assets should result in moderating NOI declines and contribute to a slight improvement of credit metrics, with debt leverage declining back to the high 7x by year-end 2018.

Rating Action

On Nov. 6, 2017, S&P Global Ratings lowered its corporate credit rating on Chattanooga, Tenn.-based CBL & Associates Properties Inc. to 'BB+' from 'BBB-'. The outlook is stable.

We affirmed our 'BBB-' issue-level rating on subsidiary CBL & Associates Limited Partnership's senior unsecured notes and assigned a '2' recovery rating indicating our expectations for substantial (70-90%; rounded estimate: 80%) recovery in the event of a payment default. At the same time, we also lowered our issue-level rating on the company's preferred shares to 'B+' from 'BB'.

Rationale

The downgrade reflects CBL's weaker-than-expected operating results in the third-quarter-ended Sept. 30, 2017, and lowered guidance for the rest of 2017. CBL reported a total portfolio same-center NOI decline of 2.6% for the three months, and a 1.6% decline for the nine months ended Sept 30, 2017. Based on the lowered earnings guidance for a same-center NOI decline of 2%-3%, we now expect NOI to drop 2.5% in fiscal 2017 (mid-point of guidance).

Higher-than-expected tenant bankruptcies, rent concessions to boost occupancy, and lower rent from renewed leases all contributed to the revenue decline in the quarter. In fact, rents on renewed leases dropped a sharp 16.1% for the three months ended Sept. 30, 2017 (-7.9% year-to-date), and we expect continued pressure on rent growth over the near to intermediate term.

S&P Global Ratings expects the U.S. retail landscape to remain challenging with a high number of distressed retailers and the potential for increased store closings due to additional bankruptcies and further store footprint rationalization. The retail industry is going through a structural change as a result of the rapid rise of e-commerce, and retailers are forced to address excess real estate capacity. Apparel and department store tenants are the most vulnerable, in our opinion, particularly those that have a significant debt burden from past leveraged buyout transactions. We expect retail tenants' continued distress to exert pressure on retail REITs' performance in the next year, driving the need for REITs to spend capital redeveloping assets in an effort to improve their tenant mix and support NOI growth. In general, we expect higher-quality malls in areas with favorable demographic trends to be more resistant to the secular retail disruption and better withstand tenant weakness.

CBL's regionally dominant market position has come under stress over the past few years, as its historically well-occupied asset portfolio has weakened primarily because of an increased number of tenant bankruptcies and store closures. As of Sept. 30, 2017, portfolio occupancy decreased modestly to 93.1% from 93.5% a year ago. This reflects an improvement from 91.6% in June, as CBL increased rent concessions in an effort to stem recent occupancy declines. However, same-center mall occupancy is weaker than the rest of the portfolio, with occupancy of 91.8% as of Sept 30, 2017, compared with 93% a year ago. The decline in occupancy reflects the exposure to the troubled teen/fast fashion apparel and accessory retail subsector. We also expect continued weak performance at department stores, which could require significant capital expenditures to redevelop or repurpose CBL's property base over the next two years. Partially offsetting CBL's challenged occupancy and predominantly speculative-grade tenant base is its broad scope of operations with generally good tenant and geographic diversification.

CBL operates retail properties with a leading position in its markets as its malls are generally distant from other competitors. CBL's core operations target mid-tier malls in markets with stable economic fundamentals and growing populations. CBL's mid-sized real estate portfolio (\$7.5 billion of

undepreciated real estate assets) is spread across 26 states, mostly in the southeast and midwest U.S. CBL's tenant base remains relatively well-diversified with no single tenant accounting for more than 3.9% of annualized revenues; however, the company's tenant base, on average, is of speculative-grade credit quality. This leaves the company vulnerable to higher tenant disruptions. While CBL's mall lease maturities are relatively well-staggered, averaging 14%-16% of annualized rents in both 2017 and 2018, the company will face increased re-leasing pressures moving forward as retailers take advantage of the shift in negotiating power. We believe CBL has historically been successful in its ability to repurpose and re-tenant vacant space and we expect CBL to make progress in repositioning its portfolio over the long term.

We believe CBL's location recapture and redevelopment efforts should present an opportunity to mitigate secular pressures over the long term. CBL has successfully completed a number of redevelopment projects including J.C. Penney and Sears. Moreover, we expect CBL's longer-term growth strategy will be highly focused on development and more importantly redevelopment rather than on acquisitions. Although this heightens execution risk, we believe these will be executed prudently, leveraging tenant relationships and mitigated by high pre-leasing.

We believe weaker-than-expected NOI growth will put pressure on credit metrics, with total debt to EBITDA increasing to about 8x in 2017 while fixed-charge coverage remains relatively in line with historical metrics at 2.2x. That being said, the company has focused on improving credit metrics and maintaining adequate levels of liquidity. To enhance liquidity, CBL announced that it will reduce its dividend per share to \$0.80 from \$1.06, resulting in cash savings of about \$50 million per year which is expected to bolster redevelopment funding. In July, CBL completed the extension and modification of two unsecured term loans expiring in 2018 including their \$400 million term loan, which increased to \$490 million until July 2018. Subsequently, the loan will be reduced to \$300 million and matures in 2020 with two one-year extension options (the first is CBL's option and the second is at the lenders option). The second term loan was extended to June 2021 (with a one-year extension option) and reduced to \$45 million from \$50 million. In September, the company completed a \$225 million dollar add-on to its 2026 senior unsecured notes while retiring two secured loans totaling \$206 million, further unencumbering the company's asset base.

Other assumptions in our base case forecast include:

- U.S. real GDP growth of 2.1% in 2017 and 2.3% in 2018;
- Retailers continue to focus on growing their online business and rationalizing their store bases in response to shifting consumer-shopping behavior. We therefore expect the environment to remain challenging for traditional retailers as competition remains intense;
- Negative same-store revenue growth of 2.0% to 3.0% in 2017 and with the potential for further pressure in 2018 as the full year impact of rent concessions is felt, and further potential for tenant bankruptcies and store closures.

- Approximately \$150 million to \$200 million of development and redevelopment spending over the next two years, with completions in the \$150 million range annually at a 8.5% to 9.0% yield;
- No material acquisitions in 2017 or 2018; and
- Asset sales of approximately \$200 million in 2017 and 2018, respectively.

With these assumptions, we derive the following credit metrics for 2017 and 2018:

- Debt to EBITDA of 7.9x in 2018 and improving to the high-7.0x range in 2019;
- FCC in the low-2.0x range; and
- Debt to undepreciated capital in the low-60% range.

Liquidity

CBL has adequate sources of liquidity to cover its cash needs over the next 12 months, in our view. Our assessment of the company's liquidity profile incorporates the following expectations and assumptions:

- Liquidity sources will exceed uses by at least 1.2x over the next 12 months;
- Liquidity sources less uses will be positive, even if forecasted EBITDA declines by 10% (a REIT specific threshold for adequate liquidity);
- Sufficient covenant headroom for forecasted EBITDA to decline by 10% without the company breaching covenant tests, and debt is at least 10% below covenant levels; and
- Sound relationships with its banks.

Principal Liquidity Sources

- Unrestricted cash of \$31.4 million at Sept. 30, 2017;
- Access to revolving credit facilities total \$1.1 billion, however, availability could be constrained by the unsecured indebtedness to unencumbered asset value covenant under the credit agreement, as of Sept. 30, 2017.
- Cash FFO of approximately \$450 million expected per year for the next two years; and

Principal Liquidity Uses

- Principal mortgage amortization of roughly \$45.5 million in 2017;
- Unsecured credit facility balance of \$36 million maturing over the next 12 months (optional extended maturity date for \$100 million revolver);
- Unsecured term loans of \$350 million maturing over the next 12 months (optional extended maturity date for \$350 million term loan not accounted for until executed);
- Approximately \$120 million of capital expenditures annually related to tenant allowances, renovations and maintenance, and contracted redevelopment; and
- Common and preferred dividends between \$200 million and 220 million given the recently announced cut in dividend in the next 12 months.

Outlook

We based the stable outlook on our view that despite our expectations that same-store NOI will continue to decline over the next year as rent concessions help stem occupancy declines, debt leverage should remain in the high-7x area for the next one to two years. We think CBL's efforts to reposition and redevelop its portfolio of assets should help offset some of the pressure from declining rents.

Upside Scenario

While unlikely over the next 12 months, we could raise the ratings by one notch if CBL is able to reverse recent negative operating performance and strengthen credit protection measures from current levels. These two items would indicate to us that, despite a continued negative retail environment, management could stabilize performance and absorb vacant space with limited disruptions to its business. At that time, we would expect the company to achieve slightly positive NOI growth, execute on extending any upcoming debt maturities, or accelerate asset sales and use proceeds for debt reduction, such that debt to EBITDA improves toward the low-7x area.

Downside scenario

While also unlikely over the next 12 to 24 months, we would consider lowering the ratings by one notch if operating performance deteriorates significantly from current levels, potentially because of increased tenant bankruptcies and continued steep declines in rent renewals. This could result in materially lower EBITDA margins and weaker profitability compared to its peers. Additionally, we would also consider lowering the rating should debt to EBITDA weaken to the mid-9x area.

Ratings Score Snapshot

Corporate credit rating: BB+/Stable/--

Business Risk: Satisfactory

- Country risk: Very low
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/leverage: Significant

Anchor: bb+

Modifiers:

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)

- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Recovery Analysis

Key analytical factors

- We estimate a gross recovery value of \$3.6 billion (pro rata share) which assumes a \$386 million emergence NOI with the application of a blended 11.2% overall capitalization rate and we ascribed a 50% discount to book value on non-stabilized properties. We assumed that by emergence, NOI would be at 40% below current levels in consideration of declining secular demand for physical retail space. Our cap rates considers the company's mix of property types, in particular the mall properties which for the majority are B malls.
- With regards to the encumbered stabilized properties, we estimate \$351 million in residual value after \$1.0 billion in property level debt (pro rata share) is repaid from stabilized properties. From unencumbered stabilized properties we estimate about \$1.94 billion in unencumbered recovery value. We also estimate about \$58 million in residual value (after \$74 million in property level debt satisfied and \$6 million in non-recourse deficient claims) from non-stabilized properties. This results in an aggregate recovery value of \$2.35 billion.
- Our simulated default scenario contemplates that the secular decline in physical retail locations deteriorates further for B and C malls which results in significantly lower occupancy rates while re-development costs to refit properties to better meet mall trends could further hinder liquidity for the company and property valuations would be negatively impacted.
- The '2' recovery rating reflects a substantial (70% to 90%; rounded estimate: 80%) recovery for second-lien note holders in the event of a payment default. As a result, our 'BBB-' issue-level rating on the second-lien notes is one notch above the 'BB+' corporate credit rating on the company.

Simulated default assumptions

- Simulated year of default: 2022
- Blended stress on NOI: 40%
- NOI at emergence: \$386 million
- Blended capitalization rate: 11.2%

Simplified waterfall

- Gross recovery value: \$3.47 billion
- Less property level costs (5%): \$173 million
- Less property Level debt (1): \$1.0 billion
- Stabilized property recovery value: \$2.29 billion
- Non-stabilized property recovery value: \$58 million
- Total recovery value: \$2.35 billion

After 5% in administrative costs, we estimate \$2.23 billion that would be available to the unsecured corporate level debt in the aggregate of \$2.76 billion. This results in substantial (70-90%; rounded estimate: 80%) recovery prospects. Although our recovery ratings criteria stipulate that unsecured recovery ratings are typically capped at '3' for 'BB-' to 'BB+' rated companies unless there are certain structural protections for these unsecured creditors, in which case we could allow for a '2' recovery rating. In this instance, the unsecured senior notes require the company to maintain financial covenants typical for real estate companies including a secured and total debt to asset tests and a minimum unencumbered asset value to unsecured debt test of no less than 150%, as such we have assigned a '2' recovery rating.

- Total recovery value: \$2.35 billion
- Less: 5% bankruptcy related administrative costs: \$117 million
- Net recovery value: \$2.23 billion
- Aggregate unsecured debt (1): \$2.76 billion
- Recovery range: (70%-90%: 80% rounded estimate)

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Real Estate Industry, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Downgraded; CreditWatch/Outlook Action

To

From

Research Update: CBL & Associates Properties Inc. Downgraded To 'BB+' As Rent Concessions Pressure Performance; Outlook Stable

CBL & Associates Properties Inc. Corporate Credit Rating	BB+/Stable/--	BBB-/Negative/--
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Ratings Affirmed

CBL & Associates Limited Partnership Senior Unsecured Recovery Rating	BBB- 2(80%)
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Downgraded

	To	From
CBL & Associates Properties Inc. Preferred Stock	B+	BB

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