

Lessons Learned in Shopping Center Development

*Looking back at the last 40
years, a noted shopping center
developer finds many lessons.*

DEVELOPMENT IS AT the heart of Regency Centers' heritage. Since the company was founded in 1963 we have developed approximately \$3.5 billion of commercial properties. Over the years we experienced many hard-earned lessons learned. No matter what any future savant may assert, there will always be cycles in the economy and real estate, and it is during market peaks that even the best and most experienced developers let their guards down and lapses occur. Then, the recessions and difficult times will surely follow and the most valuable lessons are repeated and business judgments and principles are hopefully honed. Regency's president, Brian Smith, has frequently said

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that mistakes are more often made in good times rather than during downturns.

PRE-IPO, 1963-1993

My parents, Joan and Martin Stein, started Regency's predecessor company to develop the first major regional mall in Jacksonville, Florida. In the ensuing thirty years the company developed a number of projects throughout Florida. These included various property types: multi-family, suburban and downtown office buildings, regional malls, and community and neighborhood shopping centers. Over time, grocery-anchored community and neighborhood shopping centers became the most appealing property sector to the company. We liked the significant daily traffic that the supermarket anchors generated and long-term twenty-year leases. We found the daily necessity and convenience-oriented tenant mix to be recession-resistant. Given Florida's growth and Publix's increasing dominance, there seemed to be plentiful future development opportunities. Most important of all, our shopping centers performed well. In contrast, the playing field for mall development was severely restricted by competition from the major developers like Simon, DeBartolo, GGP, Macerich, and CBL. Their relationships with department stores and willingness

to pay large inducements to those stores made the mall space too formidable.

Our less-than-favorable views on office development were influenced by the wild swings in the operating fundamentals caused by economic cycles and lack of constraints to new supply other than the availability of capital. Even if capital were plentiful, shopping center and mall developments were not viable without anchor tenants, whereas all that an adventure-some developer would need to build an office building was an undisciplined bank willing to provide a construction loan. Moreover, due to sizable lease commissions, tenant improvements and free rent, we found that less than 70 percent of Net Operating Income (NOI) from office buildings was available for debt service or equity distribution. This compares with over 90 percent of shopping center NOI, where there were typically lower tenant and building improvements and leasing commissions in relation to rent.

In addition to being attracted to grocery-anchored shopping centers, there are many lessons learned from our first thirty years in business. Perhaps the most critical is that shopping centers that are anchored by market leaders have much higher odds of both performing well in good times and enduring the downturns. It also became evident during the recession in 1990 and 1991, when capital went on strike, that financing developments and our com-

pany with permanent long-term capital, including substantial equity, was critical to surviving economic and financial crises and taking advantage of the opportunities that are usually only available in times of stress. One of my memories is hearing the late Peter Knox, a founder of Merry Land Properties, an early apartment REIT, talk about the risk of too much debt. He said, “Leverage is like salt. A little will make your dinner taste better. Too much will ruin the whole meal.”

Regency’s current senior executives, including Brian Smith and Bruce Johnson, Regency’s chief financial officer, who have been my partners for more than twelve and thirty years respectively, all lived through similar experiences in the early 1990s, whether it was with Regency or other fine shopping center companies like Trammell Crow. Brian’s notes from a 1990 Crow partners meeting captured ten of the critical development “mistakes made” and “lessons learned” that still ring true today:

- Years of success and flawed confidence that the “music” of a good market won’t stop combine to lull a company into believing this time it’s different and, ultimately, into complacency.
- Be extra careful doing deals at the height of the market and when the markets become frenzied.
- Be wary when the company culture lionizes growth and the development beast

has to be fed. Do fewer deals, do them better, and don’t be afraid to say “no.”

- An anchor relationship can obscure reality and an anchor lease doesn’t guarantee success or achieving 95 percent leased.
- Stay away from fringe areas and secondary locations.
- Maintain careful underwriting. Don’t bank on future population growth or build too much speculative space. Build based on existing rooftops, current rents, and reasonable absorption.
- Avoid buying land as a competitive advantage in excess of near-term requirements.
- When the market was good, we were too lenient on tenant credit. When the market was falling we tried to hold out for higher rents too long. Leases signed in early months of a downturn turned out to be our best ones.
- Maintain hiring standards. The tougher the market, the greater the need for the best people.
- During good times don’t overstaff and lose focus on overhead. While it is easy to staff up, it is hard to cut back.

**BUILDING A NATIONAL
COMPANY, 1993-2008**

With the benefit of these lessons, a sharpened focus on grocery-anchored shopping

centers and a keen recognition of the critical value of substantial equity for the company's long-term survival and growth, our company went public in 1993 as a REIT. Within six years of the IPO, we made two major acquisitions and a merger that expanded our portfolio to a national scope. Also, the purchases of Branch (operating in Atlanta and the Southeast), Midland (in the Midwest), and especially Pacific Retail Trust (in the Western United States) ultimately enabled us to have a development presence in virtually every major market. By 2000, we could reasonably claim that we were the leading national owner, operator and developer of shopping centers. During the next nine years we developed 174 shopping centers at a cost of more than \$2.6 billion. With twenty-nine centers anchored by Publix, twenty-two by Kroger, thirteen by Safeway, and twelve by Target, the company established itself as one of the leading national shopping center developers.

As Table I shows, the developments that Regency started between 2000 and 2004 were successful by every measure. On average the shopping centers achieved

95 percent occupancy within about a year of anchor opening. The unleveraged return on \$1.4 billion of invested capital was 10.4 percent, creating almost \$700 million of value at a profit margin of nearly 50 percent.

In spite of the fact that, by 2005, we were becoming concerned that the strong tailwinds in the economy and the housing boom might be peaking, and could even change directions to become headwinds in the next few years, it is now obvious that we did not adequately moderate our development program. We did not appreciate how difficult it would be to substantially slow a \$500 million development program at the sign of darkening economic clouds. And, unfortunately, the disciplines from the lessons previously learned were not more forcefully applied.

With the benefit of hindsight it is now apparent that five blinders distorted our judgment. These were:

- Our track record by all accounts was impressive, and we perhaps began to take that success for granted.
- Realized profits from development sales totaled more than \$250 million for the

Table I: Development performance 2000-2004

# of Project	Net Development Costs	NOI Yield	Underwritten Yield	Average Months to Project Completion ⁽¹⁾	Estimated Total Value at 7% Cap Rate	Estimated Net Value Creation	Profit Margin
103	\$1,415,934	10.4%	10.4%	25.0	\$2,101,696	\$685,762	48%

(1) From closing on land. Construction was typically 12 months.

period 2000-2008 and had expanded to 20 percent of Funds from Operations (FFO, which is the primary earnings metric for REITs). We had created a machine that was responsible for a large percentage of our reported earnings.

- Regency's partnerships with institutions were the primary acquirers of many of our developments, which mitigated the funding risk but not the development risk.
- The need to productively employ the large amount of overhead devoted solely to development.
- Almost all developments were anchored by best-in-class operators like Target, Publix, Kroger, and Safeway, which gave us great comfort. As we were reminded, having the best operators is only one of the necessary ingredients of a successful development.

Before examining the results of developments that deviated from our standards, it is important to note, as Table II shows, that even late in the cycle, where we fully "stuck to our knitting," our forty-two developments performed pretty well. The average time to 95 percent leased was less than two years from anchor opening, and the average return on invested capital was nearly 9 percent. Although these returns were less than the 2000-2004 developments, the profit margins were still in the 30 percent range, and more than \$150 million of estimated value was created.

The story wasn't nearly as pretty for the twenty-nine projects where we strayed from our proven strategy. While the majority of these projects enjoyed the benefits of a number one anchor in a premier location, a good portion of the leasing challenges that we faced in these centers can be attributed to a housing bust and a recession that were much worse than most anticipated. Still, the adverse impacts would have been mitigated had we relied on our experience and instincts to say "no" more often. A number of these deals involved developing for our anchor tenant customers in "greenfield" areas or secondary markets with the "promise" of a significant amount of projected future housing growth. Many were large community centers, which were slated to be contributed to a fund that was created with institutional partners to buy an 80 percent interest in our larger format centers. One particularly large development was our first—and last—lifestyle center development. Since the decisions to go forward were made at the height of the market, too often we ended up paying too much for the land and building too much space. As graphically illustrated in Table II, the results were long lease-up times and poor returns on capital. The bottom line is that, until these centers are 95 percent leased, we will have lost nearly a quarter of the \$850 million of estimated value that was created by the successful proj-

Table II: Development performance 2005-2008

2005-2008 Starts	# of Projects	Net Development Costs	NOI Yield	Underwritten Yield	Average Months to Project Completion ⁽¹⁾	Estimated Total Value at 7% Cap Rate	Estimated Net Value Creation	Profit Margin
Met Criteria	42	\$572,201	8.9%	9.5%	31.9	\$728,932	\$156,732	27%
Below Regency Standards	29	\$641,735	4.9%	9.1%	53.1	\$445,383	(\$196,352)	(31%)
Totals	71	\$1,213,936	6.8%	9.3%	40.6	\$1,174,315	(\$39,620)	(3%)

(1) From closing on land. Construction was typically 12 months.

ects developed between 2000 and 2008. Additionally, the cost basis of the 500-acre land bank was written down by more than \$100 million, or more than 50 percent.

Having relived the class of hard knocks during the worst recession and financial crises since the Depression, I am hopeful that the most important lessons have been reinforced and now become permanently engrained in management’s psyche and our principles and strategies. Building on Brian’s notes from the Crow partners meeting twenty years ago, my “10 Lessons Learned 2.0” are:

- The perception and reality of a strong balance sheet and reliable access to capital matter a lot and are critical to weathering and profiting from future recessions and financial storms that will surely be encountered.
- Infill shopping centers with dominant anchors, especially supermarkets, that are located in protected trade areas with high purchasing power in Regency’s target markets perform better regardless of the economic cycle. This also applies to developments.
- A focus on growing NOI, recurring earnings and NAV—rather than non-recurring earnings that can be distorted by profits from development sales—is a better way to grow intrinsic value over the long term.
- In that vein, developing core shopping centers that meet Regency’s investment criteria is preferable to merchant development. Believing that a third-party buyer may want to own a shopping center that might not be up to Regency’s standards for core assets can be “fool’s gold.”
- Be extremely cautious when developing larger community shopping centers. They are much more complicated and more things can go wrong, including store closings and the adverse impact from opening covenants. They also take longer to entitle, develop and lease, which exposes the developer to a higher degree of market risk.
- Always, always be thinking about what can go wrong: think scared, negotiate assuming the worst will happen, and think of the consequences. Anchor

tenant commitments that are not iron-clad are worthless.

- Don't develop lifestyle projects, period, or mixed use developments, which can be even more complicated than community centers, without a partner possessing substantial office or apartment expertise and deep pockets.
- Build the amount of space based on demonstrated tenant demand, not the size of the site.
- Do fewer deals, and do them better with talented professionals and attention to the details. Make sure there is as much focus and incentives on making the existing projects successful rather than the next new one.
- Don't forget Lessons Learned 1.0.

APPLYING LESSONS LEARNED

Armed with Lessons Learned 2.0, we have attempted during the last two years to make the most of the difficult times to position the company for the future, including moderating and sharpening the focus of the development program. These significant measures included:

- Raising more than a billion dollars of capital through a combination of two common stock offerings that totaled nearly \$600 million, mortgage and unsecured debt financings, and prop-

erty sales, all of which further strengthened an already stolid balance sheet.

- Intensifying the focus on restoring occupancy in the operating portfolio to 95 percent from 92.5 percent and achieving 95 percent in those developments still under way. By attaining this goal an additional \$35 million of NOI will be harvested, thus creating an estimated \$500 million in incremental value. Almost a third of this NOI and value will come when we achieve 95 percent occupancy from 80 percent in the developments.
- Using recurring FFO as the primary earnings metric rather than FFO. Since recurring FFO excludes transaction profits, it is more closely tied to sustaining growth in NOI and, in turn, NAV per share. In my view, the size and volatility of transaction profits can distract from the focus on growth in recurring earnings, which is a more reliable way to build intrinsic value over the long term.
- Substantially slowing new development activity, focusing instead on the best opportunities that fully met our underwriting and investment criteria. In addition, the amount of space being constructed at a number of developments was cut back through phasing.
- Completing four developments and redevelopments that will serve as the model for future value-add investments.

The strong openings in 2010 by the two Publix's, Safeway, and Giant stores are evidence of strong anchor sponsorship. Both the pace of leasing and the level of rents exceeded expectations, demonstrating that the right amount of shop space was built and proving the attractiveness of the infill trade areas in target metro areas.

- Reducing the size of Regency's overall work force by 30 percent. The majority of these painful cuts were related to development. Even after eliminating these positions, the development team still has the capabilities to manage our existing developments and create new ones that meet our more stringent criteria.
- Instituting a more focused and team-oriented approach in each of our target markets. This means that the functional organization structure with separate development and operations groups was replaced by regional and market teams responsible for all aspects of the business.
- Establishing a high priority on meaningfully reducing the land bank by converting the parcels to developments that meet Regency's standards or to cash through sales.

**THE FUTURE OF
DEVELOPMENT**

You might ask "Should REITs be in the development business?" The question seems more than appropriate given our view that REIT investors will be pleased with a future compound total annual return of 8 percent to 10 percent using low levels of leverage. This means that REITs need to sustain long-term growth in earnings of 5 percent annually in addition to paying dividends in the 4 percent to 5 percent range. This compares with just three years ago when the unrealistic and unsustainable expectation was for a total shareholder return of 12 percent to 15 percent and an 8 percent to 10 percent growth rate in earnings with higher leverage levels.

Our conclusion is that companies like AMB, AvalonBay, Boston Properties, ProLogis, and Regency, which can augment reliable growth in NOI and NAV from a high-quality portfolio with a properly managed and sized development program, should be able to offer superior long-term growth in shareholder value. The first reason is that development enables companies with those capabilities the capacity to "manufacture" high-quality properties that most probably could not be purchased on a third-party basis. Also, these developments can be "manufactured" at returns that are accretive to the cost of acquiring comparable properties, the cost of capital and NAV. The profitable returns should translate into higher growth rates of per

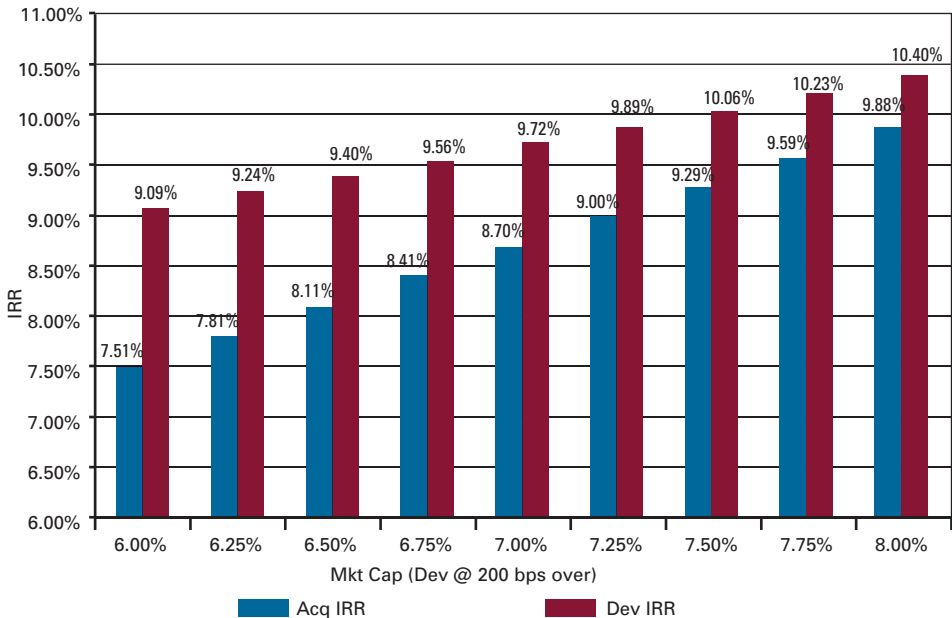
share recurring FFO and NAV. Further, the value-added skills are transferable to redevelopments to improve assets within the operating portfolio. Finally, there is no better way to service key customers than to provide for their expansion needs through development.

What does this mean for retail developers? Creating new shopping centers in target markets with dominant anchors and demonstrated demand for shop space and reinforcing through redevelopment the competitive advantage of existing centers at attractive risk adjusted returns and margins remains and should always be a com-

peting use of capital. The four developments and redevelopments that we opened last year, for example, share these ideal attributes and furthered our relationships with Publix, Safeway, Giant and other retail customers that expanded into the centers. Each asset is a quality shopping center that would be extremely hard and expensive to replace through acquisition.

Figure 1 shows how we can manufacture high-quality shopping centers at much higher returns than by acquisition. The weighted average return for the four is projected to be 9.5 percent. This results in a projected internal rate of return in

Figure 1: Returns on developments vs. acquisitions



Assumes development initial returns are 200 bps higher than acquisitions. For example, on a typical acquisition with a 6.5 percent initial return, the initial return for a comparable development would be 200 bps higher, or 8.5 percent, and the IRR would be 9.4 percent, compared to 8.11 percent for the acquisition.

excess of 10 percent that is meaningfully higher than an IRR of slightly above 8 percent from buying the centers at a 6.5 percent cap rate, if they ever became available. The projected IRR for developments in the figure does incorporate a full allocation of development overhead. The returns from these developments are also well in excess of Green Street Advisors' most recent estimate of Regency's cost of capital of 6.3 percent.

By building on the successful profiles of the four developments and redevelopments that opened last year, we want to reach \$150 million to \$200 million of annual development/redevelopment starts over the next several years. Given our abundant caution toward "greenfield" sites, the mandate to align the amount of shop space with demonstrated demand, and preference for more difficult infill developments in major markets, we anticipate that the opportunity set for developments that meet our more rigorous criteria will be much more modest than the last cycle.

Furthermore, we have no appetite to grow the development engine and the associated overhead back up to the \$500 million level of annual starts at the peak. We are all too familiar with how that story ends. We do plan to capitalize on our unique combination of a long-standing development track record, in-house development expertise, presence in key markets and close relationships with the leading anchor tenants and local development partners to win more than our fair share of developments that we will want to pursue. In addition, there are ample value-add redevelopment opportunities within the existing portfolio. As a result we are comfortable that \$150 million to \$200 million a year in development and redevelopment starts represents a manageable and attainable level of value-add investments for our market and regional teams. Over a five-year period the future development program should enhance the portfolio through the addition of \$750 million to \$1 billion of outstanding shopping centers.

Table III: Development contribution to earnings model

	Base	2.5% same property NOI growth - No development	2.5% same property NOI growth - Development at \$150m per year ⁽¹⁾
NOT	\$400,000	\$410,000	\$413,000
FFO⁽²⁾	\$220,000	\$230,000	\$233,000
FFP Growth Rate		4.5%	5.9%

(1) \$150 million per year of developments at 9 percent returns funded by selling an equal amount of assets at 7 percent cap rate generates a net gain of 2 percent, or \$3 million of additional NOI

(2) FFP is based on \$5.7 billion of assets, 40 percent leverage, interest at 6 percent and G&A of \$45 million FFP = NOI - (\$135 million interest - \$45 million G&A)

The hypothetical model below (Table III) shows how \$150 million of development at returns on capital of 9 percent can increase the annual per share growth in FFO by 25 percent or more for a company with assets in the \$5.5 billion range. It has been our experience that growth in recurring FFO translates into a roughly equivalent growth in NAV. In our view, building recurring earnings and being able to then increase dividends together with growing NAV is a proven recipe for compounding shareholder value.

As a result of the potential for meaningful future contributions to recurring earnings and NAV and the enhancements to the quality of the portfolio, development will remain an integral component of our strategy in the future. Along with owning and investing in high-quality grocery-anchored shopping centers, maintaining a strong balance sheet, and engaging a top-flight management team, development will continue to play a prominent role in our distinctive approach to creating shareholder value.