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Simon Property Group, Inc. (SPG)

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Sector: Financials
Industry: Retail - REIT
Current Price: $165.23
Target Price: $206.00

Company Description: Simon Property Group, Inc. (SPG) is a real estate investment trust (REIT) specializing in the ownership, development, and management of large retail plazas including malls, outlet locations, community centers, and mills. Their clientele primarily include Class-A and high end anchor stores as their main source of revenue comes from rental fees and lease payments. The company is headquartered in Indianapolis, Indiana.

BUY

Current Price: $165.23
Target Price: $206.00
Market Cap: $59.4B
Moody's Credit Profile: A2, Stable
Comp. NOI Growth: 3.8%
FFO Y/Y Growth: 4.2%

- FFO/Revenue: 73.2%

Debt/Mkt. Cap: 32.5%
Tenant Occupancy: 95.6%
Lease Margins (psf) Growth: 13%
Dividend Yield: 4.24%

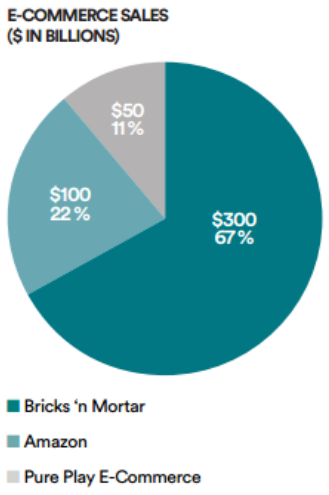
Catalysts:

- New expansionary development programs set to finish by year's end both domestically and internationally
- Guidance estimates of 6% FFO growth; industry leading, bullish outlook adds to heavy liquid cash-flows
- Optimistic and contrarian governance concerning the future of the retail industry

Thesis: Market appreciations have become a stranger to most companies specializing in brick-and-mortar retailers because of the growing popularity of e-commerce. Companies, like Amazon, have been able to capitalize on the convenience of shopping from the couch and waiting for the product to show up on the doorstep. However, even Amazon is beginning to shift towards a strategy that Simon Property Group has already been utilizing: omnichannel retail. This method of shopping gives the consumer more of a choice between the internet and brick-and-mortar, thus allowing companies to tailor to the wide spectrum of consumer preferences. SPG's main leg on Amazon is that their utilization of omnichannel retail is much more developed, and their financials prove this. Beyond steady FFO and NOI growth, SPG's $7B in liquidity has allowed them to tailor their own business to capitalize on contrarian strategies, acquire industry stragglers, and become the largest brick-and-mortar firm in an evolving industry.

Industry Misconceptions:

Throughout the retail industry, there is a stigma surrounding the threat of online shopping towards brick-and-mortar stores due to its exponential growth within the last decade. Stores that focus more on the online aspect of their business tend to throw the physical experience of the establishment on the back burner. Many retailers are not able to provide the same expectations culminated from online shopping (in terms of value and convenience) in their own physical stores, thus leading to major headwinds on the revenue-growth front.



To add to this, damaged retailers that have turned their focus to online sales attempt to generate growth through the cost structure of the website, which is minimal compared to their existing operating costs. While it may be saving capital outlay, there are still underlying costs associated with the decision to compete online. For example, incentives such as free-shipping and heavy discounts destroy margins. As costs may be getting slashed, revenue is exceedingly dropping as well, and therefore not creating the spread needed to create serious value. Large anchor stores like Macy's and JCPenny's have been facing this conundrum as well as the operators of many other REITs.

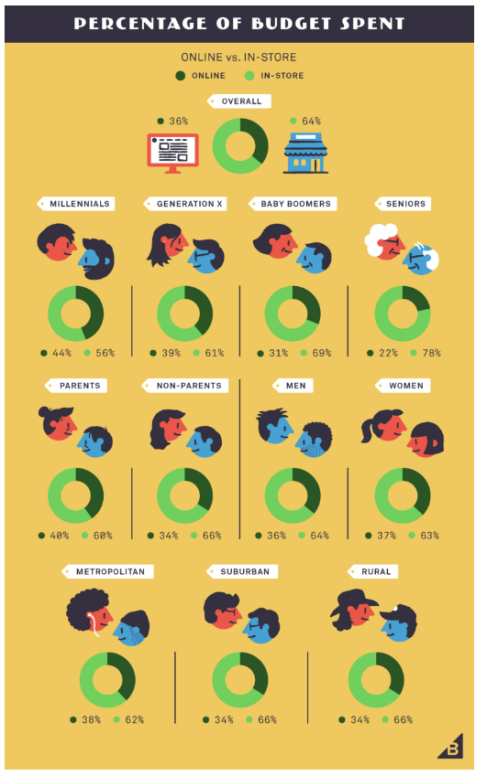
Source: SeekingAlpha

However, the beauty in this case is that online sales still make up a small portion of the entire industry's sales figures. In exhibit one, brick-and-mortars still hold 67% of the entire revenue structure, with Amazon following at 22%, and genera e-commerce at 11%. That's not to say that e-commerce will stop growing, but the common misconception tends to justify an Amazon-ruled industry when it's truly a fallacy. Still, as revenues will inevitably grow, could online retailers eventually plateau into a growth ceiling?

The Prius of Retail: An Industry Hybrid

Due to the dynamic of industry, retail property managers must evolve with the preferences of the consumer. With that being said, adopting an omnichannel system allows consumers to either shop online or go into the store and select their own merchandise, a sort of "retail hybrid."

The comparison between Simon and Amazon comes into play when considering the necessary components of the omnichannel system. The system itself favors a company with boots on the ground. That is, if a company like SPG already has an established brick-and-mortar presence through their tenants, their collaboration with an online platform becomes more effective. Logically, a consumer would see an item in the store and realize they could purchase the same merchandise online at a later time. This aspect of the strategy fills the digital void that exists strictly



Source: BigCommerce

with online shopping because of the actual physical interaction.

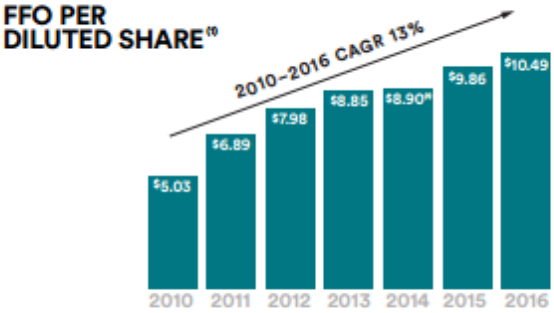
It's clear that e-commerce companies are aware of this evolving aspect of the industry, especially Amazon. Bill Stoller, a contributor to Seeking Alpha, quoted contrarian George Kesarios, indicating that the online powerhouse plans on opening an additional five bookstores. Guidance suggests that we should expect more, plus specialty stores selling furniture, home appliances, and more. This is a clear indication of the fruitful future of a balanced, omnichannel system.

So it's difficult to prove that the market may be heading towards a kwazi-electronic/physical preference, but it's not out of left field given the evolution of malls themselves. SPG's strategic position addressing the omnichannel structure as well as revolutionizing the mall experience has strengthened their competitive advantage.

Cash-Flow Meets Innovation:

Beyond offering consumers a multi-platform shopping experience, SPG utilizes much of their capital to enhance the overall mall experience. Their innovative initiatives hit the market at perfect timing since many large retailers and box stores are closing (although, out of their entire portfolio of over 400 department stores, only one is empty). SPG has capitalized on many failed retail locations by implementing a recreational aspect to their properties including restaurants, hotels, and residential units.

The transition from a sole retail destination into one that encompasses entertainment creates further opportunities for the surviving retailers. In theory, if consumers view the malls as destinations for social gatherings, they would spend more time there which would allow increased exposure to the tenants.



Source: SeekingAlpha

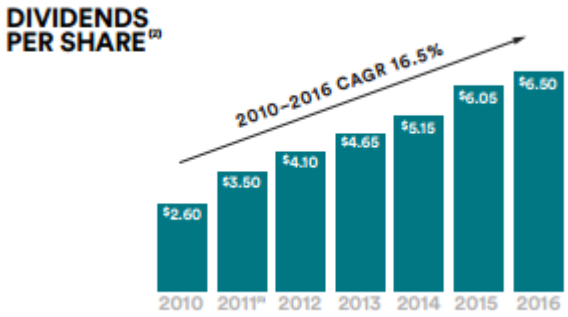
Since 2012, SPG added 275 restaurants, 10 hotels, and 3000 residential units and realized their pockets were getting deeper. FFO growth, since 2010, grew 13% with a 16.5% CAGR increase in dividends per share, which is impressive for an incredibly capital intensive business. As SPG continues to deploy capital in order to generate higher returns based on operations, their shareholders still benefit.

Further Investments:

In order to stay competitive beyond their own capital investments, shareholders are never left out of their strategy. During Q1 in 2017, they dedicated $2B from their liquid $7B to share repurchases and enhanced the value of their current outstanding shares. From there, the dividend growth Y/Y reached 9.4% as they pointed towards a prosperous 2017.

"Finally, we are reaffirming our 2017 guidance in the range of $11.45 - $11.55 per share, which is approximately 6% growth compared to our comparable FFO per share growth, which we believe will lead our retail real estate industry peers." – ***David E. Simon, Chairman and CEO***

Additional capex deployed to redevelop and develop properties was facilitated on a global level. In the United States, 25 projects dedicated to revitalizing properties and modernizing their amenities are expected to finish within twelve months. Internationally, two new properties were just opened in Seoul, South Korea and Provence, France. Not only will these investments provide additional opportunities to maximize capitalization, but also provides insulation against exchange-related headwinds. Since their profitability is based on the health discretionary spending habits, the strong dollar has weakened foreign travel demand to domestic outlet stores. Thanks to the international investments, gains in foreign exchange arbitrage could be another source of cash-flows for SPG.



Source: SeekingAlpha

Valuation: Since SPG is considered a REIT, the valuation is dependent on the worth of the company's assets after deducting liabilities and equity commitments.

The value of the assets are based a forward looking NOI figure compounded with a capitalization rate. The rate itself indicates the level of return expected from the utilization of their assets. In doing so, the forward looking NOI figure is discounted by the capitalization rate to get the present value of the assets.

In this scenario, the base rate used was simply a rational estimate between the rate of economic productivity growth and historic growth levels within the company's portfolio. Settling at 2% for their various segments of NOI generation (new developments, international developments, and other investments), I was able to estimate the present value of their assets well above $68B, already indicating they are undervalued considering their market cap of $59B.

After deducting various liabilities and equity commitments, I was able to get an intrinsic value of roughly $189 per share. With the current share price equaling $165.23, Simon Property Group, Inc. is undervalued at this time.

Conclusion: SPG is on the right track of value generation in an extremely competitive industry. Their ability to remain evolving with market trends and implement innovative initiatives to bolster traffic through the malls is proving effective and lucrative. Their capital deployment to redevelop properties will enhance their capitalization rate, and therefore profitability as long as they keep evolving. Although the industry is somewhat choppy at the moment, they are still positively surprising earnings. Out of the last 44 quarterly earnings statements, or 11 years, they have missed only twice with one being in the midst of the recession. Due to their valuation, financial predictability, superior capital deployment strategies, and promising guidance with impressive FFO and dividend growth, I recommend a BUY on Simon Property Group.

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Equity REIT - Sample Net Asset Value Model

	Assumed Cap Rate:	12-Month Forward NOI:	Current Value:
Capitalized Income:			
NOI Contribution from:			
Development/Expansion/Acquisitions	2.0%	$ 34,819	$ 1,740,934
International	2.0%	$ 105,203	$ 5,260,169
Investments	2.0%	$ 60,585	$ 3,029,247
Existing	2.0%	$ 1,371,602	$ 68,580,089
	Balance Sheet Value:	**% of BS Value:**	**Current Value:**
Balance Sheet Assets:			
Non-Operating Real Estate Assets:			
Other Balance Sheet Assets:			
Cash & Cash-Equivalents:	513,400	100.0%	513,400
Investments in Equity Interests:	2,374,693	100.0%	2,374,693
Tenant Receivables, Accrued Revenue (net)	621,600	100.0%	621,600
International Investment, at Equity	1,821,994	100.0%	1,821,994
Deferred Costs/Other	1,384,667	100.0%	1,384,667
Total Asset Value:			**$ 85,326,793**
Liabilities:			
Mortgages/Unsecured	$ 23,149,053	100.0%	$ 23,149,053
Accounts Payable:	1,081,185	100.0%	1,081,185
Other	459,926	100.0%	459,926
Cash Distributions/Losses in Partnerships, at equity	1,360,077	100.0%	1,360,077
Total Liabilities Value:			**26,050,241**
Other Claims on Equity:			
Noncontrolling Interests (Excl. OP):	-	100.0%	-
Preferred Stock:	166,847	100.0%	166,847
Total Other Claims on Equity Value:			**166,847**
Net Asset Value:			**$ 59,109,705**
Diluted Shares:			312,033.0
OP Units & Restricted Shares:			-
Total Diluted Shares & Units Outstanding:			**312,033.0**
Net Asset Value Per Share:			**$ 189.43**
Current Stock Price:			**$ 165.26**
Premium / (Discount) to NAV Per Share:			**(12.8%)**